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REMEMBERING THE FUTURE

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India's Next Era: Walking the Tightrope

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Introduction

Overwhelming skepticism has been the dominant reflex of commentators and analysts when discussing political and economic governance since the onset of the Financial Crisis. The impunity towards Wall Street executives, the glacial responsiveness and myopia plaguing the Eurozone, and childish debt ceiling debates in D.C. are just a few examples that can be pointed to for justifying a cynical mentality towards the future of structural reforms that could unlock growth.

The news and sentiment is not bad everywhere however. Michael Pettis, Professor of Finance in Beijing, has documented efforts underway in China to transition the economy off investment dependency. Indonesia is another spark of optimism due to anticipated changes. However no market has inspired the kind of euphoria gripping India in 2014 in the hope that the country's monetary and fiscal authorities, among others, can guide the nation to a brighter future. Some forecasts quietly wonder whether the South Asian economy can overtake China as the darling of the Emerging Markets (EM).

The jubilation is evident in the Sensex, India's stock market. The index has been one of the best performers in 2014, soundly beating benchmarks from other Emerging Markets and even outpacing the gains made in more developed nations (Figure 1).

Figure 1: 2014 Major Market Performance
India (Red), US (Blue), UK (Green), China (Pink)

In light of this performance and the breadth of pressing issues India faces we wish to use this month's newsletter to bring into focus some of the country's fundamentals and what is in store going forward.

Dawn of A New Era

India's status as one of the peaks in the range of promising EMs is not new. Jim O'Neil's BRICS acronym cast an economy growing over 5% per year in the late 1990s and picking up steam into mainstream commentary. Investment in India

surged, rising from roughly a quarter of the economy to over 34% of GDP in a span of just over 5 years before the Financial Crisis. Economic growth was north of 7% for much of this period and the national poverty rate fell from approximately 37% in 2005 to roughly 30% in 2009.

India's fortunes haven't been so robust since the Financial Crisis though. Unable to recover the pre-crisis momentum, India became a quagmire of slow growth, high inflation, and rapidly rising income inequality, in addition to various social and political tensions.

The election of Narendra Modi has captured most of the headlines in 2014 for turning a tide of negative feelings into bullish hope but the reversal started prior to the Prime Minister's election victory in May.

In September 2013 the Reserve Bank of India (RBI), the nation's central bank, tapped Raghuram Rajan as its Governor. Mr. Rajan is a prescient economist and surveyor of financial markets, warning long before the crisis in 2008 about the dangers brewing in Wall Street's debt factory while the Chief Economist for the IMF. Upon starting his tenure at the central bank Mr. Rajan signaled a clear message to markets that inflation would be controlled; so far he has delivered as inflation has fallen from a peak of 11% shortly after his assumption to below 8% as of July thanks to his interest rate policy. Mr. Rajan has also expressed a vision of expanding financial services to a population chronically under-banked, introducing more competition to the banking industry, and seeing that India's banks become better capitalized.

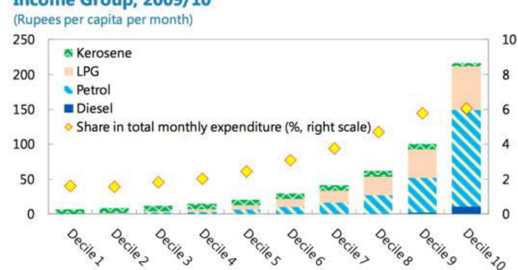
The fervor expressed at Mr. Rajan's governance has been matched and exceeded with the election of Narendra Modi as Prime Minister. The former chief minister of the Gujarat trumped rivals and has a mandate for reform; his BJP party holds the first majority of any Indian government in 30 years. India's stock market erupted at the result in anticipation of Mr. Modi's reform agenda. While he had some success governing at the regional level, the troubles plaguing India nationally are more delicate.

The Road to Reform: Where to Start?

India's economic deficiencies come from structural impediments and can often be traced to a central policy that obfuscates efficiency. In areas such as energy and banking the government's presence is too meddlesome. In others, such as infrastructure, more assertiveness is necessary. This is India's defining conundrum: knowing when, where and how far the leadership in New Delhi should institute itself in the economy.

Start with agriculture and energy. In order to keep the price of fuel low, India implements one of the most generous subsidy programs around the world. The same goes for its farmers, protecting them to such a degree that the Indian government has stifled WTO progress on trade agreements. The program is notorious for its excessive consumption and waste, bleeding cash from federal revenues. Historically the fuel subsidies have amounted to about 2% of GDP but the previous administration bumped the rate to 2.5% of GDP in its final year. Mr. Modi's predecessors attempted to reform the system but were met with protests and discord from the population, electing instead to keep subsidies in place. While well intentioned, the programs have been more instrumental in hoarding consumption and exacerbating inequality within India as opposed to helping the poorest citizens in India. Rather than lifting up the poor, the subsidies are regressive, benefitting the well to do more than the poor according to the IMF (Figure 2).

Figure 2: Uneven Subsidy Benefits
Source: IMF



The result is billions squandered in the energy and agriculture, waste that contributes to fiscal shortfalls and widens India's current account deficit. The money and resources used for these subsidies could be put to better use in other parts of the economy.

While India needs to do a better job of efficiently spending its resources the more daunting task may be actually collecting more revenue. According to Credit Suisse half of India's GDP and over 90% of its employment is in the informal sector, one of the highest in the world. This is a staggering proportion, on par with ratios seen in Sub-Saharan Africa, and has large consequences on India's fiscal state.

The informal sector does not contribute tax revenues, forcing the government to budget and plan expenditures over a very narrow tax base. It is not surprising then that India's fiscal position is often not balanced. Low tax receipts and the various development needs India has strain public finances and contribute to inflationary pressures.

In addition, much of India's informal sector does not have access to credit and lacks contemporary labor protection. Credit Suisse also cites poor intellectual property rights as being pervasive in India. This stifles incentives to innovation. Without labor sector reform and strong property rights potential returns are capped, limiting worthy credit prospects for banks.

One reason for the large informal sector is India's reliance on agriculture. The sector accounts for almost half of employment in India and is made up largely of small, private farms. Prime Minister Modi has laid out a goal to lift manufacturing's portion of GDP from the current 15% to 25%. This would put it on par with current levels in China and South Korea. With a young population in need of jobs emphasizing manufacturing is a prudent move. This shift can also bring greater urbanization to India, allowing for agglomeration to help build industry scale and reduce costs.

India as a whole is also chronically under-banked. According to the World Bank only 35% of adults in India have an individual or shared account with a financial institution. This untapped population is an opportunity for banks to strengthen their position and for India's capital markets to deepen and become more liquid.

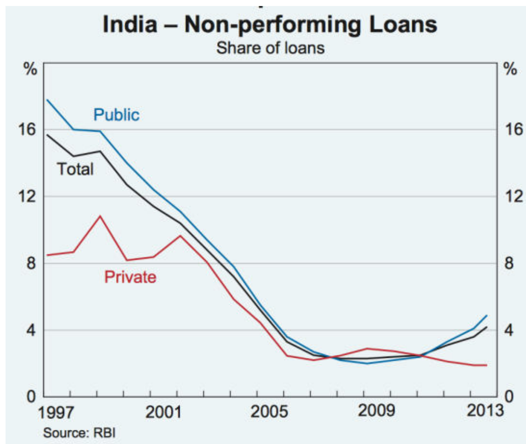
A multifaceted approach will be needed to resolve this financial exclusion. First, the public banks are too sheltered from competition. This past March the RBI announced the issuance of new banking licenses for the first time in nine years. Allowing for more competition in the industry will benefit consumers and the overall financial welfare of India. While the new licenses are a positive sign leaders need to ensure the trend stays on course as the myriad of regulations and requirements can make the licensing process tedious.

Secondly, to implement greater competition India will vastly need to upgrade its infrastructure. The physical segregation of India's various regions raises the cost of doing business for all sectors, including financial services. According to research by The Guardian, only 74,000 out of India's 600,000 villages have access to a brick and mortar bank. Mobile banking has potential but that requires getting over the fact that only 10% of Indians had access to the internet in 2013, per a report by McKinsey. In addition, according to Lombard Street Research most of India's deposits sit in accounts linked to real interest rates, which have been negative due to inflation. As a result savers in India put their money elsewhere, namely physical assets.

Third, India's banks are poorly capitalized. Estimates on how much capital India's banks need vary but the most recent estimate from Fitch put the figure at $200 billion over the next five years in order for the nation's financial system to comply with Basel standards. The more immediate concern is the rising number of non-performing loans (NPLs). According to analysis by the Reserve Bank of Australia India's banks are in the

worst position relative to other Asian economies. The overall proportion of NPLs to total loans reached 4.2% this year, up from 2.3% just five years ago. Moreover restructured loans have gone up from 2.5% to over 6% in just the last three years, signaling that debtors are worried about meeting payments. In the meantime credit growth has deteriorated and economic growth (i.e. the ability to service debt) has also worsened.

Figure 3: Non-Performing Loans in India Rising
Source: Reserve Bank of Australia

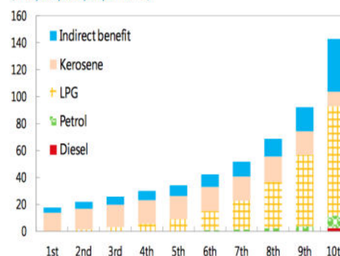


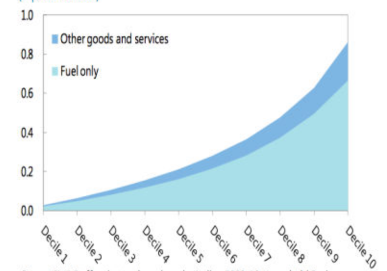
Public banks are the biggest culprits of having inadequate levels of capital but the risk is industry wide and the need to address it is urgent. India's vulnerability to capital flight was on full display in the summer of 2013 when then Federal Reserve Chairman Ben Bernanke spooked markets with what seemed like an accelerated schedule of tapering accommodative policy. For India, and other major emerging markets, the result was a sharp depreciation of their currencies. Bernanke's announcement signaled higher U.S. rates and a stronger dollar, two factors that worked against economies needing foreign capital for financing. India's slow growth, stressed banks, twin deficits, numerous political scandals and high levels of inflation put it a member of the infamous "Fragile Five" by commentators (Figure 4). The efforts of Mr. Rajan since September 2013 have stabilized the currency and provided a clear outlook and set of priorities the monetary authorities have.

Figure 4: The Rupee Slides, Then Stabilizes, USD/IND

India's policy makers need to use the window of opportunity in front of them to solidify reforms. By cutting subsidies and reallocating the funds towards bank capitalizations India can add a layer of protection to its capital situation before the threats of European and East Asian instability suck capital out of emerging markets indiscriminately. The burden of increased prices from lifting subsidies will come from India's wealthiest and not the poor according to analysis from the World Bank (Figure 5). Compensating the bottom 40% of India's citizens from the subsidy loss would cost 0.2% of GDP, while saving over 2% of GDP.

Figure 5: India's Wealthy Bear Brunt of Subsidy Reform Source: World Bank

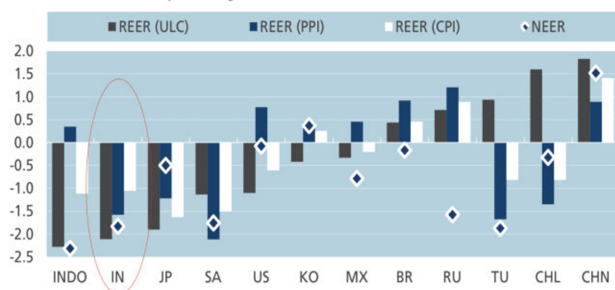




In Need of Goldilocks Governance

The era facing India is crucial. Not because it is in jeopardy of slipping in its development, but rather because it is rare for emerging economies to possess the confluence of factors in its favor that India currently possesses: a leader with a vision of facing his country's realities and issuing reforms, favorable demographics, monetary leadership and credibility, a track record of growth, a democratic tradition and a status of being one of the most competitive countries in the world (Figure 6).

Figure 6: India's Low Labor Costs Boosts Competitiveness
Source: Lombard Street Research



The common thread tying India's various needs and shortcomings is investment, its deficient amount and/or its inefficiency. It will be up to India's new leadership to sort out the issues but no panacea is available. Resources dedicated to subsidizing energy and agriculture should be pared and directed towards infrastructure where transport costs are high and power outages frequent. Tax revenues need to grow by expanding the base. Developing the manufacturing sector to utilize labor cost advantages will go a long way towards boosting productivity, raising incomes, and providing jobs to a young population.

The government needs to follow through on its regulatory reforms in banking and finance so that capital can flow freely and go to where it will offer the greatest returns. But to get to that point the state may need to inject capital in the immediate stage. A wealth of other changes are needed as well for India to reach its full potential including ensuring property rights, protecting labor, privatizing some state run firms, removing entrenched corporate interests in the government and guaranteeing gender equality, among others.

The progress of the past year is promising. India's current account deficit has shrunk and the budget released this summer promises to build on recent momentum for fiscal balance, including reducing subsidies. The currency has stabilized. Improving competition in the banking sector has started and the "Make in India" campaign of Prime Minister Modi is putting the nation's manufacturing center front and center.

There are still numerous hurdles preventing any sort of linear rise for India's economy. The global economy is weak. Without strong demand India may not be able to fully realize the strength of its competitive edge. Also, Mr. Modi's recent WTO negotiations left onlookers disappointed in his insistence on shielding agricultural subsidies from reform. Finally, while the recent budget was cheered on the whole, it was short on details for key programs including how subsidies would be cut back and capitalizations for banks. There's also the question of how an interest rate rise by the Federal Reserve will impact nation's possessing current account deficits. While India has improved its resiliency since taper talk was introduced in mid-2013 how its markets and economy will react to interest rate normalization in the United States is still to be determined.

India's leaders have a delicate balancing act ahead of them. If the state relinquishes too much then current vulnerabilities such as inequality can stiffen. If the administration remains too involved, especially in key sectors, growth may be below potential and the public could lose faith in New Delhi's ability to govern. If the state gets it right however, India could enjoy a fairy tale of a future.

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