

ARTICLE FOR THE EDGE

INDIA: SHUFFLING FORWARD, NOT QUITE TAKING OFF

There is a spring in the Indian economy's step, after a year when few things seemed to go right. Prime Minister Modi's bold attack on the black economy through demonetization in November last year did not quite achieve its objectives but did hurt a large part of the economy. The lacklustre implementation of the Good and Services tax (GST) earlier this year has also depressed economic confidence. Now, finally, we are seeing light at the end of the tunnel. The economy rebounded in the third quarter of this year, with growth accelerating to 6.3% from a cyclical low of 5.7% in the second quarter, ending a streak of declines. The action by Moody's to upgrade India's sovereign rating for the first time since 2004 also helped to raise hopes.

Can India really overcome its period of despondency and regain its lustre as a dynamic economy? There is certainly evidence to suggest that the worst is over and that economic activity will perk up in the coming year. There is also more reason to think that some of the heavy structural headwinds which kept the economy down are easing, brightening the longer-term prospects. But the case for expecting India to enjoy a period of sustained super-charged growth will not be compelling until the political situation is settled enough to allow further reforms.

The economy is returning to life

While the headwinds from demonetisation and GST implementation have not receded fully, there are reasons to believe that the growth is set to pick up further in the quarters ahead.

- **The Composite Leading Indicator (CLI) bottomed out in March 2017** and has been rising since, hovering at levels that suggest the economy should return to near trend rates of growth for most of 2018.
- **The manufacturing purchasing manager's index surged** in November, with production rising at its fastest rate in a year. Moreover, industrialists reported growing order books – encouragingly, new export orders have started to grow again after three months of decline.
- **The Reserve Bank of India's industrial outlook survey** showed that, after a year of poor confidence, companies' perceptions of the near-term outlook are now at a multi-year high.

These data points are underpinned by improvements in the underlying economy:

- **First, the disruptions posed by the rollout of the GST are likely to ease** in coming months, as the authorities adjust the GST regime to reduce the burden on businesses. For example, to lower the cost of compliance for small businesses, the GST council has lifted the

turnover threshold for the composition scheme from INR7.5mn to INR10mn in the Oct 17 meeting. The composition scheme would allow businesses to file returns on a quarterly, as opposed to a monthly basis. Tax concessions and further inventory restocking should provide a fillip to growth prospects.

- **Pent-up demand is likely to be released as the worst effects of the demonetization wear off:** In November last year, the government with no notice cancelled the legal status of 500 and 1,000 Rupee notes, rendering 86% of the money in circulation useless in an economy that was heavily dependent on cash. The disruption to business activity, especially in the poorer areas of the countryside has lingered for much longer than the government anticipated. The new Rupee notes are now circulating and the economy is finding its feet again. This improvement in demand will receive an added fillip from salary hikes from the 7th Pay Commission.
- **Rural consumption will be buoyed** by a good enough monsoon season. Although the monsoon ended with a slight deficit compared to the long period average of rainfall, there were enough rains to bolster farm incomes. The auto sector, for instance, has just reported sterling sales of scooters in November, which they attributed to the good monsoon.

Stability indicators also look fine, for now

So, the Indian economy has turned the corner on economic growth. Overall, it also looks like risks to inflation and the external accounts, while still problematic, are mostly contained. Indeed, the Indian Rupee has been on an upward trajectory, appreciating 5.5% against the US Dollar in the year to November, despite some worrying trends, reflecting investor confidence in the economy:

- **The current account deficit widened to a multi-year high in 2Q17 (-2.4%)** on the back of gold imports which nearly tripled in the same period, ahead of the rollout of the GST (see Chart 7). India's trade balance has also been deeper in the red as import growth (2Q17: +33.7%) continues to outpace that of exports (2Q17: +8.75%). The recent recovery in oil prices will also translate into a hefty import bill and put the current account under greater stress.
- **However, a gush of foreign portfolio investment (FPI) has helped to fund this the deficit.** Global investors still favour India's equity market, and their confidence was buoyed by the government's reform efforts and the upgrading of its sovereign rating. This has helped to boost foreign exchange reserves which broke past the USD400bn threshold at the end of November, giving India one of the largest hoards of foreign exchange in the world.
- **Inflation has edged up:** Consumer inflation rose to a 7-month high of 3.58%YoY in October mainly because food prices accelerated. Core inflation is also running at close to 5%, uncomfortably high but not alarming in India's context. But this does mean that the central bank is probably wise not to bend to government pressure to relax monetary policy further.

- **Fiscal pressures remain though as the revenue shortfall could worsen:** The rationalisation of GST tax rates on over 200 items will reduce GST revenues, which have already dipped to INR833bn in October, compared to the monthly average of INR917bn between July – September. With the Modi government commendably determined to keep the fiscal deficit under control, this means that the government has little space to use fiscal stimulus to boost demand.

Long term prospects helped by reforms

So, the cyclical prospects for the economy look reasonably good despite some hiccups. What of the longer term? Here too, there is good news. In recent months, the government has announced a slew of measures that have helped to burnish its reformist credentials. These initiatives can be expected to deliver a powerful boost to growth prospects over the medium term, making this cyclical rebound more durable:

- **A big push on infrastructure:** The Modi launched a INR7tr–infrastructure project in October which aims to pave more than 80,000km of roads and highways by March 2022. In particular, the first phase of the INR5.35tr–Bharatmala project, which was previously mooted in Jul 15, was also approved. Construction will commence in earnest by end–2018 if hurdles such as land acquisition can be overcome. If the Bharatmala project materializes, the construction of highways, roads and economic corridors would boost connectivity, alleviate traffic congestion and reduce logistical costs in the transport of goods.
- **A massive INR2.11tr–bank recapitalization plan was also unveiled** to relieve stressed balance–sheets in the corporate and banking sector. This was a long overdue measure – stressed loans totalled INR9.5tr while its share as a proportion of total loans stood at a hefty 12.6% as of June 2017 and were one reason why the economy was sputtering. The Modi government has also amended the Insolvency and Bankruptcy Code (IBC), a bankruptcy law passed in 2016 aimed at expediting the resolution of insolvency.
- **Don't under–estimate the cumulative effect of administrative reforms:** The GST reform is game–changing: by unifying India's fragmented markets into one globally scaled economy it will release powerful synergies. But Prime Minister Modi has been quietly at work in the past three years, energetically cutting red tape and slashing bureaucracy. The result has been a dramatic improvement in India's ranking in the World Bank's ease of doing business report. India's rank improved to 103rd from 136th – we believe it will continue to improve as the effects of the above reforms to the bankruptcy code and other changes are fully felt.

These reforms will help to sustain India's growth rate above 6%. But India is capable of much better performance if further reforms were made. The core of India's problem is governance and, while Prime Minister Modi has worked hard at overcoming this deficit, he has a long way to go. Just look at the shocking levels of pollution in Delhi, India's capital as well as in virtually all major metropolitan areas. Some analysts estimate that 2.5 million Indians die prematurely

each year because of this. Yet, government action to resolve this environmental disaster has not been forthcoming. Until the Indian government's capacity to deliver essential public goods – whether it is clean air or good education or a court system that can adjudicate cases in a timely fashion or good roads and dependable electricity – is drastically overhauled, India will struggle to enjoy a true economic lift-off. India also needs to substantially reform its labour laws so that more jobs are created in the formal sector. In particular, some labour regulations have the impact of discouraging manufacturing companies from gaining the scale needed to be globally competitive – such perverse regulations need to be overhauled but the political risks to doing so are considerable.

Ultimately, India's take-off depends on good politics – and that's the problem

There is a real risk that the impetus for reforms will cool off in the next two years. The next general election is due before the middle of 2019. Results of the Gujarat and Himachal Pradesh state assembly elections are due soon – it looks like the ruling Bharatiya Janata Party (BJP) of Prime Minister Modi is having a challenging time defending its position. But Modi will have little respite, as he will be kickstarting the BJP's campaign in Meghalaya in the coming week – and there are five crucial state elections in 2018. Modi and his party will be in campaign mode for the next year and a half.

While the BJP remains the party to beat in both state assembly and general elections, India's complex and fragmented polity means that neither Modi nor his BJP can take anything for granted – particularly as the opposition Congress party seems to be regaining some momentum. With Modi's reforms likely to take time before delivering jobs and rising incomes to voters, the ruling party may well be tempted to resort to populism and communal appeals to shore up its political position. If that were to happen, India's economic take-off would be once again postponed.

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