

India Watch

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Elections are coming

- **Modi's NDA expected to win April/May elections, lose majority in parliament**
- **With inflation low, new RBI governor acts quickly and eases monetary policy**
- **Government presents interim budget with populist characteristics**
- **Despite political uncertainty, India well-placed to remain fastest growing giant**
- **Current account deficit in check**
- **With hung parliament, we expect slowdown, no breakdown, of reforms**
- **Strengthening the banking system remains a key challenge**

Elections coming closer: Modi's NDA coalition has lost some of his popularity

In April-May 2019, the world's largest elections (about 875 mln eligible voters) will take place in India. Key question will be whether PM Modi and the National Democratic Alliance (NDA), the centre-right coalition led by Modi's hindu-nationalist Bharatiya Janata Party (BJP), will be able to stay in power. The ruling coalition has lost some of its popularity since Modi's impressive victory in 2014, particularly in rural areas. That is for instance shown by losses in various state elections in 2017-18, most recently in the centre states of Chhattisgarh, Madhya Pradesh and Rajasthan, former BJP strongholds. Voter concerns relate to for instance distress in the agricultural sector and high job losses at SMEs. In reaction, the Modi-government has been busy adjusting its policy agenda somewhat for a while to please the electorate (see below), while also aiming at strengthening its image of being a tough corruption fighter.

... and is expected to lose its absolute majority in parliament

According to most recent polls, the NDA (currently holding around 60% of the seats in the Lower House) is expected to win the elections, but it will likely lose its majority. That would imply that a second Modi-government would have to put more effort in convincing other parties. As we already indicated in our recent [India Outlook 2019, Modi-fication](#), we expect a modification of the reform agenda, not a complete breakdown, with a stronger focus on social programmes (e.g. healthcare, housing, farmers). Still, improving the business climate, strengthening the manufacturing base and investing in the outdated infrastructure will likely remain key priorities. That said, progress with regard to the politically most sensitive reforms (for instance relating to the labour market and land ownership) will be less likely under an 'hung parliament'.

An interim budget with populist characteristics

On 1 February, acting Minister of Finance & Corporate Affairs, Piyush Goyal, presented the interim budget for FY 2019-20 in parliament. This budget has an interim status, as it will be followed up by the next government's formal budget in July. The interim budget targets a general

deficit of 3.4% of GDP in FY19-20 (FY18-19: 3.5%), taking away some of the market fears that the government was going to leave its gradual fiscal consolidation path by allowing a higher deficit. That said, the budget is partly based on fiscal revenue assumptions that may well prove to be too optimistic. Should tax revenues disappoint, that may probably lead to a future cut in (capital) expenditure.

The interim budget can be seen as a final attempt by the Modi-government to raise its popularity just before the elections. The interim budget is specifically targeted at the part of the voters among whom Modi has been losing support. It includes a new program of cash transfers to farmers, benefits for workers in unorganized sectors and tax exemptions for the middle class. There are little to no new initiatives to support infrastructure programmes or the manufacturing and banking sectors.

Note that if we add the combined deficit of the state governments and off-balance sheet borrowing by state enterprises, India's total public sector borrowing requirement remains above 8.5% of GDP. This public borrowing has been one of the factors driving India's bond yields up over the past two years, risking a crowding out of private investment and/or a rise in foreign borrowing (recently the central bank relaxed foreign borrowing norms for corporates).

Manufacturing PMI remains at high level



Source: Bloomberg, Thomson Reuters Datastream

Growth exports/imports drops in line with global picture



Source: Thomson Reuters Datastream

Despite some political uncertainty, India well-placed to remain fastest growing giant

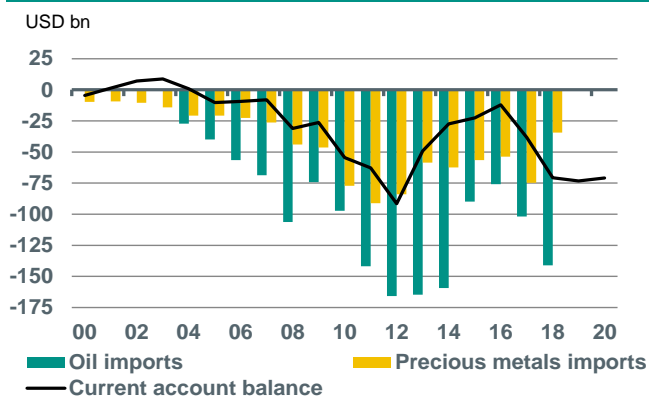
After being strong (around 8% yoy) in the first half of calendar year 2018 – helped by base effects caused by demonetization in late 2016 and GST introduction mid 2017 -, economic growth dropped back to 7.1% yoy in Q3-18. That slowdown was primarily driven by a surge in import growth, causing a negative contribution from net exports, while strong public investment (in the run-up to the 2019 elections) was a cushioning factor. Recent high frequency data (e.g. growth of exports, imports, industrial production and car sales) point to spill-over from the current weakness in global industry and trade. That said, compared to East Asia India is less exposed to the global business cycle and relatively shielded to the US-China trade conflict in our view. The manufacturing PMI remains at a high level of around 54. The PMI export subindex dropped to 52.6 in January (December: 53.6), but remains one of the highest in emerging Asia. All in all, we expect economic growth to pick up a bit, with annual growth rising from 7.2% in FY2017-18 to 7.5% in the current and next two fiscal years. Despite the short-term risks on the political/policy front, India therefore is set to remain the fastest growing giant, profiting from catch-up potential

(India's GDP/capita is one-fifth of China's), a demographic dividend and structural reforms implemented during Modi's first term.

Current account deficit remains in check

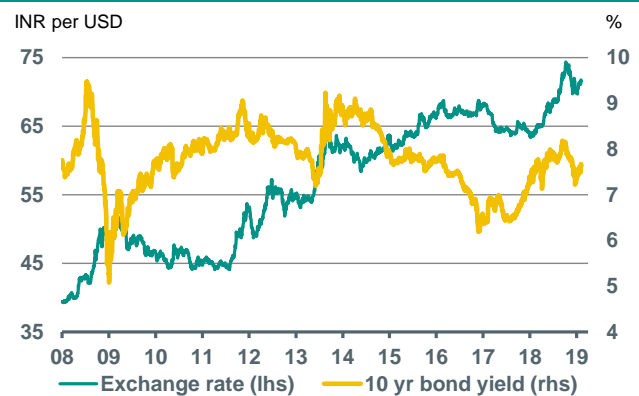
Since 2016, strong domestic demand and a rising oil bill have driven India's current account deficit up, rising from 0.5% of GDP in 2016 to an estimated 2.7% of GDP last year. The government has taken measures to keep the deficit in check (rate hikes, import restrictions). Gold imports have fallen sharply last year, reflecting a drop in the rupee (making gold more expensive) and certain import restrictions. Reflecting these measures and given that oil prices have corrected downwards, the current account deficit in GDP terms is expected to fall again somewhat in 2019-20. That implies that the deficit will remain clearly below the 5% GDP level seen in 2012-13 during the *taper tantrum*, when India was classified as one of the *fragile five* EMs. Meanwhile, while FX reserves have fallen by around 7% since the peak reached in April 2018, they remain at comfortable levels covering around 6.5 months of imports, four times short-term external debt and around 70% of total external debt.

Current account deficit remains in check



Source: Thomson Reuters Datastream, EIU

Rupee has recovered a bit versus USD



Source: Thomson Reuters Datastream

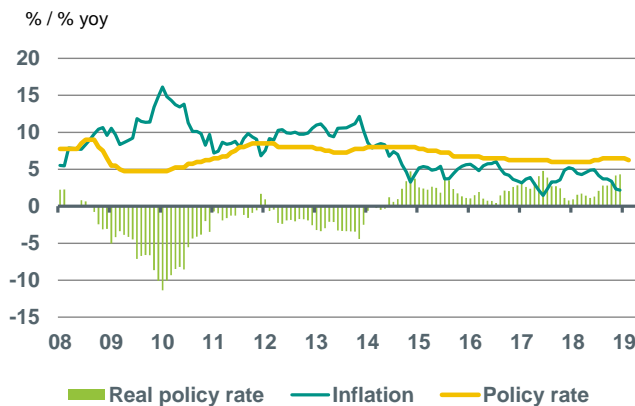
During the EM turmoil last year (driven by Fed tightening and escalating trade tensions), the Indian rupee came under pressure together with many other EM currencies. The rupee lost around 12% versus USD between end 2017 and early October 2018. That was similar to the depreciation seen in other EM Asian countries with external deficits (Indonesia, Philippines), but much less compared to for instance the Argentine peso and the Turkish lira. Since then, in line with our expectations, the India has recovered somewhat. We have left our end-of-period USDINR forecasts for 2019 and 2020 unchanged, at 70 and 68, respectively.

With inflation remaining low, new RBI governor acts quickly to ease monetary policy

Core inflation has picked up in the first half of 2018, but has stabilised since (hovering around 6% yoy). However, headline inflation has fallen sharply since mid 2018, driven down by falling food prices which account for around 40% of India's CPI index. As a result, the real policy rate (measured by subtracting current CPI inflation from the RBI repo rate) recently reached a four-year high of 4.3% yoy. As we already indicated in our [Asia Outlook 2019, A challenging year](#), published last month, we expected a more dovish monetary policy under the new RBI Governor Das (who replaced outgoing Governor Patel last December). And this is indeed what happened. Today, the RBI decided to shift its monetary policy bias from hawkish to neutral and to cut the

repo rate and the reverse repo rate by 25 bps, to 6.25% and 6.0%, respectively. In the accompanying statement, Das said that it is important to act decisively and timely to support growth once inflation stability has been achieved. He added that the RBI will stay 'data dependent', suggesting that one or more further rate cuts are possible should inflation remain low and/or growth disappoint.

Low inflation enables RBI to cut policy rates



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Lending growth has picked up



Source: Thomson Reuters Datastream

Strengthening the banking system remains a key challenge

Following the change at the helm of the RBI, tensions between the central bank and the government have eased. These tensions related to several issues, but one of them was the RBI's role as banking supervisor. Doubts about India's banking system – and in particular its shadow banks – came to the surface in the course of last year, after IL&FS, a large infrastructure finance company, run into payment problems in the summer. While the government take-over of IL&FS helped to stem contagion, its distress is symptomatic for broader problems within the financial sector. There is a large infrastructure-related debt burden, high NPLs at public sector banks (around 15%) and inadequate governance standards. In its Financial Stability Report published last December, the RBI is positive about credit growth picking up and expects banking sector health to improve gradually over the next two years, partly thanks to some relaxation of regulatory policy. That said, markets will continue to monitor and assess the credibility and independence of the central bank closely in this respect.

To conclude

We expect India to grow by 7.5% in the coming years and the country to remain the fastest growing emerging giant. Emerging market turmoil has eased as the Fed has turned more dovish and concerns relating to the US-China trade conflict have faded somewhat. India's external position remains manageable, and low inflation has enabled the central bank to shift to a more dovish stance. That said, risks remain. Political uncertainty relates to the coming elections. Key question is how the political landscape will change after the elections and what that will mean for policy making and for India's reform path. Another key risk stems from the problems in India's financial sector and the way banking supervision will be shaped to deal with those issues and to safeguard the intermediary role of banks to finance the needed upgrade of India's infrastructure.

Key forecasts for the economy of India

	2016	2017	2018e	2019e	2020e
GDP (% yoy)*	8.2	7.2	7.5	7.5	7.5
CPI inflation (% yoy)	4.9	3.3	4.0	4.0	4.5
Budget balance (% GDP)*	-3.5	-3.5	-3.5	-3.5	-3.5
Government debt (% GDP)	50	50	50	48	47
Current account (% GDP)	-0.5	-1.5	-2.7	-2.5	-2.0
Gross fixed investment (% GDP)	28.5	28.5	28.3	28.2	28.7
Gross national savings (% GDP)	28.6	27.4	28.8	27.6	28.4
USD/INR (eop)	68.0	63.9	69.8	70.0	68.0
EUR/INR (eop)	71.7	76.7	79.9	87.5	88.4

Economic growth, budget balance, current account balance for 2019 and 2020 are rounded figures

Source: EIU, ABN AMRO Group Economics

** Growth and fiscal data: fiscal years*

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