India's Investment Climate Under the New Government

Narendra Modi Flckr Account

India's economy and investment climate have faced significant global and domestic headwinds in the last few quarters. India voted for a new national government between April-May 2014 amid a marked anti-incumbency sentiment and voter restlessness. Much of this feeling was driven by the perceived failures of the two-term Congress[1]-led coalition, particularly in reining in high-level corruption and inflation, as well as the coalition's lack of progress on the economic and development fronts. Consequently, during Congress' tenure business uncertainty remained high and investment confidence remained uncomfortably low. The results of the 2014 elections were revealed on 16 May. Mr. Narendra Modi[2] of the opposition Bharatiya Janata Party[3] (BJP), four-time Chief Minister of the state of Gujarat, won a decisive mandate to become the next Prime Minister[4] of India. *How will this outcome impact India's investment climate?* We believe the impact will be highly positive. The change of government has made India an ever more attractive destination for investment. Our conclusion is based on the assessment that a highly capable administrator will be at the helm, simultaneously other key drivers — political stability, positive economic conditions and compelling structural fundamentals — are all favourable for investment.

In this report, we review the merits of the new government and Mr. Modi's successful track record in driving economic growth. We also highlight how India is poised for an economic rebound which will generate significant opportunities for foreign direct investment (FDI).

Strengths of the New Government

A historic mandate in the lower house

For the first time in 30 years, a single party was granted an absolute majority in India's lower house.[5] This outcome eliminates the need for any sort of a political coalition to form the government, and frees the ruling party from the whims and blackmail of smaller 'allies' who tend to have a regional, rather than a pan-India agenda. Previous governments have been frequently plagued by such restrictions that arise from fractured coalitions. This government will be able to adopt a long-term view. Political uncertainty will mostly be a non-issue for the next five years.

Favourable upper house dynamics is attainable

India's parliament operates under a bicameral[6] model. Unlike the lower house, the upper house[7] is elected indirectly (by the country's state assemblies). Presently, the government holds less of an advantage in the upper house compared to its significant mandate in the lower house. However, the situation is expected to improve for the government because of two reasons. First, the new administration has already launched initiatives to create alliances to improve its leverage in the upper house. If these initiatives succeed, the BJP will be in a materially stronger position even in the upper house. Second, the upper house refreshes one-third of its membership every two years. Although the government will require deft manoeuvring to influence the upper house — which is doable — the historic mandate given to them in the lower house should be sufficient in a joint sitting of both houses, and as a symbolic show of force to pass much of the party's agenda.

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1 Congress is one of two pan-India political parties. It was the majority and ruling party most recently from 2004 to 2014 and ousted by the BJP party in the 2014 elections. Congress is a dynastic (Nehru-Gandhi) clan, ideologically secular and left-leaning. It is the most successful party to-date, having ruled India for nearly five decades out of a possible 66 years.

2 Previously highly-admired Chief Minister of Gujarat (one of India's more developed states) and now India's 15th Prime Minister.

3 The BJP is the other dominant national party in India. Perceived as right-leaning, pro-market and Hindu-nationalist, the party has been elected back into power in 2014. Previously, it was in power between 1999 and 2004.

4 Leader of the Indian Government. India's President is mostly a ceremonial figurehead.

5 The lower house or the *Lok Sabha* is one of two houses of the Indian Parliament. It is the more powerful of the two houses. Maximum strength of 552 representatives, of which 543 are directly elected by the people.

6 Mixed government consisting of two legislative bodies. Most legislation needs the support of both bodies.

7 The upper house or the *Rajya Sabha* of the Indian Parliament comprises 250 members. Members are elected indirectly by the state assemblies and the President for six-year terms. One-third of the total membership is refreshed every two years.

Constructive centre-state relationships are attainable

In India's federal system[8], it is imperative that the state and central governments are harmonious in their perspectives and actions. This is because states enjoy substantial autonomy and hence their cooperation is essential for meaningful progress. Currently, six out of the 29 states are ruled by the BJP (party in power at the centre) or parties allied with the BJP. As states roll into elections over the next five years of this government's term, this number is generally expected to increase owing to a continuing pro-Modi wave and a spirit of change stemming from an anti-incumbency sentiment. Elections for new assemblies are predicted to result in more BJP or BJP-allied governments in at least some of the states, thus bolstering the Prime Minister's standing and support for the government.

Appointment of a capable cabinet

Mr. Modi has appointed a capable and experienced cabinet[9] and assembled a strong advisory team comprising seasoned political operators and knowledgeable private sector intellectuals. Compared to the cabinet in the previous administration, this administration's cabinet team is highly integrated and far leaner, and thus is expected to operate on far quicker timelines and much reduced red tape.

The New Prime Minister: A Proven Performer with a Stellar Reputation

Gujarat's economic outperformance and Modi's pro-business track record

The state of Gujarat outperformed the country and most other states on many economic and investment indicators during Mr. Modi's rule as Chief Minister. Growing in excess of 10% in the 2000s, Gujarat's GDP outpaced India's GDP growth. In the same period, the per-capita income of state residents quadrupled and the unemployment rate was one of the lowest in the country.

In agriculture, a cornerstone sector of India's economy and livelihood, Gujarat recorded growth in excess of 9% during the Modi regime.[10] This is a very impressive rate, compared not only to India's average (which is less than half that), but also globally (a 4% rate is widely considered very respectable). The chief driver of this agricultural miracle is Mr. Modi's rural electrification project, the Jyotigram scheme.[11] Through this scheme, rural households and farmers in Gujarat now have access to power on a 24/7 basis. Importantly, Mr. Modi structured this mega-scheme on market principles. Power is provided on a 'freemium' model, where a fixed, low supply is delivered for free and the excess is charged to the farmer. This is in contrast to the populist but unsustainable policy adopted in many other Indian states where farmers are provided free electricity, thus leading to the accumulation of losses in the state government's account.[12] Gujarat's win-win model at this intersection of agriculture, energy resources and market economy principles was one of Mr. Modi's biggest achievements during his Chief Minister appointment in Gujarat.

Because of his consistent track record, Mr. Modi is generally believed to be a hands-on, business-friendly administrator who thrives on delivering results and getting things done. This stands in direct contrast to the previous government and Prime Minister who were accused of apathy and inaction for 10 years. During Modi's tenure in Gujarat, the state experienced meaningful declines in corruption and bureaucracy and notable gains in governance and transparency. Together, these improvements stimulated investor interest. To capitalise on the increased interest from investors, Mr. Modi launched a unique and far-reaching initiative in 2003: the 'Vibrant Gujarat' summit. This summit, held once every two years, brings together leaders from Indian and foreign governments, heads of Fortune 500 companies and chief executives of some of India's biggest companies under one roof to showcase Gujarat's business-friendliness. At each of these summits, thousands of memorandums of understanding worth hundreds of billions of dollars are signed. It is no surprise that the Vibrant Gujarat summits and Mr. Modi himself are championed by business councils across the globe, including those of Japan, Canada, U.S., UK and Australia.[13] Between 2000 and 2013, when Mr. Modi was Chief Minister of Gujarat, India received an estimated US$314 billion of FDI, of which Gujarat was responsible for an estimated US$9.3 billion.[14] This ranked the state as the 5th highest receiver of FDI out of India's 28 states and seven union territories.

During his tenure, Mr. Modi welcomed foreign investment and sanctioned big-ticket manufacturing projects to both Indian and foreign firms in the automobile, solar and other sectors. Mr. Modi is well positioned to replicate his economic growth strategies on a national level over the next five years.

8 Power divided between a national government and various state governments.
9 Council of high-ranking officials in charge of ministries such as defense, finance, energy, etc.
10 Gulati et al, Agriculture performance in Gujarat since 2000, IWMI and IFPRI, May 2009.
11 Swaminathan Aiyar, Gujarat is India's top state in economic freedom, The Economic Times, April 2014.
12 Swaminathan Aiyar, Agriculture: Secret of Modi's success, The Economic Times, July 2009.
13 U.S., UK business councils endorse Vibrant Gujarat, The Hindu Business Line, December 2012.
14 Fact sheet on foreign direct investment (FDI), Reserve Bank of India (RBI). RBI is India's central bank; in charge of monetary policy.

Government elected on a campaign of reform and development

The BJP ran on a change, development, and reform platform which included promises on, amongst others:

- Rationalising India's tax, labour and land laws.
- Curbing outflows of unaccounted black money and repatriating it.
- Establishing first-rate institutions of higher learning (Indian Institutes of Technology and Indian Institutes of Management) in each state.
- Liberalising the economy.
- Building next-generation infrastructure.
- Enhancing governance while minimising government.
- Reining in endemic corruption.

The government has prioritised tax reform. This focus on tax reform should be cause for investor optimism, considering investor confidence was majorly dented when the previous government irrationally amended tax laws with retrospective effect, negatively affecting the Indian operations of global majors such as Vodafone, Shell and Nokia, amongst others. Even at the time, Mr. Modi was a vocal critic of the then government's 'tax terrorism.' The nature of the new government's tax reform is still to be determined, but will certainly involve a major thrust toward the introduction of a Goods and Services Tax (GST). GST legislation is predicted to have a far-reaching impact on the Indian economy, but will require political will and savvy to implement. The government has pledged to work with state governments in implementing a direct tax code and GST soon; the opposition Congress party too has indicated their support for the introduction of the GST; and Indian industry is also in favour of a simplified GST regime. A GST system in lieu of the current cryptic tax code is expected to reduce the cost of doing business, increase transparency and boost collections, even while resulting in lower tax bills.

The government has already taken up the issue of untaxed black money stashed in offshore havens. The administration has appointed a special panel to trace this money and bring it back onshore. The total amount could be as high as US$500 billion.[15] A significant success in this area will result in three key benefits. One, the tax charged on this amount will boost government receipts. Two, the reintroduction of this money in the country's economy will be a substantial stimulus to the country. Three, it will be an early and major win for the new government and its credibility.

The government might also introduce reforms in India's capital markets.[16] Reforms could include the easing of borrowing restrictions on foreign investors; reversing the capital controls previously imposed by the central bank; replacing the short-term capital gains tax with a transaction tax; introduction of tax incentives for both retail and institutional investors; an overhaul of the use and role of depository receipts; and support for further development of the corporate debt market.

Approximately 280+ economic and development projects are stuck at various stages of approval.[17] One way or the other, investors can expect resolution on most of these during this government term. Several ministries of the new government have already put in motion options for online submission and tracking of approvals and tenders for projects. If all projects go through, the stimulus to India's economy could equal approximately US$250 billion.

In summary, all early indications point to a business-friendly administration in India for at least the next five years.

Government supported broadly

A clear majority for the BJP and Mr. Modi has paved the way for Mr. Modi to replicate his previous success on a national scale. Election results revealed that the BJP's and Mr. Modi's voter base cuts through major social, economic and geographic boundaries in the Indian populace. Media that was once highly critical of Mr. Modi has largely warmed up to him. India Inc. was always unanimous and vocal in its support for Mr. Modi.

A resurgent India and an economically stricken West have the opportunity to create a mutually beneficial relationship. The U.S., UK and German governments have already extended congratulations and invitations to Mr. Modi. Meanwhile, it is expected that Mr. Modi will seek to further improve trade with China (it is generally believed that Mr. Modi admires the Chinese model of growth). Mr. Modi already enjoys a close relationship with Japan, which had translated into sizable Japanese investments in Gujarat.[18] These early indicators support the prediction of a strengthened relationship between India and the rest of the world.

Positive reactions from the financial markets

In the period between Mr. Modi's nomination as the BJP candidate and election as Prime Minister, Indian equities rose by US$332 billion, the benchmark stock index rallied by 21%, and foreign inflows into Indian equities amounted to more than US$14 billion.[19] As it became clear that the BJP would win a clear majority thereby ushering economic reforms, the Indian Rupee strengthened to an 11-month high, India-focused

15 India special task force to find black money, BBC News, May 2014.

16 Big-bang capital market reforms on the cards, Business Standard, May 2014.

17 Cabinet Secretariat & Goyal et al., Modi Faces Greece-sized Snag to Economic Revival, Bloomberg, May 2014.

18 Shrey Verma, Big in Japan. Why Abe is Rooting for a Modi Win, Foreign Policy, February 2014.

19 Santanu Chakraborty, India Traders Watching Polls with $332 Billion at Stake, Bloomberg, May 2014.

Exchange Traded Funds (ETFs) rallied and domestic stock markets hit all-time highs. This upsurge in Indian markets has continued since the new government officially assumed leadership in May. Investment Banks have reported an increase in the number of IPO inquiries, indicating interest in Indian industry to tap the capital markets. Suffice to say, Indian financial markets have been euphoric at the prospects presented by the change of guard.

India's Resurgent Economy

India is predicted to grow fast while other economies struggle

India escaped the worst of the Global Financial Crisis and it has emerged much stronger than most major economies. India's GDP is projected to grow at 6.2% in 2014-15 and 7.1% in 2016-17,[20] the second-fastest rate of growth (amongst the major economies) after China, which is projected to grow at 7.7% and 7.5% respectively. At the same time, interest rates, growth rates and employment in the developed world are expected to face continued downward pressure, while global GDP growth is predicted to be 3.4% and 3.5% respectively. These growth patterns are expected to continue until at least 2019.

India's inflation crisis is alleviating

Former IMF economist Mr. Raghuram Rajan, now Governor of the Reserve Bank of India, has already made great strides in tackling India's persistent inflation crisis. The inflation rate is more than a percentage point lower since he took office. Mr. Rajan is widely considered to be the best person for the central bank job; he enjoys strong investor confidence; and appears to have initiated his relationship with the new leadership on a positive note. In his first major policy decision, he cut the statutory liquidity ratio by 0.5%. The statutory liquidity ratio dictates the amount of bank deposits to be held in government bonds. By relaxing this limit, Mr. Rajan's action allowed the redirection of more than US$6.5 billion.

Progress likely on controlling fiscal and current account deficits

Strong government action in the areas of welfare, infrastructure, trade, FDI and tax reforms — all already identified by the incoming leadership as key agenda items — can potentially decrease India's twin (fiscal and current account) deficits in the new government's first year. India's current account woes have abated and the deficit stands at a four year low. However, certain voices, including that of the government's potential chief economist, are urging the government to boost fiscal spending further rather than constrain it, arguing that growth is a higher priority than controlling the fiscal deficit.[21] Policy clarity and decisiveness in tackling India's twin deficits will be beneficial for India's sovereign credit ratings and investor confidence. To that end, the government has hinted at unveiling strong measures for restoring financial discipline.

Assessment

In conclusion, key economic drivers — political stability, an effective Prime Minister and positive economic conditions — are aligned for India to embark on a path of significant and sustainable growth.

India's structural strengths are nearly unmatched. A stable and democratic nation possessing immense human capital, India harbours the world's second-largest population and is on track to become the most populous nation by 2028. India has the world's youngest population and has just begun reaping the demographic dividend that was instrumental in propelling many Asian and other post-war economies. India's entry into the demographic dividend phase coincides almost with China's exit from it. By some estimates, India also has the second largest English speaking population. Indian universities produce highly regarded STEM (science, technology, engineering and mathematics) and MBA graduates numbering into the hundreds of thousands every year. Rising incomes combined with aspirational consumerism will drive India's middle-class to become the world's biggest consuming bloc surpassing the U.S. and China by 2030, that is, merely 15 years from today. In essence, India's development would seem to be inevitable — a capable leader and government will only expedite it.

The BJP's campaign and election have inspired hundreds of millions of Indians, and instilled a can-do spirit for making things happen. India in 2014 is at a landmark and stands ready for investment, poised to be an engine of global growth for years to come.

Our assessment leads to three recommendations:

- **Develop meaningful relationships with Indian partners:** India will be an investment theme for years to come. Hence, we recommend taking a long-term view. Succeeding in India needs a combination of western know-how and an understanding of the Indian consumer. We highly recommend investors to recruit credible Indian partners in their ventures.
- **Deploy capital:** Investors cannot afford to hesitate now, or worse, ignore, what will be the world's largest consuming bloc, in as soon as 15 years from now. While a healthy dose of caution is essential, we emphasise that the new government was provided a decisive mandate to overhaul India's economy and investment climate. As such, we recommend deploying capital to the Indian economy based on a carefully crafted strategy. The ideal time for action will be July 2014 and onward when the new government outlines its first budget and the outlook on India's crucial rainy season is revealed.
- **Go overweight on specific sectors:** Infrastructure, information technology and the energy sectors look likely to be most receptive to foreign investment in the new government's regime.[22]

[20] World Bank
[21] Rajesh Kumar Singh, Arvind Panagariya backs higher deficit for India revival, Reuters, May 2014.
[22] Deepshikha Sikarwar, Finance ministry to introduce a framework that will allow 49% investment in most sectors, The Economic Times, May 2014. Narendra Modi to unveil top 10 policy priorities, Reuters, May 2014.

- **Infrastructure:** While campaigning, the government repeatedly decried India’s infrastructure gap and emphasised the need for directing foreign and domestic capital to the sector. The government’s pre-election manifesto promised housing for every Indian family by the end of the government’s term in five years. The real estate sector is expected to be opened up further to attract foreign interest. In the area of transport, the government intends to bring a high-speed rail revolution to India modelled on the Japanese way. The government has also indicated an intention to open India’s rail sector to domestic and foreign investment.

  – *Technology:* Next to infrastructure, technology has been a recurring theme in Mr. Modi’s observed past and promised future. He has promised 100 ‘smart cities,’ modelled on a similar initiative he launched in Gujarat and has also made commendable progress in overhauling Gujarat’s governance by using technology. IT and e-commerce are expected to be near the top of the government’s list for boosting foreign investment.

  – *Energy:* In the energy sector, rumours are doing rounds that the government may breakup the state-owned Coal India, the single largest coal producer in the world. Such a move would be in search of revenue to alleviate the country’s fiscal deficit problem. It is expected that the government will explore all opportunities in the energy sector. These could be transactional, such as offloading its stake in public sector firms, or policy-related, such as reduced or eliminated fuel subsidies and completely freeing India’s energy sector and allowing it to attune to market forces.

  – *Other:* In other sectors, particularly strategic and politically-sensitive ones such as retail, insurance, banking and defence (a sector sure to grow under this nationalist regime and indeed rumoured to be opened up to 100% FDI), the information so far has been conflicting. Possibilities range from moderately encouraging to the best case of full liberalisation. Nevertheless, it is most promising that the government is credibly believed to be considering privatisation and raising the FDI cap under the automatic route in all sectors, deeming it acceptable so long as institutional control rests in Indian hands.

How Can FTI Consulting Help?

Investing in India at this time is likely to reward investors with outsized returns. A prudent investment strategy includes a comprehensive inventory and understanding of the risks involved. In our experience, entities considering investing in India often encounter reputational and regulatory risks such as:

- Weak corporate governance
- Lack of timely and reliable information
- Non-transparent corporate structure
- Insufficient and/or inaccurate disclosure
- Risky and/or opaque business model
- Less formal approach to business transactions and agreements
- Reckless strategies in pursuit of growth
- Off-balance sheet transactions and transactions between related companies.
- Limited operational expertise
- Fraud and corruption risk
- Concerns over quality of audits and financial reporting
- Lack of verification of figures, records and credentials

Ineffective or incomplete due diligence can result in catastrophic consequences. However, engaging a capable and effective team with deep expertise in risk and investigations advisory in the Indian market can assist investors in neutralising these risks over the entire lifecycle of their investments. FTI Consulting’s Global Risk & Investigations practice works with clients to prevent as well as contain these risks.

FTI Consulting is available to investors in each phase of their India operations:

Entry	Setup	Scale-up	Resolving Issues
• Market entry research • Feasibility studies • Competitor assessment • Industry assessment • Political and economic risk assessment • Security risk assessment	• Vendor screening • Supply chain and KYC related risk assessment • Investigative due diligence on potential partners • Financial due diligence • Pre-employment screening	• Strategic Intellectual property program • Market surveys • Royalty audits • Business reviews • Internal controls consulting • Compliance audits	• Fraud and internal investigations • Data forensics • Forensic accounting Asset searching • Litigation support • FCPA and anti-bribery investigations and audits • AML consulting • Leveraged negotiations

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