Revive private investment after fiscal consolidation

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Policymakers' decision to pursue the bad growth mix — high fiscal deficit, low investment spending — since the credit crisis has been at the heart of most of the macro challenges facing India. However, we now see early signs of a reversal in the stagflation-type environment — high inflation, low growth — as policymakers have taken clear steps since September 2012 to correct this bad growth mix. Policymakers' decision to pursue the bad growth mix — high fiscal deficit, low investment spending — since the credit crisis has been at the heart of most of the macro challenges facing India. However, we now see early signs of a reversal in the stagflation-type environment — high inflation, low growth — as policymakers have taken clear steps since September 2012 to correct this bad growth mix.

The first step of correcting the high fiscal deficit is being delivered and the government will likely stay the course going into 2013-14. We believe that the government would need to take aggressive measures to deliver the second step of reviving private investment to fully correct the bad growth mix. The government has made significant progress in delivering fiscal consolidation over the last few months.

For 2012-13, the government will likely achieve a fiscal deficit of 5.6% of GDP, but will report it as 5.3% with some deferment of oil subsidy. This is a major change compared to our tracking estimate of 6.1% of GDP in September 2012. The government has achieved this with an aggressive reduction in expenditure growth.

There are three key components of expenditure: interest payments, subsidy, and expenditure excluding interest and subsidy (ExpXIS). With no control on interest payments, the government has focused on cutting oil subsidy and ExpXIS. Indeed, in November and December, ExpXIS declined by 2.8% and 5.7%, respectively, compared to the same period last year.

Similarly, for 2013-14, the government is likely to stay on the course of fiscal consolidation, cutting deficit further by 0.6% of GDP. Most of the reduction in the fiscal deficit in 2013-14 would have to be achieved by cutting expenditure growth as there is not much room to augment revenues.

Increasing tax rates will send a negative signal for corporate investment. Also, accelerating nominal tax revenue growth meaningfully higher from 2012-13 levels will be challenging even as real growth picks up, given the decelerating inflation trend. Fiscal tightening via expenditure control is a positive for the economy as it helps to bring about an improvement in macro stability risks such as inflation, current account deficit and deposit growth.

However, the reduction in government spending does mean that GDP growth rates will be constrained in the near term even as growth has already slipped to a 10-year low in 2012-13. The moderation in government expenditure growth ditions are largely out of policymakers' control, domestic policy actions can play a meaningful role in reviving private capex.

Hence, we believe that it is important for the government to now focus on reviving investment spending, the second step of correcting the bad growth mix. To be sure, reviving capex in a counter-cyclical manner at a time when overall growth has been slowing will be challenging.

Some of the key factors affecting private investment sentiment are volatile global capital markets, relatively high energy prices, inflation and cost of capital and corruption-related investigations and slowdown in execution of the government's administrative machinery. While the government has taken some steps in the right direction since September 2012, we believe there is a need to pursue campaign-style effort to revive investment sentiment.

There are four key sets of measures needed to revive investment. First, continued efforts to strengthen the institutional processes for the allocation of national resources for industrialisation. Second, government administrative machinery needs to accelerate the approvals of investment projects (like environment, etc).

Third, we believe that in the FY2014 Budget, the government could announce a special tax incentive for accelerating capex spending in the next 12 months as well as for encouraging long-term financial saving. Fourth, government could attempt to jump-start critical urban infrastructure facilities, which can be taken up in a countercyclical manner.

The central government could provide a capital grant of about $10-15 billion to initiate projects worth $40-50 billion. Funding of this capital grant can be done through additional divestment of government stake in state-owned enterprises. The need to move at a quick pace cannot be overemphasised. We think private investment will be key to support aggregate demand and GDP growth as the government stays on the path of fiscal consolidation will act as a natural drag on aggregate demand and, hence, GDP growth. Moreover, rural consumption, which had earlier been benefiting from fiscal transfers and high rural wage growth, will also moderate as support from these factors wane.

So, in the near term, as government spending and rural consumption growth moderates, the importance of capex and exports as growth drivers will rise. On the external front, as the domestic demand outlook in developed economies improves slowly, we expect India's exports to pick up. However, the headwinds of deleveraging in developed economies will mean that the pick up in exports will likely be gradual.

Given this gradual recovery in exports, capex spending has to pick up more meaningfully in order to fill the slack in aggregate demand and drive the economic recovery. While external demand con

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