India

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS December 16, 2013

Analyst: Rolf Danielsen. Tel: +46-8-7638392. E-mail: rolf.danielsen@seb.se

Following a slide in GDP growth since late 2010, hopes are rising that the economy may finally have bottomed. However, few observers expect much more than a tepid recovery perhaps around 5% annual growth as major uncertainties remain, including important general elections in 2014.

Country Risk Analysis

Summary and main conclusions

Annualized growth in the second quarter of FY2013 (ending next March) rose unexpectedly to 4,8%, 0,4 pp up on the preceding quarter, raising hopes of an end to the three year long economic slowdown from the spectacular 10% economic expansion achieved in 2010. The rise was broad based but spearheaded by net exports as the current account deficit shrank sharply prompting observers to projects its fall to below 4% of GDP, still large but an improvement on the alarmingly high 5% deficit for 2012.

The light in the tunnel, however, is still weak. Following two major bouts of foreign market turmoil since 2011, confidence in the rupee is battered and inflation is back at nearly double digit levels. The authorities are left with the unenviable choice of either fighting inflation or running the risk of killing recovery. So far the central bank appears to have opted for the first.

That choice should be a winning streak provided exports continue to grow faster than imports on the back of a sharply depreciated exchange rate and barring new major turmoil including related to Fed "tapering". That could be a death spell to many companies and some banks which have borrowed heavily from abroad in recent years. It is also highly necessary that the government continues to deliver on promised structural reforms and completes the many new infrastructure projects that have stalled for several years after high profile corruption cases, even involving ministers, paralyzed government decision making until last December.

The domestic political situation is uncertain. Recent by-elections in five states suggest the incumbent is facing a steep uphill battle in nationwide elections next May. However, investors and businesspeople would probably not regret a change of government to one led by the main opposition party, the right-of-center BJP. In a not unlikely worst case scenario a coalition of a myriad of smaller parties will join to take office. As regards external security, the situation with China has worsened albeit in a silent manner.

Over the last year external ratings have remained unchanged except Fitch which last May changed its outlook in BBB- from negative to stable. With the benefit of hindsight that could appear premature.

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Recent developments

The economy is at crossroads. In FY2013 (fiscal year ending March 2014) growth will undershoot the government's target above last year's 5,1% and even officials see growth below 5% as more realistic. Some observers – including our forecast provider, Oxford Economics, sees economic expansion falling as low as only a fraction above 4%, marking the poorest achievement since the payment crisis in 1991. However, with the latest quarterly estimate at 4,8% most pessimists have lifted their whole year performance to the 4,5-5% range. Hopes are that the economy has bottomed out but few are seeing reasons for a spectacular recovery. The way back to potential 8-9% growth path could prove long.

Investments and exports led the slowdown but may now lead the upturn: The long slowdown affected in particular exports and investments, while private and government consumption maintained the little momentum left. Investments were hit by various factors; first, higher interest rates in 2011 as the central bank struck back against overheating caused by the oversized fiscal stimulus to counter the global financial crisis (GFC) of 2009; second, by serious delays to the government's investment program in infrastructure. The lack of sufficient power supply caused increasingly frequent brown-outs ending in nationwide power outages in July 2012. Exports, in contrast, suffered under weak global demand and an exchange rate that had become too high. Recent improvements to both, however, include, firstly, a rebound in announced projects, a 6% rise so far this year in the production of coal – a leading indicator power production – and, secondly, growing net exports helped by a depreciated exchanged rate. As an extra Fillip, the monsoon turned out unusually favorable in 2013 in most parts of the country, boosting agriculture which represents almost a quarter of GDP by and estimated10%.

Inflation pointing up. Since last May, the rate of inflation has picked up. In the first instance this reflected growing food prices, in particular of vegetables. Second, however, prices rose as a result of higher import prices following the steep devaluation during the summer and early fall which combined with a new pricing scheme for diesel and other energy products intended to reduce budget subsidies. Latest statistics show the rate of inflation exceeding 10% yoy in October, 2013, as measured by the consumer price index (CPI). Hopes are now that the bumper harvest of recent months should help damp the price pressure as food represents half of the CPI basket. However, it is not for sure that India's domestic transport system will be able to handle the extra shipments for the final consumer. Even in normal years waste may reach 20-30%. By contrast, rapid wage hikes, not least in rural areas have added to underlying price pressure. The government's employment guarantee for rural workers is now causing labor shortages according to many observers since introduced some years ago, although poor statistics remain a hurdle against a more informed analysis.

Rising exports and falling imports strengthen the current account balance. Having remained virtually flat for two years, exports have recently begun to show some revival. That combined with a more pronounced drop in imports has led to a sharp improvement in the trade balance. In view of the weakening rupee since May would apparently prove the J-curve wrong.[1] However, special forces have been at play. In 2012 many Indians invested in gold in part as a hedge against inflation, but also perhaps for outright speculative purposes. The steep drop in the international

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[1] This is the theory that a drop in the exchange rate causes the trade deficit to widen for some quarters, before it eventually shrinks.

price of gold may now have turned at least the speculative motive into a major disappointment, and one could expect gold imports fall fast. Last year they represented 11% of the total import bill. In addition, easing oil prices on world markets has helped contain the import bill of which crude represented 35% in 2012. The improvement to the trade balance combined with continued strong net exports of services is about to produce a rebalancing estimated at more than 1 pp. (percentage point) of GDP to the current account deficit. Last year, that reached an alarmingly all-time high of 5% to GDP. This year's tally could leave it below 4%.

Volatile capital flows cause balance of payment wobbles. Notwithstanding capital controls, capital flows can still create instability in India's foreign exchange market. That happened again when rumors spread around the world that the US Federal Reserve was about to turn off – "taper" -- its massive liquidity support, basically to the US domestic market, but in reality to the whole world. In a matter of days, previous portfolio inflows to emerging markets, including India, turned to outflows. The frenzy lasted until September when the Fed announced it would still wait.

The central bank looses foreign reserves which, however, still remain strong. During the three months, May to September, the rupee came under severe pressure. A 15% drop prompted the central bank, Reserve Bank of India (RBI), to cushion the fall in order to maintain proper market conditions, loosing some $16bn of foreign reserves in the process. That left RBI with reserves at around $260bn. -- enough to cover 6 months of import or three times the level of debt falling due in 2014. It is noteworthy that during this period of failing market confidence among some investors, long term investors, by contrast, appear to have held up good faith. As a result, expectations are for another year of continued money inflows to FDI (foreign direct investments) in line with recent years' experience around $15-20bn a year.

Financial policies

Fiscal policies remain under stress: After a better than expected fiscal performance in FY2012, as final numbers showed the budget deficit at just below 5%/GDP – 0,2 pp. below the target, the situation for the present year looks more challenging. In August, only five months into the fiscal year, the deficit had already reached 75% of the whole year target, in part due to delayed payments for government expenditures related to the previous budget year. In addition, new food subsidies passed Parliament in the summer will kick in in late 2013and have full impact in FY2014 to the tune of almost 0,5% of GDP. Also, despite new efforts to reign in energy subsidies, which may count for up to 2% of GDP depending on the oil price, the under-coverage (the gap between world market prices and domestic prices) may rise again this fiscal year because of the rupee depreciation. Last but not least, the present budget may have been based on unrealistic tax revenue assumption – up 19% in the budget forecast -- in regard of what now seems to be a weaker than expected performance of the economy. As a result, we project the budget deficit to rise to 5,4% of GDP in the current year and remain at that level in FY2014 before starting to reduce toward the government's stated goal of driving it back to 3%/GDP by FY2017. On top of this state government deficits are estimated at around 3% of GDP. While they used to be the main trouble makers in the past, they seem now to have stabilized in most states.

Government debt ratio stabilizes: Despite high total government annual budget deficits at more than 8%/GDP, even more rapid nominal growth of the economy is now helping the overall government debt ratio to stabilize at around 64% of GDP. Only 9% of the debt is denominated in foreign currencies and the rupee

denominated part of it finds a captive domestic market due to capital controls and the obligation of domestic banks to place at least 23% of the deposit funding in government bonds. Average dated maturity is reportedly more than 14 years, and the government is not likely to experience any near term problems in refinancing maturities.

Monetary policies face stark choices. Even though few observers doubt the commitment of the RBI to inflation targeting, it is also clear that it may face severe criticism should that objective challenge the hoped for recovery in 2014. While not often brought to the fore it seems obvious that the task of the RBI must also be complicated by the several measures of price pressure. Traditionally, the WPI (whole sales price index) has dominated the discussion, but a recent statistical revamp of the CPI (consumer price index) may have widened the uncertainty of policy making. The CPI has proved to deviate significantly from the WPI being higher by a few percentage points and not always developing in parallel with the WPI. In addition, The RBI must also weigh in the old dilemma between core and overall inflation developments. In the case of the CPI, core is almost the same as the overall index, but in case of the WPI core is clearly below the nominal index. As the graph shows, monetary policy has taken a middle stance with the policy rate somewhere in between the CPI and the WPI. However, it may also be argued that in face of double digit annual wage rises, none of the two inflation rates are relevant. Households – perhaps more than corporates -- often look more keenly at what leverage they actually can afford than the alternative cost measured by inflation adjusted interest rates.

Marginal facilities rate: In addition to the policy rate, the central bank can also use the "marginal facilities rate" (MSF) for fine tuning monetary policies.. Normally, this rate is one percentage point higher than the policy rate, but during the foreign currency turbulence in May-September, the MSF was used to stem capital outflows and hiked to 10,75% about 4 pp. above the policy rate. As the markets calmed down, the RBI was able to reestablish the old difference to the policy rate, mainly by cutting the MSF while hiking the policy rate by 50 bsp -- the latter motivated by the overall rise in the rates of inflation. There is a debate about whether the totality of these measures really has tightened or loosened the monetary stance in recent months.

Financial sector facing rougher times?: The financial sector is dominated by banks most of which are reasonably well capitalized but apparently face a rising level of non-performing loans after recent years' borrowing binge mainly by corporates. The slowing economy has already forced many banks to raise provisioning and it has been calculated that recapitalization of the banks may cost the government up to 3% of GDP, which would be unwelcome, but so far manageable.

Structural polices: We have previously to great extent discussed on these pages the structural rigidities of Indian labor and product markets that potentially hampers India's industrial development. On that front little has changed over the last year as for example seen in continued poor ratings given by business people in surveys such as the World Bank's "Ease of doing business" and the "Corruption prevention index" by the Transparency International. Another side of this has now become much clearer, namely how domestic politics over recent years have been able to paralyze serious decision making on structural policies. Hopefully, that is now about to be corrected, but many observers have yet to be convinced and argue that the jury is still out. (Conf. Box 1).

Politics:

Domestic politics: After two full terms with a Congress led coalition India is heading for national elections in next May. Poor performance by Congress in recent by elections in five states, may augur well for the main opposition party, the BJP, who is held as the favorite by the business community. Its leader. Mr. Modi, has successfully wooed business in his home state, although at some cost to the state budget. However, being the front-runner may not guarantee ability to form a government on its own and observers warn that due to controversies surrounding Mr. Modi, the likely BJP PM candidate, smaller coalition partners will balk at joining a BJP government. In a worst case scenario, a "third party" coalition government will be formed by the multitude of small mainly local political parties. India has had a dismal experience with such a solution in the past, most recently in the late 1990s.

External security tilting toward the worse: In terms of external security the situation seems to have deteriorated. (For a more detailed analysis of the extraordinary events on the border with China in late April we refer to Box 2.) The military-diplomatic stand-off with China last April could bode long term consequences for what had become a quite flourishing economic cooperation. This has motivated the Indian government to beef up its defenses. In return, both the US and Japan see a new security ally in India and have offered economic cooperation.

Internal security undergo changes but remain a concern. The Naxalite movements, which started as a social uprising of poor people, have in many places been taken over by criminals bent on extorting money from entrepreneurs with plans to set up shop in rural areas or disrupting local elections to spread overall chaos.

Outlook:

Shallow recovery: This year is likely to prove the trough of the present business cycle. For 2014 (fiscal year ending March 2015) we expect a modest recovery as growth picks up 0,3 pp to 4,9% helped by some push from domestic investments, including government led infrastructure projects, some improvements to the global environment while private consumption remains more uncertain. That is provided a workable parliamentary situation after elections in May 2014, the medium term scenario should not provide too many adverse surprises. India is struggling with long standing structural and cyclical problems but has experience in managing storms without ending up in a devastating financial crisis and sovereign defaults.

However, it can be noted that this time it is again finding itself not too far from the precipice and the danger is that one day it could eventually tip over. For example, monetary developments including ongoing intensification of price pressures could lead to policy mistakes as could new external shocks, including recurrent bouts of global capital flight from emerging. A new deep depreciation of the rupee would no longer be welcomed by the many domestic corporates and banks which borrowed heavily from abroad in recent years often with inadequate hedging. The main near term concern, however, is that India can be left with a very complicated parliamentary situation after next general elections in coming May. Barring extreme events, however, we foresee modest improvements to the economy next year, combined with further reduction of the current account deficit.

In the longer term, India is still the sure bet for many global investors. For example, the much debated risk that the coming demographic dividend should turn into a demographic curse, has yet to be demonstrated. Rapid wage hikes do not herald lengthening dole lines so far.

Key ratios	2013
Population (millions)	1265
GDP/capita ($)	1482
GDP (change)	4,6%
Inflation	11,0%
Curr.acc. balance/GDP	-3,9%
Reserves/imports (months)	7
Budget balance/GDP(*)	-5%
Government debt/GDP(*)	51%

External ratings:
Fitch: BBB-
Moodys: Baa3

Peers:
Russia
Brazil
Indonesia

(*) Central government only

Graph: India's risk profile shows strengths on infornation, but other parts of the pentagon fall within the average (i.e. worse). Our event risk estimate includes the potential for instability in Pakistan and intensification of border tensions with China.

Box 1: Three years of reform paralysis

India managed reasonably well during the GFC in 2008-09. Its banks had been conservative and stayed away from exotic assets. In 2010, growth reached an all-time high of nearly 10%. A host of new government projects to improve crumbling infrastructure, roads, railways, power etc., were rolled out and apparently completed up to an average of 60%. However, by the second half of 2011 it became clear that growth was decelerating, and since then there has been a continuous slide.

So what happened? In 2010 the first major corruption scandals broke out, several of which hit at the core of government administration and the cabinet itself. Ministers were charged with part-taking in fraud that had incurred losses to the government in the range of tens of billions dollars. Even the reputation of the PM himself was no longer sacrosanct. This paralyzed the administration. Who would dare to grant a new license or give green light to a new project in a climate of allegations and recriminations? Eventually many or most of the new large projects (a number of 29 may be indicative) were slowed or stalled. In 2012, growth decelerated further and the slowdown continued into the first half of the current year in line with frequent brown-outs.

Hopes are now that a new Cabinet Committee for Investments since late 2012 will remove remaining legal and administrative hurdles for unfinished infrastructure projects. In addition, Parliament recently passed a new Land Acquisition law to speed up legal processes related to industrial developments. Recently, Japan offered support to develop the planned Delhi-Mumbai industrial corridor. Skeptics nevertheless abound and point to continuing problems including the apparent impotency of the CCI against courts which are holding back many projects for environmental and other reasons.

Box 2: Sino-Indian border incident of April 2013.

The situation along parts of the long Chinese-Indian common border has been tense since China occupied parts of Indian Himalaya in the shadow of the Cuban crisis in 1962. That in itself was predicated by century long uncertainties over border demarcations, first with Tibet, and then with China after this had annexed Tibet in 1959. Over the years agreements have been made to ease tensions by laying down a code of behavior regarding military activities along the border. These rules did not restrict construction of infrastructure within undisputed areas, which China took advantage of at an early stage. However, when India recently built a landing strip on its side, China reacted with displeasure.

What actually happened in April? The areas of overlapping claims stretching some kilometers wide between undisputed territories are often in non-inhabited remote and very inaccessible mountain areas at high altitudes. This time the incident took place in Ladakh, a barren waste land of India's northernmost region, Jammu and Kashmir. As normal, one day in mid-April, a Chinese platoon patrolled the disputed area walking along the undisputed Indian border at a distance of perhaps some hundred yards. As normal they made camp and put up large banners reading in Chinese and English that "this is Chinese territory" and also as normal duly photographed by Indian troops, which had advanced within some 50 yards of the Chinese camp, and later published and distributed to media.

What was not normal and not in accordance with code of conduct, the Chinese platoon (some 40-50 servicemen), put up tents and stayed in this place for the following 21 days while a diplomatic tug-of-war took place between Delhi and Beijing. As seen from Delhi, this was formally an invasion into Indian territory. Seen from Beijing, this was an assertion of China's rights. At the end of the incidence, the Chinese platoon withdrew without any occurrence of violence.

Key data:	2008	2009	2010	2011	2012	2013	2014
GDP (bill. US$)	1282	1263	1626	1864	1827	1875	1946
GDP/capita (US$)	1083	1052	1337	1512	1463	1482	1520
GDP (change)	8,1%	6,5%	9,7%	7,5%	5,1%	4,6%	4,9%
Investments/GDP	37%	34%	37%	36%	35%	34%	34%
Budget balance/GDP*	-4,8%	-7,0%	-3,8%	-6,7%	-4,9%	-5,4%	-5,4%
Govt debt/GDP**	53%	54%	51%	51%	52%	51%	50%
CPI inflation (%)	8,3%	10,9%	12,0%	8,9%	9,3%	11,0%	9,0%
Money demand (%)	20,5%	19,4%	16,5%	16,5%	13,4%	12,9%	13,2%
Stock prices	14441	13630	18186	17769	17630		
Interest rates	9,9%	5,5%	6,3%	9,5%	9,5%	9,4%	7,7%
Exch. Rate ($)	43	48	46	47	53	52	55
Trade/GDP (%)	41%	35%	36%	42%	44%	43%	42%
Oil price (Brent)	$97	$62	$80	$111	$112	$108	$103
Millions US $							
Export of goods	198 599	168 059	225 916	307 195	301 852	314 457	315 859
Imports of goods	323 919	275 227	357 739	475 270	503 519	491 988	507 431
Other:	94 346	80 987	79 553	105 279	110 196	104 861	119 466
Current account	**-30 974**	**-26 181**	**-52 270**	**-62 796**	**-91 471**	**-72 670**	**-72 107**
(% of GDP)	-2,4%	-2,1%	-3,2%	-3,4%	-5,0%	-3,9%	-3,7%
FDI	26 677	19 515	11 012	21 832	15 443	18 681	11 744
Loan repayments	-23 685	-10 985	-19 014	-22 138	-37 985	-46 505	-47 982
Net other capital flows	83 329	-5 878	68 238	79 066	100 041	95 431	143 767
Balance of payments	**55 347**	**-23 529**	**7 966**	**15 963**	**-13 972**	**-5 063**	**35 422**
Reserves	281 937	258 408	266 374	282 337	268 365	263 302	298 724
Total debt	218 404	245 285	277 555	317 839	351 786	367 819	374 831
o/w short term debt	40 923	45 560	52 756	69 951	81 133	85 596	86 995

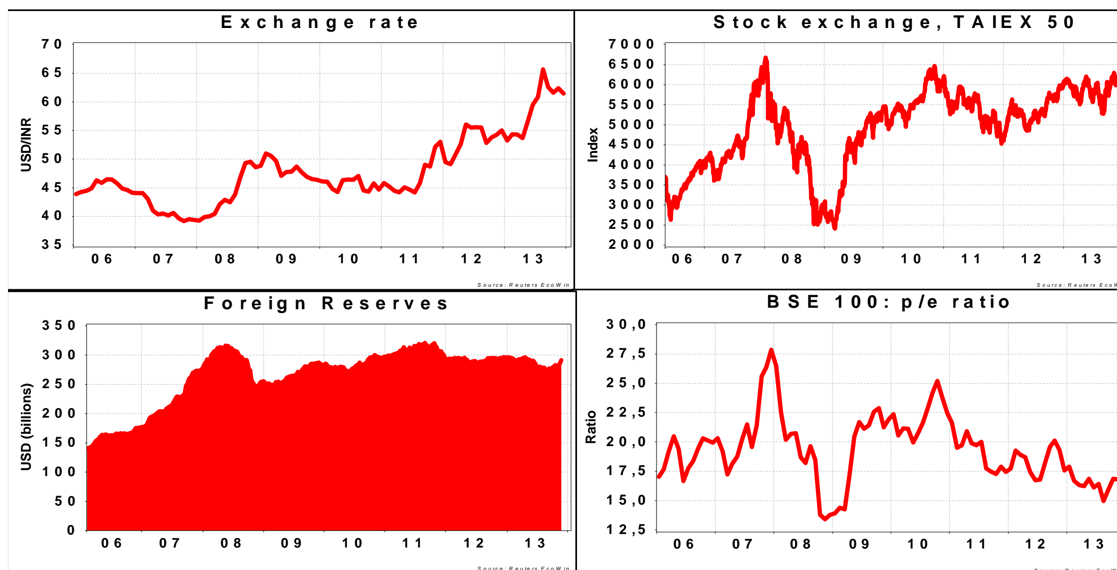
Sources: Oxford Economics and SEB estimates.

*) includes central government on-budget transactions only. **) Includes central government debt only

Rating history

Moody's	Baa3	Baa3	Baa3	Baa3	Baa3
Fitch (eoy)	BBB-	BBB-	BBB-	BBB-	BBB-

Type of government: Parliamentary Democracy
Next elections 2014
Other:
Latest PC deal None
Latest IMF arrangements 1993/SBA



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