KFW ECONOMIC RESEARCH

Emerging Markets Spotlight

India – major reforms needed in the energy sector

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Economic situation

Real growth

Consumer climate

Inflation

Slow growth with a high level of inflation

Although the current economic momentum is good compared to other countries, it is much slower than in the former boom years. It remains to be seen whether the current good consumer climate results in a sustained upturn. One negative factor is the continuing high level of inflation, which particularly affects the poor (⅔ of the population live on less than 2 dollars a day). In this situation monetary policy has little scope for stimulating the economy on the basis of interest-rate policy.

Growth financing

Current account balance

Forex reserves / imports

Budget deficit / GDP

Consolidation of state finances as a key challenge

India's development is based on both internal and external finance. Until the global financial crisis the deficit on current account was mainly covered by FDI, but since then more (volatile) portfolio investments and loans have been used for this purpose. Forex reserves are adequate. The weak point is the state budget: the large deficits recorded by the central government and the union states are not viable in the long term.

Growth resources

Investment ratio

Labour force participation rate

Governance

Still plenty of untapped potential

The investment rate is still strong compared to other emerging markets. However, the economy is still dominated by relatively unproductive agriculture. The areas of education / job market also show considerable deficits (participation- and illiteracy rate). The governance indicators present a similarly weak picture to other emerging markets.

Economic relations with DEU

Share of DEU in goods exports

Share of DEU in goods imports

FDI inflows from Germany

Germany not a leading partner for India, but still important

Germany's share in India's foreign trade has hardly changed at all recently. Bilateral trade has tended to decrease since 2011. Germany is India's most important trading partner within the EU, but comes a long way behind China and the US. German FDI in India are increasing, but are low overall.

Legend (for detailed explanation of methodology see p. 4)

very good | good | neutral | weak | very weak

much improved | improved | stable | worse | much worse

Investment climate: assessment of our local experts

The economic downturn observed since 2010 is the result of increasing dissatisfaction on the part of companies and consumers with the government's economic policy. An improvement in the underlying conditions is urgently needed. The new government under Prime Minister Modi has promised this. However, the state budget offers little scope for new initiatives with an impact on spending, many reforms are politically problematic and overcoming structural problems will take time.

Continued on p. 2

Priority issue: energy

Energy supply is a key determinant for the economic development and international competitiveness of an economy. The Indian electricity sector is in a poor condition. Generating capacity is insufficient and often technically outdated, the transmission and distribution losses are high and the electricity tariff policy is questionable. India's CO_2 emissions do harm to the global climate and greater use could be made of renewable energy sources. At least those in responsibility have recognised the problems, but the political implementation of reforms is difficult.

Continued on p. 2

Investment climate: assessment of our local experts

India is not a country but a continent. The enormous size and diversity of India applies not only to its geography and people, but also to its economy. It cannot be characterised in just a few short and snappy phrases. For example, India has many billionaires, but at the same time more than 400 million Indians live below the poverty line of 1.25 dollars a day (= one third of the world's poor). The economic boom since 2000 has been driven by industry and the service sector. In spite of this India is still very much an agricultural country (50 % of total employment). This means that sectors such as information technology with its global market level exist side by side with traditional agriculture with its low level of productivity. In the very large domestic market a middle class has increasingly established itself that has the necessary purchasing power to satisfy the pent-up demand for up-market consumer goods. This benefits both the domestic economy and foreign suppliers.

"Both ... and" is a fundamental characteristic. Not all emerging markets can claim, as India does, to have a multi-party system in which fair elections are held and the losers accept their role as opposition. At the same time, however, the political decision-making processes are long and complex. India has a very large number of well-trained workers, who in addition regard speaking English as matter-of-course. On the other hand there are 300 million people who can neither read nor write. Many regard the creation of jobs as the priority issue and see the past few years rather a phase with "jobless growth". The education and healthcare systems are in urgent need of improvement. Due to the large domestic market India, with a share of goods and service exports in GDP of 23 %, is relatively independent of the global market (Germany 50 %), but thus also receives little in the way of stimulus from outside. Public-sector debt presents major problems. Over many years the budget deficit of the central government and union states has stood at 10 % or even more in relation to GDP with one third of public revenue being absorbed by interest payments. This means that too little funding is available to maintain and extend the infrastructure, which constitutes a serious obstacle to growth. Without an Indian business partner, foreign investors have a hard time coping with the ponderous Indian bureaucracy. In general the business world complains about a lack of a reliable legal system and widespread corruption. Nevertheless, thanks to a free press public awareness of these problems is increasing.

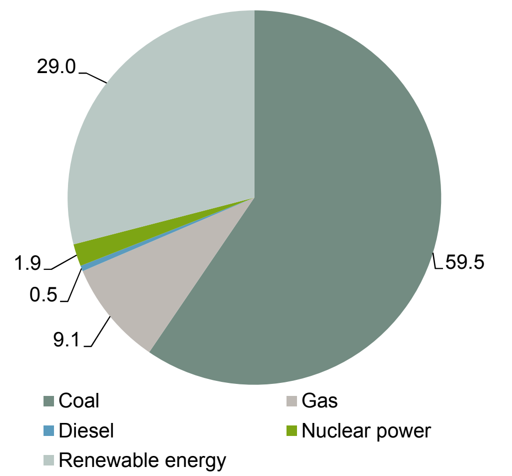
Economic outlook: The IMF estimates medium-term potential growth at 6.75 % p. a. based on the current economic and political status quo. In other words, an improvement of the underlying conditions would increase this potential. The chances of this happening are not bad: the newly elected Modi government has promised reforms and has a comfortable majority in parliament. Now it has to deliver.

Based on an interview dated 22.07.2014 with Andreas Thermann
(Deputy Head of the Indian External Office of KfW Development Bank) ■

Priority issue: unfavourable underlying conditions in the energy sector

A reliable energy supply is a basic prerequisite for all economic activity. India has impressive (primary) energy resources of its own, but is also very dependent on imports, which weigh on the balance of payments. This makes it all the more important to make increased use of renewable energy sources and to increase energy efficiency. The potential in these areas is high.

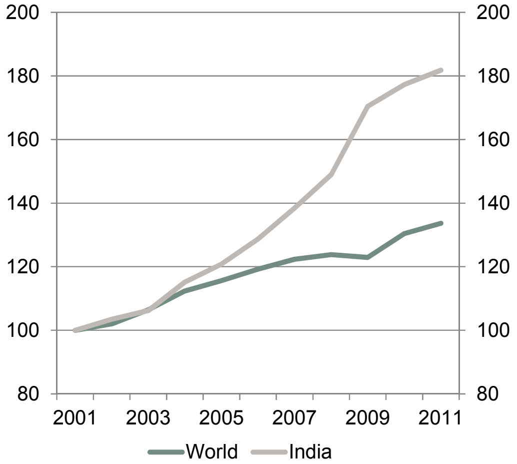
Figure 1: Installed power generation capacity June 2014 (percentage)



Source: Central Electricity Authority

The electricity sector deserves particular attention. Here there is considerable need of reform. Electricity is of central importance as a production factor, making it a major determinant for the international competitiveness of an economy. The Indian electricity sector has been hugely expanded in the wake of the rapid economic growth. Installed electricity-generating capacity has increased by 128 % since 2000. Two thirds of existing capacity is accounted for by coal- and gas-fired power stations (Figure 1). The large share of fossil energy sources has led to a considerable increase in Indian CO_2 emissions (+80 % since 2001, Figure 2). This makes India the world's third largest emitter of CO_2. In addition to this, the coal-fired power stations cause major damage to the environment as their level of technical efficiency is sub-optimal and Indian coal has a very high ash content. Coal mining also often entails major environmental damage.

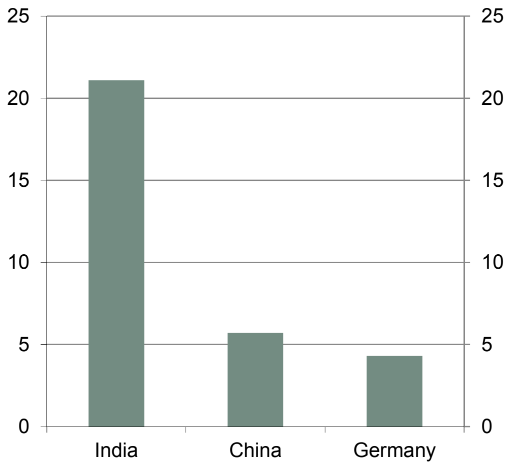
Figure 2: CO_2 emissions (Index 2001=100)



Source: International Energy Agency

Electricity supply is still inadequate despite the increase in capacity. Around one third of Indian households have no electricity connection. In summer 2012 the northern power grid collapsed entirely for two days, the greatest power outage in history. According to information from the World Bank, a very high 21 % of electricity generated is lost in the transmission and distribution system (Figure 3, other estimates even put the figure at up to 28 %), caused by technical shortcomings but also by the theft of electricity. This poor supply compels many companies to maintain their own diesel generator, which entails high costs. The economy is also negatively affected by the electricity price policy. Because of the political objective of supporting agriculture, in many union states, for example, electricity is supplied to farmers free of charge. Trade and industry pay the price for this in the form of high tariffs (cross-subsidisation).

Figure 3: Losses during electricity transmission and distribution as a percentage of electricity generation (2011)



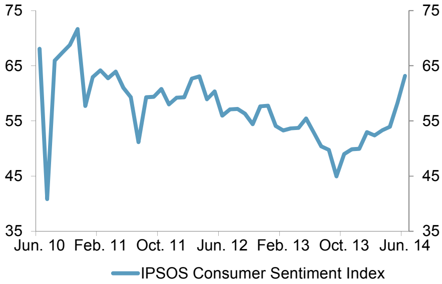
Source: World Bank

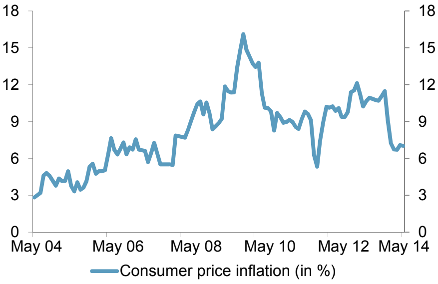
The political control of the electricity sector is not very stringent, so this sector is only gradually becoming attractive for private investors. At central government level five ministries are responsible, which makes it difficult to impose a clear sector policy and results in lengthy decision-making processes. At least now in the new government the three most important ministries have been combined under one minister. The union states also share responsibility for energy policy. Any number of power distributing companies are de facto bankrupt. Solutions to this have now been initiated, but these will not show effect overnight. The electricity sector is in principle open for private investors. However, many investors are deterred by the aforementioned problems and the generally cumbersome Indian administration. Against this backdrop it is not surprising that the share of the private sector in installed power generation capacity amounts to date to a mere 35 %.

India wants and is able to become greener. The potential for greater use of renewable energy sources is large. The positive aspects of this country are the large amount of sunshine, the long coastline (wind) and the natural incline of the Himalayas (hydroelectric). The government is in favour of an energy mix and also wants to extend the renewables segment. As in other countries, complex questions have to be clarified for this purpose. German companies are operating successfully in this area as in conventional power plant technology, both as investors and suppliers. ■

Overview of figures

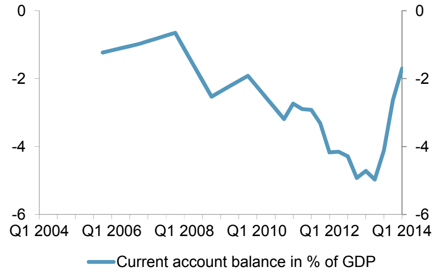
Economic situation

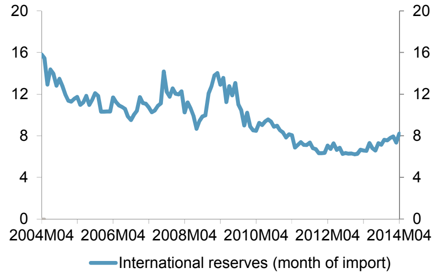


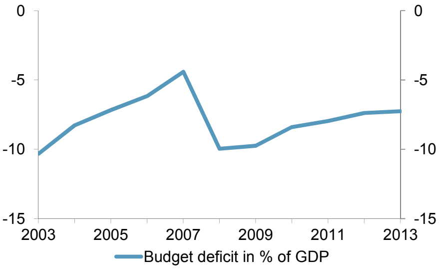


Source: Datastream; OECD, Thomson Reuters IPSOS; Labour Bureau, Government of India; authors' calculations.

Growth financing

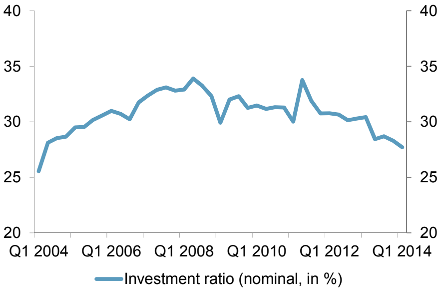


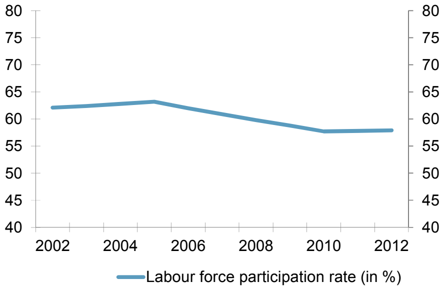


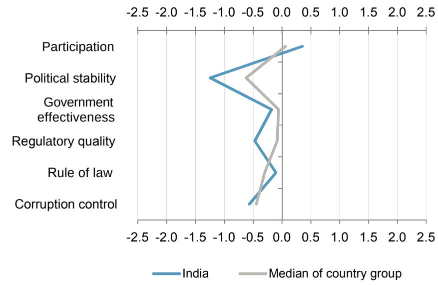


Source: Datastream; IWF, World Bank, authors' calculations.

Growth resources

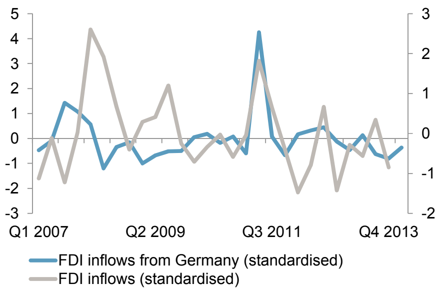






Source: Datastream; OECD, World Bank WDI, WGI; authors' calculations.

Economic relations with DEU



Source: Datastream; Deutsche Bundesbank; IMF, OECD; authors' calculations.

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

Firstly, the development of the indicators over time is examined for the country itself. As a rule, the analysis is based on the last ten years. The direction of arrow is determined by the current change in comparison to the previous period. An improvement in the indicator is shown with an arrow pointing upwards, while a deterioration is shown with an arrow pointing downwards. A horizontal arrow indicates that the variable is practically unchanged. For example, a higher inflation rate compared to the previous period signals a deterioration, and – depending on the extent of the change – is labelled with an arrow pointing diagonally or straight downwards. The magnitude of the absolute change compared to the average historical absolute change determines the extent of the change and therefore the direction of the arrow.

⇧ Strong improvement in the given indicator: > 3/3 of the historical absolute change

⬀ Improvement in the given indicator: 1/3 – 3/3 of the historical absolute change

⇨ Slight change in the given indicator: <1/3 of the historical absolute change

⬂ Deterioration in the given indicator: 1/3 – 3/3 of the historical absolute change

⇩ Significant deterioration in the given indicator: > 3/3 of the historical absolute change

Secondly, the indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours:

Quintile 1
Quintile 2
Quintile 3
Quintile 4
Quintile 5

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

Disclaimer

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