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Gita Gopinath, Feb 8, 2011, 04.03am IST

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The Indian economy has a lot of strengths and its potential to continue to grow at over 8-9% a year can and should be realized. The three major concerns to the macro health of the country relate to the fiscal deficit, inflation and the current account. All three issues are on the radar of policymakers so it is time to make tough decisions.

First, there is the issue of the fiscal deficit that is too high. The consolidated fiscal deficit as a ratio of GDP ranged between 8% and 10% over the past year. Some of this deficit arose from the expansionary policies the government adopted during the most recent crisis. Now that the economy has returned to high growth and given the inflationary pressures that exist it is time to rein in the deficit. The best practice to reduce a deficit is to do it through reducing government expenditure and not through raising taxes since the latter is known to have negative effects on growth. The specific areas where the government can reduce expenditures are on subsidies it provides for fuels such as diesel and kerosene, as it has done for petrol.

In the absence of this, as global fuel prices rise the fiscal deficit will worsen. The government should certainly not undertake projects that greatly increase its expenditures such as those proposed in the National Food Security act. This does not mean that I am opposed to welfare schemes that help those at the bottom of the economic ladder. Quite the contrary, I believe that instead of adding programs that rely on failed and highly inefficient delivery mechanisms, the government's priority should be to greatly improve the effectiveness of the existing transfer schemes in place as a way to increase the welfare impact of its policies and expenditures.

In other words, the lack of social security for the poor is not due to inadequate spending by the government, but because of weak governance and accountability structures that lead to leakages, wastage, inefficiency and corruption - all of which deny the poorest the services they deserve and the funds that the government earmarks for them. For example, a lack of effective implementation and of failure to ensure that the targeted benefits reach the poorest results in 57% of the food grains from the public distribution system not reaching the poor. The economy as a whole has no "free lunches" so it is important that the waste in expenditures be cut rather than adopt the easy way out of introducing new programs that promise a lot and deliver little.

The second potential risk to the economy is inflation. Wholesale price inflation is running over 8% and food inflation is in double digits. The bigger concern is if this high rate of inflation generates a life of its own, which will happen if it gets embedded in inflation expectations. The key question is if this level of inflation signals policy imbalances (e.g. a lower than warranted interest rate set by RBI or high fiscal deficits) or structural imbalances in the economy (e.g. demand for food outstripping supply, or supply bottlenecks in the food production and distribution channel)? The high fiscal deficit and the negative real interests suggest demand pressures on the economy.

Some of this inflation is clearly being passed on from commodity/food inflation that is the outcome of global shocks including weather-related losses in agricultural production in Russia and Australia that are out of the control of domestic policymakers. But what cannot be ignored are the structural imbalances in the economy. There has to be serious reform that reduces supply side bottlenecks to match the growing demand that arises from rising incomes. There is a need for better physical infrastructure, higher quality education and more skilled labour, increased agricultural productivity and efficiency in storage and disbursement of food grains. Otherwise cost-push inflation pressures will remain.

The third risk relates to the current account, which measures the sum of the trade balance (exports minus imports) and net foreign asset returns. The current account has been in deficit at around 3% of GDP. This level of deficit in and of itself does not sound alarm bells. What does, however, cause alarm is the recent change in the nature of the foreign capital inflows that have helped finance this deficit. A good rule of thumb is that if the capital inflows take the form of foreign direct investment (FDI) and not foreign debt then one is less concerned about sudden reversals in these flows that can negatively affect the economy very quickly.