Twin Deficit Problem

Why in News?

The finance ministry in its **'Monthly Economic Review'** cautioned the re-emergence of the twin deficit problem in the economy, with higher commodity prices and rising subsidy burden leading to an increase in both **fiscal deficit** and **Current Account Deficit (CAD).**

- It's also the **first time the government** has explicitly **talked about** the possibility of **fiscal slippage** in the current fiscal year.

What are the Major Highlights of the Report?

- 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.
- Meanwhile, **Indian financial markets** have **witnessed hefty foreign investment outflows the past eight months.** A weak GDP growth outlook has exacerbated the situation.
- In a **black swan event** comprising a **combination of shocks, there is a 5% chance of outflows under portfolio investments of 7.7 %of GDP** and short-term trade credit retrenchment of 3.9 %of **Gross Domestic Product** (GDP).

What will be the he Impact of Twin Deficit Problem?

- The twin deficit problem, especially the worsening current account deficit, may compound the effect of **costlier imports, and weaken the value of the rupee** thereby further aggravating external imbalances.

Way Forward

- **Trim revenue expenditure** (or the money government spends just to meet its daily needs).
- **Promoting domestic manufacturing** and decrease in imports of unessential items.
- **Prudent Fiscal Policy:** The government **should rationalise both the capital and revenue expenditure** and should go for a balance budget to avoid a fiscal slippage.

Key Terms

- **Fiscal Deficit:** It is the gap between the government's expenditure requirements and its receipts. This equals the money the government needs to borrow during the year.
- **Current Account Deficit (CAD):** The current account measures the flow of **goods, services, and investments** into and out of the country. It represents a country's foreign transactions and, like the capital account, is a **component of a country's Balance of Payments (BOP).**
- **Twin Deficit Problem: Current Account Deficit** and **Fiscal Deficit** (also known as **"budget deficit"** is a situation when a nation's expenditure exceeds its revenues) are together known as **twin deficits** and both often reinforce each other, i.e., a high fiscal deficit leads to higher CAD and vice versa.
- **Stagflation:** It is described as **a situation in the economy where the growth rate slows down, the level of unemployment remains steadily high and yet the inflation or price**

level remains high at the same time.
- **Black Swan Event: It can be characterised by a combination of all adverse shocks experienced in the history coming together, leading to a perfect storm.**

UPSC Civil Services,Previous Year Questions (PYQ)

Q. In the context of governance, consider the following: (2010)

1. Encouraging Foreign Direct Investment inflows
2. Privatization of higher educational Institutions
3. Down-sizing of bureaucracy
4. Selling/offloading the shares of Public Sector Undertakings

Which of the above can be used as measures to control the fiscal deficit in India?

A. 1, 2 and 3
B. 2, 3 and 4
C. 1, 2 and 4
D. 3 and 4 only

Ans: D

Exp:

- In general, fiscal deficit occurs when the total expenditures of the government exceed its revenue.The government takes various measures to reduce the fiscal deficit such as increasing tax-based revenue,reducing subsidies, disinvestment, etc.
- Downsizing of bureaucracy as well as selling offloading of the shares of public sector undertaking directly contributes to reduction in fiscal deficit.
- Without knowing the destination and the effect of FDI inflows, it is difficult to determine its actual impact on the fiscal deficit. Privatisation of higher educational institutions may improve the situation but its impact may not be effective in reduction of fiscal deficit. **Hence, statements 3, 4 are correct and statements 1, 2 are not correct.**
- **Therefore, option (d) is the correct answer.**

Source: IE