Emerging from the abyss

India will have to swim against the tide to capture the shrinking pie of global trade. This requires fast tracking reforms to improve the investment climate and attract investments.

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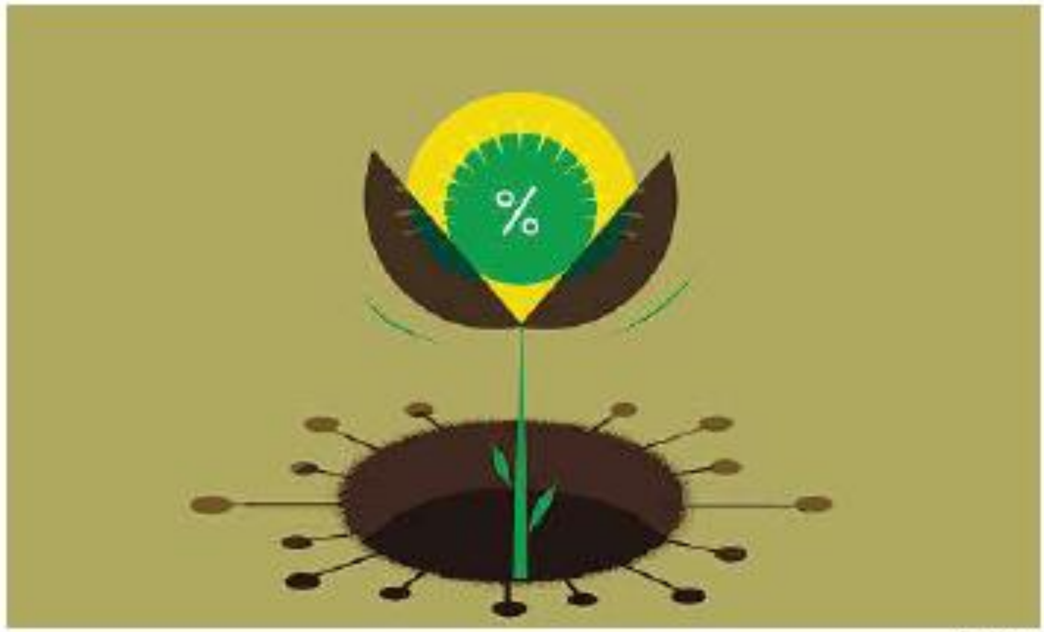

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GOING, BY THE, flurry of revisions in forecasts since the National Statistical Office (NSO) announced that gross domestic product (GDP) in the April-June period had shrunk by 24 percent, a much deeper hit to Indian economy this fiscal appears certain now.

We, for one, have revised our real GDP growth forecast for India this fiscal to (-) 9 percent from (-5) percent projected earlier in May. This revision, however, is not premised on first quarter data- our projection at (-) 25 percent was anyway close to NSO's estimate- as much as on the unfettered spread of COVID-19 infections and the inadequate fiscal stimulus convulsing the economy. Besides, unless inflation, climbs down below 6 percent, the Reverse Bank of India would be constrained from cutting trates.

As things stand, till the time a vaccine is found and mass distributed forecasting the economic environment, and as a consequence, decision-making, will be dominated by what John Kay and Mervin King, in their recent book, refer to as "radical uncertainty" - a situation in which we know something but not enough to act with confidence. And that too when the stakes are high. If the experience of the last few month is any guide, it will indeed be a very complicated transition to what we regard as normal.

High-frequency economy indicators till August-end show a recovery vis-a vis the first quarter. But they remain in contractionary phase, indicating that the economic contraction will continue in the second quarter, though not as severe. We expect the economy to contract by 12 percent in the second quarter. If the pandemic were to peak out by October, GDP growth could move into mildly positive territory towards the end of this fiscal.

As was the case in the deep downturns in the past, 2021-22 could see a sharp mechanical lift from the deep trough this fiscal. Milton Friedman's "Plucking Model" could be used to explain if such a recovery does take place next fiscal push. Friedman compares an economy to a string instrument- while recession pluck the string down, it bounces back thereafter. This has been used to explain the economic recovery in parts of Europe post the global financial crisis ("The Plucking Model" of recession and recoveries" by Gregory Claeys and Thomas Walsh).

Quite in sync, we see India's growth rebounding to 10 percent in 2021-22, on a very weak base and with some help from the rising global tide that will lift all boats. The key assumption here is the availability of vaccine in early 2021, in the absence of which, all bets are off. Even so, real GDP will merely catch up to the 2019-20 level in 2021-22. The economy will suffer a permanent loss of 13 percent of GDP which works out to Rs. 30 lakh crore in nominal terms. So a sharp recovery in 2021-22 can be highly misleading.

The manufacturing sector is likely to recover faster than services with face-to face contact (tourism, hospitality, and sports), which continue to be restrained by regulatory restrictions and a likely persistence of risk-averse behavior of consumers till a vaccine is mass distributed. Countries such as China, which have already emerged from the pandemic, bear this out-demand for such services there is tepid even after opening up. This is also reflected in India's manufacturing PMI rising faster than services in August.

The rural economy, representing almost half of the Indian economy, appears to have held up somewhat better than its urban counterpart largely because of normal agricultural performance and the rural tilt of government's support. This shows up in demand for products with rural footprints such as tractors, motorcycles and fast moving consumer goods. But rural wages remain depressed and remittances are likely to have been hit due to reverse-migration. Moreover, the pandemic's rapid spread to rural areas can challenge the rural story.

The critical question now is what happens to medium term growth prospects after the next fiscal.

Data till the 1990s shows that in most instances, growth in India has rebounded, and that the medium-term average has not gone majorly off-track even after a deep hit to the economy. During the global financial crisis, however, medium- term growth did slip to 6.7 percent per year from 7.9 percent in the preceding five years. But world GDP growth also slowed by similar magnitude to 3.7 percent from the pre-crisis of 4.9 percent. The pre-crisis phase was an indeed an abnormal one for the world economy and the excessive leverage -driven fillip to growth could not be sustained with many economies expanding at half the pace post the crisis.

The current crisis, however, has no parallel and brings with it massive uncertainty and lingering behavioral shifts not experienced in independent India. India is facing this crisis on a weak wicket, with growth slowing, investments falling, and a stressed financial sector- it has been hit the hardest among its contemporary.

In the post pandemic world order, relentless pursuit of efficiency will take a back seat as other considerations such as resilience and reliability take precedence. And this, along with the accelerating trend of deglobalisation, could reduce reliance on supply chains in the current form. For developing countries such as India, the hit to global supply chains may limit the opportunity of industrializing through this route.

The manufacturing sector has been in recession since the second quarter of the last fiscal, long before the pandemic struck. Consequently, the share of manufacturing in gross value added fell from 18.1 percent 2018-19 to 17.4 percent in 2019-20. Given that investments are likely to take a substantial hit, with the government's ability and the private sector's willingness and ability to invest impaired, medium- term growth potential is likely to trend lower in the base case scenario. That said, India's medium term growth trajectory will be largely influenced by domestic factors as the global environment will be less favourable.

The received wisdom is that in the post pandemic world order, relentless pursuit of efficiency will take a back seat as other considerations such as resilience and reliability take precedence. And this, along with the accelerating trend of de-globalization , could reduce reliance on supply chains in the current form. For developing countries such as India, the hit to global supply chains may limit the opportunity of industrializing through this route. India will have to swim against the tide to capture the shrinking pie of global trade. This require fast tracking reforms to improve the investment climate and attract investment, relocating away from China.

Policy makers will need to take more steps to address the current pain by raising spending to support vulnerable households and small business and services that have been debilities by the pandemic. This will strengthen the recovery process and many also help contain the damage to the productive capacity of the economy. Together with accelerated efficiency enhancing reforms, this can create conditions for a sustainable push to growth over the medium run. Fingers crossed.

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