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What the Fiscal Cliff Means for India

By Kunal Kumar Kundu

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What is the 'fiscal cliff?' And why should India care?

"Fiscal cliff" must be one of the most heard phrases globally right now. A Google sear GOOG +0.18%ch for the term produced 650 million results, as of Tuesday morning, more than for "US Presidential Election."

The issue has an added frisson of excitement as people watch to see whether President Barack Obama, freshly re-elected earlier this month, can bridge the intellectual divide between the Democrats and the

Republicans before the cliff is reached. With barely a month before the holiday season kicks in, time is, as they say, running out.

But what is the fiscal cliff? It is meant to describe several big events, all fiscal in nature, that are set to occur in the U.S. at the end of the year. These include:

–The expiration of tax cuts initiated by Mr. Obama’s predecessor, at the end of 2012, including current lower tax rates on capital gains, dividends, income, and estates

–The expiration of stimulus measures like payroll tax cuts and extended unemployment benefits.

–Spending cuts scheduled to be triggered automatically in January.

Unless President Obama is able reach agreement on action needed before the end of December, as much as $600 billion of expiring tax cuts, the levy of new taxes, and automatic spending cuts are set to take effect at the beginning of 2013.

The U.S. would also need to change its laws so that the government can borrow more than the current limit of $16.4 trillion.

If no agreement is reached, the automatic measures will bring in about $7 trillion to the U.S. Treasury over the next 10 years. The austerity measures will, in the long run, reduce the U.S. deficit and improve its debt picture, improving the country’s economic prospects. But in the shorter term, higher taxes will crimp private consumption and reduced government expenditure will result in the contraction of public expenses – a double whammy that will impair the U.S. economy and hurt already-fragile global growth.

The question uppermost in the mind of the Indians is what impact falling off the fiscal cliff will have here.

It’s worth remembering that Indian banks and financial institutions largely escaped the crisis that engulfed the developed markets However, because of growing global integration, the Indian economy didn’t remain immune to the economic crisis that followed.

The troubled eurozone is now experiencing a double-dip recession and weakness is clearly spreading from the outlying countries to the core of France and Germany. At the same time, China is showing clear signs of a slowdown. And now, this fiscal cliff.

What happens if the U.S. goes over the edge? I view that as very unlikely. But the International Monetary Fund estimates that U.S. gross domestic product would be negatively impacted by four percentage points, so if the economy was to have grown by 2% in the absence of a fiscal cliff, it would contract by 2% in case it falls off the cliff.

Lets assume a compromise will be reached. Even then, the result will entail some fiscal measures that are a drag to the U.S. economy and reverberate around the world. It is quite likely that the U.S. economic growth rate will still be approximately 1.5 percentage points lower since some tax increases, spending cuts and reduction in transfer payments will still occur.

In that case, the impact on India is likely to be both positive and negative.

The good news is that commodity prices will ease off and oil prices will stay significantly lower than in the recent past. In fact, fear of the fiscal cliff has already drove down commodity prices, starting in October. The World Bank estimates that energy and non-energy prices fell by 2.4% and 1.6%, respectively, during October. This will mean that India's inflation rate may come down fast enough for the central bank to cut interest rates more quickly than anticipated to stimulate growth.

The bad news, however, is the potentially adverse impact on the Indian economy from reduced trade and investment. India's merchandise exports now account for nearly 16% of Gross Domestic Product, while total exports account for approximately 24% of GDP. With India's major trading partners in trouble, exports are expected to take a hit. In fact, India's monthly exports contracted on an annual basis during six of the last seven months. The outlook for India's exports during 2013 certainly doesn't look good.

Capital flows in India will also be affected as the global recession that may result, even if the fiscal cliff is avoided, will lead investors to safe havens. That means rising demand for gold and dollar-denominated assets and capital will move away from risky assets (both equity and currency) of emerging markets, including India.

At the recent International Monetary Fund meeting in Tokyo, Indian Finance Minister P. Chidambaram said that "the issues of fiscal cliff and the lifting of the debt ceiling in the U.S. also need to be resolved. The need is to put in place a medium-term fiscal plan while avoiding excessive fiscal correction in the short run. Should the economic situation in the U.S. worsen, its impact on emerging market economies will be much more severe than in the case of the situation in the euro area."

Clearly, India needs to brace for further economic challenges as the fiscal cliff draws near.

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