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Republic of India: Country Risk Insights

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In a nutshell

- India's key strengths lie in its favourable demographics, large domestic demand base and diverse economy. The latter, which has helped sustain economic resilience, includes traditional village farming, modern agriculture, a wide range of modern industries and a multitude of services. India has successfully capitalised on its large educated population to become a major exporter of computer and information services. The services sector accounts for more than half of India's gross domestic product (GDP). Though the country has until the recent past experienced very strong economic growth, its medium-term prospects continue to be constrained by structural weaknesses, which include a crippling deficit in transport and power infrastructure.

- However, India faces a number of challenges. Private sector banks, which hold about one-quarter of banking system assets, are well-capitalised, profitable and have low non-performing loans (NPLs). On the other hand, public sector banks (PSBs), which hold the rest, have lower capital adequacy positions and asset quality. For example, as at end-March 2011, gross NPLs as a percentage of outstanding loans stood at 2.4%; by end-March 2014, it had risen to 4.1%. As PSBs make up a large portion of the industry, their weaknesses have critical implications on the stability of the overall banking sector, and ultimately country risk.

- Meanwhile, the banking sector is saddled with high corporate leverage, which not only hampers the recovery of bank asset quality but also constrains corporate demand for debt. This is an especially serious concern considering that 36.9% of Indian firms have an interest coverage (EBITDA/interest expense) ratio of below 2, the highest among Asian countries covered in the International Monetary Fund's (IMF) Global Financial Stability Report published in April 2015.

- India's current account (CA) balance remains in deficit, though it has improved. As a percentage of GDP, the CA balance in FY2014/15 stood at a post-global financial crisis (GFC) low of -1.3%, compared to the recent high of -4.8% in FY2012/13. However, concerns persist about the country's external vulnerability because the causes of the deficit are structural in nature. These can only be addressed by long-term structural solutions, and much remains to be done. Meanwhile, rising expectations of economic reforms and better near-term growth prospects have led to sizeable capital inflows and high equity prices. Unfortunately, this has led to an increase in risks associated with the possibility of sudden capital outflows. Mitigating this risk is India's high level of foreign exchange reserves, which provides some cushion against such shocks. As at end-March 2015, its foreign exchange reserves stood at USD341.4 billion.

- A major problem facing the Indian economy is persistent budget deficits. India's fiscal deficits have been falling though; in FY2014/15, the central government achieved a fiscal deficit of 4.0% of GDP, compared to 6.4% of GDP in FY2010/11. At the general government level, however, the pace of fiscal consolidation has been slower, and roughly half of the general government fiscal deficit is accounted for by state governments. In FY2014/15, the general government fiscal deficit as a percentage of GDP stood at 7.2%, unchanged from the previous fiscal year. Meanwhile, as a result of persistent fiscal deficits, India has one of the highest public debt as a percentage of GDP in the world. As at end-FY2014/15, general government gross debt stood at 64.4% of GDP.

- India's new government has initiated economic reforms that include: a) deregulating the price of diesel; b) improving labour market flexibility; and c) enhancing financial inclusion. However, the country has weak institutions and an unfriendly business environment that continue to hamper efforts to raise potential growth. For example, the results of the World Bank's Worldwide Governance Indicators (WGI) project show that India is ranked generally low in terms of governance. Against such a backdrop, a major challenge would be investors' perceptions about the ability or political will of the government/regulators to maintain consistent policies and adhere to contractual obligations. Not surprisingly, India is lowly ranked in the World Bank's Ease of Doing Business 2015 report (142 out of 189 countries) and the World Economic Forum's Global Competitiveness Report 2014–2015 (71 out of 144 countries). There are many other major reforms that need to be carried out and it remains to be seen whether Prime Minister Modi would be able to push through all of them. As Modi's popularity has waned somewhat, it is possible that the pace of structural reforms may slow down going forward.

Table 1: Selected economic indicators

	2009/10	2010/11	2011/12	2012/13*	2013/14*	2014/15*
Real GDP growth (%)	8.6	8.9	6.7	5.1	6.9	7.3
Inflation rate (end-of-period; %)	14.9	8.8	9.4	10.4	8.2	5.3
General government fiscal deficit (% GDP)	-8.4	-8.1	-7.5	-7.2	-7.2	-7.2
General government gross debt (% GDP)	67.5	68.1	67.5	65.5	65.0	64.4
Current account balance (% GDP)	-3.0	-2.9	-4.5	-4.8	-1.7	-1.3
International reserves (USD bn)	277.0	303.5	294.4	292.6	303.7	341.4
External debt (% GDP)	19.3	19.6	22.0	22.3	23.7	24.2

Source: RBI, CEIC, IMF, MARC Economic Research
*Note: * GDP calculation methodology updated*

Key Strengths

Favourable demographics, large domestic demand base and diverse economy

Demographic growth is one of India's most powerful advantages; when combined with economic growth that creates better-paying jobs as well as transforms its youthful demographic into a rising middle class, the dividends in terms of providing a boost to an already large domestic demand base, as well as economic potential, can be tremendous. In addition, India's diverse economy is an economic strength; comprising traditional village farming, modern agriculture, a wide range of modern industries and a multitude of services, it has played an important role in sustaining India's economic resilience. The services sector, a major source of economic growth, accounts for more than half of India's GDP. The country has successfully capitalised on its large educated population to become a major exporter of computer and information services.

India grew at a rapid average rate of 6.3% over the 1981-2011 period. In FY2010/11, the economy grew 8.9% year-on-year (y-o-y), higher than the average for the previous three decades; in the following fiscal year, however, the economy faltered, growing just 6.7% y-o-y. The economy grew at an even slower pace of 4.5% y-o-y in FY2012/13. There are, however, signs that the economy might have started to turn around; in FY2013/14, GDP growth inched slightly upwards to 4.7%.[1] A cheaper Indian rupee (INR) had helped revive exports, and ongoing reforms to the monetary policy framework, which gives more weight to inflation, helped boost confidence.

India's government statisticians recently revised their methodology for estimating GDP. The new methodology, which uses 2011/12 as the base year and market prices instead of factor costs, ratcheted up India's official GDP growth figures for FY2012/13 and FY2013/14 to 5.1% and 6.9%, respectively. The revision thus marked FY2013/14 as a year of sharp recovery rather than of continuing stagnation. And according to the new methodology, GDP grew at an even faster pace of 7.3% in FY2014/15.

However, contrary to what one would expect from the dramatic upward revision of India's GDP growth trajectory, the Reserve Bank of India (RBI), which had switched monetary policy to a new easing cycle on 15th January 2015 with its first interest rate cut in 20 months, cut its overnight lending rate again and again on 4th March and 2nd June. The RBI cited "lower domestic capacity utilisation, still-mixed indicators of recovery and subdued investment and credit growth" as reasons for its June policy rate cut to 7.25%.

Consumer price inflation, which hit a four-month low of 4.87% in April 2015 which was well within the RBI's target range of 2%-6%, also gave it enough room to cut interest rates. India used to struggle with high

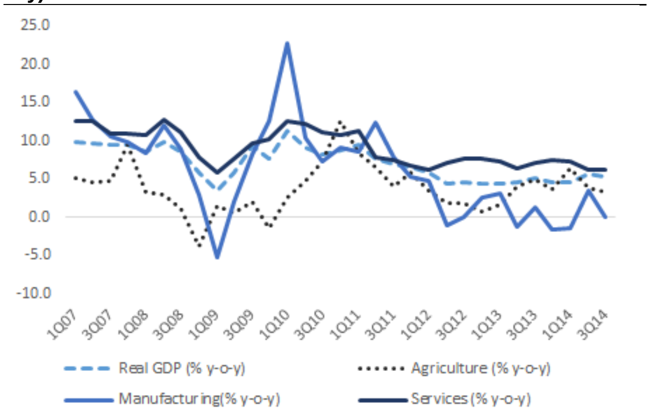
[1] GDP growth data based on 2004/05 prices.

inflation; at end-2013, for example, CPI inflation was at a debilitating 11.2%. Notwithstanding the current lower pace of inflation, high inflationary expectations remain a macroeconomic challenge. As economic growth picks up and favourable base effects unwind, India's CPI inflation will likely rise again over the short term. There will also be impacts from food price rises if seasonal monsoon rains are weaker than expected, and/or global oil prices recover.

India's medium-term growth prospects continue to be constrained by structural weaknesses. In fact, the recent GDP growth decline has raised questions about whether the decline is in the trend or the cycle, and evidence suggests that there is a strong element of both. To counter the decline in growth trend, much needs to be done. Despite two decades of economic reforms, sustainable growth and job creation continue to be hampered by, for example, a cumbersome business environment, inadequate education and training, and infrastructure bottlenecks. For example, India faces a crippling deficit in transport and power infrastructure.

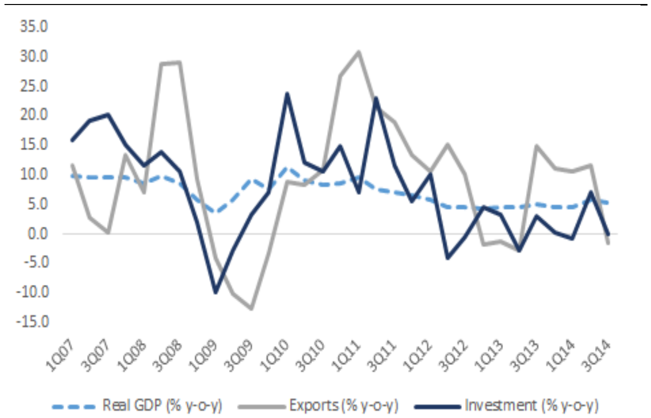
Notwithstanding the challenges faced by India, we expect the combination of positive factors that include moderate inflationary pressure, lower energy prices and stable INR to buoy the Indian economy going forward over the short term. We also expect the new Indian government to continue with efforts to institute more structural reform policies that will enhance India's business environment, boost international competitiveness and ultimately economic growth over the medium term. All of these are critical if the government is serious about reversing the decline in India's economic growth trend.

Chart 1: GDP – agriculture, manufacturing and services (% y-o-y)



Source: CEIC, MARC Economic Research

Chart 2: GDP, exports and investment (% y-o-y)



Source: CEIC, MARC Economic Research

Major Challenges

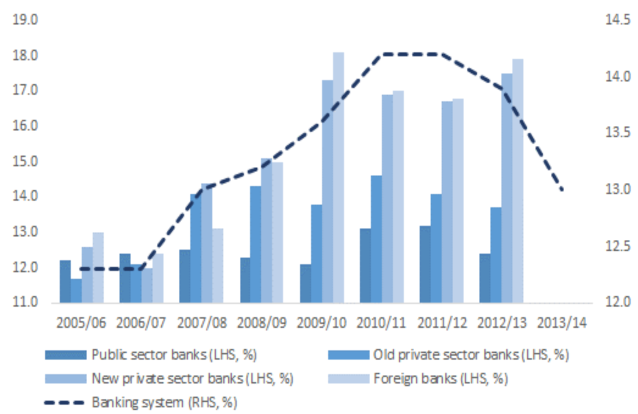
Deteriorating bank asset quality and high corporate leverage

Private sector banks hold about one-quarter of banking system assets, and PSBs hold the rest. The former are well-capitalised, profitable, have low NPLs and limited exposure to troubled sectors; the latter, on the other hand, have lower capital adequacy positions and asset quality. Since PSBs make up a large portion of the industry, their weaknesses have critical implications on the stability of the overall banking sector, and ultimately country risk.

The banking system's overall asset quality has been affected by past weak growth, delayed infrastructure investment projects, as well as supply-side bottlenecks. Over the last few years, stressed assets in the banking system have been rising. At end-March 2011, gross NPLs as a percentage of outstanding loans stood at 2.4%; by end-March 2014, it had risen to 4.1%. While restructured assets are not considered non-performing, they imply sub-par asset quality. As of end-March 2014, restructured loans comprised 5.9% of the banking system's outstanding advances (end-March 2011: 3.5%).

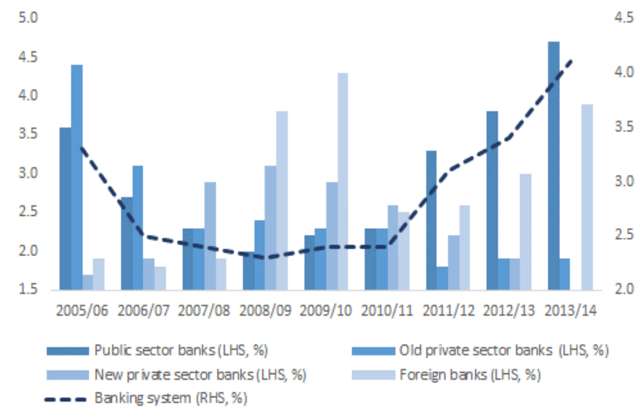
The risk-weighted capital adequacy ratio (CAR) of the Indian banking sector has also deteriorated; in FY2013/14, the CAR of the banking system fell to 13.0 from a post-GFC high of 14.2 achieved at the end of both FY2010/11 and FY2011/12. Considering India's challenging operating environment and the Basel III requirements, banks, particularly PSBs, will likely require additional capital injections over the next several years.

Chart 3: Risk-weighted CAR



Source: IMF, MARC Economic Research

Chart 4: Gross NPLs (% of outstanding loans)



Source: IMF, MARC Economic Research

We expect economic reforms being initiated by the new Indian government to help keep the economy growing and thus help keep bank asset quality from deteriorating further. It should be pointed out though that corporate leverage is high, making corporates vulnerable to economic growth slowdowns. According to a 2014 IMF study, Indian companies whose total debt exceeded five times of equity accounted for 29.5% of the borrowings of Indian corporates in FY2012/13, compared to just 7.9% in FY2005/06.

High corporate leverage can have a dual impact. Firstly, it can affect the demand for corporate debt, and therefore affect economic growth; in fact, research findings indicate that about one-third of the decline in corporate investment-to-GDP ratio since FY2011/12, when compared to the previous decade, can be attributed to corporate leverage build-up. Secondly, high corporate leverage can hamper the recovery of bank asset quality. This is an especially serious concern considering that 36.9% of Indian firms currently have an interest coverage (EBITDA/interest expense) ratio of below 2, the highest among Asian countries covered in the IMF's Global Financial Stability Report published in April 2015.

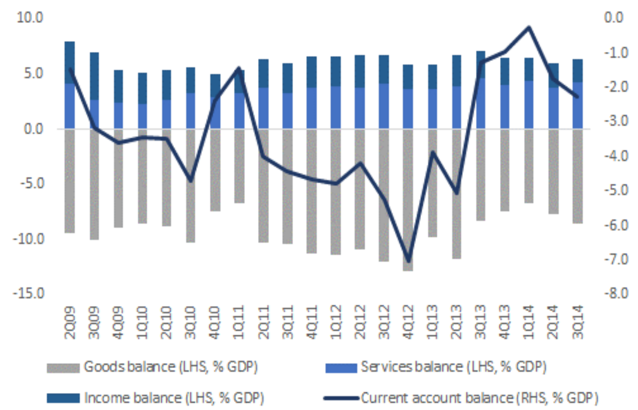
According to the IMF, the corporate vulnerabilities of Indian non-financial corporations are at their highest levels since the early 2000s. As of March 2013: a) the percentage of debt owed by loss-making firms exceeded 26%; b) a composite measure of corporate vulnerabilities indicates that the financial health of corporates is at its weakest in a decade; and c) the share of corporate borrowing by the sectors that experienced recent financial strains has increased since 2008. As such, there are risks that macroeconomic stability could be compromised by high corporate vulnerabilities over the medium term.

Externally vulnerable

Econometric evidence suggests that in India's Balance of Payments (BoP) crisis of 1991, CA deficits played a significant role. India's CA balance remains in deficit, though the situation has improved. As a percentage of GDP, the CA balance in FY2014/15 fell to a post-global financial crisis (GFC) low of -1.3%, down from the recent high of -4.8% in FY2012/13. The high CA deficits registered in FY2011/12 and FY2012/13 were on account of the fallout of the euro zone crisis and inelastic domestic demand for certain key imports such as crude oil and gold, the latter being used as a hedge for inflation.

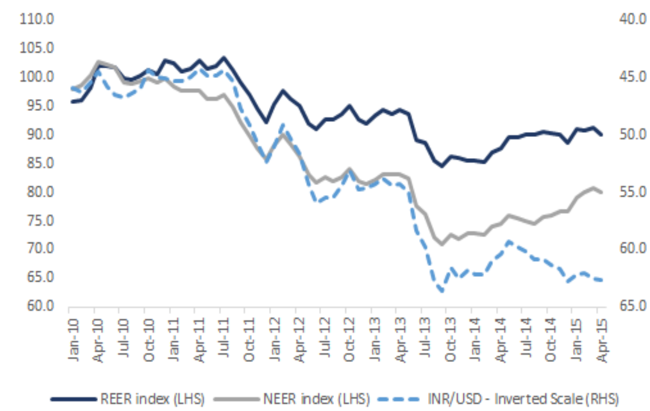
Over the short term, the CA deficit will likely remain contained. Significantly lower crude oil prices will help keep in check the CA deficit though improved near-term growth prospects may result in balance of payments stresses increasing slightly. Despite the improvement in CA balance, India's external vulnerability remains a concern because the causes of the deficit are structural in nature. The problem is, these can only be addressed by long-term structural solutions, and much remains to be done.

Chart 5: Current account balance (% GDP)



Source: CEIC, MARC Economic Research

Chart 6: Nominal and real effective exchange rates



Source: CEIC, BIS, MARC Economic Research
Note: REER: Real Effective Exchange Rate Index
NEER: Nominal Effective Exchange Rate Index

India should take steps to improve its low global competitiveness ranking. It should also enhance its business environment to attract stable, non-debt creating capital flows, particularly FDI, which would improve India's CA deficit financing mix. Supply-side constraints in, for example, transport and energy infrastructure that have hampered manufacturing exports need to be tackled going forward. Manufactured exports growth y-o-y has fallen to single-digit levels from double-digit levels less than a decade ago. On top of that, gains in export market shares have slowed. A stronger INR cannot be the reason for these developments because post-GFC, specifically during FY2011/12, FY2012/13 and FY2013/14, the nominal exchange rate, as well as both the real and nominal effective exchange rates of the INR were trending downwards.

As for India's external debt metrics, they are not as worrisome as Indonesia's and Malaysia's. External debt has been rising (end-FY2014/15: USD495.2 billion; end-FY2013/14: USD442.3 billion); however, at 24.2% of GDP (end-FY2013/14), it is better than Indonesia's 33.0% (end-2014) and Malaysia's 69.6% (end-2014).

Rising expectations of economic reforms, better near-term growth prospects, easing CA pressures, as well as the RBI's success in reducing inflation have led to sizeable capital inflows and high equity prices. While a sudden stop or reversal of capital inflows could expose India to significant risks, its massive holdings of international reserves are seen as adequate to cover a broad set of risks. As at end-March 2015, India's significant foreign exchange reserves stood at USD341.4 billion.

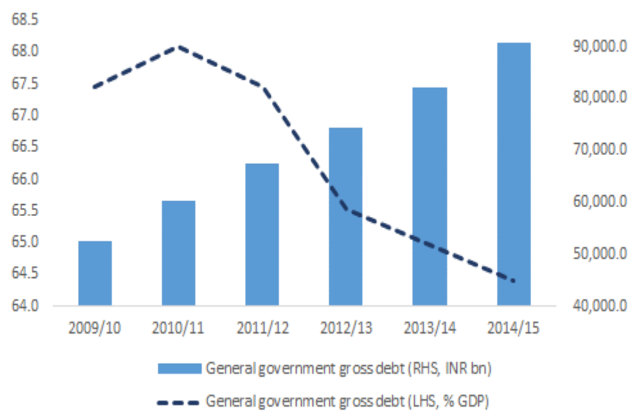
Persistent fiscal deficits and high government debt

One of the major problems facing the Indian economy is its persistent budget deficits. While India's average economic growth pace over the past two to three decades has been tremendous, there have been questions about its sustainability because of persistent fiscal deficits. Fiscal deficits have a number of adverse consequences that include increasing the risk of financial and economic crises. Fiscal consolidation is thus a policy priority of the Indian government.

In 2003, India adopted a rules-based fiscal framework, the Fiscal Responsibility and Budget Management (FRBM) Act. As a result, there was a sustained decline in the fiscal deficit. At the onset of the GFC, the FRBM Act was put in abeyance because it did not provide room for countercyclical fiscal policy. As the 2009 fiscal stimulus has been only partially unwound, India's fiscal space remains partially rebuilt. In FY2012/13 the Indian authorities amended the implementation rules for FRBM to re-establish a fiscal adjustment path.

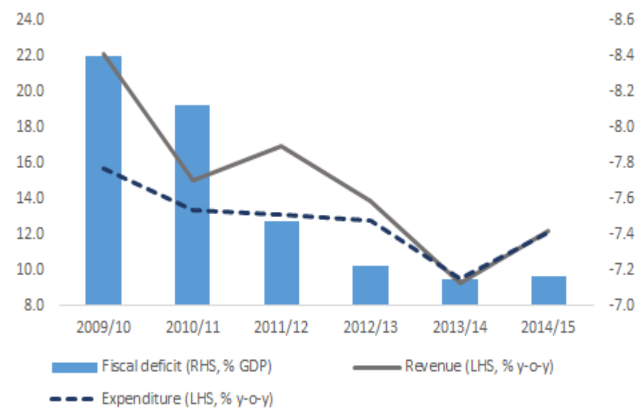
The results have been positive at the central government level. In FY2014/15, the central government achieved a fiscal deficit of 4.0% of GDP, an improvement from FY2010/11 when deficit was 6.4% of GDP. According to the new fiscal consolidation roadmap in Budget 2015-16, the central government fiscal deficit will be brought down to 3.9% of GDP in FY2015/16. At the general government level, however, where roughly half of the general government fiscal deficit is accounted for by state governments, the pace of fiscal consolidation has been slower. In FY2014/15, the general government fiscal deficit as a percentage of GDP stood at 7.2%, unchanged from the previous fiscal year.

Chart 7: General government gross debt



Source: IMF, MARC Economic Research

Chart 8: General government fiscal balance



Source: IMF, MARC Economic Research

In Budget 2015/16, the government prioritised growth over fiscal consolidation. It, however, seems committed to fiscal discipline going forward as the Budget contained measures aimed at improving public finances. For example, the budget reiterated on the introduction of the Goods and Services Tax (GST), which is expected to be rolled out by April 2016. The GST is aimed at widening the currently narrow tax base and offset slow revenue growth, a critical issue.

As a result of persistent fiscal deficits, India has one of the highest public debt as a percentage of GDP in the world. At end-FY2014/15, general government gross debt reached an estimated 64.4% of GDP. However, India's public sector debt is mostly domestic debt; at end-FY2014/15, public sector external debt stood at only 3.4% of GDP.

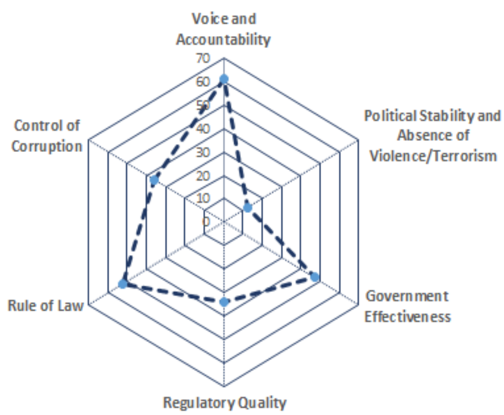
Going forward, India's public debt is expected to remain on a downward, albeit very gradual, path. It is anticipated to remain sustainable for the following reasons: a) relatively high nominal GDP growth; b) favourable maturity structure, currency composition and captive domestic investor base. As India's fiscal consolidation continues, the public debt-to-GDP ratio is expected to fall gradually further over the medium term. It, however, remains vulnerable to large negative growth shocks.

Weak institutions and an unfriendly business environment

India has weak institutions and an unfriendly business environment. The results of the World Bank's Worldwide Governance Indicators (WGI) project, which constructs aggregate indicators of six broad dimensions of governance, show that India is ranked generally low. It is also not surprising that in the World Bank's Ease of Doing Business 2015 report, India is ranked a lowly 142 out of 189 countries. And in the World Economic Forum's Global Competitiveness Report 2014–2015, India is ranked at number 71 out of 144 countries.

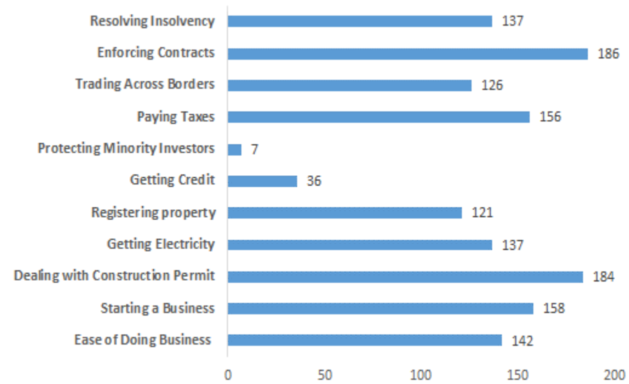
India's low ranking for infrastructure (87), one of the pillars of competitiveness in the Global Competitiveness Report, implies supply-side bottlenecks that have both short- and medium-term implications for economic growth. India's anaemic infrastructure development has been blamed on poor implementation. What this implies is that without improved governance, infrastructure development could likely remain anaemic; it also means that India's other structural problems could continue to threaten to overwhelm its future prospects if governance remains poor.

Chart 9: World Governance Indicators 2014



Source: World Bank
Note: Percentile ranking; higher is better

Chart 10: World Bank Ease of Doing Business 2015



Source: World Bank
Note: Ranking out of 189 countries; lower is better

In the May 2014 parliamentary elections, the Bharatiya Janata Party (BJP), for the first time ever, scored a landslide victory with an outright majority. The mandate to deliver reforms that many hope can resuscitate the Indian economy and deliver sustainable growth for the foreseeable future was the strongest in 30 years. Economic reforms that have been initiated by the new government include: a) the deregulation of diesel price; b) improving labour market flexibility; and c) enhancing financial inclusion.

There are, however, many other major reforms that need to be carried out and it remains to be seen whether Prime Minister Modi would be able to push through all of them. For example, the government faced a lot of hostility when it tried to push through Parliament a new land acquisition bill. The new bill will make it easier for industries and infrastructure firms to acquire land for new projects. If it does not become law, Modi's ambitious economic reforms agenda for India will be badly affected.

That Modi's popularity has waned somewhat has not helped; in the February Delhi assembly elections, the BJP suffered a major setback, inflicting a blow to Modi's image and the electoral mandate he received last year. According to conventional wisdom, politicians are more likely to initiate painful economic reforms early in their terms when they're most popular. Going forward, it is thus possible that the pace of structural reforms may slow down.

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