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THE REASON THAT INDIA CANNOT AFFORD TO GO ON A DEBT BINGE

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Industry & Services Sector incl. MSMEs and PSUs

It could leave its macroeconomy far less secure than it was in 2014

India’s economy has suffered more than most from the covid pandemic and so have its people. The country has lost more than a year’s worth of growth and perhaps a decade’s progress in its efforts to reduce poverty. Its economic contraction—the first in India since the 1970s—has put pressure on its government, like so many others, to respond.

Until this week, that response had been relatively restrained. Prime Minister Narendra Modi’s government seemed to recognize that there was only so much it could do to address the economic contraction [in the first half of fiscal year 2020-21], especially while the pandemic was still raging. By its actions, the government implied that any welfare-promoting and growth-enhancing measures had to stand on a solid macro-economic foundation.

The federal budget for the next financial year, 2021-22, which starts on 1 April, has poked a hole in that optimistic narrative. Not only has the fiscal deficit for the current fiscal year exploded to 9.5% of gross domestic product (GDP)—two percentage points higher than the consensus estimate, but still defensible for a pandemic year—next year’s deficit is now forecast to reach almost 7%. The government has effectively abandoned its long-term commitment to bring the deficit down to close to 3% of GDP, pitching instead for a gentle descent to 4.5%—six years from now.

Once the covid pandemic retreats, India might end up with a debt-to-GDP ratio north of 90%, compared to the low 70s at present. It would be saddled with a permanently elevated fiscal deficit and a financial system bogged down by high levels of bad debt. Consumer price inflation has topped the Reserve Bank of India’s target zone of 2%-6% since the covid lockdown began last year. These are, I am afraid, numbers more associated with Latin American stagnation than your typical Asian tiger.

The government is obviously hoping that increased spending will help India grow out of this predicament. Unfortunately, actual growth before the pandemic was already just 4% a year. Fitch Ratings thinks India’s potential annual growth is at best 5.1%. That won’t be enough to deal with the macro-economic predicament India is in.

The only way India can pull itself out of this jam is if private investment pours into the country, financing projects that push up the country’s potential growth rate. Yet the government, already monopolizing domestic financial savings, seems to want to go to war with global markets as well.

In his pre-budget survey of the economy, the government’s seniormost economist spent an entire chapter attacking international ratings agencies—a pre-emptive salvo against a possible sovereign downgrade. Print money without fear, he urged, saying that doing so would “not necessarily lead to inflation and a debasement of the currency" if the extra money is invested in the right projects.

To paraphrase Tropic Thunder, never go full Modern Monetary Theory (MMT). Unlike the US or

China, countries in India's position—which have neither a reserve currency nor strong growth momentum—cannot grow rapidly while exploding their debt. They can't afford to ignore rating agencies because of their supposed bias, or cock a snook at bond markets and just run the currency presses instead. They need to grow in order to reduce their debt. That's a very different dynamic.

India isn't so attractive that it can expect vast sums of investment to arrive even if its macro-economic numbers look bad and its sovereign rating is junk. We don't have a history of deflation, we aren't hitting the zero lower bound. It's quite the opposite; we have an economy prone to sustained high inflation.

And, finally, if there's a country somewhere with a government bureaucracy efficient enough to build really productive assets using sustained deficits, that country definitely isn't India. This is still a developing economy, which especially in bad times should tread carefully rather than throw caution to the winds.

Modi's greatest strength as an economic manager had been his commitment to fiscal responsibility. Some of that was visible in this year's budget as well—which, for example, boasted a welcome return to transparency about how much the government is borrowing, ending a tradition of fudging numbers that has persisted since the last financial crisis.

Yet, with this new willingness to binge on debt, India's Prime Minister now faces the prospect of leaving India's macro-economy far less secure than when he inherited it back in 2014. That would be a dire legacy indeed.

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