Three Arrows by Finance Minister

After the Koizumi government ended in 2006, Japan continued to struggle with slow growth, deflation and, in 2011, a tsunami and nuclear disaster. Following a series of several more unsuccessful prime ministers, Shinzo Abe again became the prime minister in 2012 and announced a new strategy of "three arrows," rapid quantitative easing, fiscal stimulus and structural reform. We, at Vallum, believe the Finance Minister Mrs. Sitharaman's announcements on Friday resonate with Abe's three pronged approach. FM shot the first arrow by announcing liquidity improvement measures. The FM would be back after a fortnight with another set of announcements. The next set of arrows would follow soon.

The Government finally paid attention to the growing demand from industry participants for intervention and announced a strong set of confidence and demand boosting measures addressing multiple pain points. We are relieved that the Government is taking the necessary steps to arrest the vicious cycle of economic contraction. Besides, the government is trying to shun the recent public impression that it is disregarding role of financial markets in economic growth, which is a very positive step.

Confidence is oxygen for the economy and at the present, the confidence of consumers and trust of corporates are in extreme deficit. As suggested, these measures are the first of many necessary steps and we are optimistic that these measures would lay the path towards re-vitalizing the Indian economic machine.

The economy has been starving for liquidity since the last 18 months. This has impacted every sphere of the economy. M3 growth has lagged GDP growth for two years now and the M3 to GDP ratio has compressed sharply. However, the bigger problem is the money multiplier, which continues to shrink.

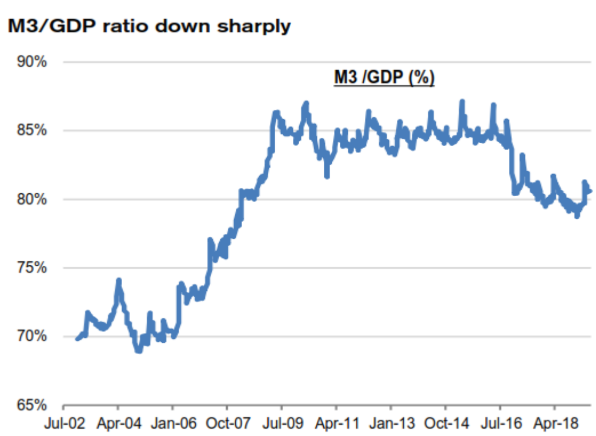
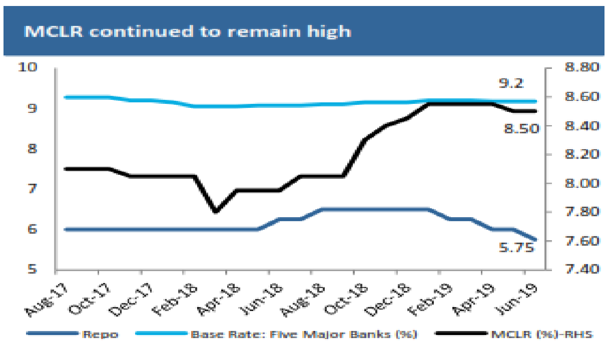


Figure 1: DBIE, Credit Suisse Estimates

Liquidity enhancement measures were perhaps the most vital part of the entire set of announcements.



Source: CEIC, Spark Capital Research

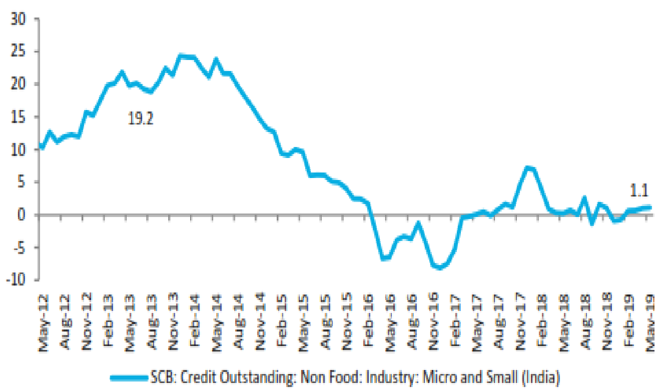
The economy has struggled with transmission of interest rate cuts to the real economy with the MCLR continuing to remain high. Going forward, Banks will be persuaded to link their loan rates to repo linked instruments, like the repo linked lending rate (currently 8% vs. SBI's 1-year MCLR of 8.25%). This change will be on a prospective basis and it will boost the transmission of rate cuts. The transition to repo-rate linked lending is likely to be gradual as seen in the case of transition to MCLR regime where the transition period was about 2 years and only 60-70% of the lending book has been transitioned as of date.

In our view, front-loading of PSB recapitalization worth Rs. 700bn (as provided in the budget earlier) would have a strong positive outcome as lenders would be more amenable to focusing on loan book growth as opposed to the present situation where the bulk of capital infusion is being used to meet the regulatory provisioning requirements. Additional 700bn of tier 1 capital infusion towards capital deprived PSUs is expected to create a liquidity support of Rs. 5tn in the system in the form of additional lending in lieu of additional capital. Typically, capital infusions are staggered over a period of time and so it was a bold step by the government to frontload its contribution. In our view, though additional capital may create additional ability to lend, an untoward focus on retail loans by PSBs, especially housing loans, may create excessive competition in the retail loan sector.

The Govt. has also announced enhancement of liquidity support by National Housing Bank (NHB) to Housing Finance Companies (HFC) from Rs. 100bn to Rs. 300bn, this will provide an additional impetus to the liquidity deprived HFCs. With this step, the Government has effectively doubled the support to HFC Companies from 150bn last year to 300bn in the current year.

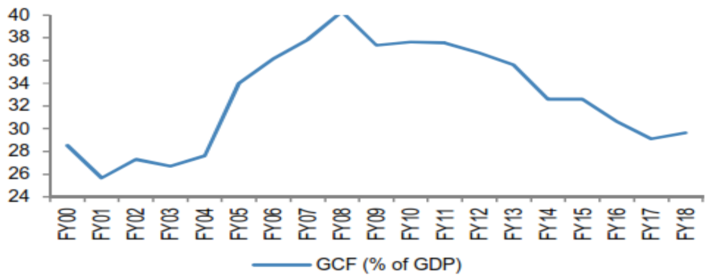
The Govt. finally came into the rescue of the MSME sector struggling with intense liquidity crunch post demonetization and implementation of Goods and Services Tax (GST)[1]. The credit growth for the MSME sector had severely dwindled since the beginning of CY2017. Flow of credit to the MSME sector fell by 48% between April 2017 and April 2018. Measures for the MSME Sector included expedited GST refunds to MSMEs, MSME bill discounting and looking at implementing UK Sinha committee recommendations. All pending GST refunds will be paid within the next 30 days, while future dues will be settled in 60 days. The government also plans to amend the MSME Act to provide a single, holistic definition for MSMEs. At present, MSMEs are categorised as Micro, Small and Medium Enterprises based on their revenues with sops for each category described seperately. MSME's do not have a streamlined infrastructure to map the entire outstanding inventory with tax invoices. They also do not have better financial flexibility, as their working capital requirements have increased due to their dependence on MSME vendors since input credit availability under the GST mechanism has to be matched otherwise credit is not available. Working Capital Needs Of Manufacturers after GST has gone up and more so the requirements for the majority of the participants in the manufacturing sector (steel, textile, auto and auto ancillary) owing to the requirement to pay the entire tax at the point of the dispatch of goods from factory gates, and also for the movement to warehouses. These steps, if implemented with precision, should be sufficient to kick-start the revival of the MSME Sector by imparting it the necessary liquidity. MSME credit growth should also pickup as a consequence.

Figure 1: Credit Growth of MSMEs



Source: RBI, Spark Capital Research

The biggest push and support which the Indian economy needs for long term growth is on the infrastructure and capex side. Public capex has been the growth driver for the last seven years, even as private projects under implementation have shrunk. **Gross Capital Formation (GCF) as a % of GDP has constantly declined post peaking out in FY09.** Given damage to sentiment, private capex is still far away, so government capex is only hope**.**



Source: CMIE, J.P. Morgan

Clogged dues from the public sector including the government and CPSEs have been a significant source of cash crunch in the infrastructure sector and projects associated with large companies. A Niti Aayog study earlier noted that India takes as much as 1,420 days and 39.6 per cent of the claim value for dispute resolution. The situation is only slightly better than Bangladesh, the report found. A 2016 Govt. Press Release mentions that roughly 70,000cr is stuck in arbitration for construction companies alone. The Centre will expedite pending payments to private infrastructure developers, many of whom are facing financial distress, due to **ongoing arbitrations** with the government. The FM said that, in accordance with NITI Aayog's 2016 recommendation, 75% of the payments under arbitration will be released immediately while the remaining 25% will be paid post the final order. This will massively *improve the circulation of money in the economy and grant a breath of air to the struggling infrastructure sector.*

The sops for the Auto sector were encouraging. The FM also tried to allay concerns regarding Electric Vehicles and validity of ICV registrations. There is also a plan to implement vehicle scrappage subject to creation of relevant infrastructure. The enhancement for depreciation provisioning to 30% for all types of car and deferment of one time registration fees till 2020 are significant measures to boost demand.

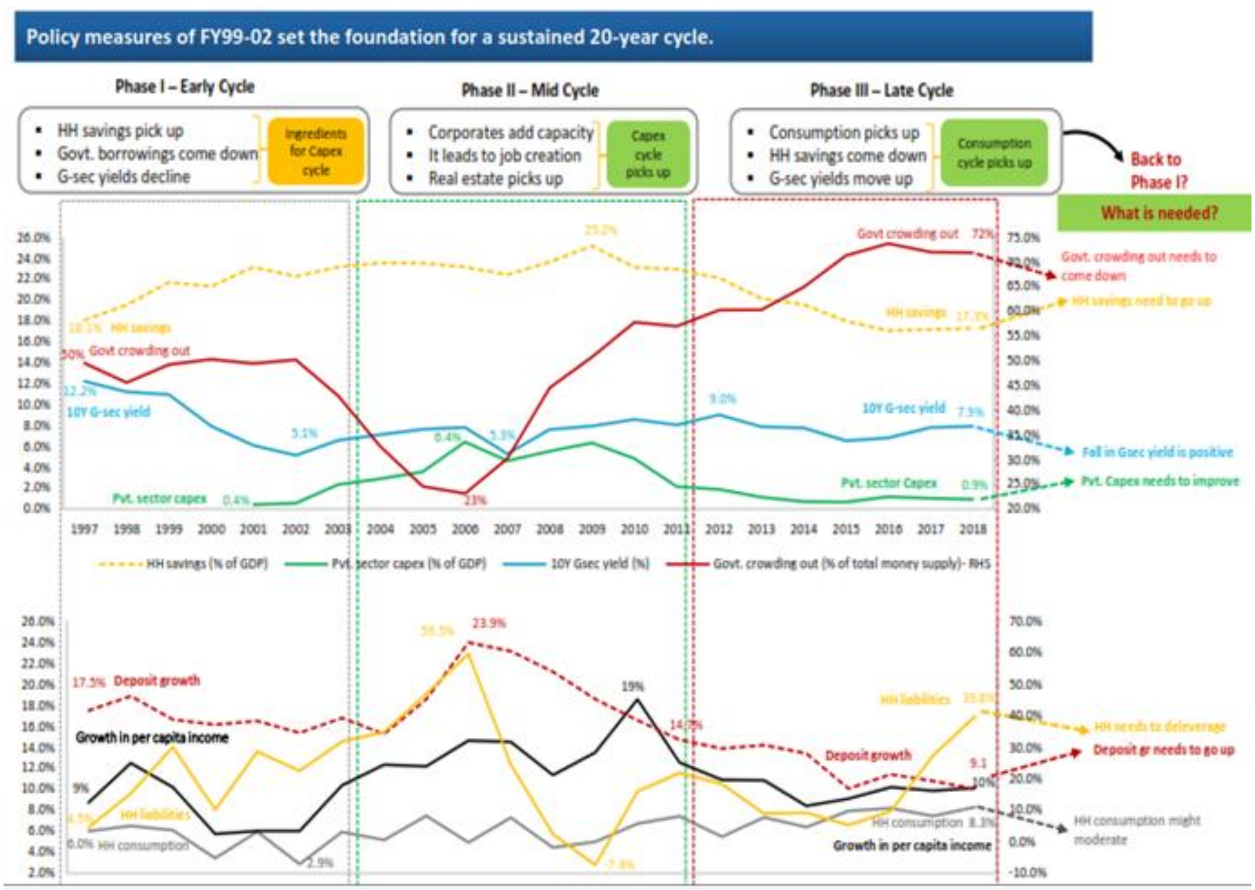
Let's accept the truth: India is dependent on Foreign Capital for Balancing Balance of Payment: Addressing Taxation problem.

Govt. announced a rollback of recently implemented surcharge on FPIs and domestic investors. This will improve stock market sentiments as well as aid in counter-balancing depreciation pressure on the rupee in the near term since

FIIs/FPIs have been net sellers since Budget, pulling out more than Rs. 25,000 crore. ‘Angel tax’ was often touted by the startup community as an unfair tax burden affecting young companies and their financial backers. Angel Tax on startups has finally been withdrawn. This was a much-needed respite since tax scrutiny on startup valuations had scared their investors.

Is BJP resetting stage similar to Year 1999-2004?

Our thesis on the evolution of India economy post liberalisation and its present state is impeccably reflected in the image below**.**



When it comes to putting the economy back on the track of growth, we believe it will be the Govt. which would have to lead the show. Contribution from the Private sector is indispensable but will come later. **Friday’s announcements give us the much-needed confidence about the Govt’s skin in the game. As well said,**

there are decades when nothing happens and there are weeks when decade happen.
We are waiting for the next set of arrows to be shot! Hope some or all of them hit the target!

Sincerely,
Madhusudan Sarda, Vallum Capital