State of the Indian Economy
Coherent strategy for revival

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Introduction

Over the past few years, the Indian economy has witnessed sluggish growth with relative moderation in all three sectors: agriculture, industry and services. The economy is in need of a fillip to pull itself out of this slump and be redirected to a path of continued and sustained growth.

A strong and stable government at the center does instil hope. In this regard, the first Budget of the newly formed government is of paramount importance, particularly as it signifies the path as well as long term vision of things to come. While the government has a number of issues to focus on, three key areas are of particular importance to the economy i.e. fiscal prudence, sectoral growth and containment of inflation.

Fiscal prudence has been an issue in recent years with successive finance ministers having it as their top priority item. While the previous government claimed to have achieved the fiscal deficit target, fiscal consolidation is still a distant goal. Subsidies are still a major expense for the government in addition to the concern that any rationalization plan has socio-economic implications. Further, external factors such as the ongoing crisis in the Middle East are expected to exacerbate volatility in global oil prices. This will put further pressure on government balances. The economic slowdown is also restricting the government's potential to generate revenue and hence, efficient and effective planning of government budget is very important.

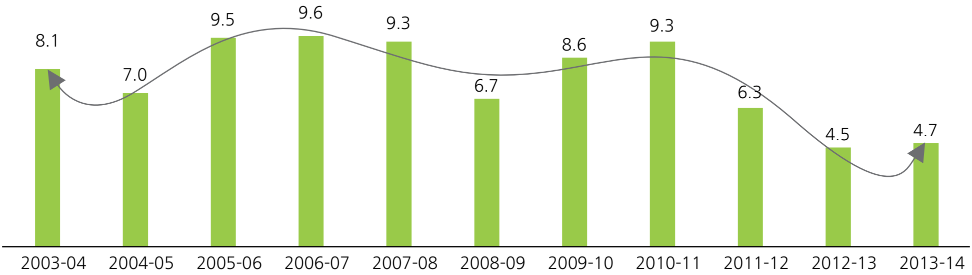
Another issue that the government needs to address, in cohesion with the central bank, is that of inflation containment. Inflationary pressures have almost become a defining feature of the Indian economy for the last few years. With food and fuel inflation still hovering above comfort levels, price pressures are affecting the common man and the entire industry supply side. Due to such chronic pressures, margins are getting squeezed and investment induced growth has virtually slowed down. Remedial steps in controlling inflation by tackling structural bottlenecks is the need of the hour.

Last but not least, is the revival of the economy. Immediate attention is required for the industrial sector which experienced its first ever contraction in the last three decades in FY 2013-14. The biggest vertical within industry is the manufacturing sector which has stagnated over the past 24 months. Incentives aimed at a manufacturing revival would be welcome. Further, fiscal policy should also focus on the faltering infrastructure industry. With potential of economic growth as well as employment generation, this segment should receive its due attention and be made attractive for investments.

With these impeding issues, the government does have a difficult task in its hands, a task they are expected to achieve. The Budget is an important means on achieving macro-economic goals. One may expect the Budget to bring with itself a sense of optimism combined with some required tough policy stances. However, it needs to be appreciated that economic problems will not be resolved immediately and it will take some time to plan and implement necessary steps and subsequently get desired results. What is important is to build a positive and robust base necessary for economic revival and long run sustainable development.

GDP growth in 2013-14 disappoint for second year in a row

Figure 1: GDP Growth Rates (%)



Data Source: MOSPI

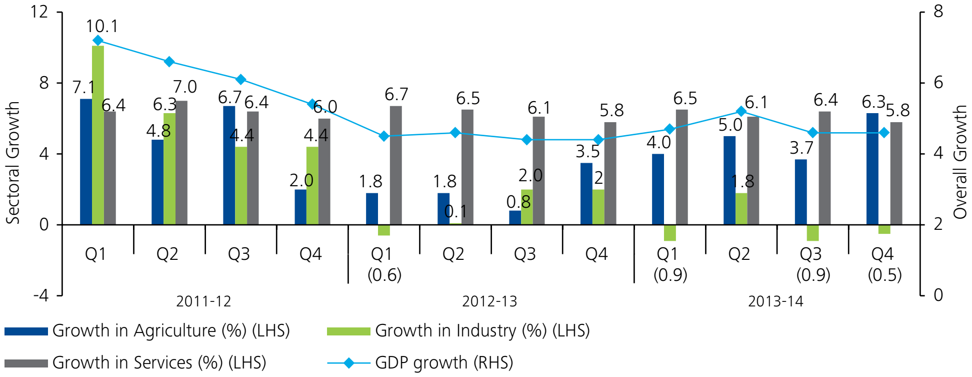
The Indian economy experienced a second successive year of weak performance with the Gross Domestic Product (GDP) growing at 4.7% in 2013-14 compared with 4.5% in 2012-13. The economy was marred by structural issues such as persistently high inflation, moderation in the overall fixed capital formation as well as low business confidence, leading to subdued domestic activity.

Moderation was primarily affected by a less than desirable service sector performance and significant contraction in the industrial sector. Though robust performance of the agricultural sector somewhat offset the sluggish performance of these two sectors, overall growth was still depressed. The industrial sector has experienced a rough year with the Index of Industrial Production (IIP) contracting by 0.1%, its first contraction in over three decades. One of the concerns is the annual IIP contraction in relation to capital goods which contracted by around 3% and consumer durable goods, which contracted by around 12.2%. This indicates a contraction in both domestic demand and investment. In addition, the manufacturing sector also contracted by 0.7%. Within the manufacturing sub-sectors, the automobile sector has been the worst hit with contraction in sales of cars, commercial vehicles as well as three wheelers. Along with the manufacturing industry, even the mining industry has struggled, with an annual contraction of 1.4%. Questionable allotment, scams and stalled projects have affected the sector which in the past has contributed significantly to overall GDP and employment. Overall, the eight core industries forming the backbone of the economy have also struggled recording a measly annual growth of 2.6%. Sectors such as coal, crude oil as well as natural gas have performed below expectation.. The only saving grace has been the performance of the electricity sector which has achieved a growth of 6.2% during 2013-14.

Although sluggish, the services sector has shown resilience in the face of tough global conditions, growing at 6.2% in 2013-14. External factors like moderation in global demand have affected exports of services, leading to a slow down. However, recent recovery in global growth accompanied by global output and demand has helped the services sector and it is expected to perform better in the coming quarters. Within the services industry, financing, insurance, real estate & business services segment has contributed the most with a growth of 12.9% in 2013-14. Due to supply side linkages, along with the infrastructure sector, construction activity has also struggled with a meagre growth of 1.6% in 2013-14. One of the key contributors for this has been the poor performance of the cement industry which has grown at just 3%.

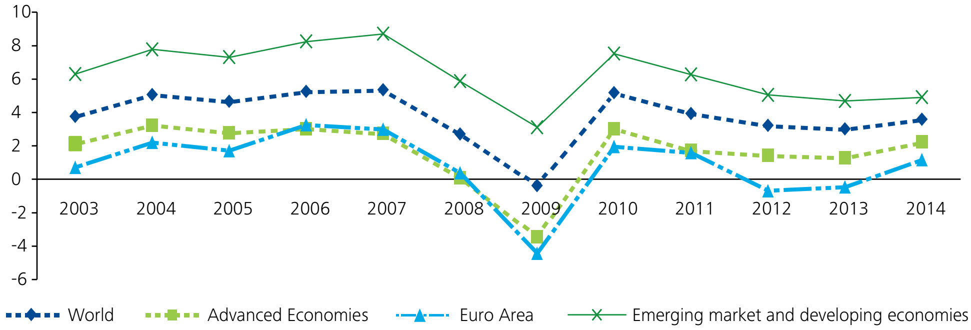
The expenditure side of GDP has also under performed. Government Expenditure (GE) which contributes 11.1% of the GDP grew by a meagre 3.8% in 2013-14 as compared to 6.8% in the previous year. The strict stance taken by the government on fiscal prudence has been reflected in the decline in GE. This indicates a reduction in economic activity in terms of expenditure on goods and services as well as market borrowing. Private Expenditure (PE), which contributes around 60% of the GDP, grew by 4.8% in 2013-14 as compared to 5% last year. PE depicts the overall consumer demand within the economy. This dip indicates the lack of domestic demand on the

Figure 2: Sectoral Quarterly GDP growth (%)



Data Source: MOSPI

Figure 3: Global GDP growth rates (%)



Data Source: IMF

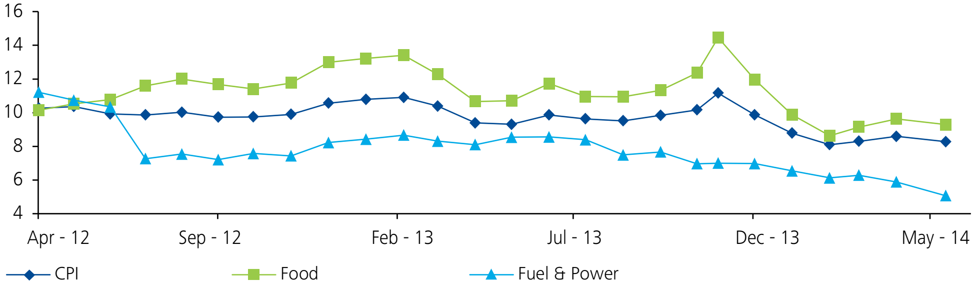
back of moderating income. Capital Formation (CF), which contributed around 32 percent, experienced a contraction of 0.1% as compared to growth of 0.8% last year which in itself was low. These are ominous signs for the economy as a contraction in this indicator not only signifies an adverse current performance but also low future investment expectations. Issues such as structural bottlenecks, pending infrastructural projects, inflation as well as lack of investor confidence have all led to contraction in investments.The global economy is expected to grow at a projected rate of 3.6% in 2014. However, there are several downside risks to this projection. Reduced economic activity is still persistent in the Euro Area (EU). Emerging Markets and Developing Economies (EMDEs), which are mainly driven by export led growth, have struggled due to less favorable external conditions. Another factor the global economy is facing is the resurgence of global market volatility, which brings into focus the basic fundamental institutions of the emerging markets.

However, aided by relaxation in fiscal tightening and accommodative monetary conditions, the global economy is expected to bounce back in the coming year. Growth in the US and part of EU as well as continued growth in emerging economies with improving external conditions, are expected to bring about a revival in the global GDP growth. This, in turn is likely to benefit the Indian economy, in particular the services industry and export led sectors such as gold, jewelry, etc.

With the industrial sector contracting for the first time in three decades, focus on reviving the manufacturing sector is of utmost importance

Inflation driven by supply side inefficiency poses a persistent threat to growth

Figure 4: Growth in Consumer Price Index (%)



Data Source: RBI

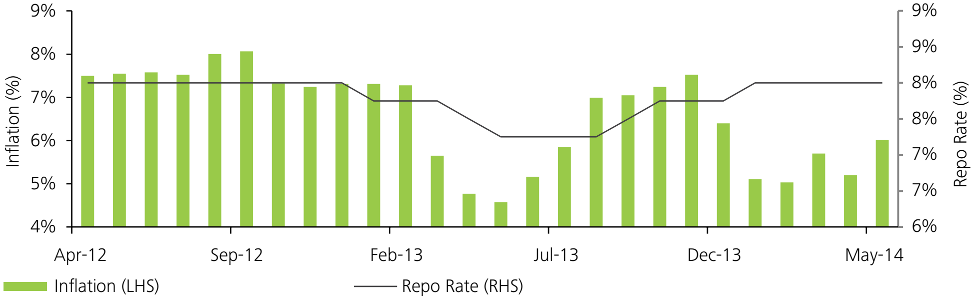
One consistent factor facing the Indian economy in recent years has been persistently high inflation. This has been a paralyzing factor for the economy and has received considerable attention from the Government and the Reserve Bank of India.

Although inflationary pressures have experienced a decline recently, the average of annual Consumer Price Index (CPI) in 2013-14 was 9.5%. This is higher than the comfort level, particularly in light of Reserves Bank of India's (RBI) target of containing the CPI to 6% by 2016. Policymakers have recently moved from focusing on the Wholesale Price Index (WPI) to a targeted CPI. This is in accordance with the recommendations of an expert committee, headed by Dr. Urjit Patel which was appointed to examine the current monetary policy framework of the RBI. One of the key factors for the upside pressure in inflation has been the food and fuel prices. Within the CPI, the food, beverages and tobacco group constitutes around 50% of the total weightage which has played an important role in determining the CPI. Recently food prices have moderated leading to food inflation declining from as high as 13.2% in January 2013 to 9.1 in March 2014. This is mainly because of a good harvest of kharif crop leading to price correction in vegetable prices. Along with this, moderation in sugar and edible oil prices has also contributed to moderation in food inflation. Consequently, inflationary pressures have recently been on a decline as CPI has moderated from as high as 10.9% in February 2013 to 8.3% in March 2014. However, this moderation is expected to slow down as vegetable prices appear to have run their course of seasonal correction. Similar to food, fuel inflation has also contributed significantly to the high inflationary pressure. Fuel inflation has experienced a degree of moderation from highs of 8.7% in February 2013 to 6.3% in March 2014. This has been due to a stabilization of global crude oil prices. However, recent events in the Middle-east have raised fears of an impending price rise.

Even with this decline, CPI excluding food and fuel has been sticky. A key contributor to this has been the housing, transportation, communication component and the services component which includes medical care, education and stationery. The rise in wages has played a contributory part in the rise of CPI in services.

The RBI has been responded to these situations by maintaining a high policy rate (repo rate), at current rate of 8%. A combination of a reflective monetary policy and strong economic fundamentals has assured contraction in inflationary pressures in recent months. Even with this positive development, upside pressures still continue to exist. Inflationary pressures in the coming months will hinge on factors such as movement in food and global fuel prices, output gap, deregulation of food and fuel subsidies as well as the strength of disinflationary impulses from policy actions.

Figure 5: Monetary policy Vis-a-vis Inflation levels

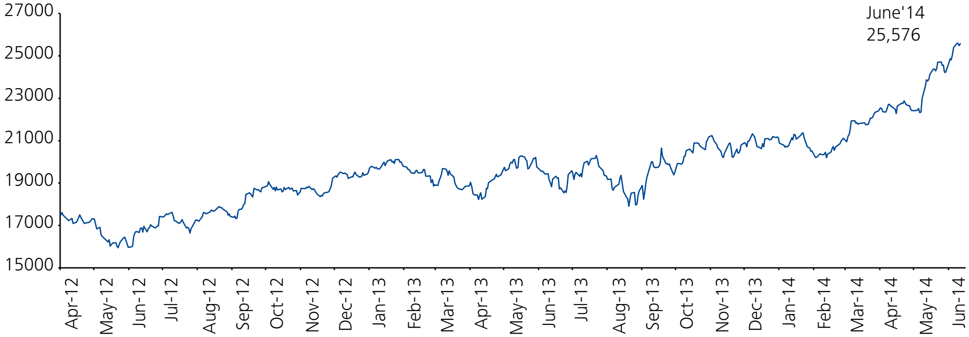


Data Source: RBI

Co-ordinated efforts between the Government and RBI are required to address the double conundrum of low GDP growth and high inflation

Capital Markets show a bullish performance in tough global scenario

Figure 6: Movement of SENSEX (Apr'12- Jun'14)



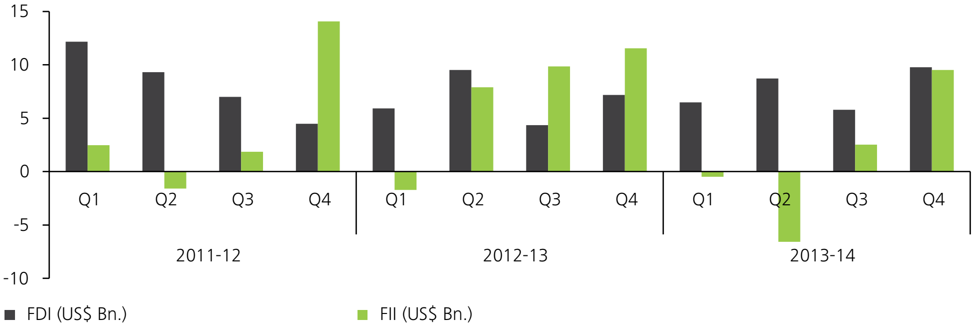
Data Source: BSE

Capital markets in India have been fairly positive during the last year, primarily in anticipation of the elections and optimism about consequent change in business sentiments and investment policies. In keeping with expectations, the government decided to further open up new sectors such as petroleum and natural gas, defense, telecom services, single brand retail, asset reconstruction as well as power exchanges. These policies have also further helped the already buoyant Foreign Institutional Investment (FII) inflows aiding in instilling confidence among global investors.

In terms foreign investment inflows, 2013-14 experienced a volatile movement with the second half of 2013-14 faring better than the first half of 2013-14. In terms of FIIs, first and second halves depict completely contrasting pictures. The first two quarters experienced a total outflow of US$ 7.1 billion as compared to a net inflow of US$ 12 billion in the second half. During the first half of the year, the decision by the US Federal Reserve to taper its asset buying programme resulted in a surge of capital outflow from emerging markets, including India, with capital virtually drying up from global market in September 2013. Consequently, the economy witnessed large FII outflows, especially in the debt segment as bond prices fell. With an already volatile currency, FII investors fled the Indian market. Post the tapering announcement till August 30, FIIs withdrew US$ 13 billion from domestic debt and equity markets. This also led to a fall in the Nifty and SENSEX indices.

The first half of 2013-14, where FIIs became net sellers, was depicted by volatility, depreciation of the currency as well as loss of investor confidence.

Figure 7: Foreign Investment Inflows



Data Source: RBI

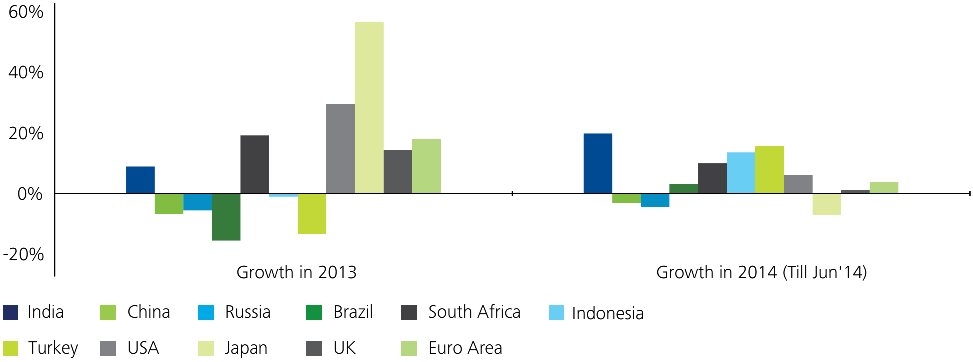
The markets, however, rallied back in the second half of the year. As investor confidence returned, FIIs became net buyers, especially in the debt and equity segment.

Compared to this, Foreign Direct Investment (FDI) inflows were quite consistent throughout the year. Total FDI inflows were to the tune of US$ 30.8 billion. The services industry still attracted the highest FDI inflows - US$ 13.2 billion contributing 9% of the total FDI inflows in 2013-14. The other sectors that attracted heavy FDI were computer hardware and software and hotel and tourism. A notable development this year is of Singapore emerging as the largest FDI investor in India with a share of 24.6%, overtaking the previous leader i.e., Mauritius at 20%. This development can be seen as a combination of two factors - an increased inflow from Singapore as well as more than proportionate decrease in inflow from Mauritius which can be attributed to pending issues of General Anti Avoidance Rules (GAAR) and retrospective amendments made with regards to investments done through Mauritius.

The Indian markets fared much better as compared to other developing economies due to a highly responsive monetary policy and strong fundamentals of the financial markets which instilled confidence in the global investors.

While announcements were being made by the US Fed on tapering of quantitative easing as well as when it was actually implemented, global capital markets experienced volatility as stocks prices plummeted on the back of heavy capital outflow. In contrast, the Indian capital market appeared stable.

Figure 8: Performance of global stock markets in 2013 & 2014



Data Source: Bloomberg

The investment activity through FIIs was also reflected in the SENSEX which showed resilience as compared to indices of other emerging economies. Gradual growth in investor confidence, with the added impetus of the general elections led to record highs of the SENSEX post January 2014 which continued its good performance till June 2014 reaching record highs of 25,576. In summary, after a mundane start to the year, investments have rallied back with credible growth in FIIs and importantly stable FDI inflows in various sectors across industry verticals.

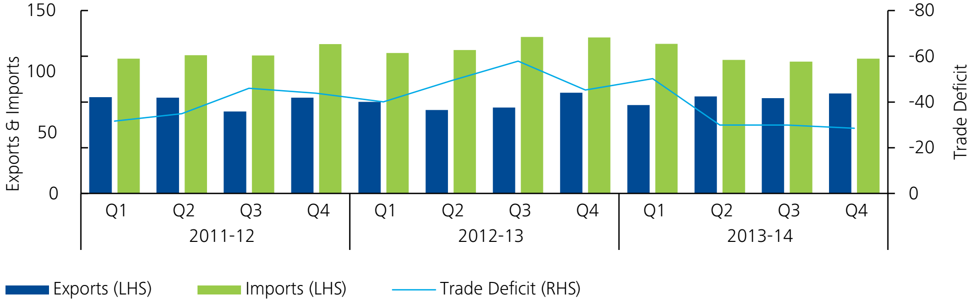
Investor confidence seems to be improving since the second half of 2013-14 as SENSEX has rallied to record levels and has stabilized around the 25,000 mark in June 2014

External sector can lead the charge towards economic revival

The external sector has been the saving grace in an otherwise sluggish year for the economy. Trade deficit, Current Account Deficit (CAD) and exchange rates have all shown signs of heading in the right direction. One of the highlights of the economic performance last year has been the significant decline in trade deficit. This has been a combination of both rise in exports and a substantial decline in imports. The cumulative growth of exports for 2013-14 has been around 4% and imports have contracted by 8.1%. This led to an overall contraction of the trade deficit in 2013-14 of more than 20% as compared to the previous year. This favorable trend has continued even in the current financial year with cumulative growth of exports in 2014-15 (April-May) of around 8.9% and contraction in import by around 13.2% with the overall trade deficit declining by around 42% in the first two months.

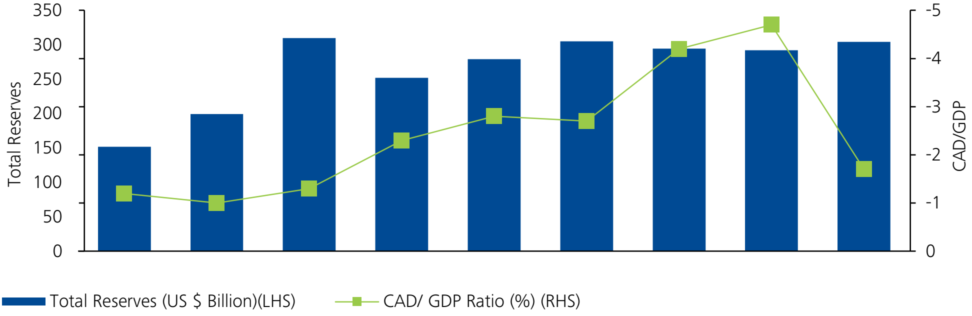
This performance has been on the back of supportive fiscal policies as well as strong fundamentals within the economy. The sustained decrease in import was mainly brought about by the sharp decline in gold imports since July 2013, when the government decided to step in and curtail gold imports by increasing the excise duty on gold imports. The overall Petroleum, Oil and Lubricant (POL) bill has also been contained mainly due to stable international crude oil prices as well as only a marginal rise in the quantum of oil imports. Exports however, did not experience a consistent rise and grew only between the June-October period accompanied by a depreciation of rupee. During the 3rd and 4th quarter, exports witnessed a decline mainly due to external factors such as decline in global gold prices as well as export demand in economies such as the EU, the Organization of the Petroleum Exporting Countries (OPEC) region, Singapore and Hong Kong.

Figure 9: Quarterly trade figure (US$ bln.)



Data Source: Ministry of Commerce

Figure 10: CAD and FOREX Reserves



Data Source: RBI

By contrast, service exports, which are a critical element of the Indian economy, have performed well by consistently outweighing import of services, leading to a trade surplus. Cumulative exports of services for 2013-14 grew by 7.8% whereas cumulative imports for services grew by 2.1% during the same period. This resulted in a rise in surplus of trade in services from US$ 62.9 billion in 2012-13 to US$ 72.4 billion in 2013-14, a growth of 15%. Further, with global growth and demand expected to improve in 2014-15, exports growth is expected to receive a further boost, reducing any potential trade deficit.

Further, despite significant depreciation during the last year, the rupee has shown signs of stability in recent months. During the US quantitative easing, the exchange rate experienced slight volatility, which however has stabilized in recent months.

Overall, favorable trade conditions have led to a significant drop in CAD. After posting record highs of 6.7% in CAD/GDP ratio in second quarter of 2013-14, the annual CAD/GDP ratio has been contained at 1.7%. This significant contraction in CAD has been brought about by the favorable terms of trade. The CAD was at an all-time high towards the end of the second half of 2013-114, with the second quarter recording a CAD/GDP ratio of 6.7%., CAD declined in successive quarters, with figures of 1.2% and 0.9% achieved in the 3rd and 4th quarter respectively.

The improved terms of trade, decline in CAD as well as the recent stabilization of the rupee has all led to increased foreign currency reserves. At US$ 304.2 billion, foreign currency reserves experienced a growth of around 4% during 2013-14. This is an important development for the economy as the

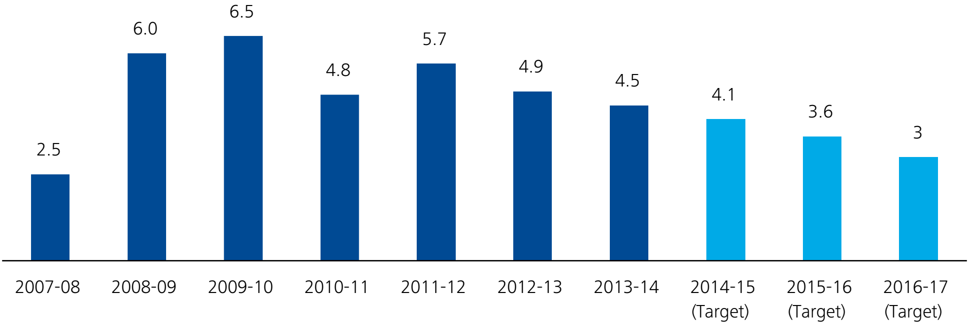
Improving conditions in India's external sector i.e. declining trade deficit and growing forex reserves can lead the revival of the Indian economy, provided appropriate measures are taken to address other challenges

rise in foreign currency holdings can help shield the economy from external shocks. Within the reserves, Foreign Currency Assets (FCA) dominates with a share of 91% in 2013-14. The FCA witnessed a growth of around 6%.

Fiscal condition signifies a credible improvement although future caution required

The government, in its effort to adhere to the fiscal road map, has done a credible job in containing the fiscal deficit to 4.5% of GDP, lower than its target of 4.8% set for the year. The contraction in fiscal deficit has been a combination of recovery in revenue towards the end of the year and substantial cutbacks in government expenditure. The fiscal scenario experienced a noticeable improvement in the second half of the year. The quarterly fiscal deficit/GDP decreased from the highs of 10.1% in the first quarter of 2013-14 to 3.8% in 3rd quarter and -0.3% in 4th quarter of 2013-14 respectively.

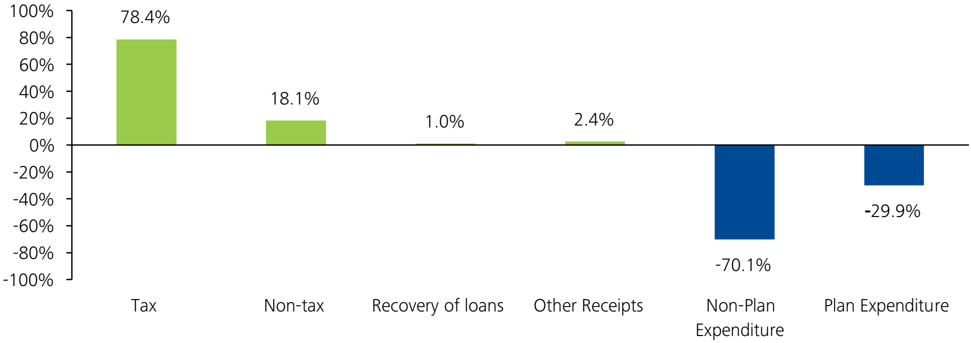
Figure 11: Fiscal Deficit (% of GDP)



Data Source: Planning Commision

Focusing on the income side, revenue receipts containing tax and non-tax revenue, contributed around 96% of total income. Tax collection formed the single largest source of income for the government. With a faltering manufacturing sector and an overall slump in the economy, tax collections were expected to suffer. However, the government experienced moderate tax collections for the better part of the year, with gross tax collections at 1,138,832 crore for 2013-14 representing a growth of 9.9% over the corresponding period of the previous year. In terms of non-tax revenues, the government has experienced a significant rise of around 45% in 2013-14 as compared to the previous year. Non-tax revenue has also had a healthy contribution to the overall revenue receipts. Both major heads of non-tax revenue, i.e. interest receipts and dividends and profits from public undertakings, which contribute around 57% of the total non-tax receipts, surpassed their budget estimates achieving 107% and 103% respectively.

Figure 12: Factors contributing to fiscal deficit



Data Source: CGA

On similar lines, the non- debt capital receipts, primarily disinvestments and loan recoveries have shown a greater than expected rise in income.

On the expenditure side, the government has attempted to curb expenditure by targeting subsidies and avoiding leakages. The expenditure side mainly comprises planned and non-planned expenditure. Both include revenue and capital account items of various government ministries. A majority of the proposed cuts have been through the planned expenditure route. In February, during the interim Budget, the government cut INR 79,790 crore from planned expenditure, primarily by reducing government expenditure on social sector schemes like Bharat Nirman, Rural Employment Guarantee Scheme and the National Rural Health Mission. Further, control on subsidies has also contributed to reduced expenditure. During the year, decisions such as slashing subsidies on phosphates and fertilizers have saved expenditure to the tune of INR 5,000 crore. It is important that such rationalization measures are continued in the long term.

Besides fiscal performance, an important area of focus is that of financing the fiscal deficit. Traditionally, more than 98% of the fiscal deficit has been financed through internal sources which has restricted its exposure to global market movements and have made it less vulnerable to external conditions. In contrast, close to 92% of domestic financing in 2013-14 has been through market borrowings. This in turn has led to a crowding out of private investors.

Even with this performance, there are still issues that need to be addressed. One of the key issues relates to disinvestments. The government had set a target of INR 40,000 crores in disinvestment receipts, however, disinvestment was achieved only to the tune of INR 1,607 crores. With the new government in place, disinvestment should be one of the main priorities for the exchequer.

While the fiscal condition is better than before, there is hardly any space for complacency. With a struggling economy and rising inflation, revenues are bound to be affected. A twin pronged effort of efficient fiscal expenditure and increase is revenue generation is required to sustain growth and lower deficits.

The government has done laudable work in containing the fiscal deficit. However, in order to contain it at the same levels, special focus should be on disinvestment receipts due to its revenue generating potential

Overall outlook and expectations from the Budget

With a sluggish GDP growth, high food and fuel prices and a slightly fragile exchequers' account, there are some steep expectations from the upcoming budget. To start with, the policies aimed at the revival of the manufacturing sector are expected to be implemented as soon as possible. It is expected that the government will try to resolve these bottleneck as well as facilitate investments into the industry sector through targeted policies. Another factor has been the amount of pending projects in the pipeline. This has greatly affected the productivity of the industrial sector. Speedy clearances of projects, especially in the infrastructure industry can help in the revival of industrial growth.

A related factor is that of containment of inflationary pressures. One of the issues affecting inflation is supply-side bottlenecks. Addressing supply-side bottlenecks and implementing a mechanism for a better farm to market flow of agricultural products is likely to curtail food inflation. Investments in developing infrastructural facilities such as storage, transportation etc. in line with global standards will help in reducing the cost of production and will eventually ease pressure on prices. This in turn will lead to decrease in wastage of perishable commodities.

While the fiscal condition is better than before, there are still certain issues that need to be addressed. The government needs to lay out a feasible disinvestment plan with achievable targets. This will go a long way in improving the exchequer's finances as well as promote investments within the economy. A certain degree of privatization may also help the productivity of the PSUs under consideration for disinvestment. Along with revenue generation, controlling expenditure leakage is also of equal importance. In this respect, rationalization of subsidies is an important task which should receive due priority. A reduction in subsidiary expenditure and effective implementation of the subsidy program will go a long way in decreasing government expenditure with little disruption to socio-economic considerations.

Similar to the fiscal scenario, containment of CAD is an important consideration. CAD has reached record lows over the past few months, however upside risks still persist. Volatility in global financial markets, hike in global oil prices due to geo-political issues can all affect the CAD. Hence, an increased focus on export based industries and promoting exports thorough friendly policies can help in future containment of CAD. Special attention must be placed on the services industries which is losing its global competitive edge in the face of newer competitors. Improving trade relations through newer but more effective Free Trade Agreements (FTA) will help the external sector perform better.

The recent slump in the economy had dented investor confidence. However, resilient performance of the Indian markets, recently concluded election as well as imrpoving economic fundamentals has revived confidence. To maintain this positivity is of key importance. A proactive fiscal policy, fillip to infrastructure and inflation containment are priority areas which will boost investor confidence and help revive growth.

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