Explained: India’s emerging twin deficit problem

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The report underscores the need to trim revenue expenditure (or the money government spends just to meet its daily needs). (File)

In its latest **‘Monthly Economic Review’**, the Ministry of Finance has painted an overall optimistic picture of the state of the domestic economy. “The World is looking at a distinct possibility of widespread stagflation. India, however, is at low risk of stagflation, owing to its prudent stabilization policies,” it states.

The economic growth outlook is likely to be affected by several factors owing to the trade disruptions, export bans and the resulting surge in global commodity prices —all of which will continue to stoke inflation — as long as the Russia-Ukraine conflict persists and global supply chains remain unrepaired. "However, the momentum of economic activities sustained in the first two months of the current financial year augurs well for India continuing to be the quickest growing economy among major countries in 2022-23," states the Finance Ministry report.

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But, given the uncertainties, the report highlights two key areas of concern for the Indian economy: the fiscal deficit and the current account deficit (or CAD).

Fiscal deficit

The report states that "as government revenues take a hit following cuts in excise duties on diesel and petrol, an upside risk to the budgeted level of gross **fiscal deficit** has emerged". The fiscal deficit is essentially the amount of money that the government has to borrow in any year to fill the gap between its expenditures and revenues. Higher levels of fiscal deficit typically imply the government eats into the pool of investible funds in the market which could have been used by the private sector for its own investment needs. At a time when the government is trying its best to kick-start and sustain a private sector investment cycle, borrowing more than what it budgeted will be counter-productive.

The report underscores the need to trim revenue expenditure (or the money government spends just to meet its daily needs). "Rationalizing non-capex expenditure has thus become critical, not only for protecting growth supportive capex but also for avoiding fiscal slippages," it states. "Capex" or capital expenditure essentially refers to money spent towards creating productive assets such as roads, buildings, ports etc. Capex has a much bigger multiplier effect on the overall GDP growth than revenue expenditure.

Current account deficit

The current account essentially refers to two specific sub-parts:

* Import and Export of goods — this is the "trade account".
* Import and export of services — this is called the "invisibles account".

If a country imports more goods (everything from cars to phones to machinery to food grains etc) than it exports, it is said to have a trade account deficit. A deficit implies that more money is going out of the country than coming in via the trade of physical goods. Similarly, the same country could be earning a surplus on the invisibles account — that is, it could be exporting more services than importing.

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If, however, the net effect of a trade account and the invisibles account is a deficit, then it is called a current account deficit or CAD. A widening CAD tends to weaken the domestic currency because a CAD implies more dollars (or foreign currencies) are being demanded than rupees.

The Ministry’s worry is that costlier imports such as crude oil and other commodities will not only widen the CAD but also put downward pressure on the rupee. A weaker rupee will, in turn, make future imports costlier. There is one more reason why the rupee may weaken. If, in response to higher interest rates in the western economies especially the US, foreign portfolio investors (FPI) continue to pull out money from the Indian markets, that too will hurt the rupee and further increase CAD.