Dealing with Fiscal Deficit: The Tough Choices for Finance Minister

By

Sayan Banerjee

Asst. Professor, Economics Area

Institute of Management Technology (IMT), Nagpur

Sbanerjee@imtnag.ac.in

Dealing with Fiscal Deficit: The Tough Choices for Finance Minister

The case is written with an objective of highlighting the issue of difficult policy choices government faces while faming up any stabilization measure for the economy. The case essentially deals with probable consequences of different fiscal measures on the society in general and the macro-economic business environment for the industry in particular.

Introduction

The global economic slowdown had an adverse impact on the growth rate of Indian economy in 2008-09. Export sector was badly hit and the business confidence was low. The ministry of finance took a proactive stance to deal with it through a series of expansionary Fiscal measures. This surely brought the economy back to the path of faster growth, but resulted in higher Fiscal deficit. Moreover, early signs of inflations had crept in the economy as well. The finance minister, before presenting his next year's union budget, faces a tough choice between Fiscal consolidation and risking a slower growth rate. He has to weigh the pros and cons of continuing with the expansionary fiscal policy and take a decision that will not only be good for the economy, but politically acceptable as well.

Background of the Fiscal stimulus package in India

India's economic growth rate was expected to moderate to 7.8 per cent in 2008-09, mainly on account of a global slowdown, as per the Economist Intelligence Unit (EIU), an arm of London-based magazine Economist. Even though the economy, according to government estimates, was expected to grow at 8.7 per cent during 2007-08.

Despite moderation in growth, India continued to remain the second-fastest growing economy in Asia. The growth was mainly driven by the services sector with IT and IT enables services (ITeS) playing a major role and In the long run, India's innovation in the engineering sector and R&D services could lead the growth story. Among the major challenges, India faced threats like those of high inflation , which surged to as high as 5.92 per cent due to rise in prices of food items. India ranks fourth in Asia and Australasia in terms of available market opportunities, though its

---

This case was prepared by Sayan Banerjee, asst. professor, IMT Nagpur and is intended to be used for class discussion rather than to illustrate either effective or ineffective handling of the situation. Presented to and accepted for the International Case Conference, November, 2011, Goa, India

ranking was quite low on other parameters. The country needed to maintain low and stable inflation which could rise to as high as 6-6.50 per cent in the next three to four months.

India's GDP growth could drop further in 2009-10, RBI governor D Subbarao said "All indications are of a downside revision and we would be doing our own estimates. There will be a period of painful adjustment. There will be an impact on 2009-10. It is going to be a difficult year, perhaps a more difficult one."The RBI head honcho said the Reserve Bank would come up with fresh GDP numbers when it does policy adjustments keeping in mind the IMF's forecasts on global growth and that for emerging economies.RBI is slated to announce the quarterly review of the monetary policy on January 27, 2009. According to the IMF, the world economy is likely to grow 2.2% in 2009 against the earlier projection of 3%.On the impact of the global slowdown on India's economy, Subbarao said that the country would also be impacted. But the RBI and UPA government have collectively taken a lot of measures to minimize its impact, he added.

The Fiscal Stimulus Introduced in the Union Budget (2009-10)

As part of the Short-term Measures to counter the negative fallout of the global slowdown on the Indian economy, Government responded by providing three focused fiscal stimulus packages in the form of tax relief and increased expenditure on public projects along with RBI taking a number of monetary easing and liquidity enhancing measures. Such fiscal accommodation led to an increase in fiscal deficit from 2.7 per cent in 2007-08 to 6.2 per cent of GDP in 2008-09. The fiscal stimulus at 3.5 per cent of GDP at current market prices for 2008-09 amounts to Rs.1,86,000 crore and the measures taken by the Government were effective in arresting the fall in GDP growth rate in 2008-09. The GDP growth rate recorded in 2008-09 was merely 6.7 per cent. There was emphasis given on infrastructure development with IIFCL to evolve a Takeout financing scheme in consultation with banks to facilitate incremental lending to infrastructure sector. It was to refinance 60 per cent of commercial bank loans for PPP projects in critical sectors over the next fifteen to eighteen months. IIFCL and Banks were then in a position to support projects involving total investment of Rs.1,00,000 crore. Allocation to National Highways Authority of India (NHAI) for the National Highway Development Programme (NHDP) increased by 23 per cent over B.E. 2008-09 in B.E. 2009-10 and allocation for Railways increased from Rs.10,800 crore in Interim B.E. 2009-10 to Rs.15,800 crore in B.E. 2009-10. Allocation under Jawaharlal Nehru National Urban Renewal Mission (JNNURM) stepped up by 87 per cent to Rs.12,887 crore in B.E. 2009-10 over B.E. 2008-09. Allocation for housing and provision of basic amenities to urban poor enhanced to Rs.3,973 crore in B.E. 2009-10. This includes provision for Rajiv Awas Yojana (RAY), a new scheme announced.

Allocation under Accelerated Power Development and Reform Programme (APDRP) increased by 160 per cent to Rs.2,080 crore in B.E. 2009-10 over B.E. 2008-09. Target for agriculture credit flow set at Rs.3,25,000 crore for the year 2009-10, where as in 2008-09 agriculture credit flow was at Rs.2,87,000 crore. Time given to the farmers having more than two hectares of land to pay 75 per cent of their over dues under Debt Waiver and Debt Relief Scheme extended from 30th June, 2009 to 31st December, 2009. Adjustment assistance scheme to provide enhanced Export Credit and Guarantee Corporation (ECGC) cover at 95 per cent to badly hit sectors extended up to March 2010. To facilitate flow of credit at reasonable rates, Rs.4,000 crore was provided as special fund out of Rural Infrastructure Development Fund (RIDF) to Small Industries Development Bank of India (SIDBI). This was to incentivize Banks and State Finance

Corporations (SFCs) to lend to Micro and Small Enterprises (MSEs) by refinancing 50 per cent of incremental lending to MSEs during the current financial year. Stimulus package for print media comprising waiver of 15 per cent agency commission on DAVP advertisements and 10 per cent increase in DAVP rates to be paid as a special relief subject to documentary proof of loss of revenue in nongovernmental advertisements, extended from 30th June, 2009 to 31st December, 2009.

Challenges for the RBI

One major aspects of Budget 2009-10 that occasioned much debate was the huge increase in gross government borrowing, projected at Rs 451,000 crore, up Rs 90,000 crore over the previous year. Bond markets, equity markets, rating agencies, economists and of course, columnists had all reacted sharply. After this, senior government officials, and the finance minister, had scrambled to try and limit the damage.

The finance secretary made a public statement that approximately half the borrowing would be completed through open market operations (OMOs) by the RBI and subsequent to that provided a clarification that OMOs do not mean monetization. These should have calmed markets. But strangely, they did not. In the instant case what the finance secretary presumably meant was that the RBI would not lend directly to the government but would, instead, groom the market to ensure government is able to complete its borrowing operation. It would do this by first buying government securities from banks (i.e., providing them with funds) timing its purchase such that banks have funds to be able to buy fresh securities as and when the government approaches the market. However, if government securities earlier held by banks are now be held with the RBI, there would be an increase in both money supply and in RBI's credit to government as the two main sources of money supply are

RBI's holdings of domestic assets (government securities) and forex assets. Other things remaining unchanged, any increase in either will increase money supply.

Though the RBI will technically be on the right side of the law — the Fiscal Responsibility and Budget Management Act (FRBM) proscribes it from subscribing directly to government securities except in 'extraordinary circumstances' — the effect of OMOs will be the same. It will make more money available to government from the RBI.

The fact that the RBI managed a borrowing of Rs 362,000 crore in the last fiscal without much disruption ignores the reality that overseas inflows were expected to fall sharply in 2009-10. So both private as well as government demand for funds will had to be met by domestic savings. To the extent there is more demand from government there would be fewer saving available for the private sector. This may put pressure on interest rates; unless the RBI eases liquidity in the system sufficiently to offset this pressure. This is what the RBI intends to do — pump-prime and introduce just enough liquidity, through OMOs so that both government and private demand for funds is met and at a reasonable rate of interest.

However, the RBI does not have an option of finding just the ‘right’ amount of liquidity. If it pumps in more liquidity than needed by the real economy it risks setting off inflationary pressures. If on the other hand, it holds back, it risks pushing up interest rates. The other two sources of funding government borrowing — overseas borrowing by government and increasing the limit for foreign institutional investors to buy government securities — are fraught with even more risk. One of the many lessons of the financial crisis was the danger posed by dollar liabilities. Comparisons with the US and the UK are absurd. These economies have the advantage of borrowing in their domestic currency. But India does not have this option.

Given the choices, OMOs or de facto monetization of debt is perhaps the least bad alternative. But if it is not to boomerang on the economy, the RBI would have to tread carefully — with one eye on inflation and the other on interest rates. The deciding factor will not be the quantum of borrowing as much as how it manages the borrowing.

Is the challenge for real?

Paolo M Martelli, Director (south Asia) of the World Bank arm IFC said a large part of the government’s borrowings can be invested in infrastructure as part of a stimulus package to revive the economy. It will not only enable it to achieve 7% growth in 2009-10, but would also help enter the sustained high growth trajectory of 9%. The government's huge borrowing programme of around Rs 4, 00, 000 crore need not be inflationary, he said. If crude prices remain less than $80 per barrel, inflation will remain well within tolerable limits. At the same time, chances of oil to remain below $80 per barrel is high, as the demand from developed world would be low for quite some time and production capacity of crude is likely to be higher than consumption, Martelli said. On the other hand, investment in infrastructure will improve efficiency of companies, which will lead to higher growth. This will make India an attractive investment destination. At a time when the global economy is not likely to return to high growth in the near future, growth centers like India and China will attract foreign investments, provided they could maintain the momentum. He felt the global economy is out of the worst phase of the crisis. Most of the bad news was already out. But, he felt stock markets will remain volatile as some investors will sell to book profits.

The tough Choice for the finance minister

The finance minister while presenting the next year's Budget, has the challenging task of striking a balance between addressing the interests of the 'aam aadmi' reeling under soaring inflationary pressures and garnering more revenue for a sustained, inclusive growth. At the current juncture of tremulous economic revival, the question looming large is whether the economy would be able to sustain the recovery if the fiscal stimulus package is withdrawn. Even globally, the prime focus amongst the advanced and developing economies is on the timing of the exit policies. The IMF has projected a global growth recovery to 3.1% in 2010, with OECD pegging the figure at 1.9% for its member countries. While these countries continue to face concerns such as unemployment and fiscal imbalances, India's growth is coupled with an additional challenge of high food inflationary pressure, causing a serious fiscal dilemma. Taking a cue from the G20 Nations' framework for sustainable and balanced growth, the forthcoming budget would ideally need to continue with the fiscal stimulus measures for some more time.

However, with the threat of a high fiscal deficit of 6.8%, the government would be hard pressed to look at some tough, revenue generating fiscal measures. Thus, the stimulus measures extended to the industry last year would certainly be reviewed. Taking cognizance of the high inflation, fuelled by food price inflation at 17.4%, which has the threat of translating into a generalized inflation, the RBI has already tightened the earlier expansionary monetary policy by increasing the CRR by 75 basis points.

Questions for discussion:

1. **Should the finance minister roll back the stimulus package in the next union budget?**
2. **How does the Fiscal Stimulation put pressure on RBI?**
3. **Are the observations by World Bank too optimistic?**
4. **Do you think RBI's decision to raise the CRR justified?**