Animal Spirits

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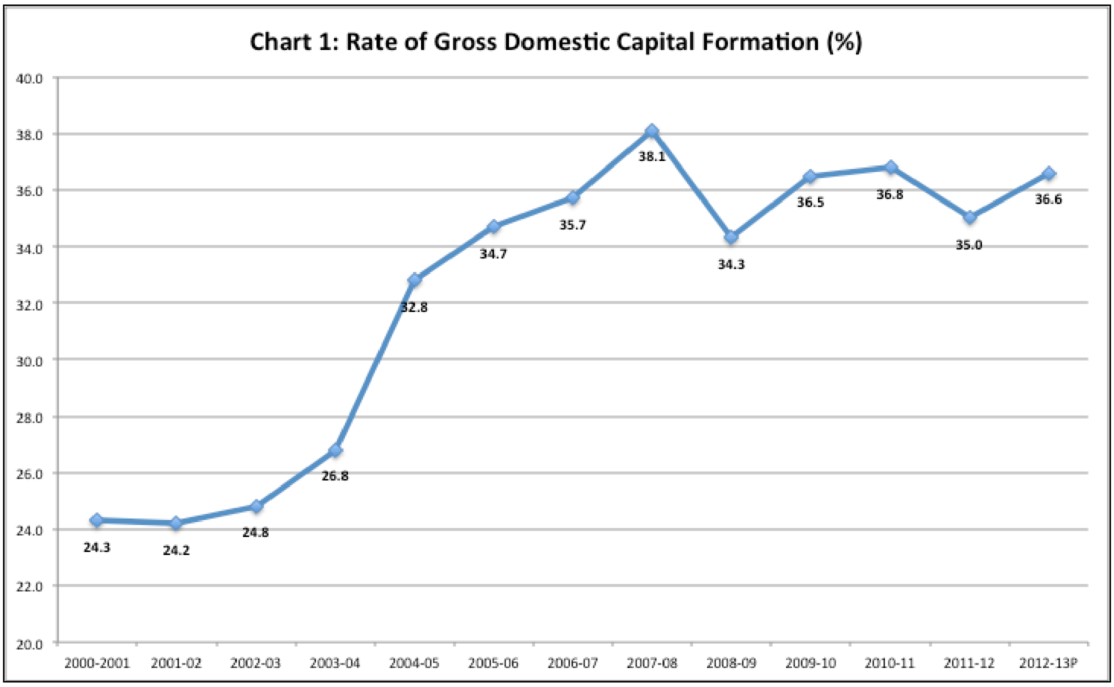
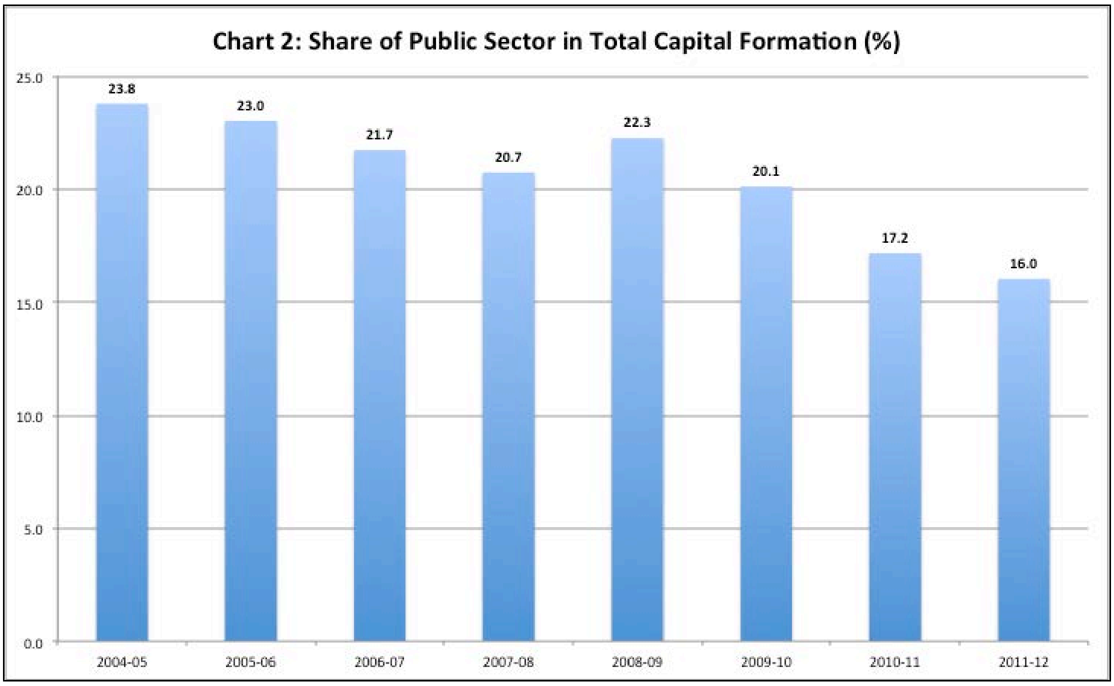
Confronted with slowing growth, the government has been arguing that stalled investment resulting from a range of policy and supply side constraints are the causes of the downturn. In response, therefore, besides aiming to ease rules governing foreign and domestic private investment, it has also been focusing on fast-tracking clearances in areas varying from land acquisition to compliance with environmental regulations. This is expected to unleash the "animal spirits" of private entrepreneurs, spur private investment and revive growth.



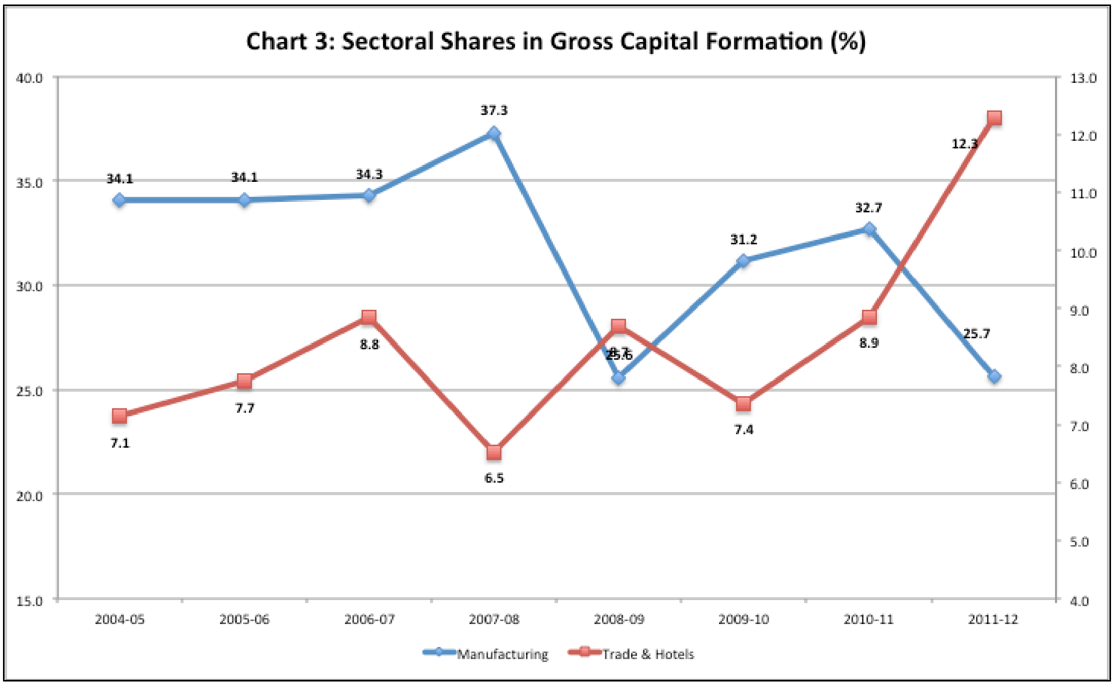
However, there is reason to believe that this policy thrust may be misplaced. It is indeed true that India's shift to a trajectory of higher GDP growth, of between 8 and 9.5 per cent in most of the years between 2003-04 and 2010-11 was accompanied by a significant step up in the rate of investment. As Chart 1 shows, the rate of gross domestic capital formation rose from around 24 per cent during the first three years of this century to 38.1 per cent in 2007-08 and remained above 35 per cent in most years thereafter. This was also the period when the share of the public sector in gross capital formation declined from close to 24 per cent to just 16 per cent (Chart 2), suggesting that it was an acceleration in private investment that was responsible for the higher rate of investment and the accompanying higher rate of growth in the economy. This lends credence to the government's view that the unleashing of the "animal spirits" of private investors was what was responsible for the growth acceleration from 2003-04.



There are, however, two difficulties with this argument. First, since consecutive governments since the early 1990s have consistently pursued liberalisation, it is unclear why the unleashing of animal spirits and the transition to a higher growth strategy occurred only in 2003-04. The second is that the aggregate capital formation rate, as estimated by the Central Statistical Organisation (CSO), has continued to rule high even during the years when the rate of growth has fallen, to 6.2 per cent in 2011-12 and a provisionally estimated 5 per cent in 2012-13. Also, obviously ICORs (incremental capital output ratios) in the economy as a whole are rising rapidly if similar rates of capital formation as in the past are resulting in significantly slower rates of growth. This suggests that it is not the rate of capital formation that may be the problem, but the character of capital formation.

There seem to be reasons to believe this may indeed be true. To start with, if we look at the sectoral composition of capital formation, we find that while the agricultural sector accounted for a near stagnant 7 to 8 per cent of aggregate capital formation between 2004-05 and 2011-12, the share of capital formation in manufacturing which was in the 34 to 37 per cent range in the initial years, fell subsequently, touching lows of around 25.5 per cent in the 'bad' years 2008-09 and 2011-12 (Chart 3). As compared to this unimpressive performance with capital formation in the commodity producing sectors, there has been a significant rise in the share of capital formation accounted for by Trade, hotels and restaurants, which, while fluctuating, rose from 7 per cent in 2004-05 to 8.8 per cent in 2006-07, 8.9 per cent in 2010-11 and a high of 12.3 per cent in 2012-13. Services that don't need much by way of machinery and capital stock, other than for land and buildings, seem to lead in capital formation.

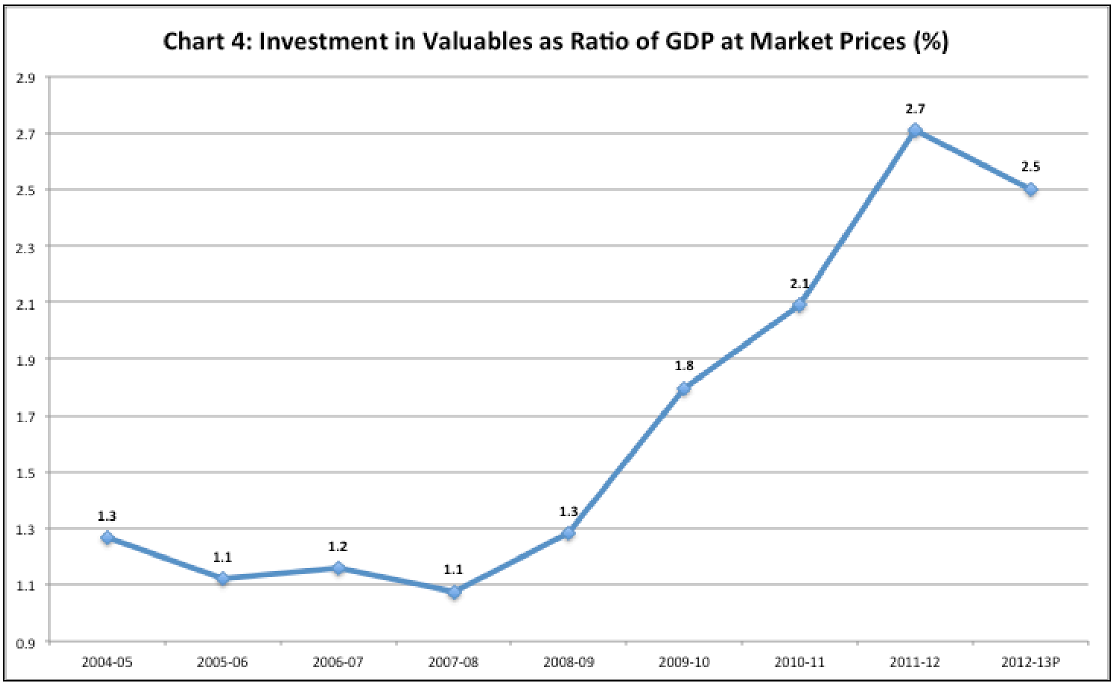
The combination of a high rate of capital formation and the importance of a sector such as Trade and hotels as a target for incremental investment makes the argument that investment is being held back by policy impediments difficult to swallow. It is not that investment is not occurring, but that it is being directed at lower end services at the expense of manufacturing. This seems to be particularly true of the private sector. If we examine the structure of capital formation in the public sector, we find that manufacturing, which accounted for 11 per cent of the total in 2004-05, accounted for a significantly higher 15 per cent in 2010-11 and around 12 per cent in 2011-12. Besides this, around 30 per cent of capital formation in the public sector went to the infrastructural areas (Electricity, gas and water supply and Transport, storage and communications) and around 35 per cent to public administration and defence. Thus, besides the requirements set by governance, the government was playing the role of infrastructural services provider and the provider of manufactured inputs of a capital-intensive kind.



Contrast this with aggregate capital formation, in the case of which the share manufacturing was declining and that of trade and hotels was rising. This must mean that the decline in manufacturing's share in private capital formation must have been even steeper and the rise in the share of trade, hotels and restaurants much sharper. Further, capital formation in the Financing, insurance, real estate and business services sectors accounted for between 15 and 17 per cent of the total in the economy as a whole. However, the share of these sectors in public sector capital formation was only 2-2.5 per cent. If there is a display of animal spirits by the private sector, the appetite was not for profit from productive activity. Profits, however, were substantial during 2003-04 to 2009-10, because of the many ways in which the government favoured the private sector. It is just that these profits only partially went to finance more investment in the commodity producing sectors.

This conclusion is partly corroborated by the growing share of "valuables" in aggregate 'capital formation', from about 1.3 per cent of the total in 2004-05 to 2.5 per cent in 2011-12 (Chart 4). The practice of providing for acquisition of valuables in the capital account is based on the UN's System of National Accounts of 1993, which recommended including under valuables "expensive durable goods that do not deteriorate over time, are not used up in consumption or production, and are acquired primarily as stores of value". These were to be shown on the capital account but not included in capital formation. By including this in the national accounts and also under capital formation in the 2004-05 base year revision of National Accounts

Statistics, the CSO has not only inflated saving and investment estimates, but also made a kind of hoarding into investment. What we now observe is that, perhaps reflecting the Indian passion for accumulating gold, the valuables component of 'capital formation' has risen. This too partly explains the fact that "investment" while still high, does not seem to be driving GDP growth.



In sum, while the objective of economic reform of getting the private sector to pick up the baton from the public sector and lead investment in the economy has been partly realised, that transition has not been so beneficial for the pattern of investment and growth. The rise of the private sector has been accompanied by a shift in investment towards "soft" sectors in the services domain and by an increased role for speculative investment in "valuables" that inflate capital formation without creating productive capacity and driving growth.

These features of capital formation are in keeping with the lop-sided growth path characterising the Indian economy in recent years where manufacturing growth is concentrated in sectors that are import intensive with a smaller component of domestic value added than would have otherwise been the case, and aggregate growth occurs largely in the services sector. A counterpart of that kind of growth is that the focus of investment in India, whether by domestic or foreign firms, tends to be the domestic market. The growth of the domestic market is in turn dependent in the final analysis on debt-financed private consumption and investment. With the debt overhang having increased as a result, that growth strategy is running out of steam. It is this demand side weakness rather than constraints on private animal spirits that is responsible for the growth slowdown.

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