

RBI Guv Raghuram Rajan warns against fiscal deficit driven growth



Raghuram Rajan also warned about the danger of straying from a fiscal consolidation path saying the country already has high consolidated fiscal deficits. (Reuters)

Ahead of the Budget, Reserve Bank of India (RBI) Governor Raghuram Rajan today warned against generating economic growth through additional debt saying that any deviation from the fiscal consolidation path will hurt stability of the economy.

Rajan said that macroeconomic stability during the global turmoil cannot be risked and the government and RBI should continue to bring down inflation.

“As Brazil’s experience suggests, the enormous costs of becoming an unstable country far outweigh any small growth benefits that can be obtained through aggressive policies. We should be very careful about jeopardising our single most important strength during this period of global turmoil – macroeconomic stability,” he said here.

Delivering the CD Deshmukh Memorial lecture, Rajan said there is a public discussion whether India should yet again postpone fiscal consolidation path with some arguing that it could lead to higher growth.

“Unfortunately, the growth multipliers on government spending at this juncture are likely to be much smaller, so more spending will probably hurt debt dynamics. Put differently, it is worth asking if there really are very high- return investments that we are foregoing by staying on the consolidation path?” he said.

Rajan said that consolidated fiscal deficit of the Centre and states rose to 7.2 per cent in 2015 from 7 per cent in the previous year.

“So we actually expanded the aggregate deficit in the last calendar year. With UDAY, the scheme to revive state power distribution companies, coming into operation in the next fiscal, it is unlikely that states will be shrinking their deficits, which puts pressure on the centre to adjust more,” he said.

The NDA government had last year deviated from the fiscal consolidation path, postponing reduction in fiscal deficit target by a year.

Originally, the target was to bring down fiscal deficit to 3.6 per cent of the GDP in 2015-16 but it has been postponed by a year. Now, government is targeting 3.9 per cent in the current fiscal.

Rajan said deviation from the fiscal consolidation path could push up government bond yields, both because of the greater volume of bonds to be financed and potential loss of government credibility on future consolidation.

He said that fall in inflation has been on account of the “joint work of the government and the RBI, aided to some extent by the fall in international commodity prices. This is no mean achievement given two successive droughts that would have, in the past, pushed inflation into double digits”.

Unfortunately, he added, despite the success on the inflation front there are voices suggesting weakening the fight against inflation.

He said: "Let me reiterate that macroeconomic stability relies immensely on policy credibility, which is the public belief that policy will depart from the charted course only under extreme necessity, and not because of convenience. If every time there is any minor difficulty, we change the goal posts, we signal to the markets that we have no staying power.

"Let me therefore reiterate that we have absolutely no intent of departing from the inflation framework that has been agreed with the Government. We look forward to the Government amending the RBI Act to usher in the monetary policy committee, further strengthening the framework."

Macroeconomic stability, Rajan stressed, would be the platform on which "we will build the growth that will sustain our country for many years to come, no matter what the world does".

On the interest rate, he said, both industrialists and retirees overstate their case and the way to resolve their differences is to bring CPI-based, retail inflation steadily down.

RBI is scheduled to announce the next bi-monthly monetary policy on February 2.

Rajan also cautioned against raising tariffs to protect the domestic industries which are facing problems.

"Clearly, there are industries in trouble. We should, however, be particularly careful about raising tariffs at a time when costs are falling everywhere – aside from the inflationary impact, for every happy domestic businessman whose prices are raised by the imposition of tariffs on imports, we have an unhappy domestic businessman whose costs are raised by the very same tariffs, as well as unhappy consumers," he added.

Rajan said that though RBI is in "fine fettle", the world today is much less comforting as industrial countries were still struggling, with a few exceptions, to grow.

"Our fellow BRICS all have deep problems, with confidence about China waxing and waning. Indeed, India appears to be an island of relative calm in an ocean of turmoil," he said.

Citing the example of Brazil, which is facing double digit inflation, Rajan said it is confronted with financial problems because it tried to grow too fast on the back of substantial stimulus.

He added: "While the Brazilian authorities are working hard to rectify the situation, let us not ignore the lessons their experience suggests. It is possible to grow too fast with substantial stimulus, as we did in 2010 and 2011, only to pay the price in higher inflation, higher deficits, and lower growth in 2013 and 2014.

"Of course, India is not in the same situation today. Given the inhospitable world economy and two successive droughts, either of which would have thrown the economy into a tail spin in the past, it is to the immense credit of the government that we have over 7 percent growth, low inflation, and a low current account deficit. But it is at such times that we should not be overambitious."

The Brazil's experience suggests that the enormous costs of becoming an unstable country far outweigh any small growth benefits that can be obtained through aggressive policies, he said, adding that "we should be very careful about (not) jeopardising our single most important strength during this period of global turmoil, macroeconomic stability".