The long road to recovery that lies ahead for India’s economy

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Loose monetary and fiscal policies can’t be sustained for long and we need comprehensive structural reforms to drive growth

The coronavirus death toll in India has crossed 50,000 and is still rising, though at a declining rate. The growth in daily deaths has slowed from 20% in early April to less than 2% now. The recovery rate is also rising, while the mortality rate is declining. A vaccine will probably be available for mass immunization by early next year. The worst of the pandemic seems behind us. It is time now to turn to repairing the economy.

Estimates of the gross domestic product (GDP) decline in 2020-21 vary from 1% to over 15%. My assessment is of a 5% contraction, a number on which there seems to be fairly wide agreement. The April-June quarter was the worst affected. Year-on-year output is still declining, but at a slower rate. The decline will probably taper off by the fourth quarter. Output will then start recovering. After a brief sharp turn-around, the recovery path is likely to stretch into a long pan handle as we approach the previous peak output level of 2019-20. Available data on leading indicators such as non-food credit, power consumption, industrial production, employment, goods and services tax collections and production managers’ expectations all point in this direction. This year and the next are lost years. Only at the end of 2021-22 will output be back to where it was at the end of 2019-20. India’s growth performance after that will depend on the policies that are pursued during the next year and a half. The options depend on where we are today.

The combined fiscal deficit this year, correctly measured, will likely amount to 10.5% of GDP, or 12.5% if we also count the additional borrowing headroom allowed to states. The total public- sector borrowing requirement, including the

borrowings of public undertakings, will be around 14-15% of GDP. Taken together with liquidity infusion of nearly 9% of GDP, this amounts to a massive aggregate demand stimulus. How much of this will translate into a recovery of output and how much to higher inflation would depend on supply-side constraints. Most analysts have focused on the current recession, and some have even raised fears of deflation. But in my Mint column (Demand stimulation, supply constraints and recession risks) of 19 June 2020, and elsewhere, I have been pointing to the risks of stagflation, i.e., a recession combined with rising inflation. Unfortunately, that assessment has turned out correct. Along with a sharp decline in GDP, headline inflation has risen to almost 7%, well above the Reserve Bank of India's (RBI's) tolerance band, and food inflation is close to 10%.

Hence, India's expansionary fiscal and monetary policies will have to be gradually reined in, reverting to fiscal compression and a tight money policy by 2022-23. The external environment is also unlikely to stimulate high growth without a strong reversal of the pandemic-led global recession and continuing geopolitical tensions. The country's current account balance had temporarily turned into a surplus because, along with low oil prices, declining GDP had led to a sharp decline in imports. However, as the recovery proceeds, imports will rise, leading again to a trade deficit and a negative net impact on aggregate demand (*i.e.*, aggregate domestic demand + exports - imports). Given this context, the only viable strategy for a return to sustainable growth of 7% or more in the medium to long term is to stimulate investment and business confidence through the resumption of long-pending structural reforms.

Space limitations prevent my getting into the details, but a priority list of such reforms is as follows. The top priority is the financial sector. Bringing public sector banks under the exclusive regulation of RBI and reducing public ownership to less than 50% are necessary but not sufficient reforms, as the private sector scams at Yes Bank, IL&FS, etc. have shown. Strengthening the supervision of both banks and non-bank finance companies is key to cracking the non-performing assets problem. Second, fiscal reforms should include a sharp reduction in tax concessions and exemptions, a policy reversal on discretionary ad hoc tariffs, elimination of non-

merit subsidies, and a progressive shifting of central and state government expenditure towards education, health and physical infrastructure. Third, in the power sector, the core reform required is privatization of distribution. The experience of states like Delhi can serve as templates for others. Fourth, India needs to abolish regulations that dis-incentivize the growth of small and medium enterprises, such as the Factories Act. This is essential for rapid growth of employment in industry and services. Fifth, public enterprise reform. This has proven intractable, but state-run firms should either win or wither in fair competition with private enterprises without repeated capital infusions at the cost of taxpayers. Sixth, in agriculture the key requirement is to reform the marketing system to narrow the huge margins between what consumers pay and farmers earn.

Apart from economic reforms, the quality of our governance institutions, the legislature, executive and judiciary, also impinge on economic performance. Strengthening these is essential to sustain high growth. Finally, reforms are to be seen as a process, not an event. Past experience in China, India and elsewhere suggests that it could take up to a decade for the process to work itself out and return us to a path of high growth.

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