FIXED INCOME

India's Reform Movement Gains Momentum

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India has embarked on a sweeping reform movement under Prime Minister Narendra Modi, which has attracted investors' attention. Templeton Global Macro CIO Michael Hasenstab recently visited India, and takes a look at some of the reforms he's most excited about as a global fixed-income investor. He believes India's future looks bright and that its growth trajectory should remain strong—despite some short-term adjustments.

Earlier this summer we traveled to India—it was a good time to visit. The country has put through some ambitious reforms in recent years under the leadership of Prime Minister Narendra Modi, who took office in May 2014. India's economy has appeared invigorated under Modi, with annual gross domestic product (GDP) rising from 5.5% in 2013 before he took office to 7.5% in 2015 and 8.0% in 2016.[1] That growth rate has been the highest among the world's largest economies, and it has attracted waves of foreign capital in recent quarters.

However, we are at an important juncture in Modi's tenure—growth has moderated a bit in 2017 (estimated annual growth is 7.1%[2]) as some reform efforts have generated short-term headwinds. Some market participants have seemed concerned, but the short-term negative effects on growth are often necessary consequences of pursuing the right longer-term solutions.

The key to India's economic future likely won't depend on what happens to growth over the next few quarters, but instead on whether Modi can continue to push through the types of long-lasting transformational reforms that India needs, and whether they can meaningfully expand the country's economic potential. We believe they can.

Already, we've seen bankruptcy laws enacted (May 2016) that are intended to help enforce contracts and ultimately encourage more lending activity by bolstering confidence in the financial system. We have also seen a massive revision of the tax code, putting in place goods-and-services taxes (implemented in July 2017) to help remedy the complexities and inefficiencies of the domestic tariff system.

The government also deployed a bold plan to pull money out of the shadow economies and bring it into the formal economy by demonetizing 86% of the currency in circulation (November 2016). These are unprecedented and important structural reforms for India—Modi's government has been able to push ahead in areas of policy that have languished for decades under prior governments.

From a macroeconomic standpoint, Modi has also instilled much-needed stability. The Reserve Bank of India (RBI) has maintained responsible monetary policy, in our view, while using inflation targeting to break periods of high inflation that could destabilize the economy. Inflation in India has dropped from more than 10% in 2013 to below 2% on a year-over-year basis in 2017.[3] On the fiscal side, we think the government has also done its part by maintaining a responsible budget. The current account has also significantly improved from the large deficits of 2013.

Taken together, we believe India's macro picture looks relatively healthy. However, what's good for long-term health can sometimes feel like tough medicine in the short-term. A credible central bank may need to maintain higher interest rates and a government may need to spend less to maintain fiscal discipline—these measures can inhibit short-term growth but fortify the longer-term health of the economy.

We may see a deceleration in India's economic activity over the next year or so, but we think it's important for investors to recognize that it would be a moderation of growth in the world's fastest-growing large economy, not a contraction or derailment. India is re-envisioning its economic future, and these near-term adjustments could unlock tremendous economic potential over the decades ahead.

Overall, we continue to have a positive outlook for India, despite some near-term challenges. There are a number of additional actions the government can take in upcoming years to change how the economy may perform for decades to come. Efforts to deal with the accumulation of non-performing assets in the banking sector and to improve overall confidence in the financial system will be important. There are also a number of inefficiencies in the land and labor markets, and in utility and transport infrastructure that could benefit from comprehensive reform.

Nonetheless, as fixed-income investors, we think India is at a compelling stage—it has a fiscally conservative government, a moderating but largely resilient economy and a central bank that has brought down inflation and maintained appropriate rates. These are strong conditions for bonds and we continue to see attractive valuations across India's local-currency markets. On the whole, we remain optimistic for Modi's reform efforts and we continue to see greater economic potential ahead.

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1. Sources: India Central Statistical Organisation, Bloomberg. India Annual GDP (constant 2011 – 2012 prices, y/y).

2. Source: India Central Statistical Organisation, Bloomberg. There is no assurance that any estimate, forecast or projection will be realized.

3. Source: India Central Statistical Organisation. India CPI combined (y/y).