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Urgent action to reinvigorate the financial system is imperative, as delay increases costs exponentially

A Shot to Boost Confidence

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India's lockdown has been both most stringent compared to other countries as well as one of the most effective. But as with countries battling Covid-19 with similar containment strategies, this has come at a cost.

A 'revival' strategy consists of different components: direct expenses to fight the virus itself; 'relief' for those whose lives and livelihoods have been severely impacted; 'stimulus' for getting businesses back on their feet.

A common misconception is that resources allocated for revival have been insubstantial. This argument assumes that stimulus must necessarily be fiscal in nature. However, economic revival is also contingent on the aggregate flow of funds to the economy. RBI's targeted long-term repo operations (TLTROs) aimed at enhancing investment in corporate bonds and commercial paper amounting to ₹1.5 lakh crore must be taken into account. So, an accurate measure of the total amount already allocated for economic revival — the relief package, plus targeted liquidity facilities — adds up to ₹3.2 lakh crore, or 1.5% of GDP. This is by no means insignificant.

Should We Scale the Wall?

However, more is needed. Increased allocations to infrastructure programmes and employment schemes like MGNREGA must be bolstered. Which brings us to the inevitable question of the dangers of going beyond the boundaries set by 'fiscal space'.

How real is this threat? Credit rating methodologies, and policy benchmarks such as targets set by the Fiscal Responsibility and Budget Management (FRBM) Act, give an impression of 'exactness' based on mathematical calculations. They are, however, more thumb rules. Policymakers may want to bear some things in mind. This is an exceptional year and if rating agencies were to penalise any amount fiscal 'slippage', it would dent their credibility as arbiters of a country's economic health. Second, on GoI's external debt obligations front, India is particularly comfortable. Its externally held sovereign debt is a paltry 3.8% of GDP.

Rating agencies are known to put considerable emphasis on 'structural factors'. India has made considerable efforts to improve its 'structural stability' via implementation of the Insolvency and Bankruptcy Code (IBC), goods and services tax (GST), etc. So, the short-term prospects for growth relative to the rest of the world should work in India's favour.

More needs to be done on the reforms front, though. A reform package must be accompanied by a medium-term plan to return to a path of fiscal discipline. How much fiscal stimulus can GoI realistically give? The consensus among economists, banks and other stakeholders is that a stimulus of around ₹4.5 lakh crore can be announced without rocking too many boats.

Factoring in revenue losses on the back of a drop in GDP, a large shortfall in disinvestment receipts, and significant compression of regular budgeted expenditure to 'accommodate' a stimulus, the fiscal deficit-to-GDP ratio should be 5.5%. Assuming an overshoot of 1% on the aggregate for states, this should take the consolidated deficit for the economy to 9.5%. This seems reckless profligacy, but may be the bare minimum needed to bootstrap the economy.

Even as the size of the fiscal package matters, its design is just as important. So, for India, with admittedly fewer fiscal resources than many other economies, the challenge is to get the best bang for our buck.

Credit Where It's Due

We must redefine stimulus as the effective flow of funds to the economy that can aid its revival. A critical component of this flow is credit. The task cut out for our policymakers is to ensure that in an environment of enhanced credit risk, adequate credit flows to sectors needing it urgently.

GoI must guarantee that it would bear the first loss on bank lending to sectors like MSMEs and NBFCs. This can be done through the Credit Enhancement Guarantee Corporation envisaged in Budget 2019-20, or through more focused special purpose vehicles (SPVs) housed in entities like the Small Industries Development Bank of India (Sidbi). GoI will have to provide the capital for these SPVs.

The mitigation of credit risk through the guarantee will spur banks to open up their lending sluices. Simulations show that a ₹20,000 crore equity commitment could facilitate ₹3 lakh crore of credit flow. Currently, banks have about ₹8.5 lakh crore parked with RBI as reverse repo balances. This is, potentially, the quantum of funds that can be channelled to the real economy with a relatively small allocation of capital along with guarantees. Guarantees involve no immediate spending and have no direct fiscal impact. This is, thus, a formula for maximum stimulus with minimum fiscal cost.

If credit risk still hold banks back from lending to particular sectors, these SPVs with government guarantees open up an avenue for RBI to purchase debt paper issued by companies in these sectors, be they finance, manufacturing or services. Each credit guarantee or direct purchase of securities is an important 'signal' that provides help to credit. It is unlikely that the entire quantum of guarantees will be invoked, or that RBI will have to purchase large amounts of corporate bonds or commercial paper. But the confidence it brings back to credit, bond and money markets could be a game-changer.

What we need is renewed confidence in the financial system to revive the economy. And the price of this confidence is just a small fiscal allocation, not a gargantuan stimulus.

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We have to flip the switch now!

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