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## India: Too little, too late?



**The Indian government's knee-jerk financial measures and public spending proposals might not be enough to revive investor interest in an economy that seems to be in the doldrums, writes *Dilsher Dhillon*.** In assessing the current state of India's economy, a quote from the popular Netflix show *Bojack Horseman* comes to mind: "When you look at something through rose-coloured glasses, all the red flags just look like flags." After a resounding re-election victory in May, the expectation of which led to a surge in domestic equity and bond markets for months beforehand, Narendra Modi's administration has talked up its creation of millions of jobs and the big reforms that it has implemented as part of its plans to make India a \$5 trillion economy by 2024. Global and domestic investors have all been bullish on the business-friendly Modi for quite some time, but the administration's talk masks a troubling reality. The economy, which the government continues to tout as the fastest growing in the world, is in the midst of an unprecedented slowdown – one that it is partly attributable to the inability of small businesses to adapt to the new goods-and-services (GST) tax regime and a reversal of low oil prices that helped the Modi government to a large degree in its first term. In the first quarter of the current fiscal year, fresh investments hit a 15-year low of \$6 billion – 87% less than the year-ago period. Auto and consumer goods sales have plummeted since the start of 2019. Bank credit has dried up. Inflation has consistently remained benign owing to a decline in the prices of farm produce. Demand has also stalled, as incomes have stagnated and household savings have fallen, especially in rural India – the backbone of the economy. "The certainty that producers once enjoyed — of finding buyers for their wares without doing much beyond minor price adjustments— has ceased to exist," writes Harish Damodaran, author of *India's New Capitalists*, in *The Indian Express*, a national daily. Exacerbating things further, the Modi government's revised July Union Budget included a higher capital gains surcharge on foreign investors, an increase in taxes for high earners and a plan to increase the minimum public shareholding threshold in listed companies from 25% to 35%. **The result?**

Foreign investors pulled out nearly \$2 billion from Indian equities in July – higher than any other emerging market. The Reserve Bank of India (RBI) and International Monetary Fund (IMF) and

a number of credit ratings agencies downgraded their forecasts for annual growth. Bond yields increased and the stock market declined as domestic investors scrambled to invest their money in gold. Prices for the asset have been reaching record highs of late, and are set to increase further. “The trajectory for gold prices is upward,” says Sanjay Poonia, managing director of Bright Moon Capital Management. “We’re seeing money continually move from equity markets to gold as jittery investors search for safer avenues for their savings.” GDP figures released at the end of August revealed that growth contracted to a mere 5% between April and June – the second successive quarter of sub-6% growth. This is the worst the economy has performed since early 2013. **And then, the panacea**

In early August, the RBI cut interest rates for the fourth consecutive meeting in a row, reducing the repo rate by 35 basis points to 5.4%. The government also capitulated to businesses and investors, rolling back a series of measures it announced in the budget, such as the higher surcharge on foreign investors and high earners, and the angel tax provisions on start-ups and investors. In addition to linking vehicle loan rates with the repo rate, the government announced increased liquidity support to the country’s struggling shadow banks, or non-banking financial companies (NBFCs), and a recapitalisation of state-owned banks to the tune of Rs700 billion (\$9.8 billion). Furthermore, in late August, the RBI approved the transfer of a staggering \$24.5 billion from its reserves to the Indian government as part of the latter’s plan to plug its deficit and revive the economy with a fiscal stimulus package – the details of which are yet to come. The move allayed investor fears that the government would increase its borrowing to finance a public spending programme. The Modi administration is also likely to go ahead with a series of sovereign bond issuances in a bid to prop up the rupee, ease pressures in the domestic debt market and take advantage of extremely low bond yields in developed countries. **Short-term bounce**

The immediate reaction to the measures has been, as expected, positive. The day after the funds transfer was announced, bond yields fell, stock markets rose for the third straight day and the rupee recorded its largest daily gain in five months. In anticipation of further public spending announcements and additional measures, the momentum is likely to persist throughout the quarter. Coupled with another rate cut at the RBI’s October meeting, bond yields should continue to be low. “The central bank will probably cut rates again,” says Deven Choksey, managing director of KR Choksey Investment Managers. “Inflation will continue to be on the lower side and the government will want customers to avail the additional funds it has put into public-sector banks.” Looking beyond the short term, a revival in demand is unlikely in the absence of higher wages, job creation and long-lasting structural reforms. **The recent measures are too modest to impact the Indian economy in a meaningful way, according to Poonia. “This slowdown is more severe than what India experienced in 2002 and 2008,” he says.** Prithviraj Srinivas, the chief economist at Axis Capital, agrees. “The government’s measures will arrest a negative sentiment spiral from developing,” he says, “but what we really need to see is a pick-up in public spending, which will create jobs.” Furthermore, people are unlikely to take out loans to buy homes and cars if they are uncertain about the future – despite the mandatory transmission of reduced interest rates. This uncertainty – which is compounded by persistent global headwinds such as the US-China trade war, oil price volatility and the impending Brexit – will also make foreign investors risk-averse and hurt the rupee. **“The cyclical slowdown in the economy and investor flight will continue to drive the rupee’s depreciation,” says Poonia, “but settling on an exact price band is difficult.” In the week since the measures were announced, the exodus of foreign funds continued.** Even with concerns of fiscal slippage mitigated for now, foreign investors will likely

steer clear of India until more concrete steps are announced. **The road ahead**

The government's potential stimulus package points to a troubling truth. It has no choice but to pick up the slack in the face of a decline in private investment. And despite getting \$12 billion more than it had budgeted, it was actually hoping for a higher payout from the RBI. However, the committee in charge of the transfer declined the request, citing a breach of risk parameters. There is near-unanimous consent that India's near-term growth story hinges on an effective stimulus and the clean-up of its banks. "Addressing liquidity constraints in the banking sector will be key to reviving consumer and investor sentiment," says Sarthak Gupta, an India analyst at the UK-based Economist Intelligence Unit. However, initiatives to increase liquidity such as recapitalising state-owned banks will have to be backed up by a change in governance standards and the extension of operational autonomy at these lenders – which currently account for a bulk of the banking sector's bad loans, given their longstanding habit of skimping on due diligence and financing ill-advised government-promoted projects. Choksey feels that a stimulus package, while a good long-term solution in theory, will be beset by a lack of cohesion when it comes to implementation. "There's a lack of coordination between the centre and the states, and between the states and local municipalities," he explains. "In order for foreign investment projects to be executed and public spending to be effective, there needs to be a single governance mechanism tying all these stakeholders together." **A waiting game**

Andrew Tilton, chief Asia-Pacific economist at Goldman Sachs, noted in a report that this period of sluggish growth could continue till the end of the year. "The risks to our outlook for economic activity for FY20 continue to be tilted to the downside, given the continued weakness in consumption indicators, and persistent confidence concerns emanating from NBFCs [non-banking financial companies]," wrote Tilton. However, the US-based investment bank has said that consumer confidence could gradually increase by March next year amid the loosening of domestic financial conditions. There is a silver lining to the aforementioned measures. It shows the government is willing to respond to investor concerns and act in accordance with economic data. This makes the announcement of further measures inevitable if the slowdown persists. "The government has shown it's ready to act," says Srinivas. "Now, we need to see tax cuts for households and the rollout of the government's spending plan."

For the most part, however, investors will do well to adopt a wait-and-watch approach. The impact of the government's fiscal support programme, especially on boosting the agriculture and manufacturing sectors as well as restarting long-delayed infrastructure projects, will take a few quarters to be felt by businesses and investors alike. During this time, a strengthening of India's bond and equity markets looks unlikely. **In the meantime, Poonia has his eye on some safe investments. "In addition to gold, high-rated corporate bonds and government bonds are going to generate decent returns," he says. "Sophisticated domestic investors can also take a position in silver."** ©2019 funds global mena

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