Budget 2013: Macroeconomic challenges ahead of budget

Notwithstanding an alleged inflation-growth tradeoff, high inflation and low growth have bedevilled the Indian economy for more than two years. The fact of the matter is some of the same factors are behind high inflation and low growth. Addressing these factors is crucial to the success or failure of the forthcoming Budget for 2013-14 and RBI's Monetary Policy Statement.

Key to understanding the current situation is the sharp (but different) drops in saving and investment which have not only lowered economic growth but exacerbated the current account imbalance and fiscal deficit.

The large improvement in domestic savings from 26.5% of GDP in 2001-02 to 36.8% in 2007-08 is largely attributable to fiscal consolidation, i.e., additional public savings. About half of this gain has been eroded largely through fiscal stimulus in response to the global financial crisis (2.1% of GDP between 2007-08 and 2010-11 and an estimated 3.2% in 2011-12). There was a compositional effect as household savings in gold and real estate increased dramatically, essentially to hedge against inflation. Prices of both these assets are subject to bubble type effects. If any of the bubbles burst, there could be negative wealth effects.

Gross household financial savings fell sharply, according to the Economic Advisory Committee of the Prime Minister (EACPM), from 15.4% of GDP in 2007-08 to 13.6% in 2010-11 and even more in 2011-12. Net household financial savings (available to the rest of the economy) fell from 11.6% of GDP in 2007-08 to 10.0% in 2010-11 and 9.0% in 2011-12. Contributing to the move away from financial saving are low real returns (barely positive for short-term deposits) and RBI's policy of requiring a high Statutory Liquidity Ratio (SLR) whereby Indian banks are forced to hold a hefty portion (23%) of their assets in government bonds.

This, of course, subsidises the government and is financed by private savings. Some even call it 'financial repression'. The paucity of financial instruments available to savers is underscored by the near absence of a corporate debt market, even as corporates borrow heavily in foreign markets. So, not only is current saving low but its value is subject to considerable downside risk and the spectrum of financial instruments in which this saving could be parked is very narrow.

The government's fiscal deficit could soon cross 6% of GDP. Again, distribution of fiscal deficit matters. Aggregate fiscal deficit of the states was 2.3% of GDP in 2011-12 and is likely to be 2.1% in 2012-13, well within the Finance Commission's guidelines. Hence, the central government is principally, if not solely, responsible for the rising fiscal burden. IMF Fiscal Monitor April 2012 argued that among emerging market economies, India is the most stressed in terms of government borrowing needs with some rating agencies threatening rating downturns. SLR and other sources provide easy finance to the government and there is no decisive domestic pressure to reduce the deficit since neither is the public debt unsustainable nor is the structure of such debt geared towards high short-term or external sector borrowings.

Investment has also been falling with fixed investment dropping from 32.9% of GDP to 30.4% between 2007-08 and 2010-11 and further in 2011-12. Rising wages, consequent

on setting in of a wage-price spiral, reduced margins and, therefore, corporate investment. Interest rate hikes instituted to combat high inflation had the desired effect of reducing corporate investment demand, since this is sensitive to interest cost, with a much smaller impact on government demand on resources.

Prevailing pessimism about domestic investment prospects contributed to 'push' factors facilitating outward flow of FDI from India. In 2000, outward FDI stocks amounted to just over 10% of inward FDI stocks ($1.7 billion as compared to $16.3 billion). Ten years later, outward stocks were almost half the size of inward stocks ($92.4 billion compared to $197.9 billion). In 2011-12 outward FDI stock from India touched $112 billion. The RBI, while lauding the benefits of outward FDI in terms of enhanced competitiveness and market access, expressed concern about its huge rise, especially with falling domestic investment.

The response of macroeconomic policies to these challenges should include the following. Over the short term, the fiscal deficit of the government needs urgent correction. This need not be achieved only with a zealot's aversion to subsidies. Revenue augmentation should also be pursued. Asher (2012) showed that direct tax arrears in 2009-10 amounted to 2.8% of GDP and 67% of total direct tax revenues. Similarly, tax collection charges are much too high. These need to be addressed as priorities. The RBI must make corrections for the impact its high interest policy has on corporate investment. It should have a concerted programme to drastically reduce SLR and develop a domestic bond market.

Such coordinated monetary and fiscal policies have a high chance of raising savings and investment and altering their compositions so that sustained high growth is possible. The resulting supply augmentation will moderate inflation.

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