State of the Economy Seminar
Quarterly Review of the Economy

April 22, 2010

National Council of Applied Economic Research, New Delhi

The quarterly seminar on the State of the Economy was held at NCAER on April 22, 2010. Mr. Suman Bery, Director General chaired the seminar. The seminar included presentation on the economy the NCAER team and comments by invited experts and discussion by the participants. The invited experts included Dr. Sanjaya Panth from International Monetary Fund, Dr. Devendra Kumar Pant from Fitch Ratings India and Mr. Sukumar Mukhopadhyay, former member, Board of Excise and Customs.

The presentation by NCAER included a review of trends in the economy and an assessment of the prospects for 2010-11. A brief summary is provided below.

The Policy Action

There was much policy action during the last quarter with considerable immediate and longer term implications to the course of the economy. The Railway Budget and the Union Budget for 2010-11 were presented in February. The Right to Education Act was brought into effect on April 1. The Rajya Sabha gave approval to Women's Reservation Bill. The Food Security Bill is on its way to become a reality. The civilian nuclear commerce is also likely to gain momentum if the bill on nuclear liability gets the approval of the Parliament. The Thirteenth Finance Commission (TFC) submitted its report.

There has also been progress on some economic policy reforms, such as permission for the entry of new private sector banks, steps to rationalize fertiliser subsidy, consolidate FDI policy and the reforms in the petroleum fuel pricing policies. However, some of this is work in progress.

There have also been unsettling events in the shape of violence in Naxal affected areas, disruption of the economic activity due to support and opposition to the demand for a new state of Telengana. While these are not new issues, their impact on the economy has intensified. The high rate of food inflation for much of 2009-10 highlights the vulnerability of the economy to persistent supply side rigidities.

The monetary policy for 2010-11 announced on April 20, 2010 raised the policy rates- repo and reverse repo- by 25 basis points. The Cash Reserve Ratio (CRR) was also increased by 25 basis points. Increase in CRR was also effected in February 2010 by 75 basis points. Exit from accommodative monetary policy stance to address inflationary tendencies was articulated in the Third Quarter Review of Monetary Policy by the RBI in January 2010. It had then said that it is necessary to move forward with the process of 'exit'. While concern with the economic recovery was strong, the shift in priority to controlling inflation is now evident.

The Central Budget for the year reflected the need to restore fiscal balance with signs that the economic crisis of 2008 and 2009 has now abated. The budget provided some relief to the income tax payers by increasing the upper limit of income range where the marginal tax rate is 20 per cent. The surcharge on Indian companies was reduced. However, the Minimum Alternative Tax rate was increased. The resource mobilisation effort was evident in the increase in the indirect tax rates. The subsidies have been budgeted to be lower this year in absolute value than in the previous year. The infrastructure sector has been given prominence in the budget speech.

The implementation of Direct Tax Code and GST has been promised for the next year. The fiscal deficit to GDP ratio has been budgeted at 5.5 per cent for 2010-11, lower than the revised estimate of 6.7 per cent for 2009-10.

On the positive note, there has also been significant progress in the much delayed G3 spectrum auction that may catalyse the telecom services again.

It is against this backdrop of heightened policy activity that we have presented a review of the developments in the previous quarter. The review includes a forecast of the macroeconomic parameters for 2010-11. The three main production sectors: Agriculture, Industry and Services are presented in sections following the forecast. The subsequent sections of the report cover Money and Capital Markets, External Trade, Prices and Public Finance. The annex provides a compilation of data on key economic indicators. In the Overview section, we provide a summary of the discussion contained in the respective sections.

Agriculture, Industry and Services

Although the latest available official GDP estimates for 20091-0 for agricultural and allied sectors have indicated a marginal decline of 0.2 per cent over the previous year the impact of deficient monsoon on the output of some of the key crops has been significant. The second advance estimates put out by the Ministry of Agriculture for 2009-10 in February suggest that food grain production during the year is expected to witness a decline of about 7.5 per cent from 234.5 million tonnes in 2008-09 to 216.9 million tonnes. This is the sharpest decline in seven years after 2002-03 when food grain output had fallen by 18 per cent over the preceding year's output.

The decline in output during 2009-10 was essentially due to the impact of drought on kharif season output. Although this appears to be a marginal reduction compared to 1 per cent increase witnessed during the same period last year, but two successive years of low growth have pushed the average growth rate of this sector to a level of just about half the target set for the Eleventh Five Year Plan. The growth rate for the three-year period of the 11th FYP from 2007-08 to 2009-10 for the agricultural sector has now clocked an average of just about 2 per cent per annum.

The end result of reduced crop output has been a relatively high rate of food inflation. The average rate of inflation for food articles during 2009-10 has been about 15 per cent and in 2008-09 nominal food articles recorded an increase of 8 per cent. Prices of many commodities have come down a bit during the last couple of months, and current price rise is expected to maintain a downward movement.

Taking into account the assessments on storage conditions for irrigation water reservoirs, incidence of pests and diseases and if monsoon actually turns out to be normal across regions, the agricultural sector should witness significantly higher growth this year.

The industrial sector has turned in high rates of growth in the final months of 2009-10. The average year-on-year growth rate of IIP for the manufacturing sector is now expected to exceed 10 per cent. The mining and electricity sectors have also shown significant improvement in output in 2009-10 as compared with the their growth performance in the previous year. In the manufacturing sector, intermediates, capital goods and consumer durables have experienced output growth of more than 10 per cent during April-February 2010 over the same period in the previous year. The consumer non-durables have been the weak segment within the manufacturing sector. The consumer non-durable segment is strongly influenced by the agro-based industries and the export markets. Both these drivers were weak in the previous year and may explain the poor performance of the sub-sector.

In the case of services, the growth momentum was propped up by the government spending in 2008-09 and to a lesser extent in 2009-10. The external sector related services have shown slower growth in 2008-09 and 2009-10. Tourist arrivals, international air cargo and ports traffic have recorded slow growth. The only sub-sector within services that sustained its growth momentum through the economic crisis is the telecommunication sector. The subscription numbers for telephones continue to rise at an annual rate of more than 40 per cent.

Money and Capital markets

Based on the recommendations of the Working Group on Benchmark Prime Lending Rate set up by Reserve Bank of India in 2009 to review the present benchmark prime lending rate (BPLR) system, RBI has announced the replacement of the BPLR with the Base Rate System (BRS) effective July 1, 2010. This is a landmark change in many respects. This implicit deregulation of the lending rate may increase credit flows to small borrowers at reasonable rates and direct bank finance would provide effective competition to other forms of high-cost credit.

While concerns on prevailing high rate of inflation are valid, the role of supply side factors underlying current phase of inflation remain strong, thus increasing the likely costs of tightening monetary conditions. The more accommodative monetary policy stance has helped in the recovery of economic growth in 2009-10. However, robustness of the recovery needs to be validated with the performance of industry in the final quarter of the year for which no firm data are yet available. Increasing inflation rate has led to negative real interest rates. This may have helped to some extent investment spending and purchase of consumer durables. The February 2010 yield curve holds out expectations of lower inflation in the medium term and higher inflation at the longer ends. It also reflects investor confidence as reflected in the stock market.

The increase in CRR has absorbed significant amount of liquidity from the system. There is a concern that sharp increase in CRR may affect credit growth. The YoY growth in bank credit to the commercial sector (BCC) increased by 10.74 per cent during Q4: 2009-10 compared to 17.23 per cent growth during Q4: 2008-09.

The trend in the exchange rate of the rupee reflected in the appreciation of REER and NEER in the recent months is not favourable to export growth.

The policy choice faces complex trade-offs. Fine tuning of monetary policy that sustains growth recovery as well as restrains inflation is the challenge for policy makers.

External Sector

Projections by the IMF (January 2010) show that the World GDP, measured with purchasing power parity (PPP) weights, is estimated to have declined by (-) 0.8 per cent in 2009 compared with 3 per cent growth in 2008. In 2010, this growth is expected to accelerate to 3.9 per cent. China posted impressive growth in 2009 at 8.7. Brazil, Mexico and Russia were poor performers at (-) 0.4 per cent, (-) 6.8 per cent and (-) 9 per cent in that order. All these countries are expected to perform better during 2010: China 10 per cent, Brazil 4.7 per cent, Mexico 4 per cent and Russia 3.6 per cent. These are positive signs for trade flows. During 2010, world trade volumes is projected to rise by 5.8 per cent.

The 2009-10 was dismal for India's external trade. In dollar value, total exports posted a decline of 11.3 per cent during April-February 2009-10 YoY over 2008-09. Total imports registered a decline of 13.5 per cent. Non-oil imports declined 11.4 per cent and oil imports fell 18.2 per cent.

During April-December 2009, YoY basis, services exports suffered decline of 16.4 per cent with its major component, exports of miscellaneous services, declining by 20.5 per cent. However, software services export fell only by 1.7 per cent. The major hit was taken by business services other than software services with their exports declining by 37.9 per cent.

Prices

The WPI based annual inflation rate touched 9.9 per cent at the end of February 2010 and is expected to cross the 10 per cent mark by the end of financial year. However, the major concern during the second half of 2009 was the emergence of double-digit food inflation. Since December 2009 the gradual hardening of fuel prices has got transmitted to non-food items. Any hike in fuel prices leads to higher transport costs, a key input in economic activity.

Among the components of WPI, primary articles registered the highest increase (15.5%) at the end of February 2010. The WPI of non-food articles recorded double-digit growth of 10.6 per cent in January 2010, the highest growth since December 2008.

The concerns on inflation now remain central to economic policies. There is also transmission of higher commodity prices in the international markets to domestic prices. In the case of oil prices, however, current expectation is that the international crude price will be within the range of $75-85 per barrel.

The retail price trends are dominated by food prices. To some extent increase in housing prices has also contributed to retail consumer price index.

Public Finance

The fiscal position of the Centre during the last two years has been a matter of concern. During this period, the government had to borrow from the market and the Central Bank to finance spending on infrastructure, implement the Sixth Pay Commission award and meet various social programme expenditures. The borrowing became significantly large as indirect tax rates were cut to restore consumer confidence. The gross tax revenue collection to GDP ratio which was 12 per cent in 2007-08 declined to 10.3 per cent in 2009-10(RE). On the other hand, total expenditure to GDP which was 14.4 per cent in 2007-08 increased to 16.6 per cent in 2009-10(RE).

Fiscal and revenue deficits of the Centre rose during the second half of 2008-09 and first half of 2009-10 as compared to the other respective half of the year. Revised estimates of 2009-10 shows fiscal and revenue deficits were 6.5 and 5.0 per cent of GDP in the second half of the year as against 7.0 and 5.8 per cent in the first half. These higher deficits could be attributed to the extra spending and tax cuts announced as a part of the fiscal stimulus packages late in the second half of fiscal 2008-09. The trend in quarterly deficits numbers are illustrated in Figure PF2.

Fiscal deficit as percentage of GDP showed a moderate increase since Q2:2009-10. Similar trend is also in evidence in the case of revenue deficit. In the 2010-11 budget the government has targeted a lower deficit for the current and subsequent years based on the MTFP. For the current fiscal year, a fiscal adjustment is done by partially withdrawing the tax concessions. As per the budget estimates for 2010-11, fiscal, revenue and primary deficit to GDP ratios are targeted at 5.5, 4.0 and 1.9 per cent, respectively.

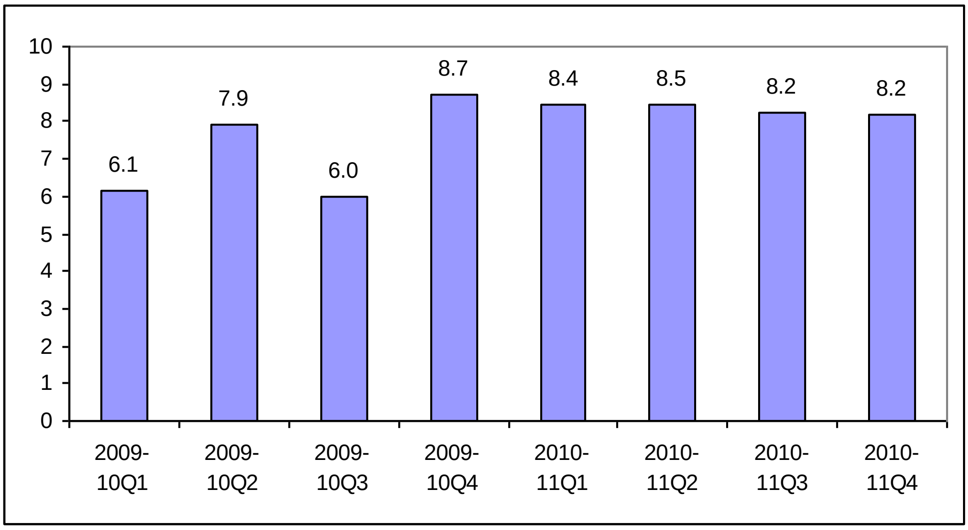
The central government's total debt as a percentage of GDP measured at 51.5 in 2009-10 (RE). The government in its Medium Term Fiscal Policy has set a target to limit the debt/GDP ratio within 52 per cent in the current fiscal year (2010-11), and bring down the ratio substantially to 48.2 per cent by 2012-13. The Thirteenth Finance Commission also recommends cuts in debt levels.

Forecast 2010-11

We have examined the macroeconomic prospects for 2010-11 based on two approaches. One is a simpler quarterly assessment of GDP growth based on the time path of a few selected explanatory variables and GDP from the three main sectors: agriculture, industry and services. The other approach is based on an assessment of the parameters using a macroeconometric model.

The overall growth rate for 2010-11 based on the quarterly estimates of GDP is fairly even across quarters and for the year as a whole works out to 8.3 per cent (Figure 1).

Figure 1. Patterns of quarterly GDP growth: projections for 2010-11



The detailed annual model provides a GDP growth forecast of 8.1 per cent for 20010-11. Both the projections are based on the assumption of a normal monsoon in 2010.

The annual model provides estimates of a range of other macro parameters (Table 1). The WPI based inflation rate is projected at 6.6 per cent for the year as a whole. This does imply that the inflation rate would moderate from the currently prevailing high level as the year progresses. The fiscal deficit of the Centre is projected to be lower than the budget estimates, mainly because of the higher growth in revenues- both tax and non-tax as some of the revenues are linked to the growth of nonagricultural GDP growth in current prices. Higher inflation rate increases ad-valorem revenue collections. The analysis projects recovery in the trade flows: both exports and imports. The current account deficit is projected at 2.8 per cent of GDP at market prices.

Table 1. Assessment of the Macroeconomic Scenario for 2010-11

Item	**2007-08**	**2008-09**	**2009-10**		**2010-11**
			NCAER January 2010 QRE	**Latest Official data**	**NCAER April 2010 QRE**
% yoy change					
Real GDP					
- Agriculture	2.7	2.0	-1.6	-0.2	4.6
- Industry	9.4	6.3	7.0	8.6	8.5
- Services	10.6	8.5	9.5	8.7	8.7
Total GDP at Factor Cost	**8.9**	**6.8**	**7.0**	**7.2**	**8.1**
Exports (US$, merchandise)	40.2	5.1	2.5	-11.0	7.2
Imports (US$, merchandise)	47.3	7.4	3.0	-11.9	18.3
Inflation (WPI)	4.3	8.7	3.9	3.7	6.6
As Percentage of GDP(market prices)					
Fiscal Deficit (Central government)	2.6	6.0	6.3	6.7	4.3
Current Account Deficit	-1.6	-2.5	2.3	2.2	2.8
Central government debt	60.9	56.9	53.3	51.5	51.1*

Note: In the case of latest data for 2009-10, following data sources were used: GDP: Advance estimates from CSO; Exports/ imports: based on data upto February 2010 from DGFT; Fiscal deficit: Union Budget 2010-11 (revised estimates for 2009-10) Inflation: WPI data from Ministry of Industry.

* Based on the medium term fiscal policy statement in the 2010-11 budget documents.