THE TUESDAY INTERVIEW/ DEEPAK NAYYAR

'Yes, there were differences'

DEEPAK Nayyar was chief economic adviser to the government for 18 months, till December last year, when he decided to return to academia. In this first interview since he demitted office, he speaks to The Economic Times about a range of questions connected with the macro-economic adjustment and structural reform programmes now underway. The interview is being published in two parts; the second and concluding part will be published on this page next Tuesday.

Q: How do you see your 18 months in office as chief economic adviser?

A: It was, to say the least, a difficult 18 months. There was turbulence in the polity, which saw three governments in office. There was a crisis in the economy, the like of which we have not experienced in independent India. And for those of us concerned with the macro-management of the economy, there were long periods of anxiety interspersed with moments of despair.

Q: Are you saying it was all gloom and despair?

A: Well, there were some occasional moments of relief, but no moments of joy. Yet, it was a challenge for a professional economist interested in macro-economics and policy formulation. And it was an opportunity to serve the country in difficult times.

Q: What was the most difficult period?

A: The period from mid-March to mid-June last year was the most difficult. The balance of payments situation was almost unmanageable, and we were close to default for much of the time. The prolonged political interregnum in the run-up to the elections, when there was only a caretaker government, made an exceedingly difficult task close to impossible, because essential policy instruments, which required major policy decisions, were simply not usable.

The period from late-June to early-August, after the present government assumed office, was also exceedingly difficult. The balance of payments situation was desperate as the threat of default loomed large. Making difficult choices and reaching hard decisions during this phase was not any easier.

Q: How did we get into this crisis?

A: The fiscal mess and the balance of payments crisis are neither an accident nor a coincidence. They are a direct consequence of financial profligacy and fiscal laxity in the second half of the 1980s. The irony is that, at the time, many of us had warned that any growth process based on borrowing was simply not sustainable, as the BoP situation would become unmanageable and inflation would exceed the limits of tolerance. But the decision-makers then were convinced that they could borrow and spend their way to prosperity.

Q: What do you see as your main achievement during your term in office?

A: It may sound odd, but the main achievement was that India did not default on its obligations. It was touch and go, but we were able to save the nation from bankruptcy.

Q: What were the failures?

A: An important failure, due to circumstances beyond the control of individuals, was that the Budget could not be presented last February. In terms of the management of the economy, this narrowed our limited options even further, and made it difficult to cope with the deepening fiscal crisis.

Q: Would you like to comment on the reasons for your decision to leave the government and return to academia, especially after your selection by the UPSC as chief economic adviser?

A: The decision to resign and return to academia was indeed a conscious act on my part. For one, I am not a career civil servant. Nor do I seek a career in the civil service. So my return to the ivory tower is only natural. For another, in any situation, there is a time for arrival and a

> **The main achievement was that India did not default on its obligations. It was touch and go, but we were able to save the nation from bankruptcy.**

time for departure. I came to the conclusion that, all things considered, it was time for departure.

Q: You are not saying very much.

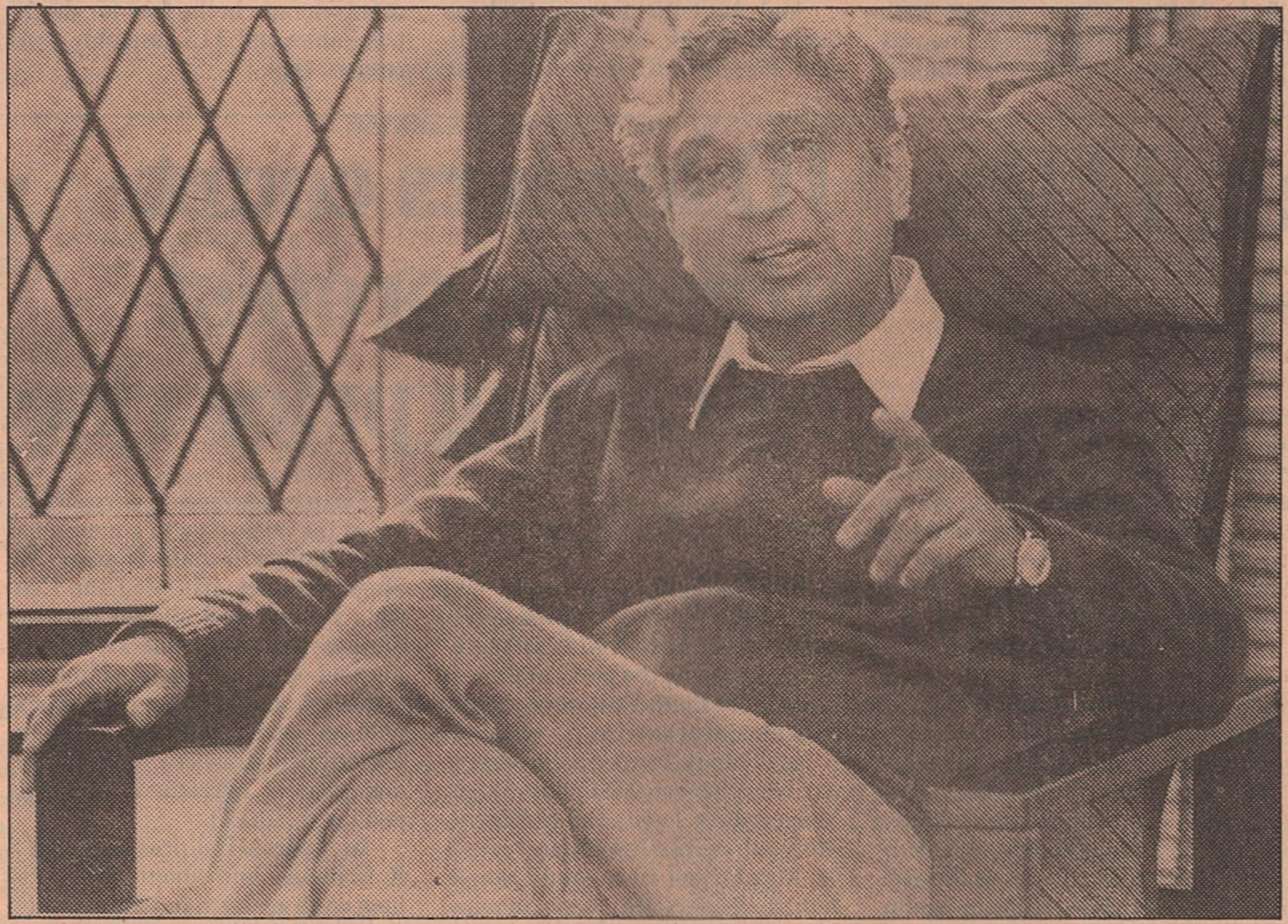
A: I think I am saying enough. Some things are best left unsaid. I am sure you understand.

Q: Did you have any policy differences with the government that prompted you to take this decision?

A: Yes, there were differences. I should add that differences in perception and judgement are inevitable when the nation is confronted with such difficult choices in the management of the economy. At the same time, there are thresholds which are important. But my decision to leave should not be attributed to these differences alone.

Q: Your departure, and the decision to replace Mr S.P.Shukla as finance secretary, has been interpreted as the departure of the 'leftists' in the finance ministry, leaving behind people who are more in tune with the thinking of the IMF and the World Bank. Would you like to comment?

A: This is not for me to say, it is for others to judge. On my part, I



would only like to stress that I worked as chief economic adviser for three successive governments. My advice to each, always dispassionate and candid, was based on considered professional judgement where the fundamental concern was national interest.

Q: When the Budget was drawn up in July 1991, the calculation was that economic growth this year would be 3.5 to 4.0 per cent, and inflation about 10 per cent. Both assessments have gone awry. Why did the government's assessments go wrong, and what does the situation today mean for the short-term future?

A: In retrospect, it is clear that both assessments were wrong. But there is no such thing as perfect foresight in economics. The slower growth in GDP this year is attributable to the severe import compression and the tight monetary policy, which have affected industrial production. Agricultural growth too may be lower than expected, if not negative.

Inflation is higher than expected because there was no seasonal downturn in prices in the third quarter of the fiscal year. There was the large liquidity overhang inherited from the unbridled growth of money supply during the Seventh Plan period, and monetary policy is not able to discipline the parallel economy.

Inflationary expectations are considerable, and have been accentuated by the stop-go method of hikes in administered prices, which came in hiccups over time: first fertiliser and petroleum, then coal, subsequently sugar and foodgrains, now steel, and so on. When these increases come in stages, it tends to make people believe that prices will increase further.

Q: Couldn't these factors have been foreseen, and why did the government fail to see them?

A: Some could not have been foreseen. Others could. This is where assessments go wrong.

Q: What does it mean now, since both growth and inflation are worse than had been anticipated?

A: Taken together, it means that the danger of stagflation is much greater.

Q: The indications are that the target for fiscal deficit this year, at 6.5 per cent, will prove almost impossible to achieve. What would be your assessment of the final level of fiscal deficit? And what is the IMF's reaction likely to be if the target is missed by a fairly wide margin? For instance, would that throw the stand-by arrangement into crisis?

A: In the absence of the data, it is difficult for me to give an assessment of what the fiscal deficit would be. Newspaper reports suggest that it will be very difficult, if not impossible, to stay within the limit of 6.5 per cent of GDP. There are expenditure over-runs, as in the case of subsidies, and revenue shortfalls, especially in customs duties. These far exceed the savings realisable from the 5 per cent cut in expenditure announced in September. Imbalances in trade with the erstwhile USSR also mean that technical credit is running at levels much higher than anticipated. So is net RBI credit to the Centre. These trends suggest both the budget deficit and the fiscal deficit would exceed the estimated levels.

Q: Some attempt seems to be under way to paper over these problems in the accounting.

A: It will serve little purpose to defer expenditure or advance receipts in order to achieve 6.5 per cent in a cosmetic manner, because that will only postpone the day of reckoning.

Q: Will the IMF accept any deviation from the 6.5 per cent target?

A: I do not know. The IMF may accept a small deviation, say one-fourth of a percentage point. Anything beyond that could have serious implications, and the future of the stand-by arrangement with the Fund would then become a matter for fresh negotiation.

Q: If there is to be no fudging of the figures, and one has to stay within the limits agreed to with the IMF, what are the options available?

A: The danger is that we will go in for the least desirable pattern of expenditure cuts, on social sectors and on infrastructure. Unless the ministry of finance can pull a rabbit out of the hat, or unearth undisclosed cushions, at this late stage adjustment can only come from cuts in expenditure, especially in social sectors and in infrastructure. This would add to the burden on the poor in the short run and squeeze supply responses in the medium-term.

Q: How easy, or difficult, will it be for the government to achieve the fiscal deficit target next year, of 5 per cent of GDP?

A: Easy is not the word. It would be exceedingly difficult at the best of times. It will be close to impossible if the limit for this year is missed by a wide margin. In terms of an intellectual construct, it is possible to

> **Inflationary expectations are considerable, and have been accentuated by the stop-go method of hikes in administered prices.**

think of methods for reducing the fiscal deficit to 5 per cent next year, but all the hard decisions needed for this are not likely to materialise.

Q: Why?

A: To give you an idea of how difficult 5 per cent is, one must recognise that the primary deficit (which is the fiscal deficit less interest payments) would have to be reduced from about 4 per cent of GDP last year to near zero level next year.

Q: What are the options which the finance minister has if he is to limit the fiscal deficit next year to 5 per cent of GDP?

A: It is clear to me that such a substantial fiscal adjustment will have to come from an appropriate mix of expenditure cuts and revenue raising measures. I believe there are limits to expenditure adjustment; first, the available fat has already been trimmed to a considerable extent in this year's Budget; second, it is imperative to protect outlays in social sectors and investment in infrastructure. In the current year, only 20 per cent of the fiscal adjustment has come from revenue raising measures (if one excludes the sale of public sector equity), while 80 per cent of the adjustment has come from expenditure cuts.

Therefore, an extraordinary effort is now needed to mobilise revenue, where the focus must be on direct taxes. In a period where we are imposing a substantial burden on the poor through expenditure adjustment, the equity principle demands that the non-poor share in this burden through their contribution to direct taxes. In my judgement, it is absolutely essential to broaden the base for direct taxes so that a larger number of people are brought into the tax net, and to deepen the structure of direct taxation by increasing the average rates of tax.

This means that the income tax exemption limit should be reduced rather than increased, and the deductions should be removed rather than rationalised; and loopholes in the provisions should be plugged to pre-empt avoidance and improve compliance. The provisions for tax deduction at source (TDS), introduced this year, should be strengthened rather than diluted, and the rate of TDS should be raised rather than lowered.

Similarly, there is considerable scope for mobilising revenue from direct taxes through a structural change in the provisions for capital gains tax. I see no reason why 60 per cent of long-term capital gains should be deductible from taxable income after a base deduction of Rs 15,000. There is a need to index-link the cost of acquisition of assets in computing long-term capital gains, but the present provisions are far too generous.

Q: What are the implications of a dramatic cut in customs tariffs?

A: If the widely expected reduction in customs tariff levels is to be revenue-neutral, every rupee foregone on customs duties means almost two rupees must be raised from excise duties, because 45 per cent of excise duties accrue to the states, whereas customs duties accrue entirely to the Centre. The reduction in customs duties may not be feasible in view of the balance of payments situation and the dependence of the exchequer on tariff revenues. The compensating increase in excise duties is not desirable because it is both inflationary and regressive.

Q: Since inflation has not been brought under control, will this force the continuation of a very tight monetary policy, with the inevitable result of more widespread industrial recession? What, for instance, would be your assessment of the economy's and industry's growth prospects in 1992-93?

A: If inflation is not controlled, and the balance of payments situation does not stabilise, the tight monetary policy is bound to continue. The prospects for growth next year would then be gloomy. Even otherwise, in a period of substantial fiscal adjustment, I would not expect growth of over 3 per cent.

Q: Would you then consider the Eighth Plan's five-year growth target of 5.6 per cent to be realistic?

A: No, sir. In a process of macro-economic adjustment which will take at least three years to complete, the growth target for the Eighth Plan is simply not realistic. Compared with the Seventh Plan, a slowdown is inevitable because growth in the last plan was sustained by borrowing, which created the large macro-economic imbalances that have led us into this crisis.

Both the country and the government must learn to live within their means, and this means a slower, sustainable, growth process. Unless, of course, you assume a major increase in the savings to GDP ratio, and a significant improvement in the capital-output ratio.

Q: It has been argued that the commitment which the government has given to the IMF, to reduce the fiscal deficit drastically this year and next year, is one that will be almost impossible to achieve, and that we should not in fact have agreed to such stiff conditionality with regard to fiscal adjustment. Did we have any option, say in the form of a trade-off for structural adjustment in return for easier fiscal correction?

A: At that juncture, there was little choice in the matter. We were in a terrible fiscal mess and an acute BoP crisis, so that our bargaining position was by no means strong. It is my view that there was no leeway in the negotiations with respect to what was perceived as the minimum essential fiscal adjustment. This adjustment, difficult though it may be, is also in our national interest, provided its composition is appropriate and desirable. Let me emphasise that there is no trade-off between fiscal adjustment and structural reform. This illusory choice is perhaps advocated by those who did not have to manage the impossible situation then and would like to move farther and faster with structural reform now.