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By Anuja Munde,
Portfolio Manager

Nikko Asset Management

REFORMING INDIA

It has only been four years since India was labelled as being part of the fragile five. This was during the taper tantrum when US Treasury yields surged as a result of the US Federal Reserve (Fed)'s announcement to gradually reduce quantitative easing. At that time in 2013, India's current account and fiscal deficits were large, inflation was high and large capital outflows led to a sharp depreciation of the Indian rupee.

But today, India's narrative has changed, as the country has embarked on a path of fiscal consolidation, the current account deficit is at manageable levels, inflation and inflation expectations are running low and the Reserve Bank of India has cut rates by a cumulative 175 basis points (bps) since early 2015. Consumption levels and penetration rates of toothpaste, cosmetics, steel, cement, cars and mortgages are at low levels, even in comparison to other emerging markets.

Combine this with one of the largest and youngest populations in the world, and it is easy to see India as one of the great investment destinations among emerging and developed markets. But what will take India from low per-capita income and double digit poverty rates to an economy with medium per-capita income and lower socio-economic disparity? We believe the only way to do this is through deep rooted structural reforms.

The process of undertaking reforms in any economy is nuanced; however, the task is much more complex in a country as large and diverse as India. Its democratic set up, relatively independent institutions and a free media make reforms a slow and painstaking process. One of the pre-conditions for structural reform is the need for strong leadership. Narendra Modi led the National Democratic Alliance (NDA) to a decisive election victory in 2014; the first time in 30 years that a single party achieved a majority in the lower house of Parliament. His government came with a promise of minimum government and maximum governance with a burden of massive expectations.

We are impressed with the macro reforms undertaken by the government in the last three years. The overarching theme of economic reforms in India has been the formalisation of the economy and the thrust towards enhancing the tax base. The government has also focused on transparent regulations, simplification of regulations and reduction of corruption.

In this paper we discuss some of the key reforms undertaken to put India's economy on a sustainable growth path over the past three years. These include the Goods and Services Tax (GST), individual identification through the Aadhaar system, and demonetisation.

Goods and Services Tax

India's July 2017 introduction of the GST will lead to a major overhaul of the indirect tax regime in the country. There are 29 states in India and historically one of the core problems plaguing businesses has been the lack of a common market due to a complicated indirect tax structure, as tax rates on products varied from state to state and there were also taxes on interstate movement of goods. The GST is expected to be a major improvement over the current system, and we see the following benefits from its implementation:

Uniformity of tax rates and structure

India's existing indirect tax structure is plagued with multiple layers of taxes imposed by the federal and state governments and also local authorities. The GST will subsume these taxes into one common tax. The current indirect tax regime has several complexities that result in corporates "planning to reduce taxes" rather than "planning to grow business." Since the GST will lead to a uniform tax rate across all states, firms will base their investment decisions on growth prospects rather than on lowering the incidence of taxes. This will enable economies of scale, lower logistics costs and lead to faster movement of goods to end markets.

Ease of doing business

The GST will ensure that indirect tax rates for a product are common across the country and GST paid can be offset across the value chain. This offsetting mechanism is not common at the moment, which leads to various inefficiencies. The GST is likely to improve India's ranking in the Ease of Doing Business Index and is estimated to increase the GDP by 1.5% to 2%.

Revenue buoyancy

- The GST is expected to bring buoyancy to government revenues by widening the tax base and improving taxpayer compliance.

- The GST will give a major boost to the government's 'Make in India' initiative, by making Indian goods and services competitive in national and international markets. Further, all imported goods will be charged with integrated tax (IGST), which will be more or less equivalent to Central GST + State GST. This brings parity in taxation on local and imported products.

- Uniform GST rates will reduce the incentive for evasion by eliminating rate arbitrage between neighbouring states as well as between intra and inter-state sales.

Total taxes in India are around INR 26-27 trillion, of which nearly INR 10 trillion are indirect taxes. While indirect taxes can increase with the GST, it is possible that direct taxes also go up (as evasion becomes more difficult if all invoices are uploaded).

While we see a number of positives from implementation of the GST, the transition phase could lead to a few issues in the short term. A period of de-stocking and slowing production during the transition could affect aggregate GDP, tax collection and corporate earnings. However, the longer term positives far outweigh the short term negatives.

Biometric identification and financial inclusion

Historically, a large section of the Indian population did not have documentation to prove their identity or place of residence. For example in FY10, India had 610m bank accounts but just 244m of these related to "unique" individuals. Due to the absence of a system of unique identification, many Indians did not have access to the formal financial system. Also, social sector schemes (such as subsidies) implemented by the government for lower-income sections of the population suffered from huge leakages, corruption and misappropriation.

In 2010, the United Progressive Alliance (UPA)-led government started implementing an identification system for all citizens of the country. The unique identification system, named "Aadhaar", which in Hindi means 'base' or 'support', consists of a unique number which is randomly generated, with the proof of identification done through biometrics - ten fingerprints and two retina scans.

While progress on implementation was initially slow, the NDA government placed a major thrust on the project after it came to power in 2014. As a result, as of March 2017, 1.13bn Aadhaar numbers have been issued and over 99% of India's population above 18 years of age has been covered under the project. The Aadhaar project is now considered the world's largest national identification number project. It has helped eliminate fake identities, and has created digitally verified, authenticated identities in a cost-effective manner. The government has also started using Aadhaar as the basis for granting access to many social sector schemes and for financial inclusion.

JAM Trinity has led to increased financial inclusion

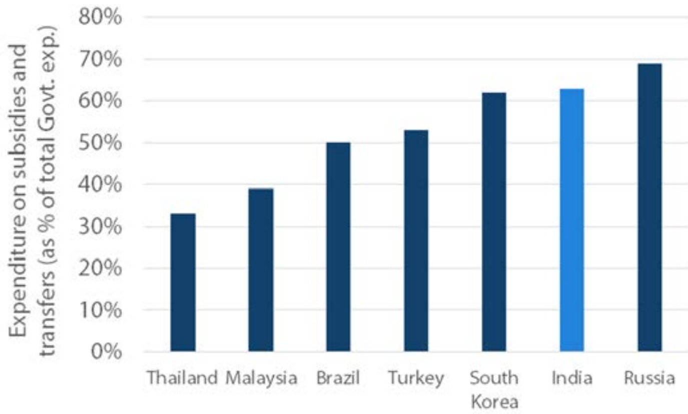
In 2014, an estimated 100m out of 250m Indian households did not have a bank account. In August 2014, Prime Minister Modi announced a scheme to open 100m no-frills bank accounts for these unbanked households. The scheme was coined "Pradhan Mantri Jan Dhan Yojana" (Jan Dhan).

The use of Aadhar numbers with proof of identification and address has greatly simplified the process of opening a bank account. There has also been a drive for financial security via the May 2015 launch of a government funded pension and insurance scheme. The combination of Jan Dhan, Aadhar, and Mobile Banking —collectively called the "JAM Trinity"—has increased financial inclusion.

Direct benefit transfer

According to the World Bank, social spending by central and state governments in India is high at 10-12% of GDP; government spending on subsidies and transfers as a share of total expenditure is among the highest in emerging markets. Currently, government benefits total USD70bn (or 4.2% of GDP) mostly for selling or distribution of subsidised products such as transport and cooking fuel, food grains and fertiliser. But the social spending mechanism inherently had high leakages due to corrupt distribution practices and the absence of a foolproof system to identify beneficiaries.

Chart 1: High subsidy spends compared to other emerging markets



Source: World Bank, CEIC

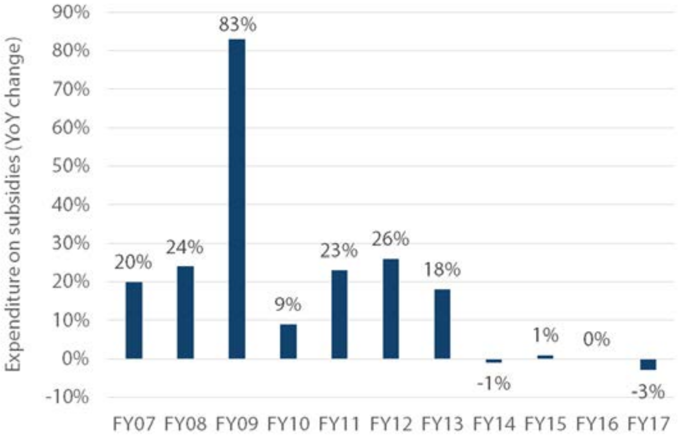
In response, the government implemented the direct benefit transfer (DBT) system, which uses Aadhaar as the basis for social spending. DBT aims to deliver government benefits or subsidies directly to beneficiaries, as it changes the form of benefits from discounted products to cash amounts being paid directly into beneficiaries' bank accounts. Some of the benefits of DBT are:

1. Plugging leakages and duplication: as leakages have been estimated at about 10-40% of the value of transfers, this is the biggest benefit of DBT. These problems are especially prevalent in food, cooking fuel, pension, and scholarships.

2. Conditional cash transfer rules eliminate any automatic benefits: for example, a cooking fuel subsidy will not be offered to someone who does not qualify for it.

3. Improving the fiscal situation: switching to DBT for food subsidies will likely result in INR 250bn annual savings for the government.

Chart 2: Subsidy spends have been coming down



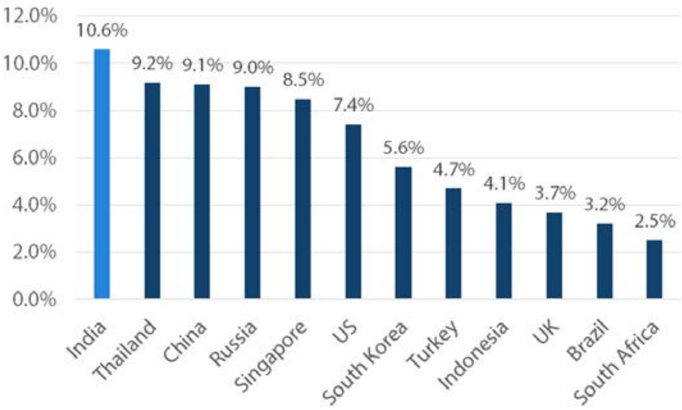
Source: World Bank, CEIC

Demonetisation

In November 2016, the government decided to derecognise currency notes of INR 500 and 1000 denomination (which accounted for about 86% of the currency notes in circulation). While this initially inconvenienced the general population, we believe it will be a long term positive for a number of reasons.

First, the measure fights against the shadow economy and black money since it will become difficult to use cash for high-value transactions without the disclosure of a PAN (tax number). Also, large sections of the unorganised sector, along with professionals such as doctors and lawyers who previously transacted predominantly in cash and did not report their full income, will find it difficult to conduct cash transactions. As a result, the shadow economy will be forced to pay taxes and cash based corruption will become more difficult. The Indian economy will benefit from higher GDP on a reported basis and a higher tax-to-GDP ratio from proper reporting of income in the future. The demand for real assets (such as gold and real estate) will come down and lead to higher financial savings.

Chart 3: Cash to GDP ratio (%)



Source: CEIC, IMF, Kotak Institutional Equity, February 2017

More reforms needed, but India is expected to shine

As discussed, reform momentum in India has accelerated significantly in the last three years, and we expect more reforms to follow, but this is not to say that India's challenges are over. It still has a high level of government debt compared to peers, which limits its options for fiscal expansion. Corporations in some sectors remain highly leveraged, and banks, especially in the public sector, remain saddled with non-performing loans. In terms of major reforms, the rationalisation of public sector enterprises and labour reforms is where we expect progress. Labour reforms are especially necessary for India to fulfil its demographic potential.

That said, the current set of reforms have already started to gain traction. India has improved on most macroeconomic parameters; we are especially impressed with the growth-inflation mix, fiscal prudence and positive real rates.

Growth inflation mix has improved

India continues to be one of the fastest growing economies in the world; however, the quality of its growth-inflation mix has improved significantly. Currently India's real GDP growth is in the 7.0-7.5% range, with CPI inflation anchored in the 4.0-4.5% range. This is markedly different from the FY10-11 period, when real GDP growth averaged about 9.5%, but CPI inflation was running at 11.5%. While high economic growth is important, in our view, it is more important to achieve this with contained inflation.

Focus on fiscal deficit remains

The government has shown encouraging resolve to continue with fiscal consolidation despite various competing considerations such as growth, capital for public sector banks, and higher wages for public sector employees, among others. The sharp decline in oil prices has helped, but the government has also shown restraint on the expenditure front to achieve its fiscal targets. More importantly, the quality of fiscal consolidation has improved, with the revenue deficit/fiscal deficit ratio (which indicates the extent to which borrowings are used to meet current expenditure) declining to 60% in FY17, from 74% in FY13.

The new Fiscal Responsibility and Budget Management (FRBM) committee has recommended that the central government reduce its fiscal deficit to 3% of GDP from FY19 (from 3.2% of GDP targeted in FY18) and then further to 2.5% of GDP by FY23, so as to drive India's debt/GDP to 60%, from the current 68% levels. We think the central government will continue on the path of fiscal consolidation, although there are some concerns related to the health of state government finances.

Positive real interest rate reduces vulnerability

India's sustainable current account deficit is about 2.0-2.5% of GDP. A substantially higher current account deficit leads to macro imbalances, and can lead to disorderly depreciation of the currency if capital flows were to fall short of financing the deficit. However, the central bank's commitment to keep real interest rates positive, along with the government's push for fiscal consolidation, is slowly improving the domestic savings-investment dynamic, thereby reducing excessive reliance on foreign inflows to fund the current account deficit.

Equity market ramifications

India's underlying medium-term economic cycle continues to be on the mend as shown by strong structural reform momentum (regarding GST, bankruptcy, subsidy reduction, Aadhaar card, etc.) and improving corporate balance sheets.

Meanwhile, the impact of demonetisation was not as bad as feared. However, we believe it will have some residual impact on economic growth over the next twelve months. Further implementation of GST in the July quarter might also somewhat diminish economic growth.

Despite these near-term growth headwinds, India remains one of our favoured equity markets as we believe it still offers the best structural economic growth profile in Asia over the medium and long term. We also expect market earnings growth to improve over the next few years.

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