The Budget after Demonetisation*

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Having announced that it is advancing the date for presentation of annual budgets by a month from end-February, the Finance Ministry is in the midst of preparations for next year's exercise. But with the attention of economic analysts diverted to the unfolding crisis created by the government's demonetisation decision, little attention has been paid to what would be the first budget to be presented in the post-planning era. It was to be expected that the implicit and explicit rules adopted by the government to make allocations under different heads of capital and current expenditure would have attracted much attention. But with the announcement of demonetisation on November 8, which is expected to affect the level of GDP and revenue collections from direct and indirect taxes in financial years 2016-17 and 2017-18, the principal concern now is the impact that the exercise would have on the government's fisc.

Even before the demonetisation was announced, figures from the Controller General of Accounts on the budgetary position of the Centre gave cause for concern. Though the revenue receipts of the government during April-October 2016-17, at 50.7 per cent of the budgeted figure as compared with 51.7 per cent in the corresponding period of the previous year, appeared comfortable, revenue expenditures that were 60 per cent of the total, had taken the revenue deficit to 93 per cent of the budgeted totalin the first 7 months of the year. One reason for this was probably the underestimation by the government of the outlays it would have to make for implementing the Seventh Pay Commission's recommendation.

The economic contraction resulting from demonetisation is expected to slow output growth, reduce revenue collections and further widen the revenue and fiscal deficits. Estimates of the actual likely fall in GDP growth during 2016-17 vary, ranging from 1 to 2 percentage points and more. But there are some who expect a sharp slowdown in the immediate future. Ambit Capital, an oft-quoted Mumbai-based equity research firm, has estimated that the demonetisation-driven cash crunch will result in GDP growth falling to as low as 0.5% in the second half of financial year 2016-17, as compared to 6.4% in first half of financial year 2016-17. Since the Union Budget assumed a nominal GDP growth rate of 11 per cent and the RBI had set itself a target of 4-5 per cent inflation, the Budget was possible based on an estimate of real (adjusted for inflation) GDP growth of about 6.5 or 7 per cent. If GDP growth slows much more and if revenue collection are hit by the cash crunch precipitated by the demonetisation, it is quite likely that the government would be faced with a potential explosion of its revenue deficit. That together with lower than expected receipts from disinvestment and spectrum sale would mean a higher fiscal deficit as well.

It is in this background that another consequence of demonetisation has to be assessed-that flows from the sharp increase in deposits of the demonetised notes with the banking system. On November 28, 2016, the Reserve Bank of India in a press release declared that upto November 27, 2016, demonetised worth Rs. 8.45 lakh had been returned to the banking system. Since then the estimate has been revised to Rs. 11.55 lakh crore, as reported in the Press Conference presenting the Fifth Bi-monthly

Monetary Policy Statement 2016-17 held on December 7, 2016. That leaves Rs. 3.89 crore, much of which is expected to reach the banking system by 31 December, 2016.

For the banks, the receipt of these deposits was a burden, since they had to pay depositors interest on their deposits which could not be withdrawn at the pace they were being generated because of the ceilings on cash withdrawals. On the other hand, lending or investing against these deposits to earn interest that can cover the cost of deposits was problematic because much of the money would be withdrawn as ceilings on withdrawals are relaxed. Moreover, such lending against large deposits received over a short period of time can not only be risky for a banking system already overburdened with stressed assets but extremely difficult to implement. Thus, it was to be expected that the banks would seek to park this money in interest earning instruments with the central bank. This should be possible since only the cash impounded to meet the cash reserve ratio (CRR) requirements imposed on the bank cannot earn interest.

Any such transfer of the interest burden created by the inflow of the demonetised notes from the banks to the central banks would affect not only the balance sheet of the central bank, but also its income-expenditure balance with the likelihood that the central bank will not only see a fall in its profit, but also record a loss. To foreclose such a peculiar possibility the RBI decided to impose a temporary CRR of 100 per cent on the incremental deposits received by the banks. Banks would have to pay interest on deposits but cannot earn any returns by lending or investing that money. This was in place for a brief period before the government and the RBI agreed to increase the ceiling on government securities that can be floated by the central banks under the Market Stabilisation Scheme (MSS) from Rs. 30,000 crore to Rs. 6 lakh crore.

The MSS was originally launched to help the RBI address the difficulties it was facing in managing the exchange rate when large foreign capital inflows were strengthening the rupee and adversely affecting exports. To counter that the RBI had to buy up foreign exchange to reduce its supply in the market. Since the resulting increase in the foreign exchange assets of the central bank implied an equivalent increase in its liabilities, there was an unplanned increase in the supply of money. To neutralise that, the RBI had to resort to "sterilisation" through the sale of assets other than foreign exchange, principally government securities. Since fiscal reform that limited government borrowing from the central bank had resulted in a fall in the accumulation of government securities with the latter, the RBI was soon running out of government securities to sell.

This led to the launch of the Market Stabilization Scheme in April 2004. Under the scheme, the Reserve Bank of India is permitted to issue government securities to conduct liquidity management operations. That is, depending on requirements, it can issue and sell securities to the banks to withdraw excess cash circulating in the system; or it can buy back such securities, to infuse liquidity into the system. The ceiling on the maximum amount of such securities that can be outstanding at any given point in time is decided periodically through consultations between the RBI and the government. Since the securities created are treated as deposits of the government with the central bank, it appears as a liability on the balance sheet of the central bank and reduces the volume of net credit of the RBI to the central government to match any increase in foreign exchange assets that need to be sterilised. By increasing such liabilities subject to the ceiling, the RBI can balance for increases in its foreign exchange assets to differing degrees, controlling the level of its assets and, therefore, its liabilities. The money absorbed through any sale of these securities is not available to the government to finance its expenditures but is held by the central bank in a separate account that can be used only for redemption or the buy-back of these securities as part of the RBI's operations . As far as the central government is concerned, while these securities are a capital liability, its "deposits" with the central bank are an asset, implying that the issue of these securities does not make any net difference to its capital account and does not contribute to the fiscal deficit. However, the interest payable on these securities has to be met by the central government and appears in the budget as a part of the aggregate interest burden. Thus, the greater is the degree to which the RBI has to resort to sterilization to neutralize the effects of capital inflows, the larger is the cost that the government would have to bear, by diverting a part of its resources for the purpose.

When the scheme was launched in 2004, the ceiling on the outstanding obligations under the scheme was set at Rs. 60,000 crore. Over time this ceiling has been revised both upwards and downwards, touching Rs. 2.5 lakh crore in November 2007. Now, post-demonetisation, to deal with the completely different problem of excess deposits with the banks and give them a safe instrument in which they can invest those deposits the government has enhanced the ceiling on the MSS to Rs. 6 lakh crore and the RBI has been rapidly exhausting that level by issuing cash management bills under the scheme and selling them through auctions. Between December 2, 2016 and December 13, 2016, the RBI has sold as much as Rs. 5 lakh crore of cash management bills alone. It is likely that the ceiling on the MSS would be further raised. From the point of view of the RBI, its purpose has been served, since it has been able to lift the unsustainable 100 per cent CRR on incremental deposits, since those deposits can now be invested in these securities. The interest on those bills is amounting to around 6.2 per cent, and this is the cost that the government would have to carry as interest burden on the total amount of securities issued. Assuming that the RBI holds on average Rs. 6 lakh worth of such bills for a period of three months, the additional interest burden on the government's budget would be more than Rs. 9,000 crore

This obviously has additional adverse implications for the revenue and fiscal deficit targets. If the government still adheres to its deficit targets, at a time when the recommendations of the 7th Pay Commission have been implemented, this could imply a substantial cut in capital expenditures or social expenditures or both. Such expenditure reduction would worsen the contraction set off by demonetisation. Political compulsions do pressure the government to set aside its targets and borrow more to spend. But given its desire to please international finance with curtailed deficits and its obsession with hype and propaganda, the government may choose to manufacture another illusion under which it claims to be stimulating the economy without spending. But that may be difficult to sell in India's emerging cashless economy.

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