

WILL INDIA MAKE IT?

2016



"For an economy powered by private consumption and government investment, it is doing well ... fiscal and monetary policy stances must be carefully re-assessed"

ARVIND SUBRAMANIAN, Chief Economic Adviser, Government of India

# HOW TO REVIVE INVESTMENT

Govt capex and growth in consumption together could revive India's investment cycle – eventually



Illustration: SHYAM

Another year has passed and there are still no signs of a revival in private investment. It was never meant to be easy. After all, India is in the midst of what resembles a "credit-less recovery". GDP growth has bottomed out, but several big banks are grappling with huge stocks of non-performing loans (NPLs). Credit growth, in both real and nominal terms, is well below the long-term average, recovering more slowly than during previous slowdowns (see chart). The big question is can investment rise convincingly when the funder-in-chief, the country's banking system, is still limping.

Once considered rare, credit-less recoveries are actually quite common. An IMF paper analysing 223 case studies from around the world found that one of every five recoveries are credit-less and they have special characteristics, which are surprisingly consistent across countries. First, output growth is about a third lower than during normal recoveries, and this has been the case for India this time around. Second, the financially-dependent investment sector makes a disproportionately lower contribution to growth. Lower investment has been a stand out characteristic in India, while consumption has fared relatively better. In fact a substantial portion of bank credit is funding consumer loans rather than investment. In short, going by global experience, India's low-credit investment recovery was never meant to be rapid.

What's the way out? Amid all this uncertainty, the words of Saint Francis of Assisi seem particularly insightful: "Start by doing what's necessary; then do what's possible; and suddenly you are doing the impossible." His message from 800 years ago is still relevant today.

India tried the "necessary" in 2015. Taking a break from the path of fiscal consolidation, the government attempted some counter-cyclical fiscal policy and did a good job. Savings from the oil subsidy bill were deftly channelled towards investment and, hey presto, government capex rose 31% yoy. Sadly, this was not sufficient to "crowd in" the private sector. While some previously stalled investment projects showed signs of life and parts of the transport sector received additional government funds, overall, the results were lacklustre.

The government realised that a crucial piece was still missing. Even if the



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private sector was interested, greater incentives were required. A new public private partnership (PPP) model was needed to allay private sector concerns about shouldering excess risks, while at the same time making sure there were no free lunches on offer. This is work in progress and, hopefully, PPPs will be the talk of 2016.

All this is encouraging but can new PPP contracts alone lift the investment cycle? This time around, it is not just a funding problem. The system is also plagued by insufficient demand. There is excess capacity and slack across several sectors, as made clear by output gap estimates and RBI's capacity utilisation survey. But, how long do we need to wait for this overcapacity to shrink?

Luckily, there is another development brewing on the horizon, what St Francis referred to as the "possible". The stars seem to be aligning for a meaningful lift in consumption demand, which could in turn eventually encourage investment. The Sev-

enth Pay Commission has recommended a hefty 24% wage hike for government employees.

The last time this happened, in FY09-10, a 30% "windfall" in wages stoked demand for big-ticket items like cars and houses. But back then urban private sector wage growth was low (remember the fallout from the global financial crisis?) and a shocking rise in inflation had eroded real purchasing power. Overall consumption growth was not just unbalanced and inflationary, but also weaker than before.

This time, recovering private sector wages and real gains from low inflation are also likely to provide additional support to government wage hikes. We find that consumption that is driven by real wage growth across the whole labour force, rather than a windfall for a select few, tends to drive demand for all goods and services (not just the expensive ones). As such, this time, the spurt in demand could be more balanced and sustainable, as shown in the accompanying chart. Over time, this should shrink overcapacity and provide incentives for greenfield investment. Admittedly, these building blocks are complex. But this could well be India's 'best case' scenario for ushering in private investment.

The problem is that this scenario is fraught with risks, primarily fiscal ones. If the government cuts back on capex to fund wage hikes, it could block the "necessary" channel needed to crowd in the private sector; the point where our conversation began. Ultimately, the ability of the government to finance the competing demands of capex and higher salaries may hinge on whether it can generate fresh fiscal funds over the next few years.

The roadmap looks something like this: 2015 marked the start of higher government capex. Consumption starts to rise in 2016, helping shrink overcapacity; new PPP contracts are unveiled and government capex continues like in the prior year. This could set the stage for the long-awaited arrival of private sector investment in 2017 and beyond. RBI's efforts to deal with NPAs, continued monetary transmission and low commodity prices could also help the process.

The bad news is that the rise in private investment—even with the necessary and the possible playing their part—is not going to happen immediately. The good news is that there are some drivers out there that could make the seemingly impossible, possible—eventually.

# Disruption is the new normal

What a year we have just been through! From the oil collapse to Delhi's and Beijing's deadly pollution—extreme uncertainty is the order of the day.

The other uncertainty is the rate at which technology is impacting our lives. From Google Glass to gene editing, from commercial space flights to driverless cars, radical change is impacting millions of people in a very short span of time. Within India, too, technology is changing the way we live—the e-commerce revolution, for instance, has changed the way we buy groceries. Working in a start-up is a more popular career choice than a regular job. Data analytics now shapes political campaigns and can win elections. While we are all familiar with adage 'change is the only constant', the pace of change today is quite disruptive. For India, the question is: Are we prepared to accept this new normal of constant disruption?

India, over the next few years, will remain the world's fastest-growing economy. But we could stumble if we don't embrace the new normal. It makes speed more important than perfection, results more important than vision, adapting to the surroundings more important than shaping them, skills more important than qualification and so on.

Amid such uncertainty, the only way to survive is to constantly innovate. But even innovation has to be more relevant to solving real problems than being experiments that serve no end. It needs to show faster results, rather than dragging on for years. Large corporates now measure their R&D quality based on outcomes rather than absolute spend.

If one accepts that emerging markets (EMs) will drive global economic growth, then innovation has to be relevant to EMs. The one theme that dominates EMs is affordability, and that too of basic amenities like electricity, healthcare, etc. Even the developed world and China realise that public money can't be just spent on expensive infrastructure. Innovation, therefore, has to be focused on improving affordability. Another dimension of affordability is to improve outcomes by eliminating inefficiencies. India's e-commerce revolution is all about this, and look how it has taken off.

GE's efforts addresses both these aspects of innovation. For instance, GE's Lullaby Warmer, a reverse innovation, makes neonatal healthcare in India highly affordable and accessible. Discovery IQ, a molecular imaging system, provides early disease detection capabilities to understand patient's response to cancer treatment. GE's affordability-focused innovation motive has led to its Sustainable Healthcare Solu-

tions Business being headquartered in Bengaluru. The other focus of GE's innovation efforts is to be the global leader of industrial internet, wherein data from various machines is analysed to improve efficiencies and outcomes. The potential of this initiative, on a global basis, is massive. In India, GE's predictive wind power solution makes renewable power more predictable and, therefore, usable. Faster power distribution and outage management through intelligent analytics; better grid management by balancing load with generation and loading of the transmission lines; lessening

fuel consumption by aircraft through optimisation of approach path for landing based on traffic data; traffic lighting fixtures being used as data gathering points to better manage traffic and security, etc.—these initiatives have tremendous capability to improve efficiency and cut costs.

For innovation to flourish, an entrepreneur has to get direct and open access to the market. The best role the government can play would be to help aggregate markets to provide scale. The government would, naturally, play a role in some of the capital-intensive innovation, like in defence or space. But, it is crucial that government let free entrepreneurial spirits prevail in the other areas. India has demonstrated tremendous capability in frugal engineering as seen in the auto sector and the space programme; energy efficiency as seen in the cement sector; benefit of scale as seen in the sharp decline in prices in LED lighting, renewable power, telecom, etc. But, given the market and the abundance of skills available, much more is achievable.

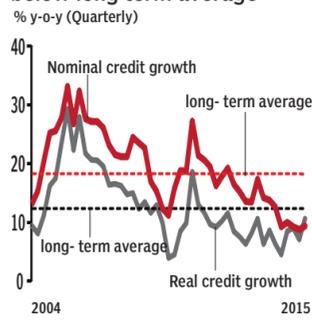
The one sobering fact to be cognizant of is the impact on our environment. Environmental challenges are no longer an issue for just future generations. There is adequate technology to tackle almost every challenge we face. The only daunting challenge, however, is affordability of these technologies. Environment is one area where affordability conflicts with sustainability. This fine balance is indeed difficult to find, and more so when the whole world shares the same environment but not similar wealth. The one area where both affordability and the environment find common ground is when we improve efficiencies and outcomes. There is ample room for us in India to just stay focused on improving efficiency and make greater progress.

We, in India, do not need disruptive innovation or miracles to improve the quality of life. We just need a sense of urgency in getting things done and getting basic issues addressed on priority.



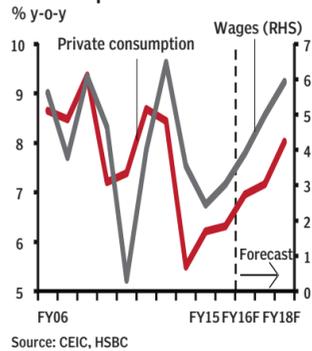
BANMALI AGRAWALA, PRESIDENT & CEO, GE SOUTH ASIA

## Credit growth is running below long term average



Source: CEIC, HSBC

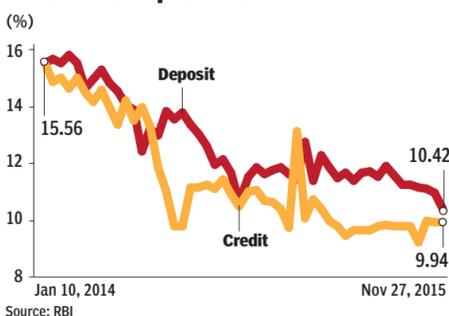
## Real wage & private consumption



Source: CEIC, HSBC

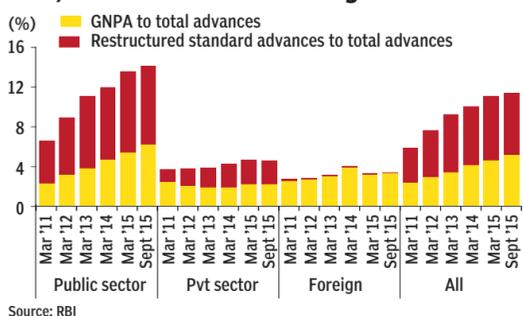
## DATA DRIVE

### Credit and deposit weak



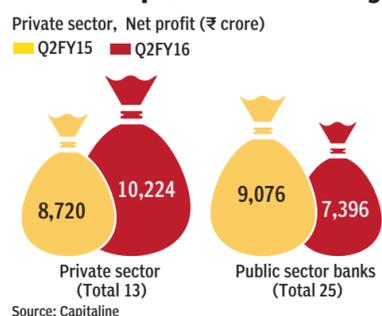
Source: RBI

### NPA, stressed bank loans rising



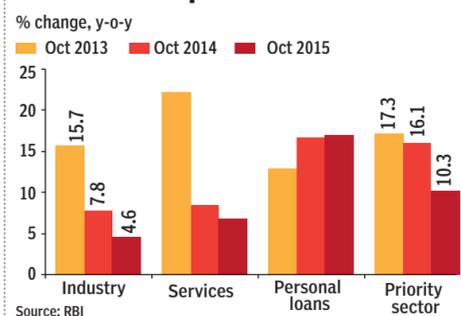
Source: RBI

### PSU banks' profit share shrinking



Source: Capitaline

### Private consumption drives credit



Source: RBI



Illustration: SHYAM