Ecowrap

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'Be the Bank of Choice for a Transforming India'

Issue No. 22, FY21

Date: 23 JUNE 2020

DECLINE IN PER CAPITA INCOME TO BE MORE SEVERE POST COVID: INDIA TO WITNESS A CLOSING GAP BETWEEN RICH AND POOR STATES IN TERMS OF PER CAPITA INCOME LOSS

The current crisis is testing the policymakers' acumen to its limits as we have not seen anything like this before. Past crises were financial in nature and were precipitated by a change in investor sentiments and the epicentre was identifiable, which suffered the maximum. But support from other regions propelled the world economy forward. However, this crisis is such that GDP growth of every country is in contraction mode at least for 2020/FY21.

For India we project a GDP decline of 6.8% for FY21. We believe that **India will clearly have a "statistical V-shaped recovery / Swoosh " in FY22 primarily due to the favourable base effect**. **Beyond such base effect, it would however take at least till FY24, if India replicates the best case example in history, if not more before India gets back to pre pandemic level growth rate**! It will be an arduous journey, but we can change our destiny if we are clear in our mind of what we need to do! **Historical experiences shows that it takes on an average 4 years for a country to get back to pre crisis growth rates, once it gets out of any crisis, and the best example in history is only around 2 years!**

However, in all the analysis so far, what we have missed out is the impact on per capita income of countries. Countries' income in per capita terms, coming back to the old levels takes even longer than the GDP coming back to the old levels, after a crisis. **Thus, with every crisis inequality increases at least for some years.** Globally also inequality will increase as the decline in per capita GDP of 6.2% in 2020 is greater then the 5.2% decline in global GDP. Subsequently, inequality will see further increase with countries like Italy, Greece and Cyprus still not attaining the pre crisis per capita GDP levels even till 2018.

In Indian perspective, we estimate that at all India level, the per capita income (PCI) will decline by 5.4% in FY21 to Rs 1.43 lakh. This decline in PCI is higher than the nominal GDP decline of 3.8%. State-wise, the results are quite startling and interesting. Our estimates suggest that rich states (states whose per capita income is greater that all India average) will be most affected in per capita income terms. In Delhi (-15.4%) and Chandigarh (-13.9%), the decline in PCI is almost thrice than the decline at all India level (-5.4%). States like Maharashtra, Gujarat, Telangana, and Tamil Nadu are expected to witness a decline of 10-12% in PCI in FY21! **A total of 8 states and Union Territories are expected to witness a decline in PCI in double digits in FY21 and that is most alarming**. These states and UTs constitute as much as 47% of India's GDP! However, in the relatively less well off states like Madhya Pradesh, UP, Bihar, Odisha, etc. (where per capita income is below the national average) the decline in PCI is less than 8%. Thus quite intriguingly, we expect that inequality gap in India will narrow down post-COVID pandemic as decline in income of rich states will be much greater than the decline in income of poor states.

We must however caution policymakers (India included!) against being excessively fiscally conservative. **For example, even IMF has acknowledged that tighter fiscal policy during the Asian crisis led to exacerbating the output declines and GDP recovery could have been faster had fiscal policy not been so tight.** Similarly, the contractionary fiscal policies adopted by many nations, viz. Greece, Ireland, Italy, Portugal and Spain after the 2008 crisis again prolonged recovery, with few countries not attaining the pre crisis per capita GDP levels even till 2018. **To that extent, India's fiscal policy response will have to be much more aggressive and India should not repeat what other countries during Asian financial crisis and Euro Zone crisis! Sovereign rating in FY22 of India will be determined by what is our policy response now and not by our fiscal response!**

In the words of the new World Bank economist, Carmen Reinhart supposed to be fiscally conservative -"You're talking to a very fiscally conservative person," said Ms. Reinhart recently in response to a question on the wisdom of borrowing so much in response to the pandemic. ***"But this is a war. In a war, you worry about winning the war, and then you worry about paying for it."***

WHAT WILL BE THE SHAPE OF RECOVERY?

- COVID-19 pandemic has sent GDP growth of every country in contraction mode at least for 2020/FY21. The most pertinent question after this is that: what will be the shape of recovery? To gauge the shape of recovery post GDP contraction, we did a detailed analysis for countries beginning from Latin American debt crisis (from 1980 onwards). We found that most of the countries experienced V and a Swoosh (longer than V but faster than U) shaped recovery, after seeing a contraction in their GDP. Only Greece and Venezuela experienced L shaped recovery in which there was a permanent effect on GDP and GDP didn't come back to the pre-contraction level. (*see Annexure for Country-wise Graphs*)
- In the current circumstances, the economic activities of the countries have plummeted in the wake of the COVID-19 pandemic and unemployment has soared—largely the result of social distancing policies designed to slow the spread of the virus. The depth and speed of the decline is much more than the Great Depression. It is widely believed that the most optimistic scenario is a Z shaped recovery where economy bounces back up above the level it would have been in a pre-pandemic baseline though a good part of the GDP foregone during lockdown was simply delayed. Another optimistic scenario is V shaped recovery where economy permanently loses the production that would have occurred absent the pandemic, but very quickly returns to its pre-pandemic baseline once social distancing is lifted.

The case for India

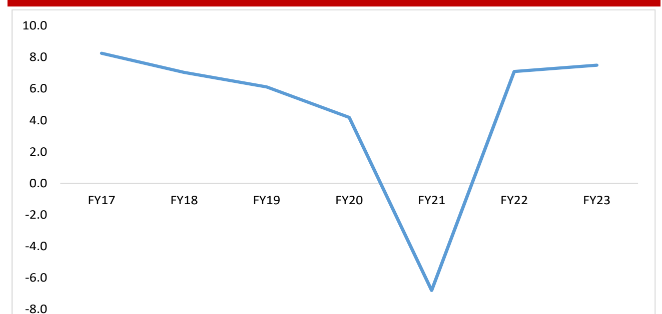
- In the case of India we project a GDP decline of 6.8% for FY21. We believe that **India will clearly have a "statistical V-shaped recovery / Swoosh " in FY22 primarily due to the favourable base effect**.
- Beyond such base effect, it would however take at least till FY24, if India replicates the best case example in history, if not more before India gets back to pre pandemic level growth rate!

Shape of Recovery

Country	Years with GDP Contraction	Shape of Recovery	Country	Years with GDP Contraction	Shape of Recovery
Venezuela	1980, 1981,1983	Z	Argentina	1999 to 2002	V
Brazil	1981, 1983	W	Germany	2002 to 2003	U
Mexico	1982, 1983	Swoosh	US	2008, 2009	V
Chile	1982, 1983	V	Denmark	2008, 2009	V
Philippines	1984, 1985	U	Italy	2008, 2009	V
Argentina	1988 to 1990	V	Japan	2008, 2009, 2011	Z
Brazil	1990 and 1992	W	UK	2008, 2009	V
South Africa	1990 to 1992	Swoosh	Greece	2008 to 2013	L
Hungary	1990 to 1993	V	Venezuela	2009, 2010	L
Sweden	1991 to 1993	U	Spain	2011 to 2013	U
Finland	1991 to 1993	Swoosh	Portugal	2011 to 2013	Swoosh
Thailand	1997 to 1998	V	Cyprus	2012 to 2014	V
Japan	1998 to 1999	U	Italy	2012 to 2014	Swoosh
Singapore	1998, 2001	W	Finland	2012 to 2014	V
Turkey	1999, 2001	W	Iran	2012, 2013, 2015	W

Source: IMF; SBI Research

India's Statistical Shape of Recovery (%)



Source: SBI Research

- It will be an arduous journey, but we can change our destiny if we are clear in our mind of what we need to do! Historical experiences shows that it takes on an average 4 years for a country to get back to pre crisis growth rates, once it gets out of any crisis, and the quickest is only around 2 years!

IMPACT ON PER CAPITA INCOME

- However, in all the analysis so far, what we have missed out is the impact on per capita income of countries. When we look at the countries' income in per capita terms, it shows that per capita income coming back to the old levels takes even longer than the GDP coming back to the old levels. **Thus, with every crisis inequality increases at least for some years.**
- Advanced economies in the Euro Area were already recovering from the Sub-prime crisis and Sovereign debt crisis and had just barely recovered and thus did not have the cushion to handle a shock like this. Thus it is possible that inequality will see further increase as the 2008 crisis and the ensuing sovereign debt crisis have done lasting damage with countries like Italy, Greece and Cyprus not attaining the pre crisis per capita GDP levels even till 2018.

The case for India

- In Indian perspective, following our **bottom up approach** as was done in our Ecowrap *"Q4FY20 GDP at 1.2%:FY20 AT 4.2%, FY21 at –6.8%: Important to look into quarterwise GDP Trends in FY21 than headline GDP: Last Week of June Might see the COVID Peak", dt. 26 May, 2020,* we estimated the possible decline in per capita income (per capita GDP on current prices) for all the states for FY21. Our results indicate that at all India level, the per capita income (PCI) will decline by 5.4% in FY21 to Rs 1.43 lakh. This decline in PCI is higher than the nominal GDP decline of 3.8%. Globally also, the decline in per capita GDP of 6.2% in 2020 is significantly greater then the 5.2% decline in global GDP.
- State-wise, the results are quite startling and interesting. Our estimates suggest that rich states (states whose per capita income is greater that all India average) will be most affected in per capita income terms. In Delhi (-15.4%) and Chandigarh (-13.9%), the decline in PCI is almost thrice than the decline at all India level (-5.4%). A total of 8 states and Union Territories are supposed to witness a decline in PCI in double digits in FY21 and that is most alarming. These states constitute as much as 47% of India's GDP! This is due to the fact that these are the urban areas (and red zones also) where lockdown was implemented most severely. The closure of markets, shopping complexes and malls adversely affected income of these areas. Even after opening of markets (in staggered manner), the number of customers is still 70-80% less than the normal times.
- States like Maharashtra, Gujarat, Telangana, and Tamil Nadu are expected to witness a decline of 10-12% in PCI in FY21. However, in the relatively less well off states like Madhya Pradesh, UP, Bihar, Odisha, etc. (where per capita income is below the national average) the decline in PCI is less than 8%. The possible reasons are larger number of green zones, prominence of agricultural activity and already low levels of income.
- Thus quite intriguingly, we expect that inequality gap in India will narrow down post -COVID pandemic as decline in income of rich states will be much greater than the decline in income of poor states. A similar type of experience of decline in inequality was witnessed in Germany after the collapse of Berlin war (1989). Post-collapse the per capita GDP of West Germany (which was already higher than the East Germany) had decelerated while per capita GDP of East Germany increased resulting in decline in inequality.

Growth of GDP and per capita GDP in global recessions (%)

		Global recession years				
		1975	1982	1991	2009	2020
World	GDP	1.1	0.4	1.3	-1.8	**-5.2**
	Per capita GDP	-0.8	-1.3	-0.3	-2.9	**-6.2**
Advanced economies	GDP	0.2	0.3	1.3	-3.4	**-7.0**
	Per capita GDP	-0.7	-0.3	0.6	-4.0	**-7.3**
EMDEs	GDP	4.2	0.9	1.5	1.8	**-2.5**
	Per capita GDP	2.0	-1.2	-0.4	0.4	**-3.6**
LICs	GDP	0.0	1.0	-0.7	5.9	**1.0**
	Per capita GDP	-2.4	-1.6	-3.6	3.0	**-1.6**

Source: World Bank; SBI Research

Per Capita GDP Growth and GDP Growth During Crises

Crisis	Country/Area	Number of Years for Per Capita Income to go back to previous level	Number of Years for GDP to go back to previous level
Sub-prime and Sovereign Debt Crisis	Euro Area	8	7
	European Union	7	6
	France	8	3
	Portugal	9	9
	Cyprus	Has not attained the level yet	9
	Spain	10	9
	Greece	Has not attained the level yet	Has not attained the level yet
	United States	6	4
	United Kingdom	8	5
Asian Financial Crisis	Thailand	6	5
	Indonesia	7	5
	Malaysia	3	3
	Phillipines	3	2
	Korea	2	2
	Singapore	3	2
1991 Nordic Countries Banking Crisis	Finland	7	6
	Sweden	5	4
Argentina 2002 crisis	Argentina	8	7
Latin American Debt Crisis	Argentina	14	12
	Brazil	6	5
	Mexico*	16	4

Source: SBI Research, *Mexico went through another crisis in 1994 while per capita GDP was recovering

COVID-19 Impact on Per Capita GDP of States (at Current Prices)

States	Per Capita GDP (Rs in Lakh)*		
	FY20	FY21	Change in %
Delhi	4.48	3.79	-15.4
Chandigarh	3.91	3.37	-13.9
Gujarat	2.42	2.14	-11.6
Tamil Nadu	2.39	2.12	-11.4
Telangana	2.54	2.25	-11.1
West Bengal	1.40	1.24	-11.1
A & N Islands	1.99	1.78	-10.6
Maharashtra	2.06	1.85	-10.3
Haryana	2.92	2.63	-9.8
Jammu & Kashmir	1.12	1.01	-9.6
Rajasthan	1.33	1.21	-9.2
Bihar	0.55	0.50	-8.7
Punjab	1.82	1.67	-8.4
Kerala	2.44	2.25	-8.2
Andhra Pradesh	1.72	1.58	-8.1
Karnataka	2.60	2.40	-7.8
Uttar Pradesh	0.81	0.75	-7.5
Madhya Pradesh	1.09	1.01	-7.1
Uttarakhand	2.36	2.22	-5.7
Jharkhand	0.91	0.86	-5.4
Puducherry	2.59	2.46	-4.8
Himachal Pradesh	2.06	1.98	-3.7
Odisha	1.15	1.11	-3.7
Tripura	1.40	1.35	-3.6
Meghalaya	1.07	1.03	-3.3
Sikkim	4.42	4.32	-2.4
Mizoram	2.10	2.05	-2.4
Assam	0.99	0.97	-2.3
Chhattisgarh	1.12	1.10	-2.1
Nagaland	1.40	1.38	-1.5
Manipur	0.82	0.82	-0.6
Goa	5.29	5.31	0.3
Arunachal Pradesh	1.62	1.62	0.3
India	**1.52**	**1.43**	**-5.4**
Memo: India's Nominal GDP in Rs Lakh Crore			
Nominal GDP	202.3	194.6	**-3.8**

Source: SBI Research; * SBI Projections; Assuming Population growth of 1.1% p.a.

MONETARY AND FISCAL RESPONSES TO VARIOUS CRISES

- Regarding the time taken by the countries to reach the pre-COVID growth levels, the country-wise past recession experience suggests that the recovery in economic activity and the capital formation tends to be slow and it typically takes roughly 5 to 10 years (lost decade) for real economic activity to reach its former peak level.
- Every crisis has seen a combination of fiscal, monetary and exchange rate responses to get back growth. Bailout by IMF and international agencies with certain conditionalities for structural reforms have also been part of handling the crises.
- The Latin American debt crisis of 1980s was caused by the external debt accumulation (mainly from US Banks) by Latin American countries which became unstainable. Things came to a head when IMF had to provide a bridge loan to Mexico for repayments. As the crisis spread beyond Mexico, commercial banks agreed to restructure the countries' debt, and the IMF and other official agencies lent them sufficient funds to pay the interest, but not principal, on their loans. In return, the countries agreed to undertake structural reforms of their economies and to eliminate budget deficits. As a result of the management of the crisis, the 1980s were years of strong contractionary macroeconomic policies. However, despite the loans provided and reduction in government expenditure the crisis just protracted for years and finally in March 1989, the United States Treasury Department formulated the Brady Plan which focused on debt and debt service reduction by commercial bank creditors for those debtors who agreed to implement substantial economic reform programs. The Plan offered banks credit enhancements in exchange for their agreement to reduce claims. These credit enhancements were created by first converting commercial bank loans into bonds, and then collateralizing principal and rolling interest payments on those bonds with US Treasury zeroes purchased with the proceeds of IMF and World Bank loans. It was only after this that the growth returned consistently for these countries.
- In case of Asian Financial crisis, which was due to loss of investor confidence and reversal of capital flows, initially, interest rates were kept largely stable, fiscal policy was largely neutral (or expansionary, in the case of Thailand). The main initial response in Thailand and Korea to capital outflows in 1997 was to intervene heavily in the foreign exchange markets in the defence of the currency. However, it did not help. With the exception of Malaysia, all the crisis countries went with a policy of floating the exchange rate and maintaining and even increasing capital account liberalization. IMF provided support, however, the general approach followed was not to fully finance external liquidity gaps but, following the diagnosis that fundamental weaknesses had set the stage for these crises, to provide external finance a cushion while demanding reforms, to solve the underlying problems. **Fiscal tightening was emphasized. However, it has been stated by IMF itself that this could have led to exacerbating the output declines and GDP recovery could have been faster had fiscal policy not been so tight.**
- The 2008 crisis saw active monetary policy intervention, with Fed slashing rates. As the crisis spiralled globally, Central Banks in England, China, Canada, Sweden, Switzerland and the European Central Bank (ECB) also resorted to rate cuts to aid the world economy.

Anatomy of Recession

Countries	Decline in GDP (%)	Number of years for GDP to reach prior peak
Chile (1978-95)	14	5
Peru (1986-95)	30	9
Brazil (1987-95)	7	1.4
Mexico (1991-05)	-	2
Bulgaria (1995-03)	-	8
Thailand (1993-04)	14	5
Indonesia (1994-12)	14	5
Korea (1994-01)	9	1.7
Malaysia (1991-01)	9	2
Philippines (1994-08)	3	-
Colombia (1995-08)	7	4
Turkey (1997-03)	10	2
Argentina (1998-12)	15	5
Russia (2005-11)	8	-
Average	**12**	**4**

Source: SBI Research

- The U.S. Government then came out with National Economic Stabilization Act of 2008, which created a corpus of $700 billion to purchase distressed assets, especially mortgage-backed securities. USA also adopted expansionary fiscal policy with about $800 billion in tax cuts and federal spending to stimulate the economy over two to three years. Other countries also provided fiscal stimulus. However, the biggest policy response was that of continued Quantitative Easing with FOMC purchasing securities to keep liquidity in the markets.
- After the 2008 crisis the liquidity squeeze precipitated the Euro Area Sovereign Debt crisis, the epicentre being Greece. With rates already approaching zero, Euro Area also undertook the unconventional monetary policy measure of asset purchases. Funds were also provided by IMF to avoid default. However, the contractionary fiscal policies adopted by many nations, viz. Greece, Ireland, Italy, Portugal and Spain was unavoidable as part of the bailout packages and to avoid further debt accumulation, again prolonged recovery. Although unconventional monetary policy was adopted, growth has been slow to return to the region.
- The present crisis is not something that came from the financial markets and from withdrawal of investor confidence and there is no epicentre, although the loss of lives is more in the advanced economies. However, the scale is unprecedented and concerted efforts from all central banks plus support from Governments with adequate fiscal stimulus will be the key as to what shape the recovery will take. **To that extent, India's fiscal policy response will have to be much more aggressive and India should not repeat the mistake of what other countries during Asian financial crisis and Euro Zone crisis!**

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Contact Details:
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point
Mumbai - 400021
Email: soumya.ghosh@sbi.co.in
gcea.erd@sbi.co.in
Phone:022-22742440
:@kantisoumya

Annexure: Country-wise GDP Contraction and Shape of Recovery (1)

Source: IMF; SBI Research

Annexure: Country-wise GDP Contraction and Shape of Recovery (2)

Source: IMF; SBI Research