

Springtime for Modi or an Indian Summer?

*For every complex problem there is an answer
that is clear, simple, and wrong
H.L. Mencken*

*A revolution is not a dinner party
Mao Zedong*

*Don't be stupid, be a smarty
Come and join the BJ Party*

Exasperating. India's failure to arrest its growth slowdown and to address festering bad loan problems, when both have seemed ostensibly relatively easy to resolve, has been, well, exasperating. Especially in the context of Prime Minister Modi's electoral hegemony. Although emphasising *Hindutva* ideology is understandable (if not particularly laudable) in the context of the PM's own activist roots, national renaissance also needs to be built upon strong economic foundations.

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The good news is that the foundations are much improved. Having inherited a beautifully apportioned Victorian mansion that required loving restoration, and having spent a good part of his first term fixing a mess of clogged pipes, fraying lead wiring and rotten floorboards, the edifice is primed for further development.

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As I wrote in "India – (Do you?) Mind the Gap"¹: *De-monetisation, GST, a new bankruptcy code, and a raft of other changes in tandem with the digitisation leap provided by the biometric Aadhar Unique Identity Number (or UID) and India Stack, all promise a far more efficient and inclusive economy.... in the medium-term.* Nevertheless, these words were penned two years ago and indigestion pains remain uncomfortably apparent – especially in the rural and SME sectors. These continue to be aggravated by a serial failure to unblock the plumbing of an impaired financial system that, while challenged, should not be systematically so.

The optimistic case – and I remain an Indian optimist, albeit an increasingly jaded one – is that with a fresh, strong mandate secured, the BJP administration, in tandem with a less adversarial central bank, will now turn its attention to getting credit flowing again and revitalising the domestic investment cycle.

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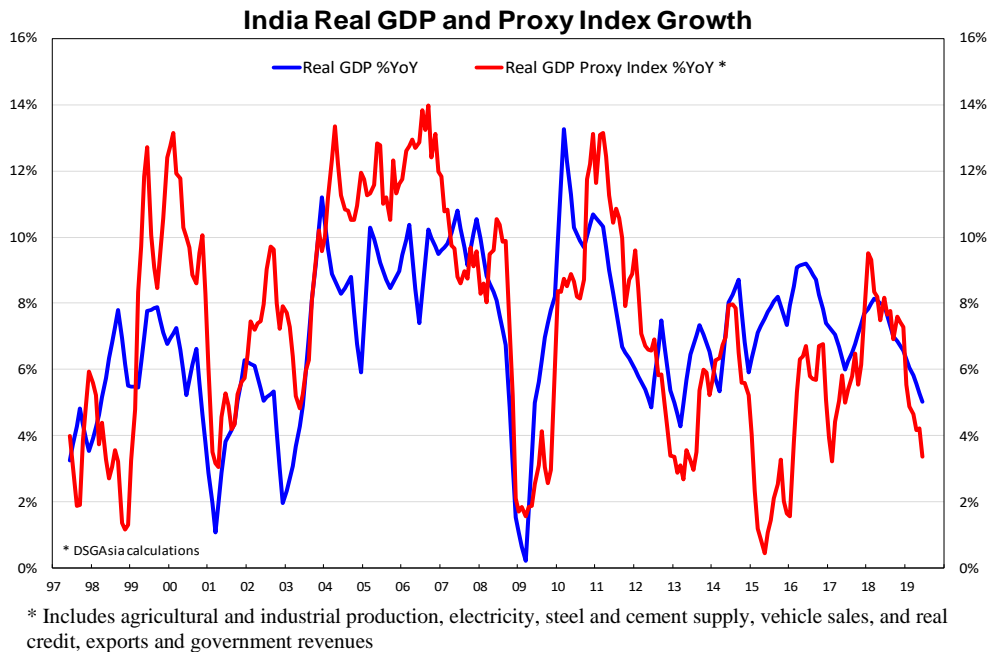
¹ 25th September 2017



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The counter is that although the economy is a lot weaker than potential and the financial system clearly impaired, things are not so bad, especially in the context of the electoral calendar, that grubby matters of economics need to distract from the fundamentally more important ideological agenda. As with other major countries in the region, one is increasingly likely to have to divorce matters of social conscience from economic engagement.

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For much of Prime Minister Modi's tenure, Indian growth has been trending rather lower than the headline numbers might suggest. The government has, not altogether unfairly, claimed that the country's statistical coverage needed to be updated and expanded, but escalating partisanship has fed into a belief, in some quarters at least, that such revisions have been a cloak for rigging the numbers. Irrespective, having appeared to re-converge post the disruptions of demonetisation and the introduction of GST, **DSGAsia's** own (and others') estimates vis-à-vis the official metrics have started to diverge again to the downside (see chart above).

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One might have thought that such a precipitous slowdown in growth – both official and implied – so clearly apparent over 4-5 quarters now, might have focussed government minds rather earlier on matters economic. Especially with an election to win, albeit against an opposition leader with all the utility of an ejector seat on a helicopter. Yet, correct psephological calculi notwithstanding, the macroeconomic policy response remained tepid,

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disjointed and in some cases outright destructive culminating in a collective puke of disgust at the unveiling of the 2019-20 budget in July. Policy responsiveness over the past few weeks has been much improved though. The RBI has delivered additional rate cuts though as I will argue in due course, real interest rates remain arguably too high and there will be more to come. Nirmala Sitharaman, India's Finance Minister, was also bounced into delivering a mini-budget less than two months after her original effort.

The mini budget not only reversed a tax surcharge on portfolio investors but was aimed at delivering at least partial relief to the embattled auto sector and SMEs. The latter have long been complaining about delayed GST refunds and liquidity constraints stemming from the authorities' inability to resolve funding and asset quality constraints across a range of financial institutions – public and private.

Most recently and most radically, the government has announced that it is cutting the basic corporate tax rate from 30% to a 22% rate more in line with that prevalent in other Asian economies. Greenfield manufacturing is to receive even more favourable treatment with tax rates plunging from 25% to 15% on establishments incorporated after 1st October which begin production by 31st March 2023. Modi has talked a good game about “Made in India” since he came to power but there has been scant evidence to date of much delivery outside of certain areas of capital-intensive manufacturing. Nevertheless, as I argued last year in “ASEAN's chance to get back in the game”²: *Out of the dysfunction that currently passes for US-China relations, the ASEAN economies, and those of the Indian subcontinent, have a real opportunity to exploit a recalibration of global supply chains that only seems likely to accelerate.* To be sure, tax rates alone will not stimulate mass hiring and investment in labour intensive industries since other areas of absorptive capacity³ (to which I will return later in this missive) need to be expanded concomitantly. Yet the signal of intent is a strong one.

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To be sure, tax rates alone will not stimulate mass hiring and investment in labour intensive industries since other areas of absorptive capacity need to be expanded concomitantly. Yet the signal of intent is a strong one.

² 14th November 2018.

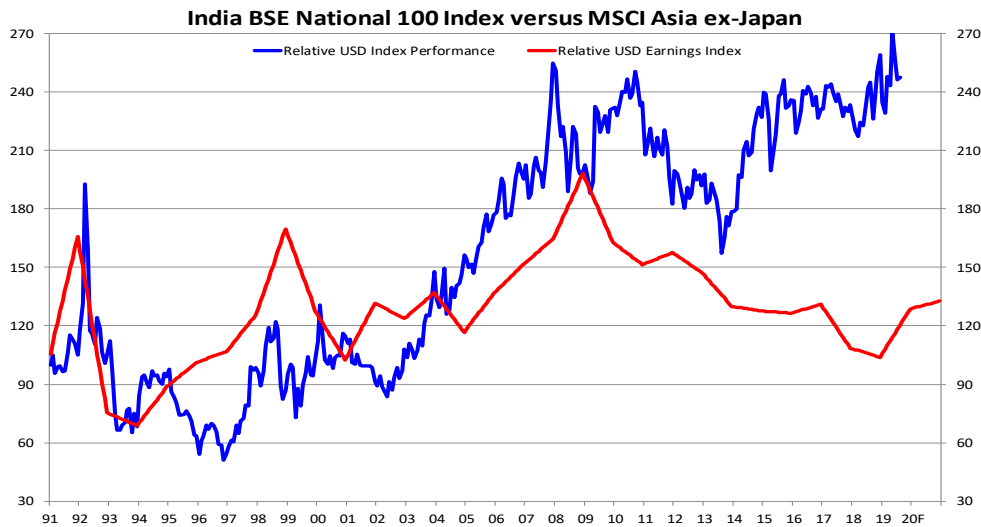
³ At the physical level absorptive capacity argues for sufficient provision of ports, roads, power, communication networks, as well as the ability to secure usable land for operations. However, while physical infrastructure is a necessary condition, it has to operate in tandem with the requisite human capital. This, in turn, is a function of both education and training, and labour laws that while offering necessities of worker protection, also encourage companies to hire in the first place. Finally, the greater the certainty in contract and security recourse available, the greater the likelihood that long-term capital will engage.



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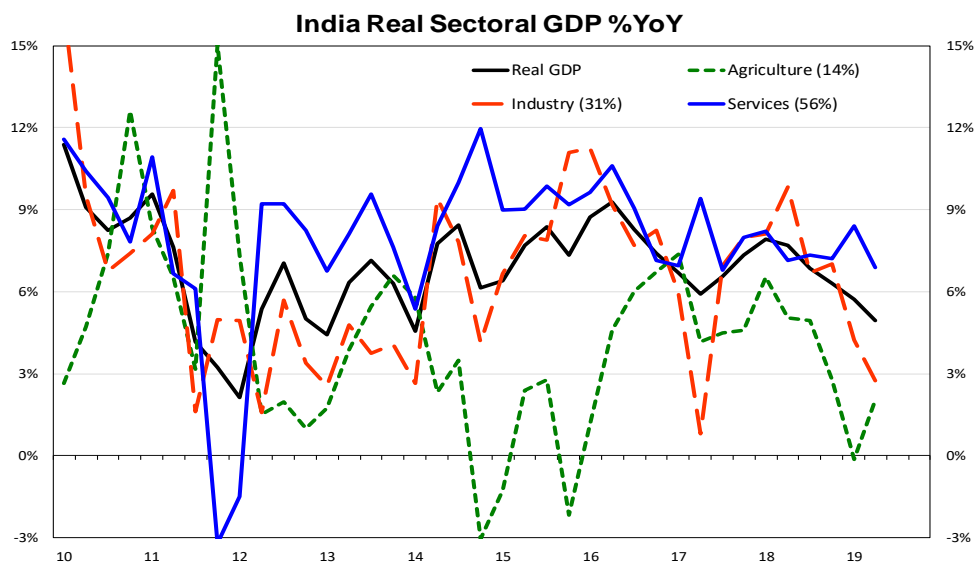
Prime Minister Modi was voted into office in May 2014 and, since then, Indian equities have been on a relative tear, despite his lofty words and visions failing largely to translate into improved headline economic and corporate earnings growth. In essence, rather like your author (who has p.a. been more than happy to be wrong in expecting economic recovery), hope has continued to trump experience.

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The biggest and most persistent drag on growth, as illustrated by the chart below, has been agriculture. Although these days this sector comprises only 14% of total output, around 70% of Indians still reside in rural areas of whom only a third are in formal employment.

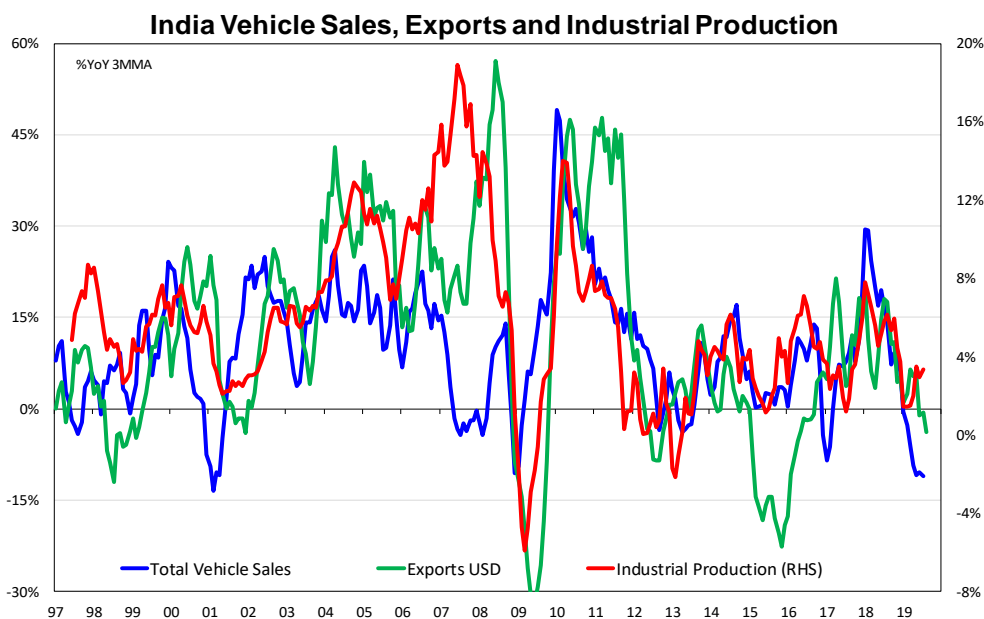
The biggest and most persistent drag on growth has been agriculture



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I make no claims whatsoever to be an India rural expert; *prima facie* though, it has been hit by a Lemony Snicket-like series of unfortunate events. The litany of woe includes: a long run of sub-par weather;⁴ persistently low food prices (a boon for urbanites and inflation control, terrible for rural incomes), the outgrowth of better production numbers yet still antediluvian distribution and logistics networks; and the disproportionate disruption to the less formalised economy from demonetisation and more recent stress in the non-bank financial corporation or NBFC sector.

The rural sector has been hit by a Lemony Snicket-like series of unfortunate events



Agricultural woes have been compounded more recently by near-recessionary industrial conditions. As the chart above shows, while exports cratered in 2015 in tandem with a collapse experienced globally, domestic activity, at a time when the credit mechanism was unimpaired, was less adversely impacted. The current export drawdown has been rather less torrid but has occurred in the context of a badly constipated financial system delivering a far more synchronised industrial downturn. Tax cuts, in the absence of a resolution of the festering non-performing loan problem and sputtering financial intermediation, is unlikely to deliver quite the bang hoped for.

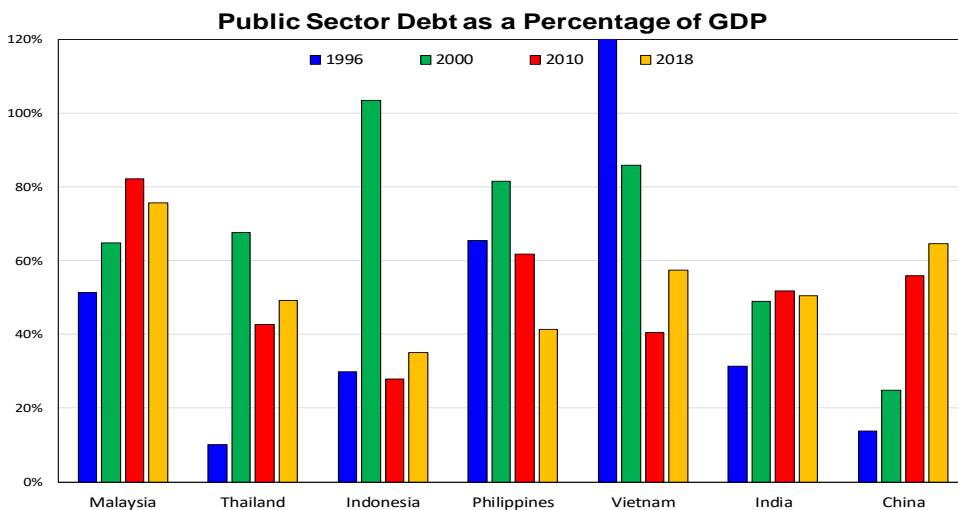
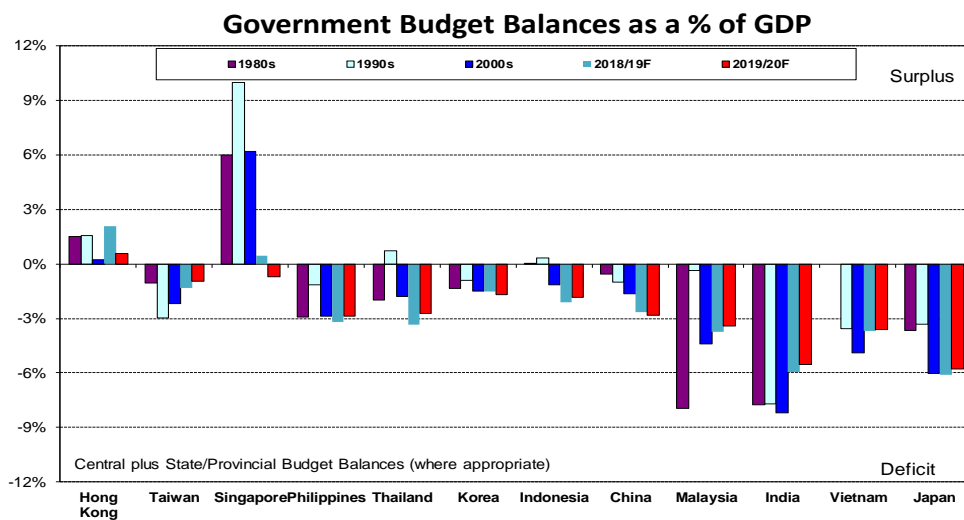
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⁴ Indian monsoons have recorded deficit rains every year since Modi took office and more generally: <https://www.downtoearth.org.in/news/water/india-had-a-deficit-monsoon-in-13-of-the-last-18-years-61772> Forecasts for 2019 suggest another shortfall is in the offing.

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The fiscal bet is that lower headline tax rates will re-stimulate investment and pay for themselves without blowing out the deficit. The Indian equity markets have been more than happy to buy into this narrative; the bond markets have been rather more circumspect. As the charts below show, India has always run sizeable consolidated central and state deficits (granted the profile has improved in recent years),⁵ yet thanks to a combination of robust nominal growth and generally decent monetary policy conduct, public debt ratios have remained relatively stable and under control.

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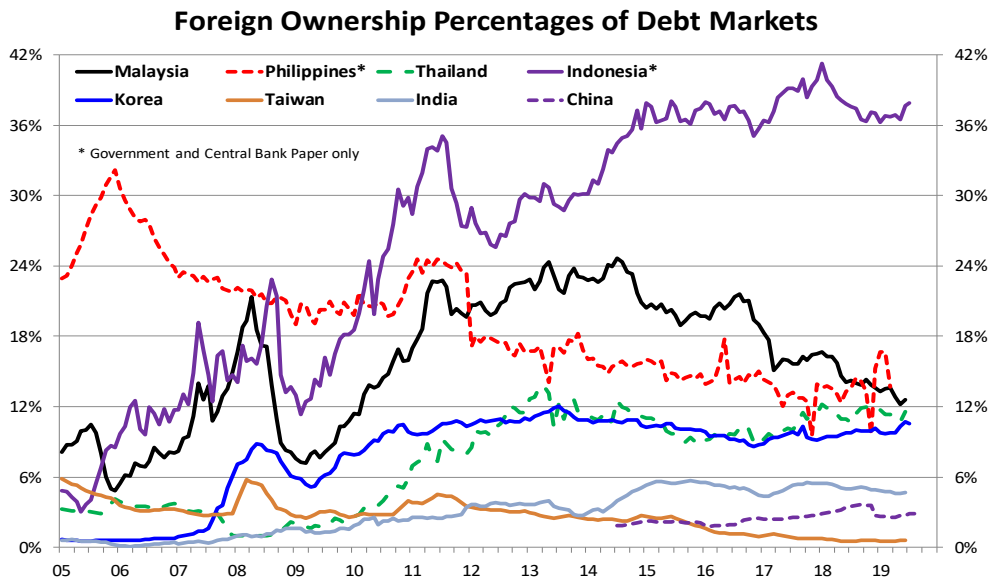


⁵ Indeed, India has never recorded a surplus in any year since independence. The again, France's profile over the past 70 years has been little better.

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The Indian government has always benefited from having a large and captive audience for its debt. As the next chart below shows, there remains plenty of scope to increase foreign participation in the bond market should the desire be there. The government had also been toying with issuing sovereign foreign currency bonds for the first time, the idea of which had been conceptually well received by international investors. Of course, too much foreign currency debt can be a killer but zero, in the context of the global reach for yield, is probably not maximising capital efficiency. For whatever reason, the authorities demurred but the window remains open.

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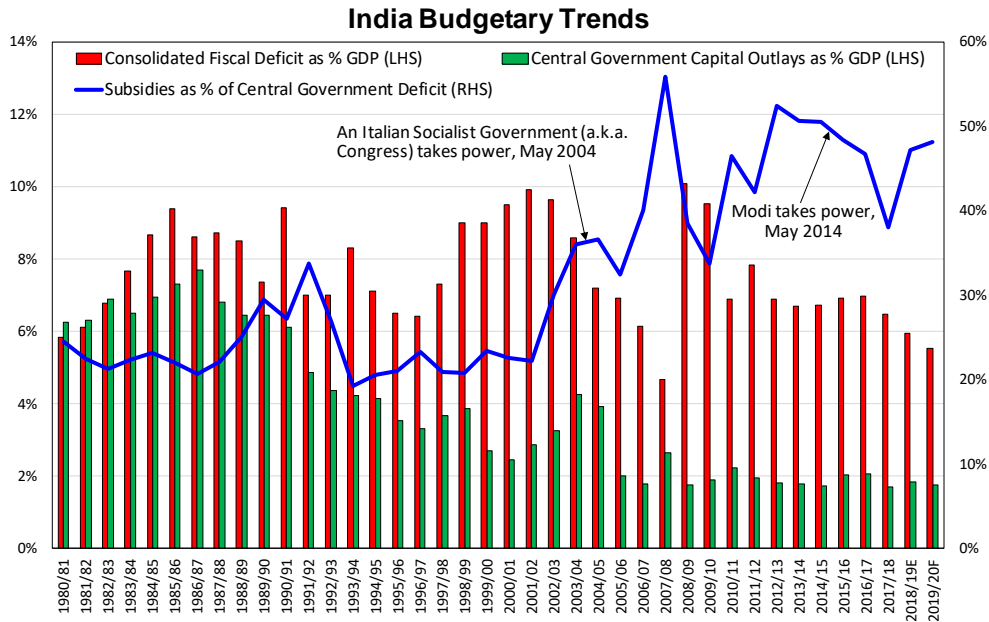


My guess is that the markets will generally tolerate a little fiscal slippage both if they expect better growth prospects, and if the authorities are seen to be prioritising capital outlays and cleaning up the financial system. The Congress government that preceded the current administration concentrated its fiscal fire on ramping up subsidies and handouts. These can be exceedingly hard to take away once implemented so it is understandable that Modi has been reluctant to be seen to be paring back popular, albeit wasteful, headline disbursements. Nevertheless, his administration *has* had some success, building on the *Aadhar* system introduced by its predecessor, in stemming at least some of the leakage (see chart overleaf).

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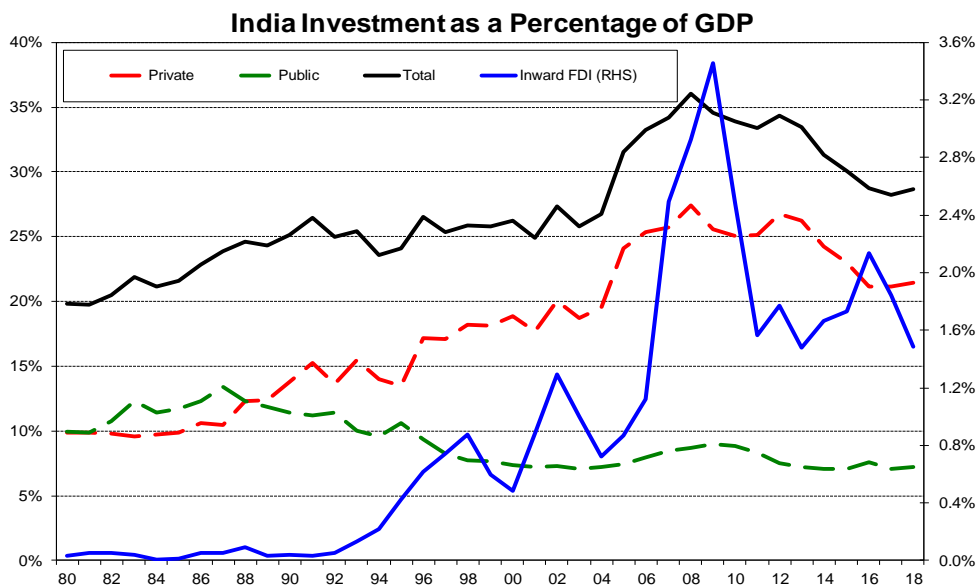


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The “quality” of the fiscal deficit had been on an improving path, at least until the latest election year. However, government capital outlays have disappointedly failed to be mobilised by the fiscal room created while, over the same period, private domestic capex has also weakened. FDI, far less subject to domestic financing constraints, has held up better, but even here, recent trends have been rather less encouraging.

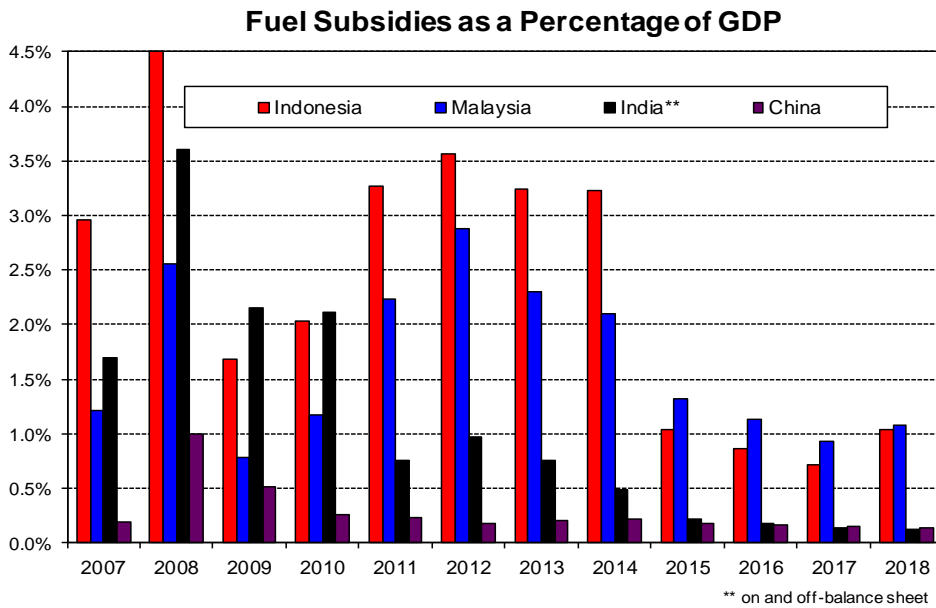
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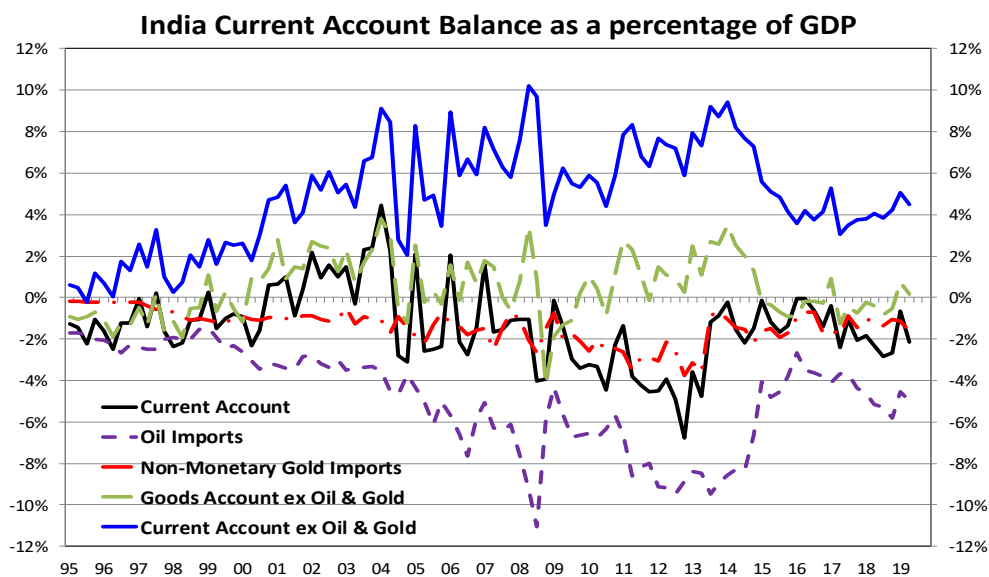
The one area of government subsidy all but eliminated has been that on fuel. Indeed, Asia in general has made significant strides in detaching budgetary outlays from movements in international energy prices.

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Should the recent resurgence in oil prices be sustained, it *will* likely deliver a re-deterioration in India's current account deficit. Yet with domestic demand so weak, any widening should be relatively mild in the context of a deficit largely covered by inward direct investment flows.

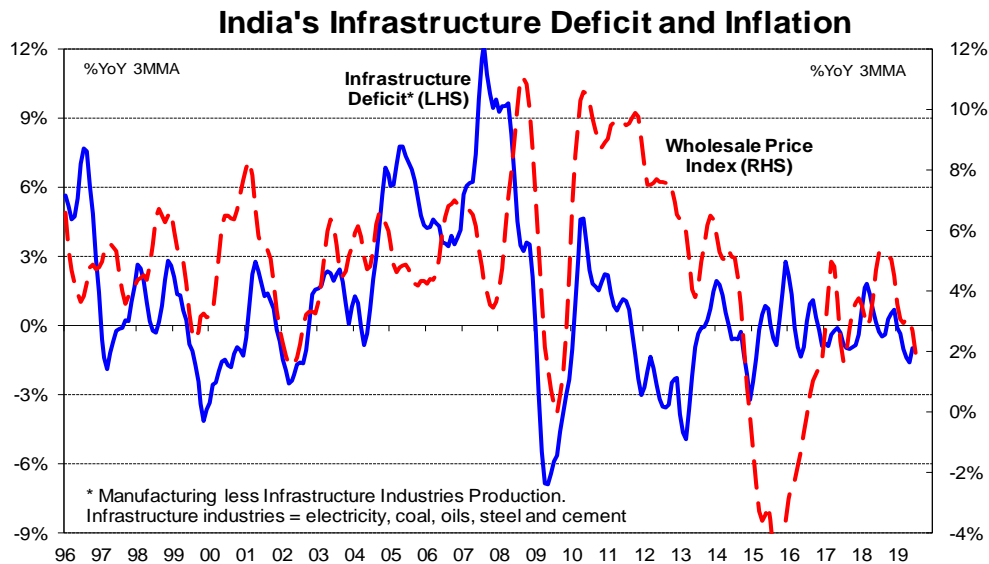
The smallest current account deficit is largely covered by inward direct investment flows



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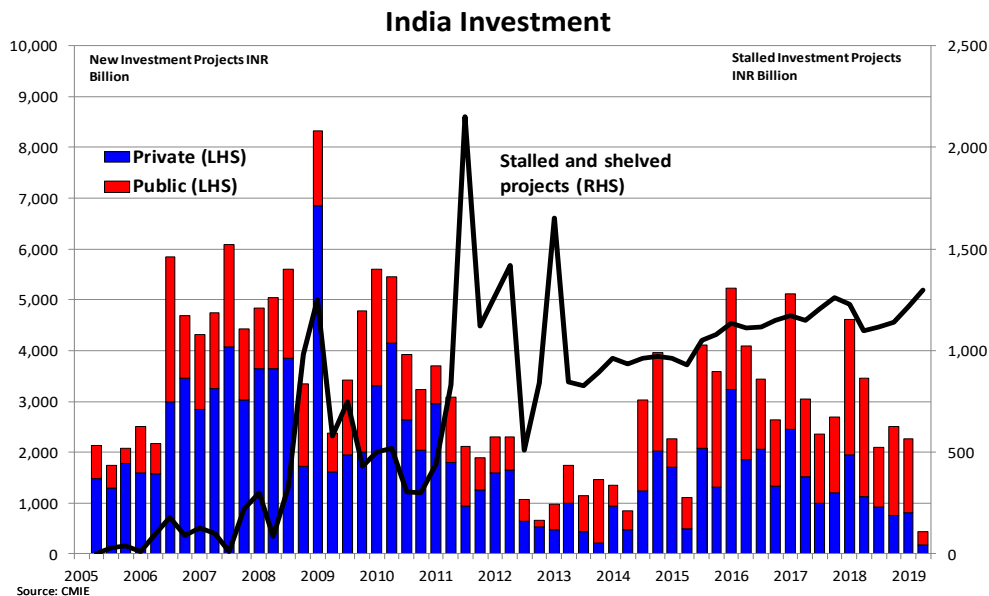
Although higher oil prices can now feed more directly and immediately into local inflation, excess capacity and weak demand should moderate any pass through.

Excess capacity and weak demand should moderate any oil price pass through



Assuming aggregate savings rates remain unchanged, any recovery in the moribund investment cycle would also be reflected in a “good” deterioration in the current account balance. The chart below, sourced from the excellent Centre for Monitoring the Indian Economy’s regular capex surveys, suggests that the pipes remain firmly blocked for now.

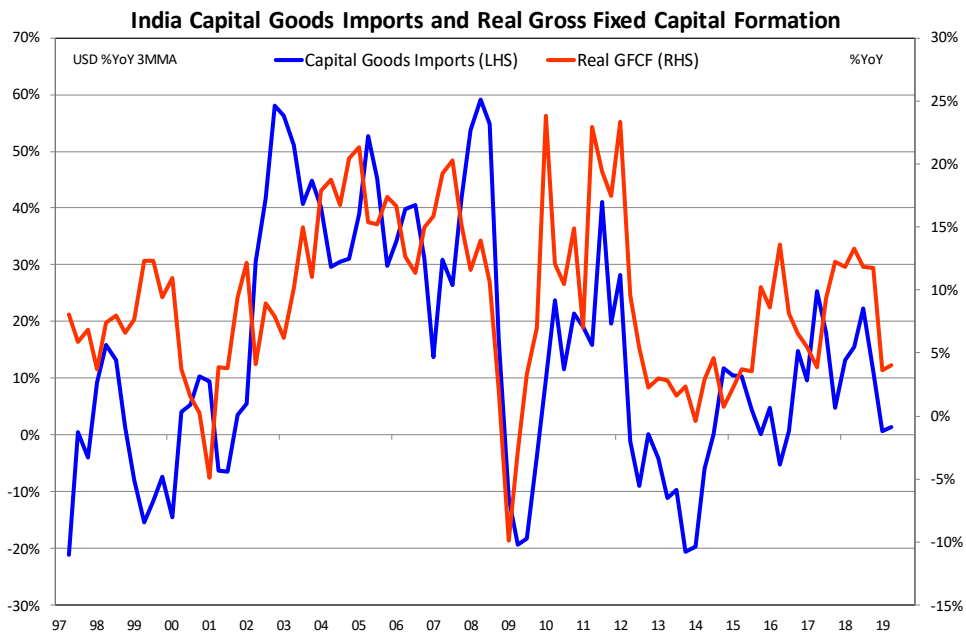
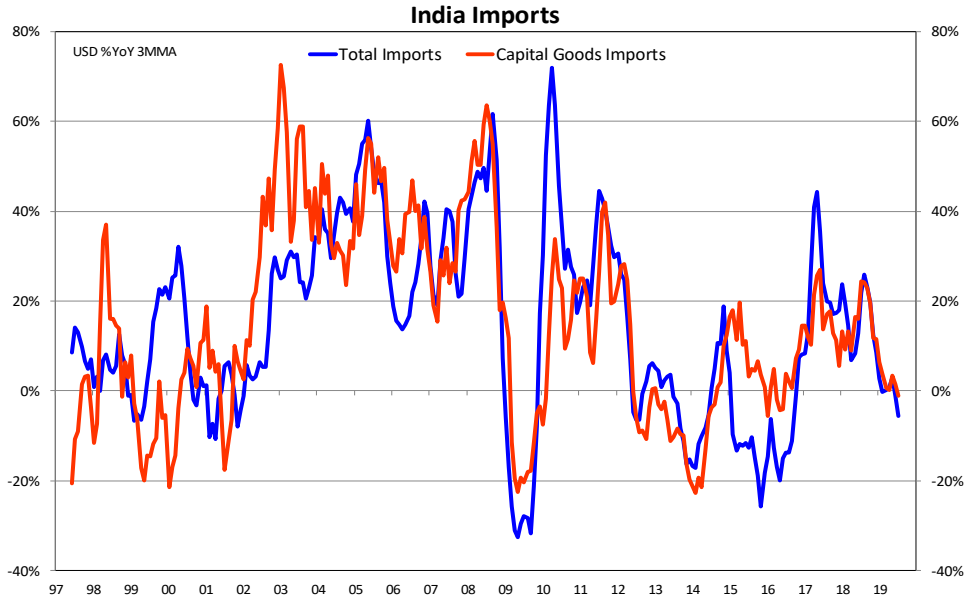
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Unfortunately, import trends are signalling little immediate capex respite.

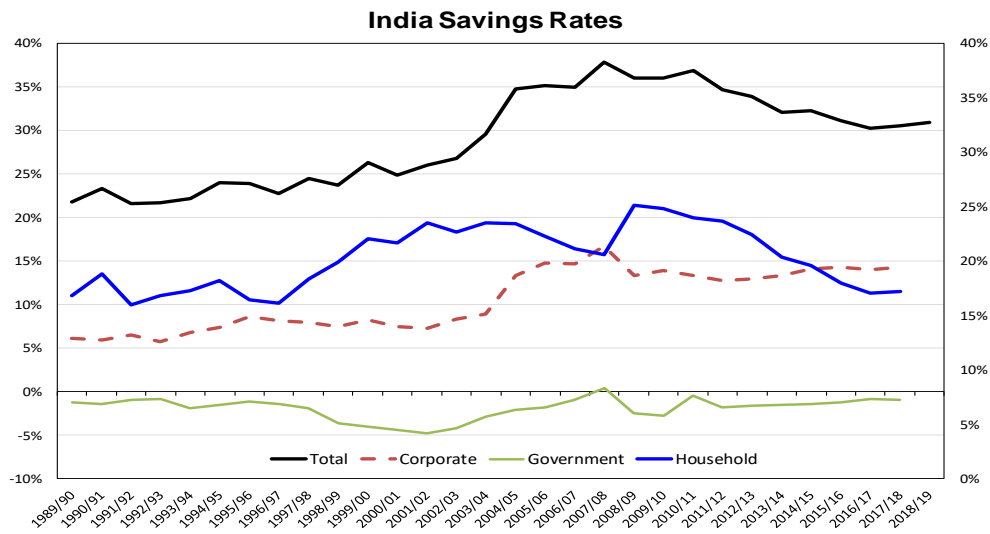
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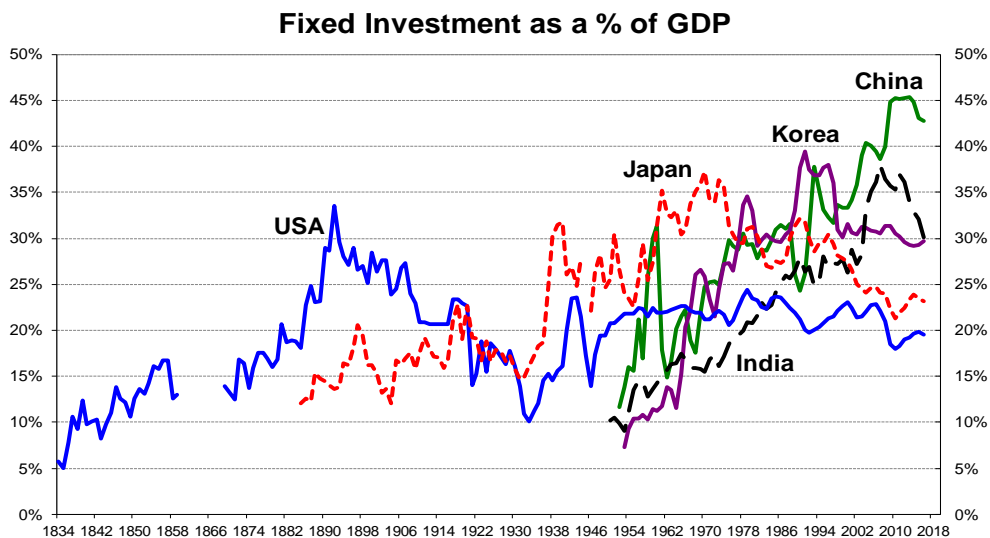
Indian savings remain more than respectable but have been led lower by the household sector in recent years. One should note that the seemingly stable corporate measure would tend to cover only larger businesses operating in the formal sector. Unincorporated smaller rural and urban businesses, which have been disproportionately impacted by demonetisation and the introduction of GST, would tend to be captured in the household category.

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The impacts of these disruptions should dissipate over time and, one hopes, credit flows will be restored. Hence, the savings rate should be able to return to nearer the 40% level that would accommodate a higher investment rate without blowing out the current account deficit.

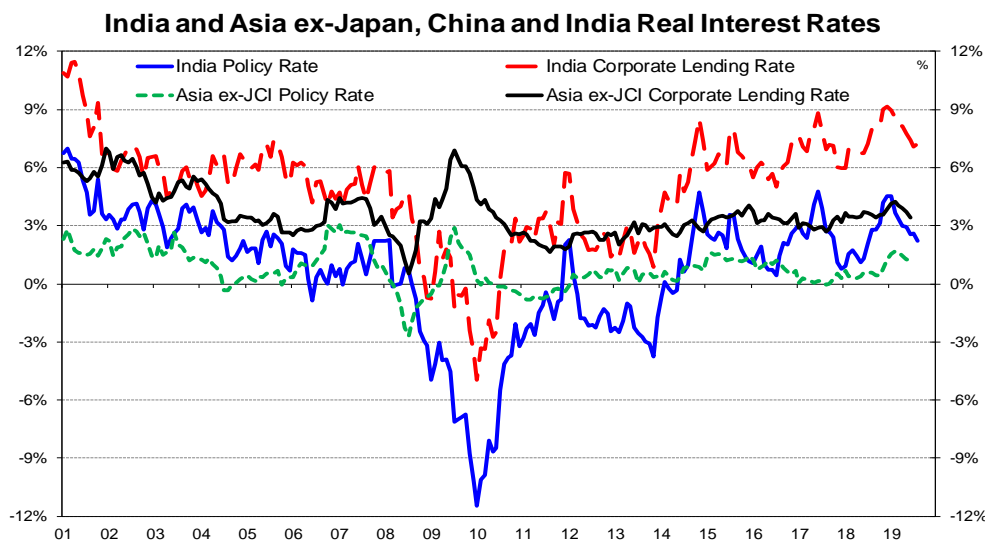
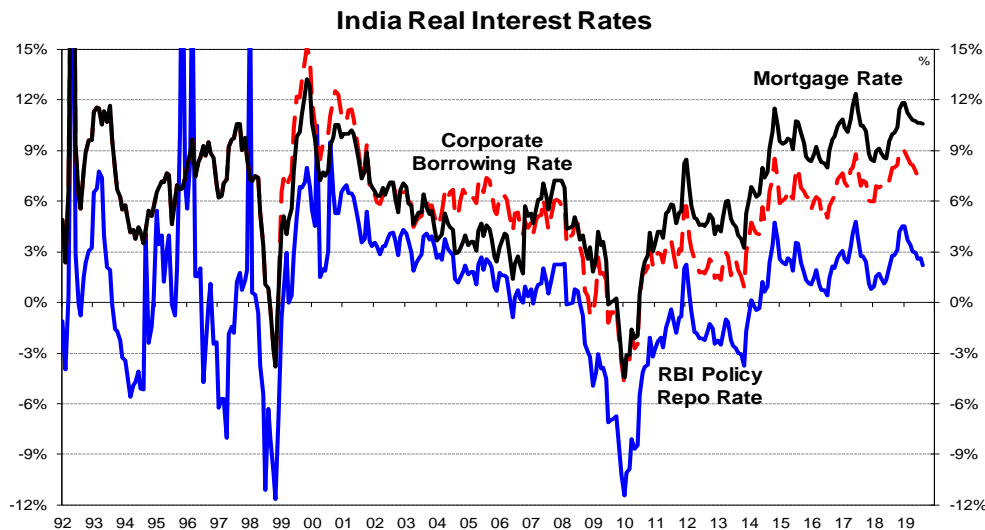
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Turning to the monetary transmission mechanism, it is no secret that relations between the Reserve Bank of India and its political masters have been rather fraught in recent years. Central bank independence, rather like Western civilisation according to Mohandas Gandhi, would seem to be a good idea. In practice, if not exactly slaves to the politicians, then central bankers have become increasingly subservient to the whims of financial markets, undermining the creative destruction mechanism so central to capitalism, and underwriting serial moral hazard and bubble blowing. The RBI has been a notable outlier yet arguably has been guilty of being both overly restrictive and slow to act to ameliorate liquidity crises. With real borrowing costs so high, it is no wonder the government has grown increasingly disgruntled.

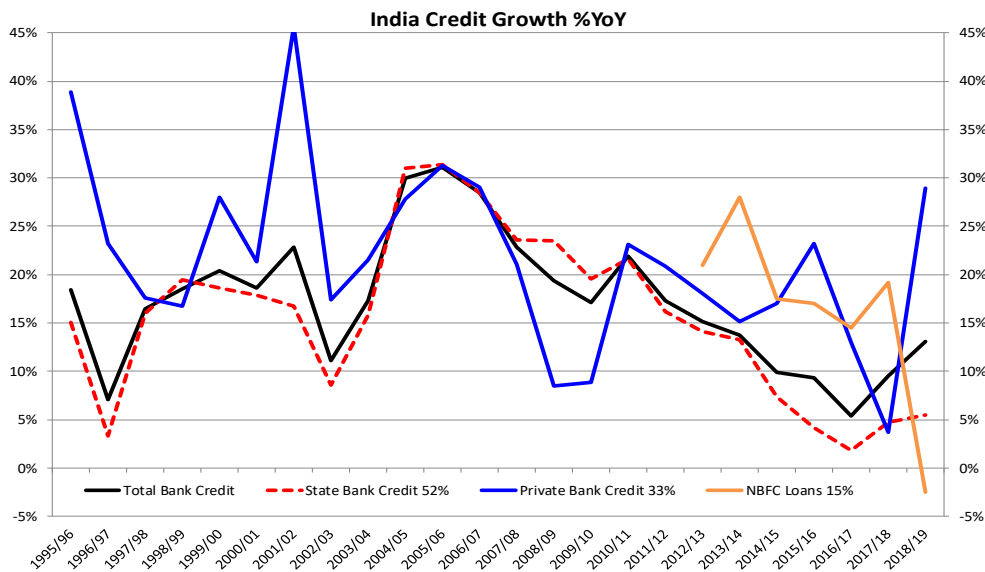
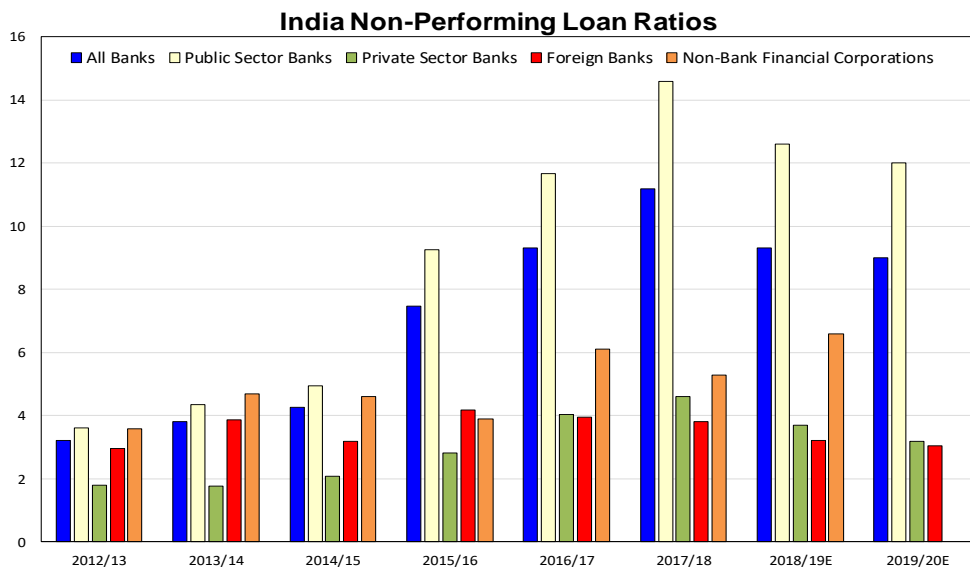
With real borrowing costs so high, it is no wonder the government has grown increasingly disgruntled with the RBI



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The government has not helped its cause by being slow to address a festering non-performing loan (NPL) problem, largely residing in the public sector banks (PSBs). Total system NPLs still total around USD140 billion, or nearer USD200 billion if one accounts for “restructured” loans, many of which have merely been evergreened rather than fully resolved. The PSBs account for around USD100 billion of this NPL pile even after having received around USD40 billion of government capital injections over the past three years. Yet loan disbursements have remained highly constrained while there has been scant evidence of improved operational efficiencies.

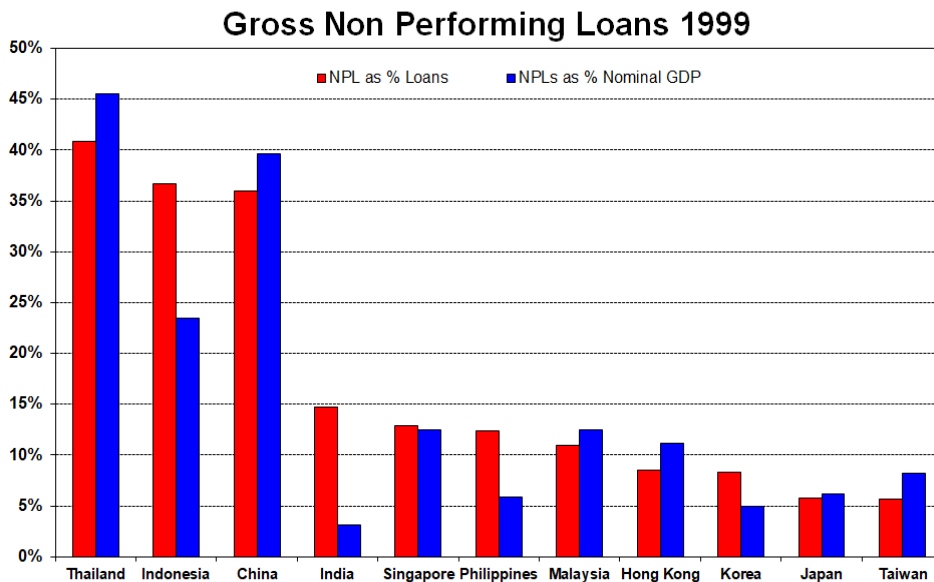
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The PSBs are at least liquid. The failure has been the government's reluctance to entertain seriously extracting their bad loans into a separate bad bank and forcing consolidation and better practice. Conversely, the blame for the more recent blow-ups in a non-bank financial corporation (NBFC) sector which had been increasingly filling the gaps left by the PSBs, rests rather more with the RBI which has failed to provide more aggressive, emergency liquidity support. To be somewhat fair, the government's rhetoric has been skewed towards punishing alleged malfeasance which has likely helped stay the central bank's hand. Yet irrespective of where the ultimate fault lies, the knock-on effect to already struggling construction companies and SMEs has been readily apparent.

The more recent blow-ups in a NBFC sector, which had been increasingly filling the gaps left by the PSBs, has only aggravated the situation further



The frustration, for this outside observer at least, is that while USD140-200 billion sounds like a big number, it only represents around 5-8% of GDP. This seems eminently resolvable based both on the country's public indebtedness and historical precedence. Without wanting to play down the questionable optics of the rapid loss of two respected central bank governors in short order, the opportunity is clearly there for a holistic, coordinated clean-up effort.

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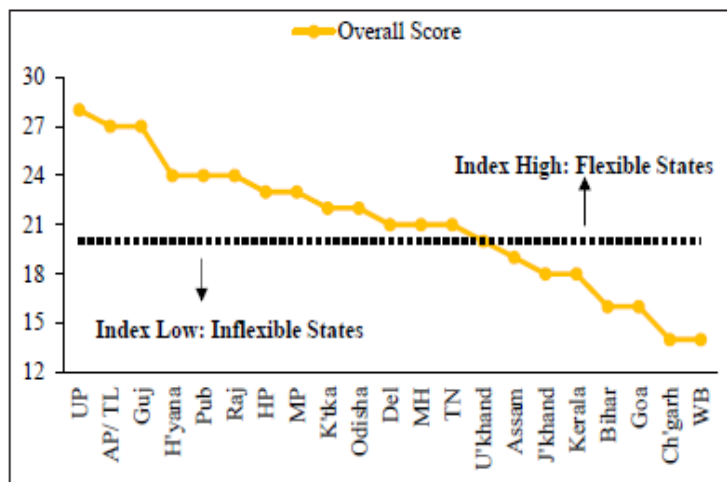
Un-impairing the financial plumbing and getting the new bankruptcy code to work as designed are necessary steps to get credit and investment flowing again, but they are still insufficient on their own to shift India more towards an 8-10% potential growth path. A simplified and more attractive tax code should also help at the margin. However, all of these need to be combined with significant additional reforms in areas such as the labour markets, land acquisition and ease of doing business.

Can we expect/hope for significant additional reforms in areas such as the labour markets, land acquisition and ease of doing business?

By way of conclusion, I would like to cite two analyses contained in the Indian government's last two annual economic surveys. If nothing else, these suggest that identification is not the problem. However, I highlight these since Prime Minister Modi was an extremely successful Chief Minister of Gujarat, a state that scores highly both on labour market flexibility and export penetration. For sure, Gujarat is also blessed with a highly favourable littoral geography and an extremely entrepreneurial diaspora.⁶ Yet the opportunity is there to use his second term to encourage the states to compete amongst themselves for investment capital and employment creation by allowing local deregulation and experimentation.

Identification is not the problem

Figure 5. Classification of States as Flexible & Inflexible based on labour restrictions



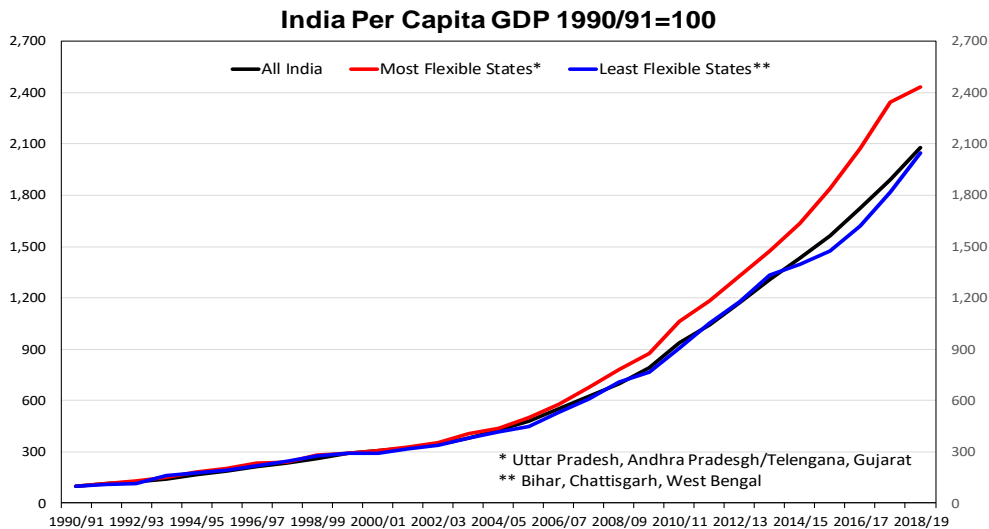
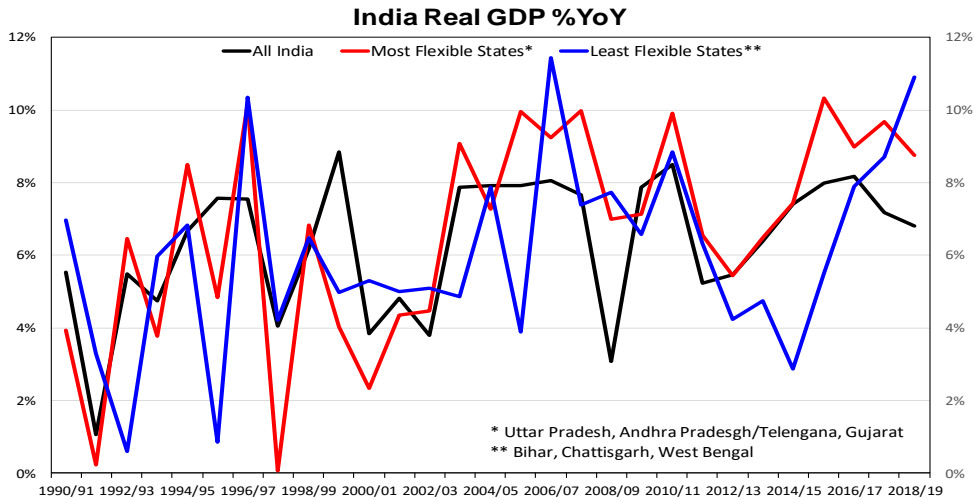
Source: OECD Economic Survey, 2007 updated with Survey calculations.

Source: India Economic Survey 2018-19, <https://www.indiabudget.gov.in/economicsurvey/>

⁶ At the UK state school your interlocutor attended, the most common surname was Patel. Add to this the significant Jewish cohort and it is clear that most of the rest never stood a chance.

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Correlation is not causation but Indian states with greater labour market flexibility and export penetration have, over time, outperformed their more protected peers.⁷



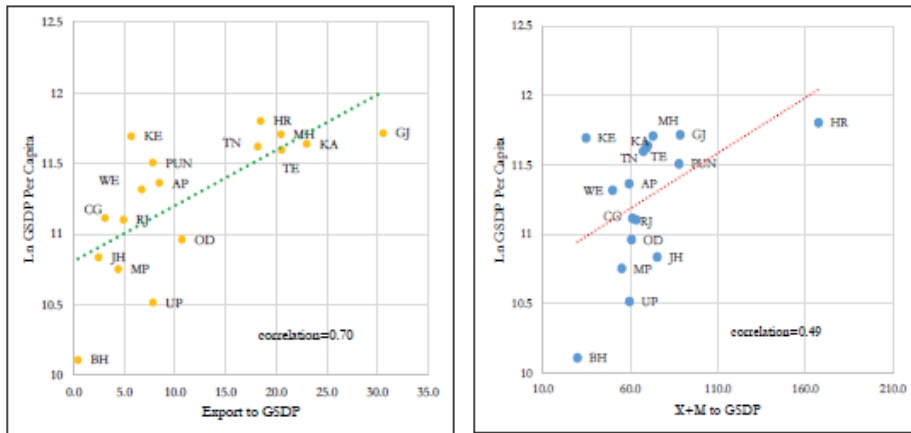
⁷ I have excluded Kerala and Goa from the calculations above. Although their labour market regulations are highly restrictive, the two states attract between them a disproportionate 20% share of India's overseas tourist arrivals. They also have far higher overseas remittance shares of state GDP than any others – for example 35% and 22% respectively in 2008. http://www.unescogym.org/wp-content/uploads/2015/05/Remittances-in-India-Facts-and-Issues-2011-C.Tumbe_.pdf I have not seen updated numbers but would expect huge changes,

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3. States' prosperity is correlated with their international and inter-state trade

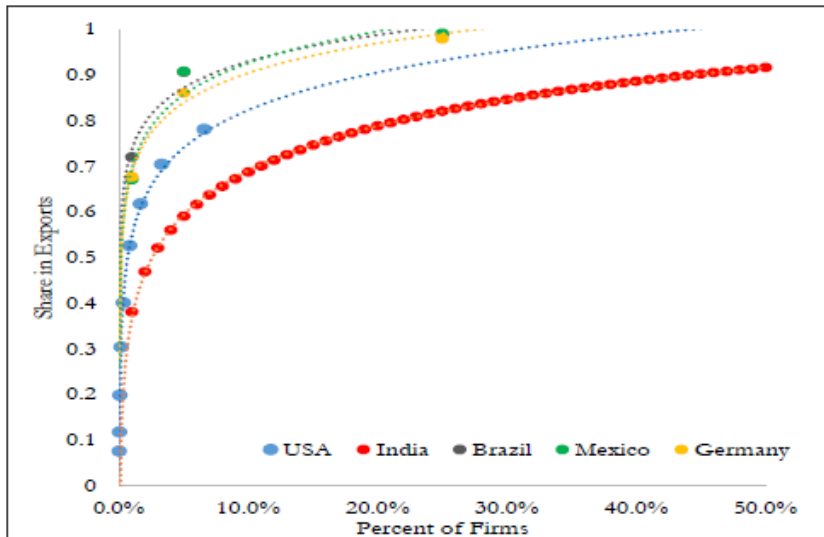
States that export more internationally, and trade more with other states, tend to be richer. But the correlation is stronger between prosperity and international trade.

International Exports and States' Prosperity States' Inter-state Gross Trade and Prosperity



4. India's firm export structure is substantially more egalitarian than in other large countries

Top 1 percent of Indian firms account for 38 percent of exports; in all other countries, they account for a substantially greater share (72, 68, 67, and 55 percent of exports in Brazil, Germany, Mexico, and USA respectively). And this is true for the top 5 percent, 10 percent, and so on.



Source: India Economic Survey 2017-18. See also: <https://www.financialexpress.com/budget/union-budget-2018-states-with-higher-exports-show-better-standard-of-living-reports-economic-survey-of-india/1036334/>



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