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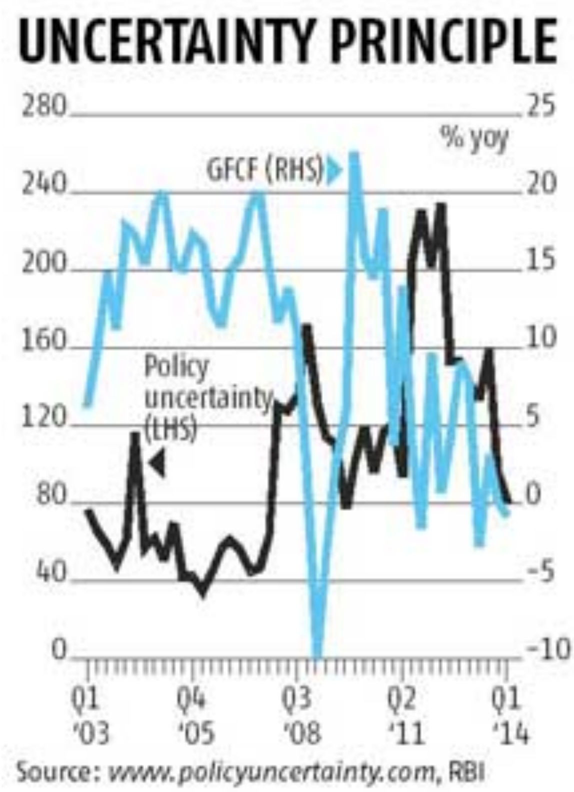
Kunal Kumar Kundu: Prodding the capex cycle

India released its gross domestic product (GDP) numbers for the fourth quarter of 2013-14 on Friday and they confirmed that the economy is facing stagflation on the back of one of its worst slowdowns in the past 26 years. I believe, however, that the economy is bottoming out, although recovery will be slow. The expectation of a mild recovery during the current year is based on the assumption that the formation of one of the most stable governments in India over the past three decades would ensure an end to policy paralysis afflicting the economy. This will engender an investment-led recovery as business sentiment perks up.

Anecdotal evidence suggests many investors were waiting on the sidelines, especially during the final stages of the previous government's tenure, as political uncertainty rose, policy-making stalled and business confidence plummeted. However, with the formation of a stable government at the Centre, the pall of gloom seems to have been lifted and business confidence is returning, albeit slowly, as investors are keenly awaiting policy moves from the government. Nevertheless, history suggests that an end to uncertainty can act as a catalyst to spur investment activity in the country, thereby helping the economy grow.

To ascertain how policy-level uncertainty has changed over a period of time, I have considered the Economic Policy Uncertainty (EPU) indexintroduced by Scott Baker, Nicholas Bloom and Steven Davis. To measure policy-related economic uncertainty for India, they have constructed an index based on newspaper articles regarding policy uncertainty with certain sets of key words. A high EPU score indicates higher degree of uncertainty, while a low EPU score indicates increasing levels of certainty. The EPU index is then plotted with the gross fixed capital formation (GFCF) data and, not surprisingly, we see higher levels of GFCF growth coinciding with a stable policy environment.



According to the data, India has never had such a prolonged period of policy uncertainty as it has had recently, and this coincides with a sustained growth slowdown. Now, with policy uncertainty easing gradually, capital formation has likely bottomed out.

I have been (like many of my ilk), for long, talking about how India's growth model needs to change from being consumption-driven to being investment-driven. The recent slowdown in economic growth and spike in inflation can be largely attributed to a sharp fall in fixed capital formation, which exacerbated the structural constraints in the economy. Falling policy uncertainty and a concomitant improvement in business sentiment would likely bring about a revival in investment in the economy.

However, what is important to note here is that although the investment cycle will likely pick up as the cloud of uncertainty dissipates, key to its sustenance is a continued focus on appropriate policy measures and steadfast adherence to reforms.

Although an increasingly certain policy environment, improving business sentiment and low base effect will propel the economy up to and beyond a five per cent growth rate, all eyes are on government actions in the run-up to the forthcoming Budget. Thus far, the new government has been making all the right noises, economically speaking. However, implementation remains the key. Even if the government is able to introduce reform measures that meet our expectations, growth in the current year will still be anaemic, given the past trends. The results of government initiatives will slowly manifest themselves from next year onward.

Given that a large number of projects are stuck at various levels of approval, fast tracking those (which is what the government's stated priorities are) would rev up the investment cycle. What is also important to note here is that, while India's investment to GDP ratio is roughly around 33 per cent, the fact that a large chunk of investment was stuck resulted in the falling productivity of capital (or rising ICOR - incremental capital-output ratio). As more of these projects become productive, India's incremental investment requirement will likely rise at a lower pace going forward compared to savings (as real rates start rising). This will ensure that India's savings investment gap (or current account deficit i.e. CAD) will remain under control and thereby ease the depreciation pressure on the currency that a large CAD otherwise entails.

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