

Indian field trip - February 2013

(We visited Bangalore, Chennai, Ahmedabad, Chandigarh, Delhi and Agra in six days.) It is said that for a foreigner to understand India is impossible, I concur! The film "Slum Dog Millionaire" captures some sense of the corruption that pervades Indian life but it falls well short of revealing the immensity of the problem and the degree to which **corruption is accepted as a part of everyday life** across all strata of society. Whenever we came across some inexplicable contortion of logic which was to the benefit of one group but at the expense of another, those we asked felt it perfectly adequate to answer, "**it is a political issue.**" The scale of kickbacks is colossal. For example, facilitation fees involved in the recent Augusta Westland bribery scandal are put at about 10% of the face value of the contract which was US\$720 million for the 12 helicopters. As one ranges over the social spectrum one comes across rent extraction at every level, be it teachers paying to procure jobs where the capital outlay is a multiple of their annual earnings which might be say, US\$1,800 per year. Even on leaving this earth, there are reports of surviving family members needing to bribe the issuer for a death certificate!

Some argue that corruption has become even more entrenched, if that is possible, and that the system is more dysfunctional than ever. Our own observation is that this greed breeds huge uncertainty down the entire line of command as subordinates are unable to follow the logical course of action in performing their jobs for fear of treading on a deal that has been negotiated by their superiors and some influence peddler. The cost to the economy is enormous as it causes significant delays and invariably stifles competition. In case you feel that these claims are exaggerated, please note that some 160 MPs in the Lok Sabha, or lower house, have criminal cases pending. In total there are over 500 criminal cases against MPs and while the BJP MPs head the list, they by no means monopolise the rankings¹.

Transparency International provides a corruption perceptions index (CPI) which ranks India among the lowest for countries of large population at 3.1, this is slightly better than Indonesia at 3.0 and worse than China and Brazil at 3.6 and 3.8 respectively. For context, the least corrupt countries are considered to be Sweden and Finland in the 9s and most West European nations are in the 7 to 8s.

One could argue that for all this apparent interference in the marketplace, the country has grown at 6% in real terms over the last 20 years and should we not simply ignore it. The problem with this view is that moneyed self-interest is eroding decision-making across the entire economy. Quick fix solutions take precedence over long-term planning; party rivalry results in delays in approval in those States in opposition to the Centre and hard decisions on matters such as labour law reform, transparent pricing and the reduction of distortions caused by subsidies are all deferred, seemingly in perpetuity. The legal system is used to thwart opposition and drag out resolution².

1 There is a terrific site, <http://www.Indiaassuperpower.blogspot.com> that maps the location of 128 MPs currently facing legal proceedings, their parties, and their alleged crimes

2 Indian judiciary would take 320 years to clear the backlog of 31.28 million cases pending in various courts including High courts in the country, Andhra Pradesh High Court judge Justice V V Rao said. "If one considers the total pendency of cases in the Indian judicial system, every judge in the country will have an average load of about 2,147 cases," Justice Rao said, while delivering the keynote address on 'E-Governance in Judiciary' from *The Times of India*, 6 March 2010.

In the meantime, the economic environment is soft even with a fall in the savings rate, down from 34% in 2011 to 30% last year and exports are flat in the face of a 20% decline in the value of the rupee. In 2012, the current account deficit was met by strong foreign share purchases on the Indian market of the order of \$20 billion. Some are projecting the current account deficit gap to widen to perhaps \$80 billion in 2013 which indeed will be a challenge without further weakness in the rupee. We heard a lot about the high level of gold imports which have been running at an annual rate of 900 tonnes. This represents approximately half the current account deficit of about 5%. Considering that this preference for gold may principally reflect distrust of the rupee, and the money printing activities of the Central Bank, it is amusing to hear quite sensible people talking about mobilising this wealth via paper claims in order to improve the productivity of savings!

Now that I have set the scenario for India to face a miserable future, let us look at the **positive changes** that have been taking place within the country.

1. The country has reappointed Mr Chidambaram as Minister of Finance and he is acting as the Prime Minister's enforcer. Manmohan Singh has hitherto struggled to lead the coalition government led by the Congress Party. Helped by the threat of a sovereign downgrading to junk by the rating agencies, the finance minister has managed to convince the Cabinet of the need for a reduction in the budget deficit to 5.3% this current year, dropping to 4.4% in 2013/14. The budget will be delivered this week.
2. Steps have already been taken to cap the subsidies on fertilisers though the leader of the Congress party, Sonia Gandhi, is pressing for greater food subsidies. The table below highlights the magnitude of these distortions within the Indian economy.

	<u>FY07</u>	<u>FY08</u>	<u>FY09</u>	<u>FY10</u>	<u>FY11</u>	<u>FY12Est</u>
	<u>Rupees Billion</u>					
Fertiliser subsidy	262	325	766	613	623	672
Food subsidy	240	313	438	584	638	728
Petroleum subsidy	27	28	29	150	384	685

These account for 95% of State subsidies, equivalent to 2.3% of GDP; see too how they have accelerated since the GFC! (Current exchange rate Rs 54= 1US\$)

We learned that the changeover to fixed subsidies based on the nutritional value has resulted in a fall in the use of phosphorus and potassium. Essentially by capping the rupee amount of the subsidy on these nutrients, the Indian government has removed the arbitrage that existed which enabled traders to acquire subsidised fertilisers in India which they then smuggled out of the country for sale to the likes of Indonesia, Vietnam etc. There has been a meaningful drop in the domestic demand for potash even as its global price has come off. Urea remains highly subsidised selling for about Rs5.5 a kilogram versus common salt which sells at Rs12kg. At US\$100 a tonne, it is a quarter of the world price and is resulting in imbalanced application by farmers. The ideal ratio is 4:2:1 but at present it is running at 9:2:1. If this continues, there will be systematic degradation of the soil and a decline in output. Why is urea sold so cheaply when 20% is imported and there are inadequate supplies of gas? Answer, "It is a political issue."

3. Through the canny use of the **judicial powers granted to Cabinet committees**, Mr Chidambaram is forcing through price increases for electricity distributed by the State Distribution Boards (SDB). There is a plan to fund these entities out of their debt problems but associated with this is the requirement for them to raise prices to fully reflect the current and rising costs of inputs, notably thermal coal. As we identified in previous visits to India, the problem with electricity deficiency lies in low plant load factors, which run at around 65% of installed capacity of 210 GW. They are underutilised for several reasons but the most important by far is the unwillingness of politicians to pass through the full costs of electricity to their electorates which has resulted in a chronic rise in losses and hence of indebtedness of the SDB's. At present, sensible States such as Gujarat have fully funded Distribution Boards and are selling electricity at around Rs4.5 to the householder and Rs6, which is around US11 cents, to industry. To date, all the distribution boards have complied to raise their prices and last year saw the more inefficient boards raising prices by as much as 37%. The idea is that they continue to raise prices progressively over the next several years to eventually eradicate their debt.

The second issue around **power supply**, which is deficient to perhaps 10% in the interlinked grid of the North and 20% in the separate grid in the Southern States, relates to the availability of coal from Coal India and the pass-through provisions of earlier IPP (independent power producer) contracts which use imported coal. IPP's, like Tata Power and the Andani group, have suffered from changes in the cost of imported coal either because of the falling exchange rate or because of export pricing parity demanded by the Indonesians. This may well be resolved this year to the benefit of the IPP operators.

4. An important breakthrough is taking place with the work pursued by the **Unique Identification Authority of India** (UIDAI). This organisation, led by the retired head of Infosys, comprising only 300 employees and 10 offices has set up the so-called **AADHAAR scheme** to provide an ID number and card to all inhabitants of India. Using both fingerprints and an image of a person's iris, UIDAI, working in conjunction with local government, post offices and the like, has already signed up 245 million people to the system. The process is totally scalable and relies on a PC, printer, modem and camera to record and transmit details of each individual to a central repository. As we were reminded frequently, change in India invariably comes by stealth. The scheme has already faced its share of hurdles, in particular in States not controlled by the Congress coalition, there has been a reluctance to comply because of fears about the loss of power to the Centre. Even Sonia Gandhi was slow to appreciate the value of this registration system until the penny dropped. Congress has always believed that voters respond to the handouts at the local level and have little interest in the grand designs of the Centre. Having initially been lukewarm on unique identification, Congress now understands the benefits that can be derived from direct payments to the individual (voter) from Delhi, to the exclusion of middlemen. Ultimately, this identification scheme is seen as a way of paying cash directly into the appropriate beneficiary's bank account be it supplementary food grants, entitlements for fertiliser inputs, or the payment of bursaries for education. As always, nothing flows smoothly in India, and in this case the fact that some 600 million Indians do not yet have bank accounts will prove a hindrance.

In addition, registration takes around 15 minutes per person and in some cases labourers have so worn down their fingerprints, through toil, that it is hard to achieve a strong biometric image. One can expect resistance from non-complying States but it seems as though the Congress party is going to use this as a large carrot to the great Indian peasantry in the forthcoming 2014 election. Various pilot schemes have been initiated in specific districts where direct cash transfers have been made in the place of subsidised products such as kerosene. In one district, kerosene consumption has fallen by over 80% as the subsidy was given to genuine users and not siphoned off as a supplement to dieseline.

5. **Periodic violent outbursts remind** the masters at the Centre of the molten fury of the underclass, an awareness perhaps amplified by the recent unrest in North Africa. This may be helping the proposals to changes in the land acquisition law. Should it go through it is likely to reduce compulsory acquisition provisions that have hitherto allowed cunning, greedy politicians to acquire and assemble parcels of land which are then rezoned and passed on to property developers in exchange for favours and participation. The early draft provides for compensation that is up to four times the appraised value, but the latter tends to be significantly understated as most transactions are executed at one price with the true value being completed with a cash payment. An example of this type of compulsory land acquisition is the Yamuna Expressway from Delhi to Agra which was built by Jaiprakash in exchange for some 6,250 acres of rezoned farmland in five separate parcels along the 165km route.
6. An older scheme that has had a huge effect on the labour market is the provision of **100 days work a year for a minimum of Rs120 per day** for the adult member of any rural household willing to do public unskilled manual work; MRNREGA, the Mahatma Gandhi National Rural Employment scheme. Even though they earn little, it has allowed workers who would otherwise be migrants seeking work in other States to stay at home and tend their own fields. This has reduced the migrant population and had interesting implications. For example, rice production in Bihar, now a well-led state, has risen from 3.1 mt to 8.2 mt in the 2012. (This significant rise can in part be attributed to changes in land husbandry and cultivation techniques.) On several occasions we were told by disgruntled employers about the effects of the scheme and making rural workers lazy etc. It is evident from relative wage changes that the lot of rural workers has improved.

One important side benefit has been the building of rural roads. This improvement in vital infrastructure has palpable benefits to local communities by enhancing trade and interaction with the 'outside' world.

7. When in Gujarat, we were given presentations by various **government bodies that are pro-business in terms of speeding-up approvals, providing serviced land** parcels to industry and so forth. The First Minister, Mr Modi, is consequently held in great esteem by the business sector for his ability to get things done and is seen as a promising future Prime Minister of India. Importantly there are four or five other First Ministers who are running their States effectively and understand the importance voters attach to the reliable supply of electricity, water and sanitation rather than hearing extravagant promises and receiving pathetic handouts. We reckon that this will **gradually have a domino effect** across India. Rather like China, where provincial governors have

enormous powers, it could be said that many First Ministers in India's 28 States, follow a similar pattern of crony capitalism with the least talented FM's tending to be more concerned about near-term gratification than national development.

8. There are still many hurdles and it is noticeable that the discussion of the Hindu influence on the economy has diminished. However, the labour laws act as a huge impediment to industrialisation and a disincentive to hiring. Interestingly, only 50 million workers are registered taxpayers and my guess would be that half of these are probably government or semi-government employees. As we have noted previously, the tax take in India is simply too low at around 17% of GDP. The proposed introduction of a value-added tax is way behind schedule and looks like being diluted by obstreperous State governments. Even so it could have the effect of raising the tax take by 3 to 4% of GDP. This could remove the money printing proclivities of the Central Bank.
9. Several commentators reflected on the threat from Chinese competition; our take is somewhat more optimistic and we suspect that the gradual improvement in infrastructure such as the **two new rail corridors**, which are admittedly some years off, combined with a relatively weak rupee may lead to some positive surprises for India. It is important to remember that recorded GDP per head is barely over US\$1,000 per annum though this is probably under-stated by a third, with few rural workers earning a couple of dollars a day and engineering graduates working in the IT sector, earning only US\$6,500 a year. There is a clear distinction between the haves and have-nots as portrayed by Bollywood but the striking observation is that companies that have managed to survive and prosper in this environment are, in a perverse way, protected from new competition.

In summary, India faces gigantic hurdles, but this old and deep civilization with its enormous diversity has achieved remarkable feats in the last 20 years with real growth of 6.7% pa, never mind its contribution to humanity over the ages. It has grown despite the machinations of its politicians and this gives one confidence that growth is unlikely to stop. Land values are continuing to rise and with 40% of households said to own at least one acre of land, one should expect this roller-coaster to be driven from the bottom-up. The unleashing of the great energy of the Indian people, is likely to surprise long-time observers.

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