Overview

Bountiful rain has had a positive impact on agricultural growth but it will not be enough to pull up the rest of the economy which is suffering from a lack of confidence, high inflation, dismal domestic scenario and uncertain external scenario. Predictably growth rates have been revised onwards

GDP numbers that came in since the date of our last Quarterly Review in July 2013 suggest some of our worst fears have been realised. First quarter growth for 2013-14 plummeted to 4.4%, the slowest quarterly growth in the past seventeen quarters.

Growth in the second quarter (for which data is awaited) is also likely to be subdued partly on account of the upheaval caused by developments on the external sector. The outlook for the third and fourth quarters is not much brighter, thanks to a combination of domestic and external factors.

On the domestic front, though the government has embarked on a flurry of activity during the past three-four months, these are unlikely to bear fruit in the near-term in view of the political uncertainty on account of impending general elections in May 2014. On the external front, likewise, there is uncertainty regarding the timing and pace of the US Federal Reserve's move to taper its record stimulus programme under which it has been pumping liquidity into the system by buying bonds worth US$ 85 billion every month. Any reduction in the Fed's bond buying programme will drive investors away from emerging markets and led to volatility in the forex market.

In such a scenario it is not surprising that estimates by various agencies of GDP growth during 2013-14 have progressively been lowered. While the government has not formally lowered its estimate of 6.5% announced at the time of the Budget, the Prime Minister's Economic Advisory Council in its latest Economic Outlook published in September 2013 has lowered its estimate from 6.4% (projected in April 2013) to 5.3%. The Reserve Bank of India has gone one step ahead and lowered its GDP projection to just five per cent, down from 5.5% earlier.

A notable aspect of the second quarter was continuance of turmoil on the external front. The immediate trigger was the US Federal Reserve Chairman, Ben Bernanke's testimony of 22 May suggesting the US Fed might start tapering its Quantitative Easing programme sometime later this year.

The resultant mayhem on Indian markets was marked by large scale exit of foreign institutional investors (FIIs), especially debt funds. This led to a sharp depreciation of in the exchange rate of the rupee vis-à-vis the dollar by 7.5% during the period 22 May to 15 July compelling the Reserve Bank of India (RBI) to announce liquidity tightening measures on 15 July in a bid to raise the short-term interest rate and thereby curb volatility in the exchange rate.

Following the Fed's decision to defer tapering of its bond-buying programme and a series of confidence-boosting measures announced by the RBI, stability seems to have returned but economic agents are on edge. The worry is that this stability may only superficial and the next six months may not be any better, especially given the political over-hang.

The performance and outlook for the various sectors is detailed below:

Agriculture, Industry and Services

The rain gods have been kind to us. Monsoon rainfall during June-September period of 2013-14 has been excess-to-normal in large parts of the country. The actual rainfall received during the entire monsoon season is 6% above its long-term average. Of the total 36 agro-meteorological sub-divisions, 31 sub-divisions covering about 78% of all districts in the country have received normal-to-excess rainfall. The spatial distribution of seasonal rainfall at the level of sub-divisions and districts has also been fairly good this year.

This has improved the outlook for agricultural production tremendously. This is reflected in the first advance estimates of kharif output released by the ministry of agriculture. According to these estimates the output of kharif food grains is likely to be in the region of 129 million tonnes, marginally above the previous year's estimated output of 128 million tonnes. Our estimates are still higher because of differences in the method used to arrive at these estimates. The ministry's estimates are based on information supplied by the state governments. Our own estimates for the kharif season are based on regression models, which incorporate the impact of monsoon rainfall as well as trend factors both of which suggest significant improvement in the output of various crops.

The performance of industry and within industry of manufacturing has been nothing short of dismal. The index of industrial production (IIP) for April-August 2013 grew marginally by 0.1 per cent. Contraction of the mining and manufacturing sectors is the main factor responsible for lowering overall industrial growth. Excluding capital goods and the mining sector, IIP grew by 0.5% during the period.

In terms of use-based industries, consumer durables and basic goods, which together have 54% weight in IIP, pulled down overall growth. Capital goods have been particularly volatile; (-) 15.6% growth in July was followed by a two per cent decline in August. Unfortunately, the quality of IIP data, marked by frequent revisions and spikes in output of certain items, makes it very difficult to come to any clear conclusion about the sector.

Output of eight core industries improved consecutively for three months with September growth reaching 8%. However, this has not translated into higher industrial growth. The pickup in performance is led by led by steel, cement and electricity. However, on a year-to-date (YTD) basis, the growth of eight core industries decelerated to 2.3% during April-August 2013 from 6.3% in the corresponding period last year.

The services sector grew at 6.2% during Q1 of 2013-14 compared to 7.6% during the same period last year largely on account of a moderation in the growth of ‘construction’ and ‘trade, hotels, restaurant, transport and communication’ sectors.

Developments in lead indicators of the services sector reveal a mixed picture. Passenger and commercial vehicles sales and some segments of the aviation industry contracted even though indicators like tourist arrivals, railway freight revenue and steel production showed signs of improvement. The Reserve Bank’s services sector composite indicator, which is based on growth in indicators of construction, trade and transport and finance, showed a downturn in Q1 of 2013-14, but a modest pickup in July-August. Either way what is clear is that the services sector can no longer be the engine of growth. Growth has hit a plateau and this sector alone cannot power growth and more importantly provide employment opportunities to our teeming millions.

External Sector

In September 2013 the World Trade Organisation (WTO) cut its forecasts for trade growth in 2013 and 2014 to 2.5% and 4.5% respectively, well below the 20-year average of 5.4 %.

The fall in world trade is a direct consequence of slowdown in emerging markets and dollar weakness, driven by signs that the US Fed is likely to continue its stimulus. The dollar has declined five per cent on a trade-weighted basis since mid-July.

If the first six months of the current fiscal were tumultuous, most of the tumult was caused by developments on the external sector.

In common with emerging markets the world over, the exchange of the rupee in terms of the US dollar fell sharply following the May 2013 remarks of the US Fed Chairman, Ben Bernanke about a possible tapering of the US bond purchase programme in the course of the year. The rupee, however, declined much more than other currencies, barring the South African Rand and the Indonesian Rupiah, in view of our more adverse current account deficit (CAD).

Fortunately, by early September 2013 the rupee recovered ground and appreciated by six per cent and further by 1.9 per cent by 25 October 2013 as market sentiment improved. Sentiment was also boosted by definite signs that the CAD will be more manageable this year; despite the widening of the CAD to 4.9% of GDP in Q1: 2013-14 as against 3.6% of GDP in Q4: 2012-13.

The trade balance seems to have responded to the policy measures taken by the government and the RBI. Gold imports have declined significantly (though there are indications that smuggling is on the rise) and exports have picked up. As a result the trade deficit, that had widened to $ 50.5 billion in Q1: 2013-14, up from $ 43.8 billion a year ago, is expected to come down substantially in the second quarter. For now external risks have come down. But the recent CAD improvement cannot be taken for granted. It must be bolstered through more structural adjustments.

Greater attention will also need to be paid to altering the pattern of financing of the CAD – towards stable long-term capital inflows and away from volatile portfolio flows especially debt flows. This is critical given that the share of external debt, especially short-term debt measured by residual maturity – has risen sharply in recent months.

Money Credit and Finance

The monetary situation continues to be extremely challenging. On 15 July, in response to extreme volatility in the market, the RBI hiked the MSF rate sharply to 10.25%. The overall allocation of funds under LAF was also capped at one per cent of the Net Demand and Time Liabilities (NDTL) of the banking system. On 23 July the RBI tightened liquidity further by restricting access to LAF by way of repos at each individual bank level and restricting it to 0.5 % of the bank's own NDTL with effect from 24 July, 2013. Rules for maintenance of CRR were also tightened.

These measures had an immediate impact on bond yields though the rupee continued to be under pressure (touching an all-time low of Rs 68.85 on 28 August 2013) till early September. Stability returned to the market only it became evident that the Fed was not going to commence its tapering any time soon.

The RBI in its mid-quarter review of monetary policy on 20th September (for the first time the original date of the Review was pushed backed to after the Federal Open Markets Committee meet) rolled back some of the exceptional liquidity-tightening measures announced in July but raised the repo rate 25 basis points to 7.50%. This was again raised to 7.75% in the Second Quarter Review announced on 29 October 2013. The MSF rate was correspondingly reduced 25 basis points to 8.75, thereby restoring the corridor between the two rates to 100 basis points.

> The slowdown in the economy impacted both deposit as well as credit growth. Deposit growth has been slowing over the past few years as savers responded to negative real rates of interest by turning away from banks towards gold and other physical assets.

As on 6 September 2013, deposit growth was only 13.4%, compared to 14.5% in the previous year. Credit growth, in contrast, was higher at 18.2% as on 6 September compared to 16.6% in the previous year.

As far as stock markets are concerned, it was a roller-coaster ride during the second quarter as FIIs first fled the market on talk of Fed tapering and then returned with almost as much vigour once it became apparent the Fed would stay the course for a while. On 16 August the BSE Sensex tanked 769.41 points, the largest single day fall in four years. The Nifty also nose-dived 234 points. On 21 August the Sensex slipped below the 18,000 mark to close at 17,905.91. However by the end of August, it had recovered ground to again touch the psychologically important level of 18,000 before touching a high of 20,646 on 19 September 2013. It has since gone on to touch an all-time high of 21,034 on 30 October 2013 on the back of strong overseas inflows.

Prices

Driven by a spike in vegetable prices, inflation has once again reared its ugly head during the second quarter of the current fiscal. Retail inflation is persisting at close to double digits and inflationary expectations have gone up. India's retail inflation is the highest amongst the BRIC countries and United States, United Kingdom, France and Germany. Forecasts till 2018 show that India's inflation rate is going to remain the highest amongst the countries although the inflation rate will come down. High inflation also affects India's competitiveness adversely

Headline inflation, as measured by the Wholesale Price Index (WPI) with base year 2004–05 had fallen below 5% on a y-o-y basis in the first quarter of the current fiscal. The trend has since reversed and wholesale inflation increased to 6.1%, although this is significantly lower than the inflation rate in the corresponding period last fiscal year (7.9%).

Second quarter inflation is mainly due to supply side factors though demand side factors continue to play a role. Persistence of high retail inflation is a matter of serious concern because it has a destabilising impact on inflation expectations. While food inflation may come down in the immediate future, uncertainties regarding currency fluctuations and energy pricing remain and may aggravate price pressures.

Public Finance

While it is still early to dismiss the promises made in Budget 2013-14 outright, the portents to date are not encouraging. The Finance Minister, P Chidambaram remains confident that he will be able to abide by the line he has drawn in the sand as far as the GFD is concerned.

However, as per the latest numbers released by the Controller General of Accounts the fiscal deficit has already reached 75% of the Budget Estimates (BE) during the first five months of the year compared to 66% in April-August 2012 period.

The cumulative fiscal deficit reached 3.7% of GDP during April-August 2013 (vs. the budget estimate of 4.8% of GDP for full year FY14).

With growth likely to be significantly lower than the 6-6.5% projected in the Budget, it may be difficult to achieve the budgeted tax-GDP ratio of 10.9% even with the budgeted tax buoyancy of 1.4 % during 2013-14. Indeed gross tax revenue growth during the first quarter of 2013-14 was lower than a year ago due to deceleration/decline in major tax revenues. The other major items of government revenue such as disinvestment receipts of Rs 400 billion are likely to be just as problematic given the volatile conditions in financial markets.

Forecast

Forecasting economic growth during crisis or recession periods is becoming difficult due to unusual structural shifts in some of the key macroeconomic parameters. Wide variations between the actual and projected GDP growth rates have become the norm.

For the current fiscal all agencies started with optimistic growth numbers of around 6.5% in their preliminary assessments but have since revised their estimates steadily downward. NCAER is no exception! We expect growth to remain low in the current fiscal despite better performance in agriculture as the sector's share in total GDP is only about 14%.

Investment data released by the Centre for Monitoring Indian Economy (CMIE) for the quarter ended June 2013 is not encouraging. New investment announcements during Q1:2013-14 at Rs 784 billion were 32% lower than the quarterly average of Rs 1.1 trillion new proposals announced during 2012-13. New investment proposals in the manufacturing sector slipped 47% to Rs 544 billion over its year ago level. Commissioning of new projects fell to Rs 270 billion in Q1:2013-14, the lowest in the past 34 quarters. On a positive note, the quantum of stalled projects has improved 34% to Rs 940 billion during the June 2013 quarter compared to the year ago level.

Weakening private investment is also explained by the continuous decline in business confidence. The NCAER-MasterCard Business Expectations Survey reveals that business confidence index has been declining continuously since April 2012 mainly due to weak overall economic conditions and an unfavourable business environment. The June 2013 quarter, however, shows a marginal improvement in business sentiment though questions regarding sustainability remain.

Against this backdrop, we have re-assessed the economic outlook for the current fiscal year using two approaches: (1) quarterly GDP growth assessment based on a quarterly model that incorporates some of the inter-sectoral relationships and the evolving pattern of variables over time and (2) annual GDP growth assessment based on a more detailed annual macro-econometric model. The assumptions underlying the two approaches have been detailed in the Section on Forecast.

Based on our assumptions regarding exogenous variables, we have revised our quarterly GDP estimates from Q2:2013-14 onwards. The GDP growth rate at 2004-05 constant prices is estimated at 5.3% for 2013-14, a downward revision of 0.4 percentage points over our July 2013 estimate of 5.7%. GDP growth in all three quarters has been revised downwards compared to our previous estimate in July 2013. This is mainly due to contraction of output in industry and services sectors. While agricultural output is revised upwards from 3.3% in July to 4.1% in the current estimates on account of better rainfall, industrial growth is revised downward to 2.9% from earlier estimates of 4.5% in July 2013. Services sector growth rate is also revised downward from 6.8% in July 2013 to 6.6% in the current estimates.

It is important to note that the current quarterly model is unable to fully capture the impact of a few important factors such as investment, exchange rate, interest rate etc. on sectoral output. Hence, the trend slowdown or policy impact of these variables on output at the sectoral levels is difficult to quantify accurately.

The second approach based on a more detailed annual macro-economic model gives us overall GDP growth, in constant 2004–05 prices, at 5.2% in 2013-14 which is 0.7 percentage points lower than our earlier estimate of 5.9% in July 2013.

A substantial downward revision of growth is made in the case of the services sector followed by a marginal decline in the growth in industry. In case of agriculture, we estimate a higher growth rate of 3.9% compared to our earlier estimate of 3.2% in 2013-14.

In an alternative scenario, where we assume disinvestment revenue will fall short of our baseline target of Rs 40,000 crore and the exchange rate would depreciate more than that assumed in the baseline, overall GDP growth, in constant 2004-05 prices, is estimated at 4.8%. At the sectoral level, industry is expected to grow by 2.6% and services by 6% in 2013-14. Thus, the annual model gives a GDP growth range 4.8-5.2% for the current fiscal.