GUEST VIEW

Opt for policies that are pragmatic and not dogmatic

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The covid-19 pandemic is not just a health crisis; it is in equal measure an economic crisis, the consequences of which could potentially be catastrophic. As policymakers scramble to contain the outbreak's economic fallout, the Reserve Bank of India (RBI) must play a critical role in financing both the government and private sector. A conventional recession typically occurs when people choose to cut their spending. It is usually dealt with by designing a broad-based stimulus package intended to stimulate economic activity. An off-the-shelf package, however, may not be very useful in a pandemic-induced slowdown where large parts of the economy cannot operate, as they are under a lockdown. The first order of business, therefore, is for the government to transfer resources to sectors impacted by social distancing measures to help them minimize the cost of the crisis.

Countries have lost no time in mobilizing resources to confront the crisis. Japan, for example, has earmarked a whopping 20% of gross domestic product (GDP) to fight it. The Indian response, at barely 1% of GDP thus far, is woefully inadequate. Conservative estimates suggest that India would need upwards of 10% of GDP to address the fallout from the crisis. However, this then begs the question of how the Union government, with limited fiscal elbow room, proposes to finance these expenditures.

The government, as many analysts have pointed out, has already helped itself to India's entire household savings. Further borrowing would drive up bond yields and crowd out already weak private investment. Extraordinary times call for extraordinary measures, and therefore, policymakers must put previously discarded options such as external foreign currency borrowing and RBI monetization of the fiscal deficit back on the table. While the former is susceptible to rollover and exchange rate risk, the latter might result in runaway inflation. However, these concerns must be weighed against the consequences of an inadequate government response for lack of mobilized resources.

With very low costs of borrowing abroad, foreign currency borrowings look attractive for a cash-strapped government. Fears that money financing, or simply printing money, could spark inflation and raise long-term borrowing costs are not borne out by recent academic evidence. Jordi Gali (*bit.ly/2VNQHY6*) shows that if prices are slow to adjust, then increased liquidity under money financing may actually lower borrowing costs and stimulate economic activity. A recent IIMB study by Abhishek Naresh and Chetan Subramanian finds that fiscal multipliers in India are higher under a money-financed fiscal deficit.

Let's turn to the needs of Indian industry. India was already in the midst of a full-blown credit crisis at the outset of the pandemic. Lack of adequate credit to industry is likely to result in a fresh wave of bankruptcies. Payment moratoriums and postponing the recognition of non-performing assets by a few months are like pennies thrown at companies before they get hit by a steamroller. The central bank must move fast to separate insolvent firms from illiquid firms, and address the needs of the latter. If not, otherwise efficient firms could collapse as well.

The economy needs a stimulus package as much as an RBI ready to act like an asset rebuilder

Conventional monetary policy has been highly ineffective in stimulating credit provision in India. The transmission of changes from the short-term interest rate to the long rate, the one that matters to most economic activity, has been quite weak. Moreover, monetary policy effects take time and are dependent on the banking system for transmission to the broader economy. We do not have that time now. To drive down long-term yields, RBI must therefore carry out large-scale purchase of long-term assets. The RBI must kickstart a "quantitative easing" programme. However, instead of buying tradable securities, as is conventionally done, we suggest that RBI take toxic loans off the balance sheets of banks and non-bank finance companies.

In doing so, RBI can inject liquidity quickly and also stall the degradation of these loans with its longer holding capacity. Central banks in other countries have done this before and have even made money by taking on risks that commercial banks are loath to taking during a crisis. Allowing the problem to fester could result in a wave of defaults that could spill over into debt markets and affect millions of retail investors through their mutual fund holdings. The news that Franklin Templeton is shutting down six of its debt funds suggests that such a wave might have already started.

An aggressive asset-buying programme by RBI can focus on firms and sectors that are likely to have the most significant impact on the economy. Metrics such as employment creation and linkages with other sectors can be used to pick loans to target.

The unique nature of this economic crisis caused by the pandemic requires us to be flexible in our response and not be wedded to existing frameworks. The medical fraternity has made it clear that a vaccine is a good 18 months away and that a second wave of infections will almost certainly come during the latter half of 2020. Addressing the economic fallout would require a massive effort on all fronts. The central bank must do what it takes, even if it means temporarily morphing into an asset reconstruction company. It is time for us to follow pragmatic and not dogmatic economics.

Ankit Kumar of IIM Raipur contributed to this article