

Paper -IV

ECONOMY AND DEVELOPMENT OF INDIA

Major Challenges of the Indian Economy:

Context

While India remains one of the fastest-growing major economies, recent macroeconomic data reveals deep structural frictions. The economy is grappling with volatile growth trajectories, sectoral stagnation, imported inflation, and external sector vulnerabilities that require urgent policy recalibration.

**Going ahead, the economy faces headwinds.
Policy support is needed**

Growth is expected to slow down, while inflation is likely to edge upwards. Much will depend on how long the conflict in West Asia drags on

Testing times: On India's GDP growth data

GDP data reveal some strengths, but they will come under strain

Published - June 08, 2026 12:30 am IST

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**Indian Economy Yearender 2025 | As the year
ends with solid economic indicators, govt
faces challenges of reviving consumption,
triggering pvt investment**

India Tariff impact US: India has ended the year with a fairly strong set of macroeconomic numbers, including tepid inflation and low interest rates, but external uncertainties such as tariffs and AI will continue into 2026.

Below-normal monsoon and West Asia conflict cloud India's agriculture outlook: BoB

ANI • Last Updated: Apr 18, 2026, 02:02:00 PM IST

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Synopsis

India's agriculture faces a challenging year. A below-normal monsoon forecast and the West Asian conflict threaten crop production and rural economic growth. The India Meteorological Department predicts rainfall at 92 percent of the Long Period Average, the lowest initial forecast in 25 years. Disruptions in gas supply also affect fertilizer and pesticide availability.

Explained: India's Growth Story Explained: Key Takeaways from the RBI Annual Report 2025-26

India reports surprise balance of payments surplus in Jan-March quarter

By Reuters

June 8, 2026 5:51 PM GMT+5:30 · Updated June 8, 2026



1. Inconsistent & Volatile Macro Growth Rates

The Growth Paradox

- **Data Point:** According to MoSPI, India's real GDP grew at a robust **7.7% in FY26**. However, the RBI and independent economists project a sharp moderation to **6.6% in FY27**.
- **Implication:** This indicates underlying macroeconomic volatility rather than a stable, sustained growth trajectory.

The "K-Shaped" Recovery

- **Skewed Demand:** Growth is heavily concentrated in **premium consumption** and **state-led public capital expenditure (Capex)**.

- **Sluggish Segments:** Rural consumption (wage growth) and private corporate investment remain weak, indicating structural instability and unequal wealth distribution.
- *Mains Keyword:* **Uneven Growth / K-Shaped Recovery.**

The "Headwind" Factor

- Economic momentum faces a **dual tightening squeeze**:
 1. **Intended Domestic Fiscal Consolidation:** Government reducing its borrowing and spending to meet fiscal deficit targets.
 2. **Unintended Global Monetary Friction:** High global interest rates (especially US Fed rates) keeping borrowing costs high and dampening investment.

2. Sectoral Crises: Agriculture & Manufacturing Stagnation

GVA Sectoral Share Shift (Structural Imbalance)

Sector	2022-23 Share	FY26 Share	Trend & Implication
Agriculture	22.1%	Sub-20%	High labor absorption, but low value addition.
Services	51.9%	54.3%	Premature leapfrogging (skipping the industrial phase).
Manufacturing	Stagnant	Stagnant	Friction-heavy, failing to absorb surplus farm labor.

A. Agriculture: Low Growth, Weather & Supply Shocks

- **Decelerating Growth:** Agriculture and allied sector growth slowed to **3.0% in FY26** (down from 4.2% in FY25).
- **Monsoon Vulnerability:** The IMD forecasted the Southwest Monsoon at just **92% of the Long Period Average (LPA)**—the lowest initial forecast in 25 years, threatening rain-fed crops and rural demand.
- **Geopolitical Spillover:** Conflicts in West Asia have choked international maritime routes (e.g., Red Sea crisis), causing severe domestic **fertilizer and pesticide supply constraints**. This drives up input costs and compresses rural profit margins.

B. Manufacturing: Jobless Growth & Global Disconnection

- **Global Disconnection:** Despite Production Linked Incentive (PLI) schemes, India accounts for just **2.9% of global value-added manufacturing** and a mere **1.8% of global merchandise exports**.

- **The Complexity Gap:** India ranks a lowly **44th on the Economic Complexity Index (ECI)**, indicating a lack of diversification into high-tech, knowledge-intensive manufacturing.
- **Premature Deindustrialization:** The economy skipped directly from agriculture to services, failing to create the millions of blue-collar factory jobs needed for workers exiting the farm sector.

3. Imported Inflation & The Crude Oil Vulnerability

Supply-Driven Price Shocks

- **Global Trend:** The IMF raised its 2026 global inflation forecast to **4.4%** due to global shipping lane disruptions and surging energy blockades.
- **Domestic Impact:** India is highly susceptible to **Imported Inflation**, where global supply chain shocks directly translate into domestic retail price spikes.

The Crude Oil Threat

- **Import Dependency:** India imports **over 80%** of its crude oil requirements.
- **The Transmission Mechanism:** Every geopolitical escalation in West Asia pushes up the oil import bill. This directly bleeds into domestic logistics costs, transport fares, and manufacturing input costs, keeping core inflation sticky.

Monetary Deadlock

- **The RBI's Dilemma:** Stubborn food and energy inflation prevents the RBI from cutting the Repo Rate.
- **Consequence:** Prolonged tight monetary policy maintains high borrowing costs for domestic businesses, crowding out private capital expenditure (Capex).

4. Current Account Deficit (CAD) & Unfavorable Balance of Payments (BoP)

The RBI's external sector data reveals deep friction points in India's structural balancing act.

The Ballooning Trade Gap

- **Merchandise Deficit:** India's full-year merchandise trade deficit widened sharply to **\$337.3 billion in FY26** (up from \$286.9 billion in FY25).
- **Q4 Surge:** In the final quarter alone, the trade gap surged to **\$83.4 billion** (vs \$59.3B in the previous year), driven by high oil and gold imports.

Full-Year CAD Stretch & The "Cushions"

- **CAD Widening:** The Current Account Deficit widened to **\$25.2 billion**.
- **The Emergency Cushions:** The CAD was kept steady at a manageable **0.6% of GDP** only because of:
 - Strong **Services Exports** (\$60.4 billion in Q4).
 - Resilient **Global Remittances** (\$143.6 billion net for the full year).

Foreign Capital Outflow (BoP Stress) & Reserve Depletion

- **FPI Flight:** Driven by global "risk-off" sentiments and a strengthening US Dollar, Foreign Portfolio Investors (FPIs) pulled out **\$16.4 billion** from Indian markets in FY26.
- **FDI Shortfall:** Net Foreign Direct Investment (FDI) recoveries were a mere **\$6.9 billion**, insufficient to offset the FPI flight.
- **Forex Depletion:** To balance the national books and defend the rupee, India's Foreign Exchange Reserves depleted by **\$23.6 billion in FY26**.

5. Way Forward: Strategic Policy Interventions

To address these structural challenges, a multi-pronged approach is required:

Revitalizing Agriculture:

- Promote **climate-resilient farming** and micro-irrigation (Per Drop More Crop) to mitigate monsoon risks.
- Accelerate **PM-PRANAM** to reduce dependence on imported chemical fertilizers and promote alternative bio-fertilizers.

Fixing the Manufacturing "Complexity" Gap:

- Shift focus from just capital-intensive PLI sectors to **labor-intensive sectors** (textiles, leather, footwear, toys) to absorb semi-skilled agricultural labor.
- Reduce logistics costs through **PM Gati Shakti** and the National Logistics Policy to make exports globally competitive.

Tackling Imported Inflation & Oil Vulnerability:

- Aggressively push the **Energy Transition** (National Green Hydrogen Mission, Ethanol Blending Programme, and EV adoption) to structurally reduce the crude import bill.
- Diversify crude sourcing and utilize **Rupee Internationalization (Special Rupee Vostro Accounts)** to bypass the US dollar in bilateral energy trade.

Stabilizing the External Sector (BoP):

- Leverage the **Services Export boom** by negotiating Mutual Recognition Agreements (MRAs) for IT and professional services.
- Shift the capital inflow composition from volatile "hot money" (FPI) to sticky, long-term **Foreign Direct Investment (FDI)** by improving the Ease of Doing Business and ensuring policy predictability.

Conclusion

India's macroeconomic narrative is currently caught in a tug-of-war between robust services-led growth and deep-seated structural vulnerabilities in agriculture and manufacturing. While the "emergency cushions" of remittances and IT exports are currently shielding the Current Account Deficit, long-term macroeconomic stability requires a decisive shift from **premature deindustrialization to inclusive, labor-intensive manufacturing**, coupled with an aggressive domestic energy transition to neutralize the persistent threat of imported inflation.

Current Account Deficit (CAD) and Balance of Payments (BoP): Static Concepts for Mains

1. Balance of Payments (BoP): Meaning and Structure

Definition

The **Balance of Payments (BoP)** is a systematic record of all economic transactions between residents of a country and the rest of the world during a given period (usually a year). It is based on the **double-entry bookkeeping system**, where every transaction has a credit (inflow) and a debit (outflow) entry.

Key Components of BoP

The BoP is broadly divided into three accounts:

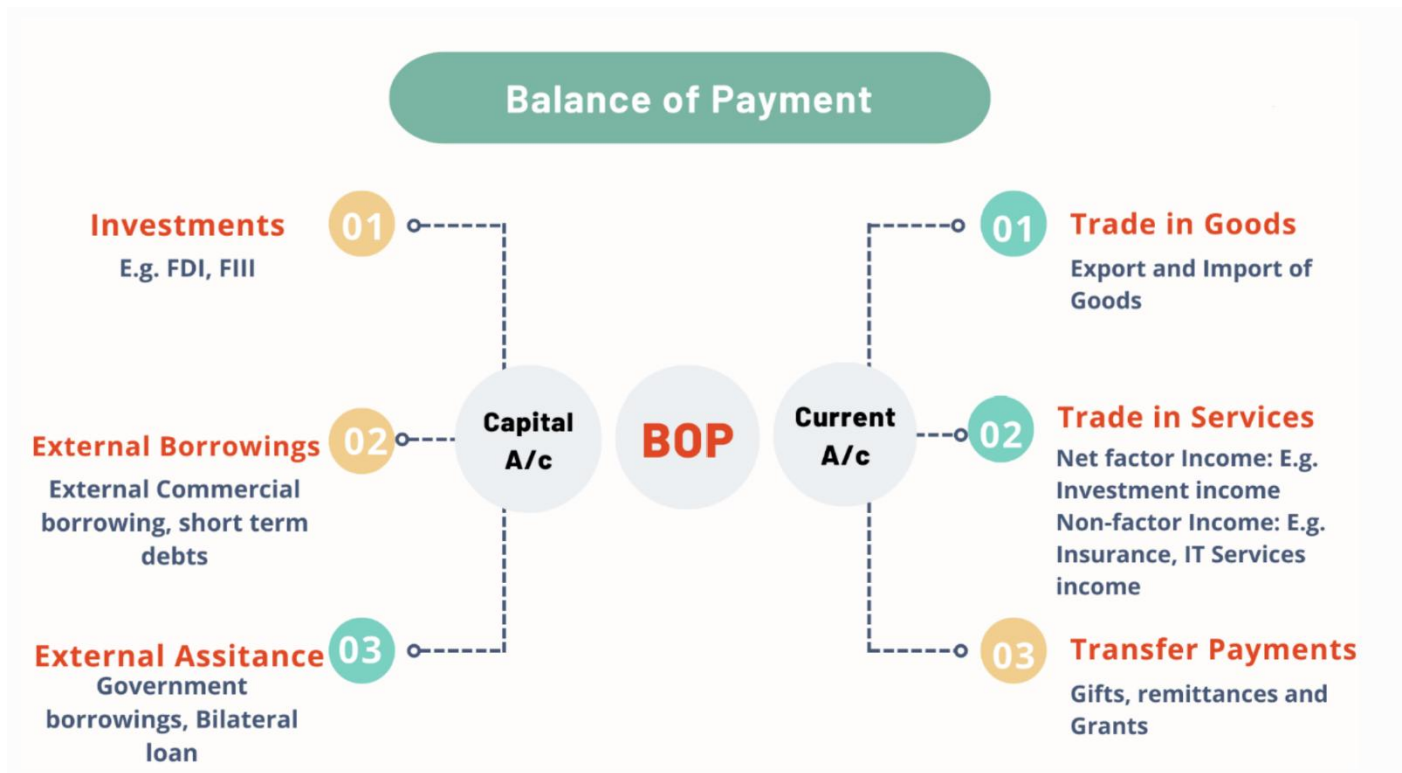
Account	Records	Nature
Current Account	Trade in goods & services, income flows, current transfers	Flow of real resources; affects national income
Capital Account	Capital transfers, acquisition/disposal of non-produced, non-financial assets	Flow of financial capital; affects asset-liability position
Financial Account	Direct investment, portfolio investment, other investments, reserve assets	Flow of financial claims; most volatile component

Note: In India's BoP presentation (RBI), the Capital and Financial Accounts are often combined under "Capital Account".

Accounting Identity

BoP Identity: Current Account Balance + Capital Account Balance + Financial Account Balance + Net Errors & Omissions = 0

- A surplus in one account must be matched by a deficit in another.
- **Net Errors & Omissions:** A balancing item to account for unrecorded or misrecorded transactions.



2. Current Account: Detailed Components

The Current Account records transactions that do not result in a change of ownership of financial assets. It reflects a country's net income.

A. Trade in Goods (Visible Trade / Merchandise Trade)

- **Exports (Credit):** Sale of physical goods abroad (e.g., petroleum products, gems, pharmaceuticals, engineering goods).
- **Imports (Debit):** Purchase of physical goods from abroad (e.g., crude oil, gold, electronics, machinery).
- **Balance: Trade Balance = Exports of Goods - Imports of Goods.** India typically runs a merchandise trade deficit.

B. Trade in Services (Invisible Trade)

- **Exports (Credit):** Software services, business process outsourcing (BPO), travel, transport, financial services.
- **Imports (Debit):** Payments for foreign consulting, insurance, freight, travel abroad.
- **Balance:** India typically runs a **services surplus**, driven by IT/ITeS exports.

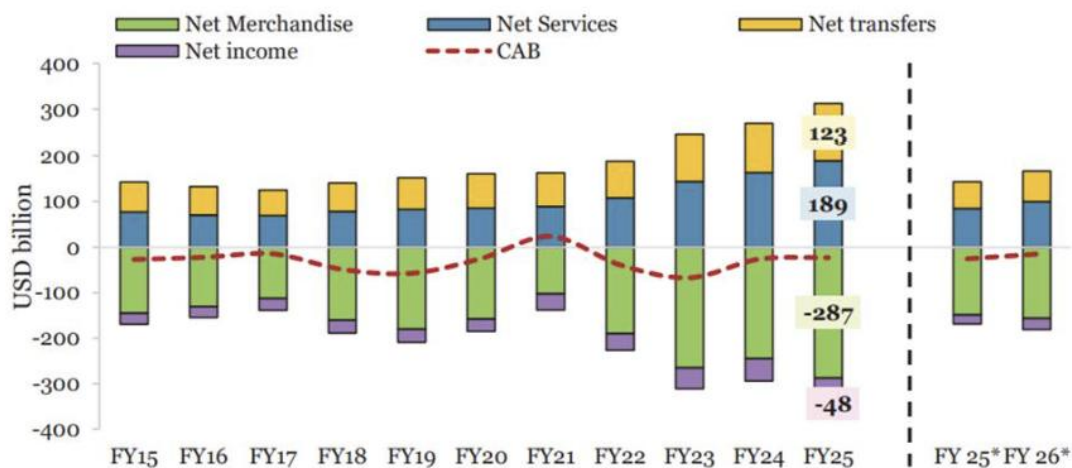
C. Primary Income (Investment Income & Compensation of Employees)

- **Credit:** Income earned by Indian residents from foreign investments (dividends, interest) and wages earned by Indians working abroad.
- **Debit:** Income paid to foreign investors on their investments in India and wages paid to foreign workers in India.
- **Balance:** India typically runs a **primary income deficit** due to repatriation of profits by foreign companies and interest payments on external debt.

D. Secondary Income (Current Transfers)

- **Credit: Remittances** from Non-Resident Indians (NRIs), foreign aid/grants received.
- **Debit:** Remittances sent by foreign workers in India, foreign aid/grants given by India.
- **Balance:** India runs a **large secondary income surplus**, primarily due to massive NRI remittances (world's largest recipient).

India's current account balance



India's current account structure reflects a merchandise trade deficit offset by strong net inflows of invisibles, led by rising surpluses in services and private transfers.

- [EconomicSurvey2026](#)

Current Account Balance (CAB) Formula

CAB = (Exports of Goods & Services - Imports of Goods & Services) + Net Primary Income + Net Secondary Income

- **CAB Surplus:** Country is a net lender to the rest of the world.
- **CAB Deficit:** Country is a net borrower from the rest of the world.

3. Capital Account: Detailed Components

The Capital Account records transactions that involve a change in ownership of financial assets and liabilities between residents and non-residents.

A. Foreign Direct Investment (FDI)

- **Inflow (Credit):** Long-term investment by foreign entities in Indian enterprises with management control (e.g., setting up a subsidiary, acquiring >10% stake).
- **Outflow (Debit):** Indian companies investing abroad.
- **Nature: Stable, non-debt creating, "sticky" capital.** Preferred for long-term development.

B. Foreign Portfolio Investment (FPI)

- **Inflow (Credit):** Investment by foreign entities in Indian financial assets (stocks, bonds) without management control (<10% stake).
- **Outflow (Debit):** Indian investors buying foreign financial assets.
- **Nature: Highly volatile, "hot money",** driven by global risk sentiment and interest rate differentials.

C. External Commercial Borrowings (ECBs)

- **Inflow (Credit):** Loans taken by Indian corporates/banks from foreign sources.
- **Outflow (Debit):** Repayment of principal and interest on these loans.
- **Nature: Debt-creating,** adds to external debt burden.

D. NRI Deposits

- **Inflow (Credit):** Deposits made by NRIs in Indian banks (NRE, FCNR accounts).
- **Outflow (Debit):** Withdrawal/repatriation of these deposits.

- **Nature:** Relatively stable, but can be volatile during global crises.

E. Other Flows

- **Banking Capital:** Changes in foreign assets/liabilities of Indian banks.
- **Rupee Debt Services:** Repayment of principal on rupee-denominated external debt.
- **Other Capital:** Miscellaneous capital transfers.

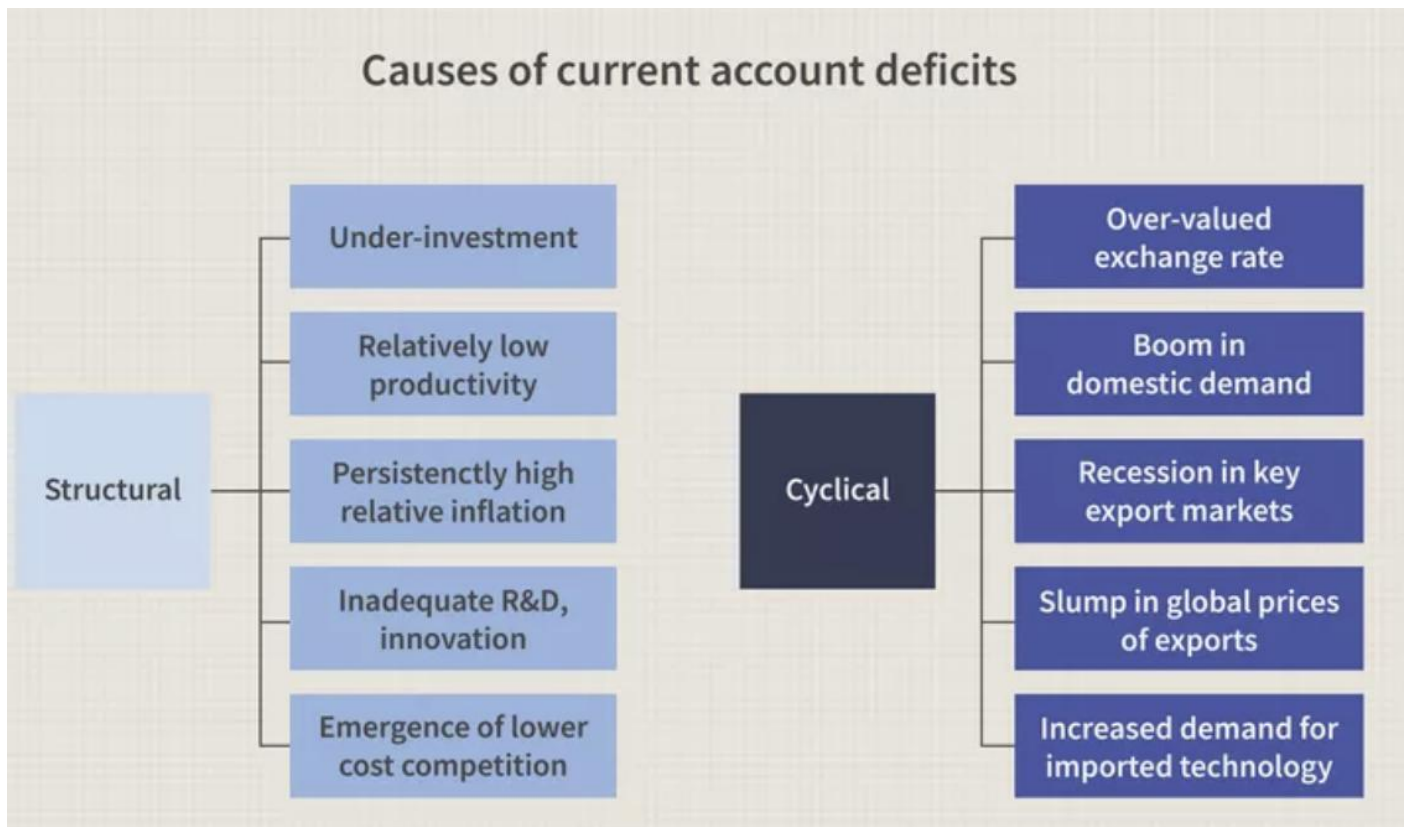
4. Current Account Deficit (CAD): Meaning, Causes, and Implications

Definition

A **Current Account Deficit (CAD)** occurs when a country's total imports of goods, services, and transfers exceed its total exports. It means the country is consuming more than it produces and is financing this gap by borrowing from abroad or selling assets.

Causes of CAD in India (Structural & Cyclical)

Type	Cause	Explanation
Structural	High Import Dependence (Oil & Gold)	India imports >80% of its crude oil and significant gold. These are price-inelastic and volume-inelastic in the short run.
Structural	Low Export Competitiveness	Manufacturing bottlenecks (infrastructure, logistics, labor laws) limit export growth. Export basket lacks diversification into high-value goods.
Structural	Savings-Investment Gap	Domestic savings are insufficient to fund high investment needs, necessitating foreign capital inflows which manifest as CAD.
Cyclical	Global Commodity Price Shocks	A spike in global crude oil prices directly widens the import bill and CAD.
Cyclical	Global Demand Slowdown	Weak global demand reduces demand for Indian exports, worsening the trade balance.
Cyclical	Exchange Rate Volatility	A rapidly depreciating rupee can increase the rupee value of imports faster than it boosts export volumes (J-Curve effect).



Implications of CAD

A. Negative Implications (If Large & Persistent)

- **External Vulnerability:** High CAD increases reliance on foreign capital. If capital flows reverse (sudden stop), it can trigger a balance of payments crisis (e.g., 1991).
- **Currency Depreciation Pressure:** Persistent CAD increases demand for foreign currency, putting downward pressure on the domestic currency.
- **Inflationary Pressure:** A depreciating currency makes imports (especially oil) more expensive, leading to imported inflation.
- **Credit Rating Downgrade:** Large, unsustainable CAD can lead rating agencies to downgrade sovereign credit ratings, increasing borrowing costs.
- **Crowding Out of Productive Investment:** If CAD is financed by short-term, volatile FPI rather than stable FDI, it can lead to asset price bubbles and financial instability.

B. Positive/Nuanced View (If Moderate & Well-Financed)

- **Financing Productive Investment:** If CAD finances imports of capital goods and technology that boost future productive capacity and exports, it can be growth-enhancing (e.g., East Asian tigers in their development phase).

- **Consumption Smoothing:** Allows a country to maintain consumption and investment during temporary shocks (e.g., drought, oil price spike).

Sustainable vs. Unsustainable CAD

Feature	Sustainable CAD	Unsustainable CAD
Size	Moderate (e.g., <2.5-3% of GDP for India)	Large and widening (e.g., >4% of GDP)
Financing	Financed by stable, non-debt flows (FDI, remittances)	Financed by volatile, debt-creating flows (short-term ECBs, FPI)
Composition	Imports are capital goods for future export capacity	Imports are primarily consumption goods (oil, gold)
Duration	Temporary, cyclical	Persistent, structural
Reserve Buffer	Adequate forex reserves to cover several months of imports	Depleting forex reserves

5. Financing the CAD: How India Bridges the Gap

A CAD must be financed by a surplus in the Capital and Financial Accounts.

Sources of Financing for India's CAD

1. **Foreign Direct Investment (FDI):** The most desirable source. Stable, long-term, brings technology and jobs.
2. **Foreign Portfolio Investment (FPI):** Volatile. Can reverse quickly during global risk-off episodes.
3. **External Commercial Borrowings (ECBs):** Debt-creating. Increases external debt burden and vulnerability.
4. **NRI Deposits:** Relatively stable, but sensitive to interest rate differentials and global sentiment.
5. **Drawdown of Forex Reserves:** RBI can sell dollars from its reserves to finance the deficit. This is a temporary measure.
6. **Multilateral/Bilateral Borrowing:** Loans from IMF, World Bank, or other governments.

The Critical Link: CAD, Capital Flows, and Forex Reserves

- **CAD + Net Capital Inflow = Change in Forex Reserves**
- If **Net Capital Inflow > CAD** → Forex Reserves Increase.

- If **Net Capital Inflow** < **CAD** → Forex Reserves Decrease.
- India's strategy has been to attract sufficient stable capital inflows to not only finance the CAD but also build a robust forex reserve buffer.

6. India's BoP and CAD: Historical Trends & Recent Position

Historical Context

- **Pre-1991:** Persistent CAD, financed by short-term borrowing, led to the 1991 BoP crisis.
- **Post-1991 Reforms:** Liberalization attracted FDI and FPI. Services exports (IT) grew, providing a cushion.
- **2000s:** High growth period, but CAD widened due to high oil prices and gold imports. CAD peaked at 4.8% of GDP in FY13 (Taper Tantrum).
- **Post-2013:** Policy measures (gold import restrictions, FDI liberalization) helped contain CAD.

Recent Position (Illustrative - Based on User's Data)

- **FY26:** Merchandise trade deficit widened to **\$337.3 billion**.
- **Services Surplus:** ~\$60.4 billion (Q4), Remittances: ~\$143.6 billion (full year) acted as cushions.
- **Full-Year CAD:** **\$25.2 billion** or **0.6% of GDP** (manageable level).
- **Financing:** FPI outflows of \$16.4 billion were partly offset by FDI inflows of \$6.9 billion, leading to a drawdown of forex reserves by \$23.6 billion.

7. Policy Measures to Manage CAD

A. Export Promotion

- **Schemes:** RoDTEP, Remission of Duties and Taxes on Exported Products.
- **Infrastructure:** PM Gati Shakti, National Logistics Policy to reduce export costs.
- **Diversification:** Focus on new markets (Africa, Latin America) and new products (pharma, engineering goods).

B. Import Management & Substitution

- **Oil:** Accelerate strategic petroleum reserves, promote ethanol blending, EVs, and renewable energy.

- **Gold:** Issue Sovereign Gold Bonds to monetize household gold and reduce physical import demand.
- **Electronics:** PLI schemes to boost domestic manufacturing and reduce imports.

C. Attracting Stable Capital Flows

- **FDI:** Further liberalize FDI norms in key sectors, ensure policy predictability.
- **Masala Bonds:** Promote rupee-denominated bonds issued overseas to attract foreign investment without currency risk for India.
- **FPI:** Develop deep and liquid bond markets to attract long-term foreign institutional investment.

D. Macroeconomic Prudence

- **Fiscal Consolidation:** Containing fiscal deficit reduces government borrowing, which helps control inflation and interest rates, making the economy more attractive for stable capital.
- **Inflation Targeting:** RBI's flexible inflation targeting framework helps maintain macroeconomic stability, which is crucial for managing external vulnerabilities.

E. Building Forex Reserves

- RBI's active forex market intervention and prudent external debt management have helped build a large reserve buffer (\$691 billion as of March 2026), which acts as a shock absorber.

8. Mains Answer Writing: Keywords and Framework

Key Terms to Use

- Twin Deficits (Fiscal Deficit & CAD)
- J-Curve Effect
- Terms of Trade
- External Vulnerability Index
- Sudden Stop of Capital Flows
- Original Sin (inability to borrow abroad in domestic currency)
- Impossible Trinity (Mundell-Fleming Trilemma)

Conclusion

"The management of the Current Account Deficit is a delicate balancing act for an emerging economy like India. While a moderate CAD financed by stable, long-term capital inflows can support growth by

financing productive investment, a large and persistent deficit financed by volatile flows poses significant risks to macroeconomic stability. India's strategy must therefore focus on **structural transformation**—enhancing export competitiveness through manufacturing revival, reducing import dependence via energy transition, and attracting stable FDI—while maintaining prudent macroeconomic policies and a robust forex reserve buffer to navigate global volatility."

