Overview

After significantly weakening in the third quarter of 2012-13, the Indian economy shows signs of recovery here and there. However, these signs are fragile. India needs to remove structural barriers to encourage sustainable economic growth and inflation.

The Context

There is a glimmer of hope after the economy came to a "standstill" in the third quarter of 2012-13, growing at 4.5 per cent. Things may have just turned for the better with agriculture performing better than expected. There is recovery of merchandise exports in the fourth quarter of 2012-13. Inflation as measured by wholesale price index has come down. Fiscal deficit is under control for now. Gross Fixed Capital Formation exhibited strong growth. Manufacturing has shown signs of positive growth. All together indicate some sort of recovery. Services, however, remains weak. The current account deficit is worrisome. Therefore, the government needs to lead the upturn by more purposeful actions, which will prompt recovery in business sentiments and therefore investment. Whether beleaguered by accusations of corruption, it is able to realize some structural change in the year before the elections, will be a drama that unfolds before our eyes. The timing, unfortunately, is not so good for the Indian economy and its people.

The latest available third quarter data of Gross Domestic Product at Factor Cost shows that India grew barely at 4.3 per cent. Growth rates in almost all sectors have worsened as compared to the second quarter except 'manufacturing' and 'electricity, gas & water supply' (EGW). Manufacturing barely grew at 2.5 per cent and EGW at 4.5 per cent in 2012-13:Q3. 'There is remarkable slowdown in the services sector, the workhorse of the Indian economy.

Global economic conditions are showing improvement. The International Monetary Fund World Economic Outlook April 2013 predicts a fragile and bumpy recovery in the advanced countries and a strong recovery for the emerging & developing countries. The short-term risks in the world regarding the United States(US) fiscal cliff and the break-up of the Euro Area have dissipated by purposeful actions of policymakers. Within the advanced countries, there is bifurcation in terms of the US and the Euro Area. The recovery in the US is going to gather strength over 2013 whereas the weakness in the Euro Area continues to linger a little more. The price of oil is predicted to stay weakened in 2013 and 2014.

While weakened commodity prices is good news for India, the fact that the consumer price inflation continues to remain in double digits and is diverging from the Wholesale primary index (WPI) is not encouraging. More than spatial differences in inflation (rural and urban inflation), food inflation is what plagues the whole country. There is double digit inflation in cereals despite record production of food grains indicating food management problems in India. Vegetables inflation has reared its ugly head again. Eggs, Meat and Fish inflation continues to linger in double digit category, albeit weakening.

Unfortunately, double digit retail inflation binds the Reserve Bank of India hands in lowering interest rates. Even though the government has reduced its fiscal deficit and weakening WPI inflation gave the RBI some space but its options are increasingly limited. At the same time India's external vulnerability has increased.

With the government reducing expenditure, services are affected. Fall in foreign tourists, fall in the manufacturing sector means fall in demand for freight both at ports and airports, changes in the communications sector all contribute to significant weakening of the services sector. However, last year saw portfolio investment flowing into the economy but FDI investment which is purported to be more stable has varied.

Clearly revival in investor sentiments is key to revival to economic growth as this will only spur investment - whether domestic or foreign. The economy is crying out for well-thought out structural changes like reforms in land acquisitions, goods and services tax, direct tax code etc. The government can ease regulations on doing business India. These are areas which can significantly spur economic growth.

In conclusion, the 2013-14 may yet prove to be better with predictions of a normal monsoon and recovery in the external economy. While growth rates may recover in the short-run, India needs to carry out structural reforms to make them more sustainable.

Agriculture

These trends in output of both food grains and commercial crops reveal that despite setbacks due to somewhat uneven monsoon, the performance of agricultural sector in 2012-13 is likely to be much better. Output of rice is likely to exhibit an increase of about 2.4 per cent over its level of output estimated earlier and wheat output is now estimated at 93.6 million tonnes, which is again close to the record output of 93.9 million tonnes harvested last year. The output of pulses show an increase of about 4 per cent over the previous year's output. Among non-food grain crops, output of oilseeds is 2.3 per cent higher than what was produced in 2011-12. The output of other two non-food grain crops, fibre crop cotton and sugarcane is expected to show significant decrease of 4 per cent and 6 per cent, respectively.

The prospects for 2012-13 for the agricultural sector in particular depend largely on monsoon rainfall, preliminary estimate for which has been released by the India Meteorological Department (IMD). The forecast suggests that south-west monsoon season rainfall for the country as a whole is most likely to be normal. A lot will, however, depend on the timely arrival and actual distribution of rainfall throughout the season, which will become clearer in June when the second stage forecast will be made. Though, if these early expectations turn out to be correct the agricultural sector should witness normal growth in 2013-14. Some reassurance to this affect is also provided by the level of water storage in the country's main reservoirs, which is close to last year's level and above last ten year's storage.

Industry and Services

Investment demand had slackened steeply in the first two quarters of 2012-13. However, in the third quarter (Q3) of 2012-13, the Gross Fixed Capital Formation (GFCF), has registered a growth of over 6 per cent. The growth of the major components of IIP clearly shows steep decline in all of its components between April-February 2011-12 and April-February 2012-13 with the mining sector performing the worst. Manufacturing sector growth rate was barely 1 per cent during April-February 2012-13. Month-wise the IIP data shows that on a year on year (yoy) basis, the growth touched just 2.2 per cent.

Among the use-based classification of the industries, two categories of goods show an upturn - consumer durables and intermediate goods. Using 2 digit classification, 13 out of the 22 industry groups in the manufacturing sector showed positive growth in February, 2013. The eight infrastructure industries (crude oil, petroleum refinery, coal, electricity, cement, steel, natural gas, and fertilisers) registered a growth of 2.6 per cent during April-February, 2012-13 as compared to 5.2 per cent in the coresponsing period of 2011-12

The growth performance of service indicators reveals a pessimistic outlook. The weak outlook for transport and communication sector and dwindling tourist arrival numbers in particularly during third and fourth quarter of 2012-13 may further worsen the outlook for 'trade, hotels, transport & communication' sector.

During Q3:2012-13 the yoy growth of total software services exports deteriorated to 2.1 percent compared to 15.3 percent increase in the second quarter of the same year. The Q3:2012-13 of growth non-software miscellaneous services also declined to 5.7 percent compared to rise of nearly 5 percent in the second quarter of 2012-13.

The April-February 2012-13 performance of FDI inflows into major segments except services (financial and non-financial) deteriorated compared to their cumulative historical patterns.

External Sector

The Macroeconomic and Monetary Policy Development released on May 2, 2013 shows that the current account deficit has reached 6.7 per cent of GDP in 2012-13:Q3. Further external debt to GDP has risen indicating rising external vulnerability. The drop in software exports has particularly hurt India.

There is revival of merchandise export growth in the fourth quarter of 2012-13. The Reserve Bank of India predicts that trade deficit is expected to narrow in the fourth quarter of 2012-13 with revival of exports and the fall in commodity prices (which may slow down growth in imports).

Money, Credit and Finance

The need for monetary policy easing was being made throughout 2012-13 given the stagnation in industrial output. The average IIP for the period April 2012-February 2013 was just 0.1 per cent higher than the average for the same period in 2011-12. The overall GDP growth in 2012-13 is estimated to be 5 per cent, one of the lowest in a decade. After a reduction by 50 basis points in April 2012 the policy rates remained unchanged till January 2013. Reduction in CRR by 50 basis points in January 2013 helped the commercial banks in reducing the lower end of base rates in February 2013 from 9.75 per cent to 9.5 per cent. The impact of modest easing of monetary policy was not adequate to stimulate economic activity. The monetary easing was induced by a decline inflation rate since January 2013. The WPI based inflation rate dropped from 7.5-8 per cent range during April 2012 to September 2012 to 6.5-7.5 per cent from December 2012 onwards. The food inflation rate has remained at a higher level and has been a concern for the monetary policy.

The sluggish pace of overall demand led to lower cost of funds for the government. The capital markets showed signs of improvement in the first three quarters of 2012-13 even as the growth impulses were muted. Some of the impetus to the rise in stock prices in the early part of the year may have been expectations of recovery in the advance economies. However, domestic clues to the recovery in BSE Sensex were few.

The monetary policy for 2013-14 announced on May 3, 2013 decreased repo rate under Liquidity Adjustment Facility (LAF) by 25 basis points from 7.5 per cent to 7.25 per cent. The previous reductions in the repo rate were in January 2013 and March 2013 again by 25 basis points, on each occasion. In the current calendar year itself, the policy rates have declined by 75 basis points. The decline, however, is not likely to lead to an immediate and significant reduction in the lending rates in the banking sector because reduction in deposit rates is unlikely. At 7.5 to 9 per cent rate of interest, deposits do not hold significant attraction to savers. Nevertheless, the drop in policy rates does lower the cost of funds to the banks and cost of a variety of other refinancing credit.

Along with the fiscal policy stance of the Union Budget for 2013-14, the monetary policy for the year provides for conditions where reforms that help accelerate investments may not lead to higher inflationary expectations.

Prices

The divergence between the WPI inflation and retail price indices is of concern. Retail prices indices whether rural or urban are rising marginally and are in double digits. This is mainly driven by the food inflation.

Globally commodity prices are weakening and this is also being passed through to India. However, LPG and High Speed Diesel prices are increasing because of the on-going adjustment process of those commodities to market prices.

Public Finance

The revised estimates for 2012-13 bring the gross fiscal deficit of the central government close to the budget estimates indicating the efforts of the government to hold back expenditure growth in the face of drop in revenues. Net tax revenues increased by only 17.4 per cent over 2011-12 as per the revised estimates for 2012-13 whereas the budget estimates were 22.4 per cent. The shortfall in non-tax revenue was even greater. The budget estimates for 2012-13 were 35.3 per cent increase over 2011-12 and the realisation was not even 10 per cent. The expected growth of the economy did not take place and revenue realisation was short of expectations. The government reined in expenditures so that fiscal deficit was Rs 520,000 crore as against the budget estimate of Rs 513,590 crore, an excess of less than 1.5 per cent for 2012-13. The so called exit from fiscal stimulus of the crisis period of 2009-10 was in full force during the year. The budget was closely watched by the credit rating agencies and the government succeeded in any further deteriorating in credit score into the post budget period.

Forecast

The current forecast is the second revision of real GDP growth rate for 2013-14 after the preliminary forecast presented in January 2013. We had projected real GDP growth at 6.2 per cent in January 2013 and it remains the same in April 2013. The current forecast incorporates the changes of key macroeconomic parameters during the past three months. The key assumptions on which the forecast is based are the following.

Rainfall: For the current fiscal year, we assume that rainfall during the monsoon season of June-September 2013 will be 'normal'.

World GDP growth: As per the April 2013 World Economic Outlook (WEO) of IMF, real world GDP growth is revised downward to 3.3 per cent from the earlier estimates of 3.5 per cent in January 2013.

International crude oil price:In April 2013 WEO, IMF revised its estimates on international crude oil prices upward by 2.3 percentage points from its earlier estimates in January 2013. We assume yoy 3 per cent increase of international crude oil prices compared to no change in January 2013.

Non-fuel commodity prices in the international markets:IMF's April 2013 WEO estimates also show upward revision in nonfuel prices. As we had already discounted this increase in January 2013 forecast, we retain our earlier assumption of yoy 5 per cent increase of nonfuel prices in 2013-14.

FDI net inflows and net invisibles receipts: We had assumed 10 per cent yoy increase of net invisibles in January 2013. We retain this assumption for the current round of estimates.In case of net FDI inflows, we assume yoy 15 increase in 2013-14 compared to our earlier assumption of 10 per cent.

Foreign institutional investment: We retain our earlier (January 2013) assumption of 15 per cent yoy change of net FII inflows in 2013-14.

Domestic energy price index (WPI for fuel, power, light and lubricants):As both international and domestic oil prices have been revised upward, we assume yoy 4 per cent increase of domestic fuel prices in the current fiscal as compared to our assumption of 1.5 per cent in April 2013.

BSE Sensex: We had assumed no yoy increase of average BSE Sensex in January 2013. In the current round of estimates, we assume 5 per cent yoy increase of BSE Sensex.

Interest and exchange rates: We assume slight moderation of interest rate in the current fiscal. We also retain our earlier assumption of LIBOR at 0.2 per cent and exchange rate depreciation of Rupee against US dollar at 1.5 per cent.

Central government finances: As per the Budget 2013-14, the government has proposed to generate disinvestment revenue of Rs 55,814 crore in current fiscal. The past trends show that the government always had difficulties in achieving the target. For the current estimates, we assume disinvestment revenue of Rs 40,000 crore compared to Rs 20,000 crore in January 2013. In case of subsidies, we assume the ratio of 2.03 per cent of GDP at current market prices as per the budget estimates which is higher than our earlier estimates of 1.85 per cent in January 2013. We also assume an improved public investment in agriculture and non-agriculture sectors in current estimates as compared to earlier estimates. As the Finance Minister did not tinker the tax collection rates in the Budget, we retain our earlier assumptions of yoy increase of direct and indirect tax collection rates at 2 and 1 per cent respectively.

Concluding remarks

India is going to recover from 2012-13. The strength and sustainability of the recovery will depend on the policies enacted and implemented and whether we are able to overhaul the structural barriers . Of course,a good monsoon and recovery in the external economy may encourage economic growth.