Union Budget 2022-23: Fiscal-Monetary Interface

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Abstract

If the Reserve Bank of India hikes the policy rates against the backdrop of the mounting geopolitical risks and inflationary pressures, the growth recovery process may slow down. At the same time, keeping the status quo on policy rates for a prolonged period could catalyse the de-anchoring of inflationary expectations. The Union Budget 2022–23 has accommodated high fiscal deficits and has emphasised on "crowding-in" effects of public infrastructure investment. The intensity of global macroeconomic uncertainties on economic recovery in India can be lessened through sustainable fiscal and monetary policy coordination.

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Against the backdrop of mounting geopolitical risks and inflationary pressures, if RBI will hike the policy rates, the growth recovery process may slow down. At the same time, keeping the policy rates status quo for prolonged period could catalyse the de-anchoring of inflationary expectations. The union budget 2022-23 has accommodated high fiscal deficits and has emphasised on "crowding-in" effects of public infrastructure investment. The intensity of global macroeconomic uncertainties on economic recovery in India can be lessened through sustainable fiscal and monetary policy co-ordination.

The union budget 2022-23 was presented in Parliament prior to the mounting geopolitical risks of war in Ukraine. How these global macroeconomic uncertainties impact the fiscal arithmetic in India depend on how the fiscal-monetary policy interface to respond to the crisis. The recent Omicron wave is also a reminder that ever-mutating coronavirus would continue as a determinant of macroeconomic uncertainties. Globally, several central banks have begun monetary policy normalisation, by reducing their balance sheets by ending asset purchases and also through an "earlier than expected" hikes in policy rates (Roubini2022). The financial markets in emerging economies have turned volatile indicating strong capital flight, with mounting uncertainty on the potential rate hikes by the United States (US) Federal Reserve.

The Reserve Bank of India (RBI) in the monetary policy committee (MPC) deliberations during 8-10 February 2022 has delayed normalisation procedure by maintaining a status quo policy rate at 4% (RBI 2022). However, when inflation is rising, a slower policy tightening by the central bank could accelerate the de-anchoring of inflation expectations, further exacerbating stagflation (Roubini 2022; Chakraborty 2021). Given the mounting pressures of inflation, if central banks "bite the bullet and become hawkish" by hiking rates, the growth recovery process may slowdown. . Given these constraints on monetary policy stance, can we rely on "fiscal dominance" to counter the adverse impacts on growth recovery of exogenous supply shocks?

Climate change risks further accentuate the macroeconomic uncertainties. How well monetary policy stance can incorporate such risks and uncertainties, within the available toolkit, is questioned by many economists. There is a broad consensus among economists that fiscal policy is capable to deal with the climate crisis, and national budgets have become an important tool to address climate change commitments. The union budget 2022-23 has announced green bonds for the first time ever in India.

Against this backdrop, this paper analyses the monetary-fiscal interface of Union Budget 2022-23 in India. The paper is organised into 5 segments. The first segment analyses the global uncertainties and the monetary policy stance. Segment 2 analyses the fiscal dominance by analysing the macroeconomic framework of the union budget 2022-23. The third segment analyses the sectoral credit stimulus and financial stability. Segment 4 highlights the monetary-fiscal interface of climate change commitments. Segment 5 concludes.

Uncertainties and the Monetary Policy

The International Monetary Fund (IMF) revised global output and trade growth projections for 2022 downward to 4.4% and 6.0% from its earlier forecasts of 4.9% and 6.7%, respectively, in its January 2022 update of the World Economic Outlook. These revisions in global growth is due to the hardening of commodity prices and mounting inflationary pressures. The war in Ukraine will accentuate the global stagflationary recession when inflationary expectations are becoming unanchored and the massive negative supply shock in the global economy will reduce growth further (Roubini 2022). The volatility in energy prices – the spike in oil prices to well above $100 per barrel; along with hardening of global commodity prices – will add to the uncertainties. Roubini (2022) highlighted that a deep stagflationary shock is also a nightmare scenario for central banks, which will be damned if they react, and damned if they don't.

Against the backdrop of mounting macroeconomic uncertainties, the real GDP growth for 2022-23 is projected by monetary policy committee (MPC) at 7.8% with Q1:2022-23 at 17.2%; Q2 at 7.0%; Q3 at 4.3%; and Q4:2022-23 at 4.5% (RBI, 2022). The thirty third meeting of the (MPC - constituted under section 45ZB of the Reserve Bank of India Act, 1934 - was held from 8-10 February 2022. The MPC retained the status quo on repo rate at 4%. The reverse repo rate under the liquidity adjustment facility (LAF) also remained at its status quo rate of 3.35%. There is no formal normalisation process yet, though the cut-off yield rate of variable reverse repo rate (VRRR) has risen to 3.99%. The marginal standing facility (MSF) rate and the bank rate stood at 4.25%. The MPC had decided to retain the 'accommodative stance' to revive economic growth on a sustained manner and mitigate the impact of COVID-19 on the macro economy. These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2 percent, while supporting the growth momentum.

The normalisation procedure for the monetary policy stance is crucial for the effective functioning of the term structure of interest. The term structure of interest rate refers to the link between short term and long term rates of interest. For instance, the call money market rates are below the repo rate in India. As per the RBI data published on 4th March 2022, the weighted average call money rate is 3.530%. The treasury-bill cut off price of 91days is 3.70%. The treasury bill cut off price for 182 days and 364 days was 4.19% and 4.52% respectively, as on 4th March 2022. On the long term rate of interest, the average yield on 10-year government bond increased to 6.76% in 4th March 2022.

There is mounting pressure on RBI to increase the policy rates due to inflationary pressures and the instability in global financial markets (due to impending taper tantrums and the plausible rise in the policy rates by US Federal Reserve) which can trigger capital flight. In India, the foreign exchange reserves increased by $ 55 billion in 2021-22 (up to 4 February 2022) to $ 632 billion. Correspondingly, the reserve money (adjusted for the first-round impact of the change in the cash reserve ratio) expanded by 8.4% (y-o-y) on 4 February 2022. In 2022 February, the growth rate of reserve money was 13.7%. The net foreign exchange reserves (66.80%) constitutes the major source of reserve money while the other components of the reserve money are the net RBI credit to government (34.77%), and government's currency liabilities with the public (0.22%) . The change in net RBI credit to the government to GDP is termed as seigniorage. In India, over the years, the seigniorage financing of deficit has been controlled due to inflationary pressures. In the next few paragraphs the levels and financing of deficit in India against the backdrop of union budget 2022-23 are discussed.

Fiscal Dominance : The Macro-fiscal Framework

While monetary policy has limitations to trigger the economy, fiscal dominance is crucial for economic growth recovery. The union budget 2022-23 has predominantly focussed on the public infrastructure investment for the sustained growth recovery, through crowding-in of private corporate investment. The taxonomy of crowding out—real and financial—has been treated in detail in literature (Chakraborty 2016). The *real* (direct) crowding out occurs when the increase in public investment displaces private capital formation broadly on a *dollar-for-dollar* basis, irrespective of the mode of financing the fiscal deficit. The *financial crowding out* is the phenomenon of partial loss of private capital formation, due to the increase in the interest rates emanating from the pre-emption of real and financial resources by the government through bond financing of fiscal deficit. The finance minister, from a position of strength, refuted these neoclassical arguments of crowding –out and she emphasized the significance of "crowding-in" effects of public investment on private corporate investment in the context of emerging economies like India. The empirical evidence also supports crowding –in rather than crowding-out effects of public investment in the context of India (Chakraborty 2016; Vinod, Karun and Chakraborty 2020). The mechanism through which public investment crowds-in private investment is through the multipliers related to capital infrastructure, and the union budget 2022-23 has given emphasis to this narrative.

In union budget 2022-23, the government has increased the capital spending to a record high of 2.9% of GDP. However, the fiscal deficit to GDP is 6.9% in 2021-22 RE as compared to the pegged 6.8%in 2021-22 BE. The fiscal deficit-GDP ratio was 9.2% in 2020-21. High fiscal deficit-GDP ratio of 9.5% of GDP in the RE of 2021-22 against the pegged 3.5% in 2021-22 BE was announced against the backdrop of macroeconomic uncertainty due to COVID-19 pandemic. However, a fiscal consolidation roadmap has also been announced to bring down the fiscal deficit to GDP ratio to 4.5% by financial year (FY) 2025-26. The revenue deficit GDP ratio is 3.8%in 2022-23 BE, as against 4.7% in 2021-22 RE. In 2020-21 actuals, revenue deficit to GDP ratio was 7.3%. In the times of pandemic, the high revenue deficit is crucial for economic growth recovery. The "golden rule" of fiscal responsibility and budget management (FRBM) was to phase out the revenue deficit. However, this rule was eliminated in the 2018 amendment of FRBM Act and the clauses relate to this is included in the Finance Bill of 2018. Reducing revenue deficit to zero in the time of pandemic is not feasible, as compression in revenue expenditure can affect economic recovery (Chakraborty 2022).

The revenue deficit to fiscal deficit ratio is 59.61% in 2022-23 BE. This ratio was 79.72% in 2020-21 actuals, and 68.40 % in 2021-22 (RE). The primary deficit, which is the difference between fiscal deficit and interest payments, is pegged at 2.8% in 2022-23 BE. The primary deficit to GDP has reduced from 5.8% in 2020-21 (actuals) to 3.3% in 2021-22 (RE). The primary deficit reflects the current fiscal policy stance of the government, without the legacy of past interest liabilities. The union budget 2022-23 needs to be co-read with the FRBM Act, which includes the statements of the macroeconomic framework and medium term fiscal policy cum strategy to reduce the current general government debt to GDP of 90.6% (Singh 2022). However, the efficacy of "cyclically neutral fiscal deficit" needs to be threaded with caution, because if the fall in GDP is a permanent drop from the trend growth rather than a transient deviation, it is incorrect to assume that an upturn in business cycle can eliminate the cyclical part of deficit (Chakraborty 2021).

The fiscal rules at the state level has been revised and borrowing limit of 4% than the 3% in the state FRBM with 0.5 per cent is efficiency parameter-linked to power sector reforms. In addition to this, a capital outlay of Rs 1 lakh crore is transferred to the states for strengthening their capital infrastructure development. However, against the backdrop of state elections, the union budget 2022-23 has not engaged in populist policy announcements to incentivize the "calculus of consent" of voters.

A threshold-ratio of debt and deficit and the fiscal rules might prove detrimental in the time of pandemic as it constraints the fiscal space. High public debt has no fiscal costs if real rate of interest (r) is not greater than real rate of growth (g) of economy. In the union budget 2022-23 BE, the fiscal deficit to GDP ratio is pegged to be 6.4%.

There is an increasing recognition of the fact that public investment has suffered from fiscal consolidation when the national and subnational governments have over-adjusted to the fiscal rules by capital expenditure compression (Chakraborty 2021). Therefore, the emphasis on the public infrastructure investment in the union budget 2022-23 is crucial for strengthening the gross capital formation. This is especially when the credit infusion, the predominant component of economic stimulus package has limited impact. The next few paragraphs deals with the analysis of credit stimulus and the financial stability.

Credit Stimulus and Financial Stability

Credit infusion into the economy has been the predominant narrative of pandemic economic stimulus programmes in India. The RBI has done a heavy-lifting to support the economic growth recovery through liquidity infusion strategies. The operation twist – simultaneous buying (long term) and selling (short term) of bonds has led to elongation of maturity structure of bond markets, by postponing the refinancing risks to engage in the economic growth revival process. The RBI has also engaged in targeted repo operations to provide liquidity to the stressed sectors of the economy. Has the credit infusion into the economy been an effective strategy for economic recovery? Stiglitz and Rasheed (2020) highlighted in their paper titled "Which Economic Stimulus Works?" that the credit-related economic stimulus has limited multiplier effects. It is also cautioned that the credit infusion might also lead to mounting non-performing assets if there is no corresponding growth of credit in the economy.

The data on credit deployment for the month of January 2022 was published by RBI (collected from select 39 scheduled commercial banks, accounting for about 92% of the total non-food credit deployed by all scheduled commercial banks) on 28th February 2022 showed that the non-food bank credit growth stood at 8.3% in January 2022 as compared to 5.9% in January 2021, on a year-on-year (YoY) basis.

The composition of outstanding credit showed that credit deployment to agriculture (12.4%) was relatively smaller than the credit to industrial sector (26.3%) and service sector (25.1%) as per the outstanding credit figures in January 2022. The large industries received 20.4% of total credit deployment, while micro industries and medium industries received 4% and 1.9% of total credit. The personal loans constitute 27.5% of total credit deployment, where housing loan constitute (13.4% of total credit deployment) the major component. The non-food credit at the aggregate level constitutes 99.3%of total credit deployment. The broad inference from the credit deployment statistics from RBI is an uneven access to credit when large industries accessed credit significantly higher than the small and medium industries.

The credit growth to agriculture and allied activities grew to 10.4% in January 2022 as compared to 8.5% in January 2021. The credit to industry improved to 6.4% in January 2022 from 0.7% in January 2021. The credit growth to services sector registered 7.3% in January 2022 as compared to 8.1% in January 2021. Within the service sector, the credit growth is registered in 'NBFCs', 'transport operators' and 'tourism, hotels and restaurants'. The "Personal loans" has noted a robust growth rate by 11.6% in January 2022 from 8.7% in January 2021. The priority lending is given as memo in credit deployment statistics by RBI, which constitute 37.5% of total credit. The priority lending includes agriculture (11.7%), micro and small enterprises (10.7%), medium enterprises (2.4%), housing (4.2%), educational loans (0.4%), renewable energy (0.01), social infrastructure (0.01), export credit (0.2) and credit to weaker sections (7.6).

The Financial Stability Report published by RBI in December 2021 showed that macro stress tests for credit risk indicate that the gross non-performing asset (GNPA) ratio of scheduled commercial banks may increase from 6.9% in September 2021 to 8.1% by

September 2022 under the baseline scenario and to 9.5% under a severe stress scenario. The report further clarified that the scheduled commercial banks would, however, have sufficient capital, both at the aggregate and individual levels, even under stress conditions. The capital to risk-weighted assets ratio (CRAR) of scheduled commercial banks (SCBs) rose to a new peak of 16.6% in September 2021. As per Basel III stipulations the norm of CRAR is at 8%. CRAR is also called capital adequacy ratio (CAR), which is bank's capital by its risk-weighted assets. The provisioning coverage ratio (PCR) (the percentage of funds that a bank sets aside for losses due to bad debts) was 68.1% in September 2021.

The uneven growth recovery in India is a matter of concern. Given the limitations of credit-infusion related economic stimulus packages on equitable growth, the welfare policy measures by the fiscal authorities, especially for the poor income households and small business firms are crucial. Strengthening employment guarantee programmes is also crucial for arresting the uneven recovery.

Is Climate Change is more fiscal than monetary?

On the monetary policy front, integrating climate change is a matter of debate. Economists have highlighted that monetary policy does not have sufficient toolkits to integrate climate change criterion. Hansen (2022) analysed the ways to examine the toolkits of central bank policy to combat climate change and warned that "*hastily devised policy rules unsupported by empirically grounded quantitative modelling could backfire if or when climate policy targets are missed, harming reputations of central banks and weakening their ability to act in the future on a variety of fronts; and could compromise central bank independence in the longer run*". Hansen (2022) also highlighted that "*climate change mitigation targets added to currently well-defined mandates may generate excessive expectations and unwarranted confidence in the abilities of central banks to address this important social and economic problem while diverting the attention away from fiscal policy*".

Hansen (2022) explained the significance of modeling systemic risk and climate change in support of rules-based policy for financial stability; and how to quantify the exposure of financial institutions and businesses that receive their loans to uncertain climate change. The climate-focused stress test conducted by the central banks is an upcoming policy tool to address long term possibilities of climate change and slanting central bank portfolios towards green technologies (Chakraborty, 2021a). Such green stress test is to assess how the banking system is exposed to climate risks and uncertainties. Such test was first conducted by the Bank of England.

The US Federal Reserve Chair Jay Powell also explained that the Fed has asked the lenders to articulate their risk exposure and how they can mitigate such risks. The Reserve Bank of India has published a chapter on greening monetary policy, however there is no further communication on toolkits. Raghuram Rajan, the former RBI Governor, mentioned that central banks should turn their focus to the financial stability of the green investments instead of asking whether to buy only green bonds, not brown bonds, which is primarily "fiscal" decisions (Chakraborty, 2021a). The broad consensus is that central banks should focus on price stability and financial stability. However, this can be refuted by the concern that climate change is a crucial determinant of financial stability and it is significant to integrate such climate related risks and uncertainties in financing investment decisions (Chakraborty, 2021a). In general, economists are apprehensive about the efficacy of central banks in dichotomizing green bonds and brown bonds in their asset portfolio and moving towards a low carbon-emission enterprise.

Against this backdrop, the green bonds announced in union budget 2022-23 reflects India's commitment to decarbonisation from the fiscal policy front. Green bond is an onshore rupee denominated sovereign bond. This is a debt-instrument to strengthen green infrastructure projects. The sovereign green bonds will be the part of government's gross market borrowing in 2022-23. However, integrating climate change criterion in fiscal policy in India has not begun with green bonds announcement this year. India was the first ever to integrate climate change criterion in the inter-governmental fiscal transfers in 2014. The green bond is a policy strategy to finance "just transition" towards a sustainable climate-resilient economy. The Fourteenth Finance Commission was the first ever in the world to integrate climate change criteria in the intergovernmental fiscal transfers. This was when the Fourteenth Finance Commission integrated climate change as one of the criteria to determine the intergovernmental fiscal transfers to the 29 states. The Fifteenth Finance Commission has retained the criterion.

Within the environmental federalism frameworks, the "principle of subsidiarity" demands that the responsibility for providing a particular service should be assigned to the level of government closest to the people. Chakraborty (2021a) argued that this unconditional tax transfer through Finance Commissions is to compensate for the cost disabilities of the subnational governments for revenue foregone and other opportunity costs of protected areas in their path towards economic growth. However, ecological fiscal transfer is only one among many fiscal policy tools to ensure the climate change commitments. In addition to these fiscal transfers, the long term public financial management (PFM) tool like climate responsive budgeting at national and subnational levels is crucial to address climate change commitments. This PFM tool links national climate action plans to budgetary commitments. The roadmap and the analytical matrices to prepare climate responsive budgeting can also eliminate the "fragmented approach" by line ministries towards adaptation and mitigation in India (Chakraborty 2021a). However, differential tax rates can lead to "race to the bottom" to attract mobile capital and create 'pollution havens" through trading lower environmental quality for more mobile capital.

The recent initiative of green bonds is a significant step towards *greening of the fiscal policy*, by earmarking the sovereign bonds to a specific objective of green infrastructure and other. This might open an earmarking of bond financing towards human development as well in future, in addition to climate financing.

Conclusion

Given the constraints on monetary policy stance to exogenous supply shocks which are growth-dampening, relying on "fiscal dominance" is crucial for sustainable economic recovery. Globally, an accommodative fiscal stance has been maintained with high fiscal deficits to support growth recovery. In India, the union budget 2022-23 has emphasised on "crowding-in" effects of public infrastructure investment on private investment. The efficacy of rules-based macroeconomic framework – both monetary and fiscal – needs to be recalibrated to support economic growth, as fiscal conservatism can adversely affect growth process and accentuate macroeconomic uncertainties. The credit related stimulus has limited multiplier effects and also lead to financial instability, if the liquidity infusion is not adequately followed by the credit growth in the economy. Climate change risks and uncertainties affect sustainable growth process and there is an increasing recognition to integrate climate change commitments in fiscal and monetary policies. However, the monetary policy toolkit is often viewed as inadequate to deal with climate change commitments. There is a broad consensus among economists that fiscal policy is capable to deal with the climate crisis, and that the national budget is an important tool in this regard. The financing of climate change through sovereign rupee denominated green bonds – earmarked within the gross market borrowing programme for green infrastructure – is a right step towards making fiscal policies green in future. The global macroeconomic uncertainties from the war in Ukraine and the ever-mutating corona virus may impact the fiscal arithmetic in India, however the sustained economic growth recovery will depend on how the fiscal and monetary policies respond to the crisis.

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