ISAS Insights
No. 537 – 25 February 2019

India's Economy – Concerns and the Road Ahead

S Narayan

Summary

The financial markets in India are under stress due to defaults in several companies and this is affecting the availability of credit for the goods and services sectors. Lenders have become risk averse. At the same time, consumption demand in small towns is growing. There are also new industries and technologies that are attracting investments, thereby providing a fillip to the India economy. However, the new government would have to meet the many challenges to put the economy back on an even keel.

The IL&FS Default

The results of the third quarter (ending 31 December 2018) of several companies listed in India have been below par, as the turbulence in the economy is being felt in the financial markets. Several developments over the last few months have worried investors, and the road ahead appears to be bumpy. Since October 2018, there has been a lot of bad news in the country. First, Infrastructure Leasing & Financial Services Limited (IL&FS), a major infrastructure leasing, financing and construction company, with assets of ₹1 trillion (S$20 billion) and liabilities to match, defaulted on interest and term payments of its liabilities, and very soon, it was clear that this company was in serious distress. IL&FS has been an iconic company, pioneering infrastructure activities where other firms have hesitated, and building a huge network of partnerships with state governments and with private players to implement complex projects. The company's argument is that several of the government projects have had huge costs and time overruns, for which it has not been compensated. However, a close look at the accounts indicated that all was not well, and the government moved quickly to replace the Board of Directors and to put up assets for sale. The fallout from this has been huge, as lenders to this company have been scrambling to retrieve their money, and there have been allegations of wrong utilisation of funds, complicity of auditors and misdemeanors of management.

Impact on the Markets

The IL&FS defaults had a significant effect on the markets. For the last three to four years, as scheduled banks, both private and public, have been struggling with non-performing assets and large defaults in their loan portfolios, the category of non-banking finance companies (NBFCs), loosely regulated by the Reserve Bank of India (RBI), have prospered by offering credit where banks have been reluctant to step in. A majority of the credit has been short-term, financed in turn by the NBFCs through borrowings from corporates, mutual funds and deposits of high net worth individuals through non-convertible debentures. After the IL&FS crisis, corporates have been pulling their money out, and individuals, as well as mutual funds, have been seeking redemption, as a result of which several NBFCs are under stress. Asset-liability mismatch, where short-term borrowing has been deployed for long-term return activity, has been common among NBFCs, corporates as well as infrastructure firms. It has been working as long as the rollovers of the loans happened at regular intervals. Once the plug has been pulled, there has been a domino effect among several companies, which are struggling to meet liabilities. Dewan Housing Finance, a company focusing on retail housing finance, saw its share prices fall by over 50 per cent between September 2017 and February 2019. The Zee Group, a very large conglomerate in the media, packaging and infrastructure industries, suffered likewise. There are other companies and NBFCs which are likely to follow. Promoters, who have pledged their shares to borrow, are having to meet sudden margin calls as their share prices have nose-dived and they are scrambling for funds.

There is more bad news. R-Com, a company belonging to Anil Ambani, has defaulted in payment to Ericsson, and the Supreme Court has held him in contempt, asking him to pay up ₹5 billion (S$100million) in a month or face a jail sentence. His complaint is that a deal with his brother fell through as his brother did not co-operate. Whatever the reasons, the markets have been spooked by this development. Mutual funds are trying to get out of investments in companies where they perceive stress, driving down share prices further. The mid-cap index in the National Stock Exchange has dropped by over 30 per cent, with several scrips quoting 40 per cent or more lower than the same period last year.

In short, money is short. This has been coming for a while. Banks have been reluctant to lend to long gestation projects, with a huge non-performing liability of past loans in their balance sheets. The RBI has been aggressively asking them to clean up, but the government is not necessarily happy with this aggression. NBFCs that provided a source of alternate finance are drying up. Stock markets are volatile.

Stock Volatility

Some of the reasons for stock volatility are also the global concerns for economic growth. There is a slow-down in the European Union, uncertainty in Argentina and Brazil, expectations of slow growth in the United States (US), concerns over the future of the US-China trade relations, rising oil prices due to sanctions on Iran and problems in Argentina. The markets in India are jittery. In 2007-8, problems in the real economy, and in the housing and insurance markets caused asset prices to fall through the floor. At present, in India, it appears to be the reverse. The poor performance of the banks and financial institutions is washing back into corporate distress, affecting the real economy.

A large number of small and medium enterprises are struggling. In Tamil Nadu alone, there are over 50,000 enterprises fewer than last year—this was stated by the Minister for Industries in the state assembly. Capacity utilisation in the established industry is still below optimum, and fresh investment has no access to long-term debt. Sales of automobiles have dropped in the last few months, affecting not only the large manufacturers, but also all the ancillary units that feed into these manufacturers.

Distress in the Farm Sector

This is exacerbated by the distress that is evident in the farm sector. Unlike in the past, the distress, in several cases, is caused by plentiful production that is not able to command good prices. Output in agriculture, in states like Madhya Pradesh, has been growing. Production has diversified from cereals into cash crops like soybeans, turmeric, chillies and other grains. Production is good but the markets are not giving the farmer the expected prices, as these markets are fragmented, and there is not yet a system of logistics support or price support for these products. The RBI, in its latest monetary policy review, has noted that food price inflation is low. However, this appears to be a result of farmers getting poor prices for their products.

Fiscal Expansion and Economic Growth

The government has embarked on fiscal expansion. The budget, recently presented in Parliament, provides for cash doles to the farmers, as well relief in income tax to the salaried and middle-class. The RBI has chipped in with monetary easing, arguing that concerns about inflation are benign. The expectation is that these injections would help drive up consumption expenditure, hence demand, and would eventually help to push up economic growth. This fiscal expansion has happened at the expense of fiscal prudence, with fiscal deficit and government borrowings on the rise.

The gross domestic product (GDP) growth figures put out by the government indicate that the economy is growing at over seven per cent, even though there are a number of sceptics who doubt this. There have been fierce debates about GDP numbers, the method of calculation, and the base on which they are premised. Yet, in spite of all the issues mentioned above, there is little doubt that the economy continues to grow.

The question is, where is this growth coming from? It is possible to identify sectors that appear to be contributing. Even though there is farm distress, this is in pockets and production is up as well as consumption. Tier two and three cities are growing rapidly and consumption demands are becoming quite sophisticated. The sale of two-wheelers is very robust (even though growth of four-wheelers is languishing). The Good and Services Tax regime, pilloried by many, is enabling better and quicker movement of goods throughout the country, thus accelerating consumption. Fast moving consumer goods are reporting high sales and growth volumes, and are looking at diversification and better penetration of small town markets. Industrial production in tires, paper, chemicals, white goods and mobile phones continues to be robust. The information technology sector is reporting good results and, more importantly, hiring large numbers this year. This would immediately improve consumption expenditure trends. Remittances are robust, driving prosperity in Kerala and Punjab.

The stress in the financial markets is very slowly moving retail savings back into real estate, and the beginning of a revival is perceivable in core areas in all metropolitan cities. Transactions have picked up. The government's programme of low cost housing, which comes with subsidies, has resulted in a construction boom in urban as well as semi-urban areas. If money comes back into real estate, so will employment.

There are two sunrise areas that are showing signs of significant growth. Start-ups, especially in Bangalore, Chennai, Hyderabad and Pune, are coming up with novel solutions based on technology and artificial intelligence, and are gaining significant traction, attracting investors and venture capital. There is a demand for digital solutions, logistics, operations and maintenance solutions that are based on virtual reality/augmented reality platforms, and this is likely to spin-off into a new realm of services. The second growth initiative surprisingly emanates from the significant successes of the Indian Space Research Organisation (ISRO). There has been a significant growth in activities and the ISRO is now recognised for low-cost, effective launches. In 2018, the ISRO put over 50 satellites in orbit. They are also miniaturising payloads and attempting retrievals of launch craft, and there is a considerable global demand for their services. More importantly, this growth has resulted in the development of a number of new technologies and products, that the ISRO is now ready to license out to private manufacturers—these are often products that would be of everyday civilian use. There is, thus, a growth in the technology and machine learning sector, which is leading to fresh innovation in services and products. The sizes are still small but can no longer be called insignificant. A number of defense companies, several of them from overseas, are expanding their manufacturing base in India.

Priorities for the New Government

After the parliamentary elections, the new government will have to grapple with these sets of complex issues. There is the need to set right the financial services sector, so that it can act as a support to the goods and services economy. There is a need to push up manufacturing and provide support for the micro, small and medium enterprise sectors. Importantly, there is a need to modernise agriculture and also incentivise the sunrise industries.

Most importantly, the government needs to provide jobs for all. Employment for the youth is likely to remain the most significant challenge for the new government. At present, a very large percentage of the urban work force is engaged in the informal sector. It is important that these people should become part of the formal economy to enable them to access livelihood benefits, like provident funds and insurance.

. . . . .

Dr S Narayan is Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). He is a former Chief Economic Advisor to the Prime Minister of India. He can be contacted at snarayan43@gmail.com. The author bears full responsibility for the facts cited and opinions expressed in this paper.