IASCC
Ideas sans Ideology

The Indian Economy: Making a Case for the Government to Play its Economic Role

Help Individuals, Families and Small Businesses deal with Economic Uncertainty

Anil K Sood,
Professor & Co-founder

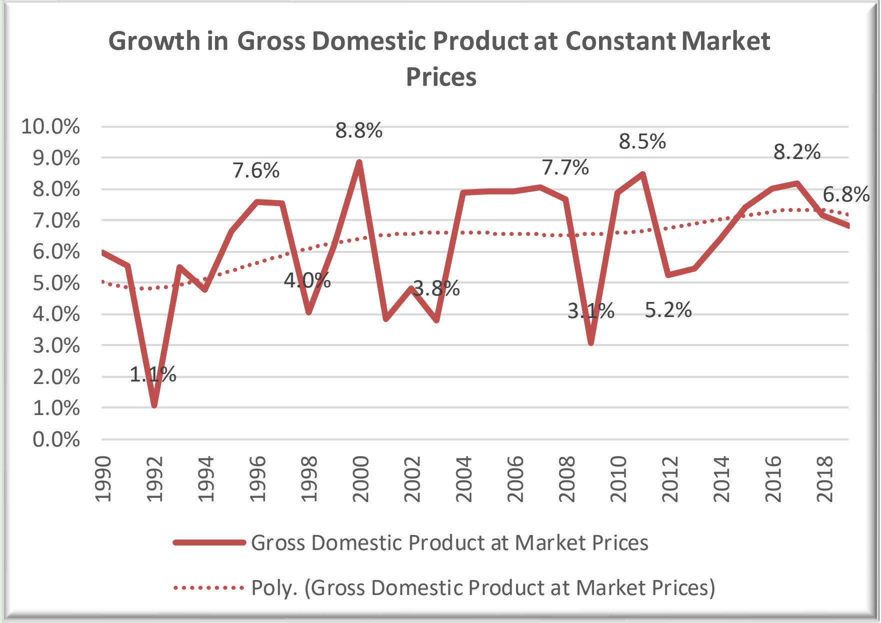
What are we trying to study?

- During the earlier years of post-reform period (Fiscal year ending March 1995 to March 2000), India experienced on annual average growth of 6.8%, which increased to 7.9% between 2003-04 to 2007-08, but not without sharp declines during years ending March 2001 and March 2003.
- It has been on a bit of roller coaster ride since the year ending March 2009, though the growth rate did reach 8%+ during 2015-16 & 2016-17. (Slide 3)
- The growth rate has been declining since the last peak, with the quarterly (QOQ) growth falling to 4.4% during the quarter ending Dec 2019. (Slide 7)

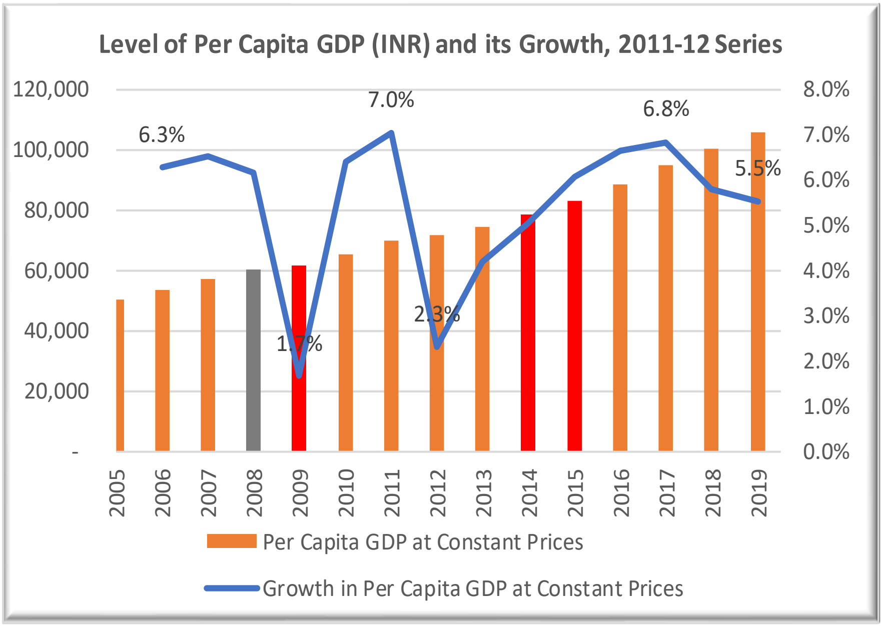
We have assessed the current state of India's economy answering the following questions:

1. What have been the key contributors (consumption, investment and next exports) to India's growth? Slide 5
2. Is India still an agriculture dependent rural economy? Slide 4
3. Why has India's investment-led, credit-driven growth not sustained? Slide 6
4. What does the consumer and business confidence suggest about future growth? Slides 8 & 9
5. Does India have adequate private risk-capital (equity and long-term debt) to deal with current and expected economic uncertainty & resolve the current NPA (Non-performing Assets) in the financial system? Slides 10-12
6. Can India access international capital, if it does not have the required domestic risk-capital? Slides 13-15?
7. If there are limits on availability of domestic and international risk-capital, can the Indian government invest to provide the required risk-capital? Slides 16-18
8. Is the government raising the required resources for fulfilling its economic role of providing the required risk-capital? Is it following the most appropriate resource mobilization strategy, given India's stage of development? Slide 19
9. How far does the government spend and fiscal deficit impact inflation? Slides 20-21
10. What is the expected impact of Novel Corona Virus (NCV) on the Indian economy? Slides 23-24

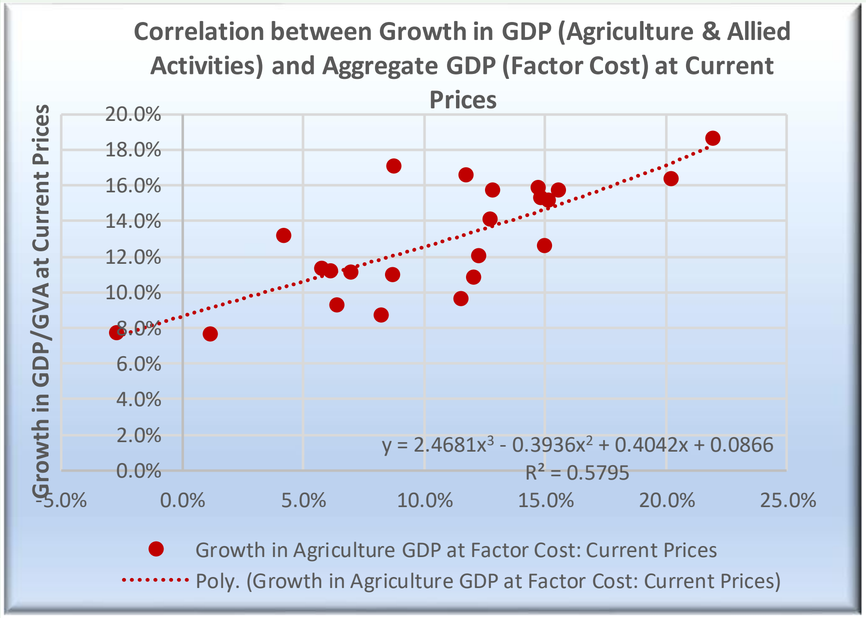
Post Reforms Growth: Directionally Positive, but….



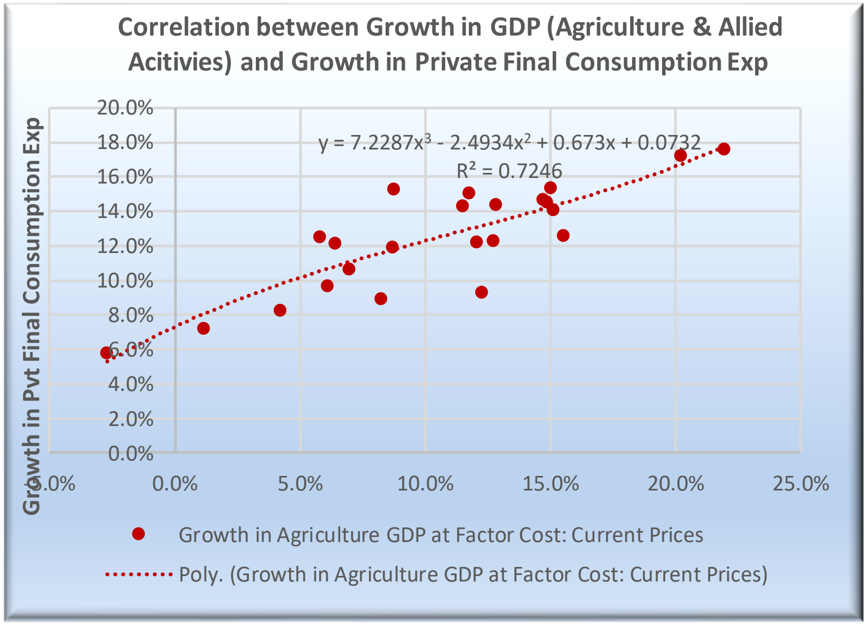
- Post Reforms India has experienced steady growth in GDP, with a few sharp declines. It recovered well from these sharp declines.
- However, the growth rate has been declining during the last few years, after having recovered from lows of 2009 & 2012
- Real growth in Per capita GDP during the last 14 years (2004-05 to 2018-19) has been @ 5.44%, with a couple of deep declines in growth, the earlier 10-year growth being 4.34%.



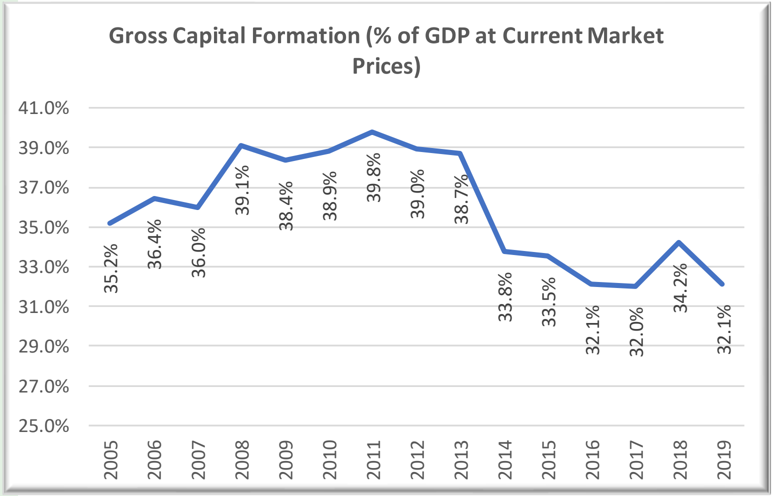
Agriculture continues to matter and therefore the Rural India matters too

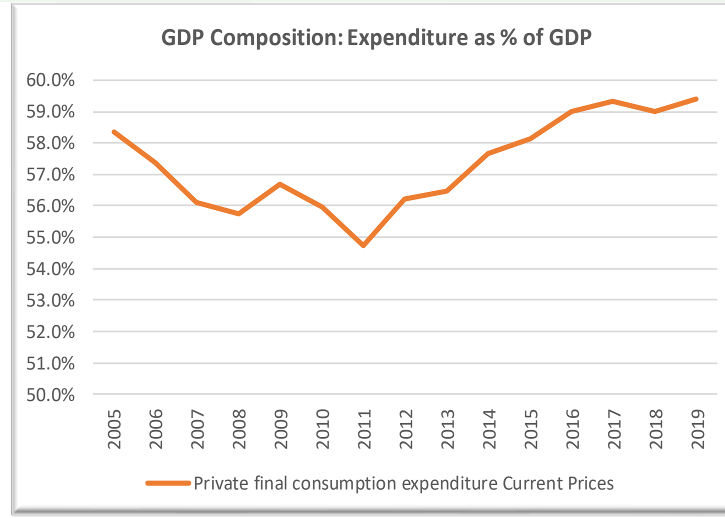


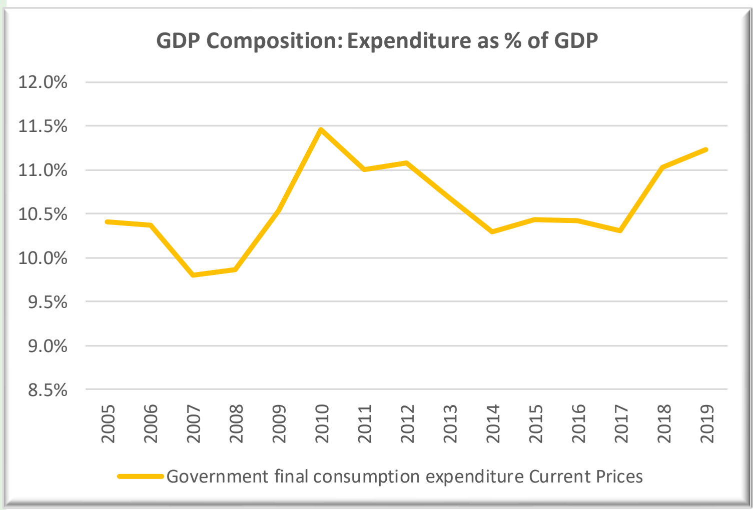
Agriculture drives Private Consumption.

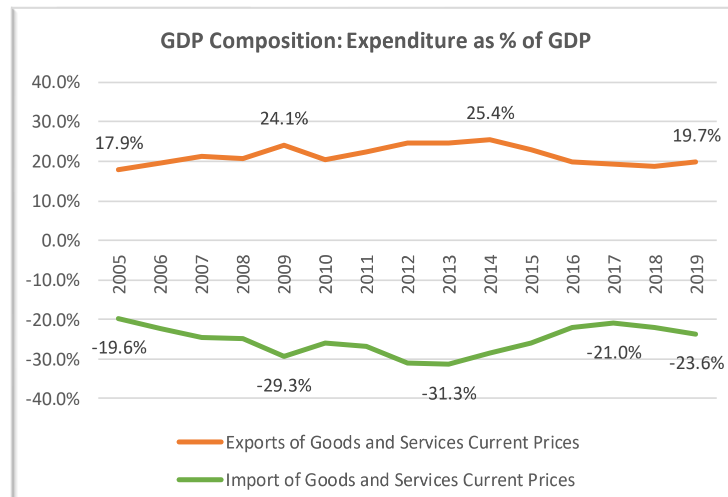


India has had investment-led import dependent Growth, which is now faltering…





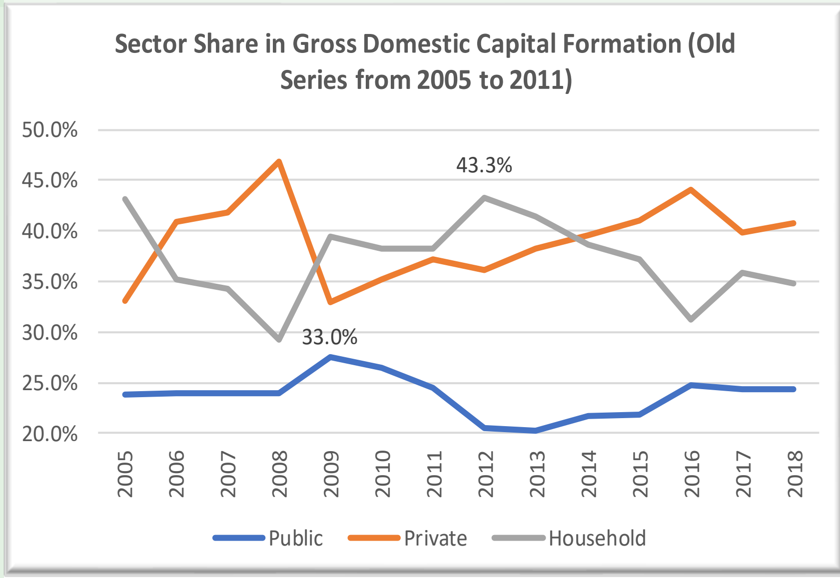




Import Dependent Investment-led Growth, till 2013

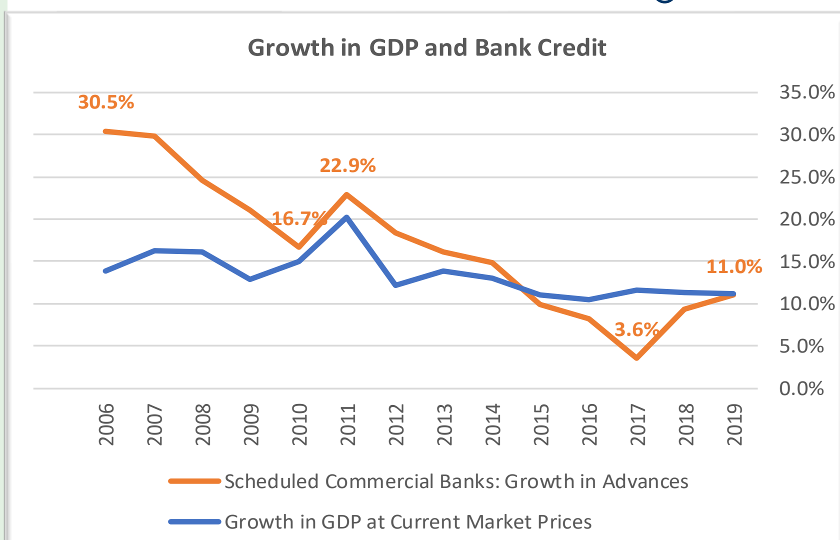
Relative Share of Consumption has gone up, post decline in investment growth, but consumption growth has also slowdown during the last few years as we will see later.

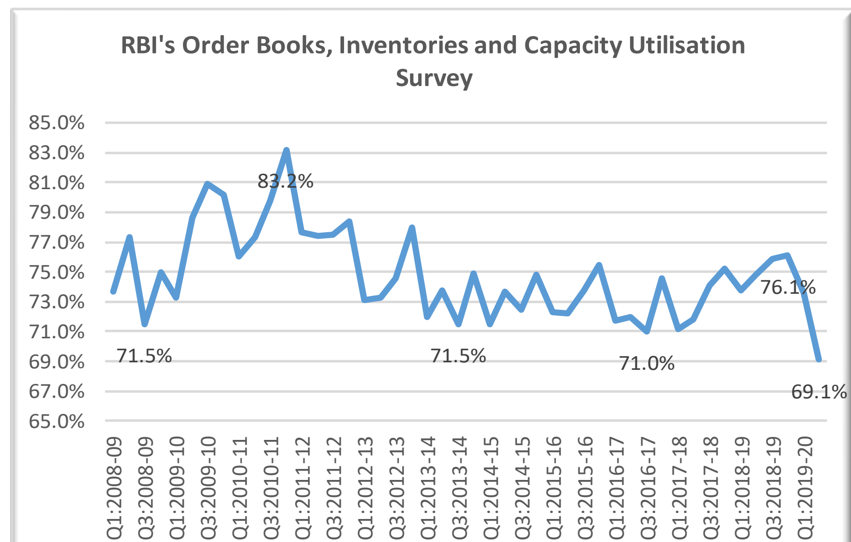
Credit-driven, investment Growth that has not turned out to be sustainable…



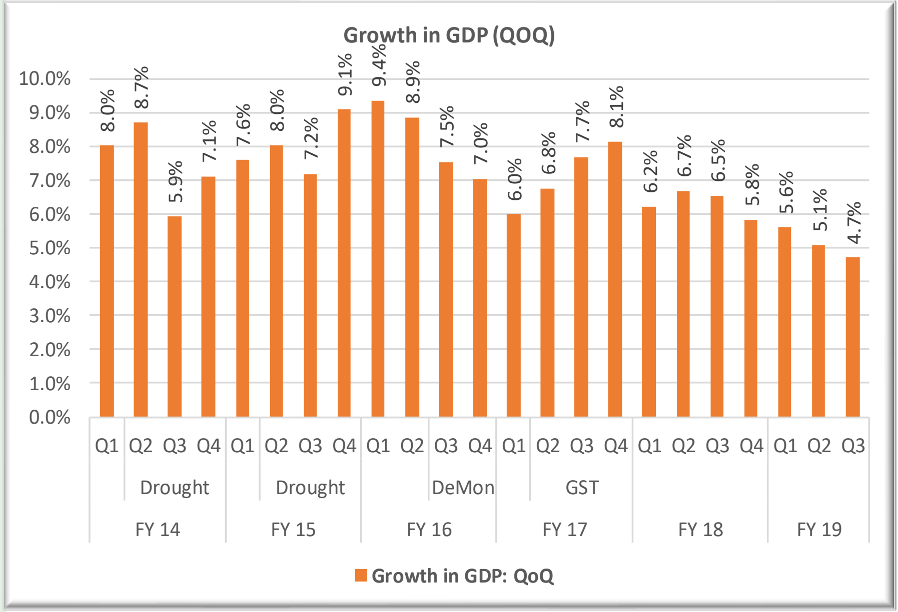
- The share of private-Sector investment has declined recently, after growing since 2009.
- Household Investment has been declining since 2012.
- Share of public-sector investment has been stagnant during the last 3 years.

Credit has not really helped put the economy on a sustainable growth path and the credit growth has declined significantly. Indian businesses need more equity to deal with poor operating cash flows and incremental investment.





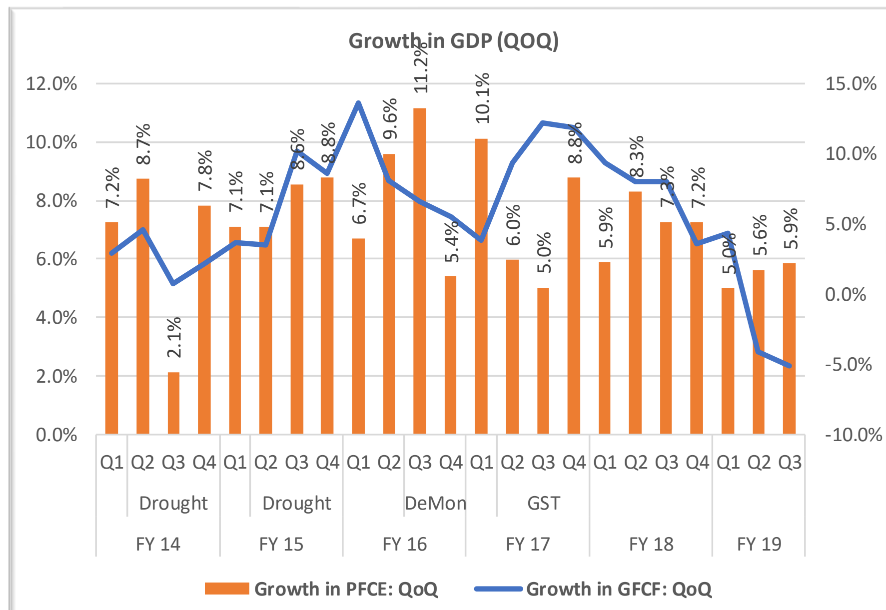
India is experiencing a declining growth momentum….



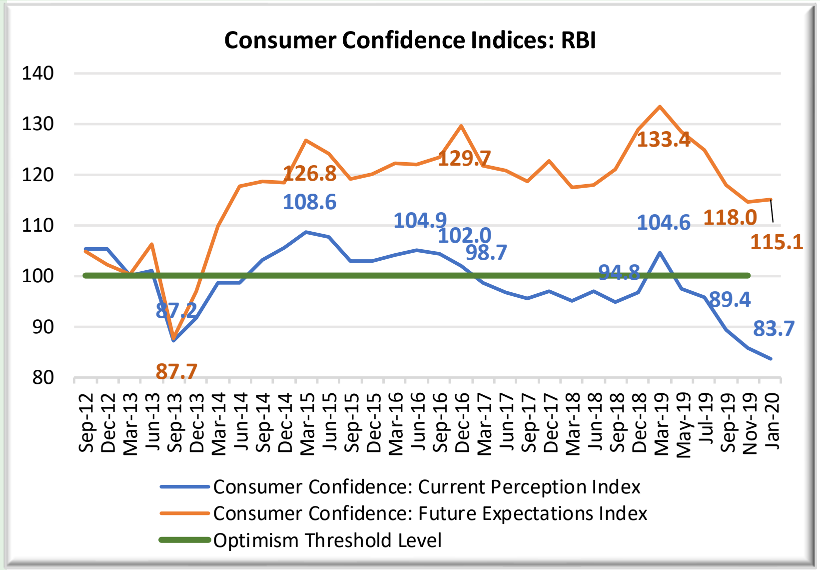
- Consumption growth has been a little more volatile than in the past and investment growth has almost collapsed.

To be read on 2 different axes.

- A strong investment cycle is expected to accelerate growth and that too with low-risk. We have seen this in Japan, Korea, South East Asia, and China.
- Though conditions apply: We need earnings and consumption growth to follow.
- We seem to have missed that in India.



Consumer Confidence has been low and declining….



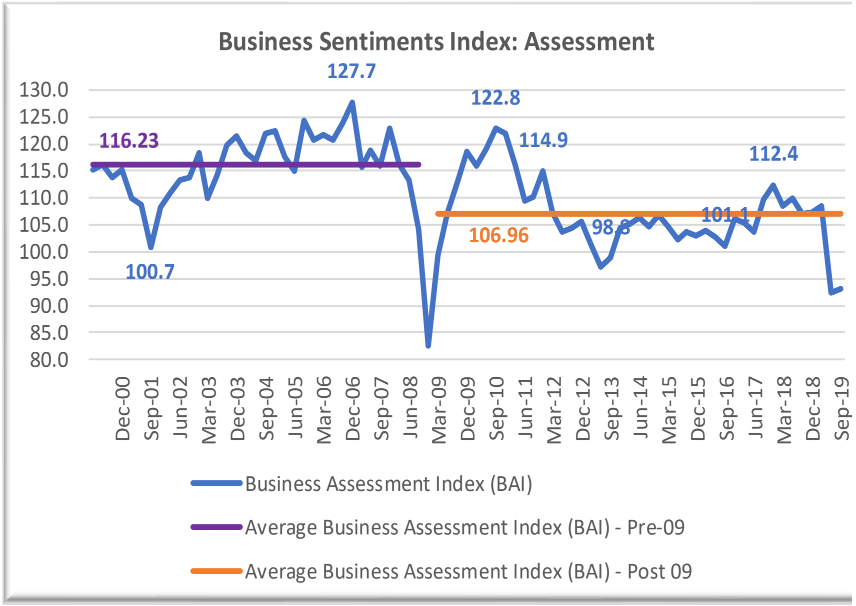
- Urban Consumer has been pessimistic about current situation for nearly 3 years, though still optimistic about future.

It has been observed that about 50% of workforce in some of the largest firms in the country is contract workforce. A flexible workforce passes on the risk of employment and earnings to individuals rather than the organisation. **Quality of Employment?**

Monthly Per Capital Exp (Mixed Reference Period for different Exp Categories)	**1994**	**2000**	**2005**	**2010**	**2012**
MPCE: Rural at 1994 Prices	162.6	179.4	181.6	192.9	221.9
Rural MPCE Growth: Constant	*-*	*1.7%*	*0.2%*	*1.2%*	*7.3%*
MPCE: Urban at 1994 Prices	268.4	306.4	326.8	369.0	413.5
Urban MPCE Growth: Constant	*-*	*2.2%*	*1.3%*	*2.5%*	*5.9%*

Nominal amount during 2012 was INR 1,287 for Rural and 2,477 for Urban. Multiplied with population, the total expenditure is about equal for rural & urban households. In other words, size of the rural and urban economy is about the same.

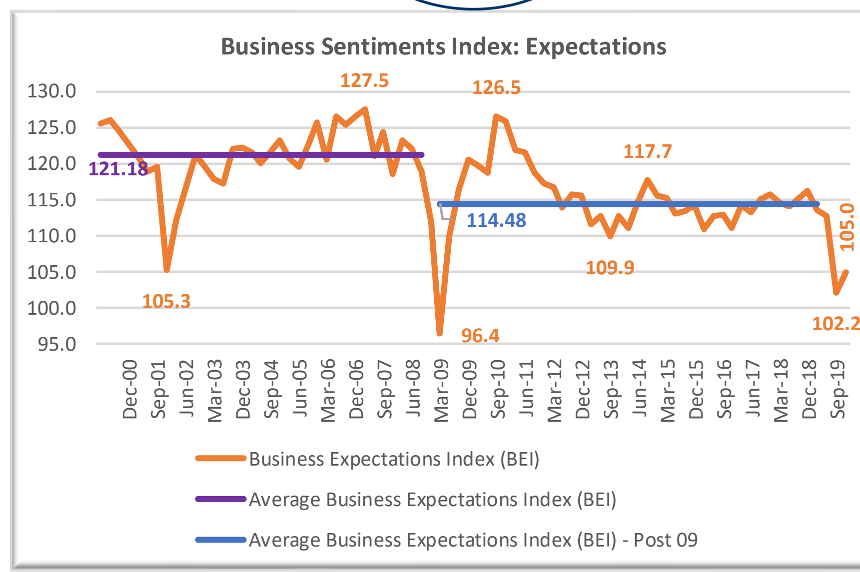
Business Confidence is also struggling….



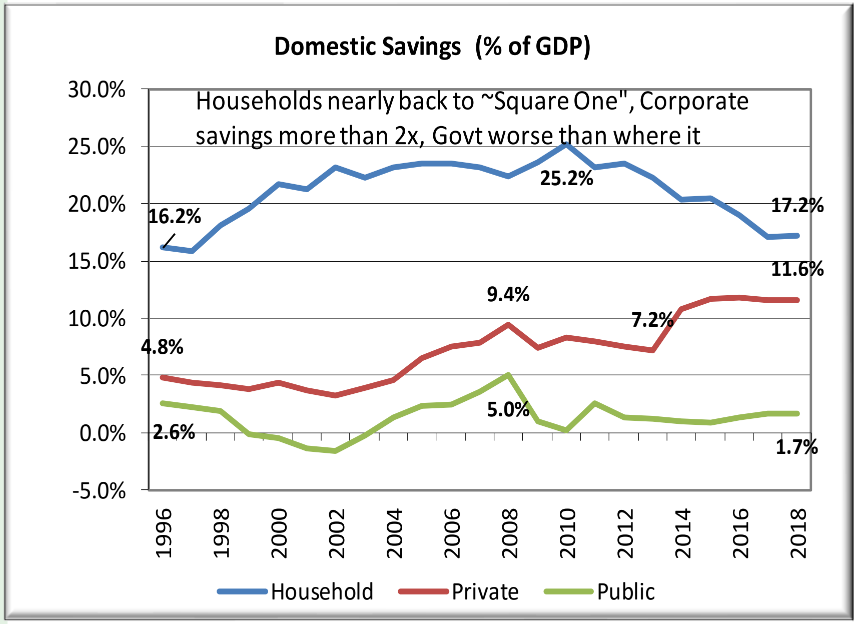
- Business Assessment and Expectations are positive,
- But with a downward shift.

Given the declining consumer confidence and lower business confidence, we expect the new investments to carry higher risk. Consequently, the economy needs additional risk-capital – equity and long-term debt.

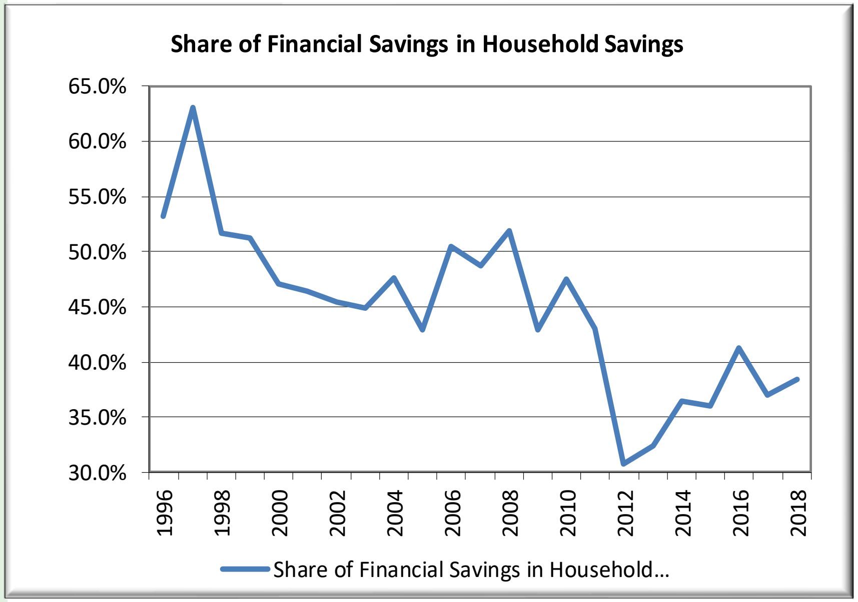
- Is the downward shift structural? Probably yes, as these readings have been at the lower lever for nearly 10 years.

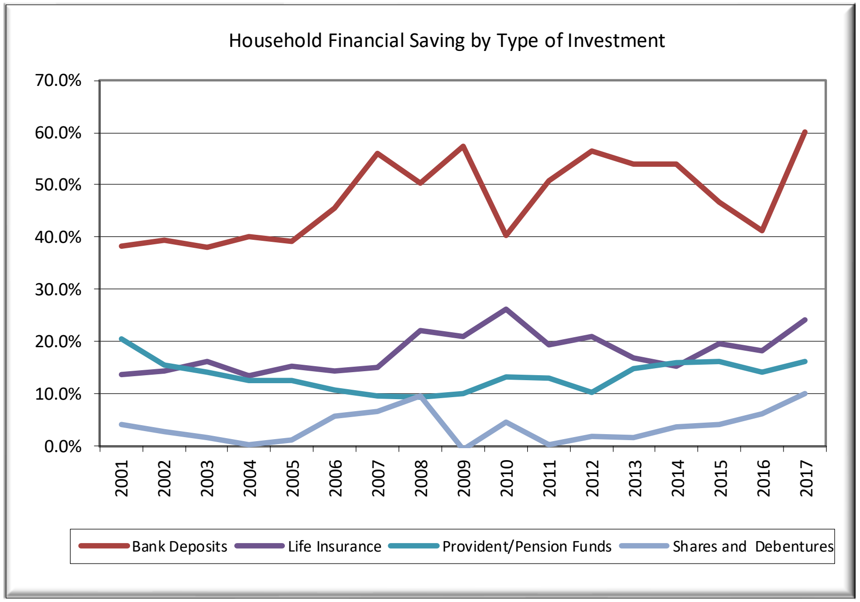


Financing of Economic Growth: Household Savings rates are declining

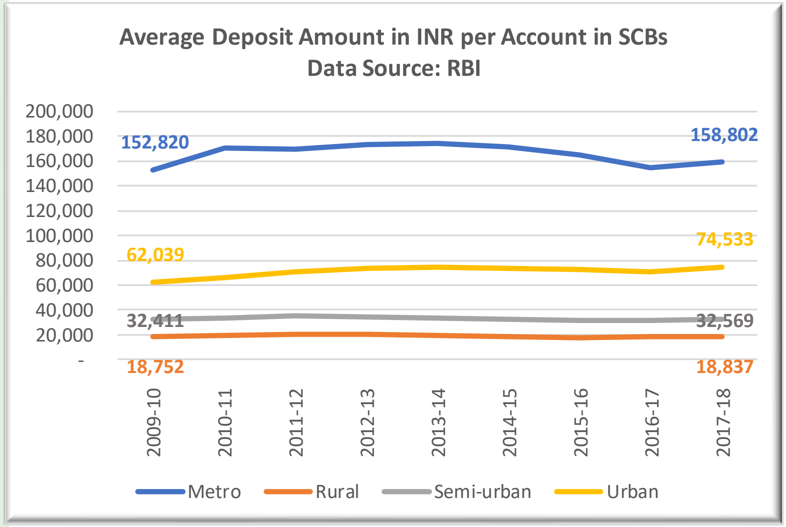


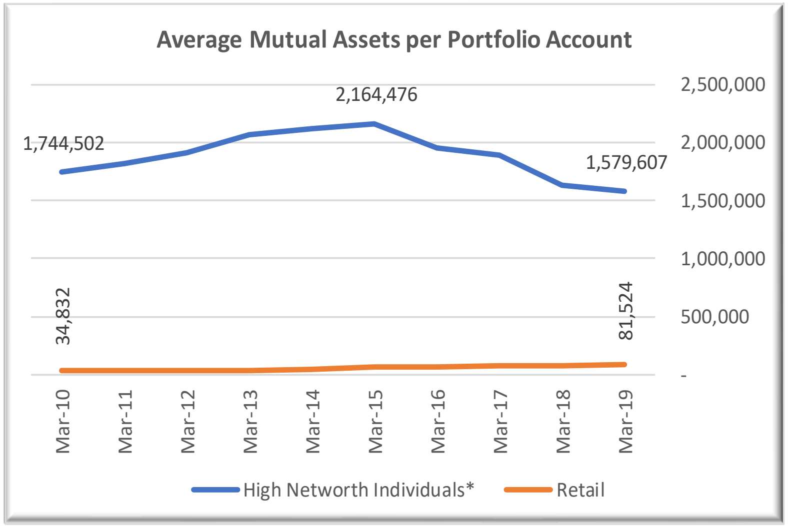
- Growth has largely been financed through domestic savings.
- Indian household was a significant saver during high-growth years, not anymore, saving rates are declining.
- Share of financial savings in household sector is also coming down, i.e., share of physical savings is increasing.
- Since the Indian saver is largely a risk-averse debt (bank deposits) investor, a large amount of available capital for investment comes in form of debt from the banking system.

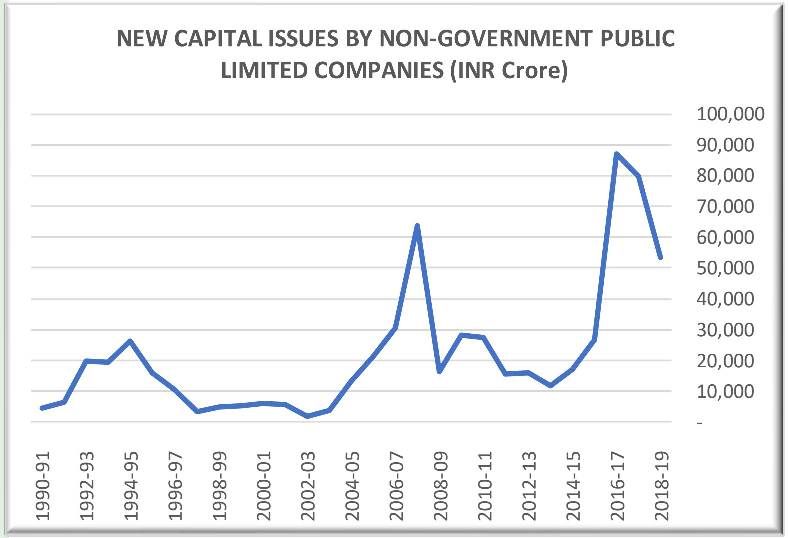


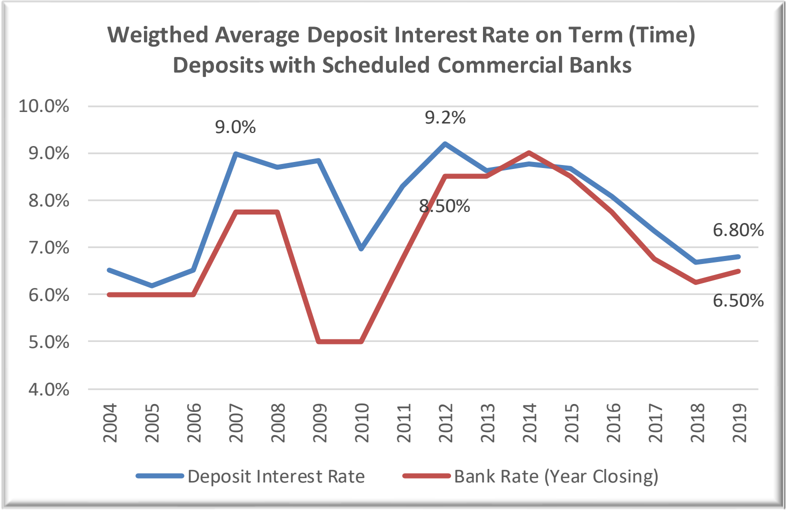


Households don’t provide a lot of risk of capital



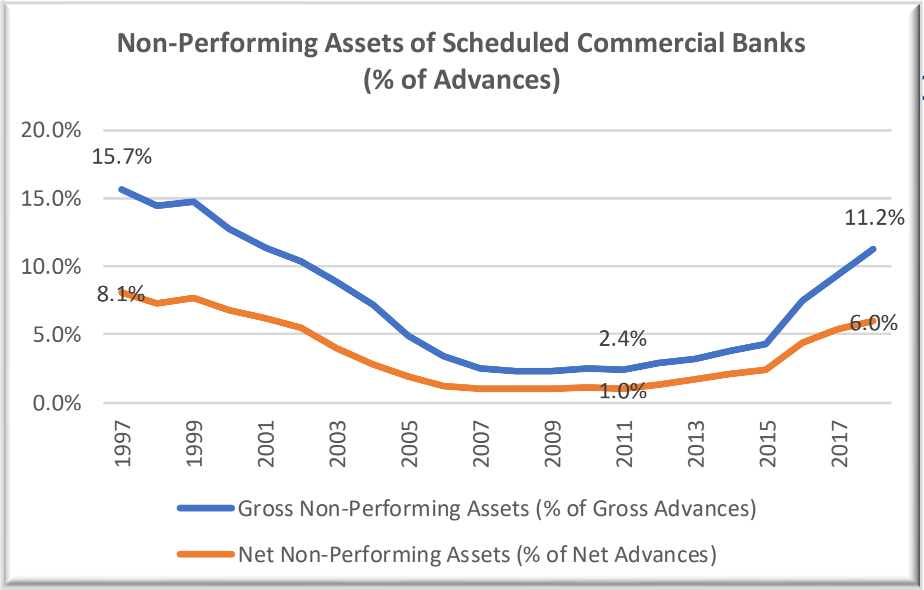






India does not really have adequate private risk capital? Not surprising, given that it is still a low-middle income economy. An average Indian saver is not a financial saver and that to saves in form relatively risk-free assets.

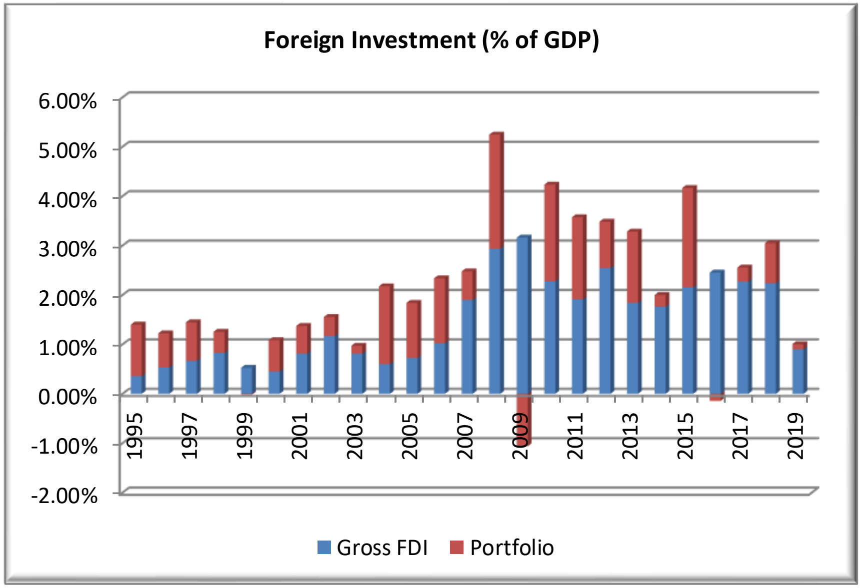
Even the Banking System is not in a position to finance growth



Banking System is constrained, given the poor quality of investment-led growth.
It needs additional equity to resolve the current situation and start financing further growth.

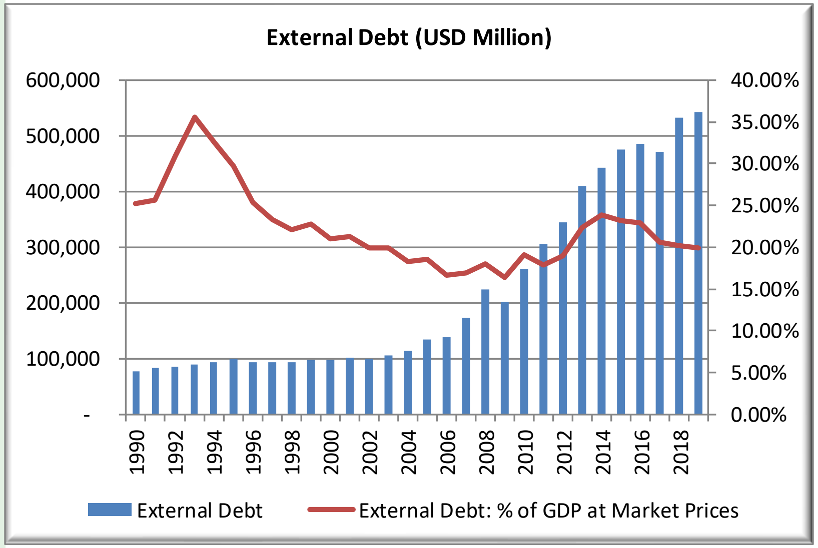
Can India not raise risk-capital from international sources?

India is not a big user of international risk capital, except in secondary markets



- India's dependence on international risk capital has been low (almost always)
- In the best year, it has received about 3% of GDP in form of FDI.
- India has had large portfolio flows in some years, but they are usually volatile.

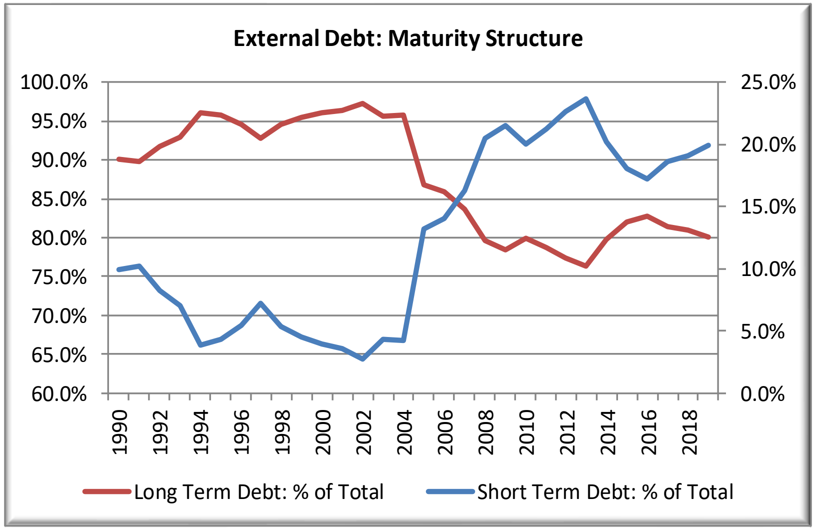
Can India borrow or get additional international investment? Yes, it can. But…



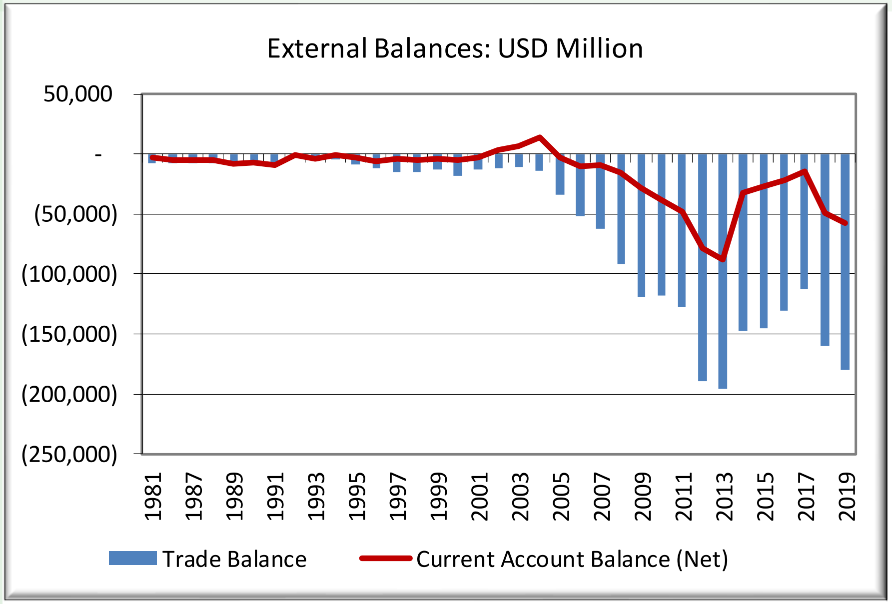
- External debt levels and maturity structure can cause volatility in exchange rates and availability of international finance

- External debt has been increasing for a while, largely driven by private and banking sector borrowing. Aggregate debt level is still not bad.
- Given the India runs a large trade deficit, increased borrowing increases foreign exchange price risk.
- Share of Short-term Debt has been on an increase.

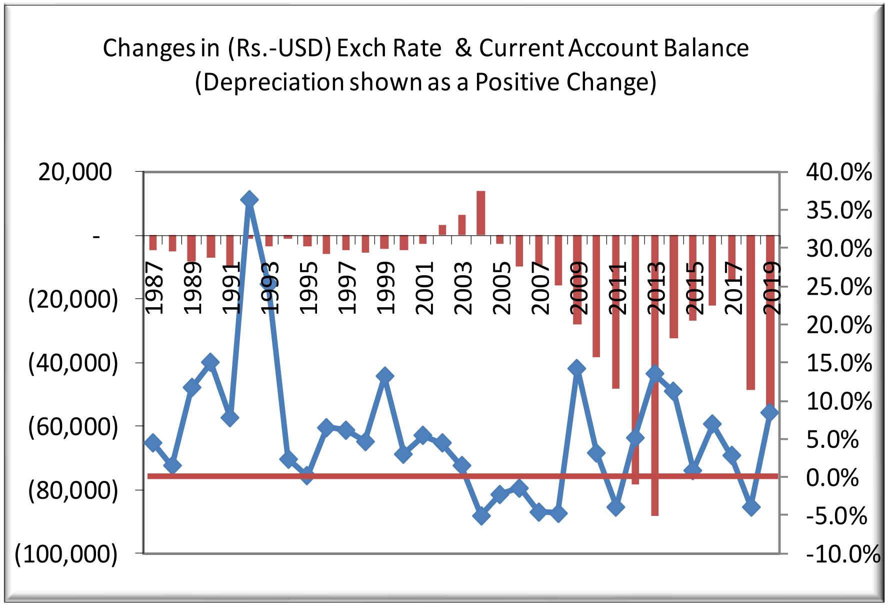
To be read on 2 different axes.



Large trade deficit is the challenge….it limits India's ability to raise international debt capital

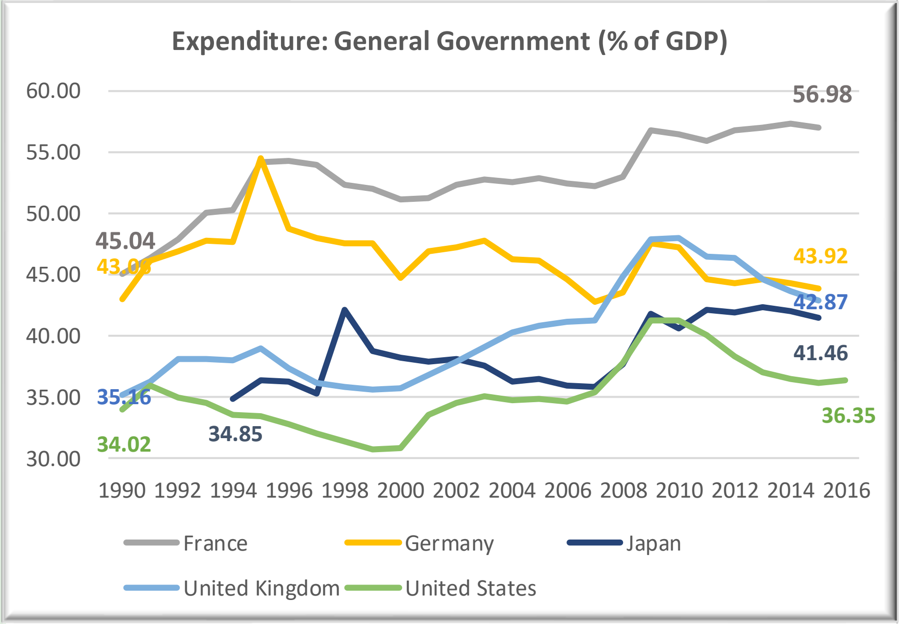


To be read on 2 different axes.

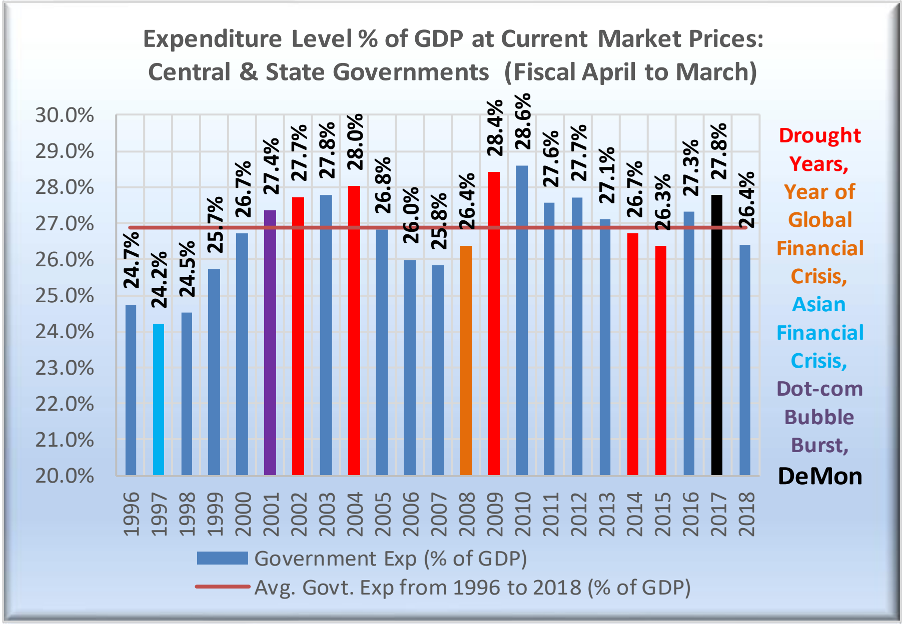


- Sharp increase in current account deficit was caused by oil price changes and gold imports.
- Off late the oil prices have fallen and so have gold imports.

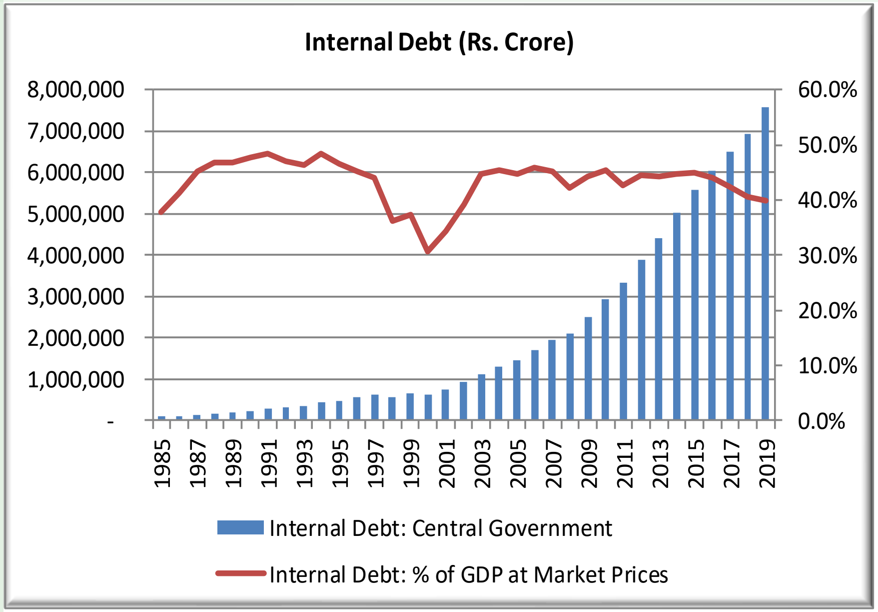
Does the Government have room to finance growth?



Yes, it does, given that the government expenditure is just about 27% of GDP.



Does India not have too much government indebtedness already?

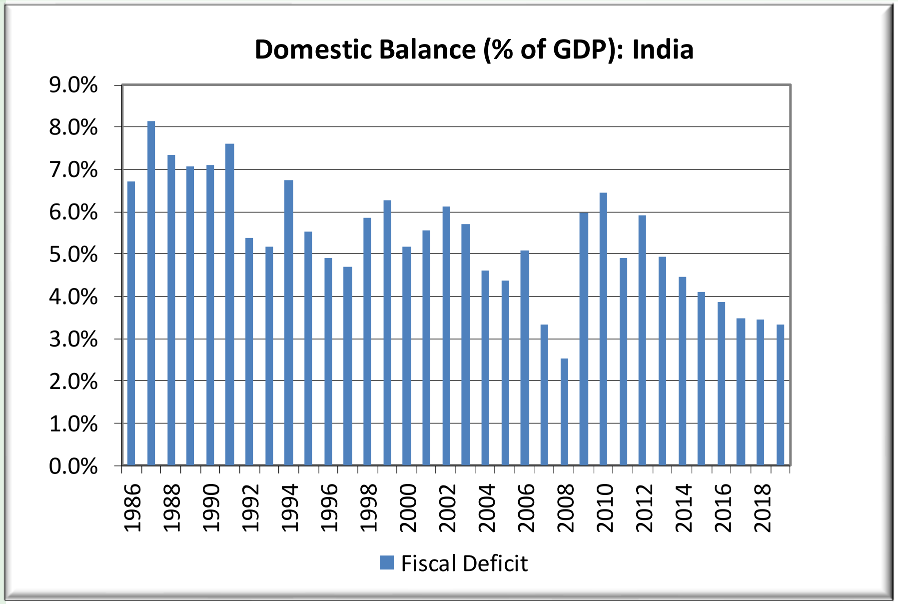


To be read on 2 different axes.

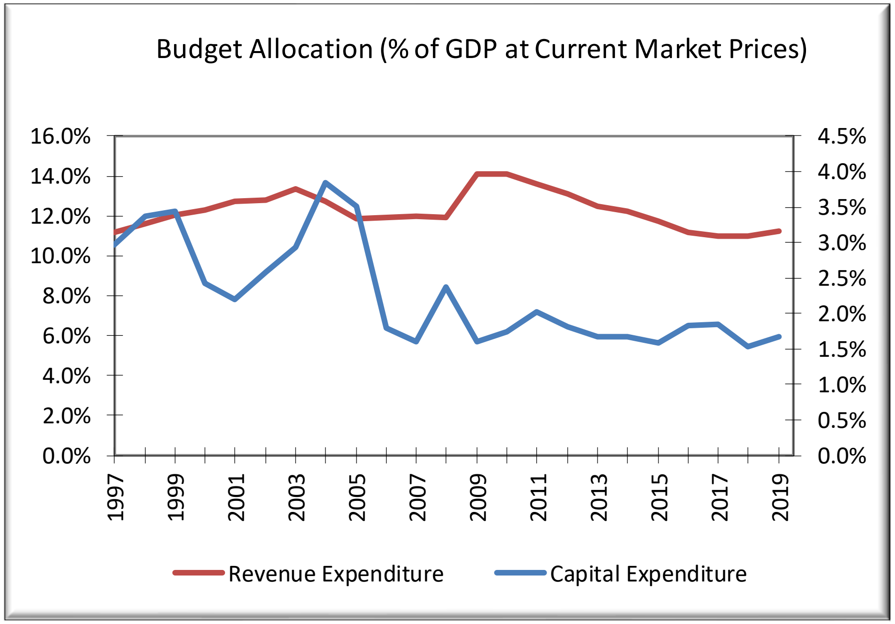
Not really!!!

- Internal debt (central government) has been stable in relation to the size of our economy.
- If the earlier household savings rate can return, it is not a worrisome challenge.
- State governments add about 25% of GDP to total borrowings.
- Excludes debt raised by government bodies like NHAI, FCI, etc.
- Current indebtedness of the US government is about 100% of GDP.

What about fiscal deficit?

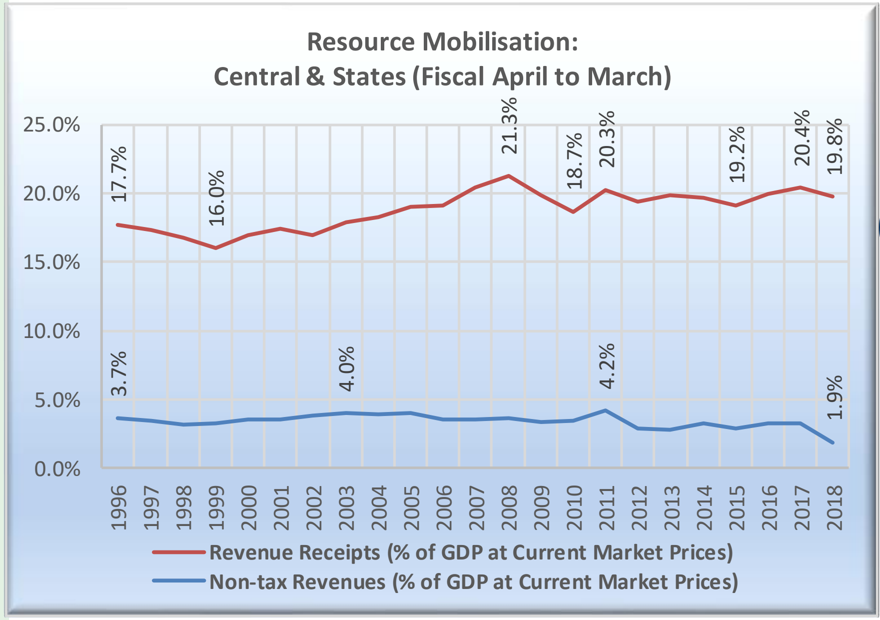


To be read on 2 different axes.



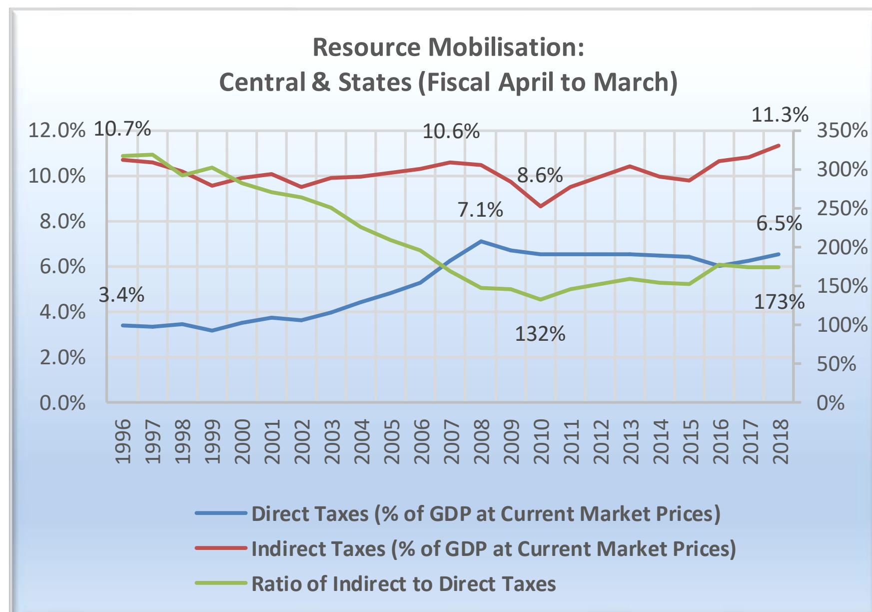
- Fiscal deficit did increase significantly for some time, driven by government spend and sharp increases in subsidies.
- Government has been trying to control the fiscal deficit over the years, which often involves reduction in capital expenditure by the government.
- Currently the State Government also run a fiscal deficit ~3% of GDP.

Deficit is a concern, only when the Government does not mobilise enough resources?

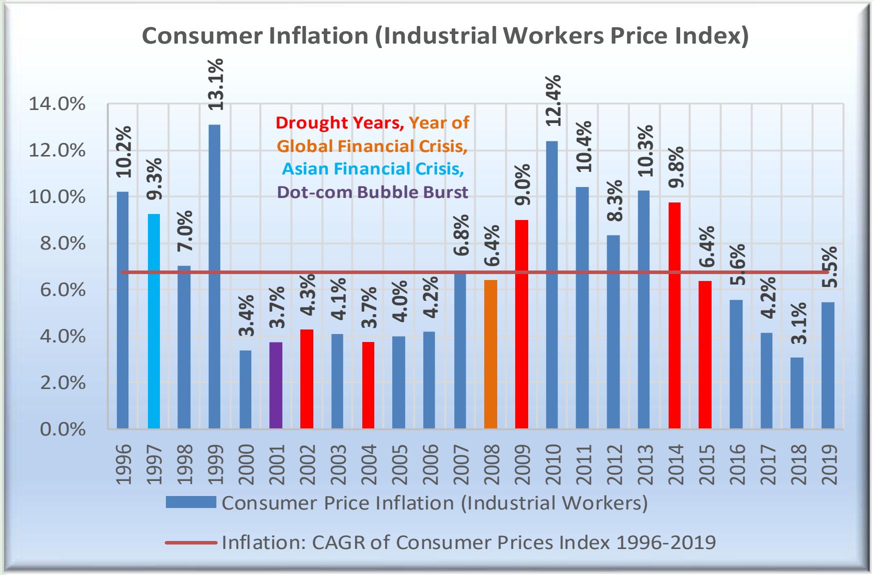


Near Stagnant Resource Mobilisation Level. India has room to direct tax rates, as the well-offs and corporations have been major beneficiaries of economic growth acceleration during the post reform period.

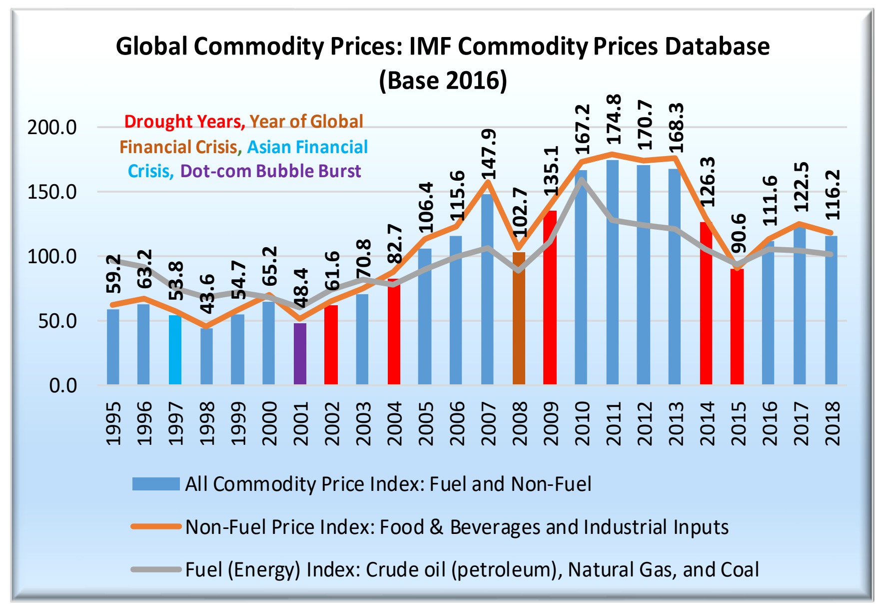
To be read on 2 different axes. Ratio on RHS



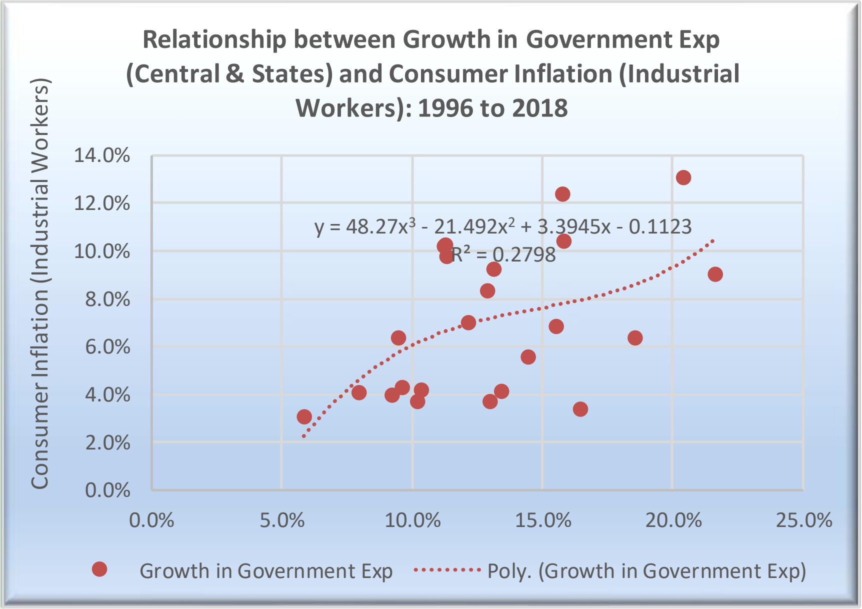
What about inflation?

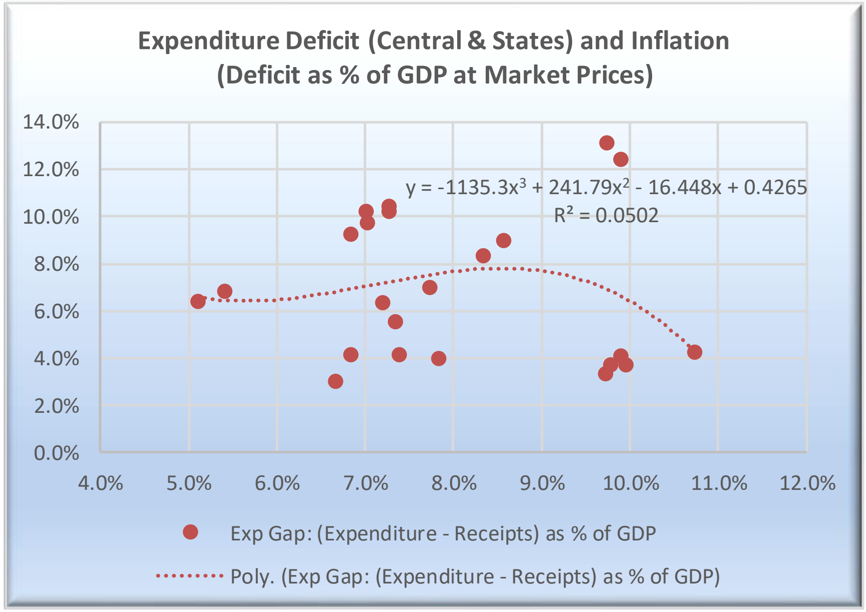


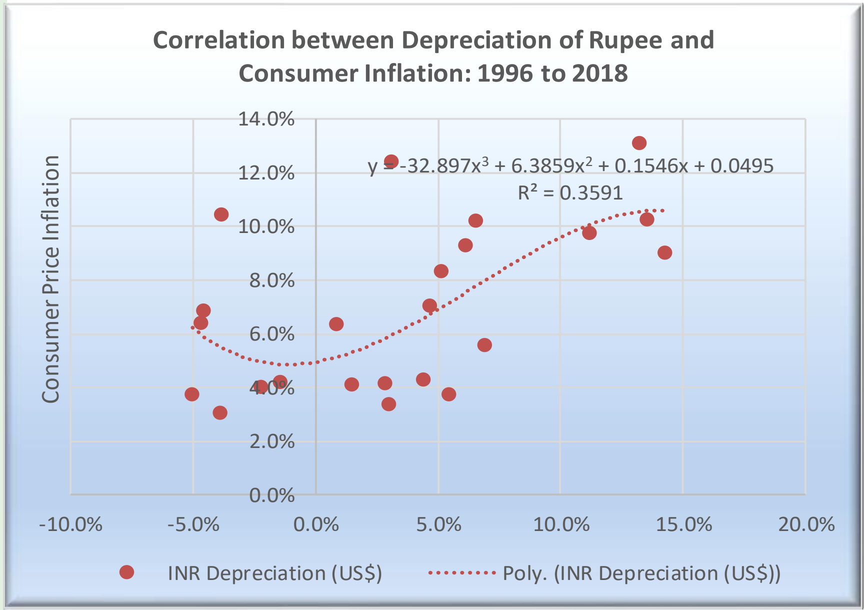
The average inflation has been ~7% for quarter of a century. It has been driven by commodity prices during the recent high-inflation period.



Inflation and Deficits and INR Depreciation







India Growth Story: India has limited risk-capital, investment-led growth therefore has greater financial risk, particularly if the global or local economic uncertainty is high.

- Import Dependent, Private-Sector driven, Investment-led Growth, with relatively smaller role for consumers.
- Agriculture matters, as it has a strong relationship with consumption growth.
- Financed largely with Domestic Savings channeled through the Banking System, Limited dependence on Foreign Direct Investment, but large Portfolio Investment.
- Banking System is constrained to finance growth. Credit-led growth has not been sustainable. It does not have adequate equity-capital to resolve the NPA problem.
- Level of productive Government Spend is coming down, Large trade deficit and current account deficit do constrain India's ability to attract foreign capital.
- External debt levels and maturity structure can cause volatility in exchange rates and thereby limit the availability of international finance.
- Internal debt does not pose much problem given India's historical savings rates.
- Rupee is expected to depreciate between 3 to 5 per annum (against the USD), depending on the level and volatility of financial and trade flows, and differences in inflation.
- Inflation is largely a commodity price-driven phenomenon, not so much driven by the government deficit.
- **Limited availability of risk-capital requires that the government plays an important role in financing growth – investment and consumption.**

Expected Impact of NCV on Consumption and Investment

Consumption

- Lower spending, as the unemployment levels go up across the board.
- Lower spending as people conserve resources, slack will get removed to an extent, depending on the period of disruption.
- Discretionary spends across sectors may slowdown.
- India may see a V shape recovery in some consumption sectors (aviation, transportation, consumer goods, etc.) though the demand trajectory may end up being lower than in the past in many sectors.

Investment

- Capital Intensive purchases (auto, housing, large appliances, etc.) may get delayed, even among the upper-middle income households, arising from concern about future earnings.
- Large capacity expansion decisions may get delayed, particularly those depending on borrowings. Businesses will try to get the maximum out of existing capacity or may even shrink it.
- Cost of Capacity may come down, if investment sentiments remains poor.

Financing and International Flows

- Savings rates may fall further if the government does not support consumption for households.
- Financial system may experience increased default in personal finance as well as MSME segments, further curtailing their ability to finance consumption and investment.
- Labour Remittances may fall, as Middle East growth is curtailed in view low oil prices. But I expect the ME governments to invest at rates faster than in the past.
- International Financial investors may come back to the Indian market, if the economy starts recovering at a faster pace than currently expected.
- INR may continue to be weak, particularly if the economic recovery is slow.
- Cost of finance for businesses with lower credit rating may go up, as credit spreads increase.
- Financial Markets may drive commodity prices, particularly if the zero-cost, on-tap liquidity starts chasing commodity markets for returns as was the case post-GFC.

Expected Impact of NCV on Consumption and Investment

Based on What If Sensitivity for QOQ Growth	2019-20	2020-21
Private Final Consumption	4.6%	3.0%
Government Final Consumption	11.0%	11.0%
Gross Fixed Capital Formation	-1.3%	-2.0%
Changes in Stock	1.5%	1.8%
Valuables	9.5%	0.0%
Exports	-1.2%	-4.0%
Imports	-4.7%	-5.0%
Discrepancies	-4.7%	-2.0%
GDP at Factor Cost	**4.4%**	**2.7%**
Government Consumption Share in GDP	11.5%	12.4%

Growth estimate table above is a very simplistic estimate of growth, based on broad based assumptions about the lock down period. The objective is just to get a sense of what is likely to happen to growth in the short run.

Impact on Business	If the Govt. Investment is Significant	If it is not
Growth	++	+/-
Profitability (%)	+	+
Operating Cash Flows	Increased WC Intensity	Increased WC Intensity
Risk of G, P & CF	Low	High

Given the Pre-NCV state of the Indian economy (structural decline in investment and consumption growth and lack of availability of private risk-capital) and the negative impact of NCV on consumption and investment, it is absolutely essential that the government supports household consumption (for the poor, lower-middle and middle income families) and invests, on government account (not PPPs), in short-gestation infrastructure projects spread across the country.

India has sufficient capacity for manufacturing and construction and import prices for manufactured goods will also be lower given the global slowdown, lowering India's cost of building capacity.

Data Sources and Acknowledgements

Data Sources

- Various reports from RBI's (Reserve Bank of India) Data Base of the Indian Economy.
- Various reports of RBI's Quarterly Consumer Confidence, Industrial Outlook of the Manufacturing Sector and Order Books, Inventories and Capacity Utilisation Survey (OBICUS) Surveys.
- Various reports of Level and Pattern of Household Expenditure, National Sample Survey Organisation, India.
- Various reports from the Basic Statistical Returns (BSR-1 and BSR-2) of Scheduled Commercial Banks to the RBI.
- IMF's Government Finances Data Base.
- IMF's Global Commodity Prices Data base, accessed through Commodity Data Portal.

Acknowledgement

The presentation has benefitted from detailed comments from my professional colleagues and the members of IASCC Board. I am grateful to Mr Marc Alderding, Mr Amitabh Doss, Mr Brij Chandiramani, Mr Biten Kathrani, Dr Anujayesh Krishna, Mr Ramesh Menon, Mr Alok Mishra, Mr Anand Pandey, Ms. Chitra Sood and Mr C Srinivas for their insightful inputs. In addition, I have received many suggestions about the possible ways in which the Government of India and the business could potentially respond. We will share them at the next stage.

IASCC

Ideas sans Ideology