Budget pre-empts monetary policy

MPC OPTIONS. Given the inflationary situation, a change of stance or rate cut is not advisable

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The MPC will vote its decision on policy interest rates tomorrow. Those who expect it to lower interest rates may well note that its job has already been done by the Union Budget. All the Mint Street needs to do is to take a leaf out of North Block and avoid anything disruptive.

The Interim Budget has taken the fiscal consolidation challenge head on. India's public debt to GDP ratio, combining Centre and State government liabilities, had shot up from 75.3 per cent in 2019-20 to 89.5 per cent in 2020-21. The fiscal stimulus in 2020-21 had caused GFD/GDP ratio to rise by 0.5 percentage points (ppt) to 9.2 per cent.

One can't fault that as the pandemic shock merited succour even though revenues had taken a hit. The government effectively used guarantees much more than on-budget support, thus avoiding fiscal derailment. In this Budget the government has attempted a consolidation of 0.7 ppt surpassing all market expectations. This has resulted in reduction in GFD/ GDP ratio by 4.1 per cent in four years after pandemic.

Is this excessive fiscal contraction? Let us not lose sight of the fact that in the four years before 2019-20, the GFD/GDP ratio had averaged 3.6 per cent. So, we need even further consolidation, especially as the debt dynamics remains adverse.

FISCAL CREDIBILITY

Even if the consolidation is not enough for us to get a sovereign rating upgrade, India now has fiscal credibility in bucking the general trend of exploding debt dynamics in EMEs. But the States must do their part on fiscal consolidation.

Secondly, this Budget has pushed India to a lower interest rate regime. Fiscal policy rather than monetary policy has been used to achieve this. This Budget rolled back the ever-proliferating recourse to market borrowing.

Both the gross and the net market borrowing have now been budgeted lower in absolute amounts. The sharper reduction in gross terms has been accomplished with use of the GST compensation fund. This will also contribute to lowering of yields.

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Thirdly, the fiscal arithmetic in the Budget is credible. In fact, it leaves room to cope with moderate shocks without fiscal slippage. As a base case, inflation may average 4.6 per cent and growth 6.9 per cent next year.

Therefore, the nominal GDP growth could still exceed by about a full percentage point from the 10.5 per cent assumed in this Budget. This augurs well for fiscal arithmetic. Tax revenue buoyancy assumed at 1.1 can also turn out to be higher.

So, what should RBI's action be? The case for rate cut is non-existent. As a base case, despite a fall close to target in Q2, inflation is still likely to stay at 4.6 per cent or marginally above in the coming first half (H1) of the fiscal year and to my mind stabilise above target at an average about 4.6 per cent in H2 given the structural bottlenecks and insufficiently competitive economy. Fresh supply chain disruptions may leave risks more on the upside than downside.

Growth could be about 6.8-7.0 per cent with some drag from lower external demand with possibly weaker rural consumption. Central bank keeping real policy rates at about 125-150 bps is fine in this milieu if it wants to anchor inflation expectations and nudge it to the target of 4 per cent.

What it could do is to use more of Variable Rate Repos (VRRs) to infuse more liquidity at the margin, especially as core inflation has been softening.

Should it change policy stance? Any change will now risk easing financial conditions beyond what is desirable. Will central bank need to worry about trilemma in the coming year? Unlikely. Even with JP bond index inclusion kicking off from June and possible Bloomberg-Barclays bond index announcement coming just before that, the central bank will be in a position to manage the impossible trinity without any drastic moves. So, India is likely to remain an attractive destination for bond inflows, further pushing interest rates down and growth up.

There have been two major counts of criticism against this Budget. First, it does less for the bottom of the pyramid. But the end-goal of growth with equity can best be achieved by lower interest rates, lower inflation and stable macro-economic environment that this Budget pushes, especially if schemes are well-implemented for the bottom of the pyramid.

Second, the lower capex spending increase in line with nominal GDP growth was a trifle disappointing. But the government might be holding its cards for the final Budget.

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