**Ch 01: State of the Economy**

The World Economic Outlook (WEO) Update of January 2020 published by IMF has estimated the global output to grow at 2.9 per cent in 2019, declining from 3.6 per cent in 2018 and 3.8 per cent in 2017. the deceleration in India’s GDP growth since 2017 has tracked the decline in world output. However, for three years prior to 2017, when global output growth was not declining, India surged ahead of the rest of the world.

Along with the weakening of global economic activity, inflation the world over also remained muted in 2019. From the supply side, lower energy prices in 2019 also contributed to softening of inflation. In India, inflation slightly rose to 4.1 per cent in April- December 2019, after a sharp decline from 5.9 per cent in 2014 to 3.4 per cent in 2018. The global slack in consumer demand affected industrial activity, which slumped in most of the major economies in 2019. Global production in automobile industry fell sharply due to a decline in demand, which was caused by changes in technology and emission standards in many countries. Increasing trade barriers as well as trade uncertainty stemming from growing trade tensions also weakened business confidence

The Union Budget 2019- 20 had articulated the vision of the Hon’ble Prime Minister to make India a US$ 5 trillion economy by 2024-25. The march towards this milestone has, however, been challenged by less than expected growth of India’s GDP so far this year. Yet, given India's record of growth with macroeconomic stability over the last five years (annual average growth rate of 7.5 per cent and annual average inflation of 4.5 per cent), the economy is poised for a rebound towards the US$ 5 trillion goal.

As several polices have been implemented to enhance the formalization of the economy, examining the impact of the same is crucial. As per the latest available data on employment, there has been an increase in the share of formal employment by 5 percentage points and this increase has been on account of 5 percentage points decrease in the share of casual workers i.e. an evidence of formalization in the economy. The proportion of women workers in ‘Regular wage/salaried’ employees’ category has increased by 8 percentage points. The drop in casual labour has mainly originated from the rural sector where rural labourers have shifted from agricultural to industrial and services activity. In urban region, there has been a shift of employment from self- employed to salaried jobs.

In 2019-20, Centre’s fiscal deficit was budgeted at 3.3% of GDP as compared to 3.4% of GDP in 2018-19. Goods and Services Tax (GST) collections, the biggest component of indirect taxes, grew by 4.1 per cent for the Centre during April-November 2019. This may be the result of concerted efforts taken by the Government to improve tax compliance and revenue collection as well as a reflection of a rebounding economy.

The liquidity condition of banks became comfortable after June 2019 and has remained healthy since then. The growth of bank credit which was picking up in 2018-19 started decelerating. The deceleration was witnessed across all major segments of non-food credit, save personal loans which continued to grow at a steady and robust pace. The deceleration in credit growth was most in the services sector. Credit growth to industry also witnessed a significant decline in recent months, both for MSME sector as well as large industries. Agriculture and allied activities benefited from a higher growth of credit. Decline in credit growth has been attributed to growing risk aversion of banks that continue to apprehend the build-up of Non-Performing Assets (NPAs).

In October and November 2019, major commodity groups have shown a growth in exports over the corresponding month of the previous year while imports of major commodity groups have contracted. The contraction in import bill was partly contributed by a decline in oil prices in the current year as compared to 2018-19. Lower Current Account Deficit (CAD) reflects reduced external indebtedness of the country making domestic economic policy increasingly independent of external influence. The CAD, which was 2.1 per cent of GDP in 2018-19, has improved to 1.5 per cent in 2019-20 on the back of significant reduction in trade deficit. Foreign Direct Investment (FDI) provides a more stable source of financing the CAD as compared to external borrowings. During 2014-19, gross FDI to India has been robust as compared to the previous five years; the trend has continued in 2019-20 as well. Consequent to the improvement in current account and higher capital flows into the country, the Balance of Payments (BoP) position of the country has improved from foreign exchange reserves of US$ 302 billion in end March 2019 to US$ 461.2 billion as on 10th January 2020.

Resources move across sectors in response to changes in relative prices causing different sectors of the economy to grow at different rates. A high growth of GDP does not attract much attention to sectoral contribution to growth as much as low growth of GDP does. Yet, at all levels of growth, structural change is imminent, and it is the pace of change that becomes a matter of interest.

* Share of agriculture and allied sectors in the total GVA of the country has declined from 2009-14 to 2014-19 mainly on account of relatively higher growth performance of tertiary sectors.
* The contribution of industrial activities to GVA has also declined from 2009-14 to 2014-19. Manufacturing sector, which contributes more than 50 per cent of industrial GVA, has driven the decline while the share of construction sector has also moderated.
* Financial, real estate and professional services has driven the increase in the contribution of service sector followed by public administration. Even globally, the services sector has supported global growth partly offsetting the decline in manufacturing activity.

**THE RECENT GROWTH DECELERATION: DRAG OF THE FINANCIAL SECTOR ON THE REAL SECTOR**

The virtuous cycle of growth wherein increase in the rate of fixed investment accelerates the growth of GDP that in turn induces a higher growth in consumption. Higher growth of consumption improves the investment outlook, which results in still higher growth of fixed investment that further accelerates the growth of GDP, inducing a still higher growth of consumption. This virtuous cycle of higher fixed investment-higher GDP growth-higher consumption growth generates economic development in the country.

Conversely, when this virtuous cycle rotates slowly, declining rate of fixed investment decelerates GDP growth with a lag, which eventually causes a deceleration in the growth of consumption as well. In case of India, the lag between rate of fixed investment and its impact on GDP growth is seen to be of three to four years. The impact of GDP growth on consumption growth gets reflected in one to two years.

* The drop in fixed investment by households explains most of the decline in overall fixed investment.
* Fixed investment in the public sector only marginally decreased.
* the stagnation in private corporate investment at approximately 11.5 per cent of GDP between 2011-12 to 2017- 18 has a critical role to play in explaining the slowing cycle of growth and the recent deceleration of GDP and consumption.

To make sense of the decline in corporate investment when it stems from issues related to the financial sector, we must understand the boom in credit. It is now well recognized that a sudden credit expansion, which is purely supply led, results in short lived expansion of output and employment but causes significant contraction in the long run. The International Monetary Fund (2017) finds this relationship for 80 countries. In most of these cases, the credit channel works through household debt where households increase demand using debt in the short run and reduce demand later during the deleveraging phase, thereby, resulting in recessions. In the Indian context, the credit channel has worked through corporate investment. The bust following the boom was characterized by deleveraging and low investment rate in the corporate sector, eventually causing the recent deceleration of GDP growth.

The IMF in its January 2020 update of World Economic Outlook has projected India’s real GDP to grow at 5.8 per cent in 2020-21. World Bank in its January 2020 issue of Global Economic Prospects also sees India’s real GDP growing at 5.8 per cent in 2020-21. Following are the downside/upside risks for India:

* Continued global trade tensions could delay the recovery in the growth of global output, which may constrain the export performance of the country. Weaker export growth may reduce the inducement to increase the fixed investment rate in the economy.
* Escalation in US-Iran geo-political tensions may increase the price of crude oil and depreciate the rupee. Net FPI inflows may weaken, as a result, adding further pressure on the rupee to depreciate.
* Growth in advanced countries has weakened with very low inflation. The conventional monetary policy has almost run its full course.
* Investment in the public sector may increase, as is expected after the announcement of the National Infrastructure Pipeline (NIP) of projects worth Rs. 102 lakh crores.
* There are tentative signs that manufacturing activity and global trade are bottoming out. This may positively impact India's exports. At the same time, there is renewed initiative to boost exports through various reform measures including scaling up of logistics infrastructure that may increase export competitiveness.
* Government’s thrust on affordable housing is evident, in order to boost the real estate sector and consequently the construction activity in the country.
* Global sentiment continues to favor India as reflected in robust and rising inflows of net FDI into the country. Relocation of investors from other countries to India in the wake of trade tensions will also add to the flow.

On a net assessment of both the downside/upside risks, India’s GDP growth is expected to grow in the range of 6.0 to 6.5 per cent in 2020-21.

**Ch 02: Fiscal Developments**

Amidst the global setting of subdued growth and intensified trade tensions, the Budget 2019-20 presented in July 2019 reaffirmed Government’s commitment to growth with macroeconomic stability. Following the path of fiscal consolidation, the Union Budget 2019-20 sought to contain the fiscal deficit i.e. 3.3 per cent of the GDP, as against 3.4 per cent of GDP in 2018-19. The ratio of revenue deficit to fiscal deficit broadly measures the extent of borrowings used for financing current expenditure of the Government. In 2019-20 BE, it was pegged at roughly the same level as in 2018-19. The prominent changes in the Central Government finances include improvement in the tax to GDP ratio and reduction in primary deficit as a per cent of GDP.

Central government receipts can broadly be divided into Non-debt and debt receipts. The Non-debt receipts comprise of Tax revenue, Non-Tax revenue and Non-debt Capital receipts like recovery of loans and disinvestment receipts. Debt receipts mostly comprise of market borrowings and other liabilities, which the government is obliged to repay in the future. The Budget 2019-20 targeted a high growth in Non-debt receipts of the Central Government, which was driven by high expected growth in Net Tax revenue and Non-Tax revenue. Non-Tax revenue comprises mainly of interest receipts on loans to States and Union Territories, dividends and profits from Public Sector Enterprises including surplus of Reserve Bank of India (RBI) transferred to Government of India, receipts from services provided by the Central Government and external grants. Better tax administration, widening of TDS carried over the years, anti-tax evasion measures and increase in effective taxpayers’ base have contributed to direct tax buoyancy. Widening of tax base due to increase in the number of indirect tax filers in the GST regime has also led to improved tax buoyancy. Going forward, sustaining improvement in tax collection would depend on the revenue buoyancy of GST.

It is imperative for any developing economy to optimally allocate the available resources without compromising on the crucial developmental and macroeconomic goals. As India’s tax to GDP ratio is low, Government faces the challenge of providing enough funds for investment and infrastructure expansion while staying within the bounds of fiscal prudence. Therefore, improving the composition and quality of expenditure becomes significant. The composition of government expenditure in the last few years reveals that expenditure on defence services, salaries, pensions, interest payments and major subsidies account for more than sixty per cent of total expenditure. Budgetary expenditure on subsidies has seen significant moderation through improved targeting. There is still headroom available for further rationalization of subsidies especially food subsidy. There has been considerable restructuring and reclassification of Central sector and Centrally Sponsored Schemes in the recent years.

Government budgetary expenditure is envisaged to increase by one percentage point of GDP in 2019-20. The entire increase is on revenue account with capital spending remaining unchanged as per cent of GDP. Within revenue expenditure, more than forty per cent of the increase is explained by increase in interest payments and major subsidies. The budgetary expenditure on major subsidies has shown a declining trend over the past years. **The quality of expenditure is captured by the share of capital expenditure in total expenditure.**

The Fourteenth Finance Commission (FFC) for the award period 2015-20 had made far-reaching changes to strengthen fiscal federalism in the country. Consequently, States have obtained larger fund transfers as well as greater autonomy to utilise funds as per their needs. Transfer of funds to States comprises essentially of three components: share of States in Central taxes devolved to the States, Finance Commission Grants, and Centrally Sponsored Schemes (CSS), and other transfers. In fact, the RBI Study on State Finances attributes the fiscal consolidation of the States in the last four to five years to the steep decline in expenditure, mainly capital, which may have adverse implications for the pace and quality of economic development, given the large welfare effects of a much wider interface with the lives of people at the federal level.

The States have thus continued the path of fiscal consolidation and contained the fiscal deficit within the targets set out by the FRBM Act. On the other hand, the debt to GDP ratio for States has risen since 2014-15 owing to the issuance of UDAY bonds in 2015-16 and 2016-17, farm loan waivers, and the implementation of Pay Commission.

It is critical to analyse the General Government finances to get an overview of fiscal position of the Government as a whole. The General Government (Centre plus States) is expected to continue the path of fiscal consolidation as the fiscal deficit of General Government is expected to decline from 6.2 per cent of GDP in 2018-19 RE to 5.9 per cent of GDP in 2019-20 BE. However, the combined liabilities of Centre and States have increased to 69.8 per cent of GDP as on end-March 2019 (RE) from 68.5 per cent of GDP as on end-March 2016.

**Outlook**

* The year 2020-21 is expected to pose challenges on the fiscal front. While on one hand the outlook for global growth persists to be weak, with escalated trade tensions adding to the risk; on the other hand, the pace of recovery of growth will have implications for revenue collections.
* In order to boost the sluggish demand and consumer sentiments, counter-cyclical fiscal policy may have to be adopted to create additional fiscal headroom. During the first eight months of 2019-20, the indirect tax collections have been muted. Therefore, revenue buoyancy of GST would be key to the resource position of both Central and State Governments. On the expenditure side, rationalisation of subsidies especially food subsidy could be an important tool for expanding the headroom for fiscal manoeuvre. The Fifteenth Finance Commission reportedly has also submitted its Interim Report and its recommendations especially on tax devolution would have implications for Central Government finances.
* Finally, the geopolitical situation unfolding in West Asia is likely to have implications for oil prices and thereby on the petroleum subsidy, apart from having implications for current account balance.

**Ch 04: Monetary Management and Financial Intermediation**

Monetary policy remained accommodative in 2019-20. The repo rate was cut by 110 basis points in four consecutive Monetary Policy Committee meetings in the financial year due to slower growth and lower inflation. However, it was kept unchanged in the fifth meeting held in December 2019. Liquidity conditions were tight for initial two months of 2019-20; but subsequently it has remained comfortable. The financial flows to the economy however, remained constrained as credit growth declined for both banks and Non-Banking Financial Corporations.

Transmission of monetary transmission has been weak in 2019 on all three accounts: Rate Structure, Quantity of Credit, and Term Structure. After growing very fast in 2017-18 and in first half of 2018-19, the Non-Bank Financial sector has decelerated sharply since then. The growth of loans from NBFCs declined from 27.6 per cent in September 2018 and 21.6 per cent in December 2018 to 9.9 per cent at end September 2019. There is an observable shift in the sources of funding of NBFCs. The growth (YoY) of loans from NBFCs declined from 27.6 per cent in September 2018 and 21.6 per cent in December 2018 to 9.9 per cent at end September 2019.

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| Bank credit growth slowed down in 2019-20 and stands at 7.1 per cent (YoY) as of December 20, 2019, as compared to a growth of 12.9 per cent in April 2019. Systemic liquidity has been largely in surplus in 2019-20. Weighted Average Call Money Rate remained mostly close to repo rate within the Liquidity Adjustment Facility (LAF) corridor. |

The total money raised by public issue and rights increased to Rs 73,896 crore in 2019-20 (up to December 31, 2019) from Rs 44,355 crore in the corresponding period last year. Rs 6.29 lakh crore was raised through private placements in 2019-20 (up to December 31, 2019) as compared to Rs. 5.3 lakh crore in the corresponding period of previous year. As on end December 2019, Rs. 1.58 lakh crore were realizable in cases resolved under Corporate Insolvency Resolution Processes. The proceedings under IBC take on average about 340 days, including time spent on litigation, in contrast with the previous regime where processes took about 4.3 years.