Current Issues

India Special

January 13, 2006

India's public finances: Do they matter?

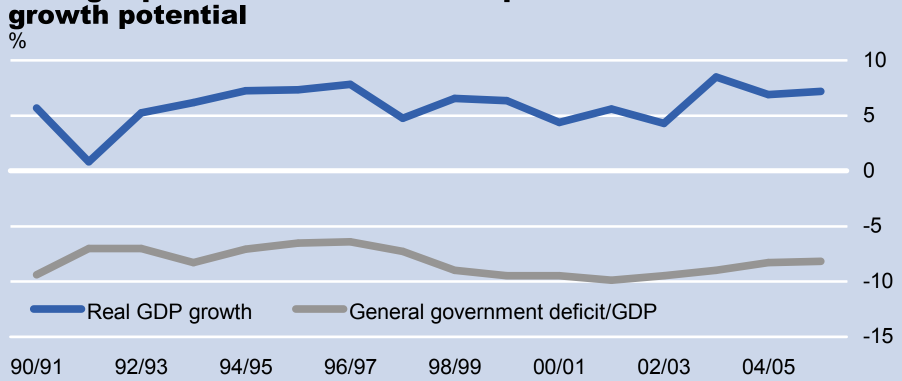
India's general government deficits and public debt have remained high despite faster economic growth in recent years and periodic attempts to instil greater fiscal discipline. Modest fiscal tightening at the centre has been offset by significant fiscal slippages at the states level, leaving the general government deficit largely unchanged as a percentage of GDP.

A track record of macroeconomic stability and a local bond market that allows the government to issue long-dated, fixed-rate securities in its own currency have allowed India to sustain such high levels of public indebtedness. These attributes, coupled with a high savings rate and external capital controls, have meant that large fiscal deficits have been comfortably financed from captive private savings.

India's public debt dynamics are not explosive, but nor are they capable of defying gravity. The fact that the debt-to-GDP ratio has continued to edge up even as growth has accelerated to 7-8% indicates that India is unlikely to simply outgrow its debt burden. There is, too, the abiding risk that contingent liabilities lurking in the broader public sector could come home to roost.

Expectations that India could attain Chinese-style rates of expansion are possible, if only the government was prepared to pursue fiscal consolidation more forcefully, thereby reducing its dependence on household savings and domestic capital markets. However, it would be a mistake to repeat the experience of the mid-1990s when greater fiscal discipline did indeed help deliver markedly higher growth, but only at the expense of sharp cuts in public investment.

Stronger public finances could help India to realise its full growth potential



Sources: Fitch, National Sources

* Guest authors express their own opinions which may not necessarily be those of Deutsche Bank Research. Please see page 12 for a short biography of Paul Rawkins.

www.dbresearch.com

Author
Paul Rawkins
Fitch Sovereign Ratings

Editors
Maria L. Lanzeni
Jennifer Asuncion-Mund
+49 69 910-31714
jennifer.mund@db.com

Technical Assistant
Bettina Giesel

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director
Norbert Walter

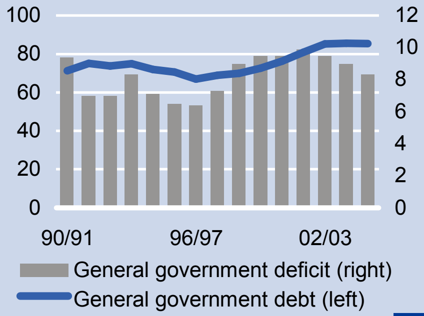
I. Background

India's fiscal malaise first came to prominence in 1990-91 when a longstanding deterioration in the public finances boiled over into a classic balance of payments/external debt crisis. Melded with political instability and an oil price shock, India stood on the brink of external default by early 1991 and was forced to accede to an orthodox IMF adjustment programme, the first in its history. Most of the burden of fiscal adjustment fell on the shoulders of the central government, which concentrated on stabilisation and structural reforms. However, with hindsight, by the mid-1990s it was clear that fiscal consolidation had run its course.

By fiscal year 1999/2000 the general government deficit had risen to 9.5% of GDP, reclaiming the heights of 1990/91 and simultaneously eliminating all the gains of the intervening years. Similarly, general government debt again exceeded 70% of GDP. Subsequent years have seen the deficit continue to fluctuate in the range of 9-10% per annum, while the general government debt-to-GDP ratio has climbed to over 80%.

Public finances a longstanding challenge

General government finance, % of GDP



Sources: Government of India, Fitch Ratings 1

The deterioration in India's public finances goes much deeper than these numbers alone would suggest. Yet the macroeconomic backdrop could hardly be a greater contrast to 1990/1991: the economy recorded robust growth of 8% yoy in Q2 2005; the current account deficit is running at 1.6% of GDP, barely half its 1990/1991 level, notwithstanding a doubling of the oil import bill over the past two years to nearly USD 40 bn; and international reserves standing at about USD 140 bn at the end of 2005.

A. What lies behind fiscal deterioration?

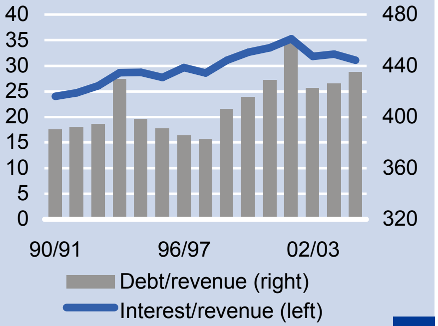
The short answer to this question is simple: there has been a secular decline in tax revenue as a share of GDP since the mid-1980s, even as the policy-neutral rate of growth has doubled to 6% from 3%. Meanwhile, government at all levels has struggled to meet spiralling current expenditure commitments in a climate of coalition politics since the mid-1990s.

Again with hindsight it now seems clear that the story of fiscal adjustment in the first half of the 1990s was one of incomplete tax reform – indirect trade and financial sector taxes were cut, but compensating increases in direct taxes failed to materialise – coupled with steep reductions in capital expenditure (down from over 6% to around 3% of GDP) dressed up as deficit reduction.

By the second half of the 1990s, with growth starting to slow as reforms tailed off, the limitations of this strategy were starting to show. With tax revenues continuing to decline to a nadir of less than 14% of GDP and the cost of salaries, pensions, subsidies and debt service continuing to mount, the general government deficit peaked at 9.9% of GDP in 2001/02.

Weak measures of public solvency

General government, %



Source: Fitch Ratings 2

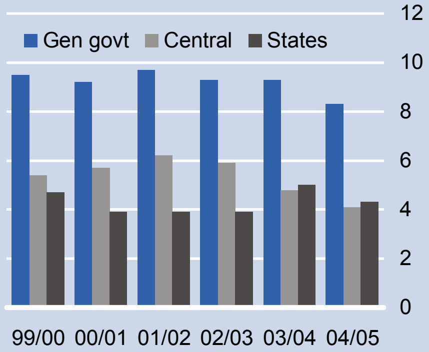
One of the starkest measures of the government's plight was the revenue deficit – current revenues minus current expenditure – which had risen to 7% of GDP by 2001/02 (compared to a then peak of 4% in 1990/91), implying that 70% of borrowing was to fund current expenditure. Other more commonly recognised measures of fiscal incontinence included a primary deficit of close to 4% of GDP, interest payments over 35% of revenue and a debt-to-revenue ratio of almost 460%.

B. Centre-states imbalance

Any analysis of India's fiscal landscape has to take account of the country's federal structure. Under this arrangement, the central government collects about 60% of general government taxes, while state governments collectively undertake a similar proportion of general government expenditure. One of the problems of this arrangement has been enforcing all-round fiscal discipline. Thus, periodic attempts at fiscal consolidation at the centre have often been undermined by fiscal profligacy at states level. This was certainly the case in the mid-1990s and the pattern has repeated itself since 2000.

The central government has a poor record of meeting budget targets (roughly 1 in 5 over the past decade). Nonetheless, tighter control over expenditure – helped by a fortuitous decline in interest rates – and more buoyant revenues have delivered a reduction of more than 2% of GDP in the deficit since it peaked at 6.2% in FY 2001/02. Moreover, in the last two fiscal years the deficit has come in below target, falling to a revised 4.1% of GDP in 2004/2005, the lowest since the mid-1990s. However, weak state government finances have meant that the improvement in the general government deficit has been less than 2% of GDP over the same period.

Centre and state deficits: almost a zero-sum game
Fiscal deficit, % of GDP



Sources: Indian authorities and IMF 3

The plight of state government finances first came to light in 1998/1999 when their collective deficit jumped from 2.8% to 4.2% of GDP in a year. While the proximate cause of this deterioration was large public-sector real wage increases (and associated hikes in pensions) mandated by the Fifth Pay Commission, it also served to highlight a secular decline in revenue. Unrelenting increases in wages and pensions, debt service and subsidies – to the point where they now absorb almost 90% of revenues – have meant that state government deficits have remained close to 4% of GDP. Off-budget liabilities, chiefly arrears in connection with the subsidised power sector, have also started to come home to roost, adding 1% of GDP to the states' deficits in 2003/2004.

C. Taking stock of fiscal consolidation

India's tax system is well developed…

For an emerging market, India has quite a well developed tax system, but it has become increasingly complex over time, while numerous exemptions and loopholes have robbed it of its effectiveness. Although the average tax intake is low – some 5 percentage points of GDP below the developing country average – marginal tax rates are high, limiting the scope for further increases. Indirect taxes – chiefly state taxes on commodities and services and centrally levied customs and excise duties – are the principal source of revenue; direct taxes on companies and individuals make a much smaller contribution.

… but has limited flexibility in relation to the changing structure of the economy

The main problems with India's tax system lie in its narrow base and limited flexibility in relation to the changing structure of the economy. India is still a poor country, but the ranks of the middle classes have reportedly swelled to over 300 m people, yet less than 1% of the population (38 m) pay income tax. Similarly, extensive tax holidays and exemptions have eroded the corporate tax base, while agriculture and services remain largely outside the tax net. Thus, taxes on services amount to just 0.3% of GDP, even though this sector now accounts for 50% of GDP. Meanwhile, industry and trade, the most tax-buoyant sectors of the economy, continue to labour under a disproportionate tax burden. As aforementioned, some cuts in taxes on trade were made in 1990/1991, but these served only to

Narrow tax base & limited tax flexibility underscore malaise in public finances

FY 2003/04	% of GDP	% of total
Central government	**9.2**	**61.0**
Corporate tax	2.3	15.2
Income tax	1.5	9.9
Excises	3.3	21.8
Customs	1.8	11.7
Other (mostly service tax)	0.4	2.4
States & union territories	**5.9**	**39.0**
Income taxes	0.1	0.6
Taxes on property & capital	0.6	4.3
Taxes on commodities & services	5.1	34.1
Total	**15.0**	**100**

Source: Indian authorities & IMF 4

erode the tax base because they were not fully compensated for elsewhere, highlighting the risks of incomplete tax reform.

The current government – a Congress-led coalition headed by Manmohan Singh (the architect of the reforms of the 1990s) – has inherited a two-pronged approach to fiscal consolidation set in train by the previous BJP-led government. The first prong – the Fiscal Responsibility and Budget Management Act (FRBMA), 2003 – seeks to impose a medium-term disciplinary framework on government, while the second – the Kelkar Committee on Tax Reform – sets out a roadmap of how the targets embedded in the FRBMA might be attained.

The major challenge for the current government has been and continues to be how to marry these strictures with its campaign promises – summarised in its National Common Minimum Programme – to step up spending on infrastructure without reneging on existing social commitments. Its task is further complicated by a diverse array of coalition partners that often restrains its hand on reform and liberalisation.

D. Fiscal Responsibility Act: Mixed messages

Fiscal responsibility acts can be useful for injecting a greater measure of transparency and accountability into fiscal policy, but they are neither a necessary nor a sufficient condition for fiscal consolidation. Having already been amended once and breached once in its short life, India's Fiscal Responsibility and Budget Management Act (FRBMA) currently envisages a reduction in the central government budget deficit of 0.3% annually, prospectively reducing the deficit to 3% of GDP by 2008/2009. In addition, it mandates an annual reduction of 0.5% in the revenue deficit with a view to eliminating it by 2008/2009.

Fiscal Responsibility Act neither a necessary nor a sufficient condition for fiscal consolidation

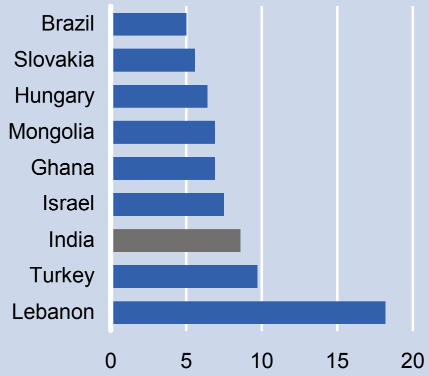
The budget handed down for 2005/2006 foresees a deficit of 4.3% of GDP compared to an estimated outcome of 4.6% for 2004/2005, thereby meeting the first requirement of the FRBMA. However, revised estimates for 2004/2005 now indicate a deficit of 4.1% versus 4.3% for 2005/2006, implying a fiscal easing rather than a tightening. At the same time, the government has already indicated that it will miss the revenue deficit target in 2005/2006, on account of larger transfers to the states in line with the 12th Finance Commission's (TFC) recommendations (see below).

While the overall deficit reduction target is arguably the more important of the two, the fact that the government saw fit to 'press the pause button' on the second directive, rather than take the necessary remedial measures, did nothing to dispel concerns about India's track record for meeting budget targets. This may not matter much in the larger scheme of things if the general government balance, which is invariant to higher transfers to the states, starts to come down. However, as yet figures for the general government outturn for 2004/2005 are not available and forecasts for 2005/2006 look more hazardous than usual, given the changes underway in state government finances.

E. Incomplete tax reform

True to its remit, the Kelkar Committee set up in 2002 proposed far-reaching reforms to the tax system aimed at broadening the tax base, eliminating exemptions, rationalising taxes on trade and moving towards a nationwide value-added tax (VAT). With the economy growing strongly, there were high expectations that the

India's fiscal deficit among the highest in emerging markets
Average fiscal deficits 1995-2004, % of GDP



Source: Fitch Ratings 5

government could use this opportunity to push through aggressive reforms in the 2005/2006 budget. In the event, although corporate income taxes and import tariffs were cut and some exemptions closed, the budget failed to advance broad-based tax reform. This was disappointing, effectively limiting the window of opportunity for the government to take unpopular measures early in its term of office.

That said, revenues have been growing strongly so far this year – up almost 17% yoy in April-October – on the back of strong economic growth, improved tax compliance and the ending of some exemptions. This is fortunate given the risk of fiscal slippage that could arise from lower profit remittances from state-owned oil companies this year, as they are forced to absorb some of the impact of high oil prices.[1] Moreover, although the five-month revenue and budget deficits look disproportionately large, it is hard to compare like-with-like this year, given the discontinuation of debt swaps[2] and the implementation of the 12th Finance Commission's recommendations.

F. A breakthrough in inter-governmental fiscal relations?

Improving state finances is critical to future economic growth

The Finance Commission meets every five years to review revenue sharing arrangements between the central government and the states and make recommendations. Reversing the deteriorating trend of state finances is critical to future economic growth because many of the factors determining that growth lie in the states' domain (e.g. power, irrigation, education, transport and health). To this end, the TFC recommended increased transfers from the centre, along with debt relief and outright debt write-offs. In return, states are expected to enact fiscal responsibility legislation and implement a new VAT from April 1, 2005. They will also be able to borrow on their own account for the first time.

Enactment of fiscal responsibility legislation remains very uneven across the states. However, the central government regards the adoption of VAT by 21 out of 27 states in April 2005 as one of the most important tax reforms since independence. States that have taken the government's lead like Karnataka, Tamil Nadu and Haryana (the first to introduce VAT) have produced very impressive results and the TFC is hopeful that similar developments nationwide could bring the general government deficit down to 6% by 2009/2010, with the deficit being split equally between the centre and the states.

Is nationwide adoption of VAT sufficient for fiscal consolidation?

Welcome though this statement of intent is, it hardly qualifies as an ambitious programme of fiscal consolidation. On the one hand, a general government deficit of 6% of GDP would still be high by any standard, emerging market or otherwise; on the other, the revenue increases the TFC has in mind (2% of GDP over five years) are positively modest compared with the enormous scope for broadening the tax net, while expenditure is expected to decline by just 1% over the same period.

No one doubts the need for higher spending on infrastructure, but there is still no appetite for the front-loaded adjustments favoured by

[1] The government is proposing to issue bonds to the state oil companies to cover the losses they have incurred by effectively subsiding domestic fuel prices: this will add to the public debt and the interest burden on the budget.

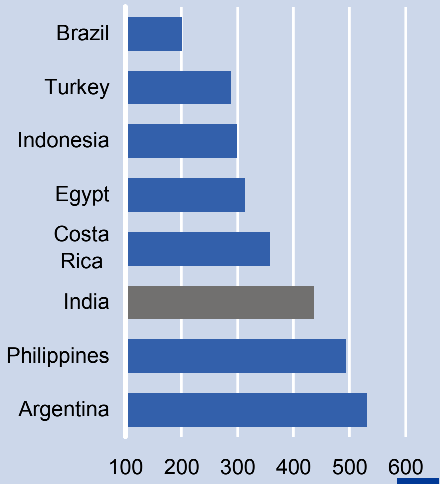
[2] Under this scheme states were able to swap high-cost borrowing furnished by the central government for market borrowing and loans from the National Small Savings Scheme.

the Kelkar Committee to accommodate this. Indeed, the centre has chosen to create new special purpose vehicles to fund such spending off-budget, rather than make more painful adjustments, while privatisation has also been moved firmly off-budget.[3]

Returning to the states, this fiscal year promises to be an important test of the central government's willingness to subject the states to a more severe fiscal regime. A key pointer will be the attitude the centre takes towards those (weaker) states that are unable to access the domestic capital market: put bluntly, will it be a case of sink or swim, or will the centre ultimately step in to rescue them? Looking further ahead, some argue that the TFC is simply a zero-sum game played out between the centre and the states and point to the 11th Finance Commission which also set well-meaning deficit reduction goals, few of which were realised. Here, it is worth noting that the 'carrot' being offered this time around – debt write-offs – is materially different from the 11th FC.

India's public debt ranks high among emerging markets...

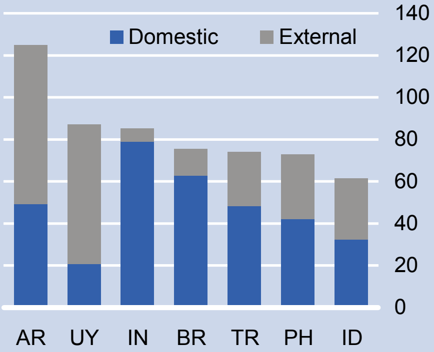
General government debt, % of revenue, 2004



Source: Fitch Ratings 6

... but it has little public external* debt

General government debt, % of GDP, 2004



* on a residency basis. Source: Fitch Ratings 7

II. Record of macro-stability mitigates risks of debt crisis

It is hard to find another major emerging market with India's level of public indebtedness that has not experienced a crisis of investor confidence in recent times. This is all the more surprising when one considers the material deterioration that has occurred in India's public solvency indicators since 1990/1991: interest payments have risen from one-quarter to one-third of revenue, while general government debt as a percentage of revenue has escalated from 375% to 435%. Yet, even with general government debt now among the highest of any major emerging market, there is still no sense of alarm among investors or the authorities that these debt levels are in any way unsustainable.

Part of the explanation for this situation would seem to lie in the fact that, apart from 1990/1991, India has an acknowledged track record of moderate inflation – politically very sensitive in such a poor country – and macroeconomic stability. India is also comparatively rare among emerging markets in having an unblemished debt service record, both domestically and externally, notwithstanding the scare of 1990/1991.

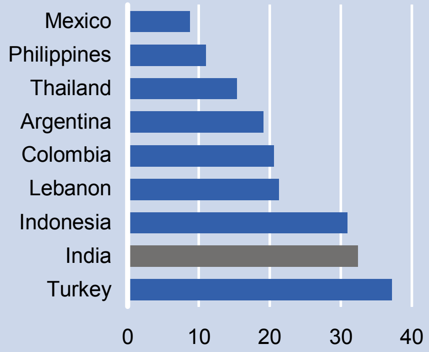
One by-product of this set of circumstances has been very low levels of dollarisation; another has been the development of a local bond market that allows the government to issue long-dated, fixed-rate securities in its own currency. These attributes, coupled with a high savings rate for such a low-income country and external capital controls, have meant that large fiscal deficits have been comfortably financed from what are in effect captive private savings.

Several outcomes have followed from this. One is that, compared to other major emerging markets, virtually all of India's public debt is denominated in local currency and held by residents.[4] With little exposure to exchange rate risk in any shape or form – most public external debt is owed to multilateral and bilateral institutions – India escaped largely unscathed from the Asia crisis and has not had to

[3] Previous governments had counted privatisation 'above the line' as a revenue item. In recent years it has become something of a 'political football', adding to the volatility of government revenue and complicating budget outcomes.

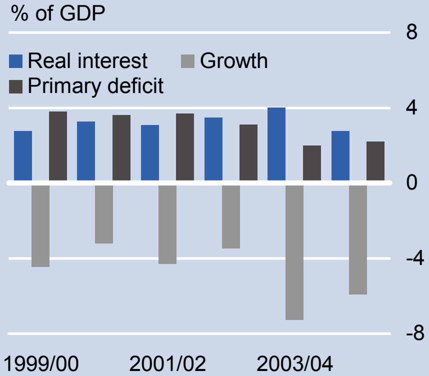
[4] With the exception of authorised foreign financial institutions, non-residents are not permitted to hold domestically issued public debt.

Indian banks: Captive demand source for government securities
Government securities, % of total assets, 2003



Source: IMF
8

Disaggregating changes in the public debt-to-GDP ratio
Contributions to changes in public debt*, % of GDP



* Positive values imply debt increasing factors.
Source: Fitch Ratings
9

cope with the contagion risk emanating from sudden shifts in international investor sentiment. That risk is further mitigated by international reserves of about USD 140 bn, which have turned the public sector into a growing net external creditor since 2001/2002.

Such external insularity has, however, come at the price of financial repression and a still partially closed external capital account. Thus, the subjection of Indian banks and financial institutions to a combination of regulatory and portfolio requirements effectively ensures that a significant share of private savings is channelled into government securities. As a result, Indian banks' holdings of government securities as a share of total assets rank among the highest in the developing world.[5]

Quite apart from arguments about squeezing out lending to the private sector, this level of public debt concentration has several potential implications for broader debt management. On the one hand, it gives the government an extra degree of freedom insofar as most of the banking system is in the public domain and could reasonably be expected to be more receptive to moral suasion in a funding crisis. On the other hand, however, if some form of debt restructuring should become necessary, it could severely impair the health of the financial system, ultimately adding to public sector indebtedness.

Be that as it may, in such an environment of preferential access to funding, the normal pressures of market discipline have tended to take a back seat and the government has effectively enjoyed a soft budget constraint. Moreover, plentiful global liquidity and a benign interest-rate environment have lent themselves to an extension of average maturities and a reduction of average borrowing costs in recent years. Such factors have allowed the authorities to sidestep the issue of public debt sustainability, seemingly safe in the knowledge that deficits of 9-10% of GDP and general government debt greater than 80% of GDP are not incompatible with growth of 7-8%.

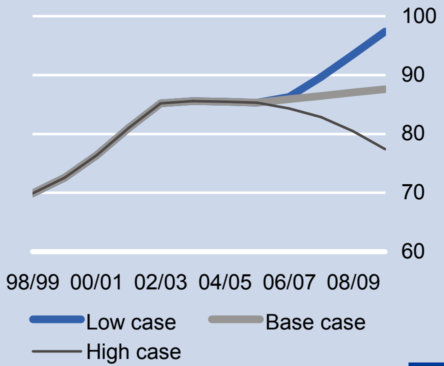
The main factors influencing past movements in the general government debt-to-GDP ratio have been real growth, real interest rates and the size of the primary deficit. Exchange rate effects have been marginal, reflecting the low level of foreign currency debt (see chart 7), while other factors like privatisation receipts have been small and intermittent at best.

Looking back over recent years, one thing is clear: any slowdown in growth rapidly translates into a deteriorating debt ratio. Thus, when growth slowed between 1999/2000 and 2002/2003, the debt ratio rose from 73% to 85% of GDP. Moreover, even in the current climate of higher growth of 7-8%, the debt ratio has continued to edge up. The main reason for this would seem to be that the gap between real growth and real interest rates – a key debt sustainability variable – has started to narrow. Real interest rates have been rising since mid-2004 and turned positive earlier this year for the first time since mid-2003.

India's public debt dynamics are not explosive. Indeed, based on current trends of growth of 6.5%, real interest rates of 4.5% and a primary deficit of slightly over 2% (the 'base' case), the debt ratio would rise only slowly to 88% of GDP by 2009/10. Moreover, even

[5] Similarly high ratios in Indonesia and Turkey are attributable in large part to financial sector crises that have necessitated extensive recapitalisation backed by government securities.

Public debt dynamics are burdensome, but not explosive
% of GDP



Source: Fitch Ratings 10

though real interest rates have started to rise, their impact on the public finances is moderated by the long average maturities of public debt. However, the government's gross market borrowing was up 10% yoy in April-September 2005, while floating rate bonds accounted for 29% of gross market issuance in 2004/2005.

While the Indian authorities appear unconcerned about the levels of public indebtedness, the fact that the debt-to-GDP ratio has continued to edge up even as growth has accelerated to 7-8% indicates that India is unlikely to simply grow out of its debt problem. This has led some observers to conclude that India is in a 'debt trap'. While this judgement may be too harsh, public finances are much more highly geared to the India growth story than they were. Thus, the 'low growth' scenario (see chart 10), which assumes a repetition of the slow growth experience at the turn of the century, highlights the attendant risk that the public debt ratio could easily spiral up towards 100% of GDP by 2009/2010.

Conversely, if the government were to display the necessary political will to undertake stronger fiscal adjustment, reducing the primary balance to zero by 2009/2010, thereby setting the stage for lower real interest rates and higher growth, the public debt ratio could be launched on a lower growth trajectory (the 'high' case). But, even then, it is unlikely the ratio would fall much below 80% of GDP by 2009/2010.

The main point to come out of this debt sustainability analysis is that the public finances are already highly geared and a prolonged growth shock could easily set them on a potentially unsustainable path. What is also true is that high growth is not a given; it relies upon a favourable external environment and the maintenance of policy-driven reforms at home. There is, too, the abiding risk that contingent liabilities lurking in the broader public sector could come home to roost, resulting in an unexpected steep increase in public debt.

A. Contingent liabilities could threaten fiscal consolidation

The public sector's writ runs deep throughout the Indian economy – three-quarters of the banking system remains in state hands while inefficient state enterprises remain a drain on public finances, particularly at state level, raising concerns about contingent liabilities that could thwart fiscal consolidation such as it is.

State utilities and government guarantees represent a large contingent liability

State utilities: One of the largest reservoirs of contingent liabilities is the off-budget activities associated with the supply of power and irrigation to households and farmers. Subsidies rarely cover more than 50% of these costs, especially where these services are supplied at no charge to the end-user, a practice which some states have started to revert to again under the current central administration. The World Bank estimated losses arising from these activities at more than 1% of GDP as long ago as 2001/2002 and estimated that the states' deficits would rise by 30% and general government debt by 1-1.5% of GDP if they were recognised on budget. Recognition of arrears was an important contributory factor to state government deficits in 2003/2004.

Government guarantees: Government-guaranteed debt outside of the general government framework amounts to 10-11% of GDP. Most of this is accounted for by the securitisation of the financial losses of state electricity boards and borrowing by special purpose vehicles for irrigation projects. Independent estimates suggest that up to a sixth of the guarantees issued in 1996-2002 could be called in coming years. Because many of these debts have been guaranteed by the states themselves, many of which are in no position to honour these guarantees, the risk of them ending up on the balance sheet of the central government is high, unless the latter takes a tough line and forces the states to restructure the loans.

The recapitalisation of the banking system could also add to fiscal woes

Banking system: The Asia crisis of 1997-1998 focussed attention on how rapidly a financial sector crisis could transform public finances, adding anything up to 50% of GDP to public debt. In India, where the state dominates the financial system, the cost of assisting public banks and financial institutions has averaged about 0.3% of GDP per annum since 1992/1993, although in some years, like 2002/2003, it has been as high as 0.8%.

In a full-scale crisis, the costs of recapitalising the banking system could be expected to be much less than those of some of India's Asian counterparts – perhaps 5-10% of GDP – on account of lower lending as a share of GDP (and, hence, smaller non-performing loans) and already high holdings of government securities. However, with general government debt of over 80% of GDP, India starts from a much weaker position than, say, Korea, Thailand or Indonesia did.

Pensions are becoming a growing item of expenditure for the central and state governments

Pension liabilities: Pensions have become one of the fastest growing items of expenditure for both central and state governments. This is partly the result of an expansion of public sector employees over more than 30 years, but also the 5th Pay Commission which greatly raised public sector wages and indexed pensions to real wage increases. An exercise by the World Bank in 2001 estimated the net present value of unfunded pension liabilities at 25% of GDP.

With pensions set to continue growing rapidly over time, both centre and states are exploring ways of altering the parameters of the existing schemes while simultaneously moving more towards schemes with defined contributions. Moreover, with another pay commission in the offing, the authorities are acutely aware of the risks of repeating the mistakes of the 5th Pay Commission.

B. Privatisation could be an invaluable source of funding

Privatisation can be a key source of public funds…

Privatisation receipts can provide an invaluable source of public funds for containing borrowing and/or outright debt reduction and reducing transfers from the budget. Previous governments have treated privatisation as a revenue item, in contrast to the international norm of treating it as a financing item, and persistent budget shortfalls have owed much to overambitious plans in this area.

… but has been slow in recent years

The scope for privatisation in India is virtually limitless. However, the current government has displayed a less aggressive stance to privatisation right from the outset, abandoning strategic sales in favour of less attractive sales of unprofitable loss-making enterprises and residual stakes of partially privatised companies. In the last budget, privatisation was moved off-budget altogether mainly to depoliticise what had become a contentious issue with the Left Front contingent of the coalition. Further backsliding has occurred since with 13 proposed public-sector disinvestment candidates effectively stalled.

III. Does the fiscal deficit matter? The macroeconomic context

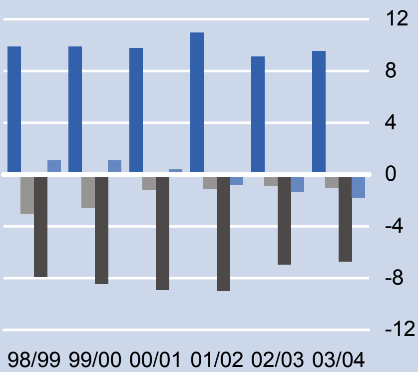
Investment in infrastructure is imperative for growth, but public sector resources for that purpose are limited

One of the mantras of the current government has been the need to emulate China and raise long-term growth from around 6% at present to 8% and more. In the Tenth Plan document India's planners argue that one of the essential building blocks in the pursuit of this goal will be a rise in the rate of investment from its most recent decade-long average of 24% to 28% of GDP. Much of this new investment will need to be directed into infrastructure, the present lamentable state of which remains a formidable barrier to higher growth and private investment.[6] Yet the public sector is in no position to embark on an expansionary fiscal policy to stimulate public investment.

The government has made it very clear that it regards infrastructure renewal as its number one priority, ranking well ahead of fiscal consolidation. The problem here is that it is very hard to see how India can attain the first without the second. Indeed, the main reason why India's general government deficits have not been higher than 10% of GDP is that capital expenditure has been halved from over 6% to around 3% of GDP in order to accommodate higher current expenditure. Not only has this process run its course now, but the prospects of reversing it in the absence of a convincing fiscal adjustment on the revenue side of the budget are slim.

Household sector is the country's saving engine

Gross domestic saving minus investment, % of GDP



Sources: RBI, Fitch Ratings 11

This brings us to the broader question of how the fiscal deficit interacts with the economy as a whole and, specifically, whether India can sustain growth of 8% and more without addressing the need for fiscal consolidation. Ordinarily, persistent fiscal deficits of 9-10% of GDP would be expected to expand aggregate demand, squeeze out private sector investment, drive up inflation and interest rates and tip the external current account balance into deficit – the so-called 'twin deficits' problem – yet the evidence for this in India has not been compelling. Indeed, for a time (2001-2003) India appeared to have defied the logic of the 'twin imbalances' altogether with fiscal deficits of 9-10% of GDP coexisting with a move into current account surplus. However, few countries have managed to sustain this situation for any length of time – Japan is the most impressive example – and India has proved no exception.

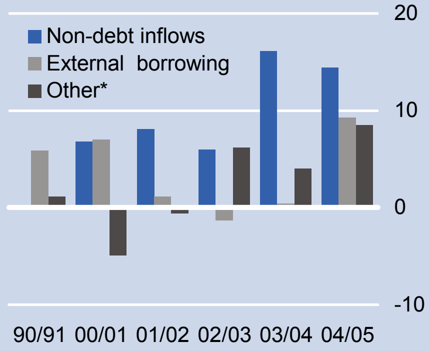
Nonetheless, in order to understand how India attained this feat at all, it is instructive to examine the savings and investment behaviour of individual sectors of the economy. Thus, the deterioration in the public finances which occurred at the turn of the century coincided with an upturn in net household savings (i.e. net of investment) and a reduction in the corporate sector's demand for funds as it pursued a period of restructuring. These sectoral adjustments in savings behaviour were more than sufficient to accommodate an increase in public sector dissaving, allowing the current account to shift into modest surplus (shown here as net lending to the rest of the world).

This trend continued until 2003/2004 when a sharp upturn in growth in the context of little apparent change in public dissaving and a recovery in net corporate borrowing started to spill over into the balance of payments, opening up a current account deficit of some 1% of GDP in 2004/2005. From this we deduce that the link between

---

6 Reserve Bank of India (RBI) research points to strong complementarities between public investment in infrastructure and private investment and, indeed, anecdotal evidence (e.g. telecoms) suggests that the private sector would be prepared to enter into public-private partnerships given the right incentive structure.

Non-debt-creating flows still dominate net capital inflows
USD bn



*Net lending abroad, other unspecified capital.
Source: RBI
12

the public finances and the balance of payments has begun to reassert itself. The manner in which this link plays itself out will depend primarily on households' saving behaviour.

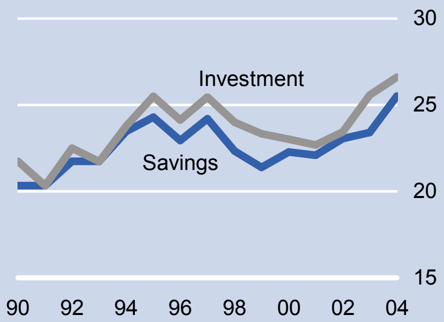
In the recent past the government has absorbed 80% of household financial savings, aided by a sealed capital account which prevents savings seeping abroad. However, this state of affairs is changing now, as a sharp increase in the financial liabilities of the household sector – reflecting higher borrowing for consumer durables and property – reduces the availability of net household savings to the public sector. Indeed, the more pertinent consideration here may be to what extent a consumer boom in India would be compatible with current levels of public dissaving.

In contrast to the turn of the century, corporate demand for funds is also rising as Indian firms start to invest again. For the moment, incremental competition for funds is effectively being satisfied from abroad, with net capital inflows running at a rate of 3% of GDP. Most of these funds are being channelled to the private sector, attracted by India's favourable growth prospects. Moreover, at least half of these funds in most years are non-debt-creating – foreign direct investment is minimal compared with China, but portfolio equity investment is significant – boosting international reserves and contributing to India's growing net external creditor position.[7] Nonetheless, there is little cause for complacency.

Assuming that current trends continue, what these behavioural observations suggest is that in the absence of a fiscal correction, higher growth in India is going to become increasingly dependent on external financing, reflected in a growing current account deficit. As such, any tightening in global liquidity and/or a shift in investor sentiment towards emerging markets is likely to impact on growth, domestic interest rates and the exchange rate, with adverse consequences for the public debt-to-GDP ratios. In short, India's public finances are set to become more highly geared to external financial conditions, unless the government changes its behaviour and curtails its rate of dissaving.

Reasons to be cheerful

Increasing savings and investment a future source for growth
% of GDP



Source: Fitch Ratings
13

While it is important to be aware of this growing external vulnerability to growth and the fiscal accounts, it is also worth noting that India has rarely been better prepared to withstand external shocks. Fifteen years of sporadic reforms have bought India greater structural flexibility and the economy has barely paused for breath this year, notwithstanding the sharp rise in oil prices that has added USD 40 bn to the import bill since 2003/2004. Some analysts have focussed on India's growing dependence on portfolio equity inflows, arguing that this amounts to uncertain financing of a certain (current account) deficit. Valid though this observation is, it is also true that about USD 140 bn of international reserves buys considerable insurance against external shocks.

Looking further ahead, the rise in gross domestic savings and investment that has occurred since the late 1990s suggests that India should have the capacity to finance higher growth from domestic sources, providing that these funds are employed more

[7] Defined here as gross international reserves plus banks' foreign assets (USD 144 bn end-March 2005) less gross external debt (USD 137 bn at end-March 2005).

productively. India already boasts a high savings rate for such a low-income country (GDP per capita at market exchange rates was USD 650 in 2004). Moreover, demographic factors – a young population with a fast growing workforce and a declining proportion of dependents – should underpin further advances in savings and investment in the future.

India has an edge in capital allocation relative to China

One other factor that suggests that India could indeed emulate China's growth rates, if the public sector could only extricate itself more aggressively from the capital markets, is the efficiency with which India allocates capital relative to China.[8] This edge is best appreciated by looking at the incremental capital output ratio (i.e. the amount of capital required to deliver an extra unit of output). In India this ratio has been running at close to 3.5 in recent years, compared to nearer 5.0 in China, suggesting that gross domestic investment of 30-35% could deliver growth of 9% in India. This contrasts with 40-45% in China. Inexact though these calculations may be, they do at least serve to illustrate the potentially powerful impact a sharp reduction in public dissaving could have on Indian growth.

Paul Rawkins (paul.rawkins@fitchratings.com)

Paul Rawkins is a Senior Director at Fitch Sovereign Ratings. He has been involved in sovereign risk analysis for many years and his expertise on the Indian subcontinent and Southeast Asia dates back to the late 1970s. In the early 1990s he was heavily engaged in sovereign debt negotiations associated with the Brady plans for the major middle income debtor countries. During his career Mr Rawkins has contributed to a number of publications on sovereign risk analysis.

FitchRatings

http://www.fitchratings.com

8 This should be reflected in higher real returns on investment in India and also reflects greater transparency, better corporate governance and a more developed domestic capital market.

Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN Print: 1612-314X / ISSN Internet and e-mail: 1612-3158