Suman Bery: Loss of nerve

BUDGET OPINION

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It is difficult to believe that Thursday's Economic Survey and Friday's Union Budget emanated from the same Finance Ministry.

The Economic Survey got the tone exactly right. It was calm, measured and restrained. It noted that India was now clearly experiencing an economic take-off led by private-sector investment. This in turn reflected a dramatic and pervasive improvement in the investment climate. The 9 per cent growth of the past three years marks a new and decisive phase in India's growth, based largely on domestic demand; economic policy needs to accommodate and facilitate these enlarged possibilities.

Problems such as those presently facing India (inflation, monetary management, exchange rate appreciation) are those of success, and have in general been successfully managed. At the same time the country is well-poised to deal with the slowdown in the global economy, given our relatively low reliance on external demand and our strong external position. To paraphrase the Beatles, the thrust of the Economic Survey is "to give growth a chance".

The Budget Speech exuded none of this sense of relaxed confidence. One got the sense that the populist centre-piece of the speech, the Rs 60,000 debt waiver, was added at the last moment, perhaps after attempts to resist it failed. On a first reading of the budget documents, there seems to be no financial provision for compensating the affected banks anywhere although it seems unlikely that the banks will take the hit completely on their own. The Finance Minister was honest enough to dissociate the Radhakrishna Committee from this ill-considered action, and there is every reason to think this will retard, rather than advance, the cause of financial inclusion over the medium-term. Much of the devil will be in the detail, so we will have to wait and see.

The absence of budgetary detail on the cost of the waiver, and the parking of the Pay Commission impact till the end of March (when the Railway Budget chose to make provision for it), suggest that the "headroom" in meeting the fiscal deficit target for 2008-09 (of 3 per cent) is likely to be at least partially used up. This would have an equivalent impact on the adjustment projected in the primary deficit (now surplus) which is currently shown to improve by a further half percent in the coming year, to 1.1 per cent of GDP, with interest payments remaining approximately level at 3.6 per cent of GDP.

How concerned should we be about the under-performance on the revenue deficit? There are three considerations here.

First, a smaller fiscal deficit (ideally through a reduced revenue deficit) would make it easier for the Reserve Bank to manage capital inflows. High interest rates and an appreciating exchange rate are the predicted consequences of our existing mix of loose fiscal policy and tight monetary policy.

Rebalancing that mix toward tighter fiscal policy would reduce the supply of government bonds, reduce the attractiveness of government debt to banks, and allow small and medium enterprises (who are more dependent on bank financing than large corporates) to participate in the investment boom.

Second, a smaller fiscal deficit would also reduce pressure on the exchange rate to appreciate. This would both benefit labour-intensive industries like textiles and footwear, reducing the need for special fiscal sops. It would also dampen the incentives for capital inflows which are attracted by the seductive combination of high interest rates and an appreciating currency, reducing the need for the expense of sterilised intervention and the expense of market stabilisation bonds.

Finally, some over-adjustment of the fiscal position in boom times such as now would provide room for counter-cyclical fiscal policy in the event of a downturn, leaving monetary policy free to focus on fighting inflation, rather than worrying about economic activity. In brief, we are seeing some of the limitations of an excessive reliance on fiscal rules (such as the FRBM). As we saw with the Europeans and the Maastricht treaty, these include creative accounting, and insensitivity to the cyclical position of the economy.

Thus fiscal populism is not costless; if political commentators (such as Swami Aiyar, or T.C.A. Srinivas-Raghavan) are to be believed, it also seldom succeeds electorally. Quite apart from the disappointments noted above, the standstill on customs duties, though perhaps predictable in light of the declining

dollar, represents a retreat from this Minister's commitment to reduce peak industrial tariffs to "ASEAN levels". It also is inconsistent with the abandon with which our Commerce and External Affairs Ministries are negotiating free-trade agreements with all and sundry, since it invites trade diversion and revenue loss. It also puts us further and further behind China is our regional economic diplomacy.

Not all in the budget was negative. There were certainly elements (development of the bond and foreign exchange markets, for example, derived from the Report of the Committee on Mumbai as an International Financial Centre) which were encouraging. But the tone of the speech was defensive, as though the Minister had to apologise for the economy's strong performance. Moments like the present come rarely in the life of a nation. It would be sad if our politics once again led us to snatch defeat from the jaws of victory.

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