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INDIA DEVELOPMENT UPDATE

October 2023

Preface

The India Development Update (IDU) reports on recent developments in India's economy and places these in a medium-term and global context. Based on these developments and on policy changes over the period, the IDU updates the outlook for India's economy.

The report is prepared by a team from the Macroeconomics, Trade and Investment (MTI) Global Practice, under the guidance of Auguste Tano Kouame (Country Director), Mathew Verghis (Regional Director), and Hoon Sahib Soh (Practice Manager). The team is led by Dhruv Sharma (Senior Economist) and comprises, Ran Li, Tanvir Malik, Kanika Bhatnagar, Abhishek Anand, Aurélien Kruse, Mohini Gupta, Rishabh Chaudhury, Michel Ragnvald Mallberg, Nandini Krishnan, Nayantara Sarma, Naresh Kumar and Tushar Arora. The report benefited from in-depth feedback and inputs from Bhavna Bhatia.

 The report is based on data as of September 28, 2023.

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1. Executive Summary

Global economic growth continues to slow down but service activities remain robust, helping India's growth…

Global economic growth is set to slow in 2023, compared with the previous year. Continued high inflation and the effects of monetary policy tightening added pressures to economic growth over the short term, particularly in the Europe. The fading rebound of economic activities from the pandemic, combined with fragilities in the real estate sectors, has eroded growth in China. While the growth outturn in the US over the first half of 2023 has been stronger than expected, demand is weakening amid exhausting excess savings accumulated during the pandemic; tightening credit conditions; and the banking sector turmoil earlier this year. Nevertheless, in contrast to softening global manufacturing activities, service sectors experienced solid growth in the past year, as measured by Purchasing Managers' Indices (PMI). As a result, India, as a large service exporter, showed relative resilience against the challenging external conditions: India remained one of the fastest growing major economies in the world; in FY22/23, its GDP expanded by 7.2 percent, with robust growth in domestic demand bolstered by strong investment activity and solid private consumption. Net exports especially goods exports, however, were a drag on growth amid weakening global demand weighing on India's merchandise exports and resilient domestic demand pushing up imports.

…but the growth momentum moderated in the first quarter of FY23/24

Growth is projected to moderate to 6.3 percent in FY23/24, as consumption growth continues to decelerate, and external headwinds depress foreign demand. Real GDP grew 7.8 percent in Q1 FY23/24, thanks to strong public sector investment, steady private consumption growth, and lingering base effects. Private consumption growth accelerated relative to the second half of FY22/23 (to 6 percent), more than offsetting a contraction in government consumption, as remaining pandemic-related stimuli are progressively withdrawn. Investment grew strongly, with sharp increases in capital spending by both central and state governments. Slowing growth among major trading partner led to a contraction in India's exports, while strong domestic demand kept import growth high. Thus, net exports contributed negatively to around 4.6 percent of total growth.

Headline inflation averaged 5.3 percent between April-July

Headline inflation averaged 5.3 percent y-o-y between April-July (compared to 6.6 percent over FY22/23). After remaining within the Reserve Bank of India's (RBI) target range (2-6 percent) for the first quarter of FY23/24, inflation surged to 7.4 percent y-o-y in July as unfavorable weather patterns caused food prices to spike. To mitigate the impact on households, the government introduced temporary tariffs on onion exports, restrictions on stockpiling of certain crops, increased central government procurement and supplies to local markets from the central pool, as well as temporary bans on the export of several varieties of rice, wheat, and sugar. The impact of high food prices on overall inflation was partially offset by a moderation in fuel and energy inflation—primarily reflecting a high base effect (the prices of fuel and light grew by 10.5 percent on average during April-July 2022[1]). Core inflation continued to moderate from 6.1 percent y-o-y in FY22/23 to 5.1 percent y-o-y in April-July—its lowest level since April 2020, thanks to modest growth in prices of transport and communication.

[1] after the government removed subsidies on Liquid Petroleum Gas, used as cooking fuel, and kerosene

The RBI has held interest rates steady and banks' asset quality improved

Given the expected transient supply-side drivers of inflation and moderate core inflation, the Monetary Policy Committee (MPC) of the RBI kept the policy rate unchanged at 6.5 percent as of August 2023, and focused on withdrawal of monetary accommodation to help keep inflation within the target range. The asset quality of scheduled commercial banks (SCBs)[2] continued to improve, driven by higher loan growth, decline in slippages, better recoveries and write-offs of bad loans. The gross non-performing assets (GNPA) of SCBs as a ratio of gross advances reached its lowest level in a decade at 3.9 percent as of March 2023 compared to 5.9 percent in March 2022. With asset quality improving, bank credit grew by 15.8 percent in Q1 FY23/24 compared to 12.0 percent in Q1 FY22/23., driven primarily by personal loans and services segment.

The current account deficit widened to 1.1 percent in Q1 FY23/24, which remains low

The current account deficit to GDP ratio widened to 1.1 percent in Q1 FY23/24, from a record low of 0.2 percent in the previous quarter (Q4 FY22/23). However, it remained below the pre-pandemic average of 1.4 percent. The widening was driven by a sharp fall in exports, due to slowing demand from major trading partners and declining prices for refinery oil exports. Lower commodity prices also led to a drop in merchandise imports, but this decline was not as steep as the fall in exports thanks to the relatively resilient domestic demand. India's current account balance remains adequately financed by net capital inflows. Foreign portfolio flows surged in Q1 FY23/24 and net foreign direct investment (FDI) inflows increased to 0.6 percent of GDP compared to a multi-year low of 0.2 percent in Q3 FY22/23, although remaining well below the pre-pandemic average of around 1.3 percent of GDP. Capital inflows, lower imports and RBI interventions to smooth exchange rate volatility helped the rupee remain relatively stable against the USD as of September 2023 data.

The general government fiscal deficit declined in FY22/23 along with the public-debt-to-GDP ratio

The general government fiscal deficit declined to 9.0 percent of GDP in FY22/23 (from 9.6 percent in FY21/22). The narrowing deficit, combined with the favorable growth-interest rate dynamics, helped lower the public debt in FY22/23 to an estimated 82.9 percent of GDP. In the first four months of FY23/24, both the central and state government front-loaded spending, particularly on infrastructure and capital spending increased sharply, compared with the same period in FY22/23. Revenue growth was tepid at the start of the fiscal year but income tax collection picked up pace in August and September. While most post-pandemic welfare support measures had already been withdrawn, the government announced an additional subsidy for cooking fuel in August. Nevertheless, the government remains committed to fiscal consolidation, especially on the current spending, expecting the annual fiscal deficit continues narrowing.

Growth is projected to moderate further in FY23/24 as it reverts to its potential rate, with external downside risks

Over the medium term, growth should hover around its potential rate between 6-6.5 percent. Investment growth is projected to remain robust, supported by high public investment and improved corporate and banking sector balance sheets. The current account deficit is expected to narrow as commodity prices are projected to decline relative to its peak in FY22/23, while services exports and remittances remain buoyant. The fiscal deficit is projected to narrow gradually over the projection period, stabilizing public debt at around 83 percent of GDP. Risks include slower-than-expected global growth, higher oil prices, and more persistent inflationary pressures. However, the risks remain manageable given India's large and diversified economic base, and significant reserves buffers.

[2] Scheduled Commercial Banks refer to those commercial banks which have been included in the Second Schedule of the Reserve Bank of India (RBI) Act, 1934. These banks must have a paid-up capital and reserves of an aggregate value of not less than five lakh rupees. SCBs take up that vast majority of total assets of the commercial banks in India.

2. Recent Economic Developments

a. Real sector and inflation

Growth & labor market

Real GDP growth remained high in Q1 FY23/24 (April-June 23)

Real GDP grew 7.8 percent year-on-year (y-o-y) in Q1 FY23/24. Though a deceleration from Q1 FY21/22, which also reflected prominent base effects, it is faster than over the preceding quarter (6.1 percent), driven by high public sector investment and private consumption growth as well as lingering base effects. Private consumption growth accelerated to 6 percent (compared to 2.5 percent in the second half of FY22/23), more than offsetting a contraction in government consumption, as pandemic-related stimulus measures are being gradually withdrawn. Investment grew strongly, with a sharp increase in capital spending by both the central and state governments (Figure 2.1). Slowing global growth weighed on India's exports, which contracted by 7 percent, while strong domestic demand kept import growth high at 10 percent. Thus, net exports had a large negative contribution to growth.

Figure 2.1: Growth was bolstered by consumption and investment in Q1 FY23/24
(Contribution to GDP growth, percentage points, y-o-y)

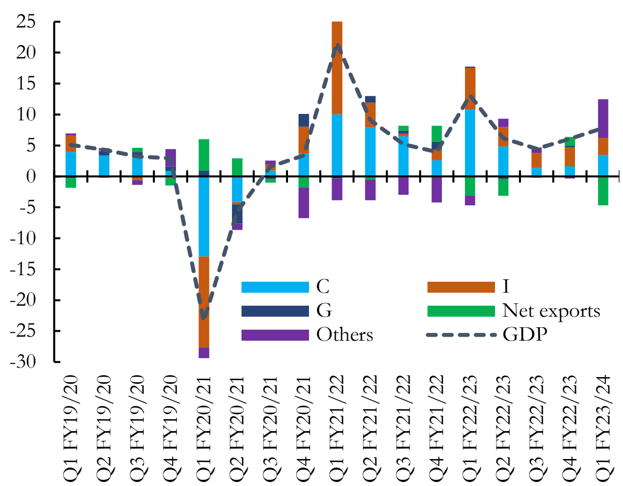
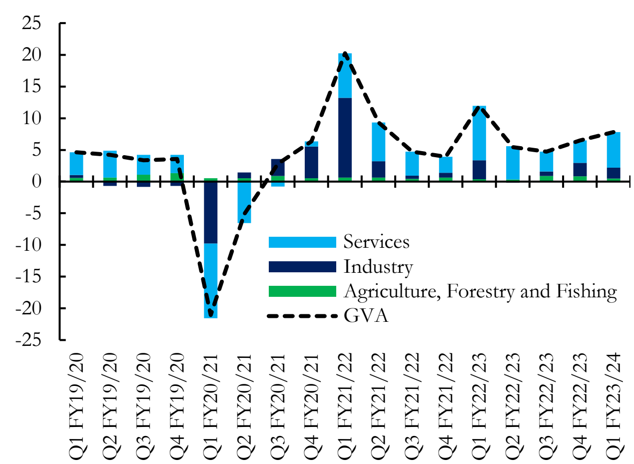


Figure 2.2: The services sector continued to drive growth in Q1 FY23/24
(Contribution to GDP growth, percentage points, y-o-y)



Source: NSO, CEIC and World Bank staff calculations.
Note: "Others" includes change in inventories, valuables and discrepancies. The contribution of "others" was high in Q1 FY23/24 owing to large discrepancy between production and expenditure estimates of national accounts and may be expected to reconcile over time with subsequent revisions to the initial data release".

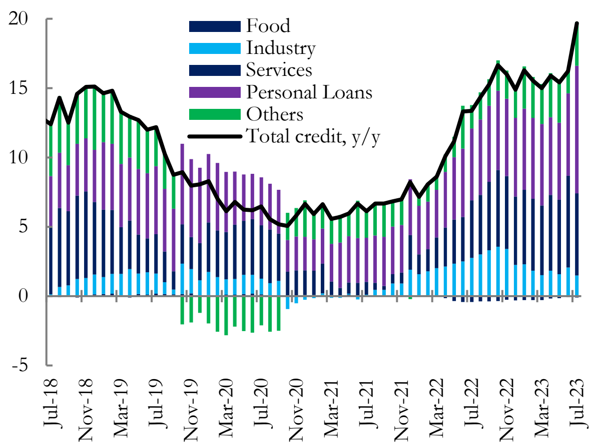
On the supply side, growth was driven by services and construction …

Real Gross Value Added (GVA, which excludes subsidies and taxes on commodities) grew by 7.8 percent y-o-y in Q1 FY23/24 compared to 6.5 percent in Q4 FY22/23 (Figure 2.2). The services sector, accounting for over 50 percent of GVA, was the main driver of growth. An acceleration in both credit and deposit growth in the financial sector, resilient growth in exports of technology and business services, and the continued recovery in high-contact services like retail, hospitality and travel all contributed to the double-digit growth. Meanwhile, the construction sector grew 7.9 percent on the back of strong public investment in infrastructure. However, growth remained modest in manufacturing due to the slowdown in global activity. Agriculture growth also slowed sequentially to 3.5 percent due to unseasonal rain during the harvest period.

Economic indicators suggest robust activity in Q2 FY23/24

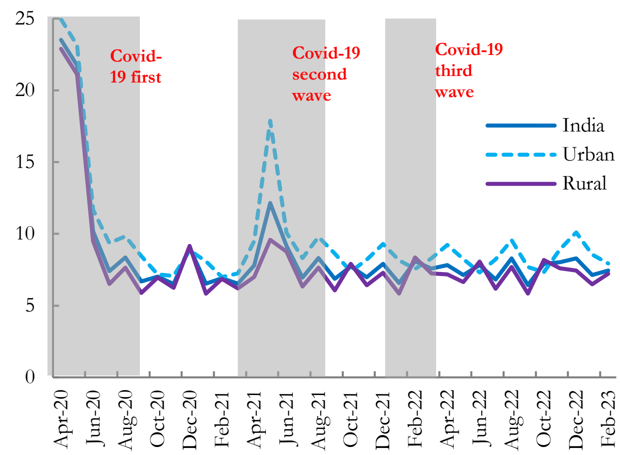
High frequency indicators suggest economic activity continued to expand in July-August. The index of eight core industries, which account for 40 percent of the Index of Industrial Production, grew by 8 percent in July (y-o-y). The Purchasing Managers' Index (PMI) also remained high reflecting favorable conditions of the manufacturing and services sectors. Proxies for domestic demand like vehicle sales, domestic air travel, and GST e-way bills all showed that the growth momentum continued from the previous quarter. Bank credit growth also accelerated to nearly 20 percent, driven by greater credit demand in the services and retail sectors (Figure 2.3).

Figure 2.3: Credit growth has accelerated
(contribution, percentage y-o-y)



Source: NSO and World Bank staff calculations.

Figure 2.4: The unemployment rate moderated in Q3
(unemployment rate, percentage)



Source: CMIE and World Bank staff calculations

The urban labor market continues to improve in 2023, but at a slower pace for females

The urban labor market continues to improve in FY22/23; unemployment rates have declined further (Figure 2.4), while the worker-population ratio shows marginal improvement[34]. As per the data from the Periodic Labour Force Survey (PLFS), the quarterly urban unemployment rates have steadily declined over the last year; between Q4 FY21/22 and Q4 FY22/23, the urban unemployment rate declined from 8.2 to 6.8 percent, based on the current weekly status[5] (CWS). Figure 2.5 shows that the decline was more significant for youth (15-29 years) and males, by 2.8 and 1.7 percentage points, respectively; particularly, the unemployment rate for youth has halved in Q4 FY22/23 from its peak of above 34 percent in Q1 FY20/21. In contrast, unemployment for females only decreased by 0.9 percentage points over the year (Box 2.1).

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[3] The labor force participation rate refers to the percentage of the working-age population (aged 15+) who are either employed or actively seeking work (unemployed); the worker-population ratio represents the proportion of the working-age population that is currently employed (workforce).

[4] The PLFS and the International Labor Organization (ILO) treat forms of unpaid work differently in their definition of employment. As a result, national estimates of LFPR, WPR, and unemployment rates may differ from those based on latest ILO guidelines; details of ILO standards, see: https://ilostat.ilo.org/resources/concepts-and-definitions/forms-of-work/

[5] All estimates are based on national definitions and using current weekly status which uses a reference period of 7 days preceding the date of survey to determine the employment status. While PLFS provides estimates based on the current weekly status and the usual status approach, the latter using a reference period of one year.

Figure 2.5: Unemployment rates declined more significantly for males and youth…
(Quarterly urban unemployment rate for males, females, and youth)

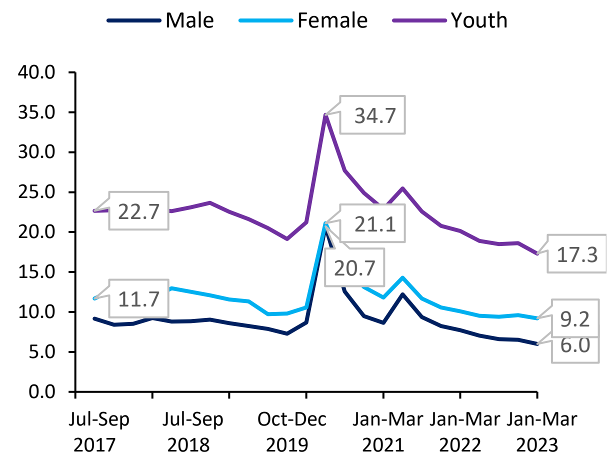
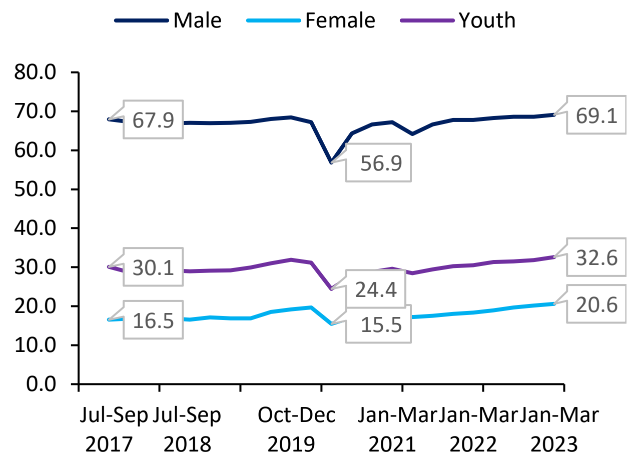


Figure 2.6: …and the increase in women's worker population ratio was driven by unpaid family work
(Quarterly urban worker population ratio)



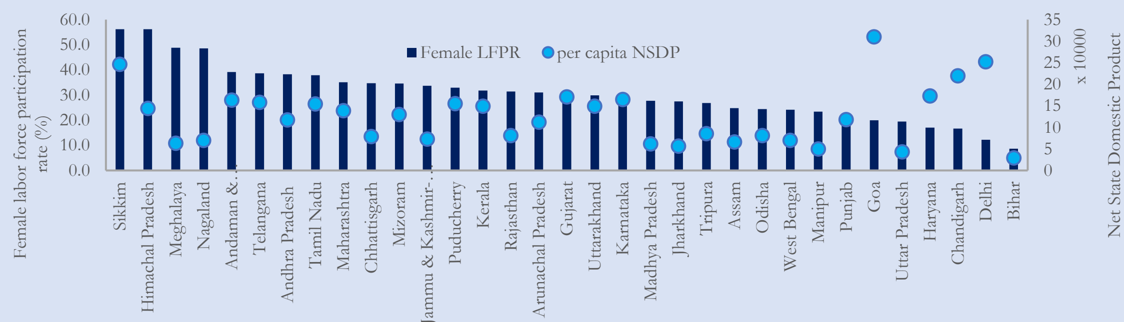
Source: Periodic Labour Force Survey, multiple years, World Bank Staff Calculations

Box 2.1: Jobs for women and in the rural areas continue to lag jobs for men

The urban worker population ratio (WPR) shows a marginal improvement relative to Q4 FY21/22; it increased by 1.4 and 2.3 percentage points for males and females, respectively. However, the increase in WPR for women is primarily driven by an increase in the share of women in unpaid work to 11.7 percent, a 1.5 percentage point increase since Q4 FY21/22. In Figure 2.6, we see that the WPR for males, females, and youths (15-29 years) have improved after a decline in 2020 and are now at their highest level since 2017. While the male labor force participation rate (LFPR) in urban areas has remained stagnant between Q4 FY21/22 and Q4 FY22/23 at 73.5 percent, female LFPR increased by 2 percentage points to 22.7 percent[6].

Furthermore, studies using cross-country data have found that high-income and low-income countries have the highest female LFPR, while middle-income countries have the lowest (Goldin, 1994). However, is significant variation in female labor force participation across Indian states, the relationship with per capita income is not fully consistent with U-shaped pattern (Figure 2.7). Hilly states like Himachal Pradesh, Meghalaya, and Nagaland have higher female LFPR relative to the per capita income, in contrast, more industrialized states such as Maharashtra, Gujarat, and Haryana have lower female LFPR despite their higher per capita income.

Figure 2.7: Economic growth and women's participation in the labor market in Indian states, 2021-22



Source: Periodic Labour Force Survey, and Ministry of Statistics and Programme Implementation
Note: NSDP per capita in constant prices.

[6] The estimates use international standards developed by the International Labor Organization; details see: https://ilostat.ilo.org/resources/concepts-and-definitions/forms-of-work/

Moreover, the quality of women's jobs in India is much lower than that of men, and the share of regular salaried employment for women in urban areas is declining. According to data from PLFS (2021-22), women in India are almost three times less likely to be employed than men; even when they are employed, the average quality of their jobs is much lower their male counterparts. Based on the Job Quality Index (JQI) which rates regular salaried and casual-wage jobs from 0-4 based on income adequacy, employment benefits, written contracts, and job satisfaction parameters, jobs for women in the rural areas were rated at 1.0 between July 2021 and June 2022. In contrast, the JQI for rural men stood at 2.1, underscoring a substantial gender disparity in job quality in rural areas. In urban areas, the gender gap in JQI is less pronounced, with men's having a JQI of 2.6 and women's at 2.0 (Figure 2.8**).** According to Q4 FY22/23 PLFS data for urban areas, a higher share of women workers (54.2 percent) is employed in regular salaried jobs than men (47.3 percent). However, regular salaried positions, offering benefits such as written contracts, health insurance, and social security benefits have remained stagnant between 2017 and 2023. In fact, between Q4 of FY21/22 and FY22/23, the share of men employed in regular salaried jobs increased by over a percentage point while women's share declined by over two percentage points to 54.2 percent.

In the past decade, real wages in rural areas have marginally declined for agricultural work and remained stagnant for non-agricultural work. The PLFS data for rural areas is released annually, the latest available data is for July 2021-June 2022 and does not allow for wage monitoring at the monthly level. However, data from the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) program indicates that the demand for these jobs in FY22/23 exceeded that of the pre-pandemic period. MGNREGA is often referred to as the employer of the last resort as it guarantees employment for those who cannot otherwise find work and at a wage lower than the prevailing market rates, effectively setting a wage floor. Furthermore, monthly wage data from the Labour Bureau indicates that the real daily wages of rural workers, both agricultural and non-agricultural, have remained unchanged since 2013 with some volatility (Figure 2.9). The high demand for MGNREGA jobs, and stagnant wages indicate a surplus of labor and a lack of employment opportunities in the rural sector.

Figure 2.8: Job quality in rural and urban regions
(Job Quality Index)

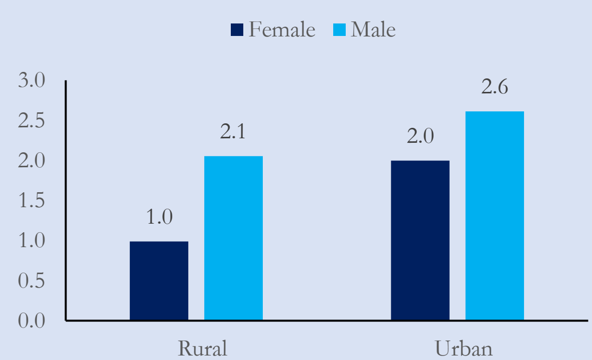
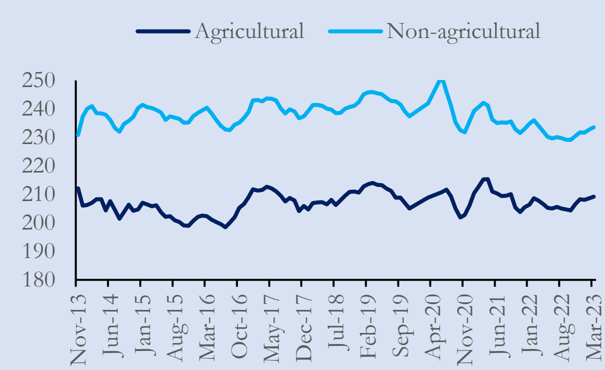


Figure 2.9: Daily wages of rural, male workers
(Real wages per day, INR)



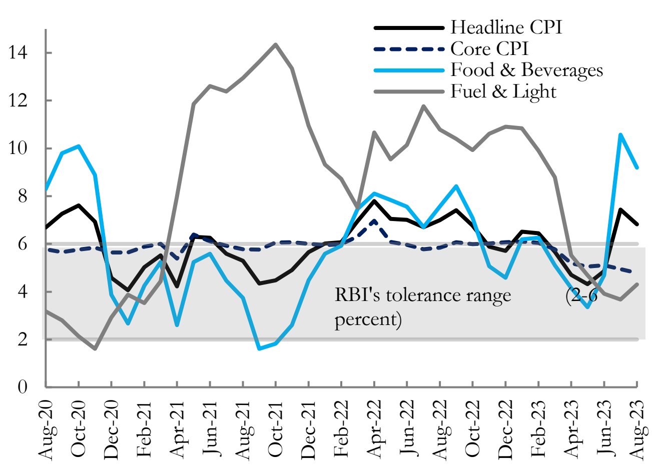
Source: Periodic Labour Force Survey, 2021-22; Labour Bureau daily wages from DBIE-RBI, World Bank Staff Calculations.
Note: Wages are deflated by rural state CPIs (2012=100).

Inflation

Headline inflation averaged 5.3 percent between April-July 2023

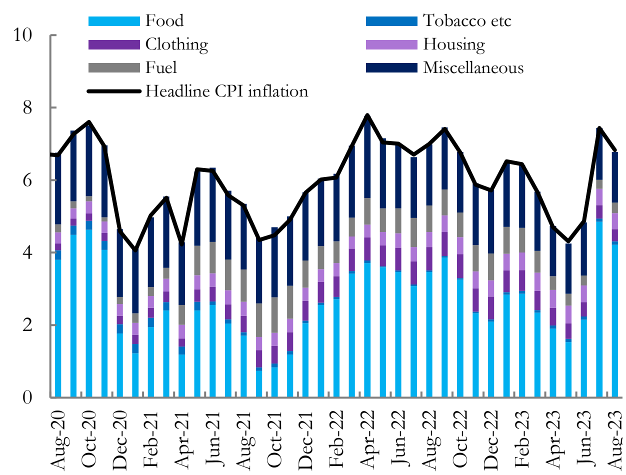
Headline inflation averaged 5.3 percent y-o-y in April-July (from 6.6 percent during full-year FY22/23, Figure 2.10). After remaining within the RBI's tolerance range (of 2-6 percent) for the first quarter of FY23/24, it spiked to 7.4 percent y-o-y in July before moderating to 6.8 percent in August. The principal driver was a significant increase in food prices (which account for nearly 46 percent of the consumer basket) due to unfavorable weather patterns (Figure 2.11). To address price volatility, the government introduced several supply-side measures, including tariffs on onion exports, restrictions on stockpiling of certain crops as well as temporary bans on the export of several varieties of rice, wheat, and sugar. Overall inflation was contained by a moderation in fuel and energy inflation (averaging 4.4 percent y-o-y in April-August). The moderation in fuel and energy inflation reflected a high base (the prices of fuel and light grew 10.6 percent on average in April-August 2022 following a sharp rise in LPG and kerosene prices[7] driven by rising global energy prices). Retail selling prices for petrol and diesel remained unchanged over the past 13 months (despite a fall in global crude oil prices). This was offset by higher electricity tariffs (up 13.8 percent and 13.5 percent y-o-y in July and August). Though food prices fell and inflation eased to 6.8 percent in August, risks remain from the monsoon deficiency and its evolving impacts on prices, El Niño phenomena, and global supply chain disruptions.

Figure 2.10: Headline inflation spiked in July…
(percentage, y-o-y)



Source: CEIC and World Bank staff calculations. Note: Shaded portion represents the RBI's tolerance range (2-6 percent)

Figure 2.11: …reflecting a sharp rise in food prices
(Contribution to headline inflation, percentage points)



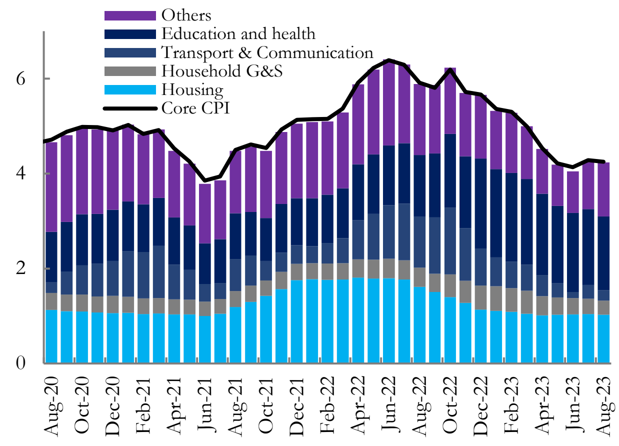
Source: CEIC and World Bank staff calculations.

Core inflation eased to average 5 percent in April-August 2023

Core inflation decelerated from 6.1 percent y-o-y in FY22/23 to 5 percent y-o-y—its lowest level since April 2020 (Figure 2.12), thanks to modest growth in prices of transport and communication. Prices of apparel, footwear, and household goods and services, also grew modestly, possibly reflecting stable transportation costs. Easing global commodity prices since the beginning of 2022 kept WPI inflation subdued in April-August. The WPI fell 2.1 percent over this period. The contraction in wholesale price inflation slowed in August, to 0.6 percent y-o-y (from 1.4 percent in July) due to an upswing in the wholesale prices for primary commodities, predominantly food which partially offset the continued contraction in the wholesale prices of fuel and manufactured items (Figure 2.13).

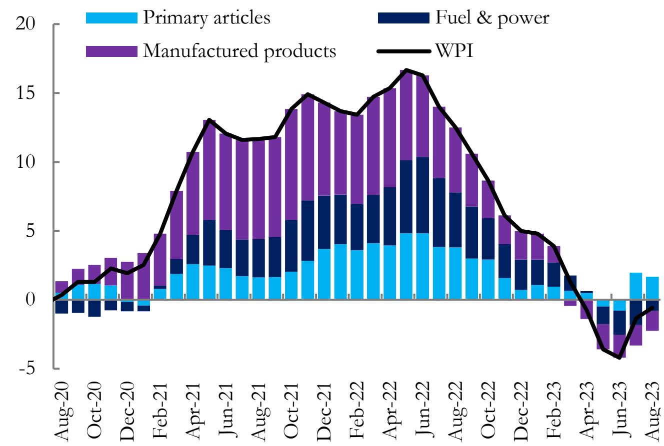
[7] The government started a targeted subsidy of INT 200 per 14.2 Kg cylinder for Pradhan Mantri Ujjwala Yojana (PMUY) beneficiaries for up to 12 refills a year for select households under PMUY.

Figure 2.12: Core inflation moderated in H1 FY23/24 before picking up slightly in July.
(Contribution, percentage, y-o-y)



Source: CEIC and World Bank staff calculations.

Figure 2.13: An uptick food prices offset overall wholesale price decline
(Contribution, percentage, y-o-y)



Source: CEIC and World Bank staff calculations.

Box 2.2: Government implemented measures to counter food inflation pressures

Adverse weather conditions combined with geopolitical tensions raised food inflation. Uneven and scarce rainfall in July-August across large parts of the country impeded the sowing of staple crops like paddy and sugarcane, potentially affecting rice and sugar supplies. The discontinuation of the Black Sea Grain Initiative[8] (which is expected to cause supply disruptions of wheat and sunflower oil), unfavorable weather in Canada and the USA (that might curtail soybean and rapeseed supplies), and dampened production in Malaysia have amplified global concerns regarding further spikes in wheat and vegetable oil prices.

The government took steps to address supply shortages and mitigate price volatility. Further steps to compensate farmers adversely affected by export restrictions and adverse weather conditions may also be taken.

Government response	Applicable food items	Timeline
Increased procurement to raise buffer stocks of food items and supply in major consumption centers: government agencies (National Agricultural Cooperative Marketing Federation of India and National Cooperative Consumers' Federation of India Limited) were directed to increase the procurement of certain food items to increase government buffer stocks of the centralized procurement system (also known as the central pool).	Tomatoes and onions	To be continued till prices stabilize
Increased supply through calibrated releases from the central pool: the government is expected to periodically release food stocks in local markets to ensure continuous supplies of staple food items at affordable rates.	Pulses (tur, urad, moong, Masur and gram) and onions	To be continued till prices stabilize
Increased supply through the Open Market Sale scheme: Increased releases of food grains from the central pool by the Food Corporation of India to traders, bulk consumers and retail chains, to influence retail prices.	Wheat and rice	To be continued till prices stabilize

[8] The Black Sea Grain Initiative was an agreement between Russia, Ukraine, Turkey and the United Nations during the Russian invasion of Ukraine, effective for a year from July 2022 to July 2023, to allow the safe transportation of grain and food items from Ukrainian ports. The G20 held in New Delhi (9-10 September 2023) has called for revival of the Initiative.

Hoarding prevention: Wholesale and retail stock limits imposed on certain varieties of pulses and wheat under the Essential Commodities Act (1955).	Pulses (tur and urad) Wheat	Till October 31st 2023 (pulses) and March 31st 2024, respectively (wheat)
Bharat Dal Initiative: a new initiative to provide pulses (chana dal) at subsidized rates.	Pulses (chana)	To be continued till prices of chana stabilize
Export duties and temporary export bans: The government imposed a 40 percent duty on onion exports and banned exports of non-basmati white rice (beginning July 20th). The government also imposed 20 percent duty on parboiled rice and placed a minimum export price of USD 1200 per ton on basmati rice.	Onions and non-basmati rice	Till December 31st2023
Removal of import duties: imports of certain pulses have been made temporarily duty free.	Pulses (tur, urad and masur)	Till March 31st, 2024

The government is expected to continue to take supply-side interventions to maintain food supply and contain price volatility. Food items contribute to roughly 46 percent of the Indian consumer basket—comparable to 53 percent in Indonesia, 49.8 percent in Vietnam and 36.7 percent in China. Given the high share of food in household expenditure, particularly in low-income households, food prices directly affect household welfare and also play a role informing inflation expectations and wage setting. As a result, several governments in the region have used fiscal instruments, such as cash transfers and income support to boost household purchasing power during crises. In the past, the Indian government also resorted to increased food distribution using the public distribution system to ensure food security and temporary trade restrictions to prevent supply shortages of staple food items.

b. Monetary and financial sector

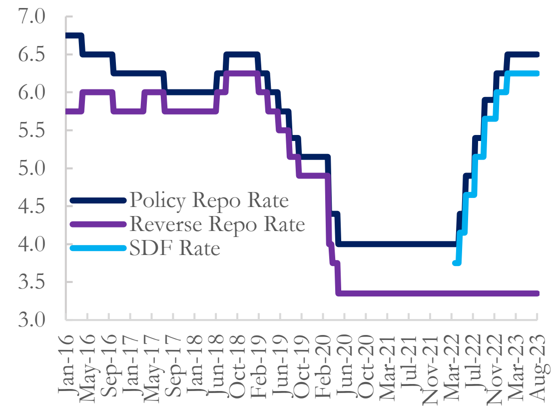
The MPC kept the policy rate unchanged

After hiking the policy rate by a total of 250 basis points (bps) between May 2022-February 2023, the MPC paused in April 2023 as inflation eased to near 4 percent – the mid-point of the RBI's target range. The policy repo rate currently stands at 6.5 percent and the Standing Deposit Facility (SDF), the overnight deposits of commercial banks with the RBI, remains 25 bps below the repo rate (Figure 2.14). Despite an increase in inflation in June and in July due to a spike in food prices caused by supply chain disruptions and adverse conditions, the MPC has not changed the policy rate as it expects these developments to be transitory.

RBI remains committed to mop-up surplus liquidity, resulting in moderation in liquidity in the banking system

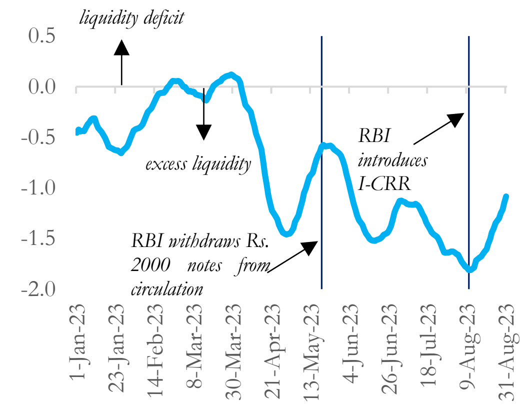
The RBI's interventions to keep inflation within the target range has led to a moderation in liquidity in the banking system. In its third bi-monthly policy announcement of FY23/24, on August 10, 2023, RBI introduced an incremental cash reserve ratio (I-CRR) of 10 percent to manage excess liquidity (partly caused by the return of the Rs. 2000 notes to the banking system following the decision to withdraw these notes from circulation in May). Banks have been mandated to maintain a I-CRR of 10 percent on incremental deposits made between May 19 and July 28. Consequently, excess liquidity in the system has declined from an average of INR 2.2 trillion in the first half of August 2023 to INR 0.5 trillion in last week of August 2023 (Figure 2.15).

Figure 2.14: After six successive rate hikes, the MPC has maintained status quo in FY23/24
(percent)



Source: CEIC, RBI, World Bank staff calculations

Figure 2.15: Surplus liquidity in the banking system declined after the introduction of I-CRR
(INR trillion)



Note: Liquidity refers to 1-month rolling average of outstanding net amount under RBI's liquidity absorption facility.
Source: RBI, World Bank staff calculations

India's financial sector remains strong, with further improvement in asset quality

The asset quality of Scheduled Commercial Banks (SCBs)[9] continued to improve in FY 23/24 driven by higher loan growth, lower slippages, better recoveries and write-offs of bad loans. The gross non-performing assets (GNPA) ratio of SCBs reached its lowest level in a decade (3.9 percent) in March 2023 (Figure 2.16). The improvement in asset quality has been broad based, with a steady decline in the stressed advances ratio across all major sectors. Asset quality also improved across all manufacturing sub-sectors. Asset quality in the large borrower portfolio improved significantly with the share of top 100 borrowers in SCBs' GNPA declining from 6.8 percent in March 2022 to 1.6 percent in March 2023. Capital adequacy (the capital to risk weighted assets ratio) improved from 16 percent in September 2022 to 17.1 percent in March 2023. SCBs' profit after tax grew 38.4 per cent (y-o-y) during 2022-23, with a strong increase in net interest income and lowering of provisions.

Credit growth sustained double-digit growth in Q1FY23/24

Credit growth remained buoyant, on the back of robust private consumption and improvements in asset quality of banks. SCBs' credit growth (y-o-y), which started accelerating since early 2022, remained in double-digits in FY23/24, driven by services and personal loans even as industrial credit slowed (Figure 2.17). Credit growth averaged 15.8 percent in Q1 FY23/24 compared to 12.0 percent in Q1 FY22/23. The personal loans segment grew 19.9 per cent (y-o-y) with all major segments registering robust expansion. Bank credit to the services sector grew by 23.3 percent in (y-o-y) primarily driven by non-banking finance companies. However, credit growth to industry remained solid at 8.1 percent in June 2023, though slowed down from its peak at 13.6 percent in October 2022 partially attributing to the end of the Emergency Credit Line Guarantee Scheme[10]. The availability of funds with SCBs to meet the credit demand continued to improve in FY23/24. Growth in outstanding deposits accelerated to 13 percent by June 2023 from 9.6 percent in March 2023.

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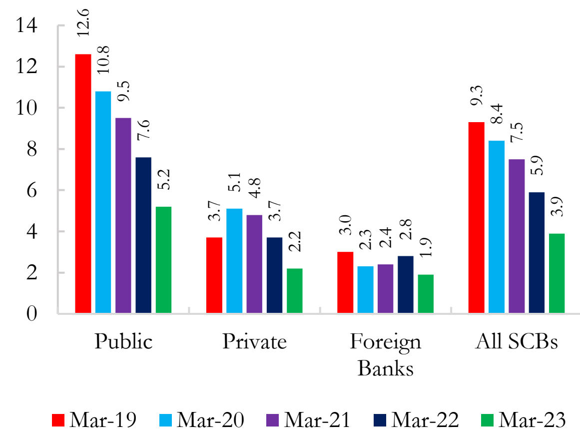
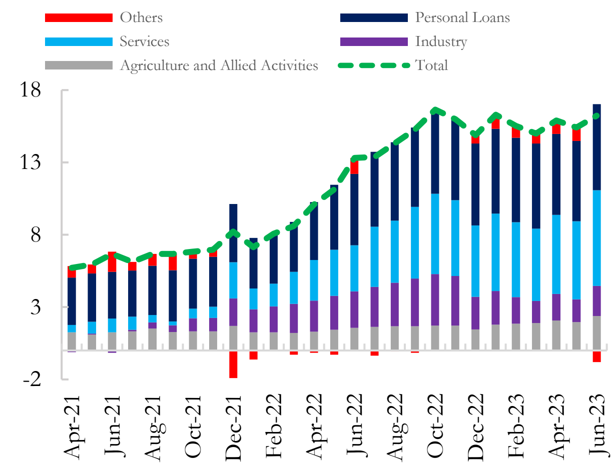
[9] Scheduled Commercial Banks refer to those commercial banks which have been included in the Second Schedule of the Reserve Bank of India (RBI) Act, 1934. These banks must have a paid-up capital and reserves of an aggregate value of not less than five lakh rupees.
[10] The ECLGS was launched in May 2020 as a part of the central government's Covid-19 measures. Under the scheme, the central government provided 100 percent guarantee coverage to banks and NBFCs to enable them to extend emergency credit facilities to MSMEs to meet their additional term loan/ additional working capital requirement.

Figure 2.16: Gross NPAs have fallen across all banks
(percent)



Source: RBI

Figure 2.17: Credit growth in double-digits, with increased contribution of personal loans and services
(Growth, y-o-y percent)



Source: RBI, World Bank staff calculations

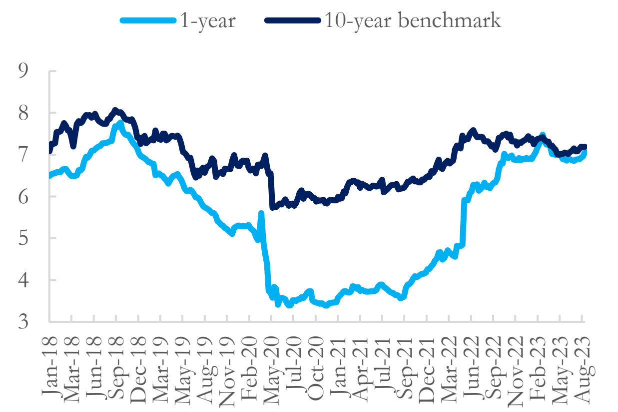
Various factors drove the recent large movement in the 10-year benchmark yield

The benchmark yield on 10-year sovereign bonds declined sharply from 7.3 percent on April 3, 2023, to 7.0 percent by May 31, before jumping back to 7.2 percent by the end of August (Figure 2.18). The temporary softening of yield between April and May may be attributed to the pause of monetary policy rate hikes, easing of liquidity condition of the banking system, and the decline in US treasury yields. However, from June onwards, rising inflation, tightening of liquidity conditions, and growing expectations of the Fed increasing interest rates, pushed up the 10-year yields. The new condition also facilitated market expectations that the RBI is likely to hike interest rate, as reflected in the steepened yield curve, which calculates the difference in yields of securities with different maturities.

India's financial markets reached new highs in July followed by some correction in August

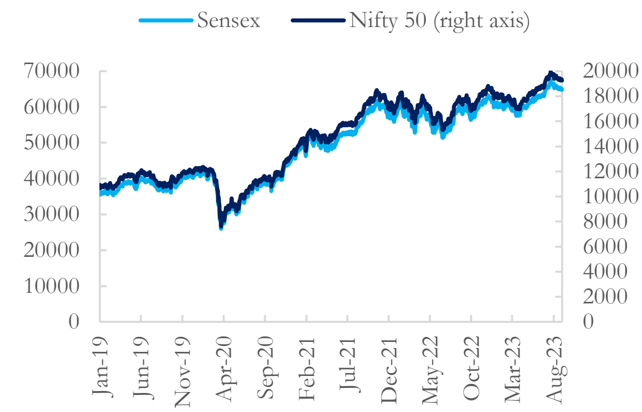
Equity markets have been performing strongly since the onset of FY 23/24 and scaled new highs in July 2023, driven by robust corporate earnings, the moderation in inflation and easing global commodity prices. However, the market witnessed some correction in August, prompted by Fitch's US credit rating downgrade and poor economic outcomes in China and Europe (Figure 2.19). On balance, from April 1 to August 31, 2023, the Sensex and Nifty 50 surged by 9.9 percent and 10.9 percent respectively. The rally was spearheaded by sectors such as automobiles, oil and gas, insurance, banking, and capital goods. In contrast, sectors with deep global ties, including chemicals, IT, and metals, faced headwinds.

Figure 2.18: Benchmark yield and short-term interest rates have trended upwards since June 2023
(percent)



Source: RBI

Figure 2.19: Financial markets have moderated after reaching historic highs in July 2023
(index)



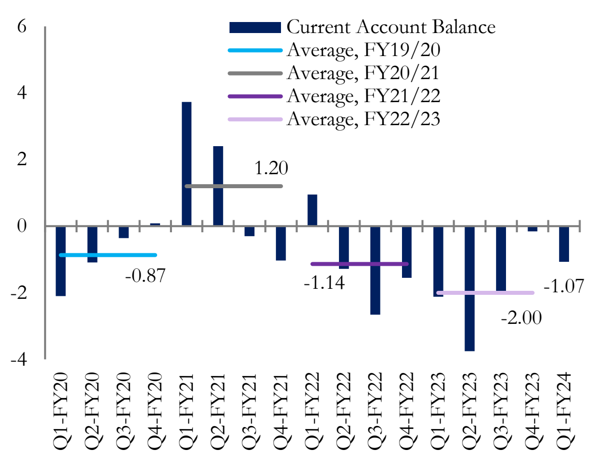
Source: Nifty and BSE Limited

c. External sector

The current account deficit widened to 1.1 percent in Q1 FY23/24 but remains below the pre-pandemic average

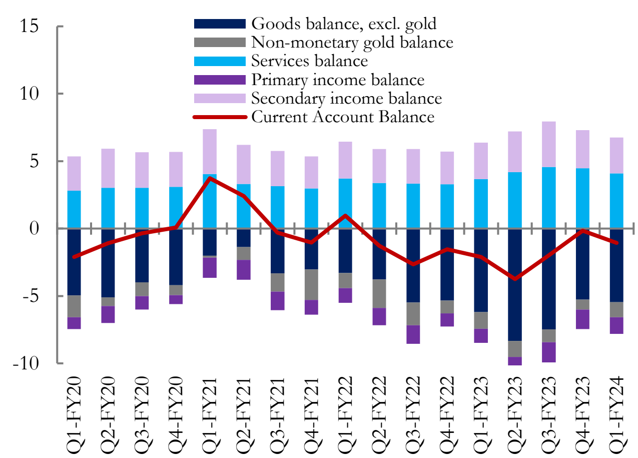
The current account deficit-to-GDP ratio widened to 1.1 percent in Q1 FY23/24 from a record low of 0.2 percent in the previous quarter (Q4 FY22/23). However, the deficit remained below the pre-pandemic (FY16/17-FY19/20) average of 1.4 percent of GDP (Figure 2.20). Services export growth was robust, particularly for IT, professional and management services, and bolstered the services trade surplus in Q1(Figure 2.21). In contrast, India's merchandise exports fell sharply reflecting the weakening external demand, and the goods trade deficit widened to 6.6 percent of GDP in Q1 FY23/24 (+0.6ppt from Q4 FY22/23). Resilient inflows of workers' remittances boosted income receipts (both primary and secondary) in both Q4 FY22/23 and Q1 FY23/24.

Figure 2.20: The current account deficit widened in Q1 FY23/24…
(Percentage of GDP)



Source: CEIC, RBI, World Bank staff calculations

Figure 2.21: …primarily due to a widening merchandise trade deficit
(Percentage of GDP)



Note: The shaded part is the WB estimate based on the monthly data on trade in goods and services.
Source: CEIC, RBI, World Bank staff calculations

Weak external demand caused the goods trade deficit to widen in Q1 FY23/24

India's merchandise exports declined in Q1 FY23/24 primarily due to a 29 percent y-o-y contraction in refinery petroleum exports – in contrast to a 12 percent y-o-y increase in Q4 FY22/23 (Figure 2.22). This downturn reflected mainly the steep decline in global oil prices for refinery oil exports in Q1 FY23/24 (-31 percent y-o-y), which was barely offset by a 2 percent y-o-y increase in volume of petroleum exports. Other key exports – farm and allied products, chemicals, base metals, and textiles – collectively accounting for more than a third of India's total goods exports, also contracted in Q1 FY23/24. Weak demand from India's key export destinations – the US, the EU, ASEAN economies and China – has weighed on merchandise exports. In contrast, exports of a few high technology goods– electronics, machinery, and transport equipment – grew and contributed positively to export growth. The share of these goods has steadily increased in India's total exports during the last decade (Box 2.3). Meanwhile, merchandise imports declined in Q1 FY23/24 due to a sharp fall in commodity prices – primarily driven down by sluggish global demand – impacted the import value of minerals and ores, gems and petroleum, which account for half of India's merchandise imports. This notable resilience in the domestic demand also contributed to an uptick in the import of electronics, machinery and metals, though at a lesser extent to offset the overall decline in merchandise imports.

Figure 2.22: Export growth has collapsed across major categories of goods, except for high-technology goods
(contribution to growth y-o-y, percentage points)

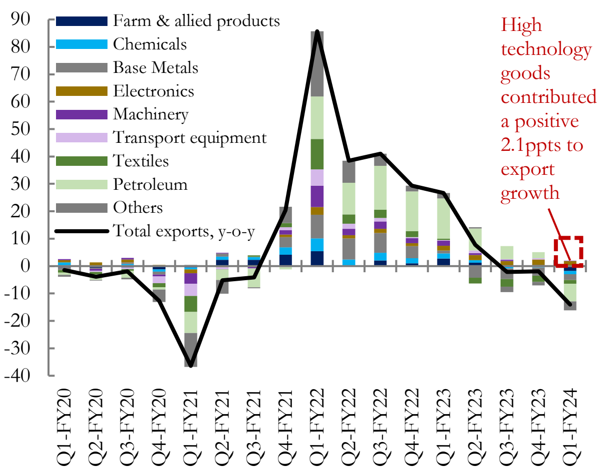
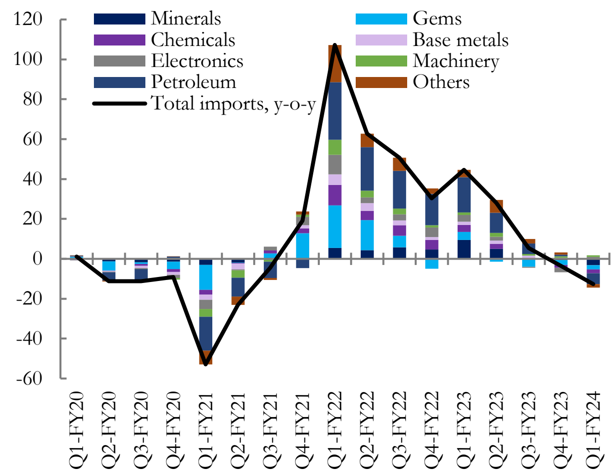


Figure 2.23: The downtrend in merchandise import growth has been driven by lower commodity prices
(contribution to growth y-o-y, percentage points)

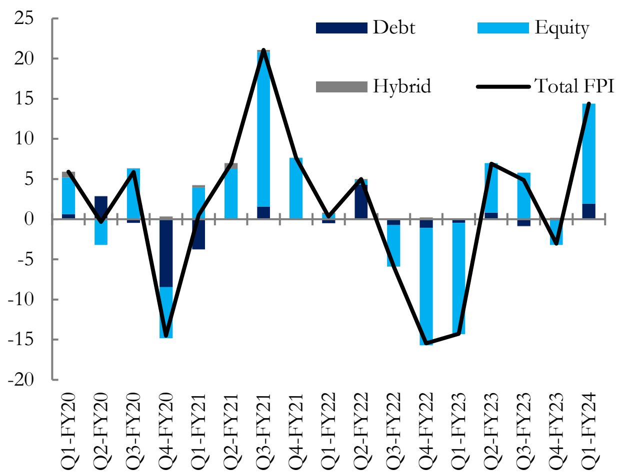


Source: CEIC, Ministry of Commerce and Industry, World Bank staff calculations

Foreign portfolio flows have been resilient and net FDI inflows, while still below the pre-pandemic average, were strong in Q1 FY23/24

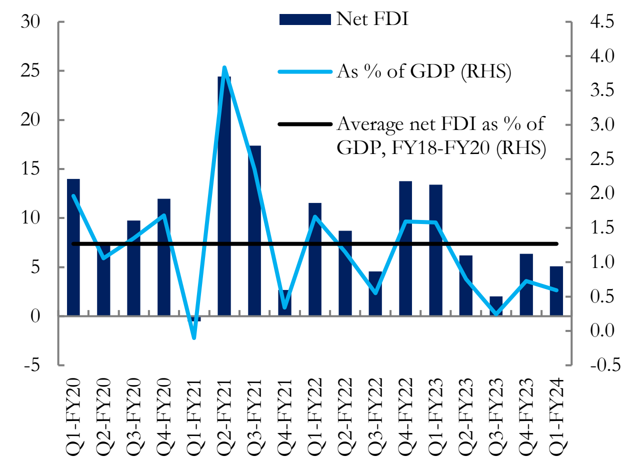
Net portfolio investment flows into India's equity markets surged to levels last observed in Q3 FY20/21 (Figure 2.24). With the US Federal Reserve holding off on policy rate hikes, foreign investors have sought to maximize risk-adjusted returns in emerging economies. In this context, India's elevated interest rates, last this high in 2018, along with strong fundamentals have made its financial market attractive. Meanwhile, net FDI inflows bounced-back in Q1 FY23/24, doubling from a low of USD 1.7 billion in Q3 FY22/23 (Figure 2.25). Notwithstanding the recent increase, net FDI inflows as a percentage of GDP have remained below the pre-pandemic (FY18-FY20) average for the past four consecutive quarters.

Figure 2.24: FPI inflows surged in Q1 FY23/24 as foreign investors sought higher risk-adjusted returns in India
(USD billions)



Source: CEIC, RBI, World Bank staff calculations

Figure 2.25: FDI inflows have rebounded but remain below the pre-pandemic average
(USD billions, left axis); (Percentage of GDP, right axis)

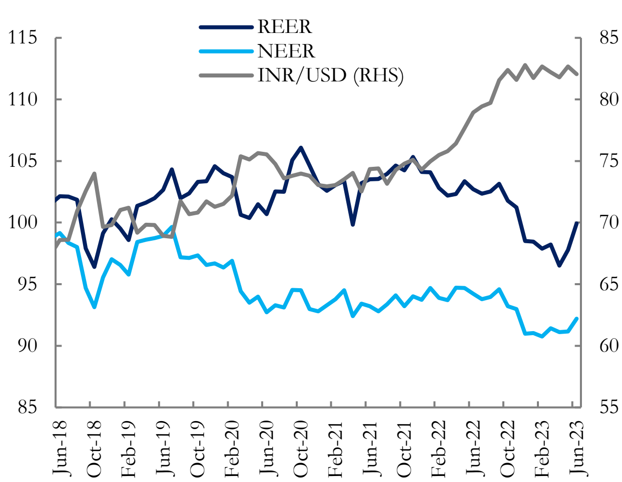


Source: CEIC, RBI, World Bank staff calculations

The rupee appreciated slightly but has remained stable this year compared to last year's volatility

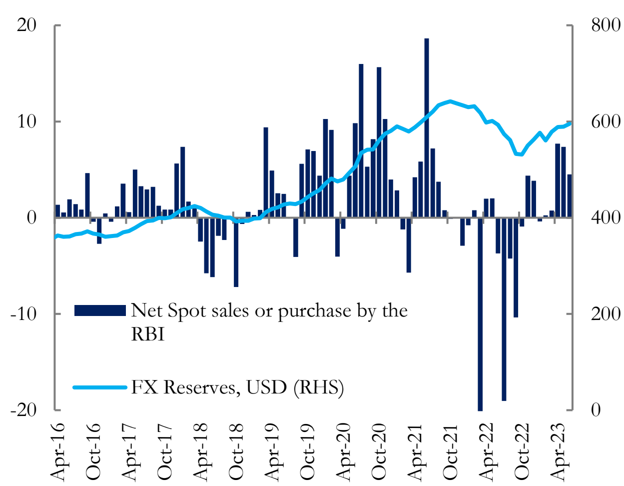
The rupee appreciated marginally against the USD in Q1 FY23/24. This was primarily influenced by a decline in imports – in turn driven by softening global commodity prices – and a surge in portfolio capital inflows from Q4 FY22/23 (Figure 2.26). Additionally, relative to the previous year, exchange rate volatility diminished considerably, and the rupee moved in a narrow range of 82-83 INR/USD. This was partly thanks to the RBI's intervention in the FX market: the RBI has been a net buyer of US dollars this year due to which India's stock of foreign exchange reserves increased to USD 595 billion at end-August 2023 from about 561 billion at the beginning of 2023 (Figure 2.27). In Q1 FY23/24, the real effective exchange rate (REER) appreciated slightly. This was largely driven relatively higher domestic inflation compared to India's major trade partners (such as the US and UK).

Figure 2.26: The Indian rupee appreciated marginally against the USD on the back of capital inflows and lower imports
(INR/USD)



Source: Haver, IMF, World Bank staff calculations

Figure 2.27: Foreign exchange reserves have been increasing on the back of the RBI's FX intervention
(LHS & RHS: USD billion)



Source: CEIC, RBI, World Bank staff calculations

Box 2.3: The composition of India's exports is shifting from medium-low technology towards higher technology goods

The share of high and medium-high (HMH) technology manufactured exports in India's total goods exports has risen by almost 10 percentage points between 2012 and 2022. The technology intensity of manufactured goods exports has important implications for an economy's growth, with higher technology exports generating greater gains for productivity through efficiency gains, technology and knowledge spillovers, than trade in less sophisticated activities (Cuaresma and Wörz, 2005). Meanwhile, the share of low technology goods has remained unchanged over the last decade, but the share of medium-low technology goods has declined, from 48 percent in 2012 to 42 percent in 2022 (Figure 2.28) and HMH exports now account for a third of the total.

HMH technology exports have been the fastest growing category over the last decade (Figure 2.29). While exports of low technology goods grew marginally and that of medium-low technology goods contracted during 2013-17, HMH goods exports expanded by 3.1 percentage. Within this category, exports from sectors such as railway transport, inorganic and organic chemicals, chemical products, electrical machinery and equipment, plastics, as well as nuclear reactors, boilers and generators have performed particularly well. Consequently, India's share in global high technology exports increased from 0.6 to 0.8 percent over 2012-19.

Exports of both medium-low and low technology goods have been extremely volatile over the last decade. Although medium-low technology exports have had a large contribution to total export growth, due to a higher share, the growth has been volatile (Figure 2.30a). This volatility has stemmed from the resource-based products like minerals and ores and precious stones, which are subject to fluctuations in global commodity prices.

India still has a "revealed comparative advantage" in low and medium-low technology exports. The revealed comparative advantage11 (RCA) of most low and medium-low technology products has declined over 2010-20 (Figure 2.30b), but India still maintains a comparative advantage in several low and medium-low technology goods. Therefore, India still has the potential to increase its global market share in these goods as supply chains for relatively low technology goods are gradually shifting out of China.

Figure 2.28: India's share of HMH technology manufacturing exports has risen
(Share in total merchandise exports, percent)

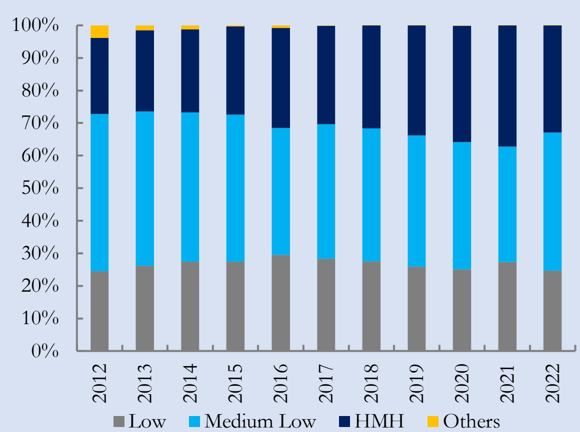
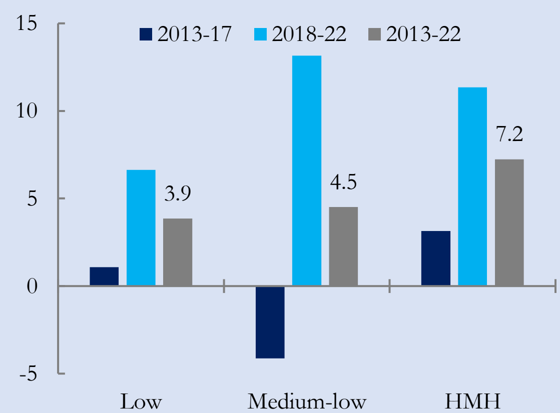


Figure 2.29: HMH technology exports have grown robustly over the last decade
(Growth, y-o-y percent)



[11] The RCA index of country I for product j is measured by the product's share in the country's exports in relation to its share in world trade. If the index exceeds one, the country is said to have a revealed comparative advantage in the product.

Figure 2.30a: The contribution of medium low technology is substantial but volatile
(Contribution to merchandise export growth, y-o-y percentage points)

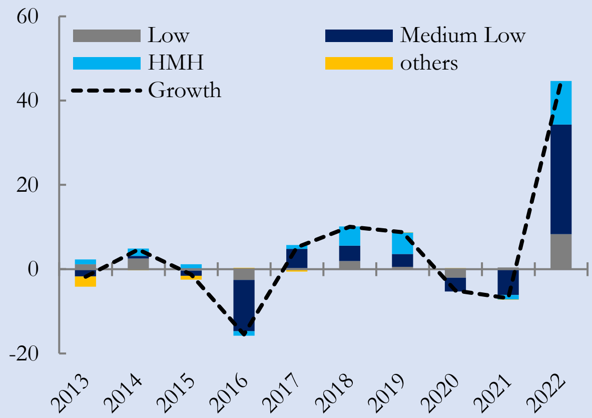
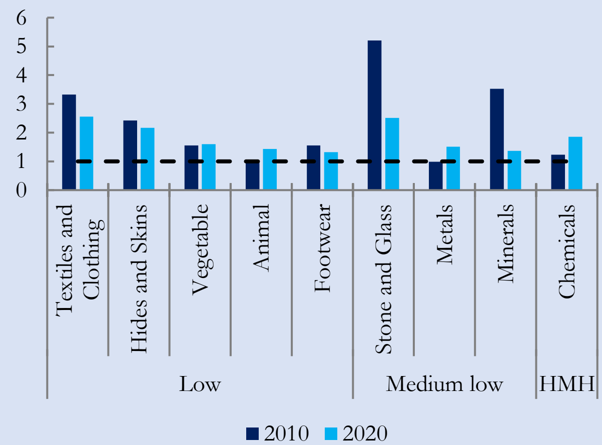


Figure 2.30b: India still has a comparative advantage in low and medium-low technology exports, although it has declined
(RCA of goods with RCA>1 in 2020)



Source: Ministry of Commerce and Industry, WITS, and WB Staff calculations
Note: Category of goods (low, medium-low, high and medium-high technology) are based on Hatzichronoglou, T. (1997)

d. Fiscal sector and debt sustainability

The general government fiscal deficit declined in FY22/23 along with the public-debt-to-GDP ratio

The general government fiscal deficit -the combined deficit of the center and states-declined from 9.6 percent of GDP in FY21/22 to 9.0 percent in FY22/23 (Figure 2.31). Expenditures declined as some post-pandemic welfare measures were withdrawn, but revenues also declined as fuel tax cuts were introduced to soften the impact of high global crude oil prices on domestic inflation (Figure 2.32). Public debt also declined from 87.6 percent of GDP in FY20/21 to 82.9 percent in FY22/23, as the primary deficit narrowed and growth-interest rate dynamics remained favorable, with strong nominal GDP growth.

Figure 2.31: The general government fiscal deficit declined in FY22/23, as did the debt/GDP ratio
(percent of GDP)

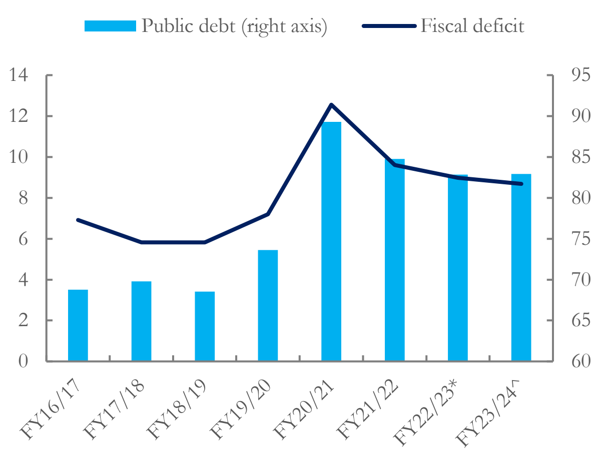
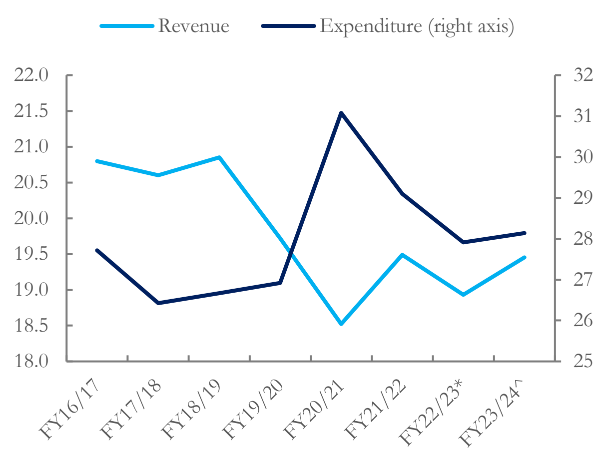


Figure 2.32: Both expenditures and revenues declined as a share of GDP in FY22/23
(percent of GDP)



Note: *Based on provisional accounts for the central government and the states.
Source: CEIC, RBI, CSO and WB staff calculations

The government targets a fiscal deficit of 5.9 percent of GDP for FY23/24

The targeted consolidation from 6.4 percent of GDP in FY22/23 to 5.9 percent in FY23/24 is expected to be driven mainly by continued consolidation of recurrent spending through the withdrawal of all pandemic-related welfare measures. the improvement in revenue collection also contributes to the narrowing deficits: the GST collection is expected to pick up benefiting from the pre-pandemic reforms; the corporate income tax is projected to remain buoyant owing to an improved bank balance sheet.

Since then, an additional subsidy on cooking gas has been announced…

The central government cut the price for liquified petroleum gas (LPG) cylinders, which are primarily used for cooking, by INR 200/cylinder and increased the subsidy for eligible households by a similar amount. While the cost of the price cut will be absorbed by the state-owned oil marketing companies, the cost of the increased subsidy (around 0.3 percent of GDP) will be borne by the central government. The government has also responded to the sharp increase in food prices in July by imposing several restrictions on vegetable and cereal exports but it has, so far, refrained from additional welfare measures in the form of increased subsidies or cash transfers to support vulnerable households.

…and revenue growth improved in August and September after a slow start

In the four-month period (April-July) for which data is available, the central government's gross tax revenues only increased by 2.8 percent y-o-y. The government had only achieved 28 percent of its budgeted target for tax revenues compared with over 30 percent of the budget estimate on the expenditure side (as capital spending was front-loaded at the start of the year) (Figure 2.33). As a result, the fiscal deficit reached 34 percent of the budget estimate or 2.0 percent of GDP (Figure 2.34). However, growth in GST revenue and direct tax collections showed a marked improvement in August and September.

Figure 2.33: Front-loaded spending caused the fiscal deficit to increase in the first half of the fiscal year

(fiscal deficit, percent of FY22/23 budget estimates)

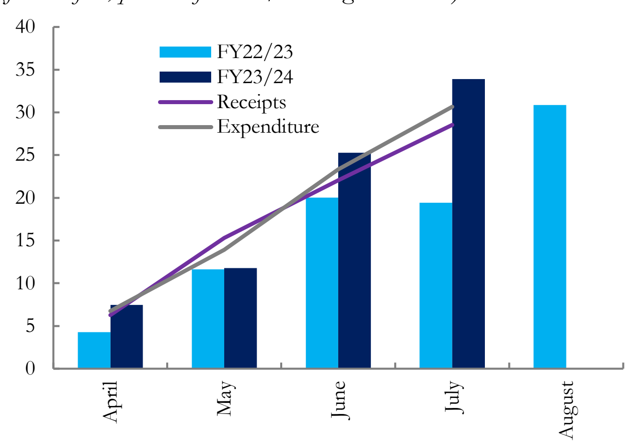
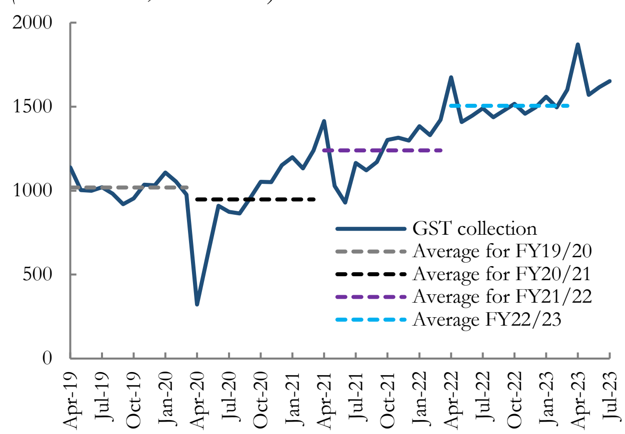


Figure 2.34: GST collection has continued to grow at a robust pace

(GST collection, INR billion)



Source: CEIC, Ministry of Finance, and WB staff calculations

State governments have budgeted for a fiscal deficit around 3 percent in FY23/24 and capital spending has increased

According to budget estimates, the combined fiscal deficit for the states is projected to be 3.1 percent of GDP in FY23/24, somewhat above the provisional estimate of 2.7 percent in FY22/23. Revenue growth is expected to reach 11.6 percent y-o-y, in line with the budgeted growth in central government tax revenues, while expenditure growth is projected to be around 9.2 percent. Capital spending is projected to increase by 18 percent, buoyed by 50-year interest-free loans from the central government. Monthly fiscal data for April-July for 16 major states show that capital spending increased by over 50 percent y-o-y, indicating front-loaded capex also at the state level particularly sharply in Madhya Pradesh, Telangana and Rajasthan.

Public debt decreased to 82.9 percent of GDP in FY22/23

According to quarterly public debt data published by the central government, the central government's total liabilities fell from 61.5 percent of GDP in FY20/21 to 57.1 percent by the end of FY22/23, mainly thanks to rapid nominal GDP growth and a decline in the primary deficit. At the state level, the combined debt/GSDP ratio remained stable around 27 percent of GDP, though some states are observing higher public debt levels.

Box 2.4: Relatively high public debt levels and cost of borrowing impose a high debt servicing burden

India's debt ratio is higher than that of most other emerging market and middle-income countries. Among 34 emerging market and middle-income countries, only 4 countries had a debt-to-GDP ratio higher than India's. As a result, India's debt-servicing costs are also much higher at over 5 percent of GDP, compared with the combined average of around 2 percent for all emerging market countries. Although public borrowings help boost economic development, the associated significantly higher debt servicing burden reduces the overall level of savings in the economy and consumes government resources that could be directed towards other productive purposes.

Although India's debt is significant, sustainability risks are low. Nearly all of India's public debt is rupee-denominated, with external borrowings (form bilateral and multilateral sources) only accounting for about 3 percent of GDP. Domestically issued debt, largely in the form of government bonds, is mostly medium or long-term and domestically held, with a weighted average maturity of over 11 years for central government debt. Thus, rollover risk is low and exposure to volatility in exchange rates or external interest rates is limited.

The cost of borrowing is relatively high but it has been declining. The effective interest rate for public debt is around 6.2 percent, higher than for most other EMEs. However, it has fallen gradually from a peak of around 7.1 percent in 2013. This is due in part to the gradual linking of interest rates on small savings instruments to market interest rates. The spread between the yield on Indian government securities and US government securities has also narrowed over the past 10 years, as relatively stable macroeconomic performance in terms of moderate inflation, fiscal discipline and steady growth has contributed to a lower risk premium.

Figure 2.35: India's debt and interest payments are higher than most other countries…
(X-axis: interest payments, percent of GDP, Y-axis: debt, percent of GDP)

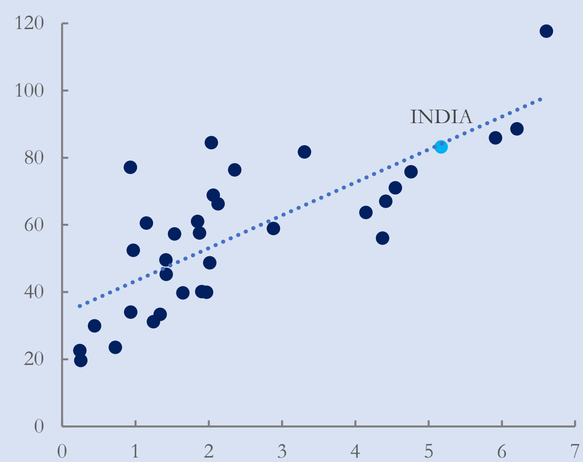
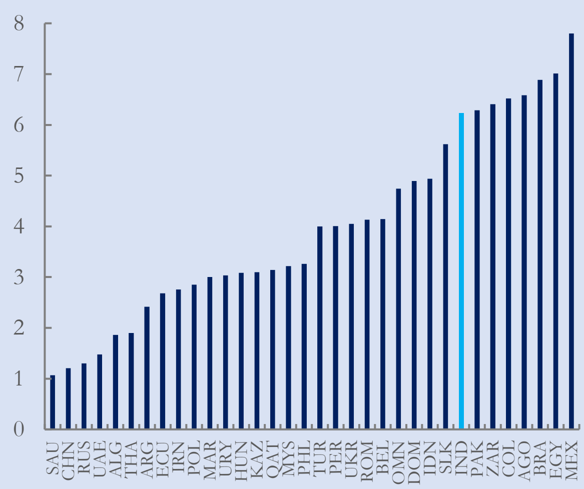


Figure 2.36: …and the effective cost of borrowing is also relatively high
(effective interest rate, percent)



Source: IMF Fiscal Monitor, WB staff calculations

3. Outlook

Real GDP growth is expected to moderate in FY23/24

India's growth is expected to moderate to 6.3 percent in FY23/24 from 7.2 percent in FY22/23, but it will remain one of the fastest growing major economies in the world. The expected slowdown is mainly due to waning base effects, slowing global growth, and domestic price pressures. Private consumption growth is likely to slow as the post-pandemic catch up fades, and external demand for India's exports will be affected by slowing growth in major trading partners, including the EU. (Table 3. 1). However, activity will be supported by strong investment, driven by a continued increase in public investment in infrastructure.

Strong investment will drive growth but consumption growth will moderate

Growth of domestic demand is expected to remain robust, albeit at a slower pace (Figure 3.1). Despite the sharp increase in lending rates since early-2022, conditions remain conducive for private investment: balance sheets of banks and the corporate sector have improved, capacity utilization has increased, and the government has stepped up capital spending on infrastructure. Private consumption growth is likely to taper off as post-pandemic pent-up demand fades and high food price inflation constrains demand, particularly for low-income households. Meanwhile government consumption is expected to grow slowly, in line with the central government's efforts to lower the share of current spending.

Rising food prices will keep headline inflation elevated

Headline inflation is expected to average 5.9 percent in FY23/24. Abnormal rainfall during the monsoon months caused a sharp increase in food prices in July 2023. Though eased in August, it is expected to continue to weigh on headline inflation through the rest of the fiscal year. While oil prices have moderated from their peak in 2022 and will help stabilize inflation, they are expected to remain elevated than the pre-pandemic levels. The RBI's policy of withdrawing accommodation and raising the policy interest rate over the last year has helped rein-in core inflation, which is expected to continue to decelerate gradually.

The CAD will narrow as commodity prices ease

The current account deficit (CAD) is projected to narrow to 1.4 percent of GDP in FY23/24 driven by a decline in the merchandise trade deficit (Figure 3.2). The merchandise import bill will be lower than in FY22/23, on account of lower global commodity prices, that should more than offset the decline in merchandise exports from slower global growth. Meanwhile India's services trade surplus from exports of IT and professional services and, stable remittances and FDI inflows are expected to buoy the CAD. The direction of foreign portfolio investment flows is likely to reverse with net inflows as India remains one of the fastest growing emerging market economies.

The fiscal deficit should continue to decline gradually

The general government deficit is expected to decline to 8.7 percent in FY23/24 from 9.0 percent of GDP in FY22/23. Fiscal consolidation is likely to be led by modest growth in recurrent spending and buoyant revenue growth, making room for investment. Although fiscal intervention has been limited so far, fiscal consolidation could be delayed by subsidy programs to limit the impact of high food prices on vulnerable households ahead of the general elections in 2024.

Debt to GDP remains elevated, but the level of debt is

Public debt should stabilize around 83 percent of GDP, only falling to 82.4 percent by FY25/26. Nonetheless, debt remains sustainable with gradual fiscal consolidation[12] and double-digit nominal GDP growth supporting a negative interest-rate growth differential. Most of the debt is held by domestic investors and the rollover risk is low. The weighted average maturity of market borrowings of the central and state governments is over 11 years

[12] The fiscal deficit is expected to narrow 7.9 percent of GDP by FY25/26, which is lower than the 8.2 percent forecast in the previous edition of the World Bank's Macro Poverty Outlook.

sustainable with low rollover risk	and 8 years respectively and has increased in recent years. However, the elevated level of debt does impose a significant debt-servicing burden and a meaningful reduction in debt as a share of GDP would require the government to reduce the primary deficit even more.

Figure 3.1: Investment will continue to drive real GDP growth in FY23/24

(Contribution to growth, percentage point)

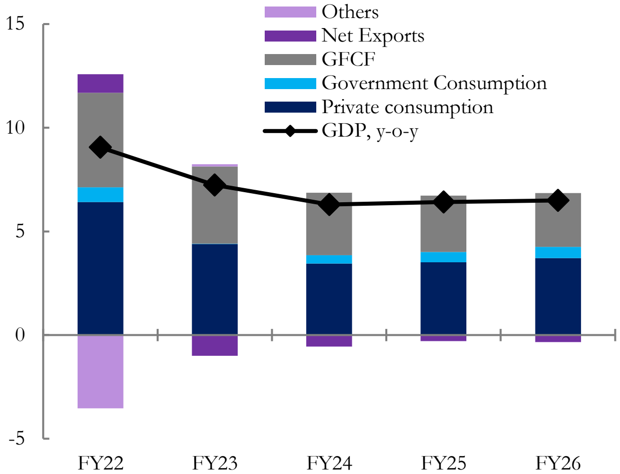
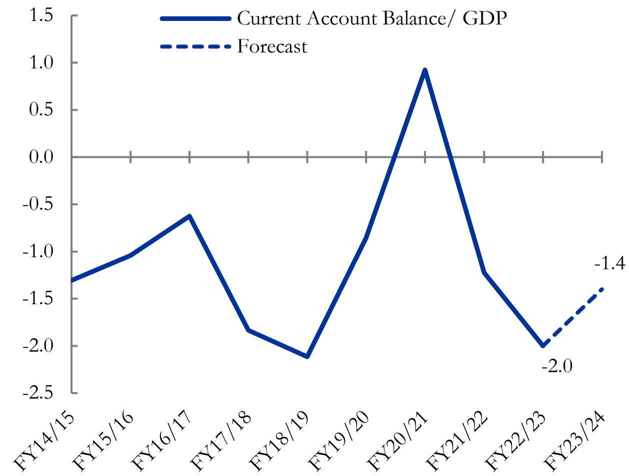


Figure 3.2: Current account deficit will narrow on the back of a smaller merchandise trade deficit

(percentage share of GDP)



Source: CEIC and World Bank Staff calculations
Note: The shaded portion reflects the World Bank projections

Table 3. 1: World Bank macroeconomic outlook indicators

Indicator *(percent y-o-y growth, unless otherwise specified)*	FY20/21	FY21/22	FY22/23	FY23/24	FY24/25	FY25/26
Real GDP Growth, at constant market prices	-5.8	9.1	7.2	6.3	6.4	6.5
Private Consumption	-5.2	11.2	7.5	5.9	6.0	6.4
Government Consumption	-0.9	6.6	0.1	4.1	5.1	5.8
Gross Fixed Capital Formation	-7.3	14.6	11.4	8.9	7.8	7.3
Exports, Goods and Services	-9.1	29.3	13.6	0.9	6.7	8.2
Imports, Goods and Services	-13.7	21.8	17.1	3.0	7.2	8.7
Real GDP Growth, at constant factor prices	-4.2	8.8	7.0	6.3	6.4	6.5
Agriculture	4.1	3.5	4.0	3.5	3.6	3.7
Industry	-0.9	11.6	4.4	5.7	6.4	6.4
Services	-8.2	8.8	9.5	7.4	7.2	7.3
Inflation (Consumer Price Index)	6.2	5.5	6.7	5.9	4.7	4.1
Current Account Balance *(percent of GDP)*	0.9	-1.2	-2.0	-1.4	-1.2	-1.6
Net Foreign Direct Investment *(percent of GDP)*	1.6	1.2	0.8	1.1	1.4	1.5
Fiscal Balance *(percent of GDP)*	-12.6	-9.6	-9.0	-8.7	-8.1	-7.9
Debt *(percent of GDP)*	89.3	84.8	82.9	82.9	82.5	82.4
Primary Balance *(percent of GDP)*	-7.2	-4.4	-3.9	-3.3	-2.7	-2.5

Source: CEIC and World Bank Staff calculations
Note: (i) Shaded columns are WB forecasts

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