Economics & Strategy

DBS Focus

India's economy and markets around elections

Group Research

February 28, 2019

Taimur Baig
Chief Economist
taimurbaig@dbs.com

Radhika Rao
Economist
radhikarao@dbs.com

Please direct distribution queries to
Violet Lee +65 68785281
violetleeyh@dbs.com

- *Resumption in the India-Pakistan border tensions comes at a tricky time for both countries*
- *India heads into elections, while Pakistan's economy is on a weak footing*
- *India will hold the world's largest elections in April-May 2019, with over 800mn citizens casting their votes for the lower house of Parliament, the Lok Sabha*
- *We analyse the impact of the elections on the economy through an event study framework*
- *Growth, on average, slows a quarter before the elections but rises subsequently, by an average of ~200-250bps*
- *Fiscal slippage occurs in the year of/succeeding the election, but the magnitude is slight*
- *Inflation tends to pick up post elections. However, price dynamics are quite benign this time, easing our concern on this issue*
- *Foreign portfolio flow improves in the three quarters after the elections*
- *Equities rise prior to the election but pull back thereafter. Apart from earnings and valuation, the global environment is also a big influence on these trends*
- *The rupee tends to appreciate before elections, extending the rally for a quarter after, before turning stable-to-weaker*

The world's largest election

India's lower house elections, slated for April/May, is a herculean undertaking. Over 800 million people will cast their votes across 29 states and 7 union territories, electing 543 members, with the majority party or alliance forming a government to lead the world's largest democracy for the next five years.

This year's election comes at a critical juncture for the economy. Despite some reforms, a welcome improvement in the business climate, and a discernible decline in governance lapses, growth has been lacklustre, the savings-investment gap remains large, external vulnerabilities loom against an improved but still modest buffer to absorb shocks, and financial sector stress remains high. For the BJP-led NDA alliance, it remains an election to lose, as Prime Minister Modi continues to govern with strength and has considerable popularity, but a recent spate of state election setbacks and some fledgling governance scandals have dented the aura of inevitability from the elections. A spike in political tensions vis-à-vis Pakistan is another complicating factor.

Without getting into the art of predicting the election outcome, we delve into what could one expect from India's economy and markets around this pivotal event. We examine what tends to happen to growth, fiscal, inflation, investment flows, stocks, and the rupee in the quarters prior and subsequent to general elections in India. This event study approach allows us to discern any macro regularities or peculiarities associated with the election cycle.

For this study, we take stock of the four lower house elections since 1999. These elections took place under varying domestic and external conditions, and the outcomes were sometimes surprising and sometimes not. Averaging the outcome of such disparate events is therefore not sufficient; one needs to account for the volatility around the data. Our event study charts therefore contain 1 standard deviation bands around the mean of the variables under observation.

Recent polls

I**n 1999**, the National Democratic Alliance (NDA), the coalition led by the Bharatiya Janata Party (BJP), returned to power after a few years of political instability that led to several governments come and go. The next five years were marked by market reforms, including a push for privatisation of key public sector companies.

In **2004,** an anti-incumbency wave brought the opposition alliance, the Indian National Congress (INC)-led United Progressive Alliance (UPA), to power. During the subsequent years, consumption and investment trends were strong, hitting a peak around 2007-2008.

2009 elections presented the UPA with a second consecutive term. This coincided with a challenging domestic and external environment, just as the global financial crisis unfolded. Inflation soared, investment slowed, external balances worsened, and the currency came under pressure, and a string of governance lapses hurt sentiments.

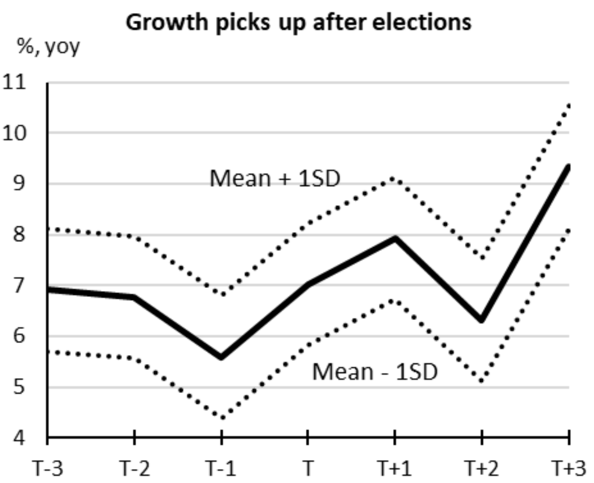
The tough economic backdrop swayed support away from the incumbent in the **2014 elections** and led the NDA to victory. The coalition won with an outright majority of 336 seats in the parliament, with the BJP single-handedly attaining 282 seats (more than 50% of the seats).

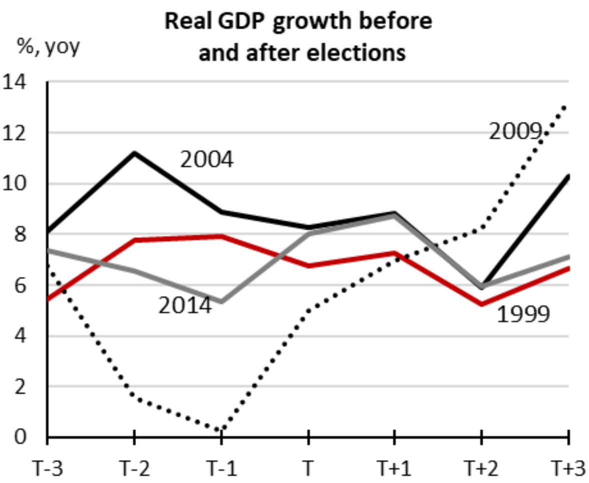
In the run-up to 2019 polls, parliamentary by-polls and recent state legislature elections saw the incumbent government lose some ground, raising the risks of a hung verdict at the elections. Four recent opinion polls point to an average of 220-230 seats for the BJP-led coalition, falling short of a majority. The UPA is expected to fare better than 2014, but regional parties not part of either alliance could enjoy strong bargaining power.

Growth

To assess the impact on growth, we use quarterly GDP growth numbers since 1998. Noting a lack of continuous historical series due to several interim rebasing exercises, which also involved data collection and methodology changes, we maintain data under the respective base years. **On average, growth slows a quarter before the elections, but rises three quarters after, by an average of ~200-250bps.** As election-related uncertainty eases, private sector investments return, and the government resumes capex spending plans. Lagged impact of any consumption-boosting measures also boosts spending.

Amongst the past election cycles, the year 2009 stands out when the economy recorded a strong expansion. GDP growth at market prices accelerated from 0.2% YoY in March 2009 (under 2004-05 base year) to peak around 11% average for four-five quarters between March 2010 and March 2011. Strong fiscal and monetary stimulus measures reinvigorated the economy and helped deal with the after-effects of the credit squeeze in midst of the global financial crisis.



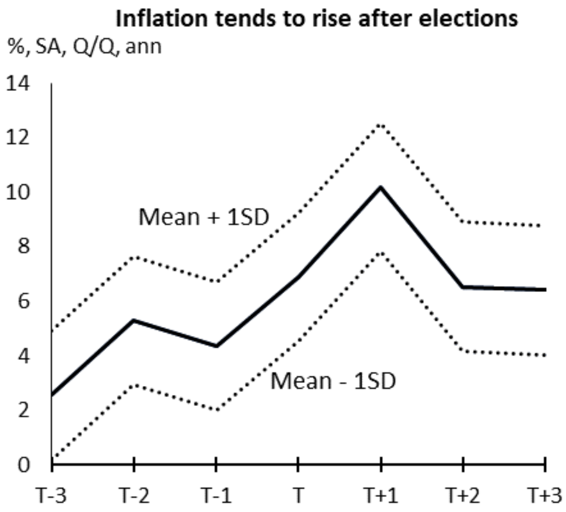


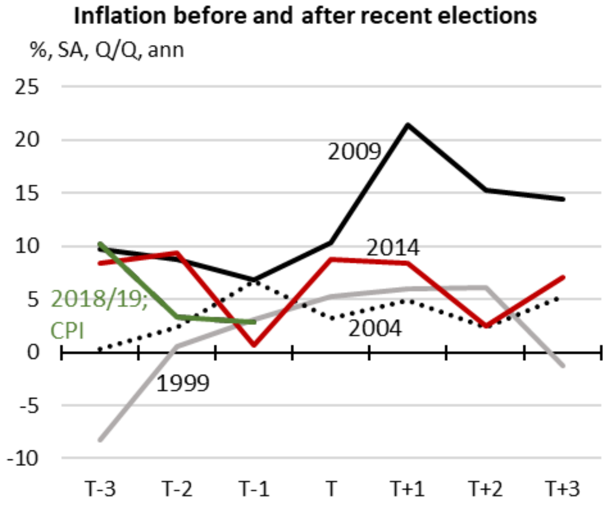
Source: CEIC, data transformations by DBS Group Research

In FY19, real GDP growth is likely to decelerate from 8.2% YoY in the June 2018 quarter to sub-7% by the March 2019 quarter, with full-year growth at 7.1%. Rural demand has been depressed by falling returns on crops, while tighter financial conditions and slowing auto sales point to weak urban spending. Investment growth received a hand from public sector participation (government and central public sector companies) and is expected to persist after the elections. Slowing global demand and firmer oil prices will, nonetheless, result in a weaker trade balance. Our GDP Nowcasting model for India indicates further slowing of growth momentum in 1H19. **Stability is, nonetheless, likely in 2H19 as political uncertainty fades, fiscal pro-consumption measures kick-in and private/ public spending returns (latter getting more headroom for higher fiscal targets).**

Inflation

Indian policymakers have used different price gauges over time to set monetary policy decisions. WPI inflation was the primary tool until 2015, after which the RBI moved to an inflation-targeting framework, with focus on the CPI inflation gauge. Considering subsequent rebasing exercises, we have used the CPI-industrial workers series as a proxy gauge, which has enough backdated reference data and broadly maps retail inflation trends. **Past cycles show that, on average, inflation eases before elections, and then rises.**





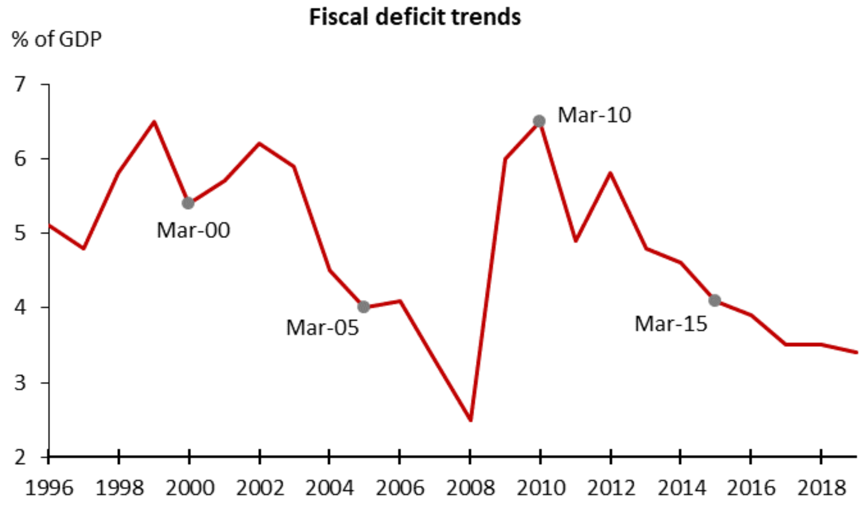
Source: CEIC, data transformations are by DBS Group Research

Notably, in addition to elections, inflationary trends are equally influenced by factors outside of the polling cycle - oil prices, administrative changes, crop production, monsoon and support prices. In this context, since the RBI moved to an inflation-targeting framework three years back, price dynamics have changed significantly. India has transitioned from high, double-digit inflation to 4-5% in FY16 and FY17, slipping below 4% last year and remain so this year.

More recently, lower food inflation has been responsible for the sharp pullback in the headline, while services hold ~5-6% range. **The green line in the chart (citing CPI inflation) above highlights the evolving inflation trajectory ahead of this year's elections.** While low inflation is a macro positive, a sustained deflationary trend led by declining food prices is a micro concern, as we discuss here. To address this, the government introduced a direct income transfer scheme aimed at small and marginal farmers, apart from higher rural spending, which resulted in a small slippage in fiscal targets. Given these new dynamics, base effects and our observation of movements around elections, inflation is expected to rise gradually to 3.5-4.0% in second half of FY20 but stay within the RBI's target band of 4% -/+2%.

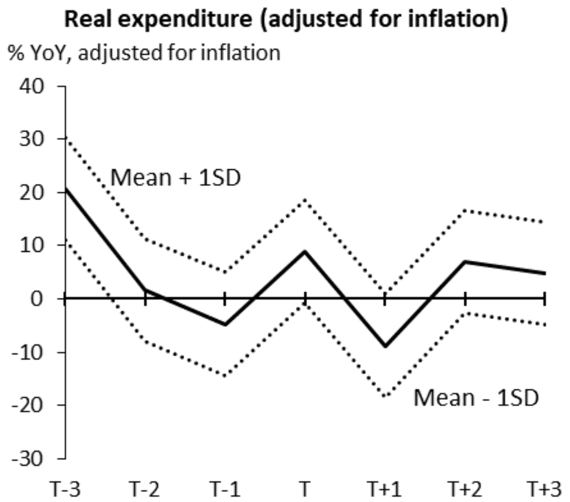
Fiscal dynamics

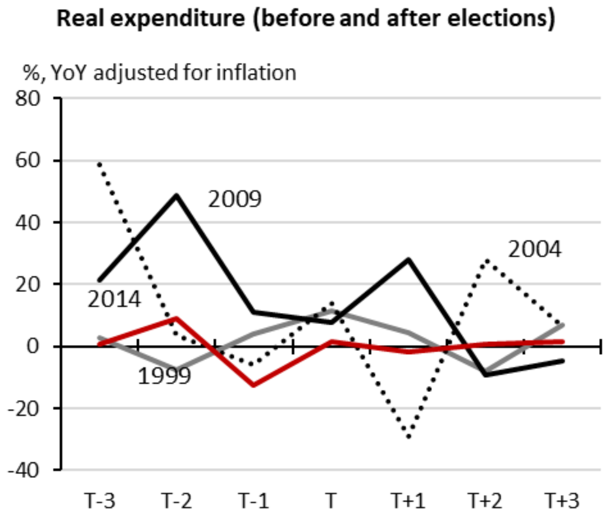
In addition to annual fiscal deficits, we note overall expenditure and pay commission trends around past elections. 2008-2009 are clear exceptions in this study as a global financial crisis saw the authorities take unprecedented steps to boost financial markets and spur growth. Large-scale fiscal stimulus drove the fiscal deficit ratio from 2.5% of GDP to above 6% in FY09 and stayed above 5% for the subsequent years.



Source: CEIC, data transformations are by DBS Group Research

Excluding 2009, annual deficit trends witness a slight deterioration in the fiscal math (i.e. higher deficit), in the year succeeding an election, likely on higher spending pressures. Real total expenditure trends (YoY, inflation adjusted) also reinforce the observation, that spending is high about a year earlier, before moderating towards the elections, but rising again a quarter after. We also note that three of past five elections have coincided with pay commission revisions (announced independent of the poll cycle), which likely also contributed to wider deficits (circling back to our first point) in the year succeeding an election year.





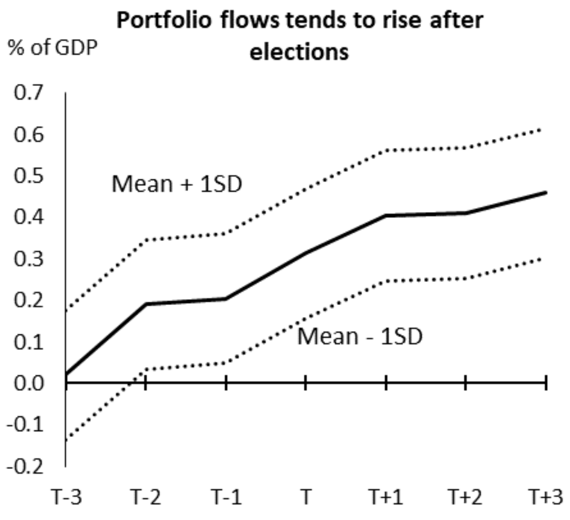
Source: CEIC, data transformations are by DBS Group Research

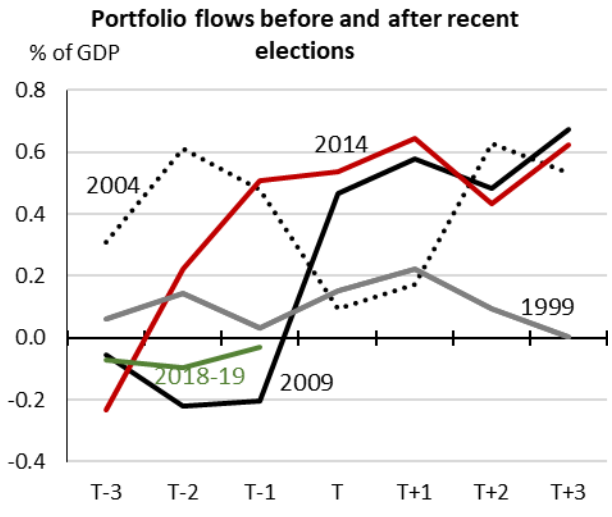
More recently, the government has been more committed to fiscal consolidation, resisting the pressure to turn outright populist. Deficits have been capped at 3.5% of GDP, despite a modest slippage in both FY19 and FY20 targets. The government revised up the FY19 fiscal deficit to -3.4% of GDP vs -3.3% in the budgeted estimate. FY20 deficit was also pegged at -3.4% (vs -3.1% projected). The breakdown revealed that the government has built in aggressive revenue assumptions in FY20, even if nominal growth assumption was realistic. Gross tax revenues are forecasted to improve, with bulk of the lift coming from higher income tax collections as well as GST revenues. These revenue projections and a sharp increase in markets-based borrowings is intended to fund higher spending requirements, as the government adopted a pro-consumption focus in the FY20 Interim Budget. Plans are lower the deficit to -3.0% of GDP in FY21 and FY22.

Foreign portfolio and investment (FPI) flows

We have used net FPI flows, capturing equity and debt flows, and calculate the quantum as a % of annual GDP. **On average, flows are stable to weak in the three quarters prior to the elections, followed by an improvement in the three quarters after uncertainty eases.**

The post-election trend deviated sharply in 1998-1999, rising in the first quarter post polls but declined sharply thereafter. This owes to high global volatility in wake of the Asian financial crisis, which affected flows into the region and emerging markets. During rest of the cycles – 1999, 2004 and 2014, flows broadly stuck to trend after elections. Interestingly, even in wake of the 2014 election that handed the government with a strong mandate, the rise in flows did not deviate too sharply from the mean. Markets had likely already priced in a win for the BJP-led coalition, but the margin of victory surprised many.



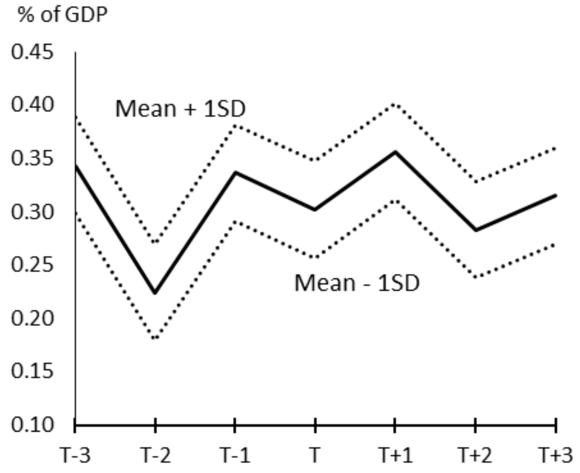


Source: CEIC, data transformations are by DBS Group Research

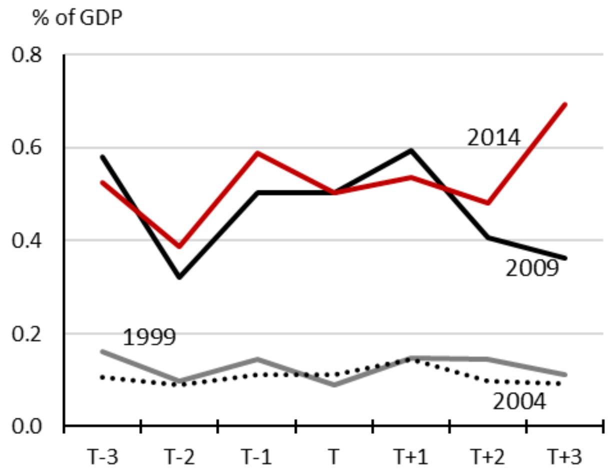
Besides the poll cycles, portfolio flows are driven by global risk-appetite and domestic developments. Elections with an uncertain verdict tend to increase volatility, which if accompanied by broader risk-off environment, could amplify the sell-off. Better risk sentiments at the start of 2019, a cautious Fed and firmer asset markets have drawn flows back into Asia. Portfolio investors are, however, more cautious towards the Indian markets as concerns over a hung verdict rise ahead of elections. Add to this, earning estimates have been trimmed, and worries over high valuations reign high. First two months of 2019 have witnessed USD820mn net outflows, after -USD11bn last year; latter primarily due to global risk sentiments.

For FDI, we have pegged gross FDI as a % of annual GDP. Around past elections, the trends are mixed, understandably so. Unlike portfolio flows, real money is driven by a supportive ecosystem, business cycles, reforms landscape and growth prospects. Fresh investments typically slow ahead of elections, with a positive and clear verdict likely to draw stronger investment interests.

Cyclical factors matter more for FDI flows



FDI flows before and after elections



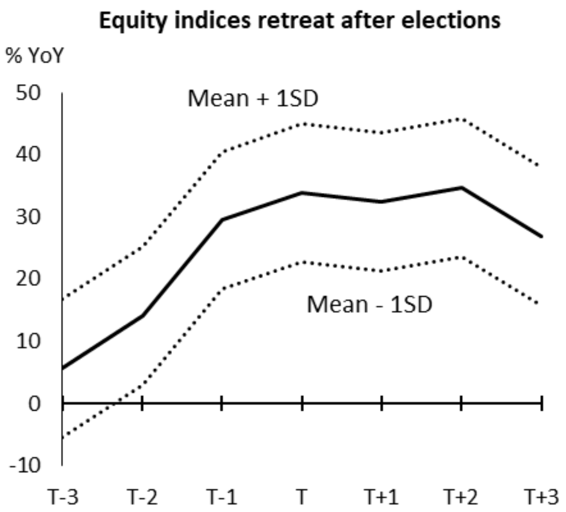
Source: CEIC, data transformations are by DBS Group Research

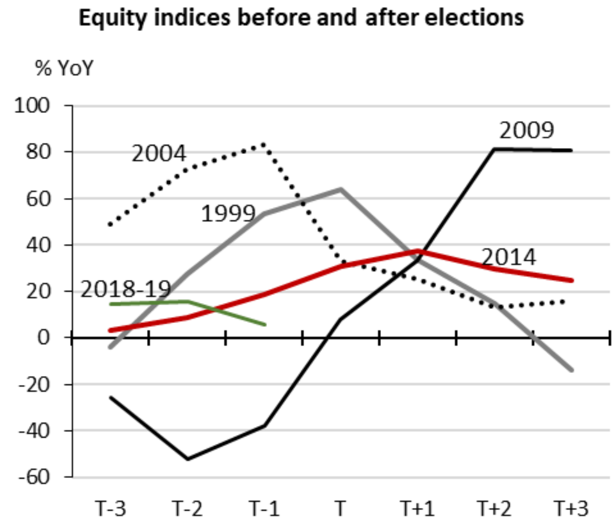
The chart on the right makes two interesting observations. Firstly, FDI inflows in the 2000s has grown more sharply than in the 90s. Since the inception of the WTO, globalisation has gathered momentum, with companies seeking to produce and distribute in locations which enjoy competitive advantages and lower costs, vis-à-vis their home countries. Quantum of flows into India have accordingly risen since the 2000s, with successive governments keen to attract offshore manufacturing and service investors.

Second, the trend after the 2014 election stands out, as gross FDI touched a record high of over USD60bn in FY17 and FY18, before moderating last year. Efforts to provide a conducive ecosystem saw India climb 30 notches to 100 in the World Bank's Ease of Doing Business 2019. Heading to the 2019 polls, investment flows have eased, not helped the least by an ongoing tariff dispute between US and its key trading partners, which has pushed businesses to delay large-scale investment decisions until better clarity emerges. Domestically, apart from election-related uncertainty, changes to tighten vigilance on taxation treaties in 2016 (new tax rates kick in from April 2019) have also moderated flows from the key source economies i.e. Mauritius and Singapore.

Equity markets

Tracking the benchmark equity gauge SENSEX, the index usually rises three quarters prior to the election quarter, flatlining a quarter after, before correcting down. These movements likely point to the tendency for investors to factor-in a favourable outcome at the elections and take profits after the final verdict. We also note here that apart from elections, the broader risk environment and other domestic considerations around the said period.





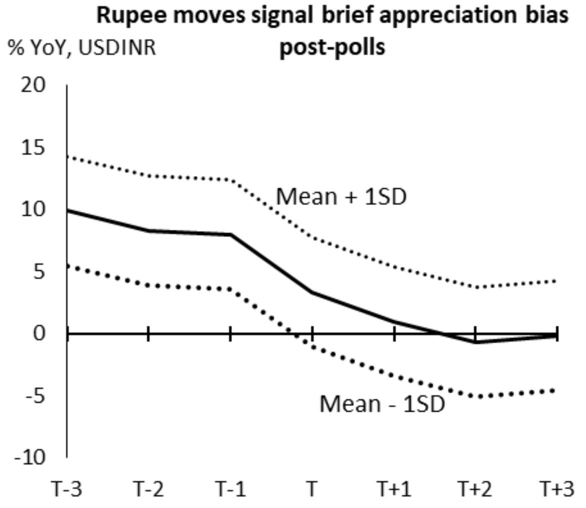
Source: CEIC, data transformations are by DBS Group Research

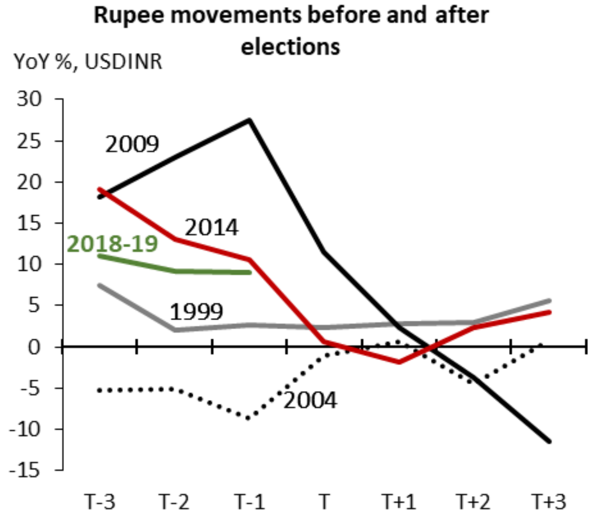
A case in point is 2009, when sharp gains since before the elections were driven more by global and domestic stimulus measures in wake of the global financial crisis, rather than purely the election timetable. By contrast, rest of the election years largely mirror the mean trend.

This year, Indian equity markets are underperforming the regional peers as pre-election opinion polls point to a hung verdict (see chart on right). As highlighted in the previous section, cut in earnings estimates and prevailing high valuations have also left investors jittery. Nonetheless, we note a sharp pick-up in retail participation (through mutual funds, systematic investment plans etc.), apart from purely institutional and foreign participants. An increase in global and domestic volatility has, however, translated into lower funds channeled into

Currency movements

In the past, the rupee tended to appreciate in the three quarters before the election, extending the rally for a quarter after, before stabilising/ weakening in the rest. Just like portfolio flows, the currency gains ahead of the elections on the anticipation of a favourable outcome at the elections, beyond which the currency loses momentum and remains rangebound. On average, the rupee appreciates ~100bps over a quarter, post-elections.





Source: CEIC, data transformations are by DBS Group Research

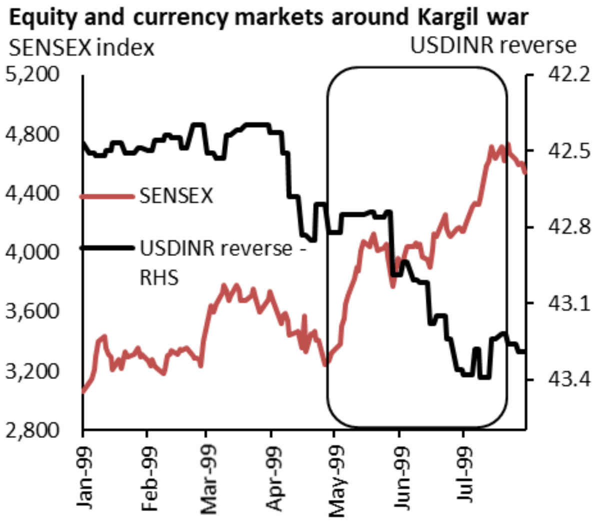
Yet again, like risk-sensitive flows, the broader risk environment also influences the rupee direction, with the currency experiencing a sharp rally soon after the 2009 crisis abated, and policymakers stepped up support. At the 2014 elections, expectations of a strong mandate for the BJP-led NDA coalition triggered a strong rally in the INR/USD ahead of the election. The rupee extended the rally briefly soon after the results but returned to a weakening bias for the rest of the quarters.

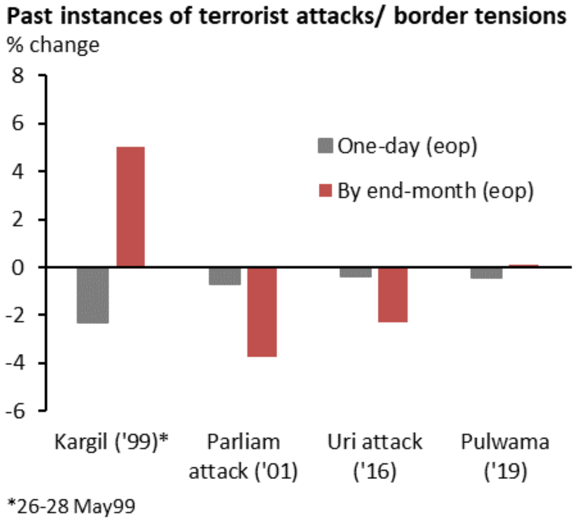
In 2019, the rupee remains the regional underperformer owing to net portfolio outflows (YTD), oil price bounce, higher political premia and at the margin, rate easing expectations. Factoring in our forecasts for the US dollar to peak in 3Q19, as the last of US rate increases are delivered in 2H19, the rupee is likely to stay under pressure over the next two quarters.

Markets around conflicts

While much of the attention is on upcoming general elections, a spike in political tensions vis-à-vis Pakistan has complicated matters in the interim. Questions arise over whether such instances can leave lasting impact on markets.

We draw inferences from past instances; majority of which show that the impact was short-lived and localised. For instance, during the more protracted Kargil war in 1999, markets briefly underperformed but regained their footing quickly. The 2016 episode triggered a -0.3% decline in the SENSEX in two days after the incident but stabilised thereafter. Other instances and impact are highlighted in the chart below.





Source: CEIC, data transformations are by DBS Group Research

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin
Economist – Indonesia & Philippines
masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit Strategist
+65 68782072 neelg@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India, & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).