विकास! विकास! विकास!

Modinomics -- Reason to believe?

Source: Reuters

Six concrete steps that we like about the 'Gujarat model'

(1) *Provided stability to the agricultural sector in Gujarat and reshaped the agricultural landscape in drier regions of Gujarat such as Saurashtra and Kutch.*

(2) *Separated electrical supply systems (feeder lines) to the rural sector for household consumption purposes and for use in agricultural land—these actions helped in curtailing leakages, limiting distribution losses and in improving the quality of power.*

(3) *Strengthened a three-tier governance model within Gujarat—that could emerge as a possible blueprint for decentralizing the national government.*

(4) *Simplified the land acquisition process by empowering the Gujarat Industrial Development Corporation.*

(5) *Electricity tariff collection efficiency at 100 per cent*

(6) *Significant improvement in fiscal position*

We agree with the consensus that the decisive mandate delivered in the 2014 general elections is likely to mark the beginning of what could well be a sustained revival in the economy. With the BJP led NDA alliance receiving 332 seats a figure that is well above the simple majority of 272 seats required to form a government, it is free from the shackles of coalition politics that have often (or so politicians would have us believe) hindered the ability of previous governments to move ahead with reforms. Confidence and the clichéd 'animal spirits' of investors at least seem to have revived and could, over time spill over to the corporate sector and their capex decisions. This confidence, we believe, is legitimate. Mr. Modi has a proven track record in his home state and it is rational to expect that he will be able to replicate his development record at the national level to some degree at least.

Table 1: The NDA wins a strong mandate

Lok Sabha election outcome		
No. of seats	**2009**	**2014**
1.) NDA	**141**	**336**
--BJP	116	282
2.) UPA	**234**	**59**
--Congress	206	44
3.) ADMK	**9**	**37**
4.) TMC	**19**	**34**
5.) Others	**140**	**77**
Total (1+2+3+4+5)	**543**	**543**

Source: Reuters and HDFC Bank

I.) What can he offer to turn the economy around?

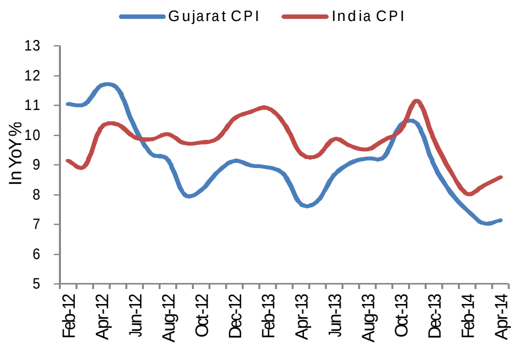
Even though Mr Modi has received a strong mandate, it is important to keep in mind that he is inheriting an extremely weak economy that is stuck in a low growth but high inflation trap. For him to engineer a significant change in the domestic macroeconomic landscape, a lot will depend on how he executes and revamps the reform process.

Based on our assessment of Gujarat's record, these are some of the things that the new PM could bring to the table:

1. **Infrastructure man!:** Inadequate infrastructure is perhaps one of the main obstacles that is holding back growth. In fact, India ranks as the 85th nation of 148 nations in the World Economic Forum's global competitiveness rankings for infrastructure. Hence, a top priority for the new government will be to get project clearances and implementation expedited. This would help both aggregate demand and ease some of the critical supply bottlenecks that have held back the Indian economy's 'potential' rate of growth. Mr. Modi is recognized by even his most bitter detractors for his single-minded focus on infrastructure projects in his state. Thus it is possible that the new PM's focus could be on fast-tracking projects on the infrastructure sector.

2. **Leadership and administrative acumen:** Mr Modi is one of the few chief ministers to become prime minister of the country. He has more than a decade of leadership and administrative experience of steering a state that has grown consistently above the national average. His experience in state-level governance and administration could help in tackling bureaucratic hurdles and supply-bottlenecks. For instance, inadequate supply chain management that resulted in short-term shortfalls in the supply of food commodities emerged as an important contributor to the sudden spurts in food price inflation in the past. These shocks have taken a while to die down and have partly lingered on as more generalized inflation. Some of these factors that have contributed to pushing food inflation higher reflect problems with the failure of contingency mechanisms both at the central and the state level and the inability to coordinate supply and delivery of food items between surplus and deficit states. What is needed here is not the 'rocket science' of monetary economics but the ability to simply handle things better administratively. These might eventually help in lowering inflation expectations. Two things go in Modi's favour in this context. Modi has a reputation of being a systematic problem solver. Second, having been a chief minister for many years, he has a keen understanding of the nuances and complexities of inter-state coordination.

Graph 1: Gujarat's CPI inflation is lower than the national CPI inflation levels



Source: RBI & HDFC Bank

Box 1: A possible plan to contain rise in inflation

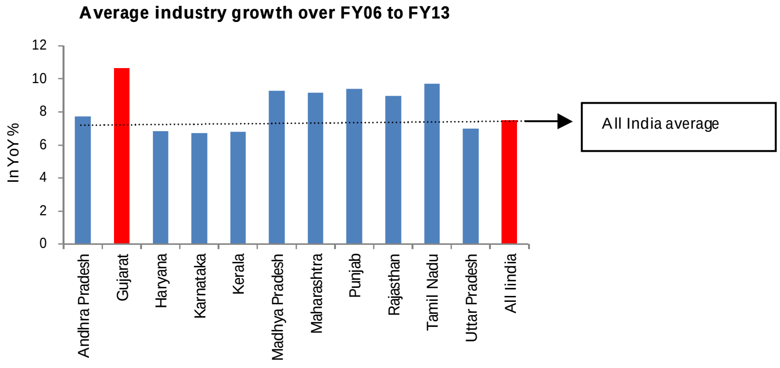
Back in 2011, the then Gujarat Chief Minister, Narendra Modi headed a working group on consumer affairs and submitted a plan to the Central government detailing steps to control inflation. In particular, he spelt out 20 specific recommendations and 64 actionable points.

Some of the key points of his plan were:-

- Liberalisation of the Agricultural markets, reforming the Agricultural Produce Market Committee (APMC) act
- Unbundling of Food Corporation of India operations of procurement, storage and distribution
- Set up of a price stabilisation fund by the Centre to help state governments procure and distribute essential commodities in short supply
- Setting up of a ministerial-level coordination mechanism at the national and the regional level for coordinated policy making
- Enlarging the scope of priority sector lending so that agriculture marketing activities are also made eligible
- Increase in competition by promoting retailing by the organised sector and cooperatives
- Creation of a dedicated agency to collect and widely disseminate information to all stakeholders on production, import, stocks and overall availability of essential commodities
- Recommended banning on future trading of essential commodities and strengthening the Essential commodities act

3. **Recognizing the importance of industry:** Our assessment is that at least some of the problems of industrial growth have to do with the hostile environment that industry, particularly manufacturing, faced from both the centre and some state governments. Gujarat on the other hand has seen a single-minded commitment to industrial growth (For example the industrial growth rate has averaged around 10.6% from 2005-06 to 2012-13 that is much higher than the national average of 7.5% in the same period). During his tenure, Modi has introduced a number of mechanisms to facilitate the development of industry. One such example was the establishment of the Industrial Extension Bureau with the objective of acting as a single point of contact for entrepreneurs for setting up industrial ventures. It is possible that similar mechanisms could be introduced at the national level and the BJP's manifesto has made a commitment to this.

Graph 2: Gujarat's industrial sector has outpaced the national average



Source: Planning Commission & HDFC Bank.

4. **Improve co-ordination between the Centre and States:** Lack of coordination between the centre and states in an environment where state governments increasingly wanted their due stake in the federal structure of governance and public finances was yet another obstacle that hampered growth prospects in the UPA regime. This was visible in the fact that while the UPA government did take a number of initiatives to kick-start project investments, the pending approvals of investment projects at the state level meant that limited progress was made in a number of cases. Modi's election campaign explicitly identified this source of concern and spoke of a more collaborative model of governance. As a member of both the National Development Council and the Inter-state council of chief ministers, both apex forums for state CMs, the new PM is likely to have a ready blueprint for what this collaborative model could constitute. This will also be critical in ensuring the implementation of reforms such as the implementation of GST that is considered an integral part of the fiscal consolidation process.

5. **Land-reform measures:** Land-acquisition has emerged as a major stumbling block for implementing large projects. There have been numerous instances in which large companies have had to shelve major projects because of issues relating to land acquisition. For example, both the Tata Nano plant in Singur, West Bengal and Arcelormittal Steel Plant in Odisha were stopped because of land-acquisition related concerns. The net result is that yet again the investment climate has suffered. However, the situation has been very different in Gujarat. The Gujarat Industrial Development Corporation and Investor Facilitation Portal that were instituted by Mr Modi have simplified land acquisition (see box 2) in Gujarat. This in turn has directly aided stronger industrial growth in the state. We hope that Mr Modi can replicate this model and simplify land-acquisition and other environmental related legislation as that could positively impact sentiment and allow for a quicker implementation of projects.

Box 2: Land related interventions in Gujarat

The state of Gujarat was recognized as best practice in various reports including the DIPP & Accenture report titled "Best Practices to Improve the Business Environment across India " in 2014, 'Ease of Doing Business in India' report published by CII in 2014 and 'Empowering India' report published by FICCI in 2012 .

Key Features

- Gujarat Industrial Development Corporation (GIDC) MITRA – Online Grievance Redressal and monitoring system
- Timelines for approval are incorporated in the backend online system
- Information on land made available on online portal with highlights on availability of land, power, gas, distance of port, airport, SEZ among 65 parameters for Industries based on the critical parameter specific requirements chosen by the entrepreneur
- 50 Skill Up-gradation centres constructed for imparting training in various GIDC estates, 50 more have been planned
- GIDC is allowed the flexibility to negotiate, offering developed land as part of the compensation.
- Provision for employment of one member of each family whose land is acquired

Success rate

- GIDC has been able to bring down the days taken to provide land possession to less than 45 days from the date of application
- Land allotment increased fourfold with the launch of online portal in 2010

6. **Better Management of PSUs:** A major success story of Mr Modi in Gujarat was his ability to turn around loss-making PSU companies. Two of his prominent success stories are: The Gujarat State Electricity Board (GSEB) and the Gujarat State Fertilizers & Chemicals (GSFC). The GSEB went from posting a loss of INR 2246 crore for 2000/01 to making a profit of around INR 533 crore by 2010-11. Similarly, the GSFC went from accumulating losses of INR 692 crore during Mar'01 – Mar'03 to a profit of around Rs 1113 crore by Mar'12. A key strategy of Mr Modi was to empower officials of the PSUs and bring in qualified bureaucrats (rather than place politicians) to take effective management decisions that in turn helped in reversing the fortunes of the two respective companies. He could perhaps replicate such a model at the national level. ***One area in which this kind of management restructuring could reap results is PSU banks where outright privatization is not politically feasible but better management could help tackle many problems such as inefficiency and rising bad loans.***

Box 3: How the Gujarat State Fertilizers & Chemicals was turned around

- There has been an impressive turnaround in GSFC. From accumulated losses of Rs 692cr incurred during Mar'01 – Mar'03, the company posted profit before tax of Rs 391cr by Mar'06, which then jumped to Rs 1113cr by Mar'12.
- Two major steps helped the company in its turnaround. The implementation of the corporate debt restructuring programme helped in bringing down the interest cost significantly and to switch from naphtha to natural gas for feedstock, which reduced the input cost substantially.
- The government's decision to not appoint a political leader as chairman of the company and instead appoint a bureaucrat with significant autonomy in decision-making was another key factor.

Box 4: Success story of the Gujarat State Electricity Board

- From an accumulated loss of INR 2246 crore in 2000/01 the company posted profit of around INR 533 crore in 2010-11.
- For starters the Modi led state government appointed an experienced bureaucrat as the head and further empowered her and kept political leaders away from interfering in the process
- What followed was the careful rebuilding of the company's balance sheet through the renegotiation of loans and PPAs with the private sector while also rebuilding employee morale.
- By May 2003, the Gujarat government had passed the Gujarat Electricity Industry (Reform and Reorganisation) Act, which divided the GSEB into a holding company, a power generation company, a power transmission company and four distribution companies.
- Another crucial reform was the separation of the feeder line that supplied power to the rural areas into two: one to supply power for agricultural needs and other for household needs, which is now being recommended in states throughout the country.
- Besides, the government also got strict on power theft and set up five police stations exclusively for this purpose.
- An interesting aspect is that Gujarat's tariff collection efficiency is close to 100% while the state itself has turned power surplus.

Note: Figures for the Gujarat State Electricity Board have been taken from newspaper articles

II.) The Gujarat 'model' of Governance and Economic Management

There has been considerable debate on what exactly the Gujarat model is and whether the claims made by its supporters are truly justified. We believe that there are varied nuances to the entire Gujarat story - one can interpret it in terms of relative economic performance vis-à-vis other states, over different time periods, in absolute terms or incremental terms, social performance, governance and so on.

While we acknowledge some of the criticisms of the Gujarat model of development, we also believe that there is enough in the Gujarat story that highlights the success of efficient governance in delivering economic development.

The growth barometer

Even though gross state domestic product (GSDP) is the widely used parameter of economic performance, which indeed has been the highest (average annual growth during 2000/01 - 2011/12) in Gujarat, a better indicator in our opinion to gauge economic growth is per capita net state domestic product (NSDP), which has also been the highest in Gujarat when compared to similar high growth states (table 2).

Table 2: Strong Economic Performance by Gujarat over the last decade

Average annual growth rate during 2000/01 - 2011/12		
States	**Per Capita NSDP**	**GSDP**
Andhra Pradesh	6.6	7.9
Bihar	6.1	8.0
Gujarat	**7.1**	**8.9**
Haryana	6.7	8.8
Karnataka	5.0	6.5
Kerala	6.7	7.6
Madhya Pradesh	3.8	5.9
Maharashtra	6.1	7.7
Punjab	3.6	5.8
Rajasthan	5.0	7.2
Tamil Nadu	7.1	8.0
Uttar Pradesh	3.5	5.7
All Iindia	**5.6**	**7.4**

Source: Databook 2014, Planning Commission, Government of India and HDFC Bank

The social dimension

If we look at Gujarat from the perspective of conventional parameters of development (perhaps most controversial aspect of the debate on the Gujarat model), some of them actually point to the fact that there has been considerable improvement. Gujarat has recorded one of the best improvements in literacy rates as compared to other states in the country in the Modi period. Furthermore, Gujarat's improvement in Human Development Index (HDI) scores is just second to Haryana's increment (table 3). This improvement was achieved despite the fact that Gujarat's HDI score and literacy rates were higher than national average in 2001 when Modi came into power in Gujarat.

Table 3: Improvement in some of the Social Indicators exhibited by Gujarat over the last decade

Change between 2011-2001		
States	**Literacy (%)**	**HDI Score**
Gujarat	**10.2**	**0.035**
Haryana	8.7	0.036
Karnataka	9.0	0.03
Kerala	3.1	-0.013
Maharashtra	6.0	0.026
Punjab	7.0	0.032
Tamil Nadu	6.9	0.013
All Iindia	**9.2**	**0.032**

Source: Databook 2014, Planning Commission, Government of India, UNDP, and HDFC Bank

Contrary to the general perception that development in Gujarat has only benefited the industrial sector and people in the higher income bracket, we find that in fact Gujarat is one of the better performing states. In terms of inequality measured by the Gini coefficient of distribution of consumption, Gujarat beats other high growth states such as Andhra Pradesh, Haryana and Madhya Pradesh (Table 4).

Table 4 – Inequality as measured by Gini Coefficients of Major States

Gini Coefficient of Distribution of Consumption : 2009-10		
States	**Rural**	**Urban**
Andhra Pradesh	0.269	0.353
Bihar	0.215	0.319
Gujarat	**0.252**	**0.309**
Haryana	0.278	0.357
Karnataka	0.231	0.375
Kerala	0.35	0.4
Madhya Pradesh	0.276	0.365
Maharashtra	0.244	0.38
Punjab	0.285	0.358
Rajasthan	0.214	0.316
Tamil Nadu	0.257	0.327
Uttar Pradesh	0.438	0.321
All India	**0.276**	**0.371**

Source: Databook 2014, Planning Commission, Government of India and HDFC Bank

Gujarat's success in agriculture

Even though agricultural growth in Gujarat was fairly strong and better than most of its other peer states even before Mr Modi's stint as chief minister, he still played an important role in driving growth. For instance, a notable highlight of Modi's regime was when he turned around some of the drier regions within Gujarat such as Saurashtra, Kutch and North Gujarat. According to a report titled "Secret of Gujarat's Agrarian Miracle after 2000" by Ashok Gulati et al, these regions could not have performed so well had the Gujarat government not been aggressive in pursuing an innovative agriculture development programme of liberalising markets, inviting private capital, reinventing agricultural extension, improving roads and other infrastructure and improving the availability of groundwater for irrigation, mass-based water harvesting and farm power reforms. Another aspect of Modi's tenure as chief minister was that volatility in agricultural growth appeared to have come down quite substantially (see table 5).

Table 5: Average Annual Growth Rate (%) of GSDP from Agriculture & Allied Sector

	94-95 to 99-00		00-01 to 08-09	
States	**Growth rate**	**CV**	**Growth rate**	**CV**
Andhra Pradesh	2.8	4.9	5.9	1.4
Bihar	8.7	2.6	7.1	2.9
Gujarat	**5.2**	**5.2**	**7.7**	**2.5**
Haryana	2.1	3.2	3.4	1.5
Karnataka	4.1	1.4	-0.7	16.9
Kerala	1.9	2.6	0.4	7.1
Madhya Pradesh	2.7	1.1	2.5	7.7
Maharashtra	3.1	3.3	2.0	5.2
Punjab	2.5	1.8	2.3	0.9
Tamil Nadu	1.8	5.3	1.4	8.3
Uttar Pradesh	4.1	1.5	2.3	1.0
India	**3.0**	**1.6**	**2.6**	**2.0**

Note: The coefficient of variation (CV) is defined as the ratio of the standard deviation to the mean. It shows the extent of variability in relation to mean of the population.
Source: CSO and HDFC Bank

Box 5: Improved Market Access to farmers – Gujarat's Experience

- Gujarat was among the early states to amend the Agricultural Produce Marketing Committee (APMC) Act to enable farmers to directly sell their produce to wholesalers, exporters, industries and large trading companies.
- It also allowed large players to establish spot exchanges.
- The amendment also helped create conditions conducive for the spread of contract farming.
- The government encourages large corporates to establish retail chains and source their requirements directly from farmers.
- Efficient value chains, lower spread of farm product prices and lower mandi charges (For instance, under 3.0% in Gujarat against almost 14.5% in Punjab) are some of the reasons that kept the prices of major essential commodities in check.

The governance model revisited

Another bright spot of Gujarat's Model has been many successful turnaround stories of Public Sector Enterprises such as Gujarat State Fertilizers & Chemicals (GSFC) and Gujarat State Electricity Board (GSEB) among others. One of the very interesting and common bits that emerge from various case studies (Box 3&4--above) on these PSUs is the government's bold decision of appointing deserving bureaucrats and not politicians to lead these ailing enterprises. E-governance has been implemented successfully resulting in a direct connect between the government and citizens.

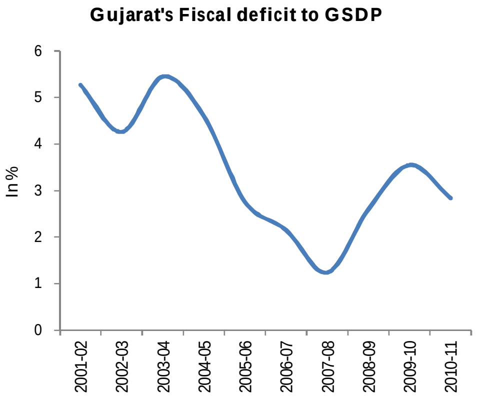
Box 6: SWAGAT - Online Grievance Programme

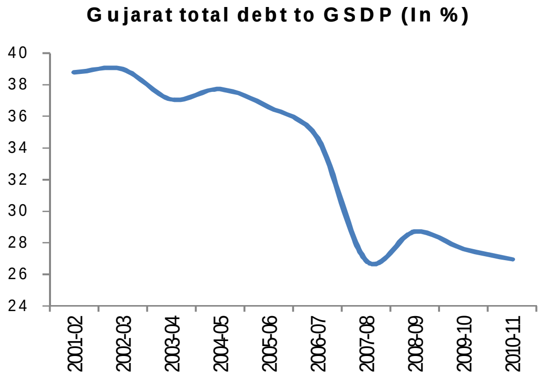
- SWAGAT- functional from the year 2003, helps citizens to seek redressal of their pending grievances once a month (fourth Thursday of every month)
- This is a three-tier system at Taluka, District and State level.
- All grievances are reviewed by the Chief Minister himself.
- The review is done based on the problems solved and not on the petition disposed.
- The programme has also bagged UN award for public service.

Gujarat's fiscal parameters

Another important area in the Gujarat model warrants careful attention is the manner in which the fiscal parameters have improved since 2001-02. There have been significant reductions in both the fiscal deficit to gross state domestic product and total debt to gross state domestic product (see graph 3). However, the real improvement in visible in the manner in which Modi has been turned around the revenue account from a deficit to a surplus. Given the need to commit to fiscal consolidation at the national level, this augurs well.

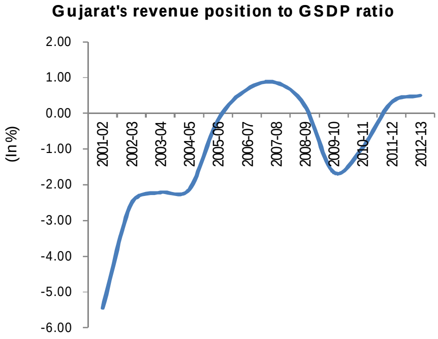
Graph 3: Gujarat's fiscal parameters have improved considerably since 2001-02

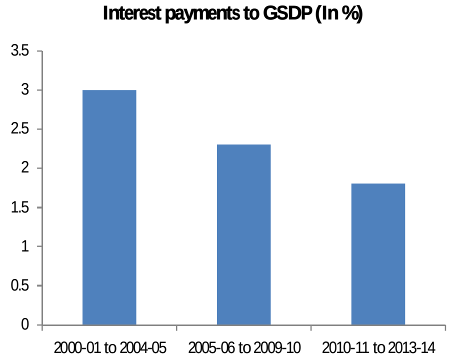




Source: Planning Commission & HDFC Bank.

Graph 4: There have been significant improvements in Gujarat's revenue accounts





Source: Planning Commission & HDFC Bank.

III) Now the forecasts

Near-term: Don't expect too much of an improvement in growth

While the impact of the election outcome is likely to be positive from a macroeconomic perspective, it will perhaps be a little too optimistic to assume that there could be a significant uptick in growth in the near term. After the initial honeymoon period is over, there needs to be a firm delivery on the ground for the level of optimism to stay intact. The immediate focus should be on: (a) plans to remove the bottlenecks that are hampering the recovery, (b) firmly committing to kick-start the investment climate and (c) passing a credible budget in July with definite assurances to the market that the government is prepared to stick to a long-term fiscal consolidation plan.

However, even if the government takes the right set of measures, the impact on growth is unlikely to accelerate immediately. Besides, the need to commit to fiscal consolidation will likely reduce the ability of the new government to provide a major impetus to growth in the near term. Hence, we maintain our base-case scenario of a marginal pick-up in domestic GDP growth from 4.7% FY14 to 5.5% in FY15 with downside risks that are dependent on the outcome of the monsoons. That said, if the government commits to and is able to push ahead with the reform process, there is likely to a significant step-up in growth that could become more visible from FY16 onwards.

Domestic assets: Scope for correction?

Given that the general election outcome was much better than anticipated, there could be some more upside in domestic assets in the near term. A critical determining factor for the markets will likely be on how the government manages to alter the growth-inflation mix in the domestic economy. The problem is that markets tend to be somewhat impatient and expect quick changes in growth and earnings. We remain worried that the prospect of a moderate recovery coupled with the fact that reforms work with a lag could perhaps limit the magnitude of upside for the domestic markets. Hence, we do see the prospect of some scope of disappointment setting in after the initial euphoria dies down. The immediate 'trigger-event' is likely to be the domestic budget that is due sometime in July.

INR: As portfolio flows pick-up responding to the election outcome and the greenback trades lower in the international market responding to softness in US sovereign yields, we see some downside in the USD/INR pair. However, we suspect that continued RBI intervention could limit the magnitude of downtrend in the pair. We are subsequently lowering our USD/INR projections for Q22014 and expect it to trade in the 57.50-59.50 range over the period.

In the medium term, we maintain our call for depreciation. We believe that a gradual reversal of US monetary policy over 2H2014-2015 will likely emerge as the main driver for FX markets. The prospect of an uptrend in US yields as the Fed prepares the market for a rate hike by mid-2015 could mean that there is a rotation of funds from EM markets to US markets. Thus, there could be some outflows from the domestic markets as well. However, if the government does move forward with reforms and the current account deficit remains at around 2% of GDP, there is only likely to be modest depreciation.

Our USD/INR forecasts	
2Q2014	57.50-59.50
3Q2014	58.50-60.50
4Q2014	59.50-60.50
1Q2015	60.50-61.50

Domestic bond markets: The formation of a stable market friendly government is positive for the bond markets. As such, it will likely ensure that the yield on the benchmark 10 yr bond remains at around the 8.70%-8.90% range. That said, we would not expect any material change in the outlook for the bond market in the current fiscal year. Firstly, markets continue to speculate over the possibility of the fiscal deficit target being revised up under the new regime that could possibly push up the market borrowing numbers. Secondly, the threat of a sub-par monsoon pushing up CPI inflation close to double digit level still exists. Lastly, the cost of funding within the domestic banking system is likely to pick-up as the RBI continues with its market development measures like building the short end of the yield curve. Hence, we expect the benchmark 10 year bond yield to trade in the 8.65% to 8.95% range over the course of the fiscal year with a downside possibility of 8.60%.

IV.) In conclusion, some questions

Finally, we are left with some questions regarding the stand on the government that would broadly fall in the domain of political economy. First, would the government have a firm stance on the rupee and support an appreciation bias by gently nudging the RBI? Second, would it try and champion the case for lower interest rates and try and change the conversation on managing the growth inflation trade-off. Finally, would it take the first step in removing ridding the budget of the smoke and mirrors and actually decide to show the government's dues instead of conveniently deferring major payments like subsidies to the next year and risk an increase in the budgetary targets to achieve this? We have no immediate answers but are aware that these are critical issues that will determine the course of our markets going forward

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