

**Quarterly State of the Economy Seminar
National Council of Applied Economic Research, New Delhi**



February 3, 2010

The quarterly seminar on the State of the Economy was held at the National Council of Applied Economic Research on February 3, 2010. The seminar included presentations by the NCAER team on the economy followed by presentation on Steel outlook by Sanjay Sinha of SAIL and comments by Sanjaya Panth, IMF, Ulrich Bartsch, the World Bank and Mythili Bhusnurmath, Economic Times. The proceedings were chaired by Suman Bery, Director General, NCAER.

A summary of the quarterly review presented by NCAER is provided below.

Revival of growth

As the fiscal year comes to a close, there is increasing evidence of revival of economic growth, particularly in the industrial sector which bore the brunt of shocks of the global economic crisis in the past two years. While the economy did not remain immune to the external financial and trade shocks, the large domestic component of aggregate demand provided the safety net for the enterprises which suffered loss of external markets and lack of access to finances. The role of fiscal stimulus and proactive monetary policy support in sustaining aggregate demand was crucial in the second half of 2008-09.

The first half of 2009-10 saw overall GDP growth increasing by just below 7 per cent. This growth belied the pessimism that the year 2009-10 would also see weak growth because of the severity of the global crisis. The growth in the first half was even more remarkable because the industrial growth was fairly strong in the same period in 2008-09. The U- shaped recovery was expected to show slower growth in the first half of the year and then pick up in the second half. However, the recovery began early.

An important driver of the recovery was the acceleration in government spending. In H2: 2008-09, government consumption expenditure increased by 36 per cent over the same period in the previous year. The private final consumption expenditures increased at a higher rate in the current fiscal year, apparently led by the expenditure on consumer durables as the IIP for consumer durables has recorded double digit growth rates for every month during the period April-November in 2009-10.

The investment expenditure has been slower to revive. Although capital markets have seen improvement in stock prices, interest rates have been low as compared to the previous year and business confidence improved, the YOY growth rate of investment spending in H1: 2009-10 was about the same as in the same period in the previous year.

Net imports in H1: 2009-10 have registered a negative growth over their level in the previous year. The decline in oil prices reduced oil import bill. The non-oil imports also showed decline during the period. The need for turning to domestic markets for demand was quite evident.

It is in this context of revival of growth that the 'exit' from 'expansionary' fiscal and accommodating monetary policies has become relevant. The large fiscal deficits of six per cent or more relative to GDP are not sustainable. The latest RBI review of monetary policy has left the key policy rates unchanged but increased the CRR by 75 basis points to mop up excess liquidity. The central government budget for the coming fiscal year may also emphasise the need for returning to more prudent levels of deficits from the high levels seen in the last two years.

An assessment of the current economic scenario for the major sectors and at the aggregate level is now summarised.

Agriculture, industry and services

The erratic rainfall pattern in the current led to drought conditions in 316 districts in 13 states. To make the matters worse, in Andhra Pradesh, Karnataka and Maharashtra, floods ruined many crops including rice, pulses, oilseeds, and vegetables. The overall output of *kharif* foodgrains is expected to witness about 16 per cent fall over last year's output of 117.7 million tonnes. The provisional *kharif* estimate for oilseeds is a 15 per cent drop from last year's output of 17.9 million tonnes. In the case of cotton, the ministry's estimates have placed the output at about 23.6 million bales, a marginal increase from last year's estimated output of 23.2 million bales. And, for sugarcane, the official estimates suggest 9 per cent decrease for the second successive year over last year's decline of 21 per cent. The adverse impact of weak monsoon on *kharif* output has also meant that agricultural prices are on the rise. The increase in food inflation, however, is not just due to vegetables and sugar. The items that have played a leading role in the recent surge in inflation include cereals, milk and eggs, meat and fish. These five commodity groups account for little over 85 per cent of the increase in food inflation which occurred during April-December compared to the same period last year. There is, however, a positive outlook for the *rabi* output which would help compensate for some of the monsoon shortfall. The government's stockpile of cereals could also be of immense help if these stocks are released in the open market to cool prices.

The coming budget has difficult choices on reigning in farm subsidies and finding more resources for improving rural infrastructure.

At an aggregate level, industrial output has increased by 7.6 per cent during April-November 2009 as compared to a growth of 4.1 per cent in the corresponding period of the previous year. The growth acceleration has taken place across a wide spectrum of industries although there are also sectors where growth has been weak. Consumer non-durables segment has seen particularly weak growth. This sector includes some of the export intensive segments such as textiles and it also includes a variety of agro-based industries. The expected weak performance of agriculture has also impacted on the agro-based industries. The capital goods sector is another where revival of growth has not been striking. Although a number of fiscal and monetary measures have been taken to sustain overall demand for industrial output, the impact of global economic slowdown has had a significant adverse impact on investment spending.

The services sector had also experienced sharp deceleration of growth in the crisis period of 2008-09. The sub-sector comprising of banking, insurance and other financial services, real estate and business services experienced sharply lower YOY growth rate of 6-7 per cent in H1: 2008-09 as compared to 10-12 per cent in the previous year. The growth rates improved in the

second half of the year and the pace of H2: 2008-09 has continued into the present year. The construction sector has also seen gradual improvement in output. Among the service sub-sectors, the main driver of growth has been government. GDP from community, social and personal services increased sharply in H2: 2008-09 and the trend has continued at a moderate level in H1: 2009-10 also. The services sector has synergies with both internal and external markets. Sustained recovery in this sector will require sustained recovery in the global markets, particularly for services such as IT and financial services.

Fiscal, Monetary and credit policies

The global economic crisis of 2008 and 2009 has had significant and long-lasting impact on the financial sector and fiscal policies not only in India but also at the global level. Fiscal response to the crisis has been to sustain aggregate demand level so that the disruptions caused by the external shocks to the economy are moderated. The strategy appears to have worked in the Indian context as the economic growth, particularly industrial growth, has made a recovery in the current fiscal year. The fiscal position, however, has consequently deteriorated. The fiscal deficit of the Centre has been budgeted at 6.8 per cent of GDP for 2008-09. The deficit had increased to 6.2 per cent of GDP in the previous year whereas the medium-term goal has been to bring fiscal deficit to 3 per cent of GDP. The widening of deficit has been a result of loss of tax revenue dues to slower economic growth, reduction in indirect taxes to stimulate demand and increase in expenditure to maintain the level of economic activity.

The monetary policy has also aggressively sought to avoid disruptions to the financial markets as the global markets nearly collapsed. The interest rates were maintained at relatively low levels, credit to exporters was made more easily available at softer terms, the financial sector in general was provided easier access to funds so that the on-lending was not affected due to lack of funds. The exchange rate of the rupee did see significant depreciation during the crisis period but there were no additional restrictions on capital outflows during the period.

The timing of exit from these expansionary policies, has now become an important policy choice. The recent monetary and credit policy review has indicated that inflationary concerns are becoming central again although growth recovery needs to be sustained. On the fiscal front, the major indirect tax reforms, in the form of launching of a GST, are awaiting implementation. The return to fiscal consolidation is dependent on sustained recovery of economic growth. Therefore, it is important to gain confidence that tax revenue collections are on track before the fiscal stimulus is entirely withdrawn. The final results for the current fiscal year would be critical for choosing the time to 'withdraw' the fiscal stimulus.

External Sector

The current assessment of global economic conditions by the international agencies suggest that the intensity of the global financial crisis is now seen gradually tapering out. The recovery process began in the third quarter of 2009. However, the recovery is also expected to be slow and fragile with growth rates of the economy varying across regions and countries.

Global industrial production has posted 13 per cent year-on-year (YoY) growth in Q3: 2009. Deceleration of global trade also got reversed in October 2009, having posted growth of 36 per

cent in annualised terms. While the developing economies began recovering since Q2-2009, the high-income countries entered their paths to recovery in Q3-2009. The recovery is likely to slow during the latter half of 2010 due to tightening of fiscal and monetary largesse. In 2010, world GDP growth, in PPP terms, is expected to accelerate to 3.9 per cent from its negative range in 2009.

Although trade flows registered a huge decline on a cumulative YOY basis for the period April-November 2009, there has been positive growth in the recent months of November and December. The service exports also declined in the first half of the current fiscal year. The software exports declined by 11.5 per cent during H1: 2009-10 in dollar value.

The performance of various sub-sectors in the exports and the pattern of direction of exports show that the impact of global economic crisis was felt across the board. There were very few cases which escaped decline in trade volumes. In the case of imports, while oil bill decreased as crude oil price dropped, the non-oil imports also decreased, YOY basis, during April-November 2009.

The bright spot on external front was the FDI flow. The flows maintained the volumes in H1: 2009-10 which were experienced in the same period in the previous year.

Prices

The year 2009-10 was marked by one of the lowest rates of inflation in terms of the wholesale prices but at the same time troubled by one of the highest rates of inflation in terms of consumer price index. For the period April-December 2009, the all commodities WPI rose by less than 2 per cent as compared to its average for the same period in the previous year. The CPI for industrial workers rose by 11.4 per cent in the corresponding period in 2009. The overall WPI was held in check by the drop in petroleum fuel prices but the weak monsoon and rigidities in some of the agricultural prices led to sharp increase in the prices of food items.

It is now expected that the year-end rates of inflation in the WPI would reach eight per cent, primarily because of the low rates of inflation seen in this period in March 2009. While this surge may be partly due to the low base, the concern on rising inflation rate will remain a policy issue for the coming year as recovery of growth across the world will put pressure on available supplies of the commodities needed for industrial production.

Forecast

Taking into account the current trends in the economy, we have presented an assessment of the macroeconomic parameters for 2009-10.

The overall GDP growth for the year is pegged at 7 per cent, somewhat above our previous forecast of 6.9 per cent provided in October 2009. The agricultural GDP (agriculture and allied sectors) is projected to decrease by 1.5 per cent, the same as in the previous forecast. While the *rabi* harvest may offset the impact of poor monsoon, this factor was taken into account in our October 2009 forecast also and hence the previous forecast has been maintained. In the case of industry and services, there are two opposite forces in play. On the positive side, the impact of adverse global business sentiments has weakened as reflected in the return of FII capital and the

investment sentiments in the economy may also have improved. Although we do not see evidence of this in any surge in actual investment spending, the second half of the year may show better results on capital goods output and construction than in the first year. In terms of our own projections, the export performance has been far weaker in April-November 2009 than our October 2009 forecast. Imports growth is also much smaller than our previous forecast. Thus, the revised trade projections have offset some of the gains due to improved investment climate.

The average inflation rate, based on WPI trends has been projected at 3.9 per cent for 2009-10. The fiscal deficit of the centre is projected at 6.3 per cent of GDP, below the Budget Estimates for the year, but this appears to be somewhat optimistic given the current trends in revenues. The current account deficit is projected at 2.5 per cent of GDP reflecting the decline in both imports and exports during the year.

The quarterly trends also suggest that the GDP growth is likely to be about 7 per cent with the growth to exceed 7 per cent in the final quarter of the fiscal year.

The year that is drawing to a close has reflected the strengths and weaknesses of the economy as it recovered from the severe shocks of a global crisis. The cooling of commodity prices in the wake of global deceleration in growth provided more flexibility for fiscal and monetary support to sustain overall demand. Going forward removing supply side constraints on growth would be the prime concern of policy. Capacity to deliver high rates of growth in a sustained manner without the inflationary pressures will be tested in the coming years.

Table 1: Revised assessment of the macroeconomic parameters for 2009-10

Variables	2008-09	2009-10 Forecast provided in different months this year			
		Apr '09	July '09	Oct '09	Jan '10 (Current forecast)
% YOY change					
Real GDP					
- Agriculture	1.6	2.5	1.0	-1.5	-1.5
- Industry	3.9	6.3	6.7	6.9	7.0
- Services	9.7	8.5	9.4	9.5	9.5
Total	6.7	6.9	7.2	6.9	7.0
Exports (\$-value)	16.4	9.1	12.0	10.5	2.5
Imports (\$-value)	34.1	10	5.5	4.9	3.0
Inflation (WPI)	8.5	5.2	3.7	3.8	3.9
As Percentage of GDP at market prices					
Fiscal Deficit of the centre	6.2	4.5	6.2	6.3	6.3
Current Account Deficit	2.5	3.5	2.4	2.5	2.3