Covid's aftershocks: Why we need wide-ranging reforms now

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Likely hysteresis and a closing demographic window make a case for wide-ranging reforms to sustain high economic growth

Post-covid scenarios chalked out by NCAER indicate that effects of this shock will persist for a long time and we can't expect a quick return to our pre-pandemic growth path even in the most optimistic of recovery cases

No one really knows what the long-term consequences of the covid pandemic will be. From the experience gained in India and abroad, epidemiologists and doctors have learnt a great deal about how the virus behaves, how to contain its spread, and how to treat infected persons. But they know little about the long-term health consequences of covid infection simply because enough time has not passed to observe such consequences. However, this column is not about the epidemiological and health consequences of the pandemic, but it's possible long-term economic consequences for India.

The seductive symmetry of V-shaped growth curves that often follow an adverse economic shock induces many analysts to quickly pronounce after a shock that the economy is bouncing back. However, such curves that simply reflect the 'bowstring' effect of a negative shock can be quite misleading. A strong upswing may follow a sharp contraction, but all it means in terms of levels is that the economy is getting back to where it was before the shock. In the present case, most forecasts have suggested that the Indian economy will grow by about 8% to 10% during 2021-22. This implies the economy will be more or less back to the level where it was in 2019-20, about ₹146-149 trillion at constant (2011-12) prices. Two years have been lost to the pandemic.

But where will the economy go from there? In a recent exercise at the National Council of Applied Economic Research, we have looked at a few possible scenarios and their long-term implications, benchmarked against a counterfactual growth path the economy might have followed had there been no pandemic. These exercises reveal hysteresis—effects of the pandemic shock that will persist for a very long time.

In the optimistic scenario, it is assumed that after recording a growth of over 10% this year, the economy will continue to grow at a high trend rate of 7%. Even in this scenario, the economy catches up with the ‘no pandemic’ growth path only by 2029-30. In the pessimistic case, it is assumed that because of a third covid wave, a weak policy response to it and inadequate macroeconomic stimulus, the economy will grow at 8.4% this year, then settle down to a low steady state growth path of 4.5%, increasingly falling behind the ‘no pandemic’ growth path. A third intermediate scenario assumed that effective management of the third wave and appropriate expansionary macroeconomic policies would enable the economy to settle at the pre-pandemic trend growth path of 5.8% after growing at 8.4% in the current year. Despite this, the intermediate path will always lag behind the ‘no pandemic’ path because of the two lost years.

Apart from the long-lasting adverse effect of the pandemic, the other main takeaway is that the economy can only get back to its pre-pandemic growth path at high growth rates of around 7% or more. Two points are important to note in this regard. Even at this high growth rate, the catch-up will only happen by the year 2029-30. This is also the year when our low demographic dependency ratio will bottom out, implying that the narrow window for India’s so-called demographic dividend will start closing.

That leaves just a few years to take advantage of this potential dividend. That will entail, first, a complete reform of our dysfunctional basic education system to improve learning outcomes. That alone will enable secondary school graduates to acquire skills that can make them employable. It will also require a more effective skilling programme, driven by potential employers even if it is publicly financed and, finally, rapidly growing employment opportunities to absorb the large slack of unemployment and underemployment. Absent these prerequisites, the demographic dividend will turn into a disaster, as has often been pointed out.

The other point is that a high trend growth rate of 7% or more can only be sustained through an ambitious, wide ranging 1991-like reform programme to offset the adverse effects of the two-year pandemic shock. The first priority for this in present conditions is a complete overhaul of the network of primary health centres, which is the base of our public healthcare system. While this administrative foundation exists, it is non-functional in many states. Hopefully, the present crisis will motivate the central and state governments to urgently introduce this reform. The urgency of also reforming our basic education system and skilling programmes has already been mentioned.

A third urgent area of reform is the fragile financial sector. As the latest Financial Stability Report (FSR) points out, the gross non-performing assets (GNPA) ratio has not deteriorated further in 2021. But this has happened only because of regulatory forbearance by the Reserve Bank of India on account of covid. The FSR stress tests indicate that even in its base case, the GNPA ratio is likely to rise to nearly 10% by March 2022. In a severe stress case, it could rise to over 11%. The power sector, especially the distribution system in states, is another constraint that requires urgent reform attention, even as we start a long journey of transformation from high-carbon fossil fuels to renewable energy. Finally, the regressive return to discretionary tariff hikes and other protectionist trade policy measures needs reversal if the country wishes to successfully compete in global markets.

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