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Economic Analysis

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Five challenges for India in 2013

After a disappointing 2012, India heads for an uncertain 2013. Here are five key challenges we would recommend the Indian economic authorities to focus on.

The first key challenge will be to start bringing **India's current account deficit to sustainable levels**. The deficit has widened to a record 4.2% of GDP in 2011-12, far above what the Reserve Bank of India, itself, considers to be a sustainable level, namely 2.5% of GDP. The key reason for the large current account deficit lies in the trade deficit having ballooned due to India's relatively poor competitiveness and high dependence on oil and gold imports which alone account for virtually half of total imports. Boosting merchandize exports through greater diversification across destinations and products are essential to bridge the trade deficit but this cannot be achieved without boosting labour productivity and enhancing transportation infrastructure, specially ports.

With regards to gold, dematerialisation and introduction of inflation linked bonds would help reduce its physical imports of gold. Meanwhile, for oil, achieving greater energy efficiency, aligning domestic oil price to international prices are a key.

The second challenge is **qualitative and quantitative fiscal consolidation**: Together with the current account deficit, the stubbornly high fiscal deficit (5.8% of GDP in 2011-12) makes the Indian economy more vulnerable to shocks than most emerging markets. India's twin deficits have adversely affected macro stability by pushing up inflation, undermining growth and leaving limited room for monetary accommodation. India's fiscal policy has been too loose for too long. The government must focus on quality spending by channelling resources towards infrastructure and human capital investments while reducing unproductive spending, particularly on food, fertiliser and fuel subsidies. Furthermore, the government must implement revenue enhancing reforms by making the tax system more efficient and improving compliance.

The third challenge, very much related to the previous one, is **lowering high and sticky inflation**. India's persistently high inflation is fallout of myriad factors that are both cyclical and structural in nature. These include supply side bottlenecks, very high reliance on imported energy and lax fiscal policy. While a loose fiscal policy has boosted aggregate demand, particularly across rural areas, an enabling environment to enhance supply response is missing, thus aggravating inflation pressures. Containing inflation near the RBI's comfort zone of 4% to 5% is crucial to facilitate sustainable growth.

The fourth challenge lies in **rebalancing the growth mix in favor of investment:** India's GDP growth is mainly consumption driven in good part due to consumption subsidies. Eliminating such subsidies will, thus, actually has three positive outcomes: reducing the fiscal deficit as well as excessive consumption which should also help reignite a virtuous savings-investment cycle. In fact, since the global financial crisis of 2008-09, India's savings rate has declined (to near 29% from a peak of 37% in 2009) amid high inflation and fiscal slippages. Given that India's investment upturn during the golden years between 2004-2008 was largely financed by domestic savings, a revival in India's domestic savings is critical for aiding a sustainable upturn in investment. In this regard, the Indian government needs to improve further on reforms execution and policy clarity so as to underpin foreign investor confidence.

The fifth and last challenge is to the boost manufacturing sector: Being a primarily services driven economy, the share of manufacturing has been stagnant at a mere 16% of total GDP. India's Asian peers such as China, South Korea and Taiwan, have immensely benefitted from a strong manufacturing sector, which enables greater employment creation, attracts higher and stable foreign direct investment and bolsters infrastructure development. However, bottlenecks in land acquisition, archaic labour laws, poor physical infrastructure, less favourable tax rules and tight regulations deter manufacturing sector growth in India. Reassuringly, the Indian government has approved a national manufacturing policy aimed to increase manufacturing's share in GDP from the current 16% to 22% in a decade and in turn create millions of jobs and add capacity to sustain the pace of economic growth. That said, effective implementation of such policy drive will clearly prove difficult given past records.

All in all, although India's challenges for 2013 look massive, they could still be manageable given India's huge growth engines stemming from a young and massive population in a deep urbanization process. The Indian authorities must grasp the opportunity of reform in the good times rather than waiting any longer.