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The FY10 Budget-Macroeconomic Analysis

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Overview

Four questions on Budget:

- Does it respond to the global crisis?
- Will it deter private investment?
- What are the downside risks?
- Where do we go from here?

Does it respond to the global crisis?

Continued weak OECD growth implies:

- Sluggish exports (trade channel)
- Diminished capital inflows (finance channel)
- Slowing domestic private investment (confidence channel)
- Muted commodity prices, specially oil

- Skeptical of “demand deficiency” arguments in Indian context.
- But these are unprecedented times!
- To stimulate growth, what matters is the *change* in the (realised) cash fiscal deficit.
- So 6% (R.E. FY09) represents “neutral” fiscal stance

- 6.8% FD (B.E. FY10) includes presumed nominal growth of 10.05% (!), itself reflecting growth impact of discretionary fiscal, monetary policy.
- Multiplier effects of direct spending higher than transfers (interest; subsidies). But government cannot spend quickly.
- Major gamble: that welfare transfers, tax cuts will get spent this year.

Will it deter private investment?

- Three potential channels for crowding out:
  - – Financial markets (real interest rates).
  - – Country risk rating.
  - – Exchange Rate.
- If investment function has shifted to left, (e.g. because of increased uncertainty) possible to expand output without raising (real) interest rates- no crowding out (IS-LM analysis).

- Economic Survey, Acharya both argue that, in general, fiscal consolidation has been good for growth.
- India’s “policy mix” has typically been loose fiscal policy, tight monetary policy.
- This can result in high interest rates, appreciation of real exchange rate to offset potential effects on inflation, current account.

- Government spending likely to enhance demand for non-tradables, which are in less elastic supply
- Real exchange rate appreciation quite likely unless sharp decline in private demand.
- Question: can loose fiscal policy be accompanied by (temporarily) loose monetary policy?

What are the major risks?

- Is there a “doomsday” scenario, a la 1991, with capital flight, speculative attack on rupee?
- Probably not, because of political stability, stock of reserves, India’s relative standing, capital controls.
- Risks more from external sector: commodity price shocks, surge of liquidity which will complicate monetary management.

- Problems likely to be longer-term: inability to liberalise capital account, inability to reduce fiscal deficit while other sources of demand are weak, build-up of debt stocks.

Where do we go from here?

- Urgent need to articulate fiscal “exit strategy”, between Thirteenth Finance Commission, Mid-Term Review of Planning Commission.
- Will be that much harder if nominal GDP growth remains low
- Net exports unlike to provide much relief in the near-term
- Reform needed to stimulate private investment.

Thank You