India

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Economic growth has bottomed, sentiment is rising following the elections in May, and inflation is falling. With external balance improving too, the economy is becoming increasingly resilient.

Country Risk Analysis

Summary and main conclusions

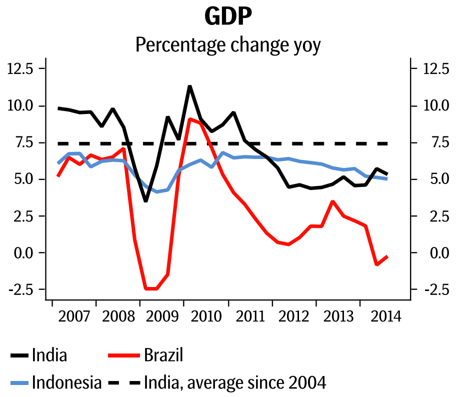
After expanding by less than 5% in 2012 and 2013, GDP growth is expected to accelerate this year. Real growth slowed slightly in the third quarter as investment and export activity slowed but still showed a healthy 5.3% rise. Meanwhile inflation has declined significantly since the start of the year making it likely that the central bank's target of 8% by January 2015 is met. In this respect, the near-term outlook appears bright with a gradual pick-up in growth and a declining inflation rate. However, any more significant economic recovery will require that the investment cycle picks up. The grounds for this are slowly being laid, including through the implementation of various long awaited structural reforms.

Several key measures of country risk have improved in the past year. The necessary fiscal consolidation remains on track with the government targeting a deficit of 4.1% in the current fiscal year ending in March 2015. Expenditure reduction is helped by the full liberalization of diesel prices announced in October implying a welcome reduction in fuel subsidies. General government debt is more or less unchanged in the past year at just below 70% of GDP (high compared to peers), capped with the help of financial repression. The current account deficit remains manageable. In the meantime foreign exchange reserves have risen significantly and the exchange rate has stabilized following the rapid depreciation in 2013. On a more negative note, vulnerabilities in the banking sector have increased.

The new government's ambitious reform agenda, if implemented, should pave the way for a higher potential growth rate of the economy. Higher economic growth is by itself not sufficient to improve the country's risk, but if the pace of reform can be sustained and generate improvements in business climate, in the fiscal metrics and, in general, show proof of improved policy sustainability and predictability this would signal lower country risk. India's improved political situation and the rising likelihood that growth enhancing economic reform will be implemented made one external rating agency change its outlook from negative to stable recently.

Recent economic developments

Growth upturn is likely to be gradual: After 2011, India's economic growth slowed more than most OECD countries and GDP growth in 2013 was the lowest since 2002. Some of the slowdown was due to the reversal of fiscal and monetary stimulus that was introduced in response to the global financial crisis. Another factor has been weak global demand which has weighed on exports. At this time, however, most forward looking indicators suggest that the economy has hit the bottom and is at its early stages of recovery. Confidence has returned, boosted by reforms to the monetary policy framework and by the pro-growth agenda of the new government. The large depreciation of the currency has also helped revive exports. A significant rebound in real GDP growth in this year's second quarter was followed by a more moderate growth of 5.3% in yoy terms in the third quarter as investment and export activity cooled.



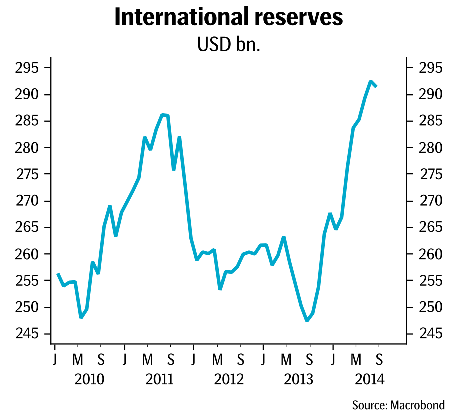
Source: Macrobond

Some forecasters, including the OECD have recently raised their growth projections for FY2014 above 6%, arguing a cyclical recovery is in train. Consensus forecasts are lower. While it is becoming increasingly clear that the economy has bottomed out, few observers are seeing reasons for any spectacular recovery. The way back to the 8% growth targeted by the government in the medium term could prove long, mainly due to supply constraints.

Inflation has fallen: Until this summer, consumer price inflation was much higher than in several peer economies and in other BRIICS countries. Poor weather conditions and higher administrative prices were among the underlying factors. In addition, real interest rates had been in negative territory for a long time. Since then, much has changed, and rapidly so. Oil prices have collapsed, the monsoon made a late but significant comeback and interest rates were raised. Consequently, but also due to favourable base effects inflation has fallen significantly with CPI hitting 5.5% in October, a five-year low. Inflation expectations, however, remain stubbornly high. The central bank expects inflation to reach 6% by March 2015.

Oil price collapse helps reduce the current account deficit: India's record high current account deficit made it one of the hardest hit economies during last year's "tapering tantrum" in financial markets. Since then external vulnerabilities have fallen significantly helped by policy action from the previous and new government. The past months' declining commodity prices, in particular the collapse of oil prices implies an important improvement to India's terms of trade. Oil and oil related products normally account for 40-50% of total import costs. While some analysts expect last year's deficit of 2.8% of GDP to turn into a surplus, we see it more likely with a deficit closer to 1%. Given India's level of per capita GDP and demographic structure, this should not be of great concern. Indeed an RBI study (Working Paper Series 16/2012) concludes that a deficit of 2.4-2.8% of GDP would be a sustainable, financeable current account deficit. Consequently, the expected improvement would make India less vulnerable to financial market worries than it was last year.

The central bank has built up foreign reserves: During the financial market turbulence last year, the rupee came under severe pressure. The Reserve Bank of India (RBI) was prompted to cushion the fall through interest rate hikes and currency interventions in order to maintain proper market conditions, thus losing some USD 16 bn of foreign reserves in the process. That left RBI with reserves enough to cover 6 months of imports. Since mid-2013 the appetite for rupees among investors has risen and the RBI has intervened on the opposite side to limit the pace of appreciation. Consequently, there has been a rapid build-up of international reserves to more than USD 290 bn.

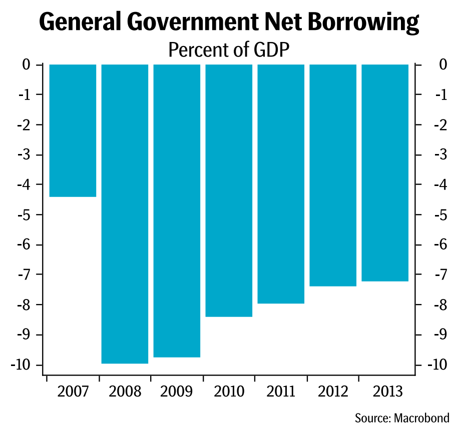


Foreign direct investment is rising: During 2013 the widening current account deficit was financed largely by portfolio flows and short-term debt. Foreign direct investment as a share of GDP fell below 1% in 2012. With financial market sentiment improving in the wake of the elections this year, capital inflows have picked up and the Mumbai stock exchange hit new all-time highs recently. Not only portfolio flows are strong, but also foreign direct investment. Since the start of the fiscal year in April, net inflows of FDI have totaled USD 14.1 bn, which implies an increase of about 30% compared to the same period last year.

Most observers appear to hold the view that inflows at these levels are sustainable given the pro-growth economic policies of the new government. Prime Minster Modi has travelled extensively to promote foreign public and private investment in India. Modi has also launched the campaign "Make in India" aimed at attracting foreign participation in India's manufacturing sector. Another factor strengthening the case for continued solid increases in FDI is the relatively favourable growth prospects in India compared to many other emerging market economies. Higher FDI inflows would provide a more stable financing for India's current account deficit. Replacing the shorter term portfolio flow would improve the economy's resilience which would be particularly welcome at a time when the global economy is nearing the long-expected US monetary tightening.

Economic policies

Gradual fiscal consolidation continues: India's public debt and deficit are high compared with other emerging markets. It is therefore positive that the fiscal consolidation efforts embarked upon by the previous government are set to continue, albeit at a very gradual pace. Following a decline in the central government deficit to the slightly better than expected 4.6% of GDP in the previous fiscal year the government targets 4.1% in FY2014. The budgeted revenues, although low as a share of GDP compared to peers, appear to be on the optimistic side. Consequently, to meet this year's target, there is a risk that the authorities, like in previous years, will have



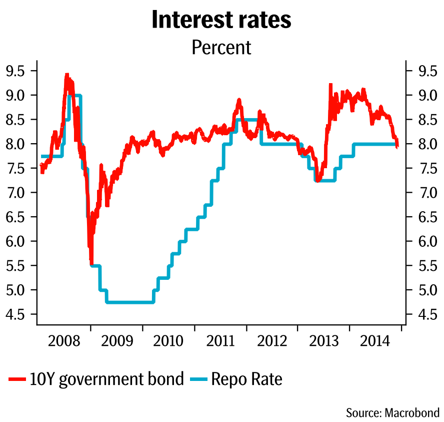
to resort to one-off measures and deferred expenditures. What is perhaps of somewhat greater concern is if expenditure cuts, like in previous years, will affect growth enhancing capital expenditures.

The medium-term strategy outlined in the Fiscal Responsibility and Budget Management Act from 2003 entails reducing the deficit to 3% by FY2017. Sticking to this target would strengthen the government's credibility on the fiscal front and be positive from a risk perspective. On top of the central government deficits discussed here, state government deficits are estimated at about 2% of GDP.

India still has scope to improve efficiency in fiscal policy making. Government revenues are very low compared to, for example, the other BRIICS countries. Tax revenues, for example, amount to only 17% of GDP. The tax base is narrow and compliance is low as reflected by corporate taxes being about 30% (very high) but income being just average. Getting in place a countrywide sales tax would not only raise revenues but would also be expected to increase competitiveness and economic growth by making the country work more efficiently as one common market. Work on the General Goods and Services tax (GST) to replace the local indirect taxes on state level have been in progress for a long time but is not expected to be implemented before 2016.

Government debt ratio stabilizes: Despite high government budget deficits of around 8% of GDP recently, even more rapid nominal growth of the economy is now helping the general government debt ratio stabilize at just below 70% of GDP. The rupee denominated part of it finds a captive domestic market due to capital controls and the obligation of domestic banks to place a significant share of the deposit funding in government bonds. Banks account for more than half of the government's net borrowing requirement. External debt is low compared to peers at less than 25% of GDP which together with ample foreign reserves makes India's external position one of its key country risk mitigants. The IMF's regular debt sustainability exercise indicates a sustainable debt burden given that economic growth is expected to pick up and that interest rate costs are assumed to remain low.

Monetary policy in quasi inflation targeting mode: As a response to last year's financial market turbulence, the central bank hiked interest rates by a cumulative 75 basis points and introduced various liquidity reducing measures. In real terms the repo rate remained negative until early 2014. As external pressures abated, the RBI started to withdraw the liquidity measures but has left the repo rate at 8% since January 2014 despite pleas for cuts from the business lobby. It is now expected that the central bank will cut interest rates in early 2015.

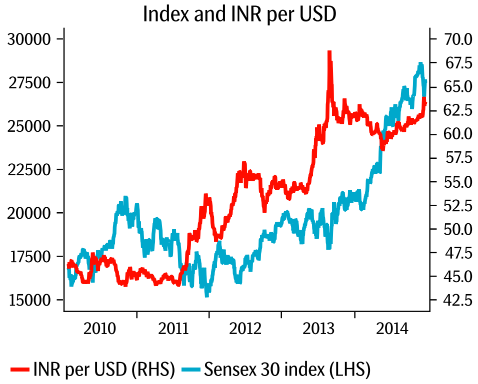


While already the appointment of a new central bank governor last fall gave a boost to investor and corporate sentiment, the policy measures taken by RBI since then have contributed to raising policy credibility and sentiment further. Monetary policy currently has three main objectives: maintaining price stability, supporting economic growth and securing financial stability. However, the RBI has embarked on the road towards a flexible inflation targeting regime. Among other things, they have communicated that they aim for 8% CPI inflation by January 2015 and 6% by January 2016. These and other steps should increase credibility and predictability of policy, helping to contain inflation expectations. Lower inflation expectations, in turn, are key to savings and investment decisions that are important determinants of economic growth.

The financial sector, a rising contingent liability: India's relatively high public debt makes it vulnerable to any additional costs arising from materializing contingent liabilities. In addition, banks remain the most important channel for capital allocation in the country which is why the banking sector's continued weakness poses a risk to economic growth and hence to the country risk. Therefore, while the financial system is reasonably well capitalized and supervised, the past year's worsening of the banks' asset quality warrants some attention. Non-performing loans have risen to the highest level in three years, although problems remain concentrated to the three state-owned banks standing for about 70% of the sector's total assets. Here NPLs are about 10% of total loans.

Equity market and exchange rate

Index and INR per USD



Source: Macrobond

Some progress on the structural front is expected: Over the recent years, domestic politics have effectively been able to paralyze any serious decision making on structural policies. Now, with the political situation being radically different (see below) a window of opportunity may have opened. The new government has proposed an ambitious agenda of structural reforms, spanning over a broad and highly relevant range of sectors, to lift the efficiency and growth of the economy to higher levels.

So far, steps have been incremental rather than radical. The government appears to have taken a long-term view on reforms, possibly considering that they have at least one full term of around 5 years to push through their plans. This being said, they have ended the government's fuel subsidy programme by deregulating diesel prices. Other reform measures include the opening up of the defence and railway sectors to a higher degree of foreign ownership as well as steps to increase the efficiency of the government itself. It also appears that the insurance industry may be opened up to increased foreign ownership in the near future. Meanwhile, India has slipped a few steps in ranking in indices such as the World Bank's "Ease of doing business" and the "Corruption prevention index" by Transparency International.

Doing Business Index

ranking of 189 countries

	2015	2014
Russia	62	64
China	90	93
Indonesia	114	117
Brazil	120	123
India	142	140

Source: World Bank, 2014

Implementation risk remains: Going forward, it is reasonable to expect that at least part of the ambitious reform agenda will be agreed upon and actually implemented. This is an assumption underlying our forecasts. There is a risk however that the government falls short of the expectations that have risen high following their election victory. The reform process may be stalled by the government not gaining a majority in the upper house and that it cannot gain further powers among state governments. Many key reforms are in areas which have been decentralized to the state level. Furthermore, Prime Minister Modi is considered reluctant to press ahead too hard on the most politically unpopular measures. Most notably this refers to land acquisition rules and to labour market legislation.

Political situation

Improved political situation: After two full terms with a Congress led coalition, the previous main opposition party, Bharatiya Janata Party (BJP), won a landslide victory in the May elections. The party became the first single party to gain a majority in India's lower house of parliament since 1984. Hence, in contrast with previous governments, the BJP will not be dependent on support from left or regional parties to stay in power. Consequently, it is likely that the government will deliver five years of political stability, and that it will have ample time to push through its pro-business economic agenda.

There are two caveats to this proposition. First, the BJP led alliance is in minority in the upper house of parliament, which has to approve legislation passed by the lower house on all issues but the budget to which it can only suggest modifications. Second, some of the reforms also need the approval of state governments. For example, legislation relating to the important goods and services tax requires constitutional amendments and approval by two-thirds of both houses of parliament and more than half of the state assemblies. Since the general elections in May, the BJP has also won the elections in two important states, raising the number of states in which it has the majority to 10 out of 29. However, most analysts agree that even optimistic scenarios suggest that the BJP cannot take control of the upper house until 2018.

Outlook

One of our main concerns a year ago was that India could be left with a complicated parliamentary situation after the general elections. This concern evidently proved to be unwarranted. It now remains to be seen if the positive sentiment created by the stable political situation will translate into higher economic growth and increased resilience. A reflection of past years' very slow pace of reform is the deteriorating position for India in the World Economic Forum's global competitiveness ranking. Being ranked the lowest among BRIC countries for the first time ever points to the need to ramp up investment in the key areas mentioned above, in particular on infrastructure. Higher rates of growth requires an increasing share of investment which in turn requires bolder reforms related to areas such as land acquisition and instituting a uniform goods and services tax.

Average GDP growth in the previous decade was around 8%. Some observers such as the OECD note that growth could very well accelerate back to these levels again even without any deeper, more difficult structural reforms being implemented. Most agree, however, that extensive reforms need to be implemented to reach GDP growth above 8%. Our forecast provider Oxford Economics sees potential GDP growth at a relatively meagre 5.9% in the coming 10 years.

India: Key Indicators

Key data:	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
GDP (bn. USD)	1517	1740	1710	1748	1859	2056	2267	2478
GDP/capita (USD)	1256	1423	1380	1394	1465	1601	1746	1887
GDP (change)	9.3%	7.7%	4.8%	4.7%	5.4%	5.8%	6.1%	6.3%
Investments/GDP	36%	37%	37%	35%	34%	34%	34%	34%
Budget balance/GDP*	-4.0%	-7.2%	-5.8%	-5.9%	-4.7%	-4.3%	-3.9%	-3.5%
Govt debt/GDP**	48%	47%	49%	49%	49%	48%	47%	45%
CPI inflation	10.3%	9.6%	9.7%	10.1%	7.3%	6.0%	6.4%	6.3%
Stock prices	18186	17769	17631	19722	24786	30294	34352	39468
Interest rates	6.3%	9.5%	9.5%	9.3%	9.1%	8.6%	8.4%	8.2%
Exch. Rate (USD)	46	47	53	59	61	52	55	55
Trade/GDP	38%	44%	46%	45%	42%	43%	42%	42%
Oil price (Brent)	$80	$111	$112	$109	$100	$70	$81	$91
Millions USD								
Export of goods	226 351	302 905	296 828	314 699	324 982	365 531	403 030	440 555
Imports of goods	350 233	464 462	489 694	465 517	458 079	512 367	558 865	611 443
Other:	69 369	99 053	101 395	101 592	114 642	116 096	120 457	132 805
Current account	-54 513	-62 504	-91 471	-49 226	-18 455	-30 740	-35 379	-38 083
(% of GDP)	-3.6	-3.6	-5.4	-2.8	-1.0	-1.5	-1.6	-1.5
FDI	11 012	21 324	15 747	26 390	27 731	37 622	41 969	48 361
Loan repayments	-19 018	-22 228	-21 089	-27 981	-33 106	-35 298	-38 042	-41 387
Net other capital flows	70 485	79 370	82 841	48 922	53 489	81 470	90 800	96 865
Balance of payments	7 966	15 963	-13 972	-1 895	29 659	53 053	59 349	65 755
Reserves	266 374	282 337	268 365	266 470	296 129	349 182	408 531	474 286
Total debt	281 424	333 820	375 070	409 008	431 742	444 920	461 407	480 536
o/w short term debt	52 756	69 951	87 613	96 330	101 454	104 132	107 395	111 063

Sources: Oxford Economics and SEB estimates.

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

Rating history (end of year)					
Moody's	Baa3	Baa3	Baa3	Baa3	Baa3
Fitch (eoy)	BBB-	BBB-	BBB-	BBB-	BBB-
S&P	BBB-	BBB-	BBB-	BBB-	BBB-