AVALON Consulting

INDIA: LOOKING BEYOND THE OBVIOUS

– By Raj Nair

Asia's Top 10 Strategy Firm Vault Rankings 2013

On The Cover: "Looking Beyond" is an acrylic painting by the author. In the painting, a part of the scenario, hidden by the trees, can be seen because the trees that block the view have been filtered out. It is suggestive of the need to look beyond what is obviously in front of you and beyond the information that you can see at first glance, if you want to see the truth that lies beyond. In business, many people consider the symptoms to be the problem, hearsay to be facts and past trends to play out in the future. Often, they pay a high price for that view.

"There is nothing more deceptive than an obvious fact"
\- *The Case-Book of Sherlock Holmes* by **Arthur Conan Doyle**

INDIA : LOOKING BEYOND THE OBVIOUS

A Perspective by **Mr. Raj Nair**, Chairman of Avalon Consulting

The author had forecasted on November 21, 2007, the big global downturn of 2008 and the consequent collapse of the Indian stock market. He advised a German MNC against their plan to dilute equity holdings to comply with FERA Regulations back in 1989 because of his expectation that liberalisation is nigh - India would have no other option with the Forex Reserves running out in the next 2 years and the potential rescuer's prescription being well known.

***"The nights are for dreaming and the following day is for making them come true",* said the wise one. But what if all we see at night are nightmares and in the day, we see grounds for the next night's nightmare? This despair has been greasing mal-governed India's downward slide for a while. Things are bad but India is not about to slip off the cliff. It is time to wake up and smell the coffee.**

WHITHER IS INDIA HEADED?

Contrary to the popular expectation, India will rise from the current alarming decline, and will rise sooner than most commentators predict. And for a very strange reason. I have been talking about this since August, based on Game Theory and not on sighting of a few green shoots. India's plight is largely a result of policy paralysis and one does not have to look further for its resurrection. The energy and growth potential in the economy have just got submerged and not destroyed for good. The moot question is *"Why would the paralysis get cured suddenly"?*

As the UPA and NDA are targeting each other for the next general election, there are two strategic positions for each political grouping to take: Secular vs. communal and development vs. stagnation. Since its governance and performance record has been pathetic, the UPA's best chance to beat the NDA is by convincing the electorate that the BJP is communal and therefore bad for the minorities, while at the same time, it needs to show that the economy is not really messed up. The BJP's best chance of winning (maximising their seat wins and getting smaller parties to align with them) is to show that they are pro-development and not anti-minority (different from being pro-minorities) and to highlight the UPA's dismal track record in development and governance. Each group has to attack on one platform and defend on the other.

This is not quite like the Prisoner's Dilemma in Game Theory. One does not need to compute a complex Nash Equilibrium because the BJP has already made the first move by announcing their PM candidate and playing the development card. It is rightly gloating over the dismal performance of the UPA government, and is likely to use subtle ways to show that they are not anti-minorities. It is hoping that the Congress with its weak and doddering leadership will continue to mess up the economy. So far the UPA has obliged. The BJP would also like the next General Elections to be seen as a contest between Narendra Modi and Rahul Gandhi so that Modi's development credentials will deliver a knock-out blow. But the UPA will not rise to this bait. The BJP will do what it has to, but the UPA, having messed up India's growth story big time, can, at the very least, position itself as 'Secular but not for stagnation/pro growth'. It is important for the UPA to play a two stage game. First, cover its glaring weaknesses- a dismal track record of mal-governance, policy paralysis, big scams, etc. which have driven the economy into the ground. The UPA has to move the economy into positive territory quickly and leave time to act in stage two, in order to focus on the BJP's Achilles heel, Communalism. Merely referring to the 2002 riots is not going to wash with the voters. The problem is that they have just half a year or so to enact this game plan. India's hope of a very quick uptick in economic fortunes originates from this. This is not to suggest that the Government will do anything to solve India's well known, fundamental problems by significantly improving infrastructure, substantially reducing subsidies that are burdening the Fiscal balance, taking the CAD into positive territory, reducing corruption that is killing the country, etc. They will however, cover the pot holes in the economy to make the sentiment positive in India.

My hypothesis is that Indian politicians will do the right thing now that they have exhausted all easy options. The UPA has to act between now and end November to clean up their act and then claim credit for steering India out of troubled waters, having finished announcing to the country that the current crisis is because of global factors that have affected all emerging markets. Once sentiments turn positive on the economic front, they can launch the secular missile.

The second hypothesis is that stage one will be triggered by a politician in the Government who stands to gain hugely and personally, if the right thing is done. The biggest gainer from resurrection of the economy is Chidambaram. If he succeeds in overturning the sentiments, he will get a real shot at the PM's post in the next cabinet. It is almost like one day cricket in which he will open along with Raghuram Rajan. He will bat like Shikhar Dhawan. He will be permitted by the Coach to do so, now that she has got the Food Security Bill passed. Besides, the UPA needs to win for the sake of Rahul's career. The Non-Playing Captain does not matter.

SO HOW CAN THE UPA UNDO THE HUGE DAMAGE?

The downswing in domestic demand, high food inflation, and the falling rupee are the three most apparent issues. The root causes however are high Current Account Deficit (CAD), high Fiscal Deficit (FD), broken supply chains on account of policy paralysis, poor infrastructure, etc. The demand downturn was largely self-inflicted. Slowdown in infrastructure investments, dislocated coal linkages, high interest rates, slowdown in investments due to a near-freeze in decision making by bureaucracy and senior bankers following a number of scams, killing of the golden (FDI) goose by the Government - the insane act of trying to amend laws retrospectively after losing the case in the Supreme Court in order to get even with a particular foreign company, etc. have together created a mess.

Some of these have quick fixes that could take India back to where it was before the recent crisis, i.e. a growing economy, where people nurtured hope despite all its imperfections and problems. This is doable, and therefore, may be attempted.

The Government has no option but to address the twin ills of CAD and FD immediately. A string of long awaited but simple financial sector reforms and some operational moves, starting with those that will open up the economy to foreign investors, will be unleashed from September in small doses, with some big hits in between, to keep the tempo alive for a sustained period. Some bills have already been pushed through the Parliament. The RBI has started to play its part. These new measures will include stabilising the Rupee at around ₹59 to ₹63, balancing the outflow from $ 172 Bn short term foreign debt, with new short term forex inflows. The Finance Ministry and the RBI working in tandem are expected to take a number of steps to reduce CAD and FD, as listed in **Exhibit 1.**

Current Account Deficit (CAD)

CAD is already falling, despite a rise in oil imports, due to gold import reduction and a small rise in exports. But the Fed's decisions and oil prices can spoil the party. However, positive action is expected or has begun on the following:

- Some Bilateral netting of trade and settling only the balance in $ started
- Oil Cos to raise $ 4 Bn (fuel price increase needs to be signaled)
- FCNR deposits made attractive
- ECB allowed ($ 10 Bn more this year?)
- Quick FDI clearances (more than another $ 3 Bn this fiscal)
- Oil Marketing Companies' weekly demand of $ 1.7 Bn taken off the market
- Curbing Gold imports (fall from $ 8.24 Bn in May to $ 0.65 Bn in Aug 2013)
- More steps to come

Fiscal Deficit (FD)

- Food Security Bill will really start biting only in FY 15 (and that too, to the extent of about Rs. 40,000 Crs.
- Brutal cut in plan & non-plan expenditure (Apr-Aug 63% target used up)
- Disinvestment (PSU and non-PSU portfolio share) to net c. ₹50,000 Crs
- Aggressive direct and indirect tax collection drive (some bullying)

The new RBI Governor has already outlined various steps that he intends to take to stop the Rupee's free fall against major foreign currencies and eventually let it stabilise at about ₹ 60-63 to a $. The RBI has applied band-aid by virtually removing the Oil Marketing Companies (OMC) from the forex market through a direct Dollar swap with the OMCs. This has taken out a weekly demand for around $ 1.7 Bn from India's shallow Forex market. India could actually end up with a CAD closer to 4% than to 5%.

Since the biggest single contributor to the CAD is crude oil imports to support the insatiable demand for petrol and diesel, one can expect reduction in subsidies, which are perverse incentives to use more fuel. The FM has officially said that he will not hastily raise retail fuel prices, especially diesel, but does he have an option? The Public Sector Oil companies are likely to be used as conduits to raise about $ 4 Bn through the issuance of bonds this year. How can that be attempted without showing investors that the Government will make OMCs more viable? Inflation will result whether one resorts to deficit financing to fund the subsidy or one allows fuel prices to rise to reduce subsidy.

Supreme Court intervention following scams that disrupted iron ore and coal mining has not only reduced the GDP growth in the first half of FY 14 but also put pressure on the CAD and the Rupee. With iron ore exports having fallen from around 118,000 T to 18,000 T due to the ban on iron ore exports, it is reasonable to expect the Central Government to do what it takes to convince the Supreme Court that they will punish the offenders and implement processes to prevent a repeat of the offence especially because the culprits are known. The country can ill afford to lose $ 4.5 Bn from not exporting iron ore, but more significantly it cannot afford the collateral damage of the kind the economy of Goa has suffered. There is a sense in political circles that this may be set right by the Government pleading with the Supreme Court about the dire need to start exports of iron ore as soon as possible. The Goa Government's steps to help their mining companies to start operations as soon as the embargo is lifted, is also a case in point. Coalgate scandal which drew the same response from the Court has sent Coal imports soaring to $ 10 Bn and also left billions of dollars of investments idle.

There has begun demand from the FM and the industry to reduce interest rates for some time now, but that may have to wait till inflation is tamed. It is not expected to ease till end November when good crop arrivals start.

With the FM likely to get credit for many corrective steps there will be clamour from various Ministers (Commerce, Heavy Industry, etc.) for incentives to be given to sectors under their charge in order to share the credit, unlike in 1991 when Man Mohan Singh was credited as the sole architect of liberalisation. Construction and automotive sectors are sliding backwards. Because on them, depend the fortunes of a large swathe of industries which live off them, we expect some action on this front and to support exports and infrastructure projects.

The Government will give a push to infrastructure projects which are stuck due to one reason or the other, by getting the inter-ministerial group to coordinate their efforts at removing road blocks which are holding up these projects. How the issue of land acquisition for some of them will be solved is not known. This could have been done long back but total lack of leadership has delayed it. It takes a crisis for politicians to act. The first to benefit will be the cement, steel and automobile sectors, hundreds of contractors, and a few hundred thousand workers in the organised sector and more in the unorganised sector. It is too much to expect this Government to announce comprehensive measures for the revival of industry across the board in the next 3 months if it involves huge financial outlay, but one should expect some support to a few high impact industries like the automobile sector and export driven sectors. **See Exhibit 2** for more likely steps that could be taken by the Government to make everyone feel good about India.

Exhibit 2: Various likely steps to make everyone feel good about India

Make Foreign Direct Investors happy

- Stabilise Rupee in the ₹ 60-63 range
- Make Tax administration more reasonable
- Liberalise FDI Rules
- No retrospective legislations

Make Foreign Institutional Investors happy

- Similar steps as in FDI
- Friendly taxation laws
- Improve the sentiments in the capital market

Make Indian Businessmen happy

- Speed up project clearances (esp. Environment)
- Revive many Infrastructure projects (nearly ₹ 92,000 Crs of clearances expected before mid-October. More to follow
- Increase bank loan availability (RBI: Curb excess G-Sec investments)
- Incentives for new capital investments
- Lifting of Mining exports ban (intervene with the Courts)
- New factoring scheme for quicker payments to MSME (RBI)
- Special incentives for certain sectors like auto and auto components, exports, etc.; lower interest rate (but RBI will find it tough to do it before food inflation dips. After December?)

...........And more, including better fuel linkages, stable F&O market, etc.

Make Indians at large happy

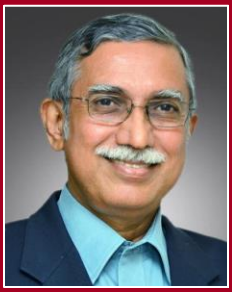
- A number of other steps to make the common man happy including revival of micro lending, direct transmission of subsidies through Adhaar, issuance of inflation indexed savings schemes, etc.

IMPLICATIONS FOR BUSINESS

"You never let a serious crisis go to waste. And what I mean by that it's an opportunity to do things you think you could not do before," a quote attributed to an Obama advisor, Rahm Emanuel, sums up the work cut out for Indian businessmen, especially manufacturers. The fact that the Rupee is not going back to ₹ 50 to a US $ in a hurry, opens up opportunities that were unthinkable six months ago. This is the time for capital goods manufacturers and the entire manufacturing and service industry where the raw material is Indian, to wake up and look at the whole world as their market. Barring China, there will soon be no other manufacturing location which will be as competitive as India. They need to start thinking like Chinese entrepreneurs did over the past four decades. The time for investing in new capacities is approaching fast. Some sectors like garments may run out of capacity sooner than most people expect. Many Western manufacturers will come shopping in India for sourcing and for investing in manufacturing.

When the dust settles down at the year-end after a tumultuous and depressing period for the Indian economy because the Government slept at the wheel, India's sentiment would be relatively positive. The FY 14 GDP growth of about 5 % will be seen as a sign of good times to come rather than as a confirmation that the Indian economy continues to be in the doldrums- a case of the glass being half full. If businessmen and entrepreneurs seize the opportunity to capture global markets, the pain we endured till now would have been worth it.

ABOUT THE AUTHOR



As a strategy consultant, Raj has helped companies across diverse industries in India, USA, Europe, and the Middle East to develop strategies, align strategy to vision, grow in competitive markets, restructure to make companies more customer focused etc.

In his current role, Raj serves as - Chairman: Avalon Consulting, Director: OC&C Strategy Consultants India, Chairman: Ugam Solutions Pvt Ltd., Chairman, Avalon Global Research and Chairman: Germinait Solutions Pvt Ltd.

In his previous roles, Raj has worked as a Merchant Banker with Grindlays bank and has also worked in the Consumer Durables industry

Raj holds an engineering degree from the Indian Institute of Technology, Bombay and an MBA from India's top business school, IIM Ahmedabad

AVALON Consulting

www.consultavalon.com

Contact Us:

INDIA – AVALON CONSULTING

MUMBAI: ☎ +91 22 6619 1100

Raj Nair, Chairman | ✉ Raj.Nair@consultavalon.com

K.A.Ramakrishnan, Director | ✉ K.A.Ramakrishnan@consultavalon.com

DELHI: ☎ +91 11 4051 6600

Sridhar Venkiteswaran, Executive Director | ✉ Sridhar.V@consultavalon.com

CHENNAI: ☎ +91 44 4345 5345

Premchand Chandrasekharan, Executive Director | ✉ Premchand.C@consultavalon.com

BANGALORE: ☎ +91 80 6771 0709

Naimish Dave, Executive Director | ✉ Naimish.Dave@consultavalon.com

SINGAPORE – APEX AVALON

☎ +65 9815 4170

Girija Pande, Chairman | ✉ Girija.Pande@apex-avalon.sg

Jaldeep Sodhi, CEO | ✉ Jaldeep.Sodhi@apex-avalon.sg