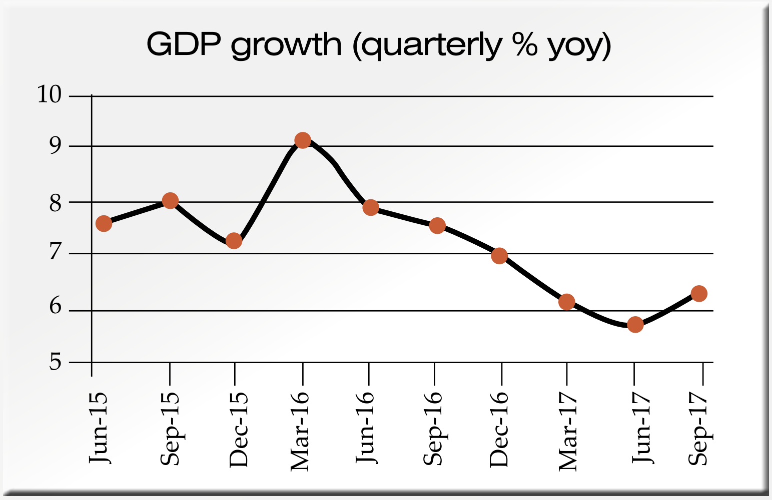
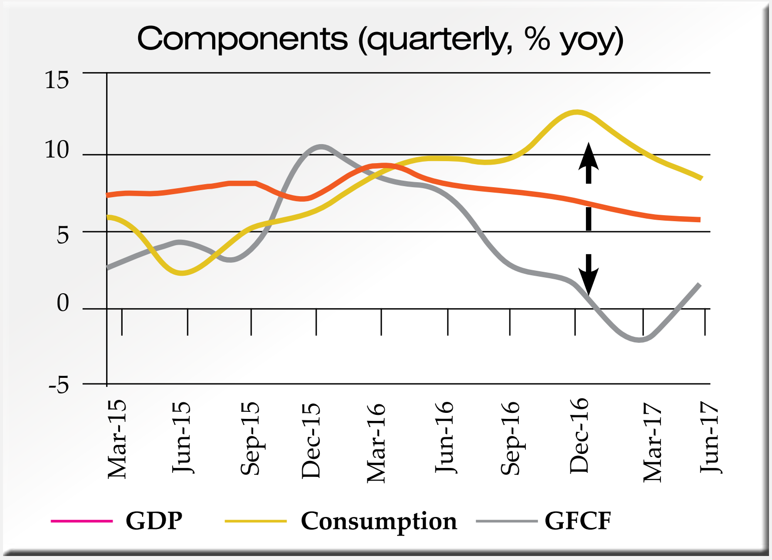
Drivers of Transformation

In conversation with Adit Jain, Chairman and Editorial Director, IMA India

There was once a time when economists used to say that even if everyone were to fall asleep, the Indian economy would still grow at 6 per cent. Few would have realised just how low things could sink – almost no one could have imagined the several quarters of barely 4 per cent growth seen during the UPA-II years. The more recent 'slide' to 5.7 per cent in the first quarter of FY18 is more understandable, driven as it was by the twin shocks of demonetisation and the GST. Today, while the media continues to focus on 'falling growth' and a lack of jobs, there is, in fact, a modest recovery underway. It is true that investment appears weak, capacity utilisation levels are modest and credit growth is low at 7-8 per cent. However, consumption demand is consistently strong and there are several positive signals coming out of the environment. Overall growth will be in the 6.3-6.5 per cent range this year and possibly 7 per cent in FY19. More critically, several structural policy initiatives – including the DBT and UDAY programmes and a push towards greater 'financialisation' – will have a cumulative and substantial bearing on long-term growth, investment and job creation.





Source: CSO, SEBI, CEIC, IMA analysis

THE STIMULUS PACKAGE

Bank recapitalisation is both clever and can be effective...

The government's recently announced two-part 'stimulus' package will have a critical bearing on future growth. Firstly, under the bank recapitalisation programme, Rs 2.1 trillion of fresh capital will be injected into PSU banks, including Rs 1.3 trillion of depositor money that will be invested through bond purchases. Cleverly, the FM has ensured that the fiscal burden of the programme will be a manageable Rs 80-90 billion a year. This does not imply that PSU banks have been 'fixed' or that they will not get into trouble again – perhaps privatisation is the only solution for this. However, it will allow them to start lending again, hopefully boosting the investment cycle. Larger firms have access to other sources of capital – including foreign funds, the bond markets and internal accruals and reserves – but for smaller firms, who make up 70-80 per cent of industry and depend heavily on bank loans for capital, it will be a big leg up.

...and even a part of the planned public investment, if executed on, can be transformative

The second and more ambitious part of the stimulus package – Rs 15 trillion of public investment over 5 years – will take longer to unfold but its potential impact is huge. The plan is to invest some Rs 7 trillion in highways, Rs 3.1 trillion in affordable housing, Rs 4 trillion in capex for PSUs and Rs 163 billion in rural electrification. A key element is the Bharat Mala programme, which will connect India's major towns and cities by building

Capex generally takes place when capacity utilisation rates cross 80 per cent, inflation is above 5 per cent, and the cost of capital is 10 per cent or lower

The Political Context: An Expanding BJP Footprint

Politics and economics are inseparable, and India's forward-path will be determined, at least in part, by the reality of a dominant BJP as the fulcrum of Indian politics. As recently as 2010, it would have been unimaginable that the party – either singly or with allies – would be in power not only in the Centre, but also in 19 of India's states. In the last year alone, it has won 6 of 7 state elections, including a landslide in UP and an unprecedented sixth consecutive term in Gujarat, where it was battling not only anti-incumbency but also farmer distress and the twin shocks of demonetisation and GST. Never before has any party or political grouping – not even the formidable Indira Gandhi – achieved anything similar. Much of the credit must go to Narendra Modi, in whose sincerity India's people continue to have immense faith. Voters, including the poor, who were perhaps the worst hit by demonetisation, have been willing to accept the pain that they believe is necessary for the greater good.

The longer-term fallout of an ascendant BJP is that the party will gain strength in the Rajya Sabha, where the opposition has so far stalled legislative progress. Over the coming months, it will pick up 11-12 seats, while the Congress will lose 3-4. By April, it will be the single-largest party, and together with its allies, will edge towards controlling the Upper House. Over time, this will change the Rajya Sabha's operating 'rhythm', and should make it easier to push through important reforms.

A 5-year, Rs 15 trillion infrastructure programme will, if even partly successful, prove transformative. Bharat Mala may well be Mr Modi's legacy scheme

at least 100 criss-crossing motorways. In doing so, it will bridge the gap between the 'new' India of excellence and growth and the 'old' India of stagnation and mediocrity.

Like Atal Bihari Vajpayee's Golden Quadrilateral programme, Bharat Mala could well become Mr Modi's defining legacy and all signs are that he is keen to implement it well. Mammoth spending programmes often draw scepticism given India's historical record on delivery. However, the efficiency of capital spending under the current administration has been significantly better than in the past. From a situation where capex budgets would often go unspent ministries are today achieving higher levels of utilisation, in some cases almost 100 per cent as with the Railways. At the same time, under Mr Modi, the targets (e.g., for solar energy) as well as the performance benchmarks are becoming ever stiffer. Thus, even if only 60-70 per cent of the goals get met there will still be credible outcomes at the end of 5 years. Indicatively, a previous target of installing 20 GW of solar power capacity by 2022 has been achieved four years ahead of schedule as the administration is now pursuing a much bolder target of 100 GW by 2022.

FOUR LONGER-TERM TAILWINDS

1. The DBT: Cutting Graft – and Waste

Every year, the Indian government spends roughly Rs 6 trillion on welfare programmes but according to a previous edition of the Economic Survey it was estimated that up to 70 per cent of these funds would not reach the intended beneficiaries. The funds would often be siphoned off and channelled back into a nexus of weakly regulated industries such as real estate, educational institutions and hotels, often owned by politicians all across India. Further, subsidies have created serious price distortions. For instance, there are two prices for kerosene in India – one that is state controlled, the other a 'free market' price that – which afford large opportunities for arbitrage and hence the scope for diversion and pilferage, sometimes through intimidation and violence.

This is where the Direct Benefit Transfer (DBT) programme comes in. The DBT programme aims to ensure that welfare benefits reach the targeted beneficiaries directly rather than through intermediaries. It also aims to eliminate duplication and ghost recipients and hence check the occurrence of pilferage and leakages in the system. Powered by Aadhar and 250 million new bank accounts, what started in 2013 with 27 schemes today covers 411 schemes across 56 ministries. From 108 million beneficiaries in 2014, over 600 million people have now been 'on-boarded' to DBT schemes and the volume of funds disbursed has jumped from Rs 70 billion to Rs 1 trillion. Cumulative savings from just three schemes – LPG, PDS and MGNREGA – already amount to Rs 570 billion according to Government estimates. In 2016-17, DBT is estimated to have generated savings of Rs 209 billion on a total spend of Rs 747 billion i.e. 28 per cent, or nearly a third of gross transfers. The gains would have been even higher but for the fact that the Aadhar-seeding process is incomplete (currently at ~77 per cent on average), and much of the 'mischief' that still occurs takes place at the edges that have yet to be covered. By extension, once India achieves 100 per cent seeding and if the DBT gets extended to all spending programmes, the savings could be as high as 30-40 per cent on a total expenditure base of Rs 6-7 trillion – or 1.5-2.0 per cent of GDP. Further, some high leakage programmes such as the fertiliser subsidy are yet to be covered by DBT. Conceivably, their inclusion might drive the average rate of savings even higher.

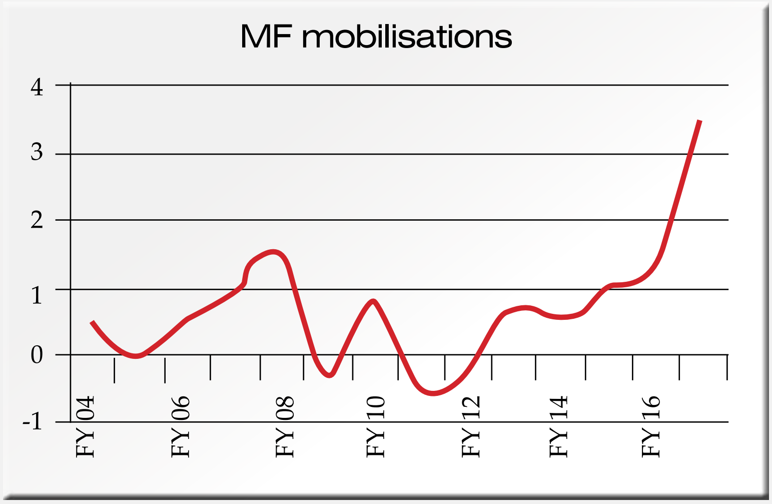
2. The Financialisation of Savings

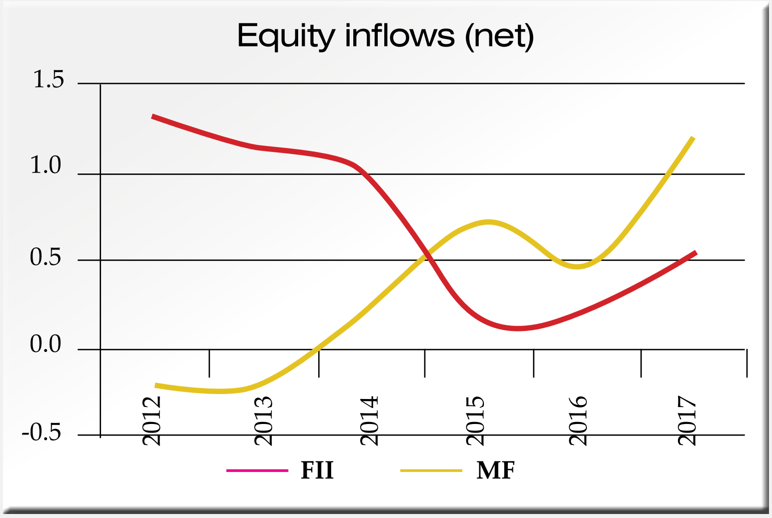
India saves 32-36 per cent of GDP or Rs 44-50 trillion a year. Households account for the bulk of this though their share has fallen from 72.7 per cent in 2005 to 59.3 per cent in 2016. Public sector organisations make up 7 per cent of the total while the government dis-saves 3-4 per cent of GDP each year. Private corporate savings have risen significantly, from 20.2 per cent to 36.7 per cent, highlighting the increasing privatisation of the economy as well as government disinvestment in certain sectors.

In the past, households would channel around 30 per cent of their savings, or around Rs 8-9 trillion in financial instruments. Consequently, this was the amount of free capital available for intermediation in the economy. The rest of their money would be locked in physical assets that offered either no returns (gold) or very low returns (real estate). This is now changing, with the share of financial savings jumping to over 40 per cent of the total household surplus in the last 5 years, adding up to Rs 14 trillion in 2016. The effects are clearly visible in the financial markets. Mutual fund (MF) mobilisations have jumped from Rs 1 trillion to Rs 3.5 trillion in the last two years, with monthly systematic investment plan (SIP) volumes rising three-fold, to Rs 300 billion, and total assets under management tripling to Rs 6 trillion. Bond markets have deepened with the value of outstanding bonds having surged from Rs 1-1.5 trillion a year to Rs 4 trillion. Consequently, even as bank credit growth has stalled, bonds have taken their place ensuring that the overall credit flow to the economy continues to rise. Bonds now account for 40 per cent of all fresh credit, up from 13 per cent a few years ago. IPO issuances have doubled from Rs 0.4 trillion to over Rs 0.8 trillion.

Besides making more capital available for investment deeper financial markets also mean that India no longer depends as heavily as it once did on foreign capital, especially in the context of equity markets. Today, a major capital reversal may hurt the economy but not cripple it as domestic financial institutions have become larger investors in the capital markets than foreign portfolio managers.

If the DBT finds universal application, it could yield savings as high as 30-40 per cent of total government spending, eventually adding up to 2-3 per cent of GDP





Source: CSO, SEBI, CEIC, IMA analysis

Households are putting a much greater share of their savings into financial instruments, borrowing more frequently from formal institutions, and insuring themselves against contingencies. This might eventually boost disposable income by 4-12 per cent annually

In 2017 for instance, FIIs invested Rs 512 billion in the equity markets while mutual funds invested more than double of this – Rs 1.12 trillion. This provides a degree of insulation to both the currency and market indices from global capital shifts.

At the household level, rising financial savings are driving up the yield on investments. According to one estimate, by replacing 25 per cent of its gold holdings with financial instruments a household could raise its annual income by between 1.4 per cent and 6 per cent. Further, by borrowing from formal rather than from informal institutions, households can save up to 3-4 per cent of their income on reduced debt servicing costs. Finally, rising insurance coverage has brought down out-of-pocket expenses on medical and other emergencies which can make a tangible difference to cash flows. Taken together, the rising use of formal financial instruments can drive up disposable household income by a substantial 4-12 per cent a year on an ongoing basis. This is the real impact that 'financialisation' can have in the long term.

3. India's investment conundrum

On the surface, private investment appears weak. Measured on a rolling, 6-month-average basis, investment volumes collapsed in the second half of the UPA-II regime and do not seem to have recovered. However, much of what came in prior to 2012 was 'sticky money' – illicit offshore funds or diverted subsidy payments and not genuine investments. This is clear from the anomalous gap between what was proposed to be invested versus the amount of capital that was actually available for investment i.e. banking and debt capital. This gap collapsed in late-2011 and has since 'normalised' to around zero, signalling a more realistic investment scenario. At the same time, there is today a much stronger 'conversion' between investment proposals and actual spending. In the past, investors would make grandiose statements of intent but implement no more than 1.5-2 per cent of the proposed amounts. Today, the conversion ratio stands at a much better 25 per cent, and the value of both proposed and actual investment continues to move upwards.

Broadly, three factors drive investment in India: inflation rates of over 5 per cent; capacity utilisation rates of 80 per cent or more; and a cost of capital that does not exceed 10 per cent. Clearly, there are policy, operational and demand-related issues at work too, but primarily it is subdued inflation and low capacity utilisation (at about 70-75 per cent) that are guiding investment decisions today. Going forward, with CPI inflation starting to rise and exports on the mend, firms will begin to see capacity constraints, prompting them to invest more. Moreover, it is likely that the official investment figures are understating the real amount of investment taking place in India. Consumption has continued to grow at about 7 per cent a year, which – in the absence of new investments – can only be sustained if productivity is also rising at a similar rate. In fact, productivity has been on the rise, but is driven mainly by spending on automation and IT. If this has not shown up in the investment numbers, it is because firms have been writing off such spends on their P&L account rather than amortising it on the balance sheets. Rather than treating it as an investment – which it is – they have expensed it out.

4. UDAY: reviving the power sector

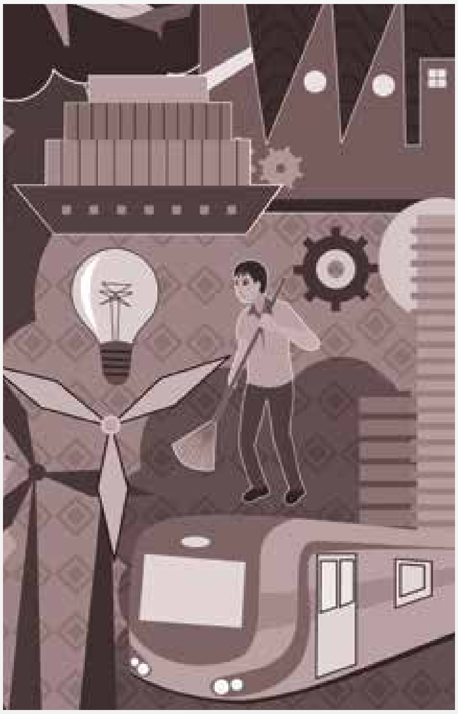
As with its other initiatives, the Narendra Modi government has set very high targets for itself in terms of the power distribution sector. Distribution is a state subject and for decades, mismanagement and under-priced tariffs led to distribution companies (discoms) losing 60 paise on every unit of power they sold. 25 per cent of all power was lost to theft and low billing efficiency levels meant that a fifth of all consumers were not billed at all. In 2015, the discoms' accumulated losses stood at Rs 4 trillion, growing at Rs 0.6 trillion a year. They had receivables of Rs 1 trillion, owed Rs 1.3 trillion to generation companies and banks were refusing to lend them money threatening, in some cases, their very survival.

Launched in 2015, the UDAY (Ujjwal Discom Assurance Yojana) scheme sought to resolve this muddle by encouraging states – through incentives and penalties – to clean up their act. Under UDAY, states are to take over 75 per cent of the outstanding discom debt through state bonds, reducing the latter's interest burden. The balance 25 per cent is to be offloaded by the discoms to the markets or refinanced by banks at a set rate (base rate + 0.1 per cent). Most crucially, future discom losses are to be shared by the state government to ensure that everyone's interests are aligned. The goal is for discoms to cut AT&C losses to 15 per cent and become cash-flow positive by 2019.

So far, 31 states have signed on to UDAY. They have completed the issuance of state Government bonds worth Rs 2.1 trillion as part of the debt restructuring component while their discoms have issued bonds worth Rs 0.23 trillion, a little short of the target of Rs 0.63 trillion. Cumulative interest-cost savings stood at Rs 170 billion till FY17; further, Rs 400 billion of bank defaults have been averted. Under-recovery on the sale of power is down from Rs 0.6 to Rs 0.35 per unit of power through a mix of cost reductions and tariff hikes. AT&C losses are down to 23 per cent, although the target for FY18 is 21 per cent. Encouragingly, there is a growing sense of competition among the states, but at the same time, they are cooperating by sharing knowledge and best practices. While India's power-sector problems have not yet been fixed there is a sense that things are on the right track. If all goes according to plan, the total savings from UDAY can be as high as Rs 1.8 trillion through reduced debt servicing costs, elimination of theft, higher distribution efficiency and lower production costs. This would bring down NPAs in the banking sector and spur investments upstream and midstream in the power sector itself. According to an estimate by the Government, India's power sector can absorb investments worth USD 250 billion across the value chain but a significant proportion of this is held back by the poor state of the distribution sector. If UDAY is successful this potential can be fully unlocked.

THE ULTIMATE IMPACT

In an ideal world, if the multiple game-changers identified above were to play out according to script, they can theoretically drive up GDP growth by as much as 5.5 per cent a year. The DBT can create savings of as much as 2.5 per cent of GDP, which – assuming an incremental capital-output ratio (ICOR) of 5 – translates into an additional 0.5 per cent of growth a year. UDAY can create savings worth 1 per cent of GDP, which implies a 0.2 per cent increment to growth. Most important, however, is the realignment of savings. The household sector accounts for 60 per cent of GDP, so by giving a 4-12 per cent boost to household income (or, taking the middle point, 8 per cent), GDP growth could rise by as much as 4.8 per cent. Plainly, this is an idealised scenario but even if the game-changers deliver half of what they are meant to, the growth impact would be 2.0-2.5 per cent a year. In other words, India could look forward to 8.0-8.5 per cent growth in the long term. ■



UDAY has made a promising start, with 31 states and UTs signing on so far, and Rs 2.1 trillion of state bonds issued. Total savings from the programme might eventually swell to Rs 1.8 trillion

---

The contents of this paper are based on discussions of The India CFO and the India CEO Forums in Bangalore, Chennai and Hyderabad with Adit Jain, Chairman and Editorial Director of IMA India in January 2018. Please visit www.ima-india.com to view current papers and our full archive of content in the IMA members' Knowledge Centre. IMA Forum members have personalised website access codes.