COUNTRY NOTE: INDIA

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Elections for India's Lok Sabha (its lower house of Parliament) had commenced during our April visit to Delhi and Mumbai and results are due June 4. Incumbent Prime Minister Modi's Bharatiya Janata Party (BJP) is highly expected to hold a majority of seats, and therefore policy continuity is likely for the next 5 years. We think that leads to projected economic growth rates of 6-7% and fiscal austerity. While we see similarities between India's situation today and that of China in the early 1990s, we also note some challenges, mostly in terms of strict and counterproductive legislation on land, agriculture, and labor markets. That being said, India's economy should be able to grow much faster than most of its emerging and developed market peers through the coming decade.

By Alexander Friis Illum, Senior Analyst

Elections: By how much will Modi win?

In the last elections in 2019, Prime Minister Modi's BJP won 303 out of 543 seats available in the lower house of the Indian Parliament, safely surpassing the 272 required for a majority. Modi's popularity – especially in India's Northern and Western states – is immense, and a third Modi term in office seems very likely.

The important question is: by what margin Modi will win this time? The target of the National Democratic Alliance (NDA), the collective of mostly conservative parties that the BJP leads, is 400 seats (from 345 currently). While that seems far-fetched according to political experts, if the NDA can win 359 seats (a 2/3 majority threshold), it will be viewed as a win for Modi. On the other hand, if the alliance loses seats, it will be a disappointment and structural reforms become unlikely.

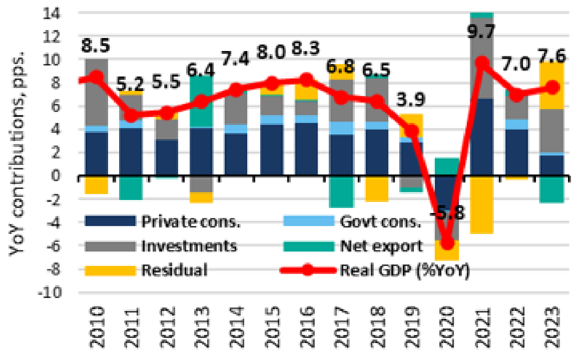
Throughout Modi's first term (2014-2019), the Indian parliament passed important structural reforms such as the GST (a comprehensive VAT-type tax reform) and demonetization (cancellation of larger bank notes to curtail the informal economy). However, throughout his second term, structural reforms were sparse, and the government opted for more project-based spending, such as public infrastructure investments. While India's economic growth potential is solid with a young and relatively well-educated workforce, structural reforms on issues such as land acquisition, agricultural liberation and labor market rigidities are necessary over time.

Based on this, we were disappointed to learn that BJP's election manifesto contains no plans for significant structural reforms. However, much probably depends on the election outcome. If NDA and Modi secure more than a 2/3 majority in the elections, they could seek some structural reforms. If not, a continuation of the less politically demanding public infrastructure investments seems the likely path.

Economic growth: A "new" China?

Under Modi's leadership, the Indian economy has grown by an average of 6.8% yearly (excluding the pandemic years of 2020 and 2021). Recently, private consumption has made smaller contributions to growth, whereas investments have become more important. To revive and structurally improve demand, reforms are needed.

Real GDP: Investments gaining importance.



Source: Haver, Global Evolution

If no such reforms pass, growth is likely to continue in the 6-7% yearly range throughout Modi's third term. Compared to other large economies, these growth rates appear impressive but are nevertheless far from the 10-15% growth seen in China throughout most of the 1990s and early 2000s.

In 1990, GDP per capita in China and India were at similar levels. In 2021, GDP per capita in China was 5.6x that of India. If India sustains growth rates of around 6.5% through the next 15 years, the gap will shrink to 3x. But if India carries out important reforms to remove rigidities and improve competitiveness, the gap could shrink to 1.5x (using IMF assumptions on population growth, relative inflation, etc.)

GDP per capita: China vs. India

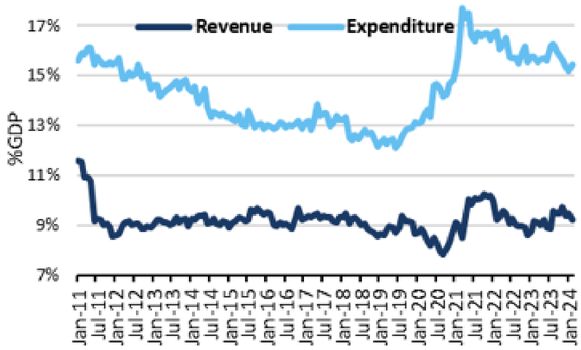
Source: IMF, Haver, Global Evolution

India's economy is service-oriented, with agriculture employing 50% of the workforce but contributing only 15% of GDP. To exceed 6.5% growth, India must improve its manufacturing capacity through reforms. However, employment regulations and legal challenges in acquiring land hinder progress. Prompt reforms could increase growth to 8-9%, advancing millions to middle-income levels. Unfortunately, political motivation for such reforms is currently low.

Fiscal policy: Austerity continues

With a simple majority in the lower house, Modi's government alliance can pass fiscal bills at will. However, outside the pandemic years of 2020 and 2021, Modi has generally showed fiscal restraint. In fact, his government lowered expenses from around 15% of GDP to 12% just before the pandemic. Most recently, expenses have once again started to decline. Along those lines, we see early indications that the GST reform is starting to improve tax revenues, albeit on a small scale. We expect these trends to continue in the coming years.

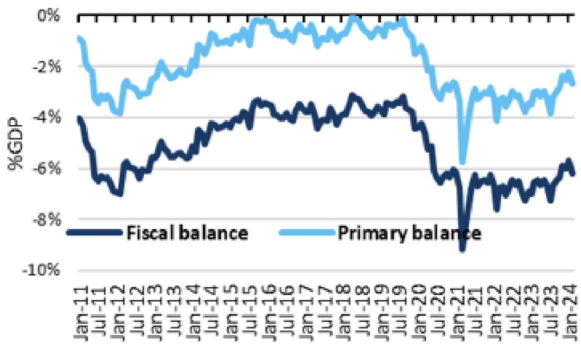
Central government: Revenue & expenditures



Source: Haver, Global Evolution

With rising revenue and decreasing expenditures, the fiscal deficit is expected to shrink. Finance Ministry officials estimate that a headline fiscal deficit of 4.5% of GDP is sufficient to make debt levels gradually shrink, which is what they target. This translates into a primary balance around 0. Currently, the fiscal deficit stands at 6.2% of GDP.

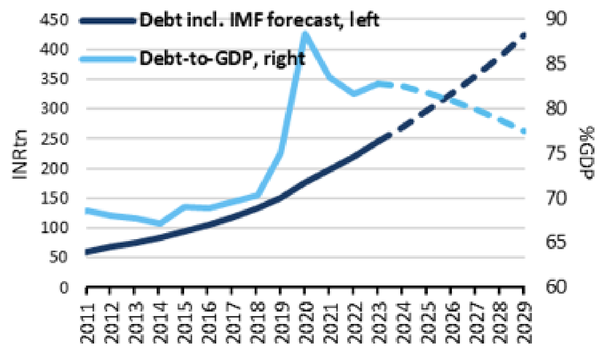
Central government: Headline & primary balance



Source: Haver, Global Evolution

The IMF in its latest World Economic Outlook (IMF, April 2024) seems to agree with the Indian Finance Ministry, as they expect debt to decrease from here.

General government: Debt incl. IMF forecasts



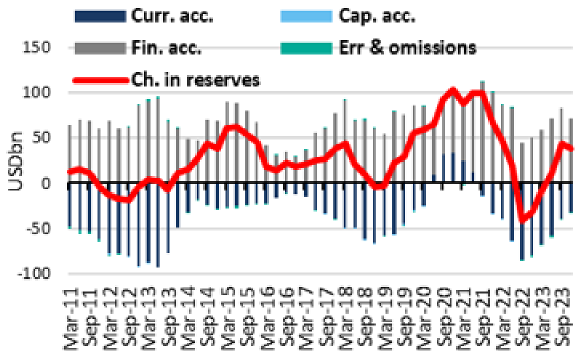
Source: IMF, Haver, Global Evolution

Overall, we see little reason to be worried about developments in fiscal balances and debt. The local investor base is large, and foreign investors own only 2% of government debt. India's bonds will be included in global bond indices beginning later this year, which will bring some foreign investors into India's bond markets, but not to any significant or market-moving degree.

Externals: Reserves are the name of the game

India has experienced large financial account inflows throughout the last 5 years. Heavy goods imports during a few quarters in 2022 took their toll on foreign reserves, but the trend has reversed, and reserves are once again growing at a solid pace.

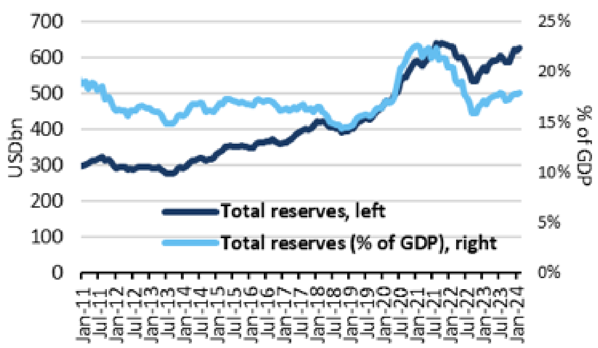
Balance of Payments: Back to inflows



Source: Haver, Global Evolution

Central bank officials are very focused on the reserves, and they see it as a way of protecting the Indian economy in times of uncertain geopolitical developments. They are very happy to observe that reserves are on their way back to the highs of 2021.

Foreign reserves: Near all-time highs



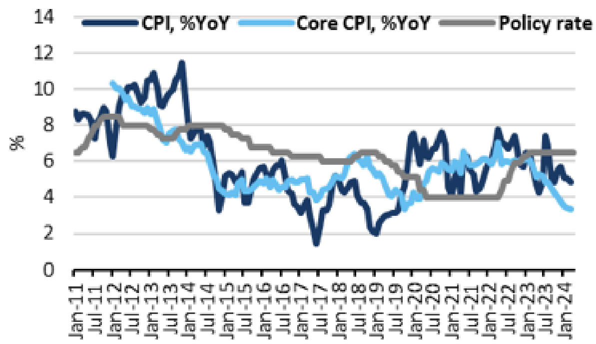
Source: Haver, Global Evolution

The current account continues to be in deficit, but the level is largely negligible at 0.9% of GDP. With the upcoming index inclusions, solid growth rates and easing of regulations, we expect India's reserves to keep growing. One could argue that the developments of the economy should have led to strengthening of the Indian rupee during the last few years, where it has been almost completely stable against the dollar. Central bank officials stresses that they are not intervening in the FX market, but the IMF has recently noted that the currency does not seem to be fully free-floating.

Monetary policy: RBI to stay put for now.

CPI inflation is running at 4.9% YoY as of March 2024. Progress toward the central bank target of 4% has been slow, but we do expect gradual improvements throughout the remainder of this year. Central bank officials stressed that they need to see inflation at or very close to 4% for a "prolonged" period to cut the policy interest rate from the current level of 6.5%. This is not imminent, but rate cuts in the 3rd or 4th quarter look likely. The central bank does not pay much attention to core inflation.

CPI and policy rate: No cuts yet



Source: Haver, Global Evolution

Conclusion: Optimistic but work to be done

We view the developments of the Indian economy in a very positive light, both in terms of economic growth and fiscal policy. However, to become a global superpower, comprehensive reforms are needed. The political willingness to chase such reforms seems limited, but a very positive election surprise for Modi could change this.

Risks to our view include rising unemployment if growth slows (the workforce is growing quickly), a significant election loss for Modi, geopolitical tensions in the region, the absence of government support for ongoing economic improvements, and a lack of fiscal restraint among state governments.

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