Budget and the twin deficits

By now, hundreds of thousands words have appeared in the Indian print media, about the budget. I still thought of articulating a few points, not much commented. In his speech, the Finance Minister stated that it is the "*beginning of a journey towards sustained growth of 7-8% within 3-4 years; macroeconomic stabilization that includes lower inflation, lesser fiscal deficit and a manageable CAD* (current account deficit)." I have several problems in relation to each of the points, namely inflation, fiscal deficit, and "CAD". Indeed, in many ways, this seems to be an "impossible trinity" of macroeconomic policy objectives.

As for the first, regular readers of "The Other Side" would recall my argument that policy-makers need to rely more on supply-side measures; lowering demand through tighter monetary policy would surely affect growth and employment creation. Also, the demographic profile of an economy is equally relevant to the issue of acceptable inflation.

Turning now to the fiscal deficit, the Finance Minister has prescribed very ambitious targets. Quite apart from their feasibility, the question is whether fiscal contraction is really necessary -- or is it a tribute to the power of the rating companies? This power is truly amazing considering their performance in recent years, in relation to both sovereign ratings and, of course, the AAA ratings given to thousands of mortgage backed securities. As for the former, they did not foresee the crisis in east Asia, practically until the eve of its occurrence. Nor was the sovereign debt crisis in Greece predicted in a timely fashion. And, quite possibly, the financial market crisis of 2008, which led to the largest drop in global output since the deflation of the 1930s, would not have been as severe had the rating companies not distributed the coveted AAA rankings so liberally.

This is not to deny that continued high fiscal deficits can be a problem if they increase government debt to unsustainable levels. The generally accepted number is that alarm bells should ring if the ratio of debt to nominal GDP comes close to 90%. What is our record? The number has actually come down from 58.9% on 31/3/2008 (and an even higher 65.5% at the end of fiscal 2004-05) to 52.2% on 31/3/2014! And, this should not really be surprising given that inflation leads to higher nominal GDP: inflation, in effect, "devalues" the outstanding debt and improves government's debt servicing ability as revenues are strongly correlated with nominal GDP. It is the "quality", not so much the "quantity", of the deficit that needs significant improvement if growth targets are to be achieved: the amount of investments financed by fiscal expenditure was 73% higher than subsidies in 2007-08; it is now less than 50% of subsidies! (I have taken the investment and expenditure numbers from T.N. Ninan's piece in Business Standard last Saturday.)

Let me now turn to the question of "CAD". In fact, not only the Finance Minister but also the last month's Financial Stability Report of the Reserve Bank of India uses the same acronym, and the need to control it. Have we all become such pessimists on the external account that we can no longer think of a current account balance – let alone targeting CAS, or current account surplus? Financial markets' memories are notoriously short but surely policy-makers recall that we recorded surpluses on the current account for a few years early in this century. Or, are we back to the "export pessimism", the accepted wisdom of policymakers in the 1950s and 1960s? It was this pessimism which led to the import substitution and industrial licensing policies and sky high customs duties. The result was decades of the Hindu rate of growth.

One of the few economists who did not agree with the then "accepted wisdom" was none other than the last Prime Minister. Dr. Manmohan Singh had then argued that India's exports will grow given an exchange rate which would create a competitive tradeables sector. It is perhaps high time that we end our mental fixation with "CAD", and how to finance it. As it is, India's net external liabilities (i.e. a negative NII or net international investment position) have gone up from 4% of GDP at the end of 2007-08 to 18% at the end of fiscal 2013-14, one of the highest in the G 20! Surely, there is a limit to how long we can continue to depend on the savings of the rest of the world to finance our continued CADs! Besides, lest we forget, the trade deficit means lower domestic output and employment, even as the overvalued exchange rate increases consumption and reduces savings, a point I have elaborated earlier.

A couple of other points: is it not time to give up the concepts of plan and non-plan expenditures and focus the numbers on capital and revenue expenditure? Again, surely there is a case to increase the transparency of the government's accounts by also specifically disclosing the revenue and expenditures postponed or pre-poned? Another point: surely Rs. 50 and 100 crore schemes are too small to merit specific mention. What these details do is to overlook far more substantive issues like: why we have fallen so far behind too many east Asian economies from Korea, Taiwan, Malaysia, Thailand, and of course China. It is worth reminding ourselves that a little over a generation back our GDP was more than China's – today it is just one fifth!

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