NOTE

How to Break Recession

B J writes :

Government has decided to increase govern-ment spending to break the recession. The idea is to generate domestic demand to compensate for reduction in export orders. For example, steel manufacturers are under pressure due to cancellation of orders from the United States. The Government is trying to compensate for this by generating domestic demand for steel by increasing outlays for construction of highways in order to help steel manufacturers. The fiscal deficit has been increased from 2.5 percent of GDP to 6 percent to make available money for these increased expenditures.

The difference between the Government's income and expenditure is called 'fiscal deficit'. The Reserve Bank of India issues treasury bonds on behalf of the Government and raises money from the market. This money borrowed from the market is used by the Government to make expenditures in excess of its income. The impact of such borrow-and-spend policy is two sided. Say the money available with the banks is being presently borrowed by businessmen to establish factories or by consumers to buy cars at an interest rate of 13 percent per year. Now, the Government enters the market and lifts part of this money by selling Treasury Bonds. This leads to an increase in the interest rates and businessmen and consumers take fewer loans as a result. The liquid money available in the financial system is diverted from private- to government spending. This diversion of credit leads to increased demand for steel in making of highways. At the same time, it leads to less demand for steel because businessmen are establishing fewer factories and consumers are buying fewer cars. It is incorrect, therefore, to assume that increased Government spending will lead to increased demand in the market. Indeed, the opposite can happen. In truth the total impact of this policy will not be very favourable.

Increased Government spending can yet help break recession if the quality of expenditures is good. This favourable impact depends upon how much demand is actually generated in the market from the additional expenditures. For example, the Government has paid more money to its employees as per the award of the Sixth Pay Commission. This is not likely to generate much demand. Government employees will mostly deposit their additional income in Fixed Deposits in the banks. The money borrowed by the Government from the banks will, then, reach the same vaults again. If Government employees buy gold, then the demand will be generated in South Africa. Or, if they buy an imported TV then the demand for components etc. will be generated in Japan, not India. Demand will be generated in India only to the extent they make additional purchases of goods made in India.

A good part of increased Government expenditures in people-oriented programmes like Employment Guarantee likewise is appropriated by Government employees towards administrative expenses. Increased spending in infrastructure projects also may not translate into domestic demand because many contracts are given out to foreign companies who prefer to import goods from their home countries instead of buying them here. Turbines for a thermal power plant may be purchased by the Swedish company from Swedish manufacturers. This writer was once shocked to find that executives of a foreign embassy were using imported pencils. In this way the demand generated from Government expenditures is passed on to foreign countries by foreign contractors.

The Government's policy of breaking the recession by increasing spending is not likely to be successful for this reason.

The second leg of the Government's policy is to attract more foreign investors. Limits of Foreign Direct Investment have been upped in many areas. The Government hopes that foreign investors will establish factories in India and that will generate domestic demand. But the policy of integration with the global markets comes as a composite whole with many dimensions. Free movement of capital comes along with free movement of goods. It becomes necessary to open Indian markets for imports when the government seeks foreign investment. This brings trouble. Countries across the world are facing problem these days in selling their goods. They are willing to accept lower prices. This will lead to more imports into India and less domestic production. The increased demand from inflow of foreign investment will be nullified by increased inflow of foreign goods that comes along with. □□□