COFACE ECONOMIC PUBLICATIONS

April 2019

FOCUS

By Carlos Casanova
Economist for Asia Pacific
based in Hong Kong

Despite five years of "Modinomics", India continues to be constrained by economic fragilities

When Narendra Modi ran for Prime Minister in 2014, he pledged to boost the competitiveness of India's industrial sector to promote growth. Five years later, the economy is in a better position, but many of the structural fragilities that Modi inherited continue to afflict India today. In particular, a mixed track record in terms of executing three crucial economic reforms has dampened enthusiasm for Modi: the new insolvency and bankruptcy code, demonetisation, and the introduction of a harmonised goods and services tax. India will host its next general election from April 11 to May 19, with Modi running again. Assuming he manages to secure enough votes to win a simple majority, the 17th Lok Sabha (Parliament) will likely be a more fragmented one, which could slow India's reform process. The incoming administration will have to focus on cleaning up the banking sector as well as boosting employment to support India's burgeoning workforce. Achieving this while simultaneously promoting macroeconomic stability will likely prove challenging.

Weaker support ahead of General Elections

When Narendra Modi ran for Prime Minister in 2014, he pledged to boost the competitiveness of India's industrial sector. His experience as Chief Minister of Gujarat, compounded with a pro-business approach to unlocking India's potential, garnered him much support from boardrooms across the country. Indeed, Modi took over an economy in disarray. In 2013, growth had plummeted to 5.9%, down from a previous nine-year average of 8.2%, while inflation had averaged at 9.7%, crippling Indian households. Meanwhile, the outgoing government was on the brink of policy paralysis[1], unable to rein in corruption and in need of key structural reforms.

Five years on, India will be hosting general elections for its 17th Lok Sabha (Parliament) between April 11 and May 19, and Modi will run again. The economy is in a better position than it was in 2014: growth reached 7.3% in 2018, while inflation dropped to 4.0%, in line with the Reserve Bank of India's long-term target. This has enabled the country to go from being one of the "Fragile Five" emerging economies, to a preferred investment destination, with Moody's upgrading its sovereign credit rating for the country to Baa2 on November 2017[2].

However, despite sizeable progress on the economic front, a mixed track record in terms of economic reforms has played a role in dampening support for the Prime Minister. Moreover, an intensification of Hindu Nationalism has antagonised many segments of Indian society contributing to a loss in support for Modi. India's ruling coalition, the National Democratic Alliance (NDA), is an alliance of several parties, of which

1 - *Jha R. & Truong D.N. (2015).* Estimates of trade misinvoicing and their macroeconomic outcomes for the Indian economy. *Review of Economics and Finance, 5 (1), 19-34*
2 - *Moody's Investor Service.* Moody's upgrades India's government bond rating to Baa2 from Baa3; changes outlook to stable from positive. *November 16, 2017.*

the Bharatiya Janata Party (BJP) – the party of Prime Minister Narendra Modi – is the most important. Modi's popularity dropped, leading the BJP to suffer setbacks in 2018. Although BJP still rules 18 out of 29 Indian states, it lost support during the 2018 state elections (Vidhan Sabhas). BJP also lost its simple majority in the May 2018 by-elections.

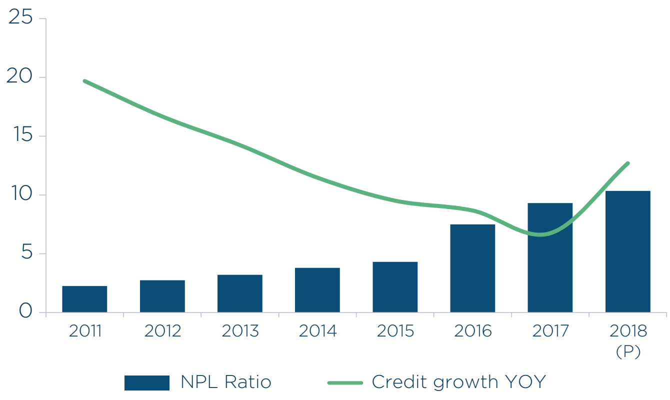
The opposition remains frail, with Rahul Gandhi failing to displace BJP. However, assuming Modi manages to secure enough votes for even a simple majority, the 17th Lok Sabha will likely be a fragmented one, requiring more alliances and politicking. Modi would therefore have to make compromises. While the former would be welcome by many segments of Indian society as well as foreign investors, a divided Lok Sabha may slow India's economic reform process, with negative implications for potential growth.

Modi's mixed track record on economic reforms

The expectations for "Modinomics" – the term used to describe the economic policies proposed by the then incoming Prime Minister – were exceptionally high. Modinomics aimed to revamp the execution of deep structural reforms to ensure that India returned to the high growth trajectory that characterized its economy in the 2000s[3]. The benefits of such growth were expected to reach a larger section of society, thereby alleviating existing pressures associated with India's burgeoning demographics – indeed, one of the main campaign slogans was *sabka saath, sabka vika* (everyone's participation, everyone's progress). Nonetheless, the implementation of these reforms encountered practical constraints:

Insolvency and Bankruptcy Code: The Government of India implemented the Insolvency and Bankruptcy Code (IBC) to consolidate all laws related to insolvency and bankruptcy and to tackle Non-Performing Assets (NPA) on banks' balance sheets, a problem that has dragged on economic growth for years (**Chart 1**). Moreover, prior to the introduction of the IBC on May 5, 2016[4], India's insolvency framework was plagued by fraud: bad debt would be offloaded onto the state bank's balance sheets and business owners would often walk away unscathed. However, some barriers to implementation of the IBC remain. Among other things, although the new code expedites the recovery of debt to 180 days, World Bank figures show it still takes 4.3 years on average to resolve an insolvency case in India, the same time it took in 2013. While as many as 12,000 cases have been filed since the introduction of the new law[5], resource constraints at the National Company Law Tribunal (NCLT) are contributing to significant delays, even if the NCLT is currently expanding the number of judges and benches. Moreover, it can prove challenging for foreign investors who are not acquainted with the Indian market to navigate the legal framework. For example, Ericsson had to undergo a costly legal process in order to recover USD 80 million in overdue debt from Reliance Communications in 2019[6].

CHART 1:
Non performing loans (NPL) and credit growth



Sources: Bloomberg and Coface

Demonetisation: On November 8, 2016, Modi attempted to tackle illicit money flows and tax evasion – which had resulted in lower tax revenues to support the country's mushrooming population – by removing the 500 and 1000 Indian rupee banknotes from circulation. Prior to their removal, which accounted for 86% of the total currency in circulation[7], India had a very large informal economy, estimated at around 30% of GDP according to figures by McKinsey[8]. By removing these bills from circulation, Modi also boosted financial inclusion, with positive spill-over effects in terms of transparency and productivity, such as bank account ownership rates increasing from 53% in 2014 to 80% in 2018. However, the demonetisation drive has had unwanted indirect effects on consumption via wealth effects. The move left cash-dependent sectors exposed to tighter liquidity. This translated into weaker demand for consumer discretionary and services, dragging on the formal economy. Moreover, the implementation was done abruptly, which caused investors to fear that the drive would result in a liquidity squeeze. The stock market plummeted over 6% the day after the decision was enacted, further aggravating the distortionary impact via wealth effects. Furthermore, the long-term efficacy of the measure remains questionable. According to figures by the Reserve Bank of India (RBI), the currency-to-GDP ratio was 12.1% in 2016 but declined to 8.8% after the demonetisation drive in 2017. The ratio increased again to 10.9% in 2018, which is only marginally lower compared to the level before demonetisation.

Goods and Services Tax: Following from the demonetisation drive, Modi's government implemented an overhaul to the taxation system on July 1, 2017. This was a much awaited reform, and something his predecessor Manmohan Singh did not achieve. The introduction of a goods and services tax (GST) aims to boost government revenues: at 16.8%, the tax-to-GDP ratio remains low compared to China (20.1%) and the United States (26.0%). The GST also resolved a multiplicity of state-level taxes, subsequently streamlining rules and making it easier for investors (foreign and domestic alike) to navigate the tax environment in India. India possesses a huge

3 - *Jha R. (2018).* Modinomics: Design, Implementation, Outcomes and Prospects. *Asian Economic Policy Review (2019) 14, 24—41*
4 - *4 - The Economic Times.* Lok Sabha passes bill to fast track debt recovery. *August 2, 2016. Available at:* https://economictimes.indiatimes.com/news/economy/lok-sabha-passes-bill-to-fast-track-debt-recovery/articleshow/53495364.cms?from=mdr
5 - *The Times of India.* 12,000 cases filed since implementation of insolvency law, says official. *March 25, 2019. Available at:* https://timesofindia.indiatimes.com/business/india-business/12000-cases-filed-since-implementation-of-insolvency-law-setting-up-of-nclt-says-official/articleshow/68563082.cms
6 - *Bloomberg.* Ericsson Teaches Anil Ambani – and India – a Lesson. *March 18, 2019. Available at:* https://www.bloomberg.com/opinion/articles/2019-03-19/ericsson-s-ambani-victory-hands-india-a-bankruptcy-lesson
7 - *BBC.* Modi's currency gamble damaged Indian economy. *November 8, 2017. Available at:* https://www.bbc.com/news/world-asia-india-41896865
8 - *McKinsey Global Institute.* Boost Growth by reducing the informal economy. *October 18, 2004. Available at:* https://www.mckinsey.com/mgi/overview/in-the-news/boost-growth-by-reducing-the-informal-economy

domestic market, so removing internal barriers to trade plays a key role in unlocking the country's potential. The GST has enabled the Indian economy to progress significantly in this direction. Nevertheless, as was the case with the demonetisation drive, the GST incurred a one-off negative impact on growth. Domestic consumption fell in the aftermath of the introduction of the GST. Additionally, while the tax reform is a landmark, it is far from perfect. The GST remains quite complex, with different taxes for different categories of goods, and with many important products – such as oil – remaining out of the scheme for now.

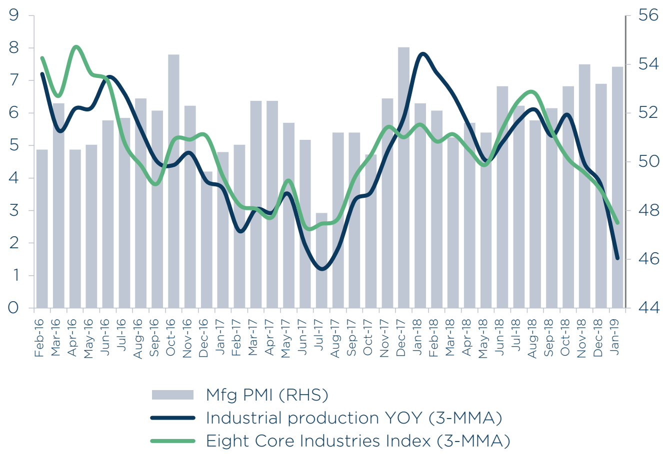
"Make in India" strategy: no tangible result on the manufacturing sector so far, despite an improved business environment

As a result of these economic reforms, India's GDP growth dropped to 6.5% in 2017, the lowest level since 2012. In particular, demonetisation had negative spill-overs on employment and output, as cash serves an essential role in facilitating economic activity in India[9]. In hindsight, while the rational for the demonetisation drive and the introduction of the GST were sound in the medium-term, their implementation was blunt and created uncertainties in the short-term. Tighter liquidity and issues surrounding corruption continue to afflict India's economy, with consequences for both domestic and foreign investors. Despite the RBI's surprise rate cuts in February and April, policymakers have not been able to fully pass-on lower borrowing costs, meaning liquidity remains tight. This has impacted domestic activity (**Chart 2**). Industrial production growth averaged 5.1% YOY in 2018 – up from the anaemic 3.5% registered in 2017, but far from India's potential growth and lower relative to other regional peers. In contrast, China saw its industrial output expand by 6.0% YOY during the same period, although it registered double digit growth rates in the early 2010s.

In response to the need to seek additional financing to boost domestic industry, Modi pledged to implement measures to boost Foreign Direct Investment (FDI) into India. This goal, encapsulated in Modi's "Make in India" strategy, was launched on September 25, 2014 to encourage companies to manufacture their products in India and stimulate FDI into manufacturing. However, while FDI flows have picked up in recent months, they remain low in terms of GDP (1.5%). Moreover, most inflows have concentrated around the service sector, where India has a comparative advantage owing to an abundance of skilled labour (**Chart 3**). On the contrary, manufacturing received a smaller proportion of total FDI in fiscal year 2017-18. FDI is also necessary in order for India to build an adequate level of basic infrastructure. Large supply bottlenecks continue to hobble India's infrastructure sectors – such as roads, railways, and ports – with the government's latest Economic Survey pointing to an infrastructure gap worth USD 4.5 trillion between now and 2040[10]. This cannot be financed domestically, given the stressed balance sheets of private firms and a widening fiscal deficit (-3.2% in 2018). Investments in infrastructure can have a significant multiplier impact on economic activity over the medium- to long-term, in turn facilitating more inflows into the manufacturing sector.

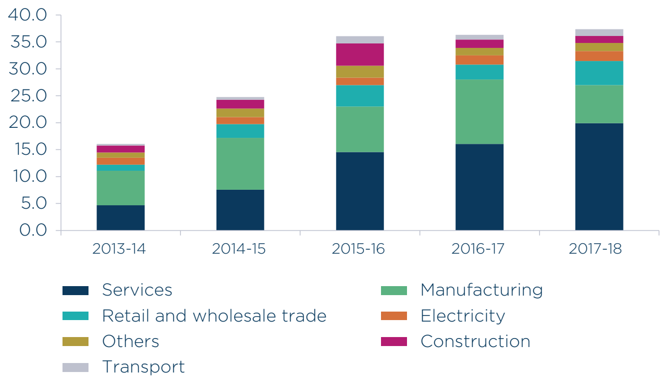
But despite Modi's mixed track record on economic reforms, he has managed to significantly improve India's business environment. India has steadily ascended the ranks of the World Bank's Ease of Doing Business Index. The country moved from 134th in 2015 to 77th in 2019, favoured by the Prime Minister's economic reforms and pro-business outlook. India does particularly well in the areas of electricity connection and the protection of minorities, but lags behind in areas such as property rights and law enforcement, with the latter reflecting a less sanguine situation pertaining corruption. Although Modi has attempted to improve India's institutional quality, the country retains a very low score on Transparency International's Corruption Perception Index (41/100 in 2018), with little progress having being made since 2015[11].

CHART 2:
Activity indicators have shown signs of slowdown



*3-MMA = 3-month moving average
Source: Bloomberg and Coface

CHART 3:
FDI inflows by sector in billions of USD



Source: Reserve Bank of India and Coface

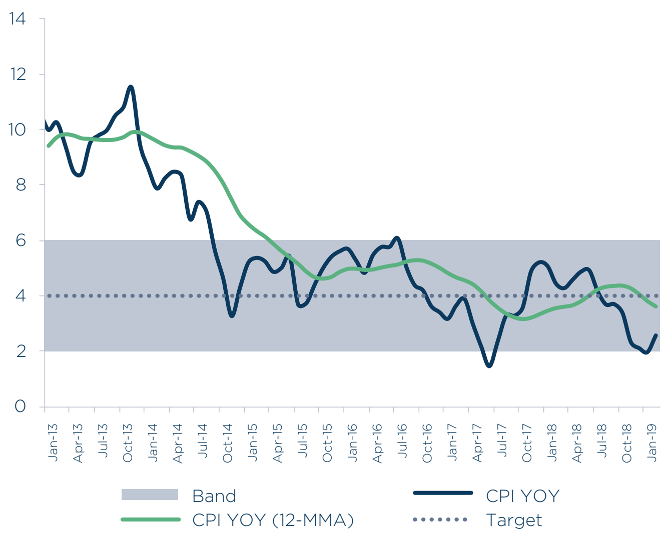
9 - *Chodorow-Reich G., Gopinath, G., Mishra P. and Narayanan A. (2018).* Cash and the Economy: Evidence from India's Demonetization. *National Bureau of Economic Research, Working Paper No. 25370.*
10 - *The Economic Times.* India needs $4.5 trillion by 2040 to develop Infra. *January 29, 2018. Available at:* https://economictimes.indiatimes.com/news/economy/infrastructure/india-needs-4-5-trillion-by-2040-to-develop-infra-eco-survey/articleshow/62694945.cms
11 - *Transparency International.* Corruption Perception Index. *Available at:* https://www.transparency.org/country/IND

Two key challenges ahead: clean-up of the banking sector and management of growing workforce

In spite of five years of Modinomics, the Indian economy remains constrained by fragilities which will continue to impede India from achieving its full potential. Even if Modi emerges victorious, the next Lok Sabha will likely be a divided one, so investors will be paying close attention to ensure that critical reforms continue to be steadily implemented.

One key priority for the incoming administration will be to clean up the banking sector. A recent banking scandal has brought issues surrounding India's corporate governance to the fore. The USD 1.8 billion bank fraud unveiled at Punjab National Bank (PNB), one of India's largest state-owned lenders, sent ripples across the country's banking sector. The company at the centre of this scandal is Mumbai based jeweller Nirav Modi. PNB allegedly issued letters of undertaking, a form of guarantee, so that the jeweller could take out more loans. Several arrests have been made since, and the RBI scrapped quasi-official instruments of guarantees such as Letters of Undertaking and Letters of Comfort on March 2018. However, the PNB scandal added to existing pressures on the banking sector at an inopportune moment. Banks had been grappling with high levels of NPA, as the RBI attempted to implement monetary policy easing to alleviate a liquidity squeeze. Heightened scrutiny in the wake of the PNB scandal only served to reduce incentives for banks to lend, interfering with the less-than-optimum monetary policy transmission mechanism and adding to the pressures on the liquidity front. The RBI had a much more stringent stance under the management of Governor Raghuram Rajan and to a lesser extent Governor Urjit Patel. Incumbent Governor Shaktikanta Das has pledged to resolve the issue too, albeit in a much more gradual manner, so as to not upset a fragile domestic balance.

CHART 4:
Inflation remains towards the lower end of RBIs target, which should support additional cuts



Source: Bloomberg and Coface

On a more positive note, a deflationary environment should support the RBI's pro-growth stance this year (**Chart 4**), with up to two or three interest cuts to the RBI's Repurchasing Repo Rate in 2019 being likely. Nevertheless, given the volatility surrounding India's inflation figures, this tailwind could dissipate going forwards. Basic perishables weigh a lot on India's CPI basket, and the price of these commodities is highly dependent on normal monsoon rains. Moreover, India is a large net importer of crude oil, so the RBI's strategy remains in large part contingent on there being a stable oil price outlook.

Finally, in addition to these economic reforms, Modi's 2014 election manifesto included a myriad of policies aimed at boosting employment and improving education of India's youth. India has a very large working age population, which poses both advantages and risks. The participation rate remains low at 52% – this means that more than half of the working age population is not contributing to GDP – and boosting this figure will prove challenging. With that being said, some progress has been made in recent years in terms of "formalising" the potential gains that a growing middle class can offer. The introduction of the Aadhar Card (mandatory ID number for all residents) and Permanent Account Number ensures that the government can tap into a larger base of tax payers in the future, but it can also facilitate the transfers of welfare to accommodate the needs of this growing group. However, 11 million jobs were lost in 2018, with 83% of these job losses taking place in rural areas, as opposed to the booming service centres in Mumbai. For all of the pieces of the puzzle to fit together, India will need to generate enough economic activity to absorb its growing workforce, which requires growth rates above 8% according to some estimates. Achieving this while simultaneously promoting macroeconomic stability and inclusive growth will likely prove to be quite challenging.

COFACE SA
1, place Costes et Bellonte
92270 Bois-Colombes
France

www.coface.com

FOR TRADE