STATE OF THE ECONOMY

Quarterly Assessment:
July – September, 2020

DECEMBER, 2020

NOTE FOR THE
ECONOMIC ADVISORY COUNCIL
TO THE PRIME MINISTER

NATIONAL INSTITUTE OF PUBLIC FINANCE
AND POLICY | NEW DELHI

HIGHLIGHTS

1. The real GDP contraction of -7.5% in Q2 (July-September) is significantly lower than the -23.5% contraction in Q1. With the gradual unlocking of the economy and the easing of mobility restrictions, the manufacturing sector also turned around and grew in Q2. Agricultural growth continued to be on an upward trajectory. High frequency data show a recovery in sectors related to consumer durables, including passenger cars and two wheelers.

2. Going forward, growth will depend on the demand recovery and the epidemiology of the virus. With the imminent roll out of Covid vaccine and the ease in mobility restrictions, the outlook in the next quarter appears positive. The real GDP growth is projected at (-) 7.5% in 2020-21 by the RBI and is an improvement compared to the earlier growth assessment.

3. The CPI inflation has breached the RBI threshold/ upper bound of 6% and rose to 7.6% in October 2020. Food inflation reached double digits at 11% in November 2020 due to a series of supply shocks.

4. RBI has responded to the Covid-19 pandemic with "whatever it takes to" narrative through liquidity infusion measures, regulatory interventions and key policy rate adjustments. RBI has desisted from abruptly rolling back its liquidity infusion measures because of its possible negative impact on growth in times of pandemic.

5. The growth in money supply (M3) declined marginally to 11.6% (Y-o-Y) in October, 2020 as compared to 12.2% in September. 2020. But reserve money or high-powered money increased by 16.3% (Y-o-Y) in October 2020 as compared to an increase of 14.7% in October 2019.[1] The components of reserve money which were significant for this increase were Currency in Circulation and the Net Foreign Assets (NFA).[2]

6. The call money rates and Treasury Bill rates for 91 days, 180 days and 365 days are now below repo rate at around 3%. The cut off yield rate of 10-year government securities (G-Sec) FBIL was 6.20% on December 4, 2020 as compared to 5.78% on July 31, 2020. The term spread (which is the spread between the short term and the long-term interest rates) between >10 year G-Sec yield and the repo rate was around 2 percentage points in December 2020.

7. The credit to agriculture and allied activities grew from 7.1% in October 2019 to 7.4% in October 2020. The credit to medium scale industries increased to 16.7% in October 2020 compared to 1.2% in October 2019. However, a few components of non-food bank credit have not shown any acceleration in growth. At the aggregate level, the growth of non-food bank credit has declined to 5.6 % in October 2020 from 8.3% in October 2019, on a year-on-year basis.

8. The increase in GST collections in October (Rs. 1,05,155 crore) over September (Rs. 95,480 crore) is a reflection of revival signs in the economy. The growth in GST collections increased to 5% in October 2020 from a negative of -14% in Aug. 2020.

9. The trends in quarterly revenue collections in the second quarter for the previous two years were 25% of the total revenue collections. The corresponding figure for Q2 2020-21 is 18%. The present trend suggests that aggregate revenue collection for the current fiscal year would fall short of the budget estimate by a considerable amount, despite an upturn in GST collections.

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[1] RBI (2020) State of the Economy, RBI Bulletin, November 2020, pp. 17.

[2] This creates a danger of monetary overhang. Money supply growth may accelerate if and when the money multiplier reverts to its normal level.

10. While Q1 of 2020-21 **was characterised by sharp contraction in own revenues of Union and States on account of Covid-19 induced lockdown, the second quarter saw revenue contraction moderating with the opening of the economy in a phased manner and gradual revival of economic activities**.

11. Trends in Union government finances indicate that there is an underlying concern for maintaining fiscal sustainability and macroeconomic stability by not allowing central government expenditure to increase exponentially. However, States have been provided with extra borrowing powers to maintain their fiscal space for meeting their expenditure needs.

12. The combined borrowings of Union and States in 2021 would be 9.63% of Advance Estimate of GDP. The RBI has projected the real GDP to contact by -7.5% in 2020-21. Assuming a 4% rate of inflation, the contraction in nominal GDP works out to 3.5% in 2020-21. Considering the revised GDP numbers, the combined borrowings of the Union and State governments would be around 10.97%. Furthermore, assuming a 0% nominal GDP growth, which implies assuming an inflation rate of 7%, the combined borrowings of the Union and the States works out to 10.58% of GDP.

13. On allocation for social protection to boost employment and consumption in rural India, as of June, 2020 Rs. 1,01,500 crores were allocated for the MG-NREGS by the Union Government, of which Rs. 60,441 crore were released up to 10 September 2020. On the jobs front, between April and August 2020, the number of person days generated was 198.13 crore as compared to 131.21 crore person days during the same period in 2019, an increase of 51%.

14. Most state budgets were presented before the onset of the pandemic. The own tax revenues of 18 States contracted by 5.94% in Q2 as compared to a contraction of 40.20% in Q1. With 2% of GSDP as additional borrowing facility provided to the States as part of the Atmanirbhar Package, States are expected to receive about Rs. 4.28 lakh crores for the year 2020-21.

15. Government of India has also provided assistance under "Scheme for Special Assistance to States for Capital Expenditure". The special assistance is provided in the form of 50-year interest free loan aggregating to Rs. 12,000 crore. The capital outlay of all States for the year 2020-21 (BE) is Rs. 5.98 lakh crore. The capital expenditure contracted by 40.43% and 28.25% in Q1 and Q2 of 2020-21 respectively. Any stimulus directed towards capital spending will be growth enhancing. Thus, further increase in assistance under this scheme can help in increasing capital spending in the States.

16. Fiscal stimulus in terms of higher borrowing power to the States will be more effective if there is better absorption by States. For an appropriate response to the pandemic, it is equally important to provide for higher government spending in 2021-22. A higher deficit than what was specified in the FRBM Act may be necessary for reaching a full revival of the economy.

17. However, from a macro-fiscal point of view, in the Union budget for 2021-22, it will be important to provide a clear exit strategy for fiscal adjustments in the medium term. The government may also have to revive the efforts to achieve its budget targets of non-debt receipts, particularly from disinvestment and strategic sale of stake in PSUs.

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I MACROECONOMIC ASSESSMENT AND GROWTH OUTLOOK

1. Past Trends In Growth

- Following the onset of the pandemic and lockdowns beginning March 2020, the real growth rate for Q1, 2020-21 registered a -23.9% decline. With gradual reopening beginning in June, the growth rate for Q2, 2020-21 has improved significantly from the initial drop of -23.9% to -7.5%. This trend is in alignment with the economic recovery across the globe reflecting a world-wide pickup in business and consumer confidence.[3] The sectoral growth experiences in the two quarters following the pandemic can be classified into four categories.

- **No significant contraction in Q1 or Q2**: Agricultural sector remains on a positive growth trajectory and is unaffected by the pandemic in both the quarters. After contraction in Q1, Electricity, Gas and Water registered a positive growth rate of 4.4% in Q2.

- **Large contraction in Q1, fast recovery in Q2**: Manufacturing and construction were both hit severely during Q1 due to the lockdown. With the gradual reopening of the economy, manufacturing registered a positive growth rate of 0.6%. The rate of contraction in construction declined sharply from -50.2% to -8.6% between Q1 and Q2.

- **Large contraction in Q1, limited recovery in Q2**: Trade, Hotels, Transport and Communication as well as Mining and Quarrying sectors also contracted significantly in Q1 due to the lockdown. Furthermore, social distancing requirements and the possibility of pandemic-related health risks in some of them have prevented these sectors from stronger recoveries during Q2.

- **Moderate contraction in Q1 and Q2**: Finance, Real Estate & Professional Services and Public Administration, Defence etc., exhibited contractions in both the quarters. This may be due to 'work from home' in some parts of these sectors that have enabled them to avoid large contraction, but logistic or demand shocks in other parts of these sectors have resulted in contractions.

Table 1: Growth Rates (of GVA (in %), Constant Prices, 2011-12 series

Sectors	Annual 2019-20	Q1 2020-21 Apr-Jun	Q2 2020-21 Jul-Sep
		Y-o-Y	Y-o-Y
GDP	4.2	-23.9	-7.5
Agriculture, Fishing, etc.	4.0	3.4	3.4
Mining & Quarrying	3.1	-23.3	-9.1
Manufacturing	0.0	-39.3	0.6
Electricity, Gas, Water etc.	4.1	-7.0	4.4
Construction	1.3	-50.2	-8.6
Trade, hotels, Trans., etc.	3.6	-47.0	-15.6
Financial & Profn. Serv.	4.6	-5.3	-8.1
Public Admin, defence, etc.	10.0	-10.3	-12.2

Source: NSO (2020) Press Release on Quarterly estimates of GDP, November, 2020

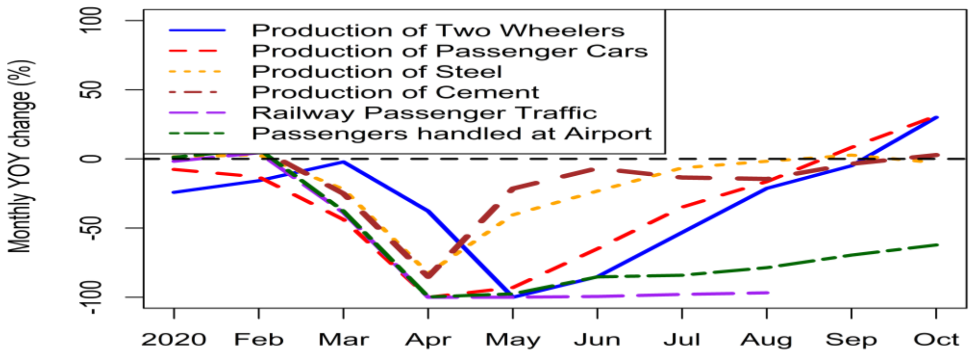
[3] Source: Govt. of India (2020) Monthly Economic Review, Dept. of Economic Affairs, November, 2020.

- On the expenditure side, private final consumption expenditure[4] was 54.3% of GDP in Q1 and 54.2% in Q2. The corresponding figure for Q2 of 2019-20 was 56.5%. The gross fixed capital expenditure in Q2 2020-21 was 29.0% of GDP, compared to 22.3% in Q1 2020-21.

2. Growth outlook

- Sectors related to consumer durables (e.g., two-wheelers and passenger cars, Figure I) have recovered very strongly. This recovery is expected to drive higher growth during the rest of the year. Sectors related to raw materials etc. (e.g., steel and cement, Figure I) have recovered from the deep recession, but have stagnated more recently. These sectors may have become demand constrained due to the income loss in the economy. Sectors related to services like transport and tourism (e.g., railway and airport traffic, Figure I), where social distancing is difficult, have continued to be in recession.

Figure I: Monthly Growth Rate of Selected Indicators (Y-o-Y, %)



Source: Economic Outlook database, Centre for Monitoring Indian Economy

- **The growth rate during the rest of the year is expected to move closer to positive territory. There are, however, sector-specific risks, both on the demand side** (due to loss in income) **and supply side** (due to social distancing requirements and newer waves of the pandemic). **The recovery is also expected to be uneven across States**. States like Gujarat and Tamil Nadu that have larger manufacturing sectors are likely to recover faster. On the other hand, States that depend on transport and tourism like Himachal Pradesh, Kerala and Goa will take more time to recover. The recovery in state wise GST collections is uneven. This is also a reflection of uneven growth recovery across States.

3. Past trends in inflation

- **During the first half of the financial year 2020-21, the average CPI inflation was 6.86%**. CPI inflation rose sharply to 7.3% in September and further to 7.6% in October, 2020, with some evidence that price pressures are spreading (MPC: Dec., 2020). The resolution of the MPC on December 2-4, 2020 observed that CPI inflation has remained muted across advanced economies while it picked up in some EMEs, firming food prices and supply disruptions. The core inflation, i.e. CPI excluding food and oil also picked up from 5.4% to 5.8% between September and October, 2020.

- The average inflation in CPI food has been 11% from November 2019 to October 2020 (Figure II, left panel). This elevated level was due to crop damages on account of prolonged abnormal rainfall in onion producing States since August, 2019. The pressure intensified and spread across other food commodities during and post lockdown period due to supply chain

[4] NSO (2020) Press release on quarterly estimates of GDP, 27th Nov., 2020.

disruptions and labour shortages in the agricultural sector. The core (non-food, non-fuel) CPI inflation was affected more by supply shocks caused by disruption than by negative demand shocks.

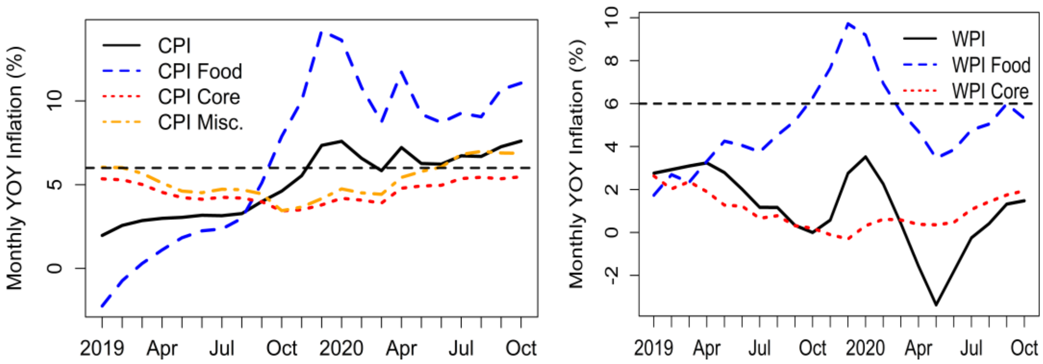
- The inflation rate in miscellaneous items (30% of CPI basket) is persistently higher than the 6% mark since June, 2020. This is due to the rise in expenditure on health, particularly in urban sector, and transport systems caused by the pandemic.

- WPI exhibited deflation in April-July, 2020, but have risen thereafter. The deflation was caused by declining fuel prices during this period. (Figure II, right panel). The divergence between the CPI and WPI inflation rates was primarily driven by declining oil prices. The average deflation in crude oil prices during January-October, 2020 was 34%. The crude prices have shown an upward trend since mid-November 2020. The corresponding WPI energy inflation rate was 8.6% compared to the CPI energy inflation rate of 3.3%.

- WPI food (food articles and manufactured food products) inflation experienced a transitory effect of abnormal rainfall in Q3 and Q4 of 2019-20. It has been higher than the 6% mark during the last quarter of 2019-20, but has moderated since then. However, it again showed an increasing trend since the lockdown period as a result of supply side shocks including rising agricultural wage growth.

- WPI core (non-food, non-oil) inflation has been stable at around 1.1% during the first half of the financial year 2020-21.

Figure II: Recent Trends in CPI and WPI



Source: Office of the Economic Advisor, Dept. for Promotion of Industry & Internal Trade, and NSO (2020), Press release on Wholesale Prices

4. Inflation outlook

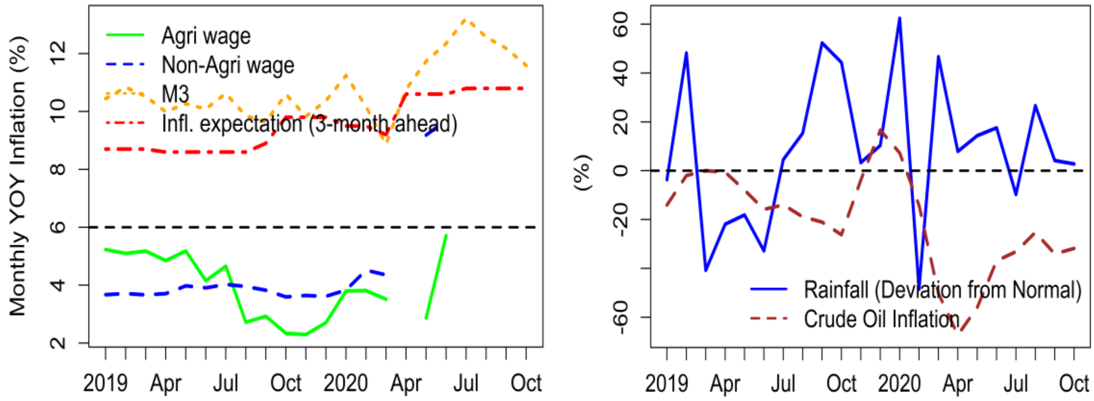
- Inflation outlook is based on past trends and underlying drivers of inflation including inflationary expectation, labour (wage) cost, money supply and oil prices.

- Inflationary expectation: RBI's household inflation expectation (3 month ahead) was at a high of 9% in the pre-Covid period (January, 2019, to March, 2020, Figure III, left panel). During April to October, 2020, it increased to 11%. This rise indicates a risk in the inflation front and a challenge for monetary policy to anchor inflation expectation on a sustained basis.

- Labour cost: The non-agricultural wage growth has jumped to 9% in May, 2020 and further to 9.7% in June 2020, while agricultural wage growth has jumped to 5.7% in June, 2020, indicating rising agricultural and non-agricultural labour cost (Figure III, left panel).

- The headline inflation is expected to be elevated beyond or around the upper level of RBI's tolerance band for the rest of the second half of 2020-21. Apart from the elevated wholesale vegetable inflation, it is driven by unanchored inflationary expectation, high money supply and rising rural wages. There may be upward pressure on inflation if there is an increase in the spread of the pandemic and associated supply disruptions.

Figure III: Factors driving Inflation



Source: RBI, CMIE, Pink Sheet Data: World Bank

II FISCAL ISSUES: UNION GOVERNMENT

1 Tax Revenues

- The shock to the economy from the prolonged lockdown has resulted in a sharp decline in the revenue collections in the first quarter of the current financial year. The gross revenue collection in the first quarter was about 11% of BE for the current fiscal as compared to over 19% in the preceding two years.

- The trends in quarterly revenue collections in the second quarter for the previous two years were about 25% of the total revenue collections. The corresponding figure for Q2 2020-21 is 18%. The present trend suggests that aggregate revenue collection for the current fiscal year would fall short of the budget estimate by a considerable amount, despite an upturn in GST collections.

- The Q2 revenue performance, when compared with Q2 of last two years, except Union excise duty, other taxes show a decline. The gross tax revenue registered a negative growth of 16.8% during this period.[5] In October, 2020 nearly 80 Lakh GSTR-3B E-returns have been filed.[6] The government has announced reduction in the turnover limit of E-invoicing from Rs. 500 crore to Rs. 100 crore from January 2021. This change is a significant step and will improve tax compliance.

- The collections of both non-tax revenue and non-debt capital receipts have been substantially lower than the levels observed in earlier years, both in nominal terms and as a percentage of BE 2020-21. Since non-tax revenue is in the nature of regular payments while non-debt capital receipts require special effort to mobilise including disinvestment proceeds, it is fair to assume that the non-tax revenue would be much lower than the budget estimates of 2020-21. The non-tax revenue collection fell by 48.2% during April-October, 2020, relative to the same period last year.

[5] Source: Govt. of India (2020) Monthly Economic Review, Dept. of Economic Affairs, November, 2020.
[6] Ministry of Finance, Press release on GST collections, 1st Nov., 2020.

Table 2 : Potential Levels for Tax Revenue (Rs. crore)

	Q2 Revenue collection to Total Collection in the year, %		Q2 Revenue	Expected Revenue	Q2 as a % of BE 20-21
	2018-19	2019-20	2020-21	BE 20-21	
Corporation Tax	26.7	32.1	96252	681000	14.13
Income Tax	23.7	24.2	104366	638000	16.35
CGST	27.1	26.5	107432	580000	18.52
Customs Duty	26.0	29.6	24931	138000	18.06
Union Excise Duties	26.2	24.6	93406	267000	34.98
Gross Revenue	24.6	25.8	451210	2423020	18.62

Note: Assignment to States are assumed to be the same fraction of gross revenue as observed in Q2. Source: Computed from CGA, Monthly Accounts

- In October, 2020, the RBI approved a dividend of Rs. 57,128 crore to the central government for the year 2019-20, which was nearly 39% of the total budgeted Dividends and Profits for 2020-21. The net collections from the other major items of non-debt capital receipts such as proceeds from disinvestment of equity holdings and stake of government in PSUs is only Rs. 6,178 crores, amounting to 5% of the budgeted amount of Rs. 1,20,000 crore for 2020-21.[7]

- The central government's ability to spend will depend on the level of fiscal deficit that it is willing to accept as tolerable. The central government's fiscal deficit stood at Rs. 9.53 lakh crore during April-October 2020, which is 119.7% of BE 2020-21.[8] Going forward, government will have to strike a balance between the increasing expenditure needs and level of fiscal deficit. As of November 2020, the central government's gross market borrowings for the fiscal year 2020-21 was Rs. 9.05 lakh crore, which is 68% higher than the amount raised in the corresponding period of the previous year.[9] This is against the revised target of Rs. 12 lakh crore for fiscal year 2020-21. Expansionary fiscal stance, if any, needs to be accompanied by an exit strategy from fiscal expansionary mode, with credible commitments.

- Further to operationalize the special window to States for meeting the GST compensation cess shortfall of Rs. 1.1 lakh crore, the gross market borrowings of Government of India was revised to Rs. 13.1 lakh crore in October 2020. This amount works out to 5.82% of the 2020-21 Advance Estimate of GDP. States' unconditional borrowings for 2020-21 is expected to be around Rs. 8,54,640 crore (i.e. 4% of 2020-21 budgeted GSDP aggregated across all states, or 3.8% of 2020-21 Advance Estimate of GDP). This amount would increase further if States were to meet any of the four reform conditions and become eligible for additional borrowings.

- The combined borrowings of the Union and States in 2021 would be 9.63% of Advance Estimate of GDP. The RBI has projected the real GDP to contact by -7.5% in 2020-21. Assuming a 4% rate of inflation, the contraction in nominal GDP works out to 3.5% in 2020-21. Considering the revised GDP numbers, the combined borrowings of the Union and State governments would be around 10.97%. Furthermore, assuming a 0% nominal GDP growth, which implies assuming an inflation rate of 7%, the combined borrowings of the Union and the States works out to 10.58% of GDP.

[7] CGA (2020) Non-Debt Capital receipts, CGA Monthly Accounts Review, October, 2020.
[8] Govt. of India (2020) Monthly Economic Review, Dept. of Economic Affairs, November, 2020.
[9] Govt. of India (2020) Monthly Economic Review, Dept. of Economic Affairs, November, 2020.

- Government of India has also provided assistance under "Scheme for Special Assistance to States for Capital Expenditure". The special assistance is provided in the form of 50-year interest free loan aggregating to Rs. 12,000 crore. The capital outlay of all States for the year 2020-21 (BE) is Rs. 5.98 lakh crore. The capital expenditure contracted by 40.43% and 28.25% in Q1 and Q2 of 2020-21, respectively. There is a need to augment well planned and well executed capital spending for growth. Any stimulus directed towards such capital spending will also be growth enhancing. Thus, further increase in assistance under this scheme can help in increasing capital spending in the States.

- According to the RBI data, during the first half of 2020-21 there has been an increase of more than 60% in the borrowings by the state governments on a year on year basis.

- In order to meet the shortfall in GST compensation cess payment to States in the current fiscal the Government of India gave two borrowing options to States, namely, (1) borrow Rs. 1.1 lakh crores which is the shortfall arising out of GST implementation through issue of debt under a special window coordinated by the Ministry of Finance or (2) borrow the entire shortfall in GST revenue collection of Rs. 2,35,000 crore through issue of market debt. Under option-1, the Union government would borrow Rs.1.1 lakh crore (assuming all States join) and pass on to States the borrowed amount as a back-to-back loan. States opting for option-1 can also avail additional 0.5% borrowing unconditional. As per the latest information all the States have opted for option-1.

2. Trends in the Expenditures

- On the expenditure side, Centre's total expenditure for the first seven months of 2020-21 registered an year-on-year growth of 0.4% and stood at 54.6% of BE as compared to 59.4% of the BE during the corresponding period in 2019-20. The revenue expenditure witnessed a growth of 0.7% while capital expenditure fell by 1.9% during April-October 2020 as compared to the same period in the previous year.[10]

- There is emerging evidence of compression in the primary expenditure of the Union government. In the first quarter, government spending was 28.08% of BE 2020-21. In the second quarter, it was 22.21% (Table 3). In the first half of the year, the total primary expenditure was 50% of the budget estimates for the year 2020-21.

Table 3: Trends in Expenditures in Q1, Q2, 2020-21 (Rs crore)

Item	BE 20-21	Q1	Q2	H1/BE (%)
Revenue Expenditure net of interest payment	1922018	567178	440744	52.44
Capital Expenditure	412009	88273	77563	40.25
Total Primary Expenditure	2334027	655451	518307	50.29

Source: Computed from Monthly Accounts, CGA

18. Given that over 50% of non-interest revenue expenditure has already been spent in the first half of the financial year, any compression in expenditure will result in more than proportionate compression in the second half of the year. As of June, 2020 Rs. 1,01,500 crore were allocated for the Mahatma Gandhi NREGS, of which Rs. 31,493 crore were released in the first tranche. It increased to Rs. 60, 441 in the 2nd week of September. On the jobs front, 6.69 crore jobs were offered in 2020-21, which is 73% higher than the average number of jobs offered

[10] Govt. of India (2020) Monthly Economic Review, Dept. of Economic Affairs, November, 2020.

in May 2019.[11] Between April and August 2020, the number of person days generated was 198.13 crore as compared to 131.21 crore person days during the same period in 2019, an increase of 51 per cent.

- Trends in Union government finances indicate that there is an underlying concern for maintaining fiscal sustainability and macroeconomic stability by not allowing central government expenditure to increase exponentially. However, States have been provided with extra borrowing powers for meeting their expenditure needs.

III FISCAL ISSUES: STATE GOVERNMENTS

- The shortfall in revenues coupled with the increase in expenditures implies considerable increase in deficits as compared to the budget estimates of 2020-21 for States. The revenue and fiscal deficit aggregated across 23 States as percentage of GDP during the Q1 of 2020-21 were around 4.14% and 4.90%, respectively.

- State governments have been on the forefront in meeting the challenges that Covid-19 has thrown up leading to significant increase in expenditure needs. From available data, during Q1 of 2020-21, we see that revenue expenditure aggregated across 23 States was up 13.51% vis-à-vis Q1 of 2019-20 (Table 4). Service-wise break-up of expenditure show an increase in expenditures on social services, which include expenditures on medical & public health, water supply & sanitation, labour & employment, social security & welfare etc., and general services, while the expenditure on economic services declined. Expenditure on social services was 16.21% higher in Q1 of 2020-21, while those on economic services were lower by 16.18%. Capital expenditure on the other hand contracted by 41.78% during this period.

- With the phased unlocking of the economy starting from 8 June 2020, there has been a gradual improvement in the fiscal position as compared to Q1. During July-September 2020, the decline in own tax revenues aggregated across 18 States moderated from -40.20% to -5.94% as compared to the corresponding period in 2019-20 (Table 4). The shortfall in SGST was -14.64%. To generate additional revenues, several state governments increased duties on petrol, diesel and alcohol.[12] The revenues from state excise during Q2 of 2020-21 increased by 23.17% as compared to that in 2019 while the decline in sales tax moderated to 5.30%.

- Central transfers aggregated across 18 States show an increase of 22.68% during Q1 of 2020-21 vis-à-vis 2019-20 largely due to higher grants from the Union government. The increase in grants to States could be attributed to the release of GST compensation for the period from December 2019 to February 2020 on 4th June 2020, by the Union Government. However, central transfers to States show a decline of 28.92% during Q2.

- The fiscal imbalance faced by the States required additional funding provisions to manage evolving spending needs in the short run. Government of India, under the Aatma Nirbhar Abhiyan in May 2020, allowed the States to increase their borrowing limits from 3% to 5% of GSDP for the fiscal year 2020-21. This is expected to generate resources of about Rs. 4.28 lakh crores.

- Fiscal stimulus in terms of higher borrowing power to the States will be effective if there is a better absorption by States in 2020-21. For an appropriate response to the pandemic, it is

[11] Ministry of Rural Development, Press Note on Provisions for Mahatma Gandhi NREGS, 8th June, and 15th September 2020.
[12] RBI (2020) Study of State Budgets, 2020-21, Reserve Bank of India.

equally important to ensure higher government spending in 2021-22. A higher fiscal deficit than what was specified in the FRBM Act may be necessary for rapidly achieving a full revival of the economy.

Table 4: % change in key fiscal indicators of States in 2020-21 over 2019-20

		23 States	18 States		
		Q1 (Apr-Jun)	Q1 (Apr-Jun)	Q2 (Jul-Sep)	Q1+Q2 (Apr-Sep)
Revenue					
1	Total Revenue Receipt	-19.36	-16.80	-17.24	-17.04
2	Own Revenue Receipt	-40.82	-38.95	-8.19	-23.16
3	Own Tax revenue, *of which*	-43.40	-40.20	-5.94	-22.73
	(i) SGST	-40.63	-38.04	-14.64	-25.92
	(ii) Sales Tax	-39.11	-36.19	-5.30	-19.86
	(iii) State Excise	-37.06	-32.32	23.17	-6.66
4	Non-tax Revenue	-18.64	-29.47	-23.49	-26.25
5	Central transfers	19.00	22.68	-28.92	-7.88
6	Devolution	-6.68	-1.98	-30.45	-18.14
7	Grants	54.66	56.23	-27.25	4.31
Expenditure					
8	Revenue expenditure	13.51	13.84	-11.33	-0.004
9	Capital expenditure	-41.78	-40.43	-28.25	-33.63
10	Total expenditure *of which*	7.50	7.41	-13.41	-4.07
	(i) Expenditure on Gen. Serv.	5.19	1.97	-4.30	-1.40
	(ii) Expenditure on Soc. Serv.	16.21	17.82	-5.50	4.58
	(iii) Expenditure on Econ. Serv.	-16.18	-15.92	-19.43	-17.81

Notes: Negative value indicate decrease and positive value increase.
Source: Comptroller and Auditor General of India (CAG).

- Expenditures (both revenue and capital) aggregated across 18 States also show a decline during Q2 of 2020-21 vis-à-vis 2019. The fall in revenue expenditure could be partly attributed to reprioritisation of expenditures by curtailment of some of the expenditures like DA freeze; deferment of part or full salaries and wages and deductions from salary etc. by state governments.[13]

- While Q1 of 2020-21 **was characterised by sharp contraction in own revenues of the Union and States on account of covid-19 induced lockdown, the second quarter saw revenue contraction moderating with the opening of the economy in a phased manner and gradual revival of economic activities**.

- Revival of economic activities in the coming months is likely to strengthen the finances of Union and state governments. It is crucial at the same time to strike a balance between short-term resource requirements and long-term debt sustainability. The additional borrowing may not be fully absorbed as the capacity to borrow and avail flexibility offered by the central government will vary across States.

IV MONETARY POLICY

- The Monetary Policy Committee (MPC), in its meeting on December 2-4, 2020 kept the repo rate

[13] RBI (2020) Study of State Budgets, 2020-21, Reserve Bank of India.

unchanged at 4%. The reverse repo rate, the rate at which banks park their surplus funds with the RBI under the liquidity adjustment facility (LAF) is kept at 3.35%. The CRR is kept at 3% and SLR at 18%. The Marginal Standing Facility (MSF) rate (overnight borrowing facility from the central bank for further liquidity) and the Bank Rate remained at 4.25%.

Financial Sector

- The monetary policy transmission is the process through which repo rate transmit to various interest rates, such as bank deposit and lending rates and bond yield rates. The rate of interest on term deposits with a maturity of more than one year in commercial banks ranged between 4.93% to 5.50% in October 2020. In the pre-pandemic period, in 2019-20, the term deposit rate ranged between 5.90 - 6.40%.

- The cut off yield rate of 10-year government securities (G-Sec) FBIL is 6.20% on December 4, 2020 as compared to 5.78% on July 31, 2020. The term spread (which is the spread between the short term and the long term interest rates) between >10 year G-Sec yield and the repo rate was around 2 percentage points in December 2020.

- In the gilt market, a significant share of government securities are held by the commercial banks (40.41%), followed by insurance companies (25.09%), RBI (15.13%), Provident Fund (4.72%), Foreign Portfolio Investors (2.44%) and others (12.22%). The share of dated government securities with maturity of above 20 years has increased from 13% in 2012 (March 31) to 17% in 2020 (Sept.) (RBI Bulletin, 2020), which is likely to reduce roll-over risks in the future.

- The net foreign capital inflows reached a record high at USD 24.6 billion in August 2020, whereas the net FDI inflows also reached a record high of USD 17.8 billion in the same period. The net portfolio investment inflows (FPIs) were at a 17-month high of USD 6.8 billion in August 2020, which declined to USD 0.748 billion in September 2020.[14]

Money Supply

- The growth in money supply (M3) declined marginally to 11.6% (Y-o-Y) in October, 2020 as compared to 12.2% in September 2020. Reserve money or high-powered money increased by 16.3% (Y-o-Y) in October 2020 as compared to 14.7% in October 2019.[15] The components of reserve money which were significant for this increase were Currency in Circulation and the Net Foreign Assets (NFA). This creates a danger of monetary overhang. Money supply growth may accelerate if and when the money multiplier reverts to its normal level.

Credit Growth

- Growth of gross bank credit declined to 5.5% in October 2020 (Year-on-Year) from 5.5% in October 2019. Growth of non-food bank credit declined to 5.6% in October 2020 from 8.3% in October 2019, on a year-on-year basis. Credit to agriculture and allied activities grew by 7.4 % in October 2020 as compared to 7.1% in October 2019. Growth in credit to industry declined to 1.7% in October 2020 as compared to 3.4% in October 2019, on account of decline in credit to large industries. However, the credit to medium scale industries has significantly increased by 16.7% in October 2020 as compared to 1.2% in October 2019. Credit growth to the services sector increased to 9.5% in October 2020 from 6.5% in October 2019, contributed by 'professional services', 'computer software' and 'trade' components. Personal loans registered a decline in

[14] RBI (2020) Foreign Investment Inflows, RBI Bulletin, November, 2020.
[15] RBI (2020) State of the Economy, RBI Bulletin, November 2020.

growth to 9.3% in October 2020 from 17.2% growth in October 2019. However, vehicle loans registered a growth of 8.4% in October 2020 compared to 5.0% in October 2019.

- Household financial savings increased to 21.4% of GDP in Q1: 2020-21, from 7.9% in Q1 and 10.0 % in Q4: 2019-20. As observed by RBI: "*The gap between credit extended and deposits mobilised during the Q1: 2020-21 contributed to the spike in household financial savings as the financial instruments relating to banks continue to dominate the household financial assets and liabilities*" (RBI Bulletin, Oct. 2020)."

Global and Domestic response to the pandemic

- The central banks globally have responded to the pandemic through liquidity infusion into the system to stabilize the market reactions. Within a flexible inflation targeting regime, the US Federal Reserve has responded by lowering the interest rates effectively to zero, engaging in unlimited asset purchases, and establishing emergency lending facilities to keep credit flowing to households and businesses. In a low interest rate regime, the European Central Bank (ECB) has announced an Emergency Pandemic Purchase programme, The ECB has issued long term bonds to hold down future financing costs.

- The RBI has announced liquidity infusion measures by the Monetary Policy Committee. The "regulatory easing" measures were also announced by RBI to promote credit flows to the retail sector and MSMEs and real estate developers; along with the extension of the loan moratorium and support for working capital financing till August. The RBI has announced the Targeted Long Term Repo Operations to nudge the banks for liquidity infusion to selected sectors. This facility will be available up to March 31, 2021,[16] with tenors of up to three years for a total amount of up to Rs. 1,00,000 crore at a floating rate linked to the policy repo rate. Liquidity availed by banks under the scheme are to be deployed in corporate bonds, commercial paper and non- convertible debentures issued by the entities in agriculture, agri-infrastructure, secured retail, micro, small and medium enterprises (MSMEs), and drugs, pharmaceuticals and healthcare.[17] Among many measures, increasing the state's Ways and Means Advance (WMA) by 60%, compared to 30% earlier was a significant one.

V EXTERNAL SECTOR OUTLOOK

- Current account was in deficit until Q3 of 2019-20. It turned into surplus in Q4 of 2019-20 at 0.5% of GDP which further increased to 4.4% in Q1 of 2020-21. This surplus was achieved not due to rising exports but due to the decline in merchandise imports.

- During 2020-21 Q1, exports declined by 20%, while imports declined by 40%. In 2020-21 Q2, the corresponding contractions in exports and imports were 1.5%– and 17%, respectively.

- Exchange rate depreciated from Rs. 71.3 per USD in January 2020 to Rs. 76.2 per USD in April 2020. Thereafter it appreciated to Rs. 73.5 per USD in September 2020. The appreciation was 3.6% during this period.

- The global outlook after the onset of the pandemic has been driven by caution, uncertainty and an equal amount of optimism about the resilience and recovery of economies around the world. While the initial setbacks to economic growth and livelihoods had led to severe contractions globally, the emerging trends have provided a positive outlook for 2021.

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[16] RBI Statement on Developmental and Regulatory Policies, December 4, 2020 and RBI Governor's Statement on December 4, 2020.

[17] RBI (2020) State of the Economy, RBI Bulletin, November 2020.

Table 5: Share of services sector and projected real GDP Growth

Country	% of Service sector in GDP	% of Manufacturing sector in GDP	Real GDP Growth 2020-21 (%)	Projected Real GDP Growth 2021-22 (%)
UK	71	9	-9.8	5.9
France	70	10	-9.8	6.0
US	68	11	-4.3	3.1
Brazil	63	9	-5.8	2.8
Germany	62	19	-6.0	4.2
India	55	18	-10.0	8.1
China	54	27	1.9	8.2
Indonesia	44	20	-1.5	6.1

Source: IMF (2020) World Economic Outlook, October, 2020, World Bank National Accounts Database, 2020

- The IMF in its World Economic Outlook (WEO: October, 2020) highlights that economic recovery across countries has been much faster than expected and has signalled a clear rebound to pre-crisis levels. After a major contraction in 2020, most advanced countries are projected to show a positive real GDP growth for 2021-22; US: 3.1%, South Americas: 3.6%, UK: 5.9%, major European economies; Germany: 4.2%, France: 6.0%, Asian economies; Japan: 2.3%, Korea: 2.9 and Australia: 3.0%. Countries with a larger services sector are expected to experience larger contractions in GDP on account of restrictions in physical movements and social distancing. Thus, the recovery is likely to be shaped by the pace and extent of revival of the services sector. The revival of manufacturing activities would be critical for a faster and broad-based recovery.

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