

## **Seminar on the State of the Economy Quarterly Review of the Economy: Q2, 2009-10**



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### **The setting**

The GDP grew by 6.1 per cent in the first quarter of the current financial year with the service sector providing the momentum for an overall growth rate of above five per cent. The industrial growth picked up pace in the first two months of the second quarter with the Index of Industrial Production (IIP) for manufacturing reaching double digit growth in August over the same period of the previous year. Following a long spell of near stagnant industrial growth during October 2008 to May 2009, this has been a significant sign of recovery of industry from the impact of the global economic and financial crisis. The industrial output of consumer durables has shown consistent and sharp increase since the beginning of the financial year. The improvement in capital goods and basic goods has been somewhat erratic although there has been steady rise in the case of growth of intermediates sector.

The recovery in industrial growth has also been accompanied by the improvement in corporate performance and capital markets. The RBI's second quarter review of the economy for 2009-10 shows that although the sales of the corporate sector (non-government, non-financial companies) have not shown any increase in the first half of the year, the profits have grown. The stock price index, BSE Sensex, has shown steady improvement recording a rise of 37 per cent between April and August of 2009. The rate of decline in exports, year on year (YOY) basis, has decreased. In fact from May till August 2009, exports have increased consistently over the previous month.

At the global level, there is a perception that the economies are stabilising and limping back to a slow and moderate growth path. There has also been an improvement in the business sentiments. July witnessed a sharp increase in Business Confidence Index.

However, there have also been pointers to the risks to recovery in growth. The monsoon in the current year has been poor and agricultural output may in fact see a decline. The divergence in wholesale and consumer price indices has continued with the rise in the prices of primary articles refusing to moderate. As the accommodative monetary policy and expansionary fiscal policy remain necessary to sustain growth, the outlook on inflationary pressures remains a cause for concern. The RBI's review of monetary and macroeconomic developments for the second quarter of 2009-10 has observed that "While premature reversal of the monetary policy stance entails the risk of stifling recovery, persistence of accommodative stance could adversely impact inflation expectations".

The concerns emanating from the prolonged spell of recession in the developed economies have continued to be at the centre of fiscal and monetary policies. Although the recent assessments of the global economic prospects indicate that the decline in output has moderated and economies are stabilising, the recovery in growth is expected to be gradual and moderate. There is an increasing need for the developing countries to re-balance their strategies at least in the short-

term with greater attention on strengthening domestic demand. In the Indian context, the government has signaled the intentions to maintain the fiscal support for the economic growth recovery while reducing the risk of inflationary pressures.

Some of the recovery in economic growth observed in the current financial year can be attributed to the fiscal and monetary policy measures which provided stability to demand conditions and stability to the financial system. In this sense, continuation of the supportive policies is necessary until a broad based growth momentum is established. The global efforts to ensure that such an environment prevails until there are indications of sustained economic growth would be needed. Global efforts are also needed to curtail the effects of contagious diseases like H1N1 flu and the threats to peace and security. In this review of the economy for the second quarter of the year 2009-10 we provide a discussion of the trends in three major sectors, agriculture, industry and services, developments in monetary and credit conditions, external trade, prices and public finance. In addition, we also provide a re-assessment of the macroeconomic parameters for 2009-10.

### **Agriculture, Industry and Services**

The main concern with respect to the prospects for agriculture in the current year has been the erratic nature of the monsoon. The extent of rainfall deficiency during June-September 2009 was so severe that the country as a whole ended up receiving below-normal rainfall this monsoon. At the broad regional level, cumulative monsoon rainfall was 18 per cent below the long period average in the East, 26 per cent less in the West, and 38 per cent lower in the North. For the country as a whole, using unirrigated area under foodgrains as weights to aggregate rainfall data at the sub-division level, the deficiency in rainfall works out to 23.5 per cent below the long-term average.

The erratic nature of the rainfall this year can be gauged from the fact that 12 states declared drought conditions in 299 districts between them while states like Karnataka and Andhra Pradesh experienced severe floods as rainfall intensified when the south-west monsoon retreated.

The estimates presented in this review suggest that *kharif* foodgrain output may be 12-17 per cent lower than last year; *kharif* oilseeds output may be lower by about 6 per cent; cotton and sugarcane output is expected to show positive growth. The *rabi* harvest is expected to offset some of the losses in *kharif* as the water levels in reservoirs feeding irrigation systems have reached satisfactory level.

The impact of diminished *kharif* output on prices has been visible. Prices of pulses and vegetables are higher by about 20 per cent during April-September 2009 as compared to the same period last year. Efficient management of trade, distribution and price policy for agriculture this year will be a priority for policy this year.

In the case of industry, the pickup in growth in the first two months of Q2: 2009-10 has been a positive sign for the prospects for the economy as a whole. The sustained rise in the consumer durables segment through the first five months of the current financial year may reflect some of the fiscal policy stimulus to demand. However, the growth recovery has been somewhat broad based as the intermediates sector has also shown sustained improvement in growth. Although poor agricultural conditions may imply some set back to demand from rural areas, the high prices of agricultural products, if they reach the producers of farm output, may offset some of the adverse effect of output losses on demand. More importantly, stability in demand conditions and

financial markets can be expected to bring back the consumer confidence just as the business sentiments have also revived.

In the case of services, the signals have been mixed. Although important sectors such as trade, hotels, transport and communication recorded lower rate of growth in Q1: 2009-10 as compared to the YOY growth in Q1: 2008-09, in the case of finance, insurance, real estate and business services the growth was higher this year as compared to Q1: 2008-09. The seasonally adjusted quarterly data shows continuation of output trend in the current financial year for the services sector, inclusive of construction. For a variety of indicators of service sector activity, there are signs of rising pace of output in the first quarter of 2009-10 as compared to the conditions in Q4: 2008-09. Sustaining this trend may in fact depend on sustaining the momentum of industrial growth as production and trade related services would require demand conditions created by industrial growth.

### **Money and Prices**

The second quarter review of the Reserve Bank released on 27<sup>th</sup> September, while demonstrating signs of stability in policy stance has also indicated contours of exit out of the stimulus provided in response to the international financial crises. The repo rate and reverse repo rate continue at 4.75% and 3.25%, while CRR is maintained at 5.0% of net demand and time liabilities (NDTL). However, as a part of the exit from accommodative monetary policy some measures have been announced. The statutory liquidity ratio (SLR), which was reduced from 25 per cent of demand and time liabilities to 24 per cent, is being restored to 25 per cent. The limit for export credit refinance facility, which was raised to 50 per cent of eligible outstanding export credit, is being returned to the pre-crisis level of 15 per cent. The two unconventional refinance facilities: (i) special refinance facility for scheduled commercial banks; and (ii) special term repo facility for scheduled commercial banks [for funding to mutual funds (MFs), non-banking financial companies (NBFCs), and housing finance companies (HFCs)] are being discontinued with immediate effect. There have also been proposals to review and suitably modify the regulatory systems in view of the lessons from the financial crisis which the world has passed through in the past 12 months.

The review presented here points to the wide divergence in the global and domestic interest rates. The drop in inflation rate has only increased the real interest rates further. The dilemma of timing the exit from the accommodative monetary policy has been highlighted by these conditions. Pointing to the lack of significant recovery in exports despite the sharp depreciation of the rupee, this review has pointed to the need for recovery in global demand conditions for sustained improvement in export performance.

The weak growth in Bank Credit to Commercial Sector points to the nascent stages of economic recovery. As the interest rates remain relatively high, the firms may be averse to borrow and rather focus on expenditure controls and conserve internal surpluses. The enthusiasm of the capital markets may last only if there is sustained improvement in the production conditions in the advanced economies.

The low inflation rate experienced in the last financial year has been a result of the slump in economic activity worldwide. Improving economic conditions may imply rising prices of commodities and then manufactured products. The crude oil prices, though lower as compared to

the \$100 per barrel experienced in March-September 2008, have begun to rise. The retail prices, especially for food articles and products reflect inflation rate of double digit level.

The concern over the potential for rising rate of inflation in the remaining months of the year appears justified in view of the need for moderate inflation to sustain recovery in consumer and investment demand.

### **External sector**

The volume of world trade is expected to dip in 2009 for the first time since 1982. The fall may be as high as 11.9 per cent. Exports of developing countries may shrink by 7.2 per cent. A far bigger hit would be taken by the advanced countries whose exports could decline by 13.6 per cent.

Many countries around the globe have been adopting protectionist measures through WTO's legal as well illegal trade restricting measures. The World Bank has reported 78 new trade measures announced by different countries since the beginning of the financial crisis. These include 66 trade restricting measures of which 47 have been implemented. About half these measures deal with tariff increases. Other measures lack transparency since these refer to non-tariff barriers and subsidies.

The revival in the price spurts of commodities in international markets has been fuelled by improved market sentiments and depreciation of the Dollar. Oil prices have risen due to increasing demand and restricting supply. Nevertheless, it is expected that 2009 would post sharp declines in commodity prices: 36.6 per cent for oil and 20.3 per cent for non-fuel commodities.

As import bill rose because of the high crude oil prices and exports slumped as global demand contracted, India's trade deficit in 2008-09 exceeded \$100 billion.

Foreign direct investment (FDI) inflows touched \$9.5 billion in Q1 2009-10 compared with \$11.9 billion in Q1 2008-09.

### **Public Finance**

The pickup in industrial growth is yet to be reflected in the public finances. The data for April-August show that both tax and non-tax revenue collections are lagging behind last year's levels. Overall revenue receipts reached 25.6 per cent of Budget estimates for the first five months of 2009-10 compared to 26.89 per cent for the same period of 2008-09. The borrowing program is also yet to proceed at the pace of last year.

In Q1:2009-10, corporate tax recorded a meager growth of 1.9 per cent as compared to a whopping 43.4 per cent in the corresponding quarter of 2008-09. The income tax collections recorded positive growth of 7.2 per cent in Q1: 2009-10 as compared to 50 per cent in Q1:2008-09.

Customs duty registered negative growth of 37.4 per cent in Q1:2009-10 against positive growth of 20 per cent in Q1:2008-09. Central Excise recorded negative growth of 23.8 per cent in

Q1:2009-10 as compared to smaller negative growth of 0.9 per cent in the corresponding period of 2008-09.

Tax cuts on the one hand and low rate of inflation on the other may have contributed to the slump in tax collections in the current year. Further acceleration in economic activity would be necessary to help improve revenue receipts of the government.

### **Re-assessment of macroeconomic conditions for 2009-10**

The GDP growth for 2009-10 has now been projected by the Prime Minister's Economic Advisory Council at 6.5 per cent with a range of 6.25 to 6.75 per cent. The RBI has also projected a growth of 6.5 per cent for 2009-10.

In this review, after a review of various relevant indicators, the key macroeconomic indicators have been projected for 2009-10.

The revised assessment for the year as a whole places the overall GDP growth at 6.9 per cent of GDP, lower than the July forecast of 7.2 per cent. The decline in growth is a result of decline in the estimated agricultural output. While agricultural GDP is projected to decrease by 1.5 per cent, industrial GDP (inclusive of construction) is projected to increase by 6.9 per cent. The GDP from services sector is projected to increase by 9.5 per cent. The fiscal deficit of the Centre is projected at 6.3 per cent of GDP, lower than the budget estimate of 6.8 per cent. The overall annual average inflation rate, corresponding to WPI, is projected at 3.8 per cent. Projections are summarised in the table below.

### **Revised assessment of the macroeconomic parameters for 2009-10**

Variables	Forecast for 2009-10 provided in		
	April'09	July'09	October'09
<b>Real GDP</b>			
- Agriculture	2.5	1.0	-1.5
- Industry	6.3	6.7	6.9
- Services	8.5	9.4	9.5
<b>Total</b>	<b>6.9</b>	<b>7.2</b>	<b>6.9</b>
Merchandise Exports (US\$)	9.1	12.0	10.5
Merchandise Imports (US\$)	10	5.5	4.9
Inflation (WPI)	5.2	3.7	3.8
<i>As Percentage of GDP at market prices</i>			
Fiscal Deficit	4.5	6.2	6.3
Current account deficit	3.5	2.4	2.5