THE ECONOMIC TIMES
INDIA LEADERSHIP COUNCIL

IS INDIA'S ECONOMIC AND FINANCIAL CONDITION FUTURE-PROOF?

CONTENT

EXECUTIVE SUMMARY

Financial stability is the most important pre-condition for any country's uninterrupted economic growth and overall development. Promoting financial efficiency and stability is therefore an eminently important task for public policy. Global economic activity continues to face significant headwinds since the second-half of 2018, culminating in a lower global growth forecast. Adverse geopolitical developments and trade tensions are also gradually taking a toll on business and consumer confidence.

Correspondingly, Indian economy took a hit as private consumption, the key driver for GDP, turned weak. On the other hand, the series of reforms to formalise the economy and make it transparent along with a strict control on inflation in the past few years has led to a fall in private investment. Summing it up, the proximate factors responsible for the slowdown of the Indian economy include declining growth of private consumption, lukewarm private investment, and soft export markets.

In this context, it is important to understand whether India is future-proof when it comes to its economic and financial stability, the country being a critical engine of global economic growth as it is world's seventh-largest economy by nominal GDP and still remains the fastest-growing major economy in the world.

Looking at the state of current geopolitical scenario of the country, it is for the first time since 1971 that an incumbent prime minister has secured an absolute majority for their party for a second successive term by winning even more seats than before. This surely ensures a political stability for the country, and though the political stability has come at a time when growth is slowing, the new government's budget has set the tone for its policy response, with a vision of $5 trillion economy by 2024.

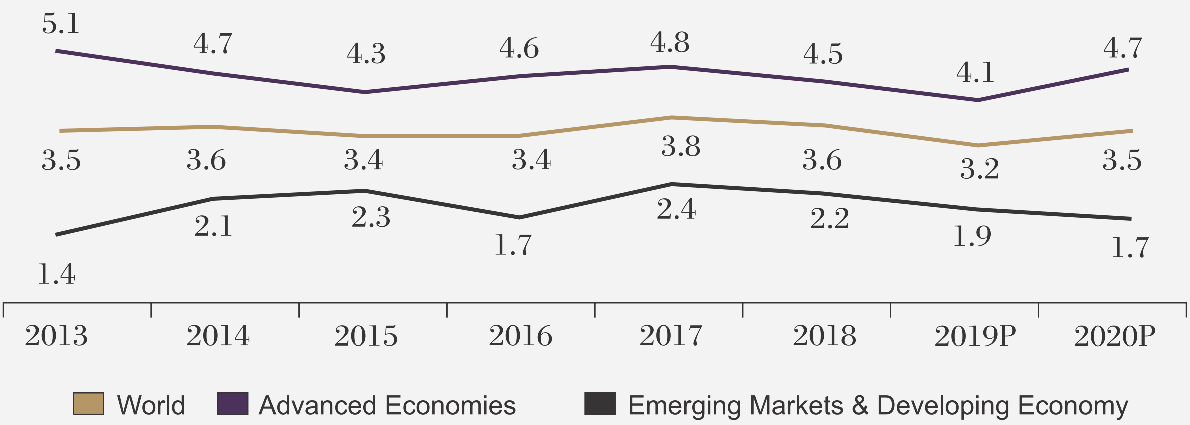
On the other hand, the government, in the Union Budget for 2019-20, focused on reviving investments and the rural economy as well as improving the financial structure to spur credit and spending growth. It needs to be seen whether, in the making of this new India, the driving forces of the country's growth - including urbanization, a rising middle class, and consumer spending can take the country out of its gloomy sentiment and derive a path that is sustainable and stable.

MACRO FINANCIAL ENVIROMENT

High frequency indicators signal a continued slowdown for the Indian economy, which has characterized the entire fiscal of 2018-19 and continued during the first three months of fiscal 2019-20. Demand related information available on critical sectors such as automobiles, cement and transport also confirm this continuing slowdown. At this backdrop, Indian economy appears to be losing momentum, when the global economy is also going through a muted phase.

Sluggish global growth: Global growth remains subdued, and according to IMF forecast (July 2019), global growth is expected to pace at 3.2% in 2019, picking up to 3.5% in 2020 (a 0.1% point decrease for both years from April 2019 forecast by IMF).

World Economic Growth Rate



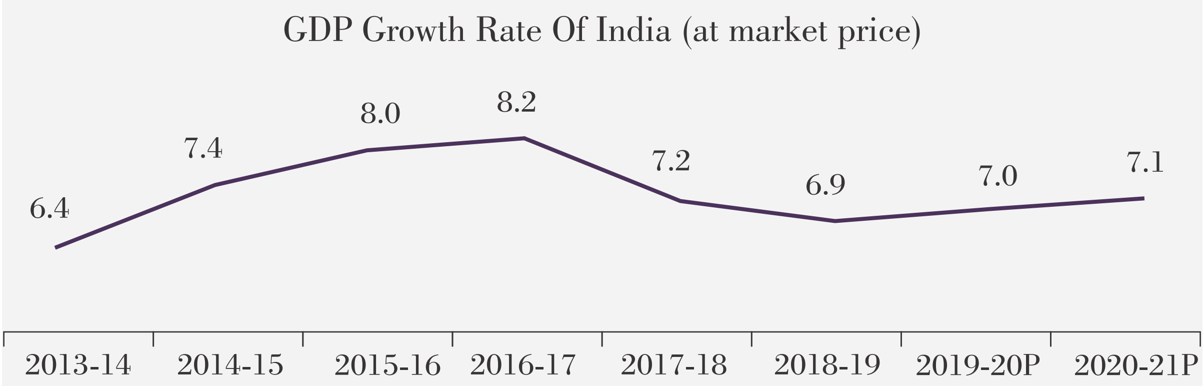
Source: World Economic Outlook, IMF (January 2019)

GDP releases so far this year, together with generally softening inflation, point to weaker-than-anticipated global activity. Investment and demand for consumer durables have been subdued across advanced and emerging market economies as firms and households continue to hold back on long-range spending.

Global geopolitical risks and trade protectionism: Heightened geopolitical risk is also becoming increasingly prevalent in today's world, with uncertainty surrounding policy, international relations and political leadership now a driving force behind financial market volatility and sentiment.

Against a difficult backdrop that includes intensified US-China trade and technology tensions, unrest in Hong Kong, as well as prolonged uncertainty on Brexit, momentum in global activity remained soft. According to IMF, broad data across countries paint a picture of subdued global final demand, notably in fixed investment, despite the upside surprises in headline GDP for some countries for the first half of 2019.

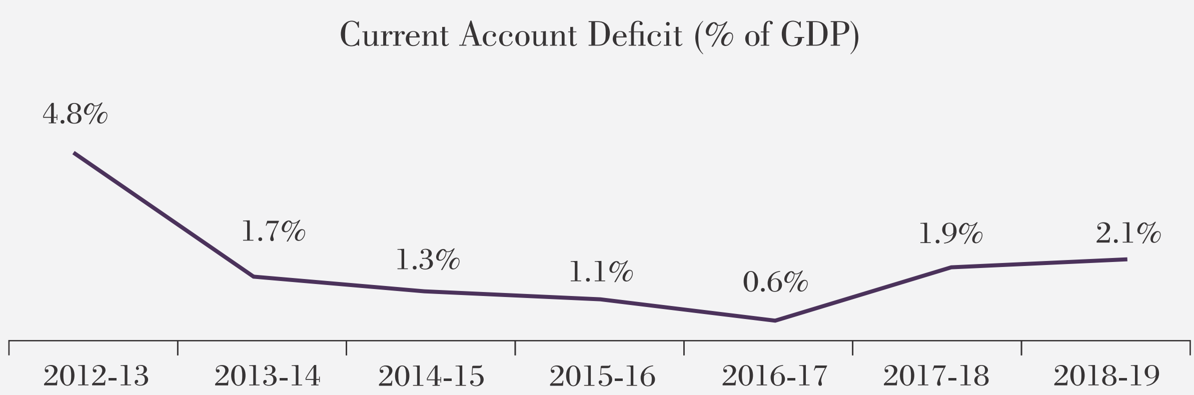
Domestic macro-financial developments: India's Q4 FY19 GDP posted a five-year low figure of 5.8% year over year. Annual growth for FY19 was 6.8%, compared to 7.2% in FY18. Growth will likely to hover around 7% in the next two fiscal years, as per latest IMF forecast, primarily reflecting a weaker-than-expected outlook for domestic demand.



Source: Ministry of Statistics and Programme Implementation-Govt. of India, IMF (July 2019)

Though there is a subdued outlook for the economy, a growth of around 7% is not bad, considering the global growth standards. If the government continues with its promises announced ahead of elections, India should experience near-term growth.

Also, if we closely look at some of the other headline numbers, it's a combination of negatives and positives. India's current account deficit (CAD) for FY19 widened to 2.1% of GDP, the highest in six years, on account of a higher trade deficit caused by high crude oil imports. But the deficit for Q4 FY19 was lower at 0.7% of GDP, which is a ten-quarter low, compared to 1.8% in the same period a year ago. Latest quarterly numbers have shown a narrowing of CAD too. If oil price remains soft, and India can bolster export growth faster than imports, CAD can come down further.



Source: RBI (August 2019)

Further to this, the capital account saw a robust surplus during Q4 FY19, bolstered by portfolio inflows, allowing net accretion to the country's foreign exchange reserves. However India's external debt witnessed an increase of 2.6% in FY19 over its level at FY18, primarily on account of an increase in short-term debt, commercial borrowings and non-resident Indian (NRI) deposits, according to RBI. The increase in external debt was partially offset by valuation gain resulting from the appreciation of the US dollar against Indian rupee and other major currencies. The external debt to GDP ratio stood at 19.7% at FY19, lower than its level of 20.1% at FY18.

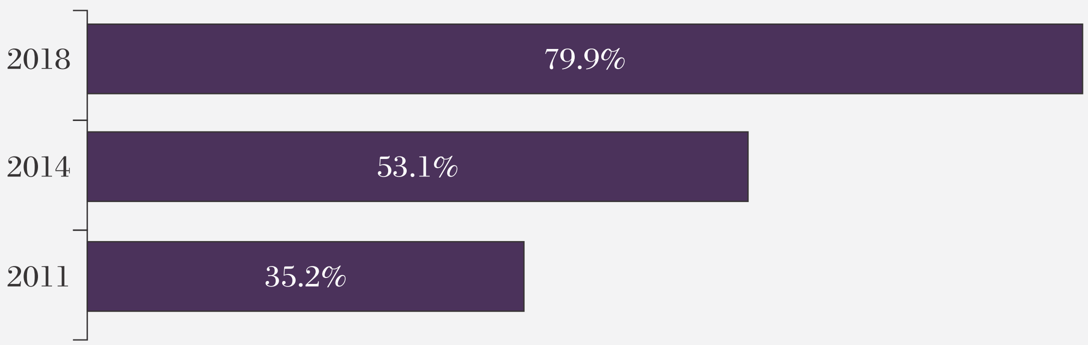
It is of no doubt that India is passing through a sluggish economic growth. Though industry experts suggest that the slowdown in the economy is more than a cyclical one, at this moment it is difficult to tag it as either cyclical or structural. However, given the current economic condition, policy makers must think about ways that can take the country out of the situation, and create path for structural long term growth.

THE STATE OF FINANCIAL SERVICES SECTOR

The diversified financial services sector in India is going through a volatile phase, and the volatility has resulted in financial institutions struggling to maintain their growth and profitability. The recent NBFC crisis related to illiquidity and insolvency, issue on NPAs and credit growth problem, alongside the global economic slowdown have taken a toll on the Indian economy, pressurising margins as well as the sustainability of financial service companies.

Amidst this mess and its multiplier effect, India continued to take massive strides towards financial inclusion. When the first Global Findex Database was released by the World Bank in 2011, it stated that 35% of adult Indians had a bank account. An overwhelming majority of Indians, especially in rural areas, were financially weak and were effectively excluded from the formal economy. Seven years later, almost 80% of adult Indians have bank accounts, according to the Global Findex Database published in 2018.

Improvement in Financial Inclusions



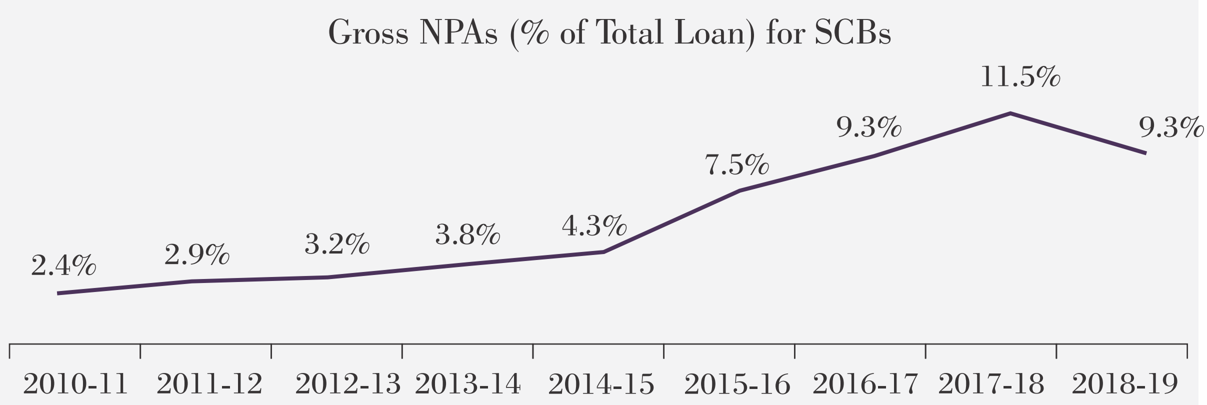
Source: World Bank Global Findex Database (August 2019)

Given this backdrop, where the Indian financial services sector is trying to move ahead in a tight-strapped environment, it's important to dive deep into the main branches of the sector including Banking, NBFC, Insurance and Capital Markets.

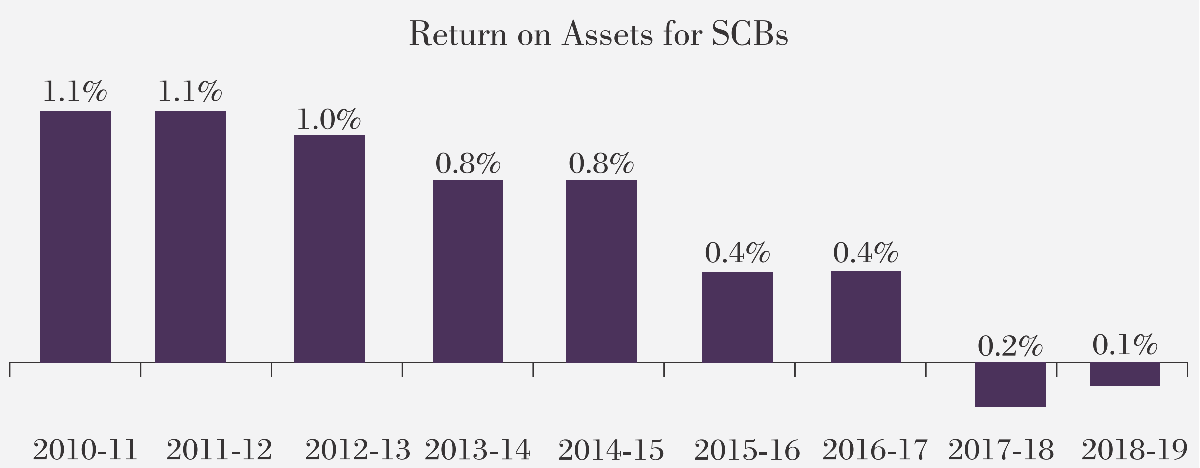
Banking sector improving resilience: In the past couple of years, India's banking sector faced considerable challenges with high non-performing assets and slow deleveraging & repair of corporate balance sheets, testing the resilience of the banking system and holding back growth.

Moreover, banks are not able to raise money easily, especially public-sector banks that have higher number of bad loans. All this led to a challenging environment for the banking sector to operate.

Though the sector has witnessed significant headwinds in the past eight years, the recovery process seems to have started. There has been a significant improvement in asset quality of scheduled commercial banks (SCBs) during 2018-19 as gross NPA ratio declined to 9.3% as on March 2019 against the peak of 11.5% recorded in March 2018. RoA too has shown signs of improvement in the same period.



Source: RBI (August 2019)



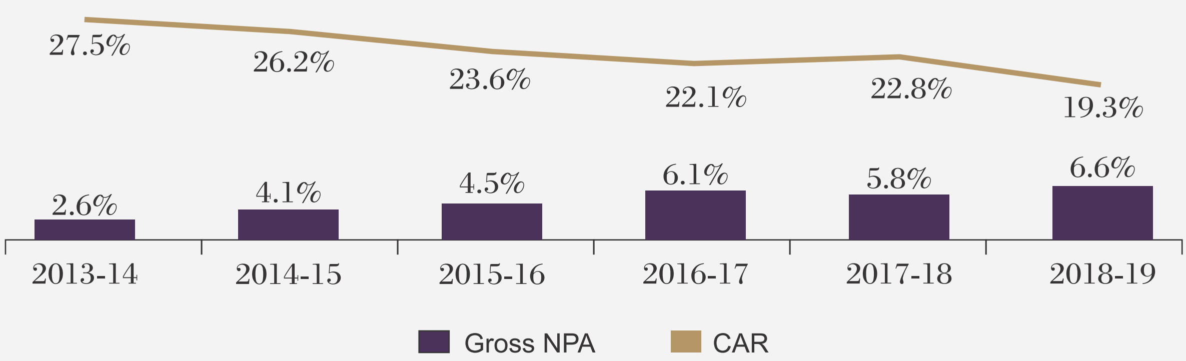
Source: RBI (August 2019)

Resonating this, RBI in its 19th edition of FSR (Financial Stability Report, June 2019), highlighted that Indian banking sector continues to show improvement as impairment ratios decline and credit growth picks up. The Public Sector Banks (PSBs) showed a noticeable improvement with recapitalisation, where both provision coverage as well as capital adequacy improved. Provision coverage ratio (PCR) of all SCBs rose sharply to 60.6% in March 2019 from 52.4% in September 2018 and 48.3% in March 2018, increasing the resilience of the banking sector.

NBFCs trying to revive with budgetary help: The NBFC sector, popularly known as 'Shadow Banking' - referring to the practice of banking like activities performed by them with not so strict regulation, plays a critical role in ensuring availability of loans and they have maintained high credit growth over the past few years, at a time when banks have gone slow on lending owing to ongoing asset quality concerns and corrective actions.

The sector, however, has been under pressure since last year, when a series of defaults by IL&FS forced the government to intervene and exposed weaknesses in the sector. In recent past, the proportion of non-performing assets as percent of loan book has steadily increased, while capital adequacy ratio has declined.

Gross NPA and CAR For NBFCs

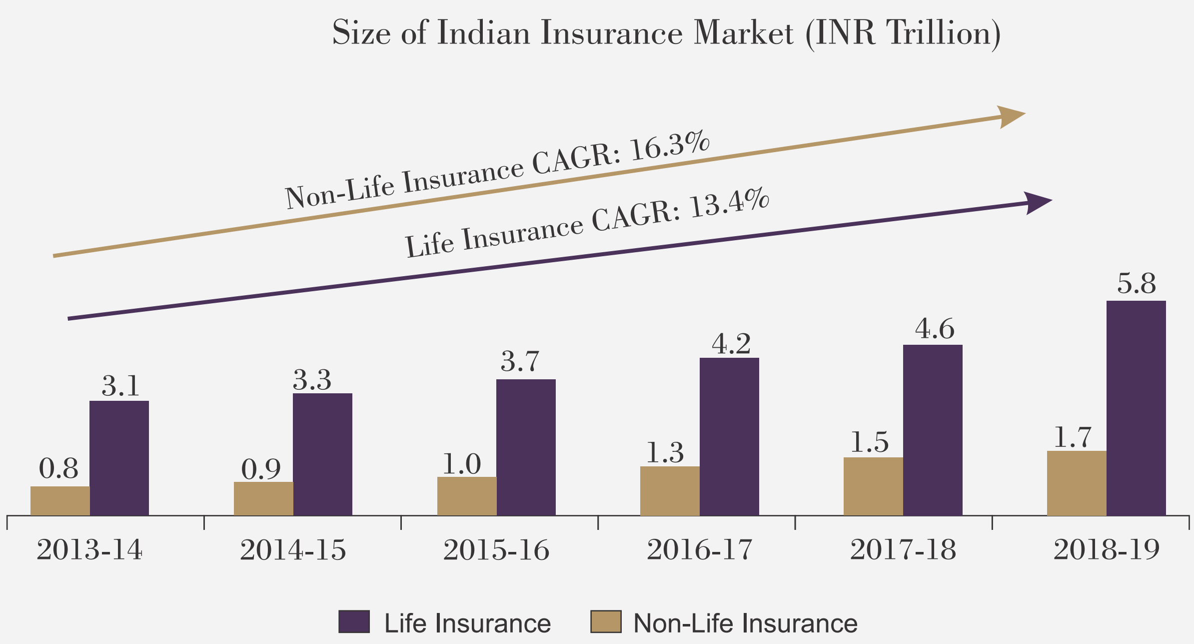


Source: RBI (August 2019)

These developments have brought the sector under greater market discipline, and the funding market has dried up for them. Despite the dip in confidence, better performing NBFCs with strong fundamentals were able to manage their liquidity even though their funding costs moved with market sentiments and risk perceptions. The government's Budget acknowledged that NBFCs need help and offered certain measures, such as the government's partial guarantee to state banks for the acquisition of up to INR 1 trillion of highly rated assets from NBFCs. With RBI taking over the regulation of HFCs and NBFCs, such budgetary offers should instil confidence among banks to start lending to NBFCs again, and the problem of NBFC crisis should ease down in near future.

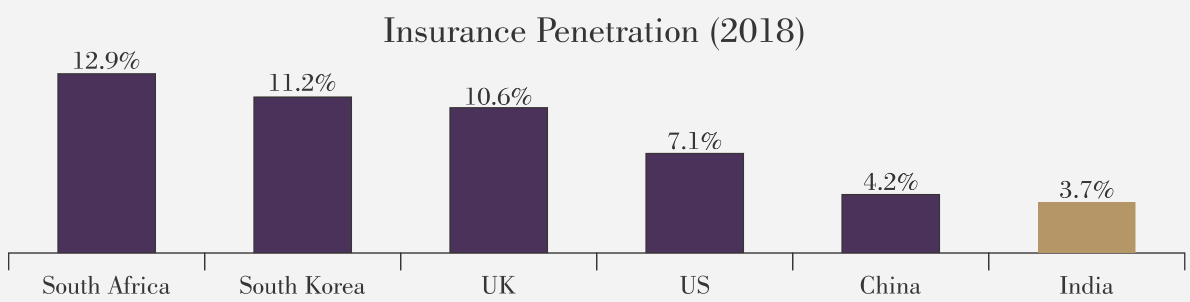
Insurance sector beefing up: The insurance industry in India has recorded significant growth post liberalization, but it has a long way to go.

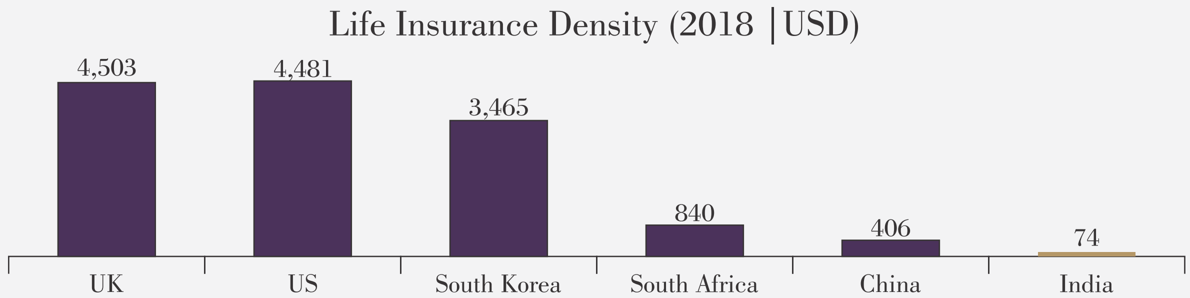
According to Swiss Re 2018 estimates, India accounts for approximately 1.9% of the world's total insurance premiums despite being the second most populous nation. The size of the Indian insurance sector stood at INR 7.48 trillion in 2018-19, with life insurance premium stood at INR 5.78 trillion, and non-life at INR 1.70 trillion..



Source: IRDAI (Handbook of Statistics on Indian Economy 2017-18, Publication August 2019)

Despite this, India continues to remain an under explored market, with insurance penetration (refers to premiums as a percentage of GDP) at 3.7% in 2018, as compared to 12.9% in South Africa, 11.2% in South Korea and a global average of 6.1%. Similarly, insurance density (per capita premium) also remains very low at USD 74 (global average USD 682) in 2018 as compared to other developed and emerging market economies.





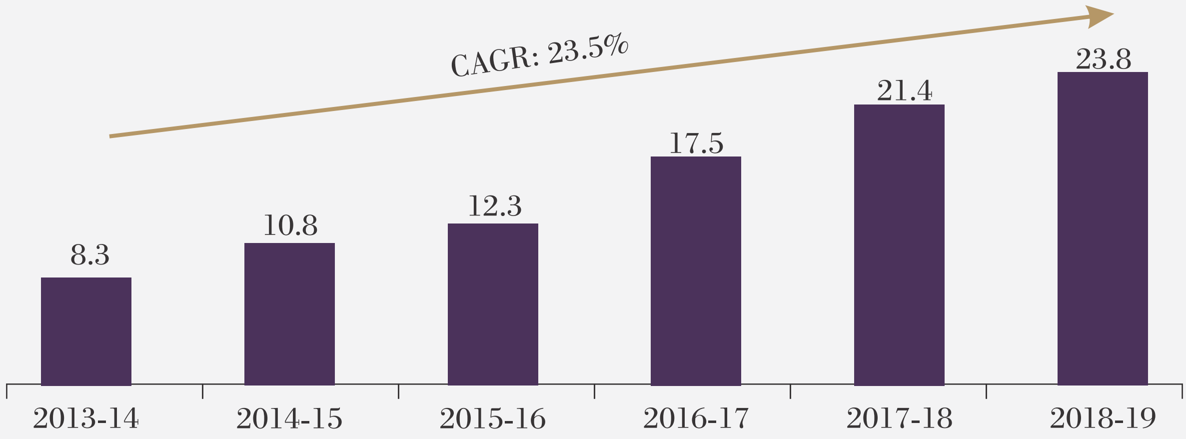
Source: Swiss Re Sigma (World insurance, March 2019)

Low levels of penetration, a favourable demography, government initiatives (maximum permissible shareholding for foreign investors to 49% of paid-up equity capital from 26%, proposed 100% FDI in insurance intermediaries etc.), rising financial literacy and increasing domestic savings as a result of rising per capita incomes are expected to support the growth of the life insurance sector. On the other hand, awareness and popularity of general insurance requirements is growing steadily in India. Apart from the mandatory third party risk cover for motor insurance, own damage insurance, health insurance and crop insurance are also becoming increasingly popular.

Capital markets going through volatility: Despite uncertainty through the past year related to a host of factors, Indian markets continued its rally among the global community. India's stock market capitalization, as at March 31, 2019, stood at INR 151.1 trillion. As on December 31, 2018, India's stock market capitalization amounted to 2.8% of the total global stock market capitalization and 8.7% of the stock market capitalization of the Asia-Pacific region. However a synchronized global economic slowdown, the US-China trade conflict and other international factors such as China's growth deceleration continue to threaten Indian capital market.

The Indian mutual fund industry, holding a bright spot in the sector, is one of the fastest growing segments of the financial sector. Buoyed by robust capital inflows and strong participation of retail investors, the asset base of the mutual fund industry stood at INR 23.8 trillion as on March 31, 2019, recording a growth of 11.4% over the previous fiscal year.

Growth Of Mutual Fund AuM (INR Trillion)



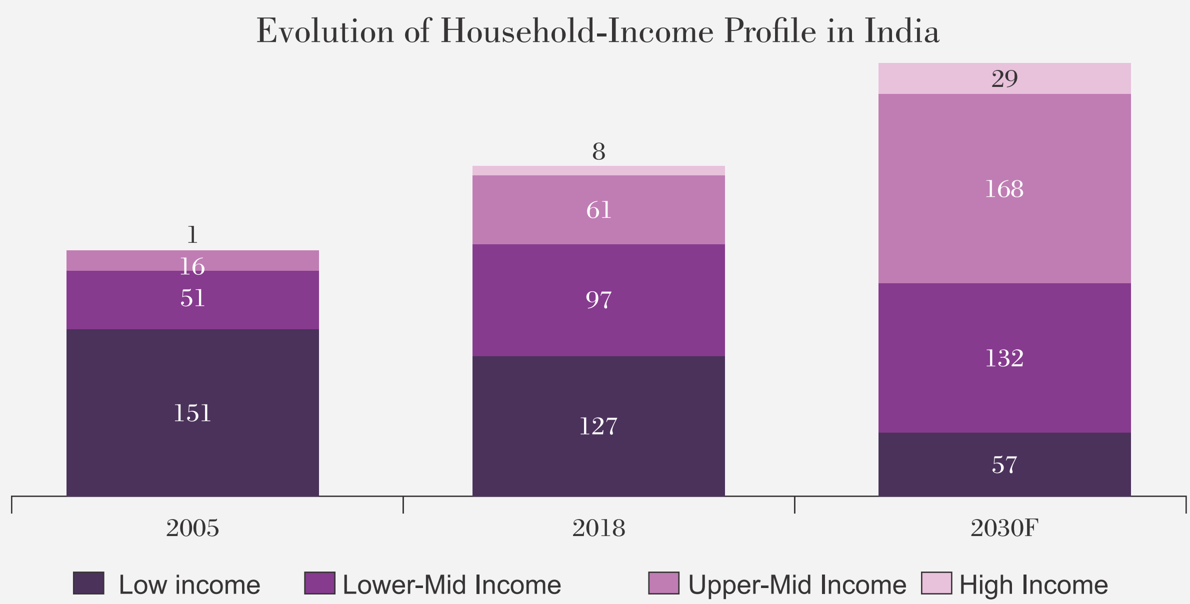
Source: AMFI (August 2019)

However, despite a robust sentiment in the mutual fund industry, the Indian capital market suffered a net outflow to the tune of INR 389.3 billion in 2018-19 as macroeconomic headwinds weighed on investor sentiment through the year, even after a heavy capital infusion by FPIs (foreign portfolio investors) towards the end of the fiscal year. To counter this and further develop the Indian securities market as an avenue for fund raising, eligibility norms for FPIs were relaxed and data privacy concerns of FPIs were addressed. The recent announcement from the finance ministry on rolling back the imposed surcharge on foreign and domestic portfolio investors should further perk up consumer demand and investments.

PRESENT AND FUTURE OUTLOOK ON CONSUMPTION

India is a domestic consumption driven country, with approx. 60% of GDP driven by domestic private consumption. The country being the largest democracy in the world and the second most populous nation, such a domestic consumption-led economy provides with certain structural advantages that can enable robust growth and allow the economy to be relatively resilient to the peculiarity of global economic patterns. However, at the same time, it is equally important to ensure that the economy is not falling into the risk of stagnation due to 'middle income trap', and there is inclusive progress. Given the current demography of India, there are opportunities to shape consumption patterns – in terms of categories consumed, brands purchased or ways of accessing products and information.

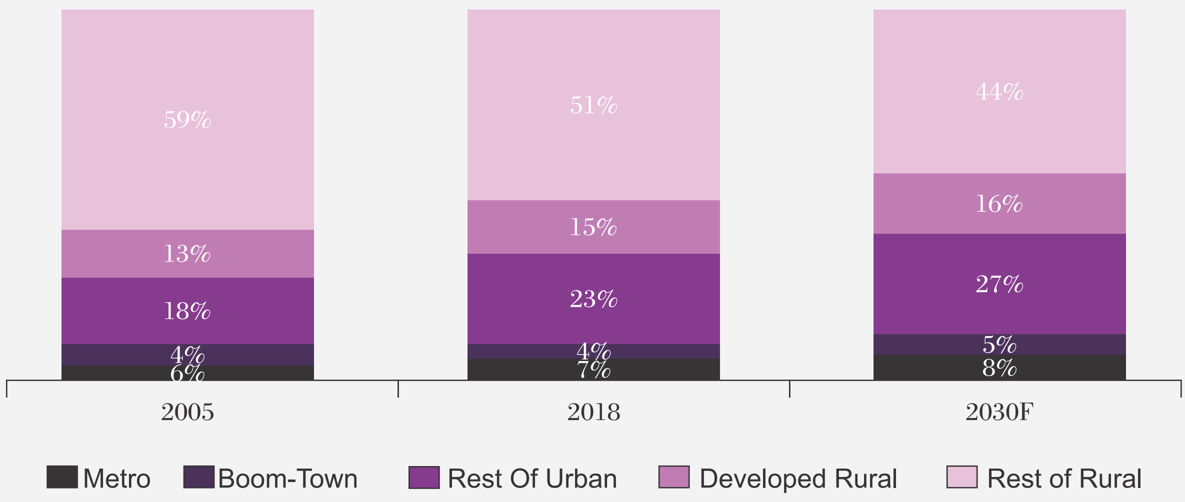
Middle-class expansion & income growth: According to an estimate by World Economic Forum, India is a nation of young working-age persons with median age of 28 years, and it will continue to remain young up to 2030 with a median age of 31 years, compared to 40 years in the US and 42 years in China. This segment of population drive both income and consumption, and increase in working-age population should generate a 'demographic dividend' that can power economic growth.



Source: World Economic Forum (January 2019)
Note: Household income per annum in 2017-18 prices by income segment; Low: < $4k (<INR 2.5 lakhs), Lower-middle: $4k – 8.5k (INR 2.5 – 5.5 lakhs), Upper-middle: $8.5k – 40k (INR 5.5 – 27.5 lakhs), High: >$40k (>INR 27.5 lakhs)

Steady and dispersed urbanization: It is expected that by 2030, 40% of Indians will be urban residents, and metros and emerging boom towns will continue to drive economic growth.

Population Growth Across Urban and Rural India



Source: World Economic Forum (January 2019)

However, to mitigate the strains that will develop as cities expand, and to maximize the potential economic opportunity that well-managed cities can offer, India needs to develop a fresh, proactive approach in addressing the challenges of urbanization. Policy framework should address basic facilities like infrastructure, drinking water, housing, transport etc.

Rural consumption growth: The population living in rural India is largely dependent on agriculture, and farm income is mainly dependent on the quantum of hike in Minimum Support Price (MSP) for food-grains and on the quantum of monsoon rainfall. Various measures by the government like hike in MSPs, farm loan waiver, direct income transfer (DIT) and allocation to schemes related to rural India have been able to uplift the sentiment, with natural factors point to an encouraging monsoon season this year. Combining all these, we should see a revived rural India that will drive the demand for discretionary and non-discretionary goods. With an increase in the incomes of rural India and greater internet penetration narrowing digital divides, growth of rural consumption and breakdown of the urban-rural paradigm paves further way for increased consumption. However to unlock the full potential of rural consumption, the issues of poor infrastructure such as roads, power, internet, access to organized retail and financial inclusion need to be addressed.

Evolving consumer archetype: India, a nation of 1.3 billion people, is the most varied market in the world, thanks to its regional differences in cultures, lifestyles and preferences. The existing as well as the evolving demographic profile, education and occupation, and connectedness will result in distinct consumer preferences even as income will continue to remain a strong determinant of consumption choices.

To sum up the overall consumer story:

- Rising incomes and the expansion of the middle class and high-income segments will reshape future consumption
- Inclusive India will drive consumption growth and the urban-rural divide will contract significantly
- Connected India, with more than 1 billion internet users, will have significantly more informed consumers who will demand greater transparency
- Many consumer archetypes will persist as age, education, occupation and connectedness begin to strongly influence preferences
- Such consumer archetypes will shape future opportunities in emerging areas such as e-commerce, value-for-money brands and digital entertainment

IN CONCLUSION

As we have studied the financial and economic stability of India through different lenses covering macro-financial environment, financial services sector and consumer landscape, it is evident that the country is not going through a journey of exuberant growth. It is clearly evident that Indian economy is in some serious troubles - double-digit growth nowhere in sight, it is facing its worst jobs crisis, the agrarian sector is distressed, real estate is subdued, and banks are struggling to get out of the burdens of bad loans. The most recent announcement from Central Statistics Office justifies all these events – India's GDP growth crashes to seven-year low of 5.0% in the first quarter of 2019-20. In gross value added terms, the economy grew even a bit slower at 4.9%.

Though a section of the economists believe that the slowdown is cyclical rather than structural while others disagree, every school of thoughts agree on one aspect – there exist certain deep-rooted problems and some structural reforms will be needed to ensure that growth gets back on track. As we have studied the sections above, the story is that of a mixed bag with some of them facing structural challenges, while others are going through a cyclical soft patch. Given the sheer volume of India, the overall story can be directed towards a growth path with necessary policy measures. India still remains as the fastest-growing economy, clocking a growth rate of over 6.0% in next two years, as highlighted by many eminent institutions. The country has a large volume of population who can drive both labour force and consumption. Recently, the finance ministry has announced a number of measures to revive economic growth, and such measures should definitely help to instil confidence. However at the same time, the policy makers should also focus on key structural issues that are detrimental for economic growth.

On the structural front, India has less focus on industrialization, which has hurt job creation and India continues to be a service-led economy. This needs to be addressed. The efforts on 'Make in India' should be more concrete, which can eventually translates into the substitution of imports by domestic manufacturing and 'Make in India' can bring in 'economies of scale' for the country. Though the government has worked on providing monetary stimulus, that has not upped the sentiment to the level it is required.

A large scale spending push by the government could have helped, but being constrained by the fiscal discipline, that did not happen in the Union Budget. Hence a framework for sector specific support can be drawn down.

With the government's focussed policies on raising farmer's income, offering tax cuts to corporates, setting aside more funds for infrastructure etc., the economy should be able to find some breathing air. However at the same time, policy makers should put equal importance on further simplifying procedures, incentivising performance, reducing red-tape and making the best use of technology. And, for all of these factors to contribute positively to the growth of the economy that is inclusive and sustainable, it is important to tackle the following challenges:

- Skill development and future-focused employment generation, particularly in the manufacturing sector, will be critical to direct the potential of India's young workforce. As nearly 10-12 million working age persons get added to India annually over the next decade, it will be critical to provide them with gainful and more formal employment and reduce the skills-gap that exists today.

- Social and economic inclusiveness of rural India is also a key imperative, especially as connectedness creates aspirations.
- The policy makers and other broad stakeholders will need to evaluate and respond to the challenges of creating a sustainable and healthy future through better access to healthcare & education, reduction in pollution and better urban planning to reduce congestion.

In Q2 FY20, the government announced a slew of measures to boost economy and that sends a strong message that government is concerned about the slowing economy and intends to support the situation with corrective measures. Together with these reactive measures, if the government continues to focus on structural reforms addressing the key challenges discussed above, India should definitely position itself as a country that is financially and economically stable. Though the overriding sense is one of cautious optimism, the consensus is that India is still on a steady position. Hence even if the economy is not future-proof in its current state, it has the elements to make it future-proof. A stable government at the centre should draw this path with necessary policy measures, before it's too late.

References:
- Financial Stability Report, Issue No. 19 (July 2019), RBI
- World Economic Outlook (July 2019), IMF
- Handbook of Statistics on Indian Economy 2017-18, RBI
- RBI Annual Report 2017-18
- Future of Consumption in Fast-Growth Consumer Markets: India (January 2019), World Economic Forum