Essay

Nursing the economy back to health, post-Covid

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In his commentary on the Bhagavad Gita, Swami Mukundananda writes, "If we keep struggling to eliminate negative situations, we will be unable to avoid unhappiness. But if we can learn to accept everything that comes our way, without sacrificing our best efforts, we will have surrendered to the will of God, and that will be true Yog.".[1]

Most of us find ourselves in this situation confronted with the Covid virus. The lockdown was an attempt to eliminate a negative situation. No surprises, then, that the world has been unable to avoid being infected by the virus. The lockdown, if at all, was meant to be a stop-gap measure to get the health infrastructure up to speed. It is doubtful if either developed or developing countries achieved that goal fully. If so, the lockdown would not have become an end in itself in many countries. There is also the bizarre situation of some States in America condemning the absence of social distancing in some cases and condoning them in others. That is a digression. The point is that the lockdown was not the answer to the virus.

In India, we face multiple risks when we step out on to the road. Road accidents are the highest in India, in the world. Our untreated sewage and solid waste are health hazards. Tuberculosis deaths in the country numbered 4.4 lakh in 2018. It is infectious and one-in-five infected die. Yet, Indians hardly worried about someone coughing in public and spitting in public places. However, in the case of Covid, India chose to follow the western template and shut down the economy. The ripple effects may take a long time to work their way through the economy.

1 Mukundananda, Swami. "Chapter 2, Verse 48 – Bhagavad Gita, The Song of God – Swami Mukundananda." Chapter 2, Verse 48 – Bhagavad Gita, The Song of God – Swami Mukundananda. https://www.holy-bhagavad-gita.org/chapter/2/verse/48.

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Of course, it can be said that hindsight is 20/20 and that our observations would be different if the country had chosen not to lock down and scores of older people had died because infected youngsters returned to crowded homes and infected older people who may have pre-existing conditions such as diabetes, hypertension or heart related ailments. The headlines that would have made would have been unacceptable to the government, or to the society. The verdict would have been that the government was callous and it would have extracted an unacceptably high political cost too. Therefore, a definitive judgement on the Indian government's approach to the Covid virus would be impossible to deliver, ever. Humans are not good in visualizing counterfactual scenarios, especially if, doing so, threatens their strongly held biases.

What we can say clearly is that, because of the lockdown strategy adopted, India faces a more formidable economic challenge than before. The choice of words is deliberate. India was already facing a formidable economic challenge. Economic growth had been decelerating since 2018. It had not been arrested. If anything, the deceleration had become more pronounced in 2019-20. The hope was that 2020-21 would see the growth rate stabilize and then begin a long road to recovery. Instead, India got Covid 19 and faces, arguably, its worst economic challenge in the last forty years if not since Independence.

These statistics tell their story about the loss of economic momentum in 2019-20:

Indicators	Annual	
	2018-19	2019-20
Production of Coal	7.4	-0.5
Production of Crude Oil	-4.2	-5.9
Production of Cement	13.3	-0.8
Consumption of Steel	7.5	1.3
Sales of Commercial Vehicles	17.6	-28.8
Cargo Handled at Major Sea Ports	2.9	0.9
Cargo Handled at Airports	2.5	-9.0
Passengers Handled at Airports	11.8	-1.0
Railways		
(i) Net Tonne Kilometers	6.6	-4.5
(ii) Passenger Kilometers	1.7	-4.3

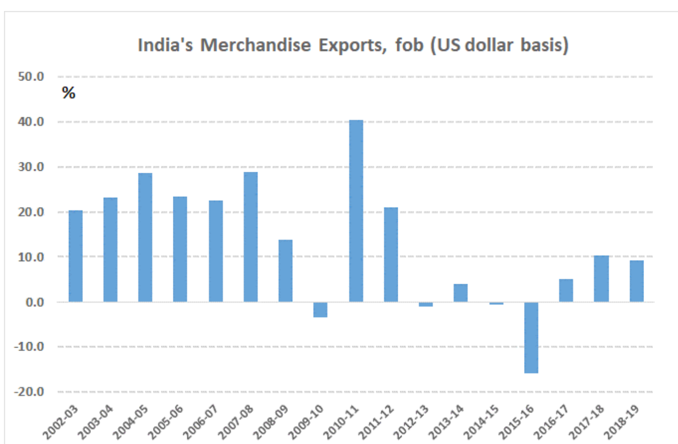
Source: press note on provisional estimates of annual national income 2019-2020 and quarterly estimates of Gross Domestic Product for the fourth quarter (q4) of 2019-2020. National statistical Office, Ministry of Statistics & Programme Implementation, Government of India. 29th May 2020.

The Problem of Growth

Why was growth a problem well before the virus made its appearance in India? The principal reason is the problems in the banking sector. On account of the lending and borrowing decisions made since the economic boom in the early years of the new millennium, the government-dominated Indian banking system has been saddled with a huge non-performing asset (NPA) problem. That is, the borrowers are neither servicing the loans nor are they able to repay them. In general, the dominant reason for bank loans to go sour is that economic growth and hence industry growth assumptions fail to materialise. That applies in the Indian case.

In 2008, India was affected by the global economic and financial crisis. Between 2009 and 2012, the economy appeared to recover and register high growth rates (since partially revised down) that were experienced between 2003 and 2008. High growth rates had led to optimistic growth assumptions and encouraged both borrowing and lending decisions. To an extent, even bank frauds that had risen too fast in recent times could be attributed to optimistic growth assumptions. Even those promoters who divert loans for personal ends would have anticipated being able to repay them under sustained high economic growth. That was not to be.

Then, there were global factors such as huge steel imports that made steel company loans go sour. Import duties made some of the loans viable partially. Global economic growth and global trade volume growth slowed post-2009. India's exports that grew at over 20% between 2003 and 2008 have hardly grown since 2012. That had a knock-on effect on some domestic manufacturing units. Third, India's electricity generation and distribution policies, shared between the Union government and State governments, have been a big source of NPA in power generation assets. Fuel supply agreements and Power purchase agreements have been either not honoured or changed post-facto and arbitrarily. So, India's governments themselves have been the source of NPA for India's government-owned banks.



Annual growth rate of India's Merchandise Exports (fob) measured in US dollars.
Source: Reserve Bank of India's Handbook of Statistics on the Indian Economy

Economic slowdowns caused by woes in the financial sector take time to reverse. That is the international experience. Further, developing economies, in general, have experienced slower growth in 2018 and in 2019. India is not an exception. India's real GDP growth rate dropped to a low of 4.2% for the year ending March 2020, as per the provisional estimates the government released on 29th May. Nominal GDP growth was pegged at 7.2%. This is lower than the most recent estimates of real and nominal GDP growth in 2018-19 of 6.1% and 10.8% respectively. The non-supportive global economy in terms of trade volumes knocks off about 1% to 1.5% of India's GDP growth. The International Trade Monitor produced by CPB in the Netherlands noted the following facts in its last bulletin published in March 2020:

- World trade volume decreased 1.4% month-on-month (growth was -0.7% in February, initial estimate -1.5%) and growth was -2.5% in 2020Q1 (-0.5% in 2019Q4).
- World trade momentum was -2.5% (non-annualised; -1.3% in February, initial estimate -1.4%).
- World industrial production decreased 0.2% month-on-month (having increased 0.1% in February, initial estimate 0.2%) and growth was -4.2% in 2020Q1 (0.3% in 2019Q4).
- World industrial production momentum was -4.2% (non-annualised; -2.4% in February, initial estimate -2.6%).

So, financial sector woes that result in anaemic growth in bank credit together with weak export growth prospects have dragged down India's potential growth rate. At this time, it hovers between 5% and 6%. We should remember, however, that potential growth is a dynamic concept. It can go up and it can go down. India's underlying potential growth is much higher. But, unless the constraints on credit growth are removed and unless international trade picks up (a remote possibility for almost the rest of the decade), India should accept that potential growth is, at best, 6% per annum and, on average, would be closer to 5% per annum.

Amidst this somewhat dreary economic backdrop, came the standoff with China in the border area near Ladakh, in June. It would mean, among other things, an increase in defence outlay at a time when the economy needs all the support it can get from the government. An article first published last year has been republished in *Firstpost.* The gap between the military expenditures incurred by China and India has widened. More than that, the gap two countries spend on defence capital expenditure (equipment) is even bigger than the gap between their overall expenditure. In other words, India's personnel expenditure has gone up much more than outlay on equipment. No wonder that this is probably the most difficult challenge any government has faced in India in recent decades.

New Economic Initiatives

It is in this milieu that India unveiled its first response to the Covid crisis in March-- the *Garib Kalyan* package. The package announced in May was called the *Atmanirbhar Bharat or* Self-reliant India. It was announced in five instalments. The Government combined modest on-budget fiscal support to the country with abundant liquidity support and structural reforms. Most of the details are available from government websites. The perception is that the Government crimped on putting money directly in the hands of people through the budget and focused on providing them more loans or extensions on payments due on their current loans. After all, moratoriums are not the same as standstill offers where the clock stops. Here, the interest arrears are collected later with interest charged on them too. That does not seem like much help to people who might still face uncertainty with respect to their incomes and business prospects whether they are households or businesses.

That said, even grants cannot be forever. In the United States of America, for example, the grants are set to expire in June. The question of whether the early signs of stabilisation in the economy would continue after the grants are ended is an open one. Second, the cash grants – they were sent to every American – has come in handy for many to speculate in the stocks of bankrupt companies such as Hertz. The monetary policy of the Federal Reserve Board in America has fuelled and encouraged such tendencies. But, history suggests that such speculative endeavours would only end in tears. If so, open-ended grants might end up harming the public more than helping them. That is why it is important to remember two iron laws of public policy. One is that the law of unintended consequences always operates and the second one is that the road to hell is paved with good intentions.

India's on-budget support to the economy is estimated variously at 0.8% to 1.3% of GDP with most estimates putting the number at 1.2% of GDP. This is on the lower side compared to many countries. A table prepared by the Bruegel think-tank – although including only developed nations – shows that many countries had incurred additional on-budget expenditure of more than 2% GDP. A few like America, Britain and Germany have spent considerably more. However, the controversy over whether India's total *Atmanirbhar* package was worth 10% of GDP is a no-brainer. India followed the template that other countries have followed. India included tax deferrals, loan moratoriums and central bank liquidity support in the total size of the package. That is in line with international practice.

Discretionary 2020 fiscal measures adopted in response to coronavirus by 25 May 2020*, % of 2019 GDP

	Immediate fiscal impulse	Deferral	Other liquidity /guarantee	Last update
Belgium	1.4%	4.8%	21.9%	03/06/2020
Denmark	2.1%	7.2%	2.9%	28/03/2020
France	3.6%	8.1%	13.9%	04/06/2020
Germany	13.3%	7.3%	27.2%	03/06/2020
Greece	1.1%	2.0%	0.5%	01/04/2020
Hungary	0.4%	8.3%	0.0%	25/03/2020
Italy	0.9%	13.2%	29.8%	27/04/2020
Netherlands	3.7%	7.9%	3.4%	27/05/2020
Portugal	2.5%	11.1%	5.5%	04/05/2020
Spain	2.3%	0.9%	9.2%	25/05/2020
UK	4.8%	1.9%	14.9%	25/05/2020
United States	9.1%	2.6%	2.6%	27/04/2020

Note: we calculate the ratio of the 2020 measures to 2019 GDP, because the 2020 GDP outlook is very uncertain. The category 'Other liquidity/guarantee' includes only government-initiated measures (excludes central bank measures) and shows the total volume of private sector loans/activities covered, not the amount the government put aside for the liquidity support or guarantee (the amount of which is multiplied to cover a much larger amount of private sector activity).

** The cut-off date is earlier for some countries, see at the country specific descriptions.*

Source: https://www.bruegel.org/publications/datasets/covid-national-dataset/ (valid as of 4th June 2020)

Compared to European nations, India has spent more cautiously, on-budget. But, India's starting point is not very good. That is, India's estimated fiscal deficit for 2019-20 is around 4.5% of GDP. If one added the borrowings from small savings schemes, India's federal fiscal deficit comes to around 5.1% of GDP. Then, in 2020-21, the revenue shortfall could be easily between 2.0% to 3.0% of GDP. On top of that, the states will incur deficits too. While, as per the Fiscal Responsibility and Budget Management Act, their fiscal deficit cannot exceed 3% of the State GDP. But, for 2020-21, it might well exceed 4% of GDP. If we add all of this, India is looking at a consolidated fiscal deficit of around 11% to 12% of GDP. This does not include contingent liabilities. Hence, India's ability to spend on-budget on a comparable scale was constrained.

It is not that India was worried about credit rating downgrade. It is not that credit rating agencies matter. That is beside the point. Regardless of the fairness or unfairness of the ratings assigned by credit rating agencies, their impact on financial market behaviour cannot be dismissed. That is what the government was concerned about. Moody's Investor Service, one of the top-three global credit rating agencies, downgraded India from Baa2 to Baa3, which is the lowest investment grade category. Thankfully, the Standard & Poor's did not downgrade India from BBB- to sub-investment or speculative grade category. Luckily for India, financial markets have not pushed up the cost of borrowing for the Government after the announcement of the *Atma Nirbhar* package and the downgrade by Moody's. If anything, the yield had dropped down a little. That is, the cost of borrowing by the Government of India from the market for ten years has become a bit cheaper. It is now 5.84%. Six months ago, it was closer to 7.0%. Clearly, the financial markets had not expressed a lack of confidence on government's fiscal spending and attitudes nor over the government's medium term prospects.

It is clear that governments in developed countries have an advantage in the short-term. Their history (distant and not recent) of fiscal prudence and rectitude is helping them to borrow in their own currencies at record low interest rates. However, their fiscal prospects are gloomier due to likely weaker growth arising from ageing population and lack of innovation, etc. Therefore, they need to be mindful about entering into bigger fiscal commitments. Yet, they are doing so. They are sacrificing the medium term for the short-term.

India, on the other hand, has had a chequered history of fiscal prudence. But, its medium-term fiscal prospects are far better. Its population is young and its potential growth is around 6% with the prospect of an increase once structural impediments, principally in the financial sector, are removed. So, India can afford to take greater risks with budgetary spending now because it can bank on economic growth in the medium-term to ensure that government finances are in a sustainable trajectory. Yet, the government has been careful about overspending so far. Perhaps, it is keeping the powder dry for additional support to the economy that might be needed, in the coming months. If so, it is a sensible approach.

In the next package, *Atma Nirbhar Bharat 2.0*, whenever it is announced, the government should focus on putting cash in the hands of households and businesses that are worst affected by the lockdowns and the pandemic outbreak. Public health infrastructure including the recruitment of thousands of community workers would constitute both a short-term economic stimulus and a medium-term economic measure. There is no economic growth without sound public health. Preventive care in India needs to be ramped up substantially to make secondary and tertiary care sustainable.

Significant Reform Measures

As for the non-fiscal measures announced as part of the *Atma Nirbhar Bharat* package, the Government had taken several far-reaching decisions. The government will vacate several sectors that are non-strategic. It will throw them open to the private sector. In strategic sectors, it will limit itself to four entities. Defence production is now open to the private sector. Coal and mining sectors have been delicensed and private players can mine for coal and other minerals. Farmers have been empowered to sell directly in the market skipping intermediaries. Relevant amendments to the Essential Commodity Act will be made. Norms for classifying enterprises into micro, small and medium are being upgraded. On top of these, several credit schemes for MSME, for farmers and for Non-Banking Finance Corporations were announced.

While there will always be unfinished reforms in India, the changes announced in several areas have been far-reaching. If they are followed through and implemented without dilution of the original intent, they will transform the public sector in general, defence production, the mining sector and, more importantly, the farm sector. In its credit rating downgrade, Moody's pointed out: "*Policymakers' limited success in achieving stated objectives in recent years -- an important aspect of governance under Moody's definitions – together with Moody's expectation that policymaking will remain challenged is an important driver in both the downgrade to Baa3 and the assignment of a negative outlook*." Of course, many other important issues that hold back the Indian economy such as public health, education, labour and land reforms come under State governments.

Need for Wider Reforms

Primary and secondary education are in a state of crisis with learning outcomes well below desired levels. Land acquisition is both costly and time-consuming. Conversion of land for non-agricultural use takes time and involves non-legal compensation in many jurisdictions. Doing business has to become easier for MSME in smaller cities and towns. State and local administrations have a big role to play in creating an enabling environment for water, power, drainage and sanitation facilities and access to ports for raw material and finished goods are provided by the state and local authorities. India cannot hope to attract investment – domestic and foreign – without taking care of the last mile issues conclusively. For that, a mission-mode approach to the economy is needed at all levels of the government for the next half decade, if not longer.

In the final analysis, these are challenging times for any leadership. Arm-chair critics, with the benefit of hindsight and without any skin in the game will be offering wisdom and criticising the government whichever way it decides. Therefore, the government must do its homework, have the courage of conviction and go about making decisions, after having availed of the best possible wisdom and experience. It should not hesitate to lean on retired distinguished civil servants in different domains. Even experts from across the aisle can be courted, as circumstances warrant. Bureaucrats will take their cue from political leadership. Risk-taking for the larger cause of nation's long-term future is necessary in these times. Open minds and larger hearts combined with some luck stand a better chance of getting India out of the current crisis than a conventional approach.