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India

Economy

Growth was under-estimated in CY21, but reforms will spur strong growth in CY22 and CY23

- Nominal GDP grew 19.1% in CY21, while real GDP was reported to have grown only 8.3% (still the fastest in the G20, the fourth year India was the world's fastest-growing large economy in the past 7 and 75 years). The GDP deflator (+10.8%YoY) rose even faster than the reported rise in WPI in CY21 (10.7%); the largest component of GDP (private consumption expenditure, PCE, about 60% of GDP) saw its official deflator rise 7.7% in CY21, improbably faster than the 5.1% rise in CPI. Real GDP was, in our view, under-estimated considerably in CY21 because the deflators were inaccurate.

- The biggest source of under-estimation was in the contribution of net exports of goods and services. According to the Balance of Payments (BoP), the current account deficit was just 1% of GDP in CY21 (after a surplus of 1.5% of GDP in CY20). The BoP merchandise trade balance uses the FOB (free on board) measure for both exports and imports (observable figures). But India uses an "adjustment factor" to measure imports on a CIF (costs, insurance & freight) basis. As a result, nominal net exports of goods & services (which should be near-identical to the BoP current account) showed deficits of 0.24% of GDP for CY20 and 2.35% of GDP for CY21. The inflation-adjusted net exports of goods and services (which go into the calculation of real GDP) showed deficits of 1.8% of GDP in CY20 (versus a BoP current account *surplus* of 1.5%) and 4.6% of GDP in CY21 (versus a BoP CAD of just 1% of GDP), suggesting that "real" net exports erroneously subtracted over 3% from real GDP in each year.

- Our estimate is that real GDP will be reported to have grown 5% YoY in Q4FY22, implying 9% real GDP growth in FY22. But this headline growth will be despite the large discrepancy between the current account balance and the inflation-adjusted net exports of goods & services (the latter having subtracted 3pp from real GDP growth in FY22). This will provide a large cushion to be adjusted in the subsequent year(s), as real GDP will have been artificially under-estimated in FY21 and FY22. In H1FY23, we expect growth to remain export-led, with domestic demand also benefitting from the low-base of Q1FY22 (when India was hit by serial lockdowns in different states during the second wave of covid). However, we estimate that the fiscal deficit in FY23 will be only 5.6% of GDP (much lower than the official estimate of 6.2% of GDP) as direct tax revenues in FY22 have already exceeded the FY23 projections. The recently-announced cuts in excise duties will not alter that outlook, as corporate and personal income tax revenues stay strong, as do GST revenues. The government's substantially lower borrowing requirement (especially in H2FY23) will help crowd-in more private investment, delivering 8.2% real GDP growth in FY23. The low, globally-competitive corporate tax rate (25%, and just 17% for new manufacturing units), more flexible labour market (aided by the contract labour law) and the production-linked incentive (PLI) scheme will draw in substantially more fixed investment across a broadening swathe of industry, enabling real GDP to accelerate to 9% in FY24, aided by the cushion of FY22 statistical discrepancies.

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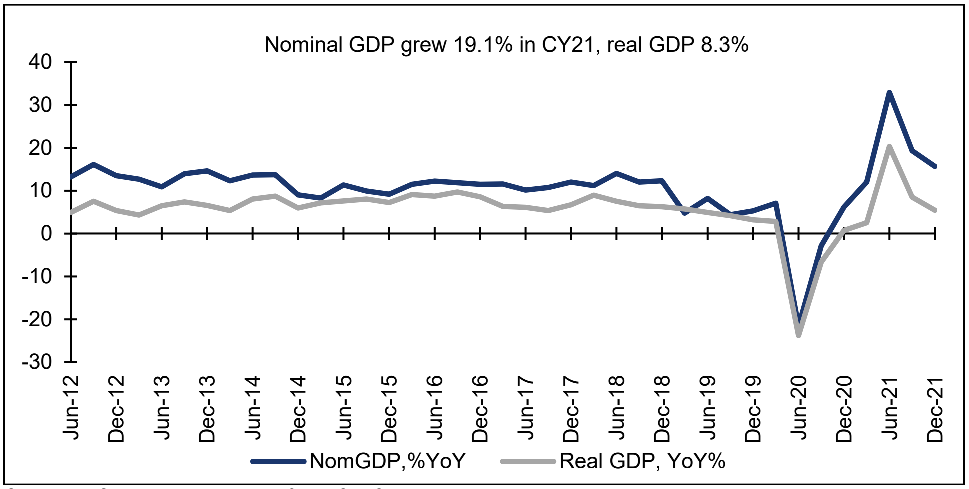
India's real GDP grew 8.3% in CY21, restoring India's status as the fastest-growing economy among the G20 (the group of the world's 20 largest economies). China's real GDP grew 8.1% in 2021, the next-fastest growth in the G20. India was also the fastest-growing G20 economy in 2015 (7.5% vs China's 7%), 2016 (9% vs China's 6.9%) and 2018 (7.3% vs China's 6.7%), never having achieved that distinction in any year prior to 2015. At market exchange rates, India's nominal GDP grew to US$3.078trn in CY21, keeping it in 6th place among the world's largest economies (marginally behind the fifth largest economy, the UK, with a nominal GDP of US$3.108trn). However, going forward, given India's demographics and the impact of the reforms of the past 2 years, we expect India to lead the G20 in economic growth over the next few years.

Chart 1: Nominal GDP grew 19.1% in CY21, but real GDP was reported to have grown only 8.3%

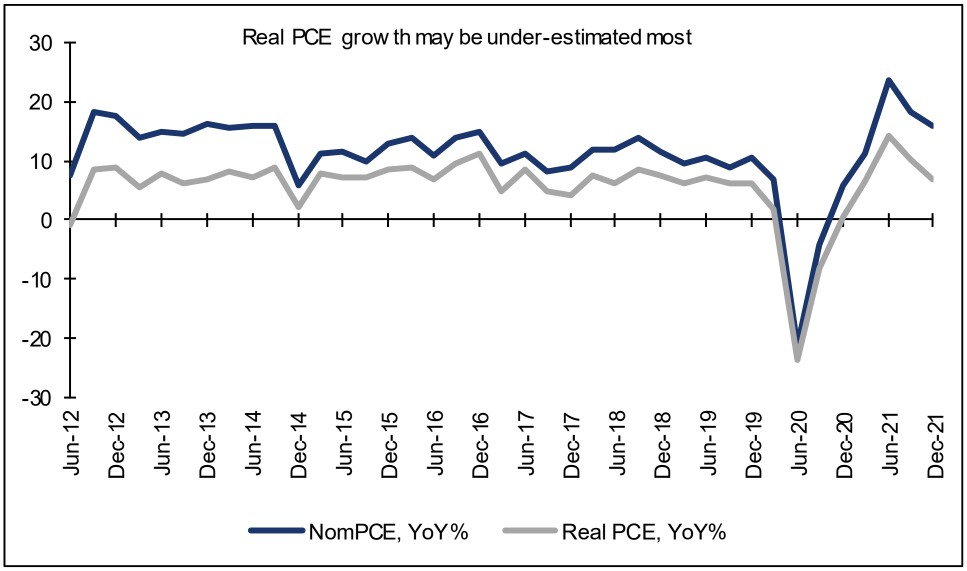


Source: I-Sec, based on data from CEIC

Nominal GDP grew 19.1% in CY21, implying that the GDP deflator (a broader measure of inflation than the CPI) was estimated to have increased 10.8% YoY during the year. CPI inflation averaged 5.1% YoY in CY21, while WPI inflation averaged 10.7% YoY. The GDP deflator is fiendishly difficult to accurately measure, with different components of Aggregate Expenditure being deflated using different proxy measures; in the past (Dec'19), the IMF had criticised India for using the WPI as the main proxy for the GDP deflator (at a time when WPI inflation was very low). By the same token, using a deflator that is close to the WPI – which is now rising at a very rapid pace – is probably causing real GDP to be under-estimated currently.

PCE deflator (+7.7% in CY21, vs 5.1% rise in CPI) suggests that real PCE may be under-estimated. Conceptually, since private consumption expenditure (PCE) is the largest component of Aggregate Expenditure, the PCE deflator is the most crucial component of the GDP deflator – and it should rise at a pace similar to that of the CPI (consumer price index). In CY21, nominal PCE grew 16.8% (after contracting 3% in CY20) and real PCE grew 9.1% (after contracting 7.3% in CY20), implying a rise in the PCE deflator of 7.7% in CY21 (after rising 4.3% in CY20). The 7.7% reported rise in the PCE deflator was much larger than the rise in the CPI in CY21 (+5.1%), an improbable gap that suggests real PCE growth was being under-estimated in CY21. Since PCE accounts for about 60% of GDP, real GDP growth too was likely under-estimated for CY21.

Chart 2: Among expenditure components, PCE growth may have been under-estimated the most



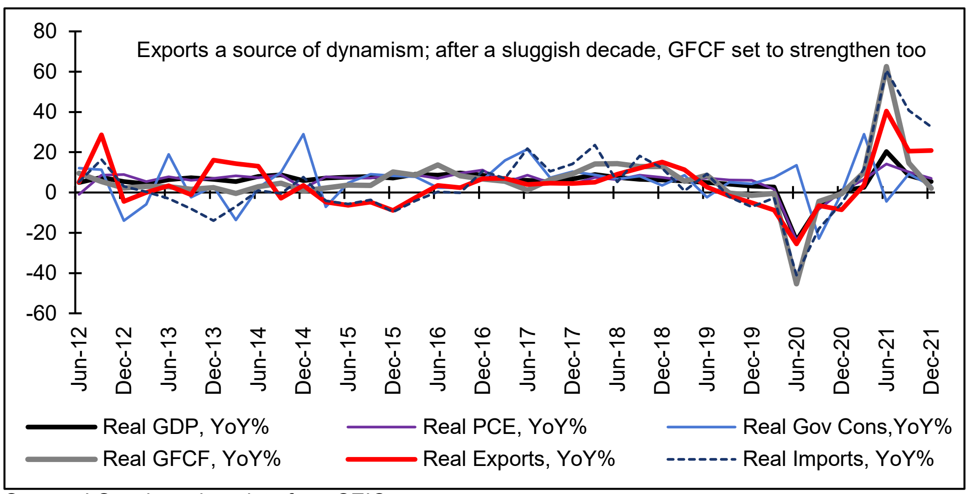
Source: I-Sec, based on data from CEIC

Nominal net exports (using the GDP definitions) show a deficit of 2.35% of GDP in CY21, far wider than the observable BoP current account deficit of 1% of GDP. The biggest discrepancy, however, occurs between real and nominal net exports of goods and services (i.e., the difference between exports and imports). India had a BoP (balance of payments) current account *surplus* of 1.5% of GDP in CY20, but net exports of goods and services (in the GDP definition) reported a *deficit* of 0.24% of GDP for CY20. The BoP definition of the merchandise trade balance measures both exports and imports using the FOB (free on board) figure, but the GDP accounting (and customs trade figure) is based on CIF (including the cost of insurance and freight) for imports. This can generate a difference between the BoP and GDP figures for merchandise trade. But, if properly measured, that difference should disappear once services are added (as they are) in the GDP estimates. India, however, is known to use an arbitrary "adjustment factor" (of around 10%) to adjust the FOB to the CIF estimate of imports – and this adjustment is not disappearing once the services are factored in (perhaps because freight and insurance now cost much less in the containerised era than they used to when India began this statistical practice of using an "adjustment factor"). For CY21, the GDP measure of nominal net exports shows a deficit of 2.35% of GDP, while the actual BoP current account deficit was just 1% of GDP.

Nominal exports in CY21 were 23.7% higher than in CY19, while nominal imports were only 21% higher; yet reported "real" exports in CY21 were just 5.4% higher than CY19, "real" imports 10.9% higher than CY19 -- suggesting a big error in the export or import price deflator. The export and import price deflators widened the discrepancy further. Nominal exports of goods and services in CY21 were 23.7% higher than those of CY19 (the last pre-covid year), while imports of goods and services in CY21 were 21% higher than in CY19. But while nominal exports were growing faster than nominal imports, real exports were only reported to have increased 5.4% in CY21 relative to their CY19 level, while real imports were reported to have increased 10.9% in CY21 relative to CY19. This implies export prices were rising substantially faster (up about 18.3%) over the 2-year period than import prices (up only 10.1% in CY21 relative to CY19) – an improbable outcome, given that most exports use imported components, the prices of which rarely diverge this much from the prices of final export products. As a consequence, the inflation-adjusted deficit for CY21 is reported at 4.6% of GDP – nearly double the reported nominal deficit of 2.35% of GDP, which in turn is much wider than the observable BoP current account deficit of 1% of GDP. For CY20, the BoP current account *surplus* of 1.5% of GDP somehow became an inflation-adjusted net-export *deficit* of 1.8% of GDP.

Real GDP was reportedly only 1.2% higher in CY21 than CY19, but nominal GDP was 15.75% higher; 3.6pp of the difference is the gap between BoP current account and real net exports in CY21. In our view, the far larger reported real (inflation-adjusted) trade deficit than the measurable nominal deficit implies that real GDP growth is being under-estimated for CY21 by at least 1.3 percentage points (pp), and more likely by 3.6 pp (the difference between the BoP current account and the “real net exports of goods and services” in the GDP accounting). Similarly, the difference between the nominal BoP current account balance (a surplus of 1.5% of GDP) in CY20 and the “real net exports of goods and services” in the GDP accounting (a deficit of 1.8% of GDP) suggests CY20 real GDP growth was also under-estimated. Real GDP in CY21 is reported to be just 1.2% higher than in CY19, although nominal GDP for CY21 is 15.75% higher than in CY19. The extra 3.3pp of missing real GDP growth in CY20 and the 3.6pp of missing real GDP growth in CY21 would go some way toward more credibly closing this wide gap – implying real GDP likely grew 11.9% YoY in CY21 (rather than just 8.3%), and contracted 3.3% (rather than -6.6%) in CY20.

Chart 3: Net exports severely under-estimated, but exports have become a source of dynamism since CY21



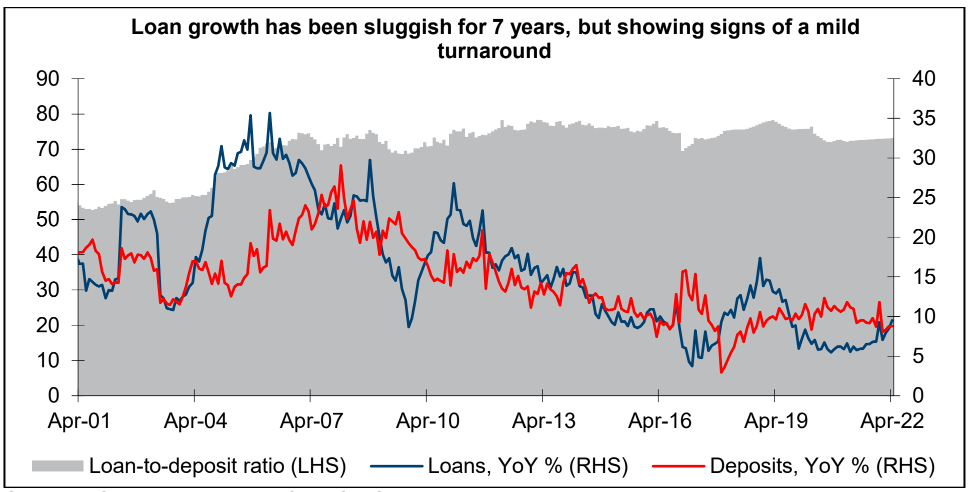
Source: I-Sec, based on data from CEIC

Quarterly growth driven mainly by PCE, but inflation-adjusted net exports subtracted over 3pp from real GDP every quarter. Setting aside the many caveats regarding measurement, the largest component of Aggregate Expenditure, real PCE (private consumption) was the key driver of real GDP growth in CY21, particularly in the second half (Jul-Dec’21), growing 10.2% and 7% YoY in the final two quarters. Real fixed investment spending (GFCF) was, however, reported to have decelerated sharply to 14.6% YoY and 2% YoY in those quarters (after an exceptional rise of 62.5% YoY in Apr-Jun’21, from the extremely low base of the ‘lockdown’ quarter, Apr-Jun’20, in which real GFCF declined 45.3% YoY). Inflation-adjusted net exports of goods & services reported a deficit of 6.1% of GDP in Q4CY21 (3.4pp of GDP wider than the BoP current account deficit), and those “real” deficits were 3.5pp and 3.9pp of GDP wider than the

BoP current account balances in the previous two quarters, and 3.2pp of GDP wider in Q1CY21. For FY22 (Apr'21-Mar'22), the official second advance estimate is 8.9% growth – implying just 4.5% YoY growth in Q1CY22 (ie, Q4FY22). Our estimate is that real GDP will be officially estimated to have decelerated to 5% YoY in Q4FY22, and real GDP will thus have grown 9% in FY22.

In H1FY23, we expect India's growth to remain export-led – as it has been for the past 16 months. In Apr'22, goods exports grew 30.7% YoY – and were 54.4% higher than their pre-covid level in Apr'19. We believe the improved export performance reflects productivity gains in the goods-export sectors, arising from heightened FDI and other investment in exportable goods and related infrastructure. India's own recently-imposed restraints on exports (of wheat and steel, for instance) will adversely impact merchandise export growth in Jun'22 and beyond, although the buoyancy of other engineering goods, chemicals, electronics and textiles/garments exports should continue to deliver strong (but gradually decelerating) growth in Jun-Sep'22. With global trade likely to decelerate sharply beyond Sep'22 as the impact of the US Fed and ECB's abrupt shift to monetary tightening causes US and Eurozone domestic demand to weaken significantly, India's exports too will grow less rapidly in H2FY23, although still likely posting about 11% nominal growth in FY23 (while global trade volume decelerates to 6% growth in CY23).

Chart 4: Tentative signs of the start of a turnaround in bank credit growth



Source: I-Sec, based on data from CEIC

We expect the baton of Indian growth to pass from exports to fixed-investment spending in H2FY23. The unofficial estimate of corporation tax revenue in FY22 is 17.7% higher than the budgeted revenue from corporation tax in FY23, while the FY22 income tax revenue receipts are also 7% higher than the budgeted figure for FY23 (see Link and our report Link Twin Deficit Watch: BoP current account to improve; revenue surge provides fiscal leeway for FY23). GST revenue for FY22 was only 8.3% lower than the projection for FY23. The direct tax buoyancy implies that even modest estimates of revenue growth in FY23 will take actual collections far above the budgeted numbers, while GST revenues too will exceed the budget targets by at least 5%. Despite the recent reduction in petrol and diesel excise duties, we expect the fiscal deficit in FY23 to moderate to 5.6% of GDP (vs the official estimate of 6.2%). The lower deficit (driven by stronger revenue) will reduce the government's net market borrowing, especially in H2FY23. Lower market borrowing by the government will help crowd-in private investment. Tentative signs of the turnaround in bank credit were already visible in Mar-Apr'22 (with credit growth accelerating to 9.9% YoY growth in Apr'22, and over 11% YoY on 6th May'22), and are likely to gain momentum as the reduced government borrowing becomes evident, contributing to excess liquidity in the banking system, and inducing banks to enhance credit-supply to a de-leveraged corporate sector (that is much better-positioned to borrow than it was 5-7 years ago). We expect the export-led H1 and private-investment-led H2 to deliver 8.2% real GDP growth in FY23.

PLI, flexible labour market and competitive corporate-tax regime make India an attractive investment destination. The longer-term turnaround in fixed-investment spending will be facilitated by the confluence of three additional factors: (a) The sharply lower corporate tax rates (nominally 22%, and effectively 25%), and the especially low corporate tax rates for new manufacturing units (effectively 17%, among the most competitive rates in Asia and the world); (b) a quantum leap in the flexibility of the labour market, with the simplification of the labour codes, and especially the contract labour law (which allows new workers to be taken on fixed-term contracts, which obviate the need to lay them off once the contract term ends), making India's labour market as flexible as most of East Asia; and (c) the East Asia-style production-linked incentive (PLI) scheme being offered to induce manufacturers to boost output and exports in order to qualify for the "incentive" payment. (India's PLI will last only 3-4 years for most sectors, but should provide the biggest boost to investment spending in FY23 and FY24). Our baseline scenario would substantially boost private investment across a broad swathe of industry in FY24, delivering an acceleration to 9% real GDP growth.

For growth to accelerate to 10% or more by FY24 requires labour-intensive manufacturing to gain momentum, helping to draw low-productivity labour from agriculture towards better-paying and far more productive manufacturing and service-sector jobs. India is already a successful producer of steel, aluminium, cement (for all of which, India is the second largest global producer), vehicles (fifth largest globally) and chemicals. The two missing wings of the industrial story in India are labour-intensive manufacturing (where India is producing and exporting far below its potential), and high-technology/electronics. The latter is attracting large investments – albeit occasionally in highly risky projects like semiconductors, but more viably in smart-phone manufacturing, white goods and consumer electronics. If the flexibility conferred by the contract labour law attracts more investment in large-scale manufacturing of textiles, garments, shoes, toys, and processed foods – especially for the vast global market – it would be transformative for India's prospects, generating substantially more employment in higher-productivity jobs that boost real wages, and bolster the growth of private consumption, generating self-sustaining real GDP growth of over 10% annually. Such a transformative surge in labour-intensive manufacturing is not yet our base case, but one that we will be closely scouring for any evidence of the sector attracting substantial flows of capital into large-scale labour-intensive manufacturing.

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