GROWTH DRIVERS

INDIAN ECONOMY 2009

Q S Consultants India Pvt. Ltd.

INTRODUCTION

Established in February 2008, Q S Consultants was conceptualized as a consultation firm providing advisory services in the Travel & Tourism, Infrastructure and Sustainable Business Practices Areas, bringing dedicated expertise and an imaginative approach to meet the demands of an industry in the midst of rapid transition and offer well-defined and executable strategies to achieve business objectives.

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Growth Drivers - Indian Economy 2009

The **gross domestic product (GDP)** of a country is the market value of all final goods and services produced within that country for a year, the demand for these final goods and services is generated by (a) **consumption**, (b) **investment**, (c) **net exports** (exports minus demand for imports which contributes to other countries' goods and services) & (d) **government expenditure**.

Figure 1: Components or Drivers of an Economy

Understanding Growth Drivers

The four sources of demand account for all output produced and it's growth over time. The magnitude of the sources of demand, are in turn determined by many supply and demand side factors, some of which are more quantifiable, and hence more policy amenable. Hence, growth in GDP and it's sectoral components are driven by these sources of demand and the interplay between them.

Consumption Demand	**Strongly dependent on income, which in turn is a factor of wage, profit and rental incomes.**
Investment Demand	**Broadly determined by the level of total aggregate demand, profitability conditions, and the risk environment.**
Export Demand	**Determined by Unit Labor Costs (ULCs), in turn a function of productivity, wages, exchange rates and market access.**
Government Expenditure	**Determined by revenues, the demand for expenditures and the fiscal and monetary space permitted.**

Aggregate Demand Drivers in India

Components:

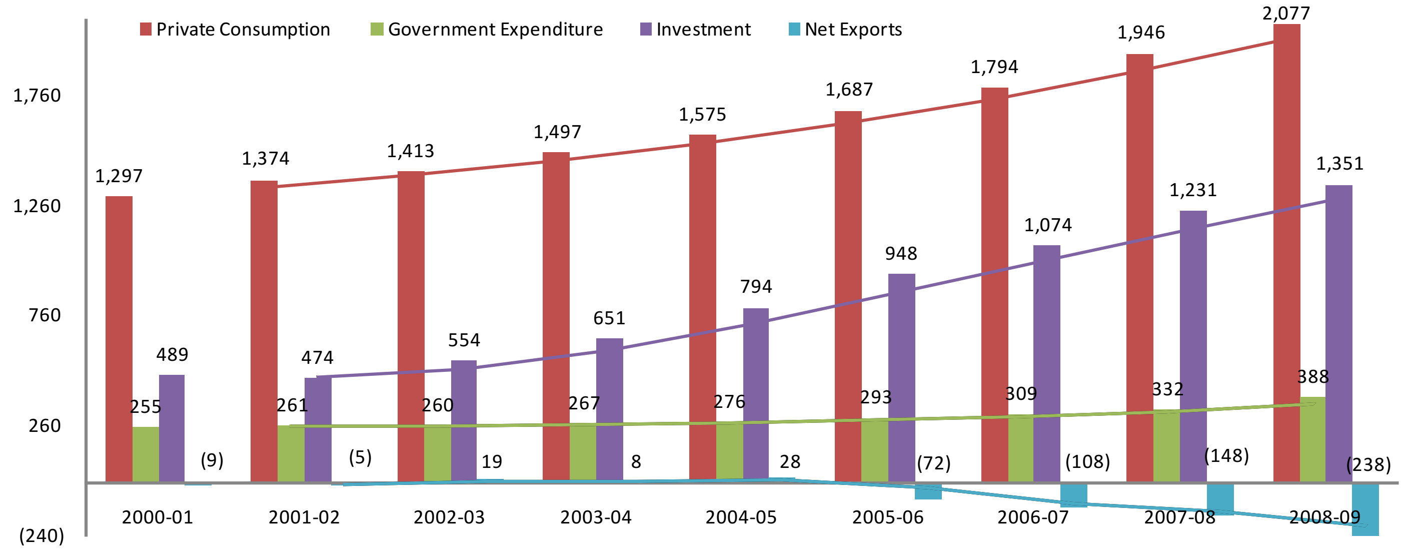

Figure 2: Composition of India's GDP by Sources of Demand (in '000 Rs. Crore)

- *Private consumption* accounted for 57% of GDP in 2008-09 and therefore can be considered as a major source of demand. The share of private consumption in GDP peaked in 2001-02 at 64.3% and has since seen a steady decline over the years.
- *Investments* (includes private fixed investments and stocks) are the second most important source of demand. They accounted for 37.1% of GDP in 2008-09. Investments have shown a steady increase *over the last decade.*
- *Government expenditure* contributed 10.6% of GDP in 2008-09. Fiscal stimulus measures in the form of tax cuts and additional expenditure amounted to 2.9%.
- *Net exports* contributed (-6.5%) to GDP in *2008-09.*
- In terms of y-o-y growth, as GDP growth rates declined over the last two years to 7.1% (GOI estimates), growth rates of private consumption moderated at 6.8%, investment declined to 9.7%, government expenditure increased to 16.8% and net exports fell to (-60.5%).

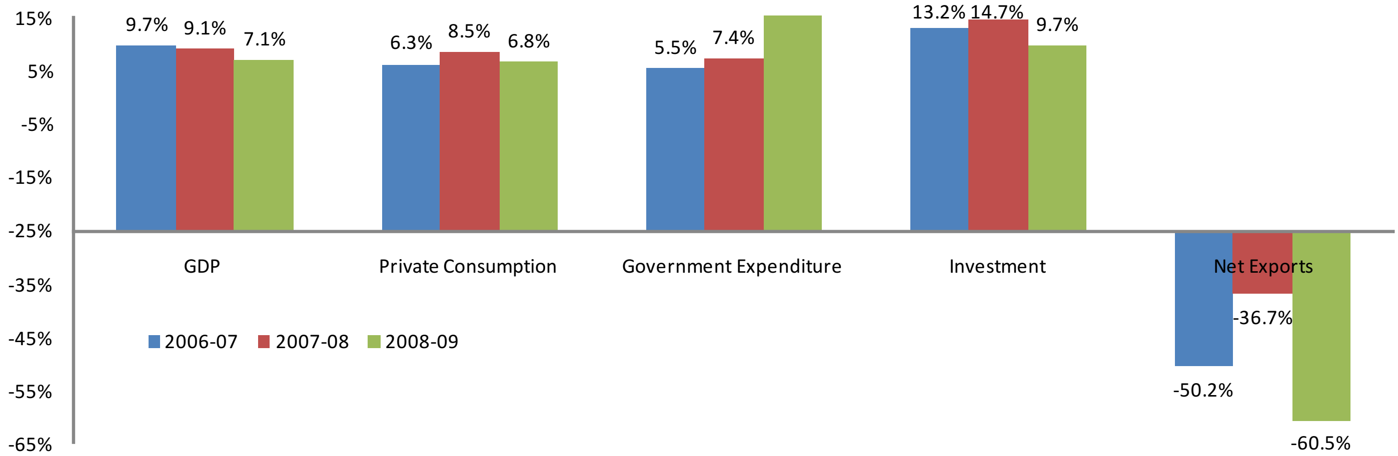

Figure 3: Year on year growth (2006-07 to 2008-09) India's GDP & Sources of Demand

- The sharp decline in external demand resulted in India's poor performance in net exports.
- Stable domestic demand resulted in moderation in both *private consumption* and *investments*.
- *Government expenditure* was increased in an attempt to offset contraction in other demand drivers.
- Moderation in overall savings due to lower household savings, reduced public sector savings (high subsidies) and limited corporate savings (reduction in corporate profits & asset devaluation) and moderation in retained earnings (impact of monetary tightening) resulted in decline in investment.

Demand Driver Trends

Private Consumption

- The largest demand driver in India, private consumption plays a very important role in defining GDP growth. The moderation in consumption from 8.5% to 6.8% over 2008-09 is mirrored by a corresponding moderation in GDP growth from 9.1% to 7.1%.
- Per capita private consumption grew at 5.4% in 2008-09. Though private consumption mirrors income, it's average growth is much slower primarily due to rising savings rates and tax burdens.
- Flagging consumption is expected to stabilize as the effect government stimuli and RBI measures come into play. This will provide an impetus to industrial production.
- Domestic consumption from rural, semi-urban and non-metro cities (insulated from global recessionary impact) emerges as the driving forces.
- Rural and semi-urban insulation from the global recession is attributed to extensive agricultural self-employment (41%) coupled with a large labor population (35%) that is dependent on the local economy.
- As urban households earn 85% more, spend 75% more and save 50% more than their rural counterparts, increased focus on rural consumption as a factor of income indicates a moderate growth pattern.

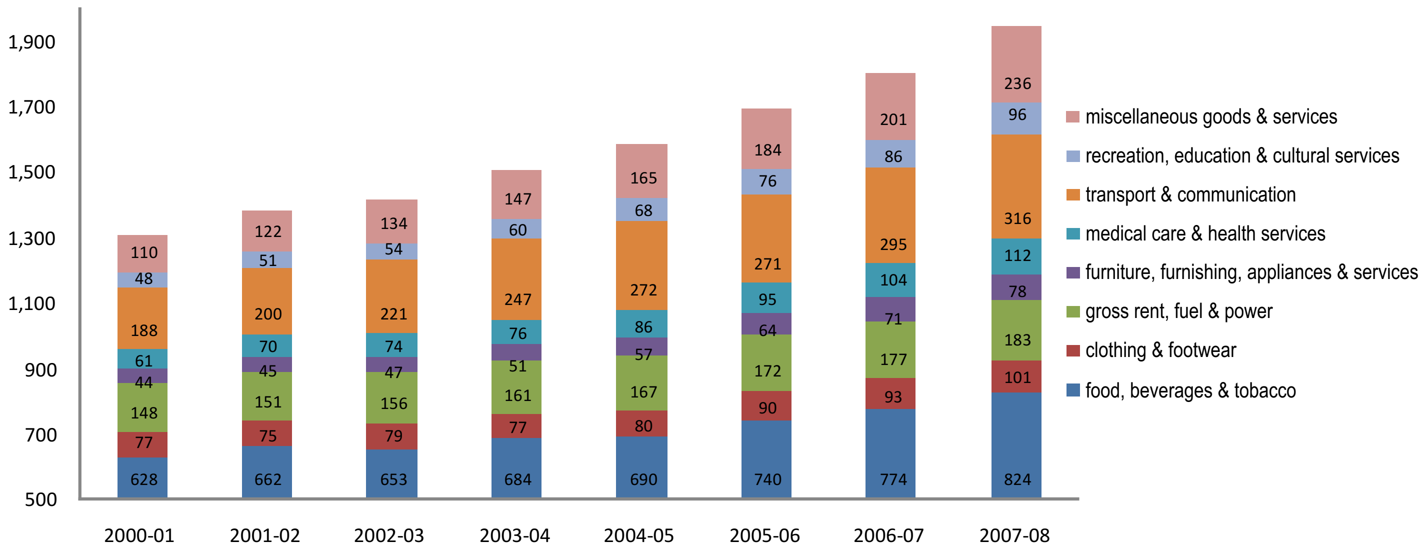

Figure 4: Composition of Private Consumption (in '000 Rs. Crore)

- Household consumption is dominated by essential commodities. Food & beverages (37%) is the predominant component followed by transport and communication (16%), rent fuel & power (9%), medical care (6%) and education (3%). Household & personal goods (16%), recreation (5%) and clothing (5%) also constitute significant components.

- As per capita consumption rises consistently, analysis predicts a decline in the share of consumption on essential commodities like food and an increase in luxuries (including entertainment and consumer goods).
  - Food and beverages recorded the lowest growth rate though it is still the largest constituent of consumption.
  - Significant growth potential in transport and communication, education, recreation, hotels, and consumer goods and services is also estimated.
  - Erratic consumption of clothing, footwear and personal items over the last decade result from middle class perception classifying the same as residual expenditure.
  - Increased consumption on education and healthcare, even among the lower middle class and rural areas, despite high incidence of free healthcare/ public health and public education systems are a rising concern reflecting lack of appropriate supply factors (e.g. infrastructure, facilities, human capital etc.)

- Private consumption would be heavily influenced by **the success of the agrarian economy driving rural demand supported by mandated agri-lending and safety-net programmes, moderation in headline and consumer price inflation, reduced wealth loss due to devaluation of physical and financial assets and human capital trends.**

Investment

- Investment, the second largest demand driver in India, is also the fastest growing source of demand. With double digit growth over the last five years till 2007-08, it continued to grow at 9.7% in 2008-09. The slowdown in the Indian economy has been associated with a deceleration in investments. Adverse conditions including external capital outflows and depressing effects of the global crisis on business confidence contributed to moderation in investment demand.

- Investments accounted for 37.1% of GDP in 2008-09, the private sector contributed 23%, corporate sector (10%) and households (13%) being the main contributors.

- Fixed investment accounted for 33.4% of GDP in 2008-09, the private sector contributed 21%, corporate sector (9%) and households (12%) being the main contributors. Change in stocks was largely contributed by the private corporate sector.

- The focus of investment growth is primarily on private fixed investment (not a buildup of inventories) aimed at increasing the productive capacity of the economy in the medium term to help the economy climb back to a stable growth rate.

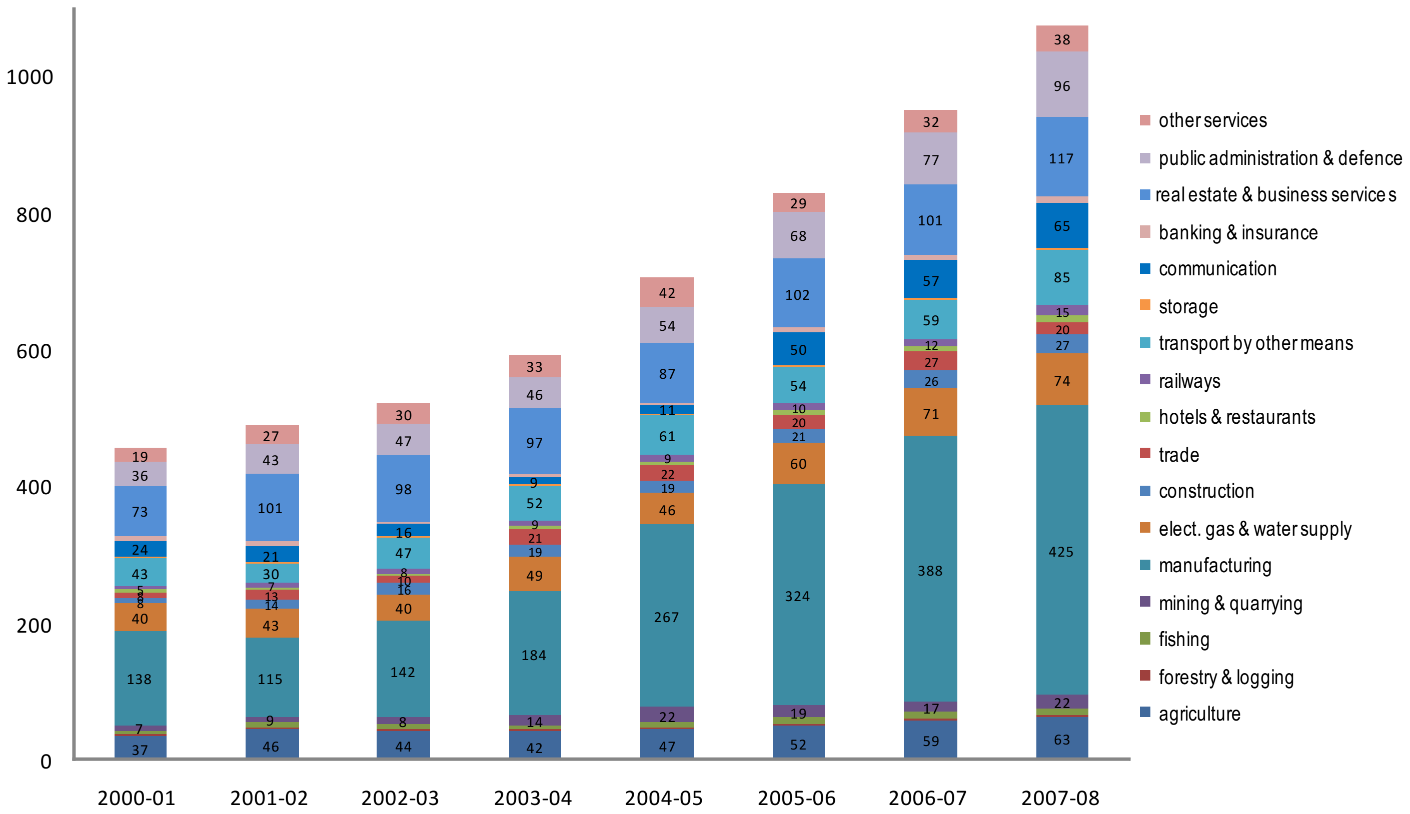

Figure 5: Investments in different sectors (in '000 Rs. Crore)

- Growth in investments by sector shows how much of the sector's growth has been associated with expansion in
  - While the manufacturing sector showed the highest growth rate over the X plan period (33.6%), it's growth rate slowed to 10% in 2008-09.
  - While a 25% growth in investment for the mining sector seems inconsistent with relatively low GDP growth, increased investment could be a precursor to higher growth given long gestation lags in mining projects.
  - Railways and transport services with investment growth of 25% and 44% respectively reflect the focus on transport development and infrastructure.
  - Hotels & restaurants and communications with investment growth of 17% and 15% respectively are the third fastest growing sectors. They play a vital role in generating higher employment at relatively lower investment costs and affirm the key role played by competition induced productivity growth.
  - Finance and business services (10%), real estate, electricity (5%), agriculture and allied sectors (5%) recorded significantly lower growth in line with moderation in sectoral production.

A moderation in corporate investment is a result of rising costs of borrowings coupled with increased input costs and decreased profitability thus causing a shift in sourcing of funds leading to higher demands for bank credit in the backdrop of capital outflows and low confidence levels. As larger corporate entities enter the credit market:

  - the small and medium enterprise sector are exposed to a lower supply of funds
  - despite regulatory measures, interest costs are higher

- Resultant increased investment costs affects industry competitiveness leading to slackening in the growth momentum.
- Investments would be influenced by **continued stability in the financial markets, increase in business confidence, moderation of corporate profits, availability of funds and bank credit and development of long term debt markets to support financing of infrastructure projects.**

Government Expenditure

- Government expenditure is the stabilizing demand driver. It has maintained a moderate rate of growth over the last decade. However, a sudden fall in private consumption, net exports and investment necessitated a significant increase in government spending with growth rates doubled to 16.8% in 2008-09.
- Energy (27.6%) continues to be the largest contributor to government expenditure closely followed by social services (22.7%), transport (20.7%) and rural development (10.3%).
- The focus of government expenditure has shifted towards rural development, social sector and infrastructure development in 2009-10 to ensure sustainable impetus to the economy post the global recession.
- Increase in government expenditure is mainly attributed to the 6th pay commission payout, expenditure on agricultural debt waver, oil and fertilizer subsidies and counter-cyclical fiscal measures, thus leading to an increase in both the fiscal deficit and revenue deficit.
  - Revenue expenditure accounted for 89.2% of total government expenditure in 2008-09 while capital expenditure was reduced to 10.8%.
  - Non-plan outlays accounted for 68.6% of total government expenditure spent mainly on interest payments (21.4%), defence outlays (12.7%) and subsidies (14.4%). Value of subsidies (food, fertilizers and oil) increased over 80% against plan as a result of counter-cyclical fiscal measures.

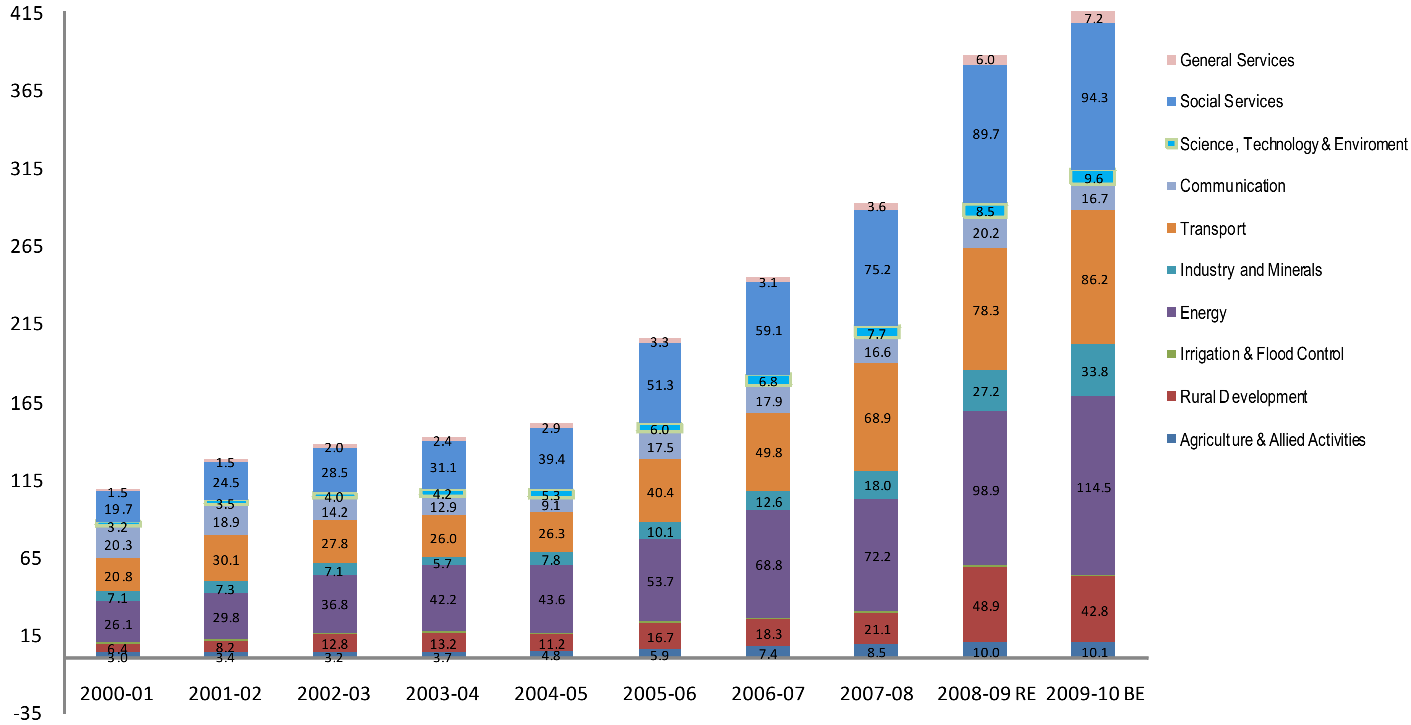

Figure 6: Government Expenditure in major sectors (Rs in crore)

Government expenditure is influenced by **the need to sustain aggregate domestic demand (as other drivers continue to moderate), overcome infrastructure bottlenecks and increase market participation to optimize market access, credit flows and private investment for sustainable economic growth.**

Net Exports

- Export growth, because of it's spillover effects on productivity and efficiency, has the potential to act as an important driver of growth.
- External trade has had a negative contribution to GDP over the last 3 years. Contribution of net exports of goods and services to overall demand also declined. External trade thus had a dampening effect on the aggregate demand.

- The principal components of exports include agriculture and allied products (11.4%), chemicals and related products (12.9%), manufacturing goods (23.1%), textiles (12%), gems and jewellery (12.4%) and petroleum products (15.6%).
- The principal components of imports include crude petroleum and products (33.3%), capital goods (24.4%) and gold/silver and gems (11%). Export related imports constitute 8.7% of total imports.

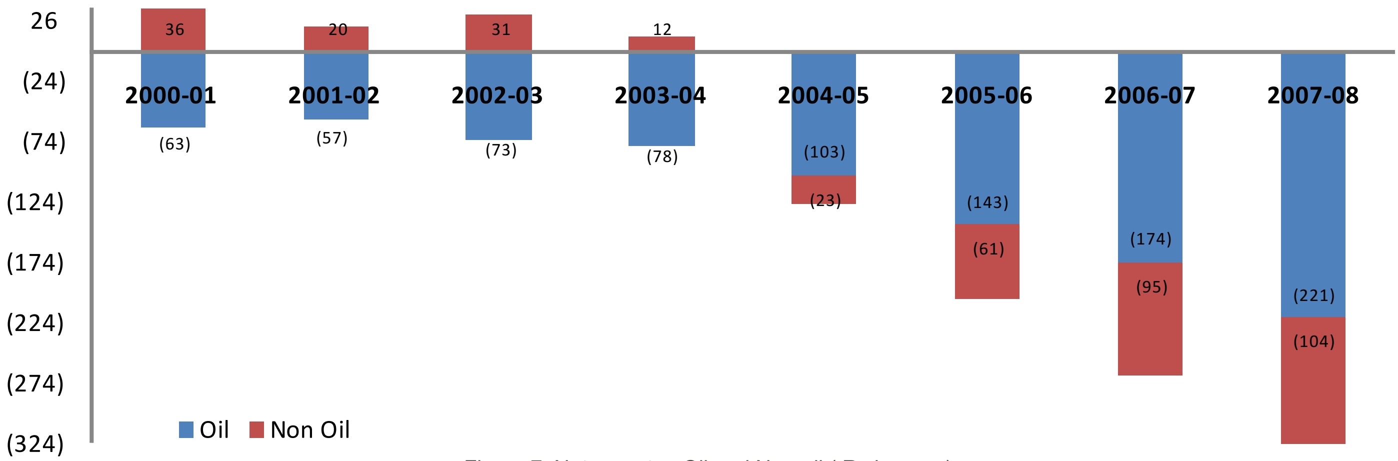

Figure 7: Net exports - Oil and Non-oil (Rs in crore)

- The global crisis resulted in sharp deceleration of exports. While imports also slowed down due to a downturn in domestic consumption and production, the sharper deceleration of exports resulted in a widening trade deficit.
- Developing countries (39.9%) are the largest markets for Indian exports followed by OECD countries (38.2%) and OPED countries (19.9%). USA with an export market of 11.9% continues to be the single largest export destination. The other major markets for Indian exports were the UAE (11.2%), Singapore (5.1%), China (4.4%) and Hong Kong (3.8%). Exports to all regions and countries except OECD countries have seen a sharp decline over the last year.
- OPEC had the highest share in India's imports (35.6%), followed by developing countries (31.4%) and OECD countries (30.2%). China was the single largest source of imports, with a share of 10.0%, followed by Saudi Arabia (7.7%), the UAE (6.5%), the US (5.9%), Iran (4.6%) and Switzerland (4.2%).

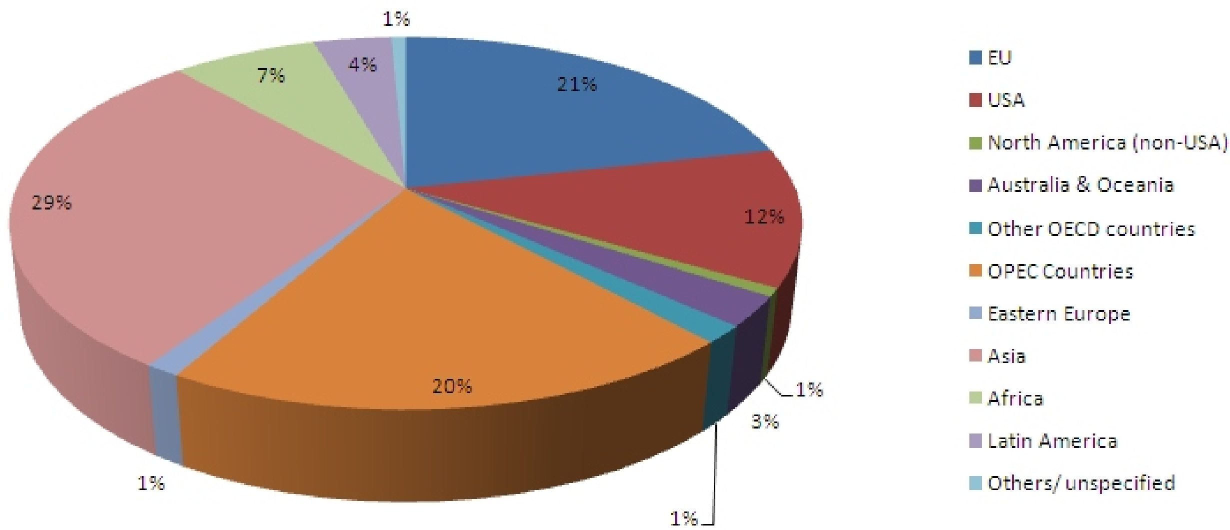

Figure 8: India's Exports to Principal Regions

Net exports are strongly influenced by **the deficit on account of India's oil trade, global trade trends (especially merchandise exports) and commodity prices.**

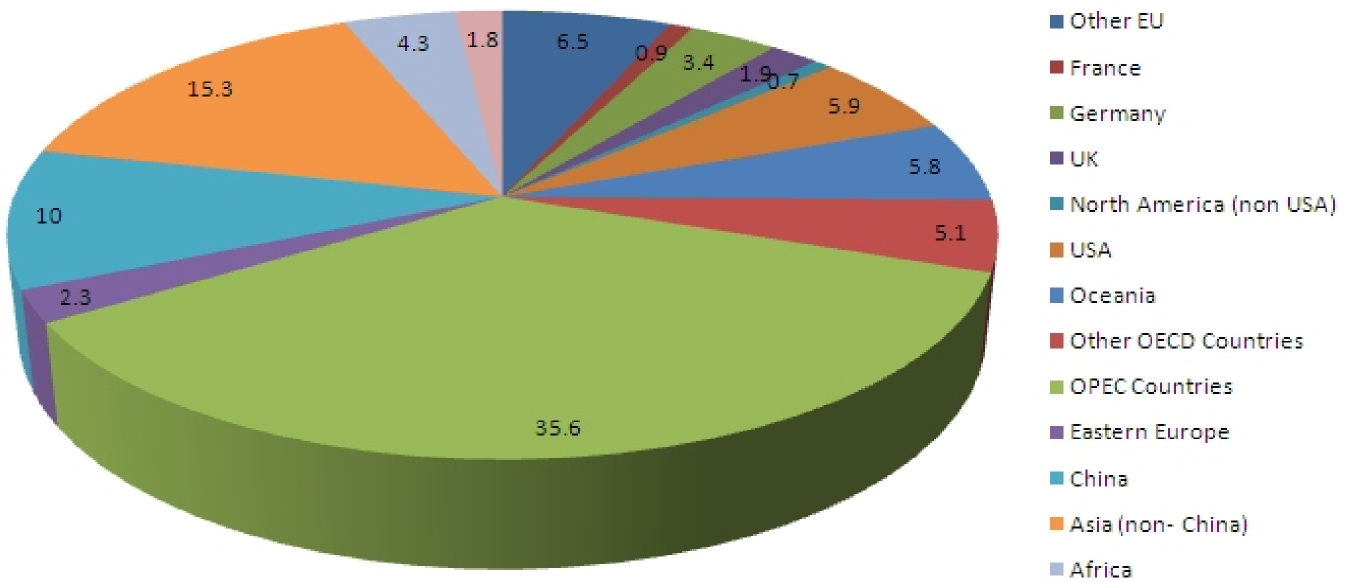

Figure 9: India's Imports from Principal Regions

Projections for 2009-10

- The Indian economy continues to be driven by domestic consumption and investment. The biggest macroeconomic challenge continues to be the ability to support aggregate demand drivers to enable sustained economic growth.
- Private consumption continues to be the most stable and sustainable driver of domestic demand. Strong rural demand, lagged impact of monetary and fiscal stimuli, softening of domestic input prices, investment demand from brown-field projects and some restructuring initiatives are expected to have a positive impact on aggregate demand and industrial production in the months ahead.
- A moderation in private investment is expected as a result of increased public investment and government spending in the short term, increased credit flows and stabilization of corporate profits.
- Government spending is set to increase in 2009-10 at 6.5% with a 5.6% increase in revenue expenditure as fiscal stimuli (3% 0f GDP) continue to drive aggregate demand in the face of moderating investment and consumption. The focus of expenditure is rural development, infrastructure and social sector. Stability in growth drivers as the result of government stimuli and RBI measures is expected to promote industrial production in 2009-10.
- As global trade continues to decline over H1 (2009-10), net exports are expected to moderate steadily. Merchandise exports recorded a deceleration of 15.9% whereas imports recorded a deceleration of 24.1% resulting in an increase in the trade deficit by 47.4%. As global trade reflects significant shifts in export trade destinations and composition, Indian exports (supported by a stable production capacity) have several growth avenues available to them.

Opening new doors of opportunity for you...

Q S Consultants India Pvt. Ltd.

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