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Indian Economy Looks Up, In a New 'Start'

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Four months after a new government assumed office in India on 26 May 2014, the country's economy presents an improved outlook. Challenges, nonetheless, remain. This paper examines the macroeconomic developments and the risk to the outlook.

Economic Growth: Revival led by Services

The real GDP growth of 5.7 per cent for the first quarter (April-June) of the current financial year (2014-15) was a euphoric beginning for the new government led by Prime Minister Narendra Modi. The quarterly estimates reflected rebound in growth (year-on-year) for several sectors. However, it was evident that the real sectors of the economy – agriculture and industry – despite recovering from their last-year slumps were not the main contributors to the uptick in overall growth. The main contributors to the better GDP performance were the services, notably electricity, gas and water supply, financing, insurance, real estate and

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business services and community, social and personal services. All the three service categories grew at around 10 percent or close to 10 percent. Agriculture and manufacturing, while leaving behind the negative rates of growth they posted in the first quarter of 2013-14, were still range-bound at subdued rates of 3.8 percent and 3.5 percent[2] respectively.

The sectoral performances highlight the structural behavioural patterns of the Indian economy that have become pronounced over the last two-three quarters. Infrastructure and financial services are contributing substantively to shaping a cyclical upturn in the economy. Core industries, electricity, steel, and cement, are also recording higher growth than in the previous year. Financial services are performing well due to a massive upsurge in the capital market. These sectoral gains can become broad-based and sustainable if agriculture and manufacturing join the rally. Much of the economic buoyancy in the medium term will depend upon how these two sectors respond to various initiatives announced by the government.

Extraneous Factors: A Mixed Bag

Since assuming office, the new government has had mixed fortunes in so far as extraneous factors influencing the economic outlook are concerned. Worries over the supply-side, particularly agricultural production, continue to prevail due to the deficient monsoons. The estimated shortfall in monsoon has been around 12 percent, with North and Northwest India, particularly the major wheat-growing states of Uttar Pradesh and Haryana, getting much less rain. While a drought is now ruled out, the shortfall in the already-retreating south-west monsoon and its erratic distribution will impact the crop sowing cycle leading to some delay in the arrival of the winter crop. This would be so notwithstanding the government's efforts to manage disruptions in the production cycle by increasing subsidies on essential inputs like diesel and seeds and facilitating import of feed ingredients.[3] Anticipation of the delayed arrival of the *kharif* crop will impact expectations about inflation. This explains the Reserve Bank of India (RBI)'s persistence with a cautious monetary policy stand and refusal to lower the key interest rates.

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[2] 'Press Note on Estimates of Gross Domestic Product for the First Quarter (April-June) 2014-15', Central Statistics Office (CSO), Ministry of Statistics and Programme Implementation, Government of India, 29 August 2014. http://mospi.nic.in/Mospi_New/upload/nad_PR_29aug14.pdf. Accessed on 30 September 2014.

[3] Department of Agriculture & Cooperation, Ministry of Agriculture, Government of India. http://agricoop.nic.in/. Accessed on 30 September 2014.

If the less-than-normal monsoon is an extraneous factor dragging the supply-side and adversely affecting lower-inflation prospects, the government has been fortunate in encountering a period of relatively benign global energy prices. The first half of the current fiscal year has witnessed a steady softening of global crude oil prices with the Brent crude price dropping below US$100 per barrel in September 2014. As the RBI points out in its latest Monetary Policy Report (September 2014), the global crude prices have moved against popular expectations of their hardening on account of the occasional flare-up of geopolitical tensions in the Gulf. The softening has been largely due to higher supplies from OPEC and North America. Along with energy prices, world food and commodity prices have also reduced.

Macroeconomic Recovery

The somewhat unexpected easing in global resource and commodity prices will positively influence the outlook on inflation. In the near term, their positive effect through lower monetary value of imports has already been felt in the balance of payments, with the current account deficit (CAD) in the first quarter of 2014-15 contracting sharply to 1.7 percent of GDP compared with the rather precarious 4.8 percent of GDP in the first quarter of 2013-14. The relaxation of pressure on the external sector is a major relief for the government as it now has greater room for allowing imports for tackling supply shortages without worrying about the expansion in trade deficit.

Lower global crude prices have also enabled reductions in retail prices of petrol and aviation turbine fuel. If the trend sustains, the government might well be encouraged to cut retail prices of diesel that are still regulated, and which have not been reduced for more than five years now. Other than the distinct sobering effect on consumer prices and headline inflation, lower global crude prices are also helping fiscal management by keeping petroleum subsidies in check. At the end of the first half of the current financial year, the hopes of containing the annual fiscal deficit to the budgeted level of 4.1 percent are becoming stronger.

Return of the FIIs

The biggest shot-in-the-arm for the new government has been the resurrection of the ‘feel good’ factor. This had set in well before the Modi Government assumed office with election

forecasts pointing to the possibility of a new government headed by a decisive and business-oriented prime minister. FIIs have pumped in a staggering US$17.8 billion in the Indian capital market during the first four months of the current financial year (April-June 2014-15), which has pushed the aggregate inflow of foreign investments into the country to US$ 29.4 billion during the period. The upsurge in capital inflows is remarkable given that it has already exceeded last year's total foreign investment inflows of US$ 26.4 billion.[4] It is also interesting that the FII investments in the Indian debt market have matched those in the equity market pointing to the confidence of foreign portfolio-investors in returns from India's long-term debt instruments.

The equity market has been the most prominent indicator of the revival in investor confidence. The market has grown rapidly in both volume and value with the benchmark stock market indices touching record highs. The return of institutional investors, along with the government's decision to mobilise substantive resources through disinvestment of several large public sector enterprises, has made the market rally increasingly broad-based across sectors. The disinvestment plans, and the Security and Exchange Board of India's (SEBI)'s directive urging all listed public sector enterprises to achieve at least 25 percent public shareholding within three years[5] have assured market actors about availability of liquidity and adequate choices for portfolio diversification in the medium term. As a result, the sentiments have become conducive for resource mobilisation through initial public offers (IPOs) that have got encouraging response.

The final confirmation of the international investors reviving their faith in the Indian economy has come from the Standard & Poor (S&P) upgrading its outlook for India's sovereign credit rating from negative to stable. In a statement expressing optimism about the future of economic reforms, the rating agency justified its revised outlook on India's 'improved political setting'.[6] Announced hours before the Indian Prime Minister's departure for a high-profile visit to the US, the timing and significance of the revision can hardly be overlooked.

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[4] *Monthly Bulletin,* Reserve Bank of India; September 10, 2014; http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/34T_CB080914F.pdf. Accessed on 1 October 2014.

[5] 'Sebi throws a lifeline to primary market', *Business Standard*, 20 June 2014. http://www.business-standard.com/article/markets/sebi-throws-a-lifeline-to-primary-market-114061900451_1.html. Accessed on 1 October 2014.

[6] 'S&P revises India credit rating outlook to stable', *livemint*, 26 September 2014; http://www.livemint.com/Politics/tXNip7WfVTfLo46BLIWJSP/SP-revises-India-credit-rating-to-stable-in-boost-for-Modi.html. Accessed on 1 October 2014.

Will the Good Going Last?

A benign external environment, characterised by falling resource- and commodity-prices and an overwhelmingly large 'feel good' factor, has contributed to the building of a robust economic context in the first four months of the new government. Can this be maintained over a year and more for ensuring India's return to the high-growth trajectory of the last decade?

The RBI Governor sounded a note of caution in his latest monetary policy statement by pointing out that the 'momentum of activity in all sectors of the economy is yet to stabilize'.[7] Indeed, notwithstanding a GDP growth of 5.7 percent in the first quarter, the RBI has forecasted a median GDP growth rate of 5.5 percent for 2014-15. Its forecast is based on the expected slack in agricultural output during the next couple of quarters inflicted by the deficient monsoon and the time that manufacturing and industrial activity will take to revive because of various measures, including the ambitious 'Make in India' programme announced for making India a global manufacturing hub.

In popular business parlance, the 'green shoots' of an economic turnaround are visible in the Indian economy. These are manifesting through stronger macroeconomic fundamentals like a lower current account deficit, better growth in core and infrastructure industries and moderation in consumer prices. Nonetheless, serious challenges remain in the macroeconomic outlook. The most critical among these is inflation. Though consumer price inflation has come down from its peak of 11 percent in November last year, it needs to be managed carefully for meeting the target of 8 percent in January 2015.

Another major challenge for the government is drawing in adequate long-term investment. The government appears to be relying rather heavily on private investments in this regard. Much would depend on whether the relaxations of foreign investment norms in railways, construction and defence fetch the kind of funds that the government is aiming to attract. This will also, albeit partially, depend on the extent by which the Prime Minister has been able to convince the Japanese, Chinese and American leaders about the importance of investing long-term in the Indian economy.

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[7] 'Fourth Bi-Monthly Monetary Policy Statement', 2014-15, by Dr Raghuram G Rajan, Governor, Reserve Bank of India; 30 September 2014. http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=32197. Accessed on 1 October 2014