December 2016

Economy Watch

Monitoring India's macro-fiscal performance

Building a better working world

Contents

List of abbreviations:

Sr. no	Indicator	Description
1	ADB	Asian Development Bank
2	CAB	Current account balance
3	CPI	Consumer Price Index
4	CSO	Central Statistical Organization
5	EMEs	Emerging market economies
6	FII	Foreign investment inflows
7	FPI	Foreign portfolio investment
8	FY	Fiscal year (April–March)
9	GFCE	Government final consumption expenditure
10	GFCF	Gross fixed capital formation
11	GST	Goods and Services Tax
12	GVA	Gross value added
13	IIP	Index of industrial production
14	IMI	Index of macro imbalance
15	MCLR	Marginal cost of funds based lending rate
16	MPC	Monetary Policy Committee
17	NEXP	Net exports [Exports minus imports of goods and services]
18	NPA	Non-performing asset
19	OPEC	Organization of Petroleum Exporting Countries
20	PFCE	Private final consumption expenditure
21	PMI	Purchasing Managers' Index (Reference value = 50)
22	PSU	Public sector undertaking
23	WPI	Wholesale Price Index
24	y-o-y	Year on year

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Foreword: stimulating growth after demonetization

Demonetization has undeniably led to severe short-term pain but its potential long-term gain can outweigh this adverse impact. The Union Budget for FY18 provides an immediate opportunity to quickly uplift growth which had started slowing down even prior to demonetization.

Domestically, investment has been slowing down for three successive quarters, with growth in fixed capital formation having become negative starting from 4QFY16. This investment contraction continued to increase in magnitude in the first and second quarters of FY17. The Advanced Estimates released by the CSO for the full year indicate that even private final consumption expenditure has slowed down. Demonetization has further accentuated the consumption slowdown. There is clearly a need for an substantive fiscal stimulus which can be supplemented by a monetary stimulus.

While we expect that the government would meet the current year's fiscal deficit target of 3.5% of GDP, it might involve some sacrifice of expenditure, particularly capital expenditure. Given that the Budget is being presented one month in advance compared to its usual time, the fiscal stimulus can be converted into augmented capital expenditure right from the beginning of new fiscal year.

There are a number of feasible channels through which this fiscal stimulus can be financed. First, the government can access a one-time fiscal windfall through the extinguishment of a part of the demonetized money and additional tax revenues resulting from the surge in bank deposits where the source of income may not have satisfactory explanation. The extent of this gain could be as much as 0.75% of GDP. Second, it is the appropriate time for the government to relax the FRBM norms and define the relevant targets in cyclically adjusted terms rather than rigid annual norms. Given that GDP growth has fallen well below potential growth, there is a strong case for borrowing tangibly above the target of 3% of GDP for FY18 as per the existing fiscal consolidation path. We consider that there is room for incurring additional fiscal deficit of 1% of GDP, which may be divided equally between Centre and state governments since state governments have also been asking for some relaxation. In addition, departmental enterprises such as posts and railways and non-departmental public enterprises can initiate their expansion plans and their borrowing can be off-budget. Together, these channels provide a scope for additional fiscal stimulus to the extent of 2.5% of GDP.

Demonetization and digitization have also laid the groundwork for a longer term gain in terms of a potential but steady increase in the tax-GDP ratio. With GST and greater coverage of transactions through digitized means, the tax buoyancy should significantly go up on a sustainable basis. We estimate that with a buoyancy of 1.3, the tax-GDP ratio can increase by a margin of 2% points by 2020-21 under feasible growth assumptions. In addition, significant efficiency gains can also be obtained on the expenditure side. With the abolition of plan-non-plan distinction and the merger of a large part of plan grants in the regular fiscal transfers under the Finance Commission, there is an opportunity for the central government to scale down many of the ministries that have been dealing with state subjects and administration of plan grants. Together, these initiatives can provide the means to uplift India's growth close to its long-term potential growth of 8% and above.

D.K. Srivastava, Chief Policy Advisor, EY India

Highlights of December

1. **The US Fed raised the policy rate by 25 basis points in December 2016.**
2. As per CSO's Advance Estimates of GDP, investment contraction and subdued consumption demand has resulted in a **slowdown of GDP growth in FY17 by 0.5% points as compared to FY16.** This does not take into account the impact of demonetization.
3. The World Bank, ADB and the RBI have revised downwards, their estimates of India's growth prospects in FY17 by 0.5-0.6% points, post demonetization. Reading this together with CSO's latest estimates implies that GDP growth for FY17 could be in the range of 6.5-7%.
4. Industry data as well PMI indicate contraction both in manufacturing and services post demonization. At 49.6 for manufacturing and 46.8 for services in December 2016, **PMI has gone below the threshold of 50**, indicating continued contraction from November 2016.
5. A further reduction in food prices led to a **fall in CPI inflation to 3.4% in December 2016** from 3.6% in November.
6. **Cumulated fiscal and revenue deficits stood respectively at 86% and 98% of their annual budgeted targets** during April-November FY17.
7. Post demonetization, **bank credit growth fell to 6.6% in November 2016** with food credit contracting sharply by 15.7%.
8. **Current account balance declined from 0.1% to 0.6% of GDP.** Indian rupee relative to USD weakened to INR67.6 in November 2016 from INR 66.7 in October 2016.
9. **The index of macro imbalance improved to 10.1 in 2QFY17 from 84.0 in 1QFY17,** mainly reflecting an improvement in Centre's fiscal deficit.
10. **Global crude prices surged to US$ 52.6/bbl in December 2016** from US$45.3/bbl in November 2016 as a result of agreement on supply cuts agreed to by both OPEC and non-OPEC producers.

1 Growth: investment contraction and subdued consumption demand results in growth slowdown

A. GDP growth

- As per the advance estimates released by the CSO, India's real GDP is expected to grow by 7.1% in FY17, moderating from 7.6% in the FY16 (Table 1). However, the impact of demonetization on GDP growth has not been factored in. Some key features of the advance estimates of GDP release are as follows:
    - First, government consumption is the largest driver of GDP growth in FY17. GCE grew by 23.8% in FY17 from 2.2% in FY16. This growth is largely attributed to the pension and pay revisions as recommended by the Seventh Central Pay Commission.
    - Second, growth in PFCE is estimated to moderate to 6.5% in FY17 from 7.4% in FY16. Consumption demand may fall down further when the impact of the cash crunch due to demonetization is assessed.
    - Third, GFCF (investment) contracted by (-) 0.2% in FY17 from a growth of 3.9% in FY16 due to stressed balance sheets of the corporate sector and the presence of excess capacity in the manufacturing sector.
    - Fourth, export demand is estimated to grow by 2.2% in FY17 as compared to a contraction of (-) 5.2% in FY16 while import growth is expected to contract at a faster pace of (-) 3.8% in FY17, compared to (-) 2.8% in the previous fiscal.
    - Fifth, nominal GDP is estimated to grow by 11.9% in FY17 which is higher than the budgeted growth of 11.04%. This indicates that inflation based on implicit price deflator is expected to be higher at 4.5% in FY17 as compared to just 1.1% in FY16.

Table 1: real GDP growth (%)

AD component	FY13	FY14	FY15	FY16	FY17
PFCE	5.3	6.8	6.2	7.4	6.5
GCE	0.5	0.4	12.8	2.2	23.8
GFCF	4.9	3.4	4.9	3.9	-0.2
EXP	6.7	7.8	1.7	-5.2	2.2
IMP	6.0	-8.2	0.8	-2.8	-3.8
GDP	5.6	6.6	7.2	7.6	7.1
Of which					
% contribution of Discrepancies	1.1	-1.2	0.1	2.4	0.2

Source: (Basic data) MOSPI

Table 2: sectoral real GVA growth (%)

Sector	FY13	FY14	FY15	FY16	FY17
Agr	1.5	4.2	-0.2	1.2	4.1
Ming.	-0.5	3.0	10.8	7.4	-1.8
Mfg.	6.0	5.6	5.5	9.3	7.4
Elec.	2.8	4.7	8.0	6.6	6.5
Cons.	0.6	4.6	4.4	3.9	2.9
Trans.	9.7	7.8	9.8	9.0	6.0
Fin.	9.5	10.1	10.6	10.3	9.0
Publ.	4.1	4.5	10.7	6.6	12.8
GVA	5.4	6.3	7.1	7.2	7.0

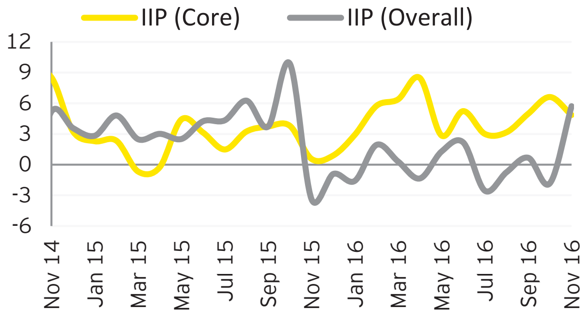
Source: (Basic data) MOSPI

- On the output side (Table 2), with the exception of agriculture and public services, there was an across-the-board reduction in the growth rates in FY17 as compared to FY16. Real growth in the overall GVA is likely to be lower at 7.0% in FY17 as compared to 7.2% in FY16.
- Growth in manufacturing, electricity and construction sectors is expected to moderate to 7.4%, 6.5% and 2.9% respectively while mining sector output is likely to contract by (-)1.8% during this fiscal.
- Among services, transport, trade, hotel, communication and other services is expected to grow at a slower pace of 6.0% in FY17 (9.0% in FY16) and growth in financial, real estate and professional services will moderate to 9.0% in FY17 (10.3% in FY16).
- Growth in agriculture and allied sector improved to 4.1% in FY17 (1.2% in FY16) while public administration and other services grew by 12.8% (6.6% in FY16).

B. Industrial growth: Sudden increase in IIP in November is entirely due to base effect

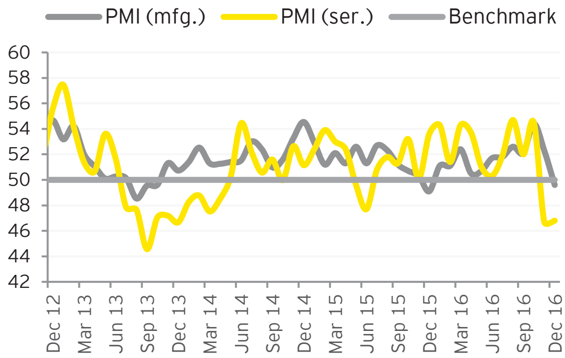
- Growth in IIP turned positive in November 2016 (Chart 1) as it recovered to 5.7% (y-o-y) from (-) 1.8% October 2016, driven by a favorable base effect. However, the month-on-month (m-o-m) growth numbers indicate that IIP contracted for two successive months in October ((-) 0.7%) and November ((-) 1.3%).
- On m-o-m basis, growth in the manufacturing sector contracted by a lower magnitude (-) 1.3% in November 2016 as compared to (-) 2.6% in October. Electricity sector, on the other hand, contracted by (-) 6.2% in November 2016 as compared to a growth of 1.7% in October 2016.
- As per use-based industrial classification, capital goods industry grew by 15.0% (y-o-y) in November 2016 reversing its contractionary trend since November 2015, partly owing to a favorable base effect. Consumer goods industry grew by 5.6% in November as compared to a decline of (-) 1.6% (y-o-y) in October 2016.
- Growth in the output of eight core infrastructure industries fell to 4.9% (y-o-y) in November 2016 from 6.6% in October 2016. The slowdown in core sector output was driven by lower growth in the output of steel (5.6%), petroleum refinery (2.0%), cement (0.5%) and a contraction in crude oil ((-) 5.4%) and natural gas output ((-1.7%), which together account for over 57% of the core sector output.

Chart 1: IIP and core IIP growth (% y-o-y)



Source: Office of the Economic Adviser, Ministry of Commerce and Industry

Chart 2: NIKKEI PMI



Source: NIKKEI PMI, Markit Economics

IIP growth turned positive in November 2016, owing to favorable base effect. Growth of industrial output grew by 5.7% in November 2016 as compared to a contraction of (-) 1.8% in October 2016.

C. PMI: post demonetization, PMI signals significant fall in outlook for services and manufacturing

In December, India's manufacturing sector registered a contraction for the first time in 2016. Shortages of money led to a decline in output and new orders, thereby interrupting a continuous sequence of growth that was seen throughout 2016. Similar but sharper contractionary trends were observed in the services sector.

- Headline manufacturing PMI (sa) fell below 50 for the first time in 2016, indicating contractionary trends. It from 52.3 in November to 49.6 in December (Chart 2). Sub-components like new orders and output registered a contraction during the month reflecting reduction in demand and job losses due to the cash crunch.
- Headline services PMI (sa) marginally changed from 46.7 in November to 46.8 in December 2016. The slowdown was broad-based as activity decreased in most sub-sectors with hotels and restaurants being the worst hit.
- Composite PMI Output Index (sa) further decreased from 49.1 in November to 47.6 in December 2016.

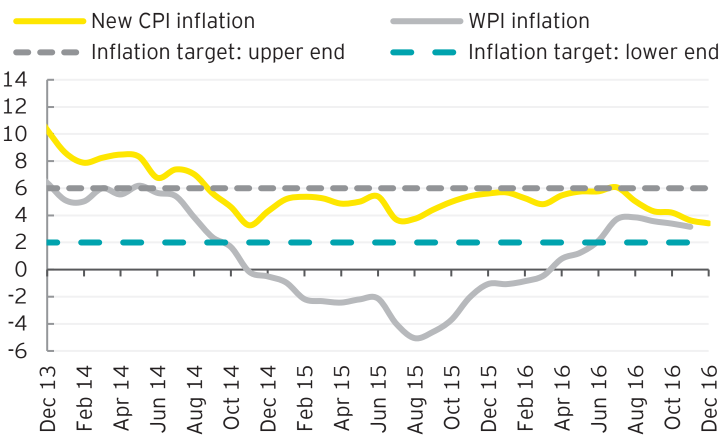
2 Inflation: declining food prices push CPI inflation to a 16-month low

Annual CPI inflation declined further to a 16-month low of 3.4% in December 2016 after reaching a 23-month high of 6.1% (y-o-y) in July 2016 due to a fall in food prices.

- CPI-based inflation (Chart 3) declined to 3.4% in December 2016 as compared to 3.6% in November 2016.
- Core CPI inflation (excluding food and fuel) however increased to 4.0% after remaining stagnant for four consecutive months at 3.5% (y-o-y).
- CPI-based consumer food inflation has been on a declining trend since July 2016 when it reached a 23-month peak of 8.4%. In December 2016 it declined to 1.4% from 2.1% in November 2016.
- Fuel and lighting inflation increased to a 10-month high of 3.8% as compared to 2.8% in the previous month.
- According to the RBI, the contraction in demand as a result of demonetization was partly responsible for the decline in prices of vegetables.

Core CPI inflation has increased to 4% in December 2016 from 3.5% in August 2016 despite a 160 basis point fall in headline inflation over the same period. Global crude prices could impart an upside bias to headline inflation in the near term though it is expected to remain below 5% till 4QFY17.

Chart 3: inflation (y-o-y; %)



Source: Ministry Of Statistics and Programme Implementation (MOSPI)

WPI inflation declined marginally to 3.2% in November 2016 from 3.4% (y-o-y) in October 2016 because of a decline in the prices of food and non-food primary articles.

- WPI inflation for primary articles fell sharply to a 5-month low of 1.2% in November 2016 from 3.3% in October 2016. WPI inflation in food and non-food articles substantially declined from their respective 2-year peaks of 12.6% and 9.5% in July 2016 to 1.5% and (-) 0.1%, respectively, in November 2016.
- WPI inflation for fuel and power increased to 7.1% in November 2016. Inflation in diesel prices remained constant at a 37-month high of 19.3% in November 2016.
- After contracting for 16 months, WPI core inflation remained positive and increased for the fifth successive month at 1.6% in November 2016 as compared to 1.0% in October 2016.
- Fuel and power inflation climbed to a 28-month high of 7.1% in November 2016 as compared to 6.2% in October 2016.
- WPI and CPI inflation rates converged further in November 2016.

3 Fiscal performance: cumulated fiscal deficit at 86% of annual budgeted target by November 2016

A. Tax and non-tax revenues

Center's gross tax revenues grew by 21.5% during April–November FY17, driven by robust growth in revenues from income tax, Union excise duties and service tax. The impact of demonetization on tax revenues appears to be limited in November 2016.

- The Center's revenue receipts during April–November FY17 were at 57.8% of the annual budgeted target as compared to 55.9% during the same period of FY16.
- Growth in cumulated gross tax revenues was higher at 21.5% during April–November FY17, compared to 20.8% during the corresponding period of FY16 (Chart 4). Direct taxes grew by 14.1% during April–November FY17 as compared to 9% during the same period of FY16. However, growth in indirect taxes was lower at 27.5% during this period as compared to the corresponding value of 33.4% in FY16.
- Income tax revenues grew by 20.9% during April–November FY17 (Chart5) as compared to 10.1% during the same period of FY16. This is attributed to the additional tax revenues from the first installment of 25% under IDS1 which was to be paid by 30 November 2016. Growth in corporation tax revenues was at 9 during April–November FY17 as compared to the corresponding value of 8.2% in FY16
- Among the indirect taxes, Union excise duties witnessed a robust growth of 46% during April–November FY17. Growth in service tax revenues was also higher at 27.1% during April–November FY17 as compared to the corresponding value of 24.4% in FY16.
- However, growth in customs duties remained subdued at 6.8% during April–November FY17 due to contraction in imports as compared to 15.7% during the same period in FY16.

Chart 4: growth in cumulated gross tax revenues up to November 2016

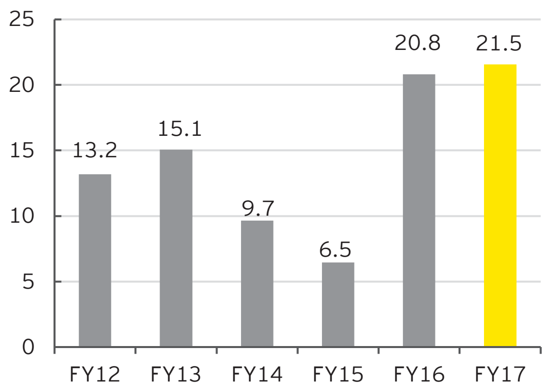
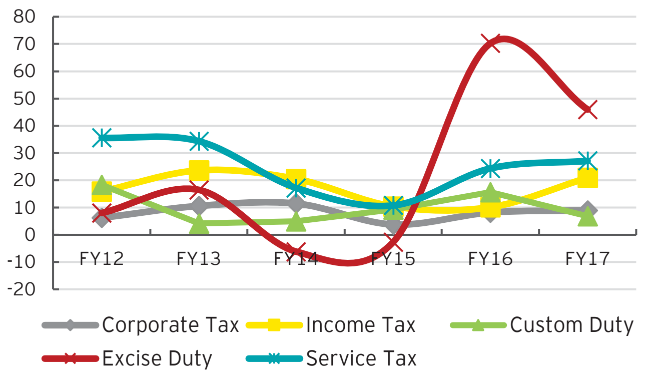


Chart 5: growth in cumulated tax revenues up to November 2016



Source: Monthly Accounts, Controller General of Accounts, Government of India

- States' share in central tax revenues was sharply reduced in November. As a result, its cumulated growth rate came down to 2.8% during April-November FY17 as against 8.9% during April-October FY17.
- Growth in non-tax revenues remained subdued at 1% during April–November FY17 as compared to 34.9% in the corresponding period of FY16. As a percentage of the annual budgeted target, non-tax revenues were at 54.2% during April–November FY17 as compared to 78.1% in FY16. Similarly, growth in non-debt capital receipts was also low during this period as compared to the corresponding period of FY16.

B. Expenditures: revenue and capital

- Total expenditure grew by 12.6% during April–November FY17 as compared to the corresponding value of 6.3% in FY16.
- Growth in revenue expenditure increased to 16.4% during April–November FY17 as compared to 3.2% during the same period in FY16 (Chart 6).
- Center's capital expenditure contracted by (-) 10.4% during April–November as compared to a growth of 30.8% in the corresponding period of FY16 (Chart 7).

Center's revenue expenditure grew by 16.4% during April–November FY17 while capital expenditure contracted sharply by (-) 10.4%.

Chart 6: growth in cumulated revenue expenditure up to November 2016

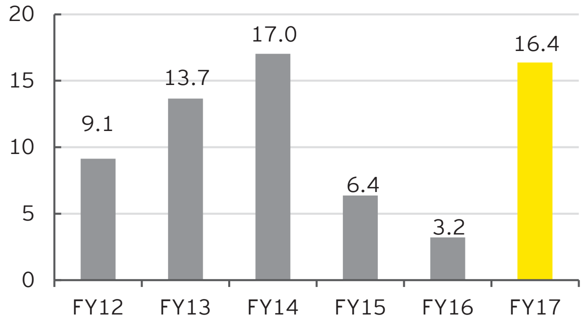
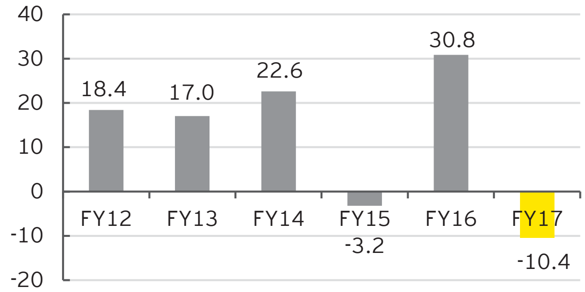


Chart 7: growth in cumulated capital expenditure up to November 2016



Source: Monthly Accounts, Controller General of Accounts, Government of India

C. Fiscal imbalance

- Center's fiscal deficit stood at 85.8% of the annual budgeted target during April–November FY17 as compared to 87% in the corresponding period of FY16. Some part of additional tax revenues from IDS1 and IDS2 which may come in the current fiscal year and a fiscal windfall (although, of a limited extent) due to extinguishment of high-denomination currency would help the government achieve the fiscal deficit target for FY17 (Chart 8).
- The Center's revenue deficit increased to 98.4% of the annual budgeted target during April–November FY17 as compared to 87.5% during the same period in FY16 (Chart 9).

If the fiscal deficit target of 3.5% of GDP is to be met, then, taking into account the borrowing already done by the Centre up to November 2016 and the committed revenue expenditures, the scope for providing the much-needed fiscal stimulus in the last quarter of FY17 through increased capital expenditure particularly in the aftermath of demonetization seems limited.

Chart 8: cumulated fiscal deficit up to Nov 2016 as a % of annual budgeted estimates for FY17

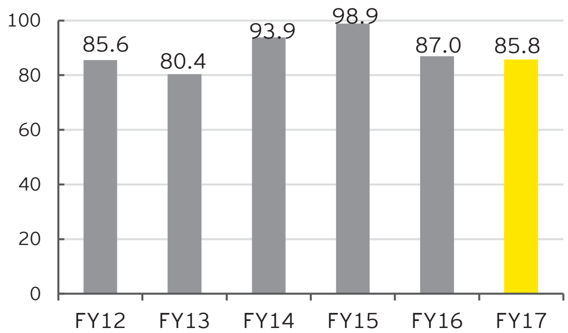
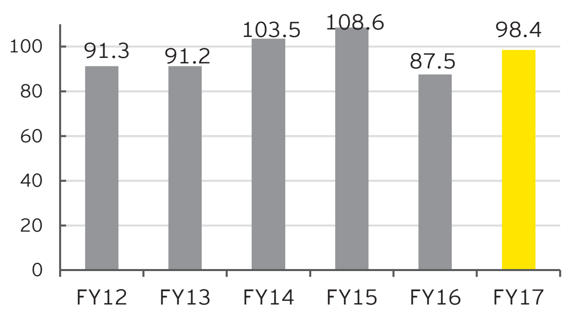


Chart 9: cumulated revenue deficit up to Nov 2016 as a % of annual budgeted estimates for FY17



Source: Monthly Accounts, Controller General of Accounts, Government of India

4 In focus: Budget FY18: case for substantive fiscal stimulus

Union government's budget for FY18 would be unique in three respects: (a) merger of railway budget with the general budget, (b) abolition of plan non-plan distinction, and (c) presentation of the budget nearly one month in advance as compared to its regular time. This would enable the government to launch its capital expenditure from the beginning of April 2017. In earlier years, it used to get delayed until the end of monsoon, that is, up to September.

Growth Prospects: Demonetization Dip and Beyond

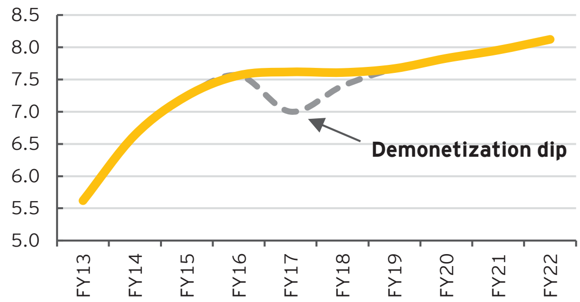
The CSO published the advance estimates of GDP on Jan. 6, 2017. The downward revision of the FY17 GDP growth to 7.1% from 7.6% in FY16, even without taking into account the adverse effects of demonetization, is not positive news. Due to demonetization, it would fall further. Quarterly GDP data shows that investment demand as measured by gross fixed capital formation had been contracting for three consecutive quarters. As shown by year-on-year growth rates of -1.9% in 4QFY16, -3.1% in 1QFY17 and -5.6% in 2QFY17, this contraction has increased in magnitude. Demonetization has accentuated these contractionary trends, leading to a fall in consumption demand in addition to the falling investment demand. Manufacturing and services PMI, respectively at 49.6 and 46.8, have slided way below the benchmark value of 50 in December 2016, indicating growing contraction (Table 3). On the output side, the sectors that are likely to suffer relatively more are construction, trade, hotels, transport, and storage etc. real estate, and to some extent, manufacturing and agriculture. The World Bank, ADB and the RBI have revised India's growth outlook downwards by 0.5%-0.6% points for FY17. Rating agencies have also revised their earlier GDP growth estimates downwards. We expect that the contractionary effects would last up to the 2QFY18. Taking these into account, there is a clearly identifiable dip in India's GDP growth prospects as shown in Chart 10 which indicates IMF's long term GDP growth forecasts for India prior to demonetization.

Table 3: Lead Indicators of Contractionary Effects

#	Indicator	Sep-16	Oct-16	Nov-16	Dec-16
1	Headline Manufacturing PMI	52.1	54.4	52.3	49.6
2	Headline Services PMI	52.0	54.5	46.7	46.8
3	Headline Composite Output Index (Adjusted)	52.4	55.4	49.1	47.6
Growth rates (month over previous month)					
4	Electricity Generation	3.0	1.7	-6.2	1.7
5	Motor Vehicle Sales (Volume)	11.0	-3.2	-25.8	-17.6

Source (Basic Data): NIKKEI PMI, Markit Economics, Central Electricity Authority and Society of Indian Automobile Manufacturers

Chart 10: India's real GDP growth (%)



Source: Based on IMF forecast, with estimates for FY17 and FY18

Growth in bank credit has also been slowing down since September 2016, when it was 12.1% on a y-o-y basis. In the fortnight ending 23rd December 2016, this had more than halved at 5.1%. This is in spite of the fact that the policy interest rate was reduced earlier in October 2016 (Table 4).

Table 4: Y-o-Y growth in bank deposits and credit

	Growth in Aggregate Deposits			Growth in Bank Credit		
	Total Deposits	Demand	Time	Total Credit	Food	Non-food
FY16	10.5	10.3	10.5	9.7	-0.3	9.9
Sep-16	13.3	29.9	11.7	12.1	-16.8	12.5
Oct-16	9.2	10.5	9.1	8.7	-0.2	8.8
Nov-16	15.9	30.3	14.5	6.6	-15.7	7.0
23-Dec-16 (P)	15.2	28.1	13.8	5.1	-5.4	5.3

Source (Basic Data): RBI, P: Provisional

Growth in exports was near zero in 2Q of FY17, after remaining negative in all the quarters of the previous year. With the US President-elect Trump, policy orientation towards building strong tariff barriers and inward-looking policies of a number of developed countries, India will have to rely progressively more on domestic demand in the medium term.

Stimulating Domestic Demand

In order to resume the pre-demonetization longer term growth path (Chart 10), strong policy stimuli are needed. Fiscal stimulus can come from a number of feasible channels. First, the government can access a one-time fiscal windfall through the extinguishment of a part of the demonetized money and additional tax revenues resulting from the surge in bank deposits which may partly be due to unaccounted money. The extent of this gain could be as much as 0.75% of GDP. Except for a small increase in tax revenue in FY17, most of this potential gain can be accessed only in FY18. Second, the government can relax the FRBM norms and define the relevant targets in cyclically adjusted terms rather than rigid annual norms. An FRBM Review Committee is already deliberating on this matter. Given that the GDP growth has fallen well below potential growth, there is a strong case for borrowing tangibly above the target of 3% of GDP for FY18 as per the existing fiscal consolidation path. We consider that there is room for incurring additional fiscal deficit of 1% of GDP divided equally between central and state governments. In addition, departmental enterprises such as posts and railways and non-departmental public enterprises can also initiate their expansion plans financed by off-budget borrowing. Taken together, these channels provide a scope for additional fiscal stimulus to the extent of 2.5% of GDP. Finally, the fiscal stimulus can be supplemented by monetary stimulus through reduction in interest rates.

Tax Reforms and the Tax-GDP Ratio

For stimuli directed towards specific sectors such as construction and housing, both tax and expenditure side concessions might be introduced in the budget. Further, reforms in both personal and corporate sectors can be considered. In the latter case, the government has already promised to bring down the CIT rate to 25% in four years' time. This might be the right time to take a tangible step in this direction while also abolishing a number of tax deductions and concessions.

Over the longer run, the combined effect of demonetization-linked digitization and GST can potentially lead to a significant increase in the tax-GDP ratio. The GST rate structure is being designed in a way such that state governments are ensured of a minimum growth of 14% on their taxes subsumed in GST considering 2015-16 as the base year. There is a fear that a large number of states may have to be compensated if nominal GDP growth is inadequate or the GST buoyancy required for revenue neutrality turns out to be much higher than the buoyancy achieved in the compensation years. This would imply a revenue-augmenting GST rate structure. This, along with improved compliance would lead to an increase in the tax-GDP ratio. In the long term, India's tax-GDP ratio could increase as economic activities shift from unorganized to organized sectors. At a buoyancy of 1.3 applied to both central and state taxes, the tax-GDP ratio can be uplifted by 2% points of GDP by FY21 (Table 5).

Table 5: Tax-GDP ratio (Centre and states): Potential increase under alternative buoyancy assumptions

	Scenario 1	Scenario 2	Scenario 3	Assumed nominal GDP growth
Buoyancy	1.2	1.3	1.4	
2016-17	16.3*	16.3	16.3	10.0
2017-18	16.6	16.7	16.9	10.0
2018-19	16.9	17.2	17.5	11.0
2019-20	17.2	17.7	18.2	11.0
2020-21	17.6	18.3	19.0	11.0
Cumulated increase in tax GDP ratio over FY17 to FY21 (% points)	1.3	2.0	2.7	

Source (Basic data): CAG, CGA and EY estimates (factoring the expected contractionary effect of demonetization on combined tax revenues in 2016-17), *Note: combined tax-GDP ratio for FY16 was 16.6%

Expenditure Side Reforms

Significant efficiency gains can also result from expenditure side reforms. With the abolition of plan non-plan distinction and the merger of a large part of plan grants in the regular fiscal transfers under the recommendations of the Fourteenth Finance Commission, there is clearly a major opportunity for the central government to scale down some of the ministries that have been dealing with state subjects and administration of plan grants. In fact, this effect showed in the negative growth of plan revenue expenditure in FY16 (Table 6). But the ministries seem to have reclaimed their fiscal space in the FY17 budget with a growth of 28% in plan revenue expenditure which is mainly at the cost of capital expenditures which have been reduced.

Table 6: Growth in Central government expenditure

Sno.	Expenditure Head	FY15 over FY14	FY16 over FY15	Estimated FY17* over FY16
1	Plan revenue expenditure	1.4	-8.5	28.0
2	Non-plan revenue expenditure	7.5	10.1	7.2
3=1+2	Total revenue expenditure	6.0	5.5	11.6
4	Plan capital expenditure	-4.4	49.7	-11.4
5	Non-plan capital expenditure	4.0	0.5	-5.8
6=4+5	Total capital expenditure	-0.5	25.8	-9.2
7=3+6	**Total expenditure**	5.2	7.8	8.8

Source (Basic Data): CGA, *based on extrapolating data for April-November FY17

In the longer term, reducing revenue expenditure, after the one-time effects of pay revisions in FY17 have been normalized, can open up further space for augmenting central capital expenditure. Together, these initiatives can provide the means to uplift India's growth to its long-term potential growth of 8% and above.

5 Money and finance: post demonetization, bank credit growth fell to 6.6% in November 2016 with food credit contracting sharply by 15.7%

A. Monetary sector

i. Monetary policy

- With heightened uncertainty, both in global and domestic economic conditions, RBI had left the repo rate unchanged in its Monetary Policy review meeting held on December 7th 2016 (Chart 11). Although CPI inflation has trended downwards during the last two months, significant slowdown in the growth momentum led by subdued demand conditions is a major concern for policy makers.

Chart 11: movements in repo rate

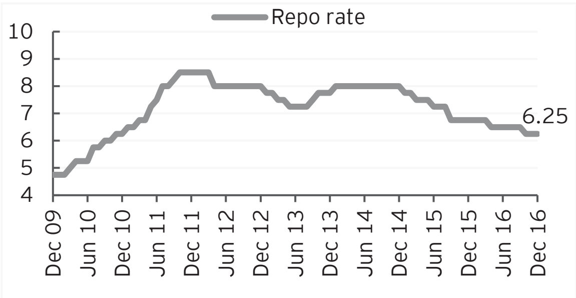
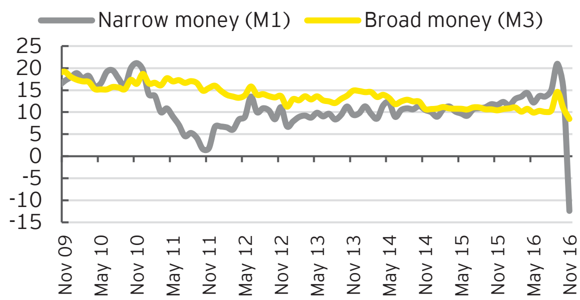


Chart 12: growth in narrow and broad money



Source: Data Base on Indian Economy, RBI

RBI adopted a 'wait and watch' approach by maintaining its policy rate unchanged in its December 2016 policy review meet. By doing so, the RBI has shifted the onus on to the central government to take the initiative in stimulating domestic economic activity. Investment demand continues to remain subdued and RBI's earlier efforts have not yielded any noticeable improvement.

ii. Money stock

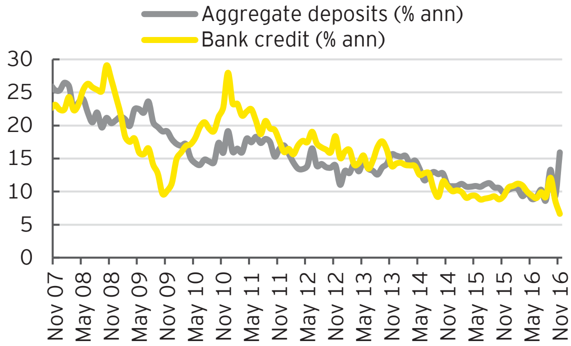
- Growth in broad money (M_3) plummeted to its lowest level of 8.5% (y-o-y) in November 2016 from 10.9% in October 2016 (Table A4). Growth in time deposits, accounting for over 76% of broad money stock, increased to a 31 month peak of 14.2% in November 2016 from 9.7% in October 2016.
- Growth in narrow money (M_1) fell to a historically low level as it contracted by (-) 12.4% in November 2016 as compared to a growth of 15.2% in October 2016 (Chart 12). With demonetization of high denominated currency, which accounted for over 86% of the total value of currency in circulation, growth of currency in circulation declined by (-) 23.6% during the month. A slow and constrained re-monetization process has aggravated the situation further.

iii. Aggregate credit and deposits

- Growth in bank credit fell to a historic low of 6.6% (y-o-y) in November 2016 as compared to 8.7% growth in October 2016 (Chart 13). Growth in non-food credit fell to 7.0% in November (from 8.8% in October 2016), while food credit sharply contracted to (-) 15.7% during the month.
- Banks continue to struggle with mounting NPAs which increased to 9.1% of total advances by the end of 2QFY17 from 7.6% in 4QFY16. Worsening asset quality of large borrowers, whose share in total NPAs is close to 85%, has increased the risks to banks.
- Growth in retail credit fell in November as demonetization took its toll on retail demand. In particular, personal loans felt to 15.2% in November from 17.0% in October. Loans to both consumer durables and housing slowed during the month. Credit to industries contracted for the second straight month by (-) 3.4% in November 2016 (Chart 14). Industrial credit growth remains subdued due to elevated levels of stressed assets among large industries.

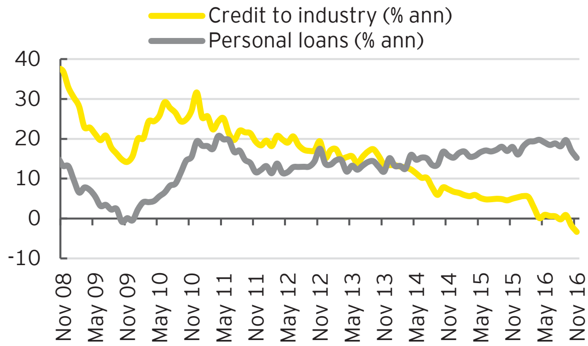
- Demonetization has led to a significant surge in bank deposits in November 2016. Aggregate bank deposits grew by 15.9% in November 2016, its fastest pace since July 2012.

Chart 13: growth in credit and deposits



Source: Data Base on Indian Economy, RBI

Chart 14: growth in industrial and personal loans



Source: Data Base on Indian Economy, RBI

B. Financial sector

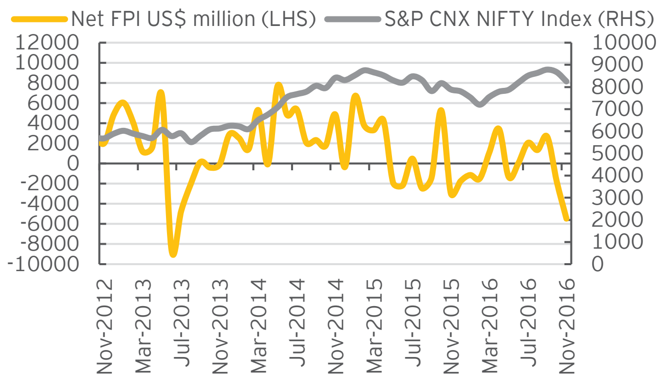
i. Interest rates

- The MCLR was lowered further to 8.65% in November from 8.80% in October 2016 and this has lowered the borrowing costs especially for the home loan segment.
- Banks lowered the interest rates on term deposits (>1 year) from 7.1% in October 2016 to 6.88% (mid-point) in November 2016.
- The average yield on 10-year Government bonds fell further to 6.61% in November 2016 from 6.78% in October 2016. Bond yields were influenced by additional liquidity in the banking system due to withdrawal of high denominated currency and lower inflation rate.

ii. FPI and stock market

- The benchmark S&P NIFTY index fell to 8251 points in November 2016 (average) losing nearly 416 points as compared to the average index value of 8667 in October 2016 (Chart 15). The after effects of a sudden demonetization and announcement of the US election results were identified as the key factors responsible for a decline in stock prices.
- As per the provisional data, overall FIIs turned negative for the first time in the last 11 months registering a net outflow of US$3.4 billion in November 2016 as compared to net inflows of US$0.6 billion in October 2016. Net FPI outflows increased to US$5.5 billion in November 2016, the highest since July 2013, as compared to an outflow of US$1.8 billion in October 2016. Net FDI inflows slowed to US$2.0 billion as compared to US$2.4 billion in October 2016. Large FPI outflows have also dented the stock market performance during November 2016.

Chart 15: Stock market movement



6 External sector: current account balance deteriorated from 0.1% to 0.6% of GDP

A. Current account balance

The CAB as percentage of GDP deteriorated to (-) 0.6% in 2QFY17 (Table 7, Chart 17) from (-) 0.1% in the previous quarter. Merchandise trade balance worsened to (-) US$25.6 billion in 2QFY17 from a seven-year low of (-) US$23.8 billion in 1QFY17. Based on data for October and November 2016, showing an increasing trade deficit, it is expected that the current account balance may deteriorate further in 3QFY17.

Table 7: current account balance (US$ billion)

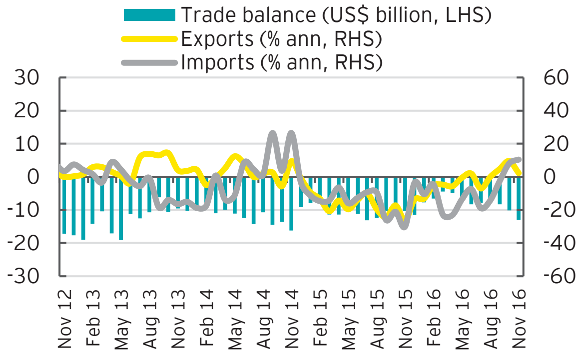
	CAB (- deficit/+surplus) (US$ billion)	CAB as a % of nominal GDP	Goods account net (US$ billion)	Services account net (US$ billion)	Income account net (US$ billion)	Transfers net (US$ billion)
FY13	-88.2	-4.8	-195.7	64.9	-21.5	64.0
FY14	-32.4	-1.7	-147.6	73.0	-23.0	65.3
FY15	-26.8	-1.3	-144.9	76.6	-24.1	65.7
FY16	-22.0	-1.1	-130.1	53.7	-17.8	47.7
3QFY16	-7.1	-1.3	-34.0	18.0	-6.4	15.3
4QFY16	-0.3	-0.1	-24.8	16.1	-6.6	15.1
1QFY17	-0.3	-0.1	-23.8	15.8	-6.2	14.2
2QFY17	-3.4	-0.6	-25.6	16.3	-7.9	14.0

Source: Database on Indian Economy, RBI

B. Merchandise trade and exchange rate

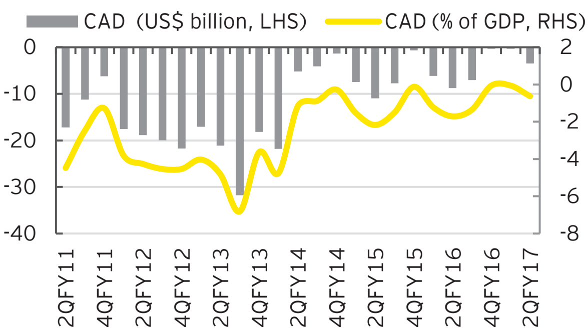
- Growth in merchandise exports significantly declined to 2.3% in November 2016 after reaching a 29-month high of 9.6% in October 2016. (Chart 16).
- A sharp decline of (-) 12.8% was observed in the exports of gems and jewelry in November 2016 as compared to 21.8% in October 2016. This largely reflects the effect of demonetization as this is a cash-intensive sector.
- After reaching a 28 month peak of 7.2% in October, growth in oil exports eased to 3.4% in November 2016.
- Growth in overall imports increased to 10.4% in November 2016 from 8.1% in October, when it turned positive for the first time after 22 successive months of contraction. Growth in oil imports reached a 26-month peak of 5.9% in November 2016 as compared to 4.0% in the previous month.
- India's merchandise trade deficit increased further to US$13.0 billion in November 2016 as compared to US$10.2 billion in October 2016.
- The Indian rupee weakened to INR67.6 per US dollar in November 2016 from INR66.7 per US dollar in October 2016 as a result of lower demand for the rupee in the aftermath of demonetization.

Chart 16: developments in merchandise trade



Source: Ministry of Commerce and Industry

Chart 17: CAD



Source: Data Base on Indian Economy, *RBI*

7 Global economy: Fed raised the policy rate in December 2016

A. Global growth outlook

- OPEC, in its December issue of the Oil Market Report, projected global GDP growth at 2.9% in 2016 and 3.1% in 2017 (Chart 18).

- In the US, growth picked up to 3.2% in the 3Q of 2016 driven by improvement in government consumption and private investment. The US Fed, in its December Policy Meet increased the target range of the policy rate by 25 basis points to 0.5%- 0.75% on account of employment gains and improved inflation outlook. ADB has projected the US GDP growth at 1.6% in 2016 and 2.4% in 2017.

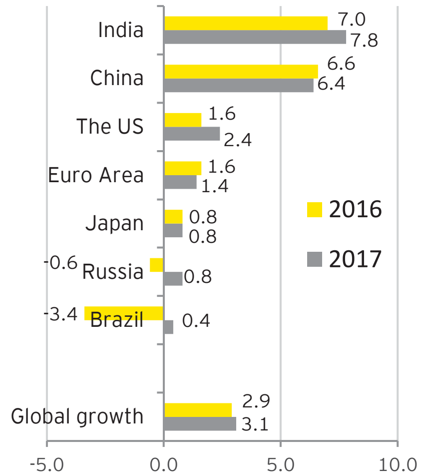
According to OPEC, global growth is projected at 2.9% in 2016 and 3.1% in 2017. Major industrial economies (the US, the Euro area and Japan) witnessed a better-than expected growth in the 3Q of 2016.

- In the Euro area, growth in 3Q of 2016 increased to 1.4% as compared to 1.2% in 2Q. ADB projected the region to grow by 1.6% in 2016 and then fall to 1.4% in 2017 in expectation of highly complex and potentially disruptive negotiations in the aftermath of Brexit. Further, political instability and banking sector vulnerabilities in Italy is another source of uncertainty for the Euro area.

- In Japan, GDP growth is projected at 0.8% in both 2016 and 2017. Global uncertainty over trade and other policies following the US elections might have implications for the external sector. Subdued domestic demand is an additional challenge for the country. Despite monetary easing, core inflation declined to a 3-year low towards the end of 3Q of 2016.

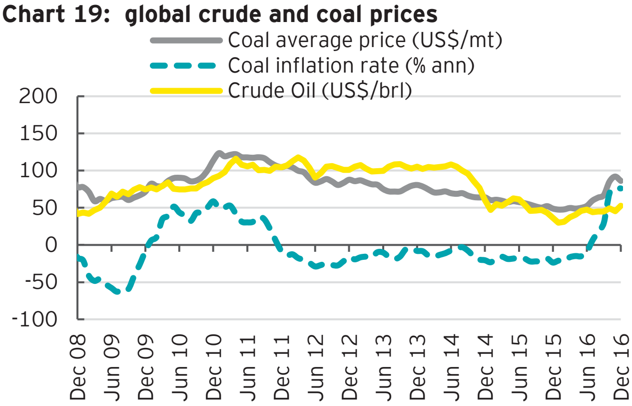
- Growth in China is projected at 6.6% in 2016. Despite continued monetary and fiscal support, growth is expected to moderate to 6.4% in 2017. With crude and other commodity prices recovering, Russia and Brazil are forecasted to move out of recession in 2017 and grow by 0.8% and 0.4% respectively.

Chart 18: Global Growth Projections



Source: Asian Development Outlook Supplement, December 2016 and OPEC Oil Market Report (December 2016)

Chart 19: global crude and coal prices



Souce: World Bank, Pinksheet

B. Global energy prices

- The global crude prices surged from US$45.3/bbl in November 2016 to US$52.6/bbl in December (Chart 19). This is attributed to the OPEC agreement to restrict output to 32.5 mb/d, effective from 1st January 2017. Additional supply cuts have also been announced by major non-OPEC producers including Russia. On a quarterly basis, global crude oil prices were higher at US$49.1/bbl in 3QFY17 as compared to US$42.2 in 3QFY16.

- After increasing for 7 consecutive months, average global coal prices declined from US$92/mt in November 2016 to US$86.2/mt in December. On a quarterly basis, average global coal prices were significantly higher at US$87.8/mt in 3QFY17 as compared to US$50.5/mt in 3QFY16.

8 Index of Macro Imbalance: macro balance marginally improved in 2QFY17

India's macro imbalance reduced in the 2Q FY17 as two components of the index namely, Centre's fiscal deficit and current account deficit were lower than their respective benchmarks.

- This "Index of Macro Imbalance (IMI)" is obtained by adding the percentage deviation of inflation rate (based on New CPI 2011-12=100), current account deficit (as percentage of GDP) and fiscal deficit (as percentage of GDP) from their respective benchmarks of 4%, 3% of GDP and 1.3% of GDP[1]. All three components of IMI have been given equal weight (33.33%).
- The state of 'balance' is judged by a value of '0'. An index value >0 indicates the presence of imbalance in the economy. In considering the percentage deviation of each of the indicators from its selected norm, only the positive deviations are taken. Negative deviations are equated to zero to ensure that negative and positive deviations across indices are not cancelled out.
- The data for New CPI is available from 4Q FY11. The IMI has been constructed from 4QFY12. IMI has broadly remained high from 4QFY12 to 2QFY15. It reached a peak of 156.3 during 1QFY14 as the percentage deviation of all the three components was significantly high. Since 2QFY14, the current account deficit has not contributed to the imbalance as the CAD relative to GDP has stayed below the benchmark level. The seasonality of the index, especially during the first quarter of each year, is largely on account of seasonality in the Centre's fiscal deficit. Given this seasonality, it is relevant to consider changes on a quarterly basis, year-on-year.
- Comparing quarterly, y-o-y change in the index of macro imbalance, there is a mild improvement in 2QFY17 as compared to 2QFY16 largely on account of Centre's fiscal deficit and CAD which remained below their respective benchmarks (Chart 20). In 2QFY17, the fiscal deficit sharply narrowed to 2.2% of GDP and current account deficit stood at 0.6% of GDP. However, CPI inflation rate at 5.2% continued to remain above its benchmark (Chart 21)

Chart 20: Index of Macro Imbalance (Quarterly)

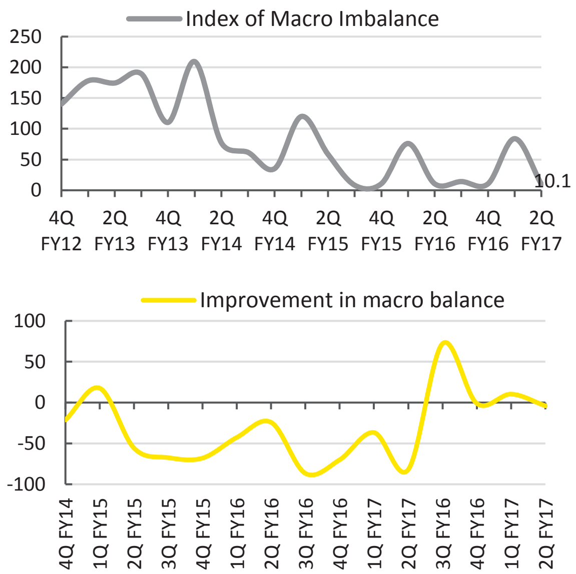
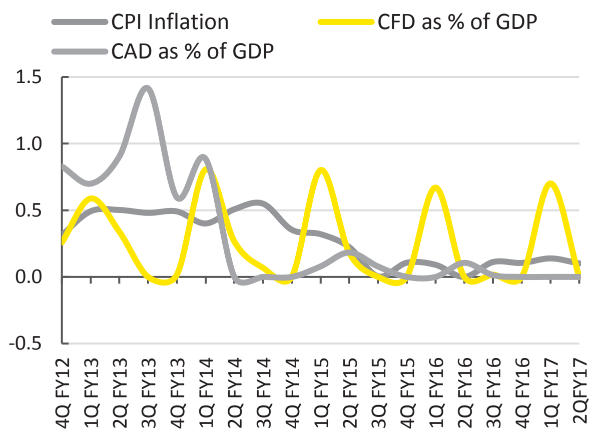


Chart 21: Components of IMI



Source (Basic data): RBI, MOSPI and EY estimates

[1] Rangarajan, C (2016): "Can India grow at 8 to 9 per cent?", The Hindu, Opinion, May 17, 2016. Website http://www.thehindu.com/opinion/lead/can-india-grow-at-8-to-9-per-cent/article8596824.ece Accessed on May, 17, 2016.

9 Appendix: capturing macro-fiscal trends

Table A1: industrial growth indicators (annual, quarterly and monthly growth rates, y-o-y)

Fiscal year/quarter/month	IIP	Mining	Manufacturing	Electricity	Core sector IIP	Fiscal year/quarter/month	PMI mfg.	PMI ser.
	% change y-o-y							
FY13	1.1	-2.3	1.3	4.0	6.5	FY13	53.7	54.3
FY14	-0.1	-0.6	-0.8	6.1	4.2	FY14	50.5	48.5
FY15	2.8	1.5	2.3	8.4	4.5	FY15	52.2	51.7
FY16	2.4	2.2	2.0	5.7	3.0	FY16	51.3	51.7
3Q FY16	1.7	3.2	1.1	4.4	1.7	4QFY16	51.5	53.3
4Q FY16	0.2	2.2	-1.1	9.3	5.0	1QFY17	51.0	51.7
1Q FY17	0.7	2.5	-0.6	9.0	5.4	2QFY17	52.2	52.9
2Q FY17	-0.8	-2.7	-0.9	1.4	3.7	3QFY17	52.1	49.3
Aug-16	-0.7	-5.9	-0.3	0.1	3.2	Sep-16	52.1	52.0
Sep-16	0.7	-3.2	0.9	2.4	5.0	Oct-16	54.4	54.5
Oct-16	-1.8	-0.7	-2.4	1.1	6.6	Nov-16	52.3	46.7
Nov-16	5.7	3.9	5.5	8.9	4.9	Dec-16	49.6	46.8

Source: Office of the Economic Adviser- Ministry of Commerce and Industry and NIKKEI PMI-Markit Economics

Table A2: inflation indicators (annual, quarterly and monthly growth rates, y-o-y)

Fiscal year/quarter/month	CPI	Food & beverage	Fuel & lighting	WPI	Food articles	Mfg. products	Fuel & power
	% change y-o-y			% change y-o-y			
FY13	9.9	11.2	9.7	7.4	9.9	5.4	10.3
FY14	9.4	11.9	7.7	6.0	12.8	3.0	10.2
FY15	5.9	6.5	4.2	2.0	6.1	2.4	-0.9
FY16	4.9	5.1	5.3	-2.5	3.3	-1.1	-11.6
4QFY16	5.3	5.8	4.4	-0.8	4.8	-0.5	-8.4
1QFY17	5.7	7.0	2.9	1.1	6.9	1.0	-4.9
2QFY17	5.1	6.0	2.8	3.7	8.8	2.3	2.0
3QFY17	3.7	2.8	3.1				
Sep-16	4.3	4.1	3.1	3.6	5.7	2.5	5.6
Oct-16	4.2	3.7	2.8	3.4	4.3	2.7	6.2
Nov-16	3.6	2.6	2.8	3.2	1.5	3.2	7.1
Dec-16	3.4	2.4	3.8				

Source: Office of the Economic Adviser, Ministry of Commerce and Industry and MOSPI

Table A3: fiscal indicators (annual growth rates, cumulated monthly growth rates, y-o-y)

Fiscal year/month	Gross tax revenue	Corporate tax	Income tax	Custom duty	Excise duty	Service tax	Fiscal deficit	Revenue deficit
	% change y-o-y						% of GDP	% of GDP
FY14	9.9	10.8	20.5	4.1	-3.6	16.7	4.4	2.0
FY15	9.3	8.7	6.4	9.3	11.1	8.5	4.0	2.9
FY16 (RE)	17.2	5.6	12.5	11.4	49.6	25.0	3.9	2.8
FY17 (BE)	11.7	9.0	18.1	9.8	12.2	10.0	3.5	2.5
	Cumulated growth (% y-o-y)						% of budget target	
Apr-16	54.2	34.8	55.1	22.2	85.1	13.3	25.7	33.6
May-16	38.3	-165.4	42.8	22.5	94.6	30.1	42.9	56.2
Jun-16	30.6	3.9	53.4	17.8	60.5	28.5	61.1	79.7
Jul-16	26.7	1.1	48.2	8.7	55.6	26.1	73.7	93.1
Aug-16	21.9	-1.4	31.9	6.5	50.8	24.4	76.4	91.8
Sep-16	16.6	2.3	17.8	5.3	47.9	22.8	83.9	92.1
Oct-16	18.0	4.5	19.3	4.9	46.4	24.5	79.3	92.6
Nov-16	21.5	9.0	20.9	6.8	46.0	27.1	85.8	98.4

Source: Monthly Accounts, Controller General of Accounts-Government of India, Union Budget Documents

Table A4: monetary and financial indicators (annual, quarterly and monthly growth rates, y-o-y)

Fiscal year/month	Repo rate (end of period)	Fiscal year/quarter/month	M1	M3	Bank credit	Agg. deposits	10 yr. Govt. B Yield	Net FDI	Net FPI	FX reserves
	%		% change y-o-y				%	US$ billion	US$ billion	US$ billion
FY13	7.50	FY13	9.2	13.6	16.6	13.7	8.2	19.8	26.9	292.0
FY14	8.00	FY14	8.5	13.4	14.9	14.2	8.4	21.6	4.8	304.2
FY15	7.50	FY15	11.3	10.9	11.0	12.1	8.3	31.3	42.2	341.6
FY16	6.75	FY16	13.5	10.1	9.7	10.5	7.7	36.0	-4.1	355.6
May-16	6.50	3Q FY16	12.3	10.7	9.6	10.2	7.7	10.7	0.6	352.0
Jun-16	6.50	4Q FY16	13.5	10.1	11.0	10.1	7.6	8.8	-1.5	355.6
Jul-16	6.50	1Q FY17	13.7	10.3	9.5	9.3	7.5	4.1	2.1	360.8
Aug-16	6.50	2Q FY17	21.0	14.6	10.4	10.7	7.0	12.7	6.5	372.0
Sep-16	6.50	Aug-16	15.1	10.4	9.2	8.7	6.9	6.0	1.3	366.8
Oct-16	6.25	Sep-16	21.0	14.6	12.1	13.3	6.9	6.3	2.7	372.0
Nov-16	6.25	Oct-16	15.2	10.9	8.7	9.2	6.8	2.4	-1.8	367.2
Dec-16	6.25	Nov-16	-12.4	8.5	6.6	15.9	6.6	2.0	-5.5	365.3

Source: Database on Indian Economy-RBI

Table A5: external trade and global growth

	External trade indicators (annual, quarterly and monthly growth rates)							Global growth (annual)		
Fiscal year/quarter/month	Exports	Imports	Trade balance	Ex. rate (avg.)	Crude prices (avg.)	Coal prices (avg.)	Calendar year	World GDP	Adv. econ.	Emer. econ.
	% change y-o-y		US$ billion	INR/US$	US$/brl	US$/mt		% change y-o-y		
FY13	-1.8	0.3	-190.3	54.5	103.2	86.6	2008	3.0	0.1	5.8
FY14	4.7	-8.3	-135.8	60.9	103.7	76.1	2009	-0.1	-3.4	2.9
FY15	-1.3	-0.5	-137.7	61.2	83.2	65.9	2010	5.4	3.1	7.5
FY16	-15.8	-15.4	-117.7	65.5	46.0	52.7	2011	4.2	1.7	6.3
3QFY16	-19.2	-19.4	-31.3	65.9	42.2	50.5	2012	3.5	1.2	5.3
4QFY16	-8.5	-13.2	-19.2	65.9	32.7	48.4	2013	3.3	1.2	5.0
1QFY17	-2.1	-14.5	-19.2	66.9	44.8	50.4	2014	3.4	1.9	4.6
2QFY17	-0.9	-12.1	-23.8	67.2	44.7	63.5	2015	3.2	2.1	4.0
Aug-16	0.0	-14.2	-7.6	66.9	44.9	63.7	2016*	3.1	1.6	4.2
Sep-16	4.8	-2.5	-8.3	66.7	45.0	67.1	2017*	3.4	1.8	4.6
Oct-16	9.6	8.1	-10.2	66.7	49.3	85.2	2018*	3.6	1.8	4.8
Nov-16	2.3	10.4	-13.0	67.6	45.3	92.0	2019*	3.7	1.8	5.0

Source: Database on Indian Economy- RBI and World Economic Outlook Update July 2016, Pink Sheet-World Bank; * Indicates forecasted data (IMF-WEO October 2016)

Table A6: macroeconomic aggregates (annual and quarterly growth rates, % change y-o-y)

	Expenditure components						Output: aggregate and selected sectors			
Fiscal year/quarter	GDP (Real)	PCE	GCE	GFCF	EX	IM	GVA	Agri.	Ind.	Serv.
FY14	6.6	6.8	0.4	3.4	7.8	-8.2	6.3	4.2	5.0	7.8
FY15 (RE)	7.2	6.2	12.8	4.9	1.7	0.8	7.1	-0.2	5.9	10.3
FY16 (PE)	7.6	7.4	2.2	3.9	-5.2	-2.8	7.2	1.2	7.4	8.9
FY17 (AE)	7.1	6.5	23.8	-0.2	2.2	-3.8	7.0	4.1	5.2	8.8
2QFY15	8.3	9.2	15.4	2.2	1.1	4.6	8.1	2.8	5.9	10.7
3QFY15	6.6	1.5	33.2	3.7	2.0	5.7	6.7	-2.4	3.8	12.9
4QFY15	6.7	6.6	-3.3	5.4	-6.3	-6.1	6.2	-1.7	5.7	9.3
1QFY16	7.5	6.9	-0.2	7.1	-5.7	-2.4	7.2	2.5	6.7	8.8
2QFY16	7.6	6.3	3.3	9.7	-4.3	-0.6	7.3	2.0	6.3	9.0
3QFY16	7.2	8.2	3.0	1.2	-8.9	-6.4	6.9	-1.0	8.6	9.1
4QFY16	7.9	8.3	2.9	-1.9	-1.9	-1.6	7.4	2.3	7.9	8.7
1QFY17	7.1	6.7	18.8	-3.1	3.2	-5.8	7.3	1.8	6.0	9.6
2QFY17	7.3	7.6	15.2	-5.6	0.3	-9.0	7.1	3.3	5.2	8.9

Source: National Accounts Statistics, MOSPI

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