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India's Economy: Reviving Investment for Higher Growth

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INTRODUCTION

The last few quarters have been rather disquieting for India's economic prospects. Domestic savings and investment rates are trending downwards. The GDP growth rate, from a low of 6.1% in the last quarter of 2016-17, has gone down further to 5.7% in the first quarter of 2017-18. Aggregate fresh private investment growth has been showing a steady decline with the capital investment growth rate now becoming negative. This is reflected in the worrying negative growth rate of bank credit to industry.

Increasing internal demand for domestic goods and services is the key to reversing the declining trend. This would lead to higher capacity utilisation of Indian manufacturing industry, which has fallen to around 73%. That, in turn, would trigger a fresh cycle of private capital investment. All of this would nudge growth upwards into a higher trajectory.

With inflation under control, the RBI has started reducing interest rates. However, in the absence of increase in demand and capacity utilisation and hence the business case for additional new capacity, lower interest rates may not alone have the ability to adequately revive private investment.

Progress in addressing the NPA (Non-Performing Asset) problem of Banks with the new bankruptcy mechanisms (a long overdue reform) now in place is a welcome step. Restoring the health of Banks has been a major concern and has been in need of urgent attention. It is also a prerequisite for steady and sustained higher growth. However, solving the critical banking issue of NPAs would also by itself not generate demand for credit and the revival of private investment.

The standard, time tested, short term measure for creating additional demand has been a fiscal stimulus. At the time of the 2008 financial crisis, this was used and was effective. However, this is not a significant

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option now as with considerable difficulty and effort, the fiscal deficit is on a downward trajectory. This has helped in keeping inflation low. Control over both inflation and the deficit are essential for stable and sustained growth over the medium and long run.

Within the constraint of adhering to the path of lowering the fiscal deficit, efforts have been made to increase public investment in infrastructure, especially in the Railways and in highways. This is a positive development. But the investment needs are very high and what is under way has not been large enough to lead to a revival of private investment. It is also only a fraction of what is actually needed.

The material question then is, are there some viable options for increasing demand and investment, especially private investment? If so, what are these? What are the implications? Some ideas going beyond the traditional mind set are explored in this policy note. Though somewhat unorthodox, they are considered to be pragmatic and feasible.

REVIVE PPP IN INFRASTRUCTURE

The lessons from the earlier experience of Public Private Partnerships should provide a way forward for the next round of PPPs in infrastructure. It is worth trying to get additional private investment into infrastructure rather than giving up on it due to the difficulties of PPPs in roads in recent years.

The willingness to design afresh a fair apportionment of risks and gains is the key. Many of the Bank NPAs relate to infrastructure projects. These need sector specific policy and PPP contract redesign decisions, rather than the straightforward bankruptcy and takeover, or, asset sale approach used for normal commercial failures in the market. The earlier NDA government decision of the late nineties in the telecom sector is a good case study. By accepting that private telecom licensees had overbid and were in no position to be able to pay the committed license fees on which they were in heavy default, and shifting to a revenue sharing model, the government created the framework for India's extraordinary success in providing quality and affordable mobile phone services to almost all Indians within a decade and that too primarily through private investment. The standard response of treating contracts as immutable and sacrosanct irrespective of larger consequences for the public and, therefore, cancelling of licenses, blacklisting of defaulters and bankruptcy proceedings was, in retrospect, wisely avoided. This is a good example as well as a precedent.

At present, private sector appetite for investing in infrastructure is fairly low. Resolution of sectoral issues in a pragmatic manner and with transparency would be helpful in regenerating investor interest again. It is essential to generate a broad consensus for this. Infrastructure projects tend to be fairly capital intensive. Lenders as well as promoters need to regain confidence. Getting private investment back into infrastructure development could yield significant positives in increasing investment and demand in the economy.

PRIVATE INVESTMENT IN WATER

The standard template for PPPs typically involves private investment in, say, a toll road with recovery from the toll income making the investment financially viable. If required, some capital subvention through Viability Gap Funding (VGF) could be provided. However, there are a range of needs where recovery of user charges to make the investment financially viable is just not feasible. Provision of water to urban households and the treatment of sewage waste is a good example of provision of a need which is not amenable to investment being made viable on the basis of user charges. However, if the concerned public agency assumed the responsibility of paying user charges, then private investment could be made viable. This could quickly make good the gap between critical needs and the actual investment taking place.

In a modest way at a micro level, there is experience of such an approach. The CGHS (Central Government Health Scheme) has outsourced testing and specified treatments to private sector health service providers on prescribed rates. Patients get the service free. The Service provider gets paid by CGHS which is able to avoid the investments needed to create the requisite additional capacities.

Then there is the successful experience in recent years of growing private investment in power transmission on the basis of long term contracts for payment of transmission tariffs. Gaps and needs in transmission are being met through private investment and there is increasing confidence among all stakeholders that this model is working.

Adopting this approach to bigger needs, one could actually envisage achieving full urban sewage treatment within five to seven years through private investment,

with payment for sewage treatment being made at a cubic meter rate by the municipal authority. In each case, private investment could be invited through a competitive and transparent bidding process with the rate for treatment being the bid parameter. The needs for provision of additional storage of excess water during the monsoons and water carriage networks for urban and agricultural needs appear amenable to such an approach of attracting private investment. There would naturally be the challenge of designing the contract and the bid process creatively. If private investment is brought in through a transparent and competitive process and this has no linkage whatsoever with the sensitive and difficult decisions on user charges, subsidies and cross subsidies, it should not pose political difficulties.

AFFORDABLE HOUSING

Private investment in housing in India saw a surge after the 1991 reforms, with the number of developers growing and ready availability of housing loans from Banks. Construction and housing has been one of the major drivers of growth and job creation in the Indian economy. This has been the case in most economies in their high growth and urbanisation period. After a typical boom phase with rising prices attracting a lot of investment, the sector is now going through adjustments with many developers in difficulty and this process may still take some time.

At this juncture, the pursuit of the national goal of affordable housing for all offers a real possibility of this sector again becoming an engine for higher growth. But success needs recognition of the reality that the private market structure as it has evolved serves, at best, those who would constitute the Indian middle class. With the provision of interest subsidy, some progress is taking place towards meeting the needs of those with lower incomes. But it would be unrealistic to expect a surge in construction of affordable housing in view of the difficulties in assembling land anywhere and prevailing high prices.

To address the issue of land and its high price, a new paradigm based on experiences like those of Council Housing in London and elsewhere, where affordable rental housing is provided with the housing stock being publicly owned, can be considered. This would require the state assuming primary responsibility but getting the private sector to be the actual investors, managers and service providers. The state should assume responsibility for:

a. Assembling land;
b. Getting housing stock built by private investment;
c. Paying for it in instalments to cover financing costs and returns for the builder;
d. Managing it separately for maintenance and renting at prescribed rates by the private sector through outsourcing; and
e. Absorbing the differential between the income from affordable rentals and the instalment payments for the housing stock.

Volumes should create the market for pre-fabricated building blocks and the economies of scale that come with it. Actual costs of construction should come down significantly. Substantial cost reduction with large volume bulk procurement has already been seen. Such a model could quickly provide the scale of construction and development needed. The multiplier effect in terms of demand for labour, goods and services from this alone should nudge the GDP growth rate upwards.

CPSE INVESTMENT

There is one substantial under-leveraged resource which could and should be used for stepping up investment. These are the Public Sector Enterprises (PSEs). The better ones have been doing well over the years with rising profits and growing reserves. Their debt to equity ratios have been declining. Private conglomerates routinely use the surpluses of successful enterprises to finance ambitious diversification and to absorb the high initial entry level shortfall in revenues before viability is achieved. Reliance's Jio is a good example. This is something CPSEs have not yet been able to seriously attempt. The reserves and surpluses of the large profitable CPSEs are well over Rupees 4.00 lakh crores. Though the government is the promoter and controls the CPSEs, actual control is exercised through the line Ministry and within the Ministry through the concerned Division. This makes big investment decisions on ambitious diversification, or, setting up a new enterprise unlikely especially as there is no central coordinating process and mechanism for examining options and taking decisions and the associated risk. The situation is further complicated by the mandate to the independent Boards to focus on short term commercial returns. In theory, this can be easily addressed by taking higher dividends from the more profitable undertakings and using these for riskier, but nationally needed, new

investments. This has yet to happen. While government has on occasion taken higher dividends, these have been used as additional revenue to achieve fiscal deficit reduction targets.

To illustrate, India needs a national gas grid but investment on this would actually take place only when GAIL sees commercial viability in these investments and this does not seem to be the case now. Similarly, BHEL may be facing terminal decline as the age of coal fired stations is coming to an end. But they have been unable to take the big decisions to diversify into making electric trains, solar panels covering the full value chain, or, engines for ships and aircraft. Each one of these areas is well within their technical capacity as well as a strategic national need. Such major initiatives naturally entail high risks and may even require some government support. It may be noted that Airbus is such a success only because of the strategic support and perseverance of the promoter European governments. In fact, HAL potentially has the reserves and the capacity to develop a civilian aircraft. The last time something big was attempted in India with government support was with Maruti a generation earlier, and it did transform the Indian manufacturing scene.

It is time some strategic depth was brought into Make in India. A state of the art fabrication facility to make chips for computers and smart phones is an immediate and obvious need. The growing reserves of the CPSEs and their modest debt levels provide considerable potential for fresh and substantial capital investment.

PUBLIC PROCUREMENT

Public procurement is a potent instrument which could generate large investments with consequent job creation in some key sectors. This requires designing the bid process in some key areas with this as a primary objective, in addition to the normal requirements of transparency and fairness. The recent extraordinary success in lowering LED prices through bulk procurement by a specially created public agency, EESL (Energy Efficiency Services Limited), provides a glimpse of the enormous untapped potential of smart public procurement. Earlier, the Railways have received investments from GE and Alstom for diesel and electric locomotive engine plants on the basis of long term procurement contracts. State of the art super critical thermal power plant equipment manufacturing facilities were created by the private sector in the country on the basis of bulk tenders for the more energy efficient 800 MW super critical turbines and generators, with the stipulation that these be made in India. These are a few recent examples. An easy breakthrough in the manufacture of electric vehicles and their batteries in India could be achieved with bulk tenders for replacement of the existing fleet of government owned cars in the central and state governments and their agencies over the next five years. The tender should stipulate a high level of value addition in India, including the manufacture of batteries. As in the case of super critical power plants, the effort should be to create a competitive industry structure by giving the second and third lowest bidders the option of matching the lowest bid price and getting smaller percentages of the order.

STABLE REAL EXCHANGE RATE

The exchange rate, surprisingly, gets a fairly modest salience in the discourse on economic issues. The actual experience in India has been of appreciation of the real exchange rate. The real exchange rate is the nominal rate adjusted for the difference in inflation rates with trading partners. To illustrate, to maintain the real exchange rate, the India Rupee would need to depreciate by 5% in a year if the inflation rate in India is 5% higher than that of its major trading partners that year.

There has been a simplistic equivalence between a strong currency, a strong economy and a strong nation in common perceptions. Unfortunately, the exact opposite has been the experience of development and industrialisation of the East Asian economies over the last seventy years. Starting with Japan, followed by South Korea and, more recently, by China, a conscious policy of keeping a depreciated real exchange rate was one of the key pillars of their strategy of success in manufacturing and acquiring global competitiveness.

By having an appreciating exchange rate, success in manufacturing has continued to elude India. While there is some recognition that the exchange rate matters for exports, what is usually missed is that in the open liberal economy with no import restrictions that India has been for many years, the exchange rate has a huge impact on domestic manufacturing and value addition for the domestic market, in addition to the impact on exports. The higher the domestic value addition, the greater the impact of the exchange rate, as imports become cheaper and increase market share. Labour intensive sectors get impacted more. The withering away of many segments of domestic manufacturing due to cheaper imports, primarily from China, over the last fifteen years has been to a considerable extent due to the continuous real

strengthening of the Rupee. A real exchange rate appreciation of 10% is roughly equivalent to an import duty reduction of 10%. Similarly, a 10% real exchange rate depreciation is roughly equivalent to a raising of import duties by 10%.The case for maintaining a competitive exchange rate and not allowing it to appreciate has been well argued but with no effect so far.[1] A competitive exchange rate is a necessary and helpful condition for increasing domestic value addition and job creation.

A strong exchange rate favours large corporates with large ECBs (External Currency Borrowings) as the low interest rate advantage of dollar borrowings would be adversely impacted by depreciation. Similarly, FIIs would see the capital gains from rising share prices of Indian stocks get lowered with currency adjustment. Again, the wealthier Indian loses as his foreign holidays, children's education overseas and consumption of imported branded luxury goods would all cost more with the currency going down. On the other side, those who gain are producers including exporters who create value and jobs, and poor youth hoping to get good productive jobs. Where the public interest lies is quite clear. It is for the political leadership to weigh in on the right side. The instruments to be used are well known. To begin with, ECBs may not be permitted where domestic manufacturing capacity exists, or, can be easily created. Then, if necessary, the RBI should intervene in the market and add to the reserves to the extent required to maintain the real exchange rate. So far the Bank's position has been that it enters the market only to minimise volatility. That should change.

SUMMARY

To summarise, the following areas have the potential of reviving private investment on a significant scale, thereby increasing the growth rate of the Indian economy:

1. Revived PPPs in infrastructure with a redesigned framework.
2. Private Investment in water storage, carriage and sewage treatment.
3. Private investment to build and, separately, rent and manage affordable housing.
4. Leverage CPSEs resources and reserves for needed investments
5. Use Public Procurement strategically to promote investment and job creation in key areas.
6. Manage Real Exchange Rate Appreciation to facilitate domestic value addition and job creation.

Endnote:

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