

# Economy Watch

Monitoring India's  
macro-fiscal performance

December 2017

The EY logo is positioned in the bottom right corner of the page. It consists of the letters 'EY' in a bold, white, sans-serif font. A yellow triangle is integrated into the bottom right corner of the 'Y'.

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# Highlights

1. Reversing its falling trend, **real GDP and real GVA growth improved to 6.3% and 6.1% respectively in 2QFY18.**
2. **Overall IIP growth moderated to 2.2%, while core sector growth remained flat at 4.7% in October 2017.**
3. **Headline services PMI dipped to 48.5 in November from 51.7 in October 2017 partly attributable to subdued demand as growth has been falling and partly due to GST-related transitional issues.**
4. **CPI inflation reached a 15-month high of 4.9% in November from 3.6% in October 2017 primarily due to rising vegetable prices.**
5. **Capital expenditure up to October 2017 stood at 52.5% of the FY18 budgeted target, compared to the three-year average of 54.2% achieved up to October as a percentage of the annual actuals.**
6. **The Center's fiscal deficit during April–October FY18 stood at an all-time high of 96.1% of the annual budgeted target, while the revenue deficit during this period was at 124.7% of the corresponding annual budgeted target, both showing a deterioration from the previous month.**
7. **Due to heightened risks to CPI inflation and increased inflation expectations, the RBI retained its policy repo rate at 6.0% during its fifth bi-monthly monetary policy review held on 6 December 2017.**
8. **Growth in credit by scheduled commercial banks rose to a seven-month high of 7.1% (y-o-y) in October as compared to 6.5% in September 2017.**
9. **Growth in exports reached a six-year high of 30.5% partly due to favorable base effect.**
10. **With all the three components of the Index of Macro Imbalance (IMI) – namely, CPI inflation, the Center's fiscal deficit and current account deficit – remaining close to their respective benchmarks, the economy moved to a near full macro balance for the second time since 4QFY12.**



# Foreword

## A spate of positive news for the Indian economy

A series of positive economic news in recent times has uplifted the mood of the policymakers. After falling for five successive quarters from 9% in 4QFY16 to a low of 5.7% in 1QFY18, GDP growth at 6.3% in 2QFY18 reversed trend. There are clear signs that growth numbers might progressively climb up from now on with the effects of demonetization and the transition hiccups of the Goods and Services Tax (GST) firmly behind us. Within GDP growth numbers, a highly encouraging sign is that while export growth has remained positive, import growth has fallen, enabling a reduction in the negative contribution of “net exports” to GDP growth in 2QFY18.

Preceding the release of quarterly growth numbers, Moody's, on 16 November 2017, upgraded the Government of India's local and foreign currency issuer ratings to Baa2 from Baa3 and changed the outlook on the rating to stable from positive. Moody's also upgraded India's local currency senior unsecured rating to Baa2 from Baa3, short-term local currency rating to P-2 from P-3, long-term foreign-currency bond ceiling to Baa1 from Baa2 and long-term foreign-currency bank deposit ceiling to Baa2 from Baa3.

In doing so, Moody's expressed its belief in India's continued progress on economic and institutional reforms, India's high growth potential and its large and stable base for financing government debt. Among the key reforms that Moody's cited were the recently introduced GST, improvements to the monetary policy framework, measures to address the overhang of non-performing loans (NPLs) in the banking system and targeted delivery of benefits through the Direct Benefit Transfer (DBT) system.

Given the improved growth prospects combined with expectations of CPI inflation firming up in the latter part of the financial year, the RBI, on the recommendation of the Monetary Policy Committee, abstained from reducing the policy rate in its meeting held on 6 December 2017. This has put the burden of stimulating growth back on the fiscal policy. But the Central Government's fiscal deficit had already reached 96% of the annual budgeted target by November 2017, constraining the Government's ability to fiscally support growth. In fact, there is a degree of uncertainty regarding GST's revenue prospects and overall indirect tax revenues. If the Government adheres to the fiscal deficit target of 3.2% of GDP or if a slippage becomes inevitable and the Government decides to keep it to a low margin, some curtailment of government expenditure, particularly capital expenditure, may be called for.

In the meanwhile, the 15th Finance Commission (FC) has been constituted. Its terms of reference (ToR) bring out some refreshing changes. In many respects, the ToR of this Commission have moved away from the more conventional ToRs of the FC. **First**, for the first time after the 7th FC, the 15th FC has been asked to use 2011 census data rather than that of 1971. Prior to that, the 6th FC also used 1971 population data, which was the latest available, although it was not mandated in its ToR. **Second**, the Commission has been asked to examine the relevance of revenue-gap grants, a practice characterized by strong adverse incentives. This raises the possibility of using equalization transfers as the guiding principle in determining fiscal transfers. **Third**, the Commission has been asked to comprehensively examine the fiscal consolidation path for the Central, state and combined governments. **Fourth**, there is a reference to examine the impact of GST on Central and state finances including the issue of discontinuance of the present arrangements for compensation to states. **Fifth**, there are references to cover capital expenditures whereas until now, the FC's scope of work had remained limited primarily to the revenue accounts. **Sixth**, the Commission has been asked to design incentive schemes so as to encourage alignment of state policies with Central policies and programs. **Finally**, the FC has been asked to examine the impact of the recommendation of the 14th FC that sharply raised states' share in central taxes to 42% from 32%. In this month's In-focus section, we have included a detailed discussion of the ToR of the 15th FC.

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# 1. Growth: Trend of falling GDP growth reversed in 2QFY18

## A. GDP: Growth reverses trend after five quarters

Reversing its falling trend, real gross domestic product (GDP) and real gross value added (GVA) growth improved to 6.3% and 6.1% respectively in 2QFY18.

- ▶ Real GDP growth improved to 6.3% (y-o-y) in 2QFY18 from a three-year low of 5.7% in 1QFY18. This was largely on account of recovery in the growth of fixed investment along with a sharp decline in the growth of imports.
- ▶ Real investment in fixed assets (excluding valuables), which remained subdued for four quarters in a row, sequentially improved for the third successive quarter to 4.7% in 2QFY18 as compared to 1.6% in 1QFY18. However, the nominal investment rate, measured as the ratio of gross fixed capital formation to GDP, fell to 26.4% in 2QFY18 from 27.5% in 1QFY18.
- ▶ While exports grew at a marginal rate of 1.2% in 2QFY18, the same as in 1QFY18, import growth fell to 7.5% in 2QFY18 from 13.4% in 1QFY18, leading to a lower negative contribution of net exports to GDP growth in 2QFY18 (Table 1).
- ▶ Private consumption expenditure, with a share of 57.3% in the overall nominal GDP, grew at a slower pace of 6.5% in 2QFY18 as compared to 6.7% in 1QFY18. Growth in government consumption expenditure (GCE) fell to 4.1% in 2QFY18, after recording high double-digit growth for five consecutive quarters.

**Table 1: Real GDP growth (%)**

Aggregate demand (AD) component	3Q FY16	4Q FY16	1Q FY17	2Q FY17	3Q FY17	4Q FY17	1Q FY18	2Q FY18
PFCE	5.9	11.8	8.4	7.9	11.1	7.3	6.7	6.5
GCE	5.1	2.4	16.6	16.5	21.0	31.9	17.2	4.1
GFCF	7.0	3.9	7.4	3.0	1.7	-2.1	1.6	4.7
EXP	-8.7	-1.6	2.0	1.5	4.0	10.3	1.2	1.2
IMP	-10.0	-3.7	-0.5	-3.8	2.1	11.9	13.4	7.5
<b>GDP</b>	<b>7.4</b>	<b>9.0</b>	<b>7.9</b>	<b>7.5</b>	<b>7.0</b>	<b>6.1</b>	<b>5.7</b>	<b>6.3</b>
Net exports contribution to growth (% points)	0.5	0.5	0.5	1.2	0.4	-0.3	-2.6	-1.3

Source (Basic Data): MOSPI.

- ▶ On the production side, reversing its falling trend, growth in real GVA increased to 6.1% in 2QFY18 from 5.6% in the previous quarter. This turnaround was due to strong growth of 7.0% in manufacturing output while the growth in construction sector also marginally increased to 2.6% during 2QFY18 (Table 2).
- ▶ There was a broad-based slowdown in services sector growth. GVA growth in financial, real estate and professional services slowed to 5.7% while that in transport, trade and communication services eased to 9.9% in 2QFY18. Growth in public administration and defense services also fell to 6.0% in 2QFY18 from 9.5% in the previous quarter.
- ▶ GVA growth in agricultural and allied activities moderated to 1.7% in 2QFY18 from 2.3% in 1QFY18.

**Table 2: Sectoral real GVA growth (%)**

Sector	3QFY16	4QFY16	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18
Agr.	-2.1	1.5	2.5	4.1	6.9	5.2	2.3	1.7
Ming.	11.7	10.5	-0.9	-1.3	1.9	6.4	-0.7	5.5
Mfg.	13.2	12.7	10.7	7.7	8.2	5.3	1.2	7.0
Elec.	4.0	7.6	10.3	5.1	7.4	6.1	7.0	7.6
Cons.	6.0	6.0	3.1	4.3	3.4	-3.7	2.0	2.6
Trans.	10.1	12.8	8.9	7.7	8.3	6.5	11.1	9.9
Fin.	10.5	9.0	9.4	7.0	3.3	2.2	6.4	5.7
Publ.	7.5	6.7	8.6	9.5	10.3	17.0	9.5	6.0
<b>GVA</b>	<b>7.3</b>	<b>8.7</b>	<b>7.6</b>	<b>6.8</b>	<b>6.7</b>	<b>5.6</b>	<b>5.6</b>	<b>6.1</b>

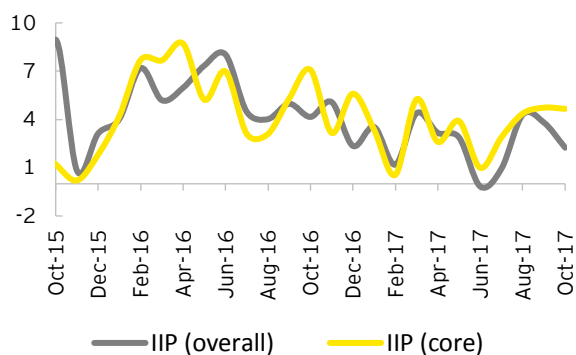
Source (Basic Data): MOSPI.

## B. Industry growth: IIP growth dips to a three-month low in October 2017

Overall IIP growth moderated to 2.2%, while core sector growth remained flat at 4.7% in October 2017.

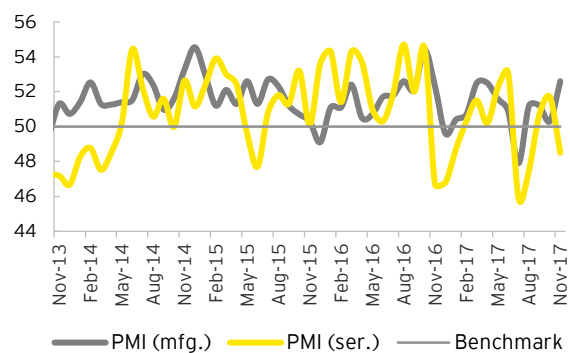
- ▶ Owing to unfavorable base effect, IIP growth fell to a three-month low of 2.2% (y-o-y) in October 2017 from 4.1% (revised) in September 2017 (Chart 1). The slowdown was broad-based as growth rates of the three key sub-indices – namely, manufacturing, electricity and mining – had moderated.
- ▶ The manufacturing sector output (accounting for 77.6% of overall IIP) grew by only 2.5% in October 2017 as compared to 3.8% (revised) in September. Growth in the output of mining and electricity slowed further to 0.2% (7.8% in September) and 3.2% (3.4% in September) respectively during the month.
- ▶ The output of the capital goods industry (a proxy for investment demand) grew at a slower pace of 6.8% in October 2017 as compared to 8.2% (revised) in September 2017. The output of consumer durables contracted further by (-) 6.9% in October as compared to (-) 3.4% in September. Infrastructure sector grew by 5.2% in October 2017, its fastest pace in the last ten months, as compared to 0.4% in September.
- ▶ The output of eight core infrastructure industries grew by 4.7% (y-o-y) in October 2017, the same as witnessed in September (revised down from 5.2%). Excluding steel (8.4%) and fertilizers (3.0%), the other six sub-industries recorded a sequential slowdown in growth. Output growth of petroleum refinery (7.5%), coal (3.9%), electricity (2.1%) and natural gas (2.8%) was positive, while that of crude oil ((-) 0.4%) and cement ((-) 2.7%) turned negative in October.

Chart 1: 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.

## C. PMI: Contraction in services nearly offset recovery in manufacturing in November 2017

In November 2017, contraction in services nearly offset the recovery in manufacturing, resulting in the Composite PMI Output Index depicting a stagnation in the private sector output.

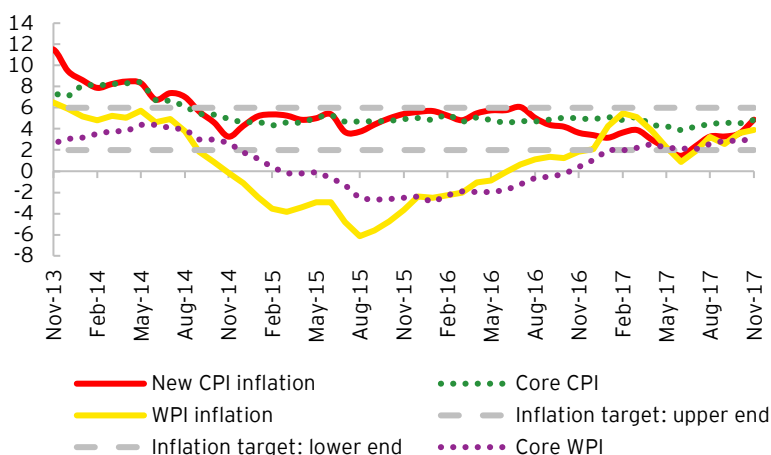
- ▶ Headline manufacturing PMI (sa) increased to a 13-month high of 52.6 in November 2017 from 50.3 in October 2017 (Chart 2). Growth in output and new orders picked up to their highest levels since October 2016 supported by reductions in GST rates and recovering demand conditions. However, headline PMI still remained below its peak levels observed in FY10 and FY11.
- ▶ In contrast, headline services PMI (sa) dipped to 48.5 in November 2017 from 51.7 in October 2017 partly attributable to subdued demand as growth has been falling and partly to GST-related transitional issues.
- ▶ Composite PMI Output Index (sa) was at 50.3 in November 2017, falling from 51.3 in October 2017, signaling a broad stagnation in private sector output in November 2017.

## 2. Inflation: CPI inflation reached a 15-month high as vegetable prices rose sharply

**Overall CPI inflation reached a 15-month high of 4.9% in November from 3.6% in October 2017 primarily due to rising vegetable prices, while core CPI inflation increased to an eight-month high of 4.8%.**

- ▶ Growth in vegetable prices reached a four-year high of 22.5% (y-o-y) in November from 7.5% in October 2017 partly due to unseasonal rainfall and partly due to base effect.
- ▶ Vegetable price inflation was driven by inflation in tomato prices, which increased by 118.3% in November 2017 as compared to 49.7% in October, and onion prices, which rose by 130.0% during the month from 81.2% in October on account of a drop in sowing because of unseasonal rains.
- ▶ The Consumer Food Price Index based inflation picked up to 4.4% in November from 1.9% in October 2017.
- ▶ Fuel and light-based inflation rose to a 50-month high of 7.9% in November as compared to 6.4% in October 2017 due to rising crude prices.
- ▶ Core CPI inflation (excluding food and fuel and light) increased to 4.8% in November from 4.5% in October 2017 primarily due to inflation in housing services reaching a 42-month high of 7.4% in November 2017 from 6.7% in the previous month.

**Chart 3: Inflation (y-o-y; %)**



According to the RBI, CPI-based inflation is expected to average in the range of 4.3%–4.7% in the second half of FY18, reflecting the combined effects of an increase in food price inflation, rising crude prices and increase in HRA by Central and state governments.

Source: MOSPI.

**WPI-based inflation increased to an eight-month high of 3.9% (y-o-y) in November from 3.6% in October 2017 due to a rise in vegetable and crude prices.**

- ▶ As a result of increased inflation in vegetables and crude oil, inflation in primary articles rose to a 16-month high of 5.3% in November from 3.3% in October 2017.
- ▶ Inflation in vegetables rose to a four-year high of 59.8% in November from 36.6% in October 2017 led by inflation in tomato prices, which reached an all-time high (based on 2011-12 series) of 269.4%, followed by inflation in onion prices at 178.2%.
- ▶ Inflation in crude petroleum turned positive at 6.1% in November 2017 after five months of contraction.
- ▶ Fuel and power based inflation remained elevated at 8.8% (y-o-y) in November 2017 as compared to 10.5% in the previous month due to sustained increase in crude and coal prices.
- ▶ WPI core inflation remained stable at 3.0% in November 2017 as compared to 2.9% in the previous month.
- ▶ Inflation based on the newly constructed WPI Food Price Index, consisting of primary food articles and manufactured food products, increased to 4.1% in November from 3.3% in October 2017.

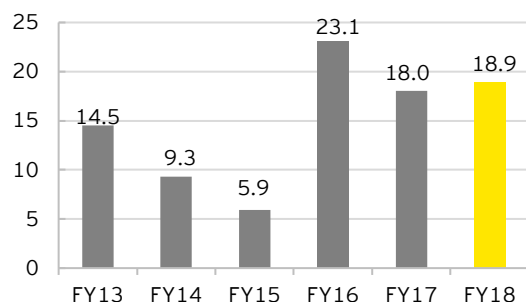
### 3. Fiscal performance: Fiscal deficit was at 96% of annual budgeted target during April–October FY18

#### A. Tax and non-tax revenues

As per CGA data, gross central tax revenues grew by 18.9% during April–October FY18, while non-tax revenues contracted by (-) 43.4% during this period.

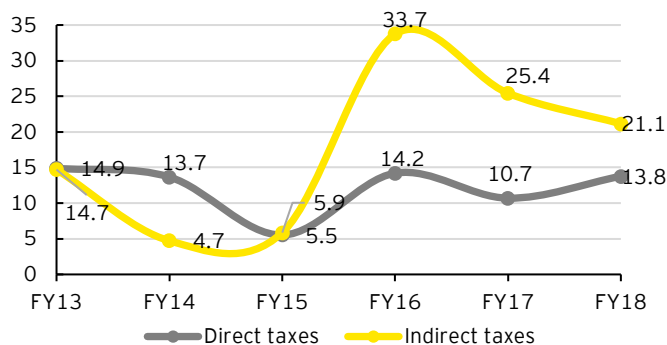
- ▶ Gross central taxes grew by 18.9% during April–October FY18, slightly higher than 18% in the corresponding period of the previous year (Chart 4).
- ▶ Gross central taxes up to October 2017 stood at 50.9% of the FY18 budgeted target, higher than the three-year average of 46.9% achieved during April–October as a percentage of the annual actuals.
- ▶ Growth in direct taxes (comprising personal income tax and corporation tax) up to October FY18 was higher at 13.8% as compared to 10.7% in the same period of FY17 (Chart 5).
- ▶ Growth in personal income tax during April–October 2017 was 16.2% as compared to 19.3% in the corresponding period of the previous fiscal year. Corporation tax revenues grew by 11.8% up to October FY18 as compared to 4.5% in the corresponding period of the previous year.
- ▶ Growth in indirect taxes (comprising union excise duties, service tax, customs duty, CGST, UTGST, IGST and GST compensation cess) was at 21.1% during April–October FY18 as compared to the corresponding value of 25.4% in FY17.
- ▶ The Center's gross tax-GDP ratio for 1HFY18 increased to 10.5 as compared to 9.6 in 1HFY17. This was largely on account of an increase in the indirect tax-GDP ratio from 5.0 in 1HFY17 to 5.6 in 1HFY18. The direct tax-GDP ratio increased from 4.6 to 4.8 in the same period.
- ▶ Tax collection on account of GST (CGST, IGST and GST compensation cess) during July–October 2017 stood at INR205,117 crore.

**Chart 4: Growth in cumulated gross tax revenues up to October 2017**



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

**Chart 5: Growth in cumulated tax revenues up to October 2017**



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

Note: Direct taxes include personal income tax and corporation tax, and indirect taxes include union excise duties, service tax, customs duty and CGST, UTGST, IGST and GST compensation cess from July 2017 onwards

- ▶ During April–October FY18, non-tax revenues contracted by (-) 43.4% as compared to a growth of 3.7% in the same period of FY17.
- ▶ The Center's non-tax revenues up to October 2017 stood at 33% of the FY18 budgeted target. This was almost half of the three-year average of 60.8% achieved during April–October as a percentage of the annual actuals.
- ▶ Total receipts from disinvestment up till 14 December 2017 amounted to INR52,389.86 crore, which was 72.3% of the annual budgeted target of INR72,500 crore<sup>1</sup>.

<sup>1</sup> Department of investment and public asset management (<http://dipam.gov.in/>).

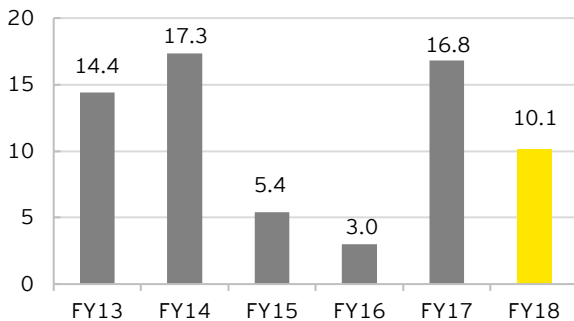


## B. Expenditures: Revenue and capital

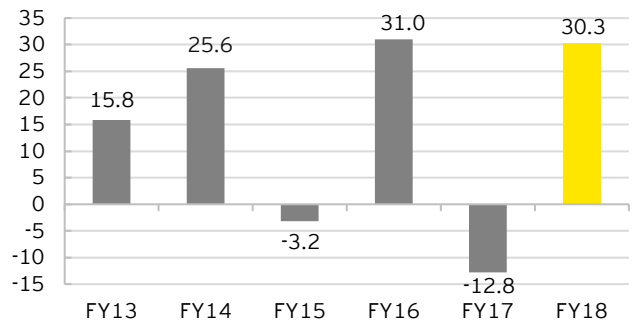
- ▶ Total expenditure grew by 12.3% during April–October FY18 as compared to the corresponding value of 12.6% in FY17.
- ▶ Growth in revenue expenditure was at 10.1% up to October FY18 as compared to 16.8% in the same period of FY17 (Chart 6). Revenue expenditure up to October 2017 stood at 61.5% of the FY18 budgeted target as compared to the three-year average of 58.8% achieved up to October as a percentage of the annual actuals.
- ▶ Capital expenditure up to October 2017 stood at 52.5% of the FY18 budgeted target, compared to the three-year average of 54.2% achieved up to October as a percentage of the annual actuals.

The Center’s capital expenditure up to October 2017 stood at 52.5% of the FY18 budgeted target, compared to the three-year average of 54.2% achieved up to October as a percentage of the annual actuals.

**Chart 6: Growth in cumulated revenue expenditure up to October 2017 (% y-o-y)**



**Chart 7: Growth in cumulated capital expenditure up to October 2017 (% y-o-y)**



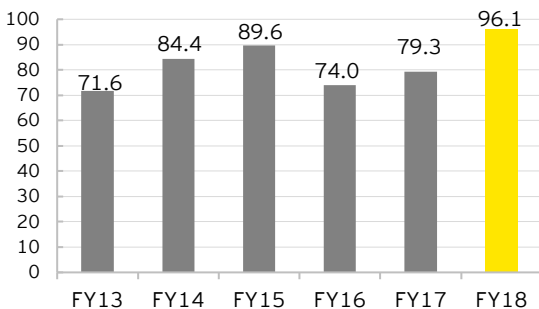
Source: Monthly Accounts, Controller General of Accounts, Government of India.

## C. Fiscal imbalance

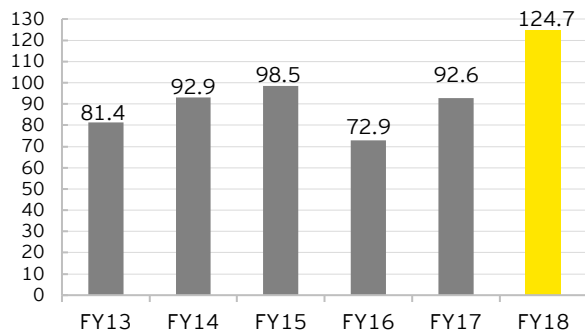
- ▶ Fiscal deficit during April–October FY18 stood at 96.1% of the annual budgeted target as compared to 79.3% in the corresponding period of FY17, increasing from 91.3% up to September 2017 (Chart 8).
- ▶ Revenue deficit up to April–October 2017 increased to 124.7% as compared to 118% up to September 2017. Revenue deficit during April–October 2016 was at 92.6% of the annual budgeted target (Chart 9).

The Center’s fiscal deficit during April–October FY18 stood at 96.1% of the annual budgeted target, while the revenue deficit during this period was at 124.7% of the corresponding annual budgeted target, both showing a deterioration from the previous month.

**Chart 8: Fiscal deficit up to October 2017 as a % of annual budgeted estimate for FY18**



**Chart 9: Revenue deficit up to October 2017 as a % of annual budgeted estimate for FY18**



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

## 4. India: Comparative economic performance and prospects

### GDP growth: India is projected to re-emerge as a global growth leader in 2018

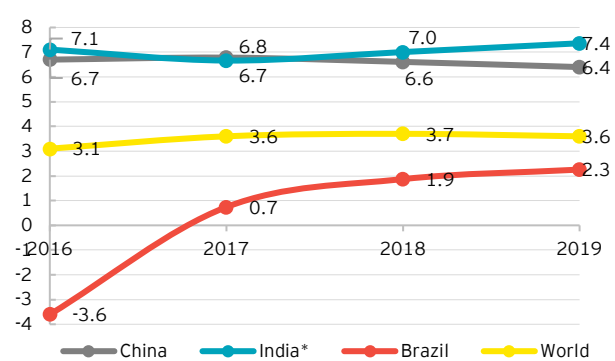
- As per OECD, global GDP growth is projected to improve from 3.1% in 2016 to 3.6% in 2017 and 3.7% in 2018. Growth is forecasted to remain at 3.6% in 2019 as the recovery in investment, trade and productivity is expected to be limited.
- GDP growth in India is projected at 6.7% in 2017 due to the transitory adverse impact of GST and demonetization. Growth is projected to gradually recover to above 7% in 2018 and 2019, the highest among the major economies.
- GDP growth in China at 6.8% in 2017 is expected to be the highest among the major economies. Growth is projected to moderate in 2018 and 2019 due to easing of fiscal stimulus, high debt levels, weak investment and trade growth as a result of excess capacity and less favorable demographic developments.
- A recovery is projected in Brazil and Russia helped by higher commodity prices and more accommodative monetary policies.
- In major advanced economies such as the US, Euro area and Japan, growth is projected to pick up in 2017 as investment has started recovering. However, a more robust investment upturn is critical for a sustained recovery.

**Table 3: Real GDP growth (% change)**

Country	2016	2017 (f)	2018 (f)	2019 (f)
China	6.7	6.8	6.6	6.4
India*	7.1	6.7	7.0	7.4
Germany	1.9	2.5	2.3	1.9
Euro area	1.8	2.4	2.1	1.9
US	1.5	2.2	2.5	2.1
Russia	-0.2	1.9	1.9	1.5
UK	1.8	1.5	1.2	1.1
Japan	1.0	1.5	1.2	1.0
South Africa	0.3	0.7	1.0	1.5
Brazil	-3.6	0.7	1.9	2.3
World	3.1	3.6	3.7	3.6

Source (Basic Data): OECD Economic Outlook, November 2017.  
\*Data pertains to fiscal year, (f) indicates forecast.

**Chart 10: Real GDP growth – Selected countries**



### Inflation: India is projected to have the second-highest inflation rate among peer economies in 2018

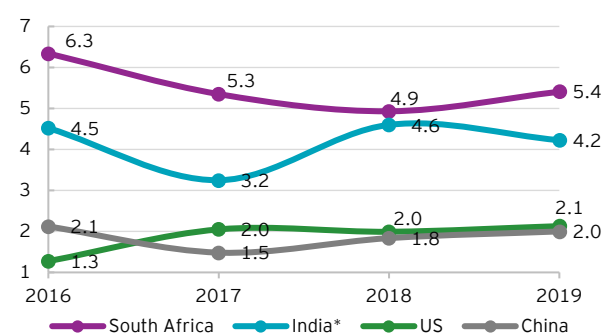
- In major emerging market economies (EMEs), CPI-based inflation has eased in 2017. It is forecasted to fall from 8.7% in 2016 to 3.6% in 2017 for Brazil and from 7% to 3.7% in Russia, helped by past currency appreciation.
- In India, inflation is projected to fall from 4.5% in 2016 to 3.2% in 2017, partly reflecting transitory factors such as demonetization, a good monsoon and a stronger rupee. However, CPI inflation is projected to pick up to 4.6% in 2018.
- In advanced economies, CPI-based inflation is projected to pick up from 2017 onward but is expected to remain below the target of 2% in the Euro area and Japan. Inflation would be driven by rising crude prices and stronger wage cost pressures.

**Table 4: CPI-based inflation (% change)**

Country	2016	2017 (f)	2018 (f)	2019 (f)
South Africa	6.3	5.3	4.9	5.4
Russia	7.0	3.7	3.8	4.0
Brazil	8.7	3.6	3.9	4.2
India*	4.5	3.2	4.6	4.2
UK	0.6	2.7	2.6	2.2
US	1.3	2.0	2.0	2.1
Germany	0.4	1.7	1.8	2.0
Euro area	0.2	1.5	1.5	1.7
China	2.1	1.5	1.8	2.0
Japan	-0.1	0.4	1.0	1.7

Source (Basic Data): OECD Economic Outlook, November 2017.  
\*Data is based on fiscal year, (f) indicates forecast.

**Chart 11: CPI-based inflation – Selected countries**



## Comparative fiscal performance: Except for Brazil, India's combined government deficit remains the highest in 2018 and beyond

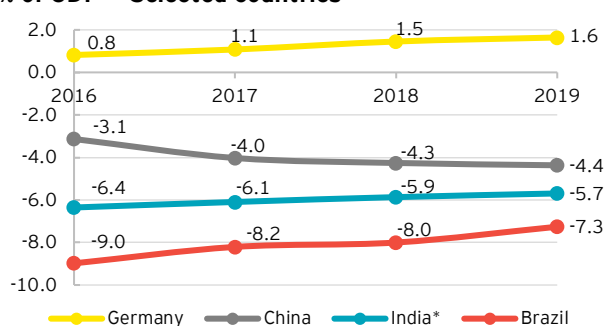
- ▶ Among the set of selected advanced and EMEs, Germany is the only country that posted a general government fiscal surplus in 2016 and is projected to have a fiscal surplus in 2017 and beyond.
- ▶ The fiscal policy stance in major advanced economies (Euro area, the UK and the US) is expected to remain accommodative over 2017–19. Despite that, overall financial balances are expected to improve between 2017 and 2019, reflecting lower net interest payments and a stronger cyclical upturn in growth.
- ▶ In India, the general government fiscal deficit-GDP ratio is projected to decrease from 6.4% in 2016 to 6.1% in 2017 while in China, this ratio is projected to increase during 2017–19, reflecting the accommodative fiscal policy stance adopted by the Government in recent years.

**Table 6: General government financial balances as a % of GDP**

Country	2016	2017 (f)	2018 (f)	2019 (f)
Germany	0.8	1.1	1.5	1.6
Euro area	-1.6	-1.1	-0.7	-0.4
Russia	-3.7	-2.2	-1.4	-1.0
UK	-3.3	-2.3	-2.1	-1.9
China	-3.1	-4.0	-4.3	-4.4
US	-5.0	-4.6	-4.5	-4.5
South Africa	-3.8	-4.8	-4.6	-4.7
Japan	-4.6	-4.8	-4.1	-3.6
India*	-6.4	-6.1	-5.9	-5.7
Brazil	-9.0	-8.2	-8.0	-7.3

Source (Basic Data): OECD Economic Outlook November 2017.  
\*Data is based on fiscal year, (f) indicates forecast.

**Chart 12: General government financial balances as a % of GDP – Selected countries**



## Potential GDP growth: India leads all major economies in potential GDP growth

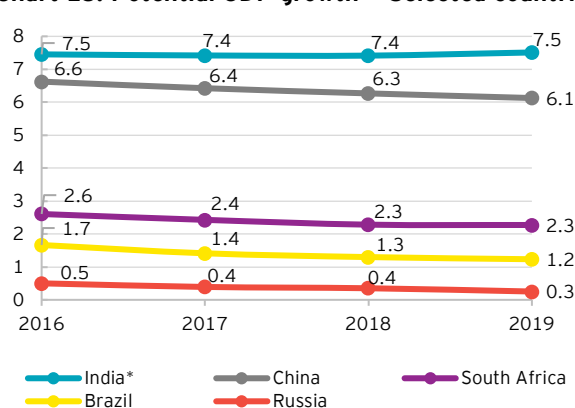
- ▶ OECD projects India's potential GDP growth to be 7.4% in 2018, the highest among the major economies, reflecting a stronger pace of structural reforms in India.
- ▶ Potential GDP growth in China is forecasted to decline from 6.6% in 2016 to 6.1% in 2019 due to weaker investment and trade growth. Moreover, demographic developments have become less favorable in China.
- ▶ Potential GDP growth in the US and the UK is forecasted to be in the range of 1.3%–1.7% during 2017–19. Recovery in investment has been weaker than the past recoveries, implying slow growth of productive capital and limiting prospects for productivity growth and potential output.
- ▶ In Japan, potential GDP growth is projected to be stagnant at 0.7% during 2017–19.

**Table 6: Potential GDP growth (% change)**

Country	2016	2017 (f)	2018 (f)	2019 (f)
India*	7.5	7.4	7.4	7.5
China	6.6	6.4	6.3	6.1
South Africa	2.6	2.4	2.3	2.3
UK	1.5	1.6	1.3	1.3
US	1.6	1.5	1.6	1.7
Brazil	1.7	1.4	1.3	1.2
Germany	1.3	1.3	1.4	1.4
Japan	0.7	0.7	0.7	0.7
Russia	0.5	0.4	0.4	0.3

Source (Basic Data): OECD Economic Outlook November 2017.  
\*Data is based on fiscal year, (f) indicates forecast.

**Chart 13: Potential GDP growth – Selected countries**





## 5. In focus: Terms of Reference of the 15th Finance Commission – Moving away from the conventional

### Introduction

India's Finance Commission (FC), a constitutional body set up with a periodicity of five years or less, has, for nearly seven decades, overseen the system of fiscal transfers from the Central to state governments, consisting mainly of sharing of central taxes and a variety of grants. Since the early 90s, the Central FC has also been recommending measures to augment the resources of the local governments taking into account the recommendations of the respective State FCs. The 15th FC is the latest incarnation of this eminent, institutional body with a set of Terms of Reference (ToR) that have significantly moved away from the conventional ToR given to the FCs. Some of these changes are quite refreshing. We examine the ToR for the 15th FC as contained in the Presidential order constituting the Commission from the viewpoints of both continuity and change. Continuity follows from the reference to the clauses defining the main duties of the Commission as specified in articles 270 (sharing of central taxes), 275 (grants-in-aid of revenues) and 280 (main responsibilities) of the Constitution. The changes reflect India's new economic realities and the significantly transformed approach of the current Central Government to economic and fiscal policy formulation. Addressing these ToR by the 15th FC may call for evolving a significantly different approach compared to its recent predecessors. We discuss below some of the more salient departures in the ToR.

### From 1971 population to 2011 population

From the 7th FC onward, every FC had been mandated to use only 1971 population in all cases where population was regarded as a factor for the determination of devolution of taxes and duties and grants-in-aid. Prior to that, the 6th FC also used 1971 population data, which was the latest available, although it was not mandated in its ToR. This practice continued until the 13th FC, even though new population data became available based on the latest Census of the population. In the case of the 14th FC, there was a reference to the latest available Census data but the use of 1971 population dominated the methodology. Thus, even though by this time 1981, 1991, 2001 and 2011 census data had become available, the FCs continued to use dated information. The usage of 1971 data by the 14th FC, whose recommendation period was for 2015–16 to 2019–20, meant using information that was dated by margins of 45 years (first year of award) to 50 years (last year of award). The mandating of the usage of 1971 population data for nearly four decades, even though more recent relevant data had become available, had no constitutional or legal basis. In the ToR of the 15th FC, the reference to 1971 population has now been dropped by specifically mandating the usage of 2011 population data, which would be the latest available census to the 15th FC during its deliberation period running from end-2017 to end-2019. This much-needed change is not only commonsensical but would avoid several significant distortions in the recommendations of the FC. In providing resources to the state governments whose main concern is to provide fiscal, social and economic services to its population, not making reference to its current population but considering some old population as relevant was an archaic and distortionary practice. This practice was sometimes justified by some analysts as disincentivizing the states from letting their population proliferate, although there was no evidence that any state did follow such a policy. However, it resulted in lower standards of services provided by the state governments to its citizens. Furthermore, such a static provision did not take into account the effect of net migration on the state population. With the current discussions on the "demographic dividend," larger populations are being seen as significant potential contributors to overall growth, provided this population is catered to by the respective governments by educating and skilling it and keeping it in good health. This task would become much easier by using the latest available population data so that the Central Government can augment the states' resources with reference to their current population. The underlying principle of determining fiscal transfers is to enable the states to provide their citizens an equitable level of services. The 15th FC has, however, also been asked to take into account the effort of the states to reach replacement rates of population growth.

### From "revenue-gap" grants to equalization transfers

Major federations in the world such as Australia<sup>2</sup> and Canada<sup>3</sup> have been following an "equalization approach" in determining fiscal transfers. The equalization approach involves using a system of fiscal transfers that aims to provide services at comparable levels across states provided they make a comparable effort in raising revenues. This approach makes up for deficiency in fiscal capacity but not that in revenue effort. This is the approach followed by Canada. In Australia, apart from fiscal capacity utilization, cost and need differentials are also brought under purview. The equalization approach corrects for differences in fiscal capacity and unit costs of service delivery but not differences in revenue effort. Indian FCs have long been criticized by leading economists<sup>4</sup> for following a "gap-filling" approach, which is based on historical trends in expenditures and revenues rather than by reference to norms. States that create a history of excessive expenditures and deficient revenues would show large revenue gaps subject to their capability of temporarily financing these. In the next cycle, following the FC's approach, involving the projection of historical trends for their recommendation period, these gaps would be financed by additional transfers.

<sup>2</sup>Commonwealth grants commission, Australia (2017).

<sup>3</sup>Department of Finance, Canada.

<sup>4</sup>Federalism and Fiscal Transfers in India (in co-authorship with C.Rangarajan), Oxford University Press, India, 2011.

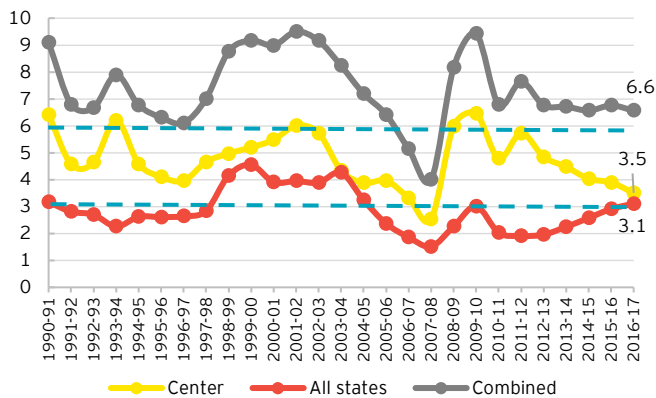
The genesis of this gap-filling approach lies in the interpretation of the provision of article 275, clause (1) of the Constitution, which says: “Such sums as Parliament may by law provide shall be charged on the Consolidated Fund of India in each year as grants-in-aid of the revenues of such States as Parliament may determine to be in need of assistance, and different sums may be fixed for different States.” Thus, the phrase “grants-in-aid of revenues ... to be in need of assistance” called for determining the “need.” Most of the early FCs estimated need by assessing the difference for the projection period between expenditures and revenues based on historical trends. Some norms were applied on a piecemeal and ad hoc basis. The 9th FC was the first Commission that made an attempt to assess the “need” by application of norms. Other Commissions such as the 12th FC determined equalization grants for selected services such as health and education. A comprehensive normative approach did not find a place in the FC design of fiscal transfers.

The 15th FC has for the first time been asked under clause (5) of its ToR whether revenue deficit grants should be provided at all. If the Commission considers that revenue deficit grants need not be provided at all, it will have to suggest an alternative approach to determining grants. Given the international practice and relevance, a full-fledged equalization transfer approach can be developed. The revenue-sharing formula guided by the equalization approach supplemented by equalization grants can potentially deliver a high degree of equalization. There is a good amount of literature regarding the conditions under which the “distance formula” in revenue sharing can be interpreted as following the equalization transfer approach<sup>5</sup>. This should be considered as part of the overall equalization approach where equalization grants, whether applied to selected services or all services, will help achieve an acceptable degree of equalization. There are also some works that suggest how to measure the degree of equalization achieved in a given scheme of fiscal transfers where shares in central taxes and grants are considered together<sup>6</sup>. In this context, the use of the latest available population will facilitate matters and the degree of equalization can also be measured by reference to the same population data.

**Debt, deficit and fiscal consolidation roadmap**

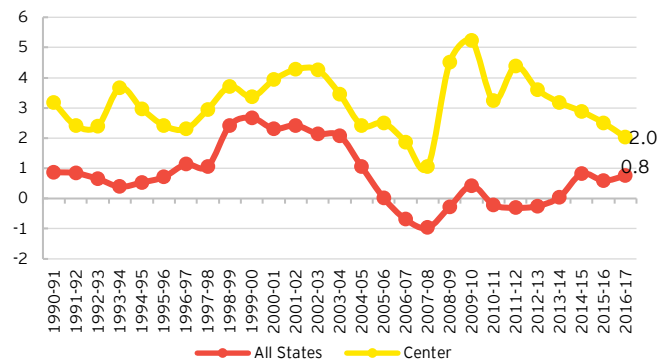
The issue of a sustainable level of borrowing for the Central and state governments gained prominence as the combined, central and state finances, all descended into fiscal imbalance and high levels of debt-GDP and debt-GSDP ratio led to inordinately high-interest payments for the Central and state governments. Since the 11th FC, the matter has been examined in detail. Once the Central Government slipped back into high levels of fiscal deficit in the wake of the global economic and financial crisis in 2008–09, it never really regained the norm of 3% of GDP as specified in the center’s FRBMA, 2003.

**Chart 14: Fiscal deficit as a % of GDP: Long-term trend**



Source (Basic data): IPFS, CAG, and CGA and EY team.

**Chart 15: Revenue deficit as a % of GDP: Long-term trend**



Note: -ve indicates revenue surplus.

Chart 14 shows the relative performance of the Center and states in reaching the benchmark level of 3% of GDP. States achieved this in 2004–05 and remained at or below this level in the subsequent years. The Center achieved this in 2007–08 but it was breached in 2008-09 and never regained. Table 7 provides the corresponding numbers. Chart 15 shows the comparative performance of the Center and states in achieving revenue account balance. In this case also, the performance of the states has been better.

<sup>5</sup> Fiscal Transfers in Nepal: Design and Implementation Plan, Forum of Federations, Canada, 2013.

<sup>6</sup> Federalism and Fiscal Transfers in India (in co-authorship with C.Rangarajan), Oxford University Press, India, 2011.

**Table 7: Fiscal deficit as a % of GDP: Center, all states and combined**

Fiscal year	Fiscal deficit as a % of GDP			Fiscal year	Fiscal deficit as a % of GDP		
	Center	All states	Combined		Center	All states	Combined
2000-01	5.5	3.9	9.0	2009-10	6.5	3.0	9.4
2001-02	6.0	4.0	9.5	2010-11	4.8	2.0	6.8
2002-03	5.7	3.9	9.2	2011-12	5.7	1.9	7.6
2003-04	4.3	4.3	8.2	2012-13	4.9	2.0	6.8
2004-05	3.9	3.2	7.2	2013-14	4.5	2.2	6.7
2005-06	4.0	2.4	6.4	2014-15	4.0	2.6	6.6
2006-07	3.3	1.9	5.1	2015-16	3.9	2.9	6.8
2007-08	2.5	1.5	4.0	2016-17	3.5	3.1	6.6
2008-09	6.0	2.3	8.2				

Source (Basic Data): IPFS, CAG, CGA and EY team.

Fiscal consolidation roadmaps were prepared from time to time in this context so that the path could be specified to reach the prescribed level in the FRBMA, 2003, read with subsequent amendments, given growth and interest rates. Clause (5) of the ToR of the 15th FC provides as follows:

*"The Commission shall review the current status of the finance, deficit, debt levels, cash balances and fiscal discipline efforts of the Union and the States, and recommend a fiscal consolidation roadmap for sound fiscal management, taking into account the responsibility of the Central Government and State Governments to adhere to appropriate levels of general and consolidated government debt and deficit levels, while fostering higher inclusive growth in the country, guided by the principles of equity, efficiency and transparency. The Commission may also examine whether revenue deficit grants be provided at all."*

The reference is to "appropriate" rather than "sustainable" levels of debt. While sustainability is defined in a technical manner in the literature on debt sustainability, the term "appropriate" will be open to interpretation by the FC. Since "State Governments" have been referred to in the plural, the Commission may need to determine an appropriate level of debt and deficit for each state government. Since there is a reference to consolidated government debt and deficit, individual central and state-specific levels of debt and deficit must correspond to or be linked to the overall consolidated debt and deficit as considered appropriate.

In this context, the ToR also makes reference to conditionalities on states with respect to their borrowing programs under clause 6 (vi): *"The conditions that Gol may impose on the States while providing consent under Article 293 (3) of the Constitution."* There is an asymmetry here in the sense that while the FC has been asked to consider conditionalities for borrowing should any of the states deviate from their FRBM norms, there is no such conditionality for the Central Government.

### Reference to capital expenditure

Until the 14th FC, the scope of assessment of expenditure was limited to the revenue expenditures of the state governments. It was the Planning Commission which dealt with capital expenditures through the vehicle of plan grants. After the abolition of the plan process, no institutional mechanism has been available for consideration of states' capital expenditure needs. There are several critical references in the ToR of the 15th FC that can extend the scope of its work to potentially cover capital expenditures. In clause (6), particularly sub-clause (iii)<sup>7</sup> of the ToR, there are references to "critical infrastructure." The infrastructure needs of the states also need to be considered separately. In sub-clause 6 (iv)<sup>8</sup> of the ToR, there is a reference to the national development program in which states will also have to play a significant role, and in clause (7) (iv) of the ToR there is a reference to "increasing capital expenditure." These references call for developing a comprehensive approach covering both revenue and capital expenditures, which would need to be financed by tax and non-tax revenues, including fiscal transfers, as well as by fiscal deficit. This would require determining state-wise appropriate fiscal deficit levels so that these can be used to finance capital expenditures while tax and non-tax revenues are used for meeting revenue expenditures while meeting the condition of zero revenue deficit.

### Incentivizing alignment with central priorities and schemes

Under clause (7), the 15th FC has been asked to propose performance-based incentives, which may perhaps take the form of performance-linked grants particularly incentivizing national priorities and alignment of state policies with Central Government priorities. FCs have been suggesting performance-linked grant from time to time, e.g., grants linked with a reduction in the debt-GSDP ratio (12th FC), increase coverage of forest areas (13th FC) etc.

The Commission may consider proposing measurable performance-based incentives for states, at the appropriate level of government, in the following areas:

<sup>7</sup> *"The demand on the resources of the state governments, particularly on account of financing socio-economic development and critical infrastructure, assets maintenance expenditure, balanced regional development and impact of the debt and liabilities of their public utilities."*

<sup>8</sup> *"The impact on the fiscal situation of the Union Government of substantially enhanced tax devolution to States following recommendations of the 14th Finance Commission, coupled with the continuing imperative of the national development program, including New India - 2022."*





- (i) Efforts made by the states in expansion and deepening of tax net under GST
- (ii) Efforts and progress made in moving toward replacement rate of population growth
- (iii) Achievements in implementation of flagship schemes of the Government of India, disaster resilient infrastructure, sustainable development goals, and quality of expenditure
- (iv) Progress made in **increasing capital expenditure**, eliminating losses of power sector and improving the quality of such expenditure in generating future income streams
- (v) Progress made in increasing tax/non-tax revenues, promoting savings by adoption of DBT and Public Finance Management System, promoting digital economy and removing layers between the government and the beneficiaries
- (vi) Progress made in promoting ease of doing business by effecting related policy and regulatory changes and promoting labor-intensive growth
- (vii) Provision of grants in aid to local bodies for basic services, including quality human resources, and implementation of performance grant system in improving delivery of services
- (viii) Control or lack of it in incurring expenditure on populist measures; and
- (ix) Progress made in sanitation, solid waste management and bringing in behavioral change to end open defecation.

It is perhaps for the first time that an FC is being asked to reward alignment of state policies with those of the Central Government.

#### **Impact of GST and other structural reform programs**

Under clause 6 (v), the Commission has been asked to take into account the impact of GST and other structural reforms on the finances of the Center and the states. The clause reads as follows:

*“The impact of the GST, including payment of compensation for possible loss of revenues for 5 years, and abolition of a number of cesses, earmarking thereof for compensation and other structural reforms programme, on the finances of Centre and States.”*

The present compensation arrangement for the states who may lose revenue in the transition to GST will come to an end in June 2022. The recommendation period of the 15th FC will extend up to 2024–25. This clause of the ToR raises the hope that for the revenue-losing states, the period of compensation may be extended. The Commission will also have to decide what other structural reform programs may be considered under this clause.

#### **Re-examining states' share of 42% in divisible central taxes**

The 14th FC had increased the share of states in the sharable pool of central taxes to 42%, an increase of 10% points from the share recommended by the 13th FC. Over the period covered by the recommendations of 14 FCs, the share of states in the divisible pool of central taxes had been moving in only one direction, namely, increasing. For the first time, an explicit reference has been made to examine whether 42% is excessive (clause 6 (iv)). The reason the 14th FC recommended this sharp increase was the abolition of the plan process, as a result of which plan grants that the states received were to be discontinued. The 14th FC did not explicitly provide the method or calculation of the exact figure of 42%. There is, of course, no reason why the share of states in central taxes cannot move in the other direction. At the very least, the basis of reaching 42% and the basis of moving away from it in one or the other direction will have to be examined by the 15th FC.

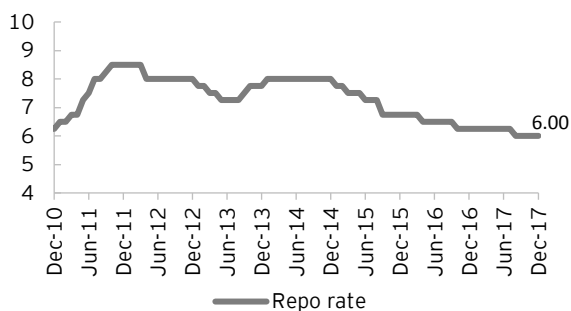
## 6. Money and finance: Repo rate left unchanged at 6% in December 2017 review

### A. Monetary sector

Expressing their concerns over the rising trend in inflation and inflation expectations, the RBI's Monetary Policy Committee recommended to retain the policy repo rate at 6.0% in the bi-monthly policy review held on 6 December 2017.

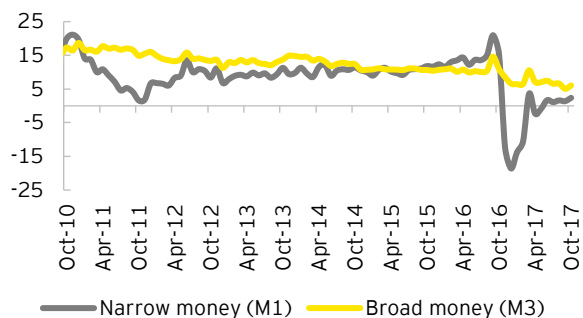
- ▶ Citing heightened risks to CPI inflation and increased inflation expectations, the RBI retained the policy repo rate at 6.0% during its fifth bi-monthly monetary policy review held on 6 December 2017 (Chart 16). The RBI's latest round of household survey showed a firming up of household inflation expectations for both three months ahead and one year ahead horizons.
- ▶ As per the RBI's projections in December 2017, CPI inflation is expected to range between 4.3% and 4.7% during 3QFY18 and 4QFY18, 10 basis points higher than the projection range of 4.2%–4.6% reported in the October 2017 policy statement. The following factors could influence the CPI inflation in the coming months: (a) impact of HRA increase by the Central Government, which may peak in December 2017, (b) the staggered impact of HRA increases by various state governments and (c) a sustained increase in international crude prices.

**Chart 16: Movements in repo rate**



Source: Database on Indian Economy, RBI.

**Chart 17: Growth in narrow and broad money**

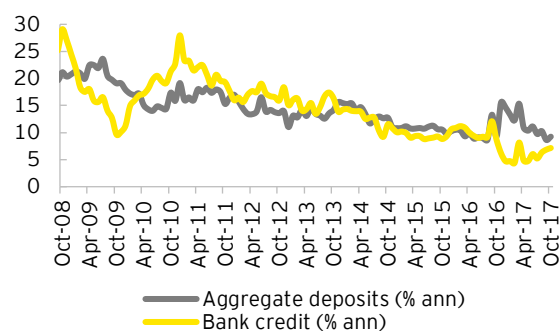


### Money stock

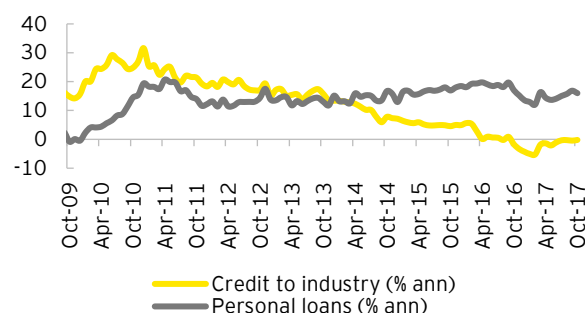
- ▶ Growth in broad money stock (M3) increased to 6.5% (y-o-y) in October 2017 recovering from 5.6% (revised) in September led by higher growth in time deposits. Growth in time deposits (accounting for over 76% of the broad money stock) rose to 7.6% in October 2017 from 6.7% in September 2017, while growth in demand deposits improved to 21.4% in October 2017 as compared to 17.1% in September.
- ▶ Narrow money (M1) grew by 2.7% in October 2017, marginally increasing from 1.6% (revised) in September 2017. Growth (y-o-y) of currency in circulation continued to contract for 12 straight months (Chart 17). The pace of the re-monetization process has been gradual. This is depicted by a modest increase in currency in circulation (excluding non-demonetized currency) as a percentage of the total demonetized currency (indicating the extent of re-monetization), which had reached 91.7% by 24 November 2017 as compared to 90.1% on 27 October 2017.

### Aggregate credit and deposits

- ▶ Growth in credit by scheduled commercial banks rose to a seven-month high of 7.1% (y-o-y) in October 2017 as compared to 6.5% (revised) in September 2017 (Chart 18). This increase in credit growth was possibly due to a temporary pickup in demand due to the festive season. But credit growth still remained well below its 10-year average growth of 15.2%.
- ▶ Non-food credit grew by 6.6% in October 2017, increasing from 6.1% in September 2017. Credit growth to the services sector increased to 9.4%, its fastest pace since March 2017, as compared to 7.0% in September. Credit to industries contracted by (-) 0.2% in October 2017, although at a relatively slower pace as compared to (-) 0.4% in September 2017.
- ▶ Growth in personal loans, a key driver of retail sector credit, marginally fell to 16.0% in October 2017 as compared to 16.8% in September as growth in demand for housing loan eased during the month.
- ▶ Growth in aggregate bank deposits improved to 9.2% (y-o-y) in October 2017 from 8.2% (revised) in September.


**Chart 18: Growth in credit and deposits**


Source: Database on Indian Economy, RBI.

**Chart 19: Growth in industrial and personal loans**


Source: Database on Indian Economy, RBI.

## B. Financial sector

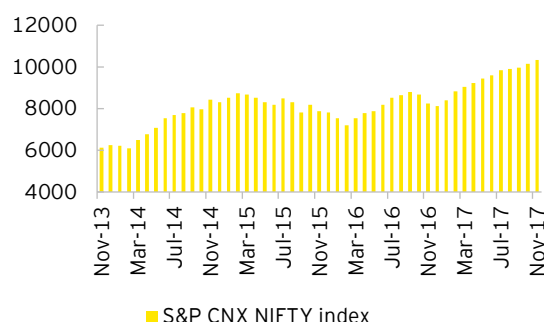
Both net FDI and net FPI inflows improved in October 2017 as compared to September.

### Interest rates

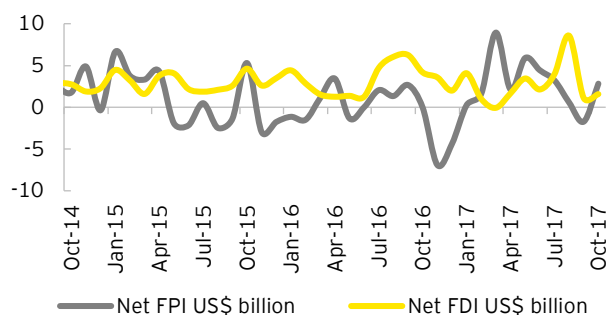
- ▶ Banks lowered the term deposit rates (with a maturity of more than one year) to range between 6.00% and 6.75% in November 2017 from 6.25–6.75% in October 2017.
- ▶ The marginal cost of fund-based lending rate (MCLR) ranged between 7.7% and 8.1% in November 2017, similar to the levels seen in October 2017.
- ▶ The average yield on 10-year government securities reached a seven-month high of 7.15% (weekly average) in November 2017 as compared to 6.9% in October 2017. Benchmark bond yields have been increasing since August 2017 due to upward risks to domestic inflation coupled with concerns over global rate tightening.

### FPI and stock market

- ▶ The benchmark S&P NIFTY index increased further to reach 10,325 points (average) in November 2017, from 10,139 points in October 2017 (Chart 20). The overall index gained 186 points on average during November 2017. The factors that drove the market sentiment included strong domestic inflows, further reforms and rationalization of the GST rate structure and sovereign rating upgrade by Moody's. However, higher crude oil prices due to political uncertainties in the Middle East and the retention of India's rating at BBB-minus by S&P acted as deterrents to the overall performance of the stock market during the last week of November.
- ▶ As per provisional data, overall FII inflows rose to US\$4.4 billion in October 2017 as compared to an outflow of US\$0.6 billion (revised) in September 2017 led by higher net FPI and FDI inflows in October 2017.

**Chart 20: Stock market movement**


Source: Database on Indian Economy, RBI.

**Chart 21: Net FDI and FPI**


Source: Database on Indian Economy, RBI.

- ▶ After falling to a six-month low of US\$1.1 billion (revised) in September 2017, net FDI inflows rose marginally to US\$1.6 billion in October 2017 while net FPIs inflows amounted to US\$2.8 billion as compared to an outflow of US\$1.7 billion (revised) in September 2017 (Chart 21).



## 7. Trade and CAB: Growth in exports rose to a six-year high in November 2017

### A. CAB: Significant improvement over 1QFY18

CAB as a percentage of GDP improved to (-) 1.2% in 2QFY18 from a four-year low of (-) 2.4% in 1QFY18 (Table 8 and Chart 23). This was primarily due to the combined effect of a slowdown in merchandise imports and pickup in merchandise exports along with faster growth in net transfers. Merchandise trade deficit moderated substantially to (-) US\$32.8 billion from a four-year peak of (-) US\$42.0 billion, while growth in net transfers reached a 21-quarter high of 12.5%. Growth in net service exports reached a 10-quarter high of US\$18.4 billion from US\$18.3 billion in 1QFY18.

**Table 8: CAB**

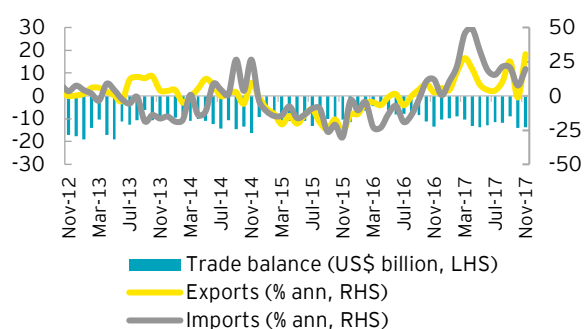
	CAB (- deficit/ +surplus) (US\$ billion)	CAB as a % of nominal GDP	Goods account net (US\$ billion)	Services account net (US\$ billion)	Income account net (US\$ billion)	Transfers net (US\$ billion)
<b>FY14</b>	-32.4	-1.7	-147.6	73.0	-23.0	65.3
<b>FY15</b>	-26.8	-1.3	-144.9	76.6	-24.1	65.7
<b>FY16</b>	-22.2	-1.0	-130.1	69.7	-24.4	63.0
<b>FY17</b>	-15.3	-0.7	-112.4	67.5	-26.3	56.6
<b>3QFY17</b>	-8.0	-1.4	-33.3	17.8	-6.4	13.9
<b>4QFY17</b>	-3.5	-0.6	-29.7	17.6	-5.6	14.2
<b>1QFY18</b>	-15.0	-2.5	-42.0	18.3	-5.8	14.5
<b>2QFY18</b>	-7.2	-1.2	-32.8	18.4	-8.5	15.6

Source: Database on Indian Economy, RBI.

### B. Merchandise trade and exchange rate

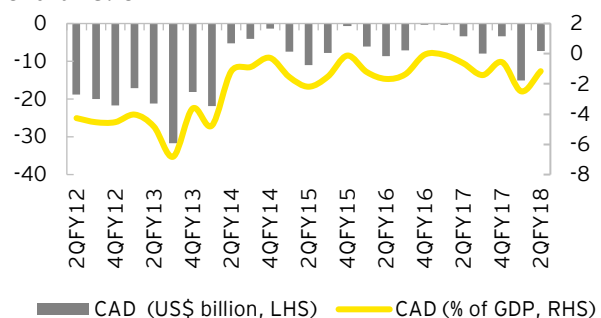
- ▶ Growth in merchandise exports reached a six-year high of 30.5% (y-o-y) in November as compared to a contraction of (-) 1.1% in October 2017 (Chart 22), partly due to favorable base effect.
- ▶ The sharp upturn in exports growth was led by growth in gems and jewelry at a two-year high of 32.7% ((-) 24.5% in October), engineering goods exports at 43.8% (11.8% in October) and oil exports at 47.7% (14.7% in October). Growth in gems and jewelry and oil products seems to be partly driven by rising crude prices, leading to greater demand from oil-producing countries, while an increase in exports of engineering goods reflects improved global demand conditions.
- ▶ Imports growth fastened to 19.6% in November 2017 (7.6% in October) as the value of imports reached a three-year peak.
- ▶ The increase in overall growth in imports was led by the growth in pearls and precious stones at 85.8% ((-)1.6% in October), oil imports at 39.1% (27.9% in October), electronic goods at 25.0% (7.0% in October) and a slowdown in the pace of contraction of transport equipment to (-) 8.4% ((-) 48.0% in October).
- ▶ Due to a faster rise in exports vis-à-vis imports, India's merchandise trade deficit marginally narrowed to US\$13.8 billion from a three-year high of US\$14.0 billion in October 2017.
- ▶ The Indian rupee appreciated marginally to INR64.9 per US dollar in November from INR65.1 in October.

**Chart 22: Developments in merchandise trade**



Source: Ministry of Commerce and Industry.

**Chart 23: CAD**



Source: Database on Indian Economy, RBI.

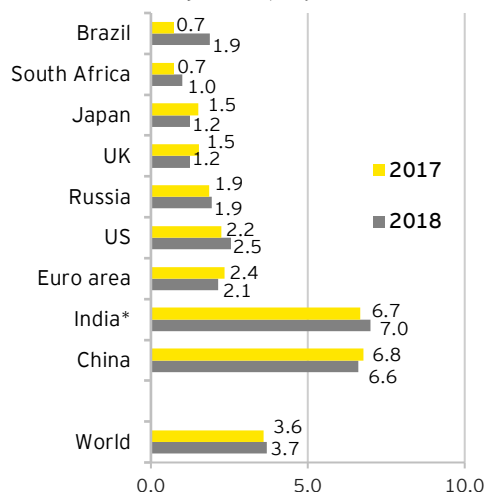
## 8. Global growth: OECD projects global growth to improve in 2017 and 2018

### A. Global growth outlook

- ▶ As per the OECD (Organisation for Economic Co-operation and Development) Economic Outlook November 2017, global growth is projected to improve to 3.6% in 2017 and 3.7% in 2018 (Chart 24). However, growth in investment, trade and productivity has remained subdued until now. High household and corporate debt in many advanced and EMEs has posed a challenge to the sustainability of growth in the medium term.
- ▶ In the US, GDP growth is projected at 2.2% in 2017 and 2.5% in 2018. Tax rates on corporate and personal income are expected to be lowered, stimulating investment and consumption. In the light of improving labor market conditions and recovering economic growth, the US Fed, in its monetary policy review on 12-13 December 2017, has raised the target range for the federal funds rate to 1.25%–1.5%.
- ▶ Growth in the Euro area is projected at 2.4% in 2017 and 2.1% in 2018. In OECD's assessment, growth in the region is broad-based, driven by domestic as well as external demand. Wage growth is expected to be moderate and inflation is likely to rise closer to but remain below 2% by 2019.
- ▶ Growth is projected to remain weak in the UK as private consumption remains subdued as a result of high inflation due to the past depreciation of the sterling. However, an agreement about a transition period linked to the EU exit after March 2019 is expected to support growth in 2018 and in 2019 by reducing the existing uncertainties.
- ▶ Aided by stronger international trade and fiscal stimulus, GDP growth in Japan is projected at 1.5% in 2017. But it is forecasted to fall to 1.2% in 2018 even though export growth is expected to remain robust. Sustained above-potential growth is likely to boost inflation to 1% in 2018 and around 1.5% in 2019 (excluding the impact of the increase in the consumption tax rate). The Bank of Japan is expected to retain its expansionary monetary policy until the 2% inflation target is achieved.
- ▶ In China, growth is projected to strengthen to 6.8% in 2017 driven by services and some strategic industries but is expected to moderate in 2018 as exports decelerate. The fiscal policy would remain supportive while the monetary policy is likely to have a neutral stance. Corporate debt relative to GDP has stabilized at a high level while household debt has been rising.
- ▶ In Russia, growth is projected to remain moderate at 1.9% in 2017 and 2018. Recovering crude oil prices, better business sentiment and improved credit conditions are expected to support investment and consumption.

**According to OECD, global GDP growth is projected to improve from 3.1% in 2016 to 3.6% in 2017 and 3.7% in 2018. However, for a strong and sustained medium-term growth, a more robust investment upturn and productivity-enhancing structural reforms are required.**

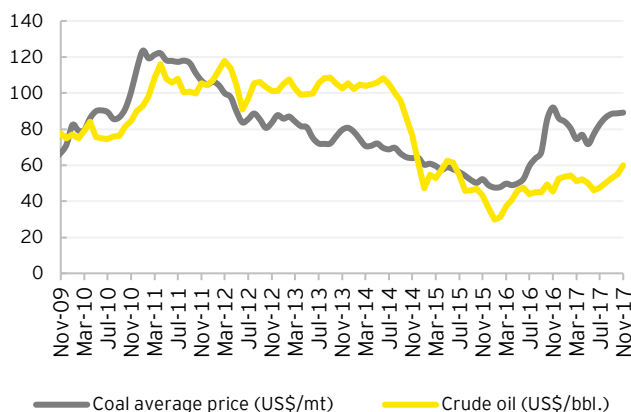
**Chart 24: Global growth projections**



Source: OECD Economic Outlook, November 2017.

\*Forecast pertains to fiscal year.

**Chart 25: Global crude and coal prices**



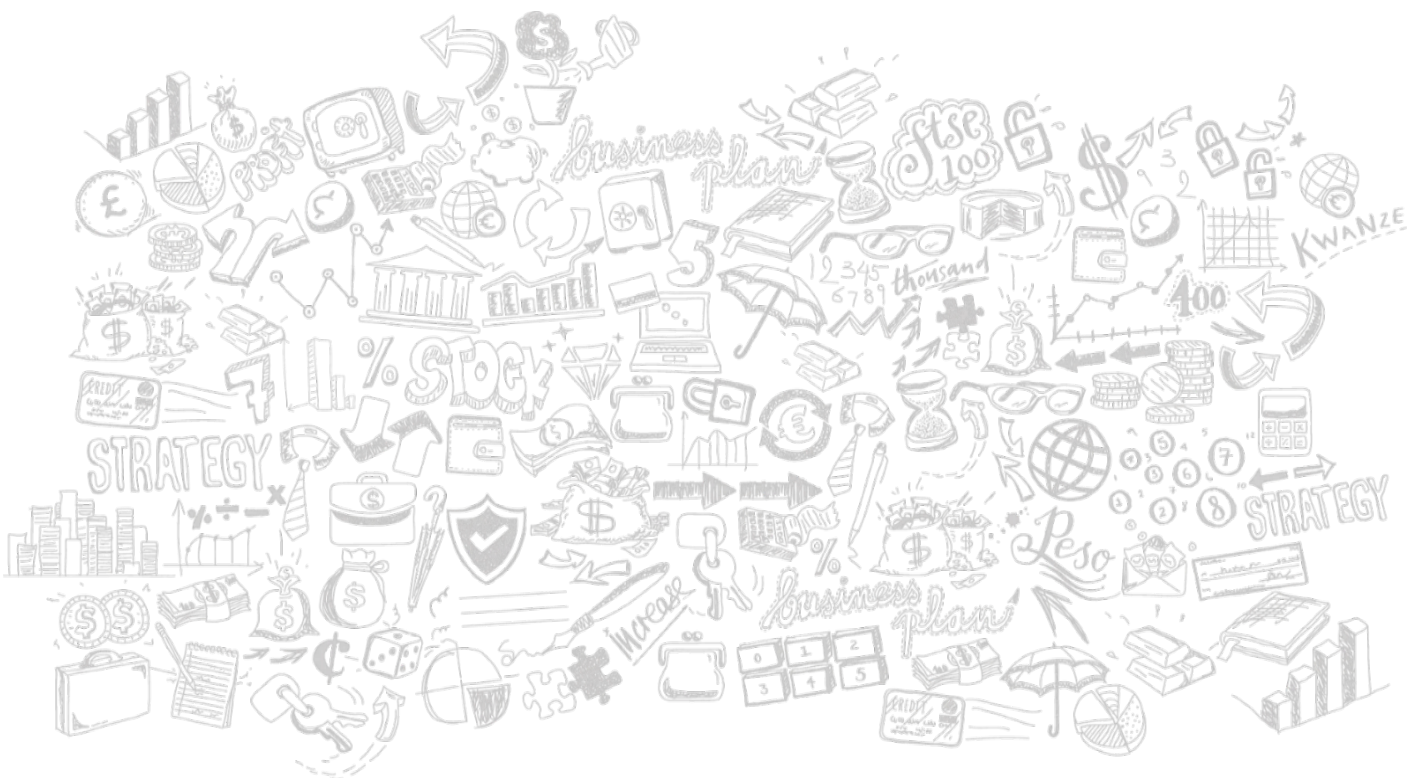
Source: World Bank, Pinksheet.



## B. Global energy prices

At US\$59.9/bbl., average global crude price increased to its highest level since June 2015 due to the decision of continuing the production cuts for the whole of 2018 in the OPEC meeting held on 30 November 2017.

- ▶ Average global crude prices<sup>9</sup> increased to US\$59.9/bbl. in November 2017, the highest level since June 2015 (Chart 25). This was largely due to the decision taken at the recent OPEC meeting on 30 November 2017 of continuing with the production cuts for the whole of 2018. It was recognized that although the oil market rebalancing has gathered pace with the OECD excess stocks falling in October, it is vital that stock levels be drawn down to normal levels.
- ▶ Average global coal prices also increased to US\$89.1/mt. in November 2017 (US\$88.8/mt in October 2017), its highest level since November 2016. According to the World Bank, coal prices are expected to average US\$85/mt in 2017 due to continued efforts by China to reduce coal supply as well as stronger demand. China's coal policy will be a key driver given that the country consumes half of the world's coal output and that coal accounts for more than 60% of the country's energy needs.

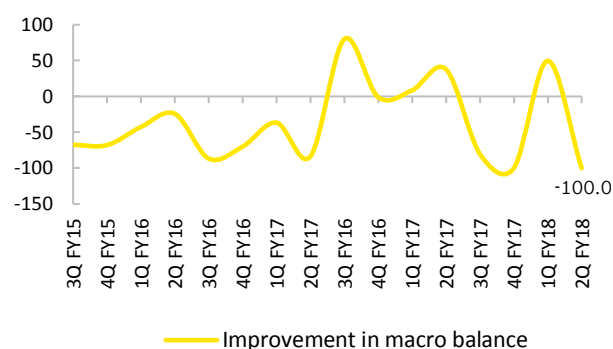
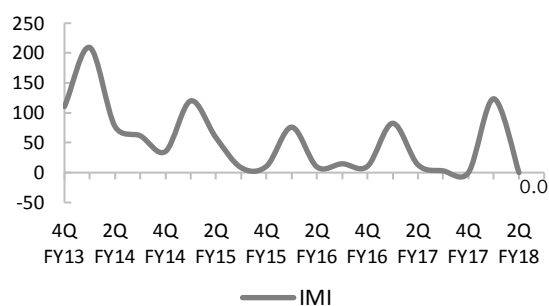


<sup>9</sup> Simple average of three spot prices, namely, Dated Brent, West Texas Intermediate and Dubai Fateh.

## 9. Index of macro imbalance (IMI): The economy achieved near full macro balance in 2QFY18

- ▶ The IMI is obtained by adding the percentage deviation of inflation rate (based on new CPI 2011–12=100), fiscal deficit (as a percentage of GDP) and current account deficit (as a percentage of GDP) from their respective benchmarks of 4% of GDP, 3% of GDP and 1.3% of GDP<sup>10</sup>. All three components of IMI have been given equal weightage (33.33%). The state of “balance” is judged by a value of “0.”
- ▶ An index value > 0 indicates the presence of an 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 the negative and positive deviations across indices are not canceled out.
- ▶ Quarterly y-o-y change in the IMI fell sharply in 2QFY18 as compared to 2QFY17, indicating a near full macro balance (Chart 26). All the three components of IMI – namely, CPI inflation (3.0%), the Center’s fiscal deficit (1.4% of GDP) and current account deficit (1.2% of GDP) – remained below their respective benchmarks during 2QFY18.

**Chart 26: IMI (Quarterly)**



Source (Basic data): RBI, MOSPI and EY estimate.

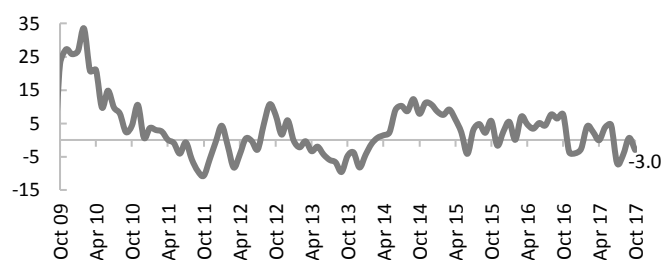
With all the three components of IMI close to their respective benchmarks, the economy moved to a near full macro balance for the second time since 4QFY12. However, rising CPI inflation may pose a challenge to India’s macro balance in 3QFY18.

## 10. Index of aggregate demand (IAD): Contracted in October 2017

Growth in the IAD contracted in October owing to unfavorable base effect and subdued demand conditions in the manufacturing and agricultural sectors.

- ▶ The IAD contracted by (-) 3.0% in October 2017 as compared to a growth of 0.6% in September (Chart 27). The decline was partly due to unfavorable base effect while lower demand in the manufacturing and agricultural sectors added to this contraction. However, demand conditions in the services sector improved during the month.

**Chart 27: Growth in the IAD (y-o-y)**



Source (Basic data): RBI, MOSPI and EY estimate.

<sup>10</sup> Rangarajan, C (2016): “Can India grow at 8 to 9 per cent?” The Hindu, <http://www.thehindu.com/opinion/lead/can-india-grow-at-8-to-9-per-cent/article8596824.ece>. Accessed on 17 May 2016.

## 11. Capturing macro-fiscal trends: Data appendix

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

Fiscal year/quarter/month	IIP	Mining	Manufacturing	Electricity	Core IIP	Fiscal year/quarter/month	PMI mfg.	PMI ser.
	% change y-o-y							
FY14	3.3	-0.2	3.6	6.0	2.6	FY14	50.5	48.5
FY15	4.0	-1.3	3.8	14.8	4.9	FY15	52.2	51.7
FY16	3.3	4.3	2.9	5.7	3.0	FY16	51.3	51.7
FY17	4.6	5.3	4.3	5.8	4.8	FY17	51.6	51.0
3QFY17	3.8	6.7	3.1	6.1	5.3	3QFY17	52.1	49.3
4QFY17	3.1	7.9	2.2	4.3	3.1	4QFY17	51.2	50.2
1QFY18	1.9	1.1	1.6	5.3	2.5	1QFY18	51.7	51.8
2QFY18	3.2	7.1	2.4	6.1	4.0	2QFY18	50.1	48.0
Jul-17	1.0	4.5	-0.1	6.6	2.9	Aug-17	51.2	47.5
Aug-17	4.5	9.2	3.4	8.3	4.4	Sep-17	51.2	50.7
Sep-17	4.1	7.8	3.8	3.4	4.7	Oct-17	50.3	51.7
Oct-17	2.2	0.2	2.5	3.2	4.7	Nov-17	52.6	48.5

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 Price Index	Fuel and light	Core CPI	WPI	Food Price Index	Mfg. products	Fuel and power	Core WPI
	% change y-o-y								
FY14	9.4	12.1	7.7	7.2	5.2	9.6	3.0	7.1	2.7
FY15	5.9	6.4	4.2	5.6	1.3	4.3	2.6	-6.1	2.7
FY16	4.9	4.9	5.3	4.6	-3.7	1.2	-1.8	-19.7	-1.8
FY17	4.5	4.2	3.3	4.8	1.7	5.9	1.3	-0.3	-0.1
3QFY17	3.7	2.2	3.2	5.0	1.7	4.8	1.9	1.7	0.4
4QFY17	3.6	1.5	4.2	4.9	5.0	4.7	3.3	21.3	2.1
1QFY18	2.2	-0.9	5.3	4.2	2.3	0.5	2.7	11.2	2.3
2QFY18	2.9	1.0	4.7	4.0	2.6	2.9	2.4	7.8	2.5
Aug-17	3.3	1.5	5.0	4.4	3.2	4.5	2.4	9.9	2.4
Sep-17	3.3	1.2	5.6	4.6	3.1	2.0	3.0	10.5	3.2
Oct-17	3.6	1.9	6.4	4.5	3.6	3.3	2.6	10.5	2.9
Nov-17	4.9	4.4	7.9	4.8	3.9	4.1	2.6	8.8	3.0

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
<b>FY15</b>	9.3	8.7	8.7	9.2	11.6	8.6	4.0	2.9
<b>FY16</b>	17.0	6.0	8.5	11.9	51.9	25.8	3.9	2.5
<b>FY17</b>	17.9	6.7	21.5	7.4	32.7	20.4	3.5	2.0
<b>FY18 (BE)</b>	12.2	9.1	24.9	12.9	5.0	11.1	3.2	1.9
Cumulated growth (% y-o-y)							% of budget target	
<b>Feb-17</b>	17.6	3.5	20.9	5.2	40.3	21.3	113.4 (RE)	142.8 (RE)
<b>Mar-17</b>	17.9	6.7	21.5	7.4	32.7	20.4	100.1 (RE)	99.1 (RE)
<b>Apr-17</b>	33.0	322.4	8.0	16.5	429.1	14.3	37.6	55.5
<b>May-17</b>	25.0	2068.2	11.4	17.6	15.9	10.2	68.3	100.7
<b>Jun-17</b>	15.2	24.3	10.6	15.0	7.3	20.4	80.8	119.3
<b>Jul-17</b>	17.1	24.2	18.8	31.7*	-0.6	14.3	92.4	131.5
<b>Aug-17</b>	20.0	15.5	13.3	-	-	-	96.1	133.9
<b>Sep-17</b>	19.9	11.3	16.4	-	-	-	91.3	118
<b>Oct-17</b>	18.9	11.8	16.2	-	-	-	96.1	124.7

\*Collections under customs in July FY18 include INR21,377 crore on account of IGST on imports/exports and compensation cess on imports/exports amounting to INR609 crore for 2017-18.

Month	Direct taxes*	Indirect taxes**	CGST	UTGST	IGST	GST compensation cess	Total GST
	% change y-o-y		INR crore				
<b>Jul-17</b>	21.1	13.9	-	-	34	-	34
<b>Aug-17</b>	14.2	23.6	15,253	-	70,918	7,749	93,920
<b>Sep-17</b>	13.5	23.0	15,135	-	30,395	8024	53,554
<b>Oct-17</b>	13.8	21.1	31,187	21	18,370	8031	57,609

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

\*Includes corporation tax and income tax \*\*Includes customs duty, excise duty, service tax, CGST, UTGST, IGST and GST compensation cess.

**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
<b>FY14</b>	8.00	<b>FY14</b>	8.5	13.4	14.9	14.2	8.4	21.6	4.8	304.2
<b>FY15</b>	7.50	<b>FY15</b>	11.3	10.9	11.0	12.1	8.3	31.3	42.2	341.6
<b>FY16</b>	6.75	<b>FY16</b>	13.5	10.1	9.7	10.5	7.7	36.0	-4.1	355.6
<b>FY17</b>	6.25	<b>FY17</b>	3.6	10.6	8.0	11.7	7.0	35.6	7.6	370.0
<b>May-17</b>	6.25	<b>3QFY17</b>	-18.9	6.2	6.5	13.2	6.6	9.7	-11.3	360.3
<b>Jun-17</b>	6.25	<b>4QFY17</b>	3.1	10.1	5.8	13.6	7.0	5.0	10.8	370.0
<b>Jul-17</b>	6.25	<b>1QFY18</b>	1.3	7.0	5.1	10.6	7.0	7.2	12.5	386.5
<b>Aug-17</b>	6.00	<b>2QFY18</b>	1.6	5.6	6.1	9.3	6.6	13.6	2.1	399.7
<b>Sep-17</b>	6.00	<b>Jul-17</b>	1.5	6.7	5.8	9.9	6.6	4.0	3.2	392.9
<b>Oct-17</b>	6.00	<b>Aug-17</b>	1.7	6.7	6.0	9.8	6.6	8.6	0.6	394.6
<b>Nov-17</b>	6.00	<b>Sep-17</b>	1.6	5.6	6.5	8.2	6.7	1.1	-1.7	399.7
<b>Dec-17</b>	6.00	<b>Oct-17</b>	2.7	6.5	7.1	9.2	6.9	1.6	2.8	398.8

Source: Database on Indian Economy-RBI.

**Table A5: External trade and global growth**

Fiscal year/quarter/month	External trade indicators (annual, quarterly and monthly growth rates)						Global growth (annual)			
	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\$/bbl	US\$/mt		% change y-o-y		
<b>FY14</b>	4.7	-8.3	-135.8	60.5	103.7	76.1	<b>2011</b>	4.2	1.7	6.3
<b>FY15</b>	-1.3	-0.5	-137.7	61.1	83.2	65.9	<b>2012</b>	3.5	1.2	5.3
<b>FY16</b>	-15.5	-15.0	-117.7	65.5	46.0	52.7	<b>2013</b>	3.3	1.2	5.0
<b>FY17</b>	5.0	0.0	-105.6	67.1	47.9	70.4	<b>2014</b>	3.4	1.9	4.6
<b>3QFY17</b>	6.0	6.1	-33.5	67.4	49.1	87.7	<b>2015</b>	3.4	2.1	4.3
<b>4QFY17</b>	16.8	25.6	-29.2	67.0	52.9	79.8	<b>2016</b>	3.2	1.7	4.3
<b>1QFY18</b>	10.6	32.8	-40.1	64.5	49.4	75.3	<b>2017*</b>	3.6	2.2	4.6
<b>2QFY18</b>	13.4	19.1	-32.1	64.3	50.2	85.9	<b>2018*</b>	3.7	2.0	4.9
<b>Aug-17</b>	10.7	21.5	-11.6	64.0	49.9	86.5	<b>2019*</b>	3.7	1.8	5.0
<b>Sep-17</b>	25.1	20.4	-9.0	64.4	53.0	88.4	<b>2020*</b>	3.7	1.7	5.0
<b>Oct-17</b>	-1.1	7.6	-14.0	65.1	54.9	88.8	<b>2021*</b>	3.8	1.7	5.1
<b>Nov-17</b>	30.5	19.6	-13.8	64.9	59.9	89.1	<b>2022*</b>	3.8	1.7	5.0

Source: Database on Indian Economy- RBI, Pink Sheet-World Bank and IMF World Economic Outlook October 2017; \*Forecasted data.





## List of abbreviations

Sr. no.	Abbreviations	Description
1	AD	Aggregate demand
2	bbl.	Barrel
3	CAB	Current account balance
4	CGA	Comptroller General of Accounts
5	CGST	Central Goods and Services Tax
6	CPI	Consumer Price Index
7	CSO	Central Statistical Organization
8	Disc.	Discrepancies
9	EMEs	Emerging market economies
10	EXP	Exports
11	FC	Finance Commission
12	FII	Foreign investment inflows
13	FPI	Foreign portfolio investment
14	FY	Fiscal year (April–March)
15	GDP	Gross domestic product
16	GFCE	Government final consumption expenditure
17	GFCF	Gross fixed capital formation
18	Gol	Government of India
19	GST	Goods and Services Tax
20	GVA	Gross value added
21	IAD	Index of aggregate demand
22	IEA	International Energy Agency
23	IGST	Integrated Goods and Services Tax
24	IIP	Index of Industrial Production
25	IMF	International Monetary Fund
26	IMP	Imports
27	IPD	Implicit price deflator
28	LAF	Liquidity adjustment facility
29	MCLR	Marginal cost of funds based lending rate
30	m-o-m	Month-on-month
31	mt	Metric tonne
32	MPC	Monetary Policy Committee
33	NDU	Non-departmental undertaking
34	NEXP	Net exports (exports minus imports of goods and services)
35	OECD	Organisation for Economic Co-operation and Development
36	PFCE	Private final consumption expenditure
37	PMI	Purchasing Managers' Index (reference value = 50)
38	PSU	Public sector undertaking
39	ToR	Terms of Reference
40	UTGST	Union Territory Goods and Services Tax
41	WPI	Wholesale Price Index
42	y-o-y	Year on year



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