The Pre-Budget Review of the Indian Economy

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Introduction: very challenging macroeconomic outlook

- Globally high inflation & slow growth due to Oil shock followed by Ukraine War shock, sanctions, and related supply disruptions
- Domestically also elevated inflation & slowing growth after base effect driven high growth of 2021-22
- Question: what macroeconomic policies appropriate to navigate this difficult passage?
  - Policy challenge further complicated if monetary policy tool not effective to tackle supply disruption driven inflation
- This presentation will flesh out the complex macroeconomic situation & suggest appropriate monetary & fiscal policy stance to address it as follows

  - Rudrani Bhattacharya: Growth, Inflation, Balance of Payments
  - Radhika Pandey: Monetary Policy & Financial Markets
  - Manish Gupta: Fiscal Outlook: Union and State Governments
  - Sudipto Mundle: Overview & Key Takeaways

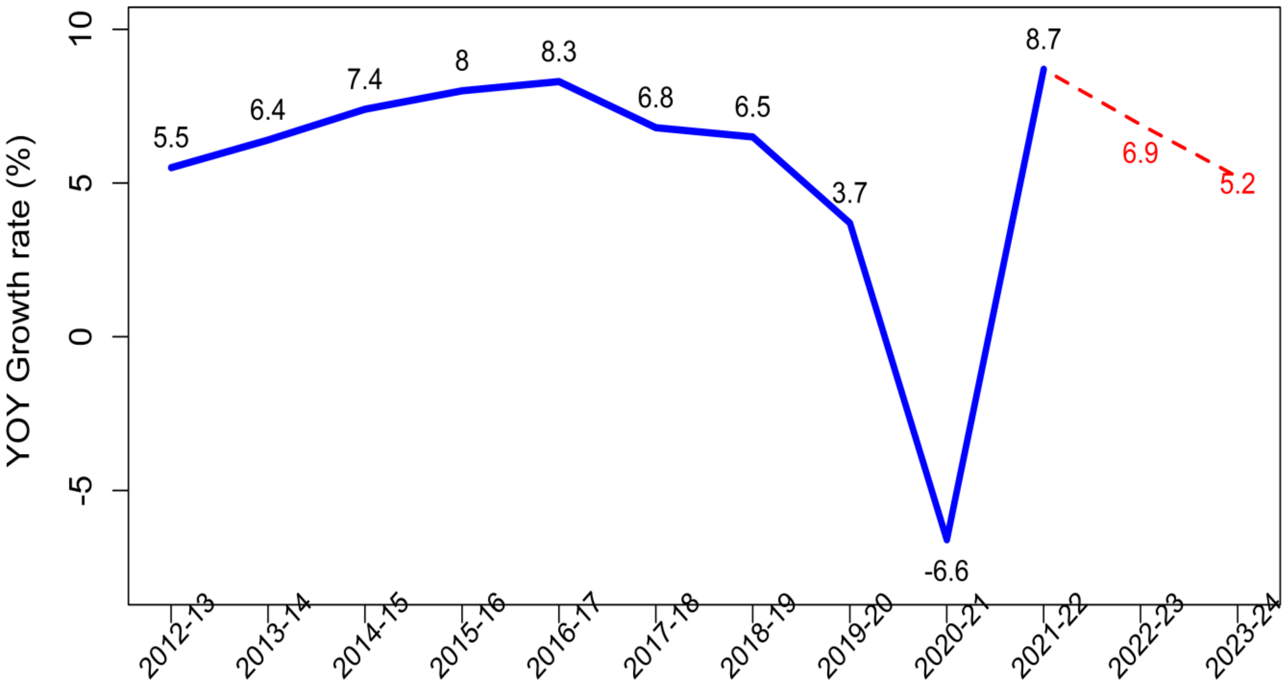
Part I

Growth

Real growth projected at of 6.9% in FY 22-23 and 5.2% in FY 23-24, down from 8.7% in FY21-22

GDP Growth

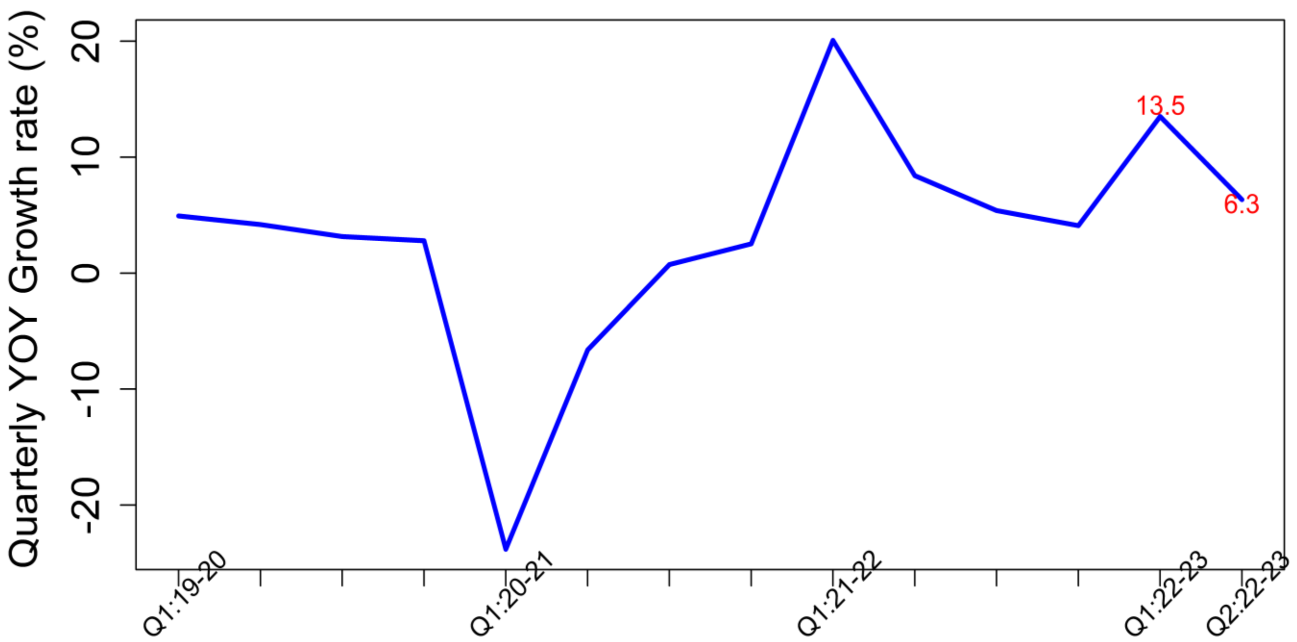
Date	Actual	Our Projection	RBI	IMF	World Bank
Q1 FY 22-23	13.5	15.0	16.2		
Q2 FY 22-23	6.3	5.9	6.2		
Q3 FY 22-23		4.7	4.1		
Q4 FY 22-23		4.2	4.0		
FY 20-21	-6.6				
FY 21-22	8.7				
FY 22-23		6.9	7.0	6.8	6.9
FY 23-24		5.2	6.5	6.1	6.2



- High growth in 2021-22 was mainly due to strong base effect of pandemic shock driven contraction in 2020-21
- Growth is now slowing with fading base effect & fiscal compression in most States
- Slowdown is expected to continue in 2023-24
- However, actual outcome will depend on impact of policy measures

Quarterly growth slowing through Q2, Q3, Q4 after very high growth of 13.5% in Q1, which reflected the low base effect of Q1 FY21-22 due to second Covid wave

- Q2 FY22-23 slow down reflecting contraction in mining and manufacturing
- However, growth in trade, hotel & transportation was still very high in Q2



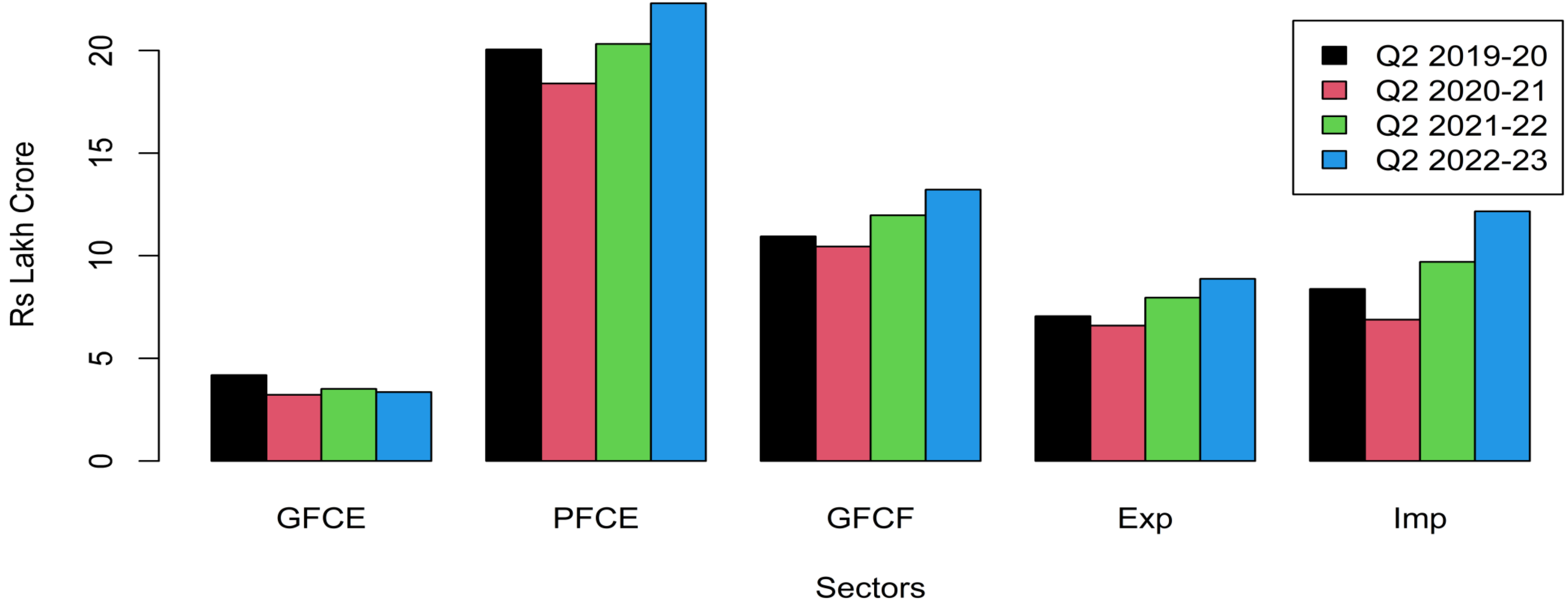
Quarter	GDP	Agri	Min	Man	Util	Cons	Trd	Fin	Pub
Q1 22-23	13.5	4.5	6.5	4.8	14.7	16.8	25.7	9.2	26.3
Q2 22-23	6.3	4.6	-2.8	-4.3	5.6	6.6	**14.7**	7.2	6.5

Trade, hotels and transport serv. (TRD) output surged in Q2 2022-23 while manufacturing output declined

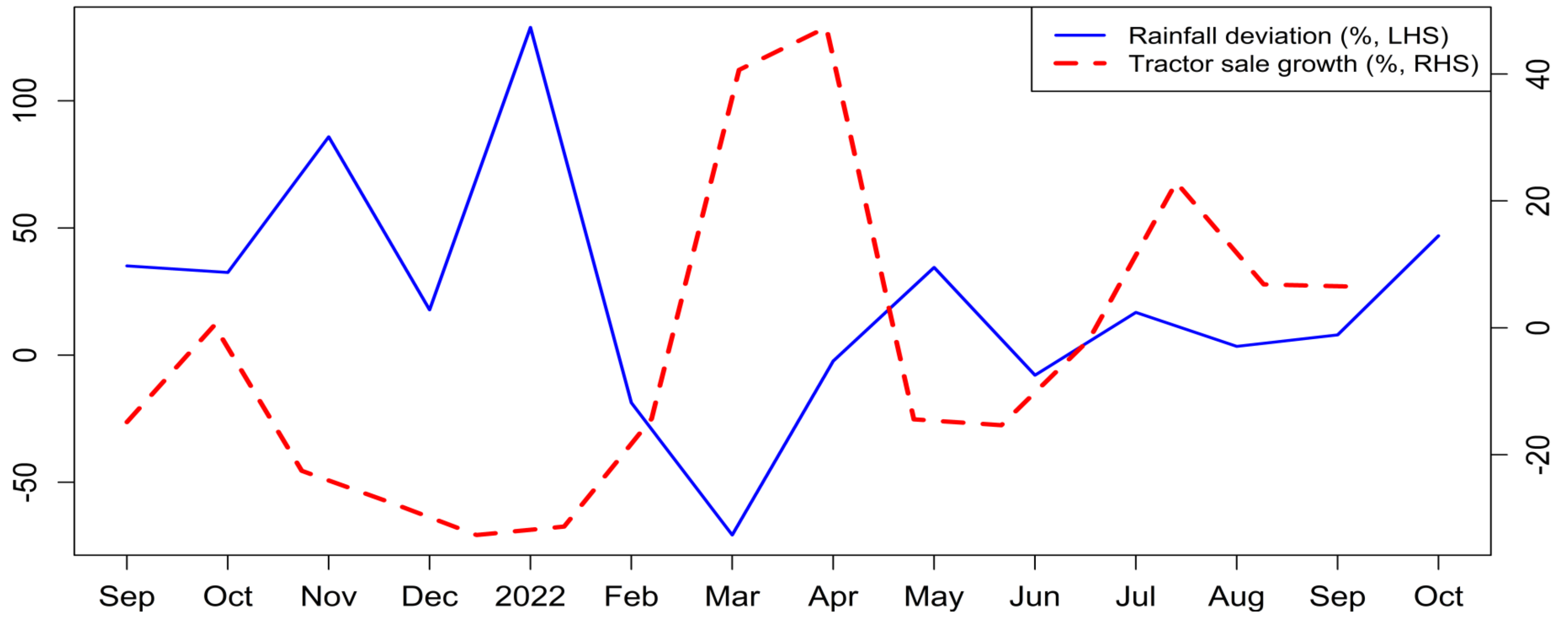
- In Q2 2022-23 TRD output finally exceeded pre-Covid levels
- This had already happened earlier in agriculture, financial services & public services
- However, manufacturing output contracted in Q2 2022-23 after growing in 2020-21 & 2021-22

On demand side, Government consumption (GFCE) contracted in Q2 YoY & still below pre-pandemic level, while private consumption (PFCE), investment (GFCF), exports & imports, finally exceeded pre-pandemic level

	GFCE	PFCE	GFCF	Exports	Imports
Q1 22-23	1.33	25.93	20.15	14.68	37.23
Q2 22-23	-4.36	9.74	10.38	11.52	25.40



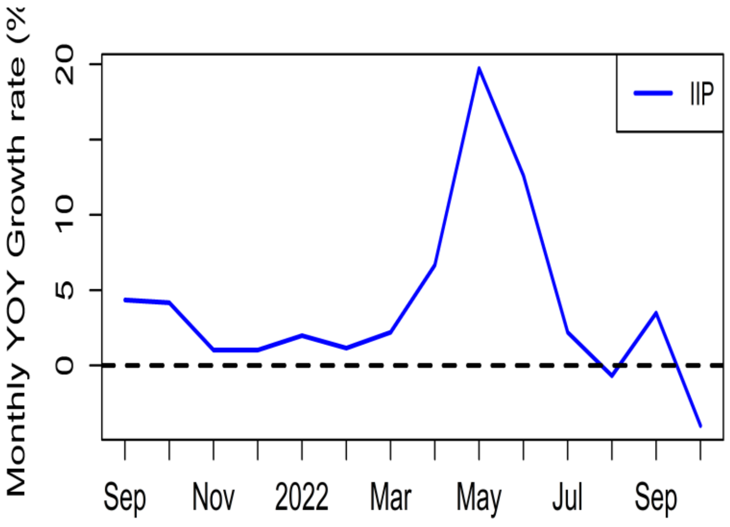
Robust agriculture growth expected in H2 FY22-23

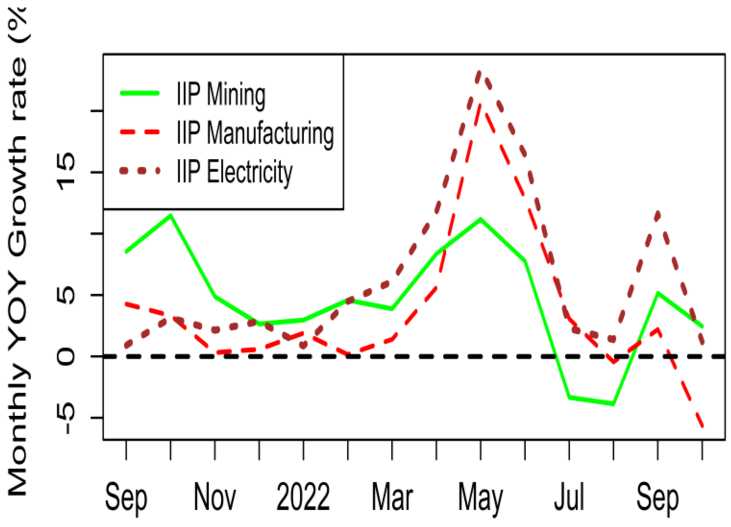


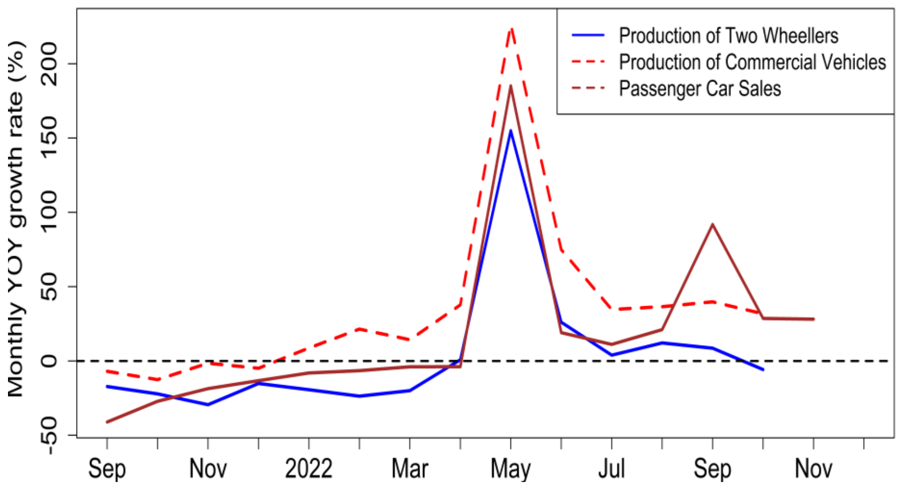
- Normal rainfall till October
- Rabi sown area in 2022 higher than in same period of 2021 because of rising wheat prices
- Domestic tractor sales growth remain resilient

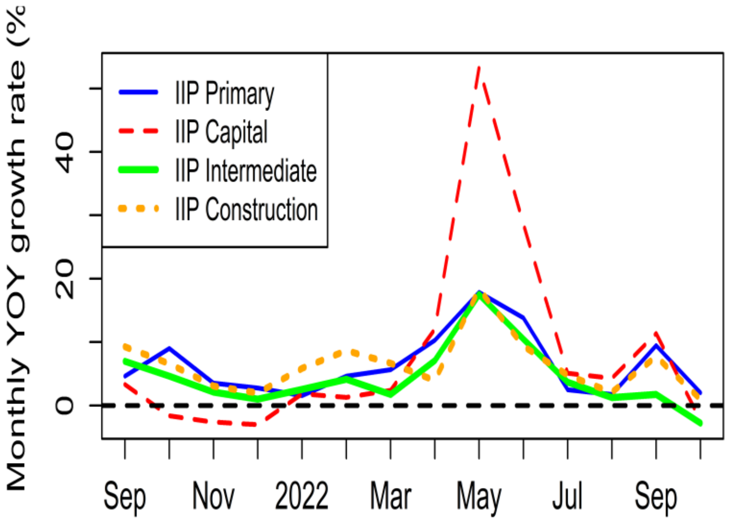
Overall industrial activities indicate downturn with volatility

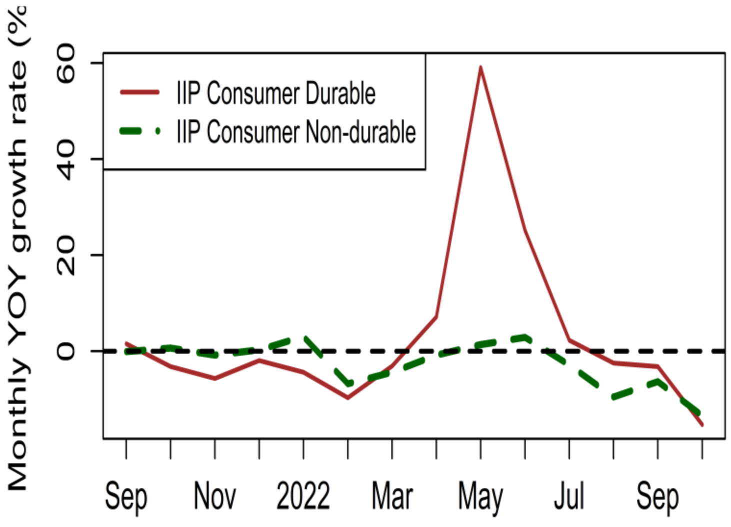
- Broad based downward trend in IIP growth
  - Both for used-based & activity-based classifications
- Pandemic-induced automobile demand driven manufacturing growth has now receded



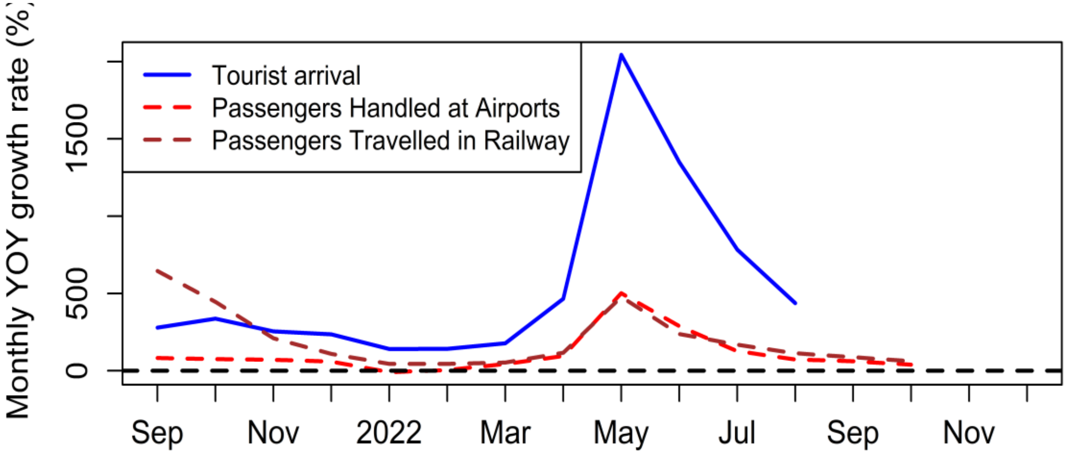


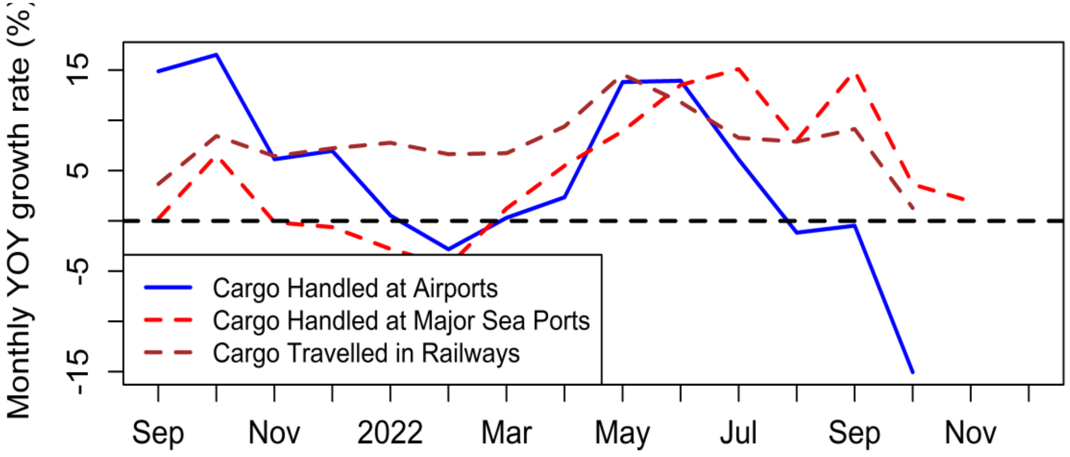


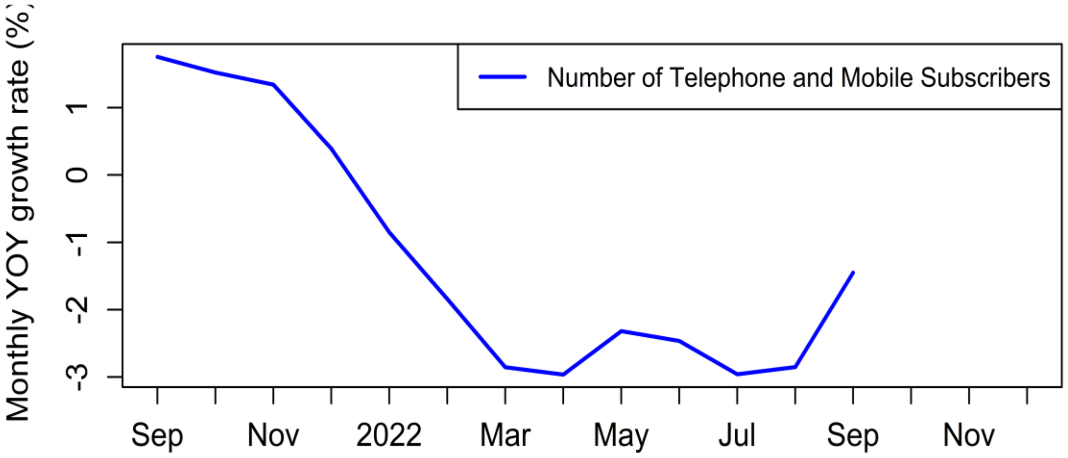


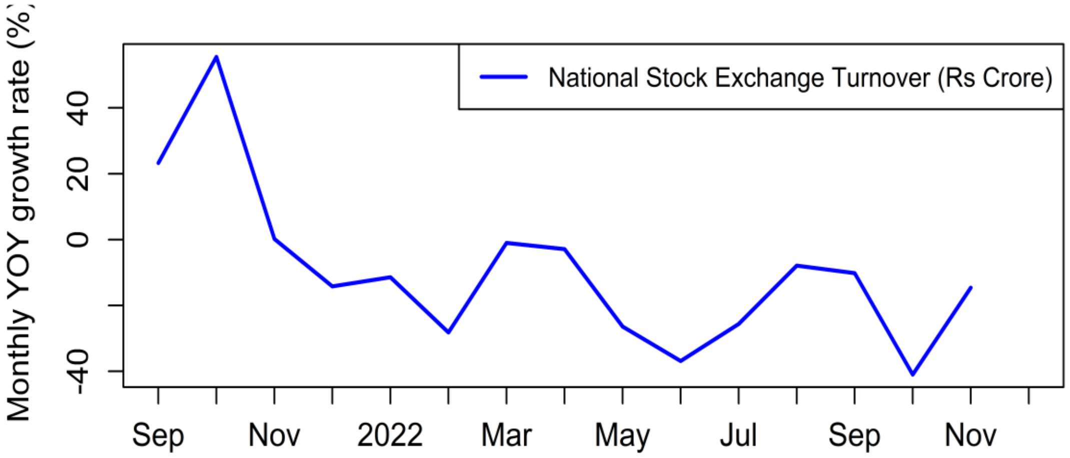


Multiple high-frequency indicators suggest volatile & declining growth in services





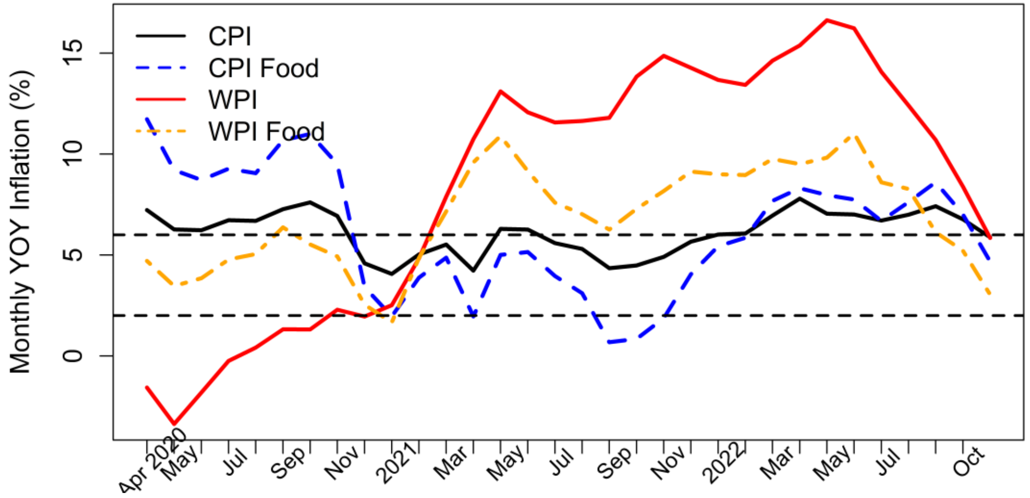


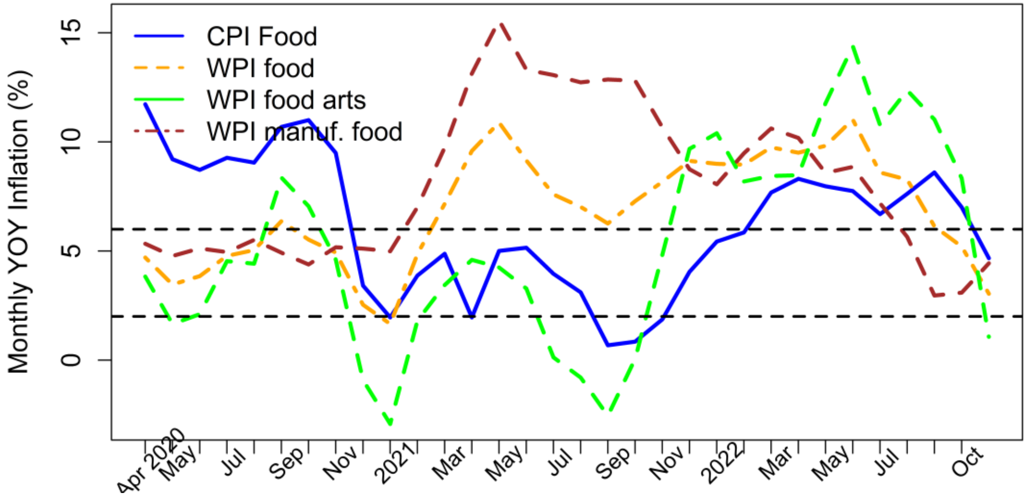


Part II

Inflation

Headline (CPI) inflation remained elevated at 6.9% during Apr-Nov 2022, however fell below 6% mark in November first time in FY 22-23





- During 2020-21 food article price inflation was driving both CPI and WPI inflation
- During 2021-22, manufactured food price inflation & energy price inflation was driving WPI while core inflation was driving CPI inflation; divergence in CPI and WPI inflation
- During Apr-Nov 2022-23, headline inflation broad-based driven by high **food inflation, core inflation, & energy price inflation**
- During this period, WPI inflation was even higher, & also driven by high **food inflation, core inflation, & energy price inflation**

Demand and supply side factors driving food and core inflation

- Food inflation

  - Food articles inflation has been driven by adverse weather condition; cost push factors (agri. wage inflation, MSP hike); global factors (crude oil price inflation, Ukraine war)

  - Manufactured food inflation due to supply disruptions driven by the pandemic

  - Lagged transmission of WPI food price inflation now driving retail food price inflation

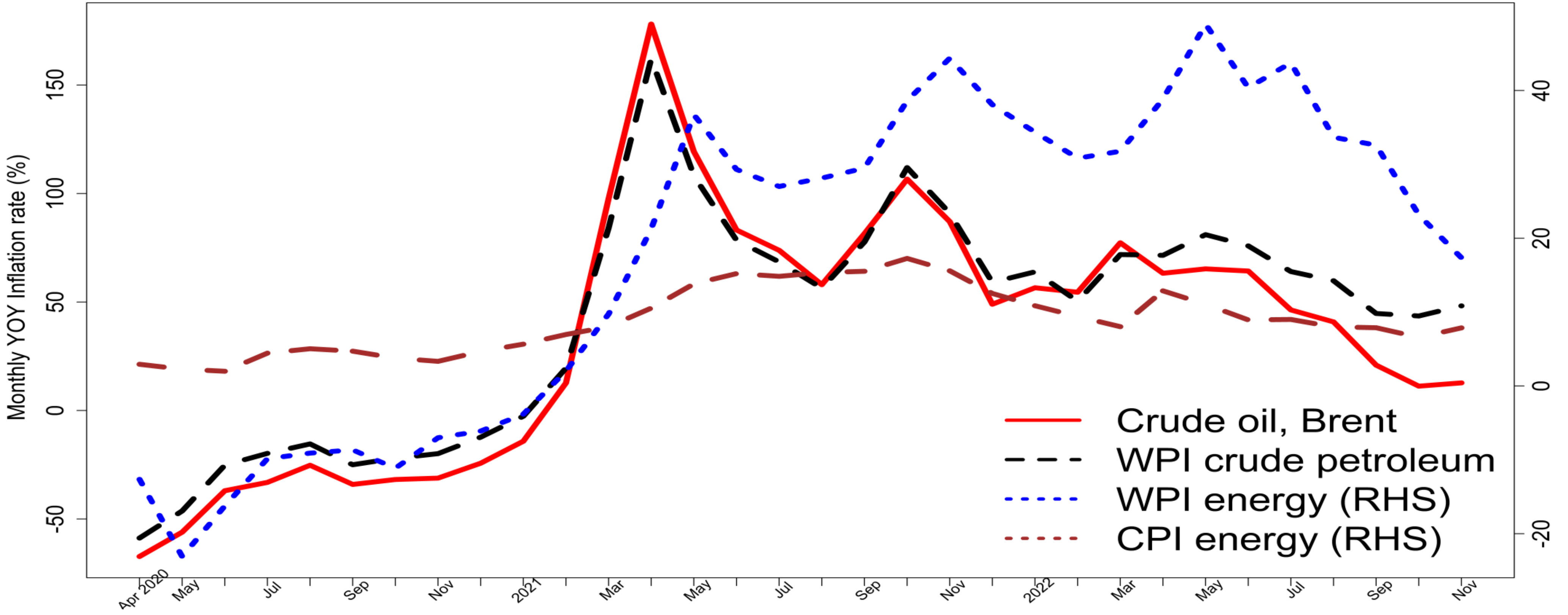
- Core inflation (non-food, non-energy)

  - During 2020-21, CPI core inflation was driven by demand for health and transport services (net of petrol and diesel prices for conveyance)

  - Broad-based rise in CPI core inflation in 2022 driven by demand revival

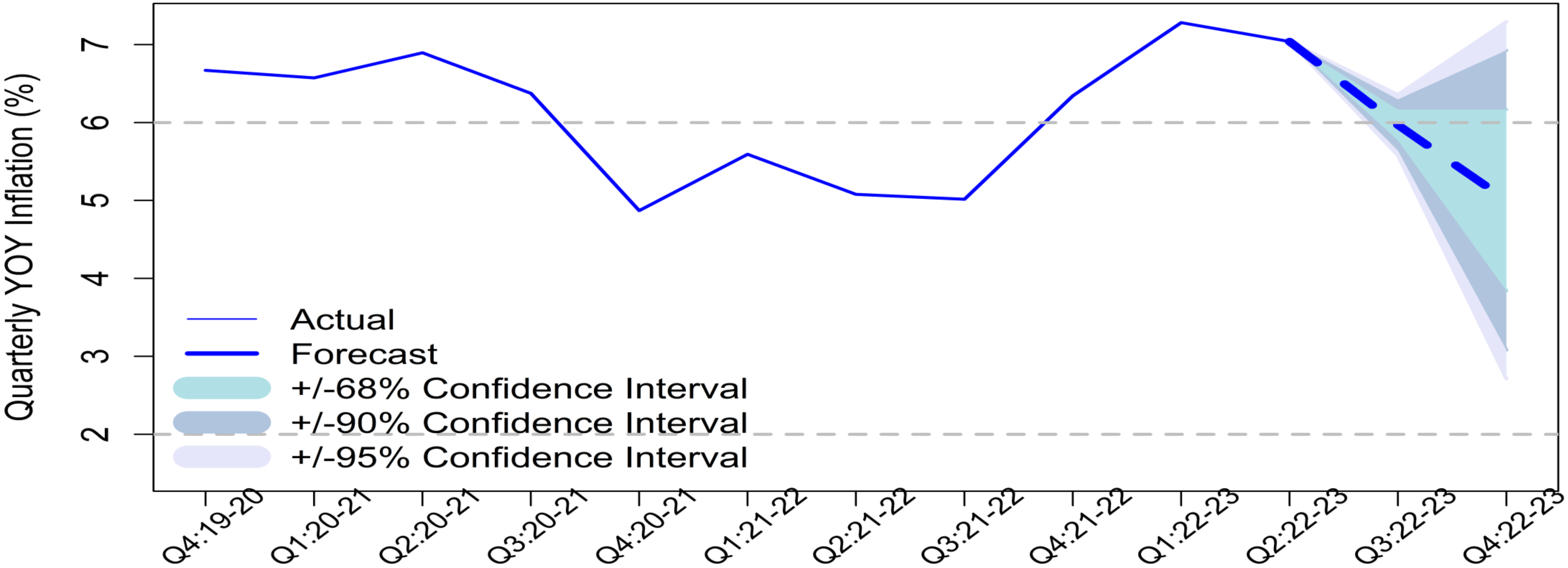
  - WPI core inflation driven by energy inflation and exchange rate depreciation

Crude oil inflation declining but energy inflation sticky due to lagged transmission



- Immediate transmission of global crude oil price inflation to WPI **crude petroleum inflation**
- Lagged transmission of global crude oil price inflation to WPI and CPI **energy inflation**
- Transmission to WPI energy price inflation is stronger compared to CPI energy price inflation
- Thus, during Apr-Nov 2022, average inflation rate in WPI and CPI energy inflation were respectively, recorded at 37.3% and 9.2%

Inflation is forecast at 5.5% for H2 2022-23 & 6.3% for FY22-23

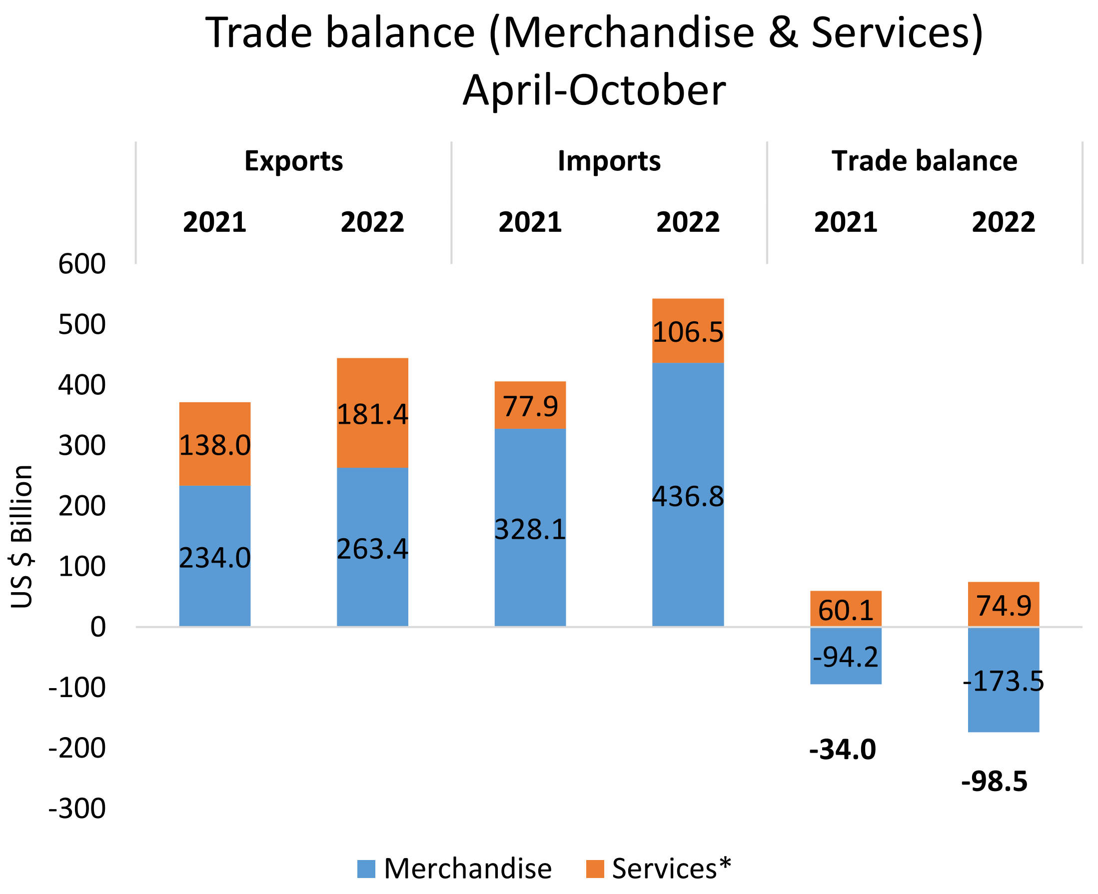


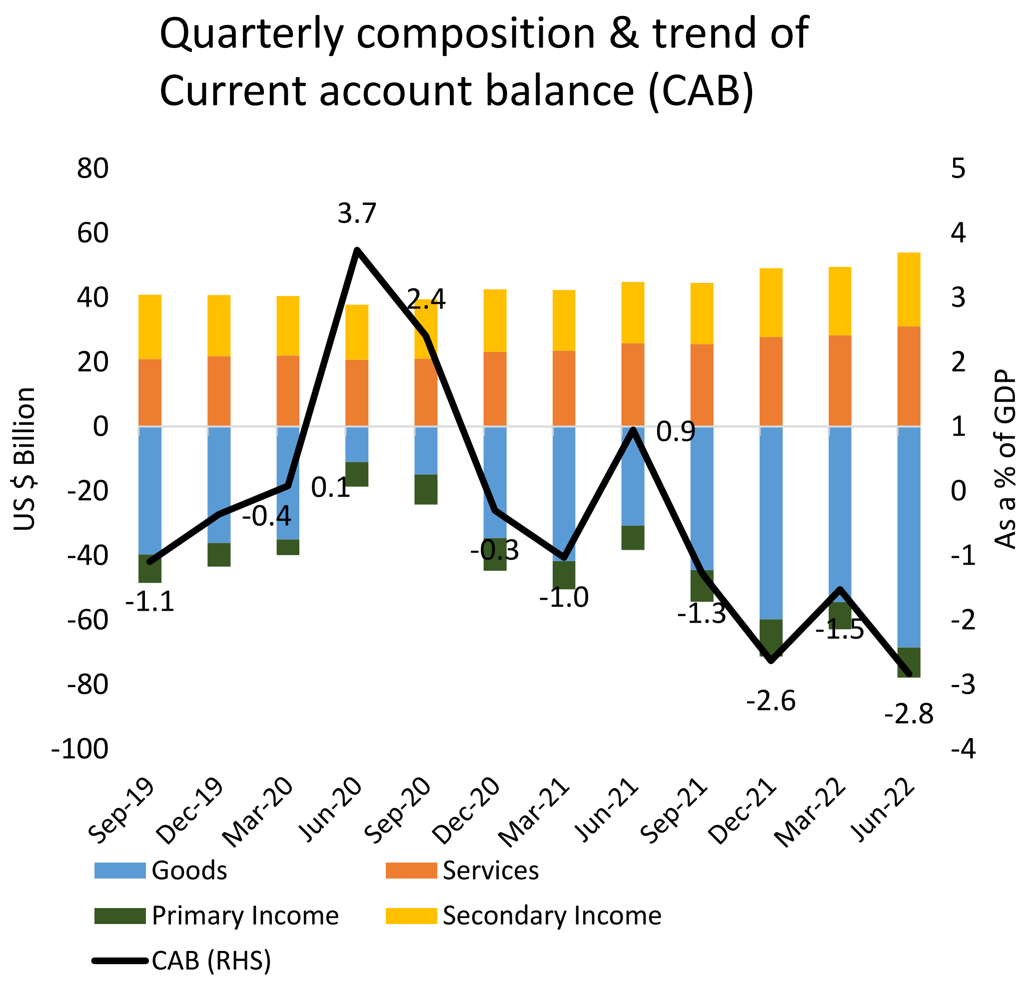
- Upward risks: (i) high crude oil inflation; (ii) increase in prices of cereals, pulses, vegetables & fruits, milk and egg, meat & fish (EMF) (iii) broad based rise in core inflation
- Possible moderating factors: (i) Slowing down of global edible oil inflation (ii) Monetary tightening by RBI

Part III

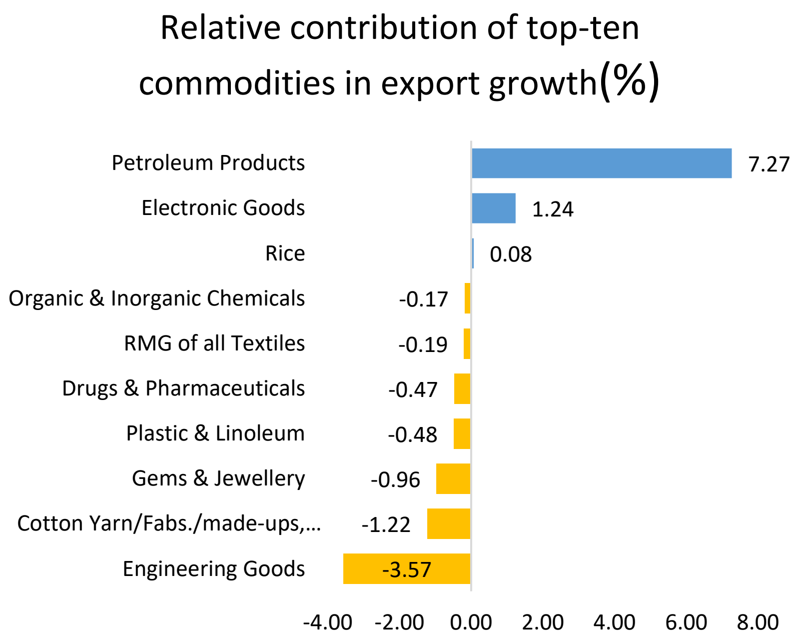
Balance of Payments

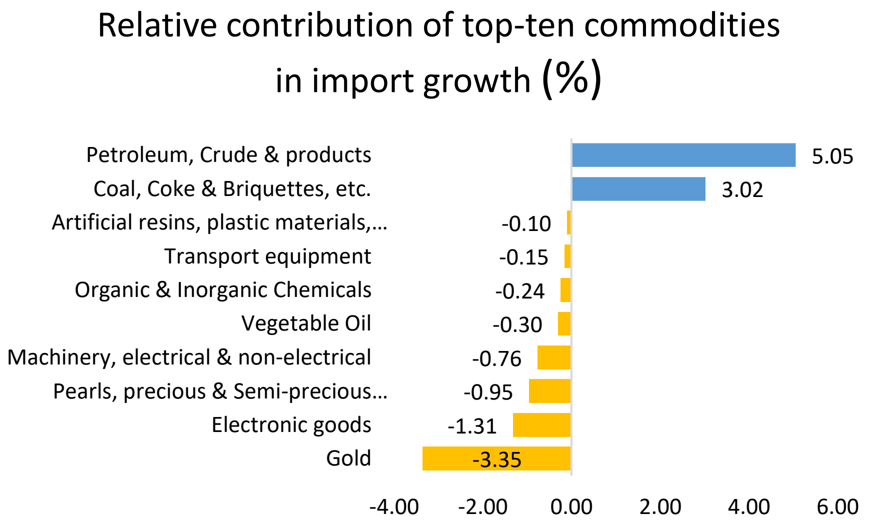
Widening trade deficit driven by deficit in merchandise trade: April-October 2022-23

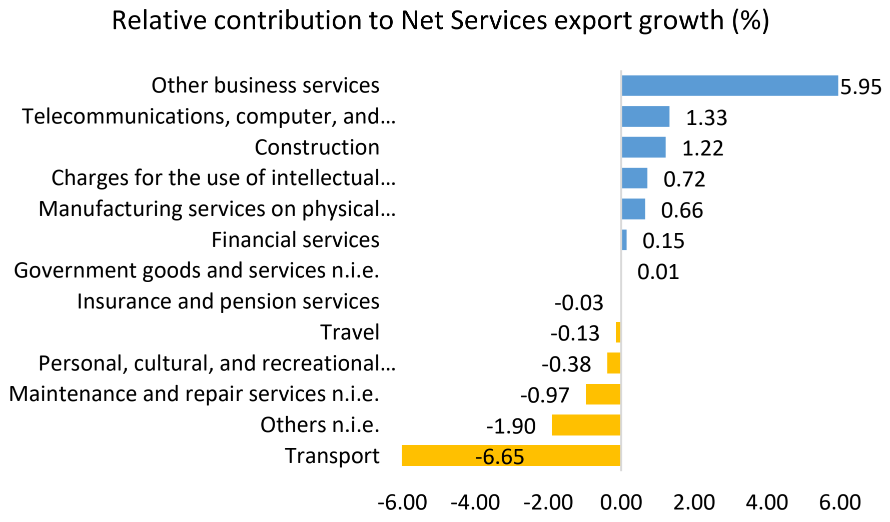




In Apr-Oct 2022-23 broad-based contraction in merchandise trade, & in half of services basket

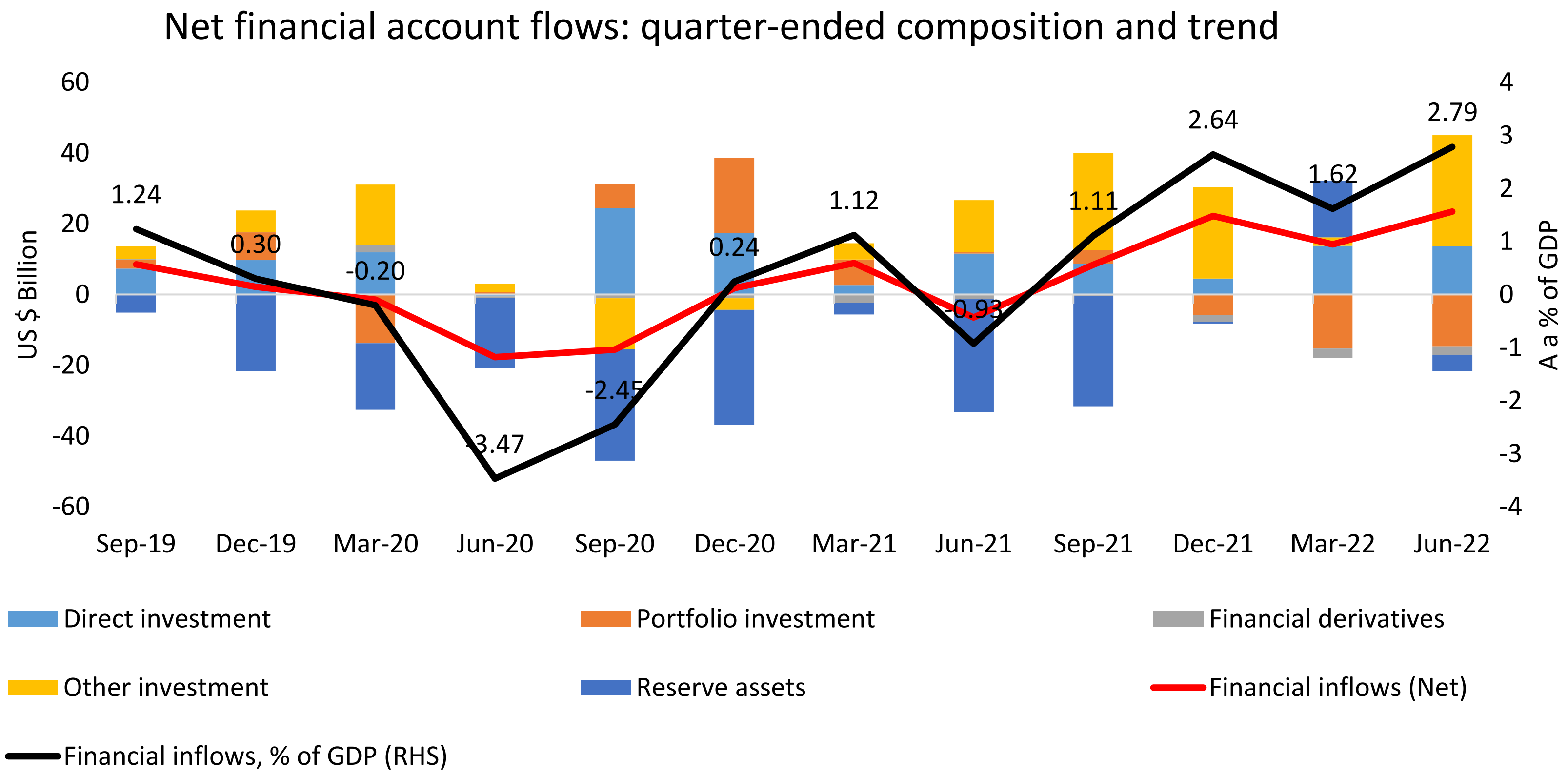






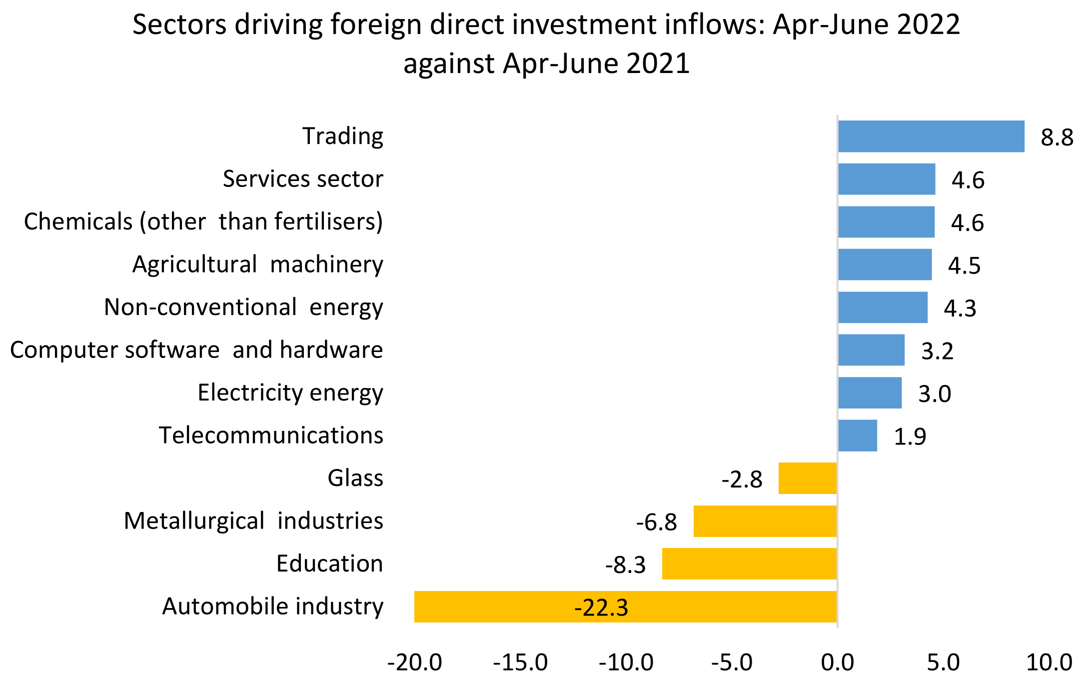
- All except two goods items contracted for both exports & imports
- Net exports contracted for 50% of services
- Broad based contraction in intermediate imports, reflecting manufacturing contraction

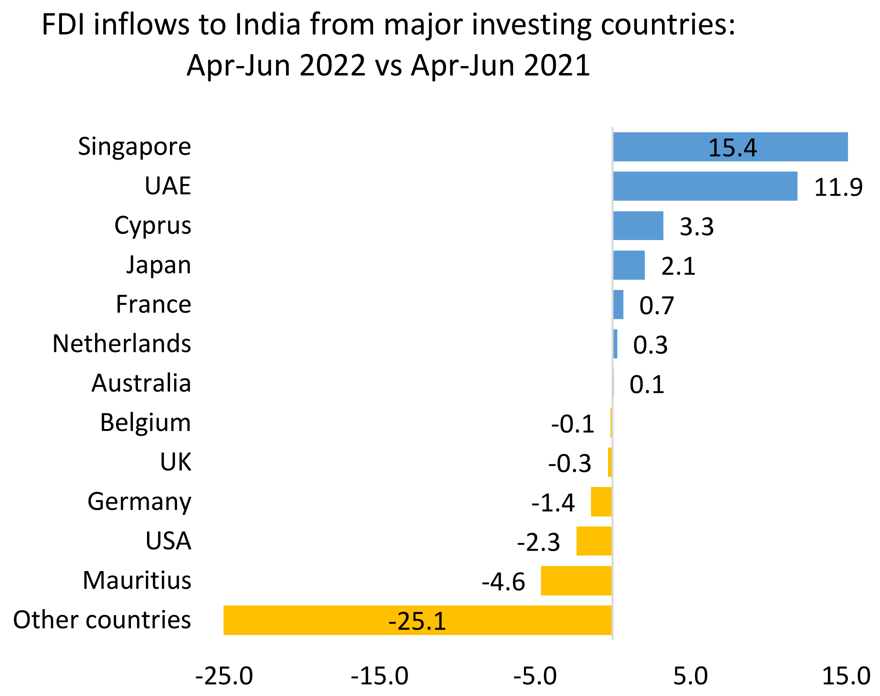
Increasing financial account surplus has largely financed increasing current account deficit in Apr-Oct 2022-23



- Financial services Net financial account inflows despite FPI outflows because of net inflows of FDI, ECBs, & trade credit

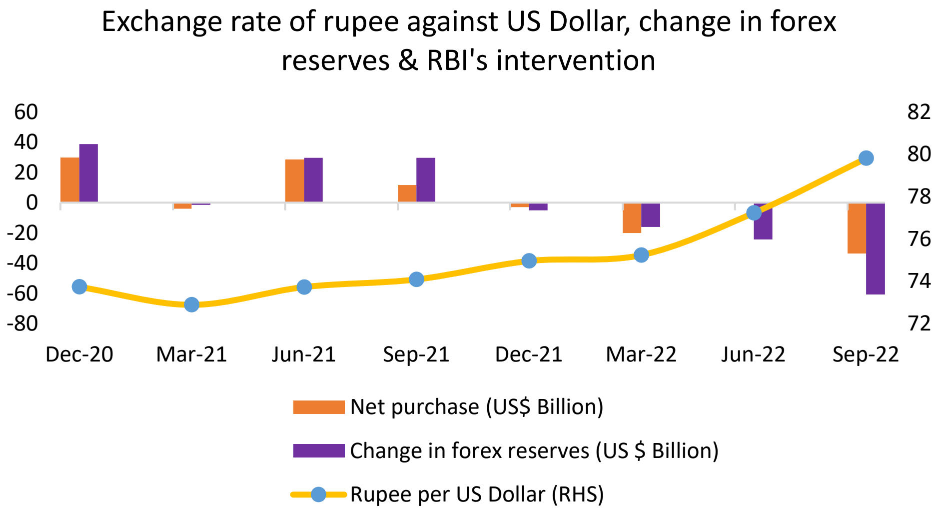
FDI has been broad-based & flows from developed countries have contracted

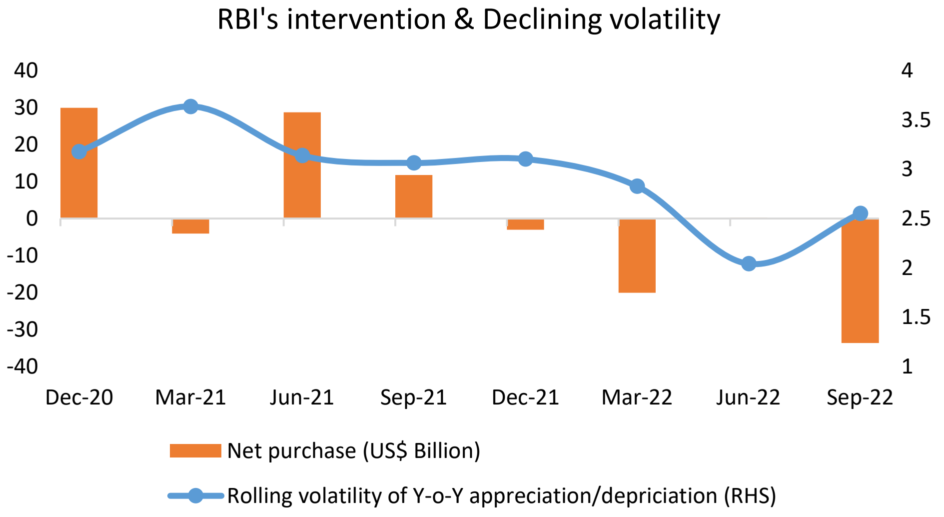




- Significant contraction in FDI flows in automobile industries, education, & metallurgical industries

Re/$ rate continues to depreciate despite RBI's intervention to contain volatility because of recent depletion of foreign exchange reserves



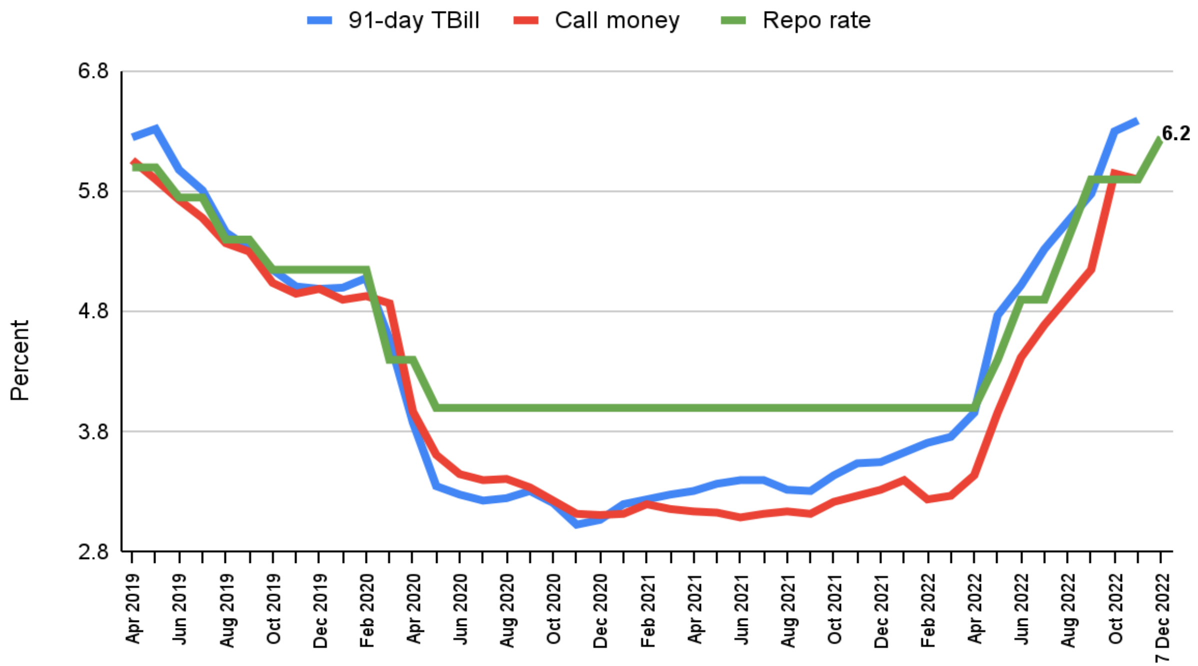


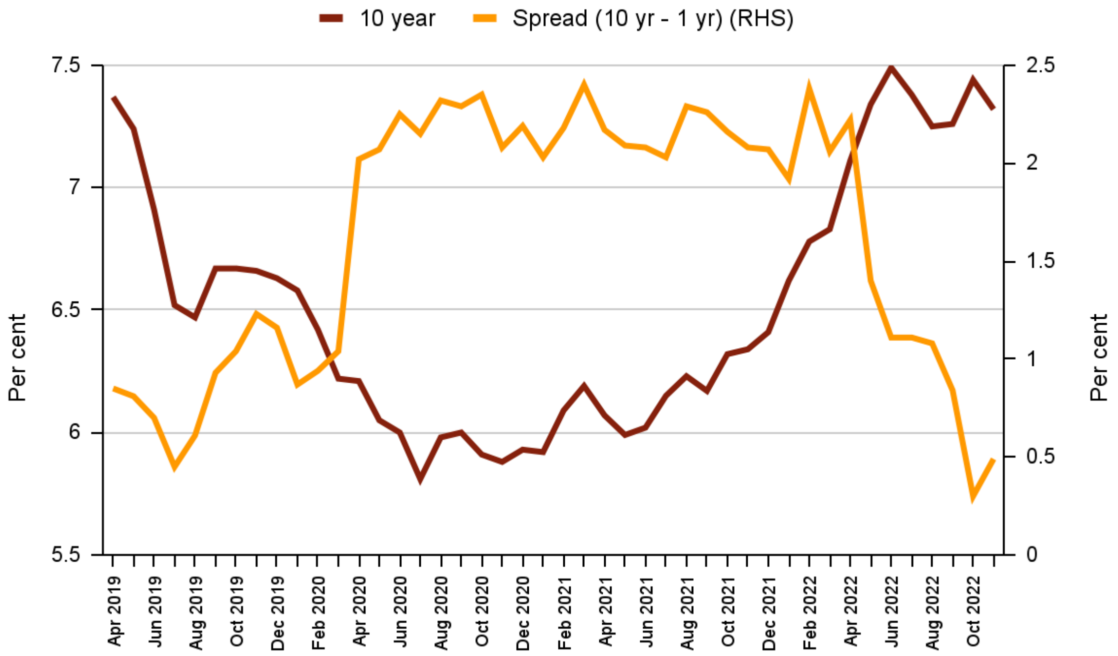
- Exchange rate depreciating because of declining in forex reserves
- Forex reserves have declined despite RBI's intervention
- Decline in reserves mainly attributable to growing current account deficit & net FPI outflows till June 2022
- Decline in exchange rate volatility has recently reversed despite RBI's intervention

Part IV

Monetary Policy & Financial Markets

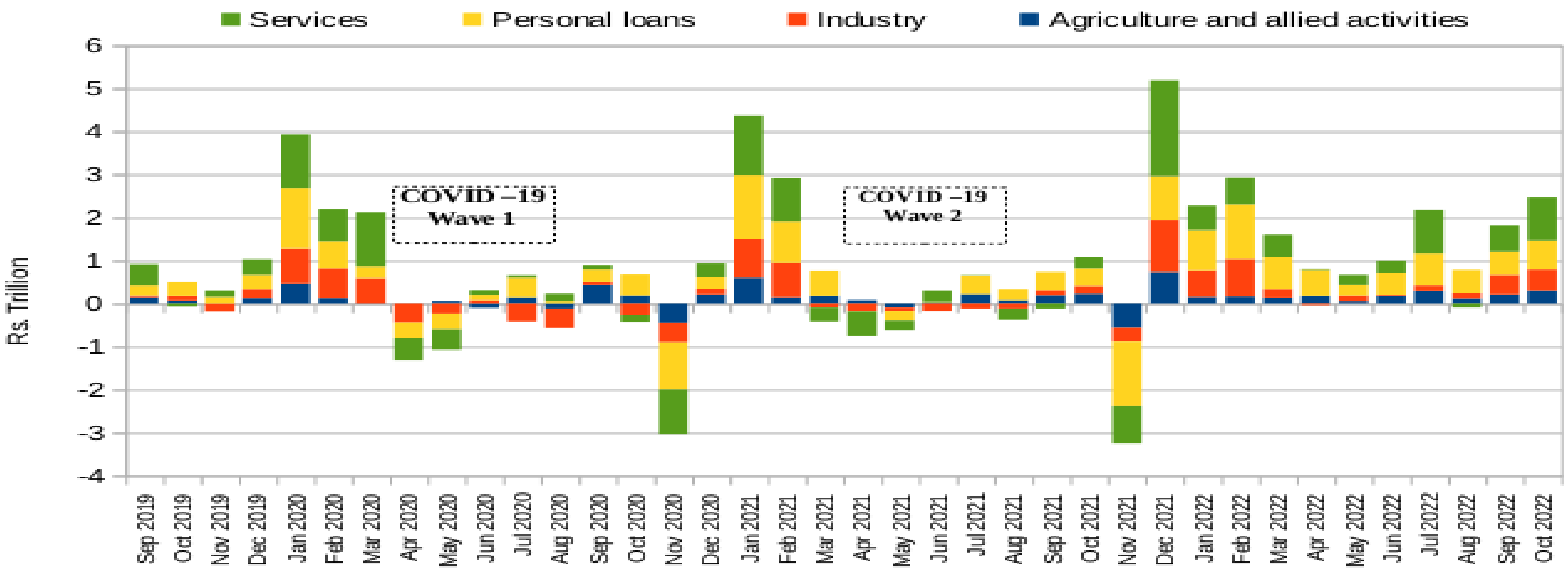
Interest rates: Short-term rates rising, spreads narrowing





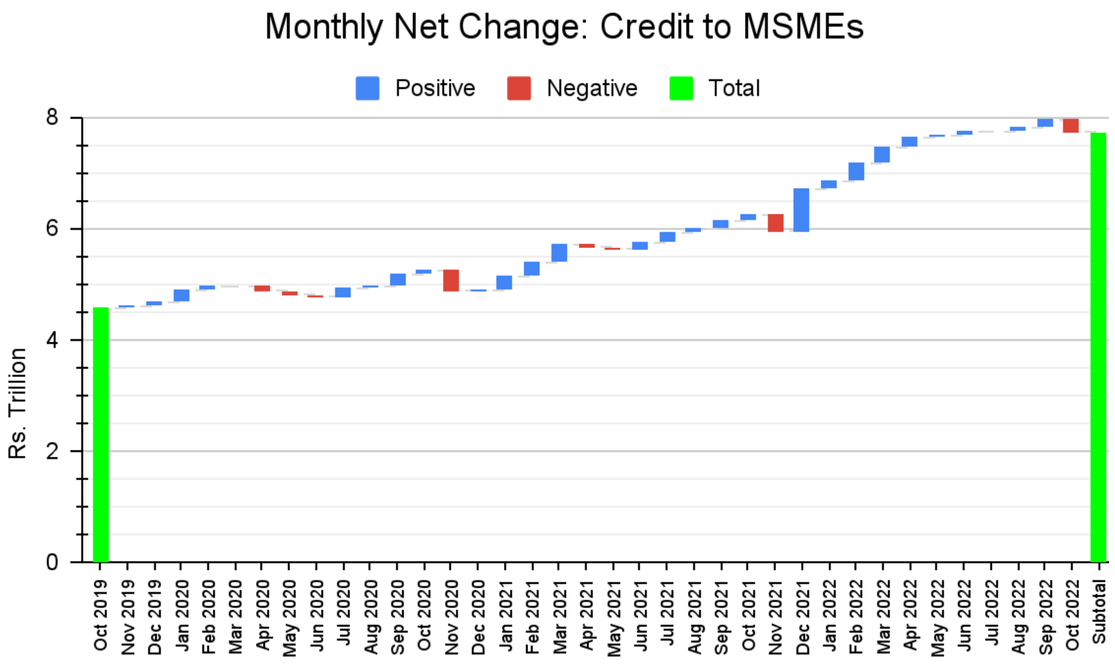
- RBI has raised the repo rate by 225 basis points this financial year. With the latest increase on 7th December, repo rate is 6.25 percent.
- This reflects change in policy stance from accommodative to withdrawal of liquidity, supported by Variable Rate Reserve Repo auctions (VRRR).
- As a consequence, short-term rates have been closely tracking the policy repo rate.
- The benchmark 10 year bond yield which was rising since July 2020 has been relatively range-bound in recent months.
- During this period, the spread between long and short-dated bonds has also declined sharply.

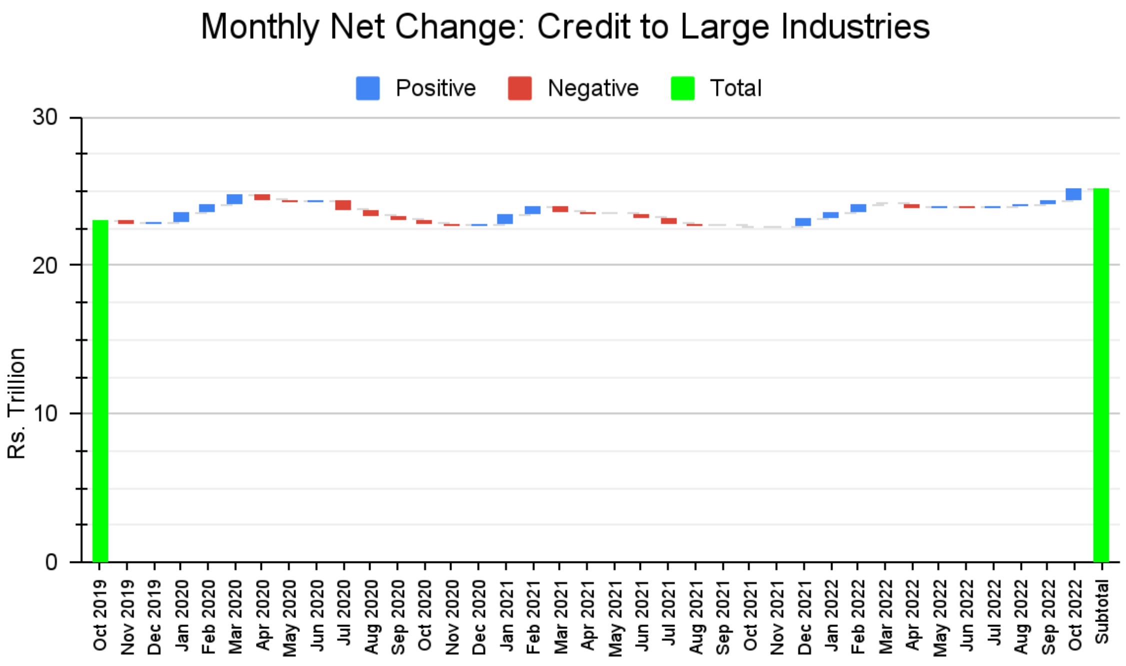
Credit flow rising despite rise in interest rates



- Non-food credit increased by Rs 2.6 trillion in October, compared to average monthly increase of Rs 1.3 trillion since April 2022 and increase of Rs. 0.6 trillion in October 2019.
- Personal loans and services have been the key drivers of non-food bank credit.
- Credit growth is far outstripping growth in bank deposits.

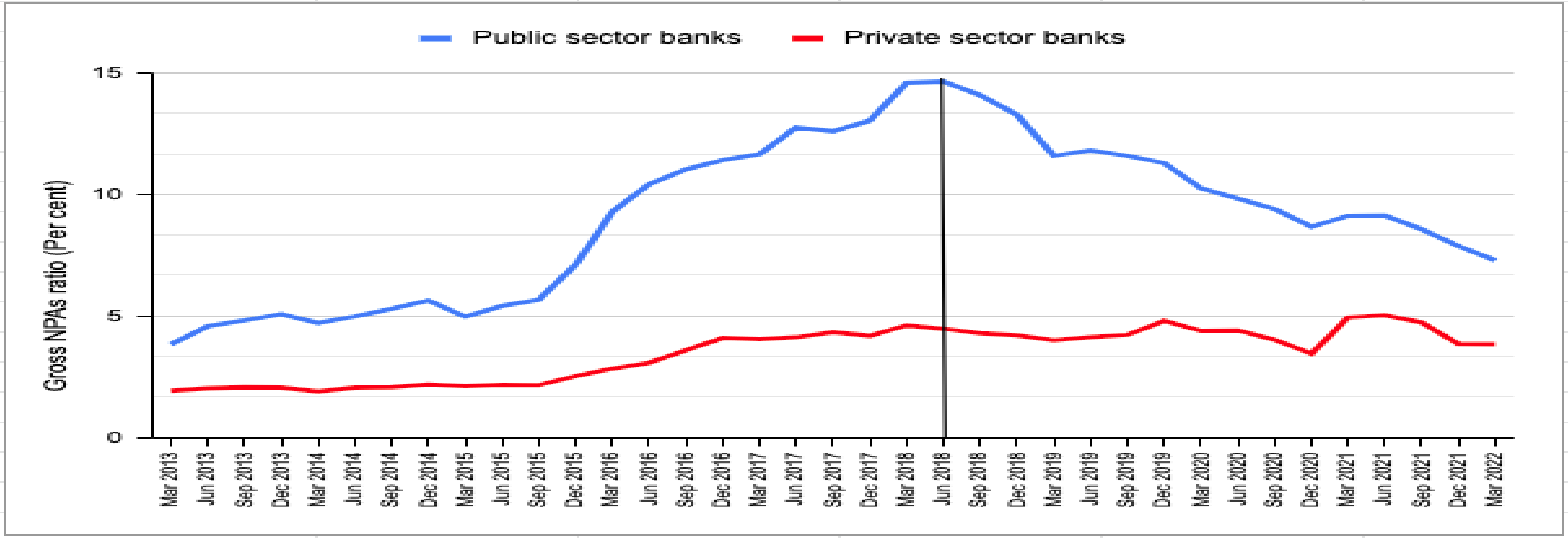
Outstanding credit to MSMEs now significantly higher than in October 2019, less so for large industries





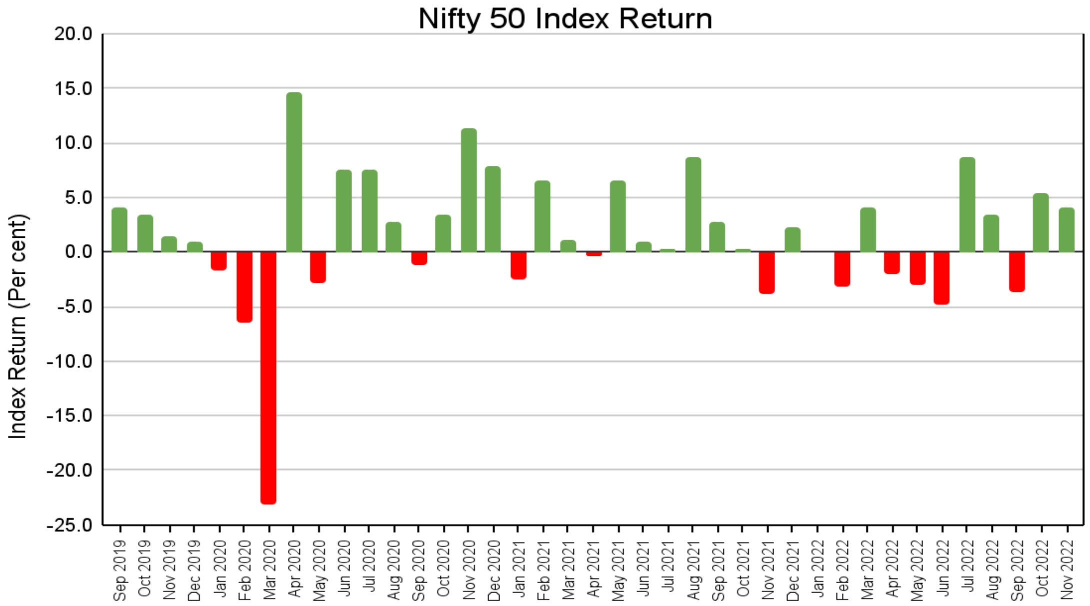
- Outstanding credit to MSMEs has increased from Rs 4.6 trillion in October, 2019 to Rs 7.7 trillion in October 2022: roughly an increase of Rs.3.14 trillion since pre-pandemic baseline.
- Outstanding credit to large industries is roughly 6 times the credit to MSMEs. However increase in credit is moderate at Rs. 25.2 trillion in October 2022 compared to Rs 23.0 trillion in October 2019.
- This increase in credit to large industries is mostly in recent months.

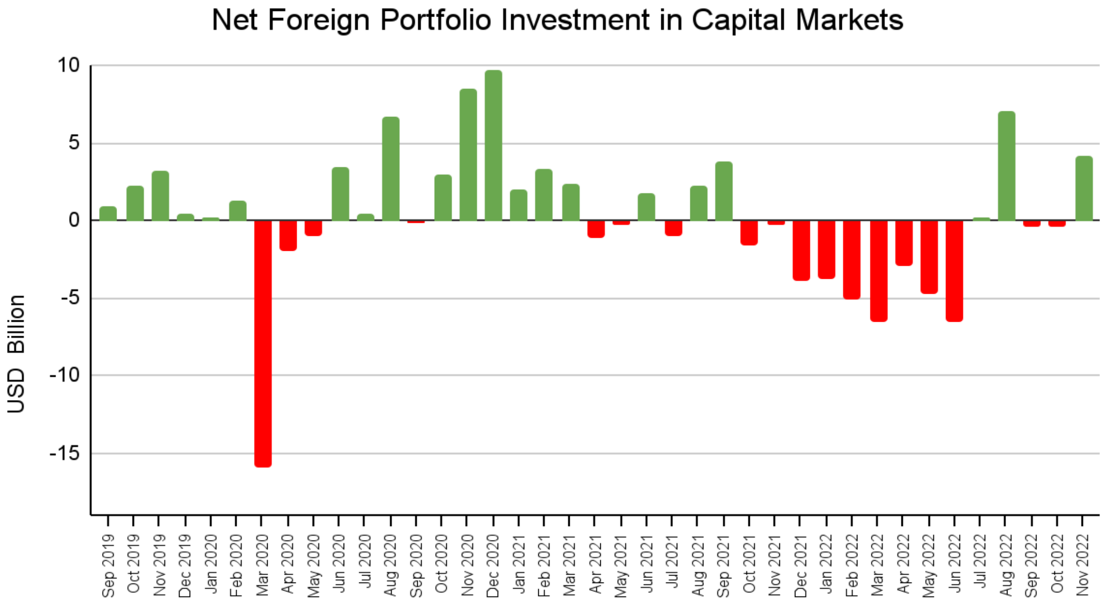
Non-performing loans of PSBs have declined sharply since June 2018 peak but still higher compared to private sector banks



- Overall GNPA ratio expected to decline moderately from 5.9 percent in March 2022 to 5.3 percent in March 2023.
- However very sharp decline in GNPA ratio of public sector banks after peaking in June 2018.
- Improvement in GNPAs and NIMs of public sector banks in second quarter of FY 2023 is mainly due to better credit off take, rising interest rates and regulatory forbearance (mainly for MSMEs and personal loans).

Rebound in capital markets during October & November, but volatility continues





- Steady rise in capital markets during last two months after long period of volatility.
- FPIs turned buyers in November with a net investment of USD 4138 million.
- FPIs were net buyers in equity while in debt segment, they have been net sellers.
- Capital market buoyancy attributable to expectation of smaller US Fed rate hikes, moderating inflation, decline in crude oil prices and rupee appreciation & hawkish tone of US Fed led to volatility in capital markets

Part V

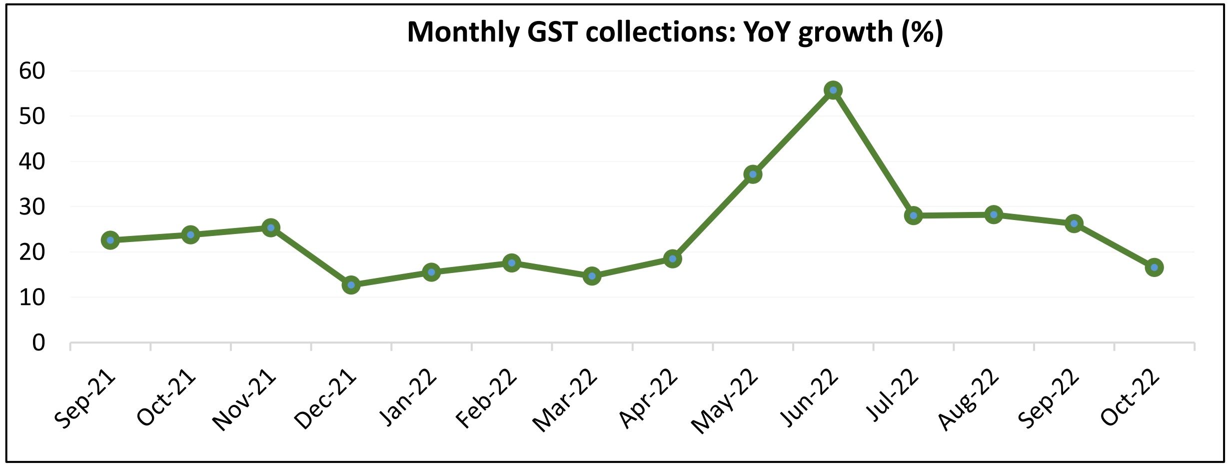
Fiscal Outlook:
Union and State Governments

Most Central Tax Revenue Collections Buoyant

Revenue Collections April-Sept 2022 - Percent change

Indicators	Percent change over Apr-Sept 2021	Percent change over Apr-Sept 2020	Percent change over Apr-Sept 2019
Centre's Net Revenue*	8.19	112.35	43.25
Gross Tax Revenue (GTR)	17.57	93.07	51.37
- Corporation Tax	21.59	149.43	50.53
- Income tax	25.67	106.95	61.76
- Excise duties	-18.53	8.64	45.81
- Central GST	28.30	110.09	37.88
- Customs duty	-6.89	113.81	20.09
Non-Tax Revenue	-1.72	70.80	-24.61

Note: * net of states' share in central taxes & collections under NCCD.



- GTR in H1-2022 51.4% higher than H1-2019 (last pre-covid normal year).
- Growth of all-taxes robust except **Union Excise Duties & Customs**
- Buoyant direct tax collections attributable to improved economic activity & higher corporate profitability.
- Duty cuts on petrol, diesel, edible oil etc. to curb inflation led to lower customs & union excise duty collections.
- Windfall taxes on oil exports and domestic crude production
- Buoyant GST collections @ Rs. 1.4 trillion per month in H1-2022 is 38% higher than same period in 2019-20 (last pre-covid year).
  - Attributable to improved economic activity, high inflation & stronger enforcement.
- Non-tax revenue decline
  - attributable to monetary compression, lower profits & reduced surplus transfers from RBI + reduced dividend of public sector banks.

Strong Central Government Thrust on Capital Expenditure

Expenditure April-Sept 2022 - Percent change

Indicators	Percent change over		
	Apr-Sept 2021	Apr-Sept 2020	Apr-Sept 2019
Revenue Expenditure	6.02	12.72	13.81
Capital Expenditure	49.50	106.76	82.84
Total Expenditure	12.15	23.27	22.50
Market Borrowing - Union	32.48	8.46	80.09

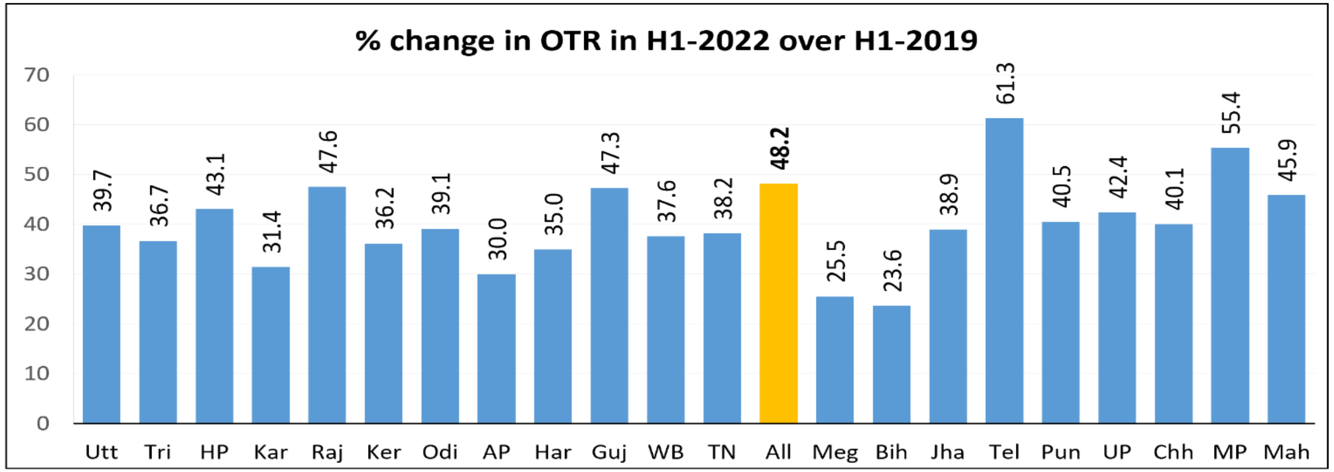
Fiscal Deficit

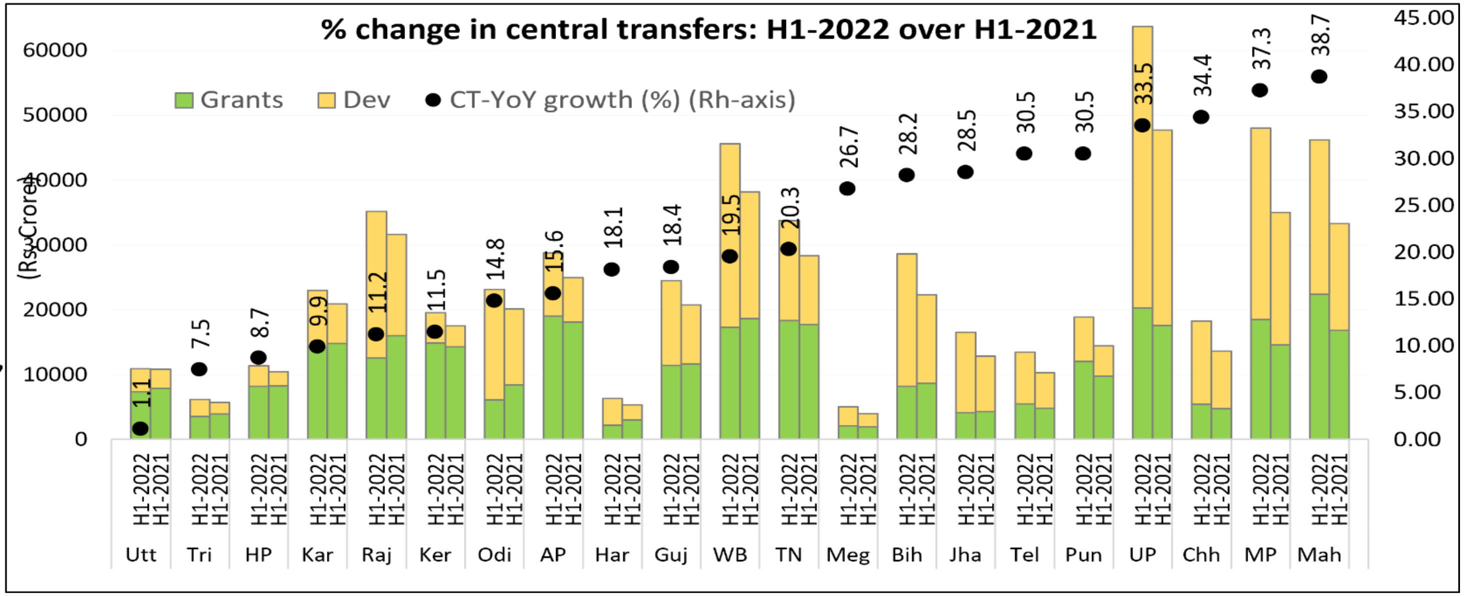
Fiscal Deficit	April-September			
	2022	**2021**	**2020**	**2019**
As % of H1-GDP	4.76	4.90	10.63	6.65
% of BE	37.31	34.96	114.77	92.58

- Central capital expenditure 83% higher than in H1-2019-20 (last pre-covid normal year)
- In contrast, revenue expenditure only 14% higher compared to H1-2019-20 implying strong shift from revenue to capital expenditure.
- Expenditure in current fiscal compared to 2021-22 will be higher mainly due to
  - High capital expenditure,
  - Extension of free food grain under PMGKAY
  - Increased fertilizer subsidy due to high global prices
- Slippage in Fiscal Deficit despite higher revenues, if any, should be tolerated to help revive growth while RBI focuses on curbing inflation.

Robust growth in state taxes, central transfers mainly driven by devolution

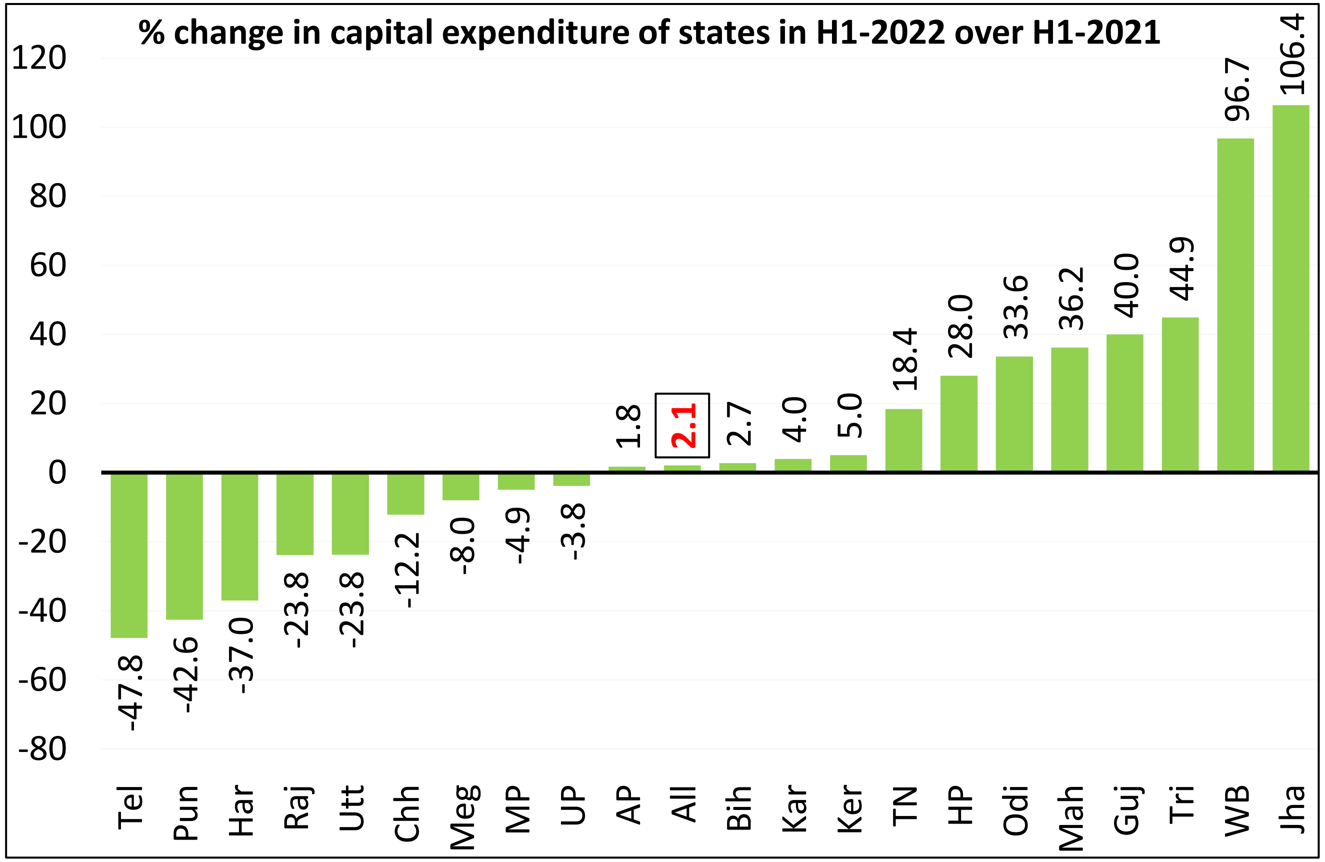
- Own tax revenues (OTR) buoyant across states compared to H1-2019-20 (last pre-covid normal year)
- Compared to H1-2021-22
  - OTR declined by 1.7% in Bihar, &
  - OTR growth moderate in Andhra (10%) & Punjab (15%)
- Large growth in Central transfers to most states
  - Exceptions are Uttarakhand (1.1%), Tripura (7.5%), Himachal (8.7%) & Karnataka (9.9%)
- Increase in transfers mainly due to devolution
- Increase in grants very modest (2.6%)
  - Reduction in grants in several states: Haryana, Odisha, Rajasthan, Tripura, West Bengal, Uttarakhand, Bihar, Karnataka, Jharkhand, Gujarat & Himachal





States’ capex tardy despite strong central support

- Major central support for states’ capital expenditure through Rs.1 trillion interest free capital expenditure loan
  - Rs. 60,301 crore has been approved till October for 20 states, of which
  - Rs. 28,401 crore (47.1% of the approved amount) has been transferred
- Despite this states’ capital expenditure has been tardy (2.1% increase over H1-2021)
  - Decline in capex in H1-2022 compared to H1-2021 in Telangana, Punjab, Haryana, Rajasthan, Uttarakhand, Chhattisgarh, MP & UP



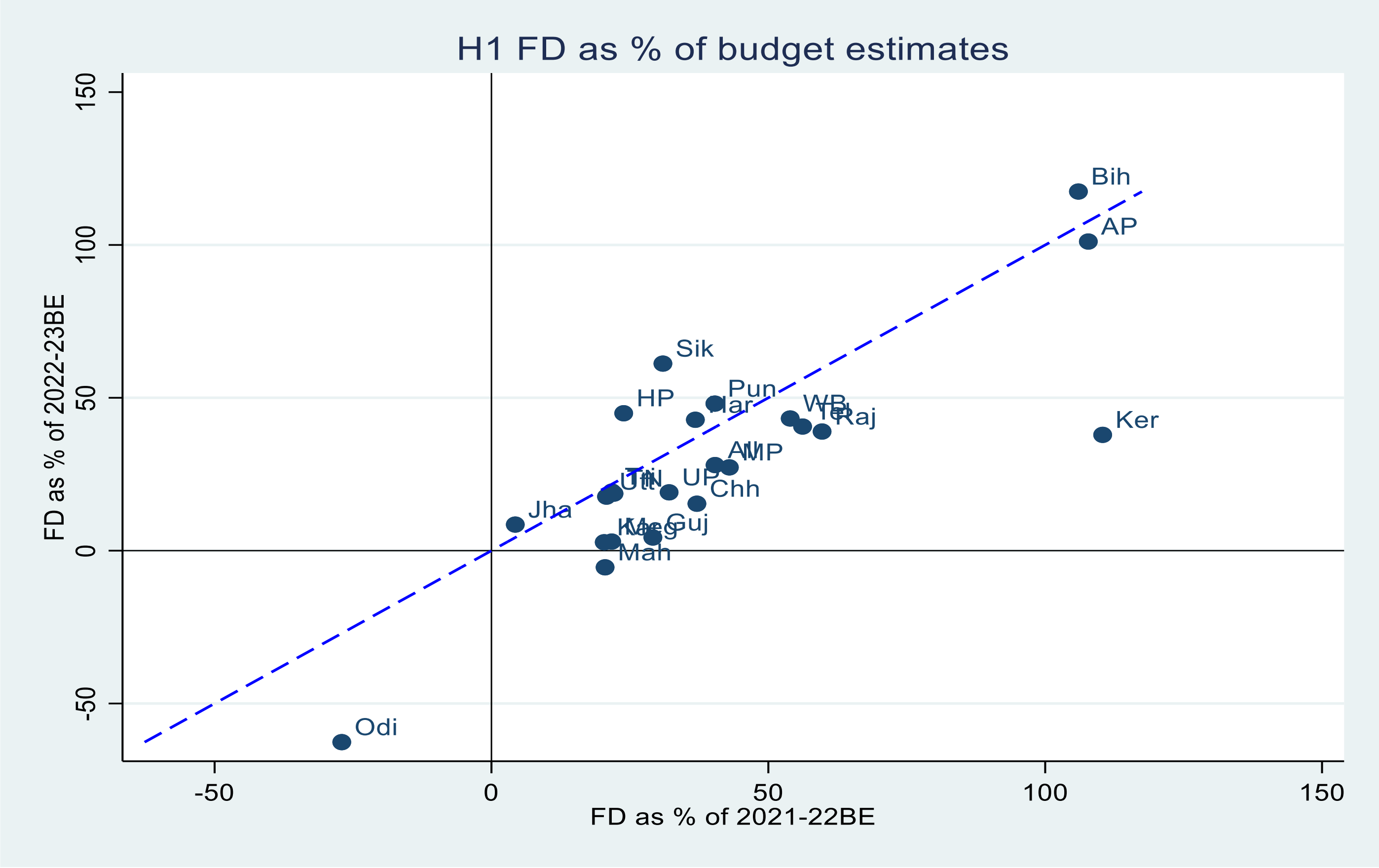
States consolidating fiscally at the cost of capex

- 26 states' combined fiscal deficit in 2022 is declining
  - As % of H1 GDP
  - Also as % of budget estimates

- Comparing H1 FD as % of budget estimates of 2022-23 and 2021-22, most states show improvement in the current fiscal
  - Maharashtra and Odisha report fiscal surplus
  - Andhra (101.1%) and Bihar (117.5%) continue to exceeded full year's FD

- Fiscal consolidation driven by buoyant OTR & devolution but also compressed capex.

Fiscal Deficit	April-September			
	2022	2021	2020	2019
As % of H1-GDP	1.84	2.96	2.23	2.18
% of BE	28.00	40.38	60.96	36.96



Central fiscal performance stable, states consolidating

- Most central tax revenues buoyant
- Strong central government thrust on capital expenditure
- Slippage in fiscal deficit despite higher revenues, if any, should be tolerated to help revive growth while RBI focuses on curbing inflation.

- Robust growth in state taxes & central transfers
  - Central transfers mainly driven by devolution, grants modest
- States' capex tardy despite strong central support
- States consolidating fiscally at the cost of capex.

Part VI

Overview & Key Takeaways

Macroeconomic environment remains challenging: slowing growth, elevated inflation & rising current account deficit

- High growth of 2021-22 & Q1 2022-23 was due to strong base effect of Covid shocks
- Growth now slowing as base effect fades, forecast at 5.2% in 2023-24
- Headline (CPI) inflation remains elevated though slight moderation in November, annual inflation forecast at 6.3%
- Meanwhile, current account deficit (CAD) is approaching 3% of GDP
  - Mainly due to slow growth of exports
  - Exchange rate continues depreciating due to rising CAD & large FPI outflows till June this year
- Macroeconomic policy stance has to be set against this complex background: since inflation is moderating, slowing growth & rising CAD should be policy priorities

Monetary Policy should now pause after large repo rate increase & liquidity tightening this financial year

- Repo rate has been raised by 225 basis points to 6.25% in FY 22-23
- This plus liquidity tightening has led to sharp reduction in spreads between long-term & short-term securities
- However, robust growth of non-food bank credit is continuing
- Need a pause to allow more time for pass through of repo rate increases, liquidity tightening & impact of forthcoming budget
- On external front allow gradual rupee depreciation to enable reversal of rising CAD with RBI intervention only to contain volatility

Fiscal Policy: Robust revenue increase enables growth revival through large capex increase but capex compression by States a major concern

- Robust tax revenue growth enables large increase in expenditure & sustained central government thrust on capex in forthcoming budget
- Slippage in fiscal deficit, if any, should be tolerated in short-term to reverse declining growth, with emphasis on fiscal consolidation in the medium-term
- Ad-hoc tampering with tariff rates, reversing two decades of tariff reform, should be avoided, relying on exchange rate depreciation to reduce CAD
- Major fiscal policy concern is fiscal consolidation through capex compression in most States, pushing the growth slow-down

  - Initiate policy dialogue with States through cooperative federalism institutions like NITI Aayog to reverse this fiscal stance of States

  - Pro-cyclical design of Central and State FRBMs should be revisited if necessary

Thank You