



STATE OF THE ECONOMY

**Breaking the Cycle: Reviving
Growth amid Structural and
Cyclical Challenges**

Abhishek Anand

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by Abhishek Anand

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Phone: 044 2441 1574/2589/9771
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Breaking the Cycle: Reviving Growth amid Structural and Cyclical Challenges

Abhishek Anand*

Abstract

India's economy is experiencing a pronounced slowdown, even as the global economy remains resilient. While post-pandemic pent-up demand had initially boosted growth, recent data suggests a loss of momentum across key sectors. Industrial output has weakened, investment growth has slowed, and government spending has tightened, further dampening demand.

The core issue is whether this slowdown is cyclical or structural. While recent fiscal and monetary tightening has played a role, deeper problems persist. Weak private investment and sluggish exports have weighed on growth for years. India has yet to capitalize on global shifts in trade, losing opportunities in sectors where competitors like Vietnam and Bangladesh have gained ground.

Policy responses must address both short-term and long-term challenges. Immediate steps include easing liquidity and reviving government capital spending. However, sustainable growth depends on structural reforms, particularly in trade and investment policies. A more open trade strategy, reduced protectionist barriers, and efforts to attract foreign investment are critical to breaking the cycle of weak demand and low investment. Without these changes, India risks prolonged stagnation, making it harder to achieve its long-term development goals.

* Visiting Fellow, Madras Institute of Development Studies

1. From Boom to Slowdown: India's Growth Slips Below Expectations

India's economy is now grappling with a sobering reality: Growth is slowing, and not just a little. Real GDP growth slipped to 5.4 percent in Q2 FY24/25, marking a seven-quarter low. For the first half of the fiscal year, growth averaged a modest 6.0 percent, down from 8.2 percent in the same period last year. While some deceleration was expected as the post-pandemic pent up demand wore off, the sharpness of the slowdown has raised deeper concerns. Is this just a temporary blip, or is something more structural at play?

On the production side, real Gross Value Added (GVA) growth declined to 6.2 percent in H1 FY24/25, down from 8.0 percent a year ago (Figure 1). The industrial sector, particularly manufacturing, has been hit hard, growing at just 6.0 percent compared to 9.7 percent last year. The services sector, long the backbone of India's economy, also decelerated to 7.1 percent from 8.3 percent, with financial services and real estate leading the slowdown. Agriculture, while stable, is too small a share of the economy to offset the broader decline.

On the expenditure side, the story is equally troubling. Investment growth (gross fixed capital formation) slowed to 6.4 percent from 10.1 percent, and government consumption growth plummeted to 2.0 percent from 6.2 percent (Figure 2). Private consumption, oddly enough, showed some resilience, rising to 6.7 percent from 4.0 percent, though this seems at odds with other high-frequency indicators pointing to weakening consumer demand. Net exports, usually a drag on GDP, actually contributed positively as exports grew by 5.6 percent while imports collapsed to 0.7 percent.

The disappointing H1 GDP numbers prompted a flurry of downward revisions to growth forecasts for FY24/25 (Figure 3). The National Statistical Office (NSO) now expects real GDP growth of 6.4 percent, down from earlier estimates. The RBI has also revised its forecast from 7.2 percent to 6.6 percent. The consensus forecast now stands at 6.4 percent, a full 50 basis points lower than at the start of the fiscal year.

High-frequency data paints a grim picture: The economy is still sputtering along, even as we head into the third quarter of FY/25, with no real signs of a meaningful rebound (Figure 4). Absent appropriate policy measures, growth risks are drifting toward the lower bound of the market's projected 6.0–6.7 percent range.

What is troubling is that this slowdown is happening against a backdrop of relative global stability. The latest World Economic Outlook (WEO) from the IMF suggests that the global growth outlook remains resilient and in line with earlier projections (Figure 5). The US economy, in particular, has demonstrated unexpected strength, prompting the Federal Open Market Committee (FOMC) to signal fewer rate cuts in 2025 than previously

Figure 1. Real GVA Growth

(percent of GDP, left axis and real 2017 rupees, right axis)

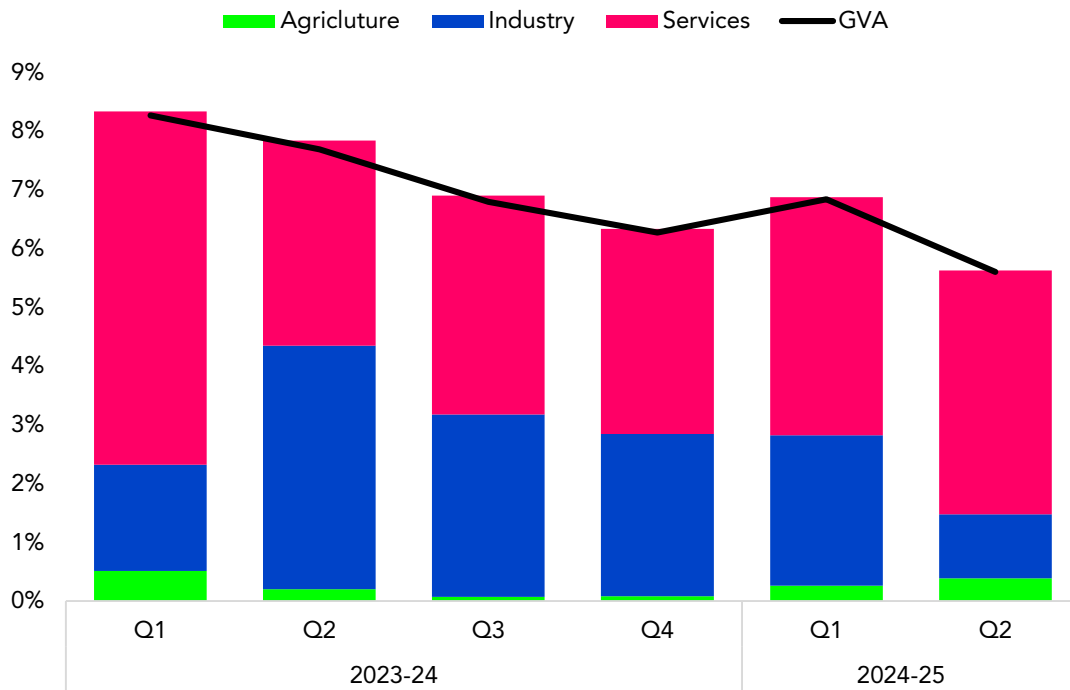
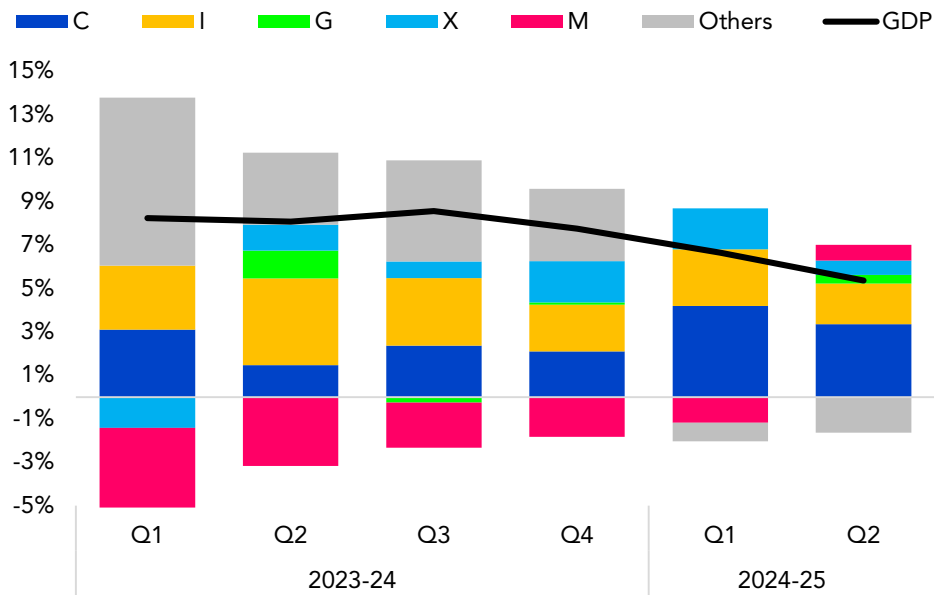


Figure 2. Real GDP Growth

(real per capita terms; 2017 rupees)



Source: MoSPI

Figure 3. Revisions in Real GDP Growth
(FY24/25, percent)

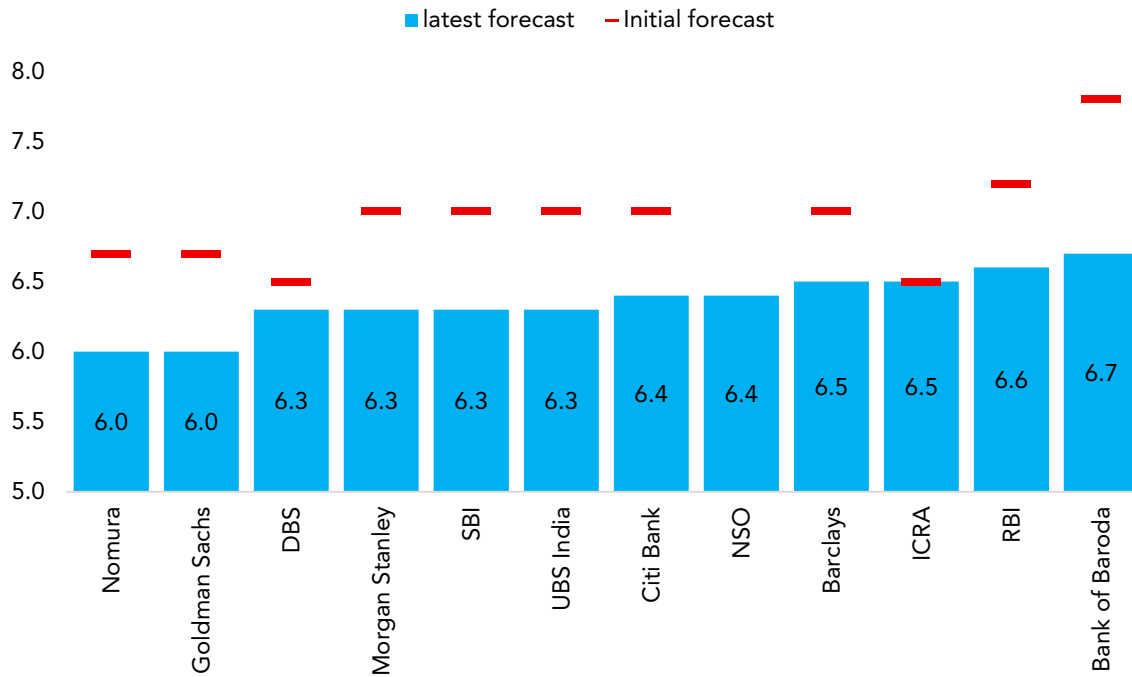
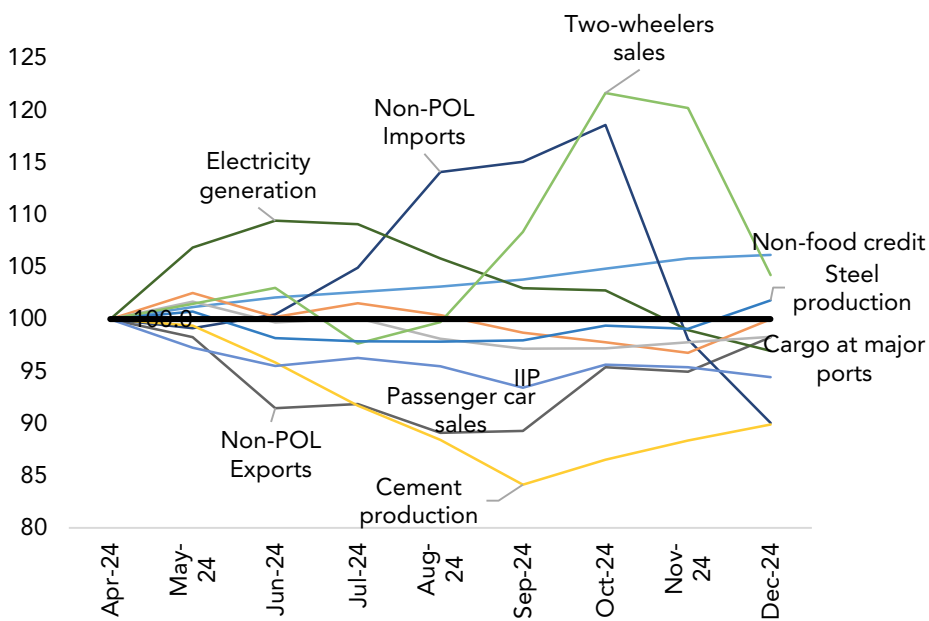


Figure 4. Performance of High Frequency Indicators
(Indices, April-24=100)



Source: CMIE

anticipated. This stability in global economic conditions contrasts sharply with India’s domestic performance, indicating that the slowdown seems to be emanating from domestic factors.



2. Sticky Prices amid Slowing Growth

Economy is slowing, but inflation? Not so much. Despite weakening growth, headline inflation, as measured by the Consumer Price Index (CPI), has remained stubbornly high in FY24/25. Between April and December, CPI inflation averaged 5.5 percent—barely budging from 5.6 percent a year earlier and still well above the RBI’s 4 percent target (Figure 6).

Food prices, driven by volatile items like tomatoes, onions, and potatoes (thanks to erratic weather and supply chain disruptions), have been the main culprit, accounting for over 70 percent of overall inflation (Figure 7). Core inflation, stripping out the volatile food and energy sectors, has eased to 3.4 percent—a clear sign that the economy is cooling off.

The urban-rural inflation divide is another worrying trend. Rural inflation averaged 5.4 percent during this period, compared to 4.3 percent in urban areas. High food prices and slower deflation in rural fuel costs are to blame, highlighting the uneven impact of inflation across the country.

Figure 6. Inflation
(percent, year-on-year)

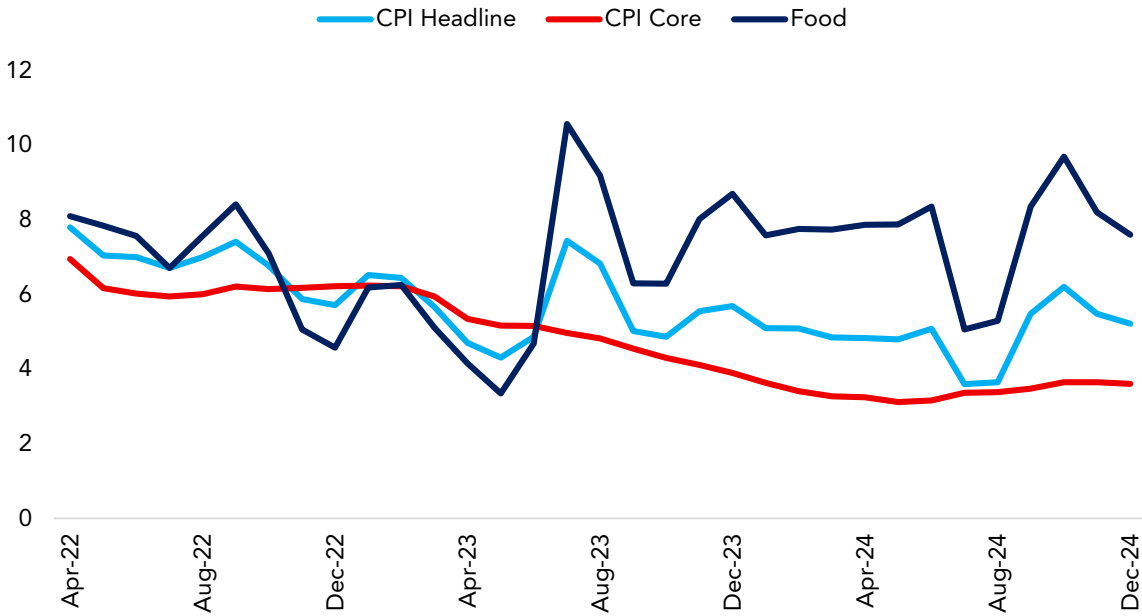
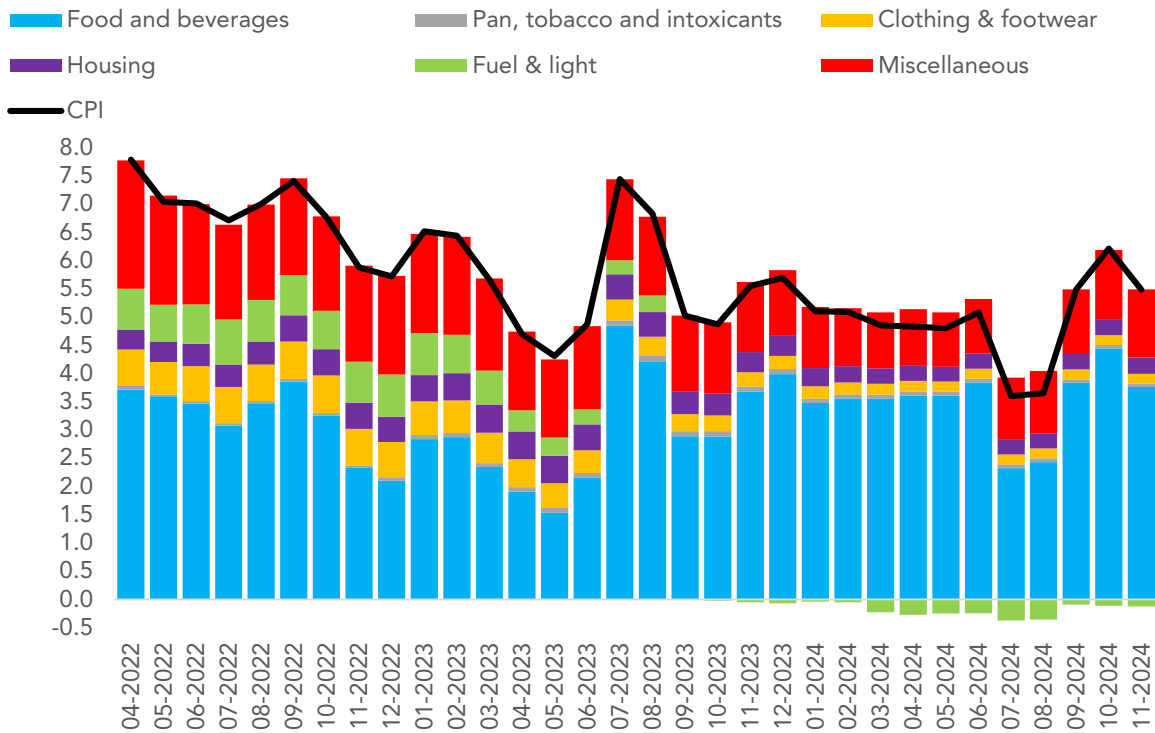


Figure 7. Inflation contribution
(percentage points)



Source: MoSPI

3. Economic Uncertainty Weighs on Markets

The economic challenges are spilling over into financial markets. After hitting historic highs in September 2024, equity markets corrected sharply, shedding more than 10 percent by end of January 2025 (Figure 8). Foreign portfolio investors (FPIs), who had poured USD 25 billion into Indian markets between June and September, reversed course in October, reversed course in October, pulling out 11.4 billion—the second-largest monthly outflow since 2002 (Figure 9). By January 2025, total FPI outflows since September had reached \$21 billion, driven by profit-booking, concerns over high valuations, and renewed global uncertainties.

Yet, bond yields tell a different story. Despite the equity market turmoil, yields on Indian government bonds have fallen by over 50 basis points, the steepest drop in four years (Figure 10). This divergence from U.S. bond yields is striking. The yield spread between Indian and U.S. bonds has narrowed to its lowest level in nearly two decades, standing at 224 basis points as of December 2024.

What explains this trend? Three possible reasons: First, India’s inclusion in JPMorgan’s Emerging Market Debt Index in June 2024 boosted foreign demand for Indian bonds. Second, a sharp reduction in government capital spending due to the Parliament elections limited the supply of new bonds. And third, markets are betting on a potential RBI rate cut, which has further pushed yields lower.

Looking ahead, Indian bonds are set to be included in two more global indices in 2025—the Bloomberg Index Services in January and the FTSE Russell in September. These inclusions are expected to attract additional inflows of USD 7 billion to USD 10 billion¹, keeping downward pressure on yields. But while lower bond yields might seem like a good thing, it could impact FPI inflows, as investors may seek higher yields elsewhere.

¹ See Dhutia (2024).

Figure 8. Stock market performance
(indices)

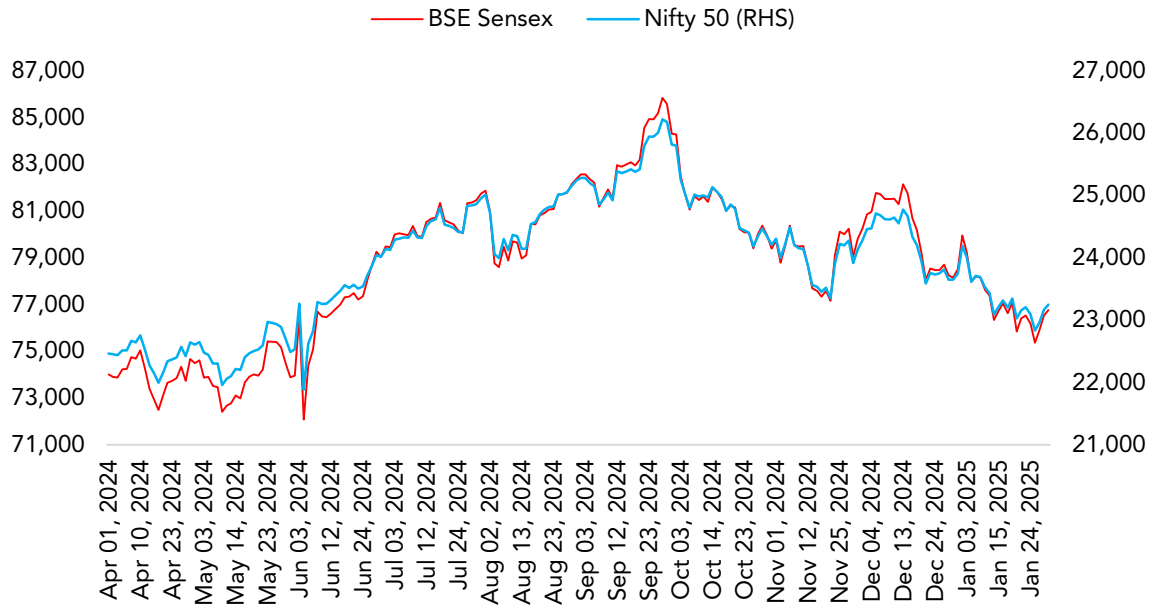
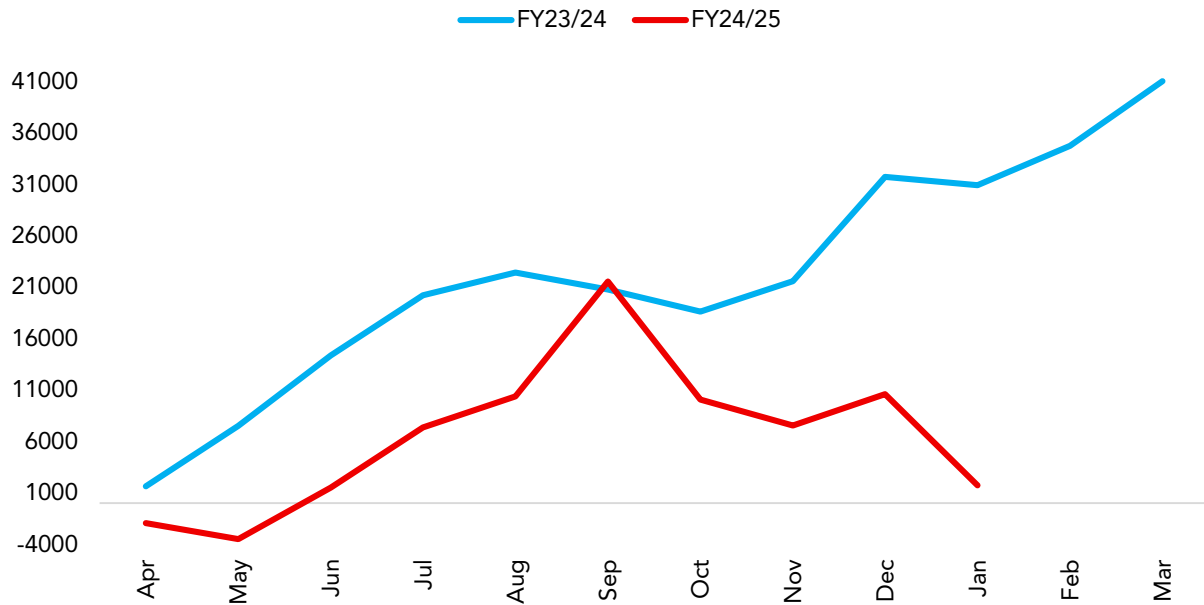
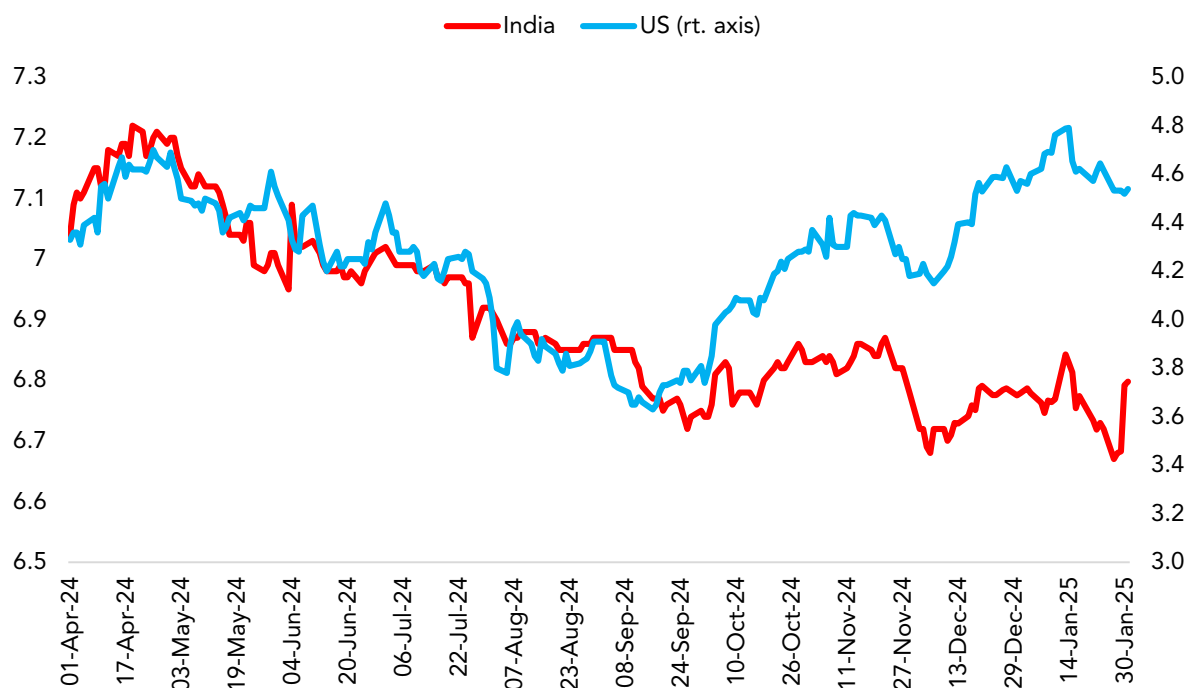


Figure 9. FPI Inflows
(USD million)



Source: RBI

Figure 10. Yield on 10-year Government Bonds (percent)



Source: RBI, FRED

4. Is the Slowdown Structural or Cyclical?

The key question that naturally arises is whether the slowdown is a temporary blip or are we dealing with something more fundamental? structural? Getting the diagnosis right matters because short-term fixes would not work if the problem runs deeper.

At first glance, the slowdown might seem like a temporary blip. After all, real GDP growth has averaged a robust 7.0 percent over the past few years, even with the recent downturn. This may lead to the conclusion that the slowdown is perhaps cyclical, and growth is likely to rebound once these issues are addressed.

However, the picture looks less reassuring if we shift the focus to nominal GDP (Figure 11). Nominal GDP growth has been decelerating since Q3 of FY22/23, averaging just 9.3 percent and hitting double digits only once. This suggests that the economy has been losing momentum for some time, weighed down by a mix of structural and cyclical factors.

While one would normally look at real GDP numbers, methodological issues with India's real GDP calculations warrant caution.

Figure 11. Real and Nominal GDP Growth
(percent)

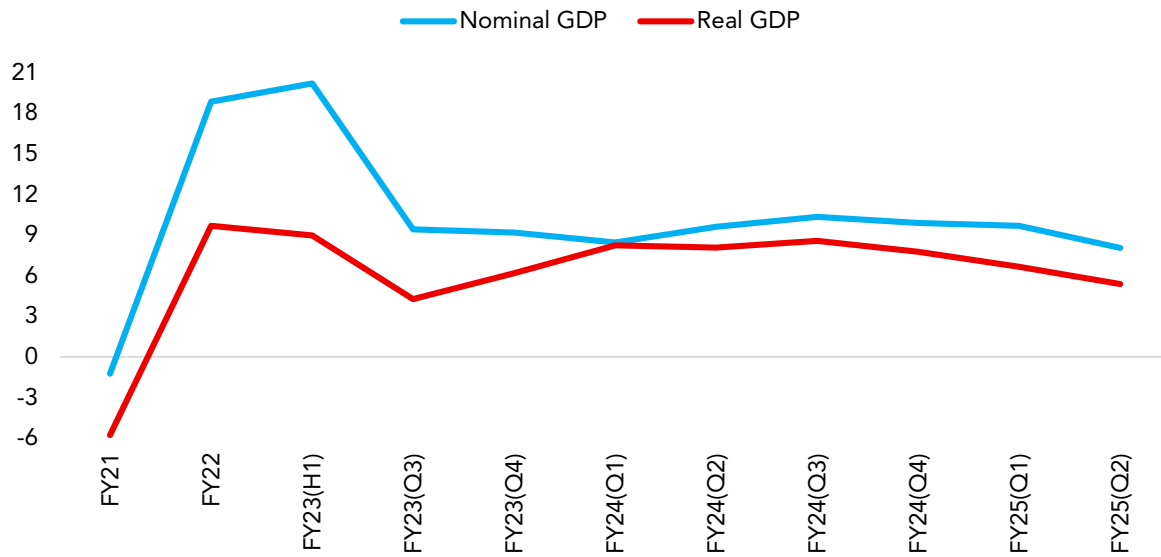
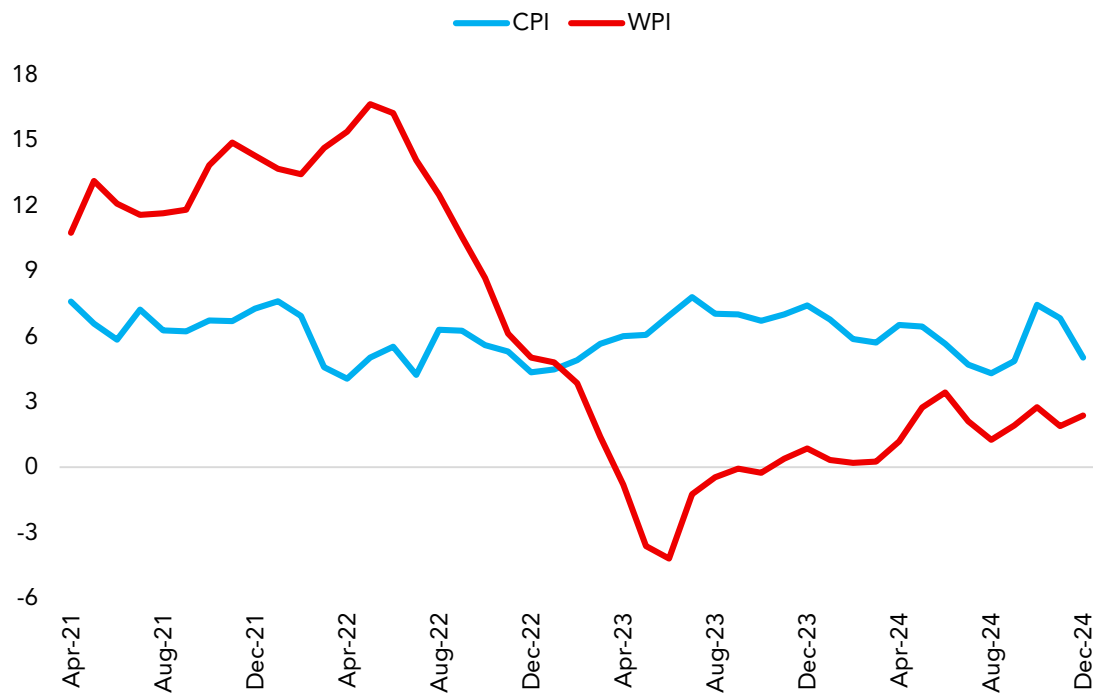


Figure 12. CPI and WPI based Inflation
(percent)



Source: MoSPI

First, the use of single deflation (as opposed to double deflation) to arrive at real GVA numbers introduces bias², especially during periods of significant commodity price fluctuations. Second, producer services are deflated using the Wholesale Price Index (WPI), which is based on tradable goods. When there is a divergence between WPI and CPI, as they have recently, this method can distort the real GDP figures³ (Figure 12). In other words, India's GDP numbers might be overstating the health of the economy, masking deeper structural weaknesses.

5. Fiscal and Monetary Squeeze: The Immediate Growth Drag

Let us start with the cyclical factors. The current slowdown has been exacerbated by a simultaneous tightening of fiscal and monetary policy. Consider each in turn.

On the fiscal front, government capital spending—a key growth driver in recent years—has come to a near standstill. In the first half of FY24/25, central government capital spending contracted by 15 percent, leading to fiscal consolidation of nearly 200 basis points (Figure 13). While some degree of consolidation was expected in an election year, the magnitude of this adjustment far exceeded that observed during the previous two election cycles. Data suggests that capital expenditure remains subdued even in Q3, with overall spending contracting by over 12 percent during April-November FY24/25 (Figure 14).

On the monetary side, the policy rates have not changed since April 2023. However, there has been a noticeable shift in the RBI's exchange rate policy. While not officially announced, the RBI effectively pegged the rupee to the dollar since late 2022 (Figure 15). Maintaining this peg has required frequent interventions in the forex market, particularly during periods of capital outflows, draining liquidity from the banking system. The RBI sold reserves worth USD 31.4 billion in the spot market and increased its forward market short positions to 65 billion (Figure 16).

These unsterilized interventions have significantly drained liquidity from the financial system (Figure 17). To be sure, some reduction in the surplus liquidity, which had built up due to fiscal expansion measures aimed at supporting post-Covid economic recovery, was warranted. However, the scale of liquidity tightening has been excessive, frequently surpassing the RBI's stated objective of maintaining a surplus equivalent to 1.2 percent of net demand and time liabilities (NDTL). Liquidity was predominantly in deficit during Q1 FY24/25, as the RBI's frequent dollar sales led to a liquidity crunch.

² European Commission et al. (2009), paragraph 15.136.

³ Alexander et al. (2017).

Figure 13. Change in Fiscal Deficit during Election Years
(relative to same period previous year, percentage points)

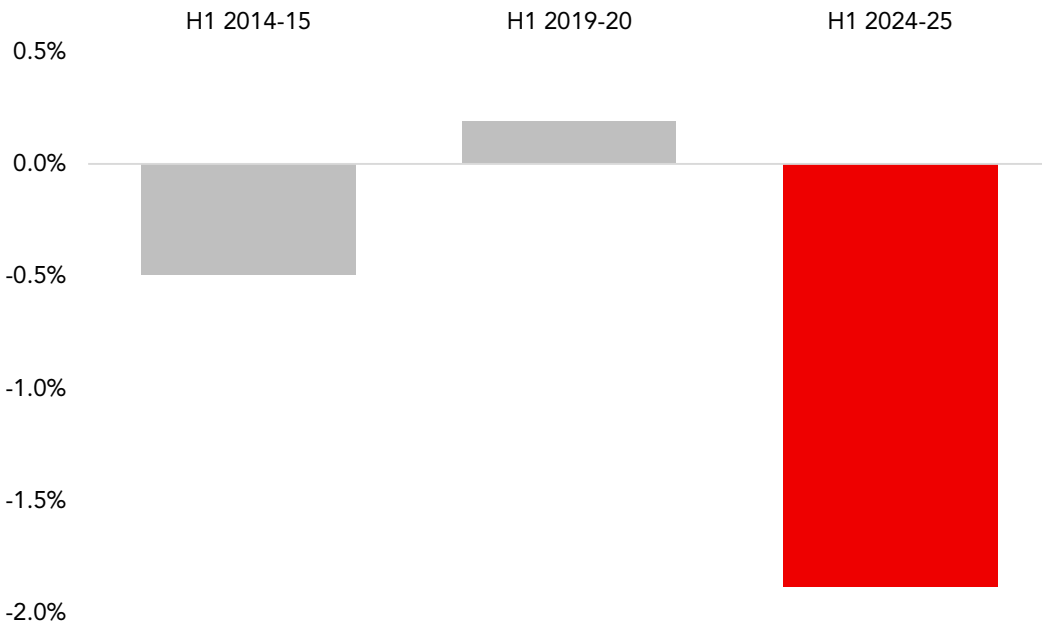
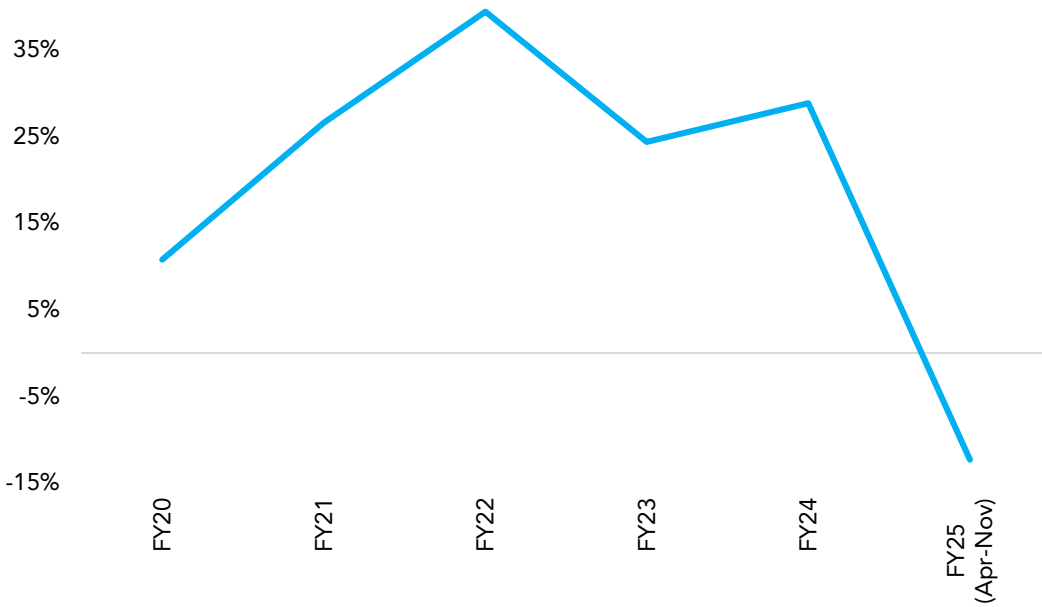


Figure 14. Growth in capex of the Center
(y-o-y, percent)



Source: RBI, Author's estimate

Figure 15. Daily Exchange Rate
(USD/INR)

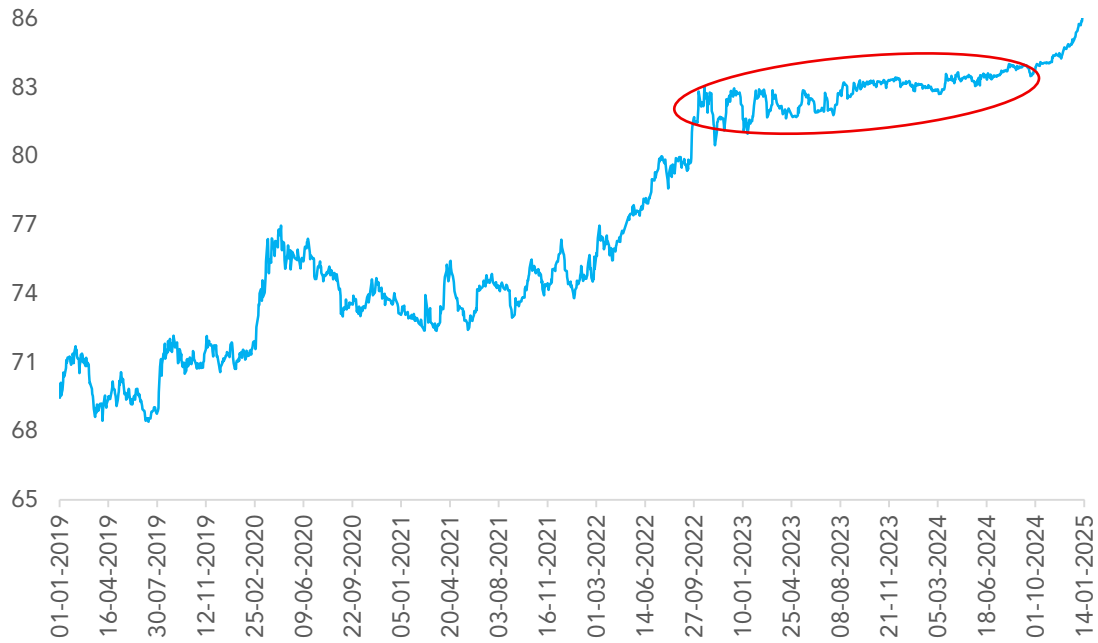
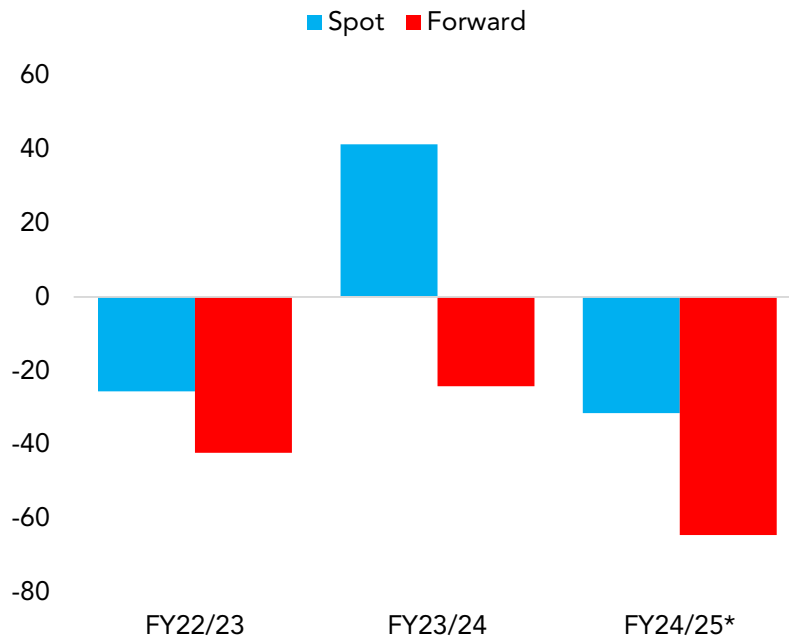


Figure 16. RBI's intervention in forex market
(USD billion)



Source: RBI

Figure 17. Liquidity under Liquidity Adjustment Facility
(Rs. trillion)

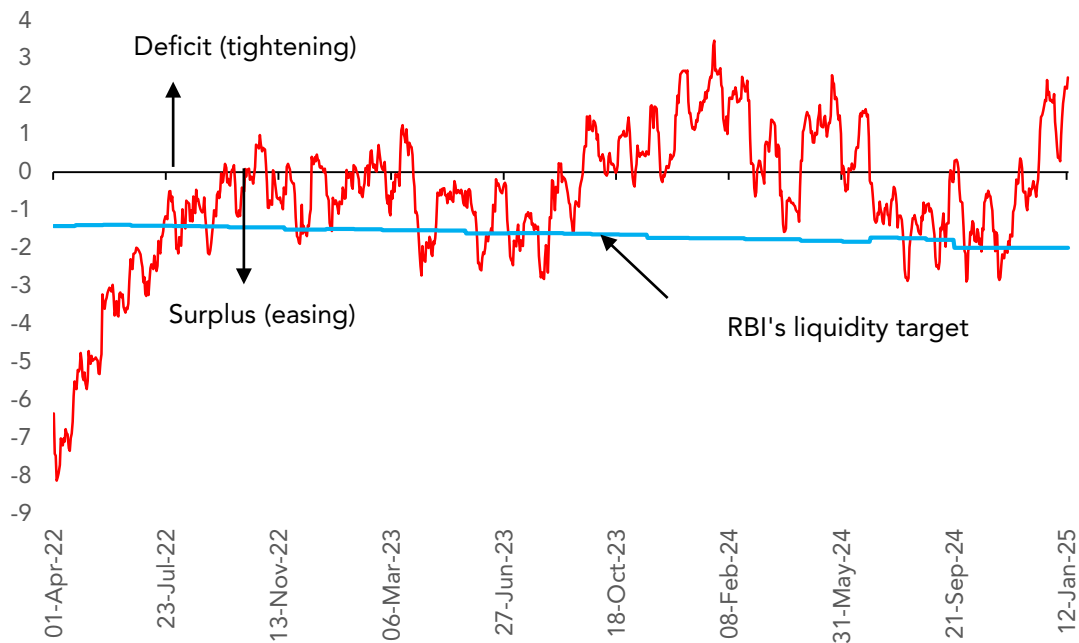
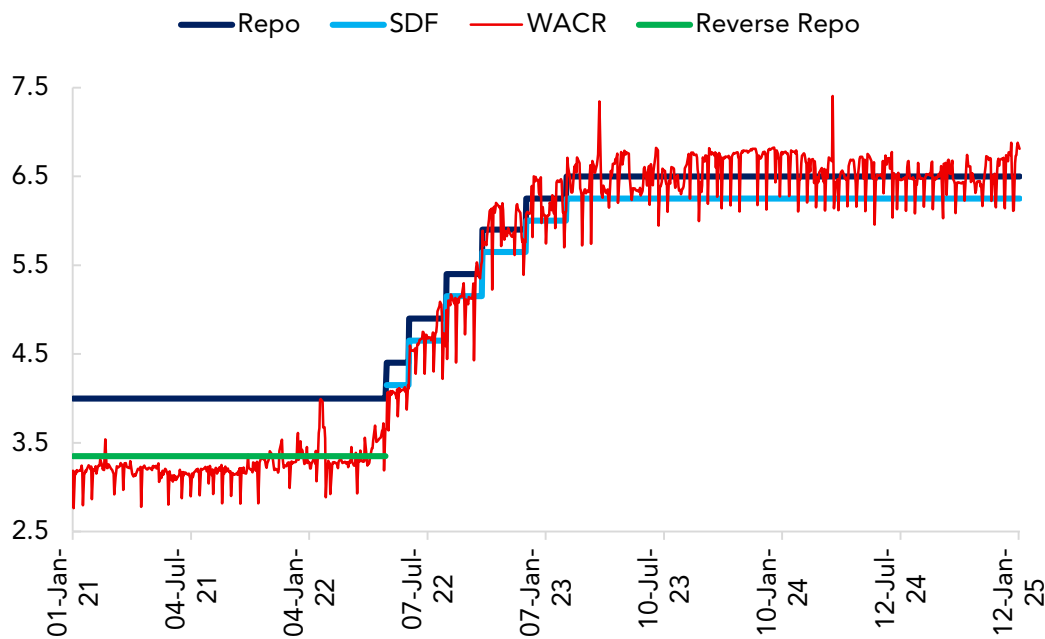


Figure 18. Key Monetary Policy Rates
(percent)



Source: RBI

The liquidity crunch pushed up the short-term interest rates, at a time when the economy was already beginning to lose momentum (Figure 18). The weighted average call rate (WACR), a key indicator of short-term money market conditions, consistently approached and frequently surpassed the repo rate. Not to forget, the excessive intervention has led to a nearly 8 percent appreciation of the real effective exchange rate, thereby making our exports relatively expensive and less competitive.

6. The Structural Challenge: Weak Investment and Exports

Let us move to the structural side of the story. It is important to recall that the economy was slowing even before the pandemic. Following the Global Financial Crisis (GFC), two critical growth engines—private investment and exports—collapsed, leaving the economy largely reliant on consumption and government spending. However, even consumption faltered in subsequent years, with growth declining to a multi-year low of 3.9 percent in 2019-20.

Post-pandemic, pent-up domestic and global demand, along with government spending, temporarily buoyed the economy. But as demand normalizes, consumption has weakened. Government spending, too, faces constraints. While the fiscal squeeze in the current quarter was undoubtedly ill-timed, elevated debt levels underscore the need for a measured approach to fiscal consolidation.

Weak consumption discourages firms from investing. Following the GFC and the rise in non-performing assets (NPAs), India's investment-to-GDP ratio dropped by over 10 percentage points. The NPA crisis has since been addressed, and the government implemented a significant corporate tax cut in 2019 to reignite the animal spirits. However, the needle has hardly moved. After all, businesses borrow and invest only when there is sufficient demand. With domestic consumption slowing down and capacity utilization at low 70s, firms see little incentive to add additional capacity.

So what can be done to break this vicious cycle?

7. The Way Forward

As cyclical factors have intensified the slowdown, the immediate focus should be to counteract the simultaneous tightening of monetary and fiscal policies.

On the monetary front, the RBI has already rolled out a series of liquidity-boosting measures. In its December 2024 meeting, the Monetary Policy Committee (MPC) cut the cash reserve ratio (CRR) by 50 basis points to 4 percent. The central bank also announced plans to buy ₹600 billion worth of government bonds in three tranches, conduct a ₹500 billion 56-day variable rate repo auction, and throw in a \$5 billion USD/INR buy/sell swap auction with a six-month tenor. Put it all together, and these moves are set to pump a ₹2.7 trillion into the banking system.

These measures are a step in the right direction, and the real issue is not just liquidity management—it is the RBI effectively trying to peg the rupee. As long as the RBI insists on propping up the currency, liquidity conditions will remain tighter than they need to be, and export competitiveness will take a hit. If the goal is to support growth, the rupee must be allowed to find its natural level.

On the fiscal side, there is room for the government to loosen its purse strings without derailing fiscal consolidation. The central and state governments must resume the capex cycle at the earliest. In addition, the latest budget for 2025-26 has rolled out a few measures to stimulate domestic demand, with a major highlight being tax relief for the middle class. With incomes up to ₹12 lakhs tax-free, people will have more to spend, and that should temporarily boost growth.

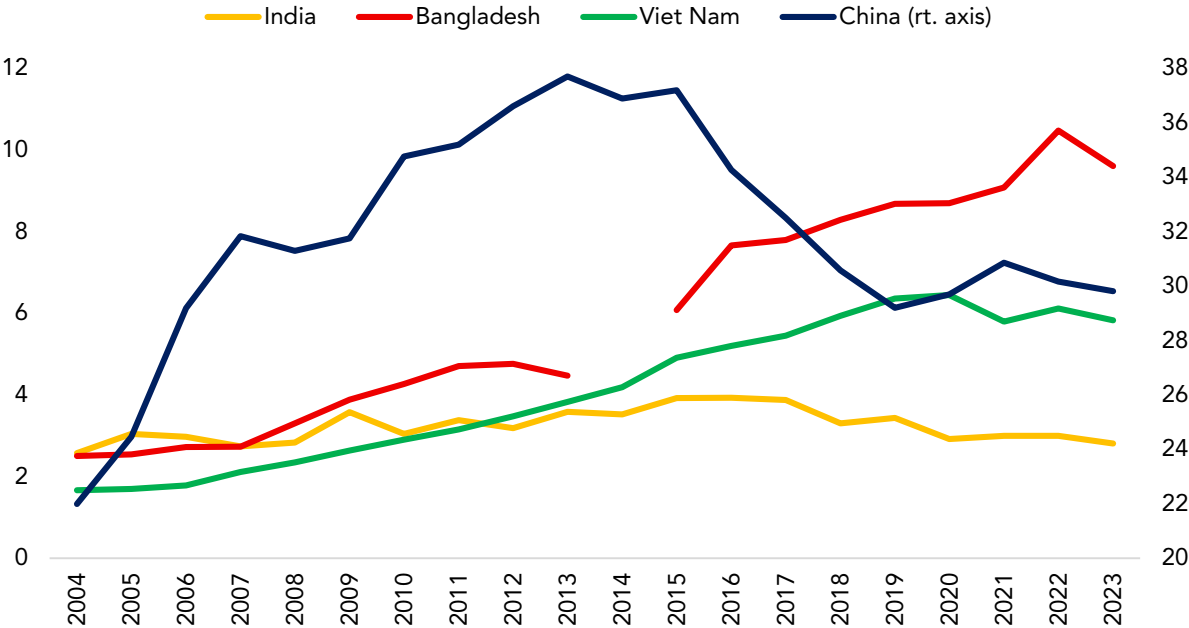
While these immediate measures might help in the short run, unlocking India's full potential requires tackling deeper structural weaknesses—specifically, the persistent cycle of low private investment and weak domestic demand. The key question is: how can this cycle be broken?

India needs to look beyond the domestic market and tap into foreign demand. True, the era of hyper-globalization is behind us, but there are at least three compelling reasons why exports still hold significant promise for India.

First, India's share in the global export market is less than 2 percent, even lower than that of much smaller nations like Vietnam, offering significant room to expand its market share even in a world shifting away from globalization. Second, new opportunities are emerging as China gradually withdraws from the low-skill export market, while global capital looks to diversify beyond China. Third, the Trump administration's possible imposition of higher tariffs on Chinese goods creates additional openings for other countries, including India, to step in.

However, India has not made much progress so far. For instance, since 2013, China has vacated approximately USD 40 billion in market share for global apparel exports. But India has failed to capitalize on this opportunity. Countries like Bangladesh and Vietnam have capitalized on the opportunity, while India’s share continues to decline (Figure 19).

Figure 19. Share in Global Apparel Exports
(percent)



Source: UN Comtrade

What went wrong? A key part of the problem has been India’s struggle to attract foreign investors, coupled with an increasingly protectionist trade policy—both of which have held back progress.

Foreign direct investment (FDI) plays a crucial role in boosting exports by introducing advanced technology, capital, access to global markets, and integration into value chains, thereby enhancing competitiveness and diversifying the export base. However, FDI inflows to India have been declining, even as foreign investors seek alternatives to China (Figure 20). While global monetary tightening has contributed to a worldwide decline in FDI, it does not fully explain the drop in India's share.

India’s diminishing share in global FDI, as well as within the developing world (including and excluding China), highlights a concerning trend (Figure 21). This decline suggests that domestic policies in India have significantly contributed to the downturn. If India had

Figure 20. FDI to GDP Ratio for India

(percent)

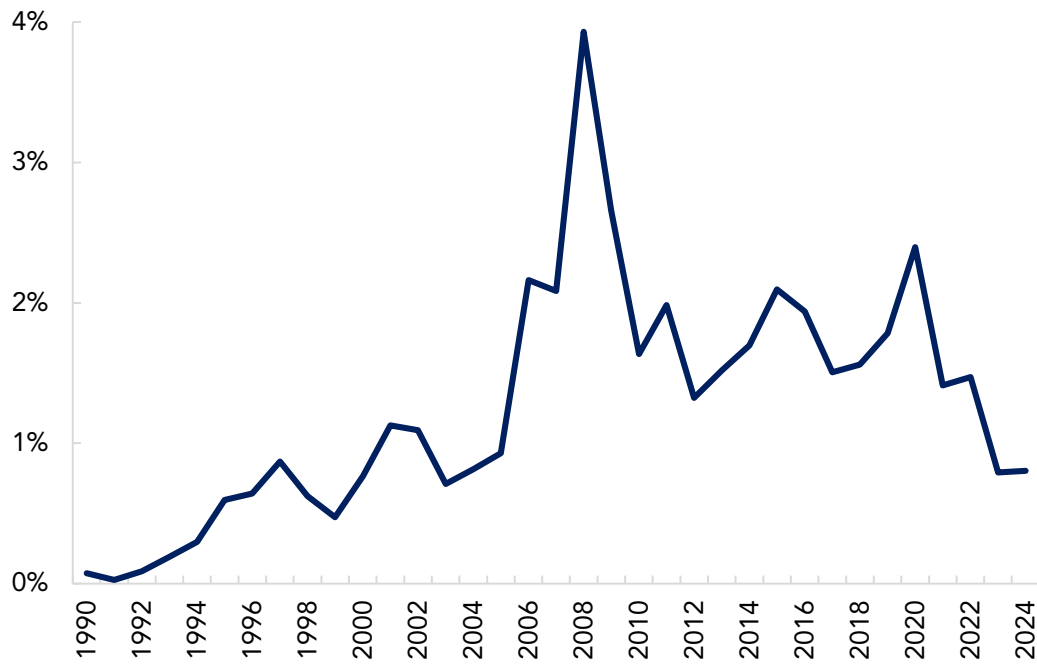
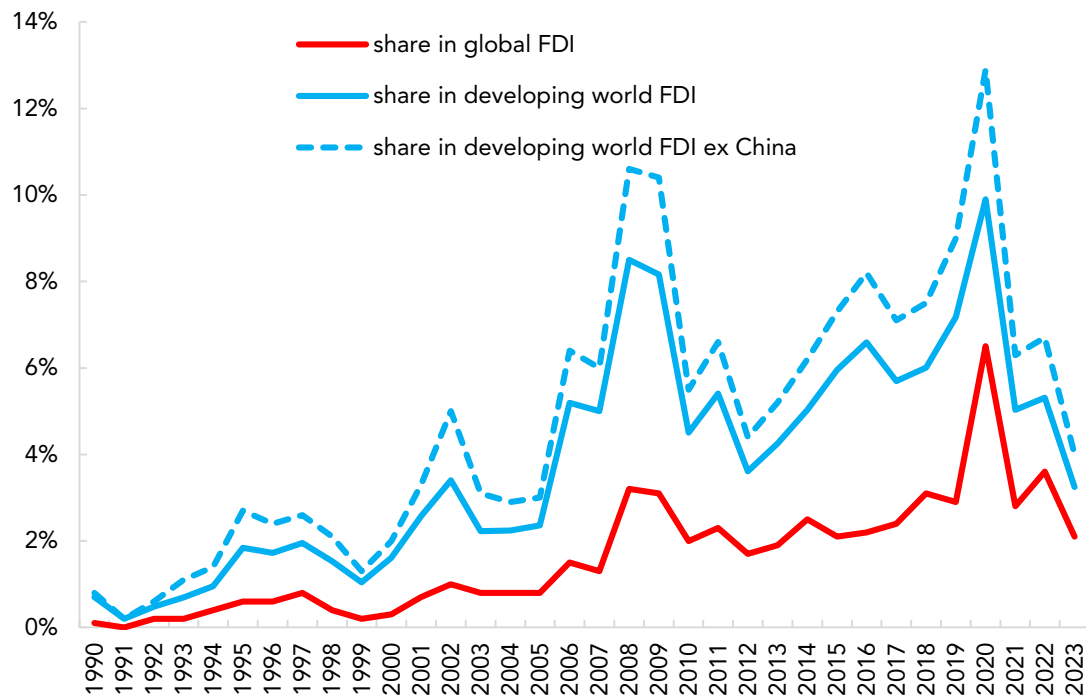


Figure 21. India's share in Global FDI

(percent)



Sources: RBI and UNCTAD

managed to maintain its share in global FDI, net FDI inflows would have been nearly 60 percent higher.

Another key issue impacting India's exports is the increasingly inward orientation of our trade policy. Trade restrictions have been on a rise, reversing the earlier trend of export orientation. Between 2017 and 2021, India implemented over 3,200 tariff increases, covering 70 percent of imports⁴. The most significant hike has been in the textile and apparel sector, where tariffs have risen by 13 percentage points between 2017 and 2022—substantially higher than those of India's competitors (Figure 22).

These tariff hikes have affected the economy in two keyways. First, they have burdened average Indians by driving up prices of cheaper and higher-quality imported goods, ultimately reducing purchasing power and lowering overall living standards. This is particularly detrimental in a country where a significant portion of the population is price-sensitive.

Second, the rise in tariffs has particularly harmed India's manufacturing sector, particularly in labour-intensive sectors. In an increasingly globalized economy, access to affordable and high-quality inputs is essential for maintaining export competitiveness. By raising tariffs, India has driven up the cost of imported inputs, increasing production expenses and making Indian goods less competitive internationally (Figure 23). This issue is particularly problematic in labour-intensive sectors, where cost efficiency is critical to remain competitive in global markets. For example, the apparel industry in Vietnam and Bangladesh has flourished because of its ability to source low-cost imported inputs, enabling it to compete effectively in global markets.

To be fair, the government has recently taken corrective measures, including significant across-the-board tariff reductions in 2023. Import tariffs have been lowered considerably, although they remain higher than pre-2017 levels. However, the potential benefits of these reductions have been largely offset by the simultaneous introduction of non-tariff barriers (Figure 24).

Take, for example, Viscose Staple Fiber, a critical input for the synthetic textile industry (Figure 25). While anti-dumping duties were removed in July 2021, followed by an import tariff reduction from 20% to 5%, the subsequent implementation of Quality Control Orders (QCO) caused a sharp decline in imports. Consequently, the sector has been unable to fully capitalize on the lower tariffs, leaving downstream industries to continue facing significant challenges.

⁴ Chatterjee and Subramanian (2023).

Figure 22. Import Tariff for Most Favored Nations
(percent)

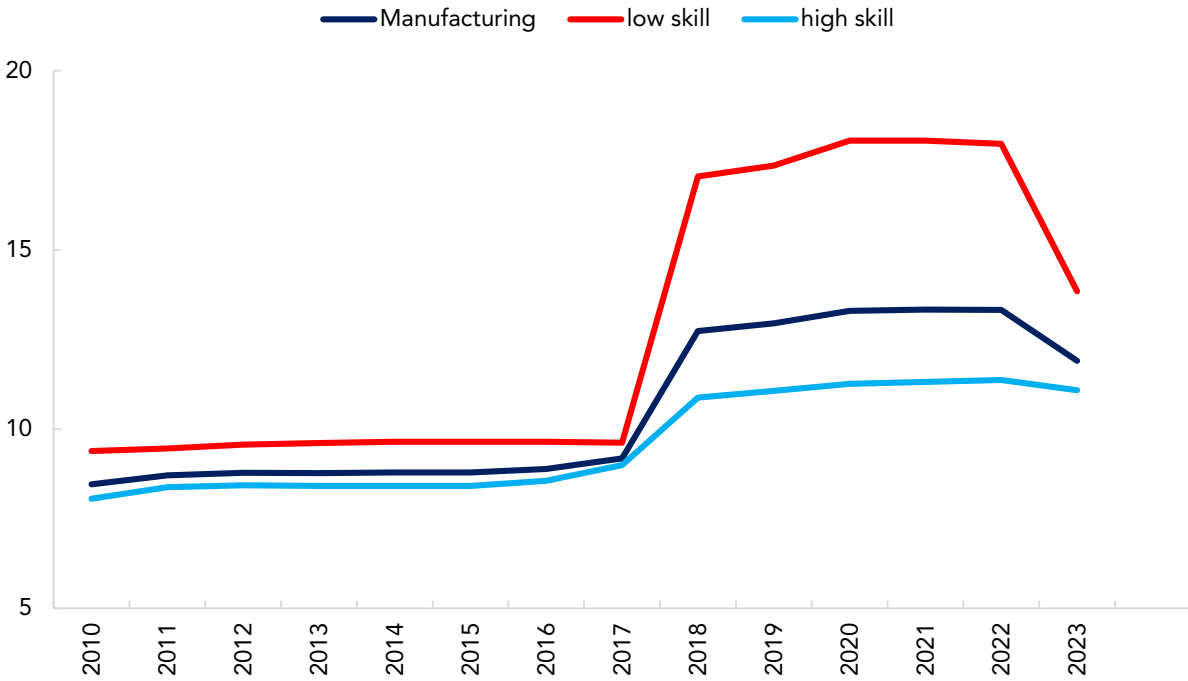
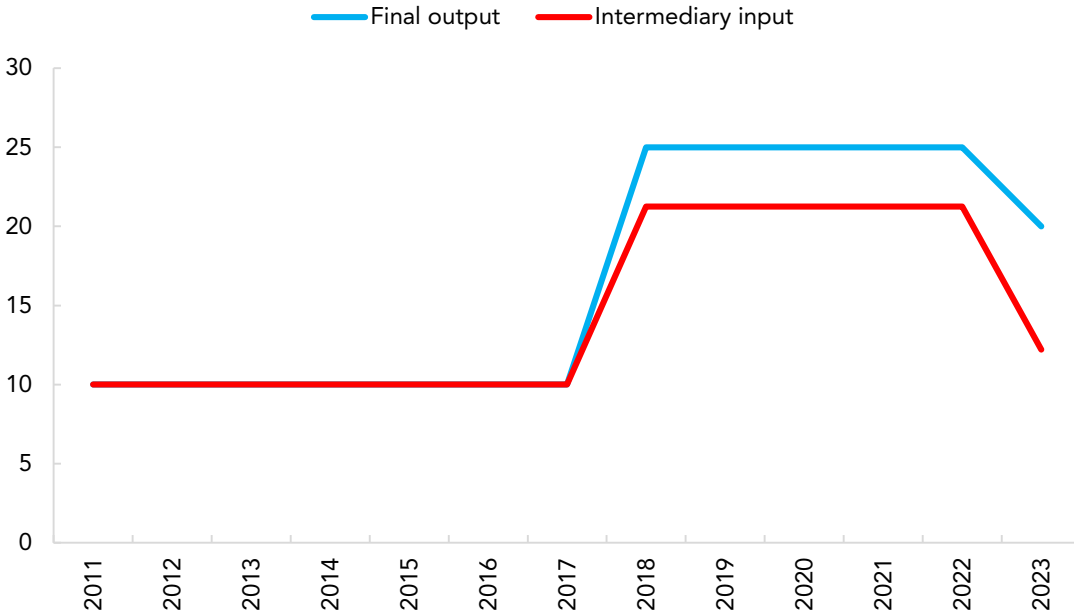


Figure 23. Import Tariff on Final & Intermediate Goods
(percent)



Sources: WTO, ASI, Author’s estimate

Figure 24. India's Trade Distorting Measures
(number of interventions)

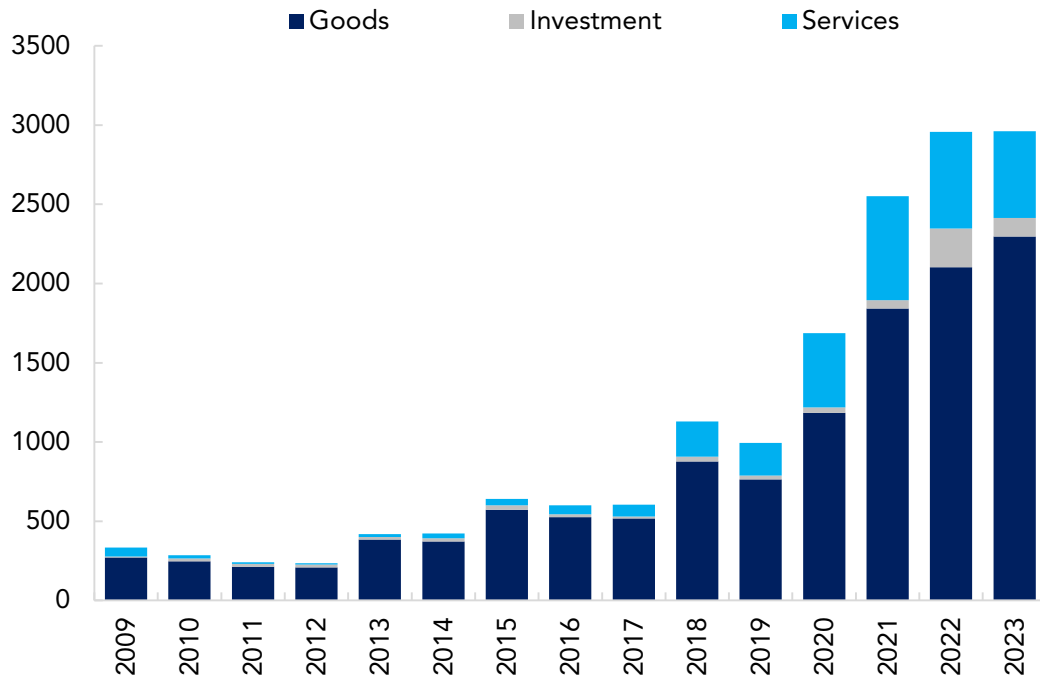
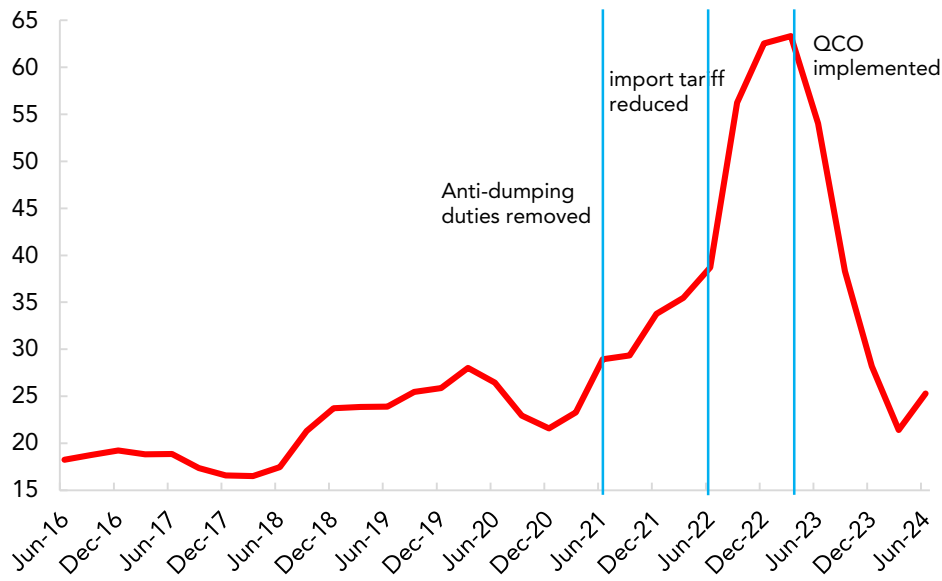


Figure 25. India's Import of VSF
(USD million)



Sources: Global Trade Alert, UN Comtrade

This contradictory policy approach highlights a lack of coherence in the government's strategy. While tariff reductions signal an understanding of the importance of a more open trade policy, the simultaneous imposition of non-tariff barriers diminishes their impact, leaving businesses and investors uncertain about the government's overall direction.

8. Conclusion

India's economic challenges are significant, and the stakes are high. For a country striving to achieve upper middle-income status, the implications are significant. Without tackling entrenched structural challenges, India risks falling into the "middle-income trap," a predicament that has stalled many economies before. While immediate measures like easing liquidity conditions and meeting capital expenditure targets provide temporary relief, addressing deeper structural issues is imperative for sustainable growth. India must adopt a more outward-looking trade strategy, leverage emerging global opportunities, and create a stable, predictable environment for businesses and investors. By reducing protectionist barriers, fostering foreign investment, and prioritizing exports, India can break the cycle of weak demand and low investment, paving the way for long-term economic resilience and growth.

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Madras Institute of Development Studies

79, Second Main Road, Gandhi Nagar

Adyar, Chennai 600020 India

Phone: 044-2441 1574 / 2589 / 9771

pub@mids.ac.in www.mids.ac.in