

Macroeconomic Outlook for 2011-12 and 2012-13 based on India-LINK Macroeconometric Model*

by
Pami Dua¹ & N R Bhanumurthy²

November 2011

For the year 2011-12, the INDIA LINK model revises downwards its GDP growth forecasts to 7.2% from 7.8% predicted in April 2011. This expectation of lower growth is due to the prevailing conditions in the domestic and external sectors. Since our April 2011 forecasts, two rounds of interest rate hikes following rigid inflationary conditions and debt concerns in the EU region are expected to have a negative impact on growth through holding up investments and suppressing demand conditions. However, the external sector risks are expected to be much more severe in 2012-13 and may impinge any recovery in growth. We expect growth to continue to be less than 8% in 2012-13. These trends clearly indicate that reaching the pre-crisis growth rate may take much longer time than expected.

The key forecasts are given below.

Key Economic Indicators 2008-09 to 2012-2013 (All in growth rates)

Year	2008-09	2009-10	2010-11	2011-12 (F)	2012-13 (F)
Agriculture	1.6	0.2	5.4	3.7	4.9
Industry	3.9	9.3	8.2	6.4	8.3
Services	9.8	8.5	9.4	8.3	7.8
Real GDP	6.7	7.4	8.6	7.2	7.4
WPI	8.4	9.9	8.9	7.2	6.7
Exports	3.4	-4.7	20.6	24.1	12.9
Imports	14.4	-8.2	26.6	21.1	11.3

#: Industry includes Manufacturing, Mining & Quarrying, Electricity, Gas & Water supply.

*: Forecasts from the quarterly INDIA LINK macroeconometric model.

The key assumptions for the year 2011-12 for important exogenous variables are: interest rate hike cycle to peak by third quarter of 2011-12 and then expected to move downwards from second quarter of 2012-13; stability in the MENA region (particularly when Libya

* These forecasts are developed as part of World Project LINK, maintained at the Centre for Development Economics, Delhi School of Economics.

¹ Professor, Delhi School of Economics, University of Delhi, Delhi. E-mail: dua@econdse.org

² Professor, National Institute of Public Finance and Policy, New Delhi. E-mail: nrbmurthy@gmail.com

restarts its production) to bring down world oil prices to average US\$100 per barrel; global consumer price inflation and food inflation to decelerate marginally; advanced country output to grow as per OECD projections (which is revised downwards to 1.6% and 1.5% for 2011 and 2012 respectively); a normal monsoon; and a modest recovery in foreign investment inflows in 2012-13 (especially FII flows that were negative in the recent period).

This time around, twin deficits are expected to pose substantial downside risks to growth. In the April 2011 forecasts, we assumed that the fiscal deficit would broadly follow the fiscal consolidation road map exogenously. But now the fiscal deficit has been made endogenous as there are strong reasons, in particular after the introduction of the second supplementary demand for grants in the Winter session of parliament, to believe that current year's fiscal deficit would be much higher than budgeted level of 4.6%. This is expected to have an adverse impact on private investment demand through a rise in interest rates. Another is the worsening of the current account deficit despite a sharp rise in exports in the first half of 2011-12. In a situation where the external demand outlook is pessimistic until the end of 2012 and there is limited space for Central Bank's intervention in the foreign exchange market, the depreciation of the rupee and the subsequent rise in the import cost could widen the current account deficit.

On the inflation front, thirteen rounds of interest rate hikes since March 2010 appear to have yielded little result in containing its expectations. While it is pertinent to understand the changing nature of monetary transmission and its lags (on containing demand side pressures) it is also necessary to look at the fiscal policy stance, which was expected to follow a stringent consolidation path. Above all, in our view, the current inflation is largely a combination of 'postponed' (or 'suppressed') and 'policy induced' factors that have resulted in a permanent shift in the trend inflation. With these conditions and with the assumption of a normal monsoon, inflation for the current year end is expected to be at 7.2% and for 2012-13 at 6.7%, although depreciation of the Rupee/US dollar exchange rate might pose some further risk through imported inflation.

We had said in our April 2011 report that there is a risk of current account deficit in the economy. Since then, the risk perception appears to have only increased. Outflow of FII investments, widening trade deficit and negligible FDI flows appear to put pressure on the external account. This is despite a higher interest rate differential, which is a major determinant, in favor of the Rupee. Higher and unpredictable exports growth, which averaged nearly 50% for the first half of 2011-12, appears to be unsustainable in the rest of the year due to a deterioration in the external demand. For the whole year, our model predicts exports growth of 24.1%. On the other hand, imports are expected to continue to grow at around 20%.

On the supply side, following a normal monsoon, agriculture output is expected to grow above its trend level. But it is not clear if there is any supply response due to sustained higher food prices. On the industrial front, demand conditions (both domestic and external) appear to start pulling down the growth. But more concern is on the liquidity conditions in the banking sector, which might hamper credit flow to industrial sector. In

addition to this, ambiguity in the mining regulations and uncertain outlook could result in negative growth in both the mining and capital goods sector. Overall, industry growth is expected to decline to 6.4% from 8.2% last year. But in 2012-13, we expect a recovery as we assume downward movement in the interest rate cycle. Following the trend in the industrial sector, services sector growth is also expected to decline to 8.3% in 2011-12. Although 2011-12:H1 has seen services growth of 8.8%, the deceleration in the construction sector (2.7% in 2011-12:H1 compared to 7.2% in the previous year), which is expected to deepen further in the rest of the quarters, could pull down the overall services growth. But in 2012-13, the decline could be larger and our model predicts a growth of 7.8%, which may be the lowest in a decade.

Thus, based on the recent developments in both the domestic and international markets, GDP growth in 2011-12 is expected to see a decline to 7.2% and 7.4% for 2012-13. As the external conditions are not conducive for higher growth, in the medium term there is a need for shift from export-led strategy to domestically driven growth with more reforms that reduce supply bottlenecks. The recent policy of relaxing FDI limits for Retail is in that direction and would have a long term impact on output.