The NCAER 2020–21 Mid-Year Review of the Indian Economy

National Council of Applied Economic Research
India International Centre

December 21, 2020, New Delhi

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NATIONAL COUNCIL OF APPLIED ECONOMIC RESEARCH

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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 2020-21, brought out under 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 a webinar on December 21, 2020. The MYR also featured NCAER Senior Fellow Bornali Bhandari, and NIPFP Assistant Professor Rudrani Bhattarcharya. Aditi Nayar, Vice President and Principal Economist, ICRA and Tirthankar Patnaik, Chief Economist at National Stock Exchange of India Limited provided expert comments and a market perspective to round out the discussion.

The Mid-Year Review (MYR) carries on the tradition started by Dr 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.

NCAER's MYR 2020 comes at a critical juncture. The Coronavirus pandemic is unlike anything that India has experienced. The pandemic intensified gradually, reaching a peak daily mortality rate of well over a thousand, after which it has come down to 300–400 persons per day. About 75 per cent of deaths so far have occurred in just seven states, Maharashtra with over a third of all deaths and another 40 per cent accounted for by Karnataka, Tamil Nadu, Delhi, West Bengal, Uttar Pradesh, and Andhra Pradesh.

The pandemic has led to an unprecedented economic contraction of 16 per cent in the first half of FY2020-21. One of the strictest lockdowns in the world during April–June 2020 resulted in an unprecedented contraction by nearly 24 per cent in Q1 of 2020–21. Progressive unlocking supported by monetary and fiscal stimulus has led to a strong recovery during Q2 2020–21. However, this recovery may be flattening. The challenge now is to accelerate and sustain the pace of this recovery over the medium to long term. This will require wide ranging structural reforms in addition to conventional macro-economic stimulation.

The ongoing recovery notwithstanding, hysteresis, the long-term effect of the sharp contraction in 2020-21, is likely to be long lasting. The economy will have to grow at more than the previous trend rate for it to catch up with its pre-pandemic growth path. Conventional macroeconomic policies alone will not do. These will have to be supported by deep and wide ranging reforms, especially in the financial sector, power and foreign trade. Additional reforms in health, education, labour and land are also urgent, and these will require close coordination between the Centre and States in a spirit of cooperative federalism since these are State subjects in the 7th Schedule of the Constitution.

The MYR 2020 provides a comprehensive history of what has happened since March 2020 and estimates of what the fiscal year will look like on the deficit and Central and State government borrowings.

I am grateful to IIC Director K N Srivastava and his team, particularly L S Tochhawng, IIC's Head of Programming. I would also like to thank the Malcolm & Elizabeth Adiseshiah Trust for their continued support for the Mid-Year Review.

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. The NCAER authors of the *Review* included Pallavi Chaudhuri, Anil Sharma, Saurabh Bandyopadhyay, and Ajaya Sahu. NCAER staff Sudesh Bala, Shilpi Tripathi, Sukriti Chauhan, Praveen Sachdeva, Anupma Mehta, Eman Rahman, Sangita Chaudhary, Khushvinder Kaur supported the work.

New Delhi
December 21, 2020

Shekhar Shah
Director General

Foreword

Each year we pay tribute to Dr Malcolm Adiseshiah, development economist and educator, who was committed to eradicating poverty and illiteracy and fostering growth in a modern economy. He wore many hats, earned several awards, and contributed his expertise to innumerable institutions. He continued his support to teaching and research in these areas even after his death in 1994, willing all his finances to the setting up of a Trust—The Malcolm and Elizabeth Adiseshiah Trust.

Dr Adiseshiah's engagement with the India International Centre dates back to the 1960s when he played a major role in getting UNESCO affiliation to the Centre. He became a member of the Centre, of its Council for Cultural Studies, and was later selected Life Trustee. The IIC became his hub when he was in Delhi. In the 1980s he chaired a committee that was entrusted with the task of reviewing the functioning of the Centre from its inception.

In 1983, Dr Adiseshiah initiated the Mid-Year Review of the Indian Economy which remains one of the definitive surveys of India's growth projection. The Review is an attempt to examine the course of macroeconomic trends for the first half of the year and provide an assessment of the prospects of the economy for the full year. There are some variables that are key to the course of the economy, such as the nature of the monsoon which affects agriculture and price trends; monetary and fiscal policy developments; and global conditions which affect external trade. Since 2001, the Trust has supported an annual seminar at the Centre. For the past few years, this event has been hosted by the Centre in collaboration with the National Council of Applied Economic Research (NCAER), which has been doing pioneering research in applied economics, and designing and executing large-scale surveys on regional and human development. The NCAER and IIC share these developmental concerns, and it is our privilege to collaborate in this venture.

This year, the COVID-19 pandemic has had an unprecedented impact on the global economy and India is no exception. Therefore, the Mid-Year Review 2020 comes at a crucial time, and is perhaps the most important to date to help us see the challenges that lie ahead.

Another fallout of the pandemic is the need for social distancing. For the first time, The Mid-Year Review was held virtually. However, it did not adversely impact the usual rigour and gravitas of the presentations, and the audience questions via chat mode were as relevant and thought-provoking.

As the presentations showed, there is cause for concern. While the number of Covid cases and deaths are declining, and the progressive unlocking of the economy, supported by stimulus policies, have led to some recovery, the full recovery of the economy will take some time. However, on an optimistic note, we can rely on the expertise of the distinguished team at NCAER to show us the way forward to a better tomorrow.

K.N. Shrivastava
Director, India International Centre

CONTENTS

Chapter 1: Overview

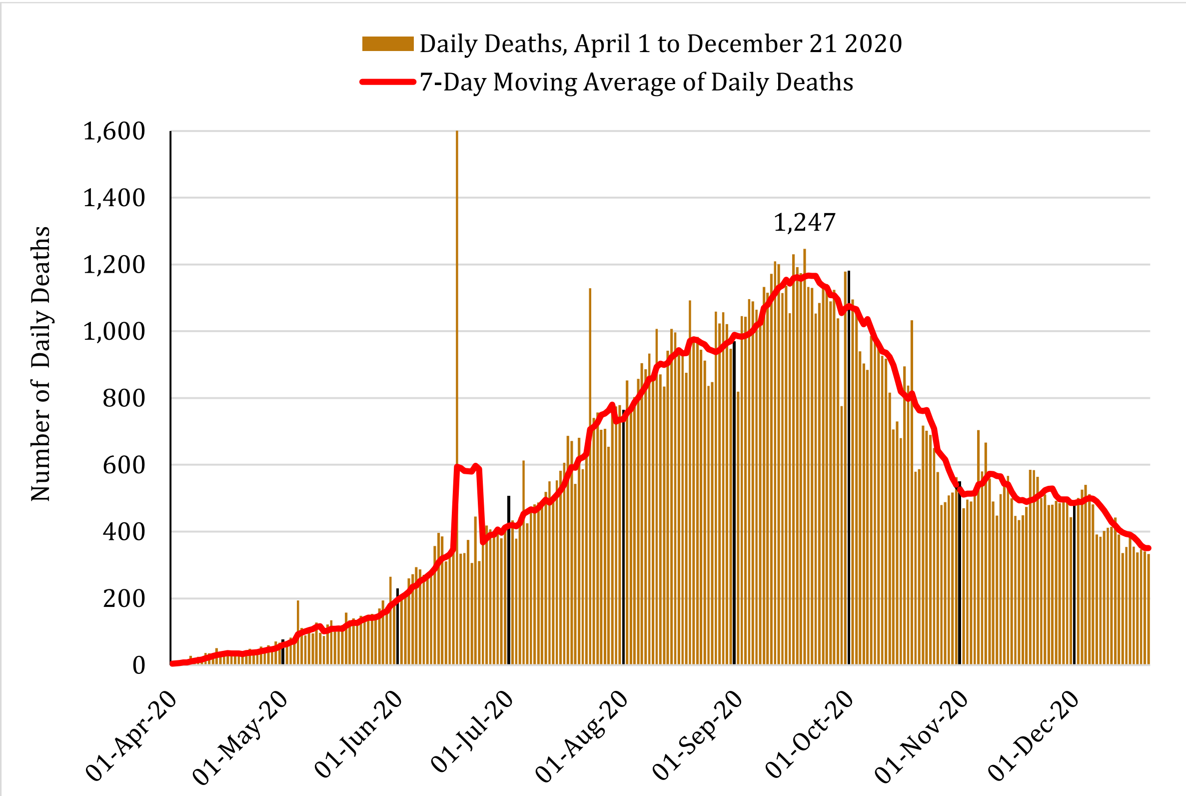
Sudipto Mundle and Bornali Bhandari

1.1 Introduction

The Coronavirus pandemic (henceforth 'the pandemic') is unlike anything experienced since the influenza epidemic of 2011. It led to an economic contraction of a scale hitherto unprecedented. The pandemic is still continuing. Despite this the progressive unlocking of the economy, together with stimulus policies, led to a strong recovery during Q2 2020. The challenge now is to sustain and accelerate the pace of this recovery along with fiscal consolidation.

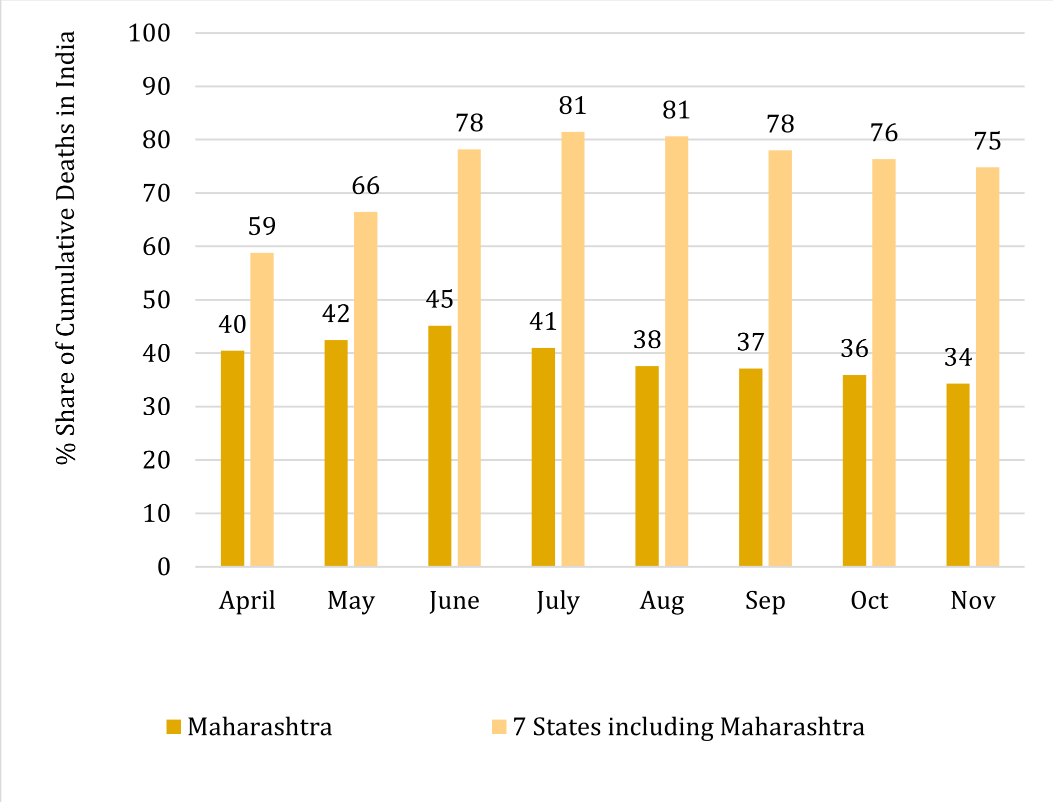
The pandemic intensified gradually, reaching a peak daily death rate of well over a thousand, after which it has tapered down to 300–400 persons per day (Figure. 1.1). Also, about 75 per cent of the deaths have occurred in just seven states. Maharashtra accounts for over 34 per cent of total deaths and another 40 per cent are accounted for by Karnataka, Tamil Nadu, Delhi, West Bengal, Uttar Pradesh and Andhra Pradesh (Figure 1.2). Most of India's largest metropolitan cities are located in these states, suggesting that the pandemic is primarily an urban phenomenon. Effectively controlling the spread of infections in cities, and timely treatment of those infected, should enable us to contain the pandemic. Also, Covid-19 vaccines, already rolled out in some countries, are likely to be rolled out in India in early 2021. These positive developments notwithstanding, the pandemic is still continuing. India could also experience a second wave as has happened in some countries. So any complacency is unwarranted.

Figure 1.1: After peaking in September, daily deaths has tapered down



Source: Ministry of Health and Family Welfare.

Figure 1.2: Maharashtra & 6 other States account for around 75% of total deaths



Source: https://www.covid19india.org/.

1.2 Real Sector, External Sector & Prices

The sharp recovery experienced in Q2, 2020 has been broad-based. Agriculture grew at 3.4 per cent during H1 of 2020–21 on a year-on-year (y-o-y) basis, mainly thanks to a good monsoon. Rainfall was above normal in all regions except the North. Rabi output is also expected to be higher than last year, mainly due to high water storage in major reservoirs (above 10 years average). Thus robust growth is also expected in H2 and the full year 2020–21.

Industry experienced a sharp V-shaped recovery in Q2 following the steep decline in Q1. The recovery has been broad based, and it is continuing but at a shallower pace since June. Some high frequency indicators suggest that the shallow industrial recovery has plateaued during Q3. Going forward, the outlook remains uncertain.

The same V-shaped pattern was observed for the services sector, which contracted sharply in Q1, followed by a steep recovery in Q2. The recovery has been shallower after June. There are large sub-sectoral variations within services. Both the contraction & the recovery were led by Trade, hotels, restaurants & communications. On a y-o-y basis the contraction moderated from (–) 47 per cent in Q1 to (–) 15.6 per cent in Q2 in this sub-sector. The contraction was less in other sub-sectors but it exacerbated in Q2. There are variations even within sub-sectors e.g. in transport there was a sharp recovery in cargo traffic while there was little recovery in passenger traffic. High frequency indicators show that the recovery has plateaued in Q3.

In the external sector both exports & imports have contracted since January but import contraction was much sharper. Both have recovered since April, but recovery has again been sharper for exports than imports, leading to a trade surplus. The large reserve accumulation during H1 was mainly on account of a current account surplus. But the trade surplus recorded in H1 has reversed in October and November. Recovery of both exports and imports has been volatile. It has been mainly driven by trade in goods while services trade has remained flat.

Indian exports could be adversely affected by its staying away from Regional Comprehensive Economic Partnership (RCEP) since 28 per cent of its exports are destined for RCEP member countries which could divert their imports to towards other member countries. Staying away from both RCEP and the Trans-Pacific Partnership, which may be revived by the new US administration, would be very risky for India as global trade is being increasingly embedded in regional trade agreements (RTAs). It is essential for India's trade policy to reverse autarkic tendencies and introduce reforms to strengthen global competitiveness so that the country can benefit from such RTAs or even a revamped World Trade Organisation.

Capital inflows were modest (7.5 per cent growth) & volatile in H1. However, during Q3 foreign portfolio inflows have amounted to around USD19 billion which has further increased India's foreign exchange reserves. Though a welcome development for external financial security, growing reserves are driving exchange rate appreciation, which will adversely affect exports. Growing reserves are also expanding the reserve money base, thereby tending to drive up liquidity & inflation, hence requiring strong counter-measures by RBI.

The CPI headline inflation has remained elevated above the RBI tolerance band of 2–6 per cent since December 2019, though it declined to 6.9 per cent in November from 7.6 per cent in October 2020. Inflation is mainly being driven by food price inflation. It was 9.4 per cent in November, down from 11 per cent in October 2020. Core inflation (non-food non-oil) has also remained close to 6 per cent. WPI inflation, which was diverging from CPI & declining till July 2020, has since been rising but it is still very muted. WPI is also being driven by food price inflation. The divergent movement of CPI and WPI inflation is attributable to (i) the higher weight of food prices, the main inflation driver, in CPI, (ii) the possibly higher disruptive impact of lockdown on retail logistics as compared to wholesale logistics and (iii) rising margins between retail and wholesale trade.

We forecast headline inflation will remain elevated at 7 per cent and 6.3 per cent respectively during Q3 and Q4. The annual inflation forecast for 2020–21 is 6.7 per cent.

1.3 GDP forecast, hysteresis and reforms

Following the steep decline in GDP in 2020 Q1, the recovery in Q2 was surprisingly sharp. Accordingly, we have revised our growth forecasts for Q3, Q4 and the full year 2020–21 to 0.1 per cent, 2 per cent and (–) 7.3 per cent respectively. The ongoing recovery notwithstanding, hysteresis, the long term effect of sharp contraction in 2020–21 is likely to be really quite long lasting. Starting from a 2020–21 baseline which is 7.3 per cent lower than in 2019–20, GDP has to grow well above the recent pre-pandemic trend rate (5.8 per cent) for India to catch up with its pre-pandemic growth path. This will require deep and wide-ranging structural reforms in the financial sector, power & foreign trade. Reforms in cooperation with the states are also urgent in health, education, labour and land, which are all primarily state subjects under the constitution.

1.4 Challenging Fiscal Policy Outlook

In the immediate future, economic management has to continue to focus on fiscal and monetary policies. On the fiscal side, the Central government's fiscal marksmanship had deteriorated significantly during the last few years. Coming on top of this, the pandemic completely disrupted the revenue and deficit projections. The Central deficit ballooned. State government spending was constrained by the steep decline in revenues and the borrowing limits of their respective FRBM acts until the recent relaxation of their borrowing limits by 2 per cent of GDP. We estimate the combined fiscal deficit of the Centre plus States for 2020–21 at over 14 per cent of GDP after factoring in the forecast (–) 7.3 per cent GDP contraction. Even the fiscal impulse, the difference between the current year's deficit and that of last year, is over 7 per cent of GDP. Combined with RBI liquidity infusion of well over 6 per cent of GDP, this amounts to a significant stimulus which compares favourably with most emerging market economies. However, the fiscal stimulus could have been more effective in terms of timing, allowing extra headroom for borrowing and spending by States earlier on, and a greater emphasis on income support for poor consumers in the composition of expenditure. The 2020–21 budget needs to pump prime a quick recovery and at the same time initiate fiscal consolidation. The expected high growth next year provides the space for a strategy that can achieve this delicate balance. However, the massive increase in government borrowing required for financing the huge combined fiscal deficit is a major challenge for monetary policy.

1.5 Monetary Policy and Financial Sector

A slew of measures initiated by the RBI have contained lending rates and the yield on government securities, though the benchmark yield on the 10-year G-sec remains elevated. Also, while the policy rates have come down, the growth of bank credit to the commercial sector continues to decline. The massive increase in government borrowing poses a major policy challenge for monetary policy and the financial sector as it tends to push up the cost of money. A fragile, NPA-burdened financial sector may not be able to handle such a massive government market borrowing without its partial monetisation. In many ways, this poses the biggest threat to macroeconomic stability and calls for urgent reform of the financial sector. Strengthening supervision to contain imprudent lending is vital. Stronger rather than weaker implementation of the Insolvency and Bankruptcy Code & effective functioning of the NCLT, and other institutional arrangements are also essential to clean up bank balance sheets. Extreme caution is required in granting banking licenses to industrial conglomerates as has been recently suggested by an RBI internal working group. However, capital could be raised by selling new shares amounting to 51 per cent of the increased equity in existing public sector banks, simultaneously reforming the governance structure of these banks. Banking licenses could also be granted to NBFCs with a robust track record, the necessary domain knowledge and experience and the required scale.

Chapter 2: Agriculture

Anil K Sharma

Agriculture grew at 3.4 per cent during H1 of 2020–21, mainly thanks to a good monsoon. Rainfall was above normal in all regions except the North. However, output of select vegetables like potatoes, onions and tomatoes have been adversely affected due to excess rainfall. Rabi output is also expected to be higher than last year, mainly due to high water storage in major reservoirs (above 10 years average).

2.1 Southwest Monsoon

The onset of the South-West Monsoon was exactly on the normal date of its arrival, June 1. After that the advancement of monsoon rainfall during the first month of the season was fairly rapid. It covered the entire southern and North-eastern states of the country in the first half of the month and by the end of June it had covered almost the entire country. As a consequence of good rainfall and fairly rapid progress of the monsoon, the month of June recorded 32 per cent higher rainfall compared to the norm[1](Table 2.1). In fact, all four regions of the country – east, west, north, and south experienced excess rainfall. As the season progressed, the behaviour of rainfall activity became very erratic. The eastern and southern regions experienced extensive rainfall, but the northern and western regions witnessed low rainfall. As a result cumulative rainfall during June and July was just 3 per cent above normal compared to excess rainfall of 32 per cent at the end of June.

In August all regions except the north received normal or excess rainfall. In September also monsoon rainfall remained very active in all regions except some parts of the northern region. Thus, on cumulative monsoon rainfall for the full season turned out to be 12.5 per cent above normal for the country, with only the northern region experiencing rainfall that was slightly below normal.

[1] Measured as a deviation of actual rainfall from the normal computed with unirrigated area under foodgrains as weights from the normal index

Table 2.1: Deviations in the Monsoon Rainfall Indices from the Normal

Region	June	Jun – Jul	Jun – Aug	Jun – Sep
East	31.1	12.7	8.9	6.1
West	40.8	(–) 4.3	16.3	21.8
North	27.1	(–) 7.9	(–) 4.4	(–) 5.1
South	9.9	15.7	25.4	35.6
All India	31.7	2.7	10.9	12.5

Source: Computed on the basis of data from *India Meteorological Department*.

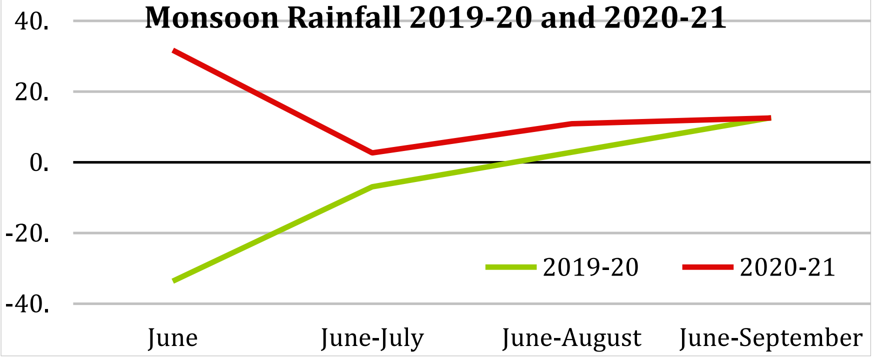
Notes: These are deviations in regional level rainfall indices computed on the basis of un-irrigated area under foodgrains as weights.

1. Eastern region: Assam, Bihar, Jharkhand, Odisha, and West Bengal.
2. Western region: Chhattisgarh, Gujarat, Madhya Pradesh, Maharashtra, and Rajasthan.
3. Northern region: Haryana, Himachal Pradesh, Jammu and Kashmir, Punjab, Uttarakhand, and Uttar Pradesh.
4. Southern region: Andhra Pradesh, Karnataka, Kerala and Tamil Nadu.

Of the total 36 agro-meteorological sub-divisions, 31 subdivisions received excess to normal seasonal rainfall. Of the remaining 5 sub-divisions which received deficient rainfall four are from the northern region (Western Uttar Pradesh, Uttarakhand, Himachal Pradesh, and Jammu & Kashmir), and one region is from the north-east comprising of Nagaland, Manipur, Mizoram & Tripura.

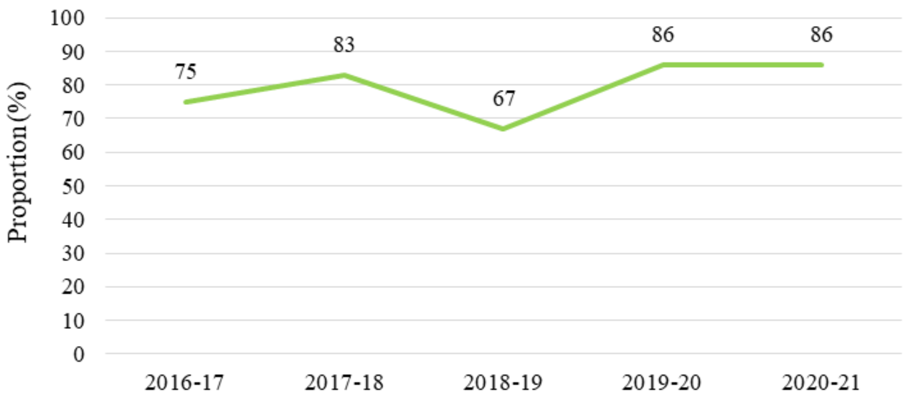
As is evident from Figure 2.1A the temporal spread of monsoon rainfall has been quite satisfactory and much better than last year. The spatial distribution has been similar to last year as reflected in the shares of sub-divisions of the country that received normal to excess rainfall (Figure 2.1B).

Figure 2.1A: Temporal Distribution of Monsoon Rainfall 2019-20 and 2020-21



Source: India Meteorological Department.

Figure 2.1B: Proportion of sub-divisions that received normal to excess rainfall (%), 2016-17 to 2020-21



Source: India Meteorological Department.

2.2 Outlook for 2020–21

Based on the foregoing, it is expected that 2020–21 will certainly be a year of normal growth for the agricultural sector. Preliminary estimates of major Kharif crops output released by the Ministry of Agriculture suggest a record agricultural output in 2020–21 (Table 2.2).

The expected output of kharif food grains is around 145 million tonnes, an increase of over 1 per cent compared last year's record output of around 143 million tonnes. The increase in output is expected especially in rice and pulses while the output of coarse grains is likely to drop marginally.

The output of kharif rice is estimated to have increased marginally, but the output of pulses is estimated to have increased by as much as 21 per cent due to better distribution of monsoon rainfall in areas where major kharif pulses are grown. The decrease in output of kharif coarse cereals is attributable to a shift of cropping pattern in favour of pulses and poorer rainfall in regions where coarse cereals are grown compared to last year. The output of kharif oilseeds is estimated to have risen, primarily due to good monsoon rainfall in the main oilseed growing regions and cotton output is estimated to have grown by about 4.5 per cent. The estimated output of sugarcane is also significantly higher compared to last year. Overall, agriculture is estimated to have grown by 3.4 per cent year-on-year in the first half of 2020–21.

Table 2.2: Estimated Output of Selected Agricultural Crops in the *Kharif Season*

Crops	*Estimated Output (Ministry of Agriculture) (Million tonnes/bales*)*		
	2018–19	**2019–20**	**2020–21 (First Advance Estimates)**
Kharif Rice	102.0	102.0	102.4
Kharif Coarse Cereals	31.4	33.7	32.8
Kharif Pulses	8.1	7.7	9.3
Kharif Foodgrains	141.5	143.4	144.5
Kharif Oilseeds	20.7	22.3	25.7
Other crops			
Cotton*	28.0	35.5	37.1
Sugarcane	405.4	355.7	399.8

Source: Directorate of Economics and Statistics, Ministry of Agriculture and Farmers Welfare.
* million bales.

Good monsoon rains have considerably improved storage of water in major reservoirs of the country. The current year's storage as on December 10, 2020 was 19 per cent more than the average storage over the last 10 years. This suggests that the rabi crop will also be good this year.

Robust agricultural performance in 2020–21 could be expected to have a moderating effect on food price inflation and indeed wholesale food price increase has been muted except in the case of milk and a few crops like potatoes, onions and tomatoes (Table 2.3). However, retail food prices have risen quite sharply, driving up the overall inflation rate. These issues are discussed further in chapter 6 below.

Table 2.3: Changes in Prices of Food Articles (April to November)

S. No.	Product	Change in 2019–20 over 2018–19	Change in 2020–21 over 2019–20
1	Food Articles	8.0	4.4
2	Cereals	8.3	(–)0.8
3	Pulses	17.9	12.4
4	Vegetables	26.9	10.0
5	Fruits	4.5	(–)1.5
6	Milk	1.6	5.2
7	Eggs, meat and fish	6.7	3.3
8	Condiments and spices	7.1	6.0
9	Other food articles	0.9	10.5

Notes: Computed using data from the *Office of the Economic Adviser*, Government of India, Ministry of Commerce & Industry, Department of Industrial Policy & Promotion (DIPP), New Delhi.

Chapter 3: Industry

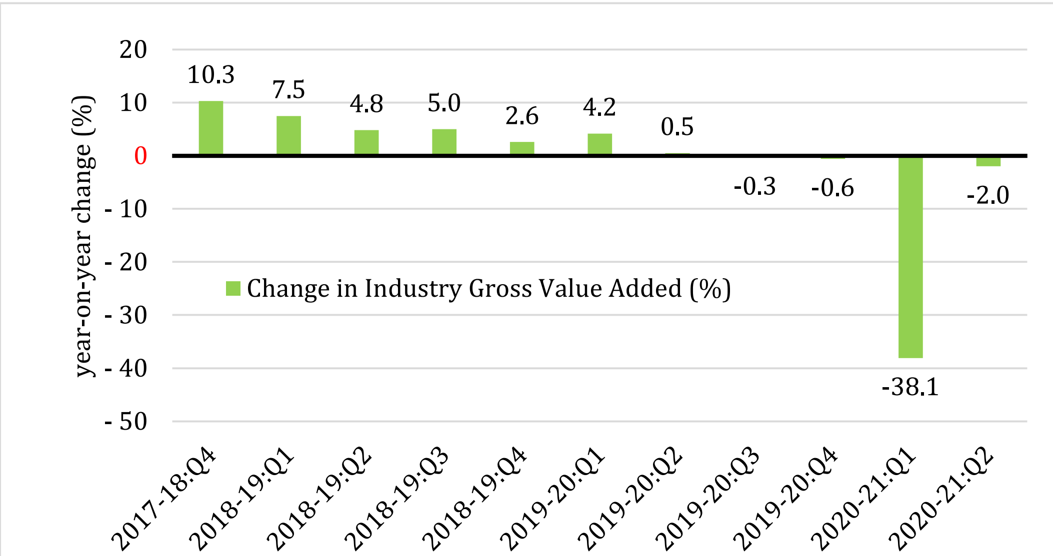
Saurabh Bandyopadhyay, Ajaya Sahu and Bornali Bhandari

Industrial output contracted in the first half of 2020–21 compared to the same period last year. It followed a V-shaped growth path i.e. contracting sharply in the first quarter due to the Coronavirus pandemic and lockdown before sharply recovering in Q2. The year-on-year (y-o-y) contraction in Index of Industrial Production was eliminated in September 2020 and it recorded positive growth in October. The recovery of industry has been broad based. However, the pace of recovery became shallower after June and some high frequency indicators suggest that the shallow industrial recovery has plateaued during Q3. Going forward, the outlook remains uncertain.

3.1 Industry: Aggregate trends during H1

Industrial growth was already declining since 2017–18:Q4 and it had turned negative by 2019–20:Q2 (Figure 3.1). Following the pandemic shock it contracted by a massive (–) 20.5 per cent y-o-y in 2020–21:H1 on a year-on-year (y-o-y) basis.

Figure 3.1: Steep decline in 2020–21:Q1 followed by sharp recovery in Q2



Source: Ministry of Statistics & Programme Implementation.

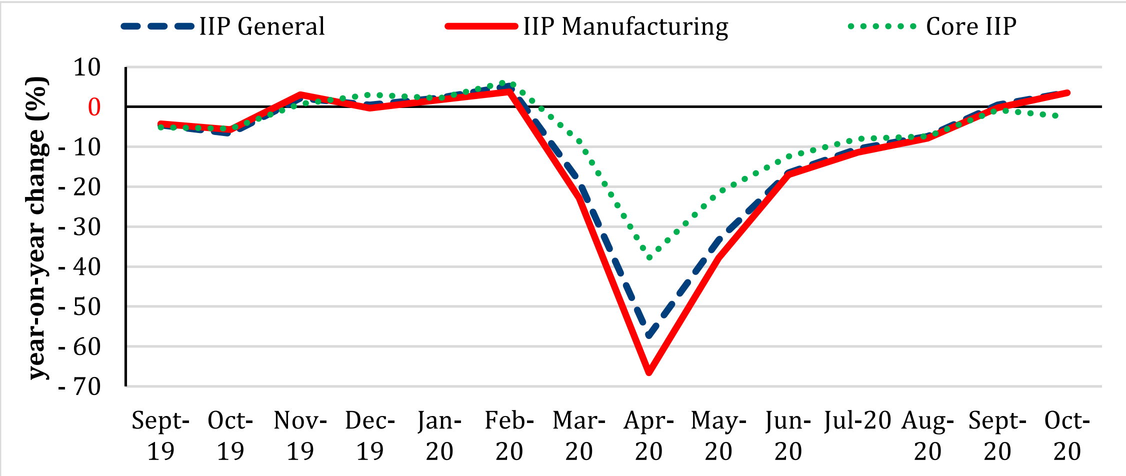
Industrial output followed a V shaped growth path in 2020–21: H1. There was sharp contraction of industrial output (–38 per cent) in 2020-21:Q1 followed by a steep recovery in Q2 (–2.0 per cent).

All the sub-sectors followed similar trends. Among sub-sectors construction was the worst affected, contracting by (–) 30.2 per cent y-o-y in 2020–21:H1 and Electricity, Gas & Water Supply (EGW) was the least affected, barely contracting by (–) 1.4 per cent. The latter are mostly essential services which were exempted from lockdown (Annex 3.1). Construction saw the sharpest recovery between Q1 and Q2 led by EGW (4.4 per cent). Manufacturing also recorded positive growth (0.6 per cent) in Q2.

3.3 Trends in Industrial Activity in 2020-21:Q3

The change in the General Index of Industrial Production (IIP) swung sharply from an increase of 5 per cent in February 2020 to (–) 57 per cent in April on a y-o-y basis. The contraction then moderated, sharply till June (–17 per cent), more gradually thereafter. It was eliminated by September and in October the general IIP rose by 3.6 per cent y-o-y (Figure 3.2).

Figure 3.2: Index of Industrial Production, General, Manufacturing and Core (% change y-o-y), Sep 2019 to Oct 2020



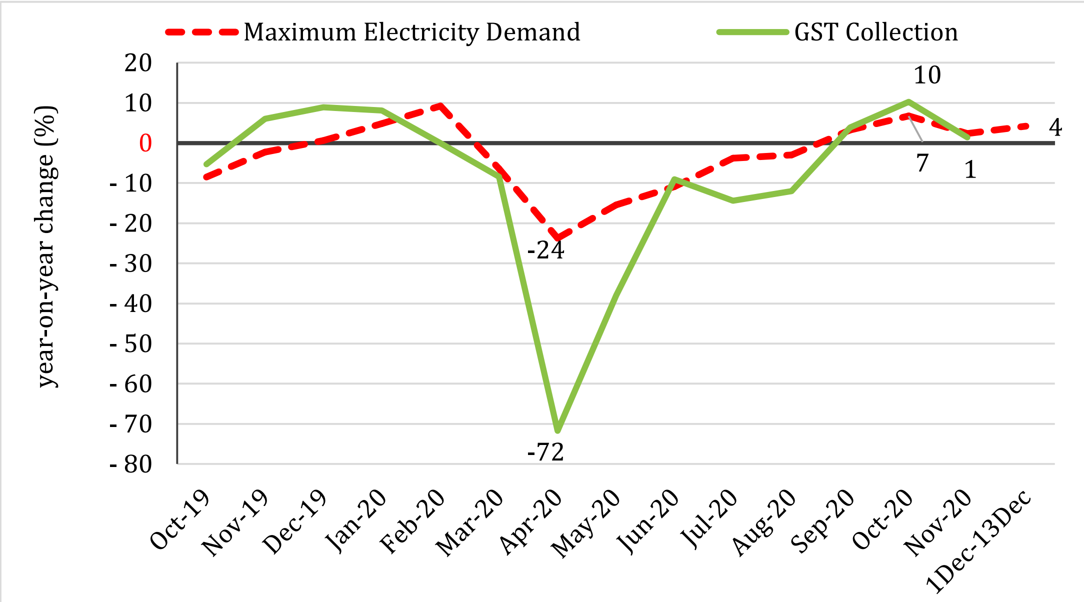
Sources: Ministry of Statistics & Programme Implementation and Office of Economic Advisor.
Note: Core IIP includes coal, crude oil, natural gas, refinery products, fertilisers, steel, cement and electricity.

This positive change was driven by the rise in IIP electricity and IIP manufacturing. The former rose by 4.9 per cent and 11. 2 per cent in September and October respectively. IIP manufacturing followed the same growth pattern as overall IIP (Figure 3.2). The use-based classification of manufacturing IIP indicates that the recovery has been broad-based (Annex 3.2). Barring primary goods, all other categories grew positively. Notably, capital goods recorded positive growth for the first time since December 2018.

The Core IIP also showed a sharp V-shaped recovery after April which became shallower after June. All the three IIP indices indicate a sharp V-shaped recovery till June which became shallower thereafter.

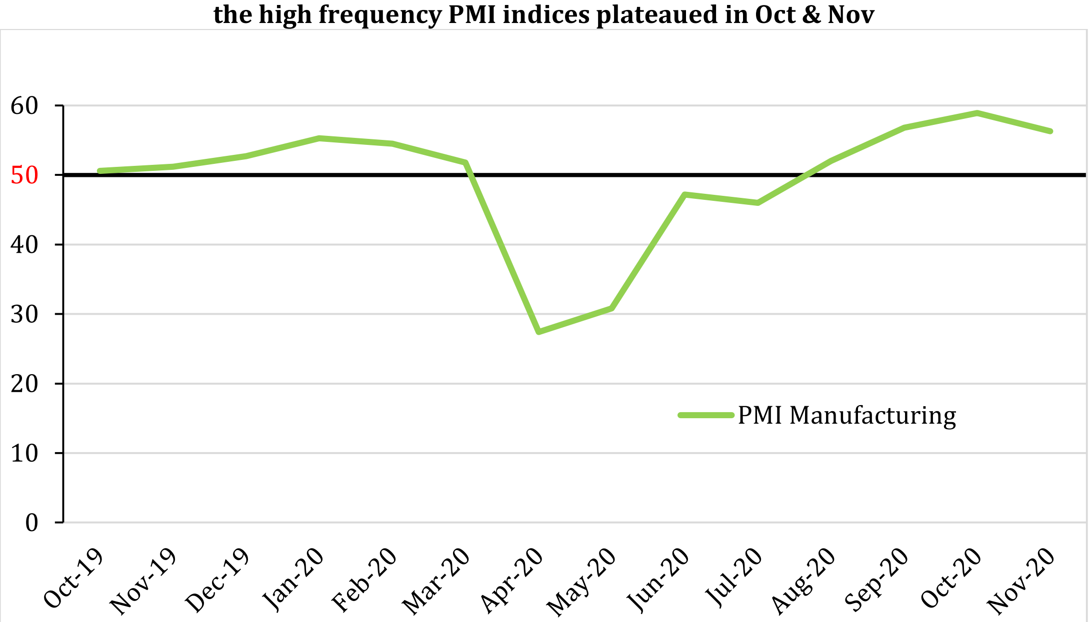
High frequency indicators like electricity demand & GST collection data showed positive y-o-y growth in September and October, somewhat less in November (Figure 3.3).

Figure 3.3: Shallow industrial recovery has plateaued during Q3



Sources: Power System Operation Corporation Ltd. and Goods & Services Tax Network.

Figure 3.4: After improvement in business sentiments in 2020-21:Q2, the high frequency PMI indices plateaued in Oct & Nov



Sources: IHS Markit and NCAER.

Business sentiments have also shown a similar pattern (Figure 3.4). The Purchasing Managers' Index (PMI) manufacturing plateaued in Q3 after recovering in Q2. The NCAER Business Confidence Index also shows recovery in Q2, the results for Q3 are awaited. As we discuss later, shallow industrial recovery is attributable to easing of supply constraints combined with demand stimulation measures. Since recovery may be losing steam, sustained recovery will require further macroeconomic & structural reforms.

3.4 Outlook

High frequency indicators suggest that the industrial recovery recorded in Q2 has continued during Q3, but the pace of recovery has become shallower, which calls into question the sustainability of the recovery. Demand conditions remain weak. This is evidenced by the decline in exports and imports which reflect, respectively, the state of external demand and domestic demand. Also, the November 2020 RBI Consumer Confidence Survey showed that consumer confidence was low compared to the same period a year ago. However, consumer sentiments were higher in November than in July and September of 2020. Consumer sentiments remain weak on general economic situation, the employment scenario, price levels and household incomes. The overall outlook for industrial growth remains quite uncertain.

Annex 3.1 Real GVA Industry and its Components (Rs trillion)

Year: Quarter	Industry	Mining	Manufacturing	EGW	Construction
			Half-Yearly		
2019–20:H1	20 (2.4)	2 (2.2)	12 (1.2)	2 (6.3)	5 (3.9)
2020–21:H1	16 (–20.5)	1 (–17.2)	9 (–19.4)	2 (–1.4)	4 (–30.2)
			Quarterly		
2019–20:Q1	10	1	6	1	3
2019–20:Q2	10	1	6	1	2
2019–20:Q3	10	1	6	1	3
2019–20:Q4	11	1	6	1	3
2020–21:Q1	**6 (–38.1)**	**1 (–23.3)**	**4 (–39.3)**	**1 (–7.0)**	**1 (–50.3)**
2020–21:Q2	**9 (–2.1)**	**1 (–9.1)**	**6 (0.6)**	**1 (4.4)**	**2 (–8.6)**

Source: Ministry of Statistics & Programme Implementation.
Notes: EGW stands for Electricity, Gas, Water Supply & other Utilities
Figures in brackets indicate year-on-year growth

Annex 3.2 Use-based classification of manufacturing IIP indicates the recovery has been broad based

			Indices			
	Primary goods	**Capital goods**	**Intermediate goods**	**Infrastructure/ construction goods**	**Consumer durables**	**Consumer non–dura-bles**
Apr–20	92	7	45	20	6	73
May–20	106	35	84	88	40	135
Jun–20	109	64	108	115	78	148
Jul–20	114	71	125	129	99	149
Aug–20	109	76	128	129	110	141
Sep–20	112	90	133	131	127	148
Oct–20	118 (–3.3)	91 (3.3)	138 (0.8)	140 (7.8)	133 (17.6)	149 (7.5)

Source: Ministry of Statistics & Programme Implementation
Note: Figures in brackets indicate year-on-year growth.

Chapter 4: Services

Bornali Bhandari

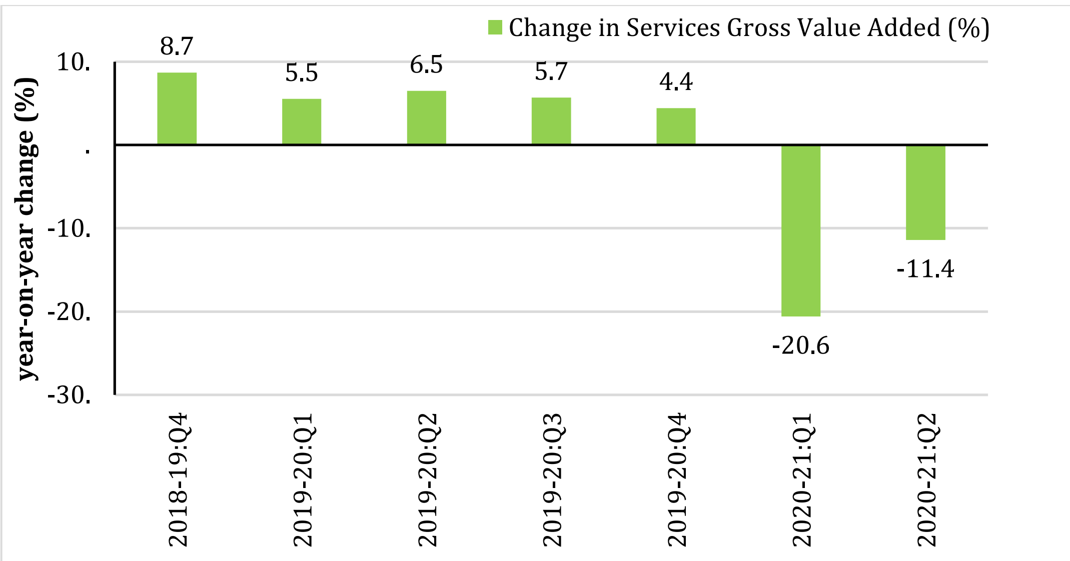
Services sector contracted sharply in Q1, followed by a steep recovery in Q2. The recovery has been shallower after June. There are large sub-sectoral variations within services. Both the contraction & the recovery led by Trade, hotels, restaurants & communications. On a y-o-y basis the contraction moderated from (–) 47 per cent in Q1 to (–) 15.6 per cent in Q2 in this sub-sector. The contraction was less in other sub-sectors but it exacerbated in Q2. There are variations even within sub-sectors e.g. in transport there was a sharp recovery in cargo traffic while there was little recovery in passenger traffic. High frequency indicators show that the recovery has plateaued in Q3.

4.1 Services sector in 2020–21:H1

Services growth had already slowed after 2018–19:Q4 (Figure 4.1) though growth was still positive. But following the pandemic and lockdown shock there was a sharp contraction of (–) 15.9 per cent year-on-year (y-o-y) in 2020–21:H1 (Annex 4.1). It shows a V-shaped growth pattern, the sector contracted by (–) 20.6 per cent y-o-y in Q1, which moderated to (–) 11.2 per cent y-o-y in Q2.

Services growth was largely driven by Trade, hotels, restaurants & communications (THRC). Its growth contracted by (–) 47 per cent in Q1 before moderating to (–) 15.6 per cent in Q2. The contraction in growth actually worsened between Q1 and Q2 for the other two sub-sectors. The Financial, real estate & professional services (FRP) sector contracted by (–) 5.3 per cent in Q1 and by (–) 8.1 per cent in Q2 (Annex 4.1). Similarly the contraction of GVA of Public administration, defence and other services (PADOS) deteriorated from (–) 10 per cent in Q1 to (–) 12.2 per cent in Q2.

Figure 4.1: Sharp decline in Services Growth in 2020-21: Q1, contraction moderated in Q2



***Source**: Ministry of Statistics and Programme Implementation.*

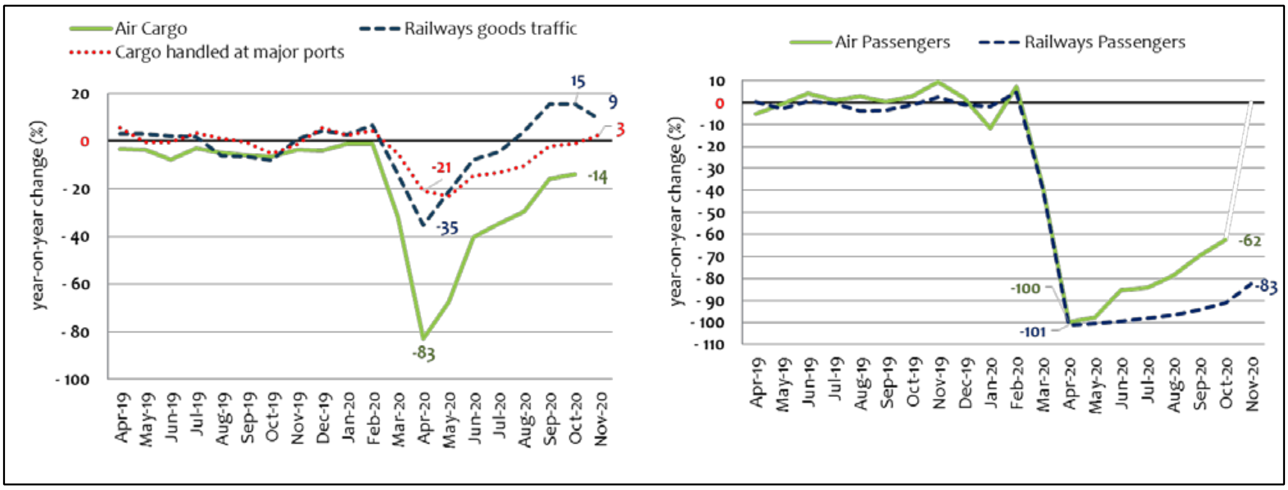
4.2 Lead Indicators for 2020–21:Q3

Leading service sector indicators from October–November showed sub-sectoral variations in recovery since April, but recovery nonetheless. A common trend observed in all the indicators is that after a V-shaped growth path between April–June 2020, there is a shallowing of recovery thereafter, in some cases a levelling off.

The most notable recovery is in the transport sub-sector, but mostly limited to cargo traffic with very little recovery in passenger traffic. Cargo traffic carried across various modes, railways, shipping and airports have exhibited a V-shaped growth path in the first half of the current fiscal (Figure 4.2). Notably railways goods traffic grew positively for four consecutive months of August to November[1]. And after eight months of contraction, ports cargo traffic in shipping grew by 2.8 per cent in November 2020 y-o-y.

An e-Way Bill is an Electronic Way bill for movement of goods generated on the e-Way Bill Portal. Using that as an indicator for freight transport, Figure 4.3 shows that the number of e-Way bills has grown since September 2020 but the recovery has plateaued in Q3. The number of new telephone connections continued contracting at an average rate of (–) 1.8 per cent per month between April–November 2020.

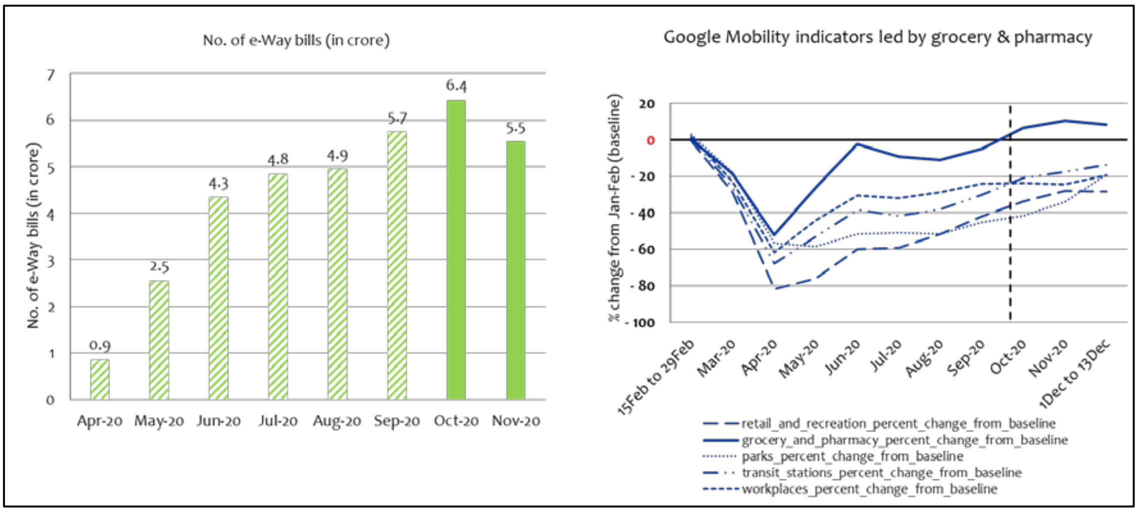
Figure 4.2: Cargo recovered much faster than passenger traffic within the transport sub-sector



Sources: Ministry of Railways, Indian Ports Association and Airports Authority of India.

[1] Roadways carry majority of freight traffic. The modest growth in railways freight traffic could also be due to substitution between modes of transport as roads transport face logistic issues across States.

Figure 4.3: Several high-frequency indicators show shallow services recovery has plateaued in Q3

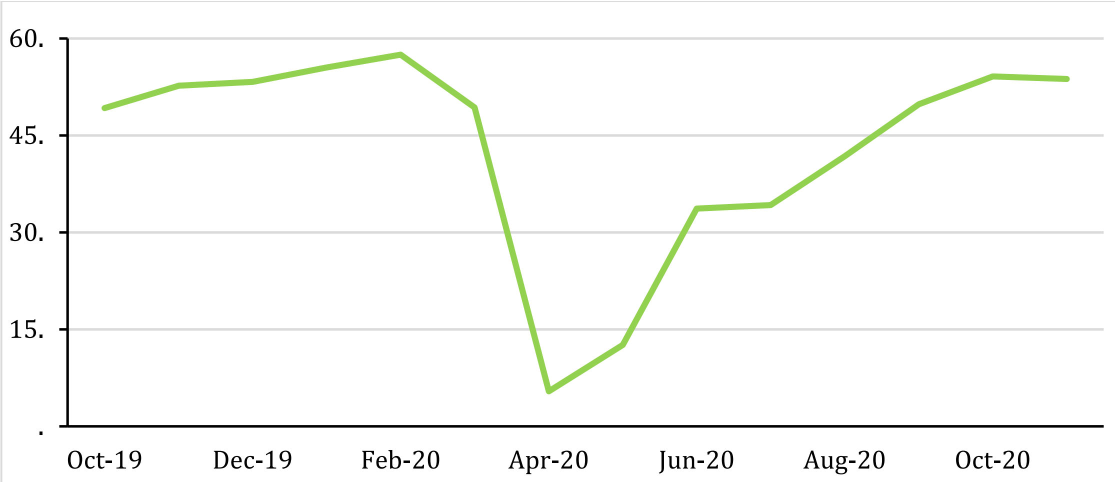


Sources: Goods & Services Tax Network & Google LLC "Google COVID-19 Community Mobility Reports". https://www.google.com/covid19/mobility/ Accessed: December 5, 2020.
Note: Graph on the RHS show deviations from the baseline, which is the median value, for the corresponding day of the week, during the 5-week period Jan 3–Feb 6, 2020

Financial sector services are among the few sub-sectors for which indicators have registered positive y-o-y growth throughout this financial year. Aggregate deposits have grown at a constant rate of 11 per cent from August to November. However, the y-o-y growth of bank credit to the commercial sector declined from 7.2 per cent in January to 5.3 per cent in September 2020. It subsequently improved during October (5.6 per cent) and November (6 per cent).

After staying below 50 for seven straight months since March 2020, the IHS Markit PMI recorded 54.1 in October 2020 but has levelled off in November 2020 (Figure 4.4). This indicated that a large majority of production managers expected output to increase in October. The NCAER Business Expectations Survey shows that services BCI went up from 53.2 in Q1 to 70.3 in Q2, indicating improving business sentiments in the sector.

Figure 4.4: PMI Services, October 2019 to November 2020



Source: IHS Markit Purchasing Managers' Index.
Note: A value above 50 means expansion and lower means contraction.

4.3 Outlook for 2020–21

The outlook for the services sector remains uncertain as there is plateauing of recovery in Q3. This sector is characterised by weak demand. Services exports and imports have both contracted by approximately (–) 10 per cent and (–) 20 per cent through April–November 2020, reflecting weak demand in the global and domestic markets respectively. As already mentioned in the previous chapter on industry, the RBI Consumer Confidence Index has remained low. The nature of the Coronavirus epidemic constraints the recovery in contact-intensive sectors.

Table 4.1: GVA Services and its Components

Year: Quarter	Services		Trade, hotels, transport, communication and services related to broadcasting		Financial, real estate & professional services		Public administration, defence and other services	
	Rs trillion	%y-o-y	Rs trillion	%y-o-y	Rs trillion	%y-o-y	Rs trillion	%y-o-y
Half-Yearly								
2019–20:H1	38	6.0	12	3.8	17	6.0	9	9.4
2020–21:H1	32	(–) 15.9	9	(–) 31.5	16	(–) 6.8	8	(–) 11.3
Quarterly								
2019–20:Q1	19	5.5	6	3.5	8	6.0	4	7.7
2019–20:Q2	19	6.5	6	4.1	9	6.0	5	10.9
2019–20:Q3	17	5.7	6	4.3	6	3.3	5	10.9
2019–20:Q4	18	4.4	7	2.6	6	2.4	5	10.1
2020–21:Q1	15	(–)20.6	3	(–)47.0	8	(–)5.3	4	(–)10.0
2020–21:Q2	17	(–)11.4	5	(–)15.6	8	(–)8.1	4	(–)12.2

Source: Ministry of Statistics & Programme Implementation.

Chapter 5: External Sector

Bornali Bhandari

Both exports & imports have contracted since January but import contraction was much sharper. Both have recovered since April, but recovery has again been sharper for exports than imports, leading to a trade surplus. The large reserve accumulation during H1 was mainly on account of a current account surplus. But the trade surplus recorded in H1 has reversed in October and November. Recovery of both exports and imports has been volatile. It has been mainly driven by trade in goods while services trade has remained flat. Capital inflows were modest (7.5 per cent growth) & volatile in H1. However, during Q3 foreign portfolio inflows have amounted to around USD19 billion which has further increased India's foreign exchange reserves. Though a welcome development for external financial security, growing reserves are driving exchange rate appreciation, which will adversely affect exports. Growing reserves are also expanding the reserve money base, thereby tending to drive up liquidity & inflation, hence requiring strong counter-measures by RBI.

5.1 Coronavirus Pandemic, World Economy & the Indian Economy

The Coronavirus pandemic continues to ravage the world, especially Europe and North America with lockdowns imposed again in several countries in these regions. The International Monetary Fund World Economic Outlook had forecast in October 2020 that the world economy will contract by 4.2 per cent in 2020 and grow by 5.2 per cent in 2021.[1] The OECD Economic Outlook, December 2020, forecasts that the global economy will contract by 4.2 per cent in 2020 and rise by 4.2 per cent in 2021.[2] Barring China, all other countries are forecast to contract in 2020. OECD contends that the recovery in 2021 will be driven by vaccination campaigns, concerted health policies and government financial support. However, however the outlook remains very uncertain as delays to vaccination deployment, difficulties controlling new virus outbreaks and failure to learn lessons from the first wave could have a negative impact on the recovery. For India the NCAER forecast is that the economy will contract by (–) 7.3 per cent in 2020–21 and the outlook for 2021–22 is quite uncertain.

5.2 India's Balance of Trade

After the sharp contraction in April, there was a steep V-shaped recovery in exports of goods & services during May–June. But the recovery has been shallow and volatile since June (Figure 5.1). The recovery has been mainly driven by goods, service exports having remained flat (Annex 5.1). The recovery of imports is also V-shaped but volatile. The movement of goods exports excluding petroleum and gems & jewellery is similar to that of total goods exports. However, the y-o-y contraction in goods imports excluding oil and gold is much less compared to total goods imports in Q3.

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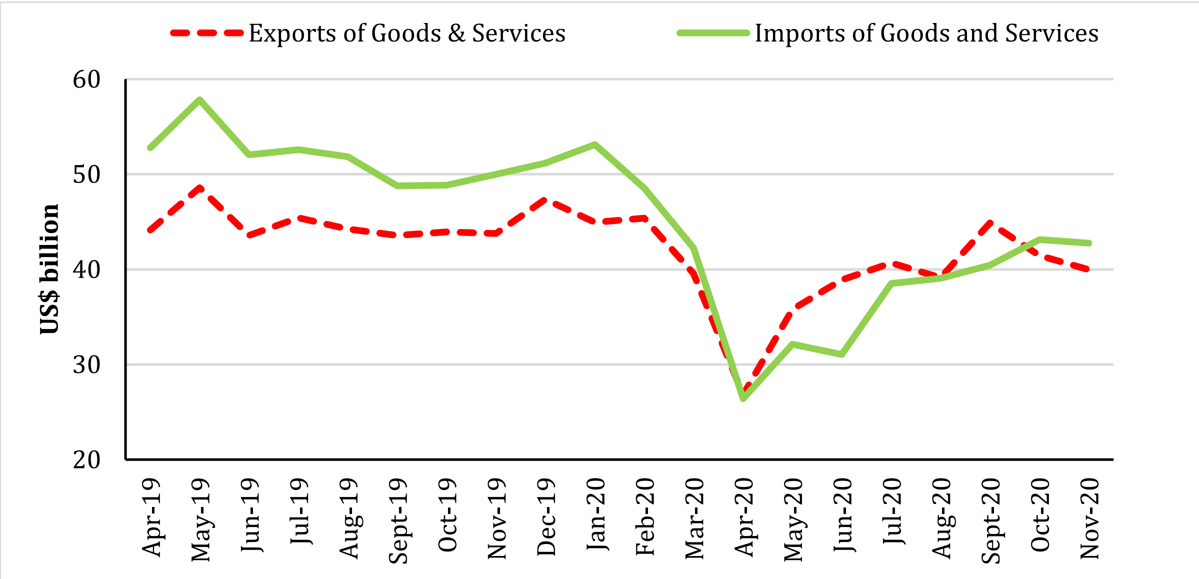
[1] https://www.imf.org/en/Publications/WEO.
[2] https://www.oecd.org/economic-outlook/.

Import contraction exceeded export contraction yielding a trade surplus in H1. A deficit re-emerged in October (Annex 5.1). In y-o-y comparisons exports contracted by 26 per cent in Q1 and the contraction moderated to 6 per cent in Q2 while imports contracted by 45 per cent in Q1 & 23 per cent in Q2 (Annex 5.1). The trade surplus rose by 145% in Q1 & 133% in Q2, y-o-y (Annex 5.1).

Figure 5.1: Sharp decline in exports & imports since January 2020, followed by V-shaped recovery after April

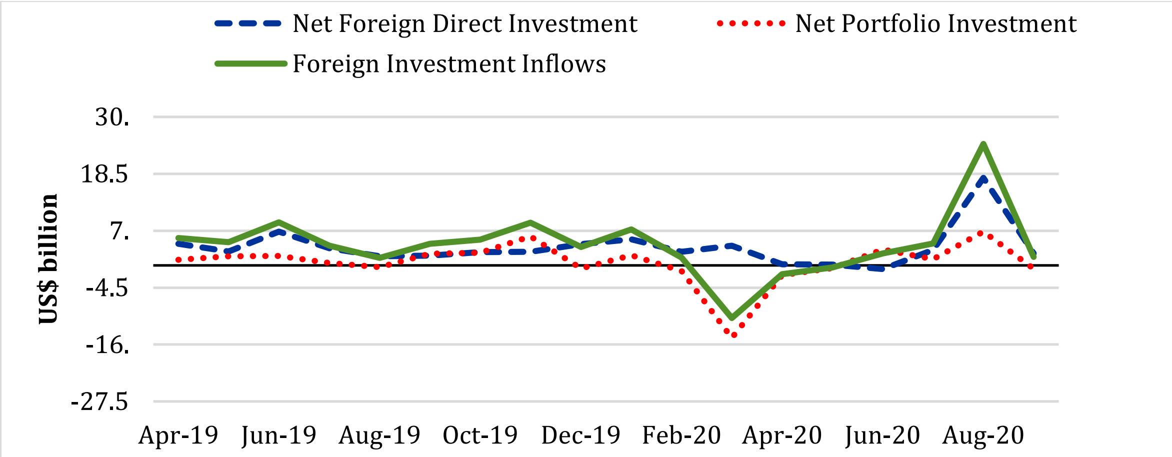


Sources: Ministry of Commerce and RBI.
Notes: 1. Services data for November are estimated.

5.3. Foreign Investment Flows

Foreign investment inflows grew by a modest 7.5 per cent y-o-y in H1 and, both its components, i.e., foreign direct investment (FDI) and portfolio inflows, were quite volatile (Figure 5.2). Portfolio inflows dipped sharply following the March lockdown while FDI saw a spike in August, probably due to direct equity sales by large corporates. There has been a large net portfolio inflows during the third quarter (October–19th December) amounting to around USD 19 billion.

Figure 5.2: Capital account: foreign investment inflows volatile in 2020-21:H1



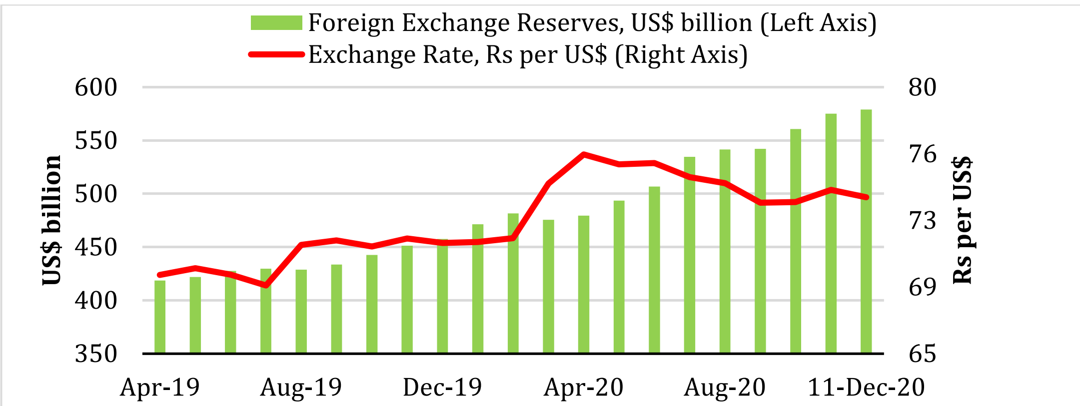
Source: Reserve Bank of India.

5.4 Foreign Exchange Reserves and Exchange Rate

Foreign exchange reserves have been rising since July 2019, especially after April 2020 (Figure 5.3). The increase in reserves mainly reflects a current account surplus, driven by import contraction, not so much capital inflows (Annex 5.2). Rising foreign exchange reserves have led to an appreciation of the nominal exchange rate. Adjusting for India's higher inflation rate relative to its trade partners, the real effective exchange rate (REER) has appreciated even more (Figure 5.4).

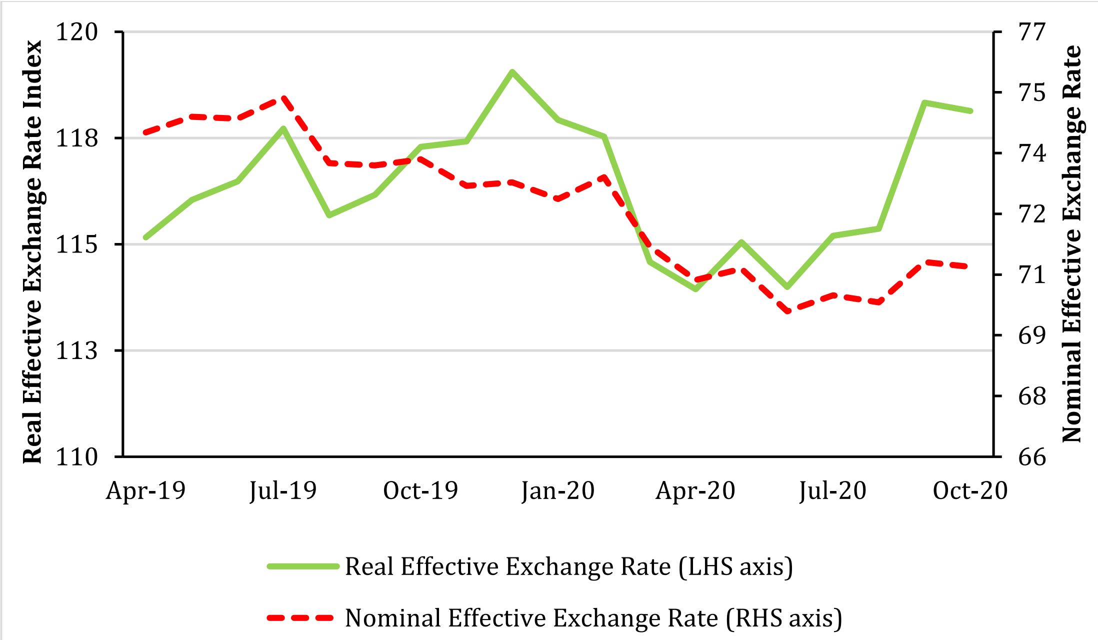
The increase in reserves is a positive development, but the exchange rate appreciation will adversely affect exports and the trade balance. Also, rising will drive up money supply & further raise inflationary pressures.

Figure 5.3: Exchange rate appreciation driven by rising foreign exchange reserves



Source: Reserve Bank of India.
Note: Foreign exchange reserves data is as on Dec 11, 2020. The exchange rate data is the average of 1 Dec-18 Dec 2020.

Figure 5.4: Appreciation of the real and nominal effective exchange rates



Source: Reserve Bank of India.

5.4 Outlook

The outlook for trade remains quite uncertain. The global growth impetus of gradual rollout of Covid vaccines & an incoming new US administration with a more co-operative global approach is likely to boost exports. On the other hand, fresh lock-downs in Europe & US following a second wave of Coronavirus cases may dampen export recovery. The recent Regional Comprehensive Economic Partnership (RCEP) agreement could also adversely affect exports.

India has lost more than it has gained from participation in Regional Trade Agreements (RTA) arrangements in the past. However, the recent RCEP agreement, which excludes India, could have a significant negative impact on India's exports. The RCEP member countries are major export destinations for India, accounting for 28 per cent of total goods exports (April–September 2020). They could potentially shift their imports from India to RCEP member countries. The door is still open for India to join RCEP if the issues it has raised are adequately addressed. If the incoming US administration revives the Trans-Pacific Partnership, that may be another option for India. However, staying out of both these mega RTAs could be very damaging for India as global supply chains are increasingly embedded within such RTAs. Resisting autarkic pressures & introducing reforms to significantly strengthen competitiveness is essential to benefit from such RTAs or even a revamped WTO.

Annex 5.1: Summary of India's Trade Balance

Time Period	Exports, US$ billion (% change y-o-y)			Imports, US$ billion (% change y-o-y)			Trade Balance US$ billion (% change y-o-y)
	Goods	*Services*	*Total*	*Goods*	*Services*	*Total*	
Apr–20	10	16	27	17	9	26	0
May–20	19	17	36	22	10	32	4
Jun–20	22	17	39	21	10	31	8
Jul–20	24	17	41	28	10	39	2
Aug–20	23	16	39	29	10	39	0
Sep–20	28	17	45	30	10	40	4
Oct–20	25	17	41	34	10	43	–2
Nov–20	24	16[1]	40[1]	33	9[1]	43[1]	–3
2020–21:Q1	**51 (–37)[2]**	**50 (–9)[2]**	**102 (–26)[2]**	**60 (–52)[2]**	**29 (–18)[2]**	**90 (–45)[2]**	**12 (145)[2]**
2020–21:Q2	**74 (–6)[2]**	**51 (–8)[2]**	**125 (–6)[2]**	**88 (–25)[2]**	**30 (–17)[2]**	**118 (–23)[2]**	**7 (133)[2]**

Sources: Ministry of Commerce (MoC) for goods trade and Reserve Bank of India (RBI) for services trade.
Notes: 1. Not RBI actuals but preliminary estimates from MoC;
2. Figures in parentheses indicate % change year-on-year

Annex 5.2 Current account surplus more than offset vanishing capital account surplus in 2020-21:Q1

(US$ billion)	2019-20:Q1	2019-20:Q2 (P)	2019-20:Q3 (P)	2019-20:Q4 (P)	2020-21:Q1 (P)
Overall Balance of Payments (1+2+3)	**14**	**5**	**22**	**19**	**20**
1. Current Account (1.1+1.2)	**(–)15**	**(–)6**	**(–)1**	**1**	**20**
1.1 Merchandise Trade	(–)47	(–)38	(–)35	(–)35	(–)10
1.2 Invisibles Trade	32	32	33	36	30
2. Capital Account (2.1+2.2+2.3+2.4+2.5)	**29**	**12**	**22**	**17**	**1**
2.1 Foreign Investment	19	10	18	(–)2	0
2.2 Loans	10	3	3	10	2
2.3 Banking Capital	3	(–)2	(–)2	(–)5	2
2.4 Rupee Debt Service	0	0	0	0	0
2.5 Other Capital	(–)3	1	4	14	(–)4
3.0 Errors & Omissions	**0**	(–)1	**1**	**1**	**(–)1**
4.0 Monetary Movements (4.1+4.2)	**(–)14**	**(–)5**	**(–)22**	**(–)19**	**(–)20**
4.1 I.M.F.	0	0	0	0	0
4.2 Foreign Exchange Reserves	(–)14	(–)5	(–)22	(–)19	(–)20

Source: Reserve Bank of India.
Note: P stands for Preliminary

Chapter 6: Inflation

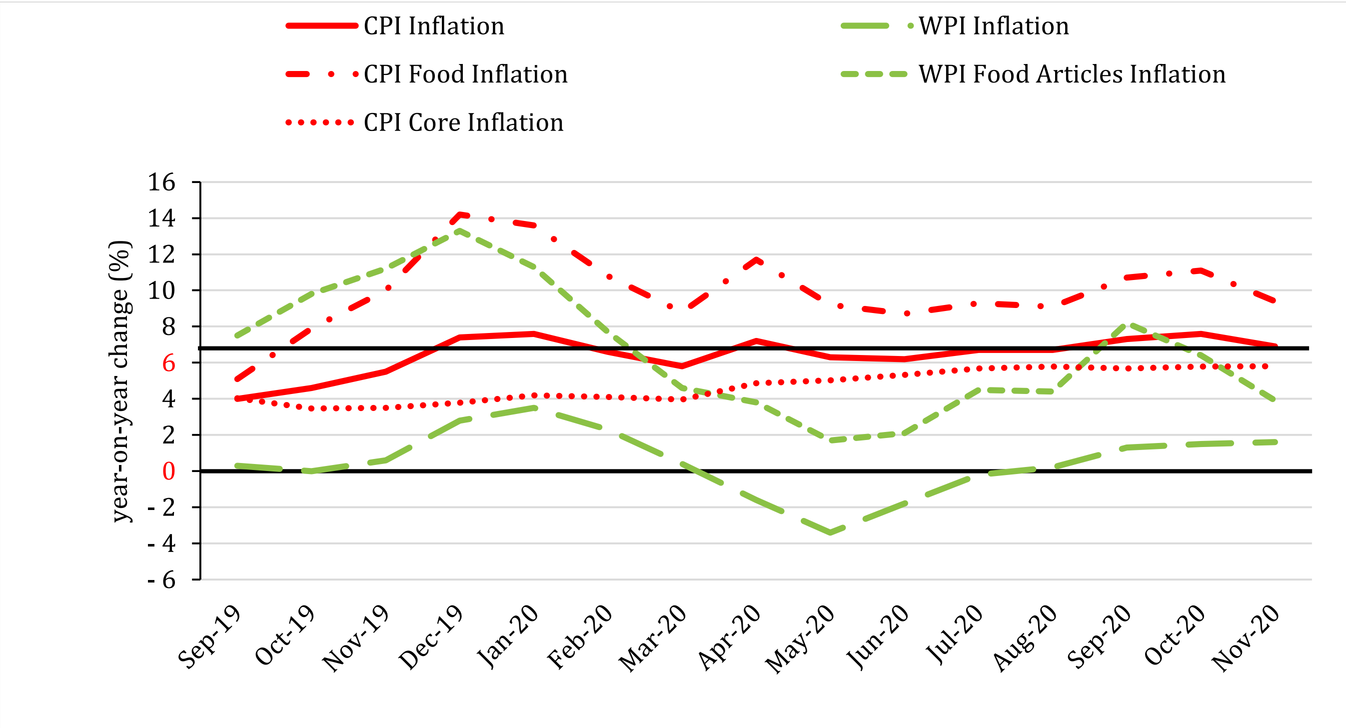
Rudrani Bhattacharya and Ajaya K Sahu

The CPI headline inflation has remained elevated above the RBI tolerance band of 2 per cent–6 per cent since December 2019, though it declined to 6.9 per cent in November 2020 from 7.6 per cent in October 2020. Inflation is mainly being driven by food price inflation. It was 9.4 per cent in November, down from 11 per cent in October 2020. Core inflation (non-food non-oil) has also remained close to 6 per cent. WPI inflation, which was diverging from CPI & declining till July 2020, has since been rising but it is still very muted. It is also being driven by food price inflation. We forecast headline inflation will remain elevated at 7 per cent and 6.3 per cent respectively during Q3 and Q4. The annual inflation forecast for 2020–21 is 6.7 per cent.

6.1 Inflation Trends in Q3

The CPI headline inflation has remained elevated above the RBI tolerance band of 2 per cent to 6 per cent since December 2019, currently (November 2020) at 6.9 per cent. Inflation is mainly being driven by food price inflation. It is now 9.4 per cent (November 2020), down from 11 per cent in October 2020. Even core inflation (non-food non-oil) has remained close to 6 per cent since July 2020 (Figure 6.1 & Annex 6.1).[1]

Figure 6.1: CPI and WPI Inflation: Overall and Food Inflation October 2019– November 2020, (% change y-o-y)



Sources: MoSPI and Office of Economic Advisor

[1] However, gold price inflation has been very high at 44 per cent y-o-y between June-August. It is still very high at 33 per cent in November.

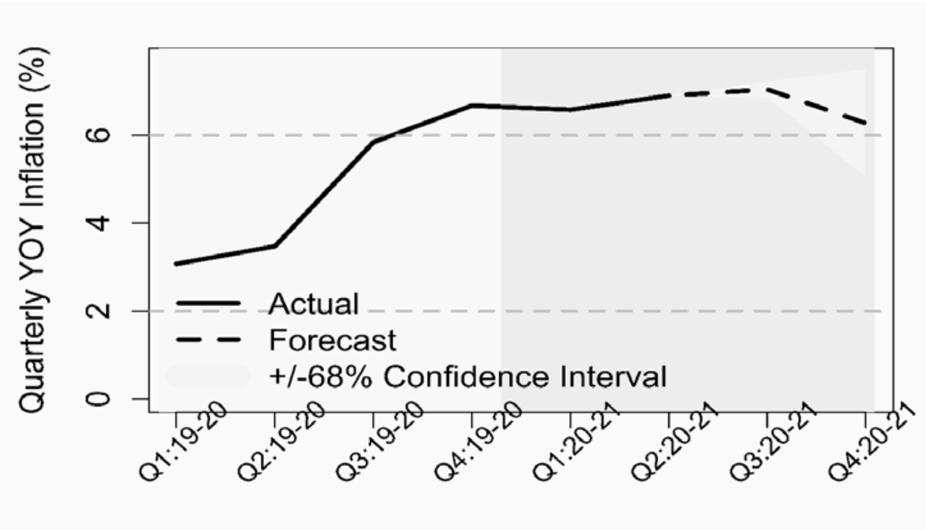
The decline in food price inflation has been mainly due to the decline in vegetable price inflation, which has been the major driver of food price inflation in recent months. Vegetable price inflation declined from 22.1 per cent to 15.6 per cent between October and November 2020. Vegetable price inflation, in turn, is mainly being driven potato, onion and tomato prices (POT). Non-POT food price inflation was somewhat lower and declined from 7.9 per cent in October to 6.6 per cent in November (Annex 6.2).

WPI inflation, which was diverging from CPI & declining till July 2020, has since been rising but it is still very muted. WPI is also being driven by food price inflation. The divergence between CPI & WPI movement was presumably due to (i) the higher weight of food articles, which has been driving inflation, in the CPI as compared to the WPI, (ii) the higher impact of logistics disruption, following the lockdown, on retail trade as compare to wholesale trade and (iii) increasing margins between wholesale & retail trade.

6.2 Inflation Outlook

We forecast that headline inflation will remain elevated at 7 per cent during Q3 and 6.3 per cent during Q4 respectively[2]. The moderation of WPI food articles and CPI food inflation has been driven by a decline in vegetables price inflation with the arrival of the winter crop, deflation in crude oil and WPI energy prices, decline in CPI energy inflation, and moderation of inflation expectations. On the other hand, sticky core inflation induced by supply side disruptions, demand revival, and increase in liquidity are expected to exert upward pressure on CPI inflation[3]. As a result, CPI inflation is expected to remain above the upper band of RBI's tolerance range (6 per cent) during Q3, and Q4, 2020–21.

Figure 6.2: Inflation Forecast



[2] The forecast is based on a co-integrated vector autoregressive model.
See Rudrani Bhattacharya and Mrigankshi Kapoor, "Forecasting Consumer Price Index Inflation in India: Vector Error Correction Mechanism Vs. Dynamic Factor Model for Non-Stationary Time Series", NIPFP Working Paper Series, No. 323, October 2020.
[3] This was mentioned earlier in the External chapter that increase in reserves may lead to rise in liquidity, which in turn may lead to higher inflation.

Annex 6.1 CPI and WPI Inflation: Overall and Food (% change y-o-y)

		CPI Inflation	CPI Food Inflation	WPI Inflation	WPI Food Articles Inflation
2019	September	4.0	5.1	0.3	7.5
	October	4.6	7.9	0.0	9.8
	November	5.5	10.0	0.6	11.2
	December	7.4	14.2	2.8	13.3
2020	January	7.6	13.6	3.5	11.3
	February	6.6	10.8	2.3	7.7
	March	5.8	8.8	0.4	4.6
	April	7.2	11.7	(–)1.6	3.8
	May	6.3	9.2	(–)3.4	1.7
	June	6.2	8.7	(–)1.8	2.1
	July	6.7	9.3	(–)0.2	4.5
	August	6.7	9.1	0.4	4.4
	September	7.3	10.7	1.3	8.4
	October	7.6	11.0	1.5	6.4
	November	6.9	9.4	1.6	3.9

Sources: MoSPI and Office of Economic Advisor.

Annex 6.2: Food Price Inflation without Potato-Onion-Tomato (POT) Inflation (% change y-o-y)

Month-Year	CPI Inflation					WPI Inflation				
	Consumer Food Price Inflation (CFPI)	Food & Beverages Inflation (F&B)	Potato-Onion-Tomato (POT) Inflation	CFPI Inflation without POT Inflation	F&B Inflation without POT Inflation	Food Price Inflation (WFPI)	Food Article Inflation (FA)	Potato-Onion-Tomato (POT) Inflation	WFPI Inflation without POT Inflation	FA Inflation without POT Inflation
Jun-20	8.7	7.9	20.5	7.6	6.9	3.1	2.1	0.1	3.1	2.1
Jul-20	9.3	8.5	35.8	7.3	6.8	4.7	4.5	28.0	3.8	3.2
Aug-20	9.1	8.3	36.2	7.0	6.6	4.8	4.4	30.1	3.9	3.0
Sep-20	10.7	9.8	56.1	7.5	7.1	7.2	8.4	77.0	4.9	4.7
Oct-20	11.0	10.1	54.3	7.9	7.5	5.8	6.4	48.6	4.3	4.1
Nov-20	9.4	8.8	50.2	6.6	6.3	4.3	3.9	46.7	2.9	1.7

Sources: MoSPI and Office of Economic Advisor

Chapter 7: GDP forecast, hysteresis and reforms

Rudrani Bhattacharya and Sudipto Mundle

Following the steep decline in GDP in 2020 Q1, the recovery in Q2 was surprisingly sharp. Accordingly, we have revised our growth forecasts for Q3, Q4 and the full year 2020–21 to 0.1 per cent, 2 per cent and (–) 7.3 per cent respectively. Starting from that baseline, which is 7.3 per cent lower than in 2019–20, GDP has to grow well above the recent pre-pandemic trend rate (5.8 per cent) for India to catch up with its pre-pandemic growth path. This will require deep and wide-ranging structural reforms in the financial sector, power & foreign trade. Reforms in cooperation with the states are also urgent in health, education, labour and land, which are all primarily state subjects under the constitution.

7.1 Forecast for Q3, Q4 and FY 2020–21

GDP growth had been declining since 2017–18: Q3 and had fallen to only 3.1 per cent by 2019–20: Q4 even before the pandemic struck. Following the pandemic and the lockdown in late March, GDP contracted by a massive (–) 23.9 per cent in Q1 of 2020–21 but it then recovered much faster than expected in Q2, moderating the year-on-year (y-o-y) contraction to (–) 7.5 per cent. Our forecast suggests that the contraction is likely to be eliminated by Q3, with 0.1 per cent y-o-y growth, and that GDP will grow by 2 per cent y-o-y in Q4 (Figure 7.1).[1] This implies an annual contraction of (–) 7.3 per cent for FY 2020–21. In other words, real GDP will decline from Rs 146 trillion in 2019–20 to Rs 135 trillion in 2020–21.

The stronger than expected recovery since Q1 reflects the combined impact of supply-side unlocking and demand stimulation. Demand stimulation measures were led by RBI liquidity injection to the tune of 6.4 per cent of GDP. The central fiscal deficit for April– October period also ballooned. It was higher by 32 per cent y-o-y (Annex 8.2). Spending by the states during HI was constrained by the sharp decline in revenues, consequent upon the GDP decline, and the Fiscal Responsibility & Budget Management (FRBM) Act 2003 limits on their borrowing, which have only recently been relaxed. It is expected that the combined fiscal deficit (Centre plus States) for the full year 2020–21 will exceed 14 per cent. These monetary and fiscal policy issues are discussed in the next two chapters.

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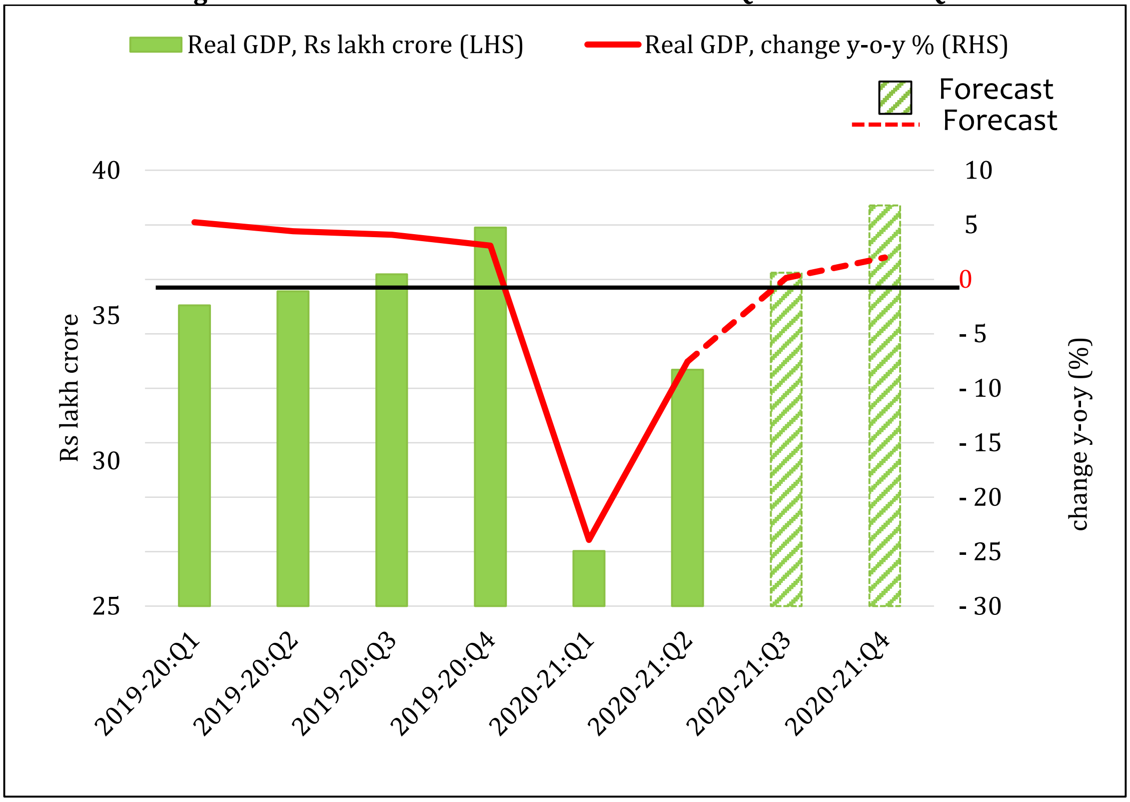
[1] This forecast is based on Factor-Augmented Time-Varying Coefficient regression model (Rudrani Bhattacharya, Parma Chakravartti & Sudipto Mundle (2019) Forecasting India's economic growth: a time-varying parameter regression approach, Macroeconomics and Finance in Emerging Market Economies, 12:3, 205-228, DOI: 10.1080/17520843.2019.1603169.
. For further details on the model and indicators see Annex 7.1.

Figure 7.1: Actual and Forecast GDP: 2019–20:Q1 to 2020–21: Q4



7.2 Hysteresis: Medium-to-long term outlook

Starting from this contracted GDP baseline of Rs 135 trillion in 2020–21, what will be the medium-to-long term outlook going forward? To address this question, we have compared a few potential growth paths to a counterfactual no-pandemic growth path in Figure 7.2.

The four growth paths are detailed below:

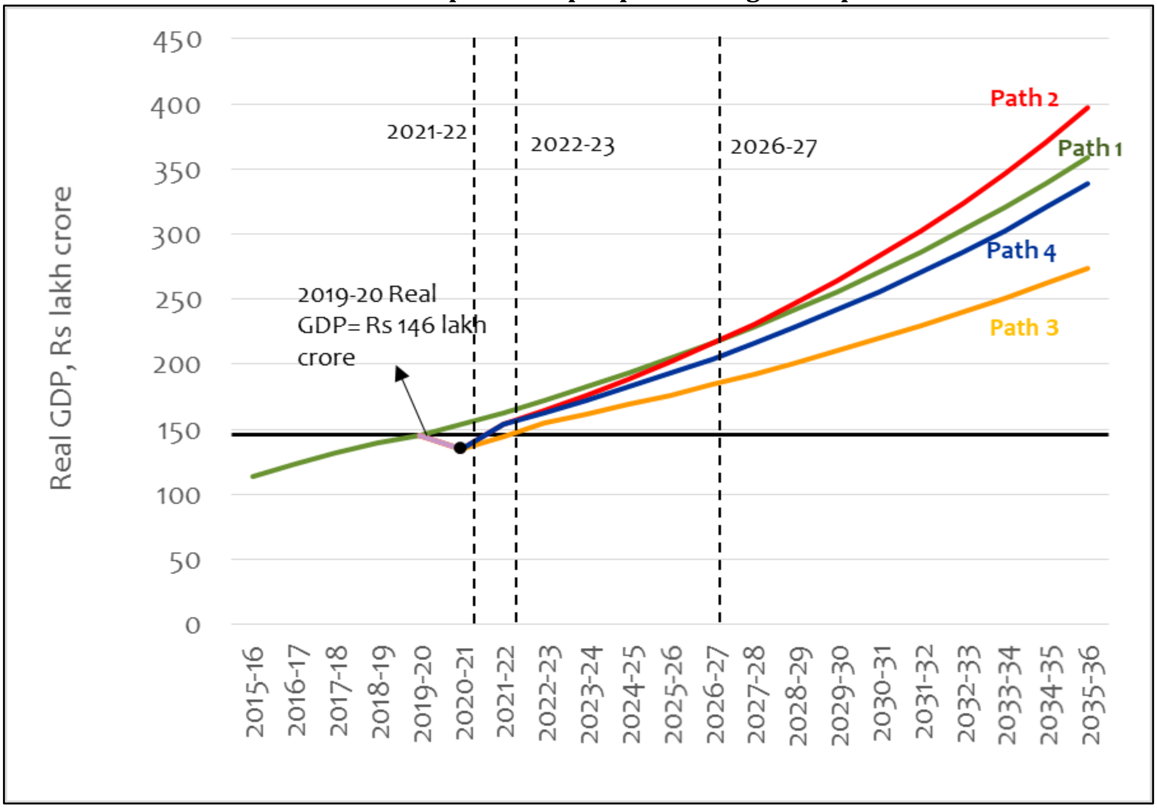
Path I: Counterfactual trend growth path (5.8 per cent) with no shock

Path 2: Highly optimistic path: Assumes rapid catch-up with 2019–20 output level by 2021–22, implying 14 per cent growth in 2021–22, followed by sustained 7 per cent growth thereafter. In our view such a path is overly optimistic and unrealistic. But even this path will catch up with the no-shock growth path only by 2026–27.

Path 3: Pessimistic Path: This path assumes that GDP will catch-up with the 2019–20 output level only by 2022–23, implying 7 per cent growth during FY 2021 and FY 2021–22 (7 per cent), which is followed by a 4.5 per cent long term trend growth rate thereafter. Of course this path cannot catch up with Path 1. Such a path is a possible scenario if pandemic containment, e.g., vaccine rollout, & economy are mismanaged.

Path 4: Realistic Path: This path assumes that GDP will catch up with the 2019–20 past peak output by 2021–22. Catch-up with 2019–20 and thereafter grow at the recent past trend rate of by 5.8 per cent. This path, in our view the most realistic path, also cannot catch up with Path 1. However, even this path will require deep, wide-ranging structural reforms. Path 4 will require wide ranging structural reforms comparable to 1991. The reform priorities should focus on the financial sector, power & foreign trade initially. Further, reform in along with health, education, labour and land are also urgent, but these can only be pursued in close coordination with the States, cooperative federalism, since these are primarily state subjects.

Figure 7.2 GDP has to grow well above recent trend rate for India to catch up with its pre-pandemic growth path



The main purpose of describing these paths is to point out that hysteresis, the long term effects of the pandemic shock, can indeed last very long. To catch up with the recent pre-pandemic trend growth path, the post-recovery trend growth rate has to be significantly faster than the previous trend growth rate. That cannot be achieved by conventional macroeconomic stimulus policies alone. These will have to be supported by deep, wide ranging structural reforms comparable to the game changing reforms of 1991.

Annex 7.1: Indicators used in the forecasting model

Increased in 2020-21:Q3 (%y-o-y)	Same in 2020-21:Q3 (%y-o-y)	Compressed in 2020-21:Q3 (%y-o-y)
•Production of two wheelers •NSE Turnover •Revenue receipts •Net tax revenue •Non-food credit of Scheduled Commercial Banks •Production of Coal •Aggregate Deposits •Electricity Requirement •GST Collection •Production of Rice •Consumer Price Index	•Steel consumption	•Food credit •Production of crude oil •Exports of goods & services •Imports of goods & services •Revenue expenditure net interest payments •Rainfall •Production of Cement •Cargo traffic at major ports •Aviation cargo traffic •Air Passengers

Chapter 8: Challenging Fiscal Policy Outlook

Sudipto Mundle, Ajaya K Sahu and Pallavi Choudhuri

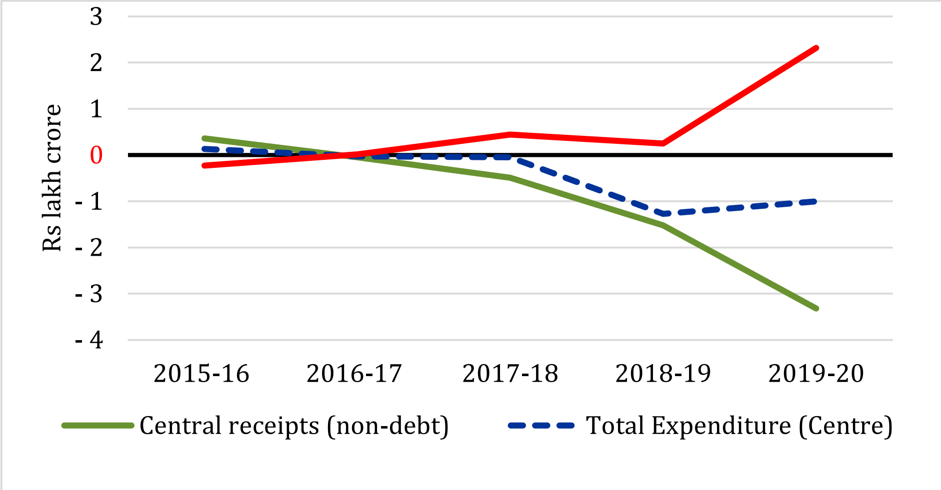
Fiscal marksmanship had deteriorated significantly during the last few years. Coming on top of this, the pandemic completely disrupted the revenue and deficit projections. The Central deficit ballooned. State government spending was constrained by the steep decline in revenues and the borrowing limits of their respective FRBM Acts until the recent relaxation of their borrowing limits by 2 per cent of GDP. We estimate the combined fiscal deficit of the Centre plus States for 2020–21 at over 14 per cent of GDP. Even the fiscal impulse, the difference between the current year's deficit and that of last year, is over 7 per cent of GDP. Combined with RBI liquidity infusion of well over 6 per cent of GDP, this amounts to a very significant stimulus which compares favourably with most emerging market economies. However, the fiscal stimulus could have been more effective in terms of timing, allowing extra headroom for borrowing and spending by States earlier on, and a greater emphasis on income support for poor consumers in the composition of expenditure. The 2020–21 budget needs to pump prime a quick recovery and at the same time initiate fiscal consolidation. The expected high growth next year provides the space for a strategy that can achieve this delicate balance. However, the massive increase in government borrowing required for financing the huge combined fiscal deficit is a major challenge for monetary policy.

8.1 Deterioration of fiscal marksmanship after 2015–16

The central government's fiscal marksmanship had severely deteriorated during the last few years even before the pandemic struck. Thus, the centre's actual tax revenue exceeded the budget estimate (BE) by 3 per cent in 2015–16 but by 2019–20 it had fallen short of the budget estimate by as much as 18 per cent. The centre's actual total non-debt receipts also exceeded the BE by 3 per cent in 2015–16. But by 2019–20 it had fallen short by 16 per cent. In contrast, actual expenditure was close to the BE till 2017–18 & fell short of BE by only 4 per cent in 2019–20. Consequently, the actual fiscal deficit which was 4 per cent less than BE in 2015–16 had exceeded the BE by as much as 33 per cent in 2019–20 (Figure 8.1)[1].

[1] See also Annex 8.1.

Figure 8.1: Fiscal Marksmanship had already deteriorated before the pandemic shock

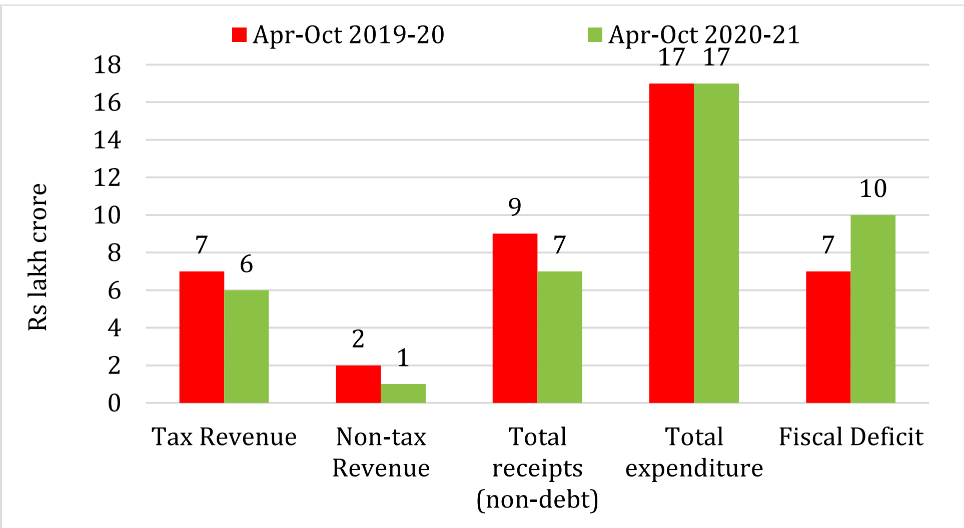


Source: Controller General of Accounts.

8.2 Pandemic shock, ballooning fiscal deficit and the stimulus

Coming on top of this, the pandemic completely disrupted revenue and deficit projections for 2020–21. Data available up to October indicates that in the post-lockdown period (Apr–Oct) Central Govt. receipts contracted by as much as 24 per cent y-o-y despite recent improvements in tax revenue (Figure 8.2)[2]. In contrast, expenditure has remained about the same. Hence the fiscal deficit for Apr–Oct 2020 ballooned by 32 per cent y-o-y. Post-budget borrowing was substantially increased to finance the deficit and maintain central expenditure levels.

Figure 8.2: Pandemic has completely disrupted revenue projections Deficit ballooned by 32% y-o-y during Apr–Oct 2020–21

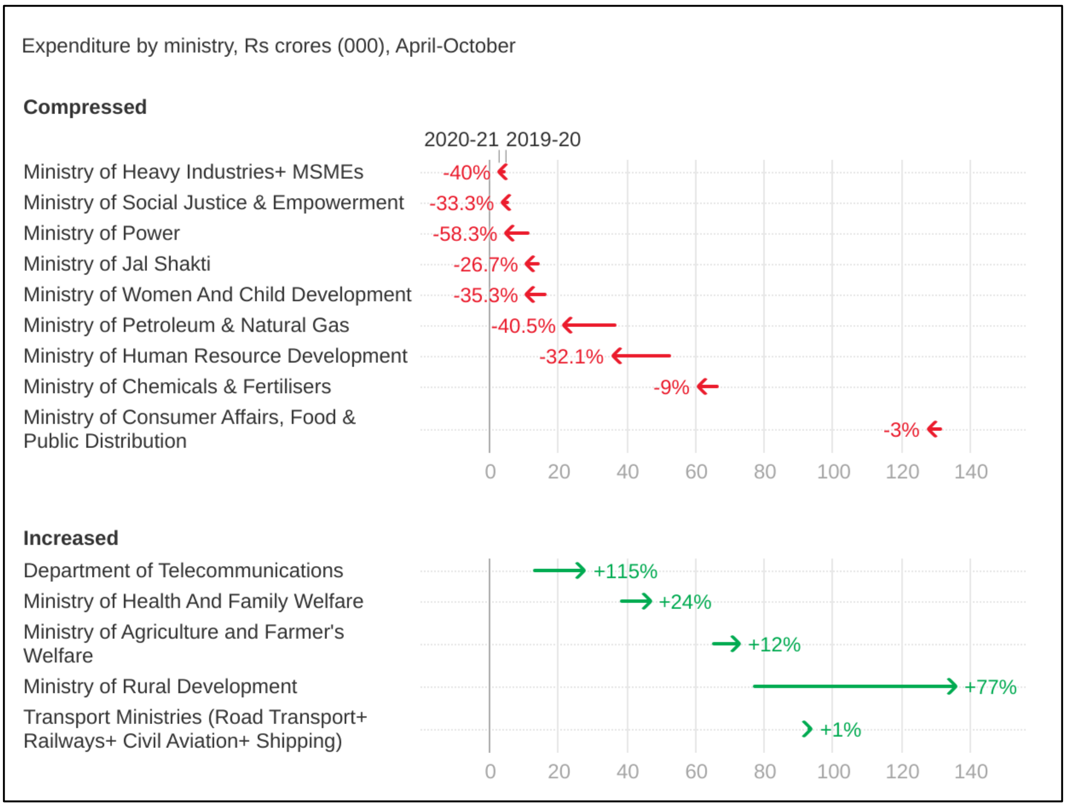


Source: Controller General of Accounts.

[2] See also Annex 8.2

On the expenditure side, total central expenditure during Apr–Oct 2020 has remained almost the same as in Apr–Oct 2019, but there are large inter-departmental variations within the overall umbrella. Thus, expenditure has increased significantly in income support departments like Rural Development & Agriculture. It has also increased for Health & Family Welfare, Telecommunications and Transport. However, expenditure has been compressed in other departments like heavy industries, power, human resource development (i.e. education) and even the food department, since much of food subsidy has been shifted off-budget (Figure 8.3).

Figure 8.3: Spending of some departments has increased significantly while others have been compressed



Source: Controller General of Accounts.

Returning to the question of the fiscal deficit and the governments' fiscal stance, it has been widely believed that government has provided little fiscal stimulus. This is presumably because of a failure in the central government communications strategy. It had focused on its flagship Atma Nirbhar Bharat program (AB) as a massive Rs 20 trillion stimulus programme amounting to 10 per cent of GDP. But analysts and the media quickly pointed out that the fiscal component of the original AB program amounted to only 1 per cent of GDP. The AB Programme has since been expanded, the fiscal component now amounting to 2.4 per cent of GDP[3].

However, the AB program is only a small component of the government's total fiscal stimulus. Combining the budgeted fiscal deficit of the central government, its additional post

[3] See Annex 8.3.

budget borrowing program, the fiscal cost of the AB program, the budgeted deficit of state governments and the additional 2 per cent borrowing headroom for states[4], the 2020–21 combined fiscal deficit of the central and state governments is estimated at Rs 29 trillion (Table 8.1). This amounts to over 14 per cent of the Rs 135 trillion GDP 2020–21 now forecast by NCAER[5]. Even the fiscal impulse, the increase in the deficit over 2019–20, considered the correct stimulus measure by some, amounts to over 7 per cent of GDP. Taken together with RBI liquidity infusion of over 6 per cent of GDP, this adds up to a very substantial stimulus program that compares well with most other emerging market economies.

Table 8.1: Estimated Combined Fiscal Deficit (Centre plus States) for 2020–21

	₹ lakh crores			***% of GDP***		***% of GDP 2020-21***	
	2019-20 (RE)	**2020-21 BE**	**2020-21 (Estimated)**	**2019-20 (RE)**	**Budget 2020-21**	**RBI GDP Forecast**	**NCAER GDP Forecast**
Fiscal Deficit (Centre)	8	8	8	3.8	3.5	4.0	3.9
Post budget additional borrowing (Centre)	0	0	5	–	0.0	2.3	2.3
Atma Nirbhar Bharat fiscal component (Centre)	0	0	5	–	0.0	2.4	2.4
Fiscal Deficit (State)	7	6	6	3.2	2.8	3.1	3.1
Additional borrowing headroom for States	0	0	5	–	0.0	2.2	2.2
Combined Deficit	**15**	**14**	**29**	**7.0**	**6.3**	**14.3**	**14.2**

Sources: Controller General of Accounts & Ministry of Finance.

Financing such a massive borrowing program is of course a major challenge for monetary policy and a fragile financial sector. This issue is addressed in the following chapter. It has to be added that while the central government decided to offset its revenue shortfall through additional borrowing in H1 to maintain budgeted expenditure levels, spending by states was constrained by their revenue shortfall and the hard borrowing limits under their respective FRBM acts. Had their borrowing headroom been relaxed earlier, the impact of the stimulus would have been more effective. States account for two-thirds of total government spending and are at the frontline of delivering all public services, battling the pandemic and

[4] An additional borrowing headroom of 2 per cent of GDP was announced along with the original AB program. But it had strong conditions attached, especially about 0.5 per cent of GDP linked to power sector reforms, which states would not be able to take up. However, along with the new arrangement for extension and financing of the GST compensation fund, states have been allowed an additional 0.5 per cent GDP borrowing headroom, implying an effective extra borrowing capacity of 2 per cent of GDP.

[5] The NCAER forecast of (–) 7.3 per cent GDP contraction in 2020–21 is only marginally higher than the RBI forecast of (–) 7.5 per cent. Most other forecasts are also in the same ball park.

providing income support to poor households who lost their livelihoods due to the pandemic and lockdown.

8.3 A Strategy for sustaining economic recovery along with fiscal consolidation

It was mentioned earlier that it is urgent to get the country back to a high growth path to contain the adverse long term effects of the pandemic and contraction in 2020–21, pointing to the need for an expansionary fiscal stance. On the other hand, elevated inflation, high yields on government securities that are crowding out the flow of credit to the private sector and the sharp increase in public debt and debt servicing costs, which will further crowd out productive public expenditure, all point to the need for fiscal restraint. The correct fiscal stance in the 2021–22 budget is therefore a tough call.

The base effect of the sharp GDP contraction in 2020–21 will most likely lead to very high growth in 2021–22, probably in double digits. This provides the space for a fiscal strategy that that can help sustain economic recovery while at the same time initiating fiscal consolidation. The core of such a strategy is to expand government expenditure significantly compared to the current year, but at a lower rate than the nominal GDP growth rate. Assuming a revenue buoyancy of 1, the observed historical norm, revenue will then also grow faster than expenditure, thereby reducing the deficit. This strategy can be repeated each year through the governments rolling 3–year medium term fiscal strategy until the combined fiscal deficit is brought down to a more tolerable level of around 5–6 per cent.

It could be questioned whether such a strategy will really sustain economic recovery, since gradual reduction of the deficit entails compression of the fiscal impulse. However, it is important to remember that apart from government expenditure, there are several other growth drivers. First, liquidity infusion by the RBI played a major role in driving the sharp recovery from Q2 and onwards alongside the relaxation of supply side constraints. It can continue to play that role over the next few years to enable fiscal consolidation. Second, though the pandemic is still continuing it has been tapering down since mid–September. Covid vaccines that have already been rolled out in some countries are also likely to be rolled out in India in early 2021. These positive developments on the pandemic front could give a strong boost to economic growth. Third, the uptick in investment and exports noted in Q2 could continue. Finally, and most importantly, if the government can initiate game changing structural reforms in the financial sector, power, foreign trade and, in cooperation with the states, in state subjects like health, education, land and labour. This could effectively shift the Indian economy to a significantly higher long term growth path.

Annex 8.1: Fiscal Marksmanship had severely deteriorated before pandemic shock

Deviation of Actuals from Budget Estimates (%)					
	2015-16	**2016-17**	**2017-18**	**2018-19**	**2019-20**
Central tax revenue	3	5	1	(–) 11	(–) 18
Non-Tax Rev (Centre)	13	(–) 16	(–) 33	(–) 4	4
Revenue Receipts (Centre)	5	0	(–) 5	(–) 10	(–) 14
Central receipts (non-debt)	**3**	**0**	**(–) 3**	**(–) 8**	**(–) 16**
Total Expd. (Centre)	**1**	**0**	**0**	**(–) 5**	**(–) 4**
Fiscal Deficit (Centre)	**(–) 4**	**0**	**8**	**4**	**33**

Source: Controller General of Accounts.

Annex 8.2: Pandemic has completely disrupted revenue projections: Deficit ballooned by 32% y-o-y during Apr-Oct 2020-21

Relative Change for Apr-Oct 2020-21 (y-o-y %)	
Direct tax	(–) 27
Indirect Tax	(–) 7
Central Tax Revenue	(–) 16
Central Non-tax Revenue	(–) 48
Total Central Receipts (non-debt)	(–) 24
Total Central Expenditure	0
Fiscal Deficit (Centre)	32

Source: Controller General of Accounts.

Annex 8.3: Atmanirbhar Bharat (AB) Package

	Items	**Total in (₹lakh crores)**	**Additional fiscal cost (post-budget) (₹lakh crores)**
Mar 2020	Pradhan Mantri Garib Kalyan Yojana (PMGKY) subtract PM-Kisan allocation (budgeted amount, Rs. 17, 380 crore)	2 (1)	2 (0.9)
Mar – Oct 2020	RBI's liquidity injection - till October 31, 2020	13 (6.4)	–
May 2020	Atmanirbhar Bharat Abhiyaan 1.0	11 (5.5)	1 (0.4)
Jul 2020	PMGKP Anna Yojana - extension of 5 months from Jul - Nov	1 (0.4)	1 (0.4)
Oct 2020	Atmanirbhar Bharat Abhiyaan 2.0	1 (0.4)	0.5 (0.2)
Nov 2020	Atmanirbhar Bharat Abhiyaan 3.0	3 (0.2)	1 (0.5)
	Grand Total	30 (14.9)	5 (2.4)

Source: Ministry of Finance.
Notes: Figures in parentheses reflect % of GDP, assuming GDP of 200 trillion rupees. Total stimulus [Additional fiscal cost (post-budget) + Liquidity / financial support through banks] amounts to Rs.25,70,113 crores, which is 12.9% of GDP.

Chapter 9: Monetary Policy and the Financial Sector

Pallavi Choudhuri & Sudipto Mundle

A slew of measures initiated by the RBI have contained lending rates and the yield on government securities, though the benchmark yield on the 10-year G-sec remains elevated. Also, while the policy rates have come down, the growth of bank credit to the commercial sector continues to decline. The massive increase in government borrowing poses a major policy challenge for monetary policy and the financial sector as it tends to push up the cost of money. A fragile, NPA-burdened financial sector may not be able to handle such a massive government market borrowing without its partial monetisation. In many ways, this poses the biggest threat to macroeconomic stability and calls for urgent reform of the financial sector. Strengthening supervision to contain imprudent lending is vital. Stronger rather than weaker implementation of the Insolvency and Bankruptcy Code & effective functioning of the NCLT, and other institutional arrangements are also essential to clean up bank balance sheets. Extreme caution is required in granting banking licenses to industrial conglomerates as has been recently suggested by an RBI internal working group. However, capital could be raised by selling new shares amounting to 51 per cent of the increased equity in existing public sector banks, simultaneously reforming the governance structure of these banks. Banking licenses could also be granted to NBFCs with a robust track record, the necessary domain knowledge and experience and the required scale.

9.1 Monetary policy, transmission and credit flow

There has been a massive increases in Government borrowings, mainly Central, during April–October 2020 y-o-y (Figure 9.1a). Despite this large increase in government borrowing, yields have remained elevated but range bound due to RBI interventions (Figure 9.1b). The average cut-off yield of 10-year State Development Loans (SDL) moderated following announcement of RBI's first ever OMO purchases of SDL on October 9, 2020. As of 22nd October this amounted to Rs.10,000 crores.

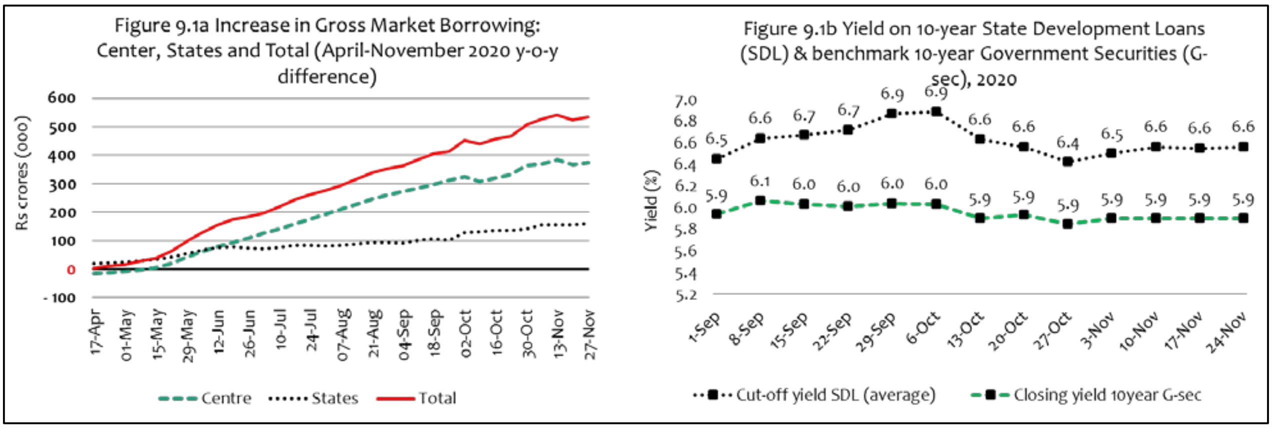


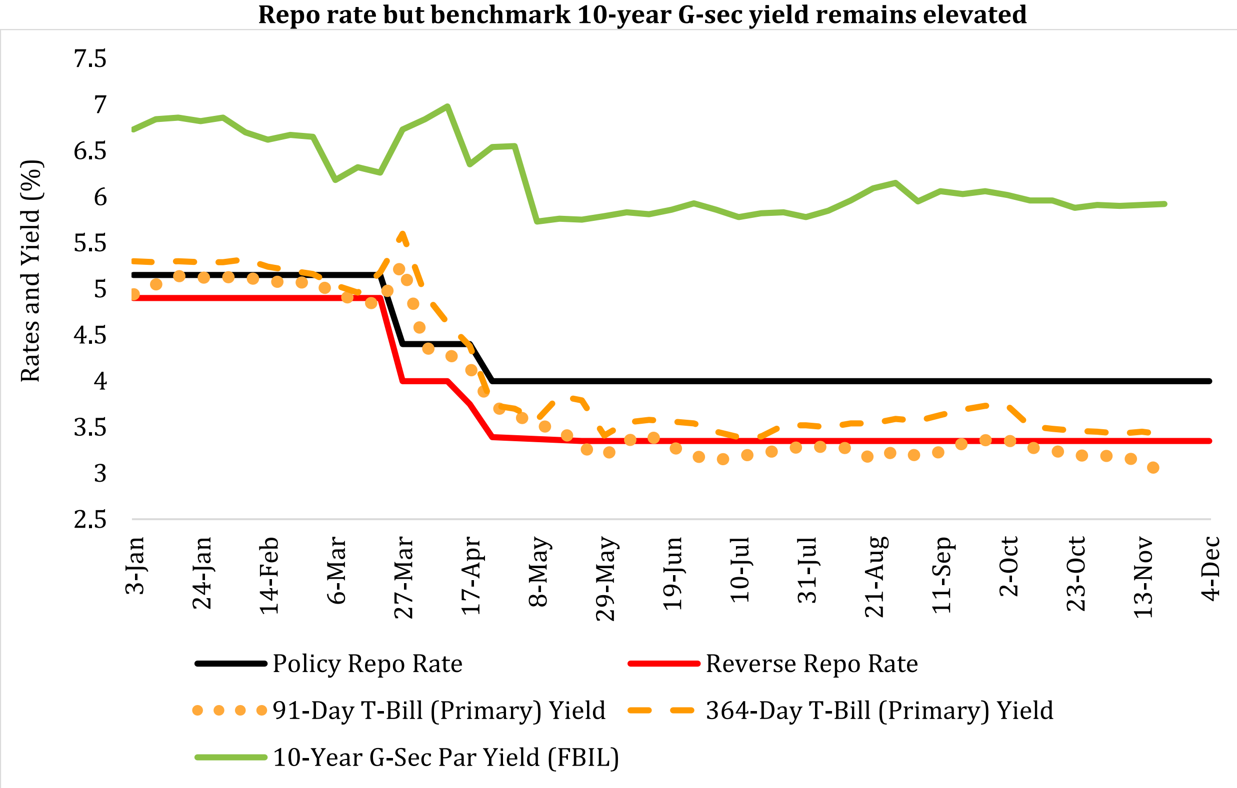
Figure 9.1a Increase in Gross Market Borrowing: Center, States and Total (April-November 2020 y-o-y difference)

Figure 9.1b Yield on 10-year State Development Loans (SDL) & benchmark 10-year Government Securities (G-sec), 2020

Source: Reserve Bank of India.

However, while the yields on short maturity G-Secs are now closely tracking the government, the yield on the benchmark 10–year G-sec continues to stubbornly hover around 6 per cent (Figure 9.2).

Figure 9.2: Yield on short-term Government securities closely tracking Repo rate but benchmark 10-year G-sec yield remains elevated



Source: Reserve Bank of India.

This is despite various measures the RBI has introduced to bring down the 10-Year G-Sec yield, such as Targeted Long Term Repo Operations (TLTRO), Twist Open Market Operations, relaxation in mark-to-market rules & raising the limit on Held-to-Maturity (HTM) bonds under the Statutory Liquidity Ratio (SLR).

In the commercial banking sector, the Repo rate reduction is now better reflected in lower bank lending & borrowing rates, which were sticky earlier (Figure 9.3a). Transmission to lower weighted average lending rate (WALR) on new loans is the strongest for foreign banks. Transmission is the least for public sector banks, but their WALR was already lower earlier compared to private banks. The public sector WALR is still lower than that of private banks (Figure 9.3b).

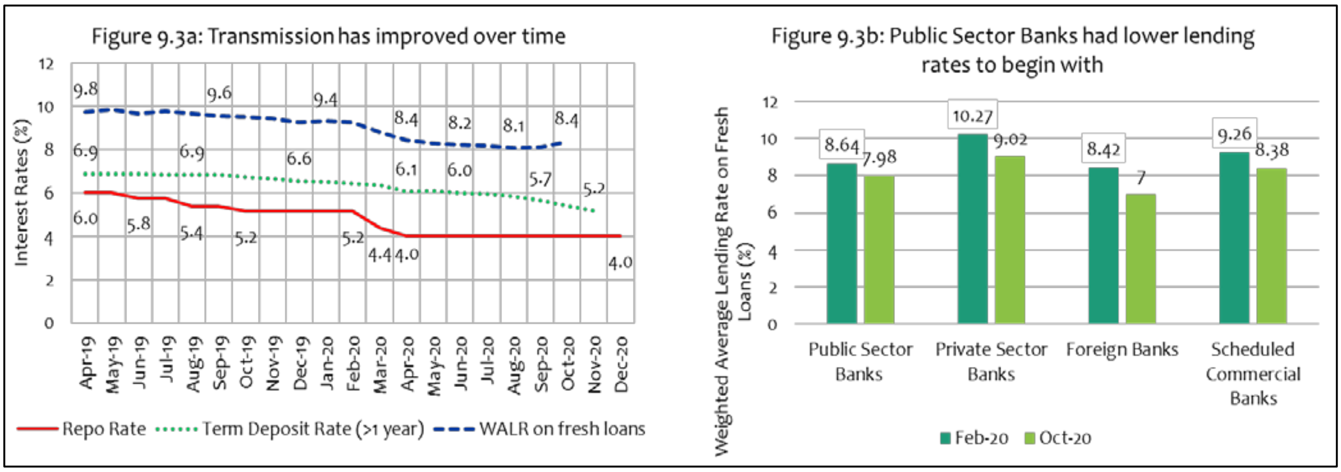


Figure 9.3a: Transmission has improved over time

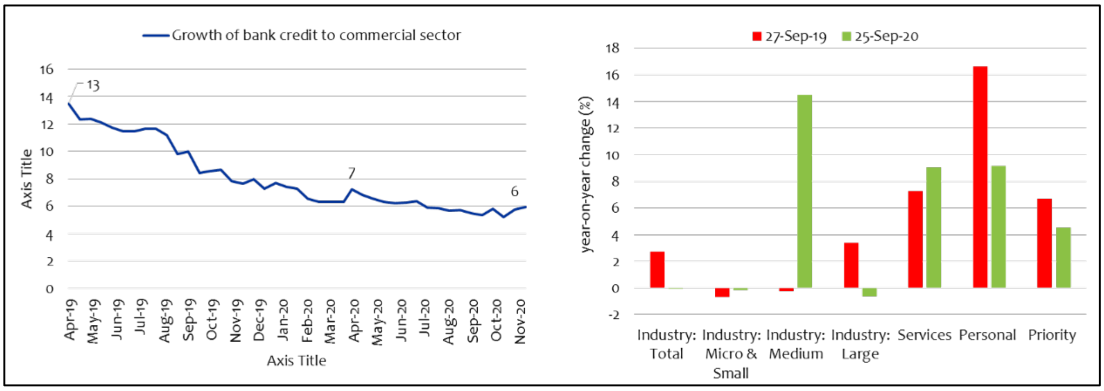
Figure 9.3b: Public Sector Banks had lower lending rates to begin with

Source: Reserve Bank of India.

Unfortunately, the growth of bank credit to the commercial sector and to most segments of industry and services are still declining (Figure 9.4a and 9.4b). Lending growth is the highest for personal loans and medium industries at around 16 per cent and 14 per cent respectively. However, while there is a y-o-y decline in the case of personal loans, there has been a remarkable increase in lending to medium industries and a curious decline in lending to large industry. These changes may be more apparent than real because of a re-definition of medium and large industries. Lending to services also shows modest growth. The real cause for concern is the continuing absolute decline in lending to micro and small industrial units for a second successive year. (Figure 9.4b).

Figure 9.4a: Growth of bank credit to commercial sector

Figure 9.4b: Credit flow to different segments



9.2 Financial sector reforms

As was pointed out at the outset, fragile NPA-burdened financial sector may not be able to handle the massive government market borrowing without its at least partial monetisation. In many ways, this poses the biggest threat to macroeconomic stability though it is also the tough problem to crack. Among important financial sector reform priorities, strengthening supervision to contain imprudent lending & multiple scams in banks and NBFCs is vital. Stronger rather than weaker implementation of the Insolvency and Bankruptcy Code & effective functioning of the NCLT, and other institutional arrangements are essential to clean up bank balance sheets.

Also, extreme caution is required in granting banking licenses to industrial conglomerates as recently suggested by an RBI internal working group. It raises the potential risk of imprudent lending by conglomerate banks to conglomerate group companies. This would also create an uneven playing field between corporate groups that own banks and those that don't. A much better and safer route for raising banking capital is for the government to sell new shares amounting to at least 51 per cent of the expanded equity of existing public sector banks. This would reform the governance structure of these banks, bringing them on a par with private sector banks, and simultaneously raise more resources for expanding the banking sector as a whole. Also, new banking licenses could be granted to non-bank finance companies which have a robust track record, have acquired sufficient experience and domain knowledge of the financial sector and have acquired the necessary scale.

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