Budget 2023, Financial Markets & Keynes on Interest Rates: A Study of Short-term Reactions

Satya Prasad Padhi

Imports can generate external economies for a robust domestic resurgence in an import-led development regime, and budgetary provisions, particularly higher budgeted capex spending, can amplify these economic signals. This may encourage greater domestic investment, which may be correlated with greater domestic real savings (capabilities). However, the short-term reactions of the bond and stock markets reveal that budget signals have not had much of an impact and the financial markets expect the pre-budget growth trajectory. The current study argued that these issues have arisen as a result of the persistence of a high interest rate policy that disregards broader involvement in growth and domestic capacities (and real savings). As a result, financial markets become speculative and capital flows are cautious.

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Introduction

The budget is a financial statement that outlines the government's short-term fiscal goals and is valid for one year. Nonetheless, the manner in which policymakers manage the fiscal deficit has consequences for future periods. The budget for 2023 informs projected revenues and expenditures, but in an election-year budget, it is difficult to regulate revenue expenditures; it is a parameter or may increase. Similarly, revenue receipts would be on expected lines if growth is consistent with its projections or experience a slight decline due to post-budget tax concessions or rationalization (also see, Bhanumurthy, 2023).

Consequently, fiscal deficit projections remain the focal point; however, even in an election-year budget, fiscal deficit projections cannot be traced back to populist positions. Regardless of which party is in power, every budget since 1991 has sought to achieve a predetermined development objective. The budgets recognize that India's post-planning domestic capabilities cannot compete internationally in an open-economy, market-friendly policy environment. It can enter a new technological frontier by adjusting to imports of intermediate and final goods that introduce innovations or newness in production processes. Imports also bring in a variety of goods that can sustain a higher level of consumption-driven economic growth. Even in election years, a road map and commitment to this development are necessary because the economy is adjusting to pandemic disruptions and job creation is a major concern. The current budget for 2023 identifies a number of areas of concern that call for reduced tariffs on sector-specific imports. Additionally, capital expenditures have increased to approximately 10 Lakh Crore rupees, primarily for physical and digital infrastructure. The plan then focuses on easing some immediate supply constraints that are preventing the adjustment to imported technology and intermediate goods.

Maintaining the government's fiscal glide path is a crucial factor to consider. If the fiscal deficit is out of control, it has repercussions for projected capital expenditures and commitment to development goals. As is typically the case with Indian responses, fiscal deficit challenges can result in a reduction in capex. In this situation, however, if the supply bottlenecks are not eliminated, there may be long-term consequences.

Management of revenues and expenditures is a component of deficit management. If, as is hoped, external borrowing and the 91-days Treasury Bills route are not resorted to, management also depends on the responses of the bond and stock markets as well as the reactions of various domestic real market participants to budget statements. However, the emphasis is not on the debt-to-GDP ratio, which financial markets also monitor and forecast, but rather on ultra-short-term budget responses (Hicks, 1935). It is an examination of a week or two's financial market responses that are unaffected by changes in the real sector or factor prices, etc.

Budget announcements have direct effects on key players such as market sentiment, and the financial markets. Policymakers have the option of informing participants about budget signals associated with specific development objectives and resulting fiscal deficits, and then allowing them to adjust. Given how financial markets operate, this would be a naive strategy, according to Keynes (1936). Investing in these markets can be guided by a budget-informed study of long-term prospects, or they can be guided solely by considerations of capital appreciation. In the latter case, not only would the participants anticipate budget proposals, but they would also employ more sophisticated strategies. Using the metaphor of a beauty contest, Keynes (1936: 156) explained how, to quote, "….the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. it is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees."

If speculative investments reign supreme, financial market development can derail growth and fiscal deficit projections and place unwarranted strain on the economy. In order to moderate and modulate any excessively speculative market investments, policymakers should, when formulating budget announcements, try to anticipate what the "average option of the budget statement believes the average opinion to be". The policymakers can then plan the appropriate announcements and signals to influence the outcomes in favor of the budget objectives.

As we will discuss below, strategic options are not limited to the domestic participants alone. The Fed, for instance, is a large and significant player that would attempt to determine how different nations would organize their budgets and behave during the recovery phase following a pandemic, and then formulate its own plan.

Budget & Financial Markets

There is evidence that budget formulation took into account the behavior of market sentiments and the RBI, taking into account current conditions and anticipated budget fiscal deficits or government commitment to development. It would also be expected that the RBI would adhere to a stringent monetary policy, keeping in mind not only inflation control, but also the way in which its policy influences prices and financial market signals, which can play a role in an import-led development strategy. Given the tight monetary policy, it is anticipated that substitution principles will determine how the financial market, particularly the bond market, and other players respond to the budget.

Scenario 1: the Bond Market

In the months preceding the budget, the stock market has been declining, while bond yields have increased by approximately 7.5%. In addition to this, the anticipation of a budget deficit and government borrowing could have led to prior bond market commitments based on the anticipation of a lower post-budget yield (and higher capital gains). However, the budget proposal contains a surprise: it also proposes to rely on small savings to cover the deficit projections. This resulted in a net fiscal deficit (net borrowing of approximately 11 lakh crore) that was significantly less than the market had anticipated (net 13 to 14 lakh crore).

An assumption could be that agents who have already made speculative commitments would opt to sell in a panic if the lower expected yield on the bond market and the capital gains did not occur. If so, this can have an adverse effect on the government's budget. Such market signals have the potential to increase or maintain higher pre-budget bond yields and government borrowing costs.

However, it is also possible that policymakers anticipated that the RBI's hands would be tied due to its tight monetary policy. In addition, the issue for the RBI is that import-led adjustment occurs with low domestic savings when adjustment brings forward capital flows and preserves the savings-investment identity within an open economy framework. Capital flows are influenced positively by a higher policy rate, particularly one that is in line with the Fed rate. In this case, the RBI will be guided by the Fed rate, which is anticipated to remain elevated. The message is that the Fed will maintain its hawkish stance because "there is still a long way to go" before price stability is achieved.

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In setting a higher policy rate, the RBI is also constrained domestically. It must consider the costs of government borrowing; some borrowing is permissible within certain parameters; and secondly, while high interest rates signal capital flows, they can undermine import-led adjustments. Assume that the Reserve Bank of India (RBI) maintains its preference for a slightly higher policy rate or that agents anticipated such higher rates.

On the surface, this (or the failure to lower the policy rate) implies that a higher policy rate (interbank lending market) will result in a higher interest rate, allowing for banks' higher government bond holdings, budget provisions for higher investments, etc. As banks and insurance companies are the major players in the Indian bond market and the overall loan market, bond market yields will go up or stay at a higher level.

All of this, including panic selling in response to a smaller-than-anticipated net fiscal deficit and higher interest rates resulting from government policy, contributes to the maintenance of a higher bond yield (and, likely, higher costs for the government to borrow).

However, budget expectations could be the reactions of financial markets, and the ensuing higher yield can attract new bond market participants, such as FIIs and mutual funds. In the Indian context, banks and insurance companies dominate the bond market, but their international exposure to global markets is limited, as is their ability to respond to global signals. They are still susceptible to exogenous shocks.

Indian mutual funds (which typically follow the lead of FIIs) and FIIs are not major players at the moment, but they are monitoring Fed rate and foreign currency market developments. If the RBI rate is in sync with the Fed and there is a higher bond yield comparable to those in the United States, they may also come in large numbers, and the bond yield will not increase by that much. If these players begin to play a larger role on the Indian bond market, it will be more in sync with global financial signals.

One possibility is that policy makers intentionally set the lower-than-anticipated net fiscal deficit, anticipating both the market's reaction and an increase in the RBI repo rate. This is done in order to increase yield and attract FIIs to the bond market. In the future, the initial higher yield will result in lower yields and borrowing costs.

However

a. US Bank (usbank.com) (2023) reports that the current high Fed rate has seen a spike in US yields from 1.5 percent to 4 percent in a year's time. In addition, the message that the US fight with inflation is far from over (especially in recession times) implies that FII might not come in a big way, as per expectations; one also has to factor in foreign exchange rates. The Fed could also anticipate that in post-pandemic revival phases, what average opinion will dominate all nations and how they will try to attract FIIs. There are suggestions that it can refrain from investing heavily in its domestic market (to finance US government borrowing) and instead provide incentives for foreign governments to invest in the United States.

b. There are obstacles for FIIs in the Indian bond markets (Acharya, 2011; Patnaik, et al., 2013), and the continuing institutional adjustments to entice them would be a gradual process. What if higher policy rates and import incentives drastically affect the stock market's earnings yield? This may result in FII investing in the stock market. Signals from FIIs continue to be significant, and this could result in a flight of money from the bond market, maintaining upward yield pressure. If this is the case, informational signposts for any firm commitments are not definitive. Investment commitments in either market would be speculative at best, with agents creating more sophisticated strategies and stratagems to estimate how others are behaving, etc. FIIs would be wary as well.

c. Banks would be more than willing to hold the safe and mandatory government bonds. However, if imports and capital flows also put pressure on investment needs (banks provide different financial services), then banks may have to raise deposit and lending rates, and yield rates would also rise, and so on. A higher bank interest rate may also cause a shift away from small savings and put upward pressure on the fiscal deficit.

Scenario 2: the Stock Market

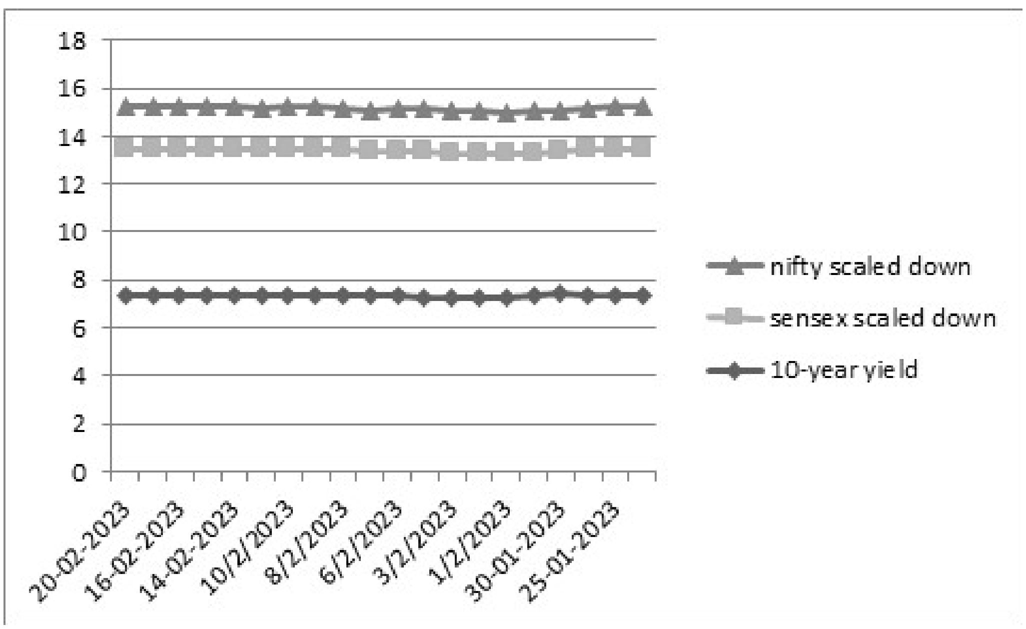
Assume the Budget signalled a lower-than-expected fiscal deficit, and the expected lower yield does not materialize. In addition, the RBI is likely to maintain a tight monetary policy by setting a policy rate capable of containing inflationary pressures while matching that of the Federal Reserve. That is, budget announcements would be followed by a higher policy rate that provides a positive signal to FIIs. One issue is: are policymakers targeting a strong stock market instead that can also partly reduce the fiscal deficit and also finance capex in an alternative financial model?

The higher policy rate and the panic reaction to a lower than expected fiscal deficit might induce a flow of funds towards the stock market.

However, a higher yield on the bond market is expected to persist, which could be a deterrent. A higher policy rate and interest rate could offset prospective adjustments to imports, so diminishing the likelihood of increasing earnings per share. Increasing bank interest rates can impede the expansion plans of some businesses, particularly those that are not well positioned in terms of imports or capital flows. In other words, the RBI policy rate might result in a lack of macroeconomic expansion and supply restrictions, allowing for interdependencies. Recall that recent positive export developments, such as the exports of metals, capital, and electronics, etc., are imbedded in interconnections between formal and informal industry. In this situation, any failure to meet deficit targets or volatility in capital flows can exert pressure on the budget deficit. This can translate into inflationary pressures in the face of supply restrictions. This might spark a chain reaction of increased interest rates.

The Data

On the interest rate front, there is no second guessing what the "prevailing average option" believes to be the "prevailing average option." The only surprise element would be whether the budget predicts significant opportunities either in realignment or macro investment and expansion prospects. The opportunities and expectations should also outweigh the as-



sumption of higher interest rates while also accounting for the expectations of exchange rates, debt hangovers, etc. Or does the budget represent the normal, routine process of requesting authorization for spending and the support of specific revenue sources? Only data could tell.

Using pre- and post-budget days to define a three-week period from 23-01-2023 to20-2-2023, the long-term bond yield, the Nifty, and the Sensex have not changed noticeably. The data indicates that the budget announcement had an immediate slight dampening effect on the yield of long-term bonds; perhaps agents discounted larger panic selling, the role of small savings, and the possibility that the government would stick to the projected smaller-than-anticipated deficit. Thereby, the brief period demonstrates that there has been no discernible change in the bond yield, allowing for a higher pre-budget yield. In line with expectations, the higher yield also did not stimulate the stock market. The spread among these variable remaining the same, agents continue to maintain their risk-adjusted pre-budget portfolio selections. Trading in these markets would be limited to speculative, short-term gain-related transactions, if it occurred at all. One inference could be that policymakers were one step ahead of the market at the time, anticipating market reactions in order to control excessive speculation. However, if this data can be projected over a long period of time, it may suggest that financial markets on the development front do not have high expectations. The stability does not anticipate long-term growth.

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At the same time, the lack of any speculation in these financial markets (or spikes), say, that aims at long-run growth prospects or the lack of FIIs flows in response to budget signals, is a worry. Is there a slowdown in the impetus coming from import-led growth, or is it that the economy, with lower domestic savings and capabilities, is slow to adjust to newer imports that demand a transition to a much higher technological frontier with higher skills and specializations? Or that growth momentum is negated by financial market signals? Such considerations should weigh in while interpreting the responses.

Interpreting the Data

The financial market signals, in the short term, how bond prices and stock (market) prices are substitutes, taking demand-side factors into account. As expected, a higher yield or expectation of a higher yield causes a decline in stock prices or indicates that a higher rate of interest has a negative impact on earning expectations that are tracked by the stock market. Otherwise, risk perception could prompt agents to diversify their portfolios, and bond and stock holdings can be complementary (Johansson, 2010). Consequently, with respect to the Indian situation, as budget has not had any change in risk perceptions (or spread between equity price and bond yield is not affected), the pre-budget risk perceptions will be maintained; the agents will continue to maintain their portfolio selections. This should be the standard response in situations with a constant amount of money.

However, growth is a significant factor to consider. As we move on to the possible high growth prospects associated with productivity growth, the emphasis is not solely on the generation of savings, but also on increased investments that indicate greater efficiency. In a domestic economy dominated by banks, a higher rate of interest may attend to both the aspects of growth.

However, a new situation emerges when the Indian economy must adapt to imports, allowing for low domestic capabilities (and savings). Allowing for trade imbalances, FIIs also contribute to domestic savings in order to accommodate import-driven investment and consumption demands. The stock market is regarded as the most significant market for capturing such opportunities.

Assuming that Indian-centric FIIs have a stock market bias, and that this market is important for current and future growth prospects, or a robust revival, the relevant literature also demonstrates how different financial markets provide different financial services, and therefore banks play a complementary role in the stock intermediation process. One market may take the lead, and the contribution of the other market to the growth outcome is endogenous (Arestis & Luintel, 2001).

Furthermore, the literature emphasizes that this growth-specific complementarity is unique to more liquid financial markets and absent in more volatile circumstances (Levine & Zervos, 1998; Nicolau, 2010). When both markets are liquid, or when the anticipation of a stock market is not negated by the availability of bank loans on unfavorable terms, growth occurs. Insufficiency in such liquidity causes volatility and lower growth.

Perspectives on Monetary Policy

The receptivity of financial markets to import-led realignment is an aspect of liquidity. A tight monetary policy will serve the purpose well. However, the introduction of import-led novelty also generates new domestic growth impulses. Domestic firms that are unrelated to import-led growth would face increased competition as a result of existing interconnections, and they would strive to improve and introduce their own innovations. Such external economies are essential for greater domestic capabilities (and savings). If one visualizes such additional growth impulses, but domestic savings plus redirected international savings do not attend to them, they remain dormant, or agents will attempt to attend to the growth via informal financial arrangements (Kaldor, 1970) and divert real savings. This may also be a source of volatility due to its inflationary effects or diversion of existing real resources.

If this is the case, one hypothesis is that the fundamental cause of volatility is the adoption of a tight monetary policy that relies solely on substitution effects in the financial market to signal real sector adjustments. First, the policy demands a substitution of domestic savings with FIIs, especially in the given circumstances of the import-led prospects. This commitment to a higher interest rate signifies a financial commitment to transition from the bond market to the stock market, which is primarily the market that anticipates the higher growth. It is possible that the higher yield can be absorbed by high growth prospects and higher capital productivity. However, the stock market's anticipation of future profits (say, capital gains with a lower risk premium and such liquidity) is accompanied by a definite anticipation of the interest rate (bank intermediation) and how labor market skills adjust. The continuing slowdown of the domestic savings may exert unwarranted pressure on interest rates, potentially nullifying the expectations. Two, the previously alluded-to decline in domestic savings is due to the fact that a tight monetary policy can only address import-driven realignments. The disregards the domestic growth momentum that can be traced to the external economies created by imports (see Padhi, 2022b), especially for those whose expansion plans rely on loan or bond markets. This neglect of possible improved domestic capabilities (and real savings) and strengthening of inter-linkages, however, reduce the economy's proper domestic capacity to absorb imports in a timely manner. FIIs would be cautious.

Given the problems of FII and imports, but allowing for the importance of imported technology and capital flows in transitional economies, an alternative is to opt for advanced knowledge-seeking FDI that is more stable (i.e., less prone to global short-run rebalancing strategies); however, FDI correlates with higher domestic investment and savings, indicating higher domestic capabilities (Padhi, 2022a; 2022b).

FDI correlates with higher domestic investment and savings, indicating higher domestic capabilities

Therefore, a tight monetary policy cannot avoid certain contradictions. As previously mentioned, greater capital productivity in growth can absorb a higher yield. However, this growth in capital productivity is a function of macro expansions a la Kaldor's technical progress function (Kaldor & Mirrlees, 1962; Padhi, 2022a) that result from capital intensity increases.

Two, stock market liquidity explains both present and future growth by allowing for the complementary role of bank loans, but the same liquidity can also facilitate the rebalancing of global portfolios, particularly in the Indian context, which demonstrates a continued reliance on FIIs with higher accumulated FIIs (Eichergreen & Gupta, 2014; Basu, et al, 2015). In addition, if the tight money policy substitutes FIIs for domestic savings, this rebalancing would be accompanied by an increase in pressure on bank loans. Both can counteract the liquidity and growth effects.

The third contradiction requires further explanation. A tight monetary policy optimizes substitution effects and maintains the health of the various components of the financial markets. In doing so, it assumes that when financial markets restructure, there is a corresponding realignment in the real sector. It assumes so despite the fact that it recognizes that there is latent or actual inflationary pressure facing supply constraints, that government expenditures and their components, as well as consumer and business commitments and future plans, can be sticky at times, or remain unfulfilled or go through course corrections, and that realignments would also induce unintended consequences, like domestic revival processes that put pressure on inflation and existing interconnections and domestic capabilities.

Capital requirement barriers are only applicable in instances where enhancements must target a particular efficiency that necessitates higher fixed costs.

In other words, the monetary policy assumes that relative price signals reign supreme regardless of output level. However, it should not be overlooked that price signals are most effective when the economy has already reached full employment, has adjusted to an imports-led transition to a steady state level, or is in a transitional phase in which an imports-led adjustment is accompanied by strong entry barriers that prevent the external economies from operating. This is not the responsibility of monetary policy. Capital requirement barriers are only applicable in instances where enhancements must target a particular efficiency that necessitates higher fixed costs. If there are no entry barriers, full employment outcomes illustrate how the economy gradually and steadily adapts to a given novelty, and this tendency of decreasing returns routes necessitates a lower interest rate!

Concluding Remarks

Why, in conclusion, does Keynes emphasize financial investment strategies in which each individual will attempt to anticipate the actions of others, some will predict the average opinion, and others will use increasingly sophisticated strategies to varying degrees? In these instances, Keynes (1936; 159) held, investments in financial market are made only with the intention of making short-run speculative gains through capital appreciation angles, and if so, "when the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." He believes that this is an important example of what happens when a monetary policy stance ignores individual actions based on a careful examination of investment prospects.

The above understating needs caution. The monetary authorities, the RBI, can take pride in the fact that their superior knowledge of how financial markets work has resulted in the containment of undue, short-term speculation in the financial markets. The tight monetary policy has worked and the financial markets are not ill-done in that respect. So far, so good; however, the lack of any speculation in these financial markets (or spikes), even the long-term ones that target long-term growth prospects, or the absence of FIIs flows in response to budget signals, is a worry. Why is there such a lack of concern for speculative activities that are intended to stimulate investment and growth on the financial markets? Why does the current budget's immediate impact not indicate that these investments will be made?

All depend on expectations regarding the stance of monetary policy. Suppose there were to be long-term speculations guided by favorable investment prospects, and that bond market and stock market euphoria would correlate. It would signal an anticipated decline in interest rates, and the monetary policy stance would need to adjust accordingly. However, if agents are confident that policymakers will maintain a tight monetary policy, the short period during which financial investment commitments will be made, will be open-ended and uncertain (or higher, unknown financial risks). How much wiggle room does the domestic monetary policy have?

Nonetheless, the focus shifts to what cannot be done with a tight monetary policy, which otherwise facilitates the efficient operation of the financial market through substitution effects. Only full employment or, in the case of India, an imported technological frontier, both with a given pool of domestic and international savings, justifies the application of the substitution principle. Maintaining the status quo requires prompt responses to signals of re-allocation prospects that savings decisions or preferences provide (which the financial market can provide). It is what it is. Its primary objective is to achieve price stability through growth regulation. Growth governed only by substitution effects would also rein in financial market investments that are speculative.

However, tight monetary policy is also adhered to in periods of higher investment commitments, any period of analysis is open-ended, such as during budget-led revival phases. Even substitution prospects are clouded by speculation and a lack of information about what will occur in the future. If controlled or modulated, both domestic and international latent growth prospects can, like latent inflation, contribute to speculation. This can cause people to think extensively without prompting action (liquidity preference). If investment commitments do take place at all, they are more likely to be speculative, with a spike in the yield of bonds with a shorter maturity as compared with the ones with a longer maturity, and at best, one would anticipate a more prolonged slowdown. It is true, as evidenced by the data, that India's monetary policy has not left leeway for such disruptive short-term speculation. But thanks to the same policy stance, these short-term speculative activities are at least theoretically made possible by the uncertainty it breeds about whether to invest in growth or not in the first place.

For the time being, then, the wait and watch continues and it's over to Lewis Carroll, "Now, here, you see, it takes all the running you can do, to keep in the same place."

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