

## India's General Election: Why such a big deal?

This article was first published in *European Pensions*, June 2009

June 2009 - Author: Jamshed Desai, Fund Manager

**The Congress led United Progressive Alliance's (UPA) landslide victory in the Indian General Election represented a major rejection by the Indian people of the BJP-led National Democratic Alliance (NDA) and various other regional and communist parties who banded themselves rather indulgently as third and fourth fronts.**

We in India are often asked by our foreign friends and visitors why a General Election, especially this one, is such a big deal when India is clearly not like the US, or even China, in its importance to the global economy. While such disdain has some validity in the scheme of international trade and economics, in the narrower domain of the country's own economic future and governance, it is indeed a big deal after all.

There are some common fears that people and investors have harboured for some time, several of which have been substantially allayed with the emergence of the UPA's victory:

1. Coalition politics in India is all about compromises, as it probably is elsewhere too. However, in India, compromises come at the huge cost of poor governance. This has been demonstrated in the past when government policymaking and commitment to reform has been singularly lacking, chiefly because the coalition is concerned more about its own survival in power rather than any will to deal with difficult choices or make decisions. The UPA-led coalition's victory adds the very important dimension of stability and prospect of improved governance over the next five years.
2. The UPA projected Dr Manmohan Singh as its Prime Ministerial candidate upfront, while the regional fronts had none, since all of them fancied their chances for a shot at the top job. In the past, when a coalition has thrown up a compromise candidate as the Prime Minister (but not necessarily the best man for the job), it has never worked. Dr Singh's image of being an honest, incorruptible and erudite reformist has always struck a chord with the rural and urban electorate. Further, people saw that there was no discord even within the Congress party about who was the best man for the job.
3. A highly fragmented coalition becomes too loose and unwieldy to manage even if there is one large lead constituent such as the Congress or BJP. This has been the undoing of many a coalition in the past. Similar fears were expressed before the elections and investors cannot be faulted for being paranoid about another such loose coalition being foisted upon the country.
4. Before the elections, people feared that a 'Third Front' government, led by Ms Mayawati (who leads a caste-based party in the North), could provide the glue and leadership for disparate regional parties, non-aligned to either the Congress or BJP to come together to form this Third Front. They feared that the communist parties would once again play a crucial role in supporting such a volatile cocktail from 'outside', making it even more unstable. The UPA victory has brought about much more stability.
5. The current state of the economy leaves little room for manoeuvre for the incoming government. A slowing economy inherited by a weak coalition is most likely to see little improvement or could worsen further. It is hoped a stronger UPA coalition can possibly take the more politically difficult measures required to bring about the urgently required fiscal correction in the economy.

6. The defeat of the 'Left' parties by centrist parties has been a major feature of this election. The people – and investors – saw the left as a barrier to progress and reform.

This election result has sparked huge investor expectations. Sentiment among domestic and foreign investors is bound to undergo a sea change now, and much of the earlier scepticism will be replaced with at least cautious optimism once the initial euphoria subsides. A vast majority of investors, including retail investors, have been underweight or underinvested in Indian equities for much of the year, choosing to sit on a pile of cash. Putting this cash to work will surely create a short-term spike in the market as expectations are built into the market ahead of the hard work that will likely commence in dead earnest from June onwards.

The stock market will now look forward to some important milestones, the first of which will be the formation of the new Government and allocation of Cabinet portfolios. The Congress party will retain all the key portfolios barring one or two, which may be shared by its two key partners the DMK from the South and the Trinamul Congress from the East.

The second important event will be the Union Budget for the financial year 09-10. This should be the first policy document which will mould and fashion the fiscal correction process and also lay the path for reforms in future. Clearly expectations will run very high from where short-term disappointments on content and quantum are very likely.

This government now has the chance to enact some of the policies that were blocked by its coalition partners and the Left parties before. While doing so, it must remember the over-riding objective of fixing the economy by slashing the huge fiscal deficits that India runs today. India's combined fiscal deficit would reach around 11-12% this year. The immediate task would be to reduce it sharply without sacrificing growth. Rather, the twin objective would be to balance it so that GDP growth remains supported above 6.0-6.5%.

Privatisation/disinvestment of public sector companies may be regarded not as a policy in itself, but more as a means by which fiscal imbalances can be quickly improved. Proceeds from disinvestment, auctioning 3G telecom licenses etc., can be used to repay government debt and will lead to lower interest costs and hence, reduction in the deficit upfront.

The new Government is expected to attack subsidies in the system with missionary zeal - fuel and fertilizer subsidies being the main ones, especially at a time when oil prices are soft relatively and when political resistance is likely to be the least.

India is clearly an oil and capital deficient economy supporting current account deficits for much of the time. Its recent growth averaging north of 8% has been driven by huge surge in foreign capital. Further liberalisation of policies in areas such as retailing, insurance, defence etc. is envisaged. Additional capital inflows through the capital markets would combine to reverse the weakness of the Indian Rupee structurally.

Investors will feel more confident now that the Government will be relatively less shackled politically to pursue its economic agenda. This has elevated the expectations, manifest in the manner in which the benchmark Sensex has rocketed up 22% in the first two days of trading post the election results. Of course, the difficulties of fixing the real economy will dawn as time progresses and the current exuberance will give way to a more cautious form of optimism. Much will also depend on the speed of the global economic recovery.

Should global portfolio flows into Asia and emerging markets continue in the face of a relatively better outlook for the region versus the developed world, then it is conceivable that much of India's capital related growth problems will be alleviated. Investors may be right in believing that the fiscal deficit could be brought under control in the next three years, if GDP growth sustains above 6%, which could then lead to the currency stabilising or even strengthening gradually. All of the ingredients to Indian equities reflect higher earnings growth and thereby, outperform its regional and emerging market peers.