India Macro View

US Mktg Trip Takeaways – Reforms Get India Back from the Edge

We recently met over 60 institutional investors in the US. Given the on-going reforms, the timing was perfect, and thanks to a mandatory training program, our trip was split across two weeks (Sept 24 – Oct 5). This gave us the opportunity to gauge investor reactions over a fortnight. The biggest change, in our view, is the significantly renewed investor interest in India.

- **Changing Investor Reaction - From Skepticism to Acceptance** — In the initial part of our trip, the reforms were met with a lot of skepticism with reactions such as "seems too neat and clean" to "can the govt survive?" But, towards the latter half, seeing the continued momentum and the resolve to stick to decisions, investors admitted that "yes, one was caught flat-footed" and now see (a) growth bottoming out and (b) aversion of a rating downgrade (for now) and early elections.

- **Rating Action Was Key, But in Hindsight Politics Played a Big Role** — There was consensus that reforms were key in averting rating action. However, many investors felt that politics played a big role with the dual leadership of the UPA finally on the same page to revive the economy. They believe this would help improve the fiscal position thus making way for welfare schemes before the next elections.

- **Reforms Good; But What Would Turn Corporate Capex and lower Deficits?** — While there was unanimous relief that the ~2 year long policy log-jam was broken, concern was that structural issues on (a) reducing the deficit and (b) incentivizing investments were yet to be addressed (*See pg 2-7 for commonly asked questions*).

- **Investor Feedback on Asset Classes** — The key takeaway was that in the short term, the fundamental tailwinds (reforms/stabilising commodity prices etc) were strong for India. Thus, in terms of most EMs, India was a preferred destination. But, the consensus worry among investors was "implementation and execution."

  – **Equities:** Most investors said that this was "a painful rally" with many active managers currently underperforming the benchmarks. While India is clearly back on the radar, most investors felt that concrete steps on incentivizing investments would help make the call on "building positions" or "taking profits".

  – **INR:** Investors recognized that reform, global easing and lower commodity prices thanks to China slowing were key to the ~6% INR strength since QE3. However, investors viewed the unit as "being reflexive" given the deficits, declining reserve coverage and inflation-growth mix. While INR remains among the best carry trades, consensus felt that the retracement could stall at USD/INR at ~51 levels

  – **Rates:** Lower commodity prices and the INR strength bode well for inflation. This could prompt monetary easing more than the 50bps currently priced in.

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WHAT'S INSIDE – 10 COMMONLY ASKED QUESTIONS

Reforms – What's Announced and Pending

Following measure on fuel prices on Sept 13 and FDI/Divestments on Sept 14, over the last fortnight, the govt announced a second slew of reforms, and raised hope that there are more to come. Key reforms introduced were FDI in Insurance and Pension, amendments to the Companies Bill, and Forward Contract Regulation Act.

Figure 1. Announced Reforms

Reform	Key Features	Parliament Approval Required?
Fuel Price Hike	Diesel price raised by Rs 5/ltr, Subsidised LPG cylinders capped at 6/household	No
FDI		
Multi-Brand Retail	51% FDI permitted subject to State approval	No
Single- Brand Retail	FDI beyond 51% requires 30% sourcing locally from MSMEs, cottage industries etc.	No
Broadcasting Services	74% FDI allowed in teleports, mobile tv and sky broadcasting services	No
Insurance	49% FDI allowed, public sector insurance cos can get listed with government stake at at least 51%	Yes
Pension	49% FDI, has one term 'return scheme' action, gives statutory power to regulatory authority	Yes
Power Exchanges	49% FDI allowed	No
Civil Aviation	49% FDI in scheduled and non scheduled air transport services	No
Divestment in PSUs	Divestment in MMTC, NALCO, HCL and OIL proceeds ~Rs 150 bn	No
Competition Bill	All sectors under the purview of competition law	Yes
SEB loan restructuring	US$38bn of loans restructured/converted to state debt	No
Lowering With-holding Tax	With-holding tax lowered from 20% to 5%; Would reduce all in cost by ~75bps	No
Companies Bill (Amendment)	Ensures more transparent corporate governance	Yes
Forward Contract Regulation Act	Facilitate entry of institutional investors, introduce commodity options and derivatives trading	Yes

Source: PIB, Citi Research

While the current reforms have led to a revival in investor sentiment, key pending measures include those on (a) Fiscal consolidation, (b) Incentivizing investments.

- Measures awaited on the fiscal consolidation front include those pertaining to GST, DTC, food/fertiliser subsidies, and finalization of proposals on UTI stake sale in select stocks and surplus land sale.
- As regards incentivizing investments, execution-related obstacles that negatively impact project implementation such as key issues in power, coal, gas, land and environment are yet to be addressed.

All the above, coupled with already announced measures, would help accelerate growth and avert a ratings downgrade.

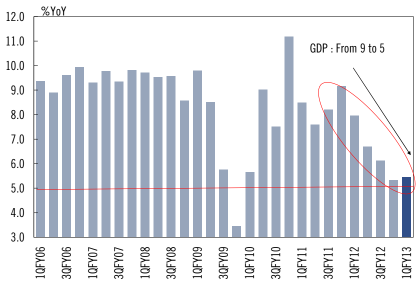
Figure 2. Pending Reforms

Reform	Key Features
Goods and Services Tax	Landmark Change - for efficiency, GDP and tax collections
Direct Taxes Code	A simplified Tax platform
Land Acquisition Bill	For commercial land acquisition, and Rehabilitation
2G Spectrum Auction	To be completed by January 2013, need to move ahead of scam
Coal Block Allocation	Ongoing, but with high political risks
Environmental Approvals, etc	Big bottleneck, Govt seems aggressively working on it
Fertilizer Subsidy Cut	Urea price hike, less distortion in fertilizer pricing
Shome Committee Report	Looks into investor concerns with GAAR and non-resident taxpayers issues
Food Subsidy Bill	recent recommendations made to cut the subsidy bill
Govt. Surplus Land Sale	to ease fiscal crunch by repaying loans and creating capital assets
Govt. UTI sale in select Stocks	Govt. started talks to sell shares in Axis Bank, ITC, L&T (total holding ~Rs 440bn)

Source: News Reports, Citi Research

Capex – What could help revive it?

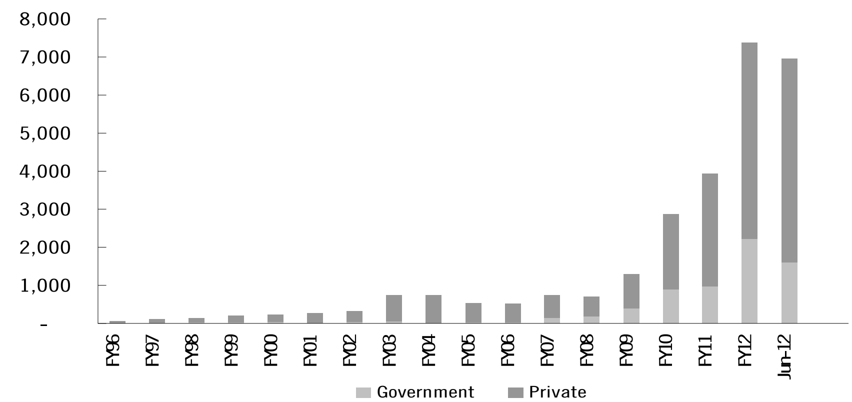
Figure 3. Qtrly Trends in GDP (%)



Source: CSO

The key factor that has led to the deceleration in GDP growth from >8% levels to the last quarterly print of 5.5% has been a near collapse in investments. As mentioned in our earlier notes, this is a result of an amalgamation of factors: (a) lack of sufficient coal/gas; (b) land acquisition/environmental clearance concerns and (c) lack of major government project announcements.

Figure 4. Trends in Projects Stalled (Rs bn)



Source: CMIE, Citi Research

The recurring delay in implementation of important infrastructure projects is partly due to presence of multiple ministries to take decisions on a single project. This delay not only slows down growth, but also adds to costs. As a result, as seen in figure 5 below, this has resulted in India not being able to meet its XIth Five Year Plan Targets.

Figure 5. XIth Five-Year Plan Targets vs. Actuals

Sector	Target	Achievement
Roads	48,479 kms.	Completed – 17,571 kms Under Implementation - 13,981 kms To be awarded - 16,927 kms
Additional power generation capacity created	78,700 MW	55,000 MW
Coal production (per annum)	680 mn tns reduced to 630 mn tns.	540 mn tns
Crude oil production (per annum)	206.73 million tns	177.09 mn tns
Gas production (per annum)	255.76 bn cubic metres	212.5 bn cubic metres
Railways capacity creation	21,500 kms reduced to 15,000 kms	14,752 kms

Source: Planning Commission, PIB, Citi Research

1. Addressing Coal Woes

In contrast to annual production targets of 630 million tonnes of coal, India has been producing ~540 million tonnes thus relying on higher imports. In addition to efficiency reasons, despite sitting on cash reserves, Coal India Ltd (CIL) is unable to increase production as 179 of its project proposals remain stuck for approvals. Coal mining requires a gamut of clearances (mining leases, land acquisition, environmental and forest clearances) before becoming operational. The clearances have to follow rigorous procedures which involve many stakeholders and are hence time consuming.

Figure 6. CIL Projects Pending Clearance

Pending Stage	No. of Projects
Stage I Clearance	130
Stage II Clearance	49
Total	179

Source: Citi Research

2. Land Acquisition Issues

Addressing issues surrounding the acquisition of private, typically agricultural land for public, industrial purposes is key as a progressive land acquisition policy could help speed up projects stalled and pave the way for improved future capital expenditure.

However, complications arise as the legislation in place (Land Acquisition Act, 1894) is dated and does not make adequate provisions for current issues. Moreover, the suggested replacement legislation (The Right to Fair Compensation, Resettlement, Rehabilitation and Transparency in Land Acquisition Bill 2012) is still a matter of political debate as it is viewed as essential for efficient acquisition, yet criticized for prioritizing industry and growth interests over those of the rural population and equality.

The key sectors with stalled projects affected by obstacles to acquisition are steel, power, and mining.

Figure 7. India Land Use – Mn Sq Km

Use	Area
Geographical Area	**3.29**
Of which:	
Forests	0.69
Agri Land	1.43
Barren/Fallow Land	0.93
Others	0.23

Source: Ministry of Agriculture

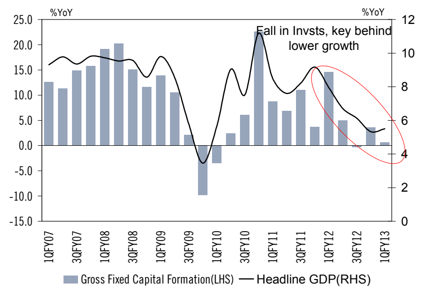
3. Environmental Clearances

The current environmental clearance process is viewed to be complex and tedious. Industries and projects have to seek up to four clearances from the Centre pertaining to environment, wildlife, forestry and coastal zone regulations. Each of these clearances requires separate procedures. The need for clearance from 4 different divisions creates more room for delay and increases risk of a project being denied approval. Furthermore, disagreement in judgment between ministries and corruption allegations in cases of approval of controversial projects further hinders the clearance process.

National Investment Board – Can it Help?

PM/FM – Focus on getting growth back on track

Figure 8. Trends in Invst & GDP (%)



Source: CSO

Following the recent reforms in fuel prices, FDI and divestments, the Prime Minister has acknowledged the need to speed up implementation of infra projects to remove "*supply bottlenecks which constrain growth in other sectors, and also for boosting investor sentiment to raise the overall rate of investment*". The PM has decided to personally review the infrastructure sector performance in the first six months to ensure project timelines are met.

Echoing him, the Finance Minister has said "*outcomes must be measured not only in terms of achieving the financial outlays but also achieving the physical targets"* and has proposed the setting up of a National Investment Board.

National Investment Board

The National Investment Board is expected to play a major role in reducing delays caused by interaction of 4 separate regulation systems, and would simplify the clearance process. The FM has proposed that the responsibility to make final decisions should be vested in one single authority - the National Investment Board. This NIB would be chaired by the PM and its authority should extend to proposals/projects where the investment is above a threshold of Rs10bn. The Allocation of Business Rules should be amended to create such a mechanism so that final decisions at a Cabinet level are made quicker. "Once the final decision is taken by the National Investment Board, no other Ministry or Department or Authority should be able to interfere with that decision or delay its implementation" said Chidambaram.

Will it be welcome? — The proposal for a National Investment Board is expected to be taken up by the Cabinet during its next meeting. The finance minister's proposal is welcome as it would impact many industry sectors on different points of the supply line, and positively impact growth. Development of facilities in sectors such as roads and highways and power would greatly add to much-needed connectivity and resources.

What may not change — It is unclear whether the NIB will be involved only in clearances or it will also monitor the progress of projects. If the former is true, it could help improve coordination and efficiency at the clearance stage, but project progress at other stages would remain unchanged. Moreover, the NIB would be at a central level, hence, state-level projects may still remain stalled.

Politics – How Do The Numbers Stand Up?

The initial announcement of reforms was followed by a variety of reactions on the political front. While the Prime Minister stood in support of reforms, saying "“We have to bite the bullet, if we have to go down, let us go down fighting”, the decision was not received with as much favor from both the Opposition and key UPA allies.

Still searching for solid ground — After the fallout with the TMC, the government now needs support of the Samajwadi Party (SP) and Bahujan Samaj Party (BSP) for the passage of the newly approved insurance and pension bills. Both these parties have not shown clear support for recent FDI decisions, but have backed the government in Parliament. The SP has said "it is important for us to support the government against communal forces" and that it will "take an appropriate stand when the time comes".

Opposition Matters – As seen in figure 9, the UPA is now a 'minority govt'. While it needs the support of the 'external parties' to pass the insurance and pension bill, interestingly, these reforms were originally drafted by the BJP during the NDA regime. Meanwhile, the Left is against the reforms and has said it will "oppose these decisions inside and outside parliament".

Politics: Never say never — While the government appears to have the numbers in place, the key in politics is "Never Say Never". The TMC's withdrawal could undermine the Congress party’s support within its allies. Moreover, the current largest ally, the DMK (18 seats) also opposes the reforms but has said that it "won’t embarrass the govt and take an extreme step". The Samajwadi party (22 seats), which provides external support to the UPA, has also stated it is "not to be taken for granted" and it is expected to announce the status of its ties with the UPA on October 10.

Figure 9. Current Composition of Lok Sabha

Party	Seats	Party	Seats
Indian National Congress(INC)	205	Bharatiya Janata Party(BJP)	114
Dravida Munnetra Kazhagam(DMK)	18	Janata Dal (United) (JD(U))	20
Nationalist Congress Party(NCP)	9	Shiv Sena(SS)	11
J&K National Conference(JKNC)	3	Shiromani Akali Dal(SAD)	4
Indian Union Muslim League (IUML)	2	Telangana Rashtra Samithi(TRS)	2
Rashtriya Lok Dal(RLD)	5	Biju Janata Dal(BJD)	14
Others/ Independents	13	AIADMK	9
UPA	**255**	Telugu Desam Party(TDP)	6
Supporting Parties		Janata Dal (Secular) (JD(S))	3
Samajwadi Party(SP)	22	All India Trinamool Congress TMC	19
Bahujan Samaj Party(BSP)	21	Jharkhand Vikas Morcha JVM (P)	2
Rashtriya Janata Dal(RJD)	4	Left Demo. Front	25
Total:	**47**	Others	11
		Total	**240**
UPA Incl. Outside Support:	**302**	**TOTAL LOK SABHA**	**542**

Source: www.loksabha.nic.in

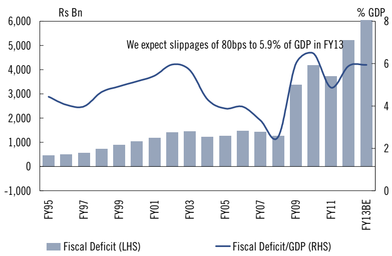
Figure 10. Current Composition of Rajya Sabha

Party	Seats	Party	Seats
Indian National Congress(INC)	70	Bharatiya Janata Party(BJP)	49
DMK	7	Janata Dal (United) (JD(U))	9
Nationalist Congress Party (NCP)	7	Shiv Sena(SS)	4
J&K National Conf (JKNC)	2	Shiromani Akali Dal(SAD)	3
Rashtriya Lok Dal(RLD)	5	India National Lok Dal (INLD)	1
UPA	**91**	Biju Janata Dal(BJD)	7
Supporting Parties		Asom Gana Parishad (AGP)	2
Samajwadi Party(SP)	9	Telugu Desam Party (TDP)	5
Bahujan Samaj Party(BSP)	15	AIADMK	5
Rashtriya Janata Dal(RJD)	2	Left Parties	12
Bodoland People's Front (BPF)	1	All India Trinamool Congress TMC	9
Lok Janasakti Party (LJP)	1	**Total NDA:**	**106**
Mizo National Front (MNF)	1		
Nagaland People's Front (NPF)	1	Nominated	10
Total:	**30**	Other Parties/ Independents	7
UPA Incl. Outside Support:	**121**	**TOTAL RAJYA SABHA**	**244**

Source: www.rajyasabha.nic.in

Kelkar Committee – Will the Reco's Be Implemented?

Figure 11. Trends in Centre's Deficit (%)



Source: Citi Research

Pursuant to the Finance Minister, P Chidambaran's statement on Aug 6 regarding the need for fiscal correction, a 3 member panel headed by Dr. Vijay Kelkar and including Dr Indira Rajaraman and Dr Sanjiv Misra was set up to assist Govt. in formulating the path to fiscal consolidation. The report submitted by the Committee states the economy is currently "poised on edge of a fiscal precipice" with a likely fiscal deficit of ~6.1% GDP in 2012-13 unless immediate measures are taken.

The report concludes on the note: "**We cannot over-emphasize the need and the urgency of fiscal consolidation**" and puts forth recommendations to contain current year fiscal deficit at 5.2% of GDP vs. 5.1% of GDP for FY13BE.

Implementation of Recommendations

The govt is expected to announce a 5 year fiscal consolidation plan that will lay down objectives to steadily narrow the fiscal gap. Moreover, the PM is focused on accelerating direct cash transfers to beneficiaries through Aadhaar linked bank accounts while the FM has decided to personally scrutinize all expenditures above INR 2bn.

However, the gradual phasing out of subsidies, as suggested by the Kelkar Committee report, has not found favour with the Government. The Dept. of Economic Affairs issued a statement saying some of the recommendations appear contrary to the declared objective of the Government of 'sustained and inclusive growth'. The FM has also been quoted as saying "*We can't wish away subsidies, but can improve their delivery.*" The Union Food Ministry has also expressed reservation against pruning of the food subsidy bill and has said it will convey its opposition to Finance Ministry soon.

Figure 10. Key Recommendations of Kelkar Committee

Tax Measures to contain tax GDP ratio at 10.3	Divestment to attain INR 300bn as per FY13BE	Subsidies to contain it at 2.2% GDP as per FY13 BE	Plan Expenditure to increase saving by INR 200bn
Comprehensive review of the Direct Taxes Code Bill & more services brought under the tax net	Use of Offer For sale (OFS), Call Option Model, Exchange Traded Fund to get market prices for divestments and offer diversification to investor	**Petroleum subsidy** a. Price rise: diesel by Rs 4/ltr, kerosene by Rs 2/ltr & LPG by Rs 50 per cylinder b. Regular adjustment & eventual decontrol of diesel	Proper prioritization and efficient use of available resources through reallocation across schemes
Profiling of all taxpaying individuals and institutions to help decrease tax evasion and tax fraud	Disinvestment of minority government equity stakes in private entities, such as the holdings in SUUTI, HZL and BALCO	**Fertilizer Subsidy** a. Dept of Fertilizer's price increase mechanism to be introduced b. Regular hike in urea prices to close gap between urea and P&K fertilizer	Better designing and targeting to plug leakages from the Plan
Pending refunds to be issued at the earliest to improve liquidity of tax payers		**Food Subsidy** a. Progressive reduction in food subsidy b. Remove levy on sugar & controls from non levy sugar c. Initiate direct cash transfer for subsidies d. Appropriate phasing of Food Security Bill accounting for fiscal challenges	Monitoring, esp of downstream expenditure deployment by Planning Commission
Negative list of services should be reviewed for "further pruning"			
Mandatory PAN /UID in all electronic transactions to reduce use of black money			
Expedite implementation of the GST regime			

Source: Kelkar Committee Report

Quick Re-cap of our Views

As mentioned in our note, Govt Delivers beyond Expectations – Bodes Well for the Macro and All Asset Classes **,** dated Sept 17 2012, the macro implications of the reform measures are unanimously positive.

Extract from our note:

- **Growth – Bottom in Sight; Impact more in FY14:** These measures are a big sentiment positive, and bode well for both consumer and business confidence which have been on a downtrend. Moreover, this sets a good platform for addressing "execution" related issues that have resulted in a collapse in investments. However, we are maintaining our 5.4% GDP estimate for FY13 as the impact on the numbers will probably be felt towards the latter part of FY13 or FY14.

- **Balance of Payments and FX, Positive Impact in FY13** — On the capital account, while the long awaited measures relating to FDI in retail will aid flows in FY14, the ability and willingness of the govt to act despite coalition pressures bodes well for FDI in other sectors. However, reforms coupled with global liquidity easing are a big positive for portfolio flows. Thus, despite the recent uptrend in oil prices, we maintain our view of the current account deficit improving from 4.2% of GDP in FY12 to 3% in FY13. All of this points to a further appreciation in the INR.

- **Inflation and Rates** — While the fuel price measures will result in headline inflation increasing by ~125bps, key to note is that the RBI has been stating that inflation rising due to measures taken to reduce 'suppressed' inflation will not be viewed negatively. Thus while the positive effects of retail on inflation via a reduction in easing supply side bottlenecks should be felt only in the medium term, we maintain our view that headline inflation is likely to average 8% in FY13.

- **Will the RBI follow?** — Despite inflation likely to remain well above the RBI's medium target of 4%-5%, we maintain our view of the RBI easing by a further 50bps in FY13. Prior to these measures we had expected easing only in 2HFY13, however, post these measures, the probability of monetary action in its policy today/mid policy measures has risen considerably.

- **Fisc and Ratings: Slippage for sure, but rating concern comes off now** — As mentioned earlier, given the unrealistic subsidy estimates, despite the fuel price hike, we expect the deficit to touch 5.9% of GDP vs. budget estimates of 5.1%. More-over the divestments announced are expected to bring in Rs150bn while the budgeted numbers are at Rs300bn. None-the-less, the reform measures send a strong signal and are likely to reduce concerns of a ratings downgrade

Appendix A-1

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