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## Unprecedented uncertainties

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The 2017-18 budget presentation scheduled for 1 February will be under unprecedented uncertainties. They relate to both internal and external stability.

The uncertainties have been caused by poor execution of the demonetisation. Kenneth Rogoff, the author of *The Curse of Cash* told CNBC early this month: “the worst of all, the Indian government hadn't printed the new cash to replace the old cash. I am for less cash, not cashless.”

Demonetisation of high denomination notes and the resultant cash shortage of smaller denominations have disrupted economic activity. Also affected was the production of goods and services in the cash-starved informal sector. Manufacturing activities have also declined, as reflected in the fall in the Nikkei India Manufacturing Purchasing Managers' Index to 49.6 per cent in December from 52.3 per cent in November. The Centre for Monitoring of Indian Economy has reported a fall in new investment proposals by 50 per cent since 8 November.

The IMF in its *World Economic Outlook* released early this week cut India's growth rate estimate by for the current fiscal year to 6.6 per cent due to “the “temporary negative consumption shock” of demonetisation. The cut was one full percentage point.

### **External sector is not rosy either...**

There has been a steady rise in the price of petroleum crude. Oil import-dependent India has now been raising petrol and diesel prices every fortnight. The US economy is looking up under the new President. The US central bank had already raised the benchmark interest rate in December. There are clear indications that there would be two more interest rate increases in 2017. Consequently, the US dollar would continue appreciating. The oil price is denominated in US dollars and hence the landed prices of oil and related products will be up in rupees. The imported inflation would push up wholesale and consumer price indices. That means inflation is around the corner

The finance minister has indicated a fiscal stimulus to boost aggregate spending; but this has taken a big hit. One has to be aware of potential inflationary implications of expansionary policies. Delays associated with implementation of public expenditure programmes prolong the gestation period. In the short run, inflation is a greater possibility.

Rise in inflation hurts not only domestic demand, but also export competitiveness and reduces external demand. It acts through its impact on real effective exchange rate (REER). Export competitiveness is determined by domestic price level relative to foreign price level. Given the nominal exchange rate, defined as price of Indian rupee in terms of foreign currency, if the domestic price level rises higher than foreign price level, REER shoots up. A higher REER indicates decreasing export competitiveness.

The REER data series updated by Reserve Bank of India (RBI) in its January 2017 Bulletin shows REER has been on the rise for the last one year. It has been steadily climbing up from 105.5 in 2013 to 118.6 in 2016.

No wonder, exports have been falling for a while. The Mid-Year Economic Analysis

presented to Parliament in late December 2016, reports that exports of India have been declining since November 2015. The fall is 24.4 per cent year-on-year basis. Imports have also declined, by 30.3 per cent. The decrease in imports is much larger and hence the deficit has shrunk. Decrease in imports would be welcome under normal circumstances. However, given the falling domestic capital formation as proportion of GDP, a decrease in imports would only confirm the deceleration of the economy.

Policy makers might lay the blame on falling world demand. They also cite poor rate of diversification of India's exports, or on not focusing on Africa. One should not ignore the negative effect of domestic inflation on export competitiveness

### **Twin deficits**

Falling exports and much higher level of imports, would give rise to bulging trade deficits. Thus, there will be fiscal deficits and trade deficits. Receipts from tourism are also influenced by rise in REER. Decrease in transfers enlarge current account deficit as a share of GDP.

Bigger budget deficits are not the remedy. They have adverse side effects.

Last year, when the chief economic adviser was keen to adopt a more aggressive fiscal expansionary policy with a higher budget deficit above 3.5 per cent of GDP, RBI and Niti Ayog advised against it.

Their advice is still valid.

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