Maybank Kim Eng

India economic outlook

Short-term pain is obscuring the potential for long-term gain

March 2013

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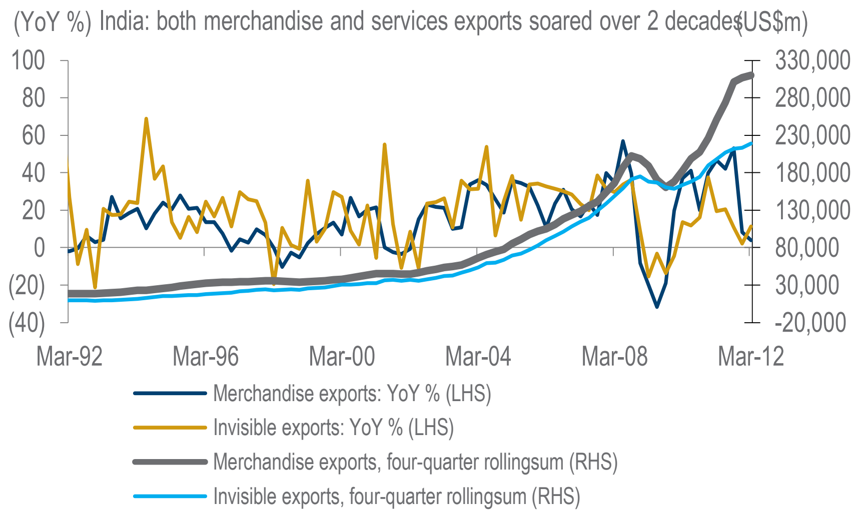
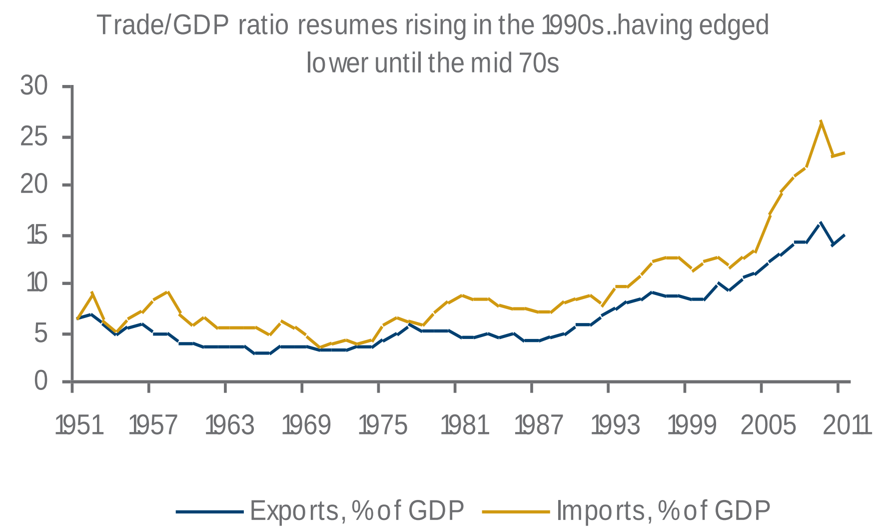
India: external sector has been transformed by economic reform



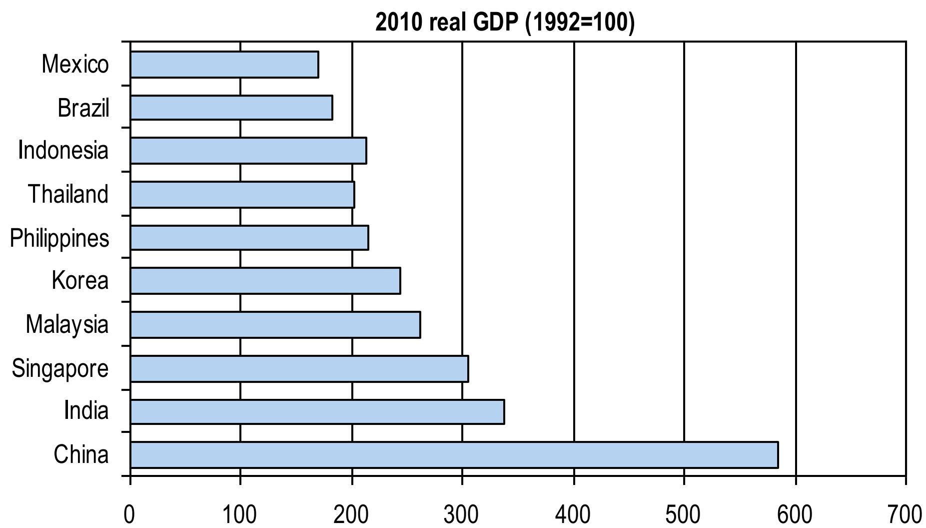
Source: CEIC, PKB

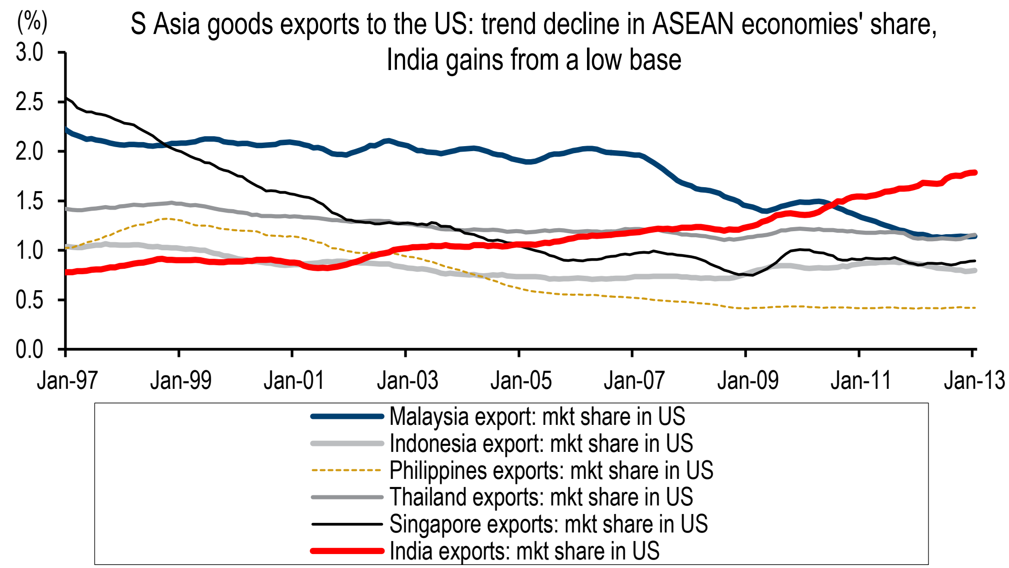


Source: CEIC, PKB

- The export/GDP ratio declined from 7% in the early-1950s to 3-5% in much of the 1965-85 period, but has since rebounded steadily to 15.2% now.
- Goods exports rose from US$18.5bn in FY1990/91 to US$310bn in FY2011/12, and invisible exports from US$7.5bn to US$220bn over the period. The surge in exports (especially of services) enabled the import/GDP ratio to rise sharply (to 23%, from <10% in 1950-90), broadening consumer choice.
- Sharply rising incomes in the export sector (goods and services) have filtered through to the rest of the economy, pushing out India's potential GDP growth rates.

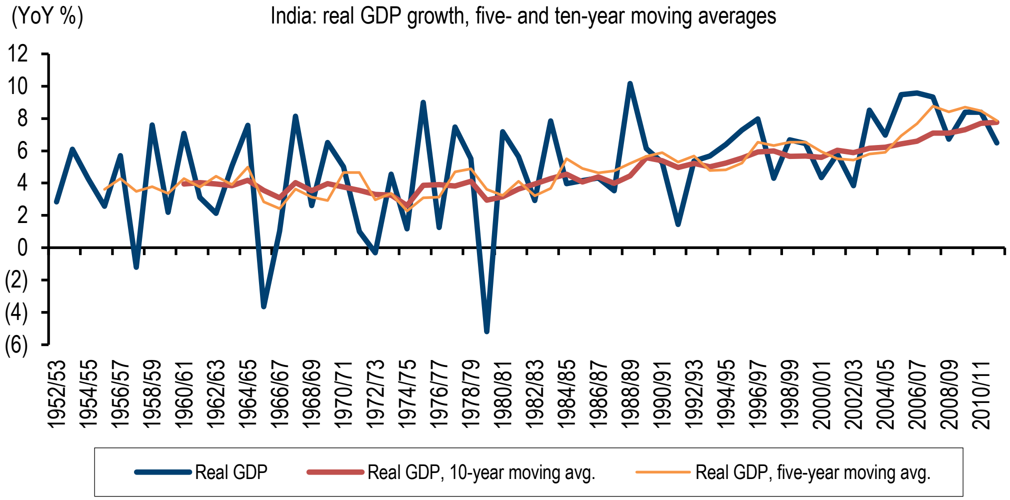
India: fastest-growing economy among the world's democracies



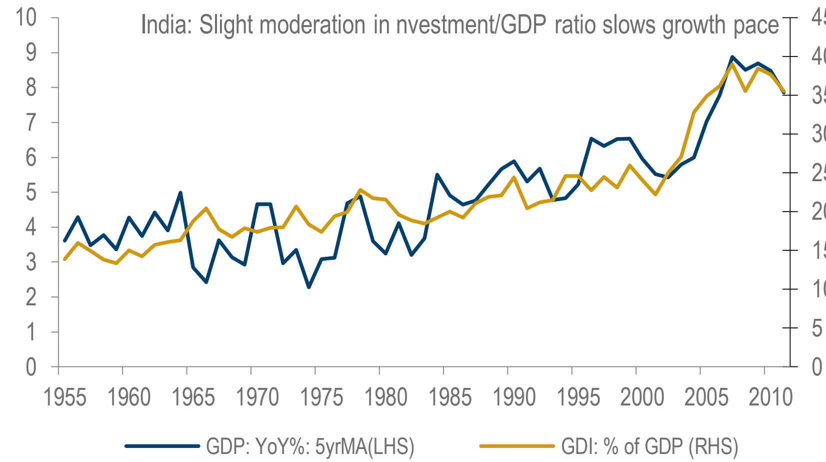


- Never has a democracy with even 200m people sustained annual real GDP growth of 6.3% over a 30-year period: *India's achievement since 1980 is unprecedented*! In human history, Japan (7.1% growth annually, 1950-80) is the only democracy that has seen faster economic growth over a 30-year period.
- Tariff reductions, financial-sector liberalisation and industrial de-licensing have contributed to more efficient capital-allocation and a robust external sector.
- Revealed comparative advantage in services, and knowledge- and resource-intensive manufacturing. However, the vast potential in labour-intensive manufacturing is untapped.
- *Fiscal reform still needed, as the FRBM Act was simply ignored by the UPA, and the gains of 2001-04 have been dissipated.*
- India's goods exports performed very well in the 2005-11 period. Last year was a poor year, but India's goods exports continued to gain US market share (especially at ASEAN's expense).

India: medium-term potential growth has risen with higher national savings and investment rates; but the latter moderated in 2011-13



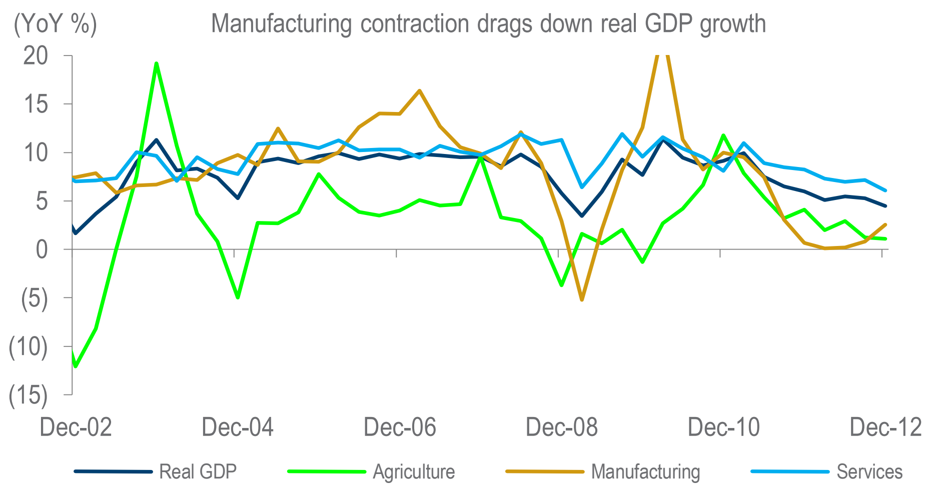
Source: CEIC, PKBasu



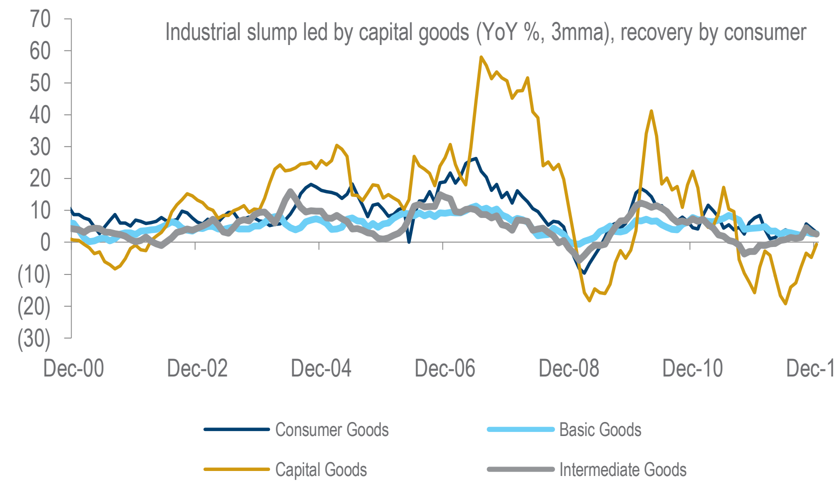
Source: CEIC, PKBasu

- Real GDP growth slowed in FY2011/12 to 6.5%, primarily because of the moderation in the investment/GDP ratio to 35.5% (from 36.2% in FY10/11) – far from catastrophic, especially as the savings rate remained above 31%. Investment/GDP is likely to have moderated further to 33%, and savings to 29%, as real GDP grew just 5.2% in FY2012/13.
- The 10-year moving average of real GDP growth has risen steadily – to 7.8% now (the same as the 5-year moving average, which peaked at 8.8% in FY2007/08, just before the global financial crisis). That inflation remains high despite the slowdown in GDP growth (almost “stagflationary”) is a reflection of the RBI’s policy error in 2010 (when it was too slow to raise rates amid 10%+ inflation, and had to consequently tighten too sharply in FY2011/12). Inflation is now finally below 7%YoY, but at the cost of slower growth.

India: services are structurally strong; the cyclical slowdown in capex has sharply reined-in manufacturing activity



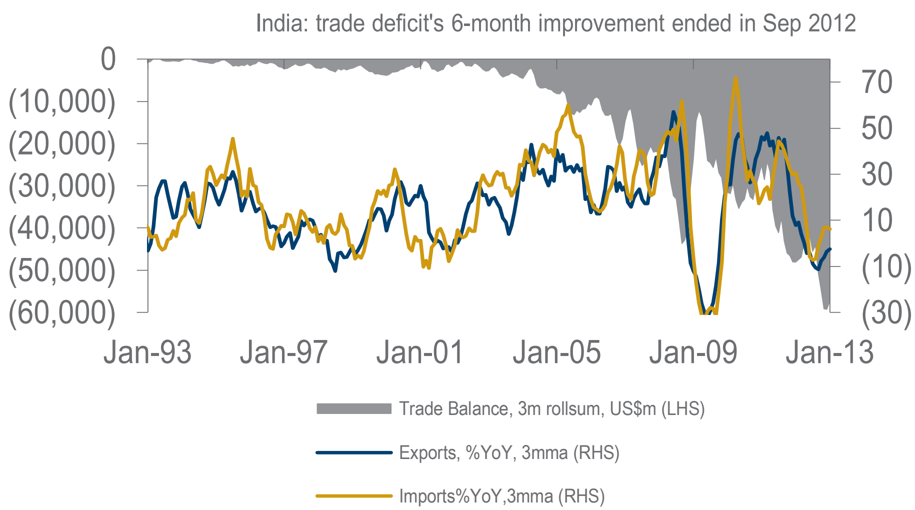
Source: CEIC, Maybank-KE



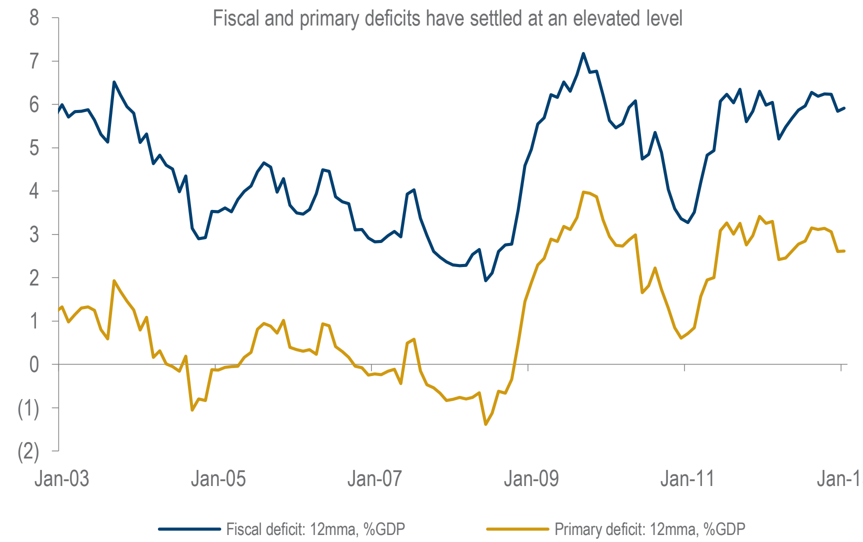
Source: CEIC, Maybank-KE

- Services account for half of GDP, and expanded at an average pace of 10% annually in 2001-11. The wider cross-border tradability of services bolstered their expansion, as India was still a price-taker for internationally-traded services. After decelerating substantially in the aftermath of the GFC, we expect Services to return to the pace seen in the previous decade. NREGA, and the shift in internal terms of trade in favour of agriculture, boosted rural consumption strongly. But policy paralysis contributed to the moderation in capex in the last 2 years.
- The slump in manufacturing would have reduced the current-account deficit, but rising oil prices caused the deficit to widen to 4% of GDP for FY11/12. The weak rupee, and lower oil prices, should allow the current account deficit to moderate in FY2013/14 to 3.6% of GDP (from 4.3% in FY2013/14).

India: the trade deficit widened sharply as oil prices soared, but the pass-through to consumers since Sep12 is reining in the fiscal deficit



Source: CEIC, MBKE

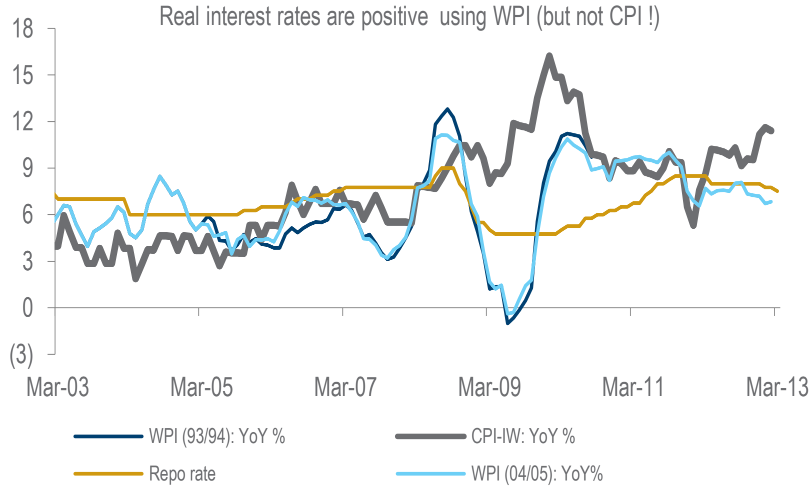


Source: CEIC, MBKE

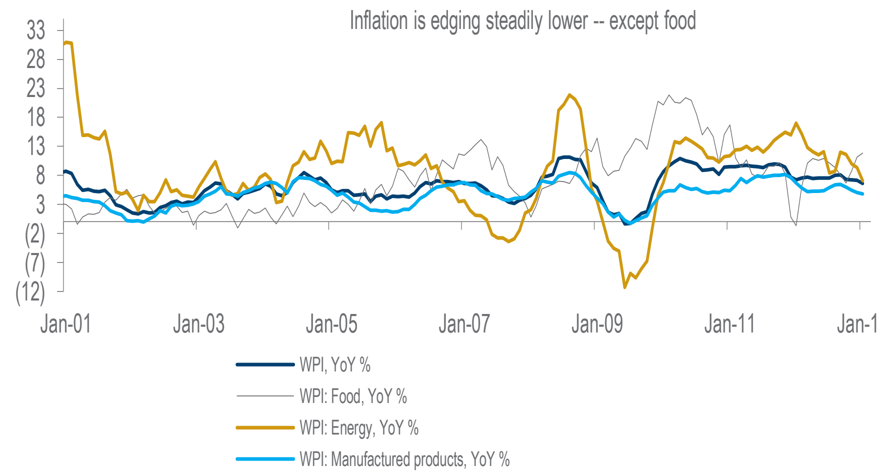
- The trade deficit widened to new record levels in FY2011/12, as surging oil prices raised the oil-import bill – causing imports to outpace even the fast 35%YoY pace of export growth.
- With oil prices moderating in the Apr-Jun12 quarter, India's exports resumed outpacing imports in Apr-May 2012 – and the trade deficit began to edge lower. But exports declined YoY in Jul12-Jan13, and imports (especially of oil) continued to rise, worsening the trade deficit.
- The sharp increases in domestic oil prices (especially diesel and LPG since September 2012) have helped cap the fiscal deficit, and the trade deficit is likely to begin improving in the current quarter (with February seeing 5% YoY growth in exports).

- Fiscal deficit target: 5.3% of GDP this year, 4.8% in FY2013/14.
- Increased taxes on the “super-rich”, lower stockmarket transactions tax, but a new commodities transaction tax.
- Services tax net being substantially widened.
- About a 10% reduction in the subsidy bill, primarily through a reduction in oil subsidies (resulting from changes already effected in the oil price regime in Sept-Oct 2012).
- Provision of only Rs100bn for the Food Security Bill appears to be the one measure that will be most difficult to sustain in an election year.
- An ambitious target for disinvestment proceeds.
- Key provision to boost fixed investment: an investment allowance (similar to what Singapore and Malaysia have long had).
- Overall: Should provide a modest boost to economic growth – to slightly over 6% YoY in FY2013/14, thereby providing a modest further boost to revenue. But achieving the 4.8% fiscal deficit target will be politically very challenging.

India: interest rates are set to moderate gradually

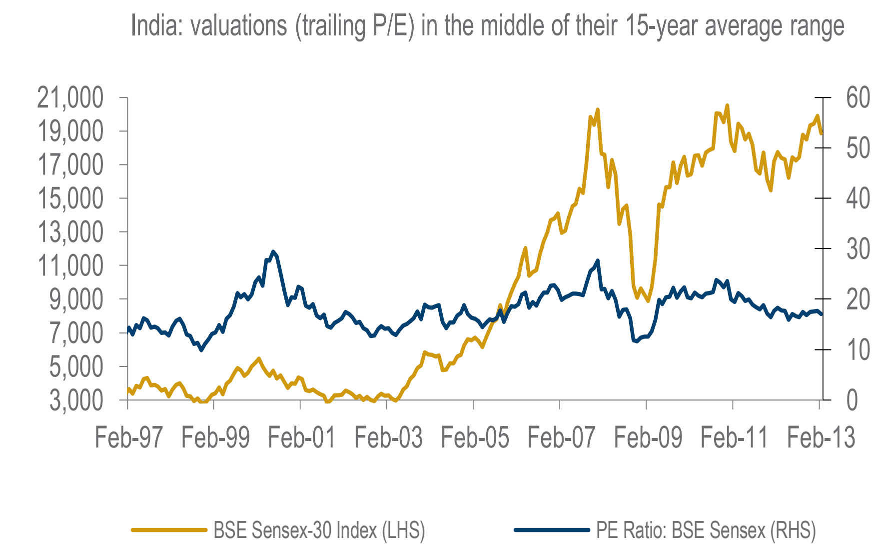


Source: CEIC, PKBasu



Source: CEIC, PKBasu

- RBI was behind the curve in fighting inflation in 2010, but turned more realistic (and hawkish in 2011, with two 50bp rate hikes, and several 25bp hikes taking the repo rate to 8.5%. Although the RBI cut the repo rate 50bp to 8% in Apr 2012 (using a window of 7-8% YoY WPI inflation), inflation proved stubborn and the next two 25bp rate cuts were only possible in Jan-Mar 2013.
- Core (non-food manufactures) inflation is likely to moderate further, but the persistence of high food inflation (and steady fuel price increases) will slow additional rate cuts – with only another 50bp of cuts in the repo rate likely before Dec 2013.
- The combination of lower interest rates, the investment allowance, and a modest pick-up in reform should allow a mild investment-led recovery to 6.3% YoY growth in FY2013/14. However, a post-election, more-reformist government is key.



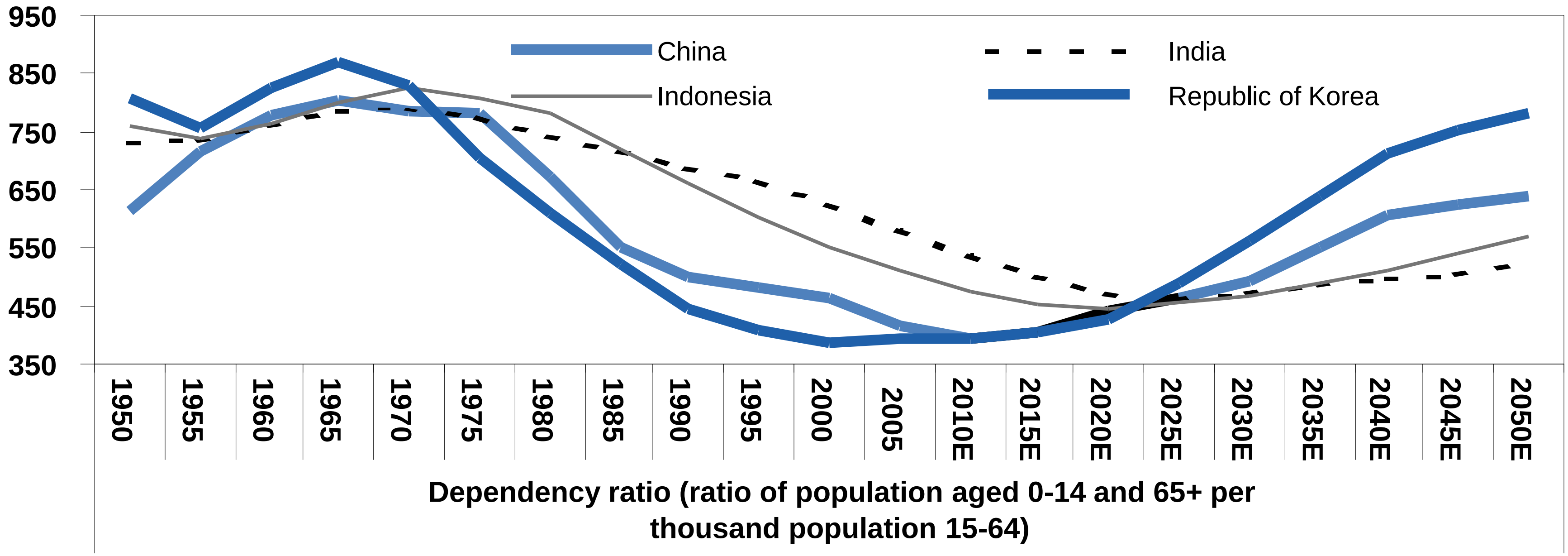
Source: CEIC, PKBasu

15th Lok Sabha 2009-2014					
United Progressive Alliance (UPA) + supporters		**305**	**287**		
UPA (participants in the Union cabinet)		**248**	**230**	**Pledged support**	**57**
Indian Nat'l Congress	206	JMM	2	Samajwadi	23
Dravida Munetra Kazhagam (DMK)	18	KC(M)	1	BSP	21
NCP	9	AIMIM	1	JD(S)	3
J&K National Conference	3	VCK	1	RJD	4
Muslim League	2			NPF	1
Rashtriya Lok Dal	5			BDF	1
				Indpt	4
Opposition		**238**			
Nat'l Dem'c Alliance	154	**Left Front**		**Others**	
BJP	116	CPI(M)	16	BJD	14
Shiv Sena	11	CPI	4	AIADMK	9
Janata Dal (U)	20	AIFB	2	TDP	6
Shiromani Akali Dal	4	RSP	2	HJC	1
TRS	2			SDF	1
Asom Gana Parishad	1			MDMK	1
				AUDF	1
				Indpts	7
				Trinamool Congress+SUCI	20

Source: CEIC, PKBasu

- The equity market's trailing PER is in the middle of its 15-year range. Corporate earnings held up reasonably well during the global downturn, but have weakened in the past year as nominal GDP growth slowed. We think the pipeline of disinvestment proceeds will restrain the upside for equity prices, and a sharp moderation in nominal GDP growth is likely to hurt corporate earnings.
- The UPA government has a thin 15-seat majority in parliament after the withdrawal of the DMK; this means that the SP (23) and BSP (21 seats) have the ability to bring the government down, and will have a stranglehold over policy. The government will face a difficult 6 months, and an early election appears likely.

Asia's demographics: well-endowed for the next decade in India and Indonesia, less so in Korea and China



Source: CEIC, PKBasu

- We expect non-Japan Asia to continue to benefit from declining dependency ratios until 2020. Typically, savings rates rise during periods of declining dependency ratios (this began to happen in Asia from 1965 onwards; in India from 1980). Higher savings should be able to fund higher investment rates, enhancing the productivity of the increasing workforce.
- Technology (embodied in FDI and through imports) should ensure strong total factor productivity (TFP) growth and a rapid economic catch-up for Asia. We think India has the demographic advantage in 2020-50.

India: demography should support steadily stronger growth

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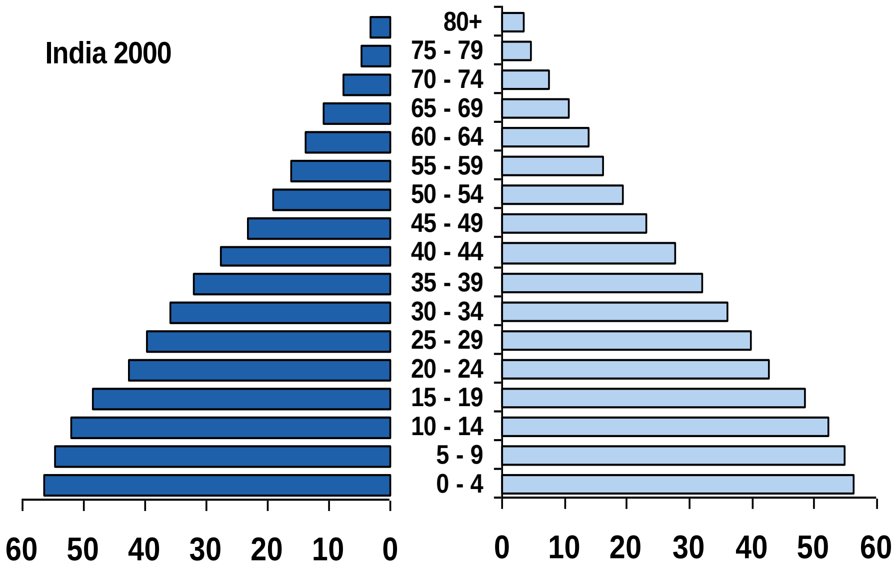
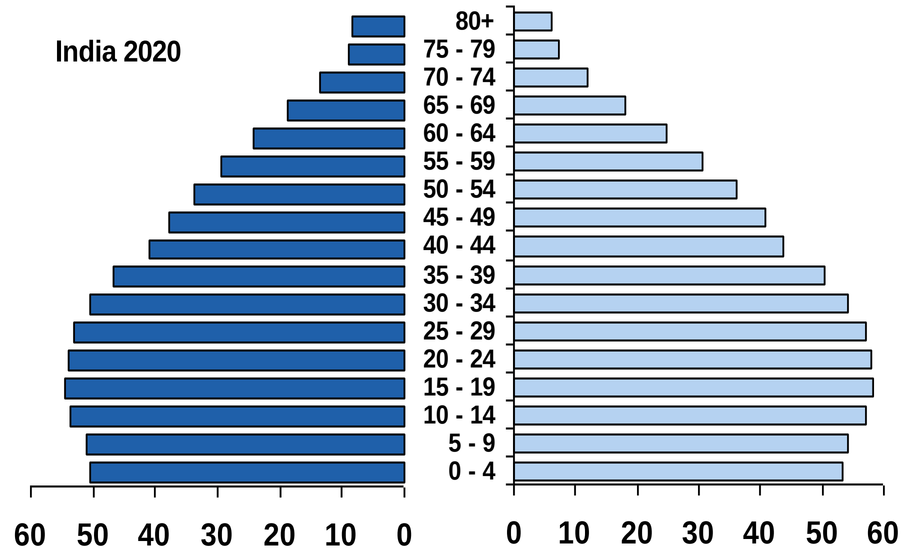


Source: UN, PKB
Note: females on the left; males on the right



Source: UN, PKB
Note: females on the left; males on the right

- The huge number of young people in the population today will reach working age over the next 15-20 years. By 2020, India is expected to have 270m people (almost equal to today's total US population) between the ages of 15 and 35.
- Savings rates and productive potential should be at their highest. In our view, the challenge for India is to develop a more labour-intensive growth model to take full advantage of the productive potential of the masses. The literacy rate of 74% should help to some extent.