Challenges and policy priorities on the eve of the Union budget

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The economy grew by 8.7% in fiscal year 2021-22 and a whopping 13.5% in the first quarter (Q1) of 2022-23, possibly the highest growth among major economies during this period.

India's economic scenario argues for a cautious withdrawal of support measures and better Centre-state fiscal coordination

In a deeply scarred global economy, facing high uncertainty, India occupies a sweet spot, it is said. But in India too there are looming challenges that need to be urgently addressed: declining growth, elevated inflation and a growing current account deficit (CAD).

The economy grew by 8.7% in fiscal year 2021-22 and a whopping 13.5% in the first quarter (Q1) of 2022-23, possibly the highest growth among major economies during this period. However, this was largely due to the strong base effect of the pandemic-driven contraction in 2020-21 and Delta variant shock of 2021-22's Q1. As the base effect has faded, growth has been slowing down quite sharply, as indicated by high-frequency indicators. We project year-on-year growth of 4.2% in Q4 of 2022-23. Annual growth will be down to 6.9% in 2022-23 and further to 5.2% in 2023-24 (see 'Pre-budget Review of the Indian Economy', National Institute of Public Finance & Policy, 20 December 2022).

At the same time, headline inflation remains elevated and has become broad-based, though it dipped below 6% in November. We project annual headline inflation at 6.3% in 2022-23, i.e., above the upper limit of the Reserve Bank of India's (RBI) tolerance band.

The third major challenge is the current account deficit (CAD), which has risen well above the comfort level of 2% of GDP and is now approaching 3%. The nominal exchange rate has continued to depreciate on account of the growing current account deficit. Foreign direct investment and other financial inflows, which exceeded the outflow of portfolio investments, have largely financed the growing CAD deficit.

India's macroeconomic policy stance, going forward, has to be set against this complex background. Inflation appears to have peaked, though it is still elevated, while growth is still slowing and the CAD is still rising. Hence, addressing the latter two should be our policy priority.

On the monetary policy front, RBI has raised the repo rate by an aggressive 225 basis points to 6.25% this financial year and the repo rate has been closely tracked by the call money rate and the 91- day treasury bill rate. Liquidity has also been drained, mainly through variable-rate reverse repo auctions. The yield on India's benchmark 10-year government security, which was rising since June 2020, has now stabilized and there is a sharp reduction in the spread between long-dated security rates and short-term rates. However, non-food credit has continued to grow rapidly despite the hike in interest rates, facilitated by improved bank balance sheets.

RBI is likely to maintain its policy stance, but a pause is necessary before any further policy rate hikes or liquidity reduction measures to allow time for the effects of measures already taken to pass through. It is also necessary to observe how markets respond to the forthcoming budget. In the external sector, it is best to allow continuing rupee depreciation to switch expenditure from imports to exports and curb the growth of the CAD.

However, RBI should continue to intervene when necessary to contain volatility around a depreciating trend.

Housing slump set to give Fed an inflation-fighting assist

In the fiscal space, gross tax revenue during April-September 2022 (H1 of 2022-23) is nearly 18% higher than in the same period last year and over 51% higher than in H1 of 2019-20, the last pre-covid normal year.

Corporation tax and income tax have grown by 22% and 26% respectively in 2022-23 HI, while goods and services tax revenue, averaging ₹1.4 trillion in 2022-23 H1, is about 38% higher than in H1 of 2019-20. Thus, all taxes have seen robust growth except customs and excise collections. These contracted due to the reduction in rates to help curb inflation.

Buoyancy in tax revenues implies double-digit growth in the Centre's tax revenues (net of states' share), as per our expectations of growth and inflation in 2023-24. This will enable the Central government to sustain its thrust on capital expenditure in 2023-24, which is essential to arrest the expected decline in growth. Slippage, if any, in the 2022-23 fiscal deficit target should be tolerated without last-quarter expenditure cuts, and the target for 2023-24 should not be reduced too sharply, so as to allow time for economic growth to recover. Strong fiscal consolidation should be resumed over the medium term.

Discretionary tampering with tariff rates in recent years has reversed gains in tariff reforms accomplished over decades and should be eschewed. It distorts relative prices, creates an anti-export bias and is self-defeating if reducing the CAD is our external-front goal. It is better to rely on exchange rate depreciation to contain the CAD. But neither will be effective without higher domestic productivity to make Indian products internationally competitive and without having them embedded in global supply chains.

Finally, a fiscal policy concern that needs to be urgently addressed is the significant compression of capital expenditure in most states, despite the ₹1 trillion interest-free loan provision for capital expenditure by states, which is exacerbating the growth slowdown.This is presumably attributable to the uncertainty that states face while preparing their budgets regarding the volume of central devolution and grants they will receive. Committed or politically sensitive revenue expenditures are more difficult to compress. A better and more timely coordination mechanism is required between budget-making at the Centre and the states to reduce this risk aversion due to uncertainty in the preparation of state budgets.

These are the author’s personal views.

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