The 3rd Dimension of the Master Plan for the Economy : The Capital Formation Policy

A 'capital formation policy' functioning alongside the fiscal and monetary policies will facilitate an integrated approach towards economic planning and multiply the impact of the actions of our policy makers thereby propelling the Indian economy onto a stable and high growth trajectory.

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The concept

In India, a robust planning and policy formulation process has always played an important role in ensuring an efficient capital market and in shaping the world's view of India.

These processes are manifested in two very important policies of the country: The fiscal policy which is conveyed in the government's Annual Budget and the Central Bank's monetary policy, which is articulated as part of the credit policy.

In order to have focused intervention in the capital formation process, in addition to the above policies, there is a case for a capital formation policy which will set the direction for capital flow in the economy based on the external environment and desired goals for the economy.

The need

Capital formation is extremely important in contributing to the growth of the economy and timely intervention, on the part of the government and regulators, will trigger off a virtuous cycle of development. If corporate India is able to obtain the right mix of capital in the form of debt and equity at an optimised cost, the outcome would be growth in the economy, employment and GDP, all leading to a rise in tax collections which would increase the ability of the government to invest in the infrastructure – both social and physical.

Let us look at the stakeholders in the capital formation process. The key providers of capital are the domestic savings, corporate surpluses and the international investment flows. The consumers of capital are Corporate India.

Providers of capital

At over 30 per cent, India boasts of a high gross domestic savings rate which few countries can match. The corresponding rate in the U.S. and U.K. is much lower, though amongst the emerging economies, we are at par with Malaysia and Chile. As real GDP growth rose, it was debated that as Indians get more prosperous they would save less and spend more. But that hypothesis did not materialise and India's household sector continues to save aggressively.

In this context the important point is the predisposition among Indians to channelize these savings into debt instruments. As a result of this, bank fixed deposits have always displayed a very healthy growth - a compounded annual growth rate of 16%, even at times when other channels of the financial system were struggling to attract flows.

The predisposition of Indians towards debt aside, the government does play an important role in determining investor preferences mainly via administered rates and tax benefits. It may be mentioned that on the equity side, direct participation is low from the Indian savings community. The indirect participation of this category in the equity markets through mutual funds and insurance companies has been growing.

Corporate surpluses post dividend payout, are also contributors to the capital formation during high performance periods.

The government plays a part in the flow of capital via various regulatory interventions and pre-emptions. Banks, for instance, function within the overall framework laid out for them in the form of the regulatory SLR and CRR norms. Insurance companies are guided by the investment norms determined by the insurance regulator.

International capital flows into the economy via the FII and FDI routes. These flows are very closely linked to the global environment and hence subject to significant volatility as is borne out by the patterns in the last few years. The growth in the FDI inflows was significant during the financial year 2006-2007 and this growth has since declined. The FII flows into the equity market have also been volatile with over 10 bn USD outflow during the last financial year (FY2009) followed by a sharp reversal with an inflow of about USD 6 bn during the first 3 months of the current financial year (FY2010).

The RBI regulates the flow of forex liabilities into India Inc., the Securities and Exchange Board of India (SEBI) controls the flow of foreign capital into the stock market through various means such as the regulation of Participatory Notes (P Notes) and the FIPB determines the flow of FDI into various sectors.

Thus, as on date, a number of regulators/policy makers through various measures control the flow of capital into the economy.

Consumers of capital – The micro view

The consumer of capital is India Inc. Corporates have internal policies which determine their mix of capital consumption- forex and domestic liabilities, short- and long-term liabilities and debt-equity ratio. At a micro level, such financial decisions are crucial to the health of the corporate. These decisions are normally taken after a detailed cost and risk analysis. Depending upon the business parameters, the mix of foreign exchange – domestic borrowings, long term through ECBs and short term through trade finance, the duration of borrowings and debt equity ratio is determined. In addition, all these decisions at the micro level fall within the policy framework of the country, which encourages or discourages capital formation in a particular way.

Consumers of capital - The macro view

At the macro level, let us assume we come to an understanding that a target 2:1 debt-equity ratio is healthy for the country. As long as foreign funds were flowing easily into equity, there was no problem because domestic flows into debt balanced the equation. But what happens when foreign equity dries up, like it did in September 2008? Then to maintain the debt-equity ratio, domestic savings into equity should ramp up. The latter is not simple, given the mindset of the Indian saver. Had this situation continued for longer, where flows into equity dried up and investors flocked to debt, the debt-equity ratio would threaten to go up causing an unhealthy imbalance in India Inc. as a whole.

This is exactly what happened in the early 1990's when the system was very highly leveraged and companies had unsustainable debt-equity ratios of 3:1 and 4:1.

When we take a master plan for the economy as a whole, we have to ask ourselves if India can afford a debt-equity ratio which is greater than 2:1. If funds are not flowing into the equity market, then the country through its various policies needs to give an incentive to the domestic saver to channelize savings into that asset class.

On identical lines, capital formation can also be skewed in asset-liabilities mismatch. For instance, if the government finds that corporate India as a whole is too reliant on short-term liabilities to fund long-term assets, then to prevent this asset-liability mismatch, policy measures can be implemented to incentivise the saver and investor into long-term instruments.

The next aspect to be looked into would be the optimal mix of foreign exchange and rupee resources. If the country is too reliant on forex debt, the impact would be felt on our interest rate. A sudden pull out of foreign funds would immediately hit the exchange rate. Then policy would have to make domestic borrowing more attractive.

Thus there is a need for a holistic policy to attract and direct appropriate capital flows into the economy.

The approach

All capital related decisions made at the micro level, be it at a corporate, bank or even a household level, fall within the policy framework of the country, which encourages capital flows into certain avenues.

As mentioned earlier, there are policy initiatives and guidelines already in place to regulate the capital formation into and within the country. The Ministry of Finance addresses a number of aspects of flow of capital through the fiscal policy by managing variables like taxes and small savings rates and FII and FDI related policies. The RBI directs the liquidity, interest and forex rates through banking regulations, credit policy and market operations. Other regulators like SEBI, IRDA facilitate risk management in various markets through measures announced from time to time.

There is an opportunity for an integrated approach through a capital formation policy to ensure that all the measures are in line with the goals that need to be achieved for the economy as a whole. For instance, in the recent past RBI's efforts to reduce the cost of credit could have been more effective if the administered small savings rate had also moved in tandem during the same time.

The goal of the capital formation policy would be to integrate all the above into a single policy which would be announced at regular intervals. Just as there are mechanisms for review and consensus building among stakeholders in the fiscal and credit policies, the capital formation policy would also be formulated with active involvement of key stakeholders. While this policy may be an annual one to ensure a certain amount of predictability and stability, it needs to be dynamic to be able to adapt to global changes and events.

The custodians

The custodians of the capital formation policy would continue to be the existing regulators and policy makers who have been articulating measures related to capital formation embedded in the various policies declared by them. Through the capital formation policy, all these guidelines would be issued in a synchronised manner which would result in a greater and more effective impact of the policies towards directing capital flows and achieving the target growth rates for the economy.

The fiscal policy, the monetary policy and the 'capital formation policy' would thus be the pillars on which economic planning would be based.

It would be apt to draw an analogy to a master plan when designing a city. The chief architect would be clear in his mind where the hospital would be located, the mall, the college, the school, the park, residential complexes etc. While each will get regulated by their own set of laws and regulatory authorities, their place in the overall plan has been conceptualised.

Similarly once the master plan for the economy as a whole is articulated, each of the participants, various government departments and policy makers – FIPB, income tax department and regulators - the RBI, the insurance regulator, the stock market regulator etc, work as independent bodies implementing their individual policies in line with this master plan.

In conclusion

India has today emerged as a stable and strong economy in the global arena. The somewhat conservative stance of the Indian regulators has been vindicated and is now being recognised and applauded by experts. India is now poised to become the engine of growth for the world economy and the regulators would be playing a major role in ensuring the same. The new government with a huge mandate from the electorate is in an ideal position to introduce policies and regulations to further strengthen the economy.

In my view, there is a unique opportunity now to develop the framework that can build a cohesive 'capital formation policy' for India Inc. Needless to say, an initiative like this would take a few years to stabilize. There is a huge process of initiation and consensus building. A task force would need to be formed to look at the various dimensions of such a policy. It would require the "coming together" of different participants in the policy making process to operate in tandem and multiply the effect of individual policies to achieve the desired growth targets.

The new government is in a perfect position to initiate such a process and formulate a structure which would propel India onto a high and stable growth trajectory.