India state election wins strengthen case for economic reform

The Bharatiya Janata Party (BJP) under the leadership of Narendra Modi has strengthened its mandate and enhanced its ability to execute on key policies by winning recent elections in two key states. Rana Gupta, Manulife Asset Management's India Equities Specialist, shares his views on the implications of the victory for economic reform in India.

Following a decisive win in national elections in May 2014, the BJP has achieved a major victory in state elections held in Maharashtra and Haryana provinces on 19 October. In our view, these elections further strengthen the reform mandate for the central government and give Prime Minister Narendra Modi enough political capital to pursue further economic reforms. The government has already accelerated the pace of reform and we expect there is more to come.

BJP goes it alone in both states

Both of the states that went to the polls had opposition (Indian National Congress) ruled state governments. These elections were significant not only because of the shifts in government, but because the BJP went into these elections on its own, after separating from traditional allies. These states are of significant importance too. Maharashtra is India's second largest state and first in terms of economic output. It contributes 15% of Indian GDP. Haryana, although relatively small, is important due to its proximity to Delhi and is a relatively rich state. Haryana contributes 4% of Indian GDP. We are confident that BJP will form governments in both states, with BJP-ruled states now accounting for nearly 50% of GDP.

Implications for policy reforms

In recent times, major challenges to policy reform were a coalition of multiple parties, which slowed down decision making, bureaucratic hurdles and lack of coordination between key ministries and state governments, which are often ruled by different political parties. That is changing. Firstly, after 30 years, a single party has secured a majority central government. Secondly, the Modi led administration has removed bottlenecks in administration and streamlined the decision making process. Most importantly, bureaucrats with reform credentials have been appointed and several ministries have been merged for better coordination and effective decision making. Lastly, now that BJP-ruled states account for more than 50% of India's GDP, we expect better national and state coordination and better implementation of policies.

It also needs to be highlighted that these elections were fought on the basis of economic development, creating jobs and reducing corruption. These mandates should further strengthen the administration's hand to pursue economic reforms to achieve those end objectives.

Acceleration in pace of reforms

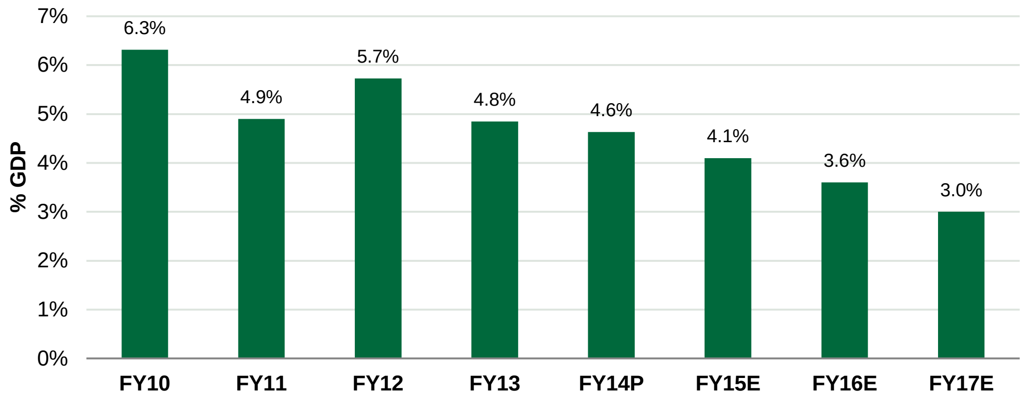
With major foreign policy initiatives and state elections behind them, the government can now increase its focus on economic policy and accelerate the pace of reforms. The following are the important decisions undertaken during the last week:

- Diesel price deregulation. This will reduce the subsidy burden on the government and may also lead to more investment in the marketing of auto fuels by the private sector.
- The price of liquefied petroleum gas (LPG), which is widely used as a cooking fuel in India, will be gradually deregulated and subsidies will be directly transferred to bank accounts.
- Domestically produced natural gas prices were raised from US$4.2 per million metric British thermal units (MMBtu) to US$5.6 per MMBtu. Going forward, natural gas prices will be reviewed against a basket of traded natural gas prices every six months. This hike is manageable for power and fertiliser companies and at the same time this should attract more investment upstream and increase gas supply over the long run.
- Following the Supreme Court order to cancel all coal block allocations to private parties since 1994, the government has come out with a policy framework to allocate natural resources such as coal in a transparent way. Such developments should reduce the scope for arbitrary allocation of natural resources and subsequent regulatory and legal uncertainties.

Going forward, we expect the government to move ahead with goods and services tax (GST) implementation. In upcoming sessions of parliament, we expect reform-oriented bills such as the constitutional amendment for the implementation of a goods and services tax (GST) and amendments to the Coal Nationalisation Act to be presented.

The government is already pursuing fiscal reform by cutting expenditures and subsidies, and we expect the fiscal deficit to reduce to 3% of GDP in fiscal year (FY) 2017 from 4.6% in FY14 (see Figure 1). The government and the Reserve Bank of India (RBI) have also worked together to bring down the current account deficit (CAD). We expect the CAD to contract to 1.5% of GDP in FY15 from 4.5% of GDP in FY13.

Figure 1: Indian fiscal deficit as a percentage of GDP



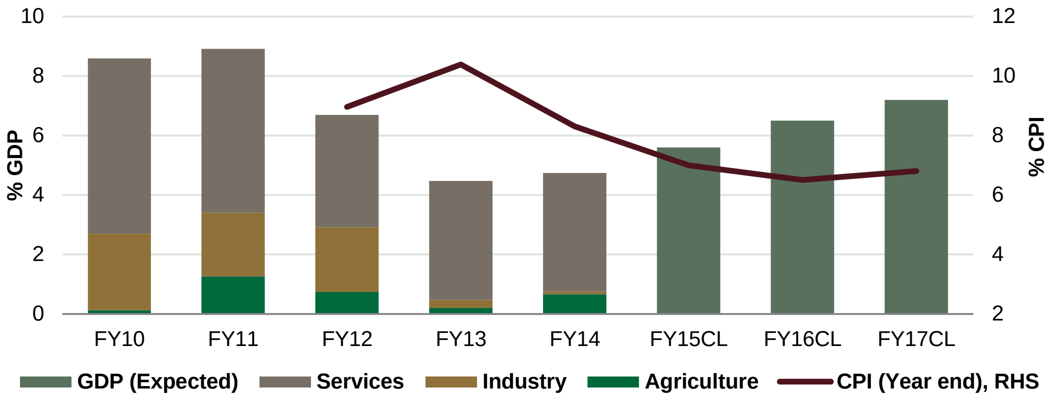
Source: CLSA, December 2013.

The revival of infrastructure investment is another area of focus. We expect to see an accelerated implementation of railway freight corridors, orders for new highways and speedier approval for stalled projects. We believe this revival in infrastructure expenditure will also add to GDP growth.

Productivity boosting reform to elevate growth potential

In the medium term, the revival of infrastructure investment, reforms in energy pricing, the evolving framework for allocation of natural resources and the streamlining of policy and decision making is expected to result in GDP growth rising to 7% in FY17E from 4.8% in FY14 (see Figure 2). In this case, India would be one of the fastest growing emerging economies in terms of incremental growth.

Figure 2: Indian GDP and CPI rates



Source: CLSA, Central Statistical Office (India), 2014.

Due to cuts in wasteful expenditures and fuel subsidies along with correction in global commodity prices, we expect inflation to remain low, despite growth picking up. A lower CPI would likely allow the RBI to reduce policy rates.

The ability to sustain growth of around 7.0% year-on-year over longer periods will depend on an increase in productivity. We are encouraged to see the implementation of productivity boosting reforms across multiple segments of the economy (see Figure 3). These should help to elevate the country's growth potential and sustain higher growth rates over the long term.

Figure 3: Recent productivity reforms

Manufacturing	Urbanisation	Empowerment of rural India
▪ Streamlining approval processes and development of a transparent framework to allocate natural resources. ▪ Implementation of a goods and services tax (GST). ▪ Relaxation of onerous conditions pertaining to implementation of labor laws. ▪ Giving State Governments more room to drive land reforms. ▪ Opening up various sectors to foreign capital and technology. ▪ "Make in India" campaign to increase domestic manufacturing.	▪ Upgrade of transport infrastructure – railways, highways, toll roads. ▪ Better delivery of public services and reduction of corruption. ▪ Connecting key cities through high speed rail. ▪ Setting up new "smart cities" across rail and freight corridors.	▪ "Clean India" campaign: providing clean drinking water and sanitation facilities. ▪ Digital India: Provision of fibre-optic backbone to villages. Should spread e-commerce and e-governance. ▪ Pradhan Mantri Jan Dhan Yojana programme: Financial inclusion by providing each household with a bank account. These accounts will also be used for direct subsidy transfers.

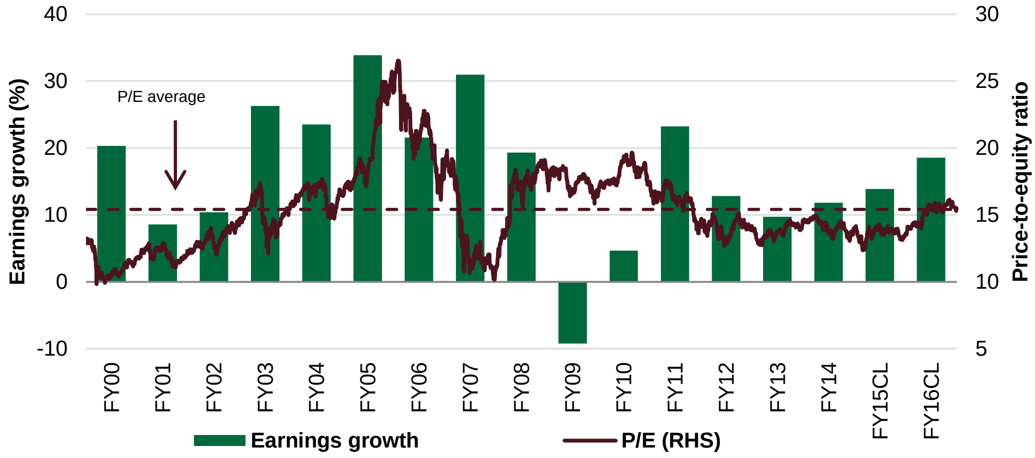
Source: Manulife Asset Management, October 2014.

From growth opportunity to return opportunity

The expected increase in the GDP should translate to better earnings growth for Indian corporates. Current revenue and margin projections are tied to low levels of growth, but we believe earnings are most likely to surprise on the upside over the next 12-24 months.

The acceleration in earnings is likely to occur at a time when valuations, in terms of price-to-equity ratio (PER), is in line with the long-term average. This is expected as, historically, PERs have typically re-rated along with sustained earnings acceleration (see Figure 4).

Figure 4: Earnings growth and P/E ratio of Indian equities



Source: CLSA, 10 October 2014.

We expect to the see stable performance from export- and aspirational consumption-related stocks in the coming quarters. In addition, we could see domestic cyclical stocks re-rate as the economy begins to respond to economic growth policies expected from the new administration. Together, we expect these trends to drive a period of attractive total stock market returns.