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The Indian Economic Slowdown

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Introduction:

The Indian economy, which seemed to be slogging ahead at a steady growth rate of 7.1% in the third quarter of 2018, has slowed down. Growth has been trailing for the past 8 consecutive quarters and is now at a low of 4.5%[1].

This slowdown is alarming and has been exacerbated by the collapse of traditional indicators of growth, whose developmental percentages are almost all in the strong negative to the barely positive area. Electricity generation, at 1.8%, is at its lowest point in the last three decades. The growth of the imports industry is at -6% and that of the capital goods industry, whose healthiness determines investment, is at -10%. The consumer goods production growth rate has fallen from 5% in 2017-2018 to 1% in 2019-2020. Exports have fallen from 9% to -1% from 2017-2018 to 2019-2020. The growth in direct tax revenue is now at 0% and consequently India's central bank, the Reserve Bank of India (RBI), found in May 2018 that 48% of those surveyed felt that the economy had regressed from what it was a year prior[2].

Causes of this crisis:

There are many causes of the current crisis and this paper will focus on the two most prominent ones.

<u>The impact of demonetization on private consumption and Micro, Small and Medium Enterprises (MSMEs)</u>

In November 2016 the government announced the demonetization of all ₹500 and ₹1000 notes. This made 86% of all Indian currency invalid[3] and had a huge impact on the backbone of the Indian economy: MSMEs. These companies contribute around 30% of the Indian GDP from service activities and around 33% of India's manufacturing output. They depend on informal channels of payment because of the easy availability and accessibility of credit in the form of hard cash. The overall impact of this is the slowdown of a vital part of India's economy. In August 2016, the growth rate of the MSME sector was reported at 1.6%, a low[4]. This policy also reduced available credit to Indian consumers, resulting in a contraction in private consumption, a traditional engine of growth, to 3.1%[5].

<u>The collapse of the non-banking financial company sector (NBFC)</u>

Despite the global financial crisis of 2008, the slowdown in infrastructure projects in the early 2010s and the impact of demonetization, the Indian economy continued to move ahead on the back of a NBFC-led credit boom. These companies are permitted to make loans like any other bank but cannot take deposits from people to cover the loans, leading them to borrow money from alternative sources like the bond market. The impact of bad loans had caused Indian banks to struggle in the late 2010s, leading to NBFCs performing better than them in the year of 2017. However, these companies were playing a risky game by:

- Borrowing money short term and lending it out long term; a risky mismatch in tenors of assets and liabilities

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[1] India Today Web Desk, "Gross Domestic Product Growth Falls to 4.5% in Q2 of 2019-20," India Today, November 29, 2019, https://www.indiatoday.in/business/story/gross-domestic-product-growth-falls-4-5-per-cent-q2-2019-20-1623733-2019-11-29)

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[5] Indivjal Dhasmana, "GDP Data Confirms Demand Slowdown; Consumption Expenditure at 17-Qtr Low," Business Standard (Business-Standard, August 30, 2019), https://www.business-standard.com/article/economy-policy/gdp-data-confirms-demand-slowdown-consumption-expenditure-at-17-qtr-low-119083001449_1.html)

- Relying on mutual funds as a source of credit. The mutual funds sector has seen a reduction in investment due to the market slowdown triggered by NBFC default, leading to less available credit.
- The investment of most available credit to companies in the housing sector, triggering a real estate bubble that burst in 2019.

The woes of the NBFCs, the loss of credit in mutual funds and the bursting of the real estate bubble have all been caused because of the collapse of a prominent NBFC, IL&FS, which is now sitting on debt worth Rs 94,000 crore[6]. This has scared prospective investors away from NBFCs, disallowing them from issuing new debt to absolve old debt due to the lack of credit, hence pulling the economy down.

<u>The uncertainty of the world economy</u>

India is not the only country going through such a crisis. According to the IMF, 90% of the world is likely to experience a slowdown. The need for trade and understanding is at an all time high, but the will to do so is lacking as some of the globe's largest economies like the US and China engage in a relentless trade war. Meanwhile, doubts over the fate of Brexit has affected the UK's growth and thus Europe's. All in all the growth of international trade has come almost to a standstill. Global growth is now at 3%, the lowest since the financial crisis of 2008. All these changes have manifested in a global slowdown, which the IMF believes is more pronounced in countries like Brazil and India[7].

Possible solutions to the crisis:

<u>Addressing the issue of NBFCs</u>

Currently India's central bank has increased the loan lending limit of banks towards NBFCs from 10% to 15%. This is expected to allow around $10 billion of liquidity to flow to the cash strapped sector[8]. In the long run however, this method seems to be a temporary solution with its own risks. If risky assets possessed by the NBFCs transfer over to the banks, the already struggling banking sector could suffer even more.

Instead, the RBI should focus on reviewing the assets of all NBFCs. Well capitalized companies should be allowed to continue their operations, while under-capitalized ones should be referred to a government established fund that can provide capital. If market capitalization and revival is not possible, the RBI and the government should nudge the NBFC in concern towards a M&A with another company.

Something similar has been done in the past. In 2015, the RBI announced a mandatory asset quality review for banks in India and went through their balance sheets in order to make sure that the banks were not understating their non-performing assets[9].

<u>Reviving the infrastructure sector</u>

As mentioned previously in this paper, the decaying of building projects started in the 2000s has impaired the infrastructure sector. Reviving this area is crucial for job creation, making exports more competitive and opening up India to tourism. The government should move immediately to clean up the land acquisition process and improve on the efforts of its predecessors by looking at environmental clearance issues and increasing the availability of raw material. Land access for development is another factor that has restrained growth in infrastructure that could be ameliorated through making land banks and computerized land mapping.

Beyond this, it is necessary for investment to flow in to the sector in order to stimulate building projects. This can be done both domestically and internationally. Public finance reforms such as expenditure reform and asset swaps are essential to freeing up domestic capital for investment. Further, while India's FDI has risen by 15% from April to September 2019 to $26 billion, it is being spent on other sectors such as computer software and telecommunications[10]. It is imperative that the government create more Special Economic Zones, with a focus on infrastructure, which will not only improve India's exports but also stimulate domestic production.

[6]ET Online, "IL&FS: The Crisis That Has India in Panic Mode," The Economic Times (Economic Times, October 3, 2018), https://economictimes.indiatimes.com/industry/banking/finance/banking/everything-about-the-ilfs-crisis-that-has-india-in-panic-mode/articleshow/66026024.cms)

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Taking another look at the banking system

The Indian banking sector currently is in stress. It has lost $30 billion due to the non-performing loans of 418 companies being written off[11]. Multiple cases of fraud such as the Nirav Modi and Vijay Mallya cases have not helped it at all either. As a result, many in th sector are straddled with non-performing assets and do not have the capital to tackle these NPAs. To assuage the entire financial system, it is essential that the banking sector be stabilized. The government must step in and assist those lagging behind in restructuring their debt. The government's creation of the Insolvency and Bankruptcy Code (IBC) in 2016 will prove useful in addressing the latter.

Reducing unemployment

International organizations such as the International Labour Organization (ILO) estimate that India's unemployment rate is around 3.5%[12]. A leaked government report in 2019, however, placed this figure at 6.1% during 2017 - 2018[13]. This is alarming, as it is almost double the estimated figure and the highest unemployment rate in the past four decades. The report is not unjustified in this claim; India's participation of women in the workforce is down from 35% in 1990 to 27% in 2019[14] and is one of the few countries to have experienced such a phenomenon. The ILO has also stated that unemployment is likely to rise in coming years.

Employment is an engine of growth. An increase in job creation in a country is likely to drive growth as well. This economic maxim should be taken seriously by the government and addressing areas such as infrastructure will undoubtedly spur employment too. The issue with employment in India, however, lies mainly in its labour laws. These laws have been called 'the most restrictive and complex in the world' by the World Bank[15] - and for good reason. For example, workers with a salary lower than ₹25,000 have 40% of their gross wages deducted for government securities and health plans. For those with a higher salary, the figure is just 9%[16]. This cuts away from labour productivity and unemployment as 82% of male and 92% of female workers have salaries lower than ₹25,000[17]. The percentage of gross wages taken away should be lowered by the government in order to bring about job creation. Apart from this, current laws allow firms to hire workers for one year before deciding whether to permanently retain them or fire them. Significant costs are associated with making a worker permanent and thus many firms hire multiple workers for one year before letting them go. Steps must be taken by the government to amend the law in concern to allow firms to negotiate renewable multi-year contracts with labourers in order to prevent such behavior. Finally, in order to encourage female participation in the workforce, the government should not legislate that firms pay for maternity and childcare leaves as this could cause lesser women to be hired. A per unit subsidy for the same should be implemented by the government thus giving firms no incentive not to lessen the hiring of women.

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