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Unwinding the Fiscal Stimulus – Dilemmas for India and China

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Abstract

This paper states that, with the return of economic growth in India and China, policy makers are concerned about inflationary pressures as well as growing asset price bubbles. The causes of concern arise from different macroeconomic fundamentals in the two countries, and accordingly, the strategies are different. For the world at large, of the two countries, the consequences of China not getting it right are much more serious. This paper examines some of the concerns.

Introduction

The last two quarters of 2009 have been good for both India and China, and in both countries, there is discussion about the sustainability of the economic recovery, the valuation of assets and the monetary strategy for next year. There are several similarities and dissimilarities between the two that are likely to determine the future course of action in these countries.

The Indian and Chinese Economies

India continues to be a supply-constrained economy, with manufacturing accounting for only about 18 percent of the total gross domestic product (GDP). In comparison, the manufacturing sector in China accounts for 33 percent of its GDP, and given that the economy is about three times as large as that of India, this means that China's manufacturing sector is five to six times as large as that of India. While the share of agriculture in India's GDP has dropped to 18 percent (China is at 12 percent), the number of people that depend on agriculture and allied activities has not dropped as sharply as in China, leaving a large number of rural underemployed.

Recent estimates of the Indian Planning Commission indicate a revision in poverty estimates to 37.2 percent.[2] The Tendulkar Committee has increased the poverty threshold to Rs. 446 instead of Rs. 368 per month for the rural population, and Rs. 580 instead of Rs. 560 per month for the urbanites. Additionally, it has compared the bundle of goods and services

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2 Tendulkar Committee Report, Planning Commission, India, December 2009.

consumed by the urban population with those in rural areas, where the poverty ratio has accordingly been pushed up from 28.3 percent to 41 percent. The recent reports from a World Bank study indicate that India has lagged behind China and Brazil in the reduction of poverty levels.[3] The very slow growth of opportunities for low-skilled employment and the large number of people in the rural areas have exacerbated the drop in the agriculture sector's share of the GDP in India. The prevalence of rural distress and Naxalism are not unconnected with the lack of opportunities for employment.

The policy answer to this has been the enlargement of subsidies and a large social welfare programme through the National Rural Employment Guarantee Scheme which has served as a stimulus for increasing consumption in the last 18 months. This programme has been generally successful, with the Planning Commission estimating that over 47 million people accessed this scheme for benefits during the period 2008-09. The estimates also indicate the beneficial aspects of the programme in terms of consumption expenditures, especially on food and food-related consumption. It has been argued that this programme has increased access to food, and coupled with the subsidy programmes under the public distribution system and the midday meals programme, has enabled those below the poverty line to have at least one more meal per day. There has been a negative effect to this as well. This year 2009 was one of unexpected drought, which has severely affected agricultural production. Though there are adequate buffer stocks of rice and wheat, prices of all other food-related articles, including edible oils, meat, milk and vegetables have increased substantially, and food inflation in November 2009 has been reported to be over 17 percent. There is also the fiscal deficit to worry about, with state and central deficits likely to exceed 10 percent this year, and the ability to continue these welfare measures would be affected in 2010.

Dilemma for India's Monetary Policy

This background is necessary to understand the dilemma for monetary policy that is being faced by the Reserve Bank of India (RBI). The Governor of the RBI has articulated concerns about inflationary pressures but has also said that monetary measures alone cannot address food price inflation, and that supply side initiatives to increase production are necessary. At the same time, there are other pressures as well. The liquidity that is available in the economy is putting pressure on asset values as well as on real goods and services. The automobile sector is on a boom, with sales of automobiles touching a high of over 82,000 cars on a single day – an auspicious day before Deepavali. Sales of diamond, gold, televisions and other durables are growing at a frenetic pace and the stock market is delivering returns at levels that had been forgotten for the whole of 2008. There are also pressures on asset values that are being caused by inward capital flows, which are seeking higher returns against a falling dollar.

The capacity of the Indian economy to absorb these flows is still constrained and it has not yet developed the capability of investing in resources and returns overseas. The last quarter's figures of GDP growth of 7.9 percent surprised everyone and analysts have now confirmed that there is evidence of fresh capital formation, namely, investments in capacity addition. Indian policymakers would, thus, have to tread a very careful path between controlling asset bubbles and encouraging growth. The RBI has already signalled that it proposes to do so. There has been some tightening of the repo rate and the cash reserve ratio of bank, and on 9 December 2009, it reintroduced an interest rate ceiling for companies borrowing from abroad

[3] Martin Ravallion, World Bank, 26 August 2008.

and closed the window for the buyback of foreign currency convertible bonds (FCCBs). In a late night release, the RBI said the facility by which Indian companies were allowed to buy back their FCCBs – under both the automatic and approval routes until 31 December 2009 – will be discontinued with effect from 1 January 2010. There is, thus, a reversion to capital control measures.

The Situation in China

The picture in China appears to be very different. In terms of the economy, while there are signals of a robust growth, nearly 90 percent of the growth in the last three quarters has come through public expenditure on infrastructure projects. At the enterprise level, exports dropped almost 14 percent in October 2009, the twelfth straight month of decline. Behind the bluster, policymakers are terrified of what the economy would look like without full state support behind it. Investment in fixed assets accounted for almost 95 percent of GDP growth in the first three quarters. Of that, 'government-influenced' investment was almost half by CEIC/World Bank estimates.

The trillion dollar fiscal stimulus package was easy to implement due to two reasons. First, policy makers pragmatically decided to use the funds to accelerate the already approved projects – the five-year plan implementation was in fact shortened to two years, and the projects were, thus, able to get off the ground fast. Second, the fiscal incentive was as much a responsibility of the provincial governments as the central government – only 35 percent of the incentive came from central funds, the rest having to be put up by the provincial governments, who were allowed access to bank funds for the projects. This measure has kept the fiscal deficits of the central government under control. Simultaneously, there has been a focus on increasing revenue collections, and efficient use of information technology has doubled tax collections as a percentage of GDP in the last three years, and is close to figures of developed countries.

Until Beijing gets a clear view of unassisted growth, external pressure to revalue will be the least of its worries. Till mid-2005, the Chinese Yuan was pegged to the United States dollar. Attempts to revalue the Yuan between 2005 and 2008 resulted in a huge carry trade of hot money as companies borrowed in United States dollars, and converted them to Yuan, and waited for the Yuan to appreciate. Unfortunately, since then the Chinese government has kept the Yuan pegged at 6.82 renminbi per United States dollar, whereas a reasonable figure would be closer to 4 renminbi to the United States dollar. Given the 2005 experience, China is unlikely to signal a gradual appreciation of the Yuan, and will be constrained from doing a one-shot appreciation due to political reasons. The Chinese trade authorities believe that it is 'unfair' to expect the renminbi to rise when the American dollar's decline was making the United States goods more competitive. However perplexing this is for politicians or investors who are long on renminbi forwards, policy shocks are not what China needs. The dilemma then is that, in a demand-constrained economy, with exports falling and a currency that is undervalued, how to extricate the macro-economy from the fiscal stimulus to a gradual non-state assisted growth process. They are severely conscious, as are the Indians, on the calamitous effects of a bursting asset bubble – actually much more for China than India.

The advantage in China is, of course, that decision making is centralised and pragmatic, and it is easier to implement central decisions all over the country. One sees signals of adjustment policies that attempt to address the above dilemma. The approach is to make input costs more reflective of true, market-determined prices. First, gradual re-adjustments of land prices are underway – compensations for land taken away are being increased substantially and land banking is being discouraged – in short, land is not being subsidised. Second, there is a recognition that wages will have to rise – if the economy is demand-constrained, then it is important that there is enough spending power in the hands of the people and, hence, a reduction of export dependency can come through increased domestic consumption. There is also a move to remove other subsidies for the industry including power and water, as well as tighter rules on environment damage mitigation. These will raise input cost and more truly reflect market-based cost. Simultaneously, there is a move to offshore low quality, low margin manufacturing to neighbouring Southeast Asia, including Vietnam, Laos and other smaller countries, to attempt to keep final margins to industry remunerative. The increases in costs would partly offset the undervalued Yuan in terms of exports. The resultant inflationary pressures will have to managed, while keeping a careful lookout for developing asset price bubbles.

Conclusion

In short, it is unlikely that the revaluation of the Yuan is at the top of the worries in China. There is still the worry that China's current account surplus would still be over five percent of GDP in 2010. As long as a current account surplus of this magnitude persists, the expectation of renminbi appreciation is bound to remain strong and will surely lead to significant 'hot money' inflows, which contribute to large and persistent foreign exchange reserve accumulation despite potentially narrowing current account surpluses. And a large foreign exchange reserve accumulation will constitute a major challenge to monetary policy implementation, namely the loss of monetary policy independence.

The common worry in both the countries is to keep a healthy growth going, which is not dependant o the state, and to prevent asset price bubbles from forming. Both countries would have their task cut out for them in 2010.

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