India

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Growth has remained above 7% beating fears of a sharp reaction to demonetization and mitigating government debt dynamics related to the fiscal deficit. Growth could accelerate further provided successful implementation of the unified sales tax across all states.

Country Risk Analysis

Summary and main conclusions

Growth edges up:: In 2016, growth slowed to 7%, down from 7,4% the previous year, but still better than feared following the government's sudden demonetization of the economy in last November. For the current year expectations are for a recovery back to a 7,0%-7,5% growth track on the back of resurgent private consumption and government expenditure while continued corporate deleveraging remain a drag on private investments. The current account deficit is set to widen temporarily but remain covered by foreign direct investments leaving reserves at a healthy level.

Cautious financial policies: Monetary policies have been eased in line with subsiding inflation to less than 4%pa, but will now keep a relatively strict stance to pare back inflation expectations and keep investors calm about the exchange rate. Fiscal policies will follow the same path as the Union budget deficit is cut further to 3,2%/GDP in order to reverse adverse government debt dynamics and crowd in private sector to the loan market where credit expansion has dropped to 4%.

Demonetization to quell corruption: The government's recent endeavor to rid the economy of endemic and rampant corruption by withdrawing all banknotes of high denominations, reduced money supply overnight by 86%. Money supply has now been almost restored and hopes are the action will speed up by formalization of financial transactions through the formal banking system.

General Sales Tax: Digitalization of payments should also facilitate the introduction of a new tax regime centered on the General Sales Tax (GST). That has now been fully approved by Parliament following recent landslide elections for the government in five states, including Uttar Pradesh, India's most populous. Most observers expect this to raise productivity by reducing bureaucracy and we believe this is a landmark decision that will unify the domestic economy into a true single market and stop centrifugal forces that otherwise could come into play.

Outlook: The IMF estimates that the GST could speed up growth to an average of 8% a year thereby helping absorb the rapid rise of the Indian workforce over coming decades. The rating agencies have yet to react to this except Moody's which raised the sovereign outlook to positive. We clearly endorse that decision while cognizant that implementation of the GST may be torturous and slow.

Recent economic developments

The economy proves resilient to the shock: The demonetization of last November 8 came out of the blue sky. Banknotes of large denominations representing 86% of currencies in circulation by value were overnight declared null and void in an economy where most retail payments and more importantly also payments for big-ticket items like housing are settled in cash. This was an almost unprecedented event in modern economic history and prompted widespread fears among observers that the economy was set for a crash. With only 5% credit card penetration, India is highly dependent on cash, but in the event the economy proved quite resilient.

Growth suffers less than expected: Admittedly, for the last quarter of last year recently released national account numbers show quarterly growth declining to 7% year-on-year (yoy) from 7,4% in Q3, but that was still a surprisingly soft drop. By year-end car sales had slumped 18% and house sales in December were down by 40%. However, a strong harvest in agriculture which employs 50% of the population helped cushion the shock as did ramped up government expenditures. That said, observers note that the shock is likely to have hit the informal economy hardest which may not have been fully reflected in official statistics.

Back on a decent recovery path: The surprisingly strong performance given unusual circumstances have led many observers to upgrade economic growth for 2016 and the current year to 7,1% and 7,4% respectively. As in recent years, growth will continue to be spearheaded by private consumption supported by a 24% decenial wage hike in 2017 for public sector employees and expectations of normal climatic conditions for agriculture after years of failing monsoons. Public investments will kick in to reactivate stalled infrastructure projects while private investments are set to continue their weak performance held back by corporate deleveraging and low capacity utilization in industry.

Abating price pressure: India's longstanding fight against high inflation has born fruits. In last February, the index of consumer price inflation (CPI) fell to only 3,2% on an annual basis, even below the central bank's self-imposed target of 4%. One-off factors like falling prices of domestically produced food-stuff contributed to the good result and that effect may taper in coming months. For the full year, the central bank expects prices to rise by 4% as the effect of last year's drop in global energy prices also fades. That will still be an excellent result in view of the quickening pace of economic activities and the low rate of unemployment estimated at only 3% of the total labor force, although underemployment, in particular in rural areas, may be clearly under-recorded.

External vulnerabilities in check: In its latest review of the economy, the IMF declares that "**external vulnerabilities are now in check**". That comes after many years of concerns about the external balance of payments which was frequently challenged by markets in the past due to uncertainty over monetary policies. Last year the current account deficit ticked in at 1%/GDP. For the current year that is estimated to rise temporarily as imports grow faster than exports but still remain well contained within the estimated 2,5% limit for long term sustainability. Due to continued buoyant inflows of foreign direct investments, FDI, the current account shortfall will remain duly covered in the basic balance. That should help keep reserves at a steady level of more than eight months of imports or, by another measure, almost three quarters of India's total debt to foreign creditors.

Policies

Fiscal situation improving gradually: Last February the government made its budget bill public for the fiscal year ending March 2018 (FY18). The deficit was projected to 3,2% of GDP, slightly higher than first announced but down 0,3pp. on the previous year. Markets still welcomed it as proof of the government's determination to persevere with fiscal consolidation which becomes more onerous when including also the aggregate deficits of India's 29 Union states. These are estimated at another 3%/GDP making the total fiscal shortfall more than 6%/GDP. Moreover, these numbers include privatization proceeds in general revenues contrary to standard international budget presentation.[1]

The deficit reduction reflected in part higher excise duties on petrol and diesel, while government capital expenditure as share of GDP remained stable at 1,8%.. The subsidy bill was also unchanged at 1,6%/GDP. That is still high but almost 1pp. lower than three years ago as energy subsidies have been almost eliminated. Lower debt servicing costs due to reduced interest rates on government debt, made a significant contribution to reducing the deficit. On present trends in terms of nominal GDP growth and interest rates the government debt ratio standing at almost 70%/GDP will decline only gradually to the end of the decade. It is unlikely, though, to present any financing problems. That is in part due to the Statutory Liquidity Ratio (SLR) that forces banks to invest in government securities at higher prices than under free market conditions.

General sales tax (GST): The GST was first tabled by Congress under the first Singh government in 2006 but then rejected by the opposition which at that time was led by the BJP party under Mr. Modi. Ten years later the same Mr. Modi, now as PM, tabled essentially the same bill again. This was subsequently accepted in two stages; First as a general amendment to the Constitution which up to then had entitled the states to set indirect taxes which in turn had led to a myriad of different tax regimes prompting the need for state border check points . This called for the Upper House approval where the government did not command the necessary majority but the Congress-led opposition gave in in-stead of resorting to filibuster tactics. In the second stage which took place in early April four supplementary bills passed Parliament. After that the deadline for the implementation of the GST has received a new deadline, July 1, 2017.

A landmark event: The GST is regarded as a landmark event. It will reduce bureaucracy which had come to slow domestic (internal) trade and sometimes made export and reimport of goods as an attractive alternative to internal trade. Being essentially a value added tax, the GST is also expected to help fight tax evasion and in the same vein reduce endemic corruption including at internal border checks. As such it should help raise the tax take and limit the often dominating informal economy with the result to widen the tax base and strengthen the fiscal balance.

But not a panacea: That said, the GST now in the process of being implemented is no longer the same as first billed. Instead of only two tax rates, there will at least be four with a possible top rate for luxury goods. And with exemptions for only alcohol and tobacco in the first GST bill, also other goods will now be held outside the GST and made subject to individual state taxes. That includes electricity, fuel and real estate. Criticism is growing louder and many observers point out that the latest

[1] The Indian budget presentation includes privatization proceeds in general revenues. Excluding these raises the deficit by some 0,3%/GDP..

deadline for full introduction is far too ambitious not only because exact definitions of the various categories of goods within each tax rate have to be ironed out. As important, the GST will require a more digitalized system at all levels of the production process. Critics will likely prove right, but that does not fully discredit the GST. Other countries in the recent past, including Australia, have also experienced teething problems that could last for a year when introducing a value added tax. It has also been noted that the added exemptions for electricity and real estate are technically the easiest to treat separately: At least they are not transported by trucks across internal state borders. There is also a political side to the event. The inability to introduce the GST for the second time might eventually have been perceived as a signal of a weakening center and as such encouraging states to rather go their own ways.

Monetary policy to remain tight for now: After two rate cuts in 2016 of 25bps each in line with subsiding price pressure, the Reserve Bank of India (RBI) at its latest meeting in last February signaled a pause to its easing cycle that had begun in 2014. This was despite the continuing fall in the CPI closer to the floor of the annual inflation target of 4%±2pp as this was judged to be temporary and likely followed by a resumption of price pressure in coming quarters. Having succeeded to calm markets as seen in a more stable exchange rate, the RBI is now fighting for its hard-won credentials of inflation targeting while wary of still high inflation expectations among households. This may also be an effort not to squander the government's recent acceptance that such targeting now being formalized including with a strengthened set-up for the Monetary Policy Committee.

Banks struggle with poor asset quality: The uptick in non-performing assets (NPA) to almost 13% of last September, continues to weigh on banks' performance. That has sped up after the policy impetus from the RBI to enforce "asset quality recognition" following the introduction of a new bankruptcy law that reduces the timing of bad asset resolution in courts from an average of more than 4 years to only 180 days. . The problem has now been exasperated by the sharp fall in credit growth to only 4% yoy last February -- most significantly among public sector banks. They dominate 70% of the loan market but their reserves for stressed assets cover less than half of their recognized NPA level. It is estimated that a total clean-up calls for additional recapitalization of up to 2,4%/GDP of which the government seems prepared to cover almost 50% over the next couple of years. It should also alleviate the situation that the government has accepted foreign investors to take full stakes in asset reconstruction companies. That said it is noted that all public sector banks otherwise meet the Basel III capital standards with a CET-1 (Common Equity Tier 1) level at 8,7% well above the regulatory minimum of 6,25%.

Weak corporate clients: The core of the problem is the public sector banks' lending to government infrastructure projects some 10 years ago of which many stalled for political reasons in the early 2010s. Corporate sector vulnerabilities are therefore particularly acute in mining and metals but prevail also in other sectors including telecommunications. However, according to the IMF there are signs of subsiding corporate sector vulnerabilities. Since 2015, the share of weak companies with profit to interest coverage less than one has declined by 3pp. to 17% of the total.

Advancing reforms: Despite an overall poor reputation, according to OECD's Responsiveness Indicator India is one of the few countries to have retained the reform momentum of recent years. Infrastructure spending has accelerated and the government has lifted the caps on FDI in more sectors. Efforts have been made to develop a domestic capital market outside of banks and last year the government raised the limits on foreign holdings of treasuries. In 2016, it also introduced the

Addhaar Act which links entitlements and subsidies to biometric identification of beneficiaries with the aim to improve targeting of social programs with the support of mobile banking. Last but not least, it has introduced an "ease of doing business" index for each state and mulled plans to link this to government transfers in order to encourage reform implementation nationwide. The new Bankruptcy law, noted above, is also a part of this reform process.

But littke break-through on structural reforms: In return there has been little progress on land and labor reforms, subsidies for agriculture or trade tariffs. Labor market regulation is still based on a law from the first year of independence which requires firms with at least 100 workers to obtain government permission for lay-offs. This is holding back many firms from exploiting economies of scale. Subsidies of fertilizers, water and power for agriculture continue untargeted resulting in excessive use with consequences for ground water levels and soil fertility. India maintains high import tariffs at an average of more than 13% which is higher than 10% among most peers. The all-important land reform have seen pockets of success in the past but no comprehensive revamp that would pave the way for more efficient infrastructure development and land-use for agriculture.

Politics

The government wins big in state elections: A rare coincidence of five state elections in February resulted in a landslide victory for the ruling BJP party. Although the opposition won in a few minor states, BJP made almost clean sheet in India's largest union state, Uttar Pradesh with about 200mn. people. Together with local coalition partners it boosted its representation in the state assembly from 12% to 77%. That will subsequently increase its representation in the Upper House of the Union Parliament in Delhi when the term of several members expire in 2018. The surprisingly strong win shows broadening support for the government's economic and institutional reform agenda according to many observers. That combined with the prospects for an outright Upper House majority as of next year would facilitate the passage of additional reforms going forward.

Outlook

Growth set to accelerate on private consumption and infrastructure: After last year's subdued performance of only 7% growth due to the government's action to weed out corruption and advance digitalization of a mainly cash-based economy, i.e. the demonetization of last November, growth is set to return to its former path and gradually speed up to almost 8% on an annual basis. For this year and possibly into 2018 as well, private consumption will remain the main engine of demand in line with strong household sentiment and rising wages led by the decenial salary adjustment in the public sector with spillover to private sector wage agreements. The government is also set to speed up infrastructure spending while other structural reforms gradually take root.

But for some time, private investments will remain weak. That will reflect corporate deleveraging and low capacity utilization. The external sector could also face more headwinds depending on import growth of main trading partners including of the Gulf countries which are also a main source of remittances. However, as long as oil prices remain around the present level of $50-60/barrel which might to be the new standard, the current account deficit should stay at less than 2%/GDP, a level commensurate with India's present stage of development and level of reserves. That is against a background of reasonably well-managed macroeconomic policies and continued reforms including the introduction of the GST later this year.

This picture could be somewhat disturbed by external events: Such events include faster than anticipated tightening of monetary policies in the US or a faster than expected economic slowdown in China. But as to the latter, India is far from a country to be most affected – China is the destinations for only 5% of exports and could even benefit if companies quickened diversification away from China.

The main risks to India's future are likely to emanate from within. An unlikely, but not ignorable turn in domestic political events could embolden the opposition to put spanners in the works for the government's implementation of the GST. While it is quite optimistic to believe in a full scale implementation as planned already from next July, should it drag out over several quarters and perhaps even more than a year, investors might start losing faith in reforms with implications for financial markets stability. That continues as key underlying uncertainty for India over the next few years.

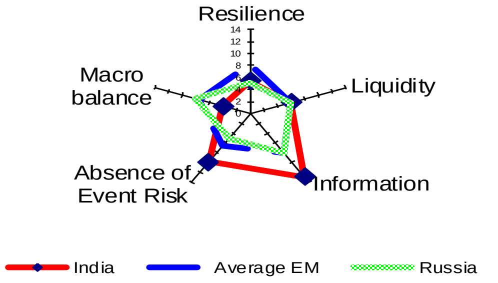
A virtuous or vicious circle? The recent rapid rise in banks' non-performing assets to 13% although much due to stricter recognition standards than a real increase, would further impair banks willingness and ability to extend new credits to the economy. Combined with weaker than expected tax revenues if GST implementation should prove unsuccessful, this could crowd out more private investors from the domestic loan market. What was hoped to become a virtuous circle of economic growth and higher tax revenues to finance infrastructure and leave more bank financing for the private economy thereby give investments and growth a new boost, could rather be turned on its head. However, after surprise landslide state elections for the government last February we believe that the opposition will now rather lick its wounds and not filibuster what it first heralded as a landmark reform itself some ten years ago.

Our upshot is of a country that with the implementation of the GST followed by other reforms has now passed a main hurdle on its path to higher growth rates that could last for decades. Much like China since the 1980s, that would be underpinned by the shift of underemployed young workers from inefficient agriculture into higher productivity jobs in urban factories and services firms. As such it would repeat the transition in China over the recent decades which itself was preceded by the history of the most developed countries of today. In this process there could be a risk of labor oversupply exceeding demand, but as other countries have proved such situations normally turn out to be self-correcting and temporary.

Key ratios	2017
Population (millions)	1345
GDP/capita (USD)	1797
GDP (change)	7.2%
Inflation	4.7%
Curr.acc. balance/GDP	-2.7%
Reserves/imports (months)	10
Budget balance/GDP(*)	-6.8%
Government debt/GDP(*)	69%

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

Peers:
Mexico
Iceland
Indonesia



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

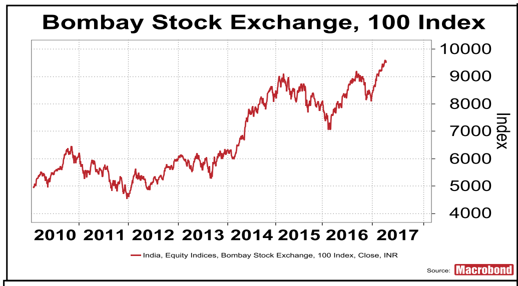
India: Key Indicators

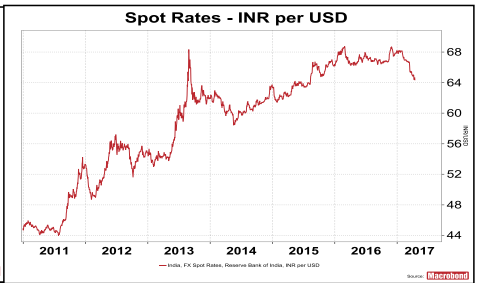
Key data:	2012	2013	2014	2015	2016	2017	2018	2019
GDP (bn. USD)	1808	1870	1994	2076	2197	2416	2725	3074
GDP/capita (USD)	1428	1459	1537	1581	1653	1797	2004	2234
GDP (change)	5.6%	6.3%	6.8%	7.4%	7.0%	7.2%	7.5%	7.1%
Investments/GDP	33%	34%	32%	32%	29%	28%	28%	28%
Budget balance/GDP*	-8.5%	-8.3%	-7.3%	-6.8%	-6.9%	-6.8%	-6.7%	-6.5%
Govt debt/GDP*	65%	65%	66%	67%	69%	69%	69%	69%
CPI inflation	9.4%	9.9%	6.6%	4.9%	4.9%	4.7%	5.4%	5.2%
Stock prices	17631	19722	24684	27347				
Interest rates	9.5%	9.3%	9.1%	8.0%	7.2%	6.6%	7.0%	6.9%
Exch. Rate (USD)	53	59	61	64	67	68	69	69
Trade/GDP	45%	43%	40%	33%	30%	30%	28%	28%
Oil price (Brent)	$112	$109	$99	$52	$44	$52	$52	$59
Millions USD								
Export of goods	301 982	319 719	328 387	272 353	266 914	276 551	304 676	341 518
Imports of goods	503 519	482 296	472 433	409 238	384 446	438 696	468 014	514 462
Other:	110 066	113 351	116 730	114 490	93 065	96 040	111 464	129 713
Current account	-91 471	-49 226	-27 316	-22 395	-24 467	-66 105	-51 874	-43 231
(% of GDP)	-5.1	-2.6	-1.4	-1.1	-1.1	-2.7	-1.9	-1.4
FDI	15 442	26 388	22 890	36 495	40 081	47 440	53 427	62 345
Loan repayments	-21 202	-28 931	-80 774	-37 406	-34 477	-36 566	-38 962	-42 175
Net other capital flows	83 259	49 874	114 409	60 024	30 974	90 180	88 347	75 998
Balance of payments	-13 972	-1 895	29 209	36 718	12 111	34 949	50 938	52 937
Reserves	268 365	266 470	295 679	332 397	344 508	379 457	430 395	483 332
Total debt	375 070	411 562	453 358	479 102	485 673	503 711	521 918	544 846
o/w short term debt	87 613	92 947	88 249	83 067	83 609	85 929	88 053	90 844

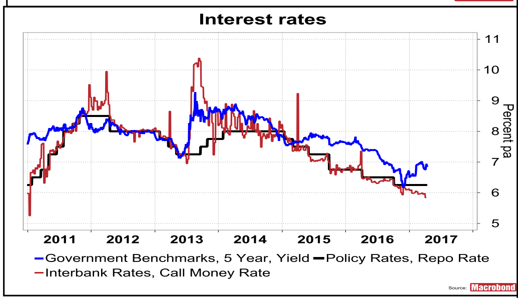
Sources: Oxford Economics and SEB estimates.
*)General governemt on-budget transactions

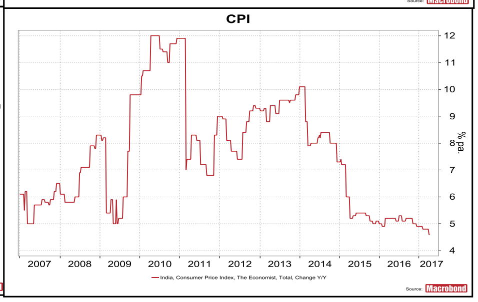
Rating history (end of year)					
Moody's	Baa3	Baa3	Baa3	Baa3	Baa3
Fitch (eoy)	BBB-	BBB-	BBB-	BBB-	BBB-
S&P	BBB-	BBB-	BBB-	BBB-	BBB-

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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