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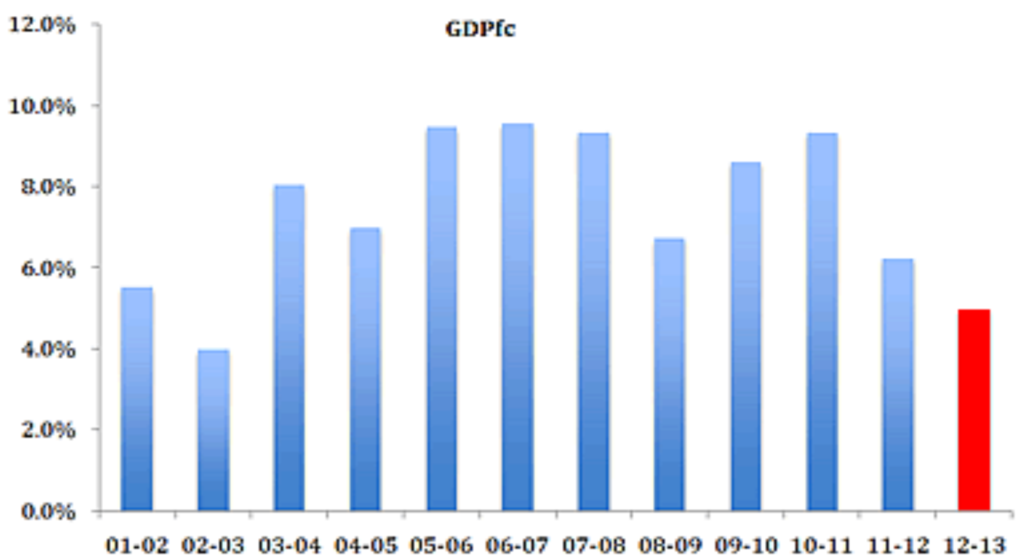
Indian economy in worsening straits

By Kunal Kumar Kundu

NEW DELHI - On February 7, India's Central Statistical Organization (CSO) released its advance estimate of India's national income for 2012-13. Coming from a government agency, it was a shocker, as it now expects India's income side gross domestic product (or GDP at factor cost, ie GDPfc) to grow by a mere 5%, much lower than the market expectation of 5.5% and among the lowest ever expected for the current and the least over the past 10 years.



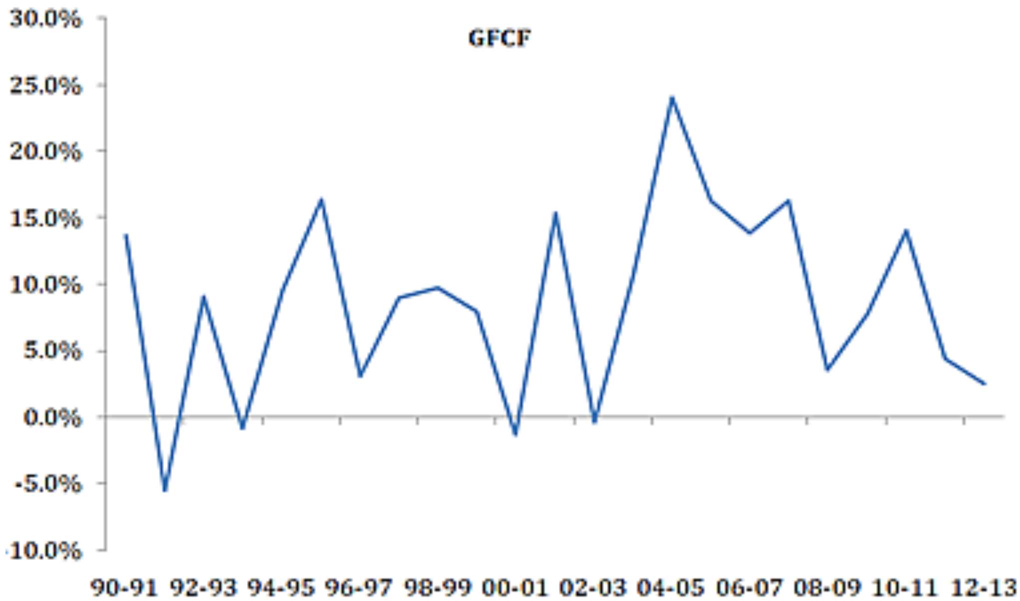
Source: RBI, MOSPI

What this means is that the second half of the financial year that ends in March 2013 will see the growth rate come down to approximately 4.6%, down from 5.4% during the first half.

In sectoral terms, agriculture growth is likely to have plummeted to 1.8% compared with 3.6% in the previous financial year. This is not a surprise given the impact of drought. Growth rate of industry as a whole is expected to be 2%, down from 2.7% recorded a year earlier. This was mainly because of a sharp deceleration of manufacturing which is likely to have grown by 1.9%, compared with 2.7% during FY12. This is not entirely unexpected given the evidence of sharp demand destruction that has taken place. Also mining, which contracted during FY12 (-0.6%), seems to have barely managed to grow (0.4%).

It was the performance of the services sector, however, that is a major cause for concern. As per the advance estimate, the service sector (which accounts for about 67% of the GDP) growth rate may have slipped to as low as 6.5% (the lowest in 12 years) as against 7.9% growth during FY12. Even this low growth got a boost by a possible 6.8% rise in community and social services (6% in FY12) as the government's social sector expenditure is seemingly on the rise.

With domestic demand falling, the expenditure side GDP (or GDP at market price or GDPmp) is expected to have grown by a mere 3.3% in FY13, virtually half the growth rate of FY12 (6.3%). The persistent slowdown in investment is reflected in the likely sharp fall in growth rate of Gross Fixed Capital Formation (GFCF) to 2.5% from 4.4% in FY12.



Source: RBI, MOSPI

Clearly, the slowdown in investment spending has gathered momentum that cannot be reversed easily. By March this year, India's 12th Five Year Plan will complete its first anniversary without any perceptible increase in government spending on infrastructure. Given the pressure on finances and the tendency of every government to cut down on capital expenditure every time the deficit situation becomes unmanageable, public spending on infrastructure will likely lag behind. With private investment not materializing, this will prevent the economy from growing faster going forward.

However, the advance estimate data may yet be suspect, given the sharp difference between GDPfc and GDPmp. At 1.6%, this is the second-highest difference in the growth rate between these two measures. The government as well as some analysts believes that the advance estimate is biased on the downside as it fails to reflect some recent uptick in activity. To an extent, they maybe correct.

In fact, the FY12 advance estimate pegged the GDP growth rate to 6.9%, having failed to reflect the falling level of activity then. The growth rate was subsequently revised downward to 6.5% (after the full-year data was first released) and subsequently to 6.2% during the first revised estimate released last week.

Therefore, while there is some merit in the argument, the possible upward revision may not be as high as 5.5% as the government is expecting because the advance estimate does not take into account the possible compression of government expenditure that India's finance minister has recently announced, faced as he is with the stark reality of a high and rising fiscal deficit. Hence, the expected 6.8% growth in social sector may yet be lower.

Also, with the December 2012 industrial production data showing yet another contraction (down by 0.6%) following a 0.8% contraction in November, the government's optimism of uptick seems to be unwarranted.

This data also confirms that, like last year, the high twin deficit (fiscal deficit and current account deficit) will continue to challenge India. While subsidies continues to rise, lower demand (both domestic and external) has impacted collection of indirect tax.

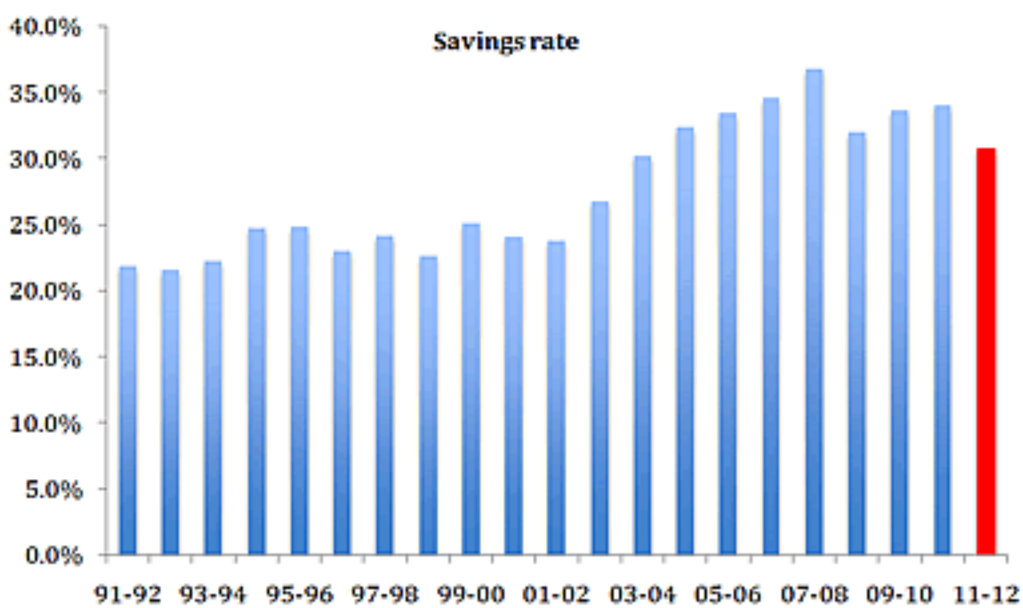
As a result, total indirect tax (net of subsidies) is estimated to have contracted by nearly 19% this year, the second-highest contraction ever, following a contraction of 27.3% during 2008-09, when India embarked on a fiscal stimulation drive (reducing rates of indirect taxes while continuing to spend heavily on social sector) to perk up the economy after the global crisis blew up.

India's fiscal deficit, therefore, is unlikely to remain contained within the revised target of 5.3% of GDP, as GDP itself is likely to be lower than expected while some proposed spending cuts might not materialize.

The bigger threat, of course is the current account deficit (CAD). Reserve Bank of India data show that for the quarter ending September, the current account deficit touched US$22.3 billion (amounting to 5.4% of GDP, the highest recorded), up from US$16.4 billion the quarter before.

This has been caused by sharp deterioration in trade balance despite falling imports as exports contracted even sharper. If the monthly trade balance data is any indicator, the deficit will likely be even higher during the December ending quarter.

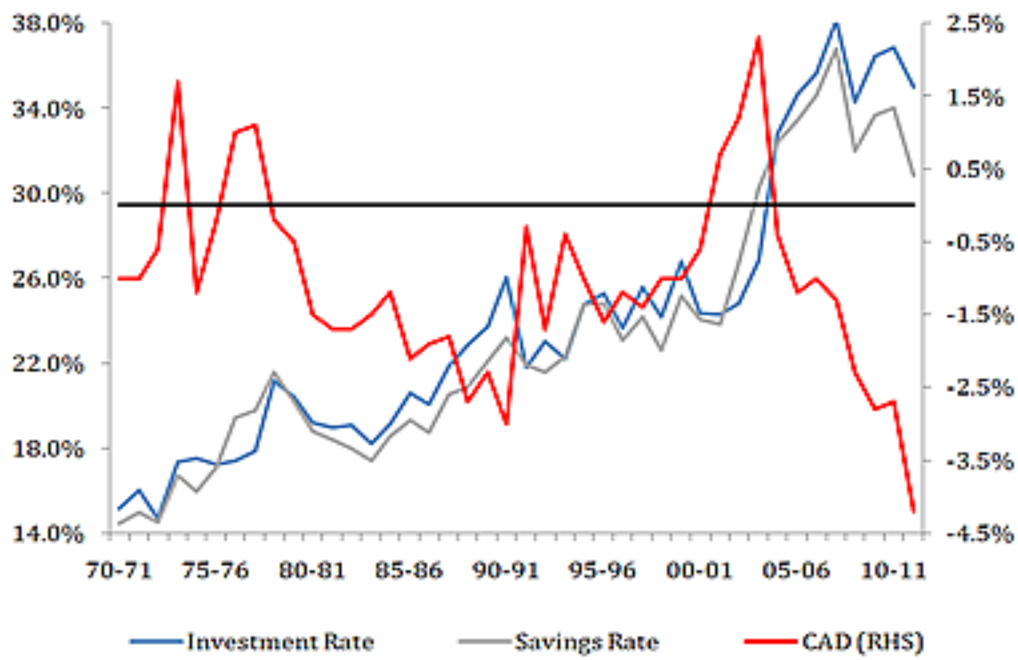
Another worrying aspect is the likely fall in the savings rate.



Source: RBI, MOSPI

As per the available data, the savings rate during FY12 fell to 30.8% of GDP from 34% the year before. During the current year, given that private domestic consumption increased by 4.1% (albeit at the slowest pace since FY03) as compared to FY12 in the face of persistently high inflation, the savings rate might well drop below 30% of GDP during the current year.

In simple economic terms, current account deficit goes up if an economy invests more than what it saves domestically. For India, the deficit has been rising despite falling investment since savings has fallen even further, resulting in rising CAD.



Note: RHS - Right Hand side. Source: RBI

The advance estimate, therefore, portends ominous signal. While the economy may have bottomed out, faster rebound ought not to be expected.

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