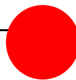

Date	November 10, 2018	Publication	Mint	Pg No.	23

A general election year with a liquidity twist and economic growth

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COMMENTARY

A consensus seems to be emerging that gross domestic product (GDP) growth in India will either accelerate in FY20 or at least record the same growth rate as in FY19. This column highlights the high probability of GDP growth in FY20 decelerating by 90-100 basis points because of the confluence of a unique set of factors.

THE INDIAN ECONOMY'S RELIANCE ON MARKET RATES HAS SHOT UP

The financial markets benefitted tremendously from the financialization of Indian households' savings. Even as the ratio of India's household savings to GDP plummeted to a 20-year low, markets had no reason to worry as the household financial savings to GDP ratio rose inorganically. This deluge of financial savings was hungry for returns and the Indian non-banking financial company (NBFC) sector made the most of this situation by indirectly borrowing short from the Indian saver and lending long.

The result was unsurprising. The Indian economy's reliance on credit, whose pricing was reliant on prevailing market interest rates which were low then, shot up. Consequently, NBFCs' share in total credit outstanding shot up from 13% in FY13 to 18% in FY18. As a result, the economy received a fillip as the weighted cost of debt capital fell.

If NBFCs have to deal with a 50-100bps increase in the cost of funds, then the cost of debt capital for the economy is likely to rise. Costlier short-term capital, when the economy's reliance on NBFC-extended debt has increased, is likely to result in lower credit growth being powered by this sector, thereby resulting in lower economic activity levels.

More importantly, NBFCs lend meaningfully to critical segments where banks lack reach or do not want to lend, such as financing of commercial vehicles, or sub-prime borrowers in the home and auto space. Even assuming banks clean their books by FY20 and are in a position to start regaining market share, these select pockets are still likely to suffer from inadequate access to credit.

Besides the higher cost of NBFC debt resulting in slower growth, GDP growth could be exposed to risks via another route. The real estate sector, with precarious fundamentals to start with, got a lease of life again because of the NBFC-led credit boom. In fact, NBFCs/HFCs' loans to developers registered a CAGR (compound annual growth rate) of -27% over FY13-FY18. These loans, too, were contracted when short term rates were low. But as NBFCs now pass on the higher cost of funds, developers may have to start pricing-down inventory which could affect the viability of smaller developers.

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Despite some critical pieces of structural reform, GDP growth is likely to slow down by 90-100 bps in FY20 because of issues such as current liquidity crisis at NBFCs and the upcoming elections.

GENERAL ELECTION DOES MATTER AND AFFECTS INDIA'S GDP GROWTH

There is another reason why GDP growth could be lower in FY20.

It is true that elections are common and over-hyped affairs. However, history suggests general elections in India have a fairly concrete impact on GDP growth. This is because every election in India since 1999 has seen central government revenue expenditure growth record a perceptible slowdown post elections. On an average, central revenue expenditure growth in the financial year following a general election is lower by -500bps when compared with the average growth rate recorded in the previous two years leading to a general election.

Post elections, it is likely that government support to gross domestic product growth will abate in fiscal 2020

This slowdown in central government revenue expenditure matters because the government consumption expenditure component of GDP accounts for 11% of total GDP and its correlation with central revenue expenditure growth amounts to 71%.

Moreover, it is well-known that pre-election freebies distributed by political parties, which include durables and non-durables, as well as hard cash, play a meaningful role in boosting consumption growth ahead of an election.

Thus, post elections, it is likely that government support to GDP growth will abate in FY20. This means that another tailwind that is supporting growth in FY19 will turn into a headwind by FY20.

POST-SCRIPT: WHAT CAN THE GOVERNMENT AND REGULATOR DO?

Despite some critical pieces of structural reform that the current dispensation has undertaken during its tenure, GDP growth is likely to slow down by 90-100bps in FY20 because of these reasons.

So what can the state do to mitigate the effects of tighter liquidity conditions and of the political economy cycle? While proactive regulation can help, it is imperative for the Reserve Bank of India (RBI) and the ministry of finance to put up a solid, united front. This becomes especially important given that the RBI's capability to infuse liquidity is constrained by its currency concerns. The state must work to foster the belief that it will move expeditiously and with near-perfect coordination among its various arms to stem any likely crisis of confidence.

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