Macroeconomics of Union Budget

This year, the agenda of Union Budget is Transform, Energise and Clean India (TEC). In both international as well as domestic macroeconomic environment, there had been significant uncertainties. On international front, uncertainties were induced by the resurgence of protectionist policies across Europe and United States and firming up of global commodity prices (both oil and non-oil) as well as upward movement in the US interest rate cycle, effecting eventually a decline in trade through a change in growth and its expectations. Domestically in the business environment, uncertainties were caused by the unravelling of impact of demonetisation on overall economic activity and indirect tax reforms through passing of the GST Bill. Discussing the domestic and external scenario, the author duo offer their comments on how to revive private investment and banking sectors. They also analyse the impact of macroeconomic scenario on the Union Budget and fiscal consolidation. Read on…

Prof. N. R. Bhanumurthy and Manish Prasad

(The former is a Professor at National Institute of Public Finance and Policy, where the latter is a consultant. They may be contacted at nrbmurthy@gmail.com.)

"Transform, Energise and Clean India" (TEC) is the agenda for this year's Union Budget. To understand the crux of this agenda, it is important to discuss the context under which the Budget is presented. On both external and domestic macroeconomic environment, there were significant uncertainties.

On the external front, the resurgence of protectionist policies across Europe and United States as well as firming up of global commodity prices (both oil and non-oil) as well as upward movement in the US interest rate cycle caused large uncertainties. These trends not only affected the growth and its expectations through decline in trade, it had also caused high risks on the external account with currency futures hitting historically high levels. On the domestic front, unravelling of the impact of demonetisation on overall economic activity as well as the indirect tax reforms through passing GST bill may create uncertainties in the overall business environment.

Present Macroeconomic Scenario

On the domestic front, a look at Table-1 suggest that real GDP growth is estimated at around 7.1 per cent in 2016-17 based on the advanced estimates prepared by the CSO (Central Statistics Office) compared to 7.9 per cent for 2015-16, suggesting a decline in economic activity even before the demonetisation. What is more concerning is the negative growth in the investments (GFCF) even before demonetisation, which is growing at -0.2 percent and the reasons for this would be discussed later. However, the growth in 2016-17 appear to be largely due to increase in Government final consumption expenditure, which is growing at 23.8 per cent and it could be largely due to the 7th Pay Commission as well as OROP proceeds. Based on the Advance Estimates for 2016-17, while the service sector growth expected to be flat, there are expectations that agriculture sector see some recovery while industrial sector expected to decline to 5.2 per cent from 7.8 per cent 2016-17. However, the recent trends in the growth of Index of Industrial Production show a sharper decline in the industrial activity with 0.3 per cent growth between April-December 2016 period.

On the inflation front, the CPI inflation declined to 3.41 per cent, much below the RBI's inflation target of 5 per cent by March 2017. Similar trend is found in WPI inflation, resulting to expectation of reduction in the policy interest rates. However, the RBI in its February 2017 policy, maintained the neutral stance with no reduction in Repo rate on the understanding that the inflation expectations are building up due to external factors.

On the inflation front, the CPI inflation declined to 3.41 per cent, much below the RBI's inflation target of 5 per cent by March 2017. Similar trend is found in WPI inflation, resulting to expectation of reduction in the policy interest rates.

Table 1: Trends in Major Macroeconomic Indicators (in growth rate)

Key Indicators	2012-13*	2013-14*	2014-15 #	2015-16 @	2016-17&
Real GDP growth(2011-12 prices)	5.5	6.5	7.2	7.9	7.1
Real GVA at basic prices	5.4	6.2	6.9	7.8	7.1
Primary Sector	1.2	5.2	1.8	2.6	4.1
Secondary Sector	3.9	4.3	6.1	7.8	5.2
Tertiary Sector	8.3	7.7	9.5	9.8	8.8
Private Final Consumption Expenditure (PFCF)	5.3	7.4	6.8	7.3	6.5
Government Final Consumption Expenditure (GFCE)	0.7	0.6	9.4	2.9	23.8
Gross Fixed Capita Formation(GFCF)	4.8	1.8	4.1	6.1	-0.2
Exports of goods and services	6.8	7.8	1.7	-5.4	2.2
Imports of goods and services	6	-8.1	0.8	-5.9	-3.8

Source: Central Statistics office, MOSPI

* Third Revised Estimates (New Series); # Second Revised Estimates; @ First Revised Estimates & Advance Estimates for 2017-18

Role of External Sector

Due to the slowdown in global economy as well as due to protectionist policies, global demand has been subdued and that is one major reason for the decline in India's exports by 5.4 per cent in 2015-16. While the advance estimate suggest a growth of 2.2 per cent in 2016-17, for the period April-December 2016, the exports growth is only 0.75 per cent. More concerning is the continuous negative growth in imports, suggesting a subdued growth expectations for the current year.

Compared to the last year's Budget assumption of US$ 40 per barrel, the crude oil increases sharply to US$53–and further increases to $58 in the futures market. Similar trends seen in

global commodity prices (except food) such as metals. Sharper than anticipated slowdown in China's growth, its currency devaluations, developments in EU appears to have large spillover effects on financial markets and its volatility. Tightening of monetary policy in US and monetary stimulus in EU and Japan suggesting an ambiguous recovery in the global growth.

Budget and Macroeconomy

In addition to the existing uncertainties, as discussed above, the Budget brings in three more major changes: advancing the Budget presentation date, merging the Railway Budget with General Budget and removal of Plan and Non-Plan distinction in the public expenditures. The advancement was justified in the context of smoothening the fund flow mechanism for various flagship social sector programs. It is clear from this year's Advance estimates, which used to be for the whole financial year, where the CSO suggests that the estimates are only for first seven months of 2016-17 and do not represent the whole year. Most importantly, it does not include the third quarter, i.e., October to December, 2016, which was most crucial to understand the impact of demonetisation on growth. In such a situation, assessing the nominal GDP growth for 2017-18, which is crucial and base figure for all the Budget calculations, is subject to large revisions. Similarly, in the case of revenue forecasts, in addition to the nominal GDP growth, one also needs revenue buoyancy estimates. As there is no actual figure for 2016-17, especially due to advancing of Budget, revenue forecasts for 2017-18 could also undergo large revisions. In the case of the merger of Railway Budget, one needs to understand that Railway Budget, like any other departments, was always part of the Union Budget. However, what is discontinued is the political economy part of the Budget and both planning and pricing could be shifted to Railway regulator.

In the case of Plan and Non-Plan distinction, this was there on the agenda for quite some time and it was part of the Rangarajan Committee Report on *Efficient Management of Public Expenditure* (2011). Also, as the Planning Commission itself has been disbanded, such distinction was in any case irrelevant. However, with these changes there appears to be some disconnect between the medium term social targets and the expenditure (demand for grants) projections by the important line ministries.

However, to revive the economy, there were expectations that the Budget would focus more on investments (both public and private) policies. There are three major areas where the Budget can focus: expansionary fiscal consolidation, reviving private sector, and reviving banking industry. We look at these three issues and see what the policies that Budget has for these areas.

On Fiscal Consolidation

On the fiscal side, major focus was on the government's commitment to the FRBM (fiscal responsibility and budget management) targets. This is more so when many of the international rating agencies have cautioned about the weak fiscal situation especially looking at the public debt numbers, which, in their view, is alarming. As per the existing FRBM, the fiscal deficit has been brought down to 3.5 per cent in 2016-17 (Revised Estimates). However, for 2017-18, the Budget Deficit is fixed at 3.2 per cent against the target of 3 per cent. Most importantly, the revenue deficit target is reduced from 2.4 per cent in 2016-17 to 1.9 per cent in 2017-18 while in the same period the capital expenditure (as ratio to GDP) is increased from 1.1 per cent to 1.3 percent. This suggests that there is a shift in expenditure pattern from revenue to capital expenditures, which is the crux of fiscal consolidation. Such shift, in our view, would lead to expansion in GDP growth through its crowding-in impact on the private investments. Such strategy also expected to bring down the public debt (Centre's outstanding liability) by two percentage points from 46.7 to 44.7 per cent.

In the case of Plan and Non-Plan distinction, this was there on the agenda for quite some time and it was part of the Rangarajan Committee Report on "Efficient Management of Public Expenditure (2011)". Also, as the Planning Commission itself has been disbanded, such distinction was in any case irrelevant.

On the downside, such fiscal deficit path appear to depend heavily on decline in the subsidy bill (especially in the oil subsidy, despite increase in oil prices) as well as on the assumption on the largely tax revenue buoyancy.

On the downside, such fiscal deficit path appears to depend heavily on decline in the subsidy bill (especially in the oil subsidy, despite increase in oil prices) as well as on the assumption on the largely tax revenue buoyancy. Another major assumption is on the disinvestment proceeds, which is assumed at ₹72500 crore. Overall, while it is not clear what the deficit targets are fixed by the new FRBM Committee (Chairman: Shri N. K. Singh), the Budget statement suggests a medium-term target of 40 per cent of Public Debt to GDP ratio. Only way to achieve this is to further shift the balance from revenue to capital expenditure, although zero revenue deficit may not be desirable. As we have argued elsewhere, having the tight fiscal targets in the context of flexible inflation target creates macroeconomic inconsistency. This is largely because there is a significant relationship between revenue deficits as well as inflation numbers.

On the public expenditure side, to revive the investment climate, the Budget has tried to allocate more resources for the public capital expenditure in most of the infrastructure sectors such as railways, rural housing, roadways, as well as on electrification. Since these sectors have large forward linkage with other sectors in the economy as well as there are highly labour intensive, such expenditures is expected to have multiplier impact on the growth of other sectors as well as in employment opportunities.

Reviving Private Investments

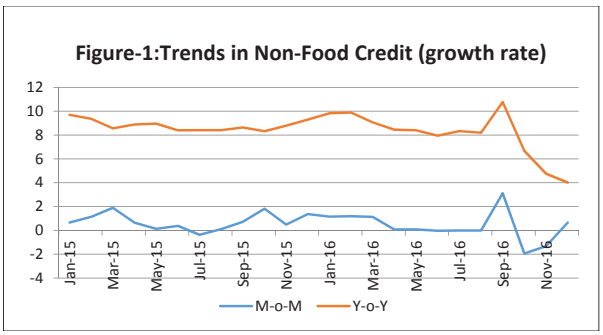
The issue of private investments needs to be looked from broader perspective and not just from Budget. In the year 2016-17, there were many reform measures that are taken, which should have impact on the private sector. Some of them are passing of the GST law, creation of Insolvency and Bankruptcy Board, formalisation of Monetary Policy Committee, launching of new National Mineral Exploration Policy, introducing Unified Payment Interface (UPI) and launching of BHIM (Bharat Interface for Money), Mudra Bank, Digital India Campaign, etc.

In the Budget, it has increased the credit supply to agricultural sector. As demonetisation was expected to have large impact on the employment at the informal sector, the Budget allocates substantial credit to MSME sector and also provided incentives through interest subventions as well as providing some tax incentives. However, what is more significant is the transmission of interest rate cuts to private lending by the commercial banks in the post-demonetisation period. (The RBI in its recent policy feels that the commercial banks have some more space to reduce the lending rates, especially to large infrastructure projects). Above all, as there is a decline in the fiscal deficit target and following this the government reduces sharply the market borrowing target to ₹3.4 lakh crore, there should be enough supply of credit to the private sector. All these measures should revive the private investments.

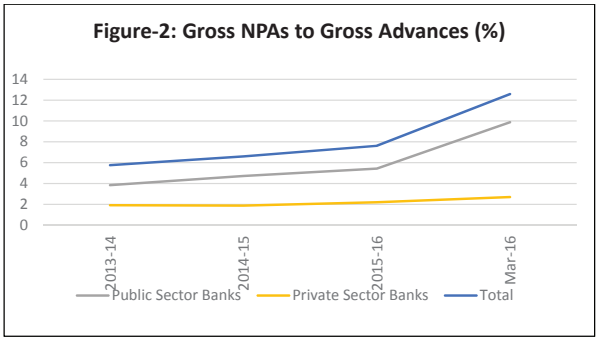
Reviving Banking Sector

It may be noted from the figure-1 that in the pre-demonetisation period, the growth of non-food credit was a meagre 8 per cent (year on year) and was not consistent if India has to achieve 7.5 per cent GDP growth as envisaged in the 2016-17 Budget. However, in the post-demonetisation, the credit growth has declined further and currently at 4 per cent, lowest since last two years. If one looks at month on month figures, the growth is almost flat and turned out to be negative in the post-demonetisation period. What drives such low credit off-take in the economy? In our view, it appears that there is both supply as well as demand issues as both banks as well as the large corporates are facing the balance sheet problems.

The extent of balance sheet problem could be assessed from figure-2, where the total Gross NPAs (as ratio to gross advances) has increased sharply from about 5.8 per cent in 2013-14 to 12.6 per cent by the end of March 2016. There are some more evidence that suggest that it has increased further since then. This increase is largely contributed by increase in the public sector banks NPAs from 3.8 to almost 10 per cent in the same period. Even in the private sector, the NPAs have increased from 1.9 per cent to 2.7 percent.



Source: Based on data from Handbook of Statistics on Indian Economy, RBI



Source: Based on "Statistical Tables Relating to Banks in India", RBI

On the back of such weak banking conditions, there were expectations that the Budget would revive them through allocating more resources for recapitalisation. However, compared to 2016-17 Budget, this Budget has actually reduced the allocation from ₹25,000 crore to only ₹10,000 crore. While there is a discussion on having Bad Bank that takes the NPAs, until then there was a need for more resources from the Budget. It is based on the assumption that Banks are flushed with easy money post-demonetisation and that should help in cleaning up the banks' balance sheets. However, as the RBI is going to remove the withdrawal restrictions from 15th March, one should expect a substantial decline in the demand deposits of the banks. This, together with reduction in the lending rates (by almost 90 basis points), may lead to problems in the banking sector in larger proportion. While the government has taken other measures such as amendments to SARFESI Act, *Indradhanush*, Debt Recovery Tribunals, etc., in sum, the policies to revive the banking sector in the Budget is very negligible. Hence, it is not clear how banks could enhance its business to support growth in the economy.

However, as the RBI is going to remove the withdrawal restrictions from 15th March, one should expect a substantial decline in the demand deposits of the banks. This, together with reduction in the lending rates (by almost 90 basis points), could aggravate the banking problems in larger proportion.

Conclusion

To sum up, while Budget tries to target higher growth in 2017-18, achieving the target depend on how far the government achieves its fiscal targets and at the same time achieve public expenditure efficiency. While proposed *Outcome Budget* may be a good idea to improve efficiency, the process could take longer time. One would have expected the Budget to focus on outputs that are quantifiable in the short run instead of outcomes. Expansionary fiscal consolidation, focus on infrastructure, improving revenue and expenditure efficiency, revival of banking sector, reduction is subsidies, etc., are the major focus of this Budget and they should create more conducive business environment. Now it is for the private sector to act. ■