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Indian economy drier than forecast

By Kunal Kumar Kundu

BANGALORE - India's 6.1% economic growth over the three months through June, announced this week, had many analysts optimistic at the prospects for the rest of the fiscal year, even though the figure was down from 7.8% in the year-earlier period and took no account of a deepening drought.

The Central Statistical Organization (CSO), releasing the figures on Monday, said the drought would be reflected in the coming quarters, but that the economy "can still clock over 6% growth" over the fiscal year that ends March 31, 2010. Even Montek Singh Ahluwalia, deputy chairman of the Planning Commission, said in reaction to the figures that the worst may be over. "We expect GDP [gross domestic product] growth to improve in the subsequent quarters," Ahluwalia said.

A closer look at the data makes it clear that the government is speaking on an agreed line to shore up sentiment, rather than commenting on reality.

First, take the agricultural sector, in which in this year's fiscal first quarter (April to June), growth slowed to 2.4% from 3% a year earlier and was down from 2.7% in the immediate previous quarter. This in itself need not be bad, except that the data reflect the *Rabi*, or spring, crop only, which was not affected by drought. The effect of the severe drought on the *Khariff*, or summer monsoon, crop, is yet to be recorded and this is going to take a major hit in the coming quarters.

With severe drought affecting the country during the *Khariff* crop-sowing season, agricultural output for the coming couple of quarters, at least, will be quite bad. That in turn means subdued rural demand, a sector of the economy that has become an increasingly important growth driver. Even anecdotal evidence already suggests that a pull-back is being felt by the fast-moving consumer goods segment. Soon, even automotive companies, particularly makers and sellers of tractors and motorized two-wheelers, will feel the heat.

The August sales data for automotive companies this week already show plummeting tractor sales. While two-wheeler sales are holding up, that can be attributed to pent-up demand of the previous year as financing conditions eased and interest rates softened, and also to the forthcoming festive season. Post October 15, when the festive period ends, sales of two-wheelers can be expected to correct substantially downward.

What really carried the day in the last quarter's GDP numbers, as in the previous quarter, was higher government expenditure. Government final consumption expenditure (GFCE) grew by as much as 10.24%, while private final consumption expenditure (PFCE), or simply consumption demand, virtually stagnated, with growth of only 1.63%. The comparison with the year-earlier overall GDP growth of 7.8% is even worse than the simple figures indicate as that was on the back of higher domestic demand, while the GFCE then was stagnant.

What is more important here is that demand generated by higher government spending in the rural sector and comparatively high growth of 2.7% and 2.4% during the past two quarters have still resulted in virtually unchanged domestic consumption.

In essence, this means that urban consumers are holding back on spending. As the effect of the stimulus package wanes and the farm sector growth rate falls, GDP is bound to record lower growth. This will be exacerbated as the government, hamstrung by a higher deficit and forced to spend more to ameliorate the impact of drought, seeks to rein in overall spending.

This growth number owes a lot to statistics. From the expenditure side, the national income identity equation looks like this: $Y = C + I + G + (X-M)$, where Y = GDP, C = consumption expenditure, I = Investment expenditure, G = government expenditure, X = exports and M = imports.

Hence, (X-M) means net exports, or the trade balance. In effect, India's exports impact GDP positively, while imports do so negatively. So a higher trade deficit reduces GDP, while a lower deficit improves GDP.

While exports in rupee terms were lower by a little more than 10% during the fiscal first quarter, imports fell at more than double the rate (about 20.5%). Additional data for July, released this week, show the same pattern - exports declined by 19% in rupee terms, while imports plummeted 29%. As a result, the trade deficit improved, thereby impacting GDP positively.

Hence, we have a curious situation in which, despite lower foreign demand for India's products, much lower domestic demand has resulted in lower imports and hence improved GDP.

In essence, the GDP improved because India's demand for foreign goods was lower than foreigners' demand for India's goods. This does not bode well, for two reasons. It implies slackening domestic demand, and more importantly, non-oil imports were down substantially. This implies lower imports of capital goods, which is an indication of lower business confidence going forward, as investment slackens.

Even gross fixed capital formation during this quarter was up by a mere 4.23%, compared with a near 18% gain in the same quarter last year. A similar phenomenon was witnessed during the fourth quarter (January to March), 2008-09. In fact, domestic production of capital goods from April to June was up by a mere 1%, compared with a 7.9% rise for April to June 2008-09. With lower investments, the economy clearly lacks the tailwind necessary to propel it forward.

With a fall likely in domestic demand, it is quite possible that manufacturing might be impacted further as manufacturers start to draw down inventories. These at present account for about 3.1% of GDP. This is not unlikely as manufacturing grew by only 3.4% in the fiscal first quarter, down from 5.5% a year earlier. Although this is better than the growth in the previous two quarters, even the current growth rate might not be sustainable in the face of slowing demand. A drop in the manufacturing growth rate would also pull down overall GDP growth.

The monthly numbers indicate some recent pick-up in domestic capital goods production, but sustainability remains a question. It is important to keep an eye on manufacturing, especially on the capital goods sector, since investment demand will be an important growth driver.

In effect, I am sticking to my projection of sub-6% GDP growth for the full year, more likely at about 5.8%.

***Kunal Kumar Kundu** , a former senior economist with a leading bilateral chamber of commerce in India, now works with the Knowledge Service Division of Infosys Technologies Ltd. He has a Masters in Economics with specialization in econometrics from the University of Calcutta. The author here is expressing his personal views.*