Motilal Oswal

Economy

2020s: Decade to regain lost economic strength

- The third decade of the 21st Century has begun on an unprecedentedly weak note. Due to the physical lockdown on account of COVID-19, global GDP decline has been the fastest in the peacetime era. This makes the 2020s decade highly unusual, but interesting. How strong or weak India's economic recovery could be and what could be done to make it stronger is what we have addressed in this note.
- India's average GDP growth in the first two decades of the 21st Century remained the same; however, the drivers varied drastically. After both decades reported strong growth in the first year, economic growth weakened. It then strengthened considerably in the middle and faltered once again towards the end, creating sleeping S-shaped growth curves. Nonetheless, the growth in the 2000s decade was led by investments, while consumption was the key driver in the 2010s decade.
- Although the third decade begins at the absolute bottom – which could only improve over the course of the decade – the scars of COVID-19 may mean limited economic strength in the recovery phase. Nevertheless, it does provide an unmatched opportunity to address difficult structural economic issues – this would help the nation move from low growth in the first half to high-single-digit growth before the end of the 2020s decade, and on a sustainable basis too.
- Besides these structural issues, there are five more areas wherein improvement is needed to support India's economic growth. Many of these areas have already shown some promise in 2020; however, sustained improvement in these areas is needed, without which lost economic strength cannot be regained.

IMPROVEMENT IN THESE FIVE AREAS IN THE 2020S DECADE WOULD BE FOLLOWED CLOSELY

01

- Without a strong Financial sector, no nation can witness high economic growth. Unlike in the first decade, India's Financial sector diversified and struggled in the 2010s decade. While it has been extremely resilient in 2020, supported by regulatory changes and strong capital injection, credit growth remains tepid. Continued efforts to keep the system clean, further consolidation, and adequate capital bode very well for higher credit growth over a period of time.

02

- India's Residential Real Estate (RRE) sector has been at the core of economic slowdown. A large reduction in interest costs and various sops by central/state governments have complemented low-to-stable home prices and low-to-stable income growth in prospective buyers to support robust recovery in the RRE sector. Although the resilience of this recovery is in question at this stage, it certainly provides a template of how the RRE sector may be revived.

03

- From being a member of the Fragile Five over 2012–14, India has come a long way in securing its position as one of the most favored investment destinations. As the country has the world's 5th largest stock of foreign exchange (FX) reserves, the external sector has turned from an area of concern to comfort. Going forward, although BoP surplus would reduce, FX reserves of USD585b provide enough insurance to follow the long-term roadmap, without worrying too much about external vulnerability.

04

- *"No crisis should be wasted,"* and the Government of India (GoI) seems to have taken this very seriously. In the past few months, GoI has announced a number of structural reforms, ranging from labor, agricultural, to educational reforms. The beauty of reforms is that they disturb the existing ecosystem and nudge the present beneficiaries to compete with new players. As a result, they are almost certain to bring efficiency or productivity improvements.

05

- Lastly, GoI has shown renewed drive toward India's Manufacturing sector. The Production-Linked Incentive (PLI) Scheme was announced for 13 shortlisted sectors in 10 ministries/departments, with the approved financial outlay totaling INR1.97t over the next five years. While the government's Make In India initiative has failed to yield the desired results in the last five years, the focused approach and linked incentives are expected to yield better results in PLIs.

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Whether Indian households would keep their financial positions healthy is an important pre-requisite for better growth over the long term

While following the developments on these important changes, we would also closely observe other important economic indicators related to the financial positions of Indian households, the corporate sector, and the government.

We believe COVID-19 may act as a trigger to nudge the Household sector to start worrying about its deteriorating finances – falling savings, rising leverage, and weak incomes. While 2020 led to extreme behaviors, pushing financial savings sharply higher, this would start reversing from 2021 as things begin to normalize. Whether Indian households would keep their financial positions healthy is an important pre-requisite for better growth performance over the long term.

Furthermore, this government has shown remarkable resistance to any major stimulus, which provides further confidence that government finances could improve consistently over the next decade. While the fiscal deficit would remain above 3% of GDP for the next few years, the path to fiscal consolidation would be watched closely. **The faster the fiscal consolidation, the lower would be the fiscal support toward economic growth and vice-versa**. As we had discussed in detail **here**, it could take many years for the general government to bring its debt-to-GDP ratio (at 86% of GDP in 2QFY21) back down to pre-COVID levels (of ~68%). This implies the fiscal support toward economic growth in the 2020s decade would be lower than in the 2010s decade.

As households and the government remain cautious on spending and repair their balance sheets, a sharp and sudden surge in non-government investments is unlikely. **With the rising formalization in the economy benefitting the organized Corporate sector disproportionately at the initial stage, this sector's balance sheet would also strengthen over the decade.**

All of these factors imply that while economic revival may be limited over the next few years, the improved balance sheets of economic participants – along with sustained improvements in the five areas mentioned above – would mean the stage is set to move from low growth to high-single-digit growth before the end of the 2020s decade. Moreover, with these adjustments, strong growth may be sustainable for several years, even a couple of decades. If, however, this repairing does not happen, it is very likely the economy would continue to crawl sideways – with some years of decent growth and some years of weak growth – leading to subdued average growth. These adjustments, we believe, are inevitable to move to a high-growth trajectory on a sustainable basis.

Healing undertaken in the third decade of the 21st Century could help India reap the benefits over subsequent decades and become a middle-income nation by the 2050s

Why talk about this now? There are two reasons: a) COVID-19 presents the opportunity to address difficult structural challenges – which is already visible in some areas and b) assuming these issues are resolved over the next few years, the nation would have two more decades (the 2030s and 2040s) to reap the economic benefits before the demographic dividend starts disappearing from the 2050s decade. Therefore, we argue that healing undertaken in the third decade of the 21st Century could help India reap the benefits over subsequent decades and become a middle-income nation before favorable factors start reversing.

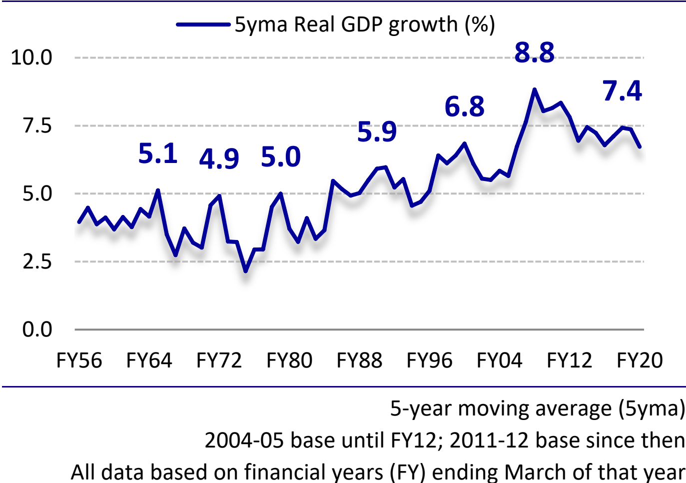
The 21st Century thus far: Two decades, two different stories

Growth in the 2010s decade may be characterized by falling savings, weak investments, strong consumption growth, fiscal spending, falling corporate profitability, a struggling Financial sector, and a subdued global environment; this is almost exactly the opposite of what happened in the 2000s decades

Average GDP growth in the first two decades of the 21st Century was almost similar at ~7% per annum. Furthermore, the GDP growth curve was also very similar: sleeping S-shaped *(Exhibits 1, 2)*. The first year for both the decades was very strong, but weakness set in quickly thereafter. Growth then strengthened considerably in the middle, only to falter again toward the end. However, the similarities end here. The drivers of the sleeping S-shaped growth curve over the two decades were entirely different. Strong growth in the 2000s decade was characterized by – higher savings and investments, decent consumption growth, fiscal consolidation, rising corporate profitability, a strong Financial sector, and a supportive global environment. In stark contrast, similar growth in the 2010s decade was characterized by – lower savings (leading to strong consumption growth), higher fiscal spending, declining corporate profitability, a struggling Financial sector, and a subdued global environment.

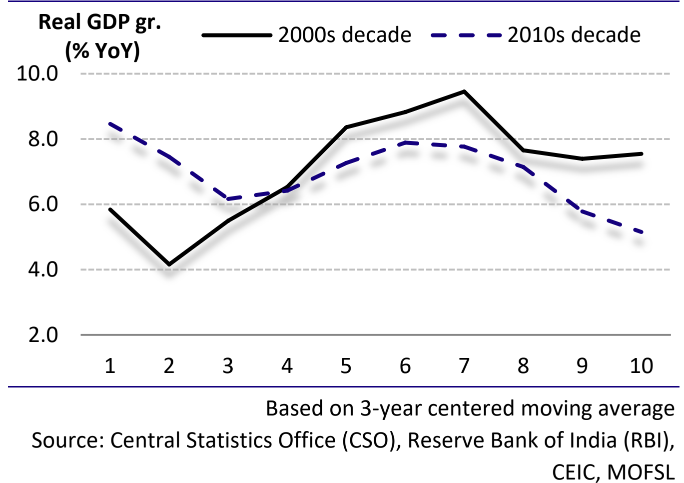
Up to the mid-1990s, the Indian economy had never witnessed two successive years of above-6% real GDP growth. With liberalization spreading across the economy, real growth averaged 6.8% in the last five years of the 20th Century. The economy, however, entered into the 21st Century with sluggish growth. Average real GDP growth in the first three years (FY01–03) was just 4.2%; nevertheless, weak growth did not last long. India's real GDP grew 8% in FY04 and improved to 9.8% in FY08 – just before the party was rocked by the Global Financial Crisis (GFC) in FY09. This five-year period (FY04–08) saw average growth of 8.8%, which has been the best episode in the past seven decades.

Exhibit 1: India saw its best five-year period in the first decade of the 21st Century…



5-year moving average (5yma)
2004-05 base until FY12; 2011-12 base since then
All data based on financial years (FY) ending March of that year

Exhibit 2: …and its growth curve in the 2010s was similar to that in the 2000s (sleeping S-shaped)



Based on 3-year centered moving average
Source: Central Statistics Office (CSO), Reserve Bank of India (RBI), CEIC, MOFSL

Notably, the Indian economy recovered quite strongly from the GFC. After weakening to 3.9% in FY09, real GDP growth surged to 8.5% in FY10 and its all-time highest (and first double-digit) growth of 10.3% in FY11. The first year of the 2010s decade was thus very strong. This high growth (seen immediately post the GFC) was, however, supported by several macroeconomic imbalances – high inflation, high fiscal deficit, and high current account deficit – due to which high growth could not sustain for long. Real GDP growth weakened once again to 6% over FY12–14, before the General Election in 2014 changed the country's leadership.

The growth pattern in the 2010s decade was, thus, very similar to that in the 2000s decade – a sleeping S-shaped curve

With the Bharatiya Janata Party (BJP) coming into power, the economy posted average growth of 7.7% in the first four years of its leadership – between 7% and 8.3% over FY15–18. Growth weakened once again to 6% in FY19, and the decade ended at 4.2% growth in FY20, similar to the growth seen in FY09 – the GFC year. The growth pattern in the 2010s decade was, thus, very similar to that in the 2000s decade – a sleeping S-shaped curve *(Exhibit 2 on the preceding page)*.

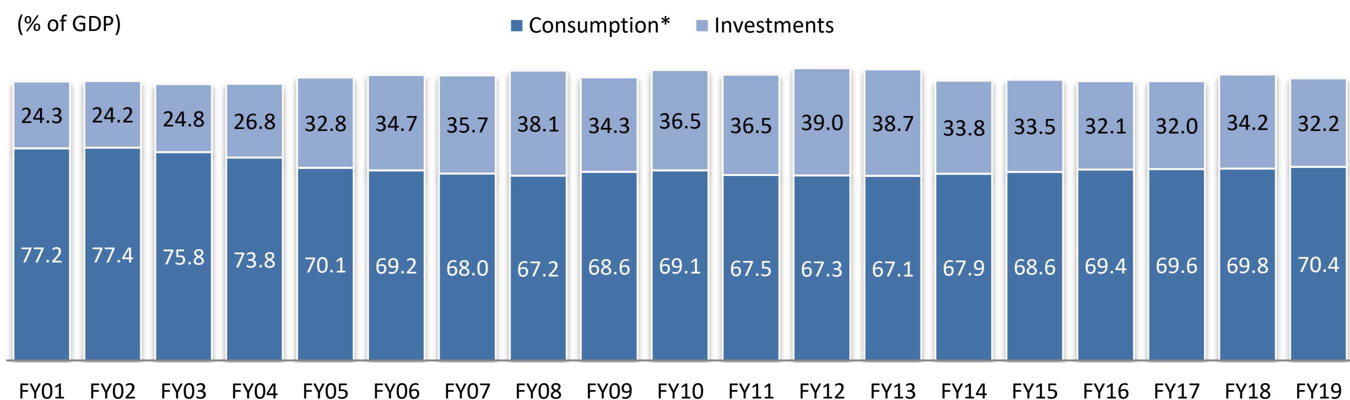
Renowned economist, Hyman Minsky[1] stated that every stable period sows the seeds of instability, leading to slowdown. After some pain and the efforts of the policymakers, the environment turns stable once again, aiding growth recovery, resulting in a business cycle – from the peak to the trough and reaching the new peak. These business/economic cycles are inevitable. Stability leads to instability, which gets corrected over due course of time; this, in turn, sows the seeds of new instability. An analysis of India's economic growth drivers in the first two decades of the 21st Century – as we will discuss next – reveals the same pattern. Slow growth at the turn of the century created room for higher growth in the mid-2000s. This eventually led to macroeconomic imbalances and slower growth in the early 2010s. As these imbalances were addressed, GDP growth improved once again in the mid-2010s. This was led by some other and new unsustainable trends, once again leading to weakening growth at the end of the previous decade.

Drivers of business cycles in the 21st Century

Investments were the primary driver of India's highest ever real GDP growth in the first decade of the 21st Century

There are only three economic activities in a nation – consumption, investments, and foreign trade. One of the simplest ways to understand the growth drivers for a period is to analyze the share of these activities in the nation's GDP. At the turn of the century, India's consumption (personal + government) amounted to more than three-fourths of GDP, while total investments (private + government) were less than a fourth of GDP. It is clear from *Exhibit 3* that investments were the primary driver of India's highest ever real GDP growth in the first decade of the 21st Century. Investments increased to 38.1% of GDP in FY08, from 24% in FY01, before this best ever growth was interrupted by the GFC. On the contrary, the share of consumption decreased from 77% to 67% during the period.

Exhibit 3: Share of consumption* and investments in GDP over the past two decades (%)



* Personal + Government
It doesn't add to 100% because net exports are not included

Data for Gross capital formation is not yet available for FY20
Source: CSO, CEIC, MoFSL

[1] Hyman Minsky, Stabilizing an Unstable Economy, McGraw-Hills Book, originally published in 1986

The situation remained fairly stable for the next few years. Investments remained at around 39% of GDP up to FY13, while consumption stood at ~67% of GDP. From FY14, however, while the share of investments reduced, the share of consumption started rising once again. Investments fell to 32% of GDP in FY19 (from the peak of 39%), while the share of consumption rose to 15-year highs of 70% of GDP in FY19.

While high growth in the first decade was almost entirely led by higher investments, a similar level of average growth in the 2010s decade was supported by higher consumption (rather than investments)

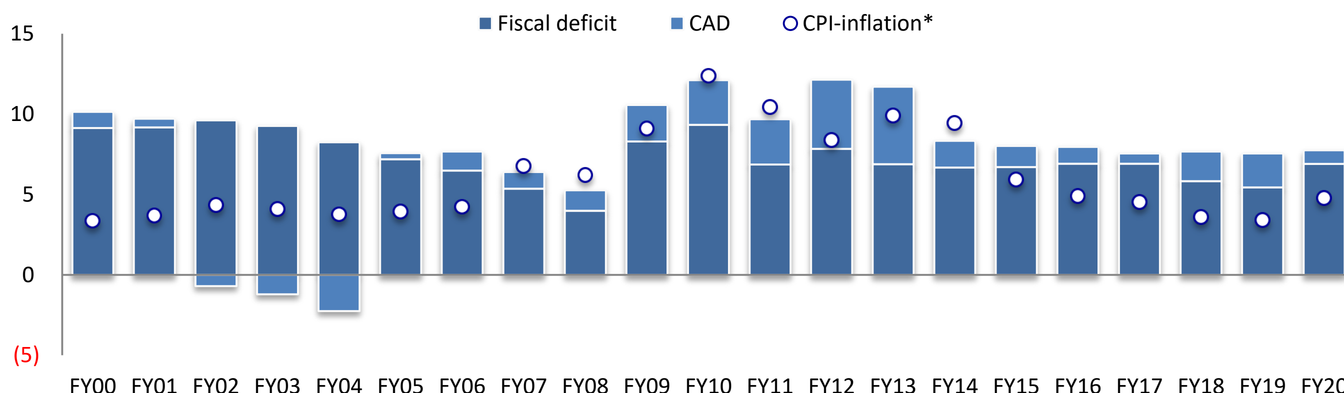
This confirms that while high growth in the first decade was almost entirely led by higher investments, a similar level of average growth in the 2010s decade was supported by higher consumption (rather than investments). Investment growth outpaced that of GDP and consumption in the first decade, while consumption growth outpaced that of GDP and investments in the second decade of the 21st Century.

How stability led to instability, which then turned into stability once again

As India's growth weakened considerably at the turn of the century, economic imbalances – in terms of current account balance, fiscal balance, and inflation – also changed accordingly. From deficit of 1.5% of GDP in the mid-1990s, weaker growth helped India's current account balance narrow. It moved into the surplus zone for the first time since the 1980s and posted three consecutive current account surpluses (CAS) for the first time since the 1950s. In fact, current account surplus was 2.3% of GDP in FY04, the highest in post-independence history. However, as India entered into a high-growth phase, its current account balance moved to deficit of 2.3% of GDP in FY09 and ended the decade at 2.8% in FY10.

India's combined fiscal deficit (center + states), on the other hand, widened from 7% in the mid-1990s to more than 9% of GDP in the early 2000s. The threatening level of fiscal deficit gave birth to the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 – which proposed to eliminate revenue deficit and reduce the fiscal deficit of the central government to 3% of GDP by FY08. Several states also implemented the FRBM Act in due course; the combined fiscal deficit narrowed to just 4% of GDP by FY08, before it more than doubled due to the GFC by the end of the first decade of the 21st Century.

Exhibit 4: Twin deficit (% of GDP) and inflation (% YoY) trends in India



* Based on consumer price index for industrial workers (CPI-IW) until FY12 and All-India CPI since then

Fiscal deficit of the General government (Center + States)

Source: RBI, CSO, CEIC, MoFSL

Higher growth in the mid-2000s allowed the government to follow fiscal consolidation; however, this did not happen in the 2010s decade

As the GFC impacted the world economy, authorities did their best to support domestic economic growth. Indian policymakers also implemented their version of a fiscal stimulus, due to which the fiscal deficit more than doubled to 8.3% in FY09 (from 4% in FY08) and 9.3% of GDP in FY10. Notably, however, notwithstanding the strong growth seen in FY11 and the mid-2010s, India's fiscal deficit remained at ~7% of GDP, much higher than the levels seen in the mid-2000s decade. This implies that while higher growth in the mid-2000s allowed the government to follow fiscal consolidation, it did not happen in the 2010s decade.

Similarly, while GDP growth was similar in the two decades, India's CAD averaged 2.1% of GDP in the 2010s decade, compared with average CAD of 0.5% of GDP in the 2000s decade. Although high oil prices could be blamed for higher CAD in the recent decade, current account surplus (excluding petroleum products) was also lower at 1.7% of GDP v/s 3.1% of GDP in the first decade of the 21st Century.

Lastly, with weak growth seen in the early 2000s, headline inflation (measured by consumer price index – CPI) also eased from the double digits in the 1990s to 4% in the first half of the 2000s decade, before rising once again to 6–7% over FY07–08. Nevertheless, headline inflation averaged 10% between FY09 and FY14, before softening to 4% in the second half of the 2010s decade.

To stabilize the economy in the aftermath of the GFC, policymakers overstimulated the economy. This certainly boosted GDP growth (the only double-digit growth was seen in FY11), but worsened macroeconomic balances, with a widening twin deficit and very high levels of inflation. This period of economic imbalances gave rise to an inflation-targeting Reserve Bank of India (RBI), with authorities trying hard (using physical restrictions) to bring CAD under control. With the sudden fall in CAD and an inflation-focused central bank, India's real GDP growth, which had slumped to 6% between FY12 and FY14, picked up once again to an average of 8% between FY15 and FY18.

While GDP growth was similar in the first two decades of the 21st Century, the decades were characterized by very different internals

In short, while GDP growth was similar in the first two decades of the 21st Century, the decades were characterized by very different internals. High growth in the 2010s decade was primarily led by consumption rather than investments. Moreover, since investment growth was generally weak, so were the profit expectation and employee cost in the corporate sector – which led to weak income growth in households. With weak income growth, but stable consumption growth, it became clear that India's growth was supported by savings withdrawals and the accumulation of debt by households, which stretched their financial positions. As a result, we **concluded** that this consumption-led growth was not sustainable and would ease off, as has happened.

The third decade of the 21st Century has begun with unprecedented weakness. Due to the physical lockdowns on account of COVID-19, global GDP decline has been the fastest in the peacetime era. This makes the 2020s decade highly unusual but interesting. How strong or weak, then, could India's economic recovery be? What could be done to make it stronger? This is what we discuss next.

IMPROVEMENT IN THESE FIVE AREAS – A KEY MONITORABLE

It is important to note the Indian economy entered into COVID-19 with very weak fundamentals. The Financial sector was weak (as non-performing assets (NPAs) mounted and NBFCs/HFCs struggled), the RRE sector had just started to show some signs of recovery, and India's Manufacturing sector was falling behind. Thus, to return to the high growth path, we need to closely monitor developments in these five areas:

01 STATE OF INDIA'S FINANCIAL SECTOR

Unlike in the first decade, India's Financial sector diversified and struggled in the 2010s decade. It has been extremely resilient in 2020, supported by regulatory changes and strong capital injections; however, credit growth remains tepid. Continued efforts to keep the system clean, further consolidation, and adequate capitalization of lenders bode very well for higher credit growth over a period of time.

02 REVIVAL IN INDIA'S LACKLUSTER RESIDENTIAL REAL ESTATE

India's RRE has been at the core of the economic slowdown seen since FY15. Large reduction in interest costs and several sops by central/state governments have complemented low-to-stable home prices and low-to-stable income growth in prospective buyers to support robust recovery in the RRE sector. Though the resilience of this recovery is in question at this stage, it certainly provides a template of how the RRE sector may be revived.

03 MASSIVE COMFORT ON THE EXTERNAL SECTOR

With the first current account surplus in 17 years and heavy inflows of foreign capital, India is currently faced with the problem of plenty. The record rise in foreign exchange reserves and general improvement in all external sector indicators certainly removes one area of concern.

04 STRUCTURAL REFORMS EXPECTED TO SUPPORT GROWTH OVER THE LONG TERM

The Government of India (GoI) has implemented some extremely politically challenging and long-pending reforms in the Agriculture, Labor, and Education sectors. While they have seen protest, these reforms hold the potential to support India's growth over a long period.

05 RENEWED PUSH TO THE MANUFACTURING SECTOR

Lastly, GoI has undertaken various measures to push India's laggard Manufacturing sector. The reduction in corporate tax rate (to start with) in September 2019 has been complemented by the implementation of the PLI Scheme to boost domestic production and substitute imports and, hopefully, encourage exports. Although PLI is the replacement of an old scheme, popularly called MEIS (Merchandise Exports from India Scheme), the focused approach may yield different results this time around.

Let's discuss each of these in detail.

01
STATE OF INDIA'S FINANCIAL SECTOR

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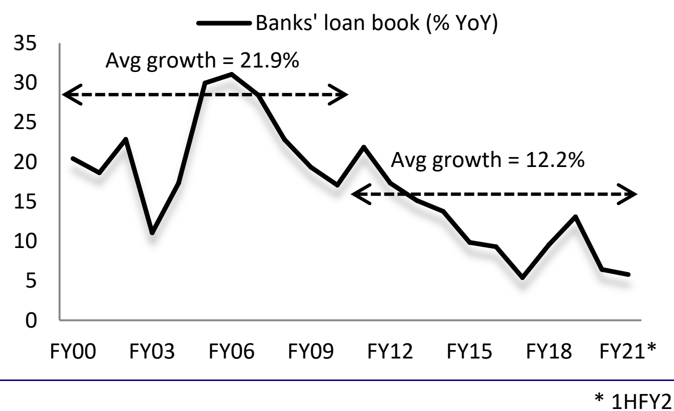
Without a strong Financial sector, no nation can witness high economic growth. Unlike in the first decade, India's Financial sector diversified and struggled in the 2010s decade. It has been extremely resilient in 2020, supported by regulatory changes and strong capital injections; however, credit growth remains tepid. Continued efforts to keep the system clean, further consolidation, and adequate capitalization of lenders bode well for higher credit growth over a period.

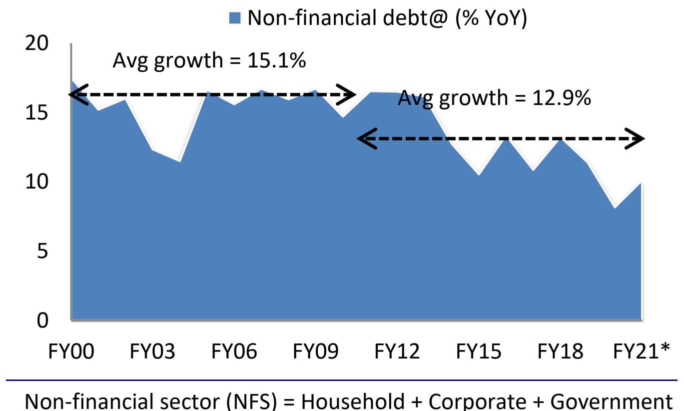
In the first decade of the 21st Century, banks' lending growth averaged 22%, with as high as 30% growth seen over FY05–06. Such strong loan growth matched the investment boom seen during the decade, which was the primary driver of higher GDP growth. During the 2010s decade, however, bank loans grew at just 12% per annum – only slightly better than half the growth seen in the previous decade *(Exhibit 5)*. While this was in line with slower investment growth, this argument misses factoring in the changing environment of India's Financial sector.

Exhibit 5: Banks' lending growth has weakened substantially in the 2010s decade…



* 1HFY21

Exhibit 6: …however, total debt in India's non-financial sector (NFS) has grown at similar levels



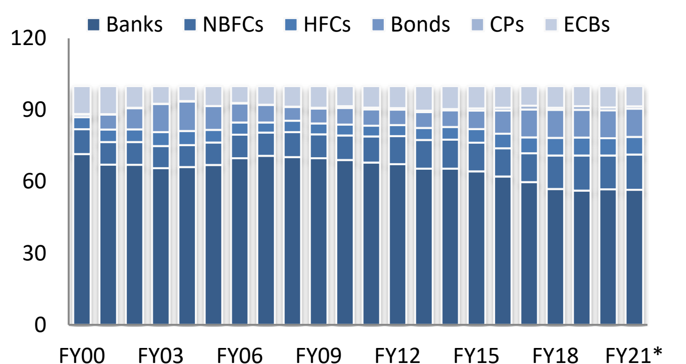
Non-financial sector (NFS) = Household + Corporate + Government
Source: RBI, Ministry of Finance, CEIC, Company reports, MOFSL

While banks' loan growth almost halved, NFS debt growth in the 2010s decade was 13%, not much lower v/s 15% growth in the previous decade

Unlike in the first decade, India's Financial sector diversified in the second decade of the 21st Century, as non-bank lenders gained prominence. Although there is no official statistics on this, our in-house estimates suggest that the shares of NBFCs, HFCs, corporate bonds, and CPs rose in India's total debt to the Non-Government Non-Financial (NGNF) sector. While banks' loan growth almost halved, NFS debt growth in the 2010s decade stood at 13%, not much lower than 15% growth in the previous decade *(Exhibit 6)*. This was attributable to two factors: a) loan growth in the Non-Bank sector was as strong in the 2010s decade as in the 2000s decade and b) higher fiscal deficit contributed to higher NFS debt in the country.

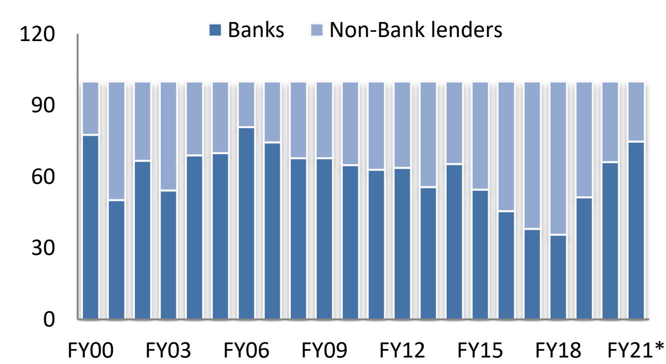
Our estimates also suggest that the share of banks in NGNF debt fell from 70% in FY10 to less than 57% in FY20. On the other hand, the share of NBFCs rose from 10% to ~15%, HFCs gained from 4.6% to 7.4%, and the share of bonds increased from 7% in FY10 to almost 12% in 1HFY21 (refer to our quarterly **updates** on the subject, which provide details on the methodology used to estimate India's NFS debt). Further, while banks accounted for two-third of NGNF debt growth in the 2000s decade, their share fell to 54% in the 2010s decade and only about 35-40% in FY17 and FY18 *(Exhibits 7, 8 on the following page)* before recovering to 66% on FY20.

Exhibit 7: Share of various lenders in India's NGNF sector debt (%)



* 1HFY21

Exhibit 8: Contributors to banks and non-bank lenders in NGNF debt YoY growth (%)

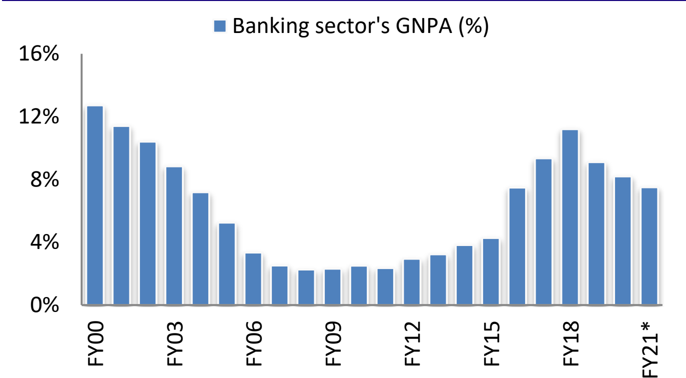


Source: RBI, CEIC, Company reports, MOFSL

Two major changes occurred in the 2010s decade: 1) role of non-bank lenders in India's debt growth increased, and 2) a shift was seen from PbSBs to PvSBs

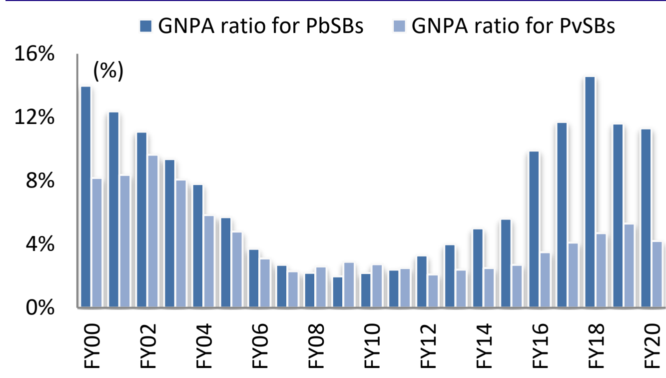
As Banks dominated the Financial sector in the 2000s and average loan growth during the decade was >20%, it created a large wave of non-performing assets (NPAs) in the system. Although banks were initially reluctant to recognize NPAs, their credit growth has weakened almost continuously since FY10. Post the implementation of RBI's Asset Quality Review (AQR) in FY15, the focus shifted to cleaning up the balance sheet. Gross NPAs (GNPAs) for the banking system – which reduced to 2.5% between FY07 and FY11 (from 12% at the turn of the century) – climbed sharply to a 19-year peak of 11.2% in FY18, before easing to 8.5% in FY20 and further to 7.5% in 1HFY21. Public sector banks (PbSBs) posted a much higher increase, from 2% in FY09 to 14.6% in FY18 and 11.3% in FY20. Private sector banks (PvSBs) reported a rise from 2.1% in FY12 to 5.3% in FY19 *(Exhibits 9, 10)*. Therefore, while PbSBs' GNPAs in FY18 were the highest in two decades, NPAs for PvSBs were much lower than at the turn of the century.

Exhibit 9: Gross NPAs rose sharply in mid-2010s decade and have eased gradually since FY19



* 1HFY21

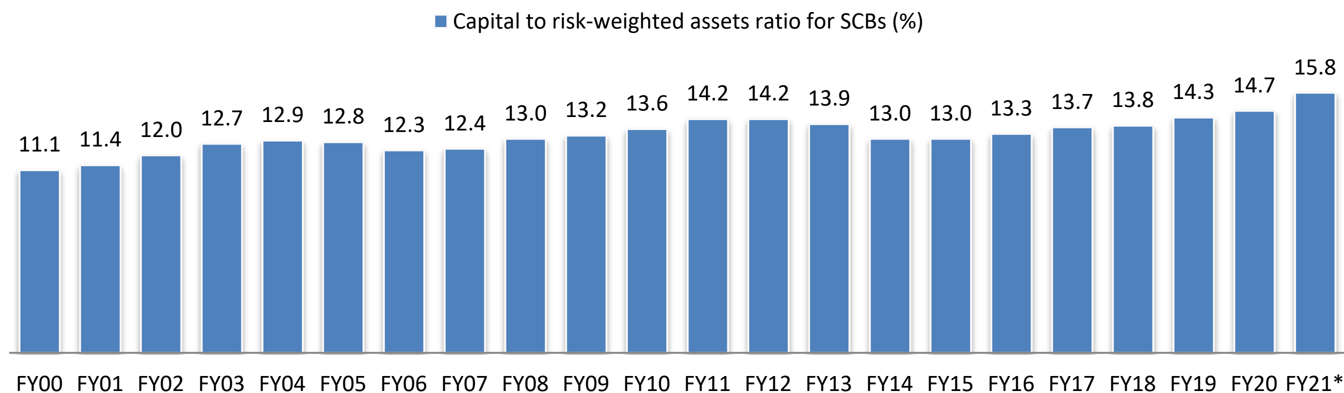
Exhibit 10: Unlike early 2000s, PbSBs have been more adversely affected than PvSBs in recent years



Source: RBI, CEIC, MOFSL

Further, Banks' capital to risk-weighted assets ratio (CRAR) rose gradually from 11% at the turn of the century to ~14% at the end of the first decade. With rising economic imbalances, SCBs' CRAR fell to 13% in FY15, before rising once again to all-time highs of 14.7% in FY20; this has risen further to 15.8% in 1HFY21 *(Exhibit 11)*.

Exhibit 11: Capital adequacy ratio for SCBs at record highs in 1HFY21



* 1HFY21

Source: RBI, MoFSL

Although Banking sector weakened in the 2010s decade, PbSBs suffered much more than PvSBs. Consequently, a sharp migration was seen from the former to the latter in terms of both deposits and loans. The share of PvSBs has increased significantly from 18% in total deposits in FY15 to 28% in FY20 and 1HFY21. Within loans, the share of PvSBs increased from 22% to 33% during the corresponding period *(Exhibits 12, 13)*. Almost the entire rise in the share of PvSBs has been on account of the losses of PbSBs.

Exhibit 12: Market share in deposits – private banks' share increased to 28%

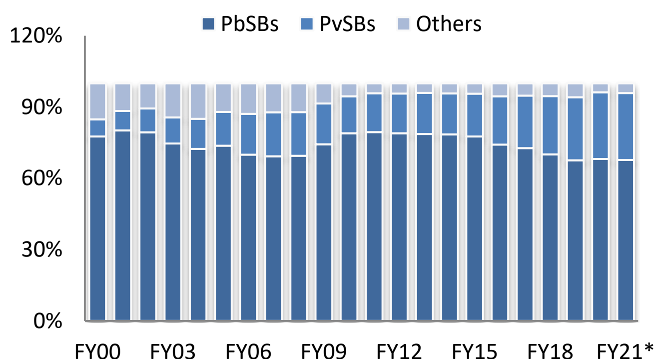
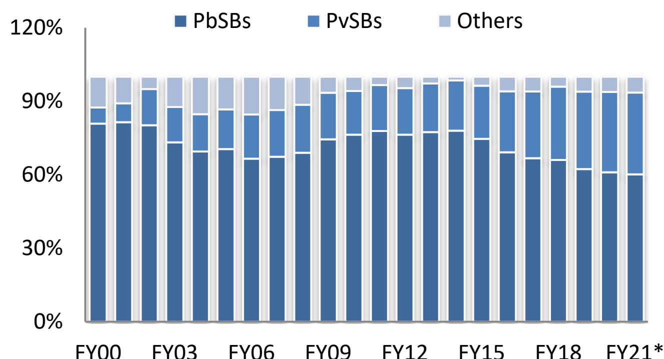


Exhibit 13: Market share in loans – private banks' share increased to 33%



* 1HFY21

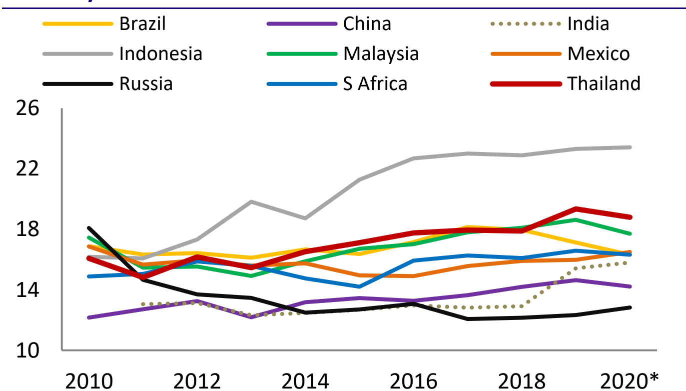
Source: RBI, CEIC, Company Reports, MOFSL

Furthermore, the government, in the past few years, has also announced consolidation within the PbSB space – such as SBIN's merger with its associates, the merging of Bank of Baroda with Vijaya Bank and Dena Bank, and the recent PbSBs mega consolidation converting 10 banks into just four banks.

While the Capital Adequacy Ratio of Indian banks has risen to the highest level in at least a quarter-century, it is still lower v/s most other nations

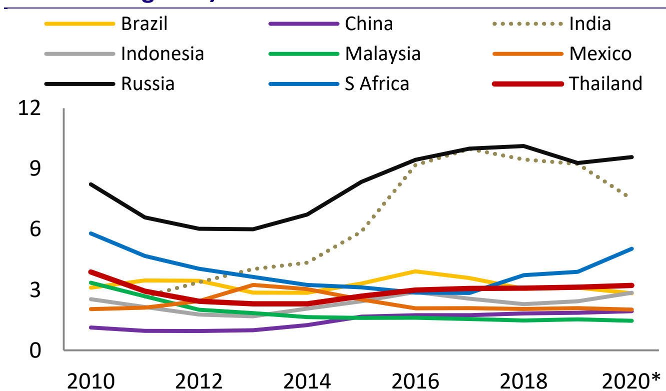
All of these developments are most welcome. Although the share of Banks in India's NGNF debt has fallen, it has to be stable and extremely strong if the economy has to grow in the high single digits for a long period. The process appears to be underway. A comparison of banks' asset quality in India vis-à-vis other emerging and developing economies reveals that while the Capital Adequacy Ratio of Indian banks has risen to the highest level in at least a quarter-century, it is still below that of most other nations *(Exhibit 14)*. CRAR of Indian banks is at slightly below 16%, lower than 16–20% in most Asian EMs and 23% in Indonesia.

Exhibit 14: CRAR for Indian banks has improved but is still lower v/s most other nations



* Data up to Sep-20 for India, Indonesia and South Africa, up to Jun-20 for other economies

Exhibit 15: Gross NPAs of Indian banks have fallen, but is still much higher v/s most other economies



Source: International Monetary Fund (IMF), RBI, MOFSL

Moreover, while gross NPAs have fallen from the peak of 11.2% in FY18 to six-year lows of 7.5% in 1HFY21 for Indian banks, they are still among the highest v/s other nations *(Exhibit 15)*. Russia is the only country with a similar level of NPAs. Otherwise, gross NPAs have generally been below 5% for other EMs, such as South Africa, Malaysia, and Thailand, among others.

Unlike in the 2000s decade, India's Banking sector took back seat in the 2010s decade

Overall, unlike in the 2000s decade, India's Banking sector took back seat in the 2010s decade, which resulted in the improvement in its asset quality during the past 6–7 years. It also led to deceleration in debt growth in the country and some profound changes in the sector as well.

As mentioned above, although the average debt growth in the 2010s decade was 13%, not much lower than 15% in the previous decade, NFS debt has grown slowly at ~10% since FY18 and NGNF debt even slower at just 7.5%. With IL&FS defaulting in September 2018, the problems in India's non-bank lenders came to the fore.

Although regulatory support makes it appear extremely resilient at this stage, the adverse impact of COVID-19 could come with a lag, testing the real strength of Indian banks as well as the entire Financial sector

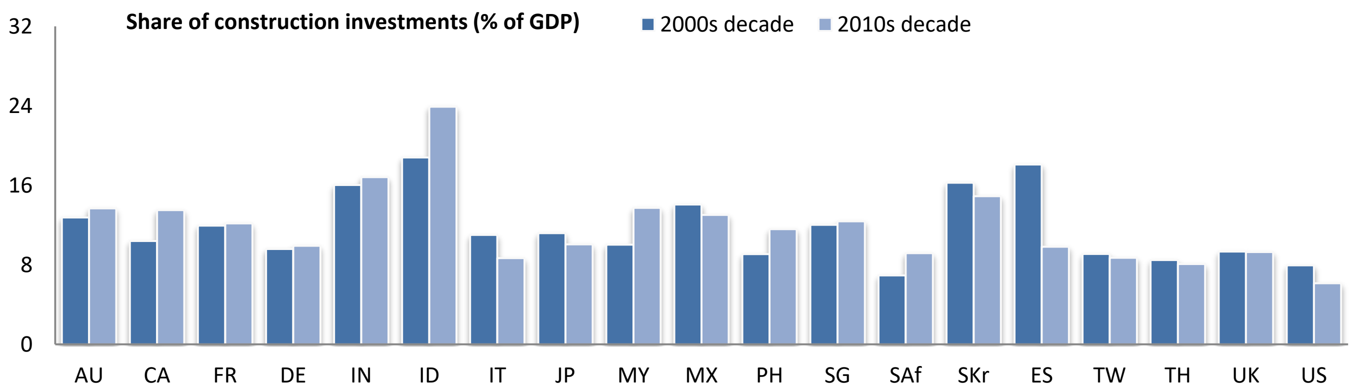
As India's Financial sector was recovering, the COVID-19 outbreak exposed it to vulnerabilities once again, posing a risk to this nascent recovery. Although regulatory support and capital raising due to the fear of COVID-induced stress makes it appear extremely resilient at this stage (with lower NPAs and higher CRAR, as discussed above), the adverse impact could come with a lag, testing the real strength of Indian banks as well as the entire Financial sector.

According to RBI's recently released Financial Stability Report, *"The stress tests indicate that the GNPA ratio of all SCBs may increase from 7.5 per cent in September 2020 to 13.5 per cent by September 2021 under the baseline scenario. If the macroeconomic environment worsens into a severe stress scenario, the ratio may escalate to 14.8 per cent."* The risks of a renewed surge in NPAs, thus, still persist and the resolution process could get delayed. Therefore, while India's Financial sector has improved in the last few years and recovery has sustained in 1HFY21 as well, there is still a long way to go.

REVIVAL IN INDIA'S LACKLUSTER RESIDENTIAL REAL ESTATE

In a **detailed note** released in February 2020, we had discussed the troubled Residential Construction sector in the country, which we called the 'core' of India's slowdown. A comparison of the level of importance of the Construction sector among the world's major economies clearly suggests the Indian economy is far too dependent on it. Total investments in the Construction sector in India (IN) averaged at 16% of GDP in the 2000s decade, lower than the highest level of 19% of GDP in Indonesia (ID), 18% of GDP in Spain (ES), and similar in South Korea (SKr). Since GFC affected the RE sectors of various nations, the share of construction investments fell sharply in ES and also reduced in SKr. However, it increased to 17% of GDP in IN in the 2010s decade, only second to 24% in ID *(Exhibit 16)*.

Exhibit 16: Construction investments play a very important role in the Indian economy (% of GDP)



* Data for 2019 for all except India (FY19, year-ending Mar'19)

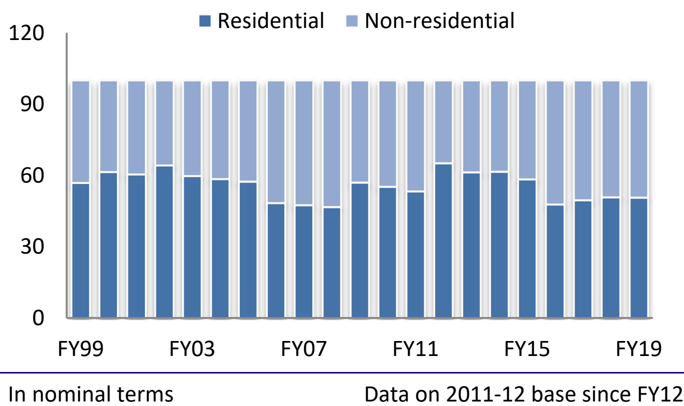
Source: CEIC, Various national sources, MoFSL

Within India's Construction sector, RRE (or household investments) plays a higher role. While investments in residential construction were the highest at 10% of GDP in Spain, the collapse in its real estate bubble reduced this to half (4.9%) in the 2010s decade. In contrast, India's RRE sector averaged 8.8% of GDP in the 2000s decade (only second to ES), further increasing to 9.4% of GDP in the 2010s decade. This means that the Indian economy is most exposed to and reliant on the RRE sector.

From its all-time peak of 12.8% of GDP in FY12, investments in residential construction in India have fallen to two-decade lows of ~7.5% over FY16–19

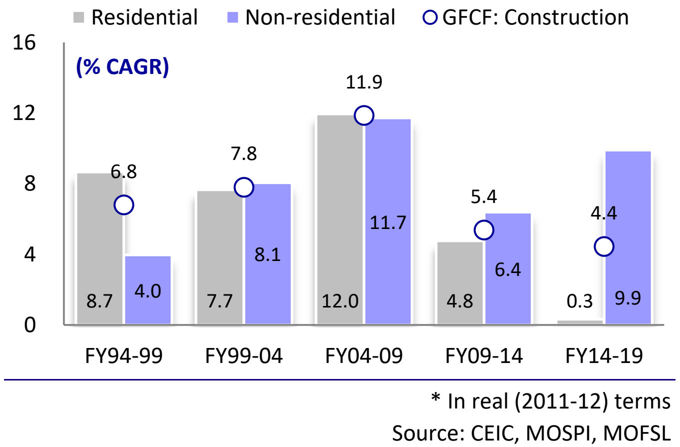
It should then not come as a surprise that the slowdown seen in RRE during the past five years has contributed massively to India's growth slowdown. From its all-time peak of 12.8% of GDP in FY12, investments in residential construction in India have fallen to the lowest in two decades to ~7.5% over FY16–19 (for which recent data is available). The majority of this slowdown in RRE was seen in the second half of the 2010s, when its share in construction investments declined to ~50% from 60% in the early part of the decade *(Exhibit 17)*. In fact, investment slowdown in India since FY16 has been largely on account of households (or residential construction), rather than the corporate sector, as is generally perceived and argued *(Exhibit 18)*.

Exhibit 17: Share of Residential sector in total construction investments has stood at ~55% in the past two decades…



In nominal terms Data on 2011-12 base since FY12

Exhibit 18: …however, real investment growth in the Residential sector has been negligible since FY15



* In real (2011-12) terms

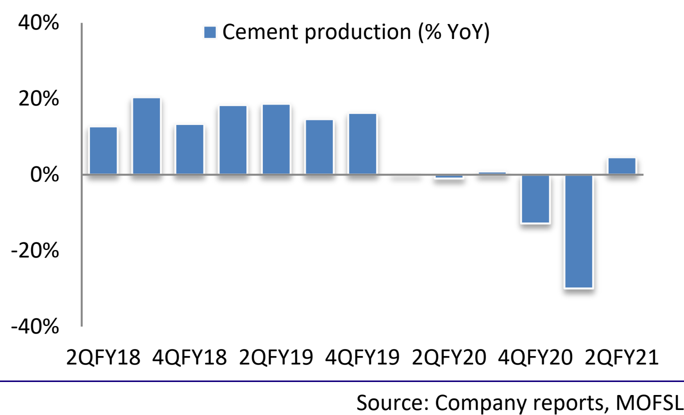
Source: CEIC, MOSPI, MOFSL

> A combination of a) low-to-stable house prices, b) low-to-stable income growth among prospective buyers, c) reduction in interest rates, and d) fiscal sops by various state governments has aided robust recovery in RE activity

With COVID-19, it appeared (and was almost unanimously believed) that the weak Real Estate sector would only become weaker, and the sector would lead to further downward pressure on the economy. The reality, in contrast, has been very different. Residential RE has surprised almost everyone on the upside. A combination of a) low-to-stable house prices, b) low-to-stable income growth among prospective buyers, c) reduction in interest rates, and d) fiscal sops by various state governments (in the form of lower stamp duty rates) has aided robust recovery in RE activity.

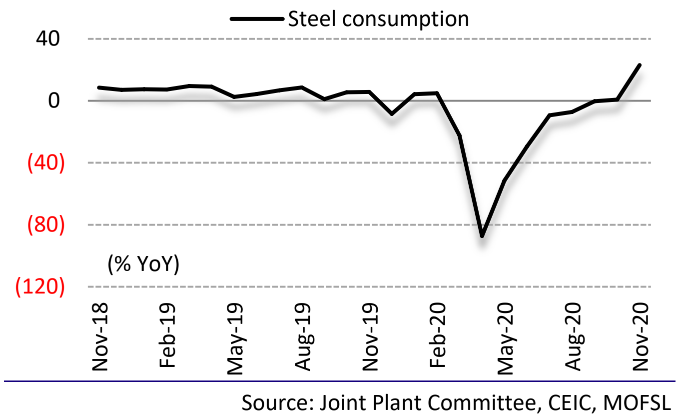
Although there are no official monthly statistics on housing transactions, we have analyzed various proxy indicators – such as cement production, finished steel consumption, and stamp duty and registration charge collection by states – to understand the activity trends in RRE. After declining 30% YoY in 1QFY21, cement production – based on 13 companies accounting for more than 80% of total production[2] in the country – grew 5% YoY in 2QFY21. This is estimated to have grown ~7% YoY in 3QFY21 *(Exhibit 19)*.

Exhibit 19: Cement production returned to the positive territory in 2QFY21…



Source: Company reports, MOFSL

Exhibit 20: …and strong growth in steel usage suggests faster-than-expected recovery in the Construction sector



Source: Joint Plant Committee, CEIC, MOFSL

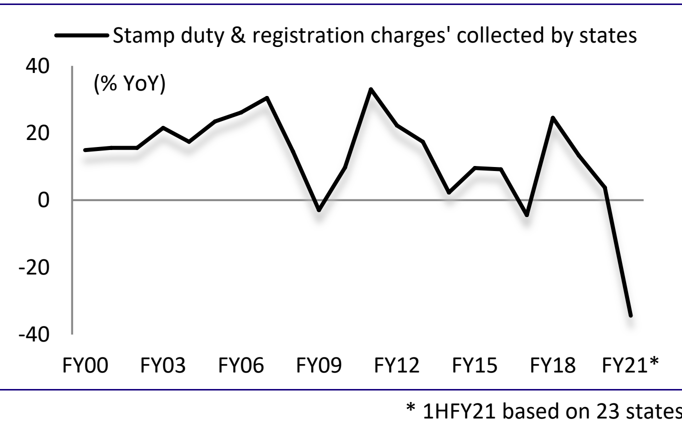
[2] We have chosen to use company data available on a quarterly basis, rather than the cement production data provided by the official agency, Office of Economic Adviser (OEA), on a monthly basis due to the differences between the two data sets. As many companies do not report to OEA, company-level data is more accurate and useful.

Similarly, while finished steel consumption declined as much as 55% YoY in 1QFY21, it posted its second consecutive month of growth in Nov'20 *(Exhibit 20)*. Since cement and steel are the primary inputs in home construction, they provide a good idea of how supply is panning out in the RE sector.

Based on limited data from 13 states, stamps & registration duty collections grew 9.3% YoY in Oct'20 and 4.3% YoY in Nov'20, marking the third consecutive month of growth

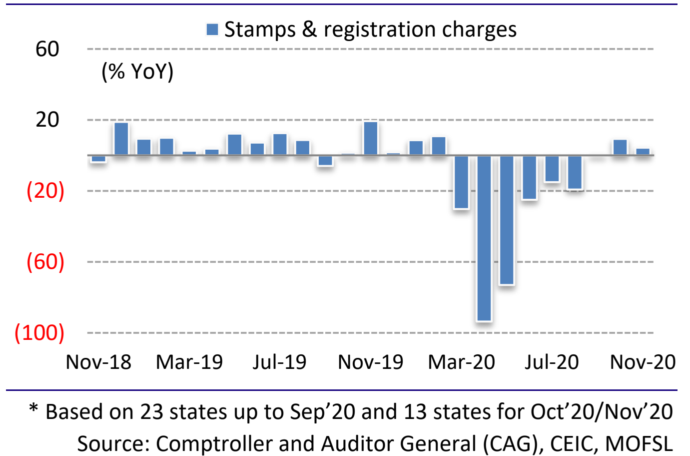
Furthermore, since all 'stamp duty & registration charges' are collected by the states, this is among the best proxies to measure demand-side activity in the Real Estate sector. Based on 23 states – together accounting for almost 90% of all collections – stamp and registration charges declined 35% YoY in 1HFY21, following ~4% growth in FY20 *(Exhibit 21)*. However, things have changed since Sep'20. Based on limited data from 13 states, stamp & registration duty collections grew 9.3% YoY in Oct'20 and 4.3% YoY in Nov'20 *(Exhibit 22)*, marking the third month of consecutive growth.

Exhibit 21: Stamp & registration charges collected by states continued to decline up to Aug'20…



* 1HFY21 based on 23 states

Exhibit 22: …however, they grew for the third consecutive month in Nov'20



* Based on 23 states up to Sep'20 and 13 states for Oct'20/Nov'20

Source: Comptroller and Auditor General (CAG), CEIC, MOFSL

Thus, the importance of the Residential Real Estate sector cannot be underlined further. Households constitute a larger share of India's Construction sector v/s other nations. As a result, Residential RE is crucial for the economy to post high-single-digit growth on a sustainable basis.

The best lesson from the last few months is that even if the strength fades going into FY22, we can learn what incentives and policies are required to help Residential RE sector's revival

Like India's Financial sector, construction investments also picked up in FY18 and FY19, but have slowed since 1QFY20, even before the COVID-19 outbreak. Although recovery since mid-CY20 has been better than anticipated – reflected in cement production, steel consumption, and the stamp and registration charges collected by the states – we need to keenly observe and track these developments to determine whether or not recovery in Residential RE is sustainable. The best lesson from the last few months, however, is that even if the strength fades going into FY22, we can learn what incentives and policies are required to help the Residential RE sector's revival.

INDIA'S ENVIABLE EXTERNAL SECTOR REMOVES ONE AREA OF CONCERN

One of the consequences of the sudden halt and glut of liquidity in the global economy has been the massive reduction in India's CAD and the large foreign capital inflows in the country. India posted three successive current account surpluses (CAS) between 4QFY20 and 2QFY21, marking the first CAS in 13 years *(Exhibit 23)*. In fact, surplus worth 3.8% of GDP seen in 1QFY21 was the highest CAS in 16 years and the second highest on record – since quarterly data became available in the mid-1990s.

Furthermore, foreign capital flows in India have been very large. Net inflows on account of foreign direct investments (FDIs) in India in 2QFY21 stood at record highs of USD23.3b – this beat the previous high of USD17b in 2QFY17. Similarly, net inflows in foreign portfolio investments (FPIs) stood at USD7.3b in 2QFY21, along with steady net flows of about USD0.65b per month on account of deposits from Non-Resident Indians (NRIs).

As a result of CAS and foreign capital inflows, India has witnessed massive external surplus in the past few months. To avoid the appreciation bias, the Reserve Bank of India (RBI) chose to accumulate foreign exchange (forex) reserves – which had risen to USD585b as of 1st January 2021 from USD480b in Feb'20. In short, while it took more than five years to jump from USD300b to USD400b, the next USD100b was added in just 15 months (from Feb'19 to May'20); another USD85b worth of forex reserves have been added in the past seven months to reach USD585b *(Exhibit 24)*.

Exhibit 23: India posted its first CAS in 13 years in 4QFY20 and third consecutive in 2QFY21…

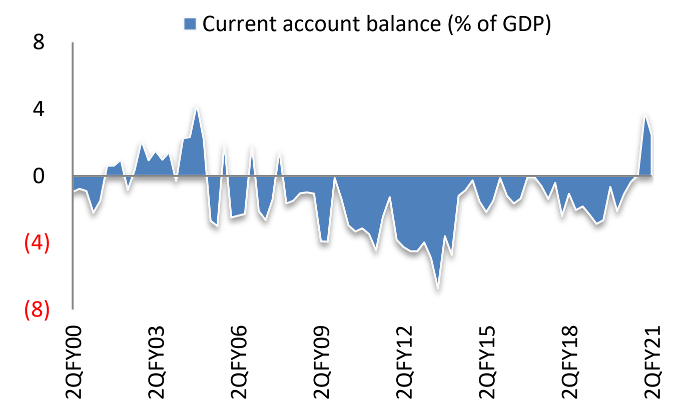
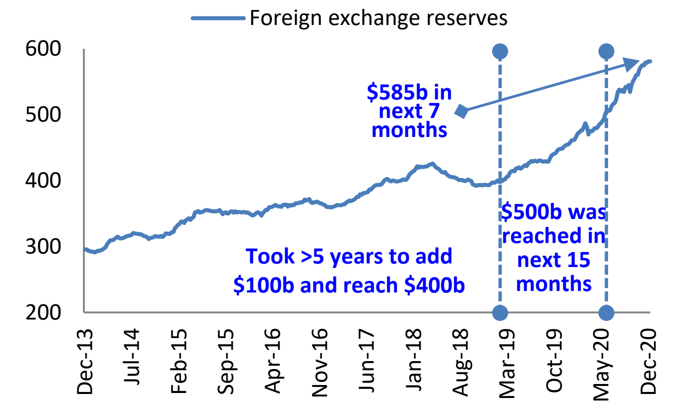


Exhibit 24: …and strong capital inflows have led to record-high forex reserves (USD b)

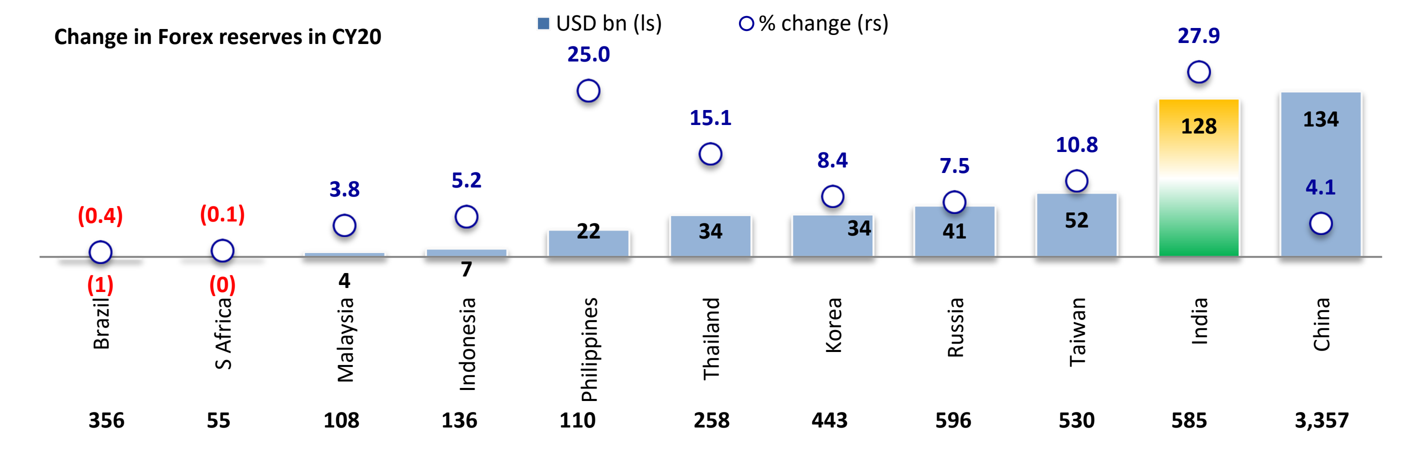


Source: RBI, CEIC, MOFSL

A comparison of the rise in forex reserves in several EMEs in CY20 confirms the surge in India has been the highest

It is also important to note that India is not an exception in terms of foreign capital inflows. As global liquidity was enhanced massively, many emerging market economies (EMEs) have seen a rise in their capital inflows and thus their forex reserves (as no one wants to experience too strong a currency at this stage). However, a comparison of the rise in forex reserves in several EMEs in CY20 confirms the surge in India has been the highest – more than USD117b, ~26% of the total forex reserves accumulated up to Dec'19 *(Exhibit 25)*.

Exhibit 25: Surge in India's forex reserves in CY20 the highest v/s other EMs



Source: International Monetary Fund (IMF), Various National sources, CEIC, MoFSL

There are many benefits to having higher foreign exchange reserves. *First*, they act as an insurance against any unfavorable or sudden foreign capital inflows. In case the central bank does not hold large enough forex reserves, it would prove a challenge for the bank to mitigate the adverse impact of such events. Consequently, strong forex reserves assure that a sudden and large depreciation in the INR is unlikely. *Second*, with such comfortable forex reserves (or external positions), authorities could securely stop being concerned about India's external weaknesses. As the economy normalizes, India would likely move back into the CAD territory. However, with such large forex reserve levels, the RBI and the financial markets could easily handle moderate CAD (and/or foreign capital outflows) for at least the next 2–4 years. *Third*, this would provide an opportunity for the authorities to focus entirely on the domestic economy. In other words, very high levels of forex reserves would help the RBI conduct absolutely independent monetary policy to achieve its inflation or domestic growth objectives. While these are certain benefits of high forex reserves, it is important to note that in such times, such holdings come with a cost as they are primarily invested in highly liquid foreign assets, on which returns are minimal.

Foreign exchange reserves of USD580b certainly provide enough insurance to focus entirely on the domestic economy without worrying about external vulnerability for the next few years

Therefore, India's very strong external position – be it on current account or capital account – provides immense comfort to policymakers and investors. While we need to track the reversal in this position carefully and avoid any complacency, foreign exchange reserves of USD580b certainly provide enough insurance to focus entirely on the domestic economy without worrying about external vulnerability for the next few years.

STRUCTURAL REFORMS TO HOPEFULLY SUPPORT GROWTH OVER THE LONG TERM

"No crisis should be wasted," and the Government of India seems to have taken this very seriously. In the past few months, GoI has announced a number of structural reforms, from labor, agricultural, to educational. The beauty of reforms is they disturb the existing ecosystem and nudge the present beneficiaries to compete with new players. Opposition to such reforms, therefore, is never surprising. However, if the reforms survive the protests of the day, they are almost certain to bring efficiency or productivity improvements. If so, the economy would certainly gain on a net basis.

In the past few months, GoI has passed various reform bills – The Farm Bill, The Labour Codes, New Education Policy, and the distribution of property cards under the Survey of Villages and Mapping with Improvised Technology in Village Areas (SVAMITVA) Scheme. Almost all of these measures are intended at strengthening the institutional framework by providing more freedom to the involved stakeholders.

Agricultural reforms to support farmers

- Farmers have relied on APMCs (Agricultural Produce Marketing Companies) for decades to trade their produce – large traders buy select commodities at the APMCs at pre-determined prices. Despite being protected in terms of prices, with the least probability of default, previous regulations have restricted the farmers from selling these commodities outside of the APMCs. The union government has finally ended the monopoly of the APMCs (Agricultural Produce Marketing Companies) through recent changes.

The recent agricultural reforms also have the potential to increase the quantum of buyers for farm produce

- The recent agricultural reforms also have the potential to increase the quantum of buyers for farm produce. Farmers can choose where to sell their produce and interact directly with the buyers. This would not only help develop a multi-player market in select agricultural commodities but also allow the farmers to determine their own asking price and bargain directly with the buyers. Farmers would get more selling choices locally as well as in the export market. The trade surplus on agricultural and allied products has fallen in the past few years as farm imports have grown faster than their exports; however, the recent reforms may help revive the farmers' income and the trade surplus on farm items.

Easing labor regulations

- The government has consolidated archaic labor laws in the country. Last year, it introduced 4 labor codes to replace 29 existing ones. The four codes regulate 1) Wages, 2) Industrial Relations, 3) Social Security, and 4) Occupational Safety, Health, and Working Conditions. The Code on Wages was passed by the Parliament in 2019, and the remaining three codes were passed in September 2020. As explained by the **PRS Legislative Assembly**, *"Multiplicity of labor laws has resulted in distinct compliances, increasing the compliance burden on firms. On the other hand, the labour enforcement machinery has been ineffective because of poor enforcement, inadequate penalties and rent-seeking behaviour of inspectors. The Codes address some of these aspects."*

- The multiple labor laws manufacturers were previously subject to have been simplified, resulting in a lower compliance burden on firms. Provisions have been made to recognize trade unions as formal negotiators with employers. The worker limit at firms has been raised; prior government permission is now needed for closures, layoffs, or retrenchments. The scope of workers covered has been expanded by including unorganized sector, gig, and platform workers.

These changes are expected to benefit both employers and workers and bring more transparency and accountability

- Certain changes may impact the ability of the workers to hold strikes and employers to lock out their workers. These changes are expected to benefit both employers and workers and bring more transparency and accountability.

Education policy revamped

- The National Education Policy (NEP) 2020, a replacement of the National Policy on Education of 1986, was approved by the Union Cabinet of Economic Affairs on 30th Jul'20. The main recommendations of the NEP include:
  - Redesigning the structure of school curriculums to incorporate early childhood care and education from 10+2 to 5+3+3+4 design, comprising: (i) five years of the foundational stage (for ages 3 to 8), (ii) three years of the preparatory stage (for ages 8 to 11 or classes three to five), (iii) three years of the middle stage (for ages 11 to 14 or classes six to eight), and (iv) four years of the secondary stage (for ages 14 to 18 or classes nine to twelve);
  - Enhancing the higher education Gross Enrolment Ratio (GER) to 50% by 2035;
  - Improving research in higher education institutes by setting up an independent research foundation; and
  - Raising the target to increase public spending in the Education sector to 6% of GDP.

- In our view, retaining students remains a challenge for the Indian education system. As of 2015–16, GER stood at 56.2% at the senior secondary level and only 23.5% at the higher education level v/s 99.2% at the primary level. This decline is particularly high in the case of females and scheduled tribes (including both males and females). GER in India is also among the lowest v/s several other developing countries. The most prominent reason for dropping out was engagement in domestic activities in the case of females and engagement in economic activities in the case of males. Therefore, strengthening schemes and policies targeted at specific groups of the population would go a long way in achieving the goal of at least 50% GER in higher education by 2035.

It is aimed at providing rural people with the right to document their residential properties so that they can use their properties for economic purposes.

Defining property rights clearly in the rural sector

- Lastly, the SVAMITA Scheme was announced as a new initiative under the Ministry of Panchayati Raj. It is aimed at providing rural people with the right to document their residential properties so that they can use their properties for economic purposes. It is for surveying the land parcels in rural inhabited areas using drone technology. The survey is expected to be carried out across the country in a phased manner over four years (2020–24), and the projected outlay of the scheme is INR800m in FY21 for the pilot phase. The pilot phase would extend to six states – Haryana, Karnataka, Madhya Pradesh, Maharashtra, Uttar

Pradesh, and Uttarakhand – covering approximately 0.1m villages. Around 0.7m villages in the country would eventually be covered in this project. Furthermore, on 11th October 2020, the PM launched the distribution of property cards under this scheme in a bid to legalize the process of owning properties and avoid future disputes.

- Most importantly, the scheme is intended at enabling rural household owners to use their property as collateral for taking loans and other financial benefits. This would increase the flow of credit to the rural areas. Moreover, it would aid in determining property tax, which would accrue to the gram panchayats directly in states where they are empowered to collect such taxes. All the property records and maps would be available with the gram panchayats, which would help with the taxation of villages, construction permits, the elimination of encroachments, etc., leading to the formalization of rural land and, optimistically, fewer land disputes.

With the help of a property card, a rural household would be able to claim exactly what it owns, leaving aside unclaimed property

- With the help of a property card, a rural household would be able to claim exactly what it owns, leaving aside unclaimed property. This would enable improved rural planning for probable industrial development by states and private companies. Additionally, since the process would be legitimate, fewer disputes related to land or property encroachment would facilitate the ease of doing business.

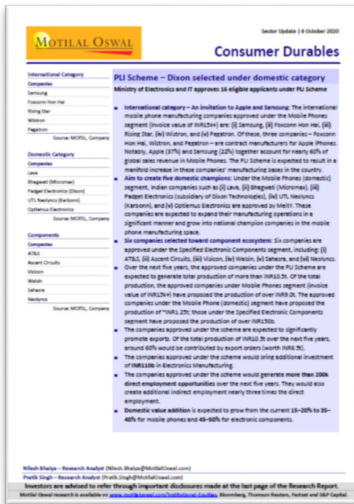
Overall, while the actual impact of these reforms would be realized only after a few years, the approval of these changes is a welcome move. We hope these structural reforms would be able to survive the protests of the day and bring about massive productivity benefits in the country.

RENEWED PUSH TO THE MANUFACTURING SECTOR

Along with the easing of regulations in the Labor market, the government has also announced a number of measures to push India's Manufacturing sector once again. Starting from the massive reduction in corporate income tax rate in September 2019, the government has complemented this by implementing the PLI Scheme to boost domestic production, substitute imports, and (hopefully) encourage exports.

- In September 2019, the government announced a cut in the corporate income tax rate to 22%, from the existing 30%, to provide a fillip to manufacturing investments – on the condition that no further exemption/incentive would be availed. To boost the 'Make in India' initiative, all new domestic companies – that were incorporated on or after 1st October 2019 and would commence their production on or before 31st March 2023 – were given the option to pay income tax at the rate of 15%. The effective tax rate was thus reduced to 22% for existing companies (from 25.17%) and was lower at 15% for new domestic companies – which improved India's attractiveness for foreign multinational companies.

- Additionally, GoI has launched three schemes recently to boost local manufacturing and strengthen the ecosystem of mobile production in the



Motilal Oswal

Sector Update | 6 October 2020

Consumer Durables

International Category
Companies
Samsung
Foxconn Hon Hai
Rising Star
Wistron
Pegatron

Source: MOFSL, Company

Domestic Category
Companies
Lava
Bhagwati (Micromax)
Padget Electronics (Dixon)
UTL Neolyncs (Karbonn)
Optiemus Electronics

Source: MOFSL, Company

Components
Companies
AT&S
Ascent Circuits
Visicon
Walsin
Sahasra
Neolyncs

Source: MOFSL, Company

PLI Scheme – Dixon selected under domestic category

Ministry of Electronics and IT approves 16 eligible applicants under PLI Scheme

- **International category – An invitation to Apple and Samsung:** The international mobile phone manufacturing companies approved under the Mobile Phones segment (invoice value of INR15k+) are: (i) Samsung, (ii) Foxconn Hon Hai, (iii) Rising Star, (iv) Wistron, and (v) Pegatron. Of these, three companies – Foxconn Hon Hai, Wistron, and Pegatron – are contract manufacturers for Apple iPhones. Notably, Apple (37%) and Samsung (22%) together account for nearly 60% of global sales revenue in Mobile Phones. The PLI Scheme is expected to result in a manifold increase in these companies' manufacturing bases in the country.
- **Aim to create five domestic champions:** Under the Mobile Phones (domestic) segment, Indian companies such as (i) Lava, (ii) Bhagwati (Micromax), (iii) Padget Electronics (subsidiary of Dixon Technologies), (iv) UTL Neolyncs (Karbonn), and (v) Optiemus Electronics are approved by MeitY. These companies are expected to expand their manufacturing operations in a significant manner and grow into national champion companies in the mobile phone manufacturing space.
- **Six companies selected toward component ecosystem:** Six companies are approved under the Specified Electronic Components segment, including: (i) AT&S, (ii) Ascent Circuits, (iii) Visicon, (iv) Walsin, (v) Sahasra, and (vi) Neolyncs.
- Over the next five years, the approved companies under the PLI Scheme are expected to generate total production of more than INR10.5t. Of the total production, the approved companies under Mobile Phones segment (invoice value of INR15k+) have proposed the production of over INR9.0t. The approved companies under the Mobile Phone (domestic) segment have proposed the production of ~INR1.25t; those under the Specified Electronic Components segment have proposed the production of over INR150b.
- The companies approved under the scheme are expected to significantly promote exports. Of the total production of INR10.5t over the next five years, around 60% would be contributed by export orders (worth INR6.5t).
- The companies approved under the scheme would bring additional investment of **INR110b** in Electronics Manufacturing.
- The companies approved under the scheme would generate **more than 200k direct employment opportunities** over the next five years. They would also create additional indirect employment nearly three times the direct employment.
- **Domestic value addition** is expected to grow from the current 15–20% to 35–40% for mobile phones and 45–50% for electronic components.

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Pratik Singh – Research Analyst (Pratik.Singh@MotilalOswal.com)

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country, as explained by Mr Nilesh Bhaiya, our Consumer Durables and Capital Goods Analyst.

- **Production-linked Incentive (PLI) Scheme:** GoI has proposed a 4–6% incentive on the incremental sale (over the base year) of goods manufactured in India and covered under the target segments over the next five years.
- **Scheme for Promotion of Electronic Components and Semiconductors (SPECS):** Under this scheme, an incentive of 25% is provided on capital expenditure on a reimbursement basis.
- **Modified Electronics Manufacturing Cluster (EMC 2.0) Scheme:** EMC 2.0 provides financial assistance for setting up both EMC projects and common facility centers across the country.

- These three schemes are expected to a) generate exports worth INR5.8t over a five-year period, b) generate employment for 1 million people, and c) reduce import dependence on these items by promoting large-scale mobile manufacturing in the country and creating supply chains in electronic components. Within these schemes, PLI has attracted most of the attention.

With the help of a property card, a rural household would be able to claim exactly what it owns, leaving aside unclaimed property

- Under the 'AatmaNirbhar Bharat' package, GoI approved the PLI Scheme for 13 sectors under 9 ministries/departments. The total financial limit spread over the next five years is about INR1.97t, or roughly INR400b per annum. Importantly, the PLI Scheme replaces RoDTEP (Remission of Duties or Taxes on Export Products), which replaced MEIS (Merchandise Exports from India Scheme) in September 2019; the annual allocation is also similar to that in MEIS. The total **allocation** under MEIS had more than doubled to INR435b in FY20 from INR203b in FY16 (when it was implemented); however, India's exports were stagnant during the period. Initially, exporters earned duty drawbacks (or duty credits) at fixed rates of 2–5%, which changed to 2–20% over a five-year period. Furthermore, MEIS covered 75% of all tariff lines. After the World Trade Organization (WTO) ruled against MEIS in November 2019, calling it unfair, GoI replaced it with RoDTEP (in September 2019, before the actual WTO ruling) – as effective from January 1, 2021. GoI has now replaced RoDTEP with the PLI Scheme.

In its new avatar, the PLI Scheme is expected to achieve what MEIS could not in the past five years. There are three major differences between MEIS/RoDTEP and the PLI Scheme.

a) MEIS/RoDTEP was purely for exporters, aimed at reimbursing the taxes and duties incurred by exporters – such as local taxes, coal cess, *mandi* tax, electricity duties, and fuel used for transportation – not exempted or refunded under any other existing scheme. It was a scheme for exporters to make Indian products cost-competitive and create a level playing field for them in the global market. PLI, on the other hand, is not specifically for exporters, but domestic producers.

b) There were no conditions attached under MEIS/RoDTEP. Exporters got a refund for indirect taxes in inputs used in the manufacturing of exported products.

Incentives under PLI are directly linked with the incremental production of goods, with 2019–20 as the base

However, incentives under PLI are directly linked with the incremental production of goods, with 2019–20 as the base.

c) MEIS/RoDTEP was applicable in all sectors, including Textiles. PLI is more focused on incentives spread over nine departments/ministries. Furthermore, only three departments – Department of Heavy Industries (INR751b), Ministry of Electronics and Information Technology (INR460b), and Department of Pharmaceuticals (INR253b) – account for almost three-fourths of all incentives announced under PLI.

As a result of this targeted and conditional approach, PLI is expected to yield better results than MEIS or RoDTEP. Furthermore, since PLI is not exclusively for exporters, it confirms that the government wants to achieve some import substitution as well, unlike in the previous schemes.

Even if the PLI Scheme is successful in attracting certain global manufacturers to India, there is no guarantee it would yield any improvement in India's trade balance

The scheme shall extend an incentive of 4% to 6% on incremental sales (over 2019–20) on goods manufactured in India and covered under target segments to eligible companies for a period of five years, subsequently to the base year. Even if the PLI Scheme is successful in attracting certain global manufacturers to India, there is no guarantee it would yield any improvement on India's trade balance. This is because higher domestic production may be led by imported inputs and could serve domestic demand, rather than exports. If so, while the FDI would see a jump initially, India's trade deficit would remain high.

Will the domestic national balance sheet recover strongly?

Apart from the five areas discussed above, it is also necessary to understand the evolving dynamics of India's economic participants – households, corporates, and the government. This note is dedicated not to the next one or two years, but to discussing the measures and steps required to ensure the Indian economy reaches high-single-digit growth as soon as possible. Any such discussion is incomplete unless we understand how the finances of three domestic economic agents have behaved in the past two decades. We further need to learn how they need to behave to achieve the objective of high-single-digit growth on a sustainable basis.

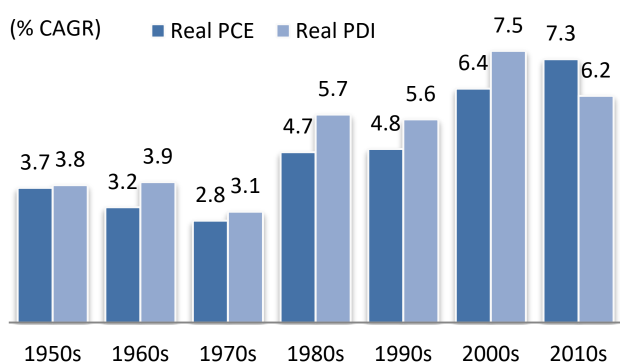
As discussed above, while investments were the key driver of high growth in the 2000s decade, personal consumption expenditure (PCE) and government spending were the key growth drivers in the 2010s decade. Not surprisingly then, while domestic savings increased and fiscal deficit narrowed in the first decade of the 21st Century, none of this recurred in the second decade. COVID-19 may have exacerbated the stress in these balance sheets, leading to serious consequences for economic growth and drivers in the 2020s decade. Thus, it is essential to understand which economic agent(s) is (are) best-placed to drive economic growth and which participant(s) needs time to repair its finances.

Indian household leverage has gone up and savings have fallen rapidly, although personal consumption has supported India's GDP growth

Indian households' vulnerability may dampen growth revival

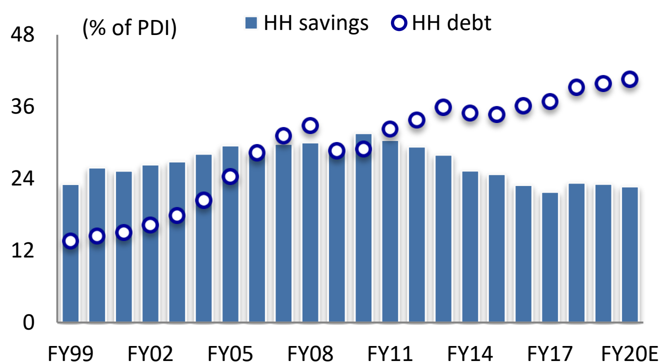
For the last several years, our key thesis related to India's growth story has remained fairly unchanged. Indian household leverage has gone up and savings have fallen rapidly, although personal consumption has supported India's GDP growth. While a year's worth of savings was enough to cover outstanding household debt in FY12, the ratio doubled in FY19 *(Exhibits 26, 27)*. This has been among our key concerns related to the nation's ability to sustain high growth.

Exhibit 26: Personal consumption growth has outpaced disposable income growth since FY13…



Data since 2012-13 is on new (2011-12) base

Exhibit 27: …led by a combination of higher leverage and lower savings



FY20 is our estimate

Source: CSO, RBI, CEIC, MOFSL

In a **note** published in May this year, in the wake of COVID-19, we had reported *"Amid the concerns related to COVID-19, we believe this event may act as a trigger to change household behavior. With the economic environment turning highly uncertain, not only will households be more thoughtful about their savings but also more calculative about leverage. Furthermore, even lenders are likely to turn more cautious and rethink their strategy to lend freely and considerably to the Retail*

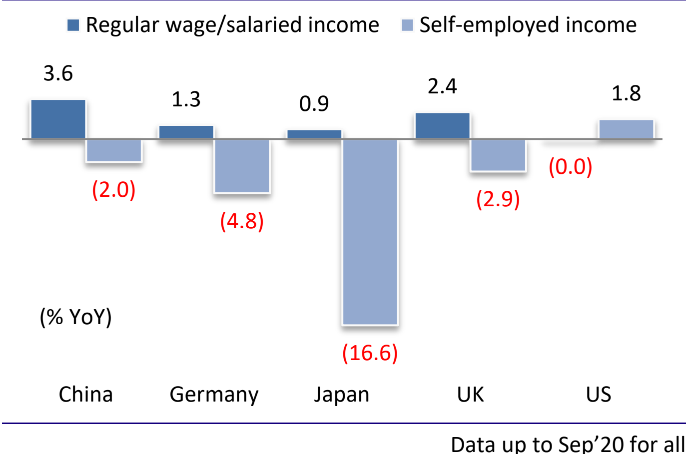
sector." This, we believe, would help repair Indian household balance sheets at the cost of slower growth in their consumption spending. We had further stated, *"And, this trend would continue in the future, depending on the speed of long-due price correction in the Housing market (affecting physical savings). The consequences of these adjustments would include weak consumption/investments and muted GDP growth for the next few years."* We see no reason, at this stage, to change our thesis.

In another **note** released in June 2020, we had discussed in detail why Indian households are more vulnerable than their counterparts in other major economies. Household incomes (or personal incomes) in any economy can be classified into four parts: compensation of employees (CoEs for regular workers/employees), self-employed income (for entrepreneurs), income from property (from interest, rents, and dividends), and current transfers. A comparison of the constituents of household income in select nations suggests that while the share of regular wages/salaries is the lowest in India, the share of self-employed/business income is the highest v/s other economies. The share of wages / salaried employees is less than 40% in India, as against over 54% in all nations, with as much as two-thirds in emerging markets (EMs) – such as South Africa (SAf) and Mexico (MX) – and above 80% in developed markets (DMs) – such as Germany (DE), South Korea (SKr), and Japan (JP). On the contrary, the share of self-employed income is ~35% in India, similar to that in the Philippines (PH), but the highest compared with other economies.

More than half of all employees in India are classified as 'self-employed' workers, while only about a quarter of the workforce is 'regular wage / salaried' workers

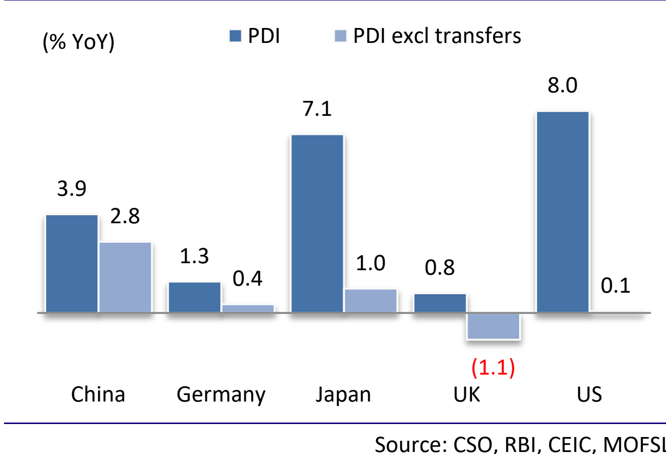
This is not surprising considering that more than half of all employees in India are classified as 'self-employed' workers, while only about a quarter of the workforce is 'regular wage / salaried' workers. This characteristic of the Indian Household sector has deep implications. Data on household income in India is released only on an annual basis, with a lag of 10 months (FY20 data would be published by end-Jan'21). Movement in household income and its components in the world's major economies suggests self-employed workers are the worst hit during COVID-19 *(Exhibits 28, 29)*. Data from five nations – China, Germany, Japan, the UK, and the US – **confirms** self-employed income in CY20 declined in four of five economies vis-à-vis decline in CoEs. The US was the only exception, where self-employed income grew v/s almost stagnant growth in regular income.

Exhibit 28: Self-Employed segment is disproportionately hit by COVID-19 v/s regular employees…



Data up to Sep'20 for all

Exhibit 29: …although fiscal intervention has made up for this in some nations



Source: CSO, RBI, CEIC, MOFSL

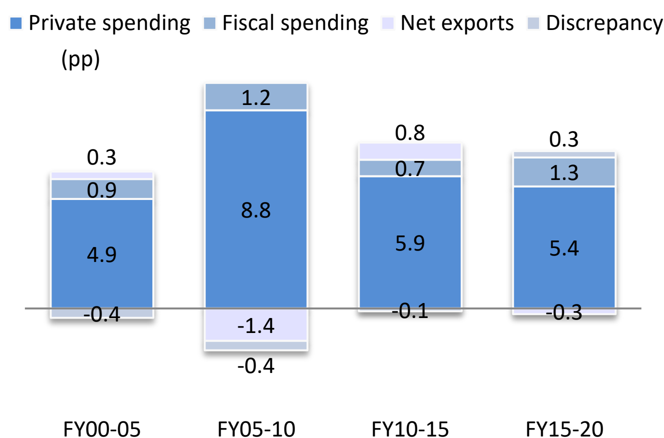
The healthy financial position of the Household sector – even if this means sacrificing some growth in the short term – would prove an extremely important indicator (and pre-requisite) for long-term growth performance

COVID-19 may probably act as a trigger in nudging households to start worrying about their deteriorating finances – depleting savings, rising leverage, and weak incomes. While 2020 led to extreme behaviors, this would start to reverse as things normalize (hopefully from 2021). Normalization could mean (a) the building up of household savings, slower growth in household leverage, and consumption growth in line with income growth, implying weak economic growth or (b) the continuation of pre-COVID trends that supported GDP growth at the cost of Household sector finances. Whether it is factor (a) or (b) is something that we would monitor closely. The healthy financial position of the Household sector – even if this means sacrificing some growth in the short term – would prove an extremely important indicator (and pre-requisite) for long-term growth performance.

Government support would fade in the 2020s

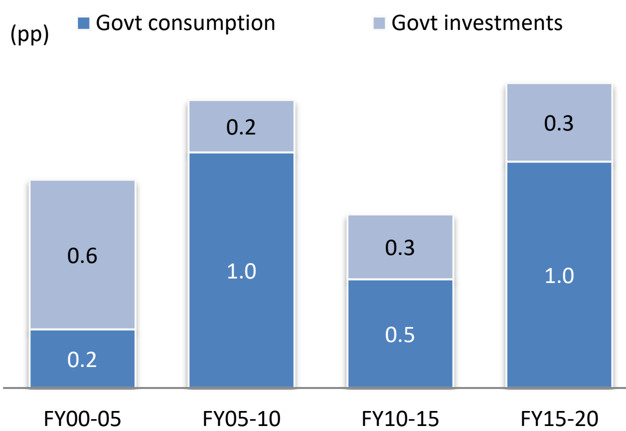
In the second half of the 2020s decade, fiscal spending (consumption + investments) has been one of the key drivers of economic activity. While real GDP growth averaged at 6.8% between FY15 and FY20, real fiscal spending grew an average 9% during this period. Consequently, fiscal spending was as much as 1.3 percentage point (pp) to real GDP growth between FY15 and FY20 – the highest contribution in any five-year period in the past two decades *(Exhibit 30)*. On the contrary, private spending grew at an average 6.3% during the period and contributed 5.4pp to real GDP growth – much lower v/s the previous two five-year periods.

Exhibit 30: Fiscal spending has contributed 1.3pp to real GDP growth in the last five years…



* Including consumption and investments

Exhibit 31: …which is the highest contribution in any five-year period in the past two decades



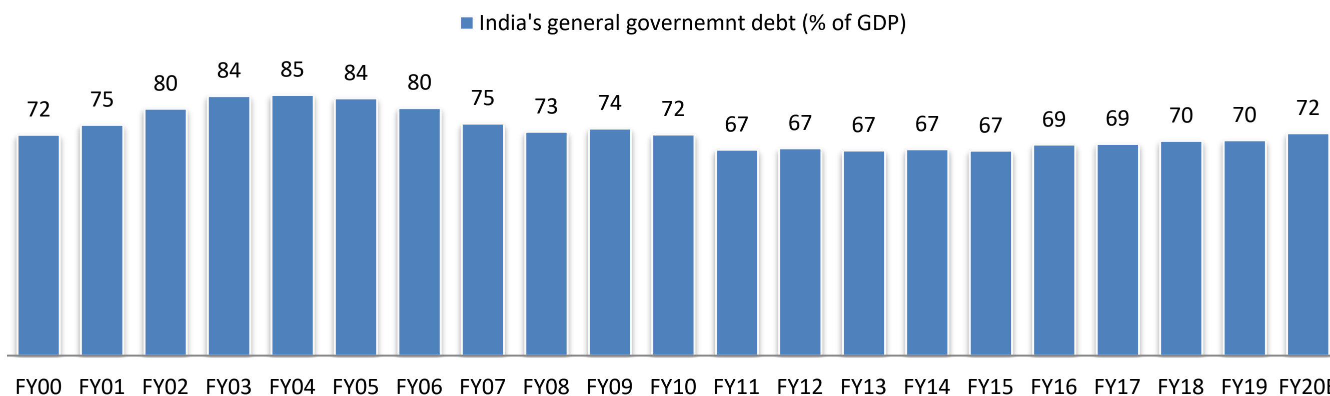
Source: CSO, RBI, CEIC, MOFSL

Within fiscal spending, while government consumption expenditure grew at an average of 9.4% during the period, government investments grew 8.6%. Consequently, like the private sector, fiscal consumption was a much larger contributor to GDP growth between FY15 and FY20 v/s investments. Moreover, it was a stark contrast to what happened in the first decade of the 21st Century *(Exhibit 31)*.

At the start of COVID-19, we published a **note** concluding India's combined (center + states) fiscal deficit could top 12% of GDP. Based on actual data available for the central government and 15 states (accounting for ~70% of all states), we **found** the combined fiscal deficit stood at ~15% of GDP in 1HFY21.

As discussed earlier, high growth in the 2000s decade allowed the government to follow fiscal consolidation, due to which its total debt reduced to 67% of GDP in FY11 from the peak of 85% in FY04. However, since GDP growth in the 2010s decade was supported by fiscal spending, government debt remained extremely stable at 67% for most of the decade, before slowly rising to 72% of GDP in FY20 *(Exhibit 32)*.

Exhibit 32: Long-term trends in government debt in India



FY20 is our estimate

Source: RBI, Ministry of Finance, CEIC, MoFSL

Gradual fiscal consolidation implies primary spending by the general government is likely to grow at an average of ~7% in the 2020s decade v/s average growth of 11.3% in the 2010s decade

Our **estimates** suggest government debt is likely to increase to the peak of ~90% of GDP by FY22–23. This would restrict the government's ability to grow its spending significantly and support economic activity in the 2020s decade (as it has done in the past few years). Gradual fiscal consolidation (to lower India's government debt-to-GDP to ~80% of GDP by FY30) implies primary spending (total less interest payments) by the general government is likely to grow at an average of ~7% in the 2020s decade v/s average growth of 11.3% in the 2010s decade. (We have provided the detailed estimations in our **note** released in August 2020 and are thus not reproducing it here.) The more rapid the fiscal consolidation, the lower the government debt, but the slower the growth in fiscal spending (and vice-versa).

Moreover, **if primary spending growth eases to ~7% over the next decade, from 11.3% in the past decade, it becomes apparent that the government would be unable to grow its investments (capital outlays) at the same pace as in the past decade.** Since a large portion of non-interest revenue spending (such as defense, salaries & wages, pensions, etc.) is fixed or non-discretionary in nature, there is a high possibility that fiscal investments would grow at an even slower rate in the 2020s decade. The government would have to rationalize its spending, else government investments growing decently in the 2020s decade would remain a distant dream.

While the central government may lower its fiscal deficit toward 3% of GDP by the end of the 2020s decade, it may easily take 10–15 years for government debt to reach pre-COVID levels

Consequently, it could be highly misleading to rely on fiscal spending to support economic growth, as has been done in the past two decades. The scars of COVID-19 on the fiscal math would remain visible for at least a decade, if not more. While the central government may bring down its fiscal deficit toward 3% of GDP by the end of the 2020s decade, it may easily take 10–15 years for government debt to reach pre-COVID levels. Thus, for most of the next two decades, the government would focus on consolidating its finances, rather than supporting economic growth.

Can non-government investments revive India's economic growth?

The Household sector could strengthen its balance sheet by turning cautious on consumption growth and the government could follow fiscal consolidation. If these events occur, the onus of helping the economy to grow even more modestly at 5–6% over the next few years relies entirely on non-government investments.

Notwithstanding all the optimism related to faster-than-anticipated recovery, cement production in Nov'20 was 80.6% that in Jan'20, the second lowest v/s any November month in the past two decades

Non-government investments include household and corporate investments. The former accounts for a third of the total non-government investments, and the latter constitutes the remaining two-thirds of non-government investments. As discussed above, household investments largely constitute residential real estate (RRE) or construction activity in the country. Although the RRE sector has recovered faster than anticipated in the past few months (as discussed above), it remains very weak vis-à-vis the previous years. This is apparent when we adjust recovery in cement production in the past few months for seasonality *(Exhibit 33)*. If we assume January of each year to be the base and compare cement production in November of each year to that in January of those years, we get interesting results. We find that – notwithstanding all the optimism related to faster-than-anticipated recovery – cement production in Nov'20 was 80.6% that in Jan'20, the second lowest v/s any November month in the past two decades (it was 79.1% in Nov'16, the month when demonetization was announced). In the 2000s decade, when household investments were strong, production levels in November averaged almost 100% that in January.

Exhibit 33: Cement production in Nov'20 (v/s Jan'20) was the second weakest in any year since 2000

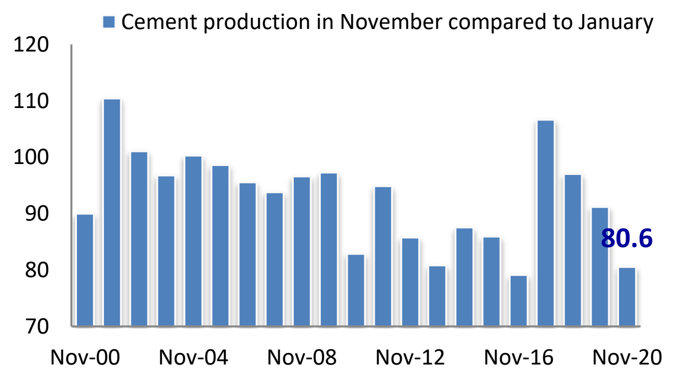
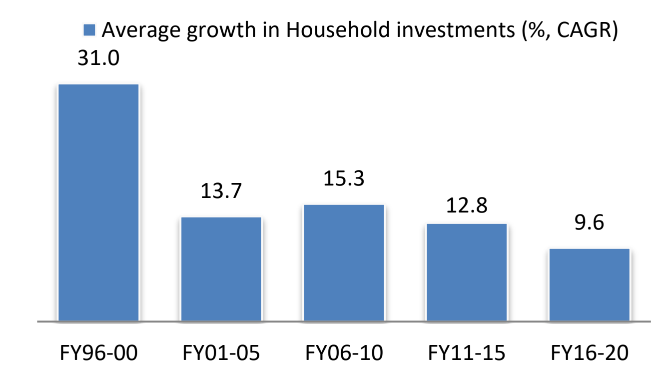


Exhibit 34: Average growth in household investments over a four-year period in the past two decades



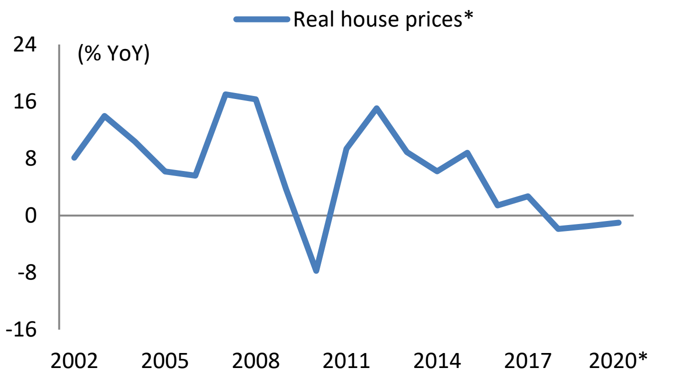
FY20 is our estimate

Source: Office of Economic Adviser (OEA), CSO, CEIC, MOFSL

House prices in India have weakened considerably in the 2010s decade and have declined in the past three years

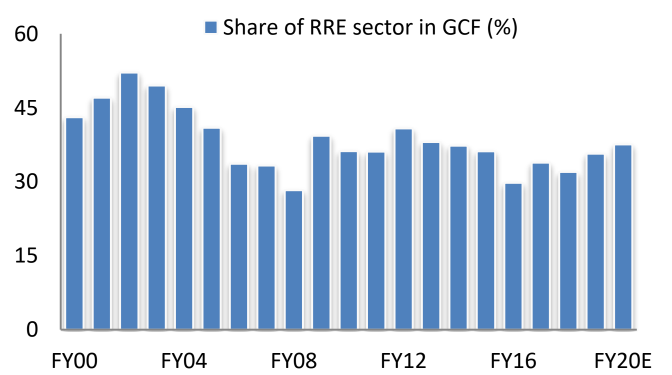
Household investments, in nominal terms, declined 1% over FY13–16, but posted growth of 15.2% over the last four years *(Exhibit 34)* – assuming our estimate of 5.5% growth in FY20. Considering this weakness in RRE, it is not surprising that house prices in India have weakened considerably in the 2010s decade – from average growth of >10% in early 2000s, 9.8% over 2005–09, 6.4% in the first half of the 2010s decade, to average growth of just 2% over 2015–19 *(Exhibit 35 on the following page)*. In fact, real house prices declined ~2% in 2018, 1.5% in 2019, and 1.0% in 2020 (up to September).

Exhibit 35: Real house prices in India eased considerably in 2010s and have declined since 2018



* Up to Sep'20 House prices deflated by CPI- Housing
RBI data from CY10 onwards, NHB 2001 index for older data

Exhibit 36: Average growth in household investments over a four-year period in the past two decades



FY20 is our estimate
Source: RBI, National Housing Bank (NHB), CEIC, MOFSL

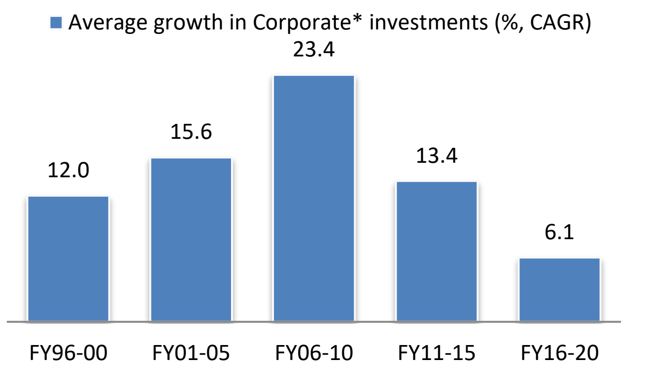
Notwithstanding declining housing prices, the share of RRE in India's total investments fell from 38% in the first half of the 2010s decade to 34% over FY16–20 – similar to that between FY06 and FY10 *(Exhibit 36)*. The major difference, however, is that while total investments were growing sharply in the second half of the 2010s decade (led by the Corporate sector), they have been very weak in the last five years.

Although house prices have declined in the past few years, further decline cannot be ruled out

Therefore, although house prices have declined in the past few years, further decline cannot be ruled out. This may cause widespread pain in the economy. However, this could be mitigated by the authorities if they ensure maintaining the same set of policies practiced in the past few months – fiscal incentives and low interest rates. At best, therefore, household investments in the mid-2020s could grow at the same pace seen over the FY17–20 period, i.e., 15%.

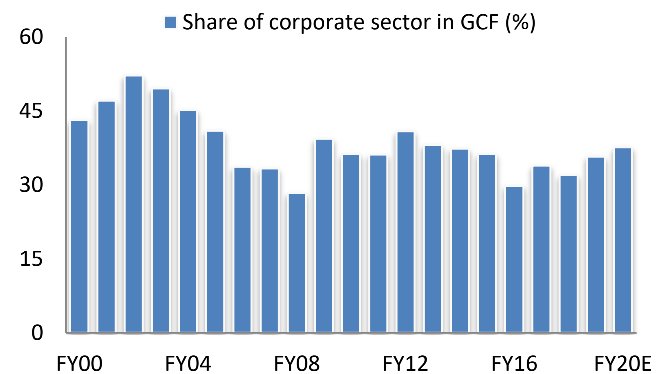
With regard to corporate investments, if the global economy and domestic demand growth remain subdued, the Corporate sector is unlikely to feel confident to invest. A look at the trends in corporate investments in the past two decades suggests: while they were the primary force driving India's GDP growth in the first decade, their growth was only 6% in the last five years due to declines in FY17 (demonetization) and FY20 *(Exhibit 37)*.

Exhibit 37: Corporate investments have grown at a weak pace in the second half of the 2020s decade…



* Private + Public corporate sector

Exhibit 38: …and share has remained constant at around 49% of total investments



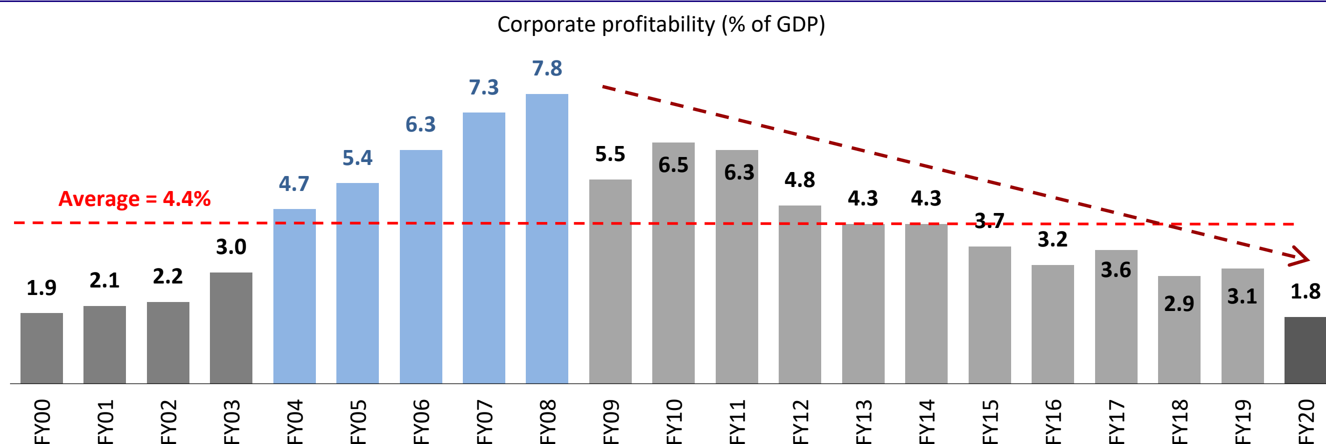
Source: CSO, CEIC, MOFSL

Corporate profitability rose sharply from 2% in early 2000s to an all-time peak of 7.8% of GDP in FY08. However, it weakened continuously in the 2010s decade.

Corporate profitability in India fell dramatically in the 2010s decade, in line with weak corporate investments growth. An analysis of long-term trends in corporate profitability (based on listed and unlisted companies) suggests it fell to record lows of 1.8% of GDP in FY20 (partly due to COVID in 4QFY20). Corporate profitability rose sharply from 2% in the early 2000s to an all-time peak of 7.8% of GDP in FY08. However, it weakened continuously in the 2010s decade – from 6.5% of GDP in FY10 to sub 4% in FY15, near 3% of GDP in FY18 and FY19 *(Exhibit 39)*.

Since corporate investments are a direct function of the economic environment and profitability, similar trends in these should not be surprising. Although corporate profitability has recovered slightly in 1HFY21, it is too early to consider this a structural improvement – which is a requirement for the Corporate sector to feel confident and grow its investments sharply.

Exhibit 39: Long-term trends in corporate profitability in India



Compiled for available listed + unlisted companies; FY20 earnings from few unlisted companies are yet to be added

Source: Capitaline, MoFSL

Not only households but corporate investments also started faltering in mid-CY19, before COVID-19 hit the global economy. Recovery in RRE and corporate profitability was better than anticipated in 1HFY21. However, it is unlikely they would grow at a faster pace to offset the weakening impact of lower personal consumption growth and fiscal spending over the next few years.

Nevertheless, a continuation in these trends would certainly help the Corporate sector repair its balance sheet, just like the Household and the Government sectors. If so, while it may take some time to address structural challenges, the strength in domestic balance sheets would set the stage for high-single-digit growth on a sustainable basis.

Conclusion: Healing in the third decade could reap benefits in the subsequent decades

Most of the successful nations in the world have been able to maintain their high growth for almost 2–3 decades before their transition to developed or high-income economies. A favorable demography is one of the most important structural factors (but not sufficient) for high economic growth. With the median age below 30 years, India is aptly placed to capitalize on its benefits. According to the United Nations, the median age of India's population would cross 35 years in early 2040s, reaching 38 years, by 2050, similar to the current median age in China and the US. Also, the global mood is such that China – the only other fast-growing major economy in the world – is making way to accommodate other nations. Therefore, we strongly believe the 2020s decade could present unmatched opportunity to address structural challenges and put the economy on a high-growth, sustainable path. The next few years may be difficult; however, to achieve sustained robust growth for 2–3 decades, this is the opportune time for action.

This note is dedicated to discussing the bird's eye view of the economic spread over the next decade. COVID-19 has weakened the economy significantly; however, it also provides occasion to think, analyze, and act from a longer term perspective. Economic activity in the past few months has been better than anticipated, probably in entirely unexpected areas. However, we should be cautious about extrapolating the last few months into 2021 and beyond. The financial markets, on the other hand, seems to have run ahead of the economic reality, led by benign global liquidity (India received more than INR 1 trillion of foreign portfolio inflows in Nov'20+Dec'20), lower interest rates (globally as well as in India), roll-out of Covid-19 vaccines, earlier than anticipated recovery in multiple high-frequency demand indicators and better-than-expected performance of corporate India in 2QFY21 earning season which drove earnings upgrade after five consecutive years of downgrades.

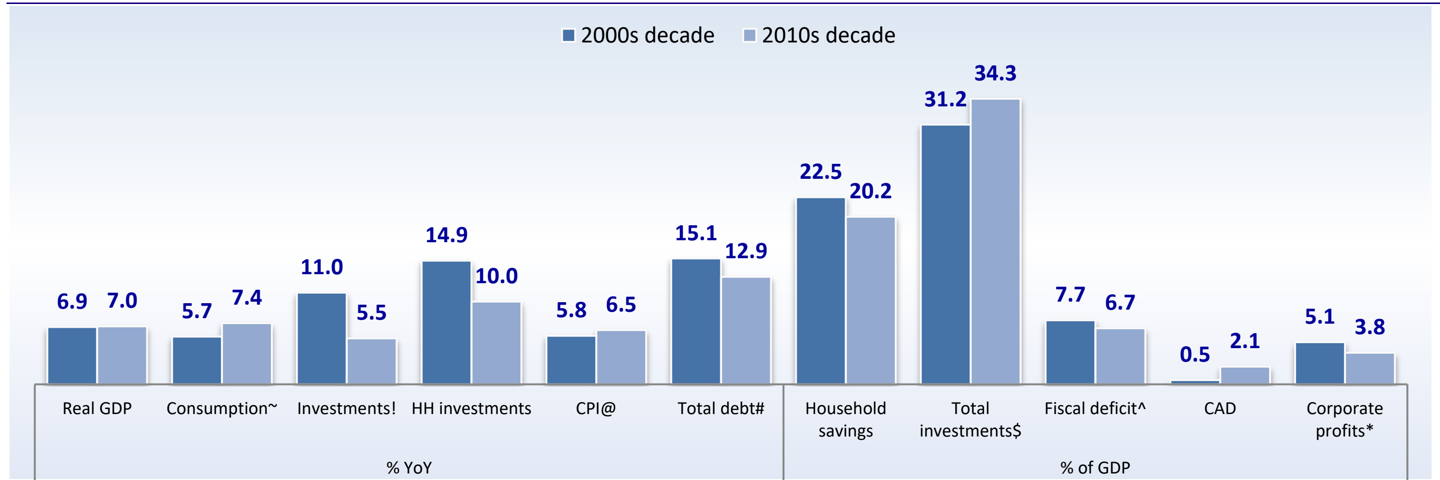
Strong growth in the 2000s decade was characterized by higher savings/investments, decent consumption growth, fiscal consolidation, rising corporate profitability, a strong Financial sector, and a supportive global environment. It was almost the reverse of this in the 2010s decade

When we speak of economic growth and look back at the first two decades of the 21st Century, we find that real GDP growth and its trajectory (sleeping S-shaped) were very similar; however, there were massive differences in the two decades. The drivers of growth in the two decades were entirely different. Strong growth in the 2000s decade was characterized by higher savings and investments, decent consumption growth, fiscal consolidation, rising corporate profitability, a strong Financial sector, and a supportive global environment. In stark contrast, similar growth in the 2010s decade was characterized by lower savings, leading to strong consumption growth, higher fiscal spending, falling corporate profitability, a struggling Financial sector, and a subdued global environment *(Exhibit 40)*.

Over the past 5–6 years, India's GDP growth was primarily driven by PFCE and fiscal spending, which has weakened balance sheets massively. Since the Indian economy entered into COVID-19 with weak fundamentals, strong economic growth recovery and maintaining a strong footing in the near future would prove a difficult task. We argue that in the wake of COVID-19, Indian households may turn more cautious about their savings and keep consumption growth subdued. In fact, if households have to rebuild their savings, which fell to 21% in FY19 from 30% of income a decade ago, consumption growth must be slower than income growth in the 2020s decade.

Furthermore, with government debt estimated to rise to ~90% of GDP in FY22/FY23 from ~70% in FY19, it may take 10–15 years for the government to return to pre-COVID debt levels. This means that government spending over most of the next two decades would be highly subdued v/s the 2010s decade.

Exhibit 40: Comparison of India's economic indicators in the first two decades of the 21st Century



~ Personal + Government ! Excluding 'errors & omissions (E&O)' @ CPI for industrial workers before FY12
# Total debt is our estimate compiled from all institutional sources for non-financial sector $ Including 'errors & omissions (E&O)'
^ Center + State governments * For listed + unlisted companies available in Capitaline

Source: CSO, RBI, Capitaline, CEIC, MoFSL

Improved balance sheets of all economic participants would mean the stage is set for a grand multi-decadal strong performance from the Indian economy

As households and the government remain cautious over their spending, it would keep GDP growth subdued; however, it will also repair their balance sheets. Similarly, we believe the Corporate sector would continue to strengthen its own balance sheet over the next decade and wait for the opportunity to grow its investments. If so, economic growth may remain on a weak footing for the next few years. Nevertheless, the situation also presents an opportunity – the 2020s decade could be used to heal, the benefits of which would be reaped in the subsequent decades. Improved balance sheets for all economic participants would mean the stage is set for a grand multi-decadal strong performance from the Indian economy.

Apart from domestic balance sheets, we argue that five important areas require sharp improvements to ensure uninterrupted high-single-digit growth as soon as possible:

1) Without a **strong Financial sector**, no nation can witness high economic growth. Unlike in the first decade, India's Financial sector diversified and struggled in the 2010s decade. Asset quality of banks certainly improved over the last few years, and this recovery sustained in 1HFY21 owing to regulatory support and capital issuances; however, there is still a long way to go. The adverse impact of COVID-19 could come with a lag, adversely affecting the asset quality of Indian banks as well as the entire Financial sector. Therefore, authorities cannot afford to be complacent about improving the position of India's Financial sector and should remain committed to staying on this path. Continued efforts to keep the system clean, further consolidation, and adequate capital bode very well for higher credit growth over a period.

2) **The Residential Real Estate (RRE) sector** constitutes a larger share of India's Construction sector v/s other nations. This makes it crucial for the sector to do well – if the economy has to post high-single-digit growth on a sustainable basis. In fact, India's RRE has been at the core of economic slowdown. Large reduction in interest costs and several sops by central/state governments have complemented low-to-stable home prices and low-to-stable income growth in prospective buyers, supporting robust recovery in RRE. Although the resilience of this recovery is in question at this stage, it certainly provides a template for how the RRE sector may be revived.
3) From being a member of the Fragile Five over 2012–14, India has come a long way to secure its position as one of the most favored investment destinations. With the world's 5th largest stock of foreign exchange (FX) reserves, the **external sector** has turned from an area of concern to comfort. Going forward, although BoP surplus would reduce, FX reserves of USD585b certainly provide enough insurance to follow the long-term roadmap, without worrying too much about external vulnerability.
4) *"No crisis should be wasted,"* and the GoI seems to have taken this very seriously. In the past few months, GoI has announced a number of **structural reforms**, ranging from labor, agricultural, to educational reforms. The beauty of reforms is that they disturb the existing ecosystem and nudge the present beneficiaries to compete with new players. As a result, they are almost certain to bring efficiency or productivity improvement.
5) Lastly, GoI has shown renewed drive toward **India's Manufacturing sector**. The Production-Linked Incentive (PLI) Scheme was announced for 13 shortlisted sectors in 10 ministries/departments, with the approved financial outlay totaling INR1.97t over the next five years. While the government's 'Make In India' initiative has failed to yield the desired results in the last five years, the focused approach and linked incentives are expected to yield better results in PLI.

The 2020s decade could be seen as the 'Healing Decade,' wherein all efforts are aimed at only one objective – to regain lost economic strength

In short, the task is not an easy one. Authorities have to avoid the temptation of continuing to support the consumption-led economic growth model, which has weakened household and government balance sheets. Moreover, they must continue to support the Financial sector and incentivize investments – households and corporate – as much as possible. Keeping government finances in check amid all this poses a real challenge. However, had it been easy to achieve growth in the high single digits for 2–3 decades, it would have been achievable by more than just a handful of nations in the world.

We strongly believe and argue that now is the time to work toward this goal. The 2020s decade could be seen as the 'Healing Decade,' wherein all efforts are toward just one objective – to regain lost economic strength. If, however, this healing does not happen, it is very likely the economy would continue to crawl sideways – with some years of decent growth and some years of weak growth – leading to subdued average growth. The problem with this strategy is that average growth is more likely to deteriorate with every passing decade, rendering adjustments inevitable.

NOTES

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BUY	>=15%
SELL	< - 10%
NEUTRAL	> - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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