I. Output

With both domestic and global factors that had impacted India's growth during 2011-12 remaining unresolved, growth remained sluggish during Q1 of 2012-13. Indicators suggest that the slowdown continued into Q2 of 2012-13 with slack industrial activity and sub-par services sector performance. Despite unconventional monetary easing by several advanced economies, global growth prospects have weakened since the previous quarter thus adversely impacting the near-term growth outlook for India. However, recent policy reforms by the government, albeit with some lag, should contribute towards arresting the downturn by easing some domestic constraints. Measures to remove constraints facing the infrastructure sector would be crucial for growth revival.

Global growth prospects weaken over the previous quarter

I.1 The global growth outlook has deteriorated further as the sovereign debt overhang, fiscal adjustments, banking fragilities and financial market uncertainties, especially in the euro area, weighed on growth prospects. Sequentially, growth decelerated in Q2 of 2012 in the US, Japan and China while euro area and UK failed to register positive growth. Though there have been signs of a mild recovery in the US housing markets, the possibility of the occurrence of a US fiscal cliff poses a significant risk to the US and global recovery, despite the "open-ended" quantitative easing announced by the Federal Reserve. The fiscal cliff refers to a possible large reduction in the federal budget deficit between 2012 and 2013 on account of certain tax hikes and spending cuts becoming effective from January 2013.

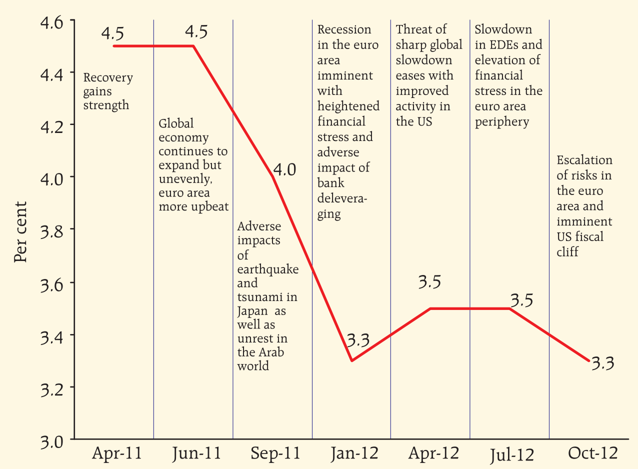
I.2 The IMF's World Economic Outlook (WEO) released earlier this month, further marked down its global growth forecast for 2012 to 3.3 per cent from the July 2012 estimate of 3.5 per cent. This is mainly due to a downward revision in growth projection for EDEs to 5.3 per cent from 5.6 per cent in July 2012. The growth forecast for advanced economies (AEs) has been reduced by 0.1 percentage point to 1.3 per cent. The latest revision in global growth forecast for 2012 means a cumulative downward revision of 1.2 percentage points since April 2011, when global recovery had gained strength (Chart I.1).

I.3 The US economy expanded by 2.0 per cent (annualised) in Q3 of 2012, faster than 1.3 per cent in Q1 of 2012. Euro area output contracted at a rate of 0.7 per cent (annualised) in Q2. The employment scenario in the AEs also continues to be grim. The unemployment rate in the US, however, declined to 7.8 per cent in September 2012 from 8.1 per cent in August 2012.

I.4 Spillovers from AEs and domestic constraints have affected economic activity in EDEs as well. The BRICS economies continued to slow. China's growth decelerated for the seventh consecutive quarter to 7.6 per cent (y-o-y) in Q3 of 2012. Only Q2 data is available for the other countries. Russia's growth weakened further to 4.1 per cent in Q2 of 2012, decelerating continuously for three successive quarters. Brazil's growth fell for the tenth successive quarter to 0.5 per cent. South Africa's growth improved marginally, but has stayed below 3.0 per cent in the preceding four quarters. With risks to global growth and trade, near-term improvement in growth prospects for EDEs seems unlikely.

I.5 Global industrial production grew at the rate of 1.7 per cent in August 2012, its slowest pace since zero

Chart I.1: IMF Projections for Global Growth in 2012



Source: World Economic Outlook and Updates (various issues).

growth in November 2009 (Chart I.2). Lead indicators such as Purchasing Managers Index (PMI) suggest no significant improvement in Q3. The volume of world trade fell in July 2012 (Chart I.3). Slowdown in global industrial activity and trade could adversely impact India's growth prospects, given the inter-linkages.

Risks from the impending US 'fiscal cliff' remain significant

I.6 A major downside risk to global growth is now looming from the US fiscal cliff. The US Congressional Budget Office forecasts that the US fiscal deficit will decline by 3.3 percentage points to 4 per cent of GDP in 2013. Such a sharp fiscal consolidation may have a deleterious impact on global growth (Table I.1). There could be an adverse impact of the US fiscal cliff on India's growth. If global growth slumps, there would be spillover impact on current account as well, though some offset may be available if global commodity prices fall.

Growth in India was sluggish in Q1 of 2012-13

I.7 Growth during Q1 of 2012-13, at 5.5 per cent, was marginally higher than in the previous quarter, but much lower than the 8.0 per cent growth registered in the corresponding quarter of 2011-12. The deceleration was seen across all the three major sectors, particularly the industrial and services sectors (Table I.2). The slowdown in manufacturing has been particularly

Table I.1: Global Implications of the US 'Fiscal Cliff'

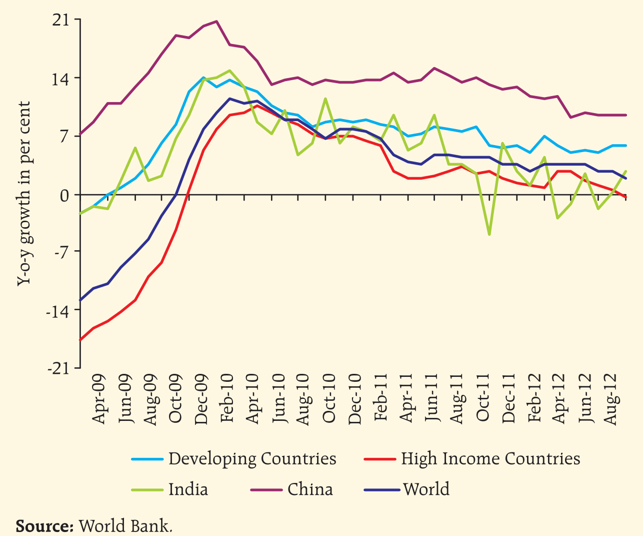
	Percentage point change from the baseline		
	GDP	Current Account Balance*	Fiscal Balance*
1	2	3	4
World	-1.0	–	0.4
US	-2.2	1.2	2.9
High Income Countries	-1.1	0.1	0.8
Euro Area	-0.4	-0.3	-0.1
Developing Countries	-0.6	-0.4	-0.3
South Asia	-0.2	0.1	0.1

Source: World Bank Estimates.
* as per cent of GDP.

severe. The services sector moderated for the second successive quarter in tandem with a sharp deceleration in the growth of 'trade, hotels, transport, storage and communication', even as construction picked-up.

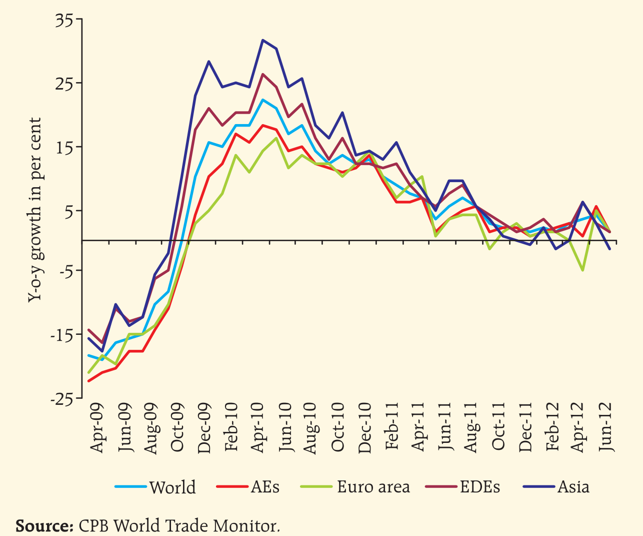
I.8 Since the second week of September 2012, the government has announced a number of policy measures towards fiscal consolidation by reducing fuel subsidies and clearing stake sales in public enterprises. It has also taken several other reform measures (see Table VII.1 on reform measures). While these measures have helped improve sentiments, their impact on growth will be felt with a lag, particularly after the substantive implementation of the initiatives relating to FDI and infrastructure.

Chart I.2: Growth in Industrial Production



Source: World Bank.

Chart I.3: Growth in Exports Volume



Source: CPB World Trade Monitor.

Table 1.2: Sectoral Growth Rates of GDP (at 2004-05 prices)

(Per cent)

Item	2010-11*	2011-12#	2011-12				2012-13
			Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7	8
1. Agriculture & allied activities	**7.0**	**2.8**	**3.7**	**3.1**	**2.8**	**1.7**	**2.9**
2. Industry	**6.8**	**2.6**	**6.5**	**2.7**	**0.9**	**0.7**	**0.8**
2.1 Mining & quarrying	5.0	-0.9	-0.2	-5.4	-2.8	4.3	0.1
2.2 Manufacturing	7.6	2.5	7.3	2.9	0.6	-0.3	0.2
2.3 Electricity, gas & water supply	3.0	7.9	7.9	9.8	9.0	4.9	6.3
3. Services	**9.2**	**8.5**	**9.3**	**8.5**	**8.7**	**7.5**	**7.4**
3.1 Trade, hotels, transport, storage & communication *etc.*	11.1	9.9	13.8	9.5	10.0	7.0	4.0
3.2 Financing, insurance, real estate & business services	10.4	9.6	9.4	9.9	9.1	10.0	10.8
3.3 Community, social & personal services	4.5	5.8	3.2	6.1	6.4	7.1	7.9
3.4 Construction	8.0	5.3	3.5	6.3	6.6	4.8	10.9
4. GDP at factor cost (Total 1 to 3)	**8.4**	**6.5**	**8.0**	**6.7**	**6.1**	**5.3**	**5.5**

*: Quick Estimates. #: Revised Estimates.
Source: Central Statistics Office.

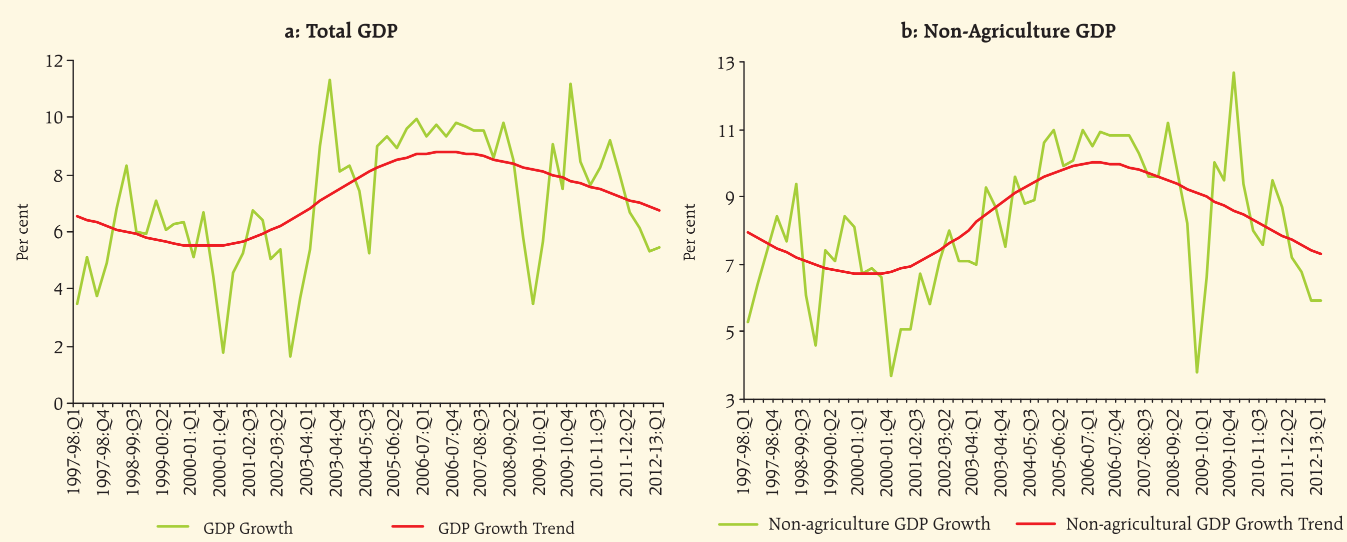
Negative output gap likely to persist in 2012-13

I.9 The potential growth rate of the Indian economy peaked around the middle of 2007-08, and has since continued its downward slide into Q1 of 2012-13 (Chart I.4). There are many methodological issues surrounding the estimation of potential output and the range of empirical estimates leaves considerable uncertainty. Nevertheless, what is clear is that potential output has been impaired as a result of the fall in savings and investment, high inflation and domestic structural impediments compounded by cyclical global slowdown. Current estimates suggest that potential growth may have now dropped to around 7.0 per cent. The output gap has been negative for four consecutive quarters.

Delayed and uneven monsoon has impacted *kharif* production though *rabi* prospects seem better

I.10 In 2012, not only was there a delay in the onset of the south-west monsoon, but its progress and distribution was uneven, especially during the crucial *kharif* sowing period of June and July. This resulted in

Chart I.4: GDP Growth

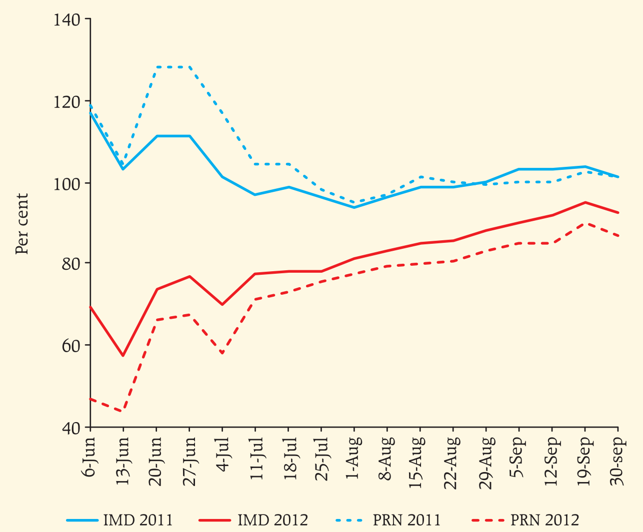


delayed sowing of most crops. Although rainfall improved during August and September, the cumulative rainfall for the country as a whole (up to September 30) was 8 per cent below the LPA. The production-weighted rainfall index (PRN) constructed by the Reserve Bank indicated a deficiency of 13 per cent for the season as a whole (Chart I.5).

I.11 Deficient rainfall resulted in shortfall in area sown for several crops, notably coarse cereals and pulses (Table I.3). The delay in sowing, particularly in July 2012 adversely impacted the production of *kharif* crops in 2012 as indicated by the First Advance Estimates. Revival of monsoon during the latter half of the season and the governments contingency plans to tackle the drought-like situation, to an extent, helped in moderating the adverse impact of deficiency of monsoon during June and July 2012. The late recovery of rainfall, especially during September has improved soil moisture content and reservoir levels, thus improving the prospects for winter and *rabi* crops which could help in compensating for the loss of *kharif* crops.

I.12 The current stock of around 67 million tonnes (September 2012) of rice and wheat is more than sufficient to meet the requirements of buffer norms (Chart I.6). However, food and nutrition security at stable prices remains a concern as food prices experienced significant upward pressures with the deficiency in monsoon (for details see Chapter VI. Price situation). There was also a spurt in futures prices of some agricultural commodities during June-July owing to concerns about a weak monsoon.

Chart I.5: Rainfall Index



Recovery of investment essential for industrial growth

I.13 The growth in index of industrial production (IIP) decelerated sharply during April-August 2012 compared with the corresponding period of the previous year. This was mainly due to a decline in capital goods production highlighting the slowdown in investment activity (Table I.4). The contraction of the mining sector

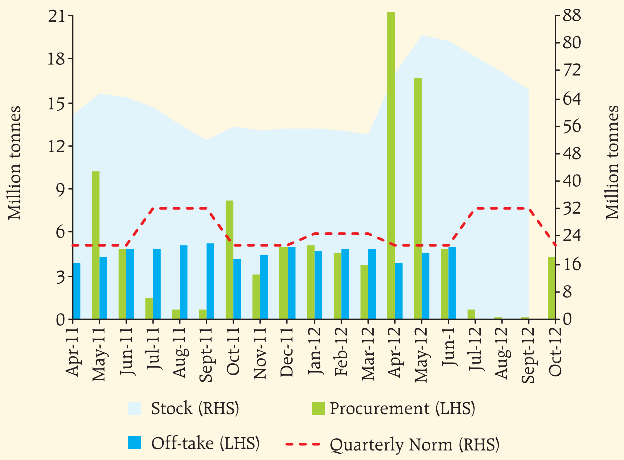
Table I.3: *Kharif* Sowing and Production

(Area in million hectares; Production in million tonnes)

Crop	Normal	Sowing*		*Kharif* Production		Percentage change over 2011	
		2011	2012	2011 4th Advance Estimate	2012 1st Advance Estimate	Sowing (4) over (3)	Production (6) over (5)
1	2	3	4	5	6	7	8
Foodgrains	71.9	72.1	66.5	129.9	117.2	-7.8	-9.8
Rice	39.1	40.1	39.2	91.5	85.6	-2.2	-6.4
Coarse Cereals	21.9	20.7	17.8	32.3	26.3	-14.0	-18.6
Pulses	11	11.3	9.5	6.2	5.3	-15.9	-14.5
Oilseed	17.9	18.5	17.5	20.8	18.8	-5.4	-9.6
Sugarcane	4.7	5.1	5.1	357.7	335.3	0.0	-6.3
Cotton#	9.9	12.2	11.6	35.2	33.4	-4.9	-5.1
Jute and mesta ##	0.8	0.8	0.8	11.6	11.3	0.0	-2.6
All- Crops	105.2	108.7	101.5	–	–	-6.6	–

*: Full Season. #: Million bales of 170 kgs each. ##: Million bales of 180 kgs each.
Source: Ministry of Agriculture, Government of India.

Chart I.6: Food Stock and its Determinants



Note: 1. Data for off-take is for April-June 2012 and stock as on September 30, 2012.
2. Procurement and off -take data are monthly figures.
3. Procurement for October 2012 is as on October 19, 2012.

also contributed to the slowdown in industrial production. Excluding capital goods, the growth rate of overall IIP during April-August 2012 was 2.7 per cent (Chart I.7).

I.14 The slowdown in industrial activity is reflected across all sectors. Manufacturing sector output did not grow during April-August 2012, reflecting subdued investment activity and moderation in external demand. Major sub-sectors of manufacturing, such as electrical machinery and apparatus, motor vehicles, food products and apparel contributed significantly to the overall decline in growth of manufacturing output. The mining sector continued to contract due to regulatory and environmental issues. Policy uncertainties with respect to coal and iron ore mining may act as a deterrent for this key sector. Power generation moderated sharply during April-August 2012, both on account of shortages in coal supply and uneven monsoon conditions.

I.15 As per the use-based classification, moderation in growth was seen in all categories except consumer durables. The contraction in capital goods production during April-August 2012 mainly reflects weak investment demand. There has, however, been partial substitution by increase in capital goods imports, which increased significantly during this period.

I.16 An analysis of the relationship between production and imports of manufacturing goods industries during April 2010 to March 2012 confirms that there is a statistically significant and negative relation between domestic production and imports in the case of textiles and electrical machinery. The negative association implies that textiles and electrical machinery industries have been subject to some loss of competitiveness, resulting in the substitution of domestic output by imports (Chart I.8).

Table I.4: Index of Industrial Production: Sectoral and Use-Based Classification of Industries

(Per cent)

Industry Group	Weight in the IIP	Growth Rate		
		Apr-Mar 2011-12	April-August 2011	April-August 2012P
1	2	3	4	5
Sectoral				
Mining	14.2	-2.0	-0.5	-0.6
Manufacturing	75.5	3.0	6.0	0.0
Electricity	10.3	8.2	9.5	4.8
Use-Based				
Basic Goods	45.7	5.5	7.6	2.8
Capital Goods	8.8	-4.0	7.3	-13.8
Intermediate Goods	15.7	-0.6	0.8	0.6
Consumer Goods (a+b)	29.8	4.4	4.4	3.5
a) Consumer Durables	8.5	2.6	4.5	5.7
b) Consumer Non-durables	21.3	5.9	4.3	1.6
General	**100**	**2.9**	**5.6**	**0.4**

P : Provisional.
Source: Central Statistics Office.

Chart I.7: Industrial Growth

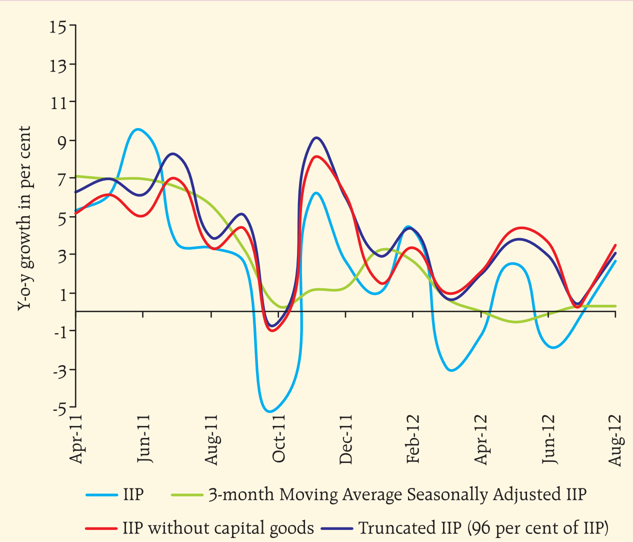
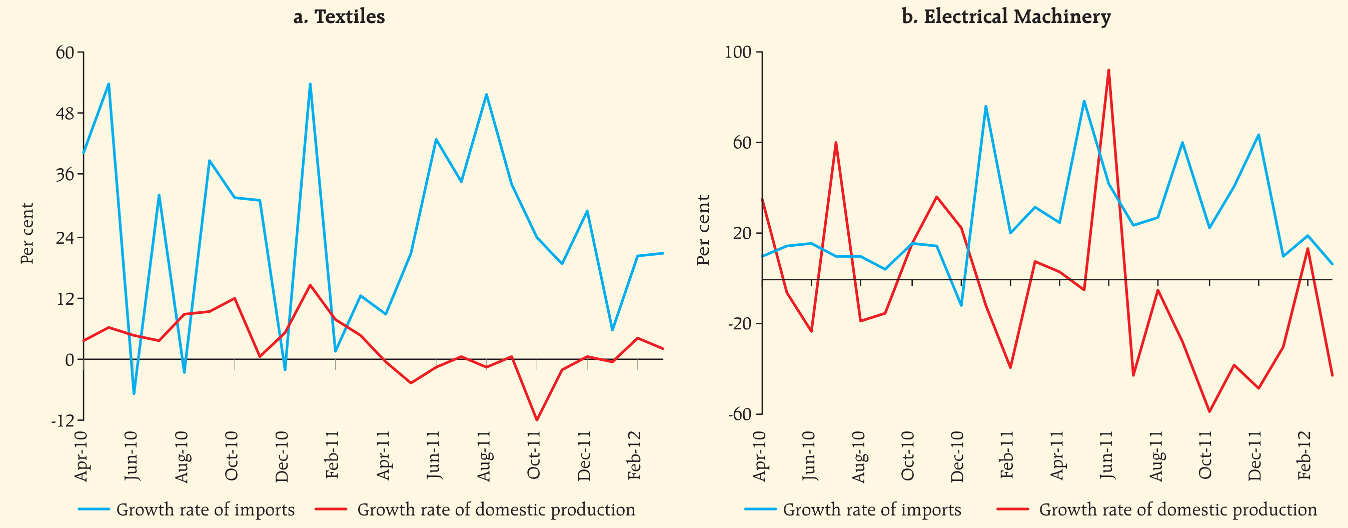


Chart I.8: Domestic Production *vis-à-vis* Imports of Manufactured Goods



I.17 To support revival in industrial growth, there is a need to take expeditious decisions to accelerate investments, especially by easing policy constraints and removing major supply bottlenecks. The recent proposal to set up a National Investment Board (NIB) is intended to improved co-ordination and expedite investment clearances of large projects thus helping to improve investment climate. However, since a large number of project clearances are also required at sub-national levels, it is important to improve coordination amongst all concerned agencies, including those which may be beyond the ambit of NIB.

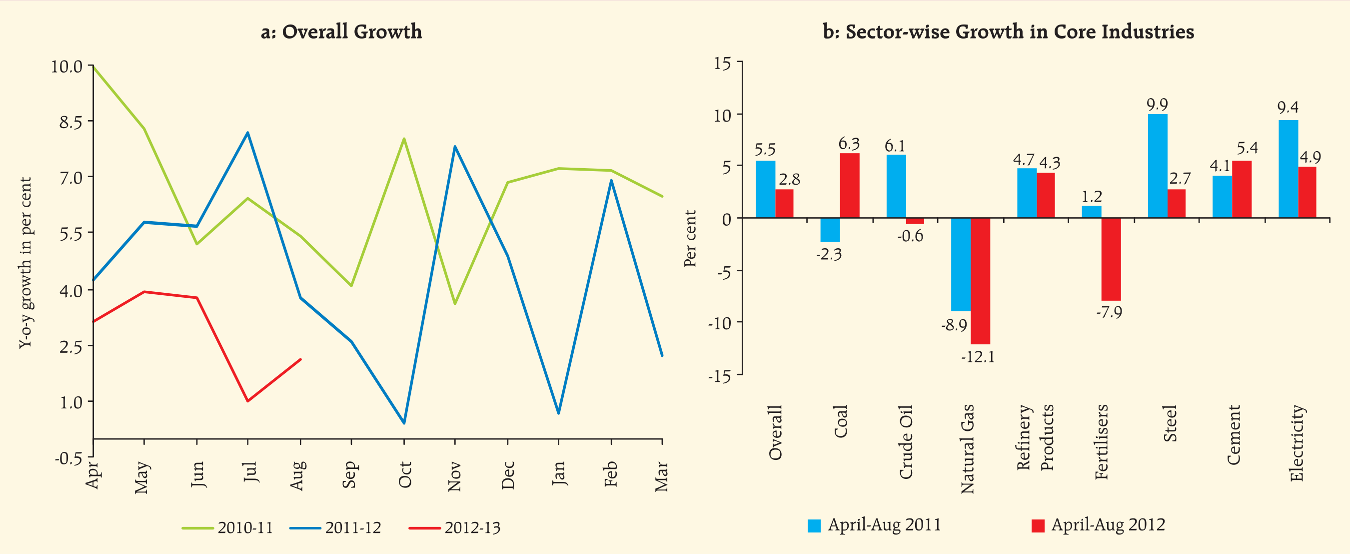
I.18 Recovery in domestic industrial production could also be contingent on a revival in global growth. A strong co-movement between domestic and global IIP is observed; the correlation coefficient of which during the period April 2008 to August 2012 was as high as 0.7 (see Chart I.2).

Revival of investment cycle hinges on resolution of policy uncertainties facing power and coal industries

I.19 The growth of eight core infrastructure industries decelerated to 2.8 per cent during April-August 2012 compared to 5.5 per cent during the corresponding period of the previous year (Chart I.9). Going forward, a reversal of downturn facing these industries essentially depends on revival of investment activity. This, in turn, hinges on resolution of policy uncertainties facing the power and coal industries. Despite large new power capacities reaching gestation stage during the Eleventh Five Year Plan, these capacities have not yielded the desired results due to input supply constraints. Though about 55 GW of new capacity creation was achieved, a large part of new capacity in thermal power was affected by coal shortages. The coal requirement for thermal power generation during 2012-13 is estimated at 476 million tones, but indigenous supplies may be only 407 million tonnes, requiring the balance to be met through imports. This demand-supply gap is projected to rise further during the Twelfth Plan. New plants that have been commissioned on the basis of coal linkage are facing severe constraints in the absence of committed Fuel Supply Agreements (FSAs). Besides, power projects are held up for want for various clearances. Also, distribution of power has come under financial stress, with state power distribution companies (discoms) sitting on an accumulated debt of ₹1.9 trillion as on March 2011. A large amount of bank finance is stuck in bad loans to these discoms.

I.20 However, over the past two months substantive progress has been made towards resolving outstanding issues confronting the sector. New FSAs that provide reasonable graded penalty clauses at pre-agreed

Chart I.9: Growth in Core Industries



disincentive triggers of 80 per cent of the Assured Coal Quantity (ACQ) are now approved by the Coal India Limited (CIL) and are expected to be signed shortly. A scheme of financial restructuring of discoms has now been put in place, which will aim at bringing about a financial turnaround of discoms (see para II.16). However, a comprehensive solution to the coal supply issue lies in addressing supply shortages through imports in the interim backed by appropriate price pooling or effective alternative mechanisms, as also getting the coal blocks auctions going so that issue does not linger beyond the Twelfth Plan period. So, while existing measures are steps in the right direction, rest of the issues would need to be resolved expeditiously to kick start the investment cycle in the infrastructure sector once again.

I.21 Other decisions in the recent period such as revoking the ban on certain categories of projects by allowing government land alienation and permission for clearance of up to 40 hectare of forest land at the regional level, are significant steps towards mitigating policy uncertainties. It has been decided that both forest and environment clearances would be processed simultaneously to avoid delays. Further, the recent policy initiatives such as permitting FDI in retail trade, civil aviation and power trading exchanges and rationalisation of diesel prices will help improve the investment climate.

Capacity utilisation at its lowest level in thirteen quarters

I.22 On account of the slowdown in economic growth, capacity utilisation measured by the 18th round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank was at a three-year low in Q1 of 2012-13 (http://www.rbi.org.in/OBICUS18). There is a strong co-movement between capacity utilisation and de-trended IIP manufacturing (Chart I.10). The survey further shows that there was higher growth in new orders, both q-o-q

Chart I.10: Capacity Utilisation and Industrial Growth

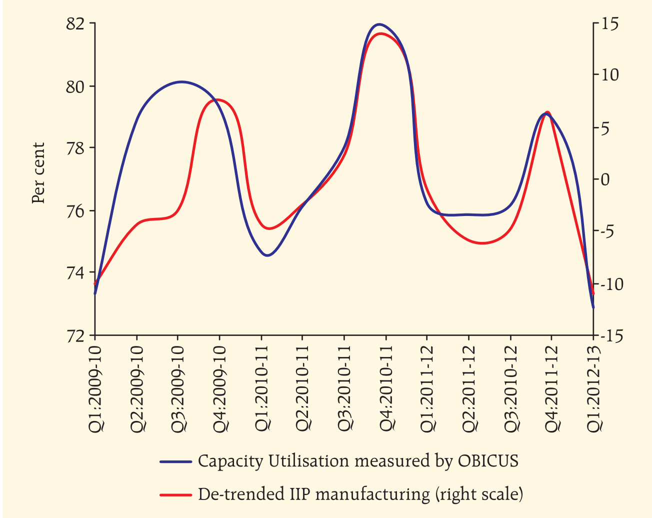


Table I.5: Indicators of Services Sector Activity

(Growth in per cent)

Services Sector Indicators	2010-11	2011-12	Apr-Sep 2011-12	Apr-Sep 2012-13
1	2	3	4	5
Tourist arrivals	9.5	8.6	9.3	3.4
Cement	4.5	6.7	4.1#	5.4#
Steel	13.2	7.0	9.9#	2.7#
Cell phone connections (in million)$	227.3	107.6	46.8*	-5.7*
Automobile sales	16.8	11.2	12.0	3.6
Railway revenue-earning freight traffic	3.8	5.2	4.8	4.8
Cargo handled at major ports	1.6	-1.7	3.1	-3.3
Civil aviation				
Domestic cargo traffic	23.8	-4.8	-5.1*	3.8*
International cargo traffic	17.7	-1.9	3.9*	-4.3*
International passenger traffic	10.3	7.6	8.8*	3.3*
Domestic passenger traffic	18.1	15.1	18.0*	-0.5*

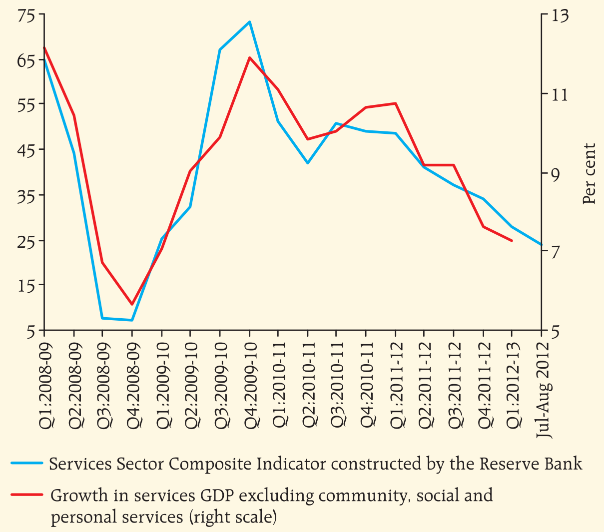
#: Data pertains to April-August.
*: Data pertains to April-July 2012.
$: Refers to wireless subscriber additions in actual numbers.
Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism, SIAM and CMIE.

and y-o-y, the latter partly due to a lower base. There was an increase in pending orders due to inability to fully meet the new orders.

Lead indicators of services sector signals moderation

I.23 At 7.4 per cent, the services sector registered its lowest growth in thirteen quarters during Q1 of 2012-13. This was largely due to the weak performance of 'trade, hotels, transport, storage and communication' sector. The contraction of the industrial sector and weak demand conditions have constrained the growth of the services sector. Leading indicators of the services sector point towards further moderation in growth going forward (Table I.5). This is also corroborated by the Reserve Bank services sector composite indicator (Chart 1.11).

Chart I.11: Services Sector Composite Indicator



Recent reform initiatives may help in turning the tide

I.24 The slowdown in the Indian economy has been due to both domestic as well as external factors. The crucial domestic factor impinging on growth was policy uncertainties and lack of reforms. Since September 2012, a number of reforms have been announced that should improve the investment climate and help attract more investment, domestic as well as foreign. The announcement of these reform measures in themselves are not sufficient to ensure recovery as their impact would critically hinge on successful implementation.