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Chapter 2 - Does Growth lead to Debt Sustainability? Yes, But Not Vice-Versa!

INTRODUCTION

Amidst the Covid-19 crisis, fiscal policy has assumed enormous significance across the world. Naturally, the debate around higher Government debt to support a fiscal expansion is accompanied by concerns about its implications for future growth, debt sustainability, sovereign ratings, and possible vulnerabilities on the external sector.

In this Chapter, Survey endeavours to provide the intellectual anchor for the government to be more relaxed about debt and fiscal spending during a growth slowdown or an economic crisis.

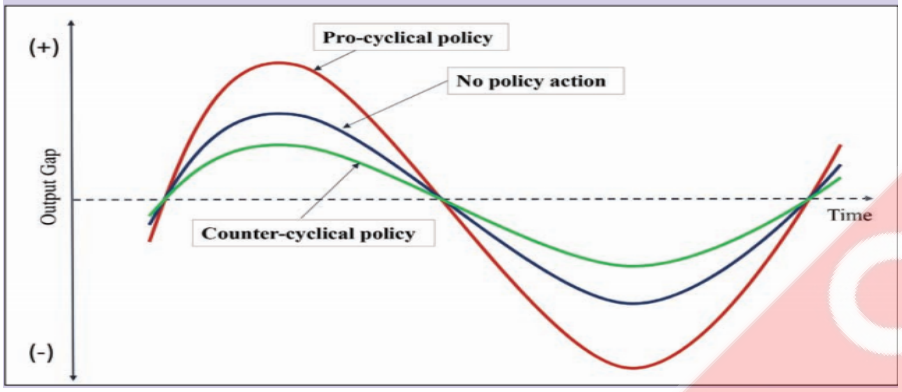
COUNTER-CYCLICAL FISCAL POLICY

Countercyclical Fiscal Policy: in a recessionary year, Government must spend more than during expansionary times. Such counter-cyclical fiscal policy stabilizes the business cycle by being contractionary (reduce spending/increase taxes) in good times and expansionary (increase spending/reduce taxes) in bad times.
Pro-cyclical Fiscal Policy: a pro-cyclical fiscal policy is the one wherein fiscal policy reinforces the business cycle by being expansionary during good times and contractionary during recessions.

While fiscal policy is especially salient during an economic crisis, in general, fiscal policy must be **counter-cyclical to** smooth out **economic** cycles **instead of exacerbating them.** Such a counter- cyclical policy becomes critical during an economic crisis. This is because fiscal multipliers, which capture the aggregate return derived by the economy from an additional Rupee of fiscal spending, are unequivocally greater during economic crises when compared to economic boom.

Fiscal policy (FP) stance	Recession (↓ GDP)	Expansion (↑ GDP)	Outcome
Pro-cyclical	Contractionary FP ↓ Govt. Expenditure or /and ↑ Taxes	Expansionary FP ↑ Govt. Expenditure or/and ↓ Taxes	Deepens recessions and amplifies expansions, thereby increasing fluctuations in the business cycle.
Counter-cyclical	Expansionary FP ↑ Govt. Expenditure or/and ↓ Taxes	Contractionary FP ↓ Govt. Expenditure or /and ↑ Taxes	Softens the recession and moderates the expansions, thereby decreasing fluctuations in the business cycle.

Figure A: Business Cycle under Various Fiscal Policy Stance



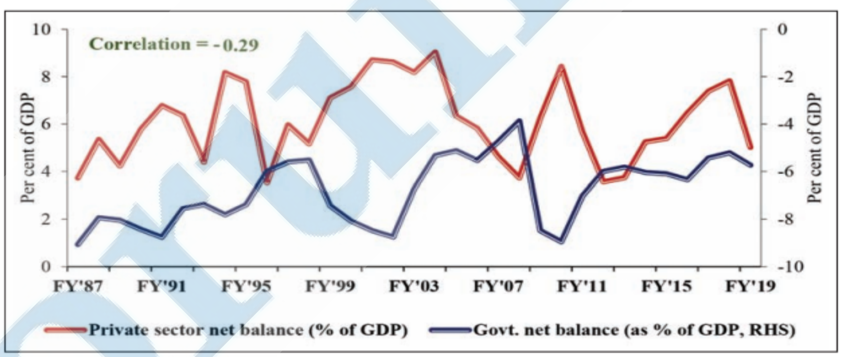
REASONS FOR COUNTER-CYCLICAL FISCAL POLICY

As per the National Income identity, Y= C+I+G+X-M, the net effect of a recession on the private sector may be in terms of lower private consumption (C), lower private investment (I), risk aversion by the private sector and pessimistic expectations/sentiments.

In such a scenario, adopting a counter cyclical policy by expanding the Government Expenditure – both consumption and investment - will support the GDP and minimise the output gap.

As seen for the United States and United Kingdom, the correlation between private sector and public sector net balances is almost perfectly negative (-0.9). In India, however, fiscal policy has not been counter-cyclical in general.

Figure 1: Trends in Government and Private sector balances
Figure 1a: *India (FY 1987 – FY 2019)*



Source: RBI, MoSPI
Note: Govt net balance = (Public Sector Financial & Non-Financial Corporations and General Govt Gross Domesic Saving) – (Public Sector Financial &Non-Financial Corporations and General Govt Gross Capital formation)
Private sector net balance = Private sector Gross Domesic Saving – Private sector Gross Capital formation
For Households, total savings does not include gold and silver (to make it comparable).

THE (r-g) DIFFERENTIAL AND DEBT SUSTAINABILITY IN INDIA

- Intuitively, when nominal growth rate exceeds the nominal interest rate for the foreseeable future, debt sustainability is obtained as explained in the figure below.

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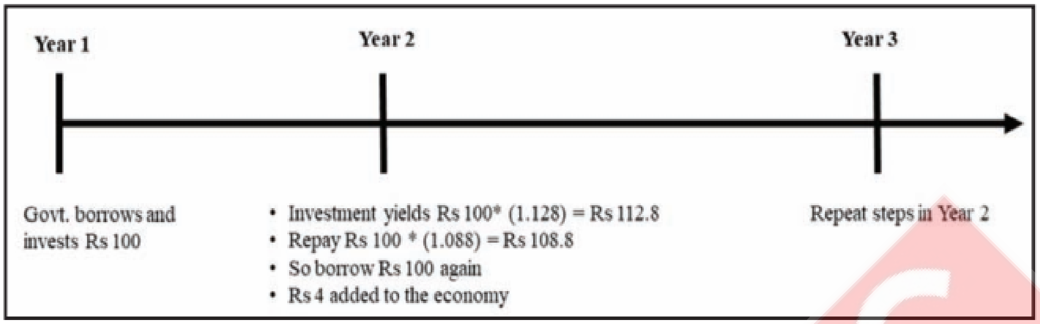
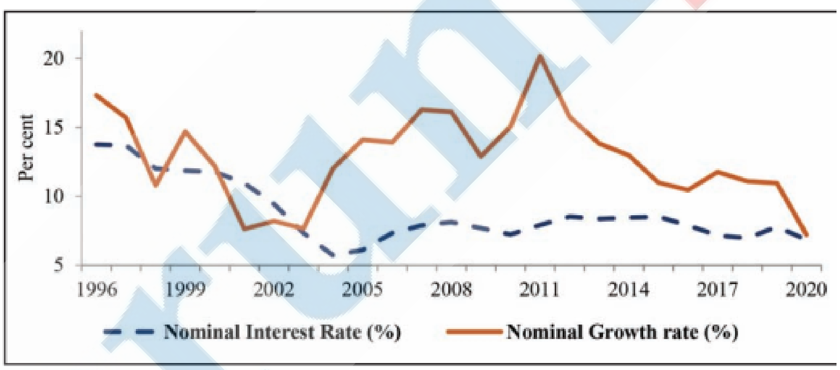
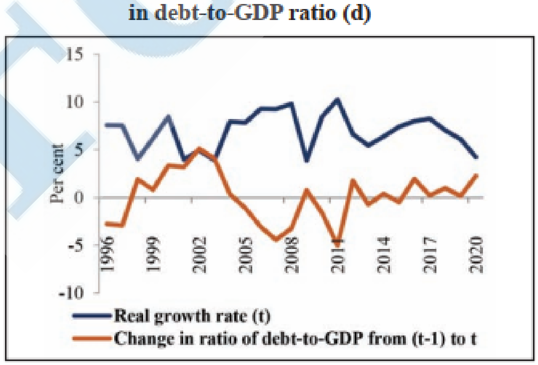


- This Chapter establishes clearly that growth leads to debt sustainability in the Indian context but not necessarily vice-versa.
- This is because the interest rate on debt paid by the Indian government has been less than India's growth rate by norm, not by exception.
- Debt sustainability depends on the 'Interest Rate Growth Rate Differential' (IRGD), i.e., the difference between the interest rate and the growth rate
- Figure below shows the strong correlation observed between IRGD and change in general government debt. Since this inequality reduces the fiscal costs of a debt rollover (Blanchard 2019), it expands the scope for fiscal policy to (i) cater to slowdowns in aggregate demand and (ii) thereby enable growth to foster debt sustainability.

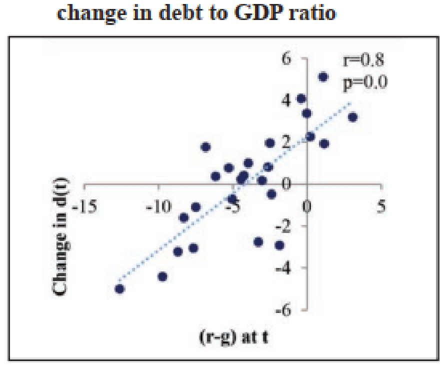
2a: During the Last 25 years, $i > \gamma$ is a Norm, Except for a Short Period During the Asian Financial Crisis



2b: Trends in real growth rate (g) and change in debt-to-GDP ratio (d)



2c: Strong correlation between (r-g) and change in debt to GDP ratio



Source: RBI, MoSPI

IN INDIA, GROWTH LEADS TO DEBT SUSTAINABILITY, NOT VICE-VERSA

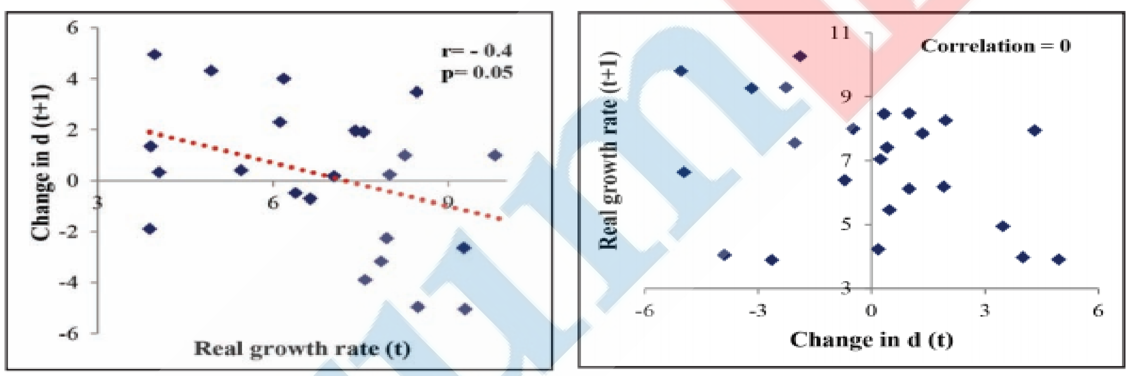
How does the consistently negative IRGD affect the relationship between debt and growth in India? Does higher growth lead to lower debt or lower debt cause higher growth? Conceptually, causality could flow in either direction.

Evidence over the last two-and-a-half decades demonstrates clearly that in India, higher GDP growth causes the ratio of debt-to-GDP to decline but not vice-versa.

Figure below demonstrates the lagged relationship between real GDP growth rates and change in general government debt-to-GDP levels over the last 25 years. Over the last two-and-a-half decades, real GDP growth rates and one-year-ahead change in general government debt-to GDP levels show a significant negative correlation. However, during the same time period, the correlation between change in general government debt-to-GDP levels and one-year-ahead growth rates turns out to be statistically indistinguishable from 0. The evidence therefore shows the direction of causality between the two variables: higher growth leads to lower public debt in India, but not vice-versa.

Figure 8: Direction of causality between growth and change in GG debt for India (FY 1996 to FY 2020)

Figure 8a: Growth → Debt : Correlation between g and 1 year ahead Δd | **Figure 8b: Debt → Growth : Correlation between Δd and 1 year ahead g**



Source: RBI, MoSPI

COMPARISON WITH OTHER ECONOMIES

- For India and other EMEs, which have consistently grown their GDP at high rates over the last few decades, the relationship between debt and growth exhibits a clear direction of causality: Higher growth lowers debt-to-GDP ratios but lower debt does not necessarily lead to higher growth.
- The same phenomenon is obtained during the high growth phases for the advanced economies, which have otherwise grown at significantly lower GDP growth rates when compared to India and other EMEs.
- In contrast, across both the high and low growth episodes, in the advanced economies, where GDP growth rates have been low on average over the last few decades, this relationship does not manifest.

INDIA'S DEBT STRUCTURE

- India's public debt-to GDP has been significantly low compared to high global debt levels.

- A cross-country comparison of debt levels points out that, India's overall debt levels as a per cent of GDP are the lowest amongst the group of G-20 OECD countries and also among the group of BRICS nations.
- Moreover, public debt and overall debt level for India has declined since 2003 and has been stable since 2011
- The Government's debt portfolio is characterized by very low foreign exchange risk
- as the external debt is only 2.7 per cent of GDP (5.9 per cent of total Central Government liabilities).
- Of the total public debt, 70 per cent is held by the Centre.
- The long maturity profile of India's public debt (issuance of longer tenure bonds) along with a small share of floating rate debt (floating rate debt of Central Government is less than 5 per cent of public debt) tends to limit rollover risks, and insulates the debt portfolio from interest rate volatility

RECOMMENDATIONS:

- As the COVID-19 pandemic has created a significant negative shock to demand, **active fiscal policy** – one that recognises that fiscal multipliers are disproportionately higher during economic crises than during economic booms – can ensure that the full benefit of seminal economic reforms is reaped by limiting potential damage to productive capacity.
- As the IRGD is expected to be negative in the foreseeable future, a fiscal policy that provides an impetus to growth will lead to lower, not higher, debt-to-GDP ratios.
- In fact, simulations undertaken till 2030 highlight that given India's growth potential, debt sustainability is unlikely to be a problem even in the worst scenarios. The chapter thus demonstrates the desirability of using counter-cyclical fiscal policy to enable growth during economic downturns.
- **Active fiscal policy** can ensure that the full benefit of reforms is reaped by limiting potential damage to productive capacity
- Given India's growth potential, **debt sustainability** is **unlikely to be a problem** even in the worst scenarios
- **Desirable** to use **counter-cyclical fiscal policy** to enable growth during economic downturns