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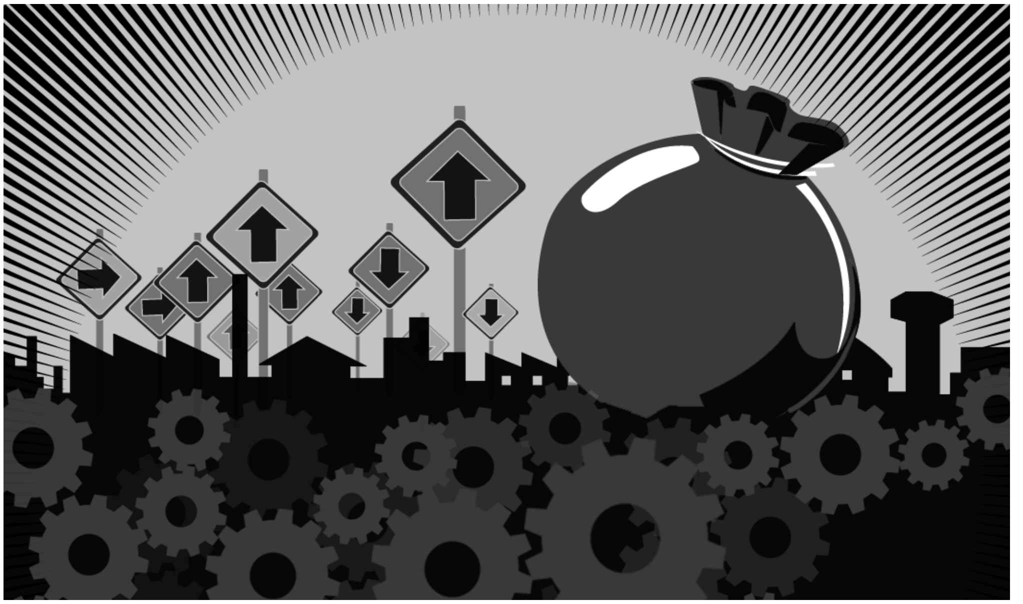

What shapes investment?

Expectations of buoyant growth are related to progress on economic reforms, with strong institutional mechanisms in place

A revival in investment is central to Indian business cycle conditions. How and when will this come about? The phrase 'animal spirits', which is often used about investment, suggests that there is something mysterious or irrational about the mood of the private sector. Investment can, however, be understood through five questions. Firms build new capacity when they are faring well on capacity utilisation, predicated on profitability and access to capital. Layered on this is the degree of optimism about Indian economic reforms and the expected tailwind of macro growth. Finally, there is an assessment about how the policy establishment will deal with situations in the future.

SNAKES & LADDERS

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Within GDP, consumption and government are fairly stable. The action over the business cycle is largely in investment and in net exports. The ups and downs of private corporate investment are a big part of the story of India's GDP.

What makes corporations invest? There is of course a major role for the judgment of the key persons in firms. The phrase 'animal spirits' seems to suggest that this is some purely an intuitive decision. While there is a role for feeling, this is layered on top of comprehensible analysis.

The first issue concerns capacity utilisation. If a line or a factory is not fully utilised, the firm has little reason to build new ones. The first priority is to get capacity utilisation up. The related issue is that of profitability. It is not just enough to get high capacity utilisation; this must happen at decent profit margins also.

An economy in a slump is one with poor profit margins and low capacity utilisation. Firms under these conditions will not invest on a large scale. Roughly speaking, in the two years before an upsurge in investment, we will see strong profit margins and high capacity utilisation.

Once a firm achieves good profit margins and attains high capacity utilisation, the question of building new capacity will be discussed. Here, questions of corporate finance will arise. The firm will look at its ability to obtain equity and debt capital and the prices seen on these markets will shape the decision.

Difficulties in financing are never a quantity constraint. Almost any firm can obtain capital if it tries hard. It is a question of price. If the cost of capital is too high, the net present value of the investment is affected. For this reason, managers never discern problems of the financial system. They are used to treating the required rates of return demanded by finance as a given. When a financial system malfunctions, and the manager is asked for an excessively high required rate of return, the manager feels his project is not attractive enough.

In Indian finance, there is an aristocracy of the top 1,000 firms which get the best prices when raising equity and debt capital. They have a financing edge. This translates into more attractive investment opportunities for them in the real sector, and less attractive investment opportunities for all other firms that are not given a friendly financial system.

The cash flows from a new investment project always lie in the future. Every projection about revenues is grounded in a view about the economy. When growth projections are buoyant, that gives a nice tailwind which makes all projects look more promising. In good times, firms are able to add a few percentage points to their top line projection, and all the financial projections then look nicer.

What makes these good times? Expectations of buoyant growth are related to progress on economic reforms. In the early 2000s, private persons saw a government that was building strong teams and executing complex reforms in numerous areas, such as highways, telecom, indirect taxation, equity market, and pensions. Each of these reforms created the confidence of enhanced growth in coming years, which fed back into more buoyant revenue projections by firms.

Going beyond all this is the incomplete contract between the government and firms in terms of action. The world will change, and unexpected situations will present themselves. Private persons form an opinion about how sensibly the government will behave in the future. Will harmful policy decisions be taken? If a difficult situation arises in a firm dealing with a government, what will the mechanisms through which the problems will be solved? Ideally, there should be strong institutional mechanisms in place, so that firms have confidence in institutions without requiring to think about the individual in charge. When institutions are weak, firms obtain short-range comfort if a sound person is seen in charge of a policy institution, but everyone knows that staffing changes will come about and lead to new kinds of uncertainty.

The term 'animal spirits' is often used, and the impression is often given that the investment by firms is an act of faith by their decision makers. While this is true in part, a lot of the investment process can be understood as a systematic set of five steps. (1) Is capacity utilisation strong? (2) Are profit rates attractive? (3) Is equity and debt capital available at attractive rates, so as to make projects viable? (4) Is a strong economic policy team in place, so that high GDP growth is forecast, after which all business endeavours are helped by a tailwind? (5) Are government institutions and personnel in good shape, so that good outcomes can be counted on with policy actions and disputes? Looking back at India's recovery from 2002 to 2004, these five questions worked well in anticipating the turning point.

The rupee value of projects under implementation has barely grown, in nominal terms, from 2011 to 2017. Why did this happen? The answers lie in these five questions. These five tests also help us to recognise conditions, at future dates, when we may expect investment to take off.

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