

The Missing Perspectives and Variables

In my post-budget article (February 8th), I had argued that a full reform of government accounts on both flow and stock bases is necessary, and that it will be interesting to see what the panel reviewing the FRBM Act says about it. The panel's report is now in public domain. To me, two major lacunae in the report are

- Silence about the adoption of the International Public Sector (i.e. government) Accounting Standards recommending full disclosure of all assets, liabilities, and contingent liabilities, which is vital for assessing the true economic implications of public sector financial management;
- The cross country data it uses gives a totally different picture than that quoted in the pre-budget Economic Review.

As for the first, the issue of contingent liabilities, legal or substantive, is all the more important for us, given the various funds being floated to finance infrastructure. To list a few: the \$ 5 bn Railways of India Development Fund (RIDF); the National Investment and Infrastructure Fund (NIIF); the Long Term Irrigation Fund (LTIF); etc. etc. In times of difficulty, such off-balance sheet liabilities come back to the promoter: remember the fate of the special investment vehicles (SIVs) of commercial banks in the US, and the "privately owned" housing loans refinance institutions in that country, at the time of the 2008 financial crisis?

This apart, let me turn to a couple of important points in the Report. The first is the arithmetic of the way the deficit targets up to 2023 have been arrived at, and their implications. The objective is to reduce the public debt level (center and states together) to 60 % of nominal GDP from the current level of 70 %. Of this, the share of states is to remain at 20 %, with the center's being brought down to 40 %. This will require the fiscal deficit to come down to 2.5 % in stages by 2023, i.e. over 6 years. The assumed nominal GDP growth is 11.5 % p.a.

For arriving at the deficit target, the Report relies on the logic that *"net household financial savings were reported at 7.6% of GDP in FY15. Further, India's external borrowing needs, proxied by its sustainable current deficit in the medium-term, are estimated at roughly 2.3% of GDP. Therefore, a total of around 10% of GDP of household savings and external borrowing would be available for the public and private sectors in the medium-term, which the Committee assumed to be allocated equally between the two. This would lead to a combined fiscal deficit of the centre and the states of 5% of GDP, and at the same time ensure an investment of 5% of GDP. The 5% general government deficit, divided equally between the centre and the states, would imply a 2.5% deficit for the centre in the medium-term."*

The logic raises several issues. Is the level of household savings a “given”? Surely it depends on several tangible and intangible variables: the real interest and exchange rates; the “animal spirits” of the consumer; etc. Again, is a current account deficit of 2.3 % of GDP “sustainable” year after year after year? As it is, our net international investment position is a negative \$ 360 bn. Adding 2.3 % of GDP to it each year will take it to say \$ 650 bn plus by 2023. Will the rest of the world finance our excess consumption forever? Or will, at some stage, there will be capital flight and a balance of payments crisis? And, is 7.5 % real growth sustainable despite the output loss implicit in the external deficit? Has any economy grown at that rate year after year except through surpluses on the external account – from Japan during its miracle years, to Korea, to Taiwan, to China....? What we need is rapid growth in manufacturing to create jobs -- and that is unlikely to come through external deficits.

Another issue is how an ever lower fiscal deficit will provide finance for needed infrastructure investment, except through “creative accounting” like off-balance sheet funds, and/or passing on the burden to commercial banks. We are seeing the effects of the latter – and of an uncompetitive exchange rate – in the asset quality of the banking system. Coming back to public debt, hardly any country has defaulted on domestic currency debt – but several have on external liabilities resulting from persistent current account deficits. We perhaps need a limit on the international investment position far more than on public debt!

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