

WELCOME

To

Chapter SIX of Vol.1

## HOW DOES POLICY UNCERTAINTY AFFECT INVESTMENT?



Before we go through the details, let's go through a  
Quick Summary



## summary

- Economic Policy Uncertainty in India has **reduced significantly** over the last decade.
- **Correlates** of economic policy uncertainty are:
  - macroeconomic environment,
  - business conditions
- **Impacts** of economic policy uncertainty are:
  - increase in cost of capital in the economy
  - lowering of investment
- Unlike generic economic uncertainty, which cannot be controlled, economic policy uncertainty **can be reduced**.
- The **following steps** can reduce the economic policy uncertainty:
  - Reduction in ambiguity in policy implementation
  - Tracking of economic policy uncertainty index
  - Quality assurance of processes in policy making must be implemented

Now, it's time for the  
Details



UNCERTAINTY



- Uncertainty in policy making can spook investors and **spoil the investment climate** in the economy.
- **Factor leading to uncertainty:** As policy making relies on judgment, it often involves discretion. Such discretion can generate uncertainty.

## RISK & UNCERTAINTY



- **Risk and Uncertainty:**
  - Both affect economic activity.
  - While risk can be quantified, uncertainty is hard to measure.
- **Measuring economic policy uncertainty:**
  - It can be attempted to measure it by globally recognized Economic Policy Uncertainty (EPU) index.
  - The index is created by quantifying newspaper coverage of policy-related economic uncertainty.

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## UNCERTAINTY & INVESTMENT



- As investment is a **forward-looking activity**, future expectations play a critical role in the decision to invest. As uncertainty influences these expectations, it **affects the decision** to invest.
- As fixed investment is irreversible, uncertainty **exacerbates risk aversion** and eventually dampens investment.

## ECONOMIC POLICY UNCERTAINTY



- Economic policy uncertainty has **reduced significantly** over the **last decade** in India.
- Economic Policy Uncertainty was the **highest in 2011-12** coinciding with the years of policy paralysis.

- It was also **high in 2013** when the economy faced the episode of “taper tantrum” leading to volatile capital flows and depreciation of the rupee.
- **Correlates of EPU index:**
  - The EPU index correlates very strongly to **macroeconomic stability** which comprises of fiscal deficit, current account deficit, and inflation.
  - Apart from this, EPU index is very strongly correlated to volatility in exchange rate, stock market and various other **macroeconomic variables**.
  - EPU is **positively correlated** to- repo rate, WPI inflation, volatility of exchange rate, and Capacity Utilization.
- **Recent status** of economic policy certainty:
  - In recent times, while the economic policy uncertainty has been increasing across the world, including US, UK and China; India’s economic policy uncertainty has been falling.
  - The low economic policy uncertainty index for India in last one-year points towards resilience of the economy even in times of global trade uncertainty.

## TRENDS IN INVESTMENT ACTIVITY



- **Gross fixed capital formation** fell from 37 per cent in 2007-08 to 27 percent in the following ten years but has since recovered to approximately 28 per cent recently.
- **Main factor that led to investment slowdown:**
  - Twin balance sheet problem.
- **Factors that helped promote investment:**
  - Insolvency and Bankruptcy Code 2016
  - recapitalization of banks
  - improvement in the business climate
- **Economic policy uncertainty and Foreign Investment:**
  - Foreign investments are also negatively related to the economic policy certainty in the economy
  - Both Foreign Direct Investment (FDI) flows and Foreign Institutional Investment (FII) flows are negatively correlated to EPU index, implying that not only the short-term inflows, but also

long term capital inflows are affected by higher uncertainty in economic policy.

- **Other factors that affect investment apart from economic policy uncertainty:**
  - **Cost of borrowing:** Borrowing costs are expected to be negatively associated with investment as they reflect higher input costs.
  - **Prices that producers get for their products:** Rise in prices are expected to trigger greater investments as businesses find it profitable to do so as long as consumption demand is sufficiently strong to overcome the impact of inflation
  - **Capacity utilization:** The utilization of capacity in any quarter is expected to have a positive relationship with investment growth in the following quarter, as excess unutilized capacity in the previous quarter may lower the need for new investment in the current quarter.

## RECOMMENDATIONS



Reducing economic policy uncertainty is critical because both domestic investment and foreign investment are strongly deterred by increases in domestic economic policy uncertainty.

Few steps in this regard are:

- **First**, top-level policymakers must ensure that their policy actions are predictable, maintain consistency in actual policy with the forward guidance, and reduce ambiguity/arbitrariness in policy implementation.
- **Second**, economic policy uncertainty index must become an important index that policymakers at the highest-level monitor on a quarterly basis.
- **Third**, for quality assurance of processes in policy making, government departments must be mandated to seek quality certifications.

Thank  
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