Investment Note

Manulife Asset Management

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Latest thoughts on India's game-changing factors to economy[1]

Manulife Asset Management's India Equities Specialist, Rana Gupta, shares some key takeaways from his recent trip to India.

He notes two game-changing factors that will dramatically transform India's financial landscape over the coming years: financial inclusion and tax reform. The financial services market is expected to grow remarkably and people will have better access to credit at cheaper rates. This could lead to better job creation, higher income levels and consumption of discretionary items. Improved tax collection from the reforms could also increase the government's revenue and lower fiscal deficit to gross domestic product (GDP).

On financial inclusion

- Over the last 2 years, 50% of the Indian population have acquired "Unique Identity Number" (Aadhar) and "Bank Account" (Jan Dhan). Smartphone penetration (Mobile Banking) has also rapidly increased. These people did not previously exist for the financial services sector due to having no proof of identity/address and no income documents.
- The trinity of Jan Dhan, Aadhar and Mobile Banking (in short JAM) is now playing out. Many of these people have now joined the gig economy (working for e-commerce) using their smartphone and cheap data plans and have been empowered by Aadhar and Jan Dhan. JAM leads to income from employment getting credited to their bank accounts, which creates a digital trail. As a result, they now have the three things required to become a financial services customer.
- As they enter the formal financing channels of regulated commercial banks and non-banks, they are (and will continue to) experiencing steep drops in rates. Previously, they were getting finance from friends, families and moneylenders at much higher rates. These can be replaced by formal credit at lower prices.
- Not only will the financial services markets grow remarkably, but people will have better access to credit. This will help small business owners, gig economy participants, etc. We anticipate this will lead to better job creation income levels and demand for discretionary items like auto and home building materials
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[1] Source: Manulife Asset Management, Credit Suisse (Digital Banking UPI Report, June 2016).

On Goods & Services Tax (GST) / Indirect tax reform

- In India, the "informal" economy is estimated to be as big as the "formal' economy". This is due to a large cash economy at the retail level.
- With the onset of GST, it will become very difficult for retailers (who were thus far underreporting their business) to survive without taking input tax credit. To take input credit, they have to register for GST. Once they become part of the formal economy, they can also access cheaper working capital finance, which will partially offset some of the higher costs due to taxation. This also presents sizeable opportunity for banks dealing with traders, retailers, inventory financing, etc.
- Once they register for GST, the information technology infrastructure is in place to track their activity which should lead to a positive impact on direct tax collection over next 2 to 3 years.
- We also believe the Governments revenue/GDP is likely to increase, thereby structurally narrowing the fiscal deficit. This is likely to put downward pressure on rates. In addition, the Government's borrowing relative to savings is expected to eventually come down. This will lead to more savings being available for private consumption and investment.

The beginning of a new era for India?

In our view, financial inclusion and tax reform could have an array of effects: lower fiscal deficit, better growth, stable inflation, stable-to-appreciating currency, stable-to-lower rates and stable-to-higher growth. Furthermore, if crude prices remain below US$60 per barrel, we expect Balance of Payments to also remain supportive. The will be led by savings on crude prices (India is a large importer) and inflow of global capital due to the financial inclusion and indirect tax reforms.

With the advent of financial inclusion and the onset of the GST introduction, India's financial landscape is set for a dramatic transformation. Business models will be redefined and unserved markets will open up as financial providers move from being data poor to data rich. We believe the beneficiaries will primarily be the retail consumers and small-to-medium-enterprises. The penetration of consumer debt could rise from 17% to 25% of GDP on the back of new data availability, which will help consumers and the SME lending market expand from the current US$620 billion to an estimated US$3 trillion over the next decade – a five-fold increase.

This will be an opportunity for mid-sized banks and non-bank financial institutions focusing on data and analytics to gain market share. As credit becomes available at beneficial rates, the expectation is for consumers to increase spending on discretionary items like autos and home building/improvement.

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