

# Indian Economy

## Of Cycles, Trend and Hysteresis



## Economy: Of cycles, trend and hysteresis

Macroeconomic instability inevitably undermines a business cycle. But does restoring stability necessarily revive growth? In the past ten years, what the government has achieved with regard to macro-stability, balance sheets and economic reforms is unparalleled. Yet, a sustained private capex upcycle has remained elusive. Indeed, India's trend NGDP growth (10Y CAGR) has slipped to ~10%—the lower-end of historical range.

This dichotomy can be understood through the phenomenon of hysteresis: a temporary shock producing a lasting effect on economic agents; for instance, prolonged debt-aversion among US HHs post-GFC. For India, that 'hinge event' was the BoP crisis of 2011–13 arguably triggering retrenchment by businesses. Yet, long after the shock has faded away and balance sheets healed, corporates remain fixated on RoE and FCF, not scale. Fiscal-monetary policies too are prioritising stability over stimulus despite low CAD as well as inflation.

This lasting behavioural change among businesses and policymakers worked to constrain HH/MSME income dynamic even as they were hamstrung by a series of exogenous shocks (2016–21: DeMon, GST, liquidity crisis, lockdowns). This impaired HHs' economic capacity and MSMEs' operational capacity. In effect, as corporate and government became debt-averse, HH resorted to debt. In a way, hysteresis worked to restore economic potential, but inhibited its realisation.

Furthermore, if not addressed, hysteresis could potentially turn endogenous: prolonged demand weakness itself could weigh on the trend growth by impeding capacity creation—physical capital (factories/infra) and human capital (skilling, migration, labour productivity)—and thereby restrict HH debt capacity. Indeed, the whole re-anchoring of economy from corporate leverage (production) to HH leverage (consumption) has limits.

After all it is puzzling that capacity utilisation is stuck at 75–76% despite slow capex, consumption is subpar despite HH leverage, railways'/SEBs' finances are softening despite reforms, and banks' LDR is hitting highs without economic overheating.

What is the way out? Maybe it's time to shift the policy focus to demand side and re-anchor the economy from HH to corporate, businesses from RoE to scale, and HH spending from leverage to incomes. Herein, two scenarios emerge. First, if the global economy rebalances well (China's consumer picks up as US's slows), global trade and India's exports could expand, helping reorient demand from HH to corporate *a la* 2002–04. A quick rebalancing looks far from certain though (refer to [Tariffs: Of Woods and Weeds](#)).

Second, if a proper rebalancing eludes, India must rely on domestic sources and use up the economic capacity—robust balance sheets, low CAD, low inflation—created by the government over past ten years. But the current fiscal-monetary framework, which was essential at one point, may now be stunting growth. It pre-empts a timely, sizeable and complementary counter-cyclical response. To be sure, GST reforms go a long way, but a broader macro-policies' framework needs reassessing. Fiscal deficit targets should be contingent on NGDP growth outcomes (refer to [Liquidity is not money](#)).

The RBI's monetary framework—targeting a 4% CPI—is a bit too constraining as well. In fact, we argue a little more weight to NGDP can help. Finally, pursuing a weak INR would help to restrict CAD. In this regard, recent INR weakness is welcome. The counter-cyclical policy space thus created could be geared towards boosting public investments (infra-spend, nudging PSUs to build scale), turbocharging PLI, etc; that, over time, would put corporates back in the driver's seat.

In sum, after all the hard work already done on the supply side, it is time to fix the demand side. We must give growth a chance—the best defence against endogenous hysteresis.

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## RGDP or NGDP: Which is the 'real' one?

Of late, India's real GDP (RGDP) and nominal GDP (NGDP) data have been giving off conflicting signals about the strength of the economy. We have been here before (2014–15; 2018–19). Indeed, if we divide the last 25 years of GDP data into two halves comprising FY01–13 and FY13–25, it is striking that while the NGDP compounded ~3% faster in the former, the RGDP compounded at a similar rate in both phases. And we know from a host of reliable real indicators (cars, cement, CVs), corporate indicators (revenues, capex), global indicators (exports/imports,) or even monetary gauges (loans/money supply) that growth in the former phase (FY01–13) was indeed vastly superior. Thus, the NGDP captures the swings and strength of the business cycle far better than the RGDP.

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## 10% NGDP growth: The fastest, but may not be sufficient

India is clocking 10% NGDP growth, among the fastest in the world, along with robust balance sheets and stable deficits and inflation. This is commendable. Yet, the fastest in the world may not be sufficient from a domestic standpoint. After all, India also has one of the largest pools of young population looking to join the workforce. On a trend basis (10Y CAGR), NGDP is growing at ~10% (lower-end of historical range) and the cyclical bounces above 10% were short-lived as they failed to kick-start a self-sustaining private capex upcycle. One also observes that in this 10Y period, some critical long-term parameters such as agri-share of GDP have stopped declining and the economic catch-up with the US (India's per-capita income relative to US) too has flattened. Thus, India must aim at higher NGDP compounding.

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## Stability secure yet scale subpar: Is it hysteresis?

One of the ways to understand India's low-pressure economy (high on stability, low on demand) is through the notion of hysteresis: a temporary shock casting a lasting shadow on the behaviour of economic agents. For example, debt-aversion among US consumers persisted long after the GFC shock. In India's case, we think the BoP

crisis of 2011–13 was one such exogenous shock—even long after the shock is gone and balance sheets healed, businesses remain anchored to margins and free cash flows (not scale) while policymakers are focused on macroeconomic stability, and not so much on demand. This behavioural change among businesses and policymakers had an adverse spillover on HH/MSME income dynamic even as they faced successive exogenous shocks (2016–21): DeMon, GST, NBFC liquidity crisis and lockdowns. This impaired HHs' economic and MSMEs' operational capacity.

In effect, as corporate and government became debt-averse and exports languished, HH inevitably resorted to debt amid slower incomes. This is how hysteresis shifted the anchoring of economy from producer (corporates) to consumers (HHs).

## Can weak demand cycle hurt the trend itself – endogenous hysteresis?

Typically, short-term demand fluctuations have little bearing on the potential growth of the economy. But prolonged demand weakness could indeed impair the economic potential (reverse of Say's Law?). This is hysteresis working endogenously. The question for India is if the new normal NGDP growth of 10% is self-sustaining, or could the economy re-equilibrate lower over time. We reckon that prolonged demand weakness itself could weigh on the economic potential by impeding capacity creation—physical capital (factories/infra) and human capital (skilling, migration, labour productivity), which then constrains HH debt capacity.

Indeed, the whole re-anchoring of economy from corporate leverage (production) to HH leverage (consumption) has limits. In recent years, it is puzzling to see capacity utilisation stuck within 75–76% despite slow capex, railways/SEBs' profitability deteriorating despite reforms, and banks' LDR hitting highs without any overheating in the economy. All this is despite a series of reforms, healthy balance sheets and sustained policy push (tax cuts, PLI, etc). Hence, it is high time that focus shifts to demand side to pre-empt the hysteresis from becoming endogenous.

## The way out: Re-anchoring economy from HH to corporates

After running a low-pressure economy (high on stability, low on demand) for a while, it may be time to run a little high-pressure economy re-anchored on corporate leverage rather than HH leverage. Incrementally, relying on HH leverage may have diminishing returns. If so, two scenarios may emerge. First, if the global economy rebalances successfully (Chinese/German consumers pick up), global trade and India's exports could accelerate over time, which could re-orient the domestic economy from HH to corporate (*a la* 2002–04). Of course, this will not be easy.

Second, if global rebalancing falters, India would have to rely on domestic sources and use up the economic capacity created over last ten years (reforms, policy credibility, balance sheets, CAD, inflation). There is a need for institutional reforms on demand-side management. Fiscal deficit targets should be contingent on NGDP growth outcomes, and if the current flexible inflation-targeting regime cannot be reformed, at least the RBI needs to run it more 'flexibly'. This will allow for counter-cyclical policy responses (missing for a while) to boost public investment (infra-spend, nudging PSUs to build scale, etc) or shore up PLIs, raising resources either through large disinvestment or fresh borrowing. Besides, an undervalued INR may be necessary to prevent leakage of domestic demand (refer to [Industrial Policy: The Hedgehog and the Fox](#)).

Overall, having done the hard work, the policy focus must now shift to demand side. It is essential to put corporates back in the driver's seat. We must give growth a chance—the best defence against hysteresis.

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***“With respect to human capital, as well as to physical capital, demand management has important long-run supply-side effects. A decade of slack labor markets, depriving generations of young workers of job experience, will damage the human capital stock far beyond the remedial capacity of supply-oriented measures.”***

***— James Tobin (1980)***

## RGDP or NGDP: Which is the 'real' one?

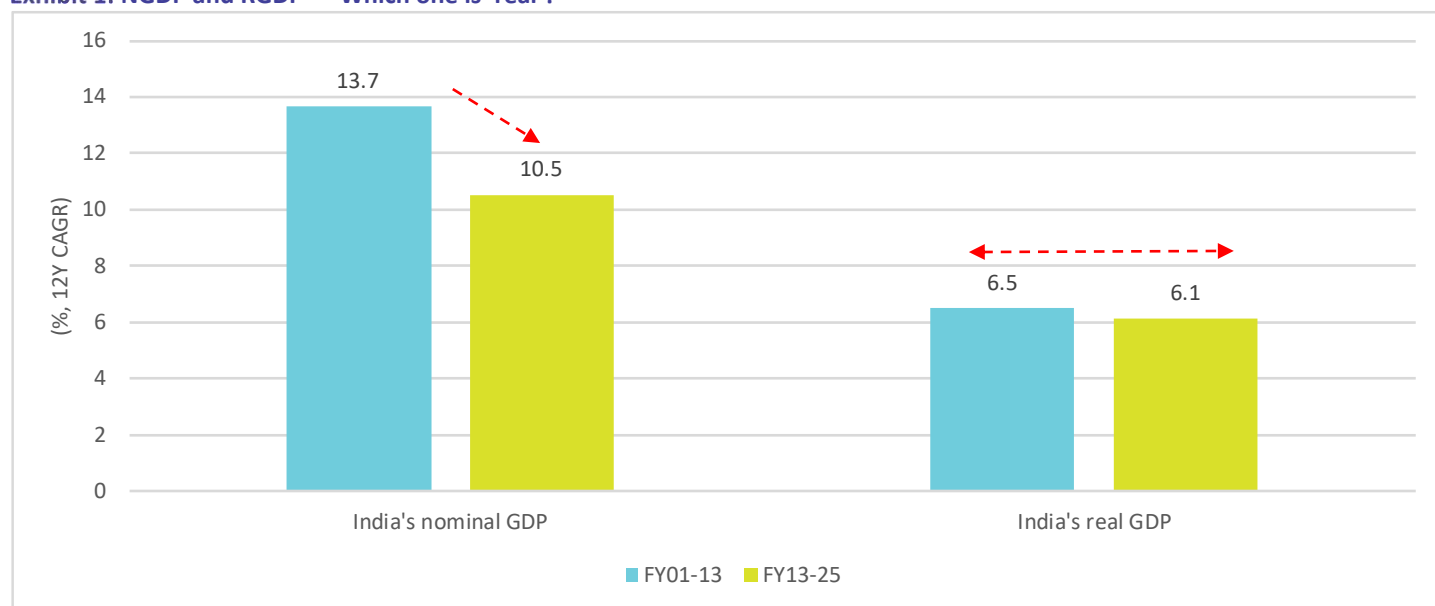
In recent times, India's real GDP growth (RGDP) and nominal GDP (NGDP) growth have been giving conflicting, if not divergent, signals about the strength of the underlying economy. For example, in Q1FY26, the RGDP growth accelerated while NGDP growth slowed sharply. A similar tension between the two gauges was seen in the past as well during periods of slowing WPI. So which one is a more reliable gauge of the economic activity? We delve into the same in this section.

### Which is a better gauge—real or nominal?

Our analysis of the past 25 years of mapping RGDP and NGDP data with broader indicators of economic activity suggests that NGDP data (which itself may not be perfect) offers a better guide to the underlying business cycle.

If we consider the last 25 years of GDP data and divide the economic growth into two halves, namely FY01–13 and FY13–25, it shows that the RGDP CAGR during both the phases was roughly the same. However, the NGDP compounding in the first phase was far superior to the second.

**Exhibit 1: NGDP and RGDP — Which one is 'real'?**

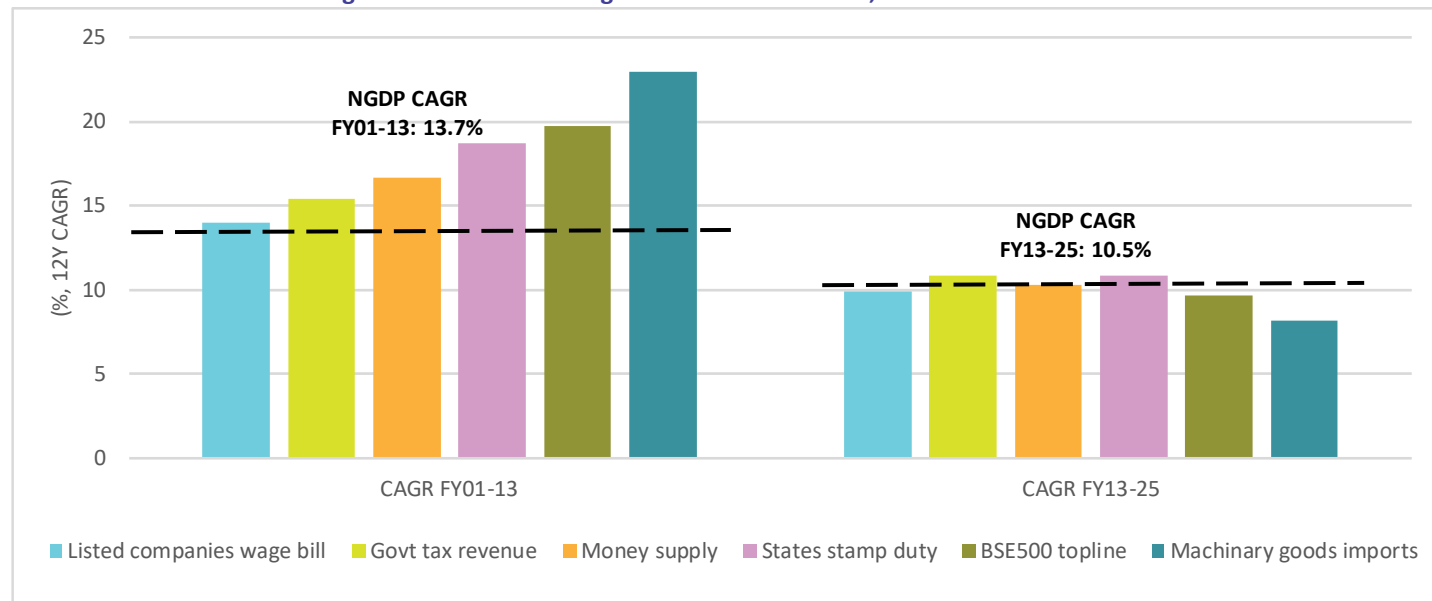


Source: CMIE, Nuvama Research

### Several volume, money and corporate indicators align with NGDP

We demonstrate that several reliable real indicators (auto sales, cement and CVs fuel consumption), corporate indicators (profits and top line), global indicators (trade/exports non-oil imports) or even monetary indicators (credit growth/money supply) align with the trend in NGDP growth. All these indicators clocked much higher growth during FY01–13 versus FY12–25. This is largely in contrast to RGDP, which exhibited similar growth in both periods.

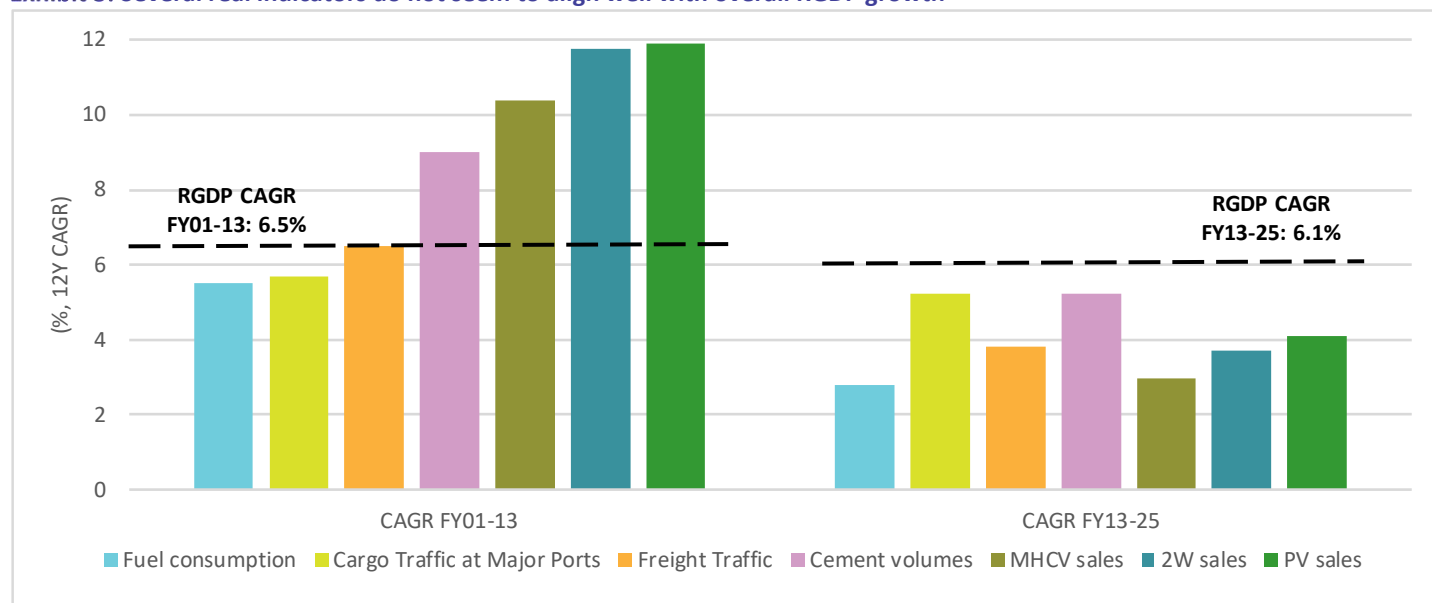
**Exhibit 2: A host of indicators grew much faster during FY01–13 than FY13–25, consistent with the trend in NGDP**



Source: CMIE, Nuvama Research

Furthermore, what is also striking is that most prominent real high-frequency indicators do not really align well with RGDP growth, particularly during the latter phase.

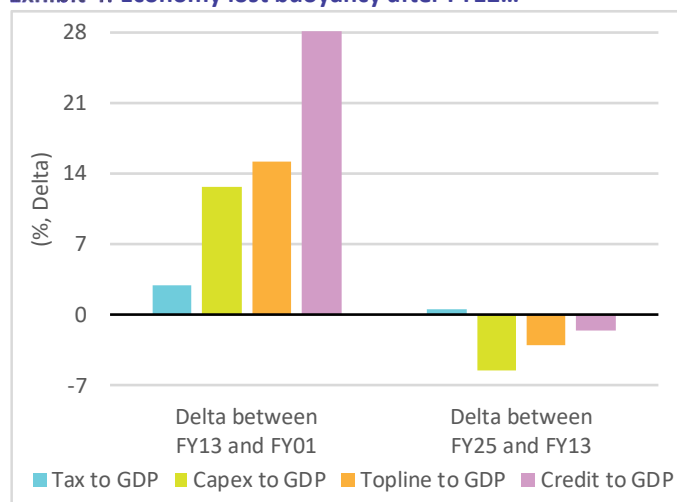
**Exhibit 3: Several real indicators do not seem to align well with overall RGDP growth**



Source: CMIE, Nuvama Research

In fact, the loss of cyclical momentum in the economy post-FY12 (with intermittent and short-duration bounces) is also well captured by the peaking out of several important macro ratios such as capex to GDP or tax to GDP around the same time.

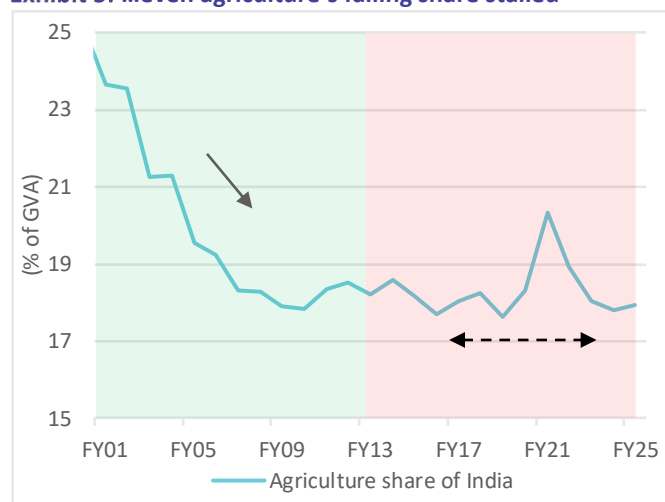
**Exhibit 4: Economy lost buoyancy after FY12...**



Source: CMIE, Nuvama Research

Note: Capex refers to GCF, Top line refers to BSE500 (ex OMCs) top line and Tax revenue refers to general government tax revenue as a percentage of GDP.

**Exhibit 5: ...even agriculture's falling share stalled**



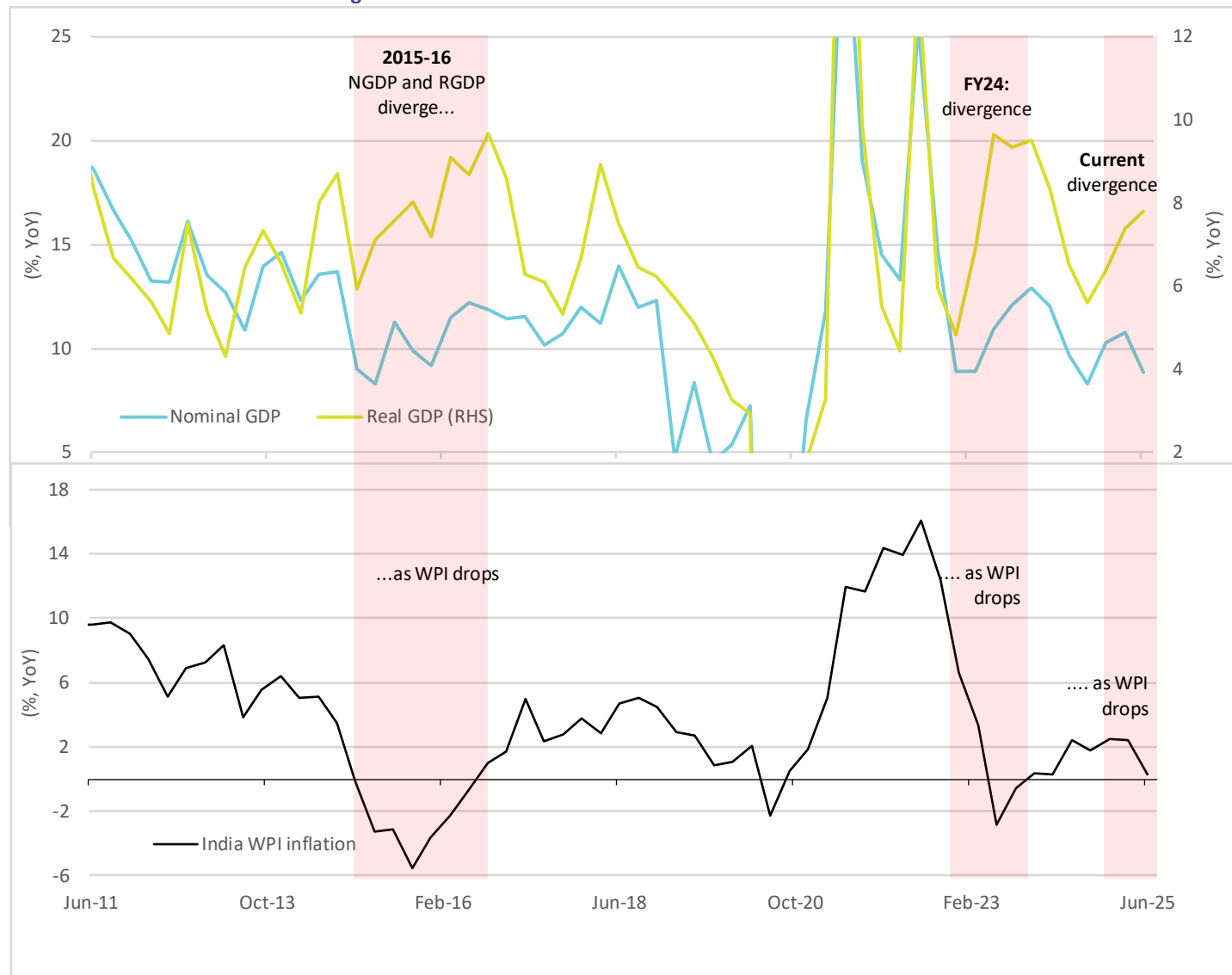
Source: CMIE, Nuvama Research

## Real GDP highly misleading during deflationary periods

As we have argued earlier ([link](#)), particularly during periods of slowing WPI, RGDP and NGDP data give off conflicting signals. For example, after 2012, the Indian economy has experienced three bouts of disinflation/deflation in WPI (see chart below) during which RGDP displayed strength or even accelerated while NGDP growth stayed weak or slowed down. In most of these cases, the RGDP eventually adjusted lower once WPI deflation was behind.

This is particularly true since under the new GDP series (2012 series), the CSO is relying more on corporate data (from Ministry of Corporate Affairs (MCA)), which is collected on a nominal basis and then deflated to arrive at real estimates. Thus, during periods of decrease in WPI, the RGDP gets a statistical boost. This was not true in the previous series where much of the data collected was on a volume/real basis and then inflated to arrive at NGDP.

**Exhibit 6: WPI deflation drives divergence between nominal and real GDP**



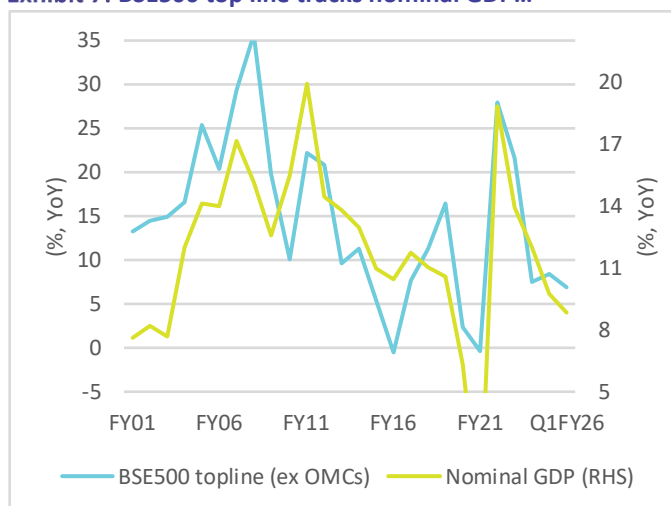
Source: CMIE, Nuvama Research

## Conclusion: NGDP a better gauge of business cycle in India

In all, the better gauge of both the direction and strength of India's business cycle is NGDP than RGDP. In any case, since tax collections and corporate revenue are more aligned to NGDP growth (versus RGDP growth), NGDP growth critically shapes the government's ability to spend and willingness of businesses to expand capital outlay.

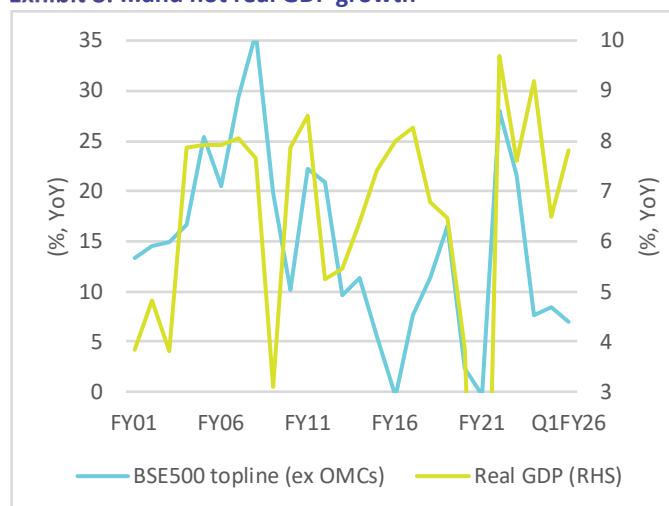
If so, NGDP growth should be an important consideration for policymakers, particularly the RBI, while deliberating on macroeconomic/monetary policies.

Exhibit 7: BSE500 top line tracks nominal GDP...



Source: CMIE, Capitaline, Nuvama Research

Exhibit 8: ...and not real GDP growth



Source: CMIE, Capitaline, Nuvama Research

## NGDP at 10%: Fastest, but is it sufficient?

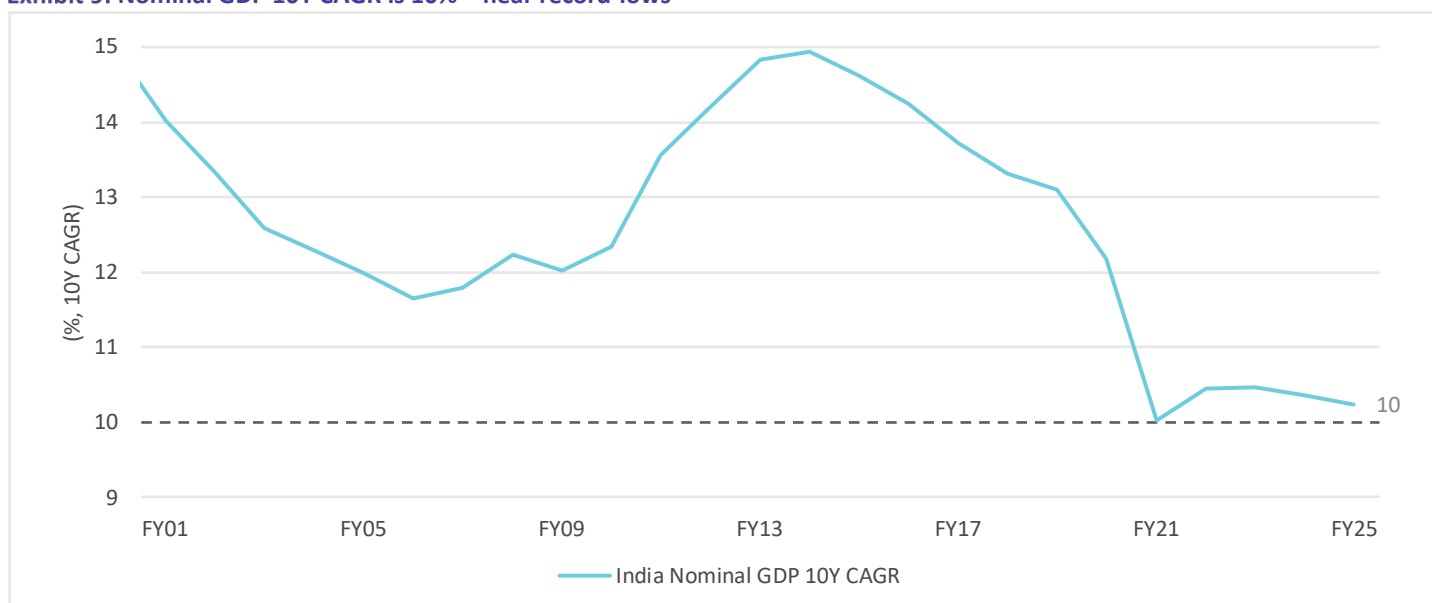
If NGDP is the right growth metric, then what is the appropriate NGDP growth for India?

### NGDP growth: 10% a new normal?

India's NGDP growth accelerated sharply during FY22–24 — the unlocking/pent-up phase, but that came off a very low base of FY20–21. However, it slipped back below 10% in FY25 itself and shall remain below 10% in FY26 as well. In fact, growth slipped to around 10% in the run-up to covid itself.

On a long-term trend basis (10Y rolling CAGR), India's NGDP growth is hovering near historic lows of about 10%. We also notice that since 2015–16, the bounces above 10% growth are modest and do not last very long.

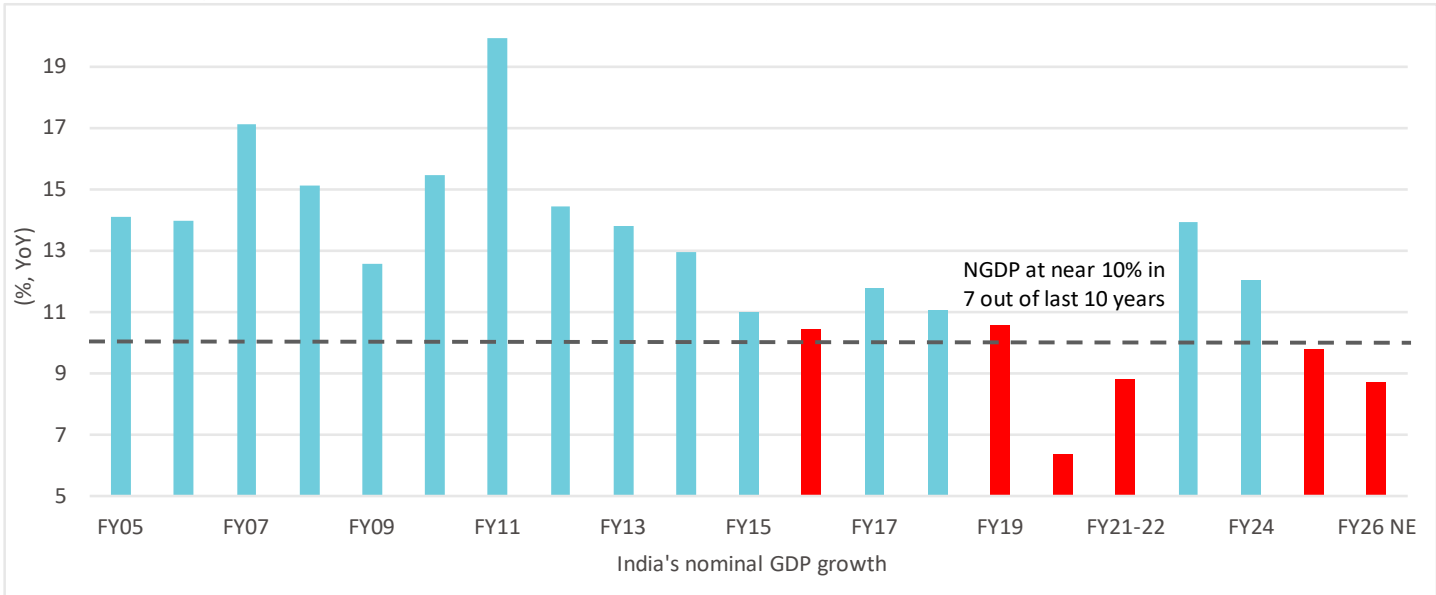
**Exhibit 9: Nominal GDP 10Y CAGR is 10% – near record-lows**



Source: CMIE, Nuvama Research

This was not so previously, where during phase of cyclical bounce in the economy, the NGDP growth stayed much above 10% for longer periods. In other words, the cyclical buoyancy of the economy seems to have tempered with 10% growth being the new normal around which the business cycle is fluctuating.

Exhibit 10: NGDP grew in a range of 10–11% in seven of the past ten years



Source: CMIE, Nuvama Research

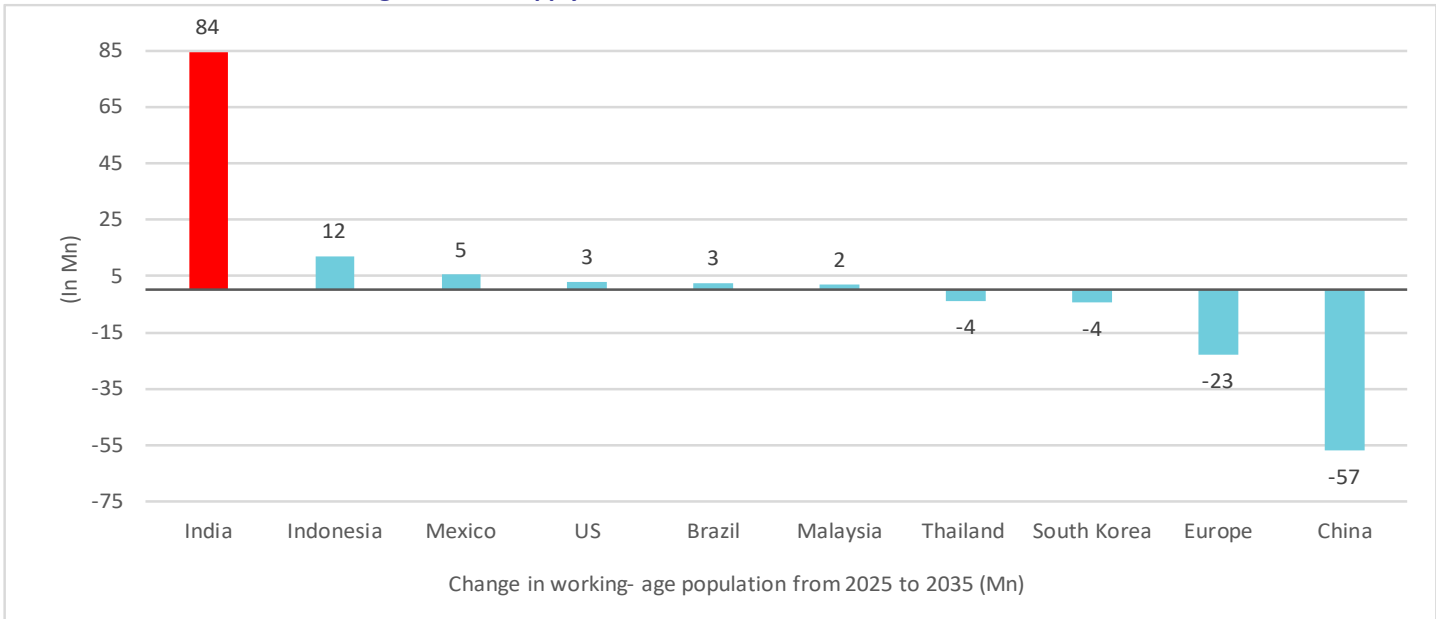
Note: Growth rates for FY21–22 are averaged to adjust for distortions from lockdowns and pent-up demand. NE refers to Nuvama estimates.

### NGDP growth of ~10% may be fastest, but is it sufficient?

At 10%, it is true that India’s NGDP growth is among the fastest in the world. That certainly stands out. However, the right benchmarks for judging whether the economic growth is in the fast or slow lane lies in domestic parameters such as level of per-capita income, rate of absorption of new labour joining the work force and trend in migration rather than how fast it is growing versus others. For example, a 5% NGDP growth may be good enough for the US economy to absorb its labour force, but a faster 10% growth for India could be insufficient.

In this regard, it is worth noting that over the next decade or so, India alone shall add 20% to the increase in the world’s labour force. In that sense, for India, a good growth is that which can gainfully employ the new entrants and pull the excess labour from the farm sector into the non-farm sector.

Exhibit 11: India to account for largest labour supply over next decade

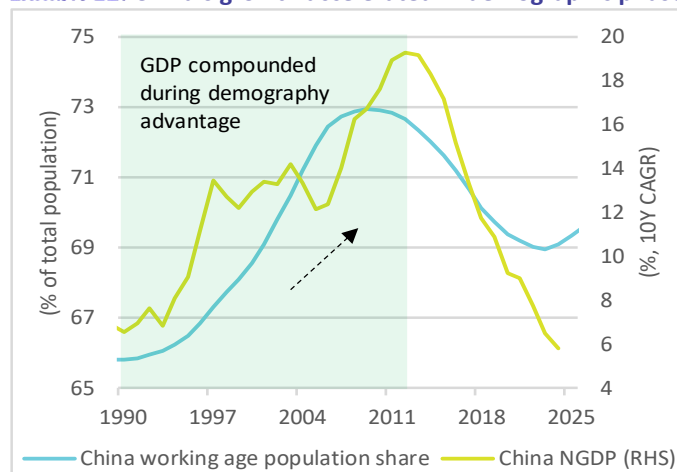


Source: World Bank, ILO, Nuvama Research

## Countries tend to grow fast during demographic bulge

A look at some countries that successfully absorbed the new entrants during their respective demographic bulge shows that these economies grew very rapidly for a sustained period. For example, some of the Asian economies such as China and South Korea have compounded growth very rapidly while some of the Latam economies such as Brazil lagged a bit.

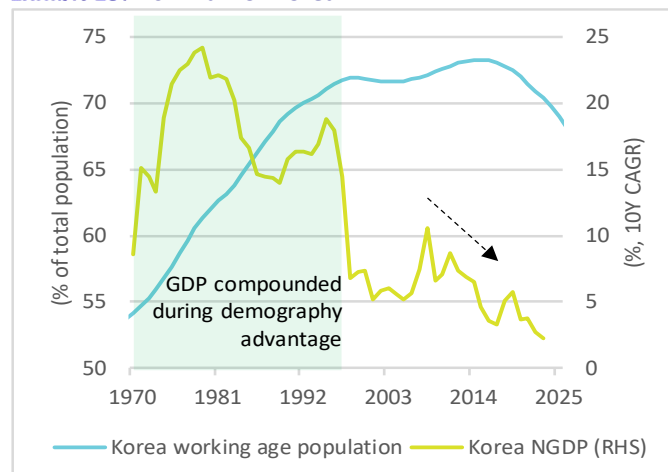
**Exhibit 12: China's growth accelerated in demographic phase...**



Source: World Bank, Nuvama Research

Note: Working-age refers to ages 15–64; NGDP is in USD terms.

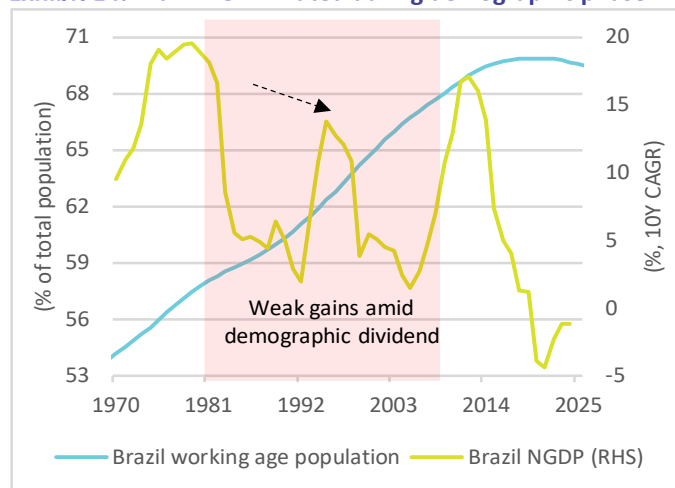
**Exhibit 13: ...similar for Korea**



Source: Bloomberg, Nuvama Research

Note: Working-age refers to ages 15–64; NGDP is in USD terms

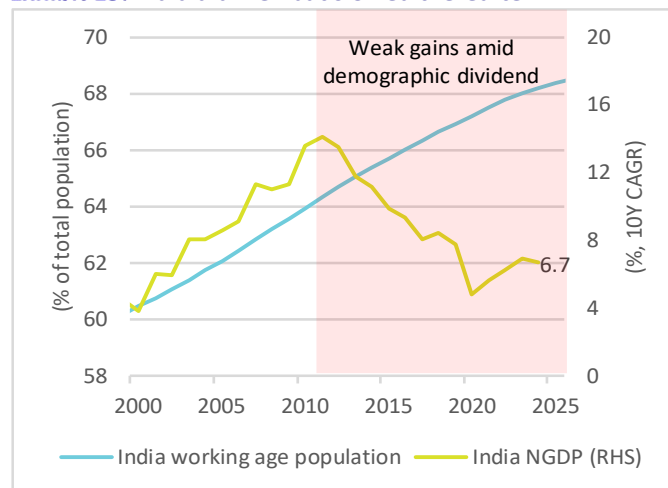
**Exhibit 14: Brazil NGDP muted during demographic phase**



Source: World Bank, Nuvama Research

Note: Working-age refers to ages 15–64; NGDP is in USD terms.

**Exhibit 15: India did well but slowed thereafter**



Source: World Bank, Nuvama Research

Note: Working-age refers to ages 15–64; NGDP is in USD terms.

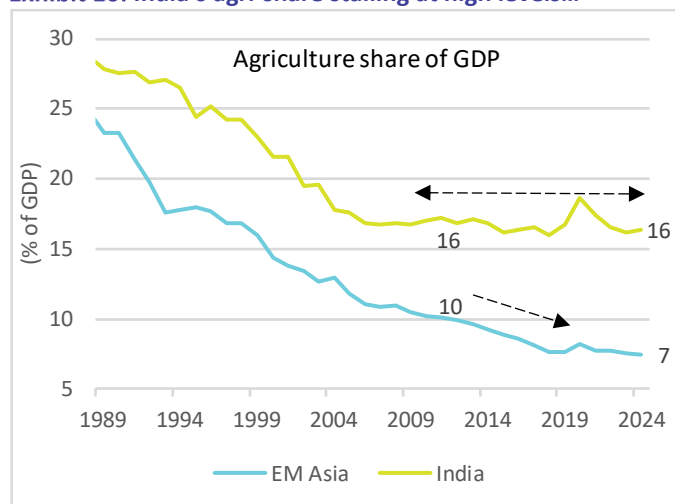
## At 10% NGDP growth, certain domestic parameters stalling

India's 10% NGDP growth, while the fastest in the world, could be insufficient from a domestic standpoint. We highlight three key parameters:

- Stalling of agriculture share of GDP at high levels:** First, over the last decade or so, India's agriculture share of GDP has stopped falling. It has been stagnant at around 17–18% and this phase has coincided with India's NGDP compounding at 10–11%. In contrast, during phases of much higher NGDP growth, agri-share was consistently dropping. Globally, the pace of drop starts to reduce when agriculture share drops below 10%.

- Per capita income catch-up with US has also slowed:** Second, during this phase of somewhat slower NGDP growth, we have also observed India's economic catch-up with the US stalling. This is to say that India's per capita GDP (in USD terms) as a percentage of US per capita income has been largely static since 2010–11, whereas it was rising in the previous decade. This is in sharp contrast to China, which was also at 3–4% of per capita GDP of the US at the start of the century, but is now at 18–20%.

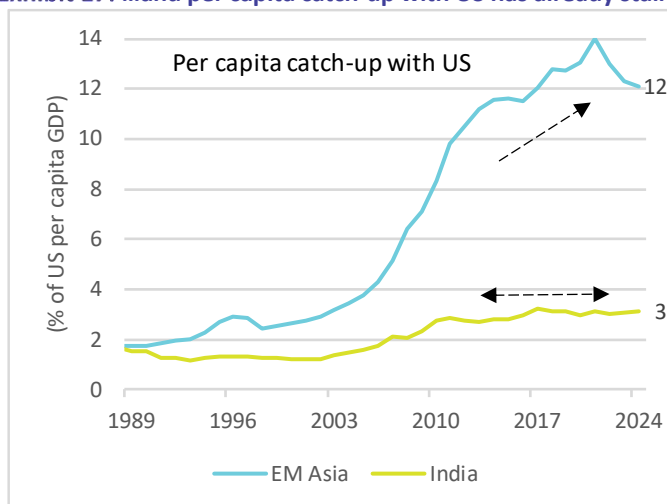
**Exhibit 16: India's agri-share stalling at high levels...**



Source: World bank, Nuvama Research

Note: EM Asia includes China, Thailand, Indonesia, Malaysia, etc.

**Exhibit 17: ...and per capita catch-up with US has already stalled**

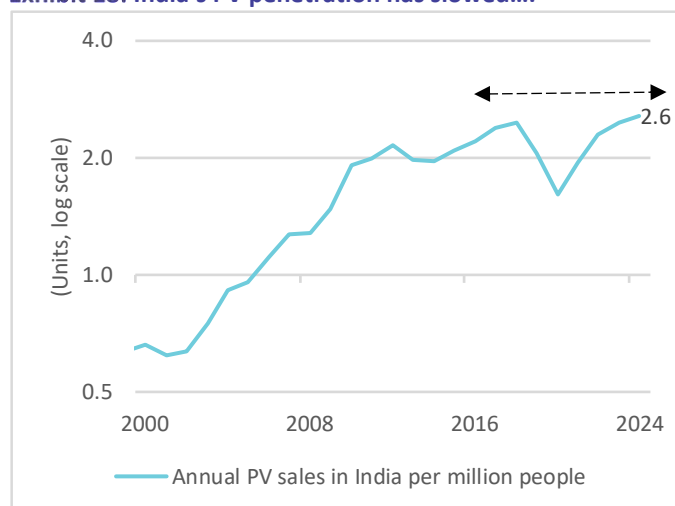


Source: World Bank, Nuvama Research

Note: EM Asia includes China, Thailand, Indonesia, Malaysia, etc.

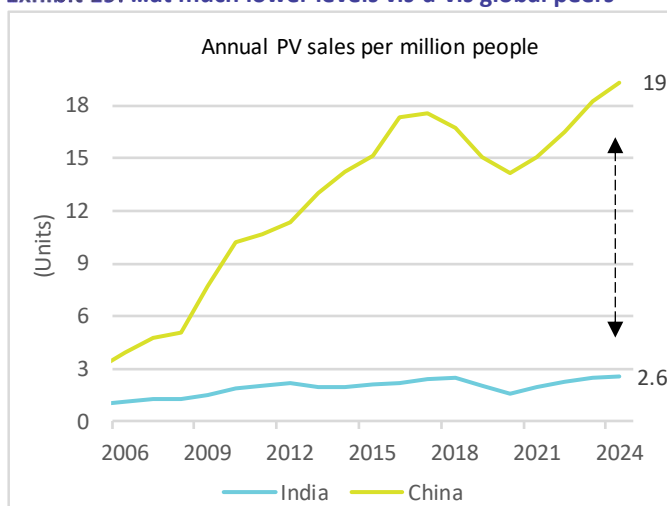
- Discretionary penetration has slowed at low levels:** We note that penetration in certain consumer segments such as PVs has been subdued. PV sales per million population rose at a CAGR of just 3% during FY14–24 compared with 10% in FY03–13—a markedly slower pace of penetration relative to EM peers.

**Exhibit 18: India's PV penetration has slowed....**



Source: Bloomberg, Nuvama Research

**Exhibit 19: ...at much lower levels vis-a-vis global peers**



Source: Bloomberg, Nuvama Research

These are just some of the domestic parameters, which clearly suggest that India's 10% NGDP growth, while among the fastest in the world, is possibly insufficient to sustainably and rapidly lift the living standards of the domestic population.

## Stability high; scale low: Hysteresis?

What explains a slower business cycle despite tremendous success with regard to macroeconomic stability, economic reforms, balance sheet clean-up and policy push? Is it hysteresis? In this section, we delve into what is hysteresis and how it has played through in India's context.

### Hysteresis: Short-run developments can have long-run effects

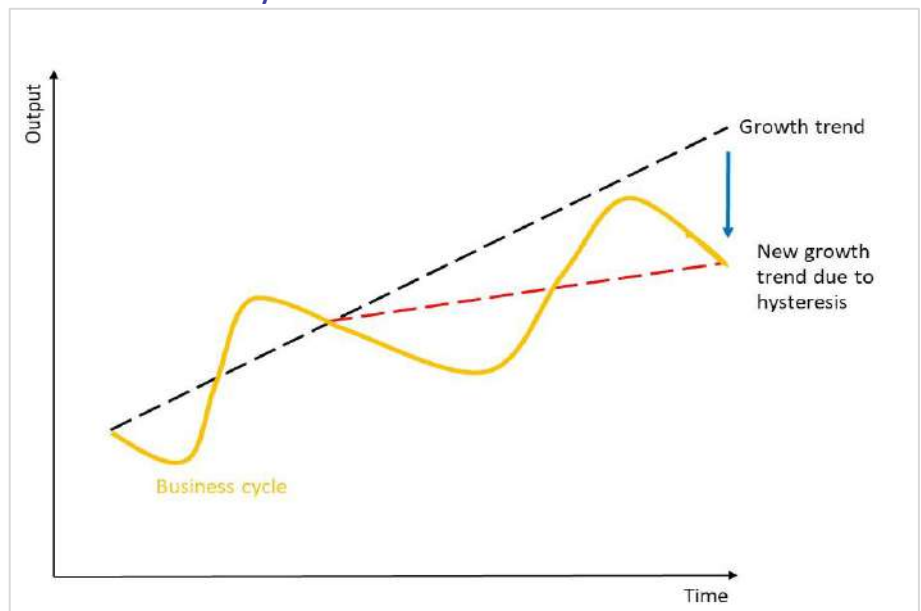
Hysteresis, as a general term, refers to a phenomenon where short-run or temporary developments cast a long shadow on the future behaviour. Sure, not all short-run developments have persistent effects, but some developments do tend to have lasting effects.

For example, if someone walking down a particular street trips over their shoelaces, he/she will likely continue to use the same route next time. However, if one is attacked while walking on a street or slips into an obscure manhole, he/she is likely to change his/her route next time.

In economics, as per conventional wisdom, the short-run or temporary developments or shocks (other than technological advancement) do not tend to alter the underlying trend growth of the economy. This is often true.

However, certain shocks do tend to have longer-run effects on the economy, which may be positive or negative. A number of academic scholars such as Larry Summers and Olivier Blanchard, among others, have applied the concept of hysteresis to the economic behaviour of the agents to explain the secular stagnation that much of the western economies faced after the GFC.

### Exhibit 20: How does hysteresis work?

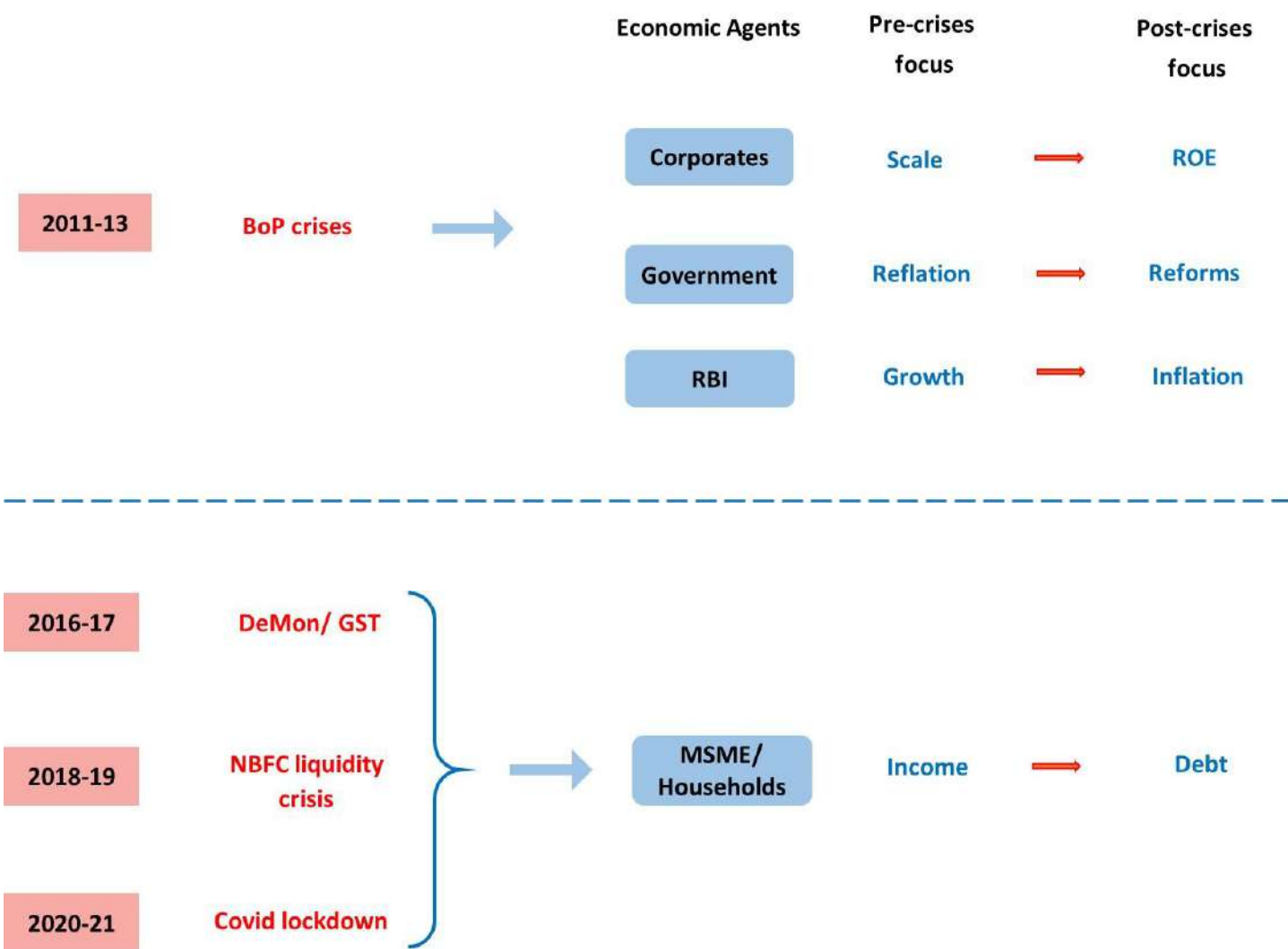


Source: Nuvama Research

### India: Economic shocks and hysteresis

We posit that one of the ways to understand India's economic experience over last 10–15 years is to take note of the notion of hysteresis. The Indian economy has been subjected to a series of shocks, which have had a persistent effect on the behaviour or decision-making of economic agents, particularly businesses and policymakers—and by extension even on MSMEs and HHs. We delve into the details below.

Exhibit 21: How crises affected economic agents?



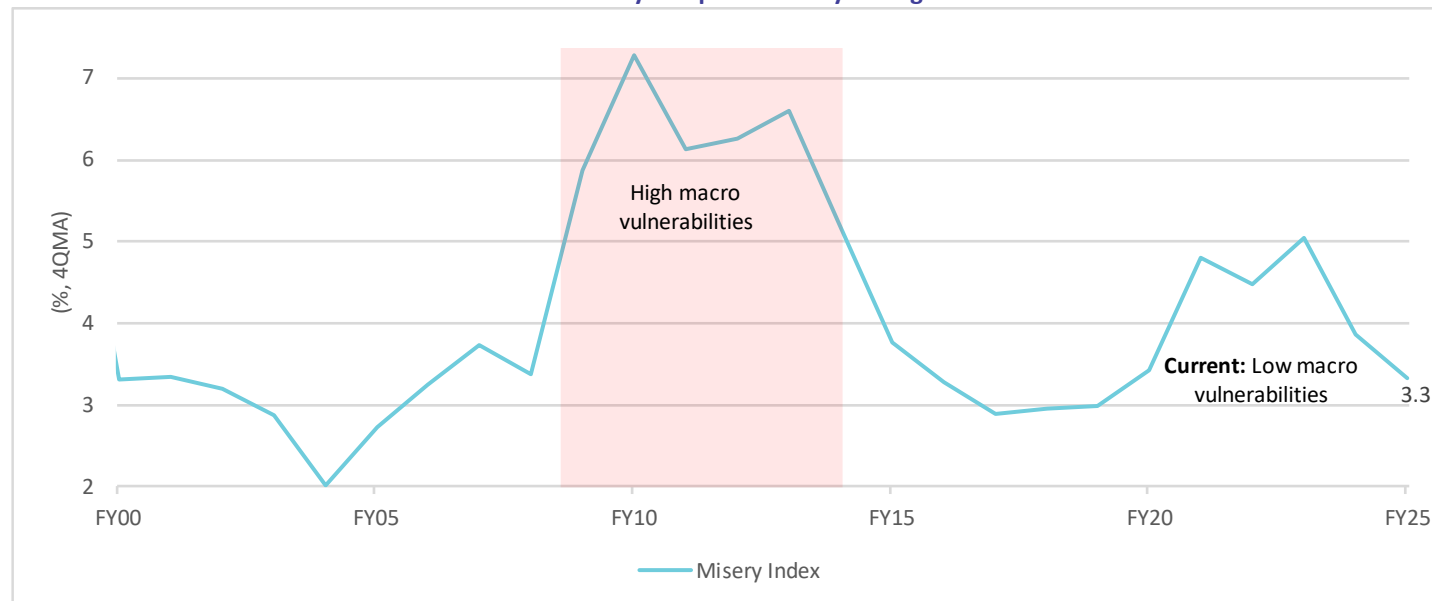
Source: Nuvama Research

**BoP crisis (2011–13): Lasting impact on businesses, policymakers**

The Indian economy was subjected to significant and painful balance of payments adjustments during 2011–13. Excessive pump-priming of the economy in the wake of the GFC and global commodity price shock led to a sustained deterioration in India’s macro parameters such as inflation, twin deficits and external debt.

The absence of economic reforms further complicated matters, triggering a loss of confidence among investors and capital flight. Currency plunged, rates spiked and liquidity tightened rendering investment projects unviable. All this ended up compromising the balance sheets of large businesses and lenders, and even macro-stability was compromised.

**Exhibit 22: Macro vulnerabilities have reduced drastically compared to 12 years ago**



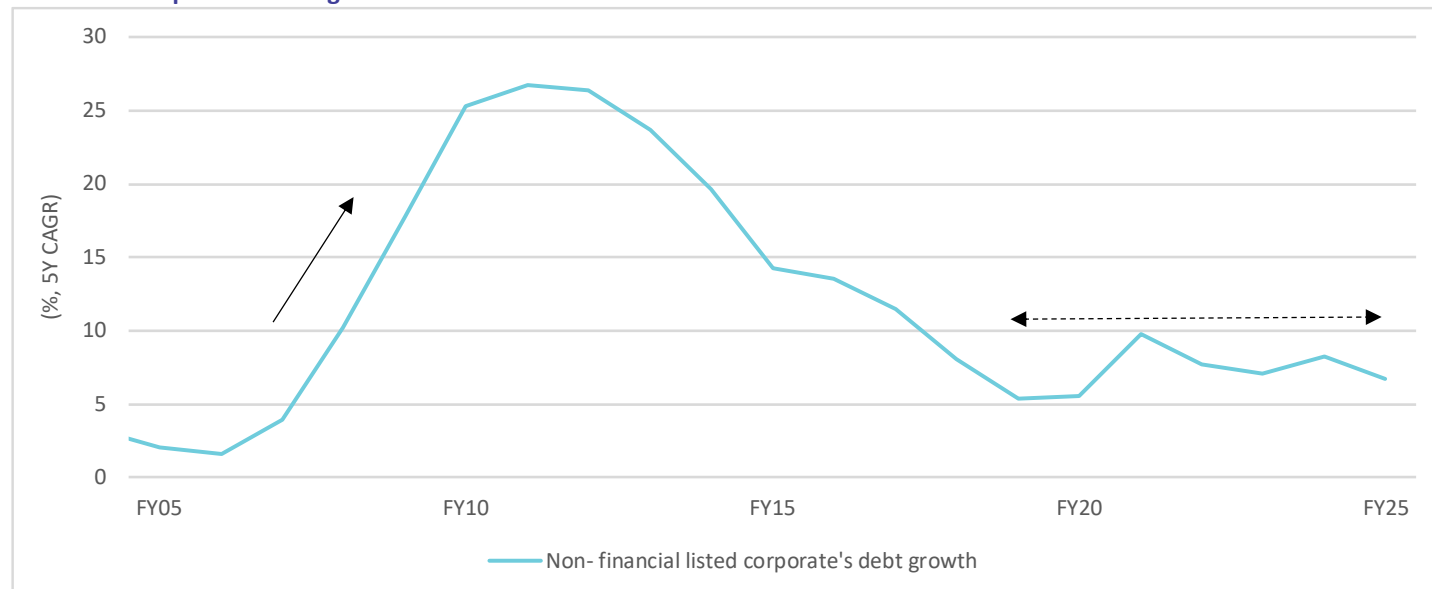
Source: CMIE, Nuvama Research

Note: Misery Index is the average of inflation, current account deficit and fiscal deficit as a share of GDP.

## Corporates: Shifted focus from scale to balance sheet and RoE

The episode left scars on the balance sheets of the businesses and casted a long shadow on their behaviour/decision-making. The problem was not that businesses retrenched investment and worked to reduce debt in the immediate aftermath (that was indeed desirable); rather, even after the shock is long gone and balance sheets are in excellent health, the corporates remain balance sheet-focused, prioritising RoE over scale. This smacks of hysteresis.

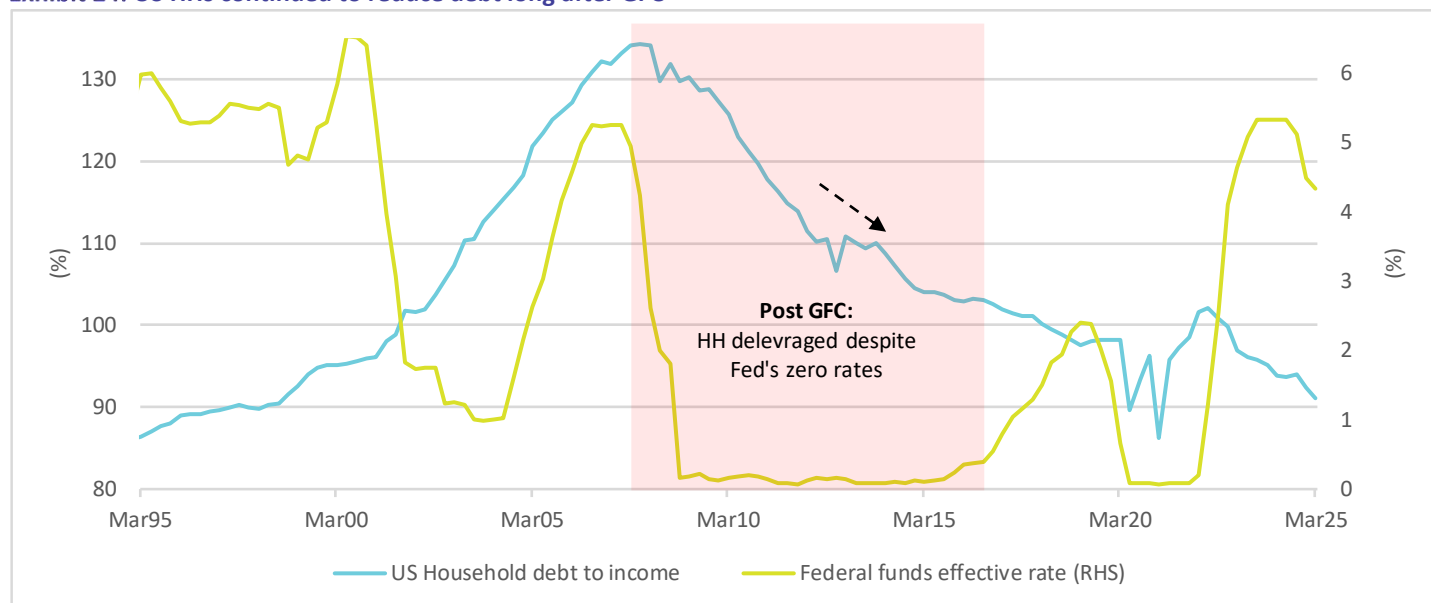
**Exhibit 23: Corporates' debt growth remains low as focus shifts from scale to RoE**



Source: CMIE, Nuvama Research

A similar lasting change in behaviour of economic agent (or hysteresis) was famously observed among US consumers after the GFC. It triggered massive debt aversion among households long after the shock was gone and despite the Fed's zero percent interest rates.

**Exhibit 24: US HHs continued to reduce debt long after GFC**



Source: Bloomberg, Nuvama Research

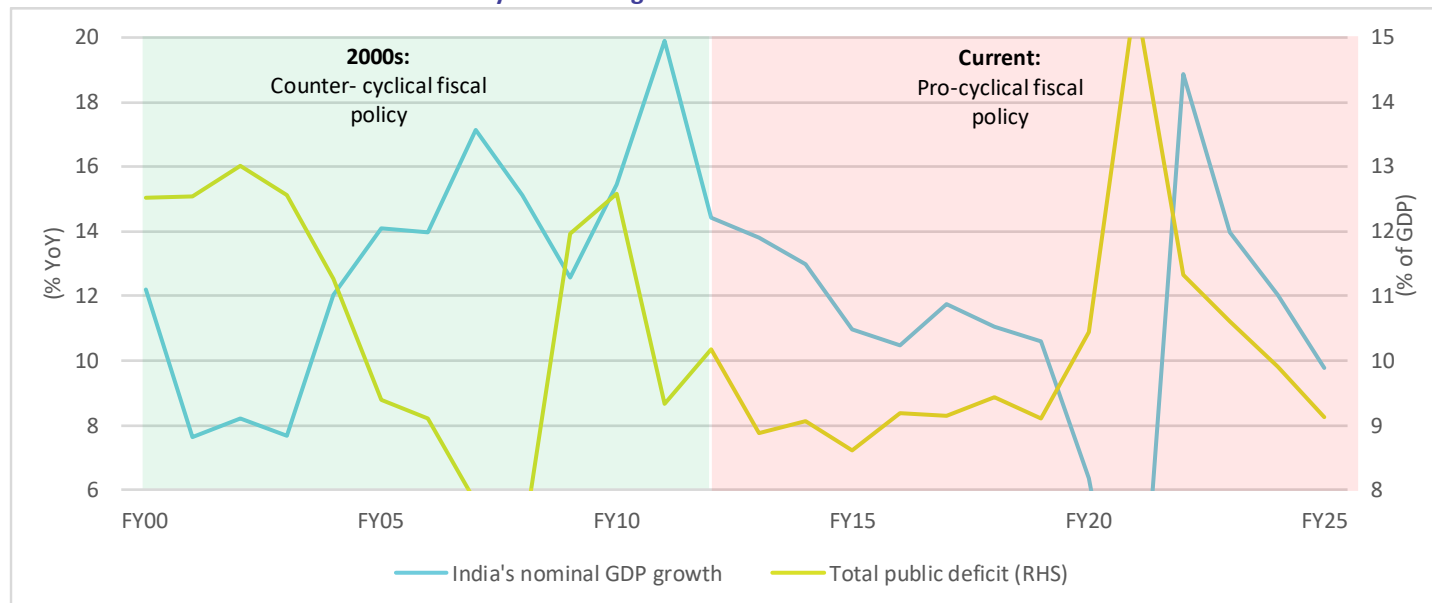
## Government: Focus shifted from reflation (demand) to reforms (supply)

The 2013 crisis also had a lasting effect on the government's approach to policymaking. The crisis demanded fiscal retrenchment as well as economic reforms to restore investor confidence even if it meant slower growth domestically. But here again, much like corporates, the government took the desirable step of fiscal retrenchment as the crisis escalated. However, long after the shock is gone and the government has regained significant policy credibility, the fiscal policy stance continues to be pro-cyclical.

Surely, during phases of economic slowdown, the government did respond in the form of corporate tax cut in 2019, infrastructure spending during 2022–24 and income tax cut along with GST cut in FY26; however all these measures were undertaken while sticking to the path of fiscal consolidation.

In other words, the 2013 shock did have lasting impact on India's fiscal policy approach. Now it is seen as more of an instrument of macroeconomic stability rather than demand management in the economy.

**Exhibit 25: Government focussed on stability even during downturns**



Source: CMIE, Nuvama Research

Note: Public deficit = Central government fiscal deficit + States fiscal deficit + Borrowings of PSUs (NHAI, Railways, FCI, NTPC, Coal India, etc)

In fact, the shift in the approach to fiscal policy after the 2013 shock (stagflationary shock) was seen on the monetary policy side as well. Keynesian business cycle management took a backseat. On this front, the evolution of India's economic policymaking after the stagflationary shock of 2011–13 bears a striking resemblance to the US experience after the stagflation of 1970s.

### Central bank: Focus shifted from growth to inflation

The stagflation of 2010–13 also shaped the RBI's approach to policymaking.

- A new monetary framework of flexible inflation targeting was instituted, wherein the RBI was mandated in clear terms to keep inflation in check.
- Inflation target moved to headline CPI (WPI was out of consideration) at 4% with +/-2%.
- A bigger focus on maintaining INR stability to ensure imported inflation remains under check.

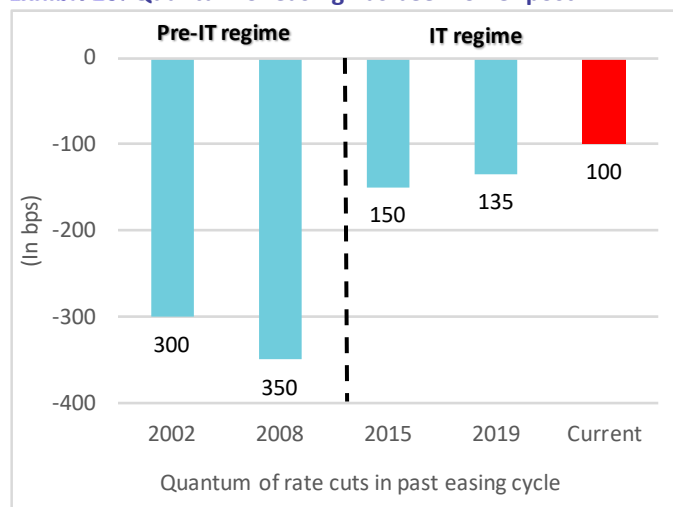
In our view, while monetary reform was much needed after the stagflation experience, we think policymakers ended up instituting an overly stringent framework, which was somewhat ill-suited to India's macroeconomic setup in our view. After all, the CPI has nearly a 45% weight of food commodities, which are neither forecastable nor influenced by monetary policy actions.

This led to wide deviations in the RBI's 12-month ahead projections of inflation from the actual outcomes. These deviations were mainly the result of large fluctuations in the food inflation relative to expectations. In any case, this inhibited RBI's ability to respond timely to the evolving underlying inflation and growth dynamic.

But, in addition to some of the problems of institutional design, there is an issue with the way the RBI actually runs this new framework, which ended up being overly constraining from a growth standpoint. For example:

- RBI's monetary easing post-2013 episode has been progressively shallower, rendering real rates structurally higher.

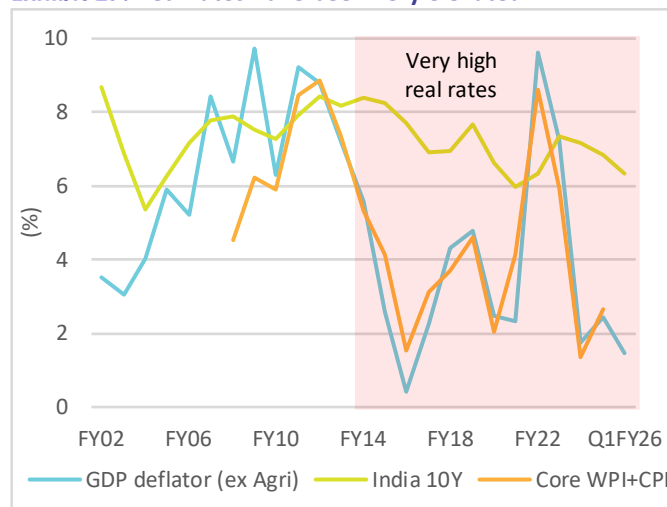
**Exhibit 26: Quantum of easing has been lower post-IT**



Source: Bloomberg, Nuvama Research

Note: Policy rate pre-GFC is taken as average of repo and reverse repo; post-GFC is repo rate. IT refers to Inflation Targeting.

**Exhibit 27: Real rates have been very elevated**



Source: CMIE, Nuvama Research

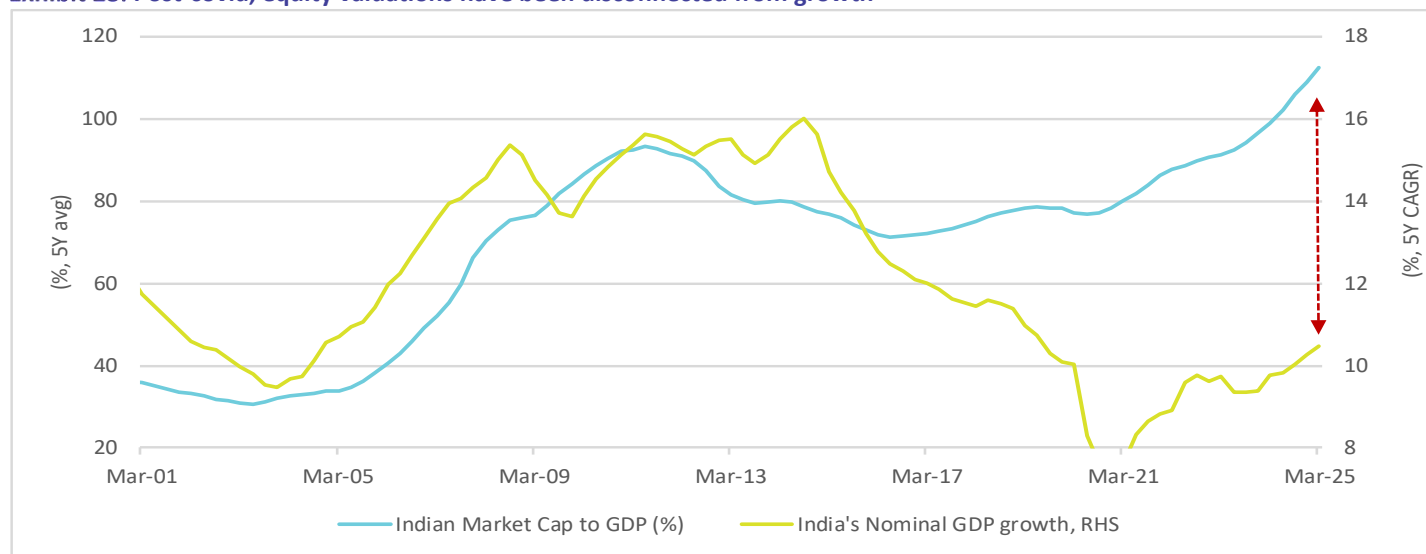
Note: Average of manufacturing WPI and CPI is included.

- The RBI relied too heavily on real GDP growth and thus overestimated the strength in the underlying economy even during periods where NGDP growth was trending lower and, as discussed in the sections above, NGDP is a better gauge of the direction and strength of the business cycle vis-a-vis RGDP growth.
- Furthermore, if one looks at interest rates (10Y yield) against core deflator (non-agriculture deflator), it is striking that real long-term rates have been very elevated after the adoption of the inflation targeting framework.

In all, we think the 2013 shock injected a significant anti-inflation bias in the monetary policymaking

The combination of improved balance sheets, series of economic reforms, stable inflation and exchange rate regime along with a revival in RoE after the pandemic was handsomely rewarded by investors. In effect, after garnering stability, investors' focus shifted from scale to RoE. In other words, capital worked to lift market cap/wealth (MCAP) without necessarily lifting the NGDP/income growth trajectory. This led to a notable divergence between MCAP and NDGP growth.

**Exhibit 28: Post-covid, equity valuations have been disconnected from growth**



Source: Bloomberg, CMIE, Nuvama Research

## Sequence of shocks (2016–22): Lasting impact on MSMEs/HH

As argued above, the BoP shock of 2011–13 shifted the focus of businesses and the policymakers towards security balance sheets and macroeconomic stability, respectively, and this in turn worked to constrain the income dynamic of the HH/MSME. But, what is more notable is that HHs/MSMEs were subjected to their own share of exogenous shocks during 2016–22, which hamstrung small businesses (MSMEs) and households.

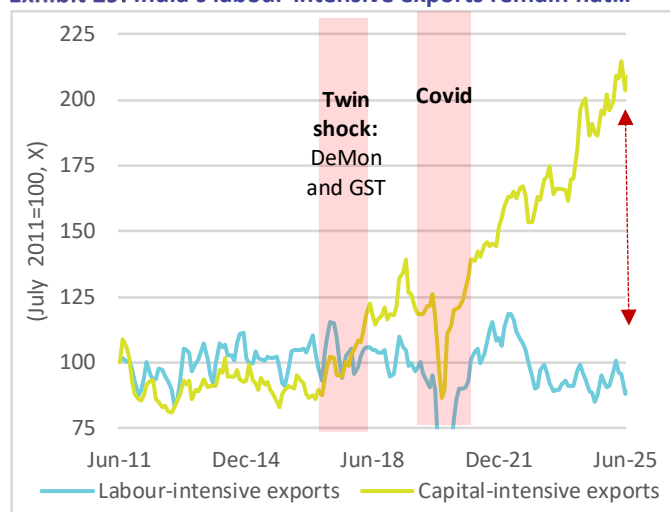
- **2016–17: Twin shocks of DeMon and GST:** Without going into merits/demerits of these moves, it is clear that the twin shock fell heavily (near-term basis) on MSMEs and households. Large businesses, however, ended up benefitting from the move as they gained market share from smaller companies.
- **2018–19: NBFC liquidity crisis:** IL&FS default triggered the liquidity crisis in the NBFC space, causing a significant retrenchment in NBFC lending to MSMEs and HHs, which were just emerging from the twin shocks of DeMon and GST.
- **2020–21: Covid lockdowns:** Again, the lockdown disproportionately impacted the MSMEs and self-employed/casual workers in the economy versus large businesses and salaried workers.

### MSMEs: Repeated shocks impair the ability to operate and compete

The cumulative effect of these series of adverse shocks on the MSME sector was the reduced ability to operate, produce and remain competitive. Not only larger businesses (in the formal sector) gained at the cost of MSMEs, but in select pockets such as textiles, leather goods and the like, India's MSMEs seem to have lost market share to Bangladesh, Vietnam, etc. s

Surely, government extended a helping hand through bridge loans, but perhaps the repeated nature of shock significantly hurt their ability to bounce back.

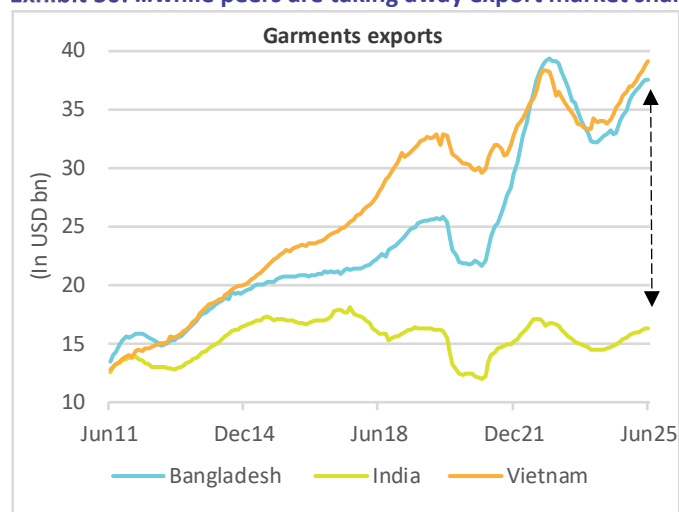
**Exhibit 29: India's labour-intensive exports remain flat...**



Source: CMIE, Nuvama Research

Note: Labour-intensive includes leather, textiles, handicrafts, sports goods, footwear and jewellery; capital-intensive includes chemicals, autos, machinery, electronic goods, etc

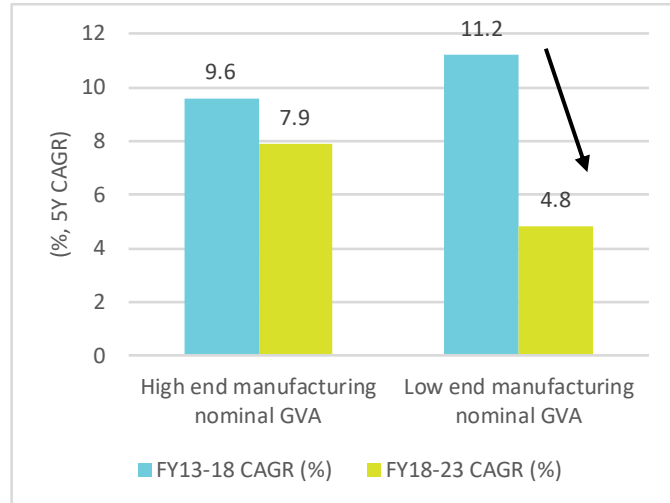
**Exhibit 30: ...while peers are taking away export market share**



Source: Bloomberg, CMIE, Nuvama Research

Thus, post-covid, there is a large skew in growth of high value-added manufacturing (autos, chemicals, etc) and low value-added manufacturing (textiles, leather, etc), and high value-added services (finance, IT) and low value-added services (trade services, etc).

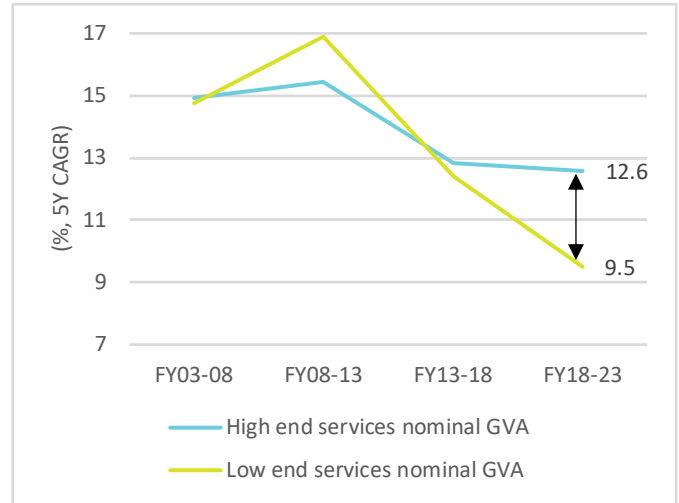
**Exhibit 31: Low-end manufacturing softer post-covid...**



Source: RBI's KLEMS survey, Nuvama Research

Note: High-end manufacturing consists of refining, chemicals, rubber, metals, machinery and transport industries; low-end manufacturing consists of food, textiles, electrical equipment and wood products.

**Exhibit 32: ...as happened with low-end services**



Source: RBI's KLEMS survey, Nuvama Research

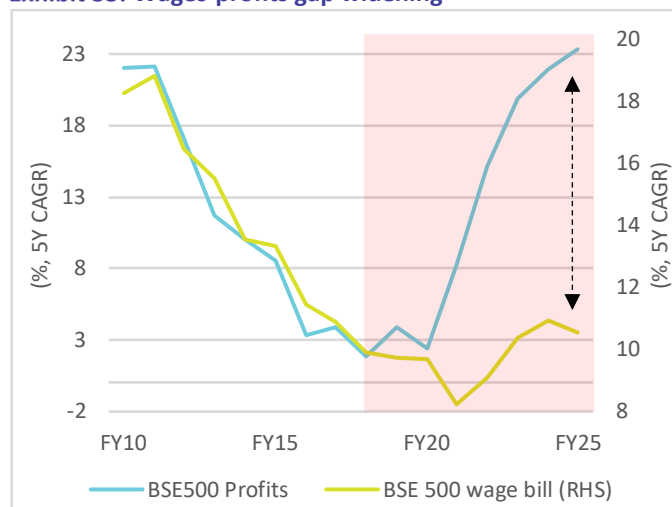
Note: High-end services include finance, IT and telecom; low-end services include trade, transport, health and education.

## Households (HH): Income dynamic compromised

In effect, the household sector suffered from slower income dynamic because of two factors. First, large corporates and the government became balance sheet-focused as argued above, which directly impacted the job/income dynamic of the household sector. In fact, it is worth noting the disconnect in corporate profits and household wages in recent years.

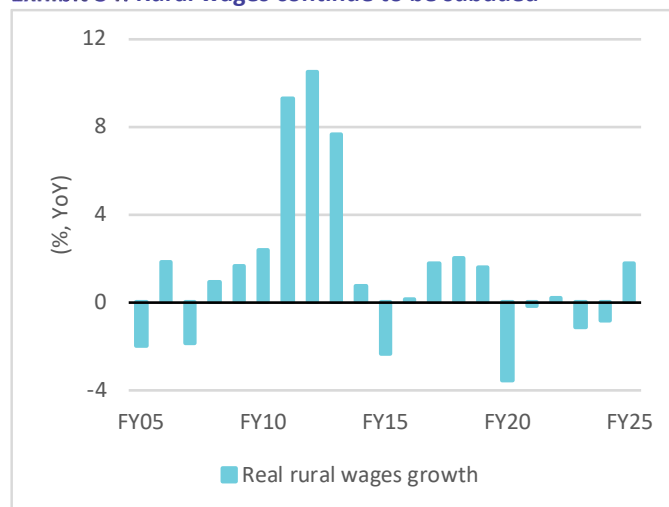
Second, HH also bore the brunt of impairment of the ability of MSMEs (labour-intensive) to operate and compete, which in turn has led to stagnation of real rural wage growth.

**Exhibit 33: Wages-profits gap widening**



Source: Capitaline, Nuvama Research

**Exhibit 34: Rural wages continue to be subdued**



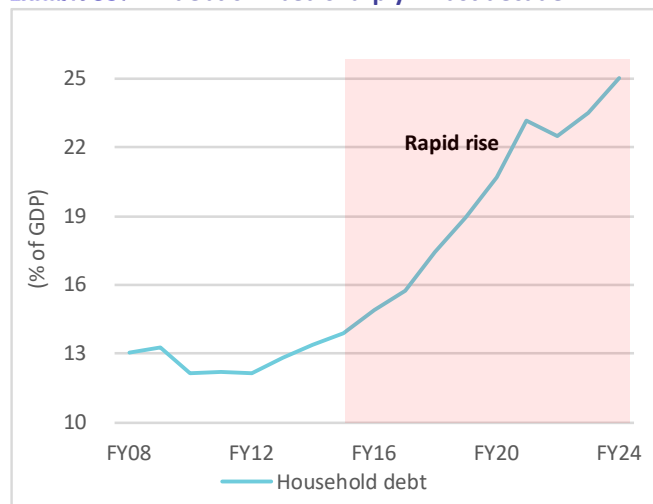
Source: CMIE, Nuvama Research

Note: Nominal wages are deflated using industrial worker CPI.

## Net result: HH spending re-anchored from incomes to debt

The cumulative effect of these series of shocks on the household sector was the impairment of the income dynamic through direct and indirect channels. Consequently, HH increasingly relied on leverage and positive wealth effect (equity market boom) to maintain their spending power.

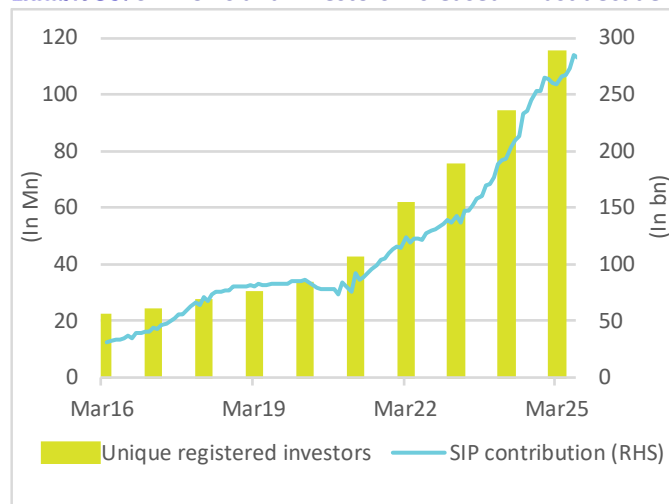
**Exhibit 35: HH debt climbed sharply in last decade**



Source: CMIE, Nuvama Research

Note: Household debt is banks personal loans+ HFC loans + NBFC personal loans.

**Exhibit 36: SIP flows and investors increased in last decade**



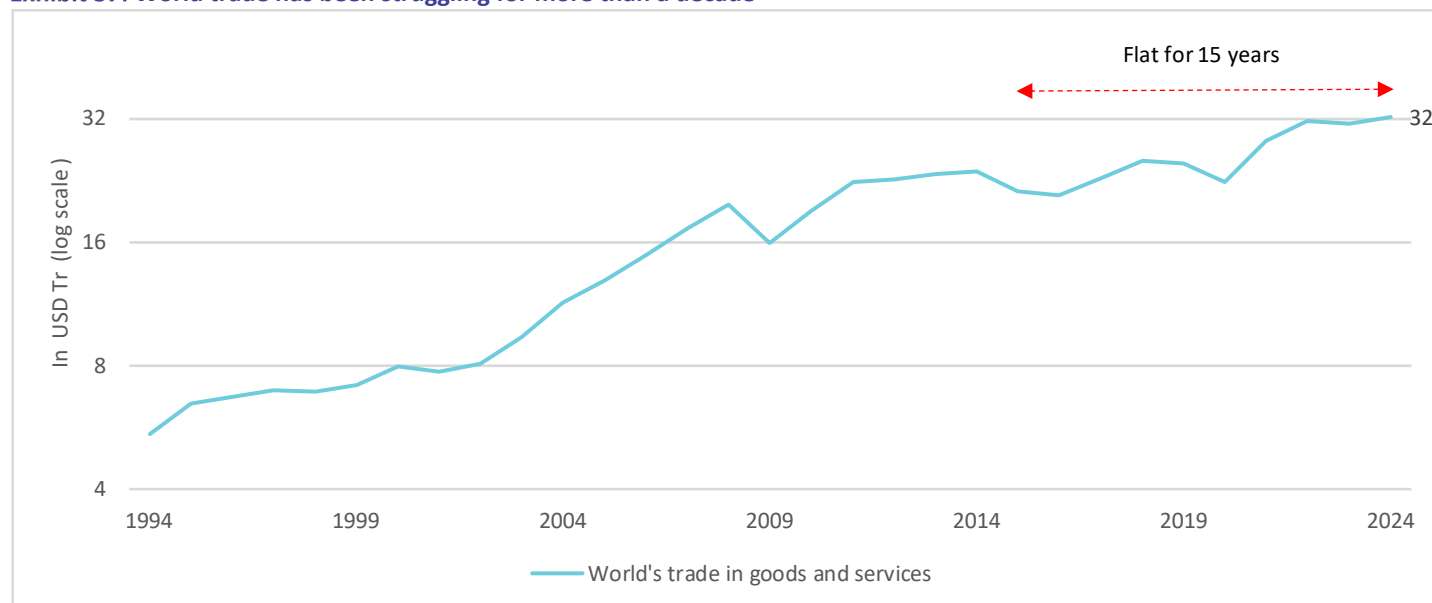
Source: CMIE, NSE, Nuvama Research

Note: SIP contribution is monthly.

## Global slowdown also weighed

To top it all, this protracted period of repeated economic shocks in the domestic economy happened at a time when the global economy too was in a slow lane for much of the period since 2012. This clearly reflected in the subpar performance of India's exports. Hence, there wasn't any offset of weak domestic demand from the global side either.

**Exhibit 37: World trade has been struggling for more than a decade**



Source: World Bank, Nuvama Research

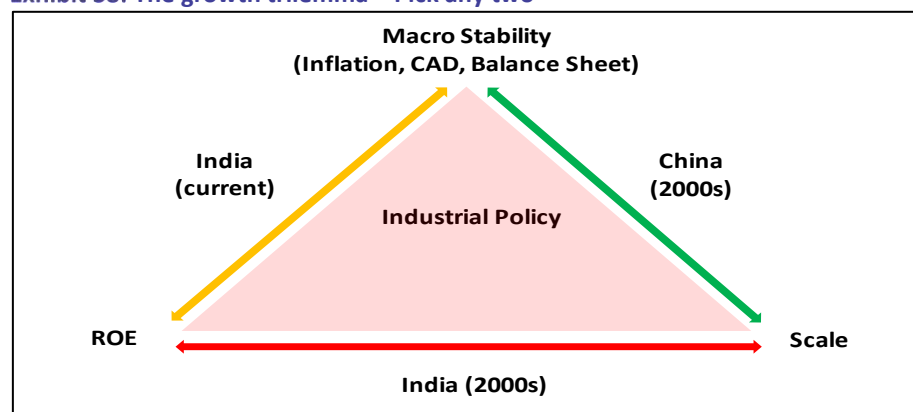
## Net result: India's macro-regime flipped 2012 onwards

All things considered, India's macroeconomic regime flipped 2012 onwards. Hysteresis effect meant that while the capacity of the economy—balance sheets, macro-vulnerability parameters, economic reforms—improved significantly, demand formation in the economy lagged.

One can capture this shift in India's macroeconomic regime through our framework of growth trilemma. Before 2012, India operated a high-pressure economy that delivered scale to the economy and RoE to shareholders. However, in that process, balance sheets got stretched and macro-vulnerabilities deepened, precipitating a BoP crisis.

Post-2013, the economy began operating as a low-pressure economy that first restored macro-stability and then delivered RoE to shareholders. However, in that process, scale has been compromised.

**Exhibit 38: The growth trilemma – Pick any two**



Source: Nuvama Research

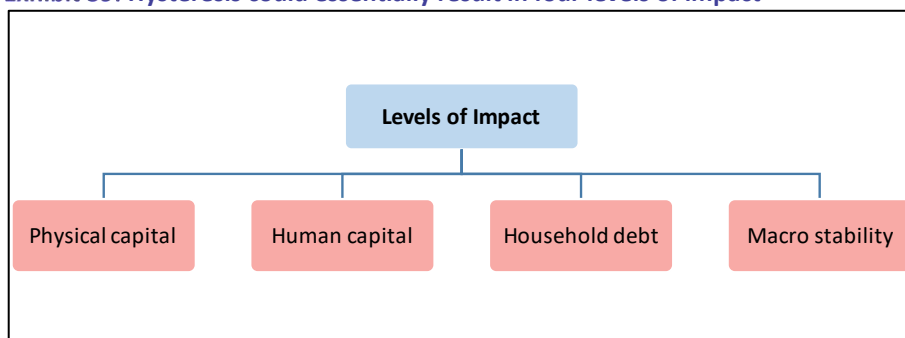
## Can weak cycle undermine trend itself?

In the sections above, we show how a sequence of exogenous shocks over the last decade or so produced hysteresis effect that worked to alter the behaviour of the economic agents in a very significant sense. It effectively re-anchored the economy from demand side to supply side. On the one hand, hysteresis worked to improve the capacity or the potential of the economy and restore the macroeconomic stability; on the other, it weighed on demand formation in the economy. NGDP is compounding around 10%, which is at the lower end of historical range and potentially insufficient to fully utilise/absorb excess labour in the economy.

In this section, we take the matter further and posit that if demand formation continues to remain subpar, it may start to affect the underlying capacity or even potential of the economy (Say's Law in reverse?). In other words, hysteresis could turn endogenous. In effect, the question is: will a new equilibrium of 10% NGDP growth continue to deliver 10% growth over coming years, or should we be mindful of the risk that if current demand conditions persist, the economy over time could re-equilibrate lower as weak demand begins to impair the potential or productive capacity of the economy?

In our view, weak demand could potentially undermine physical capital, human capital and debt capacity and even work to weigh against the macro stability of the economy. We discuss their dynamics in detail below.

### Exhibit 39: Hysteresis could essentially result in four levels of impact



Source: Nuvama Research

### Physical capital: Building factories and infrastructure

At any given time, economy produces two kinds of goods: consumer goods for current consumption and investment goods that drive future growth. Barring short-duration intermittent periods, private capex as a percentage of GDP has been gradually coming off over the last 12–13 years. There have been a few attempts at capex revival, for example in 2014–15 or 2016–17 or 2022–23, but none sustained.

### Corporates: Capex weak despite strong balance sheets, reforms

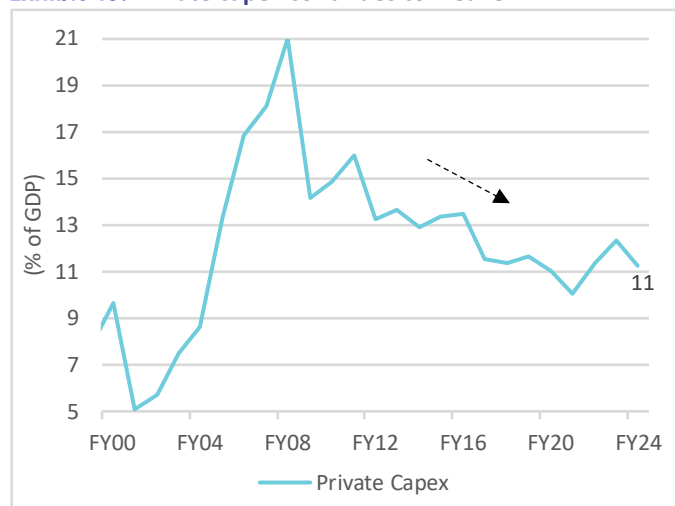
Over the last decade or more, businesses have seen several favourable developments.

- Balance sheets have improved very significantly.
- Government has given tax cuts to enhance business competitiveness vis-a-vis other countries.
- PLI schemes for various sectors.

- Global supply chain diversification (China + 1).
- Several economic reforms including ease of doing business, GST, etc.
- Government's own infrastructure push to crowd in private investment.

Despite all these measures, corporates are reluctant to invest on a sustained basis. Private capex as share of GDP, which has come off from its 2012 highs, is yet to show a sustained turnaround. Even R&D spend as share of GDP has come off a bit.

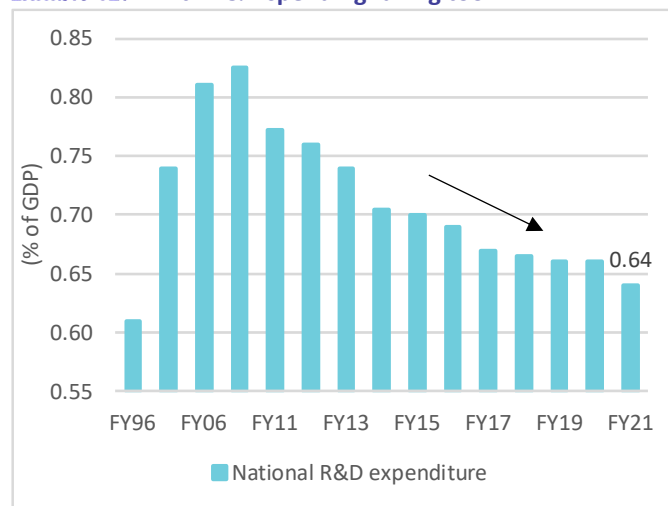
**Exhibit 40: Private capex continues to weaken...**



Source: CMIE, Nuvama Research

Note: Private capex refers to GCF of private sector (HH+ Corporate).

**Exhibit 41: ...with R&D spending falling too**

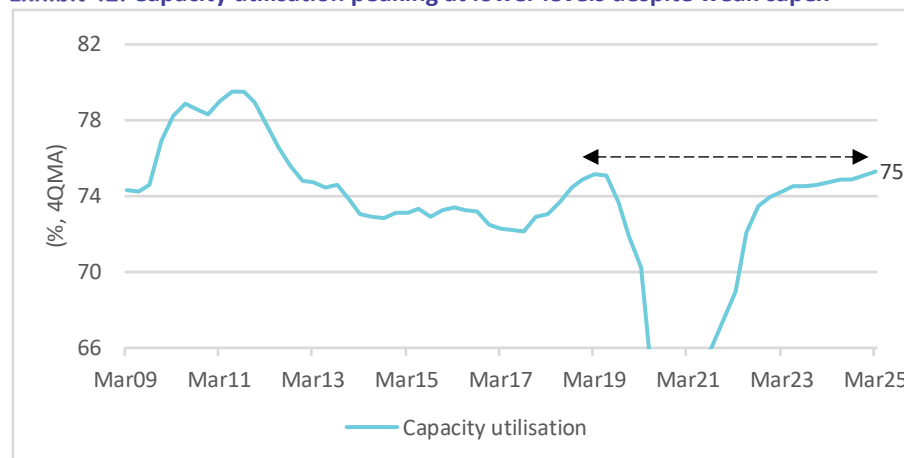


Source: NSTMIS, Dept. of Science & Technology, Nuvama Research

Note: Data prior to FY10 is only available for FY96, FY01 and FY06.

The issue is prolonged demand weakness. After all, despite slow capex creation for over a decade, capacity utilisation industrywide has not been crossing 75–76%. Amid this, businesses—being RoE-focused—remain reluctant to create new capacities. Instead, they will be incentivised to pursue M&A, which in turn will reduce competitive intensity in the economy. In this way, weak demand would begin to impede capacity or potential of the economy (hysteresis).

**Exhibit 42: Capacity utilisation peaking at lower levels despite weak capex**



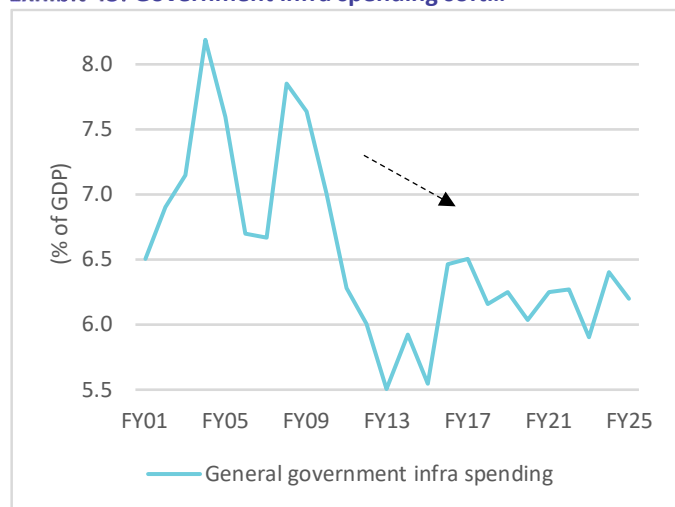
Source: CMIE, Nuvama Research

## Government: Infrastructure creation subpar

Another implication of the low-pressure economy (high on stability, low on demand) is that the tax base of the country (tax to GDP) is not scaling up in any material way. General government tax collections as a percentage of GDP have been stuck in the 16–17% range for more than a decade now. In addition, the government too remains debt-averse for macro-stability reasons. The combination of these two factors is constraining the government's ability to spend big on infrastructure.

For instance, the general government infra/capex spend as a share of GDP has been largely flat at relatively moderate levels. Surely, central government shored up infra/capex spend, but state governments and some public sector entities such as the NHAI and Indian Railways have actually scaled back spending.

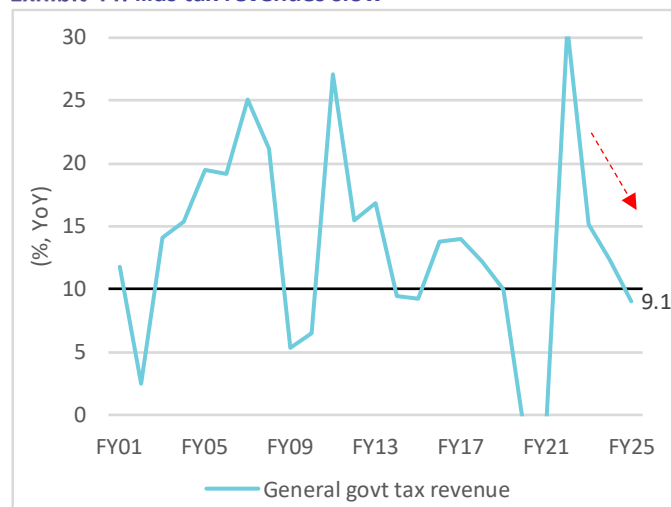
**Exhibit 43: Government infra spending soft...**



Source: CMIE, Nuvama Research

Note: Infra = Centre + State + PSU capex (excluding defence).

**Exhibit 44: ...as tax revenues slow**



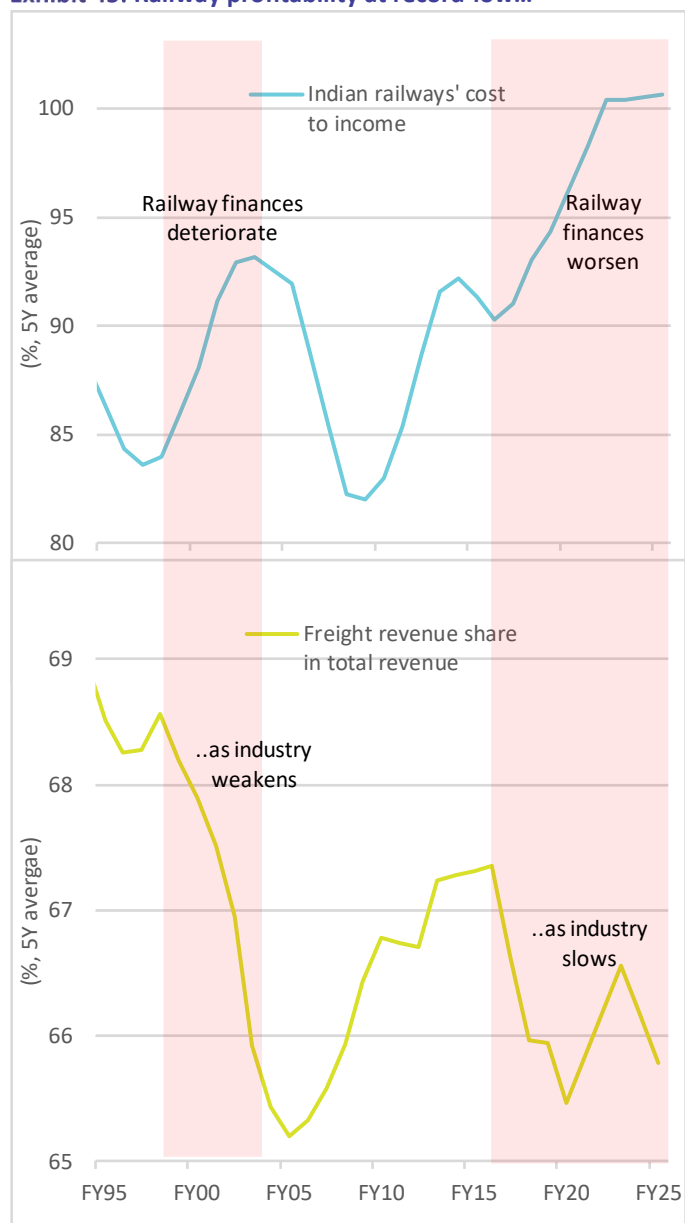
Source: CMIE, Nuvama Research

A related phenomenon is also at play particularly in the field of infrastructure. Despite economic reforms in the power sector and big focus on railways, one is seeing deterioration in railways' operating ratio (cost to income) and a rise in state electricity boards' (SEBs') losses in the power sector.

Here again, the reason is that in a low-pressure economy or a weak demand economy, industrial expansion plans have been in a slow lane for a while and it is the industry that is the high-paying customer of railways and the power sector.

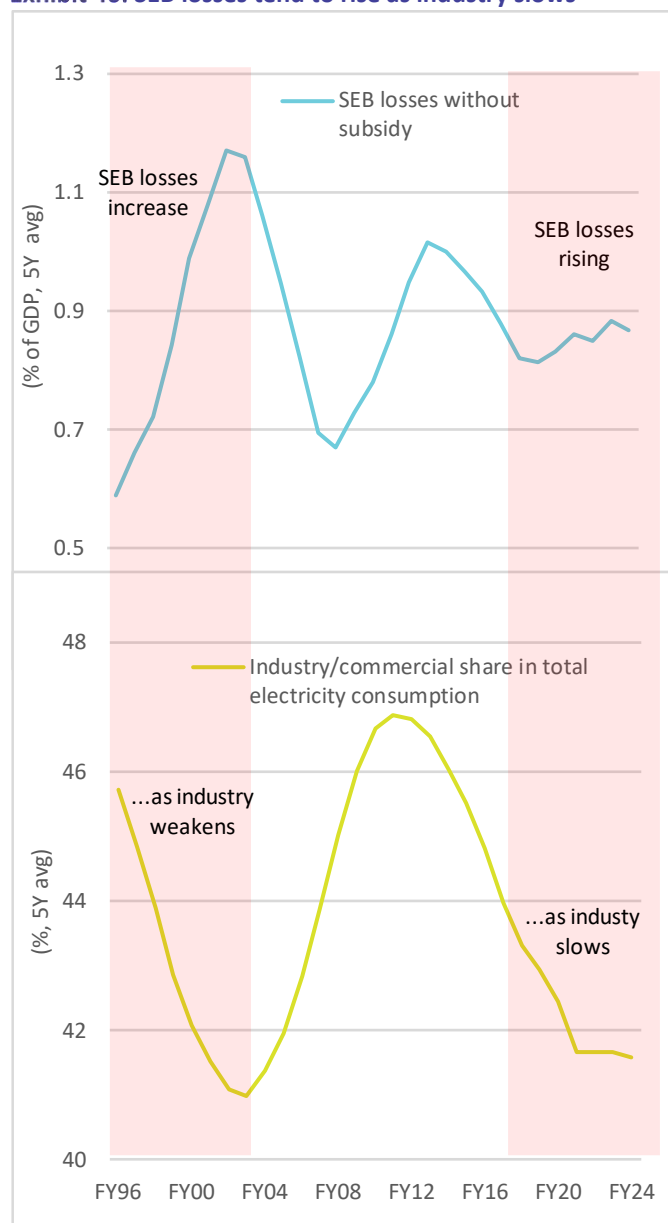
It is no surprise that when India saw large industrial expansion/capacity creation during 2000s, SEBs' losses had declined rapidly and even the railways' operating ratio had improved.

**Exhibit 45: Railway profitability at record-low...**



Source: CMIE, Nuvama Research

**Exhibit 46: SEB losses tend to rise as industry slows**



Source: CMIE, PFC report on State finances, Nuvama Research

Note: SEB losses are losses excluding tariff subsidy.

This is how persistently subpar demand could begin to impinge on forward-looking capacity creation in the economy.

## Human capital: Migration, skilling and labour productivity

Innovation and deepening technology are the key sources of productivity in an economy. But, at a low per capita income level, an economy can move up the productivity ladder through migration, which is to say moving a labourer from a less-productive sector of the economy to a little more productive sector. Labourers migrating from rural to urban centres or from agri-related activities to a non-agriculture sector (low-end manufacturing/low-end services) can drive up productivity. And, within the non-agri sector, people migrating from casual/self-employed to salaried or informal to formal sector also aid productivity.

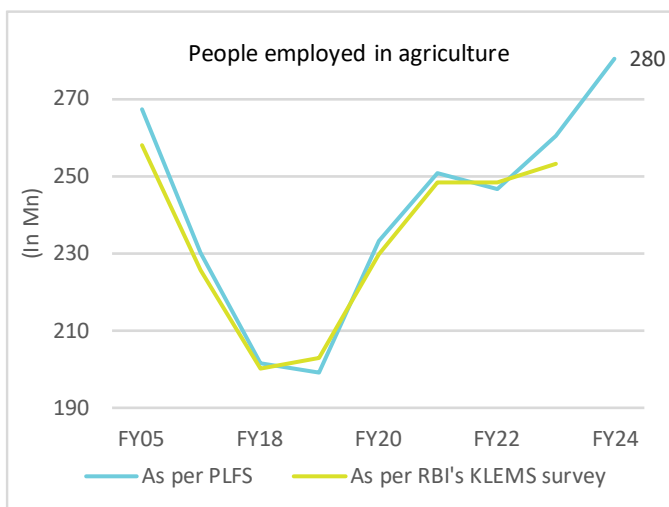
However, if the economy is low on demand for a prolonged period, it could start hurting labour productivity. Not only could migration slow, but even the skill formation in the economy could suffer. After all, in a weak demand environment, wherein job generation is relatively slow, not only spends on education/vocational training could slow, but the skill acquisition that comes with learning-on-the-job could also suffer. At the same time, late entry into the labour market or staying out of work for prolonged periods could cause de-skilling.

## Labour productivity slowing

As per PLFS/RBI KLEMS data, people employed in the economy has significantly increased over the last four–five years. However, robust additions in jobs is obscuring important underlying trends

- According to the RBI data, nearly 50% of the total jobs added in the economy during FY19–23 have been in the farm sector, a sector that already had excess labour. Of course, covid lockdowns have played a role, but the bounce-back post-pandemic has been weak. Both in FY23 (KLEMS data) and FY24 (PLFS data), no reversal is seen in the agri-jobs.
- Second, it is true that additions to the non-farm sector have been good too (not just the farm sector), but the slide in labour productivity growth in the non-farm sector does raise questions about the nature of these jobs.

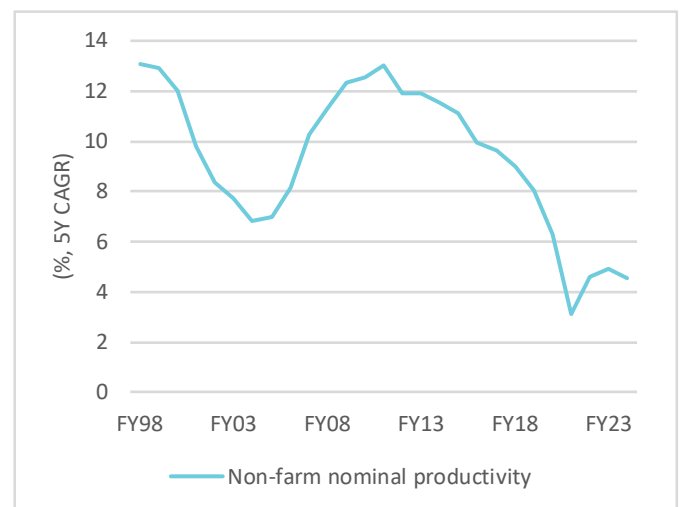
**Exhibit 47: Agri jobs have risen post-covid...**



Source: PLFS, RBI's KLEMS survey, Nuvama Research

Note: For PLFS data, the number of agriculture workers are computed by multiplying the share of workers employed in Agriculture with the worker-to-population ratio.

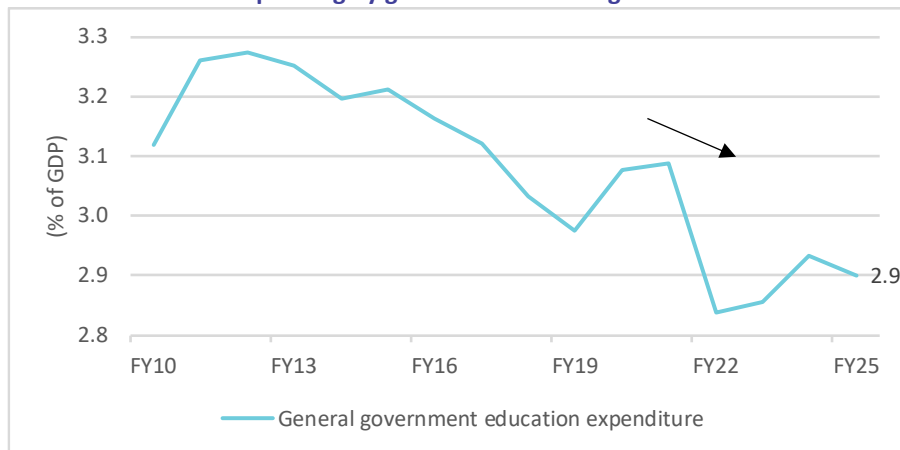
**Exhibit 48: ...and non-farm jobs' productivity has weakened**



Source: RBI's KLEMS survey, Nuvama Research

In addition, if we look at the education spend of the government (both states and Centre), it has been gradually slipping over the last decade or so. This again is the result of reduced capacity of the government to spend given fiscal consolidation priorities and a broadly flat tax-to-GDP ratio.

**Exhibit 49: Education spending by government trending down**



Source: CMIE, Nuvama Research

Note: For FY25, unaudited provisions are included.

## Household debt: Can it become a potential constraint?

One of the key macro stories of the last decade or so is the rise of HH debt. As mentioned in the previous sections of this report, the rise of HH debt has been a natural outcome of corporates shifting their focus from building scale to securing balance sheets and the government shifting its focus from boosting growth to securing macroeconomic stability.

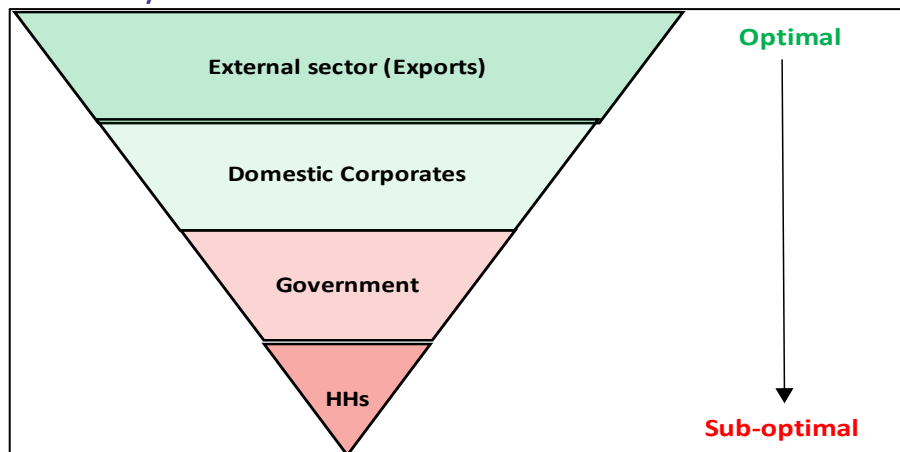
In other words, as both corporate and government became debt-averse, HHs were left with little choice but to borrow. We see three sub-issues with regard to HH debt:

- **Hierarchy of debt:** At the overall economy level, there is a hierarchy of debt in terms of who is the borrowing agent. In case of EMs (such as India), it is best if a country grows via expansion in net exports (debt is outside the country)—like China and South Korea have done.

The second best option is to add debt in the corporate sector—it is the productive sector of the economy and is efficient too.

The third best option is for the government to leverage and that too for infrastructure, and finally it is the household sector, which is least productive (used for consumption/real estate) and is often associated with large external deficits. This means for an EM, there is a natural limit to which HH debt can be used as an engine to scale up the economy.

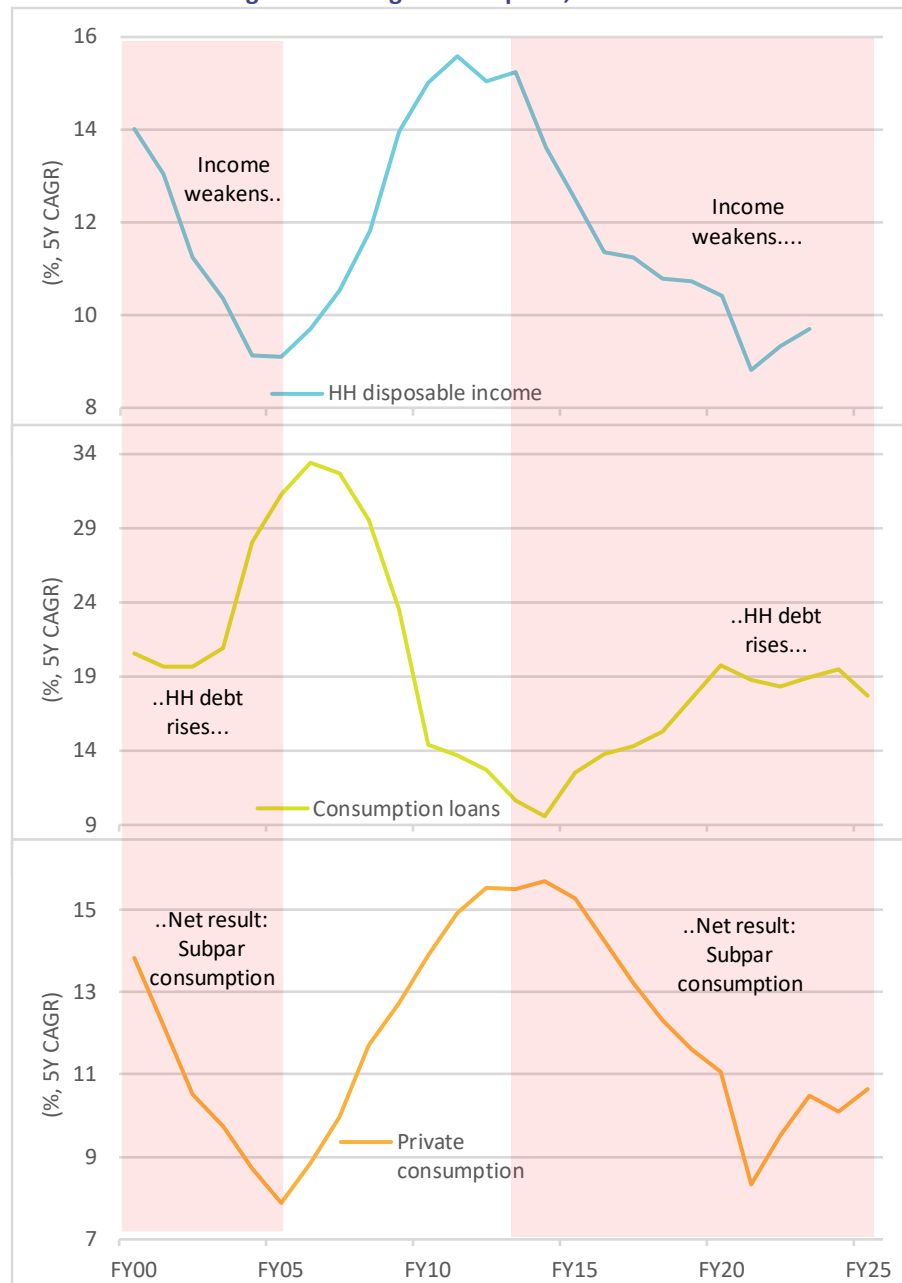
**Exhibit 50: Pyramid of debt**



Source: Nuvama Research

- **High HH debt amid weakening incomes:** HH leverage has risen at a time when the personal disposable incomes of HHs have been slowing. This raises the question about HHs' debt-servicing ability, especially at the lower end of income pyramid. It is perhaps this concern about debt servicing in some pockets of the HHs that bothered the RBI and motivated it to tighten the regulations on retail lending.

**Exhibit 51: Weakening income drags consumption, even as debt rises**

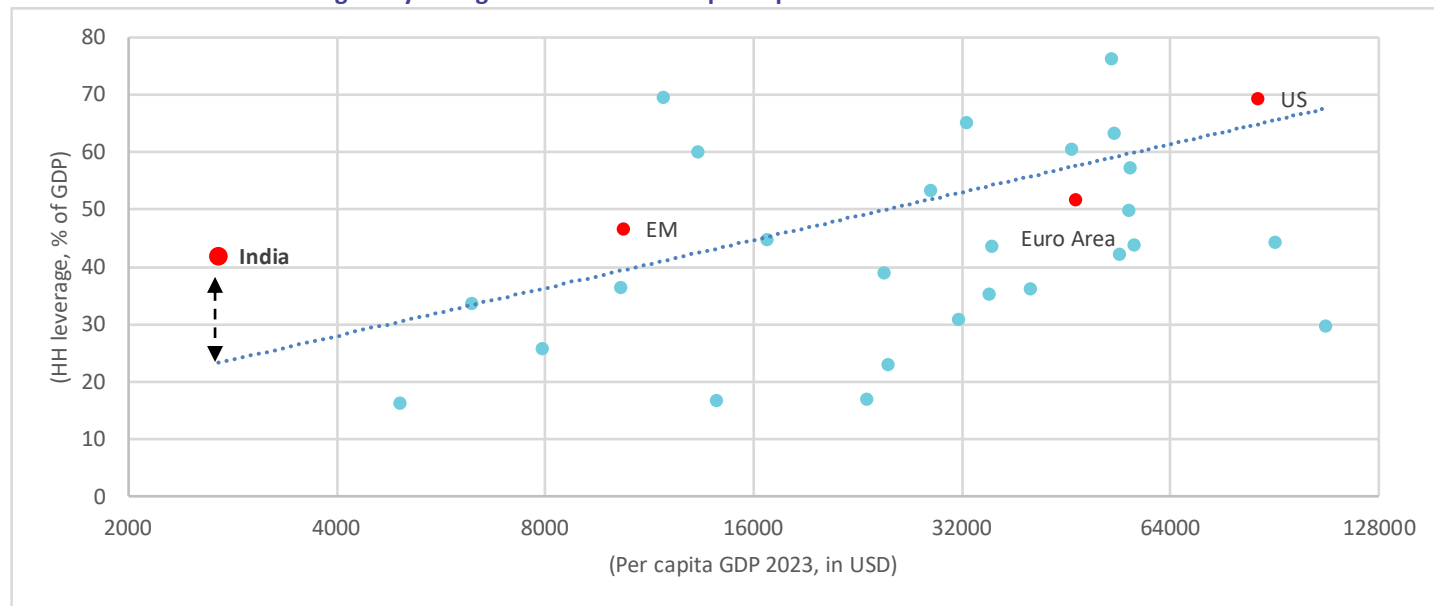


Source: CMIE, Nuvama Research

Note: Consumption loans refer to personal loans less of mortgage.

- **Debt capacity should be seen in light of the per capita income level of the country:** India's HH debt to GDP at ~40% (BIS data) is still much lower than other economies. However, if one adjusts for the fact that India is a low per-capita income country, its HH debt may not be too low.

Exhibit 52: Indian HHs' leverage may be high relative to India's per capita income...



Source: BIS, World Bank, Nuvama Research

Note: To homogenise, we have taken HH debt as defined by BIS. Dotted line represents logarithmic trend line.

## Macro stability: Slower growth could eventually hurt stability

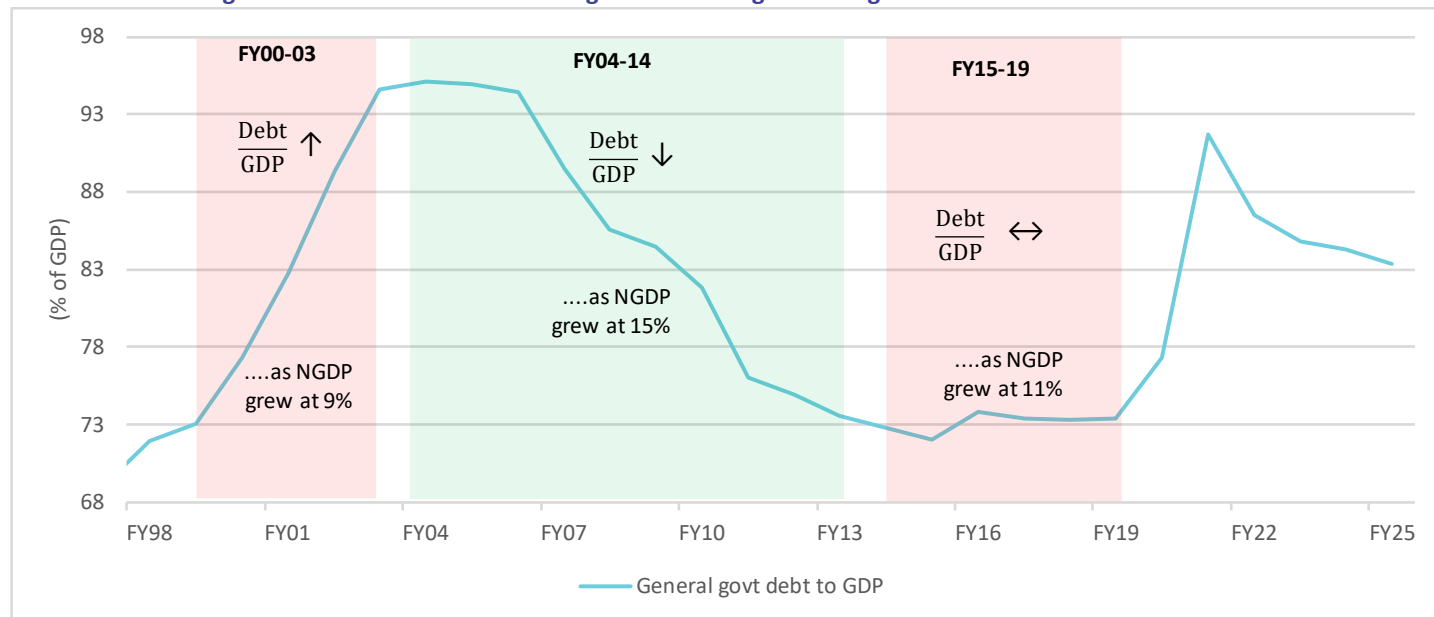
Government has done a lot of hard work to restore macroeconomic stability. India's fiscal deficit, external deficits, inflation and even balance sheets of large corporates and the broader banking system are in the best shape in the last 25 years. However, if the economy continues to operate at low pressure (high on stability, low on demand), then it is possible that weak demand could itself impinge on the stability parameters of the economy.

## Sovereign debt: Reducing debt to GDP amid slow NGDP growth is a challenge

Very often, strong growth solves the debt problem, particularly for the government. Trying to cut spending amid slower tax revenues and slower GDP growth could prove counterproductive as it could further depress the economy. If we look at India's past, the sovereign debt to GDP dropped significantly during periods of strong growth (NGDP compounding much faster than 10%).

When growth is rapid, not only tax base expands and tax revenues boom, but the denominator effect also works very favourably. Thus, we argue that since India's NGDP growth has slipped below 10% again, it is imperative to pause on debt reduction till the NGDP re-accelerates towards 12% YoY. Else, trying to deleverage amid weak private sector demand and slower tax revenues could delay economic recovery.

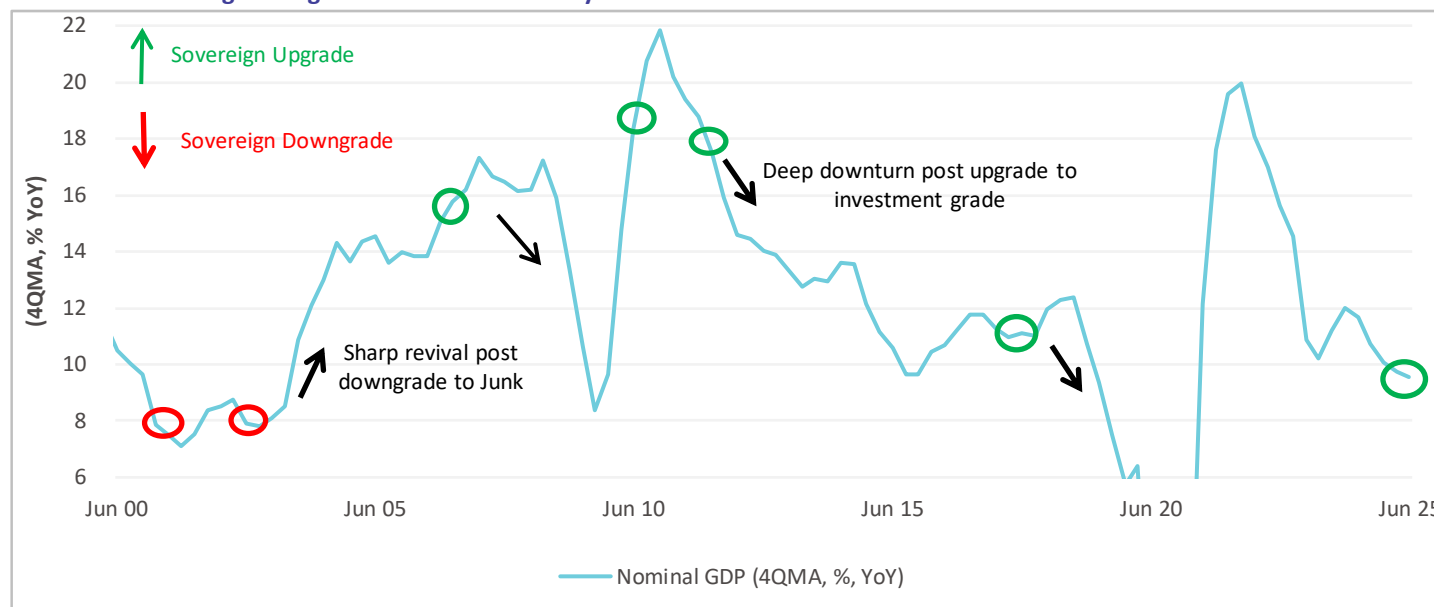
**Exhibit 53: Reducing debt to GDP becomes a challenge amid slowing nominal growth**



Source: CMIE, Nuvama Research

Surely, one could argue that India's debt to GDP is still elevated relative to the pre-pandemic period and any deviation from the promised path could trigger a 'negative' outlook from ratings agencies. It is possible but other parameters of Indian economy, policy reforms, political stability, and so on remain impressive. At the same time, if growth gets depressed in a bid to cut deficits further, ratings agencies would still raise a red flag. Finally, the [track record of ratings agencies](#) with regard to India has not been particularly impressive in any case.

**Exhibit 54: Sovereign ratings actions and business cycle – Much to be desired**



Source: Bloomberg, CMIE, Nuvama Research

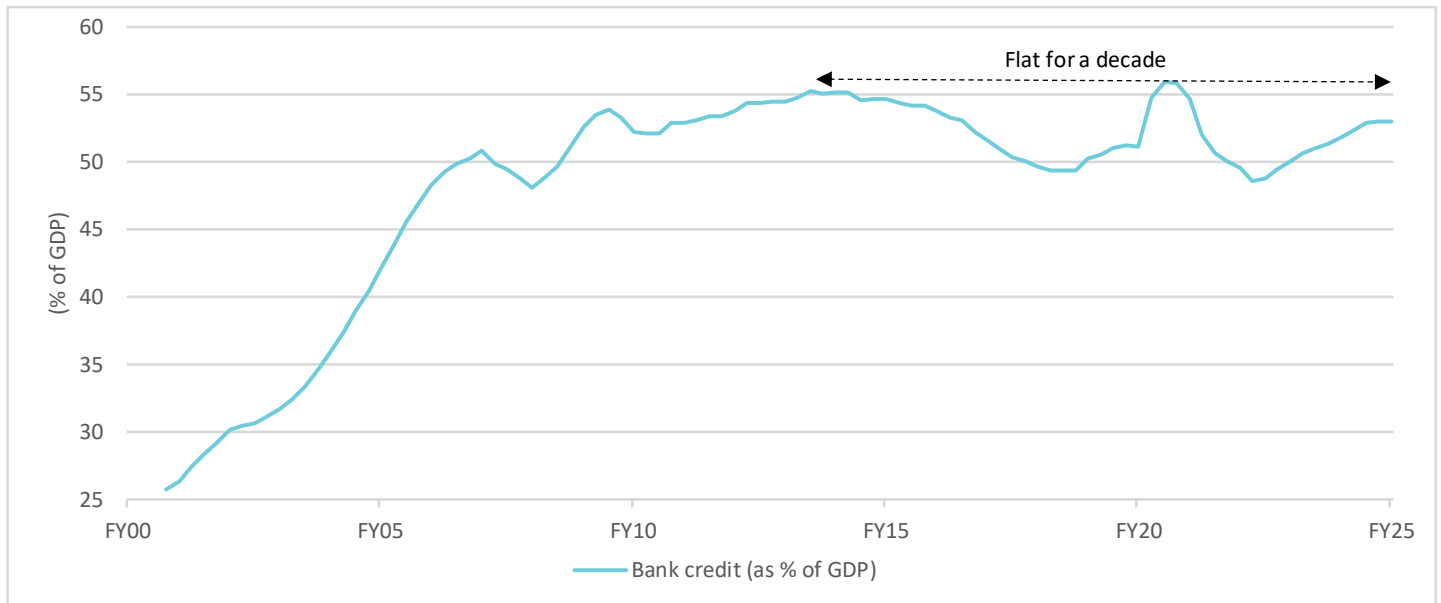
Note: Ratings include all major rating upgrades including S&P, Moody's.

## Banking sector: Risk of credit costs amid flat credit to GDP

Of late, banks have seen pockets of stress emerging in the retail lending space, be it unsecured loans including credit cards, MFI loans and—to some extent—even among MSMEs. But what is striking is that this risk has emerged despite credit to GDP remaining flat for about ten years. The last time Indian economy dealt with

rising corporate NPLs was in 2010s but that was preceded by a decade of lending boom such that credit to GDP moved up by 25 percentage of GDP. In other words, despite, running a low-pressure economy, risk of retail credit costs has spiked.

**Exhibit 55: Bank credit-to-GDP flat for over a decade**

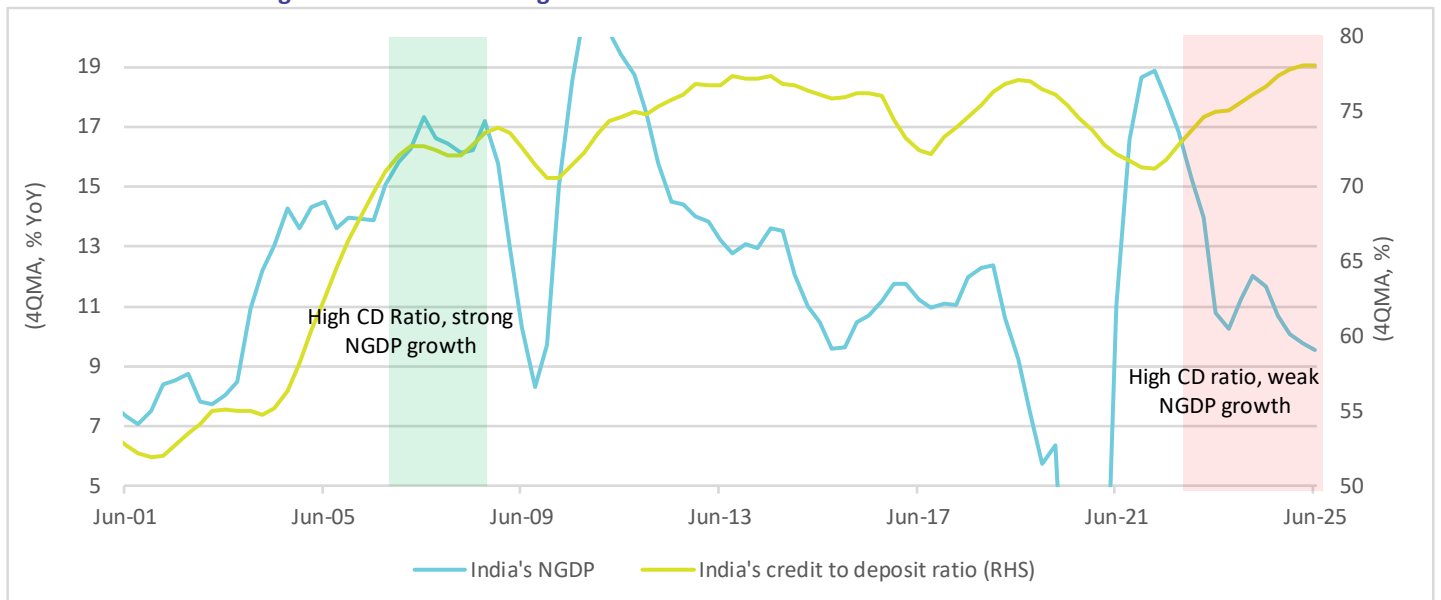


Source: CMIE, Nuvama Research

Furthermore, when one looks at the banking system LDR today, it is as elevated as it was during 2007–08 and yet NGDP today is growing at less than 10%, whereas in 2007–08, the economy was genuinely overheating with NGDP growing north of 15%.

All this seems to suggest that at much lower growth, LDR has got stretched and thus the risk of retail credit costs has risen.

**Exhibit 56: Banks' LDR high even at much lower growth**

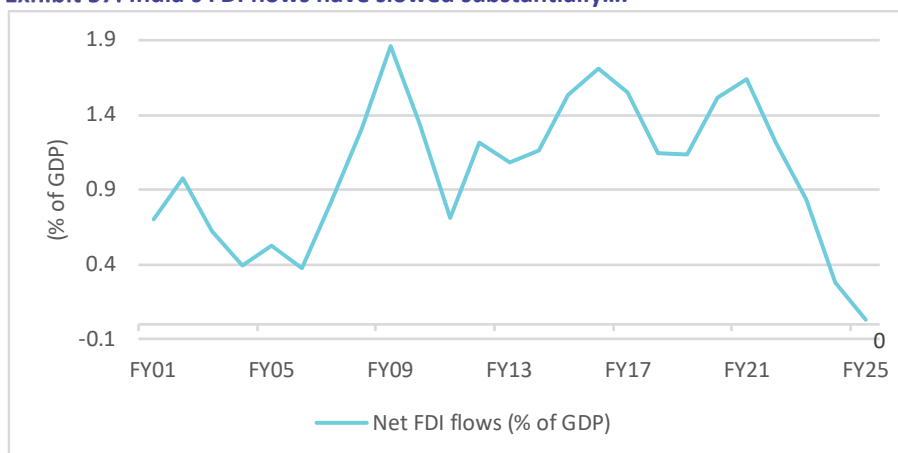


Source: CMIE, Nuvama Research

## External sector: FDI flows have slowed

On the external front, the CAD remains quite contained at 0.5% of GDP. However, the funding of CAD deserves a mention. FDI flows is not only the most stable source of funding of CAD, but it also brings in technological know-how versus portfolio flows, which tend to be rather volatile. However, FDI is growth-seeking capital and one of the reasons why FDI flows have stayed flat as % of GDP for a while—and dropping of late actually—could be slower growth. In that sense, while the overall CAD is low, the nature of financing has become a bit more volatile.

### Exhibit 57: India's FDI flows have slowed substantially....



Source: CMIE Nuvama Research

## Conclusion: Demand weakness could undermine trend itself

Overall, after exogenous shocks of last decade resulting in a hysteresis-type behaviour, low growth is resulting in an endogenous type of hysteresis. Utilisation has not risen despite low capex, migration out of farm sector has slowed and lack of industrial buoyancy is undermining infrastructure finances. Finally, even on the macro-stability front, a further reduction in sovereign debt to GDP would require higher NGDP growth. So what is the way out?

## The way out: Give growth a chance

In our view, after running a low-pressure economy for a while (that helped increase the speed limit or capacity of the economy—robust balance sheets, a healthy dose of economic reforms, fiscal prudence, etc), we think India needs to re-orient the economy towards corporate capex rather than household leverage.

Essentially, if one looks at the Kalecki equation, for corporates to embark on a capex cycle requires kick-starting demand first, either through a rise in HH leverage or government leverage or acceleration in external demand. The idea is that once demand picks up enough to generate visibility of higher revenue growth, corporates will have to expand capex; else, they risk losing market share. In other words, acceleration in demand and revenue could be a catalyst for businesses to re-anchor their focus on scale and market share rather than free cash flows and RoE.

Among these, the rise in HH leverage over the last decade is yielding suboptimal outcomes. It is not generating enough demand for corporates to lever up. Thus, some other agent needs to lever up.

Exhibit 58: Drivers of corporate profits

$$\text{Profits (P)} + \text{Wages (W)} + \text{Taxes (T)} = C_H + C_G + I_{H+C+G} + X-M$$

$$\text{Profits} = \underbrace{(C_H - W)}_{\text{Household Leverage}} + \underbrace{(C_G - T)}_{\text{Government leverage}} + \underbrace{(X-M)}_{\text{External leverage}} + I$$

$$\text{Corporate Profits} \propto \text{Household Leverage} + \text{Government Leverage} + \text{External Leverage}$$

Source: Nuvama Research

We envisage three ways in which India can achieve progress in this regard and draw lessons from the past.

### Scenario 1: Global environment turns conducive à la 2000s

The first and the ideal solution is that the global environment turns conducive and global demand/trade accelerates. This shall lift the manufacturing sector and corporate top line and incentivise them to incur capex. More importantly, export-led growth will help accelerate the economy while keeping a check on widening CAD.

Exhibit 59: Corporate animal spirits could rise if external leverage rises

$$\text{Profits} = (C_H - W) + (C_G - T) + \underbrace{(X - M)}_{\text{External leverage}} + I$$

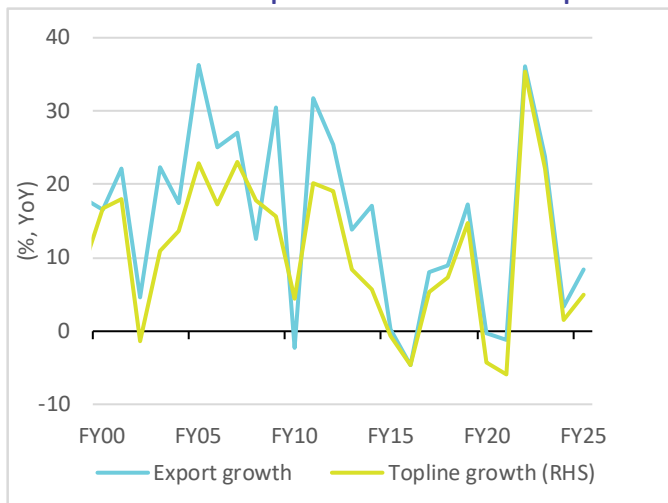
Source: Nuvama Research

## In 2000s, export revival drove corporate top line and capex

India's macro set-up and economic drivers were very similar in the preceding seven–eight years as they have been in recent years—corporate capex slow, households leveraging up and income growth slowing. But exports revival in the 2002–04 period was instrumental in re-anchoring the economy to corporate sector. Exports are very critical for India Inc. as most corporates are in the tradeable sector (IT, manufacturing, etc) with their marginal price set by external demand.

Thus, as businesses observed revenue growth accelerating amid rising exports and prices, animal spirits kicked in and businesses embarked on broad-based capacity expansion. This is how the economy re-anchored from household leverage to corporate capex.

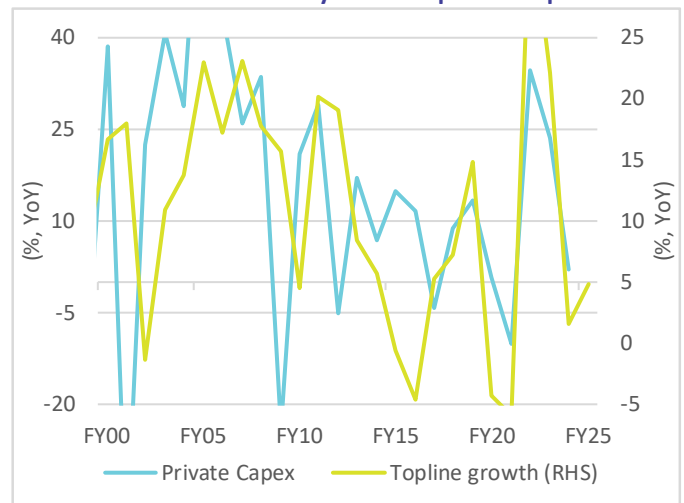
Exhibit 60: India Inc's top line is correlated with exports...



Source: CMIE, Nuvama Research

Note: Exports include total goods and services export in INR terms. Top line is included for all non-financial listed companies.

Exhibit 61: ...which is the key driver of private capex



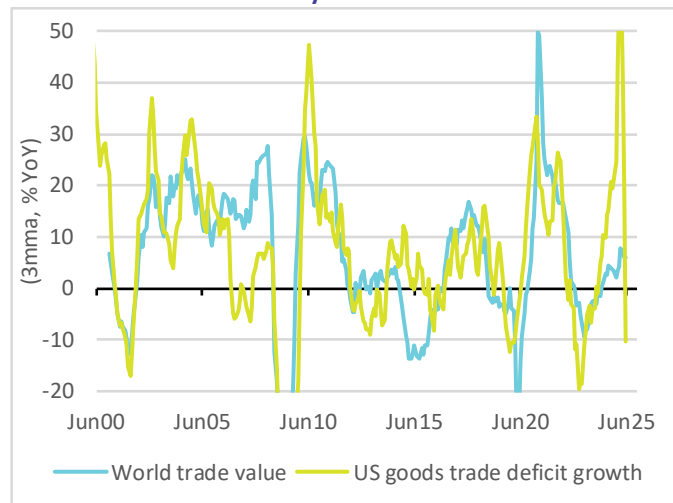
Source: CMIE, Nuvama Research

Note: Top line is included for all non-financial listed companies.

## Current: Tariffs clouding exports outlook

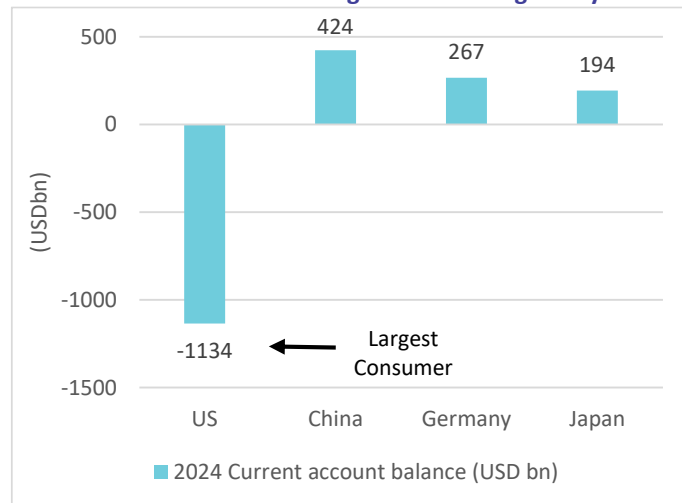
As we highlighted in [Tariffs: Of Woods and Weeds](#), the global trade outlook is clouded. The issue at hand is not just that India is facing a 50% tariff on exports to the US (in fact that might be negotiated lower), but that global imbalances may be unwinding. This implies that the US trade deficit has likely peaked both cyclically and structurally, which indicates that the overall global trade is likely to slow down, unless balanced by sustained revival in China's consumption demand. Furthermore, while the US may face higher inflation, the rest of the world could see disinflationary/deflationary tendencies in the near term.

Exhibit 62: World trade may slow as US trade deficit narrows...



Source: Bloomberg, Nuvama Research

Exhibit 63: ...since US is the largest consumer globally



Source: IMF, Bloomberg, Nuvama Research

However, we believe that once exports of surplus countries such as China and Germany begin to drop (mirror image of US deficit narrowing), these countries would necessarily have to undertake decisive steps to boost domestic consumption; else, they risk social unrest in their respective economies.

If so, then one can be optimistic that after a period of slowdown in the global economy and trade, the domestic demand boost in surplus countries could revive the global economy in a more balanced/sustainable way.

This, in our view could be a big opportunity for India to re-anchor the domestic economy more towards production versus consumption *à la* 2000s.

## Scenario 2: Running 'high-pressure' economy: Reviewing framework

In case the global environment remains sluggish for longer, India may have to think of running a high-pressure economy through domestic sources (exports may not do it). With the HH leverage engine exhausted, the onus lies on the public sector.

Exhibit 64: Alternative scenario 2 is government leverage picking up

$$\text{Profits} = (C_H - W) + \underbrace{(C_G - T)}_{\text{Government leverage}} + (X-M) + I$$

Source: Nuvama Research

Of course, running a high-pressure economy through domestic sources has its own challenges, particularly with regard to the widening of external deficits. Therefore, one has to be moderate in pursuing this path. Nonetheless, we think there are ways to pursue a middle path.

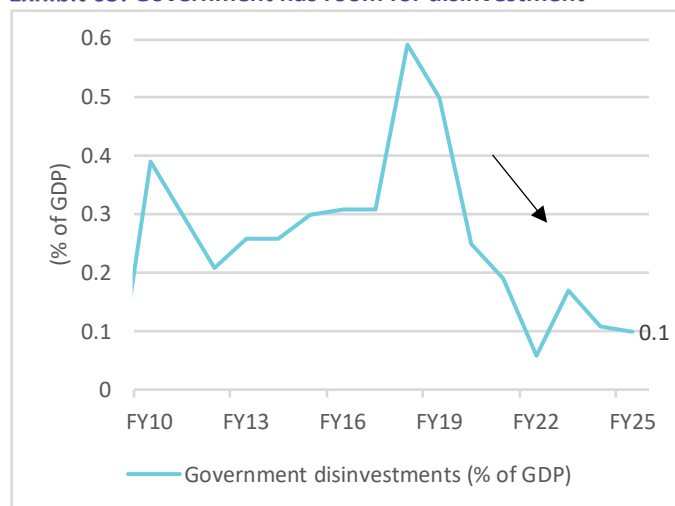
## Fiscal deficit targets should be contingent on NGDP outcomes

First, the government so far has made several attempts to revive demand or crowd-in private investments, but the traction has been limited because the overall fiscal stance has been consistently contractionary. Moreover, measures so far have been mainly supply side (tax cuts/reforms), whose benefits are slow to trickle down. The approach needs to change towards directly reflating demand.

Government could borrow excess savings from the corporate sector and convert them into income streams through spending on capex and consumption until the private sector's animal spirits revive. Essentially, the government must have debt to GDP/fiscal deficit targets premised on NGDP growth rather than have a preset path.

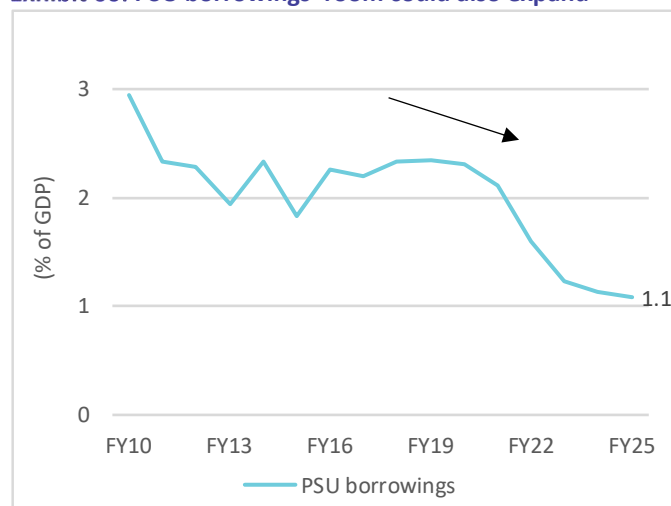
Furthermore, the government could think of raising large resources from disinvestment and use PSUs as vehicles for borrowing as they have deleveraged significantly. An INR1.5–2tn-raise from disinvestments along with a 1%-of-GDP increase in PSU borrowing could provide a meaningful boost to the economy.

**Exhibit 65: Government has room for disinvestment**



Source: CMIE, Nuvama Research

**Exhibit 66: PSU borrowings' room could also expand**



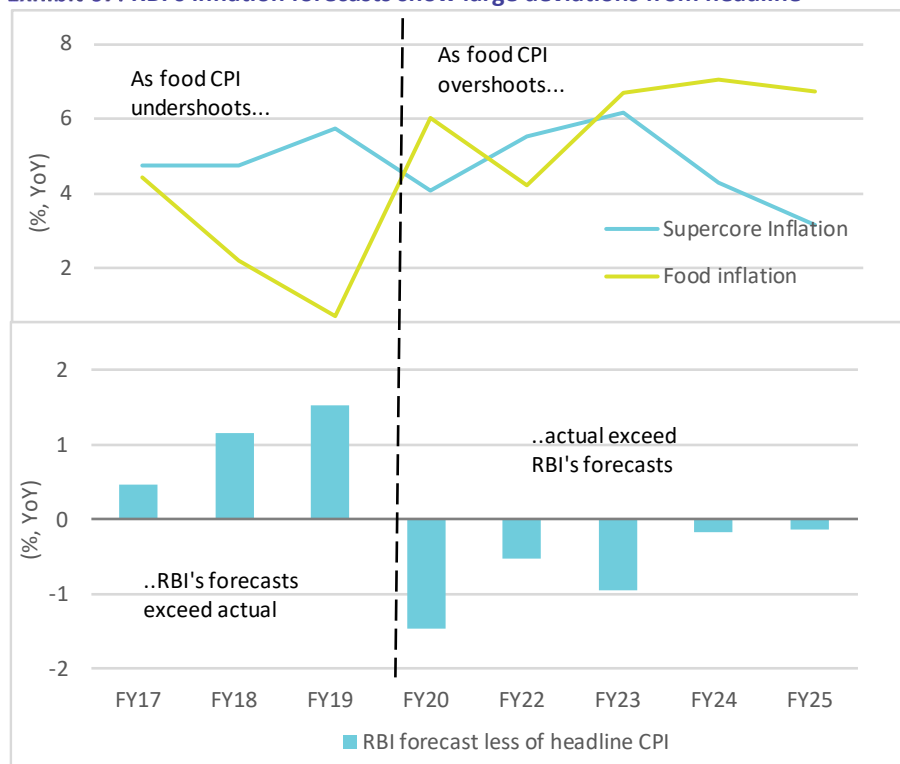
Source: CMIE, Nuvama Research

## RBI needs to run inflation targeting more 'flexibly'

Second, we think the RBI's monetary framework of targeting CPI at the headline level could be reviewed. In the CPI index, food comprises 45%, which is neither forecastable, nor linked to demand conditions or amenable to changes in the repo rate. Moreover, on the growth side, the complete neglect of NGDP growth has its costs too as we showed above. In India, the trend in NGDP growth is a better gauge of trend and strength of the business cycle.

In other words, we think the current framework and the way it is implemented, tends to deliver tighter monetary conditions than warranted.

**Exhibit 67: RBI's inflation forecasts show large deviations from headline**



Source: CMIE, RBI Monetary Policy Committee, Nuvama Research

Note: Super-core inflation is CPI ex- food, fuel & light, commodities like gold, silver, petrol, and diesel.

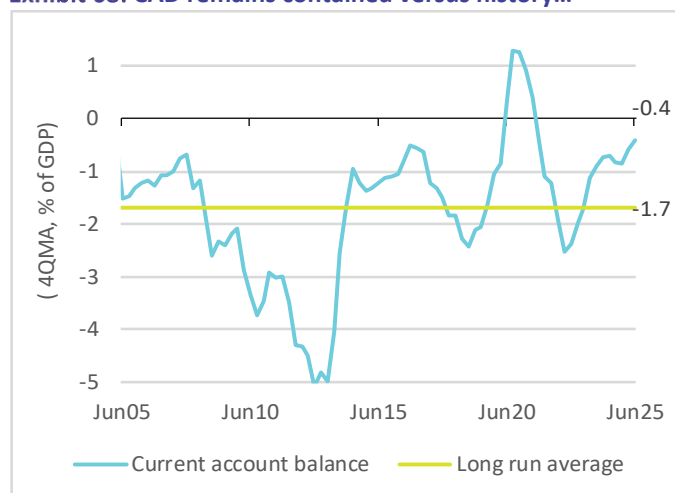
In our view, either the RBI's inflation target should be moved to core CPI or average of core CPI and core WPI or if the RBI wants to target headline CPI only, then the target could be raised to 5% instead of 4%.

This combination of a sizeable fiscal and monetary policy stimulus could trigger a virtuous cycle in the economy. As demand picks up and corporate revenue accelerates, businesses would necessarily resort to capital outlay in the fear of losing market share.

Surely, there are risks embedded in this strategy, mainly arising from the external sector. Here we make three important points:

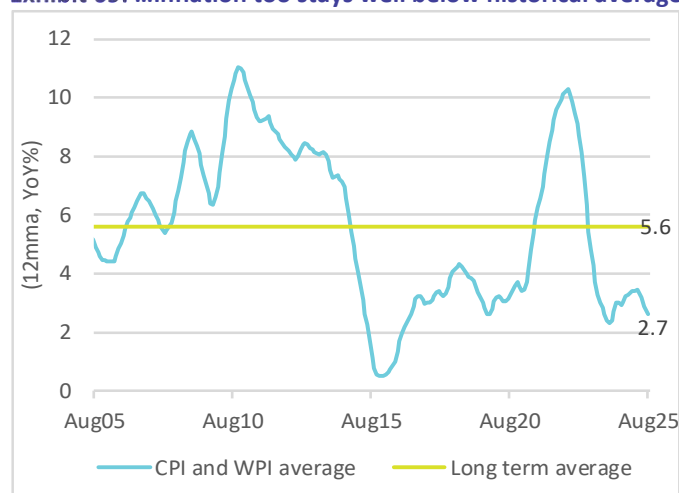
- India's CAD on a trend basis is now significantly undershooting its historical average and even core CPI (and manufacturing WPI)—both have been contained or are on the lower side for a while now. In other words, there is capacity for domestic capex to rise without pushing external deficits or inflation into the vulnerable zone.

**Exhibit 68: CAD remains contained versus history...**



Source: CMIE, Nuvama Research

**Exhibit 69: ...inflation too stays well below historical averages**



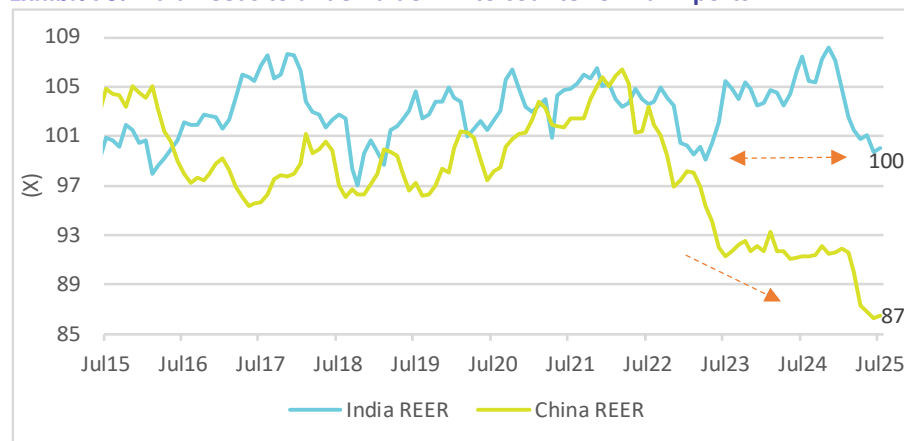
Source: CMIE, Nuvama Research

- Second, if the CAD expands as a result of higher corporate or industrial capex, it is easier to fund compared with CAD that is widening as a result of a drop in domestic savings rate (amid leveraged consumption).
- Third, the nature of capital flows could also improve if capex and growth accelerate. It would help attract FDI flows, which have been missing of late.

### India needs to run an undervalued INR policy

Finally, India needs to run an undervalued INR policy along with tariff protection in select industries in order to make sure that CAD remains in check. A weaker INR is particularly important not only to offset the tariff impact, but also to safeguard against Chinese dumping of goods. However, this would be possible if India does not further liberalise its capital account. Moreover, India's policy choices would be restricted amid the impossible trinity challenge.

**Exhibit 70: India needs to undervalue INR to counter China imports**



Source: Bloomberg, Nuvama Research

We believe such measures if pursued gradually and responsibly could deliver higher NGDP growth rate than the current trend of 10–11% without compromising too much on external deficits or inflation.

### Scenario 3: Re-thinking growth model: Scale and stability over RoE

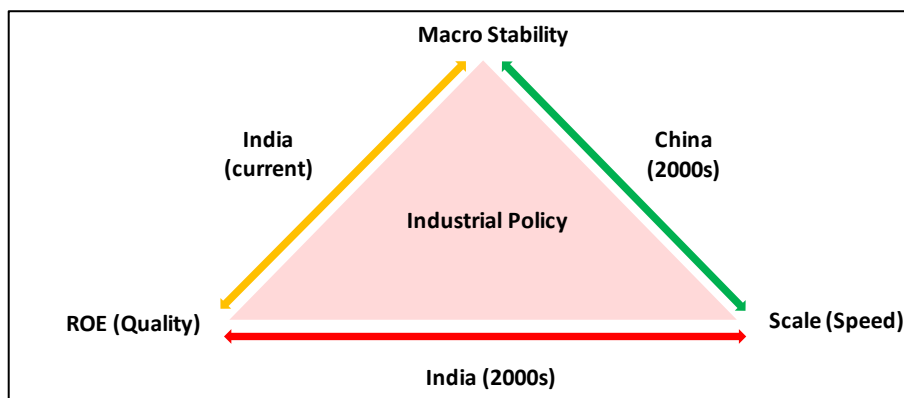
Scenario 2 above shall certainly deliver better growth outcomes. That said, to decisively scale up of the economy, India needs to re-think its growth model in a

more structural way. In other words, we need to navigate the ‘growth trilemma’ differently. We discuss it below.

## Growth trilemma – Stability, Scale and Shareholders’ returns (RoE)

Essentially, growth models are fundamentally about trade-offs. Among the three key variables in our ‘growth trilemma’—macroeconomic stability, high RoE for business and scale/high growth rates—policymakers can choose any two at the cost of the third one.

**Exhibit 71: The growth trilemma**

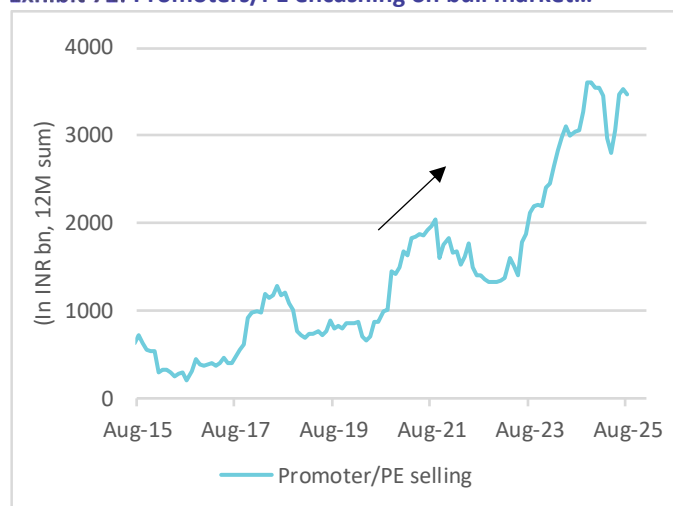


Source: Nuvama Research

- **RoE and Scale (India in 2000s):** This only works if the global economy is very buoyant (e.g. India 2002–08). In the absence of a broad-based global upswing, this can lead to macro-vulnerabilities and stretched balance sheets as India experienced during 2011–13. Only the US, by virtue of being a reserve currency can afford to pursue all three.
- **Macro-stability and RoE (current India model).** Typically, such a choice follows a balance of payments crisis in an EM. No doubt, macro-stability and RoE are worthy goals, but in this choice, growth and economic scale-up tends to take a backseat. India has taken this path after the BoP crisis of 2011–13 (India was counted among fragile five). The focus on macro-stability and good balance sheets has significantly increased even as capital markets have been liberalised progressively.

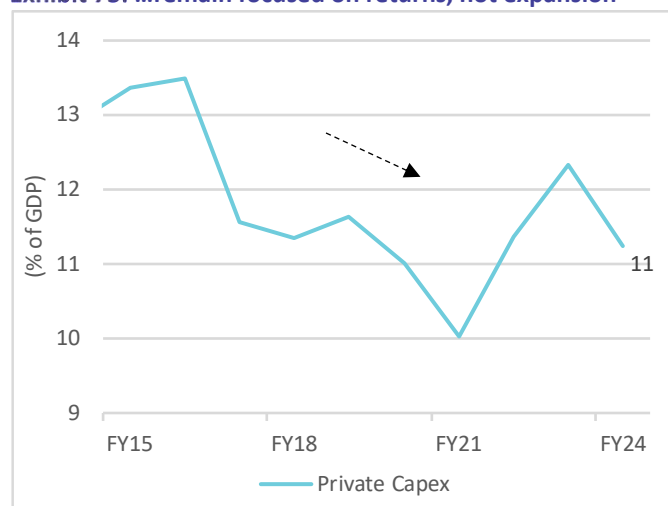
However, the growing role of capital markets and increasing financialisation are delivering suboptimal outcomes as far as scaling up of the economy is concerned. Despite good balance sheets, corporate tax cut and economic reforms effected by the government, businesses are reluctant to take risk. Promoters/private equities are encashing on the bull market and turning into investors rather than incurring capex.

**Exhibit 72: Promoters/PE encashing on bull market...**



Source: CMIE, Nuvama Research

**Exhibit 73: ...remain focused on returns, not expansion**



Source: CMIE, Nuvama Research

- Macro-stability and scale (East Asia model):** South Korea and China made this choice and grew very rapidly without compromising macro-stability. The countries rely on domestic savings (by suppressing HH leverage) rather than foreign capital (barring FDI), weaker currency and government subsidies to producers (not consumers). This allows the economy to run high investment rates (which scale up the economy) and large trade surpluses (that secures macro-stability). What is compromised is the shareholders' returns. Surely, this model also runs into trouble eventually as it delivers unbalanced growth, but this model has been very successful in scaling up the economy rapidly from low-per capital income

Indeed, implementing such a mercantile economic system in a democracy has its own challenges and one could argue that since globalisation is in a bit of a retreat, this model may not deliver scale anymore. That is fair but, in our view, there is a growing risk of Chinese goods flooding the European and Asian markets now that the US is unwilling to absorb global surpluses.

If so, running a consumption-oriented model could be a risky strategy. Rather, offence can be the best defence. Essentially have a hedgehog like focus on building scale with all resources (human capital, subsidies, directed financial capital, etc.) directed towards production. This will result in India safeguarding and potentially gaining market share in global exports even amid a slowdown—refer to [Industrial Policy: The Hedgehog and the Fox](#).

## Conclusion

Thus, overall after securing macroeconomic stability over the last decade it is perhaps time to reassess the policy framework. It is imperative that we channel the hard-earned macroeconomic stability back towards scale. Else, status quo risks recalibrating growth lower. Give growth a chance!

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