Different Strokes

As explained in IMA India's recent economic updates, we expect gross domestic product to rise by 6.4 per cent in 2017-18 and a slightly higher rate in the coming year. Output understandably took a bump in the wake of demonetisation and the subsequent roll-out of goods and services tax (GST). However, we believe these are largely behind us and recovery, going forward, should be robust and sustained. The fact is, consumption has been strong and constitutes the principal driver for growth with investment lagging behind. Be that as it may, in the years ahead the impact of certain government initiatives will play out favourably, as this editorial will in subsequent paragraphs seek to explain.

The perception is that fresh investments have lagged behind and that spending on plant and machinery remains subdued. However, the reality, we believe, is different.

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With demand continuing to grow companies are clearly producing more goods from existing capacities. This is by virtue of productivity rises which in themselves constitute an important component of growth. The reasons are a greater investment in automation and IT spending through which more widgets are churned out from existing infrastructure. However, such spends are frequently not amortised as investment but written off as a current account spend on the profit and loss statements. Therefore, whilst capex is not rising rapidly enough it is still much higher than the aggregate figures would suggest.

Transfer Benefits

Since coming to power in 2014, the Modi administration has rolled out a few structural reform initiatives some of which promise to be game changers in the longer term and are approaching a certain level of maturity. The first amongst them is direct benefit transfers (DBT), a programme formally launched in 2013 but subsequently boosted with a serious thrust in 2015. In simple terms, DBT involves the deposit of a subsidy or monetary benefit directly into the intended beneficiary's bank account rather than through intermediaries, in-kind substitutes or cash, each of which are susceptible to pilferage, leakage and diversion. The volume of fund flows through DBT-based schemes has increased from Rs 74 billion in 2014 to around Rs 1 trillion now while the number of beneficiaries has spiked from 108 million to 610 million. According to Government estimates cumulative savings through DBT up to FY17 stood at Rs 570 billion stemming primarily from three schemes – liquefied petroleum gas distribution, the public food distribution system and the national rural employment guarantee scheme. Further, direct benefit transfers removes price distortions in the economy due to controls and regulation which creates inefficiencies with a multiplier impact far worse than the initial folly. More significant perhaps, is a near elimination of pilferage. Some estimates suggest that approximately 50-60 per cent of earlier spending was misdirected, never reaching the ultimate beneficiary. Such money often found its way into poorly monitored sectors such as real estate, creating unreasonable price inflation.

In FY17, savings from DBT at Rs 209 billion amounted to 28 per cent of gross flows in the year i.e. almost a third of total spends were ultimately saved. Total government expenditure on welfare programmes and subsidies adds up to approximately Rs 6-7 trillion annually; by extension therefore the total savings that could ultimately be achieved would be 1.7 per cent of GDP, or Rs 2 trillion. However, the ultimate implications may be well and truly beyond this figure. This is based on the premise that bigger savings can be achieved when Aadhar seeding for a welfare scheme reaches 100 per cent because leakages are invariably concentrated in the un-seeded component. Currently, the average Aadhar coverage stands at around 77 per cent, up from 65 per cent two years ago. When this approaches 100 per cent the savings surge might be disproportionate, perhaps even 40 per cent or so the logic goes. Further, some schemes with very large leakages such as fertiliser subsidy are yet to be covered by DBT. In the fullness of time, Aadhar based authentication could enable more targeted subsidies and payments, consequently greater benefits with lower costs. Longer term savings could even touch 3 per cent of GDP.

Money in the markets

The second initiative has been the 'financialisation' of savings and the household balance sheet. Households are the largest savers in India contributing to a 60 per cent share of national savings. Private enterprise adds another 36 per cent and state-owned corporations, 7 per cent. The Government of India, on the other hand, dis-saves approximately 3 per cent through its fiscal deficit. However, the bulk of household savings have traditionally been in dud assets such as gold, which offers no return at all, and real estate. Therefore, the net free capital intermediated through the economy added up to a meagre Rs 8-9 trillion. However, following the demonetisation and Jan Dhan exercises, this has jumped to Rs 13-14 trillion. This was made possible because households have rebalanced their investment in financial instruments up from 31 per cent to 41 per cent of their savings. The opening of 250 million new bank accounts and the creation of a digital financial architecture were both instrumental in this. Households now invest considerably larger sums in mutual funds and by extension in bond markets. As a result, mutual fund mobilisations have nearly tripled to Rs 3.5 trillion and bond issuances to Rs 4 trillion over the last 2 years.

Apart from the fact that this change brings in larger amounts of free cash into the economy it benefits individual households in two distinct ways. Firstly, the monetary gains from investment yields can rise by 1.5-6 per cent annually by substituting gold with financial instruments in the savings portfolio. Secondly, the cost of borrowing for households could fall by 2-4 per cent annually by replacing informal borrowings with formal banking debt. Taken together, overall real household income could rise by anywhere between 4 per cent and 12 per cent per annum through a more 'financialised' balance sheet. This translates into a tangible gain in national income as households constitute 60 per cent of GDP.

By substituting gold with financial instruments households can increase incomes by 1.5-6 per cent while borrowing costs could fall by 2-4 per cent by replacing informal debt with bank loans. Household income could therefore rise by 4-12 per cent per annum through a more 'financialised' balance sheet.

Electric dreams

Finally, the benefits of the Government's power sector reforms – specifically Ujjwal Discom Assurance Yojana (UDAY) – are not widely understood. With the first phase of UDAY involving a restructuring of discom debt well underway, interest savings amounting to Rs 170 billion were achieved in the previous year; more importantly, Rs 400 billion of bank defaults were averted. In FY18, savings are likely to be even larger as the full year benefit of deleveraged balance sheets is realised. Further, the scheme has brought about a significant drop in under-recoveries on the sale of power from Rs 0.60 per unit to Rs 0.35 per unit through cost reductions and tariff hikes. In the long term, substantial benefits – of the order of Rs 1.8 trillion – are possible if the programme continues to progress at the current rate.

Theoretically, if everything worked according to plans, the rise in savings, income and investment from these measures could translate into GDP growth increasing by as much as 5 per cent per annum. Even if 50 per cent of the targets were accomplished the impact on longer term output could safely be estimated at around 2 per cent annually. This would be no mean achievement even from the most stringent benchmarks. ■

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