News: The government is facing a double whammy. The sharp deceleration in economic growth in nominal terms has shredded its fiscal math, and at the same time, the Centre cannot excuse itself from more spending.

Prelims and Mains focus: about the recent economic slowdown, its implications and ways to address them.

Background

Gross domestic product (GDP) grew by 7% in nominal terms for the first half of FY20 and economists are worried the full-year figure may not touch even 10%.

Recall that the government had assumed a 12% GDP growth in its budget in February.

In FY19, the nominal growth was 12.3% in the first half and 11.2% for the full year.

Consequences

A slowing economy by extension will lead to lower growth in tax revenues. After all, as earnings reduce, so does the potential to tax. Gross tax collections are falling for the first time in a decade and analysts expect them to miss the budget target by a mile.

Jefferies India Pvt. Ltd estimates that taxes will fall short of target by ₹3.1 trillion. “Indeed, with early indicators even weaker in Oct-Nov, the challenges may well exacerbate,” the brokerage firm said in a note dated 30 November.

Meanwhile, the government has exhausted its options to fill a widening hole. It has tapped the Reserve Bank of India (RBI) for extra dividend, held over several states’ share in revenue and delayed payments to several agencies, prized companies could fetch a large chunk. The government is also trying to hawk its land.

Even so, analysts believe that fiscal deficit would slip to 3.8-4% as against the budgeted 3.4% of GDP. Therefore, the government will have to borrow more from the market to plug the widening deficit.

Bond markets are pricing in extra borrowing. It is only the surplus liquidity which is keeping yields under check.

The yield on the 10-year government bond has eased 86 basis points ever since RBI began its
rate-cutting cycle in February. A basis point is one-hundredth of a percentage point. The drop
seems less when seen in the light of a large surplus liquidity and a cumulative policy rate cut of
135 basis points.

This indicates that bond markets have not been able to embrace the fall in policy rates given the
concerns over the fiscal deficit.

Beyond the impact on market rates, the government and its agencies are already crowding out
the private sector. With total public sector borrowing estimated at 9% of GDP, it leaves precious
little of the savings in the economy for the private sector.