BUSINESS LINE
OCT 31, 2020.

Dilemmas in policy prescriptions

Policymakers who plead for increased govt spending to boost growth must spell out how high a fiscal deficit they can tolerate

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There has been a spate of suggestions on how to deal with the damage caused by Covid-19 on the Indian economy. While there is a general consensus that the situation warrants substantial increase in government expenditure, there are differences among analysts on the nature of expenditures and the quantum. Some analysts, including editorial writers, fail to take their policy prescriptions to the logical conclusions.

Expenditure types

In a situation like the present one which is marked by weak demand, the standard prescription offered by Keynesians is to raise government expenditure. The original Keynesian formula did not make any distinction between one type of expenditure and another. In a broad sense, this is true. In the present scenario, any increase in expenditures whether it be for healthcare or cash dole for the vulnerable groups or any other type, including what is described as 'stimulus', acts as a stimulus to the economy.

However, initially these expenditures have a differential impact. The motivation for each type of expenditure may also be different. Healthcare expenditures are needed to prevent the spread of the virus. Cash dole is recommended primarily from a humanitarian angle. Vulnerable groups including migrant labour need immediate relief. The primary reason for the cash dole is not stimulating demand.

Lack of demand is felt in sectors such as the hospitality sector which includes hotels and transport, real estate including housing and other industrial segments like automobile. Cash dole for the vulnerable groups will not take care of the weak demand for the products in these sectors. Industries plead for sector-specific relief.

Besides healthcare expenditure and relief measures, what is required is a sharp increase in capital expenditures of the government and public sector enterprises. They can lead to a general increase in demand through backward and forward linkages. An aggressive capital expenditure programme by the Centre and State governments is what is needed.

Quantum of expenditure

The quantum of expenditure is also related to its financing. One may not be concerned with this issue, if there is no problem with financing the expenditure. But this is hardly true. When analysts talk about increase in expenditure, they should have a fix on what the fiscal deficit will be and how it will be financed. In fact, the fiscal deficit depends upon the revenue of the government as well. This has taken a big beating.

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The Budget was based on the assumption that the nominal income will grow by 10 per cent. We would be lucky if the nominal income growth is in a positive range. DK Srivastava and I have estimated what the level of fiscal deficit would be on certain assumptions. In order for the Central Government to maintain the level of budgeted expenditure and also provide for additional stimulus, its fiscal deficit may have to be increased to close to an estimated 8.8 per cent of GDP.

Growth push An aggressive capital expenditure programme by the Centre and State governments is needed REUTERS

This consists of estimated revised budgeted fiscal deficit of about 4 per cent of GDP due to lower denominator value of GDP plus 2.5 per cent to make up for the shortfall in tax and non-tax revenues plus 2.3 per cent for the additionality over the budgeted expenditures in the already announced stimulus package including the recently announced first batch of supplementary demand for grants.

States' deficit will be 5 per cent of GDP. Adding the Centre's and States' fiscal deficit, the combined fiscal deficit amounts to 13.8 per cent of GDP. If the nominal GDP actually contracts in 2020-21, the fiscal deficit as a per cent of GDP would go up further. This is a distinct possibility as some of the latest forecasts point to a decline by 10 per cent of real output. This also does not take into account any additionality to borrowing because of GST compensation.

This is a large fiscal deficit and cannot be financed through normal channels of savings primarily from the household sector and inflows from abroad. The support of the RBI becomes inevitable. The monetisation of debt even if it is indirect has implications for the economy including that on inflation. The impact on inflation depends on a number of factors such as the extent of increase in reserve money and the size of the money multiplier which again depends on credit growth.

One can ask, given the current situation, what is the likelihood of a sharp increase in inflation. As indicated earlier, it depends very much on the growth in money supply. With all output forecasts bleak, the concern cannot be simply brushed aside or pushed under the rug. Policymakers and analysts who plead for increase in government expenditures must take a view on how high a fiscal deficit they are willing to tolerate.

Given the severity of the current situation, we may perhaps have to live in this year with a fiscal deficit of around 14 per cent of GDP. At the same time, we need to be conscious of the implications of such a high level of deficit in terms of its financing and the subsequent impact on inflation.

Lockdown and growth

There is also a concern how effective monetary policy and fiscal policy can be under the present circumstances. A substantial reduction in restrictions is a precondition for faster growth. The government will have to look at other alternatives to prevent the spread of virus.

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