Rabobank

Country report **INDIA**

Summary

At close to 9%, inflation in India remained stubbornly well above the informal target of 4-5% in 2011. In response, the central bank continued to hike its policy rate, which had limited effect on inflation but a negative effect on economic growth. Slowing external demand also pushed economic growth down in the second half of 2011. Full year growth (which runs from April to March in India) is therefore expected to be around 7% in 2011/12, down from 8.8% economic growth in 2010/11. Looking ahead to FY 2012/13, it is expected that economic growth will pick up slightly again, but downside risks are multiple. Next to inflation, anti-corruption protests were high on the agenda of the government. Despite a landslide victory of the UPA in 2009, the ruling coalition has been unable to push through reforms – as clearly showcased by the anti-corruption bill which has been put on ice. Five state elections are planned for 2012, which will give more information on the popularity of the government and, hopefully, the UPA coalition is able to push through some reforms after the state elections are over.

Things to watch:

- Inflation risk and potential for monetary loosening
- Economic growth momentum
- State elections and reform drive

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India

National facts	
Type of government	Federal republic
Capital	New Delhi
Surface area (thousand sq km)	3,288
Population (millions)	1,130.0
Main languages	Hindi (30%)
	English
Main religions	Hindu (80.5%)
	Muslim (13.4%)
	Christian (2.3%)
Head of State (president)	Mrs. Pratibha Patil
Head of Government (prime-minist	Dr. Manmohan Singh
Monetary unit	Indian rupee (INR)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	1960	2.84
Nominal GDP at PPP	4563	5.79
Export value of goods and services	438	2.00
IMF quotum (in mln SDR)	5822	2.68
Economic structure	*2011*	*5-year av.*
Real GDP growth	7.1	8.4
Agriculture (% of GDP)	18	18
Industry (% of GDP)	26	28
Services (% of GDP)	56	54
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1631	15
Nominal GDP per head at PPP	3796	31
Real GDP per head	1116	14

Social and governance indicators	rank / total
Human Development Index (rank)	119 / 169
Ease of doing business (rank)	134 / 183
Economic freedom index (rank)	124 / 179
Corruption perceptions index (rank)	87 / 178
Press freedom index (rank)	122 / 178
Gini index (income distribution)	36.8
Population below $1.25 per day (PPP)	42%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
UAE	12	China	11
US	10	US	9
China	7	UAE	6
Hong Kong	4	Saudi Arabia	6
Main export products (%)			
Engineering goods			23
Petroleum products			15
Textiles & textile products			14
Gems & jewellery			14
Main import products (%)			
Petroleum products			32
Electronic goods			10
Gold & silver			9
Machinery			8
Openness of the economy			
Export value of G&S (% of GDP)			22
Import value of G&S (% of GDP)			27
Inward FDI (% of GDP)			1.6

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

India is an extremely diverse country with large regional differences, a huge gap between rich and poor, very diverse economic sectors and major challenges. The average income in India was USD 3,796 (in PPP terms) in 2011 and, according to the World Bank, 42% of the population lives on less than USD 1.25 per day, most of whom live in rural areas. The agricultural sector is therefore very important. Although it only produces only 18% of GDP, about 60% of the population depends on this sector for its livelihood. On the other end of the spectrum you have the world class IT sector, which is a major driver of the services sector. The services sector accounts for almost 60% of GDP and employs many of the well-educated Indians, who were able to enjoy high quality education. However, for most Indians this schooling remains out of reach and in general the education system is poor. The illiteracy rate is 25% for adult males and a shocking 49% for adult females.

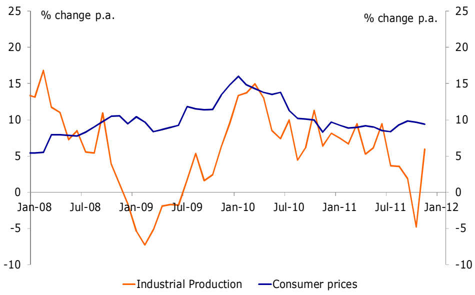
Figure 1: Economic development

	HDI (rank; 1 is best)	Gini index (%)	Population <USD1.25 per day (%)	GNI per capita (current USD)	Literacy rate (% of people)
India	134	36.8	41.6	1330	63
Indonesia	124	36.8	29.4	2500	92
Brazil	84	53.9	5.2	9390	90
Russia	66	42.3	2.0	9900	100
China	101	41.5	15.9	4270	94

Source: UN (Human Development Index), World Bank (other data)

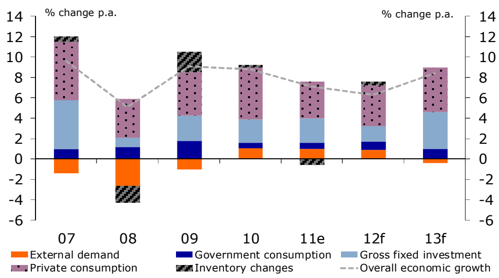
India's full year growth (from April to March) is expected to be around 6.5-7% in 2011/12, which is a significant slowdown from 8.8% economic growth in 2010/11. While at the start of 11/12, some said that India would grow faster than China that year, India faced some head winds, which tempered the growth momentum – although 6.5% growth would still be well above the global average. In 2011, private consumption, India's key growth driver, started rather solid, but high inflation and higher interest rates (and thus lower credit growth) put a drag on it. Export demand was strong up to mid-2011, but has since fallen on the back of a deteriorating external environment. Industrial production data worsened over 2011 and investment, especially in infrastructure, weakened in the final months of 2011, on the back of higher interest rates. Quarterly growth figures clearly show this trend, as GDP growth slowed from 7.8% in 1Q11 and 7.7% in 2Q11 to 6.9% in 3Q11. Key question is whether this slowdown has bottomed out yet. The latest data is mixed and monthly data tends to be volatile. PMI has rebounded to above the 50-demarcation line and inflation is falling (suggesting monetary loosening is an option), but export growth and industrial production remain weak. Unlike during the aftermath of the global financial crisis, the government lacks the room to stimulate the economy this year. Current estimations for economic growth in the coming fiscal year are around 7-7.5%. However, downside risks are multiple with the on-going uncertainty in Europe, the question whether inflation will really ease to allow monetary loosening, the political deadlock in the face of local elections and doubt on the path of the rupee.

Figure 3: Economic indicators



Source: Ecowin

Figure 4: Economic growth



Source: EIU

The financial sector in India is tightly regulated and public sector banks hold three quarters of the assets. State Bank of India, a public bank, is the largest company with 17% market share, followed by ICICI, a private bank, with 6% of the market. Moreover, the government requires banks to buy government bonds via supervisory regulation. Moody's reaffirms the close connection between the banking sector and government as they consider systemic support high in India. In FY2011, public banks received over INR 200bn from the government to boost Tier 1 capital and increase the government's share in public banks. The combination of slowing economic momentum and higher interest rates is expected to affect asset quality in the Indian banking sector over the next 12-18 months. In FY2011/12, the average borrowing rates jumped by more than 200bps so far, thereby pushing debt service costs up. The SME sector is considered most vulnerable. However, the starting point of the banking sector is good with a net NPL ratio of 1.02% and gross NPL ratio (i.e. including loan loss provisioning) of 2.35% end FY2010/11. The financial sector of India has very limited ties to the EU, except for some trade finance through the London City. Less than 5% of total credit is owed to eurozone banks, which suggests that if credit in Europe dries up, this will not automatically create a credit crunch in India. However, a global credit crunch similar to post-Lehman would be felt in India too.

Political and social situation

The United Progressive Alliance (UPA) won the 2009 elections comfortably. The ruling UPA coalition consists out of several parties, in which the Indian National Congress (INC) of Premier Singh is the most prominent. Despite the landslide victory in 2009, the progress on reforms has been slow. The (public) opposition is strong and even within the coalition consensus is sometimes out of reach. Although opposition forces are strong, the opposition parties are divided and marred by scandals of their own. The UPA coalition is therefore expected to remain in place until the next general elections in 2014.

A larger obstacle for reform progress are the state level elections in 2012. As people often vote for local and state-level issues – note that states in India can have the size of large European countries - national politics are regularly determined by local interests, which can be worlds apart. In five states, elections are scheduled in early 2012 with most interest in Uttar Pradesh, which is the largest state in India with almost 200 million inhabitants and is represented by 80 members in the national parliament (out of 545 MPs). The elections, planned for February, will give more information on the popularity of the INC and, hopefully, the UPA coalition is able to push through some reforms after the state elections are over. FDI in the retail sector (see section on balance of payments) and an anti-corruption law (see below) are the most prominent bills on ice for the time being. Besides, the prices of food and fuel continue to spark protests on regular basis and demand attention from the government. Given that poverty is widespread in India, rising food and fuel prices are a sensitive topic.

Top on the government's agenda in 2011 was the public sentiment against corruption. While present for decades, the sentiment against corruption reached new heights in 2011, triggered by a hunger strike of Anna Hazare, a social activist who follows Ghandi's principles of peaceful resistance. Faced by a series of unusually large-scale protests led by Hazare and waning public support, the government felt the need to address the issue of corruption. However, political fragmentation has put the Lokpal bill, which was intended to create a national ombudsman, on ice. Even though the Lokpal bill failed to meet all public demands, it would have been a step forward. However, it has now become the latest example of the inability of the coalition to act. While more public protests against corruption are expected, the momentum of Anna Hazare's protests seems to be fading. Still, the ruling UPA will need to tackle corruption sooner rather than later. If left unaddressed, the dissatisfaction could blow up in their face during local elections this year or general elections in May 2014.

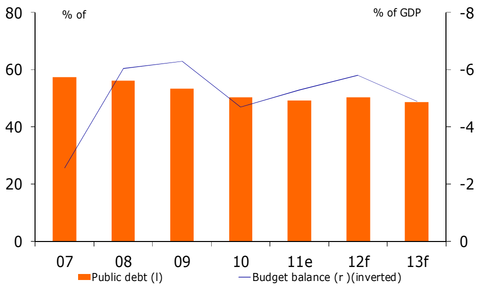
India's international relationships are influenced by the long-standing border disputes with Pakistan over the Kashmir region and with China in the northern states, as well as by the difficult relationship with Bangladesh. The relation with Pakistan is further complicated by cross-border terrorism, as India suspects Pakistani support for attacks in India in the past. The discovery of al-Qaida leader Osama bin Laden in Pakistan in May 2011 fuelled this suspicion. Still, the relationship saw some thawing in 2011, which is expected to continue slowly as long as there are no new attacks on Indian soil linked to al-Qaida. On a global scale, India aims to strengthen its position as one of the BRICs. The relationship with the US and EU are currently good, although the former might change depending on the situation in Pakistan/Afghanistan after the withdrawal of US troops from Afghanistan.

Economic policy

The 'common man' is central to the government's economic policy. While inclusive growth is on top of the official agenda, immediate issues, such as inflation and anti-corruption protests, are on top of mind with politicians. This leaves huge structural challenges such as infrastructure, poverty, health, illiteracy and agricultural efficiency with less attention than desirable. A small, but

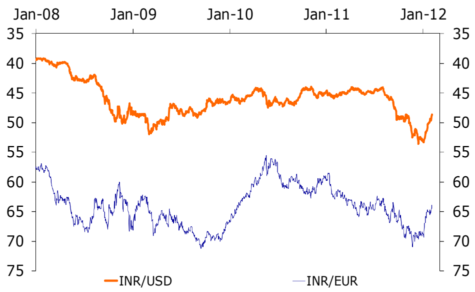
important success in the health department – India was able to eradicate polio, being free of the disease for one year as of January 2012 – shows that progress is attainable, but requires long-term commitment and international monetary and technical support.
Regarding infrastructure, which is often seen as a key factor hindering economic development, years of underinvestment and the sheer size of the country present a massive challenge. Large sums of government spending are earmarked for infrastructural development in the coming years, mainly in the area of power supply and transportation. Notwithstanding some positive signs in the last months (e.g. increase in awarded road contracts), progress is expected to be slow as the government's capacity to implement the plans is questioned, the process to acquire land is difficult and limited long-term financing possibilities hinder projects. Regarding the latter, the government needs banks or private parties to fund infrastructural projects too, in light of the fiscal position. Indian banks have indeed stepped in, especially in the profitable toll highways, but seem to run into regulatory limits with concerns over asset-liability mismatches for the long-term financing. To close the gap, the government has recently set up a framework for infrastructure debt funds (IDF). These funds are aimed at taking over running projects, so capacity is freed up with banks for new projects. If successful, this could provide a valuable boost to the infrastructural challenge.
Another policy target of the government is the stabilization of public finances, but this is challenging considering the economic slowdown and upcoming state elections. A recently proposed food subsidy bill, which will provide cheap grain to poor families, is an example of the latter, as it will boost the popularity of the ruling UPA. While high inflation makes food subsidies attractive, if approved by parliament, it will add USD 6bn (about 2% of total expenditure) to government expenditures every year.
The government has set a fiscal deficit target of 4.6% of GDP for fiscal year 2011/12. However, the budget deficit will likely overshoot its target by about 1% of GDP, pushing the fiscal deficit to around 5.5% of GDP, largely due to lower than expected economic growth – the government estimated growth to be 9% when presenting the budget in February 2011. The budget of FY 2012/13 will likely be presented in February 2012 and is expected to include fiscal consolidation efforts. The public debt level was moderate to high at 49% of GDP in 2011 and is expected to stay at this level in 2012. However, financing India's public debt is not expected to be an issue, as the government is able to place its bonds with domestic banks as, through regulation, banks have to buy bonds worth 24% of its deposits.

Figure 3: Fiscal situation



Source: EIU

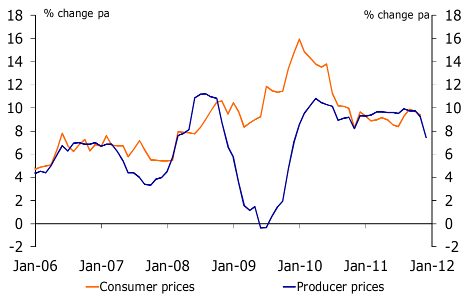
Figure 4: Indian rupee



Source: Ecowin

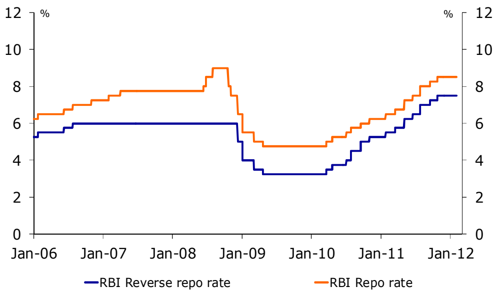
The primary goal of the monetary policy by Reserve Bank of India (RBI; central bank) is price stability. The RBI aims for an informal inflation target of 4-5%, but is hindered by its relative low credibility and the high prevalence of commodities in the reference basket. The former makes it difficult to steer inflation expectation, while commodity prices generally do not respond to policy rate hikes. Food prices tend to be determined by a combination of weather conditions in India's inefficient agricultural sector and global prices, while fuel prices – India is a net oil importer – are internationally set. The consumer price inflation and wholesale price inflation are both forecast to be around 9% in 2011, which is well above the informal target. In order to stem inflation, the RBI has been increasing its policy rate since April 2010, when inflation began to rise. However, considering the development of food and fuel prices, the impact of monetary tightening on inflation was limited. In fact, the tightening cycle had a most pronounced (negative) effect on economic growth. As economic growth is likely to slow, the RBI is expected to loosen its monetary policy again in 2012. Despite this prospect, inflation is expected to slow this year due to base effects and a global economic slowdown, which should ease global commodity prices. However, a spike in commodity prices, e.g. due to tension in the Middle East, or a late monsoon rain resulting in a bad harvest in India could push inflation up again.

Figure 5: Inflation



Source: EIU

Figure 6: Monetary policy



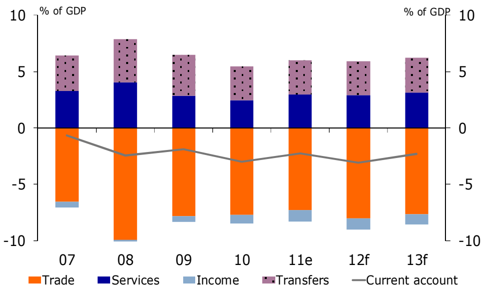
Source: Ecowin

As a secondary goal, the RBI aims to stem the volatility of the Indian rupee, creating a managed float for the currency. The Indian rupee was the worst performing currency in Asia in 2011, as it lost 20% of its value against the dollar over the course of 2011. Especially since September, the depreciation of the rupee accelerated; initially when investor sentiment turned against emerging markets on the back of euro zone problems, later also due to the disappointing growth outlook in India and a widening trade deficit. The widening current account deficit will continue to put downward pressure on the rupee, although the outlook is complicated by international developments. For example, in January the rupee rebounded strongly and appreciated almost 8%, but the question remains how long this higher appetite for Asian currencies will last. In the medium term, the rupee is expected to appreciate again, as the country will continue to be an attractive place for foreign investors. To boost India's attractiveness in the short-term, the government lifted restrictions on foreigners investing directly in India's equity market as per 15 January 2012. While the poor stock market performance in 2011 and the economic outlook for 2012 might not make India the investors' hot spot of the moment, the rupee could do with some extra foreign capital, and this would also help to cover the current account balance.

Balance of Payments

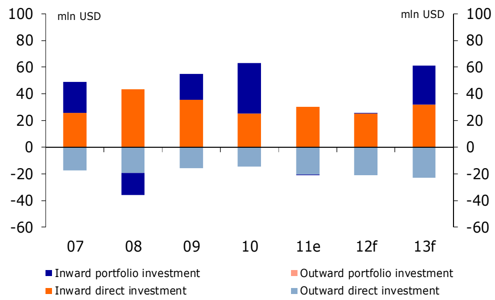
The current account balance of India tends to show a moderate deficit. Slightly slower global demand (i.e. lower exports) and higher commodity prices (i.e. higher imports) pushed the deficit up, but lower domestic demand compensated this partly. The current account deficit is estimated to be 2.3% of GDP in 2011. With global demand forecast to slow this year, the current account deficit is expected to deteriorate a bit to around 3% of GDP in 2012. The main culprit of this current account deficit is the shortage on the trade balance, which is estimated to amount to 8% of GDP in 2012. About a third of the imports are petroleum products, as India, which is the fourth largest oil consumer in the world, is unable to produce sufficient refined oil and gas. About 15% of exports are also petroleum products, which largely related to crude oil stemming from oil and gas exploration mainly in north east India and offshore fields. Gold and silver is imported (9% of import bill), while jewellery is exported again (14% of exports). India's primary export partners are United Arab Emirates (UAE), the US, China and Hong Kong. While this might suggest that India is rather immune to a European crisis, the final destination of many products shipped to UAE and, to lesser extent, China/Hong Kong really is Europe – mainly by way of *entrepot* trading in the UAE. The services and transfer balances show small surpluses, partly offsetting the large deficit on the trade balance, while the income balance generally shows small deficits.

Figure 7: Current account balance



Source: EIU

Figure 8: Investment flows



Source: EIU

India is not only a major receiver of foreign investment, but also participates globally as a foreign investor. In 2011, inward direct investment was USD 30.5bn (or 1.5% of GDP) and outward direct investment was USD 20.5bn (or 1.0% of GDP). In the area of portfolio investment, India only receives (inward) foreign capital. As by nature, portfolio investment in India tends to fluctuate strongly. After a high in 2010 (USD 38.0bn), this investment flow dropped to minus USD 0.5bn (i.e. an outflow) in 2011. With the loosening of foreign investment in equity markets in India, the portfolio flows are expected to increase again in 2012, although the height will strongly depend on international developments. Total net foreign investment (direct plus portfolio) is expected to be a little under USD 5bn in 2012, although this number is likely to be on the low side considering the small amount of portfolio investment currently expected, historical flows and the loosening of foreign investment in equity. In the medium term, investment growth depends on the reform drive of the government. India is still one of the most heavily regulated countries with regards to foreign investment. Slowly, the government is opening up to investors from abroad, e.g. with the mentioned equity market changes. But major changes such as in the retail market, which would attract large players like Wal-Mart and Ikea, are not expected shortly. The latest version of the retail law allows foreign investment up to 100% in single brand stores, but requires that 30% of the products are sourced from local suppliers. This triggered Ikea to shelve its plans to enter India for now.

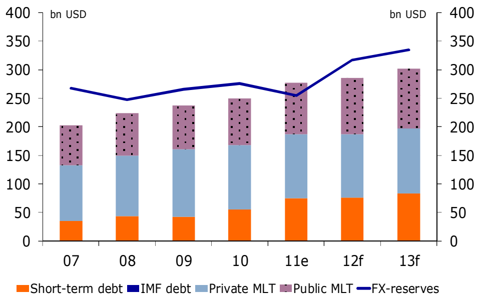
Foreign exchange (FX) reserves are estimated to be USD 254bn end-2011, which is about USD 15bn down from a year earlier. For this year, the FX reserves are expected to rise again. However, the speed of accumulation will strongly depend on rupee development and on the stance of the RBI on how far they will let the rupee weaken or strengthen.

External position

The deficit on the current account balance (about USD 64bn), repayments of short-term debt (about USD 75bn) and payments on medium and long-term loans (about USD 30bn) are expected to create an external financing need for India of close to USD 170bn (all data for 2012). As investment financing is not nearly enough to cover the financing requirements, India relies on debt financing to cover the gap. As the current level of foreign debt is very acceptable at 14% of GDP (end 2011), this seems attainable. Total foreign debt is currently expected to rise from USD 278bn in 2011 to USD 286bn in 2012, although the actual height will depend on investment flows, rise in FX reserves and other capital flows. Only about a quarter of India's external debt is short-term, supporting a favourable liquidity position.

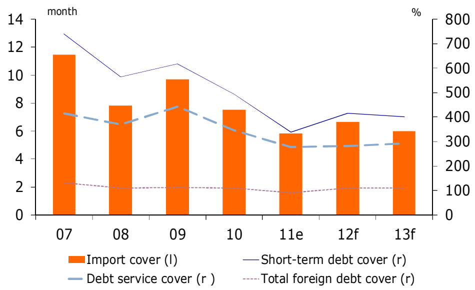
The expected rise in foreign exchange (FX) reserves this year are another part of India's rather positive external position. If FX reserves rise to USD 317bn by end-2012, it would give India a comfortable import cover of almost 7 months, a liquidity ratio of 121% and a cover of total foreign debt of about 110% in 2012. Nonetheless, the data and expectations on mainly the capital flows of India should be treated with care. The balance of payments remains tightly regulated and therefore the performance of FDI and portfolio flows is also dependent on government policies. Overall though, the external position remains sound.

Figure 9: External debt and FX reserves



Source: EIU

Figure 10: FX reserves covers



Source: EIU

India

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	9.6	5.1	9.1	8.8	7.1	6.3	8.4
Consumer prices (average % change pa)	6.4	8.3	10.8	12.0	8.9	7.8	7.9
Current account balance (% of GDP)	-0.7	-2.5	-1.9	-3.0	-2.3	-3.1	-2.3
Total foreign exchange reserves (mln USD)	266988	247419	265182	275277	254400	316740	334360
Economic growth							
GDP (% real change pa)	9.6	5.1	9.1	8.8	7.1	6.3	8.4
Gross fixed investment (% real change pa)	15.3	2.7	7.7	7.2	7.7	4.6	11.4
Private consumption (real % change pa)	9.8	6.6	7.2	8.7	6.2	6.9	7.5
Government consumption (% real change pa)	9.0	11.7	16.0	4.8	5.3	7.5	8.7
Exports of G&S (% real change pa)	5.2	15.2	-7.1	17.5	19.8	12.9	13.8
Imports of G&S (% real change pa)	10.0	22.5	-2.1	9.1	11.9	7.9	13.7
Economic policy							
Budget balance (% of GDP)	-2.6	-6.0	-6.3	-4.7	-5.3	-5.8	-4.9
Public debt (% of GDP)	57	56	53	50	49	50	49
Money market interest rate (%)	7.8	6.5	4.8	6.3	8.5	8.3	7.7
M2 growth (% change pa)	22	20	18	18	18	17	19
Consumer prices (average % change pa)	6.4	8.3	10.8	12.0	8.9	7.8	7.9
Exchange rate LCU to USD (average)	41.3	43.5	48.4	45.7	46.6	51.0	50.6
Recorded unemployment (%)	8.9	9.4	9.7	10.0	9.8	9.9	9.9
Balance of payments (mln USD)							
Current account balance	-8077	-30972	-25922	-51821	-44321	-63600	-56630
Trade balance	-77846	-125319	-106982	-131895	-142621	-164880	-186590
Export value of goods	153784	198599	168218	225647	302500	325180	386280
Import value of goods	231629	323051	274566	357438	445121	490060	572870
Services balance	39142	50959	39304	41825	58000	60000	76580
Income balance	-6136	-3542	-6851	-13759	-19900	-20410	-22230
Transfer balance	37143	48751	49293	52155	60200	61700	75620
Net direct investment flows	8202	24150	19669	10596	9996	4000	9000
Net portfolio investment flows	23403	-16784	19290	37972	-499	570	28920
Net debt flows	43355	21627	11179	11600	23966	8800	17930
Other capital flows (negative is flight)	30871	-17856	-3573	14732	-4488	99570	19900
Change in international reserves	97754	-19835	20644	23079	-15347	49340	19120
External position (mln USD)							
Total foreign debt	202793	224712	237691	250374	277893	286160	302620
Short-term debt	36093	43821	42950	55855	75198	76120	83550
Total debt service due, incl. short-term debt	64462	67029	59971	79533	91861	112380	114370
Total foreign exchange reserves	266988	247419	265182	275277	254400	316740	334360
International investment position	-74766	-85880	-132581	-223048	n.a.	n.a.	n.a.
Total assets	335780	332167	380843	410409	n.a.	n.a.	n.a.
Total liabilities	410546	418047	513424	633457	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-6.6	-9.9	-7.8	-7.7	-7.3	-8.0	-7.6
Current account balance (% of GDP)	-0.7	-2.5	-1.9	-3.0	-2.3	-3.1	-2.3
Inward FDI (% of GDP)	2.1	3.4	2.6	1.5	1.6	1.2	1.3
Foreign debt (% of GDP)	17	18	17	15	14	14	12
Foreign debt (% of XGSIT)	69	61	73	60	55	53	47
International investment position (% of GDP)	-6.3	-6.8	-9.7	-13.0	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	22	18	18	19	18	21	18
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	2	1	1	1
FX-reserves import cover (months)	11.5	7.8	9.7	7.5	5.8	6.6	6.0
FX-reserves debt service cover (%)	414	369	442	346	277	282	292
Liquidity ratio	157	134	145	128	120	121	121

Source: EIU