

Opinion | Demand stimulation, supply constraints and recession risks



The supply snap-off that saw firms forced out of business, migrant workers pushed back to their villages and chains of production disrupted will cause a secondary demand slump.4 min read . Updated: 19 Jun 2020, 06:57 AM IST **Sudipto Mundle**

Placing money in the hands of people could help save lives as our economy looks set to shrink this year and possibly the next

The coronavirus pandemic reached India late, giving us a chance to learn from the experience of countries where it had spread earlier. Drawing on that experience, an unprecedented country-wide lockdown was enforced on 25 March. The objective was to slow the spread of the virus and gain time to prepare adequately for its inevitable spread. It is not clear whether this time was well spent, because India's number of cases and, more importantly, the daily number of deaths are still rising—albeit at a slower pace than when the lockdown was implemented. Some states like Kerala have done very well. On the other hand, the rapid spread of the virus in Maharashtra, Gujarat, Delhi, Tamil Nadu and West Bengal is causing great concern.

Meanwhile, a huge price has been paid in terms of lost livelihoods, especially by millions of casual wage workers, migrant workers and the self-employed. At the National Council of Applied Economic Research, my colleagues and I have estimated that gross domestic product (GDP) declined by about 25% in the first quarter of 2020-21, compared to the same period in 2019- 20. This is also consistent with a steep increase in unemployment in April and May estimated by the Centre for Monitoring Indian Economy. However, the surveys also indicate a strong recovery of employment as the lockdown was wound down earlier in June.

Against this backdrop, it is important to assess what the government has done to stimulate an economic recovery. The dominant narrative is that it

has not done nearly enough to stimulate demand. This derives from the way the government communicated its stimulus policies. These were presented as a ₹20 trillion “aatmanirbhar” package announced on 13 May, with details spelt out subsequently by finance minister Nirmala Sitharaman. A part of the package comprises structural reforms in agriculture and other sectors, which, however desirable, will pay off only in the medium- to long-term and will do little for an immediate recovery. Another major chunk of the package consists of liquidity infusion measures by the Reserve Bank of India (RBI) and government credit guarantees to incentivize banks to extend credit, especially to micro, small and medium enterprises (MSMEs), which have been the worst hit by the lockdown. The assistance directly provided by the government, or the fiscal component of the package, amounts to only about ₹2.6 trillion, or roughly 1.3% of GDP. This was quite a communication failure. Analysts and media quickly focused on the fact that what had been hyped as a stimulus package of over 10% of GDP actually involved fiscal spending of just over 1% of GDP.

The Central government would have been better advised to focus not just on the aatmanirbhar package, but also on the substantial fiscal stimulus measures that had been announced earlier. The 2020-21 budget, for instance, had provided for a demand-stimulating fiscal deficit of 3.5% of GDP. Then, when it became evident that the lockdown would lead to a steep fall in revenues, additional borrowings of ₹4.2 trillion, or 2.1% of GDP, were announced to preserve the budgeted expenditure. Without this, the demand shock would have been that much more severe. In addition, states taken together are running a fiscal deficit of 2.8% of GDP in their budgets, which further helps preserve aggregate demand. The central government has also allowed additional borrowing by the states of up to 2% of gross state domestic product. Unfortunately, states may not be able to use this extra headroom because it comes with tough reform conditions. All this adds up to a demand-stimulating combined fiscal deficit of about 9.7% of GDP; nearly 11.7% if we also count the additional borrowing headroom for states. On the monetary policy front, RBI had provided for

liquidity infusion of over 4% of GDP prior to the *aatmanirbhar* package. The government guarantees—part of the package and aimed at incentivizing bank-lending to small businesses and vulnerable groups—amount to another 4% of GDP.

The demand generated by these large fiscal stimulus and liquidity injection measures could potentially revive the economy. But this may be pre-empted by supply constraints: businesses that have shut down, disrupted supply chains, and the reverse migration of migrant workers. Further, what appears as a supply constraint at one stage may re-appear as a demand constraint at the next stage in the circular chain of economic transactions. Thus, a recession is virtually unavoidable in 2020-21, possibly stretching into 2021-22. The most urgent step now for central and state governments is to provide income support to vulnerable households—through enhanced PM-Kisan and Mahatma Gandhi National Rural Employment Guarantee Act allocations in rural areas, as well as a similar employment guarantee scheme in urban areas or a universal income support scheme. These will help preserve lives during the recession. It will also have a strong income multiplier effect because of the high consumption propensity of the poor.

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