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Page | 1

Financial Repression – Indian Style

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As the Indian economy shows distinct signs of slowdown and with the politically and financially challenged government clearly on the back foot, 2012 has witnessed a series of announcements and actions that shows that financial repression is alive and kicking in India. Although the last quarter of the current financial year (FY2012) is yet to be completed, the following stands out:

- Seventeen Public Sector Units (PSUs) will be made to invest ~ USD35 billion in infrastructure with an aim to jump start an economy struggling to find appropriate growth drivers.
- The first serious effort at disinvestment (selling government's 5% share in Oil & Natural Gas Corporation equity through auction) during the current financial year (mismanaged as the entire process was) resulted in the government asking the Life Insurance Corporation of India (LIC) to bailout the issue which faced heavy weather due to absolutely muted private participation. Available information shows that LIC picked up 88% of the shares on offer (377 million shares), thereby increasing this existing shareholding in the company by another 4.4%.
- The government has managed to arm-twist India's insurance regulator (Insurance Regulatory and Development Authority) to allow LIC to exceed the cap of 10% that an insurance company can own in any listed company. The aim is clearly to ensure that when the government gets into disinvestment mode (remember during the recent budget the government budgeted for disinvestment revenue to the tune of INR300 billion revenue during the next financial year starting April i.e. FY2013) they can always fall back on LIC to ensure success of the disinvestment process.
- In February, LIC agreed to pick up a 5% stake in a few state owned banks like Punjab National Bank, Central Bank of India and Indian Overseas Bank, for ~ INR37 billion. In March, Dena Bank allotted preferential shares to LIC amounting to INR1.51 billion. This had to be resorted to, as the cash strapped government was not in a position to meet the growing capital requirements of these banks. We are most likely to see repeat of such investments in FY13 as bank capitalization requirement goes up. In fact, there's also a possibility of the government forcing several state-owned companies to buy some portion of the government's share in other state-owned companies, in the guise of disinvestment. Such a decision may lead to the affected companies not being able to generate adequate resources to meet their own investment needs.

Not that financial repression is new in India. In fact, this is true for all developing economies. For a capital scarce country like India, capital control was a natural outcome since the idea was to direct savings toward investment in certain targeted sectors as part of a development plan. Financial repression took the form of government's ownership of intermediaries, restrictions on interest rates, control of foreign exchange (especially outflow), credit schemes that are favourable to a few sectors etc. Regulation also stipulated (and this continues to be the case now) that the banks hold a large share of their assets in public debt instruments. These debt instruments paid below-market rate interest and hence imposed an implicit tax on financial intermediation while providing cheap source of capital to the government.

Unfortunately, for India, requirement to follow such policies have transcended beyond the need to address various development objectives to one that is now being resorted to simply because government of various hues have failed to adhere to fiscal discipline. As I keep on saying, fiscal deficit is but a natural consequence for a developing economy like India that strives to move to a path of high and sustainable growth. The problem lies with the quality of deficit as wasteful expenditures and politically motivated populist measures contaminate the nature of deficit, thereby leaving very little fiscal space to carry out the developmental activities.

In the latest instance, the government is simply playing with the future of millions of policy holders of LIC as the investible corpus, created out of the premiums paid by them, is forcefully directed toward investments that need not necessarily be prudent. In fact, after LIC bailed out ONGC at a floor price of INR290 per share, the share prices tanked post the budget announcement of an increase in the crude oil cess, for which ONGC is expected to take a hit to the extent of INR46 billion. As of today, the share price of ONGC is about 9% below the disinvestment price. Essentially the shareholder's value has declined post this forced investment.

Financial repression engendered by systemic inefficiency has the potential to distort savings and investment activity in the economy and eventually impact growth. It's time India learned from the Chinese experience and finally shows the courage to take appropriate policy measures to right the wrong. Is it a big ask? I think so, atleast in the short to medium term, given the way the political circus is playing out in the country.

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