



When Will Tightening Start?

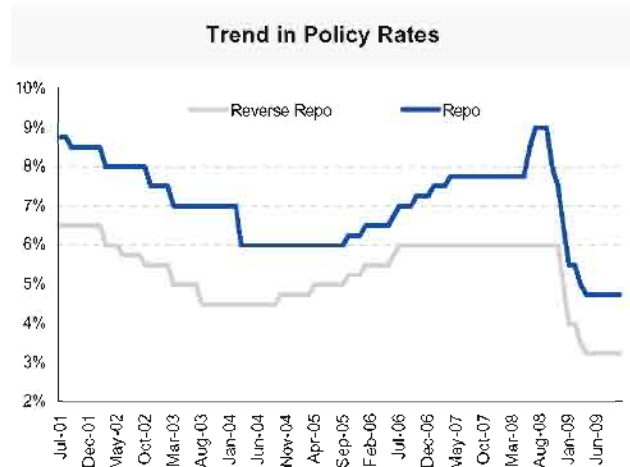
While we may heave a sigh of relief that we have been, to a large extent, untouched by the tsunami that wrecked havoc in the economy the world over, it would be well worthwhile to get some understanding of the various forces that were at play to help the turn-around.

Several tools were used to unleash liquidity into the markets in order to bring some semblance of stability into the financial markets. Many of the measures taken were well coordinated between several economies and this cooperative injection of liquidity helped the world economy to tide over what looked like insurmountable problems. But we all know that such largesse cannot be sustained for very long. In this article we have tried to peep into the probable economic outlook with regards to the tightening up of the fiscal stimulus in order to reverse the process.

In India monetary policy adjustments have been done time and again to stir up the economy. Between October 2008 and October 2009, the RBI has reduced the repo rate by 425 basis points from 9% to 4.75%, the reverse repo rate by 275 basis points from 6% to 3.25% and cash reserve ratio by 400 basis points from 9% to 5%.

Special refinance facility by RBI in the form of lowering of interest rates, increasing liquidity in the system, increasing

government expenditure, reduction of duties and taxes, subsidies, loan waivers, hike in salaries, etc. ensured that the financial markets do not come to a grinding halt, while some renewed traction is provided to industry.



Source: RBI, Morgan Stanley Research

In retrospect, as we have seen, all these measures seem to have worked rather well. The financial sector has benefited from the monetary largesse of governments both foreign and domestic. The massive infusion of liquidity by various governments made it easy for foreign institutional investors

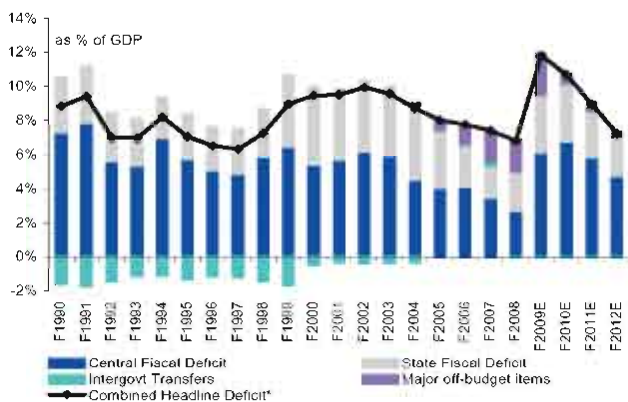
to access cheap finance. They have in turn leveraged the financial lifeline to invest in their own stock market as well as that of emerging markets like India. The rally in equity markets that has ensued as a consequence of this action has in turn encouraged domestic players to increase their participation in the equity markets thereby driving stock prices even higher. So much so even banks have joined the party and have made substantial investments in mutual funds. The real economy too has seen resumption of demand. Several industries have been experiencing effects of the lease of life provided to them and have indeed started gathering some serious momentum.

The automobile industry is one such example of an industry that gained from the largesse of the Pay Commission, tax benefits, etc. With rising salaries and easy finance as a lubricant, the propensity of purchasing automobiles has gone up considerably. Auto momentum consequently translated into auto ancillary momentum and so on. Similarly, the FMCG sector too saw some thrust and not only survived the hard period but flourished subsequently. The IT sector too has seen some reversal of fortunes aided by a rupee that saw substantial depreciation after the financial meltdown.

Thus, easy availability of finance, tax incentives and other largesse provided the much needed impetus to drive up the economy.

But as a fall-out of these stimulus packages, the fiscal deficit of the government has clearly increased. The budget of 2009-10 had projected the fiscal and revenue deficit for the year at 6.8 and 4.8 per cent respectively and figures for the first 5 months of the financial year (April – August) indicate that 46% and 55% of the respectively of the projected deficits have already been incurred.

Consolidated Fiscal Deficit (as % of GDP)

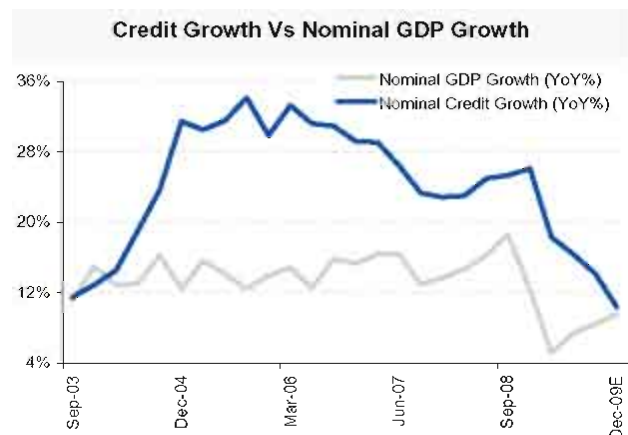


Source: RBI, Economic Survey, Ministry of Finance, Morgan Stanley Research

The central bank too has extended itself substantially to increase the volume of liquidity and reduce interest rates leaving little headroom left for further maneuvering.

The problem now is that financial markets have led the real economy recover with PE ratios touching higher levels before fundamentals caught up.

In order to keep pace the real economy needs to show a more robust recovery. The IIP figures that have just been released at 9.1% have been higher than anticipated and augur well for the real economy. However there are other issues like credit growth not taking off as per expectations. Credit offtake by the private sector which is essential for real industrial output growth has been poor. Credit growth of scheduled banks at 4.3% is much lower compared to 10.5 percent in the corresponding period last year has had its impact in petering down demand. Risk averseness is still high amongst banks which have resulted in reining in retail lending to a large extent. But with changing sentiments one could see risk appetite picking up leading to higher retail lending and consequently higher consumer demand. Hence one can expect the real economy to catch up with the financial markets going forward.



Morgan Stanley Research estimates; Source: CEIC, RBI, Morgan Stanley Research

Again due to the large government borrowing on the back of increased spending it has taken upon itself to rekindle the economy, the government's demand for money has gone up substantially. When demand goes up, the lender is bound to increase interest rates. This causes bond yields to rise. As a cascading effect, corporate yields and yields on other products too begin to rise and bond markets start turning bearish. Higher interest rate, on the other hand, has its adverse effect on industry profitability and,

consequently, equity markets leading to a possible slowing-down.

Hence the government and central banks have to perform a balancing act in framing fiscal and monetary policies in the short term. It is precisely for this reason that the government at various forums has started indicating that the current level of fiscal deficit is not sustainable and that the time is nigh when the central bank would have to pull in the reins to tighten the fiscal environment that has been prevalent since the financial catastrophe of 2008. Large deficits were justified in the wake of the financial meltdown but now clearly the tides are turning and hence governments across the world have started to plan the withdrawal of the largesse that has been sustained since the crisis. The recent decision on divestment of PSUs would go a long way in reducing the deficit chasm which would in turn soften yields giving the markets a fillip.

While “exit” seems to be the path to be treaded, the question, on everyone's mind is 'when is the right time' and how should the tightening be sequenced and phased out. The right time is critically important because if one were to slam the brakes too early, all the efforts of the past that have helped the recovery could come a cropper. On the other hand if one were to delay too much inflation could play spoilsport.

Thus both fiscal and monetary tools would be effectively used by the government and central bank to do the balancing act. The excise / CENVAT tax rates that were brought down from 16% to 8% at the height of the crisis might get revised upwards.

The monetary tools at the disposal of the central bank are repo and reverse repo rates, CRR and SLR (Do refer to our lessons on Prof. Simply Simple™ on these subjects). While the Reserve Bank has left most of these tools untouched in its policy announcement in October 2009, it gave an indication about its future intent by increasing the SLR from 24% to 25%. Since most banks over the last couple

of months have been following a conservative lending policy, they had parked a large portion of their investments in government bonds beyond their SLR limit. Hence the Reserve Bank's decision of increasing the SLR has hardly had any effect on the economy. Hence, one should read the decision more as a pointer for future course of action that the Reserve Bank is likely to take. Our Prime Minister too has recently stated that fiscal stimulus cannot go on indefinitely.

The recent government decision on divestment too indicates that the government is extremely serious about harnessing the fiscal deficit. Such objectives too point towards a policy of gradually tightening of the 'monetary' noose.

Elsewhere in other parts of the world too, the governments and central banks have started to ponder over this issue. There is increasing talk of a well-planned coordinated effort in tightening the monetary policies just like the coordinated effort at the time of loosening the monetary strings in the wake of the meltdown. Gradual tightening has been seen in several countries as well which can be construed to be lead indicators.

Australia and Singapore have already begun a phased exit from extraordinary fiscal stimulus. Though not explicitly withdrawing fiscal stimulus, most countries are targeting smaller deficits next year. With the export recovery likely gathering steam, and only a gradual withdrawal of fiscal stimulus at best, it does not appear that fiscal exit strategies will have a huge impact on growth in 2010. This gradual withdrawal of (excessive) stimulus is justified because either it is no longer needed given the swift recovery (Singapore's case), or is even leading to overcapacity (China's case).

Thus as it appears, 2010 will witness the gradual withdrawal of fiscal stimulus across several countries globally in perhaps a well planned out and coordinated manner

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