

India's Growth Prospects and Policy Options: Emerging from the Pandemic's Shadow

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Abstract

The story of the Indian economy as it unfolds under the impact of COVID-19 is disquieting. Had the economy been strong to start with, the situation would have been different. We have analysed the sharp decline in growth rate since 2011-12 and traced the causes for the slowdown to such factors as unsustainable expansion of credit followed by sharp increase in non-performing assets, and decline in savings and investment rates. We have also noted that centre's gross tax revenues declined sharply on trend basis because of the fall in nominal GDP growth. This led to a squeezing of available fiscal policy space for the central government. Disruptions caused by such decisions as demonetisation also played an adverse role on both income and employment. The lockdown imposed to curb the spread of COVID-19 has put a brake on the economy. The need to kick start the economy and move it forward has become urgent. We have in this context discussed the roles of monetary and fiscal policies. Maintenance of government expenditure at a high level is unavoidable and monetisation of debt is also unavoidable. But policy makers must also be conscious of the fact that there is a limit to monetisation. Wisdom lies in striking the appropriate balance.

JEL: E5, H2, H5, H6

Keywords: COVID-19, GDP growth, Government borrowing, Tax revenue, Debt Monetisation, Fiscal Policy.

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I. Introduction

The outbreak of COVID-19 has taken the world by surprise and its impact is now felt by almost every country. Thus, the world is experiencing an additional slowdown on top of the contracting tendencies already present and India is no exception. The economic crisis that we are facing today is vastly different from any crisis that we have seen recently. This is the first economic crisis in recent memory that has been triggered by a non-economic factor – a pandemic. It has brought to a grinding halt nearly all economic activity.

Many multilateral bodies, financial institutions, and rating agencies have recently reassessed their positions regarding India's growth prospects in 2020-21. The IMF has revised its forecast for 2020-21 from 1.9% in April 2020 to (-)4.5% in June 2020. The World Bank also revised down, India's 2020-21 real GDP growth to (-)3.2% from 2.2% (average) over the same period. In this article, we consider India's growth prospects and policy options as India emerges from the pandemic's shadow. The Indian economy was already on a downslide prior to being impacted by the pandemic's economic shock in 2020-21. Even as the economy emerges from this shock, the underlying downward growth trends and the factors that were driving these would still be there. In considering the policy options for uplifting India's growth to reach closer to its potential, policy reforms to overcome the immediate challenges as also the underlying structural and cyclical factors besetting the growth momentum should be considered.

This article is divided into eight sections. Section 1 provides introduction. Section 2 considers the structural and cyclical factors underlying India's growth experience in the past decade preceding the current COVID-19 crisis. Section 3 looks at the economic impact of COVID -19. Section 4 discusses from a fiscal perspective, the types of government expenditures required to stimulate demand in the wake of COVID -19. Section 5 looks at monetary policy options. Section 6 examines the key features of the stimulus package already provided by the central government and also looks at the available fiscal policy options. Section 7 examines strategies for financing the national infrastructure pipeline and its impact on growth in the context of achieving the full potential of the Indian economy. Section 8 provides concluding observations.

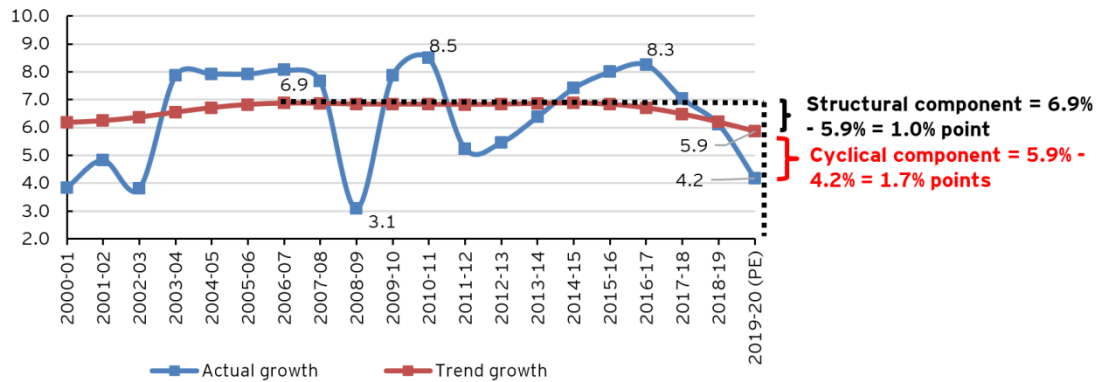
II. India's Pre-pandemic Growth Experience: Structural and Cyclical Drivers

Actual and Trend Growth Rates

In order to highlight the impact of structural and cyclical factors driving GDP growth, it is useful to distinguish between actual growth from the underlying trend growth rate (Rangarajan and Srivastava 2017). As Chart 1 indicates, actual growth had peaked at 8.5%ⁱ in 2010-11. Even more recently, it touched 8.3% in 2016-17. But trend GDP growthⁱⁱ had reached a peak of 6.9% in 2006-07. It remained stable at that level for a number of years but started trending downwards since 2015-16. In 2019-20, the trend growth fell to an estimated level of 5.9%. Demonetisation implemented in November 2016 had a serious disruptive effect on the economy. In the absence of adequate new currency to replace the old demonetised currency, many were put to serious difficulties. Daily wage earners suffered most. There was a conspicuous setback on employment. However, this is not captured in the New Series on National Income. Thus, we can decompose the fall in the real GDP growth to 4.2% in 2019-20 into two parts: (a) a fall in trend growth rate amounting to 1% point and (b) a fall of actual growth rate below trend growth rate amounting to 1.7% points. The first component of fall is due to structural factors, such as the fall in saving rates and the

second factor is due to cyclical factors such as fall in export and investment demand. This situation has arisen even before the COVID-19 crisis hit the Indian economy.

Chart 1: Real GDP growth: actual and trend growth (%)



Source (basic data): MOSPI

Saving and Investment Trends

Table 2 gives the sectoral profile of investment rates measured by gross capital formation (GCF) as percentage of GDP at current prices. Comparing investment rates in 2011-12 with those in 2018-19, it is clear that the total investment rate as well as each of its components as divided into households, private corporate sector and the public sector have fallen significantly. The aggregate fall, comparing 2018-19 to 2011-12, is 6.75% points of which 6.2% (including valuables), 1.35% and 0.3% points are due respectively to the households, private corporate and public sectors subject to correction for changes in errors and adjustments. The largest fall is in the household sector. In fact, if we consider the investment trend in the earlier years, there was a sharper fall in the private corporate investment rate relative to GDP. In the 2004-05 base saving-investment series, there is a sharper fall of 8.2% points from 17.3% in 2007-08 to 9.2% in 2012-13. In these years, the 2011-12 base saving-investment series also shows a fall in private corporate investment of 7.4% points.

Table 1: Investment - Total and Sector-wise (% to GDP at current market prices)

Year	Household	Valuables	Private corporate	Public	Errors and Omissions	Total
2011-12	15.90	2.90	13.26	7.54	-0.64	38.95
2012-13	14.73	2.75	13.63	7.23	0.34	38.69
2013-14	12.61	1.44	12.90	7.08	-0.25	33.78
2014-15	12.14	1.68	13.36	7.09	-0.74	33.52
2015-16	9.57	1.48	13.49	7.58	0.00	32.11
2016-17	10.36	1.09	11.57	7.16	1.78	31.95
2017-18	11.19	1.28	11.48	6.87	3.39	34.21
2018-19	11.50	1.06	11.91	7.24	0.50	32.20
2011-12 minus 2018-19 (% points)	4.41	1.84	1.35	0.30	-1.14	6.75

Source (basic data): RBI, CSO; Source (basic data): CSO

A significant change is discernible 2015-16 onwards. The level of household sector investment was at its trough in this year at 9.6%. After this, the household sector investment started to pick up slowly. By this year, investment rates had not fallen in the private corporate or the public sectors. These sectors experienced a fall in their respective investment rates in the subsequent years.

Table 2: Saving: Total and Component-wise (% to GDP at current market prices)

Year	Household Sector (Total)	Household Sector (Financial) Savings	Household Sector (Physical) Savings	Private Corporate Sector	Public Sector	Gross Domestic Savings
2011-12	23.64	7.36	16.29	9.46	1.54	34.65
2012-13	22.48	7.38	15.10	10.00	1.41	33.88
2013-14	20.34	7.41	12.94	10.75	1.03	32.12
2014-15	19.56	7.06	12.50	11.69	0.99	32.24
2015-16	17.97	8.07	9.90	11.90	1.23	31.09
2016-17	18.11	7.45	10.66	11.51	1.73	31.35
2017-18	19.17	7.74	11.43	11.57	1.65	32.39
2018-19	18.88	7.20	11.68	9.73	1.50	30.11
2011-12 minus 2018-19	4.76	0.16	4.60	-0.26	0.04	4.53

Source (basic data): RBI

The gross domestic saving has also fallen over the period 2011-12 to 2018-19 by a margin of 4.53% points of GDP. Almost the entire fall in the saving rate over this period is due to the fall in the physical savings of the household sector amounting to 4.6% points. Thus, it is the household sector's saving and investment behaviour that is largely responsible for the erosion of overall saving and investment rates over this period (Rangarajan and Srivastava 2019). There is some contribution in this of the private sector investment, which also fell but by a much smaller margin.

Growth slowdown: Demand Side

Annual growth data (Table 3) indicate a fall in GDP growth to 4.2% in 2019-20 from the peak of 8.3% in 2016-17. The main sources of this growth erosion can be traced to the fall in investment demand and exports in 2019-20 although growth in private consumption expenditure also fell compared to its level in the preceding year. Growth in gross capital formation and exports was negative at (-) 2.02% and (-) 3.59%, respectively.

Table 3: GDP and its Components (at 2011-12 prices)

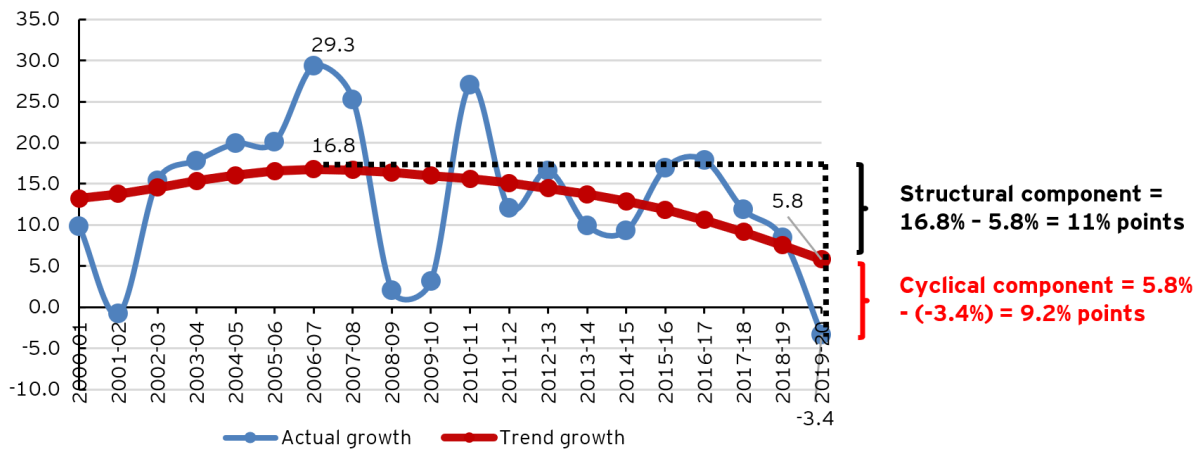
Year	(% per annum)					
	Private final consumption expenditure	Government final consumption expenditure	Gross capital formation	Exports of Goods and Services	Import of Goods and Services	GDP at market prices
2011-12	7.42	6.53	5.47	15.49	20.41	5.24
2012-13	5.47	0.61	4.29	6.81	6.02	5.46
2013-14	7.30	0.57	-3.71	7.79	-8.15	6.39
2014-15	6.39	7.59	7.69	1.78	0.87	7.41
2015-16	7.93	7.46	4.73	-5.65	-5.85	8.00
2016-17	8.13	6.07	3.67	4.98	4.38	8.26
2017-18	6.95	11.79	10.04	4.56	17.41	7.04
2018-19	7.16	10.08	9.52	12.33	8.60	6.12
2019-20	5.28	11.75	-2.02	-3.59	-6.80	4.18

Source (Basic data): National Income Statistics, MOSPI

Erosion in Growth of Centre's Gross Tax Revenues

Another noticeable trend over the years preceding the pandemic has been the persistent fall in the growth of centre's gross tax revenues (GTR). Chart 2 shows that the trend growth rate in centre's GTR has fallen even more sharply. Its peak was 16.8% in 2006-07 and since then the trend growth rate has been falling consistently. By 2019-20, it had fallen to 5.8%, a fall of 11% points. The actual growth rate of centre's GTR in 2019-20 became negative at (-)3.4%. There are two main reasons as to why the trend growth rate of centre's GTR has been falling over such a long period. First, alongside a fall in the real GDP growth rate, there has been a sharper fall, on trend basis, in the nominal growth rate. Second, on trend basis, there has been a steady fall in the buoyancy of centre's GTR with respect to nominal GDP. The differential between nominal and real GDP growth has narrowed because of a fall in the implicit price deflator-based inflation on trend basis.

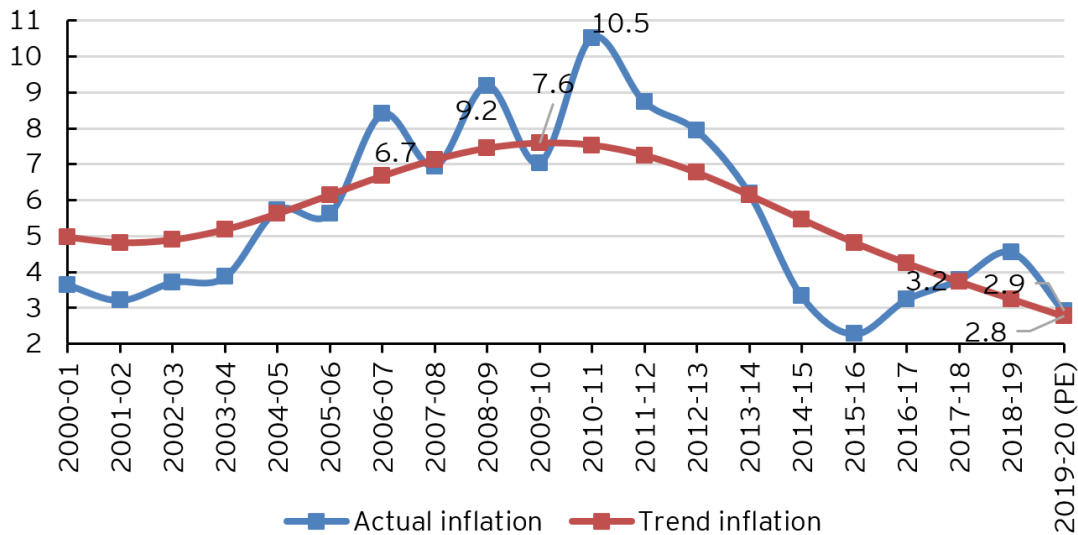
Chart 2: Gross tax revenues of the centre: actual and trend growth (%)



Source (basic data): IPFS, Union budget documents and CGA

The reason why nominal GDP growth fell on trend basis can be traced back to (a) fall in real GDP growth and (b) fall in implicit price deflator-based inflation. In Chart 3, we have shown the movement in implicit price deflator-based inflation on trend basis which shows a sharp fall from a peak of 7.6% in 2009-10 to 2.8% in 2019-20. We have already reviewed the fall in real GDP growth in Chart 1. Clearly, the sharper fall in the IPD-based inflation bears the larger responsibility in explaining the fall in nominal GDP growth relative to the fall in real GDP growth, with all growth rates measured on trend basis.

Chart 3: Implicit price deflator-based inflation: actual and trend growth (%)



Source (basic data): MOSPI

We may note that the negative growth rate of centre’s GTR in 2019-20 represents a discontinuity because of the significant CIT reforms undertaken during this year. The revenue loss on account of these reforms would have become part of the base year figure for 2020-21. As such, we would have seen a positive CIT growth in 2020-21 but the onset of COVID-19 has caused another kind of discontinuity in 2020-21 which may adversely affect the growth rate of all central taxes including the CIT revenues. The fact that centre’s tax revenues have been exposed to two revenue eroding discontinuities in succession is a major reason that has constrained centre’s ability to fight its way out of the economic impact of COVID-19

through a strong fiscal stimulus. In fact, 2020-21 represents a structural break in the economy and normal buoyancy and elasticity analyses may break down since these analyses assume a smooth response function while estimating responsiveness of tax revenues to a percentage change in the tax base which is proxied in this context by nominal GDP.

The NPA crisis

Another structural weakness of the Indian economy in the pre-COVID years relates to the banking sector which witnessed a major crisis of non-performing assets. These rose from 2.28% of total advances of commercial banks in 2007-08 to 9.3% in March 2019. It remained high at 8.3% in March 2020 (Table 4).

Table 4: Credit Expansion: NPA and GDP: 2004-2020

Year	<i>Figures in Lakhs of Crore</i>					
	2003-04	2007-08	2011-12	2015-16	2018-19	2019-20
Non-Food Credit	8.04	23.17	45.3	71.44	97.3	103.19
Infrastructure	0.37	2.022	6.3	9.6	10.56	10.54
a) Power	0.19	0.93	3.3	5.79	5.69	5.6
b) Telecom	0.08	0.38	0.93	0.91	1.16	1.44
Iron & Steel	0.26	0.82	1.95	3.11	2.83	2.62
Textiles	0.34	0.91	1.59	2.05	2.04	1.92
Construction	0.05	0.27	0.48	0.9	0.99	1.04
Gross NPA Ratio	7.20%	2.30%	2.90%	7.50%	9.30%	8.30%
Credit (growth rate)	21.00%	30.30%	18.30%	12.06%	10.84%	
GDP (Nominal)	27.92	48.99	87.36	137.71	189.71	203.39
GDP (Nominal growth rate)	12.03%	15.14%	14.43%	10.46%	10.95%	7.21%

Source: RBI; RBI Speeches (https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1097)

Source (basic data)

An important reason leading to the NPA crisis was the extraordinary credit boom during 2004 to 2016. Between 2003-04 and 2007-08, the outstanding non-food credit expanded by three times. This happened despite credit control measures being taken by the RBI. Between 2007-08 and 2011-12, it again doubled. During the next four years, it increased by 1.5 times. There was substantial flow of credit to certain sectors like infrastructure (roads, power, telecom), iron and steel, mining and aviation. While all these sectors are important for growth, these were also subject to severe output fluctuations. Court judgments had an impact on mining, power and steel sectors (Rangarajan and Sambamurthy 2019). Large Chinese imports affected iron and steel industry.

In extending credit, private sector banks were as 'exuberant' as public sector banks. Some of the private banks including foreign banks had non-performing assets ratio comparable to public sector banks. There was also some regulatory forbearance. Asset Quality Review introduced in 2015 tightened the situation and brought out greater transparency. It led to a doubling of non-performing assets ratio in one year. But by that time, damage had been done and the banks were left with a huge problem.

In resolving this situation, all major stakeholders, the RBI, the central government, and the banks have to play a role. The RBI has the responsibility to monitor macro prudential indicators such as overall credit growth and also to spot excesses, if any, to certain sectors, and groups. Regulatory design needs to reckon financial and business cycles and take remedial measures in time.

Government has the responsibility for overall management of the economy and being owner of the banks. Government may ensure that banks are run in larger national interest, but commercial decisions are best left to bank boards. Banks need to take responsibility for the soundness of credit decisions. They need to define their own risk appetite rather than lean on the big lenders' appraisal. Project appraisal and working capital assessment are quite distinct though related.

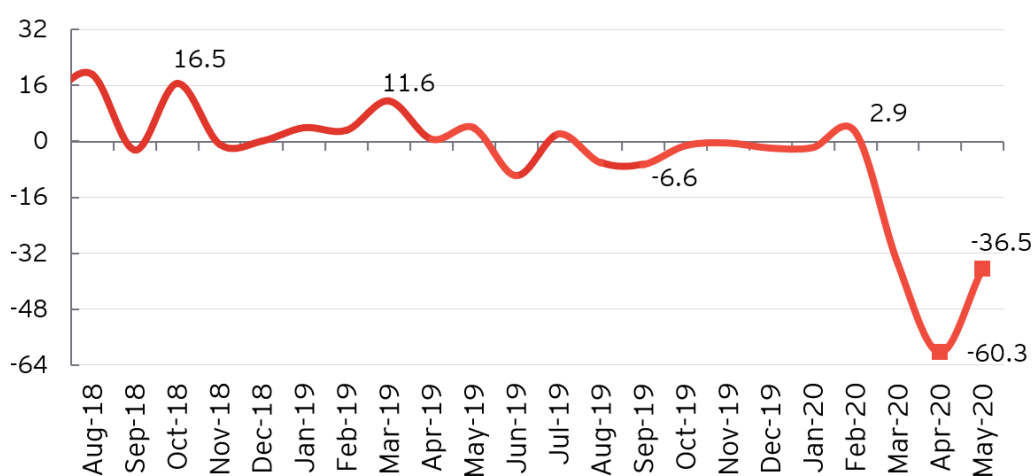
III Economic Impact of the Pandemic

The economic impact of COVID-19 on India can be traced through four channels (1) External Demand (2) Domestic Demand (3) Supply Disruptions and (4) Financial Market Disturbances.

External Demand

As the economies of the developed countries slow down and move into recession, their demand for imports of goods will go down and this will affect our exports which are even now not doing well. In fact, after six months of negative growth, it was only in February 2020 that the Indian exports showed positive growth. Since February 2020, the growth rate has turned again negative. In April 2020, it was as high as 60% (Chart 4). The pace of contraction reduced to 36.5% in May 2020. The extent of decline will depend on how severely the other economies are affected. Growth rate of advanced countries is expected to be negative at (-) 8%ⁱⁱⁱ. Not only merchandise exports, but also service exports will suffer. Besides IT industry, travel, transport and hotel industries will be affected. The only redeeming feature in the external sector is the fall in global crude oil prices. India's oil import bill will come down. But this will affect adversely the oil exporting countries which absorb Indian labour. Consequently, remittances may slow down.

Chart 4: Monthly growth (y-o-y) in merchandise exports



Source: Ministry of Commerce and Industry, GoI

Domestic Demand

Domestic demand comprises three elements – private consumption expenditure, public consumption expenditure and investment. As growth slows down, naturally private consumption expenditure will also show a declining trend. Perhaps, some sectors will be affected more severely than others. For example, as people travel less because of lockdown, the transportation industry – road, rail and air – will have a severe setback. Public consumption will be high because of various expenditures that the government has to undertake. Investment demand can be broken into private investment and public investment. There is an attempt to increase public investment. This aspect is discussed in detail in the subsequent sections. The 2019-20 CIT rate reform provides additional incentive for investment in manufacturing. However, private investment may take time to pick up (Rangarajan and Srivastava, October 2019).

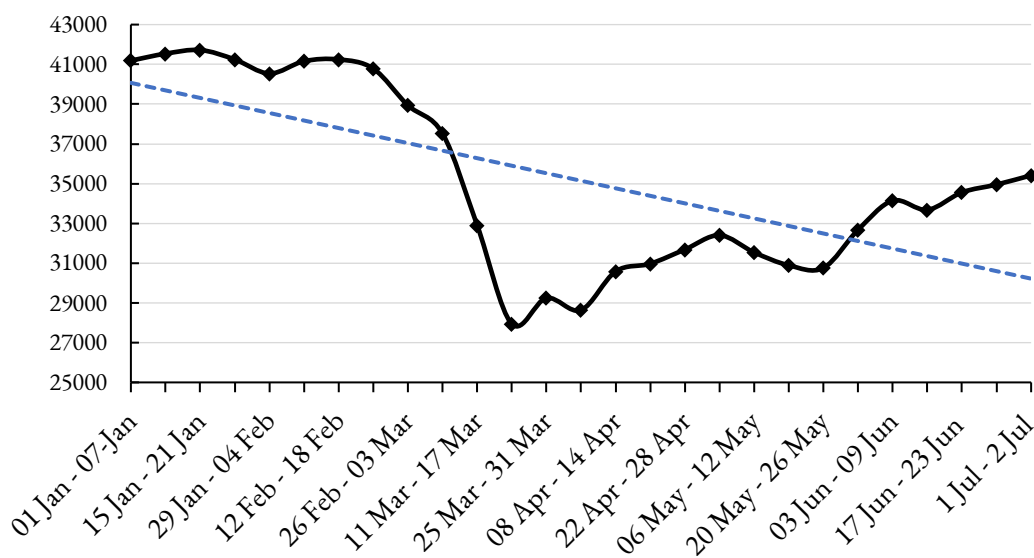
Supply Disruptions

Supply disruptions can occur because of the inability to import or procure inputs. The break in the supply chain can be severe. It is estimated that nearly 60% of our imports are in the category of ‘intermediate goods’. Imports from countries that are affected by the virus can be a source of concern. Domestic supply chain can also be affected as inter-state movement of goods has also slowed down because of lockdown restrictions.

Financial Market Disturbances

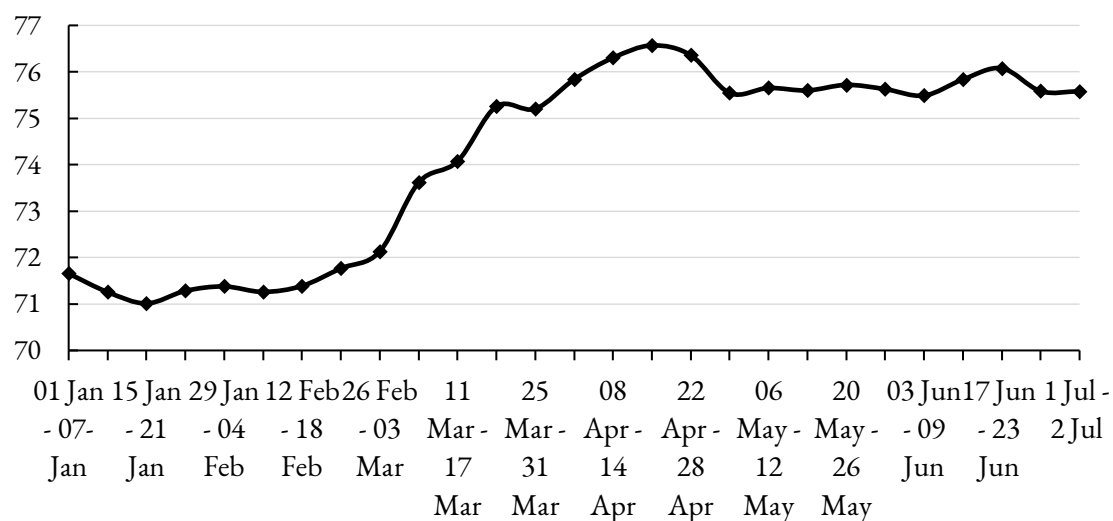
Financial markets are the ones which respond quickly and sometimes irrationally to a pandemic like COVID-19. The entire reaction is based on fear. The stock market in India initially collapsed (Chart 5). The indices touched a three-year low. However, they have recovered. It is difficult to understand the factors that move the stock market. Foreign Portfolio Investors initially showed great nervousness and the safe haven doctrine operated. In this process, the value of the rupee in terms of dollar fell (Chart 6). But it has also stabilized. The revival of the stock market in India and abroad has led the IMF to remark that “the rebound in financial market sentiment appears disconnected from shifts in underlying economic prospects” (IMF 2020).

Chart 5: S&P BSE Sensex Closing Value (Weekly)



Source: BSE Official Website bseindia.com

Chart 6: Exchange rate movement (weekly)



Source: FBIL India Pvt. Ltd. www.fbil.org.in

IV. Demand for Government Expenditures

COVID-19 has brought in its wake three sets of government expenditures which have become necessary. These are: 1) health care expenditures, 2) relief to people directly affected such as daily wage earners and migrant labour, and 3) expenditure to stimulate demand and revive affected sectors. The government must immediately address the first two categories. There is some concern among experts on the extent of testing that is being done currently. Many experts feel that the magnitude of testing must increase manifold. The first priority is to mobilise adequate resources to meet all health-related expenditures including extension of hospital facilities and supply of accessories/equipment like ventilators, masks, sanitisers, and material inputs for tests. The challenge here is not only fiscal but also organisational. The second set of expenditures tries to take care of people who have been directly affected by the lockdown. Here again there is a feeling that problems of people thrown out of employment have not been adequately addressed. It has been a heart-rending sight to view the migrant labour walking all the way to their home states from their places of work. More needs to be done on this front. Hunger needs to be fought as vigorously as the virus. The third category of expenditures is equally important. Here both RBI and Government have important roles to play. The focus has to be on the much-needed incentives to kick start the economy.

The first two categories of expenditures are paramount. They are the first charge on the government. Government cannot stint. In relation to these expenditures, the state governments have to bear the brunt. As yet, we do not have in a consolidated form, expenditures under these categories by centre and states. ‘Stimulus’ expenditures are directed towards improving demand and offsetting disadvantages imposed on business entities to start activities. It needs to be understood that in the Keynesian sense, all increase in expenditures act as a stimulant of demand. That is how the expression ‘Digging holes and filling them up’ came into usage. In a broader sense, even increased expenditures in health care are demand enhancing. However, analysts do make a distinction among expenditures depending on the fiscal multiplier. The expenditure under the category of ‘stimulus’ will be determined not only by what is needed but also what is feasible.

V. Monetary Policy

Monetary Policy measures have come in quick succession post COVID-19. The Monetary Policy Committee was convened once ahead of its scheduled date. Thus, the RBI has been proactive. The various measures taken by RBI fall under three categories – (a) policy rate changes (b) augmenting liquidity and (c) regulatory adjustments. The policy rate under the Liquidity Adjustment Facility has been brought down to 4.0% in May 2020 from 5.15% in mid-March 2020. The magnitude of the last reduction was 40 basis points, and that of the previous one was 75 basis points. The reverse repo rate now stands at 3.35%. The stance of monetary policy is accommodative. The reduction of policy rate started even before the advent of COVID-19 and it gathered momentum from end-March 2020. The low reverse repo rate is expected to discourage banks from placing ‘surplus’ funds with the RBI. The regulatory adjustments are expected to provide relief to banks so that their ability to expand credit may be facilitated. The number of refinance facilities introduced by RBI are expected to accelerate the flow of credit to MSMEs, Mutual Funds and NBFCs.

One of the important elements in the monetary policy package is to augment the liquidity in the system. This should enable the banks and other financial institutions to expand credit. Another objective is to direct the liquidity in certain directions. Open market operations and augmentation of foreign exchange reserves lead to increase in durable liquidity. From end-March 2020 to early July 2020, the foreign exchange reserves of RBI have increased from \$ 476 billion to \$ 513 billion. This will enhance liquidity. The RBI also reduced the CRR from 4% to 3% which had the effect of increasing primary liquidity by as much as Rs. 1,37,000 crores. The RBI has been announcing from time to time its schedule of open market operations. The RBI has been conducting Long Term repos. In a slight modification, in March 2020, the RBI announced Targeted Long-Term Repo Operations where it specified that the liquidity availed under this facility had to be invested in investment grade corporate bonds and commercial paper. The RBI also extended additional refinancing facilities to SIDBI and EXIM Bank.

Regulatory changes to help the flow of credit were of several types. One important measure was the moratorium on instalments falling due in term loans. Initially it was given for three months and later extended to another three months. Other measures include deferment of interest on working capital facilities and easing of working capital financing without the downgrade of asset classification. There are several more which are not listed here.

Two questions arise with respect to monetary policy measures. First, are they adequate and in the right direction? Second, what will be their effect on the overall economy? The policy rate at 4% is perhaps the lowest it can get, given India's conditions. While the industry and others welcome lowering of the rate, the savers have their own concerns. World over, there is a continuing debate whether savings are interest sensitive. While there can be some doubt about the impact on overall savings, financial savings are impacted, and this is particularly so when returns on alternative assets like gold are rising. In any case, savers are already feeling the pinch. The various liquidity enhancing measures taken together amount to our model of ‘Quantitative Easing’. We have to note that ‘quantitative easing’ took a long time to have an impact on the developed economies post 2008. While the direction of monetary policy may be right, there are two concerns. First, it is not clear whether availability of credit is the most binding constraint on growth. But more importantly, policy makers should not put too much pressure to lend. Making resources available is important and that the central bank should certainly do. It is in that sense, the measures taken so far are in the right direction. But bankers must not abdicate their responsibility to exercise judgement. Bankers should not be either adventurous or timid. The loans of today should not

become NPAs of tomorrow. This is certainly not an argument against lending. It is only a note of caution. Second, the central bank needs to keep a tab on the extent of liquidity it is injecting. It is not only the private sector that is looking for liquidity but also the government. Expansion in liquidity unaccompanied by a real sector response in terms of output can lead to problems subsequently, not necessarily in this year. It may also have to be noted that the expansion in money supply depends not only upon the initial injection of liquidity by the central bank but also on subsequent credit expansion. This is elaborated in the next section on fiscal policy. It has been questioned as to why monetary policy has not had any effect so far. It may be noted that unless the lockdown is lifted, and production starts moving, banks cannot lend. They may sanction the loans but would release them only when production starts. Without action on withdrawing the lockdown, the economy cannot move fast.

VI. Fiscal Policy

Fiscal policy has an important role to play in the situation in which India and other countries are currently placed. However, the ability to play a big role is constrained by the fact that the fiscal position of the government of India was difficult even before the advent of COVID-19. The fiscal deficit of central government for 2019-20 turned out to be higher. It stood at 4.6%^{iv}. In fact, even without COVID-19, the fiscal deficit of the centre for 2020-21 would turn out to be higher. With COVID-19, the situation gets worse. The revenue calculations of the Budget were made on the assumption that the nominal income of the country would grow at 10%. With low expectations of real growth, nominal income may grow at best at 5%^v in 2020-21. There will thus be a deep decline in nominal growth. Analysts estimate that the tax and non-tax revenue and non-debt capital receipts in the current fiscal may fall well short of the budget estimates by a margin of close to Rs. 5.0 lakh crore. This shortfall may amount to about 2.4% of GDP. The central government has already announced a revised borrowing program for 2020-21 according to which the estimated fiscal deficit may amount to 5.7% of GDP. This deficit will have to be further increased to accommodate the additional burden arising on account of additional stimulus package and to finance the National Infrastructure Pipeline. There may also be scope for some expenditure restructuring.

The series of stimulus measures announced by the FM are a mix of already budgeted expenditure, additional expenditure, extension of credit facility with government guarantee for certain select sectors and a host of reform measures that are indeed welcome (Rangarajan and Srivastava 2020). Perhaps, it would have been useful if a more analytical distinction of expenditures had been given. Analytically, the overall stimulus package of Rs. 20.97 lakh crore can be divided into a budgetary and a non-budgetary part. The non-budgetary part, accounting for nearly 85% of the overall package, consists mainly of liquidity enhancing measures for banks and NBFCs which may facilitate the financial sector in playing a key role to kickstart the economy. The credit guarantee provided by the government under the various schemes announced recently are of central importance in this context. In fact, for certain schemes, the government has come forward to provide 100% guarantee which should quicken the pace of credit sanction and delivery by banks. This will have any fiscal implications only in the subsequent years. Production of goods and services is inter-related in an economic system. Once production starts, different sectors will be mutually supporting since different industries and service providers are locked in an input-output system.

The budgetary part amounts only to about 15% of the overall package. This can be further divided into government expenditure which was already budgeted in the 2020-21 budget and expenditures constituting genuine additionality. The latter component is only 10% of the overall package equivalent to

nearly 1% of GDP. Adding this to the enhanced level of 5.7% of GDP, centre's fiscal deficit may be close to 7% of GDP. In fact, the actual deficit may turn out to be higher.

With this high fiscal deficit, the composition of government expenditure becomes critical. Some of the establishment expenditures and subsidies especially those linked to petroleum prices like fertilizer and petroleum subsidies may be reduced while expenditure on health-related items may be increased. The central government has announced freezing of increments of dearness allowance and dearness relief components in the case of salaries and pensions respectively.

According to the National Infrastructure Pipeline, centre's budgetary contribution to infrastructure is estimated at 1.25% of GDP on an annual basis. This is less than 18% of the estimated fiscal deficit of the centre in 2020-21, indicating a very poor quality of fiscal deficit. One dimension of expenditure restructuring should be to front load infrastructure spending including that on health infrastructure thereby taking advantage of the higher multiplier effects associated with capital expenditures. Investment augmentation is also demand supporting and employment and income generating.

Support to demand will come not only from the centre but also from the states and the public sector undertakings. States have been allowed to borrow an additional 2% of their respective GSDPs subject to certain conditions. In fact, at the present juncture these conditions are not required since the enhancement of the borrowing limit is for one time while the reforms linked to conditions are permanent in nature. In any case, states should be encouraged to support demand by going up to the full extent of the enhanced limit.

VII. Financing of National Infrastructure Pipeline

An important source of generating demand can be through the successful financing of the proposed National Infrastructure Pipeline, which is planned over the period from 2019-20 to 2024-25. It is meant to be financed by the central and state governments along with their public sector enterprises as well as the private sector. The time path of the ambitious infrastructure investment plan amounting to INR 111 lakh crore is such that it peaks in two years, namely, 2020-21 and 2022-23 (Chart 7). As chart 8 indicates, the investment peak is even more marked in the case of construction (EY Economy Watch 2020). Successful financing of infrastructure in the current year and the next can be an important strategy for uplifting the economy out of the pandemic's shadow.

Chart 7: GFCF in infrastructure spending excluding construction (INR lakh crore)

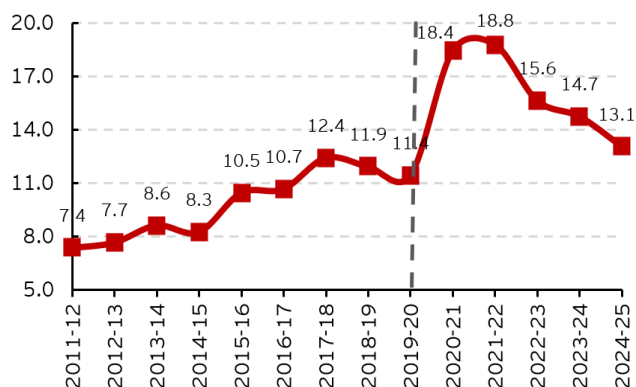
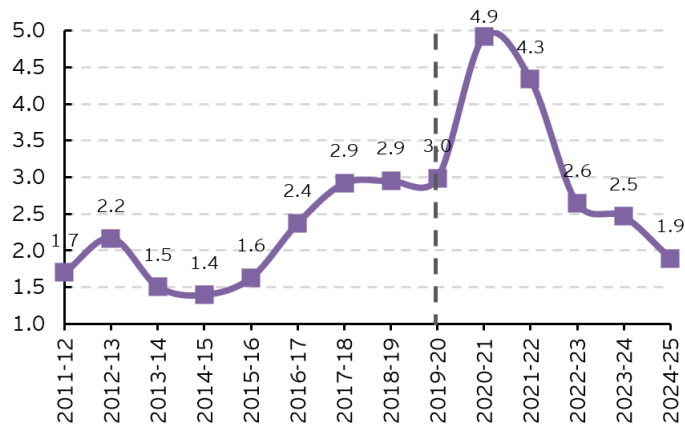


Chart 8: GFCF in construction sector (INR lakh crore)



Source: NAS (2019), MoSPI, NIP - GoI, Input-Output transactions table (2015-16), Brookings India

Public Sector Borrowing Requirement (PSBR)

The combined fiscal deficit of the centre and states alone may amount to 12% of GDP in 2020-21. Besides, the total public sector borrowing also includes the borrowing by central and state public sector undertakings. Thus, the total PSBR may well exceed available sources of financing consisting of the financial savings of the household sector and the savings of the public sector and net capital inflows (Rangarajan and Srivastava 2020). In this context, monetising debt has become unavoidable. The centre must be forthcoming on these issues while recognizing that extraordinary situations call for extraordinary solutions.

How high can fiscal deficit go? The IMF, in its June 2020 update of the WEO estimated the fiscal deficit of India and China at 12.1% of GDP. All the other countries except USA and a few other countries have a deficit lower than this. US has a complicated procedure in determining the budget. It is not clear how far the President will succeed in pushing the expenditures. Besides dollar as a reserve currency has its own advantages. Coming back to India's fiscal deficit, there are not adequate resources to support a fiscal deficit of nearly 12.0% of GDP. Financing of the NIP may require it to be increased further. All this will require substantial support from RBI which will have to take it on itself either directly or indirectly, a part of the central government debt. The question ultimately relates to the extent of debt monetisation that may be undertaken.

Monetisation of debt can be either direct or indirect. In the indirect mode, the RBI provides liquidity to banks which then take on, a part of the debt. In the direct mode, the RBI takes on the debt directly from government at an agreed rate. It took India long to move away from the automatic monetisation of debt. It happened in early 1990s. Even if RBI wants to support the borrowing programmes, it should not do so directly. The indirect method is preferable as the market still sends out the signals on interest rate. In both cases, the RBI is the provider of liquidity. In fact, government wants to borrow more at a lesser rate!

Another question pertains to whether the increase in primary liquidity (Reverse Money) automatically lead to an increase in money supply. It depends upon the money multiplier which again depends on credit expansion by the banking system. In fact, the post 2008 phenomenon in the U.S. and other developed countries is a good example. Despite "Quantitative Easing", there was no price increase because lending was poor and money supply expansion was limited. This need not necessarily be the case in India. There is a strong pressure on the banks to expand credit. Therefore, the expected increase in money supply can be substantial, leading to inflation although with a lag. This possibility cannot be ruled out. After all, many analysts forecast nil or negative increase in overall output in 2020-21. In that context, a substantial increase in money supply can lead to inflation. The only way to avoid such a situation is to ensure that credit expansion is prudent and justifiable.

Limit to Monetisation of Debt

To argue as if there is no limit to monetisation of debt is to ignore our own history. The critical concern is the impact of excessive liquidity on the economy. Money stock once increased stays. Increase in money and credit only facilitate expansion in output. If output increase slackens, increased stock of money cannot but have an impact on prices. The fear of inflation in the current year may seem unrealistic. But it can come with a lag. The high inflation post 2011 was preceded by a hefty fiscal deficit. Given the current situation of economic slack, some degree of monetisation of debt is acceptable. But to assume and act as if there is no limit to monetisation of debt is equivalent to storing up problems for tomorrow. Thus, the

approach should be to keep government expenditures at a high level with a cautionary note on monetisation of debt.

Reforms: The Next Round

Even as we take steps to kick start the economy, we must consider the shape of the next round of reforms which would pave the way for sustained growth in the post-COVID era. However, in the case of reforms, we have reached a new stage. General reforms cutting across industries and sectors have been critical in the early stages. The earlier regime of controls and permits had to be brought to a close. But now reforms have to focus on specific sectors. Applying the general principles of liberalization to sectors such as agriculture and more particularly agricultural marketing, power sector, and telecom have assumed importance. Labour market reforms are needed across all the states. But labour reforms are introduced better when the economy is in an upswing. Consensus building is critical before introducing labour reforms. Land markets need to be freed up consistent with the concerns of small and marginal farmers. Financial and banking sector reforms must continue. The major objective must be to improve the efficiency of the functioning of banks and other institutions. Recapitalization of banks and regulation of bad debts must get priority. The reform measures announced recently by the government such as private operations in coal mining are truly in the spirit of liberalisation. They need to be implemented with dedication and commitment.

India's Growth Prospects

Although many national and international agencies have projected a sharp contraction in 2020-21, ranging from (-) 3.2% (The World Bank) to (-) 6.8% (SBI), there are reasons to believe that the outcome may be better than these strong contractionary prospects. We may note that some key sectors like agriculture and related sectors, public administration, defence services and other services may perform normally or better than normal given the demand for health services. Further, goods and services categorised as essential goods and services in other sectors, technically called 'permitted goods and services' together with agriculture and public administration, defence and other services, may have a weight in the range of 40-45% of total output (Virmani 2020). These were fully operational even in the first quarter of 2020-1. Thus, nearly half of the economy may perform normally or better than normally over the full year 2020-21. Secondly, already some green shoots have become visible. GST revenues were close to INR 90,917 crore in June 2020, which is very close to the benchmark of INR1,00,000 crore. PMI manufacturing in June 2020 was 47.2, again close to the benchmark of 50. Thirdly, given the current geo-political situation, the government at the central and state levels have become very active in attracting investment from abroad. The major reforms in the corporate tax rates in 2019-20 will also facilitate relocation of various production platforms to India. Thus, a small positive growth may not be ruled out.

VIII. Concluding Observations

The story of the Indian economy as it unfolds under the impact of COVID-19 is disquieting. Had the economy been strong to start with, the situation would have been different. We have analysed the sharp decline in growth rate since 2011-12 and traced the causes for the slowdown to such factors as unsustainable expansion of credit followed by sharp increase in non-performing assets and decline in savings and investment rates. We have also noted that centre's gross tax revenues declined sharply on trend

basis because of the fall in nominal GDP growth. This led to a squeezing of available fiscal policy space for the central government. Disruptions caused by such decisions as demonetisation also played an adverse role on both income and employment. The lockdown imposed to curb the spread of COVID-19 has put a brake on the economy. The need to kick start the economy and move it forward has become urgent. We have in this context discussed the roles of monetary and fiscal policies. Maintenance of government expenditure at a high level is unavoidable and monetisation of debt is also unavoidable. But policy makers must also be conscious of the fact that there is a limit to monetisation. Wisdom lies in striking the appropriate balance.

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Notes

ⁱ This analysis is based on using the 2011-12 base GDP at market price series. In the earlier 2004-05 base GDP series, the growth rate was higher at 9.3% in both 2005-06 and 2006-07, 9.8% in 2007-08, and 10.3% in 2010-11. This also implies that the trend growth rate was higher in the 2004-05 base series as compared to 2011-12 base series.

ⁱⁱ Estimated using Hodrick-Prescott filter

ⁱⁱⁱ World Economic Outlook Update, IMF, June 2020

^{iv} Monthly Accounts, Controller General of Accounts (CGA), Government of India

^v This is implicit in the stimulus package announced by the FM in May 2020;

<https://pib.gov.in/PressReleasePage.aspx?PRID=1624651> ;

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