Developing Trends

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The Times they are A'Changin'

The Indian budget for the fiscal year 1999-2000 (April to March) will be presented on Feb. 27 by the Finance Minister, Mr. Yashwant Sinha. Unlike the West, budget documents in developing countries, and especially in India, are a major policy exercise. They can, and do, change the fortunes of the economy. And they are politically potent as well. This year's budget is the second presented by the ruling Bharatiya Janata Party (BJP), the first having been presented on June 1, 1998.

Budget time is also occasion for hyperbole, as analysts analyze expectations in terms of "the most critical budget" or a "do-or-die" budget etc. Oxus believes that the second hyperbole is actually representative of the *political* reality. Of the fifty odd budgets presented, this will be only the eighth presented by a non-Congress government, and only the second presented by a non-Congress non-Congress-clone government. The first truly non-Congress budget, and the first BJP budget, was a disaster; and the political fortunes of the BJP declined with the economy and culminated in its spectacular defeat (at the hands of the Congress) in state elections in November. If the BJP messes up again, it is likely to be curtains for them, at least until Congress messes up the economy again! So, the budget is critical, for BJP's fortunes, and those of India.

This issue of *Developing Trends*, while being an India budget special, is nevertheless concerned more with politics – of the BJP, Congress and economic reforms. Also discussed is the common (but lazy and incorrect as it turns out) refrain that political instability is bad for economic reforms. Analysis of such instability since 1984 suggests that the most important danger for implementation of economic reforms is political complacency, which comes from political stability.

Today, political instability there is a'plenty. There is talk about the BJP government failing to present the budget in parliament, let alone pass it. A new political crisis is brewing – and the Congress party has taken the lead role in trying to bring the government down. The provocation – removal of the Bihar state government, which, incidentally, has the approval of no less a neutral political person than the President of India.

Oxus views these political developments as indicating that economic reforms are around the corner. In provoking yet another crisis, the Congress is showing signs of panic. If the BJP was going to present a bad budget – again – then the Congress could just wait for the pieces to fall in place. The fact that Congress is feeling impatient suggests that large elements within the party believe that the BJP might actually pull off a coup – hence, better strike before it is too late. This leading indicator works i.e. the more the Congress gets panicky, and irrational, the more signs are there that the BJP will deliver, or that the BJP is performing.

The political scene, therefore, suggests optimism, and Oxus believes that India's 1999-2000 budget has the potential for being the most reformist since the first reform budget of 1991.

What can the budget contain? There are three specific policies that the government can implement in the new budget, and in Oxus's view, is likely to do so. First, reform of indirect taxes – **both** excise and customs. Presently, there are upwards of a dozen discretionary slabs in both sets of indirect taxes. It is well known that the only function of such discretion is to line the pockets of industrialists, politicians and bureaucrats. There is no reason why such slabs should be more than three or four. (Actually, there is no reason for there to be more than one slab – but that would be expecting too much, at least today). The Revenue department in the Ministry of Finance believes that reduction in a short time period to three-four slabs will be difficult – "eight or nine are more like it". Obviously, they have not heard of Excel spreadsheets. The question remains whether the BJP will cater to a select few, or act in the best interests of the BJP and India. Our betting is on the latter.

The second major set of reform concerns privatization. Until the BJP announced privatization plans in the June 1st budget, the term in India for such activities was a word not found in the English dictionary – "disinvestment". Unfortunately, 1998 was not a good year for world markets and such plans had to be shelved. It is expected (by Oxus) that BJP will genuinely privatize in 1999 and with amounts exceeding Rs. 10,000 crore, or more than $ 2.5 billion.

The third set of reforms are in reality the most important. These concern the structure of interest rates in India. If crisis economies are excluded, then all through the nineties, and at present, India has the highest **real** deposit, and consequently, lending rates – in double digits. It is a wonder that any Indian industry exists (let alone grows) with the trinity of highest taxes, highest energy costs, and highest real interest rates. Optimism reigns because the BJP has only recently reduced savings deposit rates from 12 percent to 11.5 percent. With inflation at around 5 percent, this means that savers, at a time of a growth recession, are receiving 6.5 percent above inflation on risk-free deposits – a return to put all equity managers to shame.

The key point on interest rates on savings deposits is that such rates are **not** set by the market. Further, "small savings" deposits – actually about Rs. 35,000 crores a year – are a major means of financing the excesses of state governments. Any similarity, nay identity, with Ponzi (or chit fund) schemes is not coincidental. The fact that savings schemes are a major source for state government finances is the reason why it has been, to date, the holy cow of Indian politicians.

Governments have looked the other way and talked about the evils of "fiscal deficits" and the remedies of "higher taxes". The solution lies elsewhere – in the administered interest rate structure. A half percent decline in interest rates is symbolic – such rates need to be reduced by at least another 300 basis points. A deposit rate of 8.5 percent would still be 3 percent real, and still be the highest real deposit rate in the world (for non-crisis economies).

Nowhere above has reduction in fiscal deficit been mentioned. This is deliberate. Oxus eschews such parrot "analyses". Such pronouncements are identical to what happens when one goes to a doctor with 103 degrees temperature and experiences the following. "Doctor, doctor, I need to be cured". "Yes, Ram, you will be if your temperature will come down". "Doctor, doctor, what shall I take?" "Whatever it takes to bring the fiscal deficit, nay, temperature, down".

But what about the fiscal deficit ? From an expected 5.5 percent of GDP (national) and 3.5 percent of GDP (states), the combined fiscal deficit should decline by 2 % over the next year, if the above recommended policies are implemented. Tax reforms should lead to considerably greater compliance, as has been the case with the income tax reforms implemented over the last two years. An increase in compliance of around 10-20 percent in the first year can be expected with reduction in tax slabs, and simplification and rationalization of the tax structure.

*With indirect tax reforms, an **increase** in tax revenue of about 5 percent should occur with the **reduction** in the average tax rates of 5 percent.*

Thus indirect tax revenues should increase by about 17 percent next year compared to an (expected) nominal GDP increase of 12 percent (6 percent growth and 6 percent inflation). This should **add** about Rs. 8000 crores to revenue. Privatization should add at least Rs. 10,000 crores.

What about reduction in deposit rates, and hence in the overall structure of interest rates? As documented in the Table, interest payments account for about 75 percent of the total fiscal deficit of the government (center plus states) of India. In absolute terms, such payments exceed Rs. 110,000 crores. Each interest point reduction means a savings of about Rs. 10,000 crores. A 150 basis point decline in deposit rates can therefore yield a saving of Rs. 15,000 crores

The above calculations are "conservative" and yield a minimum of Rs. 30,000 crores with simple economic reforms. Oxus expects the fiscal deficit to be Rs. 97,000 crores at the center and Rs. 63,000 crores at the state level in 1998-99. An extra revenue of 30,000 crores will mean a decline of 20 percent in the aggregate fiscal deficit. At the center, the deficit reduction due to reforms is Rs. 25,000 crores i.e. a deficit below 4 % of GDP is easily attainable. These calculations are **without** any extra growth assumptions. Any extra growth that will occur (an additional 1 percent can easily be expected) will be that much extra gravy for the Indian economy, and extra reduction in the fiscal deficit. What this will mean for India is that she will finally begin to realize her potential – and make true Oxus's forecast that Indian growth rate over the next five years will be higher than that of China.

There is an additional (fourth) policy which might be high on BJP's reform agenda - a constitutional limit on government borrowings. It is forecast that such a policy will soon move to the top of the list, if it is not actually announced in the budget. In addition to other reforms mentioned above, the Indian economic landscape will finally begin to look exceedingly attractive. Add to this the political measures that the BJP is undertaking – marginalization of its own reactionary wing, détente with Pakistan etc – and suddenly the non-reform *swadeshi* party, BJP, can begin to take on the mantle of the true hope of India.

What are the prospects for the BJP to implement even half of the reforms outlined above? Quite high – if only because the BJP today, due to its own mistakes, finds itself with its back to the wall – and economic reform the only bullet left. A **necessary** condition for the BJP to survive politically is for it to implement economic reforms. If it does not take the hint, then it deserves to be replaced. Elections will then occur in 1999, and the BJP will be predictably booted out. The Indian citizen, like the citizens in that classic movie *Network*, are tired of the traditional politicians, the traditional bureaucrats, have had it upto here, and cannot take it anymore.

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Stock Market

In most countries, stock markets move *pari passu* with the economy. But as with much else, India is *sui generis* i.e. unique. Since 1991-92, there have been, by any calculation, significant economic reforms in India. Obviously, as has been documented above, much remains. Nevertheless, it is revealing that the Indian stock market has been in a narrow 1000 point range – 3000 to 4000 on the Sensex – for the last **seven** years. In November 1998, the Sensex was at the same value as in Feb. 1992. To be sure, East Asian economies also saw 7 year lows in September 1998. But such economies also enjoyed a large, and secular, increase in stock prices from 1990 to 1997. In India, the stock market has been more in the nature of a random walk for *each* of the last seven years.

There are two major reasons for the Indian stock markets relative, and absolute, non-performance. First, capital market reforms have been ignored by Indian politicians, and bureaucrats; most likely because of pressure from interest groups who believe in monopoly rents. For example, brokerage rates in India are, you guessed it, the highest in the world. Second, the introduction of derivative trading has been delayed because a major stock exchange, the Bombay Stock Exchange, would lose "excess profits" – estimated at Rs. 2 billion each year for its members or about Rs. 10 million per year for **each** of its 50 largest members. The excess profits occur due to the operation of a bastard form of leverage that exists via the "badla" system – a system where borrowing rates for speculation have averaged more than 22 percent over the last eight weeks. It is likely that some of these large profits go towards exercising the wrong kind of influence.

The second reason for the nowhere nature of the Indian stock market is the presence of high double-digit (real) lending rates. It is unlikely that the market can have a sustained rally without a large (200 to 400 basis points) reduction in deposit rates, and lending rates. However, ***with*** such a reduction (either actual or expected) watch out for the Indian stock market moving towards new all-time highs – an increase of some 35 percent from the present depressed levels.

In the last issue of 1998, Oxus had advised its clients to go long the Indian stock market with 2 units, double the normal investment limit of 1 unit. We had stated that there was at least a 50 percent chance of the Indian market outpacing the Asian stock market. So far, so good. The Indian market is up about 10 percent while most Asian markets are down 10 percent. What to do now ? Stay invested; indeed, add another unit to the exposure to India. If the budget is a "bummer", Oxus will not hesitate to change its mind.

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$/Rupee

In the end-August '98 newsletter (the same newsletter that forecast that the $ was at a historical peak (yen at 145) and that Asian equity markets were crying out to be bought!) it was stated "The rupee is likely to be a non-event, as it becomes boxed in a 41.5 to 44 range". The forecast has come true with the rupee trading in a narrow 42.3 to 42.6 range for the last several months. There is a minor chance that as part of overall reforms, the government will devalue the rupee. While possible, this event has less than a 20 percent chance of occurring. Oxus's calculations of "fair" exchange rates suggest that the rupee is fairly valued at 44; hence, a devaluation is not considered either necessary or desirable. Much better that the Indian government make exports competitive by decreasing the costs of production via internal reforms; and via a rationalization and reduction in the average rate of excise rates and custom duties.

So the forecast for the rupee remains the same – steady. However, if reforms are implemented, then the rupee could come under pressure of appreciation; which would further put pressure on interest rates to decline as it is unlikely that the government would desire, or allow, the rupee to appreciate. Which would mean that India would have finally entered the win-win cycle which true economic reforms make possible.

Political Instability Does Not Matter

The conventional wisdom is that political instability is bad for the economy. In its survey of investment houses in mid-July, *Asia Pacific Consensus Forecasts* reported that the most unfavorable factor affecting the economic prospects of India was "political uncertainty" followed by international sanctions and the Asian crisis. There is a different, more compelling view. Political instability is actually *good* for economic reform. The contention is that lack of political dominance means that politicians in power will make the extra reform in order to fight for marginal votes in a future election. And if political stability is present, the politicians are unlikely to make the effort because of their inherent "shortsightedness", or complacency.

Evidence to support this unconventional view is obtained both from the observation that reforms occur when there is political instability, **and** from the observation that reforms do **not** occur when there is political stability. There are at least **six** pieces of evidence. The first example is from late 1984, when Rajiv Gandhi assumed his dynastic post with 415 seats, or more than a three-fourths majority. Not 50 percent, not two-thirds, but 76.5 percent of the seats. Mr. Gandhi had talked about reforms, and expectations were high. The rapidity with which the prospect of reforms disappeared can only be compared with the speed with which a BMW zooms towards 60 mph - or the speed with which Mr. Gandhi reduced his party's seats to less than half in late 1989 (197 seats in a 543 seat parliament). Second, the Narasimha Rao - Manmohan Singh reforms were undertaken by a *minority* government and amidst considerable political and economic uncertainty in 1991. Third, once Narasimha Rao got comfortable with a majority in parliament (political stability) the reforms stopped.

Fourth, the United Front (UF) government undertook significant reforms with the political disadvantage of two Prime Ministers in eighteen months (1995-1997). Among the reform achievements of the UF were: (a) tax reform with a reduction in the maximum rate on personal taxes to only 30 percent; (ii) rationalization of the pricing of the important oil sector; (iii) movement, albeit painfully slow, towards privatization of the bloated and inefficient state sector; (iv) the beginning of deregulation of interest rates such that today, only rates of 15 days and below are regulated by the Central Bank, in addition to deposit rates being controlled by the Ministry of Finance; and (v) movement towards capital account convertibility starting with the opening up of gold imports .

The fifth example is about the pre-November '98 and post-November '98 BJP. After the elections in March '98, the BJP considered itself invulnerable and proceeded with their anti-reform measures – explosion of the nuclear bombs on May 11 and 13, and the economic budget bomb on June 1. If these artificial highs were not enough, the BJP then refused to import onions in the face of onion prices rising by 500 percent in the short space of 4 months. It is likely that the Congress party took advantage of an inept BJP by making onions scarcer in the areas where state elections were to be held in November. If so (and there is considerable evidence to suggest that the onion scarcity of 1998 was artificial) then the onion events highlight both the political stupidity of the BJP and the economic muscle of the Congress. Whatever the reality, the BJP clearly felt secure in its seat – until it got resoundingly defeated in the November state elections.

Economic reforms occur when there is political instability, and reforms do ***not*** *occur when there is political stability. There are at least* ***six*** *pieces of evidence.*

After the defeat, and with increased instability, the BJP has been a changed economic, and political, animal. The Jekyll-Hyde reality of the BJP is now exposed, and exposed by reform (Jekyll) elements within the BJP. There is a liberal outlook on both political and economic matters. The Hyde wing of the BJP is still there, is still vocal, but it is being relegated to the sidelines. It is contended that this radical change for the better was precipitated by the impending ouster of the BJP – i.e. increased instability makes for good political, and economic, policy.

Since Dec. 1, the BJP has moved considerably forward on economic reforms – the beginnings of a cut in interest rates, the heightened concern with government borrowings and the fiscal deficit, introduction of reforms on insurance (derailed momentarily by, you guessed it, the so-called reform party, the Congress), and a conviction that large scale privatization is needed are all hallmarks of the "new" BJP – and the sixth piece of evidence supporting the equation: **political instability = economic reforms**.

When the history of BJP rule is written, it is likely that 1998 will be remembered as the year of the great BJP divide – and as the beginning of its *avatar* (incarnation) as a liberal, reform party. The fringe elements of the BJP (lumpen elements who would like to take India back to the authoritarian, inquisition sixteenth century political era and to leftist, protectionist, *swadeshi* economic policies) are being sidelined – they have nowhere to go. Why this was not realised earlier by the BJP is a mystery – though it must be said that the party caught onto the reality in less than a year.

It is an open question whether the BJP government will last. What can be said with relative certainty is that implementation of economic reforms will not be a causal factor in its demise. Indeed, such reforms may be its only asset. The leading opposition party, Congress, is ostensibly for speedy economic reforms (provided it is in power). Thus, the future prospects for the Indian economy are extremely good, even though dark political uncertainty clouds may blind one's vision.

The BJP leads an eighteen party coalition, and by most definitions, the future of this government is highly uncertain. Yet reforms are continuing, and are expected to continue with the presentation of the budget on Feb. 27. If the forecast is a reality, then this will be additional evidence that political instability is the best environment for economic reforms – at least in India.

The Importance of Interest Payments – and Interest Rates

		1991-1995					98/99	98/99
	90/91	**Max**	**Min**	**Avg**	**96/97**	**97/98**	**(BE)**	**(New Series)**
GDP at Market Prices	537.7	1119.8	616.7	846.5	1276.0	1415.5	1625.4	1785.0
Central Government								
Fiscal Deficit	44.6	60.3	36.3	51.1	66.7	86.3	91.0	100.0
Fiscal Deficit/GDP	8.3	7.4	5.4	6.1	5.2	6.1	5.6	5.6
Interest Payments	21.5	50.0	26.6	37.7	59.5	65.7	75.0	.
Interest Payments/GDP	**4.0**	**4.6**	**4.3**	**4.4**	**4.7**	**4.6**	**4.6**	.
Interest Payments/FD	**48.2**	**83.1**	**61.0**	**73.9**	**89.1**	**76.1**	**82.4**	.
State Government								
Fiscal Deficit	17.7	31.4	18.9	23.9	37.3	50.9	59.8	63.0
Fiscal Deficit/GDP	3.3	3.1	2.5	2.8	2.9	3.6	3.7	3.5
Interest Payments	.	21.9	10.9	16.3	25.6	31.2	36.4	.
Interest Payments/GDP	**.**	**2.0**	**1.8**	**1.9**	**2.0**	**2.2**	**2.2**	.
Interest Payments/FD	**.**	**76.7**	**57.9**	**67.5**	**68.7**	**61.4**	**60.9**	.
General Government								
Fiscal Deficit	62.4	91.7	55.2	75.0	104.0	137.2	150.8	163.0
Fiscal Deficit/GDP	11.6	10.0	8.2	8.9	8.2	9.7	9.3	9.1
Interest Payments	.	72.0	37.5	54.0	85.1	96.9	111.4	.
Interest Payments/GDP	**.**	**6.6**	**6.1**	**6.3**	**6.7**	**6.8**	**6.9**	.
Interest Payments/FD	**.**	**78.5**	**65.0**	**71.5**	**81.8**	**70.6**	**73.9**	.

Notes:
1. Actual figures for GDP, Fiscal Deficit and Interest payments are in Rs.'000 crores. Rs 1 crore = Rs 10 million.
2. BE refers to Budget Estimates.
3. The new GDP series released recently (1993-94 base) raises nominal income by an average of nine percent over the last few years.

Developing Trends

Developing Trends is a monthly newsletter published by O[x]us Research and Investments (ORI). Fund managers and investment banks, both in India and around the world, are its clients.

The most recent three issues of ***Developing Trends*** had the following trade recommendations:

***Developing Trends* Vol.2, No.10, dated Dec. 28, 1998:**

- There were several "bold" trades that were mentioned in the double Developing Trends issue of end August '98. Incredibly, almost all trades have turned out to be highly profitable. Except one trade – going long the Indian stock market. The rest of the world rallied, and India dived. …Oxus now believes that clients should not only go long the Indian market, but that they should do so aggressively. Instead of our normal 1 unit trade, clients should be long 2 units.

***Developing Trends* Vol.2, No.9, dated Nov.16, 1998:**

- "Short term money is tight in all the four economies, and tightest in the US. Long-term yields, however, in all four countries, are on the "low" side, with UK gilts showing the largest probability of relative decline. A "strong" trade recommendation emerging from the analysis is that of curve steepeners in all the four economies."
- "Oxus's forecast is for the world economy to bottom out in the fourth quarter of 1998. Further that the increase in world economic growth will be closer to 1 percent, i.e., world economic growth next year to be closer to 3 percent (2.75 to 3 range) than the conventional wisdom estimate of 2 percent."
- "So equity markets will likely boom – they should be allowed to do so without monetary policy being dictated to. As far as real rates are concerned, if CPI inflation does edge up to 1.8% and FED funds remain at 5 percent, that would suggest a real rate of 3.2 percent – and that would still be among the top 20 percent of such rates in the nineties. Clearly, little to be gained and much (world recovery) to be lost by stubbornly staying on course with an unduly restrictive policy."

***Developing Trends* Vol.2, Nos.7&8, dated August 24&30,1998:**

- "The Dollar has topped against the Asian currencies…The dollar has also topped against the majors."
- "The Yen beyond 145 is likely to be no different than the Yen below 85, i.e., turbulent and characteristic of an extreme."
- "No matter what the criteria, and several are offered, Asian equity values (in dollar terms) are at extremely attractive, and yes, rock bottom levels."

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