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Modinomics and its Impact on India's Capital Markets

Pre- Modi Phase: India Among the Fragile Five

Prior to 2014, when Prime Minister Modi's government came to power, India's economy witnessed a phase of low growth and high inflation. In the period FY2011-2014, real gross domestic product (GDP) growth had slowed to 5.7 percent compound average growth rate (CAGR), down from 8.2 percent over FY2007-2010. This was accompanied by high inflation. Wholesale price inflation reached its peak at 9.6 percent year-on-year in FY2011-2012. GDP growth was supported by high imports and heavy dependence on external debt, leading to sustained deterioration in current account deficit (CAD) as well as currency deprecation. CAD as a percent of GDP was at a low in FY2012-2013. The real effective exchange rate for Indian Rupee (INR) fell two percent over FY2011-2014 compared to a three percent appreciation between FY2007-2010. External debt rose to 24 percent of GDP in FY2013-2014, the highest since FY1996-1997. High inflation, large trade deficits and poor currency management led the Reserve Bank of India (RBI) to raise rates by a cumulative 2.75 percent points over FY2010-2014. The unstable macroeconomic conditions led to a sell-off in bond markets with 10-year government bond yields rising 1.8 percent points between FY2010-2014.

On the policy front, populist measures dominated market-friendly and sustainable growth policies. These included: (1) excessive Minimum Support Price hikes for farm produce leading to soaring food inflation and implying limited benefit even to farmers in real terms, (2) retrospective taxation undermining investor confidence, and (3) Land Acquisition Act of 2013, which made the land acquisition process expensive and cumbersome. In fact, the number of projects stalled, shelved, or abandoned was at a high during the period from 2011 to 2014.

Currency weakness, soaring current account deficit and lack of investment led to slowdown in economic growth. In August 2013, India was one of the Fragile Five economies including Turkey, Brazil, South Africa and Indonesia.

Thus, the Modi government took charge of the country when the economy was under tough conditions.

Modinomics: A Long Run Sustainable Growth Story

Since then, there has been a radical shift from a focus on short term income gains to policies focused on long term, sustainable development. We describe some of these key policy initiatives by the incumbent government in three key areas: (1) social/developmental policies, (2) market- and investment-friendly policies, and (3) fiscal reforms.

Social/Developmental policies

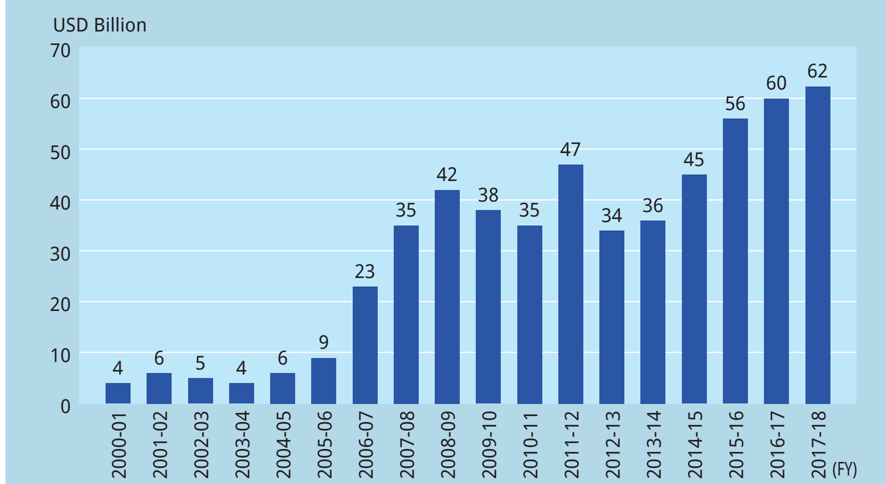
- **Provision of basic amenities:** The Modi government has remained focussed on welfare schemes that help boost the standard of living for the low-income class in a sustainable manner. The key focus areas are construction of houses for low income classes in rural and urban areas, construction of roads, and provision of gas (LPG) and electricity*[1]. The housing scheme aims at providing a *pucca**[2] house, with basic amenities, to all homeless people or to those living in *kutcha**[3] houses, by 2022. The target of the road construction scheme is to provide transportation connectivity to unconnected habitations. The pace of road construction has picked up significantly post FY2013-2014. About 48,660 kilometres of road connecting close to 11,500 new habitations were completed during FY2017-2018. In FY2017-2018, average daily pace of construction reached 134 km compared to only 73 km per day during FY2011-2014. The scheme for providing LPG connections to women from below poverty line households helps reduce the use of traditional cooking fuels that cause pollution and adversely affect health of women. The government's current target is 80 million LPG connections by 2020, which has been raised from the previous target of 50 million. So far, 41 million connections have been established.

- **Financial inclusion:** The government instituted the Pradhan Mantri Jan Dhan Yojana (PMJDY), a scheme to ensure at least one basic banking account for every household, improve financial literacy, provide access to credit, insurance and pension facilities. All bank accounts opened under the scheme are to have an overdraft facility of INR 5,000 for *Aadhar*-linked accounts after satisfactory operation in the account for six months. In addition, the beneficiaries would get a RuPay Debit card having inbuilt accident insurance cover of INR 100,000 and a life cover of INR 30,000. The accounts will also be used for transferring all government benefits including the Direct Benefit Transfer.

  As of March 2017, the almost 315 million accounts under this scheme make up about 17 percent of the total number of accounts with scheduled commercial banks. These accounts have actually led to an increase in financial inclusion. The average balance in such accounts has increased from INR 800 in December 2014 to INR 2,500 in April 2018. The results of an empirical study conducted by researchers also show that activity in these accounts catches up to non PMJDY accounts overtime. *[4]

- **Digitalisation:** There has been increased focus on digitalisation under the current government. A unique identification number has been provided to all individuals called *Aadhar*. All accounts including bank accounts (including *Jan Dhan* accounts), pension accounts and other government services can be accessed using this identification number. A digital platform called *Umang* (Unified Mobile Application for New-Age Governance) has integrated several government services online through the *Aadhar* number. For all the key schemes initiated by the government, online platforms have been developed. These not only provide information about

Figure 1: FDI Net Inflows



Source: Department of Industrial Policy & Promotion

the scheme but allow users to apply online and access their benefits. Also, these websites provide details about the progress of the schemes' execution. This system improves efficiency as it reduces the amount of paper documentation work and follow-up with government officials necessary to access the benefits of government schemes. Also, it improves transparency and provides a system for monitoring and control for better execution. The government has also initiated *BharatNet*, a scheme aiming to provide internet connectivity in rural areas. This initiative is likely to facilitate better flow of information to rural areas, which would provide such benefits as better information on agricultural techniques for farmers, improved information about government schemes for the rural population, and increased participation in these schemes.

Market- and investment-friendly policies

The Modi government has undertaken several pro-market reforms which have helped enhance efficiency in the system, improved investor confidence in the economy, and helped attract foreign capital flows.

- **Foreign direct investment liberalisation:** Foreign direct investment (FDI) is an important driver of economic growth and a source of non-debt finance for the country's development (Figure 1). The incumbent government has taken several measures to allow FDI inflow through the automatic route*[5] and simplify the foreign investment process. According to the Press Information Bureau of India, in 2018, FDI policy reforms have been adopted in a number of sectors including defence, construction development, insurance, pension, other financial services, asset reconstruction companies, broadcasting, civil aviation, pharmaceuticals, and single brand retail trading.

- **Ending retrospective taxation:** In 2012, the Income tax Act of 1962 was amended with a retrospective effect. This meant that the government had the power to take back taxes due going back to 1962. This hurt investor sentiment due to tax uncertainties for Indian firms. The Modi government ended this overhang by ensuring that no new cases of past taxes due would be opened and that ongoing cases would be resolved quickly.

- **Insolvency and Bankruptcy Code:** The accumulating non-performing assets in the banking sector were hurting lending activities by banks. Before the Insolvency and Bankruptcy Code (IBC), there was no single or comprehensive law in India to deal with bankruptcy. Liquidation and reorganisation were complex processes, with four agencies, namely the relevant High Courts, the Company Law Board, the Board for Industrial and Financial Reconstruction, and Debt Recovery Tribunal having overlapping jurisdictions, resulting in delays. In the World Bank's Ease of Doing Business report, India is ranked 103rd in terms of resolving insolvency. The recovery rate in India for insolvency is just 26.4 percent, and the recovery process takes around 4.3 years to resolution. The IBC allows creditors to assess the viability of a debtor as a business decision and agree upon a plan for timely revival or liquidation. The code puts in place an institutional framework that consists of a regulator (the Insolvency and Bankruptcy Board of India), insolvency professionals, information utilities (those who collect and disseminate required financial information), and adjudicatory authorities, such as the National Company Law Tribunal. Some of the IBC's important features are: changing the insolvency test from "erosion of net worth" to "payment default", shifting control from the shareholder and promoters to creditors, and significantly changing the priority for distribution of liquidation proceeds. Secured debt and workmen's dues are the first priority. Government dues stand below the claims of other unsecured financial creditors, unlike in the past. The IBC envisages a time-bound process for resolution. According to the quarterly newsletter by the Insolvency and Bankruptcy Board of India, of the 701 cases admitted under the IBC from the first quarter of 2017 to the first quarter of 2018, 176 cases have reached resolution decision.

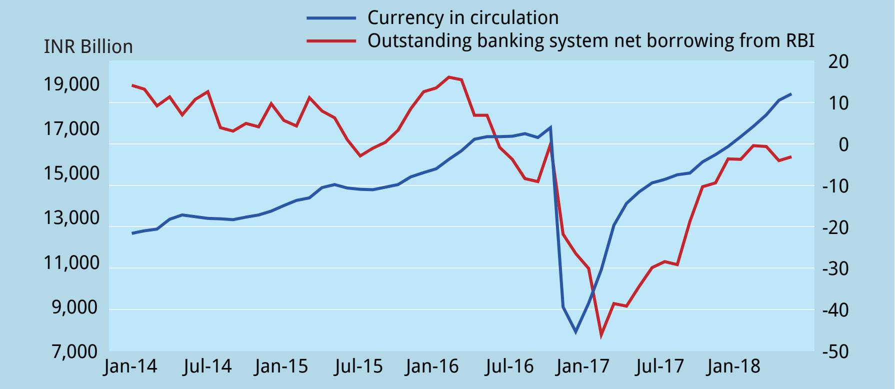
- **Enforcement of the Real Estate Regulation Act:** The Real Estate Regulation Act (RERA) has been enforced by the government to protect the interests of home buyers and enhance transparency and accountability in real estate transactions.

Fiscal reforms

- **Formalisation of the economy:** Implementation of a Goods and Services Tax (GST) was an important move towards expanding the tax base, preventing tax evasion, and formalising the economy. It brought transactions involving almost all goods and services under the umbrella of a single unified taxation regime thus reducing inefficiencies in tax collection and expanding the tax base. India's tax-to-GDP ratio, currently at 18 percent, is lower than that in other emerging markets. GST should lead to improvement in this ratio. Increased tax collections are likely to help achieve fiscal discipline. To further aid the process the government introduced the e-way bill system which is an online platform for filing GST returns. This system has reduced documentation procedures and thus helped reduced the cost and increase the efficiency of transportation of goods and services.

- **Privatisation of unprofitable public sector undertakings:** The government initiated and accelerated the process of privatisation of unprofitable public-sector undertakings. According to The Economic Times, the central government is preparing to lower its stake in all central public-sector enterprises to 49 percent in three years, except in strategically important sectors including defence and oil and gas.

Figure2: Normalisation of Currency in Circulation and System Liquidity to Pre-demonetisation Levels



Source: Centre for Monitoring Indian Economy, RBI, Nomura Research

Demonetisation

One of the key policy measures implemented by the government was demonetisation. In November 2016, the government announced demonetisation of INR 1,000 and INR 500 currency notes. This was expected to a cause permanent shift of liquidity to the banking system, thereby increasing the capital base for lending and reducing rates. However, a review of currency in circulation suggests that the total currency in circulation is moving back towards its trend levels, as indicated in Figure 2. Hence, the positive impact of demonetisation seems to be diminishing.

Implications for Capital Markets

The reforms undertaken by the Modi government positively impact the country's capital markets in two ways: a) improving the outlook for growth and b) reducing the cost of capital. The reforms have a positive socioeconomic impact. They support long term sustainable growth without fuelling inflation. Since most of the reforms target the rural population, they have a positive impact on economic growth in those areas. The investment in housing and road construction and provision of electricity is gathering momentum. We are also witnessing gradual pick up in consumption in the rural areas, which we believe can accelerate further.

The government reforms have also led to an overall lowering of the cost of capital. In our assessment, the following specific reforms have played a key role.

- The government has largely stuck to fiscal discipline thus far, which has a positive impact on government bond yields and helps lower the cost of funding throughout the system.

- The implementation of IBC significantly enhances comfort on lending as it promises a timely resolution process in case of default.

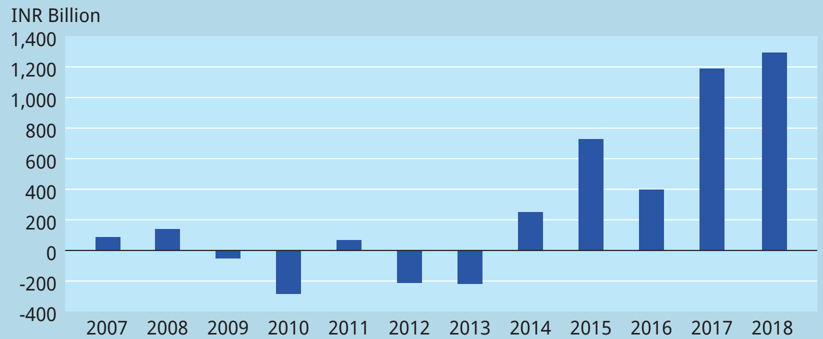
- Implementation of reforms like the GST and digitisation has brought about greater transparency and formalisation in the economy. This, we believe, should lead to better operational and financial efficiency (for instance, by lowering the working capital requirement). Further, this should lead to increased confidence on the part of lending institutions.

- Financial inclusion allows people and smaller businesses to have access to formal financial institutions. This lowers the overall cost of borrowing. In smaller towns and rural areas there is heavy dependence on informal financial channels like moneylenders, who lend at exorbitantly high rates.

- Historically most savings in India were invested in real estate and gold. These were considered safe havens for undisclosed or “black” income. Now, there is greater government scrutiny of these investments. As a result, we expect more savings to be channelled into productive sectors through financial institutions and markets. We have witnessed unprecedented inflows into mutual fund schemes (Figure 3).

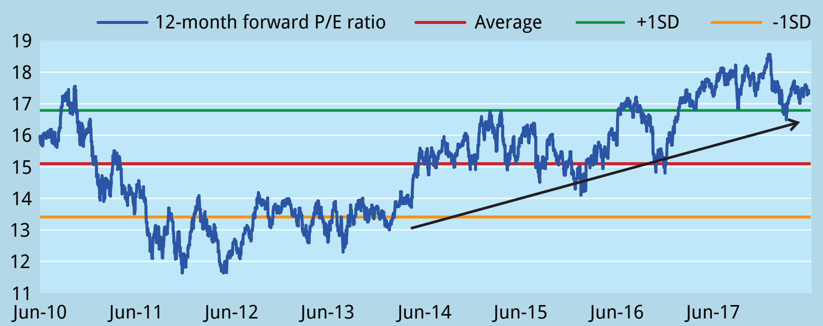
- The structural reforms have helped improve the confidence of international investors. For instance, India has jumped 42 places in the World Bank’s ease of doing business ranking. Moody’s also upgraded India’s credit rating outlook after almost 14 years. Investor sentiment has improved. India has surpassed China in net FDI inflow as percent of GDP. Indian markets have re-rated since 2014 with 12-month forward price/earnings (P/E) multiples now close to their all-time highs (Figure 4). Notably, the inflows into Systematic Investment Plans have increased and have persisted even in times of market underperformance.

Figure 3: Mutual Fund Equity Net Inflows



Note: 2018 figures are annualised using figures as of 21 June 2018.
Source: Association of Mutual Funds in India

Figure 4: NIFTY: 12-month Forward P/E Ratio



Note: 1. As of 26 June 2018.
2. SD stands for standard deviation.
Source: Bloomberg

Notes

*1 The scheme for the construction of houses for low income classes in rural and urban areas is called “Pradhan Mantri Awas Yojana”. The scheme for construction of rural roads is called “Pradhan Mantri Gram Sadak Yojana”. The scheme for provision of LPG is called “Pradhan Mantri Ujjawala Yojana”. The scheme for rural electrification is called “Saubhagya”. The scheme for financial inclusion is called “Pradhan Mantri Jan Dhan Yojana”.

*2 Houses made with high quality materials throughout, including the floor, roof, and exterior walls.

*3 Houses made from mud, thatch, or other low-quality materials.

*4 Chopra, Yakshup, Prabhala, Nagpurnanand, and Tantri, Prasanna. (2017) “Bank Accounts for The Unbanked: Evidence from a Big Bang Experiment.” https://www.bentley.edu/files/2017/04/04/pmjdy_final.pdf

*5 Foreign direct investment does not require prior approval from the Government of India or the Reserve Bank of India under the automatic route.

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Saion Mukherjee is Managing Director and Head of Equity Research for Nomura India. He covers India’s healthcare and pharmaceuticals sectors. Saion has over 10 years of experience in India’s equity markets and has been ranked among the top 3 analysts by Indian Investors in the Healthcare segment (Rank # 1 in 2011, Rank # 3 in 2012, 2013 & 2014. Saion joined Nomura in October 2008 from Lehman Brothers where he covered the pharmaceuticals and construction sectors. He has completed his Post Graduate Diploma in Business Management (PGDBM) from the Indian Institute of Management Ahmedabad and also holds an engineering degree in chemistry from the Indian Institute of Technology Delhi.