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Indian economy: An unfinished project

By James Crabtree and Victor Mallet

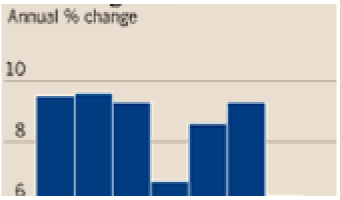
New Delhi has introduced reforms to revitalise business. But many disillusioned investors are not convinced

Slow flow: business leaders claim that India's growth is being hampered

At a private meeting in Mumbai's seafront Taj Mahal hotel last month, finance minister Palaniappan Chidambaram made corporate India an unusual offer.

Sitting in the hotel's ballroom were most of the country's leading industrialists, including billionaires Anil Ambani and Kumar Birla, who were gathered to discuss how to re-energise their nation's flagging economy. "I've come here with one mission: to understand your problems and to fix them," Mr Chidambaram said, according to one of those present.

The finance minister then offered a bouquet of flowers to any participant able to report that none of their big investments was held up by bureaucratic obstacles linked to the government. As the



conversation progressed round the table, and one tycoon after another complained of multibillion-dollar projects lying unfinished for the want of some official clearance or other, the flowers went unclaimed.

Indian gross domestic product grew only 5 per cent last year, a respectable performance by the standards of the developed world but still the country’s lowest rate for a decade. Public finances have deteriorated. Inflation and interest rates remain high, while the current account deficit has swollen and industrial output is stagnant.

All of this is a grave disappointment for a country whose economy was expanding at a rate of more than 9 per cent just two years ago. Once heady talk that the growth rate of Asia’s third-largest economy might soon overtake China’s has disappeared.

Now the question is whether India’s government can introduce more economic reforms to escape this surprisingly steep slowdown, an issue complicated by political manoeuvring ahead of a closely contested national poll early next year. If not, the country will be condemned to relatively sluggish growth for many years, an outcome with significant implications for the global economy, which is muddling through its own recovery.

“India is still almost uniquely vulnerable to a change in external economic conditions, much more so than economies like China,” says Eswar Prasad, an economist at the Brookings Institution and an adviser to India’s finance ministry. “The window for serious reforms is going to close soon because of the election, and there is a significant concern the government will just retreat and retrench. So the next few months are going to be crucial.”

India’s economic outlook seemed brighter in the final months of last year, when both Indian and foreign investors were heartened following Mr Chidambaram’s reappointment as finance minister in July.

Overcoming resistance from within the left-leaning coalition that his Congress party leads, he and Prime Minister Manmohan Singh went on to push through a series of reforms: cuts in diesel subsidies, fiscal restraint, part-privatisation of state companies and the opening of more sectors to foreign investment.

Mr Chidambaram championed these measures at home, while also heading off on a series of high-profile trips to financial centres such as London and Hong Kong – all to convince the world that India’s growth story was back on track.

He has made some progress. Following his meeting with business leaders at the Taj, Mr Chidambaram identified 215 projects that were stalled, along with a further 126 that had not even begun. A new cabinet committee on investment has also approved investments worth $27bn, in sectors such as oil exploration and electricity.

Yet investors and entrepreneurs across the real economy remain remarkably sombre. “Sentiment is awful,” says the head of one international bank. “No one is investing ... We escaped a global financial earthquake and now we trip on our own shoelaces.”

A senior executive at one of the country’s largest conglomerates concurs: “The investment story in India is completely derailed, but I think the wheels may now be coming off the consumption story, too, with huge negative growth in autos, in white goods and so on.”

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Most economists predict a slow recovery to about 6 per cent growth this year but business leaders fret that this is neither guaranteed nor enough to provide work for the 10-12m young Indians who enter the job market each year.

“Eighteen months back, if you looked at any projection, no one would have thought that India would slow down,” says Kris Gopalakrishnan, president of the Confederation of Indian Industry and one of the founders of Infosys, the software group. “It takes some to time to arrest it, to reverse it ... Have we hit the bottom?”

The answer now depends partly on politics. India faces a general election by May 2014, in which Congress – in power for the past nine years at the head of coalition governments – will be challenged by the Hindu nationalist Bharatiya Janata party, perhaps under the leadership of Narendra Modi, chief minister of the business-friendly state of Gujarat.

But even a year before the election, Mr Chidambaram is already struggling to push reformist legislation through a fractious parliament that has been labelled the most disrupted in the history of India’s democracy.

More than 100 bills await approval – a record – while opposition MPs force repeated suspension of proceedings, with shouted complaints about corruption and other grievances. Several of these bills are important to business, including one on land acquisition and another allowing foreign investors to raise their stakes in local insurers.

For Mr Gopalakrishnan, confidence has also been undermined by the “cascading impacts” of multiple other factors, ranging from the imposition by a previous finance minister of retrospective legal changes to target UK-based telecoms company Vodafone, to shortages of coal, which have increased imports and the trade deficit.

The optimistic view of this apparently unfortunate sequence of events is that while India's growth has suffered, the country is entering a new era in which corruption is no longer an essential part of doing business.

This view holds that recent actions by the government and the courts – to cancel mobile phone licences, reverse the free allocation of coal mines, enforce environmental regulations and jail bureaucrats for graft – have certainly hampered business. But they have also made officials wary of corruption, while showing the way towards a modern economy governed by impartial regulators.

"There's a huge social and cultural adjustment that needs to take place in the way of doing business," says one senior commercial banker. The problem, however, is that the old way of business – "pay people and get approvals" – has gone, while the new method, whatever it may be, has yet to be established.

Populist pre-election spending may yet boost Indian growth this year and next, while some business leaders think Mr Chidambaram's drive to clear the logjam of stalled projects should also help. Such moves could provide a boost to big companies including Tata, Essar and Mr Ambani's Reliance group, all of which have had projects held up in areas such as steel and power.

Few, however, are launching new projects of a similar size, a big reason why Indian investment levels plunged over the past year, and why total corporate capital expenditure is now projected to fall further over the next two years. In turn this means there is little chance that the private sector will be able to respond to government urgings that it stump up half of the $1tn in infrastructure investment that India needs in the next five years.

There are a few brighter signs. Some economists think a recent mild easing of inflation will allow further cuts in interest rates, spurring investment, while reductions in global oil and gold prices should reduce pressures on India's current account.

But the Reserve Bank of India has said it sees little room to trim interest rates further. The 1 percentage point reduction it has made over the past year has had little appreciable impact on the animal spirits of an industrial sector preoccupied with heavy debts.

Meanwhile, employers say labour laws are antiquated and obstructive, encouraging capital-intensive projects rather than the labour-intensive industries that most economists think India needs at this stage of its development.

Then there are also practical problems, such as the fact that even if the proposed land bill becomes law, industrialists believe buying land for factories and roads will remain a long and tortuous process.

“It’s going to be very, very frustrating,” Sajjan Jindal, the head of JSW, a steel conglomerate, recently told a conference in New Delhi organised by The Economist. “We start a project and it takes five, six years before we can start work on the ground.”

Yusuf Hamied, chairman of Cipla, the pharmaceutical company, was even more blunt in a recent interview with Indian business newspaper the Business Standard in which he complained of India’s unpredictable tax regime and poor infrastructure. “All big Indian companies are going abroad,” he said. “The time has now come for us to say goodbye to India.”

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Mr Chidambaram, who is seen by some as a possible future prime minister, insists he is making progress both in improving India’s investment climate and in maintaining “inclusive” Congress party policies catering to the poor, such as guaranteed jobs in rural areas.

He also firmly rejects the notion that electoral considerations will soon clog up political decision-making once again, while hinting at new plans to increase foreign investment limits in various sectors, including defence manufacturing and electronics.

“There is much more to be done. There are many bills that have to be passed. There are many more executive actions that need to be taken,” he said, before looking back wistfully at the period of high growth and low deficits after 2004. “There’s no reason we cannot recapture that magic.”

Unfortunately, many investors seem to think the magic has vanished. While they welcome the unblocking of stalled projects, they remain reluctant to spend anew in a country where regulations are so often in flux and politics are so unpredictable.

“We have mismanaged our macroeconomy over the last half-a-dozen years,” says Shankar Acharya, a former chief economic adviser. “Today we are in a very difficult spot in India. We should remember that and not pretend that pressing a few buttons is going to get us out.”

Neither entrepreneurs nor economists say the Indian economy is at risk of collapse, but they do think that recovery will be slow and painful.

In the world’s largest democracy, hopes for a shining new economic golden age have been again deferred.

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Tax disputes raise fears that foreign groups are being singled out

India's recent economic troubles have left many foreign investors feeling doubly aggrieved, **writes James Crabtree.** They are battling not only the effects of the slowdown itself but also what many feel are punitive tax and regulatory measures specifically designed to target foreigners.

The legal travails at UK-based telecommunications group Vodafone are only the most prominent example. By some measures, the group is India's largest foreign investor, spending at least $15bn to build up its business in the country in the five years to 2012. The lengthy dispute is over alleged untaxed capital gains linked to Vodafone's $10.9bn acquisition of Hutchison Essar in 2007. The British company thought it had emerged victorious in the $2.5bn tax case last year, following a final ruling in its favour by India's supreme court.

But a series of further legal and political setbacks over the past year mean that India's highest-profile regulatory dispute is likely to drag on, further denting international confidence both in India's legal system and its overall investment climate.

To make matters worse, this year a series of new tax disputes has broken out between India's authorities and global businesses, including Shell, Cadbury and Nokia, heightening concerns that foreign companies are being singled out for unfair treatment.

Naina Lal Kidwai, country head of HSBC and president of the Federation of Indian Chambers of Commerce and Industry, worries in particular about the spate of official investigations into foreign companies over alleged "transfer pricing" deals.

"Seventy per cent of all global transfer pricing litigation is in India," she says, referring to cases that are often brought by India's tax department following allegations of tax avoidance.

"Every day there are more and more of these controversies coming up, and unfortunately none of them are being laid to rest," says Dinesh Kanabar, head of tax policy at KPMG India.

"All these foreign companies are very worried. The need of the hour is for the government to do something to change this."

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