Former RBI deputy governor Rakesh Mohan **(Mint)**

We have a narrow window to enact fiscal relief measures, says former RBI dy governor Rakesh Mohan

17 min read . Updated: 03 May 2020, 06:22 PM ISTAnil Padmanabhan

Each sector will have to figure out how to phase in manufacturing taking account of developments in the demand side, so that what they produce gets transported and bought; it is interconnected

NEW DELHI : Rakesh Mohan has for the most part of his career always been in the policy hot seat, first as an economic adviser during the 1991 crisis—when he authored the policy proposal dismantling the 'licence raj'—which set the stage for an accelerated burst of economic reforms and later as the Reserve Bank of India (RBI) deputy governor overseeing monetary policy. Mohan, currently a senior fellow at the Jackson Institute for Global Affairs, Yale University, spoke to Mint on the fallout from the covid-19 pandemic and the desired steps, including the need for an urgent fiscal stimulus, to revive the economy. *Edited excerpts*:

The Union government has ended all speculation and announced a staggered withdrawal. Surely this would alleviate some pressure on the economy?
I would hope that it would relieve some pressure on the economy but it would depend on what kind of withdrawal it would be. What will be allowed? Which activities will start? It is a welcome sign though, from the economic point of view.

The lockdown in the last 40 days has caused a major demand shock, among other things. How do you revive demand?
That's a very important question. Revival of demand has two levels to it. First, that as the lockdown is lifted, people who have enough cash to spend, depending on what is open can start spending. These are people who have reserves of cash which they have not spent; those in the upper classes, whose incomes were not affected or affected mildly. These categories would include people whose incomes have not been greatly affected by the lockdown: which includes salaried people of all kinds—government, public sector, private sector and other employees, such as university and school teachers, who have regular salaries which have kept flowing.
Second, I presume, is the vast majority of people who have not received incomes during this period. Revival of their demand does mean transfer of some kind of cash grants to them—to the extent that has not happened at all in the past 40 days. There would be a need to devise modalities for a period of a month or six weeks of doing certain kind of cash transfers which will be spent. I am not in a position to suggest how that can be done and how we select the people who get such transfers, except that obviously the priority has to be the lower-end workers who have lost their livelihoods as a consequence of the lockdown.
With the kind of information that does exist in the system, I do feel that it should be possible to devise such measures. Here I am talking about the urban areas which includes all the informal sector workers, daily workers, etc. Through consumption surveys and other information, it ought to be feasible to estimate the kind of demand that exists in income groups and then get a sense of what needs to be done. We have the capacity to do it.
However, I have been living in the US for the last four years and presently in lockdown mode here. Hence all my remarks have to be discounted to a certain extent since I do not have ground level knowledge.

Any thoughts on the magnitude (in the US)?

People have been deprived of incomes for 40 days. Sitting here in the US, one can just gauge the magnitude of this suffering. The new unemployment numbers that have just come out in the US show that almost 30 million people have applied for unemployment insurance which is just about 18 % of the total labour force. This is after the huge fiscal package that they did which is actually giving loans to enterprises to keep people employed. During the 2008-09 financial crisis, the maximum unemployment claims amounted to about 800,000.
Given the informal nature of the economy in India, there must be a larger percentage of people who have not received any income during this period. I don't have a good enough sense of the rural areas and the effect of the lockdown there. In rural areas also, there is now a large proportion of incomes that are derived from non-agricultural activities so they would also have been affected. The cash transfer schemes would need to address such segments of the population who need help.

How do you see the revival of demand playing out in this new normal where social distancing will have to be a part?
That is exactly the difficulty that one is foreseeing. Going sector by sector and starting with the most obvious large sector: airlines. We don't have any sense when we will start operating flights—domestic and international. This is one sector where supply is clearly being impacted. Even if we start certain flights, for some time to come there will be very low demand because people will be scared of flying.
Second, is the tourism sector which includes large hotels, small hotels, restaurants and so on. Supply here will also be impacted for quite some time. I would presume there are ways on how to phase in activities in these sectors. For example, for hotels it ought to be feasible to operate them at some capacity while practising physical distancing. In the case of hotels it ought to be feasible for them to operate to cover their fixed costs, assuming travel is permitted.
Third, it ought to be feasible to allow some degree of restaurant opening even if it is through a much greater emphasis on take-out and deliveries. There are a large number of people employed in that sector as well across the country.
Third, construction sector where there is both a problem of supply and demand. Given the impact that incomes have taken, I would presume that the real estate sector will go through some difficulty in the short and medium term. If they are under construction, it ought to be feasible to start getting people in and get activity going. There will be a problem there because of the labour disruption that has taken place. None of these things are easy.

If you connect all the dots, clearly the economic recovery is going to be excruciatingly slow and not V-shaped as some argue.
Yes.
If you look at the manufacturing sector, because of the lockdown there will be large inventories that exist. The first job for small, medium and large companies is to get inventories going. There is no point manufacturing if you can't sell and that is connected to the whole logistics system. It will depend on how well we are able to open goods transportation both by rail and trucks. The rail system has of course been operating where freight is concerned, but the rail share of non-bulk freight movements is very small in India. So as the lockdown is lifted, special attention will need to be given to facilitating truck freight movement.
Each sector will have to figure out how to phase in manufacturing taking account of developments in the demand side, so that what they produce gets transported and bought; it is interconnected. Each company will be trying to figure out how to increase activity while taking precautions.
It needs to be done sector by sector, region by region, area by area and therefore cranking up the economy will take time.

Given these circumstances it is clear that a massive fiscal stimulus will be required to kick-start the economy. And in this we can only look at the Union government. Thoughts?
In order to clear our thinking, it should be called a fiscal relief programme and not a fiscal stimulus. My view seems to be somewhat different from many other economists. I feel that both the government and many economists are exaggerating the negative impact of a rise in fiscal expenditure, and the possible upward trend of sovereign debt burden that would result.
First, we do need to act quickly to safeguard livelihoods, help economic activity and businesses of all sizes to weather the downturn, and maintain access to essential public services. As we all know, large segments of the Indian population make their living in informal jobs, which means that they live from day-to-day dependent on their daily earnings for keeping their body and soul together. So I would imagine that effective unemployment urban India must be much higher because the lockdown than it is in the US. Further, most of our labour force lack any kind of a safety net, to even survive very temporary disruptions of their livelihoods as is happening at present. And, unlike developed countries we don't have the luxury of unemployment insurance. So the loss of employment and earnings suffered by this large number of informed workers we need to be compensated by the government. What

has been highlighted is the plight of migrant labour in urban areas: similar problems must have arisen for resident labour as well, which have not come to light since they are presumably dispersed across our cities. If quick relief is not given to maintain some minimum semblance of livelihoods, this could have somewhat medium-term impacts in terms of their ability to recover and resume economic activity as the lockdown is lifted.

Second, small- and medium-sized firms tend to be the mainstay of economic activity in our country, but they typically lack access to working capital, which means a liquidity problem for these firms arising from the extended lock could quickly turn into insolvency. If they do not have borrowings from banks, they may just go under and have difficulty resuming their activities. If they do have bank relationships there insolvency will then affect banks' balance sheets. In either case they will need assistance during this lock down period to be able to pay their employees. Larger firms, which may be expected to have somewhat higher staying power in terms of available liquidity, are expected to continue paying their workers. In their case also the cessation of or significant reductions in their revenues could also lead to difficulties in their ability to continue paying the workers and other fixed costs. Thus there could be increasing incidence of insolvency, depending on how severely the lock down has affected particular businesses.

For example, the longer the unemployment rate is elevated, the more people experience profound dislocation from their previous employment, the more their skills become dated, the more their connections to former colleagues weaken, etc. This is a classic problem of hysteresis, when a cyclical shock produces structural change.

So we do need a well-designed package of fiscal relief to tide over, the immediate problems arising from the lockdown with an eye to enabling a quick recovery as the lockdown is eased and lifted.

Care would obviously have to be taken to minimize the cost of such a relief. It would have to be decentralized in nature and therefore will need to be done through both state and local governments with the cooperation of local business associations. Those enterprises that have banking relationships could be helped through the banking system with conditional loans which have the possibility of becoming grants on the basis of fulfillment of certain conditions.

Third, there are a number of sectors, such as hotels and airlines, logistics, automobile industry, construction, textiles, which are suffering 50% or more erosion in their earnings and output. Unless fiscal help is given to these sectors in an organized and timely manner, there could be permanent damage which would prevent them from restarting operations as the lockdown gets lifted. Even when consumer spending begins to pick up, consumers may still be reluctant to undertake certain activities (e.g. travelling long distances, attending events with large crowds, etc.). We could also be looking at the emergence of very large non-performing assets (NPAs) leading to significant difficulties in the financial sector as a whole. This has to be avoided.

Why do you feel so?

Let us first recall some recent instances of high fiscal deficits. First, it is worth recalling that the government's debt to GDP (gross domestic product) ratio had increased to almost 85% in the early 2000s. Despite a less than stellar record of fiscal probity over the last decade or so, this ratio has remained broadly stable at just under 70% since 2013. So there has clearly not been a lasting negative impact of that episode.

Second, similarly, the overall fiscal deficit of the country had indeed gone up to over 11% of GDP in 2003 and was just under 10% after the financial crisis in 2008-09. The state of the economy was much better in 2008-09, but perhaps somewhat similar to the present in the early 2000s when we had recorded low rates of economic growth and somewhat higher ratios of NPAs in the banking system at that time. But we recovered from that period after 2002.

Third, during these periods of higher fiscal expenditure and deficits there was a very negligible resort to external government financing. In none of these instances was there any resort to central bank financing either, on a direct basis. All the extra financing was done through the domestic market.

Fourth, hence this experience suggests that India has the potential capacity for sustaining high temporary fiscal deficits and then recovering by restoring relatively healthy economic growth. It won't happen in a hurry. Assuming that globally also that things start to become normal in a year from now, then we ought to be looking at restoring reasonable growth from 2021-22 onwards.

Fifth, it is true, however, that the excess fiscal and monetary stimuli in 2008 and beyond did result in both continuing high fiscal deficits and a spike in inflation to around 2013. But that was in different circumstances when the high fiscal expenditures and tax cuts did constitute a significant fiscal stimulus. They came on top of an economy that had been humming along at high capacity. There were a number of actions done in 2009 which were partly election related. That was a real fiscal stimulus along with excessive monetary stimulus which led to high fiscal deficits and excess aggregate demand, which didn't correct quickly enough. The result was high inflation of over 10% for the next three-four years. I can perceive that that hangover is what is possibly inhibiting policy makers from taking more fiscal relief measures that are urgently needed now.

Why would it be different now?
This time around, the fiscal expenditures would be much more in the nature of fiscal relief rather than stimulus. This is just substituting the expenditures which would otherwise have been made. They need to be made because people have no incomes. Of course, care will need to be taken to ensure that the demand is not higher than the increase in supply. Those are the considerations.
So it can be done much more safely, as long as India returns to prudence after the covid-19 pandemic subsides. This is the important point: fiscal relief expenditures must be seen as substitutes to private expenditure which is currently constrained because of the lockdown and will continue to be restrained even after it is lifted on a gradual basis.

What about the size of fiscal relief?
Current calculations suggest that we need a fiscal relief programme of around 5% of GDP. The longer we delay the announcement and rollout of the measures the larger will the need become. So time is of the essence.
We also need to understand that, in any case, this year's deficit will be higher because of loss of economic activity resulting in lower tax and non-tax revenues. Hence my broad quantitative assessment is that the India's debt-GDP ratio, in the present unusual circumstances, could well go up to about 90% of GDP in this fiscal year, if we undertake such fiscal relief. The guiding framework here would have to be some assessment of the fiscal actions that may be needed to restore economic activity juxtaposed against possible injections necessary to restore the financial sector in the absence of fiscal action now.

So the architecture of this fiscal relief package has to be very strong on design.
Yes. While these are not easy things to do, there must be conceptual clarity.

Should this fiscal relief package be announced immediately or later?
It should be immediate. Sooner the better; we have already lost six weeks. And the lockdown period has already been extended by another two weeks. We could end up shouldering an even higher burden of fiscal expenditure and debt if we don't do things now.

What I am saying is by not doing something now or doing something slowly, you might actually end up worse just in terms of fiscal expenditure and debt. It may be needed to restore economic activity so that you don't have a problem later.

The obvious follow up question is how do you fund this kind of stimulus?
First, it is not a stimulus, but a fiscal relief! The injection of extra liquidity in the system, so far as I understand it is nearly Rs7 trillion, and is being parked by banks with the Reserve Bank of India on a daily basis. So there is a reasonably high degree of liquidity available for the union government to borrow through the normal processes. This is obviously because demand has contracted and the risk averse banks are not lending; so you will get subscriptions to any kind of bond options. The 10-year bond yields are still around 6.1% and have not shot up because of Reserve Bank of India's (RBI's) actions in easing liquidity.

What about monetising part of the fiscal deficit?
These are totally exceptional times when we have to think out-of-the-box but prudently. If found necessary in view of developments in the financial markets, and excessive pressure on government securities yields, the Reserve Bank will need to use all the tools at its disposal to support government financing as necessary. If it is feasible to finance the deficit without resort to RBI, while keeping the long-term bond yields under control as at present, that would be preferable. That will enable appropriate price discovery, and the RBI could conduct almost back to back OMOs.
I am glad to see that it has already expanded its WMA (ways and means advances) limit to the central government significantly to Rs2,00,000 crore, and has also increased the state governmentt limits to 60%. This is a very good move. It reduces the cost of borrowing for the government; it helps the bond market from spiking in terms of yield; and gives government and the RBI time to see if further financing is needed from the RBI without disturbing the bond market significantly.
But this may not be enough. State governments are bearing the brunt of many expenditures required to protect the livelihoods of the poorest while suffering significant declines in their revenues. Thus they will also need significant support from the central government and the Reserve Bank combined. Various measures that can be thought of are OMOs in state government securities, the inclusion of state government securities in SLR provisions for banks, central government borrowing and onward lending to states... And so on.

One discussion I've not seen so far relates to the needs of local governments. I assume that their relief expenditures must have grown significantly and wonder how they are being financed?

This is a once in a lifetime pandemic and hence there is little or no institutional memory, and consequently there is a need to create a new playbook. If you were back in government what is the out-of-the-box advice you would proffer?
I would suggest one measure. Unlike the US or other developed countries where policy interest rates are zero or even negative, even if we reduce the policy rates to below the current level, the likelihood of lending rates going below the current levels is very low. That is what we also experienced in 2008-09. So my suggestion is that the government should contemplate and across the board interest-rate subsidy of 2 to 3% for on lending by banks, and possibly NBFCs (non-banking financial companies) for a specified period of time. I had made a similar suggestion in 2008 also but it was not accepted then. The cost of this is quite low in the current circumstances. So additional lending Rs1,00,000 crore would mean a fiscal cost of only Rs2,000 crore. The modalities of such a measure would need to be worked out in some detail but I do feel that this would be much more effective than any further attempts to reduce policy rates. What this does is to keep deposit interest rates at reasonable real rates, borrowers get the benefit of more interest rates, while protecting bank balance sheets and thereby financial stability of the system.

Pretika Khanna and Anuja contributed to this story.