The 6.5% warning

Almost all steps in the strategy to revive investment are likely to be slow and painful. There are no shortcuts

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THE GDP FORECAST for FY 2018 of 6.5 per cent does not come as a surprise. The introduction of a Goods and Services Tax, even in its cleanest and simplest form, would have inevitably led to disruption in any economy. In India's case, multiple rates and a complex structure have made compliance cumbersome and created gaps in the supply chains. As the government simplifies the GST regime in response to the difficulties being faced on the ground, this problem will likely get solved. The bigger challenges for the economy are the problems that have just begun to be solved.

The central puzzle is the decline in investment. Investment did not start declining immediately after the global financial crisis in 2008, but with a lag. For a couple of years, the economy was held up by expansionary fiscal and monetary policy, and the momentum of the previous years. But since 2012, the demand shock seems to have caught up with us. Investment in the Indian economy has declined from 34.3 per cent of the GDP in 2011-12 to 27 per cent of the GDP in 2016-17. The first advance estimates on national income show that investment as a per cent to GDP has further fallen to 26.4 per cent in 2017-18.

During these years, a number of solutions have been tried to revive investment, but with limited effect. First, the decline was understood to be a consequence of the policy paralysis under UPA 2. A large and increasing number of stalled projects was seen to be the reason for the slowdown in investment. There was consequently an attempt to address this issue by reviving stalled projects. Even though the number of stalled projects was reduced with active government intervention and inter-ministerial coordination, the difficulties of private investment did not go away. Stalled projects were perhaps an outcome of underlying problems and not the cause. Therefore, addressing them did not raise the growth of private investment. The outcome to watch for tracking investment is projects under implementation. These started declining in 2011 and have still not picked up after six years.

First, the decline was understood to be a consequence of the policy paralysis under UPA 2. A large and increasing number of stalled projects was seen to be the reason for the slowdown in investment. There was consequently an attempt to address this issue by reviving stalled projects. Even though the number of stalled projects was reduced with active government intervention and inter-ministerial coordination, the difficulties of private investment did not go away. Stalled projects were perhaps an outcome of underlying problems and not the cause.

Next, it was felt that private investment could be increased by raising public investment. Even though the government's ability to raise capital expenditure was limited, there was expected to be a crowding-in effect, and the increase in public investment was expected to lead to an increase in private investment. This strategy had limited effect. Public investment increased but at a much slower pace than expected. The government's ability to write good contracts and give out projects was limited by bureaucratic hurdles, government contracting systems and procurement rules.

Meanwhile, bank financing had also run into trouble. Banks had lent to companies who were no longer returning their loans or paying interest. Corporate debt restructuring, that gave borrowers additional time to pay back after the crisis, had not helped. Bank money was stuck and they could no longer lend. Credit growth had slowed down. The way out was sought in going after the bad guys or the "wilful defaulters". The others were to be given a longer rope. This strategy did not get money back to banks.

First, it was very hard to identify the bad guys who had run away with the money. Even when the Vijay Mallyas were identified, the banking system did not get the money back and bank lending did not pick up. The good guys who were given time to return the money kept pushing repayment dates further, and they were given new mechanisms to keep kicking the can down the road. Banks failed to recognise poorly performing assets as non-performing and the regulator was lax. The net result was pretty much a bankrupt banking system stuck with bankrupt companies.

The logjam can no longer be ignored. The Bankruptcy Code and the Financial Resolution and Deposit Insurance Bill are a strategy for addressing this problem. They are critical elements of trying to untangle the mess we are in and to address the huge problems being faced today in the banking and corporate sector that have brought investment to a sharp decline. These are not popular measures. Nor are they quick-fixes. The 12 cases that the RBI has sent to the the bankruptcy process could lead to haircuts and losses that cause a number of banks to become unable to meet their capital adequacy requirements in the coming quarter. To prevent this from happening, Rs 2.11 lakh crore is being put into bank recapitalisation. This money could well have been spent on infrastructure or public investment. But until a better plan is ready, the immediate need to allow exising banks to function is the first step.

However, looking forward, as bankrupt companies and bad loans will be resolved by the bankruptcy process, bank losses will rise and putting budgetary resources into loss-making public sector banks will become increasingly infeasible. The creation of a Resolution Corporation will allow banks to be sold to other buyers in an orderly way. The FRDI bill is currently being examined by a Joint Parliamentary Committee and is likely to be passed after taking into account the fears and concerns.

Another critical requirement for investment growth is the availability of non-bank finance. There has been discussion about a corporate bond market that could provide funds to industry, particularly big industry. Yet, no country has been able to develop a liquid and well-functioning corporate bond market without a risk-free benchmark rate provided by a government bond market. The creation of a well-functioning government bond market with a public debt management agency and integration with equity markets was proposed in the March 2015 Budget. This proposal was rolled back to give the RBI time to work with the Ministry of Finance on a transition plan. As a critical element of facilitating finance for investment, this work needs to be prioritised.

Almost all the steps in the strategy to revive investment are likely to be slow and painful. A sustained pick-up in investment and growth can be expected only once these essential elements are in place.

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