

A world map composed of a grid of small grey dots, with the density of dots increasing to form the shapes of continents. The map is centered on the Atlantic Ocean.

# INDIA IN CHARTS

## POLICY CONTINUITY = GRADUAL REFORMS

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**Shumita Deveshwar**  
**June 2019**

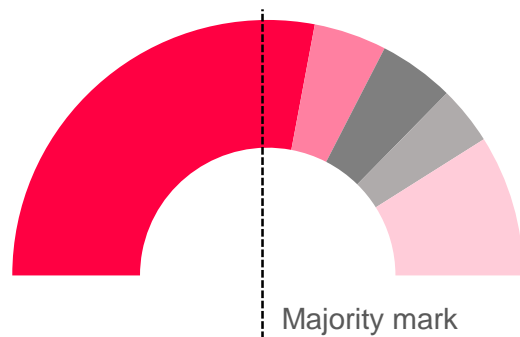
# A WINNING MIX OF WELFARE AND REFORM

- Prime Minister Narendra Modi's landslide re-election = political stability and policy continuity.
- Modi will stick to his winning policy mix of welfarism with limited, gradual reforms.
- He still lacks a majority in the upper house of parliament to enable constitutional changes.
- After the initial euphoria, investor attention will switch to worrying economic fundamentals.
- GDP growth has slowed to its weakest pace in 5 years and global headwinds are rising.
- Falling consumption and slow investment imply that 7%-plus GDP growth will be a challenge.
- Unpredictable monsoon rains are a near-term risk while oil price volatility is a structural risk.
- Fiscal consolidation will be gradual, especially as Modi needs to revive economic growth.
- A more accommodating RBI leadership will continue to ease policy rates and banking norms.
- Creating jobs, improving rural incomes and reviving credit growth will be Modi's key priorities.
- Structural reforms in land and labour markets, and privatization of banks are unlikely.
- Modi's successes lie in easing the regulatory environment and in effective implementation.

# POLL UNDERLINES MODI'S PRIMACY

- Modi's Bharatiya Janata Party's (BJP), unusual second-term majority with a larger mandate than in 2014, means that it will likely to stick to its winning policy mix of welfarism and gradual reform.
- A poll sweep despite policies such as demonetisation suggests that Modi may remain unpredictable.
- His power will be constrained to some extent by the lack of a majority in the parliament's Upper House, where the BJP and its allies will be a few seats short through 2022. State polls will be key going ahead.

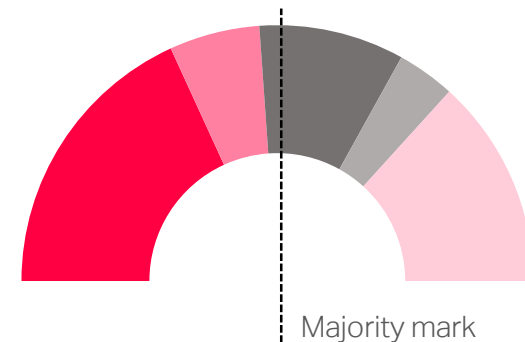
## Seats won in Lower House election, 2019



■ BJP ■ BJP's allies ■ INC ■ INC's allies ■ Others

Source: Election Commission

## Seat projection for Upper House, 2022



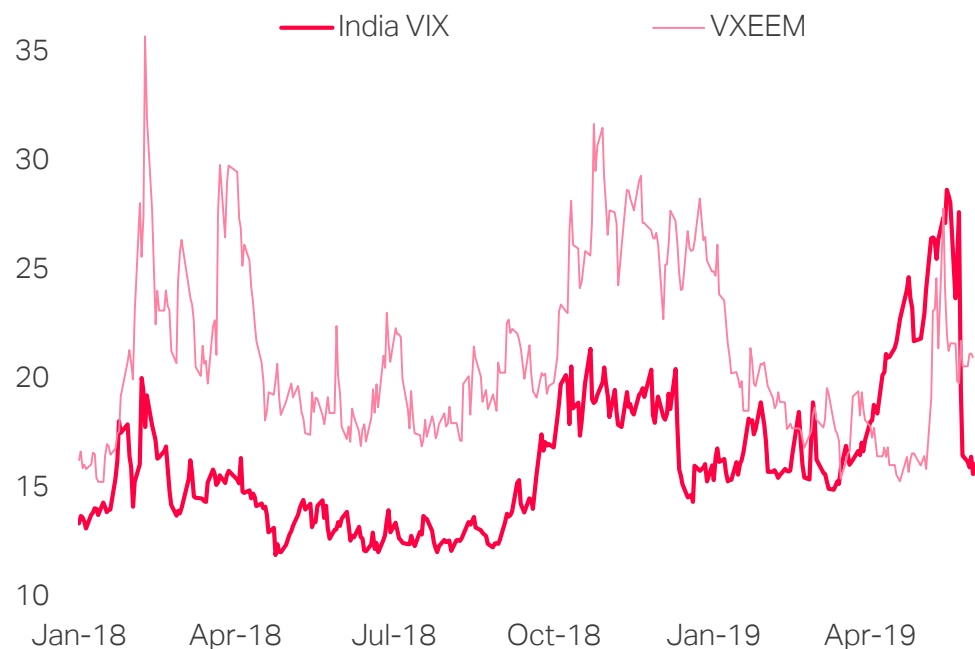
■ BJP ■ BJP's allies ■ INC ■ INC's allies ■ Others

Source: TS Lombard.

# MARKETS SURGE ON MODI "HOPE RALLY"

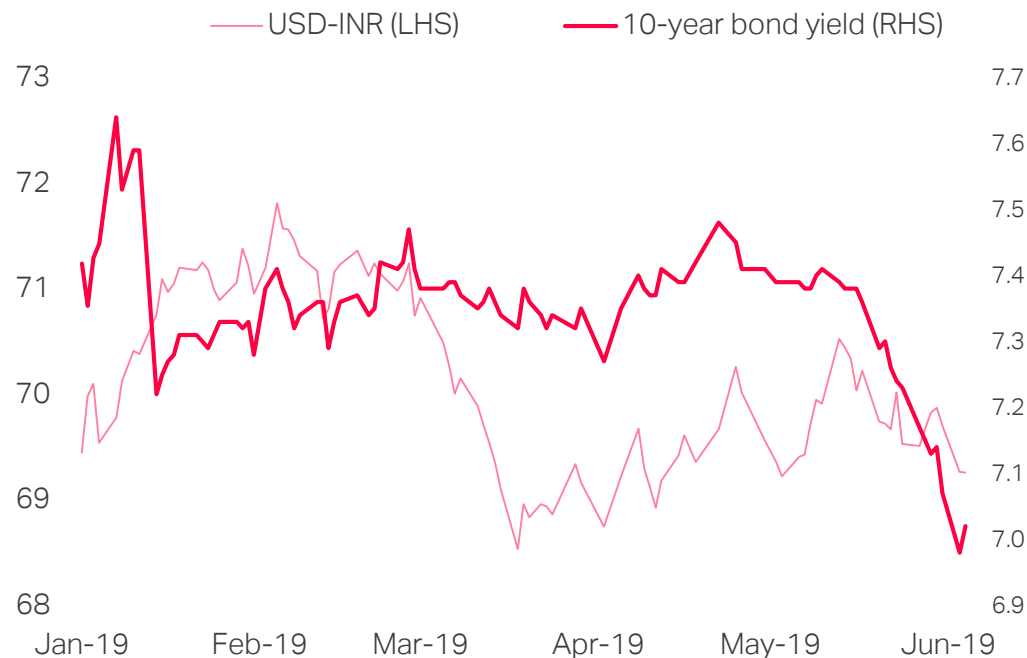
- Hopes that Modi will usher in structural reforms has led to a strong rally across Indian asset classes.
- Bond yields have fallen on hopes of further monetary easing by the RBI given relatively low headline inflation and concerns over sluggish economic growth.
- This short-term rally will likely fade as investors return focus to economic fundamentals and earnings.

## India vs EM volatility indexes



Source: National Stock Exchange.

## Rupee vs benchmark bond yield



Source: Bloomberg.

# IS THE OUTPERFORMANCE SUSTAINABLE?

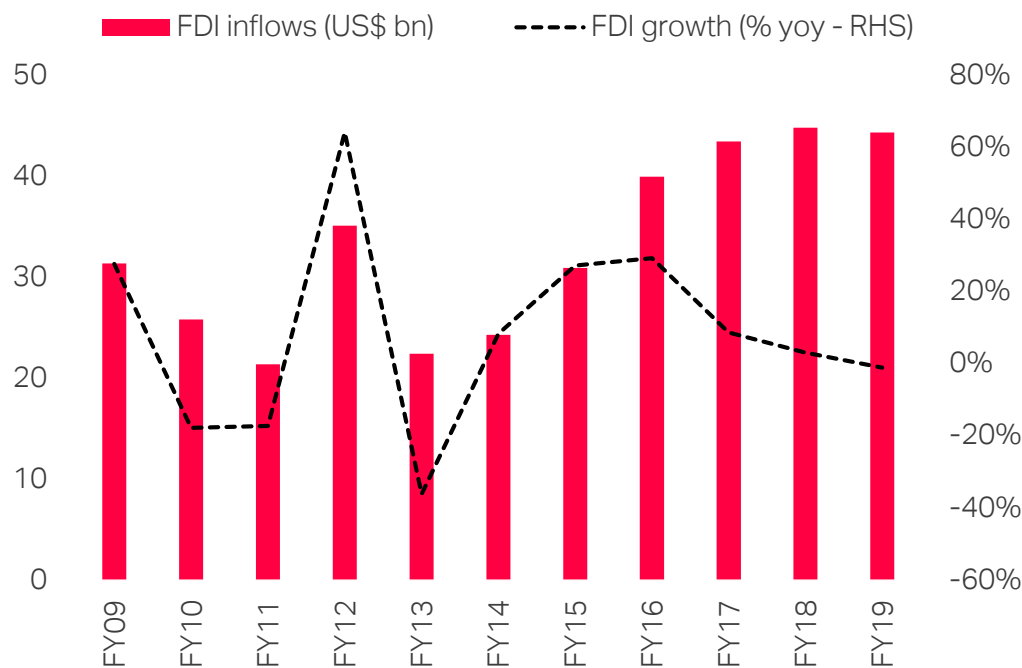
- The P/E ratio is currently at record highs despite disappointing GDP growth and weak earnings.
- Previous such levels coincided with the dotcom bubble of 2000 and pre-financial crisis in 2008.
- Despite a strong equity market performance, foreign investor sentiment in terms of FDI inflows has moderated in recent years.

## Price-to-earnings ratio of Sensex stocks



Source: Bombay Stock Exchange. \*Note: FY20 is from 1 April-4 June 2019.

## FDI flows to India



Source: Bloomberg.

# ARE WE TOO OPTIMISTIC ON REFORMS?

- Successive governments have had little incentive to reform in the absence of a crisis.
- Modi's 1<sup>st</sup> term record implies he won't take steps that may be perceived as "anti-people".

## Reforms undertaken in Modi's 1<sup>st</sup> term

Reform	Impact
<u>RBI autonomy</u>	Monetary Policy Committee set up to take independent decisions. Successful in anchoring inflation expectations. But exit of governors put RBI's autonomy in question.
<u>Demonetisation</u>	Some shift to the organised sector, increase in electronic transactions. Not worth the economic cost.
<u>Bankruptcy code</u>	Diluted from original and litigation is delaying proceedings. More teeth needed.
<u>GST</u>	A landmark tax system overhaul but chaotic implementation. Monthly revenues still falling short of target. More streamlining needed.
<u>Privatization</u>	Air India put on the backburner, IDFC Bank sold to state-run LIC. Disinvestments without losing majority control through creative M&As, ETFs etc.
<u>Fuel price deregulation</u>	When elections take place, oil marketing companies are asked to bear a part of the burden. Full benefit of lower oil prices not passed on to consumers as taxes raised.
<u>Ease of Doing Business</u>	Rank has risen sharply to 77 in 2019 from 130 two years ago. But this hasn't led to higher investments, FDI.

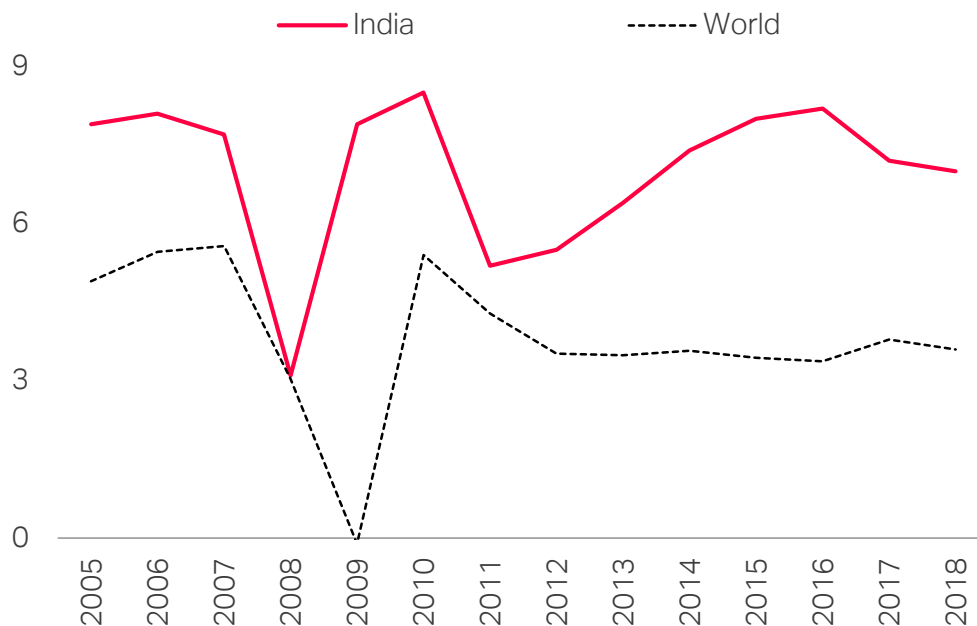
## The to-do list for Modi's 2<sup>nd</sup> term

Reform	Impact
<u>RBI autonomy</u>	New governor has eased regulatory norms and is more amenable to government priorities. RBI's reserves likely to be used for providing stimulus, with fiscal, inflationary and moral hazard implications.
<u>Fiscal consolidation</u>	Government has veered off glide path for consolidation and will likely help pump prime the economy. Likely to increase infrastructure spending as well as welfare measures.
<u>Banks</u>	M&As are likely but privatisation won't happen. RBI's reserves likely to be used to help recapitalise state-run banks.
<u>Direct tax rationalisation</u>	Promises to cut corporate tax rates were not fulfilled in the 1 <sup>st</sup> term. With the need for a fiscal stimulus and GST revenues falling short of target, rates unlikely to be cut soon.
<u>Factor markets (land, labour)</u>	Need a lot of political will, but if not now then never. Modi was unable to ease land acquisition rules in his 1 <sup>st</sup> term and labour reforms stalled. Plans to make state-owned land available for industry and proceed with some labour reforms in this term.
<u>NBFCs</u>	RBI has proposed new liquidity buffer norms to avert any future crisis but short-term worries persist, and credit slowdown likely.
<u>Trade</u>	Global trade war to test India's preparedness and competitiveness. Trend of rising import tariffs since 2017 (after two decades of gradual reduction) needs to be reversed.

# MODI'S REPORT CARD HAS DISAPPOINTED

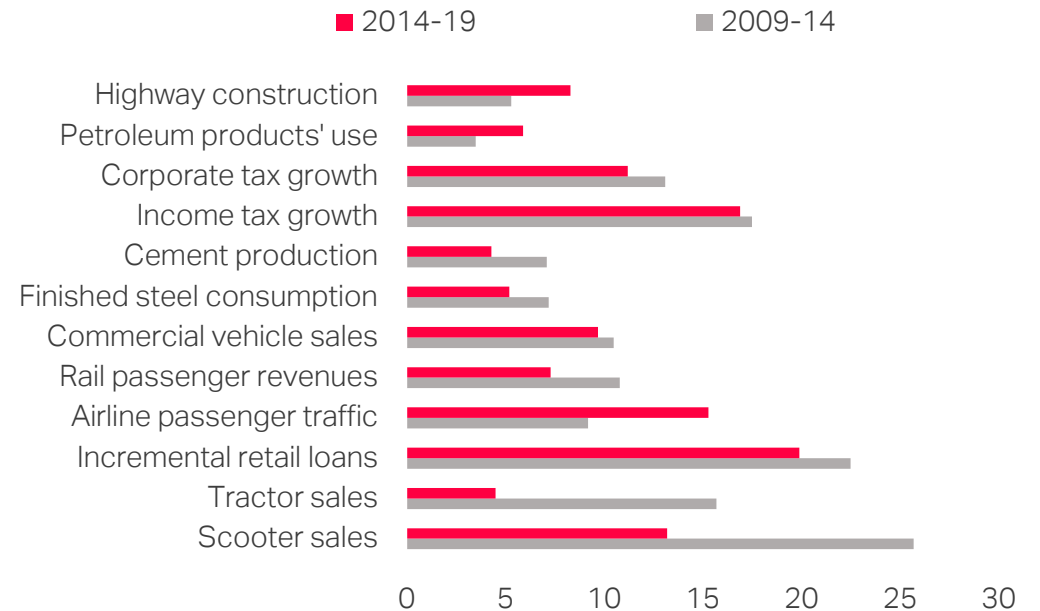
- Revised GDP methodology and past years' data show strong GDP growth under Modi's NDA coalition.
- But most high frequency indicators were more buoyant under the preceding UPA government.
- Domestic growth has historically been closely tied to global growth.
- Modi's campaign focussed on schemes for the poor and national security, not "rapid" GDP growth.

## World vs India GDP growth (%)



Source: Datastream.

## Consumer indicators (avg. growth/ year)\*

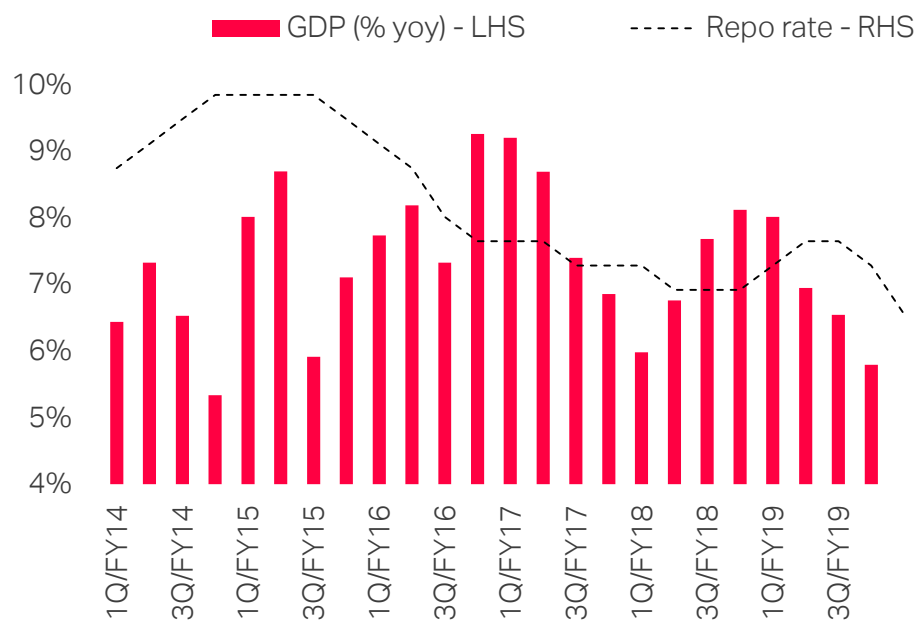


Sources: Centre for Monitoring Indian Economy, India Brand Equity Foundation, Indian Railways, Ministry of Road and Surface Transport, Budget documents, Press Information Bureau, media reports. \*Note: UPA ruled between 2009-14 and NDA government was in power from 2014-19.

# SLOWING GROWTH IS IN NEED OF A BOOST

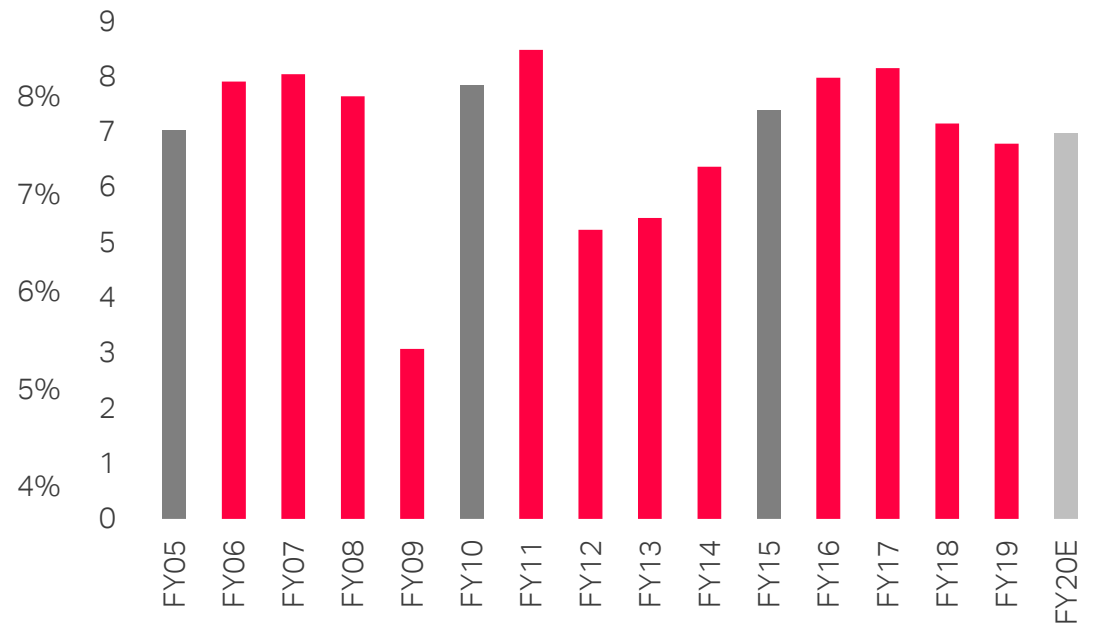
- FY19 GDP growth was the slowest in 5 years due to weak consumer spending, sluggish private investment and relatively lower public spending.
- The onus is on the Reserve Bank of India (RBI) to ease monetary policy and help jumpstart growth.
- GDP growth usually rises in the year that follows an election, providing some optimism for now.

## Quarterly GDP growth vs repo rate (%)



Sources: Central Statistics Office (CSO), RBI, TS Lombard.

## Annual GDP growth (%)\*



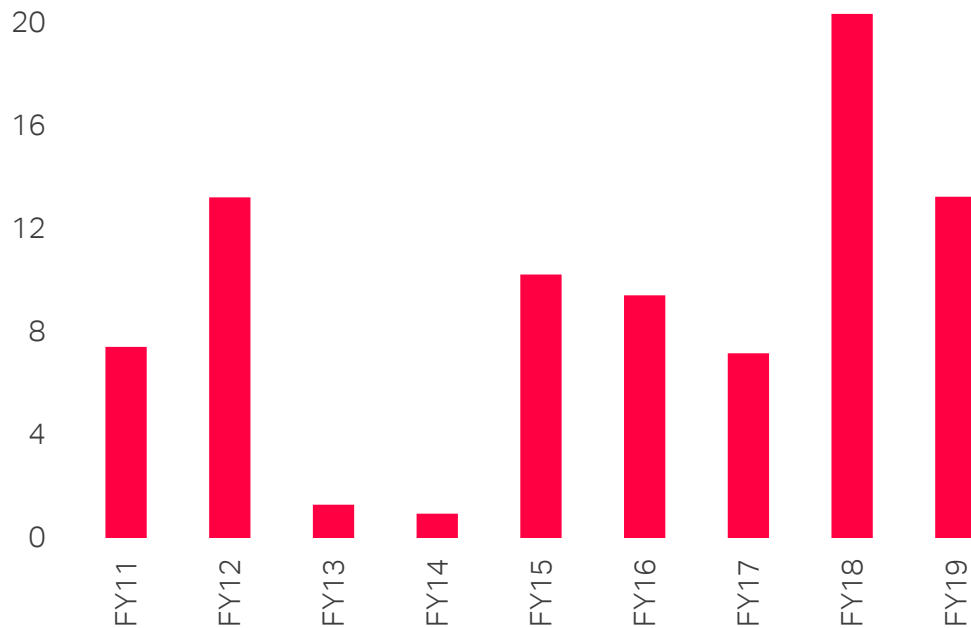
Sources: CSO, RBI. \*Years during which elections are held are marked in grey. FY20 GDP growth forecast is by the RBI.



# GOVERNMENT SPEND IS KEY TO GROWTH

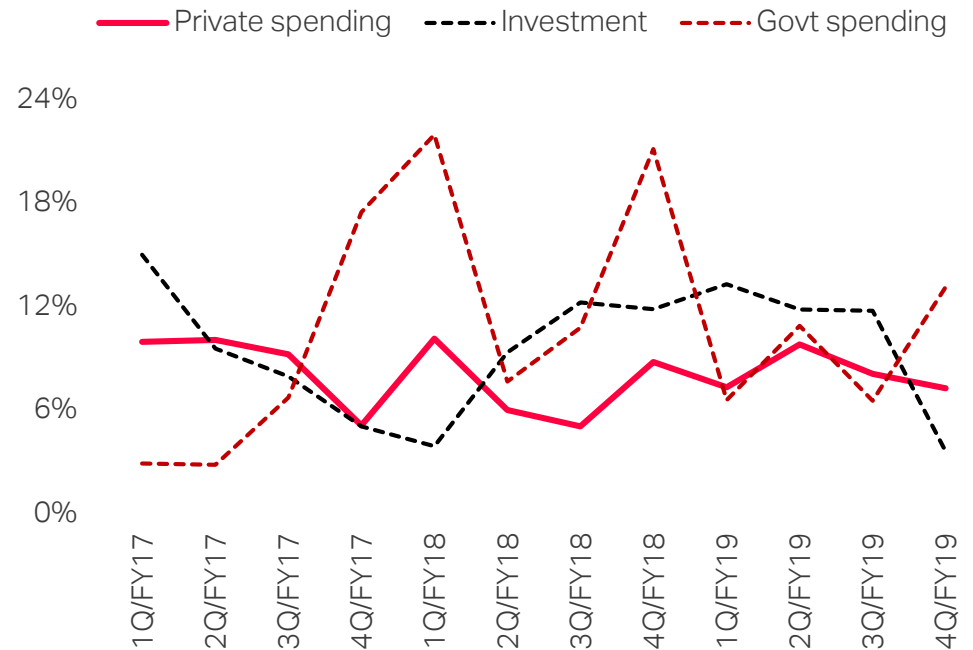
- The role of public spending in supporting growth has increased in recent years.
- Latest GDP data show that government spending was a major growth driver in 4Q/FY19.
- Private investment growth saw a sharp slowdown in that quarter, contributing to slower-than-expected GDP growth.

## Contribution of government spend to GDP growth (%)\*



Sources: CSO, RBI.

## Growth in components of GDP (% yoy)

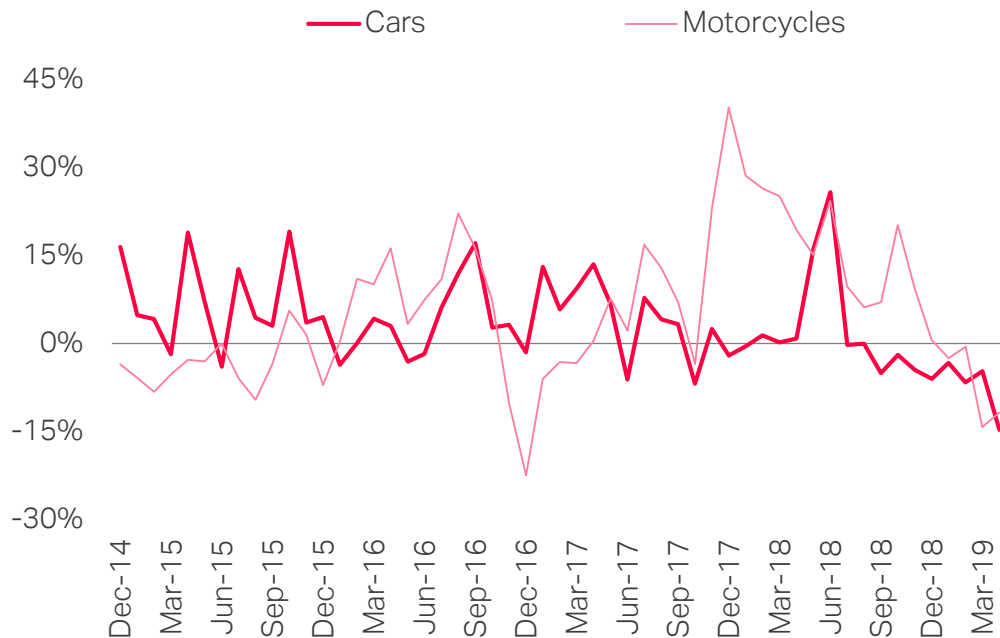


Sources: CSO, TS Lombard.

# WORRY #1: WEAK CONSUMER DEMAND

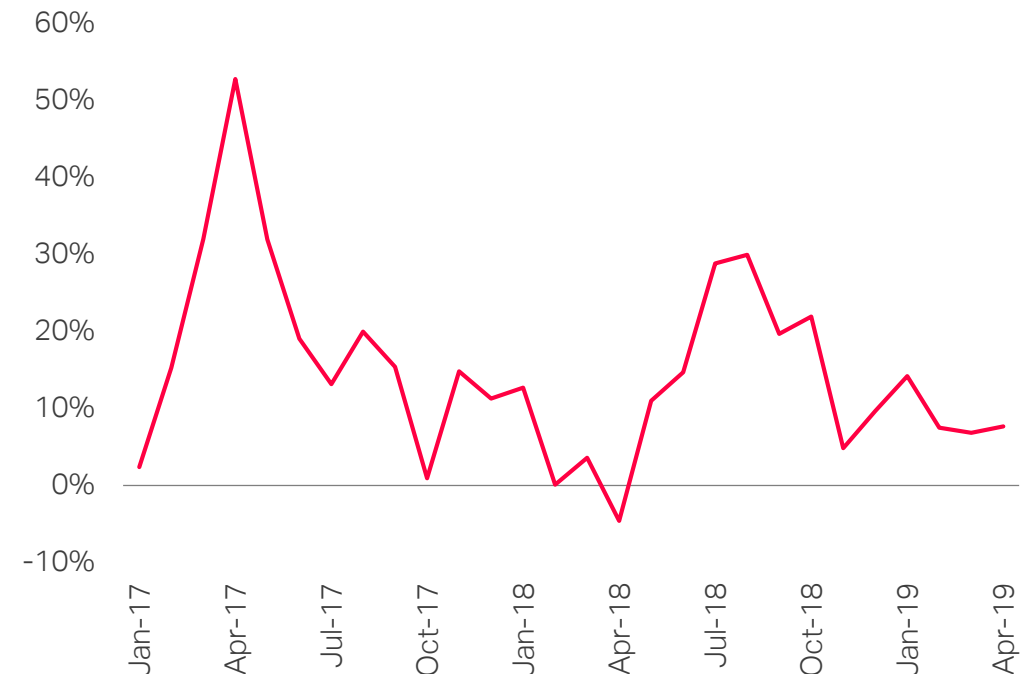
- Consumption is India's major growth driver, accounting for around 60% of GDP.
- The fall in sales of both cars (barometer of urban demand) and motorcycles (rural demand) is unusual; demand is unlikely to return before 2H/FY20.
- For discretionary, large ticket-size purchases, consumers need to be confident about prospects.
- Slowdown in non-oil imports also indicates weak domestic consumption.

## Car and motorcycle sales (% yoy)



Source: Datastream.

## Non-oil imports (% yoy)



Source: RBI.

# WORRY #2: CAPEX REVIVING, BUT SLOWLY

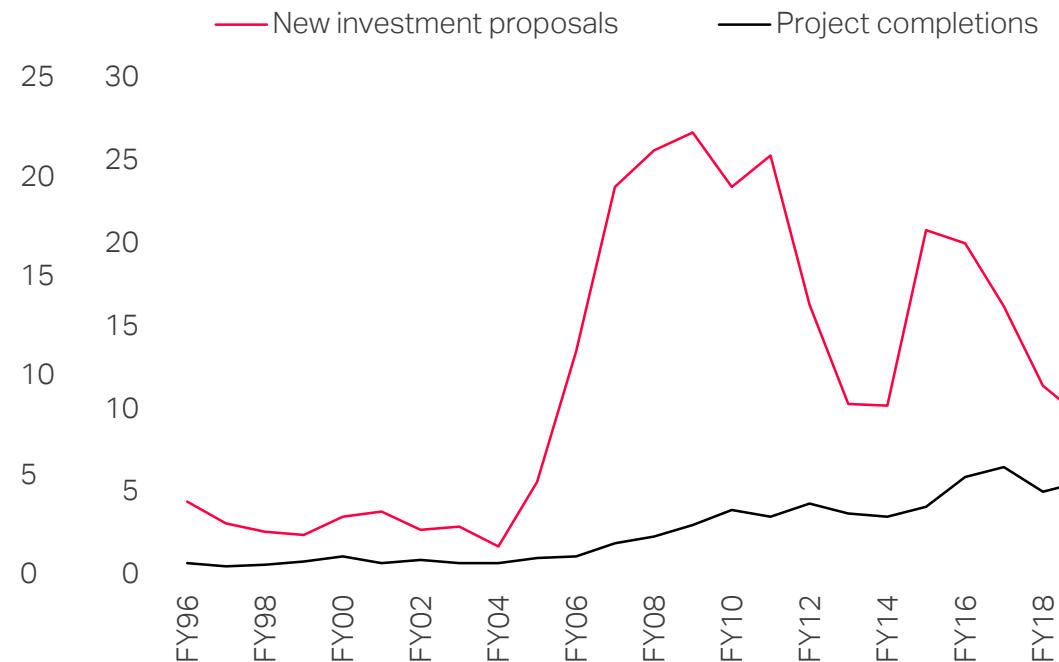
- Private capex growth is reviving but is still relatively subdued due to weak economic demand, underutilized capacity, overleveraged firms and a struggling financial sector.
- New investment proposals fell for the fourth consecutive year in FY19 but completion of projects has increased (mainly due to infrastructure projects in roads, railways, irrigation and real estate).
- Government projects accounted for a little over half the FY19 completions.

## Gross fixed capital formation



Sources: CSO, RBI, TS Lombard.

## Investment proposals vs completion (Rs tn)

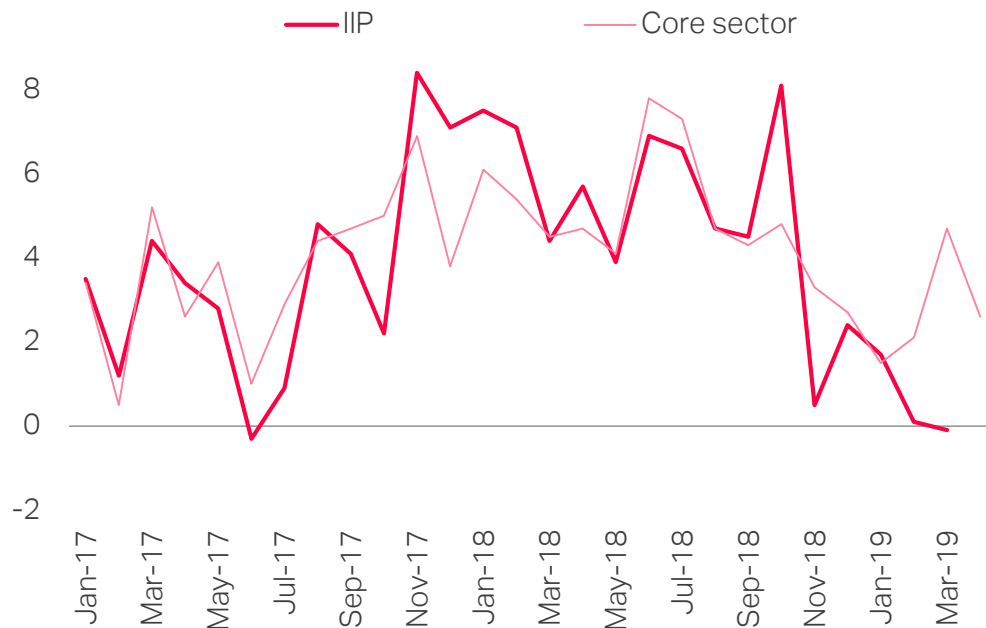


Source: Centre for Monitoring Indian Economy (CMIE).

# WORRY #3: SUBDUED INDUSTRIAL ACTIVITY

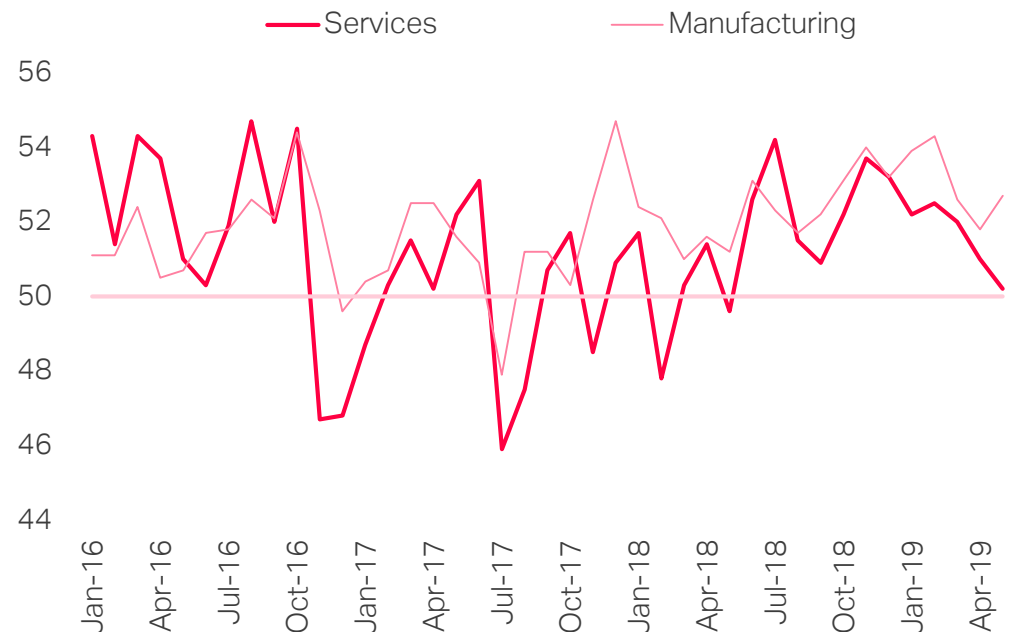
- Industrial output growth was negative for the first time in 21 months in March due to lower production of both consumer durables and capital goods.
- A dip in the April core sector print – which reflects growth in 8 key infrastructure industries and constitutes 40.3% of the IIP – bodes ill for the total industrial output in April as well.
- The privately-collated PMI indexes show that activity in the services sector continued to fall in May although manufacturing picked up.

## Industrial vs core sector growth (% yoy)



Sources: CSO, Office of the Economic Adviser.

## Purchasing Managers' Index

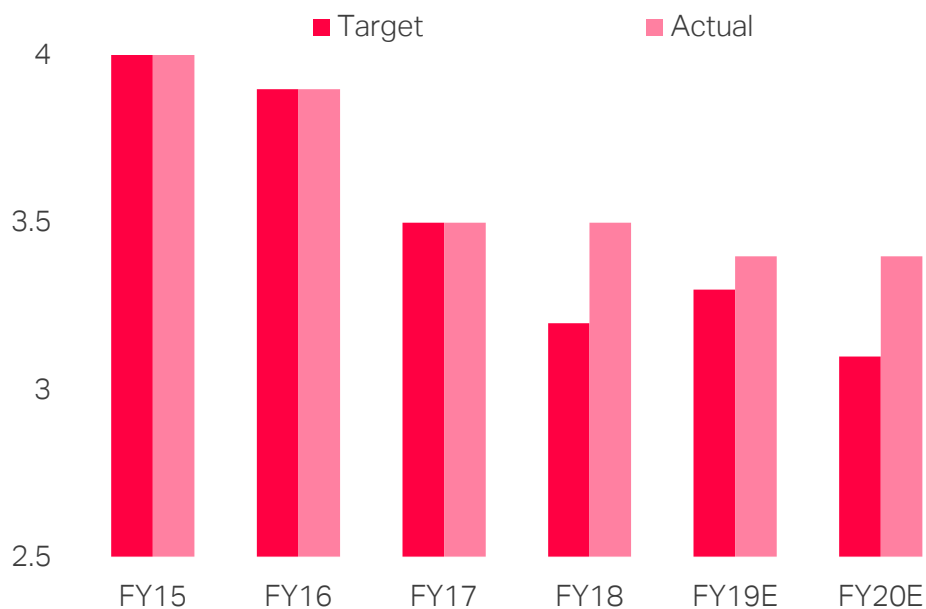


Source: Bloomberg. \*Note: The 50-mark demarcates expansion from contraction.

# WORRY #4: LIMITED FISCAL STIMULUS

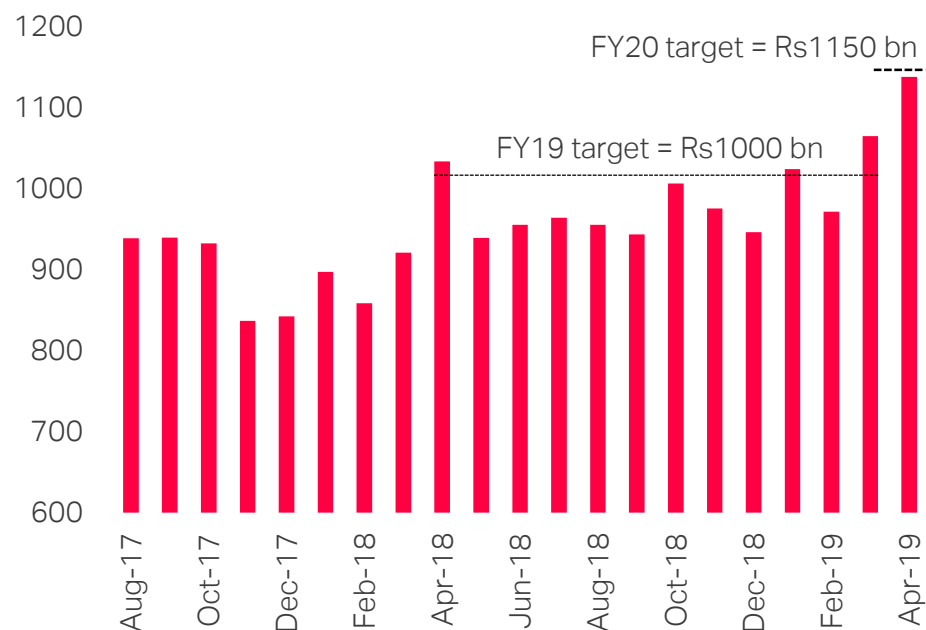
- Fiscal consolidation has veered off its "glide path" in recent years.
- Severe expenditure compression in March helped the government meet its FY19 revised target of 3.4% of GDP but economic growth in 4Q/FY19 took a hit as a result.
- Spending pressures are rising but tax revenues (both direct and indirect) are falling short of goals.
- Modi will likely focus on a mix of welfare policies to boost consumer demand as well as infrastructure spending (construction is an easy jobs generator).

## Fiscal deficit (% of GDP)



Sources: Budget documents, Controller General of Accounts.

## GST revenues (Rs bn)

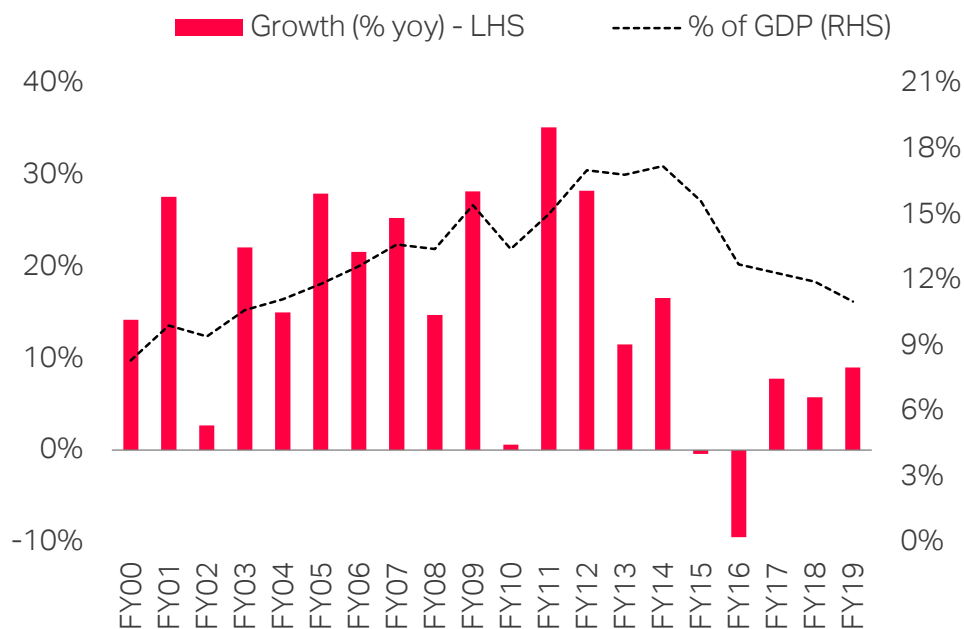


Source: Ministry of Finance.

# WORRY #5: LOW EXPORTS AMID TRADE WAR

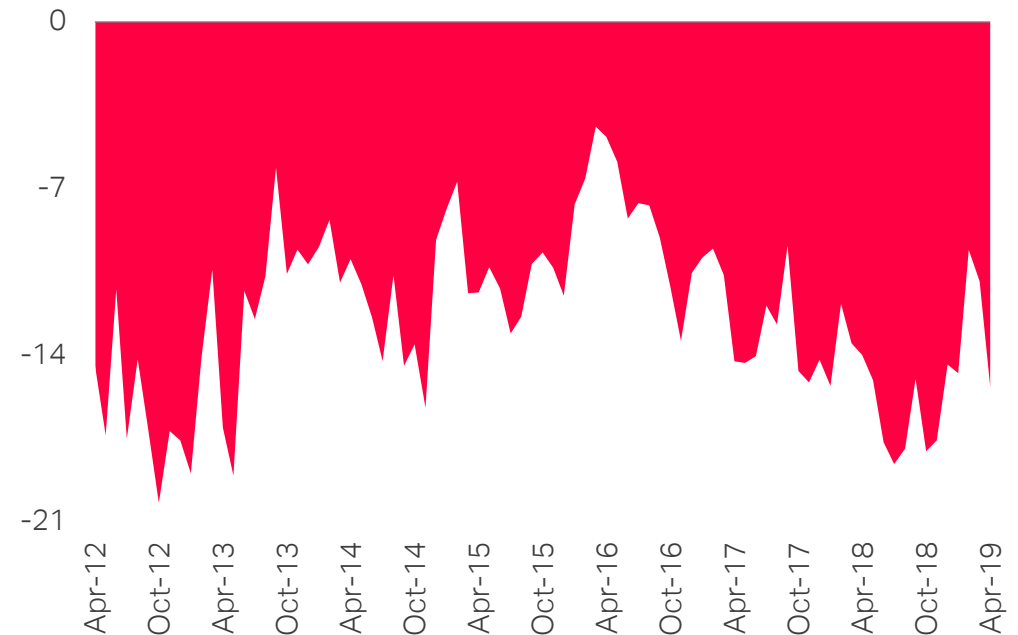
- **Export-to-GDP ratio is at its lowest levels in 15 years, implying loss of global competitiveness.**
- **Worryingly, labour-intensive exports that enable job creation have been falling in absolute terms.**
- **The trade deficit is at its largest in many years and oil price volatility is a structural risk.**
- **Stimulating export growth won't be easy as India generally tracks global trade growth.**

## Export growth



Source: RBI.

## Trade deficit (US\$ bn)

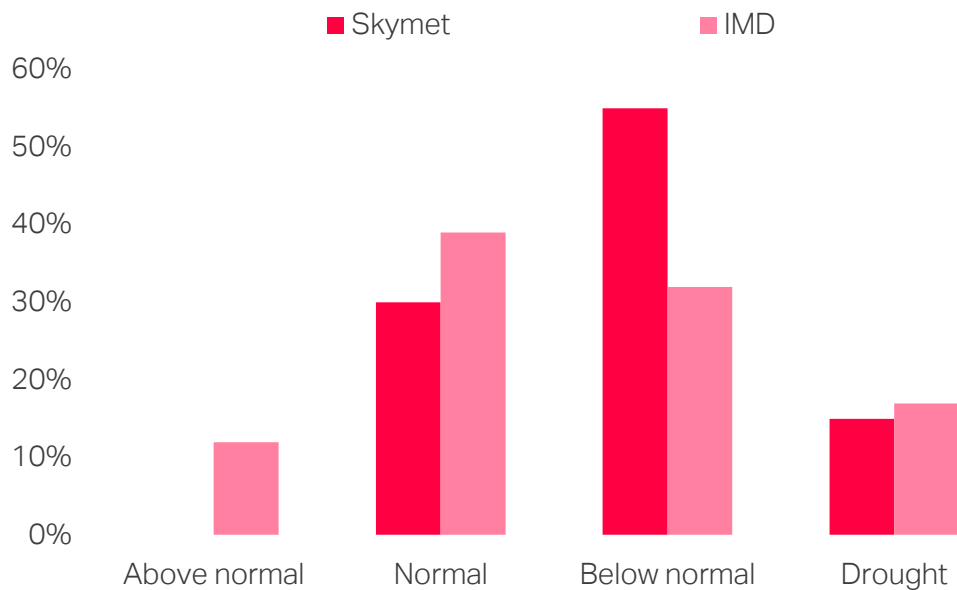


Source: Ministry of Commerce & Industry.

# MONSOON IS A NEAR-TERM RISK...

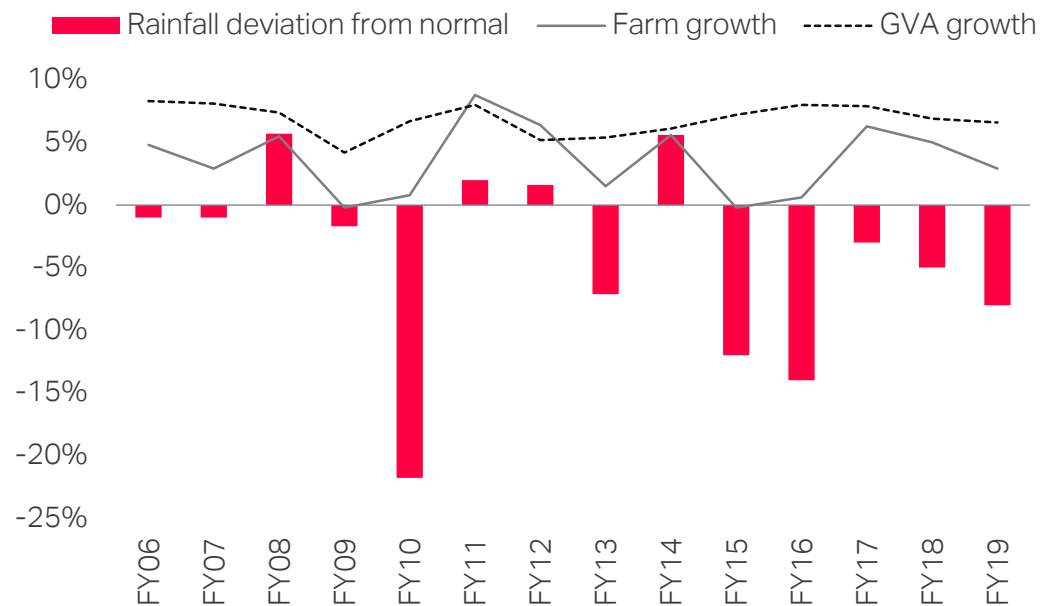
- The state-run India Meteorological Department (IMD) predicts a normal monsoon in 2019.
- But private firm Skymet puts the probability of a below-normal monsoon at more than 50%. Pre-monsoon rains during March-May were 23% below normal.
- A good monsoon is crucial as 42% of India's landmass is already facing abnormally dry conditions. Eight states declared a drought in 2018 after monsoon rains were 9% below normal.

## Probability of monsoon rainfall in 2019



Sources: IMD, Skymet.

## Monsoon rains vs GDP and farm growth

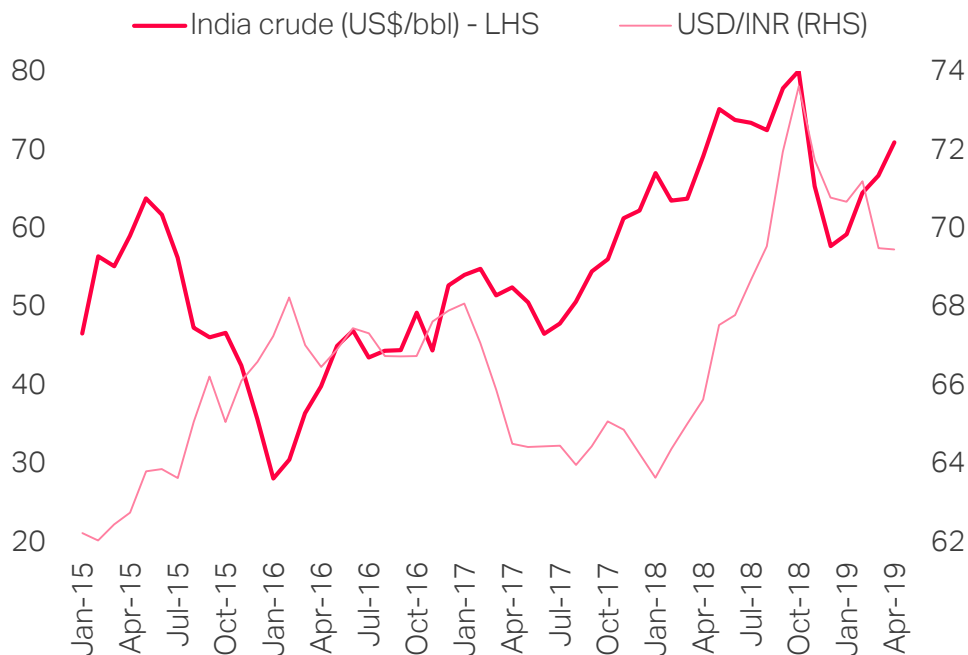


Sources: IMD, CSO, RBI.

# ... AND OIL PRICES ARE A STRUCTURAL RISK

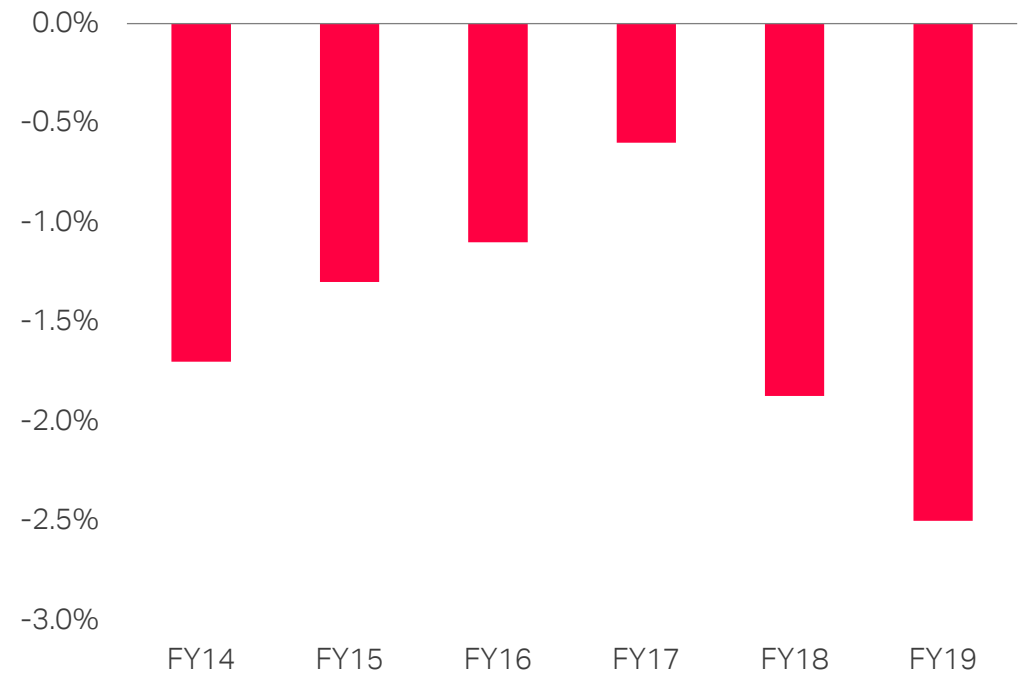
- The price of oil – India's largest import item – determines the twin deficits as well as inflation.
- Just a few months ago, a sharp rally in crude oil prices led to a sharp depreciation in the rupee.
- A drop in oil prices soon after Modi took office in 2014 helped him bring the fiscal deficits as well as inflation under control, and made it easier to deregulate fuel prices. Could Modi be lucky again?

## Oil price basket vs rupee



Sources: Petroleum Planning & Analysis Cell (PPAC), Bloomberg.

## Current account deficit (% of GDP)



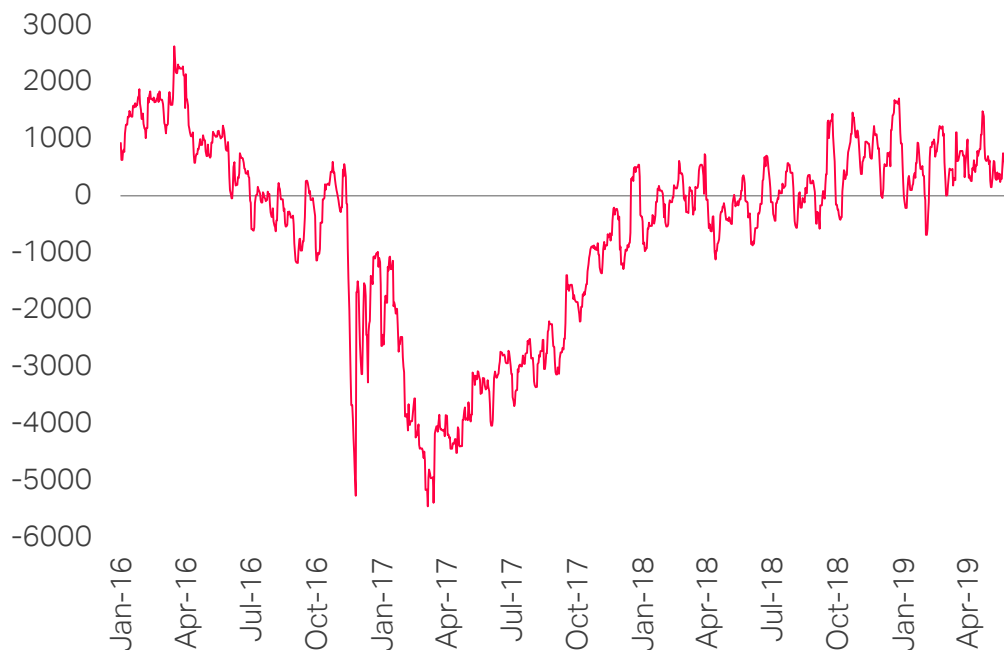
Sources: RBI, TS Lombard.



# THE ONUS IS NOW ON THE CENTRAL BANK

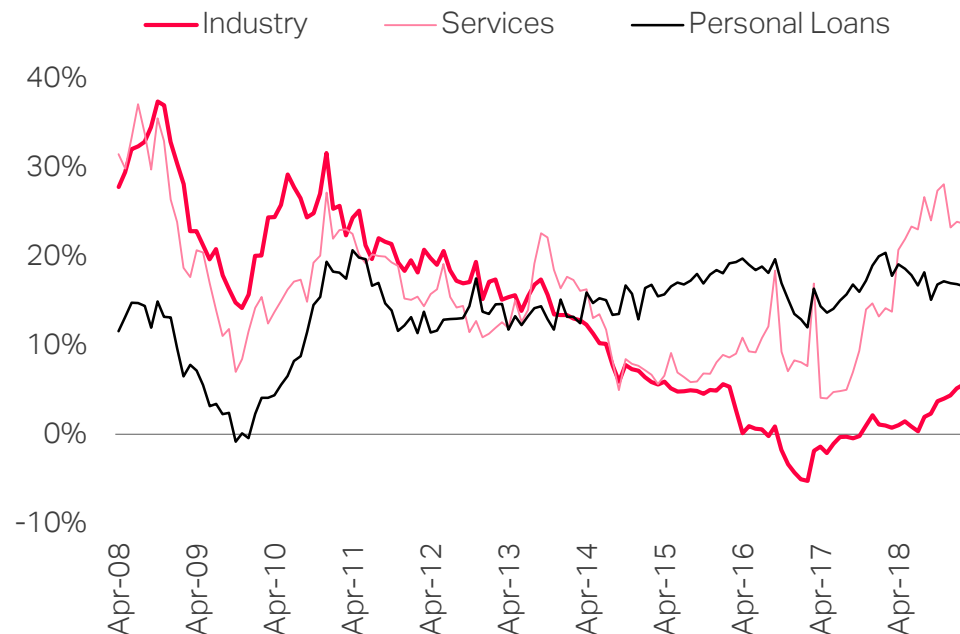
- Poll-related spending, tax payments and credit growth exceeding deposit growth have led to tight liquidity. RBI is taking steps to ease liquidity via OMOs, FX swaps.
- The near-crisis with NBFCs have contributed to slower consumer spending. The RBI plans to tighten norms for NBFCs to avert a future crisis, but this will lead to margin pressures and lower lending.
- Bank credit to the industrial sector remains relatively weak, although loans to the services sector have picked up and retail loans have been healthy.

## Banking liquidity (Rs bn)\*



Source: Bloomberg. \*Note: A positive amount indicates a liquidity deficit.

## Bank credit to major sectors (% yoy)

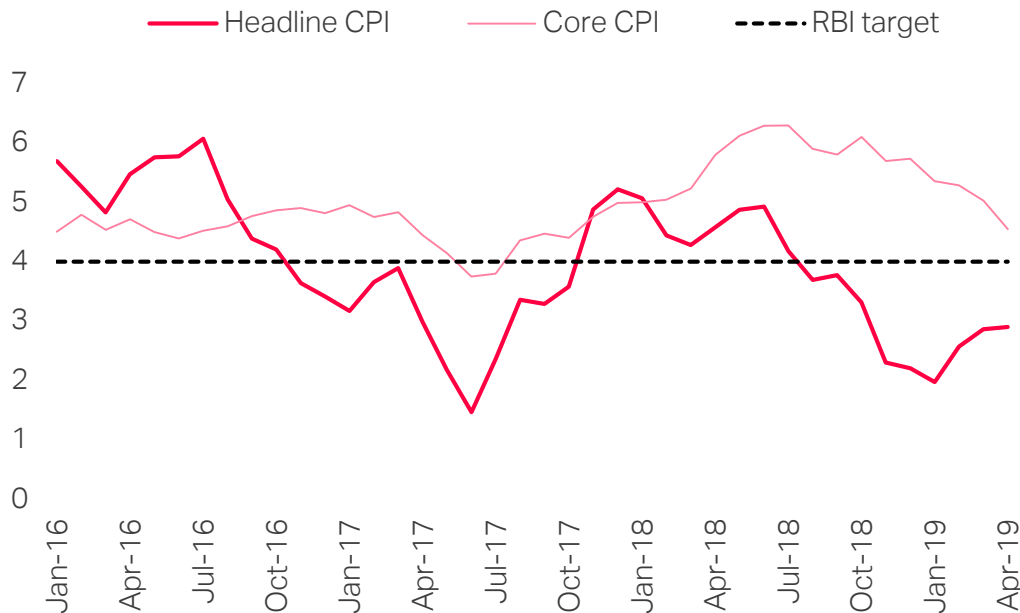


Source: RBI.

# FURTHER MONETARY EASING IS LIKELY

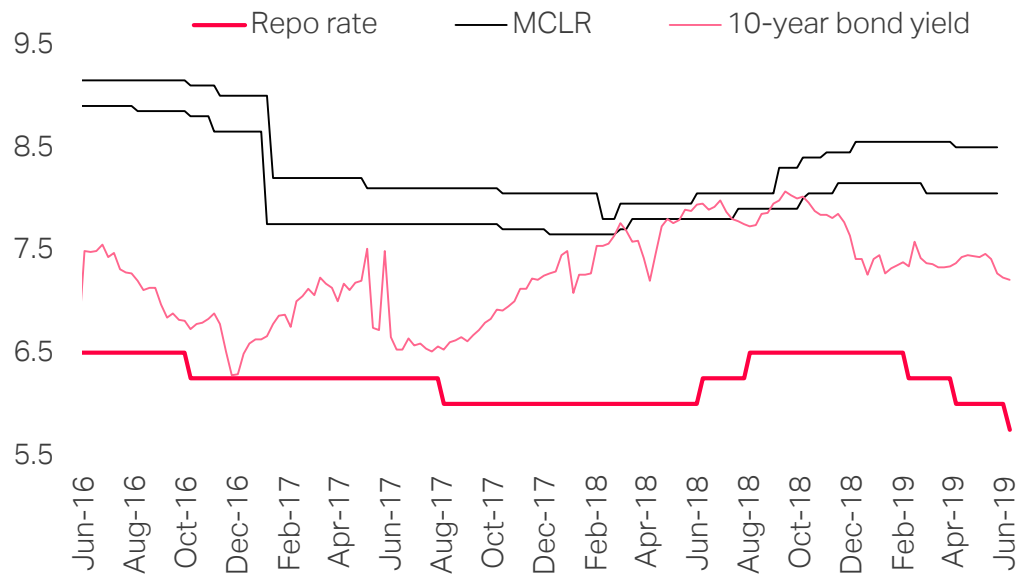
- The Monetary Policy Committee (MPC) cut rates by another 25 bps at its June policy review, citing significant weakening in growth impulses; it has now cut rates by 75 bps so far in 2019.
- The successive rate cuts, the softening in stance to accommodative and efforts to ease liquidity should help prompt commercial banks to lower their lending rates – something they have so far been wary of doing.

## CPI inflation (% yoy)



Sources: CSO, TS Lombard.

## Policy rate vs MCLR range (%)



Source: RBI.

## Global

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### Global Macro

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Daily Note

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Macro Picture

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Global View

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Global Leading Indicators

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Global Financial Trends

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### Global Political Drivers

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Global Political Drivers

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### Strategy

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Asset Allocation

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Macro Strategy

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Strategy Chartbook

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## Regional

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### Watches

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US Watch

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Europe Watch

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China Watch

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UK Outlook

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### EM Focus

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EM Watch

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The GRID

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Brazil

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India

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Russia

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LatAm

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EMEA

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**SE Asia**

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EM View

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### Strategy

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EM Strategy Monthly

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