



JSW SCHOOL OF PUBLIC POLICY

# POLICY BRIEF

No. 2020.1

June 2020

## MSME Supply Side Amidst Pandemic

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## Context & Scope of the Study

The COVID-19 onslaught has imposed several challenges all over the world. The on-going pandemic has brought the world to an economic standstill and transformed a health crisis into an unprecedented financial crisis. The purpose of this study is to understand the supply-side shocks that the current crisis has brought upon the Micro, Small, and Medium Enterprises (MSMEs) and recommend policy interventions that the government can take to mitigate the damage.

MSMEs employ nearly 114 million people and have almost one-third share in India's GDP. MSMEs also have almost 50% share in India's Global exports, making them the backbone of the Indian Economy. With India's drive for a self-reliant economy and the dream of bringing millions of Indians out of poverty, survival, and recovery of the MSME sector is extremely important.

### Executive Summary

This document recommends policy responses to the supply side shocks that the MSME sector is facing in India due to the Covid-19 led economic crisis. The research identifies 5 main supply side shocks that have had a profound impact on the MSME sector - Liquidity constraints, amassed inventories, infeasible raw material sourcing, labour unavailability and uncertainty in customer accessibility. Based on these identified shocks a few policy response recommendations have been made which can be summarized as follows:

#### Recommendations

Liquidity shocks:

- Restrictions on only old borrowers being able to borrow from the Emergency credit fund be withdrawn to address a broader set of enterprises
- Split in credit enhancement given to companies to increase responsible debt flow
- Social security contributions by MSME firms should be stalled for a few months to enable wage payments and additional liquidity in FY21
- Pending payment by SOE and the government should be paid out at once to

improve the liquidity crunch

Amassed inventories

- Allow for increase in sale date of BS-IV vehicles for Auto companies, especially at discounted rates to increase liquidity and reduce inventory management costs
- Provide subsidy on warehousing for large volume, low margin export business companies to reduce inventory costs

Infeasible raw material sourcing

- Provide subsidy on warehousing for large labour unavailability
- Provide subsidy on warehousing for major uncertainty in customer accessibility

Labour Shortage

- Provide health security to migrant worker by registering under health schemes such as Ayushman Yojana
- Provide shelter safety by ensuring free or less expensive shelter to live for migrant workers
- Provide employment security by mandating a minimum proportion of monthly salaries to be granted

Customer Accessibility

- Provide tax incentives/subsidies for operating digitally using digital platforms

## Research and Analysis Section

The challenges faced by the MSME sector in the aftermath of the Covid Pandemic are listed below. Along with that, the respective policy responses and its perceived shortfalls are mentioned which form the basis of our policy recommendations in the next section.

### 1) Liquidity crunch:

Shock 1: Increased working capital requirements of the SMEs and a distressed projection of cash flows leading to costly borrowing terms from banks (as they are not conceding on credibility of requirements)

Shock 2: Mounting interest payments after the lockdown to debtors, with seemingly no incoming cash flows

Shock 3: Firms with lower credit worthiness borrowed from credit risk funds like Franklin Templeton, some of which were shut down with majority clients from MSMEs, leaving them even more cash strapped

## 2) Amassed inventory:

Shock 1: Exporters have high volumes of inventory which have been stacked in warehouses due to trade uncertainties. This has added to their inventory management costs and have therefore affected the low margin businesses severely

Shock 2:

- Extremely high inventory levels due to almost complete decline in demand for automobiles has anguished the big companies and ancillary industry SMEs alike
- Salaries and rent are approximately 40% of the costs of Auto OEMs and ancillary companies. Many dealerships across the country have been forced to shut down due to the lack of orders and high inventory management costs.
- Unsold BS IV inventory has aggravated the inventory management problem.

## 3) Raw Material Sourcing Shocks:

A significant challenge for MSMEs is sourcing their raw materials in a locked-down economy.

Shock 1: Except for a select few enterprise sectors, the cost of raw materials has stayed the same, but what has increased is the median cost of sourcing. Some surveys have indicated a 20% increase in the median sourcing costs across MSMEs in rural and urban areas. Further, due to the movement restrictions imposed as per the social distancing norms, almost 77% of all MSMEs have been forced to pick up all their essential supplies themselves, without the availability of the adequate transport vehicles.

India's heavy dependence on imports from China and other countries leads us to the next shock.

Shock 2: So far, the cost of raw materials has not shot up significantly. Still, India's MSMEs have a heavy dependence on its comprehensive import basket sourced from China and other countries. Just from China, India imports 55% percent of electronic components, 27% of its automotive equipment, and almost all its textile raw materials. With imports sitting at almost 40% of their pre-COVID levels, the costs of raw materials across all these sectors are expected to go up and the overall output to go down, resulting in several shutdowns and job losses.

## 4) Labour Shortage Shocks

Shock 1: Amidst the current pandemic of COVID-19, reverse migration has happened to a large extent. Many workers have travelled back to their homes by simply walking or cycling, clambering onto trains or getting packed into trucks. There are various figures available to quantify the current reverse migration and most of them point out that more than 2 Crores of workers have fled to their hometowns [8]. In MSMEs, the reverse migration has amounted to 80% of the migrant workers. This percentage could be understood by an example of 11,000 MSMEs in the Pimpri-Chinchwad area. In the region there were 4 - 4.5 lakhs workers, out of which 3 lakhs workers were migrant workers and approximately 2.5 lakhs of them have moved to their respective hometowns.

Shock 2: Workers have fled from their livelihood centers to their hometowns in search of emotional connection with family and sense of security. In the pandemic scenario, often emotional connection with family outweighs the employment opportunities, making it difficult to restore Industrial operations as per pre COVID times]. According to the Secretary General of FISME (Federation of Indian MSMEs), most of the workers have fled to their homes and industrial units do not have capacity to bring them back. In an Industrial survey conducted by PHD Chamber of Commerce and Industry, 49% of the Industrialists accepted the fact that it would be hard to bring back the migrant workers to work in these unprecedented times

Shock 3: MSMEs could face several challenges and two prime challenges are absenteeism and

maintaining safety standards while operating at full capacity. After the widespread shutdown of factories and industrial units across the country, Absenteeism could be a problem. In the Wuhan province of China, absenteeism was near about 60-70% in the initial days of the post lockdown period

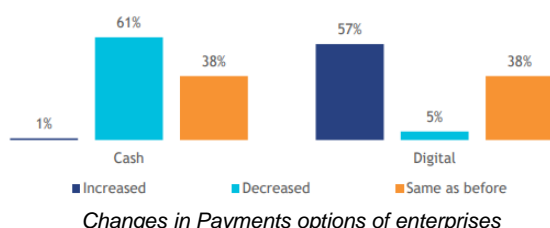
To practice social distancing on the shop floor, multiple state Governments have directed manufacturing units to operate at 50% operational capacity. Ultimately, this means the lower production and finally leading to cut in the revenues of manufacturing units

In the short term, workers might not come back to the urban centres for livelihood and there is a dire need to incentivise them.

### 5) Customer accessibility shocks

Shock 1: The sudden disruptions in the supply chain of MSMEs has made it necessary to adopt digital platforms. Most of the enterprises are not able to reach out to their customers physically and need digital platforms to perform the same. Four reasons for MSMEs to adopt for digital platforms could be (a) to increase the customer base for MSMEs in these economic dull times (b) to effectively serve the current customers (c) to avoid current disruptions in the supply chain due to lockdown (d) to operate in the period where remote working is a necessity and digital transformation would ensure higher employee engagement

Approximately one third of the enterprises have started using social media such as WhatsApp & Facebook for order booking purposes after the COVID-19 pandemic. The usage of digital payments has also seen a rise, and more than half of the enterprises have moved towards digital payments amidst the current pandemic. There has been a decline in cash transactions also as per 60% of the enterprises during these unprecedented times.



## Exposition on the Current State/Central Policies

### 1) Liquidity constraints:

Policy Response for Shock 1:

Emergency credit lines guarantee a scheme whereby a maximum loan amount of up to Rs 200 crore or 10 percent of the existing fund-based working capital limits can be availed by MSME borrowers. A cap of 9.25% must be maintained while following a floating interest rate providing borrowers a semblance of security against exorbitant rates. Also, recognition as an MSME is not a prerequisite for the loan

Shortfalls:

- The Emergency Credit line guarantee scheme is not for new borrowers and is only restricted to existing customers of a bank/NBFC. When a majority of the most vulnerable MSMEs are unregistered entities, this scheme fails to have a wider coverage
- No certification as an MSME means even large corporates can avail this facility and may consume the majority share of the fund
- Short term future projection will obviously affect viability figures of the business negatively

Policy Response for Shock 2:

- Interest moratoriums have been provided for the duration of the lockdown where the interest payments from March to June can be deferred to be paid in instalments later
- INR 20,000 crore subordinate debt provision available for stressed MSMEs. Two lakh MSMEs which are NPAs or are stressed can avail of this facility
- As much as Rs 4,000 crore will be provided to Credit Guarantee Fund Trust which will in turn can provide partial credit guarantee support to banks. The debt given by the banks will be used to infuse equity in the unit by the promoter

Shortfalls/suggestions:

- Interest (especially in public sector banks) could have been waived for the months of the enforced lockdown since the companies have had to bear unprecedented decline in business due to governmental action
- No respite has been provided to firms with sizable employee base in matters of social security contributions or tax implications for the pandemic phase
- Penal interest for late payment of GST and similar taxes could have been cancelled
- A 100% credit guarantee leaves no incentive for either borrower to pay back — he has nothing to lose — or for the lender — the banker is assured of payback from the government so why should he bother to check if the borrower is deserving or not

#### Policy Response for Shock 3:

- LTRO 1.0 and 2.0 have infused liquidity into the system and enabled banks to transfer the policy rate cuts to the end consumers
- The financial package included a 20000-crore subordinate debt provision and a credit guarantee fund trust have been set up as mentioned earlier
- SIDBI has announced a concessional interest rate of 5% for MSME loans under the SIDBI Assistance to Facilitate Emergency Response against Covid-19. These loans would be provided within 48 hours, with no collateral and minimum paperwork but only those MSMEs that are manufacturing products or delivering services related to the Covid-19 fight are eligible

#### Shortfalls:

- Most MSMEs (especially micro firms) are unregistered since they are either too small and/or are not in the organized sector. This invisibility brings down their compliance costs but at the same time disallows them to avail benefits of government action in crisis situations

- One significant deterrent, sources said, is that the rate of interest charged by banks under the scheme is almost at par with market rates and does not offer any substantial concession. Higher interest rates make credit unviable for small companies
- Banks are not asking for fresh collateral for these loans under the scheme, but since it is extended only to existing borrowers running credit facilities with banks, their factory land, plant and machinery is mostly pledged with the banks

## 2) Amassed Inventories

#### Shortfalls of the policy response for Shock 1:

- Warehousing costs and other inventory management costs have been provided with no subsidies.

#### Policy Response for Shock 2:

- The final date for permitted sale of BS IV vehicles has been increased by the Supreme Court for a few days

#### Shortfalls:

- A 10-day extension in the middle of the lockdown is barely a beneficial policy in letter or in spirit
- Extensions in the final date for sale of BS-IV vehicles should be made for the ailing sector

## 3) Accessibility to customers

To assist the severely hit MSMEs sector, SIDBI has launched a digital repository which would help MSMEs to work remotely by providing video conferencing facilities, online collaboration facilities, automated accounting and digital borrowing platform. The private players have also come forward to assist MSMEs in their digital journey. Prominent players who are working towards smooth integration of MSMEs in the current digital world are Amazon India, InstaMojo, Tradeindia, Creditwatch, Happy Loans, Locus.

## Policy Implications & Recommendations

### 1) Liquidity constraints:

#### Shock 1 Recommendations:

- An upper cap on annual turnover should be placed on such borrowers for emergency credit fund
- Restrictions on the Emergency Credit line guarantee scheme for new borrowers should be lifted in order to have more breadth as well as depth of coverage
- Firms within 90% of the turnover range (for classification as MSME) should be allowed. This way, the money goes to firms that need it more rather than firms that stay small only for the benefits. This can be further extended as a policy measure for most beneficent policies
- Credit availability for working capital should be made with relaxations for the pandemic being mathematically mandated into the borrowers' applications
- Pending payments by the government or the SOEs for their MSME clients can be released immediately to provide some breathing space to the companies. It would also ease their liquidity positions for a short term
- Utility payments such as rent, electricity, water charges can be deferred to later months allowing businesses to prioritize their salary payments
- Soft loans should be provided to SMEs to enable them to make wage payments as has been done in Bolivia
- Periodic review of working capital disbursements to ensure that they are reaching the intended target
- Virtual credit could be provided based on past GST data to business accounts such as Jan Dhan Accounts instead of 20% emergency credit
- A sharp decline at the operating level will also impact creditworthiness, aggravating the liquidity stretch these units have been grappling with, particularly on the working capital front. History should be given higher weightage in providing access to credit to enable the business to sustain

operations at least till the end of the disruptive phase

#### Shock 2 recommendations:

- Interest (especially in PSBs) should be waived for the months of the enforced lockdown. This should have been done specifically for micro businesses and stressed SMEs (SMA – 2) that are the more vulnerable
- MSMEs in hard hit sectors could be made to forego social security contributions as has been done in Argentina
- Tax sops can be provided to ease liquidity positions of the companies as other countries have done (Bangladesh)
- Penal interest for late payment of GST could be cancelled as has been done in countries
- Access to cheaper credit is required additionally
- A split in the credit guarantee (say an 80%-20%) wherein the government assures to pay back only 80% of the new loan. This circumvents the problem of a moral hazard for the borrowers and lenders

#### Shock 3 recommendations:

- To give these most vulnerable businesses a chance to become formalized, expedited AADHAR based single window registrations should be allowed. This serves a two-fold purpose of better targeting and increasing tax compliance
- Collateral requirements should be made for small loans to be availed
- Reduce paperwork requirements for availing loans

### 2) Amassed Inventory:

#### Shock 1 recommendations:

- Subsidized warehousing facilities can be provided to ensure that exporters stay in business and the inventory is not damaged
- Unutilized capacities in SOEs like Central Warehousing Corporation

#### Shock 2 recommendations:

Automobile companies - OEMS and the ancillaries should be provided with more time to sell off the BS-IV inventory at attractive terms to customers which can alleviate liquidity problems of the firms

### 3) Raw Material Sourcing Recommendations

For Original Equipment Manufacturers, and Electronic and Automobile assembly units, it is critical to have their entire supply chain up and running. Overall, it is paramount that the government relaxes the restrictions on the movement of goods across the country so that there are no unnecessary hikes in price and sourcing cost of raw materials.

- Provide subsidy on warehousing for large labour unavailability
- Provide subsidy on warehousing for large uncertainty in customer accessibility

### 4) Labour Shortage Shock Recommendations

Few incentives amidst the COVID-19 pandemic could be ensuring food and shelter security to them, ensuring health security by registering them under Ayushman Bharat Yojana.

- Provide health security to migrant worker by registering under health schemes such as Ayushman Yojana
- Provide shelter safety by ensuring free or less expensive shelter to live for migrant workers
- Provide employment security by mandating a minimum proportion of monthly salaries to be granted

### 5) Customer Accessibility shock Recommendations

Introduction of tax incentives for selling up on digital platforms could be a forward step in promoting the usage of digital platforms amongst MSME to counter current pandemic-like situations.

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