SPEECH

THE DISAPPEARANCE OF THE TWIN DEFICITS: MACRO-ECONOMIC POLICY IMPLICATIONS*

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I am glad to have the opportunity of interacting with this distinguished audience under the auspices of the Corporation Bank Economic Development Foundation and the Bankers' Club, Mangalore.

2. For nearly forty years macro-economic policy in India has been formulated on an almost axiomatic assumption of a large current account deficit in the balance of payments (BoP) and a large budget deficit which was monetised (i.e., financed by the Reserve Bank). While there is an esoteric debate among economists as to how precisely the twin deficits are related macro-economic accounting has decisively shown that a monetised budget deficit quickly works itself through the foreign trade multiplier into a current account deficit in the BoP. As a rising BoP deficit cannot be financed beyond a point, it would result in a haemorrhage of the foreign exchange reserves which then necessitates measures to adjust for the monetisation of the budget deficit. The fiscal adjustment requires a slow down of the economy as the public sector, given its role as a prime mover, inevitably reduces its activity. Thus, over the past four decades, the tyranny of the twin deficits held sway and any sustained revival of growth was quickly punctured as the fiscal expansion would reflect in a monetisation which in turn would result in a widening of the current account deficit. Thus, the economy was caught in the vice of the twin deficits.

3. The economic reforms initiated in July 1991 have brought about a fundamental change in the economy. The changes in the trade, industrial and foreign investment policies combined with the fundamental reform of the exchange rate system eased the bind on the BoP. The two step exchange rate depreciation of the rupee in July 1991, the move to a dual exchange rate in March 1992, the unification of the exchange rate in March 1993 and the steps towards current account convertibility initiated in March 1994 and completed in August 1994, all brought about an appropriate pricing of foreign exchange while the trade policy reforms reversed the earlier policy which had an implicit bias against exports. As a result of perseverance with economic reforms across a broad front, credibility of policies has been established and with the changes in policies relating to capital flows, inflows through foreign institutional investors and Euro-issues have become sizeable. With the substantial improvement in exports,it would not be surprising if we were to see the clear emergence, in 1994-95, of a current account surplus in the BoP. The foreign currency assets of the Reserve Bank in the first part of September 1994 amounted to US $ 18 billion and with a little over US $ 4 billion of gold, the foreign exchange reserves are now close to a year's imports.

4. While there was admittedly a bad slippage in the gross fiscal deficit in 1993-94, there has been an important development in that the monetisation of the budget deficit has been moderated after the initiation of the reform process. In the current financial year, a fundamental and historic reform was announced in the budget under which the automatic monetisation of the budget deficit through the issue of *ad hoc* Treasury Bills will be phased out over a period of three years and from 1997-98 this instrument would be totally abolished. A

* Address by Shri S.S.Tarapore, Deputy Governor at a meeting arranged under the auspices of Corporation Bank Economic Development Foundation and Bankers' Club, Mangalore on September 19, 1994 at Mangalore.

@ I am indebted to Shri M.D. Patra, Director, Department of Economic Analysis and Policy, RBI, for his invaluable help.

formal agreement was signed between the Government of India and the Reserve Bank on September 9, 1994 to give effect to this decision. In 1994-95, it has been stipulated that the creation of *ad hoc* Treasury Bills will be restricted to Rs. 6,000 crore by the end of the year and that it will not be allowed to exceed Rs. 9,000 crore for more than 10 consecutive days. Against this self-imposed constraint by the Government, it is pertinent to note that in the current financial year upto September 9, 1994, there was an absolute **decline** in *ad hocs* by Rs.7,379 crore as against a large **increase** of Rs. 13,865 crore during the corresponding period of last year. Furthermore, during the first 24 weeks of the current financial year there was an increase in *ad hocs* over the March 31, 1994 level in only 6 weeks and in most of these weeks the increase was nominal. Thus,the sharp reduction in *ad hocs* upto September 9, 1994,is reflective of an enduring trend during the year.Moreover, even if one takes into account the larger above the line market borrowing in the current year, the overall financing has been significantly smaller. While it might appear premature to draw any definitive conclusions one is emboldened by the formal acceptance of the commitment by Government that the pernicious automatic monetisation of the budget deficit would indeed soon become a problem of the past.

5. In the changed context of the disappearance of the twin deficits and the appearance of twin surplus conditions, it is useful to briefly assess the strengths and weaknesses of the economy. I should explain that as far as the budget is concerned what is said here refers to the disappearance of monetisation of the budget deficit and not the fiscal deficit which continues to be very large though somewhat lower in the current financial year. The experience, the world over, has been that during a period of stabilisation and adjustment, there is a sharp decline in overall growth. In India, after the perceptible slow down in 1991-92, the real GDP growth in the subsequent two years has been a little less than 4 per cent. Agricultural growth has been satisfactory in the past two years and indications are that the agricultural production would be satisfactory in 1994-95 also with a growth of around 3 per cent. While industrial growth has been very subdued in the three years ended 1993-94, there are clear signs of a sharp revival and it is reasonable to expect a growth in industrial production of around 7 per cent in 1994-95. Given the past trends in the growth of the tertiary sector, it is expected that the overall growth of the economy in 1994-95 would be at least 5 per cent.

6. With the improvement in the current account in the BoP and the large capital inflows, the foreign exchange constraint is no longer operative in the present situation. The large increase in the foreign exchange reserves has brought in its wake a problem of a large increase in primary liquidity which resulted in an unacceptable growth in M_3 in 1993-94 of 18.2 per cent with the attendant problem of an acceleration of inflation which reached around 11 per cent by May 1994. The problem of excess liquidity is being tackled by a combination of policy measures including a drastic reduction in the monetisation of the budget deficit, an increase in the cash reserve ratio, resort to open market operations and restructuring of the non-resident deposit schemes to reduce the element of high cost borrowing. Moreover, with ample foodgrains stocks of over 31 million tonnes, there can be no question of any shortages in the foreseeable future. Furthermore, for other commodities, any supply constraints can be quickly eased by imports. With the increase in the foreign exchange reserves being more gradual in 1994-95 and with the gathering of greater experience of handling capital inflows it should be possible to better manage the primary liquidity growth in 1994-95 by modulating the levers of various policy instruments so as to better regulate the domestic expansion of liquidity and thereby help reduce the inflation rate. Steps to effectively utilise the capital inflows and also improve the efficiency of capital use would have beneficial supply side effects.

7. I have deliberately chosen to present a somewhat optimistic picture of the trends in the twin deficits. This is deliberate as our mind set is conditioned to the existence of these twin deficits. Acceptance of the fact that the twin deficits are a problem of the past will enable us to focus proper attention on some other important problems which will emerge in the future. While there are a number of areas of concern, I would now like to turn to a few aspects which need attention.

8. With the liberalisation of the external trade and payments, it will be necessary to ensure a greater degree of discipline in macro policies. A weakening of the macro- economic fundamentals would result in an erosion in confidence and could well put the country back into BoP problems. In this context, there would be a far greater need for integration of monetary, fiscal, trade and exchange policies and expeditious corrections would have to be effected in response to changes in fundamentals and these changes would need to be transparent. One of the most important areas in which different segments of macro-economic policy will have to reinforce each other is in the endeavour to squelch inflation. All economic agents can derive benefits from an environment without inflation. Inflation control should, therefore, be the paramount objective of macro-economic policy. The world over inflation rates are coming down and to ensure competitiveness, India must follow this world wide phenomenon of a lowering of inflation rates. Inflation is a cancer which destroys the vitals of an economy and as inflation hurts the poorest segments the most, it is all the more necessary to excoriate inflation from the system in India. Since there is a well established relationship between money income and prices, it is essential that macro policy should ensure that in the foreseeable future there is no increase in domestically generated created money.

9. To achieve the declared objective of a reduction in the gross fiscal deficit to 6.0 per cent in 1994-95 from 7.3 per cent in 1993-94, it will be necessary to keep a tight leash on Government expenditures. Subventions in the system would be less forthcoming and economic agents must adjust to an environment where the fisc would no longer be a corporate called "Subsidies Unlimited". While stressing this, I would hasten to add that ultimately the bulk of investment in the core infrastructure would have to continue to be provided by Government. Bottlenecks in the infrastructure would inevitably constrain growth and it is, therefore, necessary that the users of these services are made to pay the right price.

10. With the industrial policy liberalisation, the areas in which domestic and foreign entrepreneurs would be operating would, undoubtedly, expand. The changes in the overall industrial policy, including the elimination of barriers to entry and the easing of trade and payments controls, will rapidly change the market structure. In such a rapidly changing situation, Indian industry will have to learn to absorb and not resist change. A major part of industrial sickness is attributed to resistance to accepting the fact that shifts in demand, and changes in technology necessitate firms to restructure output and persistence with a static pattern of output only guarantees the increase in incurable sickness.

11. Given the auspices under which this address is given, it would be inappropriate to conclude without referring to the financial sector reform. There is the erroneous feeling in some quarters that the financial sector reforms have slowed down. Nothing could be farther than the truth. There was great excitement when measures were announced that there would be a move to market related rates of interest, that the statutory liquidity ratio would be reduced, that prudential norms would be introduced and that public sector banks would raise capital from the market. The initial steps in these directions gave a greater sense of achievement; yet these initial measures were precisely those which could be easily implemented. When the harder measures, built on the initial measures, were taken it was erroneously thought that financial sector reforms

had slowed down. Let me illustrate. When it was first indicated that the Government would move over to market related rates of interest on Government securities and the reforms of the primary securities market were undertaken, there was considerable euphoria, yet when the much harder reform of secondary market institution building is being undertaken there is a feeling that reforms have slowed down. Again, when the first phase of capital adequacy, income recognition and provisioning norms were announced, there was a feeling that a major reform had been undertaken; yet with the implementation of the next phase of even more stringent norms the perception was that this was a mere continuation of earlier measures. I would like to stress that while Indian financial sector reform is admittedly gradual, it is a deliberate and conscious policy. Quite often, rapid and hastily prepared reforms require frequent reversal. Although the Indian financial sector reform is gradual, there should be no doubt among economic agents that the reform process is irreversible and therefore, there is a greater element of stability which is conducive to the development of a strong and vibrant financial sector.

12. I would like to refer to one other matter which is a sequel to the financial sector reform process. The distinction between banks and non-bank financial institutions is fast disappearing and increasingly traditional bank clients are approaching non-bank financial institutions and also the market. Corporates are now able to access the market at rates of interest which are lower than the minimum charged by banks. While competition between banks and non-bank institutions does contribute to market efficiency, corporate clients must recognise that banks cannot indefinitely provide lines of credit when corporates wish to oscillate between banks and non-bank institutions. Again, non-bank financial companies are now subject to various prudential norms and they must strictly abide by these norms and violations will invite the due consequences. While increased competition in the financial sector should be based strictly on efficiency criteria, the financial companies need to ensure that their operations are not explicitly or implicitly violative of the regulatory framework.

13. Before I close, let me get back to my basic theme viz., that the well known constraints of the past of the current account deficit in the BoP and the monetisation of the budget deficit are no longer going to be central issues. Changes in the economy are going to be more rapid than earlier and a system of subventions for inefficient economic agents would no longer exist. In such a milieu all economic agents must adjust rapidly to the changing environment; this is the milieu as we move into the next century. I am sure that entreprenuers and bankers in Dakshin Kannada, who have provided so much of innovation in the past will respond effectively to these challenges.