Backdoor Fiscal Stimulus in India

By Kunal Kumar Kundu

A report by the Financial Times on 18th January indicate that the Government of India is planning a fiscal stimulus to the extent of US$35 billion during FY2013, to jumpstart a lacklustre economy that's slowing down alarmingly amidst growing negative perceptions about political logjams, policy paralysis and corruption.

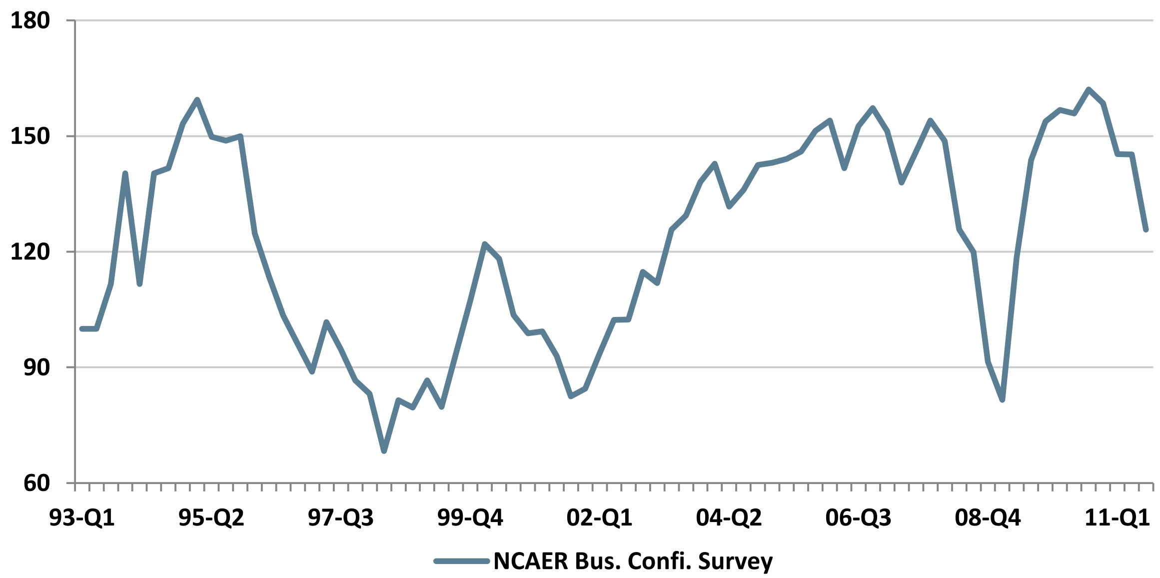
As per the report, "the government of Manmohan Singh has ordered 17 state-owned companies to use money currently held in reserve to invest in a mixture of infrastructure projects and overseas energy purchases." The report further states that, "companies, such as the Oil and Natural Gas Corporation (ONGC), Coal India and the National Mineral Development Corporation, have signed agreements to spend as much as $35bn of their cash or bank balances over the fiscal year starting in April to expand their operations."

Such backdoor fiscal stimulus is not totally unexpected, given that the 12th Five Year Plan is set to roll in from April this year. The first year of a Five Year Plan is usually accompanied by rising investment commitment by the government. But a cash strapped yet profligate government had to find an innovative solution and they did.

In one sense, this is good news for India as there are clear indications of dwindling investments during a period when India suffered from supply side constraints leading to an average inflation of 9.5% over a period of 24 months.

A more pertinent question though is whether this (although necessary) decision would be sufficient to turn the tide? What is more important is the government's ability to move ahead with relevant reforms that can reverse the sliding business confidence.

Sliding business confidence



Source: Haver Analytics

NEW YORK - 95 Morton Street, 6th Floor, New York, NY 10014 | TEL: 212 645 0010 | FAX: 212 645 0023 | americas@roubini.com | asia@roubini.com
LONDON – 120 Holborn, 5th Floor, London EC1N 2TD | TEL: +44 (0) 207 092 8850 | FAX: +44 (0) 207 242 4783 | europe@roubini.com
NEW DELHI - Suite 210 Chintels House, A-11 Kailash Colony, New Delhi, 110048 | TEL: +91-11-49022000 Ext. 3001 | india@roubini.com

Fact is, the failure of the government to move ahead with certain reform measures mainly due to political compulsions have not gone down well with the investor community, which had already been reeling under deteriorating business climate. In an interview in December last to Business Insider, Mr. Ajay Piramal (Head of Piramal Group, a diversified Indian conglomerate) spoke about how difficult he was finding it to invest the cash he generated by selling his generic drug business to Abbott Laboratories (for US$3.8 billion) in India. Rather, he would prefer investing outside India. Many other Indian businessmen also seem to share the same sentiments now. It is not a surprise, therefore, that Indian direct investment abroad, as per RBI data, was close to US$ 18 billion over the past four quarters for which data is available. Ironically, the next day after this announcement, one of India's largest private sector companies i.e. Reliance Industries Limited (RIL) has announced its decision to buy-back shares from the public. While the strategy could be to shore up the investor sentiment, it still begs the question why a company as large as RIL which is sitting pretty on a pile of cash has opted for share buy-back rather than expanding business operations in India? Does it not indicate lack of profitable investment opportunity within the country?

Within the infrastructure sector, the most contentious sector is India's power sector. According to the Central Electricity Authority (CEA), the projected energy shortfall during FY2012 is 10.3% and a peak shortage of 12.9%. In comparison, in the previous financial year, energy shortage was 8.5% with a peak shortfall of 9.8%. India's power sector continues to be plagued by plethora of challenges – shortage of coal and gas, rising prices of imported coal, delay in environmental clearance, land acquisition issues etc. While, the government has stated its intent to clear some of these challenges, the biggest challenge for this sector thus far is bankruptcy of the power distribution company. The power sector in India, is an amazing study of contrast. While power equipment manufacturing is majorly under the private sector, power generation is virtually equally divided between private and government players. In contrast, in area of power distribution, about 95% of power distribution companies (or discoms) are state owned and, save for a few, virtually all of them are bankrupt. Apart from their inefficiency, political populism (supplying free to extremely cheap power and waiving of off past dues) have bled these discoms to a comatose state. Unless, the discoms become profitable and are able to pay for the power supplied to them, power generation in India will continue to be a big concern (apart from the few fully integrated private power companies) as most of the power equipment manufacturers and power producers would find the business unviable. However, reforming the discoms is a herculean task and is fraught with political implication that is unlikely to be addressed soon.

It seems that the government, being fiscally constrained, wants to shift the onus of pump priming to the PSUs (Public Sector unit) irrespective of whether such investments make economic sense for them. A recent report by Business Standard mentioned that the government is planning to cap the price at which ONGC and OIL sell their crude oil to domestic refiners to between US$55 to 60, rather than at the prevailing international crude prices. Any realization above the capped price will be used to subsidise the oil retailers. This seems to be a process of institutionalising sharing of the government's subsidy burden by these companies. Earlier, they used to make good the losses of the oil retailing companies by offering them discounts, without any set formula. Thus, on the one hand, these companies continue to share the government's subsidy burden (given the reluctance of the government to free up oil prices), on the other hand, they would now be forced to make investments which will not be core to their business, leaving them short of resources to make relevant investments. This has the potential to destroy the valuation of the company, what with the majority shareholder (read the Government of India) riding roughshod over the interest of the minority shareholders. Given such arbitrariness, this can also impact the government's disinvestment programme going forward.

Bottomline is, the investment climate in the country will improve only if the government is able to demonstrate that it is capable of translating its willingness to bring in more reforms into real action on the ground. The country

NEW YORK - 95 Morton Street, 6th Floor, New York, NY 10014 | TEL: 212 645 0010 | FAX: 212 645 0023 | americas@roubini.com | asia@roubini.com
LONDON – 120 Holborn, 5th Floor, London EC1N 2TD | TEL: +44 (0) 207 092 8850 | FAX: +44 (0) 207 242 4783 | europe@roubini.com
NEW DELHI - Suite 210 Chintels House, A-11 Kailash Colony, New Delhi, 110048 | TEL: +91-11-49022000 Ext. 3001 | india@roubini.com

has been subjected to plenty of statements of intent without any follow-up action. There's no gainsaying the fact that economic reforms in India has taken a backseat now as self-centred political battle wages on. Big ticket investments in India continue to suffer from bureaucratic hurdles, land acquisition problems, environmental clearance delays etc. On the fiscal front, it is absolutely imperative for the government to be able to reign in their wasteful expenditure and reduce leakages due to rampant corruption etc that can ensure a healthy fiscal situation. This will eventually improve business confidence. The intent of providing fiscal stimulus through forced investment is unlikely to bear the desired result.

NEW YORK - 95 Morton Street, 6th Floor, New York, NY 10014 | TEL: 212 645 0010 | FAX: 212 645 0023 | americas@roubini.com | asia@roubini.com
LONDON – 120 Holborn, 5th Floor, London EC1N 2TD | TEL: +44 (0) 207 092 8850 | FAX: +44 (0) 207 242 4783 | europe@roubini.com
NEW DELHI - Suite 210 Chintels House, A-11 Kailash Colony, New Delhi, 110048 | TEL: +91-11-49022000 Ext. 3001 | india@roubini.com