ALL DEFICITS AREN'T EQUAL

Carmignac's Note

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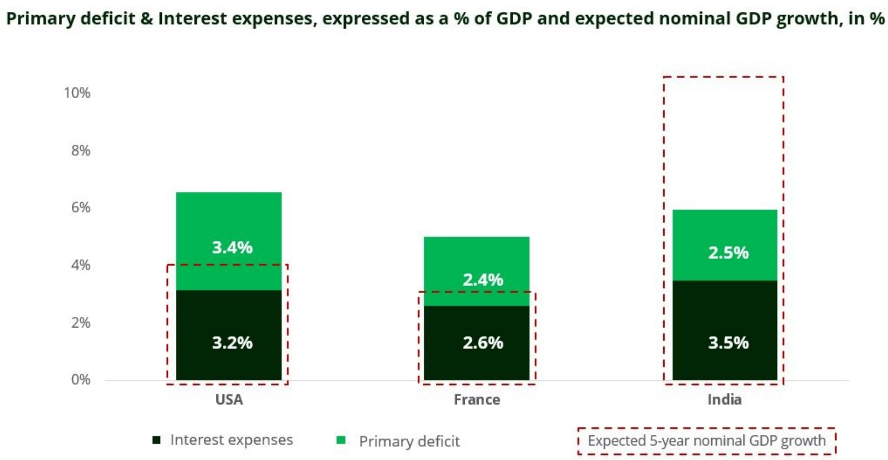

Source: Carmignac, Bloomberg, IMF, April 2024

Deficits receive a lot of attention, and rightly so. A widening deficit is typically associated with imbalances and uncertainty, and generally accompanied by volatility in interest rates and foreign exchange markets. But not all deficits are created equal. When looking at three distinct countries across three continents, we observe that the deficits of India, the United States and France, while close in magnitude[1], are very different indeed. The potential impact of a budget deficit on national debt dynamics differs according to both the maximum level a deficit can reach before it starts to worsen the debt-to-GDP ratio, and the government's ability to alter its trajectory.

Let's first examine how much headroom a government has to expand its deficit. Considering the three countries, whose stock of debt expressed as a percentage of GDP is relatively close (approximately 100%), the viable level of deficit i.e. the "non-increasing debt ratio" deficit is directly proportional to the level of nominal GDP growth. The latter determines the upper bound of the deficit beyond which the debt-to-GDP ratio starts increasing.

Strong potential growth allows the denominator (the size of the economy) to grow at a faster pace than the numerator (the size and the cost of debt). And with India's potential real GDP growth predicted to trend at more than 7% per annum, and inflation in the country typically in the region of 4%, the coming decade is expected to be more beneficial for the subcontinent than for France or the USA, where both real GDP and inflation are foreseen to grow at about 2% per year. Being a young country, catching up with the rest of the world, is a clear advantage for India.

LET'S NOW LOOK AT ACTIONABLE LEVERS A GOVERNMENT HAS TO INFLECT THE DEFICIT TRAJECTORY

It can either raise revenues, reduce expenditures, or do both. First looking at what contributes positively to a budget balance. The revenue of each government is a key parameter to consider along with that government's capacity to raise taxes. Government revenues in mature economies tend to be relatively higher than those of so-called emerging markets. But with tax revenues accounting for more than 45% of GDP in France, the capacity of its government to find additional sources of revenue can be questioned. US economist Arthur Laffer's eponymous curve implies, that beyond a certain point, tax increases can become counterproductive; or as former French president Jacques Chirac would put it "too much taxation, kills tax". In contrast, the US and India have ample headroom to draw upon – if need be.

Second, the potential reduction in expenditures must be scrutinized carefully. Two of the largest, and potentially growing, expenses of the three governments pertain to social transfers and interest expenses. The former tends to become irreversible with the ageing of societies in the developed world, growing social demand for welfare benefits and the necessary outlays related to decarbonization and re-armament. As for at net interest outlays, while they account for 2.6% to 3.5% of GDP for each of the three countries, the expected path ahead is somewhat different. India's is expected to gradually come down over the coming years, while those of the US or France are expected to remain stable at best[2].

To conclude, as an Indian Minister has said, a "country needs fiscal discipline to build a strong economy and for social justice"[3].

[1]*When compared to the size of those respective economies.*

[2]*IMF Fiscal Monitor pointing at a decrease by 1% to 2% of GDP by 2029, while that of the US is expected to remain stable at 3.4% of GDP and that of France is expected to increase to 2.8% of GDP.*

[3]*Smriti Irani, Union Cabinet Minister and member of the parliament/Lok Sabha.*