Business Standard

Awaiting genuine economic reforms: Why foreign investors are still selling

Policy measures taken to counter the slowdown are not enough

Akash Prakash September 10, 2019 Last Updated at 00:45 IST

Selling of Indian equities by foreign investors continues unabated. We see a net negative figure between $100 and $200 million on a daily basis. India continues to underperform global markets, most of which, unlike India, are solidly in positive territory in terms of performance for the year.

The macro picture for India remains benign. Oil prices seem anchored in a range of $60-70 per barrel. Nearly $17 trillion of debt globally is yielding negative interest rates. Any country able to deliver strong growth and have a positive carry should be able to attract disproportionate capital. Central banks around the world are set to embark on another round of easing, and liquidity currently is plentiful.

The government has listened to investors, both local and global, and removed the surcharge on capital gains, which had been a real pain point. There also seems to be acceptance that growth has slowed to unacceptable levels, and policy measures are being taken to counter the slowdown.

Despite the above, global capital continues to exit. On discussion with investors, who run global or regional fund mandates, the following concerns are repeated.

There is concern as to whether the current slowdown is more structural than cyclical. The relentless grind down in rates globally seems to indicate that nominal growth rates are expected to slow dramatically across the world. Maybe India is now destined for an extended spell of 5-6 per cent real growth instead of the 7-8 per cent everyone expected. With inflation consistently undershooting, that may translate into nominal growth rate of 8-9 per cent. If you extend this line of argument further, nominal growth in single digit implies a similar rate of corporate earnings growth. Most investors, given the extremely low profit share of GDP, had budgeted high double-digit earnings growth for India over the coming five years. This was how they would defend the valuation premium of India compared to the rest of the emerging market. These expectations of high double-digit earnings may not be met. Investors are starting to give up on profit share mean reverting. Maybe there is a new normal here as well. While India will still grow faster than most, the absolute levels may be disappointing. Valuations may need to correct for this.

The concern is also that there is absolutely no space for a countercyclical fiscal response. With slower GDP growth, tax revenues will disappoint, and weak markets mean no upside on divestment either. The only tool policy-makers have is monetary policy. They are pulling on this lever, but a despondent corporate sector, determined to deleverage may not invest despite lower

rates. Most expect the global economy to slow as well. Thus, trade and exports cannot be a saviour to address our growth challenges. Many investors argue for a structural slowdown, as the government has limited ability to get us out of this funk.

Another fear is around debt dynamics. The stock of government debt has a yield of about 8.3 per cent. If nominal GDP grows slower than this number, as it did in Q1, debt dynamics can turn ugly, if the slow growth persists.

Illustration: Ajay Mohanty

A second concern is around the goods and services tax (GST). Many investors now believe that it will have to be rejigged. The Centre has guaranteed a tax revenue growth of 14 per cent to the states. With nominal GDP in the single digits, that may be impossible to deliver. The central government will have to fill the hole, further straining its finances. Invoice matching may be the last hope. Once that is implemented, we may see some buoyancy. Without this, the whole architecture of the tax may have to be looked at again. We had all thought that GST would create fiscal space. It seems to have severely cramped fiscal maneuverability instead. Given the slowdown, low nominal GDP and continued implementation challenges, the revenue shortfall this year may be Rs 1 trillion.

The third concern is around corporate governance and transparency. There is genuine dismay around the governance standards in corporate India — the CG Power episode being the latest. How can the actual debt be double that reported in the balance sheet? How can a company hide thousands of crores of debt for neither the management nor the board to know? The true nature, size and complexity of the IL&FS default are now apparent. Banks may have to take a 50 per cent haircut. The financial system may lose Rs 45,000-50,000 crore. The auditors, rating agencies, management and board seem culpable of fraud or at least incompetence. We seem unable to have professionally run, board managed companies (without a credible promoter) with one or two exceptions. Invariably, the board gets captured by management. Most investors now actually prefer a strong promoter with a track record of good governance with high inside ownership. At least it reduces the agency problem. There is a real trust deficit in financial markets. Poor governance standards will corrode valuation multiples.

Indian equity markets had started narrowing in breadth two years ago. In hindsight, the markets were right, it has paid to stick to the proven leaders in governance. The quality premium was worth paying.

Sentiment among corporate India remains very subdued. Investors meeting companies find it difficult to remain positive. Companies complain of no demand, risk aversion in the financial system, judicial activism, unsympathetic policy-makers/regulators and poor profitability. I have not seen such negative sentiment since the taper tantrum of 2012-13.

Although the government has begun to act and appreciate the contours of the slowdown, not enough has been done yet. There still seems to be a lack of communication between the different arms of the government and between policy-makers and corporate India. We need to rebuild corporate confidence.

Investors want to see this slowdown as an opportunity for genuine reform. India has to be seen as being more hospitable for business.

While I am not as negative as some of the above feedback, one hopes the government puts in place a more ambitious economic reform agenda. I do not think this slowdown is structural. As we reach the anniversary of the NBFC crisis, growth will start to look better as the base turns favourable. Profit share/GDP will rise from today’s abysmal levels. The global macro has rarely been better. The next six months may turn out to be a buying opportunity, but more on that in a subsequent article.

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