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EXECUTIVE BRIEFINGS
BUSINESS AND ECONOMY: CREDIT AND INVESTMENT

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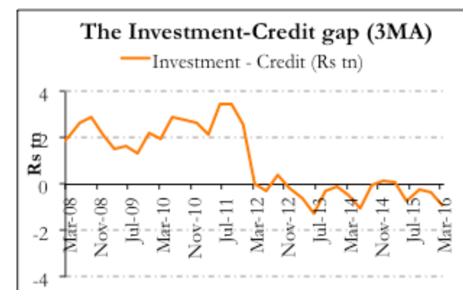
A credit quandary, but much more

Analysts have bickered that despite the efforts of the government and the Make in India initiative, investments have failed to nudge ahead proportionately. This reflects in the stunted growth in credit to the industrial sector, which fell from 25% in March 2011 to 5% in July 2014 and to a puny 1% in March 2016. Consequently, the industrial economy has stuttered and the more reflective capital goods index is even worse off. Credit to services is however rising at 7% and to consumers at 20%. These have collectively powered the overall economic output.

One reason for lacklustre industrial credit figures stems from structural problems within banks. The colossal amount of dud loans constrains their ability to lend and undermines their risk appetite for further exposures. But that is not all. Low manufacturing inflation also discourages new capacity creation. Companies can hardly look for expansion when prices are either flat or rising marginally. The capacity utilisation rate – a measure of industrial resilience – has fallen from 80% in 2011 to about 70% now according to the RBI's industrial surveys. With so much capacity to spare businessmen understandably feel reluctant to create even more.

The muted rates of credit growth however do not by themselves paint the complete picture. The fact is, in earlier years, investment figures were inflated. This can be gauged through an analysis of the investment-credit gap. As the chart shows, during the period 2008-2011, the aggregate investments proposed by industry exceeded the available banking credit in the economy by Rs 2-3 trillion per quarter. In some months, this translated into investment proposals amounting to an astounding 300% of credit disbursed, implying an exceptional appetite for equity investment! Possibly, the source of these funds was 'sticky' money comprised of siphoned subsidies being re-routed into the economy as well as illicit foreign funds brought back by businessmen and politicians in the form of investment funds. During the years of the previous administration, subsidies were growing by 20% and some estimates conservatively suggest that about half of these were leaked and rerouted into sectors such as construction, real-estate, hotels and education institutions. Oddly, by 2011, real estate and construction alone accounted for 10% of GDP and over half of all capital expenditure. In subsequent years, following a series of regulatory and judicial measures and the shift to Direct Benefits Transfers (DBT), illicit flows have virtually collapsed and the investment credit gap therefore appears more sensible. Essentially, the large number of what could only be called anomalous investment proposals are no longer warping the data.



Source: CEIC, RBI, DIPP, IMA analysis

To determine the real picture a closer examination of the data is warranted. This shows that while there is some drop in investments they have not dried up as some may have suggested. For instance, whilst investment *proposals* declined from Rs 15.4 trillion in 2011 to Rs 3.1 trillion in 2015, *actual* investments (i.e. those that have been implemented) have jumped manifold. From a mere Rs 100-200 billion in 2010-2011, executed investments stood at Rs 800 billion in 2015 (see charts below). The conversion ratio of 'intention to execution' has escalated from a pittance to nearly 40%, thus indicating not only a

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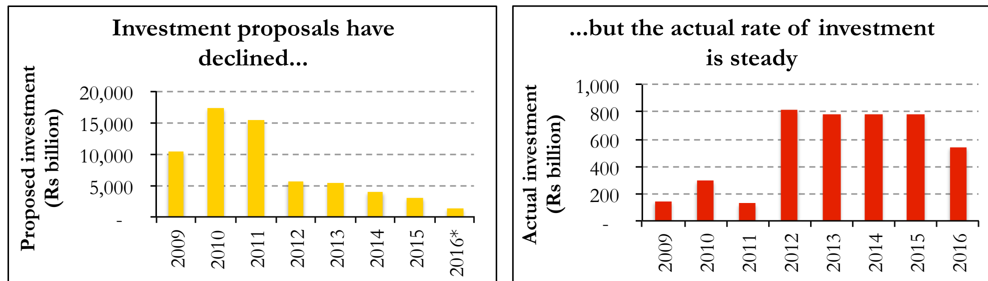
more realistic data set but also a more conducive environment for implementation than that which existed 4-5 years ago.



Source: CEIC, RBI, DIPP, IMA analysis. 2016 figures pertain to January-May.

However, that is not to suggest that all is well. Investment may not have dried up but it is not growing either – evident from the fact that implementations have been stagnant at around Rs 800 billion for four years. From a broad perspective, investment is influenced by five levers. These include, a friendly tax regime; industrial support reflected in the overall productivity levels (influenced by various factors such as government, infrastructure, skilled labour); bank credit; demand; and buoyancy within financial markets. In India, only one of these, demand, has really been steady and reliable as an investment driver. Credit is constrained by a crippled banking sector which may take a few years to be fully revived. Taxation has been a perennial challenge but the recent emphasis by the Prime Minister on transparency and taxpayer-friendliness within the revenue service should be construed as an encouraging sign.

The biggest problem remains productivity, especially in the manufacturing sector. According to a 2013 estimate by EuroStat, India's productivity as measured by GDP (PPP) per hour worked is 3.40. By comparison, Thailand is 8.54, Malaysia is 16.47 and Korea is 32.31. It is not surprising that many businesses privately lament that it is easier to produce overseas and export to India than to produce locally. Declining customs duties only make this proposition more appealing, further encouraging industry to seek foreign manufacturing destinations. This is a worry.

What started as a trickle some 10 years ago, is now a stream with capital outflows by Indian companies jumping from USD 2 billion in 2005 to USD 8-9 billion annually in recent years. The lure of overseas manufacturing opportunities through better infrastructure, more responsive local governments and a friendlier tax regime are sometimes too attractive to resist. The fungibility of capital and the availability of offshore funds, have enabled this. In the final count businessmen are inspired by ease-of-doing-business considerations and profits. Nationalism, unfortunately, takes secondary place. Over the course of the past twelve months, estimates suggest that around 5,000 businessmen have migrated overseas. Many of these have done so on grounds of a better living environment and business conditions.

The drivers to the ease of doing business are local, rather than determined by national policy. Local governments provide industry with the essentials – power, water, land, roads and other infrastructure. They can facilitate a better quality of life for citizens and businessmen. Harassment by municipal officials and inspectors are key deterrents and need to be fixed quickly. The central government appears to be doing its bit in streamlining broad policies but local impediments are beyond its purview. Therefore, sustaining growth in the longer term, has more to do with better local governance than national policies. The investor is really a victim of local apathy, trapped in its bureaucratic and political clutches. Fixing the credit quandary, whilst important, will simply not be enough going forward.

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