India’s new normal: from public finance to project finance

Today’s media is full of stories about the ‘new normal’. The high profile failed bombing attempt at Times Square this month was splashed across headlines as the new normal of home-grown terrorism. Two million Boston residents had to adjust to the new normal of life without safe drinking water after municipal mains ruptured. *The Huffington Post’s* Caroline Dowd-Higgins penned five tips for navigating the new normal in today’s job market. *Time* reports on the growing prevalence of memory-loss diseases like Alzheimer’s or other forms of dementia: clearly, forgetting is the new normal. For military families, the new normal is repeated redeployments of their loved ones to ever-increasingly dangerous zones. Much closer to home, Suman Bery highlighted the issue of exchange rate as part of the new normal monetary policy framework. Strangely enough, the Indian infrastructure story has not been phrased in the new normal rhetoric. At least not as yet.

India has moved rapidly from public finance to project finance in infrastructure. In the first quarter of 2010, India topped the Asia Pacific region with eight out of the ten largest project deals, amounting to $15.2 billion or 46% of market share. Seven out of these are infrastructure projects. Globally too, India accounts for five out of the top ten projects. 2009 was a turning point: When the world responded to the financial meltdown with a 44% decline in project deals, India came out as the most active country for project finance with 72 deals totaling $30 billion, leaving the runners-up Australia ($12.6 billion) and Spain ($11 billion) far behind. Moreover, the 2009 PFI award for Bank of the Year for Asia was taken by the State Bank of India. So what drives this new normal of Indian infrastructure?

A push from the highest quarter of the Indian government is surely a factor. The high profile Infrastructure Committee is chaired by the Prime Minister and is guided by the Deputy Chairman of the Planning Commission. There is also a bottom-up cry for more infrastructure services. Power availability in April was 14.6% short of demand at the all-India level, and seven states faced a peak deficit of more than 20%. High macroeconomic growth at home, global financial troubles, and PPP mania are some of the other impulses driving this new normal.

Most of these deals are highly leveraged: A typical PPP project has less than 10% equity from the promoter. But this is precisely what has changed globally after the collapse of Lehman Brothers. In March 2009 Ian Davis, the Worldwide Managing Director of McKinsey, characterized the new normal world as having two distinct features: It involves a fundamental restructuring of the economic order with, firstly, significantly less financial leverage and, secondly, a much greater role for government. So is there a quiet disconnect from the global new normal? Easy availability of project finance has made it possible to add infrastructure capacity without dealing with the much-needed sector reforms. Take the example of the Indian power sector: Overall subsidy which was $6.2 billion last year is expected to rise to $26 billion by 2014-2015, despite some moderate improvements anticipated in the next few years. The Indian states carry huge contingent liabilities because of power, and other, demands. Overall efficiency of the SEBs remains low and increasing the share of private providers in the sector will not change this. In fact it may even exaggerate fiscal problems, at least in the medium term. For example, SEBs which have not planned for capacity addition or taken steps for load management will end up relying on short term power exchange at a much higher rate than the cost of new capacity. The open access policy will allow the paying private sector users to contract with the new PPPs directly, leaving SEBs with loads that imply large subsidies under the current regimes.

One should always remember that PPPs carry much larger foreign exchange and fiscal risks compared to government financed projects. The new infrastructure model can work, provided the government undertakes important sector reforms, particularly tariff reforms, now. Let us not forget that the last two centuries have seen many waves of private infrastructure followed by state solutions that levied huge fiscal costs for tax payers. And most of the time, it is these highly leveraged infrastructure projects that were responsible for such swings. India’s new normal looks great at the moment, but how long will it last?

Posted by Rita Nangia on May 19, 2010