

Evoking India's twin deficits: a flawed guide to policy

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[SASHI SIVRAMKRISHNA](#)

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Representative Image

India's twin deficit problem of rising fiscal and current account deficits (CAD) as a major challenge to macroeconomic policymakers has been in the news for some weeks now. With direct control over the current account difficult due to macroeconomic conditions across the world as well as the inelastic nature of India's imports, the government seems to be responding strongly to conventional calls of economists to reduce or at least ensure that the fiscal deficit does not cross the targeted 6.4% of GDP. At the same time, pressure is also on states to keep their deficits in check so that the overall deficit is contained to about 10% of GDP.

This is, however, a challenging time for the government to rein in the deficit. The soaring prices of crude oil on account of the Ukraine-Russia war made it necessary to cut excise on petrol and diesel to lessen the impact on local consumers. There has also been an increase in fertilizer and food subsidies apart from granting subsidies on cooking gas. To some extent the government cushioned the deficit arising from these measures by raising revenues through a 'windfall tax' on domestic crude and levies on fuel exports.

Nonetheless, if the fiscal deficit can indeed be controlled, it is expected that this will also have a positive outcome on the CAD, which had become a matter of greater concern due to flight of portfolio investments from the country and the depreciation of the rupee vis-à-vis the dollar.

While the logic of the twin deficit problem may make intuitive sense, it is at best an incomplete equation that does not reveal an accurate picture of the economy. For one, it is not an equation because fiscal deficits are most often not equal to current account deficits. For instance, in FY 2021, India's overall fiscal deficit in India was about 13% with a current account surplus of 0.9% of GDP. This year, the fiscal deficit may be around 12% and CAD at 1.2%, once again nowhere close to being equal. Explicitly bringing in the missing link is crucial if we are to understand the implications of macroeconomic policies fully and clearly.

Not commonly referred to by economists is the sectoral financial balances (SFB) identity conceived by the British economist, Wynne Godley, and based on the double-entry bookkeeping principle that a financial asset of any entity must appear as a financial liability in another entity's books of account. If

we divide the economy into three sectors, namely, the domestic private sector including households and firms, the government and the foreign sector, their net financial asset accumulation (asset accumulation outside that sector) *must be* equal to zero.

In other words, if one sector is accumulating net financial assets then at least one of the other sectors must be accumulating net financial liabilities. It must be reiterated that the SFB equation does not delineate cause-effect relationships but by nature of its construction – it's derived from double-entry accounting after all – must hold true.

India's CAD implies that the foreign sector is accumulating net financial assets (including capital inflows or lending to India). This is around 1.2% of GDP but may rise to even 3% of GDP. If the (overall) government is accumulating net financial liabilities of 10% of GDP by running fiscal deficits, the question is who is accumulating net financial assets to the tune of 7%. By the SFB identity, it must be the domestic private sector whose savings exceed investment spending by 7% of GDP.

We can now articulate the repercussions of reductions in the fiscal deficit on the other sectors of the economy, keeping in mind that the SFB equation must hold good. If the government is able, through whatever measures, to bring down the deficit from 10% to, say, 6%, then the sum of the net financial asset accumulation by the domestic private sector and the foreign sector must sum to 6%. Various combinations are possible but let's assume that the CAD is contained at 2%. If so, the net financial asset accumulation by the domestic private sector must be 4%, down from 7%. Although not the only possibility, this can happen either with a rise in private sector investment spending or a fall in savings.

In fact, economists argue that fiscal consolidation by the government would mean lower borrowings and lower interest rates so that private sector investment will rise. This, unfortunately, is not supported by facts. Even a cursory look at the data between 2012 and 2019 shows that while interest rates fell throughout, there was a distinct secular decline in private sector investment spending. If investment spending does not rise, savings must fall. For this, either consumption expenditure picks up strongly through improved consumer sentiment or savings fall due to (and at a higher rate than) contraction in GDP. The latter could also reduce the CAD by curtailing import demand and even turn it into a current account surplus if the contraction is large enough – as was the case during the pandemic.

This may only be one plausible outcome of fiscal consolidation but it highlights why the SFB equation can serve as a more useful guide to policymakers than the truncated twin deficit hypothesis, which focuses on just two out of three sectors, keeping out the backbone of any economy – the domestic private sector's decisions on savings, consumption and investment.

Sashi Sivramkrishna studies macroeconomics from a Modern Money Theory (MMT) perspective. Views are personal and do not represent the stand of this publication.

SASHI SIVRAMKRISHNA is an economist, economic and environmental historian, and documentary filmmaker. Twitter: @Sashi31363.