Navigating the narrow passage between recovery and inflation

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The new MPC has done well but it would take game-changing reforms for our economy to regain its pre-covid trend growth

The new monetary policy committee (MPC), which submitted its first report last Friday, has started well. Faced with an unprecedented crisis, a steep gross domestic product (GDP) contraction of 24% in the first quarter of 2020-21, along with inflation rising above the Reserve Bank of India's (RBI) tolerance band to nearly 7% , the MPC chose to navigate a cautious path between stimulating economic recovery and containing inflation. It has maintained all its policy rates, including its repo rate (held at 4%), to contain inflation. Meanwhile, RBI has taken several measures to ease liquidity, lower the yield on the benchmark 10-year government security (G-Sec), and lower the private sector's cost of borrowing, to stimulate economic activity. The MPC and RBI have correctly judged that elevated inflation is a transient phenomenon, driven largely by supply-side disruptions during the lockdown. Given the exceptional circumstances, they have focused on the steep economic contraction rather than their principal mandate of containing inflation. (I should disclose here that MPC member Shashank Bhide is my colleague at the National Council of Applied Economic Research, or NCAER).

Going forward, RBI has forecast that the economy's contraction will moderate in the months ahead, with growth turning positive by the fourth quarter (Q4) of 2020-21, but annual GDP will still decline by 9.5% this year compared to 2019-20. Official projections are typically over-optimistic, which helps anchor expectations positively. This is understandable. Hence, a 9.5% contraction forecast suggests that RBI has internally considered a double-digit contraction. Governor Shaktikanta Das has hinted as much, mentioning there are downside risks to this forecast. A 9.5% contraction is nevertheless a bold projection. It provides a compelling official rationale for deploying both monetary and fiscal policy to revive the economy.

At the NCAER, we had assessed by 17 May that GDP would contract by 26% (NCAER Quarterly Economic Review: 2020-21) in this fiscal year's first quarter (Q1). It was later confirmed that the economy indeed contracted by nearly 24%. We are now forecasting that while the economy has been recovering since Q2, output levels are still much lower than in the same period last year. The year-on-year contraction will moderate from -23.9% in Q1 of 2020-21 to -12.7% in Q2, -8.6% in Q3, -6.2% in Q4, resulting in -12.6% for the whole year (NCAER Quarterly Economic Review 2020-21 Q2, 25 September 2020). This moderation in the relative contraction from -23.9% in Q1 to only -6.2% in Q4 actually marks a very sharp recovery, the so-called “bow string effect" of the steep decline to a very low base in Q1. It accounts for the many references to a V-shaped recovery. But it also implies that the annual real GDP level in 2020-21 will be 12.6% lower than the real ₹146 trillion GDP of 2019-20.

The key question is how the economy will perform from there on. To assume that real GDP will reach its 2019-20 peak of ₹146 trillion even by the end of 2022-23 would imply a swing in the year-on-year growth rate from -12.6% this year to 7% next year, a positive growth swing of about 20%, followed by a 7% growth again in 2022-23. Nothing like this has ever been seen in India's growth history. It is more likely that the 2019-20 real GDP level of ₹146 trillion will be reached again only in 2023- 24. But assuming very optimistically that it is reached again by the end of 2022-23, thanks to the very low base affect of 2020-21, and assuming even more heroically that the 7% growth path will be maintained over the long-term beyond 2022-23, the NCAER Q2 review demonstrated that we would catch up with the output level of a counterfactual “no pandemic" trend growth path of 5.8% only by 2039-40. Of course, to assume that the Indian economy can quickly recover from a 12.6% contraction and continue to grow at 7% per year for the next 20 years is just a pipe-dream.

The purpose of all this growth arithmetic is to make the simple point that the long-term effects of a major economic shock, or economic hysteresis, is really very long lasting. So, narratives about the Indian economy soon getting back to a high growth path are unwarranted if not irresponsible. To achieve a new normal of even 5-6% trend growth would be quite challenging. Despite a combined fiscal deficit of nearly 14% of GDP, factoring in the 12 October stimulus package, plus extra-budgetary borrowing plus liquidity infusion of around 9% of GDP, such conventional stimulus policies are unlikely to get the economy back to that growth path. That would require deep economic reforms across a wide front, no less far reaching than 1991's game-changing reforms.

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