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SOCIO-ECONOMIC VOICES

"Tackling Regional Disparities: A New Fiscal Approach"

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How India Must be Re-shaping its Global Financial Role Amid Geopolitical Risks

Intro: This week on **Socio-economic Voices** we have **Sarbartho Mukherjee, Senior Economist at CareEdge,** who offers actionable insights on easing inflation pressures, leveraging India's demographic dividend, and tackling regional disparities. This interview with **Mahima Sharma** of **Indiastat** provides a compelling roadmap for policymakers, businesses, and citisens alike. He details strategies to ensure India's economic resilience, sustainable growth, and a stronger role in the global financial system. Are we ready to take on the much-needed reforms? Read on...

MS: How do you foresee the RBI's monetary policy evolving in response to current inflation trends in India? And what needs to be done further to ease out the masses who are already facing job losses and unemployment?

SM: The RBI will remain cautious of the evolving risk to inflationary outlook before opting for any changes in the monetary policy stance or rates. While the overall GDP growth is projected to remain healthy around 7% in FY25, the concerns about inflationary pressures currently seem to dominate the narrative of the MPC members.

The risk to inflation primarily stems from elevated levels of food inflation led by vegetables, pulses and cereals. **Risk to food inflation continues to remain high as critical agrarian regions in North India and Eastern Gangetic plains continue to witness a significant deficit in rainfall,** despite all India monsoons being above normal. However, if the distribution of the monsoon improves resulting in some moderation in food inflation, we could see a shallow rate cut by the end of the fiscal year. By that time, the RBI will have greater clarity on the monetary policy trajectory of the developed markets. **According to the latest estimate by RBI, the natural rate of interest is between 1.4% and 1.9%. With the RBI projecting FY25 average inflation at 4.5%, the real interest rate stands close to 2%, providing opportunity for up to 50 bps cut in repo rate.**

The ongoing concerns about job losses and unemployment are partly structural and partly driven by the global economic cycle. **Structural factors impacting job creation include the employability and skill levels of the workforce, as well as increasing capital deepening.**

Despite healthy economic growth, India has not fully succeeded in translating this growth into productive employment opportunities. Ideally, at this stage of economic development, we would expect a shift of labour from agriculture to industries and services. However, the share of employment in agriculture has increased and remained above pre-pandemic levels. The government has attempted to address this issue in the current budget through apprenticeship programs and employment-linked incentives for firms. Additionally, **the global monetary policy cycle**

has remained tight, and growing uncertainties due to geopolitical developments have softened growth in developed markets (DM). This has not only impacted India's merchandise exports but also impacted the demand of services exports. However, this is likely a cyclical issue that is expected to improve as DM central banks eventually ease their monetary policies.

MS: How do you envision India's role in the global financial system changing over the next decade?

SM: India's influence in the global financial system will be significantly shaped by four key factors: **its economic strength, geopolitical influence, technological advancements, and commitment to sustainable development.** As one of the fastest-growing major economies, India is poised to become one of the top three economies globally. This growth will enhance its influence in global financial markets and international economic policies. **The rapid ascent of both private and public enterprises, in line with economic growth, has positioned the country among the top in terms of market capitalisation.** India's growing economic clout is evident from its increasing weight in major stock market indices such as MSCI-EM and the inclusion of Indian government securities in major bond indices.

Beyond economic strength, India's role as a regional power in a multipolar world is becoming more pronounced amid rising geopolitical fragmentation. **India holds membership in key international economic forums like the Shanghai Cooperation Organisation (SCO), BRICS, and the G20. Recent free trade agreements (FTAs) with trading partners, such as the India-UAE Comprehensive Partnership Agreement and the India-EFTA Trade and Economic Partnership Agreement (TEPA), will further bolster India's economic, trade, and geopolitical influence.**

The global trend towards diversifying supply chains, exemplified by policies like "China Plus One," will further integrate India into the global economy as it emerges as a viable alternative. **This shift not only enhances India's economic prospects but also strengthens its position in international trade and investment networks.**

Technological advancements, including innovations like the Unified Payments Interface (UPI), will drive the next phase of India's growth. **The fear of the dollar's weaponisation,** particularly following the financial sanctions imposed after the Russia-Ukraine war, has heightened the demand for alternative financial infrastructures. This shift is driving countries and businesses to explore and adopt diversified financial systems to mitigate risks associated with reliance on a single dominant currency. Additionally, **India's commitment to sustainable development and climate action** is likely to shape global financial strategies, particularly in areas like green finance and renewable energy investments.

MS: How do you see climate change influencing public finance and trade policies in India?

SM: Climate change has been a trend that will continue to shape India's macroeconomic policies. The country is committed to achieve the Net Zero emission target by 2070. This will see more policy support from the government both at state as well as central level. On one hand, we can expect higher budgetary allocation and subsidies towards greener technologies and sectors such as renewable energy and electric vehicles.

We have already seen increased emphasis on policies such as **PM Surya Ghar Muft Bijli Yojana, reduction in taxes on EVs and Hybrid cars, Green Energy Corridors, Bio Energy Program, Green Hydrogen mission and PM-KUSUM Scheme.** At a global level, the country is also pushing the **One Sun One World One Grid (OSOWOG) with the International Solar Alliance,** which will reduce our dependence on conventional energy sources which are largely dependent on imports. Over the next decade, we could see much more budgetary support for these policies.

While these policies are looking for long term solutions, India also remains highly vulnerable to the adverse effects of climate change. **The incidences of uneven rainfall, flooding and adverse weather patterns have increased**

significantly. The union budget presented last month saw special allocation for flood relief in several states like Sikkim, Assam, Bihar, Uttarakhand and Himachal. Government has been supporting the agriculture sector which continues to witness several disruptions from weather related vagaries.

On the trade front, policies on climate change in a few developed countries have been an issue of concern particularly for a developing country like India. **Policies such as Carbon Border Adjustment Mechanism (CABM) in the EU has been a trade protectionist measure in the form of a non-tariff barrier.**

Carbon intensive industries like steel, cement and fertilisers are expected to be negatively impacted by such trade barriers. Going ahead, the free trade negotiations with trading partners are likely to focus on such barriers.

MS: How can India better leverage its demographic dividend in macroeconomic planning and public finance?

SM: Leveraging India's demographic dividend is not a straightforward solution. In today's world, where manufacturing and services are increasingly capital-intensive, human capital is often replaced by machines, robots, and AI. Therefore, investing in **human capital is crucial to enable the young labour force to move up the skill ladder, partially mitigating the impact of automation on low-skilled jobs.** Without such investment, the risk of squandering the demographic dividend remains high.

Moreover, without the benefits of the demographic dividend, supporting the current population will become a burden as society ages. From a public finance perspective, increasing expenditure on the social service sector is essential. **Currently, general government expenditure on health and education is a meager ~5.2% of GDP.** Prioritising these areas is crucial to ensure sustainable growth and social stability.

MS: How do you see India's fiscal deficit impacting its sovereign credit ratings moving forward?

SM: India's fiscal deficit which soared during the pandemic is unlikely to impact its sovereign ratings adversely as the government remains focussed on bringing it down to 4.5% of GDP by FY26 following the glide path laid out by the finance ministry. In fact, the government is pitching for an upgrade in sovereign ratings citing strong growth momentum and higher resilience of the economy. India's foreign exchange reserves have **risen from pre-pandemic levels of ~USD 480 billion to USD 670 billion as of August 2024** which is sufficient to cover more than 10 months of imports.

Higher buffer in terms of forex reserves will also protect the country against any shocks from capital outflows. India was upgraded and put under the lowest investment grade (BBB by S&P) category in 2007 and since then there has been no major change in the country's rating category, even though the outlook was revised. Since then, **the Indian economy has matured and several structural reforms were undertaken such as Goods and Services Tax (GST), bankruptcy code, and various initiatives to enhance the ease of doing business.** India has now emerged as a major contributor to global growth and as one of the fastest growing major economies of the world.

The country has zero sovereign default history and most of the debt is denominated in rupee which minimises the risk of default. In short, the current **ratings provided by the international rating agencies does not justify the strong macro-economic fundamentals of the country.**

Hence, there is a need to relook at the methodologies used by such rating agencies. Having said that, it is essential for the policy makers to continue to focus on fiscal discipline and strengthen the resilience of the economy further.

MS: What future fiscal strategies could the Indian government employ to manage its public debt effectively?

SM: India's general **government debt currently stands at just over 80% of GDP. According to the latest Union Budget, interest payments are projected to increase by 9.3% year-over-year, raising the interest burden to 24% of total expenditure.**

Given the significant costs associated with managing this debt, it is essential to focus on reducing the country's overall debt levels. **Public debt can be reduced through two primary methods:** implementing austerity measures to cut expenditure or fostering economic growth to outpace debt levels. While maintaining fiscal discipline by controlling the fiscal deficit is important, India should also aim to grow out of its debt. Macroeconomic principles suggest that when nominal growth exceeds nominal interest rates (i-g), the government can sustain a primary deficit while maintaining a stable debt ratio.

Therefore, if India can sustain strong economic growth, it can effectively manage debt levels even with a deficit. Considering the country's stage of economic development, the **focus should be on growth rather than drastic reductions in public expenditures to manage public debt levels.** Considering the absence of robust social safety nets and the increasing need for social sector spending, a significant reduction in expenditure could hinder growth prospects. Instead, the **emphasis should be on the increasing quality of expenditure, prioritising areas with higher multiplier effects over the medium term, such as health, education, and infrastructure.**

MS: Geopolitical breakdown is just getting wider. The threat of China looms large. What Macroeconomics piece of advice do you have for India in the financial economy sector? And why?

SM: Geopolitical risk has escalated in recent years and is expected to continue as power struggles intensify during the transition from a unipolar to a multipolar global order. This transition is particularly significant for India, given its complex and often contentious border relationship with another major power, China. The current economic survey has addressed this "China Conundrum." Over the past decade, China has emerged as the world's manufacturing hub, and India must find a way to integrate into the global supply chain without becoming overly dependent on China. **Trade between the two countries remains substantial, with Chinese imports surpassing USD 100 billion in FY24.**

Since 2020, India has scrutinised Chinese investments, requiring mandatory government approval. However, **it is crucial to acknowledge the need for foreign investments to promote local manufacturing. Despite the China Plus One Strategy and increasing calls for 'friendshoring' to enhance supply chain resilience, Chinese firms continue to maintain a strong hold on the global supply chain.**

The solution to the 'Chinese Conundrum' is not purely economic but will be driven by strategic considerations.

a. Chinese firms benefit from substantial subsidies and government support, and they have a history of **dumping cheap products, which distorts domestic industries.**
b. Additionally, opening critical sectors to Chinese investments can have significant implications for domestic producers. While countries like Vietnam may compete for a share of the China Plus One strategy, India should focus on **improving the ease of doing business and attracting foreign investment.**
c. Simultaneously, it is crucial to **enhance domestic manufacturing capabilities** through initiatives like the Atmanirbhar Bharat, particularly in key sunrise sectors such as battery manufacturing and chip production.
d. Furthermore, India needs to look beyond a goods export-led growth strategy by maintaining **a sustained focus on high-value services export.** The labour intensity of manufacturing is anticipated to decrease with the rise of automation, while demand is expected to remain sluggish due to demographic changes in Western economies. As societies age, the demand for goods tends to decline, whereas the demand for services increases.

MS: What future changes in public finance could help mitigate regional economic disparities within India?

SM: Regional disparities in India represent a significant and multifaceted issue, encompassing economic, social, and infrastructural dimensions. For instance, states like **Bihar have a Per Capita Net State Domestic Product (NSDP) of approximately ₹50,000,** comparable to underdeveloped African economies. In contrast, states such as **Tamil Nadu, Karnataka, Maharashtra, and Gujarat boast an average Per Capita NSDP exceeding ₹250,000.**

Geographical challenges, particularly in the Himalayan and North-Eastern states, contribute to higher development and administrative costs. The budget has addressed these challenges by granting these states Special Status, which ensures additional financial support from the central government. However, **states experiencing regional disparities due to other factors require distinct and tailored approaches.**

To address the issue effectively, a **multifaceted approach** is required:

- Decentralisation
- Investment in the social sector
- Targeted investments in specific regions. Economic growth in India is predominantly concentrated in urban centers. To distribute the benefits of development more evenly, **it is essential to allocate resources for the creation of Special Economic Zones in underdeveloped states.** This would attract both private and public investments, thereby stimulating economic growth in these areas.

Empowering local bodies with additional resources is also crucial, as it allows for the implementation of development projects that cater to the specific needs of each region. Furthermore, focusing on social sector expenditures, particularly in health and education, is vital for empowering the local population and enhancing the overall productivity of human capital.

In addition to policy actions, it is necessary to reassess the devolution of funds to states. The weightage of 'income distance' for determining the share of state funds (horizontal devolution) was **reduced to 45%** under the 15th Finance Commission, **down from 62.5% in the 11th Finance Commission.** Lower allocations for states with higher income distances can hinder their development. Therefore, it is imperative to increase the weightage of income distance to ensure equitable and inclusive development across the country.

About Sarbartho Mukherjee

Sarbartho Mukherjee is currently a Senior Economist at CareEdge. He was previously associated with the economic research teams at Mahindra Group, ICICI Bank, UBS, and Global Data. Over the past decade, he has closely monitored the Indian economy, with a particular focus on public finance, monetary policy, financial markets, and trade policy. His work has involved policy research, impact evaluation, and engagement in various policy advocacy projects.

About the Interviewer

Mahima Sharma is an Independent Journalist based in Delhi NCR. She has been in the field of TV, Print & Online Journalism since 2005 and previously an additional three years in allied media. In her span of work she has been associated with CNN-News18, ANI - Asian News International (A collaboration with Reuters), Voice of India, Hindustan Times and various other top media brands of their times. In recent times, she has diversified her work as a Digital Media Marketing Consultant & Content Strategist as well. Starting March 2021, she is also a pan-India Entrepreneurship Education Mentor at Women Will - An Entrepreneurship Program by Google in Collaboration with SHEROES. Mahima can be reached at media@indiastat.com

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