November 2016

Economy Watch

Monitoring India's macro-fiscal performance

Building a better working world

Contents

List of abbreviations:

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

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Foreword: demonetization and its aftermath

November's economic news was dominated by demonetization of high-currency notes. With the sudden announcement of demonetization on 8 November 2016, about INR15, 240 billion worth of high-denomination notes became illegal. Its first impact was a sudden shortage of cash due to the imbalance between the volume of demonetized currency and the rate at which it is being re-monetized. Although this cash crunch is easing by the day, only 26.2% of the demonetized currency stood re-monetized as of 8 December 2016 (RBI Monetary Policy Press Meet 7 December 2016) as compared to 16.4% as of 27 November 2016. This gap has remained sharp, and its bite is likely to remain until the end of January 2017. The contractionary effect of this cash crunch would significantly affect 3Q and 4Q growth outcomes.

The adverse impact is the largest in sectors with relatively large shares of the unorganized sector, which is heavily dependent on cash transactions. Available information on the services and manufacturing sectors captured through PMI indicates a significant contraction in services and an easing of growth in manufacturing during November.

Most analysts are predicting a fall in their pre-demonetization GDP growth estimates for FY17, although the margins of these falls reflect considerable variations. The RBI, in its 7 December Monetary Policy Review, reduced its FY17 GDP growth forecast from 7.6% to 7.1%. Other analysts estimate it to be below 7%.

Demonetization can be considered a success only if it (a) leaves a positive long-term effect on the potential GDP growth and (b) makes a significant dent on the size of India's black economy. In both cases, demonetization by itself may not prove to be enough and would require strong supplementary policies. However, it is expected to improve productivity in the economy because of the drive toward higher digitization of the economy, which will also improve the tax-GDP ratio. Increased transparency in economic activities and an increased tax base will uplift long-term potential growth.

For a tangible dent on the black economy, supplementary policy interventions should include reduction in stamp duty rates, reduction and simplification of tax rates and tax codes relating to both direct and indirect taxes, effective and transparent provisions for financing of elections and an effective penalty regime for proven cases of black money generation. Exchange of information between India and the countries that serve as tax havens and complete abolition of "benami" property registration would provide sharper teeth to combat the menace of black money.

One unanticipated effect of demonetization has been that the amicability with which GST Council meetings were held appears to be waning. With states hardening their stance, implementation of GST may well be pushed to September 2017.

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

Highlights of November

1. **The RBI, in its December Monetary Policy Meet, has left the repo rate unchanged at 6.25%** in view of heightened uncertainty, both in global and domestic economic conditions, belying market expectation of a 25 bps cut.
2. **Real GDP growth in 2QFY17 showed marginal improvement at 7.3%** from 7.1% in 1QFY17, while **GVA growth moved in the opposite direction**, falling to 7.1% from 7.3% in the first quarter.
3. **Demand conditions signal weakness due to weak investment demand and near-stagnant export demand in 2QFY17.** The contractionary effect has been further exacerbated by demonetization. **The RBI has revised its FY17 GDP growth projection from 7.6% to 7.1%.**
4. **Services PMI, at a 3-year low, has reflected a significant fall, going below the threshold level of 50** in November. Manufacturing PMI has also fallen, although it has remained above 50.
5. Contractionary forces have led to a fall in **CPI inflation, which, at 4.2%, was at a 14-month low in October 2016**.
6. However, **global crude prices** and other commodity prices have started **firming up,** leading to potential upward pressure on CPI.
7. **The Center's gross tax revenues grew by 18% during April–October FY17.** In the latter half of the fiscal year, additional tax buoyancy may be seen due to demonetization-linked changes in the IT Act providing for higher and penal tax rates in view of implausible surges in Jan-Dhan and other bank deposits.
8. **Success of demonetization in curbing the black economy would depend on strong supplementary policies** aimed at (a) supporting growth and (b) combating the generation of black money**.**
9. On the monetary side, **growth in bank credit increased to 13.3% in September 2016.** After demonetization, bank deposits have suddenly surged and credit creation may further be accelerated if interest rates are brought down.

1 **Growth:** persistent weakness in investment demand

A. GDP growth

- India's real GDP grew by 7.3% in 2QFY17, improving from 7.1% in the 1QFY17. However, it was lower than the growth of 7.6% seen during 2QFY16 (Table 1). Some key features of the latest GDP release are as follows:
  - First, growth in PFCE increased to 7.6% in 2QFY17 from 6.7% in 1QFY17.
  - Second, GFCE grew by 15.2%, lower than 18.8% in 1QFY17. A large part of this growth is attributed to the implementation of the recommendations of the Seventh Pay Commission.
  - Third, GFCF, reflecting investment demand in the economy, contracted further from (-) 3.1% in 1QFY17 to (-) 5.6% in 2QFY17, registering its third consecutive quarterly decline. Real investment rate in fixed assets fell to 32.7% in 2QFY17.
  - Fourth, growth in export demand nearly stagnated at 0.3% in 2QFY17 as compared to a growth of 3.2% in 1QFY17, while import growth contracted at a faster pace of (-) 9.0% in 2QFY17, compared to (-) 5.8% in the previous quarter.
  - Fifth, discrepancies still accounted for a relatively significant portion of GDP in 2QFY17. GDP growth in 2QFY17 would have been significantly lower at 5.8% but for the contribution of 1.5 percentage points made by the discrepancies.

Table 1: real GDP growth (%)

AD component	1Q FY16	2Q FY16	3Q FY16	4Q FY16	1Q FY17	2Q FY17
PFCE	6.9	6.3	8.2	8.3	6.7	7.6
GCE	-0.2	3.3	3.0	2.9	18.8	15.2
GFCF	7.1	9.7	1.2	-1.9	-3.1	-5.6
EXP	-5.7	-4.3	-8.9	-1.9	3.2	0.3
IMP	-2.4	-0.6	-6.4	-1.6	-5.8	-9.0
GDP	7.5	7.6	7.2	7.9	7.1	7.3
Of which						
% contribution of Discrepancies	2.0	1.2	2.1	4.1	0.9	1.5

Source: (Basic data) MOSPI

Table 2: sectoral real GVA growth (%)

Sector	1Q FY16	2Q FY16	3Q FY16	4Q FY16	1Q FY17	2Q FY17
Agr	2.5	2.0	-1.0	2.3	1.8	3.3
Ming.	8.5	5.0	7.1	8.6	-0.4	-1.5
Mfg.	7.3	9.2	11.5	9.3	9.1	7.1
Elec.	4.0	7.5	5.6	9.3	9.4	3.5
Cons.	5.6	0.8	4.6	4.5	1.5	3.5
Trans.	10.0	6.7	9.2	9.9	8.1	7.1
Fin.	9.3	11.9	10.5	9.1	9.4	8.2
Publ.	5.9	6.9	7.2	6.4	12.3	12.5
GVA	**7.2**	**7.3**	**6.9**	**7.4**	**7.3**	**7.1**

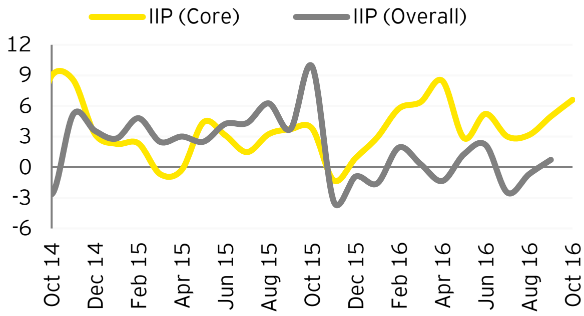
Source: (Basic data) MOSPI

- Examining the output side of GDP, with the exception of agriculture, construction and public services, there was an across-the-board reduction in the growth rates in 2QFY17 as compared to 1QFY17. Growth in the overall GVA in real terms fell from 7.3% in 1QFY17 to 7.1% in 2QFY17 (Table 2). Weakness in the overall output is reflective of a fall in demand, particularly investment and export demand.
- The fall in the growth of manufacturing, electricity and services GVA is particularly disappointing. Growth of manufacturing GVA fell from 9.1% in 1QFY17 to 7.1% in 2QFY17, while that of the electricity sector fell from 9.4% to 3.5%.
- Among services, trade, hotel, communication and other services grew at a slower pace of 7.1% in 2QFY17 (8.1% in 1QFY17) and growth in financial, real estate and professional services moderated to 8.2% in 2QFY17 (9.4% in 1QFY17).
- Sectors that showed minor improvements include agriculture (3.3% in 2QFY17 vis-à-vis 1.8% in 1QFY17), construction (3.5% vis-à-vis 1.5%) and public administration (12.5% vis-à-vis 12.3%).

B. Industrial growth: overall IIP recovers but at a slower pace

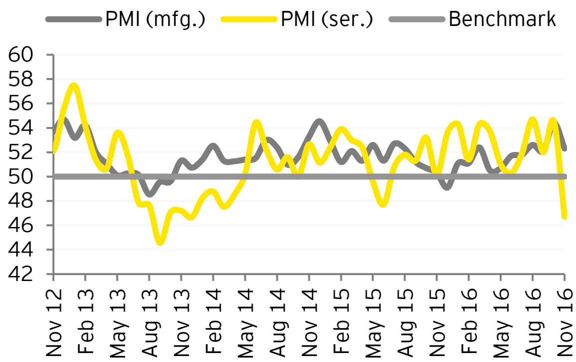
- After contracting for two consecutive months, growth in industrial production, as measured by IIP turned positive in September 2016 (Chart 1), at 0.7% (y-o-y), but was still weak. Growth in both manufacturing (0.9%) and electricity (2.4%) improved, while the output of the mining sector contracted by 3.1% during the month. During 1HFY17, IIP had contracted by (-) 0.1%, which was the lowest since FY07 (growth in IIP was at 4.0% in 1HFY16).
- As per use-based industrial classification, growth of the capital goods industry contracted for 11 straight months to (-) 21.6% (y-o-y) in September 2016 ((-) 22.1% in August 2016). Contraction in the capital goods industry reflects slackness in investment demand in the economy. Growth in the consumer goods industry improved to 6% in September 2016 from just 0.7% in August 2016.
- Output of eight core infrastructure industries rose to a six-month high of 6.6% (y-o-y) in October 2016 from 5.0% in September 2016. This pickup in core sector output was driven by higher growth in the output of steel (16.9%), petroleum refinery (15.1%), cement (6.2%) and electricity (2.8%), which together account for over 66% 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

After decelerating for two successive months, industrial output grew by 0.7% in September 2016 led by an improvement in the output of the manufacturing and electricity sectors. However, capital the goods industry continued its contractionary trend, reflecting weakness in investment demand.

C. PMI: cash crunch causes a slowdown in manufacturing and services

Recent demonetization of high-value banknotes adversely affected private sector activity in both the manufacturing and services sectors in November 2016. However, the disruption is expected to be short-lived.

- Headline manufacturing PMI (sa) expanded for the 11th consecutive month in November 2016 (Chart 2). However, it came down from the 22-month high of 54.4 in October 2016 to 52.3 in November 2016. This slow rate of expansion could be attributed to the cash crunch caused by the recent demonetization of high-value banknotes, leading to a significant slowdown in the growth of new orders and output during the month.
- Headline services PMI (sa) decreased from 54.5 in October 2016 to 46.7 in November 2016, contracting for the first time since June 2015 and pointing toward the sharpest reduction in almost three years. Activity decreased in three of the six monitored sub-sectors, namely, financial intermediation, hotels and restaurants, and renting and business activities.
- Composite PMI Output Index (sa) decreased from the 45-month high of 55.4 in October 2016 to 49.1 in November 2016.

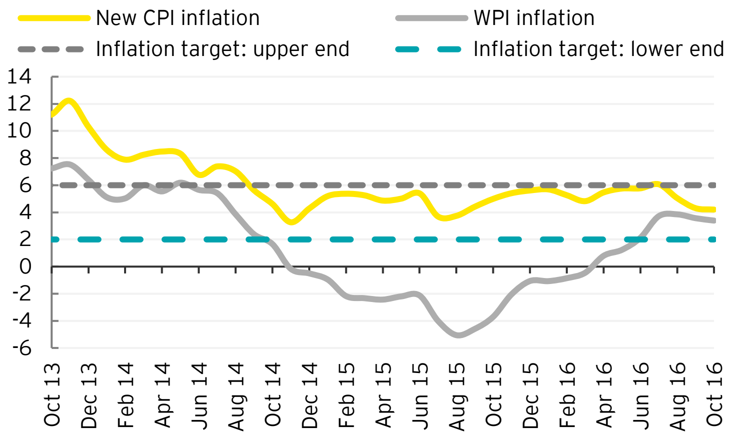
2 **Inflation:** declining food prices push CPI inflation to a 14-month low

Annual CPI inflation declined further to a 14-month low of 4.2% in October 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 4.2% in October 2016 as compared to 4.3% in September 2016.
- Core CPI inflation (excluding food and fuel) remained stagnant for the third consecutive month at 3.5% (y-o-y) in October 2016.
- CPI-based consumer food inflation has been on a declining trend for four months. It further declined from 3.9% in September 2016 to 3.3% in October 2016.
- Fuel and lighting inflation was at a four-year low of 2.5% (y-o-y) in August 2016. It increased to 3.1% in September 2016 but subsequently declined to 2.8% in October 2016.
- According to the RBI, the impact of demonetization could result in a temporary reduction in inflation of the order of 10–15 basis points in 3QFY17.

Although CPI Inflation in October 2016 was 4.2%, the RBI expects it to increase to 5% in 4QFY17 because of increased global crude prices and domestic food prices.

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



Source: Ministry Of Statistics and Programme Implementation (MOSPI)

WPI-based inflation declined marginally to 3.4% in October 2016 from 3.6% (y-o-y) in September 2016 because of a decline in the prices of agricultural items, including food and non-food articles.

- WPI inflation for primary articles fell sharply to 3.3% in October 2016 from 4.8% in September 2016. WPI inflation in food and non-food articles substantially declined from their respective two-year peaks of 12.6% and 9.5% in July 2016 to 4.3% and 1.1%, respectively, in October 2016.
- WPI inflation for fuel and power increased to 6.2% in October 2016. Inflation in diesel prices reached a 37-month high of 19.3% in October 2016 as compared to 19.1% in the previous month.
- After contracting for 16 months, WPI core inflation remained positive and increased for the fourth successive month at 1% in October 2016, as compared to 0.6% in September 2016.
- WPI and CPI inflation rates now appear to be converging.

3 Fiscal performance: cumulated fiscal deficit reduces to 79% of annual budgeted target by October 2016

A. Tax and non-tax revenues

The Center's gross tax revenues grew by 18% during April–October FY17, driven by robust growth in revenues from income tax, Union excise duties and service tax. Non-tax revenues registered a growth of 3.7% during this period.

- The Center's revenue receipts during April–October FY17 were lower at 50.7% of the annual budgeted target as compared to 51.7% during the same period of FY16.
- Cumulated gross tax revenues grew by 18% during April–October FY17, compared to 23.1% during the corresponding period of FY16 (Chart 4). Direct taxes grew by 10.7% during April–October FY17 as compared to 14.2% during the same period of FY16. Growth in indirect taxes was also lower at 24.6% during this period as compared to the corresponding value of 33.1% in FY16.
- Income tax revenues grew by 19.3% during April–October FY17 (Chart5) as compared to 14% during the same period of FY16, while growth in corporation tax revenues was much lower at 4.5% during April–October FY17 as compared to the corresponding value of 14.4% in FY16.
- Direct tax refunds during April–October FY17 were 32.2% higher than those issued during the corresponding period last year.
- Among the indirect taxes, Union excise duties witnessed a strong growth of 46.4% during April–October FY17. Growth in service tax revenues was also higher at 24.5% during April–October FY17 as compared to the corresponding value of 23.5% in FY16.
- However, growth in customs duties remained subdued at 4.9% during April–October FY17 as compared to 17.1% during the same period in FY16.

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

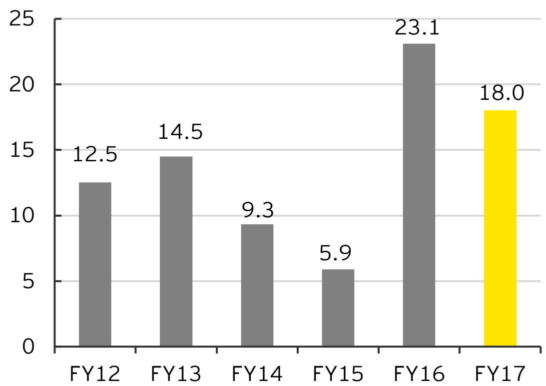
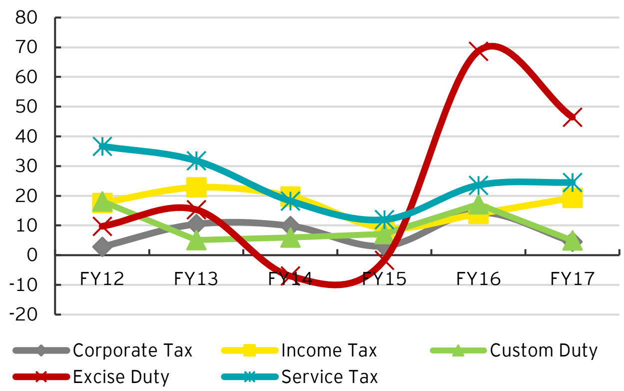


Chart 5: growth in cumulated tax revenues up to October 2016



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

- After contracting for six consecutive months, non-tax revenues finally registered a growth of 3.7 % during April–October FY17. However, it was much lower than the growth of 45.6% seen in the corresponding period of FY16. As a percentage of the annual budgeted target, non-tax revenues were at 52% during April–October FY17 as compared to 73% in FY16.

B. Expenditures: revenue and capital

- Total expenditure grew by 12.6% during April–October FY17 as compared to the corresponding value of 6.2% in FY16.
- Growth in revenue expenditure increased to 16.8% during April–October FY17 as compared to 3% during the same period in FY16 (Chart 6).

- The Center's capital expenditure, after experiencing a growth of 5.3% in the first half of FY17 (Chart 7), contracted by (-) 12.8% during April–October.

The Center's revenue expenditure grew by 16.8% during April–October FY17 due to increased salary and pension payments by the Government. Cumulated capital expenditure contracted sharply by (-) 12.8% during April–October FY17.

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

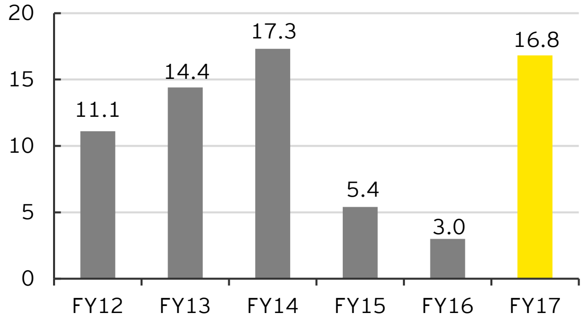
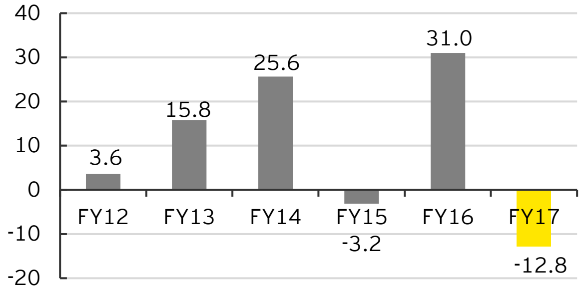


Chart 7: growth in cumulated capital expenditure up to October 2016



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

C. Fiscal imbalance

- The Center's fiscal deficit stood at 79.3% of the annual budgeted target during April–October FY17, which is an improvement over 83.9% up till September. This was largely due to an increase in non-tax revenues and proceeds from disinvestment. However, the fiscal situation during April–October FY17 remained weak as compared to the corresponding period of FY16 (Chart 8).
- There was a significant increase in the proceeds from disinvestment of the Government's equity holdings in October 2016. Disinvestment proceeds stood at 59.5% of the annual budgeted target during April–October FY17 as compared to 31.2% in the corresponding period of FY16. As a result, non-debt capital receipts grew by 49.5% during April–October FY17.
- The Center's revenue deficit increased to 92.6% of the annual budgeted target during April–October FY17 as compared to 72.9% during the same period in FY16 (Chart 9).

The Center's fiscal deficit amounted to 79.3% of the annual budget estimate during April–September FY17, while the revenue deficit in this period increased to 92.6%.

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

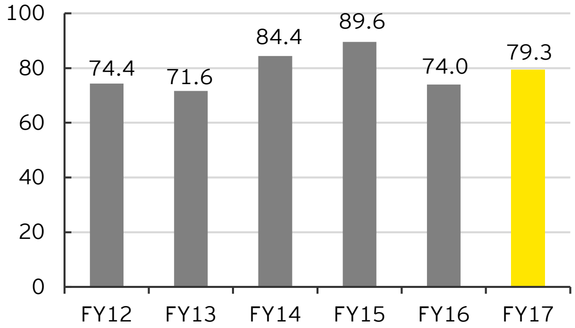
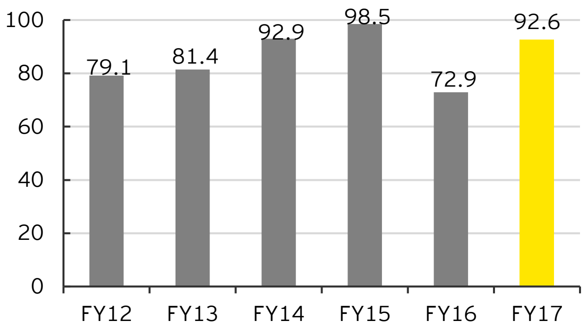


Chart 9: cumulated revenue deficit up to Oct 2016 as a % of annual budgeted estimates for FY17



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

4 **In focus:** dissecting demonetization — balancing losses and gains

India's November 8 demonetization has evoked strong reactions from both protractors and detractors. A short-term contractionary effect seems beyond dispute. The RBI, in its Monetary Policy Review, pared its FY17 GDP growth estimate from 7.6% to 7.1%. The policy issue is how to realize potential long-term gains and ensure that they more than make up for the short-term losses. Much will depend on the follow-up policies.

Re-monetization rigidities

While demonetization happened in one stroke, re-monetization has been a far slower process because of constraints on the RBI's capacity to print and supply new currency notes. This has created an imbalance in the rate at which the demonetized notes are being brought into the banks and that at which they are getting re-monetized. This imbalance has resulted in a severe cash crunch accompanied by a huge surge in additional deposits with banks. According to data released by the RBI and our estimates, the picture as on 27 November 2016 was that of the INR15, 241 billion worth of the demonetized high-denomination notes, 55.4% had come back into banking and the new cash system: only 16.4% (in value terms) had been remonetized, while 39% remained as net additional deposits with the banks. As per information given on 7 December 2016, about 78% of the demonetized money has already come back into the system. We expect that in the next few weeks, the cumulative percentage of re-monetization will significantly increase. Alongside, the cumulative share of additional bank deposits will reach a peak and start falling.

Chart 10: cumulative re-monetization (withdrawal and exchange) as a % of value of demonetized currency

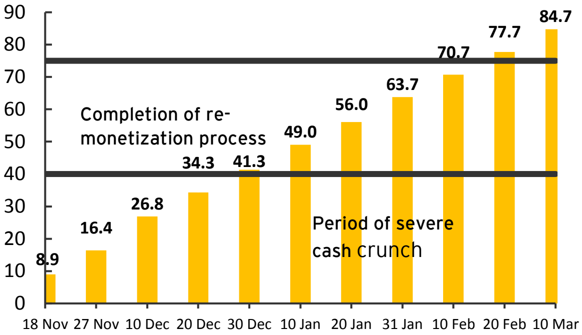
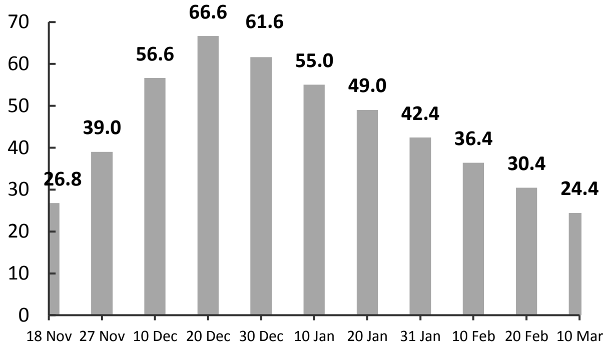


Chart 11: cumulative net additional deposits as a % of value of demonetized currency



Source: Estimates based on available information; Ratios are indicative only

Chart 10 shows the expected progressive increase in re-monetization as a percentage of the value of demonetized currency. Given the current trends, by the end of December 2016, about 40% of the demonetized currency would have been re-monetized. By 20 February 2017, the cumulative coverage would be close to 75%. We expect that further re-monetization may not be needed. Instead, there would be a net increase in the deposits held with the banks. Chart 11 shows that initially, net addition to bank deposits as a percentage of demonetized currency would rise fast, reaching a peak at about 65%, and then decline to about 25%.

Table 3: managing demonetized currency in five buckets

At the time of demonetization		After re-monetization is completed			Amounts (INR billion)
Black money	20%	A	Currency extinguished	10%	1,524
		B	Currency re-whitened but kept in bank deposits	5%	762
		C	Currency re-whitened and re-monetized	5%	762
White money	80%	D	Additional deposits with banks	20%	3,048
		E	Share re-monetized	60%	9,144
Total currency demonetized	100%	F	Total currency extinguished, deposited or re-monetized	100%	15,240
Total re-monetized money after Government accesses the equivalent of extinguished money through rebalancing of the RBI's assets and liabilities (A+C+E)					75%
Additional bank deposits (B+D)					25%

Source: Estimates based on available information; Ratios are indicative only

For the purpose of analysis, the demonetized money can be arranged in five buckets as shown in Table 3: (A) share of currency extinguished (10%), (B) currency re-whitened but kept in bank deposits (5%), (C) currency re-whitened and re-monetized (5%), (D) additional deposits with banks (20%) and (E) share of white money brought to banks for re-monetization (60%). Items (A), (B) and (C) constitute the original black money. These add up to 20%. Items (D) and (E) constitute white money, amounting to 80% of the demonetized money. The indicated shares are broad assessments as the available information is limited.

Rebalancing the RBI's assets and liabilities

The critical question is this: If less than 100% of the demonetized currency is re-monetized, what would be the impact on the money supply? We consider two scenarios: (a) 65% of the demonetized currency is re-monetized, 10% is extinguished and the balance ends up as additional bank deposits and (b) 75% of the demonetized currency is re-monetized by bringing back the extinguished money through rebalancing of the RBI's assets and liabilities and net additional deposits remain as in case (a). The RBI's liabilities consist of notes issued, deposits and other liabilities. Its assets primarily include foreign currency assets, gold coins and bullion, and rupee securities and Treasury bills of the Government. Since on the liability side a portion of the issued notes will be extinguished, it may reduce the RBI's liabilities. We expect, based on current trends, that no more than 10% of the demonetized money (amounting to about INR1, 524 billion) will be extinguished. This amounts to just 1% of GDP.

Table 4: the RBI's assets and liabilities (INR billion) – after demonetization, assuming no changes in notes in circulation and deposits

Liabilities		Assets	
Notes issued	13,072.5	Foreign currency assets	23,193.0
Deposits	8,961.0	Gold coin and bullion	1,367.9
Other liabilities	9,254.9	Rupee securities including Treasury bills	7,563.1
		Loans and advances	555.5
		Bills purchased and discounted	0.0
		Other assets	109.6
		Investment	23.2
Total liabilities	31,288.4	Total assets	32,812.5
		Excess assets	1,524.1
		FY17 GDP	1,50,650.1
		Excess assets as a % of GDP	1.0

Source (Basic Data): RBI and EY Estimates (As on 11 November 2016)

The mechanism by which the Central Government can access this resource is still to be worked out. Some analysts have suggested that this can be given by the RBI as special dividends. There are also doubts on whether there would be any scope of such a fiscal windfall if almost all of the demonetized notes are deposited back.

The demand for currency might be fully met by about 75% of the currency in circulation at the time of demonetization. A suitable increase in the deposit to currency multiplier (ratio of total deposit to currency held with public) or equivalently a fall in the demand for currency relative to money supply would be needed to ensure that there is no contraction in money supply. This would be facilitated by a tangible increase in digitization of transactions.

Neutralizing contraction in money supply

There is short-term money supply contraction because of the cash crunch largely in 3QFY17. To counterbalance this, the Government has to undertake some fiscal stimulus measures in 4QFY17. Broad money supply (M3) depends on currency with public (CP), demand and time deposits, and "other deposits" with the RBI. The process of credit creation leads to a link between CP and demand and time deposits through a multiplier. This multiplier is the ratio of demand and time deposits to currency held with public. Whether there is a contraction in money supply in the longer run would depend on three critical factors.

First, what would be the amount of extinguished money as a result of demonetization?

Second, by what margin the demand for currency as a percentage of M3 would fall after re-monetization? Or, equivalently, by what margin the CP to M3 multiplier would increase as a result of digitization?

Third, what is the extent of increase in bank deposits as a consequence of demonetization?

Without intervention, money supply may contract and GDP may fall even in the long run. This should be neutralized by a combination of suitable initiatives. First, fiscal stimulus could be provided to an extent equivalent to extinguished money. Second, additional stimulus should be provided by using additional tax revenues through the Income Declaration Scheme. Third, aggressive digitization can lead to an increase in the deposit to CP ratio. Fourth, taking advantage of higher bank deposits, the repo rate should be reduced and transmitted so that the demand for credit increases. In conclusion, while year-on-year Q3 growth is likely to unavoidably go down, a combination of policy initiatives can make the economy recover part of the ground in 4QFY17 and make us a net gainer in FY18.

Differential sectoral effects

The short-term adverse effect of demonetization would be larger in sectors with relatively higher shares of unorganized activities (Table 5), which tend to be cash-intensive. Agriculture, construction and some of the service sector activities, including trade and transport, may therefore be vulnerable. The PMI data for the month of November has already signaled a contraction in services and a slowdown in manufacturing. With respect to agriculture, available information indicates that acreage under rabi sowing has shown a robust performance. In addition, the third quarter growth would also be affected by other global and domestic macro forces. Investment demand continues to be weak. Although, there is some recovery in export demand, it is still sluggish. Oil prices have also started to firm up. At the same time, some economic activities directly related to demonetization may show increased growth, such as the banking sector and some parts of the transport sector. The digitization drive has led to significant one-time boost in the financial activities relating to digital transactions, such as e-wallets. The net impact of the positive and negative effects may be negative but to a limited extent.

Table 5: share of unorganized sector (%)

#	Sector	Share of unorganized sector (2012–13)	Sectoral share in overall GDP (2015–16)
1	Agriculture, forestry and fishing	**94.7**	17
2	Mining and quarrying	**13.2**	2.6
3	Manufacturing	**28.2**	16.2
4	Electricity, gas, water supply & other utility services	**2.6**	2.6
5	Construction	**60.2**	8.3
6	Trade, hotels, transport, communication and services related to broadcasting	**74.5**	18.6
7	Financial, real estate & professional services	**44.2**	20.6
8	Public administration, defence and other services	**24.2**	14
9	**All sectors**	**55.3**	**100**

Source: MOSPI

Potential growth: supporting initiatives

Demand can be further supplemented by a reduction in the interest rates. This can be facilitated by a surge in bank deposits, implying an increase in financial savings, and the expectation of falling CPI inflation. There is currently a dire need to stimulate demand because of the continued weak demand for Indian exports and the falling investment demand. According to the latest release of GDP data, growth in demand for gross fixed capital formation has been negative in three consecutive quarters and the magnitude of fall has progressively increased. In terms of global factors, the main development that might constrain a reduction in the repo rate is the decision of the US Federal Reserve System (the Fed) on the policy rate. In its December 7 Monetary Policy Review, the RBI abstained from reducing the repo rate. However, this may be a temporary stance in view of uncertainty.

We also expect that the Government will have a net gain of tax revenues because of the revision in the IT Act enabling it to access part of the declared black money brought into the banks through the penal tax rates.

Several policy initiatives are required to counterbalance the potential contractionary effect of demonetization. First, the Government should find a way to finance fiscal stimulus using the extinguished black money. Second, the policy rate should be reduced. Third, aggressive digitization should ensure a fall in the currency to money supply ratio. Associated with demonetization is also an expectation regarding erosion of prices of property and valuables such as gold. This downward price revision would reduce the value of black wealth held in non-currency forms. But since there would also be an erosion of wealth of property owners who acquired property using white money, there would be an adverse wealth effect on demand.

Combating creation of black money: supplementary policies

Demonetization is only one tool for combating the creation of black wealth. It should be supported by supplementary policies. These are as follows:

1. The stamp duty rate may need to be reduced so that the incentive to understate the value of a property is weakened and people do not ask for exchange of black money in settling property deals.
2. The Government should reduce the corporate tax rates to 25% while abolishing various tax exemptions and deductions, thereby also minimizing the scope of discretion of tax officials.
3. Personal income tax rates should be lowered, rationalized and made simpler by abolishing cesses and surcharges.
4. Options for formal financing of political parties for elections may be considered.
5. Supporting policies for formalization and digitization of the economy may result in improved transparency in both government operations and private sector operations. Some initiatives to this effect have already been announced.
6. The construction sector should be brought within the ambit of GST.
7. Exchange of live information with countries that serve as tax havens should be actively pursued.

5 Money and finance: the RBI leaves the policy rate unchanged

A. Monetary sector

i. Monetary policy

- In its December Monetary Policy Meet, the RBI left the repo rate unchanged at 6.25% in view of heightened uncertainty, both in global and domestic economic conditions, belying market expectations of a 25 bps cut.

Chart 12: movements in repo rate

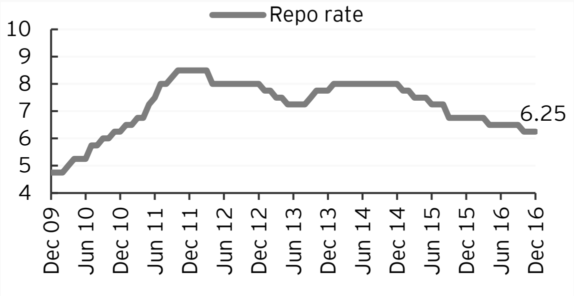
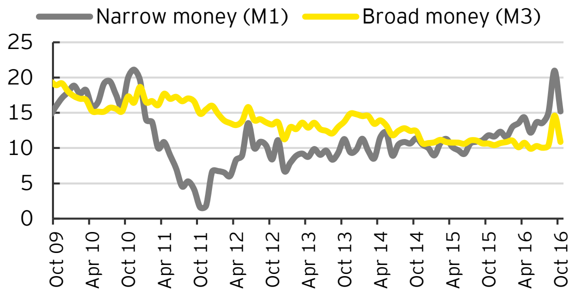


Chart 13: growth in narrow and broad money



Source: Data Base on Indian Economy, RBI

According to the RBI, though inflation in 3QFY17 may decline by 0.10–0.15 basis points because of the impact of demonetization, the outlook for inflation in 4QFY17 remains at 5% with upside risks due to expected firming of crude prices, low base effect, and the Fed's decision on its policy rate.

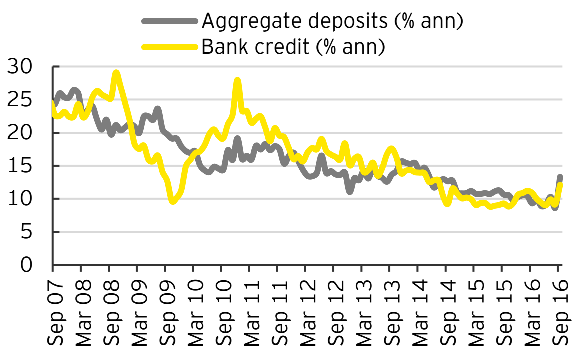
ii. Money stock

- Growth in broad money (M3) moderated to 10.9% (y-o-y) in October from 14.6% in September 2016 (Table A4). Growth in time deposits, accounting for over 76% of broad money stock, fell to 9.7% in October 2016 from 2.9% in September 2016.
- Growth in narrow money stock (M1) fell to 15.2% in October 2016 from 21.0% (revised) in September 2016 (Chart 13). Notwithstanding an improvement in the growth of currency in circulation (17.7%), a sharp moderation in the growth of demand deposits from 29.8% in September 2016 to 11.5% in October 2016 led to a fall in the growth of M1.

iii. Aggregate credit and deposits

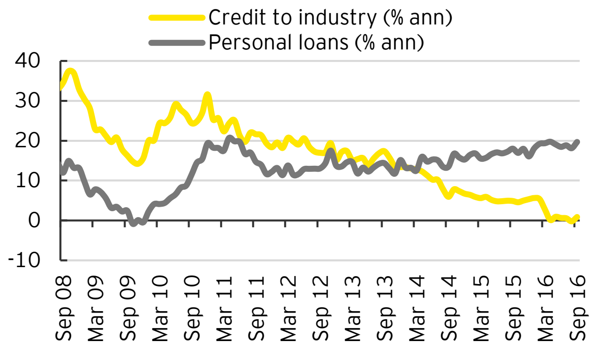
- Growth in bank credit accelerated to a 29-month peak of 13.3% (y-o-y) in September 2016 as compared to 9.6% in August (Chart 14). Growth in non-food credit improved from 9.7% in August to 13.8% in September 2016, while growth in food credit sharply contracted to (-) 16.8% during the month. This improvement in credit off-take appears to be a temporary phenomenon backed by festive demand.
- Growth in retail credit, in particular, personal loans, increased from 18.1% in August to 19.7% in September 2016. Growth in the personal loan segment was driven by a recovery in loans for housing (18.0%) and consumer durables (21.5%). Growth in Industries credit turned positive but remained low at 0.9% in September as compared to a contraction of (-) 0.2% in August 2016 (Chart 15).
- Growth in aggregate bank deposits increased to 13.3% (revised) in September 2016 from 8.7% in August 2016.

Chart 14: growth in credit and deposits



Source: Data Base on Indian Economy, RBI

Chart 15: growth in industrial and personal loans



Source: Data Base on Indian Economy, RBI

B. Financial sector

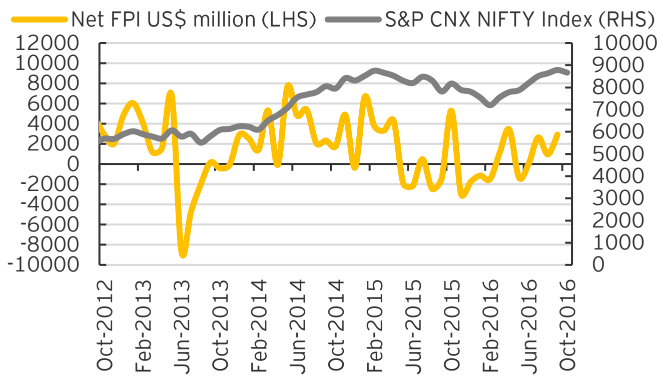
i. Interest rates

- The MCLR was marginally lowered from 8.85% to 8.80% in October 2016.
- Banks lowered the interest rates on term deposits (>1 year) from 7.2% in September to 7.1% (mid-point) in October 2016.
- The average yield on 10-year Government bonds fell further from 6.86% in September to 6.78% in October 2016. Benchmark bond yield remained below the 7% mark for the third consecutive month. Factors that drove down the bond yields include (a) fall in CPI inflation, (b) weak US non-farm payrolls, (c) the RBI's decision to lower the repo rate and (d) availability of adequate liquidity.

ii. FPI and stock market

- Despite the festive season, the performance of India's equity market remained flat during October 2016. In fact, the benchmark S&P NIFTY index fell to 8667 points (average) losing nearly 117 points as compared to the average index value of 8783 in September 2016 (Chart 16). Weak Chinese export data and a higher possibility of a rate hike by the US Fed in December 2016 have outweighed the positive impact of strong growth in automobile sales and repo rate reduction by the RBI on the domestic stock market.

Chart 16: Stock market movement



- As per the provisional data, overall FII increased from US$5.3 billion (revised) in August to US$7.5 billion in September 2016, led by sustained net FDI inflows and higher net FPI inflows. Net FDI inflows rose to US$ 4.6 billion in September (US$4.4 billion in August), while net FPI inflows increased to US$2.9 billion during the month (US$1.0 billion in August).

6 External sector: *pickup in export and import growth*

A. Current account balance

The CAD as a percentage of GDP remained stationary at a nine-year low of (-) 0.1% in 1QFY17 (Table 5, Chart 18). Merchandise trade balance was at a seven-year low of (-) US$23.8 billion in 1QFY17. The current account balance is expected to remain negative and low in 2QFY17 as well.

Table 6: current account balance (US$ billion)

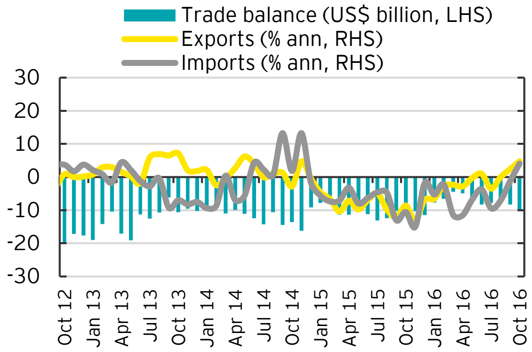
	CAD (- deficit/+surplus) (US$ billion)	CAD as a % of nominal GDP	Goods account net (US$ billion)	Services account net (US$ billion)	Income account net (US$ billion)	Transfers net (US$ billion)
FY13	-88.2	-4.8	-195.7	64.9	-21.5	64.0
FY14	-32.4	-1.7	-147.6	73.0	-23.0	65.3
FY15	-26.8	-1.3	-144.9	76.6	-24.1	65.7
FY16	-22.0	-1.1	-130.1	53.7	-17.8	47.7
2QFY16	-8.6	-1.7	-37.2	17.8	-5.5	16.4
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

Source: Database on Indian Economy, RBI

B. Merchandise trade and exchange rate

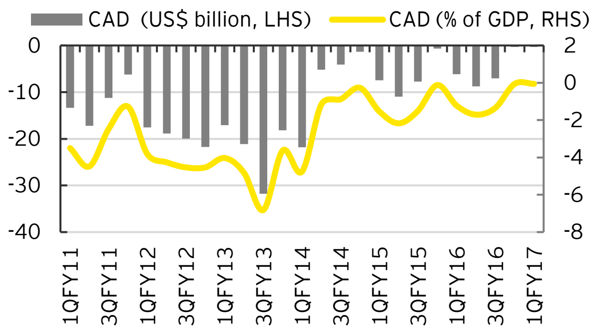
- Merchandise exports grew for the second consecutive month by 9.6% in October 2016 as compared to 4.8% in the previous month. Prior to this, export growth had contracted for 18 consecutive months beginning December 2014 (Chart 17).
- A strong growth of 21.8% was observed in the exports of gems and jewelry in October 2016 as compared to 22.4% in September 2016. This alone contributed 3.7% points to the overall export growth in October.
- After turning positive for the first time in 23 months at 1.1% in September, growth in oil exports increased to 7.2% in October. Growth in oil imports also improved to 4.0% in October as compared to 3.1% in September 2016. Prior to this, import growth had been contracting for over two years.
- Growth in overall imports turned positive at 8.1% in October after contracting for 22 successive months. Growth in gold imports at 108.4% in October contributed 5.8% points to the overall import growth.
- India's merchandise trade deficit increased further to US$10.2 billion in October 2016 as compared to US$8.3 billion in September 2016.
- The Indian rupee weakened to INR67.8 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 17: developments in merchandise trade



Source: Ministry of Commerce and Industry

Chart 18: CAD



Source: Data Base on Indian Economy, *RBI*

7 **Global economy:** OPEC reached a deal to cut crude production

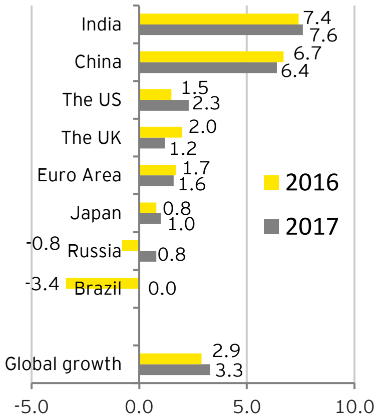
A. Global growth outlook

- OECD, in its November issue of the Global Economic Outlook, projected global GDP growth at 2.9% in 2016. Global growth could increase to 3.3% in 2017 and 3.6% in 2018 under the assumption of a more supportive fiscal stance in the US by the new administration, with associated demand spillovers to other economies (Chart 19).
- In the US, growth in 3Q16 accelerated to 2.2% (q-o-q) driven by improvement in private consumption and significant employment gains. OECD has revised upwards the growth forecasts for the US to 1.5% in 2016 and 2.3% in 2017, conditional on a significant fiscal easing through increased government spending and household and corporate tax reductions thereby promoting domestic investment and consumption.

Over the last five years, global growth has hovered around 3%. In most advanced countries, extraordinary monetary stimulus that has reduced the interest rate on government debt has provided the opportunity to deploy fiscal initiatives, which could substantially boost private economic activity, pushing global growth to 3.6% by 2018

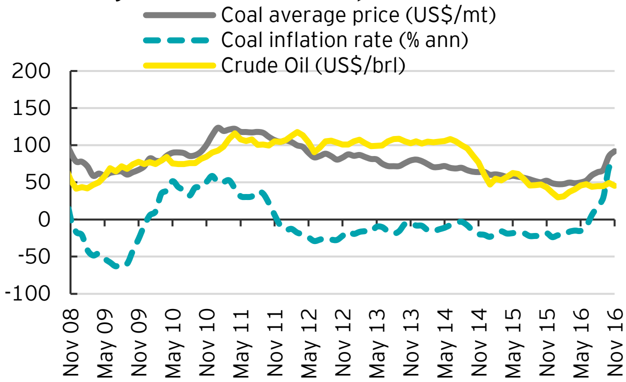
- In the Euro area, growth in 2016 is projected at 1.7%, which is expected to decline to 1.6% in 2017. Despite the expectation of an accommodative monetary policy and a modest fiscal easing during 2016-18, domestic demand is likely to be moderate because of low investment, high unemployment and high non-performing loans in some countries. A more robust use of the fiscal space could improve growth prospects for the region.
- Growth in the UK is projected at 2% in 2016 and 1.2% in 2017. Private investment is expected to contract amid large uncertainty. Recent currency depreciation and higher inflation could slow down the growth of private consumption expenditure.
- In China, growth is projected at 6.7% in 2016 and 6.4% in 2017, as the support from policy stimulus eases and demand is further rebalanced toward domestic sources. Rising financial system risks remain a key challenge. In Brazil and Russia, a slow recovery is projected in 2017 and 2018, helped by firmer commodity prices, recent improvements in confidence and monetary policy support.

Chart 19: OECD Global Economic Outlook



Source: OECD Global Economic Outlook, November 2016

Chart 20: global crude and coal prices



Souce: World Bank, Pinksheet

B. Global energy prices

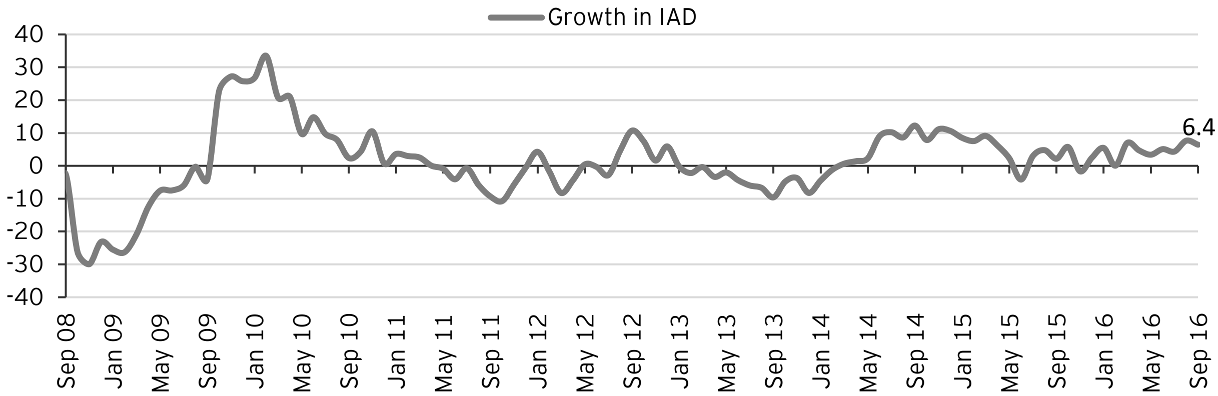
- After increasing for three consecutive months, global crude prices declined from US$49.3/bbl in October 2016 to US$45.3/bbl in November 2016 (Chart 20). This could be attributed to an increased crude oil supply by Russia and OPEC and appreciation of the dollar during November. However, in its meeting in Vienna, OPEC reached an agreement to restrict output to 32.5 mb/d, effective from 1 January 2017. An effective reduction in supply and a consequent price recovery are dependent on cooperation from major non-OPEC producers.
- The average global coal prices increased for the eighth consecutive month to US$92/mt in November 2016 from US$85.2/mt in October 2016, reflecting strong demand and tightening supply in China. The World Bank projects the global coal prices to average US$58/ton in 2016 and US$55/ton in 2017.

8 **Index of Aggregate Demand:** falls in September 2016

Growth in India's aggregate demand strengthened during the 2QFY17 as compared to the corresponding period of FY16. However, on a monthly basis, aggregate demand grew by 6.4% in September 2016, marginally slowing down from 7.7% in August 2016.

- An IAD has been developed to reflect demand conditions in the agriculture, manufacturing and services sectors on a monthly basis. It takes into account movements in PMI for manufacturing and services, which traces the demand conditions in these sectors. Demand conditions in the agricultural sector have been captured by movements in monthly agricultural credit off-take.
- In the IAD, the sectoral weights are based on the share of three sectors – agriculture **(18.4),** industry **(33.1)** and services **(48.5)** – in overall nominal GVA in the base year (2011–12).
- Growth in the IAD moderated to 6.4% in September 2016 from 7.7% (y-o-y) in August 2016 (Chart 21). A recovery in the growth of agriculture and industry in September was not sufficient to offset the impact of a slowdown in the services sector.
- However, in terms of quarterly performance, growth in aggregate demand was higher at 6.1% in 2QFY17 as compared to 4.4% in 1QFY17.

Chart 21: growth in IAD (y-o-y)



Source (Basic data): NIKKEI PMI - Markit Economics, RBI and EY estimates

Table 7: IAD

Month	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	July-16	Aug-16	Sep-16
IAD	119.5	116.2	121.3	120.9	118.6	117.6	119.0	122.8	122.1
Growth (% y-o-y)	5.4	0.0	7.0	4.7	3.4	5.1	4.3	7.7	6.4

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	1.7	3.2	1.1	4.4	1.1	FY13	53.7	54.3
FY14	0.2	2.2	-1.1	9.3	5.0	FY14	50.5	48.5
FY15	0.7	2.5	-0.6	9.0	5.4	FY15	52.2	51.7
FY16	-0.8	-2.7	-0.9	1.4	3.7	FY16	51.3	51.7
3QFY16	2.2	5.3	1.0	8.3	5.2	3QFY16	50.0	52.3
4QFY16	-2.5	0.9	-3.5	1.6	3.0	4QFY16	51.5	53.3
1QFY17	-0.7	-5.8	-0.2	0.1	3.2	1QFY17	51.0	51.7
2QFY17	0.7	-3.1	0.9	2.4	5.0	2QFY17	52.2	52.9
Jun-16	1.7	3.2	1.1	4.4	1.1	Aug-16	52.6	54.7
Jul-16	0.2	2.2	-1.1	9.3	5.0	Sep-16	52.1	52.0
Aug-16	0.7	2.5	-0.6	9.0	5.4	Oct-16	54.4	54.5
Sep-16	-0.8	-2.7	-0.9	1.4	3.7	Nov-16	52.3	46.7

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
3QFY16	5.3	5.9	5.3	-2.3	5.6	-1.5	-12.3
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
Jul-16	6.1	8.0	2.7	3.5	11.8	1.8	-1.0
Aug-16	5.0	5.8	2.5	3.7	8.2	2.4	1.6
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

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	
Mar-16	17.0	6.0	8.5	11.9	51.9	25.8	99.5 (RE)	100.3 (RE)
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

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	17.5	14.2	8.2	19.8	26.9	292.0
FY14	8.00	FY14	8.5	13.4	15.6	13.9	8.4	21.6	4.8	304.2
FY15	7.50	FY15	11.3	10.9	11.0	10.9	8.3	31.3	42.2	341.6
FY16	6.75	FY16	13.5	10.1	10.1	11.1	7.7	36.0	-3.6	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	Jul-16	13.6	10.0	9.9	10.3	7.4	3.6	2.6	365.5
Oct-16	6.25	Aug-16	15.1	10.4	9.2	8.7	6.9	4.4	1.0	366.8
Nov-16	6.25	Sep-16	21.0	14.6	12.1	13.3	6.9	4.6	2.9	372.0
Dec-16	6.25	Oct-16	15.2	10.9	0.0	0.0	6.8	0.0	0.0	367.2

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)						Calendar year	Global growth (annual)		
	Exports	Imports	Trade balance	Ex. rate (avg.)	Crude prices (avg.)	Coal prices (avg.)		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
Jul-16	-6.8	-19.0	-7.8	67.2	44.1	60.1	2016*	3.1	1.6	4.2
Aug-16	-0.3	-14.1	-7.7	66.9	44.9	63.7	2017*	3.4	1.8	4.6
Sep-16	4.6	-2.5	-8.3	66.8	45.0	67.1	2018*	3.6	1.8	4.8
Oct-16	9.6	8.1	-10.2	67.8	49.3	85.2	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.
FY13	5.6	5.3	0.5	4.9	6.7	6.0	5.4	1.5	3.6	8.1
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
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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