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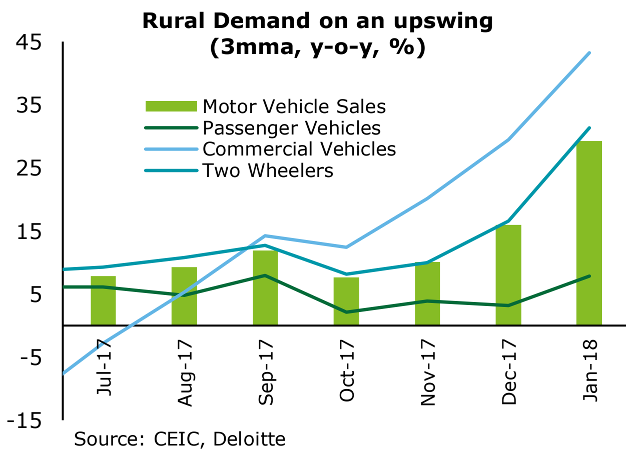
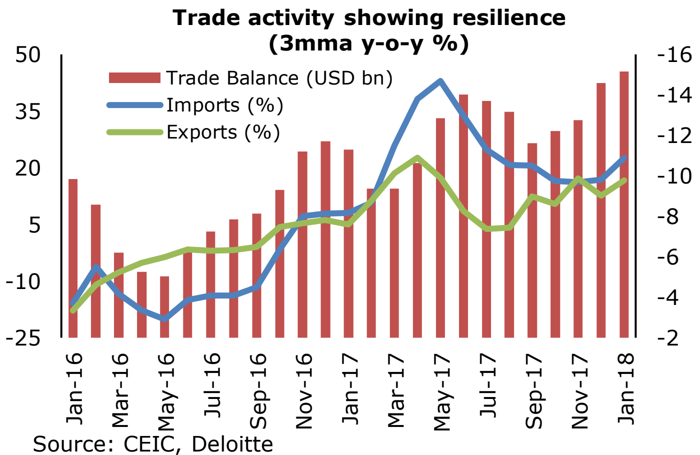
Indian Economy in 2018: Rising deficits to finance growth?

The recent data on GDP/GVA growth in Q3 of FY 2017-18 has again revived expectations that the deceleration in the economic activity because of GST and demonetization may have bottomed out. Some of this good news is also mirrored in the data on corporate earnings as well as other high frequency data.

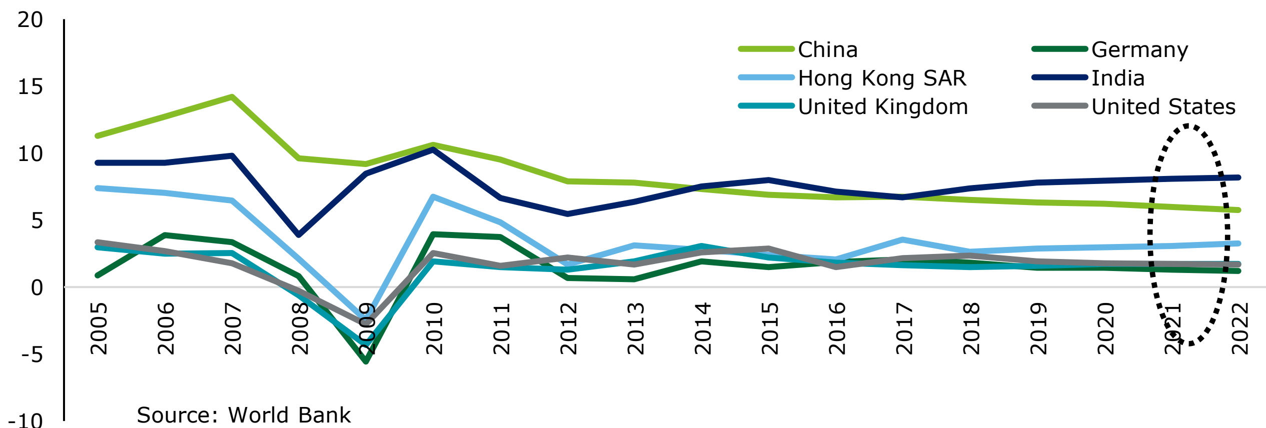


Source: CEIC, Deloitte

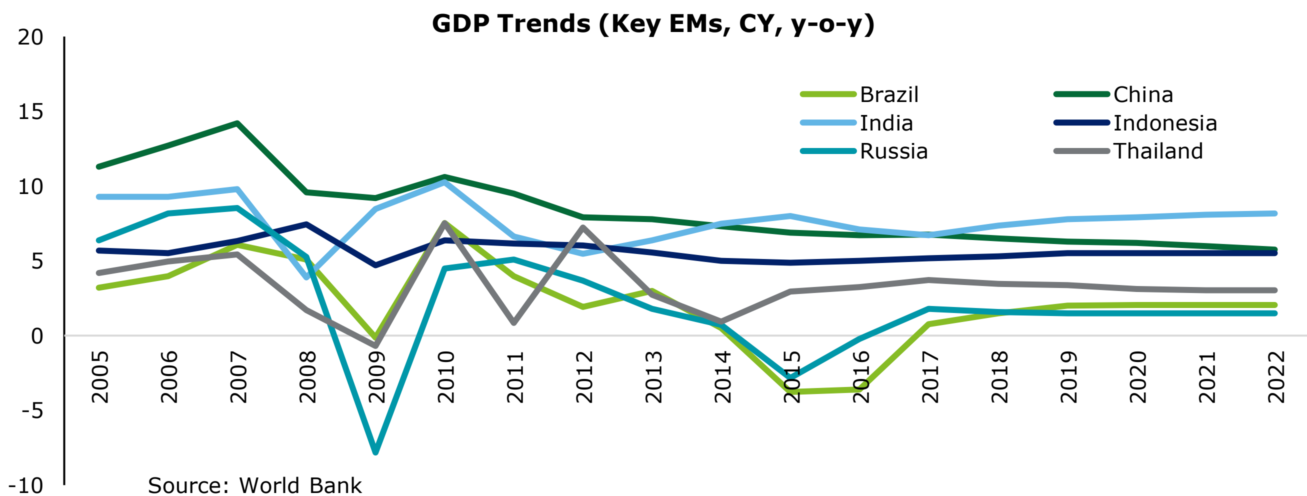


Source: CEIC, Deloitte

In the following couple of charts, we have compared the growth trajectory of Indian economy vis-a-vis countries that received highest levels of FDI in 2017. We have also compared India's growth with other emerging market economies (EMs). As can be seen, it is expected that India will grow faster than the EMs as well as the advanced economies (AEs).



Source: World Bank



Sundry projections, including those by the Economic Survey, World Bank and IMF expect the Indian economy to grow in the range of 7-7.5% in FY 2018-19. It appears that the Indian economy still is not expected to cross the 8% Rubicon in the near term. Hence, the key challenge for 2018 appears to be not to reach the full potential but to maintain the path to recovery.

While the recent data has shown the recovery to be broad-based, what has been a pleasant surprise is the sudden jump in investment. This is surprising more so because, the data on investment proposals has not shown growth in the same period. Nevertheless, the economy is rebounding and is appearing to do so on the back of increased spending as well as investment by the government. Indeed, the increased government spending helped cushion the possibility of a sharper fall in GDP in FY 2017-18, especially as private investments continued to remain muted. The pessimism in the domestic market was overcome also, to a certain extent, by the steady inflow of both FPI and FDI in 2017. This helped in managing CAD at stable levels at around 1.2% of GDP in the second quarter of FY2017-18[1] and is expected to remain in manageable range.

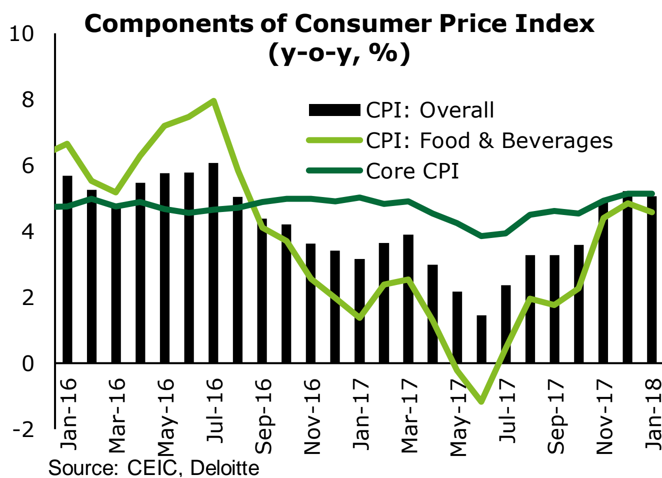
The FDI is expected to continue its robust growth in FY 2018-19 as well, especially on the back of better consumer spending. The government's recent focus on agriculture and allied activities and its ambitious infrastructure schemes can be expected to boost rural incomes and rural spending. Inflows from FIIs are typically volatile and a much stronger US economy with US Fed also steadily increasing rates are not going to help matters. However, more than foreign fund inflow, what is required is that Indian exports are able to benefit from the era of all round world economic growth in 2018, something that could not happen as per expectation in 2017. A rapid and sustainable increase in exports will also help "Make in India" as well as boost job creation.

More worrisome is the enhancement of the fiscal deficit target. There is no arguing against the fact that an expansionary fiscal policy is required to boost a slowing economy. In such a scenario, what is vital is the quality of the enhanced fiscal spend as well as sources utilized in financing the said expenditure. The healthy rise in tax revenues was outweighed by a sharp deceleration in non-tax revenue reflecting deceleration in spectrum auction proceeds, dividends and profits of state-owned enterprises and the Reserve Bank of India. Between Apr-Dec 2017, close to 80% of the total receipts of the government were generated from tax revenues while a meagre 13% came from non-tax portion with the gross tax to GDP ratio likely to have risen by 0.2% to 11.6% in FY17-18[2]. Part of the shortfall in revenues was met via disinvestments and thus the government hopes to breach the disinvestment target set for FY17-18 by collecting INR 1 trillion and further expects to raise INR 800 billion in FY18-19[3]. However, it is significant to note that the disinvestment proceeds cannot be viewed as a long-

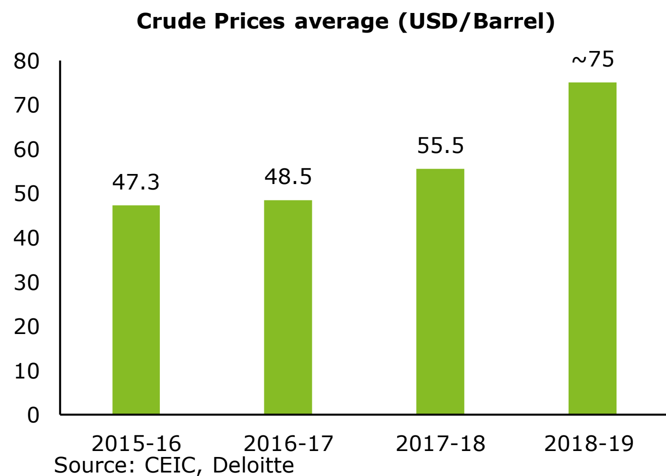
[1] CEIC Data and Deloitte Analysis
[2] CEIC Data and Deloitte Analysis
[3] http://www.business-standard.com/article/economy-policy/niti-aayog-preparing-new-list-of-sick-psus-for-disinvestment-amitabh-kant-118022200081_1.html

term source of revenue generation. Hence if a longer path to fiscal consolidation has to be taken, it should be based on sustainable, recurring revenue sources.

A higher fiscal deficit also reflects government's worsening financial position, reinforcing the negative view on inflationary risks, which have started to build and are expected to remain at elevated levels on the back of pay revisions, increased government spending, and expectations of hardening crude oil prices. In a signal of the times to come, the SBI has already announced an increase in the deposit as well as lending rates. With recent CPI data continuing to stay above the 5% mark and the economy in a recovery mode, RBI may go in for a rate hike sooner or later. Along with the twin balance sheet problem, even with the progress being made under the insolvency code and infusion of additional capital in the PSBs, a rate hike may still act as a dampener to revival of private Indian investment.



Source: CEIC, Deloitte



Source: CEIC, Deloitte

That said, beyond the government spending, rise in GDP growth must be supported by robust private sector investment. This has been a sticky point for the economy over the last few years. Apart from economic reforms engineered to boost demand and income, the private sector may also be looking for a certain and stable regulatory environment and stimulus to encourage their appetite for credit. From a long -term perspective, we believe that an inflection point may have been reached and consumer and business spending should see improvement in the period ahead. Ultimately, economic behavior will respond not so much to big ticket policy announcements, but to actual implementation of the proposed schemes.

Data source where not mentioned has been taken from CEIC and Deloitte

Information for the editor for reference purposes only

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