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Is a Crisis Around the Corner?

(Comment on Nouriel Roubini's and Richard Hemming's paper "A Balance Sheet Crisis in India")

The central thesis of Nouriel Roubini and Richard Hemming in this provocative paper is that "India is as vulnerable to a financing crisis today as it was in 1991 and as other economies that have experienced severe financial turmoil." They therefore urge an immediate fiscal correction that will help contain the debt and alleviate other vulnerabilities.

I agree with the authors' prescription that fiscal correction is urgently needed but disagree with the conclusion that a crisis is around the corner. In as much as the possibility of an imminent crisis can spring the government into urgent action, one would like to be able to make the case the authors have tried to make. But the available evidence simply does not add up. Admittedly, a crisis is bound to hit India some time in the future if it fails to take corrective action but the likelihood that this will happen in the

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[1] The paper by Montek Ahluwalia mentioned in the text has heavily influenced these comments. I am deeply indebted to him.

immediate future, say, within one or two years, is tiny.[2] This said, a case for urgent fiscal adjustment nevertheless exists on the ground that deficits of current magnitude may be costing the economy heavily in terms of growth foregone.

I divide the discussion into three sections. In Section 1, I argue why the case for an imminent crisis is weak. In Section 2, I argue why there nevertheless remains a case for immediate fiscal correction. In Section 3, I make concluding remarks.

1 Which Crisis?

Let us consider various forms of crises and assess their likelihood. A crisis could manifest itself in one or more of the following: capital flight similar to that experienced by Latin America and Asia in the last decade; a loss of international creditworthiness as happened to India in 1991; a banking crisis involving run on the banks and bank failures; and a sovereign default. Consider the case for each of these possibilities in turn.

1.1 Capital Flight

Both fiscal deficit and public debt in India are very high currently. The combined fiscal deficit of the center, states and public sector is between 11 and 12 percent of the GDP while the total debt is more than 85 percent of the GDP. Viewed in isolation, these indicators would make potential lenders to the government nervous. In addition, a very substantial part of the assets of commercial banks in India is in the form of government securities. Therefore, any loss of confidence in the solvency of the government translates

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[2] In a recent paper, Ahluwalia (2002) carefully dissects the vulnerability of India to a crisis and reaches the conclusion that "India does not face any immediate danger of a capital account crisis" and that "the system is not seriously vulnerable to a run on the bank deposits." Though two years

into a loss of confidence in the banking system. In turn, this may force savers and investors to move their funds rapidly out of the country and force a large devaluation of the rupee.

Prospects for this scenario to play out are remote at this point for many reasons. India's short-run debt is currently less than 10 percent of foreign exchange reserves compared with 130 percent prior to the 1991 crisis. The ratio of debt service to exports is less than half of that in 1991. Residents are not allowed foreign currency deposits. Private debt incurred by both domestic and foreign firms is strictly controlled. In particular, firms can incur foreign debt only if the maturity of such debt is five years or more. Though direct foreign investment and portfolio investment have been rising and a sizeable stock of them now exists, they cannot move out rapidly enough to cause a crisis; this is because the rupee value of these investments declines as they move out and the induced depreciation of the rupee imposes additional cost (only 30 percent of the total FII investment is allowed forward cover under the current rules). Finally, unlike in the 1980s, high fiscal deficits during the last decade have not manifested themselves in high current account deficits. Instead, given the relatively muted response of imports, the RBI has had to purchase foreign exchange in large volumes to prevent the rupee from appreciating.[3]

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have passed since Ahluwalia wrote his paper, in my judgment, his basic analysis and conclusion remain valid for now.

[3] Recently, India has been taking measures to open its capital account, however, which may make it substantially more vulnerable to capital flights. In particular, according to a recent measure, resident Indians can buy up to $25,000 per year for any purpose whatsoever. This measure would seem to effectively permit citizens to hold foreign-currency accounts and open an avenue to capital outflows. Precisely what impact it will have on capital flight will depend on whether the measure is allowed to stay in place indefinitely.

1.2 Loss of International Creditworthiness

While the absence of capital account convertibility minimizes the scope for capital flight, it does not rule out the loss of creditworthiness in international markets, putting the availability of trade credit at risk and thus delivering a sudden stop on exports and imports as actually happened to India in 1991. Again, given the current parameters, the likelihood of a repeat of 1991 in the next year or two is tiny. To begin with, foreign exchange reserves at $107 billion are sufficient to cover more than a year's worth of imports. There is also great sensitivity on the part of the RBI to avoid overvaluation of the rupee, which is clearly the driving force behind the rising stock of foreign exchange reserves in the first place. Finally, debt-service payments as a proportion of total exports are considerably lower currently than in 1991. The presence of these factors makes a repeat of 1991 in the near future quite unlikely.

1.3 A Run on the Banks

As the Roubini and Hemming point out, the banking system suffers from many vulnerabilities. For example, more than 80% assets of banks are in the public sector that remains hugely inefficient. At 12% in gross terms and 7% net of provisioning in 2001, the stock of non-performing assets (NPA) remains large relative to the international norm of 2% or less. Banks also remain poorly supervised.

But again, these and other vulnerabilities fail to add up to a run on the banks in the next year or two. To begin with, given that deposits are held in the domestic currency, banks do have a lender of last resort in the RBI. Moreover, in the past, the government has refused to let any banks fail even when the cost of failure did not justify saving them. As a result, public confidence in the banking system remains high.

1.4 Sovereign Default

A final form the crisis may take is sovereign default. At present, a default on the external front is quite unlikely. India's external debt as a proportion of GDP is approximately 21 percent, which is not much more than the current level of foreign exchange reserves. Alternatively, the debt-service ratio defined as the ratio of interest plus current-year repayment of principal to the current-account receipts is 18 percent, which is not unusually high for a growing, developing country.

India's domestic debt is much larger and has been rising recently, however. This raises more serious concerns of default on the domestic debt. Roubini and Hemming offer several simulations that point to the dangers of ever-increasing debt-to-GDP ratio. But again, if we focus on the next year or two, the likelihood of a sovereign default on domestic debt remains tiny. The chances are that with the growth rate having picked up in the current year and interest rates having come down and possibly staying low, the growth-interest-rate differential will more than offset the primary deficit in the next year or two. In turn this means that the prospects for a decline in the debt-to-GDP ratio are good on that account unless primary deficit itself is allowed to balloon further. But in view of the fiscal responsibility act that requires attaining zero revenue deficit within a few years, prospects for this are low.

2 Sluggish Private Investment and the Need for Fiscal Correction

The low likelihood of a crisis in the short run notwithstanding, the case for rapidly closing the deficit, especially revenue deficit, is very strong indeed. To make the point clearly, let me introduce the savings-investment identity:

(1) $I_g + I_p = S_g + S_p + S_{f,}$

where I_g and I_p denote government and private investments and S_g, S_p and S_f government, private and foreign savings, respectively. Each variable is measured as a proportion of GDP. Government investment includes investment in infrastructure, health and education. Private investment refers to investment in plant, machinery and buildings by firms. Private savings consist of savings by households and firms. The former equal incomes of households not allocated to current expenditures and the latter the excess of firms' revenues over current expenditures. Government savings equal revenues minus current expenditures and are represented by the revenue surplus.

Foreign savings are represented by two equivalent measures: external current account deficit and external capital account surplus. A positive current account deficit means that the country's current exports of goods and services fail to fully pay for its imports. The gap is effectively covered by sales of its assets such as plant and machinery, equity or domestic debt instruments to foreigners. Thus, the current account deficit of the country, which equals its capital account surplus, effectively represents foreign savings invested in it.

The key policy implication of the identity between the current account deficit and capital account surplus is that the government can control the current account deficit (and therefore the inflow of foreign savings) by controlling the capital account surplus. The latter is readily controlled through the accumulation of foreign exchange reserves. To the extent that RBI purchases foreign exchange reserves, it offsets the inflow of foreign capital by outflow.

Denoting then the current account deficit as a proportion of GDP by CAD and capital account surplus as a proportion of GDP by CAPS and recognizing that each equals savings from foreign sources, we can rewrite the savings-investment identity as

(1') $(I_g - S_g) + (I_p - S_p) = S_f = CAD = CAPS$

Remembering that government savings represent revenue surplus, the investment-savings gap in the government sector ($I_g - S_g$) represents fiscal deficit. Therefore, if fiscal deficit rises more than private savings, either the current account deficit must rise to bring additional foreign savings into the economy or private investment must decline. Unless private savings are rising fast enough, a profligate government is forced to choose between declining private investment or rising current account deficit.

In the light of these implications of the savings-investment identity, consider the current macroeconomic scenario in India. RBI rightly worries about significant appreciation of the rupee lest it scuttles the competitiveness of Indian exports. As a result, it has reacted to the large inflows of dollars through foreign investment and remittances by buying foreign currencies and thus accumulating foreign exchange reserves. But this act of RBI automatically reduces the capital account surplus and therefore the current account deficit. The inflow of foreign savings is choked off.

In fact, recently, RBI's efforts to prevent an appreciation of the rupee have turned the capital account surplus into deficit, which implies that on net India is investing a part of its savings abroad albeit at the very low return fetched by foreign exchange reserves. Though private savings have risen, they have been partially offset by this reduction in foreign savings. What is left has been absorbed by increased fiscal deficits, leaving no room for private investment to expand.

One may wonder why the government has been able to mop up private savings at interest rates that are now substantially lower and why private sector has failed to compete for them. There are two possible answers. First, the economy has been in a downturn, which has kept the investment demand sluggish. Second, in so far as non-corporate borrowers are concerned, banks do not want to lend them at interest rates comparable to those available on the government securities. Not only are these borrowers untested, the current administrative controls unduly punish bank managers for making bad loans while failing to offer symmetric rewards for making good loans. As regards corporate borrowers, their investment demand is approximately limited to their retained earnings.

The question remains, however, why the investment demand of the corporate sector so limited? In part this may be due to the downturn phase of the business cycle. But given how long the sluggishness has persisted this cannot be the whole story. In all likelihood, the small-scale-industries (SSI) reservation and archaic labor laws have kept the potentially lucrative labor-intensive sectors effectively closed to the corporate sector. The corporate sector has been moving forward in areas such as pharmaceutical and auto sectors where it is not hamstrung by these restrictions nearly as much but the big potential lies in the labor-intensive sectors.

While the SSI and labor-law reforms will, thus, help stimulate investment demand, no country can escape the tyranny of the savings-investment identity. Unless private savings rise, the country must choose between cutting fiscal deficit or running larger current-account deficit if it is to let private investment rise. Without these measures, any pick up in the investment demand will be dissipated in higher interest rates.

3 Concluding Remarks

Roubini and Hemming have done a great service by forcefully making the case for immediate fiscal correction. Nothing gets a government's attention focused more sharply than the fear of a crisis. This said, it must be acknowledged that the basis of an imminent crisis in India is rather weak. Given the presence of capital controls, low ratio of short-term capital flows to foreign exchange reserves, a large stock of foreign exchange, low debt-service ratio, declining interest rates and high rate of growth, the case for an imminent crisis is difficult to sustain.

Nevertheless, the prescription offered by the authors is the right one to cure a different disease afflicting the Indian economy currently: low private investment. I have argued that the inability of the RBI to run large current account deficits and poor prospects for private savings to rise dramatically in the short run leave little room for private investment to pick up unless the government cuts its fiscal deficit. Of course, given that public investment is beneficial in its own right and also enhances the productivity of private investment, this prescription translates into a need for a reduction of the revenue deficit through both increased revenues and reduced current expenditures.