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What ails investment?

Sluggish growth, stressed financial systems and unearthed capacity created a different environment

Subir Gokarn March 29, 2017 Last Updated at 22:42 IST

The *World Economic Outlook* Update published by the International Monetary Fund in January 2017 indicates that the global economy is in a slow recovery mode. All major economies and regions are expected to grow faster in 2017 and 2018 than they did in 2016, with some of them accelerating quite noticeably. However, this relatively positive prospect for the next couple of years needs to be tempered by the fact that there are a number of structural deterrents to growth that are likely to impact longer-term performance adversely. One of these is investment.

Investment activity was a significant contributor to global growth during the pre-financial crisis period. Analysis of trends in this key indicator by the World Bank (1) shows that, during the five-year period 2003-08, investment grew by about 12 per cent per year; in 2015, this rate had slowed to 3.4 per cent. In fact, the growth rate has been declining in every successive year since 2010. Another way of representing the severe trough that investment is currently going through is to contrast the current levels of investment across countries relative to its long-term average. In 2006, when the cycle was at its peak, 70 per cent of all countries saw investment activity above trend. In 2015, this proportion had fallen to 30 per cent. Further, virtually all forecasts of investment activity indicate continuing sluggishness.

A number of factors are responsible for this decline. First, even though the global economy is recovering, growth rates are nowhere near the benchmarks they set during the pre-financial crisis decade. In this scenario, investment activity was bound to slow down. Second, in the current energy and commodity price scenario, there are significant slowdowns in investment in new capacity in countries which export these. Recent increases in commodity prices are not a reflection of recovering demand; rather, they are the result of efforts by exporters to reduce supplies. This is clearly not a situation conducive to new investment.

A third factor is the state of the financial sector in several economies. A combination of persistent asset quality problems and enhanced capital requirements has significantly reduced the risk-bearing capacity of financial systems. Even if there were demand, it is unlikely that significant funding would be forthcoming in this situation. But, in the current situation, the constraints on funding are not a binding constraint on investment. If and when investment activity picks up, the persistence of these problems may stifle an incipient recovery.

There are two other factors that are likely to be contributing. One is the presence of significant

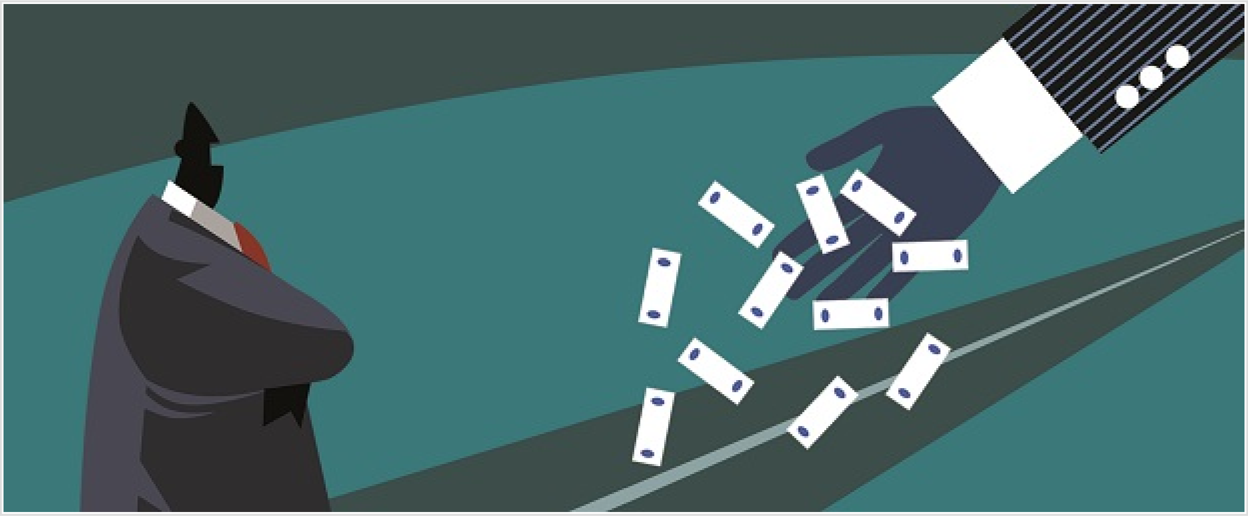

Illustration by Binay Sinha

amounts of excess capacity in a range of mostly capital-intensive industries. A recent report by the European Chamber of Commerce in China (2) indicates that in a range of capital-intensive industries in China, capacity utilisation has dropped significantly between 2008 and 2014. For instance, in the steel industry, utilisation dropped from 80 per cent to 70 per cent. The Chinese steel industry has an installed capacity of about 840 million tonnes, so 10 per cent is 84 million tonnes. This is about equal to the installed capacity of the steel industry in India! Similarly, in sectors ranging from refining to glass to cement, such declines in utilisation have a global impact, deterring any considerations of new investment in these sectors. The Chinese government has announced a capacity reduction plan, intended to shut down the older and more inefficient plants in these sectors; until that plays out, the investment scenario will remain bleak.

The second is the rapid development of the "share" economy. Companies like Uber and Airbnb are following a strategy of what I would label "unearthing" capacity. Until this business model emerged, personal vehicles and personal homes were not considered commercial assets. They are now. Suddenly, there has been a very large increase in the number of taxis and lodging facilities. Fleet owners and hotel chains are undoubtedly re-working their business plans. Moreover, Uber and Airbnb are only the tip of the iceberg in the share economy. There are several business unearthing capacity in different sectors and finding more and more efficient ways of hooking up buyers with sellers. All of this will inevitably have an impact on investment plans. Why create new capacity when already existing capacity can be unearthed?

From a policy perspective, fundamental questions arise about what is going to revive investment activity. The combination of sluggish growth and commodity prices, stressed financial systems and excess and unearthed capacity create a very different environment for investment activity. It is not clear that conventional levers like interest rates and tax incentives will be able to stimulate investment to any significant extent. This raises the question of whether there are indeed any policy instruments that will do so.

Meanwhile, even as policy makers come to grips with those questions, the basic necessities of infrastructure and streamlining regulations to make doing business easier must be persisted with. Further, infrastructure investment becomes all the more risky if private investment is not sure to follow, so the right risk-bearing and risk-sharing financial structures need to be put in place. Notwithstanding the weak trends in investment, governments need to use policy levers that will, at the very least, accelerate a recovery when it gets under way.

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1. World Bank: Global Economic Prospects, January 2017, Chapter 3
2. European Chamber of Commerce in China: Overcapacity in China, 2016
The author is Executive Director for Bangladesh, Bhutan, India and Sri Lanka at the International Monetary Fund. Views are his own. his article is an edited excerpt from a longer article "Challenges to Global Growth", forthcoming in Vikalpa, published by the Indian Institute of Management, Ahmedabad