Dealing with the Deficit

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The Central Government budget for 2009-20, which Parliament is about to approve, proposes total spending of about Rs.10.2 lakh crores. Of this Rs.6.1 lakh crores will be financed from tax and non-tax revenues. Another Rs. 5.3 thousand crores will be financed from loan recoveries and other capital receipts, in particular divestment of shares of public sector companies. That leaves a deficit of nearly 4.1 lakh crores or 6.8 % of GDP to be financed by borrowing. The large size of this deficit and how to manage it has been the subject of much discussion. Those in favour claim that a deficit of this size is essential to help the Indian economy return to a high growth path. The fiscal stimulus is designed to offset the sharp decline in export demand that has resulted from recession in the United States, European Union and Japan. Those against complain that such large scale government borrowing will drive up interest rates and crowd out private investment. They also raise concerns about the deficit possibly triggering a return to high inflation.

These differences in views derive from different schools of economic thought about the functioning of a modern market economy. Simply put, the Monetarists, Neo-classical economists, and other conservative schools are against large, interventionist governments and therefore averse to large government spending. They assume that the market economy functions well when left to itself, normally operating close to it's full productive capacity. In these conditions if the government finances a large deficit by borrowing from the market, the huge increase in public debt and the demand for credit will drive up interest rates. Furthermore, lenders will prefer riskless sovereign borrowing to borrowing by private entities. Consequently private investors will be crowded out. Alternatively, the government can borrow directly from the RBI, or the latter can offset large supplies of sovereign guaranteed government bonds by itself buying up bonds from the market on a similar scale, i.e., open market operations. In either case the supply of money in circulation will go up. Conservative economists believe that this will result in too much money chasing too few goods since the economy is anyway operating close to full capacity, and that will drive up prices -- inflation.

Those subscribing to Keynesian, Post-Keynesian and other related schools of thought debunk such views as 'deficit fetishism'. They maintain that strong government intervention is in fact essential for a market economy to sustain good performance. Citing the Great Depression of the 1930's and other recessions or depressions, they point out that business cycles and cyclical downturns are inherent in the nature of capitalist economies, which therefore operate well below their productive capacity much of the time. Without counter-cyclical government intervention, such downturns would be deeper and more prolonged. Indeed Keynesian economics was born as the antidote to the Great Depression. These economists believe that large government expenditure does not crowd out private spending but simply compensates for the decline in private spending during downturns of the business cycle, thus helping to revive economies, private incomes and private spending. Also, if large government borrowing is absorbed either directly or indirectly by the central bank, leading to increases in money supply, this should help to lower rather than raise interest rates and lead to a rise in output and employment rather than inflation.

Policy makers in the real world cannot afford to dogmatically subscribe to any one school of thought or the other. The actual impact of a large fiscal defict will be context specific and depend on whether or not a particular economy at a particular time is better approximated by the assumptions of the conservative school or the Keynesian school. It is also likely that elements of both schools of thought may be a part of the ground reality. It would be quite unrealistic to suggest after a year of reduced growth that the Indian economy is today operating close to full capacity. On the other hand, a total fiscal deficit of around 11 % of GDP last year (centre plus states plus off-budget items) has already given a very strong fiscal push to the economy in 2008- 2009. Another total deficit of around 10.3% of GDP(central deficit of 6.8 % of GDP plus state governments deficits of around 3.5% of GDP) in 2009-2010 could well lead to some overshooting of the fiscal stimulus, with all the adverse consequences that the conservatives worry about.

With these risks in view, the Government is adopting a fairly cautious approach while maintaining the large spending program. First, preparations are now underway for public sector equity divestment on a significantly larger scale than the Rs.1120 crores envisaged in the budget. Hence, the actual deficit to be financed may turn out to be smaller than provided for in the budget, something quite unusual if not unprecedented in India's recent fiscal history. Second, in consultation with the RBI the central government is front loading it's borrowing program. Rs. 2.99 lakh crores or $3/4^{th}$ of the total borrowing will be completed by the end of September. The private sector will have a relatively clear field during the 'busy season'in the second half of the year. Third, the Central Government's external borrowing from the World Bank and Asian Development Bank. Fourth will take some load off the domestic capital market, and further redemption and de-sequestering of MSS bonds will also ease liquidity. Finally, and most important, RBI will also augment liquidity through open market operations, purchase of bonds in the secondary market, to offset the sale of new government bonds on a large scale.

These steps will minimize the crowding out impact of government borrowing on private spending, especially private investment. However, the inflationary impact of deficit financing now requires careful monitoring. There is complacency on the price front at present because the headline WPI inflation rate, based on the wholesale price index has been very low or even negative. However, it's quite a different story for the CPI consumer price index, especially the price of food. The CPI inflation rate is well above 11%. With the expected supply shock in foodgrain production because of delayed and below normal rains in the North Western grain belt, the inflation rate in consumer prices will certainly rise even higher in the months ahead. The RBI has done well to take note of this in it's latest review and will hopefully be cautious in augmenting liquidity. The push for higher growth must now be tempered to contain the rising price of food.

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