Outsourcing the Stimulus*

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On May 8, 45 days into the post-Covid lockdown, the central government, through a Finance Ministry statement, announced that its borrowing requirement for 2020-21 had been raised to Rs. 12 lakh crore, as compared with the Rs. 7.8 lakh crore projected in the budget. As of now, starting May 11, the Centre expects to be borrowing around Rs. 30,000 crore every week till September 25, as compared with a Rs. 19,000-21,000 crore planned for earlier. What would happen after September 25 is not clear as of now, but what is clear is that whether the central government likes it or not, all projections of the fiscal deficit have been rendered meaningless by the pandemic.

However, while declaring that this borrowing requirement revision was necessitated by the fall-out of the Covid-19 pandemic, the finance ministry's statement did not make clear how much of it would be due to an increase in expenditure needed to address the pandemic and revive the economy, and how much due to the collapse in revenues that have resulted from the sudden stop in economic activity resulting from the extensive and stringent lockdown in response to the pandemic. Stalled economic activity and falling incomes erode revenues, necessitating increase borrowing to sustain even reduced expenditures.

This distinction between expenditures and revenues in explaining the planned increase in borrowing is crucial because there is wide agreement among economists and policymakers that a second large stimulus package was overdue. In fact, as the first week of May 2020 drew to a close, an expectant nation that was awaiting a second stimulus package to counter the Covid-induced economic crisis had begun losing patience. It had been close to a month and a half since the Finance Minister, Nirmala Sitharaman, had announced the first post-Covid package, almost timed to coincide with the start of a nation-wide lock down. At Rs. 1.7 lakh crore, or less than one percent of GDP, the package was grossly inadequate, given the magnitude of the unfolding economic crisis that was depriving workers of their jobs, damaging livelihoods, devastating the informal sector and threatening widespread bankruptcies in the formal sector. Even conservative business leaders were demanding a package in the range of 5 per cent of GDP. Sitharaman's first package was also disappointing because a significant component of it involved bringing forward already planned expenditures or releasing deferred incomes, rather than including only new expenditures.

The measly nature of the package was justified as being only the first step in a promised, extended recovery effort. But six weeks was too long a time for the launch of a second step. By then a full-fledged package should have been in place. Explanations for this procrastination are not easy to find, though the most generous is the claim that the central government has been held back by fears that stimulus spending would result in a dangerous rise in its fiscal deficit and set off inflation and in a ballooning of the public debt to unsustainable levels. Fears of inflation or the sustainability of borrowing were not necessarily warranted. What is true is that since heavy new taxes cannot be imposed in the middle of a crisis, the deficit would initially increase.

But given the large stocks of food grain with the government, the bumper rabi crop that is currently being harvested and the massive unutilised capacity outside of agriculture, there is no real danger of inflation. If there are specific supply constraints, especially of essentials, they can be directly addressed. As for the public debt, it could be considered unsustainable if the government cannot find the wherewithal to meet the resulting debt service commitments. It can by borrowing at low rates from the Reserve Bank of India (RBI) or monetising the deficit keep interest costs under control. And, given the high level of inequality in India, the complete absence of wealth taxes and the current low level of India's tax-to-GDP ratio, when the recovery occurs, taxes can be imposed to mobilise the resources to service the debt. On the other hand, if debt financed expenditures are not undertaken and the recession intensifies and turns into a depression, revenues that are already collapsing will dry up, and even if the government opts for austerity in the midst of a health and economic emergency, minimal expenditures can result in a spike in the fiscal deficit to GDP ratio, especially given the recessionary contraction in GDP.

This explains the near consensus among economists that a large fiscal stimulus is an absolute necessity in the current context. Absent such a stimulus the humanitarian crisis would also intensify. The government will not be able to do what is necessary to mitigate the health emergency and limit loss of lives. It will not be able to prevent starvation and support those displaced from work and the disadvantaged. It will not be able to provide the subsidies and guarantees needed to keep alive the formal small and medium enterprises and India's vast informal sector. Allowing a misplaced fiscal conservatism to override the devastating implications of such neglect can only be read as callousness that comes from the belief that people's welfare does not matter for political legitimacy.

That the government is aware of what it is doing is clear from the fact that it has not ruled out a stimulus, but has outsourced a large part of the task to the RBI and the, largely public, banking system. To help out borrowers, the RBI was persuaded into allowing banks to provide a three-month moratorium on debt service payments to their clients, leaving the decision on whether this option is exercised to the discretion of the banks. In addition, to fulfil the stimulus mandate the central bank has resorted to the only instruments it has at its command, which are those that seek to expand credit flow and reduce the cost at which such credit is accessible. In an initiative signalling its stance, the RBI decided to cut its policy 'repo' rate by 75 basis points to 4.4 per cent, reducing the costs at which banks could access finance from the lender of last resort. It also substantially strengthened this effort through two rounds of special and 'targeted' long term repo operations (TLTROs), which allowed banks to access liquidity at the repo rate to lend to specified categories of clients.

In the first round, the RBI announced auctions of targeted repos of up to three years tenor for a total amount of up to Rs 1,00,000 crore. The liquidity availed under this TLTRO 1.0 facility was to be deployed in investment grade corporate bonds, commercial paper, and non-convertible debentures over and above the outstanding level of bank investments in these instruments as on March 27, 2020. The response to this offer was encouraging. When the first auction for a total facility of Rs. 25,000 crore was conducted, the central bank received 18 bids for a total of Rs. 1.13 crore. Clearly banks, saddled with non-performing assets and a highly risky environment given the crisis, saw an opportunity in borrowing at the repo rate and lending against paper issued by credit worthy corporates. The instruments in which funds access by banks from the central bank's TLTRO 1.0 facility were invested in commercial paper worth Rs. 26,666 crore issued by a set of six public sector companies and 21 private sector companies and medium and long term bonds worth Rs. 25,323 crore issued by a set of three public sector companies and 15 private sector companies. The private sector companies accounting for a large chuck of the resources were leading firms like Reliance Industries, Housing Development Finance Corporation, Larsen and Toubro and Mahindra and Mahindra. TLTRO 1.0 essentially served as a means for strong companies to access cheaper credit than available in the market, and possibly use it to retire higher cost debt on the books. Banks too, that have seen their retail lending options, involving credit for buyers of homes, automobiles and durables, eroding, must have been happy to exploit this facility, since the low cost of funds can ensure a reasonable spread.

However, the 'success' of TLTRO 1.0 was no indication that the easing of financing conditions would result in a revival of overall credit. The real crisis even among businesses that want to borrow is in troubled sectors varying from corporates that issue risky and unlisted bonds and the MSME sector. Banks are extremely reluctant to increase exposure to sectors and large and medium firms that may potentially contribute to a sharp increase their NPA portfolio during the course of the crisis. The Chairman of banking sector leader State Bank of India has declared that as much of 25 per cent of the banks Rs. 27,000 crore MUDRA loan portfolio, directed at small borrowers, is non-performing. So, any hope that more liquidity in the hands of the banks would increase credit flow to this sector is misplaced. Meanwhile, Franklin Templeton's announcement that it was shutting down six of its funds holding more than Rs. 25,000 crore of investor money, with no clear indication of how much and when investors are likely to be paid back, has created a crisis in the non-bank financial company (NBFC) space. Redemption requests are spiking as scared investors rush to exit, and there is no market for the securities these NBFCs hold to mobilise the funds to meet these demands.

The second TLTRO round, with a corpus of Rs 50,000 crore, was specifically targeted at pushing liquidity into the hands of these NBFCs. But as compared with TLTRO 1.0, banks borrowed only Rs. 12,850 crore from the RBI, which was just more than half of the Rs. 25,000-crore on offer in the first round. Banks were not impressed with the guideline that lending to micro-finance institutions and mutual funds would qualify as priority sector lending and counted for realisation of that target. They were not keen on taking on the risk that lending to these institutions carries.

Aversion to risk is also reflected in the desire of banks to park funds with the RBI, accepting a low return of 3.75 per cent as a trade-off for the safety such deposits guarantee. To match up to the lower returns and in keeping with the RBI's move to lower interest rates, banks are pruning deposit rates. Together with a preference for cash in the middle of the lockdown and fears regarding the stability of the banks, this appears to be triggering an increase in the currency in circulation. All this implies that the strategy of using the banks as intermediaries to transmit a stimulus that does not burden the exchequer is a non-starter.

Meanwhile, under pressure from the government to lend to risky clients, public sector banks are asking the government for credit risk guarantees. Others, taking a leaf out of the initiatives launched by the US Fed for example, are demanding that the central bank should directly accept paper of different kinds from non-bank financial companies, rather than fund the banks in the hope that they would take on the risk. Attempts to outsource the stimulus are running into multiple roadblocks. It is time the centre that hugely increased its powers by invoking the Disaster Management Act, on the ground that this is needed to address the pandemic and its fallout, directly takes on the responsibility of mitigating the effects of the crisis and providing a stimulus adequate to stall and reverse the collapse of the economy.

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