

CIO Flash Bulletin

India goes to polls in reform test for Asia's fastest-growing economy

Investment Solutions

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Next year, voters in India go to the polls in an election that threatens to undermine Prime Minister Narendra Modi's majority government. As Modi's political opponents form alliances, the risk to his reforms and the probability of a spending splurge are on the rise with implications that, we believe, investors need to grasp.

In 2014 Modi steered his Bharatiya Janata Party (BJP) to its first single-party majority in 30 years, giving the governing National Democratic Alliance, or NDA, a historic reform mandate in the lower house of parliament, or Lok Sabha.

The Prime Minister has been a divisive figure. Described by his opponents as a Hindu nationalist and self-publicist who turned the election four years ago into a referendum on himself, Modi won a landslide with the slogan "good days are coming" and promised to run the country along the lines of his 12-year tenure as Chief Minister of Gujarat state. Controversy over his role in the sectarian violence of 2002 there continues, and now his record as Prime Minister divides opinion.

The April/May 2019 general elections in Asia's fastest growing economy follow a four-year term in which Modi's administration has carried out multiple reforms. While it is hard to fault Modi's ambition for modernising India, the measures have had varying degrees of success. Reforms include accelerating bankruptcy and business arbitration, creating biometric identities for a national citizens' register, renovating sales taxes and overhauling currency circulation (see below). Crucially, a promise to double farmers' income by 2022 isn't on track and just last week there were more farmers' protests calling for an extension of loan waivers that have been rolled out in certain regions.

The general election may hinge on the rural population. With less than one-third of India's citizens living in urban centres, media coverage of the build up to the elections often focuses on rural discontent comparing Modi's promises with what has been delivered. In response, the government has waived loans and raised 'minimum support prices' for crops, risking a spending increase in the lead-up to the election. Finally, complex labour laws remain mostly untouched, deterring companies from hiring and expanding.



Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

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Organising the opposition

Employment may be overwhelmingly agricultural, but India’s political landscape is vast and fragmented. The BJP is itself part of the NDA, a coalition covering 45 parties that was set up to contest the 1998 general elections, which it won. The country’s political fragmentation worked to the BJP’s benefit in 2014 when together with other members of the NDA it won 51% of the seats in the Lok Sabha, based on 31% of the vote in the first-past-the-post system.

The lower house is currently made up of 36 parties, of which 23 won 5 seats or fewer in the 545-seat chamber four years ago. The Indian National Congress, the party most recently in power from 2002 to 2014, won 8% of seats in the Lok Sabha in 2014 with 19% of votes, its worst result since India’s independence. The upper house, or Rajya Sabha, holds elections for one-third of its seats every two years.

Commentators in India regularly point to evidence for an anti-BJP movement at a state, rather than national level next year. INC president Rahul Gandhi said 1 November that the opposition would unite to form an alliance against the BJP. “All opposition forces are going to work together to defend India, our institutions and our democracy,” he told the media. For now, the consensus among analysts points to the NDA winning with a reduced majority in the Lok Sabha next year.

A series of state level elections representing almost one-fifth of the electorate, including Madhya Pradesh and Rajasthan, will report their results on 11 December. This will provide an early indication of the extent to which attempts to form anti-BJP coalitions are working. Analysts are watching Rajasthan in particular as the state that has made the most progress overhauling labour laws.

Bank notes and taxes

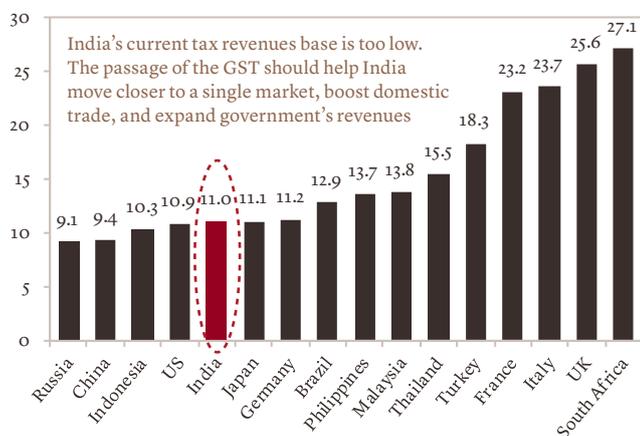
It is worth looking at some of Modi’s key achievements in office. In July 2017, the government introduced a national sales tax. Known as the Goods and Services Tax (GST) reform, it cleared bureaucratic regional and local levies that complicated trade within the country. Nevertheless, the GST is not as simple as it might have been with six rates, sometimes imposing high taxes on staple items, and little logic between them.

The GST followed another ambitious project. In November 2016, Modi’s government banned 500 rupee (USD7.08) and 1,000 rupee notes overnight, forcing people to exchange them for new notes at banks in a ‘demonetisation’ measure designed to crack down on corruption and untaxed ‘black money’. In the longer run, the move may begin to work as intended, kick starting the digitalisation of the Indian economy by forcing people into opening bank accounts. In the short run, demonetisation took an estimated 86% of India’s currency out of circulation. In an almost exclusively cash-based economy that created shortages and chaos, hitting the poor hardest with its effects visible in 2017’s economic slowdown. Nor, to date, has demonetisation increased the chronically limited tax base that draws on an estimated one percent of the population (see chart 1).

Any end of the NDA’s majority in the Lok Sabha threatens to undermine or even reverse Modi’s policies, including a promise to provide healthcare for the poorest 40% of the population, or half a billion people, under a programme nicknamed ‘Modicare’ that is estimated to cost USD1.6 billion a year.

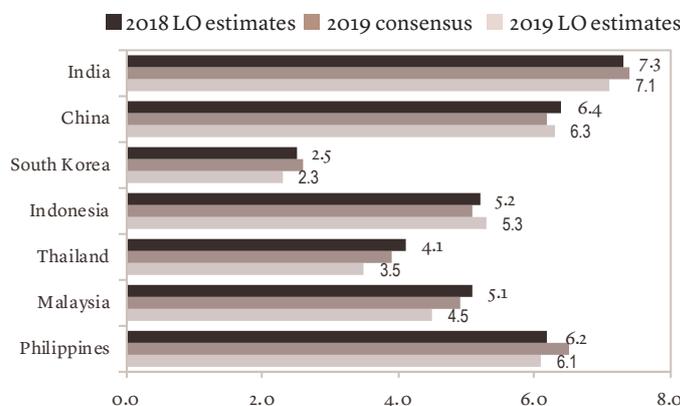
I. Government tax revenues as a % of GDP

World bank data (latest available data)



Sources: Datastream, Lombard Odier calculations

II. Asia’s fastest-growing economy



Sources: Factset, Lombard Odier calculations

Rate hikes and a booming economy

India's economic growth this year has been second-to-none (see chart 2). In the second quarter of this year, the country's gross domestic product expanded 8.2% compared with the same period a year earlier, after growing 7.7% in the first three months of 2018 as private consumption and exports rose, in part benefiting from falling oil prices. The government is due to publish third-quarter data on 30 November.

This pace of growth is likely to slow slightly as the economy shows signs of capacity constraints, signalling a cycle of interest rate hikes ahead. In June, the Reserve Bank of India raised its repo rate for the first time in more than four years, on the back of rising inflation, followed by a second 25 basis point hike in August, bringing the rate to 6.5%.

Modi was fortunate to inherit a central bank under the governorship of Raghuram Rajan who brought inflation under control, reduced the country's current account deficit and established his credibility with markets by reducing inflation from 12% to 4% over one year (see graphs 3 and 4). Urjit Patel took over as central bank governor in 2016. He has managed to uphold the RBI's credibility despite recent differences with Modi's administration, which wants more leniency for a banking sector struggling with non-performing loans as the central bank tightens provision requirements. This has left foreign investors watching for reassurances that the central bank is still pursuing an independent monetary policy.

Investment outlook

Emerging markets have in general lived through a tough 2018, with trade tensions and a strong dollar weighing on their currencies. This is less significant for India, which depends less on external foreign investment and has relatively little foreign-denominated debt. The Indian rupee has depreciated around 10% since the start of the year, underperforming its Asian peers.

While Modi's government has put the country on a reform path, and the potential remains high, political risks to his restructuring have increased. We continue to believe that emerging market exposure should be part of a strategic portfolio, but lingering headwinds mean that our portfolios remain positioned in line with benchmarks. Meanwhile, differentiation remains of paramount importance, and India represents one of the most robust countries in our emerging market coverage universe.

III. Pursuit of orthodox monetary policy...

...effective to contain domestic inflation



Sources: Datastream, Lombard Odier calculations

IV. India current account deficit contained

With robust FDI thanks to Modi's efforts



Sources: Datastream, Lombard Odier calculations

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SWITZERLAND

GENEVA

Bank Lombard Odier & Co Ltd¹

Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com

Lombard Odier Asset Management (Switzerland) SA

Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG

Banque Lombard Odier & Cie SA · Bureau de Fribourg¹

Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE

Bank Lombard Odier & Co Ltd¹

Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY

Banque Lombard Odier & Cie SA · Agence de Vevey¹

Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH

Bank Lombard Odier & Co Ltd¹

Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS

Lombard Odier (Europe) S.A. Luxembourg · Belgium branch²

Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com

Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

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Lombard Odier & Cie (Gibraltar) Limited

Suite 921 Europort · P.O. Box 407 · Gibraltar
gibraltar@lombardodier.com

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Lombard Odier (Europe) S.A.²

Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom · london@lombardodier.com

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Lombard Odier Asset Management (Europe) Limited

Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom · london@lombardodier.com

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LUXEMBOURG

Lombard Odier (Europe) S.A.

291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

Credit institution regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.

Lombard Odier Funds (Europe) S.A.

291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

MADRID

Lombard Odier (Europe) S.A. · Sucursal en España²

Paseo de la Castellana 66 · 4^o Pl. · 28046 Madrid · España · madrid@lombardodier.com

Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).

Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.

Paseo de la Castellana 66, 4^o Pl. · 28046 Madrid · España · madrid@lombardodier.com

Management Company supervised by the Comisión Nacional del Mercado de Valores (CNMV).

MILAN

Bank Lombard Odier (Europe) S.A. · Succursale in Italia²

Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com

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MOSCOW

Bank Lombard Odier & Co Ltd · Representative Office Moscow

Letnikovskaya st.2, bld.1 · 115 114 Moscow · Russian Federation · moscow@lombardodier.com

Under the supervisory authority of the Central Bank of the Russian Federation.

PARIS

Lombard Odier (Europe) S.A. · Succursale en France²

8, rue Royale · 75008 Paris · France.
RCS PARIS B 803 905 157 · paris@lombardodier.com

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Bank Lombard Odier & Co Ltd · Representative Office Dubai

Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com

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Lombard Odier (Hong Kong) Limited

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Israel Representative Office · Bank Lombard Odier & Co Ltd

Alrov Tower, 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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JOHANNESBURG

South Africa Representative Office · Bank Lombard Odier & Co Ltd

140 West Street · Sandton
Johannesburg 2196 · South Africa
johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

MONTEVIDEO

Lombard Odier (Uruguay) SA

Luis Alberto de Herrera · Torre 2 · Oficina 2305
11300 Montevideo · Uruguay
montevideo@lombardodier.com

Supervised by Banco Central del Uruguay.

MONTREAL

Lombard Odier & Cie (Canada), Limited Partnership

1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) · Canada H3A 3R7
montreal@lombardodier.com

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NASSAU

Lombard Odier & Cie (Bahamas) Limited

Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
nassau@lombardodier.com

Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

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Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama

Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com

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Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com

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Lombard Odier (Singapore) Ltd.

9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com

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TOKYO

Lombard Odier Trust (Japan) Limited

Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com

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