India

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS December 21, 2015

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

The economy is picking up speed and the macroeconomic situation is overall improving at least in a short to medium term perspective. Key structural issues, by contrast, remain unresolved for political reasons with a bearing on the country's longer term prospects.

Country Risk Analysis

Summary and main conclusions

In 2015, activity is set to quicken further to 7,3% as private consumption remains robust and the government is speeding up disbursements for stalled and new infrastructure projects. Despite headwinds from abroad external balances are likely to improve further with the current account in a moderate but stable deficit less than 1.5%/GDP and the balance of payment in a solid surplus which has facilitated continued reserve building. Price pressure continues subsiding to about 5% of annual CPI growth, well within the central bank's new target of less than 6%. Concerns about overheating are dissipating and a slightly overvalued exchange rate should find a new equilibrium. A still heightened fiscal deficit at 6-7%/GDP is a lingering worry, but mainly beyond the medium term.

Structural issues are still marring the overall credit picture of India. Key issues with significant impact on the country's long term prospects are still held back by lack of Parliamentary support as the opposition is paying the new government since 2014 back for its refusal to sign off on the proposals when it was in opposition itself. These are the longstanding Land Acquisition Act that would much help launch new industrial and infrastructure projects, and the General Sales Tax that would unify all different local sales taxes of individual states and help promote India as a single internal market for goods and services. Resolving those issues is key to India's longer term growth prospects and to keeping investor confidence in its future. At last, 70% of the banking sector is still dominated by state owned banks increasingly burdened by bad loans and a growing clamp on India's modern development.

Despite gradual improvements the sovereign is still locked in the lowest investment grade by all rating agencies mainly due to concerns about the structural issues. Nevertheless, recently attached positive outlook to one assessment suggests market appreciation with movements on the reform front by the new government. In a broader perspective the widening sovereign rating gap over the last decade between, India and China, may also be questioned. In terms of economics and finance India does not look that much different from China ten years ago, when the latter ascended into higher investment grades.

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Recent economic developments

Growth acceleration: From India's soft patch since late 2011 growth began to pick up in mid-2014 and accelerated into the current year growing by more than 7% year-on-year (YOY) through the first three quarters. That was much supported by private consumption and government capital expenditures. Subsiding price pressure following lower fuel prices and steady wage and employment gains boosted household consumption early in the year before disbursement to stalled infrastructure projects became the driving force in the third quarter. For the rest of the year, however, a weak and uneven monsoon will hold back rural incomes and raise food prices for the urban population to restrain real household spending nationwide. In contrast, net exports and private investments will continue as a drag and constrain the whole year fallout to an estimated GDP growth of 7,3% a welcome but cautious improvement on the 7,1% result from last year. However, these numbers should probably be taken with a pinch of salt. (Conf. Box 1)

Box 1: Statistical revisions "boost" growth: Last year at this time, we estimated growth of GDP at 5,4% and 5,7% for 2014 and 2015 respectively. However, in January 2015, India's statistical authorities presented new national accounts numbers based on revised methodology. That lifted the growth trajectory of recent years by at least 1 percentage point. According to the new GDP series, India has become a star performer among emerging market countries, outshining "old stars" like China. It may well be the case that the new numbers track the real development better than before, but on unchanged methodology India would likely still be lagging both China and the Philippines.

Price pressure rises temporarily: In recent months consumer prices have tended somewhat up to 5,5% in the July-September period mainly on rising food prices, but expectations are this is a temporary phenomenon due to unfavorable climatic conditions for agriculture. Before the recent new drop in global energy prices the Reserve Bank of India (RBI) – central bank – had expected some further rebound in prices toward year-end, but that seems less likely now. RBI also calculates that at $40/barrel of crude the consumer price index (CPI) should fall back by 0,25pp.[1] as a result we estimate whole year inflation at 4,9% yoy, down from 6,7% in 2014, and well within the policy target of 6% for the current year. That will be roughly in line with average wage growth around 5,1% yoy in 2015, down from 6,4% the year before based on model estimations in view of deficient statistics.

Moderate current account deficit set to continue. Despite problems for India's exporters in their struggle with softening global demand not only due to China but problems in other emerging markets as well, the current account balance will weaken only slightly from last year to end the current year at 1,4% of GDP. That is because imports are also declining mainly due to lower prices of energy and commodities but also as a consequence of the government's new restrictions on gold imports which had threatened to blow a hole in the trade balance. In addition, there should be improvements to the invisible balance much helped by rising remittances. Despite recent rupee depreciation, the exchange rate is still regarded as overvalued, including by the RBI, perhaps to the tune of 10%. As such, the exchange rate should also take some of the blame for India's weakening export performance.

Strengthening capital balance help build reserves: Rising expectations to the new government in office since mid-2014 and its reform friendly appearance, investors have in rising numbers turned their attention to India. In the first half of the current year foreign direct investments (FDI) soared by more than 50% compared with the same period in 2014 but are now likely to subside significantly in view of global investors increasingly bearish view of emerging markets and Fed's rate hiking. In

[1] Monetary Policy Report, September 2015; Reserve Bank of India, Delhi

the event FDI inflows may end this year only slightly up from 2014 at $49bn. Taking into account also declining FDI outflows the result is more pronounced, though, with a net inflow of $36bn, up from $24 a year ago. Portfolio inflows have also remained quite buoyant in the current year unfazed by weak corporate profitability and already quite high price/earnings ratios in the stock market. Net inflows to non-residential Indian deposits have supported the overall balance of payments to facilitate further reserve building in the hands of the RBI.

Strong foreign reserves: At $320bn, up $30bn. from end 2014, RBI commands a strong reserve position more than large enough according to the IMF in view of a coverage ratio at almost 8months of imports. However, the monetary authorities may also have in mind India's external debt. This has grown fast in recent years to $475bn. Even though this is only 25% of GDP -- moderate compared with many peers -- two thirds of it is owed by private sector companies after many of them went on a borrowing binge some years ago. Concerns are that they may have little natural hedge and could be hit by appreciating foreign currencies when debt matures over the next few years.

Economic policies

Fiscal consolidation continues in FY16: The budget for FY16 (Indian budget year ending March 2016) targets a new cut of the federal deficit to 3,5% of GDP facilitated by last year's cut in diesel and LPG subsidies and continued expenditure compression. Plans are underway to further rationalize India's expansive subsidy regime which still represent more than 10% of government revenues or 2% of GDP by deregulating or capping more fuel and fertilizer prices and contain leakages in the food subsidy program. The National Food Security Act recently mandated a limit to the food subsidy coverage to 40% of the population, down from 67% at the present time with the potential to yield extra budget savings around 0,5% of GDP.

But could face new hurdles: The estimated budget outcome for the current year presents an improvement of 0,8%/GDP from FY15, providing a significant boost to the new government's reform credentials. In perspective, however, the budget consolidation had been ongoing for several years before the Modi government took over about a year and a half ago. According to new plans, the revenue shortfall should be further cut to 3% of GDP by the end of the next budget year, FY17, but doubts are rising that this will prove feasible. In last November, The 7th Pay Commission -- Indian public sector wages are normally overhauled once every ten years – has recommended an average remuneration hike of 23,6% beginning January 2016 that will raise government expenditures by at least 0,5%/GDP. Expected weaker profitability of many companies could also play a greater role as corporate taxes have reached a relatively high 34% share of government revenues.

Structural rigidities show up in stalled projects: The overarching problem of government finances is the erosion of fiscal flexibility. 88% of expenditures are current with an estimated 90% of them earmarked as mandated by law. That leaves only 12% left for capital expenditures in any normal year and that is much susceptible to variations in other budget items. Being basically a rest-post capex are the first to be axed for the sake of the overall budget balance and has resulted in a growing pipeline of stalled government infrastructure projects in recent years. That is likely to impede growth going forward with paybacks on tax revenues and future fiscal consolidation efforts.

Budget financing: For the time being, the federal budget looks better than in many years and its financing is unlikely to face problems even though the privatization program for the current year is far behind targets. Of the INR700bn ($11bn) privatization plan for FY16, less than 20% has been raised so far. However, the government has several financing sources including a relatively developed domestic bond market and mandatory lending from banks equal to 22% of their deposits. In contrast, the government has been cautious tapping international capital markets and only 6% of its debt is in foreign hands. At 68% of GDP, government debt is high, but not alarmingly so. That number includes also local government debt which remains relatively stable at 20% of GDP due to a more steady local government fiscal deficit around 3%/GDP in part contained by limited financing opportunities.

Monetary policy easing: Since last February central bank inflation targeting is now official. The gradual reduction of price pressure from 6,7% CPI growth in 2014 to an estimated 4,9% in the current year has prompted the central bank to gradually lower its policy rate by a total of 125bsp so far in 2015 as allowed by foreign exchange market conditions. Interventions in the latter, however, have mainly focused on weakening the rupee by selling it against forex. That has been with the excuse to build reserves while neither being in contradiction to the possible overvaluation of the rupee. The exchange rate experienced a sharp rise in volatility during the summer associated with fits of heightened market concerns about emerging markets external debt.

India's banking system in widening dichotomy: For several years now the two pronged banking system has remained unchanged with a stable market share of around 70% for the state-owned banks (SOB) maintained through their continued and relatively strong presence in the country side. However, SOB finances have remained under pressure and apparently increasingly so as seen in low profitability and rising levels of bad loans. Value of SOB's non-performing loans (NPL) has reached 4,7% of total loans notwithstanding purchases by asset restructuring companies (ARC) financed by banks via issuance of security receipts which makes these transactions look more cosmetic than real. Adding restructured and other "special mention" loans to NPLs raises the level of "stressed loans" in SBO loan books to 11,7% - about 10% of GDP. Of this less than 60% is covered by banks' own loan-loss reserves. The prime problem for the SBO is their corporate clients and in particular government initiated projects among these as fiscal consolidation has left unfinished projects along the road. One rating agency has calculated that banks need $140bn about a tenth of GDP of recapitalization over the next several years to solve the present bad-loan problem and at the same time to achieve Basel III status by the end of the decade. The private sector banks, on the other hand, are in a better shape with stronger earnings and significantly smaller bad loans problems.

Reforms and structural issues: *The General Sales Tax (GST).* While India has left socialist experiments behind several decades ago; filibuster from both sides of the political spectrum seems to have taken center stage in the nearly stalled reform process. Indian business operating across the internal state borders have since long suffered with extreme bureaucracy and a complicated system of often overlapping tax codes. That in particular relates to the sales tax which has been under the purview of individual states and set at different levels with different characteristics. Apparently all political parties agree that this hampers the development of a single domestic market and with that efficient capital allocation and economic growth. The previous Congress government made an attempt to unify the sales tax regime but failed due to political, not ideological, resistance from the BJP party at that time in

opposition. This is now making new attempts at essentially the same but is receiving payback from Congress which commands a majority in the Upper House and can stop the bill.

The Land Acquisition Law (LAL) is another feature of business in India that holds the country back at the 130th worst among 189 countries worldwide on the World Bank's "Ease of doing business index". This law has also been around in Parliament since long despite limited ideological objections from either side. Its main intention is to cut through and intractable mass of land claims that may go back centuries and where disputes can stop acquisition of land for road building and factories. Because of the technical and legal intricacies involved hopes are not high that it will pass Parliament anytime soon, whereas the GST proposition might still gather consensus before important state elections early next year.

FDI liberalization and other reforms: The new government has continued to roll out reforms requiring only executive approval. The FDI regime has opened further by raising foreign ownership limits including of private financial institutions from 26% to 49%. Plans to clean up the finances of the power distribution companies are firming up. They have often been insolvent for years and unable to carry out new development projects. The successfully implemented labor reforms in two states which have allowed lay-offs in companies with less than 300 employees – up from 100 employees before -- without permission from local authorities may now be extended to other states.

Political situation

Political gridlock over key reforms: General elections in 2014 to the lower house, Lok Sabha, left the previous opposition party of Mr. Modi with a strong majority. However, much legislation still requires the approval of the Upper House, the Rayja Sabha, where the Congress led opposition still commands a strong majority. That may not change fundamentally by supplementary elections in five states early next year as only 51 seats to the 245 seat assembly are at stake. As a result, political gridlock over key reforms may not be resolved soon.

Outlook

The near term outlook for India looks good. Macroeconomic stabilization is on a solid path to be achieved. The current account deficit has gradually shrunk to less than 1,5%/GDP -- a reasonable level for a country with massive capital needs that cannot be expected covered by domestic savings alone. Reserves are strong at around 8 months of imports and still accumulating. The government deficit of about 6-7%/GDP -- including both federal and local governments, is high but still somewhat below the limit where debt sustainability becomes an alarming concern. That leaves the government with a modest level of fiscal space to meet a mild downturn in the economy. But first and foremost, India is picking up speed to more than 7% growth annually, outshining all peers at least according to the new national accounts methodology adopted by the statistical authorities in early 2015. Even so, there are few signs of overheating and price pressure is subsiding to about 5%.

The longer term outlook, by contrast, is potentially more clouded. Worries about the dominating public sector banks have simmered for decades without exploding, but are slowly growing worse at least in view of the need for more efficient financial institutions if India is to grow into a full-fledged modern economy. But the concerns that top all others is the inability of the political establishment to join forces to implement key reforms everybody seem to agree on at least in principle. Key issues

are the passing in Parliament of the General Sales Tax and the Land Acquisition Law. The first has been on the table since 2006 but failed approval due to weak coalition governments where members have been as much swayed by vested local interests as the interest of the country. The second issue tries to cut through a problem shared with other emerging countries without central registers or laws to regulate and protect property rights through the centuries. While the second may still take time to solve, the first issue, the GST, seems like more of an issue of political expediency. ***Inability to solve this, which is a key issue for India to make its domestic market operate with reasonable efficiency and to ensure India's sustained growth, is in our view a central rating issue both for the sovereign and the country.***

Nevertheless, India has strengths often undervalued: Those include positive demographics and a functioning democracy that leaves a lot to be desired but still delivers a minimum of good governance in terms of transparency, checks and balances. In other ways India looks much like China ten years ago. At that time China had already achieved A-rating while India is still in lowest investment grade with all rating agencies. Only one rating agency has indicated an upgrade by attaching a positive outlook to the rating of the sovereign. For a further but far from complete analysis of the India vs. China rating paradox pls. confer Box2.

Box 2: Why is India rated so much lower than China? Despite all the longer term concerns that can be heaped on India's creditworthiness, it is still a paradox why the sovereign of India is rated so much lower than China at least if we take the latter back to the early 2000s. At that time China was a country of some $1600/capita, the same as India today. China had a small current account surplus but rising rapidly, where India is still in a small deficit although that is hardly a major rating issue. China's reserves were about two times larger than India's today, but the IMF regards India's as more than strong enough. In the mid-2000s China was growing at about the same rate as India today.

In terms of long term prospects, ten years ago China was in the midst of the same positive demographic changes as India today. Today China is slowing much due to the same changes turning negative while India has the potential to grow fast at least for another decade. That said, high growth of the working age population could also become more of a bane than a boon, but the same concerns were relevant for China as well in the 2000s. While both countries are troubled by endemic corruption, as a democracy India should imbue investors with more confidence than China at least in terms of transparency.

Key ratios	2015
Population (millions)	1329
GDP/capita (USD)	1581
GDP (change)	7.4%
Inflation	4.9%
Curr.acc. balance/GDP	-1.4%
Reserves/imports (months)	9
Budget balance/GDP(*)	-6.9%
Government debt/GDP(*)	67%

External ratings:
Fitch: BBB-
Moodys: Baa3/pos
S&P: BBB-

Peers:
Mexico
Iceland
Turkey

Graph: India's risk profile shows strengths on information but other parts of the pentagon fall within the average (i.e. worse).

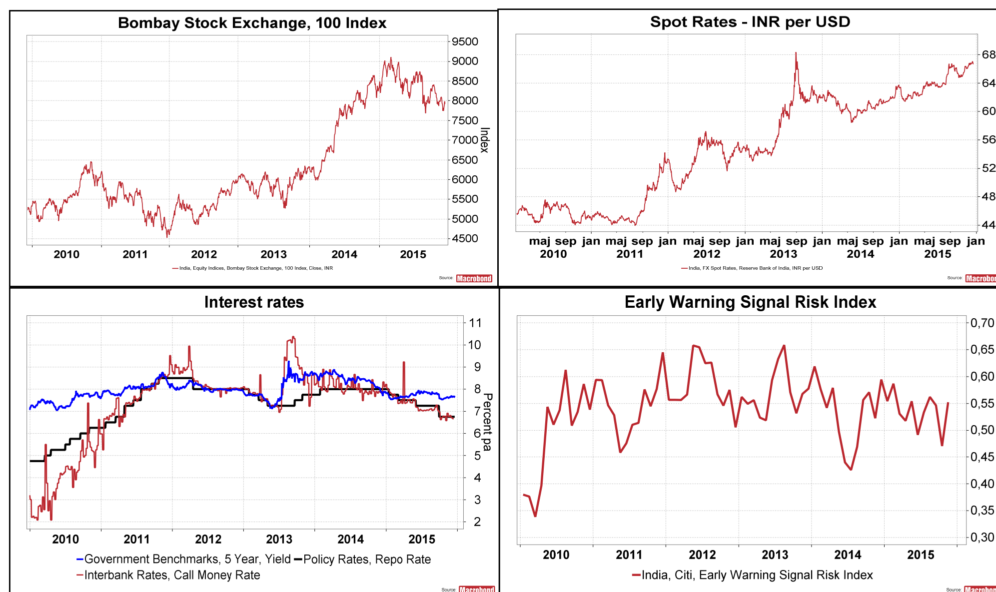
India: Key Indicators

Key data:	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP (bn. USD)	1832	1815	1885	2016	2076	2330	2600	2871
GDP/capita (USD)	1467	1434	1471	1554	1581	1754	1934	2110
GDP (change)	7.9%	5.3%	6.4%	7.1%	7.4%	7.4%	7.2%	7.0%
Investments/GDP	34%	32%	31%	30%	30%	30%	30%	30%
Budget balance/GDP*	-8.5%	-8.3%	-6.9%	-7.1%	-6.9%	-6.7%	-6.4%	-6.1%
Govt debt/GDP*	65%	65%	66%	66%	67%	69%	69%	68%
CPI inflation	9.6%	9.7%	10.7%	6.6%	4.9%	5.6%	5.6%	5.5%
Stock prices	17769	17631	19722	24684				
Interest rates	9.5%	9.5%	9.3%	9.1%	8.0%	7.3%	7.3%	7.2%
Exch. Rate (USD)	47	53	59	61	64	66	67	68
Trade/GDP	43%	44%	43%	40%	34%	33%	32%	32%
Oil price (Brent)	$111	$112	$109	$99	$53	$47	$53	$58
Millions USD								
Export of goods	307 836	301 853	319 719	329 633	273 949	300 105	337 776	374 448
Imports of goods	475 285	503 519	482 296	472 755	421 598	461 746	500 715	545 914
Other:	104 945	110 195	113 351	115 670	119 208	128 988	141 031	150 187
Current account	-62 504	-91 471	-49 226	-27 452	-28 441	-32 653	-21 908	-21 279
(% of GDP)	-3.4	-5.0	-2.6	-1.4	-1.4	-1.4	-0.8	-0.7
FDI	23 890	15 442	26 388	23 921	36 121	41 587	48 040	54 715
Loan repayments	-22 227	-21 202	-31 228	-39 557	-44 340	-46 720	-50 505	-54 468
Net other capital flows	76 804	83 259	52 169	72 299	76 200	64 363	63 713	60 998
Balance of payments	15 963	-13 972	-1 897	29 211	39 540	26 577	39 339	39 967
Reserves	282 337	268 365	266 468	295 679	335 219	361 796	401 135	441 102
Total debt	333 820	375 008	411 769	453 695	474 817	488 940	510 768	534 406
o/w short term debt	69 951	87 613	92 948	102 225	106 572	109 127	113 216	117 474

Sources: Oxford Economics and SEB estimates.
*)General governemt on-budget transactions

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

Type of government:	Parliamentary Democracy
Next elections	Legislative elections: 2019, Presidential elections: 2017
Other:	
Latest PC deal	None
Latest IMF arrangements	1993/SBA



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