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Bigger mandate for PM Modi and our wish-list for the Indian credit story

India concluded its biggest electoral exercise globally in May in a voting that saw more than 600 million citizens – the highest ever turnout – exercise their right to elect a representative to the 543 member Lower House or Lok Sabha. The election outcome may have brought in political certainty, but there is some way to go before economic benefits are reaped.

The incumbent NDA (National Democratic Alliance) government led by BJP (Bhartiya Janata Party) emerged victorious with 352 seats (~65% of the total strength), with BJP itself winning a whopping 303 seats. BJP in fact increased its seat count by 21 compared with the 2014 elections, and vote share by 6% to 37%. The next single largest party[1] only managed to win 52 seats and did not win a single seat in half of the 36 states and Union Territories.

These are astonishing results, especially considering the lukewarm economic situation of the country during the last five years. Three major sectors continue to be in distress, namely agriculture, power and banking. Additionally, the shadow banking market been frozen since mid-2018 and the onshore credit transmission mechanism remains clogged. Challenges such as high unemployment, low growth in exports and higher fiscal slippage remain key issues. Despite these challenges, the incumbent government won with a landslide victory for the second time and this warrants a deeper appreciation of the paradigm shift in the politics of the country.

India also benefits from several tailwinds. Decent growth, low inflation, an accommodative Fed and a galvanized leader who has the ability to push through difficult reforms if he wishes over the next five years.

We would like to take this opportunity to share our wish-list for India to sustain and improve its creditworthiness in the coming years.

[1] Indian National Congress.

Decoding the win – emotions running high

Hazarding a guess at what a 1.3 billion strong population (or 900 million registered voters) divided across religion, language, culture, and identity, think of a particular party/leader is naturally complex. It is no surprise then that many political analysts didn't expect such a massive win for the incumbent government led by Prime Minister Narendra Modi. While the base case was always Mr Modi returning to power, it was predicted that he would largely need support from non-BJP parties, with BJP itself failing to cross the 50% seats in Lok Sabha on its own. The elections results however have shown that his support base has only grown deeper and stronger. We consider the following as the key takeaways from this win, and consider that these factors will shape the Indian political and economic discourse over next five to 10 years.

- **Cry for change:** The massive electoral win and almost nationwide support for Mr Modi (who was the face of BJP in the elections) point to one key aspect – that the 'cry for change' that was witnessed in 2014 continues to this day. This cry for change is a result of decades of elitism, corruption, nepotism and widespread caste/religion-based politics. For the masses in India, Mr Modi remains a "chai-wallah" (tea vendor) who is not part of the system but one who can change the system. He is apparently their only hope in a system widely believed to be rigged by the rich and elites.
- **Clean image:** Mr Modi has built a solid reputation for honesty and zero tolerance for corruption. The NDA government from 2014to 19 did not witness any scam or corruption allegation that could pass the muster of legal scrutiny unlike the previous Congress-led government. Mr Modi's and his family's simplistic lifestyle puts him on a higher pedestal in the eyes of the people. The demonetization exercise of 2016, while an economic disaster on many counts, was a political masterstroke as the rich and unscrupulous were deemed to be the ones hurt most. Unsurprisingly, there is hardly any political challenger to him who can claim to have a clean and corruption-free image, and who is working for the poor and the underprivileged.
- **Nationalistic agenda:** Mr Modi and BJP have been able to establish a hardline and zero tolerance image on anti-national activities and terrorism in particular. Most other political parties suffer from an image problem and are considered soft, especially with respect to the sensitive state of Jammu and Kashmir. Mr Modi was widely perceived to have delivered strong action against Pakistan in retaliation to terrorist strikes on Indian security forces in February 2019, further established his credentials as a tough leader and likely benefitting him during the elections.

Recent economic performance has not been credit friendly

While Mr Modi is widely perceived as an investor-friendly reformist, the Indian economy hasn't benefitted to the extent it had been expected to during his past five years as leader. Several economic policy missteps and slow pace of reforms led to a largely mixed economic performance:

- **Fiscal consolidation camouflaged by higher state borrowings and off balance sheet expenditure:** India has demonstrated fiscal consolidation at the central government level – from 4.1% of GDP in FY15 to 3.4% in FY19. However, it is important to factor in two largely overlooked but significant components of public sector borrowings – i) deficits by state governments, and ii) borrowings by central government-owned corporates to fund government programmes. Borrowing discipline at state-level has slipped, especially as they have funding access (onshore) at attractive levels based on market assumptions of an implicit federal guarantee. Taken in combination with central fiscal deficit, additional total public sector borrowings are close to 9-10% of the GDP in FY19, which has significantly reduced the room for private investment.
- **High current account deficit:** India remains exposed to twin deficits on the fiscal side and current account. The current account deficit has been rising and was 2.8% of GDP for FY19. This has largely been driven by weaker export growth, even as higher oil import bill as well as machinery imports have risen. India remains exposed to any sharp increase in oil prices, which can have direct impact on the current account, leading to rupee (INR) weakness and lower debt service ability of Indian corporates in offshore credit markets.
- **Unemployment stays high:** One of the biggest failures of the government has been to generate employment. The unemployment rate stands at 6-7% – the highest in decades – as private investment has remained low in the economy and foreign direct investment (FDI) has slowed down.
- **Rural stress has intensified:** In 2014, the government set out a target to double farm income. Since then, Indian farmers have seen two years of drought as well as a sharp erosion in farm-gate prices of key agri-produce ever since the demonetization. While the government has responded with several band-aid measures, like farm-loan waivers, they did not address the core issues and this represents a big drag on the fiscal deficit.
- **Growth has slowed down:** India's economy, as per government estimates, g grew by an average of about 7.5% during the 2014 to 2018 period. Notwithstanding the concerns around revisions to GDP calculation methodology by government agencies, the growth itself has been undoubtedly negatively impacted by two policy decisions – i) demonetization in 2016 and a ii) thehastily rolled out Goods and Services Tax (GST) regime in 2017. The recent non-banking financial companies (NBFC) crisis has been another shock for the economy with GDP growth falling to 6.6% between October and December 2018.

There are areas where there have been big improvements, such as with infrastructure and the GST roll-out. The pace of road construction has picked up by 60% versus previous government, with particular progress made in road/highway construction and electrification of railways lines. With regards to the GST roll-out,

India passed a landmark Good and Services Tax (GST) legislation in 2017 replacing various overlapping state/central level taxes. Anecdotal evidence suggests that, along with better infrastructure, the GST roll out has helped in cutting the travel time for inter-state logistics movement by up to 50%.

On balance, while there have been pockets of improvement in the Indian economic story, the reform agenda has lagged which has led to a mild deterioration in sovereign credit fundamentals and weak credit transmission into the private sector.

Our wish list as long-term credit investors

The Indian economy showed **clear signs of a slowdown** between October and December 2018 and the reported data points to slowing industrial production and lower consumption – weaker auto sales, passenger traffic, slower consumer goods sales. More importantly, we look forward to firmer policy action for a smoother transmission of credit in the system, without undesirable growth in system indebtedness. Our wish list as long-term credit investors are as follows:

1. **A critical area of risk is emerging within the NBFC**/ shadow banking space which has suffered from a severe lack of funding since the default by IL&FS in September 2018. Restricted funding access for over nine months has not only led to concerns around the solvency of several weaker NBFCs, it has also impacted growth as NBFCs have accounted for 50% of incremental credit growth over the last few years. The real estate and automotive segments are particularly reliant on NBFC funding. Left unattended, the ongoing NBFC stress could have serious negative implications on the economy. We feel it is imperative that the government ease liquidity within the NBFC sector and put in place a framework to unclog the shadow banking system.
2. Another imminent area of attention is the **rural stress**, where the government is likely to follow up on its pre-election promise of INR6,000/yr (~USD85/yr) of minimum direct income to about 120 million farmers. However, a broader action plan to improve farm productivity as well as urbanization is needed to avoid pressure on fiscal deficit. Simply dishing out subsidies without addressing key issues such as investments in new agricultural technologies and irrigation, will mean continued long-term fiscal pressure.
3. We would also like to see the government utilize its strong mandate and bring about some non-populist but critical reforms – **primarily to land acquisition and labour.** Both of these are highly crucial to improving manufacturing productivity, private investment and, in turn, generate much-needed employment. As per the World Bank, India needs about 8-10 million in new jobs annually just to keep its unemployment rate stable, which in itself is a big ask given some estimates suggest India lost ~11 million jobs in 2018. India's widely reported demographic dividend – where working age population will cross 1 billion by 2027 – is at risk of turning into a liability in the absence of marked growth in employment.
4. While India has made remarkable progress in expanding access to electricity throughout the country, the **power sector suffers from gross inefficiencies.** For the power sector, state-owned power distributors are probably the weakest link in an industry where private sector power producers are keen to produce, and where consumers desire more reliable power. The new government should focus on reducing user subsidies and bringing efficiencies in distribution, which would lead to lower non-performing loans (NPLs) in this sector and reduce banking stress.
5. **Indian banks have been struggling with non-performing loans (NPLs)** for over last five to six years, with system-wide NPLs running at about 11%. This has significantly restricted the ability of public sector banks who suffer from weak capitalization to do much incremental lending. This needs to be addressed to unclog the credit mechanism into the private sector, which needs to grow investment urgently.

Despite the sheer amount of work that needs to be done over the next five years, the good news is that India has some tailwinds. Inflation has remained benign and that will allow the Reserve Bank of India (RBI) to maintain a loose monetary policy, especially given the US Fed's accommodative stance of late. The latter should also boost portfolio flows into India. Additionally, GST collections are showing signs of improvement recently, and a further simplification of the GST regime could likely lead to higher compliance and collections. Lastly, a weaker global growth outlook, in light of US-China dispute, could likely benefit India on two counts – weaker oil prices and any relocation of production centers by global multinational corporations (MNCs) away from China.

Overall, while we consider that the election outcome has brought in political certainty to India, there is some way to go before economic benefits are reaped. In fact, India appears to be on cross-roads, as years of economic and political mismanagement have led to growing impatience with the status quo and the mandate for the new government is clear in its aim – to bring prosperity to the masses.

How the government navigates the challenges highlighted above, will determine whether India gets to keep its current Baa2 (Stable)/ BBB- (Stable)/BBB- (Stable) from Moody's/S&P/Fitch respectively or achieves further ratings upgrade of one notch or more in the coming years. Today, India has the big advantage of having a galvanized leader whose brand can afford to push through tough reforms and it is high time that this opportunity is utilized which will benefit the Indian credit story.