Behind the plunge

High volatility of stock markets is a response to global movements, domestic concerns over disruptions

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THE LAST FEW days have seen stock markets witness a sharp fall and high volatility. Developments in the Indian markets are related both to global financial markets as well as to domestic policy. Markets also factored in the effect the budget would likely have on the RBI's monetary policy decision.

One important perception in recent months has been that the market was perhaps overvalued. The last 10 years of data show that the "trailing" price-to-earnings ratio of a broad measure of companies was historically high. In other words, earning growth has been stagnating, but markets have continued to expect that earnings would pick up. This expectation kept stock prices high. The feeling that there may be an asset price bubble appears to be part of the rationale for bringing back the long-term capital gains tax in the budget. If the intent was indeed to bring about a correction in equity prices, by putting tax and additional compliance costs for households, then the process appears to have started. A dividend distribution tax on dividend paid by mutual funds is similarly expected to make equity mutual funds less attractive. The process of correction has been more than helped by global market movements.

Global markets moved sharply after there was a surprise increase in US pay-roll data. The US job market numbers showed an addition of 2,00,000 jobs in January 2018. Along with the increase in jobs, primarily in the private sector, wages witnessed a more than expected increase. This led to the expectation that the US economy may be picking up faster than expected. Inflationary pressures due to higher economic activity and the increase in wages may lead the Federal Reserve Bank monetary policy to be tightened faster than previously expected. As a consequence, interest rate increases could be more than what the markets were expecting. This change in the perception about future liquidity conditions appears to have hit US financial markets and with them, markets across the world. Indian markets, too, moved down.

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At the same time, there were concerns that the RBI would adopt a tighter stance of monetary policy. In the policy announcement on Wednesday, February 7, the RBI has kept the policy rate unchanged. However, the Monetary Policy Committee has raised concerns about inflation. Its projection of inflation is higher than the target rate of 4 per cent, suggesting that it may think about raising interest rates at some point to bring it down. Any perception that interest rates would rise and liquidity will tighten tends to make the stock market less attractive.

According to the Monetary Policy Committee, risks to inflation arise from the effects of higher house rent allowance, higher custom duties, higher minimum support prices for kharif crops, higher oil prices and global commodity and financial markets.

A key concern is the fiscal deficit. The RBI notes that the fiscal slippage as indicated in the Union budget could impinge on the inflation outlook. It adds that apart from the direct impact on inflation, fiscal slippage has broader macro-financial implications, notably on the economy-wide costs of borrowing which have already started to rise.

The RBI has pointed to commodity prices, which have been rising in recent days. There could be an upward pressure on fuel prices. This could have a direct impact on the subsidy bill. Further, when global oil prices were low and declining, the benefit was not passed on to the consumer. The government increased excise duties. If the government tries to keep excise the same, to maintain its revenue, there may be inflation. If, on the other hand, it cuts excise, the fiscal deficit may rise. Both are reasons why the RBI may raise interest rates. Only if global oil prices do not rise will neither of these happen.

The other key concern is the increase in MSPs of crops in the budget. In the past, it has been seen that an increase in miniumum support prices has been correlated with high food inflation. This was in a system in which the key foodgrains procured were wheat and rice, both of which were important elements of the consumption basket. Now almost all crops are part of the list of crops to be procured. Higher procurement prices could feed into higher food prices. Alternatively, if they are sold to consumers through the Public Distribution System at below the cost of procurement, there will be an increase in the subsidy bill. This could push up the fiscal deficit and again be inflationary.

The huge increase in the coverage of the health insurance scheme in terms of both the population covered and the amount of payout means that health insurance premiums paid by the governent could rise if the scheme is implemented as promised. The fiscal impact of this in the coming year may be small due to the lack of the government's capacity to deliver, but as the system is put in place and people start using the scheme, there may be a significant expenditure increase.

At the same time, it is not clear that the impact of the GST on additional revenue will happen immediately. It is not just that compliance takes time, it is also hard for producers in the informal sector to suddenly become 12 per cent or 18 per cent more productive so as to be able to pay higher taxes and survive in the formal sector. These disruptions, which will have long-term gains for the economy, may lead to difficulties in the short run. This again mean risks to the fisc.

Even if this year's fiscal targets are met, thanks to the government's limited ability to spend and some good luck on global prices, it is only for the official fiscal deficit targets. Items like bank re-capitalisation bonds that do not show up as additional borrowing in the budget, and are not part of the fiscal deficit, nonetheless impact bond market conditions. Rising long-term interest rates and failed bond auctions by the RBI indicate that bond markets are already seeing a tighening even without a monetary policy announcement.

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