India

SEB GROUP COUNTRY RISK ANALYSIS **December 17, 2018**

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Economic growth has recovered over the past year and the economy should be in a good position to reap the combined benefits of the past years' economic and institutional reforms. Recent, new challenges in the banking sector and upcoming elections have added some uncertainty to the outlook.

Country Risk Analysis

Summary and main conclusions

Short-term headwinds created by the important Goods and Service tax (GST) and by the monetary reform (demonetisation) have dissipated contributing to accelerated GDP growth. The economy should now be in a good position to reap the combined medium-term benefits of these and other economic and institutional reforms implemented in the past few years. As a result, competitiveness should improve, raising economic growth and making it more sustainable, which in turn makes it more likely that government debt stabilizes.

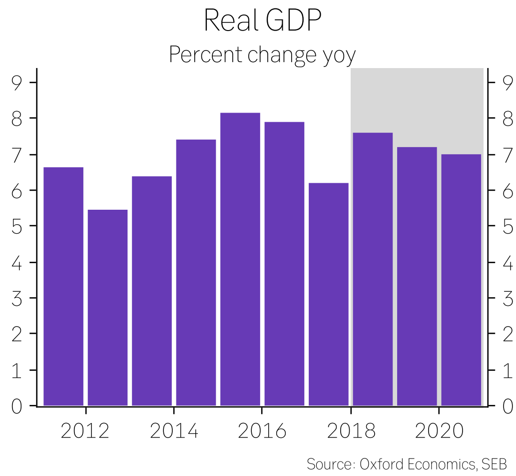
Government finances have not improved as expected and remain one of the main country risk drivers. However, a strong political commitment to fiscal consolidation should lead to a gradual decline in the budget deficit and in government debt over the next couple of years, despite possible spending pressures that may arise in the run-up to elections in 2019. Recent state level elections indicate that the ruling BJP party may face stronger than expected competition in the elections. Still they are expected to be able to secure a second period at the helm of the government.

The large swings in global oil prices in the past year and its impact on the Indian economy served as a crucial reminder of one of the economy's key vulnerabilities –its large dependence on oil imports. As a consequence, the exchange rate, bond yields and Indian equity markets have largely been swinging in tune with oil prices. Higher oil prices have also led to a rise in the current account deficit. Still, in a broader sense, external balances remain relatively strong.

Higher oil prices and weaker than expected external demand are two important external risks. Domestic risks relate mainly to the banking sector where newly arisen challenges may dampen credit supply, and to an unexpectedly weak new government stalling on further economic reforms.

Recent economic developments

Strong domestic demand led to accelerating GDP growth: Following some moderation of economic activity in 2017, growth in 2018 has been stronger. The headwinds generated by the introduction of the Goods and Serviced tax (GST) and the monetary reform (demonetisation) have dissipated. In combination with strengthening domestic demand and a reduced drag from net exports this is expected to have contributed to average growth of 7.6% for the year as a whole.



Inflation in check, despite oil prices. Brisk growth and rising crude prices boosted inflation to levels above the central bank's medium-term 4% target in the first half of 2018. However, consumer prices that rose by an average of 3.3% in 2017 have been declining since mid-2018, helped by surprisingly low food prices, and are set to average about 4% for the year.

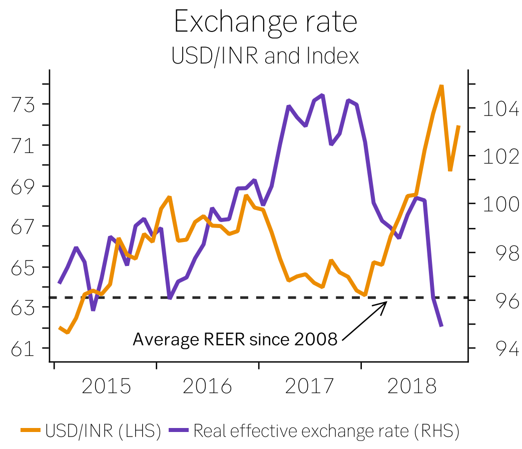
Low income levels are gradually catching up. Rapid growth has helped to lift India's GDP per capita more rapidly than in countries such as Mexico and Brazil but income levels are still significantly lower than average among peers. This is a credit weakness. Broader indicators of human development are also weaker than among peers.

Swings in oil prices serve as a reminder of vulnerability. Global oil prices have been on a roller coaster ride in 2018. The steady rise since mid-2017 and its impact on the Indian economy served as a crucial reminder of one of the economy's key vulnerabilities –its large dependence on oil imports. India is the world's third largest oil importer, importing roughly 80% of its oil needs. This normally pushes oil imports to 30-40% of the country's total import bill. Higher oil imports contribute to raising the trade and current account deficit. The higher current account deficit in turn puts downward pressure on the exchange rate which raises the costs for imports even further. As a consequence, the INR, bond yields and Indian equity markets have largely been swinging in tune with oil prices in the past year.

Current account deficit edging up... External vulnerabilities have declined since 2013 when "taper tantrum" hit the Indian economy worse than many peers. However, over the past year, strong domestic demand and higher oil prices has raised import costs and pushed up the trade and current account deficits. The latter rose to 2.9% of GDP in Q3 2018 but is expected to average a slightly lower level for the year. Although this may be somewhat higher than average for the country risk class, it is far from alarming. Remittances rose in the past fiscal year while foreign direct investment (FDI) was broadly stable at moderate levels. Despite measures to open up more sectors of the economy for larger foreign ownership, and despite some progress in improving the business climate, FDI as a share of GDP is broadly unchanged compared to a few years back.

…but external position remains a relative strength. Despite the deficit on the current account, external balances are strong. Since savings have traditionally been relatively high, the country has been able to finance its debt domestically. Less than 10% of government debt is denominated in foreign currency. In addition, FX buffers are higher than average among peers. Although edging down in the past year, reserves are about USD 390 bn which cover almost 8 months of prospective imports. India has a clean debt repayment record, contrary to many of its country risk peers.

Deficits put pressure on exchange rate. As FDI have been moderate, the country's basic balance (current account balance+FDI) has been parked in negative territory since early 2018. This has put pressure on the exchange rate which depreciated to an all-time low versus the USD. Towards the end of the year it recovered somewhat helped mainly by the lower oil prices. In real effective (trade weighted) terms, the exchange rate is close to its 10-year average level. Nevertheless, having previously prided itself with a strengthening of the rupee, the authorities responded to the weakening, and to the rising current account deficit, by adopting several measures to encourage more capital inflows. The measures include stimulating foreign investment in the domestic bond market and making it cheaper for companies to borrow from abroad. In addition, import curbs were introduced, building further on India's already relatively high trade barriers.



Source: Macrobond, SEB

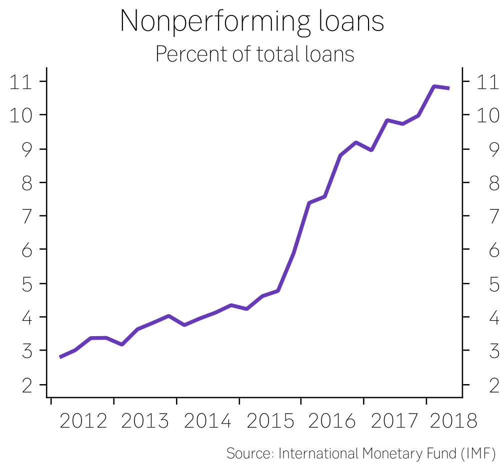
Economic policies

Fiscal consolidation has slowed. India has a long history of government balances in deep negative territory. In the past 10 years, the general government deficit has been 7.7% of GDP on average. In the fiscal year ending in March this year, lower than expected revenues generated a small rise in the general government budget deficit to about 7% of GDP (up from -6.7%). Plans to consolidate government finances in the current fiscal year were scaled back as the government introduced measures to milden the blow of high energy prices on consumers. However, the budget for FY18/19 (ending in March 2019) still envisages a narrowing of the central government's deficit to 3.3%. Fiscal pressures are likely to rise as elections approach and there is a risk that the targeted revenue levels may prove to be too optimistic, and hence that the deficit is higher. On balance, we expect the general government deficit, taking into account also the state finances which normally generates a deficit of about 3% of GDP, to 6.6% in 2019.

Room for fiscal manoeuvre is limited. Fiscal policy is operating within a relatively inflexible framework as expenditures are structurally high, including on public wages, and revenues are low due low incomes and a narrow tax base. Early signs indicate that the GST may be contributing to a widening of the tax base and that higher revenues should be expected over time.

Government debt ratio high but may have peaked. Persistent fiscal deficits have yielded a general government debt that has hovered close to 70% of GDP in the past couple of years. This is higher than average among peers and one of India's main credit weaknesses. The debt stock is mostly in local currency and held by domestic investors, easily financed as domestic banks are required to place a significant share of the deposit funding in government bonds. The foreign currency denominated part is primarily owed to official lenders. Most analysts expect that the debt ratio has peaked and is set to gradually decline over the next few years. The government aims at reducing the debt ratio to below 60% of GDP in the medium-term.

New banking sector challenges. The country's relatively high public debt makes it vulnerable to any additional costs arising from materializing contingent liabilities. In addition, banks remain a key channel for capital allocation in the country. Although lending growth has recovered in the past year, the health of the banking sector continues to weigh on overall Indian credit risk.



This is even more so following a default of Infrastructure Leasing & Financial Services Limited (IL&FS), one of the countries' largest non-bank credit institutions (NBCI). The role and market share of this and similar NBCIs have risen significantly in the past years. Hence, fears arose that the institution's problems would spread and cause a slowdown in credit growth. While one could envisage a scenario were credit supply from the NBCIs and banks (as owners of, or creditors to the NBCI) would plunge and thereby squeeze spending and investment in the near-term, we assume that the stress related to the sector will remain contained and not cause broader systemic problems.

Government leaning on RBI to stimulate. In response to these developments, the central bank has focused on improving the governance of NBCI lenders through various restrictions, eager to permanently reduce the risk in the sector going forward. The government has criticized the Reserve Bank of India (RBI) for not addressing near-term liquidity concerns, for example through a more relaxed regulatory framework and new liquidity channels. In our view, while this could spur credit growth in the short run, it would risk hampering growth eventually by delaying the resolution of the twin balance sheet problems of the banks and corporates.

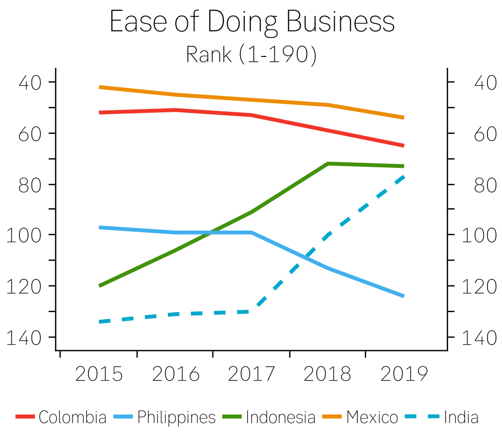
Central bank fighting to maintain its independence. Publically voiced disagreements on the matter came on top of disagreements over RBI's prompt corrective action measures (PCA, which prevents banks from new lending until their financial health is restored), and other issues such as suggestions that the RBI should transfer parts of its reserves to the government. Beyond a heated exchange of words, events also prompted the abrupt resignation of the central bank governor. The events have triggered concerns among investors and analysts over the central bank's independence. Clearly, pressures on the RBI to align its views with the government have increased. When political pressure evolves into concrete actions against the central bank this is negative for country risk.

Monetary policy framework more effective. Over the past few years, the bank's inflation targeting regime (with a 4%+-2% target) has been formalized. This, together with the setting-up of a monetary policy committee and efforts to strengthen policy transmission mechanisms should contribute to making monetary policy more effective. With inflation rising above their 4% medium-term target during parts of the year, the Reserve Bank of India (RBI) responded by raising interest rates twice in mid-2018 to 6.5%.

Structural policies

Reforms have built foundation for sustainably higher growth. Several concrete reforms aimed at removing bottlenecks have been implemented over the past few years. Institutional reform related to the central bank and its policy has already been mentioned. Other reforms that are expected to have a positive effect on the economic outlook and on country risk include the introduction of the GST, the new bankruptcy code, the so called Addhaar Act, further steps to develop a domestic capital market and the lifting of restrictions on FDI in more sectors. On other reforms often highlighted by observers as crucial, particularly those related to land acquisition, labour market and education, there has been limited progress.

Business climate improving. There are signs that the business climate may be improving following a targeted effort by the authorities to improve the country's ranking in the World Bank's ease of doing business indicators. India advanced 23 places in this year's ranking, up to place 77 which compares to 134 in 2015. However, the country is still lagging most country risk peers, including Indonesia and Peru.



Political situation

Elections in 2019 not likely to change overall thrust of economic policy. General elections are due in 2019, most likely in April or May. Prime Minister Modi's BJP is generally considered the front runner and thus should secure a second term. It appears increasingly likely, however, that the party will lose their own majority in the lower house. State level elections in late 2018 have resulted in a loss of power for the BJP to Congress in three major states, reflecting that the general elections might be a closer call than envisaged just a few months ago. The election campaign is expected to be full of polarizing religious rhetoric from the side of BJP which may raise the risk of political violence. We do not expect the electoral outcome to significantly change the thrust of economic policy.

Outlook

Sound medium-term growth prospects. Following the expected acceleration in 2018 to 7.4%, we expect real GDP to grow at roughly the same pace in 2019 driven mainly by household spending. Our forecasters, Oxford Economics expect growth to remain around these levels in the medium term. The mood for new reform is likely to cool in the run-up to the elections but continued implementation of structural reforms beyond that should reasonably raise productivity and help drive the convergence with more developed economies. A low level of per capita incomes also indicates there should be ample room for catching up. A final reflection of India's relatively sound growth prospects is its 58 (of 140 countries) ranking in the World Economic Forum's Global competitiveness index this year. This is a small improvement from 2017 and perhaps reflects recent reform progress. India thereby leads emerging markets such as Turkey and Brazil but is trailing Mexico and Russia.

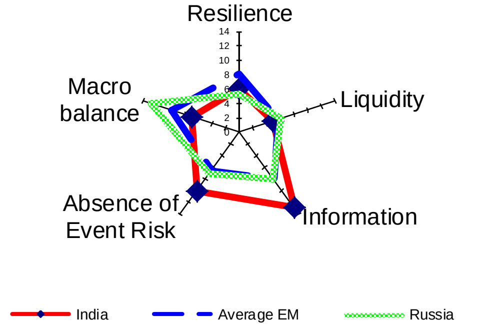
Twin deficits relatively stable. The general government fiscal deficit is expected to edge down slightly in the coming years while the current account deficit should rise a tad, assuming our oil price forecasts are reasonably accurate. A current account deficit of 2-3% should be in line with India's level of development and its level of reserves, and should be comfortably financed by relatively stable capital flows.

Risks related to a weaker government. As we assume that the appetite for economic reform returns following the elections, a risk to our main scenario relates to a weaker than expected new government. For example, there is a risk that a poor election outcome for the BJP could put them in a coalition of a wide range of smaller political parties. This would necessitate compromises on economic policy and could hence lead to a stalling of important reforms relating to land acquisition and the labour market. As a consequence, investments and growth could be lower and investor sentiment could wane.

Risk related to the banking sector. We expect some weaknesses in the banking sector to linger but we assume that credit growth will not plunge as a consequence of the troubles in the non-bank credit institutions. Moreover, there should reasonably be further progress in resolving NPLs under the new bankruptcy law. There are risks however that the woes related to NBCIs lead to wider liquidity shortages in the financial sector. That, in turn, could weigh on credit supply. Another risk relates to the authorities not completing the recapitalization of the ailing state-owned banks and dealing with their poor asset quality. This would also weigh on credit supply.

External risks from global demand and oil prices. Although India is a relatively closed economy, another risk to our main macro scenario is a more marked global slowdown. For example, a ramped up trade war, hitting the Chinese economy could have adverse direct and indirect effects on India's economy. Another external risk is higher than expected global oil prices would be likely to produce higher deficits on the current account and drive up inflation.

Key ratios	**2019**
Population (millions)	1371
GDP/capita (USD)	2280
GDP (change)	7.3%
Inflation	5.2%
Current account balance/GDP	-2.0%
Reserves/imports (months)	8
Budget balance/GDP	-6.5%
Government debt/GDP	67%



External ratings:
Fitch: BBB-, Sta
Moodys: Baa2, Sta
S&P: BBB-, Sta

Peers:
Mexico
Philippines
Indonesia

Graph: India's risk profile shows strengths on information and even risk but other parts of the pentagon fall within the average.

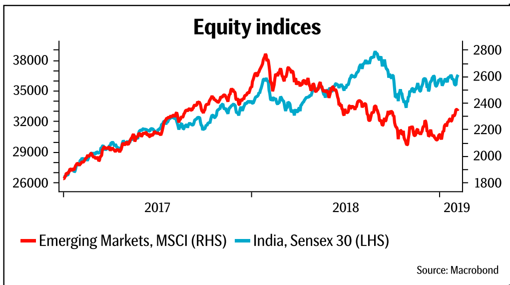
India: Key Economic Indicators

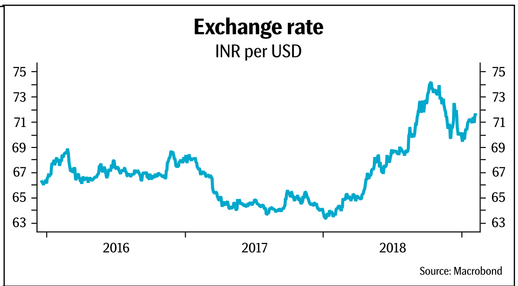
Macroeconomic	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GDP (bn. USD)	2001	2087	2210	2508	2721	3125	3602	3964
GDP/capita (USD)	1544	1592	1667	1870	2007	2280	2601	2833
GDP (change)	7.0%	7.6%	7.9%	6.2%	7.4%	7.3%	7.0%	6.8%
Investments/GDP	32%	30%	31%	31%	32%	31%	32%	32%
Government Finances								
Budget balance/GDP*	-7.3%	-7.0%	-6.6%	-7.0%	-6.6%	-6.5%	-6.2%	-5.9%
Govt debt/GDP*	66%	70%	70%	70%	69%	67%	66%	66%
Money & Prices								
CPI inflation	6.4%	4.9%	4.9%	3.3%	5.0%	5.2%	5.4%	5.4%
Stock prices	24684	27347	26361	30923	35528	38333	43692	48926
Interest rates	9.1%	8.0%	7.2%	6.5%	7.3%	7.7%	7.4%	7.1%
Exchange rate (USD)	61	64	67	65	67	66	65	66
Trade/GDP	40%	33%	29%	30%	32%	31%	31%	30%
Oil price (Brent)	$99	$52	$44	$54	$75	$77	$73	$73
Balance of Payments (USD mn)								
Export of goods	328 387	272 353	268 615	304 107	338 640	378 777	430 723	468 346
Imports of goods	472 433	409 238	376 090	452 242	527 491	605 145	672 276	724 447
Other:	116 730	114 490	95 362	109 088	121 549	144 914	168 388	187 070
Current account	-27 316	-22 395	-12 113	-39 047	-67 303	-81 454	-73 165	-69 031
(% of GDP)	-1.4	-1.1	-0.5	-1.6	-2.3	-2.0	-2.3	-1.7
FDI	22 890	36 495	39 412	28 875	42 487	53 502	59 204	68 969
Loan repayments	-80 774	-38 773	-65 972	-71 541	-81 657	-87 097	-93 081	-99 428
Net other capital flows	97 070	89 262	117 927	159 371	180 171	211 878	220 370	178 889
Balance of payments	11 870	64 589	79 254	77 658	73 699	96 828	113 328	79 400
External Debt & Liquidity (USD mn)								
Reserves	293 314	331 201	343 472	370 972	404 900	440 300	484 300	484 300
months of imports	7	9	11	9	8	8	8	8
Total debt	453 361	479 069	476 191	491 162	536 232	569 332	606 386	645 786
o/w short term debt	88 580	83 872	82 748	91 885	100 335	105 442	111 243	117 595

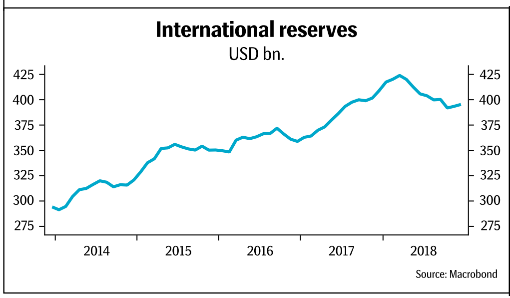
Sources: Oxford Economics, IMF and SEB estimates.
*)General governemt on-budget transactions, fiscal year

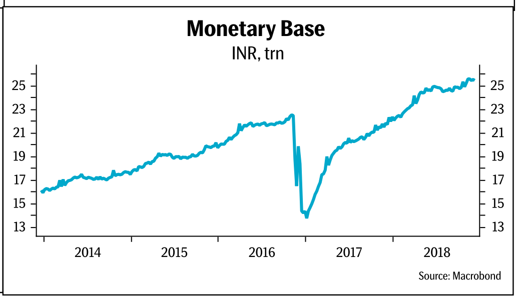
Rating history (end of year)				
Moody's	Baa3	Baa3	Baa3	Baa2
Fitch (eoy)	BBB-	BBB-	BBB-	BBB-
S&P	BBB-	BBB-	BBB-	BBB-

Type of government:	Parliamentary Democracy
Next elections	Legislative elections: 2019, Presidential elections: 2022
Other:	
Latest PC deal	None
Latest IMF arrangements	1993/SBA









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