NOTE

BHARAT NIRMAN AND INFLATION

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Finance Minister P. Chidambaram has held increased government expenditures on Bharat Nirman responsible for inflation. Replying to a question in the Rajya Sabha, he said that higher government expenditure on programmes like *Bharat Nirman* which were a major pro-poor initiative of the UPA government had pushed up the demand and increased pressure on supplies leading to increased prices. It is true that increased government expenditures lead to higher demand. Construction of roads, for example, leads to higher demand for cement. But this is only part of the story. Demand can rise from other sources as well.

The connection between government expenditures and inflation comes through printing of notes by the Reserve Bank of India. The Government raises revenues for its expenditures from two sources. The main source is tax revenue. The Union Government collects Income Tax and Excise Duty and uses the money for its expenditures. Such expenditures do not add to inflation because the increase in demand by the Government is cancelled by a reduction in demand by the taxpayer.

The second source of funds of the Government is borrowing from the Reserve Bank. The Union Government can ask the Reserve Bank to provide it with additional resource as it may require. The Reserve Bank, in turn, can provide this money to the Government from two sources. It can sell Bonds in the market or it can print notes. Raising money from selling of Bonds, again, does not lead to inflation because the spending by the purchaser of Bonds is reduced in same proportion as the spending by the Government is increased. Alternatively, the Reserve Bank can print new notes and provide to the Government. Say notes worth Rs one crore are in circulation presently. The Reserve Bank prints notes worth Rs 2 lacs and the Government buys cement with them for building roads under *Bharat Nirman*. The total currency in circulation in the economy increases from Rs 1 crore to Rs 1 crore 2 lacs and leads to increase in price. More notes chase the limited quantity of goods available in the market. The equation is simple.

The conclusion is that increased expenditure on Bharat Nirman does not lead to inflation if it is financed from tax revenues. That indeed seems to be the case. The difference between tax income and total expenditures of the government is known as fiscal deficit. It follows that if the present inflation is due to higher government expenditures then one should see an increase in the fiscal deficit. The facts speak otherwise. During his Budget Speech in February 2007, the Finance Minister expressed satisfaction that he had been able to reduce the fiscal deficit. According to a press release by ABN Amro Bank, the fiscal deficit of the Union Government stood at 4.1 percent in 2005-06 and 3.7 percent in 2006-07. It is expected to stabilize at a yet lower rate of around 3.3 percent in 2007-08. This indicates that the Union Government is making fewer borrowings for meeting its expenditures. It follows that increased expenditures on *Bharat Nirman* are being financed from tax revenues and not from borrowings; hence they are not the source of inflation.

The culprit is the policy of the Finance Minister of buying US Treasury Bills. American Government is running a huge fiscal deficit. It does not have the income to provide weapons to Pakistan or to oppose India in the WTO or to finance its continuing war in

Iraq and Afghanistan. It is borrowing heavily from the Federal Reserve Board, which is like Indian Reserve Bank. The Fed, as the Board is known, in turn, is selling US Treasury Bills just like the Reserve Bank sells Bonds to raise funds for the Union Government in India. But there are no takers for the Treasury Bills in the United States. The Fed is mighty happy if Reserve Bank of India buys the Treasury Bills and makes available the money to provide weapons to Pakistan. Finance Minister P Chidambaram has readily obliged Mr George W Bush. He has asked the Reserve Bank to buy US Treasury Bills. The Reserve Bank is doing this by recycling the dollars brought by Foreign Investors. □□□