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Kick-starting economic growth: An interview with Dr K. V. Subramanian, India's Chief Economic Advisor

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KICK-STARTING THE VIRTUOUS CYCLE OF ECONOMIC GROWTH

Dr K V Subramanian, Chief Economic Advisor to the Government of India, talks about structural reforms to boost India's economic growth, in this interview with Havovi Joshi.

What are your thoughts on the Indian economy today?

Let's go back to 2004 to get a sense of why we are where we are today. Between 2004 and 2009, we took growth for granted. We focused a lot on distribution, without really enhancing the efficiency of distribution. The bellwether of that period was the loan debt waiver that was announced in the 2008 budget, which was by far the biggest ever for any emerging economy in dollar terms and as a percentage of the country's GDP. Then, 2009 to 2014 was a period of huge misallocation of resources that was evidenced by scams and scandals, such as the 2G or coal scam, each of which ran into billions of dollars. From an economist's perspective, such events meant that scarce resources, which should have been allocated to those who are the most efficient at managing it, were allocated instead to others who may not be as productive. As a result, the productive capacity of the economy suffered.

Now this is a relatively benign view. The origins of banking stress, which we've been seeing for a long time, also started around 2009-10. The banks started lending like there was no tomorrow. While the quantity of credit went up, the quality was oftentimes quite suspect. The balance sheets of corporates took off—they were highly leveraged. Not only did they leverage a lot, they did so with extremely low equity. Very often, debt was taken on the parent company's balance sheet and put as equity in the subsidiary's balance sheet, or vice versa. As a result, the quantity of equity in the system was very small. There was also irrational exuberance, where people assumed that the higher-than-eight percent growth rates would continue to prevail. The 2008 financial crisis, combined with excessive leverage, the lack of sufficient equity in the system, and lending to low-quality projects, placed a lot of stress on the balance sheets of the borrowers which in turn affected the balance sheets of the banks.

My view is that when a banking sector experiences stress, there are only two ways through which an economy can try to get out of it. One is to grow out of the problem, where you basically achieve much higher growth rates for reasons unrelated to the banking sector. Just as a higher tide lifts all boats, banks grow out of the problem when growth picks up. The second way is by completely burning the badly affected part of a forest so that the rest of the area does not get affected. In other words, intervene early rather than pretend that the problem does not exist. As growth slowed down and the interventions came later, the bad debt problem built up. And because we did not have a functioning bankruptcy law, there was a culture of building bad credit. We also had issues relating to the incentive structure for public sector banks and even private sector banks. And the banks continued to lend poorly. So when the investigating agencies moved in to look into the wilful defaulters and the frauds, the bankers stopped giving credit. When this happened, the Non-Bank Financial Companies (NBFCs) moved into that space.

Now the asset liability structure of NBFCs is skewed towards assets of shorter maturities and liabilities of longer maturities, leading to an asset-liability mismatch. Moreover, they too ended up lending a lot without paying much attention to the quality of credit. At the same time, the real estate sector was going through a correction due to the Real Estate Regulation Act, which affected the NBFCs because a lot of them lent to the housing sector. In some cases, the Supreme Court came in and invalidated all the licences that were given, for instance, for coal blocks. As a result, all the power projects that were being built based on the coal block allocation delivered non-performing assets (NPAs). So the sector ended up with a significant number of NPAs.

The banking sector today is the result of these developments that have also affected liquidity in the real sector. So a lot of the concern stems from the financial sector, which has shown up in the real sector. Between 2014 and 2019, we invested time in identifying these problems and tried to address them through initiatives such as the bankruptcy court and the Reserve Bank of India's Asset Quality Review.

What are some of the key reforms that you would recommend to boost economic growth?

Growth has stalled because productivity is low. The 2019 Economic Survey of India revealed the importance of investment for the virtuous cycle of economic growth—it starts with investment that enhances productivity. Improvements in productivity show up as increases in the wages of people because labour productivity gets enhanced. Improvement in productivity is also important for growing exports because we have to compete in global markets. Both of them create jobs and increase the purchasing power of people. This creates demand, and firms invest more when they anticipate an increase in demand. That's how this virtuous cycle works.

The virtuous cycle of growth slowed down because of the problems in the financial sector and corporates that I spoke about earlier. It is not moving fast enough to produce the over 7 percent growth rate that we need. In order to get back to high growth rates, the focus has to be on investment again, and good quality investment. If you look at it in terms of aggregate data, the investment rate (what economists call the gross fixed capital formation as a ratio to GDP) was about 40 percent in 2008, but it came down to 28 percent in 2018. It has started going up, albeit slowly. To become a US$5 trillion economy, the main thing that we need to focus on in the medium to long run is to grow the rate of investment.

Structural reforms are required to increase the investment rate; implementing the Goods and Services Tax and the enactment of the bankruptcy court have been initial steps taken in this direction. If we compare the reforms to the proverbial nine pins, the first pin is a cut in the tax rate because that is really critical for investments to flow into the economy. In my view, the recent 15-percent tax rate cut for new investments is a good thing, as we are now as competitive as our peers. In terms of the size of the economy, we are, of course, significantly larger.

At the macro level, there are three key reforms that we need to work on: changing the size distribution of firms, revising labour laws, and facilitating the enforcement of contractual agreements.

The first is the size distribution of firms in India, which is a real challenge as it is much skewed on the side of small firms. Basic economic principles tell us that economies of scale is one of the key drivers of productivity. However, if you look at the Indian manufacturing sector for instance, 85 percent of firms are small with less than a hundred employees. These firms account for less than 25 percent of total employment. If you look at it in terms of their contribution to productivity, they contribute less than 13 percent. So we have 85 percent of Indian firms accounting for less than a quarter of the employment and less than a sixth of the value added in the economy. We need to incentivise our small firms to grow. Why has this happened? Over the seven decades since independence, we have actually been incentivising firms to remain small. A 40-year-old firm continues to be small in size because it receives the incentives and benefits of a small firm. So what you have is a 40-year-old adult that has not grown in size but continues to take away resources that should be directed to a five-year-old or an infant who is trying to find their feet. That is one of the major issues that we need to address.

Secondly, our current labour laws impose significant restrictions on larger firms. For instance, the Industrial Disputes Act, which governs decisions on hiring, is applicable to firms that have more than 100 employees. As a result, many firms are able to avoid coming under its jurisdiction by remaining small. So we need to relax the labour laws.

The third thing that we need to do is to improve the ease of contractual enforcement. While we have improved significantly on the ease of doing business, we are still ranked 163rd out of 192 countries in terms of the ease of contractual enforcement, placing us within the bottom 15 percent. Of the thousands of cases that remain stuck in our courts, close to 90 percent are in the lower courts, which are basically the district and subordinate courts. In the recent Economic Survey of India, we've pointed out that the first thing we need to do is to clear all of them. That means that there will be no piling up of any further cases, or that the number of cases that are coming in should equal the number of cases that are disposed of. For this to happen, we need to have more judges. We have laid out a plan to reduce this backlog of pending court cases in the next five years through improvement in productivity that would come about through a combination of possibly reducing the vacation period of judges, increasing the number of hours they work, and implementing some technological improvements. The combination of these three is expected to deliver a 25-percent improvement in productivity, which in fact is not very ambitious. With these measures, we believe the backlog can be completely cleared in the next five years.

What are your thoughts on the banking sector, and the initiatives taken to reduce the financial stress on the banks?

Capital has now been provided to these banks and the focus now is on giving them appropriate incentives to improve the quality of loan screening. There are also concerns about the quality of lending by private banks. Overall, the use of data and analytics in lending decisions is still not technically advanced in the Indian banking sector. All over the world, banks are focusing on using technology to make better lending decisions. This is something that India needs to focus on as well.

We see some consolidation already taking place in the public sector banks, and this will continue. This type of consolidation is already happening in other parts of the world, and is a trend that India has also followed. It is something that is required as there is a minimum size threshold to ensure that investments in technology can be made.

Corporate governance in India still appears rather weak. What are your views on improving governance?

There are a few areas in corporate governance that need improvement. The first relates to the oversight that is provided by auditors. The second area that is quite critical is the oversight provided by company boards. The third is enabling the market for corporate control. When a company is not doing well, having a takeover market enables the changing of hands. And the fear of losing control tends to make managements keep their practices in check. Therefore, developing a market for corporate control is extremely critical when we talk about governance.

How can the government address the issue of India's rising infrastructure deficit?

The government has announced INR100 trillion (US$1.4 trillion) of infrastructure spending in the next five years, primarily to address the deficit that we are facing on infrastructure. We are taking steps to enhance the flow of debt funding into Indian markets by listing some of the bonds in the index funds and incentivising foreign portfolio investors to participate in the debt market.

India is a large economy with high growth rates, so the returns for investors are quite significant. And that is important to enable more capital, especially debt capital, to flow in. We need to create an environment in which debt and pension funds, insurance companies, sovereign wealth funds, etc. are encouraged to invest in and fund our projects.

Is inflation a concern for India?

No. From 2014 to 2019, the average rate of inflation was 4 percent. To a large extent, this is because food inflation has been under control. Looking at the overall trend, food inflation has been quite low, which is a good thing. Today, if I look at India's macro performance over the last five to six years, I think the one aspect that stands out most is low inflation. That's been a real success story.

How is India navigating around the US-China trade dispute? Can India benefit in any way?

Firstly, India has a very small share of global trade—less than 2 percent. If we were to increase our share say, from 2 to even 4 percent, we can benefit a lot. In fact, after the recent tax rate cut, I think there may be significant opportunities for us to get into sectors that are really critical. We can then identify the opportunities that this serious conflict between U.S. and China presents for India.

As I mentioned earlier, if you want to compete in the global market, you have to be more productive. Therefore, I would continue emphasising productivity improvements, especially changing the size distribution of firms and enabling growth in the number of mid-sized firms. In the global context, a large firm would be one that has tens of thousands of employees. A mid-sized firm, I would say, is anywhere between 100 and 2,000 employees, and we don't even have enough of those. These are the firms that create jobs and also really contribute to the export markets.

Looking ahead, are you optimistic about India's economic growth?

Yes. There are many opportunities for India to grow significantly. If we focus on just two or three of the key structural reforms, especially those for the factor markets, I think we can easily achieve an 8 percent growth rate.

In a world economy that is struggling to grow at 2.5 to 3 percent, opportunities for foreign investors in a large economy like India that is growing at about 7 percent are significant. So I certainly remain optimistic about the growth prospects.

I would say that, sometimes, a slowdown or some challenge serves as an eye-opener and gives us the opportunity to address some of those issues that need fixing. I look at this current slowdown as an opportunity to make the necessary changes that will propel us to grow at a very high rate in the future.

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