QUANTUM Q-INDIA INSIGHTS

Lives versus Livelihoods

Piecing through India's economic response to COVID-19

Raghuram Rajan, the ex-Governor of the Reserve Bank of India (RBI), in a recent article, has stated the economic fallout from the COVID-19 crisis to be India's 'greatest emergency' faced since Independence. That may not be the mainstream view yet, but many will agree that the economic situation is indeed dire and is unlike anything India has faced until now.

The initial response from economists and portfolio managers was to compare and juxtapose the likely economic impact of COVID-19 with previous economic crises like the September 2008 – global financial crisis; the period post demonetization; the post taper tantrum impact of July-August 2013; the period during SARS - January – April 2003.

However, as things have progressed, many have realized that COVID-19 is unlike any other shock the modern global economy has seen. The fact that it is a global crisis, it is a crisis both of low demand and low supply and since it mandates humanitarian compliance and sacrifices makes it more complicated in terms of the social and economic response required to fight the pandemic.

In India, the initial response reaction was to check the spread by starting with international travel restrictions, encouraging social distancing, restricting non-essential work and finally enforcing the stricter but required full country lock-down. This was despite India's overall numbers being low and the infection rate growing slower than other major impacted economies. It was good to see India pro-active in its approach in tackling the initial spread of COVID-19 and which will hopefully pay rich dividends.

A forced lockdown continued for long though has economic consequences and the government will have to make the trade-off of prioritizing saving *'Lives'* through tough health measures and/or to relax the lockdown to allow certain segments of the society to gain back their *'Livelihoods'.*

This trade-off decision is germane and immediate for India given that

a) We have had a weak and a slowing economy leading up to COVID-19 and thus incomes are low
b) The existing social safety net needed to deal with a lockdown is poor and
c) The casual laborer is the most impacted and is the most vulnerable during the lockdown and thus requires to be looked after.

I saw a Twitter poll, which questioned – "By when will India's economy (GDP growth rate) get back to normalcy?" I asked, rather pertinently, I thought, "What normalcy?" – the normalcy prior to demonetization (7%) or normalcy back to the recent period of growth (5-6%) or the normalcy which many hoped before the 2008 financial crisis (+10%) or what some hoped post Modi's resounding win in 2014 (8%).

It is important to understand and internalize this normalcy, as it would then determine the scale, size and nature of the required economic response to deal with the economic shock of the lockdown and the overall impact of COVID-19.

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Our base case estimates put India's GDP growth rate for FY 20-21 to be just about positive with an assumption that lockdown opens up only in June, migrant laborers return gradually to urban job centers thus impacting labor availability and the revival of manufacturing and services and that the State and Centre's fiscal deficit increases to 9% of GDP from 6% of GDP.

An estimate of higher fiscal spending, efficient safety nets, better management of migrant laborers and immediate revival in activity could lead to GDP estimates ranging from 2%-5% for FY 2021.

A dire reading on the assumption of inefficient fiscal spending, migrants going back to villages on opening up of the lockdown and not returning till after the Kharif sowing, delayed revival in activity due to labor shortage and a spread of the pandemic in rural India needing a continuation of the lockdown will give for deeply negative growth rates, the impact of which will be devastating for many households.

Our base case estimate of fiscal spending increase of 3% of GDP seems limited, when you do a back of the envelope calculation of (Daily GDP * % of economy not functioning* days lost), which suggests a vastly higher fiscal support to buffer the economic hit.

The government's recent 'welfare' spending annoucement of less than 1% of GDP, some of which are already part of the budget provisions, combining free food, free gas, cash transfers and others appear limited. But it also suggests that more may be forthcoming and that the government is readying a 'stimulus' package for small business and industry.

We are of the view that in the current circumstances, spending more on 'welfare' and less on 'stimulus' should be the priority. Substituing peoples' lost income with free food, cash transfers, insurance and government mandated work will buffer the social impact of the lockdown and also help maintain consumption demand. Economic stimulus for businesses to produce and invest more can wait for when the lockdown is completely removed and business still struggle for demand.

We believe the economy never fully recovered from the sudden shock of demonetization and although the government responded by increasing NREGA spending and other rural devleopment programme, but maybe it wasn't enough to buffer the income loss of the rural and casual labourer. For COVID-19, as of now the rural economy does not seem threatened but it is the urban casual labourer, some of whom are headed back home and some are stranded looking to head back home, who is the most vulnerable and government will need better data and tools to target and reach them with income, cash and food support.

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Although, India needs to spend and not worry too much about fiscal deficit as a % of GDP, but given that the Centre+State+PSU borrowing remains at ~9% of GDP, the scope for a US style another 10% of GDP stimulus does not exist. The government thus will have to prioritise whatever leeway it has in increasing the fiscal deficit and not try to do everything for everyone. This also ties with my point above on knowing what is India's normal economic growth given the recent past and act accordingly to try and reach that over time.

Too much fiscal leeway may give us growth but will lead to a sell-off in bonds and INR. Too little, will lead to sharp mark downs in growth estimates, corporate profitability and equity asset valuation.

Foreign Investors will also watch how we deal with the migrant labor situation from a social risk perspective and on how fast are we able to get businesses back to some form of functioning as compared to other emerging markets.

The bond markets for now seem well supported by an all-encompassing RBI opening the liquidity spigot, cutting rates, allowing forbearance on EMIs and seeming ready to do more. At some time, there will be an ask of the RBI to support the government's fiscal easing, by buying government bonds directly from the government or indirectly from the market through open market operations (OMOs) and the RBI is likely to abide, which will further support the government bond markets and will prevent bond yields from rising despite higher government bond supply.

The problem though for the RBI remains the lack of risk capital in the economy. Banks, especially PSU banks, scarred by high NPAs and strung by low capital buffer, continue to shy away from risk taking. Post the IL&FS crisis of September 2018, bond market funding for lower rated corporates and stressed NBFCs has also remained frozen. With the uncertainty now with COVID-19, risk appetite of even private banks and well run NBFCs will take a hit.

The RBI thus may have to deal with this situation of very low risk taking in all segments of its credit economy into consideration in planning its response. Rate cuts and liquidity infusion at a time when risk appetite is low will not lead to monetary transmission and thus its benefits won't get passed on to the broader economy. Rate cuts and liquidity infusion will also not solve the issue of stressed corporates and NBFCs if banks, NBFCs and mutual funds do not use the surplus liquidity to lend to those companies.

Thus the only two entities which can take risks under uncertainty without worrying about too much about its impact on their balance sheets remain the Government and the Reserve Bank of India. We won't be surprised to see the RBI taking on a larger role in directly guiding Credit and Currency to the loan and bond markets and hopefully the government will use its fiscal resources in prioritizing providing Compassion and instilling Confidence in its citizens to consume and spend.

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