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Deciphering India's Stimulus Package: Adding Apples with Oranges?

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Abstract

We analyze the efficacy and skepticism surrounding the recently announced fiscal stimulus package by the Government of India in response to the Covid-19 pandemic. While the pandemic has not lost its teeth yet, countries across the world, including India, have been circumspect in formulating policy measures and balancing inter-temporal objectives. A comparison is drawn with the previously announced stimulus package in combating the global financial crisis and to understand the combined role of a fiscal and monetary policy. The paper explores whether India's choice of designing the fiscal stimulus package into varied components, including monetary policy measures and long-term capital expenditure has left much to be desired. Further, the fiscal measures of issuing guarantees could create potential fiscal risks due to the cascading effect of contingent liabilities. Moreover, as the Government nudges the banks to lend more freely, the banks too remain vulnerable in adding to their share of non-performing assets.

Keywords: Fiscal Stimulus, Pandemic, Credit Guarantees, Contingent Liabilities, India

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1. Introduction

The unprecedented Covid-19 pandemic has created havoc in peoples' lives and created enormous economic strife. Expectedly, world-over fiscal and monetary stimulus are in action to counteract such an adverse shock. India has been no exception. Even before the advent of the pandemic, India's economic growth was on a downhill trajectory, and thus an economic stimulus was necessary.Perhaps, because of the tight budgetary constraintand an implicit fear of rating downgrade, Indian authorities have been less than exuberant in devising their fiscal package (Pal and Ray, 2000a & 2020b). That is why theIndian Prime Minister's announcement of a Rs 20 trillion stimulus package on May 20,2020,was greeted by people from various walks of society, and it was expected that this is going to be a "New Deal" moment for India. His speech also shared his vision of a self-reliant India (*Atmanirbhar Bharat*) that has attracted quite a media attention.

However, after we have learned the details of the stimulus package over the next few days from a series of briefing from the Finance Minister, has some of the initial exuberance got faded away? Columnist Swaminathan Aiyar commented in the *Economic Times* of May 21, "PM Modi's excessive caution may render stimulus package useless."[4]The Wire, an on-line news portal, on May 17 2020, went on to say, "Modi's Rs 20 Lakh Crore Package will likely have fiscal cost of less than Rs 2.5 Lakh crore".[5]

What are the contours of this excessive caution?Why do the estimates of fiscal stimulus differ so drastically? What are the constituents of India's stimulus package? Such questions are, thus, blowing in the wind. It is in this context that the present essay investigates some of these questions – without any claim of exhaustiveness. The rest of the essay is organized as follows. Section 2 discusses some basic analytical consideration about monetary and fiscal stimuli. Sections 3 and 4 are devoted to the stimulus packages of 2008-2009 and the present one in 2020-21, respectively.

2. Economic stimulus as a counter-cyclical policy tool: Back to the Basics

In mainstream undergraduate Macroeconomics 101, an economic stimulus is essentially couched in terms of an intervention that is capable of shifting the short-run aggregate demand curve. The standard fiscal policy (an increase in government expenditure or a tax cut) or a conventional monetary policy (typically representing a cut in the central bank policy rate) do qualify for such a

[4]https://economictimes.indiatimes.com/news/economy/policy/pm-modis-excessive-caution-may-render-atmanirbhar-bharat-stimulus-package-useless-despite-india-being-a-resilient-economy-swaminathan-aiyar/videoshow/75862496.cms
[5]https://thewire.in/economy/modi-rs-20-lakh-crore-package-actual-spend

stimulus. Of course, these policies are effective for short-run income stabilization in the presence of some wage-price rigidity in an expectation-augmented short-run supply curve. As agents revise their expectations in the longer run, the output effect of such an expansionary monetary / fiscal policy will get faded away, and the economy will be back to the natural rate of output (*a la* Friedman) at the cost of higher inflation.

What would matter in the long run, is a shifting of the long-run aggregate supply curve. The long-run supply curve can shift due to changes in factors of production, technology, quality of human capital etc. It can also shift due to a host of structural policies. In popular policy discourse, we refer to such structural policies as 'reforms'. The intended objectives of these 'reforms' are to shift outwards the vertical long-run aggregate supply schedule by improving efficiency of the system. While these are extremely warranted policy measures, these work with some lag and hence their immediate effectiveness is in question. Illustratively, building more hospitals for the population is an extremely desired objective of a welfare state, but building more hospitals may not immediately solve the problem of paucity of growth within a quarter. In recent times there has been two major changes in this standard wisdom.

First, as the policy interest rates in many advanced countries have touched or were about to touch thezero-lower bound, a number of advanced country central banks have adopted policies of quantitative easing (QE).In QE, a Central bank buys securitiesfrom the private sector and thereby expands their balance sheets. These central banks, thus, shunnedthe orthodoxies of buying only koshersecurities and started buying securities of various quality and tenor, like those issued by state governments, commercial papers, or various government sponsored agencies. As interest rates in India is yet to touch those low rates, the issue of QE is yet to arise in India. However, the Indian Central Bank has been fairly innovative in providing non-QE monetary stimulus.

The second has been a long-standing debate between fiscal austerities versus fiscal stimulus.We have discussed this elsewhere (Ray and Pal, 2020b) but to highlight some new developments, Alberto Alesina, Carlo Fevero and FraccescoGiavazzi in their 2019 book titled, *Austerity*:*When it works and when It doesn't*have advocated "expansionary fiscal contraction", whereby a fiscal contraction may paradoxically generate growth. Distinguishing between "Expenditure Based" (EB) and "Tax Based" (TB) plans, they found a large and statistically significant difference between the effects of EB and TB austerity on output. While EB fiscal consolidations have been associated with a very small downturn in output growth, TB plans tend to get associated with large and long-lasting recessions. We have not seen any discussion along this line in the Indian context.

But what we know is that a combined monetary and fiscal stimulus works best rather than in isolation so that the crowding out effect of fiscal stimulus is counteracted by a monetary stimulus. We also know the by virtue of having a convertible currency and good credit rating, the ease at which an advanced country can undertake a monetary and fiscal policy cannot be matched by an emerging economy. This inability is all the more pronounced in a country with a current account deficit that depends on capital inflows to withstand its balance of payments constraint and to avoid a hugely fluctuating exchange rate.

Moreover, in the Indian context, more research is pointing out the possibility of complementarity of private and public investment. In an economy like India where lack of infrastructure and poor 'ease of doing business' hinder private investment, there is a possibility that right kind of public investment may actually crowd-in private investment. Bahal et.al (2018) show that post 1980s and especially since 1996, public capital accumulation has crowding-in effect on private investment. Similar results have been arrived at by Chhibber and Kalloor (2017). Mitra (2006), on the other hand, shows that while in the short-run public investment may crowd-out private investment, but over medium to long term, it complements private investment.[6]

In the context of the present crisis, which has exposed lack of medical preparedness across the globe, especially in densely populated countries like India, increased public investment in health, infrastructure and social sectors may improve a country's ability to cope with the COVID crisis and help it rebound once the crisis is managed. In a country like India, improved infrastructure and better performance of health and education indicators can attract foreign direct investment in the short to medium term. An economic stimulus package should be designed to boost domestic demand as well as towards achieving these targets.

By this time, there is a reasonably widespread consensus among economists that deficits, debt, and austerity should not be of immediate concern. As staunch pro-austerity economists like Rogoff says: "This is like war. There is no debate that they should be doing all they can to try to maintain political and social cohesion, to maintain economies".[7]

3. Economic Stimulus in 2008-2009

As a benchmark, it may be useful to have a short digression on the economic stimulus package of the last time when coinciding with the global financial crisis, and the Indian economy faced a slowdown during 2008-2009.

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[7] https://www.bloombergquint.com/coronavirus-outbreak/harvard-s-financial-crisis-experts-this-time-really-is-different

As far as fiscal stimulus was concerned, there were three fiscal stimulus packages during the second half of 2008-09 that constituted (a) tax cuts; (b) incentivizing investment on infrastructure, and (c) increased expenditure on both investment and consumption with an emphasis on consumption. An additional expenditure of 3.0 percent of GDP was provided through these fiscal stimulus packages during October-December 2008 and February 2009. Of the expenditure measures, revenue expenditure constituted around 84 percent and the remainder accounted for the capital component (RBI, Annual Report, 2008-09). As a result of all these fiscal measures, the fiscal deficit increased from 2.7 percent of GDP in 2007-08 to 6.0 percent of GDP in 2008-09. The expansionary fiscal stance continued in the next year as well. RBI (2010) has succinctly summarized it as:

> "The allocation for crucial sectors such as infrastructure, education and health, rural employment and empowerment of disadvantaged sections of the population was enhanced significantly during the Union Budget 2009-10. Indeed, the Union Budget for 2009-10 went a step further and proposed to address important challenges in the short and medium term, viz., revive the economy to attain a growth of 9.0 percent per annum at the earliest; deepen and broaden the agenda for inclusive development; re-energise the government; and improve delivery mechanism."

When it comes to monetary stimulus, the RBI tried to ease liquidity into the system through conventional measures such as "cutting policy rates [cash reserve ratio (CRR), reverse repo, and statutory liquidity ratio (SLR) and open market operations, and unconventional measures, viz., opening refinance facilities to SIDBI and EXIM Banks and clawing back prudential norms regarding provisioning and risk weights". The total amount of liquidity injected was Rs.5.85 trillion (Table 1).

Table 1: Liquidity Injection/ Availability during September 2008 - September 2009

Measure/Facility	Amount (Rs. crore)	% of GDP (2008-09)
1. CRR Reduction	1,60,000	2.9
2. Unwinding/Buyback/De-sequestering of MSS Securities	1,59,044	2.9
3. Open Market Operations (purchases) *	1,04,128	1.9
4. Term Repo Facility	60,000	1.1
5. Increase in Export Credit Refinance	22,328	0.4
6. Special Refinance Facility for SCBs (Non-RRBs)	38,500	0.7
7. Refinance Facility for SIDBI/NHB/EXIM Bank	16,000	0.3
8. Liquidity Facility for NBFCs through SPV **	25,000	0.4
9. Total (1 to 8)	**5,85,000**	**10.5**
Memo:		
Statutory Liquidity Ratio (SLR) Reduction	40,000	0.7

* Includes Rs.57,487 crore of OMO purchases against the proposed OMO purchases of Rs.80, 000 crore during the first half of 2009-10.
** Includes an option of Rs.5,000 crore.
Source: Report on Currency and Finance, 2008-09, RBI.

Thus, if one adds up both the monetary and fiscal stimuli, then the stimulus size in 2008-09 was around little less than 14 percentof GDP.

4. India's Current Economic Stimulus: Adding Apples with Oranges

The current Indian package has very distinct modules and an aggregate number could suffer from fallacy of composition. What are the distinct components?

The package includes the previously announced Pradhan *Mantri Garib Kalyan Package* (PMGKP) and liquidity infusion by the Reserve Bank of India (RBI), amounting to around 9.95 lakh crore. The remaining amount of the package, worth 11.02 lakh crore was distributed across five tranches, catering to various sectors of the economy. The details of the package are given in Table 2. We have distributed the five tranches of the second part of the fiscal package into three components: a) Monetary stimulus from the Reserve Bank of India;b) Fiscal stimulus; and c) Others, which include guaranteed and non-guaranteed liquidity Schemes. If we were to include the liquidity measures announced by RBI since February2020, the total stimulus amounts to 11.02 percentage of 2019-20 GDP. While it is expected that the 2020-21 GDP will see a further dip owing to restricted economic activities, the fiscal stimulus as a proportion of 2020-21 GDP could turn out to be larger.

However, the announced fiscal package raises anomalies in the claims of the Government of India that it amounts to 10 percent of GDP. Currently, based on Government data, the 10 percent figure has been arrived by summing up direct fiscal measures, liquidity support, guaranteed schemes, and interventions by the Reserve Bank of India. If we were to discount the monetary policy measures, long term policy prescriptions, and guarantee schemes for liquidity, the effective fiscal stimulus would be around 1.8 percent. The doubts on the Government declared proportion of fiscal stimulus has been further fuelled by its decision to revising its 2020-21 borrowing programme by 53.85percentto Rs 12 lakh crore, from Rs 7.8 lakh crore estimated earlier. The rise in borrowings by a meager 4.2percent to meet such a large expenditure would indicate that the Government would either have to compromise on its previously announced budget by re-prioritizing expenditure or that the Government has somehow managed to restrict immediate budgetary outflow. Moreover, many of the direct fiscal measures include extensions of previous budgetary announcements and long-term proposals for structural changes in the economy.

Table 2: Summary of India's fiscal package for Covid-19			
No	**Type of Support**	**Amount (in crore)**	**% of Nominal GDP (of 2019-20)**
I	**Monetary Stimulus: Reserve Bank of India Measures**	**9,57,000**	**4.68**
II	**Fiscal Stimulus**	**5,80,450**	**2.84**
	1. Pradhan Mantri Garib Kalyan Package	1,70,000	0.83
	2. Health Sector Package	15,000	0.07
	3. Revenue loss due to tax concessions	7,800	0.04
	4. Income transfer/support	3,87,650	1.90
	a) Fund of Funds for MSME	50,000	0.24
	b) EPF Support for Business & Workers	2,800	0.01
	c) Reduction in EPF rates	6,750	0.03
	d) Reduction in TDS/TCS rates	50,000	0.24
	e) Free Food grain for Migrant Workers	3,500	0.02
	f) Interest Subvention- MUDRA Loans	1,500	0.01
	g) Credit facility for street vendors	5,000	0.02
	h) Food Micro Enterprises	10,000	0.05
	i) Housing CLSS MIG	70,000	0.34
	j) Pradhan Mantri MatsyaSampada Yojana	20,000	0.10
	k) Agriculture and Animal Husbandry related	1,20,000	0.59
	l) Viability Gap funding	8,100	0.04
	m) Additional MGNREGS allocation	40,000	0.20
III	**Others**	7,15,000	**3.50**
	5. Non-guarantee liquidity schemes	2,30,000	1.13
	a) Emergency WC through NABARD	30,000	0.15
	b) Additional credit through KCC	2,00,000	0.98
	6. Fully / Partially Guaranteed Liquidity Schemes	4,85,000	2.37
	a) Working Capital facility for MSME	3,00,000	1.47
	b) Subordinate debt for MSME	20,000	0.10
	c) Special Liquidity Scheme for NBFCs/HFCs/MFIs	30,000	0.15
	d) Partial credit guarantee for NBFCs	45,000	0.22
	e) Liquidity Injection for DISCOMs	90,000	0.44
IV	**Total**	**22,52,450**	**11.02**

Notes:

(1) Amount of monetary stimulus is since February 2020 till July.

(2) Note that, our aggregate stimulus number (Rs. 22,52,450) differs from Finance Minister's announced stimulus (Rs. 20,97,053**)** solely on account of upward revision of monetary stimulus by Rs. 1,55,397.

(3) As per Advanced Estimate of 2019-20 (Economic Survey 2019-20, Statistical Appendix, Table A14) the nominal GDP of 2019-20 is taken to be Rs 2,04,42,233 crore.

Sources:

(1) Presentations on *AtmaNirbharBhratat* of the Finance Minister (June 13 – 16, 2020).

(2) RBI Governor's Speech on July 11, 2020 (https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1097)

(3) Economic Survey 2019-20, Government of India(GOI, 2020).

It is notable here that figures published by the International Monetary Fund are closer to our estimates. According to the calculations of IMF, the direct spending plus and foregone or deferred revenue part of the stimulus is around 1.9 percent of GDP. There is an additional announcement of Rs 150 billion for health infrastructure, which is approximately 0.1percent of GDP by their calculation. 'Below the line measures', that is measures without an immediate bearing on government's deficit is another 4.9percent of the GDP (Table 3).

Table 3. Fiscal Policy Measures Announced by the Government of India (As calculated by the IMF)	
Measures	**As a % of GDP**
Direct spending and foregone or deferred revenue	1.9
Health infrastructure	0.1
Total	**2.0**
Measures without an immediate direct bearing on the government's deficit position	
Credit support to business	1.9
Credit support to poor household	1.6
Support to electricity distribution cos	0.4
Targeted support for the agricultural sector	0.7
Miscellaneous support measures	0.3
Total	**4.9**
Source: https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#I	

Therefore, it appears that there are some differences in the estimates of the actual size of the fiscal deficit as calculated by different sources. To understand the reasons for the mismatch in the fiscal stimulus numbers, it is important to dissect the various components and sub-componentsof the package.

Some of the proposals especially related to infrastructure development and marketing and promotional exercises in the fiscal package raise questions on the timing of such high gestation period stimulus. By clubbing long term initiatives like *Pradhan Mantri MatsyaSampada Yojana*, Promotion of Herbal Cultivation, Agri-Infrastructure Fund, among few others, the fiscal stimulus package has been made analogous to budgetary announcements. This is where the inter-temporal perspective of fiscal multiplierscomes into the picture, as explained byIlzetzkiet al. (2013) and Batini et al. (2014) wherein a distinction is made between Impact Multiplier and Cumulative Multiplier. While the former measures the ratio of the change in output to a change in government expenditure at the time in which the impulse to government expenditure occurs, the latter measures the cumulative change in output per unit of additional government expenditure, over a considerable horizon. The Government of India has perhaps focussed more on the cumulative multiplier effects when the need of the hour required instantaneous income support. In this context, a survey of the literature on the estimates of India's fiscal multipliers is worth considering (Box 1).

Box 1. Note on Impact and Cumulative Multipliers in India

There have been few studies in the past which have explored the impact and cumulative multiplier on the basis of the composition of Government expenditure. While there is a uniform consensus that capital expenditure has a more pronounced long-run multiplier effect on the economy, the short-run effects are slightly ambiguous based on the type of model used by the authors. The long-run effects, captured by the cumulative multiplier are more for capital expenditure as it involves the creation of assets while revenue expenditures are in the form of subsidies, tax cut, or direct fiscal transfers, and hence having short-run effects. Historically, India's revenue expenditure has dominated the total Government expenditure in India and increased steadily compared to capital expenditure.

One of the earlier studies undertaken by Jain & Kumar (2013) for the period between 1980-81–2011-12, under the aegis of the Reserve Bank of India explains how capital expenditure had prolonged multiplier effects which continued up to four years, while the revenue expenditure multiplier had a very low level of persistence. They used the Structural Vector autoregression model to account for the bi-directional causality of growth and fiscal spending indicator. They further found that expenditure multipliers for state government are more than center as the fiscal policy in states has a limited and more focussed mandate. However, this relative superiority of state government multipliers over central government multipliers is reversed in the Monetary Policy Report of 2019 published by the Reserve Bank of India, as observed in Table 4. The report states that the conventional usage of the Structural Vector Auto-Regressions Model (SVAR) and the Dynamic Stochastic General Equilibrium Models (DSGE) do not explore the historical interactions among the economic variables and do not fit the data well respectively. However, both the studies unambiguously consider the revenue expenditure multiplier of the center and the states to be less than unity.

The above results were supported by Bose &Bhanumurthy (2015), who decompose the expenditure components further into capital expenditure, transfer payments by the government, and other revenue expenditure. Transfers by the government, much like the income support as part of the fiscal package resulted in higher disposable income for households, leading to higher private consumption expenditure. Transfers and other revenue components were found to have similar impact multiplier effects, which was much smaller than capital expenditure. The authors argue that capital expenditure crowds-in private investment, and contribute to higher spending. Even though interest rates rise due to higher public expenditure, but the crowding-out effect of interest rates on private investments is overshadowed by the accelerator effect acting on private investment.

A slightly contrarian view is undertaken among recent studies by Goyal & Sharma (2018). The authors find out that short run impact multiplier is the highest for revenue expenditure while the cumulative multiplier is highest for capital expenditure. These results are consistent even after taking into account monetary policy response and supply shocks. However, the short run effects for revenue expenditure fizzles out after the first quarter. The gap between capital and revenue expenditure impact multipliers reduces in the presence of supply shocks and monetary policy responses. According to the authors, higher short-term revenue expenditure multipliers are observed as they contribute to re-elections and are less affected by other macroeconomic variables. On the other hand, capital expenditure may not be always productive as also pointed out by Devarajan at al. (1996) especially in the presence of distortions in the public sector in developing countries. The excess focus on higher share of capital expenditure could turn to be counter-productive as it would also mean a fall in share of revenue expenditure.

The common thread that binds all these studies is the effect of a financial crisis and the procyclical and counter-cyclical fiscal policy effects around it. However, in the context of a pandemic like Covid19, the short-term multiplier effects could be more in favour of revenue expenditure. Firstly, the pandemic involved close to three month of government enforced lockdown, where production was forced to come to a halt unlike in other cases when cyclical factors lead to output shortage. Thus, crowding out effect would be limited as businesses resume operations after the lockdown gets lifted. Secondly, with many of the migrant labourers moving to their respective homes, there could be short term labour supply shortages leading to delay in effect of capital investment kicking in. In such a scenario, direct income support, in the form of revenue expenditure is expected to yield higher multiplier effects than long term measures.
Moreover, some emerging literature is suggesting that the fiscal multipliers are possibly larger than what the values assumed by the forecasters. This post-Global Financial Crisis literature suggests that traditional methodology of calculating the fiscal multipliers may be underestimating its actual value (Blanchard and Leigh

2013, Restrepo, 2020). Therefore, there may be a need to revisit the estimation of the fiscal multipliers in India.

Author	Revenue Expenditure Multiplier	Capital Expenditure Multiplier	Model used	Period
Jain & Kumar (2013)	0.09(Central Government) 0.60 (State Government) (Only Peak multipliers)	0.85 (Central Government) 7.61 (State Government) (Only Peak multipliers	Structural Vector Auto Regression using annual data	1981–2012
Bose &Bhanumurthy (2015)	0.99	2.45	Tinbergen-Klein-Goldberger structural model	1991-2012
Goyal, A., & Sharma, B. (2018)[8]	0.35	0.24	Structural VAR using quarterly data	1998 Q1-2014 Q3
RBI (2019)	0.45 (Central government) 0.82 (State Government) (Only Peak multipliers)	3.25 (Central government) 2.00 (State Government) (Only Peak multipliers)	Structural Econometric Macromodels (SEM)	1980-81 to 2017-18

Table 4: Summary of short-term (Impact) multipliers across Revenue and Capital Expenditure

Goyal, A., & Sharma, B. (2018). Government Expenditure in India: Composition and Multipliers. How Big are Fiscal Multipliers in Latin America? Journal of Quantitative Economics, 16(1), 47-85.
Bose, S., &Bhanumurthy, N. R. (2015). Fiscal multipliers for India. Margin: The Journal of Applied Economic Research, 9(4), 379-401
Jain, R., & Kumar, P. (2013). Size of government expenditure multipliers in India: A Structural VAR analysis. Reserve Bank of India Working Paper Series, 7
Devarajan, S., Swaroop, V., & Zou, H. F. (1996). The composition of public expenditure and economic growth. Journal of monetary economics, 37(2), 313-344
RBI (2019): Monetary Policy report, April 2019, Reserve Bank of India.
Restrepo, Jorge E (2020). How Big are Fiscal Multipliers in Latin America? IMF Working Paper WP/20/17

As far as the components related to non-income support are concerned, the first point of contention is whether the RBI monetary policy announcements(close to 4.7percent of GDP if calculated from February2020) can be attributed to Government support measures and should be included as part of the fiscal package. There have been studies in the past by Alesina& Summers (1993) and Fischer (1995) which have discussed the importance of Central Bank independence and keeping monetary policy insulated from the political process. Though the Central Bank governor is an appointed Government representative and has limited goal independence, yet it still needs to carry significant amount of instrument independence. Instrument independence implies that the central

[8]The cumulative multipliers calculated for revenue and capital expenditures are 0.62 and 2.35, respectively.

bank should be free of any obligation to finance government budget deficits, directly or indirectly especially when both are governed by their own respective rules and targets.

Secondly, the package seems to have also included several non-guaranteed and guaranteed liquidity measures, which form part of the Reserve Bank of India's prerogative. In this context, the Government focussed heavily on boosting liquidity but its measures were inadequate for treating insolvency, especially when both have affected the economy. But as Hurd et al. (2014) and Gai et al. (2011) have argued that since insolvency shocks are transmitted from debtors to creditors while illiquidity shocks are transmitted in the reverse direction, both require their respective stimulus. By focussing on liquidity driven schemes, it has enabled the banks and other lending institutions to loosen part of its balance sheet but it has ignored the plight of the firms who have been sagging under huge debt burden.

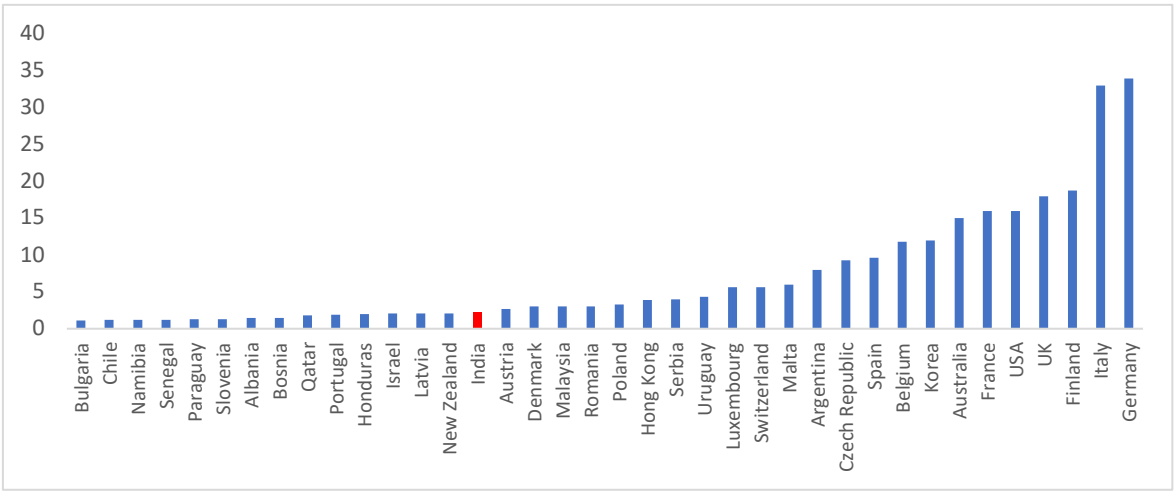
Thirdly, one of the notable features of the first and most expansive tranche worth 5.94 lakh crore was the over-emphasis on sovereign guarantees for micro small and medium enterprises (MSMEs). As seen in Table 2, guarantees occupy close to 78percent of the first tranche of the fiscal package and more than 1/3rd of the Government's apportioned fiscal package. The obvious benefit of such guarantees for the Government is to prevent immediate outflow of funds in the present and defer all liabilities for the future. Currently the Government has limited scope for fiscal maneuverings if the government wants to maintain a fiscal deficit target, which is consistent with the FRBM guidelines. At a time when revenue collections are abysmal, this was the chosen Government solution to infuse liquidity in the economy by nudging the banks and NBFCs to spend.We have argued this in detail elsewhere and suggested that while monetary policy can make credit cheaper, it cannot bring money into the hands of workers. It cannot compensate for a fiscal stimulus, especially when India is close to a liquidity trap. We further argue that for a crisis of this magnitude the fiscal spending has been inadequate (Pal and Ray, 2020).

5. Guarantees, Contingent Liabilities and Fiscal Stimulus

However, India is not the only country to inflate its fiscal package through credit guarantees. India has allocated around 2.2percent of its GDP to credit guarantees. Among a list of 39 countries, whose data on guarantees could be extracted from the IMF Policy response tracker, India stands right at the middle holding the 19th position in terms of the guarantee as a percentage of GDP (Figure 1). The proportion of India's guarantees is more than the average of most Emerging Market Economies (0.4percentof GDP) (Alberola et. al., 2020). Most of the countries having a higher proportion of guarantees are advanced and high-income countries (6.6percentof GDP), clearly stating that

guarantees might not be the most sustainable solution in low income countries. This is because sovereign guarantees can spur the growth of contingent liabilities for the Government. These contingent liabilities are a potential obligation for the government, which depends on a possible future adverse event. In other words, by guaranteeing either partially or fully the small industries and other businesses, the government assumes the risk of the borrowers' inability to pay off the debt in the future and has to take the loan on its own books. They are a cause of huge fiscal risk if they materialize into an actual liability, which could trigger large increases in public debt.[9] One of the additional reasons attributed to the usage of guarantees for India and preserving fiscal deficit could be the risk reflected in the downgrading of India's sovereign rating to Baa3 from Baa2 by Moody's, an International rating agency, with fears of capital flight waiting to be true.

Figure 1: Size of Guarantees announced by countries in response to COVID (as a percentage of GDP)



Sources:

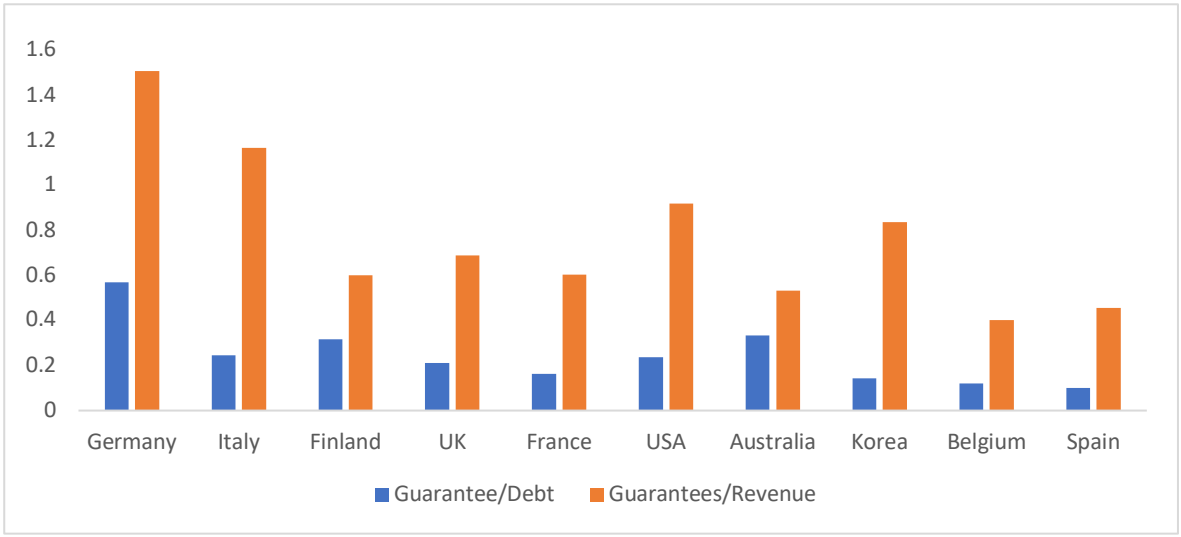
1. IMF Policy Tracker https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19
2. COVID-19 Financial Response Tracker Visualization (CFRTV) https://som.yale.edu/faculty-research-centers/centers-initiatives/program-on-financial-stability/covid-19-tracker

As far as the top ten countries resorting to sovereign guarantees are concerned, it is important to understand their fiscal space in financing them. We use the Tax revenues and Gross Debt of the countries as on 2019 to account for their existing fiscal capacity. We further take the worst-case scenario of all guarantees being defaulted as on date. Then, we compute ratios of Guarantees to Tax Revenues and Guarantees to Debt to understand the current financial health of the countries and the riskiness of the decision. A higher ratio would mean an increased probability of guarantee default and the country having insufficient funds to finance the guarantees as on date. We observe that the share of guarantees in tax revenues for Italy and Germany is well beyond

[9] https://thekootneeti.in/2020/06/09/prudence-of-sovereign-guarantees-in-the-fiscal-package/

100percentand share of guarantees to debt is among the highest(Figure 2). This suggests that both these countries are more buoyant on future tax revenues and they might resort to higher debt to repay the guarantee holders. However, India's Guarantees to Tax Revenue lies in the moderate regime of around 14percent and Guarantees to gross debt being 3percent, calculated at 2019 rates. While this helps to assess the riskiness and prudence of the guarantee measure adopted by the countries during the pandemic crisis, India has been piling on such guarantees from before which would further add to its burgeoning off-budget liabilities.

Figure 2: Percentage of Guarantees as a proportion of fiscal space parameters of 2019 (by top 10 countries)



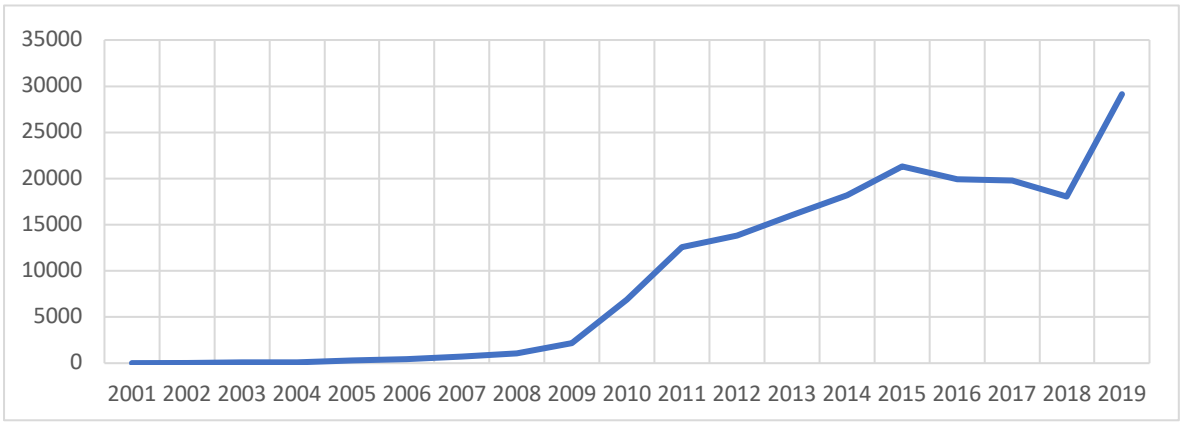
Source: IMF International Financial Statistics

6. India's tryst with MSME guarantees

The volume of Sovereign guarantees undertaken during a financial year is limited under Rule 3(3) of the FRBM Rules, 2004, which stipulates that the Central Government shall not give guarantees aggregating to an amount exceeding 0.5percent of the GDP in any financial year beginning with the financial year 2004-05. Currently, Credit Guarantee Fund Trust for MSE (CGFTMSE) and National Credit Guarantee Trustee Company (NCGTC) devise credit guarantee schemes for MSE loans but both are unregulated entities. CGTMSE is a loan level guarantee scheme while Credit Guarantee Fund for Micro Units (CGFMU) for MUDRA loans, run by NCGTC, is a portfolio level guarantee scheme. This means that pay-outs happen under CGTMSE when individual loans, covered under the scheme, start to default. In contrast, pay-outs happen in CGFMU only when the threshold NPA level of the portfolio is breached. The growing popularity for guarantees in MSME has been gauged by the increasing number of guarantees approved over the years as seen in Figure 3. In the last decade, the union

guarantees approved for MSMEs has generally been on the rise and grown at a compounded annual growth rate of 17percent.

Figure 3: Number of Guarantees approved by CGFTMSE (in crores)



Source: CGFTMSE Annual reports

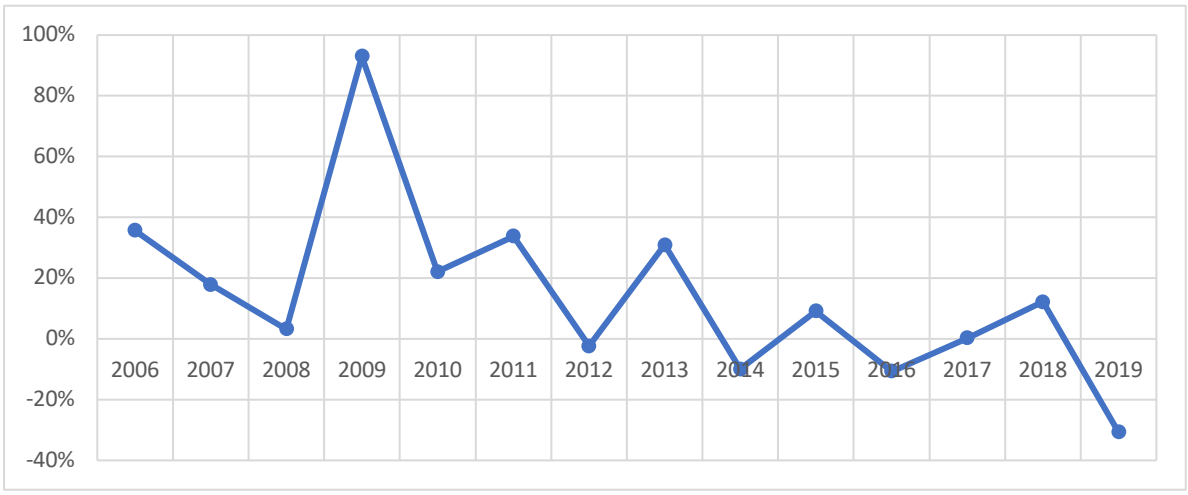
The government's decision to use sovereign guarantees for MSMEs as part of the fiscal package is based on the assumption that the MSMEs would recoup in the next 3-5 years. But the same assumption could boomerang and hit the fiscal coffers hard, if the performance of MSMEs fall short of expectation. In this regard, Cangiano et al. (2006) argue that contingent liabilities in the form of government guarantees are appropriate when the government is best placed to anticipate risk, control risk exposure, and thereby minimize the cost of risk. According to them, guarantees have two sources of uncertainties –whether the Govt has to pay in future and if yes, what is the timing and amount for it. Further, guarantees create a bias of being used as a fiscal stimulus measure as it does not create any immediate impact on the budget. It is therefore important to be transparent about the fiscal risks created by guarantees. Another aspect related to the materialization of contingent liabilities is through the accounting perspectiveof cash or accrual basis as explained by Heald and Hodges (2018). Under accrual accounting, expected costs should be reflected in the fiscal accounts right at the time a guarantee is granted. On the other hand, the prevalent mechanism of cash accounting in India is riskier and less transparent as it implies that guarantees are recorded in the fiscal accounts when a contingency occurs and a cash payment is made at the time of materialization.

7. Bank Guarantees and Future of Banking: Speculating on the shape of things to come

The Government's policy of reluctance to spend and nudge to lend has its own share of risks for the banks as well. A 100percent credit guarantee might distort the credit allocation of banks with

limited amount of incentive to scrutinise loan applications leading to moral hazard (Sengupta and Harsh Vardhan, 2020). Further, owing to the risk averse nature of public sector banks in lending in periods prior to the pandemic and ongoing process of mergers, the credit guarantee mechanism hits a roadblock. However, this has been a common instrument used by the Government to boost liquidity in periods of crisis as seen with the growth of Government secured loans in Figure 4and the peaks in 2008-09 and 2012-13, both representing the periods of Global recession and Eurozone crisis.

Figure 4: Growth of secured loans by the Government in public sector banks



Source: RBI statistical tables related to banks in India, various years.

Acharya & Kulkarni (2019) studied the performance of Indian banks during 2007-09 to study the impact of government guarantees on bank performance. They concluded that Government guarantees allowed more vulnerable state-owned banks to grow their deposit base by increasing their deposit rates. Further, those banks increased loan advances, especially to politically important sectors. These loan advances were later associated with greater non-performance and restructuring of assets. They argued that lack of market discipline on state-owned banks could result in distortions in the banking system, which manifest themselves, particularly during the crisis period.

This concept of adverse selection and moral hazard has been studied in greater details both at the firm level and in the context of Small and Medium Enterprise (SME) loans. As far as the moral hazard phenomenon is concerned, the firms availing secured loans as explained by Cowan et al. (2015) through partial guarantee schemes displayed higher delinquency rate on insured loans. A fall in the repayment rate undermined the borrower's future credit capacity with other banks but did not affect firm performance. The authors argue that firms might prioritize the repayment of non-guaranteed loans at the expense of guaranteed loans and/or they might reduce managerial effort, which increases delinquency. In addition to the moral hazard phenomenon, even adverse selection

problem wasobserved. Firms that were selected into the guarantee programs were found to be more likely to default than firms borrowing without guarantees due to reduction in monitoring and screening in banks caused by the credit risk being borne by the Government. The information asymmetry about the credit history of MSMEs is applicable for both the lenders (banks) and the guarantor (government), especially when the goal is not specifically to help a particular borrower but the sector as a whole (Honohan, (2010). Moreover, the established MSMEs could reap the benefits of the guarantees more than the relatively weaker ones who struggle to obtain collateral for loans.

Further, the moral hazard phenomenon could also spread to non-guaranteed lending as banks overcome risk aversion and are able to cushion themselves from adverse credit quality of borrowers. The direct effect of SME lending in Japanese banks was observed by Wilcox and Yasuda (2019) where they showed banks' government-promoted guaranteed lending further led to more non-guaranteed lending by banks. Thus, their estimates implied that the two loan categories were complements, rather than substitutes. However, the marginal effects reduced quite considerably as the size of the loan guarantee program grew, with the "multipliers" for non-guaranteed loans at individual banks declining and eventually becoming negative.

In India, the Scheduled Commercial Banks account for 90percent of the credit flow to MSMEs while the rest is attributed to the Non-Banking Financial Corporations (NBFCs) as per the UK Sinha Report on MSMEs (RBI, 2019). Public Sector Banks already hold 2/3rd of the guarantee coverage for the MSMEs and the maximum concentration of guarantees lies in the loan slab for the amount below 10 lakhs. At a time when many of the public and private sector banks are exposed to large amount of doubtful and non-performing assets, the fresh guarantees could make the task even more troublesome for the Government if they have to resort to rescuing the beleaguered balance sheets of the banks and MSMEs in the future.

8. Concluding Observations

India has faced several crises in the past, which have affected the fiscal and financial health of the economy. During the 2008 Global Financial Crisis, India primarily felt the aftershocks, but currently, India is gradually moving into being the epicenter of the pandemic crisis. In this unpredictable turn of events caused by the pandemic, it is evident that the Government of India might have ended up with a crisis of solution while grappling with a solution for the crisis.

The hype around the fiscal package announced by the Government has been primarily caused by the constant claims of being one of the largest fiscal packages in the world, but the devil lies in the details.The inter-mingling of short-term measures, long-term plans, credit guarantees, and the

monetary policy as a part of the fiscal package appears to beless than convincing. The implicit attempt of the Government to postpone some of its liabilities is slightly worrisome, especially after taking into accountuncertain global business parameters and simmering border tensions within the country. As far as aiding the MSME sector through guarantees is concerned, information asymmetry about the individual credit history of MSMEs for both the lenders (banks) and the guarantor (government) will continue to raise concerns on future fiscal costs.Moreover, after having shared the onus of the fiscal stimulus with commercial banks, what remains to be seen is how the Government's measures affect the credit-rationing and risk-averse nature of the banks. There is also an apprehension that the credit culture of the borrowers might also get affected by these measures.

Unfortunately, what remains unclear iswhether the pandemic crisis has seen the end of its beginning or if it is heralding the beginning of the end of certain sectors in India. In either case, the solace remains that having skipped the measure of aggressive fiscal spending in the present times, the Government's move of higher capital expenditure crowds in more private investment.On the other hand, the hope from the Government remains that the announced fiscal stimulus package is not a finished product but a work in progress.

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