

INDIA'S "DIRE" RISKS: IS THE TWIN DEFICIT THE BIGGEST THREAT FOR INDIA?

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Abstract:

Amongst the myriad of economic issues that ail India currently, four risks that can pose immediate threat to India's growth momentum are: the **DIRE risks** [DIRE refers to an acronym of **D**eficits (Current account deficit and Fiscal Deficit), **I**nflation, **R**ecession and the weakening **E**xchange rate.] In recent times, the widening fiscal deficit in India is gaining alarming proportions and compounded by the widening current account deficit, giving credence to the twin deficit hypothesis. This paper seeks to establish whether the twin deficits pose a serious threat to India's growth. In order to prove the same data on inflation, fiscal deficit, current account deficit and GDP growth rate in India for the period 1988 to 2011 was utilized. Applying correlation techniques, it was found that the twin deficit hypothesis in India exists. Both fiscal deficit and current account deficit have a negative relation to GDP growth rate. Fiscal deficit also has a positive relation to inflation. With the current account deficit uncontrollable in the short run, it is the fiscal deficit that needs to be controlled to break the vicious cycle of twin deficit and its impact on inflation.

Key words: Correlation, current account deficit, fiscal deficit, India, inflation, recession, twin deficit hypothesis

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Introduction:

According a UN report, 'World Economic Situation and Prospects 2012', India's growth will be unable to reach the 9 percent highs of the previous decade and is estimated to grow at 7.7 per cent in 2012 and 7.9 per cent in 2013 .The report warned, "The downside risks to the regional outlook have sharply increased in recent months... particularly in case of India." The report explained its reasons as India's fiscal deficit target which will be strained by slow growth and the economic turmoil in the U.S. and Europe in the coming period.

India has been mired in economic troubles in the last two years with rising inflation, politics embroiled in corruption issues, slowing down of the reform process, tapering industrial output, widening fiscal and current account deficits, depreciating rupee, paucity of capital flows to fund infrastructure development, rising oil prices to name a few. Amongst the myriad of issues, there are four risks that can pose immediate threat to India's growth momentum: the **DIRE risks** [DIRE refers to an acronym of **D**eficits (Current account deficit and Fiscal Deficit), **I**nflation, **R**ecession and the weakening **E**xchange rate.] In recent times, the widening fiscal deficit in India is gaining alarming proportions and compounded by the widening current account deficit, India is said to be facing 'twin deficits'. This paper seeks to establish whether the twin deficits pose a serious threat to India's growth prospects.

Section 1 of the paper considers the "DIRE" risks individually. Section 2 of the paper discusses the twin deficit hypothesis, and historically traces the twin deficits phenomenon in India and Section 3 analyses the relation between the "DIRE" risks and the growth prospects.

Objective and Methodology:

H0: Twin deficits are not responsible for India's slowdown.

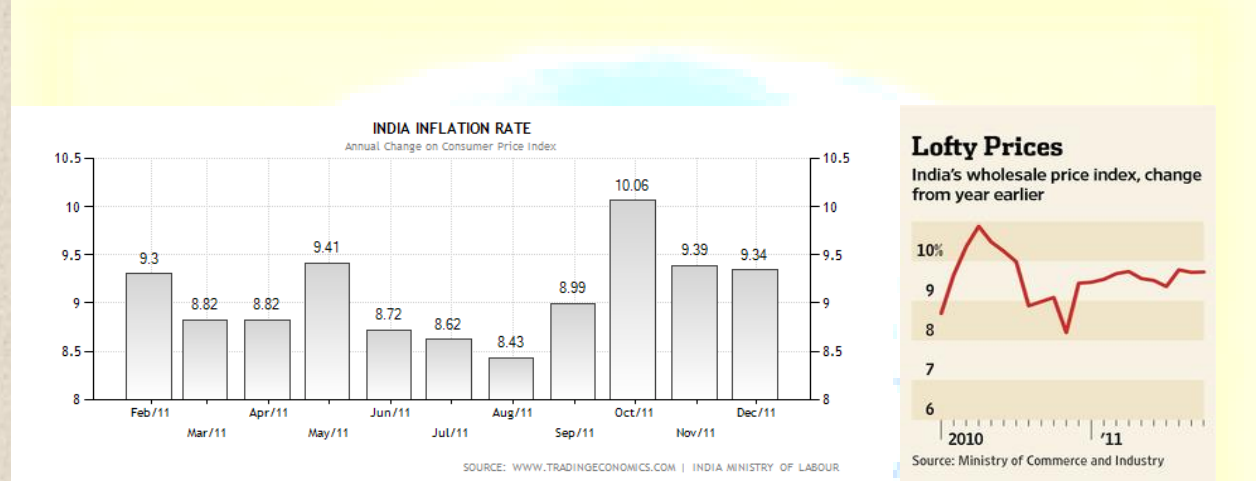
H1: Twin deficits are responsible are responsible for India's slow down.

In order to test the hypothesis, a correlation is attempted first between the two deficits. This supports the views on the twin deficit hypotheses. Further, the correlation between each of the deficits and growth is checked. The data collected is for the period 2001 to 2011. The prevalence of twin deficits is checked for the periods 1988 to 1998 and again from 2005 to 2011.

Section 1: “DIRE”risks

Inflation

The year 2011 consistently faced high levels of inflation remaining at 9 percent even after stringent measures undertaken by RBI. The central bank increased repo rates 13 times consecutively since the beginning of 2010 with the aim of taming inflation. The persistence of the inflation can be measured by the fact that despite LAF rates being raised consistently from 2009 onwards, the inflation in November 2011 was at 9.1 percent.



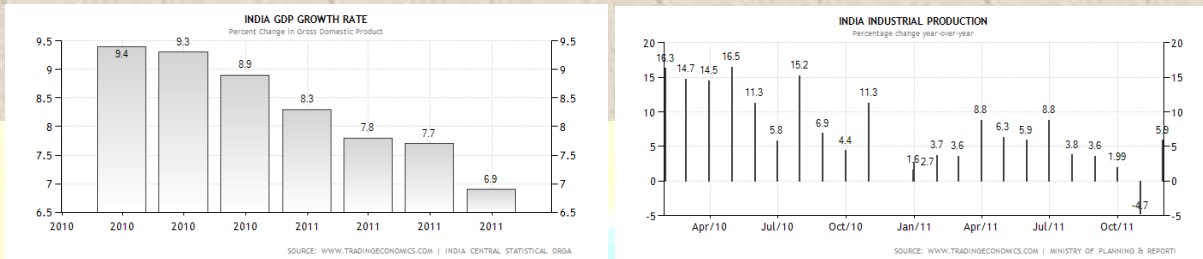
Non agricultural product inflation was a high of 7.5 percent and food prices surged to 11 percent. Manufacturing GDP is negatively related to inflation, the quarter July – September, 2011, witnessed industrial output having its slowest growth at 1.9 percent compared to the previous year which further contributed to inflation.

In India, the price rise has been contagious, moving from the asset market to commodities which then got caught by the manufacturing sector and also the services sector. It is the ‘cost push’ inflation with price levels of 9 percent for the whole year and input prices being at their peak levels.

Recession

Instead of growing at estimated 9 percent, the GDP of India grew below expectations at close to 7 percent. The Indian growth momentum stalled in the year 2011, more so in the July - September quarter bring the growth rate down to 6.9 percent. The fall was led by the mining

sector which contracted by 2.9 percent as compared to a growth of 1.8 percent in the previous quarter. Manufacturing output declined by posting a growth of a paltry 2.7 percent as against 7.8 percent in the previous three months. Agricultural output also grew at a slower pace at 3.2 percent down from 3.9 percent.



Aimed at controlling inflation, repo rate hikes translated into higher cost of borrowing affecting demand for investment. Investment expenditure declined leading to a 15.2 percent fall in capital goods production. Investment expenditure which grew in double digits in the last 7 years dropped to a paltry 5.3 percent this year. Moreover consumption expenditure also declined with the automobile sales sector dip of 15 percent in the current period and a decline in sales of consumer durables and property.

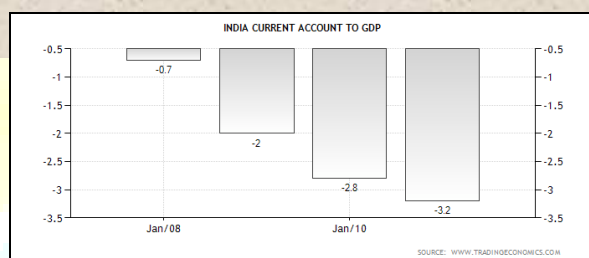
Besides demand, output has turned bearish on account of the supply side also with rising interest rate causing costly working conditions and operating environment. Manufacturing companies are finding the going tough with rising raw material prices and the commodity market turning bullish. Global crises viz. West Asian and North African region political issues, sovereign debt issues in Europe and growth and employment issues in the U.S. pose questions about India's growth rate.

Current Account Deficit

The current account deficit in India rose to 3.7% of gross domestic product (GDP) which was previously seen only during the 1991 crisis. The current account balance in India has turned sharply negative recently on account of strong import demand and at the other end declining services surplus. This deficit is alarming owing to the risk associated with the deficient funding sources i.e. the instability of foreign institutional investment which leads to the ebb and flow of

capital flows, slowing down of foreign direct investment and most importantly the threat of recessionary trends in developed economies.

Factors such as external demand, international oil and commodity prices, pattern of capital flows and the exchange rate have played a major role in the current account deficit position.



Invisibles, which have played a role in dampening the current account deficit till recently, remained low resulting in the higher current account deficit. India's exports have seen a recovery due in the recent times registering an average growth of 19.7%, but oil prices remaining high and India importing close to 75 percent of its needs, the import bill growth has averaged at 30.9%. The table below clearly shows that the current account deficit has widened by 12 percent in 2011 as compared to 2010. Besides high fuel costs, close to US\$ 100/bbl, this current account deficit can also be attributed to 'growth asymmetry' between India and the rest of the world.

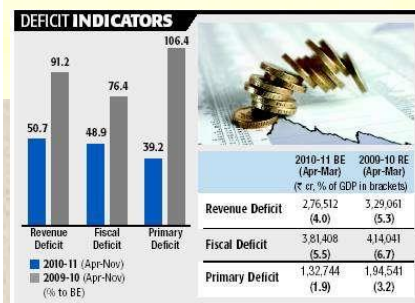
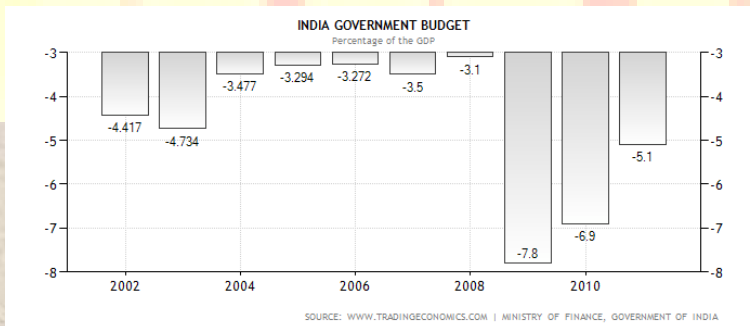
India's Current Account Balance in Rupees crores			
	2008-09	2009-10	2010-11
	Net	Net	Net
Merchandise	-547452	-560746	-595028
Invisibles	419821	380120	392494
Current Account Balance	-127631	-180626	-202532
Source: RBI: http://rbi.org.in/scripts/PublicationsView.aspx?id=13729			

This widening deficit poses a risk to growth because the volatility in the means of financing the deficit. In the current year, the current account is a deficit and capital account is a marginal surplus hence the rise in reserves is at just about USD 244 million which is as good as none. The foreign portfolio inflows witnessed a surge but the foreign direct investment that played the spoilsport. This slow down in flows is caused by uncertainty in Europe and also the poor performance at the Indian bourses this fiscal year. Also the reform process that augurs well for FDI flows has been stalled owing to corruption issues.

What also can deteriorate the situation further is the rise in the external debt that has increased on account of commercial borrowings and short-term debt which together contributed over 70% to the growth in India's external debt. India's external debt position has been deteriorating since 2008 as can be seen in the fall of foreign exchange reserves to total external debt ratio.

Fiscal deficit

After the introduction of the FRBM act in 2003, the fiscal conduct of the Indian government was moving towards target. Fiscal deficit in 2008 was just about 4 percent and revenue deficit was very close to zero along with a primary surplus and this could be credited to the robust income growth. In 2008 the sub prime crisis contagion appeared to spread to Asia and would have stemmed India's growth momentum. The Indian policy makers took steps to ascertain that the growth rate of India of above 8 percent between 2003 and 2009 should be maintained.



Source: Budget 2011:

More expenditure & less revenue will lead to higher fiscal deficit

In 2008, schemes such as the farm loan waiver and the expansion of social security schemes under the National Rural Employment Guarantee Act (NREGA), the Sixth Pay Commission award and subsidies for food, fertilizer, and petroleum were announced. As a result the fiscal deficit surged close to 8.9 percent of GDP with off-budget bonds raising it further to 10.7 percent in comparison to 5.0% in 2007–2008. This fiscal expansion bolstered domestic demand post sub prime crisis when exports suffered due to recessionary trends in the developed countries.

These deficits further got accentuated in budget estimates for 2009 with primary and fiscal deficits at 4.5 percent and 10.2 percent respectively. The deficits are a result of not only additional expenditures but also reduced collections from excise and customs duties owing to policy inflation management measures and providing a stimulus to growth.

Section 2: Twin Deficits in India

James Tobin, the Nobel Laureate in 1981 stated that “Few issues in economics theory in fact evoke such polar disagreement. The contesting views carry relatively divergent implications for public fiscal and financial policy.”

The fiscal deficit and the current account deficit of a country are referred to as twin deficits. The twin deficit hypothesis claims that any increase in the fiscal deficit will result in a widening of the current account deficit. This would imply that any fiscal excess of a government will be reflected in the current account management by that economy. From the view of policy making this would mean that a fiscal correction would contribute positively to the current account. Similarly, a significant portion of the external budget can be traced back to the budget deficit.

According to the Mundell – Flemming model, (Flemming, 1962; Mundell 1963) an increase in the fiscal deficit induces an upward pressure on interest rates which lead to capital with the oil prices inflows in an economy. This is a direct result of the increased demand by the Government in the limited financial markets. The increase in the real or inflation adjusted interest rates cause an inflow of foreign currency, thus leading to an appreciation of the exchange rate in a flexible exchange rate regime. The effect of this appreciation would reduce exports and

encourage imports thereby causing a worsening of the current account deficit (also referred to as a Feldstein chain; Feldstein, 1986).

Under a fixed exchange rate regime, the budget deficit would increase spending and worsen the current account balance. In either case the budget deficit would widen the current account deficit.

The Keynesian theory by John M. Keynes offers another logical explanation as to the relation between the two deficits. This argument is applicable even in a fixed exchange regime. An increase in budget deficit increases the domestic absorption following the multiplier theory of Keynes thus leading to an increase in the aggregate demand. This in turn increases income causing further increase in imports and a worsening of the current account deficit. To understand the relationship between the two deficits, we can use the macroeconomic identity of income and output.

$$Y = C+I+G+X-M$$

The national income identity gives us $Y = C+I+G+X-M$

Where $Y =$ Income

C : household spending by consumers

$I =$ Business Investment spending on machinery and inventories

$G =$ Government expenditure

$X =$ Exports i.e. Spending by foreigners on goods and services produced domestically.

$M =$ Imports i.e. Spending on foreign goods by households, business and government

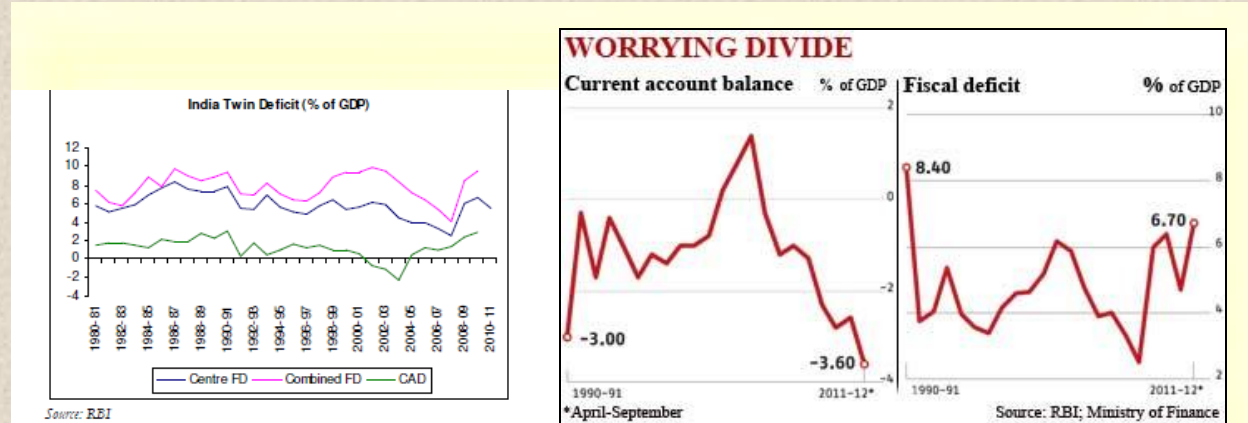
This identity can be restated as $X-M = Y - (C+G+I)$

$$\text{OR } X-M = (S-I) + T-G$$

Where $S =$ savings, and $T =$ taxes. This follows from income being distributed as savings, consumption and taxes. Hence any change in the fiscal balance i.e. $T-G$ will be reflected in the current account balance unless there is a change in the saving investment gap. Thus there exists a positive and strong correlation between the fiscal and current account deficits.

The following graph shows the similarities in trends between the fiscal and current account deficits. The combined central and fiscal deficit as a percentage of GDP had reached alarming proportions beyond 8% in the post crisis period. In the same period the current account deficit as a percentage of GDP had widened considerably.

Twin Deficits in India:



The 1991 crisis is remembered as the ‘BOP’ crisis but essentially was a twin deficit problem. At that time India was unable to finance its CAD through capital inflows being a closed economy. We faced a CAD larger than the debt inflows, import cover nose dived to a mere 2.5 months in 1990-91 and the fiscal deficit was at a high of close to 9 percent with persistently high revenue deficits. The inadequacy of external funds to boost investment at a time when the government deficit had ‘crowded out’ the production sector did not help in reducing the deficits. The twin deficits created a much bigger BOP issue which forced India to take assistance from IMF and Bank of England.

India has been unable in these two decades to stem its fiscal deficit despite the FRBM Act. The Prime Minister’s Economic Advisory Council in its economic outlook report (2009-10) explained that the deficit was high more on account of structural factors viz. subsidies, pay revision, loan waiver and less on account of cyclical factors. The government has been able to keep the deficit at the expected 5.5 percent of GDP due to augmentation of tax collections and spectrum auctions and not by controlling expenditures. Our current account has also widened due

to oil prices and global economic turmoil. Yet again our capital flows to bridge the deficit seem uncertain.

In 1991 the current account deficit reached high levels of above 3 percent of GDP and fiscal deficit was the maximum in the two decades at 8.4 percent. Now again after close to twenty years the danger of twin deficits looms large over India. In India, the causation of the ‘Twin Deficits’ could be that the fiscal deficit caused the current account deficit through the rising interest rates. The reverse causation could also be true with the high oil prices causing a current account deficit leading to fiscal deficit.

As visible in the above graphs, the relationship between the two deficits weakened in the period 1999 to 2003. A correlation has been attempted between the two deficits for the period 1988 to 1999 and subsequently between 2004 and 2011. The result of the exercise shows a positive correlation of 0.572, thus supporting the twin deficit hypothesis.

Correlation between Fiscal deficit and current account deficit

Correlations

		fd	cad
fd	Pearson Correlation	1	.572*
	Sig. (2-tailed)		.010
	N	19	19
cad	Pearson Correlation	.572*	1
	Sig. (2-tailed)	.010	
	N	19	19

Correlations

		fd	cad
fd	Pearson Correlation	1	.572*
	Sig. (2-tailed)		.010
	N	19	19
cad	Pearson Correlation	.572*	1
	Sig. (2-tailed)	.010	
	N	19	19

*. Correlation is significant at the 0.05 level (2-tailed).

Section 3: Impact of twin deficits on GDP:

The correlation between GDP and Fiscal Deficit for the period 2001 to 2011 shows a significant negative correlation between GDP and fiscal deficits. This highlights our conclusion that fiscal deficit poses a serious threat to growth.

Correlation between GDP growth and fiscal Deficit:

Correlations

		gdp	fd
gdp	Pearson Correlation	1	-.758**

	Sig. (2-tailed)		.007
	N	11	11
fd	Pearson Correlation	-.758**	1
	Sig. (2-tailed)	.007	
	N	11	11

Correlation between GDP growth and CAD

Correlations

		gdp	cad
gdp	Pearson Correlation	1	-.453
	Sig. (2-tailed)		.139
	N	12	12
cad	Pearson Correlation	-.453	1
	Sig. (2-tailed)	.139	
	N	12	12

** Correlation is significant at the 0.01 level (2-tailed).

The above table shows the correlation between GDP and Current Account Deficit. The correlation though negative again is weaker. This implies that the impact of a worsening budget deficit would be much more than a worsening current account deficit. The recommended policy

would thus be to control the fiscal deficit. In view of the high oil prices and the slowdown in exports to advanced economies, the CAD is anyways not always controllable. But greater fiscal responsibility and prudence in government expenditures will certainly go a long way in supporting growth in the future.

In the current year also growth is lower than expected at 7 percent from budgeted 9 percent. The manufacturing sector grew at its slowest pace in two years at 2.7 percent. The fiscal deficit will be much higher than the budgeted 4.6 percent estimated to be close to 5.8 percent of GDP due to lower tax collection, delayed PSU divestment plan and subsidy led losses of the oil companies.

Rising fuel prices impacting prices of fuel and fertilizers, MNREGA wages being indexed to inflation, the food security bill will further burden the budget. The government concedes that major budgetary targets viz. of inflation, deficit and growth are not expected to meet targets due to instability in the global economy. The government's fiscal deficit stands at Rs 3.07 lakh crore which amounts to 74.4 per cent of the Budget estimate already in the first seven months (April-October) of 2011-12. This in a scenario of falling revenue and below estimated growth levels explains the additional borrowing to match higher fiscal deficit. The stalling of the reform process viz. implementation of GST, adoption of food security bill, passing on of the oil subsidies to the final consumers could affect growth and delay fiscal consolidation.

Table 1: Fiscal Targets Going Ahead (% of GDP)

	2009-10	2010-11	2011-12	2012-13
Revenue Deficits	5.3	4.0	3.4	2.7
Fiscal Deficits	6.7	5.5	4.8	4.1

Source: Union Budget 2010-11

The DIRE risks have been consolidated in the following table and as is visible, India is faring worse in all the factors that impact economic prosperity. The table below clearly shows that growth has been down at 8.5 percent and even lower in 2011-12 at 7 percent, inflation at a high of close to 10 percent, CAD at its highest in the decade at 3.7 percent and fiscal deficit at 8.5 percent though lower than 2009, much higher than the FRBM targets.

Overview of Macroeconomic Indicators					
	2003-8	2007/8	2008/9	2009/10	2010/11
Economic Growth (% per year)	8.9	9.2	6.7	7.4	8.5 [#]
Inflation (GDP deflator, % per year)	4.9	5.5	7.9	4.5	10.0*
Current Account Deficit (% of GDP)	0.3	1.3	2.4	2.9	3.7*
Combined Fiscal Deficit (% of GDP)	6.2	4	8.5	10	8.5 [#]
Gross Domestic Investment (% of GDP)	33.5	37.7	34.9	35	35.4*

Sources- CSO, RBI, Ministry of Finance

Rising fiscal deficit also influences inflationary trends either through rise in base money or higher aggregate demand. In fact empirical evidence for data in India confirms that a one percentage point increase in fiscal deficit leads to a 0.6 percentage point rise in inflation (Khundrakpam & Pattanaik, 2011). Post the sub prime crisis the fiscal stimulus efforts have increased the fiscal deficit. The global meltdown and high oil prices have worsened the current account deficit. The fiscal deficit at times leads to inflationary trends which in turn aggravates the current account deficit further.

Conclusion:

Amongst the DIRE risks facing India, fiscal deficit and current account deficit together pose a major risk to growth as proven by the correlation results. Both these deficits have a negative impact on growth, as is shown by the negative correlation for the said period.

In the context of India, fiscal responsibility has always been on the government's agenda especially after the passing of the Fiscal Responsibility and Budget Management Act, 2003. However the Indian government has struggled to meet the targets. The fiscal is deficit is

currently compounded by current account turning more negative. So we face a situation with higher than acceptable fiscal deficit and a growing deficit in the current account with unsustainable means of financing the latter leading to a renewed interest in the twin deficit hypothesis. In case the twin deficits impact India's sovereign rating, capital flows will dry up, the current account deficit can worsen.

What is more worrisome is the relation of these two deficits that feed into each other. These deficits impact investment and growth negatively. There also exists a relation between fiscal deficit and inflation. Hence, the **DIRE risks** pose a serious threat to growth in India currently amongst which the twin deficits work to reduce the GDP growth rate. To break the cycle one of the deficits must be controlled.

The trade deficit which was \$ 116.8 billion in the first eight months of the financial year is expected to remain high due to the slowdown of demand in US and Euro zone. Despite the depreciating rupee exports have not increased significantly. In other words CAD will continue due to external factors especially the economic slowdown in the west and the rising prices of crude oil. This makes it imperative for the Government to reduce the fiscal deficit. The **only way out is to reduce fiscal deficit** which will dampen output which will reduce current account deficit.

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