

Economic Slowdown and Financial Fragility

The Structural Malaise of India's Growth Process

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The Indian economy is presently gripped by the dual phenomenon of an unprecedented slowdown as well as financial fragility. What has triggered this? Is this simply a random exogenous shock to an otherwise well-functioning economy? Or, is there anything structural about the present slowdown? What are the binding constraints for recovery? These questions are addressed in the context of India's overall growth trajectory and policy regime in the last two decades.

This is certainly not the first time that the Indian economy has witnessed economic slowdown in the recent past. Ever since the implementation of economic liberalisation, the economy has gone through several slowdowns, followed by many recoveries. And, yet, this time it is different. There are at least two distinguishing features of the present episode of slowdown which suggests so.

The first feature refers to the longevity of the present slowdown. Both in terms of annual and quarterly gross domestic product (GDP) growth rates, the present slowdown has been more prolonged than any other previous episodes of slowdown during the liberalisation period. As evident from Table 1, which describes this phenomenon, the longevity of the present slowdown has already surpassed not only that of the 1990s or early 2000s, but even that of the immediate post-crisis period of 2008–09 and the one witnessed during 2011–12 and 2012–13.¹ While the previous episode of slowdown between 2011–12 and 2012–13 comes close to the present one in terms of its longevity, the latter is qualitatively distinct for its second feature.

The second feature involves worsening of the balance sheet of the non-financial private corporate sector, the intensity of which is presently much greater than the previous episode of slowdown. If the financially stressed firms are defined as those whose profit income (profit before depreciation, interest, tax and amortisation) is less than the interest payments (interest coverage ratio is less than 1), then the share of such stressed firms in the corporate sector firms has increased sharply in the recent period (Figure 1, p ??).

In short, the present episode of slowdown is not only unprecedented in the recent period in terms of its longevity, but in contrast to the previous episodes of slowdown, it has set in when the economy was already gripped by financial fragility. It is this prolonged period of slowdown, along with high financial fragility that remains to be the defining feature of the present

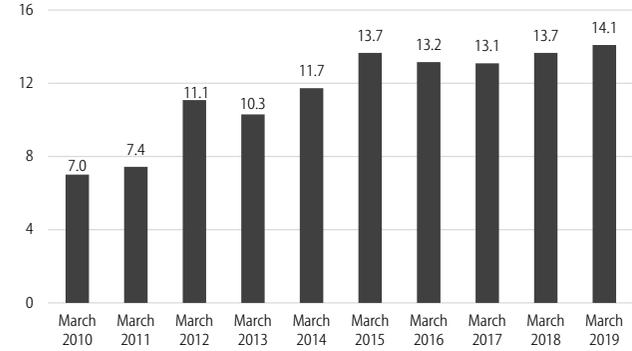
Table 1: Episodes of Slowdown, 1994–95 to 2019–20

Episodes of Slowdown	Number of years Of Slowdown	Total Number of Quarters of Slowdown	Number of Quarters When Growth Slowed Down for Consecutive Periods
1997–98	1	3	2
2000–01	1	2	1
2002–03	1	2	0
2008–09	1	4	4
2011–12 to 2012–13	2	6	5
2017–18 to 2019–20*	3	7	6

Slowdown in period "t" is defined as a phenomenon where GDP growth rate at period "t" is less than that of period "t-1." *Figures till second quarter of 2019-20
Source: Calculated from Linked GDP Series, National Statistical Commission; GDP Quarterly Estimates, CSO.

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Figure 1: Share of Stressed (ICR<1) Firms in Private Non-financial Corporate Sector (%)

Source: Calculated from CMIE Prowess Database.

slowdown. What triggered them? Is this simply a random exogenous shock to an otherwise well-functioning economy? Or is there anything structural about the present slowdown? What are the binding constraints for recovery? This article aims to address these questions in the context of India's overall growth trajectory and policy regime since the 2000s.

External Dependence and Financial Fragility

The defining feature of any capitalist economy is the analytical separation of *ex ante* investment decisions from the savings decisions, as investment decisions are formed on the basis of expectations around future profit in the midst of “fundamental uncertainty” (Keynes 2006; Dow 2015). While investment decisions and profit expectations are formed on the basis of expected demand conditions, the latter, in turn, can be argued to be affected by, *inter alia*, the present demand conditions and, hence, the autonomous components of aggregate demand. The steady state growth rate and profit rate of a typical capitalist economy accordingly is determined by expectations and autonomous components of demand (Dutt 1990; Hein 2014). These stylised facts open up the possibility of at least two forms of instability in the growth process of a capitalist economy as follows.

First, in the midst of inherited payment commitments, there exists no *a priori* reason in a capitalist economy why the exogenous components of demand would be necessarily such so that the solvency condition of firms is met. If the solvency condition of a firm is defined by profits being greater than or equal to its interest payments (interest coverage ratio greater than or equal to 1), then for a given level of interest rate and accumulated stock of debt, the solvency condition will only be satisfied if profits do not fall below the given level of interest payments. But, at any given profit share, profits would be determined by the level of output, which, in turn, are determined by the exogenous components of demand. In case the autonomous components of demand are weak, such that profits fall below interest payments, then firms become insolvent. Such insolvency can itself be associated with a fall in private investments and aggregate output and can further trigger a sequence of negative shocks across the economy.

Second, even if the economy starts off from a profit rate which satisfies the solvency condition, adverse shocks in expectations or autonomous components of demand may bring about an

exogenous fall in the investments and profits rate. And, even if profits settle to a level that initially satisfies the solvency condition, the economy can eventually start acting as a “ball lying on a grassy slope” (Harrod 1973: 32), where expectations of further decline in sales lead to a cumulative decline in investment, profit rate, expectations, and so on, till the solvency condition is breached.

In a nutshell, by its very nature, a spontaneous capitalist economy is typically susceptible to volatility and dynamic instability, and its growth rate, investments, and profits are affected by factors that are exogenous to its output. Thus, within the institutional framework of capitalism, the relevant question boils down to: How to stabilise such an unstable economy? Despite its limitation within the existing institutional framework prevalent in a dual economy like India, one policy instrument that often played such a stabilising and stimulating role in the growth process during the *dirigiste* period was government expenditures.

The introduction of new economic policies (NEP) in the Indian economy during the early 1990s, however, marked a sea change in the policy regime from what it was in the pre-liberalisation period. In sharp contrast to the *dirigiste* period of the decade of the 1980s or earlier, and except in a few odd instances, the period of economic liberalisation has been typically characterised by the reduced role of the public sector and government expenditures in providing stimulus to India's growth process. By making fiscal deficit the function of output, the implementation of the Fiscal Responsibility and Budget Management Act in the early 2000s endogenised an otherwise autonomous component of demand that was earlier used as a policy instrument.

The institutional constraint in using government expenditures as an effective policy instrument, as we shall argue, had at least two implications. First, the economy acquired external dependence to keep up the growth rate; the trend in profits and investments became largely dependent on exogenous external market conditions. Second, the very objective of stabilising profits and investments in an otherwise unstable system eventually opened up the ground for a new policy regime in which financial fragility was an intrinsic component.

External Dependence since the 2000s

Despite the withdrawal of fiscal stimulus in the early 2000s, the Indian economy did not witness any major challenge in keeping up its profits during the entire decade as it witnessed a high output growth rate (Azad et al 2017). The booms of the 2000s, however, were triggered primarily by factors that were exogenous to India's domestic policymaking (Dasgupta 2020). The global economy was characterised by two booms during this period: one before the emergence of the global financial crisis, and the other during the brief recovery period in the immediate aftermath of the global financial crisis (2009–10 and 2010–11) due to implementation of synchronised fiscal stimulus packages all across the world. In the midst of such a global upswing, India's export growth rate registered a sharp increase and, consequently, brought about a sequence of expansion of aggregate demand through at least three routes.

First, it provided stimulus to private investments as catering to a larger external market itself required incurring additional

investment expenditures at a given capacity utilisation rate. Such a phenomenon was reflected by the fact that while investments were driven by the registered manufacturing sector, as noted in Dasgupta (2020), such investments showed a positive and statistically significant relationship with the lagged value of exports, after controlling for the changes in the capacity utilisation rate. Second, the consequent rise in aggregate demand involved further rise in housing demand and demand for construction-related materials, which, in turn, provided further stimulus to private investments in a manner described by Ghosh and Chandrasekhar (2009) and Nagaraj (2013). Third, implementation of synchronised fiscal stimulus packages all across the world in the immediate aftermath of the global economic crisis not only boosted global demand and India's exports, but also created room to increase India's own fiscal deficit during this brief period (Sen and Dasgupta 2014). With IMF providing the directive to cut back deficits and the synchronised fiscal stimulus packages being withdrawn across the world, India withdrew its own fiscal stimulus and initiated a process of deficit reduction which more or less continues uninterrupted till date.

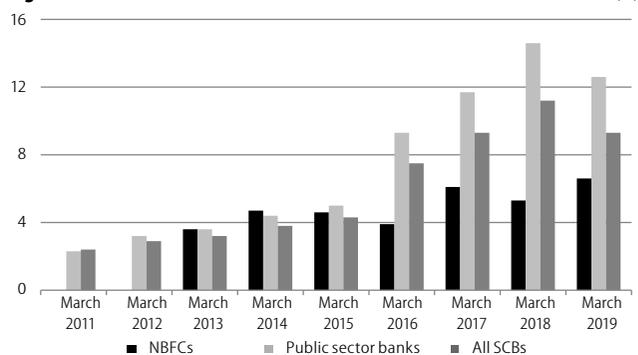
India's growth process during this period has been characterised by external dependence, such that the domestic economy primarily remained dependent on favourable, but exogenous external economic conditions for maintaining a high growth rate in domestic investment and output. Thus, as the global boom came to an end after 2010–11 following the withdrawal of synchronised fiscal stimulus packages across the world, the Indian economy started showing signs of slowdown (as we shall see later). This slowdown marked the beginning of the new policy regime during the 2010s.

Financial Fragility during the 2010s

The slowdown at the beginning of the last decade unleashed a process that involved a greater number of corporate firms becoming insolvent as their profits declined below their interest payment commitments, a phenomenon that was reflected by the rise in the share of $ICR < 1$ firms (Figure 1, p ??). In the absence of any significant presence of the public sector in the real economy that could otherwise compensate for such adverse shocks, such insolvency of the non-financial corporate sector opened up the possibility of further reduction in output and investments for the economy as a whole. But, any government that aims at keeping such firms afloat despite their insolvency, either to maintain private investments and output at the given level or otherwise, would confront three distinct policy choices in such a situation: (i) reduce the gap between interest payment payments and profits, (ii) allow firms to operate despite loan default, or (iii) facilitate ponzi-financing where borrowings are increased in order to pay off the gap between interest payments and profits.

In the wake of a self-imposed institutional constraint of reducing deficit target, increasing demand and private profit through fiscal expansion remained outside the scope of the government policy. With the monetary transmission mechanism being broken (Anand and Azad 2019; Subramanian and Felman 2019) and monetary policy being exclusively aimed at inflation targeting (Sen and Dasgupta 2014), reducing the effective interest rate

Figure 2: Share of NPAs in Gross Advance



Source: Statistical Tables Relating to Banks in India, RBI; Financial Stability Report, RBI, various years.

of the corporate sector through repo rate operations also became untenable. Despite the prevalence of significant amount of corporate tax concessions, which possibly would have relaxed the solvency condition compared to its earlier level, the adverse impact of output slowdown dominated, as reflected by the rise in the share of stressed firms during this period.

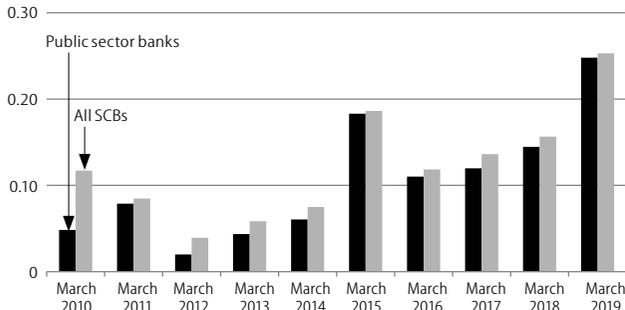
This prevalence of institutional and structural constraint to boost demand, along with the need to keep insolvent corporate firms afloat, played a central role in pushing the Indian economy at the beginning of this decade to a qualitatively new policy regime that was primarily associated with three distinct mechanisms: (i) allowing loan default, (ii) reducing corporate debt stock through debt-write-offs by public sector banks, and (iii) facilitating Ponzi financing. These mechanisms together implied, as pointed out by Rajan (2014), that the “bank’s debt becomes junior debt and the promoter’s equity becomes super equity. The promoter enjoys riskless capitalism.”² How does this new policy regime operate?

First mechanism: The first mechanism involves tolerating loan defaults of the non-financial corporate sector without penalising the defaulters to any significant extent. Since, by hypothesis, the default of loan payments or non performing assets (NPAs) indicates that firms are not making interest payments at the given level of debt, by implication, it is a de facto reduction in the effective interest rate of firms. The mirror image of such loan defaults of the non-financial sector is the burgeoning NPAs of the financial sector along with the reduction in their net profits.

Such deterioration of the balance sheet of the financial sector is reflected in Figure 2 by a sharp rise in the share of NPAs in gross advances of scheduled commercial banks and non-banking financial companies (NBFCs) during 2011–19. While the public sector banks registered such a rise right from 2011, what was noteworthy in the recent period from 2016 onwards was the sharp rise in NPAs of the NBFCs. By March 2019, while the NPA ratio of the public sector banks and all scheduled commercial banks (SCBs) stood at 9.3% and 12.6%, respectively, that of the NBFCs stood at 6.6%.

Second mechanism: The second mechanism involving debt write-offs opens up the possibility of reducing interest payment commitments of the non-financial sector at any given effective interest rate.³ While the banks’ NPAs increased significantly during the last decade, the debt write-offs of NPAs increased at a far greater

Figure 3: Ratio between NPA Write-Offs and Gross NPAs, 2010–19



Source: Statistical Tables Relating to Banks in India, RBI.

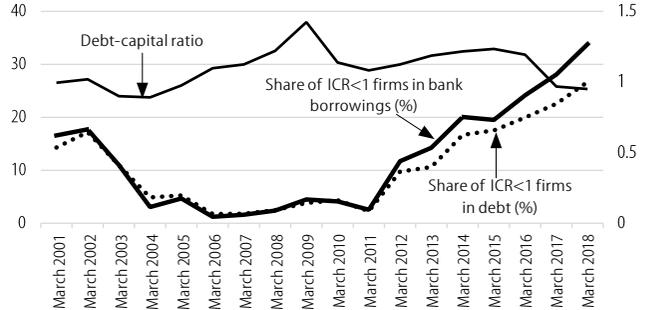
pace during this period. Figure 3 shows the ratios between NPA write-offs and gross NPAs for both public sector banks and all SCBs, both of which increased phenomenally in the last decade.

Third mechanism: In the midst of higher credit demand of the non-financial corporate sector to maintain its own viability, the credit supply was allowed to increase through an increase in the risk-appetite (reduction in the risk premium) of the financial sector. If the credit supply of the financial sector is perceived to be a negative function of its risk premium, whereas the risk premium is affected, inter alia, by the intensity of the financial stress of the borrower, then the new policy framework facilitated a de facto reduction in risk premium, where the financial sector was willing to provide additional credit to the financially stressed firms (Azad et al 2017).

The above phenomenon is reflected in Figure 4, which shows the share of financially stressed firms in outstanding corporate debt and bank credit, where the financially stressed firms are defined as those firms whose interest coverage ratio is less than 1. As evident from Figure 4, while the share of stressed firms in outstanding debt and credit either declined or remained stable during the 2000s, it marked a sharp rise in the last decade since 2010–11. Such a phenomenon of increase in debt of stressed firms was associated with a rise in the overall debt–capital ratio of the corporate sector during the first half of the last decade (Figure 4). In sharp contrast to the 2000s, when higher debt ratio was driven by non-stressed firms, as indicated by the declining share of stressed firms in debt during this period, the rise in the debt–capital ratio during the first half of the 2010s was driven by the higher debt of stressed firms. This was also the period when the share of stressed firms increased in annual credit flow (Azad et al 2017). While the debt–capital ratio declined during the present episode of slowdown, such a decline was hardly driven by the stressed firms as their share in debt and bank borrowings continued to rise.

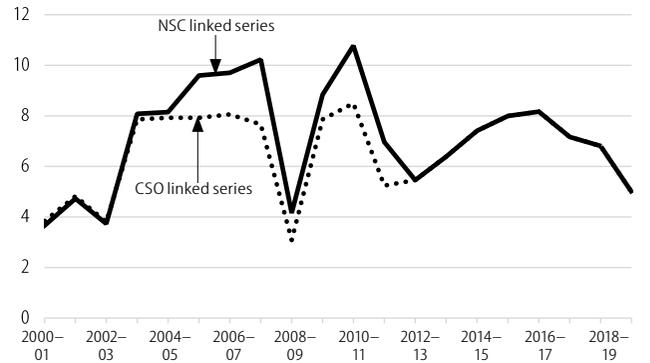
Such an experience of prolonged rise in the share of stressed firms in debt (encompassing almost a decade), along with the consistent rise in the share of stressed firms in total firms, cannot be explained simply as a cyclical phenomenon. Rather, the phenomenon of financial fragility can be attributed to a policy regime which tolerates greater balance sheet stress and loan default of the non-financial sector by transferring the risk from the debtors to the creditors. In the absence of any effective policy instrument which can boost demand, credit supply becomes a

Figure 4: Debt–Capital Ratio and Share of ICR<1 Firms in Outstanding Debt and Bank Credit



Debt–capital ratio of a given period is calculated as a ratio between stock of debt and net fixed assets of the previous period. It is measured in the secondary axis. Sample comprises of 1,198 firms. Source: Prowess Database, CMIE

Figure 5: Annual GDP Growth Rate



Source: Linked GDP series, NSC and National Accounts Statistics, CSO.

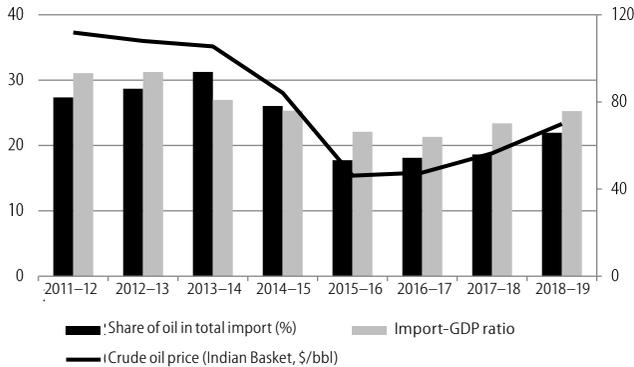
policy lever to keep firms afloat despite being insolvent or retain private investments by increasing leverage ratios.⁴ Instead of any anomaly, here, financial fragility becomes a logical necessity.

There were two implications of this financial fragility. First, despite debt write-offs, interest payments of the corporate sector increased on account of higher accumulated debt by the first half of this decade as compared to the 2000s. Since the solvency condition would be reflected by the difference between profits and interest payments, by implication, the minimum level of profit that would be required to maintain this solvency condition also increased. Second, the financial sector registered a decline in profits and far greater stress on their balance sheet during this period as compared to the 2000s. It is against the backdrop of this inherited financial fragility, along with the structural and institutional constraints in implementing demand boosting policies, that the emergence of the present slowdown is analysed in the next section.

The Immediate Causes of Slowdown

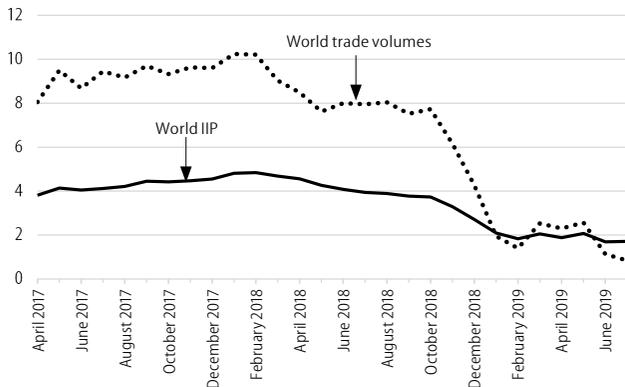
The slowdown of 2011–12 and 2012–13, as evident from Figure 5, was interrupted by a brief recovery period between 2013–14 and 2016–17. Such a recovery, similar to the growth trajectory of the 2000s, was triggered by favourable external market conditions that were exogenous to India’s policymaking as international crude oil prices registered a sharp decline during this period. However, the period of brief recovery was soon followed by the present episode of slowdown since 2017–18. What explains the present episode of slowdown? There are at least three immediate factors that can be attributed to this phenomenon.

Figure 6: Crude Oil Price (Indian basket, \$/bbl), Import–GDP Ratio (%) and Share of Oil in Import (%)



Crude oil price is measured in the right axis.
 Source: National Account Statistics, CSO; Database of Indian Economy, RBI and Petroleum, Planning and Analysis Cell, Ministry of Petroleum and Natural Gas, Gol.

Figure 8: Monthly Growth Rate of World Trade Volume and World Index of Industrial Production (IIP)

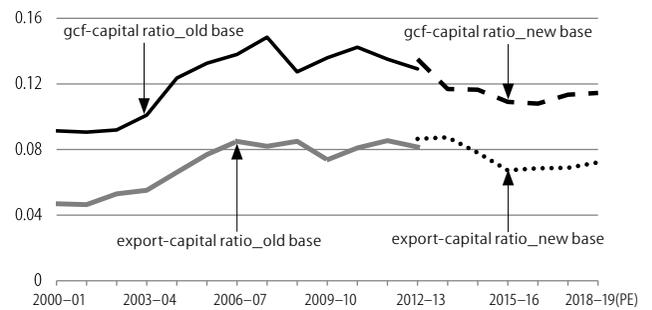


Source: World Economic Outlook, October 2019.

First, after an initial decline between 2013–14 and 2016–17, which otherwise played a key role in triggering the brief recovery, the import–GDP ratio started rising once again from 2017–18 onwards (Figure 6). Such a rise in the import–GDP ratio was driven by a sharp rise in oil imports and higher international crude oil prices, as reflected in Figure 6 by a similar rise in the share of oil in total imports during this period. While the brief decline in crude oil prices and the import–GDP ratio between 2013–14 and 2016–17 acted as a countervailing force in reviving India’s output growth rate despite weak global demand, the recovery of crude oil prices in the recent period has reversed this trend. The rise in import ratio, along with weak global demand, pushed the Indian economy into the present phase of slowdown in 2017–18.

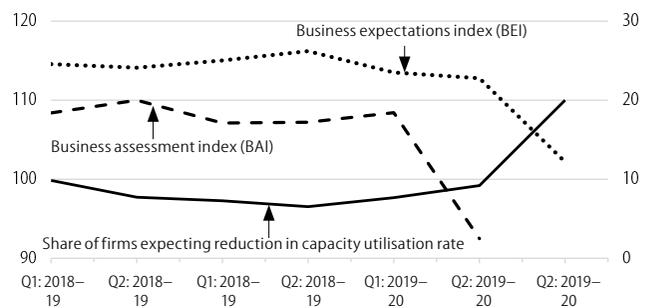
Second, while a buoyant export market during the 2000s had provided stimulus to private investments, the subsequent global slowdown was associated with a lower investment–capital ratio as it adversely affected aggregate demand and expectations of future profitability.⁵ The close relationship between the investment–capital ratio and export–capital ratio is depicted in Figure 7. The levels of both the investment–capital ratio and export–capital ratio remained far lower in 2018–19 as compared to 2011–12. Despite the rise in oil prices, the export market remained subdued. In fact, India’s export growth rate has registered a further decline since March 2019 when it

Figure 7: Investment–Capital Ratio and Export–Capital Ratio, 2000–01 to 2018–19



Source: National Accounts Statistics, CSO, various years.

Figure 9: Business Expectations and Assessments of Manufacturing Sector



Source: Quarterly Industrial Outlook Survey, RBI.

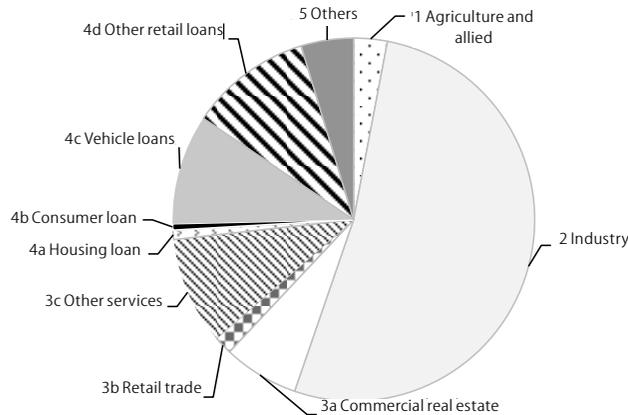
registered a growth rate of 12.2%, as the nominal monthly merchandise export growth rate turned to be negative since June 2019 (–7.8%) and stood at –1.1% in October 2019.

Despite the rise in oil prices, the export market remained subdued for the entire decade. Further, the world output growth rate declined since 2017 for three consecutive years and has been associated with increasing instances of protectionist and retaliation measures by the United States (US) and its trading partners (IMF 2019). These recent developments have been reflected by the sharp decline in the growth rate of the volume of world trade and industrial production, particularly from January 2018 onwards (Figure 8). Reflecting the trend of global demand, India’s export growth rate registered a sharp decline.

Such a fall in demand would adversely affect expectations regarding future sales and profitability and, hence, would push the producers to cut back investments leading to further reduction in demand and so on. The fact that the Indian economy went through such a process in the last one year is evident from Figure 9, which shows the trend in business assessment and expectations of selected manufacturing companies from RBI’s Industrial Outlook Survey.

The survey assesses the business sentiment for the current quarter and expectations for the ensuing quarter, based on qualitative responses on a set of indicators reflecting the perceptions of responding companies on various functional aspects. Figure 9 depicts the trend in three indicators: Business Assessment Index (BAI), Business Expectation Index (BEI), and the share of firms which expect a reduction in capacity utilisation rate for the relevant period. The fall in BEI since 2018–19 Q4 and that of BAI since 2019–20 Q1 indicates a deterioration of business expectations and assessment. Such a deterioration of

Figure 10: Sectoral Composition of NBFC Loans and Advances in September 2018



The aggregate figures for deposit taking (NBFC-D) and systematically important non-deposit taking (NBFC-ND-SI) companies are provided. The housing loan, consumer loan, vehicle loan and “other retail loans” together constitute the aggregate retail loans. Source: Calculated from Report on Trend and Progress of Banking in India, RBI.

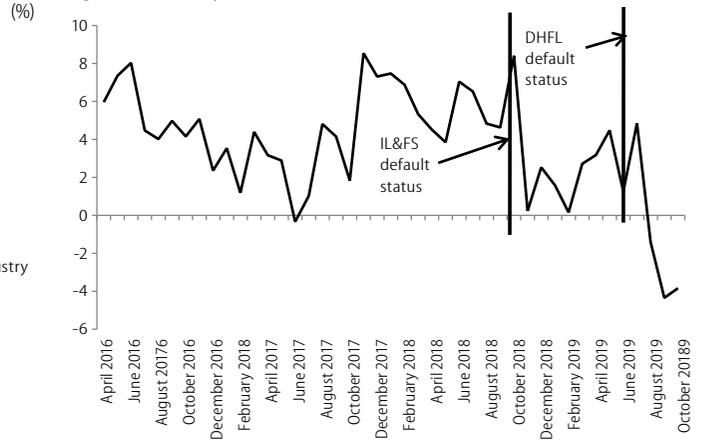
business expectations and assessment was associated with a sharp increase in number of firms that expected a fall in their capacity utilisation rate for the ensuing quarter.

The third factor pertained to the interaction between demand slowdown and financial fragility of the economy, which the latter inherited since the turn of the present decade. What was specific about the present phase of slowdown was the high debt-repayment commitment that the corporate sector inherited through its accumulated debt stock since 2011–12. At the high level of interest payments that firms inherited, decline in profit rate in the latter half of the last decade due to lower demand brought about a sharp rise in the share of stressed firms in the corporate sector as profits fell below their interest payments (Figure 1).

The consequent repayment crisis of the non-financial corporate sector adversely affected the interest income and profitability of the creditors, constituting the banks and the NBFCs. Though loan defaults and debt write-offs have otherwise been a central feature for the public sector banks in the past, what was specific during this episode of loan default was the exposure of the NBFCs to the corporate sector. By March 2018, the NBFCs had emerged as one of the important sources of credit supply for the corporate sector, with loan disbursement of more than 11.5% of the GDP.⁶ In sharp contrast to the commercial banks where deposits constitute the bulk of the liabilities, most of the NBFCs are non-deposit-taking and the largest components of their liabilities are the debt instruments. In other words, they lent long and borrowed short. The dwindling profitability of the NBFC sector with respect to their high level of debt repayment commitments pushed many NBFCs to default. The first big firm to have been labelled with the “default” status by credit rating agencies was the IL&FS in September 2018, followed by Reliance Home Finance and Reliance Commercial Finance in April 2019, DHFL in June 2019, and Altico Capital in September 2019.

The collapse of the IL&FS initiated a severe contagion effect as lenders increasingly reduced their exposure to the NBFC sector in the midst of greater uncertainty and financial fragility. As is evident from Table 2, the growth rate of total liabilities

Figure 11: Monthly Growth Rate of Index of Industrial Production (%)



Source: Database of Indian Economy, RBI.

for the NBFCs sharply declined between March 2018 and September 2019. As is evident from the decline in their shares in total liabilities during this period, the decline in the liabilities growth rate was primarily driven by a sharp fall in debentures and commercial papers (Table 2, Item 3a). The squeeze in the NBFCs’ balance sheet from the liability side led to a sharp fall in the asset side through a reduction in the growth rate of disbursed loans and advances. By September 2019, the growth rate of loans and advances by NBFCs reduced to 9.9% as compared to 31.8% in March 2018.

The sharp fall in loans and advances of the NBFCs had an immediate impact on the output of those sectors that were primarily dependent on NBFC credit. Figure 10 shows the sectoral composition of NBFC credit disbursement by September 2018. The industrial sector with 52% credit share was the largest recipient of NBFC credit, followed by retail loans (22.1%) and commercial real estate (6.7%). Within retail loans, the single biggest component was the vehicle loans with a credit share of 9.8%. The credit squeeze that engulfed the entire NBFC sector had an immediate adverse impact on the industrial sector at least through three distinct routes: (i) a reduction in industrial credit, (ii) fall in automobile demand through a squeeze in vehicle loans, and (iii) reduction in demand of infra-construction-related goods through sudden squeeze in credit disbursement to the real estate sector.

The trend in the growth rate of index of industrial production (IIP) is shown in Figure 11. The industrial growth rate registered

Table 2: Selected Balance Sheet Items of NBFCs

	March 2018	March 2019	September 2019
Growth rates (%)			
Total liabilities	26.8	17.9	13.2
Loans and advances disbursed by NBFCs	31.8	16	9.9
Share in total liabilities (%)			
1 Share of reserves and share capital	23.3	22.6	23.7
2 Share of deposits and other liabilities	7.5	9	9.1
3 Share of borrowing	69.2	68.5	67.2
3a Share of debentures and commercial papers	39.6	34.4	32.3
3b Share of other borrowings	29.6	34.1	34.9

The above balance sheet of NBFCs provides the aggregate figures for deposit taking (NBFC-D) and systematically important non-deposit taking (NBFC-ND-SI) companies. Growth rate is calculated on y-o-y basis.

Source: Calculated from Report on Trend and Progress of Banking in India, RBI.

a sharp decline particularly in two phases: (i) during November 2018, and (ii) since August 2019. The decline during the first phase was in the immediate aftermath of the IL&FL crisis where the credit squeeze would have an immediate impact. The second phase of sharp decline came about in the midst of weak global demand, when the collapse of DHFL acted as an additional negative shock to output growth rate. With negative export growth rate and credit shocks, the IIP growth rate has continued to be negative in three consecutive months from August to October 2019.

In a nutshell, the present episode of slowdown was triggered both by demand-side factors and the existing financial fragility of the economy, with each feeding on the other. What can be the policy-level response in the midst of such an unprecedented slowdown?

Immediate Binding Constraint and Policy Objective

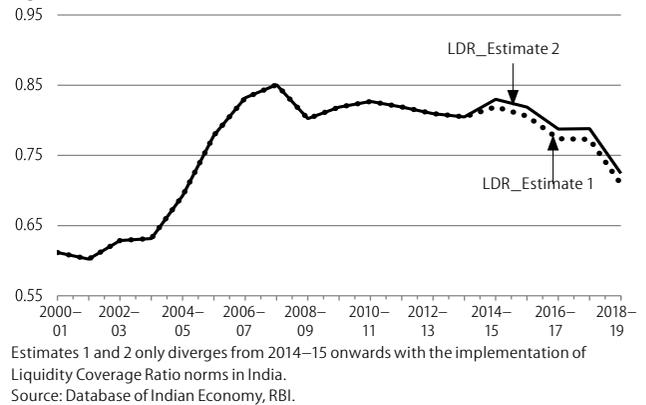
The precise nature of policy measure, inter alia, would be dependent on the diagnosis of what constitutes the immediate binding constraint on output. Given the specificity of the present slowdown, where both the output growth rate and credit growth rate registered a sharp decline, there are two possible candidates that can act as the immediate binding constraint: (i) the finance constraint, or (ii) the demand constraint. In the case of the former, higher availability of credit at a given level of the borrower’s risk revives the output growth rate by relaxing finance constraint, whereas in the case of the latter, higher demand revives the output growth rate by relaxing demand constraint.

The possibility of demand constraint emerges from the squeeze in the aggregate demand and the consequent fall in expected profitability of investment projects and actual investments. The possibility of finance constraint emerges from the stressed balance sheet of the financial sector, which may lead them to reduce credit supply at a given level of economic activity due to a squeeze in its lending capacity and, thereby, impose an immediate constraint on investment and output at a given profit rate. Which of the above constraints is immediately binding on the economy is an empirical question that we now attempt to address.

The possibility of a binding finance constraint from the creditor side would emerge if the financial sector as a whole reduces its credit supply due to a squeeze in its lending capacity at a given level of economic activity. Precisely because a credit squeeze from one sub-sector can be mitigated by higher credit supply from another sub-sector; the necessary condition for such a finance constraint to operate is that the credit supply of the entire financial sector should be constrained by its lending capacity. In the midst of a squeeze in the NBFC credit, the question which therefore needs to be addressed is whether the banking sector is also constrained by a squeeze in its lending capacity.

The lending capacity of a bank, or the maximum amount of loans that the banks can potentially disburse (say L^*), can be defined as the difference between their total financial assets (A) and that part of the liquid assets which the banks are statutorily required to hold in the form of reserves and securities (s). The

Figure 12: Loan Disbursement Rate (LDR) of Scheduled Commercial Banks



financial assets are calculated by deducting fixed assets and “other assets” from total assets, and include financial investments, cash balances, and loans and advances. The statutory part of the liquid asset (s) is determined, inter alia, through the cash reserve ratio (CRR), statutory liquidity ratio (SLR), and, after January 2015, through the liquidity coverage ratio (LCR) as per Basel III norms. Any rise in the NPAs, as the banks have witnessed in the recent past, can adversely affect their lending capacity in two ways: (i) the banks can reduce the size of their balance sheet and assets (A) to maintain a given level of capital adequacy ratio, and (ii) the external cost of borrowing of banks can rise as their balance sheet deteriorates, which, in turn, may lead the banks to hold the higher statutory part of the liquid asset (s) in order to maintain a given liquidity coverage ratio (LCR).⁷

While the lending capacity (L^*) provides the upper bound or the maximum amount of loan that banks can potentially disburse, the actual loans (say, L) is determined by effective demand of the economy and, hence, can be less than or equal to the lending capacity. In order to demarcate the demand-side effect on actual loans from the supply-side effect on lending capacity, we construct a ratio between actual loans and lending capacity. For the sake of convenience, this ratio is termed as the loan disbursement rate (LDR, henceforth). Any fall in LDR would indicate lower credit demand for a given lending capacity, whereas any rise in this rate would indicate the opposite. By definition, LDR is less than or equal to 1. We construct two estimates of LDR. In the first estimate, the statutory part of the liquid asset (s) comprises the amount determined by CRR and SLR, whereas, in the second estimate, it comprises the amount determined by CRR, SLR, and the stipulated LCR.

After registering a sharp rise during the boom period of the 2000s and maintaining a high level till 2014–15, the LDR witnessed a sharp fall particularly from 2015–16 onwards for both the estimates (Figure 12). Not only does the actual loan disbursement of commercial banks presently continue to be far lower than the lending capacity, as reflected by its relatively low value, but it also happens to be far lower than the peak value of 0.85 that it earlier attained during 2007–08. The fact that the banks are characterised by idle lending capacity and are holding liquid assets far higher than what is statutory, rather indicates a situation of a binding demand

constraint in the credit market. This conclusion is similar to that of Anand and Azad (2019).

There are primarily three reasons for the fall in LDR in the recent years. First, it can be attributed to the change in the demand pattern of the borrowers in favour of the NBFCs and away from commercial banks during the latter half of the 2010s. One plausible reason for the latter phenomenon can be greater risk exposure of the NBFCs during this period, because of which their effective interest rate, net of risk premium, would be lower as compared to the commercial banks. Second, the fall in LDR during the last two years reflects the overall demand squeeze in the aggregate economy following the fall in export demand and rise in import propensity. Third, due to massive liquidity infusion by the government in the recent period, the fall in the lending capacity has been less than proportionate to the fall in aggregate demand.

Therefore, for any policy response to be effective, it needs to be aimed at relaxing the demand constraint and stabilising the unstable economy. Notwithstanding the scepticism around “crowding out”—a proposition that otherwise remains rather unfounded either theoretically or empirically (Anand and Azad 2019)—one sufficient condition to do that is to bring back government expenditures at the centre of India’s growth process to be used as a policy instrument for boosting demand.

Concluding Remarks

What remains at the heart of the present slowdown is a growth regime where financial fragility is an intrinsic component and one which is largely dependent on favourable external market conditions for its recovery and boom. Both these features follow from the lack of any effective policy instrument of

boosting aggregate demand. The government expenditures, which once played this stimulating role, have now been withdrawn without being replaced by any alternative effective policy instrument.

Rather, the broad strategy of the existing policy regime is to try relaxing the solvency condition through corporate tax cuts, tolerating greater financial fragility through greater liquidity infusion or maintaining a lax resolution mechanism for loan defaults and, in the meanwhile, “wait out the storm” till the global economy recovers or oil prices start falling. In the midst of a binding demand constraint, there are at least three problems with this strategy.

First, while such measures can play a role in resisting further decline in the output growth rate by stopping a spiralling of demand reduction, credit crunch, and balance sheet crisis, it can hardly have any impact of increasing output. Since investment decisions are affected by present output, whereas output remains constrained by demand, relaxing balance sheet constraints or finance constraints hardly increases investment or output. Second, in the midst of external dependence, when exactly would the recovery set in is exogenous to domestic policymaking and, hence, its timing is uncertain. And, in between this long haul, livelihoods get destroyed. Third, since the present strategy has de facto involved a deterioration of interest coverage ratio of firms during the downswing, while exhibiting a somewhat downward rigidity during the upswing, continuing with this strategy makes the economy more vulnerable to negative external shocks in the future.

The Indian economy needs a change in its policy regime and growth trajectory, because what presently remains operational is a regime of financial fragility and vulnerability.

NOTES

- 1 Table 1 shows figures till 2019–20 Q2. According to the CSO’s latest press release, the GDP growth rate has fallen to 4.7% in Q3 as compared to 5.1% in Q2.
- 2 This is not to argue that maintaining viability of firms has to be necessarily the only objective of such a regime; a firm which is otherwise solvent can still receive loans more than their “normal” line of credit and be a beneficiary of debt-write offs through sheer cronyism. However, in the context of the topic at hand, our emphasis remains on the former and not the latter.
- 3 The reduction in interest payment commitment here does not necessarily imply reduction in actual expenditure on interest payments during the given period, since firms may not be making such payments to start with (which is why the asset was categorised as an NPA in the first place); rather, it absolves firms from the commitment of making interest payments even in the future.
- 4 It can be noted, that private investments can not only fall when firms go out of business, but decline even when they remain afloat once firms start deleveraging to repair their balance sheet. Koo (2011) has adopted the latter route to explain Japan’s slowdown in the post-1990s period through what he termed as the balance sheet crisis.
- 5 See Dasgupta (2020) for a detailed analysis.
- 6 The loan disbursement data is only for deposit taking (NBFC-D) and systematically important non-deposit taking (NBFC-ND-SI) companies.

figure for March 2018 is derived by deflating outstanding loans of these NBFCs by the GDP for 2017–18.

- 7 The liquidity coverage ratio (LCR) is the ratio between high quality liquid asset (HQLA) and expected net cash outflow. Any rise in expected net cash outflow, say due to actual rise in external cost of borrowing, can lead the banks to hold higher HQLA in order to maintain a given LCR. This may increase the statutory part of the liquid assets (S) held by banks.

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