



India in Twin Deficit Club – Implications and Issues

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Indian economy is one of the few economies in the world to have both fiscal and current account deficits. Hence it is also termed as a twin deficit economy. The few economies which are a member of this club are US, UK, Greece, Ireland etc. In other words, this membership is nothing to be proud of as all these economies have faced severe recession in 2007. Twin-deficit may not have been the sole reason for recession in these economies but did magnify the impact of the crisis.

In this paper, we look at the twin deficits issue from an Indian perspective.

Twin Deficits - Basics

Twin deficit economy is one that has both fiscal and current account deficits. Even if one of these deficits remains persistent, it is seen as a serious problem for an economy. Hence, one can imagine the plight of an economy which faces both these deficits.

- **Fiscal/Budget Deficit:** Fiscal deficit means government expenditure is more than its revenues. The government has to borrow to meet its excessive expenditure leading to government absorbing higher portion of domestic savings and higher interest rates. This in turn leads to crowding out of private sector investment in the economy. Higher interest rates, in turn lowers the private sector investment and consumption levels. In many economic history cases, we have seen governments resorting to printing press to manage their deficits leading to hyperinflation as seen in cases of Germany, Hungary and Zimbabwe.
- **Current Account Deficit:** Current account deficit means imports are higher than exports and hence foreign funds are needed to manage the deficit. An economy manages its current account deficit by foreign savings/foreign capital inflows. Unlike fiscal deficit the impact of current account deficit is less clear. Ideally, it should lead to depreciation of the currency but the currency can actually appreciate if capital inflows are more than the current account deficit (like in the case of India).

In case of twin deficits, an economy needs both domestic savings and foreign savings to manage its deficits. In normal times, both can be managed but in case of a shock, the deficits could lead to a severe crisis. The impact of twin deficits has to be taken more seriously now as we have multiple cases of twin deficit economies in crisis and this includes developed economies.

Before we understand the twin deficit situation in India, let us do a brief review of twin deficit economies in the 2007 crisis.

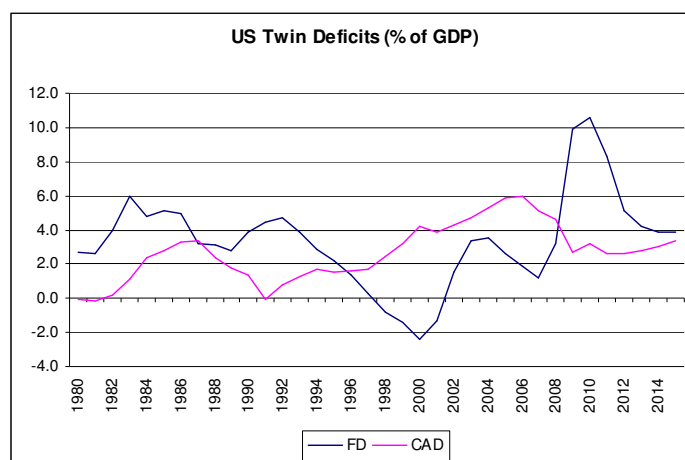
Twin Deficit economies in 2007 crisis

- **United States:** US economy has been having twin deficits since 1980s (Figure 1). The fiscal deficit did turn into surplus for a brief period during former President Bill Clinton's second term (1998-2001). The surplus turned into deficit in 2002 and widened sharply during the crisis to touch 10.6% levels in 2010. Current Account Deficits widened from 1.5% levels in 1990s to touch 6% in 2006. CAD has narrowed since 2006 levels because of the crisis. The crisis led to



depreciation of the dollar (though dollar did not depreciate much given the scale of the crisis) and decline in imports, and both led to lower CAD. However, IMF projects CAD to rise going forward.

Figure 1



Source: IMF, OMB

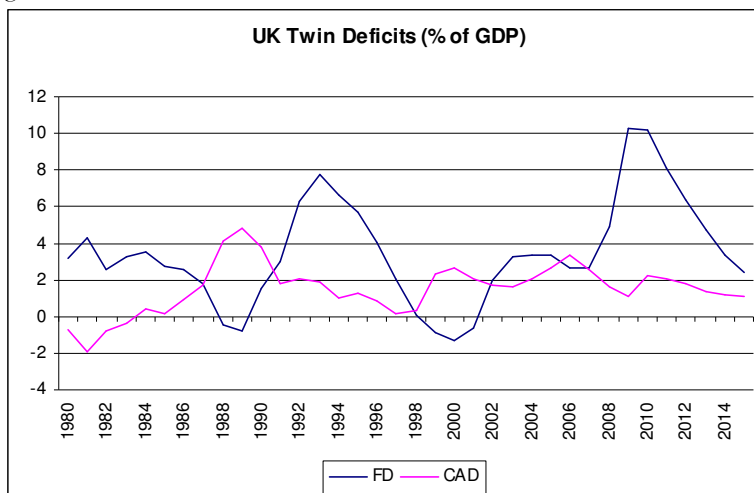
One of the deficits or both together could become a factor for a crisis or act in aggravating the impact of the crisis. In US and other cases discussed below, it was the latter.

As the crisis struck US economy, government could not intervene aggressively as fiscal position had worsened over the years. Some economists criticized the fiscal stimulus as very small compared to the size of the US economy. Others criticized that the fiscal stimulus has made the situation of US public finances highly precarious and will affect growth over a long-term. The other effect of rising budget deficits i.e. rising interest rates, crowding out of private sector investment etc did not occur as Federal Reserve pumped in a lot of liquidity. Moreover, demand remained weak and therefore there was no need to raise investment levels. However as crisis situation eased, businesses have become worried over the state of public finances in US.

US's huge CAD has been one side of the global imbalances debate with high savings of developing economies (in particular China) being the other. Before the crisis, leading economists like Martin Feldstein had raised concerns over the rising current account deficit as a source for a crisis in future. The crisis did happen but the trigger was not current account deficit. However, the global imbalances did lead to spillovers with sub-prime crisis becoming a global financial crisis. The decoupling theories which gained before the crisis were trashed as it was seen that prospects of US economy are highly interconnected with the world economy.

- United Kingdom:** The trajectory of twin deficits in UK follows nearly the same path as US. Fiscal position was in a deficit for most of the time since 1980s except for two brief periods 1988-89 and 1999-01 (in US the surplus was between 1998-01). The fiscal deficit has widened substantially in the crisis period to touch 11% in 2009 and is expected to ease till 4% by 2015. Current account remains in deficit for the entire period and is expected to remain so till 2015. Comparing with US, fiscal deficits are more or less similar as a percent of GDP but CAD in UK was much lower than US in the same period.

Figure 2



Source: IMF

UK's persistent fiscal deficit puts the government in similar problems like US. The scale of the problem was worse for UK economy as UK depends more on financial sector compared to US economy which is larger and more diversified. Hence, the pressure on UK government was more as the financial firms suffered and tax revenues declined. The situation has normalized now but it raises the dilemma of how to control financial sector size and also ensure tax revenues don't decline.

In terms of CAD, GBP depreciated significantly in wake of the crisis. So, there was more currency adjustment in UK than US. In terms of global spillover, UK did not impact because of its CAD but because of its financial sector. London is an international financial centre and financial crisis in UK had a wide impact on the global banking sector. Many UK banks have subsidiaries/branches etc in other economies especially in Asia impacting economies in latter. UK has also been setting examples in terms of financial sector policy for other economies. It has suggested some far reaching changes like a levy on banks' balance sheets, leverage ratio, banks developing their own wills etc. This could set examples for others to follow.

- **EMU economies:**

- Fiscal Deficit: The economies in European Monetary Union (EMU) have signed Growth and Stability pact under which fiscal deficits will be capped at 3%. However, this has been abused by most economies from time to time. Germany and France form the core of the union and should have led by example. But both had higher deficits in early 2000s and did little to change it. This led smaller economies in EMU to follow suit and ran deficits much higher than 3% limit.

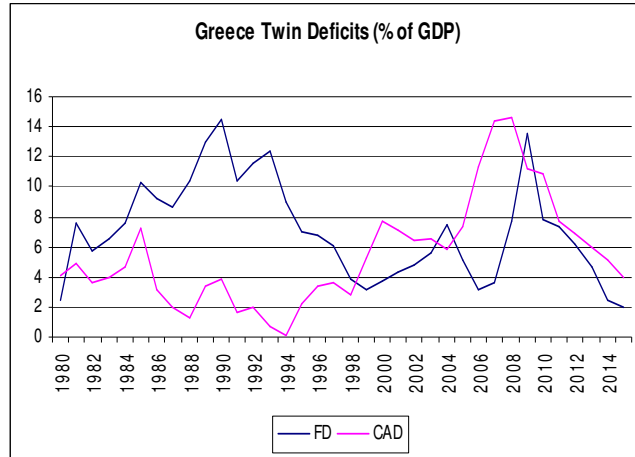
Prime example of this was Greece which just brought deficit closer to 3% in order to qualify for the union in 1999. It has missed the 3% cap in each year since 1999 and touched 7.5% in 2004. The deficits lowered to 3.5% levels in 2007 because of the global boom. In crisis years, deficits became much higher and acted as a trigger for the European crisis. The Government revised the deficit upwards from 7% to 13% in 2009 acting as a trigger for the European debt crisis. Spain and Ireland had fiscal surpluses before the crisis with Irish economic model hailed as a role model to be followed by other economies. Ireland was dubbed as a Celtic Tiger economy for its promising growth potential. The surpluses have turned into deficits in both these economies as



the tax revenues declined sharply and expenditure rose. Portugal had minor deficits before the crisis and still has lower deficits than the other three economies.

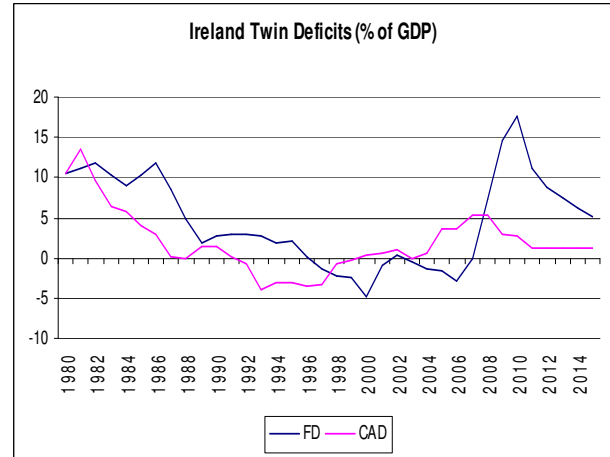
Post-crisis, EMU model was criticized severely for not having a political and fiscal union. The crisis economies could not get any finances from the better performing economies like Germany prolonging the crisis. The help came much later amidst stiff pressure from financial markets but was deemed as little as scale of the problem had grown manifold.

Figure 3



Source: IMF

Figure 4



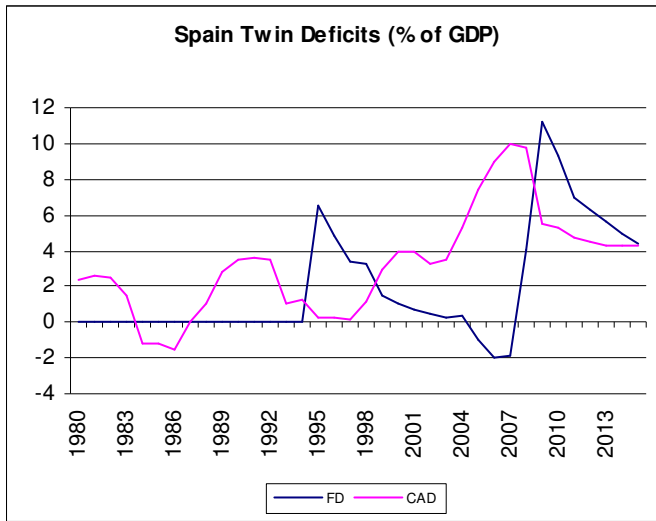
Source: IMF

- Current Account Deficit: European Monetary Union (EMU) economies ran their own imbalances with countries like Greece, Ireland, Spain and Portugal running current account deficits and Germany running surpluses. The imbalances ran fine till the crisis as the four troubled economies grew on account of consumption and Germany grew because of its exports to these economies. However, the model turned upside down in the wake of the crisis. As it was a monetary union, currency adjustments were not possible. So, the troubled four economies had to adjust internally via wages which was difficult given inflexible labour markets. People also could not migrate to more prosperous regions within the union like Germany given vast cultural differences and language issues. This compounded the problem leading to more pressures on the fiscal policy which was paralyzed for lack of a fiscal union.

Here too, Greece ran huge current account deficits before the crisis touching 14% in 2007. Spain and Portugal too had high CADs leading to problems for their economies. As the European crisis deepened, foreign flows stopped coming to these economies making it difficult to finance the current account deficits. Ireland had lower current account deficits than the other three but faced a much bigger problem from the surge in fiscal deficits.

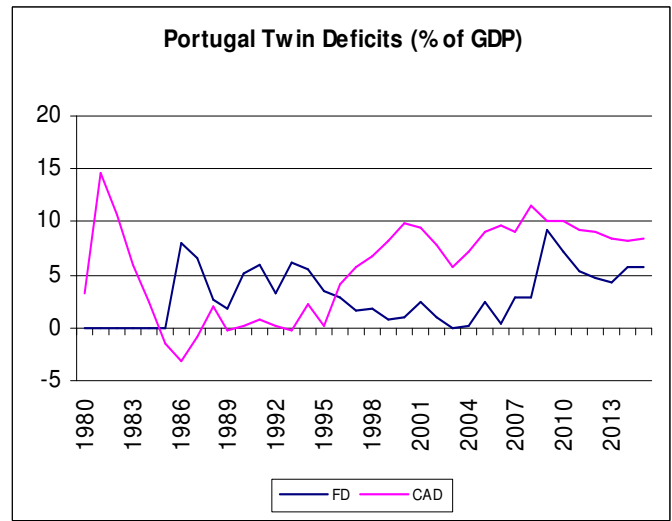


Figure 5



Source: IMF

Figure 6



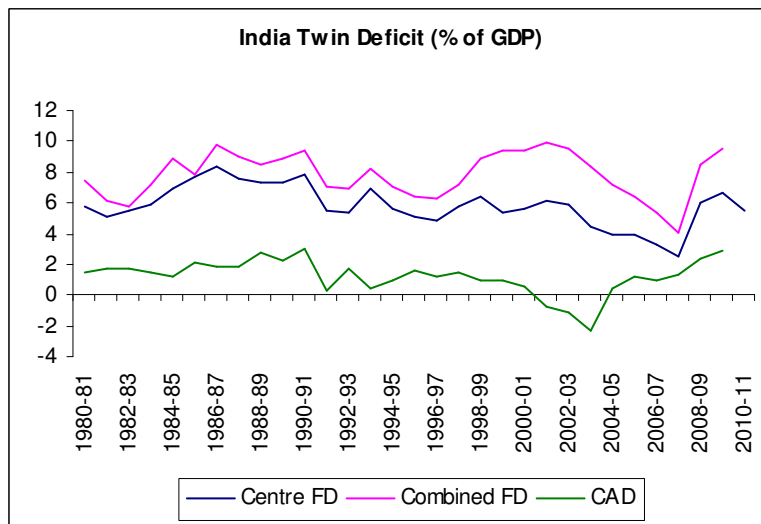
Source: IMF

Hence, overall we see different reasons for EMU economies coming under pressure. Unlike the US and UK, the twin deficits did act as a trigger for the crisis in especially in the case of Greece.

Twin Deficits in India - Trends and 1991 crisis

Figure 7 shows, India has been running persistent twin deficits since 1980-81 (even from 1970s, we see persistent twin deficits. We have taken 1980s to have similar time-periods as for the above case-studies). Current account deficit has still been around 1% but fiscal deficit has remained at an average of 5.8% for the period 1980-2010. If we include the state deficit as well, the combined fiscal deficit shows an alarming average of 7.8% for the time-period.

Figure 7



Source: RBI



It is not that India has managed to escape a crisis despite running these twin deficits for such a long time. The real concern is we have not managed to learn any lessons from our economic history. The 1991 crisis is widely known as the balance of payments crisis but was basically a twin deficit crisis.

The earlier research on the 1991 crisis said it was basically a result of high current account deficit and inability to finance it via capital inflows. The capital inflows mainly constituted commercial borrowings, external assistance and NRI deposits. As the economy was closed, there was hardly any inflow in form of foreign investment (it started from 1986-87 onwards). So as long as debt flows were available, it was all considered safe. However, concerns grew as current account deficit increased and finally a situation came in 1990-91 when the current account deficit was higher than capital inflows. Moreover, India's import cover declined to touch just 1.9 months in 1989-90 and 2.5 months in 1990-91. The situation came to limelight after Gulf war broke in 1991 resulting into a balance of payments crisis.

Later research showed that it was actually a fiscal crisis in mid 1980s that led to the BoP crisis. In the first half of 1980s the total fiscal deficit was around 6.0% to 7.5% levels. It increased to touch around 9% levels from 1985 onwards. Revenue deficit also continued to rise, implying much of the expenditure was going to meet expenditure of Government. As fiscal deficit was high, there was crowding out of domestic savings. The investment was mainly financed by borrowings from abroad, which proved to be inadequate as concerns over both fiscal and current account deficit rose. The confidence in economy deteriorated and resulted in BoP crisis.

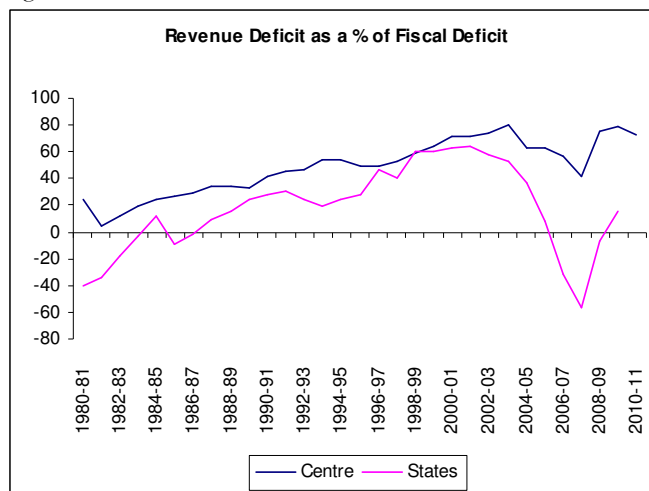
Hence, we have already had a situation where twin deficits in the past acted as a trigger for a wider crisis in the economy. India had to take assistance from IMF and Bank of England to come out of the crisis. The crisis also led to much-needed reforms in the economy but the deficits still continue.

Twin Deficits- Current Debate

Within the two deficits, persistent and high fiscal deficits remain the major worry as seen earlier as well. India never really managed to lower the fiscal deficits despite the 1991 crisis, leading to implementation of Fiscal Responsibility and Budget Maintenance Act in 2003 (FRBM). The fiscal deficits did come down after FRBM but the actual numbers were much higher as certain bonds like oil, food and fertilizers were kept off the balance sheet and were not accounted. The adjusted fiscal deficit showed fiscal deficit was higher by 0.5%-1% from the reported figures depending on the bond issuances.

Shankar Acharya a noted economist said that despite fiscal prudence being the big-bang reform of 2000s, it still remains a major concern. The 2007 crisis again led to widening of the deficit and combined fiscal deficit has again touched the highs seen in 1986-87 and 2000-03 period. Fiscal deficits rose in other economies as they faced steep crisis but this was not the case in India. The growth did slow to touch 6.8% in 2008-09 but was much higher than the decline seen in other economies. Revenue deficit as a % of GDP increased from 41.4% in 2007-08 to touch 75.2% on 2008-09, implying much of the deficit was actually to cover the revenue expenditure of the government.

Figure 8



Source: RBI

Prime Minister's Economic Advisory Council in its economic outlook report (2009-10) also pointed that rise in fiscal deficits was not on account of stimulus. It was mainly because of additional outlay on subsidies, pay revision, loan waiver, financing the increased coverage of the NREGA etc. It added that rise in deficit was mainly structural and cyclical factors played a minor role.

The Government has promised to lower the deficits going forward (Table 1). But still fiscal deficit in 2012-13 still remains higher than 3% FRBM target which was to be achieved in 2008-09. Even in 2010-11, government will achieve its 5.5% fiscal deficit target on account of surge in tax revenues and payments from 3-G auctions. Despite a windfall income from 3-G auction, the fiscal deficit is expected to be 5.5% of GDP on account as expenditure is going to be higher than budgeted estimates on account of supplementary demands made by the government. Hence like we saw in FRBM phase, fiscal deficit has been again lower on account of rise in receipts and not decline in expenditure. The quality of consolidation in fiscal position has become a more important issue than quantity of consolidation.

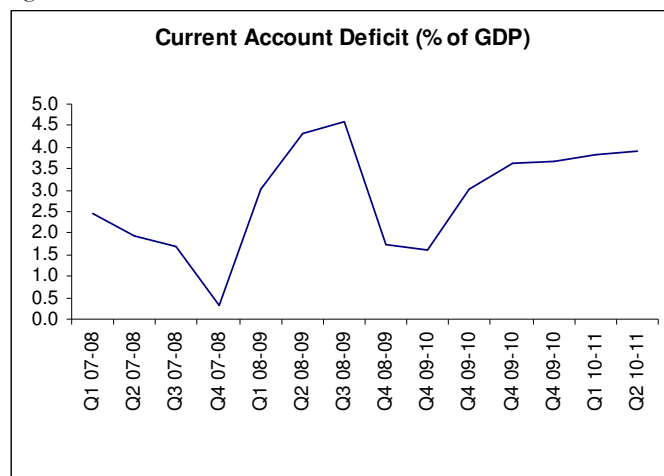
Table 1: Fiscal Targets Going Ahead (% of GDP)

	2009-10	2010-11	2011-12	2012-13
Revenue Deficits	5.3	4.0	3.4	2.7
Fiscal Deficits	6.7	5.5	4.8	4.1

Source: Union Budget 2010-11

The current account deficit has also started to widen as the economy recovered. Both oil and non-oil imports surged leading to widening of the current account deficit. The deficit declined in the crisis to touch 1.7% levels in Q4 2009-10, but has increased since then to touch 3.9% in Q2 2010-11. RBI expects CAD at 3.5% of GDP in 2010-11 which is the highest CAD so far.

Figure 9



Source: RBI

In the third quarter review of monetary policy, RBI pointed that financing of CAD is as important. If it is financed primarily by short-term flows it could lead to a problem as the flows can dry once advanced economies start to pick-up. This indeed is the case as India's CAD is financed majorly by short-term flows like FII, ECB, short term trade credit etc. This is similar to the trends we saw before the 1990-91 crisis, though this time we also have equity flows compared to just debt flows then. RBI has stressed that this widening of CAD is not sustainable and there is "a need for concerted policy efforts to diversify exports and contain the CAD within prudent limits."

Summing up

The above analysis shows how twin deficits have emerged as a risk for Indian economy. Taking lessons from the recent crisis, we see the deficits could either be a trigger or could just magnify the impact of the crisis. In India the twin deficits have been persistent and were responsible for the 1991 crisis. The deficits have again widened post the recent crisis leading to questions on the future trajectory of the Indian economy. Within the twin deficits, high fiscal deficits remain a major concern for most economists. However, as India is an emerging economy, current account deficits remain a concern as well as we have seen in numerous developing economies' crisis in the past.

Some economists say that worrying over these deficits is imprudent. India is a fast growing emerging economy and deficits are expected in such economies. India has high domestic savings which will help in financing the fiscal deficit. It has build large forex reserves which will help in case current account deficit financing becomes a problem. Others say with high growth rates expected in future, capital inflows are going to continue and financing CAD is not a problem.

However, going by the above case studies of advanced economies we can never be sure. Earlier, this domain of crisis due to deficits was seen as a domain of developing economies. But in 2007, advanced economies themselves were victims. In this highly volatile and global economic set-up, one can never take anything for granted. The deficits may not act as crisis triggers but could easily create multiple problems for the economy.

Hence, twin deficits remain a major risk for Indian economy going ahead. For instance in India's case, high fiscal deficit leads to problems of inflation management which could slow the growth going forward. The inclusive growth agenda also implies government needs to aggressively spend on



education, healthcare and infrastructure. With persistent fiscal deficits, this spending would be unlikely or may just push fiscal deficits higher. This would further lead to problems associated with rising fiscal deficits – inflation, crowding out of private sector, higher interest rates etc. The widening current account deficit will put pressure on the government to get foreign savings to bridge the deficit. The large capital flows in turn pose monetary management issues for the central bank. Overall, policymakers need to remain vigilant and work towards reducing these twin deficits.



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