Media Missed the Message
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Through out the past week much of the media, especially some TV anchors who missed the absence of 'breaking news', harped on the theme that Pranab Mukherjee had missed an opportunity to tackle the economic crisis in not announcing any major stimulus package in the interim budget. The point most missed is that during the year just ending the central government has in fact run a huge fiscal deficit of Rs 326,515 crores or 6% of GDP, the largest in almost a decade, in the process abandoning the fiscal restraint required by the FRBM Act. Combined with the deficits of the state governments, amounting to about 3.5% of GDP, and off-budget items such as the additional contingent provision for oil and fertilizer bonds, amounting to another 2.8% of GDP, the true fiscal deficit amounts over 11% of GDP or well over Rs.600,000 crores! It is the demand stimulus primed by this massive stimulus, combined with all the credit flow promoting measures taken by the RBI, that have kept the Indian economy growing at around 7% -- the second highest in the world – at a time when most developed countries are actually shrinking. The interim budget has announced a similarly large deficit for 2009 -2010 of Rs. 332,853 crores, which could again add up to a consolidated deficit of around 11% of GDP when combined with the deficits of states and possible off-budget items. Surely, that does not sound like a missed opportunity.

On the contrary, the Finance Minister made full use of the opportunity to the extent feasible within the bounds of pre-election propriety. To that end he has also indicated that a large share of the enhanced public expenditure will be allocated to precisely those items that have the quickest pay-back in terms of increased demand and employment generation – employment programs, rural and other infrastructure, education and health programs. Incidentally, this should also have a good pay back in the elections, so the interim budget was not only good economics but also good politics. Perhaps the story was missed because much of the true stimulus was outside the two official 'stimulus packages' the government announced in December and January, which mainly contained non-fiscal elements. The Finance Ministry was shy of taking credit for the main fiscal stimulus, which was slipped in through the supplementary demand for grants approved by Parliament in September and December, because it would have drawn attention to the deliberate under-provisioning for expected expenditures in the previous budget, such as the impact of the Pay Commission award, to keep it ostensibly within the FRBM parameters.

So the apparently listless interim budget actually incorporates within it a full scale strategy of public expenditure led recovery , much like the packages adopted by President Obama in USA, by Prime Minister Brown in the UK, and by many other governments all over the world. The difference is that in countries like India and China this is a strategy for recovering from high growth to even higher growth, from around 6%- 7% to 9% in our case, whereas in the developed world the strategy is aimed at arresting recession in economies that are actually shrinking. The question is will it work. In our context it all depends on how two great risks play themselves out.

The first risk relates to how the deficit for 2009 - 2010 is financed. If it is financed by government borrowing from the market, then there is every liklihood that this will keep interest rates high, crowd out private borrowers from the market, and discourage private investment. This is pretty much what has happened in the current year, which is why commercial banks have been reluctant to reduce interest rates despite all the efforts of the RBI. To a large extent the stimulus provided from the fiscal side will have been off set from the monetary side, and it won’t work. To mitigate this risk, it is imperative that a large part of the deficit be monetized, i.e., financed by borrowing from the RBI rather than the market. This will lead to a sharp increase in money supply, that could potentially build up imflationary pressures. However, with inflation already dipping below 4%, this is not too much of a worry. Such a move will also require amendment of the MOU between the Ministry of Finance and the RBI, which prevents RBI financing of the deficit. Indications are that the Ministry and the RBI are working out a temporary way around this MOU.

The other risk relates to capacity constraints on public expenditure. Can the system actually absorb the huge increase in expenditure, even if it is authorized by Parliament? Though the fiscal stimulus is ultimately intended to stimulate private demand and employment, it is in the first instance public expenditure that has to be processed through the various labyrinthine channels of government. Informed policy makers often voice a concern privately, and sometimes publicly, that our government systems just do not have the capacity to process such a sharp step up in public expenditure in time, not to mention capacity constraints of the private firms that will be contracted to implement various public or public-private partnership projects. There is another curious aspect of this matter that has been doing the rounds in the gossip circuits of Delhi. According to reports, the powers that be do not allow any contracts to be issued unless they are suitably gratified. On the other hand, the contracters are apparently reluctant to offer suitable gratification since they are not sure that they will actually get the contracts after gratification is offered. And so the projects are caught in an endless gridlock, with not enough contracts being issued, and projects interminably delayed. Intrepid young reporters might wish to check out whether there is any truth in such allegations or these are just vicious rumors.

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