Insight beyond information

EXECUTIVE BRIEFINGS
POLITICS & ECONOMY: ECONOMIC RECOVERY

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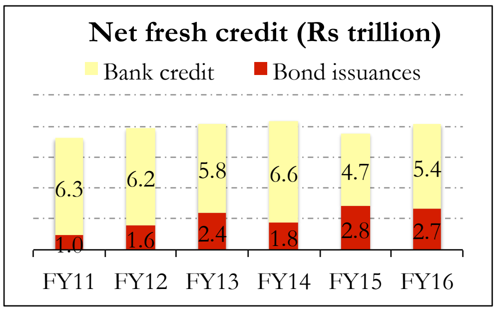
A recovery? It depends on who's asking

In recent months, analysts have struggled to make sense of conflicting signals generated by economic indicators. Consequently, they have failed to gauge the nature and strength of the economy's recovery from the trough it hit a few years ago. Some have even questioned the premise that a recovery is taking shape at all. The most obvious divergence stems from the fact that while headline GDP growth has 'recovered' from under 5% to over 7.5%, other indicators point to continued lethargy. The Index of Industrial Production (IIP), which averaged below 1% in FY13 and FY14, barely increased to 2.5% in the next two years. In FY17, it appears to be retreating to 0% again (April-August). Its capital goods sub-segment, which was a dismal -3.8% in FY13, has dropped even further in the current year, to a worrying -21%. Even providing for the limitations of the IIP – such as its imperfect representation of industry sectors – these figures would hardly seem consistent with the picture of an revival.

And that is not all. Sceptics would further emphasise the fact that capacity utilisation levels across industry are falling. The RBI's quarterly surveys of industrial order books, covering a sample size of almost 1,000 companies, show that the average capacity utilisation in the last few quarters has been a gloomy 72-74%, compared to 78-79% a few years ago. This points to excess capacity in the system, which is consistent with the point that inflation for manufactured products, at about 1-2%, is well below the average inflation rate. Depressed prices lessen the inducement to invest. Finally, the fact that outstanding non-food bank credit has increased by only 8-9% yoy in the last two years and that *fresh* lending is actually declining would seem to clinch the argument. In FY14, banks advanced Rs 6.6 trillion in fresh credit while in FY16, this fell to Rs 5.4 trillion. In high growth periods in the past, outstanding credit used to grow at 15-18% yoy and fresh lending at over 20%, so the current figures of growth would seem to refute the notion of an economic revival.



Source: CEIC, RBI, SEBI, IMA analysis

However, there is more to this picture. Firstly, the lack of buoyancy in bank credit is *completely* compensated for by the bond markets. Against the average 8.8% expansion in outstanding bank credit, bond market lending has grown almost twice as fast, at 17.3%, in the last two years. Over a five-year period, annual bond issuances have nearly tripled and in terms of fresh lending now contribute *half as much* as the banking sector itself. Five years ago, they contributed less than one-sixth and even as recently as two years ago, only a quarter. The figures are as follows: in FY11, companies raised Rs 1 trillion from the markets and Rs 6.3 trillion from banks; in FY16, these figures were Rs 2.7 trillion and Rs 5.4 trillion respectively (see chart). As a result, total new borrowing by corporates actually increased in FY16 to Rs 8.1 trillion from Rs 7.5 trillion in the previous year. This is the highest annual rise in new borrowing in the past four years.

Secondly, many indicators suggest that consumption is steady and strong. For instance, passenger vehicle sales have jumped 10.7% in April-August 2016 against 6.7% in the same period last year. The consumer durables index of the IIP is up 7.3% in April-July against 6% last year and consumer credit, a proxy for spending on high value items, is growing at 18-19% yoy in FY17 against 15-16% in the last two years. Moreover, rural consumption has begun to kick in over the past few months with two wheeler sales growing at 16.5% in April-August 2016 against -0.2% last year. Going forward, consumption is likely to remain robust through a jab from a string of extraneous flows. These include Rs 1 trillion from the implementation of the 7th Pay Commission salary hikes for Government employees; Rs 0.1 trillion due to the One Rank One Pay (OROP) payout for the Armed Forces; a disbursement of Rs 1.8 trillion in the form of small loans to entrepreneurs under the Mudra scheme; and finally, *additional* spending by the Government itself in areas such as agriculture and rural development which typically translate into immediate incomes and hence, consumption. These add up to an impressive Rs 2.8 trillion – an amount that will be (earned and) spent by rural and middle income consumers over FY17 and FY18. Logically, persistent buoyancy in consumption should absorb excess capacities within industry in a matter of months.

Finally, we have always argued that the markets drive the economy and not the other way around. When equity markets are strong, investors experience an appreciation in their holdings and this brings the 'wealth effect' into play. Consumers are tempted to indulge in discretionary, high value spending as a result of an increase in their notional wealth; consequently, aggregate consumption rises. Further, strong capital markets provide businesses appealing opportunities to de-leverage balance sheets through equity stake sales. In the case of the debt market, high bond prices drive down yields and encourage businesses to raise funds for future investments. In recent months, India's capital markets have exhibited potency. Equity markets, since February 2016, have been on a bull run and approaching the all-time high levels achieved two years ago. The market capitalisation (a proxy for the total invested wealth in the market) of the Bombay Stock Exchange has increased from Rs 85.8 trillion to 113.6 trillion between February and September 2016 – a staggering Rs 27.8 trillion increase in notional wealth. Bond markets are similarly rising as illustrated by the the drop in the 10-year sovereign benchmark from the highs of 9.5% in August 2013 to around 7% now. Both markets have been driven by strong capital inflows. In the six month period from April to Septmeber 2016, FIIs have invested USD 8.5 billion in India against a net withdrawal of USD 2.5 billion in the previous year. Although this is still a far cry from the levels of USD 30-40 billion achieved in earlier years, the trend is clearly upward. This is to a large extent driven by the global liquidity glut that is directing surplus funds towards emerging markets in search of better yields. With limited options for fund managers to earn decent returns in advanced markets, these inflows are likely to continue in the foreseeable future. Moreover, the contribution of domestic financial institutions (mutual funds) has increased significantly in the last few years and has become an additional force driving capital markets. Both factors augur well for future market movements and their consequent impact on the economy.

Sustainable economic growth is generated by investment which in turn is a function of many factors. A complex taxation regime, the uncertainties associated with the rollout of the GST and a throttled banking sector are all constraints that are not likely to go away in a hurry. Be that as it may, there are many reasons to expect better times ahead as this paper has tried to argue. However, it is also true that the wait will be longer for some industries than for others and in the final count, the answer to the question of whether or not a recovery is underway perhaps depends on who's asking.