India

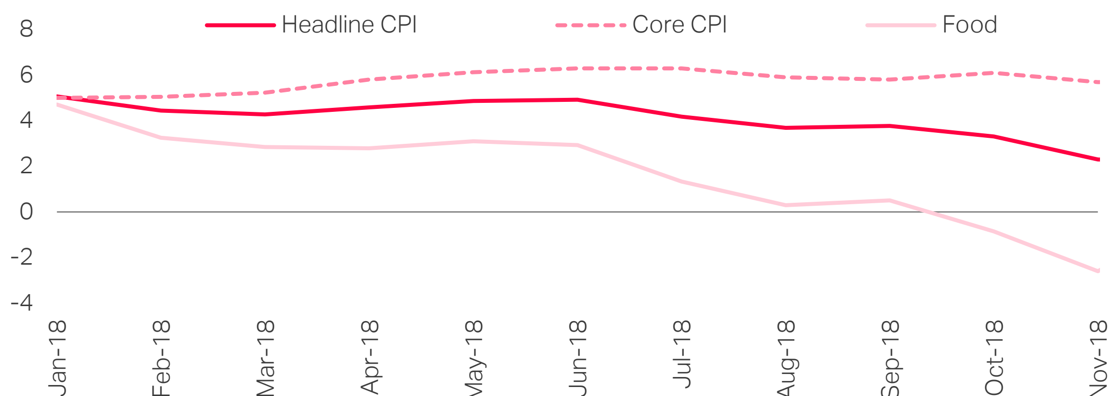
GROWTH PATH IS NOT SUSTAINABLE

Shumita Deveshwar

Ahead of the expected global growth slowdown in 2019, India stands out as a fast-expanding economy. However, the domestic economic recovery is volatile; and as politics takes centre stage ahead of the national polls in April-May of this year, the government's focus on boosting growth will likely expose India's macroeconomic vulnerabilities over the medium term.

- **Slowing growth will compel the government to become more populist**
- **Fiscal deficit goals will be missed – directly or via creative accounting**
- **The new RBI chief will be more amenable to the government's demands**
- **Easier fiscal, monetary and banking policies risk growth sustainability**
- **India's growth trajectory is not decoupled from global headwinds**

CPI inflation (% yoy)



Sources: Central Statistics Office, TS Lombard.

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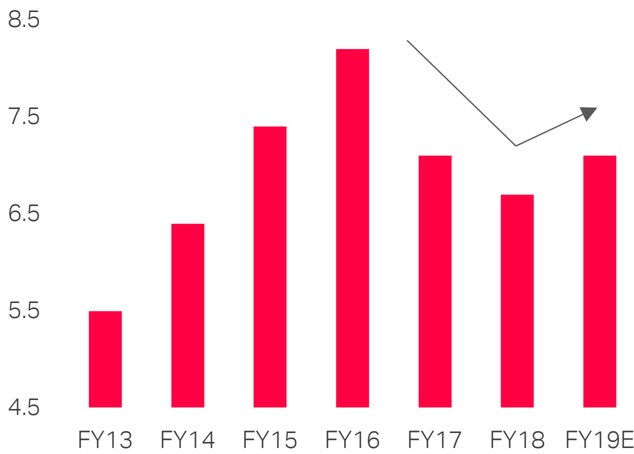
Growth recovers but still disappoints

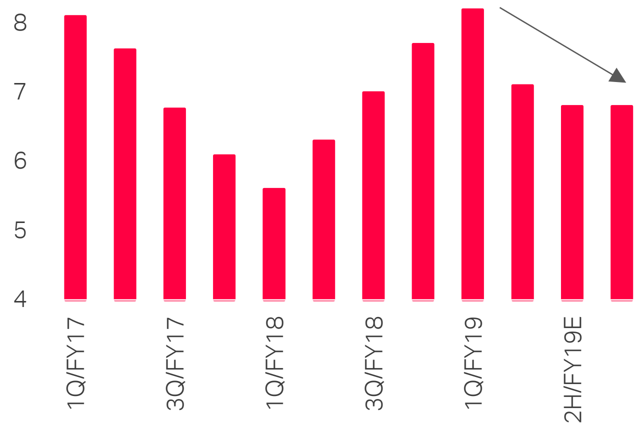
Despite the recovery in Indian economic growth after a two-year slowdown, the government has reason to be worried about the pace of the expansion. The latest FY19 projection by the Central Statistics Office (CSO) pegs India's growth at 7.2%, a number that is close to the World Bank's 7.3% forecast and a tad below the Reserve Bank of India's (RBI) 7.4% prediction. However, the 7.6% expansion recorded in H1/FY19 implies that growth in the second half of this year will be just 6.8%.

Annual GDP growth (% yoy)



Source: CSO.

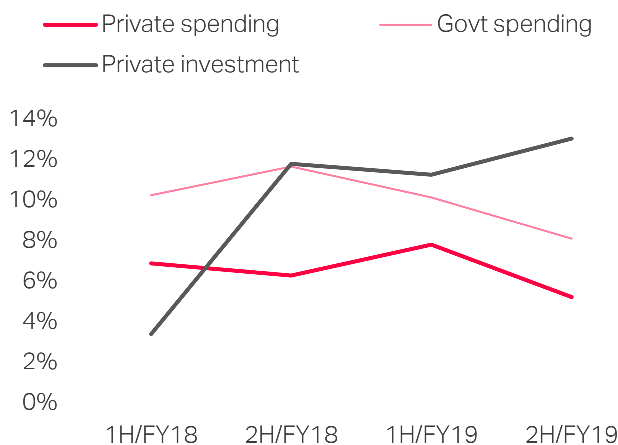
Quarterly GDP growth (% yoy)



Source: CSO.

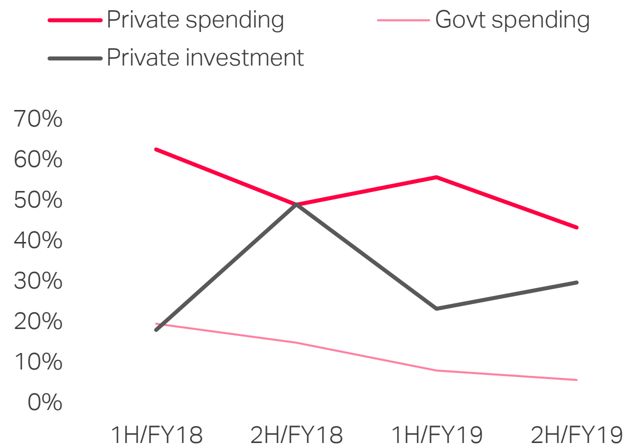
A closer look at the official FY19 GDP forecast reveals that both consumption and government spending are expected to slow in H2/FY19, while private investment is estimated to pick up the slack (see chart on the left below). Although the GDP estimate assumes that the contribution to growth from government spending will fall in H2/FY19 – as will private consumer spending – we believe it is unlikely that private investment will prove a strong enough driver to offset the decline and that the government will not try to revive consumer spending through fiscal expansion in an election year.

Growth in major GDP components (% yoy)



Sources: CSO, TS Lombard.

Contribution to GDP growth

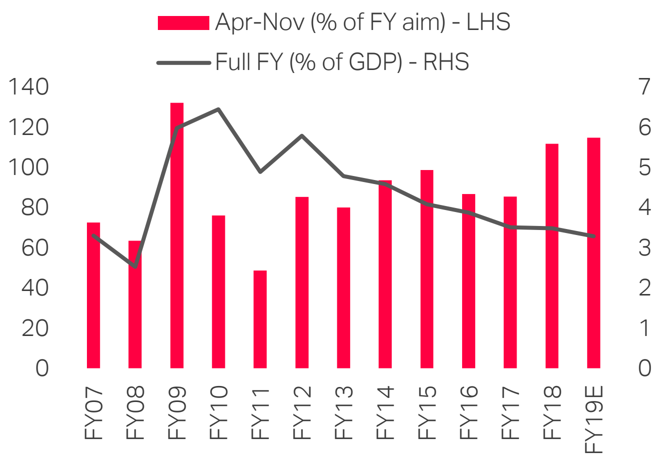


Sources: CSO, TS Lombard.

The fiscal deficit is larger than stated…

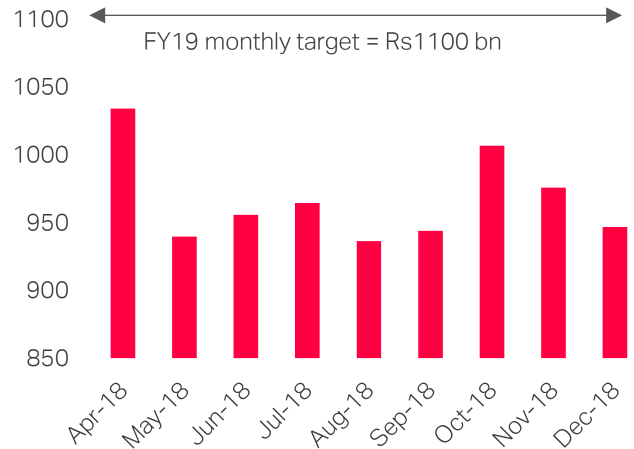
On the face of it, the government has limited fiscal room to boost spending in H2/FY19. It has already exceeded its budget deficit target, having hit 115% of its full-year aim in the first eight months of FY19. It similarly breached its target in the same period of FY18 and ended up missing the goal of a 3.2% of GDP fiscal deficit by 30bps. It blamed the FY18 slippage on the implementation of the GST regime. In this financial year as well, the government has been unable to meet its tax revenue goals, with GST receipts falling well short of the ambitious targets set.

Fiscal deficit



Sources: Controller General of Accounts, RBI.

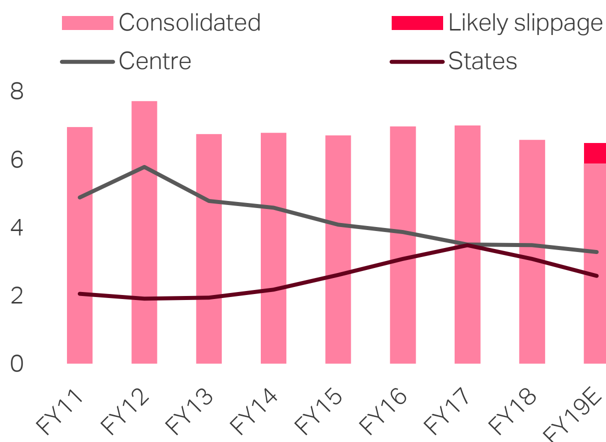
GST monthly revenue (Rs bn)



Sources: Ministry of Finance, Press Information Bureau.

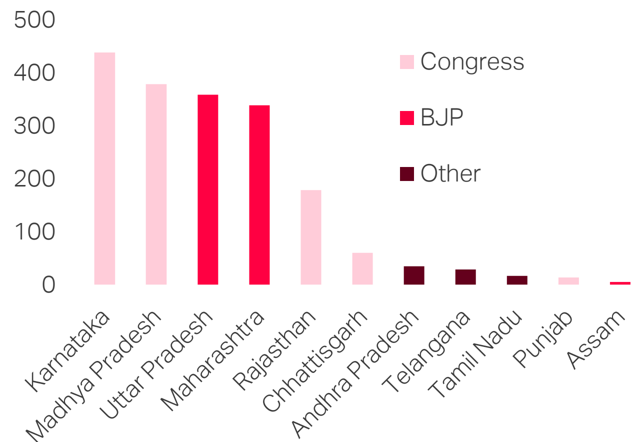
The consolidated budget gap of the states and the central government is a bigger worry. Even if we assume – as the chart on the left below suggests – that the combined budget deficits of the central and the state governments remain at similar levels to FY18, India's consolidated fiscal gap is very large. In the past, the RBI has often warned about the size of the consolidated deficit as well as about the deterioration of states' finances owing to farm loan waivers. Prime Minister Narendra Modi's writing off of loans in Uttar Pradesh in early 2017 has had a domino effect, as other states followed suit by declaring similar relief to farmers through 2017 and 2018.

Consolidated fiscal deficit (% of GDP)



Sources: Budget documents, RBI, TS Lombard.

Farm loan waivers FY18 and FY19 to date (Rs bn)



Sources: Bloomberg, other media outlets.

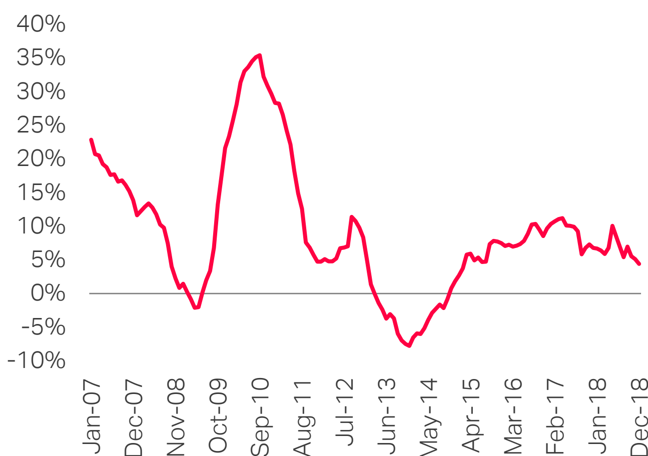
States overshot their combined budgeted fiscal deficit in FY18 by 40bps to 3.1% of GDP owing to higher spending on loan waivers and increased salary pay-outs to government employees, as well as a shortfall in tax revenues. The Fiscal Responsibility and Budget Management Act had put a 3% threshold on the states' combined fiscal deficit, but that goal was missed in FY16 and FY17 in order to implement a scheme to improve the financial health and of India's heavily indebted power distribution companies. Once that burden had been eased, states should have been able to improve their fiscal deficit to well below the 3% mark – indeed, the target for FY19 was set at 2.6% of GDP. But there will slippage once again, and although it is hard to say what the exact impact of the loan waivers will be, as they are often staggered over a period, we believe the state budgets will likely remain bloated in FY19 and even in FY20 as well.

Besides the fiscal slippage, the government is financing its expenditure through means not included in the budget. India's national auditor, the Comptroller and Auditor General (CAG), said in a report to the parliament last week that the government "has increasingly resorted to off-budget financing" to cover the deferral of its fertilizer and food subsidies as well as to finance irrigation schemes. These measures include making special arrangements with state-run banks to provide funding against subsidy dues; they also include issuing bonds and taking out loans with public-sector banks. As a result, the government is able to delay the payment of arrears in the current fiscal year, although it incurs additional costs through interest payments. The CAG has estimated that the total liability of the central government in FY17 would have been 50.5% of GDP in FY17 compared with the 45.5% stated by the government and the targeted 47.1%. The carryover of subsidy payments is not a new phenomenon, but it means that the headline numbers do not reflect India's actual fiscal deficit.

… and economic growth is lower than stated

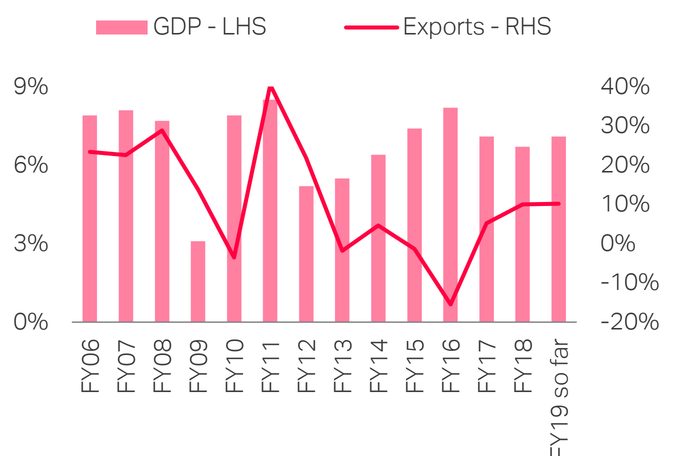
Just as India's fiscal deficit is not what it seems, so the GDP numbers do not accurately mirror the reality on the ground. The government's controversial revision of the GDP back-series data showing that growth in the past five years was higher than the preceding decade does not correspond with the slowdown in bank credit and export growth, nor does it reflect weak car sales and the reported distress in the rural economy.

Passenger vehicle sales (%, 12m/12m change)



Sources: Datastream, TS Lombard.

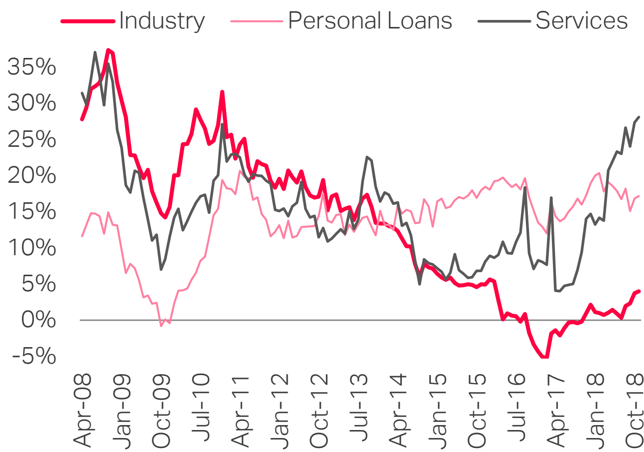
Growth in GDP vs exports (%)



Sources: CSO, Ministry of Commerce, RBI.

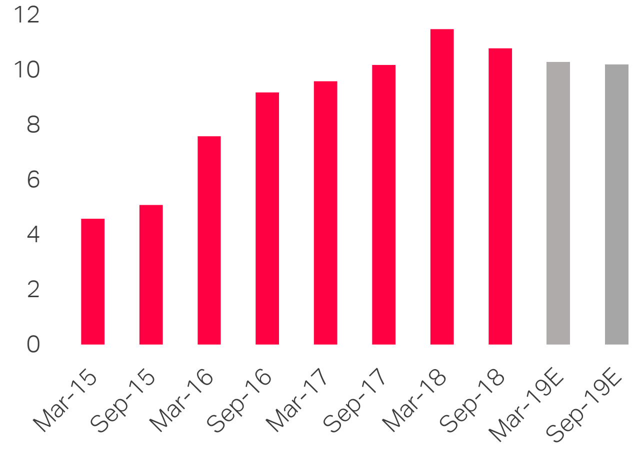
To be sure, bank credit growth has picked up significantly over the past few months but the rise has been lopsided: loans to the retail sector and the services sector account for the bulk of the increase, whereas credit to industry remains muted. India's banking sector has witnessed a prolonged period of stress and is only now – after three years – starting to show signs of recovery. However, the banks' non-performing asset (NPA) ratio is "still high for comfort", to quote the RBI. The central bank expects a very gradual decline in gross NPAs (see chart on the right below).

Sectoral growth of bank credit (% yoy)



Source: RBI.

Gross NPA ratio (%)



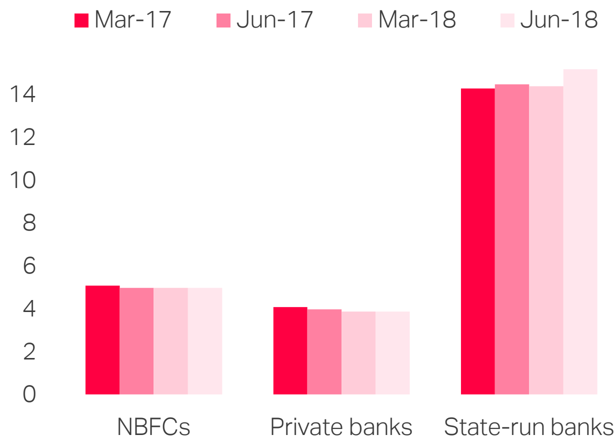
Source: RBI.

Government renews efforts to boost growth…

The government seems to be making a last-ditch effort to ramp up growth ahead of the elections due in April-May, but this may have longer-term fiscal and inflationary consequences. For instance, despite the below-target GST revenue collections, the GST Council again cut tax rates on several items in late December in the latest round of what have been many tax rate reductions. The highest tax category of 28% originally covered 224 items when the GST was rolled out 18 months ago; now it has just 30 items remaining. Finance Minister Arun Jaitley said the tax cut would cost the Exchequer Rs55 billion. Over the past year, the GST Council has not only cut tax rates but it has also delayed the filing of returns and increased both the exemption limits and the tax threshold to enable smaller businesses to avail a simpler tax format. These steps have been taken, despite the shortfall in monthly GST revenues.

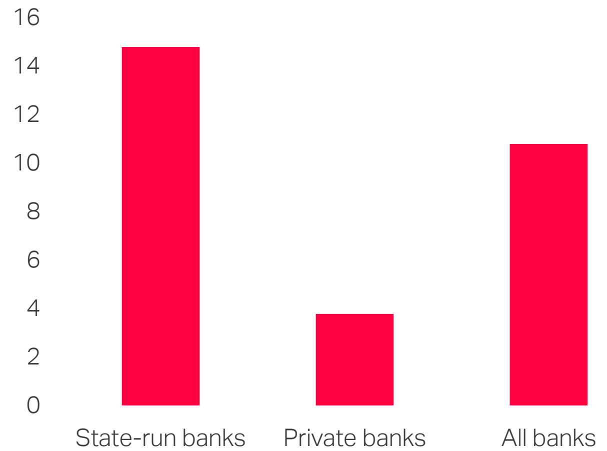
The latest step by the GST Council to double the exemption limit for businesses required to register for the GST comes on the heels of the RBI's easier norms for the micro, small and medium-sized enterprises (MSME) sector. Defaulting accounts of the MSME sector can now restructure their loans of up to Rs250 million from banks and non-bank lenders. The RBI's half-yearly Financial Stability Report, which was released just before the policy change, noted that the poorly performing state-run banks that dominate India's banking assets – they account for 70% – have the largest share of loans turned bad in the MSME sector, as the chart on the left below shows. India Ratings, a unit of Fitch, said that the RBI's softer stance towards small borrowers could "impair the credit discipline".

NPAs emanating from MSMEs (%)



Sources: TransUnion CIBIL, RBI.

Gross NPA ratio (%)

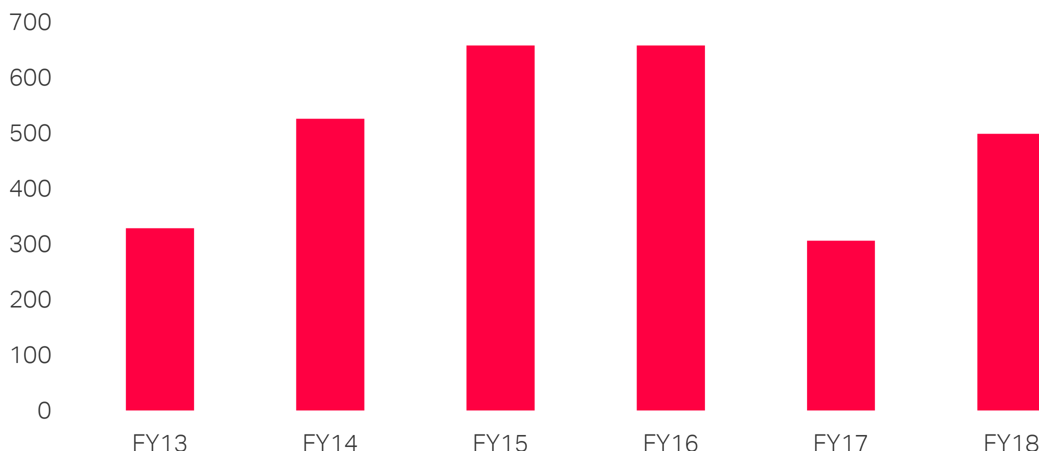


Source: RBI.

…and the new RBI Governor will likely help

Under the leadership of former Finance Ministry official Shaktikanta Das, the RBI looks set to adopt a softer stance towards both the banking sector and government demands, including the transfer of the central bank's surplus reserves to help the government in financing its fiscal deficit and providing more liquidity to the shadow-banking sector and relaxing provisioning norms for banks. Although no decision has yet been taken on the controversial issue of the RBI's surplus reserves – a key reason for the shock resignation of Governor Urjit Patel – a Reuters report last week said that the government is seeking an interim dividend from the RBI by March 2019 of Rs300-400 billion. This would be three to four times the interim dividend of Rs100 billion paid in FY18 and in addition to the annual transfer of the RBI's surplus reserves, possibly making the full amount far higher than what was paid out last year.

RBI dividend to the government (Rs bn)



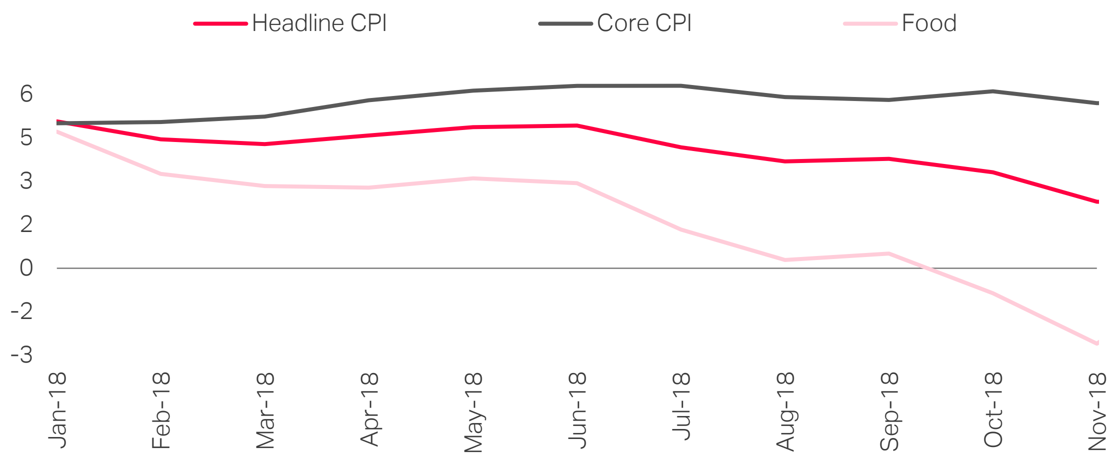
Source: RBI.

This unexpected transfer of the RBI's reserves will help compensate for the tax revenue shortfall as well as the low disinvestment proceeds. The government has so far earned just Rs341 billion via stake sales, less than half its Rs800 billion target and a third of the near Rs1trillion it raised in FY18. The previous leadership of the RBI had warned that the use of reserves has longer-term fiscal consequences similar to issuing new government bonds to fund spending; however, Das may be more amenable to meeting the government's demand. For its part, the government has set up a panel led by former RBI Governor Bimal Jalan to provide recommendations on the use of the RBI's reserves, and Jalan's comments have indicated that he will adopt a conciliatory approach with the government. But Das, along with the RBI Board, will likely announce an interim dividend before the panel makes its recommendations.

Das seems inclined towards easier monetary conditions and could help start a rate-cut cycle as early as February, as we highlighted in our 14 January 2019 EM Watch. On his first day in office in December, Das said that the inflation outlook was benign. With headline CPI inflation well below the central bank's 4% target for the past five months, the RBI faces pressure to cut interest rates now. Das may take a more pro-growth view, and the forthcoming 7 February monetary policy committee meeting – the first under his governorship – will clarify his view on inflation. As the RBI Governor, Das holds the casting vote in the event of a tie.

The main driver behind the current low inflation spell is unusually soft food prices that are symptomatic of the agrarian crisis. Under its previous two governors, the central bank seemed to have been tracking core inflation as food and fuel prices are volatile and monetary policy has no influence over them. The RBI has had a hawkish stance on inflation over the past half year; it last raised rates in August 2018 and changed its policy stance from "neutral" to "calibrated tightening" in October. Since then, headline inflation has been softening; but despite the continued drop in CPI inflation to 2.2% yoy in December, core inflation has remained near 6% levels.

CPI inflation (% yoy)



Sources: CSO, TS Lombard.

The RBI policy will come just days after the government presents its interim budget on 1 February, during which the Finance Minister is likely to announce sops for farmers. Following key state election losses that have been blamed in part on rural distress, there is speculation that the government may decide to opt for an income-support plan for farmers similar to a scheme implemented in the southern state of Telengana, where farmers have been given handouts to coincide with the cropping seasons, enabling them to buy inputs. The scheme, launched in May 2018, yielded electoral gains for the state government, which won the

recent state poll with a strong majority. Other proposals reportedly being discussed include paying farmers the difference between the prevailing market prices of their crops and the state-guaranteed prices as well as a revamped crop insurance scheme. According to some media reports, the cost of the farm relief package could be as much as Rs3 trillion, although it is unclear whether this would be budgeted for the next 12 months or over a longer period.

The pressure on the fiscal deficit from any such plans to support farm incomes will apply only from the next financial year onwards. This means that the new government will face the challenge of implementing any such schemes since even if the administration changes at the centre, it will be politically unpopular for any party to reverse the populist measures. Indeed, as we have pointed out in our research, the two national political parties – Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) and the Indian National Congress (INC) – are engaged in competitive populism. Regional parties are not far behind, as we can see from the domino effect of the farm loan waivers across states and various political parties.

Conclusion

The policies set out by the current Finance Minister in the interim budget will have a bearing on the next administration's policies, even though the new government, which is to take office by late May, will have to present its own full-year budget by July. Historical precedence shows that while there is a general tendency in any budget to overestimate revenues and underestimate spending, the deviation from targets is larger and sharper in interim budgets.

The Modi government is struggling to revive growth and faces a more competitive political landscape following its recent electoral defeat in key state polls in late 2018 and owing to opposition parties allying together. For this reason alone, it will try to throw more money at farmers. The new government – either under Modi or another coalition – will find it hard to reverse this populism, given the severity of the rural distress in the economy. At the same time, it will be unable to raise the GST tax rates either because of fear of a popular backlash. Any fiscal consolidation will come at the cost of cutbacks on government capital spending, which, given that India remains an economy where supply persistently falls short of demand, bodes ill for future growth prospects.

The looser fiscal and monetary policies will come at a time when core inflation remains sticky, and growth will remain capped as a result of both domestic and global headwinds. As the chart above on export growth shows, India's growth is not decoupled from world growth and most of the on-the-ground indicators suggest that the economy is not growing as fast as official government data suggest. This combination of factors will lay bare India's medium-term macroeconomic challenges when the new administration takes over in May.

Authors

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