Macroeconomic Update: Early Signs of Rise in Investment

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Summary

Economic recovery remains fragile on the back of a weak consumption demand. Sustained high growth will be achieved only with an upturn in the investment cycle. The government seems to have understood the importance of pump-priming the capex cycle directly through higher public capital expenditure and front loading the expenditure. While private investment remains muted due to stressed corporate balance sheets, weak external and domestic demand prospects and commercial banks' cautious approach to expanding credit, there are some early signs that the private investment cycle is likely to turn around in the next six to nine months.

Introduction

Growth expectations have weakened recently. The Reserve Bank of India, in its second bi-monthly monetary policy review in June 2015, lowered its GDP growth estimates to 7.6% yoy from 7.8% announced in April 2015. Fitch, the credit rating agency, has lowered its growth projections to 7.8% from 8%, while ICRA Ratings have now pegged growth between 7.4-7.6%.

Economic recovery remains anaemic. Reasons are not difficult to identify. Rural consumption demand weakness is persisting due to low growth in rural wages, smaller increases in minimum support prices and a decline in government revenue expenditure (see Table 1). Aggregate consumption demand in the economy has remained weak for similar reasons and because of the welcome measures against 'black money' and cash economy. Therefore, the much needed growth impetus is expected to come from an increase in capital investments and a turnaround in the investment cycle. Such an investment led growth is qualitatively better as it has the potential for generating a virtuous cycle through the multiplier-accelerator mechanism, which results in a far more sustainable growth momentum. Moreover, investment growth implies capacity expansion that addresses supply side bottlenecks, thereby ameliorating inflationary pressures.

Private investment that now accounts for nearly 39% of total investment in the Indian economy, would normally be expected to lead the upturn in investment activity. This is, however, unlikely to happen because of stressed corporate balance sheets, weak prospects for both external and domestic demand and reluctance on part of commercial banks to increase credit. The banks' reluctance is understandable in the context of very high levels of gross non-performing assets estimated at 4.45% (as on March 2015) of total assets for the banking sector as a whole which rises significantly high to 10.9% if restructured advances are included. Therefore, private corporate investment in unlikely to respond at this juncture. The onus for turning around the capex cycle has to be borne by the Government, through three modalities: first, directly raising public capital expenditure; second, indirectly through greater investment outlays by central public sector enterprises; and finallly by de-bottlenecking projects under implementation. We look at the current state of these three capex enhancing measures below.

Public Capital Expenditure

In last two consecutive years, we saw sharp pruning of public capital expenditure in order to meet the fiscal deficit target. In the budget this year, capital expenditure was slated to be 29% higher than the previous year. But the latest monthly data available shows that capital expenditure for May declined sharply (-53% yoy) raising the fear of another year of slashing of public capital expenditure. The required growth rate for capital expenditure for the rest of the year now stands at 35.6% as seen in the table below.

Table 1: Monthly fiscal data of the Central government

	May'15 (Rs '000 cr)	%YoY	Apr-May'15 (Rs '000 cr)	%YoY	Budgeted Growth (% yoy)	Required Growth in rest of the year	FY16BE (Rs '000 cr)	%Ytd of Budget
Revenue receipts	27.0	-14.3	52.4	36.0	3.8	2.7	1,142	4.6
Net tax revenues	22.7	18.0	19.9	30.6	1.9	3.0	920	2.2
Non-tax	4.3	11.4	32.5	229.5	12.6	1.2	222	14.6
Non debt cap receipts	0.1	92	1.8	85.2	84.7	84.7	80	2.3
Total receipts	27.1	-16.4	54.2	37.2	6.9	5.8	1,222	4.4
Revenue expenditure	96.7	-28.6	225.1	-7.6	5.4	8.0	1,596	14.7
Capital expenditure	11.5	52.6	37.7	2.7	20.1	36.6	241	15.6
Total expenditure	108.2	-32.3	262.8	-6.2	8.1	11.0	1,777	14.8
Fiscal deficit	81.1	-36.3	208.8	-13.4	10.7		558	37.5
Revenue deficit	69.6	-33.0	172.7	-15.8	10.1		394	43.8
Primary Deficit	49.5	-48.4	160.2	-13.9	1.7		100	161.0

Chart 1: Sharp increase in Capex spending

Note: For FY 2014-15, provisional numbers are used, for FY 2015-16, budgeted estimates are used
Source: Controller General of Accounts, budget documents, CPR research

Fiscal numbers indicate that government has been conservative in its spending in line with lower revenue receipts in May. Considering the first two months of April and May, however, yields the positive finding that despite lower revenue receipts and concommitant reduction in revenue expenditure, the Government has managed to raise public capital expenditure, albeit marginally by 2.7%. As can be seen in Chart 1, the government has significantly increased capital spending between March to May 2015.

Based on the recent trends, the government seems to be front loading capex expenditure despite lower revenue receipts. Due to fiscal compulsions, the capex spending might taper off towards the second half of the year if government continues to front-load expenditure. There is though a possibility that lower subsidy outgo due to muted oil prices and greater recourse to direct cash transfers will open up further space for higher public capital expenditure in the second half the fiscal year.

However, the government could make up for any slack in central government's direct capex expenditure in the second half of the fiscal year by encouraging higher investments by cash-rich central public sector undertakings (CPSUs) as announced in the Central Government budget. The budget envisages a sharp 34.1% increase in investments by CPSUs compared with a 10% drop last fiscal. CPSUs in the roads and railways sector are together expected to nearly quadruple their borrowings to Rs 80,300 crore in 2015-16 from the bond market compared with Rs 20,800 crore last year.

Overall, it is clear that the government seems to have understood the importance of pump-priming the capex cycle directly through higher public capital expenditure and front loading the expenditure and supplementing it through encouraging higher investment outlays by CPSUs.

Some Early Signs of Rise in Investments

There are signs of a modest pickup in private corporate investments. The latest capex related data released by CMIE shows that total projects under implementation grew at 8.5% yoy in quarter ending Jun'15 – the highest since September 2012. Interestingly, projects under implementation by the private sector moved to the positive territory for the first time in eight quarters exhibiting some fragile recovery in corporate sector capex. But, new projects announcements by the private sector still remain lacklustre.

Stalled projects have fallen for the fifth consecutive quarter (four quarter trailing sum) with un-stalling of government projects happening at a faster rate compared to private projects. Government's Project Monitoring Group is working to address various constraints like ministry clearances, unavailability of raw materials etc. and trying to facilitate un-stalling of the projects at a faster pace. It is expected that as more and more stalled projects get operational and start generating revenues, resources will get freed up for new investments. This will of course happen with a lag.

Chart 2: Projects under implementation improving

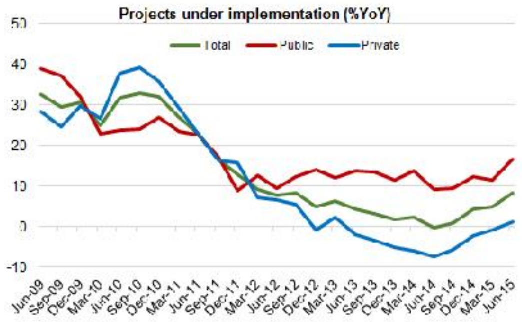
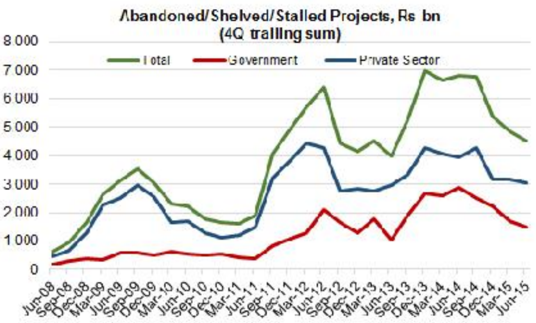


Chart 3: Stalled projects fell for fifth consecutive quarter



Source: CMIE database, CPR research

Adding credibility to capex cycle fragile revival, capital goods production within the IIP has been growing smartly since November 2014. The average growth since November is at 7.3% yoy – seven consecutive month of positive growth that has not been seen since 2010. It is true that capital goods production within IIP tends to be lumpy and one needs to be cautious in interpreting the data but the recent trend clearly shows some improvement. The recovery in capital goods production is supplemented by an increase in sales of commercial vehicles, which is generally taken as a lead indicator for the turnaround in the investment cycle.

Chart 4: Capital goods production under IIP improved

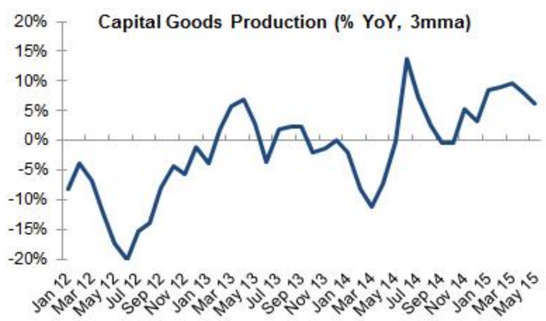


Chart 5: Commercial vehicle sales growing

Source: CMIE database, CPR research

There has also been a bigger push in the infrastructure sector under the new government – particularly in road and port sectors. According to Nitin Gadkari, Minister of Road Transport and Highways of India, road construction, that had slowed down to two km/day in 2014-15, has improved to 12 km/day. The National Highway Authority of India has already awarded contracts for 3,000 kms of road construction in 2015-16, which is twice that of total contracts awarded in 2014-15.

In line with the government's aim to facilitate investment, on July 16th, the cabinet cleared redevelopment of 400 railway stations permitting commercial development of real estate by the Zonal Railways. It also announced development of the six-laning of Eastern peripheral expressway in Haryana and Uttar Pradesh at a cost of Rs 7,558 crore. In order to promote 'ease of doing business', the government has done away with distinction between different types of foreign investments like foreign portfolio investment, NRI investment and depository receipts, foreign currency convertible bonds etc and replaced it with a composite cap on all kinds of foreign investments.

The only weakness in the otherwise positive investment picture is the persisting weakness in the overall bank credit growth that actually decelerated according to the latest fortnightly data available for 26th June 2015. This is surely a result of the increased risk-aversion of the banking sector who have accumulated high volumes of non-performing assets on their books as a result of the policy paralysis and growth downturn over the last three years of the UPA rule. Banks today are showing signs of being once burnt twice shy. The growth in commercial bank credit may happen once stalled projects begin to generate revenues, thereby improving the debt servicing capacity of major borrowers.1 In the meantime, corporates seem to be meeting their financing requirements through other sources like commercial paper, which have increased by 64% on annual basis as on end-May 2015 and FDI, which jumped up by 112% in April 2015 after increasing by 71% in March.

Conclusion

There are thus clear signs that the investment cycle is likely to turn around in the next three to six months. This augurs well for raising India's GDP growth to 8% in 2016-17 and sustaining it at that level by undertaking further structural reforms and successfully implementing Government's Flagship projects.

[1] *The causality test between credit and GDP growth in the post reform period in India indicates that GDP growth drives the credit growth. So, as growth starts improving, we believe, the credit growth will follow after some lag.*