Economics & Strategy

DBS Focus

Understanding India: Time is RIPE

Group Research

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- *With the general elections over, another term of political and policy continuity lies ahead*
- *Expectations are running high on what the next five years will hold for the economy*
- *India currently enjoys an ideal mix of political stability, a credible central bank, reform-centric focus and catalysts for growth to recover*
- *We reckon time is **'RIPE'** for the economy is climb out of the current slowdown and head back towards its potential growth rate*
- *Timely rollout of '**R**'eforms will be crucial, with the ball already set rolling in the government's first term*
- *Apart from improving total factor productivity, attention needs to raise labour and capital returns*
- *Milestones for the '100-day' agenda is being set, which includes the FY20 Budget*
- *Jumpstarting '**I**'nvestments is next priority, with pipeline efforts expected to bear fruits as cost of capital moderates*
- *'**P**'roactive efforts to guard against rising external risks is key – here in lies challenges and opportunities*
- *Addressing these aspects will return the economy to a healthy and steady '**E**'xpansion mode*
- *From a negative output gap currently, we expect the economy to accelerate past potential over the next few years*

Eye on the prize

A decisive win for the incumbent ruling party in last month's elections was a strong vote for political and policy continuity. Expectations are running high on what the next five years will hold for the economy. India currently enjoys an ideal mix of political stability, a credible central bank, reform-centric focus and catalysts for growth to recover. **We reckon time is 'RIPE' for growth to climb out of the current slowdown and return towards its potential rate over the next two-three years.**

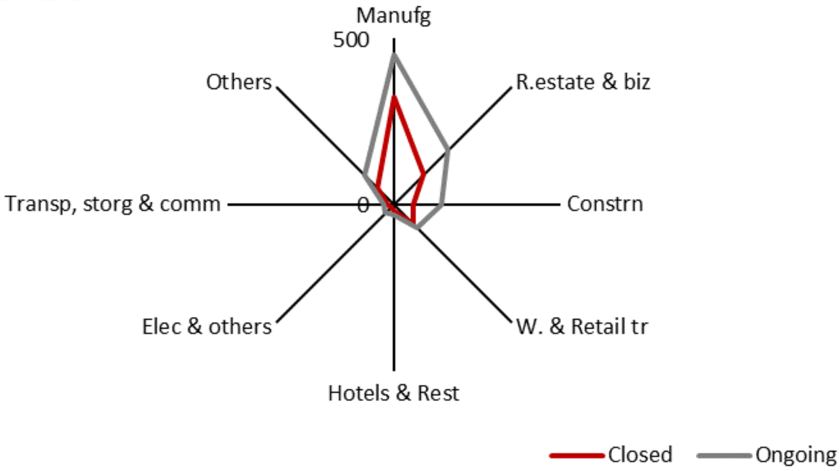
'R'eforms will be crucial, with the ball already set rolling in the government's first term. Rather that rollout of another bunch of fresh reforms, there is value in ensuring efficient and effective implementation of the already announced measures. This will not only narrow income inequality but also grow the pie to supportive more redistributive policies and raise productivity.

Refer to important disclosures at the end of this report.

Continuity and ironing out already implemented reforms: Even in the absence of fresh 'big bang' reforms, smoother execution and implementation of already rolled out reforms will benefit the economy. Key amongst this is the **Goods and Services Tax (GST)**, which was implemented in July 2017. Binding the whole country under a common tax system, it carries the potential of substantial productivity and efficiency gains. The structure and composition have undergone various iterations since it has been introduced, with more steps pending, which include streamlining multiple exemptions (petroleum, alcohol etc.), lowering number of slabs, simplify the mechanism, etc.

Formation of **Insolvency and Bankruptcy Code** and its related process have provided a common platform for creditors and companies to negotiate and expedite the exit process for stressed assets. Apart from expanding the capacity of the resolution courts, timebound resolution should be prioritized.

Sectoral distribution of Corporate Debtors under the Corporate Insolvency Resolution Process
No. of cases



Source: Insolvency and Bankruptcy Board of India, DBS

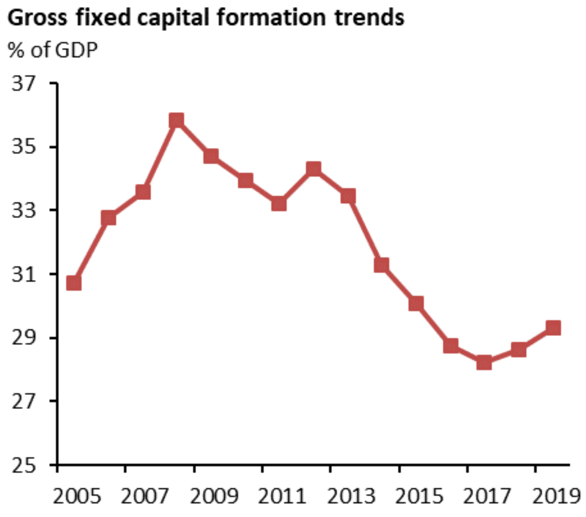
Next, substantial steps have been taken in the direction of the **digital agenda**, including introduction of India stack, a unified payment gateway, unique identification called Aadhar, emphasis on JAM trinity which encompasses financial inclusion, dentification and mobile connectivity to plug leakages and ensure efficient delivery of subsidies. Finally, introduction of the **inflation-targeting monetary policy framework** was undertaken in cohesion with the central bank, which has improved the reaction function of policy to inflation trends, whilst also anchoring inflationary expectations.

Strengthen welfare construct and efficient delivery: In the past five years, efforts have been concentrated on **filling supply-side gaps**, i.e. provision of basic utilities, including healthcare, electricity, gas connection, sanitation etc. This is likely to continue as India's spending on education and healthcare as a % of GDP remains low. Improvement here will carry multiplier benefits, including stronger consumption, prospect of better incomes, and opportunity to break out of the middle-income trap.

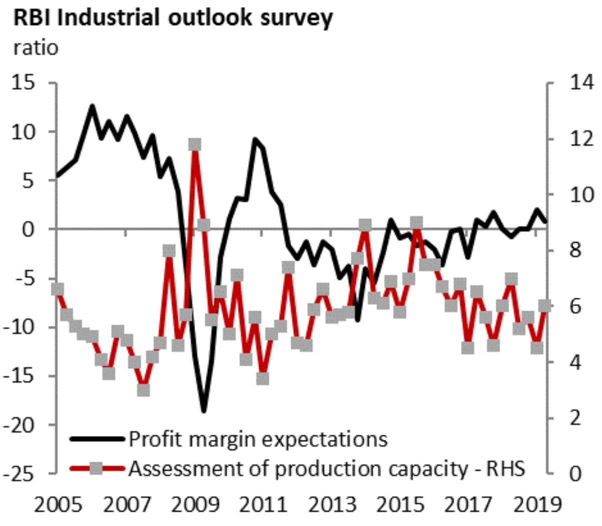
While **supply-side gaps get fixed, demand will get a hand** from plans to alleviate rural sector distress, particularly to double farmer incomes over the next few years. Back in the February's Budget, a direct income support under the aegis of PM-Kisan Scheme was introduced, with expectations that these disbursements will gain traction this year. For now, the scale of active identification of beneficiaries varies across states, with the process to be tightened to ensure stronger income and consumption boost unfolds. Secondly, improve effectiveness of Minimum Support Prices (MSPs) by a supportive procurement policy, which will help streamline production trends and lift incomes, but will require states active support. Finally, improved rural road connectivity has gained prominence within overall spending towards roads/ highways. Pension scheme for the unorganized sector workers is also a step to this end.

Ahead of the southwest monsoon, addressing the ingoing water supply shortage is a clear priority in the immediate term. Studies show that groundwater availability which accounts for two-fifths of total water supply is fast depleting. Besides weak spatial spread of rainfall in recent years, strong increase in demand, weak planning, corporate privatization, corruption, unplanned construction and inefficient usage and highly subsidized tariffs, are amongst the key reasons for this shortage. Monsoon has arrived late this year, feeding worries over scarce water supply. In response the government has consolidated all related ministries, into one, referred to as 'Jal Shakthi', to coordinate efforts, whilst also working with states to ensure differentiated responses. The planning agency, Niti Aayog has proposed a baseline and benchmark for state-level performance on key water indicators, which will describe various strategies adopted by states to improve water management practices, whilst also introducing a culture of constructive competition among states.

Resuscitate investment climate: Reviving the **'I'nvestment** climate is of paramount importance, which has been moderating for the past five-six years. Encouragingly, fixed capital formation as % of GDP bottomed out in FY17 and crept higher to 29.3% of GDP in FY19. The breakdown reveals that the government's infrastructure spending has led much of the recovery. Capacity utilization rates have improved in the past four quarters but has been insufficient to draw in private sector capex.



Source: CEIC, DBS



Source: CEIC, RBI, DBS

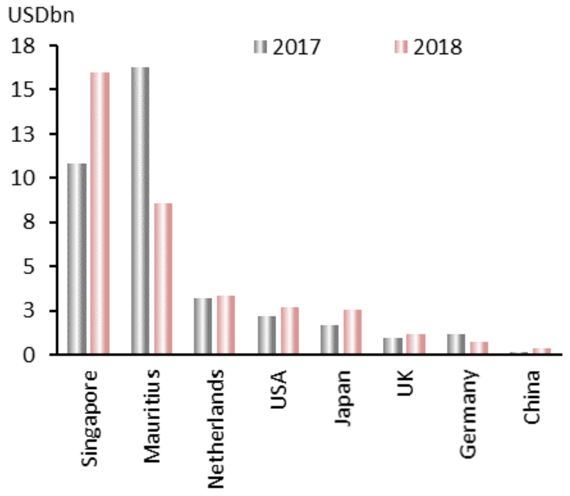
Part of this sluggishness ties back to sizeable stressed assets with banks that are still under the resolution process. Some respite is in sight as non-performing loans have nearly peaked, whilst cost of capital is expected to moderate as the central bank returns to a policy easing bias and liquidity improves. Stress is, nonetheless, evident in few pockets, including non-banks, power, auto and real estate sectors, amongst others, which are amongst the government's immediate concerns.

Recurrent debates over the need to scale back the government's and public sector borrowings also resurface, to prevent crowding out funds for the private sector. In addition to a record high of INR7trn gross borrowings, PSUs have also budgeted to raise INR1.8trn of funds in FY20, in addition to INR4trn plus from states. A strong supply pipeline but paucity of demand combined with weak sentiments is a risk overhang for the domestic bond markets, also weighing on private sector interests.

Gross FDI into India touched a record high of USD64bn in FY19 vs average USD60bn in the prior two years. FDI equity flows moderated, while reinvestment earnings rose. India's gains in the Ease of Doing Business rankings and better competitiveness rankings, coupled with relaxation in FDI ceilings attracted flows. Amongst the source countries, Singapore replaced Mauritius as the main investor, whilst flows from the US improved after a drop the year before.

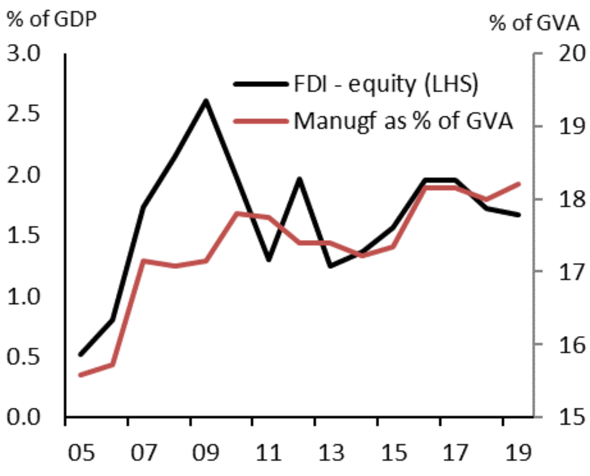
These flows are nonetheless still to boost real manufacturing activity and, in turn, growth. One should also temper expectations on the scale of flows that could be generated, especially as global investment flows have been weakening in recent years owing to lower growth expectations in the G3 (led by EZ and Japan), cyclical downturn in the tech cycle and rising economic nationalism, which stand to be aggravated by the recent escalation in trade relations.

FDI flows - destination mix



Source: DIPP, CEIC, DBS

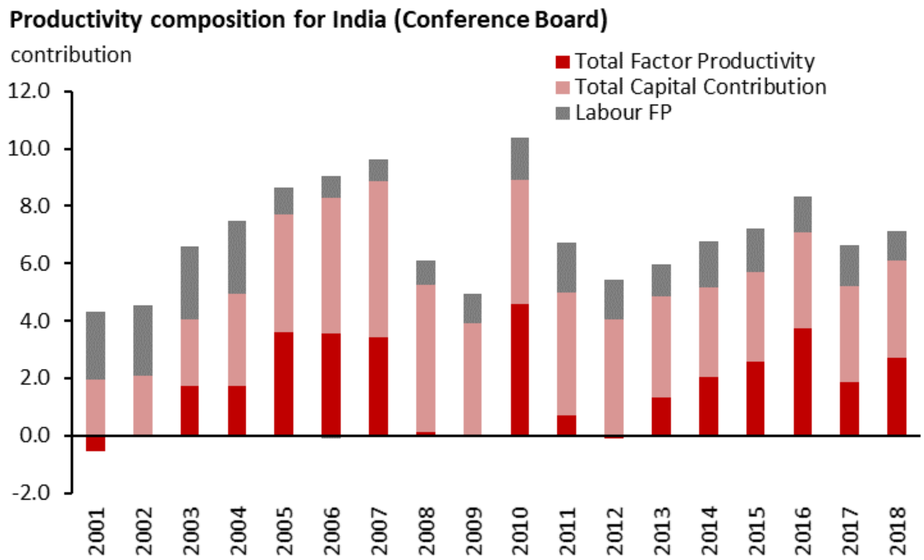
Hopes are high for boost to real growth



Source: DIPP, CEIC, DBS

Nonetheless, the ongoing trade dispute also presents an opportunity for India to provide an alternative destination for producers, and that with a sizeable home market, looking to shift their operations. For this to translate into material flows, India's ease of doing business needs to improve across the economy (beyond the two cities covered in WB study), coupled with better physical infrastructure, a trained workforce and competitive tax rates which will help global players to gain visibility on operational costs, viability and profitability.

Improving overall productivity, with emphasis on land and labour reforms: Growth is a combination of physical capital, human (labour) capital and total factor productivity (calculated as a residual). Tapping observations of the Conference Board Total Economy database, we note that **since 2011-12, India's capital stock growth has moderated (slowdown in investment growth), while TFP has improved but gains from labour has stagnated.**



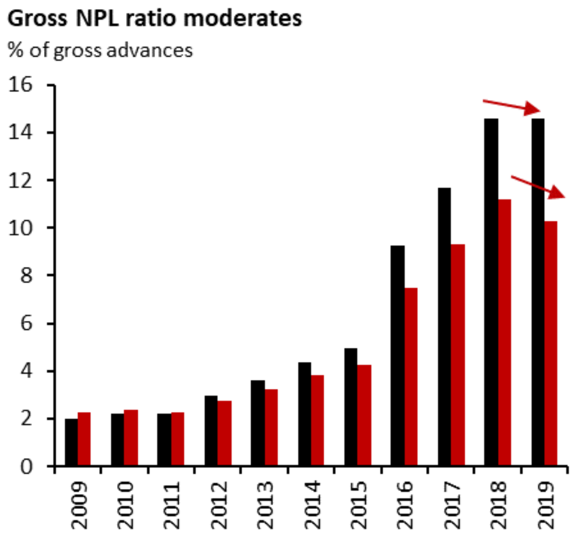
Source: The Conference Board Total Economy Database™ (Original version), April 2019, DBS Group Research

Better TFP readings could be tied down to recent reforms and associated benefits that have helped growth at the margin, but without commensurate pick-up in contribution of labour and capital inputs, it will be a challenge to raise overall potential growth. 'Capital' needs will require private sector capex investments to increase as we highlighted in the previous section of this note, which will also necessitate the need for the government to scale back its borrowing program (and those of PSUs). Raising 'Labour' productivity needs more wide-ranging changes and states participation. This will involve moving contractual and informal workers onto fixed contracts/ official payroll, which needs to provide firms to be provided with the flexibility to curb or expand their employee pool depending on operational requirements and business size. While there is an underlying push towards turning industries into being more capital-intensive, India's demographic trends will keep labour and employment challenges as the front and centre of policy priorities.

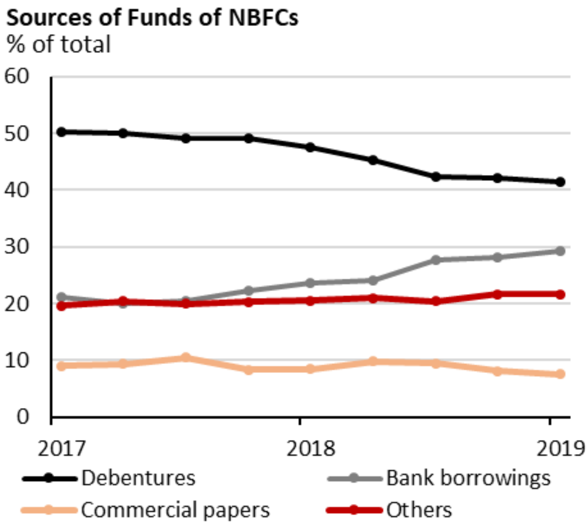
Just as challenging as labour has been land, with the latter involving acquisition troubles, slower digitalization of records and lack of transparent auctions. Being a concurrent subject, states' support is required to address the inflexible and restrictive nature of labour laws currently. Few states, nonetheless, made some progress, especially Madhya Pradesh, Gujarat and Maharashtra. More will require a careful consideration of the political economy aspects, particularly for all the stakeholders.

Immediate concern is to ensure financial stability

In the near-term, financial stability will be the central bank's key focus, as also ensuring transmission to the broad (and specific) sectors. Commercial banks are in a much better position now compared to three-four years back as most NPAs have been recognised, but the resolution process is in a state of work-in-progress. Banks' capital needs remain high to not only resolve cases but also to ensure growth impetus, as non-banks exercise tighter due diligence. Regulators and the key shareholders – the government – will be required to maintain tighter vigilance.



Source: *CEIC, DBS*



Source: RBI, DBS

Addressing troubles facing non-bank finance companies (NBFCs), is a priority on two counts. Firstly, is the need to contain contagion risks. The sector has faced headwinds in the past nine months, with the latest rating downgrade and resultant surge in bond yields of a non-bank mortgage lender fuelling worries over the creditworthiness of weaker players in the sector. Respite is not in the offing as the RBI dismissed the need for a dedicated credit line to struggling entities, where problems are solvency driven, rather than due to a shortage of liquidity. While an outright rescue package is not under consideration, piecemeal support has been underway to strengthen, stabilise and reduce the sector's regulatory arbitrage. Exposure to NBFCs has already put mutual funds under the pump, while the rest bide time - banks, provident funds, pension funds, insurance companies and retail investors. While the central bank's direct intervention comes with moral hazard risks, nonetheless regulators will need to shield the sector from any other credit events.

Secondly, tight financial conditions due to the NBFC crisis have aggravated the ongoing slowdown, with sectors most exposed i.e. auto, real estate, wholesale funding, infrastructure etc. are facing funding constraints. Looking ahead, we expect liquidity support be accompanied by stricter vigilance (correcting asset-liability mismatches).

July's full-year FY20 Budget is in focus

The upcoming full-year Budget, presented by new Finance Minister Nirmala Sitharaman, is a key focus as the government returns for a second term in office. Expectations are running high for pro-consumption effort and extended emphasis on the welfare framework. Speculation includes an likely increase in the personal tax threshold (odds are low after, tax rebates were provided in February's budget), financial markets look for removal of capital gains tax, dividend distribution tax etc., support for renewable energy sector, new national employment policy, support infra financing, industrial policy with focus on exports, boost capital infusion into banks and provide back-stop mechanism for non-banks, amongst others.

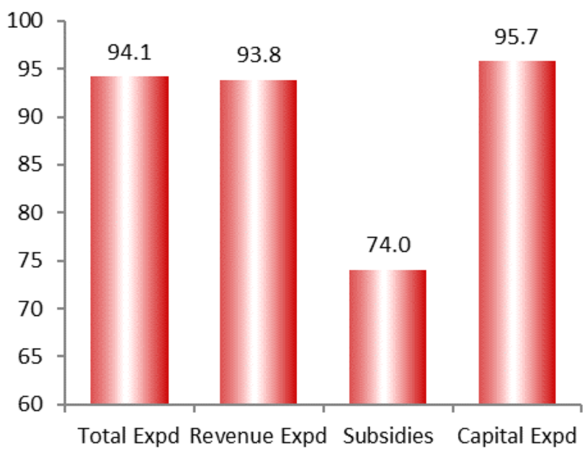
Due to be tabled on July 5, the FY20 math will be a fine balancing act. The FY19 deficit target of -3.4% of GDP was met, but by scaling back expenditure as revenues missed targets. Overall expenditure was cut by 6%, primarily via lower revenue expenditure (94% of revised estimate (RE)), mainly to deferring food subsidy allocations. Revenues undershot targets by ~INR1.8trn, owing to slower income tax and GST collections

Worry is that some slippage in deficit targets is on the cards when the FY20 math is presented. We, however, see lower odds of a sizeable miss in the target, even if underlying assumptions seem optimistic.

Equally importantly, lower borrowings are necessary to ease the cost of capital effectively. Policy rates are falling, but the spread vis-à-vis government bond yields and corporate bond yields have been slow to narrow. Part of the reason for this sizeable spread is high public borrowings. That the centre's gross borrowings were pegged at a record high in the Interim Budget, spooked the markets and which combined with states and PSUs stands at an elevated 8% of GDP. Hence, it becomes imperative that plans to increase spending is accompanied by plans to augment revenues rather than funded through the debt markets. Cognizant of this risk, we expect any slippage risks in the deficit target to be contained at -3.5% of GDP; our base case is for the target to be held at -3.4%.

FY19 Expenditure was scaled back

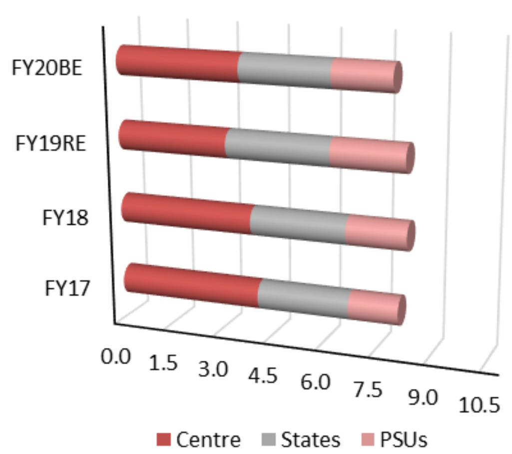
% of total - revised estimate



Source: Budget documents, CGA, DBS

Cumulative public borrowings remain high

as % of GDP



Source: Budget documents, DBS

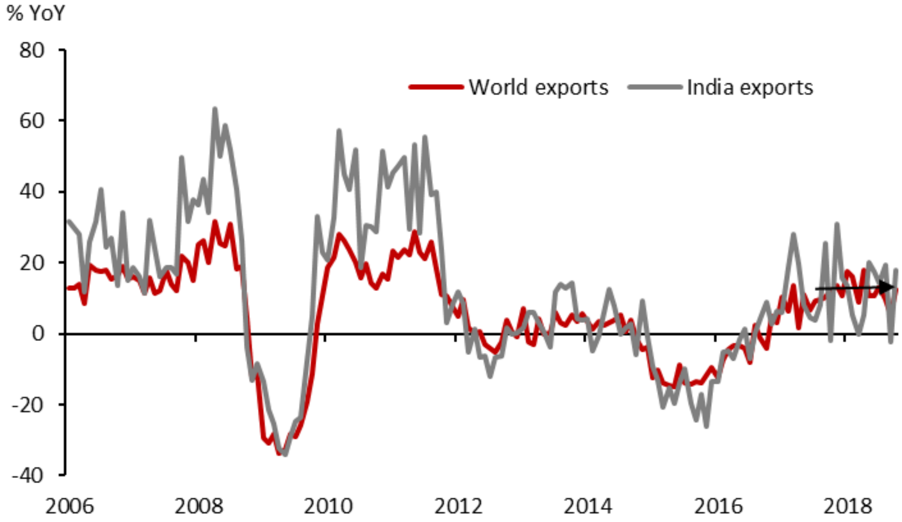
Trade war and protectionism pose a challenge, but also present opportunities

Besides the domestic agenda, authorities will require '**P'roactive** efforts to guard against rising external risks. Multiple headwinds have emerged over the course of first half of 2019, led by a rising protectionist tide across economies as US-China trade dispute escalates, moderating in in G7 growth, sluggish global trade, Brexit-led uncertainty, volatile oil prices and slower China. G3 policymakers have signaled a softening in the policy bias to proactively arrest evolving risks to growth. On trade, Washington wants to maintain existing tariffs to ensure China's compliance to address America's concerns on its trade deficit, intellectual property and other issues.

Developments on the US-China trade dispute and other protectionist policies, present both a challenge and opportunity for India.

Slow global trade, for start, is a bigger risk for India than US-China trade tensions, but risks are that latter could be a trigger for a broad slowdown. India's exports track global trade closely, with scaling back in global growth expectations a risk for India's trade, even as a stronger domestic sector helps neutralize some of this weakness.

India exports track global trends; holding pattern



Source: Bloomberg, CGA, DBS

As part of US' protectionist policies, it targeted India by withdrawing favourable treatment meted under the Generalised System of preferences (GSP). We had noted here (PDF, HTML), that the impact in exports (nominal terms) is modest as GSP makes 10% of India's exports to the US and a small 1-2% of overall India's exports. There has also been disagreement on market access concerns, with US' expressing concern over restrictions on foreign companies in the e-commerce and retail space, sector-specific regulations in pharma and dairy, data localization rules, etc. These have strained trade relations but both parties continue to negotiate to reach common ground.

About the broader US-China trade dispute, there will be knock-on impact on India, but scale will be modest. China (5%) and US (15%) accounted for a fifth of India's total merchandise exports last year. By contrast, regional economies are more exposed, particularly Taiwan, South Korea and Vietnam where ~40% of their total exports head to US and China. Tariffs implemented by the US and China will have significant repercussions on trade patterns, with the intensity dependent on the extent to which trade can be substituted or diversified from other countries

The UN Conference on Trade and Development (UNCTAD), in its February 2019 report [1], notes that manufacturing sector (intermediate, followed by consumer and capital goods) will be most affected by US-China tariffs and counter moves. The resultant diversion in trade flows is expected to benefit the European Union the most, followed by Mexico and Japan, with India falling within the top 10 economies. India's export gains [2] are pegged at USD11bn, divided between chemicals, plastics, machinery, motor vehicles and transport equipment etc.

In the immediate term, as a proxy for diversion in flows, the share of China in US imports has declined by 6ppt between June 2018 and March 2019. On the other hand, South Korea and Taiwan's share has risen by 0.4ppt and 0.2ppt respectively, while India is little changed, which suggests latter is still to materially benefit from rerouted demand.

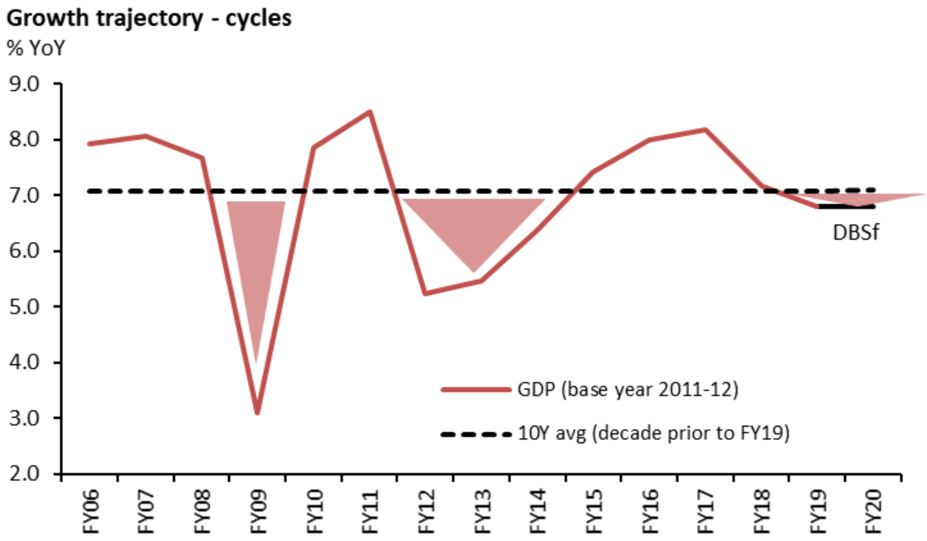
Apart from trade, diversion in investment flows is an opportunity that India could benefit from. US FDI into India jumped in 2018, accounting for 6% of total investment flows. There has been also notable pick-up in flows from China. The modest (~1%) share of China's direct investment flows into India is likely understated, as some part might be routed through countries with favourable tax treaties. Notable names that invested in the past two-three years, include, Xiaomi (electronics), CNTC (real estate), SANY (construction equipment) SAIC's purchase of GM India's assets, China Electronics Technology Group and Longi are into renewable energy, Fosun Pharma bought Gland Pharma and Tsingshan invested into India's steel sector. In the space of technology and start-ups, sector leaders Alibaba, Tencent and OPPO are notable names. India's trade ministry is also reportedly considering financial incentives to draw in more investments, identifying electronics, consumer appliances, electric vehicles, footwear etc. as targeted sectors according to local press.

Return to faster 'E'xpansion mode on the cards

Apart from the cyclical swings, there is a clear need for potential growth to improve. Various studies, RBI [3] and World Bank [4], estimate potential growth in the range of 7-7.2%. Annual GDP in the past decade has been oscillating around this level, peaking above 8% in FY16-FY17 vs a trough around 5.5% five years prior. The structural need to raise potential growth to provide for the economy's rising employment needs, higher savings rate and in turn, boost investment capacity through domestic resources, should remain a priority. Hence as highlighted in this report, the combination of effective reforms and improved productivity, are crucial ingredients for the economy to return to potential growth and accelerate further.

India's macroeconomic vulnerabilities have improved sharply vs 2013 taper tantrum and better than 2018. Current account deficit is primed to stay below 3% of GDP for the seventh consecutive year in 2019, while the centre's fiscal deficit targets are capped at -3.5% of GDP. Inflationary expectations are anchored and headline inflation below target, allowing the central bank room to return to an easing mode. This backs our expectations of further downside in the INR 10Y bond yields (helped also by softer global yields) and moderate INR depreciation for the year (middle of the AXJ pack).

In all, staying on track with reforms and focus on enhancing all drivers of growth i.e. capital, labour and total factor productivity, are key to ensure that growth not only recovers to 7-7.5% over the next two-three years, but also raise potential growth rates from the current 7-7.2% towards 8%.



Source: CEIC, DBS

Notes:

[1] Key Statistics and Trends in Trade Policy, 2018; UNCTAD

[2] https://timesofindia.indiatimes.com/business/india-business/india-likely-to-gain-11-billion-in-exports-from-us-china-trade-war-unctad/articleshow/67991391.cms

[3] RBI Working paper series; 05/2016

[4] World Bank, India Development Update, March 2018

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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