

# The Importance of Being Prudent



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The Finance Minister presenting the Union Budget for the current FY said that he had chosen to be prudent in sticking to the fiscal consolidation roadmap rather than go for an expansionary budget. In addition, the government set up the N K Singh Committee to review the working of the Fiscal Responsibility & Budget Management Act (FRBM) and suggest the way forward. Back in 2012 the Kelkar Committee had recommended the roadmap that the government is currently following.

The committee has also been tasked with exploring the option of having a fiscal deficit target range rather than a point number, and to consider counter-cyclical fiscal policy targets. Both of these options are aimed to creating flexibility in case of a cyclical downturn in the economy leading to a fall in tax revenue. Under the current system, a shortfall in tax collection has to be made up by a cut in expenditure. In recent years these expenditure cuts have been to capital expenditure / plan expenditure, which then have the potential to further accentuate the slowdown leading to a vicious cycle.

The committee has submitted its recommendations to the Finance Ministry and the same are expected to be discussed during the presentation of the upcoming Union Budget on the 1st of February.

### Understanding the importance of fiscal prudence

Why is the fiscal deficit so important? We look at two aspects that are affected by the fiscal balance: inflation and credit rating.

#### Inflation

Economics teaches us<sup>1</sup> that prices follow the principle of supply and demand. If aggregate demand rises, prices tend to rise. Conversely weak demand is associated with weak pricing power and lower inflation. One important component of demand is government consumption. Thus, higher government spending/high fiscal deficit is associated with higher inflation.

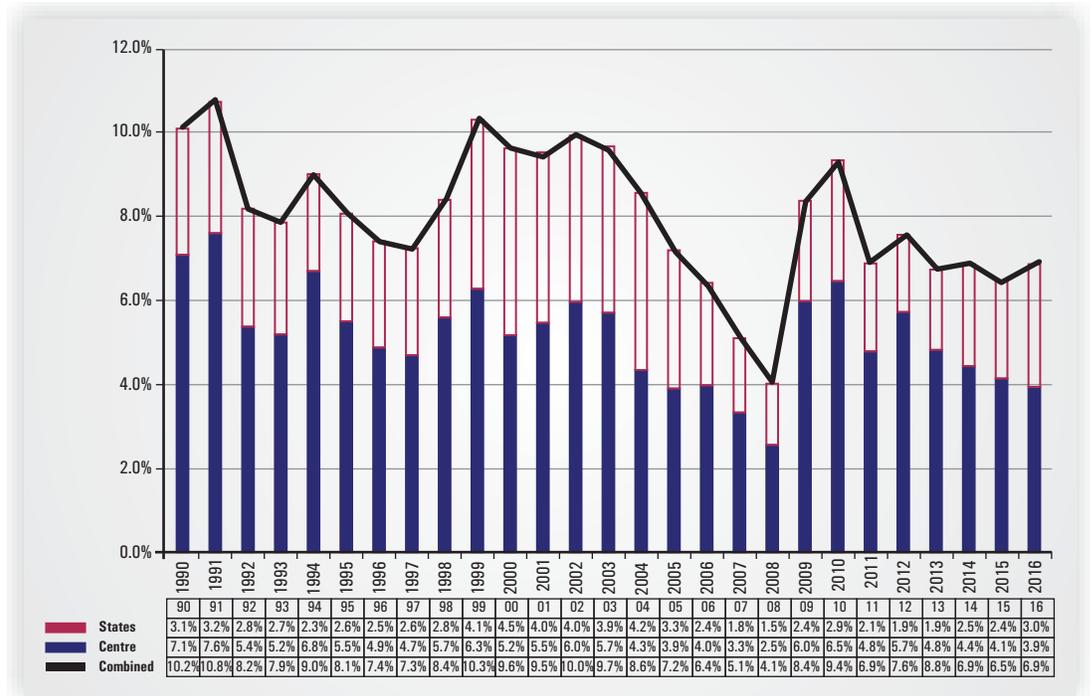
Since reaching a low of 2.5% of GDP in FY 2007-08, the central fiscal deficit rose sharply peaking at 6.5% in FY 2010. Since then there has been a steady march to lower deficits with the current year's target of 3.5% effectively cutting the deficit by close to half as a share of GDP.

However, inflation remained high till mid-2014. What explains the persistence of inflation despite the consolidation of fiscal deficit by the central government?

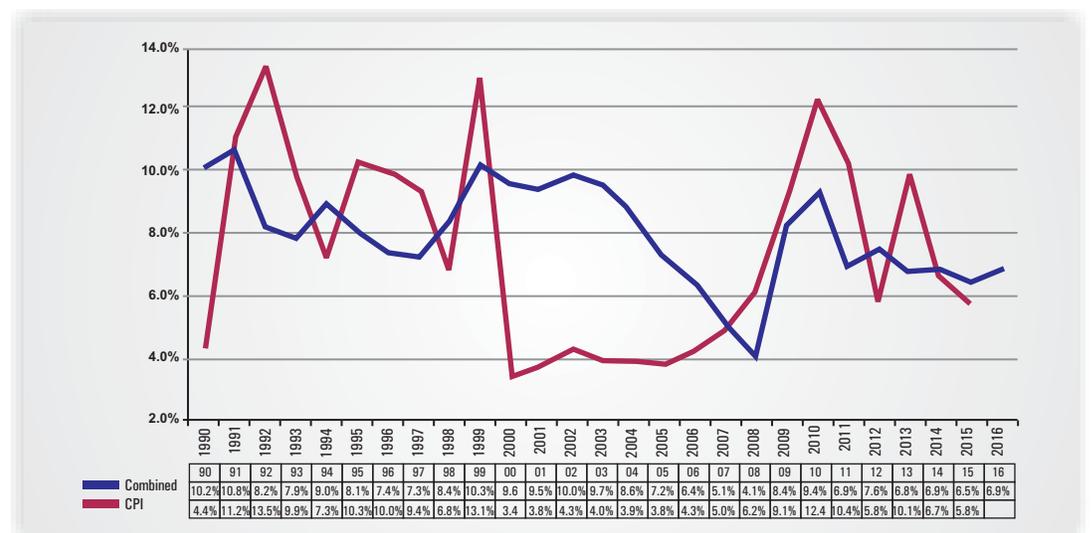
From an economic standpoint, the central deficit is only part of the general government deficit. We need to add the deficits of the state governments to the central fiscal deficit. Seen from this vantage point, there has

been little by way of consolidation of fiscal deficit post 2012. Aggregate state fiscal deficit has risen from a relatively benign 2% of GDP to 3% in the last three years negating the centre’s consolidation.

The following two charts illustrate this movement. The first chart shows the evolution of general government deficit decomposed between the centre and states. Fiscal deficits were generally in the 8-10% of GDP range through the 1990s. The period from 2003 to 2008 saw a compression of the deficit following the enactment of FRBM. More recently there was a large expansion in the general government deficit post 2008. Initially this was led by the central government, but more recently even as the central deficit has reduced, state deficits have widened to keep the general deficit at nearly the same level since 2011.



The second chart illustrates the relationship between the fiscal deficit and inflation. In the 90s as fiscal deficits remained in the range of 8-10% of GDP, inflation stayed high and volatile. As can be seen, the period 2003 to 2008 saw a compression of the deficit accompanied by soft and stable inflation. As the deficit widened with the fiscal stimulus of 2009, we saw inflation rise sharply. Inflation remained elevated and it is only now that we have seen softening inflation – again with consolidation of the general deficit from the high 2010 level.



What these charts illustrate is the close relationship between fiscal policy and inflation. In the recent past, CPI inflation has dropped thanks to the drop in global commodity prices and benign food inflation. Food inflation is affected by factors such as the minimum support prices and seasonal food price volatility. It does appear that, on average inflation appears to be driven by aggregate demand (and consequently the fisc).

The implication for monetary policy and rates is clear. As the RBI targets 4% inflation there needs to be a clear and credible progress towards fiscal consolidation. The period of 2003-2008 suggests that if the economy "buys into" a promise of credible consolidation, CPI inflation can indeed sustain at 4%. In this context the FRBM committee needs to set tighter goals for fiscal deficit if the target is to reduce inflation further from current levels.

### Sovereign Credit Rating

The second major impact of high fiscal deficits has been the credit rating of India. For several years, rating agencies have maintained India's credit rating at the edge of Investment Grade.

Rating Agency	Rating	Outlook
S&P	BBB-	Stable
Moody's	Baa3	Positive
Fitch	BBB-	Stable

Rating agencies have pointed to India's per capita income and the fiscal position of the government as the major impediments to higher ratings. India has the highest fiscal deficit (general government) among its peer BBB/Baa rated countries. A comparison of India's macro data relative to other emerging market peers is below:

Developing Countries Statistics	Median by rating group			
	India	A	BBB	BB
Indicators as of 2015				
GDP Per Capita (US\$)	1582	16558	9942	5111
GDP Growth (real, %)	7.6	1.3	3.0	3.0
CPI Inflation (%)	4.9	2.2	1.5	2.4
Current Account to GDP (%)	-1.1	-0.8	-2.9	-1.7
External Debt to GDP (%)	17.3	-26.5	38.4	52.2
Govt Revenue to GDP (%)	20.8	35.0	28.0	30.9
Fiscal Balance to GDP (%)	-7.2	-1.5	-2.9	-3.7
Govt Debt to GDP (%)	67.2	36.4	44.0	41.1
Interest Payments % of Revenue	23.1	3.7	8.1	7.7

Source: Standard & Poor's Sovereign Risk Indicators, Oct 2016<sup>ii</sup>

The strongest indicators for India are to do with growth and external debt. Growth is the highest for a major economy, while external debt to GDP ratio is low relative to other emerging economies. These indicators are the reason why India is rated investment grade even at the low level of income. GDP per capita (nominal or adjusted for purchasing power) is low relative to its peers.

The indicators of fiscal performance are clearly out of line with similarly rated peers. The fiscal deficit indicator is the worst among similarly rated peers, and is one of the worst even when compared to BB/Ba rated countries. The general indebtedness is similarly one of the worst in the peer group and compares unfavourably even with lower rated emerging markets. As a result of the high debt, interest costs make up a high proportion of government revenue. India's interest burden is by far the worst in its peer group.

The weak fiscal position is clearly a constraint to the rating and counters the strengths in GDP growth and low external indebtedness. We must remember that if growth slows down this puts downward pressure on fiscal revenues. If the NK Singh committee proposes relaxation in deficit due to cyclical slowdown, we may be in a situation where slow growth is accompanied by fiscal deficit expansion. The two factors together may pose a real risk of rating downgrade to below investment grade.

## What can we expect from fiscal policy?

The Medium Term Fiscal Policy Statement released with the Union Budget projects the centre's fiscal deficit to fall from the current year's budgeted 3.5% of GDP to 3% in the next two years. However the various states are running close to 3% fiscal deficits, which implies a general government deficit of close to 6% of GDP. The NK Singh committee may even provide for some relaxation in deficit targets which could lead to expansion of deficit from the medium term projection. While clarity on the same is expected during the presentation of the Budget, a few factors at play are the likely steps by government to counter the effects of demonetization on growth, as well as the need to compensate states for the upcoming rollout of the GST.

## Implications for investments

The risk to fiscal expansion would be felt in persistent inflation and risk to the sovereign rating. The last cycle reminds us that a credible progress towards lower deficits is required for keeping inflation low and stable. If deficits rise from here on, there is the risk of higher – and potentially unstable – inflation.

Fiscal deficit also has a direct implication for monetary policy. The RBI had warned about the quantity and quality of deficit in the last cycle. Higher deficits would constrain the ability of the central bank to cut rates.

The period of 2003-08 tells us that if growth were to return, the fiscal position improves as tax revenues pick up. This could lead to a "Goldilocks" situation if the increase in revenue were used to lower the deficit keeping inflationary pressures at bay. On the other hand, if the recovery is delayed and the fiscal targets are relaxed, we may face slow growth with inflation.

India has been the recipient of substantial Foreign Portfolio Investments, some of which could be at risk in the event of downgrade below investment grade.

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- i. Readers wishing to explore this area further should look up The Fiscal Theory of the Price Level
  - ii. <http://www.spratings.com/sri/>

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**Source of Data:** RBI, GOI, website of rating agencies, Axis MF Research