ISAS Insights
No. 99 – 11 May 2010

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Management of Fiscal Stress:
Are Greece's Solutions Relevant for India?

Sasidaran Gopalan and S. Narayan[1]

Abstract

The financial crisis in Greece and the measures to tackle it have led to a considerable debate on how fiscal deficits should be managed by countries facing fiscal stress. While the immediate causes for worry are Greece's ballooning budget deficit and the risk that other fragile countries like Spain and Portugal might default, the turmoil has also exposed deeper fears that government borrowing in bigger nations could be unsustainable. To some degree, these concerns are relevant for countries like India and those staring at similar numbers. In this context, this piece explores the relevance of the proposed Greece's solutions for India in managing its fiscal stress.

The problems of Greece are already beginning to affect the financial markets in the rest of the world. According to the New York Times[2], 'already, jittery investors have forced Brazil to scale back bond sales as interest rates soared and caused currencies in Asia like the Korean won (KRW) to weaken. Ten companies around the world that had planned to issue stock delayed their offerings, the most in a single week since October 2008. The increased global anxiety threatens

[1] Sasidaran Gopalan is a Research Associate at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He can be reached at isassg@nus.edu.sg. Dr S. Narayan is the Head of Research and a Visiting Senior Research Fellow at ISAS. He was the former economic adviser to the Prime Minister of India. He can be reached at snarayan43@gmail.com.

[2] *New York Times* (8 May 2010), http://www.nytimes.com/2010/05/09/business/global/09ripple.html?ref=business

to slow the recovery in the United States (US), where job growth has finally picked up after the deepest recession since the Great Depression. It could also inhibit consumer spending as stock portfolios shrink and loans are harder to come by.'

The financial crisis in Greece and the measures to tackle it have led to a considerable debate on how fiscal deficits should be managed. Several countries are facing fiscal stress, including the United Kingdom (UK) and the US, and to a greater extent, Portugal, Spain, Italy and Ireland. While the immediate causes for worry are Greece's ballooning budget deficit and the risk that other fragile countries like Spain and Portugal might default, the turmoil also exposed deeper fears that government borrowing in bigger nations like the UK, Germany and even the US is unsustainable. In short, it is a warning call to all countries living beyond their means. After contemplating over the last few days, the European Union (EU) Finance Ministers have managed to work out an emergency loan package worth Euros 750 billion, that includes a mechanism for the states to guarantee loans taken out by the European Commission, the bloc's executive body, to support ailing economies. The package consists of a special-purpose vehicle through which the euro area states would guarantee on a pro rata basis up to Euros 440 billion, in addition to a emergency European Commission funding worth Euros 60 billion and the International Monetary Fund (IMF) contributing up to Euros 250 billion.

The total debt burden for Greece appears to be in excess of Euros 400 billion, 140 per cent of the country's Gross Domestic Product (GDP). The debt is substantially held outside the country, but largely in the Eurozone, and hence, technically, in its own currency. During the next two years, Greece would have to repay close to Euros 110 billion of debt. The Eurozone is offering a financial lifeline through a rescue package worth 110 billion Euros (of which the IMF is chipping in 30 billion Euros), in return for an undertaking by Greece to consolidate its fiscal position by nearly 11 per cent over the next three years, thus reducing its fiscal deficit from 13.6 per cent in 2009 to 3.0 per cent in 2014. If Greece is allowed to default, apart from the collapse of the Greek economy, the negative contagion would have had serious ramifications on the other EU members (most notably Germany) holding Greek bonds in significant proportions, and the Euro in general.

To some extent, these worries are relevant for India as well. The high fiscal deficit and the current account as well as revenue deficits have been taken seriously by the Government, and fiscal management concerns in India have led to the reiteration, at policy levels, of a fiscal discipline road map.[3] There are significant differences in the Indian debt from the Greek debt, and the consequences of management in the two countries are likely to be different.[4]

---

[3] See, *Union Budget (2010-11)*, Speech of the Minister of Finance, India, http://indiabudget.nic.in/ub2010-11/bs/speecha.htm.

[4] See, also Islam. M, 'Should the sovereign debt crisis worry Emerging Asia?', forthcoming (2010).

India's gross fiscal deficit[5] (budgeted estimates) for 2009-10 stands at 9.7 per cent of the country's GDP, while Greece's fiscal deficit stands at 13.6 per cent. In order to consolidate the fiscal position, as a part of the conditionalities of the bail-out package, Greece has to undertake severe belt tightening measures. How many of those options are available for India?

Table 1: Receipts and Expenditure of the Central Government (Rs. Crore)

Item	2004-05	2005-06	2006-07	2007-08#	2008-09 (B.E.)	2008-09 (P)	2009-10 (B.E.)
Revenue Receipts	305991	347077	434387	541864	602935	544651	614497
Revenue Expenditure	384329	439376	514609	594433	658118	791697	897232
Revenue Deficit	78338	92299	80222	52569	55183	247046	282735
Capital Receipts	192261	158661	149000	170807	147949	336818	406341
Capital Expenditure	113923	66362	68778	118238	92766	89772	123606
Total Expenditure	498252	505738	583387	712671	750884	881469	1020838
Fiscal Deficit	125794	146435	142573	126912	133287	330114	400996

Notes: BE – Budget Estimates; P – Provisional; # - Based on Provisional Actuals for 2007-08.
Source: Reproduced from Chapter 3 (table 3.2, pg.40), Economic Survey of India, 2009-10, available at http://indiabudget.nic.in/es2009-10/chapt2010/chapter03.pdf

1) Is debt restructuring an option? The stock of outstanding government debt relative to GDP is a critical measure of sovereign credit standing. Debt restructuring can be plausibly undertaken when a country's substantial portion of its outstanding debt is represented by external debt. A country's external debt is defined as the part of the total debt of a country owed to foreign creditors. With nearly 70.0 per cent of Greece's national debt owned by foreign creditors, it can be an option for Greece. In the past, countries such as Mexico and Brazil have resorted to the restructuring of debt. Primarily, this has involved lenders

[5] The fiscal deficit figure reflects the combined deficit of the centre and the states. The corresponding figure for India's gross fiscal deficit of the central government (alone) stands at 6.5 per cent.

agreeing to give up some of their rights, and to write down outstandings, especially in terms of interest payments, and even accept a short payment of principal. If the lenders have deep enough pockets, then such asset restructuring exercises are possible. However, in the case of the Russian default of the early nineties, it brought down a major a lender in the US. With intertwined financial markets and instruments, a sovereign debt default is likely to have global consequences across financial and bond markets, and hence to be resorted only as a final, desperate resort. Though this has not been a part of the proposed bail-out package, as Martin Wolf[6] notes in his latest column in the Financial Times, Greece cannot avoid debt restructuring in the near future. His argument is that the bail-out package will offer only temporary relief, and since Greece does not have the capabilities of growing its revenues to meet the obligations for the foreseeable future, it would have to resort to restructuring of debt. In short, this implies that banks in the US and Europe, most notably Germany, would have to write down their dues.

In contrast, the major share of India's total outstanding debt is represented by internal debt.

Table 2: Outstanding Liabilities of the Central Government
(As a per cent of GDP)

Item	2004-05	2005-06	2006-07	2007-08	2008-09 (R.E)	2009-10 (B.E)
Internal Liabilities	59.7	58.4	56.9	55.1	54.1	54.5
(a) Internal Debt	39.4	37.5	36.1	36.5	36.1	38.2
(i) Market Borrowings	23.4	23.3	22.7	22.1	24.4	28.7
(ii) Others	16.0	14.2	13.4	14.5	11.8	9.6
(b) Other Internal Liabilities	20.3	20.9	20.8	18.5	17.9	16.2
External Debt Outstanding	1.9	2.5	2.4	2.3	2.2	2.2
Total Outstanding Liabilities	61.6	61.0	59.3	57.3	56.3	56.7

Notes: R.E. – Revised Estimates; B.E. – Budget Estimates
Source: Reproduced from Chapter 3 (table 3.6, pg.52), Economic Survey of India, 2009-10, available at http://indiabudget.nic.in/es2009-10/chapt2010/chapter03.pdf

6 Martin Wolf, *Financial Times* (4 May 2010), www.ft.com/cms/s/0/de21becc-57af-11df-855b-00144feab49a.html

India's total debt as a per cent of the GDP is nearly 57.0 per cent in 2009-10 (BE). While the share of total internal debt as a per cent of GDP is 55.0 per cent, the ratio of external debt to GDP is only about 2.2 per cent. Though India's external debt is growing in absolute numbers in the last five years, its proportion to GDP is relatively understated because of the aggregate growth in the size of the economy. Since the source of the debt is internal borrowings, any restructuring of debt would only worsen the balance sheets of the publicly-owned banks. During the last effort at writing down agricultural debt[7], the Government had to step in to provide funds for the banks that had lent to agriculturalists, in a way, worsening its fiscal woes. Any restructuring of debt in India to take care of the fiscal problems would only worsen the position of institutions and individuals who are holders of the debt, and is therefore not an option.

2) How about exchange rate alignment? Observers note that, had Greece not shared a common currency with the EU, it could have relied on conventional tools like a devaluation of its own currency to bring back the costs in line by tightening its fiscal policy. A devalued currency would have in turn helped regain its lost competitiveness by contributing an increase in its exports and would have made the process of fiscal consolidation easier and less painful. But this option does not exist and has contributed to severe deflationary pressures in the economy.

   In the case of Greece, the alignment with the euro is likely to have a cascading effect on each of the individual economies that is linked to the Euro, leading to speculation about the future of the Euro itself. In the case of India, faced with a growing current account deficit, and increasing short-term capital flows into the financial markets that are becoming necessary to hold the capital account balance, exchange rate management has become a day-to-day task for the Reserve Bank of India - a task of balancing the costs of imports with the expectations of exporters, and hence any sharp changes in currency management would be unlikely to affect the fiscal balance of the country's public finances.

3) Fiscal restructuring is one of the key propositions put forward in the bail-out package for Greece. Contracting government expenditures by substantive amounts is the only way out to achieve fiscal discipline in the long-run. But since the economy is already in a depressed state, these measures are going to likely worsen the situation.

   In the case of India, however, there is ample space for using this policy tool because of the subsidies doled out to various quarters. As a proportion of GDP, major budgetary subsidies were budgeted at nearly 1.7 per cent in 2009-10, in addition to the subsidies in the form of

[7] See, *Union Budget (2009-10)*, Speech of the Minister of Finance, India, http://indiabudget.nic.in/ub2009-10/bs/speecha.htm.

issuance of oil and fertiliser bonds amounting to about 1.7 per cent of the GDP. It is definitely possible to target these subsidies in a more effective way and reduce the subsidy bill, thereby creating a dent on the magnitude of internal debt India is facing. The only constraint would be that most of the subsidies are to important constituents, like the farmers and the middle class, and would be difficult to roll down.

Thus, the clear option available to India is to grow its way out of the fiscal deficit. With the economy growing at real terms at around 8.0 per cent, revenues in nominal terms are likely to exceed a growth rate of 15.0 per cent a year, and so long as fiscal borrowing growth is less than this number, it is possible to bring down the fiscal deficit numbers in the medium term - say by 2014. This does require careful inflation management as well as putting out of asset bubbles as and when they arise. But India has been adept in the past with regard to fiscal management - in fact; India has been good only at such critical fiscal management.

The problems of Greece are hence not likely to be the problems of fiscal management in India. However, contagion effects through volatility in the financial markets, increases in interest rates for overseas borrowings and stickiness in new equity offerings cannot be ruled out - these would be near term effects, without affecting the overall growth story.

A key take-away from looking at various options available to India to tackle such debt problems is to grow its way out of the problem by emphasising on collection of tax revenues. The revenue receipts as a per cent of GDP has been declining in India. In 2009-10, this figure stood at 7.7 per cent, back to levels in 2005-06, after seeing an increase in this ratio in the in-between period. Policy makers need to pay attention to this and corrective measures need to be taken to raise the tax revenues-to-GDP ratio.

oooOOOooo