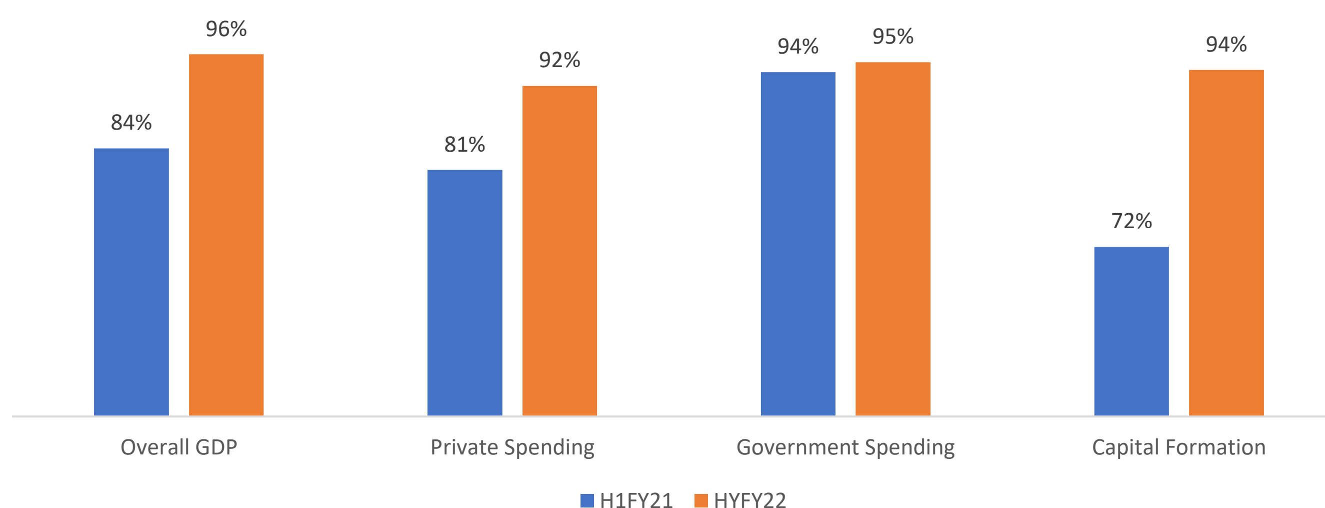
TruQuest

Data on Gross Domestic Product (GDP) reiterates that Indian economic activity is still falling short of meeting its pre-covid capacity. H1 FY22 real GDP was 96% of what it was in H1 FY20. It may take another two quarters to match the FY20 capacity, assuming an optimistic YoY growth of 9.5% in the current fiscal. The shortfall in capacity utilization vis a vis pre-covid period is spread across all components contributing to India's gross production/demand, including Government spending:

Figure 1: *Capacity utilization post Covid (vs H1 FY20) across key demand generators*

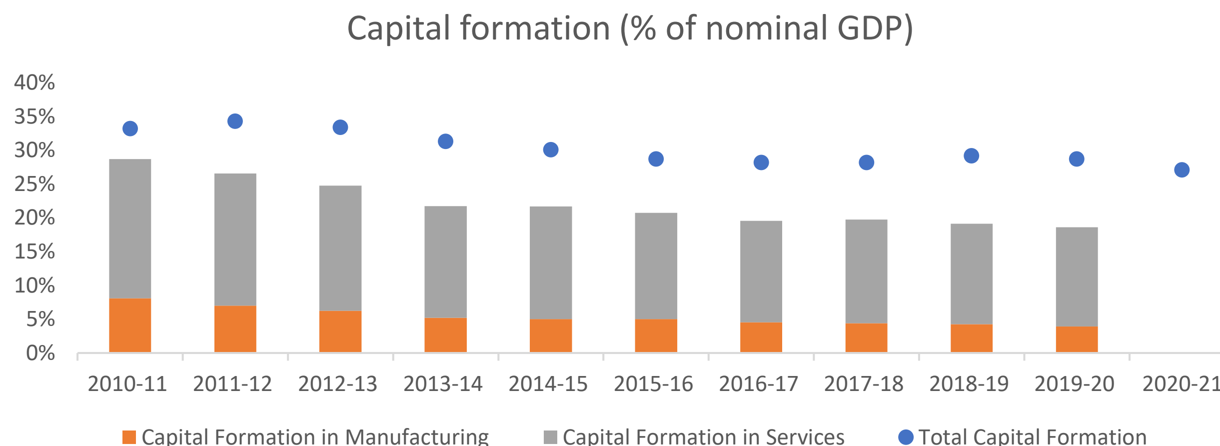


Low productivity and high inflation are gnawing at capacity utilization during this recovery phase.

Consequently, India's notoriously large output gap (i.e., difference between ability to produce and actual production) widened further in the last 18 months. RBI, in its recent policy discussion in Dec'21 observed this gap to be "very very wide". While eliminating this gap is a long term plan, all efforts should be directed to restore it to its pre-covid levels, at the very least. One immediate action is to ease credit supply. Bank credit, the traditional route for capital access, needs to grow atleast 10% yoy compared to 6% currently (i.e. an additional inflow of Rs 9 Lakh cr by Mar'22). At the same time, bond market liquidity needs to be maintained, adjusting for the likely crowding out of private issuers by massive Rs 13 Lakh crore of government's debt issuances in FY22. Easing capital flow and access will in turn generate higher capital expenditure, boosting employment and domestic consumption, eventually leading into a virtuous cycle enabling animal spirit in the economy, which mutually reinforce investment, productivity growth, job creation, demand and exports. In this sense, ample credit availability is an indication of financial development and leading financial indicator of growth.

The fallout from lack of capital access can be assessed from the decadal low level of fixed capital formation as a percentage of GDP, achieved in FY21. This is feeding into rising output gap. Tapping additional sources of investments is critical to reinvigorate this fixed capital formation cycle. Bank credit may not be sufficient in meeting the requirement especially since household savings rate is dwindling consistently. The erosion of fixed capital formation is worse within manufacturing sector, deemed to be the largest employer after agriculture.

Figure 2: *Consistent decline in fixed capital formation across sectors prompted by lack of durable funds*



Ingenious capital channels needed to complement shrinking traditional routes

Given the risks arising from weak capital availability and allocation, it is necessary to get creative around sources of capital to fund investments going forward, both government and private.

One interesting route being explored by both Ministry of Finance and Reserve Bank of India in recent times is increasing long term capital inflows into Indian government securities (Gsecs). This can potentially ease India's capital woes through two channels:

1. Free up banking assets: Higher absorption of government bonds from a new category of investors and easing pressure on public bank capital.
2. Enhance debt market liquidity: Decline in the extent of crowding out of corporate bonds by weekly government issuances. More domestic capital will be available for the private sector.

The easiest route to democratize access of Indian Gsecs to foreign investors is via Fixed Income Index inclusion. Indian policy makers are taking definitive steps to meet inclusion criteria of foreign Fixed Income indices linked to significant Assets Under Management (AUM). Some of the major Emerging Markets focused Indexes suitable for Indian GSec inclusion are:

1. JP Morgan GBI EM Global Diversified Index with an estimated AUM of Rs 20 Lakh Crores.
2. Bloomberg Global Aggregate Index with an estimated AUM of Rs 200 Lakh Crores.

With this aim, RBI had introduced the Fully Accessible Route (FAR) in March 2020, which absolves foreign investors from capital control related restrictions on Gsec exposures. 14 GSecs with notional outstanding value of Rs 15 Lakh Crores were identified to be a part of FAR where Foreign Portfolio Investors can transact without any exposure limits.

This is a good start to make Indian bonds eligible. Assuming a 10% exposure (like China's) in JPM GBI EM and 0.1% in Bloomberg GAI, can bring in Rs 2.2 Lakh Crores or 17% of the amount of GSec issuances scheduled in FY22. The freed up domestic liquidity can be utilized to fund private companies for long term capex.

Some of the lingering hindrances that is preventing the Index inclusion process are:

1. SEBI Regulations on FPI licenses involving tedious paperwork and documentation processes, often not palatable for asset managers or sovereign wealth managers.
2. Margin requirements to pre-fund all GSEC trades reduces time available for trade execution.
3. Other logistical challenges related to trade matching, trade timings, lack of clarity in taxation laws, etc.

It has been highlighted by various global agencies like JP Morgan, Goldman Sachs, HSBC etc that one quick fix is to enable access to the Indian GSec market through an international central security depository like Euroclear. The inclusion will automatically ease out multiple pain points including the ones highlighted above. Platforms like Euroclear provide a much wider investor access by standardizing and securing the trades. For example, Euroclear currently has 24 emerging markets on its platform covering approximately Rs 1,000 Lakh Crores of issuances. Hopefully, once India joins one of these platforms, Indian GSecs and eventually corporate bonds will find a new leash of life, with systematically declining borrowing costs, newer investor types and larger volumes.

TruQuest is a knowledge series launched by TruBoard Partners providing succinct updates and views on:

- Liquidity outlook
- India's macro-economic view
- Trends within the Infrastructure, Real Estate and Renewable Energy sectors
- Impact analysis of new regulations and policies on lending and capital flow

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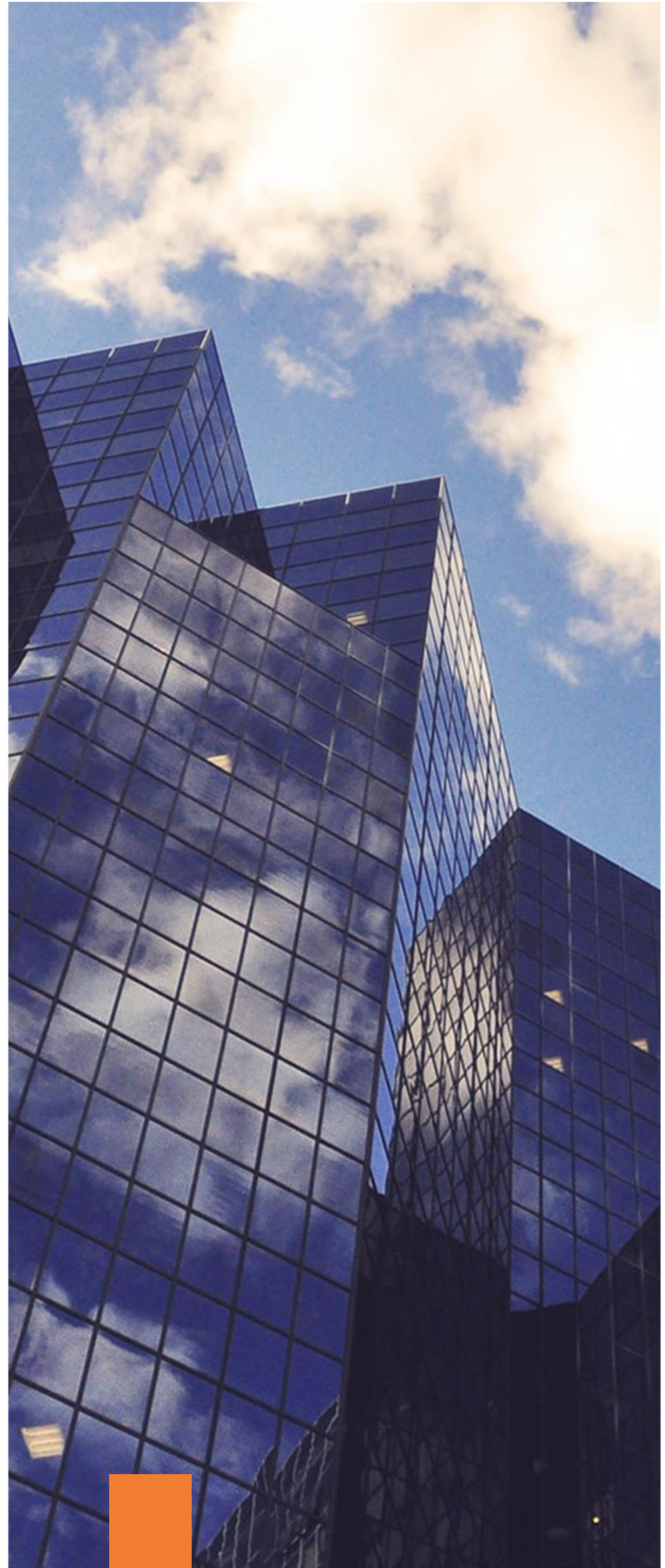

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