THE VIEW

Economic Research

02 May 2019

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INDIAN ELECTIONS:
POLICIES TO BOOST BUSINESS

Allianz

EULER HERMES

EXECUTIVE SUMMARY

Mahamoud Islam, Senior Economist for Asia
+852 3665 8989
Mahamoud.ISLAM@eulerhermes.com

Michaela Grimm, Senior Demographics Expert
Michaela.GRIMM@allianz.com

- India was the fastest-growing economy among G20 countries in 2018 with +7.4% GDP growth. Over the past five years, active and decisive policy-making (policy mix, structural reforms) has contributed as much as +0.7pp to growth p.a. on average. But our proprietary Now India Index (NII) suggests that growth momentum slowed to +6.2% in Q1 from +6.6% in Q4 2018 due to weaker private demand and uncertainties around the outcome of the general elections.
- There are three things India's next government needs to do to boost business:
    - Despite relaxation on FDIs, protectionism and interventionism continue to crowd out business opportunities. So first, (even) more openness to attract capital and support trade - this will help private banks and investors, manufacturing (pharma, motor vehicles) and IT services.
    - Second, a new infrastructure and industrial strategy could help bridge the estimated USD203bn infrastructure gap, and boost demand for infrastructure builders and their suppliers (machinery and equipment, electronic equipment suppliers), while complementing existing initiatives (Make in India, Delhi Mumbai Industrial Corridors) and digital edge.
    - Last, social spending (education, health for e.g.) and redistribution policies will have to become more cost-effective to address growing inequalities. The middle class will represent c. 286mn people in 2025 or 19.7% of the population (from 160mn currently) so job creation and income growth will create more consumption opportunities. This will benefit car, computer and households equipment sellers, and consumer services.

+6.2%

Q1 2019 GDP growth, compared to +6.6% in Q4 2018

AT A CROSSROADS

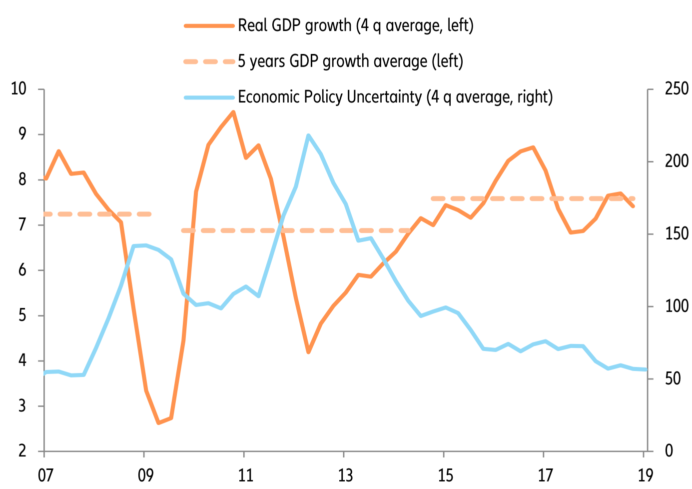
India was the fastest-growing economy (+7.4%) among the G-20 in 2018, clearly above China (+6.6%). Growth strengthened over the five past years, helped by better management of macroeconomic policies and clearer policy direction. Figure 1 shows that in 2018, economic policy uncertainty decreased to the lowest level in five years. We estimate that this policy adjustment boosted India's real GDP growth by around +0.7pp on average between 2014-2018 by strengthening both investor and consumer confidence.

The reduced uncertainty was underpinned by: (i) the strong majority Prime Minister Narendra Modi's Bharatiya Janata Party won after the 2014 election and the implementation of its pro-business strategy; (ii) prudent fiscal and monetary management over that period; (iii) a continued modernization of policy management (e.g., more transparent and credible monetary policy) and (iv) the implementation of groundbreaking reforms to improve the business environment (e.g., new bankruptcy law, tax reform.).

Apart from the financial sector, which is still struggling, macroeconomic vulnerabilities (twin deficits and inflation) have been reduced compared to the 2009-2014 period. The business environment has also improved, as evidenced by India's progress in the World Bank Doing Business survey (+53 ranks over the two past years).

But since the end of last year, the economy weakened significantly. Growth slowed (+6.6% y/y) below potential (+7%) in Q4 2018. And our new Euler Hermes NII (Now India Index)[1] - based on bank credit, air cargo freight, infrastructure output, cellular subscriptions and domestic vehicle sales figures – points to further deceleration with a projected +6.2% growth in Q1 2019 (see Figure 2) due to weaker private demand and uncertainties around elections outcome.

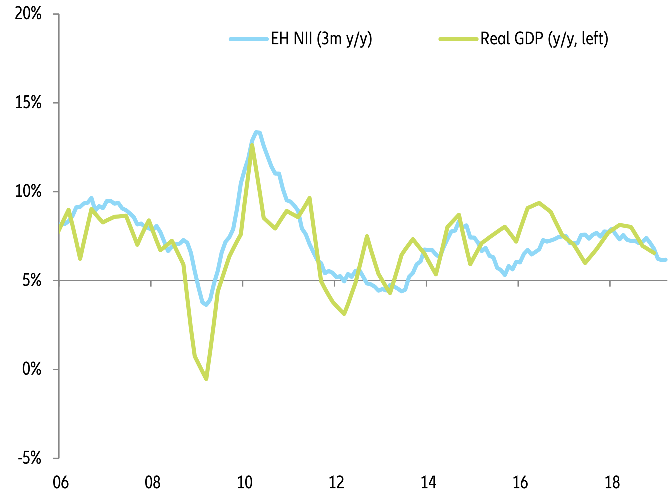
Figure 1: Real GDP growth and economic policy uncertainty



Sources: IHS, Euler Hermes

[1] Inspired by the Chinese Li Keqiang Index, we created an index to track Indian economic activity. We used five indicators that are coincident indicators of the Indian business cycle: bank credit, air cargo freight, infrastructure output, cellular subscriptions and domestic vehicle sales.

Figure 2: EH Now India Index, real GDP growth and composite PMIs



Sources: IHS, Euler Hermes

Looking ahead, we see mixed prospects for the Indian economy. On one hand, risks of policy mistakes have re-emerged over the last fiscal year as the government loosened fiscal discipline and increased pressure on the central bank to support the economy (thus threatening its independence). Externally, global demand growth is projected to slow to +2.9% this year (compared to +3.1% in 2018) and domestically, private consumption shows signs of weakness. Passenger vehicle sales, for instance, declined by -3% in March 2019.

On the other hand, the Indian economic model is still well positioned to take advantage of the next cycle. Lower oil prices (projected at USD67 per bbl on average over 2019-2022) could lead to a reduction of the merchandise trade deficit and inflationary pressures, which should support private consumption. Moreover, a trade diversion (as a result of the China-US trade spat and increasing costs in China) and the servitization of manufacturing and global trade (the delivery of a service component as an added value when providing products) provide opportunities for Indian exporters. Assuming that India makes good of this opportunity, the economy could reach the size of Germany (USD4tn+) by 2025.

By the end of May 2019, India will have a new government that will run the country for the next five years. This provides the chance to adjust policy settings to focus on openness, infrastructure and strengthening private consumption to ensure stronger and sustainable growth over the longer term.

OPENNESS TO ATTRACT NEEDED CAPITAL AND UNLOCK TRADE POTENTIAL

While the Modi administration has already made efforts to open the market to foreign capital (relaxation of foreign investment rules in crucial sectors such as defense, telecom, some e-commerce activities for instance), there's still a long way to go to address financial shortcomings and provide opportunities abroad. Financial resources are limited as public debt is high (general government debt at around 70% GDP), the banking sector is constrained by high non-performing assets (system-wide gross non-performing assets ratio rose to 11.2% in FY2017-18) and savings are too low compared to investment, resulting in a current account deficit. Maintaining the pace of reforms will be important to continue to draw investors' attention and maximize country's potential. With an investment productivity of 3 (i.e., 3 units of capital are needed to create 1 unit of GDP) and a credit intensity of 1.4, India's potential returns on investment are higher than those in China (which scores 6 and 3, respectively).

Opening the market will have three benefits: One will be to allow the government to focus on improving the creditworthiness of the public sector and banks as other actors take the baton to finance growth. Two will be a more efficient allocation of financial resources in the economy by introducing and promoting competition. Three, the move will provide a second wind to domestic demand as foreign capital will boost investment and further competition will make goods cheaper for consumers. Lower transaction costs would also boost trade, which would boost GDP growth. Research from Berg et al[2] shows that a +1pp increase in exports growth is associated with a +1/5pp point increase in economic growth. Against this background, we see two potential categories of winners among corporates:

1. Private Banks and investors: With gross non-performing assets at 4.7%, private domestic banks are the best positioned to become the main source of financing. Foreign and domestic private investors could be the next to step in.

2. Export-oriented companies (manufacturing and services): The first sectors to benefit will be those that already have strong financial buffers. Figure 3 shows the interest coverage of key sectors of the Indian economy. Among the tradable sectors we see business support services, IT services, moto Vehicles, chemical and pharmaceuticals as the main winners. The Indian economy is already well positioned for services exports, which account for 11% of GDP, compared to 6% in China.

[2] JJ Lewer and H Van den Berg, How large is international trade's effect on economic growth?, J. Econ. Surv., Vol. 17, No. 3, 2013, pp. 363-396.

Figure 3: Interest coverage ratio for listed Non-Government Non-Financial Companies

	EBIT/Interest Payment 2018
Agriculture and Related Activities	5.2
Mining and Quarrying	2.1
Manufacturing	4.7
Chemicals and Chemical Products	9.4
Pharmaceuticals and Medicines	8.1
Computer and Electronic Equipments	4.0
Electrical Machinery and apparatus	3.5
Machinery and Machine Tools	8.1
Motor Vehicles and Other Transport Equipments	10.8
Jewellery and Related Articles	3.0
Medical Precision and Other Scientific Equipments	7.8
Electricity and Gas Supply	1.4
Construction	1.3
Services (Other than IT)	1.1
Wholesale and Retail Trade	2.5
Transport and Storage Services	2.3
Hotel and Restaurant	2.4
Real Estate	1.8
Business Support Services	4.3
Hospital Services	2.8
Video and Television Programming and Broadcasting	14.0
IT, Computer software and related services	72.9
All Companies	3.8
	Above all companies average

Sources: IHS, Allianz Research

Financial opening should be accompanied by a signification reduction of protectionist measures in order to boost trade as foreign companies still struggle to access the market. India's tariffs are among the highest in the world (e.g., 13.8% simple average Most Favored Nation applied, compared to 9.8% for China in 2017) and state interventionism is also high with substantial subsidies (food-security program, for e.g.) and strong involvement of the government to protect local players (ban on foreign investments into multi-brand retail). Such persistent protectionism keeps investors away and maintains inputs costs at high levels. It has also, more importantly, led trade partners such as the U.S. to retaliate, which is a drag on Indian exporters' sales.

A JOINT INFRASTRUCTURE INDUSTRIAL (I&I) STRATEGY

In parallel, a radical improvement of infrastructure will be crucial to boost domestic trade and accelerate an economic catch up. But this has been difficult over the years because of a lack of financing and difficulty in execution. The Modi government prioritized increased investment in roads, airports, power generation and telecommunication infrastructure. This was accompanied by a more active role of the National Investment and Infrastructure Fund but also the creation of Project Monitoring Group to speed up investment approval. Yet much more needs to be done to address infrastructure bottlenecks such as delays in land acquisition, as well as the financing gap.

The Indian government estimated that the country will need USD750bn of infrastructure investment between 2017 and 2022 or USD150bn per year to create a sustainable growth environment. However, based on the World Bank Infrastructure needs simulation tool, we calculate a much higher need of USD 203bn per year. Our estimates point to significant needs in energy-related infrastructure and transport. Assuming that government spending on infrastructure rises in line with nominal GDP growth (to avoid fiscal slippage), government contribution could reach USD105bn. This would still leave a financing gap of USD98bn. A further liberalization of the financial market could ease this financial burden by allowing foreign private investors to (co-)finance needed infrastructure projects.

In order to maximize the benefit for the economy, this strategy should be complemented by an industrial plan leveraging new demand from the public sector and infrastructure builders and the reduction of transactions created by better infrastructure. Synergies with existing plans could be increased. The Make In India strategy could be readjusted into clusters. Those that are related to new demand could become of high priority (railways, aviation, for e.g.). The creation of new industrial corridors such as the Delhi-Mumbai Industrial Corridor Project could be a way to kill two birds with one stone. Lastly, the country could also use this strategy to improve its edge on digitalization. India is already a step ahead on many aspects of digital adoption with the world's largest unique digital identity program (AADHAAR), for example. It is not only the country with the second-largest number of mobile phone (1.18bn) and internet subscriptions (c.494mn) worldwide but also the one with the highest number of Facebook users in a single country worldwide (250mn in 2018). The potential is huge considering the current growth rates (+17% growth in the number of internet users in FY2017-2018) and the penetration rates of some of the aforementioned indicators – for example, in 2018, only 37% of India's population had access to the internet, compared to 53% worldwide.

This strategy will benefit various sectors. Infrastructure builders especially could take advantage from a rise in sales. Our calculation of infrastructure needs suggests that those operating in energy and transport will likely benefit the most. Telecom will come next, also supported by country's digitalization efforts. The third category of winners will be their suppliers, namely machinery and transport equipment or electronic and electric equipment providers especially.

Figure 4: Infrastructure needs per year until 2022

	Effort per year (USD bn)	Effort per year (% FY2017-18 GDP)
Total	203	7%
Energy	108	4%
Transport	48	2%
Telecom	31	1%
Water	16	1%

Sources: WB Github, Allianz Research

STRONG CONSUMERS AS A SOURCE OF SUSTAINABLE GROWTH

In order to record sustainable growth, a third pillar aiming at strengthening private consumption will be needed. This will help provide a persistent boost to demand and thus a strong foundation for future growth.

Based on the latest Household Consumer Expenditure Survey, today around 12% of India's population, i.e. 160mn people, live in middle-class households; the majority of them in urban areas. Assuming that the growth dynamic observed since the turn of the century persists, we expect the number of people in middle-class households to increase to 286mn in 2025, corresponding to 19.7% of the total population.

While the joint infrastructure and industrial strategy will support a rise of the number of jobs and total income, a cost-effective redistribution strategy will be needed to address growing inequalities.

Assuming that authorities are able to spare financial resources due to the further involvement of the private sector (which will strengthen the supply side of the economy), they could provide more resources to the demand side of the economy by investing further in education and health. Research from Bharti et al[3] shows that public spending on health stagnated in 2009-13 and 2014-18 at 1.3% GDP, while spending on education decreased from 3.1% GDP to 2.6% GDP, respectively. Besides, setting a minimum income guarantee could help strengthened private consumption. The same study shows that establishing a minimum income of INR72,000 would cost around 1.3% GDP and could raise living standards of the bottom 33% of households.

The direct beneficiary of such a redistribution strategy will be B2C sectors such as household electronic and electric equipment, the automotive sector, pharmaceuticals and consumer services.

Photo Pratiksha Mohanty on Unsplash

[3] Nitin Bharti and Lucas Chancel, 'Tackling inequality in India: Is the 2019 election campaign up to the challenge?', WIL

Director of Publications: Ludovic Subran, Chief Economist
Euler Hermes Allianz Economic Research
1, place des Saisons | 92048 Paris-La-Défense Cedex | France
Phone +33 1 84 11 35 64 |
A company of Allianz

http://www.eulerhermes.com/economic-research
research@eulerhermes.com
euler-hermes
eulerhermes

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