

THE THEME OF THE REPORT

Observed patterns of pandemics in history as well as insights from epidemiology tell us that pandemics are likely to wither in intensity, with sporadic breakouts of limited impact until they become endemic. The COVID-19 pandemic will go down in history as one of the worst health crises the world has ever faced. Its economic impact may linger for many more years and confront us challenges of rebuilding livelihoods, safeguarding businesses and reviving the economy.

India suffered among the biggest pandemic-induced losses in the world in terms of output, lives and livelihoods, which may take years to recover. Economic activity has barely recovered to pre-COVID levels even after two years. India's economic rebound also faces difficult challenges from the legacy of deep-rooted structural bottlenecks as well as the scars of the pandemic. The Russia-Ukraine conflict has also dampened the momentum of recovery, with its impact transmitting through record high commodity prices, weaker global growth outlook and tighter global financial conditions. Concerns surrounding deglobalisation impacting future trade, capital flows and supply chains have amplified uncertainties for the business environment. Against this backdrop, India's medium-term growth outlook hinges critically on policy measures to address structural bottlenecks and harness emerging new growth opportunities. This year's Report on Currency and Finance accordingly has "Revive and Reconstruct" as its theme.

The Report begins by taking a deep dive into COVID-induced downturn in the economy against the backdrop of the loss of pace in activity, evident

since H2 of 2016-17 and its structural and cyclical drivers. A key pivot has been the unprecedented public policy support, including progress on vaccination. The thrust of public policy action is now progressively shifting to revitalising growth – even as the fiscal policy stance aims at regenerating the capex cycle, monetary policy remains accommodative while focusing on the withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth.

Lessons from past crises reveal the reality of a permanent loss of output, reflected in deep wounds to investment and shortfalls in capital and total factor productivity (TFP) relative to respective pre-crisis trends.^a Potential hysteresis effects of the pandemic operating through bankruptcies and capacity destruction are not fully quantified so far and may manifest themselves through balance sheet impairments and depressed new investment demand.

Corporate balance sheets have coped with the pandemic by deleveraging and increasing liquid assets, but investment appetite that should motor a renewed capex cycle is still weak. Frail household balance sheets and labour displaced from contact-intensive activity have impacted consumption demand and quality of capital. As a result, the trend growth path of India may have shifted downwards, warranting urgency in putting in place a comprehensive range of measures for reinvigorating growth, while negotiating net-zero transition costs, deglobalisation and broken supply chains.

^a Cerra, M.V. and Saxena, M.S.C. (2017), "Booms, Crises, and Recoveries: A New Paradigm of the Business Cycle and its Policy Implications", *IMF Working Paper*, No. 17/250, International Monetary Fund.
IMF (2018), "Challenges to Steady Growth", *World Economic Outlook*, International Monetary Fund, October.

The rest of the Report is structured into six chapters. Chapter I titled “Scars of the Pandemic” draws lessons from the experience with the pandemic. It covers an assessment of the impact of COVID on growth in India, differentiating sectors that exhibited resilience. It explores risks to recovery and presents an assessment of the number of years that India may take to catch up with a hypothetical no-COVID trend GDP.

Chapter II presents the role of counter-pandemic monetary and fiscal policies in engineering the economic recovery. It also examines the current monetary and fiscal configuration in India from a forward-looking perspective, consistent with the theme of the Report. This chapter also studies the role of fiscal stimulus in a crisis and the importance of fiscal consolidation in normal times for growth. Given the risks to growth from inflation persisting above a threshold level, an empirical exploration seeks to identify threshold effects of liquidity on inflation as well as thresholds for public debt. The chapter presents feasible alternative paths for key parameters of debt sustainability – growth, inflation, interest rate and primary balance – to identify the likely debt consolidation path in India over the next five years, relative to the estimated threshold level of debt.

Chapter III titled “Structural Issues in Rejuvenating Growth” explores the role of structural policies in regaining India’s pre-pandemic trend growth and lifting it up after the pandemic. It investigates structural impediments to growth that are, in a sense, a pre-pandemic legacy – imbalances in the agriculture sector in the form of low capital formation, declining R&D expenditure, low crop yields, lack of crop diversity and intensity, and excessive dependence on subsidies and price support schemes; inadequate investments in mining despite abundant natural resources; near

stagnation of the share of manufacturing in gross value added (GVA); languishing productivity; insufficient expenditure on education, health and R&D; and high costs of doing business. Those risks are accentuated by demographic transition, with the fertility rate dropping below the replacement rate, and a drop in labour force participation. The chapter highlights the urgent need to reverse the sustained decline in private investment through a comprehensive range of strategic reforms, covering both factor and product markets.

Chapter IV highlights the role of exports and foreign capital in pushing up India’s potential output through a strategic policy reset that transforms India into a more open economy. It also highlights greater emphasis on innovations and R&D, easier access to critical inputs – both domestic and imported – and more effective trade-creating free trade agreements (FTAs) based on trade complementarities. It examines opportunities for adoption of frontier technologies for raising export potential and also underscores the need for enhancing the capacity of the economy to absorb foreign capital productively.

Chapter V addresses the modest penetration of finance in the Indian economy. This has brought to the fore the role of financial sector reforms in reactivating credit flows to the economy while managing the transition to a green economy and a digital world. In essence, the chapter asks the question: can finance lead growth in a post-pandemic recovery? In particular, the chapter assesses the role and importance of digital and green finance in reinvigorating growth.

The last chapter presents a roadmap to rejuvenate growth, with specific recommendations for reforms in different sectors of the economy, drawing on the essence of findings of the previous five chapters.