

The capex conundrum

We all know that investment demand in the economy is sluggish. But which parts of the economy show particularly weak capital expenditure and which parts are improving? The revised estimates of national income put out a few days ago by the government contain some clues. The report contains data on capital formation for the five years to 2016-17, which helps identify the trends over this period.

Total real gross fixed capital formation (at constant 2011-12 prices) in the economy grew at a compound annual growth rate of 4.85% between 2011-12 and 2016-17 (*Chart 1*). That is weak, but it hides a jump in capex in 2016-17, when it grew by 10.1%, partly pushed by the government, but also reflecting higher private capex.

Real capex of the private non-financial sector grew at a compound annual growth rate of 10.99% between 2011-12 and 2016-17. That flies in the face of the view that the private corporate sector is not adding to fixed capital. Indeed, in 2016-17, the growth in real gross fixed capital formation by private non-financial corporations was a respectable 13.95%. What's more, growth in machinery and equipment was 17.7% that year. This is real capex, at constant prices, so the growth rate is not bad at all. Was it the public sector then that held back capital expenditure? That is partly true and capex of public non-financial corporations contracted during 2016-17. Even so, the CAGR in capex by this sector was 5.72% between 2011-12 and 2016-17. What's far more important though is that the public non-financial sector's total capex is slightly more than a quarter of the capital expenditure of the private non-financial sector, so its growth rate doesn't really affect the overall economy. There must be some other sector which is pulling down overall capex.

The financial sector, both public and private, together contribute a bit more than a tenth of total capex, also not really significant for the overall economy.

Could it be that the government isn't spending enough on capex then? Not really—government capex in the five years between 2011-12 and 2016-17 grew at a CAGR of 10.74%. And in 2016-17, the year when demonetization disrupted the economy, government capex jumped up.

The big laggard was the household sector. Real capex by this sector over 2011-12 to 2016-17 fell at a CAGR of 2.69%. In 2011-12, its contribution to total capex in the economy was 45.9%—by 2016-17, that had come down to 31.6%. It is the household sector that has dragged down capital formation in the economy. Fortunately, here too there has been a pick-up in growth in 2016-17.

Households are a residual sector, after government and the public and private corporate sectors are accounted for. It's very likely then that the pick-up in household capex in 2016-17 is linked to the return of good monsoon during the year and good growth in agriculture.

Why has capex by the household sector taken a beating? Here's a clue: in 2011-12, households saved 29.4% of their disposable income—by 2016-17, this had dropped to 21.2% (*Chart 2*). Savings as a percentage of disposable income has been falling every year since 2011-12. It continued to fall in 2016-17, despite the rebound in agriculture. Is this an indication of distress, with households unable to put aside money for savings? Why, in spite of growth in disposable income, is the savings/income ratio falling? In 2016-17, total disposable income, at current prices, went up by 9%, while gross savings of the household sector increased by 1.3%. Could it be that rural distress and lack of employment has led to a fall in the savings rate?

We could also look at capex by industry. The first thing to note is that gross capital formation in manufacturing (at 2011-12 prices) was up 25% in 2016-17. That suggests a revival in the

manufacturing sector has begun. Agriculture also saw decent capex growth, but after two years of contraction.

The industry that normally contributes the most to overall capex in the economy is “real estate, ownership of dwelling and professional services”. This sector did see 0.3% growth in capex in 2016-17, but it comes after a severe 18% contraction in the previous year. Indeed, capex in this industry in 2016-17 was below what it was in 2011-12. It is here that the malaise in capex lies.

Some of the other industries that saw a fall in capex in 2016-17 include construction, down 10.4%—important because it provides employment for the masses. Also, the “trade, repair, hotels and restaurants” industry was down 24.7% and it’s another area where the masses are employed.

If we look at longer-term trends, we find that the sectors that had lower capex in 2016-17 than in 2011-12 were agriculture, mining, construction, financial services and real estate (*Chart 3*). Of these, agriculture, construction and real estate provide employment to vast numbers of people. This could be a reason for the fall in the savings rate in the household sector. The numbers indicate that to increase investment demand in the economy, savings and capital formation in the household sector needs to improve, while a revival in the real estate and construction sectors is needed.

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