Getting out of the ‘guns, germs and steel’ crisis

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Context

# India faces a “guns, germs and steel” crisis. There are Chinese “guns” on the borders. There are coronavirus “germs” in our bodies. There are “steel” makers and other businesses on the verge of bankruptcy.

# Arguably, this is the gravest confluence of military, health and economic crises threatening our nation in more than a generation.

# The Chinese military threat calls for immediate and strategic action by our defence and foreign affairs establishments. The COVID-19 health epidemic is here to stay and needs constant monitoring by the Health Ministry and local administration. The economic collapse is an enormous challenge that needs to be overcome with prudent policy.

Standoff and Kargil parallel

# The common thread across these is that its resolution requires significant financial resources. Standing up to a military threat by a superpower neighbour will pose an inevitable drain on the finances of the government.

# India’s war against Pakistan in Kargil in May 1999 provides hints of the financial burden of a military threat.

# India’s defence expenditure in the war year shot up by nearly 20% from the previous year. It also forced the then government to increase India’s defence budget for the next financial year to 2.7% of nominal GDP, the highest in decades.

# China is a far mightier power than Pakistan. In this face-off, 20 Indian soldiers have been brutally killed and many more injured by the Chinese Army.

# A portion of India’s land in Ladakh has been grabbed by China.

# Surely, India is bound to assert its rights, which will necessitate higher expenditure.

# India’s defence budget has been whittled down to just 2% of GDP for the financial year 2021.

# China’s defence budget is nearly four times larger. In all likelihood, the Chinese conflict will stretch central government finances by an additional one to two percentage points of GDP, as India staves off the current threat and shores up its defence preparedness.

Health care and economy

# The health pandemic has exposed India’s woefully inadequate health infrastructure. The combined public health expenditure of States and the central government in India is a
# The COVID-19 epidemic is expected to linger on for another two years until a suitable vaccine is available at large.

# Many public health experts are of the opinion that the central government will need additional funds of the equivalent of at least one percentage point of GDP to continue the fight against COVID-19. (i.e. 2.3% of GDP)

# It is no secret that the extreme national lockdown has thrown India’s economy into utter disarray.

# India’s economy has four major drivers — people’s spending on consumption, government spending, investment and external trade.

# Spending by people is the largest contributor to India’s economic growth every year.

# For every ₹100 in incremental GDP, ₹60 to ₹70 comes from people’s consumption spending. (60-70% is our consumption expenditure)

# The lockdown shut off people from spending for two full months, which will contract India’s economy for the first time in nearly five decades, regardless of a strong agriculture performance.

# Even prior to COVID-19 when the global economy was robust, India’s trade levels had fallen from 55% of nominal GDP in 2014 to 40% in 2020.

# Now, with the global economy in tatters, trade is not a viable alternative to offset the loss from consumption. Investment is also not a viable option at this stage since the demand for goods and services has fallen dramatically.

**Incremental funds needed**

# The only options then are to either put money in the hands of the needy to stimulate immediate consumption or for the government to embark on a massive spending spree, akin to the “New Deal” which was a series of programmes and projects instituted by U.S. President Franklin D. Roosevelt during the Great Depression of the 1930s.

# Based on estimates of loss of consumption, incomes and its multiplier impact, my estimate is that the government will need to inject incremental funds of five percentage points of GDP to absorb the economic shock and kick start the spending cycle again.

# The government had expected a nominal GDP growth of 10% this year. It is clear now that GDP will not grow but shrink.

# There is much hullabaloo about a ‘V’ shaped economic recovery, which is a mere illusion.

# A 5% fall now and a 10% growth next year will be hailed as a sharp ‘V’ shaped recovery by
economists and the International Monetary Fund. But as your local grocery store-keeper will elucidate, it only means that his total sales is a tad higher than two years ago.

# Central government revenues for this year were budgeted at 10% of GDP which will not be achieved. Revenues will likely fall short by two percentage points of GDP.

# In sum, the government needs to spend an additional eight percentage points of GDP while revenues will be lower by two percentage points of GDP, a combined gap of 10% of GDP.

# Potential new sources of revenue such as a wealth tax or a large capital gains tax are ideas worth exploring for the medium term but will not be of much immediate help.

**The ‘junk rating’ risk**

# The only option for the government to finance its needs is to borrow copiously, which will obviously push up debt to ominous levels.

# When government debt rises dramatically, there will be a fourth dimension to the “guns, germs and steel crisis”; a “junk” crisis.

# With rising debt levels, international ratings agencies will likely downgrade India’s investment rating to “junk”, which will then trigger panic among foreign investors.

# Some economists argue that there is a magical third choice – to simply print how much ever money the government needs to overcome these crises.

# Economic theory states that if money is printed at will, it can lead to a massive spike in prices and inflation.

# This theory has fallen flat in the past decade in developed nations such as America where the creation of phantom money has not led to inflation.

# Hence, the Reserve Bank of India can just create money at will and transfer them to government coffers electronically, is the argument.

# There are multiple problems with this argument but the most important one is that regardless of whether money is printed or borrowed from others, it will still be counted as government debt and not escape a potential downgrade to a “junk” rating.

# The U.S dollar, by virtue of being the world’s reserve currency, has an in-built protection against a currency crisis that can be triggered by at-will printing of money, that other developing nations such as India do not possess.

# If there were indeed no costs to printing money whenever governments need, then why tax citizens at all? Countries could just print money for all their expenses every year. The magical third choice is not a magic wand that can give the Indian government the money it needs and, also prevent a ratings downgrade.