FINVAL
RESEARCH & CONSULTANCY

REPORT

REVIVING THE INDIAN ECONOMY

Finval Research And Consultancy

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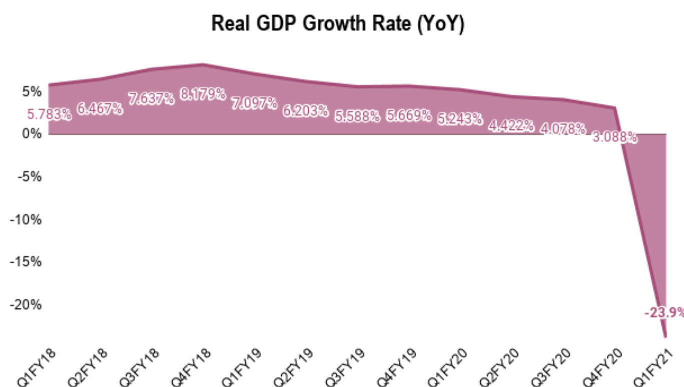
ABSTRACT



It is a well known fact that India is presently dealing with a health disaster of gargantuan magnitudes but going beyond that, there is also an economic recession which has been triggered by this disaster. This report is a brief explainer on the said economic recession, what has caused it. Further, it will delve into the details of each and every problem and will attempt to try and propose a viable solution to getting the Indian economy back on its feet.

SECTION 1: DECODING THE MAGNITUDE OF THIS CRISIS

This section briefly explains the scenario of the present times, starting when the first signs of a slowdown started emerging with the fall of IL&FS. It goes on to explain this in detail and then sheds some light on the cascading effects of the same, in terms of how several other sectors of the economy took a hit because of this and how things went from bad to worse. It ends with a set of diagrams and graphs so as to give the readers a nuanced representation about the present situation.

SECTION 2: ROOT CAUSES AND EARLY WARNINGS

This section delves into the depths of India's flawed economic structure. Starting with Dr. Rathin Roy's 2019 red flag about India falling into a middle income trap, it goes on to explain why he may be right about this. Forming this as a basis for proving existence of structural problems in India's economy, it goes on to narrate the story of India's economic growth since independence and how at several points in history, a wrong turn and lack of measures for course correction resulted in the rise of a structural flaw with long drawn effects. With a foundation in place for readers to understand the precarious state of India's economy, it goes on to explain the flaws in India's financial ecosystem. Coupling this with the hard truth about dipping household savings in India, it sheds some light on how this has rendered India's economy a single engine one whose flaming out in recent years has caused the present economic crisis. Appropriate graphs and diagrams are provided at the appropriate places for a better understanding.

SECTION 3: THE CHALLENGE AHEAD: GETTING THE ELEPHANT BACK ON ITS FEET

This section provides the readers with some essential steps which are required to be taken for the long term growth of the Indian economy. It includes reforms in the financial system, reviving DFIs, reviving domestic demand and savings, proper channelization of incoming future investments and divestment of PSUs. It also makes a detailed case for why the government needs to opt for large scale deficit financing and why we need to take urgent steps to capitalize on our highly favorable demographic dividend.

DECODING THE MAGNITUDE OF THIS CRISIS

Even before the onset of the Corona virus pandemic, the Indian economy wasn't exactly in a good shape. It has been experiencing a slowdown for over a year now. So let's go back in time a little and start right where the first signs of slowdown started emerging.

Around the time marking a decade of the 2008 global financial crisis, in late 2018, the economy which had prided itself on escaping the 2008 financial crisis almost unscathed had its very own Lehman Brothers in the form of Infrastructure Leasing & Financial Services (IL&FS).

IL&FS is one of the NBFCs or Non-Banking Financial Companies which have risen in prominence over the past two decades (early 2000s) to fuel India's growing demand for credit for funding new and coming infrastructure projects such as roads, ports, airports, etc. in one of the fastest growing economies in the world. They are often marked by constant criticism of the fact that they are not as well regulated as banks and often function in questionable manners. In fact, IL&FS was one of the first of such companies; it emerged in 1987 and became renowned as one of India's premier infrastructure financing companies. In late 2018, IL&FS initially defaulted on some of its commercial papers (CP)-a kind of promissory note issued only to large institutions and not backed by any collateral & a major source of funding for NBFCs- this marked the first sign of illiquidity and over the next few days, it turned out that IL&FS was on the verge of bankruptcy driven primarily by excessive lending towards infrastructure projects/companies which went bust over the years after the 2008 crisis. Subsequently, these loans couldn't be retrieved leading to a cash crunch. What further exacerbated the problem was under-reporting of bad loans on account of poor regulatory oversight. There is also the risk of good money going bust after IL&FS as several prominent mutual funds and provident funds are invested in it.

This had a bunch of cascading effects. The insolvency of IL&FS resulted in heightened risk aversion among commercial banks about lending to NBFCs which has subsequently resulted in all NBFCs going short on liquidity and as a result, credit extended by NBFCs has seen a dip.

Over the past few years, the NBFCs have gained a lot of prominence as they financed almost half of all vehicle purchases in India, especially in rural areas and not only that, also formed a major portion of credit in rural India. Consequently, when the 3rd quarter results were announced by major Indian automotive companies, everyone was in for a shock, India's automotive industry which had growing at an exponential rate since the early 2000s for the first time in over 2 decades, reported a fall in YoY sales, primarily driven by a fall in rural demand. This had additional consequences. While many automotive suppliers are big publicly listed companies such as Motherson Sumi, Bosch, Varroc Engineering, etc. but most of them are small firms based around the manufacturing plants and manufacture small vehicle components such as nuts & bolts, chassis, wiring, etc. As vehicle sales tanked over the months, these small suppliers also ran out of cash and many had to fire workers and shut their shops.

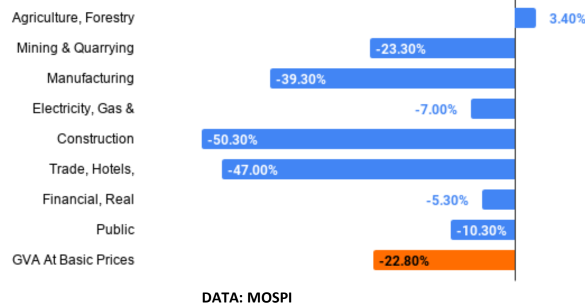
However, a much bigger bombshell arrived later in June 2019 when a more profound realization came. Not only people are deferring consumption of luxuries like cars, but also that of basic products such as biscuits, soap, oil, etc. (Fast Moving Consumer Goods or FMCG). May 2019 marked the Lok Sabha elections and during this time, with lakhs of volunteers and politicians campaigning for days on end in the scorching, FMCG companies usually see a spike in their sales of biscuits and packaged drinks, particularly companies like Parle, famous for its biscuit brand Parle-G which sees a large spike in demand for its Rs.2 packets, particularly in rural areas where such small packing finds greater demand due to a restricted propensity to consume. However, this time, Parle reported subdued sales of

Parle-G. Common opinion was that this was on account of falling rural and urban incomes due to a fall in credit and consequently small businesses shutting down. Also, responsible for this in part, was a weak monsoon.

These indications of an economic slowdown were further strengthened by an NSSO report-whose release was suspiciously held back by the government over issues of data quality-according to which, unemployment was the highest in 40 years and this raised further speculation that India was stuck in the cycle of jobless growth marked by a disproportionate rise in GDP with respect to job creation.

The final nail in the coffin, an official confirmation of a slowdown arrived with the announcement of Q4FY19 GDP data according to which GDP growth was 5.8%, down from the previous figures of 7-8% synonymous with India's growth story. Since then, things have only gone from bad to worse with GDP growth rate coming down and down, contracting industrial output and so on.

To make things worse, the Corona virus pandemic arrived early this year and in an effort to curb its spread by restricting social contact, lockdowns were induced across the country which resulted in clamping down of economic activity, shutting down of production, construction activity, large scale job losses, labor migration and so on. As was expected, this pushed the economy further down into the dumps and the fearful expectations of an impending recession were officially confirmed on 31st August 2020 when the Q1FY21 GDP data was released showing a much greater than expected contraction in GDP of 23.9% among other things. The following charts and graphs will give a more nuanced representation of the Indian economy in shambles.



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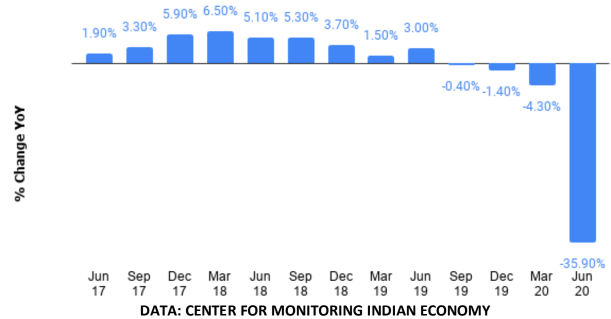
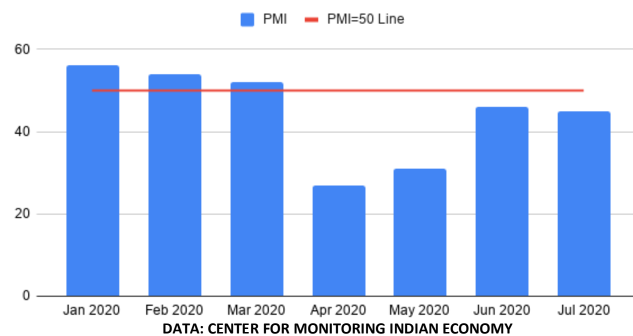


DATA: CENTER FOR MONITORING INDIAN ECONOMY



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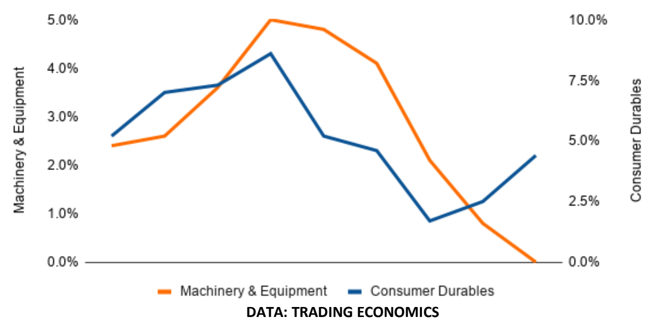
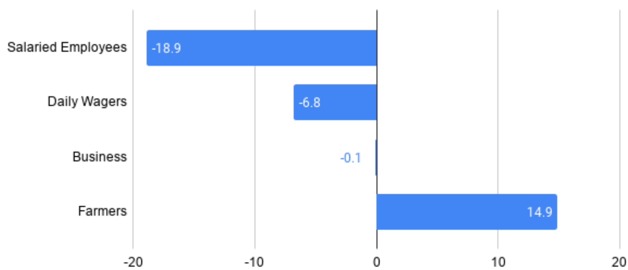


DATA: TRADING ECONOMICS

Unemployment Rises During Apr-Jul 2020. Salaried Jobs Worst Hit.

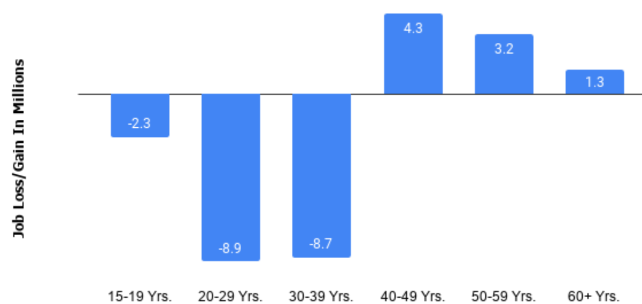
The Increase In Farming Jobs Indicates "Disguised" Unemployment Of Migrant Workers



Job Losses (Millions)
DATA: CENTER FOR MONITORING INDIAN ECONOMY

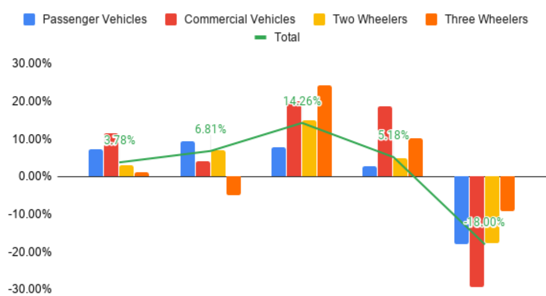
Job Losses By Age During Apr-Jul 2020

Young People Lost The Most Jobs



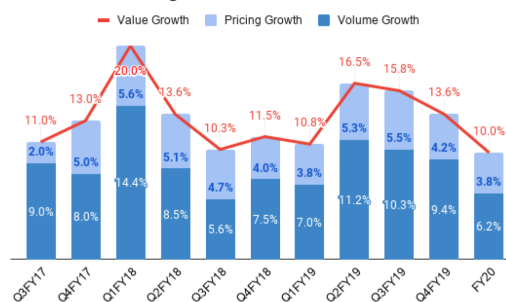
DATA: CENTER FOR MONITORING INDIAN ECONOMY

Auto Sales (% YoY)



DATA: ANNUAL REPORTS OF PUBLICLY LISTED AUTOMOBILE COMPANIES

FMCG Demnd Is Slowing Down



DATA: REPORT BY CONFEDERATION OF INDIAN INDUSTRY (CII)

ROOT CAUSES AND EARLY WARNINGS

Amidst an economic slowdown, additional fears were aroused when in May last year, Dr. Rathin Roy, then a member of the PMEAC, raised red flags that India may be heading towards a **middle income trap**.

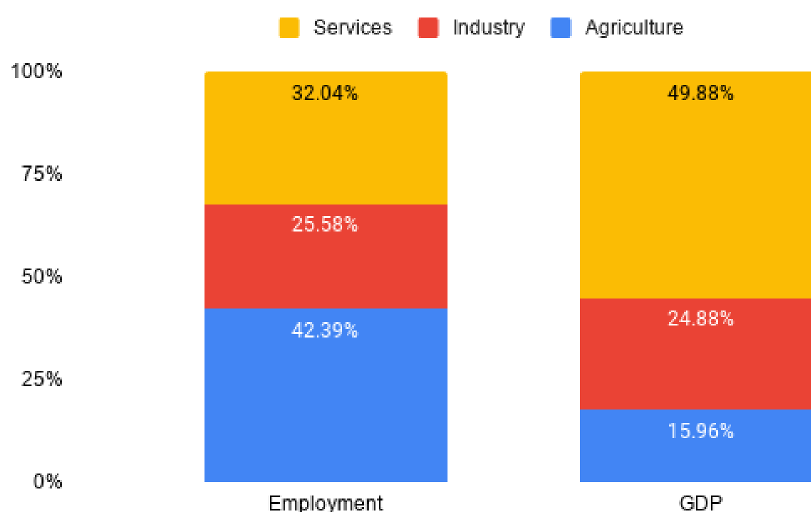
Middle income trap is a term coined by economists at World Bank in 2006 and it essentially refers to a fast developing economy entering a prolonged slowdown characterized by per capita income faltering at middle income levels, primarily due to major drivers of growth being unsustainable and experience in the cases of Brazil, South Africa and Turkey have shown that such traps are almost impossible to recover from.

In the words of Dr. Rathin Roy, with India's GDP growth slowing down, we risk per capita income levels faltering at lower middle income levels (i.e. between $1,000 and $3,800 going by latest classification from World Bank). We'll never be able to grow along the trajectories of South Korea or Japan if this happens because no country has ever been able to come out of this trap.

Existing information and evidence suggests that he maybe actually right.

Since the time of independence, efforts had been made towards increasing productivity and profitability in the informal sector by means of initiatives like the Green Revolution & Operation Flood which while brought people out of poverty, it still meant that people were employed more in agriculture and animal husbandry as the manufacturing sector still stayed undeveloped. That is because the government, for years almost entirely controlled the manufacturing sector and via its league of unprofitable and inefficient PSUs, failed to create a robust manufacturing ecosystem in India. Then came the 90s when India's doors were opened

to economic liberalization and seeing a regime willing to accept foreign investments and allow private investors to enter the manufacturing ecosystem, there was an inflow of investments into the country which brought crores of people out of poverty but this also was problematic, while the manufacturing sector was improved greatly with many foreign multinationals also setting up their units here, unlike countries like China and Japan, this growth still wasn't robust with only a few people with lack of access to education finding their way out of agriculture to manufacturing and this sector forming only a miniscule portion of output. The majority of the aforementioned investments made their way to the emerging services sector and over time, while this sector formed a majority component of the GDP, it only created a few million high skilled jobs. It is important for the manufacturing sector to grow as it is highly labor intensive and has the ability for stimulating the biggest farm to factories or rural to urban shift and there is comparatively less requirement for highly skilled labor in this sector.



DATA: TRADING ECONOMICS

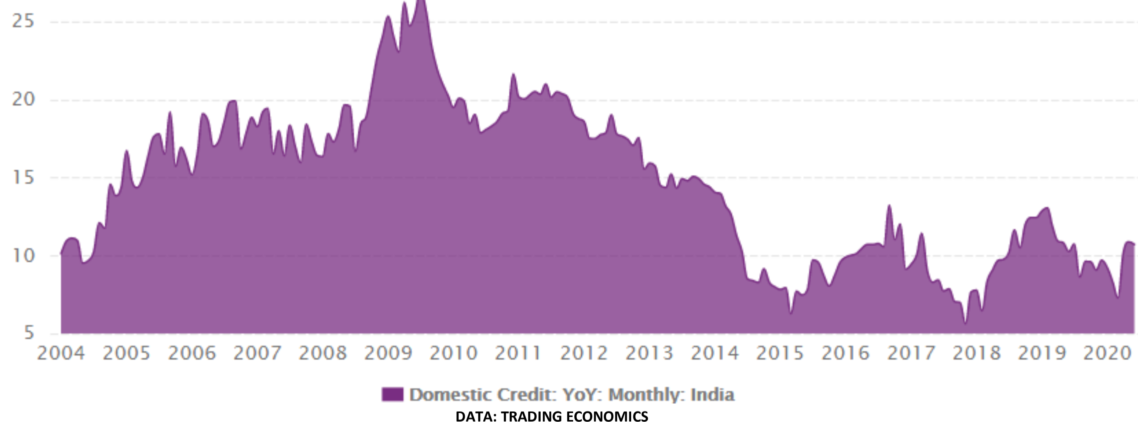
So the crux is that with the aforementioned events, India's growth took an unsustainable trajectory with high levels of growth driven almost entirely by the services sector thus forming a major chunk of the GDP. On the contrary, it didn't create an equivalent number of jobs and thus, an overwhelming majority of people remained employed in the informal sector. Hence, the lack of land & labor reforms coupled with investment concentration in corporate sector, we have experienced years of jobless growth and with such a model, we are now risking running into the earlier mentioned middle income trap.

However, there is an even bigger and blood-curdling take away from this whole debate; the slowdown we are experiencing may not be cyclical at all and there are even bigger root causes or structural issues behind it.

As mentioned above, the 90s brought with them willingness in the government to allow private enterprises to enhance their foothold in the Indian economy. Up till then, there was large pent up entrepreneurship within Indians which was allowed to release, resulting in setting up of several businesses in India, primarily in the services sector. As discussed earlier, this led to rapid economic growth and rising incomes, albeit in an unsustainable manner. However, what it did result in was that at the turn of the century, there was a new India, which was growing rapidly at a nice 7-9%, incomes were rising and people wanted to improve their standards of living. This in turn gave rise to an India which

suddenly wanted greater investments and improved infrastructure. All this required money (investments) and these come primarily in two ways, savings and credit. The early 2000s saw no dearth of savings as incomes were rising. Next, there is credit which saw a massive spurt in demand around that time as well. This demand was for financing rural consumption (retail loans) as well as for investment purposes and infrastructure purposes in the economy. This surge in demand was in part what led to the sudden meteoric rise of NBFCs or Shadow Banks. So here's the picture, it's the beginning of the 21st century, we have a promising economy which is bound to rise and keeping that in mind, corporates make lofty projections for the future and consequently take credit. Banks also feel likewise and happily lend the same and also heavily invest in big infrastructure/construction projects.

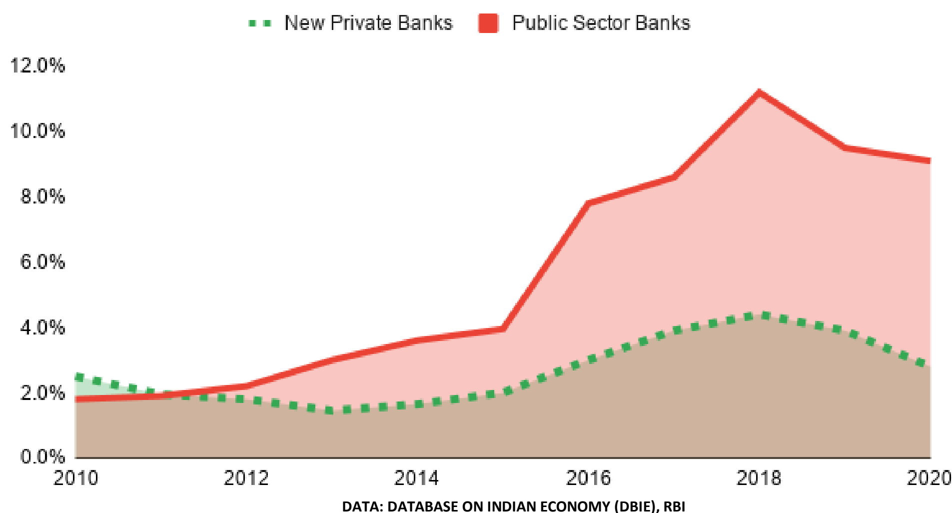
CREDIT GROWTH IN INDIA OVER THE PAST TWO DECADES



DATA: TRADING ECONOMICS

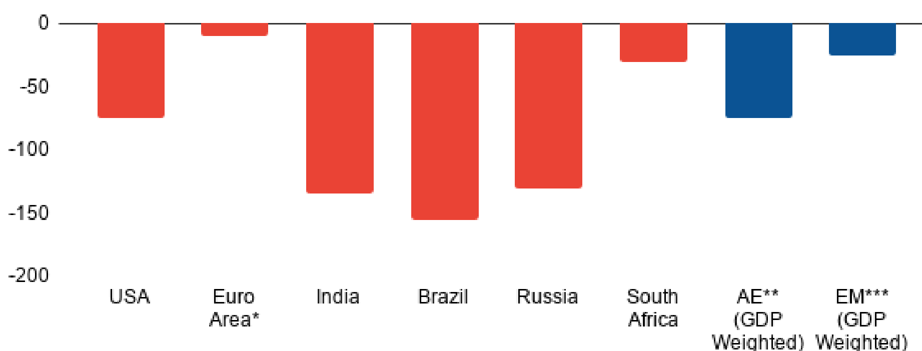
However, within the first decade of the 21st century, these prospects came crashing down. In 2008, the great recession struck and left the financial ecosystem of several major economies in doldrums. While the Indian economy didn't enter a recession, the growth prospects took a big hit.

Flaws in the Indian Financial Ecosystem: To this day, Indian policymakers pride themselves on that fact that the big crisis in 2008 could never get a strong foothold on Indian shores. This is in part the problem, the economies which had got battered by the crisis had consequently made concerted efforts to analyse the flaws in their financial system and take stock of the bad loans given out leading up to it. On the contrary, in India, no such efforts were made and the bad loan problem was never understood in its true potential. In the aftermath of the crisis, corporate profitability took a big hit (resulting in diminishing financial savings) and several huge infrastructure & construction projects were stalled. Essentially, most of the promising loans which had been doled out went bad. An ideal situation would have demanded that the banks declare these loans as NPAs & take the firms for bankruptcy proceedings and allow a new league of corporate to come forward to whom the banks would have now lent in an effort to salvage the economy. On the contrary what happened was that neither the corporate wrote off their investments/declared bankruptcy and neither did the banks declared them NPAs, instead, the corporate continued to borrow more in an effort to save themselves from insolvency and the banks also continuously give away good money after bad and under-reported their bad loans. Same was followed by the NBFCs (including IL&FS), the only difference being that poor regulatory oversight resulted in an even toxic culture- that of inflating project values, shortchanging partners, self-dealing by senior management, and building cozy relationships with civil servants. All of this continued well up till 2018 when the IL&FS fallout forced banks to see the harsh reality- they had extended their capacity and their finances were stressed. On the other side of this, corporate were now out of easy funding, meaning that the balance sheets of both the companies and the banks, were in distress. This problem is colloquially referred to as the **double balance sheet problem**.



DATA: DATABASE ON INDIAN ECONOMY (DBIE), RBI

An important point to note here is that with the NBFCs going bust and running out of liquidity, commercial banks have refused to bail them out as they have grown fearful after years of losing good money after bad and the aforementioned toxic culture of NBFCs which came to light in the aftermath of the IL&FS crisis. In general, banks have now become increasingly risk averse and unwilling to lend. This has had a very bad consequence; it has rendered RBI's monetary policy actions fruitless. During the present pandemic, in an effort to revive their economies, central banks world over have used monetary policy measures to infuse liquidity into their respective economies and while these measures often take time to reach the people, progress on this front has been abysmally disappointing. Despite multiple rounds of rate cuts and SLR cuts, banks have simply refused to increase their lending due to their extremely heightened risk averseness meaning short term rates at which banks obtain loans are low and the long term rates at which banks extend loans continue to remain high. Further, costly borrowing in times of recession gives rise to an economy which is producing less, consuming less and is adding scanty amounts to the government coffers. This may even limit the avenues for faster economic growth in the future. In fact, according to Crisil, about 10% of real GDP may be lost permanently post this crisis.

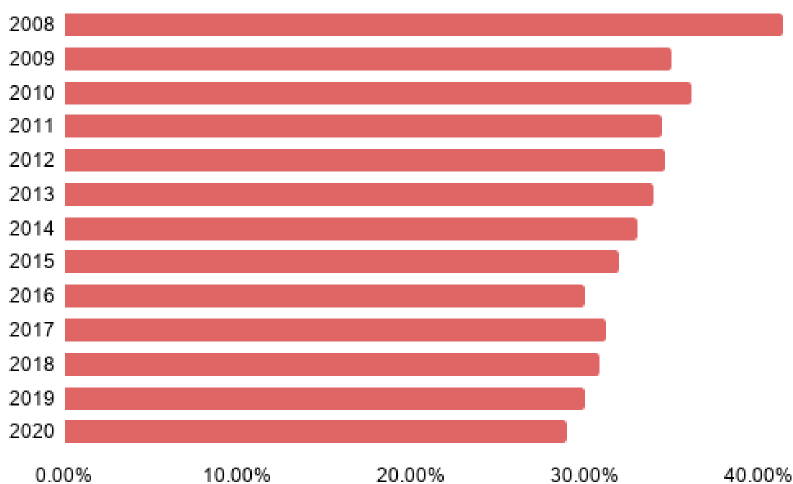


*ECB's Deposit Facility Rate, **Advanced Economies, ***Emerging Market Economies

DATA: TRADING ECONOMICS

In some cases, businesses are likely to be hit even directly by this wide gap between short term and long term rates. One particular case will be that of contractors building roads for NHAI. Currently, Indian highways are built under the Hybrid Annuity Model (HAM) wherein the government pays a small portion for the job beforehand and the remaining over 10-15 years with interest. Hence, the developer finishes the project by obtaining loans from the bank and then repaying it using the remuneration received from the government over the years. The problem is that the interest they receive the government on the payments is linked to the short term policy rate and the loans they obtain from the banks carry the high long term lending rate as a result of the slow or non-existent transmission of policy rate cuts onto lending rates. This means that the interest they are receiving from the government is coming down while the interest on their loans isn't i.e. the contractor's ability to repay his/her loans using the profits is getting humbled. According to ICRA Ltd., "On a cumulative basis, for every 25 bps (basis points) decline in bank rate, the cumulative debt-service-coverage ratio (ability to service debt through profits) of the developer reduces by two bps,"

Dipping Savings: As mentioned earlier, in the aftermath of the 2008 crisis, corporate profitability took a big hit in India and several major infrastructure projects were stalled. As a result of this, wages and salaries went down along with profits of entrepreneurs. All this meant that households now had to dip into their savings or take credit for financing some of their consumption needs, this often included short term and basic essential consumption. Hence, household savings as a source of investment in the economy also started diminishing.



DATA: DATABSE ON INDIAN ECONOMY (DBIE), RBI

Over the years, the aforementioned structural issues have had a dampening impact on the Indian economy.

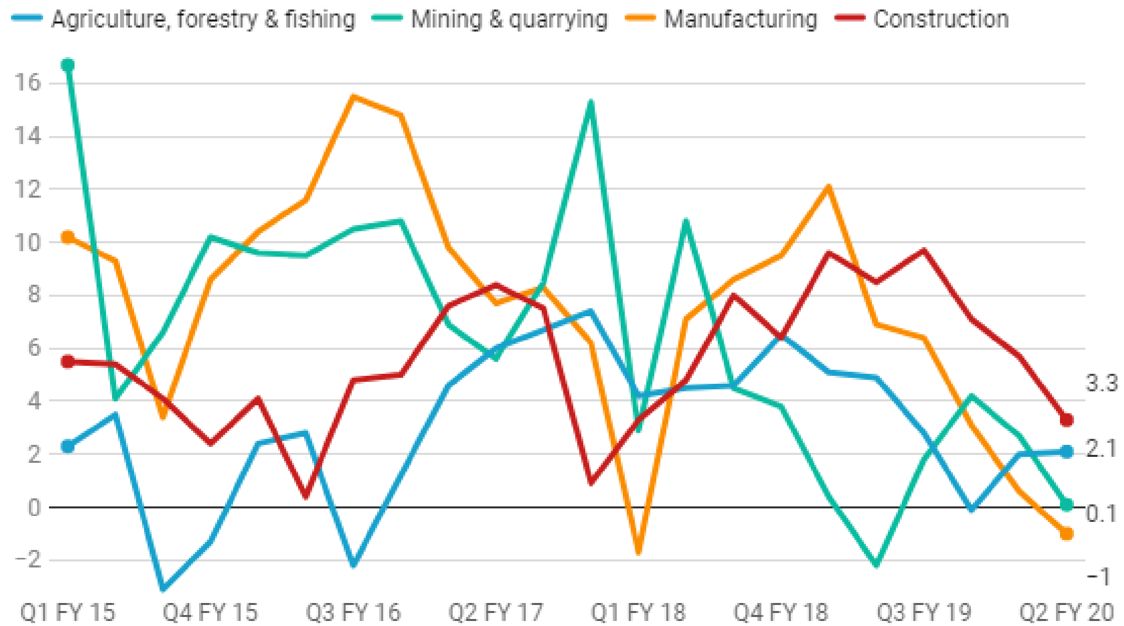
Creation of new jobs went down as a result of a restricted economic environment. Not to mention, only a few high skilled jobs were being created in the services sector.

Investments and Infrastructure spending went down as household & financial savings collapsed and good credit wasn't available (good money was being given away after bad money).

Industrial production lost steam. To add to this, the trend of decreasing globalization in the past few years where countries are increasingly trying to

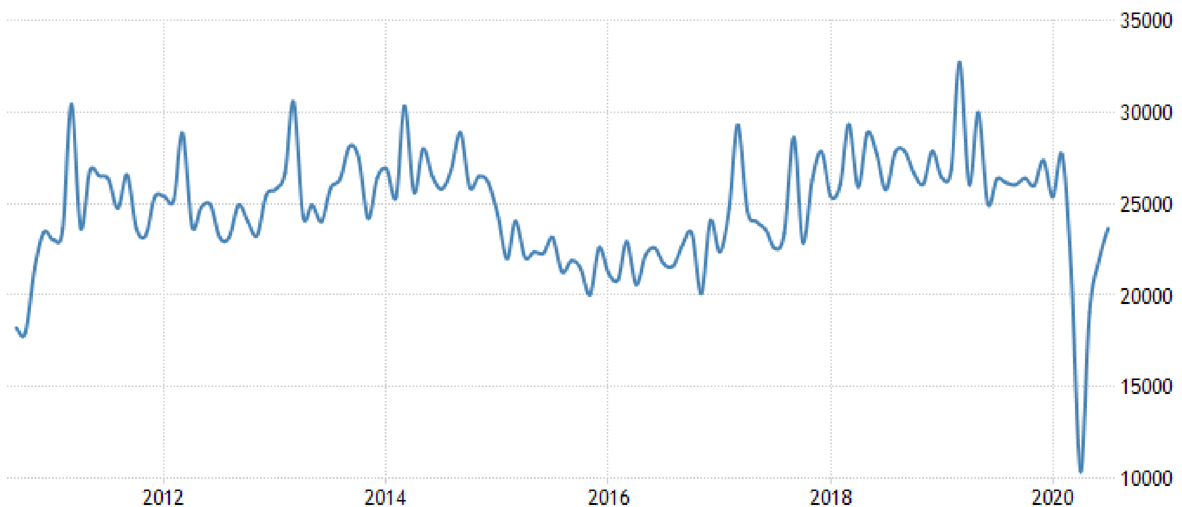
restrict imports so as to protect their domestic producers means that India's manufactured goods were finding the global market increasing hostile and India's aspirations to become an export hub also tanked.

CORE INDUSTRIAL ACTIVITY HAS LOST STEAM OVER THE LAST 5-YEARS



DATA: CENTER FOR MONITORING INDIAN ECONOMY

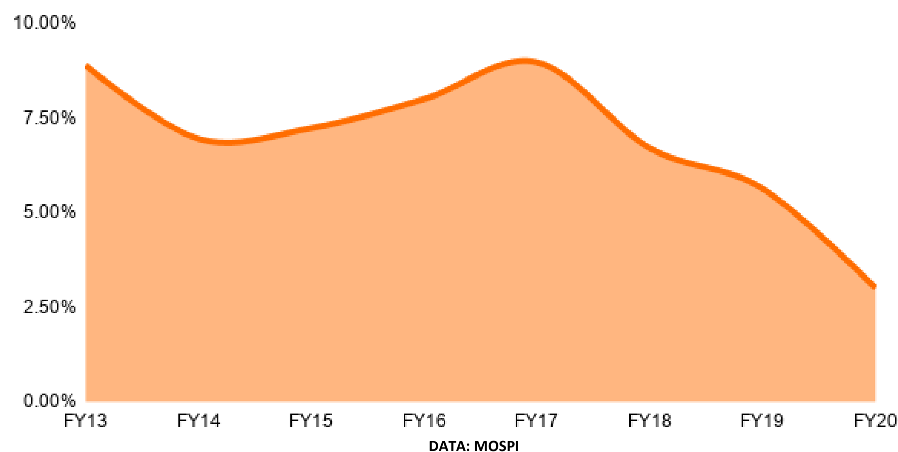
EXPORTS HAVE EITHER STAGNATED OR GONE DOWN OVER THE LAST DECADE



DATA: TRADING ECONOMICS

What this all means is that over the past 5-6 years, India has become a single-engine economy wherein the consumption of its produced goods by its own people is the driving force behind its rapid growth. Such a growth is considered very misleading as this means that there is scanty government expenditure and infrastructure spending, something highly essential for a developing economy. In such an economy, a dip in consumption would mean that there is hardly any backing from infrastructure spending and global demand to salvage the economy from entering a slowdown.

The slowdown which began last year is essentially our worst fears come true. Over the past few years, India's growth was being driven primarily by domestic consumption. The effects of nose-diving household savings and increasing unavailability of credit coupled with the twin shocks of demonetization and hasty implementation of GST meant that the one remaining engine also suffered a flameout and took our economy towards a slowdown. The Corona virus pandemic, with its extremely harsh lockdown which totally clamped down on economic activity proved to be the final nail in the coffin. It simply accelerated the process and threw the economy into a recession a little sooner.



THE CHALLENGE AHEAD: GETTING THE ELEPHANT BACK ON ITS FEET

Getting India's economy back in the green, while not being easy, is certainly straightforward as it is absolutely clear what is required. The need of the hour is large scale structural reforms.

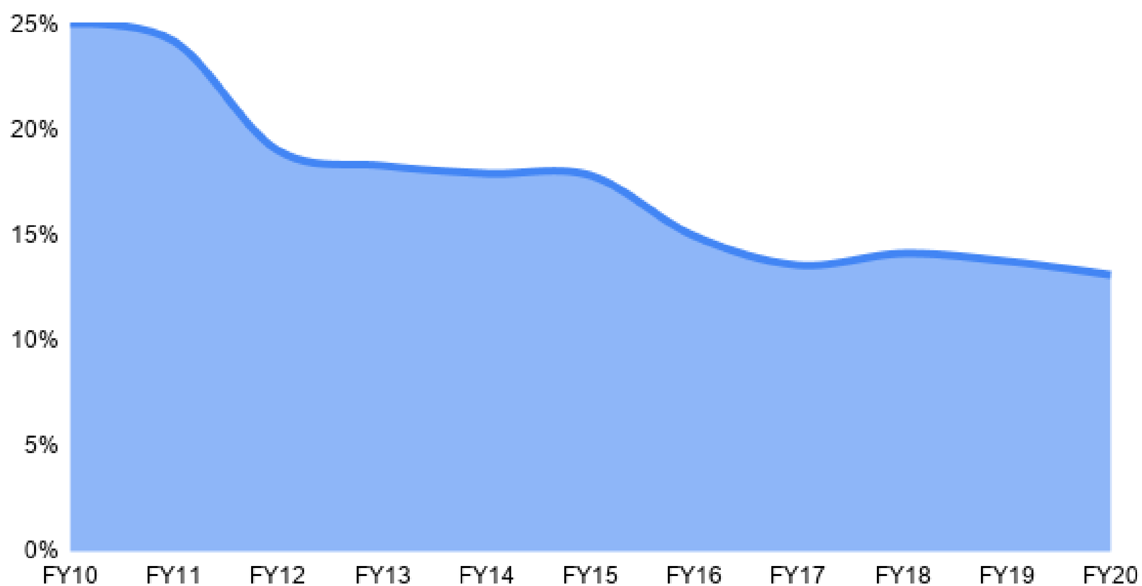
The first and foremost step that needs to be taken is to reform the financial sector as easy availability of credit is essential for any developing economy. This would involve subjecting NBFCs to the same regulatory regime as scheduled banks. In addition to this, the RBI needs to resolve the NPA problem which can be done by making banks recognize bad loans, accept that the borrower is never going to pay back the loan, take over the company, sell off assets and recover some of the money. A common opinion is that the present precarious situation of the banks has been brought about by the phasing out of Development Finance Institutions (DFIs). The 90s saw the beginning of the end of DFIs or DFIs converting to commercial banks (IDBI, IDFC, etc.). It was routinely warned at that time that this could have serious implications as experts believed that banks which have short term funds are not well equipped to handle long term financing or projects with a long gestation. The results of this misadventure are now apparent with banks riddled

with bad loans in infrastructure projects and most banks now showing reluctance with regards to handling such projects or doling out credit for large projects. Such behavior on part of the banks can hamper growth prospects for the economy. Therefore, it is essential to set up DFIs for the specific purpose of building infrastructure in India.

Next, it is essential to revive domestic consumption which essentially entails two things, large scale labor and employment-related reforms. These will also serve to increase household savings which will go a long way in bringing back investments in the country. Further, in the present scenario where people are entirely losing out on their sources of income, it is also important for the government to(i) directly put cash in the hands of people so as to revive the demand side, without which the economy can't grow irrespective of the health of the supply side. This is something which has also been emphasized upon by Nobel laureate Abhijit Banerjee on several occasions.

However, reviving investment is just a part of the resolution. What is equally important is to ensure that these investments are channelized properly i.e. like before, they don't just end up making their way to the services sector because as mentioned earlier, India still lacks a robust manufacturing sector and the agriculture sector is under-developed and highly inefficient. It is necessary to channelize funds towards these sectors as being labor intensive, they will enhance employment opportunities in the country. By creating a robust manufacturing sector, we'll also be increasing competitiveness of Indian goods in the global exports, thereby, increasing exports.

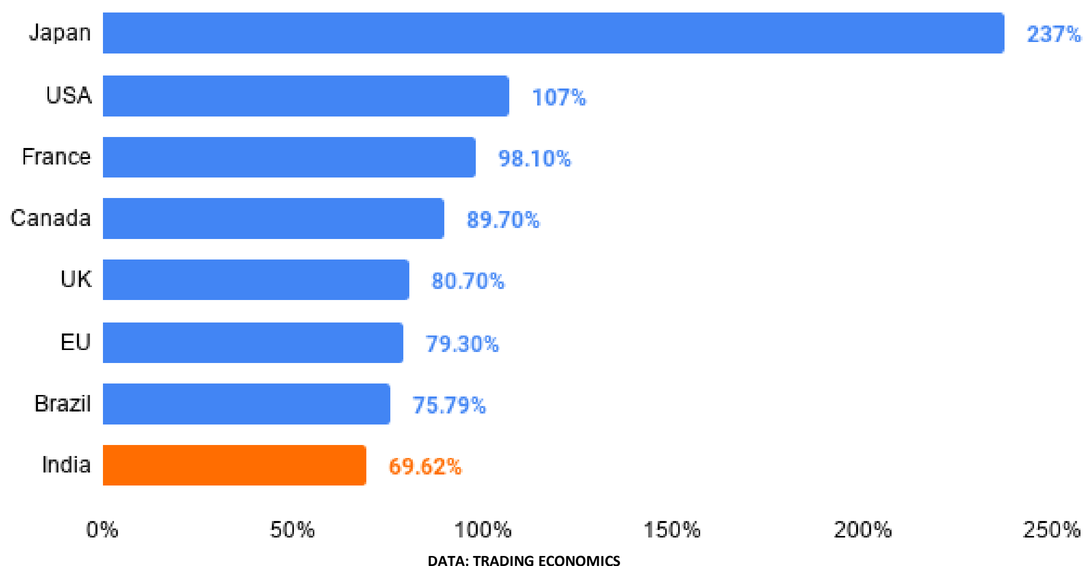
Lastly, divestment of PSUs is also important for reviving the economy. The premise on which this argument is based is simple; PSUs end up hogging a vast majority of public savings which they then deploy highly inefficiently as a result of a powerless board of directors and priorities foisted on them by politicians.



DATA: PUBLIC ENTERPRISES SURVEY, DEPT. OF PUBLIC ENTERPRISES, GoI

In these uncertain times when the sole engine which had been driving the Indian economy is flaming out, it is necessary for the government to in turn, increase its spending. So far, the government's stance on this has been utterly disappointing with its overhyped 20 lakh crore relief package majorly comprising credit guarantees. According to a research by Nomura, this package translates to an increment in budget deficit of a mere 0.8% of the GDP. Further aggravating the problem is the fact that the government may have to possibly bailout certain PSU banks after this crisis on its own budget due to a drastic rise in NPAs. According to a report by McKinsey and Company, India's already phenomenally high NPA ratio of 9.3% (compared to other major economies) may further rise by another 700 basis points. Even the RBI has warned of this now. The threat of bailing out banks could end up being another painful nail in the coffin for the government already nailed down by rising welfare expenditure and falling tax revenues.

Now, the only way forward for the government is going for deficit financing. Since the times of uncontrollably high inflation, policymaking has largely supported the idea of not converting public debt into interest free money and this has become a sort of a dogma which is now preventing the government from doing the right thing. Since 2015, the RBI has also been aiming to target inflation in the hopes of strengthening the currency and helping India get access to a lower cost of capital but now, workers are stranded without jobs or pay. Firms are failing, lenders are piling up bad credit, and state governments are running out of funds. In a recent Bloomberg article, the author says that it's crucial to secure financing worth at least 13% of gross domestic product in federal and state deficits for saving the economy. While inflation rates may rise and the rupee may weaken but these effects will be temporary and they can be overcome once the crisis gets over and with a debt-GDP ratio which is lower than most developed and emerging economies, India can easily afford to put on more debt.



DATA: TRADING ECONOMICS

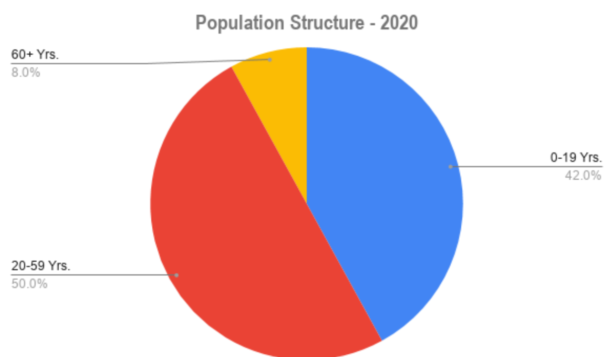
The government can also take advantage of the previously mentioned suggestion regarding divesting PSUs; a popular opinion is that the government should sell these stakes to a special purpose vehicle run by, namely the National Investment and Infrastructure Fund Ltd. The SPV will finance the purchase by issuing sovereign-backed debt. When market conditions improve, it will sell its stakes and redeem the bonds.

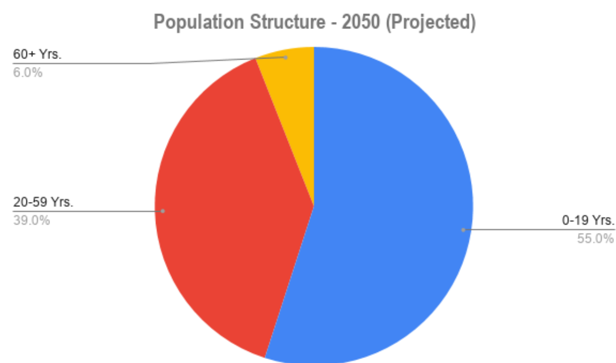
Whatever funds the government can raise, it should try to use them by having the healthcare sector at its focus as India's already shanty health system needs more spending amidst this major health crisis. This will also boost construction and create more jobs (the unemployment rate has widened to a whopping 23% in the past two months). In certain private companies such as airlines, the government may also have to infuse equity. In addition to this, the government needs to create more of essential infrastructure such as highways, airports and sea ports on its own funding and private investments in this area may take some time to revive post this crisis. These will also create highly important employment opportunities and in a way, compensate for the loss of jobs, primarily in the unorganized sector.

Lastly, another great task ahead of India is to capitalize on its demographic dividend. It is quite common for Indian lawmakers to go about boasting in international forums about how great India's demographic structure is with a large young population capable of being part of our part of our productive workforce. However, the truth is that little has been done to capitalize on this advantage and for India to continue to grow in the future, it is essential that steps are taken in this direction now.

From a demographic viewpoint, India's population is presently at a stage where death rates are low and birth rates are falling. Further within that category, it is in the initial stage where the proportion of dependents (young and old) is miniscule compared to the working population (20-59 yrs.).

The implication of this is that the working age population has fewer dependents to support and has the room to save more which can in turn empower investments in the economy. These investments will add to economic growth. Not only this, Indian then also needs to prepare for the future. As time progresses, falling birth rates and present working population growing old would imply that in the future, there will be a relatively smaller working population and a larger number of dependents which essentially means that if India wants to get the most out of its demographic composition, it need to act fast and it need to act now.





DATA: NATIONAL COMMISSION ON POPULATION, MINISTRY OF HEALTH & FAMILY WELFARE

Hence, what is required is maximizing how much can be gained from the present demography which essentially means that the system is able to generate jobs for those seeking them. This is more important now because as mentioned earlier, there is the possibility to secure larger investments from a larger working population which India presently has. Hence, the task at hand entails ensuring that there is a proper health and education infrastructure in place along with the resources and governance capacity to keep all people employed. All of this will require quick and massive investments from the government's side.

The reason acting now is even more important is that in the future, with AI, automation and other advanced technologies, there is a possibility that regular unskilled jobs and those of factory workers will cease to exist. By investing in education and other means of maximizing demographic dividend now, it will be ensured that the future working population will have avenues to remain well-educated and adapt with the times so as to be perennially trained for the types of employment the future may present, thereby ensuring continued economic growth and prosperity.

CONCLUSION

As it has been discussed thus far, there are deep rooted problems within India's economic structure, which although, has delivered promising growth till recently, will most probably cease to do so in the near future. While the answer to the question, how to revive the economy is straightforward, what is actually difficult is bringing about these changes. These changes may be difficult but they are in no way impossible and will require dedicated efforts from the government in power to ensure this.

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