Modi's BJP sweeps general elections, but faces arduous task

Special
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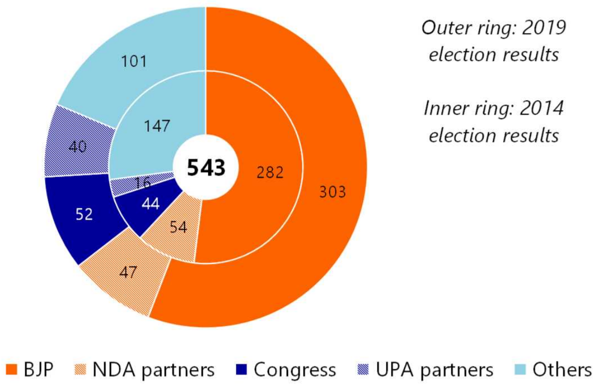
- **On 23 May, the Election Commission of India (ECI) announced that the Bharatiya Janata Party (BJP) led by Prime Minister Narendra Modi won the general elections in India.**
- **The number of seats won (303) was much larger than expected and means that BJP will have a majority (272 seats required) in the lower house (Lok Sabha), thus giving Modi a clear mandate to follow through on its reform path.**
- **Modi has made important progress on opening up India for foreign investments and has reformed the tax system. These reforms have benefitted growth and led to an increase in foreign investments. Going forward, however, we believe that a Modi-led government in the second term will struggle to implement the more difficult reforms that stalled during the first term, such as labour market and land reforms.**
- **These reforms are necessary to lift India's economic growth above 7%, which is lower than what the government is aiming to achieve. In fact, in the short term, we believe that economic growth faces downward pressure and will prompt the central bank to cut rates in 2019. We believe USD/INR will slide to 72 later in 2019. More about the implications for the fiscal position in our Economic Report 'India's fiscal path remains slippery after Modi's BJP win'**
- **Moreover, external risks are tilted to the downside, such as a more severe US recession than we have currently pencilled in or a full escalation of the US-China trade war, which both will not bode well for the Indian economy.**

BJP sweeps general elections

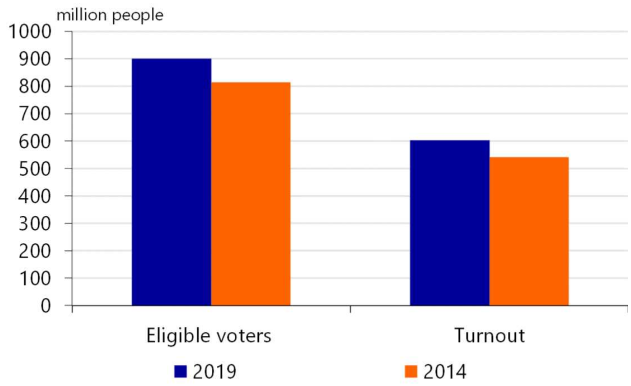
On May 23rd, the Election Commission of India (ECI) announced that the Bharatiya Janata Party (BJP), led by Prime Minister Narendra Modi, won the general elections in India. At the time of writing the BJP appears to have secured 303 seats in Lok Sabha, India's Lower House (outer ring in Figure 1). Together with its National Democratic Alliance (NDA) allies, the BJP will probably form a government with 350 seats, which is more than enough to secure the required majority of 272 seats. The voter turnout (67%) was equal to five years ago, but with more people eligible to cast a vote, the absolute turnout in 2019 was higher (Figure 2).

Figure 1: Election results



Source: various

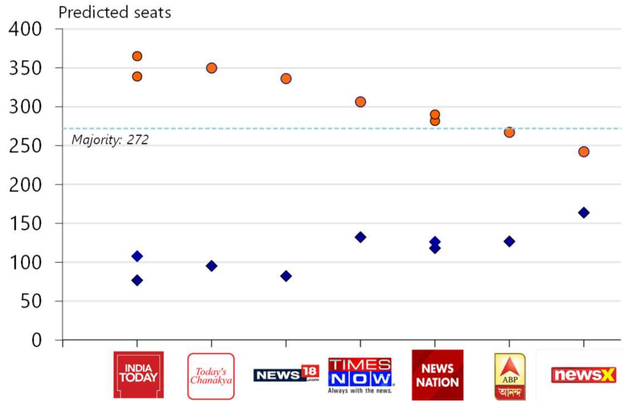
Figure 2: Voter turnout



Source: various

The main opposition party, the Indian National Congress or Congress in short, won 52 seats in Lok Sabha. Exit polls released on Sunday 19 May already indicated that the NDA was on course for a majority win (see Figure 3). Most analysts, including Rabobank, were anticipating this outcome as well, but we were not expecting the BJP to be able to seize a majority by itself. In that sense, the election outcome is comparable to the course of events five years ago, when Modi's BJP shocked India's political landscape by seizing a majority of 282 seats in Lok Sabha, the largest win by a single party in India in thirty years (see inner ring in Figure 1).

Figure 3: Most exit polls already indicated a NDA majority win



Source: various

What explains the Modi landslide win?

Last year, the popularity of the BJP was waning at a fast pace. Among other things, this was caused by distress in the farming community, which was confronted with a rapid decline in crop prices caused by a production pickup in, for instance, grains and pulses. Moreover, government intervention in monetary policy and suspicion about possible involvement in the construction of GDP back series were seized by the opposition to challenge the Modi government. The sliding popularity of the BJP became painfully visible in its defeat in Madhya Pradesh, Chhattisgarh, and Rajasthan during regional elections in December 2018. The BJP has been able to reverse the sliding momentum, partly linked to the air strikes on Pakistan in response to the terrorist attack in Pulwama in February. This event enabled Prime Minister Modi to focus his campaign on national security, counter-terrorism and Indian nationalism. A second success factor for the BJP was that it could 'play' the Modi card. With Narendra Modi being the most popular politician in India, the BJP has been successfully pushing the campaign towards an individual contest between Modi and opposition leader Rahul Gandhi. Finally, the BJP has been banking on its success to implement a number of reforms in its first term (see below).

What can we expect from the Modi-led government in the second term?

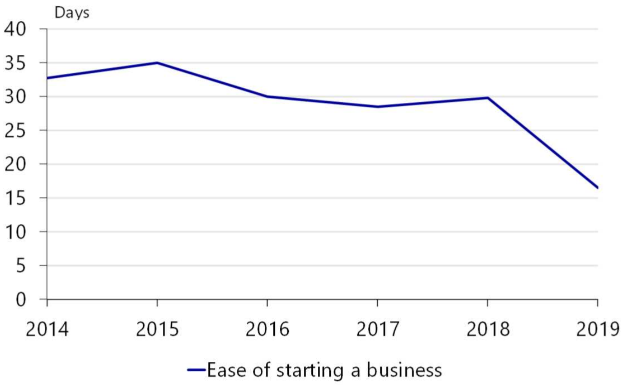
The most important question now remains: what can we expect from a Modi government in a second term? In order to answer this question, we first have to assess what the Modi government was able to achieve in the first term and what is still left to be done.

Modi's scorecard after his first term

In 2014, against the backdrop of an impressive BJP majority win in the general elections, the Modi government launched a policy agenda to crack down on corruption and foster a business-friendly environment in India. This agenda encompassed a vast list of policy initiatives and reforms, which were initiated during the first half of Prime Minister Modi's first term (see Table A1 in Annex 1).

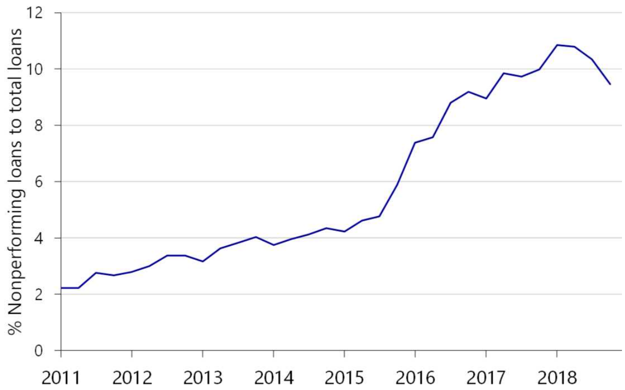
First, India has increased its position on the Ease of Doing Business index from 134 in 2014 to 77 in 2018. For instance, the number of days it takes to start a business dropped dramatically from 30 in 2018 to 16.5 in 2019 (see Figure 4).

Figure 4: Starting a business has become much easier in India



Source: Worldbank Ease of Doing Business

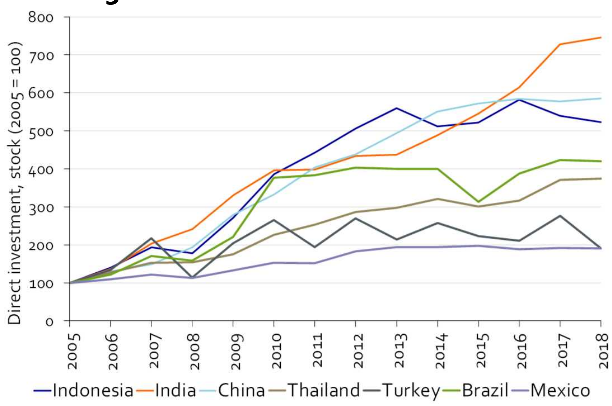
Figure 5: NPL's on a favourable trajectory recently



Source: IMF Financial Soundness Indicators

Second, the government was able to open up sectors for foreign direct investment under the flag of the *Make in India* strategy. Registering FDI of USD 386bn ultimo 2018, Modi's policy has contributed to India being one of the most favourable foreign investment destinations (see Figure 6).

Figure 6: India's has become the top destination for foreign direct investment



Source: IMF BoP IIP, Macrobond, Rabobank

Third, the Modi government was able to implement a number of reforms that were stalled for years. The Goods & service Tax (GST) has been the centrepiece of a political gridlock since the turn of the century and its implementation by the Modi government has been a hallmark achievement, although there is still the critique that GST was not well implemented and too complex in its current form.

Another key achievement was the implementation the Insolvency and Bankruptcy Code (IBC), creating a single law for insolvency and bankruptcy, which historically has been extremely difficult in India to resolve. IBC is helping to unwind stressed assets that have been on the balance sheets of banks for over a decade (Figure 5). However, with 2000 cases in excess the judicial system is now completely clogged up and there are simply not sufficient qualified judges to bring down the case load in the short term.

Mistakes and little or no progress

But the government also made mistakes, such as the execution of the demonetisation operation in November 2016, which literally banned 85% of currency notes in circulation overnight in order to wash black money from the Indian economy and foster the digitalisation of transactions. The operation was ill-prepared and triggered a severe liquidity crush in a cash-dependent economy, leaving it badly scarred in the first half of 2017.

On other fronts, the government has not been able to push the envelope, for example reducing tensions with neighbouring country Pakistan and substantially reducing corruption. Another important area where thorough reform stalled is in India’s agricultural sector.

The Modi government launched several policy initiatives for the agricultural community, such as the *Pradhan Mantri Fasal Bima Yojana* crop insurance scheme, irrigation programmes, soil health cards for 170 million farm holdings, a national agricultural e-market, higher minimum support prices (MSP) for grains and pulses and a farm-relief package[1], which was announced in the interim Budget. However, the government took little effort to tackle the structural problems that India’s farming community currently is facing. For instance, the F&A sector needs a shift away from bulk production to the cultivation of high value crops, such fruits and vegetables, including the infrastructure that would facilitate such a shift. A second option to raise farmer income without propping up inflation, are measures to clip the middlemen margins in the distribution chain of F&A products. Finally, the Modi government has hardly paid attention to the migration of farmers from low-productivity segments of the F&A sector to labor-intensive better paid jobs in industry, construction and services (health care, tourism).

Two other areas where the Modi government was unable to make substantial progress are land and labor market reforms. Under the current land acquisition laws, states can obtain land under the condition that 80% of the residents approves, which causes a serious impediment for the government to acquire land for economic and infrastructural purposes. This consequently weighs on investment and gross fixed capital formation, necessary to spur India’s low productivity per hour (currently only 8 US dollar per hour). Furthermore, India’s labor market institutions are out of date, rigid and complex. Under the Industrial Disputes Act (IDA), which was revised in 1984, layoffs of workers from a firm with 100 or more employees is prohibited without government permission. This strict regulation holds back business activity, hampers intersectoral mobility and a more productive division of labor. In 2018, the Ministry of Labour announced that fixed-term labor contracts are allowed in all sectors. This type of contract is not bounded by the protection under the IDA. Although this measure provides more flexibility to firms, it should be seen as a patch more than a cure to revitalise the labor market, which still desperately needs a complete overhaul of its institutions. Moreover, there is a risk that companies will shift to these unprotected labor contracts on a massive scale.

Policy agenda in the second term

The BJP’s manifesto released prior to the 2019 elections was titled *Sankalpit Bharat, Sashakt Bharat*, which crudely translates to ‘a self-reliant and empowered’ India. The priorities seem to be in line with policy actions and rhetoric in the previous first term with considerable attention to increasing farmer income, national security and fostering a pro-business climate. The manifesto targets to expand the economy to USD 5,000bn from current USD 2,600bn by 2025. Assuming an average annual inflation rate of 4%, which is the mid-point in the target range of the Reserve Bank of India (RBI), this would imply an annual growth rate of real GDP by 7.2%, which is ambitious given the recent slowdown in growth (see below). Moreover, the manifesto has extended its previously announced goal to double farm income by 2022. Finally, there seems to be a commitment to continuing the reform agenda, while proposing ambitious welfare-improving targets (see Annex 2 for an overview of the most important policy proposals).

Economic headwinds and risks

So what can be expected a strong Modi government in the second term? In this section we elaborate on the implications for our economic forecasts.

Economic growth

We expect the new Modi-led government to face a very difficult start, as there are several indications that economic growth does not seem to have bottomed out. Consumption indicators, such as vehicle sales, are flashing deep red (see Table 2). Moreover, industrial production and external sector activity is also looking bleak. Based on the high-frequency data currently available, our nowcasting model points to growth of 5.7% for fiscal Q4.

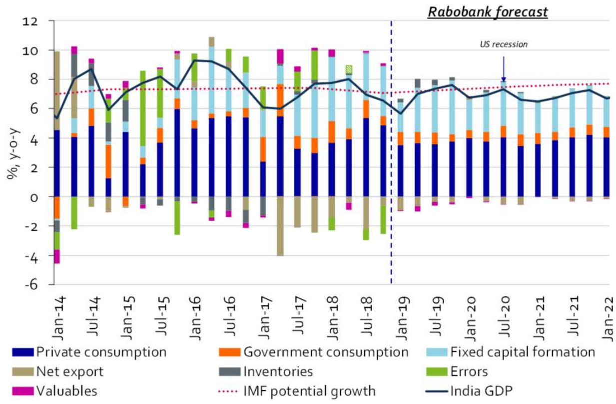
Table 1: High-frequency indicators are flashing red

		Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19
PRIVATE CONSUMPTION	Vehicle sales	30.8	22.8	18.3	17.5	12.1	25.2	8.0	3.4	3.7	15.3	5.0	-3.0	-4.7	-3.6	-14.2	-15.9
	Car registrations	0.9	2.9	-0.8	-1.0	14.5	25.0	-1.5	-1.0	-6.7	-1.7	-4.2	-7.4	-4.4	-7.6	-6.2	
	Oil consumption	11.0	5.7	7.3	5.1	2.8	8.6	7.2	0.6	-1.7	2.0	-3.3	5.6	8.7	2.8	1.4	0.3
	Personal loans	20.0	20.4	17.8	19.1	18.6	17.9	16.7	18.2	15.1	16.8	17.2	17.0	16.9	16.7	16.4	
INDUSTRY AND CONSTRUCTION	PMI manufacturing	4.0	2.8	-2.9	-1.7	-0.8	4.3	9.2	1.0	2.0	5.6	2.7	-2.7	2.9	4.2	3.1	
	Electricity productio	7.6	4.5	5.9	2.1	4.2	8.5	6.6	7.6	8.2	10.8	5.1	4.5	0.9	1.3	2.2	
	Industry loans	1.1	1.0	0.7	1.0	1.4	0.9	0.3	1.9	2.3	3.7	4.0	4.4	5.2	5.6	6.9	
	IIP	7.2	6.7	5.2	4.4	3.8	6.8	6.3	4.7	4.5	8.1	0.2	2.5	1.4	0.1	-0.1	
	Steel production	6.2	4.8	8.5	5.8	7.6	10.4	6.4	3.8	2.1	1.0	4.1	-0.6	-1.8	2.3	-1.0	
INVESTMENT	FDI (bn)	2.3	3.1	3.2	5.5	4.7	3.0	2.8	2.6	4.7	4.6	1.6	4.2	4.2	3.1	6.3	
SERVICES	PMI services	6.2	-5.0	-2.3	2.4	-5.0	-0.9	18.1	8.4	0.4	1.0	10.7	4.5	1.0	9.8	3.4	
	Loans services	13.2	14.2	13.8	20.7	21.9	23.3	23.0	26.7	24.0	27.4	28.1	23.2	23.9	23.7	17.8	
	Tourist arrivals	6.6	10.1	13.4	4.4	-3.8	2.7	3.5	9.1	-0.1	1.7	1.4	1.3	5.3			
	Railway passengers	1.1	1.0	2.1	1.2	-1.2	0.1	0.9	4.6	4.5	2.1	3.1	3.1	3.2	-0.7	0.5	
EXTERNAL SECTOR	Vehicle export	33.3	26.4	19.5	24.2	23.8	32.6	26.0	23.7	17.1	22.6	-0.6	2.6	1.3	4.2	4.0	0.0
PRICES AND RATES	CPI	5.1	4.4	4.3	4.6	4.9	4.9	4.2	3.7	3.7	3.4	2.3	2.1	2.0	2.6	2.9	2.9
	Mibor	7.1	7.2	7.5	7.0	7.6	7.4	7.3	7.4	7.6	7.6	7.5	7.5	7.6	7.5	7.8	7.1
GENERAL ECONOMI ACTIVITY	Monetary base	45.7	37.3	27.3	26.6	24.6	21.1	20.4	20.3	18.6	17.3	17.0	14.9	17.3	15.5	15.2	14.2
	Freight earnings	5.7	6.0	51.3	2.3	-0.6	-0.3	5.6	6.2	4.5	20.8	4.5	0.3	19.0	4.4	24.6	
FINANCIAL MARKET	VIX	15.9	13.8	15.8	12.4	13.2	12.9	12.5	12.6	17.0	19.8	19.2	16.0	17.1	18.3	17.2	21.8
	NIFTY	31.6	20.5	11.8	15.9	11.9	10.2	10.2	15.1	6.1	-4.2	-0.4	-3.2	-8.2	-3.4	7.7	1.6
	SENSEX	30.0	18.9	11.3	17.5	13.4	14.6	15.7	21.8	15.8	3.7	9.2	5.9	-1.0	5.0	16.9	11.0

Source: Rabobank

We do expect economic growth to rebound after the next weak quarter (see Figure 7). This rebound is due to favourable monetary policies, anticipated stimulus measures announced by the new Modi government and a heavy infrastructural package dating back from October 2017 of 7000 INR (USD100mrd), which will start to gain traction in the second half of 2019. Moreover, given the ongoing recapitalisation of banks, we also expect private sector investment growth to pick up in the short term.

Figure 7: Economic growth is expected to rebound, but also stay below 7%

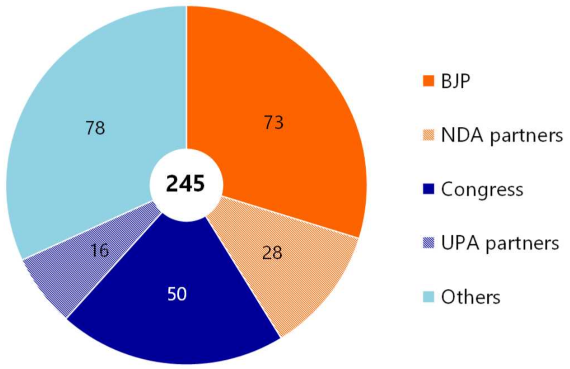


Source: Rabobank, IMF WEO, CSO

Nevertheless, we do expect that it will be very difficult for India to exceed the growth threshold of 7%. This would imply that economic growth would not live up to the targets set by the Modi administration, nor would it live up to expectations by the IMF. There are two reasons why we have pencilled in lower growth than the IMF.

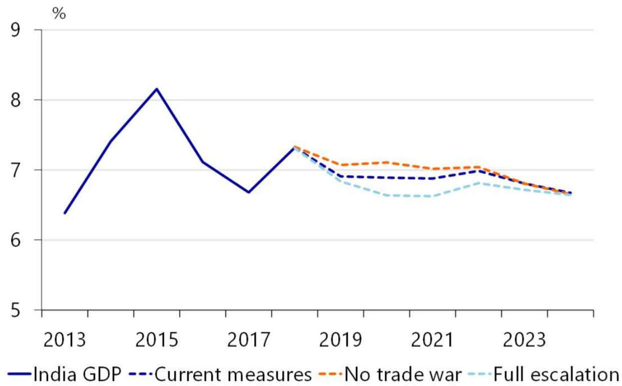
First, we feel that is will be very difficult for the Modi government to realise a breakthrough in its second term on key reforms (i.e. F&A sector, land and labor market reforms) that are necessary to push growth beyond the 7%-threshold. This will be complicated by an ongoing gridlock position of the NDA in India's Upper House, Rajya Sabha (see Figure 8), where attempts to push ahead with hallmark reforms have stalled during the first Modi term. It is uncertain if and when the NDA would be able to seize a majority in Rajya Sabha, but some analysts are even mentioning that 2024 would be the earliest, which would be a serious setback for any reforms Modi would like to initiate in his second term. Second, we have pencilled in a US recession in 2020, which would have spillover effects on a further slowdown of the global economy, including India. Finally, we should address that under the current forecast trajectory, we assume a status quo between the US and China with respect to the trade tensions. In case of a further escalation between the two countries, which is very likely in anticipation or shortly after the G20 in Japan late June, we have to revise our forecasts downward even more (Figure 9).

Figure 8: A fragmented Rajya Sabha



Source: https://rajyasabha.nic.in/

Figure 9: Full escalation of trade war will shave off 1.4ppts of Indian economic growth in total

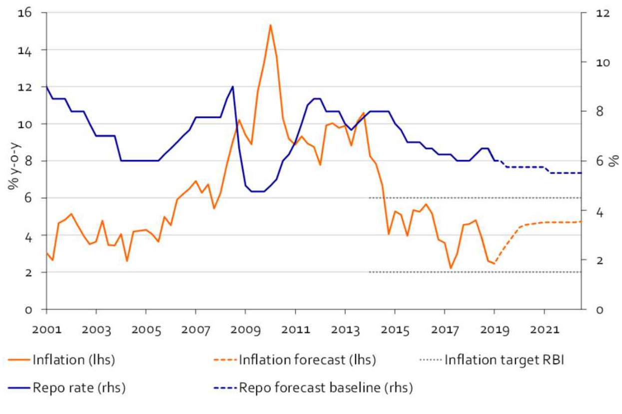


Source: Rabobank, CSO, OECD

Rates

Given the slowdown of economic activity, we do expect a rate cut of the RBI later on in 2019. For now, we have pencilled in a cut of 25bps in the third quarter of 2019, against a backdrop of a slight rebound in inflation just above 4% (Figure 10).

Figure 10: Expect another rate cut

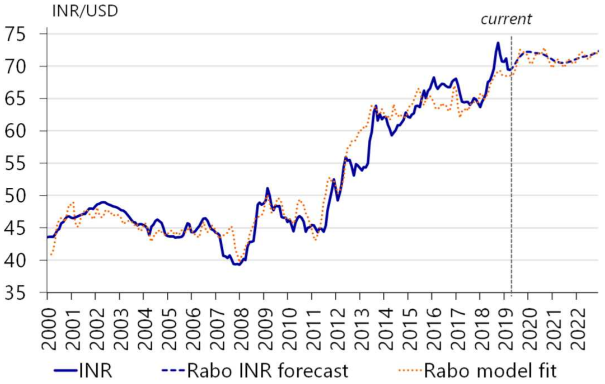


Source: Macrobond, Rabobank, RBI

Inflation is set to rebound on the back of higher oil prices which we believe will go to 74.5 USD/bbl, caused by geopolitical tensions between Iran and the US/Saudi-Arabia, as well as the oil sanctions against Venezuela. Moreover, voluntary OPEC production cuts appear likely to be rolled forward to the end of the year. Also, inflationary pressure is caused by the normalisation of food prices.

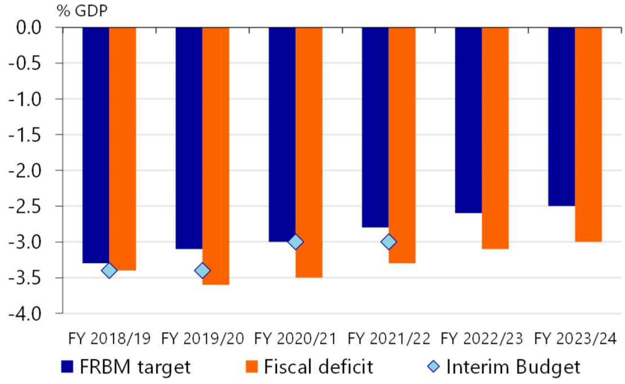
Markets already priced in a substantial BJP win. The USD/INR rate currently stands at 69.7 just after the election results were released. Going forward, we believe the INR will slide to 72 late 2019/early 2020. As said, oil prices are expected to rise and headline inflation will pick up as well. Moreover, there is a chance that we are even too optimistic on the current depreciation trajectory given the odds of a further escalation of the US-China trade war. This would definitely fuel a global risk-off sentiment, which would result in a shift from Emerging Market (EM) assets to safe havens.

Figure 11: USD/INR expected to slide to 72 later this year



Source: Rabobank, Macrobond

Figure 12: Fiscal deficit target in FY2019/20 will be breached



Source: Macrobond, FRBM, Rabobank

The fiscal deficit could widen a bit

We believe the new government's plans will not help India reducing its fiscal deficit. Instead, we believe that the deficit will even widen a little, from a budgeted 3.4% of GDP in fiscal year 2019/2020 to 3.6% of GDP (Figure 12). The budget has already been revised upward (from 3.3% of GDP) and we believe that increased spending (for example related to the government's farm-relief package and infrastructure spending) as well as challenges for revenue collection (related to GST implementation issues) make further fiscal slippage likely. This also means that the government is not likely to reach its target of reducing the central government debt to 40% of GDP in fiscal 2023.

Conclusion

BJP's unexpected sweep of India's general elections means that Prime Minister Modi has a clear mandate to follow through on its reform agenda. Indeed, Modi has a decent track record of implementing reforms (most notably the simplification of India's GST and opening up the country for foreign investments). However, we believe his government will struggle to push through more difficult reforms such as labour market and land reforms, which are much needed to lift the country's growth above 7%, which is lower than what the government is aiming for. In fact, in the short term, we believe that economic growth faces downward pressure and will prompt the central bank to cut rates in 2019. We believe USD/INR will slide to 72 later in 2019. Moreover, external risks are tilted to the downside, such as a more severe US recession than we have currently pencilled in or a full escalation of the US-China trade war, which both will not bode well for the Indian economy.

Annex 1: Indian reforms

Table A1: India's reform monitor

Reform	*Status/ difficulty*	*Description*
Opening up sectors for foreign direct investment (FDI)	Complete/low	The government removed barriers for FDI in the construction sector and the mining sector, the railway sector, defence, real estate, civil aviation and insurance (<50%). In the retail branch, foreign retailers were required to source 30% of their goods locally. Under the new regime, single-brand retailers are permitted to start with incremental purchases of goods from India for global operations during the first five years. On multi-brand retail, foreign investment is held back by restrictions on investment size, sourcing and rules.
Good & Service Tax (GST)	Complete/high	GST replaced a vast network of cascades taxes levied by states governments and the central government, thereby lowering costs of goods and services and lowering bureaucracy and red tape for businesses. The digital character of the scheme fosters efficiency and effectiveness of tax collection.
Liberalisation and deregulation	Partly/ medium	The government has conducted telecom auctions and has deregulated diesel prices. The government has not taken steps to deregulate fertilizer and kerosene prices or scale back on minimum support prices (MSP) for agricultural crops.
Fostering doing business and reducing bureaucracy	Partly/ medium	The government has extended the validity of a business license from two to seven years. India improvement markedly on the Ease of Doing Business index from the World Bank. Still, bureaucracy, red tape and corruption are still more prevalent in India than many Emerging Market peers.
Reforming the banking sector	Partly/ medium	The government was able to implement the Insolvency and Bankruptcy Code, which is a process to resolve insolvency. The government also made progress on professionalization of management of state-owned banks (SOB), scale back on priority sector lending, enhanced recapitalization of SOB's in order to get capital levels of these banks above the minimum required levels and merger public sector banks. Six banks have come out of the RBI weak banks framework of PCA (prompt corrective action) after capital infusions. Ultimately, liberalisation of the banking sector needs to be stepped up in order to bring down the high ratio of non-performing assets and revitalise loans growth.
Land reforms	Stalled/ high	Current land laws have high costs and impediments to acquire land for business or infrastructure purposes. A new land acquisition law was passed in Lok Sabha, but stranded in Rajya Sabha.
Reform the F&A sector	Limited/ high	The government launched several initiatives to eleviate the direct stress among the farmer communtty, such as the Pradhan Mantri Fasal Bima Yojana crop insurance scheme, irrigation programmes, soil health cards, a national agricultural e-market, higher MSP prices for grains and pulses and a farm-relief package. However, government policy has not painted an attractive perspective for the farming community for the medium to longer term.
Labor market reforms	Stalled/ high	Labor market laws are rigid and complex. The Ministry of Labor allowed fixed-term labor in all sectors, which provides more flexibility, but still does not solve India's outdated, rigid and complex labor market institutions.

Source: various, Rabobank

Annex 2: BJP plans for the second term

Key proposed/expected policy actions

AGRICULTURE AND FARMER WELFARE

- Direct financial assistance to farmers through higher minimum support prices (MSP) for crops in the short run
- Drastic increase in agricultural spending through productivity-improving investment of INR 25,000bn in the agricultural sector and interest-free agricultural credit card loans for 1-5 years
- Fisheries, dairy production among others is expected to get a boost. Introduction of information technology in agriculture and digitisation of land records are planned

INFRASTRUCTURE AND TRADE

- INR 100,000bn public investment in infrastructure and policies to achieve increased credit distribution to SME sector
- Establishing a national traders commission along with 'National Policy for Retail Trade' and accident insurance for registered traders in order to encapsulate more businesses into formal sector
- Continued focus on improving 'Ease of Doing Business' ranking and attracting foreign investment, while implementing policies supporting the start-up environment

HEALTH & EDUCATION

- Provide access to proper housing for everyone by 2022 and piped water connection to every household by 2024
- Under 'Modicare', create universal healthcare and improved accessibility by setting up additional 150,000 health & wellness centres (HWC) by 2022
- Improve quality of maternal healthcare for women and full immunisation coverage for children by 2022
- Increase female participation in workforce
- Increase capacity in higher education institutes in fields of engineering, science, law and management by 50%

POLITICAL/IDEOLOGICAL AGENDA

- Build Hindu 'Ram' temple in former religiously disputed city of Ayodhya in the state of Uttar Pradesh
- Abrogation of Article 370 which grants special status to the politically sensitive northern most state of Jammu & Kashmir where the central government has limited authority and residents live under separate set of laws

NATIONAL SECURITY

- Continuation of 'No tolerance policy' towards terrorism and strong stance on external threats
- Continued commitment to passing the Citizenship amendment bill which is meant to grant citizenship to immigrants of selected religious faiths, with a particular focus on the North-Eastern states witnessing large inflow of Bangladeshi migrants

Source: BJP manifesto

Footnote

[1] The income support program is targeted to 120 million small farmers with less than two acres of land, who will receive an annual lump sum amount of 6,000 rupees in three trances. The scheme will encompass 750bn INR in total (roughly USD 10.5bn).

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