# Summary

## Review of the Economy 2011/12

1. The rate of growth in 2011-12 is estimated at 7.1%, which is marginally higher than the projection of 6.9% as per the Advance Estimates (AE). The council projects a slightly higher growth for agriculture and construction than the Advance Estimates.

2. Gross fixed capital formation (GFCF) as a proportion of GDP had reached a peak of 32.9 per cent in 2007/08, the year preceding the global crisis. It dropped to 32.3 per cent in 2008/09 and then to 31.6 per cent in 2009/10. Initial estimates are that in 2010/11 this ratio slipped further to 30.4 per cent. The AE for 2011/12 suggest that there may have been further slippage to 29.3 per cent. That is a decline of almost 4 percentage points over the last four years.

3. International conditions continued to worsen through 2011. The negative developments in the Eurozone outweighed the small improvements in evidence in the US economy. It is possible that the US economy will grow by more than the 1.8 per cent projected by the International Monetary Fund (IMF) in September 2011 and reiterated in January 2012.

4. Large scale liquidity injection by the European Central Bank (ECB) since December 2011 has lowered yields on the government bonds of those countries under the magnifying glass. Though there is yet no resolution in sight and affected countries have large volumes of debt due for roll over, there is some improvement in the situation, insofar as the potential for shocks are concerned. Germany seems to be willing to provide extended support, partly as a result of which the European Central Bank (ECB) has provided large amount of finance through their banking system (€ 489 billion), which may go up further (to € 1 trillion). The Eurozone members appear to have signed up for a coordinated move towards a fiscal union – which is necessarily a precondition for a monetary union with a membership of heterogenous economic strength to survive.

### Sectoral Developments

5. Farm sector output growth in 2011/12 has been strong, coming on top of the strong growth in the previous year. The average GDP growth rate that has been reported for the farm sector in the first half of 2011/12 is 3.7 per cent. The

Council expects that in combination with the strong trend growth in horticulture and in the animal husbandry sectors, the overall farm sector GDP growth for 2011/12 will average 3 per cent.

6. The mining & quarrying sector has shown particular weakness this year. This was a combination of weak coal output growth – which was negative in four months of the year – a sharp decline in natural gas production in the KG-D6 fields and negative growth in crude oil output in the third quarter of the year. There has been improvement in coal output from November 2011 onwards. However, natural gas output growth is likely to remain in the negative for the rest of this fiscal. Crude oil production showed a decline of 4 per cent in Q3 of 2011/12, but is expected to recover in the last quarter. Moreover, restrictions imposed by the Courts on iron ore production in some parts of the country have also resulted in lower output. In consequence, the mining & quarrying sector is likely to report negative growth for the year as a whole – for the first time in three decades. The AE has placed this at (–) 2.2 per cent, an inference that appears to be accurate.

7. While the electricity sector has performed well, manufacturing and construction have disappointed – the former particularly so from the second quarter onwards with October marking the bottom of the trough. IIP output growth showed a massive decline of 5.7 per cent in October, a sizeable recovery in November (6.6 per cent), with however a low reported growth in December of 1.8 per cent. Contributing principally to the latter was a large decline reported for capital goods, a component that has shown large volatility. If the capital goods component were to be excluded, the rest of the IIP would be seen to have shown a growth of over 5 per cent year-on-year. On average, the GDP arising in the manufacturing sector for Q3 is likely to be close to 1 per cent. The Purchase Managers Index (PMI) for January 2012 suggests a sizeable expansion and the output growth in the last quarter may on average be around 4 per cent. For the year as a whole the growth rate in manufacturing sector will be 3.9 per cent. In the construction sector there should be some improvement in the second half, a view that is reinforced by the strong rise (13 and 17 per cent) in cement output in November and December 2011. Hence, the growth rate in the construction sector for the year as a whole will be 6.2 per cent.

8. Growth of GDP in the services sector was 9.6 per cent in the first half of 2011/12. The Council expects that service sector growth will continue to be strong in the

second half and will close the year with growth of 9.4 per cent, slightly less than that in the first half.

**External Payments**

9. The pressure on the Balance of Payments (BoP) – both in regard to a larger than expected Current Account Deficit (CAD) and lower than expected net capital inflows – resulted in a very sizeable depreciation in the external value of the Indian rupee. In the fiscal year to date, the nominal terms of trade weighted 6-currency index fell by 14 per cent, while in terms of the inflation adjusted effective exchange rate (REER) the decline was 11 per cent. The decline of the rupee vis-à-vis the US dollar was 19 per cent in the course of April–December 2011. However, there has been some recovery in the course of January and February 2012, with the rupee recovering about 7.5 per cent. The last few months have been about the most volatile period for the external value of the currency.

10. The CAD has weakened much more than was expected, averaging 3.6 per cent of GDP in the first half of 2011/12. The position in the third quarter was much tighter than in the first two, as a result of a combination of a significant enlargement of the CAD and further weakness in capital inflows. The situation will improve in the on-going last quarter. However, for the year as a whole, the BoP position will be tight and CAD will be 3.6 per cent of the GDP.

11. In a medium term sense, the weakening of the currency – in nominal and even more so in real terms – not only reflects the current situation of demand and supply of foreign exchange, but outlines a scheme for the stabilization and improvement of the external payments situation. A weaker currency can by improving the prospect of exports – of both goods and services – and also by making the price of Indian assets more attractive to foreign investors, help to contract the CAD.

12. However, there are three problems that we must guard against. First, a sharp depreciation can impact the liability side of corporates to an extent that it weakens their ability to invest. That can dampen the recovery in the pace of economic growth. Second, capital inflows are a steady activity over time and if the impression gains ground that depreciation is likely to be a recurring theme, investors will tend to factor in this aspect in their valuation and to that extent it will have a negative impact on the perceived value of Indian assets. Finally, the CAD in India has an idiosyncratic element. The import of gold, which is viewed

by many, if not most, Indian buyers as an investment object, forms a large component in overall imports and variation in this element accounts for a very sizeable component in the change in CAD. The dynamics that influence the import demand for gold seems to be most closely related to those which influence asset holding, rather than those which influence merchandise imports.

**Inflation and Monetary Policy**

13. Very high rates of inflation have characterized the last two years. Much of the inflationary pressure came from primary foods, including cereals in the initial months. While, open market intervention and large releases under the public distribution system (PDS) helped to stabilize the price of cereals, pressure continued to come from rising prices from other primary food items – especially pulses, milk, eggs, meat & fish. Greatly improved output of *kharif* pulses in 2010 combined with marketing of imported pulses at controlled prices, helped to curtail the inflation in pulses by July 2010. However, prices continued to rise for fruit, milk, eggs and meat & fish. The prices of vegetables took an unexpected turn in December 2010 and January 2011, resulting in an increase in the wholesale price index of vegetables by 34 and 67 per cent respectively in these two months. In consequence, primary food price inflation stayed in the double digits.

14. Such a lengthy period of sustained high food price inflation had its expected impact on money wage rates and other cash expenses, which in turn began to get passed into the price behaviour of manufactured goods. Year-on-year inflation for manufactured goods rose from around 6 per cent to 8 per cent in September and October 2011. The net effect was that the headline rate of inflation stayed close to 10 per cent for an extended period of twenty two months. However, throughout this period there has also been a suppression of the headline rate insofar as the prices of several refined petroleum products, especially diesel, continued to be restrained by policy – which has had an adverse impact on the subsidy bill and therefore on government finances and also on the finances of the public sector oil companies.

15. The effort of public policy, especially monetary policy, seems to have had its desired effect. The headline rate dropped to 9.1 per cent in November and further to 7.5 per cent in December and has dropped further in January 2012 to 6.55 per cent. The welcome developments in the easing of inflationary pressures

will enable the RBI to adjust its monetary stance over the next several months. However, the continued pressure from the fiscal side will continue to impose some limitations.

**Prospects for 2012/13**

**16. Investment & Growth**: With a return of price stability, appropriate supportive policy and administrative measures, it is possible to visualize an improvement in the investment rate, notwithstanding difficult conditions in the international financial markets. An improvement of 1.5 to 2.0 percentage points of GDP can be envisioned in the fixed investment rate in 2012/13. Price stability will also normalize consumption demand. The weaker currency is likely to improve the prospects for net export demand. However, there is a fairly wide range of outcomes both on investment side, on the financial side and on the trade front that may be reasonably envisaged. Under these circumstances the Council feels that the economy is likely to grow in the range of 7.5 to 8.0 per cent.

**17. Infrastructure**: As far as the role of Government is concerned, it can express itself most powerfully in the infrastructure area – in power, roads, railways, ocean ports and air ports, in rural and urban infrastructure. The inadequacy of infrastructure availability continues to act as a constraint for the expansion of economic activity across the country. It is likely that the targets set for 2011/12 in power and roads may be achieved. Government must set ambitious targets for 2012/13 for both capacity creation in key infrastructure areas and operational performance, especially in the coal sector, such that a fillip is provided to the improvement of economic activity in 2012/13, which is also the first year of the Twelfth Plan.

**18. Inflation:** There have to be adjustments made to the selling prices of sensitive refined petroleum products to cover costs and reduce the huge burden of subsidy being borne by Government and the oil companies. As a result the suppressed inflation on account of incomplete cost pass through in these sensitive refined petroleum products has now to be phased out in 2012/13 and will then express itself on headline inflation. The recovery of the currency may obviate the kind of adjustments in goods that are either imported or priced on import parity that was being envisaged in the closing months of 2011. Inflationary pressure will continue to ease through 2012/13 and will remain around 5-6 per cent for the year. It will be necessary to keep a sharp vigil on food prices and take proactive measures not only to encourage output increase but equally, if not even more urgently, to ensure the rollout of an adequate food logistics network that can do justice to the rising demand for and output of horticulture and animal husbandry products.

**19. External Payments**: The CAD for the year 2012/13 will be 3.0 per cent. It will however, be judicious to try and limit the CAD over the medium term to between 2.0 and 2.5 per cent of GDP. On the capital account side, capital inflows especially that in the form of equity must be encouraged and improved domestic conditions for investment and growth are the basic pre-requisites, along with fundamental macroeconomic stability, i.e. prices, exchange rate and fiscal balances.

**20. Fiscal deficit**: The fiscal balance of the Central government in 2011/12 is likely to expand beyond its budgeted estimate of 4.6 per cent of GDP. This development has been occasioned primarily by much higher than budgeted subsidies – especially that on refined petroleum products. A large subsidy bill directly reduces the resources that are available for development expenditure, while also by expanding the borrowing needs of Government squeezes investible resources to an extent that undercuts productive investment by the private sector. In 2012/13, Government must strive to contain and improve the efficacy of subsidies, vis-à-vis the development needs that need to be carved out of the Union Budget. Adequate safeguards needs to be taken to prevent any negative fallout of the government borrowing programme on the financing needs of the private sector. It must be incontestably demonstrated that government finances are indeed on the path of fiscal consolidation thus reinforcing the final pillar of macroeconomic stability.

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