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SOCIO-ECONOMIC VOICES

"India's Slowdown Driven by Cyclical Factors; Structural Issues Persist Post-pandemic"

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"Government's Borrowing Plan is Broadly in Line with Expectations"

Intro: India's economic outlook for FY2026 reflects both challenges and opportunities. While growth slows due to cyclical factors, strategic fiscal policy aims for stability. That's what is the analysis by **Suvodeep Rakshit**, eminent economist from India. Speaking to **Mahima Sharma** of **Indiastat**, he asserts that RBI's rate cuts and targeted government spending are set to support growth. However, job quality and external risks remain concerns. More such insights on **Socio-economic Voices** this week as an **EXCLUSIVE** conversation. Read on...

MS: The Economic Survey 2024-25 forecasts India's GDP growth at 6.4% for FY25, matching the decadal average. However, the IMF's January 2025 update lowered its forecast to 6.5%, down 0.5 percentage points from October 2024. What factors drove this revision, and how should policymakers respond?

SR: India's growth slowdown has been led largely by cyclical factors while the more structural factors have continued since the pandemic. Over the last 6-7 quarters, multiple headwinds in the form of

1. slower urban formal jobs creation (led by IT/ITeS)
2. slower pace of government expenditure in the run up to the elections
3. fall in the pace of personal credit (especially unsecured lending) given RBI's regulatory actions have impacted GDP growth adversely.

Some of the reversal is underway with IT/ITES sector hirings picking up from 2QFY25.

Further, government spending has also picked up after the elections and will continue to normalise over next few months. Pickup in the pace of personal credit will be contingent on the RBI's regulatory stance though at the margin credit disbursal could improve marginally given RBI's shift towards easing the liquidity conditions. From a policy perspective, easing of monetary policy along with higher disposable income for salaried individuals through the Union Budget will provide a positive impetus to growth. We expect the GDP growth to be centered around 6.5% in FY2026. Structural headwinds in the form of poor quality of job creation will continue in the year to medium term. Improving the quality of jobs would require work on more structural issues such as education/skilling, ease of doing business through deregulation, labour market reforms, etc.

MS: The budget projects a fiscal deficit reduction to 4.4% of GDP for 2025-26, down from the revised estimate of 4.8% in 2024-25. Given the anticipated nominal GDP growth of 10.1%, do you consider this fiscal consolidation path sufficient to ensure macroeconomic stability? What potential risks could arise if growth projections are not met?

SR: Macroeconomic stability works through optimising on two balances: (1) internal balance reflected in inflation and fiscal deficit and (2) external balance reflected in current account/BOP. A steady fiscal consolidation to 4.4% in

FY2026BE from 9.2% in FY2021 along with a shift to capital expenditure dominated spending has imparted disinflationary impulse from fiscal policy. Inflation, more recently, has seen spikes due to the food inflation front. In fact, core CPI inflation (and even CPI inflation excl. fruits and vegetables) has been below 4% in CY2024. Effectively, along with monetary policy, fiscal policy has ensured internal balances have been under control.

Nominal GDP growth assumption for the FY2026 budget at 10.1% is quite reasonable and revenue assumptions seem quite achievable based on this growth. Risks to growth will mostly be from the external front, possibly, due to trade and tariff wars which could lead to lower corporate and personal income growth. However, there are sufficient buffers on the expenditure front to balance out any some of the shortfalls on the tax front as well as reallocate expenditure in order to provide growth support; without deviating from the fiscal consolidation path.

MS: The budget increases the income tax exemption threshold from Rs. 700,000 to Rs. 1.28 million, resulting in an estimated revenue loss of Rs. 1 trillion. Could this lead to overheating in certain sectors, thereby exacerbating inflationary pressures? Yes or No, how must that be dealt with?

The marginal propensity to consume (MPC) is not the same at all income levels. At the bottom of the income pyramid the MPC is much higher and reduces with rising income. The MPC will also vary across location and age profile. Further, spending may also be concentrated in specific periods of the year such as the festive season. All of these factors temper any simple assumption of a large consumption boost from the income tax side. We need to note that spending/saving behaviour has also possibly changed to some extent since the pandemic. Additional income may be channeled towards savings in fixed deposits, equities/mutual funds along with discretionary consumption. It is unlikely that mass consumption or staples would see higher consumption. But a shift towards premiumisation and discretionary consumption (white goods, autos, tourism, etc.) could be on the cards. We note that compared to a per-capita GDP of around Rs 0.23 million, the tax cut benefits are accruing to Rs0.8 and above segment. The consumption behaviour and MPC are unlikely to be the same as the bottom of the pyramid. We do not expect a runaway consumption spree and hence, we do not see an immediate risk of inflationary pressures. Also, fiscal impulse remains contractionary as the continued fiscal consolidation (4.4% of GDP from 4.8% of GDP) will weigh on aggregate demand keeping the inflationary pressures under check.

MS: With retail inflation decreasing to 4.9% and the Reserve Bank of India (RBI) and the IMF projecting it to align with the target of around 4% by FY26, should the RBI consider adjusting interest rates in the near term? How might such adjustments impact economic growth and investment?

SR: The RBI has embarked on a rate cut cycle with a 25 bps of rate cut in the February 2025 policy. The focus has come back on support to growth even as it continues to be cautious on inflation. We believe that the RBI has scope to cut rates by another 25-50 bps in FY2026, given the RBI's increased tolerance for INR weakness, along with the inflation trajectory gliding toward the 4% target. We continue to expect FY2026 average inflation at around 4.2%, with real GDP growth at 6.4%. Our call for a shallow rate-cut cycle is based on the RBI maintaining balanced growth-inflation dynamics while being cautious on external sector risks from (1) uncertainties on Trump's trade policies and retaliatory tariffs, (2) a relatively hawkish stance from the Fed and (3) continued capital outflows. More importantly, liquidity measures will be required to the tune of at least Rs1 tn over next couple of months to improve durable liquidity and ensure transmission of policy rate cuts.

MS: The growth recovery in the services sector has been positive in Q3 FY2025. However, manufacturing has faced headwinds with global supply chain disruptions. How can India avoid a potential stagflationary environment while balancing the growth targets set in the budget?

SR: The budget assumes a real GDP growth between 6.4-6.8% (and pegs nominal GDP growth at 10.1%). This is not exactly a stagflationary environment as the moderate growth profile is balanced by a comfortable underlying inflation. Core CPI inflation as well as CPI inflation excluding fruits and vegetables have been below the 4% mark.

With GDP growth slowing down to 5.4% in 2QFY25, the need for policy support has increased. As highlighted earlier, increasing the pace of government expenditure and preferably front-loading expenditure can help in a cyclical recovery in GDP growth. From a medium to long-term perspective, a steady focus on deregulation for the manufacturing sector will be essential to ensure growth improves without creating inflationary pressures.

MS: With a capital expenditure allocation of Rs. 11.21 lakh crore, accounting for 3.1% of GDP, the government aims to crowd in private investment. Considering the current economic climate, do you believe this strategy will effectively incentivise private sector participation? What are the potential pitfalls if private investment does not respond as expected?

SR: The central government has shifted much of the public investment to itself post-pandemic. At an aggregate level, public sector investment (center+state+CPSEs) would be at around 7% of GDP in FY2025; only 50 bps improvement from pre-Covid levels. This is not a meaningful increase at an overall level even as the center's investment improved to 3.1% from around 1% in FY 2018-19. Incentivising private corporate investment cycles goes beyond just the central government's capex cycle. Private sector requires demand visibility over the medium to long-term which currently at around 6.5% is not too favorable. Along with domestic demand, global demand is also essential. The current structure of large Chinese overcapacity in key manufactured products, fragmented global trade, continuous geopolitical turmoil and uncertainties on tariff measures do not inspire much confidence for the private sector to expand capacity; at least for export-oriented sectors. Further, ease of doing business also needs to improve with lower legal and compliance burden, quality and availability of labour, amongst other factors.

MS: The government plans gross market borrowings of Rs. 14.82 lakh crore to finance the fiscal deficit. Given the global interest rate environment and domestic liquidity conditions, what impact could this have on interest rates in India? Could elevated borrowing costs crowd out private investment?

SR: The government's borrowing plan is broadly in line with expectations. The gross borrowing of Rs 14.82 lakh crore is slightly above expectations but there could be some buybacks by end-FY2025 and use of the compensation cess fund in FY2026 to potentially reduce this borrowing. Even without any further adjustments, it is unlikely that the levels would be an overhang. The markets have been quite used to these levels of borrowing. We do not expect a lasting impact of this borrowing plan on interest rates. RBI's rate cut cycle could lower benchmark yields by 40-60 bps with the shorter end of the curve possibly falling more due to liquidity support measures. Global rates will be a headwind for domestic rates especially if the Fed becomes relatively more hawkish.

MS: Considering the current global economic uncertainties, including potential slowdowns in major economies, how resilient is India's Latest Budget Strategy in sustaining growth? What contingency measures should be in place to address external shocks that could impact the RUPEE and exchange rates?

SR: We don't believe that the Union Budget can be a panacea to all problems. The Budget is essentially a presentation of the government's accounts along with the tax and expenditure policies which should provide a broad support to India's growth prospects while preserving macro stability. Global issues which are still evolving (such as trade and tariff wars) do not necessarily require the budget to provide solutions. The government will be adept at using policies to influence domestic policies through duties, rebates and tariffs along with measures to improve ease of doing business to maintain competitiveness. The management of external sector balance also falls on RBI which has been quite successful at dampening volatility while ensuring INR finds levels in line with market forces. The fiscal and monetary policies aimed at ensuring a manageable growth-inflation dynamics, steady fiscal consolidation and moderate current account balance ensure macroeconomic stability which helps in mitigating risks to INR in a business-as-usual scenario.

MS: The U.S. Fed's interest rate hikes have influenced the capital inflows into emerging markets, including India. How vulnerable is India to sudden changes in global liquidity and how can we mitigate FX and capital flow risks

in the coming year?

SR: Capital inflows/outflows have been a function of not just US Fed's actions but also the Trump administration's expected policies on trade, tariff and immigration. These have been expected to be eventually inflationary which will restrict the Fed's ability to reduce rates. The USD strengthened sharply which led to weakness in most other FX including INR. Risk-off phases typically see outflows from risky assets such as EMs. India will not be an exception though the degree of outflow can be managed with a focus on sustainable growth. In the near-term, the RBI is well equipped to deal with any volatility given the comfortable FX import cover of around 10 months. Further, India's short-term external debt is under control at around 43% of FX reserves with most of the debt in the form of NRI deposits and commercial borrowings of corporates. Government's exposure is negligible. It is important to ensure an orderly depreciation of the INR continues in case the global macro environment warrants it.

ABOUT SUVODEEP RAKSHIT

Suvodeep has a postgraduate degree in Quantitative Economics from the Indian Statistical Institute, Kolkata. Suvodeep Rakshit leads the Economics Research in Kotak Institutional Equities. Along with the institutional business, Suvodeep works on thought leadership and franchise building with the other Kotak group businesses such as asset management, alternate investments, investment banking, and wealth management. His interactions on policy prescriptions span across the government, RBI, and multilateral agencies such as IMF, IFC, and World Bank. Suvodeep has been with Kotak since 2010. He is consistently ranked among the top Indian market economists by global and domestic institutional investors. Prior to joining Kotak, he has covered the UK, European, and Middle East economies as part of the top-rated economics research teams in UBS and Morgan Stanley.