August 2014

Every month, Current Economics reviews the research produced by top international economists from the world's leading firms, selecting a sample of the best available for publication. Coverage includes analysis of topical issues, the economic outlook for a selection of countries and, periodically, the outlook for exchange rates and interest rates. As a benchmark for comparison with the views of individual researchers, a table of the latest consensus forecasts for growth, inflation and current account balances is presented on the back page.

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India: Investment Revival to be the Key Growth Driver

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Forecasts for FY 2014, % change (unless stated otherwise)	Gross Domestic Product	Gross Fixed Investment	Consumer Prices	Current Account Balance (US$bn)
Société Générale	5.2	3.7	8.3	na
Consensus[1]	5.4	4.3	7.9	-44.0

[1]Source: Asia Pacific Consensus Forecasts, August 2014.

With two consecutive years of sub-5% growth, the Indian economy has been passing through one of its worst phases, as reflected in real GDP growth that is approximately half the rate of inflation. Over this period, another concern has been the sustained slowdown in fixed capital formation, as investor confidence waned on the back of higher levels of policy uncertainty. The problem was further accentuated by large number of infrastructure projects being stalled due to multiple reasons, chief among those being problems related to land acquisition and environmental clearance issues.

Having said that, we believe that the worst is now over for the Indian economy. We expect India's investment cycle to recover, albeit slowly, as the new government will likely be able to take steps aimed at removing hurdles to ensure that a fairly sizeable number of these projects are re-started. We expect that a more industry-friendly Land Acquisition Bill will become reality early next year while the process of granting environmental clearance has already been streamlined. Given the government's stated focus of revamping India's infrastructure which was reiterated in the current budget, we expect India's growth revival to materialise on the back of the uptick in investment activity in the country. However, progress will likely be slow as the benefits of such policy decisions will take some time to trickle down. Our baseline scenario is that over the next five years, India's gross investment rate will rise by around 3% of GDP and this could potentially push India's growth rate higher, to around 7% by FY2019 (Apr 2018 to Mar 2019) from the current 4.6%.

The Indian Economy is Going Through a Tough Patch

For a country that was looked at as potentially being able to grow at 10% annually a decade ago, the deterioration in the growth trajectory has been a cause for concern. Burdened by high fiscal deficits (engendered by high and rising social expenses not matched by the recurrent revenue stream), high inflation caused by structural impediments, weak business confidence because of policy inertia and, added to that, a fairly adverse external environment, India's economy is now growing at a sub-optimal and below-potential rate.

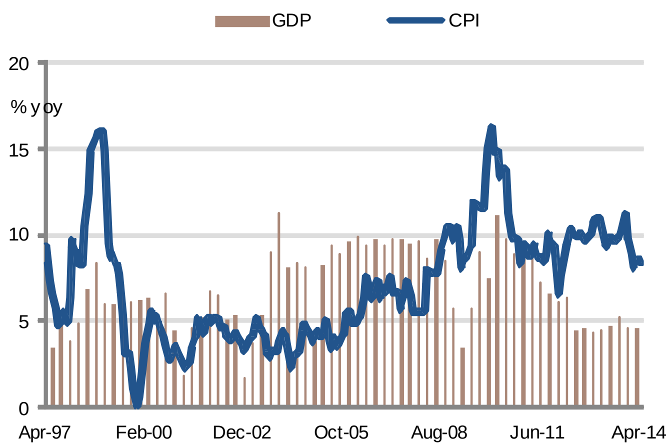
The newly elected government in India has inherited an economy that is growing at a sub-5% rate in real terms and is facing inflation that is virtually double the growth rate. The twin deficits, though relatively contained during the last financial year, remain a threat as the improvement did not come about because of prudent polices, but because of creative accounting window dressing, reductions in growth-inducing capital expenditure and a clampdown on gold imports. Though there seems to be a possibility that this perceived improvement may ease or go into reverse, we believe a significant deterioration is highly improbable. Recent macro data, however, do indicate that the economy is bottoming out, though we expect the subsequent recovery to be slow.

An important reason why the economy has settled down to a lower level of growth is the sharp fall in capital formation (see Fig 2, page 14) which engendered rising structural constraints leading to a decline in potential GDP and an elevated rate of inflation.

Economic Policy Uncertainty is Lifting Gradually

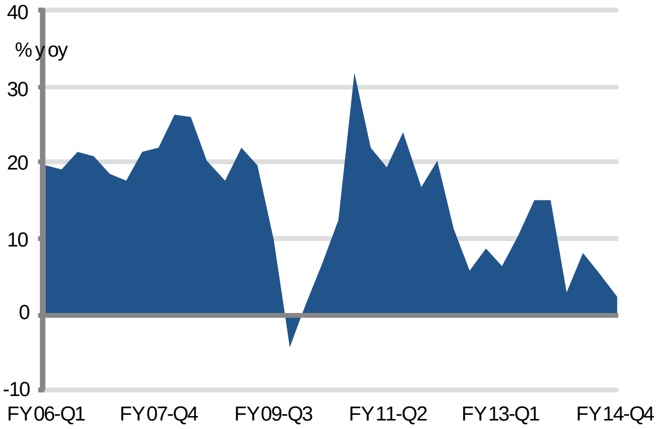
Anecdotal evidence suggests many investors were waiting on the sidelines, especially during the final stages of the previous government's tenure (which was marked by policy paralysis), and, as political uncertainty rose, busi-

Fig 1: Inflation Outpaces GDP Growth...



Source: RBI, SG Cross Asset Research/Economics

Fig 2: ... While Capital Formation Falters



Source: RBI, SG Cross Asset Research/Economics

ness confidence plummeted. However, with the formation of a stable government at the centre, the veil of uncertainty seems to be lifting, and business confidence is returning, albeit slowly as investors are keenly waiting to see what direction government policy takes. History suggests that declining uncertainty can act as a catalyst to spur investment activity.

To ascertain how uncertainty on policy has changed over a period of time, we use the Economic Policy Uncertainty (EPU) index introduced by Scott Baker, Nicholas Bloom and Steven Davis. To measure policy-related economic uncertainty for India, they constructed an index based on newspaper articles regarding policy uncertainty with a certain sets of key words. A high EPU score indicates a higher degree of uncertainty. We then plot the EPU index with growth in GFCF (gross fixed capital formation), and not surprisingly, we observe a higher level of GFCF growth coinciding with a stable policy environment.

As Fig 3 shows, India has never before had such a prolonged period of policy uncertainty as it has had recently, and this coincided with a sustained slowdown in investment activity. While the policy uncertainty index peaked by end-2012, economic growth stagnated at lower levels, leading to a weak investment environment. Now, with policy uncertainty having been reduced substantially, especially with the new government coming to power, GDP growth has likely bottomed out, as has capital formation.

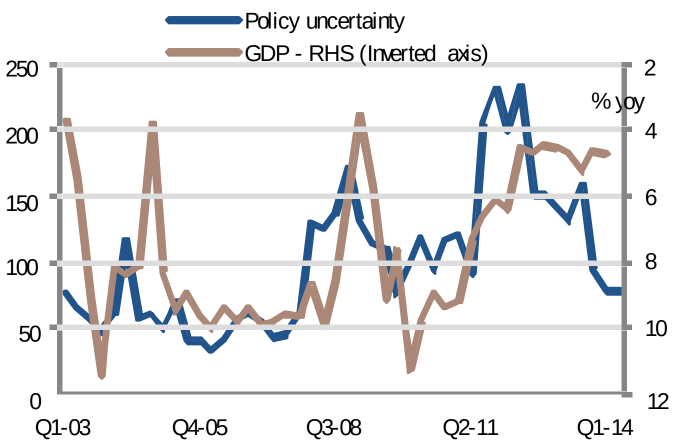
We discussed earlier how India's growth model needs to change from being consumption driven to being investment driven. Falling investment has led to a decline in India's potential growth rate, thereby increasing inflationary pressure as infrastructural constraints remain a concern (Fig 4, page 15) even though domestic demand remains strong. Not surprisingly, according to the WEF Global Competitiveness Report (2012-13), inadequate infrastructure tops the list of impediments standing in the way of doing business in India.

The recent slowdown in economic growth and the spike in inflation can be largely attributed to a sharp fall in GFCF which exacerbated structural constraints. An easing of policy uncertainty and a simultaneous improvement in business sentiment would likely spark a revival in investment in the economy.

Kick-starting Stalled Projects to Improve the Investment Cycle…

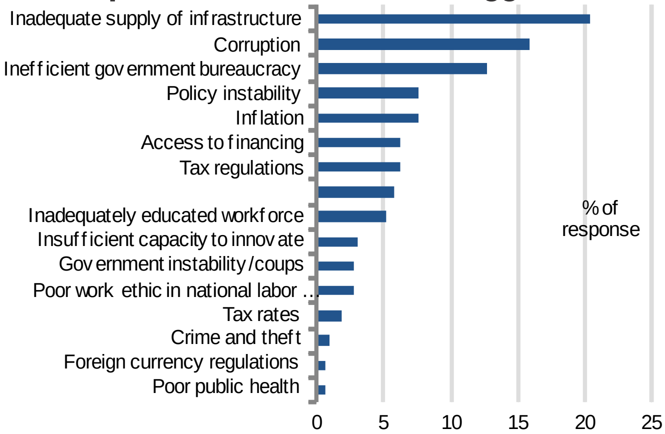
Having said that, it is important to note here that India's investment rate (Gross Capital Formation) at close to 35% of GDP (as of FY13, likely to be under 33% in FY14) is quite high by global standards.

Fig 3: Economic Uncertainty Declining



Source: www.policyuncertainty.com, SG Cross Asset Research/Economics

Fig 4: Inadequate Infrastructure - the Biggest Challenge



Source: WEF Global Competitveness Report, SG Cross Asset Research/Economics
Note: WEF Executive Opinion Survey on roadblocks for doing business in their country

Yet, gross fixed capital formation (GFCF) in the economy remains quite subdued (as investments made in stalled projects have not led to capital creation) while GDP growth has touched a 10-year low.

Clearly capital productivity has plummeted in the years. The reason for this is that a large number of projects are stuck at various stages and for various reasons (delays in approvals, funding problems, inadequate availability of fuel for power projects, falling demand, etc.), while partial investment has taken place, thereby rendering these investments unproductive. According to data from the MOSPI (Ministry of Statistics & Programme Implementation), of all the central government projects currently stalled, more than 50% of total investment has already taken place.

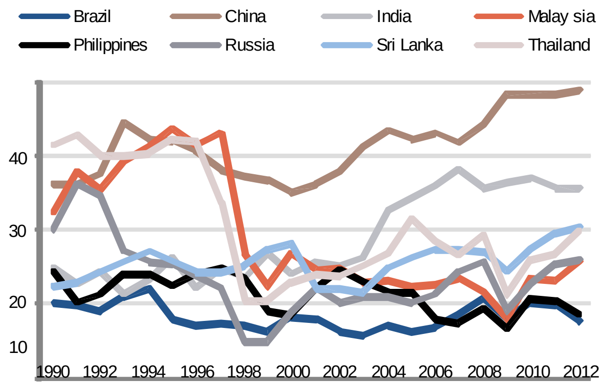
...With Infrastructure Projects Key to Growth

As per CMIE (Centre for Monitoring Indian Economy) data, of all the infrastructure projects that were announced since 2000, there are 599 infrastructure projects that are currently stalled, for various reasons. The anticipated cost of these projects now stands at US$133.7bn. In value terms, little more than 85% of the projects belong to the private sector. Of these, the most affected sectors are electricity (26.8%), steel (22.8%) and roads (16.4%).

As mentioned earlier, we expect the newly-elected National Democratic Alliance (NDA) government to focus on reviving the investment cycle, something that is also part of the BJP's manifesto. In fact, even when the NDA government was in power earlier (from 1999 to 2004), they had a clear focus on rejuvenating India's physical infrastructure essentially through the Public Private Partnership (PPP) route – by, among other things, conceptualising the national highway programmes, developing airports, reforming power sector etc.

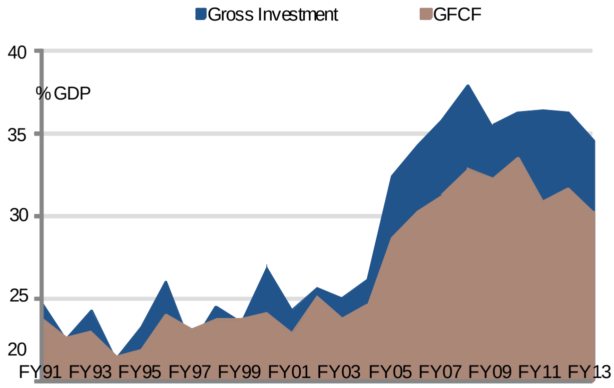
Reducing regulatory uncertainty and simplifying procedures for obtaining clearance should therefore be a priority for the government so that it can kick start as many of the stalled projects as possible. This will not only ensure that

Fig 5: India's GFCF Increasing Fairly Slow ...



Source: World Bank, SG Cross Asset Research/Economics

Fig 6: ... Although Gross Capital Formation Remains High



Source: RBI, SG Cross Asset Research/Economics

Figure 7: Top 10 Sectors with Maximum Financial Stress

Industry	No. of cases	Aggregate debt (INR bn)	% of total
Infrastructure	22	407.6	19.63
Iron & Steel	45	372.1	17.92
Power	15	263.1	12.67
Textiles	44	196.4	9.46
Telecom	5	107.9	5.19
NBFC	5	69.8	3.36
Ship Breaking/Ship Building	3	67.5	3.25
Construction	6	65.6	3.16
Pharmaceuticals	9	64.3	3.1
Petrochemicals	2	48.5	2.34

Source: RBI, SG Cross Asset Research/Economics

the invested capital, which has so far remained unproductive, comes on stream, but should also give fixed capital formation a boost, bringing down the incremental investment requirement and in turn helping control the current account deficit as the savings investment gap comes down to reasonable levels.

But, the Road Ahead is Long and Winding and Uphill

However, reviving stalled projects is easier said than done. Projects are stuck either because of a lack of funds, because they are in already-crowded markets or because they are awaiting approvals from state governments, and not necessarily the central government.

As per the MOSPI data, the proportion of projects stuck with the central government is highest for sectors like metals, mining, and oil and gas. In terms of investment, power, steel and coal together account for over 80% of the outstanding amount.

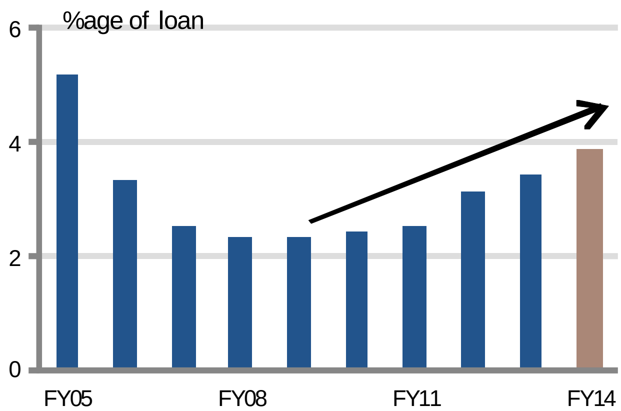
That, however, is just the tip of the iceberg. Available data suggest that only about a quarter of stalled investment projects are stuck with the central government, with the remainder being plagued by falling demand (hence projects have become unviable), financial constraints, fuel linkage issues (for the power projects) or pending approvals from the governments in the various states, not all of whom are part of the ruling NDA coalition.

A look at the problems facing the power sector gives us further cause for concern. In India, the majority of power production is thermal. Hence, coal production assumes critical importance. Unfortunately, India's state-owned coal producing monopoly, the Coal India Ltd, is less than efficient and its level of production leaves a lot to be desired. Getting things right here is not going to be easy and will likely take time. That apart, almost all of the gas power plants under construction have been stalled due to uncertainty over gas supplies from the KG-D6 Basin.

The fate of the many iron and steel projects is not dissimilar. Problems lie not only with coal production but also with iron ore production. Iron ore production is state run, and production has been impacted dramatically, of late, due to a number of corruption issues, leading to a ban on iron ore extraction by India's highest court, the Supreme Court. Fortunately, the bans are being lifted selectively, and we expect a slow improvement in the health of the mining sector which has seen a massive contraction in activity in the past two years.

Among approvals and clearances, land acquisition continues to be the biggest roadblock, followed by environmental clearance. As per CMIE data, highways and roads projects worth INR 1 trillion (US$16.7bn) have been delayed due to problems related to land acquisition. Out of these 66 projects, 44 projects (worth INR 936 billion/US$15.6bn) are

Figure 8: Rising NPA of Banks



Source: RBI, SG Cross Asset Research/Economics

promoted by the National Highway Authority of India (NHAI). Of these, only two have received environmental clearance. While environmental issues are relatively easier to handle and some progress on this front is already visible, land acquisition remains the most contentious issue. The land acquisition bill passed last year is not sufficiently pro-industry and may require a rethink.

Some Positives From the Budget for Infrastructure

The first budget from the newly-elected government (presented on 10 July 2014) emphasised that the key challenge faced by the economy is its lack of infrastructure and giving Indian infrastructure a big push was one of the key themes of the budget. The budget, however, placed greater emphasis on PPPs (private public partnerships) for infrastructure creation, which may not necessarily be a panacea for the ills plaguing the sector. India's experience with PPP over the past decade has been far from glorious and the country needs to analyse the core issues better before putting more eggs into the same basket. Failure lies at both ends: for the private operators, it has to do with over-optimistic assumptions about user numbers and revenue levels (further exacerbated by slowing economic growth) while, for the government, the lack of flexibility in contract negotiations as well as changing dynamics means that the PPP model does not have a very good reputation. Quite often, as mentioned above, delays in approvals complicate issues further.

We believe that the key to reviving the infrastructure cycle lies in the government's ability to make land acquisition more investor friendly and adopting more realistic view about environmental clearances – the two biggest roadblocks. While the budget remained silent on these issues, processes are seemingly being streamlined. With regard to land acquisition, several tough clauses could be removed. Given that both the ruling NDA and even some opposition parties are favourably disposed to a more realistic approach; we expect the revised land acquisition bill being tabled during the winter session of parliament.

In addition, the budget provision of ensuring the availability of cheap long-term funds for infrastructure lending and its commitment to ensuring better fuel linkages for power plants (including ensuring increased productivity by Coal India Limited) would provide a much-needed boost to this sector. Overall, we believe that, given the government's big push for infrastructure development and its desire to walk the extra mile to clear the logjam, this should be sufficient to spark a revival in India's capex cycle. However, it is important to realize that progress will not be very rapid as the benefits of such policy decisions will take time to materialise.

The immediate advantage, however, of some of the stalled projects coming on stream is that not only will this improve the investment sentiment in the economy, it will also reduce pressure on Indian banks from NPAs (Non Performing Assets - see Fig 8, page 16), and improve their capital adequacy ratios as write-backs occur and this in turn should increase their lending capacity.

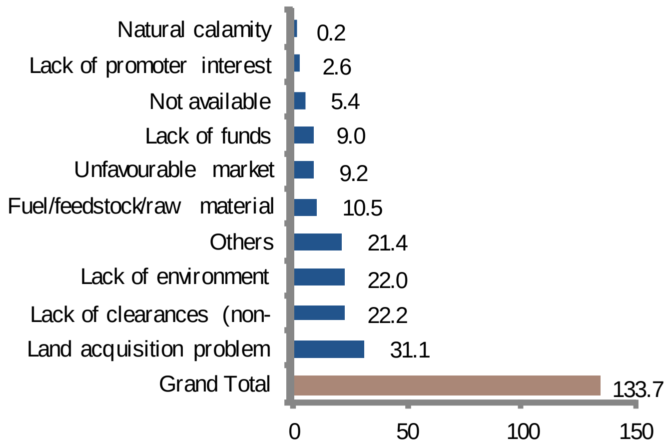
Outlook

Baseline Scenario – We believe that the government would be able to revive 45% of projects amounting to US$60bn. This, along with new investments, will raise India's gross investment rate by around 3% of GDP over the next five years and could potentially boost India's growth rate to around 7% from 4.6% at present.

Pessimistic Scenario – In the event, however, that the government is unable to push through the desired legislation and the revival in the capex cycle turns out to be much slower than expected, we think GDP growth could remain in the vicinity of 5% to 5.5%. However, we attach a very low probability to such an eventuality.

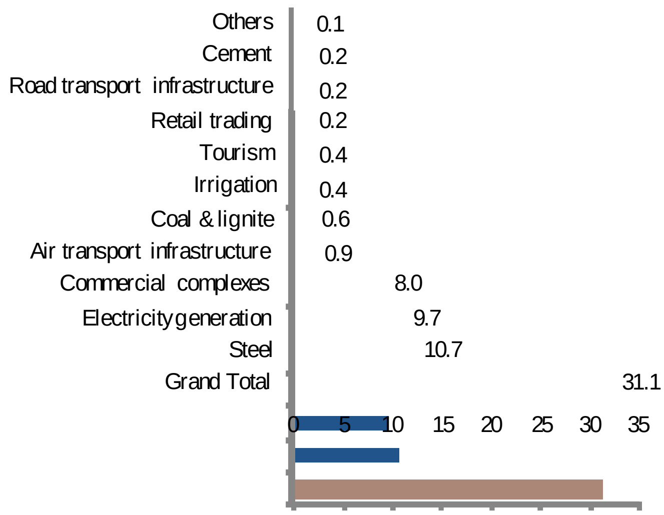
Optimistic Scenario – Over the next five years, India's GDP growth could pick up to 8.5%-9% if the government is able to hasten the pace of while at the same time fast-tracking many of the stalled projects, thereby generating a virtuous capex cycle. To this scenario also we assign a low probability.

Fig 9: Major Roadblock to Projects



Source: RBI, SG Cross Asset Research/Economics

Fig 10: Sectors Most Affected by Land Acquisition Problems



Source: RBI, SG Cross Asset Research/Economics