In focus: India Economic Survey FY2018

January 29, 2018

Kamalika Das
kamalika.das@icicibank.com
+91-22-33986280

Samir Tripathi
samir.tripathi@icicibank.com
+91-22-33987233

Sumedha DasGupta
sumedha.dasgupta @icicibank.com
+91-22-33987243

Ramakrishna Bogathi
ramakrishna.bogathi@icicibank.com
+91-22-33986943

Pradeep Kumar
pradee.kmr@icicibank.com
+91-22-33986272

Yash Panjrath
yash.panjrath@icicibank.com
+91-22-33988161

Sri Virinchi Kadiyala
sri.kadiyala@icicibank.com
+91-22-33987206

Economic Survey pegs growth at 7-7.5% YoY in FY2019

The Economic Survey was tabled today amid considerable flux in the economy and just ahead of the highly anticipated major budget presentation by the Union Government. The Survey's tone balances carefully between sounding upbeat on economic prospects going ahead but at the same time remaining cognizant of risks such as high oil prices. It also stressed the importance of fostering a facilitating environment for the two sustainable growth engines viz. private investment and exports.

The Survey emphasizes that the India growth story has been one of two halves wherein in the first half we decoupled from the global growth acceleration. The weakness in growth was attributable to several factors including

- impact of demonetization,
- implementation of GST,
- high real rates,
- rural distress due to falling food prices and
- continuing pressure from the twin balance sheet problem

However, signs of improvement have been witnessed in the second half with rise in exports, fading impact of one-off measures and policy measures undertaken to improve business climate. The uncertainties in the system have also risen with concerns growing about fiscal deficit, current account deficit and inflation, triggered by the rise in crude oil prices.

For FY2018, the Survey notes improvement in real non-food credit growth and uptick in rural demand proxies such as motorcycle and auto sales etc. The Survey also gives additional information on demonetization and notes that cash-GDP ratio has now stabilized and **estimates that the impact of demonetization is ~INR 2.8 tn less cash and INR 3.8 tn less high denomination notes.**

The survey forecasts FY2019 GDP growth at 7-7.5% YoY. The key sources of upside are expected to come from exports recovery and recovery in private investment. Exports growth in response to increase in world growth has been in line with long term average but has still been lower than the growth we had seen in the mid-2000s. Apart from this, the implementation of the Insolvency and Bankruptcy Code and the ongoing public sector bank recapitalization process will lend some impetus to private capex. The Survey feels that consumption demand will be supported by lower real rates, but higher oil prices could also constrain recovery.

On fiscal deficit, the Survey continues to stress on the importance of credible fiscal consolidation. It advocates a moderate consolidation path which incorporates "gradual but steady" reductions in fiscal deficit.

We believe that GVA growth for the next fiscal could be around 7.4% YoY and expect a pickup in inflation along with worsening of current account deficit.

Given the considerable uncertainty around fiscal arithmetic at this time, it is important to monitor the progress of GST receivables and the quality and profile of expenditure. Our base case view remains that of mild consolidation after a breach in fiscal deficit in FY2018.

Chapter-wise analysis of Economic Survey 2017-18 (Volume I) in Annexure.

ANNEXURE

Chapter 2: A New, Exciting Bird's-Eye View of the Indian Economy Through the GST

The chapter makes some key observations from the GST regime:

The Economic Survey makes several interesting observations about the potential of GST implementation in the country.

- Data analysed shows that number of indirect taxpayers has increased by 50% including a substantial rise in voluntary registrations made by small enterprises.
- In an important finding, the Survey notes that the tax base of various states for GST is in line with size of their economies, which diminishes concerns of lower tax collections by major producing states.
- India's internal trade is estimated at ~60% of GDP and surprisingly India's formal sector (especially non-farm payroll) is much greater than previously supposed.

Chapter 3: Investment and Saving Slowdowns and Recoveries: Cross-Country Insights for India

The chapter looks into the slowdown in investment to GDP ratio over the last decade and draws insights from the historical cross country trends.

The ratio of gross fixed capital formation to GDP reached a peak of 35.6% in 2007, and then slid back to 26.4% in 2017. Meanwhile the ratio of domestic saving to GDP has peaked at 38.3% in 2007, before falling back to 29% in 2016. Such sharp swings have occurred for the first time in India's history.

Based on the break-up of investment and saving, that is available up to 2015-16, private investment accounts for 5 percentage points out of the 6.3 percentage point overall investment decline over 2007-08 and 2015-16. The fall in saving, by about 8 percentage points over the same period, has been driven almost equally by a fall in household and public saving.

Interestingly, the fall in household saving has in turn been driven by a fall in physical saving but partly offset by an increase in the holding of financial assets. Within the financial assets, there has been a shift from currency and bank deposits towards market instruments, viz. shares and debentures.

India's investment slowdown is unique as compared to historical cross country comparison in that a.) it is relatively moderate in magnitude, b.) long in duration, c.) started from a relatively high peak rate and d.) was led by balance sheet-related slowdown. Balance sheet problem emerge from the fact that corporates have curtailed their investments because of stressed finances.

Lessons from cross country episodes

- Investment slowdowns are more detrimental to growth than saving slowdowns. Policy priorities over the short-run must focus on reviving investment. Mobilizing saving, is important but perhaps not as urgent as reviving investment.
- India's investment slowdown is not yet over although it has unfolded much more gradually, keeping the impact on growth – at moderate levels.
- India's investment decline seems particularly difficult to reverse, partly because it stems from overall large balance sheet stress. The deeper the slowdown, the slower and shallower the recovery. At the same time, some countries in similar circumstances have had fairly strong recoveries, suggesting that policy action can decisively improve the outlook.

The key policy prescription in this environment is to complement public investment with easing the costs of doing business, and creating a clear, transparent, and stable tax and regulatory environment. Also, creating a conducive environment for small and medium industries to prosper and invest will help revive private investment.

Chapter 4: Reconciling Fiscal Federalism and Accountability: Is there a Low Equilibrium Trap?

This chapter delves into the existing picture of fiscal federalism, and the extent to which lower tiers of Government are reliant on the extent of resources devolved by the upper tiers. The chapter postulates that economic and political development has been associated with a rising share of direct taxes in total taxes. In this context, advanced countries outshine their emerging peers, with India having the lowest share of direct taxes in total taxes in the sample considered. In conjunction with the introduction of GST, the reliance on direct taxes may decline further.

On a disaggregated level, there is significant variation across states in the extent of own revenue generation. India's urban local governments (ULGs) are much closer to international norms, with their own revenues as a share of total revenues higher than advanced countries like Germany. ULGs generate ~44% of their total revenue from own sources, in contrast to Rural Local Governments (RLGs), which rely overwhelmingly (~95%) on devolution. Given the overwhelming reliance on devolved funds which, to a large extent, are tied to sectors and schemes Gram Panchayats spend the bulk of such funds on earmarked areas, such as roads, other basic services, sanitation and community assets. Consequently, spending on purely local public goods like irrigation are not a priority.

Among property taxes collected at the second and third tiers of government, land tax and housing tax are the important direct tax components. It has been found that states collect only ~7-19% of their potential for land tax, and a similar performance is seen for housing taxation. Also, the under-collection of direct taxes relative to potential afflicts the Centre equally. The collections from these potentially buoyant sources of revenue are generally stacked at very low levels because of archaic base values—far below market values—applied to properties and low rates of taxes levied.

State and local governments in India rely much more on devolved resources and much less on their own tax resources, and they collect less direct taxes. The reason seems to be that they are not fully utilizing the taxation powers they already possess.

The chapter concludes that perhaps vertical and horizontal resource devolution to second and third tier fiscal institutions should be credibly linked to their performance in increasing reliance on own taxes, especially direct taxes. Breaking that self-reinforcing cycle of inadequate delivery-low direct taxes-weak accountability-inadequate delivery is perhaps the heart of the governance challenge in India.

Chapter 5: Is there a "Late Converger Stall" in Economic Development? Can India Escape it?

The focus of this chapter is on the convergence process of lower middle income countries such as India which are attempting to make transition to middle income status. Since 1980, India has been growing rapidly, posting an average per capita GDP growth rate of 4.5%. It can be termed as part of economic convergence, the process of poorer countries "catching-up" with richer countries and closing gaps in standards of living.

With rapid growth there were fears of India falling into the middle income trap but those fears have not materialized when we witness growth rates for three distinct periods since 1980. However, gathering global trends since global financial crisis might adversely affect countries like India which have joined the converge club later in the process. In other words, there could be a "late converger stall".

Globalization has led to a backlash in advanced economies reflected in falling world trade-GDP ratio since 2011. So late convergers like India cannot rely on trade for further development.

Manufacturing has been identified as a critical sector for ensuring successful structural transformation as it can absorb labour in high productivity sectors. However, "premature de-industrialization," the tendency for manufacturing in late convergers to peak at lower levels of activity and earlier in the development process, is a cause for concern.

A final factor impeding late convergence relates to agriculture. Rising productivity is required in agriculture to free up human capital for other higher productive sectors along with maintaining food security. But this has not been the case in India, agricultural productivity growth has been stagnant, averaging roughly 3% over the last 30 years.

Chapter 6: Climate, Climate Change, and Agriculture

The importance of agriculture in the Indian economy cannot be overstated. Given that it contributes 16% of GDP and more importantly it employs close to 50% of labour force. Agricultural growth is subject to huge volatility during 1960-2004 period but has become relatively more stable since then. However, it is still high compared to China where the volatility is virtually eliminated since 2008.

One of the important factors for variation in agriculture growth is climate change. Changes in climate over the past few decades have shown significant change and its impact on the agriculture yields and farmers income is discernible. Economic Survey's study shows Its impact is higher in unirrigated areas than in irrigated areas. In India still 52% of land is still un-irrigated and rain-fed.

According to the survey, extreme temperature shocks, when a district is significantly hotter than usual results in a 4% decline in agricultural yields during the *kharif* season and a 4.7% decline in *rabi* yields. Similarly, extreme rainfall shocks - when it rains significantly less than usual. The result is a 12.8% decline in *kharif* yields, and a smaller, but not insignificant decline of 6.7% in *rabi* yields. Also, not only the amount of rainfall but the timing of rainfall significantly impacts the yields. Accounting for a level of rainfall, increase in number of dry days (rainfall less than 0.1 millimetres) during monsoon period reduces yield 0.2% on average and 0.3% for un-irrigated areas. Another key finding of the study is varied susceptibility of different crops with pulses being more vulnerable to shocks while cereals are relatively more immune. In long-term, climate change could reduce annual agricultural incomes in the range of 15% to 18% on average, and up to 20% to 25% for unirrigated areas in the long term.

The Survey highlights the challenge of expanding irrigated area while groundwater depletion continues to increase. It recommends the use of drip-irrigation technology, more investment in agriculture research and insurance schemes to protect farmers from uncertainty on their incomes arising out of these shocks.

Chapter 7: Gender and Son Meta-Preference: Is Development Itself an Antidote?

The chapter examines gender-based outcomes in India. Some of the key observations made in the chapter are as follows:

- On 14 out of 17 indicators relating to agency, attitude, and outcomes, India's score has improved over time.
- On seven of them, the improvement is such that in the most recent period India's performance is better than or at par with that of other countries, accounting for the level of development.
- Encouragingly, gender outcomes exhibit a convergence pattern, improving with wealth to a greater extent in India than in similar countries.
- However, on several other indicators like employment, use of reversible contraception and son preference, India has some distance to traverse, because the development has not proved to be an antidote.
- While there is considerable variation within the Indian states and across dimensions, the broad pattern is that the North-Eastern states are doing substantially better than the hinterland states even in their development time.
- Hinterland states are lagging, and surprisingly, some southern states such as Andhra Pradesh and Tamil Nadu fare worse than expected given their level of development.
- The challenge of gender is long-standing, so all stakeholders are collectively responsible for its resolution.
- The skewed sex ratio in favour of males have led to the identification of 'missing' women.
- India must confront the societal preference, including meta-preference for a son (having children until the desired number of sons are born), which notionally creates 'unwanted' girls, estimated at about 21 million.
- The government's Beti Bachao, Beti Padhao and Sukanya Samridhi Yojana schemes, and mandatory maternity leave rules are all steps in the right direction.

Chapter 8: Transforming Science and Technology in India

As India emerges as one of the world's largest economies, it needs to gradually move from being a net consumer of knowledge to becoming a net producer. Investing in science is also fundamental to India's security. The report gives a broad overview of both the input as well as the output pertaining to R&D field in India. It concludes by suggesting list of measures required to improve the state of affairs.

EXPANDING R&D IN INDIA: THE WAY FORWARD:

India needs to redouble its efforts to improve science and R&D in the country first and foremost by doubling national expenditures on R&D with most of the increase coming from the private sector and universities. The report stresses on eight important steps to improve the state of affairs. They are as follows

- Improve math and cognitive skills at the school level (to address the issue of weak foundations of primary and secondary education)
- Encourage Investigator-led Research (India needs to gradually move towards an investigator-driven model for funding science research)
- Increase funding for research from private sector as well as from state governments (Types of R&D activities eligible for CSR funds must be expanded)
- Link national labs to universities and create new knowledge eco-systems
- Take a mission driven approach to R&D (Areas such as Dark matter, Genomics, energy storage systems, Mathematics, cyber physical systems and Agriculture are shortlisted as special focus areas for National Mission)
- Leverage scientific diaspora (Scholarships to attract Indian diaspora to come back and continue to research in India)
- Improve the culture of research (inculcating moves such as less hierarchical governance systems, encourage risk-taking and curiosity in the pursuit of excellence and representation of younger scientists in decision making bodies are suggested)
- Greater public engagement of the science and research establishment (emphasis on communication through the media or regular tours and lectures in schools and colleges)

Chapter 9: Ease of Doing Business’ Next Frontier: Timely Justice

India has jumped more than 40 places to reach 100 in latest Ease of Doing Business (EODB) rankings. This was largely on account of the reforms passed by the government. However, India has a lot to improve in the enforcing contracts indicator. The survey highlights the existing loopholes and the reasons for these inordinate delays in delivering justice and enforcing contracts. Even though the government has taken several measures recently such as rationalizing tribunals and scrapped over 1000 redundant legislations there is still a huge scope for improvement.

In India, the number of cases pending in Supreme Court, High Court and other tribunals is very high. Pendency of economic cases has increased manifold in the recent years. In economic tribunals, the number of cases have increased by 25% between 2012 and 2017 and the average age of the case is 3.8 years. The increase in number of writ petitions in High Courts considered for this study form more than 50% of the total cases and also in some High Courts original jurisdiction is also large which again lead to increase in number of cases. In case of Supreme Courts, number of Special Petition Leaves (SPLs) was around 25% in 2008 has reached 40% in 2016. The average age of the cases in both High Courts is 4.3 years and it is even more acute for economic cases at close to 6 years.

This pendency of cases results in inordinate amounts of delay leading to cost overruns in many projects. The Survey shows that of the total 52 projects which were stayed by courts which belong to six different ministries had an average stay of 4.3 years. This is also true in tax department cases where just 0.2% of cases constitute 56% of total demand value. While the IT Department is the largest litigant, its success rate is less than 30% and loses 65% cases unambiguously.
Contrary to the popular perception, the Survey highlights that instead of expanding the infrastructure of judiciary, it recommends the effective use of existing capacity. Also, more powers have to be delegated to lower courts to reduce the burden on the High Courts.

(Source: Various chapters from Economic Survey 2017-18)
indiabudget.nic.in

ICICI Bank Global Markets

ICICI Bank: ICICI Bank Towers, Bandra Kurla Complex, Mumbai- 400 051. Phone: (+91-22) 2653-1414

Treasury Research Group			
Economics Research			
Sunandan Chaudhuri	Senior Economist	(+91-22) 3398-7525	sunandan.chaudhuri@icicibank.com
Kamalika Das	Economist	(+91-22) 3398-6280	kamalika.das@icicibank.com
Samir Tripathi	Economist	(+91-22) 3398-7233	samir.tripathi@icicibank.com
Pradeep Goyal	Economist	(+91-22) 3398-6229	goyal.pradeep@icicibank.com
Sumedha Dasgupta	Economist	(+91-22) 3398-7243	sumedha.dasgupta@icicibank.com
Ramakrishna Reddy Bogathi	Economist	(+91-22) 3398-6943	ramakrishna.bogathi@icicibank.com
Sri Virinchi Kadiyala	Economist	(+91-22) 3398-7206	sri.kadiyala@icicibank.com
Pradeep Kumar	Economist	(+91-22) 3398-6272	pradee.kmr@icicibank.com
Sparsh Chhabra	Economist	(+91-22) 3398-7309	sparsh.chhabra@icicibank.com
Ashray Ohri	Economist	(+91-22) 3398-7249	Ashray.ohri@icicibank.com
Yash Panjrath	Economist	(+91-22) 3398-7309	Yash.panjrath@icicibank.com

Treasury Desks			
Treasury Sales	(+91-22) 6188-5000	Currency Desk	(+91-22) 2652-3228-33
Gsec Desk	(+91-22) 2653-1001-05	FX Derivatives	(+91-22) 2653-8941/43
Interest Rate Derivatives	(+91-22) 2653-1011-15	Commodities Desk	(+91-22) 2653-1037-42
Corporate Bonds	(+91-22) 2653-7242		

DISCLAIMER FOR BAHRAIN RESIDENTS:

ICICI Bank Limited's Bahrain Branch, located at Manama Centre, Manama, P.O. Box-1494, Bahrain, is licensed and regulated as a Conventional Retail Bank by the Central Bank of Bahrain (CBB). The CBB assumes no responsibility for the accuracy and completeness of the statements and information contained in this document and expressly disclaims any liability whatsoever for any loss arising from reliance upon the whole or any part of the contents of this document. Certain financial products mentioned herein may be available only to accredited investors. In such cases, following criteria should be met by accredited investors as defined under the CBB rule book:

a) Individuals holding financial assets (either singly or jointly with their spouse) of USD 1,000,000 or more, excluding customer's principal place of residence;
b) Companies, partnerships, trusts or other commercial undertakings, which have financial assets available for investment of not less than USD 1,000,000; or
c) Governments, supranational organizations, central banks or other national monetary authorities, and state organizations whose main activity is to invest in financial instruments (such as state pension funds).

In case of any doubt regarding the suitability of the products and any inherent risks involved for specific individual circumstances, please contact your own financial adviser. Investments in the financial product or financial services to which this document relates are not considered deposits and are therefore not covered by the Kingdom of Bahrain's regulation on Protecting Deposits and Unrestricted Investment Accounts.

DISCLAIMER FOR DUBAI INTERNATIONAL FINANCIAL CENTRE ("DIFC") CLIENTS:

"This marketing material is distributed by ICICI Bank Ltd., Dubai International Financial Centre (DIFC) Branch and is intended only for 'professional clients' not retail clients. The financial products or financial services to which the marketing material relates to will only be made available to a 'professional client' as defined in the DFSA rule book via section COB 2.3.2. Professional clients as defined by DFSA need to have net assets of USD 500,000/- and have sufficient experience and understanding of relevant financial markets, products or transactions and any associated risks. The DIFC branch of ICICI Bank Ltd., is a duly licensed Category 1 Authorized Firm and regulated by the DFSA".

DISCLOSURE FOR RESIDENTS IN THE UNITED ARAB EMIRATES ("UAE"):

This document is for personal use only and shall in no way be construed as a general offer for the sale of Products to the public in the UAE, or as an attempt to conduct business, as a financial institution or otherwise, in the UAE. Investors should note that any products mentioned in this document, any offering material related thereto and any interests therein have not been approved or licensed by the UAE Central Bank or by any other relevant licensing authority in the UAE, and they do not constitute a public offer of products in the UAE in accordance with the Commercial Companies Law, Federal Law No. 8 of 1984 (as amended) or otherwise.