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The real dangers facing Indian economy

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The Indian economy, one is tempted to believe, is growing not because of the government, but despite the government.

Agreed, the reforms of 1991 finally put the economy on to an altogether different growth trajectory. But one needs to realize that the reforms then were undertaken, not as a matter of choice and but purely because of lack of any other choice.

Quite often, our policy actions are more of response to crisis rather than real economic foresight. This is, not to say that there has been nothing positive from our policy makers. Indeed, there has been. But those were mostly follow-up actions of the reforms, and those that were easy to implement.

However, the difficult ones and the so-called second generation reforms are still not happening and India continues to flatter to deceive. The high single-digit growth rates are fine, but these are still lower than what India could potentially achieve if it is unfettered from many of its constraints.

A case in point is our approach to the deficit issue. If one were to list the factors that have hindered and prevented India from reaching a higher growth plane, the growing **fiscal deficit** would be at the top half of the list.

Theoretically, deficits are not necessarily bad, especially for a developing economy, if its resources are employed in a productive manner. However, if unchecked, they have the ability to ruin a nation's finances, thus having the ultimate impact on its citizens.

Deficits are but one feature of a developing economy given to the compulsions of investing for future growth, especially in a situation of a savings investment mismatch. However, in the case of India the composition of the deficit is a major source of worry, as there is a clear lack of productive focus.

To put things in perspective, the total fiscal deficit of India (i.e. the combined deficits of the central and state governments) is estimated at around 5.6% in 2007-08 (source: Handbook of Statistics, RBI). While there has been an improvement on this front (note that we were close to 10% in 2002-03), it still sticks out like a sore thumb.

Accounting jugglery

More importantly, the improvement in fiscal deficit numbers mentioned here is more a case of statistical jugglery than much real improvement. On taking the grand stand with respect to the FRBM (Fiscal Responsibility and Budget Management) Act, the government realized that they would need to walk the talk and what's the best way to keep to the target other than accounting jugglery?

Hence the government had to resort to pushing certain expenditures as off-balance sheet items. Result? Issuance of oil bonds, fertilizer bonds, et cetera in lieu of direct subsidy.

In essence, it leads to mere postponing of the problem to the future while making the current scenario look hunky dory. A back of the envelope calculation pegs these subsidies to around 2% of the GDP or more. Hence, despite a substantial buoyancy in tax revenue (which was a godsend to the government as it could show lower deficit last year), the combined deficit could still be close to 8% of the GDP.

This is definitely not a comfortable situation where the fiscal deficit gobbles up about a twelfth of India's gross domestic product.

More importantly, the structure of expenditure is quite skewed in favour of the unproductive: administrative expenses, poorly designed subsidies and the like.

According to the latest budget documents, total revenue receipt of the centre for 2007-08 (Revised Estimate) is Rs 5.25 trillion. Of this, as much as Rs 1.72 trillion (or nearly a third) is used up for interest payment and debt servicing. Add to that the amount of central government debt that has fallen due for repayment and one stares at an apocalyptic scenario.

As per the Controller General of Accounts, the amount of central government repayment of public debt in the previous year (i.e. 2006-07) was as much as Rs 14.81 trillion.

Things are unlikely to be much different in the current year. This does indicate a case of an internal debt trap, wherein the central government is forced to borrow just to repay past loans rather than using the same productively.

More gloom

Another gloomy picture emerges if one looks at the trend of **revenue deficit** (the difference between revenue income and revenue expenditure) in India. For a capital-scarce country like India, it is criminal if the government fails to manage its own expenses. But this is exactly what has been happening, resulting in high revenue deficit.

In this case also, despite some improvement, the estimated revenue deficit for 2007-08 is around Rs 634 billion, while the fiscal deficit was around Rs 1.44 trillion. Hence, the revenue deficit as a percentage of fiscal deficit is close to 50. What this means is that the government spends nearly half of its borrowings just to meet housekeeping expenses, leaving very little for capital (read: productive) expenses.

High fiscal deficits typically cause three problems:

- A balance of payments crisis;
- High interest rates (because of private investment being crowded out), and;
- High inflation (with currency depreciation being a key contributor).

How has India survived?

India suffered from all three of these problems in 1991. The question, however, is how is India surviving such high levels of deficit at this time when fiscal deficits of even 5% of the GDP have bankrupted countries like Argentina?

The main reason is the flood of invisibles in the 1990s. That makes India really different. The export of services, mainly software, has led to a deluge of foreign exchange flowing into the country. Added to that is remittances from Non-Resident Indians (NRIs). Influx of such magnitude has more than offset the impact of a high fiscal deficit.

What could happen

Next, consider the impact of the fiscal deficit on interest rates. A high deficit would raise interest rates and crowd out private investment. This is exactly what had happened in the investment boom of the mid-1990s, when corporate bond rates soared to over 20%.

This was unsustainable, led to uncompetitive production, and was followed by an investment bust that cooled interest rates. These were then pushed down even further by the flood of invisibles. What also played out to India's advantage was the amount of liquidity sloshing around (thanks to **Yen carry trade** and ultra low interest policy of the US Fed), all over the world, looking for avenues of investment.

India was a great beneficiary of the same as its economy moved into a higher growth trajectory. The flood greatly increased money supply, despite the Reserve Bank of India's sterilisation efforts. The net effect is a much lower interest rate.

While low interest rate-high liquidity is a potent combination that can stoke inflation, overall low global inflation scenario (thanks in large measure to China) helped us keep a check on inflation. What also aided us was the fact that large inflows have resulted in appreciation of the Indian rupee helping us to keep a further check on inflation through cheaper imports.

Also the conscious effort by the government to reduce short-term foreign borrowings helped. One of the perpetrators of India 's crisis in 1991 was a high concentration of short-term external debt in the total external debt basket.

Since then the government has been constantly working at reducing the extent of such short-term debt. India has also resorted to pre-paying high-cost external debts.

As a result of all the positive(?) developments, India experienced a situation of appreciating rupee and low interest rates. But, those were then. And it is now. With the sub-prime crisis threatening the global financial markets, its impact is also felt in the real economy.

The US economy is already in recession. The European economies are not in a much better shape either. Japan has, for long, ceased to be the leader. So we are now faced with the scenario of a much slower global growth. Added to this is that fact that oil prices are running amok.

In fact, the Indian basket of crude has now crossed even $100 per barrel. Food prices are also skyrocketing. Where does that leave India?

The threats are real

To be honest, the time of reckoning has come. Threat of inflation is now very real in India as it is, all over the world. With the interest rates hardening, growth is already getting impacted. The recent WPI (Wholesale Price Index) number will act as a spanner for all those hoping for a softening of the rates.

On top of it our fiscal profligacy continues. The recent budget announcement on **loan waiver** is a case in point. Despite knowing fully well that the actual small and marginal farmers would hardly be benefited since hardly many of them have access to institutional loans, our policy makers continue to indulge in these kinds of activity.

Leave aside the moral hazard issue. The amount of Rs 600 billion could well have been spent in improving rural infrastructure, maybe even providing coupons to small and marginal farmers to enable them to procure inputs at lower cost and so on and so forth.

India as a country can ill afford a situation where about one-fourth of our foodgrain production is wasted mainly because of inadequate storage and transport facility. This is all the more criminal in the situation where even a food crisis is looming round the corner. Yet we chose the least desirable option. This step will yield only some short-term succour while the basic problems would continue to remain unaddressed.

Ideally, during good times (as was the case in the last financial year when our tax revenue surged dramatically) resources should be utlised is a manner which has long term implication and not be frittered away. We have failed on this count. And, this is unaccounted for in the **Budget**.

The impact of the **6th Pay Commission recommendations** has also been conveniently ignored. More importantly, the cascading impact of the recommendation on the payrolls of the state governments, schools, colleges, etc has been ignored.

Our policy makers seem to bank on another round of tax revenue buoyancy which made them believe that the fiscal deficit can be reduced to 2.5%. High hopes indeed!

Rising prices

On top of it, the **high level of inflation** during the election year is giving sleepless nights to the government and hence we are seeing a slew of measures (read reduction of taxes) to check price rise.

The impact of these on the deficit will be more adverse. And, with the government, time and again, failing to show the courage to tackle its wasteful expenditure, we are indeed looking at a situation where our fiscal deficit might spurn out of control.

We would then see a rise in such off balance items to contain the deficit. We would also, as has happened many times in the past, see more of developmental expenditures being sacrificed at the altar of fiscal profligacy, just to ensure that the deficit numbers remain in control. In the bargain, our future growth would be held at ransom.

Also, globally inflation is rising and liquidity flow to the developing world is petering off. So what have we now? High fiscal deficit, high inflation and high interest rate. We will most likely see a situation of curtailed public investment and of private investment being crowded out.

Of course, we would still grow at 7-8 percent. We would still be smug in our achievement and say it is still better than most of the economies in the world. As for double-digit growth, let that remain only in paper.

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