Overview

On the economic front, Q3, 2013-14 has been a mixed bag. There's been both good news as well as bad. The good news is that trade numbers for December 2013 released early January suggest the current account deficit (one of the twin deficits that has caused much concern) should decline quite dramatically. Latest numbers suggest the CAD/GDP ratio should fall to below 2.5% this fiscal, down from 4.8% the previous fiscal. While exports continue to grow, the rate of growth moderated to 3.5% in December 2013 even as imports declined 15.2%, leading to a widening of the overall trade deficit to $10.1 billion. Nonetheless, most experts now place FY14 CAD at below $50 billion, down from $ 88 billion (4.8% of GDP) in the last fiscal.

Reflecting the improvement on the external front, the exchange rate of the rupee vis-à-vis the dollar stabilized during the quarter. Despite the US Federal Reserve announcing its phased programme of tapering, commencing January 2014, the rupee remained remarkably stable in the Rs 61- Rs 63 range through most of the third quarter. Some weakening was seen mid-January following distress in key emerging markets like Argentina and Turkey. But by and large the rupee has weathered the storm fairly well.

That is not all. On the inflation front, there are signs that after months of relentless price rise, both wholesale as well as consumer price inflation (CPI) might finally be on the decline. While CPI declined from 11.24 % in November (revised down to 11.16%) to 9.87% in December 2013, wholesale price inflation (WPI) fell even more sharply from 7.52 % to 6.12% over the same period. In both cases the improvement was account of lower vegetable prices. (Vegetable prices rose 39% year on year in December in the CPI basket as compared to 57% in the WPI basket).

The bad news is that there is no sign as yet of recovery on the industrial front. On the contrary, industrial production continues to trend down. While the Index of Industrial Production (IIP) registered a negative growth of 2.1% in November 2013, the consumer goods sector, especially consumer durables, performed particularly badly, recording a decline of 21.5%, a new low post May 2013, when it touched a new post-crisis low at 18.3%. Manufacturing, with a 75% weight in the IIP, remains lacklustre, declining 3.5% compared to two percent in the previous month despite numerous efforts by the government to spur growth by speeding up clearances etc.

Revised estimates of GDP for 2011-12 and 2012-13 released by the Central Statistical Organisation (CSO) on 31 January suggest the slowdown in the last fiscal may have been more severe than indicated by earlier estimates. GDP in 2012-13 at constant prices (2004-05) is now believed to have grown at only 4.5%, a ten year low, with manufacturing growth at just 1.1% down from 7.4% in the previous year and 11.3% in 2009-10.

Advance estimates due on 7 February 2014 are unlikely to be much better, as manufacturing has continued to decline and services growth, too, has begun to slacken. Agriculture, alone is expected to do better though given the low share of agriculture in GDP, is unlikely to be sufficient to lift overall GDP growth to over 5% . Thus, after many years of robust growth, the Indian economy is likely to witness two consecutive years of sub-five percent growth.

Slow growth, combined with high inflation provides a potent mix for social and political unrest. According to analysis done by the State Bank of India, growth in consumer durables sector tracks CPI inflation closely. Except for FY2010, when consumer durables peaked even when CPI inflation was also at its peak (primarily due to the fiscal impetus provided by the 6th Pay Commission disbursements), high inflation has invariably been accompanied by contraction in IIP consumer durables, suggesting subsistence needs override all other needs for households).

India has moved from being part of the famous BRICs to becoming a member of the infamous Fragile Five – Brazil, India Indonesia, Turkey and S Africa. The world's biggest asset manager, Blackrock, in the latest (October 2013) update of its Sovereign Risk Index, (which ranks 50 countries in terms of governments' creditworthiness, external finance needs, fiscal policies and banking stability, and also captures the essence of pure political risk), classified India as 'risky' along with all the Fragile Five, all of whom face elections this year.

Political risk, as perceived by market players, is bound to become a bigger factor as we get closer to the elections in May 2014. A recent study published by the U.S.-based National Bureau of Economic Research shows early-warning political risk gauges can be constructed from bond market prices and provide a valuable guide for business overseas. However, the authors - Geert Bekaert, Campbell Harvey, Christian Lundblad and Stephen Siegel – caution that sovereign spreads in emerging markets overstate pure political risks by 3.1 percentage points. That might be comforting for us in India. But their conclusion that a one percentage point rise in the political risk spread leads to a drop in foreign direct investment (FDI) of almost 12% or about $305 million on average, for the 30 emerging countries in major debt indices has serious implications for India, given our concerted efforts to move away from dependence on portfolio flows to longer-term FDI.

The World Bank in its latest update on global growth has revised its estimate upward to 3.2%, up from 2.4% in early 2013 and three per cent in July 2013. It has also revised its estimate for India to 'over 6% in 2014-15' and 7.1% the following year.

However, the disappointing news as far as emerging markets are concerned is that the Bank expects most of the growth to come from high income countries. Though the Bank does add that the withdrawal of quantitative easing and corresponding increase in global interest rates is expected to weigh only modestly on investment and growth in developing countries as capital costs rise and flows moderate in line with global portfolio rebalancing.

Agriculture

Agriculture is expected to do well this fiscal. Most forecasts suggest record production of foodgrains. Thanks to the rain gods, rainfall has been six per cent above normal. In addition, the spatial distribution of seasonal rainfall at the level of sub-divisions and districts was also fairly good as reflected in the shares of sub-divisions and districts that received normal to excess rainfall. Thus, in comparison to 2012-13 the spread of monsoon rainfall during 2013-14 was fairly satisfactory. A comparison of the performance of monsoon rainfall during the period from the beginning of June to the end of September over the last four years reveals that this year's rainfall has been the best in three of the four major regions of the country. The only exception is the eastern region, which received below normal rainfall overall.

Our estimates suggest overall foodgrain output is likely to set a new record of around 270 million tones.

However, management of foodgrains continues to pose a challenge. Poor infrastructure, archaic laws like the Agriculture Product Market Committee Act and ECMA (Essential Commodities Maintenance Act) and most of all, buffer-stocking much above buffer norms, all contributed to keeping food inflation high.

Forecast

Overall, the projections for 2013-14 based on quarterly and annual models point to a GDP growth of 4.7-4.9 per cent. The fiscal deficit may be slightly higher than the budgeted 4.8 per cent on account of slower economic growth. The current account deficit is expected to return to more sustainable levels, although at lower pace of growth of economy. Industrial growth remains the weakest link in growth momentum.

Based on the assumptions of normal rainfall, pick up in world output growth and other global demand conditions as per the recent projections of IMF and government expenditure patterns as in the current year, we have provided an assessment of the macroeconomic scenario for 2014-15.

While agricultural growth is projected to return to more normal level, improvement in the growth of non-agricultural sectors is projected to lead to overall GDP growth of 5.6 per cent.

The higher growth is expected to increase import demand and improved merchandise exports and net invisibles maintain the CAD at 3 per cent of GDP. Fiscal deficit will remain close to 5 per cent of GDP indicating the need for fresh initiatives to improve revenues and budgetary expenditures.

Industry

Lower investment and consumption demand resulted in industrial output contracting during the first two months of the third quarter with both capital goods and consumer durables output falling. The mining sector too failed to look up, thanks to a complex set of problems relating to environment, regulation and governance issues. Manufacturing output in the April-November period 2013 declined 0.6% compared to a growth of 0.9% in the comparable period last year. Poor performance was not confined to any one sector but was across-the-board with 11 out of 22 industries showing a decline in output.

On a use-based industry classification, growth in both intermediate goods and consumer non-durables improved as compared to the previous year. However, high inflation took its toll as falling discretionary spends impacted demand for consumer durables resulting in a 21.5% contraction in consumer durable output.

The index of eight core industries that together account for 38% weight in the Index of Industrial Production (IIP) also registered a lower growth of 2.5% during April- November 2013 compared with 6.7% in the comparable period last year. Here again the decline was across the board with natural gas, crude oil, coal, petroleum refinery products and cement all contracting in unison.

Services

The services sector, long regarded as the main prop of robust economic growth in the country, has not been immune from the overall slowdown. Lead indicators from the second quarter suggest the momentum is unlikely to pick up in the remaining part of the year.

Services exports may prove an exception to the generally subdued trend given that these are a function of global growth. The results of IT majors like TCS and Infosys suggest demand for IT services is likely to increase as the recovery in the West gathers steam. As per latest data, annualised GDP growth in the US is expected to be in the range of 3.5-4%. Economic recovery in the UK economy also seems on course and while Europe is not yet out of the woods the global economy is in decidedly better shape and that augurs well for software exports in Q4.

Public Finance

Public finances continue to be in disarray. Though the finance minister has reiterated his determination to keep the fiscal deficit to GDP ratio at 4.8% as projected in his budget estimates, runaway expenditure coupled with lagging tax revenues and poor collections from disinvestment have resulted in the fiscal deficit touching 94% of the target of Rs 5.42 lakh crore for the year by November 2013. Faced with the prospect of falling short on his promise, the FM is likely to cut back drastically on plan expenditure, further aggravating the slowdown.

The finance ministry is also seeking to make good the revenue loss through all possible means. Thus, public sector undertakings, like Coal India Ltd, have been nudged into declaring a special dividend way above that declared last year (Rs 29 per share as against Rs 14 per share last year), netting the exchequer a handsome sum of Rs 16, 489 crore as dividend. Other PSUs are not expected to escape – they will all be 'commanded' to pitch in to bridge the fiscal deficit, despite the obvious opportunity cost, in terms of deferment of sorely-needed investment in expanding their own operations.

Plans are also afoot to offload the government's stake in various profitable companies such as Axis bank, ITC, L&T presently held through SUUTI (Specified undertaking of Unit Trust of India) which was carved out of UTI, post the US-64 fiasco. SUUTI's holding, in these three companies (23.58 % in Axis Bank, 11.54 % in ITC and 8.27 % in L&T) is presently (January 2014) valued at approximately Rs 48,000 crore and should more than compensate for the shortfall in government's disinvestment target for the year (Rs 40,000). Spectrum auction is another channel that is expected to fetch the government some money.

The possibility of financial jugglery (deferring payment for expenses incurred this fiscal to the next) in order to meet the FD/GDP target cannot be entirely ruled out. Some amount of jugglery has, perhaps, become a feature of our Budget exercises (recall the infamous off-budget items like oil receivables of the past), but the danger of window-dressing government fiscal numbers cannot be over-stated, as the Greeks will readily testify!

However, the quality of the fiscal adjustment, moreover, is just as important as the numerical number and here the unfortunate reality is that, as in the previous fiscal, the containment of the FD has been done through the wrong kind of expenditure compression. Thus the Revenue Deficit (RD), or the extent of the deficit that has gone to meet current rather than capital expenditure, has already crossed the target for the entire year during the first nine months of the current fiscal, while the primary deficit has crossed 171% by November 2013.

Money, Credit and Financial Markets

Both money and capital markets exhibited lower volatility during the third quarter compared to the second quarter, primarily because the global environment was less turbulent and hence the overhang from external forces was also markedly less pronounced. Surprisingly, the much-awaited announcement of tapering by the US Federal Reserve on 18 December 2013 did not have the tumultuous impact witnessed earlier in the year when mere talk of the possibility of such tapering in May 2013 led to mayhem in both markets.

Healthy capital inflows under the RBI's swap facilities for overseas borrowings by banks and non-resident deposit accounts eased liquidity conditions and helped bridge the gap between credit and deposit growth during the quarter under review. There were brief periods of tight liquidity as when advance tax payments were made late December, but overall liquidity conditions were comfortable, thanks in part to the RBI conducting a number of open market operations (OMOs).

Credit disbursement slowed down in the third quarter with credit to both agriculture and industry recording a slowdown.

Overall credit growth to industry decelerated from 15.2% last year to 14.1%, led by sectors such as petroleum, mining and gems and jewelry. Nonfood credit growth declined from a peak of 18.1% early September to 15% by early January, in line with the RBI's indicative trajectory of 15%.

The decline in credit growth was partly a reflection of subdued investment sentiment among corporates, in line with slower GDP growth as well as growing risk aversion among banks faced with a growing burden of non-performing assets. Asset-quality indicators have been slipping since 2011-12, with public sector banks, which account of the bulk of bank lending, showing much greater deterioration in asset quality compared to foreign/private sector banks.

Following the strong growth in FCNR(B) balances consequent on the RBI's concerted efforts to attract dollar deposits, deposit growth, year-on-year, finally out-stripped credit growth. However, adjusted for the FCNR (B) effect, deposit growth in the third quarter continued to lag credit growth as in the earlier quarters, reflecting the declining interest of retail depositors in bank deposits, given negative real rates of interest.

In its mid-quarter monetary policy review on 18 December 2013, the RBI maintained *status quo* on rates despite the fact that inflation numbers available at the time of the review showed a sharp increase at both the wholesale and retail level. In the January policy review, however, the RBI chose to hike rates another 25 basis points (the third increase since September2013) to eight per cent on the grounds that inflation rates were still elevated. The hike, which went against consensus opinion of a pause in the rate hiking cycle, was sought to be justified on the grounds that the RBI cannot pause in its efforts to ensure financial and monetary stability, even as the slowdown in the economy was getting 'increasingly worrisome' and growth is 'likely to lose momentum in Q3'.

As with money markets, financial markets were less turbulent during the period under review. Postponement of tapering by the US Fed helped restore order in markets. Volatility, however, remained high and though the Sensex recovered strongly and indeed went on to touch an all time record of 21,374 on 22 January 2014, the underlying sentiment remained nervous. During 22 May to 30 August both the Sensex and the Nifty declined as FIIs withdrew US$ 13 billion from domestic debt and equity markets. However, both indices increased by nine per cent during the third quarter compared to a decline in the previous quarter. From a 52-week low of 17,448.71 on 28 August 2013, the Sensex has risen 3,888.96 points or 22.28% by 22 January 2014.

External sector

Export performance was robust during the third quarter, partly on account of the sharp depreciation in the exchange rate of the rupee and partly on account of a modest recovery in major advanced economies.

The improvement in exports together with a moderation in imports, especially gold imports, contributed to a narrowing of the trade deficit to $ 110 billion during the period April – December 2013, ie 25% lower than the corresponding period last year.

One noteworthy development has been the broad-basing of our exports to various destinations. Commodity-wise too our export base has grown with exports of engineering goods, readymade garments cotton yarn, basic chemicals, plastic & linoleum, leather and leather products, manmade fibre and marine products showing significant growth. The reduction in trade deficit in Q2 resulted in a fall in the current account deficit for the quarter to $ 5.2 billion (1.2%) of GDP, down from $ 21 billion in the same quarter of 2012-13.

Despite the lower CAD, Q2 saw a net outflow of capital resulting in a drawdown of forex reserves of $ 10.4 bn. The swap window offered by the RBI to shore up reserves raised $ 34.3 bn during the period September – 30 November 2013, pushing overall forex reserves to $ 292.1 bn as on 17 January 2014. Latest numbers suggest capital flows turned positive in Q3 though the outlook for Q4 remains uncertain following the US Fed announcing the next phase of its tapering programme commencing February 2014.

Trade data numbers from the DGCI & S for Q3 suggest the improvement seen in Q2 is likely to continue; so much so that both government and the RBI now expect the full year CAD to fall to less than 2.5% of GDP.

The exchange rate has been fairly stable since mid-September 2013, despite the US Fed announcement on 18 December that it would commence its taper from January 2014. In terms of the real and effective exchange rate (REER), both six and 36-currency, the rupee depreciated by 10.4 and 7.8 % respectively compared to March 2013.