Global Counsel

India Outlook

November 2014

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Executive summary

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- **The BJP won a big mandate and a comfortable majority in the lower house in the 2014 elections, but its success will depend on its ability to legislate and implement reforms.** This means working with the upper house, the states and the bureaucracy. In its first six months the government has been cautious, prioritising state elections and governance reform ahead of pushing the bold, liberalising and controversial policies many expected. Whether this patient, two-term strategy is shrewd politics remains to be seen. The risk is that support for the BJP starts to ebb and frustration grows, eating into the ample political space the government currently enjoys, before the most difficult reforms are pushed through.

- **The 2014 election and the Modi phenomenon signal a break from the caste-based identity politics that has long dominated.** The core of the BJP's new, expanded political base is the nearly 380m neo-middle class who are no longer poor but not yet financially secure. This young, mobile and aspiring constituency is willing to trade the security by the state for security by the market, but this can only be achieved if growth rates are high, creating good jobs and new opportunities, so this is how PM Modi and his government will be judged.

- **The new finance minister Arun Jaitley says 8-9% growth is achievable, but only if all of the states are on board.** The BJP writ only runs to seven of the 29 states, at least for now, and many are fiercely independent and have quite different political traditions from the BJP centres of power. The Modi strategy of encouraging competition in reforms among the states is shrewd as it creates a license to innovate and will put political pressure on laggards to follow the leaders, which will be essential if India is to reach her full growth potential. It also allows the government to conserve its political capital for deployment at the centre when it is most needed.

- **Perhaps the most important test for the government is Goods and Services Tax (GST) reform.** This is essential to create a single Indian market. Success will be transformative for domestic and foreign investment, which will be driven by economics rather than the need to avoid the bureaucratic and logistical constraints that are manifest under the current system. This is necessary for the success of the 'Make in India' campaign, which aims to increase manufacturing. We judge that for the first time the political space for GST reform has opened up under this government, allowing it to proceed, even if not every state will be on board initially, although competition between them means that all eventually will.

- **The immediate prospects for growth depend on whether the government can reinvigorate investment, which has stalled over the past two years.** This depends on investor confidence – buoyed by the decisive election result – and a number of monetary, fiscal and financial policy choices, which are likely to be difficult and controversial.

- **We see a battle brewing over monetary policy.** In one corner the Reserve Bank of India (RBI) is seeking to introduce a new inflation-targeting framework and bring down embedded inflation expectations. In the other both government and industry want looser policy to ease credit conditions. We expect a compromise, with modest easing in return for government support for the new monetary policy framework. This may improve credibility over time, but at the expense of increasing susceptibility to monetary shocks.

Executive summary (contd.)

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- **The current model for financing infrastructure investment is broken and it is unclear how this will be fixed given the multiple constraints on the policy space of the government.** The government may have unrealistic expectations about its ability to free up fiscal space by administrative reforms and by using technology to increase the efficiency of spending. The BJP government, like its predecessor and much of the professional class in India, has a deep-rooted antipathy towards privatisation, so we expect only partial divestments of government stakes in selected industries. The role played by private sector infrastructure sponsors may change, but we don't expect substantial haircuts to be imposed by the government on those behind stalled projects. We may see some governance reform at the public banks, but not radical financial restructuring. The public banks will remain important for infrastructure finance, but weak balance sheets will inevitably constrain their ability to provide this on the required scale.

- **The Indian authorities have reduced external vulnerabilities by shrinking the current account deficit and by increasing the share of FDI in external financing.** This has been helped by falling oil prices, which have pushed down the energy import bill. The government support for FDI is strong, but qualified. We expect the Insurance Bill to pass and there are clear signs that the government wants to increase the predictability of tax treatment and reduce the tax burden for foreign investors. However, we judge the centre will not push for liberalisation of multi-brand retail and will instead leave this to the states to decide, in large part because small retailers are a core political constituency for the BJP.

- **The window for structural reforms is likely to open after the budget at the end of February 2015.** The twelve months that follow will be critical in determining whether the government has the policy space and the political space to pursue ambitious reforms.

- **The most ambitious reforms are to power generation, but this is also where the implementation challenge will be greatest**. The government wants to quadruple coal output, increase renewables, improve energy efficiency, fix problems with tariffs and expand the distribution network, all with a view to India being a surplus country in power generation by 2019. The gap between these goals and what is feasible is likely to be large and may mean the government is distracted from important practicable reforms. The best could well be the enemy of the good.

- **Labour reforms are likely to be patchy as the centre will rely on the more liberalising states to take a lead**. This approach will only work if vanguard states like Rajasthan are seen to produce substantial economic gains. Even then it is likely to take time before these gains are evident. This means reform is likely to be piecemeal. Strategic investors will want to understand and anticipate this before making location decisions.

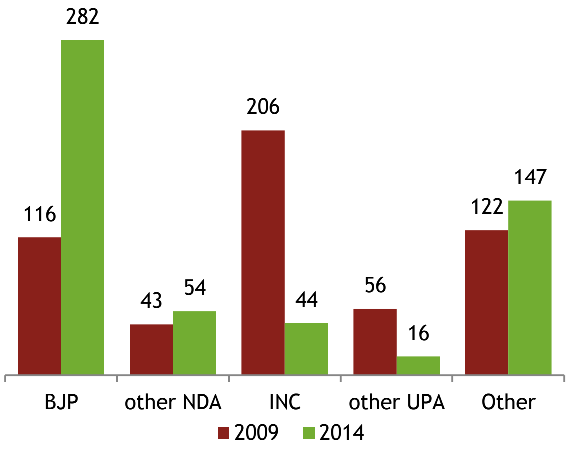
- **The government appears determined to dilute the Land Acquisition Act, which is essential for the 'Make in India' campaign**. We expect to see progress on this, although businesses should expect to pay substantially more in terms of compensation in return.

Part 1: political prospects

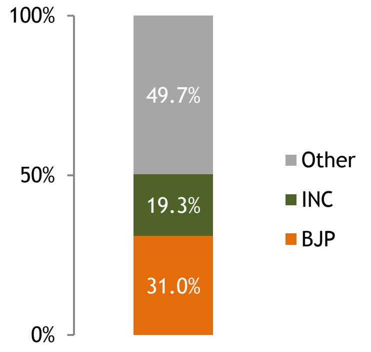
A new government with a big mandate

- **In the 2014 general elections the BJP won 31% of the vote and 282 out of 542 parliamentary seats.** The scale of the landslide was so large that the Indian National Congress was left with a rump of 44 seats. As no other party gained more than 10% of the seats, the lower house has no 'official opposition'.
- **The BJP ran in the election as part of the National Democrat Alliance with a number of regional and other parties.** The BJP has, however, a majority of parliamentary seats. This is the first single-party majority since 1984, which means the party can govern on its own if necessary. This gives the BJP an almost unprecedented amount of power.
- **The success of the BJP's reform agenda will, however, be determined by their ability to legislate.** The role of the Rajya Sabha, the upper house, cannot be overlooked. It has equal powers to the lower house in all areas except finance, and can only be overridden by a joint sitting of the two houses, where the Lok Sabha, the lower house, dominates numerically. This has only occurred three times, the last in 2002 under the previous BJP government, but Modi will take this course if necessary. Some reforms – specifically GST - require constitutional change. This requires the support of two-thirds of both houses of parliament, plus at least 15 out of 29 states.
- **Modi's coalition holds less than a quarter of the seats in the Rajya Sabha**. Regional parties and Congress continue to wield influence there. The upper house is indirectly elected, with members appointed by the state legislatures elected every six years. This means that state assembly elections over the BJP's first term in office will be critical in determining the political space available to the government to implement reform.

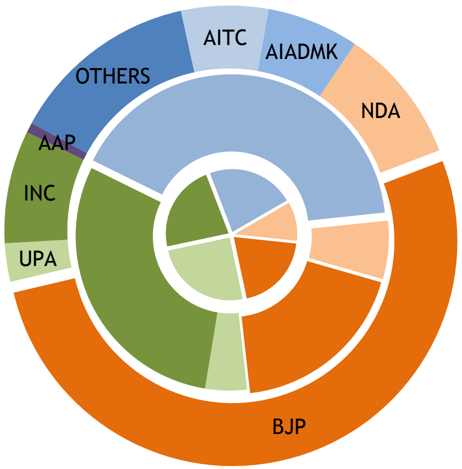
The BJP won a majority of seats in the lower house …



… on a 31% vote share …



… and controls only a minority of states and seats in the upper house



Share of seats or state ministers in:
- the lower house (outer ring)
- the upper house (middle ring)
- the states (inner circle)

The cabinet and key political figures

- **Unlike previous governments, the Modi cabinet is mostly made up of ministers from a single party, the BJP**. This reduces the need for inter-party negotiations and has allowed Modi to scrap a number of cabinet committees. This also reflects the trust that Modi has in his ministers to run their briefs independently and the level of unity within the BJP.

- **Modi is very dependent on both Arun Jaitley and Amit Shah. The three of them together are the key decision makers in government**. Other influential ministers include Rajnath Singh in home affairs who is a former President of the BJP and the new Defence Secretary, Radha Krishna Mathur, who is a former chief minister of Goa.

- **The cabinet reshuffle in early November showed that Modi has little patience with ministers who appear unwilling to pursue ambitious reforms**. The increase in the number of ministers was a surprise as Modi was critical of the large cabinet under the previous government. This was partly to take the pressure off the ministers running the top departments, such as Jaitley, who originally had responsibility for defence as well as finance. It has also partly to do with ensuring regional balance in the cabinet, particularly as the PM has an eye on winning the upcoming state elections.

- **The Modi team is different from the previous government with many senior figures coming from outside of Delhi**. A number of senior officials working in the Prime Minister's Office (PMO) previously worked for Modi in Gujarat. Both the PMO and the Finance Ministry play a bigger coordinating role in government. There has been a perceptible change in the language of Indian politics, with much greater use of Hindi.

Power figures in the new Indian government

Arun Jaitley
Minister of Finance

Amit Shah
President of the BJP

Others to watch in the Indian system

Rajnath Singh
Minister of Home Affairs

Radha Krishna Mathur
Defence Secretary

Smriti Irani
Minister of Human Resource Development

Nitin Gadkari
Minister of Road Transport and Highways

Nirmala Sitharaman
Minister of Industry and Commerce

Arvind Subramanian
Economic advisor to Modi

Piyus Goyal
Minister of Power and Energy

Raghuram Rajan
Governor of the Reserve Bank of India

Sushma Swaraj
Minister of External Affairs

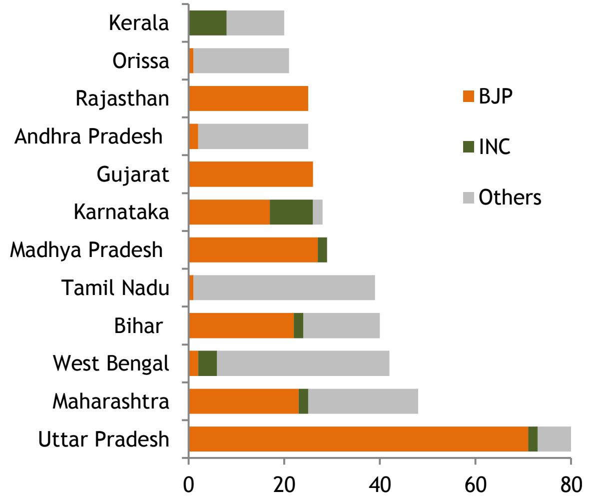
Amitabh Kant
Secretary, Department of Industrial Policy

The BJP political base

- **The BJP managed to broaden is support from its traditional base in the election.** They were able to attract votes from groups that had previously shunned the BJP, such as the Muslim community, with the BJP winning 45 out of 87 seats with the highest concentrations of Muslim voters. The BJP was also able to cut across caste lines and attract aspirational voters from the lower and middle-classes. Their supporters include many of the 150m first-time voters. The BJP's support among 18-22 year olds was 5 points higher than the average across other age groups. The Modi brand is based on clean politics, good governance, and a break from the dynastic politics of the past.
- **This broad appeal allowed the BJP to win many Congress strongholds, both in rural and urban areas.** In Delhi, where Congress previously held all seven constituencies, the BJP won 46% of the vote and achieved a clean sweep. Modi's success extended to many parts of the country, but the BJP did less well in the South and the East where regional parties still dominate. The BJP has almost no MPs in states like West Bengal and Tamil Nadu, which alone have a population of over 162m.
- **The BJP's support is strongest among a demographic that has benefited most from economic liberalisation in recent years**. It has been able to do so by tapping into their aspiration and desire for mobility, while Congress concentrated on expanding welfare for the unemployed and the most deprived. Modi was particularly able to connect what he calls the 'neo middle classes'. These are people who are no longer poor but not yet securely in the middle class and who in 2010 accounted for 380 million of the population, up from 220 million in 2001. The 'neo middle class' want government to help them help themselves. They say they trust Modi. He will now have to deliver.

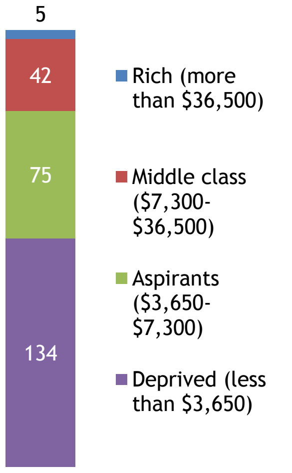
State level vote shares

Number of seats in 2014 general elections in 12 largest states



Indian households by income

millions



Source: Election Commission of India, People Research on India's Consumer Economy

Indian voter perceptions on the eve of the election

Source: Pew, April 2014

The centre and the states

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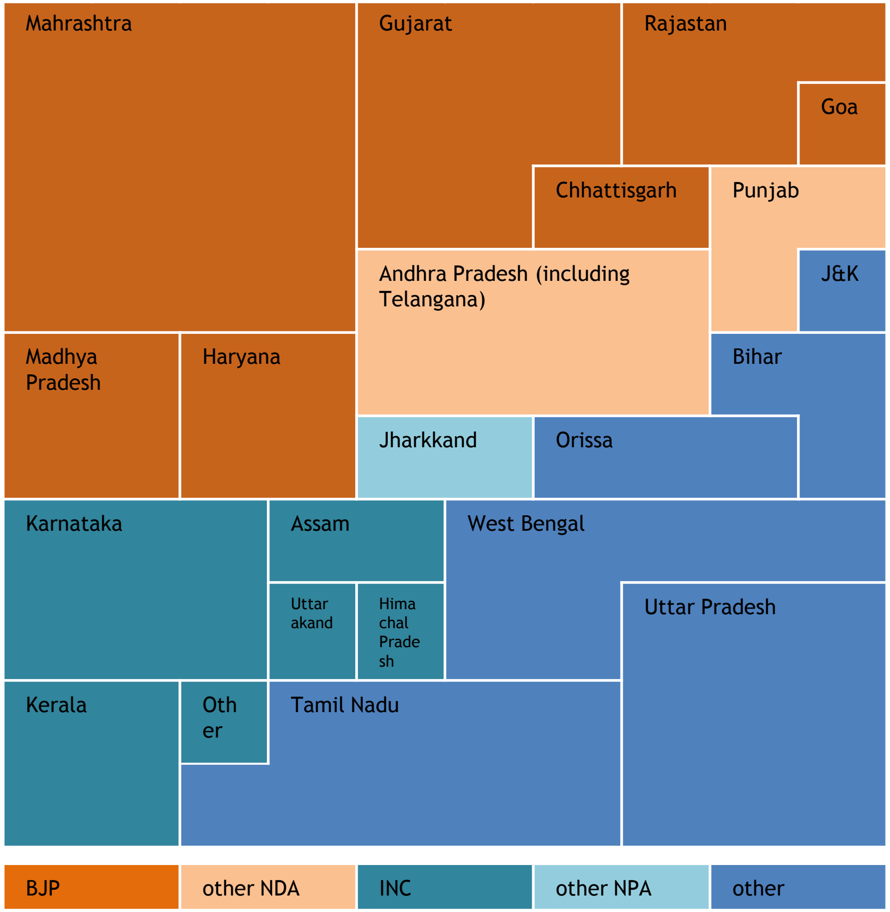
- **India's states are powerful and can help or hinder reforms by the centre.** Each of the 29 states is responsible for policing, transport, healthcare, electricity and other policy areas. They can impose sales taxes and other local taxes.
- **The BJP now controls seven of the 29 states following convincing wins in Maharashtra and Haryana in October.** These are among the most economically powerful states and together account for 40% of Indian GDP, while states governed by the BJP's coalition partners add another 12% of GDP. States controlled by unaligned local parties collectively accounting for almost a third of GDP.
- **The BJP has ambitions to break into these states**. The next elections are later this month in Jharkhand and Jammu and Kashmir. The BJP is expected to do well. There will be an election in the 'Union Territory' of Delhi at the start of next year, but no more state elections until Bihar in November 2015.
- **The states wield a large amount of political and economic power and will flex their muscles in the GST negotiations.** Tamil Nadu, the second largest state by GDP, has been the strongest opponent of GST reform. On average, indirect taxes make up 80% of state revenues, compared to 45% for central government. The states will seek exemptions to GST, while demanding compensation for lost revenue. Modi risks defeating the purpose of GST reform if too many exemptions are granted or too many states opt out.
- **The states also play an important role in structural reforms**. In some cases this involves implementing reforms driven by the centre. In other policy areas the centre encourages competition between the states in order to drive reforms.

Who controls India's state?

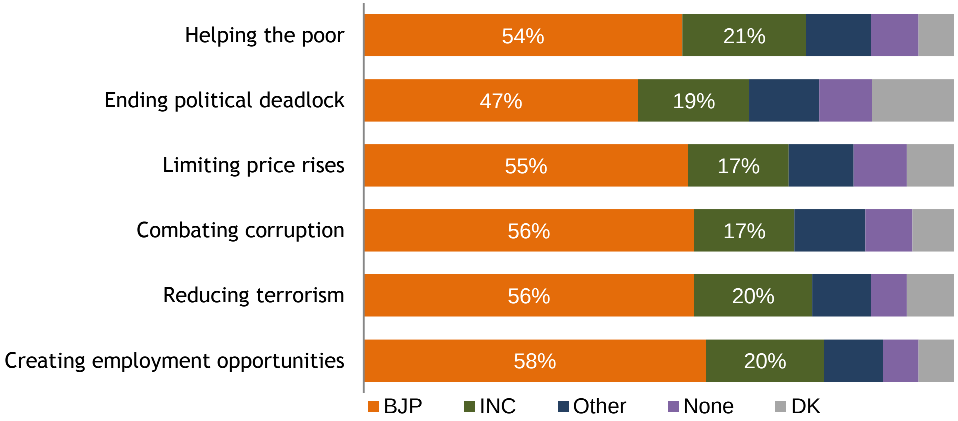
The area of each state reflects their share of total Indian GDP. Only states with a share of GDP exceeding 0.5% are shown



The Modi agenda

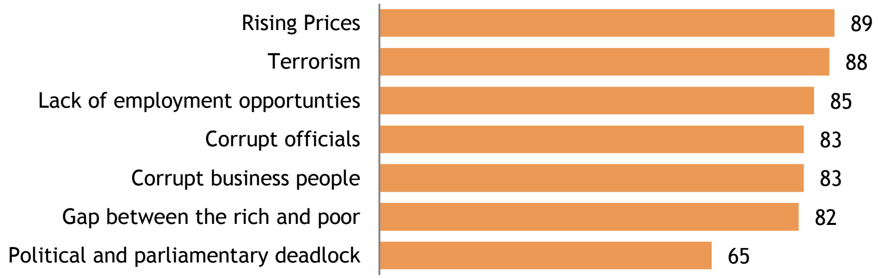
- **Modi is a reflection of a new type of politics driven by broader changes in society.** The BJP says the election has brought an end to identity politics based on caste and family, which has dominated since 1991. 70% of the Indian population is under 30. They care about jobs and opportunities. They are low on patience and high in expectation.
- **The BJP won the election because it was most trusted on all issues to do a better job than the opposition**. The list of problems that needs addressing by the new government is dauntingly long. The BJP's large mandate means that it now faces the challenge of meeting Indians' high expectations.
- **The opposition Congress Party is in a mess and unclear what it stands for.** They are still focused on what many regard as the old agenda of subsidies and social support. The BJP does not neglect this, but it is not their core agenda. Jaitley says he does not see any 'serious political opposition' to the government for now.
- **The focus of the BJP election campaign was on good governance and this is one area where they must make an early impact.** There is a tension between transparency and accountability, on the one hand, and prompt decision making. Civil servants are reluctant to issue approvals for fear they will be exposed later to allegations of corruption. This has been reinforced by a Modi requirement for decisions to be taken in writing. Jaitley believes the government must protect honest decision takers. He says public officials are 'dribbling out' decisions; turning on the taps will require sustained pressure from the top.

The popularity of the BJP extends across policy areas



The new government has many challenges to address

% of respondents who say this is a very big problem



Most still believe globalisation is good for India

Source: Pew, IPSOS Mori

Defining political issues

Can the government pass landmark legislative reforms such as GST?	The next 18 months will be critical in shaping expectations. The window during which we should expect to see momentum building for reform is the twelve months from February following the budget. GST is not the earliest test, but it is one of the most important.
Will the states help or hinder the reform agenda driven by the centre?	We are starting to see genuine competition between states vying to gain a competitiveness advantage under pressure from electorates that wonder why their state is not higher up the growth table. Vested interests in many states, however, remain a major barrier. GST and labour reform will both be revealing.
Can the bureaucracy become an agent for policy implementation or remain paralysed?	An important measure of the government is its ability to unblock infrastructure projects. Early signals matter for confidence. This requires actions by the centre and in the states. The government must balance transparency and its anti-corruption effort with ensuring decisions are taken.
Will we see a decisive break from subsidy politics to growth politics?	Poor Indians remain a large and important political constituency. The BJP says it is attentive to the concerns of the poor but prioritizes policies to help the young, mobile majority meet aspirations for higher living standards through growth. It is unclear whether this will last as the winners and losers from reforms emerge.
Can the government turn a political honeymoon into a sustained surge in political support?	The Modi team has a two-term strategy. They want to build support at state level and reform the bureaucracy. They say this is necessary to implement their full reform programme. Critics say the government is moving slowly and squandering political capital. Much depends on whether the opposition can successfully regroup.
How well will the government handle the political crisis that will inevitably strike?	The question for Modi is not whether there will be problems or crises, but how his government handles them. So far the government has benefited from tailwinds, such as falling oil prices. We have yet to see how the government responds to a crisis and whether it can stay the course when political conditions worsen.

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Part 2: economic prospects

Reinvigorating Indian growth

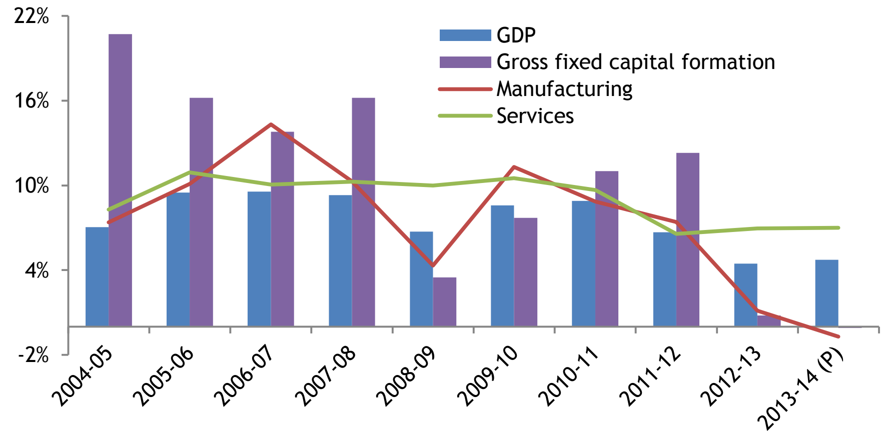
- **The IMF expects growth of 5.6% this year, rising to 6.4% next year and perhaps somewhat higher after that.** This is good, but not a return to the 8% rates seen a few years ago. Moreover, the recovery is not yet secure. While business and consumer confidence has improved since the elections the PMIs in both manufacturing and services have fallen since the summer, with services now at just 50. Moreover, growth in the third quarter was just 5.3%, down from a rate of 5.7% in the previous quarter

- **Investment has been a major driver of growth in India for many years.** Growth in investment has far exceeded GDP growth in most of the past decade, but stalled in 2012 and 2013. Several factors have been blamed for this including policy uncertainty, the business environment, delays in getting government approvals, supply bottlenecks, and falling investor confidence. Indian policymakers are in no doubt that restarting investment is the key to restoring high growth rates. But this in turn depends on policy in several areas, where the government must reconcile competing policy objectives.

- **Manufacturing growth has been a particular source of weakness, averaging below 1% since the start of 2012.** Addressing this is important politically, as 'Make in India' is a priority for the new government. It requires progress on many structural reforms as well as restarting investment.

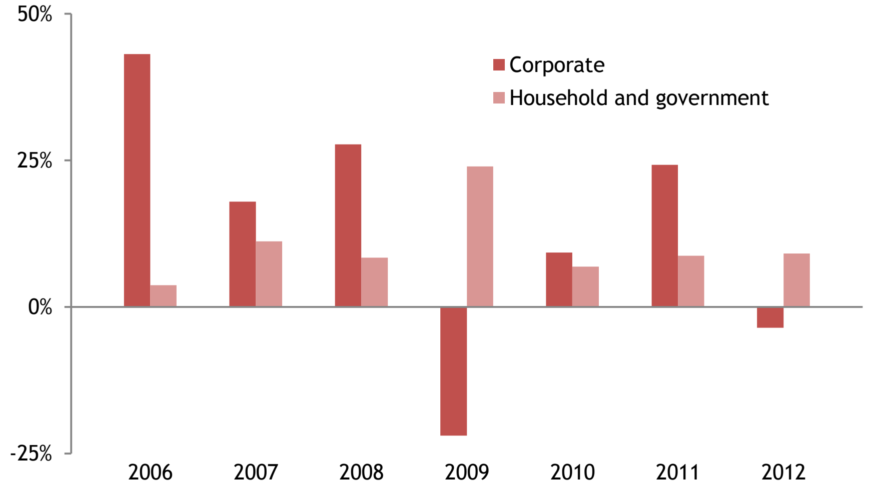
- **There is a big problem from the stark regional disparities in growth and investment.** In the nine years to 2013-14 Uttar Pradesh saw a CAGR of 6.7% while for Bihar it was 9.7% and Delhi 10%. India will only be able to realise its full growth potential if all of the states are economically vibrant. There are deep rooted reasons why some states perform worse than others. Structural reforms at the centre must be supported by state reforms.

Growth has slowed sharply, particularly in manufacturing



Source: Planning Commission

Corporate investment has been particularly volatile



Source: Confederation of Indian Industry

Monetary policy: inflation easing, but will policy?

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- **Inflationary pressures are high but are easing**. Consumer price inflation has fallen to 5.5%, down from above 10% one year ago, but still above the average of 4.6% from 2000 to 2007. Wholesale price inflation, which excludes services, has fallen sharply over the past few months, down from 5.2% in August, to 1.8%.

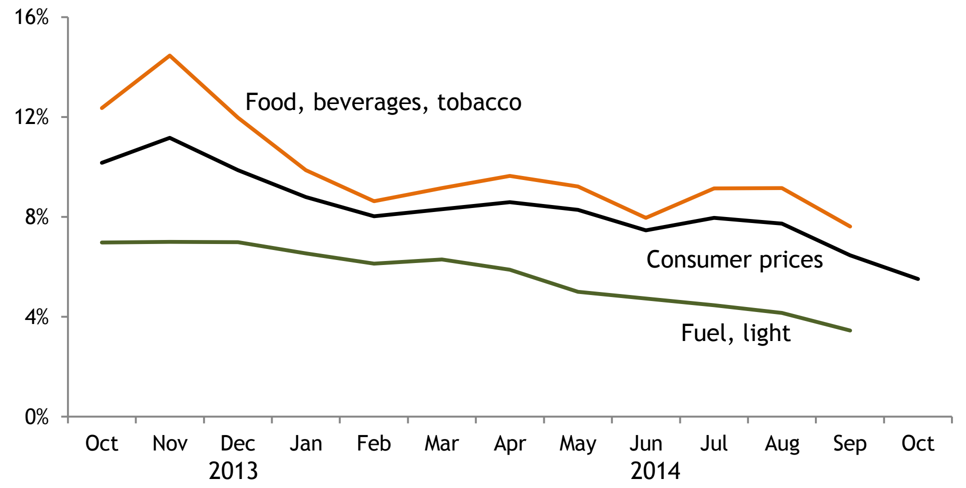
- **Food and fuel together account for 57% of the CPI, but there is little the RBI can do to influence these**. Lower oil prices are pushing down fuel inflation. The weak monsoon saw cumulative rainfall in the year to August 18% below normal, but this does not yet appear to be adding to food price inflation.

- **The authorities raised interest rates in 2013 in response to external pressures impacting on capital flows**. This was done through liquidity tightening measures rather than increases in the repo rate. This policy was unwound later in the year as external pressures abated. The RBI argues liquidity measures have a faster impact on monetary conditions than adjustment of the repo rate and they can be reversed more quickly.

- **The RBI raised the repo rate by 75 basis points in January and has since held these at 8%.**The RBI has also eased reserve norms to allow banks to increase credit. Control of the repo rate is the preferred tool for combatting inflation, although some question whether it is the most effective.

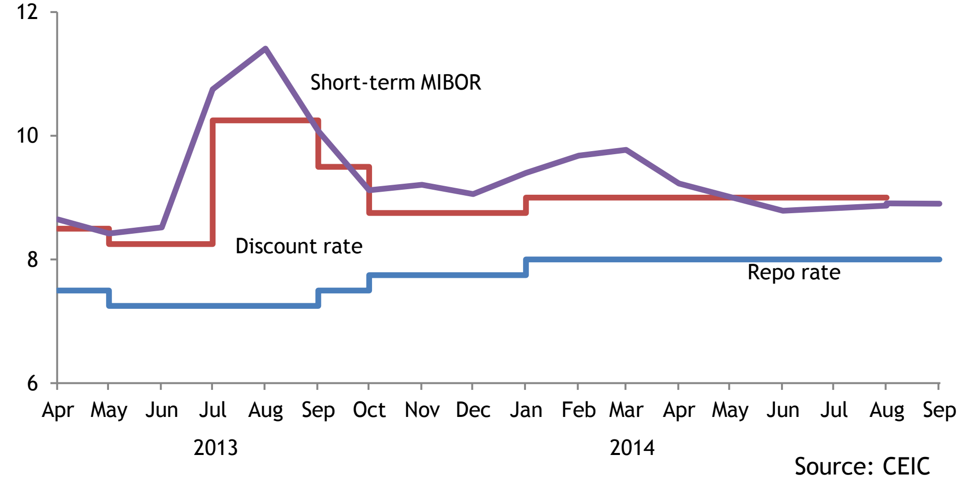
- **High inflation expectations is a sign that inflation remains engrained and may be difficult to address**. Surveys suggest inflation expectations are still above 12%. The IMF has argued that high policy rates are required to address this, which will impact on growth. The authorities have been more cautious due to uncertain transmission of monetary policy.

Inflation has been falling since the end of last year



Source: CEIC

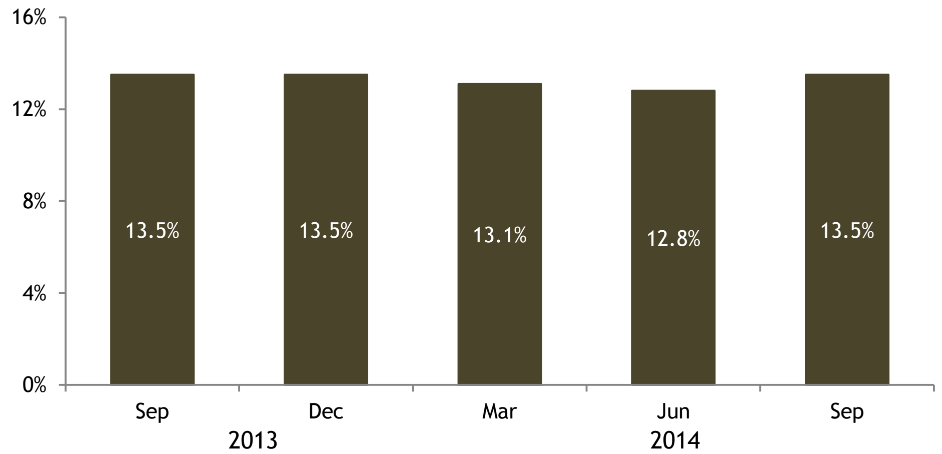
Policy rates remain relatively high



Source: CEIC

Monetary policy: an institutional crossroads

Inflation expectations remain stubbornly high
Mean survey expectations 12m from survey date



Source: Reserve Bank of India

Core recommendations of the Patel Committee

Objective	Governance	Instruments
Headline CPI as the new nominal anchor	Policy set by a five-person MPC, chaired by the Governor and with two externals	Transition towards the 14-day term repo as a new "policy rate"
Policy centred on the nominal anchor while consistent with sustainable growth and financial stability	MPC ordinarily to meet every two month with inflation report produced every six months	Other instruments such as a standing deposit facility introduced to support the framework
Transition to a new target rate for CPI of 4% +/- 2% over a two year horizon	Publically accountable for meeting target	

Source: Reserve Bank of India

- **The monetary stance of the RBI is coming under pressure from both the government and industry.** They argue that inflation is falling and the main pressure comes from food prices, which monetary policy can do little to address. They also note that falling fuel prices are easing inflationary pressure. Industry is particularly concerned that real interest rates at 6-7% are too high and note there has been a considerable slowdown in credit growth to just 6% in manufacturing last year.

- **The public relationship between Rajan and Jaitley is better than it was with Chidambaram, but there are still big policy differences.** The RBI is concerned that the full impact of the weak monsoon on food prices will not be clear until the end of the year and worries about engrained inflation expectations. Rajan and the RBI therefore face difficult choices. They are under political pressure to loosen policy. The recent data supports a move in this direction. But equally they will be concerned about the impact a premature loosening could have on their credibility. What Rajan does in the coming months will reveal much about the extent of the RBI's independence and how the RBI trades off short and long-term considerations.

- **The credibility of Indian monetary policy will also be influenced by the response to the Patel Committee on the monetary policy framework.** The RBI is informally implementing the recommendations of the report, published earlier this year, which essentially means inflation targeting without ignoring the exchange rate. The RBI has a tough job communicating its resolve to control inflation unless this framework is formalised and a Monetary Policy Committee with a clear set of objectives established. The Finance Ministry has yet to decide its response and may be wary about ceding too much political control.

Fiscal policy: early pressures

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- **The central budget deficit in FY13/14 was 4.6%, 0.2% ahead of target and 0.2% better than the year before.** Subsidy spending was 2.3%, compared with a budget of 2%, with the difference largely due to higher oil subsidies. Falling global oil prices and an increase in the domestic diesel price will contain this pressure.

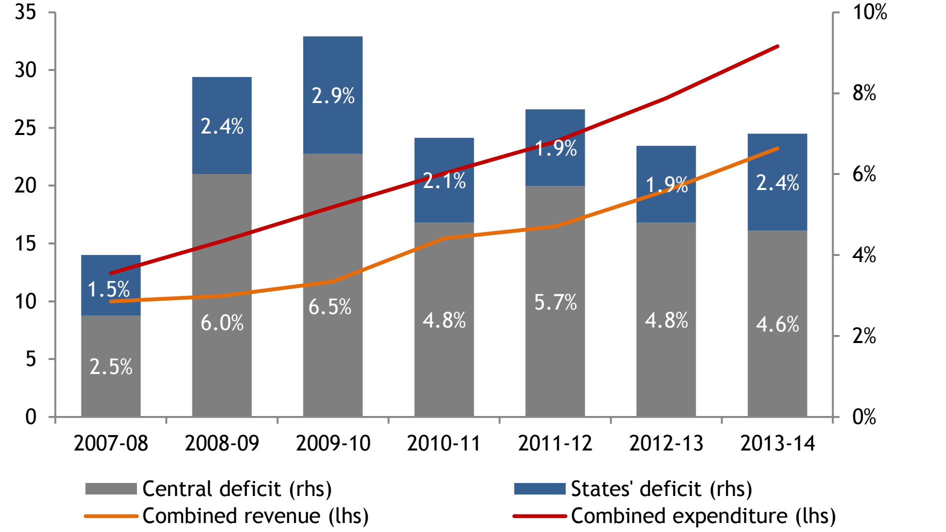
- **Six months into the fiscal year the government has already reached 83% of the deficit target for the year of 4.1% of GDP.** Revenues have increased 7%, well below budgeted growth of 19%. Expenditure has risen by 30%, compared with 13% in the budget.

- **The new government does not really believe in privatisation.** There is limited appetite due to a big-state Nehruvian culture that remains embedded even among the professional elite. The £6.3bn target for revenues from divestment of public companies has not been achieved. Instead the government says it will drive governance reforms to make public bodies profitable.

- **The government recognises it must improve tax collection rates and streamline processes.** The narrow tax base is a problem, with only 44m Indians paying direct taxes. This puts more pressure on corporate taxation, and is one reason why foreign investors sometimes find they are the subject of unexpected tax rulings, particularly towards the fiscal year end.

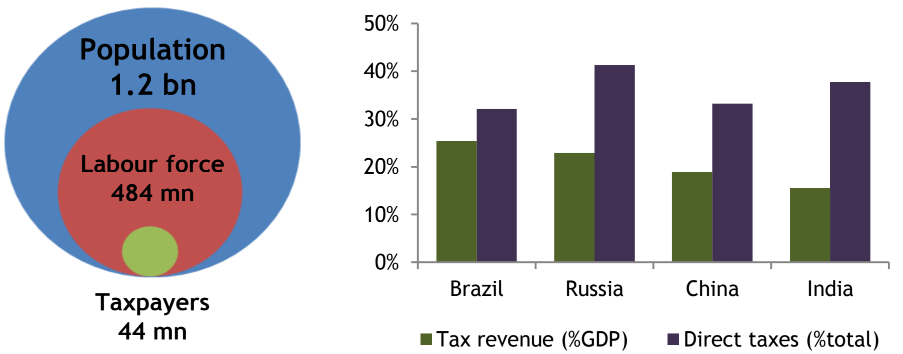
- **Subsidy reform is one of the more challenging areas, but Jaitley says the government will "go for it".** They have already deregulated diesel prices, raised administered gas prices and say they will raise duties on crude and petroleum products, taking advantage of lower global oil prices. This will improve the fiscal position and provide a buffer should oil prices subsequently rise.

Government finances remain a source of weakness



Source: Reserve Bank of India, Finance Ministry

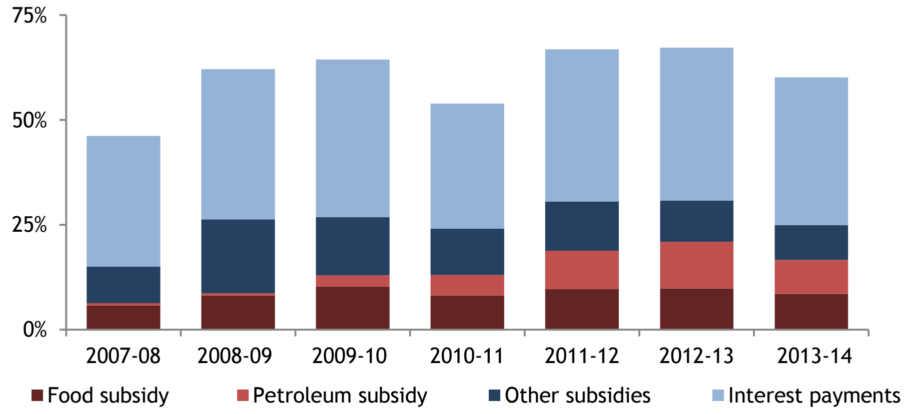
The Indian tax base is narrow and regressive



Source: World Bank, Centre for Government and Budget Accountability

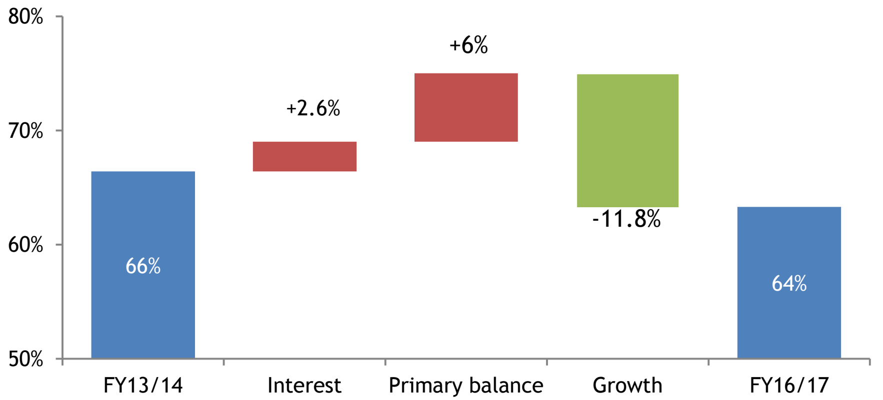
Fiscal policy: familiar challenges

Subsidy and interest payments reduce fiscal space
Payments as a percent of total government revenues



Source: Finance Ministry

Growth is important for India's debt sustainability
Decomposition of general government debt change (% GDP)



Source: World Bank

- **The government made a clear political commitment in the July budget to bring down the deficit.** This matters for macroeconomic credibility and to help contain inflation. It is also essential if the government is to create the fiscal space for infrastructure investment.

- **The final quarter of the fiscal year is crucial in determining budget outcomes.** The bureaucracy is adept at squeezing additional fiscal revenues towards the year end, but must avoid damaging investor and corporate confidence.

- **A durable reduction in fiscal pressure will require much broader subsidy reform.** This in turn depends on success in the financial inclusion agenda and Unique Identification initiative, so that payments can be made directly into accounts and "leakage" from corruption reduced. This is hugely ambitious and the expectations of the government may prove to be unrealistic, given the IT challenges alone.

- **The government has asked an Expert Committee to identify ways in which the costs of implementing policy can be cut.** This group will produce interim recommendations in time for the February budget. The credibility of those recommendations and the willingness of the government to adopt them will signal how much additional fiscal policy space can be made available through administrative reforms.

- **The need for fiscal consolidation will constrain the policy space to stimulate demand.** Lower oil prices should help to ease fiscal pressures. Progress in fiscal consolidation would help dampen inflation and create monetary policy space. It could also help crowd in investment.

Financial sector: leaning on the public banks

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- **Bank asset quality has been deteriorating but may have plateaued.** Non-performing loans were at 4.2% at the start of the year with restructured loans at 5.7%, implying a total of 10% of loans that are stressed. Loss-making firms owed 17% of debt in FY12/13.

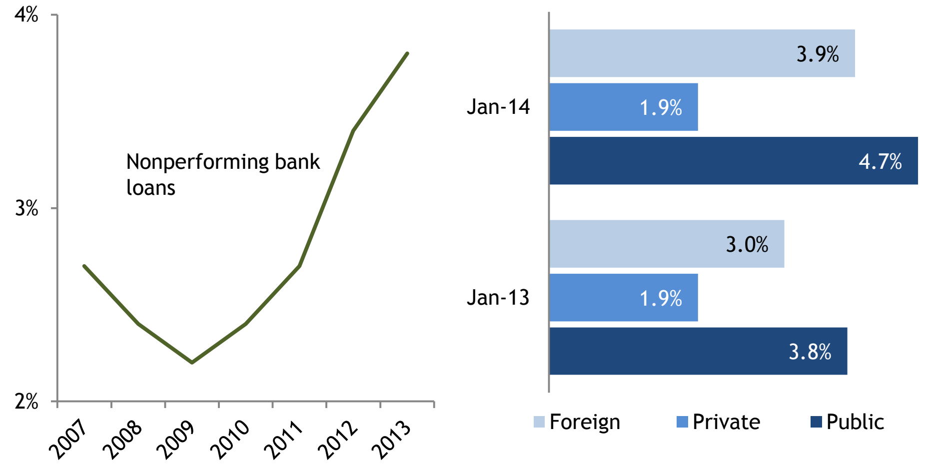
- **The public banks are the least profitable**. They have 70% of total assets, but account for just 41% of post tax profits. This is in part due to their exposure to particular sectors, such as infrastructure, aviation, agriculture, steel and textiles. It is also because of government efforts to improve financial inclusion, which imposes an additional burden. This remains a priority for the new government, in part because of the link to subsidy reform and efforts to stimulate small-scale manufacturing.

- **Many corporates are highly leveraged and there are potential concentration risks for the banks**. The average debt-to-equity ratio for non-financial corporates rose from 40% in 2001 to 83% in 2012. One fifth of corporate debt finance comes from abroad. The IMF estimates that bank loans to India's ten largest conglomerates alone account for 100% of banks' net worth.

- **The extent of un-hedged FX exposure is unknown**. The World Bank reports that 70% of aggregated balance sheet debt of large corporates (excluding financial services) belongs to net importers, creating exposure to a falling currency. Even so, the depreciation of the rupee has not exposed major problems.

- **Total domestic credit growth was 13.2% in the second quarter, substantially below the four-year average of 18%**. Growth in credit for infrastructure investment was just 15%. The growth rate of bank loans has slowed steadily over the past four years.

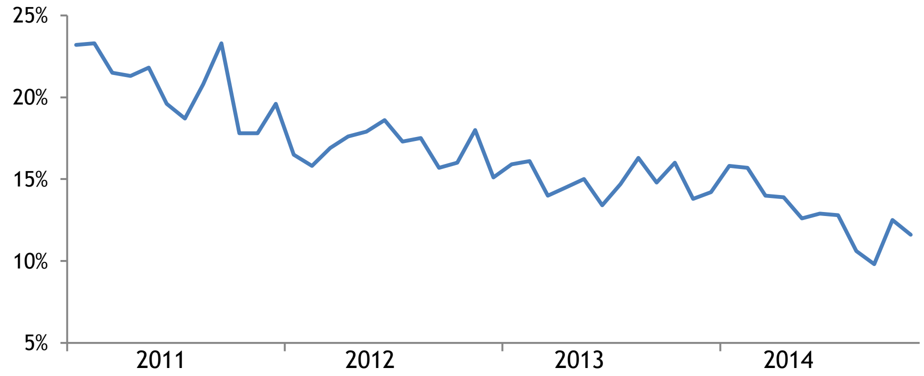
Non-performing loans are increasing particularly in public banks



Source: Reserve Bank of India, World Bank

Credit growth has slowed significantly since 2011

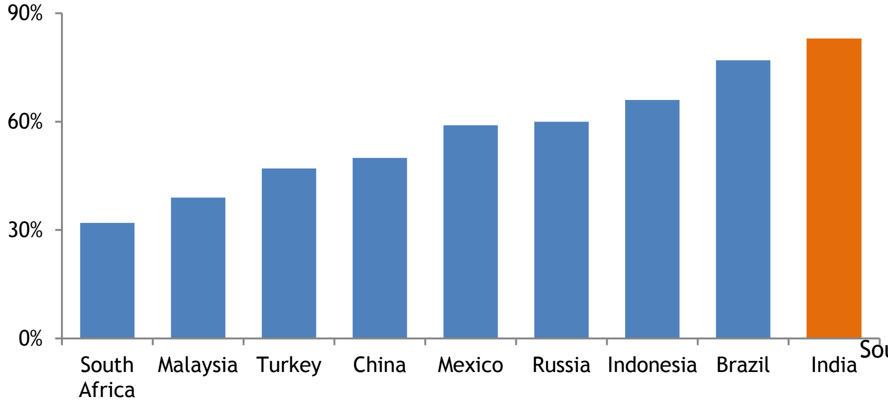
Annual growth rate of bank loans



Source: Trading Economics

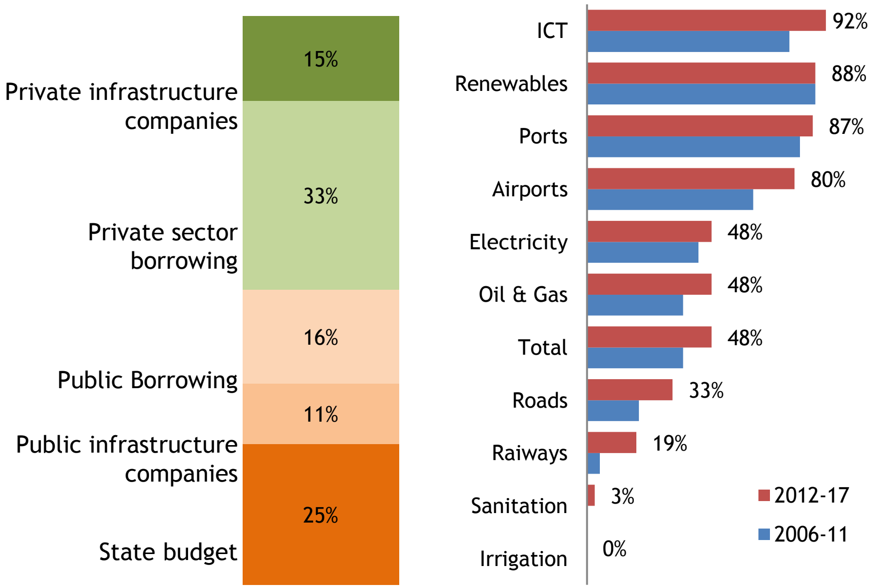
Financial sector: financing infrastructure investment

Indian corporates are highly leveraged by international standards
Debt to Equity (percent) of nonfinancial corporates (end of 2013)



Source: IMF

The five year plan assumed more private infrastructure finance



Source: Planning Commission

- **The combination of Basel III and problem assets means the banks need a lot of new capital.** Some will seek private capital. Others may need to be shut done, but probably not the largest banks.

- **The RBI believes the banks need reforming as otherwise they are simply refilling a leaky bucket.** Many firms involved in building roads and other projects are now in financial distress, creating problems for the banks. Some projects that were initiated a couple of years ago are no longer viable, given that the growth outlook is weaker. Stressed bank and corporate balance sheets are a constraint on investment as over four-fifths of infrastructure funding comes from the banks.

- **There is a debate about how to finance new infrastructure.** Some say the state should play the lead role, but through the budget rather than the public banks. Others, including industry groups, say the public banks should play a leading role once their balances sheets are tidied up. Rajan wants private sector sponsors to take a haircut on past projects that have failed, in order to get incentives right. That clearly will not be popular with corporates and may slow the recovery in investment, but it could produce better outcomes over time. Yet another view is that the problem for India is underdeveloped capital markets and an excessive reliance on banks for private finance.

- **How the government goes about fixing the banks and financing infrastructure is important.** The government has limited policy space, because of multiple competing objectives, including financial inclusion. The way they manage these trade-offs will tell us about both their priorities and growth prospects, given the importance of investment for growth.

External sector: reducing vulnerabilities

Global Counsel

- **India was exposed in 2013 when global liquidity conditions tightened.** This was due to the large current account deficit, a high external financing requirement, and a dependence on debt flows. 85% of the current account deficit was financed by FDI between FY2004 and FY2008, but between FY2008 and FY2013 the proportion fell to just 38%.

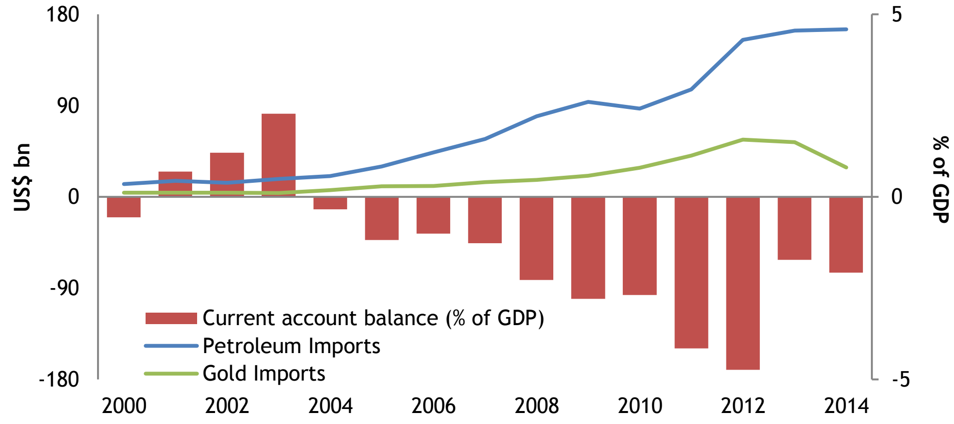
- **The policy responses since then have helped to reduce this vulnerability**. These include tighter monetary policy, restrictions on gold imports, looser restrictions on inward investment and fewer constraints on external commercial borrowing.

- **The current account deficit fell to 1.7% in the second quarter, from 4.7% in the first.** Remittances have been strong. Exports increased by 7.3% in the first five months of the financial year compared with the same period last year, while imports fell by 2.7%. Weak domestic demand and a lower rupee have constrained imports, but most of the decline is accounted for by gold and oil.

- **FX reserves at the end of August stood at $319bn, up $43bn from a year before**. These have been boosted by strong capital inflows, including FDI and deposits by non-resident Indians. Reserves are now equivalent to approximately seven months of imports, well above the amount deemed adequate by the IMF.

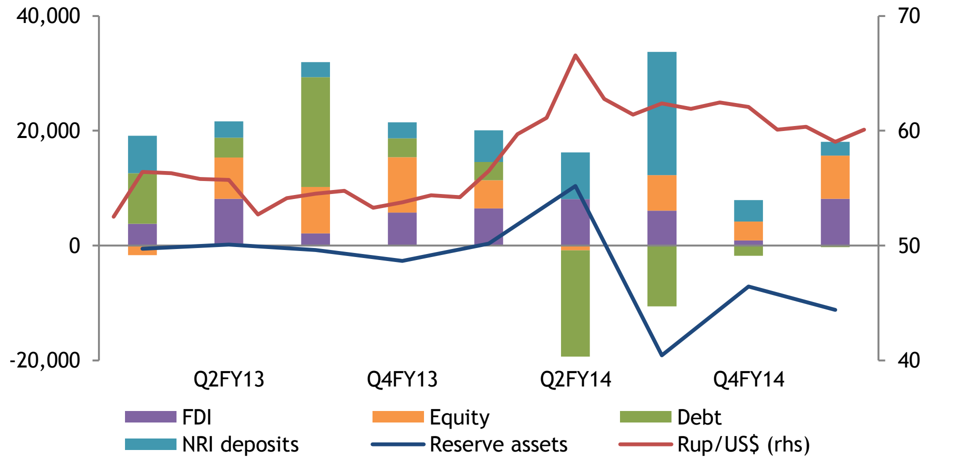
- **The exchange rate is largely flexible and helps to absorb external shocks and volatile capital flows**. Spot intervention and currency swaps are, however, used to ensure adequate FX liquidity and prevent unwarranted currency fluctuations. The exchange rate has now recovered about half of the 18% in value lost in the summer of 2013.

The current account has improved as gold imports have fallen



Source: CEIC

FDI is a stable source of financing compared to debt

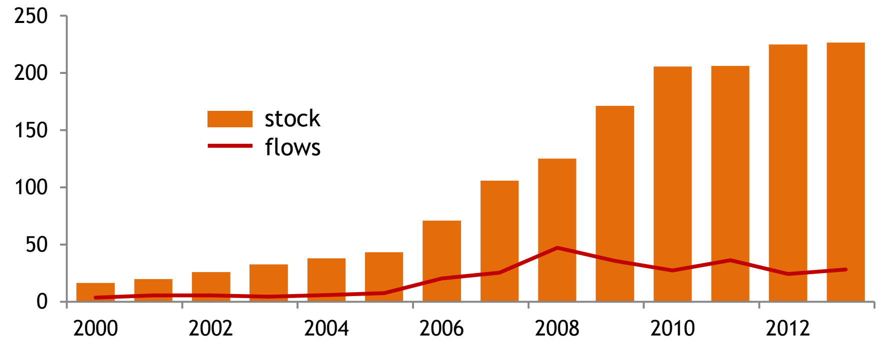


Source: CEIC

External sector: attracting investment

Global Counsel

The flow of inward foreign direct investment has slowed
$bn



FDI remains highly restricted by international standards
Barriers to establishment (colour coded) and foreign equity caps (%)

	Telecom	Retail	Banking	Life insurance	Professional services
India	74	51	74	26	0
EU	100	100	100	100	100*
China	49	100	100	50	100

Open · Minor barriers · Major barriers · Limited scope · Closed

*Excluding legal services

Sources: WTO, UNCTAD, RBI and World Bank

- **Currency risk is lower than during the turbulent summer of 2013 and some say it is now negligible.** Lower oil prices have helped. Some of the improvement in the current account is, however, explained by the slowdown in the economy and is therefore cyclical. Moreover, it is unclear whether the 47% fall in gold imports can be sustained, as ways round restrictions may be found over time.

- **India wants to finance the current account deficit from more stable sources, such as FDI.** The recent record has been poor, however. The BJP is against unconstrained FDI in multi-brand retail as this would affect small retailers who are among their core supporters. Liberalisation will be left to the discretion of the states. The government is likely to be more welcoming to FDI for infrastructure, in all but a few areas. In the coming months the government is likely to succeed in passing the Insurance Bill, which will raise the foreign equity cap to 49%, despite opposition parties putting procedural obstacles in the way.

- **The government recognises the barriers to attracting FDI from the business environment, policy consistency and taxation.** Taxation policy has become “scary” for many investors according to Jaitley. The government acknowledges the damage retrospective taxation has done to India’s reputation, but say this has now been addressed. Moreover, they say the law must still be allowed to take its course on “legacy issues” for political reasons. They say they will not weak cases to the Supreme Court so that they are not prolonged unless necessary.

- **The policy and legal decisions in the coming weeks will shape investor confidence**. The Supreme Court’s recent rejection of a case against Shell was likely greeted with relief in government.

Structural reform: delivering on GST

Global Counsel

- **India's hard infrastructure gap – the amount that needs to be invested this decade – is estimated at between $1.1-$1.7tn.** This requires fiscal support and private finance, but also structural reforms in order to attract that finance.

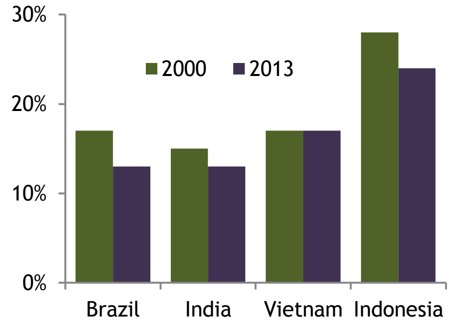
- **The new government has abolished the Central Planning Commission and streamlined decision making.** This is partly an effort to reduce barriers to investment. Individual line ministries are taking responsibility from groups of ministers for the clearance of large projects such as for infrastructure.

- **GST reform is essential if there is to be a single market and if the government's 'Make in India' policy is to succeed.** The World Bank has identified poor infrastructure and bureaucracy as two factors driving up logistics costs. Logistics costs are as high as 10-14% of net sales in manufacturing sectors and are holding back growth. Trucks travel an average of 300km per day compared to 450km per day in Brazil, in large part due to traffic congestion and delays at inter-state check posts that collect taxes and enforce state regulations.

- **Labour market reform is a second major test for the government.** Modi wants healthy competition between the states in this area. The recent labour market reforms in Rajasthan, which increase the threshold for job numbers before approval is required to fire people, are important. Labour laws are traditionally an area where the centre leads with the state playing an implementation role, so Rajasthan taking the initiative is significant. The centre may prefer to work this way as they get results, but without expending political capital. It may, however, still be challenged in the courts.

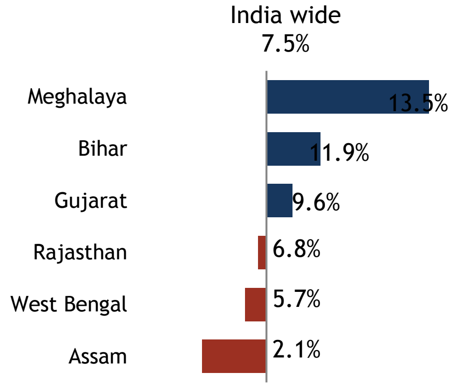
Manufacturing is small …

Percent of value added



… and growth rates vary

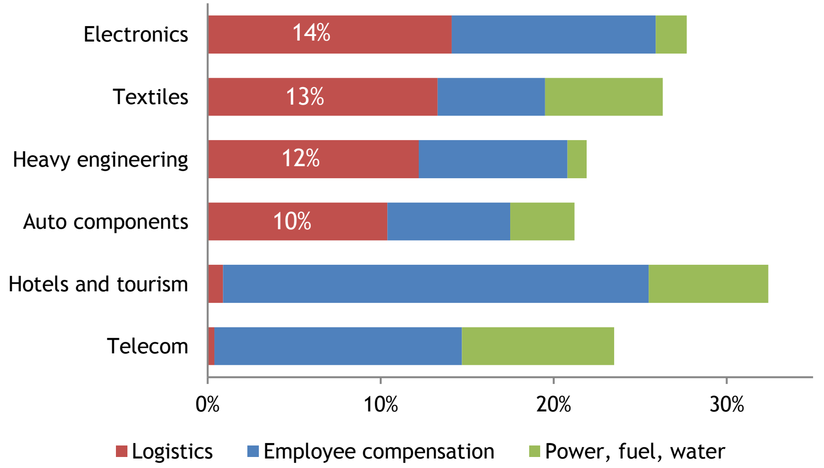
Annual rate, 2005/06 to 2013/14



Source: World Bank, Indian National Planning Commission

Logistics costs are large for manufacturing

Percent of net sales

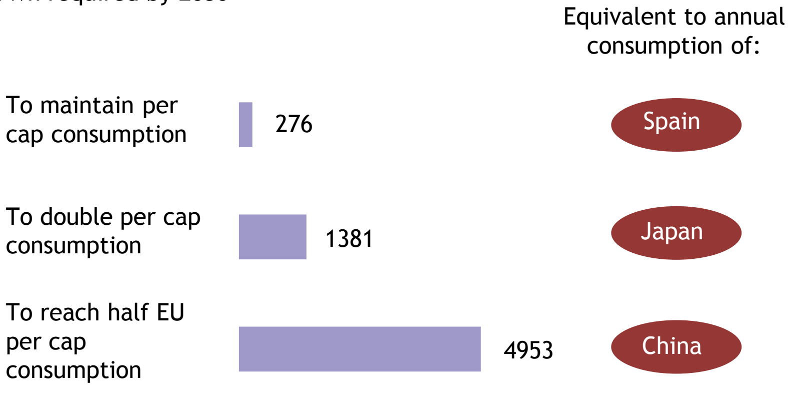


Source: Prowess, World Bank

Structural reform: will implementation match ambition?

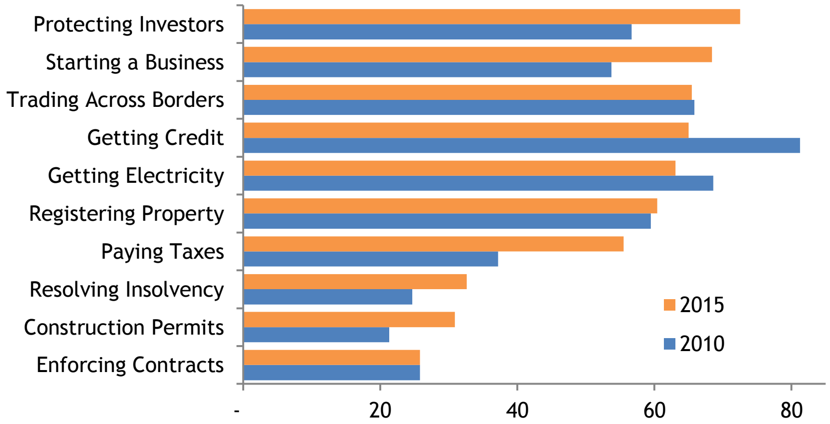
Global Counsel

India has huge power generation needs in the coming years
annual TWh required by 2050



Source: Global Counsel calculations

There is plenty of room to improve the business environment
distance to the frontier in the Doing Business rankings*



* Indicates how far India is from the best country performer

Source: World Bank

- **The government wants India to be a surplus country in power generation by 2019**. They have added considerable capacity since 2009, but this is still massively ambitious. It will require fixing the mess in the coal industry, following the cancellation of over 200 block licenses by the Supreme Court in September due to corruption. It will require improvements in energy efficiency. It will mean a considerable investment in solar and wind and a push to restart hydro projects. The government wants to increase the share of renewables in the energy mix from 6% to 15% over the next five years partly, they say, for energy security reasons. The government also needs to address problems with tariffs and the distribution network.

- **The current Land Acquisition Act, introduced by the previous government, is not working.** It makes it extremely costly and time consuming to purchase land. Jaitley says the government will "dilute" the act, arguing this is essential for infrastructure investment and to create the new 'smart cities' India wants.

- **The government has plans to improve the business environment.** India currently ranks 142 in the World Bank's Doing Business ranking, behind Iran and Pakistan. In the past five years the scores have only improved for three out of ten metrics. The government wants to reduce the number of taxes and move to online payment to cut the 243 hours each year the average Indian firm spends preparing returns. They want to cut the time to register a business from 27 days to one. They want to make electricity connections easier. They also want to involve the states in the initiative This could turn out to be important if it is to be meaningful.

Part 3: outlook and risks

Macroeconomic forecasts

Benchmark forecast – IMF, October 2014

	2012	2013	2014	2015	2016
GDP growth	4.7%	5.0%	5.6%	6.4%	6.5%
Investment rate	34.7%	31.4%	32.2%	32.6%	32.9%
Savings rate	30.0%	29.7%	30.1%	30.4%	30.5%
CPI	10.4%	8.3%	7.6%	7.3%	6.3%
Primary borrowing	-3.1%	-2.6%	-2.6%	-2.3%	-2.2%
General government debt	66.6%	61.5%	60.5%	59.5%	58.5%
Current account balance	-4.7%	-1.7%	-2.1%	-2.2%	-2.4%

Note: shaded areas show actual data

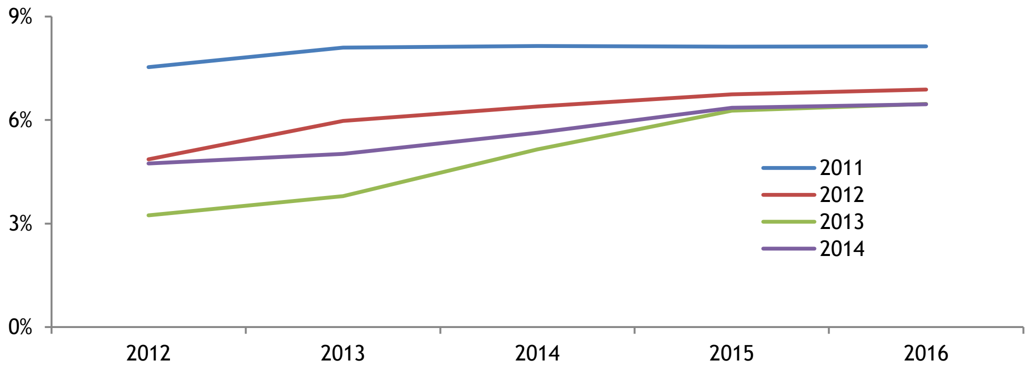
Alternative forecasts

World Bank, October 2014	2014	2015	2016
GDP growth	5.5%	6.3%	6.6%
Current account balance	-2.2%	-2.5%	-2.9%

ADB, September 2014	2014	2015
GDP growth	5.5%	6.3%
Inflation	5.7%	5.5%
Current account balance	-2.3%	-2.5%

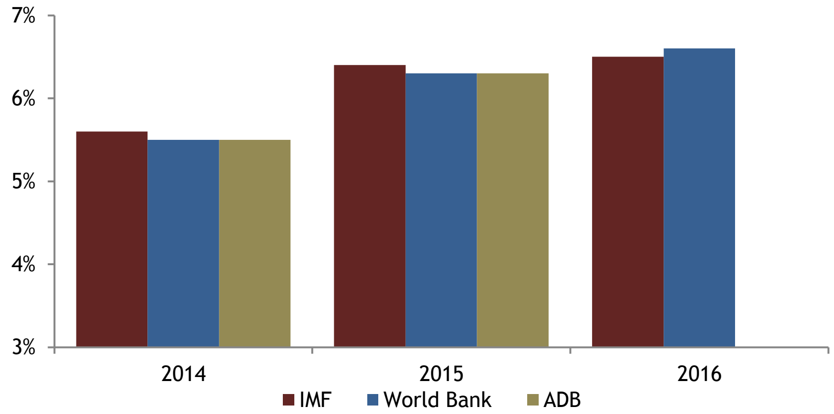
The IMF forecast has been revised down year after year

IMF growth forecast in the autumn of each year indicated



The main IFIs all expect growth to gradually increase

Latest published GDP growth forecasts



Our assessment

Global Counsel

Policy area	Primary policy objective(s)	Assessment of policy space	Assessment of political space	Short run outcome and impact	Long run outcome and impact
Monetary policy	Bring down inflation	Inflation is already falling and converging with the recommended 4% target faster than expected.	The RBI is under pressure from government and industry to loosen policy.	Inflation is likely to fall further unless food inflation picks up, possibly creating some room for looser policy.	
	Establishing a credible inflation targeting regime	The problem is not inflation, but high inflation expectations. This means the RBI would like to keep policy tighter for longer, despite falling inflation and sluggish growth.	The government must decide whether to formally introduce inflation targeting. The government may do so if they judge the boost to RBI credibility will give the RBI space to loosen policy. Much depends on the relationship with Rajan.	We expect modest nominal easing providing inflation continues to fall and more easing if inflation targeting is formally introduced. Credit conditions will remain tight.	Inflation targeting may mean lower average inflation, but more volatility due to the large share of the consumption basket beyond the influence of the RBI.
Fiscal policy	Closing the fiscal deficit to 4.1% this financial year	Falling oil prices have opened up the policy space for the reform of energy subsidies and the new government is taking advantage of this. However, the government has a substantial gap to close this fiscal year, given outturns are well ahead of expectations.	This is an important early test for Jaitley and even the opposition recognises. We anticipate that political cover will be found to introduce measures to close the deficit.	The key question is the balance between spending and revenue measures. We expect more of the former as Jaitley wants to dispel India's reputation for unpredictable tax enforcement.	If the government closes the deficit, as we expect, this will boost fiscal credibility. Failure could mean moderate upward pressure on sovereign yields.
	Creating fiscal space to support infrastructure investment	The government may under estimate the technological challenges involved in Unique Identification reforms, which will impact on the timing of broader subsidy reforms.	Financing investment from the proceeds of privatisation is economically sensible, but unlikely, as hostility to privatisation among the political and professional classes runs deep. We expect small-scale divestments.	We expect measures in the budget to improve government efficiency. If credible this could boost confidence around infrastructure investment and help get projects restarted.	We doubt this can be sustained given the constraints on policy and political space which will become progressively tighter over time.

Our assessment (contd.)

Global Counsel

Policy area	Primary policy objective(s)	Assessment of policy space	Assessment of political space	Short run outcome and impact	Long run outcome and impact
Financial sector	Improving public sector bank balance sheets	Multiple policy objectives for banks limits policy space. If the government cuts public stakes to 52% this may help side-step fiscal constraints, providing the governance is sufficiently attractive to private investors.	The review of public sector bank appointments shows the government is willing to challenge interests in this area.	Expect incremental steps as the government is not willing to disrupt further credit growth or investment.	
	Establishing a new model for financing infrastructure	The policy space is heavily constrained. The government cannot afford to finance significantly more spending through the budget and the questionable capital position of some public banks limits their ability to provide fresh finance.	The government will be reluctant to force haircuts on private sector infrastructure sponsors, both because the business lobby is influential and because they need their support to restart investment.	We expect public banks will continue to play an important role and be asked to support new investment, but this is not sustainable. We do not expect haircuts to be imposed on private sponsors.	We may see a deepening of bond markets, including further opening to foreign investors and with new investment vehicles introduced to match saver and infrastructure investor needs.
External sector	Reducing the current account deficit	Falling oil prices are a major boost. Efforts to suppress gold imports already look difficult to sustain and will be increasingly circumvented.	No major constraints.	Recent improvements are sustainable, but we are unlikely to see a further reduction.	
	Attracting more stable source of capital inflow	There are multiple policy tensions but the government appears willing and able to address key barriers to FDI, such as improving the tax environment for international businesses.	The opposition won't be able to block reform to foreign investment caps in insurance. The BJP won't push liberalisation of multi-brand retail from the centre as small retailers are a core constituency.	Cyclical factors may be as important as structural ones in making India relatively attractive for FDI over the next few years.	Some states may go further than the centre on multi-brand retail, but probably not many.

Our assessment (contd.)

Policy area	Primary policy objective(s)	Assessment of policy space	Assessment of political space	Short run outcome and impact	Long run outcome and impact
Structural reforms	Introducing a goods and services tax (GST)	The central government and the states still need to agree on the rate and how to allocate revenues. A ‘fiscally neutral’ rate of 27% has been proposed, split between the states and the centre, but many regard this as excessive.	The political space exists with cross party support. Even former finance minister Chidambaram says the required constitutional amendment will pass before the end of the year.	This is a key test for the government, but we expect it will happen in April 2016. One or two states may hold out and refuse to participate initially, but will eventually come on board.	This will have a big impact on trade and investment across India, but the full extent depends on exemptions which may include liquor or petroleum products.
	Reforming labour markets	Any reforms in this area complement efforts to expand the formal economy, even if only marginally.	There are limited signs of willingness by the centre to invest political capital in this. The government is instead relying on the example set by states like Rajasthan.	The state-led approach inevitably means that progress will be patchy, with some states moving faster than others.	Strategic investors will want to understand which are likely to lead when making location decisions.
	Increasing power generation capacity and reliability	This policy area has the biggest implementation challenge given the range and extent of the reforms and the difficulty in bringing real change to a monolithic entity like Coal India.	There is political opposition in the states to tariff reform, but the business model of power generation companies will remain fragile unless they can pass on import costs.	The re-auction of coal licenses is expected soon. The interesting question is whether anyone other than Coal India will participate.	It is doubtful the government has solutions to match its ambitions.
	Diluting the Land Acquisition Act	The government appears determined to push reform of land acquisition as they regard this as essential for the ‘Make in India’ campaign.	The BJP sees the Land Acquisition Act as typifying the failings of the previous government. Jaitley says they will seek cross party support on this reform, but push it to a conclusion if necessary.	This is likely to proceed, if only slowly, and inevitably there will be a catch for business, probably in the form of substantially higher compensation payments.	We expect progress over time given the political resonance for BJP and the importance for multiple policy objectives, including urban development.

Risks to the outlook

Risk	Scenario	Probability	Impact	Our assessment
External financing conditions	Higher interest rates in major developed economies, particularly the US, could see capital leave India.	Medium	Large negative	This risk is well understood and remains significant, but a combination of policy and circumstances mean the exposure of the Indian economy is now substantially lower than 18 months ago.
Downward oil price shock	Further falls in global oil prices reduce inflation, create monetary policy space, and reduce external vulnerabilities.	Medium	Large positive	The price of oil has already fallen below $75 providing a direct boost to the economy. The price could fall further. If sustained this would provide a major boost to the economy in part because it creates policy space for a number of reforms.
Business confidence falls as political honeymoon ends	Impatience with the government's delivery of reforms saps corporate confidence leading to a fall in investment.	Low	Moderate negative	The government remains popular and business sentiment appears moderately good. The risk is that the government fails to push ahead with reforms while popular, creating a reinforcing loss of confidence that closes down the political space for controversial reforms. Questions are already being asked about whether the government is moving too slowly.
Upward food price shock	A bad monsoon pushes up food prices and this feeds into broader inflation, leading the RBI to tighten policy.	Low	Moderate negative	This year's monsoon was patchy and while the full effect on prices has yet to be seen the effect so far has been limited.

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