Gist of Economic Survey 2017-18 [Chapter 3]: Investment and Saving Slowdowns and Recoveries: Cross-Country Insights for India

INTRODUCTION

- Since 2010, there is one question: how soon will the Indian economy revert to 8-10 percent growth? Perhaps it is just around the corner, given all the structural reforms the government has implemented in recent years.
- Underlying this expectation is the firm belief that domestic saving and investment will soon start to accelerate. But this cannot be taken for granted.
    - Neither saving nor investment is unduly depressed.
    - Investment (gross fixed capital formation) rate and gross domestic saving rate are actually above the levels that prevailed throughout the 1990s.
    - In fact, it was the boom of the 2000s that was exceptional, as India's climb to about 10% real GDP growth was accompanied by an unprecedented 9% point pick-up in domestic saving and investment rates.
    - The subsequent slide in investment and saving (as a percent of GDP) has merely brought these rates back towards normal levels.
    - Specifically:
        - The ratio of gross fixed capital formation to GDP
            - climbed from 26.5% in 2003,
            - reached a peak of 35.6% in 2007, and
            - then slid back to 26.4 percent in 2017.
        - The ratio of domestic saving to GDP has registered a similar evolution,
            - rising from 29.2 percent in 2003
            - to a peak of 38.3 percent in 2007, and
            - then falling back to 29 percent in 2016.
        - The cumulative fall over 2007 and 2016 has been milder for investment than saving, but investment has fallen to a lower level.
- **Sharp swings in investment and savings:**
    - Such sharp swings in investment and saving rates have never occurred in India's history–not during the balance-of-payments crises of 1991 nor during the Asian Financial Crisis of the late 1990s.
    - While it is true that the past 15 years have been a special period for the entire global economy, no other country seems have gone through such a large investment boom and bust during this period.
    - The only country that displays a similar pattern to India over the same time period is Brazil – and even in this case the parallel is far from exact.
- **Sectors responsible for the saving/investment decline in India:**
    - Essentially, private investment and household/government saving are responsible.
    - Private investment accounts for 5 percentage points out of the 6.3 percentage point overall investment decline over 2007-08 and 2015-16.
    - The fall in saving, by about 8 percentage points over the same period, has been driven almost equally by a fall in household and public saving.

  - The fall in household saving has in turn been driven by a fall in physical saving, partly offset by an increase in the holding of financial assets. Within the latter, there has been a shift from currency and bank deposits towards market instruments, viz. shares and debentures.
- So, what can be expected going forward, for India's investment in particular–and for the country's prospects of reverting to sustained high growth rates? This chapter attempts to answer this question, taking its cue from saving and investment slowdown episodes witnessed over the past 40 years in other, including similar, countries.

IDENTIFYING INVESTMENT AND SAVING SLOWDOWNS

- **Investment and saving slowdowns** are defined using a specific set of conditions:
  - First,
    - "**Shortfall**" is defined as the difference between:
      - the average of investment (saving) in the slowdown year and subsequent two years; and
      - the average of the previous five years.
    - "**Slowdown year**" is defined as one where the shortfall in that year exceeds a certain **threshold**.
    - If there are two or more consecutive slowdown years, this counts as a "**slowdown episode**".
  - Second:
    - The average investment rate for the 5 years prior to the slowdown year is at least 15 percent of GDP.
- **Threshold:**
  - The thresholds considered are of 2, 3 and 4 percentage points.
  - The lower the threshold, the greater the risk of capturing episodes of temporary volatility rather than more enduring slowdowns.
  - But because India's current investment (saving) slowdown has been so gradual it is best captured in the 2 percent threshold.
  - Moreover, in most cases, the results for the 3 and 4 percent thresholds also hold for the 2 percent case.
- **Frequency of investment slowdowns and saving slowdowns:**
  - Study reveals that investment episodes are more frequent than saving episodes.
  - Common episodes (where both investment and saving slow) are relatively unusual.
  - This pattern, however, has reversed after 2008, with saving episodes catching-up with investment episodes.
  - Presumably, the relatively lower number of investment episodes in the latest period reflects concerted efforts in emerging economies to revive investment after the Global Financial Crisis via stimulus and other policies.
- **Duration and magnitude of investment slowdowns and saving slowdowns:**
  - Investment and saving slowdowns tend to be similar in duration.
  - Duration is a simple count of the number of years that the shortfall in investment/saving exceeds the various thresholds. For example, if the shortfall persists for 5 years, but exceeds 2 percent only for 2 years, then the duration is

termed as 2 years. Using this definition, both investment and saving slowdowns typically last around 4 years.
  - However, investment slowdowns are greater in magnitude. Magnitudes are the shortfalls, cumulated over the entire slowdown episode.
- **Some notable differences between investment and saving slowdowns:**
  - Investment is more prone to extreme events: there are 4 cases where the cumulative investment slowdown exceeded 50 percentage points, whereas there are hardly any cases of saving slowdowns of this magnitude.
  - On the other hand, large saving slowdown episodes measuring between 30 and 50 percentage points tend to drag on for a year more on average than similarly-large investment slowdowns.
- Study of a complete cross-country list of investment and saving slowdowns reveals that slowdowns are quite frequent, appearing even in 'success stories', such as China (1988), Singapore (1985, 1999), and Mauritius (1981, 1995, 2012).
- **Slowdowns in Latin America:**
  - Most slowdowns in Latin America and Africa occurred during the 1980s, a period that became known as the 'lost decade' in those continents.
  - For example:
    - The investment and saving slowdown in Mexico following the debt crisis of 1982.
    - The weakness of the Brazilian economy manifests as investment and saving slowdowns from the early 1980s to the early 1990s.
- **Slowdown in Asian countries:**
  - Asian countries faced the largest number of slowdown episodes (10) following 1997.
  - During that period, there were large investment slowdowns in Malaysia, Thailand, Indonesia and Korea, which of course is why this period is known as the East Asian crisis—though the phenomenon extended to countries as far away as Turkey and Argentina.
  - Currently (after 2008), these economies are in the era of saving slowdowns. The fraction of countries with investment slowdowns has also increased, though to a limited extent.
    - Curiously, this relationship between the two types of slowdown turns out to be unusual.
    - From 1975 to 2007, the correlation between the number of countries experiencing an investment slowdown and those experiencing a saving slowdown was negative but now it seems to be breaking down and becoming positive in latest period.
    - Saving are perhaps less prone to cycles because of being influenced by long term trends viz. demographics.
- **Special case of India:**
  - India seems to be a special case.
  - Until recently, India had not experienced either type of slowdown: not during the 'lost decade', not during the East Asian crisis, not even after India's own balance-of payments crisis in 1991.

  - As a result, the current slowdown – in which both investment and saving have slumped – is the first in India's history.
  - Even then, the slowdown is detected most fully only in the 2 percent threshold, largely because the slide has been gradual, unlike (for example) the sharp adjustments that occurred in East Asia after the 1997 crisis.
- **Investment slowdown:**
  - The investment slowdown started in 2012 (when it surpassed the 2 percent threshold), subsequently intensified (surpassing the 3 percent and then the 4 percent thresholds in 2013 and 2014 respectively), and was apparently still continuing.
  - With the slowdown now having lasted six years, recorded in the exceptionally severe cases.
  - Yet because the investment decline has been so gradual, the magnitude of the shortfall so far is relatively less severe – it remains a moderate 21 percentage points, well under the average magnitude.
- **Saving slowdown:**
  - The saving slowdown started in 2010, and also seems to be still continuing.
  - Though like its investment counterpart, its magnitude was a below-average 15 percentage points.
- In other words, India's current investment/saving slowdown episode has been lengthy compared to other cases – and it may not be over yet.

SAVING VERSUS INVESTMENT: GROWTH CONSEQUENCES

- The simultaneous slump in saving and investment gives rise to a question:
  - Should policies that boost investment (viz. substantial infrastructure push, reforms to facilitate the ease of doing business or the 'Make in India' program) be given greater priority over those that boost saving?
  - The issue is about relative importance and urgency.
  - Both set of policies are crucial in the long run but which one needs to be prioritized at present?
- The standard solution that is often prescribed is that both problems need to be tackled simultaneously.
- **Investment is more important than saving for growth:**
  - Studies show that:
    - A simultaneous push may not be necessary as successful economic performance is not explained by saving transition episodes.
    - Countries experiencing positive saving transitions do not necessarily experience sustained growth increases. Rather, countries that experience growth transitions eventually see sustained higher rates of saving.
    - Hence policies should focus on encouraging investment, rather than saving, to boost growth.
- **Relationship between slowdown and growth decline:**
  - Given that a more intense slowdown should lead to a larger fall in real per-capita growth, the relationship between the two variables is expected to be positive.

  - Indeed, the relationship for investment slowdowns is distinctly positive; with many of the East Asian crisis episodes associated with large growth effects.
  - But the relationship for saving slowdowns is unclear, with many of the large saving episodes (e.g. Peru 1984, Kenya 1994, Mauritius 2003) not associated with sharp declines in growth.
  - In India, the impact on growth has been relatively moderate than witnessed in comparable investment slowdowns in other countries.
  - Cross-country comparison confirms that the relationship is significantly positive for investment episodes, but insignificant for saving.
  - A one percentage point fall in investment rate is expected to dent growth by 0.4-0.7 percentage points.
  - There are a few episodes across economies in which both investment and saving have slowed simultaneously. The relationship of saving with growth not only remains insignificant but turns mildly negative.
  - Not only are investment episodes followed by slower growth (unlike saving episodes), this is also true of 'pure' episodes of investment slowdowns, i.e. those not accompanied by slowdown in saving.
- **Relationship between private investment slowdown and growth:**
  - A further classification of the investment slowdowns can be: those that are driven primarily by a fall in private investment and those that are not.
  - Data on the private investment component of aggregate gross fixed capital formation is available from the WDI database.
  - The relationship between the fall in investment and growth decline hold in case of private investment slowdown episodes also as it is positive and significant.

RECOVERY FROM 'INDIA-TYPE' INVESTMENT SLOWDOWNS

- **India's investment slowdown is unusual:**
  - it is relatively moderate in magnitude,
  - long in duration, and
  - started from a relatively high peak rate of 36 percent of GDP.
  - It has a specific nature, in that it is a balance sheet related slowdown. In other words, many companies have had to curtail their investments because their finances are stressed, as the investments they undertook during the boom have not generated enough revenues to allow them to service the debts that they have incurred.
- **What do these characteristics portend for the extent of an eventual investment recovery?**
  - To answer this question, two types of international experience after slowdowns are considered:
    - balance sheet-related ones; and
    - where investment fell by 8.5 percentage points peak-to trough over 9 years.
  - **What happens after balance-sheet slowdowns?**
    - What tends to happen to investment rates in the aftermath of 'balance sheet' episodes? There are two conclusions from studies:

        - Investment declines flowing from balance sheet problems are much more difficult to reverse. In these cases, investment remains highly depressed for long time after the peak, whereas in case of non-balance-sheet slowdowns the shortfall is smaller and tends to reverse.
        - India's investment decline so far (8.5 percentage points) has been unusually large when compared to other balance sheet cases.
  - **What happens after similar investment falls?**
    - The experience of countries with similar investment declines is examined.
    - A **'full' recovery** is defined as attainment of an investment rate that completely reverses the fall, while **no recovery** implies the inability to reverse the fall at all or worse.
    - The median country reverses only about 25 percent of the decline 14 years after the peak, and about 40 percent of the decline 17 years after the peak. If India conforms to this pattern, the investment-GDP ratio would improve by 2.5 percentage points in the short run.
    - If India situates itself in the upper quartile, it can recover by more than 4 percentage points. But India is already 11 years past the peak, and its current performance puts it below the upper quartile.
    - **Moderate costs in terms of growth:**
      - Given the large fall in investment that India has registered, it has paid moderate costs in terms of growth.
      - Between 2007 and 2016, rate of real per-capita GDP growth has fallen by about 2.3% points—that is lower than the above 3% decline in growth noticed in episodes in other countries that have registered investment declines of similar magnitudes and from roughly a similar peak (about 36 percent).

CONCLUSION: POLICY LESSONS FOR INDIA

- The notion that growth is constrained by saving has a long and illustrious pedigree. But the evidence presented here points in a different direction, albeit subtly.
  - First, investment slowdowns are more detrimental to growth than saving slowdowns.
    - So, policy priorities over the short run must focus on reviving investment.
    - Mobilizing saving, for example via attempts to unearth black money and encouraging the conversion of gold into financial saving or even courting foreign saving are important but perhaps not as urgent as reviving investment.
    - In any case, the share of financial saving is already rising in aggregate household saving—with a clear shift visible towards market instruments—a phenomenon that has been helped by demonetization.
  - Second, India's investment slowdown is not yet over although it has unfolded much more gradually than in other countries, keeping the cumulative magnitude of the loss – and the impact on growth – at moderate levels so far.

- **How will the investment slowdown reverse, so that India can regain 8-10 percent growth?**
  - There is both a bleak and a hopeful pointer from similar episodes in other countries.
    - India's investment decline seems difficult to reverse,
      - partly because it stems from balance sheet stress and
      - partly because it has been usually large.
    - Cross -country evidence indicates a notable absence of automatic bounce-backs from investment slowdowns.
    - The deeper the slowdown, the slower and shallower the recovery.
    - At the same time, it remains true that some countries in similar circumstances have had fairly strong recoveries, suggesting that policy action can decisively improve the outlook.
  - Taken together, the results suggest a clear and urgent policy agenda which the government has launched:
    - first with the step-up in public investment since 2015-16;
    - and now, given the constraints on public investment with policies to decisively resolve the TBS challenge.
  - These steps will have to be followed up, along with complementary measures:
    - easing the costs of doing business further, and
    - creating a clear, transparent, and stable tax and regulatory environment.
  - In addition, creating a conducive environment for small and medium industries to prosper and invest will help revive private investment.
  - The focus of investment-incentivizing policies has to be on the big and small alike. The 'animal spirits' need to be conjured back.