# Recalibrating policy priorities

**As the global storm rages, emerging markets will have to quickly pivot from addressing the pandemic's scars to focusing on the 'twin deficits' to preserve macroeconomic stability**

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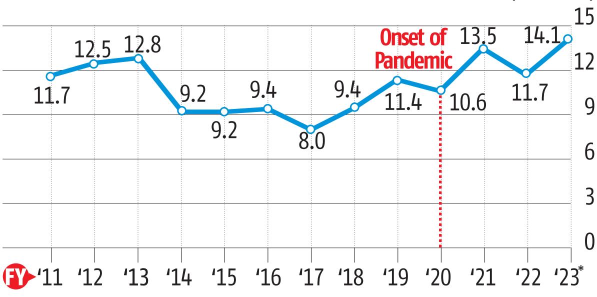
The global economic community remains singularly focused on the inflation challenge confronting advanced economies, wondering how quickly inflation can be brought down and what the collateral damage to activity and labour markets will be. The fact that central bank credibility in some advanced economies appears undermined — despite Chairman Powell's express resolve to stay the course at Jackson Hole, for example, markets are still pricing Fed rate cuts in 2023, thereby impeding monetary transmission down the yield curve — is not helping matters any. But even as these central banks face their biggest challenge in five decades, at least the intellectual consensus and direction of travel in advanced economies is clear. Demand remains relatively strong, activity was close to the pre-pandemic path at the start of this year, and labour markets are the tightest in 50 years. Bringing down inflation, avoiding a wage-price spiral, and preventing a hardening of inflation expectations must therefore constitute the unambiguous policy priority.

In contrast, the conundrums and challenges confronting emerging markets are often much less appreciated. Post-pandemic, policy in these economies has often had to oscillate between healing economic scars and preserving macroeconomic stability, which often may appear in conflict. Without the benefits of exorbitant privilege, for example, many emerging markets could not exercise the fiscal firepower of advanced economies, risking economic and labour market scarring. Then policy had to tighten prematurely in some emerging markets in response to the advanced economic cycle turning, even as domestic recoveries remained incomplete. Now the trifecta of a surging US dollar, rising global interest rates, and still-elevated commodity prices has engendered a new challenge: that of containing and financing the twin deficits — current account and fiscal.

India can serve as a case in point. The perceived growth disappointment in last week's GDP print may reignite market clamour for more policy support from the government. But, against the backdrop of an increasingly hostile global environment, the near-term policy imperative must be to contain external and internal imbalances. Take the case of the current account deficit. For the six years leading up to the pandemic, India's current account deficit averaged just 1.4 per cent of GDP, discernibly below the 2.5 per cent considered sustainable. However, a recovering economy and the global commodity price surge has meant India's CAD is estimated to have widened close to 4 per cent of GDP last quarter, is tracking above 5 per cent of GDP this quarter, and, if crude prices remain in the $90-100/barrel range, the full-year deficit in FY23 is on course to approaching 4 per cent of GDP, or about $130 billion.

Financing a deficit of this magnitude is understandably not proving easy given rising core interest rates are sucking away capital from emerging markets. Consequently, the RBI is estimated to have intervened with almost $55 billion across spot and forward dollar markets so far this fiscal year. To be clear, India still has a war chest of FX reserves, so there is no reason for any panic. Even accounting for the intervention and lower

**TWIN DEFICITS: SUM OF CONSOLIDATED FISCAL DEFICIT & CURRENT ACCOUNT DEFICIT** (% of GDP)




Note: Consolidated fiscal deficit refers to the estimated public sector borrowing requirement; *forecast
Source: Budget documents, RBI, JP Morgan estimates

"valuation effects" (a stronger dollar reducing the dollar value of non-dollar FX reserves), India's US dollar reserves are almost nine months of (an elevated) import basket, and total reserves are almost 1.5 times the gross financing requirements of the economy over the next 12 months — both metrics significantly higher than what existed at the time of the taper tantrum in 2013. That said, when assessing FX reserves, market participants often look at "burn rates" as much as "levels" and if the global environment continues to be challenging for some length of time, and BOP continues to clock a large deficit, the challenges will sustain.

A related phenomenon that policymakers will have to closely monitor is the consolidated fiscal deficit. Even if central and state fiscal targets are met this year, total public sector borrowing requirements will still be in an elevated 10-11 per cent of GDP range, reflecting, in part, the pandemic response. The Centre remains committed to fiscal consolidation, but with capex correctly having become a strategic priority to crowd in private investment, and the subsidy bill increasing again to buffer the commodity shock on households and farmers, policymakers face non-trivial fiscal trade-offs. All said and done, however, meaningful and sustained fiscal consolidation is critical, not just to ensure that large deficits can be financed domestically in a non-disruptive manner but also because of the link between fiscal and external imbalances.

**Containing external imbalances will necessitate both 'tempering demand' and changing 'relative prices'. The former will require both monetary policy normalisation and meaningful, sustained and credible fiscal consolidation**

Recall, on a more fundamental basis, the current account deficit is simply an economy's investment-savings gap. That, in turn, is a combination of the public sector investment-savings gap (i.e. total public sector borrowing requirements) and the sum of the private sector investment-saving gap. The fiscal deficit understandably ballooned during the pandemic. But because private savings surged (as people could not spend) and private investment retreated, the private sector could absorb large deficits without the need for foreign capital (proxied by the current account deficit). But as the private sector has progressively recovered (and its investment-savings gap is normalising) a large, consolidated deficit is manifesting more fundamentally in a wider current account deficit, reinforcing the inevitable link between the "twin deficits". Quantitatively, the combination of the pandemic and the war has pushed up the fiscal and the current account — summed up in the chart for illustrative purposes — to elevated levels by historic standards.

What then should the appropriate policy response be? Containing external imbalances will necessitate both "tempering demand" and changing "relative prices". The former will require both monetary policy normalisation and meaningful, sustained and credible fiscal consolidation. It's only when fiscal deficits come down that a robust private sector revival can coexist with a sustainable current account deficit. Fiscal consolidation, in turn, will need to be intelligent and selective. With the capex thrust essential to reviving growth on a sustained basis, it should not be compromised. Instead, consolidation should necessitate stepped-up efforts to target revenue expenditures and subsidies, while simultaneously finding ways to mobilise more revenues, both taxes and asset sales.

But tempering demand should be complemented by relative price changes, to ensure bringing down the current account deficit to sustainable levels does not extract an unduly large growth sacrifice. A sustained terms of trade shock would argue for a weaker equilibrium real effective exchange rate (REER), which has been effectively flat this year. Empirical evidence suggests a weaker REER boosts India's non-oil exports and, by raising the domestic price of imports, helps rein in non-oil, non-gold imports. In other words, real depreciation of the rupee can simultaneously help narrow the current account deficit and help domestic growth. Net of oil and gold, India runs a current account surplus, but one that has narrowed discernibly over the last decade, suggesting external competitiveness will need to be an ongoing policy priority. Reversing course will continue requiring all hands on deck — infrastructure, regulation, factor markets — but a competitive currency, while not necessarily substituting for the former, can serve as a crucial complement.

The focus since 2020 has correctly been on containing the pandemic and addressing the resultant economic scars. Encouragingly, some progress is visible. The private sector is slowly reviving, reflected in firming production, credit growth, taxes and imports. But even as addressing scarring — particularly in the labour market — will need to be an ongoing effort, near-term policy will need to re-prioritise and double down on addressing the "twin deficits". Policy latitude in emerging markets to address the pandemic's scars was enabled by a benign global backdrop. Now as the global environment turns increasingly hostile, emerging markets have little choice but to pivot sharply towards macroeconomic stability as the best means of insulating themselves from the raging global storm.

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