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India's Economy in 2012

Government’s Loose Fiscal Policy

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The Indian government needs to target its investments better. Jayadipta Chatterji interviews Rakesh Mohan.

Led by the poor performance of the manufacturing sector, India’s economic growth has fallen relative to expectations. The main reason is the government’s fiscal slippages - private investment has decelerated and this is related to a crowding out effect of high government borrowing and consequent high interest rates. The revenue deficit is a pointer to the poor quality of government expenditure, particularly the high subsidies, instead of undertaking expenditure that created long-lasting assets. The revenue deficit is primarily responsible for the fall in savings and investment, as the government increased its borrowings to finance its high fiscal deficit. The government’s loose fiscal policy has contributed to excess demand in the economy leading to sustained inflation. Given that our inflation is higher than most world economies, our foreign exchange interventions needed to have been continuous to carry out appropriate adjustments in our exchange rate. Instead we appear to have done the opposite, minimised our interventions, and the strengthening rupee has further hurt industry - both in the domestic and export markets. The high trade

deficit is a pointer to this, pushing up the current account deficit to the highest level ever. Speaking to Jayadipta Chatterji for CFO Connect, Rakesh Mohan, former Deputy Governor of RBI, says the ill effects of fiscal excess have been compounded by inadequate adjustments in the exchange rate, leading to the declining competitiveness of Indian industry and slowing industrial growth. Yet, when asked if India will be able to achieve the 7.6% GDP growth target set in the Budget, he says India has surprised before and we may do so again. No matter the colour of our government, or the current crisis at hand, and we have also suffered from fiscal excesses before; we have still recorded an average growth of over 6% since around 1980. We may do it yet again.

What are the key factors that the Budget should have addressed?

The country is witnessing a significant fall in overall economic growth relative to expectations, led, in particular, by a slowdown in manufacturing growth. It has been battling inflation which has been at higher levels than what has recently prevailed in most of the world's large economies. Fiscal imbalances have grown. The increase in the revenue deficit offers evidence of the deterioration in the quality of the government’s expenditure, particularly with respect to the increase in subsidies. Gross domestic savings have declined, led by a fall in public savings of 4% of GDP. This has then led to lower investment and growth. Finally, the widening fiscal deficit has spilled over into a merchandise trade deficit approaching almost 10% of GDP. This has pushed the current account deficit up to about 3.6% of GDP, which is perhaps the highest we have ever had. The root of all these problems is fiscal slippage on the part of the government. The Economic Survey, quoting the IMF Fiscal Monitor, has documented that the average fiscal deficit of the crisis-hit North Atlantic advanced economies was 6.6% of GDP in 2011, and 2.6% for emerging market economies. India is far removed from the financial crises of the North Atlantic countries, and yet we have a very high level of combined Central and state fiscal deficits of 8-9% of GDP, which is excessive.

How do you relate each of the macro economic factors that have gone wrong, to fiscal slippage by the government?

First, manufacturing has been particularly hit and it has led the fall in economic growth in 2011-12. The GDP growth year-on-year (yoy), decelerated to 6.1% in the October to December (Q3) period of 2011-12, from 6.9% in Q2, mainly reflecting a slowdown in industrial activity. Industrial growth, measured in terms of the Index of Industrial Production (IIP), was only 3.6% during April-December 2011, as compared with a growth of 8.3% in the corresponding period of the previous year. Growth in the manufacturing sector moderated from 9% in April-December 2010, to 3.9% in April-December 2011. The growth moderation was mainly due to a deceleration in private investment activity, which has, inter alia, been related to the crowding-out effect of high government borrowing and consequent high interest rates. The Reserve Bank of India (RBI) had to withdraw its accommodative monetary policy of 2009, to stem inflationary pressures. Once again, apart from rising oil and food prices, the loose fiscal policy has contributed to excess demand in the economy leading to somewhat sustained inflation. In conjunction with the emerging strains on capacity due to a fall in investment activity by corporates and the government; elevated

domestic asset prices due to high international prices of commodities; the rising prices of manufactures have alone accounted for more than half of current headline inflation.

Second, the sharp rise in the non-oil and non-gold trade deficit indicates that industry is indeed becoming relatively uncompetitive in both the domestic and export markets. The appreciation of the real exchange rate since 2009 has hurt our competitiveness. We need to fashion our exchange rate and capital account management policies in a way that gives Indian industry an even chance to compete. On the external front too, fiscal imbalances have contributed to excess demand, resulting in a widening current account deficit in the face of inadequate adjustments in the exchange rate. The trade deficit could hit almost $180bn in 2011-12, pushing up the current account deficit to about 3.6% of GDP. In contrast, this deficit was less than 1.5% during the high growth years of 2003 to 2008. A key feature of the success of our reform processes since the early 1990s has been the substantial strengthening of our external sector. We had maintained our current account deficit at a modest level of around 1-2% of GDP. The gradual liberalisation of the current account in the 1990s made the economy more efficient. Similarly, a measured relaxation of capital account controls helped in increasing foreign capital flows. Judicious management of the capital account balanced equity and debt flows in a sustainable manner. And finally, a pragmatic real exchange rate policy helped maintain the competitiveness of Indian industry. In recent years, however, it appears that foreign exchange intervention has been kept to a minimum, thus, contributing to both real exchange rate appreciation and a more volatile exchange rate in recent months. With Indian inflation being much higher than world inflation, the nominal exchange rate needs appropriate adjustment on a continuous basis. So the ill effects of fiscal excess have been compounded by inadequate adjustments in the exchange rate, leading to declining competitiveness of Indian industry and slowing industrial growth.

Third, the increase in revenue deficit indicates the deteriorating quality of expenditure, caused substantially by the rise in expenditure on subsidies. Until recently, the government's tax revenue pattern had improved with higher gross tax revenue to GDP ratios, which was made possible by a steady rise in the share of direct taxes, and particularly of corporate Income Taxes in that. However, direct taxes have grown by only 9.3% in the year to January 2012, well below the 19% growth budgeted. The share of indirect taxes is again increasing. On the expenditure front, the government is burdened by enormous subsidies, the largest component being its oil subsidy bill. While it will be quite appropriate to shield consumers from the temporary volatility in oil prices, it is not sustainable to keep domestic oil prices stable in the face of persistent increases in international oil prices. As has been widely discussed, expenditure on welfare schemes need to be better targeted. There is dire need for increasing government expenditure on investment in infrastructure and health, but other consumption expenditures need to be restrained. For instance, expenditures on rural schemes such as the Pradhan Mantri Gram Sadak Yojana (PMGSY), the National Rural Health Mission (NRHM), in primary education the Sarva Shiksha Abhiyan, among others, should be coordinated to provide employment guarantees. This is preferable to operating a separate scheme such as the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA), which inevitably results in pure consumption expenditures rather than creation of long lasting assets. It is this deterioration in the quality of government expenditure that has also contributed to sustained inflation.

Fourth, since 2007-08, the increase in revenue deficit has resulted in a fall of 3-4% of GDP in public sector savings, and hence resulted in a similar decline in the overall gross domestic savings rate. This has broken the secular trend increase in domestic savings and investment that was especially pronounced from 2003 to 2008. As a natural consequence of these improved fundamentals, India observed five years of acceleration in GDP growth that eventually peaked at 9% in 2007-08. Today, the increase in the revenue deficit is primarily responsible for the fall in savings and investment, and the consequent increase in government borrowing to finance the fiscal deficit has served to push up market interest rates, and to crowd out the private sector from credit markets.

Does the Budget provide a roadmap by which the government can reverse this trend?

My main concern with this Budget is that it does not give us adequate signaling for the kind of growth inducing fiscal consolidation that we need. Perhaps current political economy considerations do not allow for stronger action and the FM has done the best he can. The FM has set a fiscal deficit target of 5.1% of GDP for FY2013, which is lower than an upwardly revised 5.9% for FY2012. Thus the consolidated fiscal deficit for the Centre and the states for FY13 will, at best, come down to 7-8% (from 8-9% in FY 2012) The FM has said that this will be achieved by reducing the subsidies bill to 2% of GDP, going down to 1.75% in the next three years, while the government will provide fully for food subsidies. Whereas this is an impressive objective, it is to be noted that the 2011-12 budget estimate for total subsidy was 1.6%. This increased to 2.45% in its revised estimate. So even if this objective is indeed met, it does not imply any reduction in subsidies relative to the stated goals of only a year ago. Incidentally, prior to 2007-08, subsidies had amounted to less than 1% of GDP. Moreover, the Budget gives no indication of how the non-food subsidy will be controlled, and how the food subsidy will be financed. So the key slippage on the expenditure side will continue to be subsidies. Only curtailed revenue expenditures will contribute to more sustainable revenue deficits, and subsequently, to better public sector saving rates. This will then reduce government borrowings and, consequently interest rates. It is only on the back of these fiscal adjustments that private corporate investments will increase, restoring the 8-10% growth rate that we aspire towards. Monetary policy can then start becoming effective again.

What according to you are some of the more positive provisions in the Budget?

On the revenue collection front the FM has done well to unify and increase excise and service tax levels. Excise tax levels are now back up to 12%. Remember that prior to the fiscal stimulus of 2009, the excise rate was 14%. The government has done well to reverse the excise cuts, despite considerable ill-advised pressure to the contrary from private industry lobbies. This measure will provide most of the increase in tax revenue that has been projected for 2012-13 But after factoring in the concessions that the FM has given, there will be a loss in Income-Tax revenues rather than gains. Given the massive private consumption expenditures that are observed all over the country, much more needs to be done to bring more people into the tax net. Unfortunately, the Budget proposes no measures to this end, whether administrative or otherwise. For instance, the FM could have taken bolder steps by relying on the new Census information that shows that far more people have cell phones than LPG cylinders. Given the rising global oil prices, he could have raised LPG prices as this fuel is primarily consumed by relatively well-off

households. Instead, he raised the limits at which higher earning individuals pay higher levels of personal taxes.

The FM has also committed to bring back focus on the FRBM Act 2003.

Yes, the Fiscal Responsibility Budget Management (FRBM) Act, 2003, strengthens fiscal-monetary coordination. It places limits on government deficits by focusing on revenue raising measures and expenditure reforms, and by eliminating revenue deficits. It also prohibits the RBI from participating in the primary market auctions of Central Government securities from April 2006, except through 'Ways and Means Advances' to meet temporary liquidity mismatches in the Government's cash management; or under exceptional circumstances. The RBI, however, still buys or sells Government securities in the secondary market, as may be consistent with the conduct of monetary policy. So, restoration of the FRBM with the specification of new targets is a very welcome step.

The FM has also announced measures for the further development of the financial sector, including the establishment of a Public Debt Management office. However, given the current fiscal scenario, this is clearly the wrong time to make a change from the very competent debt management that the RBI has performed for the country over the last 75 years. The RBI has a capable and experienced team, a fully functioning office, and an entire infrastructure to handle this work. In the interests of financial and fiscal stability, the government will do well to shelve this ill-advised change in debt management.

Will the ECB route save the airline industry and give a fillip to low-cost housing?

This is a rather puzzling move. The FM has allowed domestic airlines to borrow up to $1bn in external commercial borrowing (ECB) in order to raise working capital for a period of one year. The ECB is a financial instrument by which the government allows Indian corporations and public sector undertakings access to foreign funds. The general policy thus far has been to allow ECBs only for longer-term borrowing for investment purposes. We have eschewed short-term borrowing for financial stability reasons, with an exception for export finance which is naturally hedged and self-liquidating on a regular basis. Some in the industry expect this move to considerably ease the operating environment for airlines, three of which, Air India, Kingfisher Airlines, and Jet Airways need substantial funds to stay afloat. But this optimism is misplaced: if domestic lenders are reluctant to lend to these entities on the grounds of credit quality, why do we expect foreign lenders to hold a different view, and moreover to lend at lower rates? Such a move would also place poor quality Indian paper in the international domain, thereby possibly reducing creditors' confidence in other Indian debt in the future. Similarly, the Budget has allowed ECB access to low-cost affordable housing sector projects. This is again a questionable move since receivables will be entirely in domestic currency. Have we learnt nothing from the North Atlantic Financial Crisis of 2008-09?

Did the RBI take the right decisions when tackling the recent high inflation in the country?

The RBI has been correct to withdraw monetary accommodation in response to the emergence of high inflation in the last couple of years, but it could have taken bolder steps much earlier than it did. It waited till May 2011, to raise the repo and reverse repo rates by 50 basis points, after a succession of 25 basis point baby steps. Just as it took bold steps to reduce interest rates rapidly in 2008-09, it could have exhibited similar alacrity on the way up. In India, the objectives of monetary policy have evolved to be the maintenance of price stability and ensuring adequate credit flows to the productive sectors of the economy. In essence, its monetary policy aims to maintain a judicious balance between price stability and economic growth. The relative emphasis between the two is governed by the prevailing circumstances at a particular point in time, and consequently, there is an ongoing re-balancing of priorities.

When should the RBI start bringing down the interest rates?

The Wholesale Price Index (WPI) inflation rate rose to 6.95% in February 2012, after dropping further to 6.6% in January from 7.7% in December, when it fell from above 9% during April- November 2011. The new Consumer Price Index suggests that inflation is actually higher than this, so the threat of sustained high inflation continues to be with us. Having cut the CRR by 125 basis points (in two tranches by 50 basis points effective January 28, and by 75 basis points effective March 10), it had injected primary liquidity of about Rs 800bn. This measure was necessitated ahead of the scheduled Mid-Quarter Review in March 2012, to address the persistent structural liquidity deficit which would have further worsened during the week of March 12-16 due to advance tax outflows. However, the RBI did not cut the interest rates because it felt that the upside risks to inflation have increased from the recent surge in crude oil prices and the government's fiscal slippage. Even so, it indicated that while there will be no further tightening and future actions will favour lower interest rates, the high inflation risk and high fiscal deficit will influence both the timing and magnitude of future rate actions.

How long will it take for lower interest rates to begin to impact the economy after the RBI cuts interest rates?

Even if the RBI does cut interest rates there will be a lag before the country's banks are able to reduce lending rates. Interest rates will soften only gradually due to a number of factors. First, the interest rate on small savings continues to be administered and has recently been raised; thus any reduction in interest rates on bank deposits will make bank deposits relatively unattractive. It will therefore, be difficult for banks to reduce their interest rates for some time. Moreover, long-term deposits continue to have high fixed interest rates, so even if interest rates on new incremental deposits start to come down, the average cost of deposits will remain high till maturing deposits get renewed. This, in turn, will constrain an immediate substantial reduction in lending rates. Moreover, because of the large government-borrowing programme for 2012-13, market interest rates have already hardened. So it is difficult to see a scenario of lower interest rates in the near future, regardless of RBI actions.

Given the current macro economic conditions, is the GDP growth target of 7.6% for 2012-13 achievable?

You never know, we may still pull it off! We have had governments of every colour in the last 30 years; we have weathered various crises during the same period; we have also suffered from fiscal excesses at different times; and yet recorded an average growth of over 6% since around 1980. We always pull back from the brink. So I have great confidence in the overall stability of our system. I remain optimistic.

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