ISAS Brief

No. 117 – Date: 10 July 2009

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

The Indian Budget: A Failure to Confront the Challenges

Shahid Javed Burki[1]

There are moments in the lives of nations when those who rule can bring about profound changes in the lives of the ruled. In India, 1991 was such a moment when then-Finance Minister Manmohan Singh, facing an economic crisis of immense proportion, chose to break with the past. With a few bold strokes, he demolished the "License Raj" that had been put in place with such tender loving care by Jawaharlal Nehru and his political associates. The Raj had kept India stuck in an economic groove that produced what its own economists called the "Hindu rate of growth" – 3.5 percent a year when the population was increasing by almost two percent a year. That did not leave much room for the poor, and the poor, in whose name the Raj had been established, suffered immeasurably. India became tremendously impoverished, with 40 percent of its population living in absolute poverty. That proportion introduced a new term in economics – the bottom 40 percent.

With the reforms in 1991, India went on a different track. The rate of economic growth more than doubled, the incidence of poverty declined, the middle classes increased in size and some parts of the economy were well integrated into the global economic system. By lowering the barriers on trade and by encouraging the entry of foreign capital, India opened its economy to foreign influences. The Indian brand name became valued in information technology, pharmaceuticals and automobiles, and even in literature, music and movies. The country seemed set to become a global economic power. The slogans "Shining India" and "Incredible India" coined by inventive Indian minds did not seem misplaced. And then the global economy went into a spin and affected India.

For a decade or so, many serious economists, those from India included, had concluded that the global economy had become decoupled, meaning that a number of emerging economies were no longer as much dependent on the markets of the rich countries and on capital flows from them to make progress. These were the factors that produced the miracles in East Asia and turned China into an economic powerhouse. Now a quarter century later, these economies had built strong economic links among themselves. Trade between them had increased and they had accumulated large foreign exchange reserves to protect themselves from the vagaries of international financial markets. If the West was sinking under the weight of its financial folly, emerging markets would not go under with it. However, they did.

---

[1] Mr Shahid Javed Burki is a Visiting Senior Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He was the Former Vice President of the World Bank, and the Former Finance Minister of Pakistan. He can be contacted at isassjb@nus.edu.sg.

The decoupling hypothesis held sway during good times. When the times became bad and difficult, it became clear that the decoupling hypothesis stood on shaky grounds. Emerging markets soon found themselves in the grip of a credit crunch. The decision by the United States authorities to let Lehman Brothers sink produced a number of unintended consequences. Among these was the hoarding of cash by the large institutions to prepare for another institutional collapse. Credit froze, including that needed by traders to finance their operations. Turning over fast – typically ranging in terms from 60 to 270 days – the total yearly flows amounted to US$10 trillion. No matter what the destination of these exports is, the countries that relied heavily on exports needed this finance. Its absence badly hurt them. One of the largest plunges in the gross domestic product (GDP) growth rates occurred in Singapore and Taiwan, two countries for whom trade is an important part of the economy.

The crisis came to India through an entirely different channel. Its banking sector, mostly under the control of the state, was insulated from Western finance. Its trade-to-GDP ratio was relatively low. However, the more vibrant parts of its economy – the information technology sector and health services, for instance, were connected with the West through the links forged over time between its own enterprises and the large corporations in the West. When the latter collapsed or shrank in size, the more dynamic sectors of the Indian economy suffered. India lost close to 2.5 percentage points in its rate of growth, with the GDP increase declining from about nine percent a year in the five-year period before the crisis hit the world economy to 6.7 percent in 2008-09.

Unrelated to the economic and financial collapse in the West, the Indian economy showed another weakness. One consequence of the economic model the country has pursued for the last couple of decades is the widening income disparities, both interpersonal as well as inter-regional. This was vividly portrayed in a study sponsored by the Asian Development Bank for the Emerging Markets Forum that held its annual meeting in Mumbai in late June 2009. According to the study, a clutch of domestic billionaires control as much as 20 percent of the county's GDP and 80 percent of the assets of the firms listed on the Bombay Stock Exchange.[2] A significant part of this wealth was accumulated in the last couple of decades when the Indian economy began to open to the outside world. An important part of this model was to push the state to the backseat of the economy. And a very large proportion of the very rich come from the western part of the country. In other words, the new riches are associated with the Western economic model and with the parts of the private sectors that operate at some distance from the government. In such a situation, what role can the government play and how could the Budget for 2009-10 have signalled a change in the direction of public policy? Before answering this question, it would be useful to look at the way some of the liberals in the country are reacting to the changes in the Indian society and economy.

A vivid portrayal of the problem comes from the novelist Arundhati Roy in her latest book, *Listening to Grassroots*. She proclaims that, while one arm of the Indian society is "busy selling off the nation's assets in chunks, the other to divert attention, is arranging a buying, howling and deranged chorus of cultural nationalism". She discusses the recent economic boom as having merely created "a vast middle class punch drunk on sudden wealth and the sudden respect that comes with it – and a much, much vaster underclass."[3] She is extremely concerned that unless the state steps in to remedy the situation, the country may have to face a serious socio-political situation.

[2] Asian Development Bank, *India 2009: An Affluent Society in One Generation,* Mumbai, 2009.
[3] Arundhati Roy, *Listening to Grassroots*, New Delhi, 2009.

In announcing the budget for the year 2009-10, the Manmohan Singh-Pranab Mukherjee team seems to have cocked half an ear to these findings and criticisms, and half an ear to the imperatives of electoral politics. Being sensitive to the unanticipated margin of victory in the elections of 2009, the new Congress government has produced a semi-populist budget. In doing so, it has gambled on the country's economic future. It is remarkable that a fiscally strapped government faced with a 6.2 percent of GDP budget deficit should have gone for a 36 percent increase in public sector spending. There are two priorities in this spending increase – rural employment, the provision for which has been increased by 144 percent, and defence, with accent on increasing the presence of the navy in the Indian and Pacific Oceans, and improving the sophistication of the weaponry available to the armed forces. The third priority has been recognised but much of the initiative has been left to the private sector. The government will allow the private sector to raise funds from the capital markets for highway construction, and the modernisation of airports and seaports. Its own contribution will be largely limited to making it possible for private builders to acquire land for their projects. This has proved to be an expensive and laborious process.

In a way, the budget for the year 2009-10 has gambled on India's economic future. By opting for a major expansion in government lending at a time when the consolidated fiscal deficit – combined fiscal deficits of the federal and state governments – were already very high, the new Congress government has placed its faith in a rapid recovery of the economy. By building in a high growth scenario in its calculations, it has increased the denominator in the calculation of the fiscal deficit. Even then the fiscal deficit will increase to 6.7 percent of the GDP at the central level. When the deficits at the state levels are combined, the consolidated deficit climbs to over 11 percent. This is not a happy situation for the government to place itself in. It has been tried before but with bad consequences. As one Indian commentator wrote after the budget was announced, "Mukherjee is not the first finance minister to pin hopes for revival of growth on government spending. His predecessors have done it many times but the results have not always been the same. It worked in the 1960s and 1970s, but the philosophy of sustaining high growth through deficit financing in the 1980s landed the country in a fiscal mess that eventually grew into a crisis of balance of payments in 1991." [4] This was the crisis the management of which brought so much fame to Dr Singh. Why would he then have allowed his Finance Minister to take the same course that could possibly lead the country to the same set of unhappy consequences?

The answer to the question lies in the way policymakers learn lessons from history. In the late 1980s when future growth was being sought on the back of large fiscal deficits, there was no precedence in India that such a strategy would yield long-term benefits. And it did not. India was thus plunged into a deep economic and balance of payments crisis. It is different this time. The Indian history reads differently. If the country's economic growth experience is divided into five-year chunks, we notice the average growth rate increasing constantly from one period to another. Given this record, it may be appropriate to bank on growth coming back fast and making it possible to manage the fiscal deficits as well as the increase in national debt, now estimated at 80 percent of the GDP. All of this may happen but to put so much reliance on it is rolling the dice.

oooOOOooo

[4] Rajesh Mahapatra, "India's gamble with growth", *The Hindustan Times*, 7 July 2009.