Government of Telangana

INDIAN ECONOMY – THE WAY FORWARD

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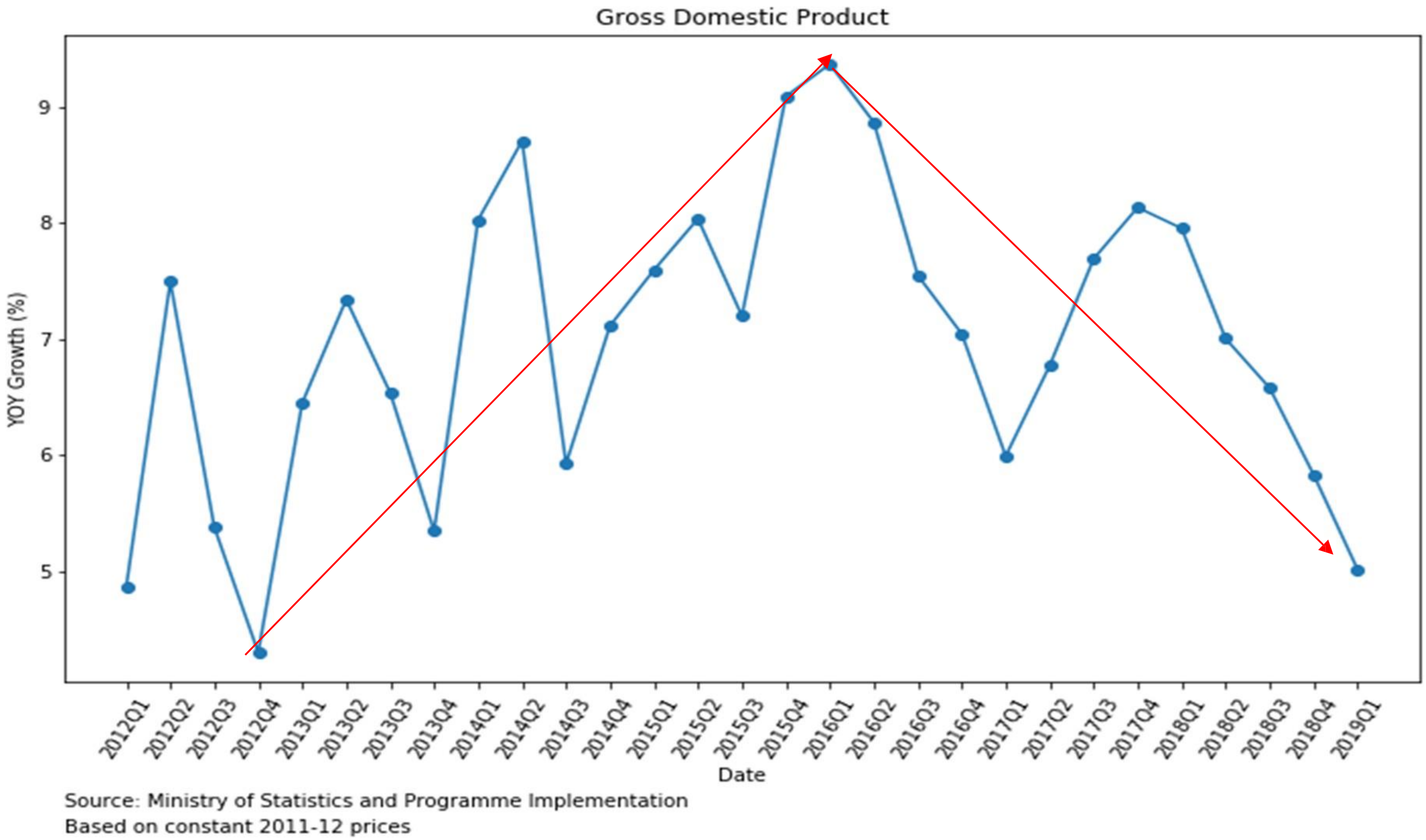
19th November, 2019

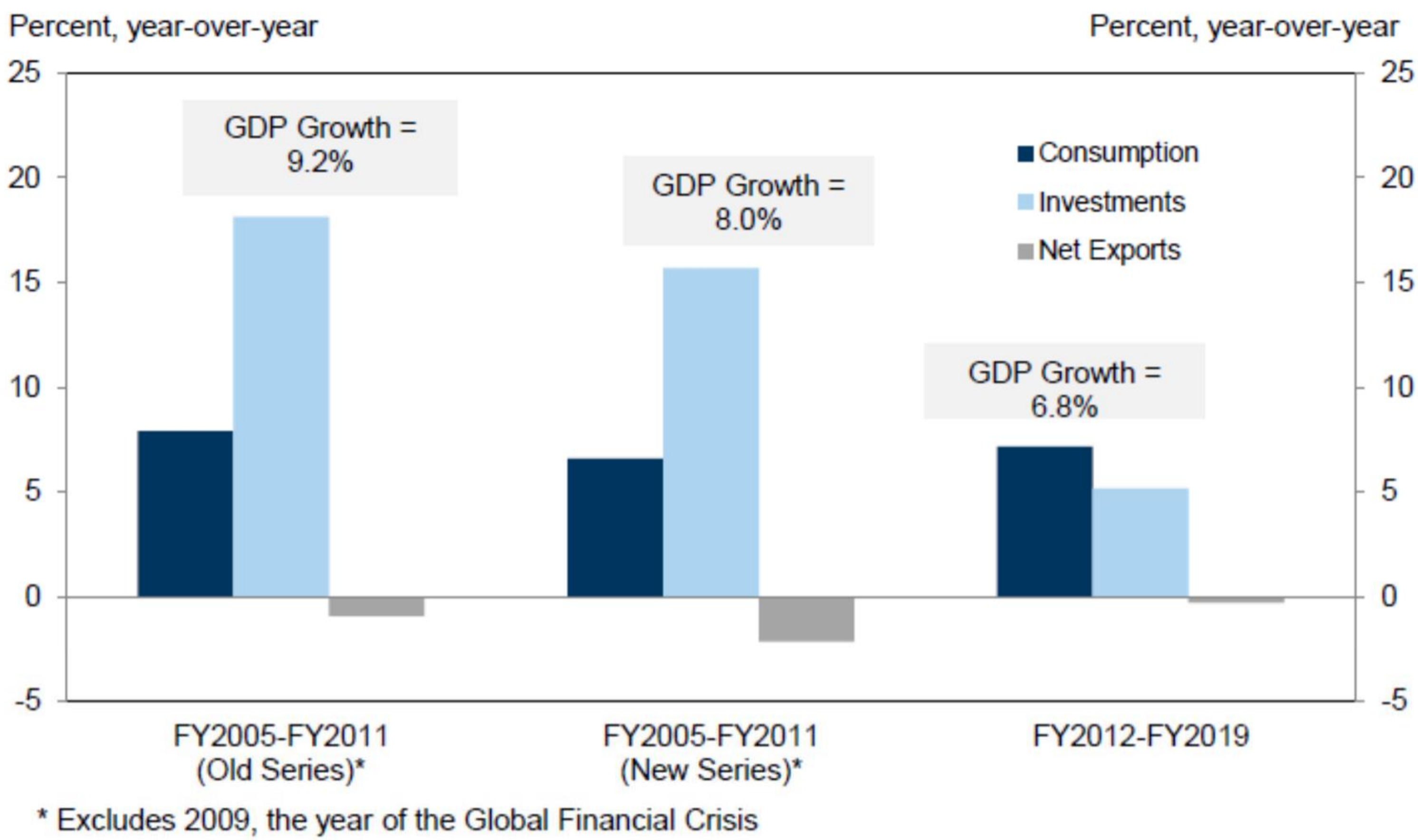
Outline of talk

- Signs of deep malaise in the Indian economy
  - Growth is slowing significantly
  - Fiscal space narrowing sharply
  - Debt and distress rising
- What are the roots of the problem?

Growth and de-growth (not UPA II and Modi I)

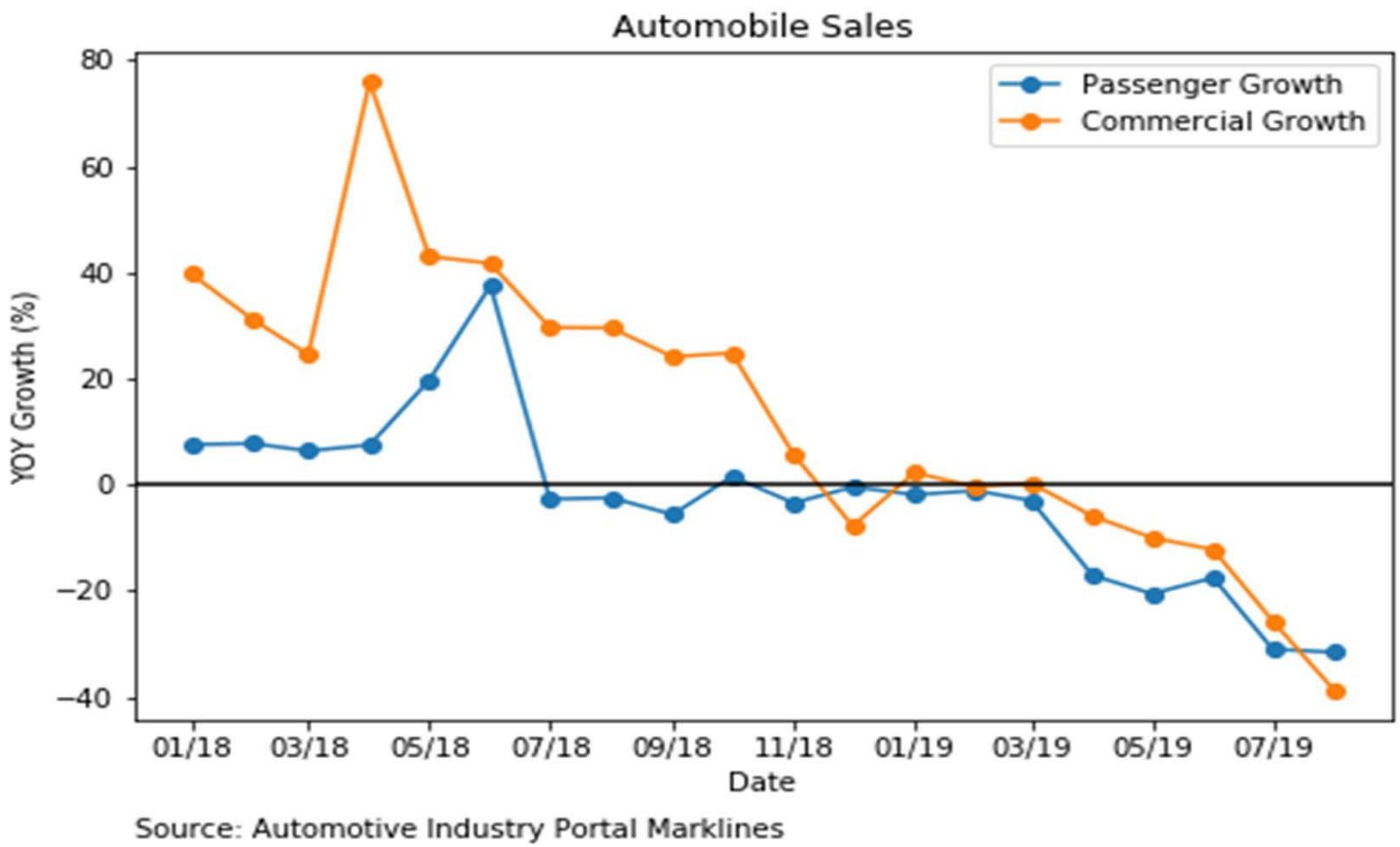


Long run trends => investment growth falling

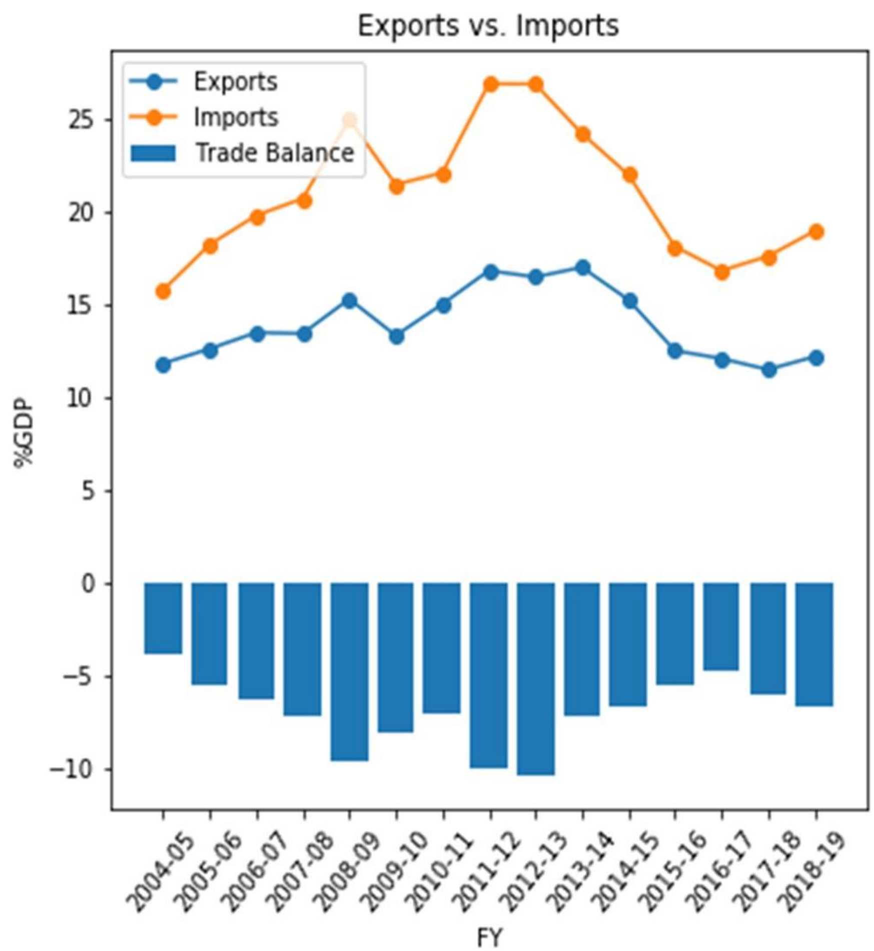


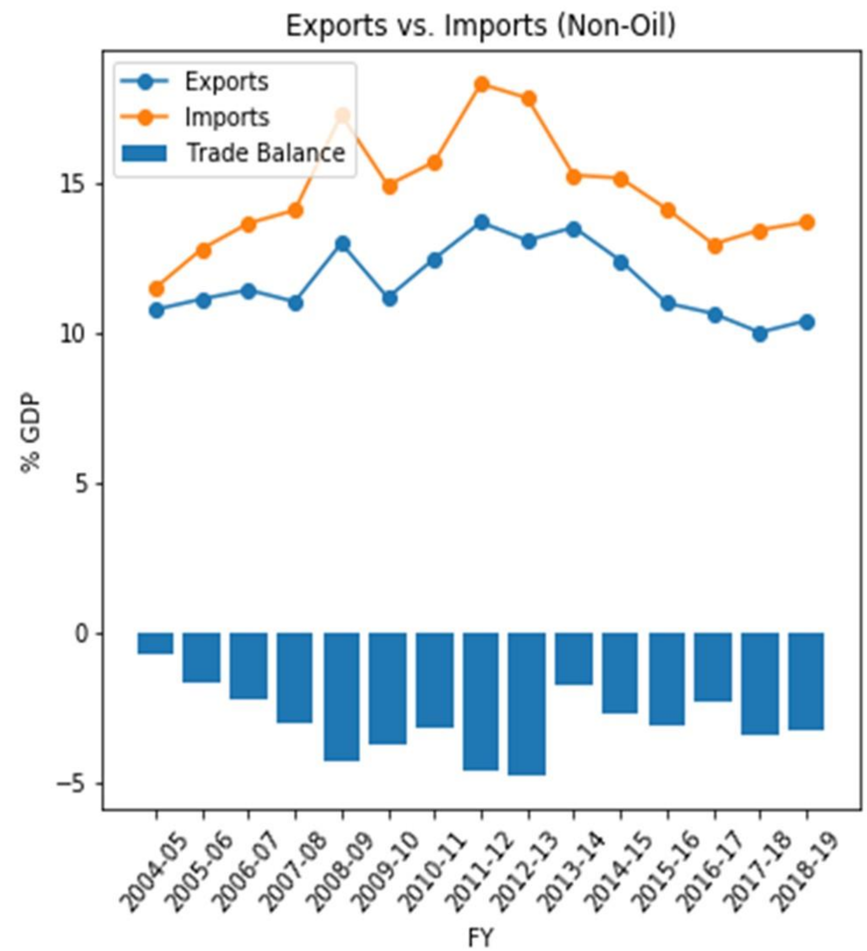
Source: Haver Analytics, Goldman Sachs Global Investment Research

Consumption was propping up growth – but it is slowing fast too



Trade Balance – exports have shrunk as a fraction of GDP



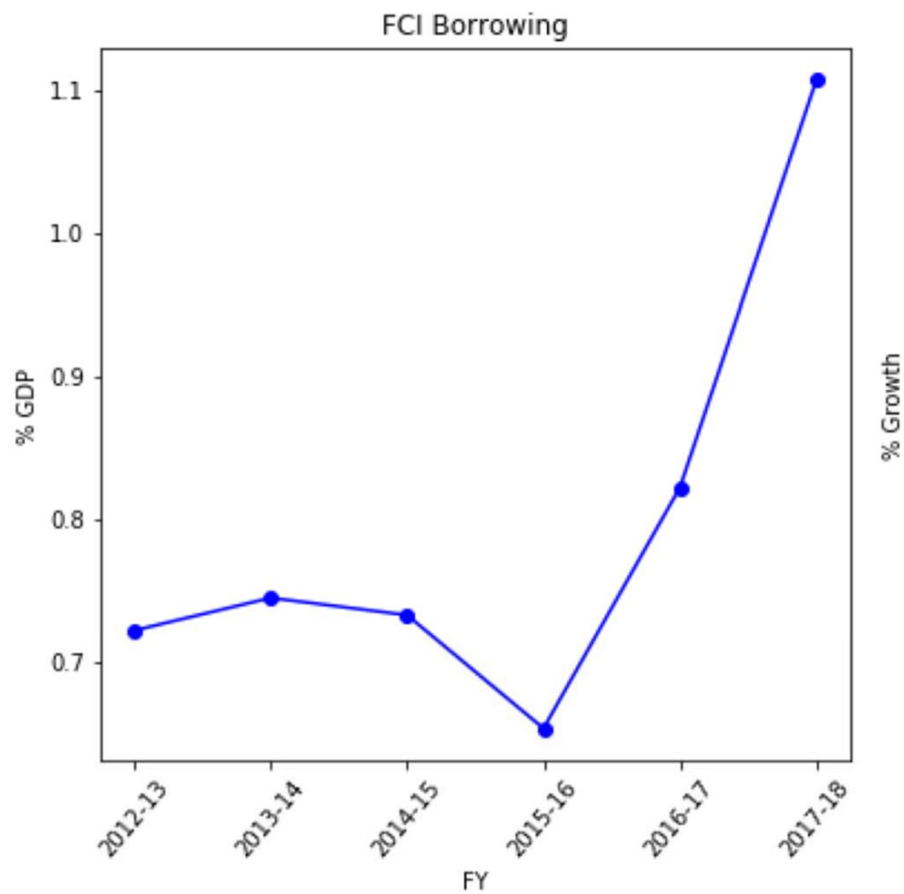


Source: Reserve Bank of India

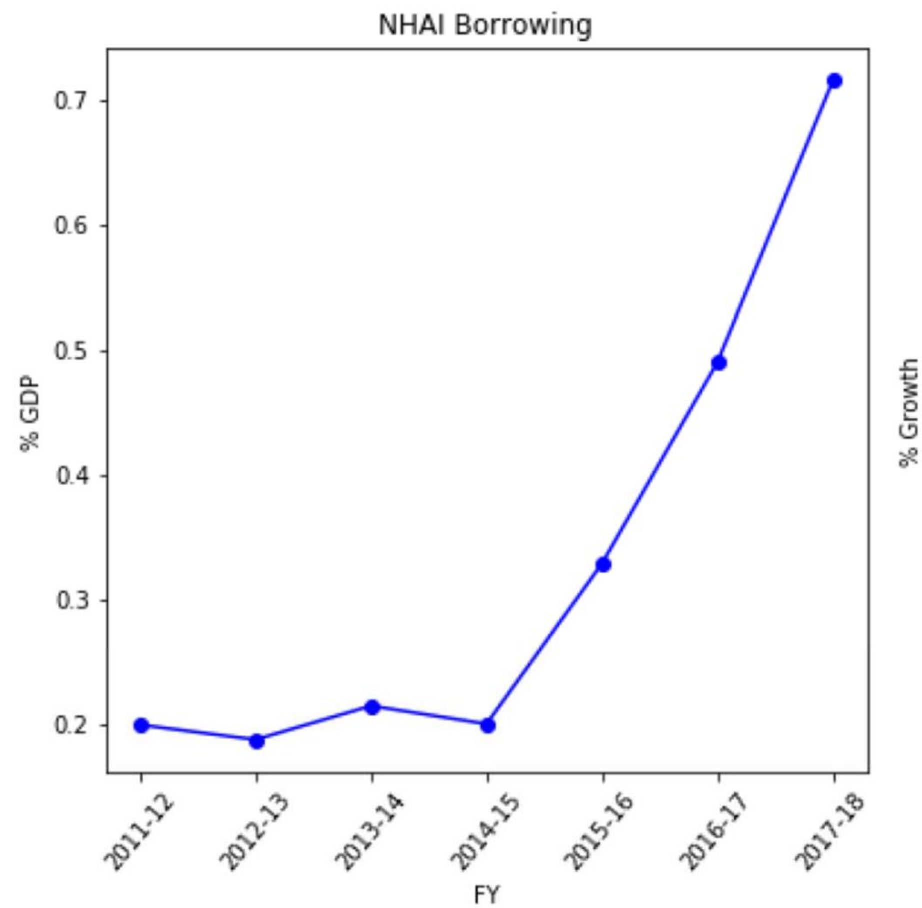
General government fiscal deficits – officially 7%…

- But estimated budget revenues are optimistic for both center and states…
- Corporate tax cut adds to burden
- Off-balance sheet borrowing (FCI, NHAI, PSB borrowing to pay government dividends) is sky-rocketing
- Contingent liabilities (NPAs, need for recapitalization and bailouts, healthcare commitments) rising
- Public sector borrowing requirement rising – between 9 and 10 percent of GDP today
- Private debt and distress are growing.

Off-balance sheet borrowing

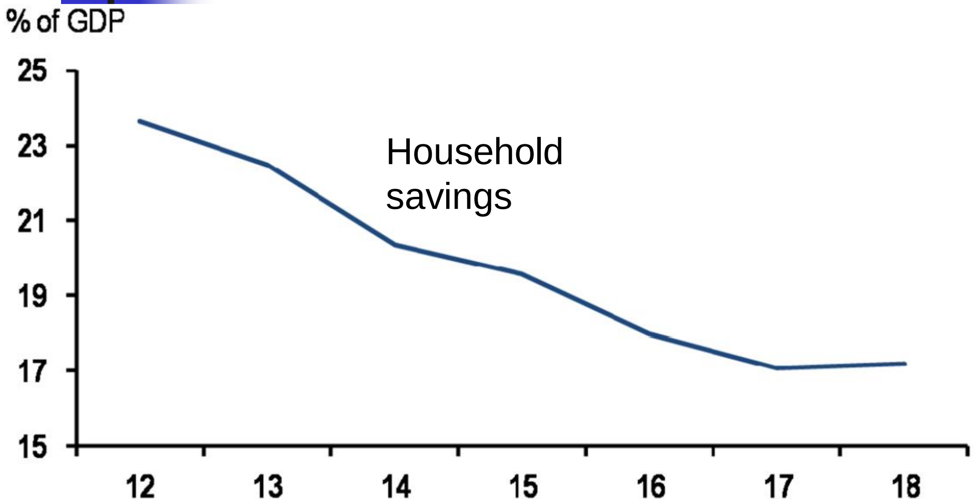


Source: Ministry of Finance and Reserve Bank of India

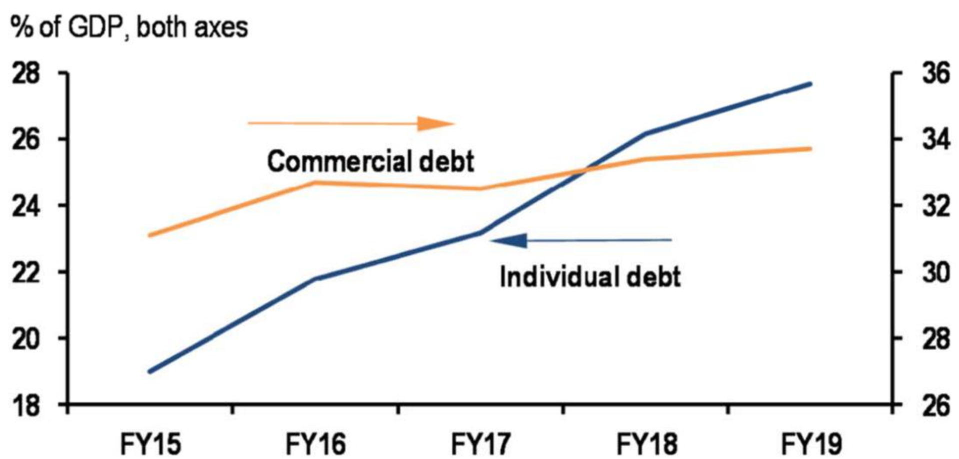


Source: Ministry of Finance and Reserve Bank of India

Private debt and distress rising…

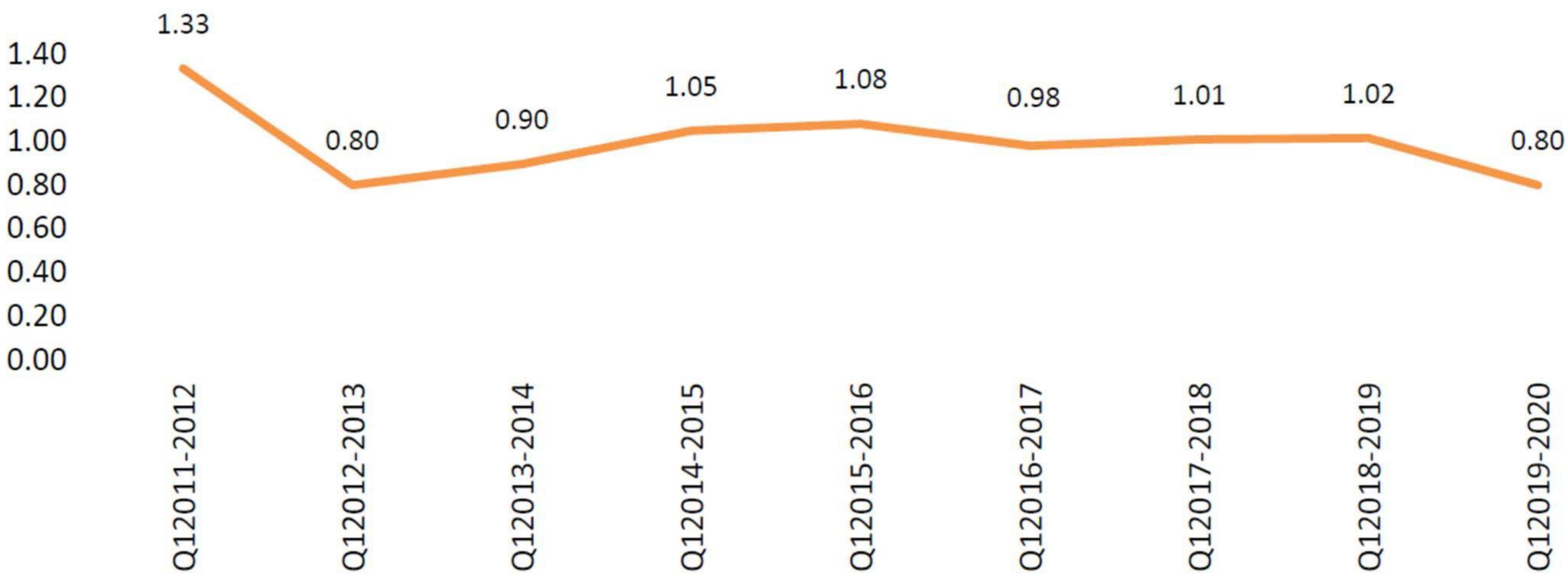


Source: MoSPI



Source: JP Morgan

Ratio of credit upgrades to downgrades at a six year low



Source: CARE

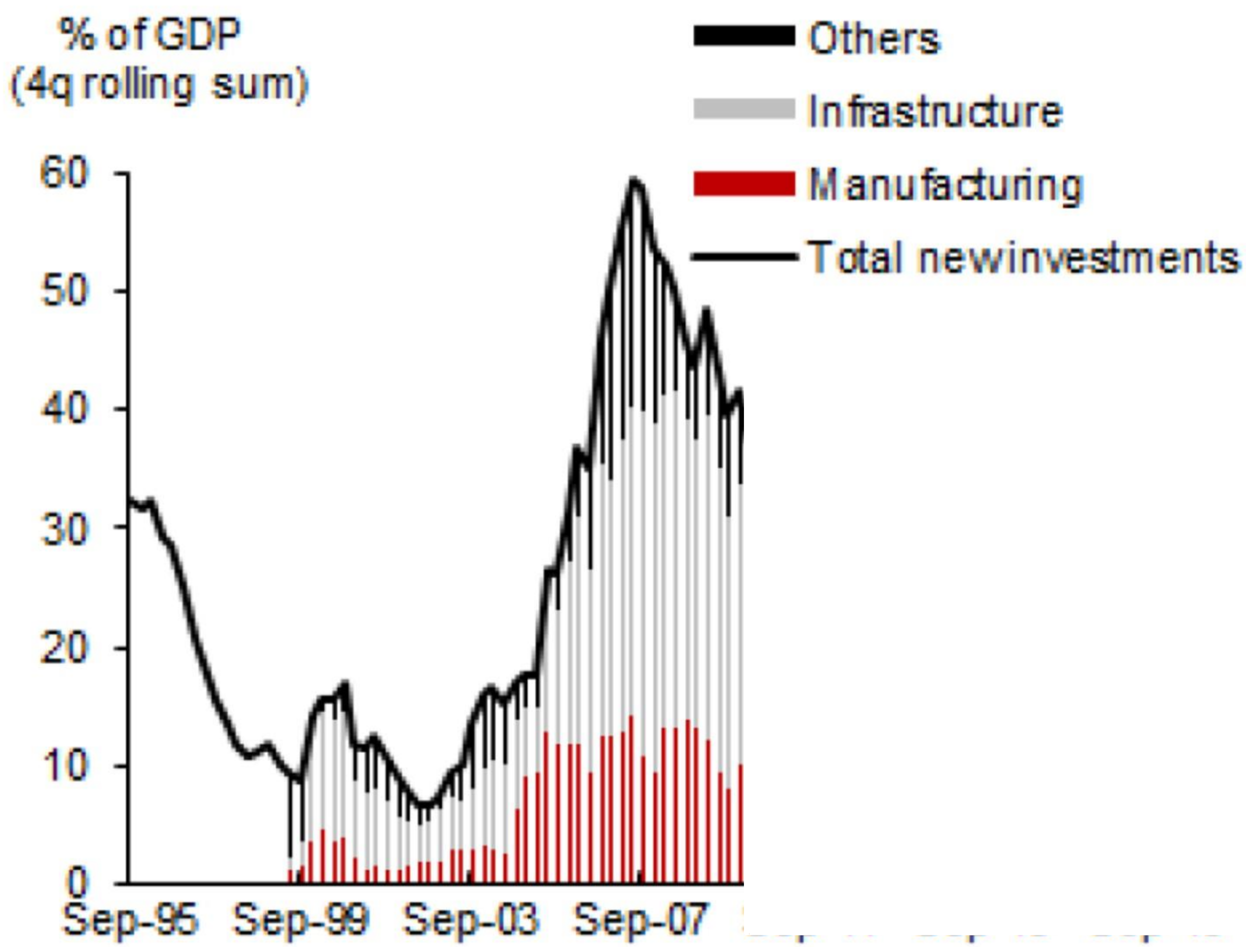
Outline of talk

- Signs of deep malaise in the Indian economy
  - Growth is slowing significantly
  - Fiscal space narrowing sharply
  - Debt and distress rising
- What are the roots of the problem?

Growth-friendly liberalizing economic reforms have been scarce since Vajpayee's NDA 1 (1999-2004)

- NDA 1 did not see strong growth despite significant reforms and its "India Rising" campaign did not convince in the 2004 election
- During UPA 1 (2004—2009) growth benefited from the lagged effects of NDA reforms but coalition partners limited further reforms.
  - Explosion in investment, including infrastructure, strong growth
  - Farm loan waiver rather than growth given credit for UPA's success in returning to power in 2009.
  - Strong growth also put pressure on existing institutions for resource allocation.
    - Land, iron ore, coal, spectrum…

New projects announced



Source: Nomura based on CMIE Data

Growth-friendly liberalizing reforms scarce since NDA 1…contd

- Corruption scandals during UPA II (2009-2014) …
  - Slowed further growth reforms as opposition turned uncooperative – e.g. GST
  - Refocus on distribution, which had wide support (e.g., food security bill), and expansionary fiscal policy to deal with spillover effects of Great Recession
  - Inflation in double digits
  - Growing road blocks e.g., land acquisition and permissions such as environmental more difficult, exacerbated by new laws and risk averse bureaucracy.
- Course correction on macro-stability started in 2012-13.
  - Government starts fiscal consolidation
- Reinforced by wake up call during taper tantrum in 2013.
  - RBI focused on reducing inflation

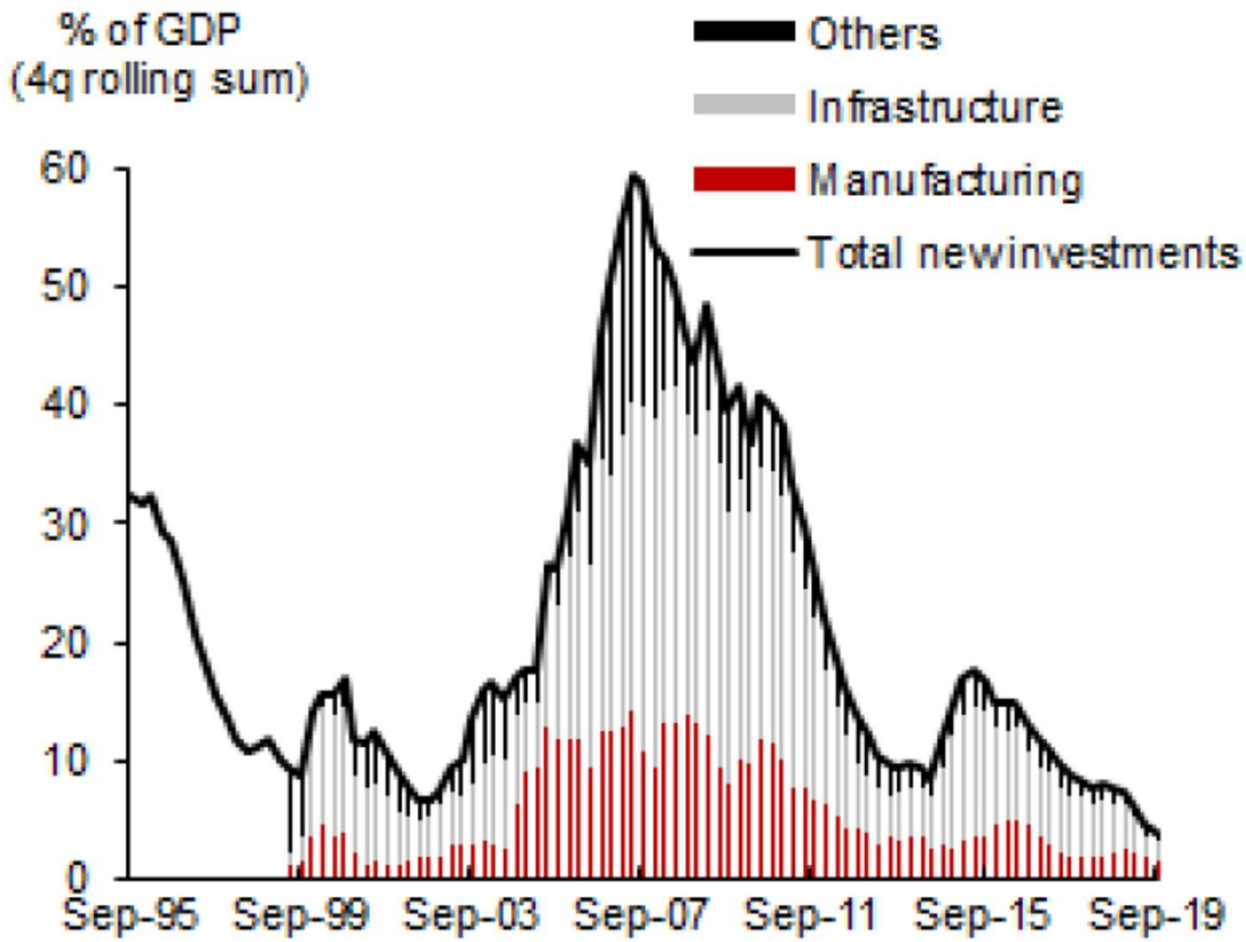
Growth-friendly liberalizing reforms scarce since NDA 1…contd

- Modi I came in with great expectations: platform of jobs, transparency, and traditional BJP elements like mandir.
- It set about implementing some important reforms.
  - Macro
  - Sectoral
  - Household focused/populist
- Unfortunately, mixed performance and outcomes.

Modi I – Macro reforms

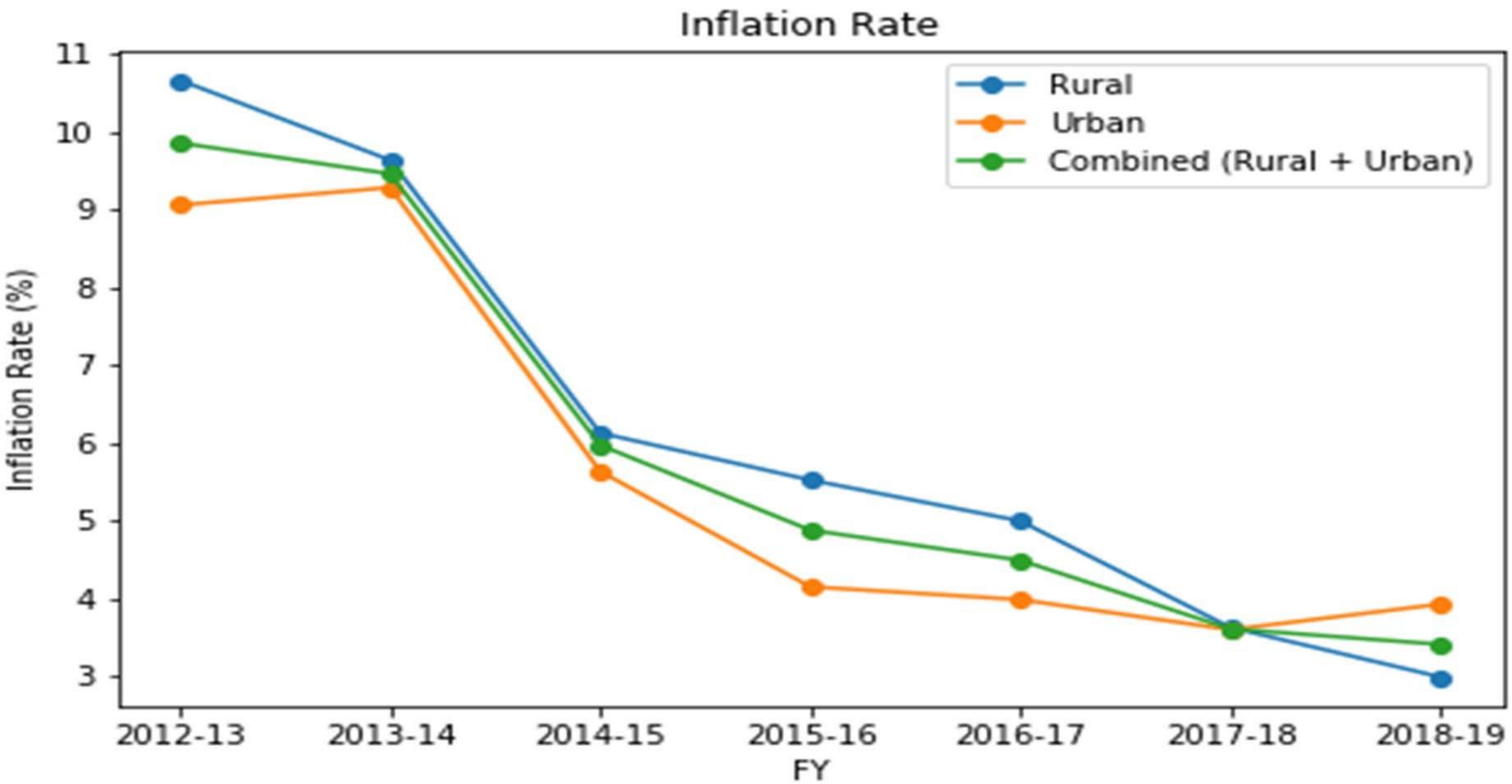
- Continued UPA II process of identifying project bottle necks and fixing them.
  - With diminishing vigor as promoters lost interest
- Approved inflation targeting by RBI
  - RBI undertook a series of reforms including opening up branching and licensing, improving retail electronic payments, and deepening fixed income and derivative markets.
- Approved AQR (banking sector cleanup), and passed Insolvency and Bankruptcy Code (IBC).
  - But bank recapitalization has been halting.
  - Promoters and judiciary are defanging IBC as they did previous debt resolution approaches.
  - Source of credit growth constantly shifts as sectors get into trouble.
- Demonetization
  - Misguided in concept, initiated without adequate preparation
  - Damage to informal sector hard to measure
  - Damage to construction and real estate maybe “just desserts” but holds back growth
- Goods and Services Tax
  - Sound in concept, initiated without adequate preparation, which undercut compliance, constant fiddling creates uncertainty

Investment keeps falling



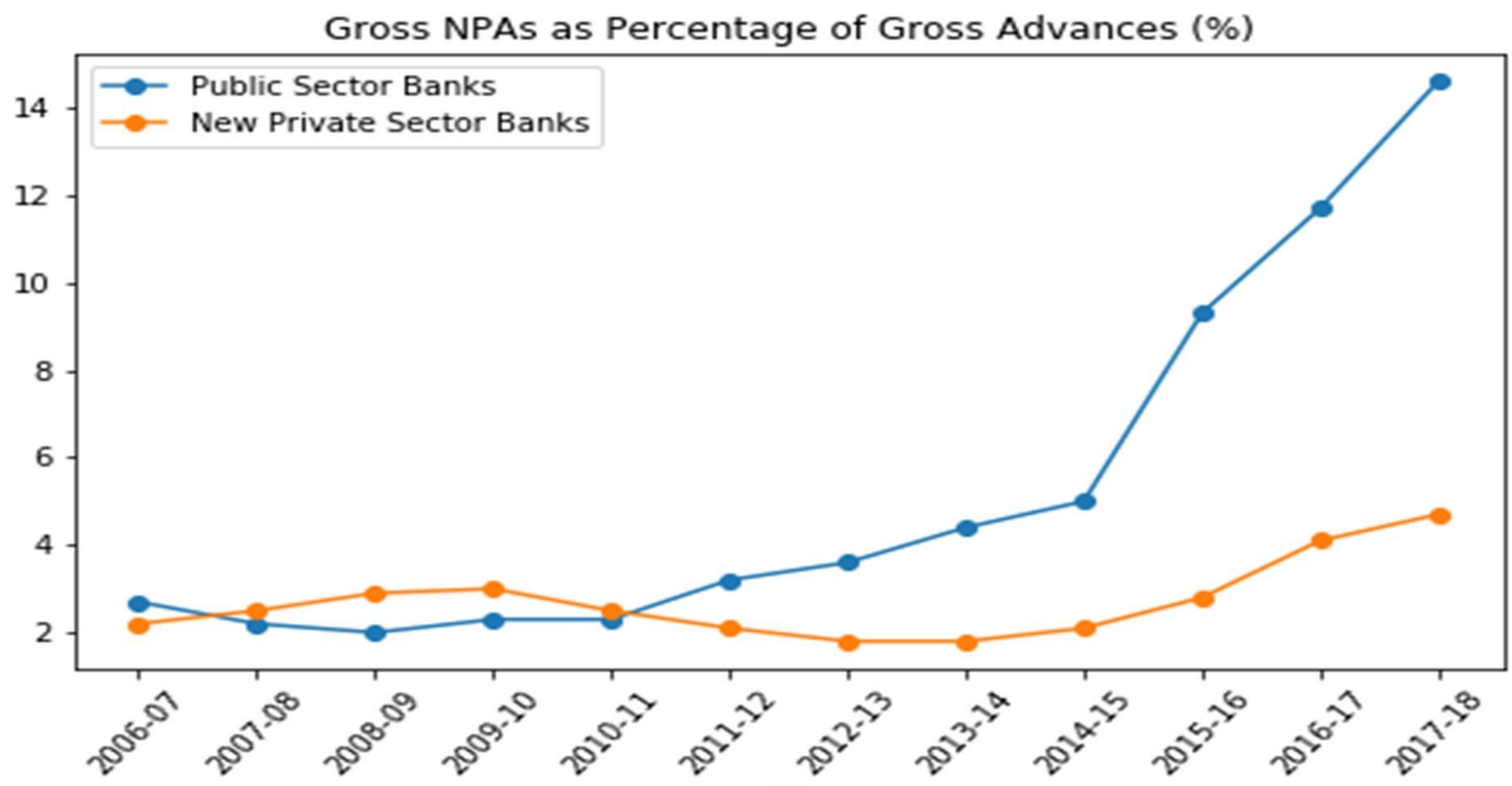
Source: Nomura based on CMIE Data

Inflation control…a success but yet to be fully tested



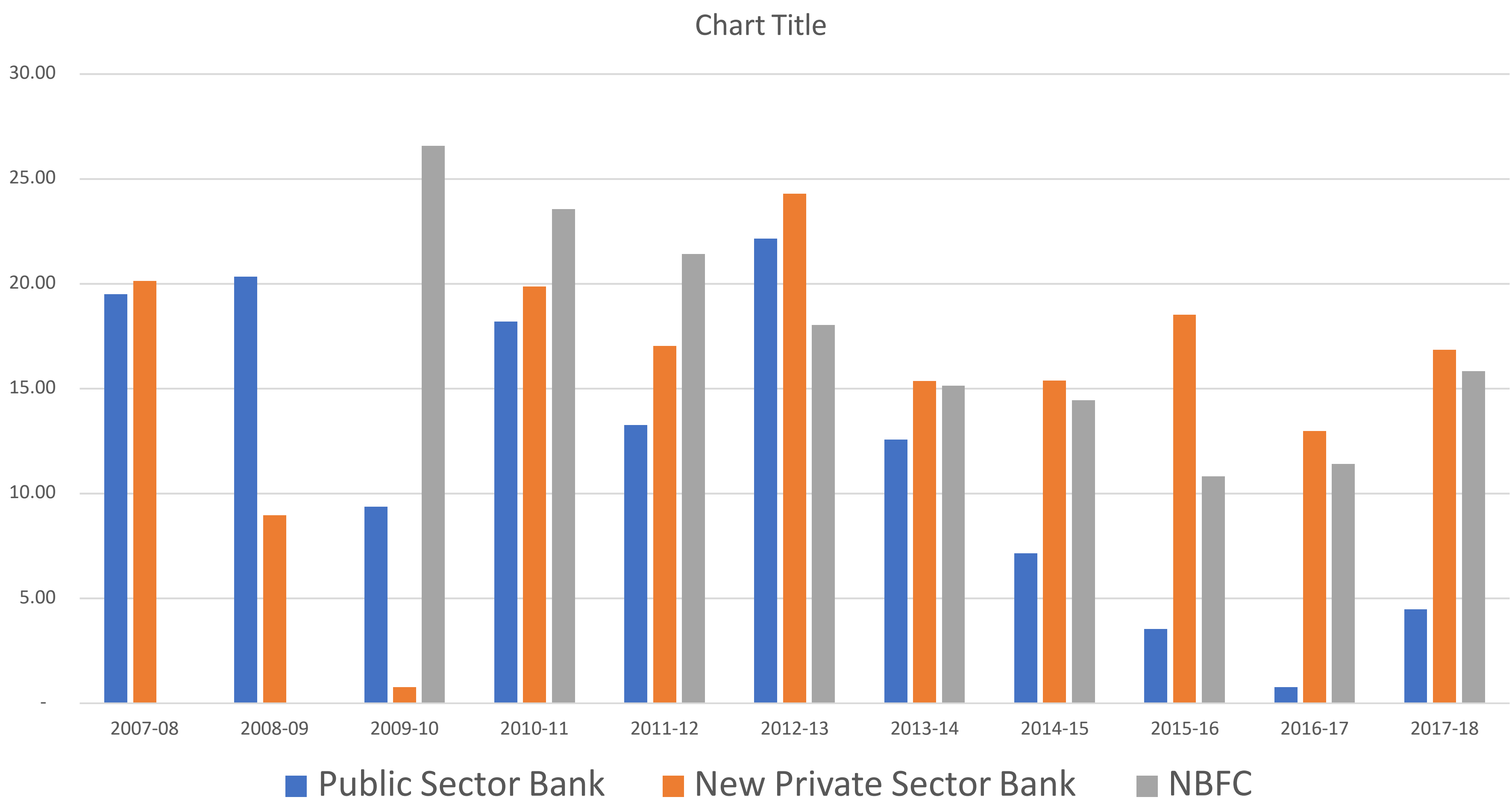
Source: Reserve Bank of India
Inflation Rate based on New CPI introduced from January 2011 (Base: 2012=100)

Rising NPAs, primarily in Public Sector Banks



Source: Reserve Bank of India

Locus of credit growth – constantly shifting as sectors get into trouble



MODI I'S SECTORAL REFORMS

Agriculture

- Objectives: Reduce rents and distortions, enhance productivity
  - Rising production and some reforms (e.g., crop insurance, DBT for fertilizers, e-NAM) but…
  - Not reflected in incomes as productivity growth has been modest, terms of trade have turned down
    - Distortions (costless power, overuse of water, overuse of urea, loan waivers) continue, absorbing resources and diverting production.
    - Agricultural extension, seed provision, and technology upgradation efforts inadequate
    - Fragmentation of landholding continues as tenancy yet to be formalized, increases risk aversion
    - Prevalence of middlemen moderately diminished, but still grab significant rents.
    - Periodic bans on exports favoring customers at the expense of farmers
    - Inadequate procurement in PDS, so support prices ineffective in many parts of the country
  - Inadequate value added to agri products through rural industry, in part because of inadequate links to final markets

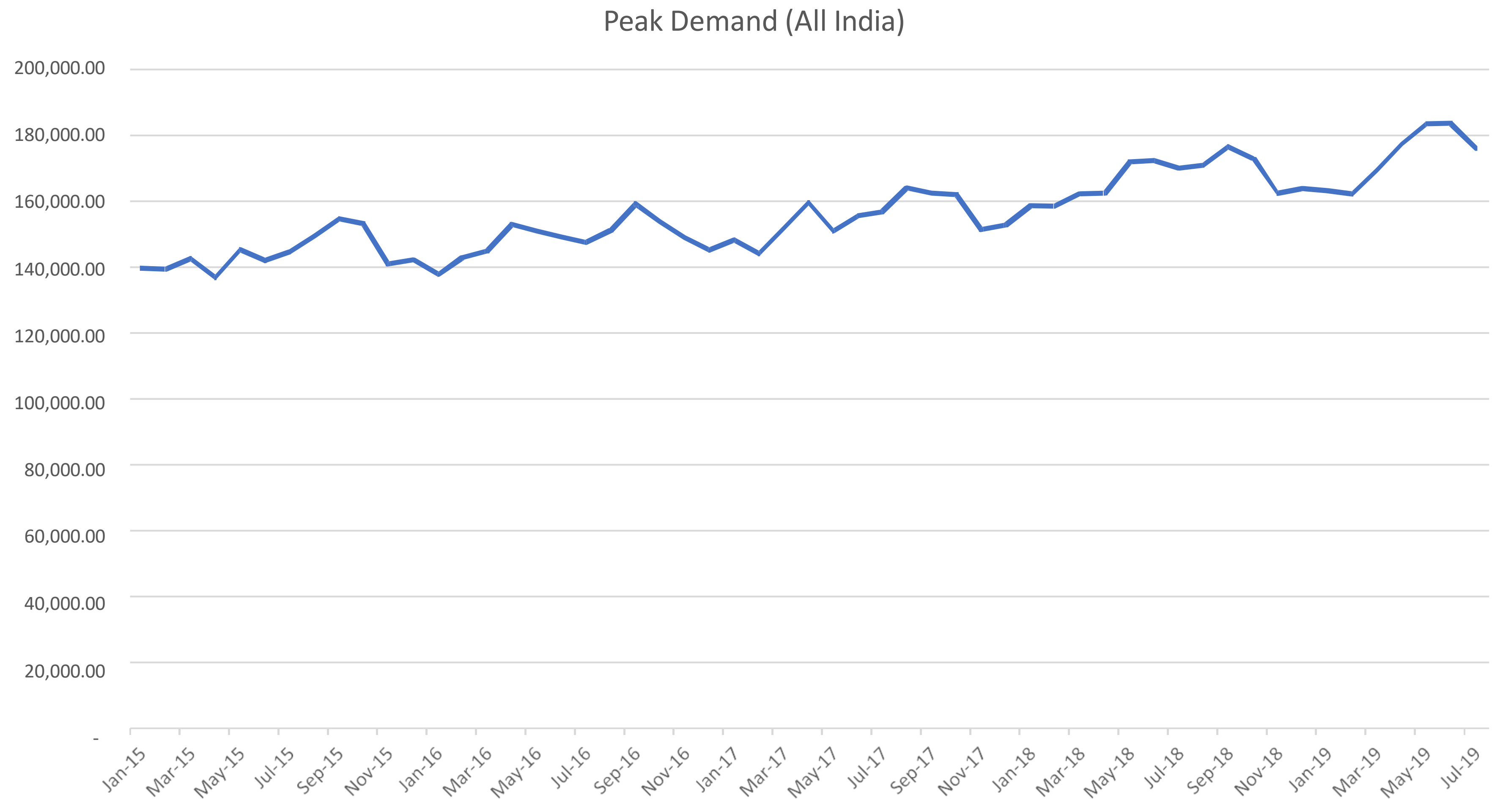
Falling terms of trade in agriculture

Source: Labour Bureau, JPM Research

Power

- Power sector objectives
  - Restoring power distribution companies to health: largely unsuccessful thus far
    - Uday – same focus on financial engineering… same outcome: Power underpriced, efficiency low, theft high, losses mounting
  - Moving to renewables: more success
    - Need states to adhere to contracts, and banks to be careful in lending.
    - Need adequate pricing of balancing capacity
  - Revive stranded power plants: work in progress
    - Underutilized generation, but we still lack 24-7 power through the country
  - Spread of electrification an important success.

Electricity supply growth steady at 6.5%, though



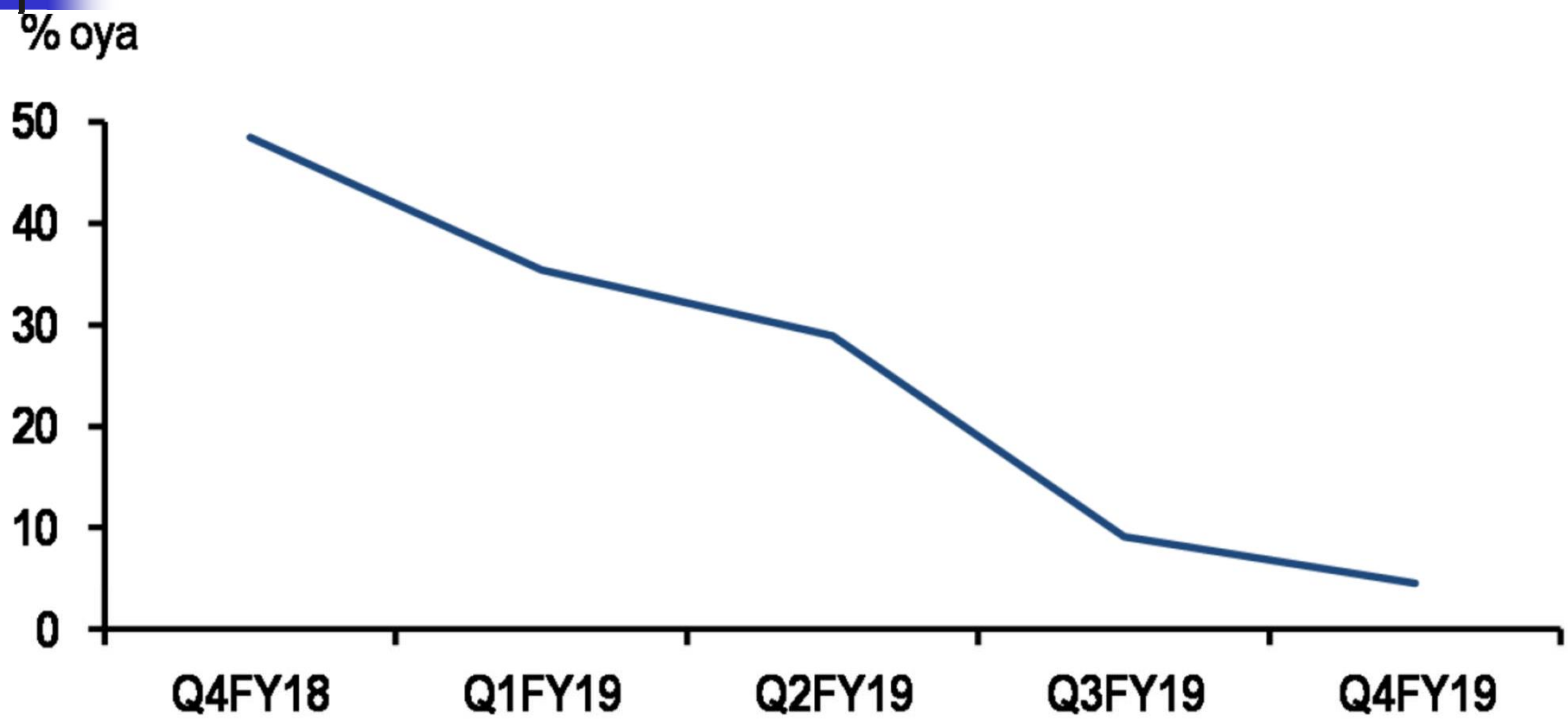
Banking and finance

- Banking sector reforms
  - Limited efforts including creation of Bank Board Bureau to make public sector appointments
    - Undercut by Finance Ministry from outset
  - PSB bank boards have little power and continue to be politicized, banks have limited executive experience and capability in pipeline
    - PSB overstaffing and overpaying at lower levels, underpaying at upper levels and limited capabilities
    - Bank consolidation without any mandate for rightsizing will divert managerial attention and add new bureaucratic battles
  - Government mandates continue
    - Mudra loans, MSME forbearance, loan melas

Banking and finance contd.

- Shifting problems as growth slows and other reforms stall
  - Private banks, co-operatives, and NBFCs not immune to mis-governance.
  - Corporate credit hard in a slowing economy which has limited means for recovery.
    - Importance of data, informational intermediaries, and IBC.
    - Use shadow of IBC as threat rather than first resort
  - Need to distinguish genuine loss from appropriate risk taking from fraud.
    - Investigative agencies often mix the two up, which chills risk taking and makes it harder to catch the fraudster.
- Perhaps excessive focus now on retail loans as corporate loans become difficult

NBFC lending after ILFS

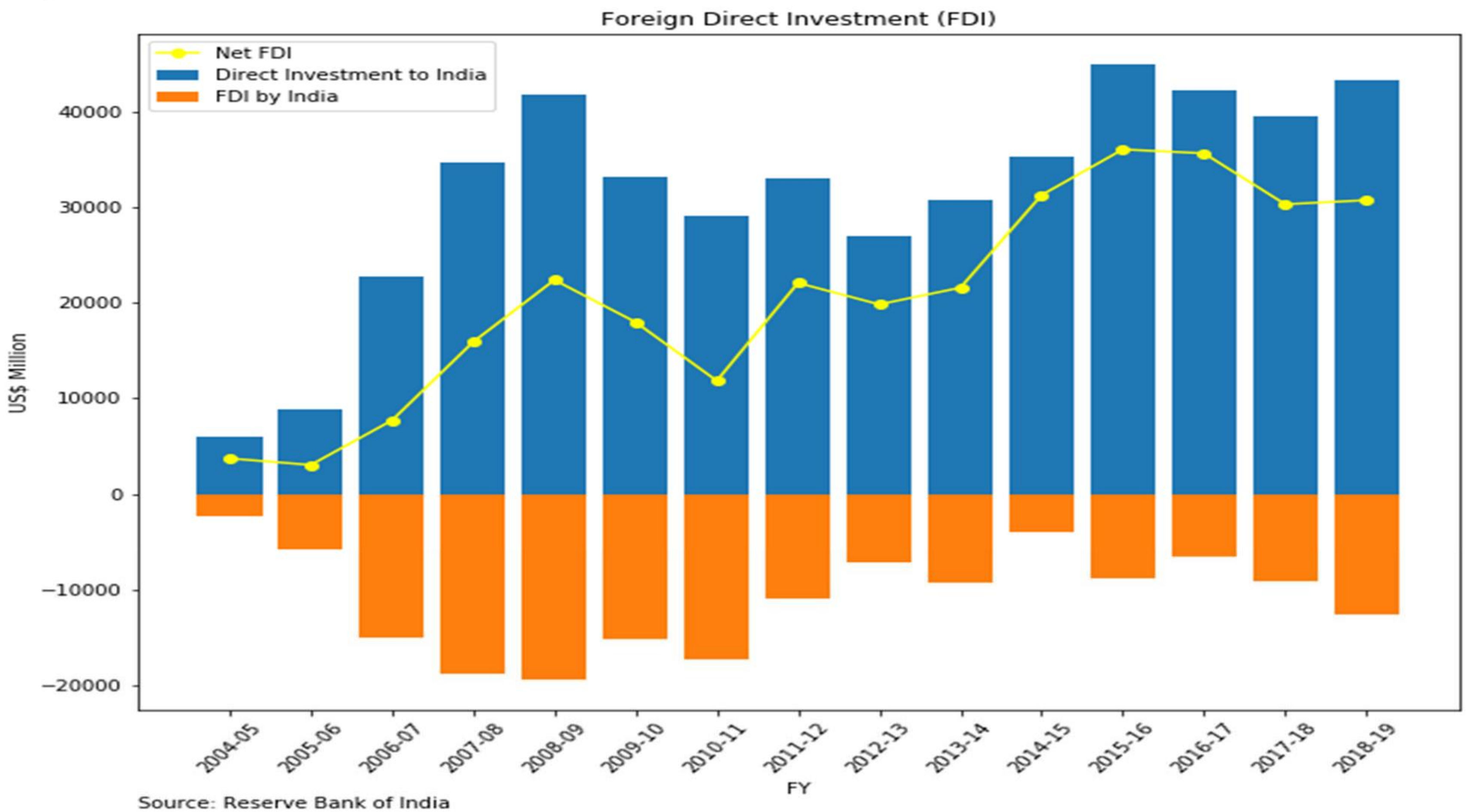


*aggregate of 8 major NBFCs for which data is available
Source: Company reports

Trade and investment

- Attempt to make Indian growth more export-led and substitute imports: Make in India.
- Objective: India should be more business friendly
  - Ease of doing business
    - Unfortunately, focus on World Bank indicators, not the specifics that make India difficult
    - No zero-budgeting on past regulations
    - Arbitrary changes to regulations – e.g., Amazon and Walmart
  - Low and stable taxes and tariffs.
    - Corporate taxes lowered but tariffs hiked. Constant fidgeting with taxes and tariffs makes planning more difficult
    - Tax authorities have been greatly empowered with few checks – they can levy demands that are hard to reverse.
  - Logistics, power, land, office space, and qualified manpower still inadequate and costly compared to India's competitors
  - FDI, textiles, and phones.

Foreign Direct Investment (FDI) flatlining at best since 2008



No sharp growth in textile share even as China's share falls

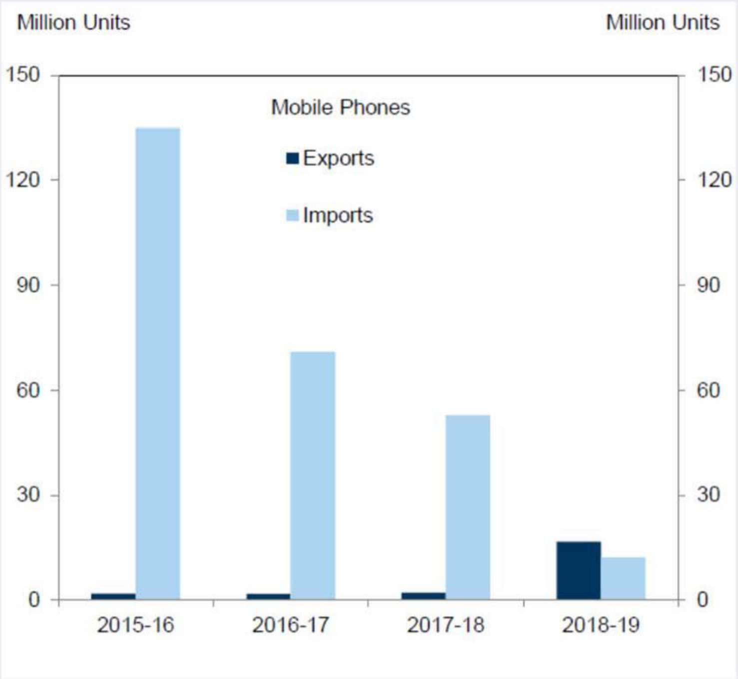
	Value (USD Bn)	Share in world exports			
Top exporters of apparel	**2018**	**2000**	**2005**	**2010**	**2018**
China	158	18.2	16.1	36.6	31.3
European Union	143	28.7	31.0	28.4	28.4
Bangladesh	32	2.6	2.5	4.2	6.4
Vietnam	32	0.9	1.7	2.9	6.2
India	**17**	**3.0**	**3.1**	**3.2**	**3.3**
Turkey	16	3.3	4.2	3.6	3.1
Indonesia	9	2.4	1.8	1.9	1.8
Cambodia	8	0.5	0.8	0.9	1.6
USA	6	4.4	1.8	1.3	1.2
Total of Above	**421**	**69.0**	**76.1**	**83.1**	**83.3**

Source: WTO, Goldman Sachs Global Investment Research

Growth in phone assembly, but value added likely small

Production of Electronic Goods in India (US$Bn)	2014-15	2015-16	2016-17	2017-18	2018-19
Consumer Electronics	9.1	8.5	9.7	11.4	11
Industrial Electronics	6.4	6.9	9.3	10.7	11.6
Computer Hardware	3.1	3	3	3.3	3
Mobile Phones	3.1	8.2	13.4	20.5	24.3
Strategic Electronics	2.6	2.8	3.1	3.7	4
Electronics Components	6.5	6.9	7.8	9.2	9.7
Light Emitting Diodes	0.4	0.8	1.1	1.5	1.9
Total	**31.2**	**37.1**	**47.4**	**60.3**	**65.5**

Composition of India's Electronic Imports (% of Total)	2014-15	2015-16	2016-17	2017-18	2018-19
Consumer Electronics	11.2	10.3	9.5	8.5	8.8
Electronics Instruments	14.7	14.7	14.5	13.4	14.4
Computer Hardware, Peripherals	19.7	18.8	16.4	15.9	16.1
Electronics Components	14.6	17.8	20.1	19.8	28.4
Telecom Instruments	39.9	38.5	39.5	42.4	32.2
Total	**100**	**100**	**100**	**100**	**100**



Source: Ministry of Electronics and Information Technology, Ministry of Trade and Commerce, Goldman Sachs Global Investment Research

Household-focused/Populist programs

- Jan Dhan– Adhaar—Mobile: Direct cash transfer of many benefits, subsidies, pensions, scholarships
- Swacch Bharat: Clean India, toilets for all
- Pradhan Mantri Ujwala Yojana – cooking gas connections for poor
- Ayushman Bharat – healthcare for the poor
- Probably area where Modi-I has achieved the best outcomes, but needs rigorous evaluation:
  - Usage of accounts/toilets/cooking gas
  - Fraud – e.g., in healthcare claims

PUTTING IT ALL TOGETHER: WHAT EXPLAINS THE SLOWDOWN?

Is it just global factors?

- IMF global growth

2013-16: 2.7%   2017-19: 3%

- Global trade volume growth

2013-16: 3.1%   2017-19: 4.2%

- Oil price

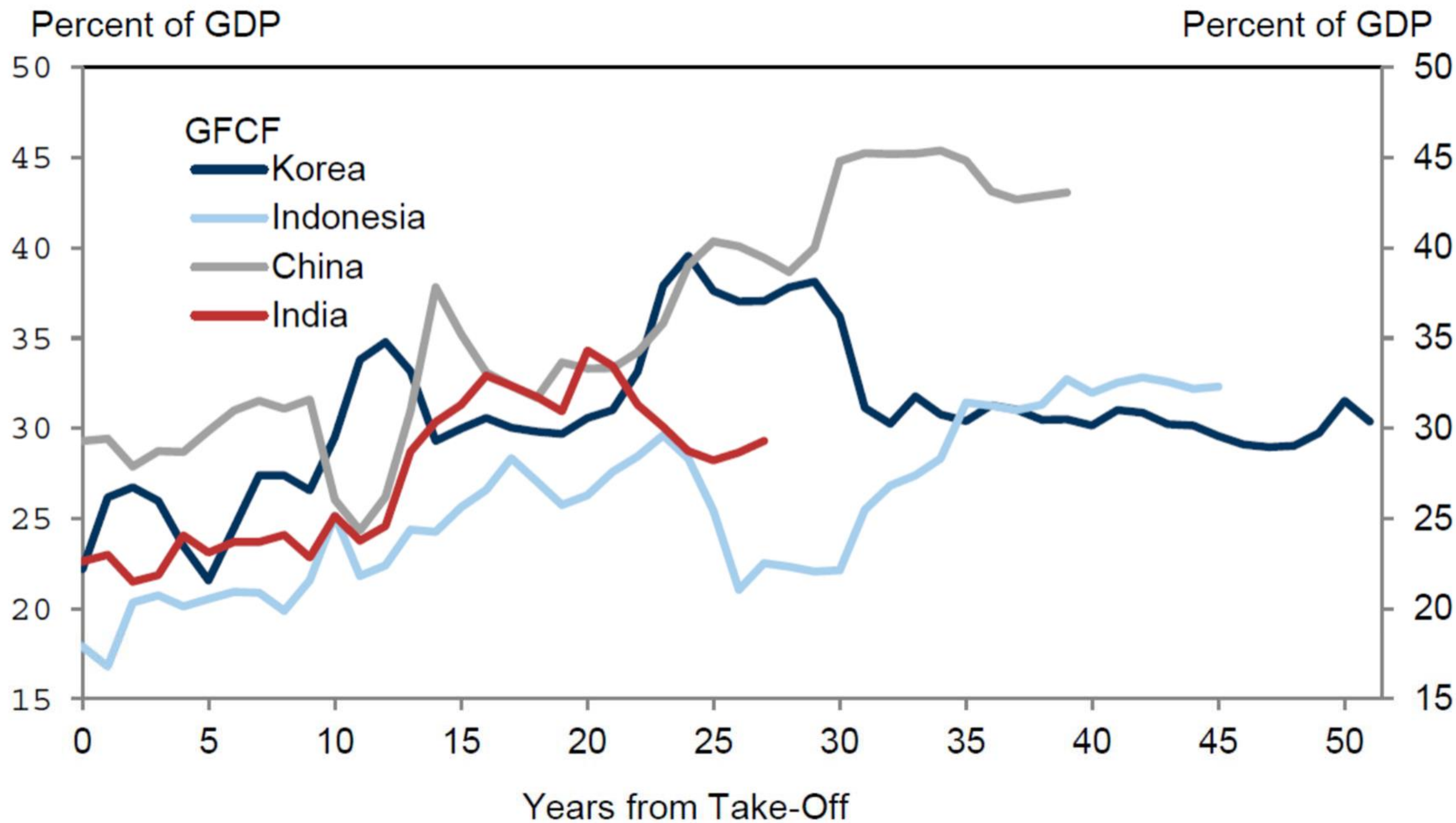
2013-16: 73.5 $/b   2017-19: 60.1 $/b

=> Global factors don’t seem the proximate culprits.

Alternative suspects

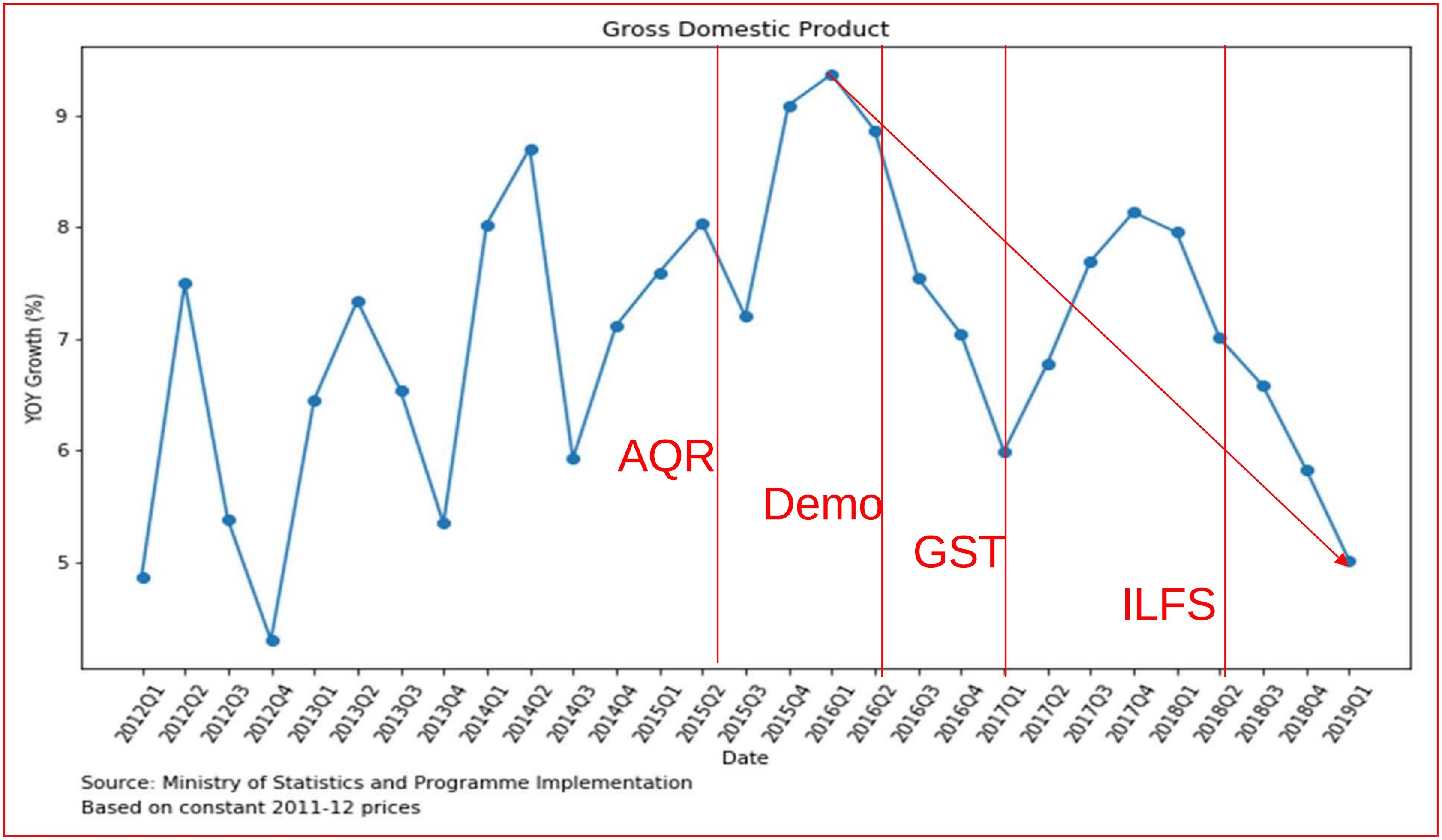
- NBFC crisis? May explain some but not all.
  - GDP growth started slowing before, from first quarter 2018
  - And household leverage was already growing rapidly, with household savings falling.
  - That implies household incomes were not keeping up with consumption needs – eventually borrowing would be unsustainable
- Low job growth and low productivity growth impeding household income growth?
  - Probably a better explanation
  - Linked to slow investment, and slow pace of tackling legacy problems like stalled projects and over-indebted firms and banks
  - Compounded by acts of commission – poorly conceived demonetization and poorly executed GST – as well as acts of omission – limited factor market reforms: land, labor, logistics, power, finance …

Investment slipping relative to fast growing peers



Source: Haver Analytics, Goldman Sachs Global Investment Research

Net effect of low investment and policy mistakes: slowing growth…

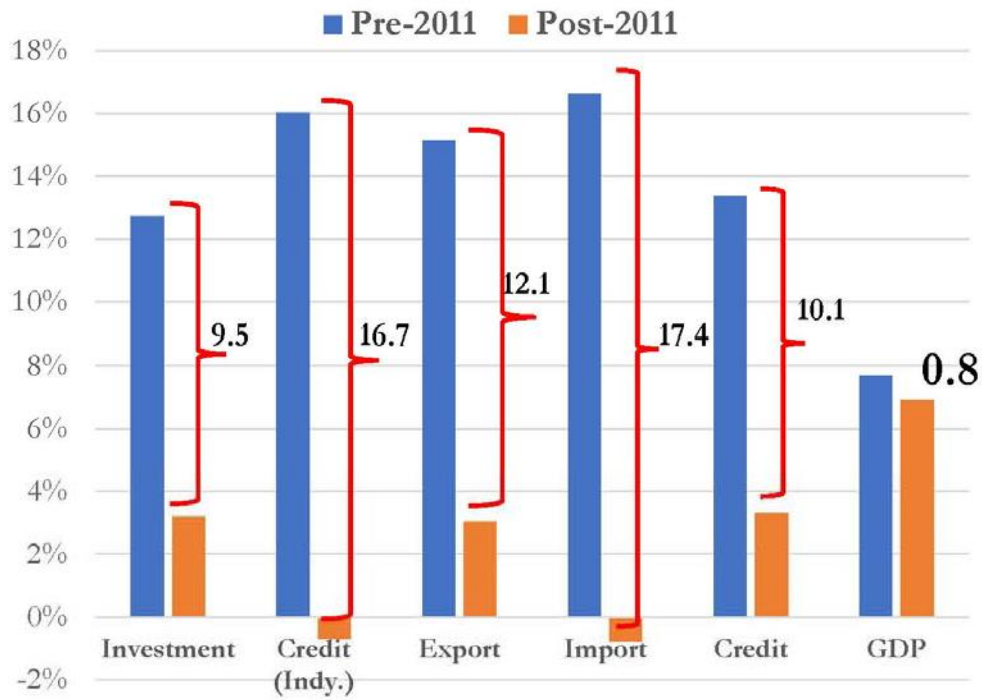


All this before we even address Arvind Subramanian's critique

- He estimates growth between 2011-12 and 2016-17 (before the slowdown starting in 2018) to be between 3.5 and 5.5 percent, not the average 7 percent (see slide from his presentation).
- Attributes it partly to incorrect use of output price deflators in deflating input prices.
- A persuasive reason to look more closely at his concerns: direct tax data
- Could GDP mismeasurement (in the other direction) account partly for current slowdown?
  - Possibly, but auto sales collapse is real and extends across the board!
- Bottom line from his critique: Need commission of independent experts to analyze our statistics and restore their credibility.

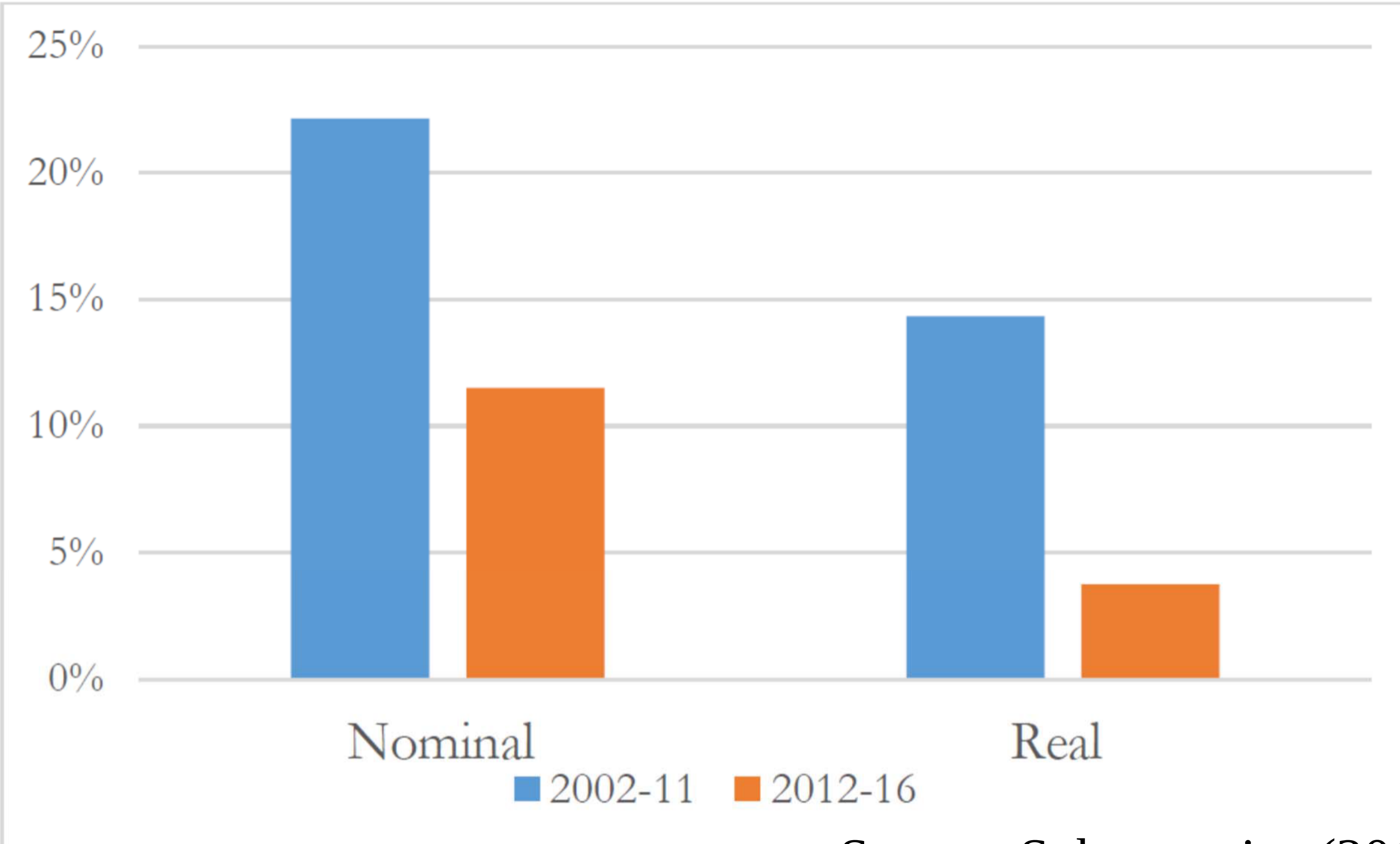
Central puzzle: Collapse in major demand indicators barely register on GDP

Growth in Demand Indicators and GDP, Pre-and Post-2011 (%)



- Shocks caused key macro "engines" to stall:
  - Investment (and credit to industry and profits)
  - Exports
  - Imports
  - Credit
  - Direct tax revenues
- Illustrative magnitudes: A 12 percentage point reduction in export growth can reduce GDP growth by 3 percentage points!
- Yet measured GDP growth slowed only marginally
  - 7.7 percent to 6.9 percent

Growth in Center's direct tax collections: Pre- and Post-2011



Source: Subramanian (2019)

Summary

- Signs of deep malaise in the Indian economy
  - Growth is slowing significantly
  - Fiscal space narrowing sharply
  - Debt and distress rising
- What are the roots of the problem?
  - India is losing its economic way, in part because it is centralizing power without a persuasive economic vision.
  - We risk wasting the demographic dividend and exacerbating internal unrest as joblessness mounts.
- What might be the way forward?

Summary so far

- India has slowed considerably.
- Investment has been slowing for a long time, but consumption has joined in.
- Legacy problems such as financial or power sector stress have not been fully resolved and financial stress is growing again.
- The lack of sustained reforms since 2004, especially in improving the quality of, and access to, factor markets such as land, labor, logistics, and power is
  - Holding back investment
  - Reducing job growth
  - Reducing income growth, increasing borrowing, and reducing consumption growth
- Ill-conceived actions like demonetization and poorly executed ones like the GST rollout have further stressed the economy.
- India cannot sustain spending on its expanding welfare programs without growth. Something will have to give.

Economic strength, national cohesion, and national security

- India's leaders are welcomed internationally today, not just because of the force of their personality, but because they represent a 1.3 billion strong <u>market</u> <u>democracy</u> that is <u>growing fast</u>.
- Any change in the underlined words will quickly change their reception and India's friends in the world.
- Returning to the Hindu rate of growth will reduce India's capacity to protect itself against external threats of domination.
- In the long run, internal cohesion and economic growth rather than divisive populist majoritarianism will be India's route to national security.
  - May win elections but is taking India down a dark and uncertain road.

Turning to the economy…

- Deal immediately with stressed sectors.
- Improve functioning of factor markets.
- Prune some regulations while improving others.
- Reduce public sector presence.
- Re-embark on steadily reducing trade barriers and tariffs.
- Put central and state budgets back on FRBM Review Committee path.

Deal immediately with stressed sectors.

- Talked about the twin balance sheet problem
- Financial sector stress spreads: Formulate targeted plans to revive distressed firms in construction/real estate/infrastructure and amongst NBFCs
  - Scrutinize stressed developers and NBFCs carefully.
  - Private sector shareholders will have to bear substantial losses and may be wiped out.
  - Government may need to find buyers/get owners to recapitalize stressed firms.
    - Auction distressed firms for minimum capital subsidy demanded by reputed players
  - Some assets (e.g., apartments) will have to be held off the market in special purpose vehicles that will unload them slowly.
  - Some arbitrary decisions are unavoidable, so transparency and oversight, without impeding speed of action, are essential.

Deal immediately with stressed sectors.

- Implement specific reforms to revive
  - agriculture
  - power
  - banking & NBFC
- Many committees have opined on each of these
- Book by 13 economists

Improve functioning of factor markets

- Labor market
  - Allow for multi-year fixed term labor contracts, renewable at end, with severance pay increasing linearly. This will facilitate mutual investment and longer term relationships with contract labor, without enforcing permanence.
  - Remove labor law penalties to increasing the scale of firms
  - Encourage various corporate worker training initiatives, including apprenticeships and partnerships with technical colleges.
  - Ensure accumulation and portability of benefits, including through self employment.

Improve functioning of factor markets

- Land market
  - Improve access to land for development
    - computerized land mapping
    - government-guaranteed titling
    - the creation of land banks including waste land, land occupied by defunct enterprises, excess psu and government undertaking land.
  - Reform Land Acquisition Act (2013) based on best practices in states
    - use of auctions for land acquisition
    - schemes for sharing future improvement in land value between buyer and seller, etc.
  - Create Special Economic Zones, not necessarily with a sole focus on exports, but also for domestic production.
    - Easier access to land, improved infrastructure and environmental clearances in such zones can accelerate investment.
    - Can be venue for experimentation for regulation and laws before rolling out all-India.

Prune some regulations while improving others.

- Reform is not just de-regulation but better, enforceable regulation.
- Prune entry- and competition-inhibiting regulations.
  - Competition authority should ensure level playing field between private, public sector, and foreign entities.
- Improve regulations focused on workers' and public's safety and environmental sustainability.
- Some competition between empowered states on regulation will be healthy.
- Detail regulatory mandates, strengthen independence of regulatory institutions, while holding them accountable to their mandates via oversight committees staffed by non-political public citizens.
  - Have transparent checks on regulatory performance and measures of behavior of specific officers.

Reduce public sector presence steadily

- Confine public sector presence steadily to sectors where essential.
  - Restructure with a view to privatizing, or shut down.
  - Delink remaining entities from the state while strengthening their public governance.
    - Can have different mandates but pay for them.
    - Don’t restrict/alter their operation based on ownership – range of functioning should be ownership neutral.

Steadily reduce trade barriers and tariffs

- Re-embark on steadily reducing trade barriers and tariffs while negotiating for open markets for Indian exports.
  - Focus on non-traditional exports like education, healthcare, and tourism
  - Have a transparent institutionalized process for changing regulations/tariffs

Put central and state budgets back on FRBM Review Committee path.

- …in line to achieve deficit (5%) and debt (60%) targets, with some allowance for slippage over the cycle
  - Coming clean on window-dressing while committing to bring budget back on track, may give a little more scope for spending today.
- Simplify and rationalize tax code.
- Raise compliance without unduly empowering tax officers, using IT and data.
- Free up public resources for investment through privatization and asset sales.
- Target welfare spending better, move to consolidated cash transfers where possible, and reduce government provision where ineffective.
- Account for contingent liabilities, including on financial guarantee schemes, pensions, and healthcare.
- Create more transparency on government spending on private sector.
  - E.g. Press advertisements, grants to NGOs and private universities
- Create a Fiscal Council to opine on budgetary assumptions and challenges.

Why would all this increase democratization?

- It places checks and balances on the government, including its ability to influence the private sector.
- The private sector becomes more efficient and independent, and has more certainty about outcomes, promoting investment and jobs.
- An efficient independent private sector can serve to check government instead of simply aiding and applauding the policies of the day.
- Foreign investors will also flock in, bringing new technologies and capital, and the need to keep them interested will prevent arbitrary government policies.

Conclusion

- Economic adversity is a terrible thing to waste.
  - It offers scope for substantial reforms.
- The government has a tremendous majority.
  - It can always decentralize more, while strengthening institutions. Unfortunately, there is no pressure on it to do so.
  - It can revitalize growth, and if it does so relying on market forces, these will help further democratize India.
- Or it can stay on the current course. Apparent political success may divert its attention from the growing economic stress.
  - Without stronger growth, distributive policies, which have been quite effective, will overwhelm revenues, driving the economy into a hard corner.
- Time will tell…

The past (buried in mystery)

- Why did India grow so fast?
- Many failings which are well known
  - Stalled Liberalisation
  - Broken banking sector
  - “absent” bond market
  - Archaic labour laws
  - Disastrous education sector
  - Poor healthcare

Possible drivers

- Top talent in a country of India's size is extremely good
- The education system failed the average person but did OK at the top
- Old and sophisticated business community
- Massive mis-allocation under central planning – people, capital, firms
- Scope for large gains from re-allocation : e.g.
  - Big domestic market, better integrated over time
  - Loosening labor laws from contract labour
  - Moving talent from public sector to private sector
- Breakdown of joint family
  - Created huge demand for real estate which is a key source of transmission of growth to rural areas

Some more drivers

- A poorly run financial sector in which it is easy to gamble on opportunities
- At some point enough accumulation of bad debts happen and the bills do become due
- Crony capitalism – created the windfall of opportunities in the shirt run
  - But there are only so many of them
  - And they happen at the expense of trampling on rights of others who eventually can fight back
- Lax monetary and fiscal policy that allowed the Government to borrow at very low real rates of interest and encouraged consumption

The current situation

- Growth has slowed massively
- Probably much more than the Government acknowledges – refer to Arvind Subramaniam's critique
- More sobering data from NSS latest round
  - Average consumption expenditure at current prices (2018) fell from Rs 1,587 per person per month in 2014 to Rs 1,524 ppm in 2017-18 in rural areas ; this decline has not happened in India over the past several decades
  - In urban areas: from Rs 2,926 ppm in 2014 to Rs 2,909 ppm in 2017-18
- Investment has total collapsed
- Exports are not growing
- Public sector borrowing, is around 9% -10% of GSDP
- We are in a crisis

NDA reaction

- Was that this was too unruly a process – wanted more control
- How to deal with these pesky institutions?
- Change the law when there is no choice (RTI)
- But gut it from inside if possible
  - Appointing people who will do what they are told
  - By punishing anyone who dares to stock their neck out
  - By inserting PMO into every line of control
- The institutions went from hyperactive to zombies – follow due process and get clearance for every step from PMO
- Potentially worse than the last days of UPA
- Part of the reason why investment has plunged and banks are not lending

Is this the only thing that’s gone wrong?

- There seems to be a demand deficit due to
- Demonetization
- GST implementation
- The monetary policy regime and the related squeezing of agricultural support prices
- The financial crisis
  - Which is both cause and consequence of real estate slow – down
  - Which means that transmission of urban growth to rural areas is broken

The future

- Sharp growth slowdowns, experience form UK and USA in the mid 1970s, Latin American Countries in the early 1980s and Japan in 1990s
- Slowdowns are not easy to manage
- The expectations are high – no one wants to admit that it will take years to fix
- The result is flailing
  - Tax cuts for the rich, public investments that may not make any economic sense
  - The experience is that they hurt income distribution and make Government debt explode
  - Often ends in a full blown melt down
  - We seem to be barrelling down this path

Alternatively : in the short run

- Get more money into hands of people
- Raise the MGNREGA wage
- Raise prices to farmers
- Sell the public sector banks rather than fix them – give the owners the freedom to make the changes that they want – tighten regulations
- Relax monetary policy
  - “Quantitative easing”
  - Not interest rate cuts, which rarely do anything in a financial crisis
- Let the rupee slide
- Pray

And in the longer run

- Strengthen institutions
  - Signal that PMO will not interfere with decisions made by professionals
  - Withdraw cases which are politically motivated
  - Encourage media to pursue transparency
  - Accept criticism – even when it is unfair – its all part of democracy – call off the attack dogs
- Make clear that there is a landing plan for the Government budget that does not require and will allow for increased investment
  - Stick to the plan without having to be “creative”
- Pray more