Pre-Budget (FY 2023-24) Review of the Economy

April-December, 2022-23

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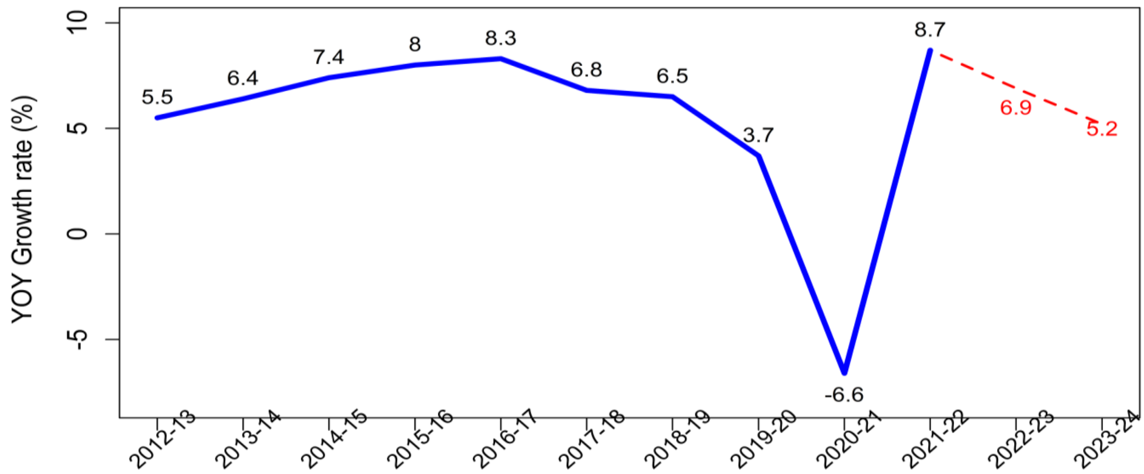
1. Introduction

The global economy is experiencing stagflation, low growth combined with exceptionally high inflation, as a consequence of multiple shocks following the Covid 19 pandemic: the Ukraine War, sanctions, the consequent oil shock and other severe supply disruptions through 2021 and 2022. Domestically also India has experienced elevated inflation and slowing growth after the base effect driven high growth of 2021-22. Given the backdrop, it is challenging to layout a macroeconomic policy path appropriate to navigate this difficult passage. Policy challenges might become further complicated if monetary policy tool turns out to be inadequate to tackle supply disruption driven inflation. This Policy Brief analyses this complex macroeconomic situation and suggests the appropriate monetary and fiscal policy stance to address the challenges.

2. Growth

Real growth is projected at 6.9% in FY 22-23 and 5.2% in FY 23-24, down from 8.7% in FY21-22: The Indian economy recorded real GDP growth of 8.7 per cent in the financial year FY 2021-22 following the 6.65 percent contraction during the Covid-19 pandemic year of FY 2020-21 (Figure 2.1, Table 2.1). The high growth in 2021-22 was mainly due to the strong base effect of the contraction in 2020-21. Growth is now declining due to the fading base effect, combined with fiscal compression in many states. The slowdown is expected to continue through FY 2023-24. The NIPFP projection is that GDP will grow by 6.9 per cent in FY 2022-23 and 5.2 per cent in FY 2023-24. These projections are close to the range of growth forecasts by RBI, IMF and the World Bank (Table 2.1) for FY 2022-23 and FY 2023-24. Of course, the actual outcome will depend on the policy measures that are taken and the market response to the same.

Figure 2.1: Real growth projected at 6.9% in FY 22-23 and at 5.2% in FY 23-24



Source: CSO, MOSPI, NIPFP

Quarterly growth slowing through Q2, Q3, Q4 FY 2022-23 after very high growth in Q1 FY 2022-23: Real GDP expanded at 13.5 per cent in the first quarter of FY 2022-23, compared to the same quarter of 2021-22 (Table 2.1, Figure 2.2). The high growth in Q1, reflected the base effect of low growth in Q1 FY21-22. In Q2 FY 2022-23 growth declined to 6.3 per cent on quarterly year-on-year (y.o.y) basis.

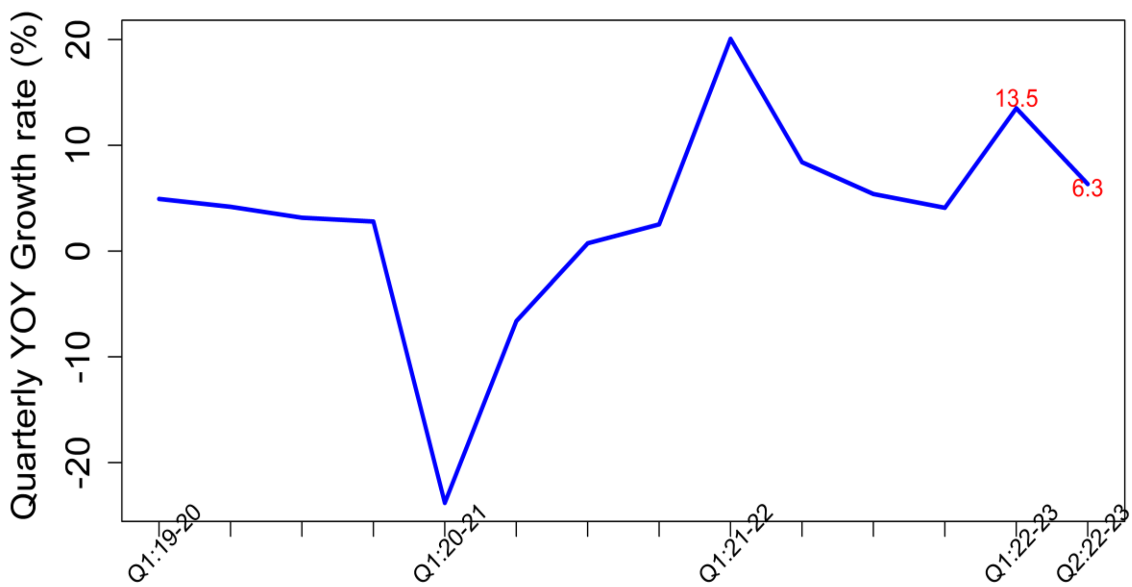
Table 2.1: GDP Growth on quarterly YoY basis

Date	Actual	Our Projection	RBI	IMF	WB
Q1 FY 22-23	13.5	15	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		
FY 20-21	-6.6				
FY 21-22	8.7				
FY 22-23		6.9	7	6.8	6.9
FY 23-24		5.2	6.5	6.1	6.2

Source: NIPFP, RBI, IMF, WB

NIPFP projections indicate the economy will grow at y.o.y 4.7 per cent and 4.2 per cent in Q3 FY 2022-23 and Q4 FY 2022-23 (Table 2.1). These estimates are not much different from the RBI projections.

Figure 2.2: Growth rate slowed down in Q2 compared to the double-digit growth in Q1 FY 2022-23



Source: CSO. MOSPI, NIPFP

Table 2.2: Sectoral quarterly YoY growth rates: Q1 & Q2 FY 2022-23

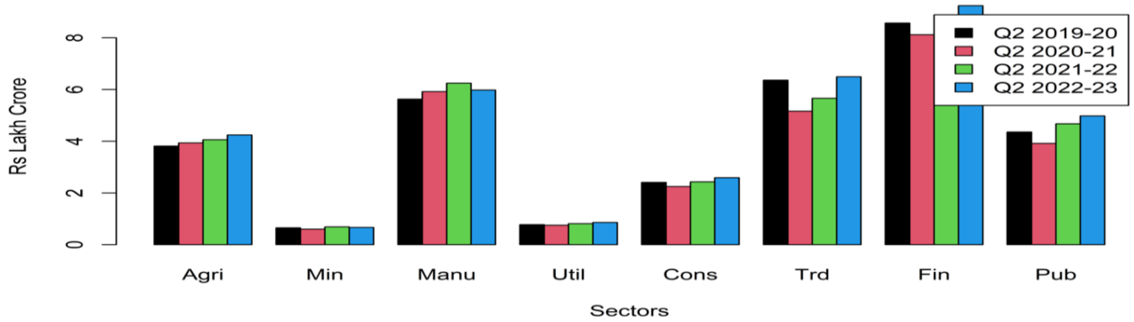
Quarter	GDP	Agri	Min	Man	Util	Cons	Trd	Fin	Pub
Q1 22-23	13.5	4.5	6.5	4.8	14.7	16.8	25.7	9.2	26.3
Q2 22-23	6.3	4.6	-2.8	-4.3	5.6	6.6	14.7	7.2	6.5

Source: CSO, MOSPI

Trade, hotels and Transports services output surged in Q2 2022-23 while manufacturing output declined: The slowdown reflected the contraction in Mining and Manufacturing sectors, although growth in the group 'Trade, Hotel & Transport (Trd)' was very high at 14.7 per cent y.o.y (Table 2.2). The high growth of Trd in Q2 FY 2022 was mainly on account of the low base effect.

The output of this sector finally exceeded the pre-Covid level in this quarter (Figure 2.3). This had happened earlier in agriculture, financial services, and public services. On the other hand, manufacturing output contracted in Q2 FY 2022-23 after growing in FY 2020-21 and FY 2021-22.

Figure 2.3: Comparing sectoral output for Q2 of the financial years from 2019-20 to 2022-23



Source: CSO, MOSPI

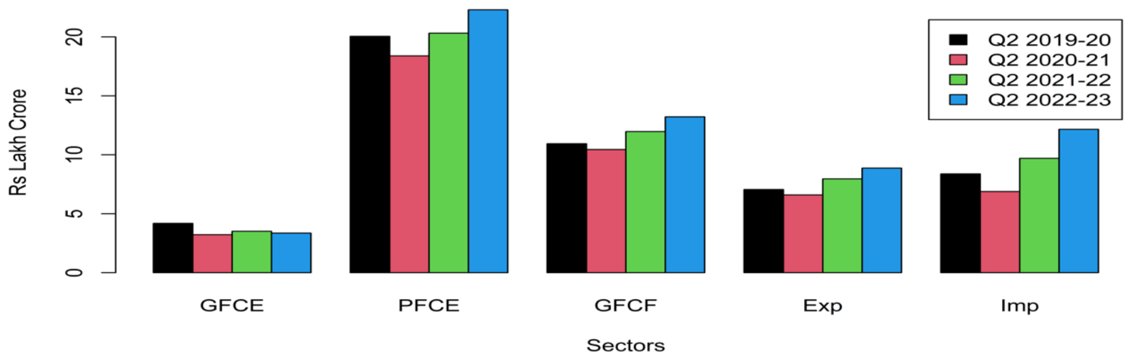
Sign of private demand revival observed: On the demand side, government consumption (GFCE) contracted in Q2 FY 2022-23 compared to the same quarter the previous year and still remained below the pre-pandemic level. However, private consumption (PFCE), total (private plus government) investment (GFCF), exports and imports finally exceeded the pre-pandemic level in this quarter (Table 2.3, Figure 2.4).

Table 2.3: Quarterly YoY growth rates of components of demand

	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	25.4

Source: CSO, MOSPI

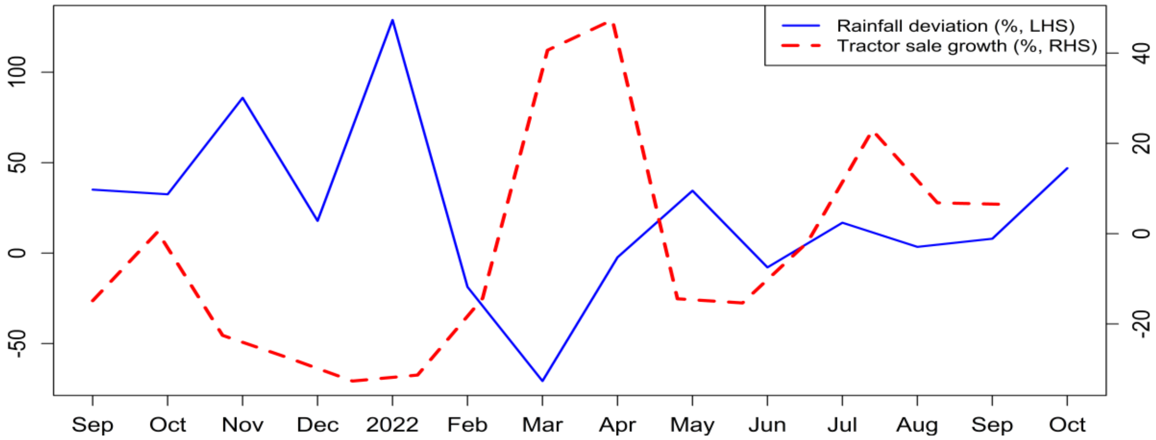
Figure 2.4: Comparing demand components for Q2 of the financial years from 2019-20 to 2022-23



Source: CSO, MOSPI

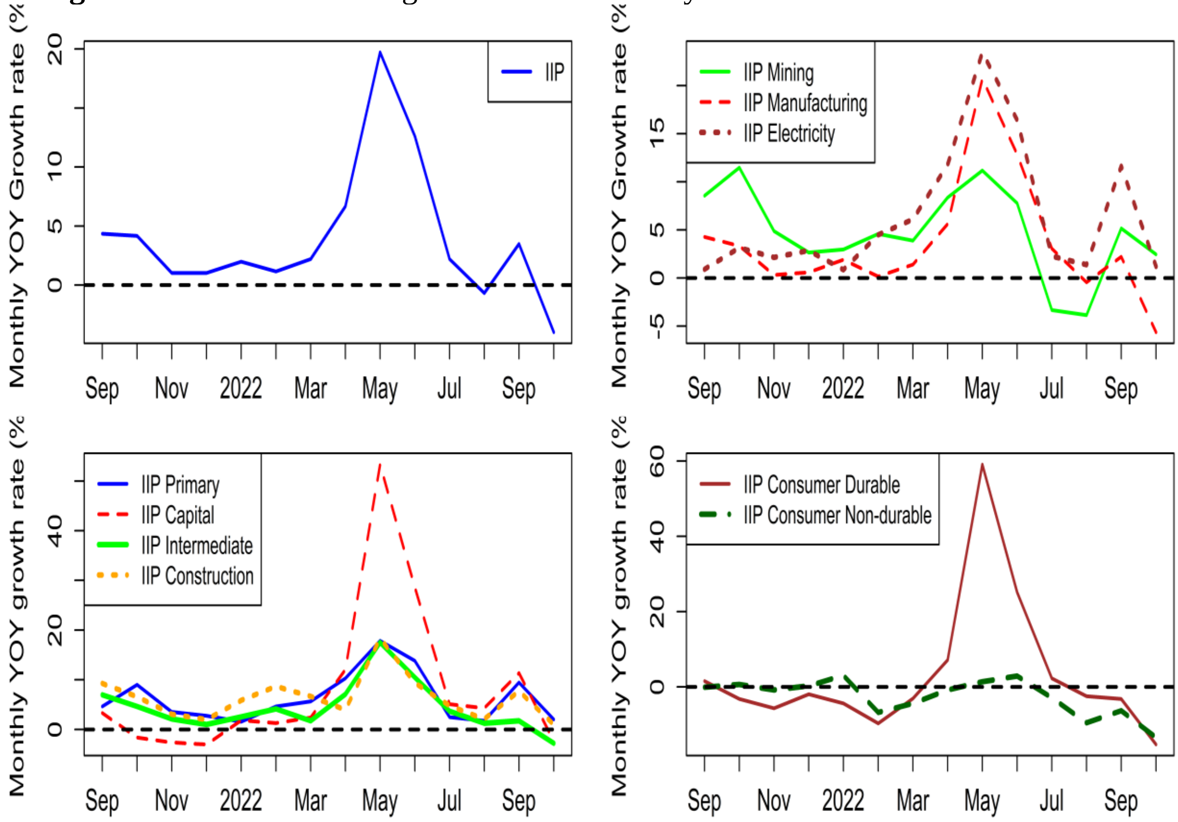
Outlook for H2 FY 2022-23 by sectors: Robust agricultural growth is expected for the second half of FY 2022-23 given normal rainfall observed till October 2022 and higher area sown under the Rabi crops in 2022 compared to 2021. This is partly attributable to the rising domestic price of wheat as a consequence of the Ukraine war. A robust agricultural outlook is also reflected in the growth of monthly tractor sales through Q1 to Q3 of FY 2022-23 (Figure 2.5).

Figure 2.5: Trend in monthly indicators capturing performance of agricultural sector



Source: CMIE, NIPFP

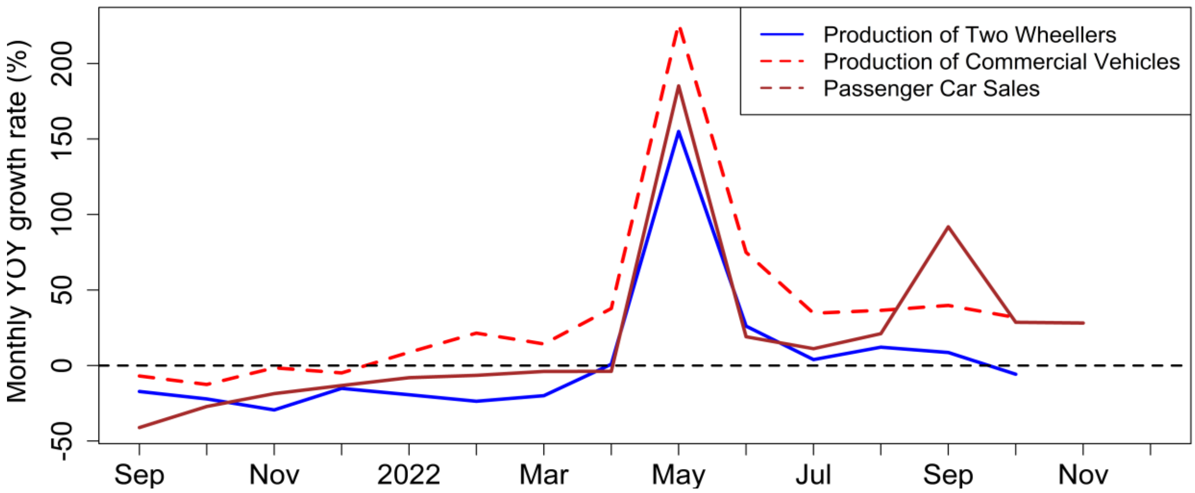
Figure 2.6: Recent trend in growth rates of activity-based and use-based IIP



Source: NSO

Both the activity-based and use-based classification of the index of industrial production (IIP) indicate a broad-based downward trend in growth in 202-23 (Figure 2.6)**.** Through 2020-21 and 2021-22, manufacturing was the engine of industrial recovery following the covid shock and within manufacturing the automobile sector was the main growth driver. This was possibly because the disruption of public transport system in the wake of the pandemic spurred the private demand for automobiles. However, the pandemic induced demand for automobile moderated in 2022-23. Production of two wheelers has contracted during Q3 2022-23, while growth in production of commercial vehicles and passenger car sales have tapered off (Figure 2.7).

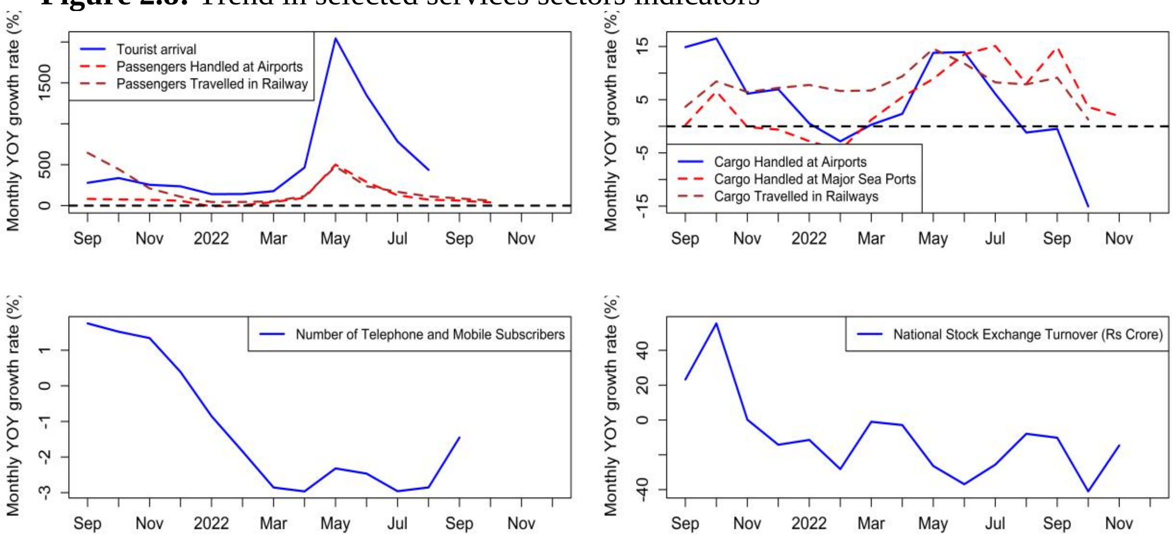
Figure 2.7: Trend in selected monthly indicators capturing performance of manufacturing sectors



Source: NSO, CMIE

Multiple high frequency indicators suggest declining growth in services in the from Q2 FY 2022-23 (Figure 2.8).

Figure 2.8: Trend in selected services sectors indicators

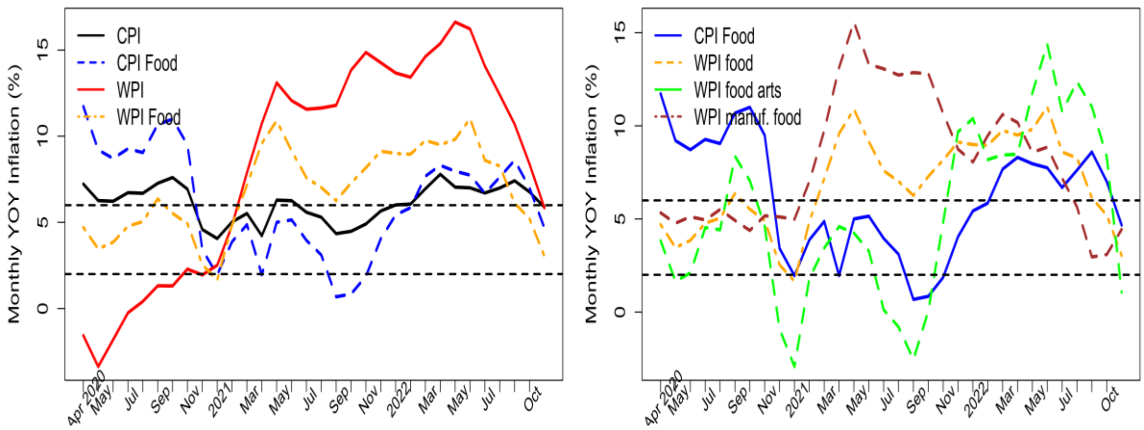


Source: Source: Ministry of Ports, Shipping and Waterways, Ministry of Tourism Press Release, Telephone Regulatory Authority of India, NSE, CMIE

3. Inflation

Headline CPI inflation remained elevated at 6.9 per cent during April-November, 2022 and finally fell below 6 per cent upper limit of the RBI inflation tolerance band in November (Figure 3.1)

Figure 3.1: Recent trend in CPI and WPI inflation



Source: CSO, MOSPI; Office of Economic Adviser

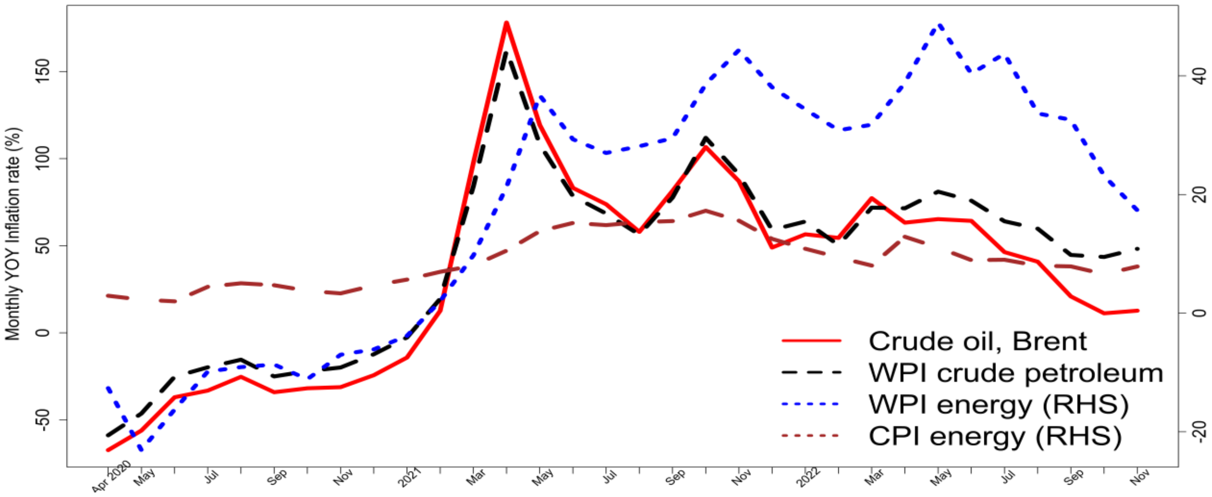
During 2020-21, food article prices were driving both CPI and WPI inflation. During 2021-22, manufactured food and energy price inflation were driving WPI inflation, while core inflation (inflation excluding food and energy prices, prices of fuel components in services) was driving overall CPI inflation. This led to the divergence between CPI and WPI inflation. During April-November, 2022-23, headline (CPI) inflation was broad-based, driven by high food price inflation, core inflation and energy price inflation. WPI inflation was even higher during this period and similarly broad based.

Food prices have risen due to domestic cost push factors such as agricultural wage inflation and increase in minimum support prices as well as global factors such as crude oil price inflation and the Ukraine war, while WPI manufactured food inflation is attributable to pandemic related supply disruptions in this period. Lagged transmission of WPI food inflation is now driving retail food price inflation.

During 2020-21, CPI core (non-food non-energy) inflation was driven by demand for health and transport services (net of petrol and diesel prices for conveyance). CPI core inflation became broad-based in 2022 driven by the revival of demand. WPI core inflation has been driven by energy inflation and exchange rate depreciation.

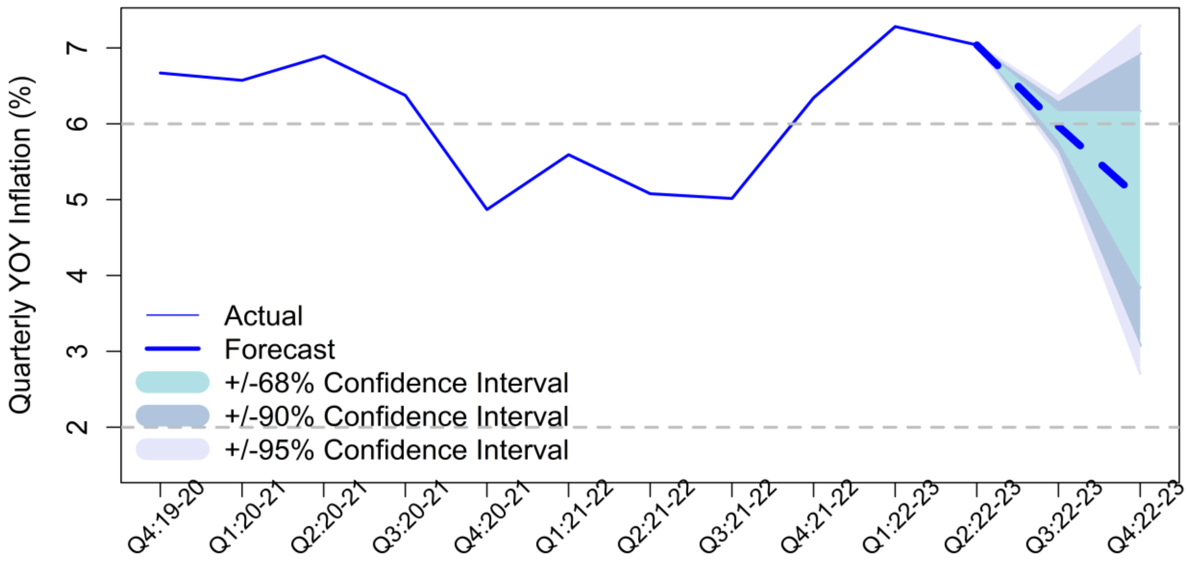
During April-November, 2022-23, average inflation rate in WPI and CPI energy prices were respectively recorded at 37.3 per cent and 9.2 per cent. There was immediate transmission of global crude oil inflation to the domestic WPI crude petroleum inflation, whereas global oil inflation transmitted to WPI and CPI energy inflation with substantial lag (Figure 3.2). Again, the transmission to WPI energy inflation was stronger, compared to that of the CPI energy inflation.

Figure 3.2 Lagged but sticky transition of global crude oil inflation to domestic energy inflation



Source: CSO, MOSPI; Office of Economic Adviser, World Bank Pink Sheet, NIPFP

Figure 3.3: Inflation forecasts for Q3 and Q4 FY 2022-23



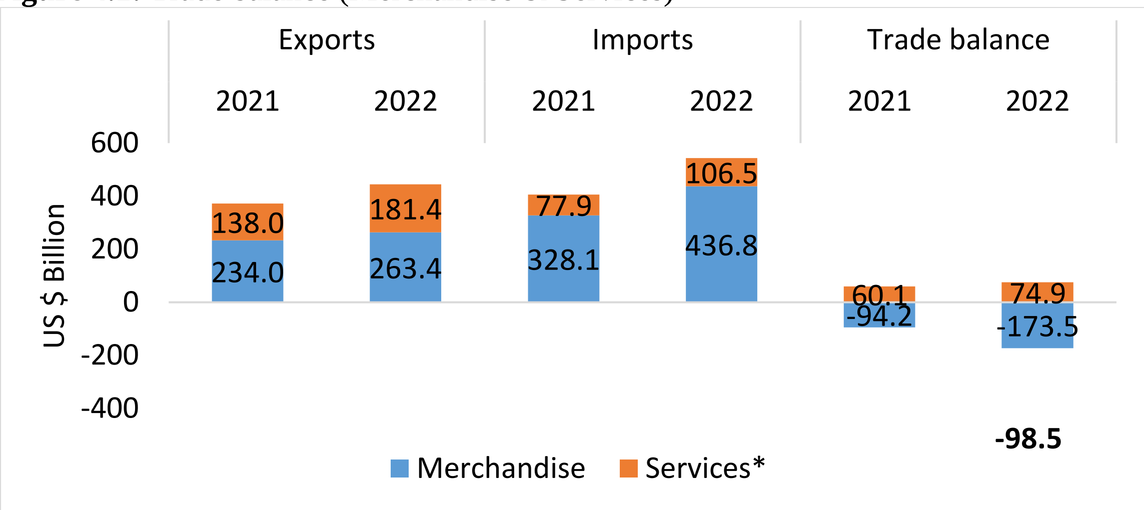
Source: NIPFP

Forecast Inflation is forecast at 5.5 per cent for H2 FY 2022-23, and 6.3 per cent for FY 2022-23 (Figure 3.3) with both upside risks and potential moderating factors. The upside risks include (i) high crude oil price inflation, (ii) increase in prices of cereals, pulses, vegetables and fruits, milk, and egg, meat and fish (EFM), (iii) broad-based rise in core inflation. However, inflation could be moderated by (i) slowing down of global edible oil inflation and (ii) monetary tightening by RBI.

4. Balance of Payments

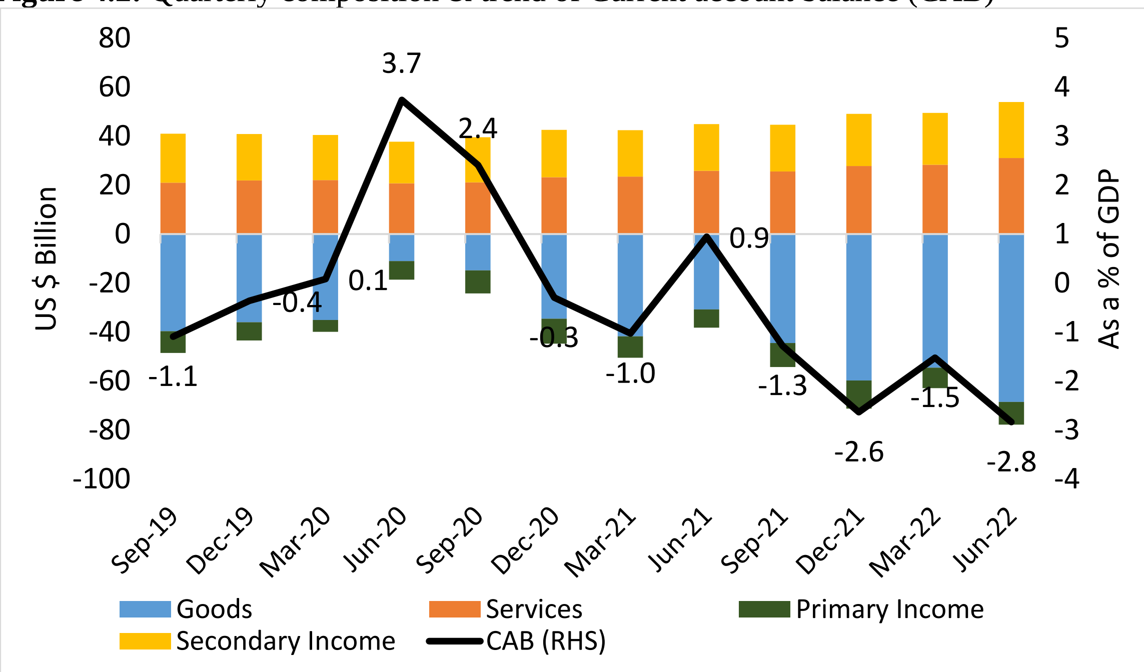
Growing current account deficit: During April-October, FY 2022-23, trade deficit was higher compared to that during the corresponding period of FY 2021-22**.** This was on account of the higher deficit in merchandise trade (Figure 4.1) in the current financial year and despite the higher surplus in services trade during April-October, FY 2022-23 compared to that during the same period of the previous financial year. This, combined with the contraction in primary income flows, has led to a continuing deterioration in the Current Account Balance (Figure 4.2). By the end of Q2 FY 2022-23, the Current Account deficit had risen to 2.8 per cent GDP.

Figure 4.1: Trade balance (Merchandise & Services)



Source: DGCIS & RBI

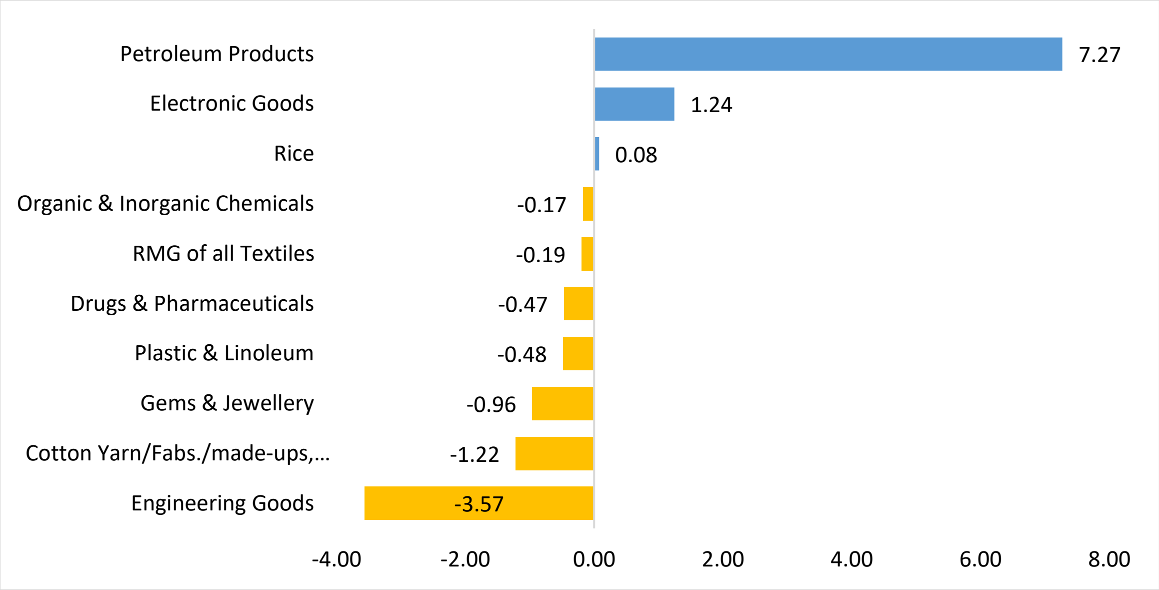
Figure 4.2: Quarterly composition & trend of Current account balance (CAB)



Source: RBI, CMIE, MOSPI & NIPFP

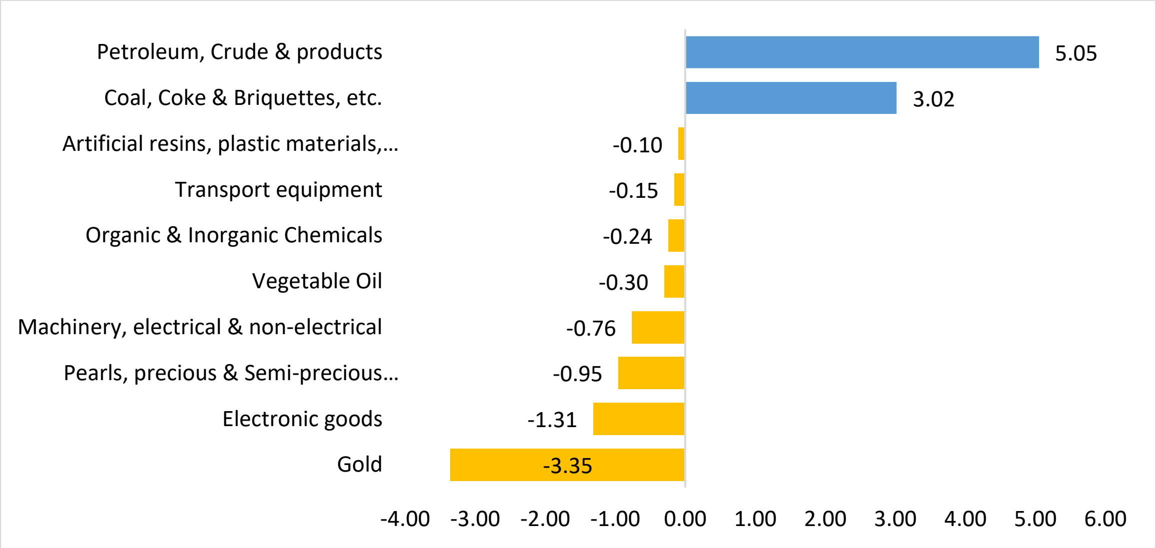
During the period April-October FY 2022-23 there was broad-based contraction in merchandise trade and in half of the services basket. In merchandise exports all items, except petroleum products and electrical goods, contracted during this period (Figure 4.3). Similarly, merchandise imports contracted during this period for most items except crude petroleum, petroleum products and coal, coke and briquettes etc.(Figure 4.4). The broad-based contraction in the imports of intermediate goods corresponds with the contraction in manufacturing output. Net exports for 50 per cent of services also contracted during the same period (Figure 4.5).

Figure 4.3: Relative contribution of top-ten commodities in export growth (%) in April-October, 2022 compared to April-October, 2021



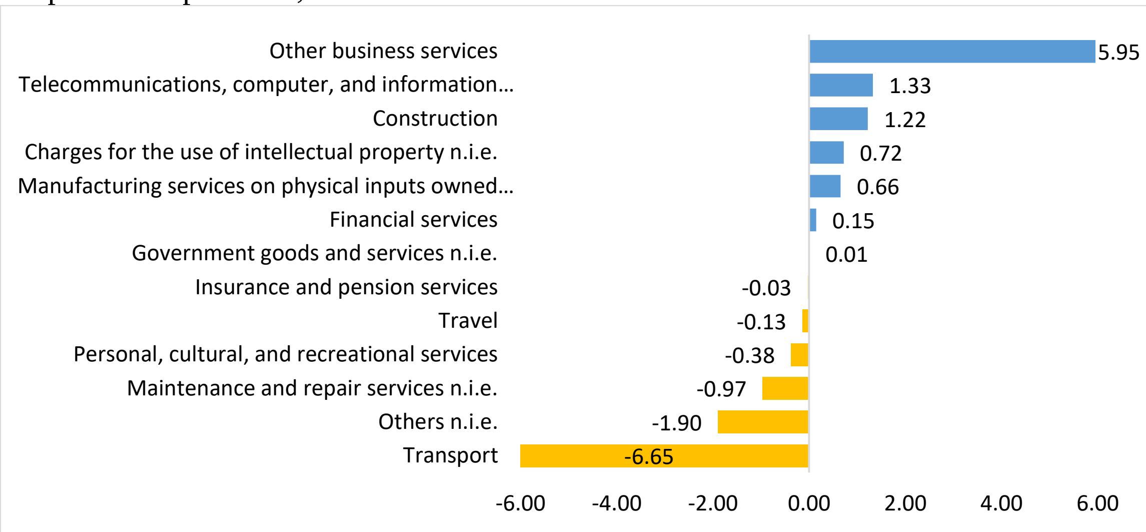
Source: DGCIS & NIPFP

Figure 4.4: Relative contribution of top-ten commodities in import growth (%) in April-October, 2022 compared to April-October, 2021



Source: DGCIS & NIPFP

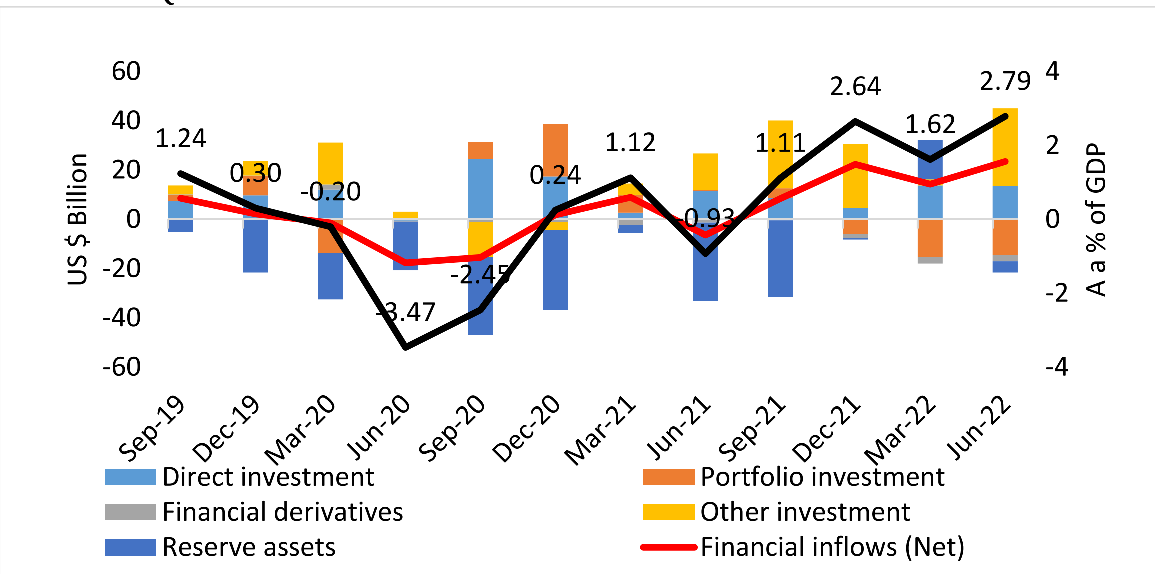
Figure 4.5: Relative contribution to Net Services export growth (%) in April-June, 2022 compared to April-June, 2021



Source: RBI & NIPFP

The increasing current account deficit during April-October FY 2022-23 was financed by the growing financial surplus on capital account. This included net inflows in foreign direct investment (FDI), external commercial borrowing (ECB) and trade credit. However, there was a net outflow of foreign portfolio investment (FPI) during this period, presumably a 'flight to safety' because of high global uncertainty, reinforced by interest rate hikes in some developed and other emerging economies (Figure 4.6).

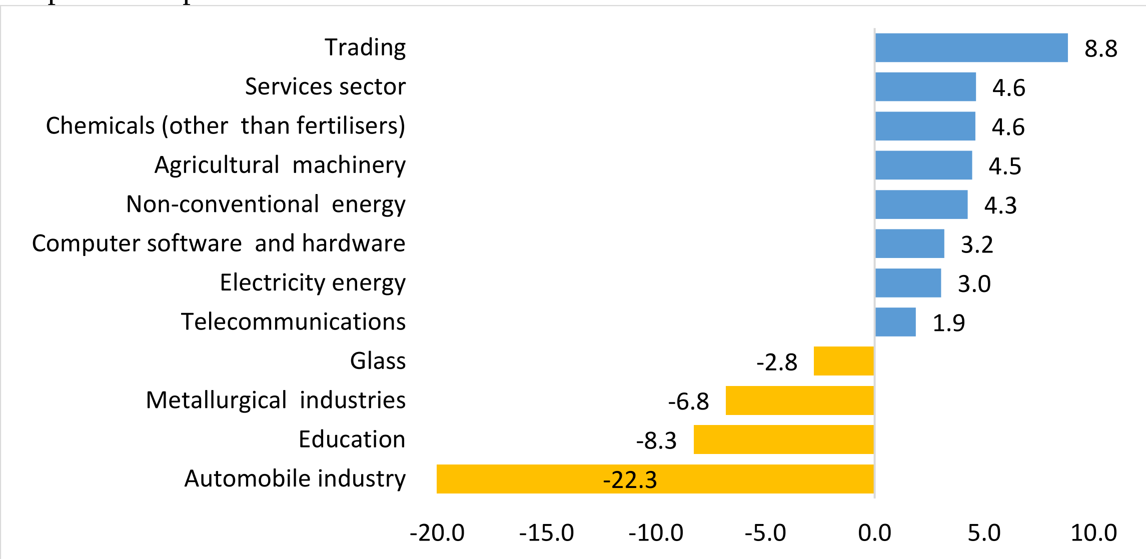
Figure 4.6: Net financial account flows: quarter-ended composition and trend: Q2 FY 2019-20 to Q1 FY 2022-23



Source: RBI, CMIE, MOSPI & NIPFP

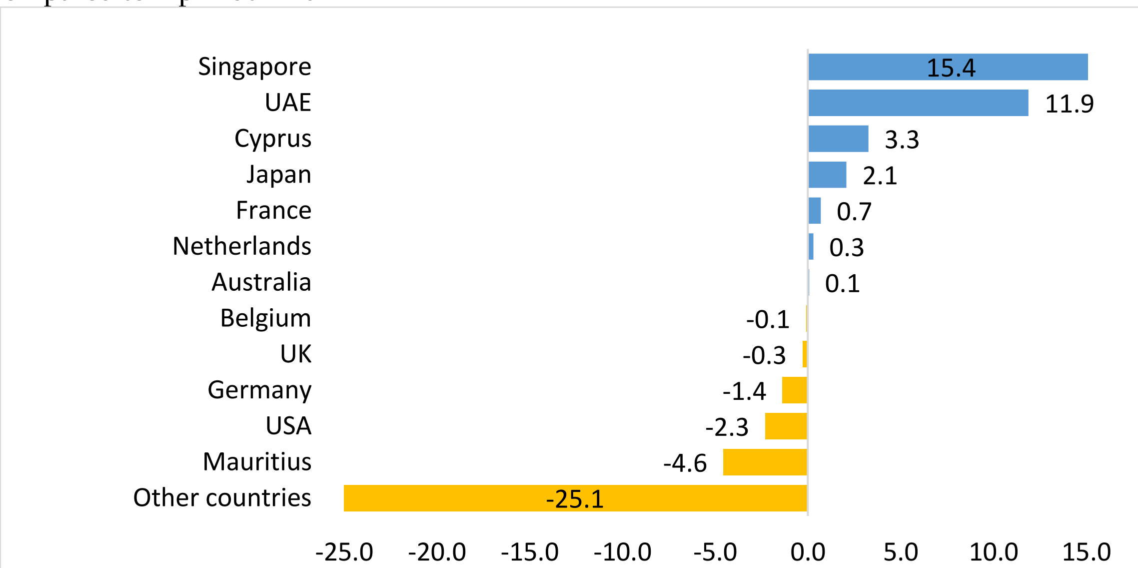
Growth in FDI inflows during April-June FY 2022-23 was broad-based though there was significant contraction in FDI inflows in the automobile industry (Figure 4.7). Geographically, Singapore, UAE, Cyprus and Japan were the major investors in this period, while FDI flows from several developed countries contracted (Figure 4.8).

Figure 4.7: Change in foreign direct investment inflows by sectors April-June 2022 compared to April-June 2021



Source: Ministry of Commerce & Industry, CMIE & NIPFP

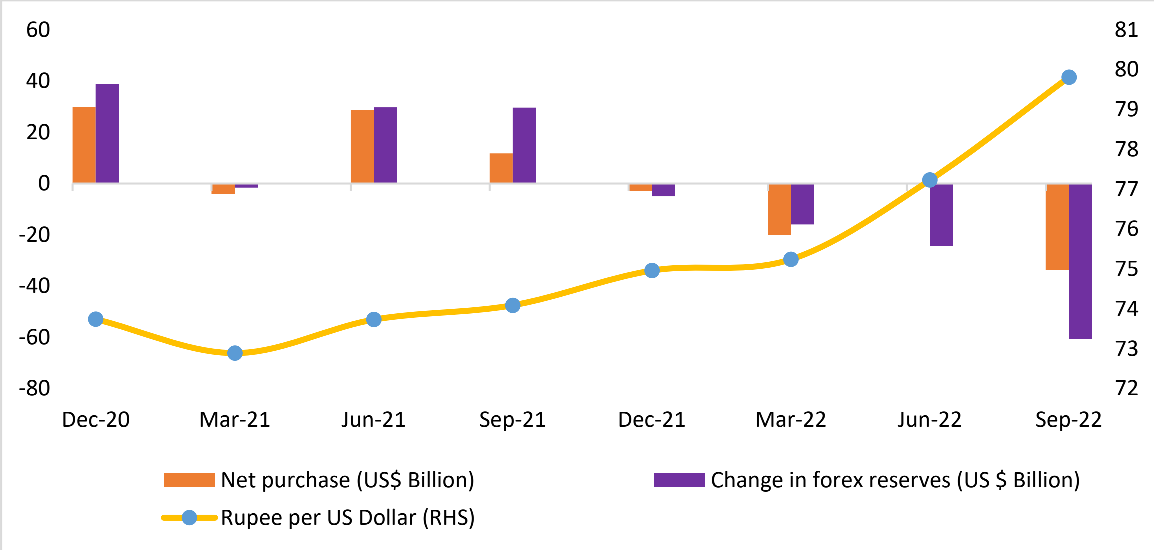
Figure 4.8: Change in FDI inflows to India from major investing countries April-Jun 2022 compared to April-Jun 2021



Source: Ministry of Commerce & Industry, CMIE & NIPFP

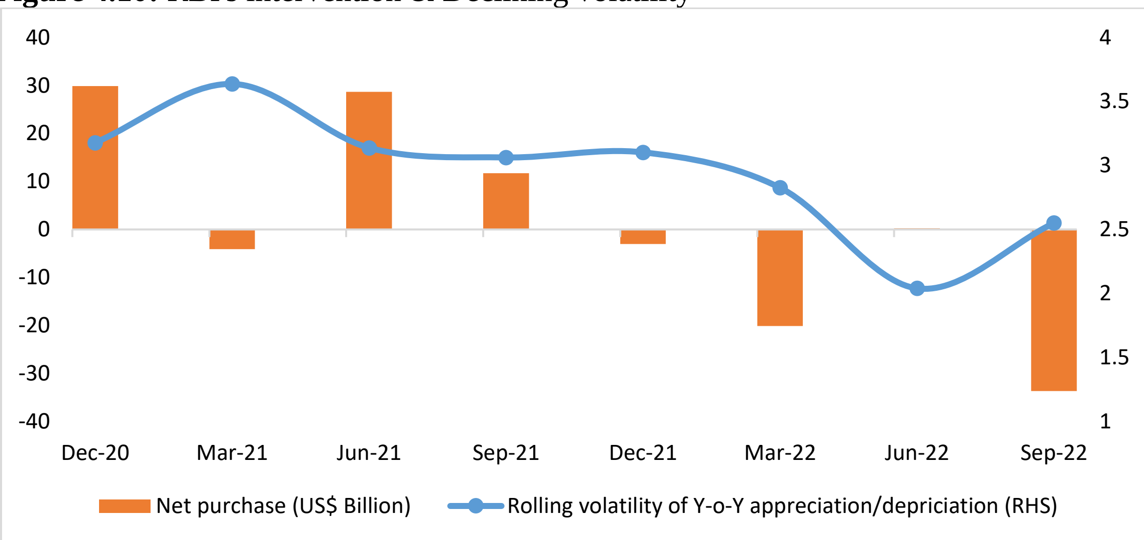
Rupee depreciation: The exchange rate continuously depreciated from Rs73/US$1 in Q1 FY 2021-22 to Rs.80/US$1 in Q2 FY 2022-23 (Figure 4.9). This was despite RBI interventions to contain exchange rate volatility, including dollar sales, since Q3 FY 2021-22. This is mainly attributable to the decline in foreign exchange reserves to finance the growing current account deficit and net FPI outflows till Q1 FY 2022-23. RBI managed to stabilise exchange rate volatility during Q1 FY 2021-22 to Q1 FY 2022-23. However, the exchange rate again became volatilile in Q2 FY 2022-23 despite of substantial net selling of dollar by RBI in this quarter (Figure 4.10).

Figure 4.9: Exchange rate of rupee against US Dollar, change in forex reserves & RBI's intervention



Source: RBI, CMIE & NIPFP

Figure 4.10: RBI's intervention & Declining volatility



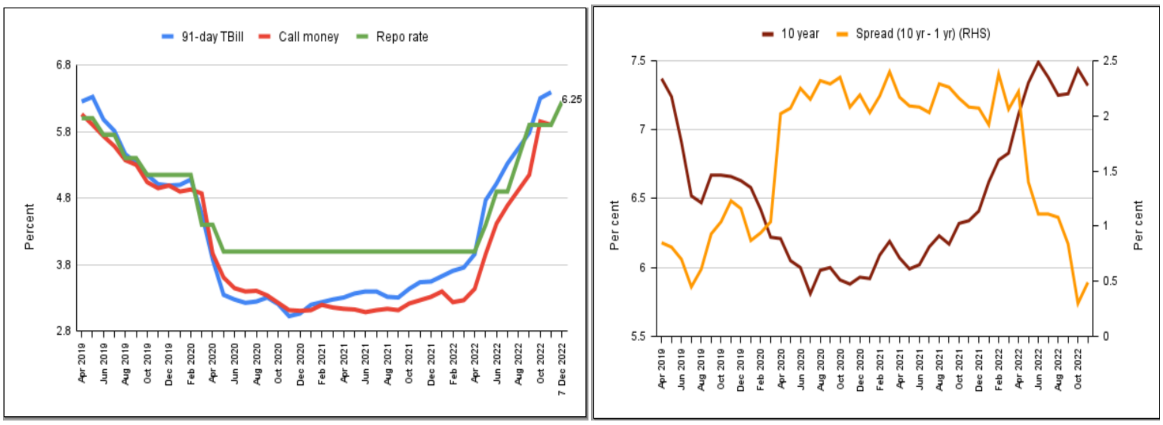
Source: RBI, CMIE & NIPFP

5. Monetary Policy and Financial Markets

Monetary policy tightening and rising interest rates: Till December 7th, RBI had raised the policy repo rate by 225 basis points since May 2022. With the latest increase in December, the policy repo rate has risen to 6.25 percent. The policy stance of the RBI also switched from accommodative to withdrawal of liquidity to ensure that inflation remains within the target going forward. The RBI has been conducting Variable Rate Reverse Repo auctions (VRRR) to withdraw liquidity from the banking system. As an outcome, the short-term rates such as the call money rate and the 91-day treasury bill rate have been closely tracking the rise in the policy rate.

While the short-term rates are seen to be sensitive to the policy rate, the yields on the longer maturity securities such as the 10 year bond have been largely range-bound in recent months. Consequently, the spread between the long and shorter maturity bonds has declined sharply during this period. The left panel of Figure 5.1 below shows the rise in the short-term interest rates and the right panel shows the trajectory of the 10 year bond yield and the narrowing of the spread between the 10 year and 1 year bond yields.

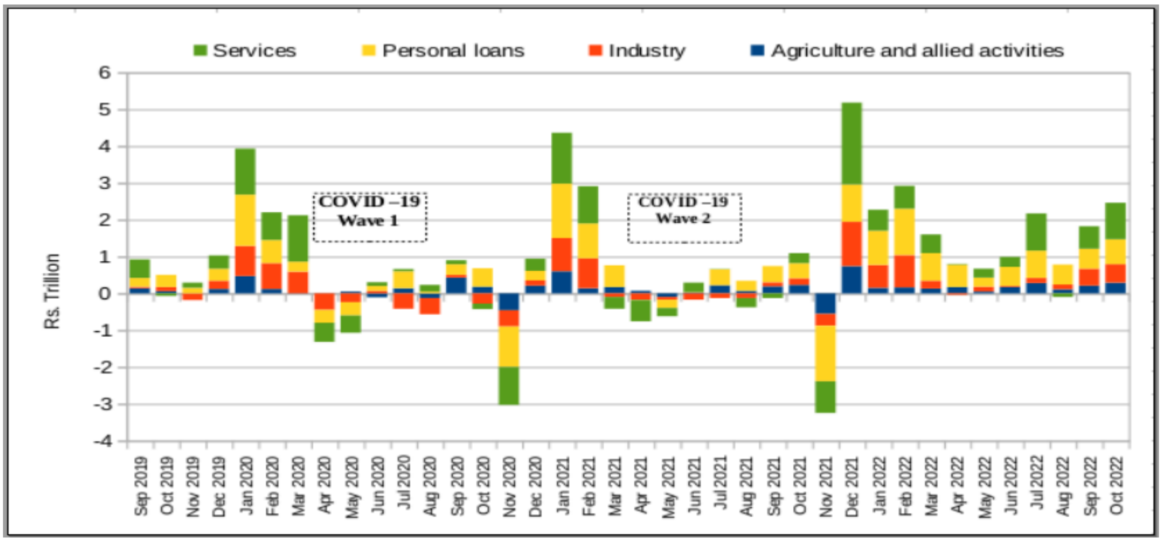
Figure 5.1: Short -term rates and narrowing of spreads



Source: CMIE Economic Outlook (EO), RBI

Robust credit growth: Despite monetary policy tightening, growth in non-food credit has remained robust. Particularly in October, 2022 the incremental increase in non-food credit was Rs 2.6 trillion, compared to the average monthly increase of Rs 1.3 trillion since April 2022 (See Figure 5.2 below). Among the components, personal loans and services have been the main channels of credit growth. Loans to services rose by Rs 1 trillion in October. The key component within services is loans to Non-bank financial companies (NBFCs).

Figure 5.2: Incremental non-food credit

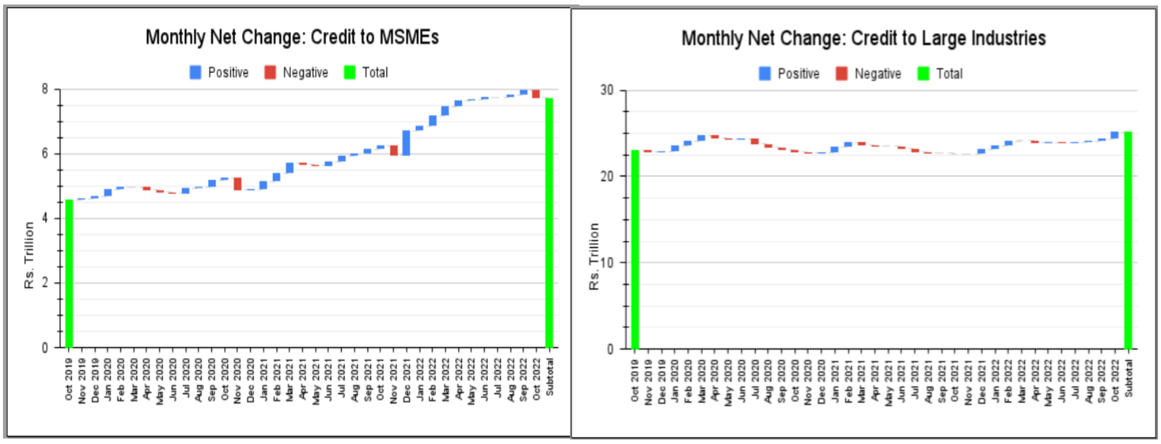


Source: CMIE EO, RBI

Credit growth has been far outstripping the growth in bank deposits. As an example, non-food credit recorded a strong growth of 17 percent in October, 2022 while the growth in deposits was languishing at 10 percent.

While personal loans and services have been the main components of bank credit growth, within industry the increase in credit has been seen mainly for micro, small and medium enterprises (MSMEs). Outstanding credit to MSMEs in October 2022 was significantly higher than in October 2019. It rose from Rs 4.6 trillion in October, 2019 to Rs 7.7 trillion in October 2022; roughly an increase of 68 per cent from the pre-pandemic baseline (Refer Figure 5.3 below). Though the outstanding credit to large industry is roughly six times the credit to MSMEs, the increase in credit to large industry from October 2019 to October 2022 was relatively muted, rising from Rs 23 trillion in October 2019 to Rs 25.2 trillion in October 2022 (Refer Figure 3 below). Moreover, the rise in credit to large industry occurred mostly in the first half of FY 2022-23. The outstanding credit to large industry was Rs 23.89 trillion in April 2022. This rose to Rs 25.1 trillion by October 2022.

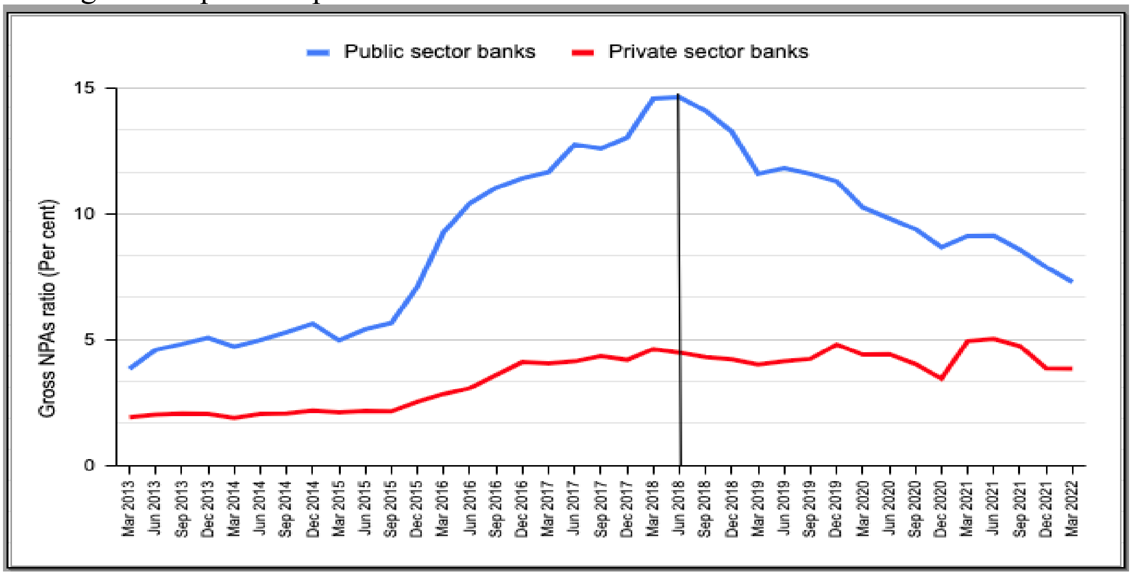
Figure 5.3: Outstanding credit to MSMEs now significantly higher than in October 2019, less so for large industries



Source: CMIE EO, RBI

Improvement in asset quality of banks: There has been a visible improvement in the asset quality of banks. According to the Financial Stability Report of the Reserve Bank of India, June 2022, gross non-performing assets (GNPA) ratio declined from 7.4 per cent in March 2021 to a six-year low of 5.9 per cent in March 2022. The GNPA ratio is expected to decline further to 5.3 percent in March 2023. The GNPA ratio of public sector banks rose from 5 percent in March 2015 to 14.6 percent in March 2018. With the transparent recognition of NPAs, periodic review of asset quality, the GNPA ratio of public sector banks (PSBs) declined to 7.6 percent in March 2022 (Figure 5.4). This is expected to fall further to 7.1 percent by March 2023 under the baseline scenario. The second quarter results of PSBs shows improvement in GNPAs and net interest margins (NIMs). The improved performance is mainly due to better credit off-take, rising interest rates and regulatory forbearance (mainly for MSMEs and personal loans).

Figure 5.4: Non-performing loans of PSBs have declined sharply since June 2018 peak, still higher compared to private sector banks

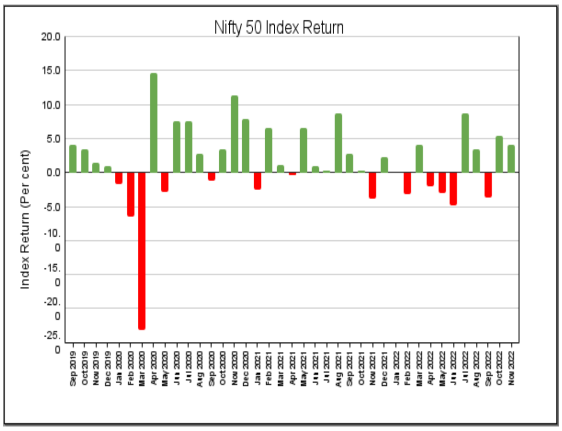


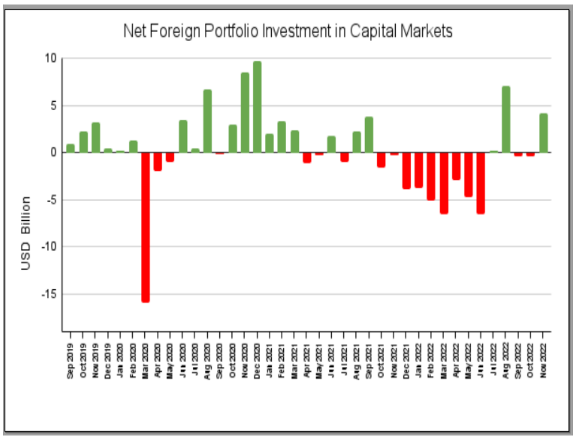
Source: RBI's Financial Stability Report (Various editions)

Capital markets and Foreign Portfolio Investments: Capital markets rebounded in October and November after witnessing bouts of volatility since the beginning of the financial year 2022-23. The NSE Nifty 50 index posted a return of 5.4 percent in October and 4.1 percent in November 2022 (See Figure 5.5 below). The moderation in the US CPI inflation since September 2022 and hopes that the U.S Federal Reserve will go for slower rate hikes boosted sentiments in the capital markets. Decline in crude oil prices and rupee appreciation also supported the markets.

Foreign Portfolio Investors (FPIs) turned net buyers in November (after registering net outflows in September and October) with a net investment of USD 4.1 billion. They were net buyers in equity and net sellers in the debt segment.

Figure 5.5: Rebound in capital markets during October & November net inflows by FPIs





Source: National Stock Exchange (NSE); National Securities Depository Limited (NSDL)

6. Fiscal Outlook: Union and State Governments

Most central tax revenue collections buoyant during H1,2022-23: The Gross Tax Revenue (GTR) of the Union government during H1-2022 is higher by 17.57% as compared to the same period in 2021. When compared to H1-2019, the last pre-covid normal year, it is higher by 51.37% (Table 6.1).

All central taxes contributed to the increase in gross tax revenue with the exception of Union Excise Duties and Customs. The rise in direct tax collections (i.e., Corporate and Personal Income tax) can be attributed to improved economic activity and higher corporate profitability, while duty cuts on petrol, diesel, edible oil, etc. to curb inflation resulted in lower customs and union excise duty collections.

Table 6.1: Revenue Collection (April-Sept 2022) - Percent change

Indicators	Percent change over		
	Apr-Sept 2021	Apr-Sept 2020	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
- Union 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**

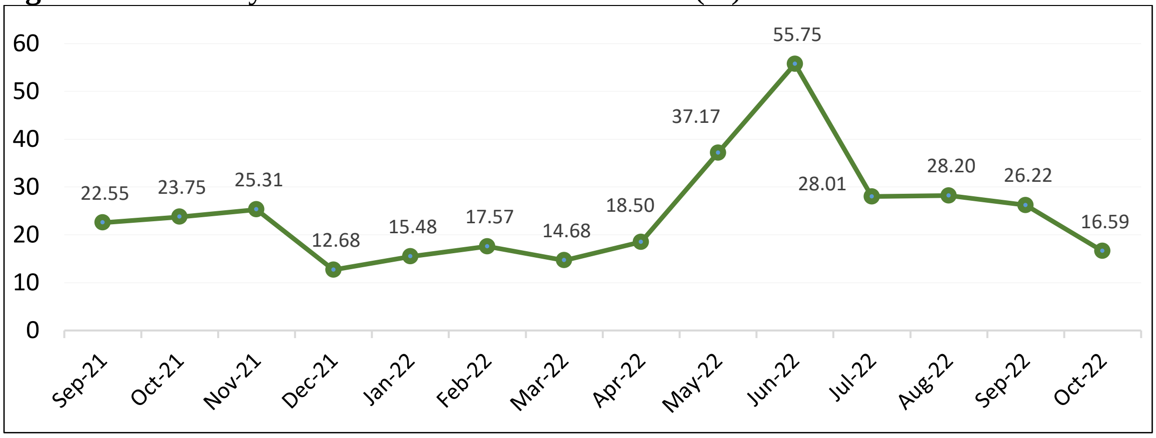
Note: * net of states' share in central taxes and collections under NCCD to be transferred to NDRF.
Source: CGA, Union Budget

From July 1, 2022, India imposed a tax on windfall gains accruing to oil companies from soaring energy prices due to the Russia-Ukraine conflict (to be revised every fortnight). It was expected that the windfall tax on oil produced domestically, and fuel exported overseas would recoup a sizeable proportion of revenues lost due to reduction in excise and customs duties.

GST collections have continued to remain buoyant during this period (Figure 6.1). For seven months in a row starting from March 2022, monthly GST revenues have been more than Rs. 1.4 trillion. High inflation, better reporting due to stronger enforcement and improved economic activity are the key drivers of higher GST revenues.

Non-tax revenues declined during April-September 2022 by 1.72 % compared to the same period in 2021. Non-tax revenues were even lower than that during the pre-pandemic period. The fall in non-tax revenue can be attributed to monetary compression, reduced dividend from the public sector banks and lower profits and reduced surplus transfers from RBI. The latter was mainly on account of higher interest paid by RBI on variable reverse repo auctions to suck out excess liquidity from the banking system that was infused following the onset of covid pandemic.

Figure 6.1: Monthly GST collections: Y-o-Y Growth (%)



Source: PIB releases

Strong central government thrust on capital expenditure: The Union government in order to give push to capital spending had budgeted for massive increase of about 24.5% over 2021-22 RE in capital expenditure in 2022-23BE. Capital expenditure during H1-2022 was 49.5% higher as compared to H1-2021 and 82.8% higher than that during H1-2019, the last pre-covid normal year (Table 6.2). In contrast, revenue expenditure was higher by only about 13.8% compared to H1-2019 implying a strong shift from revenue to capital expenditure.

The total expenditure of the union government in the current fiscal as compared to that during 2021-22 will be higher on account of (a) higher capital expenditure, (b) extension of free food grain under Pradhan Mantri Garib Kalyan Anna Yojana[1] (PMGKAY) and (c) increased outgo of fertilizer subsidy on account of soaring global fertilizer prices.

Table 6.2: Expenditures (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	32.48	8.46	80.09

Source: CGA, Union Budget

Buoyant tax revenues has kept the deficits of the Union government aligned with the budget estimates. The fiscal deficit was around 37.31% of 2022-23BE in the first half of the current fiscal or around 4.76% of H1-GD (Table 6.3).

Table 6.3: 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

Source: CGA, Union Budget

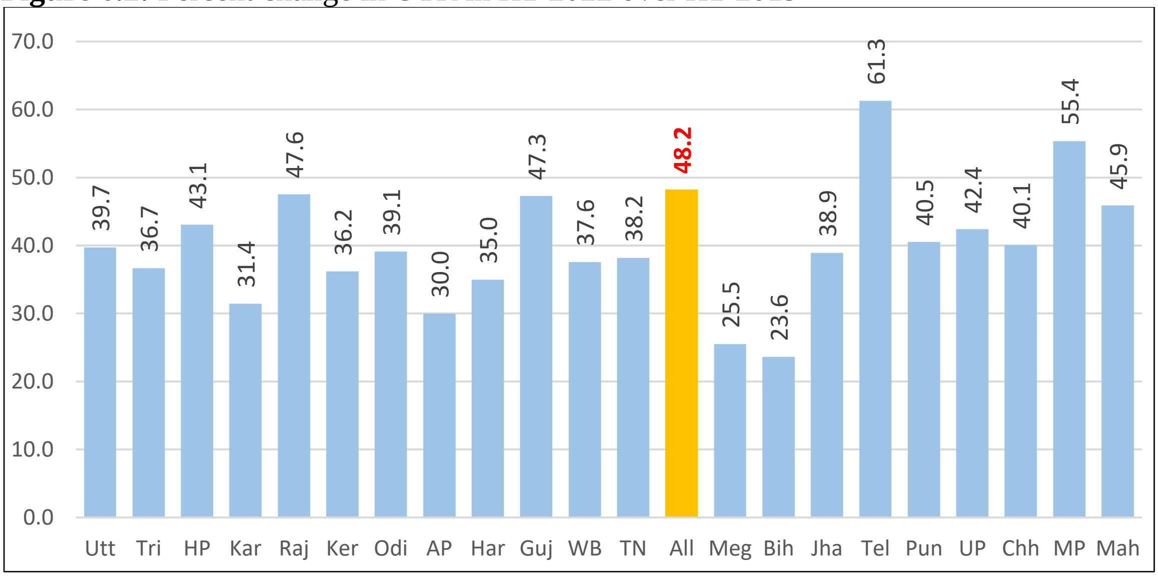
[1] The government extended the free food-grain scheme (Pradhan Mantri Garib Kalyan Anna Yojana) up to December 2022 on 29 September 2022. The additional cost to the exchequer would be around Rs.44,672 crore.

Robust recovery in tax collections augurs well for the Government to provide the required budgeted support to the economy and investment activity will a get boost from government's capex push. However, geopolitical tensions, rise in prices of essential commodities including crude oil, volatile global financial markets continue to pose risks to the process of recovery. Also, the recent extension of free food-grain scheme (Pradhan Mantri Garib Kalyan Anna Yojana) up to December 2022 and increase outgo of fertiliser subsidy on account of soaring global fertiliser prices may put some stress on government's finances. Any slippage in fiscal deficit in the current fiscal despite higher revenues should be tolerated to help revive growth while the RBI focuses on curbing inflation

Robust growth in state taxes: Own tax revenues (OTR) during H1-2022 were significantly higher across states as compared to H1-2019-20, the last pre-covid normal year, as is evident from Figure 6.2 and it increased by around 29.1% vis-à-vis H1-2021 aggregated across 23 states. However, it declined by 1.7% in Bihar and its growth was moderate in Andhra Pradesh (10.2%) and Punjab (14.9%).

Own non-tax revenues (ONTR) aggregated across 23 states shows an increase of about 33.2% in H1-2022 vis-à-vis H1- 2021. However, ONTR collections were lower during this period in Bihar (- 23.77%) and Maharashtra (- 13.60%).

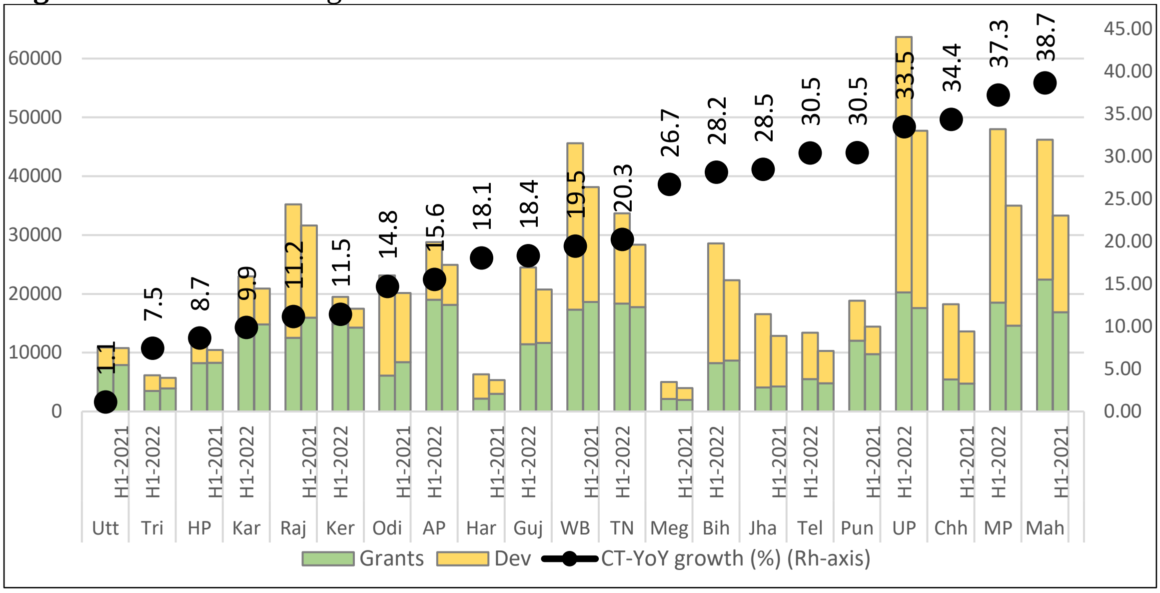
Figure 6.2: Percent change in OTR in H1-2022 over H1-2019



Source: Comptroller and Auditor General of India

Large increase in central transfers, mainly driven by devolution: In most states there has been a large increase in Central transfers during H1-2022 compared to H1-2021, though the increase in central transfers has been moderate in Uttarakhand (1.1%), Tripura (7.5%), Himachal Pradesh (8.7%) and Karnataka (9.9%) (Figure 6.3). The increase in central transfers is largely driven by the increase in tax devolution, higher by nearly 45 percent compared to H1-2021. In contrast, the increase in central grants to states during H1-2022 compared to H1-2021 was very modest (2.6%). In fact central grants were actually reduced for several states, namely, Haryana, Odisha, Rajasthan, Tripura, West Bengal, Uttarakhand, Bihar, Karnataka, Jharkhand, Gujarat and Himachal Pradesh.

Figure 6.3: Percent change in central transfers: H1-2022 over H1-2021

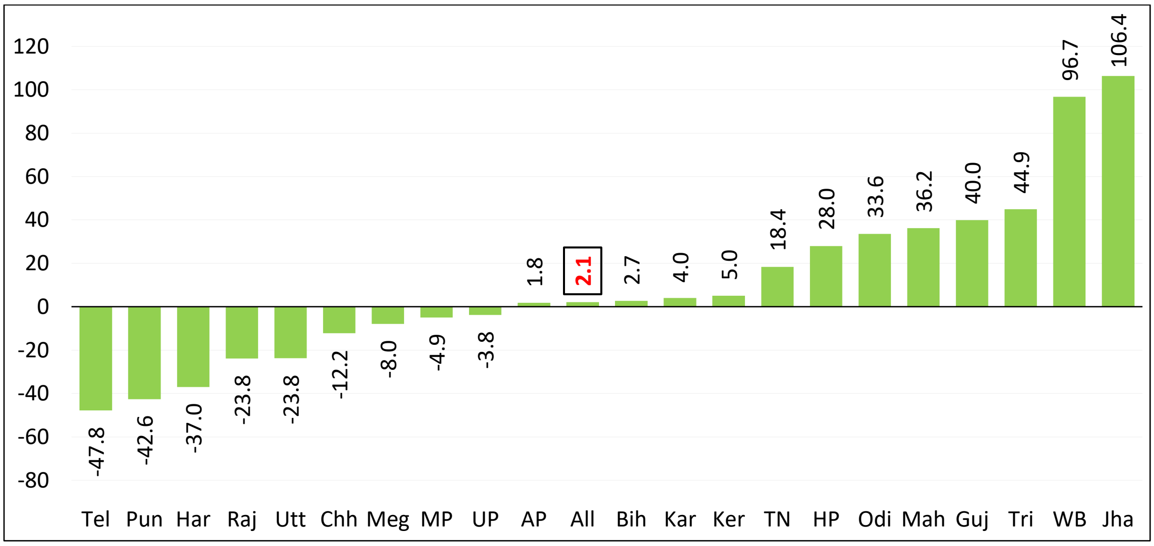


Source: Comptroller and Auditor General of India

States' capex has been tardy despite strong central support: In the 2022-23 budget, the Union government provided Rs. 1 lakh crore to states for capital expenditure under the scheme 'Special Assistance to States for Capital Investment 2022-23'. As per the monthly summary report of Department of Expenditure till October Rs. 60,301 crore has been approved for 20 states and Rs. 28,401 crore (i.e., 47.1% of the approved amount) has been transferred to the states.

Despite this we find that states' capital expenditure has been tardy, an increase of only 2.1% in H1-2022 over H1-2021. In several states there was a decline in capital expenditure in H1-2022 compared to H1-2021. These are Telangana, Punjab, Haryana, Rajasthan, Uttarakhand, Chhattisgarh, Madhya Pradesh and Uttar Pradesh (Figure 6.4)

Figure 6.4: Percent change in capital expenditure of states in H1-2022 over H1-2021



Source: Comptroller and Auditor General of India

States consolidating fiscally at the cost of capex: The combined fiscal deficit of 26 states was lower during April-September 2022 both as percent of 2022-23 budget estimates and also as percent of H1-GDP as compared to that during 2021, 2020 and 2019 (Table 6.4).

Table 6.4: Fiscal Deficit (26 states)

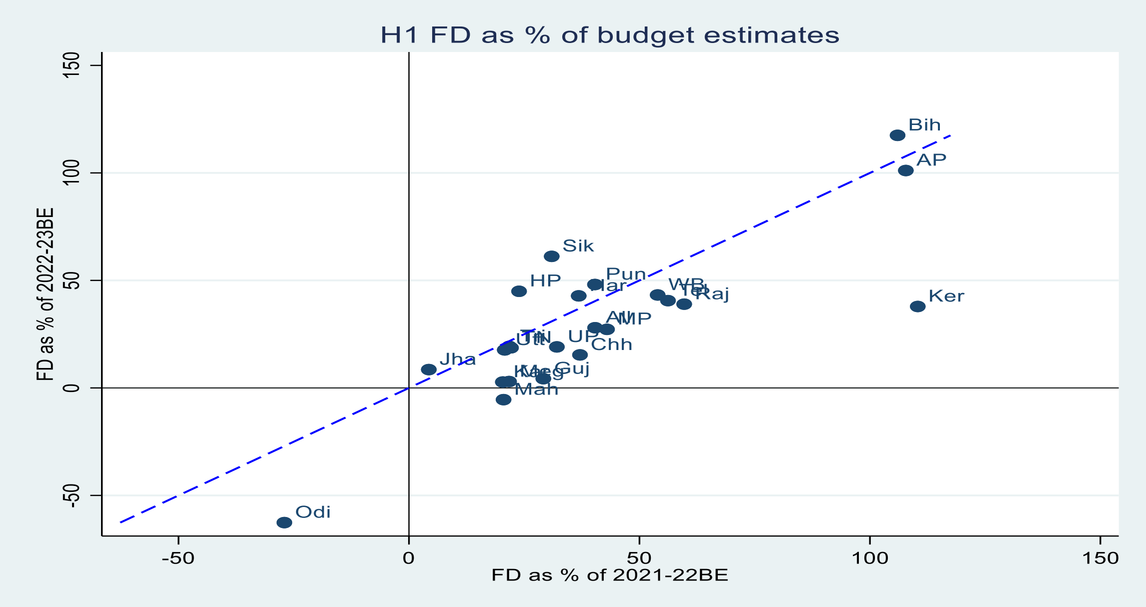
	April-September			
	2022	2021	2020	2019
As % of H1 GDP	2.32	3.77	4.76	2.64
As % of 2022-23 BE	35.31	51.44	72.72	44.68

Source: Comptroller and Auditor General of India; MoSPI.

Comparing H1 fiscal deficit as percent of budget estimates of 2022-23 and 2021-22, most states show an improvement in the current year (Figure 6.5) and Maharashtra and Odisha report fiscal surpluses, though Andhra Pradesh (101.1%) and Bihar (117.5%) continue to exceed the full year's fiscal deficit.

Thus, states as a whole are seen to be consolidating fiscally, barring some outliers. But their fiscal consolidation is driven not just by buoyant own tax revenues and larger tax devolution, which are welcome, but also by compression in capital expenditure.

Figure 6.5: H1 fiscal deficit as percent of budget estimates



Source: Comptroller and Auditor General of India; State budgets

Central fiscal performance stable, states fiscally consolidating but compressing capex: To summarise, during H12022-23 most central tax revenues were buoyant. This helped finance a strong central government thrust on capital expenditure while ensuring that the deficits of the government aligned with the budget estimates. If there is any slippage in the fiscal deficit despite high revenue growth, this should be tolerated to help revive growth on the fiscal policy side while RBI focuses on curbing inflation.

Analysis of states governments reveal robust growth in states' own taxes and central transfers. The latter was mainly driven by devolution, the increase in grants from the Union government during H1 being very modest. Despite the robust growth in revenues and the strong support from the union government, increase in states' capital expenditure has been tardy.

Thus, States have been consolidating fiscally, but the consolidation is driven as much by buoyant own tax revenues and tax devolution as by compression states' capital expenditure. This is a major policy concern as it may have an adverse impact on growth.

7. Conclusion

The following are some of the key takeaways from the foregoing pre-budget economic review.

The macroeconomic environment remained challenging with slow growth, elevated inflation and a rising current account deficit: Growth was high in FY 2021-22 and Q1 FY 2022-23 mainly due to the strong base effects of covid shocks. Growth is now slowing as the base effect fades with 5.2 per cent our projected GDP growth for FY 2023-24. Headline (CPI) inflation remained elevated during this period, though there was slight moderation in November, 2022. Inflation for the full year FY 2022-23 is projected at 6.3 per cent. Meanwhile, the current account deficit (CAD) approached 3 per cent of GDP, mainly due to slow growth of exports. The exchange rate has continued to depreciate due to the rising CAD and large FPI outflows till June 2022. The government's macroeconomic policy stance has to be set against this complex background. Since inflation showed signs of moderation, slowing growth and the rising CAD should be the key policy priorities.

Monetary policy should pause, allowing more time for the impact of the repo rate increases and liquidity tightening in FY 2022-23 to pass through: The Repo rate has been raised by 225 basis points since May 2022 to 6.25 per cent now (December 2022). This, along with liquidity tightening has led to a sharp reduction in spreads between long-term and short-term securities. However, non-food bank credit has continued to grow rapidly. It would appear there is a need to pause the sequence of Repo rate increases and allow more time for the impact of the recent repo rate increases to pass through, along with the liquidity tightening and the possible impact of the forthcoming budget (FY 2023-24). On the external front, gradual rupee depreciation should be allowed to enable a reversal of the rising CAD, with RBI intervention only to contain volatility.

Robust revenue increase enables growth revival through large rise in capital expenditure (capex), but the capex compression by states is a major concern: The observed buoyancy in tax revenue, if sustained, will enable a large increase in expenditure, and a continuing central government thrust on capex in the forthcoming budget of FY 2023-24. Slippage in the fiscal deficit, if any, should be tolerated in the short term to reverse declining growth, with emphasis on fiscal consolidation in the medium term. Ad-hoc tempering with tariff rates, reversing two-decades of tariff reform should also be avoided, relying on exchange rate depreciation to reduce the CAD. A major fiscal policy concern is fiscal consolidation through capex compression in most of the states, pushing the growth slow-down. Centre should initiate policy dialogue with states through cooperative federalism institutions like NITI Ayog to reverse this fiscal stance of the states. Also, the pro-cyclical design of Central and States FRBM should be revised if necessary.