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Indian Economy and Covid -19: An MMT Perspective

Student Research Internship Report

Samarth Khurana

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Samarth Khurana[1]

Covid-19 has had a significant impact on the world economy. Worldwide imposition of restrictions disrupted the supply chains across the world, significantly impacting the ability of firms to move products from one place to another.

According to the World Economic Outlook Report published by the IMF in April 2021, the global economy contracted by 3.5% in 2020. Although the global economy is projected to grow 6.0% in 2021 and 4.9% in 2022, the unequal access to vaccines between and within countries has resulted in the widening of fault lines in the global recovery.

Current State Of The Indian Economy

While the impact of Covid-19 can be seen worldwide, India remains one of the most impacted regions in the world. Imposition of nationwide lockdown with an aim to curb the spread of the Covid-19 disease brought social and economic life to a standstill.

From April to June 2020, India's Gross Domestic Product (GDP) contracted by 24.4%, followed by a contraction of 7.4% in the second quarter of the 2020/21 financial year. Furthermore, the unemployment rate increased from 5.3% of the total labour force in 2019 to 7.1% in 2020. According to an estimate by the Centre for Monitoring Indian Economy (CMIE), about 21 million salaried employees lost their jobs between April to August. The number of salaried people decreased from 86 million in 2019-20 to 65 million in August 2020.

A sector-wise analysis of the Indian economy shows significant contraction due to low demand and decreased exports. For instance, industries such as Hospitality and Travel & Tourism are expected to lose around $65.57 billion and $19.31 billion, respectively, as a result of the pandemic.

The Covid-19 pandemic has severely affected the government revenues while exerting pressure to increase government expenditure. For instance, revenue receipts collapsed from ₹20.2 lakh crore to ₹15.5 lakh crore and expenditure increased from ₹30.4 lakh crore to ₹34.5 lakh crore in the financial year 2021.

The fiscal deficit and revenue deficit are expected to be 9.5% of GDP and 7.5% of GDP, respectively, for 2020-2021. These are rather conservative estimates considering the significant fall in government revenue and the disinvestment receipts.

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[1] Samarth Khurana (Master's in Economics) Indian Institute of Foreign Trade, Delhi.
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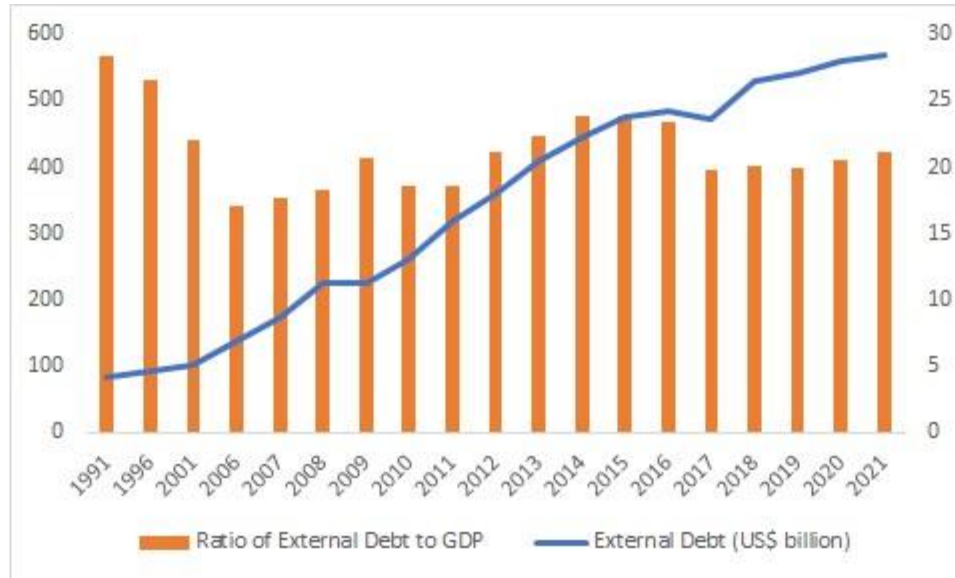
I, Samarth Khurana, declare that this is my own work and has not been plagiarized.

Moreover, India's debt to GDP ratio touched a 14-year high. The union government's debt increased from 51.6% of the gross domestic product in 2019 to 58.8% of the GDP in 2020.



Source: RBI Database

INADEQUATE FISCAL RESPONSE

Governments across the world have increased their fiscal response to the Covid-19 pandemic with an aim to support private incomes and employment. Globally, the fiscal support reached nearly $16 trillion (around 15% of global GDP) in 2020. However, the size and the composition of the fiscal expansion has varied across countries depending on their respective fiscal space, policy preferences and the severity of infections.

Despite the magnitude of the pandemic, additional budgetary allocation to various social safety measures has been relatively low in India compared with other countries. For instance, additional expenditure increases were limited to subsidies and essential relief through the Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS). Overall, expenditure increased from 13.53% (Budget Estimate) of GDP to just 17.4% (Revised Estimate) of the GDP in 2021.

Furthermore, intending to consolidate the fiscal deficit, the Indian government set a target to reach a fiscal deficit below 4.5% of GDP by 2025-2026. Similar targets were set for state governments as well.

As a recommendation by the 15th Finance Commission, state governments were asked to reach a fiscal deficit of 3% of GSDP by 2023-24. Restrictions were also imposed on the borrowing ability of the states by allowing a normal ceiling of net borrowing for the states at 4% of GSDP for the year 2021-2022.

The Modern Monetary Theory argues that these self-imposed constraints by the government can be self-destructing in nature. It considers fiscal policy as the driver of economic growth and believes that such self-imposed restrictions can significantly impede the government's ability to spend and provide much-needed support to the economy.

It argues that the government being the sole issuer of money, should be treated differently from a household or private business since it can always issue more money and regulate its debt. It also states that the intuition that increased government spending would increase inflation or crowd out private investment is a myth.

At times when private investment and consumption expenditure is low, deflation is a greater worry than inflation. In this pandemic situation, it is very unlikely that the increased government expenditure will put inflationary pressure on the prices. Even if it did, monetary policy (Reverse Repo Transactions or Open Market Operations) could be used effectively to keep the interest rates between the stipulated corridor and thereby maintain inflation within the targeted range.

Modern Monetary Theory highlights that increased government expenditure will only increase the amount of money in the hands of the people, which will put an upward pressure on savings. These increased savings translate into investments, thereby increasing the aggregate investment instead of crowding out the private investments.

Ineffective Monetary Policy

The Modern Monetary Theory further argues that monetary policy alone is ineffective and is a poor instrument for stabilization. It highlights that the attempt of the monetary policy to increase aggregate demand by reducing interest rates is very unlikely during a recession because of higher uncertainty and lower consumer sentiments.

For instance, despite the Reserve Bank of India maintaining an accommodating stance, overall credit growth and credit to the commercial sector remained sluggish in the year 2020 compared to previous year levels. While the bank credit to the manufacturing sector remained muted, the personal loans registered a decelerated growth of 9.3% in October 2020 compared to 17.2% growth a year ago.

Conclusion

The Modern Monetary Theory asserts that inflation takes off only when resources are not fully employed. Given the high level of unemployment in countries like India, an increase in government expenditure would not only increase the overall demand for the goods but also increase the total output, which can counter any inflationary pressure on the prices.

With no inflation and no bottlenecks, modern monetary theory can help the government address the true deficits with no fiscal constraint, such as the good jobs deficit, the healthcare deficit, the education deficit, the infrastructure deficit, the green climate deficit and the democracy deficit, and thus achieve economic stability.

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