



Quarterly Review of the Economy

National Council of Applied Economic Research, New Delhi

April 29, 2009

Summary

Backdrop

The term of the 14th Lok Sabha ends on June 1. About 714 million people are eligible to cast their votes in the election to send 543 representatives to the 15th Lok Sabha. Nationwide phased voting, which began on April 16, is scheduled for completion by May 13 and the results would be known by May 17. Simultaneously, elections are also being held for the state assemblies of Andhra Pradesh, Orissa and Sikkim.

So, there is now a lull in policy making. Any new major policy initiative is likely when a new government takes over, sometime early June. The Interim Budget presented in February this year by the outgoing government could not provide medium-term policies to address the deepening of the crisis.

It requires no emphasis that the impact of the global crisis has profoundly affected the Indian economy. Though exporters and investors are apparently bearing the brunt, no sector is completely untouched. Jobs have been lost and for many income levels have been lowered. Dwindling tax revenues implies erosion in the gains made through fiscal consolidation in recent years.

The key role that global markets play in boosting the growth rate of the Indian economy is well known. But now, there is the reminder that vibrant domestic demand is essential for sustaining high economic growth.

The global economic crisis has deepened over the past six months. The period of slow growth and uncertainty is expected to remain with us for some time. While the ignition of the crisis may have been the unbridled lending of housing finance in the United States, the consequences have been felt far and wide as asset prices slumped leading to turmoil in the financial systems. The World Bank has projected a decline in world GDP by 1.7 per cent in 2009 and the International Monetary Fund had forecast a slide of 1.3 per cent. The GDP of the United States, India's major trade and investment partner, is predicted to decline by 2.4 per cent and the unemployment rate there has reached to 8.5 per cent.

A positive dimension of the slowdown has been the decline in inflation rates. Oil prices have fallen dramatically and, so, energy input costs have fallen.

Modest positive growth is expected in 2010 at the global level. Policy measures to stimulate spending by lowering interest rates, reviving the financial systems and providing jobs through government programmes have been put in place by governments in a number of countries. The recent G-20 summit has strengthened multilateral development finance agencies.

In this edition of the *Quarterly Review of the Economy*, we discuss the sector-wise performance of the Indian economy during 2008-09 and present our macroeconomic outlook for 2009-10.

Agriculture

The estimates on crop output for the year suggest no significant gains. Foodgrain production during 2008-09 has been estimated at lower than the harvest of 2007-08 by about 3 million tonnes. The same is true of oilseeds, cotton and sugarcane.

However, the setback on the output front has not affected foodgrain availability to the public distribution system. In fact by the end of June 2009, foodgrain stocks with the government could be in the region of 50 million tonnes.

Agriculture's prospects for 2009-10 has brightened with the prediction of a normal monsoon for the current year by the Meteorology department. However, much would depend on how the rainfall is distributed over the monsoon period and across regions.

The availability of seeds and fertilisers is reported to be satisfactory.

Industry

Industrial output, which was booming for the past six years, began to stagnate in the second half of 2008-09. The growth of the annual Index of Industrial Production (IIP) for the year as a whole may not exceed 3 per cent. This is only a third of the growth rate recorded in 2007-08. Though growth rates plummeted in all the main sectors of industry, the IIPs for Consumer goods and Capital goods were higher than average for the industry as a whole for the first 11 months of 2008-09.

The growth rate of Capital goods for April 2008-February 2009 was 8.8 per cent. But it constitutes a sharp decline from 17.7 per cent growth seen in the corresponding period of the previous year. The first three quarters of 2008-09 saw the average year-on-year (YoY) growth rate of IIP for the sector at about 10 per cent. In the third quarter, growth dropped to 3 per cent. The investment spending boom, as reflected in Capital goods production, has, therefore, subsided. In the case of Consumer goods also, the sharp decline in growth took place in the third quarter (Q3:2008-09).

What may have sustained the pace of growth in the first two quarters is the continuing momentum and plans for the previous year. As bad news on the export front began to flow in and capital markets remained bearish, industrial activity decelerated.

What might revive growth in the immediate term is the activation of domestic demand through fiscal and monetary stimuli. Higher government spending, reduction in tax rates, slash in interest rates and a slew of credit measures could provide a basis for demand growth for goods and services.

The Construction sector has shown higher growth than manufacturing. Continuity with infrastructure projects is certainly a factor, but we should also give due acknowledgement to home construction, particularly in rural areas.

An important, positive feature of the industrial scene during 2008-09 has been strong foreign direct investment (FDI). While this may reflect the medium to long-term potential for growth, sustaining this trend calls for addressing the valid concern that investors would have for short-term returns.

There are other pointers to potential catalysts. The launching of affordable and useful products like the 'Nano' small car might revive consumer interest and confidence. The commissioning of gas supplies from new off-shore facilities of Reliance Industries could also act as a catalyst for many other industries.

Services

The single largest sector of the economy has also been affected by the deceleration in industry and trade. The average growth of GDP from services dropped to single digit levels in Q3: 2008-09. The driver of growth in recent years, telecommunications, continued to show growth as far as expansion of subscriber base goes. But growth in revenue per subscriber has not happened. The transport sector, whether civil aviation or railways, manifested evidence of being impacted by slow growth.

Government spending during Q3:2008-09 offset some of the decline in the growth rate of the 'Other services' sector.

IT and IT-enabled services have had to face growth slowdown in the US and other advanced economies. The exchange rate depreciation in the second half of 2008-09 helped the earnings grow in Rupee terms. However, this may not help bring about growth in employment and investment.

External trade

The YoY growth of India's merchandise exports in terms of Dollar earnings was (-) 8 per cent in Q3:2008-09. Import growth was 12 per cent. For the entire period of April-February, export growth was 7.3 per cent and imports grew at 19.1 per cent. There was sharp fall in non-oil imports during Q3:2008-09, indicating the weakening of domestic growth. Trade deficit had reached \$115 billion by the end of February 2009.

The expected deepening of decline in global growth is a major worry on the export front. The Doha round of multilateral trade negotiations has come to a halt. The forecasts for global trade in 2009 indicate a decline in trade volume by 11 per cent.

Money and credit

Reserve Bank of India's *Annual Policy Statement 2009-10*, published on April 21, sets the tone for monetary and credit policies for the current year. The context for the policy is clearly the current economic crisis. The policy review has announced reduction in Repo and Reverse Repo rates by 25 basis points. This measure and the overall tone of the policy are expected to result in reduction of lending rates by the banking sector. The CRR has been left undisturbed at the current level of 5 per cent

of the net demand and time liabilities of the banks. The public sector banks appear to have responded early, but the rigidity shown in respect of prime lending rates (PLR) is a matter of concern.

There is deceleration in monetary aggregates like M3 and bank credit to the commercial sector in Q4:2008-09. These reflect widespread growth slowdown. Credit flows to the government continues to be well above the statutory liquidity ratio (SLR) requirement, but not quite so in the case of the commercial sector. It's not clear whether this is a result of a fall in demand for credit or greater risk aversion of the lenders.

Prices

The easing of inflationary pressures is one of the few positives of the fiscal year under review. In the final week of March 2009, the WPI- based inflation rate (YoY) dropped to about zero per cent.

While much of this is attributed to the fall in petroleum prices, the rate of increase of prices of manufactured products also declined. Other contributors were the government's fiscal stimulus in the form of reduction in indirect tax rates. Eventually, demand pressure itself also declined. However, the Consumer Price Index (CPI) continues to manifest high rates of increase driven by food prices. The wholesale price index (WPI) of rice continued to see double-digit growth for the period April 2008-February 2009.

An important lesson learnt through this experience is the necessity for advance planning so that hardships faced by consumers in times of high inflation or low growth are avoided.

Public finance

The weak output performance of the economy has put pressure on government finances. Initially, the government sacrificed tax revenues from petroleum products in order to give relief to consumers reeling under the impact of global rise in oil prices. When economic growth began to decelerate, the government was forced to cut indirect tax rates. In addition, the pace of expenditure growth could not be slashed as it was key to demand stimulation. The year under review also saw a large outgo over the implementation of the Sixth Pay Commission's recommendations. So, 2008-09 ended with a fiscal deficit of 6 per cent of GDP.

Revenue flows are unlikely to improve until economic growth regains its momentum. At the same time, the need to sustain aggregate demand requires maintaining the pace of government expenditure. So, innovative reforms would be necessary to achieve what appears to be an infeasible combination of options.

A re-assessment of 2008-09

The revised assessment places the overall GDP growth for 2008-09 at 6.5 per cent. The sectoral growth rates do differ significantly from the AE. Agriculture is projected to grow at 2.3%, Industry at 7% and Services at 7.6%. The differences at the sectoral level between AE and actual trends arise because of the need for assumptions on a number of parameters in the projections. We recognise that growth in Agriculture and Industry may be over-estimated and that the opposite may have happened for Services.

Even if the growth seen in Q4:2008-09 turns out 5 per cent, the overall GDP growth for the year could be 6.4 per cent. In this context, we retain the overall GDP growth estimate of 6.5 per cent for 2008-09.

Forecast 2009-10

The key elements of the economy's exogenous environment during 2009-10 are weak external demand and dropping supply of investment funds. We had provided an assessment of the prospects for 2009-10 in our review of the last quarter (January 2009). Since then, the external environment has deteriorated further. However, there has also been relief in the form of lower petroleum prices, which is likely to prevail for the rest of the year. There have also been a slew of fiscal and monetary measures to revive both investment and consumption demand.

Conditional on the policies of the next government, we project GDP growth of 6.5-6.9 per cent for 2009-10. The inflation rate would be 5.2 per cent. The fiscal deficit of the central government would stand at 4.4 per cent of GDP and the current account deficit at 2.9-3.5 per cent of GDP.
