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# ANALYSIS OF INDIA'S RESPONSE IN ADDRESSING THE CONCERNS OF THE MSME SECTOR

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# Analysis of India's Response in Addressing the Concerns of the MSME Sector


## Abstract

The COVID-19 Pandemic has spelt crisis across the world and has had a severe impact on the economies. With the government imposing lockdown and mandating social distancing, the world will wake up to a new culture and trend post-pandemic. It has affected all sectors of the economy, but the Micro, Small and Medium-Sized (MSMEs) Businesses have been the worst hit. This paper focuses on the impact of the COVID-19 pandemic on the Indian MSME sector and analyses the measures and initiatives taken by the Indian government along with its Central Bank– the Reserve Bank of India (RBI)—to help the MSME industry. It also addresses the challenges that the proposed measures face and further provides policy suggestions on what can be done to provide relief to the sector and stir the economy.


## 1. Introduction

The MSME (Micro, Small & Medium Enterprises) sector is considered to be the backbone of India's economy and is one of the critical components for India's growth story. India's service sector contributes nearly 55 per cent to the GDP and 32 per cent of the total employment in India. A major part of the service sector is driven by the MSME sector, which contributes approximately 30 per cent to the GDP from service sector activities and employs 114 million people. According to the annual report of the Ministry of MSME, out of the total 63.38 million MSMEs, 69 per cent (43.73 million) are in the service sector. Of the 43.73 million MSMEs in the service sector, 23.03 million are in trade and 20.68 million in other services, i.e., trade accounts for 36 per cent, manufacturing 31 per cent and other services 33 per cent. The sector is composed of Micro (99 per cent), Small (0.52 per cent) and Medium (0.01 per cent) enterprises.

India's SME (Small & Medium Enterprises) sector is the most significant contributor to its economy in terms of registered and unregistered SMEs (42.50 million) compared to other countries[1] like the UK (5.9 million), the US (30 million), Europe (25.1 million) and China (38 million). The MSME sector is essential for India as it promotes a balanced economy, but the impact of the recent coronavirus pandemic has proved fatal for this sector.

This paper focuses on the impact of the COVID-19 pandemic on the MSME sector and analyses the measures and initiatives taken by the government along with the Central Bank to help the MSME industry. It also addresses the challenges that the proposed measures face and further provides policy suggestions on what can be done to provide relief to the sector and stir the economy.

## 2. Impact of Coronavirus Pandemic on MSMEs

The COVID-19 pandemic has caused an economic slowdown on a global scale as businesses and markets were unable to operate under the nationwide lockdown in many countries. Companies, especially in the MSME sector, are the worst hit due to the pandemic and are struggling to keep afloat

1. Numbers are in approximate

as their business activities have collapsed. In India, the lockdown forced many businesses to shut down temporarily, and many are staring at an existential crisis. As per a study conducted by the All India Manufacturers' Organisation (AIMO), approximately a quarter of over 75 million MSMEs in India would have faced closure with a lockdown extension. Their cash flows were adversely impacted and eroded six months of potential profits, leading to tightening of their liquidity positions.

MSMEs are affected across various levels, there have been issues with the production facilities and retail. Furthermore, micro-enterprises that are mainly associated with the service sector are considerably impacted. The MSME sector engaged in tourism, logistics and hotel industry has been witnessing a sharp drop in business and those involved in essential services were operational during the lockdown facing liquidity constraints. Other areas such as consumer goods, utensils, automotive segments, garments and footwear are also facing the threat.

Moreover, the sectors which are dependent on high imports are facing a shortage of raw materials like consumer durables, pharma, electronics etc. and labour even after lifting the nationwide lockdown. There are bottlenecks in the supply chain mainly due to the lack of availability of workforce post lockdown. The pandemic has also affected the export sector. It holds a share of 36 per cent[2] of the MSME sector. Over 50 per cent of orders got cancelled and there was a rise in Non-Performing Assets (NPAs) in the export sector. Loan repayments, interest payments and taxation also haunt the industry.

## 3. India's Response to the Crisis

### i) Early Response

In response to the plight induced by the pandemic, the Reserve Bank of India (RBI) took a few early measures to allay the concerns of the MSME sector. The RBI slashed repo rate and reserve repo rate by 75 basis point and 90 bps, respectively.[3] It increased limits on NPAs to prevent triggering insolvency, offered payments from the government's share of the Employee Provident Fund to avoid layoffs and permitted banks and other financial institutions to grant borrowers three-month moratorium on loan repayments (Economic Times Blog 2020).

The three-month moratorium period gave some relief to the businesses providing them with the much-needed liquidity. During the lockdown, all activities in the red zone areas were at halt, and with no revenue, more time will be needed to get the economy back to normal. Even after lifting the lockdown, the MSMEs are not in a position to generate immediate revenue, making them unable to commence loan servicing from the fourth month. The RBI also eased the working of financial capital by sanctioning CC/OD to borrowers facing stress and the financial institutions reduced the margin till May 31, 2020.

The RBI also took measures such as Targeted Long-Term Repo Operations (TLTRO) of ₹50,000 crore aimed at benefiting Non-Banking Finance Companies (NBFCs) and Micro-Finance Institutions (MFIs) to help small and medium-sized businesses. The funds availed under this scheme were supposed to be invested in investment-grade bonds, commercial paper, and non-convertible debentures of NBFCs with 50 per cent of the amount reaching MFIs and small and mid-sized NBFCs. As NBFCs and MFIs play an important role in lending to MSMEs, this initiative was the need of the hour. However, it failed to receive a positive response as there was limited participation of the banks which clearly indicated the banks' reluctance to lend to mid-size and small NBFCs and MFIs. These institutions were facing stretched liquidity conditions considering the selective behaviour of the banks in giving moratorium to them.

Before this scheme, the RBI launched a Long-Term Repo Operation (LTRO) worth ₹1 lakh crore which went to big companies as banks chose to play safe. Their risk aversion affected smaller MFIs and NBFCs as these firms had to give moratorium to the borrowers, but did not receive the same from their lenders. Due to this, RBI's liquidity support failed to benefit these firms and some of their borrowers. This clearly indicated that it is not the liquidity problem

2. NSS 73rd Round
3. 100 basis pooint/bps = 1 per cent

but the fear among banks for future defaulters. The indisposition is corroborated by the data released by the RBI in early May where the banks had parked a record high of 8.42 trillion rupees of their excess liquidity with the Central Bank. The surplus liquidity indicated the reluctance of the banks to disburse credit to the general public, which can potentially delay the economic recovery of the country.

The measures announced by the RBI were reasonable, but they did not go far enough largely because of the long-standing crisis in the financial system that predated the pandemic. Cutting the reverse repo rate was not enough to make banks lend to MSMEs or other smaller firms. Banks' unwillingness to lend is to avoid ever-greening of loans and because bankers do not see a viable future with cash flows remaining ambiguous due to a fall in demand and the following recession. There is an information asymmetry between the lender and the borrower, which decreases the probability of the borrower availing formal credit from the banks[4] even during a non-crisis period. During this period of a pandemic when bankers are aware of the risk, they are becoming more reluctant to lend due to these reasons.

### ii) Recent Measures

Recently, in response to the unfavourable economic conditions, the government announced a new financial package labelled 'Atma Nirbhar Bharat Abhiyan' for a combined stimulus of ₹20 lakh crore. Finance Minister Nirmala Sitharaman announced six-step measures in the first tranche aimed at the MSME sector. Collateral-free loans up to ₹3 Lakh with 100 per cent guaranteed by the government were proposed for firms with up to ₹25 crore outstanding and turnover up to ₹100 crore. But the eligibility conditions are met by less than 10 per cent of the MSME segment. However, the provision of 100 per cent guarantee by the government excludes the banking system from sharing the risk. This is expected to translate into the required line of credit for the miniscule lots.

The second measure is aimed at MSMEs which are NPAs or stressed. The provision of ₹20,000 crore for Subordinated Debt is made for 2 lakh MSMEs that fall under the stressed category with a support of ₹4000 crore from the government to Credit Guarantee Trust for Micro and Small enterprises. The success of this proposition is, however, questionable since the banking institutions have the discretion to exclude the risky entities.

The third measure consisted of equity infusion through Fund of Funds, where the government will set up a Fund of Funds with a corpus of ₹10,000 crore that will provide equity funding support to MSMEs. This measure was aimed at MSMEs which have the potential and are viable to grow and need government support to do so. The package for the MSME sector also attempted to allay the concerns of the MFIs/NBFCs and housing finance companies wherein they are permitted to buy payable debt documents under full guarantee from the Government of India. This is proposed with an intent to generate jobs and help businesses become self-reliant. The other measures included change in the definition of MSME, elimination of global tenders for government tenders up to ₹200 crore, and replacement for trade fairs and exhibitions post COVID-19 lockdown.

Overall, the measures taken by the government were good first steps to revive the economy in the long term. However, with these comprehensive sets of measures come various challenges and problems. While the package bets big on building a strong social framework for India's working class, only a small amount of the package forms the fiscal support that is required to support the economy. The initiative lacks direct fiscal support because the Government of India does not entirely fund the stimulus package. It includes measures previously announced by the RBI. The ₹20 lakh crore package does seem impressive as the government is injecting liquidity into the economy, but the problem lies in the realms of banks being risk averse. It is not clear as to how soon these cash flows will take place to meet the immediate requirements of the sector. The government fixated on liquidity in the market through collateral-free loans instead of directly transferring the money into

4. http://researchersworld.com/ijms/vol5/issue2_2/Paper_10.pdf

people's accounts. The collateral-free loan is not available to those who had zero outstanding loans as on February 29, 2020, or took loans post-March 1, 2020. In other words, the package assumed that if an entity was not stressed pre-COVID, it would be the same during the pandemic.

The ₹20,000 crore scheme for providing Subordinate Debt for Stressed MSMEs is meant for MSMEs which are functioning as well as those units with stressed assets and NPAs. As mentioned above, in this scheme, the government will provide only ₹4000 crore to the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), i.e., the government is expecting the banks to disburse 20 per cent of the total amount. Here, the government expects the banks to lend to MSMEs without any interest even when it is not ready to spend.

Moreover, these measures will likely favour only the viable MSMEs who are able to keep their business afloat and the outflow of credit will be less than what is actually allocated. Also, the measures announced for NBFCs are lower than the immediate requirements of the borrowers, and it will fall short of solving the liquidity problem faced by the sector. These measures will help ease market asset risks for the financial sector; however, they will not completely offset the negative impact of the virus. As much as the government should be applauded for its long-term approach, the package does not meet the direct demand of the MSMEs—an immediate and short-term support during the on-going crisis. If not, like major payroll support announced by other countries such as the US, some direct financial transfer would have been helpful for the MSMEs as it would have given them timely relief.

A survey by the All India Manufacturers' Organisation (AIMO) revealed that 35 per cent of the MSME enterprises have started shutting down their businesses as they do not see a chance of recovery. The financial package announced by the government has failed to reach the MSMEs; it is also inadequate to make up for the loss of the businesses during the period of lockdown. The secretary of AIMO claimed that many people would lose their jobs due to this pandemic. Hence, there is a need for the government to protect the wages, which could bring instant relief to those losing their jobs. Such an initiative has been taken in countries like the US and Japan, where they have provided an actual relief stimulus.

An additional measure announced by the Finance Minister focused on ease of doing business through IBC (Insolvency and Bankruptcy Code) related measures concerning MSMEs. The government raised the minimum threshold to initiate insolvency proceedings to ₹1 crore from ₹1 lakh which mainly insulates MSMEs. The Finance Minister has also suspended Sections 7, 8 and 10 of the IBC for six months. However, the MSME sector preferred IBC as a whole to be suspended for the said six months. These measures mainly aim at serving medium or large units of MSMEs. The micro and smaller firms are more extensive in number, more distressed and need more help and support. The step also comes as a misfortune to creditors of the corporate debt. The initiative was introduced with a creditor in control regime, but the suspension implies the opposite and makes a debtor in control. This process is likely to cause undue delays because the financial and operational creditors will have to go through extensive litigation to recover any dues. The suspension of Section 10 has been done without any alternative relief mechanism and it will benefit wilful defaulters in escaping liability. Even if these measures aim to help the MSME sector, it will distress the financial system even more. The government cannot push one segment into water to prevent the other one from drowning. There needs to be a balance. The government is not providing money, instead it shows a path to borrow money.

Furthermore, these measures may provide relief to some MSMEs who have large debts, but it oversees those MSMEs which hold the position of operational creditors under the IBC. These numerous MSMEs with claims of salary, trade debts or wage claims etc. are often lower than ₹1 crore as reported in Economic Times. Hence, the measure may exclude these MSMEs under the IBC as the provisions will relegate MSMEs to civil remedies for debt recovery, thus doing the opposite of what is required during this situation.

Other countries such as the UK, the US and Russia have taken measures like a temporary ban on statutory demands and prohibition on winding up petitions, effective bankruptcy relief to MSMEs and individuals through CARES Act and have also increased the threshold for filing insolvency. A moratorium has been imposed on bankruptcy proceedings, respectively. Compared to other countries, India needs to formulate a proper framework for the resolution of insolvencies for different sections of the businesses.

As an immediate measure for survival, tax benefits and refunds need to be considered by the government to help MSME to carry on with their business activities without cuts and layoffs.

## 4. Role of Informal Sector

According to the International Labour Organisation (ILO), the informal sector includes those units which are unincorporated (i.e., not constituted as separate legal entities of their owners), produce goods or services for sale and satisfy a number of categories. For instance, unregistered and small entities which have unregistered employees; they do not necessarily maintain a proper or formal set of accounts or paper-work, etc. These units also include street vendors, home-based workers, taxi-drivers, etc. Informal workers do not have written contracts, paid leave, social security or health benefits, etc. As of 2017–18, the share of the informal sector employment increased by 3.6 per cent while the share of formal employment increased by 0.9 per cent.[5] It can also be said that the percentage of informal workers in the unorganised or informal sector comprises up to 85.5 per cent in the said years. The manufacturing sector, trade and other services have the highest share of MSMEs in India. Considering the total share of the informal sector in the Gross Value Added (GVA) in the aforementioned sectors is 22.7, 86.6 and 47.9 per cent,[6] respectively. From this, it is clear that the informal/unorganised sector majorly contributes to the MSME sector. 51 per cent of the MSME enterprises are in rural areas, of which 324.09 lakh are micro units.[7]

The Finance Minister also announced MUDRA-Sishu loans up to ₹10,000 that will cover up to 50 lakh street vendors. However, loans being available are not the same as cash being made available in time. The measures taken by the government are not beneficial for the informal sector, even though it is the main contributor to the GDP. There is barely any support for the micro-units, especially in the rural areas. The government has infused liquidity into the system and has supposedly made borrowing easy. The critical question is, would they (micro-units, self-employed, home-based workers, etc.) be willing to borrow, knowing their condition or without formal documents? The bigger question is, would the banks be willing to lend to these micro-units or self-employed street vendors or taxi drivers? _

## 5. Recommendations

The government should consider direct transfer to the MSMEs, which is a viable option and will provide timely relief to the MSMEs at least until they start generating revenue.

From a fiscal standpoint, India needs to increase financial support to provide relief and rebuild the economy. Even though India's fiscal policy remains limited, it is essential to arrest the economic slowdown. The fiscal stance should be used as a shield against more severe economic downfall by using temporary and targeted measures. Doing so will put a financial burden on the government, which can be partially avoided by postponing non-essential expenditure to the next year. The announcements made by the government are credit-focused; hence, the government should have leeway for a reasonable fiscal package with direct benefits.

India is staring at a massive supply side disruption; the government's intervention to revive production activity is essential for economic recovery. Post-world war II, Germany was hit by a serious supply side

5. IMF
6. National Accounts Statistics, 2019
7. NSS 73rd Round

disruption. To reverse the slowdown in GDP, the German Chancellor lifted price controls and provided tax cuts to kickstart the economy. Faced with a similar economic situation, India should also consider building the supply side by prioritising the sectors that are employment generators and growth drivers.

There are unorganised micro industries, informal MSMEs and household entities without proper records and paper available with the government departments. For the fiscal support to reach these entities, especially the micro-units as they have been majorly left out in the previous initiatives, the government should consider a flexible approach. The government can use data available in various schemes like Udyog Aadhar Memorandum (UAM), MUDRA, MSME database and Jan Dhan, etc. to retrieve information about such entities and provide them with immediate relief.

To further devise the efforts of the government in an effective manner, it should consider engaging with multiple agencies to offer financial support to MSMEs. This could be done via a common electronic platform as it would allow the government to perform checks and balances.

A bailout from utility bills for a certain period would greatly help the MSMEs as only infusing liquidity would not help small businesses revive and could lead to a further weakening of the twin balance sheet crisis that is sure to emerge if the demand does not revive. As of now, the RBI has extended this period till August 2020. A more extended moratorium period will help the MSMEs plan for a revival in the long run. The RBI could consider an interest-free extended moratorium period or just simple interest. However, considering the factor that waiving of interest rates may be a detrimental move for the banks, the Central Bank could only make an exception to extremely stressed entities.

Depending on the current period, banks could consider increasing Open Cash Credit (OCC) depending upon the sector or the business that has been hit the hardest. For example, personal health and grooming services, restaurants and retail shops.

It would be worth considering a private-public partnership to keep the SMEs afloat at this challenging time by providing them with the support they need. Even if more private organisations step up to help MSMEs—for instance, in China, a Beijing-based JD.com allocated nearly 500 million yuan to support the SMEs using its logistics, e-commerce, financial cloud and AI resources—this may not solve the problem for the entire SMEs sector, but will lift off some burden from the government, and more liquidity will be available.

## 6. Conclusion

The nationwide lockdown has majorly impacted the MSME sector in India. As the aforementioned reasons clearly state that the sector has been experiencing excess liquidity crunch during the period of the lockdown, due to which they have not been able to pay salaries to their workers and some of them had to forego their workers or even shut down their business. There has also been a shortage of workers, raw materials, supply chain disruptions and severe effect on the export segment of the MSMEs.

Though the RBI and the Government have taken several measures, the initiatives do not hit the bull's eye as the MSME sector still remains underwater waiting for rescue. It is not the lack of efforts by the government, but the effectiveness of the schemes and initiatives and to some extent their implementation that have failed to reach the most vulnerable MSMEs.

The immediate problems that the informal sector is facing are not addressed; the sector has been overlooked. There is a lack of complete fiscal support and a deficiency of various measures that could have benefitted the MSMEs. For instance, in the Atma Nirbhar package, despite the colossal package announcement, the prerogative lies with the banking sector to provide loans to MSMEs. The government shall be appreciated for its far-sighted vision; however, it has missed the immediate solutions.

Though the government and the Central Bank have infused liquidity into the system, they have failed to address a major challenge, which is 'lending'. Banks are being risk-aversive and are reluctant to lend as they do not want a pile of NPAs. The government has handed a list of schemes to the people they can or cannot avail. This paper strongly recommends that the government should consider direct transfer as a medium to provide immediate relief to the people. It can be concluded that though the government did not entirely fail in addressing the needs of the MSMEs, its initiatives did not deliver immediate relief, which was very much expected and required.

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