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"Today's fiscal crisis is more acute than in 1991"

Q&A

Deepak Nayyar

When finance minister Yashwant Sinha was still earning his spurs in the Union finance ministry, preparing his first budget in 1991 as a member of the short-lived Chandrashekhar government, one of his key aides was the then chief economic advisor Deepak Nayyar. At present Vice-Chancellor of the University of Delhi, Dr Nayyar is a distinguished economist who began his career as an IAS officer and then went on to earn a doctoral degree in economics from Oxford University, UK. After a long stint in academia, having taught at Sussex University, IIM-Kolkata and Jawaharlal Nehru University, Dr Nayyar joined the government as economic advisor in the Union commerce ministry and was later chief economic advisor in the finance ministry. Dr Nayyar quit the ministry in 1991 due to policy differences with Dr Manmohan Singh and returned to teaching. On the eve of Mr Sinha's fifth budget, Dr Nayyar recalls the handling of the crisis of 1990-91 and how Mr Sinha could well have been the "hero of 1991" if he was only allowed to present his budget that year.

However, the fiscal situation today is in many ways less sustainable and more crisis-prone than was the case in the early 1990s, notwithstanding the accumulation of foreign exchange reserves, warns Dr Nayyar in a conversation over the weekend with Sanjaya Baru of The Financial Express. Excerpts from the interview:

You were the chief economic advisor in 1990-91 when Mr Yashwant Sinha prepared his first budget, which he couldn't then present. From your recollection of that time what impressions do you have of Mr Sinha as a finance minister and how different would his February 1991 budget have been from the July 1991 budget of Dr Manmohan Singh?

I worked in the ministry of finance under three different finance ministers and three different Prime Ministers, between 1989 and 1992, and if we focus only on February-July 1991 we wouldn't be properly contextualising what happened. The fiscal crisis, the balance of payments crisis, had been building over a period of time and what Mr Sinha did or could not have done should not be viewed in isolation. It was a difficult and an unusual conjecture - politically and economically - and the degrees of freedom were few and yet, given the fetters and constraints on the government at the time, the management of the economy during that crisis was as good as it could have been, as it should have been. There was no capacity to make fundamental changes in policy, there wasn't the mandate. But, in terms of crisis management, in the short term, we did well to ensure there was no default on international obligations so that whoever assumed office after the elections would have the freedom to put in place what they thought was desirable.

Informal consultations with the International Monetary Fund began during Mr Sinha's time. This initiated the dialogue within government that shaped the policies that found fruition later. A blueprint for the change that in fact came in June-July 1991 was already in place by February 1991. What happened in July 1991 was not a bolt from the blue, the plans were laid out in detail during Mr Sinha's tenure. The first step towards some fiscal adjustment was taken by Mr Sinha in December 1990 after consultations with the IMF when a supplementary budget was presented to raise revenues.

You went to Washington DC in December 1990 to negotiate with the IMF. Would it be right to say that Mr Sinha's team had put in place a policy package that could have saved the situation if Rajiv Gandhi had not pulled down the Chandrashekhar government. We may then never have had a Narasimha Rao-Manmohan Singh team initiating reforms!

At that time it was recognised not just in the government, and in the IMF, but across the political spectrum that there was an overwhelming need for fiscal adjustment, and that it was no longer possible to postpone the day of reckoning. The acceptance of the principle that fiscal adjustment was both necessary and desirable had already come. The nature of that adjustment was constrained by political events. We did negotiate with the IMF in December 1990 a first credit tranche of the standby arrangment and another loan under the contingency and compensatory financing facility of close to $2 billion. This provided a breathing space for us to manage the crisis in the balance of payments. What is more, the budget that was never presented, of February 1991, would not have been very different from what was presented in July 1991 by Dr Manmohan Singh! The conception and design was more or less the same. There was a consensus across most political parties that something had to be done and most were agreed on what was done.

So the hero of 1991 could well have been Mr Sinha and not Dr Singh, if the Chandrashekhar government had survived?

(laughs) Well, these are all accidents of history! Remember what Socrates was supposed to have said, that when the time for an idea has come it is unstoppable. Of course the crisis forced certain options on us which we may not have otherwise taken, but there was considerable consensus on what had to be done and anyone in office at the time would have done more or less the same thing.

Why then did you quit Manmohan Singh's team? What were your differences?

There were some differences both on strategy and tactics. In 1991 the situation we were in was grim. If we were an army dealing with such a situation, you can either make a tactical withdrawal to re-assemble and fight another day, or you can retreat in disarray. The option of default, which was seriously advocated by some at the time would have been the equivalent of retreating in disarray. Negotiating with the IMF was the equivalent of a tactical withdrawal, so that we could find the breathing time and space to restructure economic policy and the economy in consonance with our national interest and development objectives.

My concern, in part, was that what we considered a tactical withdrawal in 1990-91 came to be portrayed as a strategic advance subsequently. What was a necessity came to be portrayed a virtue. This was not a strategy of development. There was no dispute on the necessity of fiscal adjustment, there was a debate on the nature of fiscal adjustment. I believed that the adjustment should have come much more in consumption than investment, what happened was the opposite. I believed that the size of the fiscal deficit was not the issue, different levels of fiscal deficit are sustainable or unsustainable depending on what use government borrowings are put to. The fetish about reducing the fiscal deficit without worrying about the revenue and monetised deficits seemed to me both inappropriate and misplaced.

The other issue was structural reform. I did have differences about the sequence and the pace. Trade liberalisation without the necessary anti-dumping laws and provisions for countervailing duties, financial sector reform which did away with over-regulation but did almost nothing about under-governance, a foreign investment policy which did not recognise that foreign investment can never be a substitute for domestic investment but can only complement it, and that the import of technology can not be a substitute for the development of domestic technological capabilities. Finally, public sector reform. The approach, which emphasises asset sales or closures, is the most opportunistic form of privatisation. It is neither adjustment nor reform. You might send a few white elephants to the slaughter house, but unless the realisations from disinvestment are used to either retire public debt or to restructure public enterprises, there is no real solution to the problem. Even now there is no restructuring of the public sector going on, we only have asset sales.

Dr Singh told me that there were also differences on exchange rate policy, on the extent of devaluation in 1991.

We were all agreed that the rupee was over-valued and devaluation was required. Our differences were on the extent of devaluation. Some advocated a steeper devaluation than what was finally done. I favoured a more modest adjustment because I was worried about the inflationary consequences. Inflation did become a problem in subsequent months.

But the overall management of the external economy in the 1990s has been good. In your time in the finance ministry forex reserves were down to a billion dollars, today the RBI says they have crossed $50 billion!

It is true that in comparison to Latin America or Sub-Saharan Africa, India's stabilisation experience in the 1990s can be described as a success. We did transform a perilous balance of payments situation into a comfortable one within two years, in 1991-93, but please remember that this would not have been possible but for the crisis management of the 1990-91 period, when we resisted default. However, a stable and sustainable BoP can only be based on robust export performance and on the inflow of long term capital flows. On this score we have not done very well. These days $50 billion of reserves mean nothing if we do not manage our fiscal situation well. Look at Brazil, it had $80 billion reserves which vanished in a fortnight. Look at what happened in Mexico, Argentina, Thailand, Korea, Russia, Turkey.

My work on globalisation suggests to me that premature integration into international financial markets is fraught with risk. Even with $50 billion reserves I would urge caution on capital account convertibility and on short term capital flows, and still emphasise the need to increase export income. If you rely on portfolio investment to finance the current account deficit then you have to keep your exchange rate strong and the interest rate high, to ensure confidence and profitability to those who provide those portfolio flows. When you do that there are natural consequences. Strong exchange rates mean your exports become less competitive over time, your trade deficit and current account deficits rise, increasing the attraction of portfolio flows; while at the same time domestic investment is discouraged by high interest rates. Crises triggered by unsustainable exchange rate policies forced by the compulsions of attracting portfolio investment have hurt so many countries in recent years.

May I say that it is such concerns of people like me which prevented India from being more adventurous on capital account convertibility and saved us from the kind of crisis that south-east Asian and Latin American countries have experienced in recent years. If we had gone the whole hog, which many people wanted to at the time, my concerns would have been proved right.

Would you still be cautious about moving faster with capital account convertibility?

Yes. Capital account convertibility imposes limits to fiscal and monetary policy and you get locked into interest and exchange rate policies for which we are not yet ready. The fiscal situation in 2001-02 is no better than what it was in 1991. The nature of fiscal adjustment we have seen over the past decade leaves much to be desired. It makes little sense to reduce the fiscal deficit while letting the revenue deficit burgeon. The fiscal deficit is less sustainable today than it was in 1991: (a) because the cost of government borrowing is significantly higher today than it was in the early 1990s, because the government today borrows at a higher rate of interest than it did in the 1980s and early 1990s. (b) because the use to which government borrowing is being put is much worse today than in the 1980s. In the 1980s, the decade of so-called fiscal profligacy, no more than 30% ofgovernment borrowing was used to finance consumption expenditure. This ratio went up to one-half in the first half of the 1990s and to two-thirds more recently. This is simply unsustainable. Fiscal crises are a bit like treadmills, not like time bombs. The threat has not gone away. A macro-economic crisis could come again, and when it does there are going to be fewer comebacks.

Forex reserves of $50 billion are comfortable, even if a large part is short-term debt and portfolio flows, so long as international financial markets have a degree of confidence in the macro management of the economy. I don’t think anyone would disagree with me that the underlying fiscal crisis is acute. It remains as deep as it was ten years ago. Fiscal adjustment has been long on words and short on substance.

If you were the CEA now, what advise would you be giving Mr Sinha on fiscal adjustment?

I believe it is necessary to pursue fiscal adjustment by first increasing the revenue of the government, rather than cutting expenditure, and by re-orienting expenditure into investment and away from current consumption. The tax-GDP ratio has fallen over the past decade. This must be reversed. Revenues will have to be mobilised through improved tax compliance, not by raising rates, even though I think we have reduced rates far too much in the past. I would push for increased public investment in infrastructure, because this will also encourage more private investment. I would recommend lowering interest rates. I would push for policies, which would encourage employment creation. I would also push for policies that would encourage new investment to increase the investment/GDP ratio.

Permit me, however, to end on a less than optimistic note. I do not believe that there is a political consensus in this country on economic policy. People mouth mantras like liberalisation much like they did with socialism. These are only slogans. The leaders of all political parties talk a similar language these days, but go below the level of leadership and within the rank and file there is neither any understanding of what we are talking about nor any consensus. The lack of a consensus on economic policy is made worse by short-termism. Some of the issues I have raised and some of the problems the Indian economy faces require us to think big and think long.