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Dissecting the COVID crisis

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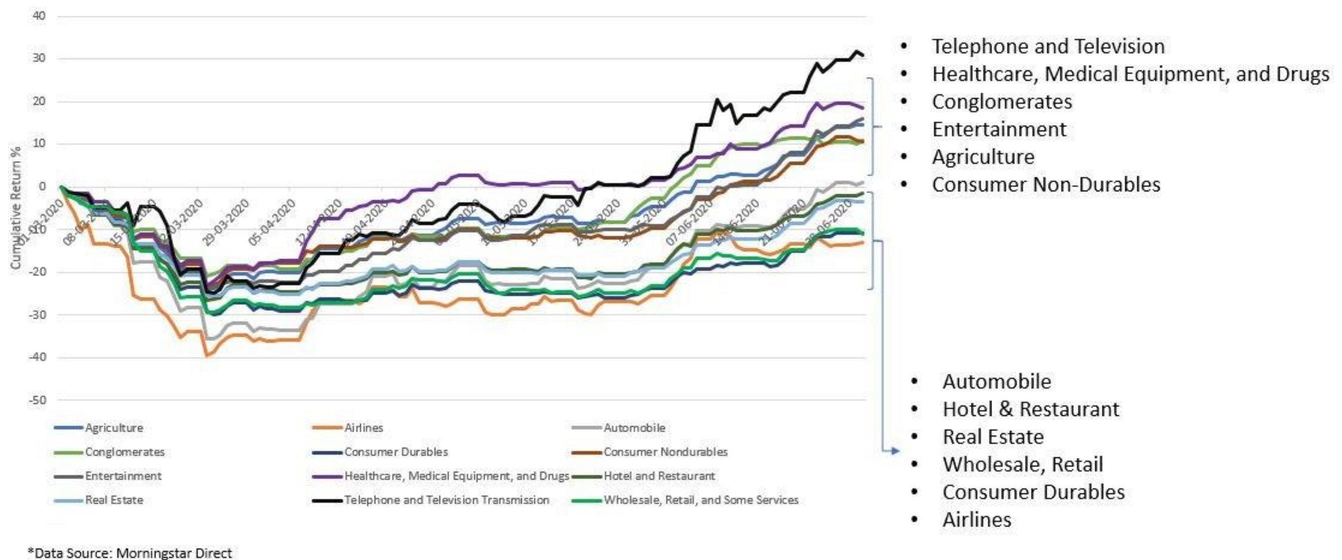
Subramanian and Felman (2019) had come out with a policy piece discussing what has been ailing the Indian economy in recent years. Their focus was on the slowdown since 2018. In this paper, the ex-CEA had argued that India suffered from four balance sheet crisis that started with the twin crisis on bank and infrastructure firms balance sheets, which later percolated to the balance sheets of NBFCs and real estate sector. The authors in this policy piece had feared that a temporary exuberance in the economy could put the policymakers back into a state of paralysis, as had happened time and again. The first of the twin balance sheet crisis had been so quickly forgotten once the economy picked up around 2014 on the back of unsustainable credit growth by NBFCs to the real estate sector. The same mistake had repeated itself since no effective regulation had resulted from a similar story of banks and infrastructure sectors. Little did these authors know that the derailment of any regulatory step would instead be caused by an unthinkable risk that was about to hit the world from its epicenter in Wuhan.

The COVID crisis has given an already battered Indian corporate sector a debilitating blow. Given that it is an ongoing crisis and the firms' financial results have only started trickling in, it is too early to comment about the magnitude of damage it could have had. The only high-frequency data point that could be an (imperfect) indicator of relative positions of the industry is the stock market return i.e. if you are a strong believer in the rationality of Indian capital markets. Figure 1 shows the relative performance of the various industry portfolios formed on 1st March and held until the end of June. The top and bottom 6 industries have been shown, and they are the usual suspects of this crisis. The worst-hit industries include automobile, hotel and restaurant, real estate, wholesale and retail, consumer-durables and, of course, airlines. The list should worry us even more because most of these listed industries were already doing

poorly before the crisis and are also the major employers.

Figure 1: Industry Aggregated Cumulative Return from 1st March 2020 to end of June 2020



WHAT MAKES COVID-19 CRISIS DIFFERENT?

COVID-19 is a very unique crisis in the sense that it has two channels of impact on the economy - the first is due to the health consequences leading to a dip in productivity at a very large scale, and the second is through the forced lockdowns. There has thus been a sharp drop in demand within months of the start of the crisis. The disproportionate impact of thecrisis on sectors that are bulk-employers does not give much confidence in v-shaped recovery in the medium term because the demand may not go back to the pre-crisis levels for a long time. In comparison, the 2008 sub-prime crisis started as a supply-driven slowdown due to the drying up of credit in the economy. In fact, studies such as Duchin et al (2010) & Joseph et al (2020) have shown that the firms which had high cash reserves completely weathered the 2008 crisis by relying on their internal capital to sustain investments. A similar exercise for Indian firms during the COVID-19 crisis tells a very different story.

HOW DID CASH RICH FIRMS PERFORM?

Could the cash reserve of the listed Indian firms before the crisis give some confidence to the investors? The answer seems to be no. First, Table 1 shows the top 5 and bottom 5 sectors in terms of cash to assets ratio. Mining, recreation, construction, manufacturing, and real estate were the worst in terms of cash reserves before the crisis, whereas professional services, agriculture, wholesale and retail, transportation and healthcare appear to have had a healthy cash reserve. There does not seem to be a very high correlation

between this list and the best/worst performing industries in the capital market.

Table 1: Top 5 and Bottom 5 Sectors by Cash Holdings as of March 2019

Top 5 Sectors	
Sector	**Average Cash-Asset Ratio**
Professional, scientific and technical activities	2.7
Agriculture, forestry and fishing	2.4
Wholesale and retail trade	1.3
Transportation and storage	1.1
Human health and social work activities	1.0
Bottom 5 Sectors	
Sector	**Average Cash-Asset Ratio**
Mining and quarrying	0.3
Arts, entertainment and recreation	0.3
Construction	0.3
Manufacturing	0.2
Real estate activities	0.1
*Data Source: Prowess	

The most interesting result, though, is shown in Figure 2 below. The figure very clearly shows a complete disconnect between the cash reserves before the crisis and the cumulative returns during the crisis (from March 2020 to June 2020). The portfolio of firmsat the bottom quintile in terms of cash to assets ratio seems to have outperformed all the other portfolios.

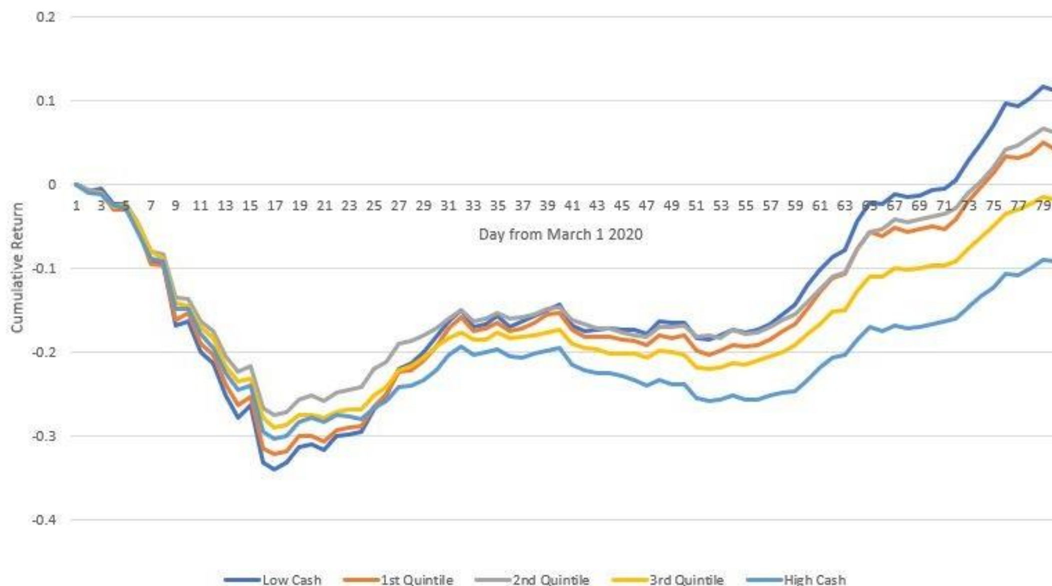


Figure 2: Average Cumulative Return for Quintiles based on cash balance in March 2019

The above figure tells a great deal about the nature of the current crisis. It is currently a demand-driven slowdown, and thus the cash reserves of the firms are not at all handy in the short term. Even if the firms are sitting on a pile of cash, what is the rationale for investing when there is no demand? This crisis is, in fact, very industry-specific and have negatively affected some industries disproportionately.

Will cash help at all then?

Although the current data say otherwise, cash is, of course, going to be an essential asset in the long term. First, the obvious implication will be on the time that it buys for the firms to keep itself going until the demand starts to pick up after the economy opens. Second, this demand-driven crisis will ultimately lead to a drying up of credit as the banks start facing the heat and then the cash will come handy as it did for firms during the sub-prime crisis. The capital market does not seem to have factored those in at the current stage.

REMEDIES?

A drop in the real demand in the economy due to lockdowns leaves policymakers with very limited options. They are currently faced with a tough choice between saving lives and saving jobs. Add to that the existing malaise in the Indian banking system, which does not allow much room for temporary forbearance. There are two difficult options for the policymakers – first, saving the large employers which are not necessarily the most efficient firms in the economy, and second, start a temporary unemployment benefit while allowing the most inefficient firms to fail – and they are mutually exclusive given the limited resources with the government. This decision could probably be driven by the expected length of limited movement of labor between states. A longer hiatus would call for unemployment benefit schemes; a shorter one would call for a temporary forbearance which could keep the employers floating until they later absorb the currently unemployed workforce.

A heterogeneous impact on the industries also calls for careful consideration of allocation of government resources, and policy targeting towards specific industries. It will come down to a welfare maximization choice, which is the central objective function of the government. Another focus should be to ensure that the firms being saved have been considerably impacted by the current situation and are not the ones who were already doing badly before the crisis and are just plain inefficient.

CONCLUSION

The current crisis that we are going through has probably not been seen by a few generations, and hopefully will not be seen again for a few generations. We are currently in the extreme tail end of the risk distribution and, to say the least, none of the countries was prepared for a crisis of this scale. India went into this crisis with an already depleted economy with growth that had fallen to 4-5% in the last few quarters. The corporate sector was especially in trouble with about 40% of the firms having an interest coverage ratio of less than 1 (Subramanian and Felman 2019). COVID-19 has given it a death blow, specially to a subset of industries which were already doing badly before the crisis hit. In such a bleak scenario, the remedial steps must succeed a careful analysis of the impact and the needs of specific sectors and their average financial positions. There is no substitute for a data-driven approach which also calls for researchers to step-up their game on India-focused policy research.

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