NATIONAL SCHOOL OF BANKING

HIGHLIGHTS OF THE ECONOMIC SURVEY - 2018-2019

(A) ECONOMY -

1. HIGHLIGHTS

In the Economic Survey for 2017-18, which was tabled in Parliament on 29th January 2018, Chief Economic Advisor Arvind Subramanian struck an optimistic note about economic growth going forward. The Survey noted that there were "robust signs of growth" in the second half of the financial year, and **predicted that growth for the full 2017-18 financial year would be 6.75 per cent year on year,** higher than the Central Statistics Office's prediction of 6.5 per cent. The Survey further estimated that the **fading of shocks to economic activity like demonetisation together with a recovery in global demand and some domestic policy actions would raise growth in the coming financial year to 7-7.5 per cent.** If this is borne out, that would mean India would again be the fastest-growing large economy in the world. **In 2017-18, "fiscal deficits, the current account, and inflation were all higher than expected". Manufacturing was still struggling, with the ratio of factory exports to GDP declining, along with the manufacturing trade balance. And agriculture has not seen an increase in real value added for four years. Demonetisation, teething difficulties in the new goods and service tax (GST), high and rising real interest rates, an intensifying overhang from the twin balance sheet challenge, and sharp falls in certain food prices impacted agricultural incomes.** However, in the second half of the year, the impact of the GST and demonetisation has faded and the economy is seeing signs of revival. **The agenda for the next year remains staying the course, by stabilising the GST, completing the twin balance sheet actions, and staving off threats to macroeconomic stability.**

Overall, this Economic Survey contained fewer big-bang policy ideas than its predecessors, reflecting the **changed and more defensive economic environment.** In its workmanlike approach to the achievements of the government in the past year and the challenges for the economy going forward, the **question of reviving private investment stood out.** The Survey argued that the government had taken major steps towards resolving the **"twin balance sheet" problem, in which indebted companies combined with banks that had a large proportion of stressed assets, leading to reduced rate of investment. This problem, which the Survey described as the "festering, binding constraint" on growth, had been addressed in the past year by the movement on recognition of stressed assets, a recapitalisation package that amounted to 1.2 per cent of GDP, as well as the implementation of the asset resolution process mandated by the Insolvency and Bankruptcy Code (IBC). The** Survey indicated that movement on bank reform would aid in the recovery of the investment mechanism, a prerequisite for growth.

The Survey warned also of down-side risks to the economy, including the danger of a delayed recovery in private investment which could not be substituted by public spending given the worries about a growing general government fiscal deficit. Consumption growth might be hit by rising oil prices and elevated stock prices might engender a "sudden stall" in growth if they underwent a serious correction.

The Indian economy is likely to grow at 7-7.5 per cent in 2018-19, reinstating the country as the fastest-growing economy in the world, said the Economic Survey 2017-18. The range is in sync with what the International Monetary Fund (IMF) and the World Bank predicted at 7.4 per cent and 7.2 per cent, respectively.

It is likely to be hemmed by higher oil prices. The IMF has predicted average oil prices in 2018-19 to be about 12 per cent higher. Now, assuming that the government does not offset the price rise by reducing taxes, **higher oil prices will lower real incomes and thus, restrict household consumption. Further, higher oil prices, by spurring inflation, will necessitate a tighter monetary policy.** It suggested to the government to go in for a modest consolidation that signals a return to the path of gradual but steady fiscal deficit reductions.

How much savers prefer shares to other assets reflected in a massive portfolio re-allocation by savers towards equity in the wake of policy-induced reductions in the return on other assets. In other words, demonetisation and other measures may have reduced the incentive to hold gold and real estate and raised the relative value of stocks. Personal income tax collection would hit a new record of 2.3 per cent of GDP. **The Survey also claimed that, post the GST, indirect tax collections would stabilise 12 per cent higher than before.**

2. AGRICULTURE

The Survey, in addition to highlighting stagnant revenues in the farm sector, has pointed out that yields in Indian agriculture are highly sensitive to variations in rain and temperature. Thus the effects of climate change will have a serious impact on productivity in agriculture going forward; and consequently, also on farmers' incomes, a major political priority. The Survey estimated that climate change might reduce farm incomes by 20-25 per cent in the medium term.

Corporates have not raised commensurate amounts of capital, suggesting that their investment plans remain modest".

3. FISCAL DEFICIT

Economic Survey for 2017-18 said that ambitious targets of fiscal consolidation for the coming pre-election year be avoided. While the Centre has hinted at breaching the fiscal deficit target the Budget Estimates, states seem to be proceeding along the path of the targeted fiscal consolidation. This could be partly attributed to the Centre's guarantee to compensate states for revenue losses under the goods and services tax (GST). The Centre's fiscal deficit has already overshot the budgeted figure of Rs.500,000 crore by 12 per cent till November this year. This was far above the average of the last five years at 89 per cent of the Budget Estimates, said the Survey.

Disinvestment receipts would surpass the budgeted target of more than Rs.70000 crores for the current financial year to partially offset the trend of lower receipts under other heads.

4. EXPORTS

Using international trade figures at the state level for the first time, the government has found severe disparity among states in terms of exports as well as the scattered nature of exporting firms. The survey revealed that **five states - Maharashtra, Gujarat, Karnataka, Tamil Nadu, and Telangana - together account for 70 per cent of India's exports. On the other hand, 16 or half of all states and Union Territories account for only 3 per cent of all exports.The Survey also said the largest firms account for a much smaller share of exports than in other comparable countries. The top 1 per cent of Indian firms accounts only for 38 per cent of exports unlike in other countries where it accounts for a substantially greater share.** This is bad news for the sector, as having larger consolidated businesses create comparative advantage and improve long-term prospects, the Survey suggested.

India's internal trade in both goods and services, excluding non-GST items, is about 60 per cent of GDP. The Survey also hinted that further rationalisation of export incentives may be on the cards. On **services trade, the Survey painted a hopeful picture, whereby India held on to the eighth-largest exporter position in commercial services in 2016, with a share of 3.4 per cent, double that of merchandise exports at 1.7 per cent.** The expansion of services trade, despite rising protectionism by importing nations, is based on inherent strengths in the sector as well as extensive streamlining.

Export growth of the sector during the period April-September 2017-18 was robust at 16.2 per cent, up from 5.7 per cent in 2016-17. But imports also rose by 17.4 per cent. Net services receipts rose by 14.6 per cent during this period.

5. JOB GROWTH

The Survey also used data from GST filings and the Employees' Provident Fund Organisation to claim that formal employment in India was considerably higher than previously estimated. It said that formal employment increased by "more than 30 per cent when formality is defined in terms of social security (EPFO/ESIC) provision" and by "more than 50 per cent when [formality is] defined in terms of being in the GST net". These findings are considerably greater than current beliefs about the size of formal sector non-farm payroll," the Survey noted. The Survey argues that more than half of the non-agricultural workforce is already in the formal sector, a significant departure from conventional wisdom. Formal jobs in the economy were far more than what the official estimates available showed, the Economic Survey 2017-18 said.

The Survey findings come at a time when a recent study estimated seven million new jobs might have been added in 2017-18, throwing a public debate over computing employment generation. Employees getting social security benefits under the Employees' Provident Fund (EPF) scheme and Employees' State Insurance (ESI) scheme were taken into account for the social security benefit-based computation of the formal workforce.

The Survey estimated non-farm payroll at around 75 million, which constituted 31 per cent of the 240 million workers in the non-agricultural sector. This estimate included 15 million non-agricultural workers in the government sector, excluding the defence personnel. For computing the number of tax-based formal sector workers, the Survey used newly available data from firms under the goods and services tax (GST) regime.

"From a tax perspective formal employment is 11.2 crore (112 million); adding government employment yields a total count of 12.7 crore (127 million). This implies that nearly 54 per cent of the non-agricultural workforce is in the formal sector. Of course, not all the firms that pay GST are formal, in the common-use sense of the term," the Survey highlighted.

COMPUTING JOBS

Definition of formal sector : Either covered under social security scheme or GST net.

- **240 mn** total workforce in non-farm sector.
- **75 mn** in non-farm jobs, according to the social security coverage.
- **127 mn** in non-farm jobs, according to the tax net.
- **13%** private firms in non-agriculture sector.

6. INDIRECT TAXATION

The indirect tax base grew 50 per cent since the GST roll-out, led by a large increase in registrations, especially by small enterprises. The demonetisation of high-value currency notes in November 2016 resulted in widening of taxpayers' base, the Survey said. As of December 2017, there were 9.8 million unique GST registrants, slightly more than indirect tax registrants under the earlier system. Although not comparable, GST has increased the number of unique indirect taxpayers by more than 50 per cent, a substantial 3.4 million.

Maharashtra, Uttar Pradesh, Tamil Nadu and Gujarat have the largest number of GST registrants. Annual GST collection for 201718, based on the five-month average till November, was Rs.10.5 trillion, which is 8.2 per cent higher than indirect tax collections last year of Centre and states combined, said the Survey.

The Survey highlighted that there was a potential of 12 per cent growth in GST revenue in the current fiscal year to Rs.10.9 trillion if a couple of additional factors were taken into account. One of these was equalising state GST with central GST.

After two months of slide, GST collections picked up slightly in December to Rs.867 billion. Amid slowing revenue, the GST Council had in its previous meeting decided to provisionally divide Rs.350 billion collected as Integrated GST between the Centre and States. The informal sector was the most affected by GST implementation.

GST also affected supply chain functions, especially where small traders were suppliers to intermediaries for larger manufacturing companies, as they found it difficult to comply with the increased paperwork.

To address concerns, the Council has reduced the rates on more than 300 items since the rollout in July. With Finance Minister Arun Jaitley hinting at converging the 12 per cent and 18 per cent tax slabs in the future, the Survey said 15-16 per cent was the single rate that would preserve revenue neutrality, based on average collections in the first few months. The implied weighted average collection rate (incidence) was about 15.6 per cent, it said.

7. INFRASTRUCTURE

A change in market sentiment, bolstered by rapid infrastructure development, would bring more foreign direct investment (FDI) in the real estate sector and create jobs in the hinterlands, the Economic Survey 2017-18 said.

The sector has been in the doldrums for some time now, registering a five-year low in sales. The Survey said the government's initiatives would boost the infrastructure sector. **India would need about $4.5 trillion in the next 25 years for infrastructure development, of which it would be able to garner about $3.9 trillion, the Survey said.**

While the residential market witnessed sales of only 58,000 units in the first half of 2017, new residential sales fell to a five-year low of 101,850 units during this period in the top 14 cities.

Admitting enforcement of the Real Estate Regulatory Act (RERA) and the goods and services tax (GST) - both of which were brought in last year - have had an effect on the residential market, the Survey said the hit would be only for a short period.

This positive sentiment was attributed to a host of factors, including regulatory environment, enhanced infrastructure, and amendments to Real Estate Investment Trusts, the Survey said.

"We need single-window clearances. A company has to take as many as 30 different approvals to get clearance for construction, which takes around three-four years at times,".

Impressed by the work done by the roads and transport ministry, the Survey said highway connectivity to hinterlands would lead to creation of jobs. It pointed to the need for last-mile connectivity by building district roads to provide better access and improving economic activities. "There is a need for developing Other Public Work Department roads, including district roads, so as to provide better access, thereby enhancing economic activities," it said.

As of September 2017, the length of national highways was 115,530 km, which accounted for 2.1 per cent of total road length. On the other hand, the length of state highways was 176,166 km as on 2015-16.

According to the Survey, the $160-billion logistics industry provides employment to more than 22 million people. E-commerce, which is a burgeoning sector in India, relies heavily on the logistics sector, making it a key sector for growth and jobs creation.

Last-mile connectivity would not just provide overall benefit to infrastructure projects but improve the logistics sector. At present, there is no cold chain network in the country for perishable goods. The logistics sector was granted infrastructure sector status in November 2017.

8. STOCK MARKETS

The Economic Survey 2018 sounded a note of caution on the high equity valuations and hasn't ruled out a possibility of a correction. After a sharp 23 per cent rally this financial year, the benchmark Sensex was, at the time of the Survey, trading at 27 times its trailing 12-month earnings. The broader-market BSE Midcap and Smallcap indices, which had outperformed the benchmark in FY18, were trading at even higher valuations of 47 and 105 times, respectively.

"Sustaining these valuations will require future growth in the economy and earnings in line with current expectations, and require the portfolio re-allocation to be semi-permanent. Otherwise, the possibility of a correction in them cannot be ruled out," the Survey said.

Domestic equities had risen sharply on expectations of strong corporate earnings. However, the earnings growth has been elusive so far, only to belie analysts' expectations.

"Expectations of earnings growth are much higher in India. Indeed, it was such expectations that lie at the origin of the stock market boom. In early 2016-17, signs emerged that the long slide in the corporate profits-to-GDP ratio might finally be coming to an end. Investors reacted to this news with alacrity, bidding up share prices in anticipation of a recovery they hoped lay just ahead. Accordingly, the ratio of prices-to-current earnings rose sharply," said the report.

The lacklustre earnings trajectory has been largely on account of policy disruptions such as implementation of the goods and services tax (GST) and demonetisation. The Street is expecting a turnaround in earnings. There is exuberance in broader market valuations, largely on account of earnings revival expectations. Therefore, if earnings disappoint or if there is a drop in incremental flows, we could see a sharp correction. According to the Survey, low interest rates, globally have resulted in a fall in the equity risk premium (ERP). Low ERPs have led to a shift in portfolio allocations from debt to equity.

"In sum, the Indian stock market surge is different from that in advanced economies in three ways: growth momentum, level and share of profits and, critically, the level of real interest rates.

In the domestic context, the portfolio re-allocation has taken place due to a fall in returns of traditional assets, such as gold and real estate. Also, demonetisation led to a spike in the financial savings, large part of it got channelised into the equity markets.

(B) BANKING -

1. NPAs

Weighed down by a pool of bad loans, performance of the banking sector, especially of public sector banks, has remained subdued in the current financial year, according to the Economic Survey. But, the situation is likely to improve with banks diligently following on recoveries and stressed asset resolution. Early signs of a pick-up in credit demand, especially from industry, also give room to expect a change in the state of affairs. The situation for state-owned banks remained precarious. Their GNPA increased from 12.5 per cent to 13.5 per cent between March and September 2017. The Stressed advances ratio of PSBs rose from 15.6 per cent to 16.2 per cent. Referring to finance companies, the survey said the gross NPA ratio (per cent to advances) of the NBFC (non-banking financial company) sector declined to 5.5 per cent as of September-end 2017 from 6.1 per cent as of March 31, 2017. The net NPA (per cent to net advances) also decreased to 3.4 per cent from 4.1 per cent. Non-food credit (NFC) grew at 8.85 per cent year-on-year in November 2017 compared to 4.75 per cent in November 2016. **Bank credit lending to services and personal loans segments continues to be a major contributor to overall NFC growth.** Credit growth finally picked up in the industrial sector after remaining persistently negative from October 2016 to October 2017. However, growth of credit to medium scale industries has remained negative since June 2015, the survey added.

2. TWIN BALANCE SHEET PROBLEM

Addressing the twin balance-sheet (TBS) challenge through effective resolution of stressed assets and bank recapitalisation should remain on the top agenda of the government next year, said the Economic Survey. The TBS refers to stress in the balance sheets of companies and the resultant stress on the balance sheets of banks that had lent to these companies. The government and the Reserve Bank of India (RBI) have stepped up efforts to address the issue by recapitalising banks and forcing defaulting companies to undergo liquidation. "The TBS actions, noteworthy for cracking the long-standing 'exit' problem, need complementary reforms to shrink unviable banks and allow greater private sector participation," the report said.

Exit from stressed accounts has proven particularly intractable because the objectives are many, conflicting, and politically difficult, and policymakers have had to find a way to reduce the debts of stressed firms to sustainable levels, the survey said. It stressed the need for minimising the bill to taxpayers, limiting moral hazard, and avoiding perception of favouring promoters. The TBS challenge is arguably the festering, binding constraint on Indian growth prospects**.** The 4 Rs of the TBS - recognition, resolution, recapitalisation, and reforms are most critical. The bankruptcy code has provided a resolution framework that will help corporates clean up their balance sheets and reduce debts. **As these twin reforms - IBC and recapitalisation of banks - take hold, firms should finally be able to resume spending and banks to lend, especially to the critical, but currently stressed sectors of infrastructure and manufacturing," the report said.**

3. INSOLVENCY AND BANKRUPTCY CODE

While the IBC provides a strong resolution framework for companies to clean up their balance sheets and settle debts, the recapitalisation plan, which, according to the Economic Survey, is estimated to cost 1.2 per cent of the country's gross domestic product (GDP), will uplift the capital base of major public sector banks (PSBs). The recapitalisation package was announced in October 2017 with the aim of strengthening PSBs' health and, therefore, improving conditions in credit markets. Credit growth to the industrial sector, for example, only turned around recently after remaining "persistently" negative during October 2016 and October 2017, while credit growth to medium-scale industries has remained negative since June 2015, the Economic Survey says. **The IBC legislation was passed in May 2016, and around 525 petitions have been admitted by the National Company Law Tribunal (NCLT) bench across the country so far. As of January 6, 2018, there were 451 cases in progress under the Corporate Insolvency Resolution Process (CIRP), totalling Rs 1,28,000 crore. So far, 10 resolution plans have been approved, 36 cases have been closed subject to appeal and/or review, and liquidation orders have been passed in 30 cases. The effectiveness of the new code has been the judiciary's adjudication in these matters, the survey's authors say, wherein the strict time limits set by the code have been adhered to, by all NCLT benches across the country, despite huge inflow of cases. These benches have admitted or rejected applications under the CIRP effectively, with minimal delays, the Survey notes. It goes on to say, in addition, appellate courts, including the NCLAT (National Company Law Appellate Tribunal), high courts and the Supreme Court have also disposed of appeals quickly and decisively. In this process, a rich case-law has evolved, reducing future legal uncertainty.**

(C) SHORT NOTES ON ECONOMIC POLICY ISSUES -

EASE OF DOING BUSINESS

- **The next frontier on the ease of doing business is addressing pendency, delays and backlogs in the appellate and judicial arenas.** These are hampering dispute resolution and contract enforcement, discouraging investment, stalling projects, and hampering tax collections, but also stressing taxpayers, and escalating legal costs.
- **Coordinated action between government and the judiciary** - a kind of horizontal cooperative separation of powers to complement vertical cooperative federalism between the central and state governments - would address the "law's delay" and boost economic activity.
- **Downsizing or removing original and commercial jurisdiction of high courts, and enabling the lower judiciary to deal with such cases will be enablers for speedy justice.**

ON GENDER

- The challenge of gender is longstanding, probably going back millennia, so all stakeholders are collectively responsible for its resolution.
- India must confront the societal preference, even meta-preference for a son, which appears inoculated to development.
- **Many of the gender outcomes are manifestations of a deeper societal preference, even meta-preference for boys, leading to many "missing" women and "unwanted" girls.**

POLICY AGENDA

- The agenda for the next year consequently remains full: Stabilising the GST, completing the TBS actions, privatising Air India, and staving off threats to macroeconomic stability.
- Over the medium-term, three areas of policy focus stand out :

  a. Employment: Finding good jobs for the young and burgeoning workforce, especially for women.
  b. Education: Creating an educated and healthy labour force.
  c. Agriculture: Raising farm productivity, while strengthening agricultural resilience.