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GROWING RELATIONSHIPS THROUGH DATA

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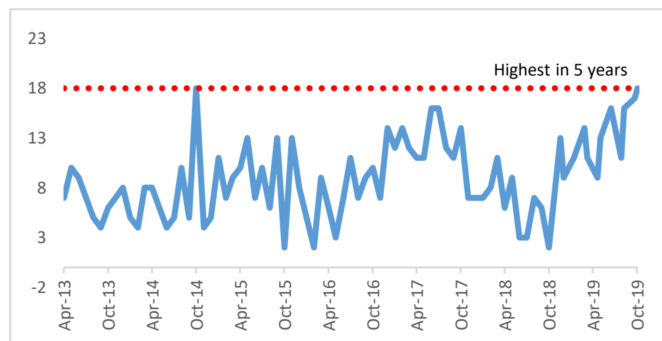
View from the top

In 2019, the growth momentum slowed across the world led by the slump in global trade. Both global GDP and trade growth have fallen to lowest levels since the global financial crisis. This has exacerbated the domestic challenges that India has been facing since the last fiscal year. India's GDP decelerated from 8.0% in Q1 FY19 to 4.5% in Q2 FY20. The macroeconomic identities, which explain the GDP growth i.e. private consumption expenditure, government expenditure, investment, and net exports remains impaired. The pressure on the government to intervene further to tide over the slowdown has thus increased even as government finances remain strained. We expect that the drop in the revenue mobilization of the government, owing to the low collection in taxes and likelihood of additional expenditure by the government might lead to breach in the fiscal deficit target by a wider margin in FY20. A breach in the fiscal deficit target can have consequences on growth in the subsequent year as some of the macroeconomic imbalances prevailing in the economy do not have short term solutions.

For instance, the balance sheet of the households, corporates, banks and the government remain weak. With growth in per capita income (GNDI) moderating and household's savings falling over the years, financial liabilities of households have increased. Since India's savings rate has been falling over the years our domestic ability to finance the fiscal deficit has lessened. The ratio of combined fiscal deficit of the central and state governments to net financial savings of households, a proxy for resources available to finance this deficit, remains higher currently than during the period of financial crisis. Given the resources constraints, increase in fiscal deficit might lead to crowding out of private investments. Corporate liabilities are also high. High interest rates, weak rupee and the slowdown in demand have impacted the profitability of the corporates making it difficult for many companies to service their debt levels. At this time when the banking sector is struggling with stressed assets as companies are unable to service their debts, banks have reported increase in gross non-performing assets (GNPAs) to the agriculture sector; the impact of farm loan waivers. Risk averseness amongst bankers thus remains high. Moreover, cautiousness amongst investors about deploying capital in stalled projects prevail as these projects can be taken to liquidation under IBC. Consequently, investment scenario remains gloomy. The high growth in government consumption expenditure over the year has not been able to stimulate/crowd-in private investment. It is thus not surprising that the unemployment rate remains high.

To conclude, revenue collection will be important for the government to implement a fiscal stimulus to support growth. To do that, tax reforms are needed. GST should be simplified further, and direct tax collections should increase. To support growth and the Indian manufacturers, reforms are also required on the land and labour fronts.

18 of the 23 IIP sub-industry groups contracted in Oct 19

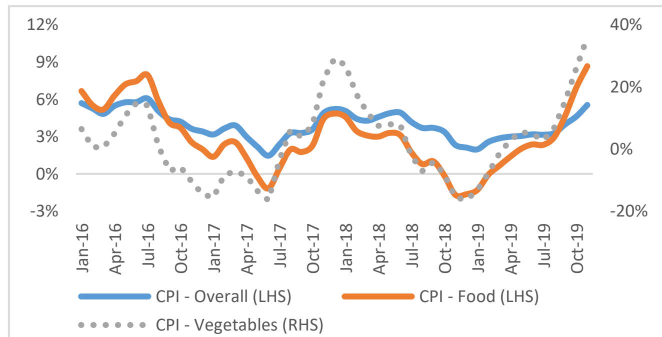


Source: MOSPI

Real Sector

- Overall Gross Value Added (GVA) moderated, for the 6th consecutive quarter, to 4.3% in Q2 FY20. GVA in industry and services moderated to 0.5% (lowest since data is available) and 6.8% (lowest in 2 years), respectively.
- Gross Domestic Product (GDP) moderated to 4.5% in Q2 FY20, lowest in six-and-a-half years. Gross Fixed Capital Formation moderated to 1%, lowest in nearly 5 years.
- The Index of Industrial Production (IIP) contracted, for the 3rd consecutive month, by 3.8% in Oct 19. Electricity sector output contracted by 12.2% - lowest since data is available.
- Capital goods sector contracted by 21.9%; Consumer durable goods sector contracted by 18%; Infrastructure/ construction goods sector contracted by 9.2%. Contraction in all the three sectors is the steepest since data is available.
- Output of the Eight core industries contracted by 5.8%, lowest since data is available. Output declined across all industries, excluding fertilizers and petroleum refinery products.

Food inflation, especially vegetable, pushes CPI to a 40-month high

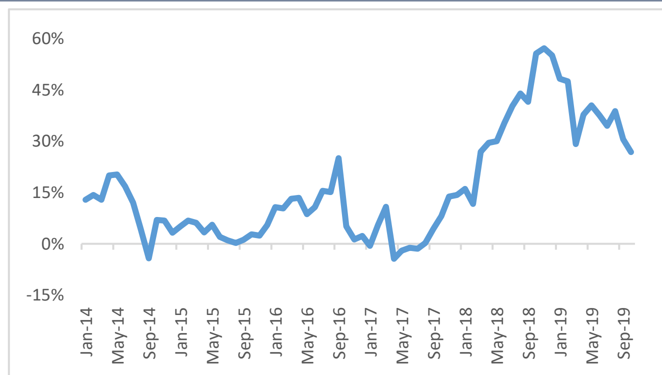


Source: MOSPI

Price Scenario

- WPI inflation increased to around 0.6% in Nov 19. Core WPI inflation contracted by 2.0% in Nov 19, lowest since Jun 16.
- Inflation in food articles increased to 11.1% in Nov 19, highest since Jan 14. Vegetable inflation increased to 45.3%. Onion inflation increased to 172.3%, highest since Feb 18. Tomato inflation remained high at 110.1%.
- Minerals inflation moderated to 2.2% in Nov 19, lowest in 8 months. Manufacturing inflation contracted by 0.8% in Nov 19, the same level as in Oct 19.
- Inflation in the fuel & power segment contracted, for the 6th consecutive month, by 7.3% in Nov 19.
- Retail inflation increased to 5.4% in Nov 19, highest since Aug 16. Food inflation increased to 8.7%, highest since Aug 14. Cereals inflation increased to 3.7%, highest since Sep 17.
- Housing inflation moderated to around 4.5% in Nov 19, lowest since Aug 15.

Credit to NBFCs moderates amid consumption slowdown

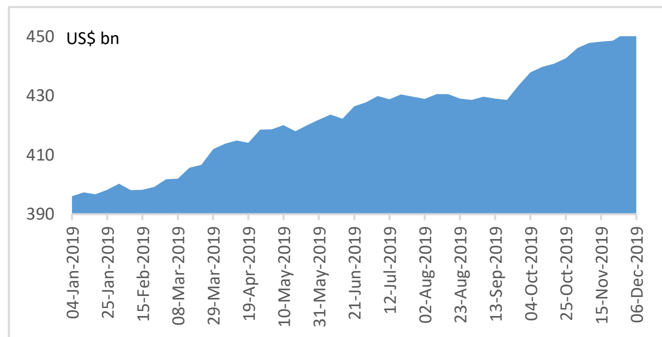


Source: RBI

Money & Finance

- The RBI in its 5th Bi-monthly Monetary Policy Statement for FY20 decided to keep the policy repo rate unchanged at 5.15%. Consequently, the reverse repo rate under the Liquidity Adjustment Facility (LAF) remains unchanged at 4.90%.
- Bank credit grew by 6.9% during Nov 19, lowest since Nov 17. Aggregate deposits grew by 8.3% in Nov 19, lowest since Oct 18.
- Bank credit to industry grew by 3.4% in Oct 19 compared to 3.7% in Oct 18. Bank credit to Micro & Small companies contracted, for the 3rd consecutive month, by 1.4%.
- Bank credit to services sector grew by 6.5% in Oct 19, lowest since Sep 17. Credit to Non-Banking Financial Companies grew by 26.8% in Oct 19, lowest since Mar 18.
- Net investments in mutual funds stood at around Rs 345.7 bn in Nov 19, lowest since Mar 19. Equities segment witnessed net outflows of Rs 48.4 bn while the debt segment witnessed net inflows of Rs 394.2 bn.

Forex reserves continue to rise



Source: RBI

External Sector

- Merchandise exports declined by 0.3% to US$ 26.0 bn in Nov 19, and imports declined by 12.7% to US$ 38.1 bn. Oil imports declined by 18.2% to US$ 11.1 bn in Nov 19. Merchandise trade deficit widened to US$ 12.1 bn, a 3-month high.
- Overall trade deficit for Apr-Nov 19 is estimated at US$ 54.1 bn compared to US$ 82.5 in Apr-Nov 18.
- The average exchange rate of the rupee stood at 71.45 per US$ in Nov 19, compared to 71.04 per US$ in Oct 19.
- Brent crude oil prices increased to US$ 60.40 per barrel in Nov 19 from US$ 57.27 per barrel in Oct 19.
- Net inflows of Foreign Institutional Investments stood at US$ 3.2 bn in Nov 19, highest in 8 months.

Dun & Bradstreet's Macro Economic Forecasts			
Variables	**Forecast**	**Latest Period**	**D&B's Comments**
I.I.P Growth	0% - 1.0% Nov-19	-3.84% Oct-19	Index of industrial production is likely to remain subdued in the short to medium term. The slowdown in demand, lackluster investment and weak exports is expected to keep industrial activity muted. Moreover, optimism of corporates remains clouded and cautiousness amongst investors has increased over the various graft and compliance related issues in the financial sector
Real GVA Growth	Q3 FY20(F) 5.6%	Q2 FY19(P) 4.3%	
Inflation W.P. I	2.1% - 2.4% Dec-19	0.58% Nov-19	Negative manufacturing product and fuel inflation is expected to keep the WPI inflation lower and keep the divergence between the CPI and WPI inflation higher. Food inflation is expected to remain higher given the supply disruptions as crops have been damaged in many states exerting upward pressure to the CPI inflation
Inflation C.P.I (Combined)	6.3% - 6.5% Dec-19	5.4% Nov-19	
15-91 days T-Bills	4.75% - 4.85% Dec-19	4.88% Nov-19	Concerns over slowing growth and slippage of fiscal deficit target by a wider margin is likely to exert upward pressure on the yields in the bond market. On the other hand, the RBI's intervention is expected to prevent the yields from inching higher
10-year G-Sec Yield	6.5% - 6.6% Dec-19	6.64% Nov-19	
Bank Credit*	6.5% - 7.0% Dec-19	6.93% Nov-19	
Exchange Rate INR v/s US$	71.0- 71.2 Dec-19	71.45 Nov-19	Strengthening of dollar, RBI's intervention in the forex market, weak growth and depreciation bias witnessed in emerging markets currencies is likely to weigh down upon rupee
All figures are monthly average			

Fiscal synchronization in India: The short and long run impact

Since FY99, the fiscal deficit (FD) of India has been breached 9 times. The highest gap between the targeted and the actual deficit occurred during the financial crisis where the government had to inject fiscal stimulus to support the economy. Post the financial crises, the government adopted a fiscal consolidation path. As per the FRBM target, India was expected to attain a 3.0% FD during FY20. Given the slowdown in the economy, the fiscal consolidation process was altered. The government had set a revised target FD target of 3.3% for FY20. Given the deceleration in growth during 2019, it is likely that the FD will again be breached again.

Understanding the relationship between revenue and expenditure is a crucial pre-requisite for any effective fiscal consolidation process. The discussion of the causal link between revenue and expenditure has resulted in several hypothesis. The four prominent ones are Tax-Spend Hypothesis, Spend-and-Tax Hypothesis, Fiscal Synchronization Hypothesis and Institutional separation of the expenditure and revenue decisions of government.

The Tax-Spend Hypothesis states that there is a positive causal relationship between government revenue and expenditure. Increasing taxes leads to more expenditure. Therefore, decreasing taxes is the appropriate remedy to budget deficits. This has been observed in countries such as Italy, Japan, Canada, Colombia, Ecuador, Guatemala. Under the Spend-and-Tax Hypothesis it has been found that changes in government expenditures lead to changes in government revenues. As higher expenditure now, leads to higher tax/revenue collection later, this hypothesis suggests that expenditure decreases are the desired solution to reducing budget deficits. Research shows that it has been observed in countries such as US, Japan, Germany, France, UK Australia, Finland, Greece, Argentina and Chile. Fiscal Synchronization Hypothesis states bi-directional causality between government expenditure and government revenue. In this case, government take decisions about revenues and expenditures simultaneously. Countries where this has taken place are Ireland, Chile, Paraguay, Brazil, Mexico, Pakistan and India. Under the fourth hypothesis i.e. Institutional separation of the expenditure and revenue decisions of government, government revenue and expenditure are argued to be independent from each other due to the independent functions of the executive and legislative branches of the government. This standpoint suggests that revenues and expenditures are independent of each other.

Current Scenario in India: Currently, the government is undertaking both - a cut in revenue and an increase in its expenditure. As per various research for India, it has been found that in the short run Spend Tax hypothesis comes into play and in the long run fiscal synchronization hypotheses operates. The concurrent adjustment on expenditure or revenue thus determines the impact on fiscal deficit and growth. In the short run, changes in tax revenue not impact expenditure, but any changes in the expenditure might impact tax revenue. Thus, according to the Spend-Tax hypothesis, the impact of the cut in corporate tax in Sep 2019 and the fall in GST revenue will be not be witnessed on expenditure in the current year i.e. there will be no reduction in government expenditure. But if the government plans to increase its expenditure, it will have to mop up additional revenue either through borrowing or by aggressively pursuing disinvestment.

As per various research, in the long run, Fiscal Synchronization Hypothesis will be applicable in India. Changes in tax revenue will impact expenditure and any deviation in expenditure from its equilibrium level/budget estimates (BEs) will be adjusted at the rate of 32% in a year viz. if the tax revenue falls by 20% from the BEs it will not lead to an equivalent decrease in expenditure. Expenditure equal to 32% of the fall in tax revenue will be adjusted during the year while expenditure equal to the remaining 68% of the fall in revenue will have be reduced by the government unless the government garners additional revenue through borrowing or disinvestment. Further, in case the government plans to increase expenditure, it will have to be supplemented by increase in tax revenue. The rate at which tax revenue will adjusted/increased will be 22% of the increase in expenditure within the year. The remaining 78% of the increase in expenditure will have to be funded through increase in tax revenue or borrowing in the subsequent year.

Scenarios: We have considered 2 scenarios that are likely to occur given the various measures that the government is considering, to support growth. **Under scenario 1**, we have considered tax revenue falls by 9% and there is no change in expenditure from budgeted estimates. The tax revenue falls owing to reduction in the corporate tax revenue by 19% (cut in the corporate tax rate to 25%) and fall in GST collection by 1%. Also, nominal GDP grows by 10.4% owing to slowdown in growth. In such a scenario, in the short run there will be no cut in expenditure due to fall in revenue. But fiscal deficit will increase to 4.13%. In the long run fall in tax revenue might lead to fall in government expenditure. Less government spending might thus impact growth in the subsequent year i.e. FY21. In this scenario, in both the short and long run, pressure on government for additional borrowing will increase unless automatic fiscal stabilizers come in to play in the form of revival of growth.

Under scenario 2, we have considered fall in tax revenue by 9% as in scenario 1, but the expenditure increases by 5% from BEs. The nominal GDP grows by 10.4%. In such a scenario fiscal deficit increases to 4.8%. In the short run changes in tax revenue will not impact expenditure but increase in expenditure might lead to increase in tax revenue or borrowing. Since we have assumed that the government chooses to increase its expenditure by 5% in FY20 from its BEs, it will have to increase its tax revenue or borrow more in FY20. If the government chooses to borrow more, fiscal deficit will rise more than 4.8%. In the long run, as described in the earlier scenario, the decrease in tax revenue will lead to a fall in expenditure in FY21 with an adjustment of 32%. In this case in both the short run and long run, pressure on government for additional borrowing will increase.

Thus, revenue collection will be important for the government to implement a fiscal stimulus to support growth. To do that, tax reforms are needed. GST should be simplified, and direct tax collections should increase. The government also needs to pursue disinvestment to prevent excess borrowing. The impact of the increase in fiscal deficit which is mainly led by the fall in revenue collection will have an impact on growth in the subsequent year.

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