C RANGARAJAN

&

D K SRIVASTAVA

PRESENT

Growth, Fiscal Policy and Monetary Policy of India

Why and how to overcome economic shocks?

#2305

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Why and how to overcome economic shocks?

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#2305

Contents

B. Fiscal Policy

C. Monetary Policy

Introduction

This is a compendium of articles written by Dr Srivastava and me in various newspapers since 2020. The cutoff date marks the advent of COVID-19. The economic crisis that followed was the first one in recent memory triggered by a non-economic factor. Our collection focuses on growth, fiscal policy and monetary policy. We have not included articles that we had written on other subjects.

In the section on Growth, the first few articles deal with the economic consequences of COVID-19. Beyond that, the focus is on recovery from the pandemic, prospects for growth in the short term and finally the long-term growth prospects and strategy. We stress the point that growth started declining even before COVID-19 and that there has been a steady fall in the Gross Fixed Capital Formation rate. The need, therefore, is to raise this rate, if a sustained growth of 6 to 7 per cent is to be achieved.

Public investment started increasing during the COVID period and it has been sustained since then. This is a good sign. But for growth to be maintained over the medium term, investment by the business sector, both corporate and non-corporate, must increase. But the global situation is not encouraging. There could be a secular decline in the growth rate of developed countries. Also, for global trade to pick up, there should be a change in the attitude of some of the leading developed countries. The potential for India to grow at 7 per cent exists. We need an appropriate strategy to quicken the pace of investment.

The second section deals with fiscal policy. Apart from discussing specific actions like Budget announcements, we take the position in several articles that stability is critically important for sustained growth and that fiscal consolidation must go along with measures to stimulate growth. The very high fiscal deficits during the COVID period must be an exception. In the context of the changed circumstances, a new glide path for fiscal consolidation must be enunciated and there is considerable logic in fixing the desirable level of fiscal deficit for the centre at 3 per cent of GDP and another 3 per cent of GDP for all states together. Household sector savings in financial assets is an important factor in determining these rules.

The third section deals with Monetary Policy. The major point that is being made through various articles is that Reserve Money and therefore money supply plays an important role in determining inflation. In more than one article, I stress that there is a difference between the determination of individual prices and general price level. Inflation cannot be sustained without an adjustment in a macro variable like Reserve Money. As early as 2020 in an article (Devil, Us, the Deep Blue Sea), it was pointed out that the massive increase in fiscal deficit which is supported by the central banks cannot but lead to an increase in prices.

This foreword is intended first to give a flavour of the articles that have been put together. I am thankful to CUTS for making these articles available to a wider audience through this e-compendium.

Dr C Rangarajan
Former Chairman
Economic Advisory Council to the Prime Minister
Former Governor, Reserve Bank of India

A. Growth

1. Dressing a Wounded Economy

C Rangarajan
The Hindu March 26, 2020

The two major tools that the government has available before it is monetary policy and fiscal actions

The impact of coronavirus is now felt by almost every country. First, there are the health effects of the virus and second the economic impact of the various actions that have to be taken to combat the virus. The world is experiencing an additional slowdown on top of the contracting tendencies already present and India is no exception.

The economic impact on India can be traced through four channels (1) External Demand (2) domestic demand (3) supply disruptions and (4) financial market disturbances.

External Demand

As the economies of the developed countries slow down (some people even talk of recession), their demand for imports of goods will go down and this will affect our exports which are even now not doing well. In fact, after six months of negative growth, it was only in January that Indian exports showed positive growth. The extent of the decline will depend on how severely the other economies are affected.

Not only merchandise exports but also service exports will suffer. Besides the IT industry, travel, transport and hotel industries will be affected. The only redeeming feature in the external sector is the fall in oil prices. India's oil import bill will come down substantially. But this will affect adversely the oil-exporting countries which absorb Indian labour. Remittances may slow down.

Domestic Demand

To ward off the spread of coronavirus, there is a literal lockdown of the country. As passengers travel less, the transportation industry - road, rail and air - is cutting down schedules sometimes drastically. This will affect in turn several other sectors closely related to them Lay of non-permanent employees has already started. As people in general buy less, shops stock less which in turn affects production. Perhaps retail units will be first affected and they will in turn transmit this to the production units.

One is unable to estimate the reduction in economic activity at this point. If the situation is not reversed soon, there can be a serious decline in the growth rate during 2020-21.

Supply Disruptions

Supply disruptions can occur because of the inability to import or procure inputs. The break in the supply chain can be severe. It is estimated that nearly 60 per cent of our imports is in the category of 'intermediate goods' Imports from countries which are affected by the virus can be a source of concern. The domestic supply chain can also be affected as the interstate movement of goods has also slowed down.

Financial Market Disturbances

Financial markets are the ones which respond quickly and irrationally to a pandemic like corona. The entire reaction is based on fear. The stock market in India has collapsed. The indices are at a three-year low. Foreign Portfolio Investors have shown great nervousness and the haven doctrine operates. In this process, the value of the rupee in terms of dollars has also fallen. The stock market decline has a wealth effect and will have an impact on the behaviour of particularly high-wealth holders.

How does the government deal with this sudden decline in economic activity which has come at a time when the economy is not doing well? The two major available tools are monetary policy and fiscal actions.

Monetary Policy

Monetary Policy in a situation like this can only act to stimulate demand by a greater push of liquidity and credit. The policy rate has already brought donors by 135 basis points over the last several months. There is scope for further reduction. But our history as well as the experience of other countries clearly show that beyond a point a reduction in interest rates does not work.

It is the environment of the overall economy that counts. Credit may be available. But there may not be takers. You can take the horse to the pond but cannot compel it to drink. Any substantial reduction in policy rate can also affect savers. Interest is a double-edged sword.

Reserve Bank needs to go beyond cutting policy rates. A certain amount of regulatory forbearance is required to make the banks lend. Even commercial banks on their own will have to think in terms of modifying norms they use for inventory holding by production units. Repayments to banks can be delayed and the authorities must be willing to relax the rules.

Any relaxation of rules regarding the recognition of non-performing assets has to be across the entire business sector. The authorities must be ready to tighten the rules as soon as the situation improves. This is a temporary relaxation and must be seen as such by banks and borrowers.

Fiscal Actions

Fiscal actions have a major role to play. Once again, the ability to play a big role is constrained by the fact that the fiscal position of the government of India is already difficult. Even without the coronavirus, the fiscal deficit of the central government will turn out to be higher than that indicated in the budgets for 2019-20 and 2020-21. Revenues are likely to go down further because of the virus-related slowdown in economic activity.

In this context, the ability to undertake big-ticket expenditures is constrained. But there are some ‘musts’. The virus has to be fought and brought down. All expenditures to test (there is some concern that the extent of testing that we are doing now is low) and to take care of patients must be incurred. Now that private hospitals are allowed to test, the cost of the people going to private hospitals must also be met by the government. The involvement of private hospitals has become necessary.

It is mentioned that a test costs ₹4500. The total cost can be substantial if the numbers to be tested run in thousands and more. This may sound exaggerated. But we must be prepared so that we avoid the tragedy of Italy.

Therefore, the priority is to mobilise adequate resources to meet all health-related expenditures including the supply of accessories like masks, sanitiser and materials for tests. The challenge is not only fiscal but also organisational.

Serious concerns have been expressed about people who have been thrown out of employment. These are mostly daily wage earners and non-temporary employees. Some of the migrant labour have gone back to their home states. We must appeal to the business units to keep even non-permanent workers on their rolls and provide them with a minimal income.

Some relief can be thought of by the government for such business units even though this can be misused. However, in general, in the case of sectors such as hotels and travel, the government can give relief through deferment of payments of dues to the government.

There is also talk of providing cash transfers to individuals. There is already a programme for rural farmers with all the limitations. For a system of cash transfers to be workable, it has to be universal. At this moment when all the energies of the government are required to combat the virus, instituting a system of universal cash transfer will be a diversion of efforts. The burden on the government will depend upon the quantum of per capita cash transfers and the length of the period.

As mentioned earlier government should advise all business units not to retrench workers and provide some relief to them to maintain the workers. A supplemental income scheme for all the poor can be thought of once the immediate problem is resolved. Provision of food and other essentials must be made available to the affected as is done at the time of floods or drought. States must take the initiative.

The fiscal deficit is bound to go up substantially. The higher borrowing programme will need the support of RBI if the interest rate is to be kept low. The monetisation of the deficit is inevitable. The strong injection of liquidity will store up problems for the next year. Inflation can flare up. The government needs to be mindful of this. All the same, the government must not stint and go in a massive way to combat the virus. This is the government's priority.

2. Laying the Foundation for Faster Growth

C Rangarajan
The Hindu, December 21, 2020

The decline in 2020-21 caused by the pandemic can be addressed only if the Indian economy grows at 8 per cent in 2021-22

The year that is shortly coming to an end has been an extraordinary year. In recent memory, this is the first economic crisis that has been triggered by a non-economic factor. It is a pandemic which has brought the economy to a halt. The actions that have to be taken to prevent the spread of the virus such as lockdown have impacted the economy severely.

As the restrictions were slowly withdrawn, the economy also started looking up. This can be seen very clearly from the performance of the Indian economy in Q_1 and Q_2 of 2020-21. In Q_1 the economy declined by 23.9 per cent and it declined by 7.5 per cent in Q_2, when the relaxations were eased.

At the dawn of the New Year 2021, several questions rise in our minds. How bad was the performance of the Indian Economy in 2020-21? What are the prospects for 2021-22? What should be the stance of monetary policy in the coming months? What should the Budget to be presented by the central government in February 2021 focus on? Will the global environment for trade and investment improve and help India? What should be the medium-term focus including the role of reforms?

Performance in 2020-21

We now know the GDP numbers for the first half of 2020-21. Reductions in the first half of GDP at 2011-12 prices in 2020-21 as compared to the first half of 2019-20 is ₹11,15,879 crore which is 7.66 per cent of 2019-20 GDP. If the Indian economy at least maintains the second-half GDP in 2020-21 at the level of the previous year, the full-year contraction can be limited to about 7.7 per cent.

D.K. Srivastava and I had estimated that if there is an increase in GDP at least in Q_4 if not in Q_3, the overall contraction in 2020-21 can be limited to the range of 6 per cent to 7 per cent. This of course would require a substantial pick-up in government. expenditure. There are many indicators such as the collection of GST, improved output of coal, steel and cement and positive growth in Manufacturing in October 2020 which point to better performance of the private sector.

Of course, some segments of the economy such as the hospitality sector will take time to recover. Thus on the whole it looks that the setback to the economy can be limited to (-) 6 per cent to (-) 7 per cent. Of course, this is a substantial improvement over the forecasts of some agencies like IMF which had forecast the economy to decline by 10.3 per cent.

Prospects for 2021-22

What can we expect in 2021-22? It is important to remember that if only the Indian economy grows at 8 per cent in 2021-22 will we be compensating for the decline in 2020-21. Thus even with a strong growth of 8 per cent, we will only be back to where the economy was at the end of 2019-20. The two years taken together cancel each other. Thus, the Indian economy must grow at a minimum of 8 per cent in 2021-22. This should be possible if by that time restrictions imposed because of COVID-19 are withdrawn and the nation comes back to a normal state.

Some sectors can act as lead sectors or engines of growth. This is where increased government capital expenditures become relevant. The private sector seems to be revising its prospects and many new issues in the capital market have met with good responses. The global environment for trade and growth is an uncertain factor. Many developed countries are still struggling to find answers to COVID-19.

Though vaccines may provide the ultimate solution, this may take time. The attitude to trade must also change. Closing the borders may appear to be a good short-term policy to promote growth. But actually, it kills growth all around. A strong surge in our exports will greatly facilitate growth i.e. 2021-22. However, much of India's growth must rest on domestic factors. Growth must not only be consumption-driven but also investment driven. It is the latter which in a developing economy can sustain growth over a long period.

Monetary Policy

The stance of monetary policy in 2020-21 has been extremely accommodative. The circumstances warranted it. Three major elements in the policy are a) a reduction in interest rate through changes in the policy rate, b) providing liquidity through various measures and c) regulatory changes like moratorium. There has been a substantial injection of liquidity into the system.

According to the recent monetary policy statement, reserve money increased by 15.3 per cent as of the end of November 2020. Money supply however grew by 12.5 per cent because some of the injection of liquidity ended up in excess reserve. With a large injection of liquidity, one should expect inflation to remain high.

In the final analysis, inflation is determined by overall liquidity or money supply in the system in conjunction with the availability of goods and services. While there may be sufficient justification for an accommodative monetary policy in a difficult year like 2020, there will be a need to exercise more caution as we move into the next year.

Fiscal Policy

Government expenditures play a key role in a situation like the one we are facing. The performance of the sector "Public Administration, Defence, and other services" which is subject to policy intervention is disappointing. In the second quarter of 2020-21, there was a contraction of this sector by 12.2 per cent. The stimulus policies involving higher government expenditures were expected to arrest the contractionary momentum.

On certain assumptions, we had earlier projected that the fiscal deficit of the centre in 2020-21 would be 8 per cent of GDP. With the slower momentum in government expenditures, perhaps the fiscal deficit of the centre may be only 6 per cent of GDP in 2020-21. As indicated earlier, government expenditures should be speeded up from now on so that the contraction in the current fiscal year as a whole can be reduced.

In 2021-22, government revenues should pick up with the rise in GDP. The process of bringing down the fiscal deficit must also start. This will still leave the government sufficient space for maintaining the expenditure at a reasonably high level. What is required is a sharp increase in government capital expenditures which can act as a stimulus for growth. A detailed investment plan for the government and public sector enterprises must be drawn up and presented as part of the coming Budget.

Growth and Investment

Even as we combat the effects of COVID-19, we must lay the foundation for faster economic growth. A sad fact is that over the past decade, the investment rate has been falling. In 2018-19, the rate fell to 32.2 per cent of GDP from 38.9 per cent in 2011-12.

Some of the recent measures including corporate tax rate changes may help in augmenting investment. A strong effort must be made to improve the investment climate. The National Infrastructure Pipeline is a good initiative. But the government must come forward to invest more on its own. We must also remind ourselves that the climate for investment is also influenced by non-economic factors of which social cohesion is most important.

Reforms are important in the context of rapid development. Recent controversies over reforms have shown that timing, sequencing and consensus-building are equally important. Labour reforms, for example, are best introduced when the economy is on the upswing.

Many cherished the idea of India reaching the status of a US$5tn economy by 2025. But increasingly the idea is becoming a more distant goal. The Indian economy in 2019 was at around US$2.7tn. To achieve the level of US$5tn, we need to grow continuously at 9 per cent for six years from now. That is the challenge before the economy. Jobs and employment will come from growth. They are not independent of growth. Will policymakers eschew other considerations and focus only on growth?

3. Government Must Raise Spending to Boost Growth

C Rangarajan and D K Srivastava
The Hindu Business Line, January 14, 2021

Despite the recessionary conditions in the industrialised countries, it may still be possible to pitch for higher growth in exports. The recent announcements on boosting exports are a recognition of this.

The first advanced estimates of the National Statistical Office (NSO) for 2020-21 real GDP growth at (-) 7.7 per cent show an improvement over the predictions by multilateral agencies such as the IMF and the World Bank at (-) 10.3 per cent and (-) 9.6 per cent respectively.

This is driven largely by an expected robust recovery in the second half of 2020-21 in three sectors namely, (1) Financial, Real Estate and Professional Services, (2) Construction, and (3) Public Administration, Defence and other services. Their growth rates in the second half of 2020-21 over the corresponding period of last year are estimated at 7.1 per cent, 4.4 per cent and 3.3 per cent respectively.

Agriculture has shown a steady positive growth at 3.4 per cent for the year. The recovery in 'Public Administration, Defence and other services is contingent upon central and state governments being able to substantially raise their expenditures in the last quarter of the fiscal year. This may call for incurring a larger than the already announced borrowing programme of ₹12 lakh crores by the central government, that is, 6.2 per cent of GDP.

Given the current revenue trends, the central government may need to revise its borrowing target upwards, exceeding 7 per cent of nominal GDP, to ensure an increase in government final consumption expenditure (GFCE) and in GVA of 'Public Administration, Defence and other services in line with NSO's first advanced estimates.

2020-21 Budgetary Aggregates

The key budgetary aggregates for 2020-21 may be assessed taking into account the Controller General of Account's fiscal data for eight months covering April to November 2020, and the signals from NSO's first advanced estimates for 2020-21 GDP reflecting COVID's full-year impact.

In the first eight months of the fiscal year, the centre's gross tax revenues showed a contraction of (-) 12.6 per cent over the corresponding period of the previous year. Except for the union excise duties which showed a positive and high growth of 48 per cent during April-November 2020, all other central taxes had shown a contraction. Corporate income tax showed the highest contraction at (-) 35.7 per cent, followed by customs duties at (-) 17.0 per cent, GST at (-) 16.5 per cent, and personal income tax at (-) 12.3 per cent.

As recovery strengthens in the fourth quarter of 2020-21, the rate of contraction in central taxes may fall tangibly. For assessing full-year tax revenue prospects, NSO's nominal GDP growth estimate of (-) 4.2 per cent may be utilised along with a tax buoyancy of 0.8, the same as in 2018-19. This gives an estimate of the centre's 2020-21 gross tax revenues at ₹19.4 lakh crores, showing a contraction of (-) 3.4 per cent as compared to the actual 2019-20 level. However, as compared to the budgeted 2020-21 magnitude, there would be a significant contraction of close to (-) 20 per cent.

Centre's non-tax revenues and non-debt capital receipts, which primarily reflect disinvestment, may also fall well short of their respective budgeted magnitudes. By November 2020, non-tax revenues were at ₹1.2 lakh crores as against the budgeted magnitude of ₹3.8 lakh crores.

Similarly, non-debt capital receipts during the first eight months stood at ₹18,141 crores as against the budgeted magnitude of ₹2.25 lakh crores. Even though spectrum sales have been announced to take off in March 2021, it may be possible to raise only limited amounts before the fiscal year closes.

Up to November 2020, the central government's expenditure – total, revenue, and capital grew by 4.7 per cent, 3.7 per cent and 12.8 per cent respectively. A substantial step-up in this growth rate would need to be ensured in the remaining four months.

According to available information, the government has already utilised nearly 90 per cent of the announced borrowing programme amounting to ₹12 lakh crores. Raising the fiscal deficit to 7 per cent of GDP or marginally above would ensure growth in total expenditure of about 9 per cent for the full year over actuals of 2019-20.

Budget 2021-22: Prioritising Expenditure Growth

In the 2021-22 Budget, deciding the level of government expenditure which is a measure of support to overall demand and its sectoral prioritisation would be important considerations. The magnitude of expenditure would depend on revenue growth and the extent of government borrowing. It is important to stress the need to step up expenditure growth to support overall demand while prioritising capital expenditure to stimulate investment.

A new fiscal consolidation roadmap may have to be drawn up although the reduction in fiscal deficit from the current year level may be limited. Policy observers are expecting the real growth rate to be 8 per cent or above in 2021-22. For nominal growth, the feasible range being considered is 11-15.5 per cent.

Considering the mid-point of this range at about 13 per cent, the level of tax revenues may be assessed by applying a buoyancy of 1.2, which is the average tax buoyancy during the period from 2015-16 to 2018-19. This gives an estimate of tax revenue growth marginally above 15 per cent and its level at ₹22.5 lakh crores. An improvement in non-tax revenues and non-debt capital receipts may also be considered feasible.

A more fruitful disinvestment programme may be reactivated and some monetisation of government assets should also be initiated. Given the buoyant stock market conditions, this would be the appropriate time for reaping reasonable disinvestment revenues.

Keeping fiscal deficit in the range of 6 per cent to 7 per cent of GDP, it should be possible to ensure growth of 10 per cent in total government expenditure overestimated expenditure of 2020-21. Capital expenditure should be targeted to increase at a faster rate at, say 20 per cent plus.

A review of the National Infrastructure Pipeline (NIP) may be undertaken highlighting the extent of deficiency as compared to the planned timelines. The budget should clearly state the investment to be undertaken by the central government and by the central public sector enterprises.

It may be recalled that in the aftermath of the 2008 crisis, the fiscal deficit was raised in two successive years namely 2008-09 and 2009-10 to 6.1 per cent and 6.6 per cent of GDP respectively. The 2020-21 COVID crisis is more serious. Even if there is a slippage in fiscal deficit in two consecutive years, this may be considered acceptable in favour of restoring growth.

To sum up, the Indian economy must grow by at least 8 per cent in 2021-22. Only then, we will be back to where we were at the end of March 2020. For this to happen, it is imperative to ensure that total government expenditure grows at more than 10 per cent and within it, capital expenditure at more than 20 per cent in 2021-22. The fiscal deficit may be in the range of 6 to 7 per cent.

A new fiscal consolidation roadmap would need to be drawn up even though the scope for reduction in fiscal deficit in 2021-22 is limited. On the revenue side, the present tax structure may be maintained.

4. Like 1991, the 2021 Crisis Presents an Opportunity

C Rangarajan
The Hindu Business Line, January 14, 2021

Even if the economy grows at 8.7 per cent in 2021-22, we may remain at the level we were in March 2020. We will need to run faster to stay where we are

With the arrival of 2021, the liberalisation regime launched in 1991 completes 30 years. 1991 is an important landmark in the post-Independence economic history of our country.

The country then faced an acute economic crisis triggered by a severe balance of payments problem. The crisis, however, was converted into an opportunity to bring about some fundamental changes in India's economic policy. It was marked by three important breaks from the past.

One was to dismantle the vast network of controls and permits that dominated the economic system; the second was to redefine the role of the state and the third was to move away from a regime of import substitution and to integrate fully with the global trading system. The new regime gave us a much faster rate of growth, even though there is concern with the recent decline in the growth rate.

Current Crisis

We have another crisis today. In recent memory, this is the first economic crisis that has been driven by a non-economic factor – a pandemic. The various measures taken to prevent the spread of the virus and most importantly the lockdown have brought to a grinding halt the wheels of economic activity. It is only with the relaxation of constraints that the economy has started moving.

In the first half of 2020-21, the economy shrank by 15.7 per cent. There will be some pickup in the second half. Most analysts now think that the economy will shrink by 8 per cent for the year as a whole. The latest estimate of CSO is (-) 7.7 per cent. If only the Indian economy grows at 8.7 per cent in 2021-22, will we be compensating for the decline in 2020-21? We will then be where we were at the end of 2019-20. As the saying goes 'we need to run fast to stay where we are'.

Reforms of 1991

Decisive steps were taken post-1991 to address the crisis and move on to a new road of progress. Liberalisation was adopted as a principle. It had the objective of improving the efficiency of the functioning of the economic system. All governments since 1991 have followed the same path. The current government has also taken several measures which are in the spirit of liberalisation.

Challenges Ahead

The tasks of the government as we emerge out of the pandemic are twofold – first to accelerate growth and second to follow the path of liberalisation with circumspection.

In a situation where the economy is stuck because of the weakening of demand, the standard advice is to raise government expenditures which will not only push up the economy directly but also act as a stimulant to the private sector. While the earlier analysts did not make a distinction between one type of government expenditure and another, analysts now believe, that capital expenditures, i.e. those which create assets, are preferable. While the present government talked of many measures to stimulate the economy, the national income data show a different picture.

According to CSO, government consumption expenditures declined by 22.2 per cent in Quarter 2. The sector 'Public Administration, Defence and Other Services' declined by 10.3 per cent in Quarter 1 and 12.2 per cent in Quarter 2. A strong effort must be made by the government to raise expenditures in Quarter 4 so that the contraction in 2020-21 as a whole can be contained. The same logic extends to 2021-22. Because of the growth in the economy, albeit from a low base, revenues should pick up in 2021-22. Government should maintain its expenditure at a reasonably high level.

The Budget for 2021-22 should lay out the investment plans of the government and public sector enterprises. A massive investment programme such as the Golden Quadrilateral must be envisaged. While it is desirable that the fiscal deficit must be brought down, the scope for it is limited in 2021-22. It could still be around 7 per cent of GDP. Going forward a new map for fiscal consolidation must be drawn up.

Push to Investment

In a developing economy, growth is sustained only by investment. What we have seen is a decline in the Gross Fixed Capital Formation rate which has fallen from 29.0 per cent of GDP in 2018-19 to 24.2 per cent in 2020-21. We need to reverse this trend. A proper climate for investment must be created. Changes in corporate tax rates announced some months ago will help once growth starts picking up.

Investment is influenced by multiple factors. First, perceptions regarding growth prospects are a key factor. Second the policy framework must be supportive and third non-economic factors such as a peaceful environment and social cohesion are also relevant. The government must begin to act on all these factors.

Role of Reforms

The reform agenda released post-1991 had an enormous impact. It released the energies of entrepreneurs to build a strong economy. But that reform agenda constituted a paradigm shift. Today we don't need a paradigm shift. We need to look at individual sectors and see which one of these needs reforms in terms of creating a competitive environment and improving efficiency. That should be the approach of the reform agenda.

Reforms do attract criticism. The 1991 reforms were dubbed by some as dictated by the IMF and World Bank.

Some criticised some of the reforms as a sellout to capitalists. Under the shadow of a crisis, some of the reforms in 1991 could be pushed. But today this is no longer possible. The power sector, the financial system, governance and even agricultural marketing need reforms. But we need a lot more discussions and consensus building. Timing and sequencing are also critically important.

Looking at the recent discussions on agricultural marketing reforms, the best course of action now may be to leave these measures to each state to decide whether they want these legislations or not. That will set the stage for experimental economics and farmers themselves will be able to see the best possible solutions for different crops and conditions.

Aspirational Goals

A few years ago, there was the hope that India would become a US$5tn strong economy by 2025. But that has become impossible. India's economy was US$2.7tn strong in 2018. To go from US$2.7tn to US$5tn, it requires the economy to grow at 9 per cent for 5 consecutive years. We must also note that India's per capita income after reaching US$5tn will be only US$3,500.

We will still be classified as a middle-income country. Growth is the answer to many of our socioeconomic problems. Growth should become the undivided concern of the government. This can be best achieved by focusing on the economy, creating better and fairer conditions for doing business, building a consensus on economic policies, and avoiding socially divisive actions.

5. Recalibrate Growth, Reprioritise Expenditures

C Rangarajan and D K Srivastava
The Hindu, May 2021

Protecting total expenditures at the budgeted level and mass vaccination is important in India's pandemic situation

COVID's second wave is currently sweeping India forcing states into successive lockdowns, eroding economic activities. The growth projections of different national and international agencies and the fiscal projections of the Centre's 2021-22 budget require recalibration.

COVID-induced Growth Erosion

The IMF, the RBI, and the Ministry of Finance's Economic Survey had forecasted real GDP growth for 2021-22 at 12.5, 10.5, and 11.0 per cent respectively. Moody's has recently projected India's GDP growth in 2021-22 at 9.3 per cent.[1] This is close to the benchmark growth rate of 8.7 per cent which would keep India's GDP at 2011-12 prices at the same level as in 2019-20.

This level of growth may be achieved based on the assumption that the economy normalises in the second half of the fiscal year. If the lockdowns come to an end earlier, the growth rate may be higher but that is perhaps unlikely.

The 2019-20 real GDP was ₹145.7 lakh crore at 2011-12 prices. It fell to ₹134.1 lakh crore in 2020-21, implying a contraction of (-)8.0 per cent. If even the growth rate of 8.7 per cent for 2021-22 comes under challenge because of a prolonged lockdown, not only India will see a fall in the real GDP in the current year as compared to the 2019-20 level but the nominal GDP numbers assumed in the budget will also be belied adversely affecting the fiscal aggregates in centre's 2021-22 budget.

[1] Moody's slashes India's growth projection to 9.3% from earlier estimate of 13.7% - The Hindu

At 8.7 per cent real growth, the nominal GDP growth would be close to 13.5 per cent, assuming an inflation rate of 4.5 per cent. This would be lower than the nominal growth of 14.4per cent assumed in the union budget. At 13.5 per cent growth, the estimated GDP for 2021-22 is ₹222.4 lakh crore at current prices. This will lead to a lowering of tax and non-tax revenues and an increase in the fiscal deficit as compared to the budgeted magnitudes.

Reconsidering Budget Magnitudes

Budgeted gross and net tax revenues for 2021-22 were ₹22.2 lakh crore and ₹15.4 lakh crore respectively. The assumed buoyancy for the centre's gross tax revenues (GTR) was 1.2. Even if this buoyancy is achieved, the lower nominal GDP growth would imply a GTR growth of 15.7per cent as compared to the budgeted growth of 16.7per cent.

If, however, the buoyancy of 1.2 proves optimistic and instead a buoyancy of 0.9, which is the average buoyancy of the five years preceding the COVID year, is applied, the nominal growth of GTR would be 12.2per cent. This would lead to the centre's GTR of about ₹21.3 lakh crore. The corresponding shortfall in the centre's net tax revenues is estimated to be about 0.6 lakh crore.

Budgeted magnitudes for non-tax revenues and non-debt capital receipts at ₹2.4 lakh crore and ₹1.9 lakh crore respectively may also prove to be optimistic. In these cases, the budgeted growth rates were 15.4 per cent and 304.3 per cent respectively. The excessively high growth for the non-debt capital receipts was premised on implementing an ambitious asset monetisation and disinvestment programme.

The COVID-disturbed year may not permit any of this. The budgeted growth in non-tax revenues is largely dependent on an assumed growth of 60 per cent in revenues from communication services and of 44.1 per cent in dividends and profits from non-departmental undertakings.

We consider that a shortfall of ₹1.5 lakh crores in non-tax revenues and non-debt capital receipts together may not be ruled out. This, together with the tax revenue shortfall of nearly 0.6 lakh crore, the total shortfall on the receipts side may be about ₹2.1 lakh crore.

Two factors will affect the fiscal deficit estimate of 6.76 per cent of GDP in 2021-22. First, there would be a change in the budgeted nominal GDP growth. Second, there would be a shortfall in the receipts from tax, non-tax and non-debt sources. The budgeted magnitude of the fiscal deficit is ₹15.06 lakh crore.

Together, these two factors may lead to a slippage in fiscal deficit which may be close to 7.7 per cent of GDP in 2021-22 if total expenditures are kept at the budgeted levels. This would call for revising the fiscal roadmap again. Protecting total expenditures at the budgeted level is however important given the need to support the economy in these challenging times. There is a case, however, for reprioritising these expenditures.

Reprioritising Expenditures

COVID's second wave has put a spotlight on India's serious under-capacity in health infrastructure. Given the likelihood of a third COVID wave, there is an urgent need to ramp up health and related infrastructure by enhancing the number of hospitals and hospital beds, sources of oxygen supplies, and manufacture of Covid vaccines and drugs. Centre's 2021-22 budget has provided for ₹71,269 crores for the Department of Health and Family Welfare. This included a budgeted capital expenditure of ₹2,508.7 crores.

In contrast, in 2020-21, the total health and family welfare expenditure (RE) was ₹78,866 crores, implying a fall of ₹7,597 crores in 2021-22. In the budgeted capital expenditure for health also, there was a fall of ₹1,724.8 crores as compared to the RE of 2020-21 at ₹4,233.5 crores. These magnitudes are quite inadequate for an economy challenged BY COVID for two successive years. The allocation for the health sector should be increased substantially by reprioritising expenditures.

Construction activities within the health sector will have high multipliers. There may also be higher expenditure on inducting a larger workforce of doctors, nurses and paramedics and other hospital-related administrative staff. Furthermore, strong support is needed for the vulnerable groups of the society including migrant labour and the rural and urban unemployed population.

Vaccination Policy

Speedy and larger vaccination coverage of the vulnerable population is key to minimizing economic damage. The Centre's budget had allocated ₹35,000 crore for vaccination as shown in the budget for the Department of Finance (demand for grant number 40) as an amount to be transferred to the states. India's population aged 12 years and above is 109 crores. Total vaccination doses at two doses per person add to 217 crores.

At an average price of ₹300 per dose, this would require ₹65,108 crore. This is a rough estimate. The cost to the government would be less if the coverage is less than full. COVID vaccination is characterised by strong inter-state positive externalities, making it primarily the responsibility of the central government. The entire vaccination bill should be borne by the central government.

If instead of individual state governments floating global tenders, the central government is the single agency for vaccine procurement, economies of scale and the centre's bargaining power would keep the average vaccine price low. The total vaccination cost would go up if the unit cost goes up.

The central government may transfer the vaccines rather than the money that it has budgeted for transfer. Some of the smaller states may find procuring the vaccines in a global tender quite challenging. A successful vaccination drive would minimise damage to the economy.

6. Big Spender: What Centre Must Do to Meet the Economic Challenges Following COVID Second Wave

C Rangarajan and D K Srivastava

The Indian Express, June 11, 2021

A word of caution, though: With higher expenditure, financed through borrowings, the impact of liquidity expansion on inflation needs to be monitored.

On May 31, important updates regarding India's GDP growth and the Centre's fiscal performance for 2020-21 became available. According to NSO's provisional estimates for 2020-21, the annual contraction in real GDP turned out to be 7.3 per cent, an improvement over the earlier estimate of 8 per cent. Real GDP growth of 7.8 per cent would be required in 2021-22 to reach back to 2019-20 real GDP levels.

The erstwhile GDP growth projections for 2021-22 are being re-examined to take into account the adverse impact of the second wave of the pandemic. The RBI has revised its 2021-22 real GDP growth forecast to 9.5 per cent. Some other recent estimates (ICRA) indicate the feasibility of a 9 per cent growth. At the lower end, a growth of 8.5 per cent is being projected by Societe Generale and 7.6 per cent by Moody's.

We consider that with suitable policy interventions, a 9 per cent real GDP growth may still be feasible if the lockdowns wind up by the end of July. It is also important to consider nominal GDP growth for 2021-22 since that would be a critical determinant of fiscal prospects.

In light of supply-side and cost-push pressures, the RBI has projected CPI inflation at 5.1 per cent. Given the recent trends in CPI and IPD (implicit price deflator) based inflation rates, the latter may be somewhat lower at say 4 per cent. Thus, the nominal GDP growth may be projected at 13.4 per cent, that is, 1 percentage point lower than the Centre's budget assumption of 14.4 per cent.

The Controller General of Accounts' data for the Centre's fiscal aggregates indicates a gross tax revenue (GTR) of Rs 20.2 lakh crore and net tax revenue of Rs 14.2 lakh crore for 2020-21. The likely growth in GTR for 2021-22 may be derived by applying a buoyancy of 0.9 — the average buoyancy for five years before 2020-21 — to the projected nominal GDP growth of 13.4 per cent (the budget assumed a buoyancy of 1.2).

This gives a tax revenue growth of 12 per cent, translating that to projected gross and net tax revenues for 2021-22 would mean ₹22.7 lakh crore and ₹15.8 lakh crore respectively. This implies some additional net tax revenues to the Centre amounting to Rs 0.35 lakh crore as compared to the budgeted magnitudes. The main expected shortfall may still be in non-tax revenues and non-debt capital receipts.

According to the CGA numbers, their 2020-21 levels are respectively ₹2.1 lakh crore and ₹0.57 lakh crore. Applying a growth rate of 15 per cent on these, a shortfall in 2021-22 to the tune of ₹1.3 lakh crore may arise in non-tax revenues and non-debt capital receipts.

Historically, the growth rates of non-tax revenues and non-debt capital receipts have been volatile, but together they average a little lower than 15 per cent during the five years preceding 2020-21. In any case, the large budgeted growth of 304 per cent in non-debt capital receipts for 2021-22 seems quite unlikely because of the challenges posed by the second wave.

Taking into account RBI's recently announced dividend of ₹ 0.99 lakh crore to the Centre, the main shortfall may be in non-debt capital receipts. Together, the overall shortfall in total non-debt receipts may be limited to about ₹0.9 lakh crore, or 0.4 per cent of the estimated nominal GDP. This indicates that a slippage, if any, in the budgeted fiscal deficit of 6.7 per cent of GDP, as revised in view of the recently released GDP data, could be a limited one.

Given the economic challenges in the wake of the second wave, three expenditure heads need to be prioritised. First, an increase in the provision of income support measures for the vulnerable rural and urban populations. This would require an amount of Rs 1 lakh crore which may be partly provided through expenditure restructuring.

Second, in light of the recent decision, the budgeted expenditure on vaccination of ₹0.35 lakh crore ought to be augmented, at the very least, doubled.

Third, additional capital expenditure for select sectors, particularly healthcare, should also be provided for. This may be another ₹1 lakh crore. Together these additional expenditures would amount to ₹1.7 lakh crore, about 0.8 per cent of the estimated nominal GDP.

Thus, we need to plan for a fiscal deficit of about 7.9 per cent of GDP consisting of (a) a budgeted fiscal deficit of 6.7 per cent (b) 0.4 per cent to make up for the shortfall in total non-debt receipts and (c) 0.8 per cent for the additional stimulus measures.

The Centre has announced borrowings of ₹1.6 lakh crore to meet the shortfall in the GST compensation cess. This amount is not to be counted as its deficit, although it adds to the borrowing programme. Given the higher fiscal deficit, it would need to add to its borrowing programme another ₹2.6 lakh crore, taking the total borrowing, including GST compensation, to about ₹16.3 lakh crore, from ₹12.05 lakh crore now.

Borrowing by states would be in addition to this. The net result will be an unprecedented borrowing programme by the Centre which may require RBI's support. That is happening now. RBI is injecting liquidity into the system through various channels. Banks have sufficient liquidity to subscribe to new debt. This is the indirect monetisation of debt. This is not new, but the scale is much higher. Direct monetisation is best avoided.

The government and the RBI are keen to keep the interest rate low despite this heavy borrowing. The household sector's appetite for financial assets may not increase. The external sector's demand for Indian sovereign bonds may also be lukewarm. The success of the borrowing programme of the Centre depends on the support provided by the RBI. The support need not be direct. It can be indirect as is currently happening. RBI is injecting liquidity into the system in a big way.

According to the latest monetary policy statement, the growth rate in reserve money is 12.4 per cent (as on May 28). So far, the injection of liquidity has been benign. Money supply (M3) growth is modest at 9.9 per cent and credit growth is only 6 per cent (as on May 21).

What these numbers show is that the money multiplier is low. This may be attributed to two reasons: Low credit expansion and larger leakage in the form of currency. The potential for money supply growth is large. The discussion in the monetary policy statement on inflation is focused entirely on supply availability and bottlenecks in the distribution of commodities. The output gap is certainly relevant.

But equally relevant in an analysis of inflation is liquidity in the system, and its impact on output and prices with lags. The injection of liquidity has its limits. Even as we emphasise the expansion in government spending, it is necessary to keep in mind the implications that liquidity expansion will have for inflation.

7. Growth Won't be Automatic

C Rangarajan
Economic Times, July 12, 2021

The year 1991 is an important landmark in the post-Independence economic history of India. The country faced a severe economic crisis, triggered largely by a serious balance of payments problem. The crisis was converted into an opportunity to effect some fundamental changes in the content and approach to economic policy.

Break with the Past

The break with the past came in three important directions. The first was to dismantle the complex regime of licences, permits and controls that dictated almost every facet of production and distribution. Barriers to entry and growth were dismantled.

The second change in direction was to reverse the strong bias towards state ownership of means of production and the proliferation of public sector enterprises in almost every sphere of economic activity. Areas once reserved exclusively for the state were thrown open to private enterprise. The third change in direction was to abandon the inward-looking trade policy.

By embracing international trade, India signalled that it was boldly abandoning its export pessimism and was accepting the challenge and opportunity of integrating into the world economy. It may be of interest to note that this is contrary to what we did normally when faced with a balance of payment problem.

Performance of the Economy

The management of the external sector is a success story of liberalisation. Except for one or two years like 2008 and 2013 when there was a hiccup, we have had a reasonable record of good performance. Even in these few years when there were difficulties, we had sufficient reserves to manage the situation on our own. Of course, we continue to run a current account deficit. But it is manageable and financing it is no problem. Foreign exchange reserves have increased, even though they continue to be the result of financial flows.

On the growth front, the Indian economy has done well in the post-liberalisation period. Looking at the data on GDP with 2011-12 as a base, between 1992-93 and 2019-20, the rate of annual growth was 6.4 per cent. With the same base, between 1951-52 and 1990-91, it was 4.2 per cent. Recent revisions in the methodology of computing national income data have made it difficult to make comparisons with earlier data. With 2004-05 as a base, GDP at market price had an impressive growth of 9.4 per cent between 2005-06 and 2007-08.

But the new series with 2011-12 as a base, gives an average growth of 7.9 per cent for the three years. The growth story as of now is a matter of concern. Even according to the new series, there has been a steady decline since 2016-17. This is a pre-COVID-19 phenomenon. The decline in growth rate after 5 years of strong growth beginning 2005-06 was partly cyclical. The economy had reached the limit of its capacity or potential. Perhaps the downturn could have been better managed.

Reforms do not automatically translate into growth. The investment sentiment must be carefully nurtured. The fall in investment rate from 39.0 per cent of GDP in 2011-12 to 34.7 per cent in 2019-20 is steep and calls for deep introspection. With the decline in the growth rate, the employment situation has also deteriorated.

No Need for Paradigm Shift

The reform agenda of 1991 had an enormous impact. It released the energies of entrepreneurs to build a strong economy. But that reform agenda constituted a paradigm shift. Today we don't need a paradigm shift. We need to look at individual sectors and see which one of these needs reforms in terms of creating a competitive environment and improving efficiency.

Reforms do attract criticism. The 1991 reforms were dubbed by some as dictated by the IMF and World Bank. Some criticised some of the reforms as a sellout to capitalists. Under the shadow of a crisis, some of the reforms in 1991 could be pushed. But today this is no longer possible.

The power sector, the financial system, governance and even agricultural marketing need reforms. But we need a lot more discussion and consensus building. Timing and sequencing are also critically important. For example, labour reforms are best introduced when the economy is on the upswing.

Looking at the recent discussions on agricultural marketing reforms, the best course of action now may be to leave these measures to each state to decide whether they want these legislations or not. That will set the stage for experimental economics and farmers themselves will be able to see the best possible solution for different crops and conditions.

Some years ago there was a talk about India becoming a US$5tn economy. We are today a US$2.7tn economy. To reach the goal of US$5tn, India needs to grow at 9 per cent per annum for at least 5 years. That is the challenge before us, as growth is the answer to many of our socioeconomic problems. It was only during the high growth period, the poverty ratio came down fast. We were also able to introduce several social safety nets such as extended food security and a rural employment guarantee scheme.

Reforms to be credible and acceptable must not only result in higher growth but also benefit all sections of society. In that sense, reforms are not ends in themselves. At the same time, equity will remain a dream, if it is not supported by growth spurred by reforms.

8. Need to Link Small and Large Businesses

C Rangarajan and M Suresh Babu*
The Hindu Business Line, July 12, 2022

By supplying large firms with 'intermediate products', small units play a key role in the manufacturing sector's growth

The share of the manufacturing sector in the gross value added in the Indian economy has hovered at 17-18 per cent for the decade 2011 to 2021. In comparison, China had 27 per cent, South Korea 25 per cent and Bangladesh 18.5 per cent in 2020.

Higher growth of manufacturing activities in the economy assumes importance for two reasons. First, the sector provides employment and can absorb workers of varying skill sets. Second, the ability to export manufactured products plays a crucial role in maintaining the external balance of an economy and influences global trading prowess.

A vibrant and growing manufacturing sector is crucial for the Indian economy on both these counts. However, the emergence of the manufacturing sector as the engine of growth, with a higher share in the gross value added or national income, is hampered by a structural feature of the sector, that is, the preponderance of a large number of small firms, enterprises and factories.

While these firms are contributors to providing employment, their growth and transition to big firms are hampered by a variety of factors. Addressing these factors needs a comprehensive policy approach which also takes into account the links between small and large firms.

Composition of Manufacturing

Data published by the Central Statistical Office in the Annual Survey of Industries for 2017-18, the most recent year for which the final results are available, reveal some important features on the manufacturing sector — 55.3 per cent of the total factories in operation produce output less than ₹5 crore annually and 31.2 per cent of the factories produce output in the range of ₹5-50 crore annually.

This classification, based on output, corresponds to the recent definition of micro and small enterprises based on annual turnover. Thus, 86.5 per cent of factories correspond to the definition of micro and small enterprises. However, in terms of share in employment and output, this group accounts for 40 and 14.4 per cent, respectively. The big factories, having an output of more than ₹500 crore annually, account for just 1.89 per cent of the total factories, but have a 22 per cent share in employment and generate 54 per cent of the total output.

In terms of capital invested, we find that 66 per cent of the factories have a capital investment of less than₹0.25 crore and they contribute to 13.5 per cent of the total output. Only 11 per cent of factories have a capital of more than ₹10 crore and their share in output is 73.5 per cent. This imbalance is what we allude to earlier.

That is, within the manufacturing sector we find that a large number of small factories contribute only a small share to the total output of the sector and less than 2 per cent of big factories account for more than 50 per cent of the output of the sector. This skewed structure, in our view, needs to be addressed for the sector to grow at a faster pace.

Data on MSMEs

Given the unique position that micro, small and medium enterprises (MSMEs) occupy, as an important segment in terms of absorbing workers, their share in the overall value added is often stated as one-third. This at best is an approximation given the range of activities undertaken by MSMEs and the extent of informality present in the sector. Further, the non-availability of data also hampers the realistic assessment of the extent of linkages that MSMEs have within the economy.

In a manufacturing ecosystem, MSMEs have crucial linkages with large firms through subcontracting arrangements and the provision of inputs. Encouraging and supporting such linkages is an important ingredient in the models of business development that can change the landscape of the manufacturing sector.

Integrating MSMEs

Attempts to integrate MSMEs with larger firms have been the focus of industrial policy reforms in many industrialising economies for some years. For example, in Malaysia in 2019, as part of its aim to increase the contribution of SMEs to reach 41 per cent of the national GDP, its Ministry of Entrepreneur Development (MED) devised new strategies to drive SME growth, particularly in key industries with high multiplier and linkages. In this context, the efforts were intensified to further enhance and strengthen the business linkages, particularly between SMEs and large firms.

With the availability of relevant data pertaining to SMEs in Malaysia it was found that in terms of output consumption by other industries and final consumers, 48.5 per cent of the total output of SMEs flows back into the economy as intermediate input, indicating that SMEs are highly domestically integrated with other industries. A similar analysis in the Indian context is hindered by the absence of data.

However, given the multitude of activities MSMEs undertake in India, it would not be entirely inappropriate to assume a similar strong linkage between MSMEs and other firms, which underscores the need to view MSMEs in conjuncture with the large firms and that their growth is influenced by the growth of large firms.

Plagued by the absence of consistent data on MSMEs, we assess the importance of linkages through an indirect method, which is illustrated in the table. We classify industrial sub-groups (within a broad group) into two sets of industries based on the nature of the products produced.

The first set of industries is termed as ‘supplying’ industries, that is, they produce parts and components and intermediate products and the second set is termed as ‘purchasing’ industries, which produce final goods.

Consider the broad industrial group of ‘Manufacture of motor vehicles, trailers and semi-trailers’, within which we identify ‘Manufacture of parts and accessories for motor vehicles as supply industry’ and ‘Manufacture of motor vehicles as purchasing industry’; 86 per cent of factories are in supplying industry, only 3 per cent in purchasing industry. The differences in size and scale are also striking.

As the market for 86 per cent of the firms (which are in the supplying category) depends on 3 per cent of the factories (essentially larger ones) in the purchasing category, the growth of the former is hugely dependent on the latter. The growth slowdown of the large firms would then be transmitted with an amplified effect on the small firms.

Strengthening Links

There is ample research evidence to confirm that forming alliances and networking help small firms to grow, cooperate and compete with big firms. The policy approach needs to focus on facilitating firms working together so that they can reap the benefits of collective efficiency. The key to success would be the ability to develop a mutually supportive approach with cumulative effort and continuous improvements rather than viewing the small and big differently.

Perceiving small and large firms in separate silos might prove costly in the long term, as slower growth of large firms might act as a drag on the growth of the other.

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9. Growth Needs Steps Beyond Reforms

C Rangarajan
The Hindu, August 14, 2021

While the reform agenda must continue, social cohesion and equity considerations must be guaranteed

The Indian economy has travelled through an eventful period through the last three decades. In the post-independence economic history of our country, 1991 stands out as a watershed year. This was the year in which the economy was faced with a severe balance of payments crisis.

In response, we launched a wide-ranging economic programme, not just to restore the balance of payments but to reform, restructure and modernise the economy.

Thus the crisis was converted into an opportunity to bring about fundamental changes in the approach and conduct of economic policy. A near tragedy was averted and a new path was laid out before the country. The words of Charles Dickens in somewhat reverse order seem appropriate. "It was the worst of times, It was the best of times...it was the winter of despair, it was the spring of hope".

It is important to recognise in what way the new regime was different from the earlier one. The break with the past came in three important ways (a) in dismantling the vast network of licenses, controls and permits that dominated the economic system (b) in redesigning the role of the state and allowing the private sector a larger space to operate within and (c) in abandoning the inward-looking foreign trade policy and getting integrated with the world economy and trade. The last was particularly important because it was the opposite of what we normally did when faced with a balance of payments crisis.

Manmohan Singh as Finance Minister spearheaded the new policy. He articulated the need for change and provided not only the broad framework but also the details of the reforms.

Narasimha Rao as Prime Minister gave valuable political support and shield which were very much needed. It must be noted that as Prime Minister, Narasimha Rao also held the portfolio of Industry which was directly responsible for initiating the changes that led to the dismantling of various types of controls and licenses related to the industrial sector. This was indeed a key element of the reform programme.

At the ministerial level, strong support came from Chidambaram as Commerce Minister who oversaw the transformation of the external sector.

There is a common thread running through the various measures introduced since 1991. The objective has been to improve the productivity and efficiency of the system by creating a more competitive environment. Thus barriers to entry and growth were removed. As the saying goes, the proof of the pudding is in the eating. It is therefore appropriate to look at three broad parameters to judge the performance of the economy after liberalisation – growth rate, current account deficit and poverty reduction.

Between 1992-93 and 2000-01, GDP at factor cost grew annually by 6.20 per cent. Between 2001-02 and 2010-11, it grew by 7.69 per cent and the growth rate between 2011-12 and 2019-20, was 6.51 per cent. The best performance was between 2005-06 and 2010-11 when the GDP grew by 8.7 per cent showing clearly what the potential growth rate of India was.

This is the highest growth experienced by India over a sustained period of 5 to 6 years. This is despite the fact that this period included the global crisis year of 2008-09. The recent decline in growth rate which started even before the advent of COVID 19 should make the policymakers reflect and introspect.

The balance of payments situation had remained comfortable. There were three years in which the current account showed a small surplus. Most of the years showed a small deficit. The exceptions were 2011-12 and 2012-13 when the current account deficit exceeded 4 per cent. This was taken care of quickly.

Foreign Exchange reserves showed a substantial increase and touched US$621bn as of last week. The opening up of the external sector which included liberal trade policy, market-determined exchange rate and a liberal flow of external resources has greatly strengthened the external sector. Of course, we still run a high merchandise trade deficit which is offset to a large extent by the surplus in services.

Besides growth, the other major objective of economic policy is to reduce the number of people living below the poverty line. There are many problems associated with the definition of poverty and the kind of data required to measure it.

Going by the procedure adopted by the erstwhile Planning Commission using the Tendulkar expert group methodology, the overall poverty ratio came down from 45.3 per cent in 1993-94 to 37.2 per cent in 2004-05 and further down to 21.9 per cent in 2011-12. The per year reduction in percentage points in poverty ratio between 2004-05 and 2011-12 was 2.18.

The post-reform period up to 2011-12 did see a significant reduction in the poverty ratio because of faster growth supplemented by appropriate poverty reduction programmes such as the Rural Employment Guarantee Scheme and the Extended Food Security Scheme. With the decline in growth rate since then and with negative growth in 2020-21, this trend must have reversed i.e. the poverty rate may have increased.

Had the growth trend seen up to 2011-12 continued, we would have an unqualified answer to the impact of reforms on growth. Growth requires more than reforms. Reforms are, in the words of economists, only a necessary condition. It is not sufficient. In a developing economy, in the final analysis, growth is driven by investment. It is the decline in investment rate of nearly 5 percentage points since 2010-11 that has led to the progressive decline of the growth rate.

Reforms normally create a natural climate for investment. But ‘animal spirits’ are also influenced by non-economic factors such as social cohesion. Reforms supplemented by careful nurturing of the investment climate are needed to spur growth again. This should become the sole concern of policymakers.

The reform agenda must continue. It will be incremental. It has to be. Policymakers should be clear about the directions in which they should move. First of all, there is a need to move in the same direction in which we have been moving in the past three decades.

Policymakers should identify the sectors which need reforms in terms of creating a competitive environment and improving performance efficiency. From this angle, we need to take a relook at the financial system, power sector and governance. The Centre and states must be joint partners in this effort.

Secondly, in terms of government performance, there should be an increased focus on social sectors such as health and education. In terms of the provision of services, the emphasis must be not just on quantitative expansion but also quality. To achieve the latter is even more difficult. The advent of COVID-19 has shown clearly our inadequate health facilities and preparedness.

Reforms are necessary to improve the productivity of the economy and achieve higher growth. But the story does not end there. We cannot ignore equity considerations. Growth and equity must go together. They must not be posed as opposing considerations. They are truly interdependent. It is only in an environment of high growth, equity can be pushed aggressively.

10. What do the Q1 GDP Numbers Say?

C Rangarajan and D K Srivastava

The Hindu, September 13, 2021

With improved revenues, the government must increase expenditures to push consumption and investment

India's GDP data for Q_1 of 2021-22 was released by the National Statistical Office (NSO) on August 31, 2021. Real GDP growth at 20.1 per cent in Q_1 of 2021-22 is largely because of the contraction of 24.4 per cent in the corresponding quarter of the COVID year, that is, 2020-21.

Even with this high growth, the magnitude of real GDP fell short of the corresponding level in 2019-20 by a margin of ₹3.3 lakh crore. A growth rate of 32.3 per cent was required in Q_1 of 2021-22 for achieving the same level of real GDP as in Q_1 of 2019-20.

Annual Growth Prospects

The Indian economy would have done better in Q_1 of 2021-22 had its performance not been beset by the adverse impact of COVID's second wave which largely affected the months of April and May 2021. The Q_1 2021-22 output and GDP growth data reflect a strong base effect since the corresponding levels of Q_1 of 2020-21 were significantly adversely impacted by COVID's first wave.

While the economic impact of the first wave was more severe, the health impact of the second wave was more serious. This occurred because of the difference in the nature and scope of lockdowns in the two waves.

An interesting issue is to utilise the Q_1 national income data to formulate views on how much additional growth would be required for the Indian economy in the remaining three quarters of the current year to clock the annual growth of 9.5 per cent as forecast by both, the RBI and the IMF.

We estimate that an average growth of 6.8 per cent in the remaining part of the year would enable the Indian economy to meet this target. This should easily be feasible in Q_2 since there would still be the benefit of a base effect, considering a contraction of 7.4 per cent in Q_2 of

2020-21. The task would become relatively more demanding in Q_3 and Q_4 considering that the real GDP growth was positive at 0.5 per cent and 1.6 per cent respectively in the corresponding quarters of 2020-21.

Demand Side Weaknesses

The largest segment of GDP viewed from the demand side is private final consumption expenditure (PFCE). Its average share over the last three years (2018-19 to 2020-21) was 56.5 per cent. In Q_1 of 2021-22, PFCE grew by 19.3 per cent, which is marginally below the overall GDP growth. At the same time, it is notable that the contraction in PFCE in the corresponding quarter of 2020-21 was relatively larger at 26.2 per cent.

Thus, if PFCE were to reach back to the 2019-20 level, it should have grown by 35.5 per cent in this quarter. The recovery in private consumption demand is lagging behind the overall GDP growth. Since private consumption depends largely on income growth and its distribution, it would be useful to focus on further supporting income and employment levels for the MSMEs and informal sectors of the economy which have a higher propensity to consume.

On the demand side, noticeable positive outcomes in Q_1 of 2021-22 came from exports and to some extent, from investment as reflected by gross fixed capital formation (GFCF). Exports grew by 39.1 per cent over a contraction of 21.8 per cent in Q_1 of 2020-21. This differential is reflected in a positive growth of 8.7 per cent over the export level in the corresponding quarter of 2019-20. In the case of GFCF, the base effect was quite large.

Despite growth of 55.3 per cent in Q_1 of 2021-22, its magnitude was still 17.1 per cent lower than the corresponding level in Q_1 of 2019-20. The only demand segment which contracted even about Q_1 of 2020-21 was government final consumption expenditure (GFCE). This contraction was by a margin of (-) 4.8 per cent.

The Output Side

The performance of the economy when viewed from the output side largely points to the adverse impact of COVID’s second wave which dragged the performance of the key service sector namely trade, transport, storage et al. This sector grew by 34.3 per cent in Q_1 of 2021-22 as compared to a contraction of 48.1 per cent in Q_1 of 2020-21.

However, relative to its level in Q_1 of 2019-20, the output of this large service sector was significantly lower by 30.2 per cent in Q_1 of 2021-22. Public administration, defence and other services although showed a growth of 5.8 per cent in Q_1 of 2021-22 over Q_1 of 2020-21, actually reflected a contraction of 5.0 per cent as compared to Q_1 of 2019-20.

The key positive news came from the agricultural sector which showed a growth of 4.5 per cent in Q_1 of 2021-22, in continuation of annual growth of 3.6 per cent in 2020-21. Given agriculture's positive growth in all the quarters of 2020-21, further contribution from this sector to the overall growth may not be expected. Its average weight to the overall output is also low at about 15 per cent.

It is the high-weight manufacturing sector and the two substantive service sectors namely, trade, transport et. al. and financial, real estate et al., which will have to support growth in the remaining part of the year. Construction and electricity, gas, water supply et. al. sectors have already started showing a robust recovery. These may respond further to the government's emphasis on expanding investment in infrastructure.

Fiscal Prospects

The government's intervention in the economy is reflected by the performance of GFCE on the demand side, and the public administration, defence and other services sector on the output side. In both cases, as noted earlier, the growth in Q_1 of 2021-22 was less than desirable given the improvement in the centre's tax revenue performance.

CGA's fiscal data released on 31 August 2021 shows that the Centre's gross tax revenues (GTR) grew sharply by 83.1 per cent during April-July of 2021-22 over the corresponding period of 2020-21 and by 29.1 per cent over the corresponding period of 2019-20. The centre's fiscal deficit in the first four months of 2021-22 amounted to only 21.3 per cent of the budgeted target as compared to the corresponding average level of 90 per cent over the last four years.

Significant policy space is opening up for the government to raise its demand and its contribution to output in the remaining part of the current fiscal year. Attempts should be made either to bypass or at least to curb the adverse impact of COVID's likely third wave.

Given the fiscal room, both the coverage of vaccination and the pace of investment in health infrastructure should be accelerated within the strategy of expanding the overall infrastructure investment. As revenues improve, expenditures can be increased. There is no need to reduce the fiscal deficit below the budgeted level of 6.8 per cent of GDP.

Even a growth rate of 9.5 per cent in the current year will mean that over two years, the Indian economy had an annual growth rate of 1.1 per cent. The real test will come in 2022-23. Will the Indian economy get back to a higher growth path of 7 per cent? We need indeed a faster rate of growth to make up for the loss of output in the previous two years from the trend rate. We must lay the foundation for faster growth this year itself.

11. The Challenge of Achieving a 9.5 % Growth Rate

C Rangarajan and D K Srivastava
The Hindu, December 18, 2021

The key lies in the government's ongoing emphasis on infrastructure spending as reflected in its capital expenditure

The NSO released the second quarter GVA and GDP numbers on November 30, 2021, indicating the pace of economic recovery in India after the two COVID waves. The contraction was highest in the first quarter of 2020-21, gradually easing off in the subsequent quarters. The resultant base effect was the strongest in the first quarter of 2021-22 as reflected in real GDP and GVA growth rates of 20.1 per cent and 18.8 per cent respectively.

The base effect weakened in the second quarter with GDP and GVA growth rates at 8.4 per cent and 8.5 per cent respectively. Considering these two quarters together, real GVA for the first half of 2021-22 at ₹63.4 lakh crore, has remained below the level in the first half of 2019-20 at ₹65.8 lakh crore by (-) 3.7 per cent. This difference is even larger for GDP which at the end of the first half of 2021-22 stood at ₹68.1 lakh crore, which is (-) 4.4 per cent below the corresponding level of GDP at ₹71.3 lakh crore in 2019-20.

As the base effect progressively weakens in the third and fourth quarters of 2021-22, a strong growth momentum would be needed to ensure that at the end of this fiscal year, in terms of magnitude, GVA and GDP in real terms exceed their corresponding pre-COVID levels of 2019-20.

Sectors that Improved Upon 2019-20 Numbers

In the first half of 2021-22, on the output side, only four of the eight GVA sectors exceeded their corresponding 2019-20 levels. These include agriculture, electricity, gas, et. al., mining and quarrying and public administration, defence and other services.

Of these, the first and second-quarter growth of public administration, defence and other services was at 5.8 per cent and 17.4 per cent respectively. The upsurge in the growth of this sector in the second quarter of 2021-22 reflects the central government's emphasis on capital expenditure which started gathering momentum in recent months. Central government capital expenditure grew by 38.3 per cent during the first half of 2021-22.

This emphasis on government investment expenditure supplemented also by the recovery of private investment expenditure, resulted in gross fixed capital formation (GFCF) showing a positive growth of 1.5 per cent in the second quarter of 2021-22 over its corresponding level in 2019-20. However, even in this case, the level of GFCF in the first half of 2021-22 has remained below its corresponding level in 2019-20 by a margin of ₹1.93 lakh crore.

Overall domestic demand including private final consumption expenditure (PFCE) in the first half of 2021-22 remains below its corresponding level in 2019-20 by nearly ₹5.5 lakh crore. This indicates that investment, as well as consumption demand, have to pick up strongly in the remaining two quarters to ensure that the economy emerges on the positive side at the end of 2021-22 as compared to its pre-COVID level.

Private consumption demand would pick up with employment and income growth, especially in the small and medium sectors which is linked to the recovery in the services sectors, particularly the trade, hotels et. al. sector. This may happen in the second half of 2021-22 provided economic activities are not beset again by COVID's new strain, Omnicron.

Annual Growth Prospects

To realise the projected annual growth of 9.5 per cent for 2021-22 given both by the RBI and the IMF, we require a growth of 6.2 per cent in the second half of 2021-22. This will have to be achieved even as the base effect weakens in the third and fourth quarters since the GDP growth rate in these quarters of 2020-21 was at 0.5 per cent and 1.6 per cent respectively.

Thus achieving the projected growth rate of 9.5 per cent is going to be a big challenge. Had the growth rate of Q_2 been higher, the task would have been easier. If we achieve a growth rate of 9.5 per cent in 2021-22, we can be confident that 2022-23 will see a growth rate of 6 to 7 per cent.

The policy instrument for achieving higher growth may have to be strong fiscal support in the form of government capital expenditure. This is currently being facilitated by the buoyant centre's gross tax revenues. Centre's gross tax revenues have shown an unprecedented growth rate of 64.2 per cent and a buoyancy of 2.7 in the first half of 2021-22.

The nominal GDP growth at 23.9 per cent and the implicit price deflator-based inflation at 9.0 per cent in 1HFY22 is the key reason for the buoyant tax revenues. The fiscal deficit target of 6.8 per cent may come under pressure because of upward revisions in some expenditure items such as food and fertiliser subsidies, MGNREGA and extension of PMGKAY along with some shortfall in non-tax and non-debt capital receipts.

Despite these pressures, it would be advisable for the centre to continue infrastructure spending. The Centre's incentivisation of state capital expenditure through additional borrowing limits would also help in this regard.

According to available information, 11 states in the first quarter and 7 states in the second quarter qualified for the release of the additional tranche under this window. Even as central and state capital expenditures gather momentum, high-frequency indicators reflect an ongoing pick-up in private sector economic activities.

High-Frequency Indicators

PMI manufacturing increased to a ten-month high of 57.6 in November 2021, increasing from 55.9 in October 2021. PMI services remained high at 58.1 in November 2021, its second-highest level since July 2011. Gross GST collections at ₹1.31 lakh crore remained above the benchmark of ₹1 lakh crore for the fifth consecutive month in November 2021. Core IIP growth increased to 7.5 per cent in October 2021 from 4.4 per cent in September 2021.

Compared to its October 2019 value, core IIP showed a growth of 7.0 per cent in October 2021. Merchandise export growth was at 26.5 per cent in November 2021 and 43.0 per cent in October 2021 as compared to the corresponding month of the previous year. When compared to 2019 levels, exports grew by 35.9 per cent in October and 15.9 per cent in November 2021, reflecting robust external demand.

An important difference between 2019-20 and 2021-22 arises from the performance of the centre's gross tax revenues. The growth in the centre's GTR in the first half of 2019-20 was at 1.5 per cent and there was a contraction of (-)3.4 per cent for the year as a whole. In the face of such weak revenues, the central government could not mount a meaningful fiscal stimulus in 2019-20 even as real GDP growth fell to 4.0 per cent.

In contrast, the government is in a significantly stronger position in 2021-22 since the growth in GTR in the first half is 64.2 per cent and the full-year growth is expected to be quite robust.

Thus, the key to attaining a 9.5 per cent real GDP annual growth in 2021-22 lies in the government's ongoing emphasis on infrastructure spending as reflected in the government's capital expenditure. This is also seen in the high real growth in public administration, defence and other services of 17.4 per cent in the second quarter of 2021-22. This momentum must be sustained in the remaining part of the fiscal year.

12. Global Uncertainties, India's Growth Prospects

C Rangarajan and D K Srivastava
The Hindu, March 24, 2022

The normalisation of the economy has been disturbed and the growth objective would be served by apt fiscal policy moves

The NSO released India's GDP data for Q3 of 2021-22 along with Second Advance Estimates (SAE) for 2021-22 on 28 February 2022. Post-COVID, the normalisation of the Indian economy has now been disturbed by ongoing geopolitical uncertainties.

Growth Performance

In the COVID year of 2020-21, both real GDP and GVA contracted by (-) 6.6 per cent and (-) 4.8 per cent respectively. NSO's SAE shows that the real GDP and GVA growth are estimated to recover to 8.9 per cent and 8.3 per cent respectively in 2021-22. Despite this improvement, the magnitude of real GDP at ₹147.7 lakh crore in 2021-22 is only marginally higher than the corresponding level of ₹145.2 lakh crore in 2019-20.

NSO's GDP data highlights that in 2021-22, the nominal GDP growth at 19.4 per cent is significantly higher than the real GDP growth due to an inordinately high implicit price deflator (IPD)-based inflation rate of 9.6 per cent. Monetary policy authorities need to take note of this.

The magnitudes of all demand components in 2021-22 have surpassed their corresponding levels in 2019-20. However, the growth of consumption and investment demand, as measured by private final consumption expenditure (PFCE) and gross fixed capital formation (GFCF) in 2021-22 over 2019-20 is only 1.2 per cent and 2.6 per cent respectively suggesting sluggish revival in domestic demand.

On the output side, the 2021-22 magnitude of the trade, transport et. al. sector, which has many contact-intensive segments, has remained below its corresponding level in 2019-20 by ₹2.9 lakh crore. Growth in the construction sector in 2021-22 was at only 1.9 per cent over 2019-20.

On a quarterly basis, both GDP and GVA show normalising growth with waning base effects. Real GDP growth moderated from 20.3 per cent in Q1 to 5.4 per cent in Q3 of 2021-22. Similarly, real GVA growth also fell from 18.4 per cent to 4.7 per cent over this period. The implied Q4 GDP and GVA growth rates are estimated to be even lower at 4.8 per cent and 4.1 per cent respectively.

Thus, without a base effect, quarterly growth performance appears to be averaging at less than 5 per cent. Assuming some base effects continue in the first two quarters, the annual growth in 2022-23 may not be more than 7 per cent. Even this may not be realised due to the ongoing geopolitical conflict.

Emerging Geopolitical Challenges

It is difficult to arrive at precise estimates of the impact of the increase in global crude prices, but some ideas can be provided using RBI's recent estimates (2021) of the growth and inflation effects of an increase of US$10/bbl., *ceteris paribus.* The estimated impact is a reduction in real GDP growth by 27 basis points and an increase in CPI inflation by 40 basis points. This is based on using their baseline global crude price level of US$75/bbl.

For the full year of 2022-23, we may consider an average global crude price of US$100/bbl. as a benchmark although in the short run, it has already surged to US$123.21/bbl. (average brent crude price for the week ending 7 March 2022). An increase of US$25/bbl. from the baseline price of US$75/bbl. would lead to an estimated reduction in growth of 0.7 per cent points and an increase in inflation of nearly 1 per cent points.

Regarding baseline growth for 2022-23 at 7 per cent and CPI inflation at 5 per cent, the revised levels of these may be put at 6. 3 per cent and 6 per cent respectively due to the impact of crude price upsurge by an assumed margin of US$25/bbl through the year. The impact would be much larger if the margin of increase is enhanced. If the prices of other imported commodities also increase, the inflation impact will be higher.

Regarding fiscal implications, reference may be made to the budgeted nominal GDP growth forecast for 2022-23 at 11.1 per cent. Assuming a revised real growth component of 6.3 per cent and an IPD-based inflation component of 6.5 per cent, which may be slightly higher than the corresponding CPI inflation, we may have a revised nominal GDP growth close to 13.0 per cent.

Applying this, a tax buoyancy of 1, the resultant Centre's gross tax revenues (GTR) would be higher than the budgeted magnitude of ₹27.6 lakh crore by a margin of about ₹3.2 lakh crore.

Alongside, there would also be increases in some components of expenditures linked to the prices of petroleum products including petroleum and fertiliser subsidies. The government should attempt to keep the fiscal deficit at the budgeted level.

Other economic challenges emanating from the global uncertainties may include a worsening of the current account balance due to higher import bills with a depreciating rupee.

A 2019 RBI Study had estimated an increase in the current account deficit (CAD) following a US$10/bbl. increase in global crude price, to be nearly 0.4 percentage points of GDP. Thus, for an increase of US$25/bbl. in global crude prices, the CAD may increase by 1 percentage point of GDP. The RBI Professional Forecasters Survey's median estimate of CAD at 1.9 per cent of GDP for 2022-23 may have to be revised upwards to 2.9 per cent.

There would also be some sectoral supply-side bottlenecks and cost escalation. Sectors that draw heavily on petroleum products such as fertilisers, iron and steel foundries, transportation, construction and coal would be adversely affected. Due to the discontinuation of transactions through SWIFT, there would be some disruption in trade to and from Russia as well as Ukraine.

However, the respective shares of imports and exports from these countries relative to India's overall imports and exports are limited. There would also be some adverse effects regarding financial flows. Net FPI outflows from October to December 2021 increased to US$6.3 billion. Net FDI inflows have also been falling during this period although they have remained positive.

Policy Options

Policymakers may have to exercise a critical choice regarding who bears the burden of higher prices of petroleum products in India amongst consumers and industrial users, oil marketing companies (OMCs), and the government. If the OMCs are not allowed to raise the prices of petroleum products, the bill for oil sector-linked subsidies would go up. If the central and state governments reduce excise duty and VAT on petroleum products, their tax revenues would be adversely affected.

If, on the other hand, the burden of higher prices is largely passed on to the consumers and industrial users, the already weak investment and private consumption would suffer further. If growth is to be revived, maximum attention should be paid to supporting consumption growth and reducing the cost of industrial inputs to improve capacity utilisation. The government may have to strike an appropriate balance among these options.

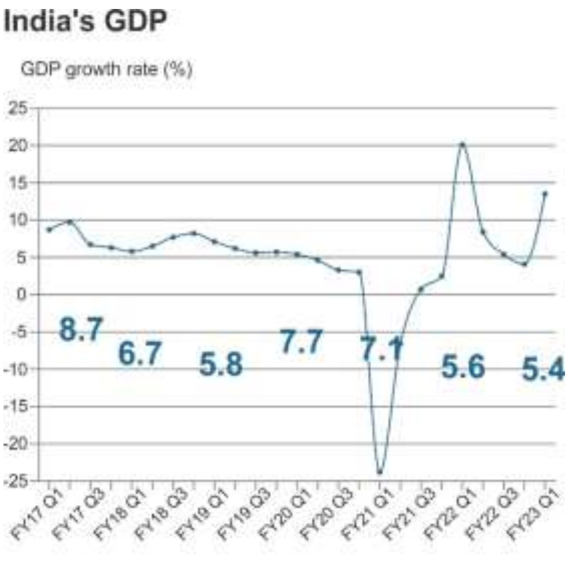
As the developed countries are being forced to raise their interest rates and inflationary pressures continue to mount in India as well as abroad, the RBI may find it advisable to raise the policy rate to stem inflationary pressures and the outward flow of the US dollar even as the growth objective would be served by fiscal policy initiatives.

13. India, 7% Plus Annual Growth, and the Realities

C Rangarajan and D K Srivastava
The Hindu, September 07, 2022

Given the desire to achieve developed country status in the next 25 years, the required rate is in the range of 8 per cent to 9 per cent

The National Statistical Office's real GDP growth estimate of 13.5 per cent for the first quarter of 2022-23 is 2.7 per cent points lower than the Reserve Bank of India's earlier assessment of 16.2 per cent.



Source: MoSPI | Govt. of India • The Hindu Graphic

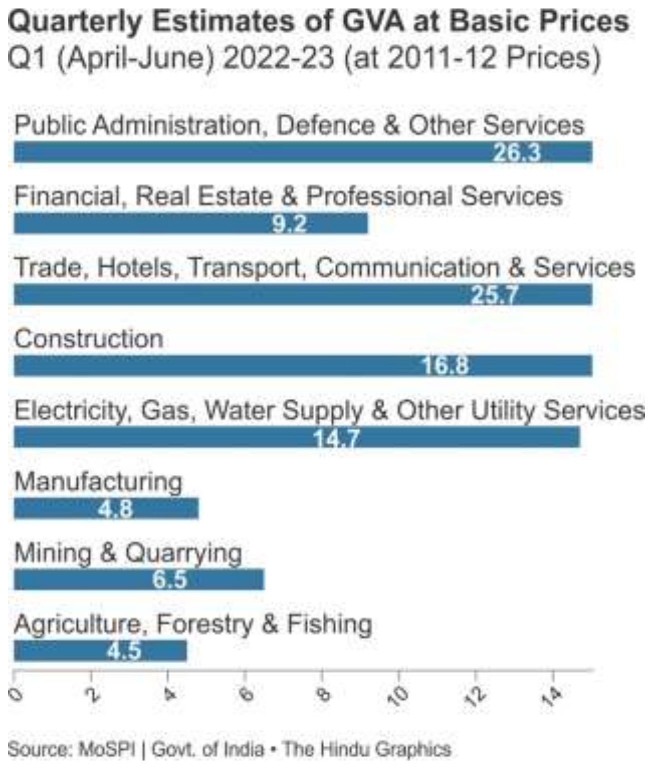
Assuming that the central bank's estimates of the remaining three quarters of the fiscal year at 6.2 per cent in 2Q, 4.1 per cent in 3Q, and 4 per cent in 4Q are realised, the annual GDP growth using the NSO's 1Q estimate works out to be 6.7 per cent. Compared to the pre-COVID-19 GDP level of ₹35.5 lakh crore in 1Q of 2019-20, real GDP at ₹36.9 lakh crores shows an increase of only 3.8 per cent. This indicates that the performance of the Indian economy is not fully normalised yet which would be consistent with a growth of 6.5 per cent to 7 per cent. In order at least to reach an annual growth of 7 per cent, GDP may have to grow at about 5 per cent in 3Q and 4Q of 2022-23.

Composition of Growth

Out of the eight Gross Value Added (GVA) sectors, the first quarter growth performance is higher than the average of 12.7 per cent in public administration, defence and other services (26.3 per cent), trade, hotels, transport et al. (25.7 per cent), construction (16.8 per cent), and electricity, gas, water supply et al. (14.7 per cent).

Agricultural growth has remained robust, showing a growth of 4.5 per cent in 1Q of 2022-23, which is the highest growth over nine consecutive quarters. Growth in manufacturing, at 4.8 per cent, however, is much below the overall average.

On the demand side, all major segments showed magnitudes in 1Q of 2022-23 that were higher than their corresponding levels in 1Q of 2019-20. Recovery in domestic demand has been reflected in the growth rates of private final consumption expenditure (PFCE), at 25.9 per cent, and gross fixed capital formation (GFCF) at 20.1 per cent over the corresponding quarter of the previous year.



As compared to its 1Q 2019-20 level, the GFCF showed a growth of 6.7 per cent. The ratio of gross fixed capital formation to GDP at current prices is 29.2 per cent in 1Q of 2022-23 which is 1 per cent point higher than the investment rate of 28.2 per cent in the corresponding quarter of the previous year.

The contribution of net exports to real GDP growth is negative at minus 6.2 per cent points in 1Q of 2022-23 since import growth continues to exceed export growth by a tangible margin. Such an adverse contribution of net exports to real GDP growth is an all-time high for the 2011-12 base series.

Import growth will likely continue to exceed export growth in the next few quarters, both in real and nominal terms, considering prevailing high global prices of petroleum products and other intermediate inputs and India’s growing demand for importing intermediate goods to boost ‘Make in India’.

On the Feasibility

The Indian economy may still show a 7 per cent plus growth in 2022-23 provided it performs better in the subsequent quarters, particularly in the last two. Two important areas of policy support for this purpose would be to further increase the investment rate and to reduce the magnitude of the negative contribution of net exports. Available high-frequency indicators for the first four to five months of 2022-23 indicate continuing growth momentum.

Headline manufacturing Purchasing Manager's Index (PMI) was at an eight-month high of 56.4 in July 2022. It remained high at 56.2 in August 2022. PMI services were at 55.5 in July 2022, indicating 12 consecutive months of expansion. Outstanding bank credit by scheduled commercial banks (SCBs) grew by 15.3 per cent in the fortnight ending August 12, 2022.

Gross Goods and Services Tax collections have remained high at ₹1.49lakh crore and ₹1.43 lakh crore in July and August 2022, respectively, although a good part of this may be due to the higher inflation levels of both Wholesale Price Index (WPI) and Consumer Price Index (CPI).

As seen in 1Q of 2022-23, GVA growth has been led by public administration, defence, and other services, with a growth of 26.3 per cent. This has been driven by the central government's frontloading of capital expenditure. The Centre's capital expenditure grew by 62.5 per cent during the first four months of 2022-23.

This momentum needs to be maintained. This would be facilitated by a buoyant growth in the Centre's gross tax revenues, which showed a growth of nearly 25 per cent during the first four months of the current fiscal year. The relatively high tax revenue growth is in turn linked to the excess of nominal GDP growth at 26.7 per cent in 1Q of 2022-23 over the real GDP growth of 13.5 per cent.

Such a large gap between these two growth measures reflects a high implicit price deflator (IPD)-based inflation which is estimated at 11.6 per cent in 1Q of 2022-23. This in turn is because of the ongoing WPI and CPI inflation trends where the former continues to exceed the latter. With buoyant tax revenue growth, fiscal policy may strongly support GDP growth without making any significant sacrifice on the budgeted fiscal deficit target.

Raise Investment Rate

In light of likely development in 2022-23, how confident are we of achieving a growth rate of 6 to 7 per cent over a normal base? Given our desire to achieve developed country status in the next 25 years, the required growth rate is in the range of 8 to 9 per cent. In 2023-24, we must try to achieve a growth rate of 6 to 7 per cent.

The key to growth lies in raising the investment rate. Public capital expenditure has shown a rise. In crisis years, it is particularly good. It can crowd in private capital expenditure. But this cannot be normal. Private capital expenditures, both corporate and non-corporate, must rise. It is pointed out that capacity utilisation in the industry has touched 75 per cent in 4Q2021-22. This should help to attract private investment if demand for goods continues to increase.

The output loss because of COVID-19 and the consequent lockdown is greater if we measure it from the trend line rather than the base of 2019-20. Had we maintained growth of 7 per cent since 2019-20 in successive years, the real GDP would have been ₹183.4 lakh crore in 2022-23. Even if we achieve a 7 per cent growth in 2022-23 over 2021-22, there is a shortfall of ₹25.7 lakh crore at 2011-12 prices.

The international environment for growth is bleak. Developed countries even fear a recession. India's growth path in the next few years must depend on domestic investment picking up. Sector-wise growth in investment must be the focus of policymakers in removing bottlenecks and creating a favourable climate.

14. Charting the Economic Journey Ahead

C Rangarajan
The Hindu, November 21, 2022

India has no choice but to grow fast, given the present level of per capita income

India's economic journey started with Independence. It is not realised often that India's economic progress in the first half of the 20th century under British rule was dismal. According to one estimate, during the five decades, India's annual growth rate was just 0.89 per cent.

With the population growing at 0.83 per cent, per capita income grew at 0.06 per cent. It is not surprising that immediately after Independence, growth became the most urgent concern for policymakers.

Early Strategy

In the early period, India's strategy of development comprised four elements —raising the savings and investment rate; the dominance of state intervention; import substitution, and domestic manufacture of capital goods. To some extent, policymakers in India in the 1950s and 1960s were handicapped. At that time, there was no clear model available for accelerating growth in developing countries. State intervention on an extensive scale seemed to be appropriate, even though there were some critics even at that time.

However, by the end of the 1970s, it was becoming clear that the model India had chosen was not delivering and that it needed modification. By that time, there were many more critics of the Indian strategy. But India's policymakers refused to recognise this. It was around that time China made a big change.

It was the crisis of 1990-91 that compelled the policymakers to turn to an 'idea whose time had come'. The break with the past came in three important directions: first, in dismantling the complex regime of licences and permits; second, in redefining the role of the state; and third, in giving up the inward-looking trade policy.

India's average growth till the end of the 1970s remained modest, with the average growth rate being 3.6 per cent. With a population growth of 2.2 per cent, the per capita income growth rate was extremely modest at 1.4 per cent. However, on certain health and social parameters, such as the literacy rate and life expectancy, there were noticeable improvements.

While India had to rely on the heavy imports of foodgrains on a concessional basis, initially, there was a breakthrough in agriculture after the Green Revolution. The industrial base also widened. India became capable of producing a wide variety of goods including steel and machinery.

While India's post-Independence economic performance was reassuring when compared to the pre-Independence period, it is not that impressive when compared with that of several developing countries even in Asia. It was also less than India's expectations. Plan after plan, actual growth was less than what was projected.

The Indian economy did grow at 5.6 per cent in the 1980s. But it was accompanied by a sharp deterioration in the fiscal and current account deficits, and the economy faced its worst crisis in 1991-92. It is extremely doubtful if, without a change in the strategy of development, growth would have picked up.

Between 1992-93 and 2000-01, GDP at factor cost grew annually by 6.20 per cent. Between 2001-02 and 2012-13, it grew by 7.4 per cent and the growth rate between 2013-14 and 2019-20 was 6.7 per cent. The best performance was between 2005-06 and 2010-11 when GDP grew by 8.8 per cent, showing clearly what the potential growth rate of India was. This is the highest growth experienced by India over a sustained period of five to six years. This was despite the fact that this period included the global crisis year of 2008-09.

During this period, the investment rate reached a peak of 39.1 per cent 2007-08. There was a corresponding increase in the savings rate. The current account deficit in the Balance of Payments (BOP) remained low at an average of 1.9 per cent. However, the growth story suffered a setback after 2011-12. The growth rate fell to 4.5 per cent in 2012-13 according to the 2004-05 series. The growth rate since then has seen ups and downs. The growth rate touched the 3.7 per cent level in 2019-20.

Raise the Growth Rate

Post COVID-19 and the Russia-Ukraine war, there is a need to lay down a road map for India's future development. The first and foremost task is to raise the growth rate. Calculations show that if India achieves a 7 per cent rate of growth continuously over the next two decades and more, it will make a substantial change to the level of the economy. India may almost touch the status of a developed economy.

This, in turn, requires India needs to raise the Gross Fixed Capital Formation rate from the current level of 28 per cent of GDP to 33 per cent of GDP. If, at the same time, India maintains the incremental capital-output ratio at 4, which is a reflection of the efficiency with which we use capital, India can comfortably achieve a 7 per cent rate of growth.

Raising the investment rate depends on several factors. A proper investment climate must be created and sustained. While public investment should also rise, the major component of investment is private investment, both corporate and non-corporate. It is this which depends on a stable financial and fiscal system. The importance of price stability in this context cannot be ignored.

Strengthen Social Safety Nets

India needs to absorb the new technologies that have emerged, and that will emerge. Its development strategy must be multi-dimensional. India needs a strong export sector. It is a test of efficiency.

At the same time, India needs a strong manufacturing sector. The organised segment of this sector must also increase. As output and income increase, India must also strengthen the system of social safety nets. Growth without equity is not sustainable.

The rapid pace of globalisation which India saw since the beginning of the 1990s will slow down for a variety of reasons. Some countries which were champions of globalisation are making a retreat. Some countries feel that dependence on other countries for certain key inputs such as crude oil or chips may land them in difficulties at times. The Russia-Ukraine war has exposed this problem starkly. An open economy with some limitations is still the best route to follow.

India today is the fifth largest economy. This is an impressive achievement. However, about per capita income, it is a different story. In 2020, India's rank was 142 out of 197 countries. This only shows the distance we have to travel. The external environment is not going to be conducive.

The Organisation for Economic Co-operation and Development reports a secular decline in growth in developed countries. Environmental considerations may also act as a damper on growth. Some adjustments to the composition of growth may become necessary. All the same, we have no choice but to grow fast, given the present level of per capita income.

15. Balance the Fiscal Consolidation with Growth

C Rangarajan and D K Srivastava
The Hindu, January 17, 2023

A careful calibration would be required for limiting revenue expenditure growth to retain space for capital expenditure to grow adequately

As the number of COVID-19 cases subsided, 2022-23 was expected to be an abnormal year. However, this hope was shattered by Russia's invasion of Ukraine. The supply of critical imports was disrupted and, as a consequence, the prices of such imports increased sharply, derailing many economies.

Growth slowed down, and India was affected too. While India's performance was relatively better than many other countries, the return to normalcy has been delayed.

Even at the currently projected growth rate, India's GDP at the end of the present fiscal year will only be 8.57 per cent higher than its level in 2019-20, giving an average of 2.86 per cent for three years. India needs to move on to a high growth path beginning 2023-24. In this context, what should be the focus of the upcoming Budget to achieve steady, high growth with reasonable price stability?

Growth Performance

In 2022-23, real Gross Value Added (GVA) is estimated to grow by 6.7 per cent. Its sectoral decomposition indicates that every output sector has turned positive as compared to the corresponding magnitudes in the pre-COVID-19 year of 2019-20. In other words, the 2023-24 Budget would pertain to the first normalised economy after the pandemic shock.

The expectation is that nominal GDP in 2023-24 may be close to ₹300 lakh crore. This is based on applying a nominal growth of about 11-11.5 per cent, which implies the assumption of real growth in the range of 6-6.5 per cent and deflator-based inflation in the range of 4.5-5 per cent. It may be noted that real growth in the second half of 2022-23 is only 5.5 per cent as per the advance estimates.

The policy response to the COVID-19 shock, which affected 2020-21, was a sharp increase in the Centre's fiscal deficit to 9.2 per cent of the GDP. This was more than three times the original Fiscal Responsibility and Budget Management Act (FRBM) norm of 3 per cent. In the two succeeding years, the fiscal deficit could be reduced to 6.7 per cent and 6.4 per cent, respectively.

With 2023-24 being the first genuine post-COVID-19 normal year, it would be best to spell out a convincing path towards the prescribed fiscal deficit ratio of 3 per cent. This calls for a total adjustment of 3.4 percentage points of GDP. Given this task, a reduction of at least 0.7 percentage points may be targeted for 2023-24.

There is, however, a need to recognise the challenges to India's growth prospects in view of the global economic slowdown. Multilateral institutions have projected global growth prospects and India's growth prospects for 2023-24. The Organisation for Economic Co-operation and Development has projected a growth rate of 2.2 per cent for the global economy in 2023 and 5.7 per cent for India in 2023-24.

The International Monetary Fund, on the other hand, has projected global growth at 2.7 per cent and India's growth at 6.1 per cent. India may be able to achieve growth in the range of 6-6.5 per cent in 2023-24, provided significant policy support is given to growth.

Saving-investment Balance

The need for correction in the government's fiscal deficit primarily arises because of the relative profile of savings and investment as a proportion of GDP. Financial savings along with the net inflow of foreign capital provide the extent of surplus available for the potential net deficit sectors in the economy, which consists of the public sector (government and non-government) and the private sector.

Financial savings in the household sector had averaged 7.9 per cent of GDP from 2017-18 to 2019-20 before it increased inordinately to 11.6 per cent in 2020-21 due to an upsurge in the precautionary motive in the COVID-19 year.

If we target a reduction of 0.7 percentage points in fiscal deficit in 2023-24 as compared to 2022-23, the resultant fiscal deficit of 5.7 per cent of GDP would imply the availability of investible resources of 1.1 per cent of GDP for both the private corporate sector and the non-government public sector. This can be financed by a household sector financial saving of about 8 per cent of GDP and net inflow of foreign capital of 2.3 per cent of the GDP assuming that States are allowed a fiscal deficit of 3.5 per cent of the GDP in 2023-24.

This balancing would not put any additional pressure on interest rates and would be ideal for sustaining robust medium-term growth with price stability. Bringing down fiscal deficit and charting out a glide path is essential for maintaining price stability. The pressure on the Reserve Bank of India (RBI) to expand reserve money will come down.

Fiscal Prospects

We expect that growth in the Centre's Gross Tax Revenues (GTR) in 2023-24 would be less than that in 2022-23. This is because of an expected fall in both real GDP growth and deflator-based inflation. Assuming a nominal growth of about 11.5 per cent and a buoyancy of 1 in 2023-24, the Centre's GTR may be estimated at ₹34.8 lakh crore while its net tax revenue would amount to ₹24.4 lakh crore.

Together with non-tax revenues and non-debt capital receipts, the total resources available to the Central government would be nearly ₹28.3 lakh crore. If a fiscal deficit of 5.7 per cent of GDP is added, total expenditure may have to be limited to ₹45.7 lakh crore. This is only about 6.3 per cent higher than the estimated total expenditure for 2022-23.

Fiscal support for growth would call for continuing emphasis on capital expenditure. A careful calibration would be required for limiting revenue expenditure growth to retain space for capital expenditure to grow adequately to support growth.

16. What are India's Immediate Growth Prospects?

C Rangarajan and D K Srivastava
The Hindu, March 15, 2023

Any stimulus for growth should be undertaken while adhering to the fiscal consolidation roadmap to keep India's medium-term story intact

The National Statistical Office (NSO), on February 28, 2023, released a set of new numbers about annual and quarterly national income for2020-21, 2021-22, and 2022-23. This new dataset provides an opportunity to make a final assessment of COVID-19's adverse impact on India's GDP growth.

Recovery Since Pre-COVID Year

As per NSO's second advance estimate (SAE), India suffered a contraction of (-) 5.7 per cent in 2020-21 which is much lower than its first advance estimate (FAE) at (-) 7.7 per cent. In this revision, the three sectors which benefited the most were manufacturing, construction, financial, real estate et al. Real GDP during this COVID-19 year amounted to ₹136.9 lakh crore, higher than the ₹134.4 lakh crore assessed earlier. Since then, GDP grew by 9.1 per cent in 2021-22 and 7 per cent in 2022-23.

Comparing the current real GDP level at ₹159.7 lakh crore, the compound annual average growth rate between 2019-20 and 2022-23 was 3.2 per cent. It may be noted that some countries including China, Bangladesh and Vietnam had a positive growth even in the COVID-19-affected year of 2020.

Sector-wise, while overall GVA in 2022-23 is higher by 11.3 per cent as compared to 2019-20, one sector — mining and quarrying — still shows a contraction at (-) 0.3 per cent. Trade, hotels, transport et al also show a weak growth of 4.3 per cent. Sectors showing a higher-than-average increase include construction at 18.6 per cent, manufacturing at 14.8 per cent, financial, real estate et al at 14.3 per cent and agriculture at 12 per cent.

From the viewpoint of aggregate expenditure, an overall increase in real GDP is 10 per cent with government final consumption expenditure (GFCE) growing at 7.4 per cent. Gross fixed capital formation and private final consumption expenditure (PFCE) show an increase of 17.7 per cent and 13.1 per cent, respectively.

The gross fixed capital formation to GDP ratio in nominal terms is 29.2 per cent in 2022-23 as compared to 28.6 per cent in 2019-20. The corresponding real investment rates are 34 per cent and 31.8 per cent, respectively. The difference in real and nominal rates is due to the differential inflation rates of capital goods *vis-à-vis* overall GDP. Thus, in real terms, there is more improvement in the investment rate.

Accordingly, the estimated incremental capital output ratio (ICOR) was at 8.5 in 2019-20 as compared to 4.9 in 2022-23. This is because the 2019-20 GDP growth rate was rather low at 3.7 per cent reflecting considerable unutilised capacity. The average capacity utilisation ratio in the manufacturing sector was only 70.3 per cent in 2019-20, having fallen from 75.2 per cent in 2018-19.

In the first half of 2022-23, the capacity utilisation ratio is higher at 73.5 per cent. While the gross fixed capital formation rate has picked up whether measured in real or nominal terms, the subdued growth implies a lower capacity utilisation and a higher ICOR.

In Q3 of 2022-23, real GDP growth was at 4.4 per cent, falling from 6.3 per cent in Q2 and 13.2 per cent in Q1. However, this decline in growth rate is in line with the projections made by the Reserve Bank of India earlier. It would now require a growth of 5.1 per cent in Q4 to enable reaching an annual growth of 7 per cent in 2022-23. This appears feasible as most high-frequency indicators point towards improved economic activity. PMI manufacturing in January and February 2023 at 55.4 and 55.3, respectively, remained above its long-term average at 53.7.

PMI services increased from 57.2 in January 2023 to a near 12-year high of 59.4 in February 2023. Core IIP showed a growth of 7.8 per cent in January 2023, increasing from 7 per cent in December 2022. Credit growth was also high at 16.1 per cent in the week ending February 10, 2023.

Monthly credit data, however, indicate high credit growth only for personal loans. Industrial credit growth was at a seven-month low. Higher quarterly growth in Q4 appears feasible because of a favourable base effect since growth was subdued in the corresponding quarter of the previous year at 4 per cent.

Sector-wise, in Q3 of 2022-23, manufacturing showed a contraction at (-) 1.1 per cent while public administration, defence et al showed a weak growth at 2 per cent. On the expenditure side, GFCE contracted by (-) 0.8 per cent while PFCE showed a weak growth at 2.1 per cent.

The contribution of net exports to real GDP growth was (-) 0.2 per cent points, improving from (-) 3.4 per cent points and (-) 3.1 per cent points, respectively, in the previous two quarters. Thus, the growth rate in Q3 and the expected growth rate in Q4 are quite decidedly low. From a normal base, growth is yet to pick up to the desired level.

Implications for Growth

Given the anticipated global economic slowdown, India's 2023-24 growth is likely to remain lower than the growth rate of its preceding year of 7 per cent. The RBI has projected a growth of 6.4 per cent for 2023-24. The International Monetary Fund, on the other hand, has projected a lower growth of 6.1 per cent. NSO's data revisions indicate a lowering of the negative contribution of net exports in 2022-23 to (-) 1.9 per cent points as per the SAE from (-)2.8 per cent points in the FAE.

If a fiscal stimulus is continued, injected largely through capital expenditures as envisaged in the 2023-24 Union budget, we may come closer to the RBI's growth estimate. However, with elections around the corner, there may be pressure to increase revenue expenditures. This might lead to a growth rate closer to 6 per cent. Any stimulus for growth should be undertaken while adhering to the fiscal consolidation roadmap to keep India's medium-term story intact.

A steady growth of 6 per cent to 7 per cent can be ensured over the medium term, only if the fixed capital formation rate is raised by another 2 percentage points. This is notwithstanding the global factors that are not encouraging.

17. Headwinds and Tailwinds in the Indian Economy

C Rangarajan and D K Srivastava

The Hindu Business Line, May 27, 2023

To maintain 6-7 per cent growth and cut poverty, private investment is needed

The IMF has recently estimated India's real GDP growth at 5.9 per cent for 2023-24in their April 2023 issue of the World Economic Outlook, revising downwards their earlier January 2023 estimate of 6.1 per cent.

The RBI had estimated a growth of 6.5 per cent for 2023-24 in their April 2023 review of the monetary policy. Their estimate is further explained in their assessment of the 'State of the Economy' included in the April 2023 RBI Monthly Bulletin.

There are considerable uncertainties in the prevailing global and domestic economic conditions and the outcome would depend largely on the balance between global headwinds and domestic tailwinds. We expect that India's real GDP growth may be close to 6 per cent in 2023-24.

Global Headwinds

Quarterly GDP data for 2022-23 indicates that while GDP growth in fi first half at 9.6per cent was characterised by a strong base effect, the growth in the second half at 4.8 per cent may be considered more relevant as it is over a near normal base.

The global economic slowdown which followed in the wake of the Russia-Ukraine war has led to a persistent slowdown in India's exports. In the third and fourth quarters of 2022-23, merchandise exports showed a contraction of 9.9 per cent and 10.1 per cent.

The global crude prices as also prices of other primary commodities came under pressure during 2022-23. The quarterly averages ranged between $110.1/bbl. in the first quarter to $79/bbl. in the fourth quarter of 2022-23. The contribution of net exports to GDP growth was negative in all four quarters of 2022-23 at 3.1, 3.4,0.2, and 1.1 percentage points respectively. The current account deficit in the first three quarters of 2022-23 was negative at 2.1 per cent, 3.7 per cent, and 2.2 per cent of GDP respectively.

According to the IMF, growth in the global trade volume of goods and services is expected to fall from 5.1 per cent in 2022 to 2.4 per cent in 2023. Growth in import volumes of key advanced countries is expected to fall in 2023. For example, in the case of the US, it is projected at (-)2 per cent in 2023.

In the case of the Euro area, growth in import volumes is forecasted to fall to 2.8per cent in 2023 from 7.9 per cent in 2022. With global developments continuing to pose challenges, India's growth prospects in 2023-24 would largely depend on domestic growth drivers.

Domestic Growth Drivers

Manufacturing PMI increased to a four-month high of 57.2 while PMI services increased to a nearly 13-year high of 62.0 in April 2023. Bank credit continued to show a double-digit growth at 15 per cent in March 2023. The merchandise trade deficit narrowed to its lowest level since August 2021 to $(-)15.2 billion in April 2023 due to a relatively faster pace of contraction in imports vis-à-vis exports.

An encouraging sign is India's services exports have risen 1.5 times since 2019 and are estimated at an all-time high of 4.9 per cent of the global services exports. Asper the Ministry of Finance, gross GST revenues at ₹1.87-lakh crore in April 2023posted the highest-ever level of monthly collections since the inception of GST in July 2017.

On the output side, agriculture showed healthy and sustained growth at an average of 4.3 per cent during 2019-20 to 2022-23.

However, due to the effect of the El Nino in 2023-24, monsoons are expected to be delayed which might cause agricultural growth to fall although in RBI's assessment, this effect may be partially neutralised by the Indian Ocean Dipole. If agriculture experiences a cyclical downturn, the Budget numbers may also change since the budgeted subsidies on food and fertilisers may call for upward revisions.

Investment Prospects

Some improvement in gross fixed capital formation (GFCF) relative to GDP has occurred in 2021-22 and 2022-23 both in nominal and real terms. In nominal terms, GFCF to GDP ratio improved from 27.3 per cent in 2020-21 that is the COVID year to 29.2 per cent in 2022-23. A good part of these increases is due to an increase in government capital expenditure.

For a sustained increase in growth, it is important for the private sector investment also to grow. There is some noticeable improvement in the manufacturing capacity utilisation ratio which increased from 72.4 in the first quarter of 2022-23 to 74.3 in the third quarter, which may favour fresh investment.

If the adverse El Nino effect proves to be strong and if the Russia-Ukraine war escalates, India's growth may fall below 6 per cent. It will be closer to the RBI's expectation of 6.5 per cent if the global economic situation improves.

As we look ahead over the next few years, to maintain a reasonably high growth of 6-7 per cent which is also needed to bring down the poverty ratio, the focus must be on private investment, both corporate and non-corporate.

For this to happen, improvement in the overall investment climate is called for. This would depend both on economic and non-economic factors. It is also important to look at the sectoral investment behaviour and take suitable action.

To some extent, a budgetary focus on government capital formation may help in crowding in private investment, especially in an uncertain situation.

B. Fiscal Policy

1. Lockdown with a Human Face

C Rangarajan
Indian Express, April 25, 2020

To return to the present, the focus of the government has to be two-fold. It must act vigorously to contain the virus, explore the possible alternatives to a complete lockdown, and prepare a road map for the removal of restrictions.

As the coronavirus spreads, severe dilemmas haunt policymakers. Even the scientific community is confused and also does not know whether the South Korean model of more intensive testing is preferable to the European model of complete lockdown.

The economic crisis that we are facing today is very different from any crisis that we have seen recently. This is the first economic crisis in recent memory that has been triggered by a non-economic factor – a pandemic. It has brought to a grinding halt nearly all economic activity.

'Life vs 'Livelihood'

The dilemma policymakers face is starkly described as the alternative between 'life' and 'livelihood'. Apparently, on strong medical advice, the government has decided to extend the lockdown by another 20 days. A lockdown essentially amounts to limited economic activity and this results in throwing temporary workers and daily wage earners out of employment. Migrant labour falls in this category.

According to the 2011 census, the number of migrant workers under the category of migrants for work/employment was 41.42 million. This must have grown substantially by now. Thus the impact of the lockdown falls very heavily on the poor and vulnerable groups. We need to bear this in mind while evolving the strategy to combat the virus.

Expenditure Categories

In tackling the virus, I have elsewhere classified the required expenditures into three broad categories. First, there are medical and healthcare expenditures which include an extension of hospital facilities, employment of additional medical and healthcare workers, costs of testing on a much wider scale and the purchase of accessories like personal protection equipment, ventilators and testing kits. Expenditures under this category are a 'must' and cannot be stinted. The length of the battle will decide the cost.

Second, there are alleviating expenditures to take care of the people thrown out of employment and those of other vulnerable sections. Third, there are stimulation expenditures aimed at restarting the economy. Here the financial system presided over by the RBI will play an important role. But the government also has a role.

Impact of Lockdown

The dilemma of 'life' versus 'livelihood' centres around the policy relating to the lockdown. A tight lockdown over an extended period may save lives by curtailing the progress of the virus. But at the same time, it puts several segments of society under severe hardship. With the lack of economic activity, many will go hungry.

In this context, the government must look through two issues. First, it must consider to what extent the severity of the lockdown can be relaxed while keeping in mind the priority of bringing the spread of the virus under control.

The government has recently announced some relaxations. This is a welcome step. However, the government must keep this concern under continuous consideration. Even medically it must explore other options. For example, will more testing make it possible to reduce restrictions?

Second, if the lockdown is a 'compulsion', we need to pay adequate attention to the plight of people who have been affected adversely. The government earlier announced certain measures to help some segments of society. With the lockdown being extended, it is necessary to raise the levels of relief, and also cover segments of society not covered earlier.

A case in point is migrant labour. They are in a serious plight. They can neither go home nor can they get employment or income. A cash transfer to these people may not be that easy as they may not have bank accounts. Nor is there a registry of these people. Many may not have local ration cards and therefore may not receive aid from the local or state government. The best course of action is to provide food and shelter systematically. Local authorities must find a mechanism to achieve this. Hunger is a blot on society and needs to be fought no less than a virus.

There is much talk about a 'stimulation package' for reviving the economy. The financial system will have to lead the charge. The government can provide direct help only to small producers and certain sectors of industry severely affected by the lockdown. In any case, both these efforts largely have to wait for the lockdown to be lifted.

Fiscal Impact

Expectations regarding additional expenditures by the government vary from 2 per cent of GDP to 5 per cent of GDP. Normal sources of financing will not be adequate to meet this order of expenditure. The finances of the government of India were under pressure even before the onset of the coronavirus pandemic. Many analysts felt that the figure of 3.5 per cent of GDP as fiscal deficit indicated in the budget for 2020-21 would be exceeded. Now comes the additional expenditures because of the coronavirus.

Furthermore, with the decline in economic activity revenues will also go down. The revenue projections were made on the assumption that the nominal income growth would be 10 per cent. But this is unlikely to be achieved. The nominal income growth may at best be 7 per cent. Given the increase in expenditures and the slowdown in revenue collection, the borrowing programme will exceed significantly what was indicated in the budget.

The monetisation of debt is inevitable and it will have its consequences with a lag. The brunt of the expenditures will be borne by the state governments and therefore the Central Government must allocate additional resources to the states. They may also be allowed additional borrowing over and above 3 per cent of the state domestic product.

In the first quarter of 2020-21, the GDP growth rate will be negative. Agricultural performance during the year may be the same as in 2019-20 as the rainfall is expected to be normal. The developed world may go through a recession over the year. Thus, the external sector may not be of much help. The economy can have a V-type recovery from the second quarter of 2020-21. On that assumption, the overall growth rate for the year can be 3 per cent. This is an optimistic estimate.

Immediate Challenges

To return to the present, the focus of the government has to be two-fold. First, it must act vigorously to contain the virus, explore the possible alternatives to a complete lockdown, and prepare a road map for the removal of restrictions. Second, it must take all actions to provide adequate help to the poor and the needy including migrant labour. Lockdown, as necessary, must be with a human face.

2. Slower Growth and Tighter Fiscal

C Rangarajan and D K Srivastava
The Hindu, May 09, 2020

India slid into the pandemic crisis in the backdrop of economic downslide; fiscal stimulus has to be structured

COVID 19's impact would be debilitating for the global as well as the Indian economies. Various institutions have assessed India's growth prospects for 2020-21 ranging from 0.8 per cent (Fitch) to 4.0 per cent (ADB). This wide range indicates the extent of uncertainty and the tentative nature of these forecasts.

The IMF has projected India's growth at 1.9 per cent, China's at 1.2 per cent, and global growth at (-) 3.0 per cent. The actual growth outcome for India would depend on (a) the speed at which the economy is opened up, (b) the time it takes to contain the spread of the virus, and (c) the government's policy support.

Growth Prospects in the Crisis Year

India slid into the Corona crisis on the back of a persistent economic downslide. There was a sustained fall in the saving and investment rates with unutilised capacity in the industrial sector. In 2019-20, there was a contraction in the centre's gross tax revenues in the first 11 months from April 2019 to February 2020 at (-) 0.8 per cent. These trends continue to beset the Indian economy in this crisis. We examine the growth prospects for 2020-21 from the output side, referring to real gross value added (GVA).

In 2019-20, which would serve as the base year, India may show GVA growth of about 4.4 per cent, well below CSO's 2nd advance estimate of 4.9 per cent as the fourth quarter number is likely to be revised downwards on account of the adverse impact of the Virus on economic activities. IMF's GDP growth estimate for 2019-20 is at 4.2 per cent.

GVA is divided into eight broad sectors. Although all sectors have been disrupted, some may be affected less than others. We divide the output sectors into four groups. In group A, we consider two sectors that have suffered only limited disruption namely agriculture and allied sectors and public administration, defence and other services.

In the case of agriculture, the Rabi crop is currently being harvested and a good monsoon is predicted later in the year. Despite some labour shortage issues, this sector may show near-normal performance. Public and defence services have been nearly fully active with the health services at the forefront of the COVID fight. For the group A sectors, it may be possible to achieve 90 per cent of the 2019-20 growth performance.

Sector-wise Growth Prospects (in per cent)

Group	Sector	Share 2019-20 (MAE)	Average growth (2017-18, 18-19, 19-20 MAE)	2019-20 MAE	Targeted growth (2020-21)	Contribution to growth (% points)
A	Agriculture, forestry & fishing	14.4	4.0	3.1	2.8	0.40
B	Mining & quarrying	2.6	0.6	2.2	1.1	0.03
C	Manufacturing	17.4	4.4	0.3	1.8	0.31
B	Electricity, gas, water supply & other utility services	2.3	8.0	4.1	2.1	0.05
B	Construction	7.8	4.7	2.4	1.2	0.09
D	Trade, hotels, transport, communication etc.	19.6	7.0	5.1	1.5	0.30
B	Financial, real estate & professional services	22.3	6.3	6.8	3.4	0.76
A	Public Administration, defence and other services	13.6	9.3	8.2	7.4	1.00
	GVA at Basic Price	**100.0**	**5.9**	**4.4**	**2.94**	**2.94**

Note: MAE refers to modified advance estimates that are derived by adjusting downwards, CSO advance estimates dated 28th February 2020.

Next, we consider the group that is likely to suffer maximum disruption (Group D). This includes trade, hotels, restaurants, travel and tourism under the broad group of ‘Trade, Hotels, Transport, Storage and Communications’. This sector may be able to show 30 per cent of 2019-20 growth performance.

Group B comprises four sectors which may suffer average disruption showing 50 per cent of 2019-20 growth performance. These sectors are mining and quarrying, electricity, gas, water supply and other utility services, construction, and financial, real estate and professional services.

In the last group (Group C) we place manufacturing which has suffered significant growth erosion in 2019-20. It is feasible to stimulate this sector by supporting demand. In this case, we apply a 40 per cent performance factor, not on the 2019-20 growth which is an outlier, but on the average growth of the preceding three years.

Considering these four groups together, a GVA growth of 2.9 per cent is estimated for 2020-21. Realising this requires strong policy support, particularly for the manufacturing sector which weights 17.4 per cent. It is also based on the assumption that the Indian economy may move on to positive growth after the first quarter. In the first quarter, GVA growth will be negative.

Calibrating Policy Support

Monetary policy initiatives undertaken so far include a reduction in the repo rate to 4.4 per cent, the reverse repo rate to 3.75 per cent, and CRR to 3 per cent. The RBI has also opened several special financing facilities. These actions will have a positive impact on output only after the lockdown is lifted. These measures need to be supplemented by an appropriate fiscal stimulus.

Although the industry has been clamouring for a large fiscal stimulus, cash-constrained central and state governments have taken expenditure-reducing measures by announcing the freezing of enhancements of dearness allowance and dearness relief. This may result in savings of ₹37,000 crore for the centre and about ₹82,000 crore for the states[2] together amounting to 0.6 per cent of GDP. There is also a talk of substantially reducing non-salary defence expenditure.[3]

With lower petroleum prices, fertiliser and petroleum subsidies may be reduced. These expenditure cuts are contemplated to keep the fiscal deficit under control.

Fiscal stimulus can be of three types: (a) relief expenditure for protecting the poor and marginalised, (b) demand-supporting expenditure for increasing personal disposable incomes or government's purchases of goods and services, including expanded health care expenditure imposed by the Corona virus, and (c) bailouts for industry and financial institutions. Centre had earlier announced a relief package of ₹1.7 lakh crore of which the additionality was only ₹65,000 crores, since it included a frontloading of the budgeted expenditures.

Centre's budgeted fiscal deficit of 3.5 per cent of GDP, may have to be enhanced substantially to (a) make up for the shortfall in budgeted revenues, (b) account for a lower than projected

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2 https://www.livemint.com/news/india/central-government-freezes-da-dr-hike-for-employees-pensioners-till-july-2021-11587629823509.html

3 https://www.business-standard.com/article/economy-policy/defence-budget-may-be-slashed-by-40-may-save-centre-rs-80-000-crore-120042900077_1.html

nominal GDP for 2020-21, and (c) provide for a stimulus. Thus, the centre's fiscal deficit may increase to 6.0 per cent of GDP.

Expenditures on the construction of hospitals, roads and other infrastructure and the purchase of health-related equipment and medicines require prioritisation. These expenditures will have high multiplier effects. Similar initiatives may be undertaken by the state governments who may also enhance their combined fiscal deficit to about 4.0 per cent of GDP to account for 3.0 per cent of GDP under their respective FRLs and to provide for the shortfall in their revenues and some stimulus.

Financing of fiscal deficit poses a major challenge this year. On the demand side, the central (6.0 per cent) and state governments (4.0 per cent) and central and state public sector undertakings (3.5 per cent) together present a total public sector borrowing requirement (PSBR) of 13.5 per cent of GDP.

Against this, the total available resources may at best be 9.5 per cent of GDP consisting of excess savings of the private sector at 7.0 per cent, public sector savings of 1.5 per cent, and net capital inflow of 1.0 per cent of GDP.[4]

The gap of 4.0 per cent points of GDP may result in increased costs of borrowing for the central and state governments. This gap may be bridged by enhancing net capital inflows including borrowing from abroad and by monetizing some part of the centre's deficit. The monetisation of debt can at best be a one-time effort. This cannot become a general practice.

[4] https://www.ey.com/en_in/tax/economy-watch/how-indian-economy-can-recover-post-covid-19

3. The Contours of Recovery

C Rangarajan and D K Srivastava
Indian Express, June 03, 2020

The Centre must be forthcoming on these issues while recognising that extraordinary situations call for extraordinary solutions. Now, reforms have to focus on specific sectors.

The fight against the coronavirus goes on. In the meanwhile, the economic problems are multiplying. With factories closed or nearly closed, workers are without jobs and pay. Stimulus or similar efforts will show an impact only when factories resume work.

Banks can provide credit only when the wheels of commerce and industry start moving. The problem of migrant workers, who may be better referred to as guest workers, can also be resolved if the production of goods and services is resumed. Then their incentive to go home will be weaker.

India's Growth Prospects

The ability to handle the problems on hand will depend, among other factors, on the growth rate in the current year 2020-21. Many analysts have recently predicted a contraction for the Indian economy. Goldman Sachs/ICRA and Nomura in their recent assessments have forecasted India's growth to contract by (-)5.0 per cent and (-)5.2 per cent, respectively. Even the RBI assesses that growth in the current year may be in the negative zone although it has not given a specific number.

We had earlier assessed a GVA growth rate of 2.9 per cent for the current year. This was based on dividing the various sectors of the economy into four categories. These categories ranged from those minimally affected to those severely affected. It was assumed that the lockdown will last for one or one and a half months. Now it has already extended beyond two months. Under the revised set of circumstances, the expected growth rate may need to be brought down closer to 2 per cent.

The World Bank has predicted growth in the range of 1.5 to 2.8 per cent. To relate budgetary magnitudes to GDP, we also need an idea of the magnitude of nominal GDP growth. In the current year, this is expected to be at least 4 percentage points less than the rate of growth at 10 per cent as assumed in the 2020-21 budget.

Stimulus and its Components

One misunderstanding about 'stimulus' must also be cleared. Any increase in government expenditure over and above the base level acts as a stimulus. This is the traditional Keynesian approach. It made no distinction between different types of expenditures. It is only later studies that made a distinction based on the size of fiscal multipliers.

The centre has already announced an increase in gross borrowing for 2020-21 from ₹7.8 lakh crore to ₹12 lakh crore. This may lead to a fiscal deficit of about 5.7 to 5.8 per cent of GDP. This may only be enough to provide for the considerable shortfall in the budgeted tax and non-tax revenues and non-debt capital receipts, which is also being estimated by several analysts to be in the range of ₹18 lakh crore, implying a shortfall of ₹4.45 lakh crore.

This shortfall is 2.08 per cent of GDP. The Centre's fiscal deficit will have to be further increased to accommodate the additional burden on the 2020-21 budget arising on account of the stimulus package.

The series of measures announced by the FM is a mix of already budgeted expenditure, additional expenditure, an extension of credit facility with a government guarantee for certain select sectors and a host of reform measures that are indeed welcome. Perhaps, it would have been useful if a more analytical distinction of expenditures had been given. Analytically, the overall stimulus package of ₹20.97 lakh crore can be divided into a budgetary and a non-budgetary part.

The non-budgetary part, accounting for nearly 85 per cent of the overall package, consists mainly of liquidity-enhancing measures for banks and NBFCs which may facilitate the financial sector in playing a key role to kickstart the economy. The credit guarantee provided by the government under the various schemes announced recently is of central importance in this context.

In fact, for certain schemes, the government has come forward to provide a 100 per cent guarantee which should quicken the pace of credit sanction and delivery by banks. Production of goods and services is interrelated in an economic system. Once production starts, different sectors will be mutually supported since different industries and service providers are locked in an input-output system.

The budgetary part amounts only to about 15 per cent of the overall package. This can be further divided into government expenditure which was already budgeted in the 2020-21 budget and expenditures constituting genuine additionality. The latter component is only 10 per cent of the overall package equivalent to 1 per cent of GDP.

Adding this to the enhanced level of 5.7 per cent of GDP, the centre's fiscal deficit may be close to 6.7-7 per cent of GDP. This will maintain the level of budgeted expenditure while providing for the additional cost of the announced fiscal stimulus. The fiscal deficit will be even higher if the current year's GDP is lower than that of the previous year.

With this high fiscal deficit, the composition of government expenditure becomes critical. Some of the establishment expenditures and subsidies especially those linked to petroleum prices like fertiliser and petroleum subsidies may be reduced while expenditure on health-related items may be increased.

The central government has announced the freezing of increments of D.A. and dearness relief components in the case of salaries and pensions respectively. The government should be doing much more to relieve the plight of migrant workers. The pictures we see are reminiscent of partition. Hunger needs to be fought as vigorously as the virus.

According to the National Infrastructure Pipeline, the centre's budgetary contribution to infrastructure is estimated at 1.25 per cent of GDP on an annual basis. This is less than 18 per cent of the estimated fiscal deficit of the centre in 2020-21, indicating a very poor quality of fiscal deficit.

One dimension of expenditure restructuring should be to front load infrastructure spending including that on health infrastructure thereby taking advantage of the higher multiplier effects associated with capital expenditures. Investment augmentation also demands support and employment and income generation.

Public Sector Borrowing Requirement (PSBR)

Support to demand will come not only from the centre but also from the states and the public sector undertakings. States have been allowed to borrow an additional 2 per cent of their respective GSDPs subject to certain conditions.

In fact, at the present juncture, these conditions are not required since the enhancement of the borrowing limit is for one time while the reforms linked to conditions are permanent. In any case, states should be encouraged to support demand by going up to the full extent of the enhanced limit.

In this scenario, the combined fiscal deficit of the centre and states alone may amount to close to 12 per cent of GDP in 2020-21. Besides, the total public sector borrowing also includes the borrowing by central and state public sector undertakings. Thus, the total PSBR may well exceed available sources of financing consisting of the financial savings of the household sector, savings of the public sector and net capital inflows. In this context, monetizing debt has become unavoidable. The centre must be forthcoming on these issues while recognising that extraordinary situations call for extraordinary solutions.

Reforms: The Next Round

We must consider the shape of the next round of reforms which would pave the way for sustained growth in the post-COVID era. However, in the case of reforms, we have reached a new stage. General reforms cutting across industries and sectors have been critical in the early stages. The earlier regime of controls and permits had to be brought to a close.

But now reforms have to focus on specific sectors. Applying the general principles of liberalisation to sectors such as agriculture and more particularly agricultural marketing, power sector, and telecom have assumed importance. Labour market reforms are needed across all the states. But labour reforms are introduced better when the economy is on the upswing. Consensus-building is critical before introducing labour reforms. Land markets need to be freed up consistent with the concerns of small and marginal farmers.

4. Growth Compulsions, Fiscal Arithmetic

C Rangarajan and D K Srivastava
The Hindu September 28, 2020

The economic situation warrants enhanced government expenditure; the policy challenge is to minimise the growth fall

India's growth in the first quarter of 2020-21 at (-) 23.9 per cent showed one of the highest contractions globally. Global growth prospects for 2020 have been projected by several multilateral institutions and rating agencies including that for India. The 2020-21 real GDP growth for India is forecasted in the range of (-) 5.8 per cent (RBI's Professional Forecasters Survey) to (-) 14.8 per cent (Goldman Sachs).

The OECD in its September 2020 Interim Economic Outlook has projected a contraction of (-) 10.2 per cent in FY21 for India. The annual projections also indicate a strong likelihood of even the nominal GDP growth showing a contraction for 2020-21.

The latest data released by the Ministry of Statistics indicates a CPI inflation rate of 6.7 per cent for August 2020. The average CPI inflation during the first five months of 2020-21 is estimated at 6.6 per cent. Given the injection of periodic liquidity into the system and the inflation trends, the year as a whole may show a CPI inflation of close to 7 per cent. Since deflator-based inflation tends to be lower than CPI inflation, it may be about 5 per cent or less.

In fact, in the first quarter of 2020-21, the GDP-based deflator was only 1.8 per cent. If we take OECD's real GDP growth projection at (-) 10.2 per cent and deflator-based inflation of about 5 per cent, the implied contraction in nominal GDP is about (-) 5.0 per cent for 2020-21.

Some of us indeed felt at one time that the economy might not do too badly because some key sectors like agriculture and related sectors, public administration, defence services and other services may perform normally or better than normal given the demand for health, relief and revival expenditures. We had even expected that a small positive growth might be possible. The recently released national income figures for Quarter I of 2020-21 hold no such hope.

What is most surprising in the Q_1 data is that the sector 'Public Administration, Defence and other Services' contracted at (-) 10.3 per cent. This means that there was no fiscal stimulus. Independent estimates show that states' capital spending fell by 43.5 per cent. The worsening of the fiscal deficit appears to be because of a decline in revenue than an increase in expenditure.

Revenue Erosion

The policy challenge for the remaining part of the fiscal year is to minimise this sharp contractionary momentum in real and nominal growth. A sharp contraction in nominal GDP growth has significantly adverse implications for the prospects of central and state tax revenues, which may both contract.

In the first quarter of 2020-21, the centre's gross tax revenues contracted by (-) 32.6 per cent and CAG-based data about 19 states show a contraction of (-) 45.0 per cent in their tax revenues. This implies a negative buoyancy of about 1.65 in the combined tax revenues of central and state governments in the first quarter.

Given the adverse impact of the lockdown, even the budgeted non-tax revenues are not likely to be realised. The revenue calculations of the budget were made on the assumption that the nominal income of the country would grow at 10 per cent. With the prospect of a contraction in nominal growth, the tax revenues of the centre would show a considerable shortfall as compared to the budgeted amounts.

Some estimates indicate that the tax and non-tax revenue and non-debt capital receipts in the current fiscal may fall well short of the budget estimates by an amount higher than ₹5.0 lakh crore. The combined fiscal deficit of the centre and the states will have to make up for the shortfall in tax and non-tax revenues if the level of budgeted expenditures is to be maintained.

Fiscal Deficit

For the central government to maintain the level of budgeted expenditure and also provide for additional stimulus, its fiscal deficit may have to be increased to close to an estimated 8.8 per cent of GDP. This consists of an estimated revised budgeted fiscal deficit of about 4 per cent of GDP due to a lower denominator value of GDP plus 2.5 per cent to make up for the shortfall in tax and non-tax revenues plus 2.3 per cent for the additionality over the budgeted expenditures in the already announced stimulus package including the recently announced first batch of supplementary demand for grants.

Adding the centre's and states' fiscal deficit, the combined fiscal deficit amounts to 13.8 per cent of GDP. If the nominal GDP contracts in 2020-21, the fiscal deficit as per cent of GDP would go up further. This also does not take into account any additionality to borrowing because of the GST compensation. It may be noted that the centre's fiscal deficit to GDP ratio for Q_1 of 2021 was 17.4 per cent. The centre's fiscal during the first four months of 2020-21 as a per cent of the annual budgeted target was at 103.1 per cent.

Limits to Deficit

How high can fiscal deficit go? The IMF, in its June 2020 update of the WEO estimated the fiscal deficit of India and China at 12.1 per cent of GDP. All the other countries except the USA and a few others have a deficit lower than this. The dollar as a reserve currency has its advantages and this benefits the USA.

Coming back to India's fiscal deficit, there are not adequate resources to support a fiscal deficit of nearly 14.0 per cent of GDP. All this will therefore require substantial support from RBI which will have to take it on itself either directly or indirectly, a part of the central government debt. In the direct mode, the RBI takes on the debt directly from the government at an agreed rate. It took India long to move away from the automatic monetisation of debt. It happened in the early 1990s.

Even if RBI wants to support the borrowing programmes, it should not do so directly. The indirect method is preferable as the market still sends out the signals on interest rates. In both cases, the RBI is the provider of liquidity. The indirect route is not new. The question ultimately relates to the extent of debt monetisation that may be undertaken. The country has also to guard against high inflation.

The economic situation warrants enhanced government expenditure. The fiscal deficit will go well beyond the mandated level – more than twice the mandated level. This has to be accepted. It appears that governments are withholding expenditures. That is not the right approach.

At the same time, there is a limit to the monetisation of debt. Perhaps the best course of action will be to keep the combined fiscal deficit around 14 per cent of GDP in the current year and find ways to finance it. This will have to be brought down gradually. It may take several years of normalisation.

5. Dilemmas in Policy Prescriptions

C Rangarajan
The Hindu Business Line October 31, 2020

Policymakers who plead for increased govt spending to boost growth must spell out how high a fiscal deficit they can tolerate

There has been a spate of suggestions on how to deal with the damage caused by COVID-19 on the Indian economy. While there is a consensus that the situation warrants a substantial increase in government expenditure, there are differences among analysts on the nature of expenditures and the quantum. Some analysts including editorial writers fail to take their policy prescriptions to logical conclusions.

Expenditure Types

In a situation like the present one which is marked by weak demand, the standard prescription offered by Keynesians is to raise the government's expenditure. The original Keynesian formula did not make any distinction between one type of expenditure and another.

In a broad sense, this is true. In the present scenario, any increase in expenditures whether it be for healthcare or cash dole for vulnerable groups or any other type of expenditure including what is described as 'stimulus' acts as a stimulus to the economy. However, initially, these expenditures have a differential impact. The motivation for each type of expenditure may also be different.

Healthcare expenditures are needed to prevent the spread of the virus. Cash dole is recommended primarily from a humanitarian angle. Vulnerable groups including migrant labour need immediate relief. The primary reason for the cash dole is not stimulating demand.

Lack of demand is felt in sectors such as the hospitality sector which includes hotels and transport, real estate including housing and other industrial segments like automobile. Cash dole for the vulnerable groups will not take care of the weak demand for the products in these sectors. Industries plead for sector-specific relief.

Besides healthcare expenditure and relief measures, what is required is a sharp increase in capital expenditures of the government and public sector enterprises. They can lead to a general increase in demand through backward and forward linkages. An aggressive capital expenditure programme by the centre and state governments is what is needed.

Quantum of Expenditure

The quantum of expenditure is also related to its financing. One may not be concerned with this issue, if there is no problem with financing the expenditure. But this is hardly true. When analysts talk about an increase in expenditure, they should have a fix on what the fiscal deficit will be and how it will be financed.

The fiscal deficit depends upon the revenue of the government as well. This has taken a big beating. The Budget was based on the assumption that the nominal income will grow by 10 per cent. We would be lucky if the nominal income growth is in a positive range.

D.K. Srivastava and I have estimated what the level of the fiscal deficit would be on certain assumptions. For the central government to maintain the level of budgeted expenditure and also provide for additional stimulus, its fiscal deficit may have to be increased to close to an estimated 8.8 per cent of GDP.

This consists of an estimated revised budgeted fiscal deficit of about 4 per cent of GDP due to a lower denominator value of GDP plus 2.5 per cent to make up for the shortfall in tax and non-tax revenues plus 2.3 per cent for the additionality over the budgeted expenditures in the already announced stimulus package including the recently announced first batch of supplementary demand for grants.

The state's deficit will be 5 per cent of GDP. Adding the centre's and states' fiscal deficit, the combined fiscal deficit amounts to 13.8 per cent of GDP. If the nominal GDP contracts in 2020-21, the fiscal deficit as per cent of GDP would go up further. This is a distinct possibility as some of the latest forecasts point to a decline of 10 per cent of real output. This also does not take into account any additionality to borrowing because of GST compensation. This is a large fiscal deficit and cannot be financed through normal channels of savings primarily from the household sector and inflows from abroad.

The support of RBI becomes inevitable. The monetisation of debt even if it is indirect has implications for the economy including that inflation. The Impact of Inflation depends on several factors such as the extent of the increase in Reserve Money and the size of the money multiplier which again depends on credit growth.

One can ask given the current situation, what is the likelihood of a sharp increase in inflation? As indicated earlier, it depends very much on the growth in the money supply. With all output forecasts bleak, the concern cannot be simply brushed aside or pushed under the rug. Policymakers and analysts who plead for an increase in government expenditures must take a view on how high a fiscal deficit they are willing to tolerate.

Given the severity of the current situation, we may perhaps have to live this year with a fiscal deficit of around 14 per cent of the GDP. At the same time, we need to be conscious of the implications of such a high level of deficit in terms of its financing and the subsequent impact on inflation.

Lockdown and Growth

There is also a concern about how effective monetary policy and fiscal policy can be under the present circumstances. So long as the lockdown continues, it is difficult to expect production to rise fast. A substantial reduction in restrictions is a precondition for faster growth. The government will have to look at other alternatives to prevent the spread of the virus.

6. Fiscal Support Can Contain GDP Contraction

C Rangarajan and D K Srivastava
The Hindu Business Line, December 03, 2020

Stretching the fiscal deficit to 7-8 per cent of GDP will provide room for expansion of capital expenditure to prop up govt demand

The recently released GDP data for the second quarter show that the real GVA and GDP contracted by (-) 7.0 per cent and (-) 7.5 per cent respectively. GDP contraction in two successive quarters of the fiscal year 2020-21 confirms that the Indian economy has entered a 'technical recession'.

In India's quarterly growth series, which the CSO started only from 1996-97, no contraction in any quarter has been seen. The lowest GDP growth at 0.24 per cent was in the fourth quarter of 2008-09 as per the 2004-05 base series.

For annual data, there are five earlier years where a negative real GDP growth was observed namely, 1957-58 [(-) 0.4 per cent], 1965-66 [(-) 2.6 per cent], 1966-67 [(-) 0.1 per cent], 1972-73 [(-) 0.6 per cent], and 1979-80 [(-) 5.2 per cent] as per the 2011-12 base series. It is difficult to say whether there were two consecutive quarters of negative growth in years such as 1965-66 or 1979-80 since quarterly growth data are not available before 1996-97.

Thus, for available data, contraction in two successive quarters has been experienced for the first time. This recession, however, may be reversed in the very next quarter if positive growth can be ensured with adequate fiscal support.

Signals from Second Quarter Growth

In the second quarter of 2020-21, both GDP and GVA growth numbers signal a faster-than-expected recovery. On the output side, apart from agriculture which continued its first quarter growth of 3.4 per cent into the second quarter, significant improvement was observed for five sectors namely, (1) manufacturing, (2) mining, (3) electricity, gas and water supply et. al., (4) construction, and (5) trade, hotels, transport and communication et. al.

In the case of manufacturing, from a contraction of (-) 39.3 per cent in the first quarter, growth recovered to 0.6 per cent in the second quarter, showing an improvement of 39.9 percentage points. This improvement is largely due to a spike in demand linked with a progressive exit from the lockdown of different states, easing supply constraints, and the release of pent-up demand. Some of the incentive measures announced by the Ministry of Finance in the second and third editions of the stimulus package may also have helped.

The two remaining sectors namely, financial, real estate and professional services, and public administration, defence and other services, have continued to struggle in the second quarter, showing a contraction of (-) 8.1 per cent and (-) 12.2 per cent respectively. The former sector is expectedly COVID-affected.

However, the performance of public administration, defence and other services, which are subject to policy intervention, has been quite disappointing. This sector performed worse than that in the first quarter when the contraction was (-) 10.3 per cent. This is the sector where stimulus policies were expected to arrest the contractionary momentum. Both the central and state governments are responsible for this.

Disappointing Contribution of Government Demand

Overall consumption demand, as reflected by growth in private and government final consumption expenditure has been quite weak. In the case of private final consumption expenditure, there was a contraction in both the first and the second quarters of the fiscal year respectively at (-) 26.7 and (-) 11.3 per cent. This is to be expected as income has been falling.

In the case of government final consumption expenditure, there was a positive growth of 16.4 per cent in the first quarter which reversed to an unexpected and large contraction of (-) 22.2 per cent in the second quarter. Investment growth, as measured by gross capital formation, also contracted by (-) 47.5 per cent in the first quarter and by (-) 8.9 per cent in the second quarter.

Although export growth contracted in both quarters, import growth contracted even more, resulting in a positive contribution of net exports to GDP growth in the two quarters at 5.5 and 3.4 percentage points respectively. Thus, there was an improvement in the second quarter as compared to the first quarter in all segments of demand except government final consumption expenditure where there was a sharp deterioration.

Q_3 and Q_4 Full-Year Growth Prospects

The positive momentum of the manufacturing, construction, trade, hotels, transport and communication et al. sectors is likely to continue in the third and fourth quarters of 2020-21. We expect a small improvement in the third quarter growth and a larger improvement in the fourth quarter due to a strong base effect, and the likelihood of near full exit from the lockdown. The base effect may be tangible, particularly in manufacturing and construction which had experienced a contraction of (-) 1.4 and (-) 2.2 per cent respectively in the fourth quarter of 2019-20.

In the case of the two large service sectors namely, trade, hotels, transport and communication et. al. and financial, real estate and professional services, growth rates although positive were quite low at 2.6 and 2.4 per cent respectively in the fourth quarter of 2019-20.

Accelerating Fiscal Expenditure

To ensure positive growth rates in the third and fourth quarters of 2020-21, fiscal support may play a crucial role. Centre's tax revenues which contracted by (-) 16.8 per cent during the first seven months of 2020-21, should start turning positive from December 2020 onwards when the extended tax return deadlines would be reached.

As far as fiscal deficit is concerned, the centre has touched 120 per cent of the annual budgeted target by October 2020. This amount is equal to ₹9.53 lakh crores, which is about 5 per cent of the estimated nominal GDP for 2020-21 as per the IMF.

The central government may consider stretching its fiscal deficit to close to 7-8 per cent of GDP this year. This will provide room for expansion of expenditure, particularly capital expenditure to support the languishing government demand.

Full Year Growth

With a strong recovery expected in the fourth quarter of 2020-21 along with positive growth in the public administration, defence and other services sectors, we expect the full year 2020-21 real GDP growth to be in the range of (-) 6 to (-) 7 per cent. Reduction in the first half of GDP at 2011-12 prices in 2020-21 as compared to the first half of 2019-20 is ₹1115897 crore, which is 7.66 per cent of the 2019-20 GDP.

If the Indian economy at least maintains the second-half GDP in 2020-21 at the level of last year, the full-year contraction can be limited to about (-) 7.7 per cent.

If an increase can be brought about at least in the fourth quarter, GDP contraction in 2020-21 can be limited to the range of (-) 6 to (-) 7 per cent. This would be a clear improvement over the forecasts given by multilateral agencies such as the IMF which has forecasted India's 2020-21 real GDP growth at (-) 10.3 per cent.

7. How far Can India's Fiscal Deficit be Stretched?

C Rangarajan and D K Srivastava
The Hindu Business Line February 24, 2021

There may not be leeway to specify a combination of fiscal deficit and debt that is very different from the current FRBM norms

The Union Budget for 2021-22 has provided for a sharp relaxation of the central government's fiscal deficit to 9.5 per cent in 2020-21 and 6.8 per cent of GDP in 2021-22. The combined fiscal deficit and debt of the centre and states may be much higher in 2020-21 at about 14 and 90 per cent of GDP. These levels, exceeding the current FRBM norms of 6 and 60 per cent by wide margins, have been justified as a countercyclical response to the COVID crisis. Now, the issue is to guide these back to levels consistent with debt sustainability.

Countercyclical Departure

The Economic Survey 2021 has argued the case for raising the fiscal deficit based on a positive growth-interest rate differential. The Survey contended that the line of causation runs from higher growth to debt sustainability rather than vice versa and that the higher the excess growth rate over the interest rate, the higher could be the primary deficit to GDP ratio consistent with debt sustainability.

The Survey, however, did not indicate a steady state or long-term combination of the levels combined debt and fiscal deficit relative to GDP, if the present FRBMA is to be amended.

Average and Marginal Interest Rates

For deriving a steady state, the focus should be on the potential growth rate and the long-term interest rate. The relevant interest rate in the derivation of debt sustainability condition is the average interest rate on government debt. This is also indicated in the Economic Survey where the applicable nominal interest rate is derived by dividing interest payment in a given year by the outstanding debt at the end of the previous period *(Volume 1, Chapter 2)*.

This is a weighted sum of the contracted interest rates on past debts. This should be distinguished from the interest rate at which current borrowing can be done which may be referred to as the marginal interest rate. If the marginal interest rate falls, the average interest rate would also fall but at a lower pace. This is reflected in the movement of the effective interest rate obtained by dividing combined interest payments by combined debt.

From FY16 to FY20, this interest rate has fallen only from 7.4 per cent to close to 7.0 per cent. By pumping in additional liquidity, the current nominal interest rate can be driven down. But this may raise the inflation rate above the policy target rate and may well reduce the real interest rate, having an adverse impact on the overall savings rate. Such a policy can only lead to financial repression with all the attendant problems. Asset mispricing will also be a consequence which can have serious implications.

Thus, the maintainable longer-term nominal interest rate for government debt may have to be close to 7 per cent, derived by combining a CPI inflation rate of about 4 per cent and a real interest rate of 3 per cent.

India’s Potential Growth Rate

For assessing India’s potential growth rate, we may juxtapose India’s falling investment rate since 2011-12 with India’s rising capital-output ratio in recent years. The real investment (gross fixed capital formation) rate, at 2011-12 prices, has fallen from 34.3 per cent in 2011-12 to 32.5 per cent in 2019-20. The incremental capital-output ratio (ICOR) estimated on a trend basis has been in the range of 5.4-5.9 during 2015-16 to 2019-20. Taking an ICOR value of 5.5, the potential real GDP growth may be estimated at 6.0 per cent.

Earlier, Rangarajan and Srivastava (2017) had estimated India’s potential GDP growth rate, based on a sector-wise decomposition of the ICORs, at 8 per cent plus. It has now come down due to a fall in the investment rate and an increase in the ICOR. To derive the corresponding nominal growth rate, we need to add an Implicit Price Deflator-based inflation rate of 3 per cent.

Combining 6 per cent and 3 per cent, we get a nominal GDP growth of 9 per cent. Thus, in the medium term, the growth rate-interest rate differential may be about 2 percentage points.

A high primary deficit relative to GDP can only be created temporarily by raising the fiscal deficit well above its steady-state path but it cannot be sustained. The average primary deficit over the last five years has been 0.7 per cent of GDP for the centre and 1.8 per cent for the central and state governments.

A study by us shows that between 1955-56 and 2000-01, the rise of debt to GDP ratio was due only to the primary deficit. Of course, its impact was substantially reduced by growth rate – interest differential (see our book Federalism and Fiscal Transfers in India).

The growth rate–interest rate comparison has the implicit assumption that the current level of debt-GDP ratio is appropriate and keeping it at that level is the desired criterion of sustainability. If it is felt that this ratio needs to be brought down as the N K Singh committee proposed, there has to be a primary account surplus.

Arguments are also being advanced that many developed and emerging market economies have a relatively high debt-GDP ratio (See Table 1). But it should be noted that in these and many other developed countries, the average and marginal interest rates have been close to zero for some years and their ratio of interest payment to revenue receipts is also very low. In contrast, in India, the average interest rate is still above 7 per cent.

More importantly, the revenue receipts to GDP ratio is quite high in countries with high debt-to-GDP ratios. Consequently, the interest payments to revenue receipts ratio is low in these countries and high in India. Therefore, lowering this ratio is an important consideration.

Table1: Fiscal Parameters for General Government (Per cent)

Countries	Revenue receipts/GDP	Interest payments/Revenue receipts	Debt/GDP
India	18.1	25.8	72.4
US	29.5	13.8	108.7
UK	36.6	5.6	85.4
Japan	35.0	4.7	238.0

Data pertains to 2019-20 for India. For UK, USA, and Japan data for revenue receipts pertain to 2018 and for interest payments and debt to 2019.

Clearly, in the long run for India, the excess potential growth rate over the average interest rate is limited. Taking into account India's low revenue receipts to GDP ratio, an amended FRBM may not have the leeway to specify a combination of fiscal deficit and debt relative to GDP consistent with debt sustainability, which is significantly different from the current FRBM norms.

8. A Chance to Support Growth, Fiscal Consolidation

C Rangarajan and D K Srivastava
The Hindu, January 24, 2022

Two years of real growth in economic activities have been wiped out by COVID-19, which the Budget must take note of

NSO released the first advance national accounts estimates for 2021-22 on January 7, 2022. India's real GDP growth in 2021-22 is estimated at 9.2 per cent which is 30 basis points lower than the RBI and IMF's projection of 9.5 per cent. In an earlier analysis (The *Hindu, December 18, 2021)*, we had considered some of the ongoing challenges to the 2021-22 growth forecast, indicating a possible decline.

The adverse effect of COVID's third wave, which is mainly affecting the last quarter of 2021-22, may call for a further downward adjustment in the growth rate to about 9 per cent. The main sectors that have held back a more robust recovery are trade, transport, et. al. on the output side and private final consumption expenditure (PFCE) on the demand side as their annual estimated 2021-22 magnitudes remain below the corresponding levels in 2019-20.

Growth Prospects

For the prospects of 2022-23 growth, IMF and OECD forecasts have indicated growth rates at 8.5 per cent and 8.1 per cent respectively. However, these may prove to be optimistic as the base effects characterising 2021-22 may be limited. In fact, as per NSO's advance estimates, at the end of 2021-22, the magnitude of GDP in real terms is estimated at ₹147.5 lakh crore which is only a shade higher than ₹145.7 lakh crore in 2019-20.

Thus, due to the three waves of COVID that India has experienced, two years of real growth in economic activities have been wiped out. The economy has to now start on a clean slate. Growth in 2022-23 would depend on basic determinants such as the saving and investment rates in the economy.

As per the advance estimates, the gross fixed capital formation (GFCF) relative to GDP at current prices stands at 29.6 per cent in 2021-22. Capacity utilisation in India continues to have considerable slack. Available quarterly data indicate a capacity utilisation ratio of only 60.0 per cent at the end of the first quarter of 2021-22 and an average of 61.7 per cent in the preceding four quarters. As such, a pick-up in private investment may take some time.

Private final consumption expenditure (PFCE) also shows a low growth of 6.9 per cent in 2021-22. Any pick-up in demand would continue to be constrained by low-income growth in sectors characterised by a high marginal propensity to consume (MPC) such as the trade, transport, et. al. sector and the MSME sector more broadly.

Growth in 2022-23 would also continue to be constrained by supply-side bottlenecks and high prices of global crude and primary products. It may thus be prudent to expect a real GDP growth in the range of 6-7 per cent. The implicit price deflator (IPD)-based inflation which was as high as 7.7 per cent in 2021-22, may come down to about 5-6 per cent. Thus, we may expect a nominal GDP growth of about 12-13 per cent in 2022-23. It is the nominal magnitude which is crucial as far as the budget is concerned.

Revenue Buoyancy

It was due to the high IPD-based inflation that the nominal GDP growth in 2021-22 at 17.6 per cent exceeded the real GDP growth by a margin of 8.4 per cent points. This high nominal growth combined with base effects resulted in the Centre's gross tax revenue (GTR) growth of 50.3 per cent during the first eight months of the current fiscal year.

In the first six months of 2021-22, this growth was even higher at 64.2 per cent. In October and November 2021, the average growth in the centre's GTR has fallen to about 17.4 per cent as the base effect was weakening.

We assess that the annual growth in the centre's GTR may be close to 35 per cent implying a buoyancy of nearly 2. With these buoyant tax revenues, the government may be able to limit the 2021-22 fiscal deficit to its budgeted level of 6.8 per cent of GDP although a marginal slippage may not be ruled out. There may be some slippage in disinvestment targets and supplementary expenditure demands have also to be accommodated.

Going forward, since the base effects in the centre's GTR would have weakened, we may expect a lower annual GTR growth of about 15-16 per cent in 2022-23 which in combination with a nominal GDP growth of 13 per cent implies a buoyancy of about 1.2. This would still compare well with the centre's GTR growth performance in the pre-COVID years which averaged only 5.6 per cent during 2017-18 to 2019-20. The major CIT reform undertaken in

2019-20 had provided, among other things, a concessional CIT rate of 15 per cent for fresh investment in manufacturing by domestic companies provided their production took off on or before 31 March 2023.

Since nearly two years have been lost due to COVID, the government may consider extending the time limit for availing this benefit. The GST compensation provision would also come to an end in June 2022. This would cause a major revenue shock at least for some states such as Tamil Nadu, Kerala and Andhra Pradesh. While this matter may be considered by the GST Council, the compensation arrangement should be extended by two years in some modified form. Its impact on the Centre's budget should be provided for.

For non-tax receipts, the scope of the National Monetisation Pipeline (NMP) may be extended to cover the monetisation of government-owned land assets. Disinvestment initiatives may have to be accelerated.

Expenditure Priorities

Expenditure prioritisation in 2022-23 should focus on reviving both consumption and investment demand. The National Infrastructure Pipeline (NIP) should be reassessed, and its path may be recast to make up for existing deficiencies in the original targets, particularly in the health sector.

In this regard, the infrastructure investment undertaken by the state governments and the public sector should be realistically ascertained and shortfalls concerning original targets may be identified and remedial measures should be initiated. Since consumption demand remains weak, some fiscal support in the form of an urban counterpart to MGNREGA may be considered in addition to supporting some of the sectors which are directly impacted by COVID. Revival of the economy in 2022-23 would critically depend on containing the adverse economic impact of COVID's third and subsequent waves to a minimum.

Return to Fiscal Consolidation

It would be appropriate now to consider a graduated return to fiscal consolidation while using fiscal policy to lay the base for faster growth in the years to come. The Fifteenth Finance Commission (15 FC) had suggested a fiscal consolidation path where the Centre's fiscal deficit was benchmarked at 5.5 per cent of GDP for 2022-23. In their pessimistic scenario, it was kept at 6 per cent of GDP.

At this point, while supporting growth is critical, signalling a return to fiscal consolidation is also important. It may be prudent to limit the reduction in the fiscal deficit-GDP ratio to about 1 per cent point of GDP in 2022-23. This would imply a fiscal deficit in the range of 5.5-6 per cent of GDP. From here on, a stepwise reduction of 0.5 per cent points per year would enable a level of about 4.0 per cent of GDP by 2025-26.

By this time, as suggested by the 15 FC, a High-powered intergovernmental group should be constituted to re-examine the sustainability parameters of debt and fiscal deficit of the central and state governments in the light of new empirical realities particularly taking into account, the likely level of interest rate on government debt.

9. The Fiscal Rethink

C Rangarajan and D K Srivastava
Indian Express, February 23, 2022

Government must reconsider cut in food subsidies, be attentive to risks of high fiscal deficit and relaxed conditions on state borrowings

The Budget for 2022-23 has been discussed from several angles. In this article, we want to raise three important issues which have a bearing not only on the current year but also on the coming years.

These are (1) Is enhancing capital expenditures the best way to stimulate an economy faced with a situation like the present one? (2) Can the government function with a high fiscal deficit for several years in a row? and (3) What should be the mechanism to determine the level of borrowing of states?

Capital Expenditures as a Stimulus

What stands out prominently in the Budget for 2022-23 is the emphasis on capital expenditures of the government. Capital expenditures are expected to rise by 24.5 per cent over the Revised Estimates for 2021-22. This is a welcome directional change that continues the trend of the previous year.

As per the Revised Estimate of 2021-22, growth in capital expenditure is estimated to be even higher at 41.4 per cent. In 2022-23, 45.2 per cent of the fiscal deficit will be used for financing capital expenditures.

In the UK, they endorsed the golden rule of fiscal prudence under which there would be no limit on fiscal deficit so long as all of it was used to finance capital expenditures to create assets. Of course, the budgetary definition of capital expenditures does not fully correspond to economists' concept of it.

Even lending is treated as part of capital expenditures. Enhancing government capital expenditures not only creates additional demand immediately but also lays the base for further growth. In the planning era, all our plans were focused on raising investment rates.

Therefore, in principle, augmenting capital expenditures appears to be the right approach. Capital expenditure has a higher multiplier, but it takes a longer duration to work itself out. Revenue expenditure has a lower multiplier, but its impact is almost immediate. In the context of the situation created by COVID-19 in terms of loss of employment and income, a question arises whether revenue expenditures such as income support for vulnerable groups should also receive a high priority.

In fact, in the budget, the allocation for MGNREGS has been reduced. Maybe as overall production (GDP) increases, the need for it may come down. If it happens naturally, it is fine. Otherwise, the government should not stint on expenditure in this regard.

On the reduction in subsidies announced in the Budget, the reduction in petroleum subsidies is well taken. But on food subsidies, there has to be a rethink. Thus while the substantial increase in capital expenditure is welcome, there is concern about the reduction in some of the revenue expenditures.

As we have argued elsewhere, there is some fiscal space available in the Budget for higher expenditures and as revenues increase over the targeted levels, revenue expenditures directed towards providing social safety nets should be raised. Even on capital expenditures, the government should bring out a separate document listing the major projects in which investment will be made not only by the government directly but also by public sector enterprises.

Level of Fiscal Deficit

The next issue is the level of fiscal deficit. The question is how long can we continue with a very high level of fiscal deficit. The fiscal deficits are way beyond what was considered to be appropriate under the FRBM Act. Centre's fiscal deficit in 2020-21 was 9.2 per cent of GDP. Part of it was of course due to some cleaning up operations which is desirable. Even then, it is extremely high. In 2021-22, it is 6.9 per cent of GDP and is expected to be 6.4 per cent in 2022-23. The norm that we had set was 3.0 per cent of GDP.

As a consequence, the Centre's debt-GDP ratio is expected to be in 2022-23 at 60.2 per cent of GDP as against the desired level of 40 per cent of GDP. For the centre and states taken together, it would touch 90 per cent of GDP. One can understand the compulsions; the economic impact of COVID-19 had brought the economy to a grinding halt at one stage. GDP fell in 2020-21.

In 2021-22, it is expected to rise to touch the level of where we were in 2020. Extraordinary measures had to be taken to kick-start the economy. Government expenditures had to rise. All economists and analysts agreed on it. But we should not belittle the situation that we are facing. It is argued sometimes that our debt-GDP ratio is low compared to other countries such as Japan.

But that is not an appropriate comparison. Since tax revenue to GDP is high and the interest rate is low in Japan, interest payment on debt constitutes only 4.7 per cent of revenue receipts. The corresponding figure for India, considering the Centre and states together, was 25.8 per cent in 2019-20. In the case of the centre alone, interest payments will equal 42.7 per cent of revenue receipts in 2022-23. This is a large preemption leaving less for other productive expenditures. Such large public borrowing poses a problem.

In 2022-23, the centre and the states taken as a whole will borrow an amount equivalent to 10.4 per cent of GDP. The savings of the Household Sector (which is the only surplus sector) in financial assets do not exceed 7.5 per cent of GDP. Thus the borrowing programme can be completed only with the support (though indirectly) of RBI. This is what we used to do in the 1980s. Such support from RBI will have its impact on inflation, if not immediately at least with a lag. Of course, one has to take into account its favourable impact on output. At present, the target appears to be to take the Centre's deficit to 4.5 per cent by 2025-26. Even this may or may not be achieved.

But will this be adequate? A medium-term plan of fiscal consolidation is urgently needed showing the period over which a sustainable level of fiscal deficit will be reached. 'Crowding out' of the private investment may not happen now. But eventually, it will become a problem, if we have a prolonged high fiscal deficit.

State Borrowings

The last issue relates to borrowing by the state government and the centre's role in it. The Government of India agreed to raise the limit of states to borrow from 3 per cent to 4 per cent of SDP for 2022-23. But it imposed the condition that 0.5 per cent of this will be contingent on the states meeting power sector reforms. This condition is unnecessary.

Power sector reforms are needed and the inducement for this can be provided through other means. The limit for 2022-23 should have been raised without imposing any conditions.

Article 293 of the Constitution stipulates that states need permission from the centre to borrow so long as the states are indebted to the centre. Before the 12th Finance Commission (in which both authors were involved), the Government of India used to borrow for lending to states.

The 12th Finance Commission recommended that this system might be stopped and that at least all major states should be allowed to borrow their entire borrowing directly from the market. We hoped that as this new system takes root, a stage would be reached when states would not be indebted to the centre and that states would then borrow based on their assessment.

Against this background, the proposal mentioned in the Budget of the centre providing an interest-free loan for 50 years needs reexamination. If the Government of India feels that states need to spend more on infrastructure, they should just be allowed to borrow more. Of course, under the present proposal, there is no interest burden on the states. It is a sweetener.

It is also appropriate here to recall one recommendation of the 12th Finance Commission which was to set up a Loan Council comprising of Union Government, States and the Reserve Bank which can decide on how much states should be allowed to borrow. This recommendation was not acted upon earlier. This also needs a relook.

10. Good and Bad Freebies

C Rangarajan
The Indian Express, June 16, 2022

Three questions arise: What goods and services should be selected for such programmes? What should be their ideal mode of delivery? What should be a prudent fiscal limit for their funding?

The newly elected Punjab government's announcement of providing up to 300 units of free power to every household has raised questions: What constitutes "freebies"? Should they be encouraged? There is, in fact, no consensus on the definition of a "freebie". It is almost a pejorative term. They constitute a sub-set of goods and services distributed by the government.

In India, policymakers have drawn on budgetary resources for providing support to low-income households for augmenting their consumption of selected goods and services, and also offering incentives to support selected categories of investors and producers. The economic objectives in these two categories are quite different.

The first category would include the free or subsidised provision of food grains and services such as health and education. The Punjab government's announcement of free power falls in this category. Sometimes, these are also referred to as "freebies", depending on the type of commodity provided. These may be distinguished from budgetary support for incentivising investment or production.

Examples of the latter group include the central government's recent initiative for production-linked incentives to various sectors and tax concessions. In the past, incentives in the form of reduction of corporate taxes have been offered to promote investment in general, or in certain regions such as backward areas.

Given the proliferation of these schemes in recent times, three important questions arise. First, what goods and services should be selected for such programmes? Second, what should be their ideal mode of delivery? Third, what should be a prudent fiscal limit for funding such programmes?

The practice of providing certain goods or services free or at highly subsidised prices has been common in budgets. Food grains, particularly wheat and rice, are supplied to target groups at a highly subsidised price through the public distribution system.

The subsidy is the difference between the price at which they are procured and the price at which they are sold. In the central budget, the food subsidy amounts to ₹2.06 lakh crore. The provision of foodgrains at a heavily subsidised price to target groups has found general acceptance, particularly among political parties, even though there are some critics of the measure.

The key question is to decide what commodities should be distributed for free or at a subsidised level and what the level of subsidy should be. So what is a "freebie" depends on the nature of the commodity or the services distributed.

As mentioned earlier, the distribution of commodities which are considered "essential", primarily foodgrains, face no criticism. There is enough evidence that such a distribution has helped to reduce poverty. There is also a category of goods which are called "merit" goods where significant positive externalities are associated with their consumption — for instance, health and education-related provisions, including mid-day meals and breakfast.

In these cases, the benefit of the use of such goods extends beyond the immediate consumer to the wider community. In such cases, subsidisation is justified: If only market prices prevail, the community will consume less than what is socially desirable.

Thus, while subsidisation or the free provision of essential and merit goods can be justified on the grounds of meeting social objectives when the list of commodities expands to include such items as TV sets, serious doubts arise.

For example, one unintended consequence of free power up to 300 units is likely to be an undue increase in the power consumption of households which use less than 300 units. Perhaps it is advisable to limit the distribution of commodities and services at highly subsidised levels to essential and merit goods. Any distribution beyond these two categories must be treated as "freebies". The words "essential" and "merit" should not be made so elastic as to lose their meaning.

The question of a suitable model for providing budgetary support arises in the context of both consumption and production-supporting initiatives. In the first case, budgetary support to a targeted segment of the population for augmenting their consumption of essential items may be provided either through direct income support or by a free or highly subsidised provision. Both involve fiscal costs.

In the former, income is raised for the targeted households which will support an increase in consumption according to the household preferences. In the latter, the consumption of the selected goods and services will increase. When the provision of subsidised goods is involved, there may, in general, be a requirement for a procurement set-up and a public distribution system.

Managing procurement and distribution by government agencies involves additional costs which tend to be higher than the corresponding supply through the market because of leakages and avoidable administrative costs.

In the case of production-related incentives, alternative methods include direct budgetary support and indirect support through tax concessions. Both have a differential impact. These schemes also require to be carefully designed to avoid their misuse and minimise their costs.

The provision of free power to farmers was often misused — it's a common practice, for instance, to leave the pump sets running for long hours. In the case of tax concessions, there have not been any convincing studies as to whether the stated initial objectives were achieved in line with the large budgetary costs.

The Government of India comes out with a statement of forgone revenues in the context of tax concessions. The magnitudes involved amounted to 1.9 per cent and 2.5 per cent of the GDP in 2018-19 and 2019-20 respectively. Some argue that production may be incentivised more effectively by other methods such as infrastructure expansion. Therefore, in respect of production-related incentives also, greater care is required for determining the total quantum of support as well as the specific forms of such support.

It is also important to consider a limit to the fiscal cost of undertaking such initiatives. We consider here only the case of the distribution of commodities that are meant to support consumption. This question should be considered in light of our limited budgetary resources. In India, the revenue-to-GDP ratio has been stagnating over a long period.

During 2010-11 to 2019-20, combined revenue receipts of central and state governments, relative to GDP, have languished in the narrow range of 18.4 per cent to 20.3 per cent. In contrast, in many developed and emerging market economies, this ratio tends to be much higher.

In 2019, these ratios were 36 per cent and 30.1 per cent for the UK and USA, 48.6 per cent and 43.6 per cent for Sweden and Netherlands, and 31.5 per cent for Brazil. Considering these trends, it would be prudent to limit overall fiscal support to such schemes to less than 10 per cent of the total expenditure of the central government and state governments until their revenue GDP or GSDP ratios are successfully increased in a sustained way. Governments that do not pay adequate attention to the strength of their fisc eventually become exposed to the cost of the choices that they make.

11. Economy Must Run Faster to Address Socio-Eco Problems

C Rangarajan
The Financial Express, August 15, 2022

The dominant view in the literature on development economics in the 1950s and 1960s was that the government had an important role to play and that it should undertake activities that would compensate for 'market failure'.

India's economic journey started with Independence. Many people do not realise that India's economic progress in the first half of the 20th century under British rule was dismal. During these five decades, India's annual growth rate was just 0.9 per cent. With the population growing at 0.83 per cent, per capita income remained almost flat. Immediately after Independence, growth became the most urgent concern for policymakers.

The dominant view in the literature on development economics in the 1950s and 1960s was that the government had an important role to play and that it should undertake activities that would compensate for 'market failure'. The literature also emphasised the benefit of a coordinated and consistent set of investment decisions.

It is this line of reasoning that led most developing countries, including India, to formulate economy-wide plans. Though India adopted a mixed economy, the mix was tilted heavily towards the state, at least incrementally. However, by the 1970s, it was becoming clear that the model we had chosen was not delivering. But our policymakers refused to recognise this.

It was around that time China made a big change. It was the crisis of 1990–91 that compelled the policymakers to turn to an 'idea whose time had come'. The break with the past came in three important directions – first to dismantle the complex regime of licences, permits and controls, second to reverse the strong bias towards state ownership and third to abandon the inward-looking trade policy.

Trends in Growth

India's average growth till the end of the 1970s remained modest with the average growth rate being 3.5 per cent. However, on several parameters, there were noticeable improvements, such as the literacy rate and life expectancy. There was a breakthrough in Agriculture after Green Revolution.

The industrial base was also widened. The Indian economy did grow at 5.6 per cent in the 1980s. But it was accompanied by sharp deterioration in the fiscal and current account deficits and the economy faced the worst crisis in 1991-92. Between 1992-93 and 2000-01, GDP at factor cost grew annually by 6.20 per cent.

Between 2001–02 and 2012–13, it grew by 7.4 per cent and the growth rate between 2013–14 and 2019–20 was 6.7 per cent. The best performance was between 2005–06 and 2010-11 when GDP grew by 8.8 per cent, showing what the potential growth rate of India was. During this period, the investment rate reached a peak of 39.1 per cent in 2007-08. However, the growth story suffered a setback after 2011-12.

The decline in growth rate which started well before the advent of COVID-19 should make the policymakers reflect and introspect. The growth performance since 2012-13 is a bit difficult to interpret. The introduction of a new series on national income with the base 2011-12 has raised many controversies.

After good performance in 2015-16 and 2016-17, growth started declining and touched the level of 3.7 per cent in 2019-20. This period is marked by a sharp decline in the gross fixed capital formation rate from 33.4 per cent of GDP in 2012-13 to 28.8 per cent in 2019-20.

The economic impact of COVID-19 is largely because of the actions taken to contain the spread of COVID-19 such as the lockdown. The net result has been a decline in growth rate by 6.6 per cent in 2021 and a rise in growth rate by 8.7 per cent in 2021-22. The economy is virtually where it was in April 2020. We have lost two years. The decline in output is even greater when looked at from the trend rate of growth.

2022–23 could have been the first normal year after COVID-19. However, the economic impact of the Russia-Ukraine war can be severe, if it continues for long. The sudden surge in crude oil prices can severely affect our BOP and the current account deficit can rise to 3 per cent of GDP or even higher. Perhaps, we should settle for a growth rate of 7 per cent in 2022-23.

Challenges and Opportunities

Post COVID-19 and post the Russia–Ukraine war, there is a need to lay down a clear roadmap for India's future development. Initially, we need to raise the growth rate to 7 per cent and then follow it up with a growth rate of 8 to 9 per cent. We have shown that in the past we can have a growth rate of 8 to 9 per cent over a sustained period of six to seven years. What is needed is to raise the investment rate steadily back to around 33 per cent of GDP.

India's future growth path cannot be unidimensional. We need a strong export sector, both for goods and services. We also need a strong manufacturing sector domestically both to meet the domestic demand as well as provide employment to a wide cross-section of talent.

Our own 'sunrise industries' will be different from those of other countries. The rapid pace of globalisation that we saw since the beginning of the 1990s will slow down for a variety of reasons. Atmanirbhar should not result in pure import substitution. That is neither economically sound nor is it desirable. An open economy with some limitations is still the best route to follow.

We need to raise the savings and investment rates rapidly and keep the ICOR around 4 which is a reflection of the efficiency with which we use capital and labour. Growth is the answer to many of our socioeconomic problems. In terms of growth, we have a long way to go. We need to run faster.

12. Fiscal Consolidation in the Context of the Budget

C Rangarajan and D K Srivastava
The Hindu, February 08, 2023

A stronger fiscal consolidation roadmap is needed over the medium term

The Budget for 2023-24 has attempted to address the aspirations of different segments of society. It is a good effort in a difficult situation. But how far do the Budget provisions go to meet the two fundamental goals of growth and stability? The two must go together for sustained growth over the medium term, which will be the answer to many of India's socioeconomic problems.

Budgetary Support to Growth

Growth is affected by the size of government expenditure and its revenue and capital components. Government expenditure is budgeted to grow at 7.5 per cent while nominal GDP growth is estimated to fall from 15.4 per cent in 2022-23 to 10.5 per cent in 2023-24. Thus, the total expenditure relative to GDP is shown to fall from 15.3 per cent in 2022-23 (RE) to 14.9 per cent in 2023-24 (BE). The composition of government expenditure, however, would be growth positive.

An increase in the Centre's capital expenditure is budgeted at 37 per cent while that in revenue expenditure is only 1.2 per cent. According to estimates by the Reserve Bank of India (2019,2020), the multiplier associated with central government capital expenditure is 2.45, while that for revenue expenditure is 0.45. Investment expenditure by central public sector undertakings (PSUs) is budgeted to fall by 0.2 per cent points.

However, State capital expenditures may increase as a result of central grants to the states meant for capital asset creation amounting to 1.2 per cent of GDP, augmentation of states' fiscal deficit to GDP ratio to 3.5 per cent, and the facility of 50 years of interest-free loans for creating capital assets in 2023-24.

It is difficult to ascertain the extent to which States might utilise these facilities. Growth may also be stimulated indirectly due to an increase in private disposable incomes following tax slab adjustments applicable to the new income tax regime. Real growth in 2023-24 may be a little above 6 per cent.

External Conditions as a Reason

According to the Fiscal Responsibility and Budget Management (FRBM) Act, as amended in 2018, the Centre is mandated to take appropriate steps to limit its fiscal deficit to 3 per cent of GDP by March 31, 2021, although this is an operational target. The mandated target pertains to the Centre's debt-GDP ratio which is to be brought down to 40 per cent. If there is a deviation from the fiscal deficit-GDP ratio of 3 per cent, the Centre is required to state the reasons.

In the medium-term fiscal policy cum Fiscal Policy Strategy Statement (MTFP), the Centre has attributed the deviation of the budgeted 5.9 per cent fiscal deficit-GDP ratio to external economic conditions. For this reason, the Centre has also not provided medium-term GDP growth forecasts.

Furthermore, the Centre has also not indicated the year by which it envisages reaching a fiscal deficit level of 3 per cent of GDP. Instead, it has indicated that a level of 4.5 per cent of GDP would be reached by 2025-26, calling for a steeper adjustment of 0.7 per cent points each in the next two years. It might require another two to three years for reaching a level of 3 per cent.

However, even by this time, the mandated debt-GDP ratio of 40 per cent would not be reached. The Centre's debt-GDP level net of liabilities on account of investment in special securities of states under the National Social Security Fund (NSSF), is budgeted to increase from 55.7 per cent in 2022-23 (RE) to 56.1 per cent in 2023-24 (BE). This increase is expected as the primary deficit to GDP ratio is indicated at 2.3 per cent in 2023-24.

The MTFP statement does not indicate the year by which the government aims to reach the mandated debt-GDP target of 40 per cent. One implication of the high level of the Centre's debt-GDP ratio is for interest payments relative to revenue receipts, which is budgeted at 41 per cent in 2023-24. This reduces, significantly, the space for primary expenditure in the Centre's budget.

Private Investment

For raising growth in the medium term, augmentation of private investment relative to GDP needs to be ensured. This requires that enough investible resources are left for the private sector after the public sector's pre-emptive claim on these resources. At present, total investible resources, consisting of financial savings of the household sector amounting to about 8 per cent of GDP and net foreign capital inflows amounting to 2.5 per cent of GDP, may be estimated at 10.5 per cent of GDP.

The central and State fiscal deficits considered together may amount to 9.4 per cent of GDP in 2023-24. This implies that only 1.1 per cent is available for the private sector and the non-government public sector.

Investment of the Centre's PSUs themselves amounts to 1.1 per cent of GDP in 2023-24, leaving little scope for State PSUs and the private sector. This is not amenable to creating an environment for interest rate reduction. Trying to borrow beyond the available investible resources by the government can only lead to inflation. We know the dilemma faced by the government.

Any further reduction in the fiscal deficit will cut expenditures which may not be appreciated. We need, however, a stronger fiscal consolidation roadmap over the medium term.

13. Fiscal Consolidation in India: Charting a Credible Glide Path

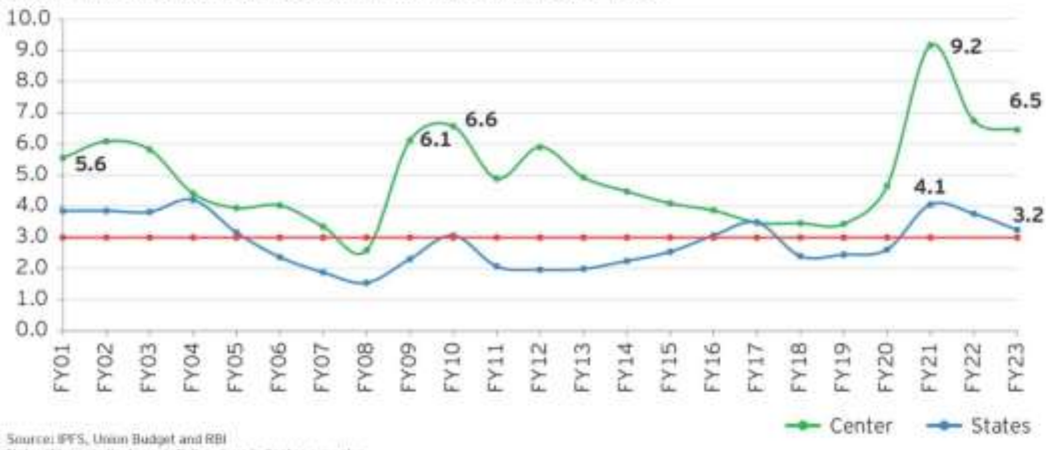
C Rangarajan and D K Srivastava

EY India Tax Insights, Issue 25, March 25, 2023

A reduced fiscal deficit will help India make more investable resources available for the private sector.

The Government of India in 2003 enacted the Fiscal Responsibility and Budget Management Act (FRBMA), which focused on reducing the fiscal deficit of the country. However, it was only in FY08 that the fiscal deficit was brought below 3 per cent. States, that enacted their individual Fiscal Responsibility Legislations (FRLs) from 2002 to 2010 considered together, were more successful in keeping their below 3 per cent in many years.

Chart 1: Fiscal deficit relative to GDP: union government and states



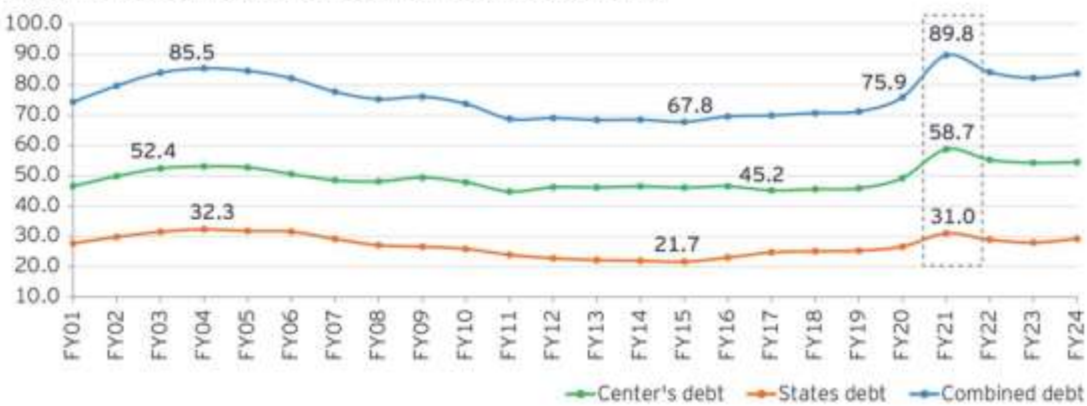
Source: IPFS, Union Budget and RBI
Note: (1) +ve indicates a deficit and -ve indicates a surplus
(2) Fiscal deficit-GDP ratios have been estimated by using NSO's latest GDP data released on 28 February 2023
(3) States' fiscal deficit for FY22 and FY23 is as per the RE and BE from RBI. Centre's FY23 fiscal deficit is as per the RE given in the FY24 Union Budget.

Bringing the union government's revenue account in balance or surplus was also part of the 2003 FRBMA and was hence, endorsed by the Twelfth Finance Commission. It became a feature of states' FRLs. However, in the 2018 amendment to the union government's FRBMA, revenue account balance as an objective was given up. The amended Act specified the debt-GDP targets for the union government, states and their combined accounts at 40 per cent, 20 per cent and 60 per cent respectively while the fiscal deficit to GDP targets was kept at 3 per cent each for the union government and aggregate of states.

COVID-19-Induced Slippages

Chart 2 shows the profiles of the debt-GDP ratio of the central and state governments and their combined account. The combined debt-GDP ratio peaked in FY04 at 85.5 per cent. It fell to 67.8 per cent in FY15 after which it increased progressively to 75.9 per cent by FY20.

Chart 2: Debt to GDP ratio: union government, states and combined



Source (basic data): IPFS, MoF, Union Budget FY24
Note: (1) Centre's net liabilities excludes all on-lending to states. It includes external debt estimated at the current market exchange rate.
(2) The combined debt-GDP ratio is the sum of central net liabilities excluding all on-lending to states and states' liabilities.

With the onset of COVID-19 in FY21, India experienced negative growth of (-)5.7 per cent as per NSO's second advance estimates. Even the nominal growth this year was negative at (-)1.2 per cent. This resulted in a major deterioration in the debt-GDP ratios across the board. The consolidated debt-GDP ratio increased sharply to close to 90 per cent with the union government's debt-GDP ratio (excluding any on-lending to states with external debt estimated at the current market exchange rate) at 58.7 per cent and that of states at 31 per cent. The combined debt-GDP ratio exceeded the benchmark by nearly 30 per cent points. The Union government's fiscal deficit to GDP ratio in the COVID-19 year peaked at 9.2 per cent, well more than the operational target of 3 per cent.

Union Government's FY24 Budget: Charting a Credible Glide Path

The union budgets post FY21, with positive growth rates and some effort at fiscal consolidation, resulted in a fall in the union government's fiscal deficit to GDP ratio to 6.8 per cent and 6.5 per cent in FY22 and FY23, respectively. This effort was strengthened in the FY24 budget, where despite global economic headwinds, the central government persisted with fiscal consolidation.

Compared to a reduction of 0.3 per cent points in FY23, the budgeted reduction in the fiscal deficit-GDP ratio in FY24 is 0.5 per cent points, which according to present indications is further to be accelerated to an annual reduction of 0.7 per cent points in the next two years, enabling a fiscal deficit level of 4.5 per cent of GDP by FY26 (Table 1).

In the FY24 budget, the union government is focused on capital expenditure growth (37.4 per cent) while limiting revenue expenditure growth to 1.2 per cent to take advantage of the high capital expenditure multiplier. According to RBI (2019), the union government's capital expenditure peak multiplier was estimated at 3.25 while that of revenue expenditure is 0.45.

Table 1: Union government's debt and fiscal deficit relative to GDP (%): glide path

Item	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Nominal GDP growth	11.0	10.6	6.2	-1.2	18.4	15.9	10.5	11.0	11.0
Fiscal deficit-GDP ratio	3.5	3.4	4.7	9.2	6.8	6.5	5.9	5.2	4.5
Debt-GDP ratio	45.6	45.9	49.3	58.7	55.1	54.1	54.5	54.3	53.5

Source (basic data): Union Budget FY24 and NSO
Notes: (1) GDP magnitudes up to FY23 are as per the latest NSO release (28 February 2023). For FY24, budgeted nominal growth of 10.5% is used. For subsequent years, a nominal growth of 11% is used. (2) In calculating Centre's debt, any on lending from Centre to states is not included and external debt is evaluated at market exchange rates. (3) Debt-GDP numbers may not tally with the numbers given in the Union Budget due to adjustments mentioned in notes (1) and (2)

Government borrowing is a pre-emptive claim on the economy's available investible resources. In India, it is only the household sector which has an investible surplus in the form of financial savings which presently amount to 8 per cent of GDP. Supplementing this by a net capital inflow from abroad of nearly 2.5 per cent of GDP, total investible resources add to 10.5 per cent of GDP.

In FY24, the combined fiscal deficit of central and state governments may amount to 9.4 per cent of GDP, leaving limited scope for borrowing by the private sector and the PSUs. As the combined fiscal deficit is brought down, progressively more investible resources would become available for the private sector.

In the years after FY26, the union government's fiscal deficit may be allowed to fall by higher margins of say 0.75 per cent points of GDP per year to reach the FRBM target in the next two years.

By FY28, a fiscal deficit-GDP ratio of 3 per cent would be reached, but according to our estimates, assuming a nominal growth of 11 per cent, the debt-GDP ratio would be close to 50 per cent, 10 per cent points above the FRBM target. Continuing with an 11 per cent nominal growth and retaining a fiscal deficit-GDP level of 3 per cent, the debt-GDP ratio is expected to reach 40 per cent by FY35.

As government debt as a proportion of GDP falls, the effective interest rate on government debt would also fall, reducing the interest payment to revenue receipts ratio, thereby facilitating the accelerated pace of reduction in fiscal deficit for reaching the desired target. If the implicit price deflator-based inflation is kept at 4 per cent, a real GDP growth of 6.7 per cent would be required over this period.

Sustaining a growth rate at this level would require suitable growth in private investment. It is only achieving the FRBM norms and adherence to these over a long period that would leave enough investible resources for the private sector to contribute to growth.

C. Monetary Policy

1. Devil, Us, the Deep Blue Sea

C Rangarajan
Economic Times, April 02, 2020

The phasing of three categories of expenditures by the Government of India is important to avoid catastrophe

Policymakers do face a dilemma while dealing with the economic impact of the Coronavirus, even though they may not want to acknowledge it openly. The current chorus of opinions advocates that the government should launch massive expenditure expansion programmes.

There is no doubt that at a time like this, the government must attack and deal with the virus, whatever it takes to do this. This reminds us of an old saying that the fundamental principle of war finance is that nothing should be decided on the principle of finance!

On what kind of expenditures the government must undertake there is a plethora of advice. Added up it amounts to a sizable increase in expenditure. Should the government (and more particularly RBI) worry? What is disconcerting is not the proposed increase in fiscal deficit but how it will be financed. There will be no takers in the market for additional loans, particularly at lower rates of interest. Therefore, the only way to finance it is for the RBI to pick up the loans either in the primary or secondary markets.

The 'escape clause' in the amended FRBM Act enables the RBI to enter the primary market in times of national emergencies. Thus what one is talking about is the monetisation of debt. The extraordinary increase in liquidity resulting from the support to the banking system and government can result in the ballooning of reserve money initially and later in the money supply, depending on the money multiplier.

With non-agricultural production stagnating, at some point, there will be an explosive increase in prices. Inflation can become a real danger. This is a lesson we can draw from our own post-2008-09 experience. Therein lies the dilemma. Should we worry about what might happen on the price front? On a war finance basis, we should not. But can we completely ignore the inflationary consequences? Is inflation a certainty? The probability is very high. It may come with a lag. A bad monsoon will make the situation worse.

Credit, where it is Due?

On the provision of liquidity to the business sector through the banking system, there are two concerns. The liquidity-enhancing measures announced by RBI are imaginative and innovative. But banks need to use these facilities with caution. Credit must be given where it is needed and justified. Otherwise, we will have a different problem to face later.

Second, the present stagnation in industrial production and services is greatly influenced by the lockdown. The mere provision of credit will not help. If the lockdown is extended beyond mid-April, the industrial and service sectors will suffer greatly. No amount of credit will help. Thus, from a healthcare point of view, the government must think of alternatives other than the lockdown.

The required government expenditures can be classified into three categories – 1) health care expenditures, 2) relief to people directly affected such as daily wage earners and migrant labour, and 3) expenditure to stimulate demand and revive affected sectors. The government must immediately address the first two categories.

The first set of expenditures is paramount. There is some concern among experts on the extent of testing that is being done currently. Many experts feel that the magnitude of testing must increase multifold times. The priority is to mobilise adequate resources to meet all health-related expenditures including supply of accessories like ventilators, masks, sanitisers, and material inputs for tests. The challenge here is not only fiscal but also organisational.

The second set of expenditures tries to take care of people who have been directly affected by the lockdown. The announcement made by the Finance Minister a few days ago directly addressed it. Here again, there is a feeling that the problems of people thrown out of employment have not been adequately addressed. It is a heart-rending site to view the migrant labour walking to their home states from their places of work. More needs to be done on this front.

Spend When You Must!

The third category of expenditures can wait until we have had some success in combating the virus. Once the lockdown is lifted and when business units are ready to expand their activities, additional liquidity from RBI as well as some supportive expenditure by the government can help. The phasing of expenditures by the government thus becomes important.

The dilemma of having to choose between the devil and the deep blue sea exists. This is not 'fiscal fundamentalism'. We are thinking of upwards of 6 per cent of GDP as a fiscal deficit. We may end up with more than double the mandated level. We should be conscious of the inflationary impact. We can however soften the impact of the choices by appropriate phasing.

2. Needed a Theory of Inflation

C. Rangarajan
Economic Times, September 22, 2020

A more explicit analysis of monetary policy on inflation is needed

With the CPI inflation touching 6.9 per cent, there is some discussion and concern about where inflation is headed. But somehow these discussions are more focussed on causes behind sectoral price increases such as food prices than the reason for the increase in the general price level.

There is a clear distinction between the two which is being overlooked. With a cap on monetary income, any increase in the price of one commodity will be offset by the decline in the price of other commodities. For the general price level to increase, we need to look beyond individual price formations.

Money and Price Level

There was the famous statement of Milton Friedman which said "Inflation is always and everywhere a monetary phenomenon". Much water has flown under the bridge since that statement was made in 1970. We have moved away from the days of strict Quantity Theory of Money which postulated an increase in prices which was proportional to the increase in money supply.

There are many modifications and adjustments to the Theory. The focus of policymakers has also shifted from quantity to price which is interest rate. But the fact remains that inflation which is defined as a continuous increase in the general price level cannot happen without the intervention of a macro variable such as money or liquidity. Only relative price changes can be explained by changes in supply and demand relative to individual products.

Structural School

However, there is the 'Structuralist School' which treats inflation as a purely real phenomenon. According to this school, inflation is the result of different segments of society competing with one another to have a larger share of the cake. A modification of this thought is that inflation happens only when society is operating at the limit of its capacity and trying to move beyond.

This is popularly described as 'overheating'. These are however not sustainable situations. There is a limit to velocity changes.

Monetary Policy Statements

In the Monetary Policy Statements, the discussions on inflation are mostly centred around real factors. There is also a lot of mention about inflation expectations. But there is no explicit discussion on how their own decisions on policy rate change (and by implication change in liquidity) will affect the behaviour of prices.v Perhaps the models they use for forecasting growth and other parameters incorporate this factor. Policy rate changes do have a liquidity impact. Central banks cannot act like King Canute. They cannot order interest rates. They have to act on money supply or the currently preferred term liquidity.

Lowering the policy rate must be accompanied by an enlargement of liquidity. Post-2008, developed economies moved directly to 'Quantitative Easing' when policy rate changes did not have the desired effect.

In the minutes of the Monetary Policy Committee meeting held on May 20-22, Michael Patra observes rightly "Relative prices tend to adjust within the budget constraint. For setting monetary policy, however, it is the absolute level of prices and their prospective moments that matter. This warrants a careful assessment of aggregate demand". He then goes on to talk about the behaviour of the money supply. Aggregate demand here must be read as aggregate monetary demand.

There is a need to clarify one point here. The injection of liquidity is not identical to the increase in money supply. The money multiplier depends on how active banks are in terms of lending. Post 2008, the injection of liquidity by the central banks in developed countries had no impact on the general price level because of poor lending.

Much of the increase in liquidity ended up as excess reserves, with very little impact on the money supply. It has also to be noted that liquidity increase has a dual effect. Availability of credit will push on the one hand output and the other demand. Studies show that the demand effect is usually stronger than the output effect.

Impact of Actions of Monetary Authority

Given the serious adverse impact of COVID-19, RBI is focussed on augmenting liquidity through several channels - OMOs, Long Term Repos and reduction of CRR. At some point, RBI may also have to support the government borrowing programme which is bound to increase. Thus liquidity will increase substantially. The impact on the money supply can be significant given the pressure on banks put by policymakers to lend.

Can in that situation inflation remain quiet? Thus the reason for the price increase will be not supply-demand imbalances about individual products but the overall increase in the money supply. The price increase can come with a lag. But given the forecast of a decline in output (GDP), an increase in money supply can only push prices forward.

Policymakers can take legitimately a view that a higher level of inflation can be accepted in a difficult year like the present one. If despite the strong injection of liquidity, the money supply does not increase or increase modestly, there will be a negligible effect on prices.

If the money supply does increase because of active lending, there will be an impact on prices, particularly if the assumption of negative growth holds. In that case, inflation is policy-induced. It is not stagflation as normally understood.

The purpose of the article is not to argue against the current stance of monetary policy. The purpose is only to point out that the actions of monetary policy authorities themselves have an impact on inflation. In the Monetary Policy Statements, there is a need for a more explicit analysis of the possible impact of changes in Reserve Money and Money Supply on the general price level.

3. Sure, Have Your Cake, But…

C Rangarajan and D K Srivastava
The Economic Times, June 28, 2021

Both monetary and fiscal policies face serious dilemmas. They need to be understood and resolved if we have to move ahead.

There is now consensus on the need to increase government expenditure to revive the economy. Real growth in 2021-22 will have to be 7.8 per cent to make up for the contraction of the economy by 7.3 per cent in 2020-21. Perhaps a growth rate of at least 9.0 per cent is desirable.

For growth to pick up, the first condition is to lift the lockdown as early as possible. Without it, even increased government expenditures will not work. Overall government expenditures will have to be at least ₹1.5 lakh crore more than the budgeted expenditures of ₹34.8 lakh crore in 2021-22.

There are added expenditures on vaccination, cash distribution etc. In this context, the fiscal deficit will have to go up. There are also some doubts about revenue assumptions. Perhaps the fiscal deficit may touch 7.8 per cent of GDP. A fiscal deficit is simply borrowing.

We estimate that the total borrowing of the central government may touch ₹16.3 lakh crore including GST compensation borrowing. It may be noted that in the pre-COVID year 2019-20, the borrowing programme of the centre was ₹7.1 lakh crore. Besides the centre's borrowing, there is also the borrowing of the state governments.

The problem before the government is how to meet this huge borrowing programme. There is no appetite for it in the market either domestic or external. It will have to have the support of RBI. It is in this context some have talked about 'printing notes'. This implies that RBI will pick up directly the government bonds and pay for them by creating money. This is a system which we abolished in the early 1990s. The FRBM act also reiterates it.

The other alternative is for RBI to provide additional liquidity to banks and other institutions and enable them to subscribe to new loans floated by the government. This is the indirect monetisation of debt. This is what is currently happening. Of the two methods, indirect is preferable because, in the direct method, the interest rate becomes a negotiated figure. The plea for enhanced government expenditure implies heavy borrowing which in turn results in expanded liquidity.

It is this expanded liquidity which poses an additional problem. RBI has introduced several measures, conventional and non-conventional to expand liquidity. Some are directly related to the purchase of government paper. The heavy borrowing programme will require RBI to push more and more liquidity as the year goes on. The impact of this will be on prices. Overall inflation will go up. The expectation of RBI on inflation is somewhat moderate.

In the recently released monetary policy statement, the RBI has projected a CPI inflation of 5.1 per cent for 2021-22 with a quarterly decomposition indicating 5.2 per cent, 5.4 per cent, 4.7 per cent and 5.3 per cent in successive quarters. It may be recalled that the CPI inflation rate at 6.2 per cent in 2020-21 exceeded the upper limit of the monetary policy tolerance range of 6 per cent. Consumer price inflation touched 6.3 per cent in May 2021.

However, food price inflation was 5.01 per cent indicating non-food inflation running at a high level. In May 2021, wholesale price inflation touched an unusually high level of 12.94 per cent. One has to wait and see whether these are just one-off flashes.

The government and the RBI are keen to keep the interest rate low despite this heavy borrowing. According to the latest monetary policy statement, the year-on-year growth rate in reserve money is 12.4 per cent (as on May 28). So far, the impact of the injection of liquidity has been modest. Money supply (M3) growth is lower at 9.9 per cent and credit growth is only 6 per cent (as on May 21).

What these numbers show is that the money multiplier is low. This may be attributed to two reasons: Low credit expansion and larger leakage in the form of currency. The potential however for money supply growth is large. Even now the stock of money about output (GDP) is higher.

The discussion on inflation in the monetary policy statement as well as in the Minutes of the Monetary Policy Committee focuses entirely on supply availability and bottlenecks in the distribution of commodities. The output gap is certainly relevant. But equally relevant in an analysis of inflation is liquidity in the system, and its impact on output and prices.

Certainly, larger availability of liquidity through extended credit is intended to stimulate production. But equally, it has a demand effect. What is relevant is ‘monetary demand’. We should not treat what is happening to inflation as simply ‘cost-push’. The specific point to note is that policy action itself has an impact on inflation. High government expenditure will require higher borrowing which in turn will require larger support from RBI that will have its effect on prices.

Policymakers need to decide on the appropriate trade-off between growth and inflation. If inflation is the price to pay for real growth, policymakers must say so. One cannot simply wish away the impact of reserve money expansion flowing from higher borrowing.

4. Taking a Closer Look at Money Supply

C Rangarajan
The Hindu Business Line, November 01, 2021

For an understanding of inflation, observing money supply growth as opposed to just reserve money growth, is very important

Milton Friedman said in 1970 that "inflation is always and everywhere a monetary phenomenon". The pendulum has now swung to the other extreme. Today's discussions on inflation do not refer to money. Neither extreme positions are valid.

The Old Quantity Theory of Money assumed that any increase in the quantity of money will not affect output (transactions). This is consistent with the classical view that money is a 'veil'. Real magnitudes are affected only by real factors. But this view is no longer accepted. We need to understand that the process of money creation is a process of credit creation. The two go together.

In the process of money creation, credit goes either to the government or the business sector. Depending on the situation, money creation may have a greater effect on output or a greater impact on prices.

The focus of policy these days is indeed more on price (interest rate) than quantity (money). But the two are interrelated. At the equilibrium, both the quantity and price are determined.

The monetary authority cannot in effect 'order' interest rate. They need to adjust the quantity (money or liquidity) so that the desired level of interest rate is achieved. More recently since 2008 'Quantitative easing' has become popular. There are occasions when quantity works better. (For a more elaborate analysis of the importance of quantity see, Rangarajan & Nachane, "Inflation, Monetary Policy and Monetary Aggregates", Journal of Indian Public Policy Review, May 2021.)

The preceding discussion takes me to the main point that recent discussions on inflation in India in the Monetary Policy Statements tend to ignore money, even though there is a reference to liquidity. The two (money and liquidity) are close but not identical, depending on what definition of liquidity one takes. Mainly discussions centre around supply disruptions due to domestic or external factors. They do explain the behaviour of individual prices but not the general price level which is what inflation is about.

If inflation is to be kept under control, the authorities need to have control over liquidity or money. The critical question is what happens to demand, that is, demand in monetary terms. Thus the quantity of liquidity or money is relevant. Analysts need to go beyond pointing out to price movements of food articles or crude oil.

Liquidity Boost

The pumping of liquidity through various channels by RBI has been quite significant. What we need to look at is not what is happening at the discount window but at Reserve Money. Here, we need to make a distinction between 'durable liquidity' and temporary liquidity. Any purchase of government securities by RBI from banks adds to durable liquidity. This is more relevant than what is lent for a short period by RBI.

Growth in Reserve Money and Broad Money Table 1

	Reserve Money		Broad Money (M3)		
Year	Stock at the end of the period (₹ cr)	Y-o-Y growth (%)	Stock at the end of the period (₹ cr)	Y-o-Y growth (%)	CPI (Combined) inflation 2012=100
2011-12	14,26,344	3.6	73,84,831	13.5	-
2012-13	15,14,886	6.2	83,89,819	13.6	-
2013-14	17,32,742	14.4	95,17,386	13.4	9.3
2014-15	19,28,463	11.3	1,05,50,168	10.9	5.8
2015-16	21,80,740	13.1	1,16,17,615	10.1	4.9
2016-17	19,00,485	-12.9	1,27,91,940	10.1	4.5
2017-18	24,18,779	27.3	1,39,62,587	9.2	3.6
2018-19	27,70,481	14.5	1,54,32,067	10.5	3.4
2019-20	30,29,707	9.4	1,67,99,963	8.9	4.8
2020-21	35,99,981	18.8	1,88,44,578	12.2	6.2

In my view, one factor that has contributed to the moderation in inflation between 2012-13 and 2019-20 is the moderation in Money Supply (Table 1). One needs a more complicated model to explain inflation including output gap and expectations. But we cannot ignore the money supply. As mentioned earlier, policy rate and Reserve Money creation are interrelated.

When we look at the recent data, two things stand out — there is a distinct difference between the rate of growth of Reserve Money and Money Supply (Table 2). The latter shows a much slower growth. This is to be attributed to lower credit expansion and greater currency withdrawal. The money multiplier has comedown. Second CPI inflation has gone up when there is a pick-up in money supply.

Growth in 2021-22 Table 2

Year	Reserve Money: Stock at the end of the period (₹ cr)	Reserve Money: Y-o-Y growth (%)	Broad Money (M3): Stock at the end of the period (₹ cr)	Broad Money (M3): Y-o-Y growth (%)
April 2021	35,85,500	18.7	1,89,17,436	11.1
May 2021	37,05,431	18.3	1,90,10,395	10.3
June 2021	36,98,987	16.9	1,91,66,960	10.7
July 2021	37,15,957	16.8	1,93,71,595	9.9
August 2021	36,79,192	15.2	1,93,28,509	9.5
September 2021	36,59,299	14.7	1,93,92,124	9.3

However, it should be noted that inflation has largely remained within the zone of comfort. Had the money supply grown in tandem with the Reserve Money growth, one would have ended up with a much higher level of inflation. Several members of the Monetary Policy Committee in their Minutes have expressed satisfaction about the fact that inflation had moderated. But they seek the reason for it in the behaviour of individual prices. But one reason is the unintended moderation in the money supply. We have to draw the right lesson.

In a difficult situation like the one posed by COVID-19, an expansionary fiscal policy and a supportive monetary policy are needed. But timing for when to moderate it is also important. Many countries including India made this mistake after the 2008 crisis. They continued with an expansionary policy over an extended period, which resulted in inflation.

The time has come to moderate Reserve Money growth. As the economy moves toward a normal situation, the money multiplier will also rise with credit growth.

There are enough excess reserves now which will also trigger growth in the money supply, once activity picks up. Currently, the policy rate is negatively adjusted for inflation. A continuance of this can lead to 'financial repression' with all the attendant consequences.

The growth since April 2021 is largely attributable to the relaxation of restrictions on mobility. So long as the lockdown continued no policy can be effective. The crucial year will therefore be 2022-23 when policy actions can become relevant. However, my main focus is not on this aspect.

What I would like to urge is that for an understanding of inflation, supply dynamics for individual commodities do not provide the full answer. The quantum of money or liquidity at large is critically important.

5. Hear the Liquidity Sloshing

C Rangarajan
Economic Times, January 25, 2022

India's policymakers cannot ignore the impact of money supply or liquidity on inflation

Inflation has emerged as an important concern in most countries including USA and India. In the US, the CPI inflation touched in December 2021 at a very high level of 7.0 per cent. One year earlier it was only at 1.4 per cent. In India, CPI inflation stood at 5.59 per cent in December.

As early as January 2020, it had touched 7.59 per cent. Thereafter it started coming down. However, it touched again a high of 7.61 per cent in October 2020. It again started coming down and after touching a low of 4.35 per cent in September 2021, it has risen to the present level. It must be noted that WPI had remained at a double-digit level since April 2021. The implicit price deflator in the national income estimates of 2021-22 released recently is above 8 per cent. These other indicators of price behaviour cannot also be ignored.

In this context, two questions arise. One relates to what the acceptable level of inflation in the context of the impact of COVID-19 is. The second centres around the factors that should be taken into account while analysing the cause of inflation.

On the first question, Fed has taken the view that the current level of inflation in that country is too high and has therefore started initiating measures to tighten monetary policy. The Indian policymakers have so far taken the view that growth is important and that the level of CPI may moderate in future. They have until now continued with the same policy stance of being accommodative. This is partly a matter of personal judgement and also depends on expectations of the future behaviour of inflation.

This aspect is related to the second question of the causes of inflation. One may not go the whole hog with Milton Friedman who had said that inflation was always a monetary phenomenon. By the same token, we cannot completely neglect the impact of money or liquidity.

Not only policymakers but also policy analysts and editorial writers tend to ignore this. Their discussions are focused on supply bottlenecks and disruptions as the key factor influencing inflation. The distinction between the behaviour of the ‘general price level’ and the prices of individual commodities is completely overworked.

The present argument appears to be that there is no demand pressure and supply considerations alone affect prices. It is further argued as the supply situation eases because of the removal of restrictions, prices will come down. Even if one were to look at the problem from the demand side what is relevant is ‘monetary demand’. In the US case, it is very clear. It is the extraordinary increase in liquidity and the ballooning of the balance sheet of the Fed that has finally resulted in price increases not seen in the last several decades.

It is interesting to look at the data on liquidity in India a little more closely. Table 1 provides information on liquidity growth. Reserve money growth since April has remained high, though year-on-year growth has shown some decline. Money supply growth has been subdued, that is, less than the growth rate of reserve money. It is not far to see the cause of somewhat lower growth in the money supply.

The credit growth has been lower and therefore the money multiplier is low. Supply shocks can only affect relative prices but not the general price level unless they (supply stocks) are accompanied by liquidity expansion.

The case for an easy money policy in the context of a situation such as the one faced after the advent of COVID-19 can be well understood and appreciated. But its possible impact on price level should not be missed. The focus on the level of interest rate should not hide the relationship between quantity (liquidity) and price (interest rate). The resurgence of the term ‘Quantitative Easing’ cannot be overlooked.

Policymakers while making the forecast of inflation must take into account the possible impact of their actions. It is well understood that the process of ‘money creation’ involves a process of ‘credit creation’. Thus the expansion of money has a dual effect - on ‘output’ and on ‘demand’ and therefore prices.

The demand effect is immediate and the output effect is lagged and sometimes uncertain. This approach is a far cry from the original quantitative theory of money. It moves away from the assumption of constant ‘output’ or ‘transactions’.

We need to be aware that after two years, output is back only to where it was in April 2020. In the meanwhile, the money supply has increased which will stay at that level. Monetary policy is always confronted with the problem of not only ‘what’ to do but also ‘when’ to do or not to do.

The time has come for the monetary authorities in India not only to 'pause' but also to give a signal of a change in stance. This does not mean that the growth recovery will be impaired. The biggest gainer of the expanded liquidity so far is the government. Keeping the interest rate low artificially has its implications. 'Financial repression' can also do some damage.

Table 1

(Rs in Crore)

Month	Reserve Money		Broad Money	
	Stock at the end of the period	Y-o-Y Growth Rate	Stock at the end of the period	Y-o-Y Growth Rate
Apr-21	3585499.95	18.74	18980415.30	11.43
May-21	3705431.46	18.32	19012125.69	10.34
Jun-21	3698987.35	16.92	19168204.11	10.70
Jul-21	3715957.38	16.80	19372714.42	9.91
Aug-21	3679192.14	15.22	19330427.06	9.53
Sep-21	3659381.97	14.74	19397300.04	9.34
Oct-21	3703450.87	14.15	19524125.56	9.66
Nov-21	3736106.80	12.76	19646645.57	9.53
Dec-21	3744265.98	12.98	19741867.49	9.34

Source: RBI

6. Controlling Inflation Needs Action on Liquidity

C Rangarajan
The Hindu, May 11, 2022

Inflation in India cannot be described just as 'cost-push'; an abundance of liquidity has been an important factor

The recent action of RBI to raise the repo rate by 40 basis points and CRR by 50 basis points is a recognition of the serious situation concerning inflation in our country and the resolve to tackle inflation.

Inflation has assumed a menacing proportion in almost all countries. The situation is worst in the United States where the consumer price inflation stood in March 2022 at 8.56 per cent, a level not reached for several decades. CPI inflation in India stood at in March 2022 at 6.95 per cent. It is expected to rise further in April.

India's CPI inflation has been fluctuating around a high level. As early as October 2020, it had hit a peak of 7.61 per cent. It had remained at a high level of over 6 per cent since April 2020. It did come down after December 2020 but has started rising significantly from January 2022.

On the other hand, the WPI inflation had remained in double digits since April 2021. The GDP implicit price deflator-based inflation rate for 2021-22 is 9.6 per cent. Even though RBI's mandate is to CPI inflation, policymakers cannot ignore the behaviour of other price indices. In the 2008-09 crisis, central banks of developed countries, particularly Fed had been blamed for overlooking the sharp rise in asset prices, even though CPI inflation was modest.

After the advent of COVID-19, the major concern of policymakers all over the world was to revive demand. This was sought to be achieved by raising government expenditure. This is the standard Keynesian prescription. The severe lockdowns imposed to prevent the spread of COVID-19 restricted the mobility of people, goods and services. Thus the expansion in government expenditure did not immediately result in increased production in countries where lockdown was taken seriously. India belongs to this category.

As Dr. V.K.R.V. Rao pointed out in the 1950s, the Keynesian multiplier did not work when there were supply constraints as in developing countries. That is why he argued that the multiplier operated in nominal terms than in real terms in such countries. Something similar has happened in the present case where the supply constraint came from the non-mobility of factors of production.

Nevertheless, the prescription of enhanced government expenditure is still valid under the present circumstances. Perhaps the increase in output could happen with a lag and also with the relaxation of restrictions.

Initially, the focus of monetary policy in India has been to keep the interest rate low and increase the availability of liquidity through various channels, some of which are newly introduced. However, the growth rate of money was below the growth rate of reserve money (see Table). This is because of lower credit growth which also depends upon business sentiment and investment climate. Thus the money multiplier is lower than usual. The government's larger borrowing programme went through smoothly, thanks to abundant liquidity.

Even as the economy picked up steam in 2021-22, inflation also became an issue. As mentioned at the beginning, this is a worldwide phenomenon. In the US, the explanation has been quite simple. There has been a balance sheet explosion of the Fed. On January 01, 2020, the total assets (less some items) of the Fed stood at US$4.17tn and in April 2022, they stood at US$8.96tn. This massive expansion in assets is the result of quantitative easing which essentially means liquidity support provided by the Fed.

The Fed Chairman has made strong statements expressing the need to reduce the size of the assets. Fed is planning to shrink its balance sheet by US$95bn a month. It raised the policy rate by 50 basis points a few days ago. In India too there is a shift in monetary policy.

The latest monetary policy reiterates the stance as one of "to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth". Without efforts to curtail liquidity, inflation will not come down.

I go back to a point which I have been making recently several times. While discussing inflation, analysts including policymakers focus almost exclusively on the increases in the prices of individual commodities like crude oil as the primary cause of inflation. The Russian-Ukraine war is cited as the primary cause. True, in many situations including the current one, they may be the triggers.

Supply disruptions due to domestic or external factors may explain the behaviour of individual prices but not the <u>general</u> price level which is what inflation is about. Given a budget constraint, there will only be an adjustment of relative prices.

Besides the fact that any cost-push increase in one commodity may get generalised, it is the adjustment that happens at the macro level which becomes critical. A long time ago, Friedman said, "it is true that the upward push in wages produced inflation, not because it was necessarily inflationary but because it happened to be the mechanism which forced an increase in the stock of money". Thus, it is the adjustment in the macro level of liquidity that sustains inflation.

The possible trade-off between inflation and growth has a long history in economic literature. Phillip's curve has been analysed theoretically and empirically. Tobin called Phillip's curve a 'cruel dilemma' because it suggested that full employment was not compatible with price stability.

The critical question flowing from these discussions on trade-offs is whether cost-push factors can by themselves generate inflation. Tobin said at one place that inflation 'is neither demand-pull nor cost-push or rather it is both', even though he did not agree with Friedman's extreme position that there would be no pure cost-push inflation.

In the current situation, sometimes it is argued that inflation will come down if some part of the increase in crude prices is absorbed by the government. There may be a case for reducing the duties on petroleum products for the simple reason that one segment of the population should not bear excessive burden. The same consideration applies to food prices.

But to think that it is a magic wand through which inflation can be avoided is wrong. If the additional burden borne by the government (through loss of revenue) is not offset by expenditures, the overall deficit will widen. The borrowing programme will increase and additional liquidity support may be required.

Commenting on the increase in repo rate and a rise in CRR, some have commented this is a double whammy. No, these are concomitant decisions. Central banks cannot order interest rates. For a rise in the interest rate to stick, appropriate actions must be taken to contract liquidity. That is what the rise in CRR will do. In the absence of a rise in CRR, liquidity will have to be sucked by open market operations.

As Governor Das put it in his statement, "Liquidity conditions need to be modulated in line with the policy action and stance to ensure their full and efficient transmission to the rest of the economy".

Inflation in India cannot be described just as 'cost-push'. The abundance of liquidity has been an important factor. The April Monetary Policy statement talked of liquidity overhang of the order of ₹8.5 lakh crore. Beyond a point, inflation itself can hinder growth. Negative real rates of interest on savings are not conducive to growth. If we want to control inflation, action on liquidity is very much needed with a concomitant rise in interest rates on deposits and loans.

Table: Growth in Reserve Money and Money

Rs Crore

Month	Reserve Money		Broad Money	
	Stock at the end of the period	Y-o-Y Growth Rate	Stock at the end of the period	Y-o-Y Growth Rate
Apr-21	3585499.95	18.74	18980415.30	11.43
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Jun-21	3698987.35	16.92	19168204.11	10.70
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Aug-21	3679192.14	15.22	19330427.06	9.53
Sep-21	3659381.97	14.74	19397300.04	9.34
Oct-21	3703450.87	14.15	19524125.56	9.66
Nov-21	3736106.80	12.76	19646645.57	9.53
Dec-21	3802775.14	14.74	20114036.38	11.40
Jan-22	3814348.18	13.46	19946628.19	8.37
Feb-22	3847490.56	13.88	20183528.17	8.73
Mar-22	3920298.48	8.90	20489597.28	8.73
Apr-21 (April 15)	4016765.62	12.03	20817118.83	9.68

Source: RBI

7. The Evolving Contours of India's Monetary Policy

C Rangarajan
The Hindu Business Line, August 14, 2022

Monetary policy must keep step with changing concerns — from funding plans to taming fiscal deficit and infusing financial stability

Monetary policy remains an important tool of economic policy both in developed and developing economies. As the institutional environment, both domestic and global, changes, the tasks of monetary policy also change. The monetary and financial system is far more complex today than in the past. Financial intermediation has reached a high level of sophistication, which has become a source of concern. The menu of financial products has expanded enormously.

The need for a central bank in India was debated for a long. Finally, the Reserve Bank of India was set up as a central monetary authority in 1935. Like all central banks in developing economies, RBI has been playing both a developmental and a regulatory role. In its developmental role, RBI focused on creating an appropriate financial infrastructure in the country.

Trends in India's Monetary Policy

The evolution of India's monetary policy reflects the changing concerns over the last seven decades. In the first three decades after Independence, the primary concern of the government was to get plans implemented. All policy instruments, including monetary policy, were tuned towards that goal. Allocation of credit consistent with plan priorities became a major concern.

In terms of monetary policy, planners talked of non-inflationary deficit financing. For example, the First Plan document said, "Judicious credit creation somewhat in anticipation of the increase in production and availability of genuine savings has also a part to play."

Prime Minister Jawaharlal Nehru's letter to RBI Governor Rama Rau, while accepting his resignation, was clear. It indicated that the government was the dominant partner and the role of the Reserve Bank was to abide by the larger concerns of the government. So long as inflation was moderate, this approach did not matter.

During the 1950s, the average annual inflation in wholesale price was only 1.8 per cent. In the 1960s, it was 6.2 per cent. But in the 1970s, inflation touched unacceptable levels, turning double-digit, and the growth of the money supply had to be reined in.

The 1980s saw a continuous exchange between RBI and the Ministry of Finance on the control of inflation, and the need to contain fiscal deficit and, more particularly, its monetisation. Though this period recorded an average annual growth rate of a little over 5 per cent, the growth path was uneven. The average inflation rate was close to 7 per cent. The annual M3 growth rate was 17 per cent.

The Chakravarty Committee, which was appointed to look into the working of the monetary system, submitted its report in 1985; it emphasised the need for regulation of the money supply and wanted money supply growth to be consistent with real growth and an acceptable level of inflation.

It also emphasised the need for close coordination between monetary policy and fiscal policy, because money supply growth was driven by reserve money and the most important factor determining the creation of reserve money was RBI credit to government. Even though the government accepted the recommendations in principle, the latter part of the 1980s still saw a higher fiscal deficit and higher money supply growth. All these landed us in the crisis of 1991.

The early 1990s saw, as a part of the liberalisation programme, far-reaching changes in the central bank's functioning. With ad-hoc treasury bills no longer issued, the automatic monetisation of fiscal deficit ended. By moving to a market-determined rate of interest, government securities became marketable and enabled the emergence of open-market operations as an instrument of credit control. The dismantling of the administered structure of interest rate helped the rate of interest to emerge as a policy tool.

Price stability and growth have always remained the major objectives of monetary policy. The uncertainty has been over which takes precedence and under what circumstance. Post-1997, RBI specifically talked of a multiple-indicator approach. But the issues connected with multiple objectives remained as before.

Exchange Rate Management

Post 1996, RBI had to contend with certain new problems because of the change not only in the monetary policy environment but also in the exchange rate regime. In February 1993, India moved to a market-determined exchange rate regime, with intervention by RBI when needed.

Between 1996 and today, India had to deal with at least three major global exchange market disturbances. The first was the East Asian Crisis, the second was the 2008-09 global financial crisis and the subsequent taper tantrums in 2013, and, finally, the current situation.

RBI managed all these situations with commendable skill. But one broad lesson is that it is no longer possible to deal with an external situation without acting on the domestic market. Protecting the exchange value of the rupee also demands action on the domestic money market.

Another lesson is that we cannot ignore what is happening to the real effective exchange rate. Inflation differentials ultimately determine the exchange rate. Excessive capital inflows and outflows have a monetary bearing, and the means of dealing with these situations had provoked conflicts between RBI and the government.

Financial Stability

Financial stability had emerged as an important objective of monetary policy. RBI, in this regard, had to play a dual role — monetary policy authority; and regulator of banking and non-banking systems. While India escaped the impact of the 2008 global financial crisis because of the restrictions, long in place, on foreign investment by banks, the rise in non-performing assets (NPAs) in the banking system became a concern in 2010.

Inflation Targeting

In the evolution of monetary policy, a major change came in 2016 when the RBI Act was amended. The new monetary policy framework requires RBI to maintain consumer price inflation at 4 per cent with a margin of plus- or minus-2 per cent. It is, in a sense, flexible inflation targeting, which fits well with the needs of our country. It is the right blend of the objectives of price stability and economic growth.

However, several aspects of the mandate remain fuzzy and can be open to multiple interpretations. For example, how long can RBI stay beyond the comfort zone without undercutting the spirit of the mandate? How much importance should attach to the mid-value of 4 per cent? Which is more relevant and central — stability at 4 per cent or being in the comfort zone?

Interpretations may vary according to circumstances. But the spirit of the arrangement is that, over some time, the system needs to be close to 4 per cent. We must recognise that 4 per cent inflation itself is well above what developed economies consider appropriate. This has implications for the exchange rate.

As we move ahead, RBI and government must recognise the important role each plays in the governance of the economy. It is in the best interest of the government to cede certain areas to the central bank, allowing it to act according to its best judgement. It is necessary to move away from a scenario of ‘fiscal dominance’.

8. What Causes Depreciation of the Rupee holds Policy Cues for India

C Rangarajan
Mint, August 31, 2022

Capital inflows can provide a buffer but prudence requires us to keep our current account deficit and local inflation in check

The Indian exchange rate regime underwent a big change in the early 1990s. From the Reserve Bank of India (RBI) determining the exchange rate every day, we first moved to a dual exchange rate regime and a year later in 1993 adopted a market-determined exchange rate regime.

It was made clear that RBI would intervene when it felt necessary. The opening up of the external sector, which included a liberal trade policy, a market-determined exchange rate and expanded sources of external capital flows greatly strengthened the external sector.

The exchange rate system has changed the world over. After the abandonment of the fixed exchange rate system adopted by the International Monetary Fund (IMF), there was a lot of confusion, leading to a series of conferences and consultations. Finally, developed countries moved to a market-determined exchange rate system; they care much less about rate fluctuations. Among them now prevails an attitude of 'benign neglect'.

How has India managed the new regime since 1993?: On the whole, external sector management is a success story of the reform process. The current account deficit remained low at less than 2 per cent of gross domestic product (GDP) from 1992-93 to 2008-09.

There were two years in which there was a surplus. Between 2008-09 and 2012-13, it remained above 2 per cent of GDP and in 2011-12 and 2012-13, it exceeded 4 per cent. But financing the current account deficit posed no problem because of ample inflows on the capital account. The exception was in 2012-13 when financing became a problem. Since then, the current account deficit has been modest, except for the current year when it can touch 3 per cent of GDP.

In the absence of capital flows, the exchange rate is largely determined by the current account of the balance of payments (BoP). Exports earn foreign exchange and contribute to the supply of foreign exchange. Imports result in payment of foreign exchange and constitute a demand for the same. But the picture changes with the inclusion of capital flows.

Capital inflows add to the supply of foreign exchange and a strong inflow can lead to the domestic currency getting stronger despite a current account deficit. The purchasing power parity theory, which states that the external value of the currency is a reflection of its domestic value, holds good only when capital flows are minimal. Foreign investment (i.e. inflows) in India has been quite strong since 1994-95. In most years, it has been above 1.5 per cent of GDP.

In several years such as 2009-10 and 2014-15, it had exceeded 3 per cent of GDP. These capital inflows, when they exceed the current account deficit, help RBI build reserves if it does not allow the rupee's value to appreciate beyond a level. That is how our reserves have been built up to the present level exceeding US$600bn. This is far from how China built up reserves. China has primarily built its reserves out of its current account surplus. This makes a difference in the quality of reserves.

Out of the various elements that have helped India accumulate reserves, some are volatile. The most significant among them is foreign portfolio investment. Investment in the stock market can flow out easily if perceptions change. Non-Resident Indian deposits are generally considered to be durable. But we found to our great horror how volatile they were in 1990 and 1991.

Let us take two instances: the 'taper tantrum' of 2013 and the current situation after the Russia-Ukraine war. In the 'taper tantrum' period, there was a sudden withdrawal of funds through the sale of shares and that led to a steep fall in the value of the rupee. In May 2013, the value of the US dollar was equal to ₹55.01.

By September 2013, it had risen to ₹63.75. But as sentiment got reversed and also as a result of certain actions taken, capital inflows resumed and the value of the dollar in terms of rupees fell. But it remained above its May level even after a year. Something similar may happen in the current situation. The value of the rupee, which has fallen steeply, may recover once capital inflows resume. But it may not necessarily touch the pre-crisis level.

What are the lessons from these experiences?: A shock to the value of the rupee can come whenever there are sudden withdrawals. Just as the inflow of funds helps to boost the rupee's value, the withdrawal of funds can lead to a fall in the value of the rupee. Volatile elements need to be kept under watch. When sentiment changes, these volatile elements give a shock. We need to accept this fact, and while taking action to reverse the sentiment, we must acknowledge the nature of the market.

We need, however, to focus on two related issues: one, the size of the current account deficit, and two, the behaviour of domestic prices. India's problem until the end of the 1980s was how to finance the current account deficit. That may not be a problem now. But that does not offer us a licence not to mind the level of the current account deficit. Inflows like borrowings impose a burden of interest payments.

As inflows increase to match or exceed the current account deficit, volatile elements in the reserves also increase, making for a shock from time to time. It is best to keep the current account deficit at around 1.5 per cent of GDP, a level close to durable inflows. The days of a current account surplus at this point look distant.

Second, despite large capital inflows, the rupee has depreciated. In June 1993, the value of the dollar was equal to ₹31.3. Today, it is equal to ₹80. Please remember that there was a time when it was equal to ₹4.75. It is here that purchasing power parity theory has some relevance.

In the final analysis, inflation differentials between countries count. Export competitiveness is correlated with low inflation. Our inflation targets cannot be too far away from the targets of other countries if we want to contain the depreciation of the rupee.

9. The Conundrum of Inflation

C Rangarajan
Mint, October 24, 2022

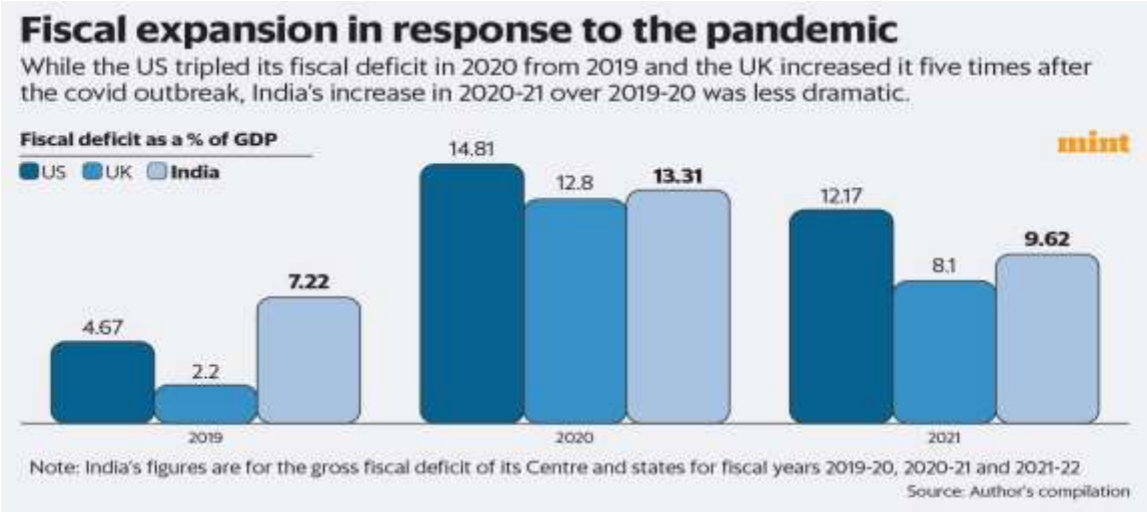
It's the central bank's response in terms of monetary expansion or contraction that impacts an economy's general price level

The world is currently caught in the grip of severe inflation. Consumer inflation in the US touched 8.3 per cent in August 2022. This is a level of inflation the US had not seen for several decades. The UK's inflation touched 9.9 per cent in August. India's consumer price inflation was 7.4 per cent in September 2022. It has been above the 6 per cent upper limit of the inflation band for more than nine months. Is there a common factor responsible for this high level of inflation across countries?

Very often, policymakers point to the sudden surge in petroleum prices immediately after the Russia-Ukraine war as a major cause. The focus on supply bottlenecks and disruptions as key factors influencing inflation fails to make a distinction between the behaviour of an economy's 'general price level' and the prices of individual commodities.

Given a budget constraint, sharp increases in individual prices will only result in an adjustment of relative prices. It is the policy response to increasing individual prices at the macro level in terms of expanding or contracting liquidity that impacts the general price level or inflation.

Several decades ago, strangely while addressing an Indian audience, Milton Friedman said, "It is true that the upward push in wages produced inflation, not because it was necessarily inflationary but because it happened to be the mechanism which forced an increase in the stock of money." Thus, while individual prices can trigger inflation, it is the adjustment in the macro level of liquidity that sustains inflation.



Fiscal Expansion in Response to the Pandemic

What has happened in the current situation is clear. The response to COVID across countries was to raise government expenditures at a time when revenues were falling. The net result was a substantial rise in government fiscal deficits which could be financed only with the support of central banks. The US fiscal deficit tripled in 2020 over 2019. The UK's fiscal deficit increased by 5 times during the same period (Table 1).

The US Federal Reserve's assets stood at US$4.17tn on January 01, 2020, and in April 2022, they stood at US$8.96tn. This massive expansion in assets is the consequence of quantitative easing (QE). Most central banks followed a similar path. A natural consequence is the unusual level of inflation which we are witnessing.

I pointed out the dilemma central banks faced in 2020 (see my article 'Devil, Us, the Deep Blue Sea' in Economic Times, 2 April 2020). The Indian situation is not very different, even though the fiscal deficit increase was more moderate than in the US and UK; this also explains why our inflation is somewhat lower.

The inflation that we are witnessing the world over is policy-induced, however well-intentioned and needed that policy might have been. The lesson to draw is that if we want to control inflation, we must contain the growth of liquidity interpreted in a broad sense.

Are we facing another dilemma in today's context? It is argued that a strong focus on inflation control may jeopardise recovery efforts after COVID. One country which sees no dilemma is the US. Inflation having hit an unbelievably high level, the Fed chairman is categorical that the Fed's sole objective right now is to control inflation. Fed Chairman Jerome Powell said, "The overreaching focus right now is to bring inflation back down to our 2 per cent goal." He added, “The first lesson is that central banks can and should take responsibility for delivering low and stable inflation."

This attitude is explained by the low tolerance for inflation in the US. The country’s economic system is not geared to adjust to high inflation. The UK is caught in a dilemma of how to provide support to citizens who are suffering because of the sudden increase in fuel prices and at the same time contain its fiscal deficit to control inflation.

In inflation-targeting countries like India, the dilemma should be less. After all, the upper limit of the band provides the basis for action. Once the upper limit is crossed, the primary goal should be clear. Action must be directed first at bringing inflation below the upper limit. The choice between control of inflation and safeguarding growth is not that clear. Inflation hits the poor even more than other sections of society. The problem with inflation is its differential impact.

Will a rise in the policy interest rate help bring down inflation? The transmission mechanism here is somewhat of a ‘black box’. John Maynard Keynes and Ralph George Hawtrey talked of the respective roles of long-term and short-term rates of interest. There are different interpretations. The objective is to bring down aggregate demand. Can this happen only with a decline in output?

We shall not go into this here now. But it is important to note that central banks cannot order interest rates. They have to take action to make it happen. In fact, in the US, the Federal Open Market Committee’s instructions to the Market Desk on 21 September begin by saying, “Undertake open market operations as necessary to maintain the federal funds rate in a target range of 3 to 3-1/4 per cent."

Liquidity contraction or expansion is concomitant with a central bank’s decision to raise or lower the policy rate. These are not two independent decisions. Post-2008-09, quantitative easing and contraction have come into usage, emphasising quantity as well.

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