ISAS Brief

No. 77 – Date: 29 July 2008

469A Bukit Timah Road
#07-01,Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isasijie@nus.edu.sg
Website: www.isas.nus.edu.sg

Will the United Progressive Alliance Victory in the Trust Vote Result in Faster Economic Reforms?

Amitendu Palit*

As the curtains came down on an action-packed two-day session of the Indian Parliament with the United Progressive Alliance (UPA) government surviving a close trust vote, the stock market erupted with joy. On 23 July 2008, the day after the trust vote, the benchmark Sensex at the Bombay Stock Exchange gained 838 points (almost six percent) in a single day's trade. The Nifty at the National Stock Exchange also responded in an equally robust manner. The signals emanating from the rally were loud and clear. Industry and business were ecstatic at the outcome of the trust vote.

Though many were expecting the markets to respond favourably to the outcome, the reaction was probably greater than anticipated. The spurts in the Sensex and Nifty marked significant departures from the prevailing market trend given that bourses have been largely bearish since early 2008. The euphoria indicated that the survival and continuation of the UPA government was a 'shot-in-the-arm' for a capital market that has been plagued by adverse sentiments following high inflation, withdrawal of short term capital flows, worrying dips in industrial and core sector output, and warning signals from international rating agencies.

It is simplistic to assume that stock market movements capture the sentiments of all segments of the economy. The stock market reflects more of the immediate perceptions on risk-return payoffs. At the same time, there is no denying that it resonates the gut impulse of business and industry. So why did the stock market respond so positively following the trust vote? For industry and business, the continuation of the UPA government minus the Left implies the revival and constructive movement on a long-pending economic reform agenda. The Left was perceived to be the major roadblock to key reforms. During the last couple of years, there were several occasions when the government was forced to backtrack on policy measures on which the Left had radically different positions. These included reforms in vital segments of the financial sector such as pension, insurance and banking, and disinvestment of government stake in public sector undertakings.

Financial sector reforms have indeed suffered in recent years. Several bills mooting major changes in policies in different financial segments are pending passage in Parliament. In insurance, for example, there is a proposal to increase the threshold limit of foreign equity in joint ventures from the current ceiling of 26 percent to 49 percent. The measure, whenever

---

* Dr Amitendu Palit is a Visiting Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He can be reached at isasap@nus.edu.sg.

approved, is expected to encourage several global insurance service providers (both life and non-life) to tap the under-exploited Indian market, where less than a tenth of the population is insured. The policy has obvious implications for incoming foreign direct investment in India. Similarly, in pension, there have been attempts to set up a regulator for the sector for quite a few years now. Once the legislation proposing the establishment of the Pension Funds Regulatory and Development Authority (PFRDA) is approved, it will pave the way for private fund managers to enter India's pension industry. This is an urgent and critical reform that has been pending for long. A functional PFRDA will not only help in creating a competitive environment in the pension industry, but will also help in making resources available for long-term investment purposes, particularly in infrastructure projects. Finally, in banking, the government has been trying hard to bring down its stake to below 50 percent of the total equity base in public sector banks. However, sustained opposition from the Left has prevented it from doing so.

There is little doubt that, if in the few months left in its tenure, the UPA government is able to get these legislations cleared, it will provide a strong boost to the sagging morale of the capital market. The portfolio investment inflows from FIIs, which have been the strongest drivers of the Indian stock market and have been lukewarm in recent months, are likely to rebound with new vigour. The pension reforms can trigger an immediate recovery, which can derive further stimulus and strength from insurance and banking reforms.

At this juncture, however, it is probably important to think through the prevailing euphoria for assessing how much of reforms are possible in the coming months. Notwithstanding the expectations of stock market actors and agents and the benefits that can accrue from pending reforms, will these actually happen? And what about the reforms which are supposed to address deeper structural imbalances such as the privatisation of public enterprises and correction of subsidies? With the Left out of the way, will these much-needed reforms also receive the desired attention?

As far as financial sector reforms are concerned, the passage of pending legislations depends on the success of the government in convincing its new allies. The Samajwadi Party has given the assurance that it will adopt an 'open mind' on reforms. Having said this, an important point cannot be overlooked. A consensus on economic reforms within the new political alliance will depend upon the perceived impact of such reforms on the electorate. Fortunately, regarding pension and insurance, barring the Left, there has not been much disagreement across the political spectrum. So these should go through, at most, with minor changes.

Unfortunately, the same cannot be said about more difficult and complex reforms such as privatisation and reducing subsidies. The possibility of these reforms occurring in the remaining months of the current government does not appear too bright. Regarding privatisation of public enterprises, the UPA government's policy, right from the beginning, has been soft and sedate. The privatisation of profit-making public enterprises was ruled out. So were strategic sales that involved the transfer of management control of public enterprises to strategic partners identified through competitive bidding. In February 2005, the government called off the process of strategic sales in 13 enterprises. Effectively, the disinvestment strategy of the UPA government emphasises on the minority sales of government shares so that the 'public' character of these enterprises do not change.

One can argue that the thrust of the government's public-sector policy, as documented in the National Common Minimum Programme, was a trade-off for the Left's support. But are there enough reasons to believe that this policy will now change with less than a year remaining before the next general elections? The government is unlikely to tread on sensitive toes so close to elections. Aggressive moves on privatisation will resume heated debates and widespread protests. Privatisation in India continues to be an emotive issue with sharply diverse views. Thus, the possibility of any progress on public sector reforms looks remote.

What about subsidies? Again, the tendency to avoid ruffling feathers is likely to result in inaction in this sphere too. Food, fertilizer and oil are the three main categories of subsidies. Cutting food subsidies at a time when food prices are high and elections are close is out of the question. Rather, there might be increases in such subsidies through the announcement of higher procurement prices if some crops do not fare well. Bringing down fertilizer subsidies will increase the costs of production for farmers. Given the inflationary conditions, such a step can prove self-destructive. Finally, the oil subsidies – considering the public outcry at the last round of subsidy cuts and price revisions (June 2008), the government will be averse to burning its fingers again. That will be unfortunate since the current moderation in global oil prices offers a wonderful opportunity for rationalising subsidies in a relatively 'painless' manner. Inaction on this front will imply a rare chance foregone.

Thus, the hopes of 'big-ticket' reforms in the coming months might actually turn out to be an anti-climax. There is unlikely to be progress on critical areas since the government will aim to avoid confrontations. So will its allies. These political considerations will inhibit precipitate actions to a large extent. As a result, the government is likely to become more circumspect for avoiding political setbacks. For example, the spectre of the current downward trend of global oil prices reversing, however unlikely it may be, will continue to haunt policy makers and prevent them from pursuing action on oil subsidies. With inflation being where it is (the latest estimates put inflation measured by the Wholesale Price Index at 11.59 percent), the government will be doubly cautious about the inflationary and 'political' impact of all policies.

So it will actually be a significant achievement if the financial sector reforms, particularly pension and insurance, go through. A couple of months ago, nobody had thought that they would actually have any chance of going through. Achieving these, therefore, will be unforeseen gains. But expecting anything more will be irrational. After all, the trust vote was only a capsule edition of the much larger countrywide exercise that is in the pipeline. Having won the battle, the focus of the government will now be on winning the war. Reforms can certainly wait. The message seems to have gone out to the stock market too. Otherwise, in spite of global cues, the market should have remained largely up and uncorrected during the later sessions of last week. However, it did not.

oooOOooo