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How Big of a Fiscal Stimulus Can Jaitley Get Away With?

T.K. Jayaraman on 20/01/2017

Inflationary concerns aside, we also have to realise that fiscal deficits are always accompanied by trade deficits.

What will this year's fiscal deficit target be? Credit: Reuters

Can the country afford to have a big fiscal deficit (FD) for the 2017 budget?

It is reported that finance minister Arun Jaitley is keen to step up public investment in infrastructure. The stated objective is to provide "a significant fiscal stimulus" to boost economic growth by filling the gap in private investment, which has been falling since 2012. As a proportion of GDP, the gross capital formation, which was 39% in 2011 decreased steadily to 31.5% in the first quarter of 2015-16 and further to 27.6% in December 2016. The Nikkei India Manufacturing Purchasing Managers' Index also plunged below its threshold level of 50% in December from 52.3% in November.

Downward revision of growth rate estimates

In addition, there is an unstated objective as well. Fiscal stimulus aimed at expanding public investment would also induce private consumption through creation of new jobs and more incomes. Consumption by households has also been hit hard by recent demonetisation of currency bills of high denomination. In fact, the World Economic Outlook released early this week has reduced the estimated growth rate for India for the current fiscal year, by one full percentage point to 6.6% from the previous forecast of 7.6%. The IMF based its assessment on "the temporary negative consumption shock of demonetisation".

The IMF's growth rate estimate is much below the estimate of 7.0% forecast both by Asian Development Bank (Dec. 2016) and by World Bank (January 11, 2017).

While ADB revised downward its growth forecast on the grounds of both weak investment and decrease in agricultural output and demonetisation impact, World Bank did it because of declines in India's automobile and real estate sales. With the latest IMF's forecast of growth by only 6.6% for the current fiscal year, the finance minister seems to have made up his mind: The way out is to step up public expenditure.

Although he asserted that revenue collections were not only on course but also were well above the targeted rates as direct tax revenue and indirect tax revenue collection have increased in the first eight months of 2016-17 from previous year by 12.01% to Rs.5.53 lakh crore and by 25% to Rs.6.30 lakh crore, it was clear that the "significant fiscal stimulus" that he had in mind would require much more resources.

The 2017 budget ideally will not consider any increase in direct or indirect tax rates, as such actions would not be palatable. Increases in rates for different slabs only depress private consumption, which has already suffered a heavy jolt since demonetisation. The contemplated increase in rates of services tax might not also materialise for the same reason.

What is the option left?

Jaitley knows that increased public borrowing of significant proportion has to be resorted to finance the deficit if it were to be larger than the envisaged FD of 3.5% of GDP for the current fiscal year. Since the banking system is awash with liquidity and fresh loan approvals have fallen as private investment has been on the decline, it is expected that expansionary fiscal measures would not crowd out private investment and hence there would not be any pressure on interest rate. In these circumstances, Reserve Bank of India (RBI) would not consider any cut in policy interest rate.

Irresistible temptation: fiscal stimulus

Can we afford a larger FD? Should it go beyond 3.5% of GDP (2016-2017) or 3.9% (2015-16)? Should it be as large as 5.9% (2011-12)?

It seems a case is made out for a sizeable deficit of presently unknown proportion by official circles on the basis of the current level inflation (INF), which is the annual percentage change in consumer price index (CPI). The RBI is guided by changes in CPI for aiming at the target rate of inflation at 4%.

It appears that the government feels that if current inflation is below RBI's targeted rate of 4% supported by falling food inflation and other favourable factors, deficit financing will not be inflationary.

The reasoning goes along like this: food inflation has been in the negative, a minus 0.7% in December 2016 as against 1.54% in November. The CPI has been rising only marginally since January 2016 having risen from 126.3 in January 2016 to 130.1 in June 2016 and to 131.4 in October, and started falling in November to 131.2 and 130.4 in December. The year-on-year change in CPI in December 2016 is only 3.41%. Correspondingly, the changes in the wholesale price index (WPI) on a year to year basis have been in the negative during January to March 2016.

However, it should be noted that WPI is now on the rise since April 2016. The WPI inflation in December is 3.39%, the ninth straight month of increase reflecting rising cost of production and increase in petrol and diesel prices.

Twin deficits

That brings us to raise the question whether policy makers have recognized the inflationary impact potential of the landed prices of internationally traded commodities, including petroleum crude and oil related products on both domestic production and consumption. The Federal Reserve has indicated two to three increases in its policy rate as the economy is now heating up. The US dollar is on the rise as well. Commodity prices are denominated in US dollars. That will lead to a higher pass through inflation in WPI and CPI.

It is not inflation alone that would be the concern. We have to fear the emergence of twin deficits: FD is always accompanied by trade deficits. Expansionary fiscal policies lead to higher capital imports and if their dollar value goes up and if there is no corresponding increase in export earnings, with unfavourable external factors such as rising protectionism, trade deficits (TD) will also bulge. If the inflows including remittances decrease, we will also face rising current account deficits (CAD).

The Table below tells us more on the relationships between FD and INF and CPI and WPI. Further, we find there is a strong correlation, a near one-to-one relationship between FD and TD (0.91); FD and CAD (0.84); FD and INF (0.80); FD and WPI (0.756); and CPI and WPI (0.76).

They cannot be ignored.

Fiscal, Trade and Current Account Deficits and Inflation

	2011	2012	2013	2014	2015	2016 (est)
FD (% of GDP)	5.91	4.93	4.46	4.09	3.94	3.50
INV (% of GDP)	39.30	38.60	34.70	34.20	31.50	27.6 (Dec)
TD (% of GDP)	10.40	10.70	7.90	7.10	6.30	5.8(Nov)
CAD (% of GDP)	4.20	4.80	1.70	1.30	1.10	1.2(Nov)
INF:CPI (%)	9.10	9.90	9.44	5.93	4.91	3.41(Dec)
INF: WPI (%)	8.92	7.37	5.97	2.02	-2.49	3.39(Dec)

At the Vibrant Gujarat Summit early this month, RBI Governor Urjit Patel spoke in strong terms against any expansionary fiscal policy measures. The 2016 budget gave a stimulus to growth by increasing government consumption: implementation of the Seventh Pay Commission recommendations and the One Rank One Pension rule. It was estimated that government consumption expenditure accounted for 33% of the growth in GDP, much higher than the contribution of government consumption to GDP growth, 3.1% in 2015-16. The new stimulus in 2017 budget now to investment would raise FD to a far greater level.

The combined fiscal deficit of Union and state governments at 6.4% of GDP in 2016-17 is among the highest of all G20 countries. Aside from increasing debt level of the nation, Patel warned against inflation. His stress was on maintaining low and stable inflation as an essential prerequisite for having a meaningful interest rate structure for encouraging savers and investors alike, for “achieving maximum allocative efficiency in an economy whose investment rate has to increase for better growth outcomes.”

We have had enough of the consequences emanating from the badly implemented demonetisation decision.

This time, the Modi government has to do some serious thinking before plunging the economy into greater chaos.

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