India

SEB GROUP COUNTRY RISK ANALYSIS | February 26, 2020

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A deeper than expected cyclical economic slowdown is a deviation from the country's historically high and stable growth rates. The government, being constrained by a rigid budget structure and high debt, has provided a measured policy response, leaving it to the central bank to stimulate the economy. The ailing banking sector is limiting credit growth while its vulnerability continues to weigh on country risk.

Country Risk Analysis

Summary and main conclusions

Following several years of relatively steady and high economic growth, the Indian economy is experiencing a slowdown that has become sharper than expected. Although external headwinds have contributed, weaker domestic demand has driven the slowdown. Any recovery back to the 7-8% real GDP growth rates seen previously is expected to take time.

The weak growth environment in tandem with tax cuts has put fiscal consolidation on hold. However, fiscal policy stimulus remains moderate, being limited by the authorities' fiscal rules. Government debt remains higher than average among country risk peers but most forecasts point to a gradual decline in the near-term. In the absence of fiscal support, monetary policy has been accommodative, including deep interest rate cuts and quantitative easing.

External balances remain fairly strong. Only a small share of government debt is denominated in foreign currency, and overall external debt as a share of GDP is moderate. In addition, international reserves have risen in the past year and are higher than average among peers.

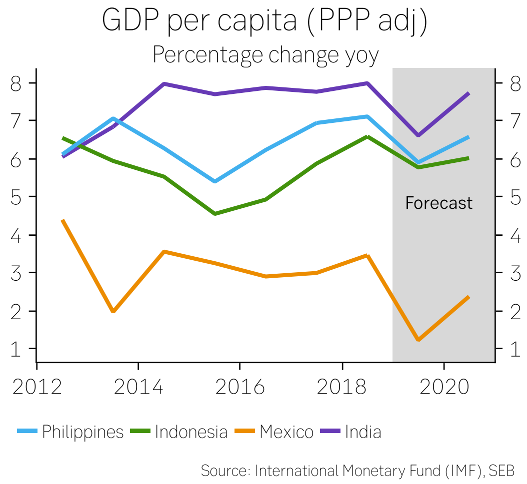
Following additional measures from the authorities to support the banking sector, including a new capital injection, aggregate vulnerability indicators have shown some stabilization. At the same time, weak bank balance sheets have led to credit growth slowing more than expected, dampening investment activity.

The BJP party secured a second period at the helm of the government. Some continued progress on structural reform has been made over the past year, although at a more incremental pace than during the first mandate period. A shift in policy focus towards social issues has raised the risk that issues involving religion and national identity may be taking precedence over economic matters.

Recent economic developments

Sharper than expected slowdown. The economic slowdown that started in mid-2018 has become sharper than expected causing downward revisions to growth forecasts recently. An important factor behind the slowdown has been the low pace of lending, in particular from non-bank financial companies (NBFC) as a result of their weak balance sheets. This has weighed on investment activity. Another factor is subdued household spending on the back of slower increases in incomes. Together with external headwinds, this development is expected to have reduced real GDP growth to just below 5% in 2019 (7.4% 2018) which would be the slowest pace since 2013.

Historically high growth has enabled some catching up in incomes, from low levels. The recent slowing of the economy is largely cyclical. Over a longer period, economic growth has been higher and more stable than most peers. This holds true also for GDP per capita, despite India's growing population. Over the past decade, annual growth in GDP per capita has been about 7.5% which is higher than average among peers. This is positive for country risk. At the same time the level of income per capita remains significantly lower than average among peers. This is a credit weakness. Broader indicators of human development are also weaker than among peers.



Inflation temporarily above target range. Inflation was moderate at 3.7% in 2019, despite a monsoon related supply distortion which made food prices jump at the end of the year. Although this has left headline inflation above the central bank's 2-6% target range recently, expectations are that these effects will abate towards the summer. Still, average headline inflation should edge up to 4.7% in 2020. Meanwhile, steady core inflation indicates limited broader price pressures which should be expected given ample spare capacity in the economy.

Current account deficit decreases, helped by lower imports. India imports roughly 80% of its oil needs which means that oil imports normally stand for a significant part (30-40%) of the country's total import bill. Over the past year, moderate oil prices and sluggish overall imports are expected to have lowered the trade gap and helped reduce the current account deficit to about 1% of GDP. The deficit has been financed by foreign direct investment (FDI), which have been broadly stable at moderate levels, and by remittances.

Low external debt, high reserves. Despite the small 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, and total external debt at about 19% of GDP is moderate. In addition, FX buffers are higher than average among peers. Stable FDI inflows, and a central bank wanting to limit exchange rate appreciation, have helped increase reserves to more than USD 470 bn by early 2020, the equivalence of about 8 months of prospective imports. India has a clean debt repayment record, contrary to many of its country risk peers.

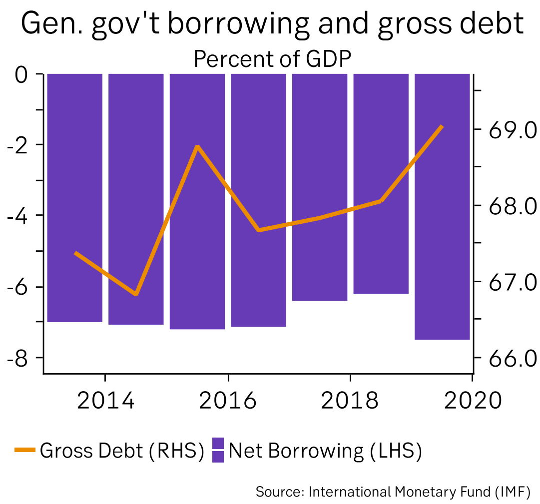
Economic policies

Slower growth delays fiscal consolidation. Government balances in deep negative territory has been a feature of the Indian economy for many years. In fact, over the past 10 years, the general government deficit has been 7.4% of GDP on average. In the current fiscal year (FY, ending in March 2020) the authorities have had to halt efforts to consolidate government finances and settle for aiming at a *central* government deficit of 3.8% of GDP. Including deficits on the state level, this is likely to yield a general government deficit of well above 7% of GDP which would be higher than the previous year.

Lower corporate taxes: Short-term negative, long-term positive. A key reason (beyond slowing growth) for a higher deficit is a package of corporate tax reforms that was introduced in 2019. Reductions in the average corporate tax rate from 30% to 22% was generally seen as positive for improving competitiveness over the medium term. However, the government estimates a negative impact on revenues equivalent to 0.7% of GDP.

Room for fiscal manoeuvre is limited. The lower taxes were said not to be met by expenditure cuts or other revenue generating measures. Indeed, expenditure adjustments are challenging given the weak growth environment. In addition, even in a more benign environment, the fiscal policy framework is relatively inflexible as expenditures are structurally high, including on public wages and subsidies, and revenues are low due low incomes and a narrow tax base. Hence the room for manoeuvre is limited.

High government debt ratio is a key credit weakness. Persistent fiscal deficits have yielded a general government debt in the order of 67-69% of GDP in the past few years. This is higher than average among peers and one of India's main credit weaknesses. At the same time, there are factors that mitigate risks attached to the high debt ratio. First, the debt stock is mostly in local currency and held by domestic investors such as banks and the central bank, easily financed as domestic banks are required to place a significant share of the deposit funding in government bonds. This reduces roll-over risk. Second, average maturity is relatively long. Most analysts expect that the debt ratio has peaked and is set to gradually decline over the next few years. However, weaker economic growth may delay the decline. Indeed, the government's aim to reduce the debt ratio to below 60% of GDP by 2025 appears overly optimistic.

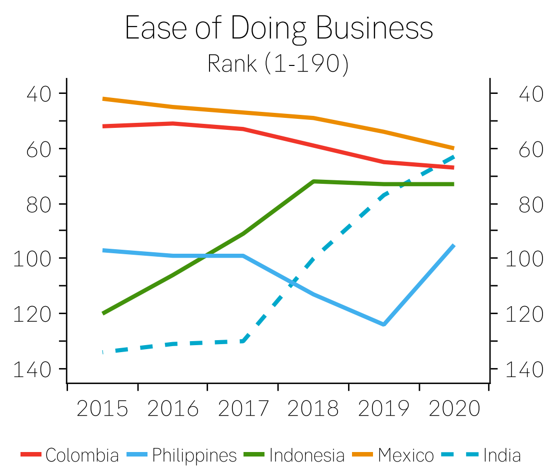


Still ailing banking sector reluctant to lend. Given the limited domestic bond market, banks remain a key channel for capital allocation in the economy. In the wake of the failure of one of the largest non-bank financial companies (NBFC) in late 2018, risk aversion in the banking sector rose and soon balance sheet problems appeared in several other institutions. The NBFCs at the time provided nearly one fifth of the lending to the private sector. As a consequence, bank lending growth has slowed significantly. Over the past year, the authorities have strengthened supervision over the NBFCs, broadened supervision to include other types of institutions, and are working to harmonize the regulations between banks and NBFCs. In the meantime, work to strengthen the broader banking sector has continued. A new round of recapitalization of banks was initiated in 2019, and a decision was taken to merge a number of public banks. Although positive in the medium-term, this consolidation process may cause some short-term disruptions to lending. On balance, aggregate vulnerability indicators reflect a continued decline in non-performing loans by mid-2019 and broadly stable capital adequacy ratios.

Monetary policy has been main policy lever to lift growth. Given the limited room for manoeuvre on the fiscal side, the authorities have mainly relied on monetary policy to stimulate the economy. A rate cutting cycle was initiated in early 2019 taking the policy rate from 6.5% to 5.15%. The acceleration in inflation to above the bank's inflation target range (4%+-2%) led to a pause in rate cuts in December but market expectations are for some further easing. Meanwhile, the central bank has initiated various unconventional measures aimed at strengthening the policy transmission mechanism as market lending rates had not declined in tandem with the policy rate. These measures and a local version of quantitative easing is slowly yielding positive results, thus making monetary policy more effective.

Structural and institutional developments

Reforms aimed at increasing investments and improving business climate. Over the past year, the government has continued to take steps, albeit perhaps more incremental than in previous years, on the structural front to improve growth prospects. Measures have included the further opening up for FDI, steps to consolidate the state-owned banks and changes to labour market laws introduced to parliament. A targeted effort by the authorities to improve the country's ranking in the World Bank's Ease of Doing Business indicators has led to continued gains over peers. India recently advanced to 63rd place of 190 countries.



Source: World Bank

Limited progress on governance and institutional qualities. Limited progress on other reforms often highlighted by observers as crucial, including on land acquisition and corruption, are reflected in poor scorings in subfactors of the Doing Business Index. Moreover, most of the World Bank's governance indicators have moved largely sideways over the past few years. In addition, India recently slipped to 68th place (of 141 countries) in the World Economic Forum's Global Competitiveness index rankings. While the organization ranks India relatively high on factors such as macroeconomic stability and on innovation, it lags on growth enabling factors such as product and labour market efficiency, and on health.

Data quality has been an issue for discussion. Controversy over the quality of GDP and labour statistics became heated last year when data yet again was revised. In addition, fiscal data is relatively opaque and the government have to an increasing extent been resorting to off-budget spending. The IMF has called for increased transparency but still considers the quality of macroeconomic data to be adequate for its surveillance.

One rating agency introduced negative outlook. In late 2019, one of the major rating agencies changed their sovereign rating outlook from stable to negative. The agency saw a rising risk of an entrenched growth slowdown and that this would reduce the likelihood of a decline in the sovereign's debt burden. They also argued that stress in the financial sector had increased. On balance these arguments would be valid also for our broader measure of country risk.

Political and security situation

Renewed mandate for Modi government followed by new political focus. Elections in early 2019 gave the BJP-led government a strong mandate to continue its reform agenda. However, a shift of focus towards social issues, in line with election campaign promises, has raised the risk that political issues involving religion and national identity may be taking precedence over economic matters. It also risks increasing inter-religious violence. Meanwhile, state elections in the past two years have led to the ousting of the BJP from several states. These developments have reduced the probability that the BJP and its coalition will gain a majority also in the Upper House in the near-term, although still the main scenario among most forecasters.

Kashmir region remains an important event risk. As regards the security environment, India's announcement last year that it changed the constitutional status of the state of Jammu & Kashmir (the part of the Kashmir region which it administers) is considered to have increased the risk of an escalation of the simmering geopolitical and military conflict between the two countries. The move also raised international critique.

Outlook

Very gradual economic recovery on the cards. The current slowdown is largely cyclical. Expansionary economic policies should support household spending and lead to a stabilization of economic activity in the near-term. Although it is uncertain when the recovery will take hold, our house forecasters Oxford Economics expect real GDP growth to edge up to 5.5% in 2020. As regards policies, the government in its recently released budget for next FY (starting in April) relaxed a previous target for the *central* government deficit to 3.5% of GDP while sticking to its medium-term target of 3%. Most observers believe this year's target could be overly optimistic, partly since it assumes significant privatization revenues. Indeed, it is not unlikely that general government balances will continue to register a deficit of well above 7% of GDP. On monetary policy, we assume some further rate cuts in the second half of 2020.

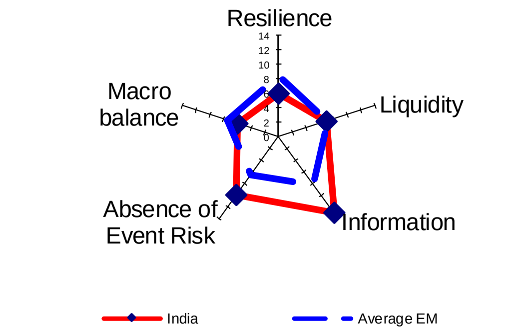
Medium-term growth prospects remain relatively favourable. Most estimates of India's potential GDP growth have edged down over the past few years. Nevertheless, expectations for longer-term growth of about 6.5% still compares favourably to most emerging market economies. Although there still is a significant infrastructure gap in the country, improvements have been made in the past few years, and the authorities show strong commitment. Meanwhile, India's long-standing demographic advantage with its growing population for yet two decades still stands. Well-known risks to this demographic dividend remain low labour force participation and poor access to education.

A rise in government debt is an important risk. With public finances being a key country risk weakness, a failure to reduce government debt would be one of the main risks going ahead. Higher fiscal deficits and higher debt/GDP could make it more difficult to roll-over maturing debt at a reasonable cost although India's domestic financing base mitigates the risk. Higher government borrowing could also crowd out lending to the private sector, and hence investments which are key to ramping up economic growth. Given the rigid budget structure, a favourable development in the debt/GDP ratio requires a favourable pace of economic growth.

Renewed concerns about health of banks could hamper credit and slow growth. Growth could be hit by, for example, sudden woes related to a major NBFC, such as a bankruptcy, which could have contagion effects in the banking system and lead to a liquidity shortage and tightening of credit supply.

External risks stemming from lower global trade and growth. Although India is a relatively closed economy, another risk to our main macro scenario is a more marked global slowdown. For example, a re-escalation of the trade war, hitting the Chinese economy could have adverse direct and indirect effects on India's economy. Furthermore, while India is less exposed than other countries in the region to spillover effects from the covid-19 outbreak in the form of tourism flows, there are signs that supply chain disruptions could be affecting certain import dependent industries. This might delay further the growth recovery. Another external risk is higher than expected oil prices which would likely produce higher deficits on the current account and drive up inflation.

Key ratios	**2020**
Population (millions)	1385
GDP/capita (USD)	2187
GDP (change)	5,5%
Inflation	4,7%
Current account balance/GDP	-1,1%
Reserves/imports (months)	8
Budget balance/GDP	-7,4%
Government debt/GDP	69%



External ratings:
Fitch: BBB-, Sta
Moodys: Baa2, Neg
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.

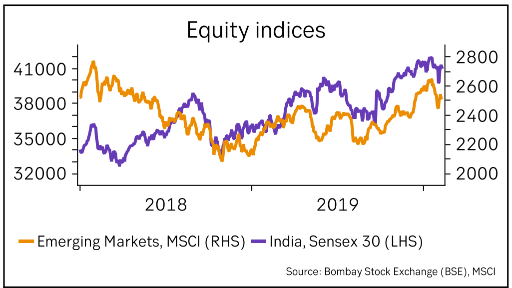
India: Key Economic Indicators

Macroeconomic	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
GDP (bn. USD)	2224	2553	2716	2833	3021	3353	3745	4135
GDP/capita (USD)	1677	1904	2006	2071	2187	2403	2659	2909
GDP (change)	8,7%	6,9%	7,4%	4,9%	5,5%	6,2%	6,4%	6,6%
Investments/GDP	31%	31%	33%	32%	31%	31%	31%	31%
Government Finances								
Budget balance/GDP*	-7,1%	-6,4%	-6,2%	-7,4%	-7,4%	-7,0%	-6,8%	-6,8%
Govt debt/GDP*	69%	69%	69%	70%	69%	68%	67%	66%
Money & Prices								
CPI inflation	5,0%	3,3%	4,0%	3,7%	4,7%	4,0%	4,4%	4,6%
Stock market index	26361	30923	35401	38371	41492	43375	43910	44955
Interest rates	7,2%	6,5%	7,3%	6,7%	5,5%	5,4%	5,4%	5,7%
Exchange rate (USD)	67,2	65,1	68,4	70,4	72,0	71,0	70,4	71,1
Trade/GDP	42%	40%	43%	42%	40%	39%	37%	35%
Oil price (Brent)	$52	$44	$54	$71	$63	$62	$62	$63
Balance of Payments (USD mn)								
Export of goods	436 876	462 217	511 139	528 509	548 257	582 649	621 808	663 108
Imports of goods	486 174	561 336	651 689	658 184	669 742	708 317	755 338	800 902
Other:	37 185	60 072	74 950	101 156	89 484	93 255	96 639	101 817
Current account	-12 113	-39 047	-65 600	-28 520	-32 002	-32 413	-36 891	-35 976
(% of GDP)	-0,5	-1,5	-2,4	-1,0	-1,1	-1,0	-1,0	-0,9
FDI	39 412	28 876	30 700	39 526	53 450	66 004	76 932	87 393
Trade balance	107 475	148 135	186 692	150 395	144 474	158 993	175 983	186 399
External Debt & Liquidity (USD bn)								
Reserves	340	389	374	432	440	487	536	576
months of imports	8	7	7	7	8	7	8	8
Total debt	456	513	521	573	616	658	701	748
o/w short term debt	84	98	104	113	121	128	136	145

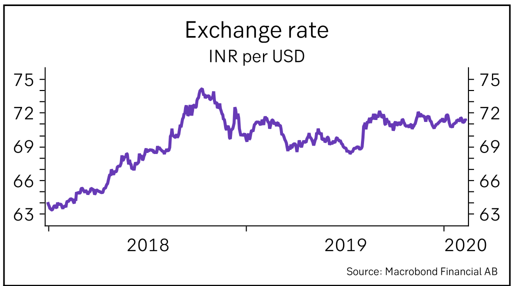
Sources: Oxford Economics, IMF and SEB estimates.
*)General government on-budget transactions, fiscal year

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

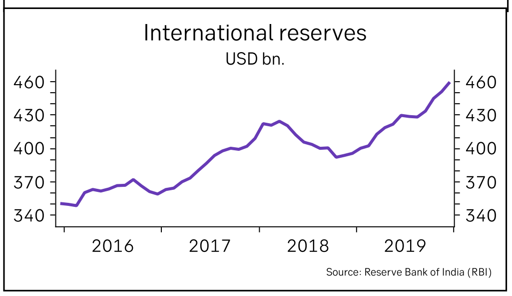
Type of government:	Parliamentary Democracy
Next elections	Legislative elections: 2024, Presidential elections: 2022
Other:	
Latest PC deal	None
Latest IMF arrangements	1993/SBA



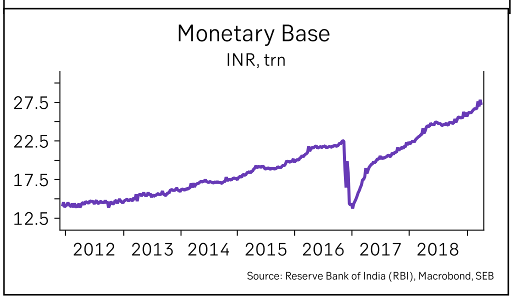
Source: Bombay Stock Exchange (BSE), MSCI



Source: Macrobond Financial AB



Source: Reserve Bank of India (RBI)



Source: Reserve Bank of India (RBI), Macrobond, SEB

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