Overview

After falling to a decadal low of five per cent GDP growth in 2012–13, the outlook for 2013–14 can at best be described as cautiously hopeful that a slow recovery is in the works. The first quarter has not brought much cheer, other than on the inflation (WPI) front. While the risk in terms of over-shooting of the fiscal deficit has abated, that on the external front remains. The vulnerability of the economy to sudden stop and reversal of capital flows, subdued investment sentiment and tightening supply constraints, particularly in the food and infrastructure sectors, pose serious risks to recovery.

External environment

Global growth remains subdued with incipient signs of recovery in some advanced economies, especially the US and Japan, getting offset by slowing growth in key emerging market and developing economies (EMDEs), including China and India. The International Monetary Fund (IMF) in its World Economic Outlook has revised the global growth down to 3.1% in 2013 from 3.3% earlier.

While global commodity prices are expected to remain range-bound, financial markets are expected to show renewed volatility in the face of uncertainty about continuance of the extraordinary easy money policy by the US Federal Reserve. Statements by the US Fed Chairman, Ben Bernanke about a possible phasing out or tapering of the policy of monthly purchase of $ 85 billion worth of bonds, have added to the climate of uncertainty. The global bond sell-off witnessed in May and June resulted in most currencies depreciating against the US dollar, triggering further portfolio flows from countries like India.

Domestic scenario

On the domestic front, the portents are not too bright. According to the Reserve Bank of India (RBI) the slowdown has become pervasive with most sectors, including services, showing below-trend rate growth. Leading indicators do not suggest any improvement. On the contrary, the index of industrial production, after remaining stagnant in April actually contracted 1.6% in May 2013. Initial numbers for June do not look much brighter with core sector growth slowing to 0.1% in June 2013, down from 7.9% during the comparable month of the previous year and 2.3 % in May 2013.

The services sector, which has so far propped up overall growth also seems to be showing signs of flagging with growth in services slowing down to single digits in the last quarter of the last fiscal. For now agriculture seems to be the only bright spot, thanks to the abundant monsoon. With the country receiving 15% more rainfall than the long-term average, the hope is that the farm sector will shore up overall growth. The dwindling share of the farm sector (about 12%) will not quite make up for the lacklustre performance of manufacturing, mining and services, nonetheless it has important welfare implications since close to 60% of the population is still dependent on agriculture. A bumper crop can also help address some of the supply constraints that have bedeviled the sector and ease food inflation.

On the inflation front, moderation in global commodity prices and measures taken by the RBI had some impact on wholesale price inflation (WPI). WPI inflation fell to below five per cent in May 2013. Non-food manufactured product inflation declined sharply to its lowest level in the past three years. However, the falling trend was reversed in June 2013 with WPI inflation rising to 4.86%, up from 4.7% in May 2013. Food inflation, in particular, rose in May and June 2013, raising the spectre of a resurgence of inflationary pressures. These pressures could moderate somewhat if the monsoon remains on track during the rest of the season. Meanwhile, consumer price inflation remains stubbornly high and recent currency depreciation and upward revisions in fuel prices have increased upside risks to both wholesale and consumer price inflation.

The external sector is presently the Achilles heel of the economy. The current account deficit moderated during the fourth quarter of the last fiscal when the deficit fell to 3.8% of GDP, down from 6.5% in the third quarter (bringing the CAD for the year as whole to 4.8%). However, indications are that it might have widened once again in the first quarter of the current fiscal. The only silver lining is that gold imports, after recording a high of 142.5 tonnes in April and 162 tonnes in May have fallen sharply to 32 tonnes in June and 40 tonnes in July.

Policy action by the RBI which embarked on a series of liquidity-tightening measures in July and fresh strictures on import of gold, have brought some semblance of stability to the exchange rate. However, the relief may prove short-lived if as is feared the underlying problem of an unsustainably high current account deficit is not addressed.

Faced with the reality of a sustained and sharp fall in GDP growth the government has announced a number of reforms, mainly with a view to encouraging foreign direct investment (FDI) flows. Thus, FDI caps have been raised in various sectors, notably telecom, and FDI in a number of sectors has been brought under the automatic approval route. Many of the caveats attached to FDI in retail trade have also been relaxed. While none of these measures is likely to result in any immediate impact on FDI flows into the country, especially since the general elections are now less than a year away, the pre-reform signal is welcome. Whether it has come too late to make a difference to GDP growth this year remains to be seen.

Agriculture

Growth in the agriculture sector fell to 1.9% in 2012–13, down from 3.6% in 2011–12, with growth in Q4, 2012–13 falling to 1.4%. The output of rice and wheat stayed closed to their record levels achieved in 2011–12. However, the output of pulses in 2012–13 seems to have touched a new record at 18.5 million tonnes. The output of non-foodgrain crops such as oilseeds and cotton has also been close to their record levels at 32.5 million tonnes (in 2010–11) and 35.3 million bales (in 2011–12), respectively.

However, timely and bountiful rainfall during the south-west monsoon 2013 has raised the prospect of a good agricultural output.

The estimates from the Ministry of Agriculture reveal that area sown under all kharif crops taken together is up 25% this year compared to the area allocated in the corresponding period last year. The incidence of pests and disease has also remained below the Economic Threshold Level for most of the crops and storage of water in major reservoirs of the country is significantly higher than last year as well as the average for the last ten years.

All these developments augur well for the sector. Food inflation, which has stayed at relatively higher levels compared to general inflation, will also be kept in check.

Industry

The Index of Industrial Production (IIP) stagnated during 2012–13, registering a dismal 1.1% growth on a low base of 2.9% in the preceding year. During the first two months of the current fiscal, the IIP registered a marginal growth of 0.1% as against 0.6 % during the comparable period last fiscal. The slowdown was not confined to any one sector but was pervasive across wide range of sectors.

Manufacturing, which accounts for about 75% of the IIP, continues to be the biggest drag on industrial growth. After recording nine per cent growth in 2010–11, the growth of the manufacturing sector (IIP manufacturing) fell steeply to 1.3% in 2012–13 and declined further to a meagre 0.1% during April–May (Y-o-Y), 2013–14.

Growth in manufacturing was constrained by high inflation and rising cost of labour and raw materials, loss of pricing power, shortage of power, lack of credit as well as policy uncertainty.

As part of the government's National Manufacturing Policy (which aims to increase the share of manufacturing in GDP to 25% by 2022 up from the present 16%), the government announced a number of steps in July 2013 to energise the sector. These include developing a civilian aircraft, adding another 300 million tonnes of steel capacity by the middle of the next decade through special purpose vehicles of central PSUs with states and increasing textile exports by 30% this year.

The performance of the mining sector is discouraging (–4.5% growth in 2013–14), thanks to policy uncertainties and the issues of governance. Among the various sectoral indices, electricity is the only bright spot (5.2%) during April–May 2013–14, though here too growth is lower than in the corresponding period of the previous fiscal.

The contraction of the mining sector and capital goods continues to affect the overall performance of the industrial sector. Excluding capital goods and mining, the growth of the IIP during April–May 2013 was a minuscule 0.1%

Services

The y-o-y growth in the services sector, including construction, was marginally higher at 6.3% in Q4, 2012–13 compared to 6.2% during Q3, 2012–13.but excluding construction, dipped to 6.6 % compared to 6.7% in Q3, 2012–13. The 'construction' sector which accounts for 7.8% share in total GDP, grew faster at 4.4% during Q4, 2012–13 compared to 2.9% in Q3, 2012–13.

Overall, the improvement in growth in 'financing, insurance, real estate and business services' countered the marginal dip in growth in 'trade hotel & restaurant; and transport storage and communication' during the fourth quarter and helped shore up growth in services GDP in 2012–13.

However, the slowdown in the services sector with growth falling to 6.8 % in 2012–13, down from 7.9% in 2011–12, seems set to continue. Key indicators of the services sector performance during first quarter of current fiscal reveal a mixed trend.

While railway freight traffic grew faster at 4.9% during Q1:2013–14 as compared to 4.7% in the corresponding quarter of last fiscal, growth in most other sectors such ports, communications, banking, air traffic etc was distinctly slower.

Export demand for services has been a major driver of growth in the services sector. The services sector has grown in importance in India's invisibles receipts in the external sector. Invisible receipts as percent of GDP maintained their share in the range of 12–13.5% during all four quarters of 2012–13.

According to NASSCOM, increased global spending on IT technologies, and newer opportunities created through disruptive technologies are likely to ensure that revenue from IT exports remain in the region of US $ 84–87 billion during 2013–14, despite the overall slowdown in export growth..

Public Finance

It is too early in the year to decipher any clear trend in either revenue or expenditure. As per the latest numbers released by the Controller General of accounts, the Centre's fiscal deficit as at the end of May 2013 stood at 33.3% of the target for the year as against 27.6% in the comparable period of the previous year and worsened to 48% of the target for the year by the end of the first quarter.

The revenue deficit at the end of May 2013 is higher at 38.1% as against the comparable figure of 33.8% of the previous year. However, the primary deficit, which is the fiscal deficit less interest payments is not only well above the 50% number for the comparable period last year but has already touched 84.5% of the estimate for the year.

The Finance Minister has reiterated his commitment to the fiscal deficit for the year (4.8%). Though the first quarter has not ended on a fiscally bright note, it is possible that severe expenditure compression of the kind resorted to in the last fiscal might keep the final deficit for the current fiscal year under check. However the outlook for the coming years is not so sanguine. The outgo on account of the food security programme that seeks to provide subsidized grain to 67% of the population is bound to put severe pressure on the centre's finances in an environment of slowing tax revenues and inability to phase out subsidies on oil and fertilizers. An estimate by Ashok Gulati, Chairman Commission on Agriculture Costs and Prices (CACP) and Jyoti Gujral puts the cost of the scheme at roughly Rs 2,50,000 crore in the very first year of rollout. The deleterious impact of such a huge expenditure cannot be over-stated.

Money, Credit and Finance

After showing a mixed trend in 2012–13, liquidity conditions improved in the first quarter of 2013. However, the rapid weakening on the rupee, following the statements made by the Chairman of the US Federal Reserve regarding a possible tapering of its QE, compelled the RBI to come out with some strong measures to restore stability to the foreign exchange market on 15 July 2013. As part of this package, the Marginal standing Facility (MSF) rate was re-calibrated at 300 basis points above the policy repo rate under the Liquidity Adjustment Facility (LAF). Further, the overall allocation of funds under LAF was capped at 1.0 per cent of the Net Demand and Time Liabilities (NDTL) of the banking system, with the cap reckoned at Rs750 billion. The Reserve Bank also conducted open market sales of G-secs withdrawing liquidity to the tune of Rs 25 billion on July 18, 2013.

The net result was a tightening of liquidity in the system and a sharp rise in bond yields from 7.6% in May 2013 to well over eight per cent by mid–July 2013, especially after the RBI came out with further measures in late July.

The deterioration in asset quality in 2012–13 continued during Q1, 2013–14, with public sector banks showing a sharper deterioration compared to private sector banks. Tight liquidity and slower growth in deposits also saw a reduction in bank lending to industry. Year-on-year bank credit growth to industry at 15.7%in March 2013 was sharply lower than the comparable number of 20.3% in March 2012.

> Deceleration in credit growth to industry was observed in all the major sub-sectors, barring leather, chemicals, cement, wood products, food processing, textiles, glass and vehicles

Prices

The first quarter number indicate weakening trend of prices. However, retail inflation continues to remain in double digits or close to it. The outlook for prices remain uncertain as the rapid depreciation of the rupee has put pressure on import prices of oil and because of pass-through, howsoever incomplete has put upward pressure on domestic prices. However, the economic slowdown has weakened prices significantly. Depending on the strength of the economic force on each side, prices may go up or down. Given that this is an election, structural reforms which could clamp down structural inflation seems remote and thereby the inflation scenario may remain volatile.

External Sector

The picture on the external front is discouraging. Just three months after the IMF presented a fairly sanguine view of the global economy in its *World Economic Outlook* (April 2013), the July update of the Fund's *Outlook* is distinctly less upbeat. Growth forecast for 2013 has been lowered to 3.1% with the prospect of stagnation replacing the hoped-for acceleration. The growth forecast for 2014 has also been revised downward.

The global economy continues to face downside risks to growth. In line with slowing global growth exports of many EMDEs, viz., Brazil, Indonesia, Malaysia and Indonesia, have contracted in recent months. India has been no exception. Trends in exports and imports in Q1: 2013–14 suggest a widening of the merchandise trade deficit. The trade deficit widened from US$ 42.2 billion in Q1 of 2012–13 to US$ 50.2 billion in Q1 of 2013–14, mainly on account of a sharp increase in gold imports.

Reflecting global demand conditions, exports contracted in May and June 2013 after recording growth for five consecutive months (since December 2012). Despite a 5.7 per cent decline in international crude oil prices (Indian basket) in Q1, 2013–14 (y-o-y), POL imports grew by 6.4%. Overall, imports grew by six per cent in Q1, 2013–14 as against a decline of 5.7 per cent in Q1, 2012–13.

Continued reliance on debt flows to finance the burgeoning current account deficit resulted in a worsening of external debt indicators

The share of short-term debt, by residual maturity, a percentage of total external debt has increased to 44.2% as at the end of March 2013, up from 42.7% the previous fiscal even as the ratio of forex reserve cover to short-term debt has fallen.

Forecast

Overall, a strong recovery in the short-term looks unlikely. However, that perception may change if agriculture performs better

Current estimates of quarterly GDP for 2013–14 are the first revision of our preliminary estimates in April 2013. They are based on a number of assumptions relating to exogenous variables and updating high frequency exogenous variables till May/June 2013, such as normal monsoon, marginally better capital market performance, slight tightening of monetary policy, slower growth in bank credit to the commercial sector (BCC) – from 16.6% in 2012–13 to 15.8 % in 2013–14, 16.4% yoy growth of government expenditure and a WPI inflation at 6.1 per cent for 2013–14.

Based on these assumptions, we project GDP growth at 2004–05 constant prices at 5.7% for 2013–14, a downward revision of 0.5 percentage points over our preliminary estimate of 6.2% in April 2013. The slower overall growth is mainly due to downward revision of service sector growth from 7.5% earlier to 6.8% now. Industrial growth is also revised downward from 4.8 % to 4.5 % while agricultural growth is retained at 3.3%

The revised annual assessment for 2013–14 places overall GDP growth, in constant 2004–05 prices, at 5.9%, 0.3 percentage points lower than our earlier estimate of 6.2 per cent in April 2013 and lower than the 5.7% growth using the quarterly GDP growth approach. Service sector growth is revised downwards from 7.7 % in April 2013 to 7.1 %; there is a marginal downward revision of industrial sector's growth by 0.1 percentage point from 4.4 % in April while the estimate for agriculture growth is retained at 3.2%.

Concluding Remarks

The Indian economy is in deep trouble. On the contrary, a new dimension – external sector weakness - has been added to the trade-off between growth and inflation that has dogged policy makers for more than two years now. Indeed much of the deterioration in our macroeconomic fundamentals can be directly traced to high inflation of the past three years. This has lowered the competitiveness of our exports, put pressure on government finances and lowered savings and investments rates. Unfortunately, the only lasting solution to our economic ills – structural reforms to reduce the current account deficit and increase savings and investment – are noticeably absent.