Opinion

Fiscal support can contain GDP contraction

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Stretching the fiscal deficit to 7-8% of GDP will provide room for expansion of capital expenditure to prop up govt demand

The recently released GDP data for the second quarter show that the real GVA and GDP contracted by (-) 7 per cent and (-) 7.5 per cent respectively. GDP contraction in two successive quarters of the fiscal 2020-21 confirms that the Indian economy has entered a 'technical recession'. In India's quarterly growth series, which the CSO started only from 1996-97, no contraction in any quarter has been seen. The lowest GDP growth at 0.24 per cent was in the fourth quarter of 2008-09 as per the 2004-05 base series.

With respect to annual data, there are five earlier years where a negative real GDP growth was observed — 1957-58 [(-) 0.4 per cent], 1965-66 [(-) 2.6 per cent], 1966-67 [(-) 0.1 per cent], 1972-73 [(-) 0.6 per cent], and 1979-80 [(-) 5.2 per cent] — as per the 2011-12 base series. It is difficult to say whether there were two consecutive quarters of negative growth in years such as 1965-66 or in 1979-80 since quarterly growth data are not available prior to 1996-97.

Thus, with respect to available data, contraction in two successive quarters has been experienced for the first time. This recession, however, may be reversed in the very next quarter if a positive growth can be ensured with adequate fiscal support.

Signals from Q2 growth

In the second quarter of 2020-21, both GDP and GVA growth numbers signal a faster-than-expected recovery. On the output side, apart from agriculture which continued its first quarter growth of 3.4 per cent into the second quarter, significant improvement was observed for five sectors — manufacturing, mining, electricity, gas and water supply *et al*, construction, and trade, hotels, transport and communication .

In the case of manufacturing, from a contraction of (-) 39.3 per cent in the first quarter, growth recovered to 0.6 per cent in the second quarter, showing an improvement of 39.9 percentage points. This improvement is largely due to a spike in demand linked with progressive exit from the lockdown of different States, easing supply constraints, and the release of pent up-demand.

Some of the incentive measures announced by the Finance Ministry in the second and third editions of the stimulus package may also have helped. The two remaining sectors, namely, financial, real estate and professional services, and public administration, defence and other services, have continued to struggle in the second quarter, showing a contraction of (-) 8.1 per cent and (-) 12.2 per cent respectively.

The former sector is expectedly Covid-affected. However, the performance of public administration, defence and other services, which is subject to policy intervention, has been quite disappointing. This sector performed worse than that in the first quarter when the contraction was (-) 10.3 per cent. This is the sector where stimulus policies were expected to arrest the contractionary momentum. Both the Central and State governments are responsible for this.

Disappointing contribution

Overall consumption demand, as reflected by growth in private and government final consumption expenditure has been quite weak. In the case of private final consumption expenditure, there was a contraction in both the first and the second quarters of the fiscal year respectively at (-) 26.7 per cent and (-) 11.3 per cent. This is to be expected as income has been falling.

In the case of government final consumption expenditure, there was a positive growth of 16.4 per cent in the first quarter which reversed to an unexpected and large contraction of (-) 22.2 per cent in the second quarter. Investment growth, as measured by gross capital formation, also contracted by (-) 47.5 per cent in the first quarter and by (-) 8.9 per cent in the second quarter.

Although export growth contracted in both quarters, import growth contracted even more, resulting in a positive contribution of net exports to GDP growth in the two quarters at 5.5 and 3.4 percentage points respectively.

Thus, there was an improvement in the second quarter as compared to the first quarter in all segments of demand except government final consumption expenditure where there was a sharp deterioration.

Growth prospects

The positive momentum of the manufacturing, construction, and trade, hotels, transport and communication *et al* sectors is likely to continue in the third and fourth quarters of 2020-21. We expect a small improvement in the third quarter growth and a larger improvement in the fourth quarter due to a strong base effect, and the likelihood of near full exit from the lockdown.

The base effect may be tangible particularly in manufacturing and construction which had experienced a contraction of (-) 1.4 and (-) 2.2 per cent respectively in the fourth quarter of 2019-20. In the case of the two large service sectors namely, trade, hotels, transport and communication *et al* and financial, real estate and professional services, growth rates although positive were quite low at 2.6 and 2.4 per cent respectively in the fourth quarter of 2019-20.

Accelerating fiscal expenditure

In order to ensure positive growth rates in the third and fourth quarters of 2020-21, fiscal support may play a crucial role. The Centre's tax revenues which contracted by (-) 16.8 per cent during the first seven months of 2020-21, should start turning positive December 2020 onwards when the extended tax return deadlines would be reached.

As far as fiscal deficit is concerned, the Centre's has touched 120 per cent of the annual budgeted target by October 2020. This amount is equal to ₹9.53 lakh crore, which is about 5 per cent of the estimated nominal GDP for 2020-21 as per the IMF.

The Central Government may consider stretching its fiscal deficit to 7-8 per cent of GDP this year. This will provide room for expansion of expenditure particularly capital expenditure to support the languishing government demand.

Full year growth

With a strong recovery expected in the fourth quarter of 2020-21 along with positive growth in the public administration, defence and other services sector, we expect the full year 2020-21 real GDP growth to be in the range of (-) 6 to (-) 7 per cent. Reduction in the first half of GDP at 2011-12 prices in 2020-21 as compared to the first half of 2019-20 is ₹11,15,897 crore, which is 7.66 per cent of the 2019-20 GDP.

If the Indian economy at least maintains the second-half GDP in 2020-21 at the level of last year, the full year contraction can be limited to about (-) 7.7 per cent.

If an increase can be brought about at least in the fourth quarter, GDP contraction in 2020-21 can be limited to the range of (-) 6 to (-) 7 per cent. This would be a clear improvement over the forecasts given by multilateral agencies such as the IMF which has forecast India's 2020-21 real GDP growth at (-) 10.3 per cent.

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