

Indian Economy: A snapshot

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Summary

This report is an evaluation of India's macroeconomic management since 2010. It proceeds to examine the supply side of the economy followed by demand side contribution to GDP and thereafter examines various indicators that impact on the economic growth. India's growth is expected to recover from 4.4 per cent in 2013 to 5.2 percent in third and fourth quarter of 2014 and 4.9 percent for the whole year. This rate of domestic growth has to be supported by stronger global growth impulses, better export competitiveness and implementation of stalled investment projects. The effect of key macro factors on economy and policy dilemma shall be highlighted in this paper.

Key Words: Indian Economy, GDP, Inflation, CAD, Rupee depreciation

Sectoral contribution to growth

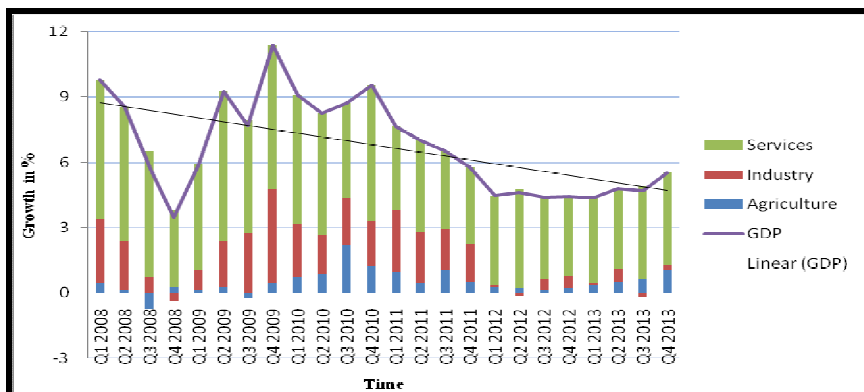
The growth in the Indian economy had been varying down from 9.6 per cent in Q4 of 2010-11 and stayed at 4.4 per cent for three quarters from Q3 of 2012-13 to Q1 of 2013-14 which pushed the expansion of the country to below the potential level. Since then, there are signs of growth bottoming out with insignificant improvement recorded during Q2 and Q3 of 2013-14 to 4.8 and 4.7 per cent respectively. However, this growth has been meagre and clear signs of revival are yet to come forward. The descending growth rate was primarily caused by structural factors that crippled investment activity and financial savings. Sluggish growth in fixed capital formation over successive quarters, high inflation and low business assurances contributed to the decline in prospective growth. In the last decade, growth has progressively come from the services sector, whose share to overall growth of the economy has been 65 per cent, while that of the industry and agriculture sectors has been 27 per cent and 8 per cent respectively.

Agriculture has improved its pursuance with the help of good monsoons and equally distributed rainfall. Water management has also improved in terms of storage for release during the rabi season with 85 major reservoirs in the country having 16.3 per cent more water compared to the previous year. The kharif food grains production is estimated at 129.3 million tones this year. Thus, sufficient preservation of soil moisture and reservoirs boosted the crop production during 2013-14. The Index of Industrial Production (IIP) showed no expansion during April-January 2013-14, compared with 1.0 per cent growth in the previous year.

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Figure 1 Sectoral contribution to growth



Source: Asian Development Outlook, 2014

This static growth over two years resulted in poor investment and consumption demand, which again had an effect on reduction in production of capital goods and consumer durables in the current year. Growth of core industries, which provide key inputs to the industrial sector dipped 2.4 per cent during 2013-14 compared to a growth of 6.9 in previous year. Output of basic metals, fabricated metal products, machinery and equipment, motor vehicles, food products, gems & jewellery and communication equipment also had a drop. The contraction in the mining sector during current year was largely because of decline in natural gas and crude petroleum output, regulations pertaining to the environment, allocation of rights to private capital and social issues like rehabilitation of displaced persons. Many industries including thermal power generation that depend on the output of the mining sector have had to import inputs from abroad, driving up costs and also contributing to import growth by increasing the current account deficit.

Industrial growth and manufacturing were volatile across all sectors in this period. The manufacturing sector’s poor performance has been driven by declining outputs of industries like machinery, metal products, radio, television, motor vehicles and communication. Many factors pulled the growth like consumer and investor pessimism about the prospects of the economy, sluggish growth of investment, poor margins of the corporate sector and decline in the rate of growth of credit flows and so on. The stable growth of service sector led experts to opine that the economy was on a service-led growth path, but long-term changes in the IT and ITES industries will be the deciding factor for the fate of the services sector. The current slowdown in this sector is due to decline in the performance of construction, trade, transport and communications activities. Thus, to achieve a higher growth rate, all the three major sectors of the economy have to perform well.

Demand side factors affecting growth

The demand side factors contributing to nation's growth is technically referred to as aggregate demand. It is related to the total expenditure flow in an economy in a given period and consists of Consumption demand by the households (C), Investment demand, i.e., demand for capital goods (I) by the business firms, Government expenditure (G) and Net income from abroad (X – M).

Table 1 Growth in GDP at Constant Market Prices (per cent)

Economic Variables	2005-06	2006-07	2007-08	2008-09	2009-10	2010-112R	2011-121R	2012-13AE
Total final consumption expenditure	8.7	7.7	9.4	7.7	8.4	8.1	8.1	4.1
Private final consumption expenditure	8.6	8.5	9.4	7.2	7.4	8.6	8.1	4.0
Government final consumption expenditure	8.9	3.8	9.6	10.4	13.9	5.9	8.6	4.1
Gross capital formation	16.2	13.4	18.1	-5.2	17.3	15.2	0.5	3.9
Gross fixed capital formation	16.2	13.8	16.2	3.5	7.7	14	4.4	2.5
Changes in stocks	26.7	31.6	31.3	-51.4	67.7	29.7	-30.6	47.6
Valuables	-1.6	13.7	2.9	26.9	57.6	32.4	6.6	-18.1
Exports	26.1	20.4	5.9	14.6	-4.7	19.7	15.3	5.1
Less imports	32.6	21.5	10.2	22.7	-2.1	15.8	21.5	5.7
Growth in GDP at 2004-05 market prices	9.3	9.3	9.8	3.9	8.5	10.5	6.3	3.3

Source: Economic Survey 2012-13, <http://indiabudget.nic.in/> last accessed at 2.00 pm, 07 July 2014.

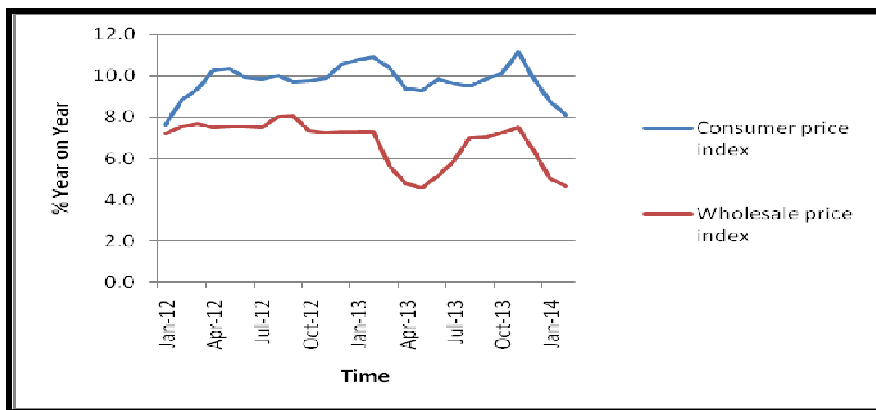
GDP measured at market prices dipped in 2012–13 as compared to 2011–12. During the same period, private consumption expenditure slowed down from 8.1 per cent to 4.0 per cent. Growth in government consumption, which sharply picked up till 2009-10, remained subdued for the rest of the year as fiscal pressures intensified. Government's consumption expenditure also slowed down from 8.6 per cent to 4.1 percent and the gross fixed capital formation continued to decelerate from 4.4 to 2.5 per cent. The rate of growth of consumption expenditure and particularly that of private final consumption expenditure has generally been more stable than investment, except in 2012-13. Increasing fuel prices, instable currency, food inflation and weak employment prospects affected the confidence of consumer. Investment compacted due to structural and procedural delays, monetary tightening and challenge of repayment in foreign currency due to weak domestic currency added fuel. According to the RBI (2013), as on May 1, 2013, nearly half of 566 central sector projects (worth Rs. 1.5 billion and above) got delayed, leading to cost overruns of 18 per cent or higher. Many reasons like bottlenecks in project approvals and implementations, problems with land acquisition, environmental

regulations, legal issues pertaining to contracts and political problems of people resisting large projects, could be cited.

Consumer and Wholesale inflation

Any macroeconomic performance is generally evaluated by growth, inflation and external balance. If economic growth is one of the crucial indicators of a country's performance, then inflation must be a close second. Due to decline in vegetable prices, inflation in terms of the all India Consumer Price Index (CPI)-Combined (Rural + Urban) declined to 9.87 per cent in December 2013 from a high of 11.16 per cent in November 2013. Excluding food and fuel components, CPI stood at 8.0 per cent in December 2013 with contributions from housing, transport & communications and miscellaneous group including services. Wholesale Price index (WPI) had steadily increased during July-November 2013 from a low of 4.6 per cent in May 2013. Input costs were high due to low agricultural productivity, absence of competition in distributional channels and wastages due to shortage of storage facilities. Supply side factors like prices of vegetable, fuel, diesel and electricity also contributed heavily to inflation.

Figure 2 Inflation



Source: Asian Development Outlook, 2014

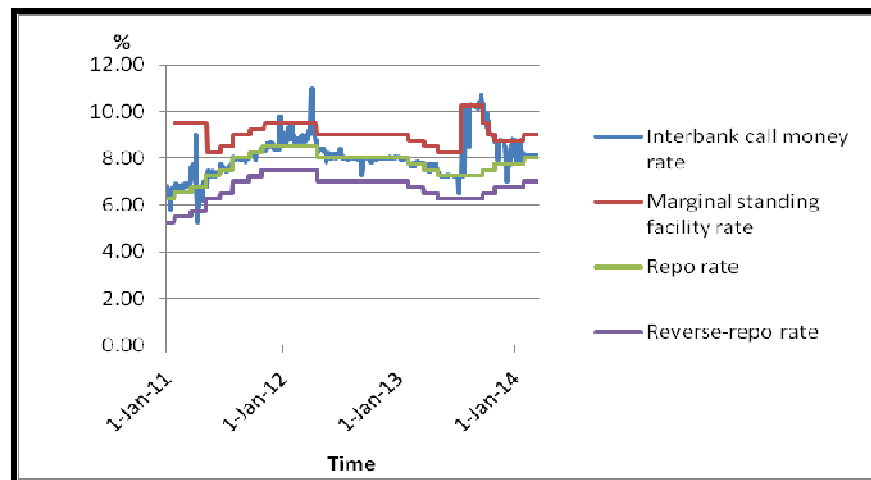
The depreciation of the rupee along with the increase in international crude oil prices has led to a rise in domestic fuel prices. In the first half of September 2013, the price of the Indian basket of crude oil had increased to Rs. 7,263 per barrel, up by 35 per cent compared with the same basket in the second half of April 2013. Domestic consumption of petroleum products has been falling since October 2012. It remained unclear if this decline was due to the response to a higher cost of fuels or the result of the slowdown in economic activities or due to rationalization of domestic oil prices. Nominal rural wage growth showed a declining trend for over two years, but the rate of increase at 15.5 per cent in October 2013 continued to put pressure on overall inflation. Increasing CPI-rural labour (RL) inflation superseded gains from rising nominal wages leading to decline in

real rural wage growth. Even if the current season's agricultural production improves, the relief from inflation may be temporary.

Monetary Management

The monetary policy of Reserve Bank of India (RBI) has remained focused on twin objectives of taming inflation and facilitating growth. RBI in its third quarter review of monetary policy on January 28, 2014, hiked the repo rate by 25 bps to 8 per cent on account of upside risks to inflation. Due to mounting inflationary pressures during January 2010 to October 2011, RBI adopted tight monetary policy and raised policy rates (repo rates) by 375 basis points, from 4.75 per cent to 8.5 per cent. There was a moderation in inflation from its peak of 10.9 per cent in April 2010, to an average of 7.6 per cent during April- December 2012.

Figure 3 RBI Policy interest rates



Source: RBI official website, accessed on 20 July 2014

RBI released the first bi-monthly review of the Monetary Policy for 2014-15 on 01st May, 2014. The highlights of the policy review are: The key Repo Rate (RR) rate under the Liquidity Adjustment Facility (LAF) was kept unchanged 8.00%. As a result, the Reverse Repo Rate (RRR) and the Marginal Standing Facility (MSF) rate stand unchanged at 7.00% and 9.00% respectively. The bank rate, MSF rate, Cash Reserve Ratio and Statutory Liquidity Ratio (SLR) remained unchanged at 9.00%, 9.00%, 4% and 23% respectively.

CAD, external debt and currency depreciation

The worsening of Current Account Deficit (CAD), external debt and rupee value has alarmed the policy makers in past couple of years. The Indian economy's CAD has increased to 4.8 per cent of GDP in 2012-13. This was considered very high by most analysts and they termed it at an unsustainable level. Exports are contracting because of

stagnating world demand and imports have been increasing despite a slowdown of domestic economic activities. The decline in exports was notable in engineering goods, electronics, gems and jewellery and iron ore. Imports, on the other hand, grew by 6.0 per cent in the first quarter of 2013–14, with gold leading the way. Imports had actually contracted in the first quarter of the previous year (2012–13) by 5.7 percent. Petroleum, oil and lubricants (POL) imports grew by 6.4 per cent despite a decrease of 5.7 per cent in international crude oil prices (Indian basket). According to the RBI, the trade deficit has widened in the first quarter of 2013–14 to US\$50.2 billion from US\$42.2 billion in the first quarter of 2012–13. The Government of India has also taken some specific steps to curb and discourage the import of gold. Apart from inflation-indexed bonds, import duty on gold was raised to 8 per cent and banks have been instructed to ensure 20 per cent of the gold imported is kept in customs warehouses and fresh imports are allowed only after 75 per cent of the retained amount has been exported. It may be noted that gold is imported for re-exporting under gems and jewellery after value addition in India.

To finance a high CAD, adequate and reasonably stable long-run capital flows are the best option. However, Foreign Direct Investment (FDI) and foreign portfolio investments made by Foreign Institutional Investors (FII) have been inadequate and the latter has been volatile in nature. Increase in the flow of FDI is the most stable option, though as is well known, the impact of greater doses of FDI on the domestic economy is not quite clear. It may have very different kinds of effects in different sectors of the economy. FII flows are volatile and current global events like the FED announcement about the future direction of monetary policy in the USA have made this kind of inflow even more unreliable.

Table 2 India's Merchandise Trade

Item	(US\$ billion)							
	April-March				April-December			
	2011-12		2012-13		2012-13		2013-14	
1	2	3	4	5	6	7	8	9
Exports	306.0	21.8	300.4	-1.8	217.4	-4.0	230.3	5.9
Of which: Oil	56.0	35.1	60.9	8.6	44.8	5.7	45.4	1.5
Non-oil	249.9	19.2	239.5	-4.2	172.7	-6.3	184.9	7.1
Gold	6.7	10.8	6.5	-3.2	4.7	-6.0	4.4	-5.4
Non-Oil Non-Gold	243.2	19.5	233.0	-4.2	168.0	-6.3	180.5	7.4
Imports	489.3	32.3	490.7	0.3	364.2	0.1	340.4	-6.6
Of which: Oil	155.0	46.2	164.0	5.9	121.8	9.8	125.0	2.6
Non-oil	334.4	26.7	326.7	-2.3	242.4	-4.1	215.4	-11.1
Gold	56.3	39.1	53.7	-4.7	38.0	-9.0	23.7	-37.6
Non-Oil Non-Gold	278.0	24.5	273.0	-1.8	204.4	-3.2	191.7	-6.2
Trade Balance	-183.4		-190.3		-146.8		-110.0	
Of which: Oil	-98.9		-103.2		-77.1		-79.5	
Non-oil	-84.4		-87.2		-69.7		-30.5	
Non-Oil Non-Gold	-34.8		-40.0		-36.4		-11.2	

Note: Negative value indicates deficit.

Source: DGCI&S.

Table 3 India's Balance of Payment

1	(US \$ billion)						
	2012-13	2012-13				2013-14	
	(PR)	Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (P)	Q2 (P)
2	3	4	5	6	7	8	
1. Goods Exports	306.6	75.0	72.6	74.2	84.8	73.9	81.2
2. Goods Imports	502.2	118.9	120.4	132.6	130.4	124.4	114.5
3. Trade Balance (1-2)	-195.7	-43.8	-47.8	-58.4	-45.6	-50.5	-33.3
4. Services Exports	145.7	35.8	35.0	37.1	37.8	36.5	36.7
5. Services Imports	80.8	20.8	18.7	20.4	20.9	19.7	18.3
6. Net Services (4-5)	64.9	15.0	16.3	16.6	17.0	16.9	18.4
7. Goods & Services Balances (3+6)	-130.7	-28.9	-31.5	-41.7	-28.7	-33.6	-14.9
8. Primary Income (Net)	-21.5	-4.9	-5.6	-5.8	-5.2	-4.8	-6.3
9. Secondary Income (Net)	64.4	16.9	16.1	15.7	15.8	16.7	16.1
10. Net Income (8+9)	42.9	11.9	10.5	9.9	10.6	11.8	9.8
11. Current Account Balance (7+10)	-87.8	-16.9	-21.0	-31.9	-18.1	-21.8	-5.2
12. Capital Account Balance	-0.3	-0.2	-0.2	0.0	0.2	0.8	-0.1
13. Financial Account Balance	85.4	16.1	21.0	30.8	17.6	20.1	5.0
of which: Change in Reserves	-3.8	-0.5	0.2	-0.8	-2.7	0.3	10.4
14. Errors & Omissions (11+12+13)	2.7	1.1	0.2	1.1	0.3	0.9	0.2
<i>Memo: As a ratio to GDP</i>							
15. Trade Balance	-10.6	-10.2	-11.4	-12.0	-9.0	-11.3	-7.9
16. Net Services	3.5	3.5	3.9	3.4	3.3	3.8	4.4
17. Net Income	2.3	2.8	2.5	2.0	2.1	2.6	2.3
18. Current Account Balance	-4.8	-4.0	-5.0	-6.5	-3.6	-4.9	-1.2
19. Capital and Financial Account, Net (Excl. changes in reserves)	4.8	3.8	4.9	6.5	4.0	4.6	-1.3

Note: Total of sub-components may not tally with aggregate due to rounding off.
P: Preliminary. PR: Partially Revised.

Source: RBI website accessed on 30 July 2014

Table 4 India's financial account

1	(US\$ billion)						
	2012-13	2012-13				2013-14	
	(PR)	Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (P)	Q2 (P)
2	3	4	5	6	7	8	
1. Direct Investment (net)	19.8	3.8	8.2	2.1	5.7	6.5	6.9
1.a Direct Investment to India	26.9	5.9	9.5	4.3	7.2	6.5	7.5
1.b Direct Investment by India	-7.1	-2.1	-1.4	-2.2	-1.4	0.0	-0.6
2. Portfolio Investment	26.7	-2.0	7.6	9.8	11.3	-0.2	-6.6
2.a Portfolio Investment in India	27.6	-1.7	7.9	9.8	11.5	-0.5	-6.6
2.b Portfolio Investment by India	-0.9	-0.3	-0.3	-0.1	-0.2	0.2	0.0
3. Financial Derivatives & Employee Stock Options	-2.3	-0.6	-0.5	-0.4	-0.9	-0.5	-1.6
4. Other Investment	45.2	15.4	5.6	20.0	4.2	14.0	-4.0
4.a Other equity (ADRs/GDRs)	0.2	0.1	0.1	0.0	0.0	0.0	0.0
4.b Currency and deposits	15.3	6.4	3.5	2.6	2.8	5.6	8.4
Deposit-taking corporations, except the central bank: (NRI Deposits)	14.8	6.6	2.8	2.7	2.8	5.5	8.3
4.c Loans*	10.7	3.5	3.0	5.7	-1.6	5.9	-5.3
4.c.i Loans to India	11.1	3.5	3.3	5.9	-1.6	5.4	-5.5
Deposit-taking corporations, except the central bank	1.3	3.0	2.0	2.6	-6.3	4.7	-6.7
General government (External Assistance)	1.3	0.1	0.1	0.4	0.6	0.3	-0.1
Other sectors (ECBs)	8.6	0.4	1.2	2.9	4.1	0.4	1.3
4.c.ii Loans by India	-0.4	0.1	-0.3	-0.2	0.0	0.4	0.2
General government (External Assistance)	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other sectors (ECBs)	-0.1	0.1	-0.3	-0.1	0.1	0.5	0.2
4.d Trade credit and advances	21.7	5.4	4.1	7.7	4.5	2.5	-1.9
4.e Other accounts receivable/payable - other	-2.7	-0.1	-5.1	4.0	-1.5	0.2	-5.3
5. Reserve assets	-3.8	-0.5	0.2	-0.8	-2.7	0.3	10.4
Financial Account (1+2+3+4+5)	85.4	16.1	21.0	30.8	17.6	20.1	5.0

P: Preliminary. PR: Partially Revised.

*: Includes external assistance, ECBs, non-NRI banking capital and short term trade credit.

Note: Total of sub-components may not tally with aggregate due to rounding off.

Source: RBI website accessed on 30 July 2014

Table 4 shows the relative importance of FDI, FII and other investments in the financial account of the balance of payments. Other investments, which are an aggregate of different short- and long-term flows such as loans, trade credit and advances and NRI deposits have been important in terms of the relative importance vis-à-vis FDI and FII. FDI flows might increase if the various measures announced by the Government of India to facilitate and augment such flows turn out to be successful. If that occurs it would benefit the economy's external balance by improving the quality of capital flows that are used to finance the CAD. There has been a net outflow of FII to the tune of US\$12.1 billion till July 2013 due to FED announcement about its future policy.

The increasing CAD financed by higher debt flows has increased India's external debt to a considerable extent during 2012–13. The stock of external debt stood at US\$390 billion on March 31, 2013. The major components of this increase are increases in external commercial borrowings (ECBs) and rupee denominated short-term non-resident deposits. The rise in external debt and the continuous deceleration in GDP growth have increased the vulnerability of the economy at the end of 2012–13 as compared with the previous year. There has been an increase in the ratio of total debt to GDP over the year 2012–13 from 19.7 percent of GDP to 21.2 per cent. The ratio of short-term debt to total debt has increased from 22.6 per cent to 24.8 per cent. The debt service ratio stood at 5.9 per cent, down from 6 per cent in the previous year, but substantially higher from the 4.4 per cent at the end of 2010–11.

The problem of a high and rising CAD along with volatile, unpredictable capital flows has not only worsened the external debt position of the economy, but also exerted pressure on the currency. This has been due to events like changes in the FED's policy stance and early signs of recovery in the USA. The FED chairman's announcement of a proposed exit from quantitative easing came on May 22, 2013. The rupee touched a historic low of Rs. 68.80 against the US dollar on August 28, 2013. It stands at Rs. 60.85 on August 1, 2014. The depreciation of a nation's currency makes headline news and is treated as indicative of a weak economy and ineffective government and central bank. The immediate inflationary effect of higher domestic cost of imports transforms the discomfort in to fear. This opens debate amongst economists and policymakers as to the need to intervene and set the economy back on wheels or to allow the market to correct itself through the forces of demand and supply. In short run, imports could be discouraged, exports could be encouraged and capital inflows incentivized. In market determined exchange rates, the RBI may decide to intervene in foreign exchange markets to stem the depreciation of the rupee which depends on its assessment of the adequacy of existing reserves and the extent of short-term debt repayment obligations. In this context, heavy FII inflows can also boost up the value of the Rupee if market conditions are favourable.

Conclusion

One of India's most pressing policy challenges is to create significantly more productive and well-paying jobs which are inclusive as well. Such jobs are vital to sustain high growth. As the proportion of the workforce that depends on agriculture declines and given that 12 million people enter the workforce each year, manufacturing will have to play a key role in generating productive and well-paying jobs. In many ways, manufacturing is well placed to play this role. First, India's factor endowments provide an abundance of semiskilled labor, which is essential for a comparative advantage in labor-intensive manufacturing. Second, India has developed the capabilities required for a diversified and dynamic manufacturing industry in terms of the range of manufactured products produced and of India's manufactured export basket, which includes relatively sophisticated chemical and pharmaceutical products, as well as auto components. Moreover, India's information technology and engineering services have increasingly been deployed by multinational corporations for designing industrial products for global markets, including sophisticated memory chips used in a range of electronic devices. Unfortunately, manufacturers in India do not perform close to their tremendous potential. For many years now, the sector has contributed around 15% of GDP and 12% of employment. By comparison, manufacturing in the People's Republic of China, Malaysia, Thailand, and Vietnam accounts for close to 25% or more of GDP.

The World Bank's Doing Business 2014 study on regulations ranks India 134th of 189 countries for ease of doing business. Particularly problematic are regulations on starting a business, obtaining permits and closing unprofitable units. To this, the recent National Manufacturing Policy proposes rationalizing and simplifying business regulations including the use of single-window clearance mechanisms; an exit policy that aims to balance firms' need to adjust employment in response to market conditions with labour's need for income security; financial and institutional mechanisms to develop technology, especially for small and medium-sized enterprises; large-scale infrastructure development; and clustering manufacturers in new national investment and manufacturing zones.

The second set of issues relates to the paucity of land that can be used for productive industry by displacing people and reducing agricultural activities. The third problem, fundamentally an economic one, relates to the pricing mechanism by which a public good can be privately apportioned as in the case of telecommunication spectrum pricing. These problems are not only vexing but have long-term economic implications and serious political consequences too. Solutions can only be found through a prolonged democratic debate about arriving at a consensus that is perceived to be fair and equitable. These problems have led to a major logjam in the clearances and approvals for infrastructure projects. As of June 2013, about 50 per cent of Central sector projects of Rs. 1.5 billion and above were delayed with estimated cost overruns of up to 20 per cent. These delayed projects were in roads, power, petroleum and railways. The leverage of the firms operating in this sector has increased with borrowing going up because of the delays. A

Project Monitoring Group has also been set by the Prime Minister's Office to monitor pending mega projects and get them started. Concerted efforts in the short and intermediate time frames would be essential to bring about a turnaround in investment demand. Infrastructure bottlenecks affect other industries too and this has been a factor contributing to the slowdown in manufacturing as a whole, ultimately affecting business firms' profitability and sales.

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