

## Indian voters' verdict on Modi arrives

After more than a month of voting in India, hopefully, the long-standing political uncertainty is set to end. Exit polls suggest prime minister Narendra Modi's return to power, but given the anti-incumbent sentiment seen in last year's state-level elections in Modi's stronghold states, the potential for surprise still remains



Source: Shutterstock

### Putting behind politics

Voting has ended in India and the final results will come through on Thursday. Exit polls suggest Narendra Modi is set to return as the prime minister for a second term.

But given the state election surprises in 2018, we think the results of this general election could still be unpredictable - and we're not alone. Recent opinion polls also indicate the main political rivals including the incumbent Bharatiya Janata Party (BJP), the right-wing National Democratic Alliance (NDA), and the Congress-led left-wing United Progressive Alliance (UPA) could come in neck and neck.

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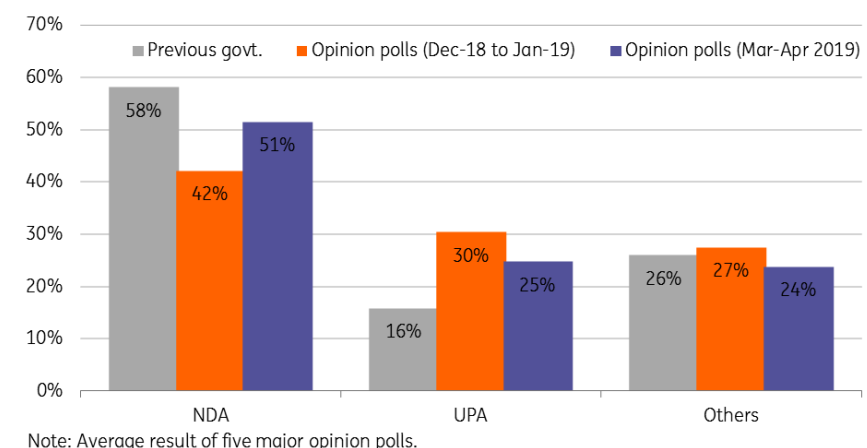
*Even if Modi's BJP party retains its absolute majority this doesn't*

*quite guarantee the throne*

Our base case remains seeing the Modi administration clinging to power for the second term, but given the anti-incumbent sentiment we saw sweeping through last year’s state-level elections in Chattisgarh, Madhya Pradesh, and Rajasthan, back when the national level polls showed the NDA losing its grip on power, there remains the potential for an election surprise. A key risk for Modi is a consolidation of opposition under Congress.

Even if Modi’s BJP party retains its absolute majority this doesn’t quite guarantee the throne. Cast your mind back to a year ago in the legislative assembly elections in the Karnataka state where BJP won the majority of seats but failed to form a government and the Congress-led coalition stayed in the power till the end.

### What did pre-election opinion polls suggest?



### Not everything is great about Modi

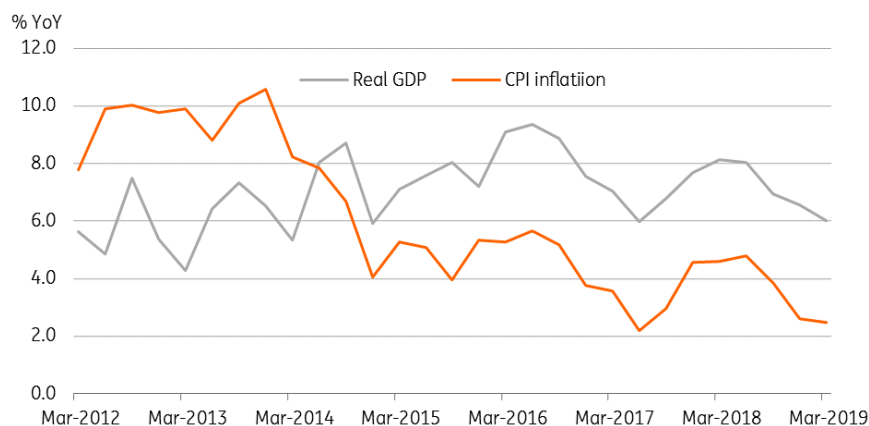
The Indian economy enjoyed solid growth of 7.5% per annum on average, during Modi’s five-year term, and low inflation of under 4% at least in the final year of his term. The tax reforms, even the chaotic implementation of the goods and services tax in mid-2017, banking sector reforms, anti-corruption drive, financial inclusion programs, kick-starting a cashless economy, and ‘Make in India’ initiative were some of the creditable measures by the Modi administration. These deserve some of the credit for the strong run of the Indian stock market relative to its emerging market counterparts, with the main stock indices almost doubling over the past five years.

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But the misery caused by the sudden ban of high-value currency at the end of 2016 remains vivid

in voter's minds and this was a big factor in the BJP's loss in its power bastions such as Chattisgarh, Gujarat, Madhya Pradesh, and Rajasthan. Adding to the negatives are continued farm distress, the excessive government intervention in central bank's affairs, bankruptcies of non-bank finance companies, banking sector scams and rising non-performing assets, and most importantly the elevated unemployment rate of 6.1%, according to the latest government survey making it the highest in 45 years - all undermining Modi's 'Make in India' initiative to transform the country into a global manufacturing base.

## Strong growth, low inflation during Modi's first term



Source: Bloomberg, CEIC, ING

## How markets are likely to react to election results?

The outperformance of the Indian markets and the rupee since February 2019 reflects increased investor confidence in prime minister Modi staying in power, but the uncertainty surrounding election results will undoubtedly sustain the negative sentiment in local markets already roiled by contagion from the escalation of the US-China trade war recently.

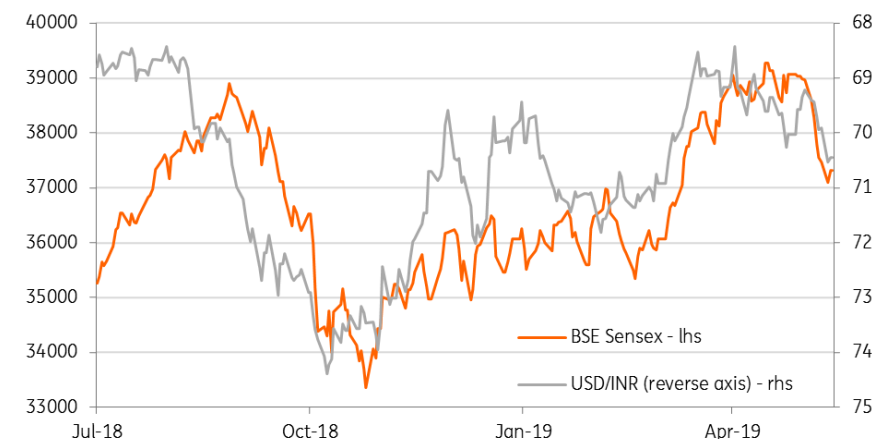
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We believe the markets are priced in for (our) baseline scenario of a BJP-led coalition retaining power albeit with a thin margin. Such an outcome means that the election results should have little impact on markets, and in turn should be left to be driven by non-political factors, domestic and external. Indeed, the currency market has so far vindicated our forecast of the INR weakening past 70 against the USD. We see the pair trading in a tight range around 71 until the election dust settles.

## Markets are pricing in a Modi return



Source: Bloomberg, ING

## Alternative events risks

As we've mentioned above, the results could go either way and depending on how the swing states - the states where BJP has lost power in state elections over the last two years - perceive the party at the national level. The alternative outcomes and our view of what these would mean for markets are:

1. **NDA remains in power:** The BJP loses its absolute majority but still forms the government with the coalition partners and Modi stays prime minister. Just as the baseline, this is likely to have little impact on markets, with USD/INR continuing to trade in the 70-71 range.
2. **A landslide victory for BJP:** This would come as a big positive for markets, with the USD/INR grinding for re-test of the March low of 68.42 and eventually settling in the 66-68 trading range.
3. **Congress-led UPA government:** Investors are likely to see this as instilling significant political and economic uncertainty for the future, by derailing economic reforms. The resultant market sell-off could see USD/INR pushing higher to a 72-74 trading range.
4. **Third front government:** A government without the BJP or the Congress would mean a significant jump in uncertainty on all fronts and for a prolonged period of time. Although such an outcome is highly unlikely, this could spell disaster for markets, driving the rupee down for a significant depreciation above 75 against the USD.

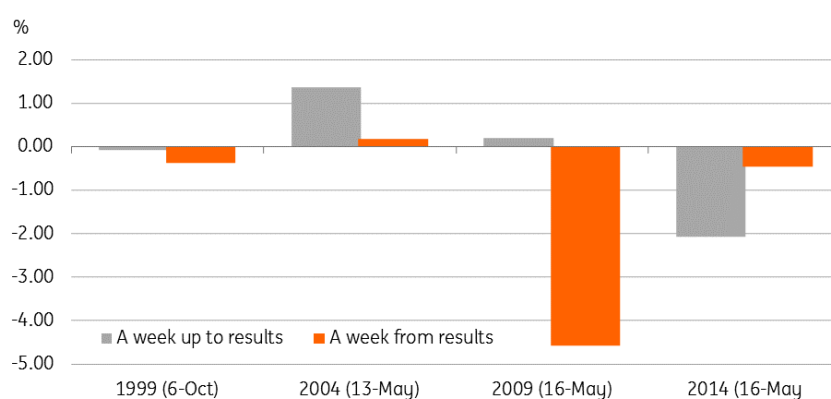
## USD/INR performance in the week up to and after results of past elections

**1999 result:** NDA swept back to power after being ousted with no confidence vote leading to fresh elections.

**2004 result:** NDA lost power to UPA

**2009 result:** UPA remained in power

**2014 result:** NDA returned to power on landslide BJP victory



Note: Election results dates in parenthesis. Negative values means INR appreciation and vice versa.

Source: Bloomberg, ING

## As political uncertainty lifts, the economy will be back in focus

Like elsewhere in Asia, recently released Indian economic indicators paint a picture of continued slowdown in growth and benign consumer price inflation – both supporting expectations of greater policy accommodation amid persistently wide fiscal and current account deficits.

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*For now, we retain our annual growth forecast of 6.8% for the current financial year*

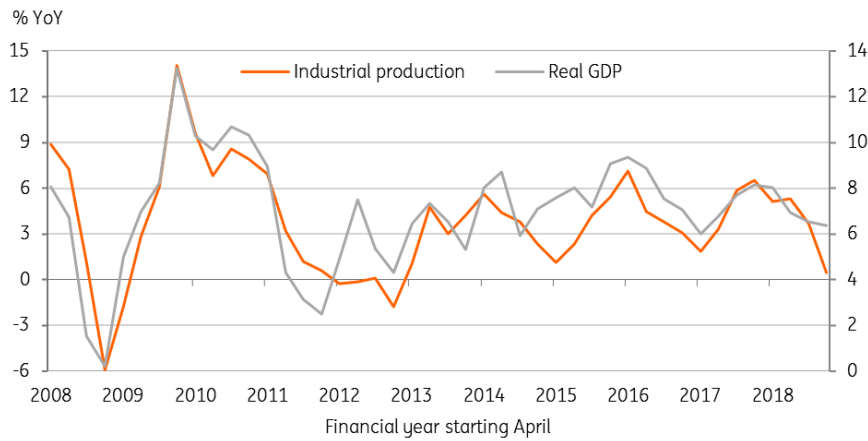
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Keeping with the broader global trend, exports and manufacturing posted a slowdown in growth in recent months. As this feeds into the overall economic growth, a downward trend in GDP growth appears to have gained pace between January-March – the last quarter of the financial year 2018-19. On our forecast, GDP growth in that quarter slipped further to 6.0% year-on-year from 6.6% in the previous quarter, making it the slowest growth quarter in two years. This puts FY18-19 growth at 7.0%, only marginally better than 6.7% in the previous year.

We anticipate growth to hover around 6% in the current quarter before the pre-election boost to government spending kick-starts the economy. However, with growing headwinds to growth, especially from weak exports and higher oil prices, sustaining growth at or above 7% will be a challenge. On technical grounds, the low base effect is likely to contribute to some acceleration in

the remaining FY19-20. But for now, we retain our annual growth forecast of 6.8% for the current financial year.

## Manufacturing has dragged GDP growth lower



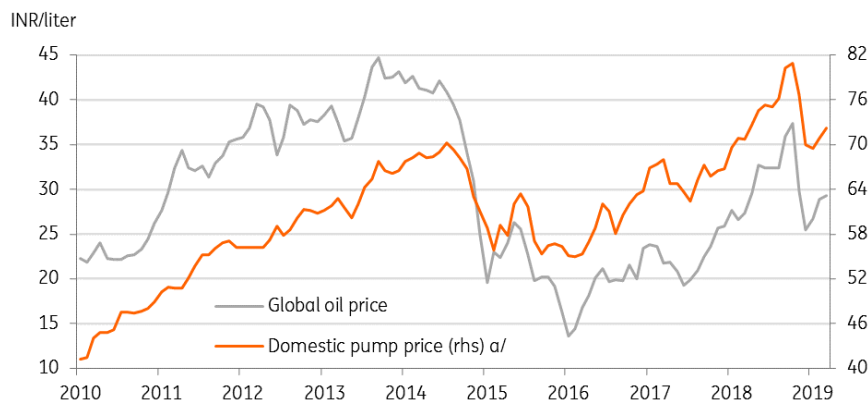
Source: Bloomberg, CEIC, ING

## Inflation genie still bottled, but not for too long

Consumer price inflation continues to be defiant to increasingly weak public finances and pass through from higher global oil prices. Annual inflation has been creeping up after it bottomed at 2% in January. It has risen to 2.9% as of April - still well below 4% - the mid-point of the RBI's 2-6% policy target.

State-owned oil companies have been blamed for holding on to the pass-through of higher global oil prices to domestic fuel prices during the election period, even though pump prices in India are adjusted on a daily basis. If so, consumers should be bracing for a significant spike in fuel prices post-election. Adding to their woes will be the lifting of the US waiver of imports from Iran. Among other inflationary drivers are higher import duties on food grains as in late April the government raised duty on wheat imports by 10 percentage points to 40 percent in protection for local farmers.

## Be prepared for higher fuel prices after election



a/ Average of petrol and diesel price in four metropolitan cities

Source: Bloomberg, CEIC, ING

## Misplaced hopes of another RBI rate cut

Low inflation has allowed the RBI to cut rates twice in February and April, which apparently were political moves (the government’s drive to boost growth before the election) rather than a real need by the economy already stimulated by the surge in election-related spending. We believe the expectation of the third rate cut in June, as some in the markets have been calling for, are misplaced.

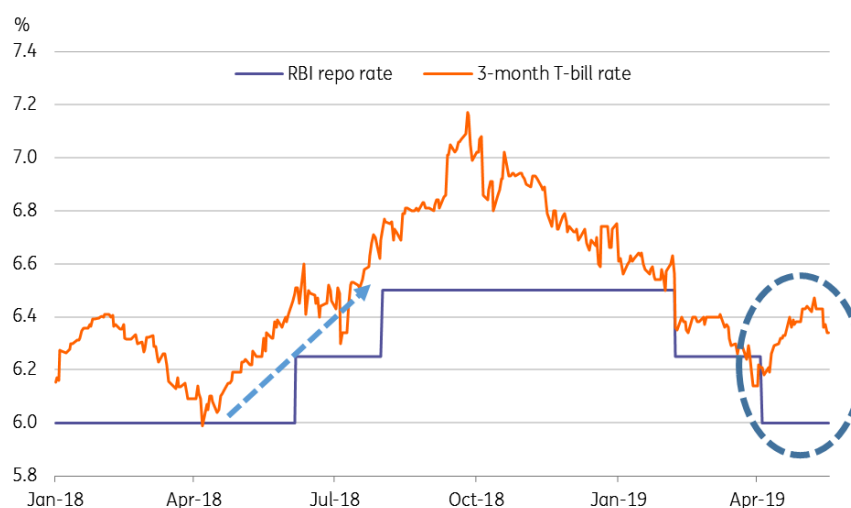
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*We forecast no more RBI policy rate cuts this year*

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Given a significant policy lag and the potential inflation headwind, we believe the RBI will stay on hold in June and rather allow the hitherto easing to sink in. We think rising short-term rates since April – the rate on 3-month T-bills is up 20 basis points – underscore a stable RBI policy in the next meeting. We forecast no more RBI policy rate cuts this year.

## Market rates suggest no more policy rate cut



Source: Bloomberg, ING

## US trade war risk shifting to India

The external risks could manifest if the US potentially targets India as its next trade enemy, after China.

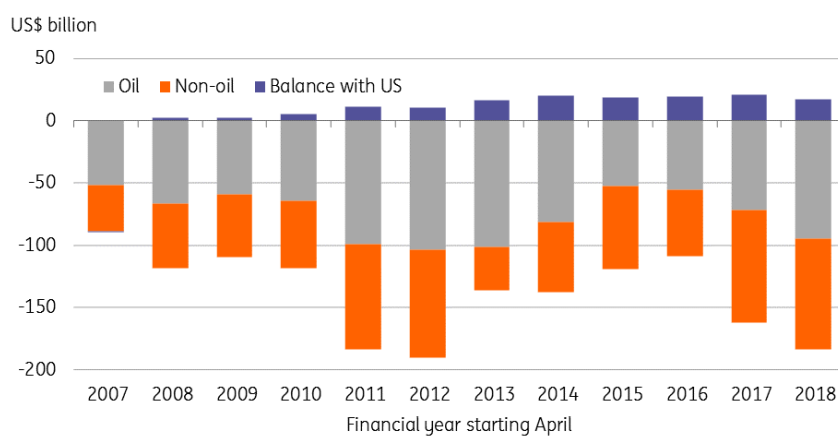
In early March, President Trump issued a notice to end trade benefits to India under the generalised system of preferences (GSP), which allows duty-free exports to the US of about 2000 products from developing countries. This special status has been put under review on the grounds that India, supposedly the largest beneficiary of the GSP, wasn’t reciprocating with free access to its market. However, India’s commerce ministry downplayed the potential impact from this on the basis that benefits from GSP had been negligible.

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India is also among the countries running a wide trade surplus with the US, which has brought it under scrutiny from the US Treasury for currency manipulation along with China, Japan, and Korea. But the annual surplus with the US in FY18-19 fell 20% below the Treasury's \$20 billion threshold - one of the three criteria for a country to be labelled as a currency manipulator. And India has dodged the bullets on the other two criteria - a wide current account surplus of at least 3% of GDP, and persistent one-sided market intervention with FX purchases of at least 2% of GDP.

It would be interesting to see the US Treasury's assessment in the forthcoming semi-annual manipulator report later this month, which will be based on the more stringent criterion - now less than 2% of GDP current surplus, though India still doesn't meet this, and this is likely to see more countries falling in this category.

## Widening total trade deficit, but still large surplus with the US



Source: Bloomberg, CEIC, ING



## India - Key economic indicators and ING forecasts

India (FY starting April)	FY2015	FY2016	FY2017	FY2018 f	FY2019 f	FY2020 f
Real GDP (% YoY)	8.2	7.1	6.7	7.0	6.8	7.2
CPI (% YoY)	4.9	4.5	3.6	3.4	4.5	5.0
Fiscal balance (% of GDP)	-3.9	-3.5	-3.5	-3.5	-3.4	-3.3
Public debt (% of GDP)	70.0	69.5	71.2	72.5	72.0	71.0
Current account (% of GDP)	-1.1	-0.6	-1.9	-2.6	-3.1	-2.9
FX reserves (mth of imports)	10.2	10.6	10.2	8.3	7.9	7.8
External debt (% of GDP)	182.1	168.2	171.4	160.0	162.2	175.5
RBI repo rate (% eop)	6.75	6.25	6.00	6.25	6.00	6.25
3M T-bill rate (% eop)	7.27	5.82	6.09	6.14	6.50	6.60
10Y govt. bond yield (% eop)	7.47	6.68	7.40	7.35	7.80	7.80
INR per USD (eop)	66.33	64.84	65.18	69.16	69.50	68.00

Sources: Bloomberg, CEIC, ING forecasts

Source: Bloomberg, CEIC, ING