

Indian state election - second term test for Modi

Political uncertainty will likely take grip of Indian financial markets in the run up to general elections in 2019.



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Gujarat elections

The fallout from unpopular demonetisation and tax reforms, evident in Prime Minister Modi's falling popularity raise the political uncertainty likely to weigh on Indian financial markets in the run-up to the general elections in 2019. The immediate test comes with the results of the legislative assembly elections in the Indian state of Gujarat, Modi's home state and his stronghold. Gujarat elections are held in two phases, the first of which was on December 9 and the second is to be held on December 14, with the results expected on December 18.

Weakening support for Modi in his home state

Opinion polls for the Gujarat election point to falling support for Modi and his Bhartiya Janata Party

(BJP) against the rival Congress Party, making it a close to call election. Stakes are high. A total of 182 legislative seats are up for grabs, and the BJP seems to lack popular support to win a clear mandate as in the previous four elections in Gujarat. However, BJP hopes of retaining power in Gujarat are still alive, if anything can be drawn from the party's landslide victory in the Uttar Pradesh state elections in March this year. The outcome will set the tone for elections in eight other Indian states in 2018 and the national election in 2019.

Unpopular reforms

The hasty implementations of demonetisation a year ago, and of a goods and services tax in July this year have adversely impacted consumers and businesses, denting India's GDP growth to a 3-year low early this year. This has increased voter ire against Modi and his BJP-led coalition government - at the centre and in 18 of 29 Indian states. Gujarat, which under Modi administration thrived to be one of the most developed and fast growing Indian states, is at the forefront of it all.

6.3% 2Q FY2017/18 GDP growth

Worse than expected

Political uncertainty in 2018

Indian financial markets are stabilizing after a sell-off in September due to increased policy jitters associated with slow growth, rising inflation and above-target fiscal deficit. GDP growth recovered slightly in the second quarter of fiscal year 2017/18 to 6.3% YoY from 5.7% in the previous quarter but there was no meaningful improvement in the underlying economic activity. Inflation continued to creep higher and is likely to remain on an upward course in the period ahead as a result of rising fuel prices. Industrial production and consumer and wholesale price data this week will inform on growth and inflation dynamics in the current quarter, though unlikely in a market-friendly direction.

The markets need political stability and economic policy continuity.

If persistent, the rise in political wind against the incumbent administration, and the policy uncertainty associated with it, will be the main headwind for financial market performance in 2018. We expect the Indian rupee to be among underperforming Asian currencies in the coming year.