Can the Budget revive investment?

CRISIL Economy Quick Byte

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In the previous two Union Budgets, the government took steps to improve the investment climate in India, but this turned out to be an exercise in futility because share of capital investments in GDP continued to fall. Investments as a percentage of GDP have fallen from 34% in fiscal 2012 to 29% in fiscal 2017. The Central Statistical Organisation estimates that fixed investment has declined 0.2% in this fiscal. As for the private sector, the appetite to invest is just not there amid high leverage and impaired balance sheets.

Private investment was expected to take another year to recover – even before demonetisation. According to the Reserve Bank of India's OBICUS survey, capacity utilisation in manufacturing was 73% in the quarter ended June 2016, or well below the threshold required to trigger fresh investments. Things haven't changed materially since.

Capacity utilisation could have improved had domestic consumption been higher, as was expected in the second half of this fiscal. However, the cash crunch following demonetisation curbed demand. That, in turn, could delay revival in private investments.

CRISIL's surveys show automobiles, cement, steel, paper, aluminium and fertilisers had the lowest capacity utilisation – and many of these have been the ones hardest hit by demonetisation. For instance, domestic sales of auto industry slumped 18.7% in December. Short-term demand for cement and steel will also be affected, since 60-65% demand for cement, and 30-35% demand for steel comes from the cash dependent real estate sector.

Demonetisation hit sectors already reeling under low capacity utilisation

Sector	Capacity utilisation prior to demonetization*	Effect of demonetisation
Tractors		Negative
Cars and UVs		Negative
Commercial vehicles		Negative
Two wheelers		Negative
Cement		Negative
Steel		Marginally negative
Paper		Neutral
Aluminium		Neutral

Deviation from optimal level of capacity utilization is greater than 10 percentage points

Deviation from optimal level of capacity utilization is between 4-10 percentage points

Source: CRISIL Research

While demonetisation may not have impacted ongoing investments, fresh ones would have been kept in abeyance. That, in turn, would further delay recovery in the private investments, so critical for sustained pick-up in investments.

What can this Budget do for reviving investments?

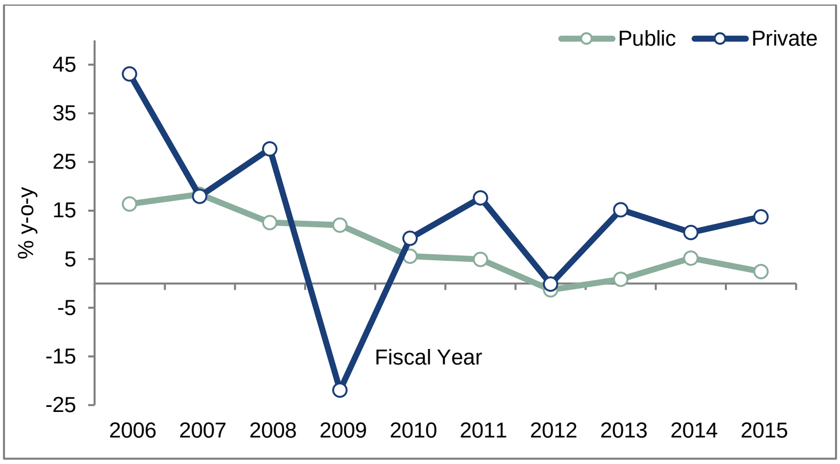
Lift up the consumption cycle

The immediate priority of the government should be to revive consumption demand. Private consumption growth slowed to 5.9% in the second half of fiscal 2017 from 7.1% in the first half (CSO, advance estimates). Domestic consumption must be boosted by improving purchasing power, especially among the rural population and workers in the unorganised sector, and smoothening transaction process in cash-driven sectors. This will help remove the short-term constraint of low capacity utilisation in the industry and pave the way for investment recovery.

Continued push to infrastructure

Historically, increase in public investment growth in India has been followed by increase in private investment growth with a lag. This indicates that public investment does help in crowding in private investment.

Private investment growth follows public investment growth[1]



Source: Central Statistical Organisation

The government can support investment directly by spending more on infrastructure, particularly roads and affordable housing. This will also help raise demand for core industry sectors such as steel, cement etc. In addition, construction of roads and low-cost housing is highly labour intensive in India, which will help generate employment in the economy.

Conclusion

The Budget can help by stepping up public investments and supporting private consumption demand. But given the government's limited fiscal space, this may not be sufficient. Therefore, revival of private corporate investment appetite is critical to the revival in the investment cycle.

1 Investment here refers to gross fixed capital formation as per national accounts. Data till fiscal 2012 is according to old GDP series. From 2013 onwards, both public and private investment include respective financial and non-financial investment.

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