INDIAN ECONOMY

CRISIL Insights

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Through the monthly CRISIL Insights Indian Economy series, we offer incisive analysis of macroeconomic parameters of the country. In this issue, we zoom in closer on the debt ratio of states, analyzing whether it improved or worsened in the past five years

Debt wish in the states

The Fiscal Responsibility and Budget Management Act, 2003, brought a measure of fiscal rectitude to states. But the trend changed with the Ujwal Discom Assurance Yojana (UDAY), farm loan waivers, and pay commission hikes, and states' debt ratios are on slippery ground again. In this issue, we analyze the debt ratio of states for the past five years. The debt ratio measures a state's debt against its income, or gross state domestic product (GSDP). For this, we compared the non-special category states (defined by the Reserve Bank of India or RBI), excluding Andhra Pradesh and Telangana, as their bifurcated debt ratios are unavailable prior to fiscal 2016. For our analysis, we classify the states based on their debt ratio and analyze what drives their debt ratio using the parameters of the debt sustainability equation. The debt sustainability equation requires that,

$$\text{Change in debt ratio } (\Delta D) = \text{Primary deficit} + [(\text{Nominal interest rate} - \text{Nominal growth rate}) \times \text{Debt ratio}]$$

Simply put, this equation implies that for debt to be sustainable, over time, the state must run a primary account surplus and/or grow at a faster rate than the nominal interest rate. Based on the equation, we find that in case of most states, an increase in the primary deficit was the major cause for worsening of the debt ratio. However, the nominal GSDP growth rate is higher than interest rates[1] for all the 16 states. Below is a snippet on the categorization of the states and the factors that led to the movement in their debt ratios

Very high debt ratio (>30%) states: Punjab, Rajasthan, and Kerala – For Punjab and Rajasthan, the debt ratio worsened after the state governments took over the discom debt under UDAY. In case of Kerala, a slowdown in the GSDP growth, which impacts the denominator of the debt ratio, was the main reason for the worsening debt ratio.

Moderate-to-high debt ratio (20%-30%) states: Bihar, Haryana, Jharkhand, Madhya Pradesh, Tamil Nadu, Odisha, Goa, West Bengal, Uttar Pradesh, and Gujarat – For most states, including Bihar, Haryana, Jharkhand, Madhya Pradesh and Tamil Nadu, the debt ratio worsened owing to an increase in primary deficit, largely on account of UDAY. On the other hand, debt ratios improved over the period for West Bengal and Gujarat as they were able to rein in their primary deficit.

Low debt ratio (<20%) states: Chhattisgarh, Karnataka, and Maharashtra – Maintaining a range-bound primary deficit while sustaining high growth rates has helped these states in keeping their debt ratios low.

Thus, the focus of most states witnessing an explosive debt ratio should be on improving their primary balances. This can be done by shoring their tax revenue, as for most states, the share of own tax revenue in GSDP has been declining.

[1] Average interest cost of the debt issued by the government in the past and not the current state development loan rate

Money and Banking	Industrial Production	Inflation
Wait and watch	IIP catches an updraft	Wind's out of inflation

MONEY AND BANKING

- The RBI's Monetary Policy Committee (MPC) decided to keep policy rates on hold in its December meeting and continue with its policy stance of calibrated tightening stance to observe the evolving situation
- The RBI proposed that from April 2019, all new floating rates on personal or retail loans and floating rate loans to micro and small enterprises will have to be linked to an external benchmark (repo rate, 91 or 182 day treasury bill or any other benchmark interest rate produced by Financial Benchmark India Pvt Ltd), instead of the internal benchmarks (PLR, BPLR, base rate and MCLR), which is the norm now
- While 10-year government security (G-sec) had a breather, rates on commercial papers rose significantly
- Systemic liquidity in the banking space tightened further, leading RBI to do higher purchases under the open market operations than announced earlier for November
- CRISIL Research expects banking credit to clock upwards of 11% on-year growth in fiscal 2019, compared with 7.4% growth in fiscal 2018, driven by strong retail credit growth, higher disbursement to non-banks, and resolution of big-ticket stressed assets

INDUSTRIAL PRODUCTION

- Index of Industrial Production (IIP) surged to 8.1% in October, from 4.5% in September. The pick-up was broad-based and led by higher growth in mining and manufacturing
- Core sector growth was also up, led by coal, cement and electricity sectors
- From an end-use classification, growth in output of capital goods and consumer durables surged. Production of primary goods also trended up
- IIP has posted much stronger growth this fiscal (April to October) at 5.6%, compared with 2.5% in the year-ago period
- For the rest of fiscal, however, growth could be slower, dragged by lower global trade and growth prospects that could hurt our exports

INFLATION

- Consumer Price Index (CPI)-based inflation fell to a 17-month low of 2.3% in November on negative food inflation and softening core inflation, besides a high base of the previous year. With this, inflation has fallen for the third consecutive month, and also tasted the lower bound of RBI's inflation target band of 4% ± 2%
- Decline in food prices, which started in October, accelerated further in November, indicating the government's procurement machinery has failed to implement the increase in minimum support prices it announced earlier
- Fuel inflation also moderated, given a significant downward movement in global crude oil prices and the excise cuts extended by the government.
- More importantly, core inflation also softened, suggesting further slowdown in GDP growth
- Wholesale Price Index (WPI)-based inflation too slowed down to 4.6% in November from 5.3% in October, led by food inflation and softer core
- Continuous decline in food prices and a sharp slowdown in crude oil prices have mitigated some upside risks to inflation. As a result, CRISIL expects CPI inflation to be 3.7% in fiscal 2019, compared with 3.6% in fiscal 2018

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Interest Rate	Rupee	Trade
Bond rebound	On the rebound	Crude cheer, exports veer

INTEREST RATE

- Yield on the 10-year G-sec averaged 7.75% in November, 20 basis points lower on-month
- External factors like oil prices and US yields turned conducive for the bond market, while policy support continued
- Oil prices dropped by more than $20 per barrel over the month
- After rising in the preceding two months, the US 10-year Treasury yields fell in November, closing at 3%, 20 basis points lower on-month
- The RBI continued to infuse liquidity with open market purchases of gilts, increasing the quantum in November and announcing more for December
- CRISIL expects the 10-year G-sec yield to average at 7.9% in March 2019, compared with 7.6% in March 2018

RUPEE

- Rupee reverted to the mean in November, gaining from the crude oil price decline and a modest pick-up in net inflow. After hitting an all-time low of 74.4/$ in October, rupee recovered smartly in the month to average 71.9/$
- On average, the rupee gained 2.4% on-month in November, the first time since January 2018 that the rupee posted on-month gains
- CRISIL believes rupee will settle around 71/$ in March 2019, compared with 65/$ in March 2018
- This is our base case, with 50% probability of occurrence. Easing crude oil prices, waivers on US sanctions for India's oil imports from Iran, and the currency swap deal with Japan will continue to support the rupee
- However, there is a 15% probability of the rupee settling at 74/$, and a 35% probability of it appreciating to our previous forecast of 68.5/ $. Risks, which were tilted to the downside in October, have corrected somewhat after the steep fall in crude oil prices. The downside risks include widening current account deficit (CAD)

TRADE

- Falling oil prices trimmed India's merchandise trade deficit in November. Trade deficit dropped $0.5 billion on-month to $16.7 billion in November. This was driven by $1.4 billion decline in oil trade deficit, even as non-oil trade deficit expanded $0.9 billion
- However, the gains were capped by a sharp slowdown in export growth. Merchandise exports grew 0.8% on-year in November, compared with 17.9% in the previous month. The fall in exports was broad-based, with 14 of 30 principal commodities witnessing a decline
- Import growth also moderated to 4.3% from 17.6%, driven by decline in gold and gems and jewelry imports. Consumption-related imports also declined, despite November being the festive season
- Going forward, trade deficit could moderate further if the recent decline in oil prices sustains. However, exports growth is likely to face headwinds in an environment of slowing global growth and escalating trade wars
- Consequently, CRISIL expects CAD to average 2.6% of GDP in fiscal 2019, compared with 1.9% of GDP in fiscal 2018

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