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Reacting to the great bull run in US markets a few years ago, Alan Greenspan famously remarked that the market displayed 'irrational exuberance'. Today it is tempting to misquote Greenspan that our own markets are suffering from 'irrational pessimism'. The Sensex dropped by about 3 per cent and the Nifty too headed down, while Pranab Mukherjee was still reading his Budget speech. That despite the fact that Mukherjee was just about right, balancing the urgent needs of the economic crisis with the demand for electoral propriety in an interim budget preceding an election. Evidently the market was expecting fiscal sops, especially for the real estate and infrastructure sectors, that were not forthcoming, because stocks in these sectors took the hardest hit.

The Interim Budget is more a stock taking, along with expenditure proposals for parliamentary approval to keep the government running till the regular Budget by the next government. But even in such an exercise, which is by design underwhelming, there are a few important points worth noting. We had hoped in these columns earlier, as had others, that the government would temporarily shelve the Fiscal Responsibility and Budget Management (FRBM) Act. This has been done. The government has provided a huge fiscal stimulus during fiscal 2008-09 amounting to over Rs 1,93,000 crore or 4.5 per cent of GDP over and above what was envisaged in last year's Budget, which already provided for a deficit of over Rs 1,33,000 crore.

The true fiscal stimulus must include not only what was announced under the two packages in December 2008 and January 2009, but also the expenditure under the two supplementary demands for grants approved by Parliament last September and December. It is another matter that these supplementary demands made up for the creative under-provisioning of some known items of expenditure in last year's Budget to remain within the fiscal parameters of the FRBM. The total consolidated deficit for 2008-09, including the actual budget deficit of the central government (6 per cent), the state governments (3.5 per cent) and some off-budget items such as the additional contingent liability for oil and fertiliser bonds (1.8 per cent), amounts to over 11.5 per cent of GDP or nearly Rs 6,26,000 crore.

It is this massive fiscal stimulus, combined with sustained monetary stimulus measures from the RBI, that have kept the Indian economy chugging along at 6-7 per cent growth, even as most of the developed world has gone into a deep recession. It has also helped to arrest the free fall of the stock market and the depreciation of the rupee.

Conventional wisdom suggests that to be successful, such stimulus packages have to be timely, targeted and temporary. With these measures having come within a few weeks of the collapse of Lehman Brothers in September 2008, and with much of the stimulus directed at the worst-affected sectors exports, infrastructure, real estate, transport the government and the central bank have clearly passed the first two tests.

But what does the Interim Budget have to tell us about the future? It provides for a central government deficit of 5.5 per cent in 2009-10, though Mukherjee indicated that this could rise by a further 1 per cent. Adding to that 3.5 per cent deficit of state governments, and possibly some further off-budget provisions, 2009-10 could also end up with a massive deficit of 10-11 per cent. Coming on top of the huge stimulus this year, this could indeed go a long way in pump-priming demand, compensating for the loss in export demand from developed countries. Moreover, much of the additional spending is targeted at infrastructure, employment programmes and education and health programmes.

However, the question is how this massive deficit will be financed. The large government borrowing this year has crowded out the private sector. This is why interest rates have not come down substantially, and banks are still shy of lending to private borrowers despite all the policy measures taken by the RBI. If next year's deficit too is to be financed by market borrowing, that could be bad news for the private sector and severely put at risk the recovery of private investment.

It is important therefore that a large part of the deficit be monetised, i.e. financed by government borrowing from the RBI by temporarily shelving the MoU between the finance ministry and RBI which prevents RBI financing of government deficits. The finance secretary did indicate that something of this kind may be in the offing. Low inflation minimises the risk of inflationary pressures arising from the consequent increase in money supply. The shelving of the FRBM and the putting on hold of the MoU with RBI would set aside the two key anchors of prudence that have guided fiscal policy in recent years. However, exceptional times require exceptional measures.

That being said, it has to be added that abandoning fiscal prudence is fraught with risk, as we have learned to our cost in the past. Hence the third test of the stimulus, that it must be temporary. The fiscal and monetary stimuli are like major shocks being applied now to revive the economy. Research shows that the lag generated by such shocks can last for years, making the recovery itself fragile. It is imperative that the fiscal and monetary breaks be applied as soon as the economy returns to a high growth path. As Mukherjee indicated, strong fiscal and monetary compression, return to the FRBM regime and the MoU with RBI must remain high priorities. Hopefully, recovery will occur by 2010, so the fiscal consolidation can be initiated within the first half of the next government's tenure, before the fiscal compulsions of the next electoral cycle take over.

The writer was a director with the Asian Development Bank.