Confederation of Indian Industry

Economy Watch

July 2011 | Volume 16 | No. 4

TRACKING TRENDS

CONTENTS

FOREWORD

Uncertainties in the global economy have increased recently – concerns about a debt crisis in the advanced economies namely US and the peripheral EU economies, high inflation and monetary tightening in the emerging nations and high international crude oil prices on account of the Middle Eastern strife have all added to concerns that global economic growth will slacken in the coming months.

Back at home, the RBI's 50 basis point increase in policy rates in the first quarter review of monetary policy has dampened business sentiment. This came at a time when there are increasing concerns about a slowdown in investment and economic growth. Signs of moderating economic growth are clearly visible, as seen in the data on overall factory output as well as on core sectors. Other indicators such as the PMI Manufacturing Index and Automobile Sales are also showing decelerating trends. In fact, the Prime Minister's Economic Advisory Council (PMEAC) has cut GDP growth forecast for 2011-12 to 8.2% from 9.0% projected earlier.

Both consumption and investment demand are likely to take a hit in the coming months as a result of the central bank's continuance of a tight monetary stance. Given the current macro-economic scenario, CII has called for supply side measures to boost economic growth. It is important that the Government focuses on regulatory and procedural measures, especially relating to environmental clearances and land acquisition, to give a push to investment. The passage of pending legislations in areas such as financial sector and taxation would also give a boost to the investment climate.

Chandrajit Banerjee
Director General, CII

GLOBAL TRENDS

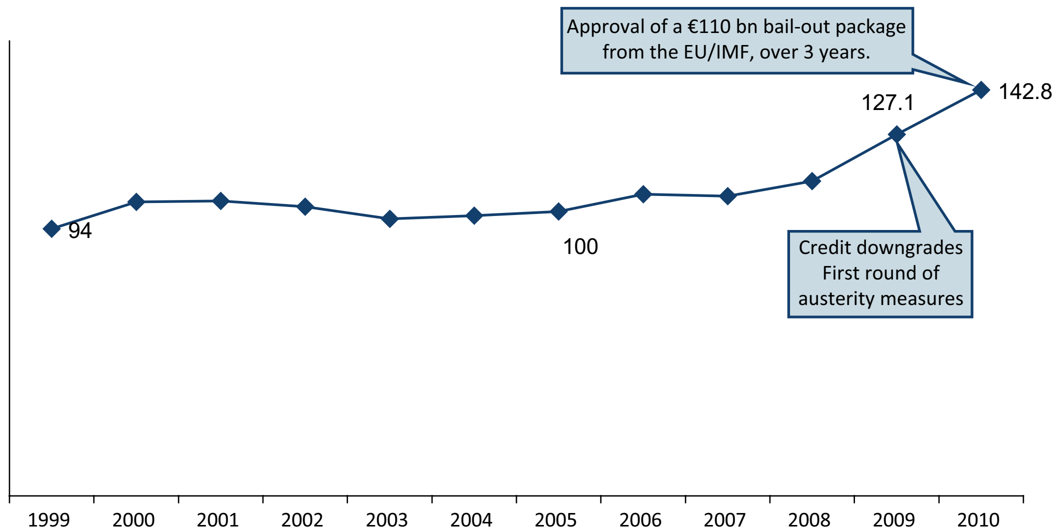
Introduction

The mounting debt crisis in the US and in peripheral EU economies particularly Greece in the last couple of months suggest that the global crisis is not yet over. Huge debt beyond sustainable levels in these economies has been posing three major challenges for the world economy – growth moderation, social instability and escalation in sovereign debt. All these challenges are intertwined and need to be resolved together with tough policy measures with respect to fiscal management and fiscal prudence to ensure robust and balanced global economic growth.

Greece Debt Crisis

Early months in 2011 have seen fresh attempts by Greece as well as the European Union along with the IMF to put in place measures to assist Greece in effectively dealing with its debt crisis. As part of the €110 billion ($145 billion) rescue package approved in 2010 (with IMF contributing €30 billion and the European Union contributing €80 billion), Greece has received a fresh round

General government gross debt (% of GDP)



Source: Eurostat

of funds. This payment will assist the country in avoiding the immediate threat of default.

The current €110 billion loan extended by the euro area countries and the International Monetary Fund (IMF) is set to expire in 2013. Following this, Greece would still require funds before it can put its debt ridden economy back on track. Although, Greece has been able to avoid the threat of default, this is a largely temporary accomplishment. It must be noted that financial assistance needs to be accompanied by strict implementation of austerity measures including improving tax collections, longer working hours and aggressive pension reforms, to have a lasting impact. Amidst protests, Greece has not been able to implement its austerity measures effectively. Analysis shows that gross debt has been increasing as a share of GDP with levels over 100% in recent years, far exceeding sustainable levels. This trend clearly raises questions with regard to the efficiency of governance in Greece and further raises doubts on the ability of the economy to return to a sustainable path without external assistance.

Austerity Drive

In order to deal with its burgeoning debt as well as to be eligible for funding, Greece has adopted a large number of austerity measures. The focus of the latest round of austerity measures has been on public sector spending cuts, higher taxation levels and privatization of government holdings.

Main Expenditure Cuts and Tax Measures

Expenditure Cuts	Tax Measures
Nominal public sector wages	Excise tax raised on fuel, cigarettes, alcohol
Wages of state owned enterprise employees	VAT rates increased across the board
Nominal pensions	Special levies on high income firms and individuals, high value real estate.
Public sector fixed term contracts	

Source: Ministry of Finance, Greece

Going forward, attention is being paid to dealing with the country's mounting debt rather than just staving off a financial crisis. A rollover of debt by encouraging private investors to exchange their maturing debt for debt with longer maturities as well as reinvest proceeds from Greek government bonds maturing over the short term, may be some of the immediate measures possible. Involvement of sovereign wealth funds in the buying of Greek debt may prove to be another way of reducing debt pressures on Greece.

Conclusion

Besides passing fiscal stimulus measures, economies in general may lower policy rates or devalue the exchange rate in order to boost the economy. As part of the Euro Area, Greece is not able to adopt any of these paths. On the one hand, if Greece were to exit the euro and adopt its independent currency, it would have the opportunity to devalue its currency, significantly leading to cheaper exports and a boost to growth. However, this would not be a viable option as not only would this lead to large scale political implications, introducing a new currency into the global monetary and financial systems would prove to be a Herculean task. As a result, Greece needs to adopt measures that deal with its mounting debt crisis in order to avoid a spillover into the larger world economy. A mix of funding, austerity measures and incentives to private creditors looks to be the way forward. In addition, Greece would be required to monitor key economic indicators and policy developments closely - possibly engaging an external monitoring body, so that policymakers continually have a realistic assessment of the existing situation.

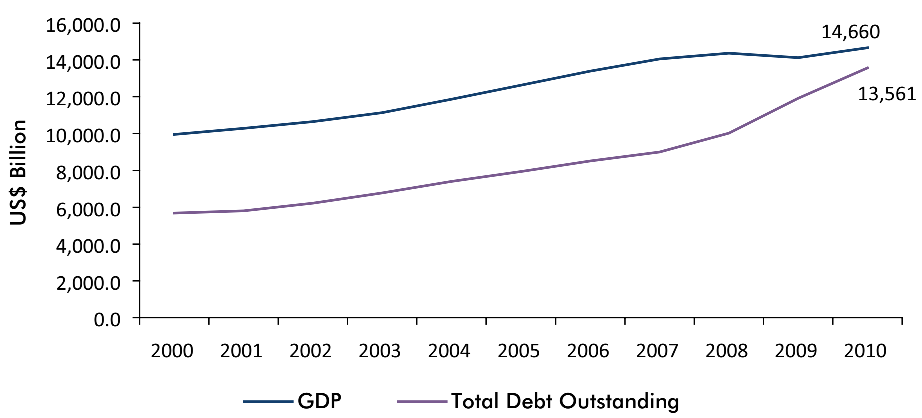
US Economy

USA's economy has experienced low growth levels since the recession - GDP grew at 3.8% in 2010 – although this is an improvement over its decline of 1.7% in 2009, it is still not adequate to pull the country out of recession. Furthermore, lead economic indicators have shown little optimism in the past months. Personal Income and Outlays rose 0.3% in May 2011 over the preceding month whereas Personal Consumption Expenditure registered a fall of 0.1% in May 2011, on a month on month basis. The employment situation continues to provide more evidence of the weak state of the economy. The unemployment rate edged up to 9.2% in June, with 14.1 million persons unemployed. Since March, the national average unemployment rate has risen 0.4 percentage points and the number of unemployed persons has jumped by 545,000. The overall size of the labor force shrunk to 153.4 million due to the departure of 272,000 discouraged workers. Although housing indicators showed some positive movement they still remained depressed - NAHB's Housing Market Index rose marginally and housing starts were up 14.6% in June.

Addressing the burgeoning debt will be the priority for policymakers and thus the Government has been making an effort to raise the debt ceiling level - this however, has been met with opposition by the Republicans – they demand the Government make large scale spending cuts in the present and future, in order to garner support to raise the debt ceiling level.

As per latest figures released by the US Department of Treasury, total debt outstanding as on June 30th 2011 stood at US$14.3

Trends in US GDP and Total Debt Outstanding

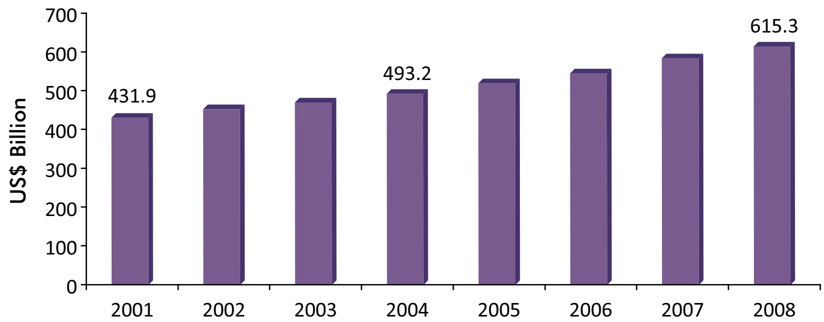


Source: Bureau of Economic Analysis

trillion. Debt levels have reached their ceiling limit of US $14.29 trillion and in the scenario of America not servicing its obligations by August the country would be unable to avert a technical default on its debt.

Inability to increase the debt ceiling would lead to the government defaulting on a large number of legal obligations including Social Security, Medicare and Medicaid, military spending and interest payments on national debt. The United States has witnessed increasing payout of benefits over the years – with an aging population and prevailing economic conditions, these payouts are becoming increasingly important and difficult to sacrifice for the citizens.

Total Retirement Benefits



Source: US Soacial Security Administration

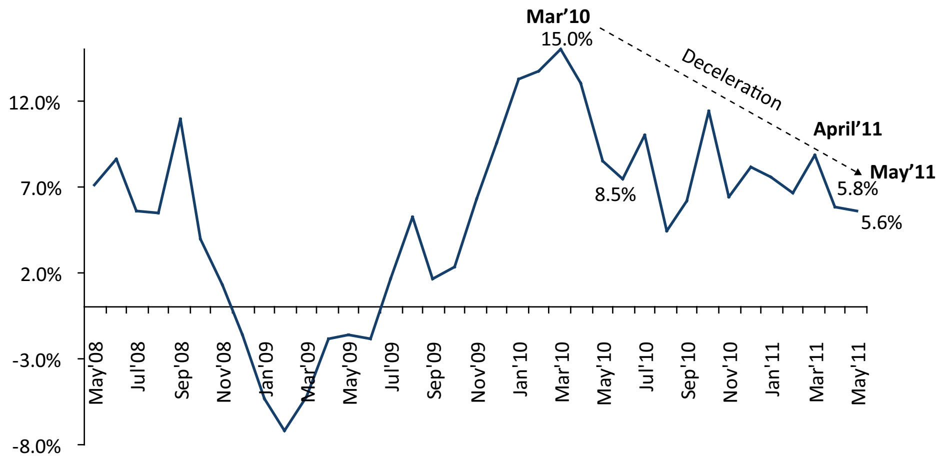
Further, inability of the United States to service its debt would also lead to a rise in interest rates across the board, a decline in the value of the dollar as the world's reserve currency and a credit downgrade for the country. Thus, simply raising the debt ceiling may not prove to be effective, rather the adoption of a credible plan involving rational spending cuts and plugging tax loopholes to jumpstart economic efficiency and deal with its US$14.3 trillion worth of debt would be the way forward.

May IIP Growth at 5.6% confirms Industrial Slowdown

IIP Growth at a Nine-Month Low

The latest data on Industrial Production (IIP) released by MoSPI, confirms that industrial growth slowed down further in May 2011, when IIP growth slipped to a nine-month low. The IIP growth figure for April 2011 was also revised downwards to 5.8% from 6.3% estimated initially. The decline in the growth of industrial production is a result of various factors on the demand as well as supply side. On one hand, inflation and tight monetary policy stance has restricted consumer demand whereas on the other, rising operating costs for corporates have restricted their profit margins thus limiting their capacity to reinvest.

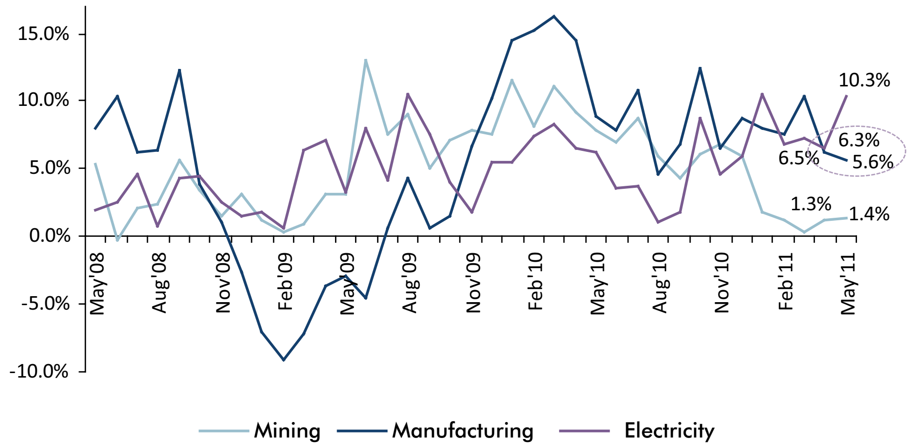
Index of Industrial Production



Source: MoSPI

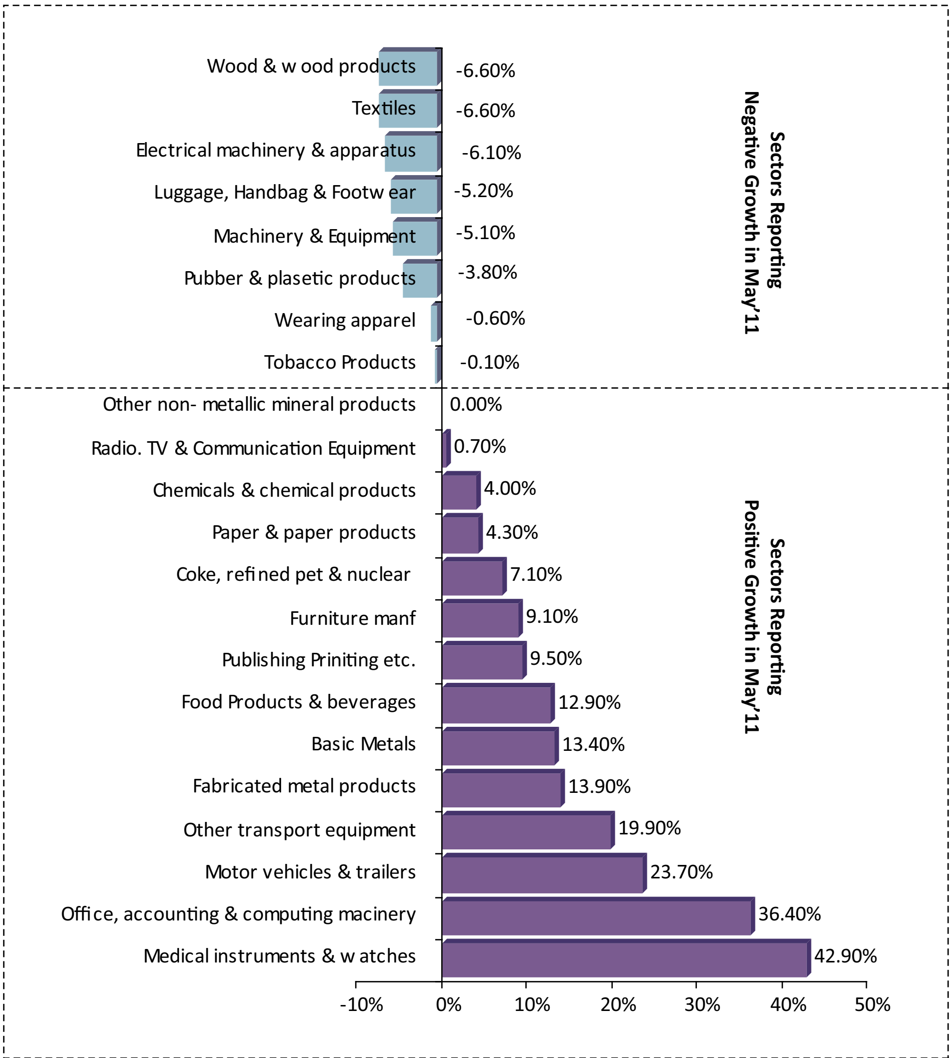
Among the broad sectors, the manufacturing and mining sectors performed poorly while electricity grew at a strong rate of 10.3%. Mining also failed to take off; expanding at 1.4% in May 2011 as compared to 7.9% during the same time period a year ago while manufacturing grew at 5.6%.

IIP Growth by Sectors



Source: MoSPI

Y-O-Y IIP Growth in May'11 (2-Digit Level)



Source: MoSPI

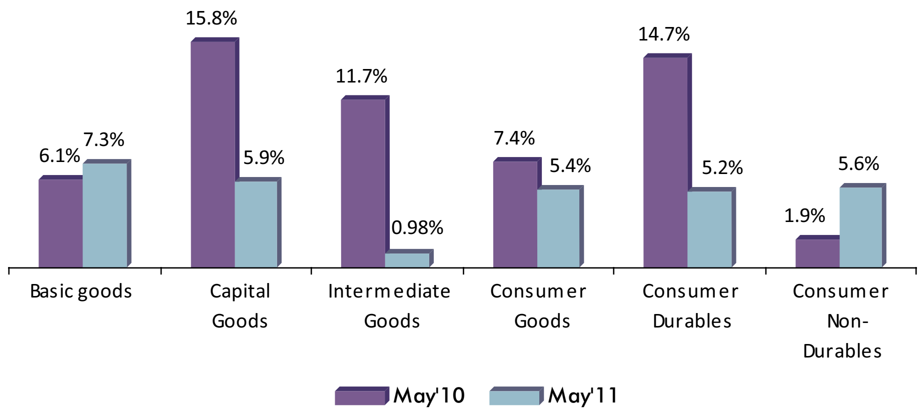
The 2-digit classification shows a fair amount of diversity in the performance across sectors. 8 out of 22 manufacturing sectors reported negative growth in May 2011 as compared to May 2010 when 7 sectors grew at double digit rates.

Slowdown in Capital & Intermediate Goods

What is more worrisome is the slowdown in intermediate goods, such as raw materials. This implies that industry is not stocking these inputs, probably in anticipation of a drop in demand in the near future. As a result, there are concerns that manufacturing growth would further slowdown.

Besides, growth of capital goods segment also moderated. Deterioration in the performance of capital goods sector indicates a moderation in investments, possibly due to decline in business sentiment. Given that capacity utilisation is quite high across many sectors, a slow pace of capacity expansions has kept industrial growth subdued.

IIP Growth based on Use-Based Classification (Y-O-Y)



Source: MoSPI

Q4 2010-11 registers reduction in Current Account deficit

Current Account Deficit

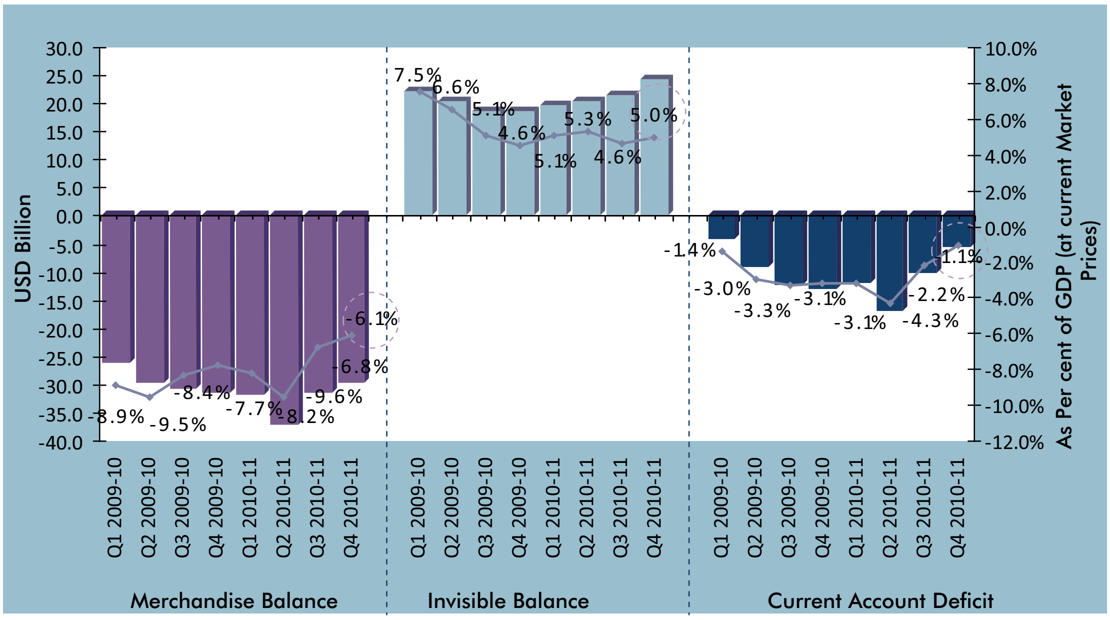
The latest data on developments in India's Balance of Payments by RBI shows that Current Account Deficit (CAD) narrowed sharply in Q4 2010-11. This can be attributed to healthy merchandise exports coupled with a turnaround in net invisibles surplus.

Exports grew at healthy 47.1% in Q4 2010-11 on y-o-y basis; much higher than the imports growth of 27.4%. This resulted in moderation of trade deficit from USD 31.6 billion Q4 2009-10 to USD 29.9 billion by Q4 2010-11. The increase in merchandise exports can be attributed to rising global demand, high commodity prices and opening up of new markets such as Africa for Indian exports. In addition, services exports experienced robust growth led by travel, transportation, software, business and financial services.

Net private transfer receipts remained buoyant, but the net outflow on account of investment income increased compared to the previous year. Consequently, net invisibles balance in Q4 2010-11 increased to USD 24.5 billion as against USD 18.5 billion during the same period last year.

As a result, CAD narrowed to USD 5.4 billion in Q4 2010-11 compared to USD 12.8 billion in the corresponding quarter of the previous year. It also moderated in comparison to the previous quarters of the same year.

Quarterly Current Account Balance



Source: RBI

For the financial year 2010-11 as a whole, despite improvement in net invisibles surplus, higher trade deficit led to increase in absolute size of CAD. Trade deficit widened to USD 130.5 billion (7.5 % of GDP) during 2010-11 from USD 118.4 billion (8.6 % of GDP) a year ago, mainly due to higher absolute increase in imports relative to exports on the back of robust domestic economic performance.

Where as, Net invisibles earnings increased from USD 80.0 billion to USD 86.2 billion during the same time period. As a result, CAD increased from USD 38.4 billion in 2009-10 to USD 44.3 billion in 2010-11. However, as a proportion of GDP, CAD was marginally lower than the preceding year. It came down from 2.8% of the GDP in 2009-10 to 2.6 % in 2010-11.

Annual Current Account Balance (USD Billion)

	2008-09	2009-10	2010-11
1. Exports	189.0	182.2	250.5
2. Imports	308.5	300.6	380.9
3. Trade Balance (1-2)	-119.5	-118.4	-130.5
4. Invisibles, net	91.6	80.0	86.2
5. Current Account Balance (3+4)	-27.9	-38.4	-44.3

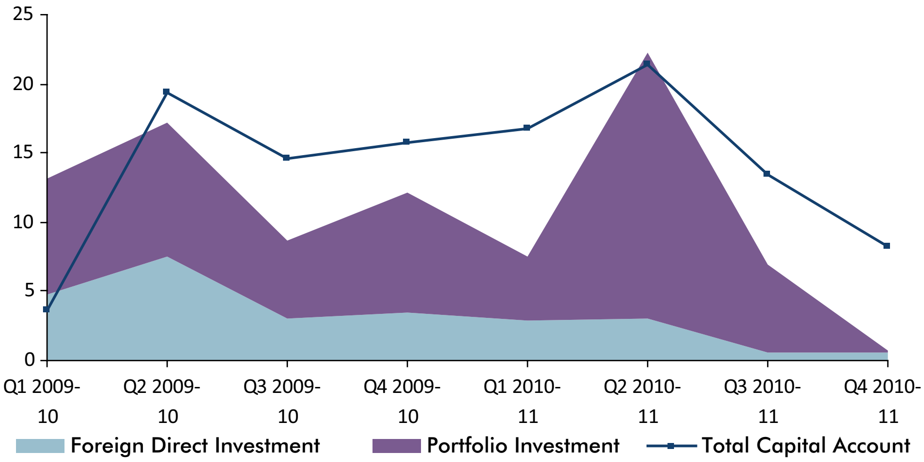
Source: RBI

Capital Account

Though the current account data came in as a positive surprise, capital account surplus witnessed moderation in Q4 2010-11. This is primarily attributed to lower Foreign Direct Investment (FDI) and portfolio inflows (FIIs). Net FDI inflows to India (inward FDI minus outward FDI) moderated to USD 577 million during Q4 of 2010-11 as compared to USD 3.4 billion in the corresponding quarter of last year.

At the same time, there was significant increase in the overseas investment by Indian corporates. FIIs pulled out their investments on macroeconomic concerns such as inflation, rising crude prices etc.

Quarterly FDI, Portfolio Investment & Capital Account Balance (USD Billion)



Source: RBI

Annual Capital Account & Overall Balance (USD Billion)

	2007-08	2008-09	2009-10	2010-11
1. Foreign Investment (a+b)	43.3	5.8	51.2	37.4
a) Foreign Direct Investment (i+ii)	15.9	19.8	18.8	7.1
i) In India	34.7	37.7	33.1	23.4
ii) Abroad	-18.8	-17.9	-14.4	-16.2
b) Portfolio Investment	27.4	-14.0	32.4	30.3
i) In India	27.3	-13.9	32.4	31.5
ii) Abroad	0.2	-0.2	0.0	-1.2
2. Loans	40.7	8.3	13.3	27.9
3. Banking Capital	11.8	-3.3	2.1	5.0
4. Rupee Debt Service	-0.1	-0.1	-0.1	-0.1
5. Other Capital	11.0	-4.0	-13.0	-10.4
Total Capital Account (1to5)	106.6	6.8	53.4	59.8
Overall Balance	92.2	-20.1	13.4	13.1

Source: RBI

However, in Q4 2010-11, the capital account surplus exceeded the current account deficit, resulting in an overall surplus of USD 2.0 billion. Accounting for valuation changes, the foreign exchange reserves increased by USD 2.0 billion during the quarter.

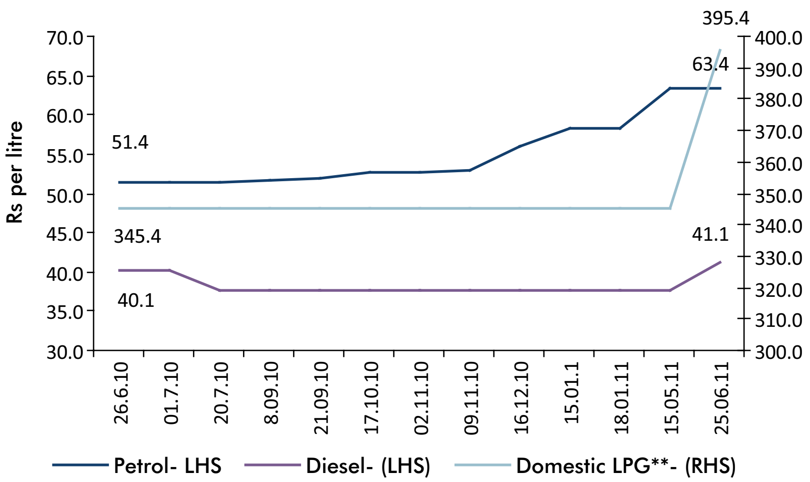
For 2010-11 as a whole, Net Capital Inflows increased from USD 53.4 billion in 2009-10 to USD 59.7 billion mainly driven by external assistance, short-term trade credits, ECBs and banking capital. Although net capital inflows were higher, the overall balance during 2010-11 was marginally lower as a larger share of increased flows was absorbed by the widened current account deficit.

Retail Fuel Price Hike: The Unavoidable Imperative

Retail Fuel Price Hike- The Recent Move

Government of India hiked the petrol price by Rs 5 per litre in May followed by increase in the diesel price by Rs 3 per litre, LPG by Rs 50 per cylinder and kerosene price by Rs 2 per litre on June 24th 2011. This implies an increase of 9% in retail petrol price, 16% in kerosene price, 9% in diesel price and 14% increase in LPG price over the previous price.

Revision in Retail Selling Prices of Petroleum Products at Delhi



Price Hike since June 2010

Petrol 23%

Diesel 3%

LPG 14%

Latest Price Hike since Previous Revision

Petrol 9%

Diesel 9%

LPG 14%

Source: PPAC

In addition, government entirely eliminated the customs duty on crude oil, reduced the customs duty on products to the corresponding extent and drastically reduced the excise duty on diesel.

Latest Retail Price Hike and Revision in Duties, 24th June 2011

	Revisions	Impact
Customs Duty		
Crude Oil	Reduced from 5% to nil	Revenue loss of 26,000 crore
Petroleum products	Reduced by 5%	
Excise Duty		
Diesel (HSD)	Reduced from Rs 4.60/litre to Rs 2/litre	Revenue loss of Rs 23,000 crore
Retail Price		
Diesel	Increased by Rs 3/litre	Reduce the under-recoveries of OMC by Rs 21,000 crore
PDS Kerosene	Increased by Rs 2/litre	
Domestic LPG	Increased by Rs 50/cylinder	

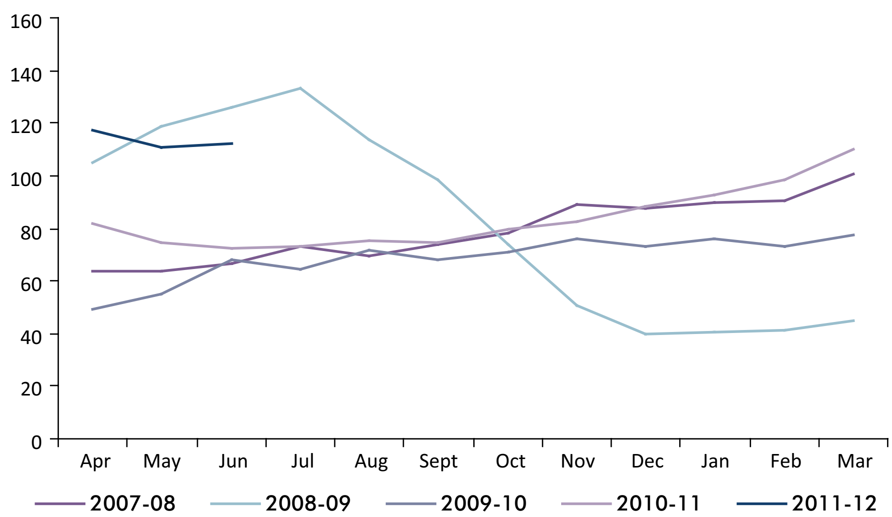
Source: MoPNG Press Release, 24th June, 2011

The Rationale

Rise in International Crude Oil Price- The Challenge

Hike in retail prices of major petroleum products in India was an attempt to pass on the burden of rise in international crude oil price to the end consumer. International crude oil prices have spiraled in the last one year. The Spot FoB price went up from USD 72.65 per barrel in June 2010 to USD 112.44 per barrel in June 2011; implying an increase of more than 50%.

Crude Oil Spot Price FOB Weighted by Estimated Export Volume (USD/ barrel)



Source: EIA

Significantly high crude oil price in the range of USD100-110/bbl in the international market and India's high dependence on oil imports pose significant policy challenges. At present, the country is facing the dilemma of who should bear the burden of high international oil prices and at the same time not affect the macroeconomic situation. For an oil importing nation like India, the impact of high oil prices would either be borne by the government, upstream and downstream oil companies or the consumer. If the government decides not to raise the retail oil prices, then it will have to compensate the same with an increase in subsidies. This increase in subsidies necessitates a need to increase government borrowing resulting in fiscal deficits. If a part of the burden is borne by the oil companies, it would lead to reduced profit margins for these companies. If the prices are allowed to increase in the retail market, the consumer is directly affected due to inflation.

Retail Price Situation before the Recent Hike

When the crude oil price is USD 110 per barrel in the international market, domestic retail price of petrol should be Rs 63.51 per litre, diesel Rs 51.45 per litre, kerosene Rs 41.14 per litre and LPG Rs 655.42 per cylinder as per the Report of The Expert Group on "A Viable and Sustainable System of Pricing of Petroleum Products" (Feb 2010). However prior, to the May 2011 hike in petrol retail price and June 2011 hike in diesel, kerosene and LPG retail price, retail petrol price were 92%, diesel retail price 73%, kerosene prices 31% and LPG prices 53% of the indicative retail price in Delhi.

Domestic Retail Price of Petroleum Products Derived from International Prices

International Prices					Indicative Retail Selling Price (at Delhi)			
	(USD/ barrel)			(USD/MT)	(Rs/ litre)			(Rs/ Cylinder)
Crude Oil	Petrol	Diesel	Kerosene	LPG	Petrol	Diesel	Kerosene	LPG
60	66	70	72	538	43.8	32.2	23.8	455.4
70	77	81	83	595	47.7	36.1	27.3	495.4
80	88	93	94	652	51.7	39.9	30.8	535.4
90	99	104	106	709	55.6	43.8	34.2	575.4
100	110	115	117	765	59.6	47.6	37.7	615.4
110								
121	127	128	822	63.5	51.5	41.2	655.4	
120	132	138	140	879	67.5	55.3	44.7	695.4
130	143	149	151	936	71.4	59.1	48.1	735.4
140	154	161	162	993	75.4	63.0	51.6	775.4
150	165	172	173	1049	79.3	66.8	55.1	815.4
Retail Price Before the Recent Hike					58.4	37.8	12.7	345.4

Source: Report of The Expert Group on A Viable and Sustainable System of Pricing of Petroleum Products (Feb 2010).

Prior to the recent retail price hike of all four major petroleum products, petrol prices had increased just by 13% and kerosene by 3% since June 2010 whereas, LPG prices remained constant and diesel prices infact declined by 6% since June 2010. This implies that the rise in international crude oil price was not being passed on to the consumer in the form of an increase in the retail price of major petroleum products such as petrol, diesel, kerosene and LPG.

Revision in Retail Selling Prices of Petroleum Products at Delhi (Rs./Litre/Cylinder)

Revision Date	Petrol	PDS Kerosene	Diesel	Domestic LPG*
As on 01.04.10	47.9	9.3	38.1	310.4
26.6.10	51.4	12.3	40.1	345.4
01.7.10	51.5	12.3	40.1	-
20.7.10	-	-	37.6	-
8.09.10	51.6	12.3	37.7	-
21.09.10	51.8	12.3	-	-
17.10.10	52.6	12.3	-	-
02.11.10	52.6	12.4	37.8	-
09.11.10	52.9	-	-	-
16.12.10	55.9	-	-	-
15.01.11	58.4	-	-	-
18.01.11	-	12.7	-	--
15.05.11	63.4	-	-	-
25.06.11	-	14.8	41.1	395.4

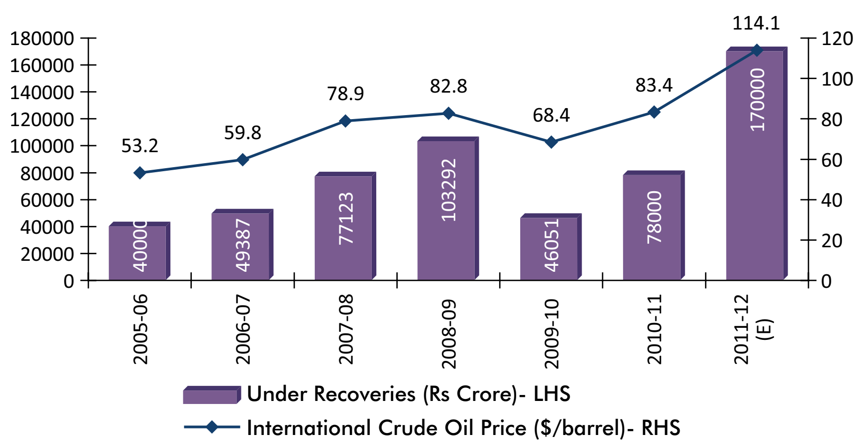
Source: PPAC

Note: *After considering Delhi State Government subsidy of Rs.40 /Cylinder, which has been withdrawn effective 1.4.10.

Under-Recoveries of OMCs

As India imports about 80% of its crude oil requirement, international oil prices play a decisive role in the domestic pricing of sensitive petroleum products. OMCs pay Trade Parity Price to refineries when they buy Diesel, and pay Import Parity Price for PDS Kerosene and Domestic LPG. Accordingly, they ought to fix retail prices based on this cost. However, the retail prices, which are modulated by the Government, are generally lower. The difference between the required price based on Trade Parity / Import Parity and the actual selling price realized (excluding taxes and Dealer's Commission) represents the under-recoveries of OMCs.

Under Recoveries of OMCs



Note: Crude oil prices in 2010-11 is average of Apr- June 2011

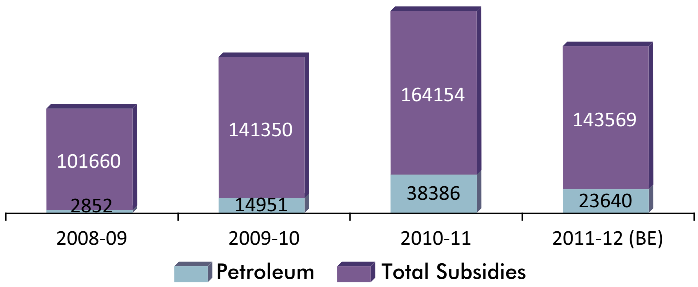
Source: PPAC & EIA

In tandem with the steady increase in international oil prices, the OMCs' under-recoveries have also been rising. In 2010-11, the under recoveries of oil companies were around Rs 214 per day translating into Rs 78,000 crore for the whole year. Out of that they received support of around Rs 41,000 crore (nearly 52%) from the government. However this year the daily under recovery is already Rs 460 crore per day. For the year 2011-12 under recoveries are expected to be Rs 170,000 crores.

Rise in Subsidy Bill

50 % of the under-recoveries would imply additional subsidy support of Rs 85,000 crores which is not feasible in the present circumstances. Union Budget 2011 had assumed the overall subsidy bill to fall by 12.5% and had budgeted a fall of 9.1% in fertilizer subsidy and a huge 38.4% fall in petroleum subsidy. However, this appears unrealistic given the present situation. In the Budget speech, the Finance Minister had stated that the government would avoid issuing bonds in lieu of subsidies to oil and fertilizer companies. Thus, all subsidies related liabilities will come under the fiscal accounting which would have serious implications for the fiscal health of the economy.

Subsidies of the Central Government (Rs Crore)



Source: PPAC

Implications of Recent Retail Fuel Price Hike

Government hopes to cut down on its ballooning subsidy bill with the recent price hike move which is understandable in the present macro-economic conditions. However, diesel accounts for 40 % of petroleum product demand in India and is the most widely used transport fuel in addition to fueling tractors and irrigation pumps for farmers. Thus, with inflation in India above 9 % and diesel price up by nearly 8 % on the year, the inflationary implications of the diesel price hike are unavoidable. Broadly, with inflation currently at around 9 %, the hike in prices would bolster the WPI (wholesale price index) into double digits again. Taken together, the recent revision is expected to directly add about 55 basis points to headline inflation.

RBI Raises the Repo Rate by 50 Basic Points

In the First Quarter review of the monetary Policy 2011-12 on July 26th 2011, RBI raised the repo rate under the liquidity adjustment facility (LAF) by 50 basis points, taking it from

7.5% to 8.0%. The reverse repo rate accordingly adjusts to 7.0%; determined with a spread of 100 basis points below the repo rate. Since the onset of 2010-11, the repo rate and reverse repo rate has been raised by 275 basis points in ten moves.

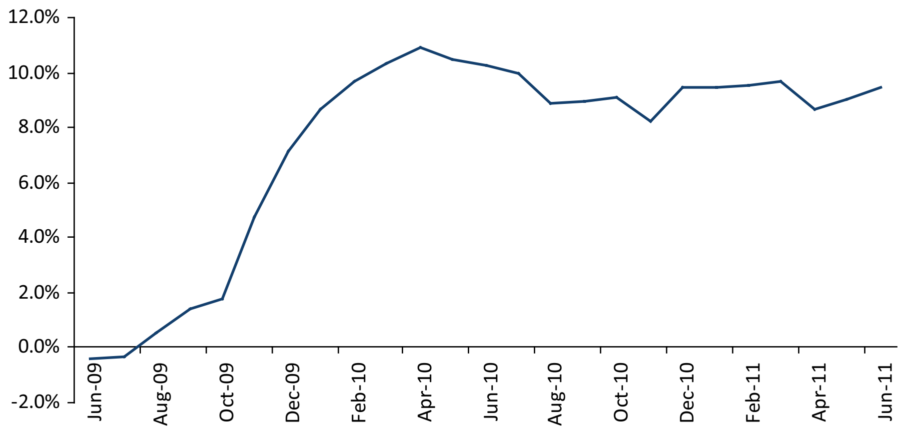
Effective Date	Repo rate	Reverse Repo rate
20-Apr-10	5.25	3.75
24-Apr-10	5.50	4.00
27-Jul-10	5.75	4.50
16-Sep-10	6.00	5.00
2-Nov-10	6.25	5.25
25-Jan-11	6.50	5.50
17-Mar-11	6.75	5.75
3-May-11	7.25	6.25
16-Jun-11	7.50	6.50
26-Jul-11	8.00	7.00

Source: Compiled from RBI Press Releases

Controlling Inflation- RBI's Rationale behind the Move

RBI intends to maintain an interest rate regime that moderates inflation and anchors inflation expectations. Inflation has been persistently high remaining at unacceptable levels. June Wholesale Price Inflation (WPI) rose to an annual 9.4 % from 9.1 % in May, driven by higher prices for fuel and manufactured goods. Inflation is further expected to be under pressure in the coming months due to the recent increase in domestic administered retail fuel prices and minimum support price for certain food items.

WPI Inflation (Y-O-Y Growth)



Source: Office of the Economic Advisor

In a regime of rising interest rates, there are signs that the economic growth has started moderating, particularly in some interest specific sectors. However, the slow down is not broad-based. Several macro-economic indicators such as; exports, imports, indirect tax collections, corporate sales, demand for bank credit indicate that demand is moderating but slowly.

Downside Risks To Growth Have Increased

- A tight monetary policy stance being followed since 2010 has had limited success in moderating inflation; on the contrary, industrial, economic and investment growth has starting decelerating. Any increase in interest rate in such a scenario is very likely to affect the growth momentum in the country. There are concerns that the economic slowdown may have reached a tipping point beyond which salvaging a downward spiral of growth could be an arduous task.

- Further, domestic demand which has held up well in recent times would also come under pressure. Some signs of stress are now emerging on domestic demand, especially in sectors where leverage is prevalent. These include automobiles, consumer durables as well as housing. Another concern is that although agricultural output is likely to grow well in view of the normal monsoon, agricultural incomes may not increase at the same pace. This is because prices of grains are falling below the MSP due to a bumper harvest combined with a lack of storage space.

- Moreover, sustaining the high export growth would also be a challenge in the ongoing financial year. It should be noted that the export sector in India is dominated by small and medium enterprises (SMEs) which will be disproportionately affected by the rise in interest costs. High cost of credit for exporters would make it really difficult for Indian exporters to compete with contiguous countries where interest rates range from 1-5 % and where exports are zero rated.

- Investment activity in the industrial sector is already slowing down on account of rising cost of capital, lack of decision making on large infrastructure projects and rising cost of raw materials. The risk appetite for capital expenditure is down and the decision-making process in the government has slowed down. Any slowdown in investment activity would imply a further deceleration of industrial sector on one hand and a supply mismatch on the other; again adding to inflation.

Monetary tightening needs to be reinforced by supply side measures that will help expend industrial capacity across sectors. Thus, investments are needed in the storage and distribution of food products which will have a moderating impact on food inflation. In the absence of such policy reforms, monetary policy alone will not be effective in containing inflation.

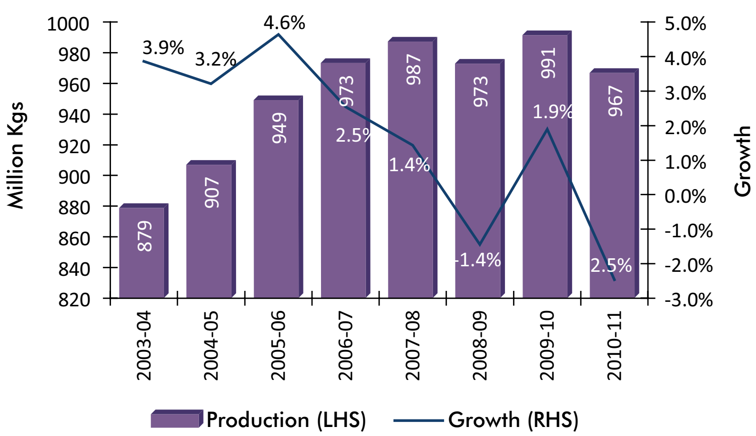
SECTOR IN FOCUS: TEA

Tea is mainly produced in most tropical countries in Asia, South America and Southern Africa. In Asia, India, Sri Lanka, China, Vietnam, Japan and Indonesia are some of the leading tea producing countries. India and Sri Lanka produce most of the black tea while the other countries produce green tea and their varieties. Overall, India is the second largest tea producing country after China; accounting for 23.8% of the world's tea production in 2010. More than 5.8 lakh hectares of land is under tea cultivation in the country.

Production & Consumption

Tea is grown in 16 States in India, of which, Assam, West Bengal, Tamil Nadu and Kerala account for about 96% of the total tea production. Tea originating from Darjeeling, Assam and Nilgiris are well known for their distinctive quality the world over. Production of tea in the country has increased at a slow pace (CAGR of 2.03% during 2003-04 to 2009-10); tea production rather dropped by 24 million kgs in 2010-11.

Tea Production in India



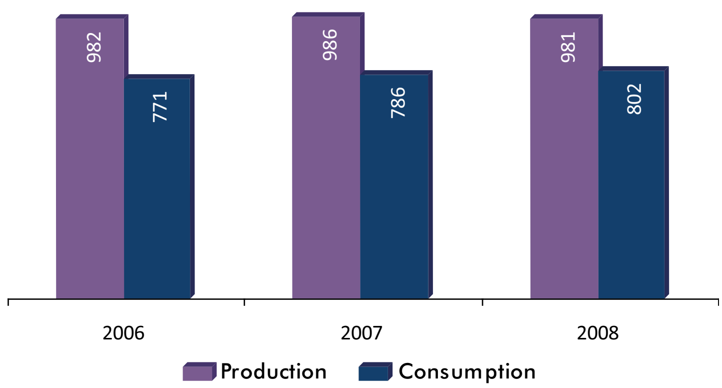
Source: Tea Board of India

Slow increase in tea production is mainly attributed to declining productivity of tea. It has been observed that Assam, the largest tea producer has recorded significant fall in productivity because of poor infrastructure namely; poor road conditions, drainage, lack of irrigation facilities, frequent and prolonged power cuts, dilapidated factories and machinery, and lower productivity of labor on account of large tracts of land in between tea estates remaining barren as cultivators do not have enough funds to replant uprooted tea bushes. In 2010-11 as well, the major reason for decline in national tea production is the decline in production in the Assam valley. Considering that total Indian tea production has been traditionally dependent on the rate of production in the Assam valley, any fall in the tea production in Assam valley has a major and adverse effect on the total tea production in the country.

Another important factor that has contributed to the fall in productivity is the growth of small tea producers (area up to 10.12 hectare) who have relatively limited technical know how about tea production as compared to large tea plantations. It is observed that for the period 2000-07 small tea growers showed a CAGR of 5.2% while big planters recorded a mere 0.6% CAGR. Poor quality of tea produced by these small tea growers due to lack of access to new technology, poor infrastructure, lack of knowledge about international quality standards etc has also resulted in declining quality of tea produced by India.

However, on the demand side, India is the largest consumer of tea in the world. The country consumes more than 80% of the domestically produced tea and exports the rest. India being a populas country has a high intake of tea. It is also attributed to the fact that tea is one of the cheapest beverages available in the country. These two factors have kept demand for tea in India high.

Quantity of Tea Produced & Consumed (Million Kgs)



Source: Tea Board of India

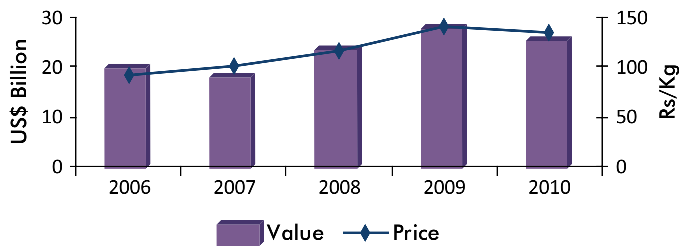
Exports

In line with production, India's tea exports have also been declining. In volume terms, tea exports from India have declined at the rate of -2.4% during 2006-10. However, in value terms it has increased at a CAGR of 5.3% during the same time period. This is primarily attributed to rising unit price of tea in the international market. Historical data shows that the prices received in the international market have always been higher than the prices in the domestic auctions. This is primarily because the quality of tea sold in the international market is much higher than the tea sold in the domestic market.

However, despite India being the fourth largest exporter of tea in the world, it has been loosing its competitive edge due to the poor quality of tea exported. The reason for deteriorating quality of Indian tea in the export market is that India has been importing poor- quality tea from countries like Nepal, Kenya, Indonesia, Vietnam, China etc. for re-export purposes. This has tarnished India's image in the international tea market. In order to attain its previous position of top exporter, India needs to introduce drastic changes in the present structure of the Indian tea industry, in order to boost the productivity of tea and accrue the benefits from the export market.

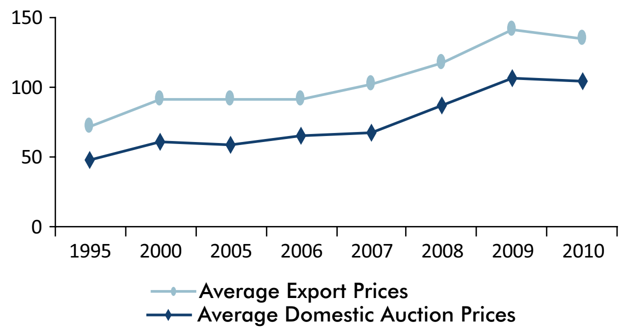
India exports the bulk of its tea produce to the CIS countries; largely to Russia followed by UAE, and UK.

Export of Tea Value Terms and Unit Price of Tea



Source: Tea Board of India

Export and Domestic Auction Prices (Rs/Kg)



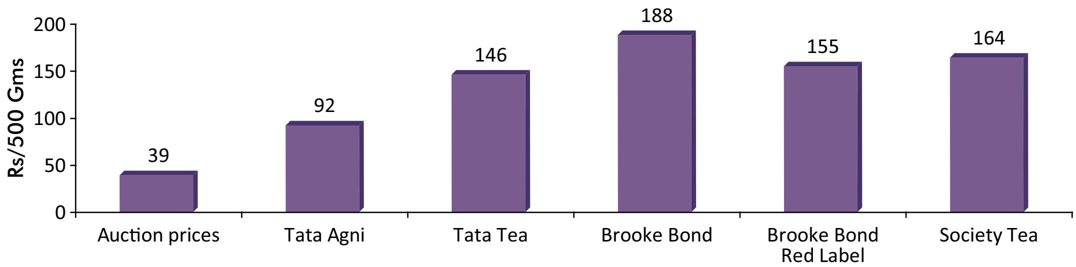
Source: Tea Board of India

Tea Supply Chain and Product Diversification

The tea supply chain can be characterized as a vertically integrated production chain whereby companies control various stages of production upstream and downstream. Analysis of the tea supply chain reveal that the North –South divide in the tea trade from the colonial days persists till date. Plucking and primary processing such as withering, rolling, drying, grading and bulk packing is carried out in the tea producing developing countries. Whereas, blending, packaging and marketing which is the most lucrative part of the tea trade is mostly carried out by tea companies in buyer developed countries such as UK. The largest proportions of the profits therefore do not accrue to the poor tea-producing countries but are made abroad by a handful of multinational companies. Most of the tea sold in bags and other forms in the West are teas blended form various tea estates from different countries around the world. In India Tata Tea and Hindustan Unilever are the two major players in the retail packaged tea market. Other players include Duncans Industries and Wagh Bakri Group.

The need of the hour is that the producing countries like India capture more value in the tea supply chain by diversifying into value added production. India is still at the infancy stage in the value added items of tea segment. In India, value added items of tea include Packet tea, Tea Bags and Instant tea. India being one of the largest producers of tea has huge potential in the value added items of tea market. Presently, very few multinationals like Tata Tea and Hindustan Unilever dominate this segment and reap huge profits from this market as prices of value added items are much higher than average prices of bulk tea in the Indian auction centers. The potential profitability in blending and packet tea can be seen in the discrepancy in prices between tea sold in auction centres and packaged tea in retail shops. Average price of 500 gms of tea in the Auction centres was Rs 39 while packet tea was in the range of Rs 90-200.

Average Price of 500 gms of Tea in Auction Center Vis-a-Vis Branded Tea in Retail shops (March 2011)

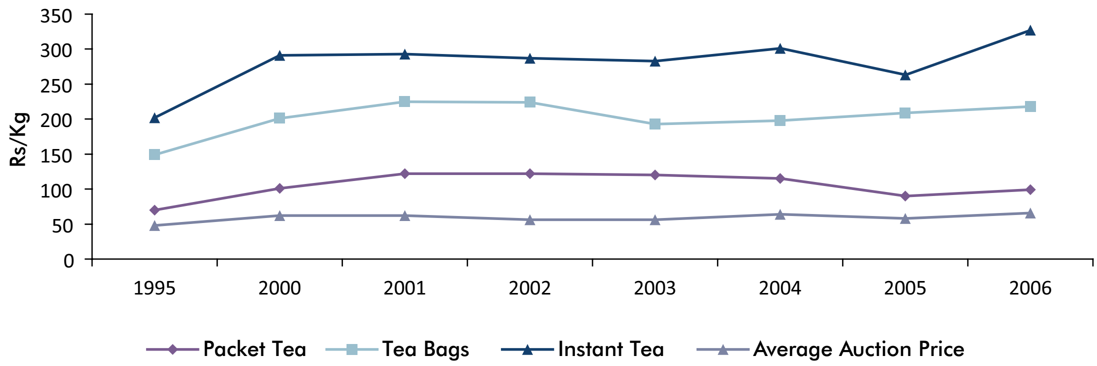


Source: CII, IAS

In addition, it is observed that while Indian tea producers largely were facing major losses in the period 1999 to 2007 due to falling prices of tea, big players in the branded tea market continued to make profits as retail prices remained stable. This is due to the fact that the most lucrative part of the tea supply chain is presently being exploited by a handful of multinationals while small tea growers have not been able to enter the downstream segment due to huge investment requirements.

However, with increase in income and changing tastes of consumers at home and abroad India has great potential in the downstream segment of the tea supply chain. Entering the downstream segment of the supply change will also reduce the vulnerability of tea manufactures to price volatility due to supply-demand imbalances in the international market. With the growth in the number of Small Tea Growers (STGs) in the recent times and also STGs being more cost effective, it is possible for them to capture this part of the tea supply chain with the right guidance and support. Therefore, the Tea Board of India and the government needs to play a more active role in integrating the small tea growers under one management and providing funds to set up co-operative factories and blending and packaging units. This would allow small tea growers to benefit from the huge proceeds available in the downstream segment of the tea supply chain.

Unit Price of Packet Tea, Tea Bags, Instant Tea and Domestic Auction Price



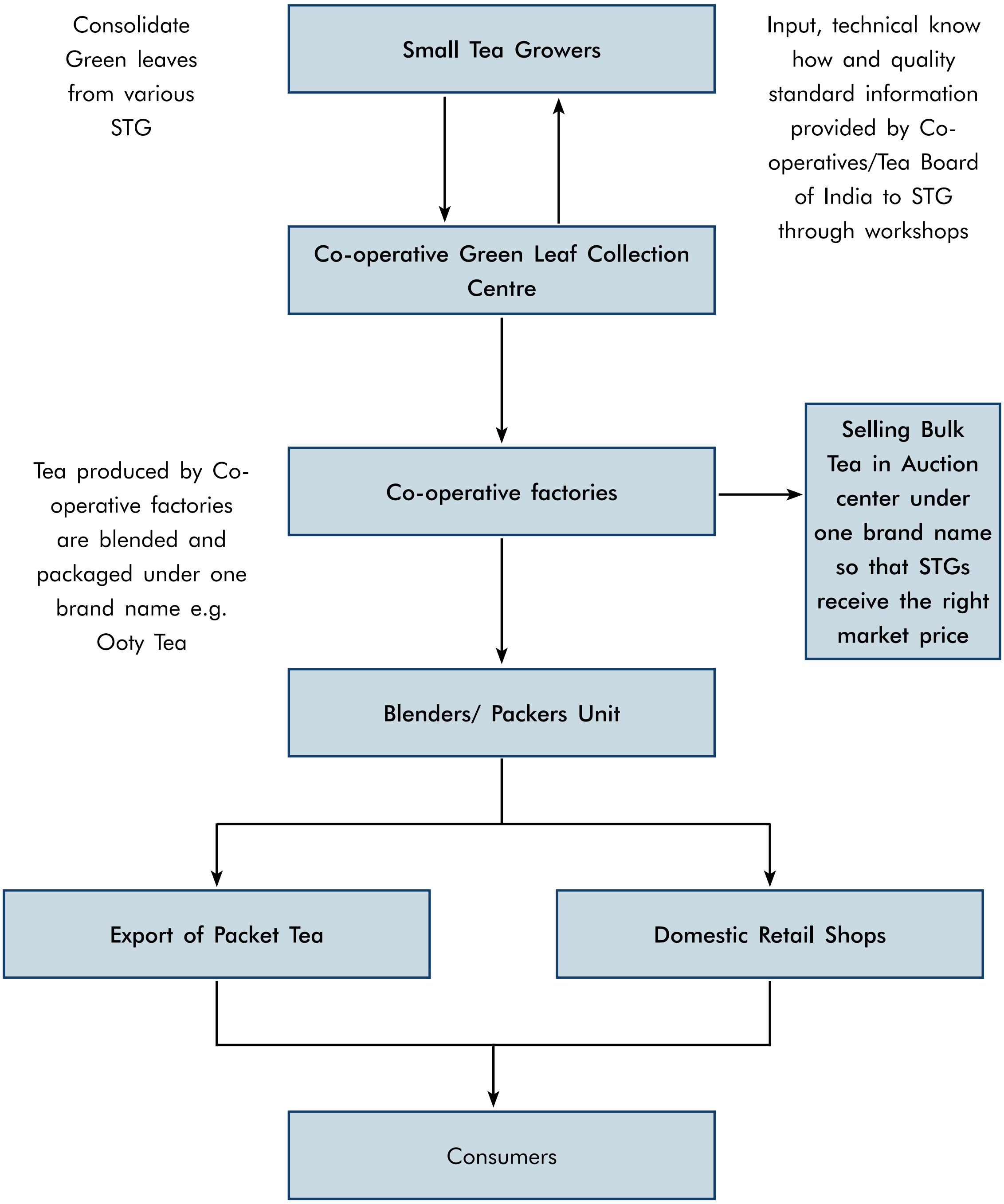
Source: Tea Board of India, Tea Digest 2005-06

The Way Forward

The Indian Tea Industry, which employs more than a million laborers and 50% of which are women, has been facing crisis over a decade now. This is due to volatility in prices, increasing cost of production, decrease in productivity and lack of infrastructure. The plantation model is no longer viable due to high labor cost; as a result we have seen companies like Tata Tea and Hindustan Lever sell out their plantations and focus only on the branded market segment which is the most lucrative segment of the tea supply chain. Sustainability of the Indian Tea Industry depends on regaining India's competitive position in the world export market. With the mushrooming of a number of small tea growers in an unorganized manner, the quality of tea production has decreased. However, with proper guidance, support and facilities, the STGs can become the driving engine of the Indian Tea Industry as it is more cost effective compared to the big tea estates. Also, STGs provide large employment opportunities to the rural population of backward areas like Assam. Keeping this in mind the following model is suggested to refurbish the Indian Tea Industry.

Consolidating Small Tea growers under one framework so that STGs can accrue the benefits from the downstream segment and Economies of Scale

Small Tea Grower's Model



Source: CII

SPECIAL ARTICLE: EMPLOYMENT SCENARIO IN INDIA

NSSO Data Reflects Increase in Employment

Key Employment Indicators

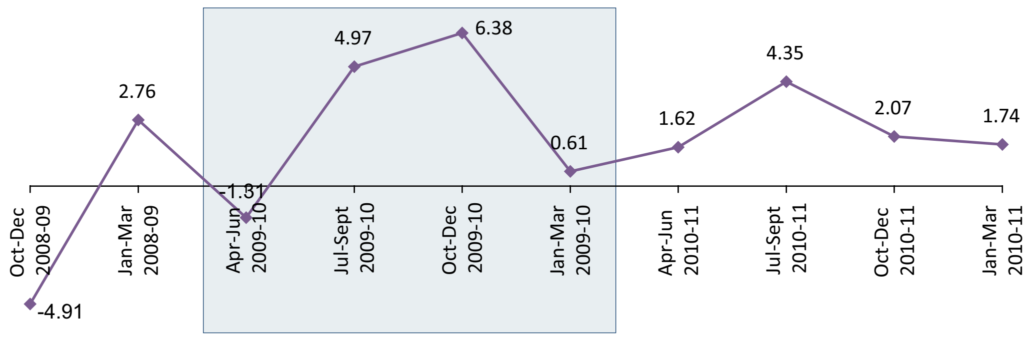
Labour force and work force*	• Between 2004-05 and 2009-10, the labour force increased by 11.7 million while employment increased by 18 million, thereby reducing unemployment
Unemployment Rate (UR)*	• Declined from 8.2% in 2004-05 to 6.5% in 2009-10
Labour Force Participation Rate (LFPR)*	• Declined from 38.2% in 2004-05 to 36.5% in 2009-10
Employment Type	• Casual labour force increased in last five years from 28.9% to 33.5% • Marginal increase in Regular employees from 14.3% in 2004 05 to 15.6% in 2009-10 • Decline in Self employed from 56.9% in 2004-05 to 51.0% in 2009-10
Occupational Structure	**Rural** • Workers engaged in the agriculture sector declined from 72.7% in 2004-05 to 67.9% in 2009-10 • Workers engaged in Secondary sector has risen from 13.7% in 2004-05 to 17.4% in 2009-10 while in Tertiary sector from 13.6% to 14.7% **Urban** • The industry-wise distribution of workers in urban areas is distinct from rural areas; no significant change in occupational structure • 58.1% of workers engaged in Tertiary sector in 2009-10 while 34.4% engaged in Secondary sector • 7.5% engaged in Agriculture
Wages	**Rural** • Average salary per day has risen by 73% from Rs. 134 in 2004-05 to Rs. 232 in 2009-10 • Female average salary increased by 81% to Rs. 156 • Male average salary increased by 72% to Rs. 249 **Urban** • Average salary per day has risen by 88% from Rs. 194 in 2004-05 to Rs. 365 in 2009-10 • Female average salary increased by 102% to Rs. 309 • Male average salary increased by 86% to Rs. 377
Monthly Per Capita Expenditure (MPCE)**	**Rural** • MPCE has risen by 66.0%, from Rs. 558.8 in 2004-05 to Rs. 927.7 in 2009-10 (URP method) • MPCE has risen by 64.6%, from Rs. 579.2 in 2004-05 to Rs. 953.1 in 2009-10 (MRP method) **Urban** • MPCE has risen by 69.7%, from Rs. 1,052.4 in 2004-05 to Rs. 1,785.8 in 2009-10 (URP method) • MPCE has risen by 68.0%, from Rs. 1,104.6 in 2004-05 to Rs. 1,856.0 in 2009-10 (MRP method)

Note: (*) Data Based on Current Daily Status *Source : NSSO*
Note: (**) URP/ MRP

The recent data released by NSSO for the period July 2009 - June 2010 through its 66th round survey, presents a largely positive picture on the current employment situation in India. The data highlights that in the five year period from 2004-05, 18 million jobs have been created compared to an addition of 11.7 million people to the labour force. As a result, the unemployment rate has declined from 8.2% in 2004-05 to 6.5% in 2009-10. This is despite the impact of the global financial crisis which created a rough patch for the economy during this period. Strong rebound in economic activity driven by upbeat domestic demand, improvement in external demand, optimal utilization of existing production capacity and new investment are probable reasons for the recovery in employment during this period. This has to some extent dispelled the fears of jobless growth, especially since there had been an increase in the number of unemployed as well as the unemployment rate in the previous five-year period.

Though the decline is small, yet it is commendable, given the adversities during 2008-09, when the global financial crisis had an impact on the Indian economy. Recent quarterly data published by Labour Bureau, Ministry of Labour and Employment reinstated that there has been continuous improvement in the employment scenario since July 2009. During 2009-10, about 10.7 lakhs jobs had been created.

Chnages in Employment During Quarters (in Lakhs)



Source: Ministry of Labour and Employment

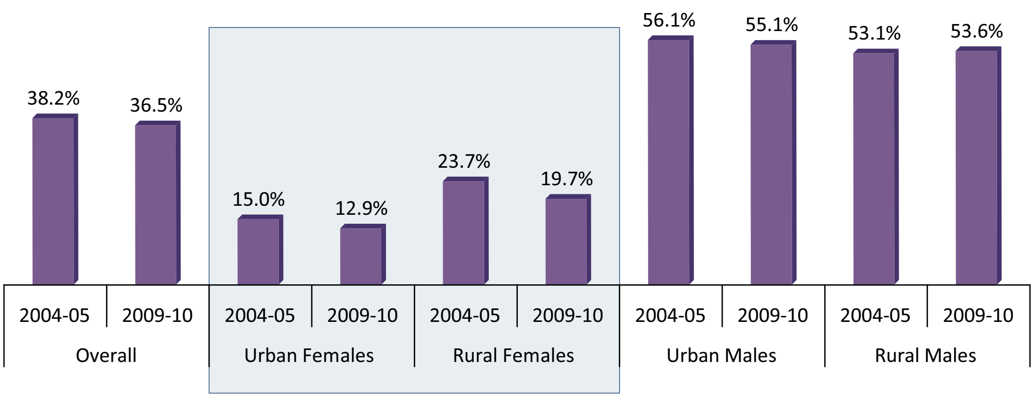
The drop in the unemployment rate is backed by a structural shift in the employment status of women in general and particularly in urban areas. Thrust on higher and professional education, broader outlook, increasing confidence, independent thinking capacity, parental and government support have been engineering this change across India. In urban areas, unemployment rate amongst females has drastically reduced by 2.8 percentage points to 8.9% in last five years from a high of about 11.7% in 2004-05. Similar changes have also been observed in rural areas but not as stark as that in urban areas. To a great extent, this transformation is also driven by the rising cost of living where it has become difficult for families to sustain a decent lifestyle with single income, making it essential for women to share the burden with men.

Labour Force Participation and Unemployment Rate

Note: Data Based on CDS *Source: NSSO*

However, the improvement in the unemployment rate is partly attributable to a decline in the labour force participation rate (LFPR) or the percentage of the population available for work. The LFPR has dropped from 38.2% in 2004-05 to 36.5% in 2009-10 due to greater rise in population vis-a-vis labour force. The number of people participating in the labour force has increased to 428.9 million in 2009-10 from 417.2 million recorded in 2004-05, up by 2.8%, while the total projected population has grown by 7.4% to 1,174.1 million from 1,092.9 million in 2004-05. Withdrawal of females from the labour force particularly in rural areas is the cause of this change. Female participation in labour force has declined by 11.9% in rural areas from 89.8 million in 2004-05 to 79.1 million in 2009-10 and by 4.0% to 21.4 million in 2009-10 from 22.3 million five years ago in urban areas. Some other reasons for the decline in LFPR could be the financial crisis and drought.

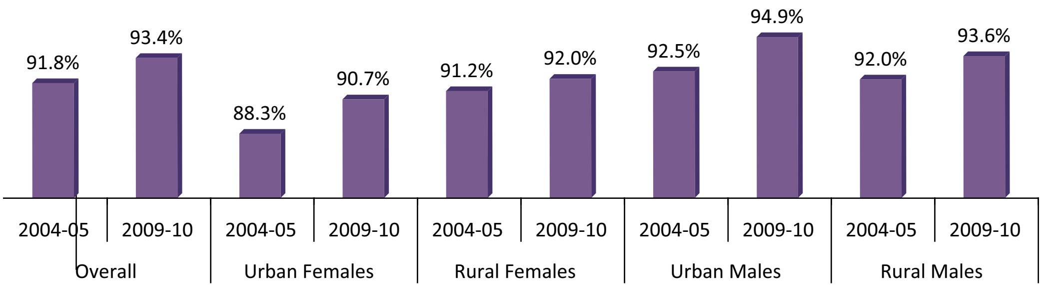
Labour Force Participation Rate



Note: Data Based on CDS *Source: NSSO*

The increase in employment has been apparent across all categories: rural males, rural females, urban males and urban females. At an all India level, employment among labour force has improved in the reference period from 91.8% to 93.4% owing to improved employment scenario in both urban and rural areas among males and females participating in labour force. This change is marked in case of urban females (from 88.3% in 2004-05 to 90.7% in 2009-10) and urban males (from 92.5% to 94.9%). This clearly indicates that job opportunities were not skewed in favour of men. However, a point of major concern is the persistently poor sex ratio in the country which is perhaps the biggest social cause of a low share of females in the total labour force. The sex ratio has worsened from 951 females per 1000 males in 2004-05 to 947 in 2007-08, subsequently leading to decline in females' share in the total labour force which stood at 4.5% in urban areas and 17.0% in rural areas in 2009-10 as compared to 4.7% and 19.6% respectively five years ago.

Employed as % of Respective Labour Force Category



Note: Data Based on CDS *Source: NSSO*

Furthermore, after the introduction of MNREGA employment guarantee scheme, employment opportunities have improved considerably in rural areas as people now have access to an assured alternative source of employment for at least 100 days. The statistics shows that the number of households provided employment under MNREGA has more than doubled in a short span of three to four years from 2.1 crore households in 2006-07 to 5.3 crore in 2009-10 and to 5.5 crore in the subsequent year.

Other Dimensions of Employment Data

Increase in Casual Labour force

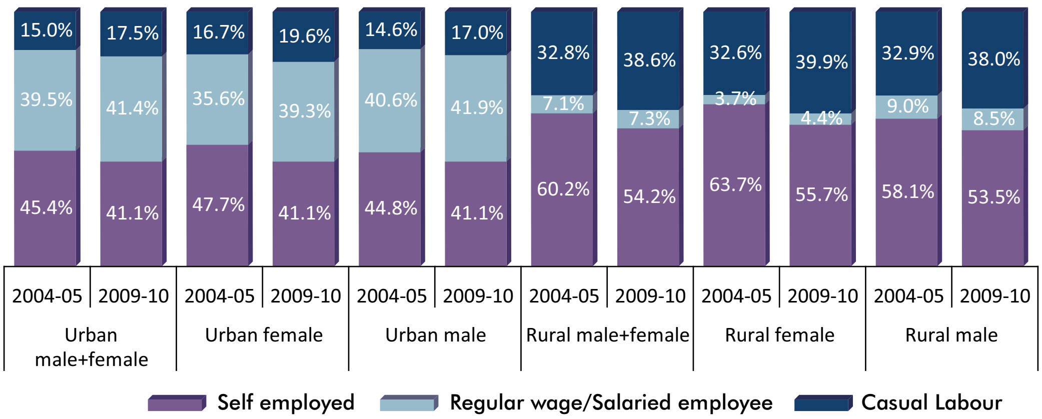
Considerable change has been noticed in the broad nature of employment between 2004-05 and 2009-10. There has been an increase in casual labour force at the all India level in last five years from 28.9% to 33.5%. The casualization of the female workforce has been faster than that of the male workforce. The former has risen to 36.6% in 2009-10 from 30.3% in 2004-05 and latter from 28.1% to 32.2%. This is an unfavourable trend which appears to be spreading to the organized sector as well which constitute mere one tenth of India's industry universe. The recent increase in labour related problems has brought to the fore the current dynamics in the organized sector. A change in the labour laws is needed to arrest this trend of casualisation.

A closer look at the disaggregate data indicates that despite a rise in casual labour and regular salaried employees, self employed remains the dominant class constituting nearly half of the workforce (51.0%) in 2009-10 at all India level. However, in urban areas, it is the regular salaried employees as well as self employed persons which dominate the work sphere, each having a share of about 41.0% in the workforce. In rural areas, the composition of the labour force is different, with self employed persons constituting more than half of the workforce followed by casual labour.

Statewise analysis shows that in Andhra Pradesh, Chattisgarh, Karnataka, Kerela, Maharastra, Tamil Nadu, Tripura and West Bengal, more than one-third of the workforce is casual labour. High proportion of casual labour force in these industrial hubs is a cause of great concern. Poor wage and incentive structure, abject working condition, insecure tenure, poor skill training which are part and parcel of casual labour force needs to be addressed to improve overall productivity, reducing loss of mandays due to strike and so on.

In many states, at least half of the working population is self employed. It is noticed that this proportion is very high (more than three fifth of the working population) mainly in Rajasthan; Uttrakhand, Uttar Pradesh; J&K, Himachal Pradesh and North East states, such as Nagaland, Assam, Mizoram, Arunachal Pradesh and Manipur, states which have lagged behind in the process of economic growth. On the other hand, Goa has the highest proportion of 64.0% of its workforce as regular wage/salaried employees.

Nature of Employment in Urban and Rural India



Note: Data Based on Usual Status (ps+ss)

Source: NSSO

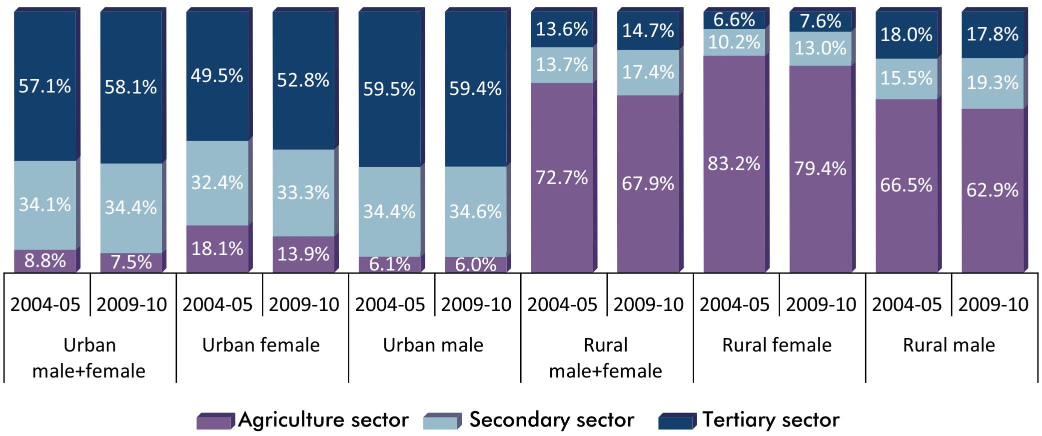
Occupational Structure has Undergone a Marginal Change

The occupational structure has undergone a marginal change yet the agriculture sector in rural areas and service sector in urban areas continue to remain the dominant labour absorbers. In rural areas, agricultural employment has shrunk from 72.7% in 2004-05 to 67.9% in 2009-10 owing to an almost equal decline (3.7%) in the proportion of both females and males engaged in this sector. Better remuneration and prospects in other sectors; declining interest among youth in agricultural activities, uncertainty of agricultural income and better education have attributed significantly to the present trend. Consequently, it has led to 3.7% and 1.1% increase in workers in secondary and tertiary sectors respectively in 2009-10. Female participation in rural areas has increased in both these sectors but more in the secondary sector. On the other hand, decline in male participation in agriculture and service sector (marginal) has been offset by 3.8% surge in secondary sector employment.

Indeed, diversion of labour towards industrial sector is favourable for moving the economy on a high growth trajectory. Detailed study of occupational structure in rural areas shows that 41.0% of the workers are engaged in skilled agricultural and fishery workers while 36.3% are in elementary occupations. About 6.0% are working in higher positions as Legislators, senior officials and managers (2.9%) and Professionals (3.2%).

In Urban areas, there has been marginal increase in the service sector employees from 57.1% in 2004-05 to 58.1% in 2009-10 and in secondary sector from 34.1% to 34.4%. This is more so because of changing occupational structure of female workforce. In 2009-10, more than 50.0% of the female workforce was engaged in the service sector followed by a little more than a third in industrial sector. This is an encouraging development as it can be inferred that in next 15-20 years service and industrial sectors will subsume all the workers in urban areas. Incase of males, the trend remained almost unaltered. Furthermore, unlike the rural area, distribution of workers in various occupations remained balanced; 29.5% are working at senior positions (Legislators, senior officials and managers (12.8%) and Professionals (16.7%)), followed by Service workers and shop & market sales workers (14.7%); Craft and related trades workers (19.1%) and Elementary occupations (18.7%).

Industrial Distribution of Workers



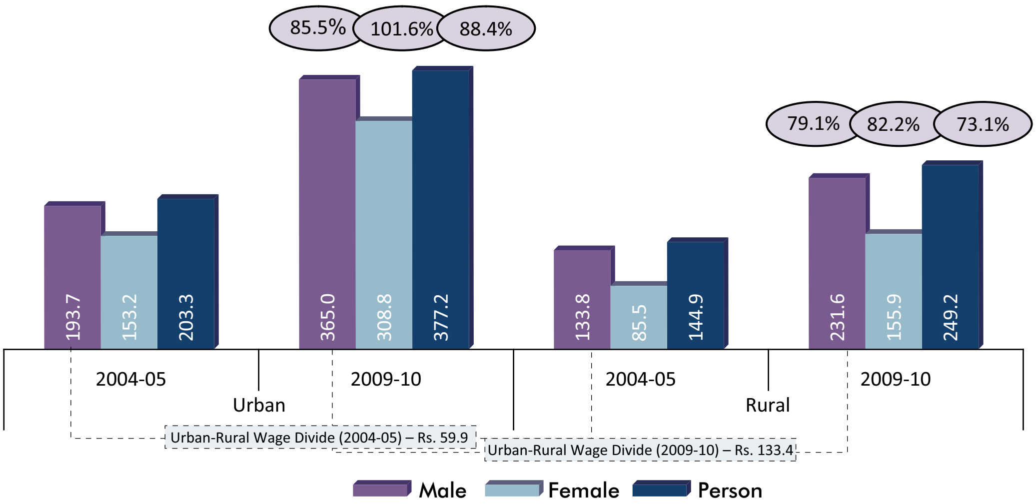
Note: Data Based on Usual Status (ps+ss) Source: NSSO

Wages Scaled up, Females See Faster Rise over Males

In the last five years wages have scaled up considerably and more so for females. In urban areas, on an average salary has risen by 85.5% between 2009-10 and 2004-05. Female wages have doubled from Rs. 153.2 per day per person to Rs. 308.8 per day per person while that of males augmented by 88.4% but remained higher than females in absolute terms. A similar trend was also experienced in rural areas. Rising wages in urban and rural areas have narrowed down respective female and male wage differential thus inching closer to wage parity. However, the urban and rural wage divide has widened noticeably; more than doubled in the last five years from Rs. 59.9 to Rs. 133.4. This trends needs to be reversed to ensure achievement of inclusive growth.

With wages rising fast, there has also been an increase in expenditures. Between 2004-05 and 2009-10, monthly per capita expenditure based on Uniform Reference Period (URP) and Mixed Reference Period (MRP) has increased in the range of 65-66.0% in rural and 68-70.0% in urban areas.

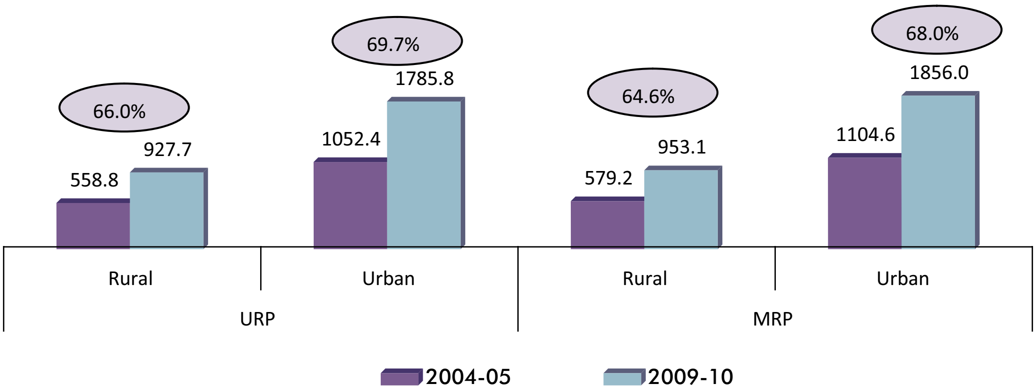
Average Salary of Regular Wage/Salaried Employee (in Rs/Person/Day)



Note: Data Based on Usual Status (ps+ss) *Source: NSSO*

Note: Figure in Eclipse Shape Is % Change in 2009-10 over 2004-05

Monthly Per Capita Expenditure (in Rs.)



Note: Figure in Eclipse Shape Is % Change in 2009-10 over 2004-05 *Source: NSSO*

Way Ahead

Greater focus on spreading education in backward areas, check on population growth, skill enhancement, infrastructure creation particularly in rural and backward areas, and strong labour laws will go a long way in addressing three major challenges - increasing employment opportunities, improving the quality of employment and addressing regional and gender employment and wage disparities across the length and breadth of the country. Furthermore, it has also been noticed that highly skewed income distribution has increased the amount of work pressure on the people in direct proportion to the income, which could be reduced by hiring more people in the same total expenditure and increasing their accountability. This will address multiple social issues - accentuating income inequality, worsening of work-life balance, unemployment, anger in youth population on account of growing imbalance between aspirations and limited opportunities at hand and growing crime rates. Like China, India should extensively promote labour intensive techniques in industry and service sector, this is important in view of the inelasticity observed in agriculture sector's labour absorbing capacity.

KEY INDICATORS

GDP

Indicator	Q3 FY 11	Q4 FY 11
GDPfc (2004-05)	8.3	7.8
Agriculture	9.9	7.5
Industry	7.1	6.1
Services	8.4	8.7
Private Final Consumption Expenditure	8.6	8.1
Government Final Consumption Expenditure	1.9	4.9
Gross Capital Formation	8.2	2.2

Price Situation

Indicator	May-11	Jun-11
WPI of All commodities	9.1	9.4
WPI of Primary Articles	11.3	12.2
Food Article	8.4	8.4
Non Food Articles	22.3	18.6
WPI of Fuel, Power, Light & Lubricant	12.3	12.8
WPI of Manufactured Products	7.3	7.4
CPI-IW: India	9.4	8.7

External Trade

Indicator	Apr-11	May-11
Exports:(%) (Y-o-Y Growth)	34.4	56.9
POL Imports:(%) (Y-o-Y Growth)	7.7	18.6
Non-POL Items Imports:(%) (Y-o-Y Growth)	17.3	71.0
Trade Balance : (US$ Billion)	-9.0	-15.0

Money and Banking

Indicator	Apr-11	May-11
Weighted Call Money Rate : Borrowing	6.5	7.1
Yield on 10-year GOI Security	8.1	8.4
Growth in M3	18.0	17.1
Base Rate (Maximum)	9.5	10.0
Indicator	**Jun-11**	**Jul-11**
Reverse Repo Rate	6.50	7.00
Repo Rate	7.50	8.00

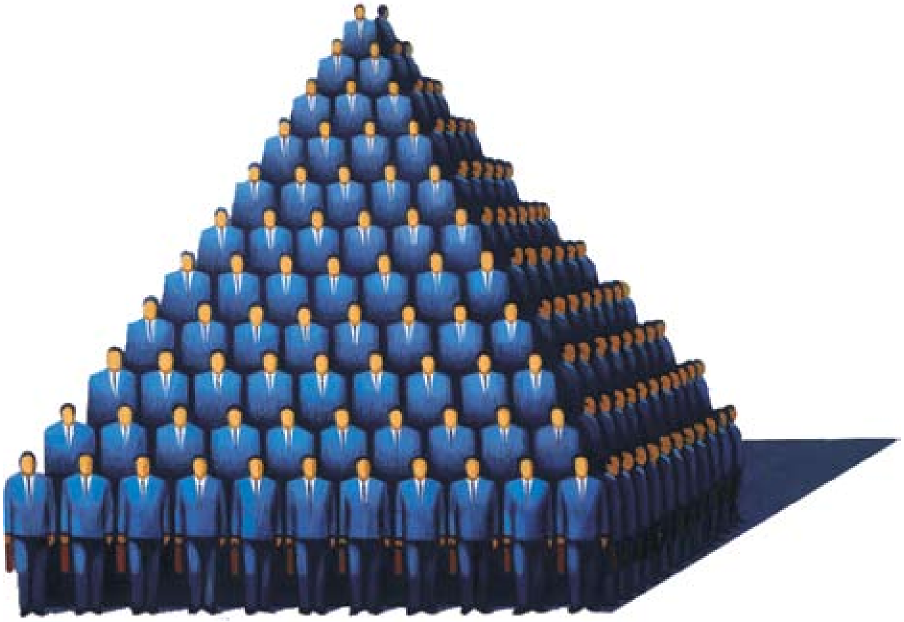
Industry Production

Indicator	Apr-11	May-11
Index of Industrial Production	5.8	5.6
IIP: Mining & Quarrying	1.3	1.4
IIP: Manufacturing	6.3	5.6
IIP: Electricity	6.5	10.4
IIP: Basic Goods	6.9	7.3
IIP: Capital Goods	7.3	5.9
IIP: Intermediate Goods	4.5	1.0
IIP: Consumer Goods	4.3	5.4

Investment Indicators

Indicator	Apr-11	May-11
Rupee Exchange Rate	44.4	44.9
Foreign Direct Investments (US$ Billion)	3.1	4.7
Fresh Net FII Inflows (US $ Billion)	3.4	-1.7
Foreign Exchange Reserves (US$ Bilion)	313.5	311.5

Source: CII, CMIE Database



ABOUT US

CII Economy Watch is a monthly report prepared by the CII Economic Research Group. With the mandate to keep members updated on economic, political and business conditions across the country and abroad, the Report

- Comments on the domestic and international economic scenario that is relevant to India's corporate sector
- Tracks policy developments to analyse the immediate as well as long-term impact of policy changes
- Presents comprehensive industry analysis to understand the industry dynamics and assess the growth potential and profitability in the broad regulatory and policy environment.
- Conducts surveys to reflect business conditions and sentiment.

The Group's other publications available to subscribers include the weekly **CII Economy Update** and the **CII Industry Series**.

Reach us at: **ecopolicy@cii.in**

Confederation of Indian Industry