Laying the foundation for faster growth

The decline in 2020-21 caused by the pandemic can be addressed only if the Indian economy grows at 8% in 2021-22

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The year that is shortly coming to an end has been an extraordinary one. In recent memory this is the first economic crisis that has been triggered by a non-economic factor. It is a pandemic, a novel coronavirus pandemic, which has literally brought the economy to a halt. The actions that have to be taken to prevent the spread of the virus such as the lockdown have impacted the economy severely. As the restrictions were slowly withdrawn, the economy has also started looking up. This can be seen very clearly from the performance of the Indian economy in Q1 and Q2 of 2020-21. In Q1, the economy declined by 23.9%; it declined by 7.5% in Q2, when the relaxations were eased.

At the dawn of the New Year 2021, several questions rise in our mind. How bad was the performance of the Indian economy in 2020-21? What are the prospects for 2021-22? What should the stance of monetary policy be in the coming months? What should the Budget to be presented by the central government in February 2021 focus on? Will the global environment for trade and investment improve and help India? What should be the medium-term focus including the role of reforms be?

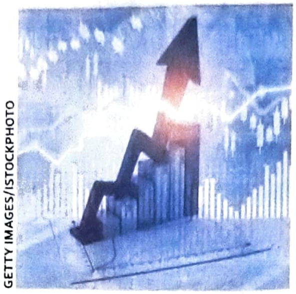
Performance in 2020-21

We now know the GDP numbers for the first half of 2020-21. Reductions in the first half of GDP at 2011-12 prices in 2020-21 as compared to the first half of 2019-20 is ₹11,15,879 crore which is 7.66% of the 2019-20 GDP. If the Indian economy at least maintains the second half GDP in 2020-21 at the level of the previous year, the full year contraction can be limited to about 7.7%.

Our estimate (by D.K. Srivastava and I) is that if there is an increase in GDP at least in Q4 if not in Q3, the overall contraction in 2020-21 can be be limited to the range of 6% to 7%. This of course would require a substantial pick up in government expenditure. There are many indicators such as collection of Goods and Services Tax (GST), improved output of coal, steel and cement and positive growth in manufacturing in October 2020 which point to better performance of the private sector. Of course, some segments of the economy such as the hospitality sector will take time to recover. Thus on the whole, it looks that the setback to the economy can be limited to minus 6% to minus 7%. Of course, this is a substantial improvement over the forecasts of some agencies such as the International Monetary Fund which had estimated the economy to decline by 10.3%.

What to expect in 2021-22

It is important to remember that if only if the Indian economy grows at 8% in 2021-22 will we be compensating for the decline in 2020-21. Thus, even with a strong growth of 8%, we will only be back to where the economy was at the end of 2019-20. The two years taken together cancel each other. Thus, it is imperative that the Indian economy grows at a minimum of 8% in 2021-22. This should be possible if by that time restrictions imposed because of COVID-19 are withdrawn and the nation goes back to a normal state. Some sectors can act as lead sectors or engines of growth. This is where increased government capital expenditures become relevant. The private sector seems to be revising its future prospects and many new issues in the capital market



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have met with good response. The global environment for trade and growth is an uncertain factor. Many developed countries are still struggling to find answers to COVID-19. Though vaccines may ultimately provide a solution, this may take time. The attitude to trade must also change. Closing borders may appear to be a good short-term policy to promote growth. But actually it kills growth all around. A strong surge in our exports will greatly facilitate growth, i.e. 2021-22. However, much of Indian's growth must rest on domestic factors. Growth must not only be consumption driven, but also investment driven. It is the latter which in a developing economy can sustain growth over a long period.

Monetary policy

The stance of monetary policy in 2020-21 has been extremely accommodative. The circumstances warranted it. Three major elements in the policy are: a reduction in interest rate through changes in policy rate; providing liquidity through various measures, and regulatory changes such as moratorium. There has been a substantial injection of liquidity into the system. According to the recent monetary policy statement, reserve money increased by 15.3% as of end November 2020. Money supply however grew by 12.5% because some of the injection of liquidity ended up in excess reserve. With a large injection of liquidity, one should expect inflation to remain high. In the final analysis, inflation is determined by overall liquidity or money supply in the system in conjunction with the availability of goods and services. While there may be sufficient justification for an accommodative monetary policy in a difficult year such as 2020, there will be need to exercise more caution as we move into the next year.

Fiscal initiatives

Government expenditures play a key role in a situation such as the one we are facing. The performance of the sector "Public Administration, Defence, and other services" which is subject to policy intervention is disappointing. In the second quarter of 2020-21, there was a contraction of this sector by 12.2%. The stimulus policies involving higher government expenditures were expected to arrest the contractionary momentum. On certain assumptions, we had earlier projected that the fiscal deficit of the Centre in 2020-21 would be 8% of GDP. With the slower momentum in government expenditures, perhaps the fiscal deficit of the Centre may be only 6% of GDP in 2020-21.

As indicated earlier, government expenditures should be speeded up from now on so that the contraction in the current fiscal year as a whole can be reduced. In 2021-22, government revenues should pick up with the rise in GDP. The process of bringing down the fiscal deficit must also start. This will still leave the government sufficient space for maintaining the expenditure at a reasonably high level. What is required is a sharp increase in government capital expenditures which can act as a stimulus for growth. A detailed investment plan of the government and public sector enterprises must be drawn up and presented as part of the coming Budget.

Growth and investment

Even as we combat the effects of COVID-19, we must lay the foundation for faster economic growth. A sad fact is that over the past decade, the investment rate has been falling. In 2018-19, the rate fell to 32.2% of GDP from 38.9% in 2011-12. Some of the recent measures including corporate tax rate changes may help in augmenting investment. A strong effort must be made to improve the investment climate. The National Infrastructure Pipeline is a good initiative. But the government must come forward to invest more on its own. We must also remind ourselves that the climate for investment is also influenced by non-economic factors of which social cohesion is most important.

Reforms are important in the context of rapid development. Recent controversies over reforms have shown that timing, sequencing and consensus building are equally important. Labour reforms, for example, are best introduced when the economy is on the upswing.

Many have cherished the idea of India reaching the status of a $5 trillion economy by 2025. But increasingly the idea is becoming a more distant goal. The Indian economy in 2019 was at around $2.7 trillion. To achieve the level of $5 trillion, we need to grow continuously at 9% for six years from now. That is the challenge before the economy. Jobs and employment will come from growth. They are not independent of growth. Will policymakers eschew other considerations and focus only on growth?

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