Budget 2019: Wooing speculative finance for development*

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The second Modi-led BJP government has provided, at best, an inkling of its economic agenda through its first Budget. That budget has been much discussed since the 5th of July when it was presented. However, an aspect that has not received the attention it deserves is the underlying perception of how development should be financed. Union Budgets are meant to lay out how the government plans to mobilise every rupee of its resources over the coming year, and how it plans to spend the money. To that end, tax and non-tax revenues and the proposed volume of borrowing, together with the proposed allocation of those receipts, should be the main concern. By listing those, the government reveals its fiscal stance, with attendant implications for growth and welfare.

Budget speech 2019 was, however, different. Of the 105 paragraphs that made up a rather tiresome Part A of the speech, 23 related to financial markets. Since many paragraphs were add-ons without substantial content, that was a large part of the budget speech. Flows mediated by financial markets rather than the government's own resources are clearly being seen as central to the government's strategy of financing development. The message is that private financial capital, domestic and foreign, normally looking for quick returns, should be tapped to meet development objectives.

The 'strategy' cannot stop with proposing this role for private finance. Development requires investment in areas that do not promise quick returns. A typical example is infrastructure, crucial for development and woefully short in India. The second Modi government has announced that it would ensure investments totalling Rs. 100 lakh crore in infrastructure over its five year term, or an average of Rs. 20 lakh crore every year. This compares with total central budgetary expenditure of Rs. 24.6 lakh crore in 2018-19, of which a measly Rs. 3.2 lakh crore is devoted to capital expenditure. Much of that expenditure was absorbed by wages, salaries, defence and interest payments. So, unless the government launches a major resource mobilisation effort, the money for that infrastructural push must come from elsewhere. There are no signs of such a push in this budget, nor any promise of one in the future.

The conventional view is that since infrastructural projects require large, lumpy investments and are characterised by long gestation lags, they do not attract private players, and tax- or debt-financed public expenditure must lead growth in the sector. But unwilling to tax and having embraced fiscal conservatism that requires reining in the fiscal deficit and public borrowing, the government finds that infrastructural shortfalls have become too large to be ignored. So alternative means of finance must be found.

Till the financial liberalisation of the 1990s, the government's budgetary effort was supplemented with resources from the publicly owned and supported development finance institutions. But with Indian-style financial liberalisation choosing to transform those development finance institutions into pure commercial banks, even that source of support has to be substituted. The government possibly realises it made a mistake phasing out the development finance pipeline. Budget speech 2019 claims that the government proposes "to set up an expert committee to study the current situation relating to long-term finance and our past experience with development finance institutions, and recommend the structure and required flow of funds through development finance institutions." But this is at best a feeble cry for return to an irresponsibly rejected past.

One alternative experiment in infrastructure investing that has been pursued for some time now is the use of so-called public-private partnerships (PPPs). That finds mention in this budget too, especially in connection with modernisation and expansion of the railways. To quote: "It is estimated that Railway Infrastructure would need an investment of Rs. 50 lakh crores between 2018-2030. Given that the capital expenditure outlays of Railways are around 1.5 to 1.6 lakh crores per annum, completing even all sanctioned projects would take decades. It is therefore proposed to use Public-Private Partnership to unleash faster development and completion of tracks, rolling stock manufacturing and delivery of passenger freight services."

But as experience, in India and elsewhere, makes clear, in most PPP projects cost and risk is largely borne by the government, while much of the surplus, if any is generated, accrues to the private sector. It is not that the government is averse to such an outcome. But the purpose of the PPP is lost if the government must provide the bulk of the finance. With limits set on its own finances, this would not resolve the problem of inadequate investment in the infrastructural sector. If the strategy of relying on private finance is to work, private capital must flow directly into the infrastructure field.

During the high growth years prior to the global financial crisis of 2008, when investment rates in India did rise sharply, an instrument used to attract private players (with a limited amount of own capital) was the direction of bank finance. Public sector banks were encouraged to substantially increase lending to PPP or private infrastructural projects. The share of infrastructure in scheduled commercial bank lending to the industrial sector increased from 3 to almost 35 per cent over the 2000s. Banks complied because they presumed that there was an implicit sovereign guarantee attached to such lending. The private sector, on the other hand, obviously saw this as a gift from the government, which was expected to make these projects remunerative enough to deliver profits after interest and amortisation costs on debt were met. That did not happen, and some private promoters even diverted the resources into their own personal fortunes.

The result were defaults which the banks were for long encouraged to ignore and keep the debts ongoing by "restructuring" them. But defaults could not be ignored for ever. When stricter asset quality recognition and classification guidelines were issued by the central bank in 2015, gross non-performing assets of the Scheduled Commercial Banks (SCBs) rose from Rs. 3,23,464 crore as on 31 March 2015, to Rs. 10,36,187 crore as on 31 March 2018. Enforced write offs have been resorted to, but that implies that the government would have to underwrite the losses of the banks. According to a reply to a Rajya Sabha question, "over the last four financial years, PSBs were recapitalised to the extent of Rs. 3.12 lakh crore, with infusion of Rs. 2.46 lakh crore by the Government and mobilisation of over Rs. 0.66 lakh crore by PSBs themselves." This is not enough to bring the banks back into infrastructure lending, which in any case they would prefer to abjure having burnt their fingers once. Moreover, since the government, given its fiscal conservatism, cannot continue to underwrite the losses of the banks, the quest for off-budget sources of infrastructure funding must continue.

It is this hopeless quest that the budget speech's obsession with financial markets reflects. The effort to coax equity and bond markets to contribute to infrastructure investment financing has three components to it. The first is to expand and make lucrative the space available to financial investors, especially foreign institutional and portfolio investors (FIIs and FPIs). The budget notes that "an important determinant of attracting cross-border investments is availability of investible stock to the Foreign Portfolio Investors (FPIs)." So it proposes increasing the statutory limit for foreign portfolio investment in a company from the current 24 per cent of total equity to a level equal to the sectoral foreign investment limit. Foreign portfolio investors will also be allowed to subscribe to listed debt securities issued by Infrastructure Investment Trusts (InvITs) and Real Estate Investment Trusts (REITs). Simultaneously, the government has asked SEBI to consider raising the minimum public shareholding in listed companies from 25 per cent to 35 per cent, to augment shares available for acquisition in the equity market.

The second is to be less rigorous when assessing the suitability of a foreign investor to enter and invest in financial markets. In the past, the criteria used was aimed at keeping speculative and shadowy investors out. But now the government plans to "rationalize and streamline the existing Know Your Customer (KYC) norms for FPIs to make (them) more investor friendly without compromising the integrity of cross-border capital flows." The terms of entry are also to be relaxed. For example, the budget has reduced the net owned fund requirement for foreign insurers setting up operations in the International Financial Services Centre from Rs. 5,000 crore to a fifth or Rs. 1,000 crore.

The third is to try and make the corporate bond market attractive for investors. Credit guarantees are to be provided by establishing a Credit Guarantee Enhancement Corporation. Measures for "deepening markets for corporate bond repos, credit default swaps etc., with specific focus on infrastructure sector," to help investors share and transfer risk are to be put in place. Markets are also to be made more liquid for foreign investors by permitting "investments made by FIIs/FPIs in debt securities issued by Infrastructure Debt Fund – Non-Bank Finance Companies (IDF-NBFCs) to be transferred/sold to any domestic investor within the specified lock-in period." This opens the doors to short term flows in an area where investments are necessarily long-term in nature.

These measures are by no means novel on a global scale, nor are they exhaustive. But the fact that they have been listed suggests that the government plans to use every trick in the financial innovation book in its desperate such for private financing of infrastructure. The Finance Minister also announced that the government is considering "organizing an annual Global Investors Meet in India, using National Infrastructure Investment Fund (NIIF) as the anchor, to get all three sets of global players—top industrialists/corporate honchos, top pension/insurance/sovereign wealth funds and top digital technology/venture funds"—to invest in India. Demands for "reforms" at those meets are bound to be added to the list of measures aimed at attracting investment. The idea is to place foreign finance on par with foreign direct investors who can integrate India into the global production value chain. To quote: "It is high time India not only gets integrated into the global value chain of production of goods and services, but also become part of the global financial system to mobilise global savings, mostly institutionalized in pension, insurance and sovereign wealth funds."

It is unlikely that this effort to coax and cajole private finance to substitute for the state in the infrastructural area would succeed. But whether it does or not, the "reforms" that would be adopted to make infrastructure an attractive option for speculative finance would result in changes in financial markets that hugely increase the quantum of risks, package those risks in opaque instruments, and pass them on to investors who are unable to judge the risks they are taking on. Increased fragility and a meltdown rather than an infrastructural boom are likely to be the result.

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