Is Fiscal Profligacy the Cause of the Crisis?

Prabhat Patnaik

Yashwant Sinha, Finance Minister under the NDA government, was emphatic on television that the current economic crisis of the country, marked above all by a falling rupee, was because of the excessively large fiscal deficits that the government had run in the wake of the collapse of the housing bubble in the U.S. This explanation is shared by many, including the present Finance Minister and the officials in his ministry, since it conforms to the standard neo-liberal perspective, which holds that if a country has a yawning current account deficit on its balance of payments, and hence a declining currency, then the fault cannot lie either with the global capitalist system to which it is yoked, or with the mode of functioning of the markets; it must lie with the State of the country in question. This strengthens the neo-liberal argument, that discretionary State intervention that goes against the conventional wisdom of financial markets must always be avoided. Let us examine this "fiscal profligacy" argument.

It goes as follows. Large fiscal deficits boost aggregate demand in the economy which spills over into an excess-demand-generated inflation, or into a larger current account deficit on the balance of payments, or some combination of the two. Hence if we find the current deficit widening substantially then the cause lies in the large fiscal deficits. In short, this argument blames excess domestic aggregate demand for the balance of payments problem, not world recession or trade liberalization.

What is striking about the Indian economy at present however is that even as the current account deficit has widened, the growth rate has slumped dramatically. In the last quarter of 2012-13 it was 4.8 percent and for the year as a whole it was 5 percent; in the first quarter of 2013-4 it has fallen further to 4.4 percent. This slump in the growth rate is obviously on account of inadequate aggregate demand: in the manufacturing sector for instance where the growth rate has been negative for some quarters (and was -1.2 percent in the April-June quarter over the figure of the preceding year), i.e. where output has fallen in absolute terms, no supply constraints can possibly explain this fall. Supply constraints, in the form of capacity or infrastructure bottlenecks, can at best prevent manufacturing output from rising; they cannot make it fall. Even in the service sector, which hitherto had shown high growth, there is a palpable slowing down, which can only be explained in terms of a slowing down of demand. In fact there is direct evidence of a slowing down of demand, since gross fixed capital formation has witnessed an absolute fall over the year and consumer expenditure is virtually stagnant.

Far from there being excess demand in the economy, we have in short a deficiency of aggregate demand, and an important reason for the deficiency of aggregate demand is the large current account deficit itself. There are four components of aggregate demand in any economy: private consumption expenditure, private investment, government expenditure (both consumption and investment) and net exports. A large current account deficit which means a large negative net export, reduces the level of aggregate demand in the economy, which is exactly what has been happening in the case of India.

Interestingly, the one element of demand that has kept up the level of activity in the economy, and with it the growth rate, is government expenditure. If government

expenditure had been lower than it actually was, then the growth rate of the economy would have been even lower than its recent meagre level. This is also reflected in the fact that the component of the service sector that has shown the most impressive growth rate of late is the one that includes government expenditure.

The explanation of the current economic crisis in India therefore is the exact opposite of what neo-liberal theorizing would have us believe. The economy is not characterized by excess demand but rather by a deficiency of aggregate demand; it is not excess demand that is the cause of the yawning current account deficit but rather it is the yawning current account deficit that is the cause of a deficiency of aggregate demand; it is not excessive government expenditure that is creating excess demand pressures in the economy but rather it is the largeness of the government expenditure that has till now acted as a counterweight to the deficiency of aggregate demand; it is not so much an improvement in the current account deficit that a curtailment in government expenditure will bring about but rather a further reduction in the growth rate of the economy through an even greater slump in aggregate demand (with only a marginal fall, if at all, in the current account deficit).

The predicament of the economy can be best understood if we look at just one illustrative case, that of BHEL. Because of import liberalization, foreign suppliers, especially from East Asia, who have the backing of their respective States, are taking away orders within India from BHEL, which, despite being a public sector enterprise, does not enjoy the backing of the neo-liberal Indian State (which would dearly love to privatize it if it could). As a result it is running at almost 50 percent capacity. Domestic production in short is being restricted because of burgeoning imports which explain both the industrial recession and the yawning current account deficit. Curtailing government investment in this situation is likely to affect BHEL even more than it will affect foreign suppliers. It will therefore aggravate the recession without making much difference to the current account deficit.

What is true of BHEL is even more true of large numbers of domestic producers, especially in the small scale sector, who are driven to the wall by competition from East Asia (that entails an element of dumping). Import liberalization, one of the shibboleths of neo-liberal policy, has been so ruthlessly practiced in India that tariff rates on imported goods are invariably kept far below even the “tariff bounds” that are allowed to the country by the WTO rules themselves. The result has been both a widening of the current account deficit and a crisis of manufacturing. It is not supply side constraints, which, in the face of excess demand pressures, have compelled us to import more, but import liberalization which has both enlarged imports and caused domestic recession and unemployment.

A facile argument is often put forward in this context, namely that the depreciation of the rupee, caused by the yawning current account deficit, will improve the competitive position of our producers and hence restrict imports automatically. The falling rupee in other words is part of the self-correcting mechanism of the market itself, and once the rupee has fallen sufficiently the economy will reach an “equilibrium” where the current deficit will automatically shrink to a level equal to what can be financed through capital inflows.

This is a facile argument for two reasons: first, since the decline in the value of the rupee raises the import price of oil which gets passed on, the competitive advantage that might accrue to domestic producers through a fall in the value of the rupee is

offset to a considerable extent by the rise in their costs owing to higher inflation. Secondly, these higher oil prices, and the cost-push inflation they generate, affect the living standards of the working people. To protect domestic producers through a currency depreciation therefore is a far more "costly" means of doing so (in human terms) than protecting them through raising tariff rates in selected spheres (where they do not have any such cost-push effects).

The fiscal-deficit-as-the-cause-of-the-crisis argument is not just wrong; it is insidious as well. It has already given rise to a veritable cacophony that subsidies must be cut in order to curtail government expenditure, so that the fiscal deficit is reined in. This means inter alia that the food security legislation passed by parliament should be kept in abeyance (and all existing subsidies should be whittled down, or, what is a euphemism for the same thing, "better-targeted").

This argument is not only anti-people, and hence insidious; it is also vacuous for the following reason. The government already has enormous food stocks which it does not even have enough storage space for. Suppose the government buys Rs.100 of FCI stocks through running a fiscal deficit, then since the FCI is part of the government itself, there is no increase in the net indebtedness of the government, only a taking over of FCI debt to banks by the government, which cannot conceivably have any impact whatsoever on the level of aggregate demand (which is what the neo-liberals are worried about).

Now, suppose the government distributes these stocks gratis to the people. Some, who did not have enough to eat earlier, will eat more, but their aggregate demand for other goods will not change at all. But some who were earlier paying the market price for grains, but would now get free government grains, would have more purchasing power in their hands. In other words the only change in aggregate demand that would occur is through a switch from open market purchases by the poor to receiving government-supplied grains. Now, typically the additional purchasing power in their hands as a result of this switch will be spent by them on a range of simple locally available goods, with very little import content, which will generate larger local employment and output. And to the extent there is some spill-over to imports of such additional purchasing power, it can be easily prevented by raising the tariffs on the concerned imported goods.

In other words objecting to the food security measure on the grounds that the fiscal deficit will be enlarged thereby misses the point that there will be no increase in the net external indebtedness of the government as long as FCI stocks exist. And the import-spillover effect of any downstream increase in aggregate demand can be handled by appropriate import tariffs, which need not even violate WTO rules.

Of course, the concern with the fiscal deficit has less to do with its actual implications than with the "reaction of financial markets". But if people have to go hungry for financial markets to be appeased, then that is an argument for liberating the economy from subservience to financial markets.

*** This article was originally published in People's Democracy, Vol. XXXVII, No. 36, September 08, 2013.**