Economic Developments in India

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Photo: EyeEm – Getty Images

Abstract

Over recent decades, India's rapid economic growth has led to a substantial increase in its demand for Australian exports. However, India is currently facing the most significant setback to its economic development in decades as a result of COVID-19. Like in many other economies, the pandemic has severely affected near-term economic activity and exacerbated existing vulnerabilities in the Indian economy. While it will take some time for the Indian economy to recover, underlying fundamentals should support growth in the long term. This in turn should increase demand for some key Australian exports such as coking coal and education services, and so India will likely remain an important trading partner for Australia. The outlook for other resource exports such as iron ore and thermal coal is less positive because India is expected to be self-sufficient in these commodities.

India's economy has grown rapidly over the past few decades but growth had been slowing before the onset of COVID-19

India has recorded strong economic growth over the past 4 decades (Graph 1). Over this period, real per capita incomes have increased four-fold. India's share of global output has doubled to 7 per cent, and it is now the world's third largest economy in purchasing power parity terms. This growth has been primarily driven by an expansion of the services sector, in contrast to the manufacturing-led growth that characterised the development of many of India's fast-growing east Asian peers (Lamba and Subramanian 2020). India's development lifted over 200 million people out of poverty over the decade to 2015 (United Nations Development Programme 2020).

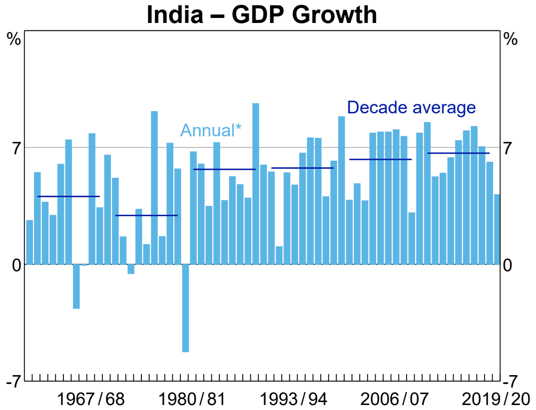
Before the onset of the COVID-19 pandemic, India was in the midst of its most significant slowdown in economic growth since the global financial crisis. Over the year to the March quarter 2020, GDP growth had slowed to just above 4 per cent, well below the decade average of around 7 per cent during the 2010s. Investment, which makes up one-quarter of GDP, contracted for the first time in over a decade. The slowdown reflected a range of factors, including disruptions associated with partial demonetisation and the introduction of a goods and services tax, and a decline in credit growth associated with structural issues in the financial sector that culminated in the default of a high-profile non-bank financial company. Fiscal and monetary authorities had provided some support to the economy, although these measures had yet to arrest the slowdown before the beginning of the COVID-19 pandemic.[1]

The Indian economy was severely disrupted by COVID-19

After the initial COVID-19 outbreak, Indian economic output fell by 25 per cent, one of the largest falls in GDP in the June quarter of 2020 of any economy. This was the result of the stringency and length of India's initial lockdown, which was one of the world's strictest (in terms of both intensity and population covered) and constrained the operations of most businesses (Graph 2). This resulted in a sudden loss of income for many of India's day labourers and led millions of migrant workers to leave urban areas and return to their villages (International Labour Organization 2020). The lockdown lasted from March until the end of May; restrictions were then progressively lifted except for areas with the highest case loads. India's lockdown appeared to slow the rise in new COVID-19 cases, although it did not fully suppress the virus.

Graph 1

India – GDP Growth



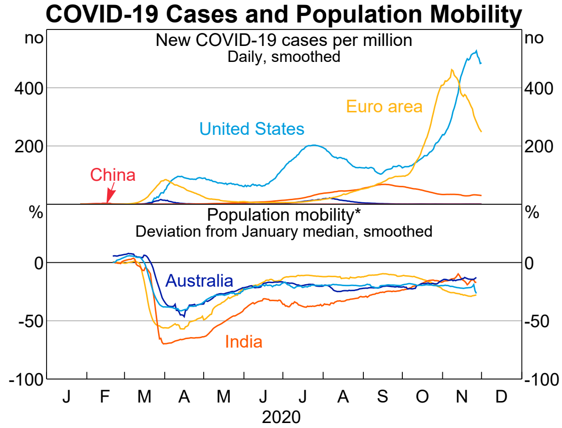
* Fiscal years ending March

Sources: CEIC Data; RBA

India has so far provided similar levels of total fiscal support as other emerging market economies, but a much lower level of support than has been provided by advanced economies (Graph 3). As with many other emerging market economies, the Indian Government's ability to provide discretionary fiscal policy support has been constrained by concerns about preserving access to affordable financing and ensuring the sustainability of government debt (i.e. India is seen as having a lack of 'fiscal space') (IMF 2020a; IMF 2020b; Sitharaman 2020). India's fiscal support has included a comparatively small amount of on-budget measures such as additional spending and tax reductions.[2]

Graph 2

COVID-19 Cases and Population Mobility



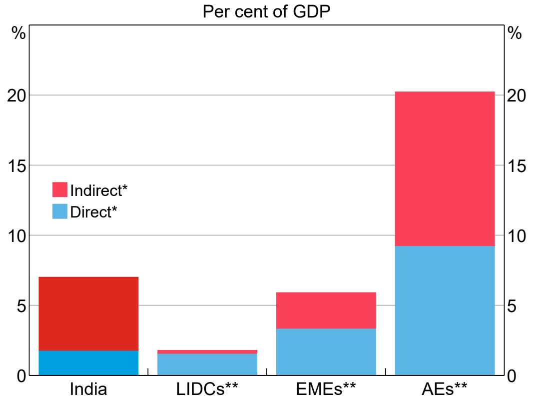
* Average of population mobility categories 'retail & recreation', 'grocery & pharmacy', 'workplaces' and 'transit stations'; mobility data unavailable for China

Sources: CEIC Data; Google LLC (2020), 'Google COVID-19 Community Mobility Reports', available at https://www.google.com/covid19/mobility/ viewed on 2 December 2020

Graph 3

Fiscal Response to the COVID-19 Crisis

Per cent of GDP



* Direct and indirect refer to the IMF categories 'on-budget' and 'off-budget'. Discretionary fiscal response only; includes data up to 11 September 2020

** AEs: advanced economies; EMEs: emerging market economies; LIDCs: low-income developing countries; as per IMF definitions

Source: IMF (2020a)

The onset of the COVID-19 crisis was also associated with a material tightening in Indian financial conditions. Capital outflows from India and the deterioration in the economic outlook drove declines in equity prices, an exchange rate depreciation, and increases in government and corporate bond yields (Graph 4). However, these adjustments in financial market prices were modest in comparison to some other emerging markets, reflecting in part pre-existing restrictions on foreign participation in Indian capital markets.

The subsequent monetary policy response from the Reserve Bank of India (RBI), alongside the actions of fiscal and monetary authorities globally, helped to ease financial conditions. Since March, the RBI has lowered its policy rate by 115 basis points, purchased government bonds in the secondary market to improve market functioning, and provided additional liquidity to financial institutions to alleviate liquidity and funding stress (Ratho and Kumar 2020). To support household and corporate cash flows, the RBI also enacted a 6-month moratorium on repayments on bank loans between March and August, and established a resolution framework for borrowers affected by COVID-19 (RBI 2020a; RBI 2020b). However, with inflation remaining above the RBI's target range, the policy rate in India has not declined as much as in other emerging markets, though real interest rates are still markedly negative (RBI 2020c; RBI 2020d).

Most forecasters expect the Indian economy to continue the recovery that began in the second half of 2020 throughout 2021. However, the level of Indian economic output in 2021 is expected to remain around 15 per cent below where it was forecast to be before the onset of COVID-19; this is the largest projected output shortfall among major economies (Graph 5). These forecasts reflect both the large initial fall in output and constraints on economic stimulus measures given the lack of fiscal policy space and persistently high inflation.

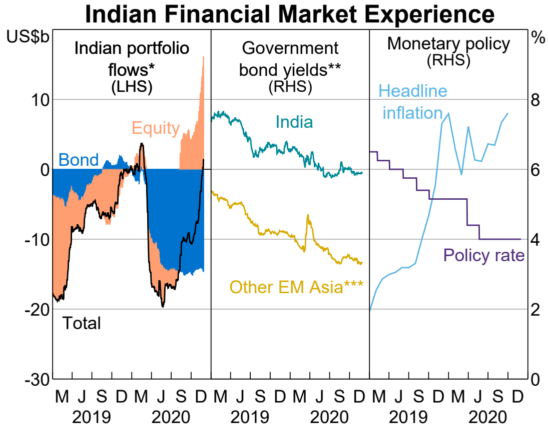
Long-term growth prospects and challenges for policymakers

Looking beyond the pandemic, India's growth outlook remains promising given its favourable economic fundamentals.[3] For instance, United Nations estimates of India's future population dynamics point to continued growth in the working-age population (Graph 6), though the effect of this on the economic outlook depends on education outcomes and whether recent declines in labour force participation persist.[4] In addition, India's productivity is still low, and there is substantial potential for 'catch-up' growth through the adoption of new technologies, movement of workers into higher productivity sectors and locations, and increases in human capital (Anand, Kochhar and Mishra 2015).

However, there are a number of significant challenges that could weigh on the longer-term

Graph 4

Indian Financial Market Experience

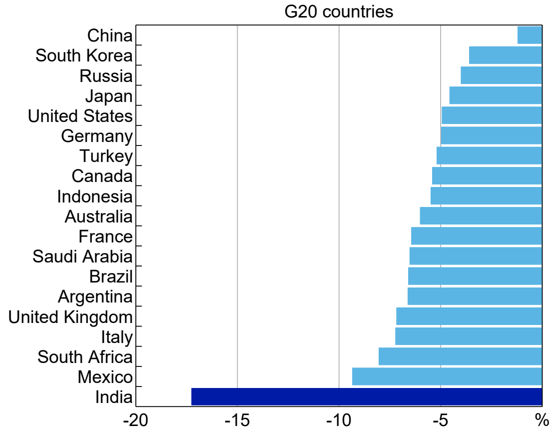


* Cumulative flows relative to 1 January 2020
** 10-year local currency bonds
*** Simple average of Indonesia, Malaysia, the Philippines and Thailand
Sources: Bloomberg; RBA; RBI; Refinitiv

Graph 5

Downgrade to 2021 GDP Forecast*

G20 countries



* 2021 GDP forecast difference between October 2020 and October 2019 World Economic Outlook publications
Sources: IMF (2019); IMF (2020c)

economic outlook, some of which have been exacerbated by the pandemic. Two key challenges in the recovery phase and beyond will be ensuring the sustainability of government debt and strengthening India's banking system.

The sustainability of government debt

Government debt relative to GDP has increased markedly as a result of the pandemic because of a combination of lower economic activity and revenue, and higher government spending (Graph 7). Larger government deficits are likely to be required in the near term to support the economic recovery; premature fiscal consolidation could lead to economic scarring (IMF 2020a). The resulting increase in government debt is expected to leave India with a much higher burden of interest payments than most other Asian economies (Graph 8). Furthermore, a slower-than-expected economic recovery would worsen government debt dynamics by depressing government revenues and further delaying fiscal consolidation.

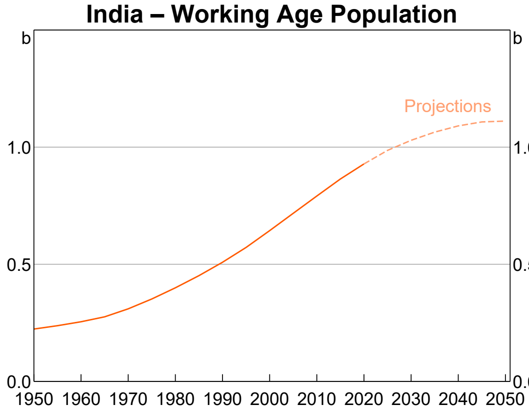
However, a combination of high potential economic growth and a credible path for fiscal consolidation should support the sustainability of India's government debt over the longer term. The IMF forecasts that general government debt to GDP will start to decline from 2021 as growth returns to the previous decade average of around 7 per cent and government deficits begin to consolidate (IMF 2020c). Bringing more activity into the formal sector of the economy, combined with recent changes to simplify the tax system, have the potential to broaden India's tax base and improve the government's ability to commit to fiscal consolidation (IMF 2019). An easing of restrictions on foreign investment or an increased role for foreign investors could help to reduce the cost of servicing a larger debt stock, albeit at the risk of greater portfolio outflows during crises.[5]

Strengthening India's financial system

The COVID-19 crisis has complicated India's efforts to strengthen its financial system. In particular, the disruption to activity is expected to compound banks' problems with non-performing loans.[6] Two-thirds of public sector banks' (PSBs) customers had paused repayments on their loans following the loan repayment moratorium (RBI 2020a).

Graph 6

India – Working Age Population

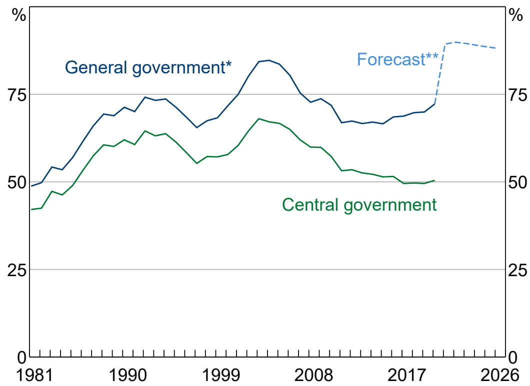


Source: United Nations (2019)

Graph 7

India – Government Debt

Per cent of GDP



* General government debt is state and central government debt combined

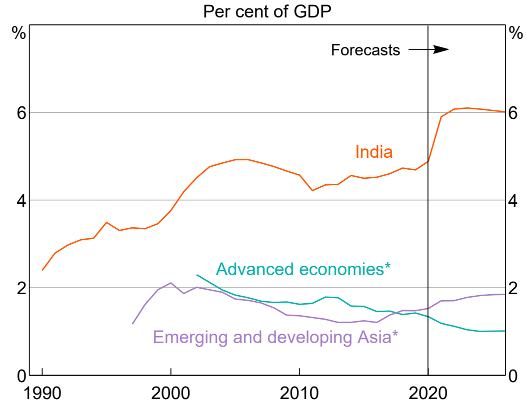
** IMF forecast for 2020 onwards

Sources: CEIC Data; IMF (2020b)

Graph 8

General Government Interest Expenditure

Per cent of GDP



* IMF definitions

Source: IMF (2020b)

Additionally, India's banks have absorbed much of the extra government bonds issued since March and have provided additional lending to non-bank financial corporations, which were already facing difficulties prior to the crisis (RBI 2020a). The resultant poor earnings and capitalisation levels at some banks is likely to diminish the transmission of changes in the stance of monetary policy to effective lending rates and more generally limit the ability of banks to extend new loans (Muduli and Behera 2020).[7]

Beyond COVID-19, the high degree of regulation and state ownership of India's banking system remains a structural challenge for India. India's PSBs own over 60 per cent of banking system assets in a financial system dominated by banks (Graph 9). The Indian Government also has some influence over how banks allocate credit; currently banks are required to allocate much of their credit to priority sectors specified by the RBI (RBI 2020e). From the early 2000s to the mid 2010s, PSBs were active in financing the infrastructure sector in line with the government's priorities – many of these exposures became distressed and some were recorded as non-performing loans (Vishwanathan 2016; RBA 2019). Indian banks are also subject to a Statutory Liquidity Ratio (SLR) that requires them to hold a material share of their assets in government securities, currently 18 per cent, increasing their exposure to changes in government bond yields and affecting their profitability (IMF 2017).

Strengthening India's financial system could provide significant benefits to India's long-term growth prospects. In 2017, the IMF identified a number of reforms including recapitalising and restructuring the PSBs, increasing private sector participation in the banking system, carefully reducing the SLR and re-evaluating the use of directed lending (IMF 2017). The IMF expected that these reforms would boost credit growth, while improving financial incentives and reducing the government's exposure to possible losses. India had made some progress in instituting these reforms prior to the pandemic. Private sector banks had been growing much faster than public sector banks for some time and since the second half of 2019, the Indian Government has consolidated 10 PSBs into 4, and recapitalised some PSBs (RBI 2019; RBI 2020f).[8] Nevertheless, the IMF reaffirmed the importance of this reform agenda in 2019, and the scale of the challenge is likely to have increased this year (IMF 2019).

Indian demand for Australian exports – outlook and opportunities

As India has grown more prosperous and become a more significant part of the global economy, its demand for many of Australia's goods and services has increased. India was the destination for less than one per cent of total Australian exports in the 1990s; by 2019, this share had increased to around 4 per cent. Australia's main exports to India are coking coal and education services, which collectively accounted for around three-quarters of total exports to India in 2019 (Table 1).

The longer-term outlook for education exports to India is strong

Australia's education exports to India have grown substantially over the past 2 decades and are now the second largest export category. India is Australia's second largest education export market after China, and one of the fastest growing (Graph 10).[9] Around half of these Indian students are enrolled in university education, and one-third in vocational education (VET). Indian students are more likely than other international students to work while studying in Australia, which confers many benefits to the Australian economy. In the short term, there is a risk that a weaker Australian labour market as a result of the pandemic could

Graph 9

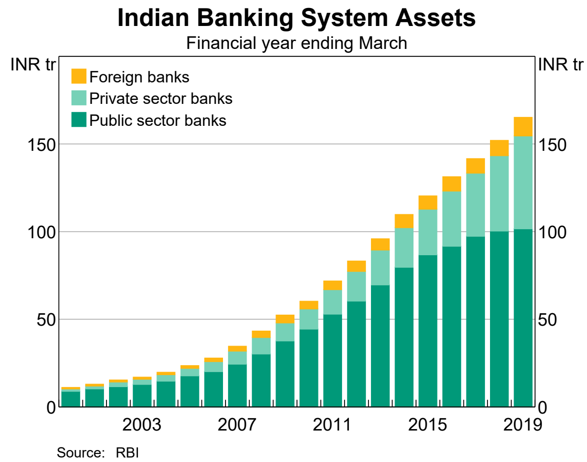


Table 1: Australian Exports to India

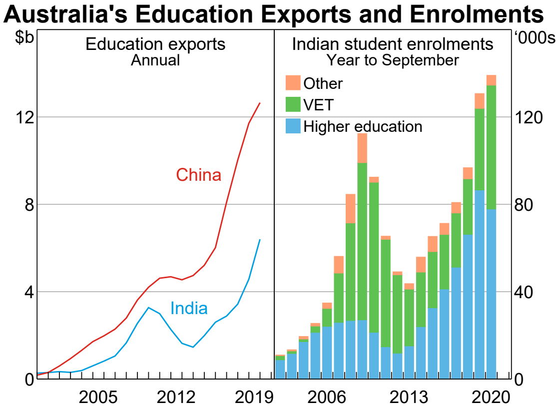
	Value, $b		Share of Australian exports, %	
	2000	2019	2000	2019
Coking coal	0.6	10.2	0.4	2.1
Other goods	1.2	3.8	0.8	0.8
Education	0.3	6.4	0.2	1.3
Tourism	0.1	0.5	0.0	0.1
Other services	0.1	0.6	0.1	0.1
Total	**2.3**	**21.6**	**1.6**	**4.4**

Sources: ABS; Department of Industry, Science, Energy and Resources (2020)

depress the demand from Indian students to study in Australia even after borders are reopened.[10]

In the longer term, there are good reasons to be optimistic about the outlook for India's demand for education, including those opportunities offered in Australia. A combination of a large tertiary-age population, rising standards of living and high relative returns to education and skills suggests the outlook for India's future education demand is strong. Indeed, given the importance of India's services sector, an essential pathway for young people to improve their living standards is to become an educated professional. This is particularly relevant in India given that it has fewer lower-skilled manufacturing jobs than other emerging market economies at a similar level of development. Continued urbanisation and formalisation of the labour market is also likely to open up further opportunities for educated individuals. Indian Government policy is also supportive. In 2020, the Indian Government presented its first National Education Policy (NEP) in 3 decades; a key target in the NEP is to increase the enrolment rate in higher and vocational education for 18–23 year olds from 26 per cent to 50 per cent. If achieved, this means that around 30 million additional students will be enrolled in higher education by 2035.

Graph 10
Australia's Education Exports and Enrolments



Sources: ABS; Department of Education, Skills and Employment

Growing demand for Australian education from Indian students could arise from scarcity of suitable domestic education, as well as demand for the unique opportunities of studying abroad. Supplying high-quality education opportunities for India's large and growing number of young people has remained a challenge, and partly explains the rapid growth in Indian students seeking education abroad (Graph 11). The NEP aims to meet India's future education needs domestically by increasing public investment in education, while limiting the involvement of overseas institutions to 'internationalisation at home' (i.e. satellite campuses of international institutions).[11] However, even if India scales up the capacity and quality of domestic education, education abroad will remain appealing for a subset of students. The opportunity to study in English at well-regarded institutions and work abroad during study and after graduation has attracted a growing number of Indian students to countries like the United States, the United Kingdom, Canada and Australia.

Relative to other alternatives, Australia has experienced particularly fast growth in demand in the past decade, potentially reflecting Australia's reputation as a welcoming country with an attractive lifestyle for international students and relatively favourable visa settings for work during and after study (Varghese 2018). Maintaining even moderate growth in education exports would require attracting only a small share of the millions of additional Indian students that will be looking for education over the next 2 decades.

Urbanisation will support demand for coking coal, but not iron ore

India has experienced near uninterrupted growth in steel production for 2 decades, and has become the second highest producing nation in 2018 (Graph 12). As a result, India has become the top destination for Australian coking coal exports, which is also Australia's most valuable export to India.

In mid 2020, India's coking coal imports declined significantly as a result of disruptions to steel production caused by the pandemic (and the associated lockdown), but recovered towards the end of 2020 as steel production resumed. Australia's Department of Industry, Science, Education and Resources forecasts steel production to return to its pre-COVID-19 growth rate in 2021, but this will be a lower level of steel production than was forecast prior to the pandemic (Department of Industry, Science, Energy and Resources 2020). Given the high degree of uncertainty surrounding the pandemic in India and globally, there is still the risk of a deterioration in the value of Australian coking coal exports to India over the next few years.

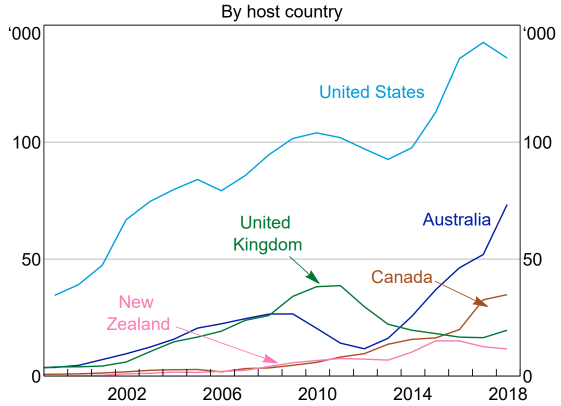
However, the longer-term outlook for Australian coking coal exports remains robust. India's steel consumption per capita is still relatively low, and the United Nations projects that around 400 million additional people will live in urban areas in India by 2050. This will support continued growth in dwelling construction and infrastructure investment, which are both heavily steel-intensive.[12] In light of this, in its 2017 National Steel Policy the Indian Government set targets for steel consumption and production to double by 2030/31 (Government of India Ministry of Steel 2017). Meeting these targets would require only a modest increase in the growth rate of steel production from recent years.

India's steelmaking industry is likely to remain coking coal intensive. The Indian Ministry of Steel has a target to increase the use of the Basic Oxygen Steelmaking (BOS) method to 60–65 per cent of steel produced by 2030/31, from 45 per cent in 2018 (Government of India Ministry of Steel 2017). This is favourable for Australia because, unlike other methods of steel production, the BOS method requires coking coal as an input. India has only small reserves of coking coal suitable for steel production (Government of India Ministry of Coal 2019).[13] As a result, steel producers rely on imports of coking coal, particularly from Australia, which currently accounts for around 80 per cent of India's total coking coal imports. Australia has a comparative advantage in supplying coking coal to India due to Australia's reliable supply and higher-quality coking coal, as well as closer geographical proximity relative to Canada and the United States (the other main suppliers of India's coking coal).

Graph 11

Indian Students Abroad

By host country

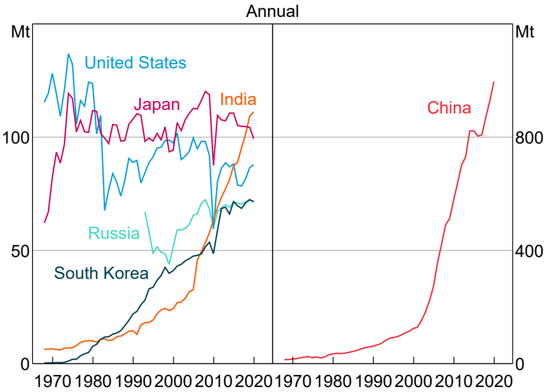


Source: UNESCO Institute for Statistics

Graph 12

Steel Production

Annual



Source: CEIC Data

Strong growth in steel production in China has, in the past, led to demand for Australian iron ore exports, another key input in the steel production process. However, as a large producer of iron ore with significant domestic reserves, India has reasonable prospects for self-sufficiency in the medium term.[14] That said, rapid growth in steel production and the potential continuation of regulatory uncertainty and product quality issues may provide some scope for Australia to increase its exports of iron ore to India in the future (Varghese 2018).

India has substantial future energy needs, but Australian thermal coal is likely to play a modest role in meeting them

India is likely to experience the largest growth in energy demand of any country in the next 2 decades (International Energy Agency 2020). In the past, the rapidly growing energy needs of a number of large Asian nations has supported strong demand for Australian energy exports, including thermal coal. However, there are compelling reasons to believe this will not be the case for India.

While thermal coal currently powers three-quarters of electricity generation in India, more new renewable energy plants have been added to the power grid than coal-fired plants for the last 4 years. By 2040, coal is forecast to produce around a third of electricity, while renewables are projected to produce over half of electricity (Graph 13). The recent growth in renewable energy follows strong government support for the sector and declining costs for renewable power projects. Recent government-run renewable project auctions have revealed costs for solar projects lower than the cost of coal-fired power for the first time (Dvorak 2020). The International Energy Agency expects these trends to continue, which would further support increasing uptake of renewables in the grid (International Energy Agency 2020). The increasing prevalence of renewables implies a levelling off of the coal-fired power sector's growth in the medium term.

India is well placed to provide the domestic coal required to service this level of generation given recent government targets, policy reforms and India's large thermal coal reserves. The government is aiming to have zero thermal coal imports by 2023/24, reversing the rise in thermal coal imports since 2010. This target will be achieved by increasing production targets for state-owned coal producers, and reducing barriers to foreign investment and commercial mining. Partly as a result, import requirements are forecast to level off over the next few years (Department of Industry, Science, Energy and Resources 2020). Even if India falls short of its production targets, imports have mostly been sourced from Indonesia in the past due to their similarity with lower energy density Indian coal and lower costs relative to Australian thermal coal (Department of Industry, Innovation & Science 2019).

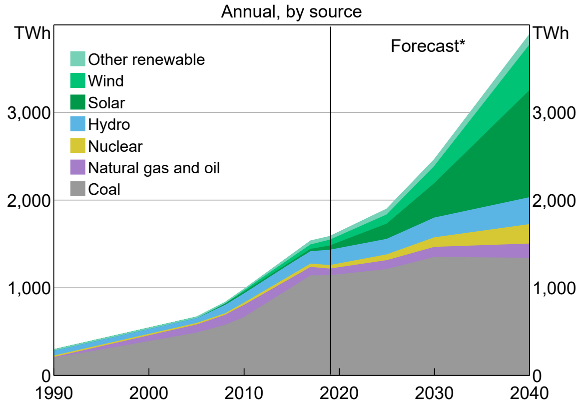
Conclusion

The outbreak of COVID-19 has been the largest shock to economic activity in India in at least 60 years. The current crisis will exacerbate pre-existing vulnerabilities, including a lack of fiscal space and a high level of non-performing loans, and this could impede the pace of the near-term recovery. Nevertheless, India's economic outlook continues to be supported by a range of favourable structural factors, including a growing working-age population and prospects for continued urbanisation, which should support the outlook for some Australian exports, including education and coking coal. The outlook for other resource exports such as iron ore and thermal coal, which have in the

Graph 13

India – Electricity Generation

Annual, by source



* Stated policies scenario

Source: International Energy Agency (2020) past been key exports to some fast-growing east Asian economies, is not as encouraging given the stronger prospects for self-sufficiency in these commodities. As a result, India is likely to remain an important trading partner for Australia, but growth in exports of the kind experienced with China in the past few decades seems unlikely. ✠

Footnotes

[*] Zan Fairweather is from Economic Analysis Department and Maxwell Sutton is from International Department. The authors extend their sincere thanks to Lea Jurkovic, who provided substantive analysis in the earlier stages of this work.

[1] For further details, see RBA (2020).

[2] Between March and November, the Indian Government announced its fiscal response to the crisis in 3 phases. In March, India introduced a support package to bolster the healthcare system and provide free food grains and cash transfers to India's most vulnerable citizens, many of whom faced a sudden loss of income with a limited safety net during the initial lockdown. In May, small and medium enterprises were offered government-guaranteed loans and equity injections to support their cash flows amid steep falls in revenue during lockdowns. Once most of the country had moved out of lockdown by October, the government also announced further stimulus measures including consumption vouchers and increased infrastructure spending targets to support the recovery.

[3] For further detail on India's long-run growth fundamentals, see Ma and Roberts (2018).

[4] In the past 2 decades, India's labour force participation rate has declined significantly and is particularly low for women relative to other Asian countries. As a result, the rapid growth in India's working-age population has not led to equally rapid growth in the size of the labour force. Part of this can be explained by higher enrolment of young women in education, which can reduce labour force participation in the short run but increase it in the longer run if the labour market is able to provide sufficient opportunities for educated women (Das *et al* 2015; Verick 2014).

[5] The RBI has established 2 schemes to provide foreign investors with additional access to its government bond market, which have so far generated moderate investment flows. The Indian Government has also recently pushed for its bonds to be included in international bond indices, which some market analysts estimate could generate portfolio inflows to India of around INR 1½ trillion (Sircar 2020). However, meeting the inclusion criteria would require removing some capital controls and maintaining or improving India's sovereign credit rating.

[6] Prior to the crisis, significant stocks of non-performing assets (NPAs) had weighed on public sector banks' ability to efficiently allocate credit, contributing to slower economic growth (RBA 2020). Indian banks' NPA ratios improved at the start of 2020; however, this largely reflects substantial capital injections from the Indian Government and the loan repayment moratorium, which has allowed banks to delay recognition of non-performing loans until the moratorium ends (RBI 2020a; Moody's Investors Service 2020).

[7] Like many countries, including Australia, India requires banks to hold a minimum amount of funds (known as capital) relative to their loans to absorb losses if banks' borrowers default on their loans.

[8] Some market analysts expect that the Indian Government may need to provide PSBs with further capital injections, equivalent to 0.25–0.9 per cent of GDP, before the PSBs can meaningfully contribute to credit growth (Moody's Investors Service 2020; Fitch Ratings 2020).

[9] An exception is the decline in education exports between 2009 and 2012, following widespread media coverage of incidents of violence against Indians, including students, living in Australia. Other factors may have included a tightening in visa rules and the global financial crisis.

[10] For further details on how travel restrictions associated with the COVID-19 pandemic affected Australia's education exports, see (Grozinger and Parsons 2020).

[11] The NEP proposes allowing satellite campuses of top foreign universities in India for the first time. Given Australia has 7 universities in the top 100, this change could be positive for linkages between India and Australia and increase the visibility of Australian universities. However, the direct impact on education exports will be much smaller from Indian students at Australian satellite campuses as fees may be regulated at lower levels and Australia will not be exporting 'living expenses', which are a significant component of total education exports.

[12] India's urbanisation is likely to be less steel intensive than China's, as height restrictions in Indian cities favour less steel intensive low-rise urban sprawl over high-rise buildings.

[13] In 2018/19 India produced 40 million tonnes (Mt) of coking coal, around 5 Mt of which is suitable for steelmaking after being washed. Over the same period, India imported 51 Mt of coking coal, including 37 Mt from Australia.

[14] India produced 205 Mt of iron ore in 2018, making it the world's third-largest producer behind Australia and Brazil. With small import and export volumes relative to production, it is also mostly self-sufficient.

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