India: A review of Modi's term ahead of the general election

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Narendra Modi's term as India's prime minister has been broadly positive economically. In the last five years, he has pushed through some important reforms, taking advantage of his majority in the lower house of Parliament. However, to achieve a significant increase in GDP per-capita and reduce India's vulnerability to external shocks, it is necessary to carry out further reforms in order to create a more conducive environment for domestic and foreign investment. The latest polls suggest that no party could win a majority in the lower house of Parliament in the general election scheduled for April and May. Mr Modi's party still looks likely to win the most seats, but could be forced to govern alongside the Congress Party. That could make it harder to implement reform and weaken the public finances.

Five years after Narendra Modi came to power and ahead of the general election due to take place on 11 April and 19 May, India is in a better place economically than it was in 2014.

Economic growth has remained robust in the last five years. It has been accompanied by rising real incomes, which has reduced poverty although it still remains prevalent.

The government's finances have strengthened because of efforts to streamline public spending and the 2017 introduction of a Goods and Services Tax (GST) common to all states. In the medium term, the GST should broaden the tax base and make India more competitive, even though it has fallen short of its targets so far.

The restructuring of the banking sector, although incomplete, has been helped by the introduction of the Insolvency and Bankruptcy Code in 2016. In addition, loan growth has accelerated significantly after slowing for two years, although public-sector banks remain fragile.

Finally, India has shored up its external position compared with 2013. However, despite a substantial improvement in the business environment, foreign direct investment inflows are still not strong enough to make India less vulnerable to external shocks and to support its potential growth.

The new government's main challenge will be to boost growth in ways that are more beneficial to the whole population. Although the poverty rate has fallen, India's GDP per capita remains much lower than that of other Asian countries. The next government must create an economic, financial, tax and institutional environment that is more conducive to domestic and foreign investment. To achieve that, it will have to continue reforms to further improve the business environment, particularly in terms of governance, education, labour market deregulation and land acquisition. The lack of investment is dragging down growth and job creation and making the country more vulnerable to external shocks. India will also need to shore up its public finances further to free up enough budget resources to allow increased government investment.

Growth is still concentrated in the service sector

India's economy has grown at an average rate of 7.5% per year in the last five years, the highest of any Asian country. However, not all of the population is seeing enough benefit from that growth. GDP per capita has risen at an annual rate of 6.2% in real terms in the last five years but remains low (USD 2,011 in 2018), and India is much less developed than other Asian countries. By comparison, China's per-capita real GDP growth averaged 9.7% between 2000 and 2010, before gradually slowing to 6.1% in 2018. In 2017, China's GDP per capita at purchasing power parity was 2.4 times higher than India's, Indonesia's 1.7 times higher and that of the Philippines 1.2 times higher. India's figure is slightly higher than Vietnam's, however. According to the UN's latest Human Development Report, India ranked 130th out of 188 countries in 2017, 14 places lower than Vietnam. The poverty rate remained high at 28% – equating to 364 million people below the poverty line – although it had fallen sharply in the previous 10 years.

Asia: real GDP growth

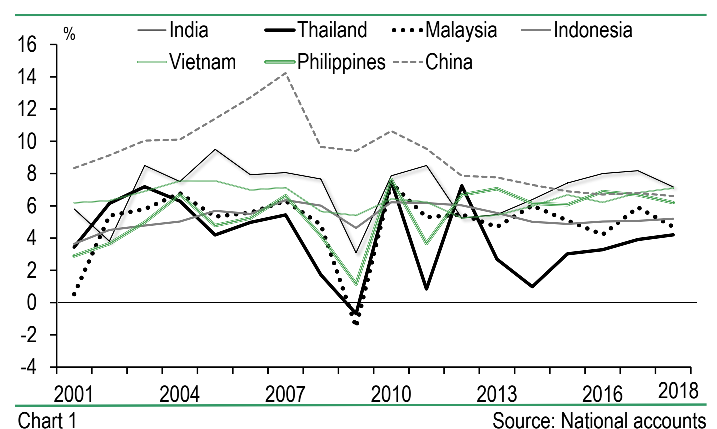

Chart 1 Source: National accounts

Asia: GDP per capita at purchasing power parity (PPP)

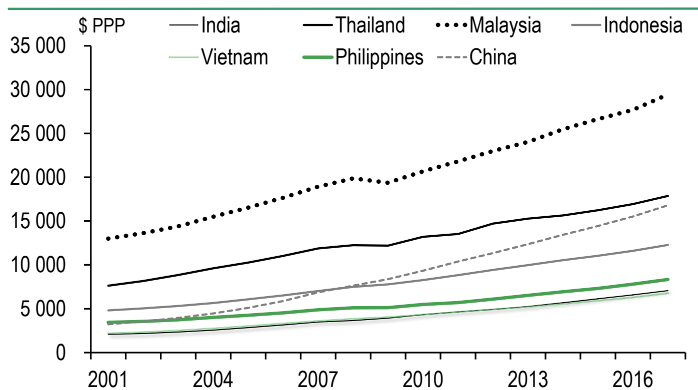

Chart 2 Source: IMF

When the Modi government came to power in 2014, on a platform of achieving growth of 10% per year, it intended to use the Chinese economic model, attracting foreign investment in order to develop its manufacturing sector. To date, however, the results have been mixed. Although India has increased its share of export markets, its manufacturing sector is still not sufficiently well developed to create jobs on a massive scale and thus increase Indians' living standards.

Structure of Indian growth

To increase its growth potential, a country can take action in three areas: capital, labour and technical progress. In its most recent report, the World Bank estimated India's potential growth rate at 7% and took the view that, to achieve growth of 8%, the country needed to increase both private- and public-sector investment.

Insufficient investment

Investment in India is insufficient. Investment as a proportion of GDP has been 32% in the last five years versus 45% in China. This lack of investment is due to three factors:

- The business environment which, although it has improved significantly, remains a brake on investment decisions.
- The debt reduction efforts made by Indian companies between 2014 and 2017.
- The fiscal base, which is too small for the government to have the resources to finance investments. In the last five years, government investment has remained very modest, averaging 1.7% of GDP per year, 0.1 points lower than in the 2008-2012 period.
- Foreign investment remains insufficient. Despite the improvement in the business environment and the fact that the Indian market has been more open to foreign investment since Mr Modi came to power, the stock of FDI in India to-GDP-ratio rose only 0.8 points in five years, reaching 14.3% in 2018. India's FDI inflows averaged 2% of GDP per year between 2007 and 2017, just over half the level achieved by China between 2000 and 2010 (3.8% of GDP).

Job creation insufficient and concentrated in low-productivity sectors

Although labour is abundant in India, the pace of job creation remains far too slow compared with the growth in the labour force: it is estimated that 6 million jobs were created per year in Mr Modi's term of office as opposed to his promise of 10 million. The situation in the labour market appears to have deteriorated in the last 10 years. According to the International Labour Organisation (ILO), the unemployment rate was 3.5% in 2017, an increase of 1.4 points over the previous 10 years. Among young people, unemployment was even above 10%. According to the highly controversial report published by India's National Sample Survey Office, the unemployment rate hit a new high of 6.5% in 2017/18. Finally, the Centre for Monitoring Indian Economic (CMIE) calculated an unemployment rate of 7.2% and a participation rate of 42.7% in February 2019.

Although India's education rate is rising, it remains lower than that of other Asian countries, including Vietnam. Informal employment accounts for most jobs (81% according to the ILO). One of Mr Modi's aims, before taking office in 2014, was to deregulate the labour market, making it easier for companies to fire workers and thus reduce informal employment. However no such reforms have been adopted during his term.

Employment remains concentrated in low-productivity sectors. In 2016, 46.6%[1] of jobs were in the primary sector, which generated only 17.2% of the country's GDP in fiscal year (FY)[2] 2017/18. The proportion of jobs in the service sector, although steadily rising, remains low (30.3% in 2016), whereas services generated 53.5% of India's GDP in FY2017/18. Despite the government's goal to develop industry and particularly manufacturing ("Made in India"), that sector's share of GDP has remained relative stable in the last five years (16.4% in FY2017/18) and has even fallen by 2 points compared with 2007/08. The manufacturing sector's share of employment, despite rising since 2010, was still low at 12.8% in 2016 according to the Asian Productivity Organisation.

The manufacturing sector is struggling to grow

Overall, in the last 10 years, growth in the manufacturing sector has remained weak, averaging 1.3% per year. Services, meanwhile, have seen a sharp acceleration, with average growth of 4.1% per year. Manufacturing's share of GDP has fallen by 3.3 points to 29.3%, although the government expects that to recover to 29.8% in FY2018/19. Nevertheless, we can see that the trend turned after Mr Modi came to power. Since FY2014/15, activity in the manufacturing sector has strengthened a little. Analysing the breakdown of value added in the manufacturing sector, we see that the proportion of activity in the machinery and capital goods industries has remained stable at 3.8%, the same as the textile industry.

However, India shows limited integration within the global trade system. Its goods exports accounted for less than 19% of its GDP in 2018, a figure that has fallen constantly since 2013/14, as opposed to 97% in Vietnam. India's global value chain participation rate is one of the lowest

[1] Employment figures published by the Asian Productivity Organisation (APO) in September 2018.
[2] Fiscal year from April 1st to March 31st.

in Asia, estimated by UNCTAD to be at 42% in 2017 as opposed to 50% in Indonesia, 51% in Vietnam, 62% in China and 64% in Malaysia.

India: growth in value added by sector

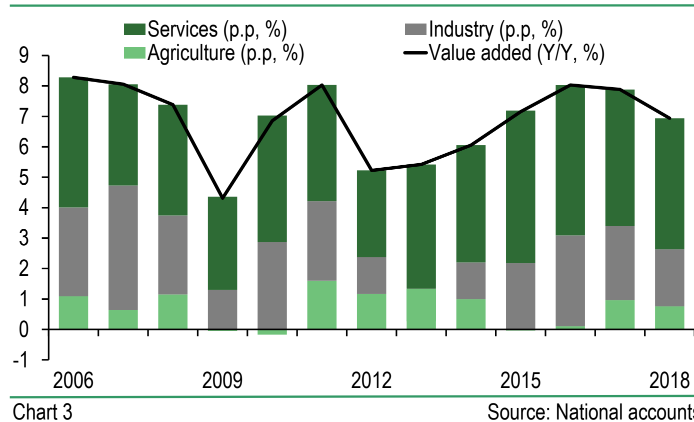

Chart 3 Source: National accounts

India has managed to grow its share of export markets, accounting for 1.7% of global trade in 2017 versus 1% in 2007. That increase reflects higher prices of primary and processed products, but also a slightly higher market share in unprocessed manufactured products.

Excluding manufactured products made by processing basic commodities, India's share of global manufactured product exports rose 0.6 points to 1.4% in 2017 as opposed to 0.8% ten years earlier. The areas in which India's export market share has increased the most in the last 10 years have been textiles, automobiles and to a lesser extent mechanical intermediate goods. However, most of the improvement took place between 2007 and 2013. India's export market shares have risen only very slightly since then, and has even fallen in the textile industry in the face of competition from other Asian countries.

Foreign direct investment remains insufficient in the manufacturing sector

Countries need foreign direct investment (FDI) to develop their manufacturing sectors. In the last five years, however, despite substantial improvements in the business environment and the Modi government's move to lift all constraints on foreign investment, foreign investment has remained modest in India and concentrated in services. According to the Reserve Bank of India's annual report, FDI in the manufacturing sector has averaged less than USD 9 bn per year in the last five years, equal to 30% of total investment and only 0.3% of GDP. By comparison, in 1995-2000 China attracted more than USD 31 bn of FDI per year on average in its secondary sector alone, equal to almost 2.5% of GDP.

Growth components

The Conference Board's analysis of growth components is instructive, although it does not take account of the most recent revisions of the national accounts carried out by India's national statistics office in late 2018. It shows in particular that the main drivers of Indian growth in 2013-2017 were capital and total factor productivity (TFP). Job creation accounted for only 13.5% of growth. The growth contribution of labour quality fell substantially between 2008-12 and 2013-17, to only 5.8%. India's low education levels are still a major problem.

Capital's contribution to Indian growth is substantial, but still insufficient. It also fell between 2008-12 and 2013-17 in tandem with debt reduction among Indian companies and efforts to clean up the public finances.

The increase in the TFP contribution reflects transfers of jobs from the least productive sectors to more productive ones. In the last five years, the proportion of jobs in the primary sector has fallen by around 5 percentage points, although it still remains too large given the sector's share of GDP.

INDIA	**2008-2012**	**2013-2017**
Growth (%)	**6.7**	**6.8**
Contribution of labour quantity	0.6	0.9
Contribution of labour quality	0.7	0.4
Total capital contribution	4.6	3.4
ICT capital contribution	*1.0*	*0.5*
Non-ICT capital contribution	*3.6*	*2.9*
Total factor productivity	0.8	2.0

CHINA	**2001-2010**
Growth (%)	**9.5**
Contribution of labour quantity	**0.4**
Contribution of labour quality	**0.3**
Total capital contribution	**4.9**
ICT capital contribution	*0.5*
Non-ICT capital contribution	*4.4*
Total factor productivity	**4.0**

Source: Conference Board, November 2018

Business environment considerably improved

India's business environment has improved in the last five years in terms of governance, ease of doing business, openness to foreigners and corruption. However, India remains less competitive than the ASEAN countries (excluding Vietnam).

According to the latest international "Ease of Doing Business" league table, India ranked 77th out of 188 countries – a rise of 55 places in five years – and was ahead of the Philippines but behind Indonesia and Vietnam.

- According to the latest World Economic Forum competitiveness league table, India ranks 58th out of 140 countries, two places higher than five years ago. However, because the methodology was different, the rise in India's ranking was too small to suggest any real improvement, except as regards infrastructure quality. Trade barriers, the lack of efficiency in the labour market and low education levels are the main constraints. India ranks lower than Indonesia and the Philippines, but higher than Vietnam (77th).
- The quality of governance has improved, but remains limited. India ranked 107th out of 211 countries on this criterion in 2017, 24 places higher than five years previously.
- Corruption has fallen in the last five years due to the Modi government's adoption of measures to make the economy more digital. India ranked 78th out of 180 countries in 2018 (ahead of Indonesia, the Philippines, Thailand and Vietnam), six places better than in 2014.

To attract more foreign investment and support domestic investment, India therefore needs to continue improving its business environment, focusing on the factors stopping the labour market from operating efficiently, along with education, female access to education and work, and reductions in tariff barriers. The next government will also have to move forward with the land acquisition reform that the Modi government put on hold in 2015.

Shoring up the public finances: the fiscal base remains too small

India's public finances still do not provide the government with enough resources to finance public investment, although they have improved significantly.

In the last few years, the central government has reduced its deficit, particularly by trimming expenditure. However, the fiscal base remains small. The adoption of the Goods and Services Tax (GST) in July 2017 should broaden the tax base and indirectly make India more competitive, even though it has fallen short of its targets so far.

At the same time, the fiscal position of India's states has worsened. That is partly because some states have taken on debts owed by the poorest farmers through the "loan waiver scheme", and partly because debts owed by public electricity companies have been restructured through the "Uday scheme".

While central government debt has fallen, debt owed by India's states has risen, causing public-sector debt as a whole to rise slightly to 67.6% of GDP in FY2017/18[3] as opposed to 67.1% of GDP in FY2013/14.

Currently, refinancing risk is moderate since public debt is almost exclusively held by domestic agents, is denominated in local currency and has a long maturity. However, interest expenses remain high and severely constrain India's investment capability.

Asia: governance indicators range from -2.5 (weak) to +2.5 (strong)

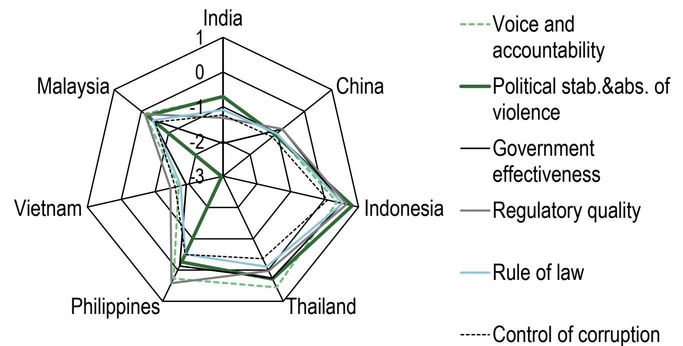

Chart 4A Source: World Bank

Asia: ease of doing business ranking among 188 countries

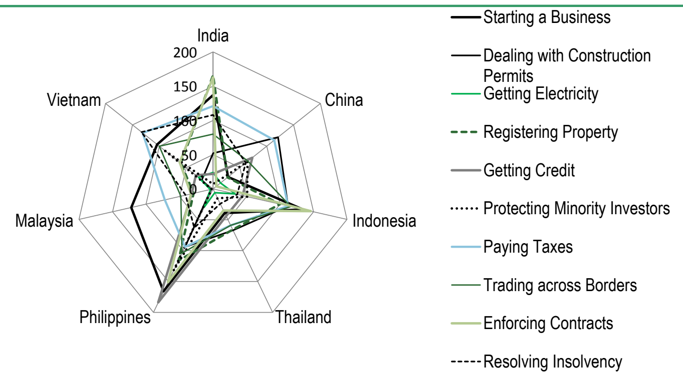

Chart 4B Source: World Bank

Lower spending behind the improvement in public finances

The central government deficit was 3.5% of GDP in FY2017/18, and the MoF expects that to fall to 3.4% in FY2018/19 (year ended 31 March 2019), from 4.5% in FY2013/14.

Until last year, the reduction in the central government deficit was mainly due to falling public spending, while the revenue-to-GDP ratio remained relatively stable. However, in FY2018/19, ahead of the general election, the government increased some types of spending to help India's poorest citizens, against a background of slightly rising government revenue caused by higher income from the Goods and Services Tax.

In the last five years, India's government spending as a proportion of GDP has fallen by 1 point, coming in at 12.9% in FY2018/19.

- The decline in public spending was due in particular to lower subsidies, which fell by 0.7 points to 1.6% of GDP in FY2018/19.

[3] Calculations based on new GDP series.

- The sharpest drop was in fuel subsidies (down 0.6 points). Continuing the previous government's policy, the MoF gradually deregulated petrol and fuel oil prices until mid-2018[4].
- Subsidies remain focused on food products, rising 0.3 points to 0.9% of GDP in FY2018/19.

The reduction in overall subsidies has reduced some of India's core expenditure. However, subsidies make India's government less able to deal with economic shocks and invest in infrastructure. Interest expenses amounted to 3.1% of GDP in FY2018/19, equal to 32% of government revenue according to MoF estimates.

The fiscal base remains small

In the last five years, India's fiscal base has remained very small. According to initial government estimates, central government revenue amounted to 9.1% of GDP in FY2018/19, only 0.1 point higher than five years previously. By comparison, government revenue in Indonesia (among the lowest in Asia) was 13.1% of GDP in 2018, and in Vietnam it was around 23% of GDP according to the IMF.

However, India's disappointing figure hides a slightly more nuanced picture. Gross tax revenue equalled 11.9% of GDP in FY2018/19, up from 10.1% five years previously. GST revenue, which has risen to 3.4% of GDP, equals 0.8 points of GDP. Direct taxes levied on businesses remained stable at 3.5% of GDP, those on households rose by 0.7 points to 2.8% of GDP[5], while revenue from customs tariffs fell 0.8 points.

Since its introduction in July 2017, GST receipts have remained lower than the MoF's targets, and the shortfall was 0.6 points of GDP in FY2018/19. Since July 2017, the list of GST exemptions has grown ever longer. Exemptions relate to the type of goods and services subject to the tax, but also the companies that have to pay it. In particular, currently, they concern small and medium-sized companies with annual revenue of less than INR 4 m.

Decline in central government debt

In the last five years, government debt as a proportion of GDP has fallen by 3.4 points, amounting to 49.1% in FY2017/18[6]. The MoF estimates that the figure fell to 47.8% at the end of FY2018/19.

The structure of India's government debt is fairly healthy. There is very little risk of the debt burden rising because of a devaluation in the rupee, because foreign-currency debt equalled less than 3% of GDP at end-2018. Refinancing risk is moderate, since the average maturity of debt is 10.4 years. Only 3% of debt securities are due to mature in the next year (the equivalent of USD 22 bn). Moreover, as 93% of debt is held by domestic agents, India is relatively well protected against increased international volatility. Commercial banks are the main holders of government bonds (40.5% at end-December 2018), followed by insurance companies (24.6%), the central bank (13.8%) and pension funds (5.5%). The central government's external debt (2.8% of GDP at end-2018) is on concessional terms.

India: central government public finances

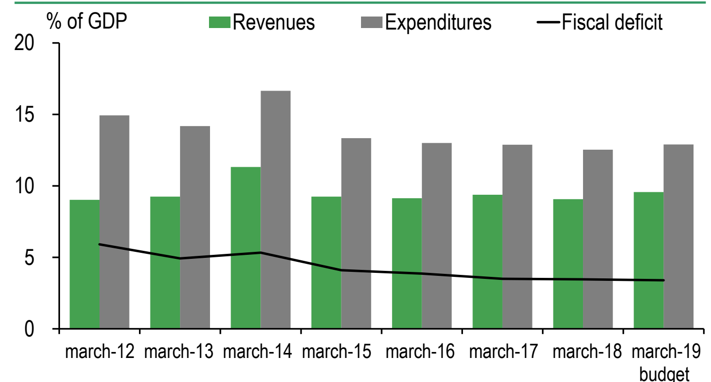

Chart 5A Source: RBI

India: general government deficit

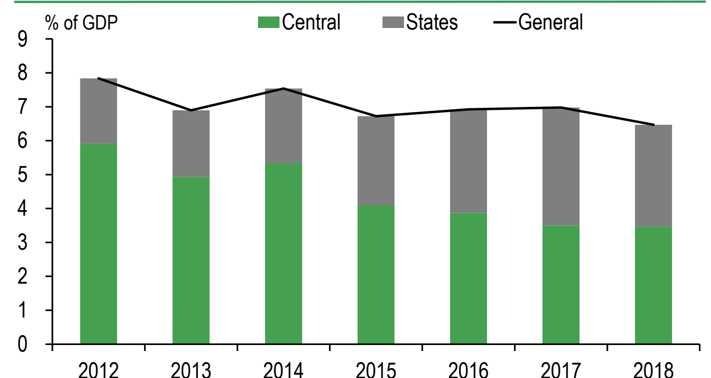

Chart 5B Source: RBI

India: public debt

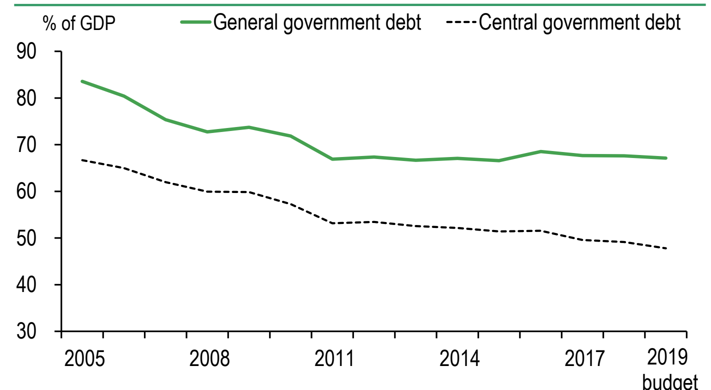

Chart 5C Source: RBI

[4] In October 2018, fuel oil prices were cut to reduce pressure on household real incomes in the pre-election period.
[5] A better managed tax system has substantially increased the number of people paying income tax.
[6] Data based on the new GDP series published by India's CSO in January 2019.

Rising debts among India's states

Unlike the central government, India's states have not managed to improve their finances. Their overall deficit as a percentage of GDP doubled between FY2011/12 and FY2016/17, reaching 3.5%. That deterioration stopped last year, with the deficit falling to 3.0% of GDP in FY2017/18. However, the states' debt has continued to grow and equalled an estimated 23.8% of GDP in FY2018/19.

The deterioration in the states' finances is mainly due to higher spending, caused by:

- The decision taken by some of them to take on some debts owed by the poorest farmers[7] through the "loan waiver scheme", costing an estimated 0.3% of GDP in FY2017/18;
- The decision to assume some debts owed by public electricity companies as part of their financial turnaround plan ("Uday scheme") in FY2015/16 and FY2016/17, costing 0.7% of GDP per year;
- Higher spending on wages and rent allowances, which make up almost 25% of the states' expenditure, applying the recommendations of the "7th Central Pay Commission";
- An increase in interest expense to 1.7% of GDP in FY2017/18 versus 1.5% of GDP five years earlier.

Difficulties in strengthening the banking and financial sector

The gradual deterioration in the financial position of India's public-sector banks between 2011 and 2018 has dragged down bank lending since 2016, and has also affected business investment. However, the Modi government and India's monetary authorities have introduced some major reforms to shore up the banking sector and enable it to support growth. The Insolvency and Bankruptcy Code, the recognition of no-performing loans and moves to recapitalise the weakest banks have allowed an upturn in lending since August 2018. However, the banking and financial sector remains fragile. Public-sector banks have been unable to raise the funds needed to comply with new Basel III solvency rules that came into force on 31 March 2019. As a result, although government expenditure on recapitalising public-sector banks has been modest (1% of GDP), it has been much higher than the initial targets announced in October 2017. Although India's public-sector banks are now more capable of meeting the economy's financing needs than they were three years ago, the quality of their assets remains poor and their governance is a concern. In addition, the interrelatedness between public-sector banks and non-bank financial institutions – whose share of lending has sharply increased in the last five years – is a growing source of risk.

One of Narendra Modi's ambitions was to tackle India's shadow economy and clean up the banking sector. To fight the black market, in November 2016 he took the unexpected decision to withdraw all 500- and 1,000-rupee notes from circulation. Today, it appears that 86% of India's money supply has been withdrawn as a result. However, the positive impact on the shadow economy seems highly debatable, because cash remains the main payment method.

Banking sector restructuring

In May 2016 India's parliament adopted the Insolvency and Bankruptcy Code, which is now the sole regulatory framework for resolving payment defaults, since all other procedures are no longer valid. Banks have only 180 days from the time of default to restructure bad loans of more than INR 20 bn. To speed up the resolution of bad debts, in 2018 the central bank lowered the threshold for lenders to reach agreement[8]. The central bank can intervene directly in the loan restructuring process, providing advice to struggling banks. Finally, to force banks to set aside more provisions to cover bad loans, since February 2018 the monetary authorities have required restructured loans and "special mention loans" to be regarded as non-performing.

India: non-performing loans in the banking sector

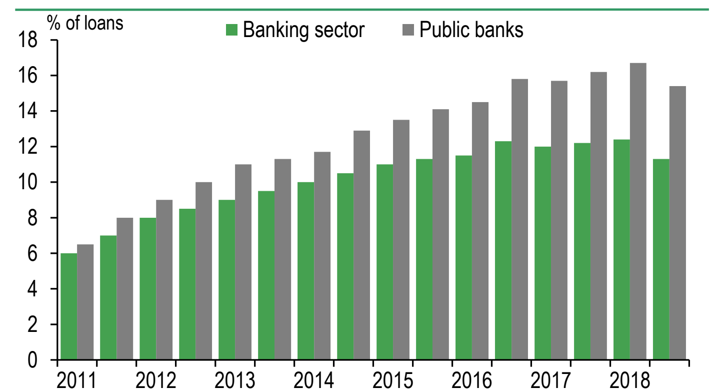

Chart 6 Source: RBI

Public-sector banks: a more stable situation

The financial position of banks, particularly public-sector banks, deteriorated sharply between 2011 and mid-2018 but has recovered since the second quarter of 2018. The NPL rate across the whole banking sector fell from 11.5% in Q2-2018 to 10.8% in Q3-2018 (14.8% for public-sector banks), and the proportion of loans deemed "risky" also fell from 12.4% in Q1-2018 to 11.3% in Q3-2018 (15.4% for public-sector banks). At the same time, the provision coverage rate rose to 52.4%, although this is still far too low. The solvency ratio across the whole banking sector was 13.7% in September 2018, falling to 11.3% for public-sector banks alone. In December 2018 the central bank took the view that nine public-sector banks would not achieve a 9% solvency ratio on 31 March 2019. The government had to inject more capital into them in early 2019. The wave of recapitalisations that have taken place

[7] Andhra Pradesh and Telangana were the first states to announce partial forgiveness of farmers' debts in 2014. In 2016, they were joined by Tamil Nadu, and in 2017 by Maharashtra, Uttar Pradesh and Punjab. In 2018, first Rajasthan and Karnataka, then Assam, Chhattisgarh and Madhya Pradesh took similar measures after elections at the end of the year.

[8] It is now enough to obtain the agreement of 50% of creditors owed 60% of the loan.

between 2017 and 2019 is estimated to have cost the government INR 1,960bn, equal to 1% of GDP.

India: credit growth

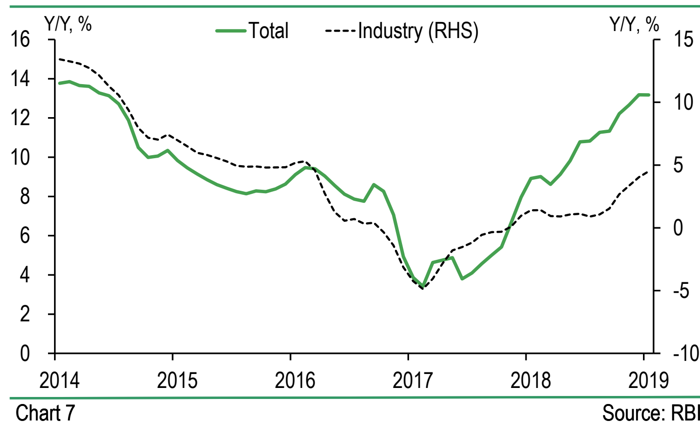

Chart 7 Source: RBI

Risks arising from the growth in shadow banking

The proportion of lending taking place through the shadow banking system has doubled in the last five years, due in particular to the problems experienced by public-sector banks. We define "shadow banking" as lending by non-bank institutions, which are mainly non banking financial companies (NBFCs) and housing finance companies[9] (HFCs). The proportion of commercial loans granted by NBFCs and HFCs was 18% and 8% respectively at end-September 2018, equal to 17% of GDP. In addition, 50% of lending to the real-estate sector was by NBFCs.

NBFCs are under the supervision of the monetary authorities and must comply with prudential rules regarding capital and bad loan provisions. However, they currently have no liquidity constraints.

Overall, their financial position has deteriorated since 2015, partly because their short-term debts have risen sharply, causing a major mismatch between their short-term assets and liabilities. In September 2018, this caused one of the largest NBFCs (Infrastructure Leasing & Financial Services) to default. However, for the sector as a whole and according to the latest report by India's central bank, it appears that:

- Their assets are less risky than those of commercial banks, because the central bank estimated their bad loan ratio to be 6.1% in September 2018.
- Although their solvency ratio has fallen by more than 5 points compared with 2015, it was still 21% in September 2018, higher than the regulatory minimum of 15%.
- NBFCs' profitability remains weak, with a RoA of 1.8% and a RoE of 4.4% at end-September 2018.

Shadow banking's growing market share is problematic because of its growing interrelatedness with the banking sector.

[9] According to the Credit Suisse report dated 12/12/2018, NBFCs and HFCs were behind almost 60% of debt financing other than bank loans (loans granted by NBFCs and HFCs and debt securities issued by companies).

Bank loans are one of the main sources of funding for NBFCs and HFCs, accounting for 47.2% and 41% of their funding respectively. However, the related systemic risk remains low because lending to NBFCs as a proportion of Indian banks' total loans outstanding rose was only 7% in December 2018. Indeed, the Indian authorities have encouraged banks to increase lending to non-financial companies. The aim is to help them access long-term funding in order to reduce the maturity mismatch between their assets and liabilities.

External vulnerability: lower than in 2013, but India is not attracting enough FDI

India is now less vulnerable to external shocks than it was in 2013. However, the country is not attracting enough FDI to speed up its development and make it less vulnerable to volatility in the international financial markets. In 2018, India's FDI stock equalled only 14.3% of GDP, versus 22.5% in Indonesia and 21.7% in China. India remains vulnerable to rises in oil prices (23% of its imports) and tensions in international capital markets. Lower FDI inflows in 2017 and 2018 compared with 2015-2016, has made India much more dependent on volatile capital flows to cover its current-account deficit, although India is less exposed to capital outflows than Indonesia or Malaysia. India has sufficient foreign exchange reserves to cover its short-term external financing needs.

Short-lived improvement between 2014 and 2016

Between 2014 and 2016, India's current-account deficit fell significantly, averaging 1.1% of GDP per year, having averaged 3.6% of GDP between 2010 and 2013. The improvement stemmed from a sharp fall in the trade deficit. India is an oil importer, and benefited from the fall in international oil prices.

FDI also increased sharply in 2015 and 2016, coinciding with the Modi government's move to lift investment constraints, averaging 2% of GDP per year as opposed to 1.6% of GDP per year between 2010 and 2013. For two consecutive years, therefore, net direct investment fully covered the current-account deficit, leading to a sharp rise in foreign exchange reserves, which equalled 1.7 times India's short-term external fincning needs in 2016.

Weaker external accounts since 2017

In 2018, India's external accounts worsened again as oil prices rose and as foreign investors became more risk-averse against a background of US monetary tightening.

India's FDI fell in 2017 and 2018 compared with 2015-16, and amounted to only 1.8% of GDP in 2018. It no longer covers India's current-account deficit, which as a proportion of GDP has risen 1.7 points since 2016 to 2.4% because of higher oil prices. This makes India vulnerable to a potential shock in the international capital markets. In 2018, India, along with Indonesia, was one of the Asian countries worst affected by the loss of investor confidence in emerging markets.

Capital has flowed out of India – with net portfolio investments falling by 1.4% of GDP in 2018 – and combined with the increase in the current-account deficit this caused a 9% fall in the rupee against the dollar and a USD 20bn fall in foreign exchange reserves. Nevertheless, foreign exchange reserves totalled more than USD 400 bn at end-March 2019 and remained comfortably enough to cover India's short-term external financing needs (1.3 times).

To make India less vulnerable to external shocks and support its growth, the next government will have to attract more foreign direct investment. The fall in foreign investment in the last two years (compared with 2015-16) is hard to explain. According to UNCTAD's latest report dating from mid-2018, FDI inflows into emerging Asian countries were broadly stable in 2017, and flows into Indonesia and Vietnam did not decline in 2017 and 2018[10].

India: balance of payments

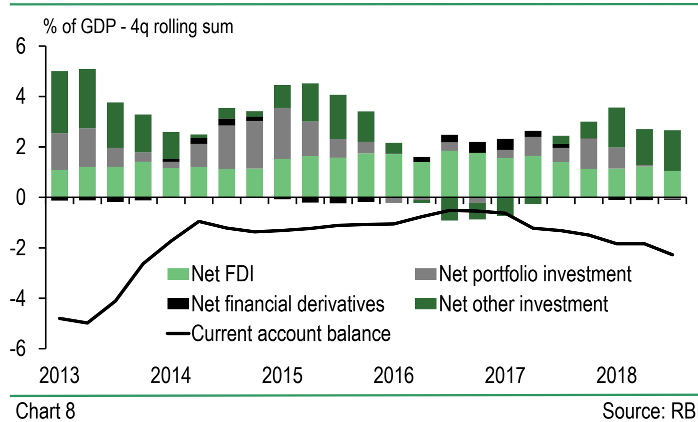

Chart 8 Source: RBI

Structure of external debt: moderate risk

India's external debt is fairly low and its structure shows moderate risk. At end-December 2018, it amounted to USD 521.2 bn, equal to only 19.2% of GDP, and more than 36% of it was denominated in rupees in Q3-2018. More than 37% of external debt consisted of securities issued by Indian companies ("external commercial borrowings") and deposits by non-residents (24% of debt). Government debt accounted for 20% of external debt.

Refinancing risks are moderate for India's external debt. At end-December 2018, the amount of debt due for repayment by December 2019[11] was USD 226.6 bn (43.5% of debt), representing 55.7% of currency reserves in March 2019. However, non-resident deposits are included in the amount "due" in less than one year. As a result, debts due to be repaid in less than one year, excluding non-resident deposits, amounted to a mere USD 136.5 bn, equal to only 33.5% of foreign exchange reserves.

India: short-term external financing needs

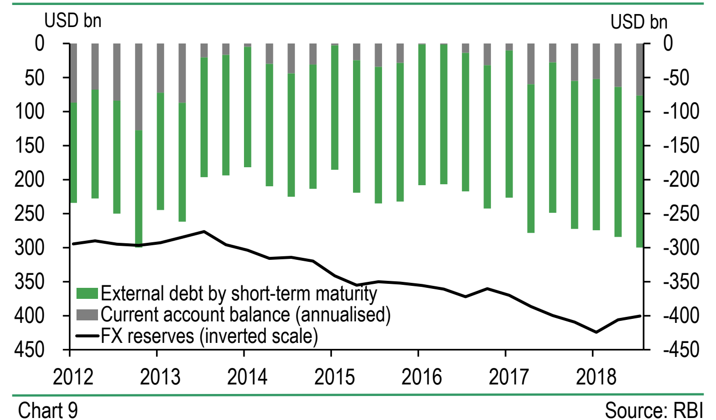

Chart 9 Source: RBI

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In the last five years, Narendra Modi's government has pushed through some important measures – the Insolvency and Bankruptcy Code, the Goods and Services Tax and greater openness to foreign investment – taking advantage of its majority in the lower house of parliament. However, to achieve a significant increase in GDP per capita and reduce India's vulnerability to external shocks, the new government due to be elected on 23 May 2019 will have to go even further with its reforms to create an environment that is more conducive to domestic and foreign investment.

The government's room for manoeuvre in the next five years will depend on the result of general election.

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[10] For those two countries, FDI also remained stable in 2018 (figures up to the first half in Vietnam's case).
[11] Short-, medium- and long-term debt repayable in less than one year.

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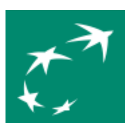

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