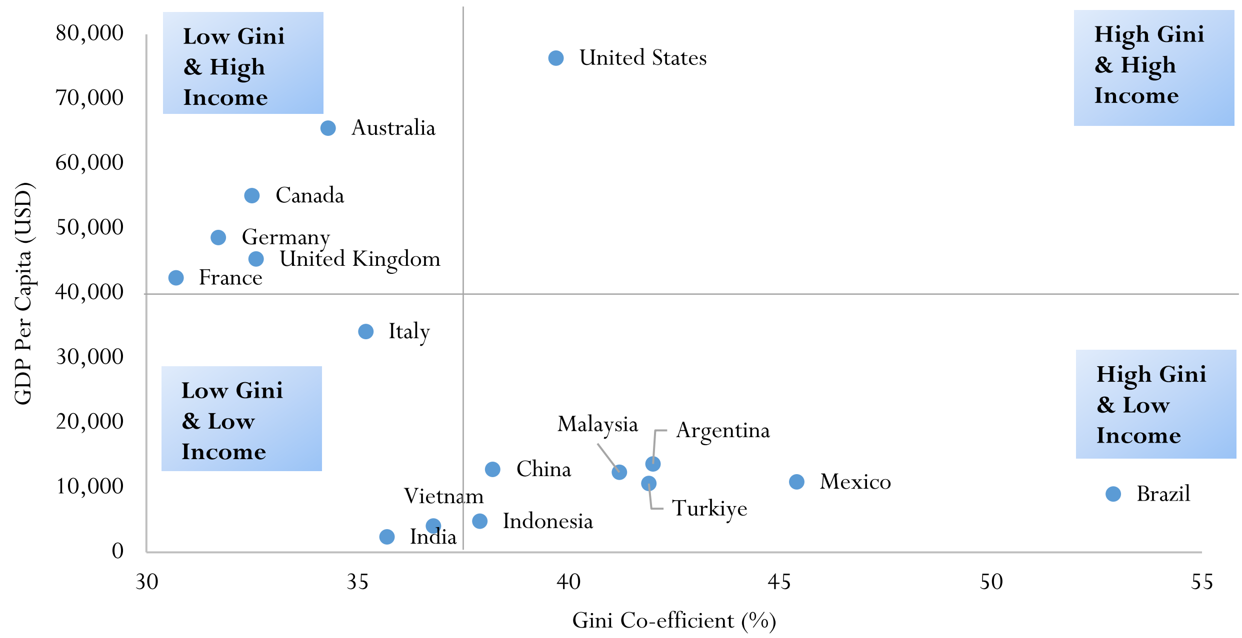
K-shaped Recovery???

Economic recoveries have a certain life of their own. The advent of "stock market economy" has added a new dimension to market economies. Commentaries have become more colorful. Recessions and recoveries are no longer the domain of specialists and policymakers alone. Investors are watching and weighing these. Over the last few decades, recoveries have assumed many hues. The primer below can be a quite useful as the shape of recovery we have in India can be of great significance to the country, its people and to the markets. We are obviously obsessed with the last and this discussion will draw from the lessons of the past.

1. V-shaped recovery – If a recession is inevitable, the bull wants this type. It gives maximum bang for the buck. This is characterized by a steep fall and the proverbial steep rise from the embers. In the current context, this is a tough ask in a world which has exhausted a lot of its firepower.
2. U-shaped recovery – This is a recovery which is a bit on the boring and predictable side. The economy falters, falls and then takes some time to recoup its strength (slow growth) before getting back closer to a trend level of growth or higher.
3. Double Dip or the W – A fall, an attempt to rise and a fall again – hopefully, a rise after that. Of course, the duration of all this and gradients can be very confusing. Parts of Eurozone experienced this after the global financial crisis of 2008-09. There were aborted attempts at a sustained recovery, and some may even argue that this is a saw-tooth recovery, and we are not yet out of this.
4. L-shaped recovery – Is actually, no recovery at all. Japan of the 1990s became so anemic that from being a powerhouse that threatened to dominate the world, the economy was on a stretcher for long years. Poor demographics and structural deficiencies were the causes attributed to the cul-de-sac for growth that Japan drove into. Quite obviously, this is a nightmare scenario for politicians and policymakers anywhere. There have been fears that Europe has been sauntering into this mode.
5. Nike swoosh – This was propounded by Stephen Roach, who was with Morgan Stanley and is not a widely accepted form of recovery by mainstream economists. Jargon apart, India may be setting up for a gradually strengthening recovery of this nature after the Covid induced economic sudden stop.
6. K-shaped recovery – This has gained prominence in the wake of the uneven recovery that much of the world is experiencing after Covid. Some economists argue that India is on this mode. We want to explore this further.

The K-shaped recovery may be one logical outcome emanating from the Covid-induced recession which affected different strata of society differently. This is in the context of the widespread inequality in major economies which is for real. Here is a measure of inequality – the Gini co-efficient which is an indicator of the rich-poor divide in the world.

Gini Co-efficient (Income Inequality) & GDP Per Capita

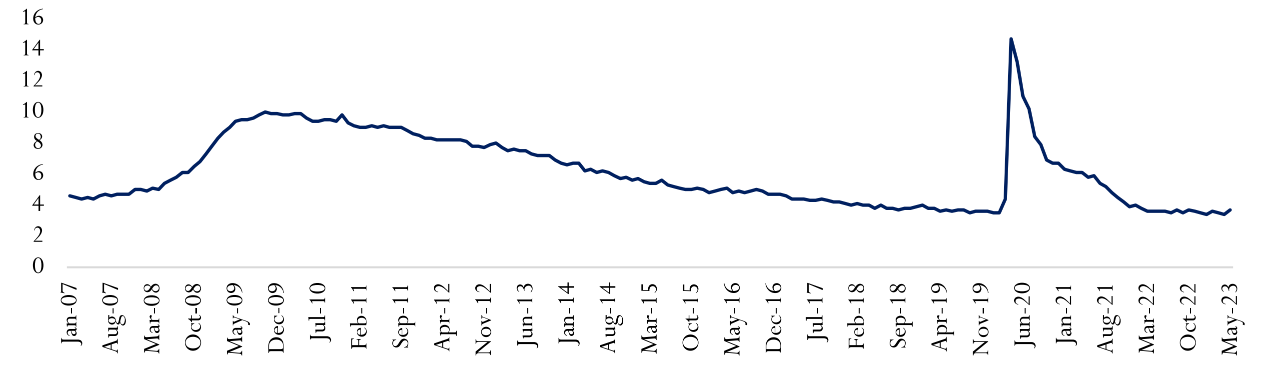


Note: GDP per capita as of 2022. Gini – available data: 2018-20
Source: World Bank, International Monetary Fund, Spark Fund Research

The measure of inequality was from before the Covid times. It is widely understood that the digital divide has widened the chasm after Covid. Besides, the strongest engine of growth in the developed world, the US, scored poorly on equity even before Covid. The K-shaped recovery might well have come about as an inevitable consequence of an already bad starting point and the stress endured by the more vulnerable sections of society when Covid hit the world.

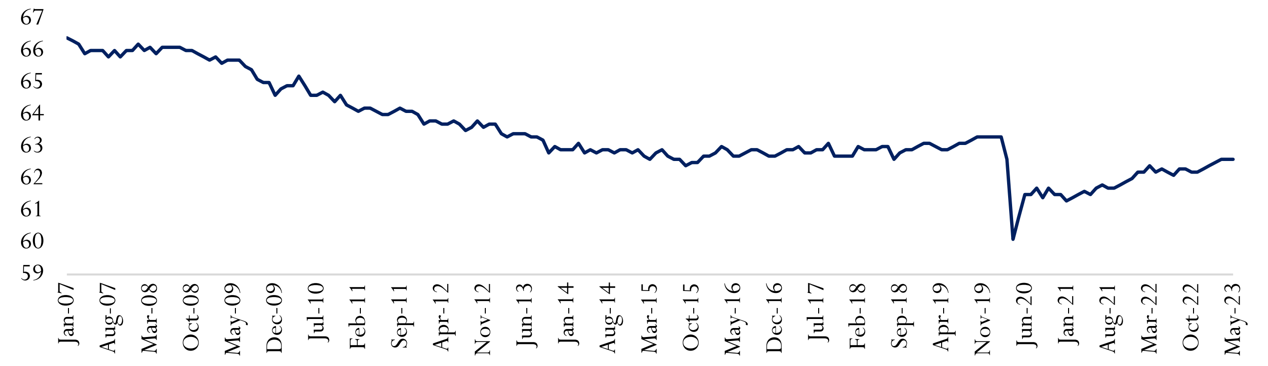
True, there was a stimulus that the governments injected into their economies. They were essentially social safety nets laid out for those that were left behind. They are safety nets and not social launchpads. Look at the picture of employment in the US:

US - Unemployment rate (%)



Source: Bureau of labour statistics (US Dept of Labour), Spark Fund Research

US - Labour Force Participation rate (%)



Source: Bureau of labour statistics (US Dept of Labour), Spark Fund Research

Even as the unemployment rate remained low after the Fed induced recovery, labor participation rate has been struggling. Deteriorating demographic profile is a structural reason. However, there are many who have dropped out of the work force because they are not easily employable. It is hard to re-tool ageing people in an economy to re-skill them in order they adapt to the altered demands from the workplace. Many people would have dropped off into the so-called social safety net or the abyss below.

However, the economy is powered and scripted by the so-called winners in this game. They are the workforce who are digitally enabled and here comes the crucial difference after Covid.

Covid was an economic sudden stop that came as a bolt from the blue. In one sense, what happened was nothing short of remarkable. The digitally enabled world carried on and arguably in a very successful way. This included financial services, IT services and even education where institutions were set to handle it. Those who did not have access to digital resources and those activities which are impossible to perform without mobility went into a tailspin. K-shaped recovery was born out of this. In the US and elsewhere, "helicopter money" was used to mitigate the suffering. That was a giant band-aid and was the need of the hour. We are beginning to see the consequences playing out since and now that is increasingly palpable.

1. The strong has become stronger – concentration of economic power.
2. Weak has been rendered weaker and maybe even fell by the wayside. What has happened to Sri Lanka and Pakistan can in part be attributed to this.

3. In the new economy that is rolling out in front of us, those lacking digital capabilities are finding it difficult.

Contact intensive industries have come back for sure. If you are a skilled factory worker or even a semi-skilled construction worker, you may be back at work. However, the world has learnt to do more with lesser contact. We have argued for a while that this is indeed great for economies like India. There is a caveat. This engenders an uneven impact. That is the genesis of this talk about the K-shaped recovery.

For the developed world, it is possible that the so-called K-shaped recovery is morphing into a labored one even for the upwardly mobile stroke of the "K". It may have exhausted itself and a sideways drift is a distinct possibility. Shape of stroke to come is work in progress.

For India, is this a K-shaped recovery or a recovery which started slowly and is picking up speed and strength? What is the data telling us?

The way things are shaping up for India

India suffered its first real recession after liberalization started. Compared to what might have been, India seems to have done well.

Some facts

1. The fiscal responsibility got a royal boot. Fiscal deficit of 6% and above has become a new normal for now. 4% was considered a Lakshman Rekha which markets guarded with strict vigil before Covid. The collective decision of the world at large to tolerate some loose fiscal policy has eased the burden on politicians everywhere. There are long term consequences and long term is here or close by. Globally, inflation genie is out of the bottle. For India, which never had a great record on inflation, the outcomes are getting better.
2. The banking system got a royal wash which cleaned up most of its past sins. Recession made the last man standing on the edge fall over the brink. What has come out of the cauldron is a relatively healthy system for lenders. They might be on the way to make new mistakes, but new excesses must happen first, or new shocks have to hit us. Anyways, we believe the banks have the balance sheet to fund India's growth if India is inclined to grow.
3. Digitization got a royal push. Those who rose to the occasion have moved up the curve on this count. The IT services and the financial system have taken it to a whole new level. Tradeable services and globally tradeable ones at that have unleashed the digital power and this has been good for India.
4. Productivity has got a royal boost. This has been evident in all parts of the economy which had the wherewithal and willingness to adapt. This is exactly what any recession is supposed to do in a free market. South Korea after the humiliating recession of the 1990s followed by an IMF intervention has gone on to become a developed economy. Nothing less. Sweden which did its own "bank nationalization" after the trouble in its financial system in early 1990s now boasts of a robust financial system.

Recessions can produce strong economies. Be it Covid or whatever else that caused one. India seems well set to have emerged stronger. Some data points:

Particulars	As projected by RBI	Actual Outcome
Banking system NPLs - FY21	10-15%	7.5%

Particulars	Expected	Actual Outcome
GDP growth - FY21	-10.0%	-1.4%

Particulars	FY15-20	FY21-23
Nifty EPS Growth	2.5%	20.0%

Particulars	FY18-20	FY21-23
Inflation differential – Indian inflation less US inflation	2.0%	-0.8%

Source: RBI, IIFL securities, Bloomberg, Spark Fund Research

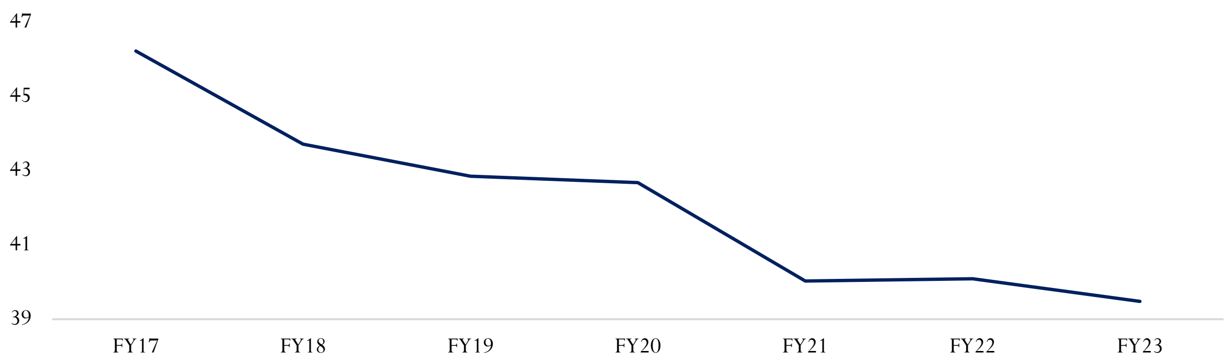
So far, so good. There is still the problem of those who were less fortunate.

Those who have fallen behind

They constitute the anemic leg of the K. While they are supposedly the victims of any free market shakeout, they are not just a statistic. They are real people. Fair enough. What do we know of "them"

1.Labor participation rate in India has fallen and according to some reports, the fall steepened after Covid. There is a lot of debate on this data. The data below is based on the Govt surveys.

India - Labour Force Participation rate (%)

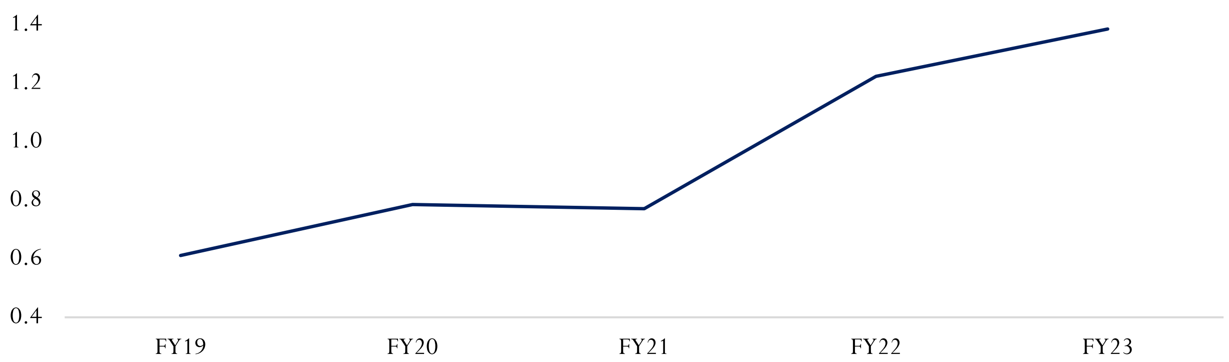


Source: Avendus Spark, Spark Fund Research

The fall prior to Covid coincides with the introduction of GST as per official data. New sources of employment and changing labor dynamics in rural areas may have brought about a lot of flux into this kind of data. It may be several years before we know better. However, it has been argued that female participation in the workforce, particularly in the informal sector, has fallen after Covid. Looking at the data and the way the digital divide has cast its spell, this could be a strong factor in the K-shaped recovery.

One interesting data point is that the number of EPFO registrations has shot up.

EPFO additions (Crs)



Source: Ministry of Labour & Employment, Spark Fund Research

That said, 1.6 crore is a number which means nothing much in a country having population of 140 crores. Even after adjusting for the children and senior citizens, the base is too large for India. The informal or unorganized workforce in India is still huge and that may have suffered at least in a relative sense in the last three years.

2. Low end consumption is hurting.

Two-wheeler Sales (Domestic)

Year	Volumes (Cr)
FY14	1.48
FY15	1.60
FY16	1.64
FY17	1.76
FY18	2.02
FY19	**2.12**
FY20	1.74
FY21	1.50
FY22	1.35
FY23	**1.58**

Maruti Suzuki entry level vs SUV sales

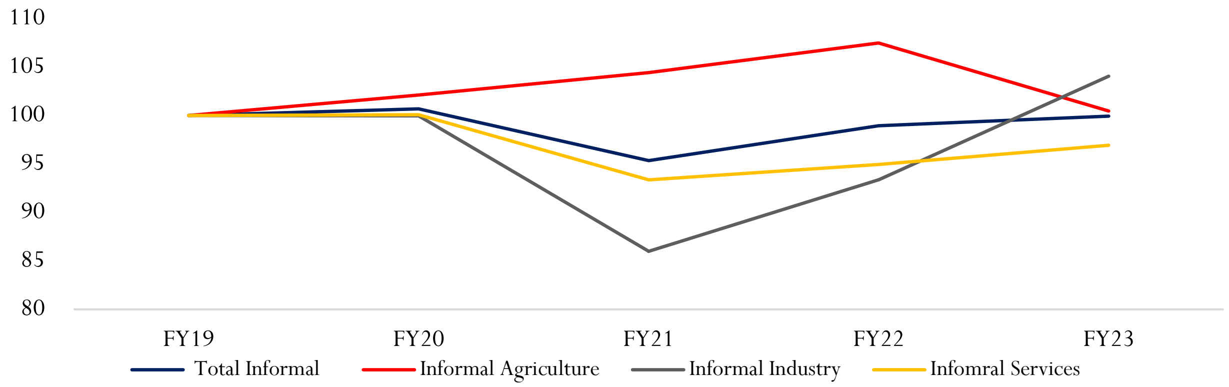
Year	Total	Entry level	SUV
FY14	11,55,041	6,88,740	61,119
FY15	12,92,415	9,21,741	68,198
FY16	14,29,248	9,74,928	94,416
FY17	15,68,603	9,98,831	1,95,741
FY18	17,79,574	11,75,658	2,53,759
FY19	18,62,449	**12,40,854**	**2,34,197**
FY20	15,63,297	10,35,386	2,35,298
FY21	14,57,861	9,45,806	2,29,101
FY22	16,52,653	9,16,643	2,90,701
FY23	19,66,164	**10,95,940**	**3,66,129**

Source: Company, AceEquity, Spark Fund Research

India sells the same number of two-wheelers as it did almost ten years back. There is a fall in the number of entry level hatchbacks sold while the sale of more expensive SUVs has picked up. Not all of this is because people at the bottom of the pyramid are thickening the foot of the K. Consumer preferences may have had some role.

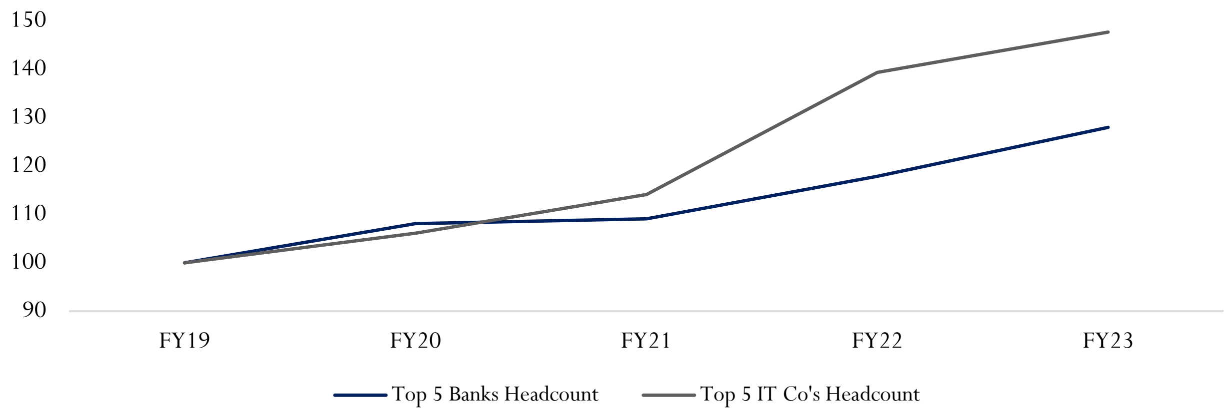
It is possible that inflation has hurt low end consumption more than the higher end. This is very typical in difficult times. Inflation management assumes priority for governments as a result. This inflation is itself the result of loose monetary and fiscal policies. There is no point in denying that the recovery has been somewhat uneven. The charts below capture the trends reasonably well.

Informal Employment (indexed to 100)



Source: Avendus Spark, Spark Fund Research

Formal Headcount in highly organized sectors which are not contact dependent (indexed to 100)



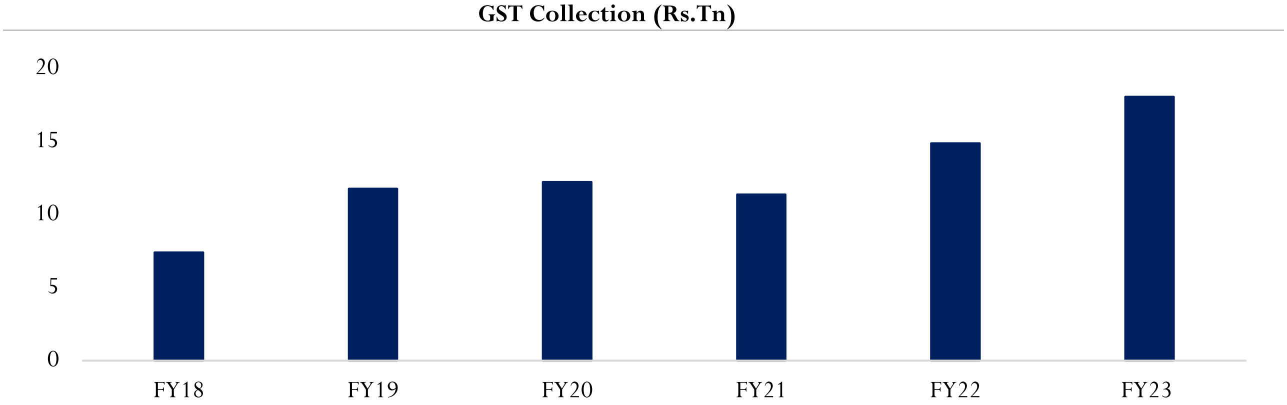
Source: Company reports, Spark Fund Research

Is uneven growth equal to low growth?

NO

No society has been able to engineer its growth dynamics so that everyone has benefitted at the same time. The last two major experiments – one in the Soviet Union and the other in China (cultural revolution – collective ownership of land et al) were unmitigated disasters. US, which is a modern-day success story as an economy, has seen inequality go up with no solution in sight. The data on the Gini co-efficient is telling. The US has remained a highly unequal society. It remains a key engine of global growth nevertheless.

Uneven growth is not equal to low growth. It need not even be equated to poor quality growth if it does not feed on itself. We should remember that specific policies did not lead to Covid. Covid led to certain policies. Nothing suggests that the policies were intended to make the growth uneven. For instance, capital markets activities were declared as essential services of sorts just after Covid. It was not done to pamper a certain part of the pyramid nor was it directed against the unfortunate. It was done because this tradeable service was able to keep the lights on and by easing restrictions, jobs were saved, and taxes got collected. The government in turn did what it could do for the less fortunate segments of the pyramid. The free food program is one such initiative. In the current inflation flare up, the government mitigated the impact on fertilizer prices and hence on food prices through rampant increase in subsidies. It is wishful thinking to believe that policy could have straightened out the uneven recovery.



Source: Bloomberg, GST Council, Spark Fund Research

Collections accelerated after Covid. It is not that the GST collections are coming only from the so-called digitally enabled or the wealthy for that matter. There is broad-based improvement in collections. The challenge for policymaking is not to banish the upwardly mobile stroke of the K but to backstop the people falling into the downward sloping line by providing a safety net. We believe this has been done by India in a much better manner than has been the case with most countries that did anything of note at all.

Consistency over flamboyance

The Chief Economic Advisor (CEA) of the Indian government went on record recently to assert that India can possibly look forward to a 6.5% p.a growth in GDP all the way till 2030. We know that in an election year, the CEA will be expected to say nothing else. That is a trifle too cynical and unfair.

When countries have got their growth recipe right, the shape of growth is not drawn by policymaking through advance assertions. A series of steps which address the right metrics create an environment where growth has come about. Sample these

1. India has kept taxation stable over the last five years. So stable that budgets do not generate enough TRPs now.
2. India has seen tax collections remain robust despite a nasty recession.
3. Indian banking system has seen low NPA levels and improving trends after Covid.
4. India has negotiated the inflation scare of 2022-23 with some aplomb. Better still, the RBI Governor is not playing to the gallery by dishing out unwanted sweeteners in monetary policy meetings. This is great news. The Central Bank is minding its business of controlling prices.
5. Capex spending by Government has been increased every year in the last five.

Government Capex

Year	Capex (Rs. Tn)	Growth (%)
FY19	3.1	17
FY20	3.4	9
FY21	4.3	27
FY22	5.9	39
FY23RE	7.3	23

Source: GoI, Spark Fund Research

While an uneven recovery is not great news for our political economy, the social interventions have addressed the pain in the short run. From now on, some of the growth kickers should take over slowly. While it is not a good idea to deny the K-shaped recovery or paper over the same, that has not prevented the growth recovery.

We are on the same camp as the CEA. The building blocks are in place for the economy to grow at a solid 6-7% growth. For a longer time than many sceptics would give it credit. An 8% growth is a tough ask in current global set-up. It may even be counterproductive. A 6.5% growth over 5 years running will take the economy over the US$ 5 trillion level. That may not excite everyone who wants positive surprise on various metrics every month. Boring as it may sound, a steady and broadening growth pattern with moderate inflation may be an outcome within reach for India.

If that pans out, India would have redeemed the promise that it has held out over the last thirty years. The scope and size of the recovery can make the shape of the recovery fade away into the background.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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