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COVID-19 AND INDIA'S FISCAL CONUNDRUM

Relevant for: Indian Economy | Topic: Issues relating to Planning & Economic Reforms

As the COVID-19 pandemic continues to **ravage economies** across the world, policymakers are desperately seeking effective ways to mitigate its economic effects. The immediate future appears dire for large emerging markets including India, which recently saw its growth forecast for 2020 slashed by the **International Monetary Fund (IMF) to 1.9%** from the previously estimated 5.8%. In April, the World Bank estimated that India would grow 1.5% to 2.8% in 2020-2021, the lowest since the start of the 1991 economic reforms. Dim as these projections are, what is of concern is that these are already starting to look overly optimistic considering that India has extended the lockdown.

Given the severity of the crisis, the Reserve Bank of India (RBI) has responded proactively and aggressively to ease liquidity concerns although the credit easing policy does not seem to have been transmitted yet to many firms. It has also granted regulatory forbearance relating to asset classification to support economic activity, though some socialisation of losses might be inevitable over time.

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In contrast, the Indian government's fiscal stimulus efforts have paled in comparison to the rest of the world's initiatives. India's fiscal stimulus to date, estimated at 1.7 trillion, is less than 1% of the country's GDP, which is paltry compared to the magnitude of stimulus injections undertaken by many East Asian countries such as Japan (20%), Malaysia (16.2%) and Singapore (12.2%).

With the Indian economy in the ICU, there has understandably been a lot of criticism regarding the gross inadequacy of the government's fiscal response to date. Several observers have emphasised the need for India to roll out a revival package of at least 5% of the GDP (10 trillion) to support the health and economic well-being of the most vulnerable (slum dwellers and migrant workers) as well as micro, small and medium-sized enterprises (MSMEs).

Some other lower-income countries have been reluctant to impose nationwide lockdowns as they recognise that this policy works best in countries that are sufficiently well endowed to offer appropriate compensatory resources to the most vulnerable.

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While the case for an aggressive fiscal stimulus is clear in these exceptional circumstances, the options to finance it do not appear to be straightforward. On the one end, most advanced economies can manage such financing by issuing bonds given their global demand. On the other, over 50 struggling low-income countries with limited resources to tackle the crisis have turned to the IMF for help. The G7 countries have in principle agreed to offer debt relief to low-income countries by suspending their debt service payments.

The ones caught in between are mostly the middle-income emerging markets in Asia and elsewhere, like India. To date, the Asian Development Bank and the World Bank have committed to offering relief packages worth $1.5 billion and $1 billion, respectively, to India, while there are reports that the country has sought further multilateral assistance from the Asian Infrastructure Investment Bank. While certainly helpful, these would be a drop in the bucket as such assistance can at best only be supplementary to the larger underlying stimulus package that India may need to roll out. However, with a government debt of around 72% of GDP, which

is comparatively higher than all other emerging markets in the region, India's fiscal room to opt for a massive stimulus appears much more limited. Any aggressive stimulus spending will not only result in a surge in India's gross public debt but will also negatively impact its credit ratings, highlighting the country's fiscal conundrum.

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Even if the Fiscal Responsibility and Budget Management constraints are relaxed, given India's limited demand for domestic bonds, there is a need to seek capital flows to finance its additional stimulus by encouraging foreign investment in government securities. However, it is unclear how much the recently liberalised norms in this area will be of help, given the heightened risk aversion and short-term capital outflows from India and other emerging markets. In fairness to the government though, other large middle-income Asian emerging markets like Indonesia have also lagged in their fiscal response, despite being hard-hit by COVID-19.

Some richer countries in the Asian region like Singapore have managed to tap into their deep reserve kitty benefiting from the significant role played by their sovereign wealth funds. While India does not have that luxury, it has been suggested that some of the country's $476 billion of foreign exchange (FX) reserves be used towards this purpose. However, this is an extremely risky option in light of India's sizeable current account deficits and heavy dependence on short-term capital inflows. Given the likely pressure on its balance of payments moving forward, utilising FX reserves does not seem to be viable at the moment.

A radical financing option would be to monetise the deficits by allowing the RBI to print money to buy the government bonds as long as inflation remains under check, though this might set a dangerous precedent (something the RBI stopped doing in 1997) moving forward. India has worked hard to move away from such money-financed fiscal stimulus polices that led to weak budget constraints and macroeconomic instability.

Although it is important to do whatever it takes to moderate the meltdown, offer disaster relief and eventually kick-start the economy, there are valid concerns that unless there is proper governance of any massive fiscal spending, even a very well-intentioned policy may end up doing more harm than good. Even countries like China have been guarded in their fiscal responses so far. In China, this was partly to avoid a rise in its shadow banking activities, which turned out to be one of the perverse side-effects of its massive stimulus post the global financial crisis.

Countries with higher initial public debt levels like India need to be particularly concerned as they also happen to possess the least state capacity to make tough decisions to return to a trajectory of fiscal credibility. This crisis has made clear the critical importance for countries to build adequate fiscal space to manage future economic distresses. Given the acute constraints on fiscal policy in India, there is clearly a need to start re-prioritising expenditures away from low-priority, unproductive areas towards greater spending on health and social safety nets for low-income households.

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