S S Mundra: Financing India's growth – challenges and way ahead

Keynote address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at a Summit on "Financing India's Growth – Way forward", organised by PHD Chamber of Commerce and Industry (PHDCCI), New Delhi, 9 September 2015.

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Shri Yaduvendra Mathur, Chairman & Managing Director, Export Import Bank of India; Shri Sunil Srivastava, Dy Managing Director, State Bank of India; Shri Alok Shriram, President , PHD Chamber of Commerce and Industry (PHDCCI); Shri Sanjeev Gupta, Chairman, Banking Committee, PHDCCI; delegates to the Summit; members of the print and electronic media; ladies and gentlemen! I am grateful to the PHD Chamber for inviting me to deliver the keynote address on a very important theme "Financing India's Growth- Way forward". I am happy to note the efforts being made by the PHD Chamber for promotion of industry, trade and entrepreneurship through its research-based policy advocacy role. The Summit today, I feel, is an important step in that journey. I also understand that the PHD Chamber and CRISIL have combined to prepare a knowledge report highlighting key issues essential for financing India's growth and I compliment them for their efforts. I trust that the recommendations made therein would positively impact the economic growth and development of the country.

2. In my address today, I intend to talk about India's growth potential, suitable model for India's growth, key challenges that undermine the achievement of the potential growth rate and the way forward in overcoming these challenges. Let me; however, begin with an overview of the global economic situation and where India stands at present.

Global overview

3. The global economy is presently dominated by four themes- the Chinese slowdown, the impending rate hike by the US Federal Reserve, the large-scale slump in global commodity prices, especially oil and the continued sluggishness in the economic recovery. Looking at the Advanced Economies (AEs), growth is virtually stagnant in Japan at 0.8% while the Continental Europe is slated to report only marginally higher growth at 1.5% during 2015. The recovery in North America, including in the USA is modest and UK is likely to witness a modest 2.4% growth during 2015.

4. The emerging and developing economies (EMDEs) have also been witnessing significant slowdown in growth. China's growth rate is likely to fall to 6.8% from 7.4%, while that for Russia (–3.4% from 0.6%) and Brazil (–1.5% from 0.1%) are set to go into negative territory in view of recessionary pressures. Of the other BRICS nations, South Africa is estimated to grow higher at 2.1% up from 1.5%. Against this backdrop of negative to modest positive growth rates for the large economic powerhouses and major EMDEs, India's economy is poised to grow at 7.6% with potential for even higher growth rates. The outlook for growth in India is improving gradually. The business confidence remains strong and as the initiatives taken by the Union Government begin to find traction, it is expected that private investment and consumer sentiment would revive. We in RBI firmly believe that moderate inflation is essential to ensure and sustain a higher trajectory of growth. That brings us to the question "***what is our growth potential?***"

India's growth potential

5. This question has been a subject of active debate in the academic and policy research circles. Literatures / research papers have put varying estimates of the country's potential growth rate notwithstanding the methodological issues surrounding the estimation of potential output, leading to considerable uncertainty. There is, however, a fair degree of

unanimity that the Indian economy is currently growing below its potential and closing this negative output gap (i.e., actual growth minus potential growth) has to be a priority.

6. What is holding India back in attaining its potential higher growth rate? Since the conference theme is "Financing India's growth – Way Forward", I would like to start with a basic question: ***Is availability of finance constraining growth?*** Financial sector is meant to sub-serve the needs of the real economy and cannot drive growth by itself. We have seen the pitfalls of the financial economy racing ahead of the real economy in the form of the Global Financial Crisis. I would argue that availability of finance, so far, has been a much smaller problem and it is more on account of structural problems that the rate of growth has not achieved its potential levels. It is contextual to mention here that as per World Bank's "Doing Business 2015" report, while as a country we languished at 142nd rank amongst 189 countries in the overall ranking; on the parameter of ease of "Getting Credit", we faired comparatively much better at 36th position.

7. As we deliberate on ways of financing India's growth, let me place some pertinent points for further reflections and begin with talking about what should be our growth model.

What kind of growth do we want?

8. The growth model that we should pursue has also been a subject of great debate amongst the policy makers. Should it be a manufacturing driven, export-led growth, should it be infrastructure led growth or one driven by domestic consumption? In fact, all models have their respective pluses and minuses. We have the examples of current Chinese meltdown and the Asian Financial Crisis of late 90s which, in part, resulted from heavy investment in infrastructure creation which ceases to provide positive returns beyond a point or too much reliance on export-led growth. Perhaps, we might want an equitable mix of all – growth led by increase in domestic consumption, investment in infrastructure and manufacturing. I believe we are well past a period when we could focus exclusively on being a world manufacturing hub for driving growth. To my mind, we would do well to aspire for a growth model which predominantly focuses at domestic manufacturing and global service delivery, which would be much more sustainable. It is also essential to realize that growth can be sustainable only if it is inclusive in nature and outlook. The inter se disparities or skewness in development between regions, communities etc., is neither desirable nor good for the society.

Key challenges to growth

9. Having discussed about the potential growth rate for India and the model of growth that we would like to pursue, let me highlight some key challenges to achievement of the potential growth rate. Although there are also certain socio-political reasons for slower growth, from an economic stand point, I feel following are some of the major challenges:

- Lack of investment in infrastructure- both physical and financial
- High level of Financial Exclusion
- Skill gap, which has implications for employability
- Decline in Gross Capital Formation & dwindling domestic savings rate

What needs to be done?

10. Government as well as RBI have been mindful of these challenges and have been taking steps to overcome them in a sustainable manner. It is also worth emphasizing here that there needs to be a fine balance struck between promoting investment in "capital intensive" and "labour intensive" companies, whether in industry or in service segments. This is necessary keeping in view the sheer number of educated workforce in the country. Over a period of time we have witnessed contribution of the service sector go up significantly to

around 57 % of the GDP. The recent growth in output in the services sector can largely be attributed to rapid development of skill intensive services like Information Technology (IT) and IT enabled Services (ITeS) sectors, e-commerce and professional service segments, mostly oriented towards the external market. There are questions raised about the quality and sustainability of this service-sector growth as also its potential for future growth. However, I believe that the Government's thrust on digital India and skill development will continue to support expansion of both: modern services like e-commerce, communication and finance as also more traditional services like trade, transport and storage, etc.

Urban migration

11. A crucial piece of the growth continuum would emerge from continued migration of people to urban areas. This would fuel demand for housing, transportation, electricity, education, healthcare facilities, etc. Governments/ Municipal bodies would also need to invest in creation of roads, sewage systems, water supply facilities, etc. While focus on impending urbanization is critical, the rural economy should continue to remain an area of focus as more than 60% people would continue to live in rural areas.

Focus on rural economy and financial inclusion

12. Income levels in the rural areas could be improved through land reforms like consolidation of fragmented landholdings, which in turn can support modern harvesting methods, and training the rural people for undertaking non-farm activities. Efforts to enhance the credit absorption capacity must be supplemented through financial literacy, vocational training initiatives and an efficient crop insurance framework.

13. RBI has for long been focused on inclusive growth through policies like selective credit control, priority sector lending norms, lending to weaker sections of the society, service area approach and through the financial inclusion drive in recent past; details of which are well too known to this audience. RBI's policies on expansion of branch network in rural and semi-urban centers have also been part of this initiative. There is a need now to leverage upon these efforts to channelize savings and deploy them for productive asset creation. The two newly licensed full-service banks, eleven payment banks and soon to be licensed small finance banks, would provide further impetus to accessibility of finance and render the credit intermediation process more efficient, thereby contributing to a sustainable and inclusive growth.

Focus on SME financing – a key driver for future

14. While on the subject of inclusive growth, it is pertinent to talk about the MSME sector, which has the potential to foster strong growth by creating local demand and driving consumption. Presently, MSMEs contribute nearly 8 per cent of the country's GDP, 45 per cent of the manufacturing output and 40 per cent of the exports. They provide the largest share of employment after agriculture and are nurseries for entrepreneurship and innovation. Acknowledging the importance of the sector to economic growth, both- Government of India as well as RBI have been taking measures to enhance flow of credit to the sector. On its part, RBI has launched several initiatives in this regard. To specifically address the issue of delayed payments to the MSME sector, TReDS has been conceptualised as an authorised electronic platform to facilitate discounting of invoices/bills of exchange of MSMEs. On the other hand, as part of capacity building of MSME divisions in banks and to develop entrepreneurial sensitivity, RBI has recently launched targeted training programmes for the functionaries in commercial banks. Government of India has also recently laid out a framework for revival and rehabilitation of MSM enterprises. The other initiatives of Government of India i.e. "Make in India", "Skill India Mission" and "Digital India" also ties in neatly to provide further push to the sector.

Role of banks in financing growth

15. Traditionally, like other emerging markets, Indian economy has been bank-dominated. So whether it is for project development, or working capital needs of the corporates, banks have been the primary source of credit. Though primarily banks are supposed to undertake maturity and liquidity transformations, there are limitations on the extent of asset-liability mismatches they can run on their books. The large scale distress being witnessed in banks' infrastructure portfolio also raises issues about their ability to critically appraise such projects. The typical role for the banks in mature markets is to originate loans and then distribute to other willing players in the market. They predominantly undertake working capital finance and provide structured financial solutions to their clients. They also act as market makers for various financial sector products. With the gradual widening and deepening of our financial markets, it would be fair to expect our banks to also gradually shift their focus to SME and retail clients while leaving the long-term resource contribution to other players including pension funds/ insurance companies which have long-duration liabilities on their balance sheets.

16. There is another factor relevant in this context. While the banks' ability to dispense credit depends upon their capital position, they are also guided by the viability of the projects to be funded. Risk aversion stemming from stress in financial assets has been one of the reasons for restrained bank credit growth in recent times.

Have borrowers been meeting their obligations?

17. I have raised the issue of borrowers' obligations on many occasions and at the cost of repeating myself, I would like to emphasise the point once more. While the quest to grow is understandable, the borrowers cannot exclusively rely on bank funds to finance this growth, without committing their own funds. The labyrinthine maze through which several large infrastructure projects have been funded point to extremely low or negligible levels of equity contributions leading to extremely high levels of leverage and virtually no skin in the game for the promoters. There is a very visible pattern here. The last few years' growth was largely on account of Infra projects. These projects were launched by a handful of promoters with thin equity as I alluded to earlier. I suspect that this small group has run out of even such thin level of equity to contribute their fair share for revival of the stalled projects, not to talk about commissioning of new projects. So, it should be obvious to everyone that if momentum has to continue then they have to either find fresh equity on their own or make way for others who can contribute such equity both for the existing projects and also for new ones.

18. It is also pertinent to mention here that the present legal system does not facilitate an easy closure/takeover of unviable firms. In order to overcome such problems and to salvage value in firms in distress, it is imperative to take measures for an early enactment of a Bankruptcy Code. Creation of a central authority for resolution of financial firms in distress also needs an early finalization.

19. High levels of debt accumulation by corporates has been encouraged in part by the availability of low-cost, abundant and flexible debt, facilitated by the search-for-yield environment created by the extraordinary policy measures undertaken in the US, UK, euro area and Japan. Several corporates have increased leverage, by borrowing in both foreign and domestic currencies. As corporates, you have to be mindful of global uncertainty, which is a given. The interconnectedness of markets lends itself to volatility. The entities with significantly higher unhedged forex borrowings are most likely to face maximum distress.

Governance reforms

20. India would continue to need external capital for growth and hence, we must create conducive environment for boosting investor confidence, which includes stable, efficient and

predictable legal, taxation and audit framework along with credible credit rating regimes, amongst others.

Conclusion

21. I shall conclude by reiterating a few points I made earlier. Persistently weak economic conditions in the global and domestic markets have perhaps been the single most important reason for moderate growth in recent times rather than availability of finance for productive purposes. Going forward also, availability of finance should not be a constraint considering India's attractiveness as a major investment destination for global investor community. However, the path to a potentially higher and sustainable growth is essentially through higher savings and infrastructure investment, which needs to be ably supported by an environment of macroeconomic and financial stability. It is essential, therefore, to sustain the momentum of gradual economic reforms which I alluded to earlier. Both, RBI and the Government would have to collectively work towards creating the necessary enablers for growth like moderate inflation, stable exchange rate, fiscal consolidation, predictable legal/taxation and auditing regime. Early resolution of the impasse on land acquisition, enactment of GST and bankruptcy code would also provide strong leg up to investment climate in the country and drive up growth. Strengthening the pace of financial inclusion and financial literacy, more efficient and better-directed public spending, particularly on the social sector (education and health) and skill-development would be equally significant steps towards this goal.

Thank you!