The Dangers of Misplaced Optimism*

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Preliminary evidence that India's economy contracted by 7.5 per cent in the second quarter of financial year 2020-21 was, as news, both good and bad. Good because that figure is far lower than the 23.9 per cent contraction registered in the first quarter of this financial year. Bad because a 7.5 per cent second quarter contraction is high both in itself and when compared with most similarly placed countries. The figure signals that the substantial relaxation of lockdown restrictions during that quarter has not ensure automatic recovery.

The government, however, sticks with its recovery hype. It has chosen to focus on the unsurprising evidence that GDP rose sharply, by 23 per cent, between the first quarter, when the lockdown was severe, and the second when restrictions were substantially lifted. Based on that evidence, the Finance Ministry's Monthly Economic Report for November speaks of a V-shaped recovery reflective of "the resilience and robustness of the Indian economy". The danger is that such optimism would provide the justification to avoid adoption of the measures crucially needed to pull the economy out of recession.

Lockdowns limit production and result in a rundown of inventories. They also adversely affect employment, income and demand. When lockdowns are relaxed, therefore, production must rise, not just to meet demands backed by the available purchasing power, but also to restore inventories to normal levels across the distribution chain. Once the latter is done, however, demand must return to and rise above pre-crisis levels for production to recover and grow. With the lockdown-induced adverse effects on demand of the loss of jobs and livelihoods, the increased indebtedness and the bankruptcies precipitated by the crisis bound to be felt well after restrictions are relaxed, the tasks of providing safety nets, reviving employment and spurring demand become crucial. Since the market cannot deliver on those fronts, state action facilitated by substantially enhanced expenditure is crucial. And since government revenues shrink during a recession, that expenditure has to be funded by borrowing. This is no time for fiscal conservatism, as governments across the world have come to accept.

It is in this light that the granular evidence on GDP movements must be read, with the caveat that these are preliminary estimates based on limited information. Going by the available numbers, there are a number of features underlying aggregate performance that are suggestive of the dynamic of the post-Covid economy. To start with, while the decline in private final consumption expenditure (at constant prices), which accounts for 56 per cent of GDP, has come down from minus 27 per cent in the first quarter (relative to the corresponding quarter of the previous year) to minus 11 per cent in the second, it still remains high. Though there are signs of a short-run recovery in private consumption demand with the lifting of lockdowns, net incomes and consumer confidence are not at levels that can even restore last year's levels. Second, as is to be expected, with production restraints relaxed, depleted stocks are being replenished. The direction of changes in stock levels has reversed, with a fall of 21 per cent in the first quarter turning into an increase in stocking of 6.3 per cent in the second quarter. Third, however, these signals from the demand side have not been adequate to spur an investment revival. While the decline in fixed capital formation has fallen from a high minus 47 per cent in the first quarter to minus 7 per cent in the second, investment is still falling year-on-year. These are all signs of an economy that is severely demand constrained, requiring a significant step up in government expenditure.

However, the government in Delhi has not just chosen to hold back on its own spending, but is adopting a stance that would squeeze expenditure at the state level as well. To start at the central level, figures from the Controller General of Accounts relating to the first seven months of 2020-21 (April to October) indicate that, over this crucial period, the total expenditure of the central government stood at 55 per cent of what was provided for in the Budget for 2020-21, which too was woefully inadequate even for normal times. In fact, in non-Covid year 2019-20, the ratio of actual spending by the central government over April-October relative to that budgeted figure was a higher 59 per cent. The shortfall in spending was sharper in the case of capital expenditure, with 48 per cent of that budgeted being spent over April to October. The corresponding figure for 2019-20 was 60 per cent.

This refers to the Centre's own expenditures. Meanwhile, with GST revenues having fallen from their lower-than-expected levels during the Covid months, the states have been cash-strapped. Yet, the government has decided not to compensate them for the shortfall, as promised under the GST regime, on the grounds that only a part of the shortfall was due to the shift to the new regime, with the rest being the result of an "Act of God" that the Centre cannot be held responsible for. States have been left to fend for themselves by going to market and borrowing at high interest rates, which they would find difficult to cover. Needless to say, as a consequence, state spending has also been curtailed.

The net result of this voluntary and enforced fiscal conservatism in the middle of a pandemic, which calls for hugely enhanced spending, is visible in the GDP figures. Government Final Consumption Expenditure, which rose by 10 per cent in the first half of 2019-20, relative to the corresponding period of the previous year, declined by 4 per cent in the first half of 2020-21, when it should have been rising. This is because, after a half-hearted 'stimulus' in the first quarter, that raised government consumption expenditure by a modest 16 per cent, that expenditure fell by as much as 22 per cent in the second quarter. This trend suggests that allocations for welfare expenditures, ranging from subsidised food to minimal guaranteed employment, needed to support those whose livelihoods have been devastated by the pandemic, would be reduced over time. As collateral damage, this frugality in a time of crisis is likely to prolong the recession, which could intensify as stocks are replenished and demand from those whom the government no longer supports, despite loss of earning and heightened indebtedness, shrinks.

The rationale that underlies this privileging of fiscal conservatism over growth and, more importantly welfare, is nowhere explained. But there are signs of where it possibly comes from. This is a government that chose to push through regressive labour codes and farm bills in the midst of a pandemic. It is a government which sees not an opportunity to tax when incomes and wealth of the super rich explode during pandemic times, but a cause to celebrate India's ability to 'ease' the doing of business and generate its own billionaires. It is, in sum, unabashedly neoliberal, possibly in the mistaken belief that, Covid-19 notwithstanding, such 'reform' would deliver a ‘robust’ and ‘resilient’ economy. That possibly explains the optimism that a V-shaped recovery is imminent, and that optimism, in turn, would justify the view that fiscal conservatism pays. It does not, as time would tell.

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