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FEATURE

India

Economy treading on thin ice

Dr. Rumki Majumdar

A challenging economic environment is giving India lemons. Can the government make lemonade?

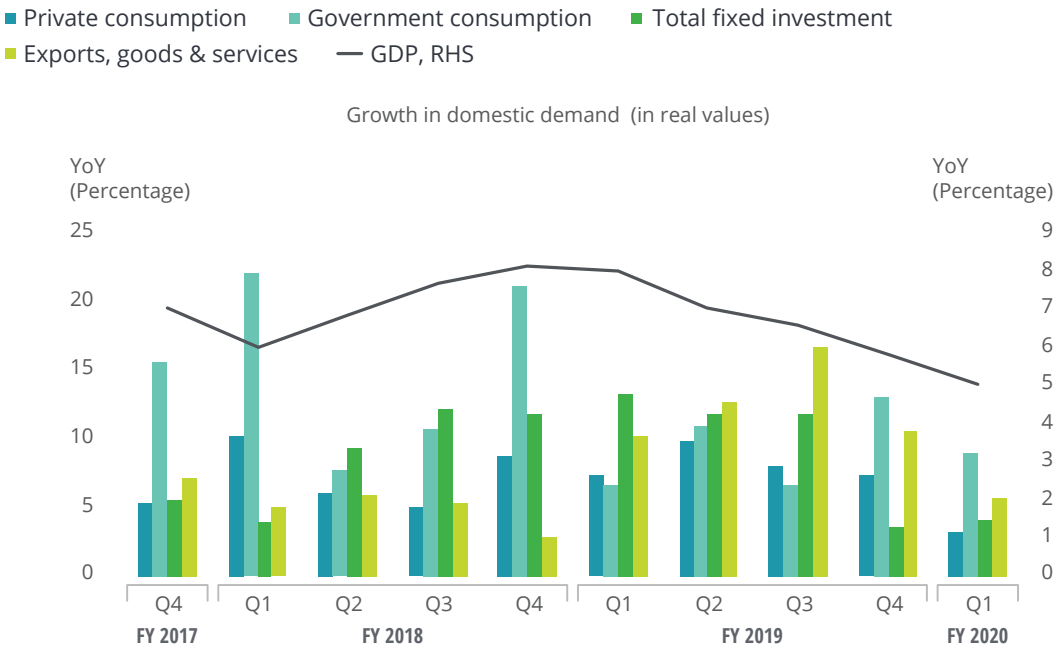
ALTHOUGH WINTER IS a few months away, there is already a chill in the Indian economy because of a slowdown and significant downside risks looming from all quarters, with questions on whether the current economic headwinds are cyclical or structural. To jump-start the economy, the government has announced a slew of reforms in the past two months. Nonetheless, uncertainty lingers as there are reservations about these being enough to prevent the economy from freezing, especially as global downside risks weigh on the domestic outlook. That said, there are opportunities that India can play to its advantage. The question is: Can this be a "lemonade moment" for India?

Gloom and doom in every corner

For the first time in seven years, India's GDP grew below 6 percent year over year for two consecutive quarters, forcing policymakers and markets to rethink India's outlook.[1] The first quarter of FY2019–20 registered 5 percent growth, the slowest since the fourth quarter of FY2012–13 (figure 1).[2] Three of the four growth engines—private consumption, private investment, and exports—have slowed down significantly. Consumption, the biggest contributor of growth, fell to an 18-quarter low of 3.1 percent in Q1 FY2019–20, pointing to fragile consumer sentiment and purchasing ability. Investments grew 4 percent, marginally up from 3.6 percent in

FIGURE 1

Demand remains sluggish



Source: Ministry of Statistical Programme and Implementation, October 2019.

the previous quarter. Exports grew 5.7 percent and have remained volatile owing to global uncertainties around trade and investments and geopolitical tensions. The fourth engine, government consumption and investment, is running out of steam because of the limited elbow room the government has for counter-cyclical spending as the budget deficit remains under pressure.

On the industry side, several core sectors including auto, real estate, and manufacturing are in deep waters. Domestic auto sales in India continue to slump, with the overall auto industry reporting a decline of 23.55 percent in August 2019. With a decline of 31.57 percent in the month, the downfall in the passenger vehicle segment has continued for over a year for the first time in a decade.[3] The real estate sector is grappling with the worst-ever slowdown in many decades—over 1.3 million houses worth about 5 percent of GDP are lying unsold across India.[4]

The slowdown indicates that domestic demand has taken a breather. Several factors—such as stagnating rural wages, tightening lending conditions (because of the ailing health of the financial institutions), and rising unemployment—are contributing to low demand for goods and services. Additionally, structural factors are contributing to the sluggishness. These include changing consumer preferences due to a rising proportion of millennials among consumers and technology innovations, both of which are transforming demand patterns.

On the supply side, excess idle production capacity, weakening corporate profits, and infrastructure bottlenecks have slowed down investment in production facilities and hiring.

Not much relief is expected from the global economy either. Growth is slowing across the globe and the International Monetary Fund (IMF) has cut its 2019 global growth forecast to 3.0 percent from 3.2 percent.[5] Global trade volume growth has been steadily declining since 2018 owing to uncertainties around trade policies. The World Trade Organization (WTO) economists expect merchandise trade volume growth to fall to 2.6 percent in 2019—down from 3.0 percent in 2018.[6] In the United States, despite a tight labor market and strong retail sales, policy uncertainties are weighing on business sentiment, and thereby business investment decisions. Sharply falling long-term yield rates and policy rate cuts by the Federal Reserve are indications of economic headwinds in the coming quarters.

That's not all. Trade policy uncertainties and geopolitical events are hurting the already weakening Chinese economy as several global companies explore alternate manufacturing destinations out of China. Weak global demand has increased the likelihood of a recession in export-dependent nations, such as Germany and Japan, while recent developments around Brexit have heightened the speculations around the deal that the United Kingdom and the European Union may agree on, now that the extension for the exit has been pushed further and the country may be looking at elections in December. Rising geopolitical tensions in the Middle East have roiled energy prices.

As for the Indian economy, all these will likely affect export growth while uncertainty will likely impact business investments as capital flows remain volatile.

So, how is the health of the overall economy?

In the past, the government managed to consolidate its fiscal position within the budget target through reforms and asset sales. However, the government's incentives to stimulate the economy (more on this in the next section) and poor revenue collections have put pressure on the fiscal balance. In the past four months, the government has already spent 77 percent of the budgeted amount of the fiscal deficit of FY2019–20.

The security yield curve has moved up higher because of the increasing downside risks of a possible sovereign rate cut and crowding out of private investments in the economy.

Credit growth has suffered as credit to consumer durables and the industry at large has shrunk. Weakening bank balance sheets, rising nonperforming assets, and slowing informal sector lending have impacted the ability and willingness of financial institutions to lend. This has adversely affected consumer demand.

On the external front, the fall in domestic demand and low international crude oil have kept the current account deficit under control. However, significant risks loom due to geopolitical tensions in the Middle East and a possible rise in oil prices. Given that India is a net oil importer, higher oil prices could have negative implications on the external account. Nonetheless, lower domestic and global demand will likely cap this risk. Foreign direct investment (FDI) has picked up over the past few quarters as India remains an attractive investment destination, while return prospects in advanced nations are poor. However, foreign institutional investment has been volatile and will likely remain so because of heightened uncertainties and poor investment sentiment. Factors concerning growth, capital outflows, and global trade disputes as well as uncertainty have weighed on the Indian rupee. It dropped to an all-time low and has stayed above the psychologically important 70-rupee mark against the US dollar over the past few months. Figure 2 summarizes the health of the overall economy and the outlook.

An all-out effort by policymakers: The Big Bang reforms

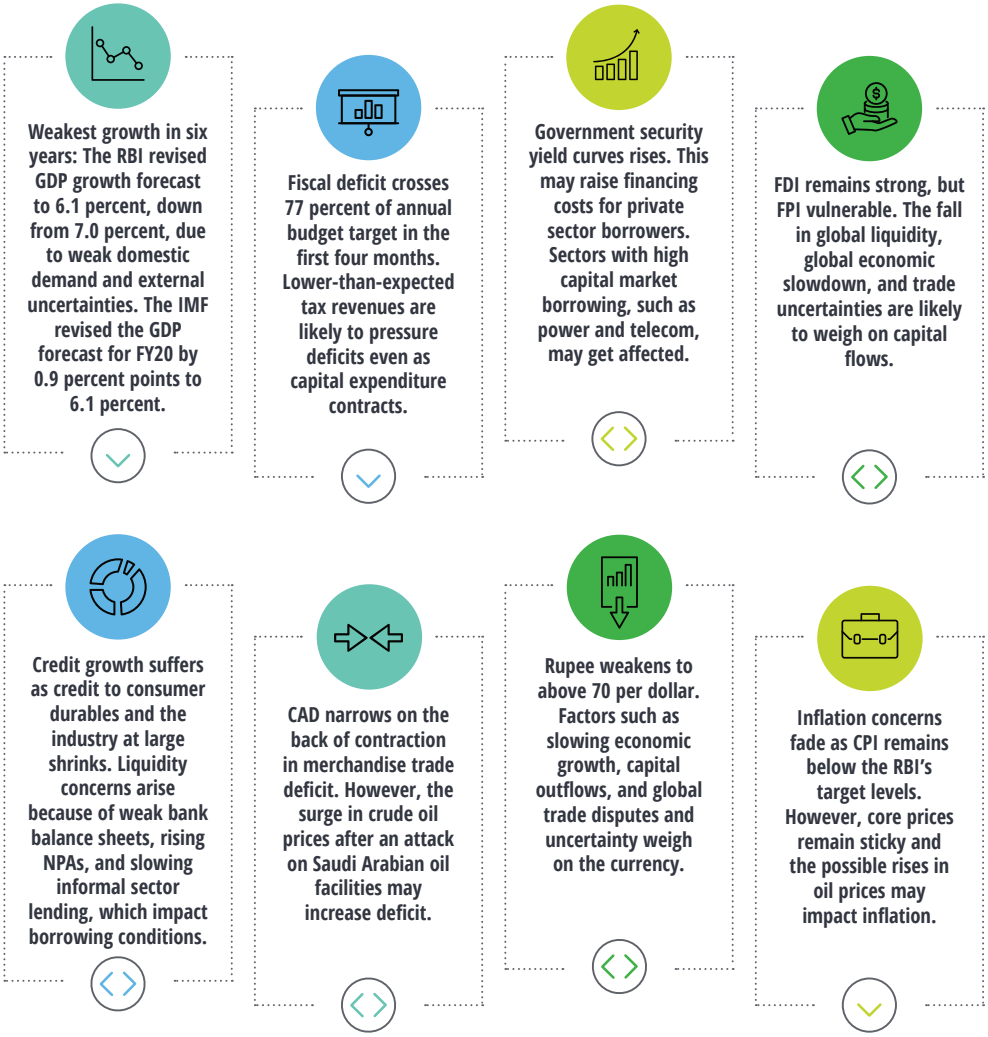
In response to the slowing economic growth, the government made a flurry of policy announcements in the past two months to boost demand and supply. These include liberalization of FDI norms for select sectors; rollback of recently introduced and much debated tax surcharge on foreign portfolio investors; incentives to support several industries; bank consolidation; and the blockbuster cut in the corporate tax rate. These measures are expected to improve credit growth, increase capital inflows, reinvigorate private investments and hiring, and thereby boost economic growth. In the following section, we discuss some of these announcements and their impact.

Financial restructuring: The INR 70,000 crores of upfront capital infusion in public sector banks (PSBs) and the merger of 10 PSBs to form four larger banks are likely to infuse capital into banks, improve liquidity in the economy, and enhance their lending capacity. In addition, these measures are likely to reduce lending costs and help improve banks' nonperforming assets (NPAs).

Sectoral reforms: Several reforms have been announced to boost the real estate, auto, and export industries, among others. With the intention of boosting demand and supply for housing, the government announced a package of INR 20,000 crore for stalled affordable housing projects, which will likely benefit around 3.5 lakh homeowners, and relaxed external commercial borrowing guidelines for affordable housing for home buyers (subject to conditions). The package will likely provide the much-needed last-mile funding for housing projects that are "non-NPAs" and non-National Company Law Tribunal. This may release the capital stuck with financial institutions and make it easier for real estate developers to access capital from a larger pool of funds. Expanded scope of the Export Credit Insurance Scheme by the Export Credit Guarantee Corporation and revised priority sector lending norms for export credit are expected to benefit small- and medium-sized enterprise exporters. These measures are likely to boost their contribution to exports as well as improve

FIGURE 2

A snapshot of macroeconomic parameters



Source: Deloitte analysis of content from various databases, the International Monetary Fund, and the Reserve Bank of India.

competitiveness. Measures such as increased depreciation cost for automobiles for corporates and businesses and deferred one-time vehicle registration fees until June 2020 are likely to improve demand for automobiles and increase the cash flow for manufacturers.

Corporate tax rate cuts: The government announced a cut in corporate tax rate to 22 percent from 30 percent, excluding surcharge and cess. Under another provision in the Income Tax Act, new domestic companies that are incorporated on or after October 2019 and are making new investments in manufacturing are now liable to pay reduced income tax of 15 percent instead of 25 percent. This move is expected to infuse capital investment in manufacturing, a sector that has failed to take off at the desired pace despite several government initiatives. The cuts that will be effective from the current financial year are subject to the condition that the eligible companies do not avail any other exemption or incentive.

With lower corporate tax rates, the government has tried to address supply-side issues. Lower tax expenses will likely enhance profitability of companies that, in turn, will likely improve business confidence and spur capital investment. The new rates bring India closer to, and in some cases even lower than, the corporate rates prevalent in many emerging and industrialized countries. This puts Indian companies on a better footing to compete with peers in the global market.

The bigger problem, however, is that of *poor domestic demand*—consumers are buying fewer goods, causing cuts in production and investment. Can the lower corporate tax rate help generate demand? To some extent, yes, as companies are likely to increase hiring and investments. Further, higher profitability will likely result in better asset valuations and improved wealth. The wealth effect could then spur demand as consumers will feel richer and, thereby, spend more. The government's previous announcements to disburse more loans and the central bank's move to ease limits on bank lending to the country's troubled nonbanking sector (with a view to improving consumer credit growth) are indications that both the government

FIGURE 3

Key announcements to boost growth and their implications

Financial restructuring	• Capital infusion into banks likely to increase liquidity and lending
	• The merger of 10 public sector banks likely to:
	  • Enhance capacity to increase credit lending
	  • Reduce lending costs
	  • Improve NPAs

Corporate tax rate rationalization	• Reinvigorate private investments and jobs through improved business confidence • Increased wealth effect, leading to higher demand • Companies better prepared to compete with peers in the global market
Measures to boost export sectors	• Benefit MSMEs* and small exporters, leading to their increased contribution to exports • Guaranteed benefits to exports • Improved competitiveness
Measures to revive the housing sector	• Boost demand for housing • Release stuck capital from financial institutions • Access capital from a larger pool of funds
Measures to boost the automotive sector	• Increase demand for vehicles • Improve cash flow for manufacturers

Note: * MSME denotes micro, small, and medium enterprises.

Source: Deloitte analysis based on news reports.

and the central bank are making efforts to propel the slowing economy upward.

That said, *fiscal pressures are bound to rise*. Corporate tax cuts will likely have an implication on the fiscal deficit as the government has to forgo substantial revenue. The cuts are expected to reduce government revenue by around INR 1.5 trillion in the current fiscal year alone, which limits the government's ability to further ease fiscal policy in the future to meet the target fiscal deficit budget of 3.3 percent of GDP.

The government's measures have been complemented with prudent monetary policies by the central bank; the Reserve Bank of India (RBI) has dropped the policy rates for the fifth consecutive time, bringing the rates to their lowest since 2010. In addition, the RBI has maintained its accommodative monetary policy stance and signaled that the stance would remain unchanged "as long as it is necessary to revive growth." The RBI has taken steps to improve cash flow to shadow lenders, including allowing banks to lend more, providing partial credit guarantees, and easing banks' mandatory liquidity ratios. Besides, it is closely monitoring the top nonbank financial corporations (NBFCs), who contribute about 20 percent of the total credit, to contain stress on key NBFCs.[7] These measures are likely to improve credit growth in the economy.

Can this be a "lemonade moment" for India?

When life gives you lemons, make lemonade. While it seems that global factors are at odds with the growth outlook, there are still opportunities that India can use to its advantage. Easy monetary policies to counter a slowdown in advanced economies and negative bond yields around the world will likely compel global investors to search for destinations with better returns. As the third-largest Asian economy, India remains an attractive investment destination due to the sheer size of its consumer market.

Multinational companies looking for alternate manufacturing destinations to diversify their supply chain and reduce costs present India an opportunity to be the next emerging manufacturing hub. Not to mention India's reputation in services exports is an advantage that is likely too difficult for global investors to ignore. Several multinational companies have already established their second-largest headquarters and R&D centers in India after the United States, and the trend may continue in the coming years because of the ecosystem created here. The question is, "Can India seize the moment?"

Both the government and businesses recognize the need to redefine business strategies and take bold decisions to address structural changes. The government has demonstrated its intent to boost demand evident from the multiple reforms and measures announced recently. India's remarkable improved ranking in ease of doing business by the World Bank (a jump of 67 position to a current rank of 63 out of 190 countries in the past three years) and the upswing in the capital market post the recent announcements are a testament to the government's effort to do what it takes to unlock its potential.[8] Nonetheless, jump-starting the economy will require a strong commitment to big-ticket reforms, their execution with agility, and the willingness and patience of the private sector and corporations to take risks and invest.

Endnotes

1. All growth projects are in year-over-year terms, unless specified otherwise.
2. FY2019–20 denotes the period between April 2019 and March 2020.
3. ET Auto, "Car sales plummet 41% in Aug; nine consecutive month decline," *Economic Times*, September 10, 2019.
4. Rashmi Pratap, "5% of India's GDP is stuck in unsold housing inventory," *Business Today*, October 4, 2019.
5. International Monetary Fund, *World economic outlook: Global manufacturing downturn, rising trade barriers*, October 2019.
6. World Trade Organization, "Global trade growth loses momentum as trade tensions persist," press release, April 2, 2019.
7. Saloni Shukla, "Slump's real. NBFC credit falls 31%. Over to RBI, govt," *Economic Times*, June 26, 2019.
8. World Bank, "Doing business 2020—Sustaining the pace of reforms," October 24, 2019; data sourced from Oxford Economics.

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