The Burden of Corporate Debt

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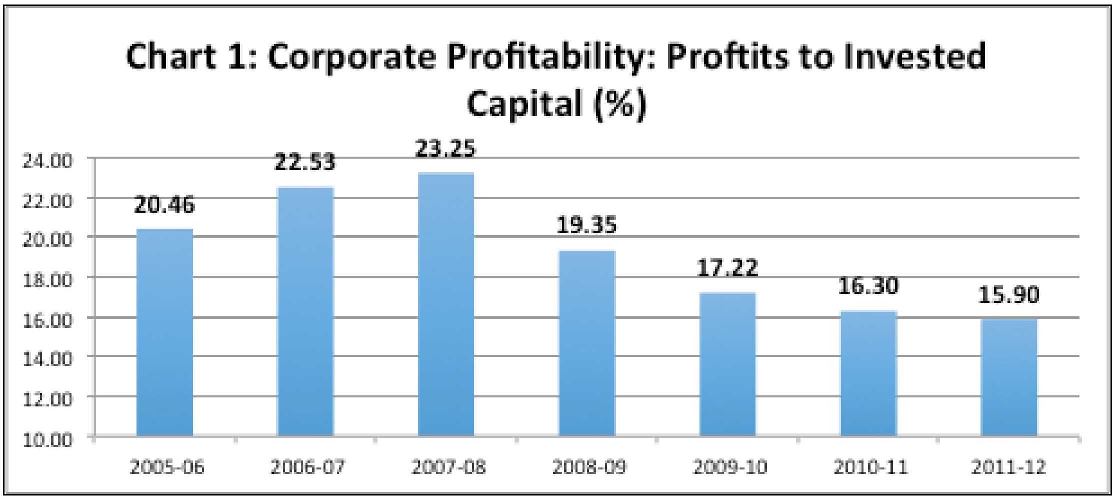
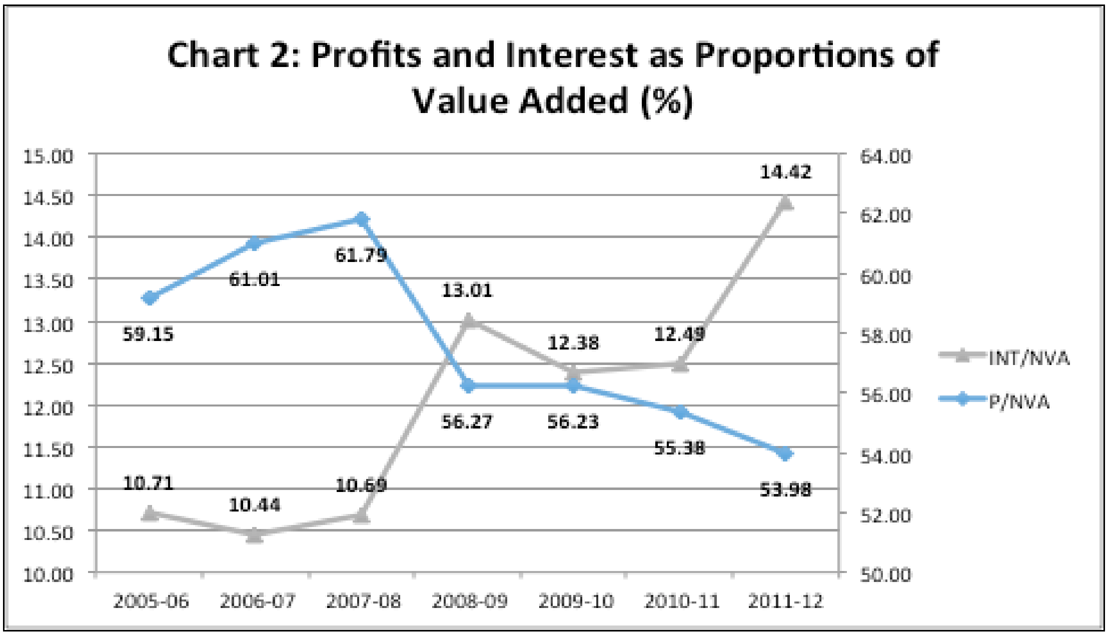
Much attention has been paid to the slowdown of industrial growth in India, with the Index of Industrial Production (IIP) for the period April to February 2013-14 having fallen by 0.1 per cent when compared with the corresponding period of the previous financial year. This is in keeping with the medium term downturn since 2008-09 that signals the end of the industrial boom recorded over the preceding five years starting 2003-04.

Associated with this slowdown is a squeeze in corporate profitability. The Annual Survey of Industries, the most comprehensive database on India's registered industrial sector, shows that the ratio of profits to invested capital (fixed and physical working capital) peaked at 23.25 per cent in 2007-08 and has since declined to 15.9 per cent in 2011-12, the latest year for which data are available (Chart 1).



An interesting fact, however, is that this decline in profitability of more than 7.5 percentage points has not been wholly the result of a squeeze in the share of surplus in the value of output. Thus, the share of net value added (which is the sum total of wages, profits, rent and interest) in the value of gross output has fallen by less than three percentage points since 2007-08. And within net value added, the share of wages in the total, which had been in long-term decline since the early 1990s from as much as 25 per cent to 10.6 per cent in 2007-08, rose only to 11.93 per cent by 2011-12.

In fact, much of the "profits squeeze" has been on account of the rising share of interest in value added. While the share of profits in net valued added fell from 61.8 per cent in 2007-08 to 54 per cent in 2011-12 or by nearly 8 percentage points, the share of interest to net value added rose from 10.7 per cent to 14.4 per cent or close to 4 percentage points (Chart 2). Since the worsening economic environment must have made it difficult to push up prices and revenues to cover higher interest costs, the increase in those costs did constrain profitability. Moreover, any recession in demand that increases unutilised capacity and therefore unit overhead costs directly affects the surplus available for distribution across profits, rent and interest. If interest costs are rising, the pressure on profits is inevitable.



Interestingly, an increase in the relative volume of debt does not seem to be prime factor responsible for the rise in the interest burden. In fact, the ratio of outstanding loans to the gross value of output, which stood at 18.4 per cent in 2005-06 and 16.4 per cent in 2007-08, fell further to 16 per cent by 2011-12. What has changed is that interest paid as a ratio of outstanding loans rose from 9.5 per cent in 2005-06 to 11.3 per cent in 2007-08 and as much as 13.05 per cent in 20011-12. That is, rising "average" interest rates, along with deteriorating economic conditions, seem to underlie the profits squeeze.

One reason why interest rates, and therefore the interest burden, have risen is the periodic effort of the Reserve Bank of India to combat persisting inflation with a hike in the reference rates (the repo and the reverse repo). This obviously impacts on the overall structure of interest rates. The repo rate had been raised from 4.75 per cent at the end of 2009 to 8.5 per cent at the end of 2011. To the extent that this increase in the administered interest rate filtered its way to actual lending rates, it must have contributed to the larger interest bill that shaved off a part of profits. Thus, corporate opposition to the high interest rate regime is not only because of the adverse effect it has on debt financed household consumption and investment, and therefore on industrial demand, but because of the direct impact it has on corporate profitability.

A second factor increasing the interest burden that weighs down corporate profitability is a rise in the interest in rupees paid on foreign debt incurred by Indian business. Repeated relaxation of the ceiling on aggregate external commercial borrowing and liberalisation of restrictions on what individual corporations can borrow abroad had encouraged Indian business to substitute high cost domestic debt with external debt that could be accessed at much lower interest rates. The net result was that the stock of external commercial borrowing debt rose from $26.4 billion at the end of March 2006 to $104.8 billion at the end of March 2012.

One factor that those engaging in this external borrowing binge obviously ignored was the exchange rate risk involved. In recent times, the Indian rupee has indeed depreciated quite significantly, which would have increased the rupee value of the interest due on external debt. Between March 2005 and March 2012 the value of the rupee fell from Rs. 43.69 to the dollar to 50.32 to the dollar, or by 15 per cent. This too must have had the effect of raising the corporate sector's interest burden during difficult times, squeezing corporate profits.

The evidence from the Annual Survey of Industries that the interest burden has been rising and squeezing the profitability of corporates is of significance because even since then, interest rates continue to remain high in the Indian market, industrial growth has slowed to 2.9 and 1.1 per cent in 2011-12 and 2012-13, external commercial borrowing has increased by $32.5 billion from $88.5 billion to $120.9 billion over the two years ending March 2013, and the rupee has depreciated by around 33 per cent since March 2011. This suggests that matters would have only got worse, squeezing corporate profitability further and making the debt burden too large for at least some firms to service.

That is one more form in which the process of financial liberalisation and shift to a debt-driven investment and growth strategy is threatening a growth story that has already gone sour.

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