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India Economics

Early Signs of Policy Response Picking Up?

Government appears to be moving in the right direction to revive capex cycle: The government cleared three major infra projects worth US$5 billion including an electricity generation plant, metro rail system and highway project. Moreover, according to media reports (Business Standard), the government is likely to approve the long debated foreign direct investment (FDI) for retail distribution chains.

In this cycle, reviving growth will be possible only with a push to capex: A further boost to domestic consumption through monetary and fiscal easing in the face of capacity constraints and already high inflation would only intensify the inflation problem. Hence, the government needs to push private investment to revive growth this time.

Counter-cyclical revival in investment trend will be challenging: From an entrepreneur's perspective, the slowdown in demand growth, weak global economy as well as global capital markets, high material prices that hurt margins, a slowing pace of approvals by government machinery, lack of major policy reforms over the last few months, and tailwinds of corruption-related investigations have affected corporate confidence.

Bottom-line: Although recent moves by the government are a good beginning, we believe the time lost with no real policy effort to push investment for a long period of time means that the government needs to now be quick and persistent in delivering a "**campaign style**" effort to get the entrepreneurs moving from the current risk-averse mode to an aggressive investment mode.

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Early Signs of Policy Response Picking Up?

Summary

Over the last few days, the government appears to be beginning to move in the right direction in efforts to revive the investment trend. We have been highlighting since May 2011 that the government needs to initiate a "campaign style" effort to revive investment or else the duration of growth slowdown will be more than 3-4 quarters resulting in a severe slowdown with the rise in non-performing loans in the banking system (*India EcoView: What's the Way Out of Current Growth Slowdown?*). Although this is a good beginning, we believe the time lost with no real policy effort to push investment for a long period of time means that the government needs to now be quick and persistent in delivering a "campaign style" effort to get the entrepreneurs moving from the current risk-averse mode to an aggressive investment mode.

Good News – Some Early Signs of Policy Response Going In the Right Direction

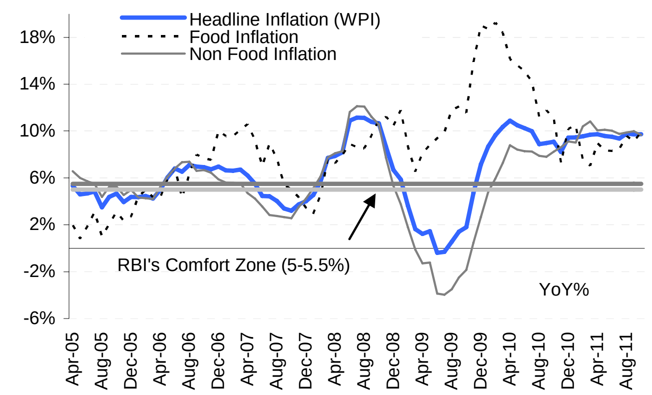
The government cleared three major infra projects worth US$5 billion including an electricity generation plant, metro rail system and highway project. The decision to approve these projects was taken in a meeting of a group of ministers chaired by the Finance Minister Pranab Mukherjee on November 18, 2011. According to media reports (Business Standard) the first meeting to review such projects was on October 18, 2011 in which the government discussed 12 projects worth US$34 billion, implying there could be more such clearances by the government in the coming weeks. Moreover, according to media reports (Business Standard), the government is likely to approve the long debated foreign direct investment (FDI) for retail distribution chains. This law if approved by the cabinet over the next few days will open up the doors for global retail distribution for companies like WalMart, TESCO etc to set up front-end retail distribution in India. We understand that this can be an executive decision and does not need approval from Parliament.

Why These Measures Are Important To Track?

We have been arguing for some time that in the current cycle recovery in growth will be feasible only with a revival in investment unlike the typical approach of pushing consumption first. In India, the sharp decline in private corporate investment post credit-crisis has meant that the sustainable GDP growth rate at which inflation is non-accelerating has also declined. As we have seen over the past 2 years, boosting consumption and intervention in the rural labor market through employment scheme in this environment has brought high and persistent inflation. Inflation has been now above RBI's comfort zone of

Exhibit 1

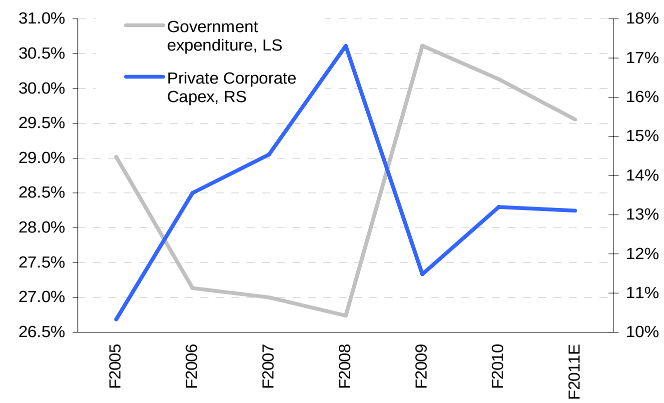
Headline Inflation (WPI) above RBI's Comfort Zone for the Past 23 Months



Source: CEIC, Morgan Stanley Research

Exhibit 2

Government Expenditure vs. Private Corporate Capex (as % of GDP)



Source: CSO, Budget Documents Morgan Stanley Research

Exhibit 3

No Room for Counter Cyclical Fiscal Policy

As % of GDP	F2007	F2008	F2009	F2010	F2011E	F2012E
Central Fiscal Deficit	3.3%	2.5%	6.0%	6.4%	4.7%	5.6%
State Fiscal Deficit	1.8%	1.5%	2.4%	3.3%	2.5%	2.3%
Sub-total	**5.1%**	**4.1%**	**8.4%**	**9.7%**	**7.2%**	**7.9%**
Inter-government adjustments	0.2%	-0.1%	-0.1%	-0.1%	0.0%	0.0%
Combined Headline Deficit	**5.4%**	**4.0%**	**8.3%**	**9.6%**	**7.2%**	**7.9%**
Major Off-budget expenditure items	*0.9%*	*0.8%*	*1.6%*	*0.2%*	*0.6%*	*0.9%*
Overall Fiscal Deficit	**6.2%**	**4.8%**	**10.0%**	**9.8%**	**7.8%**	**8.8%**
Overall Fiscal Deficit (excluding 3G receipts)		*NA*	*NA*	*NA*	*9.2%*	*9.0%*

Note: *Here the off-budget items include expenditure on oil, food and fertilizer. We have assumed oil prices average US$110/bbl in F2012.
E = Morgan Stanley Research estimates.
Source: RBI, Economic Survey, Ministry of Finance, Morgan Stanley Research

5-5.5% for almost two years now. A further boost to domestic consumption through monetary and fiscal easing in the face of capacity constraints and already high inflation would only intensify the inflation problem. Hence, the government needs to push private investment to revive growth this time. The already high starting point of fiscal deficit implies very little room for the government to pursue expansionary fiscal policy to boost public investment. Indeed, the current level of fiscal deficit is pushing government 10-year bond yields close to decade high levels of near 9%.

As domestic demand growth decelerates further, thus reducing inflation pressures, there could be some room for moderate cuts in policy rates. However, we believe that an interest rate cut is unlikely to be a sufficient driver to kick-start the investment cycle. Indeed, private investment has slowed even though real interest rates remain negative. As inflation moderates, real interest rates will need to be high for some time to ensure that we lift savings enough to fund the eventual rise in investment. Lowering interest rates to boost consumption will also not be a viable policy option since it risks a stoking of inflationary pressures.

Unfortunately, corporate confidence to push for higher investment has remained weak post the credit crisis. Currently, from an entrepreneur's perspective, the slowdown in demand growth, weak global capital markets, high material prices that hurt margins, a slowing pace of execution by government machinery, and tailwinds of corruption-related investigations are overhangs on corporate confidence. As such, neither accommodative monetary policy nor lower interest rates are likely to be a sufficient driver to kick-start the investment cycle. One can hope that the global economy and capital markets will revive quickly to support private investments to some extent. However, considering the depth of the challenge that the developed world is facing, we believe it is fair to assume that support from this area over the next few quarters will not be forthcoming. Hence, to support investment growth, the government needs to focus on policy reforms to get the productive dynamic back, in our view. A "campaign-style" effort is needed soon from the government to revive corporate investment sentiment.

What Kind of Policy Response is Needed?

We have been highlighting our framework on this issue for some time in various research reports over the last six months. We are summarizing our framework again below. In our view, a two-pronged strategy is required:

First, to accelerate the **implementation of the major policy reforms** such as:

• **Strengthening institutional capacity to allocate critical national resources such as land and minerals** to private corporate sector in a transparent manner for rapid industrialization. The aggressive industrialization from 2004-2007 meant that the scale at which the corporate sector was acquiring land and mineral resources rose significantly, increasing the risk of graft issues without having a well developed institutional capacity to manage it.

• Enacting the **Goods and Services Tax Act**—GST (value added tax). This should help improve the productivity in manufacturing business in a big way;

• **Strengthening institutional capacity to manage the awarding of major infrastructure projects** through public-private route, which should increase transparency;

• Building a **comprehensive plan for energy security** along with a systematic program for energy pricing reform;

• Initiating aggressive **fiscal consolidation** which aims to reduce the national government deficit and improve the mix of its expenditure towards development spending; and

• Allowing **FDI** in multi-brand retail distribution, insurance and other areas to build a sustainable source of capital inflows.

Second, as policy reforms discussed above could take a while to yield results, the government needs to **identify 25-30 core infrastructure as well as industrial projects which are either already under way or can be taken up for execution quickly and fast-track them** to ensure that investment activity is revived in a more timely fashion. These projects could be those that have a limited call on land and mineral resources.

We believe the government should focus in particular on infrastructure investment, which can be taken up in a counter-cyclical manner as weak global sentiment could weigh on manufacturing investment. For instance, many Indian cities need a jump-start in critical urban infrastructure facilities and the central government could provide a capital grant of about US$10 billion to initiate projects worth US$40-50 billion. We understand that in many cases the plans for such infrastructure projects are ready but need a determined push from the central government.

We believe such measures could also serve as a strong boost to foreign investor sentiment and would help revive capital inflows as investors look for strong growth opportunities in an otherwise gloomy global environment. Among the large economies in the world, India's structural growth story remains the most compelling, in our view. However, policy support would help to keep faith in this growth opportunity intact.

The Coming Growth Slowdown Will Be Deep….
We believe a number of factors are now beginning to weigh on the growth trend. Our favourite leading indicator for assessing the near term growth outlook has been M1 growth, which measures the transactionary demand for money and has been an accurate predictor of corporate revenue growth trend in the last few years (Exhibit 4). Indeed, M1 growth which leads corporate revenues by about 2 quarters is indicating the depth of the growth slowdown will be at least as bad as that seen in 2008-09, if not more.

All four key drivers of growth are now slowing simultaneously:

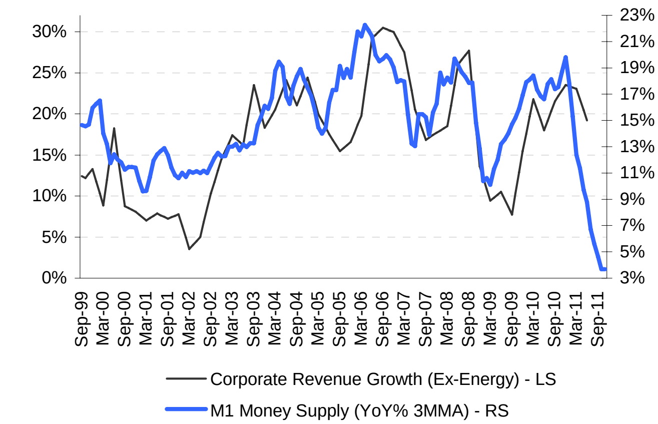
Investment spending: We do not have good real-time indicators for investment trends, but, it appears that investment spending is likely to slow sharply. The quarterly results of a select few engineering and construction companies indicate a slowdown in their sales. More importantly the forward-looking indicator-order inflows for these companies have now decelerated to 8 year lows (Exhibit 5). As of June 2011, order inflow growth for these companies declined to -27% YoY. Preliminary data for the quarter ending September 2011 indicates that a similar trend continued.

Private consumption: Consumer durables production growth has moderated from 15.2%YoY in QE Mar-11 to 7.7%YoY in QE Sep-11. Passenger car and two-wheeler sales growth has decelerated sharply. Modern format retail sales have also decelerated sharply over the last 3 months. We believe this is largely due to slowdown in urban consumption as a result of higher inflation and weaker income growth.

Government spending: While state government spending data are not available, the monthly central government spending data indicate that government spending has slowed. During April-September 2011, central government expenditure has grown at 9.9% YoY compared with an average growth of close to 20% over the three years ending March 2011. We believe the slowdown in tax revenues will force the government to slow the expenditure growth even further in the next few months.

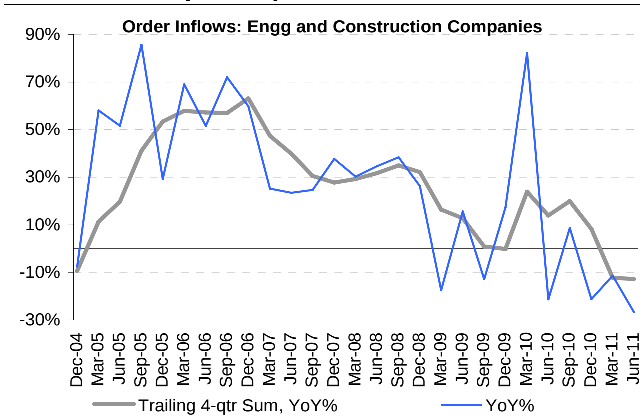
Exports: On the external demand side, while export growth was strong until recently, over the last three months it has decelerated sharply. Cumulatively, on a seasonally adjusted basis, exports have declined -21.8% (non-annualised)

Exhibit 4
Leading Indicator Raising An Alarm - M1 vs. Corporate Revenue Growth (ex-energy)



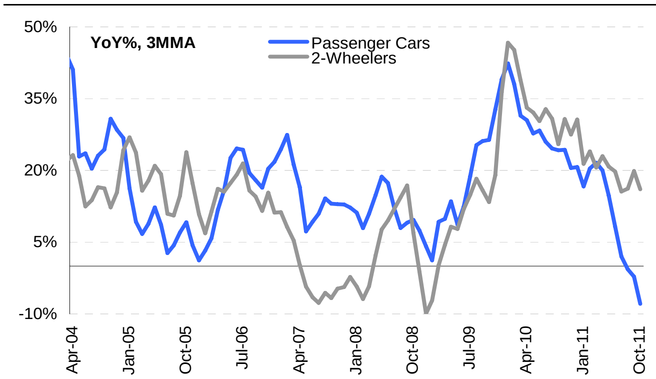
Based on a universe of 128 companies, Standalone results for Tata Motors and Tata Steel
Source: Capitaline, RBI, Morgan Stanley Research

Exhibit 5
Engineering and Construction Companies Order Inflows Book (YoY %)



Source: Company Data, Morgan Stanley Capital Goods Sector Team – Akshay Soni and Pratima Swaminathan

Exhibit 6
Slowdown in Auto Sales…



Source: CEIC, Morgan Stanley Research

over the last three months. On YoY basis it has decelerated to 10.8% in October from 81.8% in July 2011. Moreover, a further significant weakening in domestic demand in G10 in 2012 implies that this engine of growth will suffer even further.

…….Duration Will Depend on Pace of Policy Response

As discussed earlier, the revival in investment cycle is the key to recovery in overall growth. Clearly, reviving investment trend in a counter-cyclical manner will be tough. We believe that the two most important sets of factors amongst these will be (a) global economy as well as capital markets and (b) policy response. Global capital markets weigh on capital inflows into India and also tend to influence the risk appetite in the domestic markets. This factor is particularly important for India as its corporate sector's investment funding is more dependent on capital markets compared to bank credit. Moreover, businesses of many of the companies are now linked to global economy and their investment decisions are dependent on global economic outlook.

Considering, the developed world is facing major structural challenges, the support from global economy and capital markets may not forthcoming. We believe that the government's policy response will be critical to ensuring that the growth trend recovers over the next 3-4 quarters.

A Slowdown in Growth for More than 3-4 Quarters Can Be Problematic

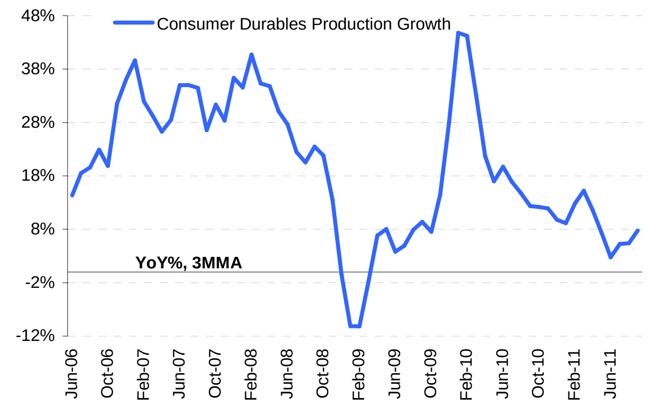
A weaker growth trend lasting for more than 3-4 quarters could potentially make the cycle more harmful with a rise in non-performing assets in the banking system. Based on the data available for banks under Morgan Stanley's coverage, our India financials team estimates that, as of March 2011, the sum of gross non-performing assets and restructured assets amounted to 5.5% of the system credit. Indeed, during the quarter ending September 2011, public sector banks have already reported a significant increase in the credit costs. We believe that the current slowdown is likely to significantly increase the non-performing loans further. This may potentially lead to risk aversion among lenders. Given that the investment cycle typically has a longer gestation period, policy makers must move quickly to reduce the possibility of a vicious cycle.

Bottom-line

Developments on policy response over the last few days are finally giving some hope of government beginning to move in the right direction. However, we believe the current global and domestic macro environment means that the government needs to now be quick and persistent in delivering a "campaign style" effort to get entrepreneurs moving from the current risk-averse mode to aggressive investment mode and kick-start an investment cycle

Exhibit 7

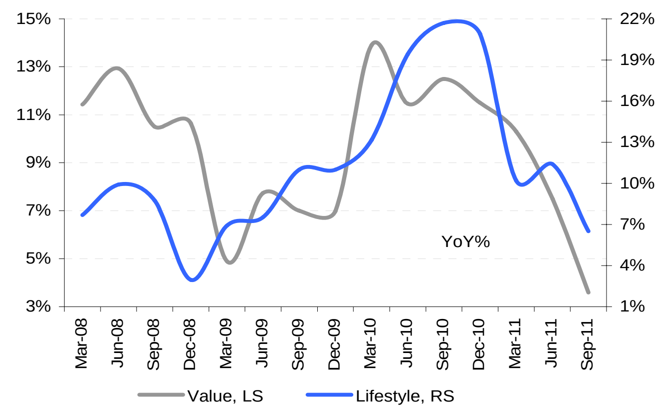
…and Consumer Durables Production



Source: CSO, Morgan Stanley Research

Exhibit 8

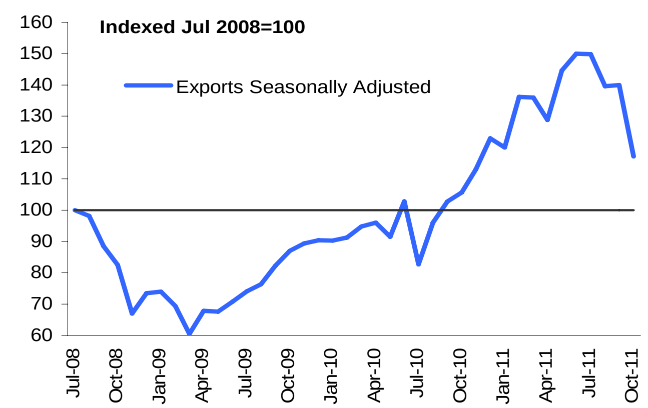
Retail Same Store Sales Growth (Pantaloon) (YoY%)



Source: Company data, Morgan Stanley Research

Exhibit 9

Exports (Indexed Jul 2008 = 100) Seasonally Adjusted



Source: Ministry of Commerce, Morgan Stanley Research

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