

## **Quarterly Review of the Economy**

**National Council of Applied Economic Research, New Delhi**

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### **Summary**

#### **The turmoil in markets**

The current fiscal year has proved to be tumultuous for the economy. The first quarter presented a highly inflationary scenario fuelled by petroleum crude and food price rise. As the year progressed, the economy could not remain insulated from the impact of the financial sector turmoil in the global markets. The growth slowdown in the developed world led to decline in trade and India's exports slid sharply as the first half of the year drew to a close. The business confidence remained depressed throughout the year. The inflation trends have finally reversed as the demand pressures on limited supplies of oil and other commodities abated. The past decade has demonstrated the opportunities and challenges of globalisation. The global shocks of inflation and collapsing financial markets have meant that the goals of sustained high rates of economic growth during the eleventh five year plan period would have to be achieved under less than favourable global conditions.

The annual world GDP growth has been projected by the International Monetary Fund at 3.7 per cent in 2008 down from 5 per cent in the previous year. The IMF projections see global output growth to decline even further to 2.2 per cent in 2009. The downturn has been led by the collapse of the financial markets in the developed world. In the United States, Euro Area and Japan, 2009 is expected see a contraction in output and not merely a deceleration in growth. The US is said to be in recession since the beginning of 2008 with a decline in GDP in Q3 of 2008 and an expected further deterioration in Q4. The growth deceleration is now expected across all the countries as trade and investment linkages transmit the contraction in the economies of the developed world. The governments and central banks have begun to stabilise the financial markets and revive the business and consumer confidence.

In the Indian context, the growth of industrial sector began to decelerate in the second half of 2007-08. The year on year growth in IIP for manufacturing was 5.3 per cent in April-June 2008, 4.5 per cent in July-September 2008 and less than 2 per cent in October-November 2008. Clearly, the overall output growth has declined significantly as compared to the current estimate of GDP growth of 7.8 per cent for the first half of 2008-09.

A manifestation of the global financial market turmoil is seen in the Indian capital markets. The BSE Sensex was at 20,000 in December 2007, rising from 9,300 in December 2005, has now touched levels below 9,000 by December 2008. The adverse implications of these sustained trends to new investments can hardly be over stated. Both the rise and the decline were fuelled by the inflows of foreign capital. The exchange rate of the rupee has seen a complete reversal of trends as it saw an appreciation of 10 per cent with reference to the US dollar during April-December 2007 (average for the period) and now experienced a depreciation of 10 per cent during April-December 2008. The interest rates have also reflected the volatile financial conditions. The 91-day treasury bill rate was around 7.5 per cent during 2007-08 surged to 9.4 per cent in July 2008 to drop to around 7 per cent in December 2008.

The global slump in markets has also led to slippage in export performance. The exports of goods have begun to see negative annual growth towards the end of 2008. The drop in prices and in volumes implies that the growth of exports would be adversely affected. The imports have also begun to decelerate. Drop in oil prices and decline in imported inputs for production will have an adverse impact on import growth.

This *review* provides a discussion of the developments in different sectors of the economy in the most recent quarter for which data are available. It draws attention to the trends and implications of these trends to the future prospects. We also point to the policy measures that may help in alleviating the current economic crisis. The review provides an assessment of the overall macroeconomic conditions for the current year and also for the next financial year.

### **Agriculture**

Amidst the uncertainty of the markets, the monsoon for the year has been close to the normal and more importantly its spread across regions within the country. The favourable monsoon will mean that the availability of food grains to the public distribution system would be a problem of plenty rather than one of scarcity. Along with the strong position of forex reserves, the large food grain stocks have lent strength to policies in managing the adverse macroeconomic conditions.

The agricultural prices have actually declined relative to the overall price index in the current year. This implies that while they have not been fuelling inflation unlike the international price conditions they also do not create conditions conducive for investments in the sector.

### **Output of industry and services**

The declining growth of the non-agricultural sectors in the current year, especially in the second half, point to the drop in demand for both investment and consumption goods. The drop in export demand is another area of concern. All these aspects are inter-linked and influenced by the financial market conditions.

The weak global demand conditions are expected to remain so during 2009.

The services sector has been the biggest driver of output growth for several years now. The present crisis will have a direct impact on some of the sub-sectors such as financial services and international tourism. However, the telecommunication sector has continued to maintain its growth momentum so far.

The policy measures that led to a decrease in interest rates, freer access to global capital and reduced indirect tax rates will have a positive impact on demand for industrial goods and also services. The drop in inflation rate would also be a positive factor that will provide strength to demand. Maintaining the pace of government spending and the increase in wage payments by the central government during the year as a result of the Sixth Pay Commission award would provide one stable source of incremental aggregate demand during the year.

### **Money and capital markets**

Until the recent deceleration in fuel prices and sharp decline in industrial output growth, the monetary policies in India appeared to be focused on reducing inflation. The diverging trend between interest rates in India and in international financial markets was a clear indication of this strategy. It was only around October 2008 that some relaxation in monetary policy parameters was announced. However, the policies were also focused on maintaining the stability of the financial system. Access to liquidity to the banking sector and financial institutions was ensured to minimise the disruption of financial markets.

### **External sector**

The current trends in exports and imports reflect the weak global economic conditions and the downward movement of prices of oil and commodities in the international markets. These conditions may remain for much of 2009. The impact of current phase of slower economic growth at the global level would also have adverse impact on investment flows for the developing countries. At a global level it is important to note that there will be a tendency to pursue inward looking economic policies which will only make the slow growth remain so longer and will lead to inefficient production structures.

### **Prices**

The slowdown of economic activity across the developed economies, to begin with, has reduced the inflationary pressures globally. In the Indian context, the decline in petroleum fuel prices has been a major positive development in the otherwise adverse economic climate. The overall inflation rate, based on WPI has decreased to single digit levels. The decline is yet to be reflected in the consumer price index as the latter has a larger weightage for the food articles where the price decline has not been so conspicuous.

### **Public Finance**

The revenues of the government have come under pressure due to the current slowdown in economic growth. Tax revenues have begun to register negative growth in the recent months over the previous year. Under a counter-cyclical policy strategy expenditures can only be expected to rise leading to large slippage of fiscal balance targets. Besides this slippage in fiscal balance, there are also concerns regarding the potential for loss of focus on spending on social sectors. The framework of inclusive growth requires that adequate resources for social sector are essential. The current crisis has yet again pointed to the vulnerability of developmental goals to the instability in markets.

## **Forecast**

The main channel by which the current global financial market crisis has an impact on the economy is through the depressed investment and consumption expenditures. While the quantification of this impact is difficult, it is likely to be felt not only in the current year but also in the next financial year. In fact the projections made by international agencies, such as the IMF, point to much sharper decline in global output growth in 2009 than in 2008. There have been some important changes in the external economic environment since the last forecast was provided in October 2008. Taking into account a number of parameters and using the NCAER's macroeconometric model results, we have provided a revised forecast for 2008-09. We have also provided an indicative macroeconomic scenario for 2009-10 also.

In the revised forecast for 2008-09 we have assumed that the private gross capital formation would have an exogenous decrease of about 9 per cent as compared to its level in 2007-08 because of the current global financial crisis. The private final consumption expenditures would also experience a decline of 3 per cent of its level in 2007-08. These are higher than the decrease we had assumed in October 2008, essentially to reflect the high oil prices. The revised forecast also takes into account the higher government spending and tax relief announced as a part of the fiscal stimulus package.

The revised GDP growth for 2008-09 has been placed at 6.7 per cent over the previous year. The agricultural sector has been projected to grow at 2.3 per cent, industry at 7.2 per cent and services at 7.9 per cent. These projections are lower by 0.9 percentage point at the overall level as compared to the forecast provided in October 2008. The industrial and service sector GDP growth is projected to decline by about 1 percentage point as compared to the October 2008 forecast. The downward revision is essentially due to the decline in the pace of private expenditure on investment and consumption. The first half of 2008-09 had an adverse impact on both these components of aggregate demand as a consequence of high inflation rate and decline in capital market prices and the second half had the further impact of contractionary trends in export earnings and continued decline in stock prices. The fiscal stimulus and monetary easing may have some positive impact on aggregate demand and we have attempted to incorporate these effects in the revised forecast. One consequence of decline in oil price and lower GDP growth is

the lower import growth and lower current account deficit than anticipated in October. The fiscal balance of the central government is, however, projected to worsen.

The 2009-10 scenario is expected to be better than in 2008-09 as the investment and consumer expenditures are likely to see some revival. However, the overall GDP growth is projected at 6.9 per cent, well below the rates that may be needed to maintain the targeted growth rate for the eleventh five year plan period. The projections, however, do not include any significant fiscal stimulus that may be provided during the coming year.

The projected macroeconomic scenarios for the current and the next year imply sharply lower rate of economic growth rates than was the experience in the last four years. It is clear that a comprehensive set of policies are needed to raise the level of growth performance and sustain it at the high level.