August 2023

Macro Updates

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Macro-Economic Updates

August 2023

The Debt Dilemma: Saving the Burden on the Future Generation*

Elevated levels of India's fiscal deficit and public debt have been a matter of concern in India for a long time. Even before the pandemic, debt levels were among the highest in the developing world and emerging market economies. The pandemic pushed the envelope further and relative to the GDP, the fiscal deficit in FY21 increased to 13.3% and the aggregate public debt to 89.6%. As the economy recovered after the pandemic, the deficit and debt ratios have receded to 8.9% and 85.7%, respectively. The projections show that even without any serious disruptions to the economy, the debt level is unlikely to return to the pre-pandemic trajectory in the medium term. With elections to eight states slated to happen in 2023 and with the general elections slated in 2024, the electoral budget cycle could push the debt ratio further and there can be serious questions about its sustainability unless targeted interventions are made to reduce the debt burden, which may not be politically easy with elections on the horizon.

The debt-dynamics equation states that when there is no primary deficit (fiscal deficit in the year excluding the past legacy of interest payments), if the growth rate of GDP exceeds the effective interest rate paid on government bonds, the overall debt will decline. However, what is missed in these discussions is the distortions caused by financial repression to keep the interest rates on government borrowing low to reduce the cost. When the Statutory Liquidity Ratio (SLR) of the RBI mandates the banking system to hold 18% of their demand and time liabilities in government securities, and when the RBI intervenes in the market through open market operations around the time when the government borrowing is taken up, the interest rate on government borrowing is kept repressed. In such a situation, the debt may decline, but the distortions from the financial repression can adversely impact growth.

Thus, even when the sustainability of debt may not be threatened in the medium term, the costs of carrying high deficits and debt to the economy are heavy. First, on average, interest payments constitute over 5% of GDP and 25% of the revenue receipts, this is more than the government expenditure on education and healthcare put together. Large interest payments crowd out the much-needed expenditures on physical infrastructure and human development and emerging priorities to make the green transition. The issue is particularly concerning in the states of Punjab, Kerala, Rajasthan, and West Bengal. In Punjab, the Debt to GSDP ratio is 48.9%, in West Bengal, 37.6%, Rajasthan 35.4%, and in Kerala close to 33%. Second, high levels of debt make it difficult to calibrate counter-cyclical fiscal policy and constrain the ability of the government to respond to shocks. Third, the debt market in India is largely captive with mainly the commercial banks and insurance companies participating in it for meeting SLR requirements. With a cash reserve ratio (CRR) of 4.5%. and SLR of 18% of net demand and time liabilities, and 40% of the credit by the commercial banks earmarked for the priority sector, the resources available for lending to the manufacturing sector are low, driving up its cost of borrowing.

The rating agencies keep the rating low when the deficits and debt are higher, and this enhances the cost of external commercial borrowing. Finally, today's borrowing is taxing tomorrow, and the burden of large deficits and debt will have to be borne by our future generation.

It is clear that, in the present fiscal environment, even achieving a consolidated debt-to-GDP ratio of 58.2% recommended by the 14th Finance Commission for 2019-20 would be unfeasible in the medium term. The Commission had recommended that the Union government should bring down its debt relative to GDP from 43.6% in 2015-16 to 36.3%, and the States should maintain their debt at about 22%. Even before the pandemic, the aggregate public debt had slipped to 74.3% in 2019-20, and the pandemic pushed it to 89.7% in 2020-21. With the nominal GDP recovering to grow at 18.5% in 2021-22 after the pandemic, the debt ratio declined only marginally to 85.7%. This implies that every individual in the country carries a debt burden of Rs 1,64,000 on his head. With the high primary deficit of 3.7% of GDP in 2022-23 and budgeted at over 3% in 2023-24, we will have to contend with elevated debt levels in the medium term.

The issue is of critical importance and the fast pacing of fiscal consolidation imperative. Fortunately, after 6 years, GST has stabilized and has shown high growth potential. As the technology platform has stabilized, it is expected to maintain high buoyancy in the medium term. The technology has helped to improve tax administration and improved compliance. With cross-matching of GST returns with income tax returns, the compliance of income tax too is expected to improve and in the medium term, the aggregate tax-GDP ratio is likely to increase by 1.5 to 2 percentage points. In terms of policy interventions, this is the time to rethink the role of the State and vacate the activities which should really belong to the market rather than competing with it. At the Central level, even after much talk about disinvestment, the progress has been slow. Rather than dispensing with activities like telecom to the private sector, the government continues to pore money to BSNL and MTNL. MRNL. Equally disturbing are the employment melas to fill the so-called vacant posts which have been anyway found redundant. At the state level, it is important to guard against the return to the old pension scheme and indulging in large-scale giveaways for electoral reasons. Of course, redistribution is a legitimate government activity and that is best done through making cash transfers rather than subsidizing commodities and services. Giving subsidies alters relative prices resulting in unintended resource distortions. Equally important is the need to impose hard budget constraints by enforcing the FRBM rules in allowing the states to borrow and that squarely is in the domain of the Union government.

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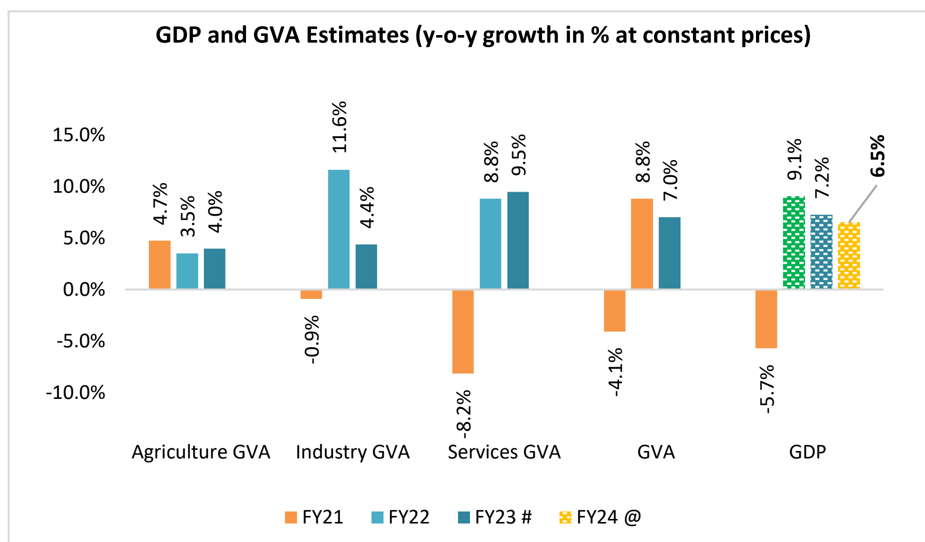
B2K Views

In a scenario of global slowdown, 7.2% annual growth for FY23 is certainly creditable. This also confirms the fact that India is indeed the fastest-growing large economy. However, in terms of per capita income, at about USD. 2000, India is still ranked at 142 among 192 countries and there is a lot of catching up to do.

Despite global headwinds, the domestic growth outlook looks strong with resilient domestic demand. Strong rebound in Q4 growth holds the promise of continued buoyancy in the economy in the coming quarters. Economic activity remains resilient in Q1FY24 as reflected in high frequency indicators. The RBI has projected FY24 GDP growth at 6.5%, similar provided by Economic Survey. This projection looks optimistic considering the global economic slowdown, coupled with the tightening of financial conditions worldwide amid continued inflationary pressures.

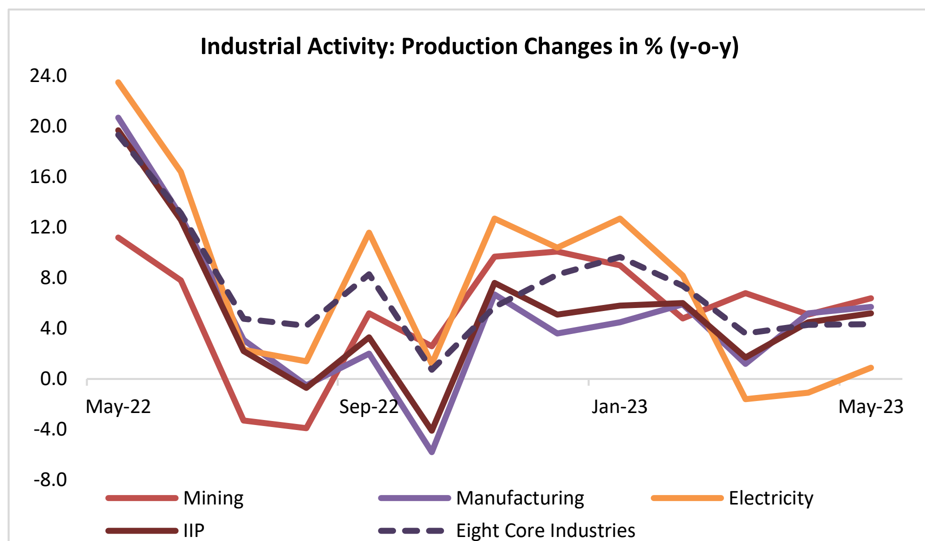
FY23 GDP estimates improved to 7.2%

As per MOSPI's quarterly estimates on growth, the Q4FY23 GDP grew at a faster rate at 6.1% compared to 4.4% in the Q3. Interestingly, after the high Q1FY23 growth of 13.2%, mainly due to the base effect, GDP growth decelerated to 6.3% and 4.4% in the Q2 and Q3, respectively. A better-than-expected Q4 growth has pushed the FY23 growth rate to 7.2%. The agricultural sector has shown strong growth of 5.5% in Q4 to take the growth of the sector for FY23 to 4%. Growth in labour intensive sectors show that the contact intensive sectors have fully recovered. The growth in manufacturing has moved into the positive territory after two quarters of contraction registering a growth of 4.5% in Q4. The service sector growth has continued to be strong, and the trend is likely to continue.



Note: Data is provisional. #: Provisional Estimates, @: RBI estimates
Source: Ministry of Statistics and Programme Implementation (MOSPI), B2K Analytics

Manufacturing industry continued to expand



Source: eaindustry.nic.in, www.mospi.gov.in, B2K Analytics

B2K Views

Growth momentum in IIP and eight core sectors continued, and the manufacturing PMI and services PMI also remained in expansion mode. Manufacturing PMI remained above last year levels and stood at 57.8 in June, while services PMI fell slightly below the last year levels and stood at 58.5 reflecting a considerable improvement in operating conditions and resilient domestic demand.

B2K Views

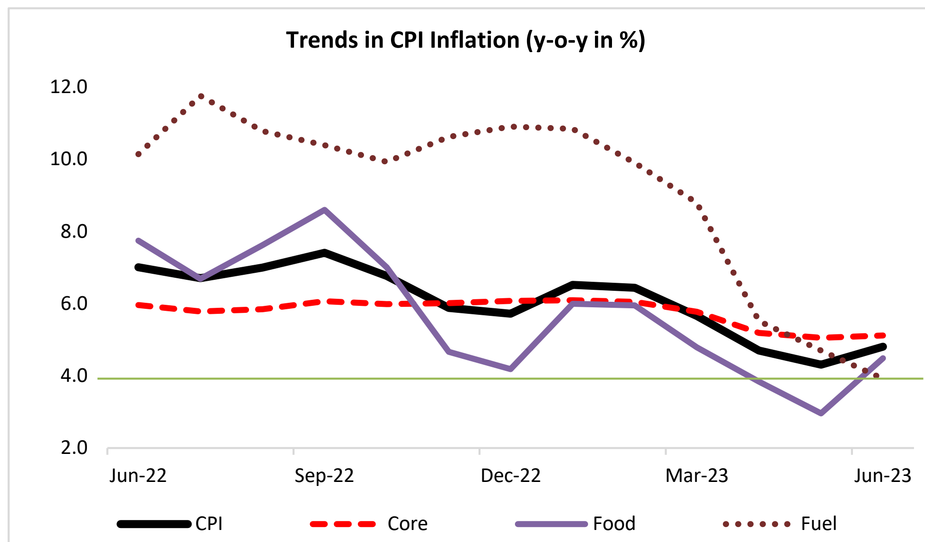
Despite the moderation in global commodity prices, particularly crude oil prices and favourable base effect, the inflation rate in India has started inching upwards in June 2023. This comes when RBI lowered its inflation forecast for FY24 to 5.1% from the earlier 5.2% in the June MPC. The inflation projections look too optimistic, although the average monthly crude oil prices remained well below USD80 per barrel levels since May 2023. The rising demand and production cuts likely to increase the global oil prices in the near term. The uneven distribution of rainfall on the domestic front is likely to harm the Kharif output and may exert pressure on food prices. Overall, we expect the pressure on RBI to control the inflation will remain a concern for some more time, hence the RBI likely to maintain a pause in its August meeting. The interest rate too remain stable for at least in the next two quarters.

B2K Views

WPI inflation has eased significantly following the easing of global commodity prices and normalisation of supply chain issues, in addition to base effect. In June 2023, the WPI inflation hit its lowest level since October 2015, whereas CPI inflation moved upwards. The RBI's MPC is mandated to contain the CPI inflation within the band of 2 to 6%, Generally, WPI and CPI move in tandem, and the former seeps into the latter in a two to three months lag. The diverging trends in WPI and CPI is not unusual, while this means producers are not getting enough money, but consumes are paying higher prices.

CPI Inflation remained below 5% for the third straight month

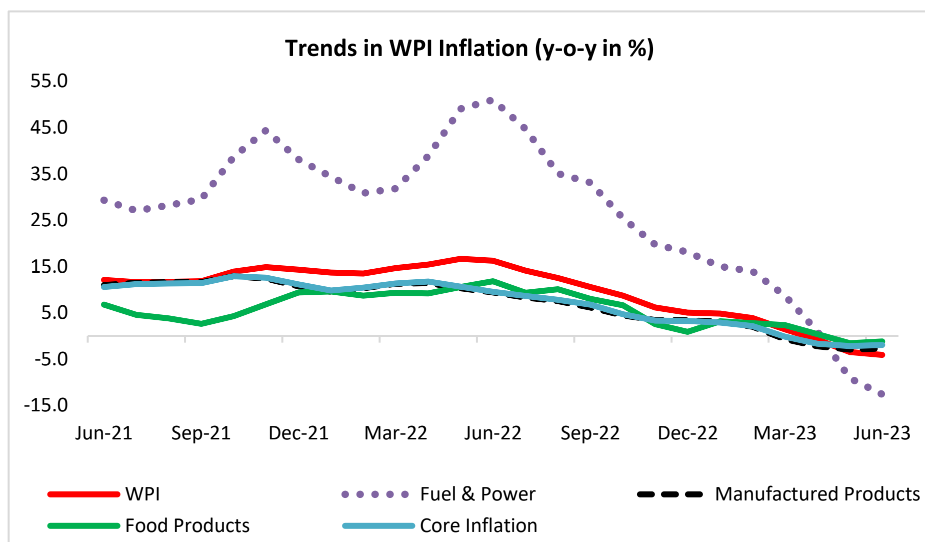
CPI inflation inched up in June, after easing in the last two months, but remained below 5% levels at 4.81%. Sudden uptick in food prices drive the overall inflation up, as there has been a sharp increase in vegetable prices and tomatoes due to flood like situation in many parts of the country. Core inflation too increased, although by a lower magnitude, which remained sticky at around 6% levels throughout FY23.



Note: Core inflation has been calculated - excluding food, fuel and light from the overall index.
Source: MOSPI, B2K Analytics

WPI inflation hit October 2015 levels

WPI inflation slipped to a negative territory since April 2023 following a sharp contraction in manufacturing prices and decline in food and fuel prices. Core inflation in the WPI basket also contracted since March, first time in the last 32 months and the trend continued in June 2023 as well.



Source: eaindustry.nic.in, B2K Analytics

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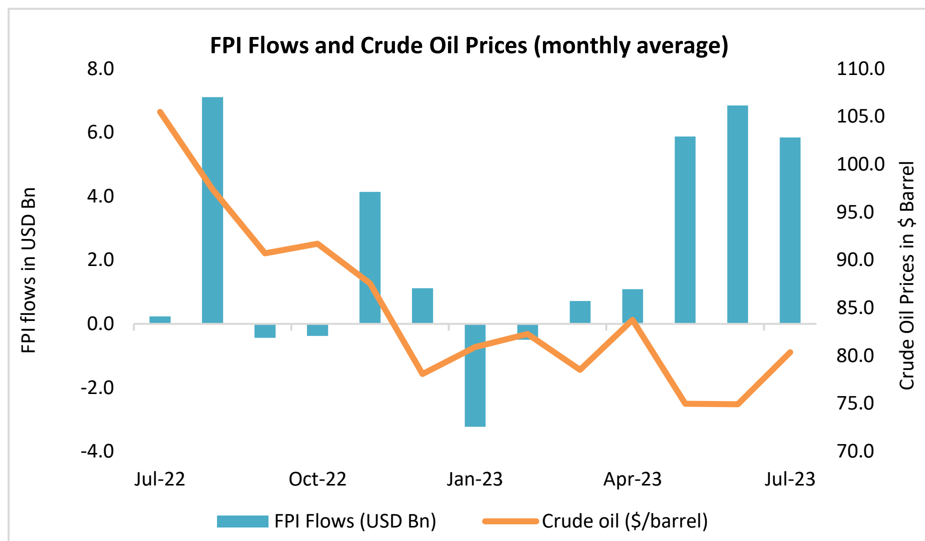
External Sector Developments

Renewed global demand and tight supply to drive the crude oil prices

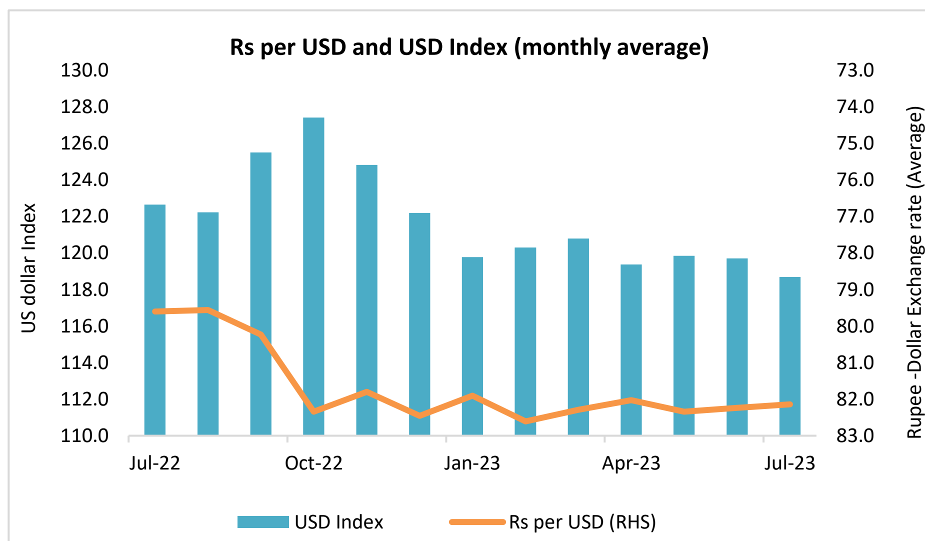
The crude oil prices (Indian basket) averaged USD75 per barrel (/b) in June and increased by an average of about USD4.7/b so far in July compared to June. The rise in oil prices is partly due to improving global demand and production cuts. Amid improve in the domestic macroeconomic fundamentals, there has been a sharp increase in FPI inflows to India. However, the rising interest rates in US may turn Indian equities less attractive to foreign investors, which were remained relatively upbeat in the current fiscal so far.



Source: www.ppac.gov.in, NSDL, B2K Analytics

Rupee to remain stable in the near-term

Stable crude oil prices and net FPI inflows in FY23 so far supported the Indian rupee to remain stable at around 82 per USD since April 2023. The US dollar index also remained below 120 so far supporting the rupee value.



Source: RBI, US Federal Reserve Economic Data, B2K Analytics

B2K Views

After major economies imposed a price cap on oil products, Russia decided to reduce crude oil production by 5,00,000 barrels per day from March 2023. This decision may influence the global crude oil prices.

On 4 June 2023, the Organization of the Petroleum Exporting Countries, and its allies (OPEC+) announced no changes in global oil output for the remainder of 2023. The oil cartel decided to reduce overall production targets only from 2024 by a further total of 1.4 million barrels per day (bpd). However, as per its fresh production cuts which begins from July, the output will decline to 9 million barrels per day from about 10 million barrels in May. With tighter supply, the crude oil prices likely to witness an uptick and move above USD80 per barrel in the near term.

B2K Views

The elevated inflation and moderate improvement in economic activity in US led to another rate hike by FOMC in July, and the Fed rates have reached to 2001 levels. The likelihood of US Fed retracting from its aggressive rate hike policy is delayed further and the US dollar continued to depreciate against a basket of major other currencies. On the domestic front, FPIs bought USD 13.82 bn in April to June 2023 following relatively better Indian market developments compared to major global economies. Any reversal in portfolio inflows and oil price movement could pose pressure on rupee.

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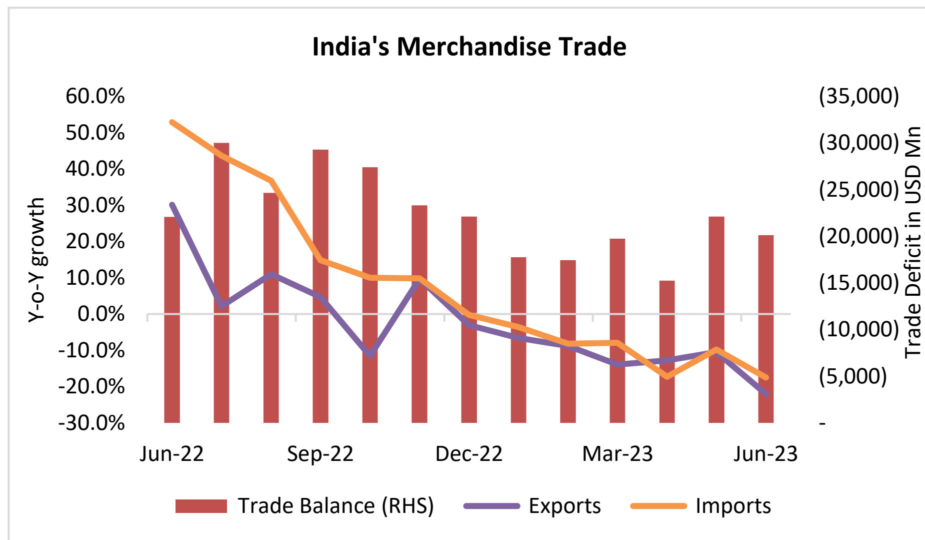
Merchandise Trade; Trade deficit to widen further

B2K Views

India's merchandise trade deficit narrowed to USD 20 bn in June 2023, lower than June 2022 levels, and close to March 2023 levels. This is predominantly due to moderation in international commodity prices leading to fall in imports value.

Geopolitical tensions and recessionary situations in the advanced economies continued to keep the external sector under stress and dampened the demand for India's exports. The slowing world economy does not leave much scope for reviving exports.

Merchandise exports and imports both slump in June 2023. In dollar terms, both fell by -22% and -17.5%, respectively, y-o-y. Similarly, during April to June 2023, exports and imports contracted by 15% and 13% over the corresponding period last year. Rapid tightening of global financial conditions and heightened geopolitical uncertainty weigh on India's exports, while moderation in global commodity prices helped the imports cheaper.



Source: Ministry of Commerce and Industry, B2K Analytics

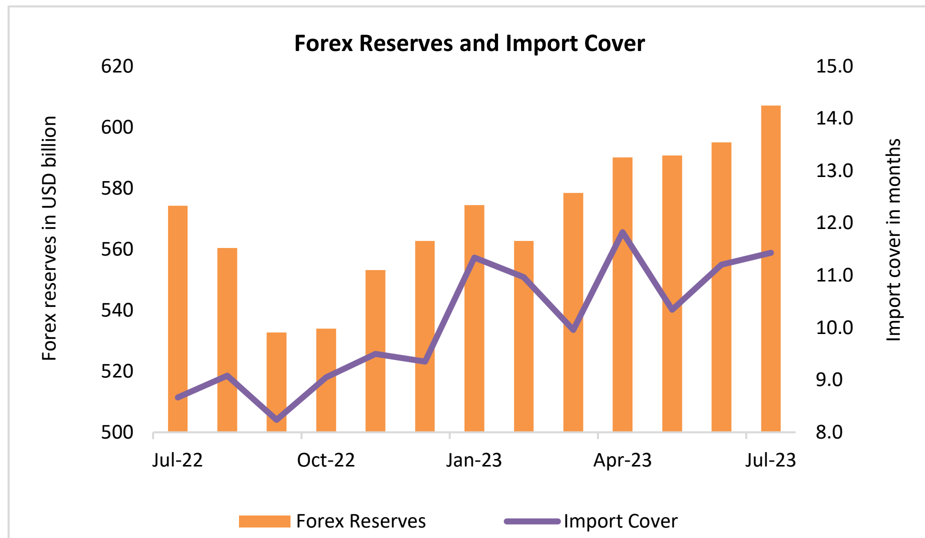
Forex reserves crosses USD 600bn after 16-months

B2K Views

India's forex reserves crossed USD600 bn mark in July 2023, first time since March 2022. Revaluation gains due to weakening dollar and reduction in U.S. Treasury yields and increase in FPI inflows helped to accumulate more reserves.

In 2022, foreign exchange reserves depleted by USD70 bn, as the depreciation of the rupee led to valuation loss. In addition, RBI frequently intervened to curb volatility in the exchange rate. Forex purchases in the spot foreign exchange markets by RBI to keep the rupee in a tight range is also partly responsible for this increase.

By the end of July 2023, forex reserves reached to March 2022 levels to USD 607 bn, sufficient to cover about 11 months of imports. With the rising FPI net inflows in FY23, forex reserves increased by ~USD30 bn so far. The fall in US dollar also resulting in valuation gains. All the four components of the reserves increased during the same period. Following the rise in gold prices, the share of gold reserves also rose to 7.6% in June 2023 compared to 6.9% a year ago.



Source: Ministry of Commerce, RBI, B2K Analytics

B2K Views

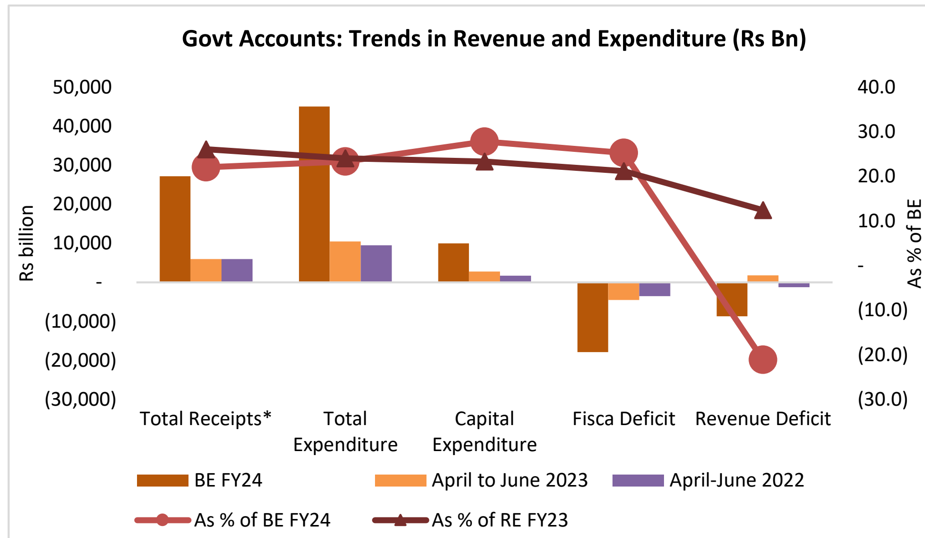
In the Union Budget 2023-24, the government has revised the revenue and expenditure targets upwards, as the overall tax revenue collection remained healthy.

The budget proposes to compress the fiscal deficit by half a percentage point to 5.9% of GDP, while increasing the capital expenditure from 2.7% of GDP to 3.3%. Elevated levels of India's fiscal deficit and public debt have been a matter of concern for a long time. Reducing the fiscal deficit to 4.5% by 2025-26 requires compression of deficit by 1.4 percentage points in the next two years.

Government Finances

Q1FY24 fiscal deficit reaches 21% of the budget estimates

Provisional data released by the CGA for April-June 2023 shows that the central government has spent 23.3% of the budgeted expenditure for FY24. During the same review period, the government earned 21.2% of the total budgeted receipts. Capital expenditure crossed 27.8% of BE, thus the fiscal deficit levels remained higher than the corresponding period last year.



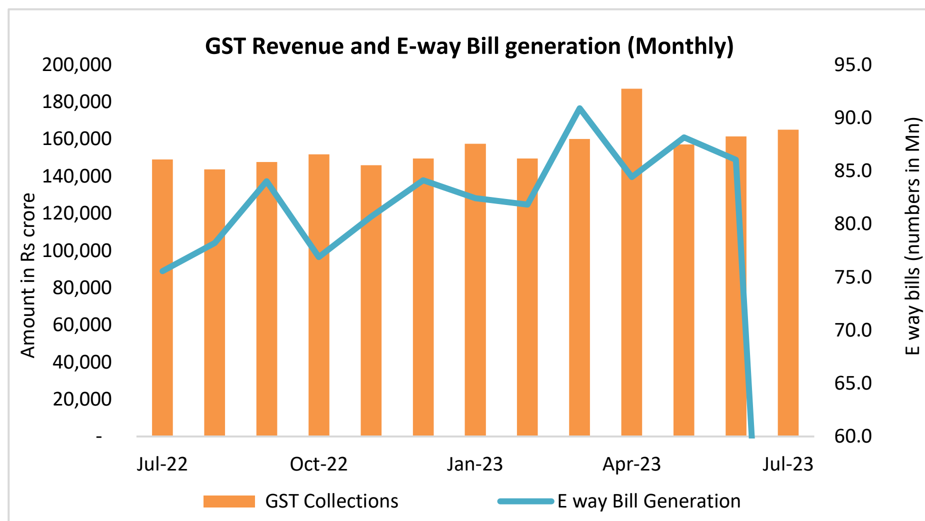
Note: Data is provisional, RE: Revised Estimates, BE: Budget Estimates
Source: Controller General of Accounts (CGA), B2K Analytics

B2K Views

GST has stabilized and has shown high growth potential. Total GST collections in FY23 so far (April to July) rose by 11% y-o-y to Rs 6.7 lakh crore. As the technology platform has stabilized, it is expected to maintain high buoyancy in the medium term. With cross-matching of GST returns with income tax returns, the compliance of income tax too is expected to improve. This may help the aggregate tax-GDP ratio to increase by 1.5 to 2 percentage points in the medium term.

GST collection continued to remain buoyant

GST has completed 6 years in India and recorded 2.26% increase in yearly revenue collections in FY23. The trend continued in the current fiscal too, with GST collections making the highest record of Rs 1.87 lakh crore in monthly collections in April 2023. There has been a consistent growth in monthly GST revenue collections, and in July 2023 it increased by 11% y-o-y.



Source: PIB press releases, GSTN, B2K Analytics

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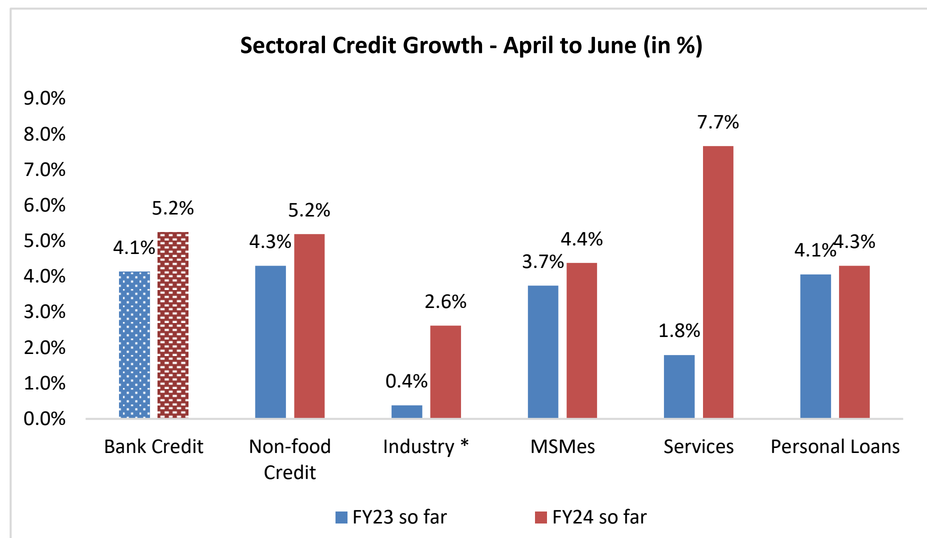
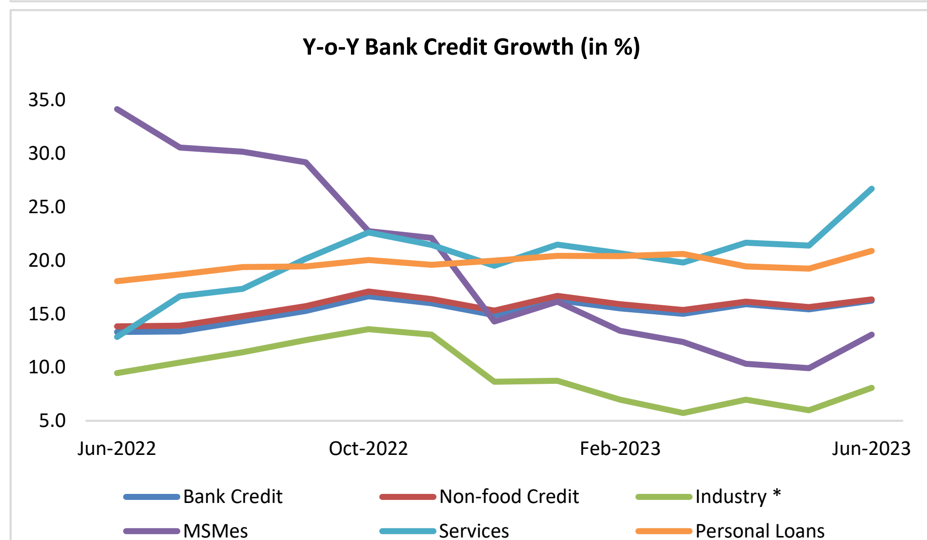
B2K Views

The outlook for the banking industry appears to be brighter for FY24. According to the June 2023 Financial Stability Report of RBI, the Gross Non-Performing Asset (GNPA) ratio of SCBs continued its downward trend fell to a 10-year low of 3.9% and net NPAs have dropped to a low of 1% in March 2023. Similarly, the capital to risk-weighted assets ratio (CRAR) and the common equity tier 1 (CET1) ratio of SCBs rose to historical highs of 17.1% and 13.9%, respectively, in March 2023. Healthy balance sheets of banks and corporates are engendering a new credit and investment cycle and brightening the prospects of the Indian economy. B2K believes that the asset quality shall continue to improve in FY24 with the continuous improvement in loan growth supported by sustained growth recovery.

Broad based credit growth reflects strong macroeconomic fundamentals

There has been sharp pick up in credit growth in June 2023, which increased by 3.6% over the previous month. In the first three months of FY23, bank credit grew by 5.2% over March 2023, with services sector reporting the highest 7.7% growth in outstanding loans. Overall credit to industries including large industries remained albeit low and grew by 2.6% so far, but relatively better than the corresponding period last year. On a y-o-y basis, total bank credit increased by 16.2% in June 2023, largely driven by the services and personal loan segment. Credit flows in the personal loans segment is largely driven by 'the housing' and 'vehicle loans' segments, while services segment was led by the NBFCs segment. Micro and Small, Medium (MSM) industries too reported some pickup in demand for credit compared to last year. The build-up of concentration in retail loans may become a source of systemic risk, while improving credit offtake to MSM industries reflect recovery in the sector.





* Micro and Small, Medium and Large, Source: RBI, B2K Analytics

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About B2K

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The B2K team has experienced domain experts and industry practitioners who have provided such services and implemented solutions across institutions in different countries. As such, team members are experts in regulatory and management practices in these areas and have helped many clients in adopting best practices.

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