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Is a Big Bang Budget, Aimed at Smoothening India's Warts, Prudent in an Uncertain Macro Environment?

By T.K. Jayaraman

The Indian economy has been recovering from unprecedented hard hits in fiscal year 2017-18. These were primarily due to domestic shocks: demonetisation of 2016 and the introduction of Good and Services Tax (GST) in 2017.

Demonetisation caused a cash crunch lasting for about six months. The new GST, with numerous revisions in rates, coverage and range and procedures, which were announced at regular intervals since July, with some more to come, are causing frequent disruptions in economic activities.

Furthermore, there is reluctance on the part of commercial banks to lend. They have already been saddled with gross non-performing loans (Rs 9.29 lakh crore, with public sector banks alone accounting for Rs 8.29 lakh crore, amounting to around 9.2% of gross loans).

The fear of mounting bad loans is real and the lingering impact of the two domestic shocks and the banking crisis have been adverse.

Growth has declined, from a high of 7.5% in the first quarter of 2015-16 to 6.1% in the first quarter of 2017-18, and to 5.7% in the second quarter of 2017-18. The downward trend was revised with a slight recovery to 6.3% in the third quarter.

Fiscal policy

The slight recovery was welcome. The eagerness of policy makers is apparent as they have a budget to make as the end of the final quarter for the next fiscal year. They are looking to a traditional Keynesian remedy, a blunt tool with its usual attendant delays and uncertain impact. But, still a popular tool: an aggressive fiscal policy.

So, there are some legitimate questions: when the country's new budget is to be announced, how about making it big to revive the economy and repeat past record growth rates again? Growth, howsoever impressive, has not solved growing unemployment. With rural areas having been left behind and farmers in distress and, above all, the 2019 national elections looming large, why not be adventurous too? Having made successful efforts towards reducing fiscal deficits as close as 3.5% of GDP, would not some kind of temporary deviation from the target of 3% be reasonable in national interest?

In addition to these concerns, there is a growing sense of disappointment too. That is with regard to the external sector, especially export performance.

External sector

The signs of global economic growth are getting firmer. That is reflected in the rising volumes of exports from developing countries to richer nations. US unemployment is at 4.1%, lower than the targeted rate of 5% to 6% and the US central bank is keen to get back to normalisation of its interest rate.

India's poor growth is clearly out of step. Its export performance is weak. It is not taking advantage of what is a largely worldwide economic recovery.

While imports registered an increase by 21.1% on year-on-year basis to $41.91 billion in December 2017 with the biggest rise in imports of petroleum, crude and products (34.9%), exports rose by only 12.4% to $27 billion. India's balance of trade is in the negative, which is not unusual, as growth-oriented imports of capital goods and raw materials, including petroleum crude are always critically needed. It is less than one per cent of the GDP and sustainable with FDI flowing in for reaching a good basic balance.

Widening of trade deficit

At present, India's foreign exchange reserves are rising, thanks to the interest rate differential between US and India. Hot money, ever ready to move, flowing in search of higher returns is not a permanent solution. Yet, these do reduce current account deficit in the balance of payments. In fact, the Indian rupee is artificially strengthened in the process, rendering the rupee prices of imports less than what they would have been otherwise.

Will hot money inflows be reversed any time?

That will happen when the US Fed acts and fulfils the long-pending, world-wide expectations of a hike in its policy rate.

But one form of capital inflows has proved to be more certain and assured. That is the steady, annual and regular inward remittances from migrants working overseas and received by their families in the country. Inward remittances are about $70 billion, much higher than foreign direct investment inflows of $44 billion to India. In fact, India is the highest remittance recipient country, followed by China ($67 billion).

India's foreign exchange reserves recorded an all-time high – $411 billion on January 5, 2018, increasing from $409 billion just a week before.

When things are fine, will not a counter-cyclical budget with its twin brother (trade deficit) be sustained by India's comfortable level of foreign reserves?

This assumption, however, holds good so long as global oil prices do not raise their ugly head. That would upset all plans of the budget formulators.

Rise in oil price

And it is wise to pay attention to the possibility of a rise in oil price. A rise in world oil price always accompanies worldwide economic growth, as oil is a key component in all economic activities. Recent increases in petroleum crude price per barrel from $54.06 in January 2017 to $56.02 in October 2017 and then to $61.1 in December 2017 indicate a rising trend in keeping up with economic growth expectations.

If in 2018, the symbolic barrier of $70 per barrel is breached, confirming that growth expectations are real, expectations would only fuel further increases in oil price, leading to revisions of all estimates and cutting targets.

If we look back, the fall in crude prices in 2014-15 and a continued downward trend led to a big windfall of gains. Conversely, a steady rise would only reduce the fiscal and monetary space available for adjustments.

The consumer price index has also already been going up.

For the latest quarter, inflation reached 5.21% (year-on-year) in December of 2017. That was the the highest inflation rate since past 18 months. The Reserve Bank of India's monetary policy targets inflation at 4% with a tolerance band of ±2%.

India's central bank raised interest rates for the sixth time this year on Tuesday to tame inflation, and indicated that the increase was likely to be its last in the near term.

The government is not talking about RBI reducing interest rates any more since bond prices are falling and interest rate is going up. The bond yields (of both government securities and corporate bonds) have been on the rise for the simple reason that the central and state governments have stepped up their borrowings. Added to the public borrowing for fiscal purposes, RBI's open market operation sales to reverse the effect of purchase of foreign exchange to stabilise rupee from appreciation has also added to net supply of bonds, exceeding the demand for bonds. The benchmark 10-year bond yield which hovered at more than 13-month highs in November 2017 at 7.0% has gone up further. It is now around 7.4%, higher than central bank benchmark interest rate of 6%, repo-rate at 5.75% and inter-bank rate at 6.31%.

Additional borrowing by government would boost the bond interest rate and crowd out private investment. Acceleration in inflation has clearly reduced chances of any cut in policy rate by RBI.

Twin deficits

That brings us back to the external sector.

Current account deficit in the balance of payments is called the twin brother of fiscal deficit. Any rise in aggregate domestic demand induced by a budget deficit spills over to the external sector.

It may now rise. If oil price rises, as feared, deficit constraints will mount. Added to this, if the world's leading central banks tighten their monetary stances in reaction to the US Fed's raising its interest rate, the rate differential would not work to India's advantage any more. Hot money, which is around 40% of capital inflows, could vanish in no time.

The balance of payments will be at high risk.

Choice before policy makers

What does this mean for this year's budget? Any adventurist policy is fraught with danger. The golden mean can be struck only if budget-makers are aware of the potential risks of a big bang budget.

India has followed sensible policies so far: low budget deficit, low current account deficit and as a result FDI flowed in. India has emerged in recent years as a reliant partner in the development process with a credible record.

All those gains will be lost in no time if a big deficit trigger swings into action.

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