

RATIONAL INVESTMENT RESEARCH

Future of Inflation in India

Implication of Issuing Off budget bonds

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[The reckless increase in off budget subsidy and use of bonds as an alternative to currency will devalue the currency at ever faster rate. A look at the magnitude of problem.]

Future of Fiat Currency in India

One rupee coin in India during the period 1902-1919 was made of mostly of silver (92%). By 1940s the rupee coin consisted of silver but now the percentage was down to 50%. It took about 40 years for erosion of half of the value of one rupee in terms of silver. In recent times value erosion has been much faster. The five rupee coins which were introduced in late 1990s have been replaced. Their face value had become less than what one could get for scrap value of metal. The new five rupee coin weighs more like 50 paise coin of 1990s. Even if it weighs somewhat more, the erosion of value for rupee in metal terms has been close to 90% in last one decade. This is much faster rate of depreciation than ever before. However, this is not the biggest cause of concern for currency holder. The bigger cause of concern is that there is a possibility that this could get worse. The same one rupee coin of early 1900s is now sold for at least Rs 250.

Paper currency is fiat money. Government says that its value is equivalent to that of coins and therefore it is valued as such. It should have been very tempting for government in short run to print money to fund its expenditure. It is not so expensive to print paper. If people believe that the promise of government is valid it can print paper to fund its expenses. However, the economy becomes aware of situation (in case government prints money) and high inflation follows. In worst cases like Germany in 1920s or Zimbabwe currently the currency notes issued before start of inflation, become completely worthless by time the period is over. That is the reason governments avoid printing of currency to fund deficits.

Indian government resorted to financing its deficit through printing of paper currency till mid nineties. As the amount of paper currency increased it fuelled inflation. Since mid nineties the explicit practice deficit financing has been stopped. However similar steps have been taken since then. This has been issuing of off budget deficit bonds to fund large subsidies and use of bonds to subscribe to capital of public sector banks. Currently, such bonds have been issued at a fast pace. In this financial year the subsidies financed in this way could be 4-6% of the GDP. This is addition to the budgeted deficit of 2.5% for central government. These unbudgeted bonds are like printing of currency. Since at the present time the amount of bonds that have been issued is not very large their effect is controlled. Though even now, the oil companies have a tough time to sell these bonds. These bonds are typically sold at a discount. These bonds are liability of Indian government and have to be paid from its resources. In long run these bonds would be a big strain to government finances.

The nature of this unaccounted deficit financing is recurring. This is happening when government finances are in much better shape than usual with buoyant tax collection. In case, these practices are continued at similar scale in future the consequences will be severe, especially when economy faces a downturn or even a slowdown.

Table 1: Budgetary Estimates

(In Rs crores)

	2006-2007 Actuals	2007-2008 Budget Estimates	2007-2008 Revised Estimates	2008-2009 Budget Estimates
1. Revenue Receipts	434387	486422	525098	602935
2. Tax Revenue (net to Centre)	351182	403872	431773	507150
3. Non-tax Revenue	83205	82550	93325	95785
4. Capital Receipts (5+6+7)\$	149000	194099	184275	147949
5. Recoveries of Loans	5893	1500	4497	4497
6. Other Receipts	534	41651	36125	10165
7. Borrowings and other Liabilities\$	142573	150948	143653	133287
8. Total Receipts (1+4)\$	583387	680521	709373	750884
9. Non-plan Expenditure	413527	475421	501849	507498
10. On Revenue Account of which,	372191	383546	412975	448352
11. Interest Payments	150272	158995	171971	190807
12. On Capital Account	41336	91875	88874	59146
13. Plan Expenditure	169860	205100	207524	243386
14. On Revenue Account	142418	174354	175611	209767
15. On Capital Account	27442	30746	31913	33619
16. Total Expenditure (9+13)	583387	680521	709373	750884
17. Revenue Expenditure	514609	557900	588586	658119

(10+14)				
18. Capital Expenditure	68778	122621	120787	92765
(12+15)				
19. Revenue Deficit (17-1)	80222	71478	63488	55184
	(-1.9)	(-1.5)	(-1.4)	(-1)
20. Fiscal Deficit	142573	150948	143653	133287
{16-(1+5+6)}	(-3.5)	(-3.3)	(-3.1)	(-2.5)
21. Primary Deficit (20-11)	-7699	-8047	-28318	-57520
	(-0.2)	(-0.2)	(-0.6)	(-1.1)

* GDP for BE 2008-2009 has been projected at Rs.5303770 crore assuming 13% growth over the advance estimate of 2007-2008 (Rs.4693602 crore) released by CSO.

\$ Does not include receipts in respect of Market Stabilization Scheme, which will remain in the cash balance of the

Central Government and will not be used for expenditure.

Figures in bracket indicate as a percentage of GDP at market price

Source: www.indiabudget.nic.in

Oil Subsidy

Oil subsidy affects the economy in two ways. One, government issues bonds to oil companies to make up for their losses worsening its financial situation, increasing its deficit and affecting cost of borrowing for everybody. Second, there is no incentive for users to adopt more energy efficient practices as they are not required to pay higher costs. So, the demand keeps on going up. With global oil supplies not increasing inspite of price rises the second issue accentuates the first one. India is now a major consumer of oil. It is a major contributor to incremental demand. The effect at this point of incremental demand from India may not be as substantial as China but it certainly second largest. Indian government provides a heavy subsidy on diesel as cost of goods transport depends on diesel cost and the government feels by reducing diesel price inflation can be controlled. In the current year the cost of subsidizing just diesel would be close to Rs 100,000 crores (USD 23 Bn) according to petroleum minister. This has been due to massive industrial use of diesel because of its lower cost compared to other alternatives for producing electricity. The use of diesel has gone up by 18-20% in last one year, according to estimates. Take a look at the total tax receipt for Indian government in 2007-08 in table above. It is around Rs 500,000 (USD 115 Bn) crores. One fifth of this amount in some way or other goes to subsidizing diesel.

The Government of India (GoI) plans to issue oil bonds amounting to Rs 94,000 crores in 2008-09. This may be an under estimation. GoI provide half of the total subsidy. The rest of the oil subsidy has to be shared equally by oil and gas producing companies and their refining and marketing counterparts (example IOC, BPCL, HPCL). While the oil and gas producing companies like ONGC, GAIL may take their part of burden by essentially selling the crude oil and natural gas at discount, the refining companies do not have any means to make up for their shortfalls. Till previous years the kind of subsidization that these companies had to do was in to the tune of Rs 20,000-30,000 crores. That was large but comparable to profits made in refining. Now the deficit is in the tune of Rs 50,000 crores and not quite manageable. There has been a significant fall in oil prices, which would reduce the volume of subsidy. However the impact of fall has been moderated by fall in rupee by over 10% in current year and consumer shift to products which are more subsidised like diesel. Barring a continued fall in oil price the current estimate of oil bonds may prove to be on lower side.

Fertilizer subsidy

According to Fertilizer secretary the total fertilizer subsidy for the year 2008-09 will be Rs 95,000 crores. Other estimates put the figure at Rs 1,20,000 crores. Indian farmers continue to pay similar prices or moderately higher prices for fertiliser as four years ago. During the last two years however, prices of both nitrogen and phosphate based fertilizer has increased by almost a factor of six. This has been driven by high naphthalene prices used in manufacture of nitrogen fertilizer and increase in prices of phosphate rocks used in phosphate fertilizers. The cost inflation of these products is beyond control as India does not produce sufficient quantity of either product. The fertilizer prices have been kept low so that farmers do not ask for an increase in support prices for food grains which would supposedly rein in food price inflation. However, low prices of food grains compared to global markets will make situation worse as they reduce the incentive to produce more for farmers. Ultimately this is likely to lead to low food grain production and higher inflation.

Sixth pay commission

The sixth pay commission report has been implemented by GoI. It is expected that the similar recommendations will be implemented by state government. At central government level this would involve a one-time payment of Rs 30,000 crores as arrears for last two years and annual increase in wage bill of Rs 18,000 crores. Going by the experience of fifth pay commission the increase of wage bill increase for state government will be at least one and a half times. Most likely it will be higher. The total recurring wage bill increase will be Rs 50,000 crores. In addition to these changes the wages will be increase by 3% every year rather than 2.5%. This increase is in addition to compensation increase

for inflation. So we can factor in an increase of almost Rs 50,000 crore which will be recurring and increasing at pace faster than inflation. Apart from this there will be onetime payment of more than Rs 50,000 crores.

Payment for Banks capital

State Bank of India (SBI) recently came up with a rights offering. GoI being almost 60% owner of bank subscribed to the offer. However, instead of paying for shares in cash it paid for it form of bonds which will mature in 2020s. The government plans to subscribe to other public sector banks rights issue in similar way. This an indication that government finances are not as good as it claims. These bonds also add to stock of bonds of issued by GoI and will in turn degrade their value.

The Way Forward

The quantity of bonds issued for subsidies is huge. For current year it will amount to close to 4% of GDP. It can potentially be more. These subsidies are wastage. They would only aggravate the problems in future. If same expenditure had been done for building infrastructure, it would have been justified. These are good times for Indian economy when it had period for 4-5 years with highest increase in GDP in last 60 years. If the government finances are bad in this phase one can only imagine what they will be in future. Already we see instances when the off balance sheet bonds issued by government have been sold at substantial discount to comparable balance sheet bonds. This has happened when the quantity of off balance sheets bonds issued was much lower. These bonds are backed by GoI. In case the buying interest is low in these bonds it would reflect in normal gilts as well. The bond yield has already increased from 5% in 2003 to more than 9% recently, though it has come down since then. The high rate of bond issuance has contributed to increase in interest rate. It is difficult to distinguish this act from printing of notes. Inflation can remain elevated for longer than expected and may remain higher than expected. Looking for assets which can maintain their value would is important for investors.

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