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How is India Doing? Mid Year Macroeconomic Review

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Rudrani Bhattacharya, Manish Gupta, Dinesh Kumar Nayak, Radhika Pandey In Association With Sudipto Mundle

National Institute of Public Finance and Policy
New Delhi

How is India Doing?
Mid Year Macroeconomic Review

SEPTEMBER, 2023

RUDRANI BHATTACHARYA,
MANISH GUPTA,
DINESH KUMAR NAYAK,
RADHIKA PANDEY
IN ASSOCIATION WITH
SUDIPTO MUNDLE,
CENTRE FOR DEVELOPMENT STUDIES

NATIONAL INSTITUTE OF PUBLIC FINANCE
AND POLICY | NEW DELHI

1. Introduction

India is currently facing a grim global economic environment and multiple domestic economic challenges.

Externally the Ukraine war continues relentlessly, leaving massive death and destruction in its wake. The war and sanctions have together disrupted global supplies, especially for fuel, food-grains and fertilisers. This together with policies of excessive monetary easing in the advanced countries till early 2022 led to exceptionally high inflation. The consequent policy of sharp monetary tightening and rising interest rates has now led to very low or even negative growth in these countries while China has also slowed down and is experiencing deflation. The slowdown in global growth has led to declining growth in demand for India's exports. Meanwhile, the recent Fitch downgrading of United States (US) sovereign debt, coming on top of the challenging economic conditions cited above, has led to a sharp reduction in foreign portfolio investments (FPI) into most emerging markets, including India.

Domestically there was a rebound of food inflation and widening current account deficits during the first half of 2023-24. The headline inflation rate breached the central bank's 6 percent upper limit of the target band in July 2023 due to surging food inflation. However, core price inflation has continued declining, reflecting the sharp slowdown in growth of consumption and investment demand. The pursuit of monetary and fiscal policy has become quite challenging because of the combination of high inflation with slowing growth. This paper reviews these recent macroeconomic developments, particularly since the latter half of the financial year 2022-23, and discusses the emerging policy challenges.

2. Growth

The economy grew by a robust growth of 7.2 per cent in the financial year 2022-23 (FY2022-23). This was due to the high growth recorded in the first half (H1) of FY 2022-23, mainly driven by a strong base effect (Table 2.1). India experienced a second wave of the Covid-19 pandemic during the first half of FY2021-22, which muted economic activity in that period. The low growth in the first half of FY 2021-22 accounts for the strong base effect and consequent high growth in the first half of FY 2022-23.

However, growth slowed down in the second half of FY 2022-23 in the absence of this strong base effect and there was a sharp reduction in growth of consumption and investment demand. Growth of private consumption demand declined from 13.6 per cent to only 2.5 percent between the first and second half of FY 2022-23, while growth of investment demand declined from 14.7 per cent to 8.5 per cent over the same period (Table 2.1). The growth slowdown of consumption and investment demand reflected, among other things, the effect of tightening monetary policy since the beginning of FY 2022-23.

Table 2.1: **Growth slowed in H2: 2022-23 without the strong base effect of Q1: 2022-23, there was a sharp reduction in growth of consumption & investment demand**

[% change, y-o-y]

Demand components	**2022-23**	**2022-23 H1**	**2022-23 H2**	**2023-24 Q1**
Aggregate demand (GDP)	7.2	9.5	5.3	7.8
Govt. Final Consumption Exp. (GFCE)	0.1	**-0.9**	**1.0**	**-0.7**
Private Final Consumption Exp. (PFCE)	7.5	13.6	2.5	6.0
Gross Fixed Capital Formation (GFCF)	11.4	14.7	8.5	8.0
Exports of Goods & Services (X)	13.6	15.8	11.5	-7.7
Imports of Goods & Services (M)	17.1	28.0	7.7	10.1

Source: CSO, MOSPI

In the composition of output, the growth slowdown was mainly visible in services. Growth in services was nearly halved from 12.6 per cent to 6.5 per cent between the first and second half of 2022-23, mainly due to the decline in growth in the group 'Trade, hotels, transport, communications and broadcasting' (TRC in Table 2.2) and the group 'Public administration, defence and other services'. Industrial growth in the second half of FY 2022-23 was stable, led by Construction and the group 'Electricity, gas, water supply and other utility'. Manufacturing growth remained muted (Table 2.2). Agricultural growth was low in the first half as volatile rainfall and excessive heat in North India adversely affected wheat production in this period. However, agricultural activity in the second half was resilient due to the increase in gross sown area compared to the same period the previous year. This is mainly attributable to high global and domestic wheat prices as a fall out of the Ukraine war.

In Q1 2023-24 there was a strong revival of growth, reflecting the residual base effect of the massive contraction of Q1:2020-21 (Table 2-1). Growth of private consumption demand in particular recorded a strong revival compared to H2 2022-23, while investment demand growth remained high at 8 per cent. However, the growth revival in Q1:2023-24 was somewhat muted due to the widening of the trade deficit. Export growth contacted by 7.7 per cent, reflecting the global growth slowdown, while imports grew by over 10 per cent, Government consumption expenditure also contracted in this quarter.

On the production side. agricultural growth declined to 3.5 per cent in Q1 of 2023-24 (Table 2.2). This was mainly on account of volatile weather (left Panel, Figure 2.1). Tractors sales, an indicator of agricultural activity, also contracted in April-May 2023 (right panel, Figure 2.1). Industrial growth in Q1: 2023-24 was 1 per cent higher compared to H1: 2022-23, while sub-sectoral performance within industry was mixed. Services led the growth revival in Q1: 2023-24, with a broad based rise in growth in most sub-sectors.

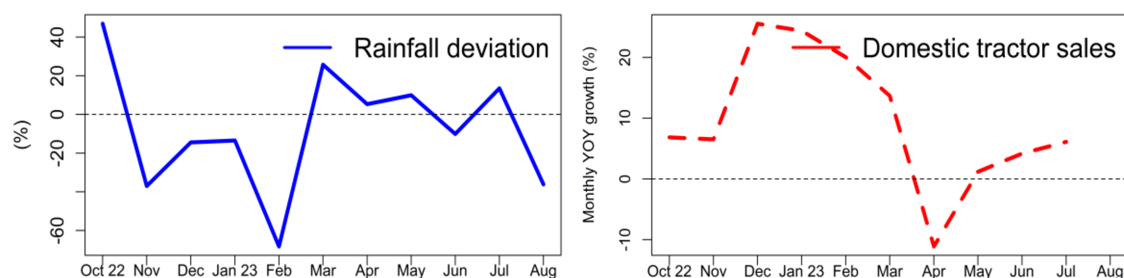
Table 2.2: Growth revival in Q1 2023-24 led by services

[% change, y-o-y]

Sectors	2022-23	2022-23 H1	2022-23 H2	2023-24 Q1
GDP	**7.2**	**9.5**	**5.3**	**7.8**
1. Agriculture, forestry & fishing	**4.0**	**2.4**	**5.1**	**3.5**
2. Industry	**4.4**	**4.3**	**4.5**	**5.5**
2.1 Mining & Quarrying	4.6	5.1	4.2	**5.8**
2.2 Manufacturing	1.3	0.9	1.7	**4.7**
2.3 Electricity, gas, water supply and other utility	9.0	10.3	7.5	**2.8**
2.4 Construction	10.0	10.7	9.5	**7.9**
3. Services	**9.5**	**12.6**	**6.5**	**10.3**
3.1 Trade, hotels, transport, communication, broadcasting (TRC)	14.0	20.1	9.3	**9.2**
3.2 Financial, real estate and professional services	7.1	7.8	6.4	**12.2**
3.3 Public administration, defense and other services (PAD)	7.2	12.6	2.6	**7.9**

Source: CSO, MOSPI

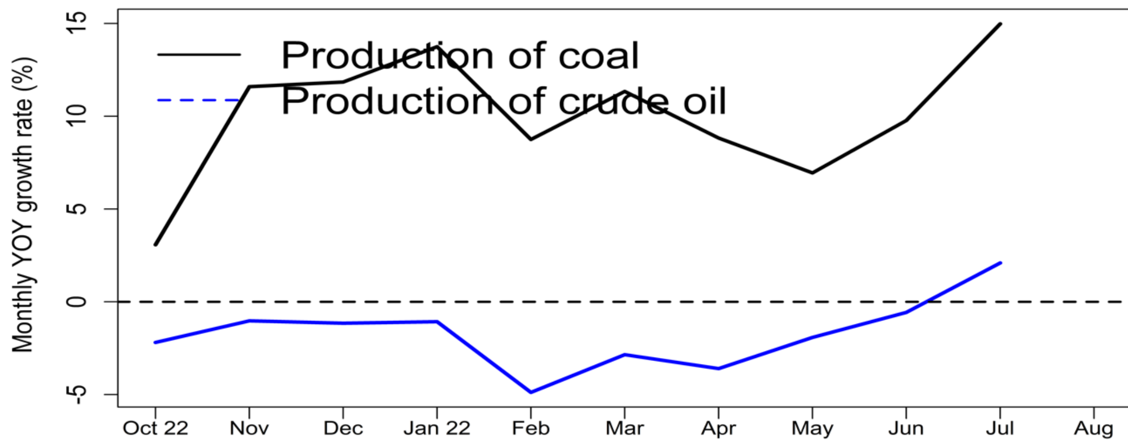
Figure 2.1: Agricultural growth is probably muted in Q2 23-24

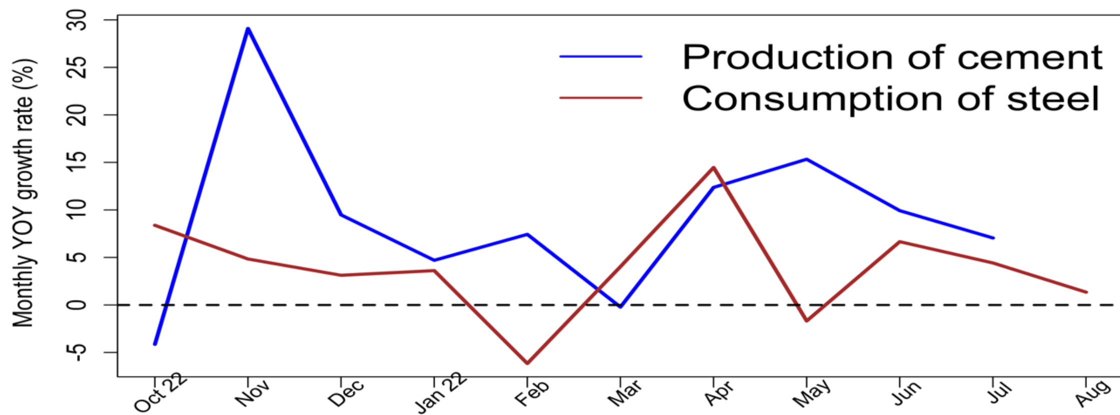


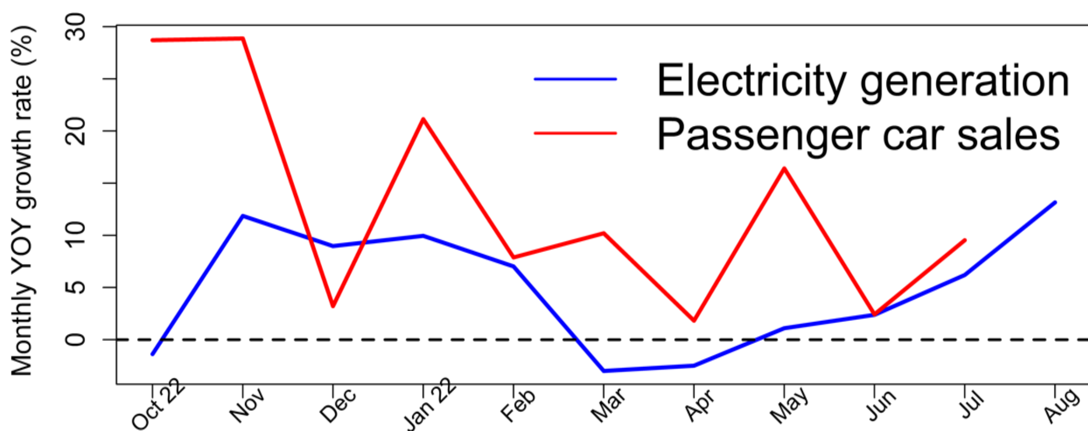
Source: CMIE

Growth outlook: Production of rice may be adversely affected in Q2 2023-24 due to less than normal rainfall in South and Eastern parts of India. On the other hand, excess rainfall and floods in North India in June-July 2023 caused higher than normal wastage of horticultural crops. Overall agricultural performance is expected to remain muted in Q2 2023-24.

Figure 2.2: Mixed outlook for industrial growth in Q2:2023-24



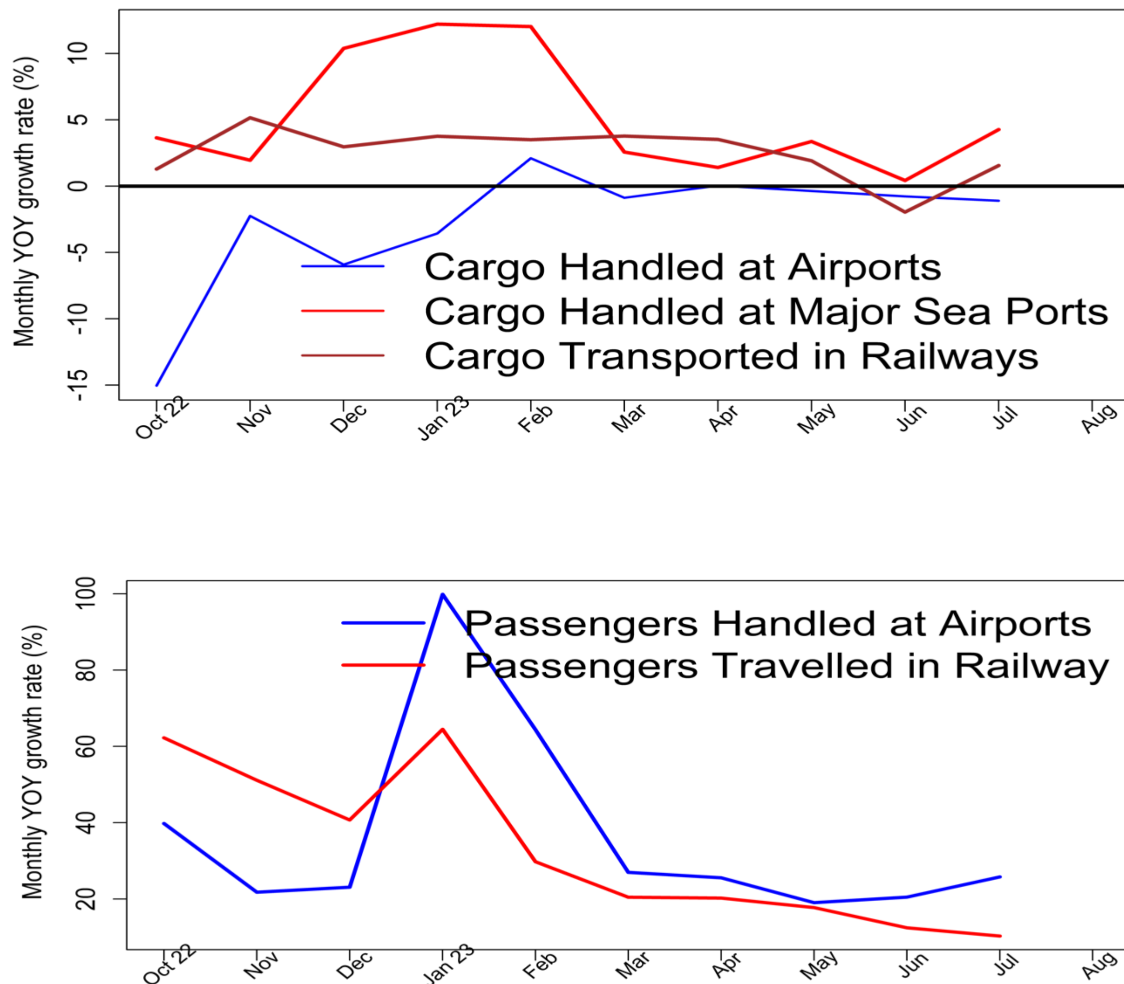




Source: Office of Economic Adviser, CMIE

The outlook for industrial growth in Q2 2023-24 is mixed. Growth in mining, utilities and passenger car sector in manufacturing (Figure 2.2) may be high. However, construction may slow down as indicated by the slowdown in growth of input use in this sector.

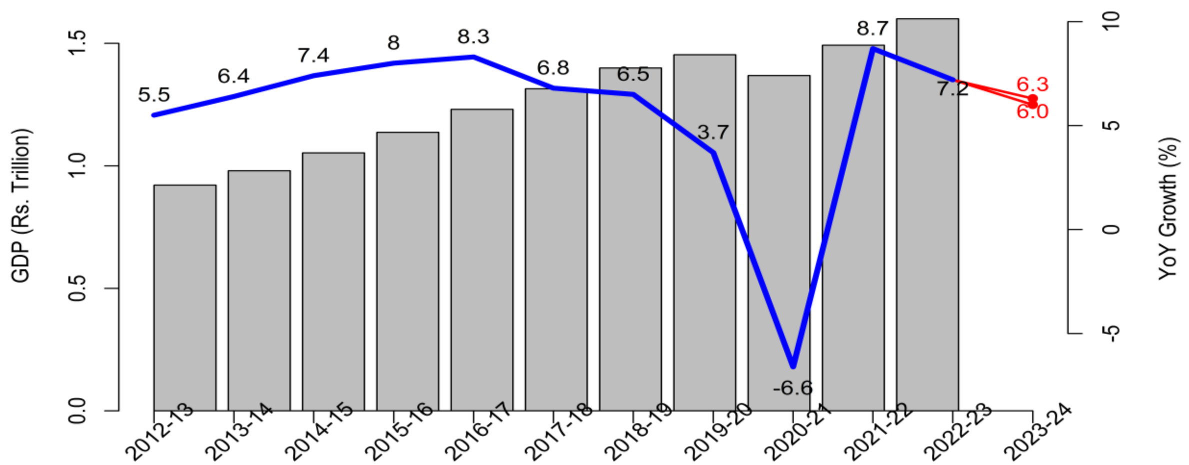
Figure 2.3: Services: Transport services are expected to drive services growth in Q2 2023-24, while trade services may remain muted



Source: Ministry of ports, shipping & waterways, CMIE

Leading indicators of services sector growth also indicate a mixed performance in H1: 2023-24. Multiple factors led to volatile growth of foreign trade services in the first half of FY 2023-24 (upper panel, Figure 2.3), while the slowdown in railway cargo movement reflects the continuing weakness in domestic trade during this period. However transport services are expected to contribute to the robust overall services growth in Q2 FY 2023-24 as passengers travelling by air maintains its momentum in this quarter (lower panel, Figure 2.3)

Figure 2.4: GDP growth forecast at 6-6.3% for FY 23-24



Source: MOSPI; Authors' computations

The NIPFP growth forecast for FY 2023-24 is in the range 6 to 6.3 per cent (Figure 2.4). The forecasts are based respectively on a nowcasting model using high frequency indicators to forecast quarterly GDP growth and an alternative model using annual frequency data (see Bhattacharya, Chakravartti and Mundle, 2019; Bhattacharya, Bhandari and Mundle, 2023 for details). Most GDP growth forecasts for FY 2023-24 GDP are clustered in the range of 6.1 per cent to 6.5 per cent, e.g., RBI (6.5 percent), IMF (6.1 per cent), World Bank (6.3 per cent).

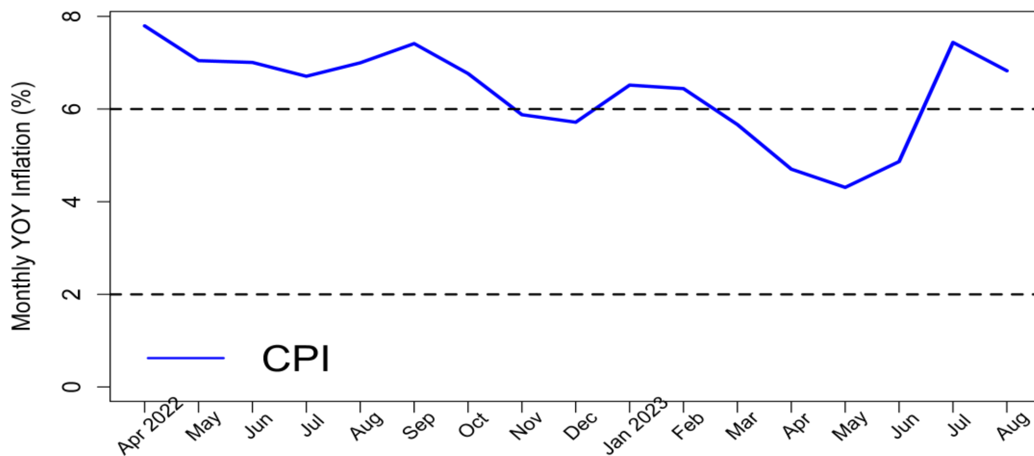
Inflation

The headline CPI inflation was at 6.7 per cent, above the 6 per cent upper limit of RBI's tolerance band during the last financial year of 2022-23. It came down to less than 6 per cent in the first quarter of 2023-24, but then rose sharply to 7.4 per cent in July 2023 (Figure 3.1).

CPI food inflation fell below 6 per cent in November 2022, followed by CPI core and energy inflation in April 2023 (Figure 3.2). As a result, there was a broad based moderation of headline inflation in Q1 2023-24. Unfortunately, CPI food inflation rose again to double digit levels in July & August 2023, driving up headline inflation, though core inflation and energy price inflation remained below 6 per cent. However energy inflation rebounded since June 2023 following rebound in global crude oil inflation.

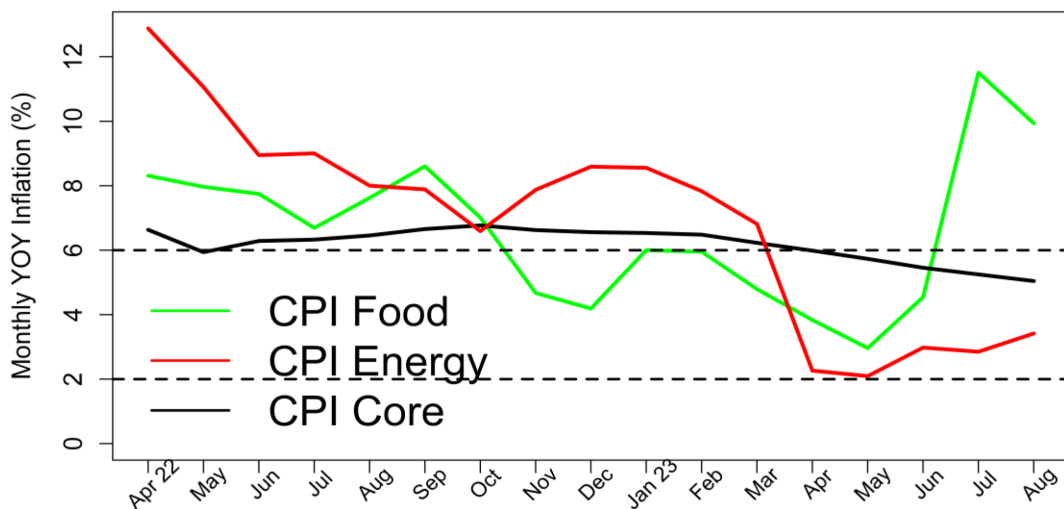
High inflation in Cereals and products, Pulses and products, Vegetables, and Spices have been the main contributors to the upsurge in CPI food inflation. Vegetable prices surged by over 37 per cent in July 2023 due to excess wastage of crops on account of erratic monsoon and floods in North India. Domestic wheat price inflation was elevated since the second half of FY 2022-23 as a consequence of surging price of wheat in the global market, while reduced kharif sowing due to lower than normal rainfall in southern and eastern India led to a short fall in rice production, further fuelling cereals price inflation. Uneven monsoon has driven up prices of pulses as well.

Figure 3.1: Inflation now above RBI tolerance band upper limit of 6%



Source: CSO, MOSPI

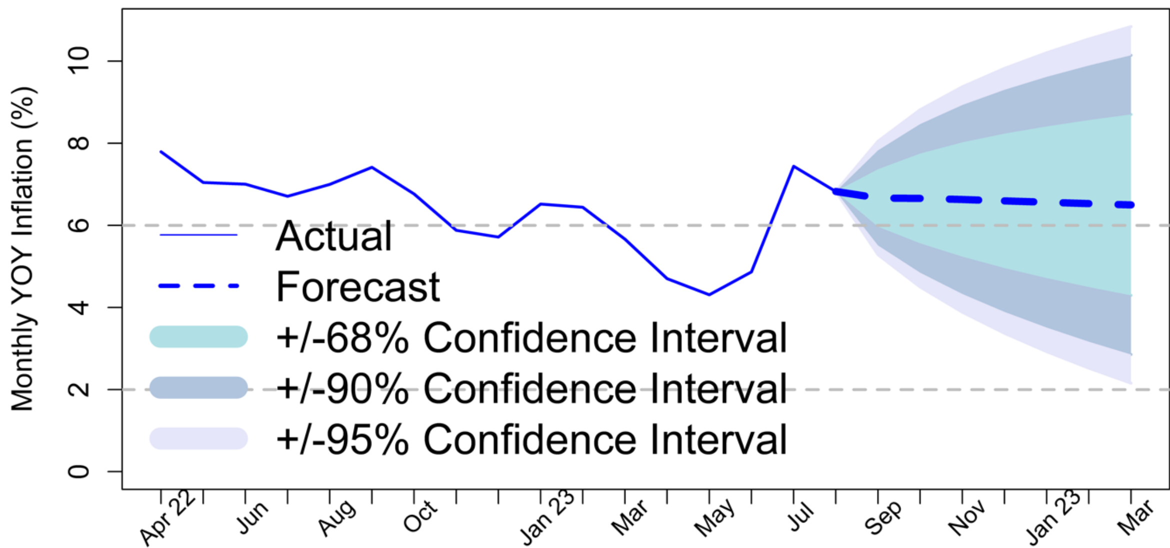
Figure 3.2: CPI food inflation is double digit while core and energy inflation remained below the 6 per cent upper limit of RBI's tolerance band



Source: CSO, MOSPI

Inflation outlook: NIPFP projects headline inflation for September 2023 at 6.7 percent, lower than the August value. Annual headline inflation for FY 2023-24 is forecast at 6.2 per cent, slightly above 6 per cent, the upper limit of RBI's tolerance band (for underlying forecasting model, see Bhattacharya and Kapoor 2020). Headline inflation is expected to moderate till the end of FY 2023-24 (Figure 3.3). The expected moderation of vegetables price inflation in November-December 2023 with the arrival of the winter crop would possibly reduce food and hence headline inflation around Q3 2023-24. However, rebound of energy prices, global food supply disruption due to Russia's suspension of the Black Sea grain arrangement, and speculation by oligopolistic global food grain traders pose risks of persistently high headline inflation in the current financial year. On the other hand, the impact of monetary tightening since the latter half of FY 2022-23 could possibly work as a moderating factor for headline inflation via core inflation.

Figure 3.3: FY 23-24 inflation forecast at 6.2%, slightly above RBI tolerance band upper limit of 6 %

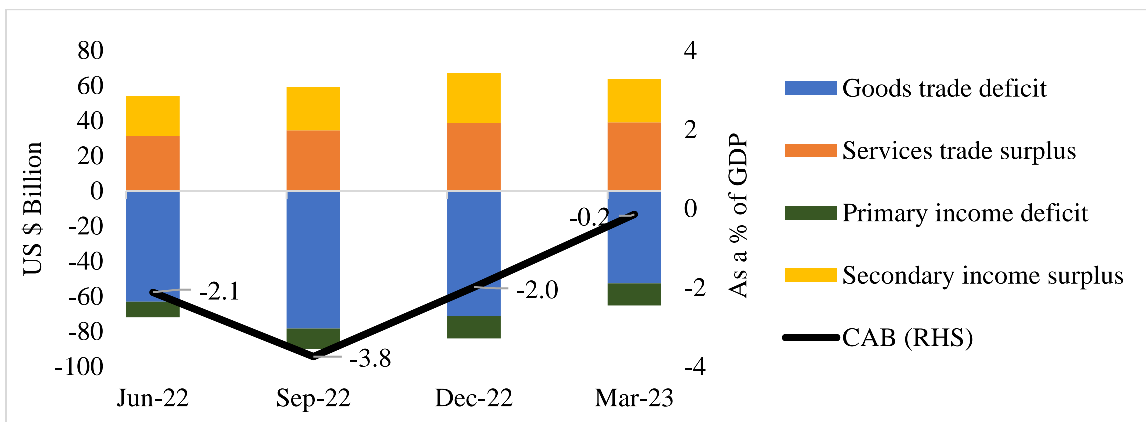


Source: Authors' computations

3. Balance of Payments

The Current Account Balance (CAB) improved during the second half of the financial year 2022-23 compared to the first half (Figure 4.1), primarily due to a reduction in the trade deficit. This decline in the trade deficit was underpinned by the contraction in the goods trade deficit, the decline in goods imports exceeding the decline in goods exports, and a simultaneous rise in net exports of services in this period.

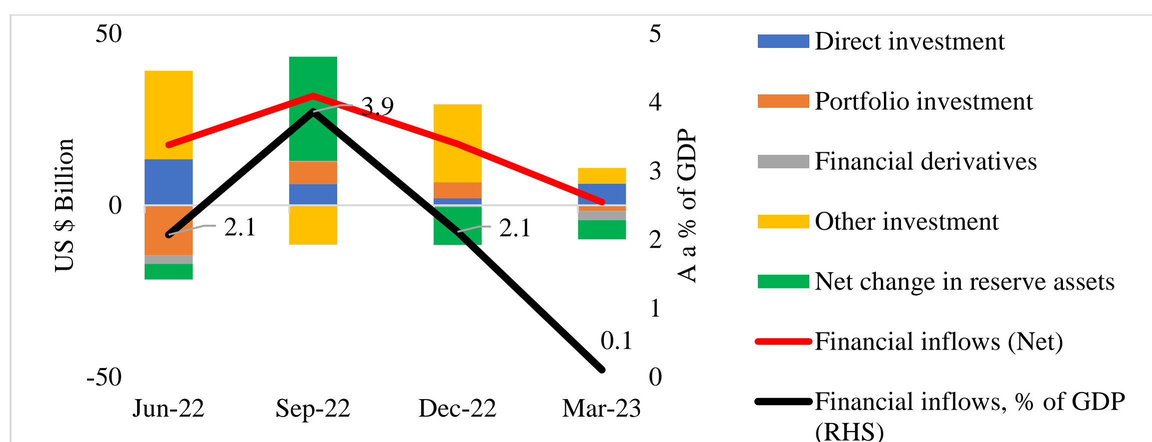
Figure 4.1: Current Account Balance (CAB) improved in H2 22-23 compared to H1 due to decline in trade deficit



Source: RBI, MOSPI, & NIPFP Computations

Corresponding to the decrease in the current account deficit, there was also a significant decrease in net inflows on the capital account in the second half of FY 2022-23, (Figure 4.2). This decline was primarily attributable to a contraction in reserve assets and Foreign Portfolio Investment (FPI) inflows while Foreign Direct Investment (FDI) and other investment flows remained volatile during this period. Net financial inflows in the second half of FY 2022-23 amounted to US$ 18.8 billion, down from the net inflow of US$ 49.3 billion recorded in the first half of FY 2022-23.

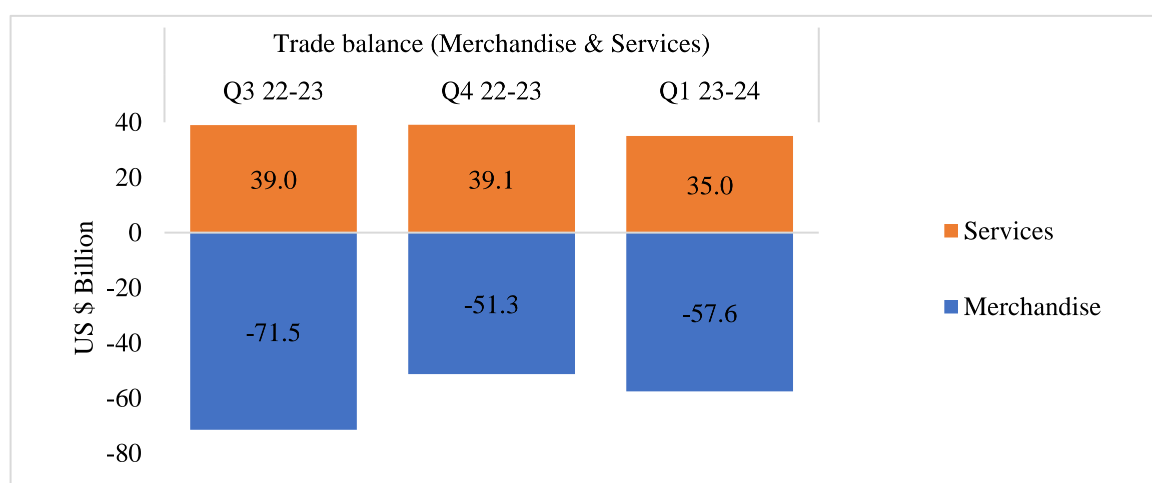
Figure 4.2: Capital account net inflow fell sharply in H2 22-23, due to contraction in reserve assets and FPI inflows, while FDI and other investment flows remained volatile



Source: RBI, MOSPI & NIPFP Computations

BoP outlook: In Q1 FY 2023-24, the trade deficits contracted compared to the same quarter of the previous year. However, there was a widening of the trade deficit compared to the preceding quarter, i.e., Q4 of FY 2022-23 (Figure 4.3). This was driven by a rise in the goods trade deficit and a simultaneous reduction in the net exports of services.

Figure 4.3: Trade deficits started widening again in Q1 FY 23-24 compared to Q4 22-23 due to an increase in the goods trade deficit & decline in the services trade surplus

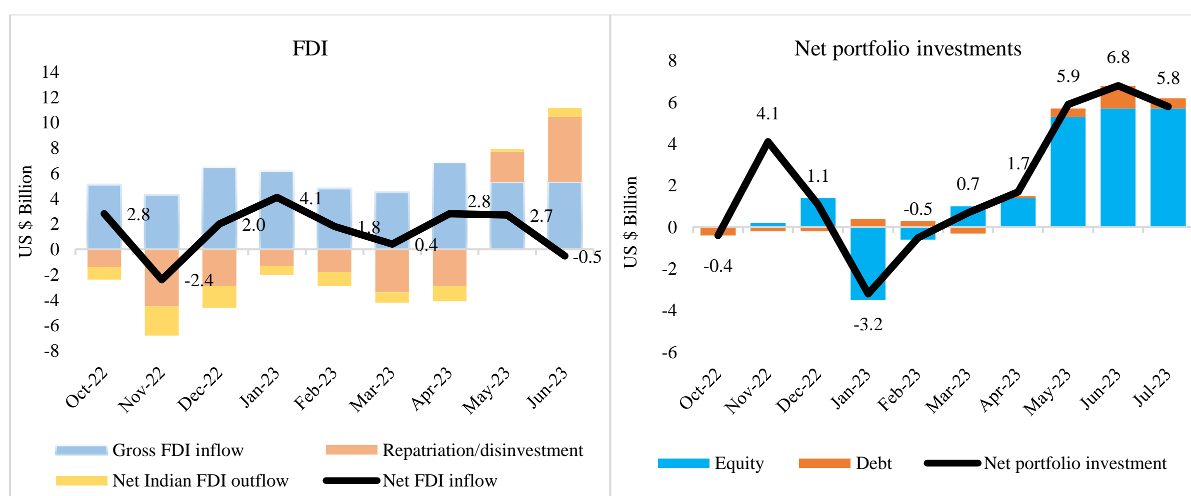


Source: RBI, & NIPFP Computations

This trend continued in July 2023. The merchandise trade deficit expanded by US$ 1.9 billion compared to June 2023, reaching a total of US$ 20.7 billion. This is because the decline in exports exceeded the decline in imports. The oil deficit, i.e, the difference between oil exports and imports, also grew during the same period and in fact in fact accounted for over one-third of the overall merchandise trade deficit in July.

Net inflows of Foreign Direct Investment (FDI) remained volatile during the months of Q1 FY 2023-24. It improved during April-May 2023-24 but turned into a net outflow in June 2023-24 (Figure 4.4). It is important to note that the decrease in net FDI inflows in Q4 2022-23 was due to decline in gross FDI inflows to India, in June 2023, it was primarily the increase in Indian FDI abroad that turned the net FDI inflow into a net outflow. Meanwhile, inflow of Foreign Portfolio Investment (FPI) peaked in Q1 FY 2023-24, mainly on account of equity inflows.

Figure 4.4: Foreign Direct Investment was stable while Foreign Portfolio Investment flows peaked in Q1 23-24

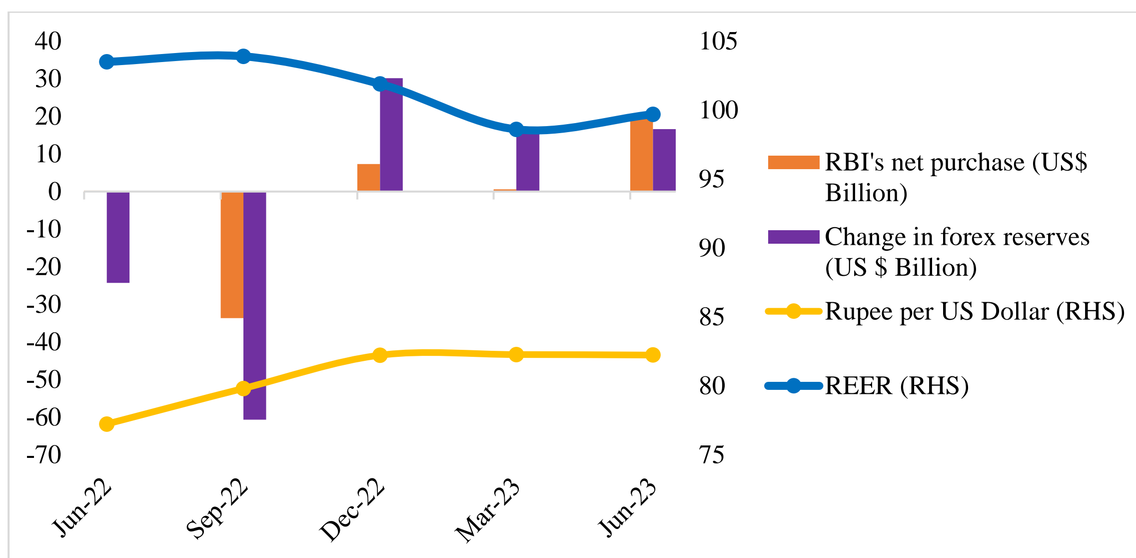


Source: RBI, National Securities Depository Limited (NSDL), & NIPFP Computations

The outlook for capital flows in FY 2023-24 remains uncertain. A widening trade deficit, growth slowdown and high inflation could possibly deter capital inflows into India in near future, given the tendency of capital flight to safety out of emerging markets in periods of high global uncertainty. On the other hand, relative to other capital flow destinations India's growth is relatively high, inflation not too high and forex reserves quite comfortable, covering 10 months of imports. The net capital flow impact of these opposing forces could well depend on the movement of interest rates and the exchange rate.

The nominal exchange rate depreciated until the third quarter of 2022-23, after which it stabilized (Figure 4.5) while the Real Effective Exchange Rate (REER) appreciated throughout the second half and has subsequently depreciated. We note that nominal exchange rate movements are correlated, among other factors, with variations in reserves. As of August 4, 2023, the foreign exchange reserves are deemed adequate to cover approximately 10 months of anticipated imports for the fiscal year 2023-2024.

Figure 4.5: Nominal exchange rate depreciated till Q3 then stabilized while REER appreciated through H2, then depreciated



Source: RBI & NIPFP Computations

4. Fiscal Outlook: Union and State Governments

Central tax revenue collections buoyant, sharp dip in revenues in Q1: 2023-24

During FY 2022-23, the growth in Central Government tax revenue was robust for most taxes, in line with the observed tax buoyancy since 2019-20, the last pre-covid normal year. Gross tax revenue (GTR) of the central government has grown at 15 percent annually during this period (Table 5.1) while the nominal GDP growth was 10.7 percent. Personal income tax grew at an average annual rate of 19 percent over the same period, corporation tax at 14 percent and central goods and services tax (GST) at 19 percent. The exception was Union Excise Duties. Duty cuts on petrol, diesel, and other items to curb inflation resulted in a reduction in union excise duty collections. The robust growth in direct tax collections can be attributed to improved economic activity, higher corporate profitability and high inflation. Central GST (CGST) collections have also been buoyant during this period, with monthly collections remaining above Rs. 1.45 trillion since September 2022. High inflation, better reporting due to stronger enforcement and improved economic activity are the key drivers of higher GST revenues.

The growth in non-tax revenues (NTR) has been volatile as evident from Table 5.1. Between the years 2019-20 and 202-23, NTR fell at an annual rate of 4.4 percent. The fall in non-tax revenue in 2022-23 (vis-à-vis 2021-22) is attributable to lower receipts of both RBI dividend and profits of nationalised banks and other financial institutions. In 2023-24, the NTR is budgeted to grow by 15.2 percent.

Table 5.1: Revenue Collections (% change)

Indicators	2022-23: Annual growth over			2023-24BE over 2022-23RE
	2019-20	2020-21	2021-22	
Nominal GDP	10.7	17.2	16.1	10.8
Centre's Net Revenue*	12.3	20.8	9.8	12.1
Gross Tax Revenue (GTR)	15.0	22.8	12.7	10.4
Corporation Tax	14.0	34.4	16.0	10.5
Income tax	19.0	31.2	20.0	10.5
Union Excise duties	10.0	-9.5	-18.4	5.9
CGST	13.3	25.5	21.5	12.1
Customs duty	25.0	25.8	6.8	11.0
Non-Tax Revenue (NTR)	-4.4	17.3	-21.6	15.2

Note: * net of states' share in central taxes and collections under NCCD to be transferred to NDRF.
Source: Controller General of Accounts (CGA); Union Budget

Though central government's tax revenues were buoyant since 2019-20, tax revenue performance in Q1: 2023-24 has been very disappointing. In the 2023-24 budget, GTR was projected to grow at a modest 10.4 percent. However, during the first quarter of 2023-24 (Q1: 2023-24) it grew by a mere 3.3 percent (Table 5.2). This is a very sharp deceleration from GTR growth of 22.4 percent during April-June 2022 (i.e., Q1: 2022-23). While growth of income tax and GST is much reduced, corporation tax growth was actually negative compared to the same period of 2022-23. Excise duty collections have declined again on top of the decline recorded during Q1: 2022-23. However, customs duty collections was an exception among sources of tax revenue, registering a sharp y-o-y increase during Q1:2023-24[1].

Table 5.2: Revenue Collections April-June 2023 - Percent change

Indicators	y-o-y change (%)	
	2022	2023
Centre's Net Revenue	5.2	3.6
Gross Tax Revenue (GTR)	22.4	3.3
- Corporation Tax	30.0	-13.9
- Income tax	40.7	11.1
- Excise duties	-9.8	-15.4
- Central GST	52.7	15.0
- Customs duty	-11.8	34.9
Non-Tax Revenue	-51.2	149.3

Source: Controller General of Accounts (CGA)

1 Non tax revenue, which had declined y-o-y during Q1:2022-23 also grew by a massive 149 per cent, but this revenue component is typically very volatile as noted above.

The deceleration in the growth of GTR in Q1: 2023-24 is a matter of great concern. However, these are early days. The fall in excise duties could be on account of softening of crude prices and the decline in corporation tax can be attributed to tax refunds. Hopefully, the Q1 numbers are not indicative of tax revenue performance for the rest of the year.

Central government's thrust on capital expenditure continues, Q1-2023-24 expenditure in line with budget estimates

Actual total expenditure of the central government in 2022-23 exceeded the budget estimates by 6.2 percent for several reasons:

(i) higher food subsidies on account of extension of free food grain scheme,
(ii) increase fertilizer subsidy due to high global prices, and
(iii)higher capital expenditure

A strong thrust on capital expenditure has been the hallmark of fiscal policy under the present central government. Capital expenditure grew by over 24 percent in 2022-23 while revenue expenditure grew by only 8 percent (Table 5.3).

This thrust on capital expenditure has been sustained in 2023-24. It has been budgeted to increase by a massive 37 percent, while revenue expenditure is budgeted to grow by only 1 percent, implying a decline in real terms. This thrust on capital expenditure is important for reviving growth, which has been slowing down.

Table 5.3: Expenditure (% change)

Indicators	2022-23: Annual growth over			2023-24BE over 2022-23RE
	2019-20	2020-21	2021-22	
Nominal GDP	10.7	17.2	16.1	10.8
Revenue Expenditure	13.7	5.8	7.8	1.2
Capital Expenditure	29.9	31.6	24.3	37.4
Total Expenditure	15.9	9.2	10.4	7.5

Source: Controller General of Accounts (CGA); Union Budget

Table 5.4: Expenditure April-June 2023 - Percent change

Indicators	y-o-y change (%)	
	2022	2023
Revenue Expenditure	8.8	-0.1
Capital Expenditure	57.0	59.0
Total Expenditure	15.4	10.8

Source: Controller General of Accounts (CGA)

The thrust of the government on capital expenditure is also evident from the data on actual expenditure in Q1: 2023-24. Capital expenditure grew by 59 percent while the revenue expenditure remained almost flat (Table 5.4). Thus, the expenditure performance of the government is in line with its budget estimates. Maintaining this stance and containing

revenue spending will be politically quite challenging this year with general elections due in early 2024.

Central government committed to fiscal consolidation, but goal of fiscal deficit (FD) below 4.5% by 2025-26 is challenging

In 2022-23, despite higher than budgeted expenditures, the government met its fiscal deficit (FD) target of 6.4 percent of GDP, mainly thanks to buoyant tax revenue growth. The government remains committed to fiscal consolidation. The 2023-24 union budget has targeted FD compression to 5.9 percent of GDP, a reduction of 0.5 per cent (Table 5.5).

In her 2023-24 budget speech, the Finance Minister announced that FD would be brought down to 4.5 percent by 2025-26, the medium term fiscal consolidation target, indicating the central government's commitment to fiscal consolidation. This would require a reduction of FD by about 0.7 percent in both 2024-25 and 2025-26. If the Q1: 2023-24 tax revenue shortfall continues during the rest of the year, this would entail an even larger FD reduction during 2024-25 and 2025-26. Achieving this without a major revenue mobilization effort would be very challenging.

Table 5.5: Fiscal Deficit (FD) - % of GDP

	2019-20	2020-21	2021-22	2022-23	H1 22-23	H2 22-23	2023-24
Target	3.3	3.5	6.8	6.4	--	--	5.9
Actual	4.7	9.2	6.7	6.4	4.8	7.9	--

Source: Controller General of Accounts (CGA); Union Budget

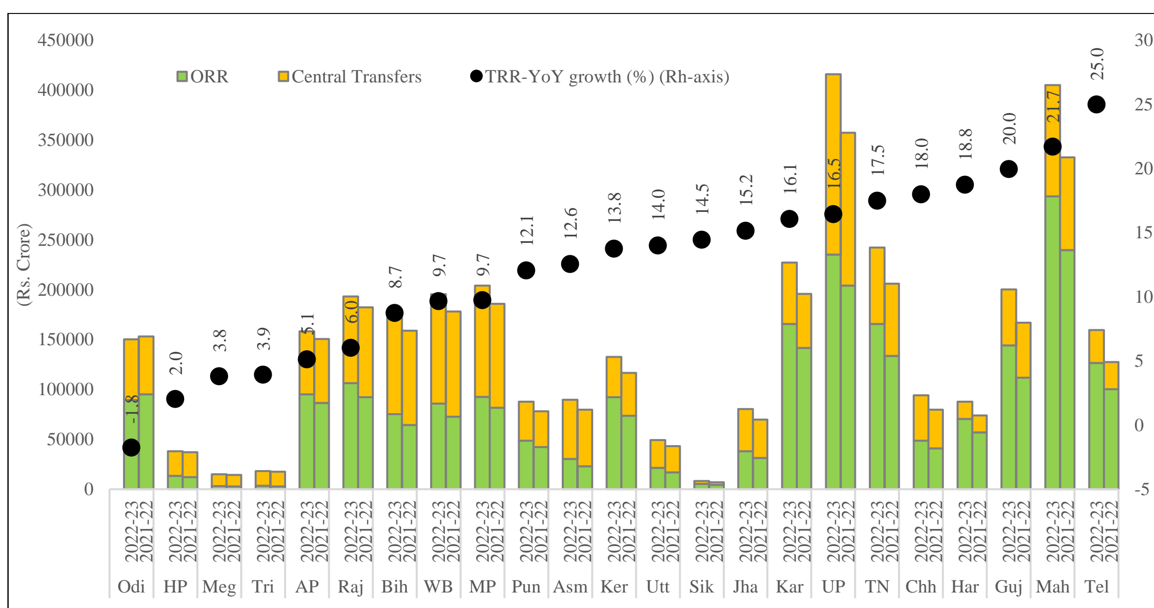
Robust growth in state taxes

Total revenue receipts (TRR) of state government comprise own revenue receipts (ORR) and transfers from the central government. On average, the share of own revenue receipts in total revenue receipts of states is 59 percent while that of central transfers is 41 percent.

All-states total revenue receipts (TRR), on average, grew by about 14 percent in 2022-23, largely due to the increase in ORR. However, there are considerable variations across states as evident from Figure 5.1. Own revenues of states consists of own tax revenues (OTR) and own non-tax revenues (ONTR), of which OTR is the main component. It accounts for about 85 percent of own revenues of states on average. ONTR accounts for the remaining 15 percent.

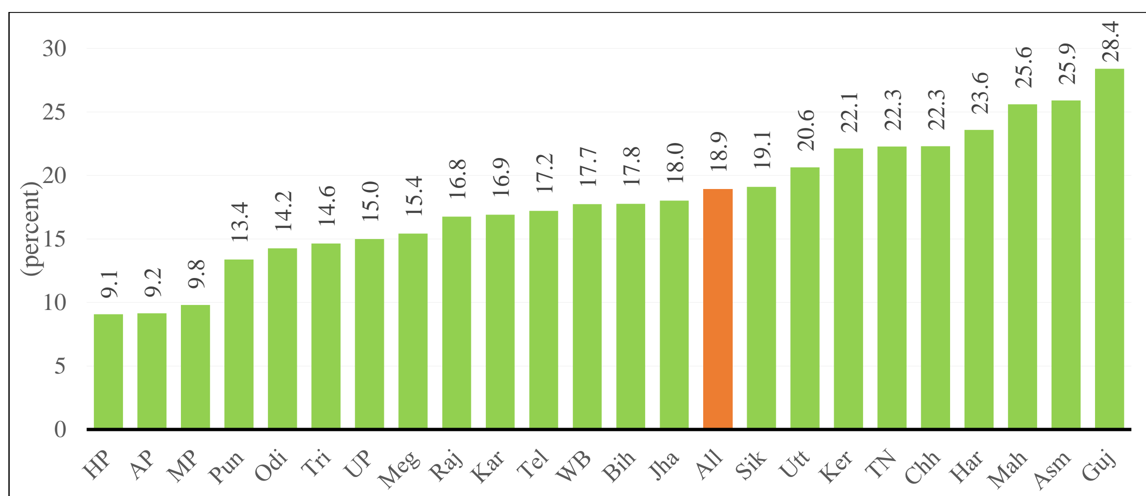
In 2022-23, all-state own tax revenue grew at a robust 19 percent (Figure 5.2). However, OTR growth was moderate in three states - Himachal Pradesh (9.1 percent), Andhra Pradesh (9.2 percent) and Madhya Pradesh (9.8 percent). In 2023-24, the combined all-states OTR has been states budgeted to grow by 20 percent.

Figure 5.1: Changes in Total Revenue Receipts: 2022 -23 over 2021-22 (%)



Source: Controller and Auditor General (C&AG)

Figure 5.2: Annual growth in OTR - 2022-23 over 2021-22 (%)

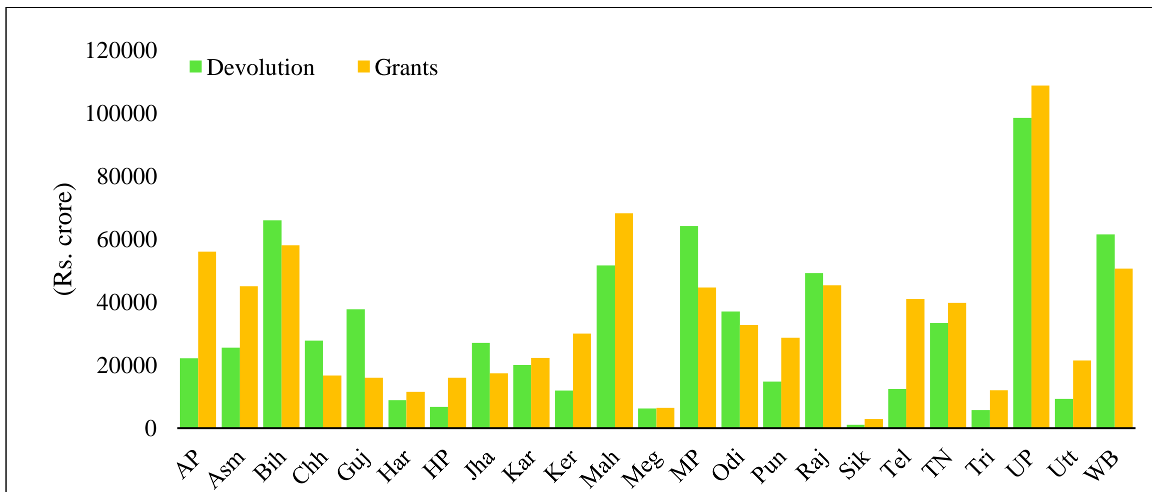


Source: Controller and Auditor General (C&AG)

Growth in central transfers modest

Central transfers to states, the other component of TRR includes mandatory tax devolution and central grants, which is discretionary except for the grants recommended by Finance Commissions. Traditionally, the tax devolution component has been higher than grants. However, in 2022-23, grants accounted for about 53 percent while the share of devolution was 47 percent. Devolution exceeded grants in 8 states, namely Bihar, Chhattisgarh, Gujarat, Jharkhand, Madhya Pradesh, Odisha, Rajasthan and West Bengal (Figure 5.3). Grants were larger than devolution in all other states. This phenomenon of grants exceeding devolution is a recent development.

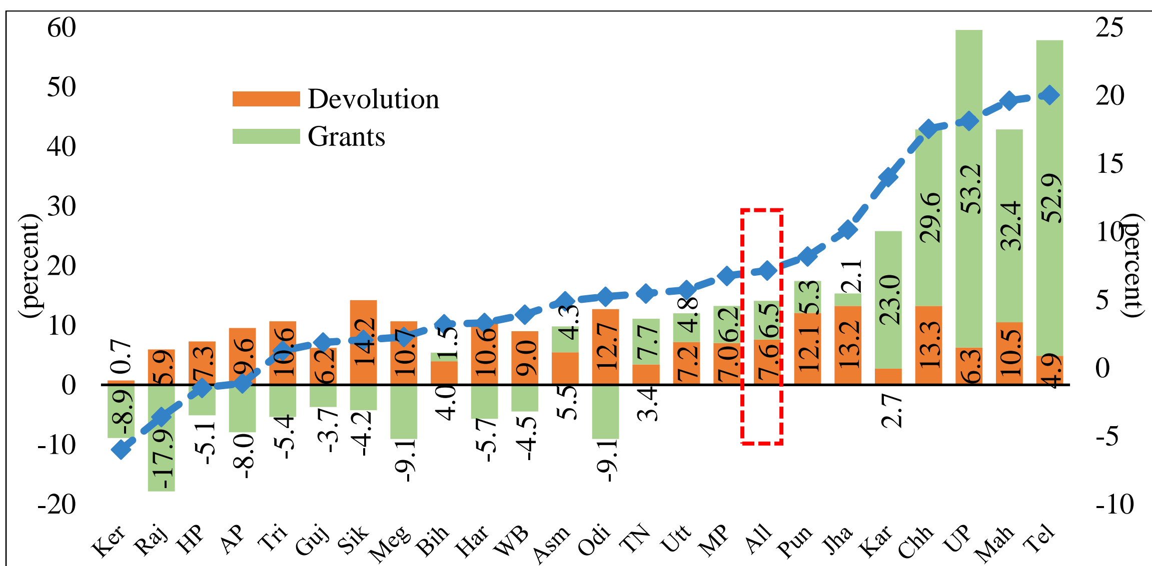
Figure 5.3: Central Transfers in 2022-23 (Rs. crore)



Source: Controller and Auditor General (C&AG)

Central transfers, aggregated across all states, increased by a modest 7 percent in 2022-23. However, it declined in four states – Kerala (-6 percent), Rajasthan (-3.6 percent), Himachal Pradesh (-1.5 percent) and Andhra Pradesh (-1 percent) as evident from Figure 5.4.

Figure 5.4: Changes in central transfers: 2022-23 over 2021-22 (%)



Source: Controller and Auditor General (C&AG)

The increase in central transfers is accounted for by both devolution and grants. The increases have been modest at 7.6 percent and 6.5 percent respectively. There has been a decrease in grants in 11 states as can be seen from Figure 5.4: Andhra Pradesh (-8 percent), Gujarat (-4 percent), Haryana (-6 percent), Himachal Pradesh (-5 percent), Kerala (-9 percent), Meghalaya (-9 percent), Odisha (-9 percent), Rajasthan (-18 percent), Sikkim (-4 percent), Tripura (-5 percent) and West Bengal (-5 percent).

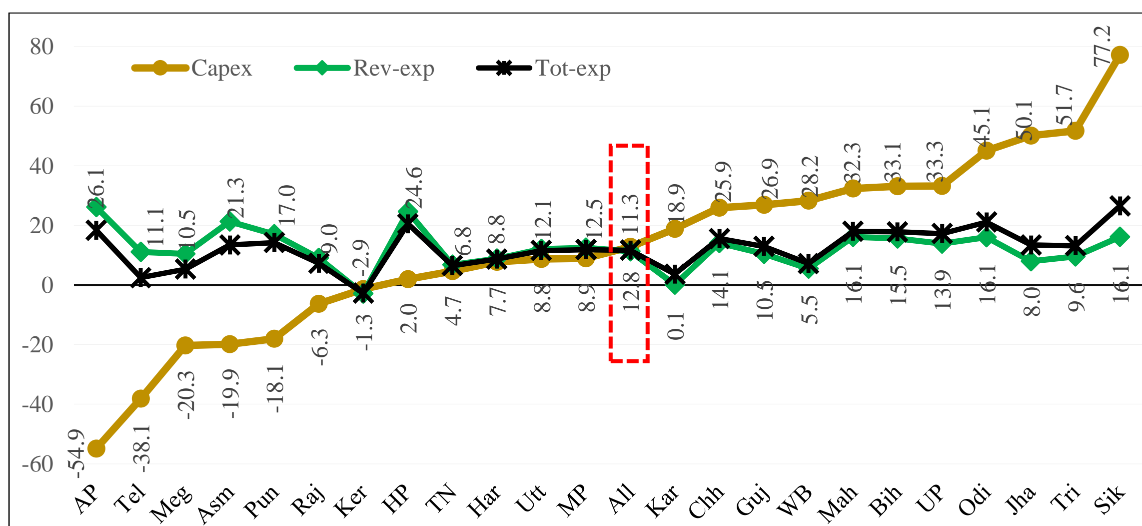
GST compensation to states is reported as grants in the state budgets. The five-year GST compensation period ended in June 2022. From July 2022 onwards GST compensation was discontinued. This could be one of the reasons for the fall in central grants to states in 2022-23.

All-states' combined budget for 2023-24 indicates an 8 percent decline in grants with 18 out of 28 state budgets assuming a fall.

States' capital expenditure performance modest despite strong central support

In 2022-23, total expenditure aggregated across all states increased by 11.7 percent. It entailed an increase in both revenue and capital expenditure, with capital expenditure rising by about 12.8 percent on average. This was modest compared to the massive increase in central government capital expenditure. Moreover, there are large variations across states, with 7 states (Andhra Pradesh, Assam, Kerala, Meghalaya, Punjab, Rajasthan and Telangana) reporting a decline (Figure 5.5).

Figure 5.5: Changes in state expenditure: 2022-23 over 2021-22 (%)



Source: Controller and Auditor General (C&AG)

To incentivise more capital expenditure by states, the Union government introduced a Rs 1 trillion scheme for 50-years interest free capital expenditure loans to states, the 'Special Assistance to States for Capital Investment 2022-23' scheme. Till March 2023, Rs. 81,195 crore had been transferred to states against the approved amount of Rs. 95,147 crores. Of this Rs.33,296 crore (i.e., 41 percent of actual transfers) were released only in the month of March 2023.

More timely transfers, earlier in the financial year, would have resulted in stronger states' performance in capital expenditure.

The central government has continued its support for states' capital expenditure in 2023-24, expanding the scheme to Rs. 1.3 trillion. Till end May 2023, Rs. 25,727 crore had been approved for 9 states.

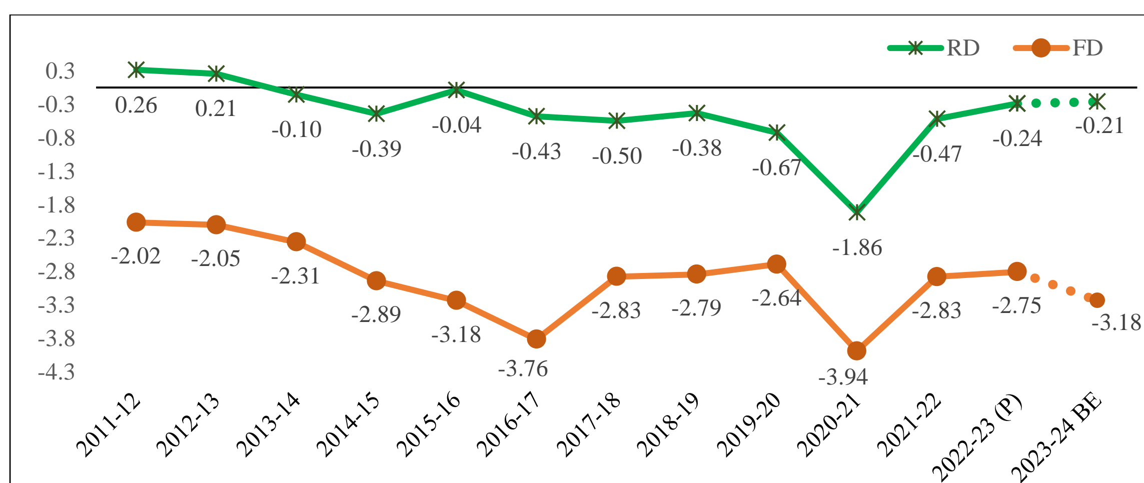
It is likely that the Centre's capex loans released only in the last month fiscal 2022-23 have mostly been spent during the first quarter of the current fiscal (i.e., Q1: 2023-24). Capital expenditure aggregated across 23 states increased by as much as 74 per cent in Q1: 2023-24 compared to the same period in 2022.

States' fiscal consolidation resumed after 2020-21 shock

Most states have resumed their fiscal consolidation following the pandemic shock in 2020-21. The combined fiscal deficit (FD) of all-states as percent of GSDP has been lower compared to all years since 2014-15 except 2019-20 (Figure 5.6). The revenue deficit is following a similar path. States' fiscal consolidation is largely being driven by buoyant own tax revenues.

This fiscal consolidation path is consistent with that recommended by the 15th Finance Commission. For 2023-24 the FD for all-states has been budgeted at FD round 3.2 percent of GSDP.

Figure 5.6: Deficits - States (% of GSDP)



Note: Deficit (-)/Surplus (+)
Source: Controller and Auditor General (C&AG); State Budgets and MoSPI

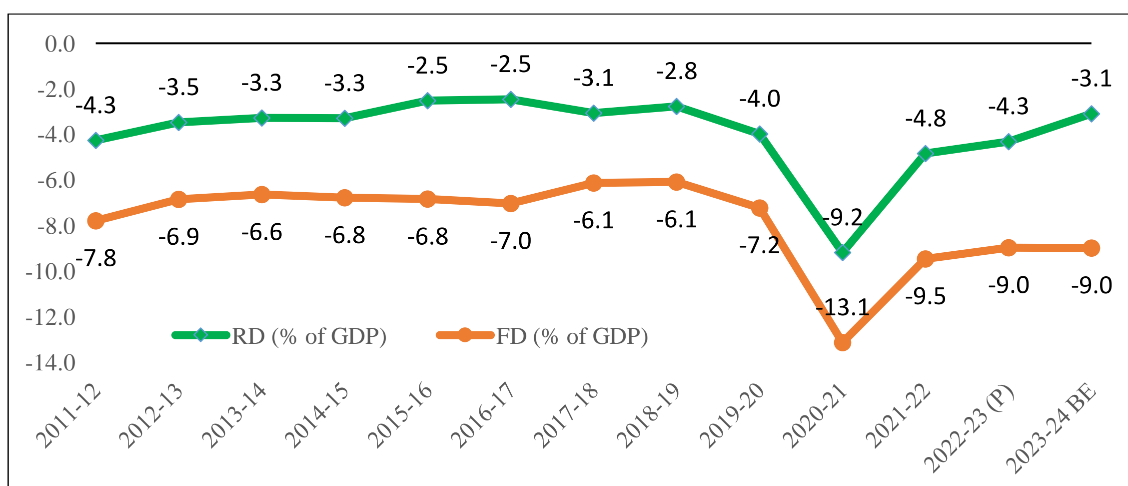
Fiscal consolidation by most states and central government, but central consolidation needs strengthening

Combined fiscal deficit of centre plus states in FY 2023-24 is budgeted at around 9 percent of GDP while the revenue deficit is budgeted at 3.1 percent of GDP (Figure 5.7).

The central government and most states have been pursuing fiscal consolidation. It is observed that both for the central government and the states (in aggregate), this consolidation is being driven by buoyant own tax revenues. However, the sharp decline in tax revenues of the central government in Q1 2023-24 is a matter of major concern. As noted earlier, the budgeted 0.5 per cent reduction in the central FD entails an annual central FD reduction of 0.7 per cent in 2024-25 and 2025-26 to reach the target central FD of 4.5 per cent in 2025-26. If the observed shortfall in central government tax revenues observed in Q1:2023-24 persists for the rest of the current financial year, the required FD reduction

during the next two years will be even higher. Achieving that will be quite challenging without a strong revenue mobilization effort by the central government.

Figure 5.7: Deficits as % of GDP - (Centre + States)



Note: Deficit (-)/Surplus (+)
Source: Controller and Auditor General (C&AG); State Budgets and MoSPI

5. Monetary Policy and Financial Markets

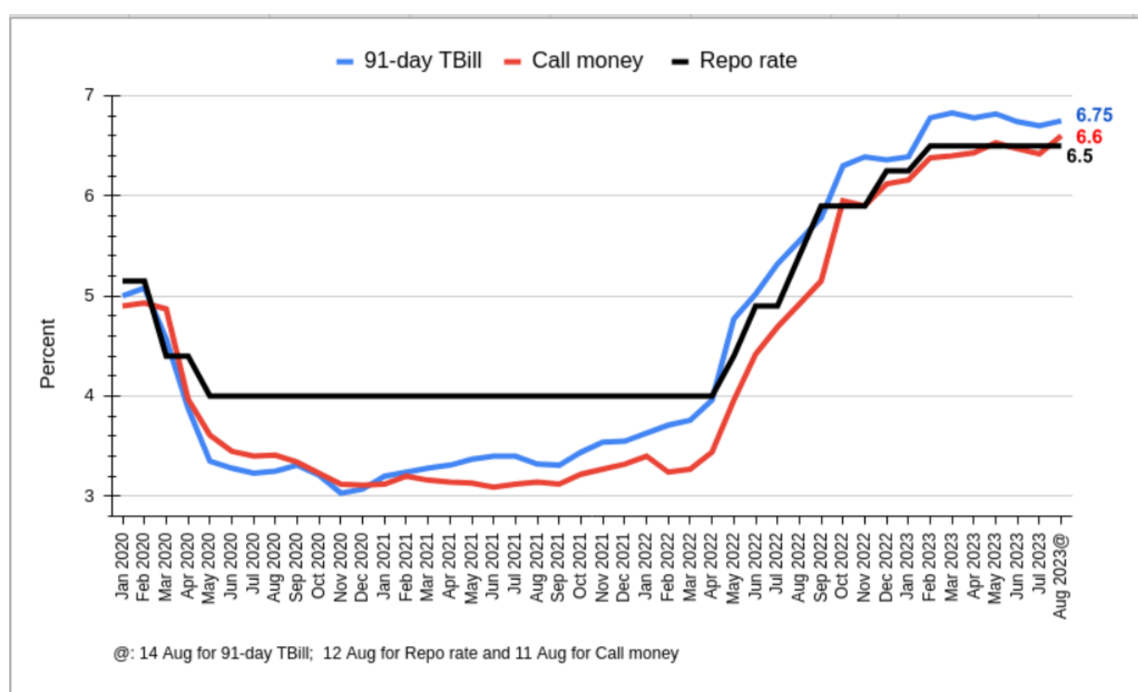
Short-term rates have risen in response to monetary policy tightening

Between May 2022 and February 2023, the Reserve Bank of India (RBI) raised the policy rate by 250 basis points to curb rising inflation. The stance was maintained at the withdrawal of accommodation to ensure that inflation progressively aligns with the 4 percent target, while supporting growth.

In the current financial year, in the three monetary policy review meetings held in April, June and August, the RBI chose to maintain status quo on the policy rate as well as on the stance. The trajectory of the short-term rates has mirrored the rise in the policy rate. The key short-term rates, the 91 day t-bill rate and the call money rate have risen in tandem with the rise in the policy rate since May 2022 (Figure 6.1).

Along with policy rate adjustments, RBI has also been conducting liquidity management operations in the form of Variable Rate Repo (VRR) auctions and Variable Rate Reverse Repo (VRRR) auctions. The VRRR auctions are conducted to absorb liquidity from the banking system and VRR auctions are conducted to inject liquidity.

Figure 6.1: Policy rate and key short-term rates



Source: RBI

Government bond yields and spreads have converged

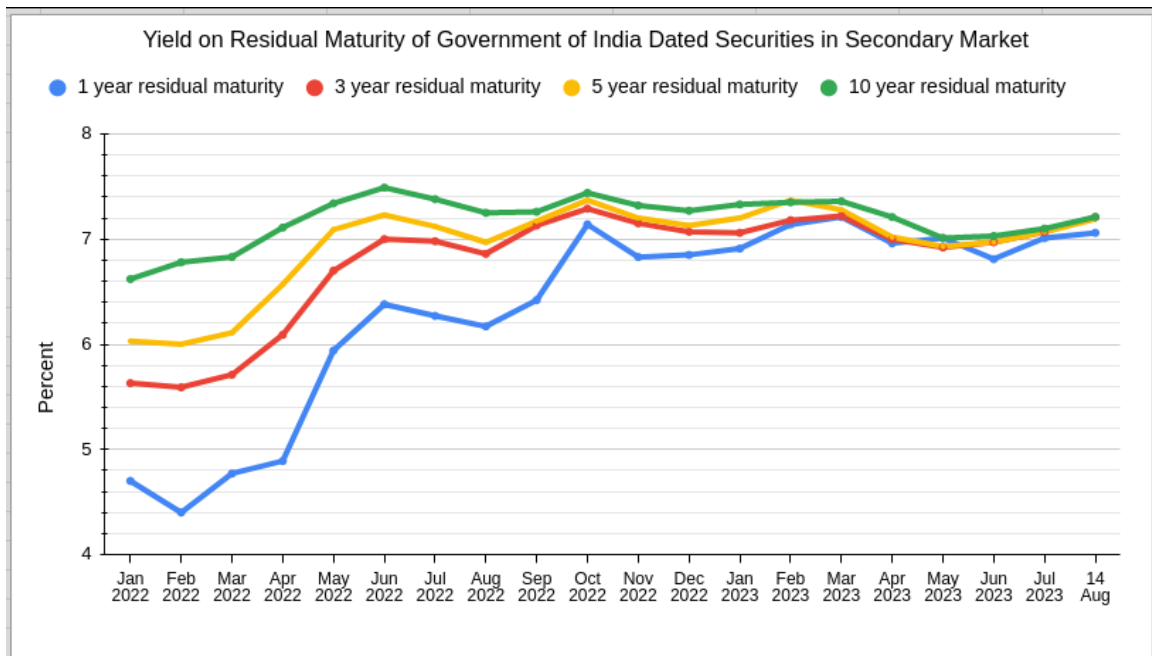
The sovereign bond yields have displayed an interesting pattern over the last one year (See Figure 6.2). Typically, the yields on the long-term bonds are greater than the yields on the short-term bonds, resulting in an upward sloping yield curve. Investors have to be offered a higher yield to park their funds in bonds for a longer duration. However, since last year, the yields on short-term and long-term bonds have witnessed a convergence. In other words, while the short-term yields have risen sharply in response to the rise in the policy rate, the long term bond yields have remained steady and, on some occasions, the yields on long-term bonds have even fallen.

The long term rates have remained more or less flat steady, possibly due to a decline in domestic inflation and status quo on policy rates in the April and June policies. The rise in short-term yields and stable long-term yields have resulted in a flattening of the yield curve. In the US a flattening or reversal of the yield curve is considered a precursor to recession or economic slowdown. It is not clear whether the flattening of the yield curve should be read as having a similar implication in India.

Since the last week of July 2023, however, long-term bond yields have inched following a 25 basis points rate hike by the US Fed, Bank of England and the European Central Bank, strong US GDP growth for the April-June quarter and the recent downgrade of US sovereign debt by Fitch. The latest minutes of the US Federal Reserve, for the meeting held in July 2023, indicated more rate hikes after the 25 basis points rate hike in July. The hawkish minutes imparted an upward pressure on US bond yields and the Indian ten year sovereign bond yield rose in tandem with the US bond yield. The Indian ten year bond yield increase was also a response to the sharp rise in the Indian CPI inflation to a 15 month high of 7.44 percent in July, raising concerns that the policy makers may find it difficult to cut rates any time soon. This caused a fall in bond prices and rise in bond yields. On August

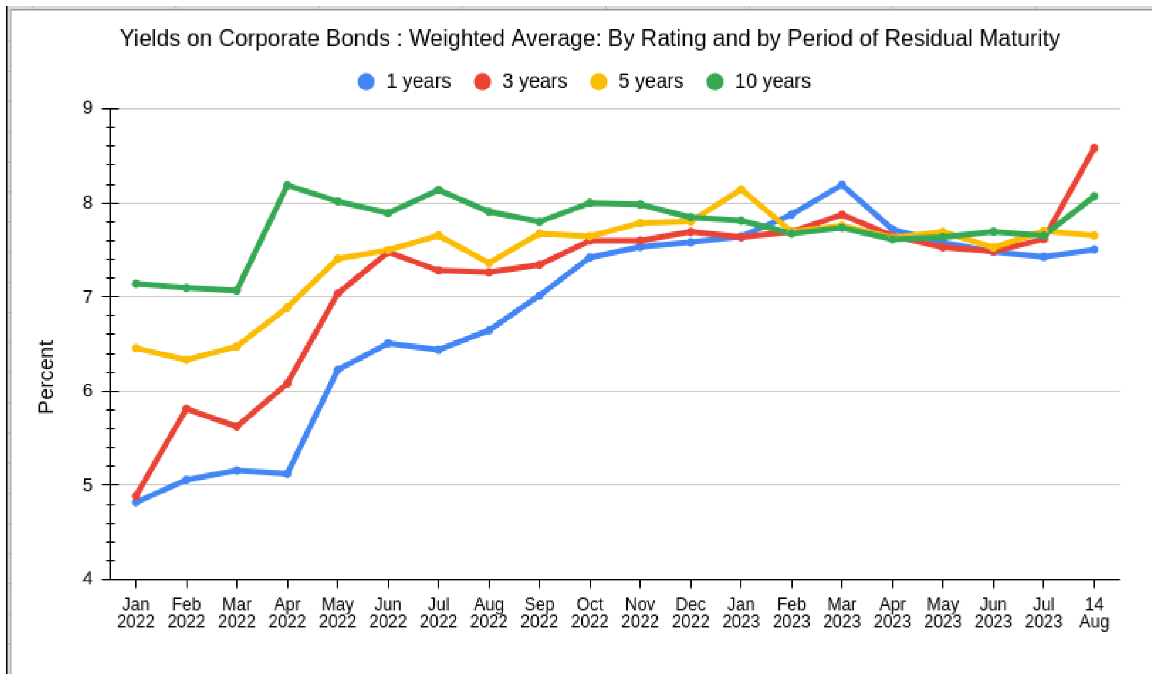
17, the ten year sovereign bond yield jumped to 7.25 percent-the highest since April 6, 2023.

Figure 6.2: Trajectory of government bond yields



Source: CMIE, Economic Outlook

Figure 6.3: Trajectory of corporate bond yields



Source: CMIE, Economic Outlook

Corporate bond yields are seen to mirror trends in government bonds

Similar to the trajectory of sovereign bond yields, yields on corporate bonds have also seen a convergence (Figure 6.3). The short-term corporate bond yields have risen faster than the bonds of longer-term maturity since last year. The convergence in yields is on account of demand-supply mismatch in the corporate bond market. Issuers of bonds are more inclined towards short-medium term bonds while investors in the corporate bond market are mainly institutional investors such as pension and insurance funds which are oriented towards investing in long-term bonds to align with their long-term asset-liability profile. As an outcome, there is an excess supply of short-term bonds and excess demand for longer-term bonds. This has resulted in a flattening of the corporate bond yield curve as well.

Liquidity in the banking system: Concepts and definitions

Liquidity in the banking system is a cumulative impact of borrowings by banks from the RBI under the Liquidity Adjustment Facility (LAF) and placing of excess funds with the RBI. If banks are short of funds, they can borrow from the RBI through the repo window and through the Marginal Standing Facility (at 25 basis points above the repo rate). If banks are flush with funds, they have the opportunity to park their excess funds with the RBI under the reverse repo window and earn an interest on their parking of funds with the RBI.

Thus:

System liquidity = Net borrowing under LAF - Excess reserves maintained by banks where,

Net borrowing under LAF = Total of all Repo/MSF/SDF borrowings - Total of all Reverse-repo deposits

Excess reserves maintained by banks = Actual reserves maintained by banks - Required reserves.

If the banking system is a net borrower from Reserve Bank under LAF, the system liquidity is in deficit (i.e., system demand for borrowed reserves is positive). If the banking system is a net lender to the Reserve Bank, the system liquidity is in surplus (i.e., system demand for borrowed funds is negative).[2]

In the last few months, liquidity has broadly remained in surplus with sporadic episodes of deficit owing to advance tax payments and Goods and Services tax payments towards the end of the quarter (Figure 6.4). Liquidity of the banking system got a further boost after the RBI's decision to withdraw Rs 2000 banknotes from circulation. The deposits of these notes into the banking system led to a surge in liquidity. Thus, on August 6, the surplus liquidity touched Rs 2.8 trillion.

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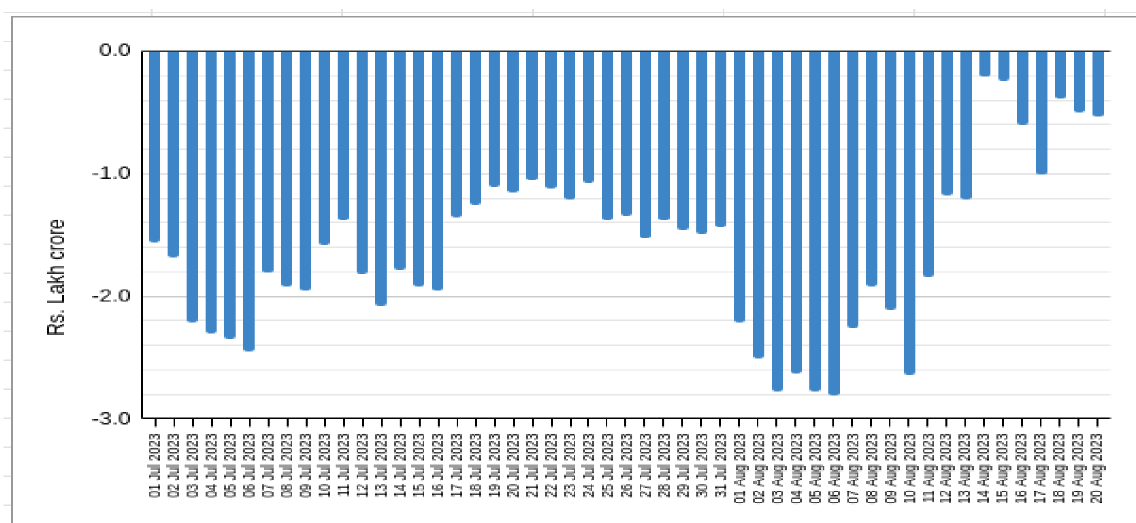
2 Reserve Bank of India. (2019). *Report of the Internal Working Group to Review the Liquidity Management Framework. https://rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=944#CP21*

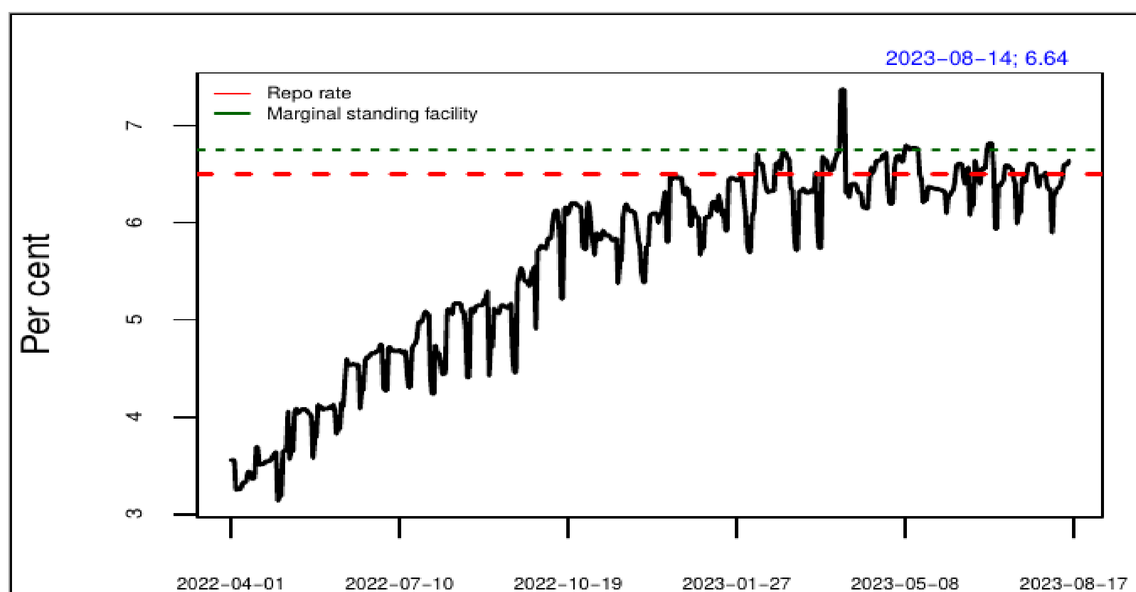
Figure 6.4: Liquidity condition



Source: RBI, Money Market Operations

Figure 6.5 compares the trajectory of the call rate with the repo rate and the Marginal Standing Facility (MSF). The call rate has risen since April, 2023. While the RBI's policy intent is to keep the call rate close to the repo rate, on some occasions the call rate hovered above the repo rate and even spiked above the Marginal Standing Facility rate of 6.75 percent.

Figure 6.5: Call rate along with the repo rate and the Marginal Standing Facility (MSF)



Source: RBI

The rising trajectory of the call money rate is at odds with the general prevalence of surplus liquidity in the banking system. The apparent dichotomy between the surplus liquidity and elevated call rate is explained by the fact that liquidity appears to be skewed in favour of

some banks as opposed to others. The RBI Governor made this remark at the June monetary policy review. [3]

To absorb the surplus liquidity, the RBI has been conducting Variable Rate Reverse Repo (VRRR) auctions, but the response of banks to VRRR auctions has been muted. Table 6.1 shows the amounts notified by the RBI and the amount parked by banks under the VRRR auctions. Banks have on average parked only around 60-65 percent of the notified amount in the VRRR auctions.

Table 6.1: Muted response of banks to Variable Rate Reverse Repo (VRRR) auctions

Date	Days	Notified amount	Total received
02/06/23	14	2,00,000	50,868
05/06/23	4	1,00,000	66,640
06/06/23	3	75,000	32,375
07/06/23	2	75,000	1,850
09/06/23	4	1,00,000	5,780
13/06/23	2	50,000	29,231
16/06/23	14	50,000	16,331
30/06/23	14	1,00,000	11,789
03/07/23	2	1,00,000	63,843
04/07/23	2	1,00,000	67,295
05/07/23	2	1,00,000	87,870
07/07/23	4	2,00,000	1,06,224
11/07/23	3	2,00,000	40,291
14/07/23	14	1,00,000	59,875
28/07/23	14	1,50,000	93,761

Note: *Amount is in Rs Crore
Source: RBI (Various notifications)

Responding to this muted response of banks to the VRRR auctions, the RBI outlined in its monetary policy on August 10, that effective 12th August, banks will be required to maintain an incremental Cash Reserve Ratio (ICRR) of 10 percent on the increase in their deposits between May 19 and July 28. Banks are mandated to maintain a certain proportion of their deposits as liquid cash with the RBI. Currently this proportion, called the Cash Reserve Ratio (CRR), is 4.5 percent.

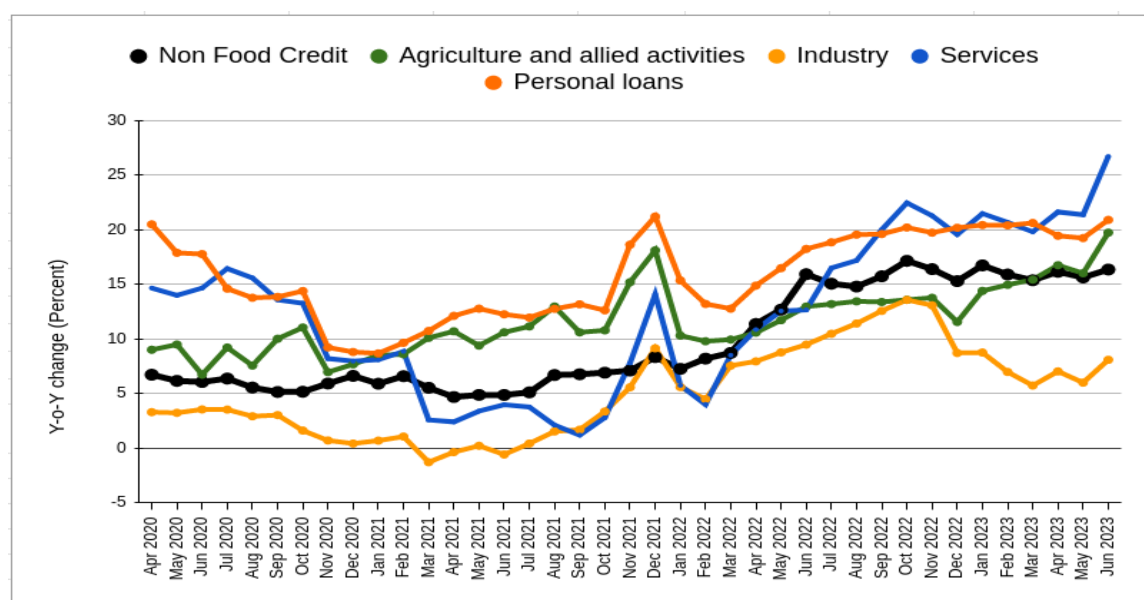
Post the introduction of the ICRR, the surplus liquidity in the banking system fell to less than Rs 1 trillion (see Figure 6.4 above). The introduction of ICRR has led to a rise in short-term rates, particularly the call rates. The requirement of maintaining additional funds with the RBI under ICRR is a temporary move and could be reviewed in September.

3 Reserve Bank of India. (2023). *Governor's Statement: June 8, 2023.* *https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=55816#F5*

Robust credit growth despite rise in interest rates

Despite a 250 basis points rate hike by the RBI, the non-food bank credit has registered robust growth (Figure 6.6). In the last financial year, non-food bank credit grew by 15.4 percent after three years of tepid growth. The strong growth in non-food bank credit continued during the first quarter of the current financial year.

Figure 6.6: Credit growth (y-o-y percentage change)



Source: RBI

Personal loans and services have been the major components of growth in non-food bank credit. The share of industry in the outstanding non-food bank credit has seen a decline. In a span of two years, the share of industry has declined from 26.8 percent in July 2021 to 23.8 percent in June 2023. Particularly, the share of large industry in the outstanding non-food bank credit has slid sharply from 21.2 percent to 17.6 percent during the same period. The categories of personal loans and services have seen an increase in their share in this period.

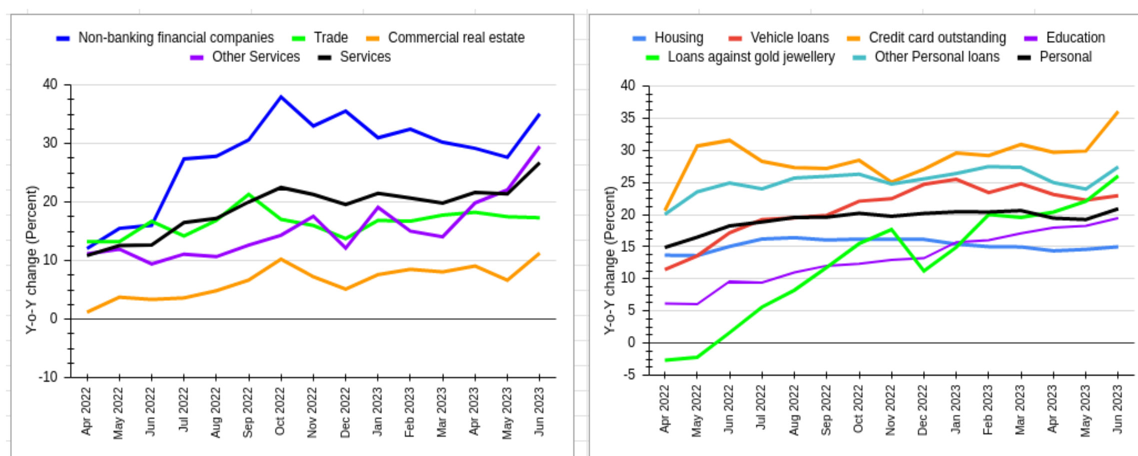
The outstanding credit to services sector in June 2023 stood at Rs. 38.85 trillion, a growth of 26.7 percent from June last year. Credit to Non-bank financial companies (NBFCs) and domestic trade are the two main components of the services category, accounting for 36.7 percent and 22 percent of the outstanding credit to services. Reliance on bank funding has increased for NBFCs as other sources of funds have tapered down. Thus, Mutual Funds (MF) exposure to the bonds and Commercial Papers (CPs) of NBFCs have seen a decline.

The outstanding credit to personal loans in June 2023 stood at Rs. 42.61 trillion, a 20.9 percent increase from June last year. Housing loans with a share of 46.9 percent in June 2023 and vehicle loans with a share of 12.3 percent are the two dominant segments of personal loans.

Figures 6.6(a), plot the year-on-year change in personal loans and services, and their key components. Amongst the personal loans category, advances against fixed deposits and credit card outstanding have grown by 46 percent and 36 percent, respectively. Though

these are smaller components of personal loans, their growth needs to be monitored in the coming months. Among services, credit to NBFCs registered a strong growth of 35 percent.

Figure 6.6(a): Year-on-year change in services (left panel) and personal loans (right panel) and their key components



Source: RBI

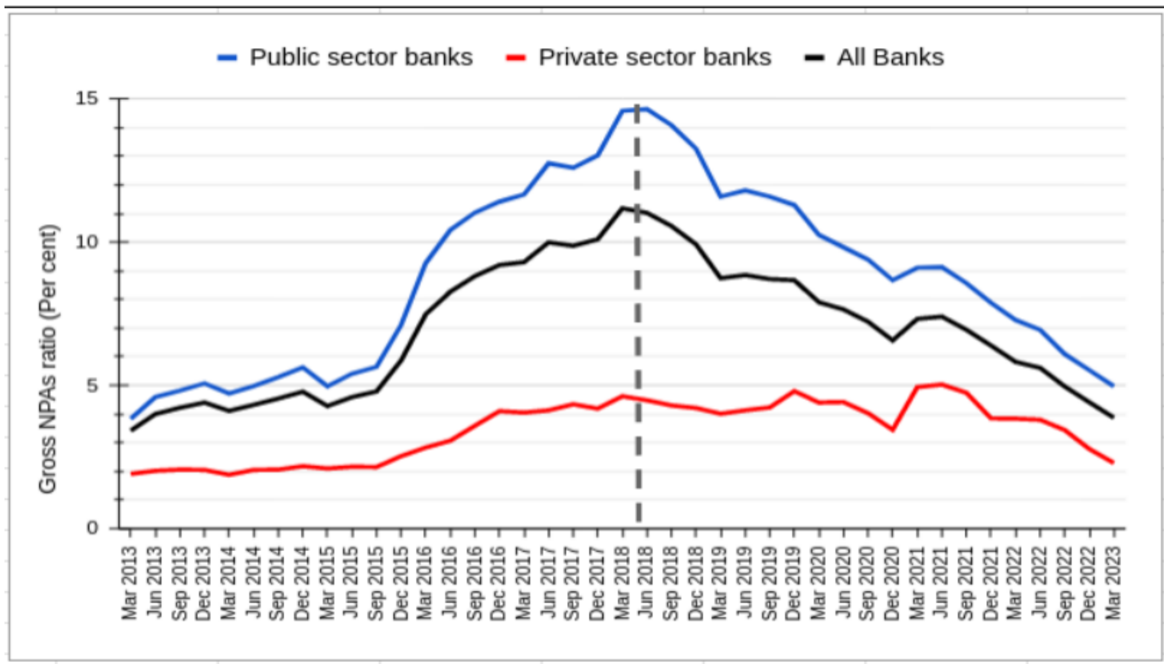
As at end July, credit growth continued to surpass deposit growth. While aggregate deposits grew by 12.9 percent, credit grew by 19.7 percent (including the impact of merger of HDFC with HDFC Bank). Excluding the merger, bank credit grew by 14.7 percent.

Visible improvement in balance-sheet position of banks in 2022-23

Robust credit growth has been facilitated by the improvement in the asset quality of banks. Their balance sheets have been cleaned up and the gross non-performing assets ratio has seen a sharp decline. For the scheduled commercial banks, the GNPA ratio has seen a decline from 11 percent in June 2018 to a 10 year low of 3.9 percent in March 2023 (See Figure 6.7). It is particularly encouraging that while the GNPA ratio for commercial banks overall has been declining, it has declined more sharply for public sector banks. The GNPA ratio of public sector banks declined from a peak of 14.6 percent in June 2018 to 5 percent in March 2023. This has led to a convergence of GNPA ratios for public and private sector banks.

At a disaggregated level, all public and private sector banks reported a drop in their gross and net bad loans as a percentage of loans in 2022-23. Other metrics of financial performance of public sector banks have also seen a visible turnaround in 2022-23. The combined net profit of public sector banks surged to more than Rs 1 trillion in 2022-23. This is a sharp turnaround as compared to a total net loss of Rs 85,390 crore in 2017-18. Stringent norms governing recognition of bad loans, healthy loan growth momentum and comfortable capital position contributed to the improvement in public sector banks' balance-sheets. A drop in provisioning for bad assets coupled with higher net interest margins have led to higher profitability of banks.

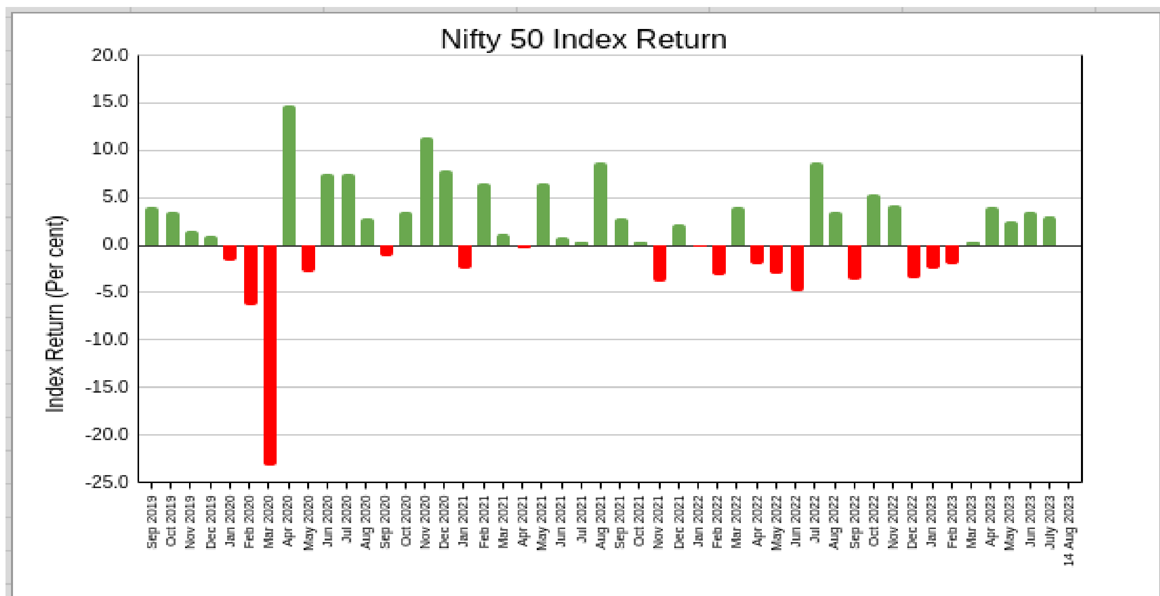
Figure 6.7: Gross non-performing assets ratio (GNPA ratio)



Source: RBI

The stellar performance of the banking sector continued in the first quarter of the current financial year. More importantly, the overall net profit of 12 public sector banks more than doubled to Rs 34,418 crore for the quarter ended June 2023 as compared to the same quarter last year.

Figure 6.8: Buoyancy in capital markets



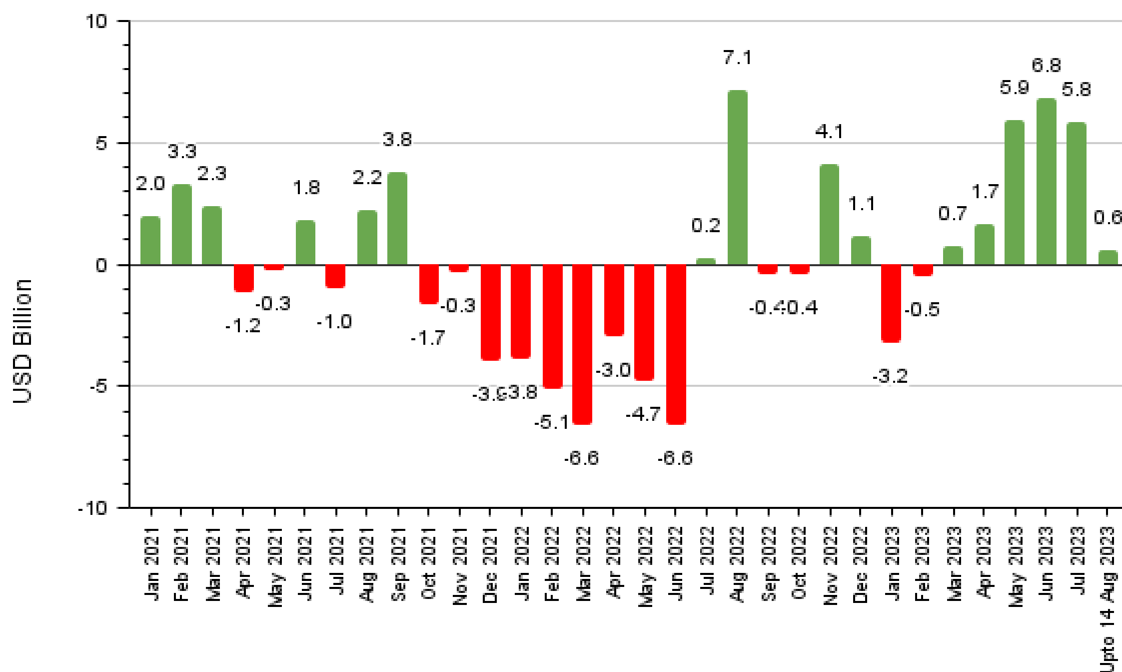
Source: National Stock Exchange

Buoyant capital market led by FPI net buying since March, but fresh headwinds emerge

After posting negative returns in the first two months of the calendar year, the equity market recovered in March. From March till July, the Nifty 50 index of the National Stock Exchange posted positive returns (Figure 6.8,). Moderation in global inflation and the hope that central banks globally would go slow in hiking rates contributed to the optimism in equity markets. However, since the last week of July, markets have seen bouts of volatility. A combination of several developments accounts for this: the downgrade of U.S sovereign debt by Fitch, rebound in global oil prices due to announcement of production cuts by Russia and Saudi Arabia, recent rate hikes by the US Fed and other advanced country central banks, the growth slowdown in China and the July spike in domestic inflation have dented investor sentiments. The first half of August saw markets in the red on many days. On other days, when the returns were positive, they were at best muted. Going forward, stock markets are likely to remain volatile.

Investments by Foreign Portfolio Investors (FPIs) also have followed a similar pattern (See Figure 6.9). After being net sellers in the first two months of the current calendar year, foreign portfolio investors turned net buyers since March. Net investments remained positive till July. However, since the last week of July investment pattern by FPIs also turned volatile. The rate hike by the US Fed and the downgrade of US sovereign debt by Fitch adversely affected FPI buying in July. The yields on the US ten year bond yields have inched higher in the first few weeks of August owing to hawkish minutes of the July US Fed meeting. The minutes indicated that more rate hikes may be required to bring inflation within the 2 percent target. Higher US bond yields tend to trigger outflows from emerging markets assets including from India. Going forward, the investments by FPIs are likely to remain volatile.

Figure 6.9: FII Net investments



Source: National Securities Depository Limited (NSDL)

6. Conclusion

The following are some of the key takeaways from the mid-year macroeconomic review.

Despite a very challenging global political-economic environment and domestic constraints, the economy grew by a robust 7.2 per cent in 2022-23. However, on closer examination it turns out this was largely due to exceptionally high growth of 13.1 per cent in Q1:2022-23, driven by the strong base effect of the sharp GDP contraction in Q1: 2021-22. In the second half of 2022-23, in the absence of a strong base effect, growth decelerated to 5.3 per cent. It is likely that the residual base effect of the Q1 2020-21 contraction also accounts for the strong growth of 7.8 per cent in Q1: 2023-24, with lower growth likely during the rest of the year without this base effect. The growth outlook from high frequency indicators is mixed. Our forecast of annual growth in 2023-24 is 6.3 per cent. Several other forecasts, including those of the RBI, IMF, World Bank etc., are also clustered in the 6.1-6.5 per cent range.

Inflation remained above the 6 per cent upper limit of the RBI tolerance band through most of 2022-23. Then there was a broad based decline in inflation to less than 6 per cent during Q1: 2023-24, presumably a lagged response to the RBI's Repo rate increase by 250 basis points between May 2022 and February 2023 and withdrawal of its accommodative monetary policy stance. However, inflation again surged to 7.4 per cent, led by food price increases. This is attributable to disruption in global and domestic food supplies. Inflation is likely to moderate later in the year as vegetable and food grain supplies stabilise, supported by the government's supply side interventions. We forecast an annual inflation rate of 6.2 per cent for the full year 2023-24.

The hallmark of the central government's fiscal policy in recent years, including the 2023-24, is the massive thrust on capital expenditure. It has been budgeted to increase by over 37 per cent in the current budget on top of very large increases during the last few years. This has been made possible largely due to buoyant growth of collections from all taxes, except excise duties, in recent years. The push to capital expenditure has been combined with very retrained revenue spending and fiscal consolidation, with a 0.5 of percent of GDP reduction in the fiscal deficit (FD) each year. However, there are serious concerns whether this 0.5 per cent deficit reduction target can be met this year if the large shortfall in tax revenue observed in Q1: 2023-24 continues during the rest of the year. The 0.7 per cent annual reduction in the FD during the next two years, required to meet the medium term consolidation target of 4.5 per cent FD by 2025-26, will be even higher. Meeting that target will then be well-nigh impossible without a major additional revenue mobilization effort.

Setting aside the large inter-state variations, 'all state governments' as a group have also performed well in own tax revenue mobilization. Own revenues account for 59 per cent of total revenue of the states and their own tax revenue accounts for 85 per cent of their total own revenue. This key component of states' available resources has been growing at 19 per cent per annum. However, most states have so far used their buoyant tax revenue growth to strengthen fiscal consolidation rather than capital expenditure. Their deficit reduction path is in line with the recommendations of the 15th Finance Commission. This relative neglect of capital expenditure by the states can change due to the capital spending incentive provided by the central government. The amount of Rs 1 trillion provided in the 2022-23 budget for capital expenditure loans to states, at zero interest for fifty years, has been

enhanced to Rs 1.3 trillion and the approval and disbursement of loans under this scheme has started gaining traction since March 2023.

Financial markets have witnessed an unusual phenomenon of persistent surplus liquidity despite Repo rate increases by 250 basis point between May 2022 and February 2023, the withdrawal of the accommodative monetary policy stance by the RBI, and rising yields especially on the call money rate and short maturity sovereign bonds as well as corporate bonds, which has flattened yield curves. The surplus liquidity has been attributed to a skewed liquidity distribution, where only some banks have a surplus liquidity. The RBI has been conducting variable rate reverse Repo operations and introduced the Incremental Cash Reserve Ratio of 10 per cent in its August monetary policy review, after which the surplus liquidity finally shrunk.

Meanwhile, commercial bank credit growth has been strong this year, thanks especially to their much reduced non-performing assets ratio (NPA), which has enabled enhanced lending operations. Particularly heartening in this context is the sharp reduction in public sector banks NPAs and improvement in other performance parameters. However, much of the credit flow has gone to services, including non-bank finance companies, real estate, and personal loans, not industry.

Turning finally to the external sector, the current account deficit (CAD) had come down to barely 0.2 per cent of GDP by the end of March 2023, mainly because of the reduction in the merchandise trade deficit exceeded the reduction in the net surplus of service exports. There was a corresponding reduction in capital inflows. However, the CAD started widening again in Q1:2023-24, with the decline in exports exceeding the decline in imports. Persistent BoP stress suggests that the policy of ad hoc increases in protective tariffs and non-participation in regional FTAs needs to be revisited.

There was a corresponding increase in capital inflows, especially in FPIs. However, during the last few weeks there has been an FPI flight to safety from emerging markets, including India, because of increased global risks: the downgrade of U.S sovereign debt by Fitch, rebound in food, fertiliser and fuel prices due to supply disruption, policy rate hikes by the US Fed and other major central banks and the growth slowdown in China. These adverse global developments have been reinforced by the July spike in domestic inflation.

At present these adverse conditions in the global and domestic economy are still persisting.

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Rudrani Bhattacharya, is Associate Professor, NIPFP
Email: rudrani.bhattacharya@nipfp.org.in

Manish Gupta, is Associate Professor, NIPFP
Email: manish.gupta@nipfp.org.in

Dinesh Kumar Nayak, is Economist, NIPFP
Email: dinesh.nayak@nipfp.org.in

Radhika Pandey is Associate Professor, NIPFP
Email: radhika.pandey@nipfp.org.in

Sudipto Mundle, Chairman, Centre for Development Studies
Email: sudipto.mundle@gmail.com

National Institute of Public Finance and Policy,
18/2, Satsang Vihar Marg,
Special Institutional Area (Near JNU),
New Delhi 110067
Tel. No. 26569303, 26569780, 26569784
Fax: 91-11-26852548
www.nipfp.org.in