A mixed economic outlook and macro policy challenges

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When macroeconomic indicators all point in the same policy direction, policymaking is straightforward. However, policymaking in the real world is not so simple. The economy is monitored with the use of a whole range of indicators, which may be pointing in different policy directions. Such mixed signals, as we are seeing now, makes macroeconomic policy quite challenging.

There is a wide consensus that India's gross domestic product (GDP) will grow at around 9-10% in 2021-22. Our own growth 'nowcast' is 9.9% (Rudrani Bhattacharya & Sudipto Mundle, NIPFP Working Paper No. 361, 2 December 2021). High growth in 2021-22 is mainly being driven by the strong base effect of the 7.3% contraction in 2020-21. The important question is how the economy will perform in 2022-23, when there will be no base effect to push growth. Our forecast is 5.2%, significantly lower than the Reserve Bank of India (RBI) projection of 7.8%. But it is similar to one of the growth scenarios projected by the 15th Finance Commission and higher than the pre-pandemic growth of 4% recorded in 2019-20. Of course, all such model-based projections, are quite fragile in an economy that is just recovering from a huge shock. More important, actual outcomes in 2022-23 will depend a great deal on the policies that are pursued during the year.

Since the pandemic struck in March 2020, RBI has done a remarkable job of accommodating the unprecedented scale of government borrowing through unorthodox liquidity measures, while ensuring that yields on government bonds remained range bound. But it is time now to re-visit this ultra-accommodative monetary-policy stance. Though there is still a large gap between potential and actual output, GDP growth is now clearly on a recovery path. On the other hand, with core inflation persisting above the

RBI target band at 6.1 %, and the wholesale-price-index inflation rate having risen to 14.2% after inflating at double-digit rates for several months, inflationary pressures can no longer be ignored.

The policy shift need not be disruptive. Excess liquidity can be drained from the system gradually. In fact, while maintaining its accommodative monetary policy stance and holding its policy rate constant at 4%, RBI has already been moving in this direction through its variable reverse repo rate (VRRR) auctions since October. The VRRR volume is slated to rise to ₹7.5 trillion by end December. In effect, with an average VRRR of around 3.8%, the reverse repo rate of 3.35% will become redundant and VRRR will become the main instrument for draining liquidity from the system by January 2022.

On the external front, unemployment in the US is lower than expected, while inflation is exceptionally high at over 6%, a rate not seen for at least 40 years. In response, the US Federal Reserve said on Wednesday that it will accelerate the tapering of its quantitative easing programme in preparation for raising interest rates. This in turn will lead to an outflow of portfolio investments from emerging-market economies. We are already seeing this in India, and the consequent depreciation of the rupee. Hopefully, RBI intervention will be limited to containing excessive volatility as the rupee depreciates, and not arresting the depreciation. As past experience in India and elsewhere has shown, any attempt to hold exchange rates above their market clearing level would eventually fail, burning up a great deal of foreign exchange in the process. Besides, further depreciation of the rupee may help arrest India’s yawning trade deficit, which continues to expand.

Turning to fiscal policy, exercises are now underway for the 2022-23 budget. Securing growth, along with income and food support for the poor, should be its primary goal while RBI focuses on inflation. The central government needs to adjust its spending programme in favour of growth-promoting infrastructure, including social infrastructure such as education and health. It also needs to ensure through its transfer programme that states have enough spending headroom to do the same.
A robust spending programme need not depend on deficit financing. There is no immediate risk of a debt trap, so long as nominal GDP growth exceeds the knife edge rate of 9% as I had explained in an earlier Mint

column (16 April 2021). But if real growth or inflation were to decline sharply during 2022-23, then existing public debt levels could become unsustainable. Hence, the central fiscal deficit should be reduced through annual counter-cyclical adjustments to about 4% by 2025-26, as recommended by the 15th Finance Commission. Robust spending can be accommodated despite such a deficit reduction thanks to the recent high buoyancy of tax revenues, growing at 16%-17% year-on-year even during the pandemic period.

However, much of the tax revenue increase is on account of indirect taxes. Direct taxes have grown at a much slower pace, less than 1% in October 2021 compared to a year ago. Hence, direct tax policy needs to focus on raising its buoyancy by minimizing concessions and exemptions and expanding the country's direct-tax base.

Finally, it has to be said that appropriate fiscal and monetary policies alone will not get us to the sustained high growth rates of 7%-8% necessary to overcome our massive problem of unemployment and under-employment. That can only come through deep, wide-ranging structural reforms of the kind seen in 1991.

These are the author's personal views.

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