



India: Make or break

The cyclical recovery will be short-lived without structural reforms.

- **India's economic fundamentals have weakened over the last four years, leaving the country with slowing growth, sticky inflation and large fiscal and current account deficits. The "2Gs" – government and governance deficits – are the root cause, in our view, while rising oil prices and weak global growth have not helped.**
- **India's economy is not short of potential, but its potential growth rate could fall further if the government fails to reduce the fiscal deficit and fails to pursue structural reforms to open crippling supply-side bottlenecks.**
- **Monetary policy easing on its own is not the solution, as lower interest rates would fuel consumption demand, worsening the demand-supply imbalance, thereby exacerbating inflation and the current account deficit.**
- **Against a backdrop of global deleveraging, high commodity prices, a structurally large fiscal deficit and high inflation, we believe GDP growth will average 7.0-7.5% pa in the next few years, compared with 8.5-9.0% before 2008.**
- **It is now make or break time for the government. Since 2008, real investment growth has averaged a lacklustre 6% pa. If maintained, we estimate that potential growth could slip below 7%.**

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

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Executive summary

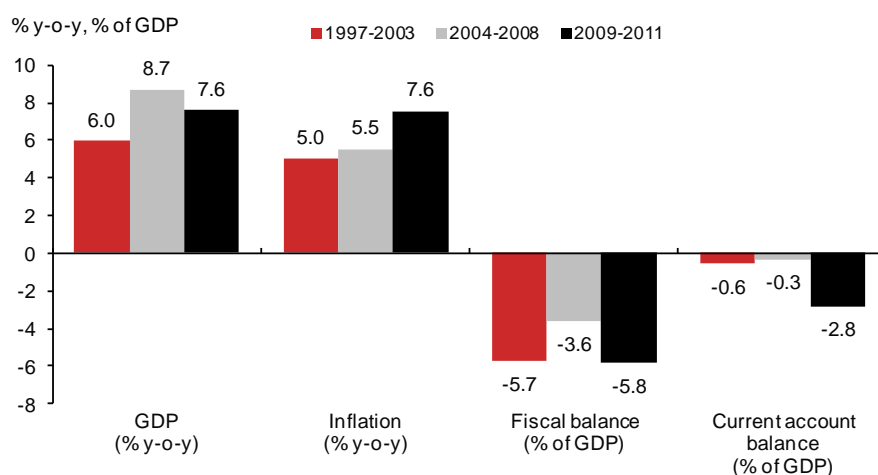
- We have a positive short-run cyclical view on India's economy: growth has bottomed, there are nascent signs of recovery and core inflation pressures should remain contained. However, policymakers flip-flopping on reforms and a widening consumption-investment gap have weakened the economy's fundamentals over the last four years.
- Rising oil prices and weak global growth are partly responsible. However, we believe much of the blame lies with 1) the government's gaping structural fiscal deficit which is the result of a rising subsidy bill; and 2) a governance deficit, evidenced by slow decision making due to scandals and back-tracking on reforms from the increased bargaining power of regional political parties.
- We believe that the 2Gs – government and governance deficits – are the root cause of many of India's economic problems, fuelling inflation, lowering the savings rate, crowding out private investment and widening the current account deficit by fuelling consumption – all of which are having the effect of retarding India's growth potential.
- We estimate that India's potential GDP growth has fallen from close to 9% pre-2008 to around 7.5%. Our analysis shows that the fall in potential growth is the result of lower capital accumulation and declining total factor productivity – a measure of technological dynamism. Our model suggests that 45% of the decline in potential growth is attributable to weaker investment, 40% to weaker total factor productivity and 15% to weaker employment growth.
- Can this be reversed? India has huge potential. Consumption demand remains very strong due to rising per capita incomes in both rural and urban areas, while its investment deficit is sizeable. Whether this potential is realized depends on jump-starting investment, the keys to which are in the hands of the government.
- Piecemeal reforms may be implemented, but with general elections due in May 2014, it seems fast-tracking economic reforms or any serious effort to tackle the structural fiscal deficit is unlikely.
- Against a backdrop of global deleveraging, high global commodity prices, a weak domestic political climate, a structurally large fiscal deficit and high inflation, we believe that India's average growth will be 7.0-7.5% per annum over the next few years, compared to 8.5-9.0% during 2003-07. In the last four years, average real investment growth has been a lackluster 6% pa. If this rate of investment continues, then India's potential growth could slip below 7%.
- It is not that the economy cannot grow faster; rather it is becoming increasingly difficult to sustain stronger demand without running into supply-side bottlenecks. Without lowering the fiscal deficit, a high current account deficit and high inflation will force the Reserve Bank of India (RBI) to keep interest rates high. Without adequate investment to address the bottlenecks, any reduction in interest rates will only fuel consumption demand. As such, growth spurts will be inflationary and require tighter monetary policy.
- Today, India is at a crossroads. The worsening of fundamentals suggests that the economy is moving in the wrong direction. India's relative growth still continues to be one of the highest in Asia, but a number of other EM countries are catching up quickly and could further gain to India's detriment. Whether the economy grows at 6.5%, 7.5% or 8.5% over the coming years depends crucially on whether the government makes the right decisions – those that can kick-start investment. Only then will the RBI have the space to cut policy rates more aggressively, and only then will a positive investment climate rekindle animal spirits. We identify 10 major structural reforms that we believe are needed to unlock India's growth potential.

Macro imbalances have risen since 2008

We have a positive near-term cyclical view on India's economy. There are signs that economic activity is starting to stabilize. An improvement in global demand, lower inflation and interest rate cuts should support the nascent economic recovery (see [India: Four cyclical tailwinds to watch](#), 11 April 2012).

However, we believe that India's economic fundamentals have worsened over the last four years. Inflation has become sticky and the twin fiscal and current account deficits have ballooned, reversing all gains accrued over 2004-07 (Figure 1). The post-crisis growth spurt has proven to be illusory and the economy is settling into a lower growth trajectory. Not surprisingly, Standard & Poor's revised its outlook on India's sovereign credit rating to Negative from Stable on 25 April. It remains to be seen whether the government can institute the reforms necessary to return the economy to its previously higher trend growth path.

Fig. 1: India's rising macroeconomic imbalances



Source: CEIC and Nomura Global Economics.

The root cause: 2Gs – Government and Governance deficits

Rising oil prices and weak foreign demand are partly responsible for India's weak economic fundamentals. Potential growth, after all, has slowed in many developed and emerging market economies, including China. However, the damage is also self-inflicted through a structurally high fiscal deficit and a rising governance deficit.

The central government's fiscal deficit, which had narrowed to 2.5% of GDP in FY08 from 6.0% in FY02, reversed nearly all its gains and reverted to 5.9% in FY12 (Figure 2). The FY13 budget projects a fiscal deficit of 5.1% of GDP, but excluding the one-off asset sales¹, the consolidation appears insignificant, in our opinion. Much of this fiscal deterioration is structural (Figure 3).

Higher spending and lower revenues are both to blame, but the composition of spending is the bigger worry. The government's revenue expenditure, mainly spending on subsidies, interest and wage payments, has risen at the expense of falling capital expenditure (Figure 4). The inability to increase administered fuel and fertilizer (urea) prices has raised the cost of subsidies from about 1.4% of GDP in FY08² to 2.4% in FY12 (Figure 5). The government's flagship Food Security Act will further add to the food subsidy burden.

On the revenue front, general government (state and centre) tax revenues have slipped from a peak of 17.6% of GDP in FY08 to 16.1% in FY12. The cyclical slowdown in revenues following the global financial crisis should reverse with the 2 percentage point (pp) increases to both services tax and excise tax rates in the FY13

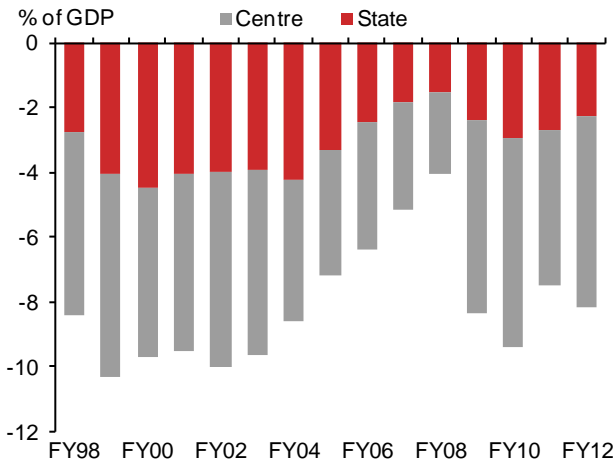
¹ Disinvestment and telecom spectrum auctions are projected to account for 0.7% of GDP in FY13.

² Subsidies were also off-budget during this period as the government compensated producers by issuing oil and fertilizer bonds.

budget. However, the crowding out of investment has hurt industrial activity and lowered excise tax collections from a peak of more than 3% of GDP to less than 2% now. We are relatively sanguine on revenues, since the introduction of the goods and service tax and the direct tax code will widen India's tax base. The tax revenue-to-GDP ratio has potential to expand, though uncertainty remains on the timing of their introduction.

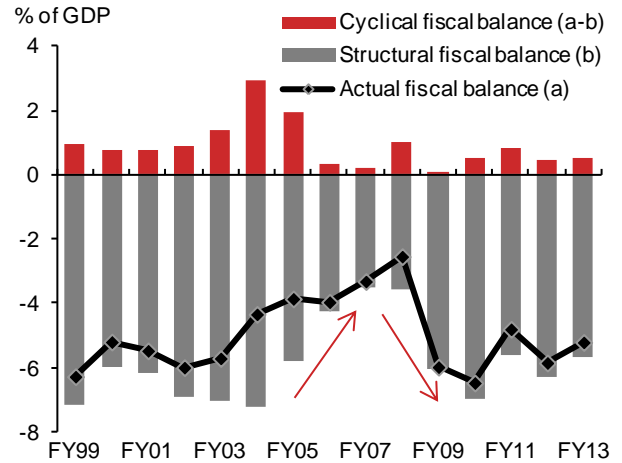
Meanwhile, the governance deficit has hurt the investment climate. Scandals over the last year have hurt the psyche of bureaucrats and slowed the decision-making process, while the rising bargaining power of regional parties has led to back-tracking on key economic reforms.

Fig. 2: General government fiscal balance



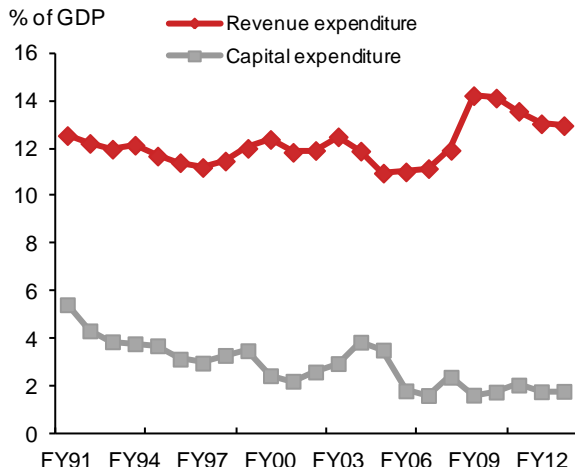
Source: CEIC, India budget and Nomura Global Economics.

Fig. 3: Central government's fiscal balance



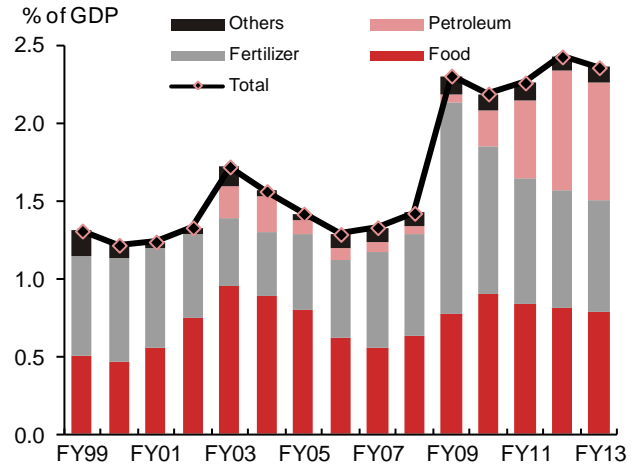
Source: CEIC, India budget and Nomura Global Economics.

Fig. 4: Government expenditure: revenue vs. capital



Source: CEIC, India budget and Nomura Global Economics.

Fig. 5: Central government's subsidy bill*



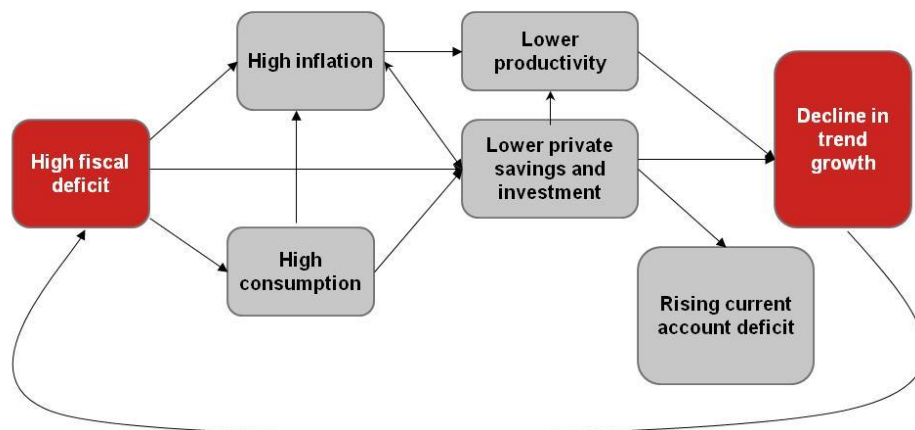
Note: Subsidies as shown in the budget. Off-budget subsidies are not captured here.

Source: CEIC, India budget and Nomura Global Economics.

How the fiscal deficit slows growth and sparks inflation: Four transmission channels

A higher fiscal deficit has worked through multiple channels to slow growth, accelerate inflation and worsen the external deficit (Figure 6).

Fig. 6: Reasons for India's structural weakness



Note: Global factors such as high commodity prices and slowing potential growth in developed economies are also responsible for high domestic inflation and slower growth. The above chart excludes that channel for simplicity.

Source: Nomura Global Economics.

Structurally higher inflation due to governmental policies

The larger fiscal deficit has fuelled inflationary pressures by widening the consumption-investment gap. Subsidized oil prices and an expansion in inclusive growth schemes (without augmenting investment) increased consumption demand to unsustainably high levels. Since the RBI responded to these demand-side inflationary pressures by tightening rates, the burden of adjustment has fallen disproportionately on investments, and more so on private investment, which is more efficient than public investment but is being crowded out by the large fiscal deficit.

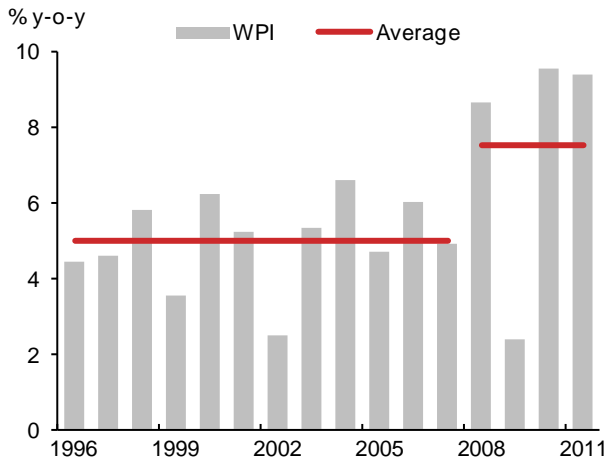
In the face of rising demand and limited production, a higher minimum support price (MSP) of food crops has fuelled food inflation. Demand is increasing faster now than during 2003-07 because the middle class is approaching the income threshold, at which demand for consumer durables and higher-protein food takes off. Since nearly half of the consumer basket is comprised of food prices, this has led to an unmooring of inflation expectations. Also, the rural employment guarantee scheme, where wage hikes are linked to CPI inflation, has set a floor on rural wages and exacerbated labour shortages. In the end, this has reinforced the wage-price spiral.

Not surprisingly, average wholesale price index (WPI) inflation has increased from close to 5% during the decade prior to 2008 to 7.0-7.5% post-2008 (Figure 7), with the majority of the increase due to higher food prices (Figure 8).

In the medium term, absent an increase in investment, we doubt that WPI inflation will fall sustainably below 6%. India's capital stock-to-GDP ratio at 1.79 in 2010, is one of the lowest in Asia (Figure 9). Plotting capital stock-to-GDP ratios against average CPI inflation rates for 2006-10 reveals that these two variables are negatively correlated, suggesting that persistently high inflation in India appears to be well-explained by the low investment rate (Figure 10).³

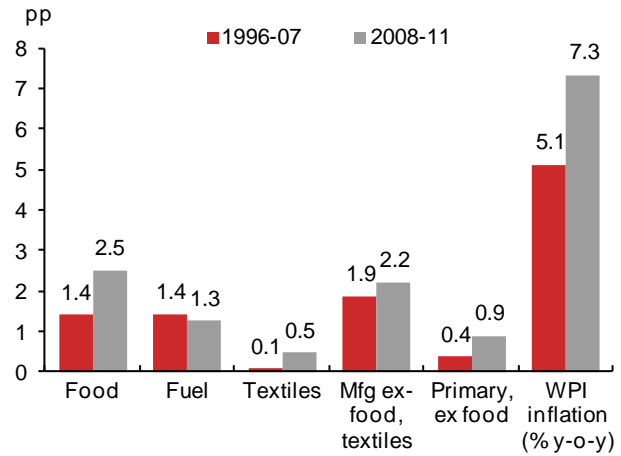
³ This draws on analysis by Tomo Kinoshita, See Asia Special Report: [Decoding India's structurally higher inflation](#), 16 January 2012.

Fig. 7: Trend in WPI inflation



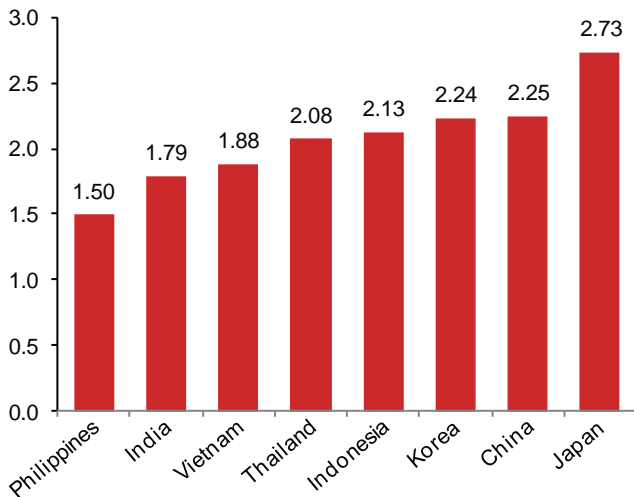
Source: CEIC and Nomura Global Economics.

Fig. 8: Contributions to WPI inflation



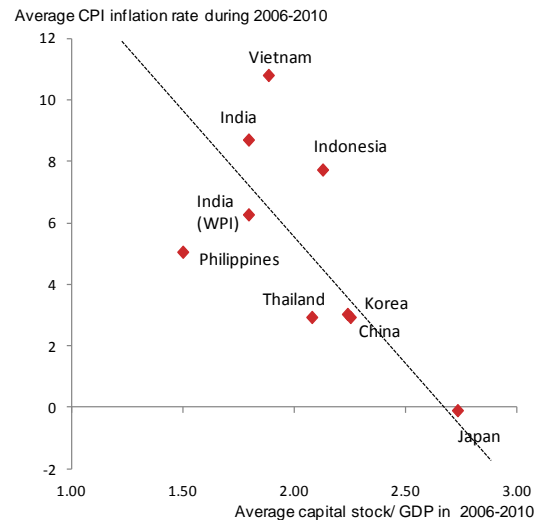
Source: CEIC and Nomura Global Economics.

Fig. 9: Capital stock-to-GDP ratio in 2010



Note: Nomura estimates except for Japan where government estimate is used.
Source: Asia Special Report: *Decoding India's structurally higher inflation*, 16 January 2012.

Fig. 10: Capital-stock-to-GDP ratio and core CPI inflation



Note: Due to lack of data, non-food price inflation figures have been used for India, China, HK, Singapore, Malaysia and Vietnam.
Source: Asia special report: *Decoding India's structurally higher inflation*, 16 January 2012.

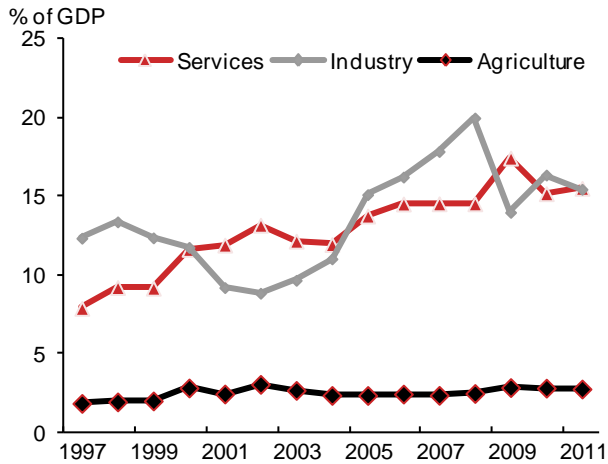
Falling investment capacity

Manufacturing investment, which was the main driver of capex during 2003-07 (Figure 11), has been crowded out by the rising cost of borrowing. Infrastructure investment has been held up due to a policy logjam in acquiring land and obtaining environmental clearances. Lower investment has also hurt productivity, due to the slower adoption of new technologies. As a result, investment has fallen from a peak of 38.1% of GDP in FY08 to 35.1% in FY11 (Figure 12).

The government has flip-flopped on policies and been noncommittal on reforms. For instance, the decision in November 2011 to allow Foreign direct investment (FDI) in multi-brand retail was reversed days after being implemented. The government is also retroactively looking at taxing cross-border deals and bringing in new general anti-tax-avoidance measures, which have increased investors' uncertainty over the taxation regime. Despite deregulating petrol prices, oil-marketing companies have not been allowed to raise petrol prices. All of this has hurt investor sentiment and diminished the pipeline of investment projects.

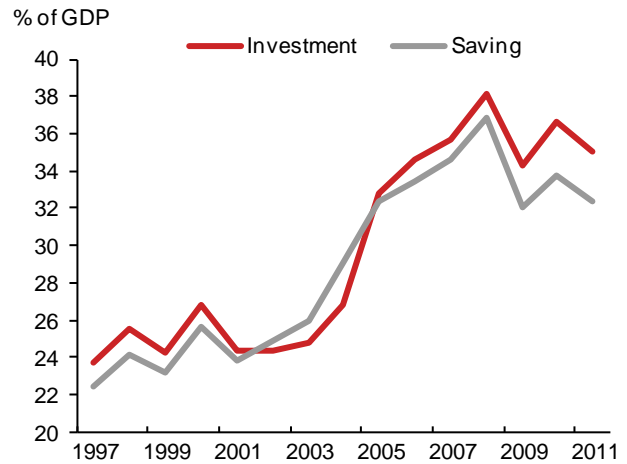
The sharp drop in both private and public capex is making it difficult to sustain growth, and there is a risk that this turns into a negative spiral. For instance, high interest rates keep investment subdued, which only exacerbates inflationary pressures. If inflation remains high, it is logical to expect interest rates to also remain high, which further deters investment. This spiral can be avoided only if contractionary fiscal policies (by lowering revenue expenditure) and an acceleration of the policy reform process creates adequate space for investment.

Fig. 11: Gross capital formation by sector



Source: CEIC and Nomura Global Economics.

Fig. 12: Investment- and savings-to-GDP ratio



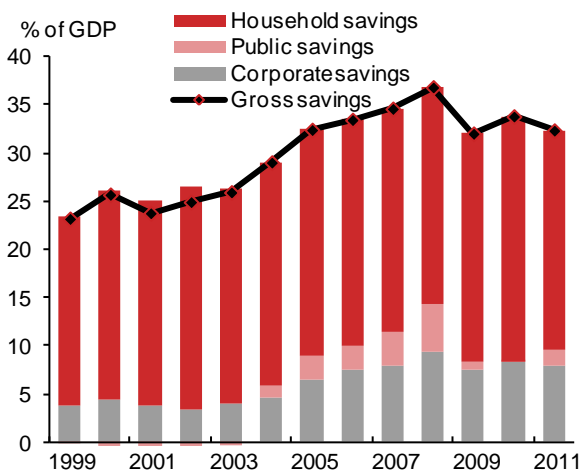
Source: CEIC and Nomura Global Economics.

The savings rate has fallen due to high inflation

A rising savings rate had been one of the foundations of India’s expanding potential growth rate. It has made investment financing sustainable due to an ample availability of domestic funding and reduced dependence on foreign capital. This cushion has slowly eroded. The gross domestic savings rate has fallen from 36.8% of GDP in FY08 to 32.3% in FY11 (Figure 13). While the rise in the central government’s fiscal deficit has reduced public savings, private corporate savings have also fallen due to a higher cost of production.

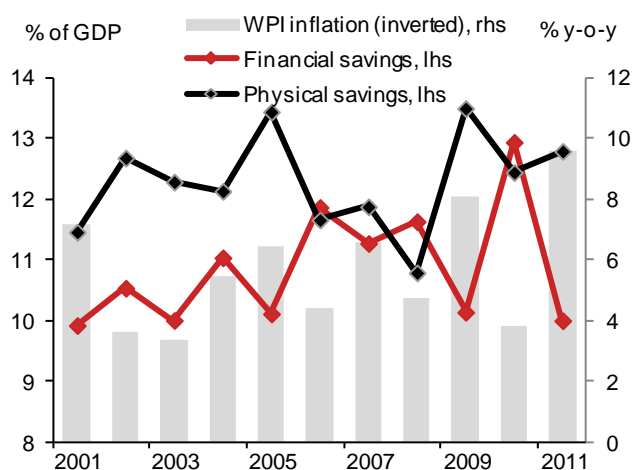
Overall, household saving has remained broadly unchanged, but its composition has physical savings trending up and financial savings falling, due to high inflation (Figure 14). Households have moved into physical assets as a hedge against inflation and trimmed their financial assets as the real rate of return has fallen. This shift in the composition of household saving (away from financial assets) does not bode well for sustaining growth, since it reduces the funds available to finance investment and blocks savings into non-productive assets such as gold.

Fig. 13: Gross domestic saving



Source: CEIC and Nomura Global Economics.

Fig. 14: Household saving: physical versus financial



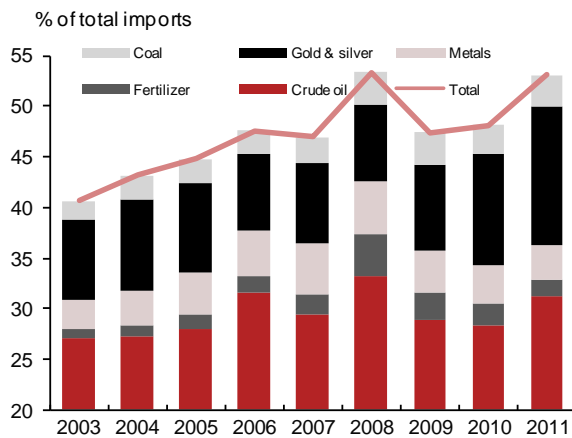
Source: CEIC and Nomura Global Economics.

A lower savings rate widens the current account deficit

India's current account deficit deteriorated because imports remained relatively robust while export growth slowed during the global slowdown. In our view, import demand was fuelled by four factors: 1) strong consumption demand was boosted by consumption-biased fiscal policies; 2) high inflation led to demand for gold imports⁴; 3) inelastic oil demand due to subsidized fuel prices (Figure 15); and 4) higher coal imports caused by delays in domestic production from slow environmental clearances (Figure 15). The national income identity suggests that a wider current account deficit reflects gross domestic saving falling much more than investment⁵ (Figure 16).

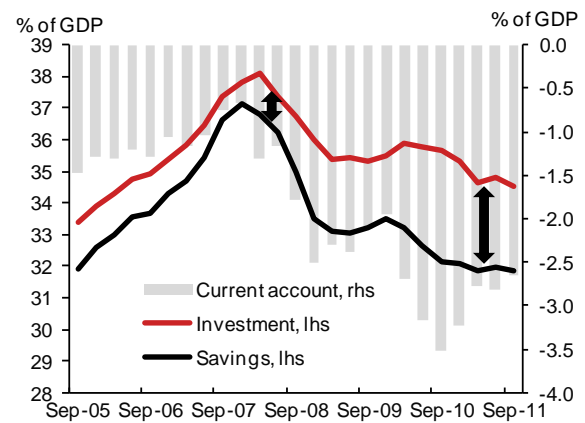
The need to finance a rising current account deficit has increased the economy's dependence on capital inflows (Figure 17). The basic balance of payments (BoP) deficit, defined as the current account plus net FDI inflows, has widened to levels last seen during the 1991 BoP crisis (Figure 18). While FX reserves provide a buffer against sudden capital outflows, their use is limited. First, domestic liquidity is already tight and USD sales by the RBI would lead to further INR liquidity shortages, which would need to be countered via open market operations and/or cash reserve ratio cuts. Second, as the RBI uses its FX reserves to defend INR, its medium-term FX vulnerability would increase as the reserve ratio worsens.

Fig. 15: India's major commodity imports



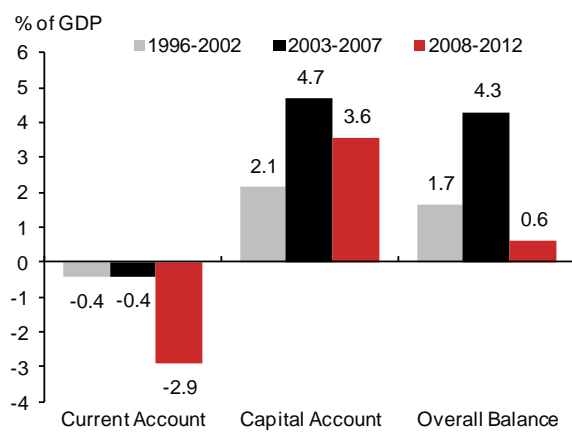
Source: CEIC and Nomura Global Economics.

Fig. 16: Savings, investment and current account



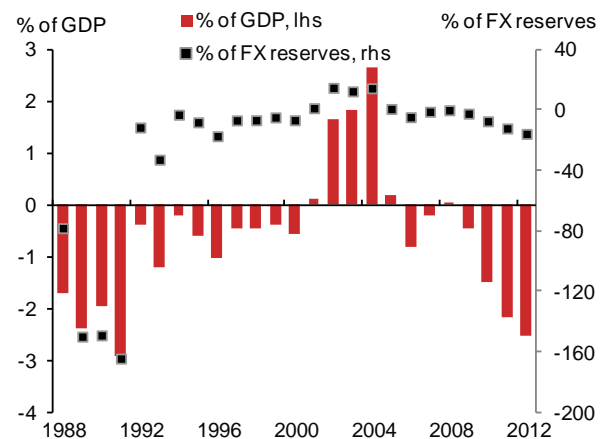
Source: CEIC and Nomura Global Economics.

Fig. 17: Components of balance of payments (BoP)



Note: Basic BoP = Current account balance + net FDI
Source: CEIC and Nomura Global Economics.

Fig. 18: Basic balance of payments balance



Source: CEIC and Nomura Global Economics.

⁴ More recently, gold imports have started to taper off. According to the World Gold Council, gold imports contracted 44% y-o-y in Q4 2011. In our view, this reflects some moderation in inflation expectations.

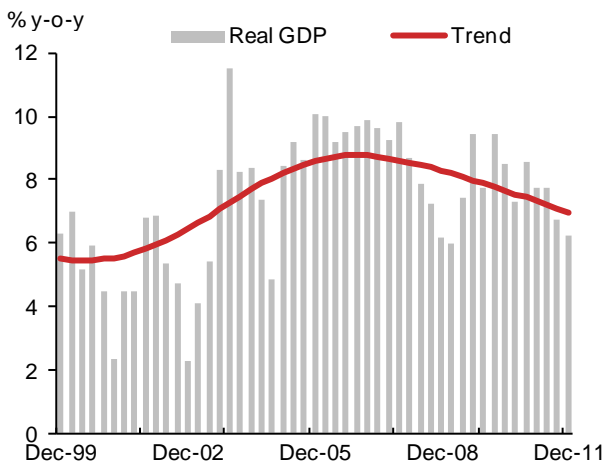
⁵ The identity is written as $(X-M) = (S-I) + (T-G)$, where X and M are exports and imports, S and I refer to savings and investment of the private sector and T and G are taxes and government spending. Therefore, a current account deficit means that either the private sector and/or the government has negative savings (i.e., it is investing more than it is saving).

Dissecting slowing growth potential

A slowdown in India's growth potential

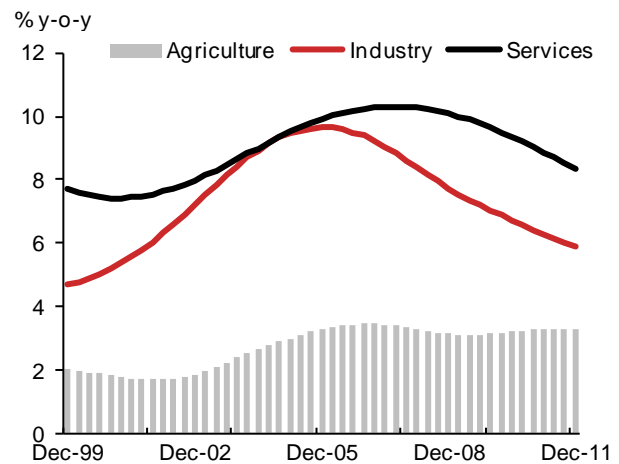
With most of the fundamental drivers of GDP growth worsening, it is not surprising that India's potential growth has fallen. The Hodrick-Prescott filter, a statistical method to filter out the cycle, suggests that India's trend growth fell from above 8.5% in 2006-07 to 7% by end-2011 (Figure 19). A look at the trend growth by sector shows that much of the slowdown is due to slowing growth in industrial production (Figure 20). Slackening industrial demand has also had a detrimental effect on the trend growth of the services sector. However, since services demand is largely consumption-driven, and consumption remains strong, the slowdown there has been marginal.

Fig. 19: Trend in India's overall GDP growth



Source: CEIC and Nomura Global Economics.

Fig. 20: Trend GDP growth by sub-sectors



Source: CEIC and Nomura Global Economics.

The growth accounting approach

The problem with statistical approaches is that they do not provide any insight on the reason for the slowdown in potential. Solow⁶ pioneered the growth accounting approach relating the level of output, Y, to the level of the employed labour force (L) and the stock of capital (K).

$$Y = AK^\alpha L^{1-\alpha} \tag{1}$$

'A' is the residual variable called total factor productivity (TFP) that explains growth beyond the traditional inputs of labour and capital. In other words, it captures the productivity gains from using labour and capital more efficiently through skill upgrades and technological advances. Research has shown that growth in TFP⁷ depends on infrastructure, capital intensity, human capital (health and education), the quality of institutions, policy environment and capital inflows (through FDI leading to technology sharing). α is the income share of capital, which we assume is 0.35 in line with standard literature. Solow assumed that a doubling of inputs leads to a doubling of output, and therefore, the sum of the share of labour and capital in income equals 1 (i.e., the production function exhibits constant returns to scale). By taking the differential of the natural logarithm, equation 1 can be re-written as:

$$y = a + \alpha k + (1 - \alpha)l \tag{2}$$

where the small case represents the time rate of change of the variables.

⁶ Solow, R. M. (1957), 'Technical Change and the Aggregate Production Function', *The Review of Economics and Statistics*, Vol. 39, No. 3 pp. 312-320.

⁷ Anders Isaksson, *Determinants of Total Factor Productivity: A literature review*, United Nations Industrial Development Organization (UNIDO), July 2007.

Explaining the slowdown in potential growth

The growth accounting approach, highlighted in equation 2, can help explain the slowdown in India's potential growth by breaking down estimated potential output growth into contributions from labour, capital and productivity (Figure 21).

Fig. 21: Contribution to growth

| Period | Real GDP (% CAGR) | Contribution to growth, pp | | | Contribution to growth, % | | |
|--------------------|----------------------|----------------------------|--------|-----|---------------------------|--------|------|
| | | Capital Stock | Labour | TFP | Capital Stock | Labour | TFP |
| Full sample | | | | | | | |
| FY81-FY12 | 6.2 | 2.1 | 1.1 | 3.1 | 34.1 | 17.1 | 48.9 |
| Sub-sample | | | | | | | |
| FY81-FY90 | 5.4 | 1.7 | 1.2 | 2.5 | 32.1 | 22.1 | 45.8 |
| FY90-FY03 | 5.4 | 1.9 | 1.3 | 2.2 | 35.7 | 23.0 | 41.3 |
| FY03-FY08 | 8.9 | 3.1 | 0.7 | 5.1 | 34.4 | 8.4 | 57.2 |
| FY08-FY12 | 7.6 | 2.5 | 0.6 | 4.5 | 32.9 | 7.4 | 59.7 |

Source: NSSO, UN, CEIC and Nomura Global Economics estimates.

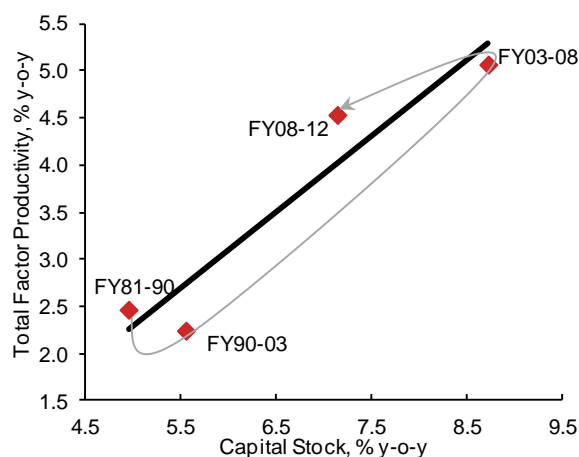
Our analysis shows that the fall in potential growth since 2008 is the result of lower capital accumulation and declining TFP. India's growth fell from an average 8.9% during FY03-08 to 7.6% in FY08-12. Of this 1.3 percentage point (pp) fall, lower investments accounted for 0.6pp (45%), lower employment growth, 0.2bp (15%), and lower productivity accounted for 0.5pp (40%) of the decline.

The employment contribution fell due to a larger retention of youth in education and lower labour force participation among working age women⁸. The higher cost of doing business and a higher cost of capital have led to slower growth in the capital stock. Meanwhile, we would link the slowdown in total factor productivity to the 2Gs – government and governance deficits.

We find that, historically, investment and TFP have been positively correlated (Figure 22). This is because India has a large population but a much lower capital stock-to-GDP ratio compared to some of its Asian peers, which suggests abundant labour and relatively scarce capital (Figure 23). Low capital stock per labour keeps the marginal productivity of labour low and of capital very high. In a capital-scarce economy, investment (additional capital) is used with the same technology and there is little incentive to innovate and hence improve productivity growth. Technical innovation and adoption of new technology, which are necessary to increase the productivity of labour and hence overall productivity, occurs at high levels of capital intensity. Further, a slowdown in the structural reform drive also discourages innovation, leading to a slowdown in TFP. In essence, investment and pro-growth reforms are the critical factor in augmenting potential output.

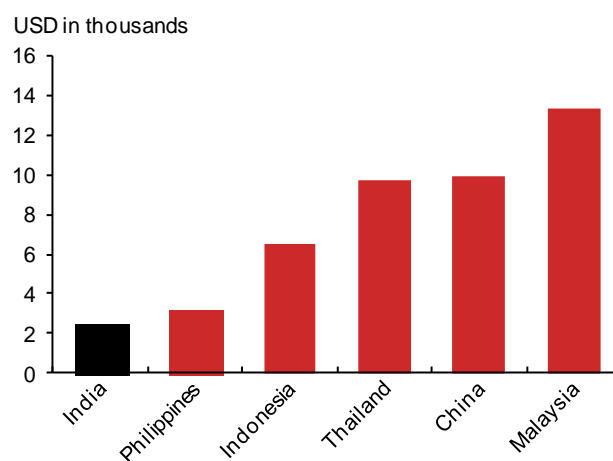
⁸ Page 307, Chapter 13: Human Development, *Economic Survey of India 2011-12*, Ministry of Finance, Government of India.

Fig. 22: Capital stock and TFP



Source: NSSO, CEIC, Nomura Global Economics.

Fig. 23: Capital stock/capita



Source: CEIC, World Bank and Nomura Global Economics.

Forecasting India's growth potential

We use the growth accounting framework to estimate India's potential growth over the next five years (Figure 24). Since investment holds the key to India's growth potential, we have simulated potential growth under different investment assumptions. Also, given the positive correlation between capital stock and TFP, we perform a linear regression analysis⁹ to estimate the growth in TFP at different levels of capital stock. For labour, we assume a steady rate of growth in the labour force at 1.6% pa, broadly based on the UN's population projections for India.

Fig. 24: Estimate of India's potential growth over the next five years

| Real investment (% CAGR) | Real GDP (% CAGR) | Contribution to growth, pp | | | Contribution to growth, % | | |
|--------------------------|-------------------|----------------------------|--------|-----|---------------------------|--------|------|
| | | Capital Stock | Labour | TFP | Capital Stock | Labour | TFP |
| 5% | 6.7 | 1.8 | 1.0 | 3.9 | 26.6 | 15.2 | 58.2 |
| 10% | 7.5 | 2.3 | 1.0 | 4.2 | 30.7 | 13.6 | 55.7 |
| 15% | 8.2 | 2.9 | 1.0 | 4.3 | 34.9 | 12.4 | 52.7 |
| 20% | 9.1 | 3.5 | 1.0 | 4.6 | 38.2 | 11.2 | 50.6 |

Source: NSSO, UN, CEIC and Nomura Global Economics estimates.

The results show India's potential GDP depends crucially on the outlook for investment growth. In the last four years (FY09-FY12), average real investment growth has been lackluster, averaging 6% pa. If investment continues at this rate, then India's potential growth could slip below 7%. To sustain an average annual growth of 7.5%, real investment growth needs to rebound to 10%. For potential GDP growth to revert back to 8%, investment growth of 15% pa is needed, and we believe returning to 9% potential growth is possible only if investment growth is sustained at 20% pa.

We believe investment slowed dramatically in FY12 due to steep rate hikes and government policy inaction. A marginal reduction in policy rates and recent policy initiatives by the Prime Minister's Office (PMO)¹⁰ should lead to some revival of

⁹ We have used data from 1981 to 2011 for the regression analysis.

¹⁰ Coal India has been asked to sign Fuel Supply Agreements with power plants that have entered into long-term power purchase agreements; the Ministry of Road Transport and Highways has awarded 7957km of new projects in FY12 and set a target of 8800km for FY13; the Prime Minister has directed increased focus on a dedicated freight corridor project. In a 14 December 2011 press release, the PMO states that the thrust of the Congress-led UPA (United Progressive Alliance) government remains on anti-graft and judicial reforms, not surprising given the wave of corruption and scams the government faced over the last year. In addition, the government's focus areas are land acquisition, skill development, national highways development, power distribution and the coal and fertilizer sectors.

investment as piecemeal reforms are undertaken. However, with general elections due in May 2014, it seems as though fast-tracking economic reforms or any serious effort to tackle the structural fiscal deficit is unlikely. Against a backdrop of global deleveraging, high global commodity prices, a weak domestic political climate, a structurally large fiscal deficit and high inflation, we believe India's average growth will be 7.0-7.5% over the next few years, compared to 8.5-9.0% before 2008.

Concluding thoughts

Breaking the fall: Latent demand in India is large; per capita consumption is low; rural demand is just picking up; half the land mass is arable; infrastructure investment needs a big push and the working age population is very young and set to expand. It is not that the economy cannot grow faster; rather it is becoming increasingly difficult to sustain any increase in the pace of demand-side growth because of supply-side bottlenecks. Without lowering the fiscal deficit and reforms to improve the investment climate, the current account deficit will remain large and inflation high, leaving the RBI little leeway to lower interest rates. For in the absence of an investment revival to expand the economy's productive capacity, any reduction in interest rates will only fuel consumption demand. Hence, monetary policy easing without structural reforms and fiscal consolidation is likely to lead to only a short-lived growth spurt, because of rising inflation and a widening current account deficit.

Signposts to look for: The circuit-breaker to this deadlock is fiscal consolidation and structural reforms, but with general elections due in May 2014, it seems as though fast-tracking economic reforms or any serious effort to tackle the structural fiscal deficit is unlikely. We identify five signposts that we believe are realistically achievable over the next two years to avoid a short-lived cyclical upswing (see Box 1 for details):

- **Fuel and fertilizer prices need to be hiked** to prune the subsidy bill, reduce the fiscal deficit and create more space for capital expenditure.
- **The cost of doing business can be reduced by fast-tracking land and environmental clearances and passing the mining bill.** This could jump-start a large number of investment projects that are currently stalled.
- **Increasing** the limit on **foreign direct investment** in civil aviation and, perhaps, in multi-brand retail.
- A second Green Revolution is the need of the hour. Creation and management of **cold chain infrastructure for agriculture** is an important step in this direction.
- **Anti-graft reforms** to tackle corruption and increase transparency in public procurement.

The cost of inaction: GDP growth is the main casualty as the cost of capital would remain high. Volatility would also remain elevated since, with a large current account deficit and a fragile global economy, India would have less cushion to cope with a sudden stop in net capital inflows. India's relative growth should continue to be one of the highest in Asia, but a number of other EM countries are hot on its heels and could make further gains to India's detriment. The high cost of doing business and continued domestic policy uncertainty could push companies to relocate operations overseas, and India's young, skilled labour could follow. The keys to avoiding this potentially negative spiral are in the hands of government.

Box 1: 10 reforms to unlock growth potential

It is now a well-accepted prognosis that policy paralysis is the core reason behind the economy's weaker fundamentals. Nevertheless, the inherent potential to grow at a rapid and sustainable pace remains, given the right policy environment. Below we list 10 key reforms that we believe would help realize that potential.

1. **Land acquisition reform:** Make the process of land acquisition more transparent by establishing a well defined system for buyers and to award compensation and rehabilitate the displaced land owners. The proposed Land Acquisition Rehabilitation and Resettlement (LARR) bill currently in the parliament addresses this issue.
2. **Mining reform:** Passing the proposed Mines and Minerals (Regulation and Development) bill to categorize mines, award licences to operate and set standards for compensation to those displaced by the activity. Together, the land acquisition and mining bills could fast-track a number of investment projects, particularly in the investment-heavy power and steel sectors.
3. **Power sector reform:** Lack of sufficient power has become a major bottleneck for industry. There is an immediate need to curtail the huge losses suffered by the state electricity boards by rationalizing tariffs via mechanisms such as differential pricing, assuring fuel linkages and reducing dependence on imported coal.
4. **New Manufacturing Policy:** India needs to develop its manufacturing sector to absorb the rising working age population and give exports a boost. The government needs to accelerate the passage and implementation of the proposed New Manufacturing Policy, increase the share of manufacturing to 25% of GDP by 2022 (from the current 15%) and add 100 million jobs in the sector (see [Asia Special Topic: India: A new Manufacturing Policy](#), 14 October 2011).
5. **Fiscal consolidation:** The central government needs to lower its fiscal deficit to 3% of GDP and eliminate the revenue deficit. Reforms should target both expenditures and revenues. The subsidy bill has to be reduced by hiking fuel, fertilizer and power prices, and prevent leakage via the Universal Identification (UID) project. On the revenue front, implementation of the direct tax code and the goods and services tax are key.
6. **Agriculture sector:** The policy paradigm for agriculture needs to shift away from a model of subsidizing inputs towards a model focused on building the capital infrastructure to lift productivity. With limited government resources, private sector participation should be encouraged to boost production and productivity through better quality seeds, increased investment in irrigation, warehousing, transportation and cold storage. Investment in agriculture has been stuck in the 2-3% of GDP range for decades and should be raised to 3.5-4.0% of GDP.
7. **Education:** Sweeping reforms are required to benefit from the so-called 'demographic dividend'. Building better infrastructure in government schools, vocational training and instilling employable skills among university graduates are all musts for skill development. Spending on education should be raised to 5.5-6.0% of GDP, almost double current levels.
8. **Financial and real sector reforms:** Measures to develop the corporate bond market are needed to finance India's infrastructure needs. In addition, pending reforms include raising the FDI limits in multi-brand retail and airlines, increasing the FDI limit in insurance, opening up the pension system to private firms and parliamentary approval to raise the cap on voting rights in private banks from 10% to 26%. Policy measures that encourage households to invest their savings in financial assets will also help better channel these savings into investments.
9. **Urbanization:** In addition to improving the infrastructure in major cities such as New Delhi and Mumbai, the central government should also assist state and local governments in building quality infrastructure in second- and third-tier cities through a public private partnership model. This would ease pressure on the larger metropolitan cities and lead to more balanced regional growth.
10. **Labour market deregulation:** More flexible labour laws can encourage employment growth and help firms gain economies of scale. India's demographic trends require developing the manufacturing sector, which is not possible without this reform.

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