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The NCAER 2019–20 Mid-Year Review of the India Economy

November 16, 2019, New Delhi

National Council of Applied Economic Research
India International Centre

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NCAER in cooperation with the India International Centre, New Delhi with support of the Malcolm and Elizabeth Adiseshiah Trust has been presenting the Mid-Year Review since 2011.

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FOREWORD

NCAER, the National Council of Applied Economic Research, is privileged to present the annual *Malcolm S. Adiseshiah Mid-Year Review of the Indian Economy* for 2019-20, brought out in a long-standing partnership with the India International Centre (IIC) in New Delhi. The NCAER macroeconomics team, led by NCAER Distinguished Fellow Sudipto Mundle, presented their analysis of the current economic situation and our growth forecasts to a select audience of policy makers, commentators, and the media at IIC on November 17, 2019.

The Mid-Year Review (MYR) carries on the tradition started by Dr Malcolm Adisheshiah at the IIC in 1976. Dr Adiseshiah, one of India's most distinguished early economists and educationists, was a Life Trustee of the IIC, recipient of the *Padma Bhushan*, founder of the Madras Institute of Development Studies, and a key architect of UNESCO's work on education and technical assistance.

The MYR 2019 comes at a time of rapidly growing concern about the serious slowdown of the Indian economy, with both cyclical and structural factors coming together at a time when fiscal and monetary policy appear to have limited headroom to tackle the slowdown.

Both global and Indian economic growth rates are currently at their lowest since the global financial recession of 2008, with India having fallen from its plus 7 percent growth to 4.5 percent in 2Q 2019-20. This slowdown has been driven by faltering aggregate demand, including private final consumption expenditure, gross fixed capital formation, government final consumption expenditure, and net exports. India's supply side constraints of weak infrastructure and the still high costs of doing business have collided with this demand slowdown. NCAER's Business Expectations Survey shows that both business and consumer sentiments have taken a beating. With large spatial and timing swings in rainfall, especially post-monsoon rainfall, the agricultural sector continues to suffer from heightened uncertainty leading to continued rural distress. The one bright spot has been moderate, and even declining, inflation, except for food prices, which have gone up sharply.

Against this situation, economic policymakers currently seem to have limited fiscal and monetary options. Despite substantial rate cuts, monetary policy has suffered from weak transmission. Fiscal data from the first half of 2019-20 suggests there will be a significant revenue shortfall, as happened in 2018-19, when both direct and indirect tax collection fell short of targets. It remains to be seen how the 2020-21 Union Budget will square this circle. At the time of the MYR, based on the first half of the fiscal year, it appeared that the large revenue shortfall would not be passed through to a larger fiscal deficit, and government expenditure would be compressed, which could potentially add to demand side problems. The September 2019 large corporate tax cut will have substantial impact over the medium run as corporate profits go up, but is unlikely to help greatly in boosting short-term demand. These are some of the challenges discussed in this MYR and debated vigorously in the MYR Panel Discussion on *Balancing Macroeconomic Stability and Deeper Structural Reforms for a Growth Recovery* on November 17, 2019 at the IIC.

I am grateful to IIC Director K N Srivastava and his team, particularly L S Tochhawng, IIC's Head of Programming, for our partnership. I would also like to thank the Malcolm & Elizabeth Adiseshiah Trust for their continued support for this endeavour. I am grateful to Pronab Sen at International Growth Centre India Programme for moderating the MYR panel discussion. I am grateful to the panellists, Abheek Barua, HDFC, Debjani Ghosh, NASSCOM, Vinayak Chatterjee, Feedback Infra, and D K Joshi, CRISIL, for bringing their insights to the MYR.

Sudipto Mundle and Bornali Bhandari at NCAER led this important work. I am grateful to Rudrani Bhattacharya at NIPFP for collaborating with us on the crucial forecasting and nowcasting exercises: we look forward to deepening this collaboration with NIPFP. The NCAER authors of the *Review* included Anil Sharma, Saurabh Bandyopadhyay, Pallavi Chaudhuri, Sandhya Garg, Samarth Gupta, Devender Pratap, Ajaya Sahu, and Prerna Prabhakar. NCAER staff Sudesh Bala, Meera Krishnan, Shilpi Tripathi, Sangita Chaudhary, Khushvinder Kaur, P P Joshi, Anupma Mehta, and Praveen Sachdeva supported the work. I am grateful to them for their dedication to this important task.

New Delhi
December 2019

Shekhar Shah
Director General
NCAER

FOREWORD

The Mid-Year Review of the Indian Economy was initiated at the India International Centre by the late Professor Malcolm Adisehsiah, Life Trustee and Convenor of the Economic Affairs Group of the Centre. Dr. Malcolm Adisehsiah, who passed away in 1994, had mandated that a portion of his financial assets be used to create a trust to be named Malcolm and Elizabeth Adisehsiah Trust. The idea behind the Trust was to support teaching and research, both fundamental and applied, in economics and development studies. Since 2001, the Malcolm and Elizabeth Adisehsiah Trust has supported the mid-year review project at the Centre, by way of holding an annual seminar. For some years now, the National Council of Applied Economic Research has been our partner in presenting the Mid-Year Review of the Indian Economy. The proceedings are subsequently published as the NCAER–IIC Mid-Year Review of the Economy.

The Mid-Year Review of the Economy is one of the definitive surveys of India's growth projection. It examines the course of macroeconomic trends for the first half of the year and provides an assessment of the prospects of the economy for the full year.

The present document details the issues faced by the Indian economy. The model of growth forecasts presented were developed jointly with National Institute of Public Finance and Policy (NIPFP) and NCAER economists. Although the data indicators presented for 2019-20 show that the Indian economy has been facing pressures both externally and internally, and across sectors, there are also glimmers of hope.

We are grateful to Dr. Shekhar Shah, Director General NCAER, and his team for their collaboration.

K.N. Shrivastava

Director, India International Centre

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Overview

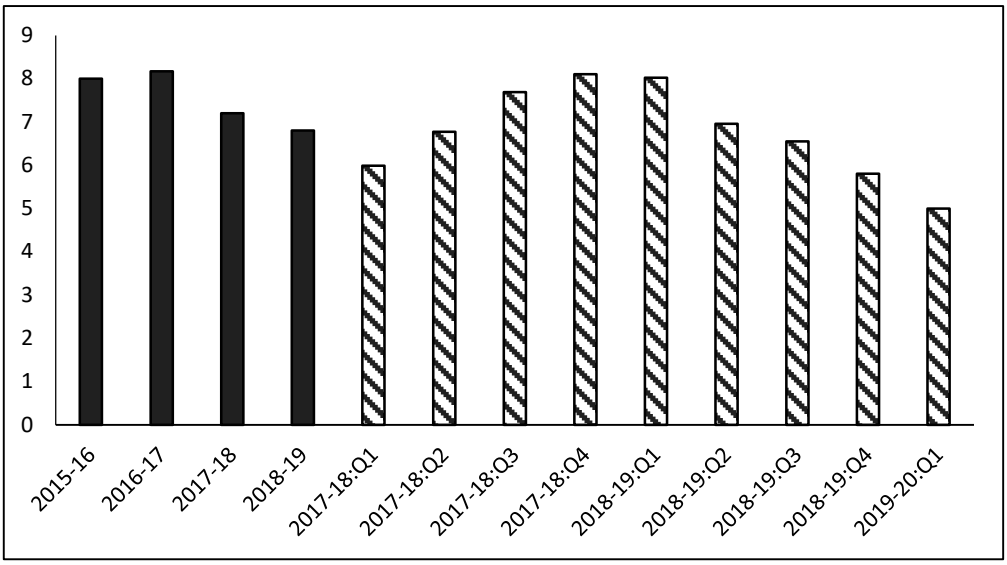
Bornali Bhandari

O.1 Introduction

The growth of the world economy is currently at its lowest since the global financial recession of 2008. It is projected to grow at only 3 per cent in 2019, down from 3.8 per cent in 2018. The growth decline is evident across most regions. Growth in some countries like the US, China, and Japan may decline further due to a variety of country-specific factors. Global trade is also projected to decline to only 1.1 per cent in 2019. It is being adversely impacted by rising US–China trade tensions, Brexit, and conflicts in the Middle East.

India is also experiencing a decline in growth, which is sharper than the global slowdown. The sharp decline in growth reflects a growth slowdown across virtually all sectors. It is primarily being driven by a simultaneous deceleration of all the drivers of aggregate demand. After having peaked at 8.1 per cent in Q4: 2017–18, GDP[1] growth has persistently declined in the last few quarters to only 5.0 per cent in Q1: 2019–20 (Figure O.1).

Figure O.1: Real GDP Growth 2015-16 to 2018-19 and 2017-18:Q1 to 2019-20:Q1 (%, year-on-year)



Source: MoSPI.

The growth of Private Final Consumption Expenditure (PFCE) decline from 9.8 per cent in Q2: 2018–19 to 3.1 per cent in Q1: 2019–20. The growth of Gross Fixed Capital Formation (GFCF) declined from 11.7 per cent in Q3: 2018–19 to

[1] GDP is Gross Domestic Product measured at 2011-12 market prices.

3.6 per cent in Q4: 2018–19, and then marginally rose to 4 per cent in Q1: 2019–20. Government expenditure shows strong compression, declining from 13.1 per cent growth in Q4:2018–19 to only 8.8 per cent in Q1: 2019–20. Exports and imports of goods and services have also fallen steadily since Q2: 2018–19. In rupee terms, the exports of goods and services barely grew at 1.9 per cent in Q2: 2019–20 while imports actually declined by 6.4 per cent in Q2: 2019–20.

We are now projecting growth in Q2:2019–20 at 4.9 per cent (with error margin of 1 standard error). This is based on a nowcasting model developed by a joint NCAER-NIPFP team. We are also forecasting annual growth for 2019-20 at 4.9 per cent (with error margin of 1 standard error) based on the forecasting model developed by the team.

A more detailed discussion of performance for individual sectors and related macroeconomic policy issues follows.

O.2 Performance of the Real Economy and Trade

Trends in agricultural production in India are still heavily dependent on the monsoon. Despite its late arrival and initial hiccups during the first month of the season, the monsoon rainfall this year has been in line with the forecasts of a normal monsoon by the India Meteorological Department. At a dis-aggregated level, of the total 36 agro-meteorological sub-divisions, 31 sub-divisions, covering about 85 per cent of the total area of the country, received normal to excess seasonal rainfall. Therefore, notwithstanding some setbacks due to delay in onset of the monsoon and the occurrence of floods in some parts of the country during the latter part of the monsoon season, the current year promises to be one of buoyant growth for the agricultural sector.

The industrial sector has experienced a general slowdown since Q3: 2018–19, mainly driven by decelerating growth in the manufacturing and construction sectors. The mining and utility sectors exhibited mixed growth trends. In Q1: 2019–20 all the industrial sectors except 'electricity, gas, water supply and utility services' recorded declining growth. In Q2: 2019–20, the Index of Industrial Production (IIP) showed a y-o-y growth of (–) 0.4 per cent as compared to a corresponding figure of 5.3 per cent in Q2: 2018–19. The three major components of IIP by economic activities, that is, mining, manufacturing, and electricity, recorded growth rates of (–) 1.2 per cent, (–) 0.4 per cent, and 0.4 per cent, respectively, in Q2: 2019–20 versus the corresponding rates of 0.9 per cent, 5.6 per cent, and 7.5 per cent, respectively, in Q1: 2018–19. Capital goods, in particular showed negative growth for first nine months in 2019, with this slowdown deepening further in August and September 2019. The consumer durables IIP has registered negative growth since June 2019. It is particularly worrying that in September 2019, the growth of consumer non-durables has also become negative. Thus the overall outlook for the industrial sector remains gloomy due to weak demand and investment activities.

The Nikkei Purchasers Managers Index fell to 50.6 in October 2019.

Services sector growth and its three components have shown a mixed trend during the last couple of years. This mixed pattern continued during Q1: 2019–20. There was a slowdown in the 'financial, real estate and professional services' and 'public administration, defence and other services' sectors. However, the 'trade, hotels, transport, communication and services related to broadcasting' sector grew at a higher rate in Q1: 2019–20 as compared to Q4: 2018–19. The indicators available for Q2: 2019–20 point to a decline in the growth of most services. The decline in railways cargo traffic, international air cargo traffic, and cargo handled at major ports, taken together, is indicative of a general decline in the level of economic activity during Q2: 2019–20. In line with this observed pattern during Q2: 2019–20, the Nikkei Purchase Managers Index (PMI) was also below 50 during both September and October 2019.

Growth in exports and imports of goods and services both stalled during the second quarter of 2019–20 as mentioned earlier. The trade deficit as a percentage of GDP has increased in Q1: 2019–20. The exchange rate has depreciated throughout H1:2019–20 except in September 2019 (on a y-o-y basis).

Business sentiments reflects the generalised slowdown in the economy. NCAER's Business Confidence Index (BCI), an indicator of business sentiments across Indian industry, stood at 103.1 in Q2: 2019–20, falling by 15.3 per cent on a quarter-on-quarter (q-o-q) basis.

Inflation in the Consumer Price Index (CPI) increased in Q2: 2019–20 to 3.99 per cent, approaching RBI's inflation target of 4 per cent (+/-2 per cent). This increase was largely driven by an increase in the prices of food items. All the other components of the CPI showed a declining inflation trend. The Wholesale Price Index (WPI) inflation rate declined to 0.3 per cent, which is largely attributable to disinflation in fuel and power, and declining inflation in manufactured products. Thus, food price inflation has been rising while most other prices have been softening at both wholesale and retail levels.

The data just released for October 2019 shows that the CPI inflation rate has risen further to 4.6 per cent, mainly on account of food prices. The WPI, on the other hand has moderated to only 0.2 per cent. Core retail inflation (non-food and non-fuel) has moderated to 3.5 per cent in October 2019.

O.3 Macroeconomic Polices

Macroeconomic policies need to be assessed against the foregoing background of a persistently slowing real economy and declining inflation, except in the case of food prices.

Given low inflation and concerns over slackening growth, the Reserve Bank of India (RBI) undertook a series of cuts, reducing the policy Repo rate by 135 bps to 5.15 per cent as of October 2019. However, the transmission of rates has been weak, raising concerns about the effectiveness of monetary policy in reviving growth. Bank credit to the commercial sector (BCC) grew by 8.5 per cent, which is lower than the growth achieved during the corresponding period of the previous year. Credit extended to micro and small industries has actually declined. In order to improve the transmission of reduction in the policy rate, the RBI has issued a directive to banks to link their lending rates to any of four alternative external benchmarks. However, lending rates also have to be related to the actual cost of money, that is, deposit rates, and these cannot be easily reduced as long as depositors have the option of getting better returns at low risk, such as in small savings schemes and riskless long-dated G-secs. In this context, and with bank balance sheets still being weighed down by non-performing loans, it is unlikely that just lowering the Repo rate and linking of lending rates to external benchmarks will be adequate to increase the flow of credit to small and medium enterprises (SMEs) and the agricultural sector.

The large shortfall in tax revenue observed in 2018–19 is likely to be repeated in 2019–20. In H1: 2019–20, direct taxes grew by only 5.2 per cent as compared to a target of 17.1 per cent set in the annual budget. Indirect tax collection has actually declined by (–) 2.1 per cent in contrast to the growth target of 19.4 per cent set in the budget. The impact of tax revenue shortfall on total revenue is moderated by the significantly high growth of nearly 92 per cent in non–tax revenue, mainly on account of the massive transfer of RBI surpluses. Nevertheless, total revenue growth in H1: 2019–20 (the Centre's share), at 18 per cent, is well below the target of 25.6 per cent. The large revenue shortfall is unlikely to be passed on as a larger deficit, and most of it is likely to be absorbed through expenditure compression. This is already evident in the trend observed in H1: 2019–20. We are, therefore, likely to see a further slowdown in aggregate demand and GDP growth during 2019–20.

O.4 Conclusions

It is evident from the foregoing account that the real economy has been experiencing a sustained slowdown. Unfortunately, because of weak transmission, it is unlikely that monetary policy can be very effective in reviving growth at the present juncture. Providing a fiscal stimulus may be desirable but also challenging unless it can be financed through better revenue generation. The public sector borrowing requirement is already very large and therefore crowding out private investment. However, there is a possible silver lining in our nowcast of 4.9 per cent for Q2:2019–20 while the annual forecast for 2019–20 is also 4.9 per cent. This suggests that the growth deceleration may be bottoming out.

Nowcasting and Forecasting Indian GDP Growth

Rudrani Bhattacharya,[1] Bornali Bhandari, and Sandhya Garg

The quarterly model nowcasts that GVA will grow at 4.96 per cent in Q2: 2019–20 ranging between 4.41 and 5.51 based on a 68 per cent confidence interval. The annual model forecasts that GDP will grow at 4.95 per cent in 2019–20, ranging between 4.24 and 5.66, with a 68 per cent confidence interval.

F.1 Introduction

The growth rate of Gross Domestic Product (GDP) declined from 8.2 per cent in 2016–17 to 6.8 per cent in 2018–19. However, this aggregate hides quarterly variations. The GDP growth rate continuously declined from 8.1 per cent in Q4: 2017–18 to 5.0 per cent in Q1: 2019–20 on a year-on-year (y-o-y) basis. The Gross Value Added (GVA) shows similar trends for both quarterly and annual data. It fell below 5 per cent in Q1: 2019–20. Further, as discussed in the later chapters, the individual sectors like industry and services are also showing signs of slowing down in Q2: 2019–20. In this background, we nowcast the quarterly GVA growth rate of Q2: 2019–20, using information from a large number of high-frequency indicators. In addition, we forecast the GDP growth rate for 2019–20.

F.2 Nowcast GVA for Q2: 2019–20

The model has been estimated using a factor-augmented dynamic coefficient model. India, an emerging economy, is subject to frequent structural changes due to exogenous as well as policy shocks. This dynamic relationship needs to be captured quantitatively to facilitate nowcasting or forecasting of economic growth. Earlier research found that dynamic coefficient models can better capture the turning points of Indian GDP growth (Bhattacharya et al., 2019).[2] We estimate a Factor-Augmented Time-Varying Coefficient (FATVCM) regression model following Hamilton, 1994; and Kim and Nelson, 1999.[3]

The monthly indicators used to nowcast GVA are:

1. *Industrial variables*: Index of Industrial Production, production of two wheelers, production of commercial vehicles.
2. *Services variables*: Cargo handled at major ports, number of tourist

[1] Rudrani Bhattacharya is an Assistant Professor at the National Institute of Public Finance and Policy.

[2] Bhattacharya, R.; Chakravartti, P.; and Mundle, S. 2019. "Forecasting India's economic growth: a time varying parameter regression approach". *Macroeconomics and Finance in Emerging Market Economies*, 12(3).

[3] Hamilton, J. D. 1994. *Time Series Analysis*. Princeton University Press.
Kim, C. J. and Nelson, C.R. 1999. *State Space Models with Regime Switching: Classical and Gibbs Sampling Approaches with Applications.* MIT Press.

arrival, number of mobile connections.

3. *Monetary variables*: Food credit, non-food credit, aggregate deposits.
4. *Exports, Non-oil imports*.
5. *Price*: CPI-industrial worker.
6. *Fiscal variables*: Revenue receipts, net tax revenue.

We carry out a nowcast of Q2: 2019–20 GDP growth zero month ahead of the GDP data release since most of the monthly information was available till September 2019. In the case of three indicators where data are available up to August 2019, we have forecast them for September.

Based on the FACTVCM, the nowcast of Q2: 2019–20 zero month ahead of the GDP data release by the Central Statistics Office (CSO) is 4.96 per cent, ranging between 5.51 and 4.41 based on a 68 per cent confidence interval.

F.3 Forecasting Annual GDP Growth for the Financial Year 2019–20

In order to forecast the GDP growth for FY 2019–20, we estimate the demand side version of the principal components augmented time-varying coefficient model in Bhattacharya et al. (2019).[4] Our forecast for FY 2019–20 is 4.95 per cent, ranging between 5.66 and 4.24, with a 68 per cent confidence interval.

The annual indicators used to forecast GDP are:

1. Stock of foodgrains;
2. Developmental expenditure of the central and state governments as a percentage of GDP;
3. Non- developmental expenditure of the central and state governments as a percentage of GDP;
4. Real non-food credit;
5. Real effective exchange rate;
6. Real interest rate;
7. Real money (M3);
8. Foreign exchange reserve;
9. Fiscal deficit as a percentage of GDP at MP;
10. Gross capital formation; and
11. Ratio of exports to imports.

[4] Bhattacharya, R.; Chakravartti, P.; and Mundle, S. 2019. "Forecasting India's economic growth: a time varying parameter regression approach". *Macroeconomics and Finance in Emerging Market Economies*. 12(3).

Agriculture

Anil K Sharma

Trends in agricultural production in India are still heavily dependent on the monsoon. Despite its late arrival and initial hiccups in the first month of the season, the monsoon rainfall this year has lived up to normal expectations, as predicted in the forecasts of the India Meteorological Department (IMD). At a dis-aggregated level, of the total 36 agro-meteorological sub-divisions, 31 sub-divisions, covering about 85 per cent of the total area of the country, received normal to excess seasonal rainfall. Therefore, notwithstanding some setbacks due to delay in the onset of monsoon and floods in some parts during the latter part of the monsoon season, the current year should be one of buoyant growth for the agricultural sector.

A.1 Background

Notwithstanding the significant increase in the country's irrigation capacity during the last seven decades, around 52 per cent of the gross cropped area still remains unirrigated, which explains why Indian agriculture continues to be dependent on monsoon rainfall. Therefore, agricultural output and the incomes of farmers and agricultural labourers are adversely affected by the vagaries of the monsoon. This, in turn, leads to knock-on effects on both rural demand as well as the overall GDP of the country.

A.2 The Southwest Monsoon

The onset of the Southwest Monsoon in 2019 was delayed by seven days as Kerala received monsoon rainfall on the 8th of June instead of the usual 1st of June, after which the progress of monsoon rainfall during the month of June remained very weak in almost all parts of the country. All the four major regions of the country—east, west, north, and south—experienced deficit rainfall with deviations in rainfall indices ranging from (-) 28 per cent in the southern region to (-) 41 per cent in the northern region (Table A.1). Therefore, the first month of the monsoon season (June) ended with a huge deficit of about 34 per cent, measured as a deviation of the actual rainfall index from the normal index.

As the monsoon season progressed in July, however, there was a significant recovery in rainfall activity. Extensive rainfall, particularly in large parts of the western, northern, and to some extent the eastern and southern regions as well, reduced the overall rainfall deficiency considerably. Hence, the deficiency in the cumulative monsoon rainfall (June and July) in the eastern and southern regions came down to (-) 15 per cent and (-) 17 per cent, respectively. And, there was a complete reversal in the western region from deficit rainfall to excess rainfall. Rainfall in the northern region also became normal. Thus, compared to an overall rainfall deficit of about 34 per cent in

June, excess rainfall during the month of July reduced the rainfall deficit at the national level to just 7 per cent.

During the month of August, except for the eastern region, the other three regions (the western, northern, and southern regions) continued to receive normal to excess rainfall as the monsoon remained quite vigorous in several parts of the three regions. As a result, the cumulative rainfall in two of the four main zones of the country (the western and southern regions) was above normal while in the northern region, it was normal.

In September, the monsoon continued to remain significantly active in many parts of all the four major regions of the country. The normal to excess rainfall during the last month of the monsoon season led to the country receiving normal rainfall in all the four major zones. The cumulative monsoon rainfall for the season as a whole was just 5 per cent below normal in the eastern region; but it was above normal in the northern, southern, and western regions, respectively.

Table A.1: Deviations in the Monsoon Rainfall Indices from the Normal

Region	June	June–July	June–August	June–September
East	-35.5	-15.4	-15.1	-4.9
West	-30.9	3.0	20.7	32.0
North	-40.9	-2.6	0.0	2.6
South	-28.0	-16.7	8.8	16.5
All India	-33.6	-6.9	2.8	12.6

Source: Computed using data from the *India Meteorological Department* and *Directorate of Economics and Statistics*, Ministry of Agriculture and Farmer's Welfare.

Notes: These are deviations in regional level rainfall indices computed on the basis of un-irrigated area under foodgrains as weights.

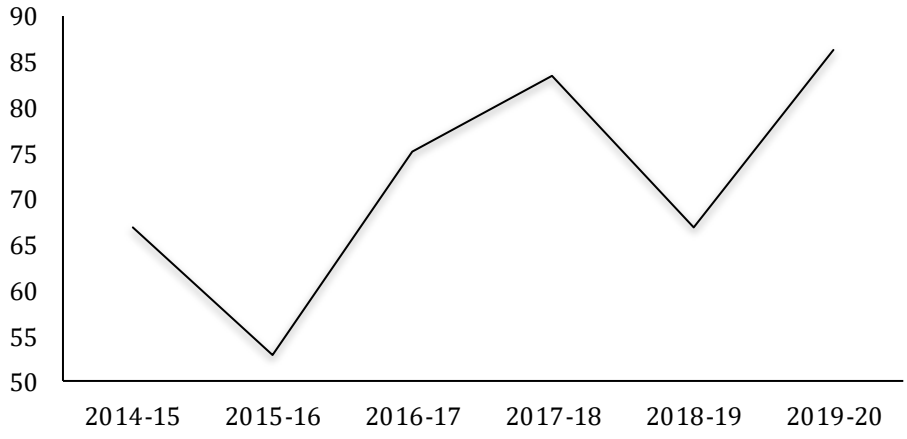
1. The eastern region includes Assam, Bihar, Jharkhand, Odisha, and West Bengal.
2. The western region includes Chhattisgarh, Gujarat, Madhya Pradesh, Maharashtra, and Rajasthan.
3. The northern region includes Haryana, Himachal Pradesh, Jammu and Kashmir, Punjab, Uttarakhand, and Uttar Pradesh.
4. The southern region includes Andhra Pradesh, Karnataka, Kerala and Tamil Nadu.

Consequently, despite its late arrival and large deficiency in the month of June, the monsoon season of 2019 ended with above normal rainfall in the country as a whole. At a dis-aggregated level, of the total 36 agro-meteorological sub-divisions, 31 sub-divisions covering about 85 per cent of the total area of the country, received normal to excess seasonal rainfall. Out of the five sub-divisions, which received deficient rainfall, two were from the eastern region [including a region comprising the States of Nagaland, Manipur, Mizoram, and Tripura; and Gangetic West Bengal], and three were from the northern region (comprising western Uttar Pradesh; Haryana, Chandigarh, and Delhi; and, Jammu and Kashmir). Hence, the spatial distribution of the overall seasonal rainfall

was also comparatively better than the last five years (Figure A.1).

Although this was a positive development, it is also important to note that heavy rainfall in some parts of the eastern, western, and southern regions resulted in severe floods, which caused significant losses of life and property in several States, including Bihar, Gujarat, Madhya Pradesh, Maharashtra, Rajasthan, and Kerala.

Figure A.1: Agro-climatic Regions with Normal Monsoon Rainfall 2014-15 to 2019-20 (%)



Source: IMD.

A.3 Outlook for 2019–20

It is obvious from the above discussion that despite its late arrival and initial hiccups in the first month of the season, the monsoon has been normal, as was predicted by IMD during April and May 2019. Notwithstanding some setbacks caused by floods, the current financial year should turn out to be a year of robust growth for the agricultural sector. To some extent, this is reflected in the preliminary estimates of the *Kharif* output released by the Ministry of Agriculture and Farmers Welfare in the last week of September (Table A.2).

Our estimates show that the estimated output of *Kharif* foodgrains is expected to be in the region of 147.9 million tonnes to 149.1 million tonnes, which indicates an increase of 4.3 per cent to 5.2 per cent over last year's record output of 141.7 million tonnes. The increase in output is likely to occur on account of the strong performance of all the three crop groups, viz., rice, coarse cereals, and pulses.

Table A.2: Estimated Output of Selected Agricultural Crops

Crops	Estimated Kharif Output (Ministry of Agriculture) (Million Tonnes/Bales*)		NCAER's estimates for 2019-20 (Million Tonnes/Bales*)	
	2018–19	2019–20 (First Provisional Estimates)	Estimate I	Estimate II
Rice	102.1	100.4	105.4	103.3
Coarse Cereals	31.0	32.0	34.2	35.2
Pulses	8.6	8.2	9.6	9.4
Food grains	141.7	140.6	149.1	147.9
Oilseeds	21.3	22.4	27.9	27.2
Other Crops				
Cotton*	28.7	32.3	30.7	29.4
Sugarcane	400.2	377.8	396.4	406.3

Source: Computed using area, yield, output, and rainfall indices.
Notes:
Estimate I: Based on output regression equations.
Estimate II: Based on area and yield regression equations.
* Million bales.

The output of *Kharif* rice is likely to increase by 1.1 to 3.2 per cent. While this may appear to be small, it signifies an increase over the record output of 102.1 million tonnes achieved in 2018–19. The output of *Kharif* coarse cereals and pulses is also likely to register a higher growth this year (Table A.2) due to the base effect of lower than expected output last year and better distribution of monsoon rainfall in 2019 in the areas where these crops are grown.

The growth in output of *Kharif* oilseeds is likely to be significantly higher as compared to last year's levels due to better performance of monsoon rainfall in the oilseed-growing regions of the country and somewhat muted performance in 2018–19. The estimates show that the production of *Kharif* oilseeds is expected to increase by about 28 to 31 per cent. In the case of cotton, our estimates indicate a growth of 2.5 to 6.9 per cent. The projected output of sugarcane is likely to be around the same as that achieved last year.

Our own estimates are higher than the first official provisional estimates, but the latter are likely to be revised upwards when the second advance estimates based on more precise information on area and yield are computed. Further, the incidence of pests and diseases has been less than normal for most crops. The incidence of normal to excess rainfall activity in 86 per cent of the country's sub-divisions has also helped improve the storage of water in the major reservoirs of the country. The current year's storage as on October 24, 2019 was 127 per cent of the long-term average of the last ten years. This is likely to benefit the ensuing *Rabi* crops immensely, which also points to an encouraging outlook for the *Rabi* season.

These improvements in the crop situation and in overall agricultural growth in 2019–20 should have a moderating effect on food prices, which have been rising during the first six months of the year. During the same period last year, the rate of food inflation for most products was much lower (Table A.3). Pulses and vegetables (including onions, tomatoes, peas, and beans), in particular, have witnessed high rates of inflation due to the delayed monsoon and late sowing.

Table A.3: Changes in Prices of Food Articles (April to September)

S. No.	Product	Change in 2017–18 over 2016–17	Change in 2018–19 over 2017–18	Change in 2019–20 over 2018–19
1	Food Articles	0.9	-0.4	7.1
2	Cereals	2.2	3.1	8.4
3	Pulses	-24.2	-18.9	18.3
4	Vegetables	5.6	-6.4	21.3
5	Fruits	2.1	0.3	4.9
6	Milk	4.3	2.5	1.4
7	Eggs, Meat and Fish	2.2	-0.3	6.1
8	Condiments and Spices	-14.5	6.5	4.8
9	Other Food Articles	-1.2	-1.9	1.5

Source: Computations by NCAER using data from the *Office of the Economic Adviser*, Government of India, Ministry of Commerce and Industry, Department for Promotion of Industry and Internal Trade (DPIIT), New Delhi.

Industry

Saurabh Bandyopadhyay and Bornali Bhandari

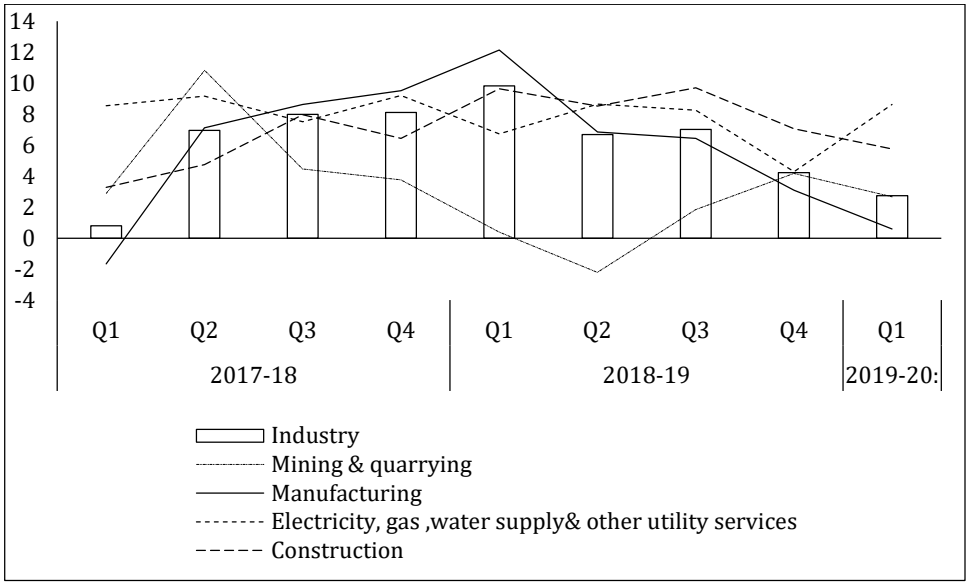
There has been a general slowdown of the industrial sector since Q3: 2018–19, mainly driven by decelerating growth in the manufacturing and construction sectors. The mining and utility sectors exhibited mixed growth trends. In Q1: 2019–20, all the industrial sectors showed declining growth except 'electricity, gas, water supply and utility services'. In Q2: 2019–20, the Index of Industrial Production (IIP) showed a year-on-year (y-o-y) growth of (–) 0.4 per cent as compared to a corresponding figure of 5.3 per cent in Q2: 2018–19. The three major components of IIP by economic activities, that is, mining, manufacturing, and electricity, showed growth rates of (–) 1.2 per cent, (–) 0.4 per cent, and 0.4 per cent, respectively, in Q2: 2019–20 versus the corresponding rates of 0.9 per cent, 5.6 per cent, and 7.5 per cent, respectively, attained in Q1: 2018–19. The outlook for the industrial sector remains gloomy due to weak demand and investment activities.

I.1 Industry: Aggregative Trends

India's real year-on-year (y-o-y) growth in Gross Domestic Product (GDP) slumped to a six-year low of 5 per cent in the first quarter of 2019–20. The slowdown was driven by driven by a y-o-y fall in private final consumption expenditure, government final consumption expenditure, gross fixed capital formation, exports and imports. Gross value added in industry and services also showed a marked slowdown.

The aggregative trend of industry and its major components, that is, manufacturing and construction, showed a downward trend, which has been more pronounced since Q3: 2018–19 (Figure I.1). The sector pertaining to mining and quarrying, and electricity, gas, water supply and other utility services showed a mixed but declining trend in growth over the corresponding period.

Figure I.1: GVA Industry and Its Components (Q1: 2017–18 to Q1: 2019–20, %y-o-y)

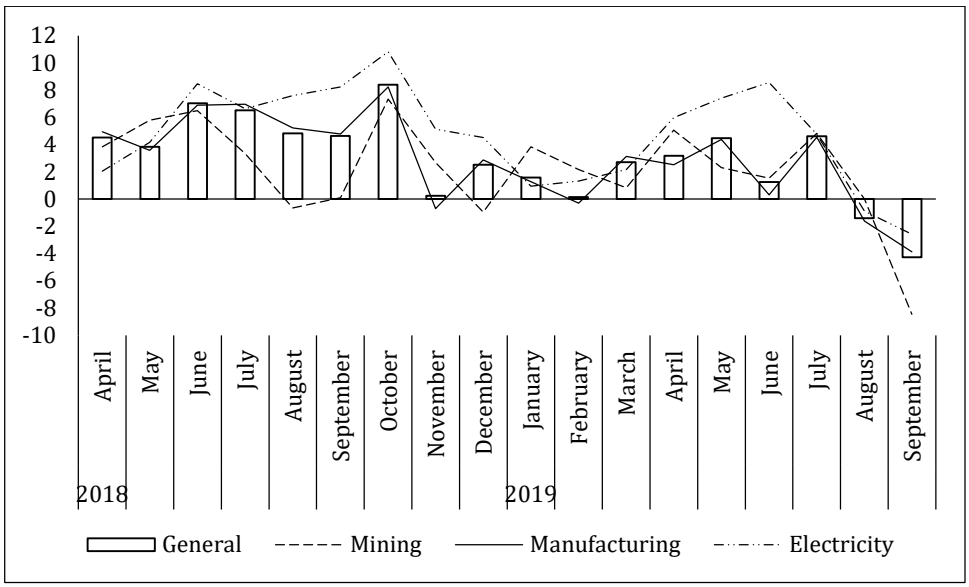


Source: NCAER Computations from MoSPI.

I.2 Trends in Industrial Activity

The Index of Industrial Production (IIP), a measure of industrial performance, shows a y-o-y growth of 1.3 per cent during H1:2019–20, against a y-o-y growth of 5.2 per cent during H1: 2018–19. The major component of IIP by economic activities, that is, the manufacturing sector, showed lower y-o-y growth (1.0 per cent) during H1:2019–20 as compared to that seen during H1:2018–19 (5.4 per cent). Mining too showed a dip in production, registering a y-o-y growth of 1.0 per cent in H1:2019–20 as compared with a growth of 3.2 per cent recorded during H1:2018–19. The other major component, that is, Electricity, showed a growth of 3.8 per cent during H1:2019–20 as compared to the preceding year (6.2 per cent). Manufacturing, which has the highest weight in the IIP (77.6), has also had an impact on the entire IIP scenario.

Figure I.2: IIP and Its Components
April 2018 to September 2019 (% y-o-y)



Source: NCAER computations from MoSPI.

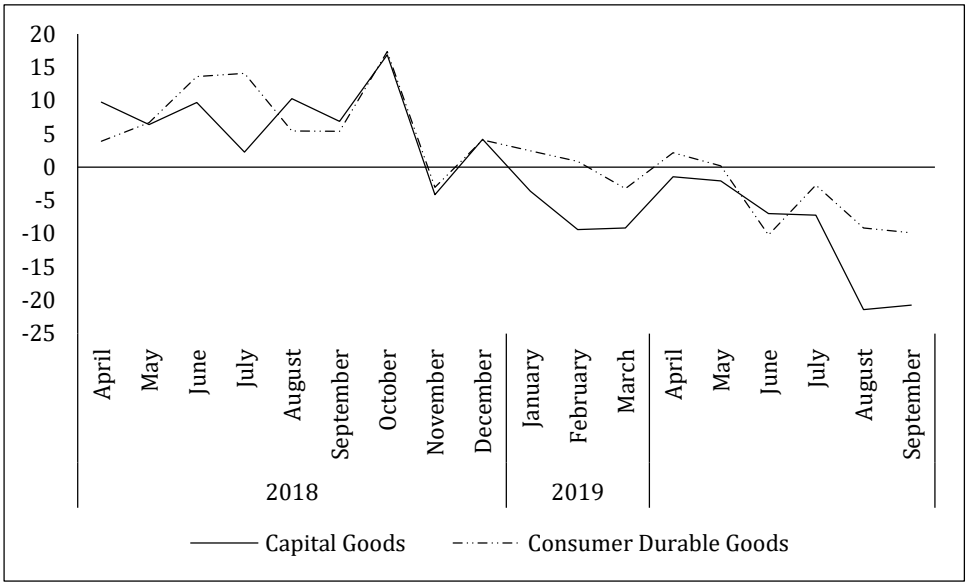
While it is well known that there was a slower growth in IIP during the first half of the current fiscal as compared to the previous fiscal, Figure I.2 particularly shows two key turning points, on in October–November 2018 and second in July–August 2019:

- There was a sharp fall in growth between October and November 2018, signalling a step down to a lower norm. While manufacturing IIP has recorded the steepest fall in November 2018, the other two components also shows a sharp fall. The decline in IIP in 2018 coincides with two events, one domestic and one global, namely, the IL&FS crisis in September 2018, and the evolving US–China trade war, which intensified during this period. Growth in merchandise exports showed a sharp y-o-y fall from 17.9 per cent in October 2018 to 0.8 per cent in November 2018 and stayed low thereafter, barring in the month of March 2019.

- The IIP growth pattern has been mixed for the intervening period between November 2018 and July 2019. Thereafter IIP has shown negative growth for two months in August and September 2019. The worsening of IIP growth along with all its components in August and September 2019 signal deepening of the slowdown in industrial activity.

In order to assess whether the above movements in IIP are due to base effects or the result of a sustained fall in growth post October 2018, we examine the de-seasonalised IIP (both general and manufacturing) annualised growth rates on a month-on-month basis. This analysis confirms that the average growth rates during the H1: 2019–20 [(–)10.9 per cent and (–)10.2 per cent, respectively] were lower for both IIP and IIP manufacturing than H1: 2018–19 [2.9 per cent and 3.8 per cent respectively). Also the volatility is significantly higher in 2019–20. The standard deviation of IIP during the H1: 2019–20 was 31.9 versus 12.5 registered in H1: 2018-19. The corresponding figures for IIP manufacturing were 33.9 and 13.4, respectively.

Figure I.3: IIP Consumer Durable and Capital Goods, April 2018 to September 2019 (% y-o-y)



Source: NCAER computations from MoSPI.

I.2.1 Index of Industrial Production: Volatility in Capital Goods and Consumer Durables

Out of the six use-based classification categories of goods, y-o-y growth declined in four categories, namely primary goods, capital goods, infrastructure/construction goods, and consumer durables, during H1: 2019–20. Capital goods and consumer durables sectors showed the maximum decline in growth. Figure I.3 depicts the sharp y-o-y fall in growth between October and November 2018 for both the categories. Thereafter, the growth for both these types of goods has continued to decline. The growth of consumer durables slipped into negative category in June 2019 whereas growth of capital goods has been there since January 2019. The fall in growth of both these categories of goods has further deepened in August and September 2019.

The fall in capital goods is a signal for a fall in investment demand, an important warning signal! In addition to negative growth in consumer durables, consumer non-durables also experienced negative growth in September 2019. The fall in consumer goods is a symptom of weak consumer demand for both necessary and luxury goods.

The decline in industrial production has been widespread. Out of 23 manufacturing industries, which account for over 77 per cent of total industrial production the, output has actually declined in 15 industries during H1:2019–20 including 'motor vehicles, trailers and semi-trailers', 'manufacture of fabricated metal products, except machinery and equipment' etc. Core industries consisting of coal, crude oil, natural gas, petroleum, fertilisers, steel, cement and electricity together account for over 40 per cent of industrial production. This group has also shown a sharp declined in growth of 1.3 per cent during the period April–September 2019–20 as against a growth of 5.5 per cent recorded during the corresponding period in the previous fiscal.

I.3 Outlook

The Nikkei India Manufacturing PMI fell from 52.8 in Q1:2018-19 to 51.9 in Q1:2019-20. After remaining stagnant at 51.4 in August and September at 2019, it fell further to 50.6 in October 2019. The Reserve Bank of India's 46th Round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) for Q1: 2019–20 shows that at the aggregate level, capacity utilisation declined to 73.6 per cent in Q1: 2019–20 from 76.1 per cent in Q4: 2018–19, based on a general tracking of the de-trended IIP. The RBI Consumer Confidence Index has also fallen. With weak demand from both domestic and international markets and weak investment, the outlook for the industrial sector in the short-run is worrying.

Services

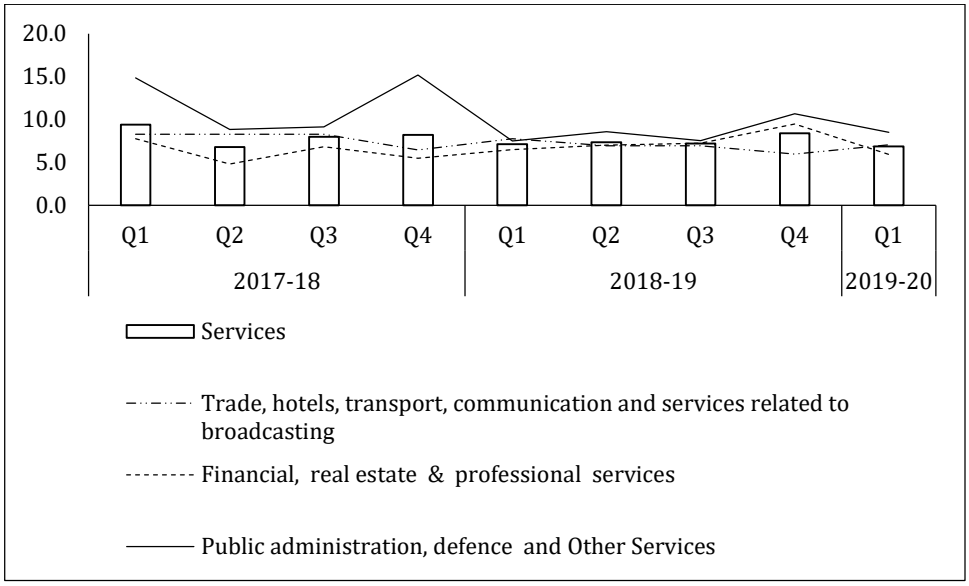
Bornali Bhandari and Devender Pratap

The growth of the services sector and its three components has shown a mixed trend during the last couple of years. This mixed pattern continued during Q1: 2019–20. There was a slowdown in the 'financial, real estate and professional services' and 'public administration, defence and other services' sectors. However, the 'trade, hotels, transport, communication and services related to broadcasting' sector grew at a higher rate in Q1: 2019–20 as compared to Q4: 2018–19. The indicators available for Q2: 2019–20 suggest that the growth of most services has now declined. In line with this observed pattern during Q2: 2019–20, the Nikkei Purchase Managers Index (PMI) was also below 50 during both September and October 2019.

S.1 GVA Estimates of the Services Sector

The services sector, which accounts for more than 56 per cent of India's Gross Value Added (GVA) has been the key driver of India's economic growth during the first quarter of 2019–20. The services sector as a whole and its sub-components showed mixed growth patterns since 2017–18 (Figure S.1). In Q1: 2019–20, the year-on-year (y-o-y) growth declined for two of the three sub-sectors of the services sector, namely, 'financial, real estate and professional services' and 'public administration, defence and other services', while it increased for 'trade, hotels, transport, communication and services related to broadcasting'.

Figure S.1: GVA Services and Its Components
(% y-o-y, Q1: 2017–18 to Q1: 2019–20)

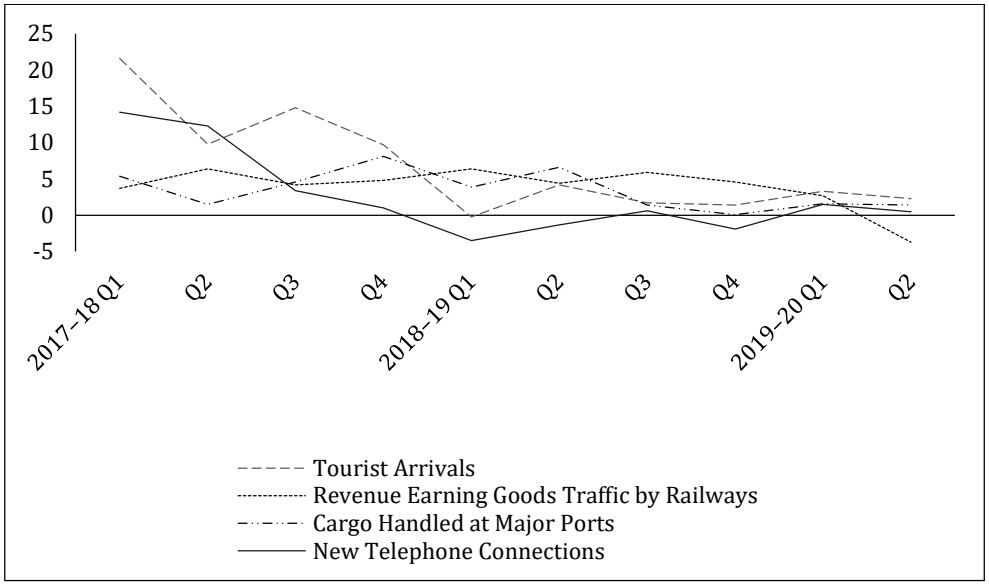


Source: NCAER computations from MoSPI.

S.2 Indicators of Individual Services during Q2: 2019–20

The indicators of services sector showed lower y-o-y growth during Q2: 2019–20. The growth of all indicators of individual service deliveries like railways, ports, tourist arrivals, and new telephone connections also declined in Q2: 2019–20 as compared to Q1:2019–20 (Figure S.2). In particular, revenue earnings from railways goods traffic declined in Q2: 2019–20. The growth of international air cargo traffic also declined (Figure S.3). However, domestic air traffic, including both passenger and cargo traffic, and international air passenger traffic showed a marginal rise in Q2: 2019-20 after having declined in Q1: 2019–20. The decline in railways cargo traffic, international air cargo traffic, and cargo handled at major ports, taken together, is indicative of a general decline in the level of economic activity during Q2: 2019–20.

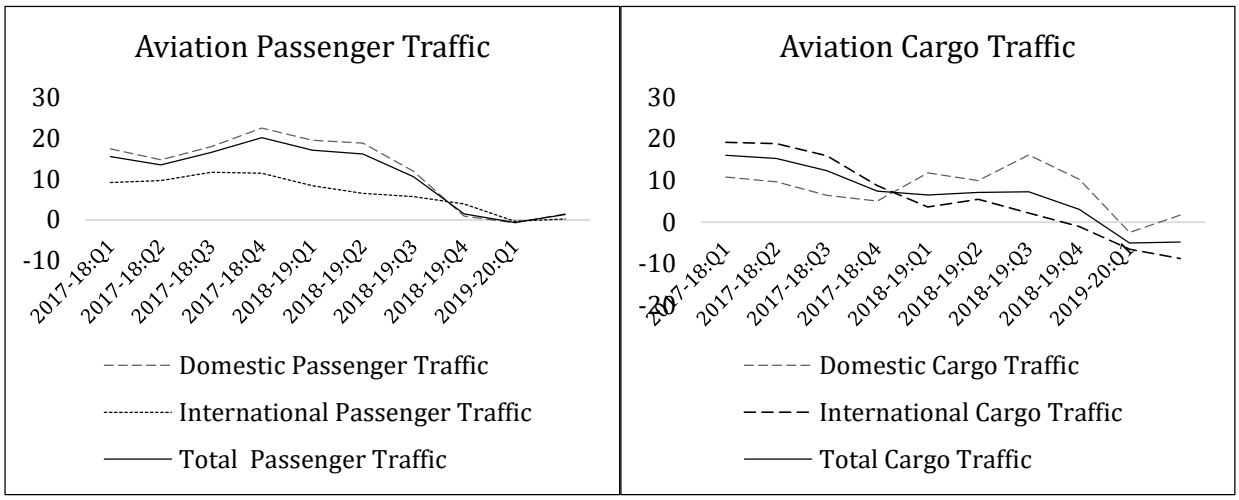
Figure S.2: Tourist Arrivals, Revenue Earning Goods Traffic by Railways, Cargo Handled at Major Ports, and New Telephone Connections, Q1: 2017–18 to Q2: 2019–20 (% y-o-y)



Sources: Foreign Tourist Arrivals—Press Information Bureau, Ministry of Tourism; Railway Traffic—Press Information Bureau, Ministry of Railways; CMIE.

Notes: New telephone connections, including both wireless and fixed connections, are for the months of July and August 2019.

Figure S.3: Aviation Traffic, Q1:2017–18 to Q2: 2019–20 (%y-o-y)

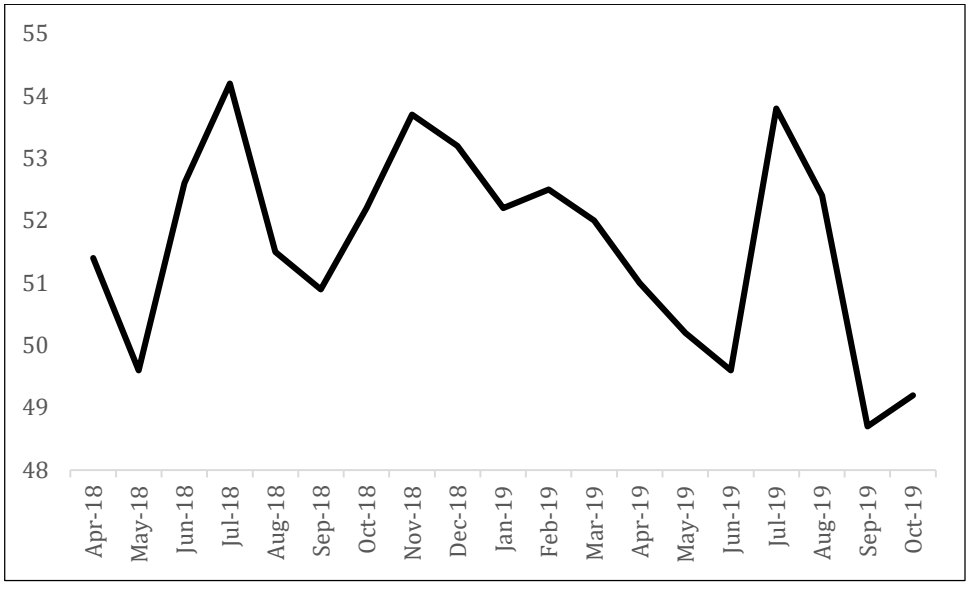


Source: Airports Authority of India.

S.3 Outlook

The Nikkei Services PMI, which had peaked in July 2018, steadily deteriorated thereafter till June 2019, increased in July 2019, but has dipped again since then. The decline in the Nikkei PMI to a level below 50 during both September and October of 2019 suggests that the outlook for the services sector remains gloomy.

Figure S.3: Nikkei Services PMI Index, April 2018 to October 2019



Source: Nikkei Asian Review. https://asia.nikkei.com/Markets/Nikkei-PMI/.

The External Sector

Prerna Prabhakar

The growth of the world economy is currently (in 2019) at its lowest since the Global Financial Recession of 2008. After growing at 3.8 per cent in 2018, the world economy is projected to grow at only 3 per cent in 2019, and this is consistent across all country groups. Although growth is expected to revive in 2020, this projection varies across countries. Growth in some countries like the US, China, and Japan may decline further due to a variety of country-specific factors. After a remarkable rebound in 2017 (when the growth rate was 5.5 per cent), global trade has been adversely impacted by rising US–China trade tensions, Brexit, and conflicts in the Middle East. It is expected to decline sharply, falling to only 1.1 per cent in 2019. Growth in India is also projected to slow down in 2019. In this global backdrop, policymakers in India need to make efforts to enhance the competiveness of Indian products. It is also imperative to ensure that Indian products become an integral part of Global Value Chains (GVCs), and occupy some of the space being vacated by China. From this perspective, policies like the recent corporate tax rate cut can encourage the enhanced flow of Foreign Direct Investment (FDI) as a possible route for embedding Indian products in GVCs. In this context, India's recent withdrawal from the Regional Comprehensive Economic Partnership (RCEP) could adversely affect the prospects of its export growth. However, it is possible that there would be further negotiations leading to India's eventual entry into RCEP.

E.1 The World Economy

Amidst declining global demand, the International Monetary Fund (IMF) has projected the global economy to grow at a low rate of 3 per cent in 2019, a substantial decline from 3.8 per cent in 2018. This is the lowest rate of growth observed since the Global Financial Crisis of 2008. This state of the global economy is characterised by a synchronised decline across the economies. Although growth is expected to pick up slightly, going up to 3.4 per cent in 2020, this improvement may not be consistent across the economies (Table E.1). The projected figures for 2019 and 2020 are lower than the projections for April by 0.3 and 0.2 per cent, respectively [IMF, World Economic Outlook (WEO) October 2019][1].

This downward trend for the global economy is mirrored in the growth projections for the advanced economies group, at 1.7 per cent, both in 2019 and 2020—the forecast for 2019 is 0.1 percentage point lower than the corresponding WEO projection for April 2019.

Growth in the United States is expected to be 2.4 per cent in 2019, 0.1 percentage point higher than the April 2019 WEO. Unlike the global trend, the US economy is expected to witness a decline to 2.1 per cent in 2020, which can be attributed to a possible shift in the fiscal policy from expansionary in 2019 to broadly neutral in 2020.

The Euro Area grew at 1.9 per cent in 2018, and is projected to grow at a much lower rate of 1.2 per cent in 2019 (0.1 percentage point lower than the April 2019 WEO figure) and at 1.4 per cent in 2020 (0.1 percentage point lower than the corresponding

[1] The discussion in this section is based on the details provided in the *World Economic Outlook*, October 2019, IMF.

April 2019 WEO figure). Acceleration in growth in 2020 is expected, as external demand is projected to recover, along with the disappearance of temporary factors like new emission standards that had hit car production in Germany.

Japan's economy is predicted to grow at 0.9 per cent in 2019 (0.1 percentage point lower than the corresponding April 2019 WEO figure). Growth is projected to decline to 0.5 per cent in 2020, which is the same as the corresponding April 2019 WEO figure. This projected decline is possibly on account of the potential hit that private consumption may take, following the increase in the corporate tax rate in October 2019. However, the temporary fiscal measures in the economy can be expected to balance this fall in consumption.

The group of Emerging Market and Developing Economies (EMDEs) grew at 4.5 per cent in 2018, but is expected to slide to 3.9 per cent in 2019, followed by a substantial acceleration to 4.7 per cent in 2020.[2] Although the growth trend reflects positive prospects for the group, the forecasts for both 2019 and 2020 are 0.5 and 0.2 percentage points lower, respectively, than those in the April 2019 WEO, pointing to downward revisions in all the major regions.

For China, which was growing at 6.6 per cent in 2018, the growth forecast is 6.1 per cent in 2019 and 5.8 per cent in 2020—0.2 and 0.3 percentage points lower for 2019 and 2020, respectively, relative to the April WEO projection. The projected slowdown in China can be attributed to escalating tariffs and weakening external demand.

In view of the restrained global demand, reduced investment, and escalating trade tensions, global trade is projected to grow at 1.1 per cent in 2019, declining by 2.3 percentage points as compared to the corresponding April 2019 WEO figure. The trade levels are projected to improve and rise at 3.2 per cent in 2020, with revival of investment demand in the EMDEs expected to lead to economic recovery in 2020.

E.2 India's International Trade

Despite a huge merchandise trade deficit, India's trade surplus in services has proved to be a saviour for the country's Balance of Payment (BoP) position.

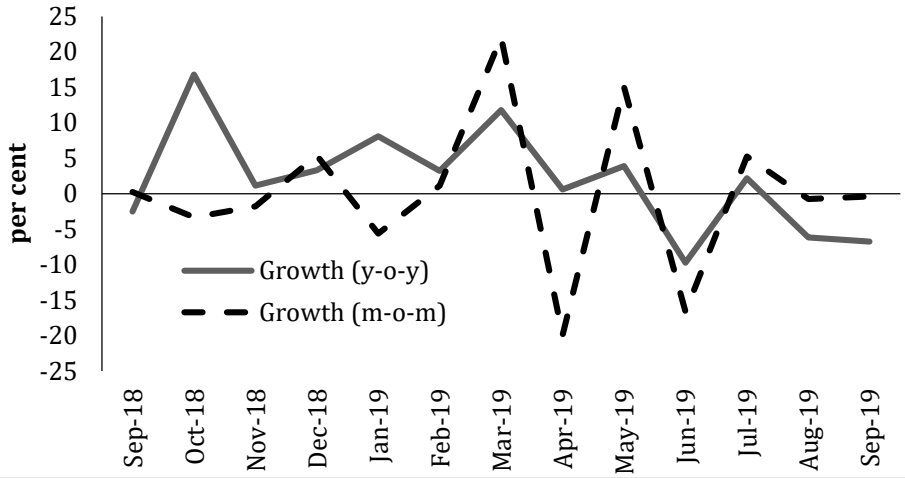
India's total exports, including merchandise and services, are estimated to be worth US$ 267.2 billion for the first half of the Financial Year (FY) 2019–20, that is, the period April–September 2019, thereby exhibiting a growth of 1.9 per cent on a year-on-year (y-o-y) basis. The total imports during this period are estimated to be worth US$ 312.16 billion, exhibiting a decline of 3.1 per cent on a y-o-y basis. The trade deficit for the period April–September 2019 stands at US$ 83.7 billion, as compared to the corresponding figure of US$ 98.1 billion achieved during the same period in FY 2018–19.

[2] The Indian economy grew at 6.8 per cent in 2018–19 and as per NCAER forecasts in November 2019 is forecasted to growth at 4.9 per cent in 2019–20.

E.2.1 Merchandise Trade

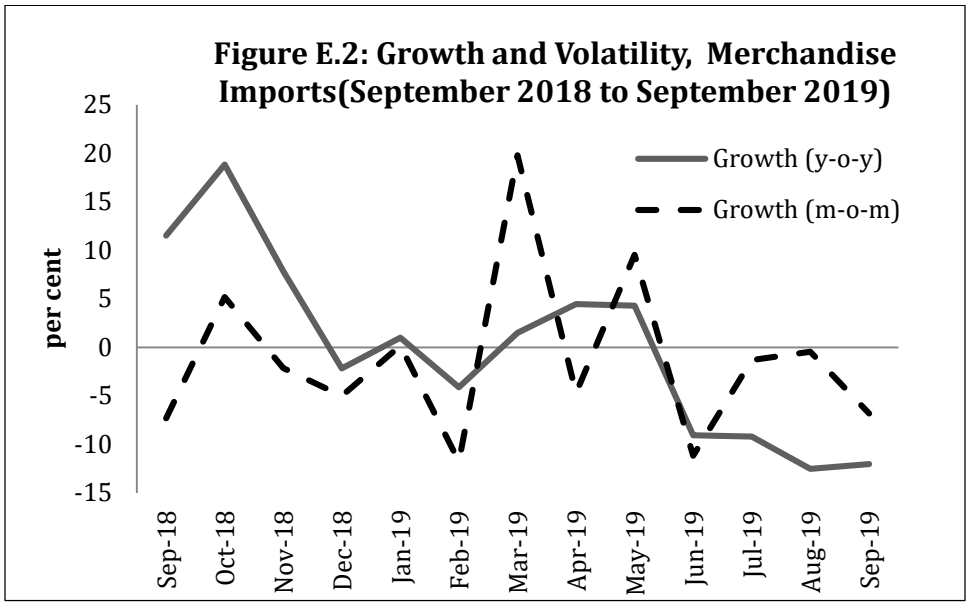
Merchandise exports during the period April–September in FY 2019–20 stood at US$ 159.57 billion, signifying a contraction by 2.39 per cent as compared to the figure recorded during the same period in FY 2019–20 (Figure E.1). Petroleum exports during this period amounted to US$ 21.5 billion, reflecting a substantial contraction by around 9 per cent on a y-o-y basis. Non-petroleum exports aggregated to US$ 137.9 billion during the period April–September of FY 2019-20, signifying a decline of 1.4 per cent on a y-o-y basis. This massive decline in exports can be attributed to escalating trade tensions and limited global demand.

Figure E.1: Growth and Volatility, Merchandise Exports (September 2018 to September 2019)



Source: Ministry of Commerce and Industry website

Merchandise imports for the period April–September 2019–20 amount to US$ 243.28 billion, exhibiting a fall of 7 per cent (Figure E.2). Oil imports during the period April–September 2019–20 stand at US$ 64.3 billion, which is 8.2 per cent lower than the corresponding figure of US$ 70 billion achieved during the same period last year. Non-oil imports during April–September 2019–20 were worth US$ 179 billion, which was 6.57 per cent lower than the corresponding figure of US$ 191.6 billion recorded during April–September 2018–19.



Source: Ministry of Commerce and Industry website

E.2.2 Services Trade

The receipts and payments for services trade amount to US$ 107.63 billion and US$ 68.88 billion, respectively, exhibiting a trade surplus of US$ 38.75 billion. On a y-o-y basis, services exports and imports grew at 9.1 per cent and 13.5 per cent, respectively. Net services receipts increased by 7.3 per cent on a y-o-y basis, mainly on account of a rise in net earnings from travel, financial services and telecommunications, computer and information services.

E.2.3 Major Trading Partners

In the backdrop of a large merchandise trade deficit, it is imperative to examine the shares of India's trading partners in its exports and imports, in order to formulate strategies for narrowing down the deficit.

As is evident from India's exports to the main regions of the world during the period April–August in FY 2019–20, the Asian region dominates India's export basket, accounting for an approximate share of 46.5 per cent of the total exports destined, followed by America (at a 22 per cent share) and Europe (at a 20.7 per cent share).

A destination country-wise analysis reveals that about 31.6 per cent of India's total exports are concentrated among the top three partners countries. The top five export destinations for India include the US (16.8 per cent), United Arab Emirates (UAE) (9.5 per cent), China (5.3 per cent), Hong Kong (3.6 per cent), and Singapore (3.5 per cent).

More than half of India's imports originate from the Asian region, at 58.7 per cent, for the period April–August of FY 2019–20. The other important source regions for India's imports include Europe (17.7 per cent) and America (13 per cent).

The country-wise imports show a higher concentration among the top 20 partners, at 76 per cent, as compared to the concentration of exports. India's top import partners include China (14.3 per cent), the US (7.9 per cent), UAE (5.6 per cent), Saudi Arabia (5.6 per cent), and Iraq (4.8 per cent).

This analysis highlights the trend of India's concentrated trade with the Asian region. In view of its existing potential, India should aim to diversify its exports within the region, while striving to exploit the latter's GVC potential. This situation also necessitates efforts to contain the deficit with respect to China, China's share in India's imports is clearly much higher than its share in India's exports.

E.3 Balance of Payments

The BoP record is available for the period April to June 2019–20 (Table E.2). During this period, India's current account deficit (CAD), at US$ 14.3 billion (amounting to 2.0 per cent of GDP) contracted by 9.5 per cent as compared to the corresponding period in FY 2018–19. Although there was an increase in the deficit in goods on a y-o-y basis, this was outweighed by a surplus in services. Net services receipts during the period April–June 2019–20 stood at US$ 20 billion, as compared to the corresponding figure of US$ 18.7 billion achieved during the same period in 2018–19.

In the financial accounts, the period April–June 2019–20 was characterised by positive net FDI of US$ 13.9 billion, exhibiting a rise of 44.8 per cent on a y-o-y basis. The sectors that attracted the maximum FDI inflows include services, computer software and hardware, and telecommunications. Foreign portfolio investment recorded a net inflow of US$ 4.8 billion during the period April–June 2019–20, as compared to an outflow of US$ 8.1 billion achieved last year. The RBI data shows that FDI equity inflows showed year-on-year (y-o-y) growth of 27.7 per cent in Q1:2019–20 versus 22.3 per cent in Q1:2018–19[3]. This net inflow resulted in a gain in foreign exchange reserves by US$ 14 billion in during the period April–June 2019–20 as against a depletion of US$ 11.3 billion in reserves during the corresponding period in 2018–19.

E.4 Is India ready to face the RCEP Fallout?

After years of deliberations and negotiations, India has finally announced that it will not be a part of the Regional Comprehensive Economic Partnership (RCEP) Free Trade Agreement (FTA) negotiations. The major issues that were flagged by India during the last Bangkok ministerial for RCEP held in early October 2019, remained unresolved. Further

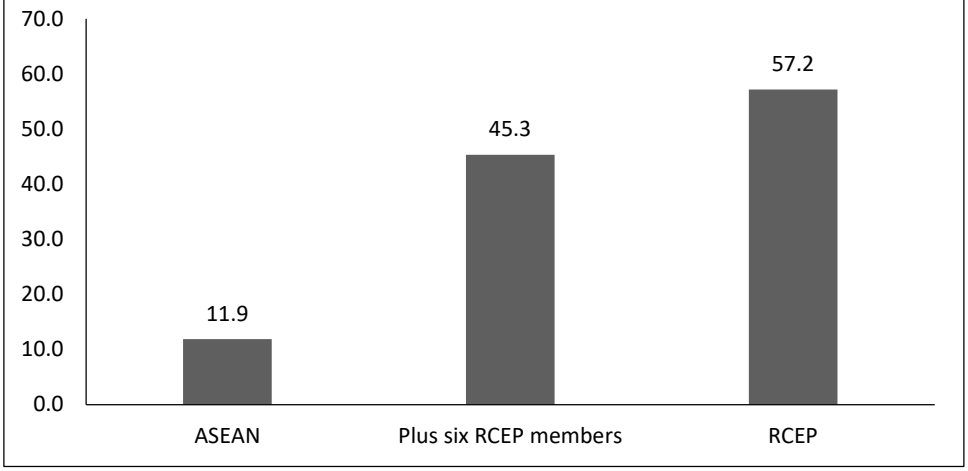
[3] The RBI data shows that FDI equity inflows grew by 14.9 per cent year-on-year (y-o-y) in H1:2019–20 versus (–) 10.4 per cent in in H1:2018–19.

potential negative effects of the RCEP on agriculture, dairy and MSME sectors were cited to reject the FTA.

The Regional Comprehensive Economic Partnership (RCEP) is a Free Trade Agreement being negotiated among 16 countries that includes ASEAN region, India, China, Japan, South Korea, Australia and New Zealand.

India's stance on RCEP negotiations is broadly characterised by perceptions that the domestic manufacturing sector maybe worse-off if India is part of the FTA. India already has a trade deficit of around 105 Billion USD with the RCEP members, which is about 57.2 per cent of India's total trade deficit. Out of India's total trade deficit with RCEP members, ASEAN members account for 11.9 per cent and six Free Trade Agreement (FTA) partners of ASEAN, namely Australia, China, Japan, South Korea and New Zealand account for 57.2 per cent, largely contributed by China – around 29 per cent of total deficit (Figure E.3). The proponents of this argument argue that given such a gigantic trade deficit with potential RCEP members, possible preferential tariff rates under the proposed FTA arrangement would enhance India's trade deficit with RCEP.

Figure E.3: Share in India's Trade Deficit in 2018-19 (%)



Source: Author's computations from Ministry of Commerce and Industry website.

Further, India has not been particularly successful in fully utilising the opportunities offered by free FTAs. This has been brought out by a NITI Aayog report in 2017, which notes that India's exports to FTA countries has not outperformed overall export growth or exports to rest of the world and FTAs have led to increased imports and exports, although the former has been greater. It is observed that India's trade deficit with Korea, ASEAN and Japan has increased since India's FTAs with these countries/groups came into existence, which is definitely not a desired scenario Other key observations from the report pertain to low utilisation rate of RTAs by exporters in India between 5 and 25 per cent.

However, there are costs of not joining the RCEP. As Asian region constitutes a substantial proportion of India's exports and imports, the cost to India for not joining RCEP can be huge as such a scenario would take away a substantial part of Asian market. This argument is supported by a paper submitted by National Council of Applied Economic Research (NCAER) to the High-Level Advisory Group (HLAG) appointed by Government of India, according to which a hypothetical RCEP like free trade area, along with US-China tariff war, will prove to be beneficial for all member countries, particularly for India.

Further, the RCEP also meant an opportunity to be a part of Global Value Chains (GVCs), which is currently being exploited intensively by Bangladesh and Vietnam.

India's own economic history shows that protectionism neither adds to domestic manufacturing capacity nor to its competitiveness nor to overall economic growth. In a scenario, where India is demand constrained, closing doors to potential markets only hinders economic growth.

Table E.1: Growth of Global Output and Trade (%, y-o-y)

	Projections		
World Output	**2018**	**2019**	**2020**
Advanced Economies	2.3	1.7	1.7
United States	2.9	2.4	2.1
Euro Area	1.9	1.2	1.4
Germany	1.5	0.5	1.2
France	1.7	1.2	1.3
Italy	0.9	0	0.5
Spain	2.6	2.2	1.8
Japan	0.8	0.9	0.5
United Kingdom	1.4	1.2	1.4
Emerging Market and Developing Economies	4.5	3.9	4.6
Russia	2.3	1.1	1.9
Emerging and Developing Asia	6.4	5.9	6
China	6.6	6.1	5.8
India	6.8	6.1	7
ASEAN-5	5.2	4.8	4.9
Latin America and the Caribbean	1	0.2	1.8
Brazil	1.1	0.9	2
Mexico	2	0.4	1.3
World Trade Volume (Goods and Services)	3.6	1.1	3.2

Source: World Economic Outlook, IMF, October 2019

External Sector

Table E.2: Overall Balance of Payments in India (US$ Million)

		April–June 2019 (P)			April–June 2018		
		Credit	**Debit**	**Net**	**Credit**	**Debit**	**Net**
1	Current account (1.A+1.B+1.C)	1,60,686	1,75,002	-14,316	1,55,748	1,71,530	-15,782
1.A	Goods and services (1.A.a+1.A.b)	1,34,926	1,61,107	-26,181	1,31,589	1,58,664	-27,074
1.A.a	Goods (1.A.a.1 to 1.A.a.3)	82,729	1,28,941	-46,212	83,389	1,29,140	-45,751
1.A.b	Services (1.A.b.1 to 1.A.b.13)	52,197	32,166	20,031	48,200	29,524	18,676
1.A.b.1	Manufacturing services on physical inputs owned by others	33	18	14	25	10	15
1.A.b.2	Maintenance and repair services n.i.e.	45	413	-368	40	207	-167
1.A.b.3	*Transport*	5344	6104	-760	4863	4776	87
1.A.b.4	*Travel*	6950	6203	747	6448	5914	534
1.A.b.5	*Construction*	754	754	0	1010	649	361
1.A.b.6	*Insurance and pension services*	588	409	179	606	373	233
1.A.b.7	*Financial services*	1287	519	769	1111	744	367
1.A.b.8	*Charges for the use of intellectual property n.i.e.*	319	2091	-1771	228	2087	-1859
1.A.b.9	*Telecommunications, computer, and information services*	23604	2207	21,397	20,746	1882	18,864
1.A.b.10	*Other business services*	11475	11,715	-239	9436	9479	-43
1.B	Primary income (1.B.1to1.B.3)	5797	11,913	-6116	5356	11,117	-5760
1.B.1	Compensation of employees	1,352	639	713	1,144	603	541
1.B.2	Investment income	3230	11,074	-7844	3563	10,337	-6774
1.B.3	Other primary income	1216	200	1016	650	177	472
2	Financial account (2.1 to 2.5)	140946	1,26,253	14,692	1,42,471	1,26,384	16,087
2.1	Direct investment (2.1A+2.1B)	21215	7323	13,891	17,235	7663	9573
2.1.A	*Direct investment in India*	20830	3976	16,854	16,960	3834	13,126
2.1.B	*Direct investment by India*	384	3347	-2963	276	3829	-3554
2.2	Portfolio investment	67178	62,335	4843	60,453	68,598	-8145
2.3	Reserve assets	0	13,984	-13,984	11,338	0	11,338
3	Net errors and omissions	447		447		322	-322

Notes: P: Provisional ***Source***: RBI, Monthly Bulletin, November 2019.

Prices

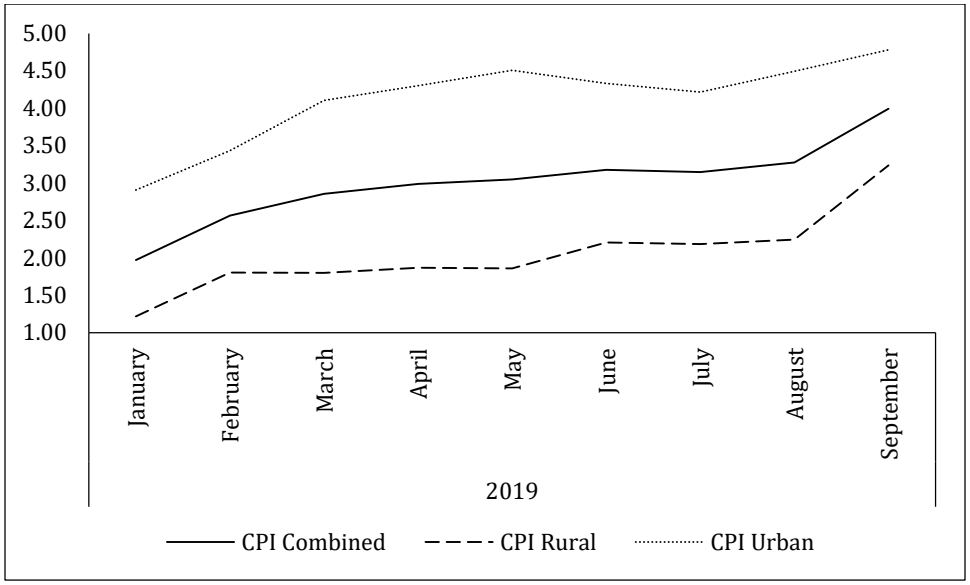
Samarth Gupta, Ajaya Sahu, and Bornali Bhandari

Inflation in the Consumer Price Index (CPI) increased in the last quarter to 3.99 per cent, approaching RBI's inflation target of 4 per cent (+/-2 per cent). The increase was largely driven by an increase in the prices of food items. All the other components of the CPI showed a declining inflation trend. The Wholesale Price Index (WPI) inflation rate approached 0.3 per cent, which is largely attributable to disinflation in Fuel and Power, and declining inflation in manufactured products. Thus, only food inflation has been rising whereas the other prices have recorded a decline in inflation, or even disinflation.

P.1 Retail Inflation

After falling to 2 per cent in January 2019, the combined Consumer Price Index (CPI) has slowly edged up to 4.0 per cent on a year-on-year (y-o-y) basis, the lower bound of the RBI inflation target. The rural and urban CPI inflation rates exhibit similar trends. The CPI rural inflation rate increased from 1.2 per cent in January 2019 to 3.2 per cent in September 2019 whereas the CPI urban inflation rate increased from 2.9 per cent to 4.8 per cent over the same period. Retail inflation rates pertaining to CPI Industrial Workers and Agricultural Labour also edged up between January and September 2019. However, the core CPI inflation (non-food and non-fuel) has remained relatively stable in the first two quarters of 2019 at around 4.3 per cent.

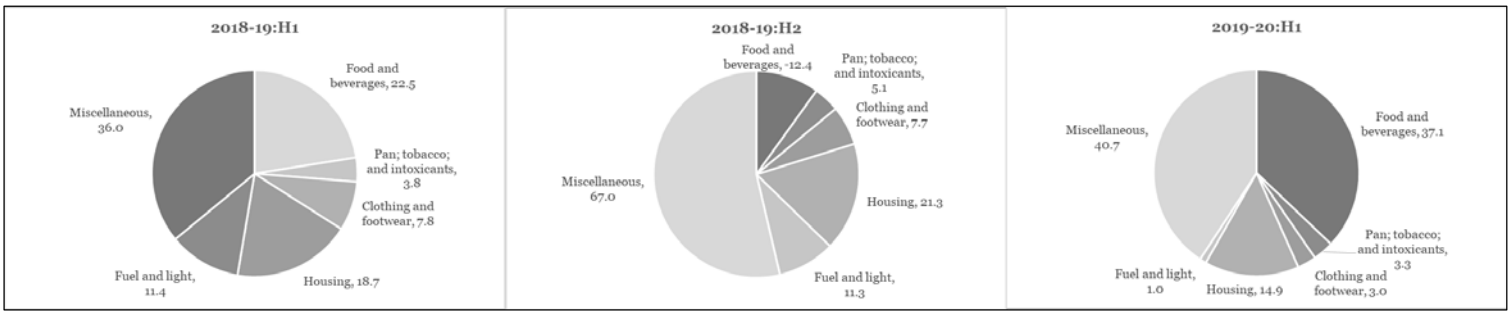
Figure P.1: CPI Inflation and Sectoral Variation, April 2018–September 2019 (% y-o-y)



Source: Authors' calculations from MoSPI.

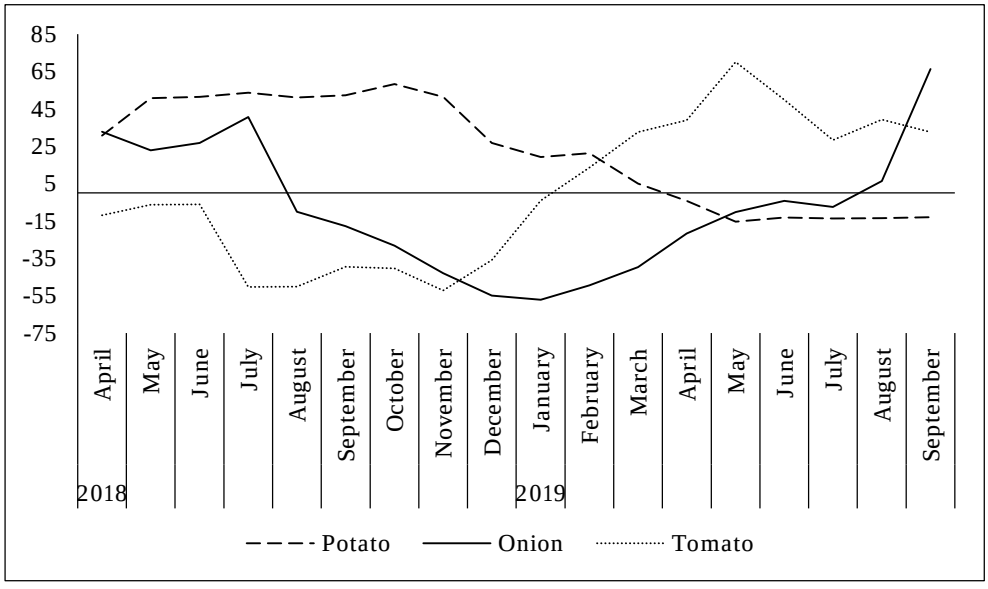
Of the major six groups, the 'miscellaneous' and 'food and beverages' groups were the biggest contributors to inflation in the first half of the current fiscal (Figure P.2). A point to be noted is that the contribution of food and beverages inflation to overall retail inflation has gone up in H1: 2019–20 versus H2:2018–19. In contrast, the contribution of miscellaneous inflation has come down. Within the miscellaneous group, the health and education sectors experienced the highest inflation. Within the 'food and beverages' group, vegetables and pulses have been the two main drivers of inflation. Within 'vegetables', we have specifically analysed the potato–onion–tomato inflation (Figure P.3). Onion inflation showed a sharp rise in Q2: 2019–20. Although tomato inflation showed moderation, it remained high. Potato, on the other hand, exhibited deflation.

Figure P.2: Contributors to CPI Combined Inflation
H1: 2018–19, H2: 2018–19, and H1: 2019–20 (% y-o-y)



Source: Authors' calculations from MoSPI.

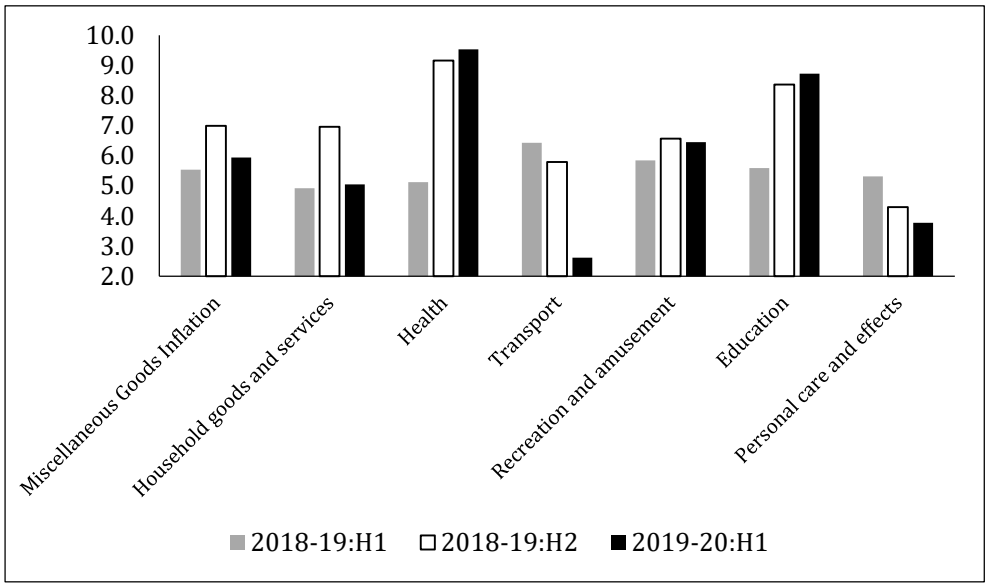
Figure P.3: Potato–Onion–Tomato Inflation
(April 2018 to September 2019, % y-o-y)



Source: Authors' calculations from MoSPI.

A decomposition of the rural and urban inflation for H1: 2019–20, shows that 70.9 per cent of the rural inflation is being driven by the 'miscellaneous' group, and 47.6 per cent of the urban inflation is being driven by the 'food and beverages' group. Within the rural 'miscellaneous' group inflation (Figure P.4), the health and education sectors recorded rising inflation in the first half of the current fiscal. Rising rural health inflation coincides with the launch of the Pradhan Mantri Jan Aarogya Yojana on 23rd September 2018.[1] In this context, whether the introduction of medical insurance drives up medical care prices needs to be investigated further.

Figure P.4: Rural 'Miscellaneous Items' Inflation and Its Components, H1: 2018–19, H2: 2018–19 and H1: 2019–20 (% y-o-y)



Source: Authors' calculations from MoSPI.

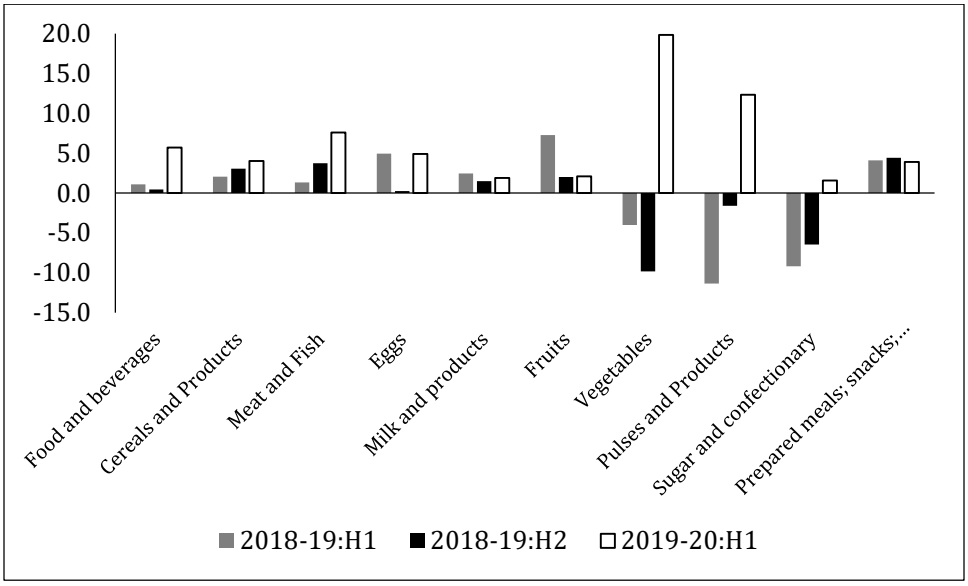
Inflation for the urban 'miscellaneous' group shows moderation, coming down from 5.5 per cent in H1: 2018–19 to 3.3 per cent in H1: 2019–20. A majority of the items showed moderation during this period. The inflation figures for education and health in urban areas were approximately half of the corresponding figures for rural inflation at 4.95 per cent and 5.5 per cent, respectively, during the first half of the current fiscal. The category of 'personal care and effects' showed rising inflation in urban areas, standing at 5.3 per cent during the first half of the current fiscal.

Inflation in vegetable prices in urban areas is driving the inflation in food and beverages in urban areas (Figure P.5), as vegetables account for a weightage of 4.41 per cent in the composition of urban inflation. Pulses and products, which have a relatively

[1] The CPI combined data for hospital and nursing home charges shows a rise in inflation during this period, with the corresponding figures being 8 per cent in Q2: 2018–19, 9.8 per cent in Q3: 2018–19, 12.3 per cent in Q4: 2018–19, 11 per cent in Q1: 2019–20, and 10.3 per cent in Q2: 2019–20.

small weight of 2.38 per cent, also showed a significant rise in inflation during the first half of the current fiscal. Other products that have shown a sharp rise in inflation include meat and fish, and eggs. In contrast to the double-digit inflation for these categories in urban areas, the inflation figures for vegetables and pulses were much lower in rural areas, at (–)0.5 per cent and 1.44 per cent, respectively. The 'food & beverages' weight account for about 54 per cent of the rural CPI and about 36 per cent of the urban CPI.

Figure P.5: Food and Beverages' Urban Inflation and Select Components H1: 2018–19, H2: 2018–19, and H1: 2019–20 (%y-o-y)



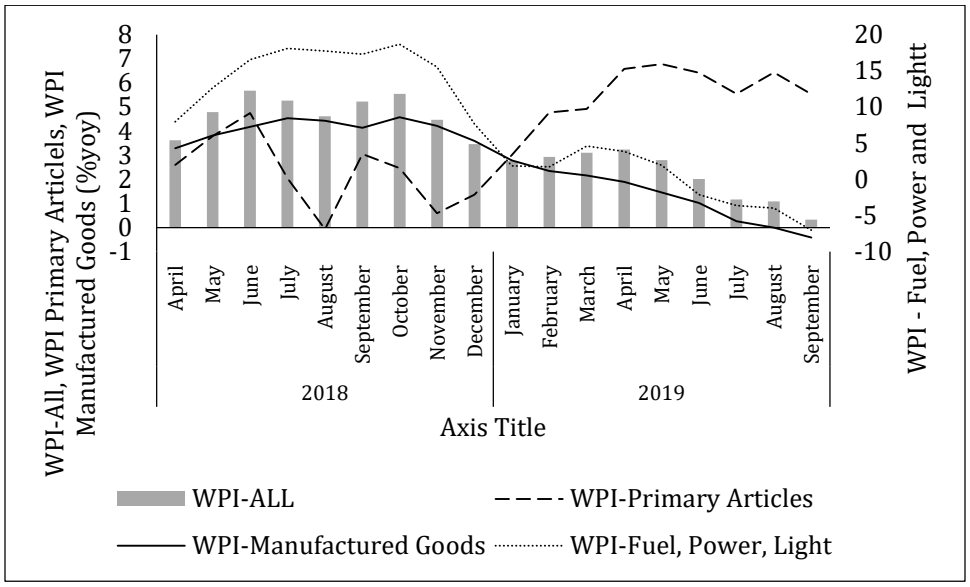
Source: Authors' calculations from MoSPI.

P.2 Wholesale Price Index Inflation

WPI inflation has eased in the second quarter of current fiscal as compared to a year ago. The y-o-y inflation rate in Q2: 2019–20 had been 0.9 per cent, as compared to 5.0 per cent in Q2: 2018-19 (Figure P.6).

All the three components of the WPI, viz., 'primary articles', 'fuel and power', and 'manufactured products' (with weights of 22.6 per cent, 13.2 per cent, and 64.2 per cent, respectively) showed a decline in inflation in Q2: 2019–20 on a y-o-y basis. Within the category of 'primary articles', food articles have been the most important contributor to inflation, accounting for a weight of 15.3 per cent in the overall WPI. The WPI in food articles showed an upward trend, rising from (–) 0.4 per cent in December 2018 to 7.7 per cent in August 2019, with a slight moderation witnessed in September 2019, when it fell marginally to 7.5 per cent.

Figure P.6: WPI Inflation and Its Components
April 2018 to September 2019 (% y-o-y)



Source: Authors' calculations based on data from the Office of the Economic Adviser.

P.3 Inflation Outlook

The rise in food prices, especially those of vegetables in urban areas, has led to an upward push in the overall retail inflation. This increases the challenge for the RBI Monetary Policy Committee to maintain inflation within the 4–6 per cent range while trying to encourage economic growth. A second challenge is to deal with rising inflation in rural education and health prices.

Money and Capital Markets

Pallavi Choudhuri

In a series of consecutive cuts, the Reserve Bank of India (RBI) has reduced the policy Repo rate by 135 bps to 5.15 per cent as of October 2019, given weak inflation and concerns over slackening of growth. However, the transmission of rates has been weak, raising concerns about the effectiveness of monetary policy easing on real output growth. Bank Credit to the Commercial Sector (BCC) grew by 8.5 per cent, lower than the growth achieved during the corresponding period of the previous year, with the credit extended to micro and small industries actually declining. In an effort to initiate a better pass-through of monetary policy transmission, the RBI has issued a directive to banks to link their lending rates to four alternative external benchmarks. However, lending rates also have to be related to the actual cost of money, that is, deposit rates, and these cannot be easily reduced as long as depositors have the option of getting better returns at low risk such as in small savings schemes and long-dated G-secs. Given this context, and with bank balance sheets still remaining weighed down by non-performing loans, it is unclear whether just lowering the Repo rate and linking of lending rates to external benchmarks alone will help increase flow of credit to Small and Medium Enterprises (SMEs) and the agricultural sector, or whether banks will continue to invest in risk-free low-yield alternatives such as government securities.

M.1 Introduction

The Monetary Policy Committee (MPC) reduced the Repo rate[1] by 25 basis points (bps)[2] for its bi-monthly meeting held in October, while maintaining an accommodative stance, backed by inflation that is within RBI's target rate of 4 per cent. With this latest cut, the policy rate has been reduced by a total of 135 bps since February 2019, when the MPC embarked on an easing cycle in order to boost a sluggish economy. The Repo rate cut, along with reductions in the basic corporate tax from 30 per cent to 22 per cent, and capital infusion of ₹70,000 crores into public sector banks (PSBs) are among the key measures expected to revive the economy, which has come under severe stress. Growth has slipped for a fifth straight quarter to 5 per cent for the quarter ending June 2019, the lowest since March 2013.

NCAER's own forecast indicates that India's Gross Domestic Product (GDP) is expected to grow at 4.9 per cent for the fiscal year 2019–20. This comes against a backdrop of a global growth slowdown. While noting that the global economy is in a mode of synchronised slowdown, the IMF slashed growth forecast to 3 per cent, the lowest since the Global Financial Crisis of 2008. Credit off-take from the banking sector has continued to be a drag, as bank balance sheets are weighed down by the high level of Non-Performing Assets (NPAs), which in turn, has affected liquidity in the private sector that is largely dependent upon bank credit. Data from the CMIE indicate that private capital expenditure fell to a sixteen-year low for the quarter ending September 2019. Industrial output contracted to 1.1 per cent in August 2019, the lowest in 81 months, while private consumption expenditure dropped to an 18-quarter low of 3.1 per cent.

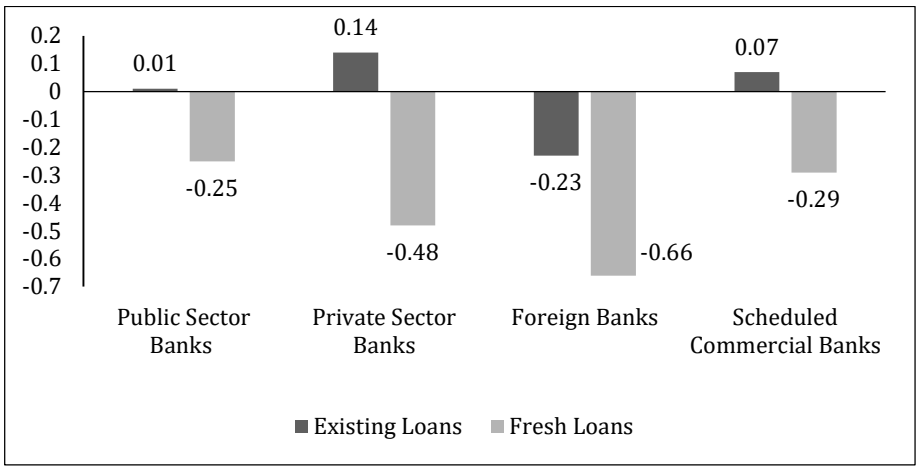
[1] The Repo Rate signifies the rate at which banks borrow from the RBI.
[2] 100 bps = 1 per cent.

M.2 Transmission

Unfortunately, transmission of these policy rate cuts to commercial bank lending rates has been weak, raising concerns about the effectiveness of monetary policy easing in reviving growth. For ensuring better transmission of rates, the RBI had, on September 4, 2019, issued a directive that commercial banks are required to link new floating rate loans to any of the four external benchmarks from October 1, 2019: the policy Repo rate, three-month Treasury Bill yield, six-month Treasury Bill, or any other benchmark market interest rate published by the Financial Benchmarks India Private Ltd (FBIL). Under the new interest rate regime, the RBI has mandated banks to reset rates every three months. Explicit linkage to an external benchmark is expected to improve the transmission of rates, as banks will not be able to widen the spread in existing loans in response to cuts in the benchmark rate. The RBI noted that "the spread over the benchmark rate — to be decided wholly at banks' discretion at the inception of the loan—should remain unchanged through the life of the loan, unless the borrower's credit assessment undergoes a substantial change and as agreed upon in the loan contract".

Banks are gradually linking their loans to the Repo rate, but given the flexibility to charge a mark-up at the onset of a loan, and considering other costs, the final lending rates have not come down in a proportionate manner. Between February and August 2019, the Weighted Average Lending Rate (WALR) on fresh rupee loans of commercial banks declined by 29 bps only. However, the WALR on outstanding rupee loans increased by 7 bps during the corresponding period, raising alarm bells. The bank group-wise break-up reveals that the WALRs on fresh rupee loans have gone down by 48 bps for private banks as compared with only 25 bps for public sector banks. On the other hand, for existing loans, the WALR increased by 14 bps for private banks as compared to one bps for public sector banks for existing borrowers (see Figure M.1). Data further show that foreign banks are most responsive to rate cuts, with rates decreasing across the board for both fresh and existing rupee loans.

Figure M.1: Change in Weighted Average Lending Rate (WALR) between February 2019 and August 2019



Source: RBI.

The differential transmission of rates between fresh rupee loans and existing loans could stem from the issue that after opting for cutting rates on fresh loans, banks have struggled to cut down their cost of funds. This is likely to be particularly true for banks that have been saddled with a larger proportion of non-performing loans or higher net charge-off ratios, which is likely to weigh down the net income earned by such banks.

It may be noted here that the WALR reflects the cost of loans. It is calculated as the interest amount paid over the total loan outstanding, with the share of outstanding credit of each bank in the respective bank group's outstanding total credit of Scheduled Commercial Banks (SCBs), at the end of the respective quarter, used as the weight for computing the WALR at the bank group level. Hence, apart from interest rate movements, the WALR can also change with changes in interest recovery from delinquent loans (numerator change) or loan write-offs (denominator change). The RBI's report on the Trend and Progress of Banking in India (December, 2018)[3] reveals that the Gross Non-Performing Assets (GNPAs) write-off as a percentage of the GNPA has been substantially higher for private banks till 2017–18. This leads to an increase in the WALR by reducing the denominator. While an RTI filed by *Moneycontrol.com* revealed the extent of write-offs by PSBs, the RBI has not revealed such data for the private sector.

Monetary policy transmission in India has been largely inefficient, raising doubts about the likely amount of pass-through in future. A lower interest rate would have prompted more businesses to borrow loans for making fresh investments. Furthermore, Repo rates do not reflect the bank's cost of funds, which is driven by a plethora of other factors. Hence, the full transmission of rates rarely takes place. The bank's cost of funds are a function of the net interest margin, the difference between the rate that banks charge on deposit rates and the rate charged on loans. Thus, for any lending rate cut to take place, banks will also need to cut down deposit rates in order to maintain a sufficient spread. However, banks are typically reluctant to reduce deposit rates due to the apprehension that savers would park their funds in instruments that offer higher interest rates. For instance, the rates on small-savings schemes, ranging from 7.6 per cent to 8.4 per cent,[4] were left unchanged for the third quarter of the current fiscal year (October–December 2019), making them more attractive as compared to bank Fixed Deposits (FDs).

As pointed out by the 2018 RBI Report on trends in the banking sector, during 2011–16, nearly 66.8 per cent of the total deposits have been term deposits with one or two years to re-price – this makes re-pricing more difficult on the liability side in the immediate term. Savers also have the option to park their funds in risk-free government securities (G-secs). While bank FDs are considered to be safe, government securities are the safest, with no credit risk, since they are backed by the government, with the yield on G-secs being typically lower than the interest on FDs. The recent turmoil in the urban cooperative bank sector, triggered by the recognition of non-performing loans on the

[3] Reserve Bank of India (2018). Report on Trend and Progress of Banking in India 2017-18. Retrieved from https://www.rbi.org.in/scripts/AnnualPublications.aspx?head=Trend%20and%20Progress%20of%20Banking%20in%20India

[4] The annual Interest rate on the Sukanya Samriddhi Account Scheme is 8.4 per cent; the annual interest rate on Kisan Vikas Patra is 7.6 per cent.

balance sheet of the Punjab Maharashtra Cooperative (PMC) Bank, has sent shock waves amongst retail depositors, who had parked their savings in the bank (see Box M.1 for a brief on the PMC Bank scandal). With the RBI imposing restrictions on the withdrawal of deposits from PMC Bank, investors looking for alternate securities may be further prompted to look for risk-free alternatives.

Box M.1: Urban Cooperative Banks

The RBI on September 2019 imposed a restriction on withdrawals from the Punjab Maharashtra Cooperative (PMC) Bank, apart from ordering the bank not to do any business for the next six months, throwing into turmoil the lives of thousands of depositors, traders, and daily wage earners, who were using the bank for either daily transactions or building their savings. This was prompted by a default of loans worth nearly ₹6,500 crore, which was previously concealed by the bank authorities. A report by *The Hindu Business Line* (October 1, 2019) indicates that, in violation of norms, the bank lent over 70 per cent of its book to realty group HDL, which was also subject to further conflict of interest.

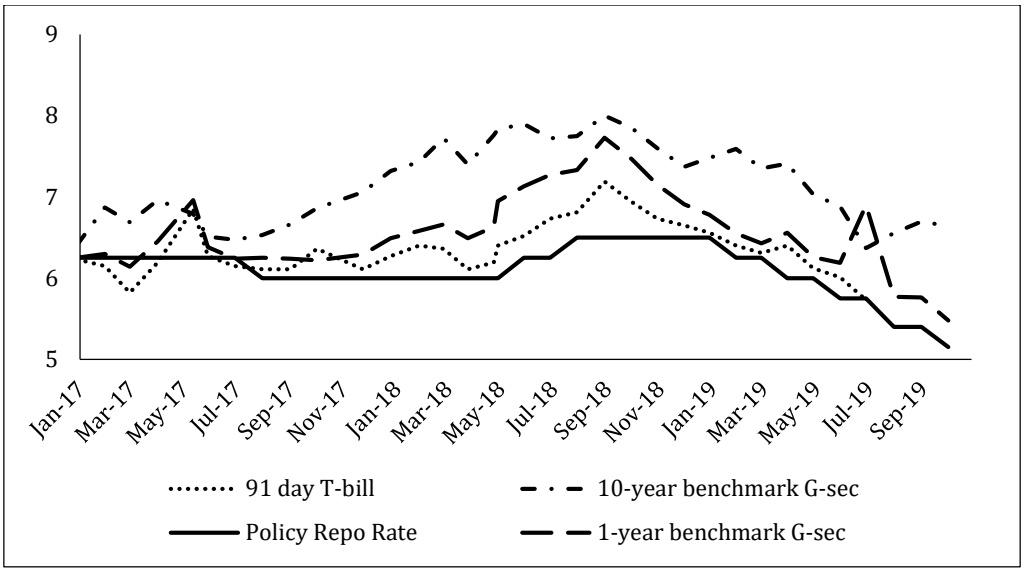
In the event that an urban cooperative bank fails, any deposits with the bank are covered by the Deposit Insurance and Credit Guarantee System of India only to the extent of ₹1 lakh per depositor. This created widespread panic amongst PMC depositors, several of whom have deposits greater than the stipulated amount of ₹1 lakh in the bank. Reports further suggest that nearly 130 smaller cooperative banks and credit societies have deposits with the PMC Bank. In the event that PMC Bank is not able to return their funds, the PMC crisis could cascade to other banks, as these banks will be compelled to mark their deposits with the PMC Bank as NPAs.

Source: Krishnan, A. 2019. "All you wanted to know about urban cooperative banks." *The Hindu Business Line*. Retrieved from https://www.thehindubusinessline.com/opinion/columns/slate/all-you-wanted-to-know-about-urban-co-operative-banks/article29563724.ece . October 1.

Typically, the yield on G-secs should be lower than that on FDs. However, data from the RBI shows that the yield on the ten-year G-sec bond is higher than that on the bank FD rates. While the spread between the two has come down since September 2018, when the 10 year G-sec bond had peaked to 8 per cent, the ten-year benchmark yield is still higher than the interest rate on a five-year FD by 39 bps.[5] While G-secs have been out of reach for small investors, being mostly traded in wholesale in the secondary market, investors have the option of purchasing G-secs of various durations through the mobile app and web platform launched by the National Stock Exchange (NSE) in October 2018, or by purchasing G-sec mutual funds.

[5] The interest rate on a five-year retail domestic FD with the State Bank of India, as of 10.10.2019, is 6.25 per cent, while the yield on the ten-year G-sec bond was 6.64 per cent as of October 2019. The post-tax return on an FD depending on the tax bracket of the investor will be lower, which further makes the risk-free G-sec a preferred option for those who can invest in longer duration securities.

Figure M.2: Yield on Domestic Bonds of Various Maturities (%), January 2017 to October 2019



Source: RBI.

While the yield on the 91-day Treasury Bill is lower than the Repo rate, and the yield on the six-month treasury Bill is hovering around the Repo rate, the yield on longer duration government bonds is higher than the Repo rate, and has shown no signs of softening since the monetary policy meet in October 2019 (Figure M.2). With G-secs being risk-free, the availability of such investment options puts additional pressure on the banks for maintaining a sufficient interest rate spread, leaving less room for reducing lending rates. All these considerations taken together suggest that commercial bank lending rates are unlikely to come down substantially any time soon.

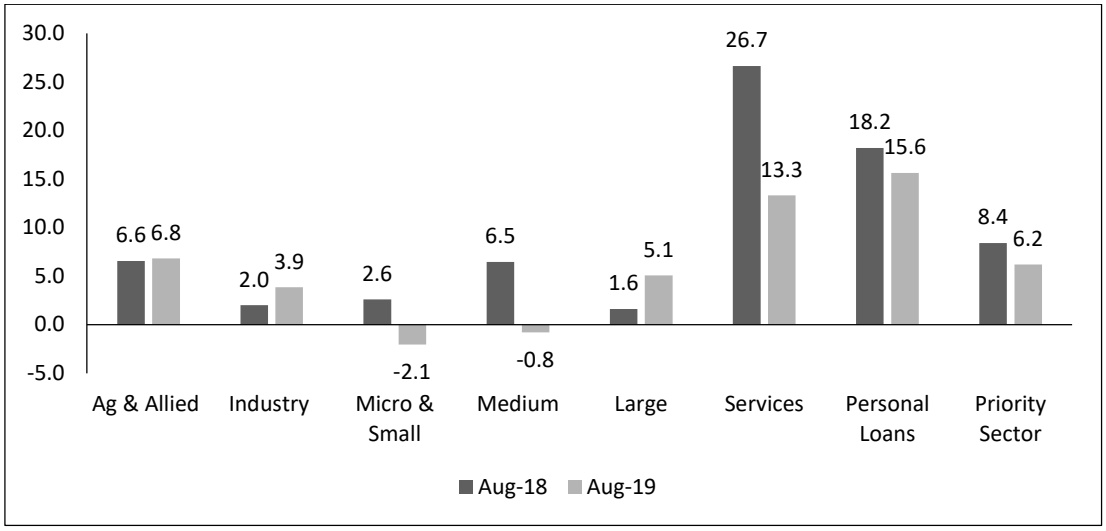
M.3 Bank Credit

Cumulative Bank Credit to the Commercial Sector (BCC) grew by only 8.5 per cent, y-o-y, up to September 27, 2019, as against a corresponding figure of 11.9 per cent up to September 28, 2018. It had risen to 12.7 per cent, up to March 31, 2019, but then declined during the first half of the current fiscal year. The growth of demand deposits, though lagging behind the BCC, picked up to reach 7.2 per cent, y-o-y, as on September 27, 2019, from 5.5 per cent, y-o-y, during the corresponding period of the previous year. However, this is still lower than the year-end growth rate of 9.6 per cent as on March 31, 2019. Any reduction in the deposit rate may lead to a further reduction in the deposit growth rate, leaving banks with less funds to finance fresh lending.

Moreover, for the credit offtake to trigger an economic recovery, it is important to ensure that such offtake is broad-based. Data from the RBI show that bank lending has picked up pace only in selective sectors. The growth rates of credit deployment (y-o-y) had gone down in services, personal loans, and the priority sector as of August-end 2019, while picking up for industry and marginally for agriculture and allied services (see Figure M.3). The credit extended to industry grew by 3.9 per cent as of August

2019, up from a meagre growth of 2 per cent in August 2018. This was primarily on account of loans extended to large firms.

Figure M.3: Growth Rate of Bank Credit by Sectors (%, y-o-y)



Source: RBI.

The growth rates of credit deployment in micro and small, medium-scale, and large industry were (–)2.05 per cent, (–)0.78 per cent, and 5 per cent, respectively, in August 2019, indicating that lending to the MSME sector declined during the first half of the fiscal year. Poor lending for the MSME segment can stem from two alternate scenarios: (i) if MSMEs have large inventories and are reluctant to borrow for any fresh inventory investments, or (ii) if banks are reluctant to lend to the MSME sector because of the level of risk associated with lending to the segment. The RBI's mid-year Monetary Policy Report (October 2019) reveals that banks have increased their Statutory Liquidity Ratio (SLR) portfolios despite the reduction in SLR by the RBI.[6] Banks held an excess SLR of 6.9 per cent of Net Demand and Time Liabilities (NDTL) at ₹35.8 lakh crore on August 30, 2019, as compared to 6.3 per cent of the NDTL as of March-end 2019, at ₹33.8 lakh crore. This indicates that banks are more willing to park their investments in low-yield risk-free G-secs rather than lending to the MSME sector.

Data from the RBI and Trans-Union CIBIL show that the risk in extending credit to the MSME sector is considerably high, particularly for the SME segment. The rates of GNPAs for the SME and micro segments were 10.8 per cent and 8.8 per cent, respectively, as of March 2019. In a bid to revive the MSME sector, the RBI provided a directive to State-owned banks not to declare stressed assets of MSMEs as NPAs till March 31, 2020. Under the existing set of norms, it is standard practice to declare any defaulter as a NPA if no interest has been paid for over 90 days. While such a move may temporarily ease the liquidity crunch within the sector, this will also lead to the

[6] The RBI announced that the SLR would be reduced by 25 bps every calendar quarter beginning January 2019, until it reached 18 per cent of the NDTL, in order to align the SLR with the Liquidity Coverage Ratio (LCR) requirement. As of January 2019, the SLR was at 19.25 per cent. Currently, the SLR is at 18.5 per cent.

bunching of non-performing loans at a later date, adding stress to bank balance sheets when such non-performing loans get recognised. The credit squeeze for the MSME sector has been aggravated following the default by ILFS, which hit the Non-Bank Financial Companies (NBFCs).

M.4 Non-Performing Loans

The RBI's move to enhance strict recognition of NPAs resulted in the NPAs reaching a peak of 11.5 per cent in March 2018, after which the GNPA ratio[7] declined to 9.3 per cent in March 2019. The June 2019 Financial Stability Report noted that macro-stress tests for credit risk reveal that under the baseline scenario, the GNPA ratio for SCBs is likely to go down from 9.3 per cent in March 2019 to 9.0 per cent in March 2020. This would be primarily due to loans being written off during 2018–19, as per data obtained from the RBI under RTI,[8] with actual recoveries being much lower. As of 2018–19, the amount written off by PSBs was ₹172,466 crore, as compared to a corresponding amount of ₹124,275 crore during the previous fiscal year. In comparison, the amounts recovered were ₹95,767 crore and ₹51,459 crore, respectively, during 2018–19 and 2017–18, revealing that the amounts written off by PSBs have been nearly twice as high as the recovery of bad loans. Thus, without the write-offs the GNPA ratio would have been much higher for 2018–19. Further, the increase in provisioning indicates that the asset quality of bank balance sheets may not have improved.

The Provision Coverage Ratio (PCR)[9] of all SCBs rose to 60.6 per cent in March 2019 from 52.4 per cent in September 2018 and 48.3 per cent in March 2018 (RBI, 2019). While this increases the resilience of the banking sector, it also signals that banks could still be vulnerable to further loan write-offs, necessitating a higher level of provisions to tide over any future stress. The RBI, in its financial stability report, pointed to wide disparity between banks with regard to the PCR, with PSBs, in particular, showing a 42–74 per cent range in PCRs.

Data also show that private sector banks have a much better GNPA ratio[10] in comparison with PSBs, with the GNPA of private banks being a little over half that of PSBs. Data at a more disaggregated level show that PSBs had a sharply higher GNPA ratio of 10 per cent as against 2 per cent for private banks in terms of the credit extended to the priority sector. It needs to be pointed out that a large part of priority lending comes from either SME loans or MUDRA loans, revealing significant stress[11] for these two categories of loans [see Box M.2 for details on the Pradhan Mantri MUDRA Yojana (PMMY) scheme]. Such a trend is also visible for both the services and agriculture sectors. The services sector, borrowing for which tends to be heavily dominated by SMEs, recorded a GNPA for PSBs at 10.6 per cent as compared to 1.5 per

[7] The GNPA ratio is measured as the ratio of gross non-performing assets to total assets.

[8] Saurav S. (2019). "Banks Have A Long Way To Go." *MoneyControl.com* (October 3, 2019). Retrieved from https://www.moneycontrol.com/news/business/analysis-banks-have-a-long-way-to-go-in-reducing-npas-4499001.html.

[9] The PCR is the ratio of provisioning to GNPAs, and provides an indication of provisions against bad loans.

[10] The GNPA ratio is defined as the ratio of gross non-performing assets to total assets.

[11] Mishra (2019). "NPAs Under Modi's Mudra Scheme Doubled in Just a Year, Reveals RTI." *The Wire*. June 23, 2019. Retrieved from https://thewire.in/economy/npa-modi-mudra-loan-scheme-doubled-rti.

cent for private banks. The GNPA ratio for the agricultural sector is also higher for PSBs, at 11.4 per cent, as compared to 3.8 per cent for private banks, though in the case of agricultural loans, the reasons for default can range from farmers reeling from weather shocks to a moral hazard problem, where the possibility of loan waivers can prove to be an incentive for delayed payments.

Box M.2: Pradhan Mantri MUDRA Yojana

In a flagship initiative, the Government of India in 2016 set up the Micro Units Development and Refinance Agency Ltd. (MUDRA), for the development and refinancing of micro and small entrepreneurs. The purpose of MUDRA is to provide access to credit to small businesses by linking the sector to formal financial institutions. MUDRA loans are offered in three categories. For small business, loans up to ₹50,000 are available under the 'Shishu' category, beyond ₹50,000 and up to ₹5 lakh under the 'Kishor' category, and beyond ₹5 lakh and up to ₹10 lakh under the 'Tarun' category.

According an RTI query filed by *The Wire* (Mishra, June 2019), the NPAs under PMMY doubled within one year. The total value of the NPAs held by PSBs under PMMY was ₹7,277.31 crore, as of March 31, 2018, as per a written reply to the Rajya Sabha on February 12 by the Minister of State for Finance, Shiv Shukla. The RTI filed by *The Wire* revealed that the total value of NPAs increased to ₹16,481.45 crore as of March 31, 2019. The number of accounts declared as NPAs increased from 17.99 lakh to 30.57 during the said period. The RBI had earlier warned that the scheme could become the next big source of NPAs and act as a drag on the health of the PSBs.

Source: Mishra (2019). "NPAs Under Modi's Mudra Scheme Doubled in Just a Year, Reveals RTI." *The Wire*. June 23, 2019. Retrieved from https://thewire.in/economy/npa-modi-mudra-loan-scheme-doubled-rti

While the current slew of measures to bail out firms in the SME sector can provide much-needed relief to the sector, it can add to the risks in the banking sector. As per the RBI directive, banks will no longer classify loans as NPAs for missed payments till March 2020. Hence, the GNPA ratio presented for 2019–20 may not convey the true nature of the risk posed by the segment, with a clustering of such assets in later years when the NPAs get recognised in bank balance sheets. The NPA crisis could further escalate if the PMC Bank is unable to cover for its deposits, after revealing a massive amount of non-performing loans on its balance sheet (see Box M.1 for a brief on the PMC Bank issue).

Public Finances

Sandhya Garg and Ajaya Sahu

The large shortfall in tax revenue observed in 2018–19 is likely to be repeated in 2019–20. In H1 of 2019–20, direct taxes have grown by only 5.2 per cent as compared to a target of 17.1 per cent set in the annual budget. Indirect tax collection has actually declined by (–) 2.1 per cent as compared to the growth target of 19.4 per cent set in the budget. The impact of tax revenue shortfall on total revenue is moderated by the very high growth of nearly 92 per cent in non–tax revenue, mainly on account of the massive transfer of RBI surpluses. Nevertheless, the total revenue growth in H1 of 2019–20 (the Centre's share), at 18 per cent, is well below the target of 25.6 per cent. The large revenue shortfall is unlikely to be passed on as a larger deficit. Most of it is likely to be absorbed through expenditure compression. This is already evident in the trend observed in H1 of 2019–20. We are, therefore, likely to see a further slowdown in aggregate demand and GDP growth during 2019–20.

PF.1 Revenue Performance

The gross tax revenue (including the share of the States) grew by only 8.5 per cent in 2018–19 and fell short of the budget projection by 18 per cent**.** Among its components, direct taxes, which account for 48.4 per cent of the total revenue, grew by 14.9 per cent, with Corporation Tax and Income Tax growing at 16.2 per cent and 13.1 per cent, respectively. Indirect taxes grew by only 4.5 per cent as against the budget projection of 22 per cent. The major shortfall in tax revenue was on account of GST, which accounts for close to 25 per cent of the total revenue, and fell short of the budget projection by 21.8 per cent (Table PF.1).

The performance during the first half (H1) of 2019–20 is not encouraging either. While the gross tax revenue (including the share of the States) for the whole year is projected to grow at 25.3 per cent, the actual growth for H1: 2019–20, compared to H1: 2018–19, is only 1.5 per cent. The corresponding growth rate for H1:2018–19 over H1:2017–18 was 8.6 per cent. Direct tax has grown by only 5.2 per cent as against the targeted growth rate of 17.1 per cent. Indirect tax has actually declined by 2.1 per cent as compared to H1 of 2018–19 as against an annual growth target of 19.4 per cent.

The shortfall in tax revenue has been partly offset by the notably sharp growth of non–tax revenue, which now accounts for about 18.5 per cent of the total revenue. It grew by nearly 92 per cent in H1 of 2019–20, mainly on account of the massive growth of dividends and profits, especially the large dividend from RBI. Nevertheless, the total revenue growth for H1 of 2019–20, at 11.2 per cent, is far short of the budget projection of 25.6 per cent.

Table PF.1: Central Government Revenue Receipts

	Percentage Change		Actuals H1:2018–19 (₹ crore)	Actuals H1:2019–20 (₹ crore)	Percentage Change	
	Actuals of 2018–19 over Actuals of 2017–18	Actuals of 2018–19 over BE of 2018–19			H1: 2019–20 over H1:2018–19	BE of 2019–20 over Actuals of 2018–19
A. Revenue Receipts	10.3	–7.5	1,013,941	1,127,685	11.2	19.2
B. Tax Revenue (89.4)	8.5	–8.4	904,972	918,647	1.5	18.3
B.1 Direct Tax (48.4)	14.9	–2.2	439,345	462,331	5.2	18.6
B.1.1 Corporation Tax (28.5)	16.2	6.9	243,742	249,327	2.3	15.4
B.1.2 Income Tax (19.9)	13.1	–12.7	195,603	213,004	8.9	23.3
B.2 Indirect Tax (41.0)	4.5	–14.6	465,649	455,830	(–)2.1	17.5
B.2.1 GST (25.0)	31.4	–21.8	289,073	280,515	(–)3.0	14.1
B.2.2 Customs (5.1)	–8.6	4.8	64,456	71,838	11.5	32.2
B.2.3 Union Excise (9.9)	–10.7	–11.0	100,590	95,930	(–)4.6	29.9
B.2.4 Service Tax (0.9)			11,530	7547	(–)34.5	
C. Non– Tax revenue (10.6)	27.9	0.5	108,969.3	209,038	91.8	27.2
C.1 Dividends & Profits (4.9)	24.1	5.7	44,695.39	154,797.9	246.3	44.2
C.2 Interest Receipts (0.6)	–5.6	–15.5	5841.63	6479.44	10.9	7.0
C.3 Other non–tax revenue (5.2)	37.0	–2.1	58,432.27	47,761.3	–18.3	13.3

Source: Controller General of Accounts, Ministry of Finance Budget documents.
Figures in parentheses refer to the respective shares of each item in the total revenue receipts for actuals of 2018–19.

Note: As a practice, the CGA provides figures for the revenue receipts and total tax revenue as a net of the share of the States. On the other hand, for individual tax items, it provides the gross figures. To make these consistent, transfers to States have been added in the revenue receipts and total tax revenue.

PF.2 Expenditure Performance

The shortfall in revenue growth is being reflected on the expenditure side. The total expenditure growth in H1: 2019–20 has been contained at 14.1 per cent as against the annual budget target of 20.5 per cent (Table PF.2). This mainly reflects the slow growth of revenue expenditure, which accounts for over 87 per cent of the total expenditure, and has grown by 14 per cent in H1: 2019–20 as against a target growth of nearly 22 per cent. On the other hand, it is encouraging to note that capital expenditure

grew by 15.3 per cent during H1: 2019–20, which is higher than the annual budget target of 11.6 per cent. However, capital expenditure only accounts for 12.6 per cent of the total expenditure.

Table PF.2: Expenditure Scenario

	Actual H1:2018–19 (₹ crore)	Actual H1: 2019–20 (₹ crore)	Y–o–Y Growth (H1:2019–20 over H1: 2018–19)	BE 2019–20 as a Ratio of Actual Provisional of 2018–19
Total Expenditure	1,304,215	1,488,619	14.1	20.5
Revenue Expenditure (87.4)	1,141,586	1,301,082	14.0	21.9
Interest Payments (18.2)	255,432	270,696	6.0	13.4
Capital Expenditure (12.6)	162,629	187,537	15.3	11.6

Source: Controller General of Accounts, Ministry of Finance Budget documents.
Figures in parentheses refer to the respective shares of each item in the total expenditure for actuals of 2018–19.

PF.3 Outlook

A quantitative forecast regarding the fiscal position at the end of the year would be premature since neither revenue nor expenditure can be pro–rated on a uniform monthly basis for the whole year. Nevertheless, the revenue trends observed last year and up to H1: 2019–20 clearly point to a large shortfall in tax revenue this year relative to the budget targets. The recent reduction in the basic corporate tax rate from 30 per cent to 22 per cent will exacerbate the shortfall in the current year, regardless of howsoever desirable it may be as a long–term reform measure. Indeed, it was reported earlier this week that the Central Board of Direct Taxes is seeking a reduction of direct tax revenue targets by ₹1 trillion.[1] Moreover, the shortfall in direct taxes cannot be offset by an increase in indirect taxes unless the inefficient administration of GST, stemming from the incomplete GSTN information system, is repaired on a war footing. Therefore, efforts to achieve the expenditure target in the budget would entail a massive increase in the fiscal deficit. The Central government is unlikely to allow a huge slippage in the fiscal deficit, given that the public sector borrowing requirement (of the Centre+ States+ Public Sector Undertakings) is already in excess of 9 per cent of GDP. In 2018–19, the Central Government compensated for the large shortfall in revenue with a corresponding compression of expenditure growth, thereby containing the fiscal deficit at 3.4 per cent, just marginally above the budget target of 3.3 per cent. The expenditure trends observed during H1: 2019–20 indicate that this year too, the Government is pursuing the same approach of compressing expenditure growth well below the budget projection. Our assessment is that while there may be some slippage in the fiscal deficit, the bulk of the revenue shortfall will be absorbed through expenditure compression. This, in turn, will entail a further reduction in aggregate demand and GDP growth on top of the growth reduction experienced last year.

[1] Bhattacharya, A. 2019. "Govt's expenditure and revenue figures for H1 don't tell the whole truth". *Business Standard*. https://www.business-standard.com/article/opinion/the-real-picture-119111000679_1.html. November 11.

Table PF.3: Central Government Receipts (Net to Centre), Expenditure and Deficits

Category	2018–19 BE (₹ crore)	Actual 2017–18 (₹ crore)	Actual 2018–19 (₹ crore)	Actual 2018–19 over BE 2018–19 (% change)	2019–20 BE (₹ crore)	Actual H1:2019–20 (₹ crore)	Actual H1: 2018–19 (₹ crore)	Actual H1: 2019–20 over H1: 2018–19 (% change)	2019–20BE over 2018–19 actual (% change)
0	1	2	3	4	5	6	7	8	9
Total Receipts (Excluding Debt) (9.9)	1,817,937	1,550,760	1,666,055	(–)8.4	2,082,589	837,065	709,483	18.0	25.0
Revenue Receipts (9.3)	1,725,738	1,430,404	1,563,170	(–)9.4	1,962,761	816,467	691,752	18.0	25.6
Non–Debt Capital Receipts (0.6)	92,199	120,356	102,885	11.6	119,828	20,598	17,731	16.2	16.5
Total Expenditure (13.2)	2,442,213	2,141,822	2,311,422	(–)5.4	2,786,349	1,488,619	1,304,215	14.1	20.5
Revenue Expenditure (11.6)	2,141,772	1,879,346	2,008,463	(–)6.2	2,447,780	1,301,082	1,141,586	14.0	21.9
Capital Expenditure (1.6)	300,441	262,476	302,959	0.8	338,569	187,537	162,629	15.3	11.8
Interest Payments (3.1)	575,795	528,952	582,675	1.2	660,471	270,696	255,432	6.0	13.4
Fiscal Deficit (3.3)	624,276	591,062	645,367	3.4	703,760	651,554	594,732	9.6	9.0
Revenue Deficit (2.3)	416,034	448,942	445,293	7.0	485,019	484,615	449,834	7.7	8.9
Primary Deficit (0.2)	48,481	62,110	62,692	29.3	43,289	380,858	339,300	12.2	(–)30.9

Source: Controller General of Accounts, Ministry of Finance Budget documents.

Figures in parentheses refer to the respective shares of each item in the projected GDP for 2019–20 for BE of 2019–20.

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