

India Flash

What to expect from India's elections? Probably not much no matter who wins

- No matter who wins, coalition politics is here to stay in India
- Modi's victory is not a done deal as opinion polls may be underestimating the support of the rural population for the ruling party
- The worst outcome would be a fragmented government/weak coalition
- In any event, the elections' results - once we exclude extreme cases of a fragmented government - may not be too important after all

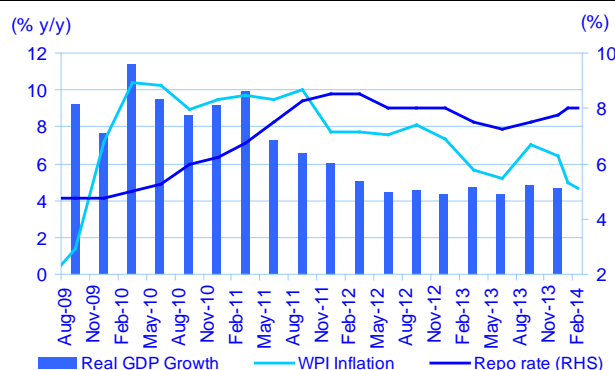
In what would be the world's single largest democratic exercise, beginning April 7th 2014, 815 mn eligible Indian voters representing 543 seats will visit the polls to elect a new government at the centre. Apart from its sheer size, this time India's national elections are particularly important given the formidable macro challenges that India faces (See Chart-1) and the implications of election outcome on the efficacy of nationwide policy making.

The election result, due May 16th, has been rife with speculations, with most opinion polls indicating a victory for the chief opposition party, BJP, led coalition (the National Democratic Alliance - NDA). Many believe that a strong anti-incumbency factor, the BJP's success at recent state elections and the growing popularity of its Prime Ministerial candidate Mr. Narendra Modi amongst the youth and middle class Indians give it an edge against the ruling Congress party led coalition government (United Progressive Alliance - UPA). (Table-1 illustrates key economic views of the Congress and the BJP).

The BJP is banking on Modi's impressive performance as the chief minister of Gujarat State, which grew at an average 10.3% y/y over the past decade, surpassing national GDP growth of 7.8% over the same period. Gujarat has evolved as a premier business destination in India, contributing nearly 17% to India's industrial output and 25% to India's overall exports. What sets it apart is the state government's clarity in policy, speedy decision making, a robust infrastructure support, and an uninterrupted power supply (power cuts are rampant in India). This has catalysed foreign private investments with global corporate heavyweights such as General Motors, Ford, Abbott, and Nestle choosing Gujarat to set up manufacturing units.

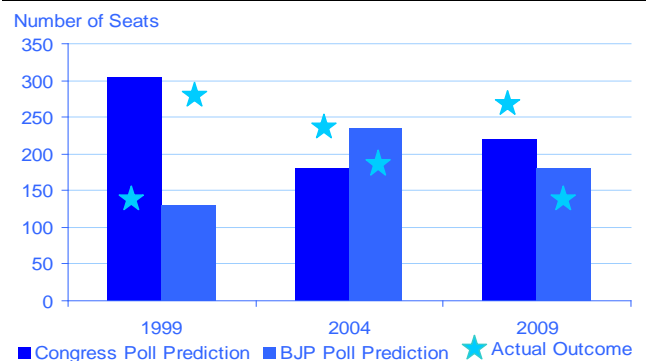
The perception about BJP as being reform-minded and a broad-based presumption of its imminent victory has bolstered investor sentiment, sparking a pre-poll rally in Indian equity markets, which have breached record levels even as India's macro backdrop stays weak. Since 2010, India's GDP growth has more than halved (from 9.7% y/y to 4.7% in 2013), dragged in part by slowing global growth but more so due to domestic issues associated with a high fiscal deficit, rising interest rates to curb inflation and delays in policy reforms, which have fallen short of reviving investment activity.

Chart 1
India's growth has slowed to multiyear lows



Source: BBVA Research, RBI data

Chart 2
Opinion polls are an unreliable indicator of election outcomes



Source: BBVA Research, Mean of opinion polls done by national media agencies

Evaluating possible outcomes - coalition politics is here to stay in India

The importance of regional parties in India's national politics cannot be discounted. India has been led by coalition governments since 1989 with regional political parties assuming increasing significance. We believe this time would be no exception with the Congress and the BJP forging alliances with a cluster of like-minded regional parties. As such, a strong and stable government would warrant a more decisive victory (220+ seats) for either the BJP or the Congress with far fewer regional allies, which in turn enhances administrative stability and allows for bolder policymaking. Opinion polls attribute this best case scenario to the BJP led NDA, which has, over the recent months, made significant progress in key non-BJP led states such as Uttar Pradesh, Bihar, Maharashtra, and Rajasthan (together accounting for 35% of total seats). On the other extreme is a scenario where the BJP and Congress fail to impress (less than 180 seats), leading to fragmented coalition of regional parties (the third front), likely supported by the Congress.

Opinion polls suggest victory for Modi, but it's not a done deal

In a word of caution, past performance of opinion polls in predicting poll outcomes is chequered (See Chart-2) and we may be underestimating the support that Congress Party enjoys across India's rural hinterland, thanks to its populist measures such as the Mahatma Gandhi National Rural Employment Guarantee Scheme and the Food Subsidy Bill. That said, over the past year, the ruling party has shown its eagerness to get reforms on track - fuel price reforms, expediting project clearances, direct cash transfers, easing foreign investment limits across sectors such as multi brand retail and construction of the Delhi-Mumbai industrial corridor - although for most, a lack of effective implementation has been an issue. Meanwhile, the emergence of AAP, a new party led by anti-corruption activist Mr Arvind Kejriwal, which tasted exceptional success at the recent state elections in Delhi, and talks about the formation of a third front of 11 regional parties (excluding the allies of NDA and UPA) have increased election uncertainty as these may eat into the votes of the two major parties.

A strong mandate is a necessary - although not sufficient - condition for success. Instead, a fragmented coalition could impair ongoing economic recovery

Recent macro trends for India have been encouraging given the stabilization in rupee (at 60.5; up 12% against the US dollar since August 2013 lows), a sharp narrowing of the current account deficit (See Chart-3), easing inflation pressures, a relatively resilient services sector and improving global growth. Given an economy that is on the mend (See our India outlook 2014), a potential change of guard at the centre is widely perceived as an opportunity for the new government to transform India's policymaking and administrative landscape. A strong and stable mandate would be necessary to expedite the revival of stalled infrastructure projects, implement taxation reforms such as the goods and services tax and the direct tax code and keep fiscal consolidation on track. However, a strong mandate in itself may not be sufficient to rekindle investment activity as project implementation is still very weak. In fact, there are a number of impediments at the state level, such as legal hurdles, power shortages, over capacity in cement and steel sectors, etc which warrant effective centre-state coordination to be resolved. Furthermore, the need for fiscal discipline would leave limited room for boosting public capital spending over the near to medium term.

In the event of a fragmented coalition, things can get worse as regional parties with conflicting policy agendas can only increase India's credit risk. This is, at least what India's political history shows. One example is the third front, which won in 1996 but collapsed soon, leading to re-elections in 1998. We foresee a greater likelihood of a less-emphatic victory for one of the major political parties, which could lead to temporary jitters until a post-poll alliance is stitched. While such an outcome may provide a stable government, implementing bolder reforms would remain a challenge.

Need to temper emotions of extreme euphoria or despair over upcoming India elections:

All said, of crucial importance is the need for a stable government regardless of which major political party comes to power and we believe that expecting the new government to be an immediate game changer would be pre-mature. While addressing structural bottlenecks to growth is critical for restoring India's lost growth potential, over the years, economic and financial liberalization has made India's GDP growth increasingly aligned to global business cycles, which are currently trending up.

Importantly, a meaningful economic recovery for India would warrant a pick up in private investments and improved trade performance. Augmenting foreign investments is crucial in this regard, particularly for a supply constrained economy such as India, as it permits faster growth with less sacrifice of current consumption. We believe that a stable mandate would bode well for foreign direct investments (FDI) in India given the consensus amongst major political parties (See Table-1) that liberal policies on FDI across a broader category of sectors is imperative to finance India's current account deficit and sustain high growth over the medium to long term. All in all, amid hopes of a stable government and strengthening global growth, we continue to foresee a gradual improvement in India's GDP growth over the next five years from 5.1% in 2014 (4.7% in 2013) to around 7.5% in 2018.

Table - 1

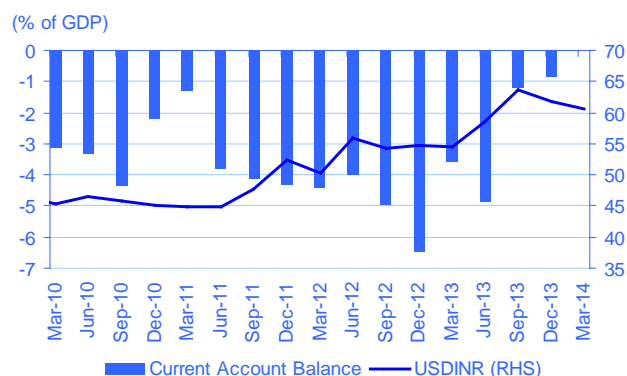
Economic views of Congress and BJP

Congress	BJP
No room for any aversion to foreign investment	Transparent and stable policies to encourage foreign investment
Rebuild and add new infrastructure	Focus on economic diplomacy for friendly trade policies
New financing structure for long term investment	Professionalize public sector undertakings
Waive taxes on exports to promote manufacturing	Set up apex court for black marketers
Rebuild cities with a new model of governance.	Price stabilization fund to stem inflation
Reservation for employment and education for economically weaker section	Set up national agriculture market
Minimum tariff protection for manufacturing	100 smart cities, Golden quadrilateral of bullet trains
To introduce goods and services tax (GST) in 100 days	Set up high quality educational institutes in all states
Reduce fiscal deficit to 3% of GDP by 2017 (4.9% in 2013)	Boost share of manufacturing in GDP from 14% to 33%

Source: BBVA Research, Finance Minister Speech, BJP Vision Document, Election manifesto

Chart 3

Stabilizing rupee, lower CAD has eased external financing risks



Source: BBVA Research, RBI data

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