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India

Gaining an Edge

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Overview

India will be in a sweet spot in the fiscal year 2015/16 as inflation eases and growth improves – with revised GDP figures adding to the sizzle. The holy trinity of a strong-willed government, a credible central bank and macro stability, has lifted the economy from a cyclical and structural trough. Such optimism is reflected in the 42% jump in the benchmark equity index from January 2014 and upheld by strong foreign inflows into the debt and equity space.

On the side, the reform agenda is moving ahead with an emphasis on improving the ease

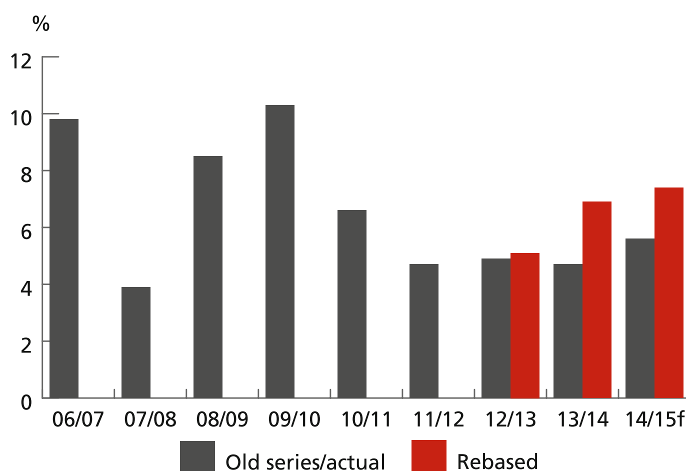
of doing business, making the tax regime more predictable and ironing out bottlenecks in the factors of production – capital, labour, enterprise and land.

The Bharatiya Janata Party (BJP) government of Prime Minister Narendra Modi won a rare single-party majority at last year's elections and we see that as an important political opportunity to initiate key reforms. Insufficient representation in the upper house of parliament, however, has become a hurdle of late. Even so, this is unlikely to scupper reform efforts. These are likely to be pursued through ordinances and joint parliamentary sessions, while the BJP gradually seeks to extend its reach through state assembly elections.

Economic growth

India recently rebased and revised its GDP growth numbers. Apart from a change in the base year, the revised methodology includes private corporate performance plus sales and service taxes, which have lifted growth for the industrial and service sectors. Other changes include an expansion of the basket to incorporate previously under-represented and informal sectors.

1 **Re-based numbers push up GDP growth**



Source: Govt, DBS Group Research

...real growth will tick up to 7.4% in FY14/15

Following the revisions, the statistics agency estimates that real growth will tick up to 7.4% in FY14/15 (the year ending March 2015). Accordingly, growth in the first three quarters of this fiscal year was held at 6.5% in April-June 2014, 8.2% in July-September and slowed to 7.5% in October-December. The end-year estimate implies January-March 2015 GDP growth will stand at 7.4%. These figures contrast with the readings under the previous series, where growth was subdued below 5% in the past two years and was expected to tick up to 5.6% in FY14/15 and 6.1% in FY15/16.

Implications of this revised set of data on other economic aspects are still being ascertained. Nonetheless, lead indicators affirm that the economy has bottomed out and is bound to improve from here on. GDP growth in FY15/16 could be in the range of 7.5%-7.8%, lifted by a firm manufacturing sector and robust domestic demand. How the Reserve Bank of India (RBI) and the finance ministry interpret these numbers will be watched closely, especially for monetary and fiscal policy guidance. Despite the revisions, the size of the economy remains largely unchanged, thereby keeping the current and fiscal deficit ratios steady.

Inflation Eases, Opens Room For Rate Cuts

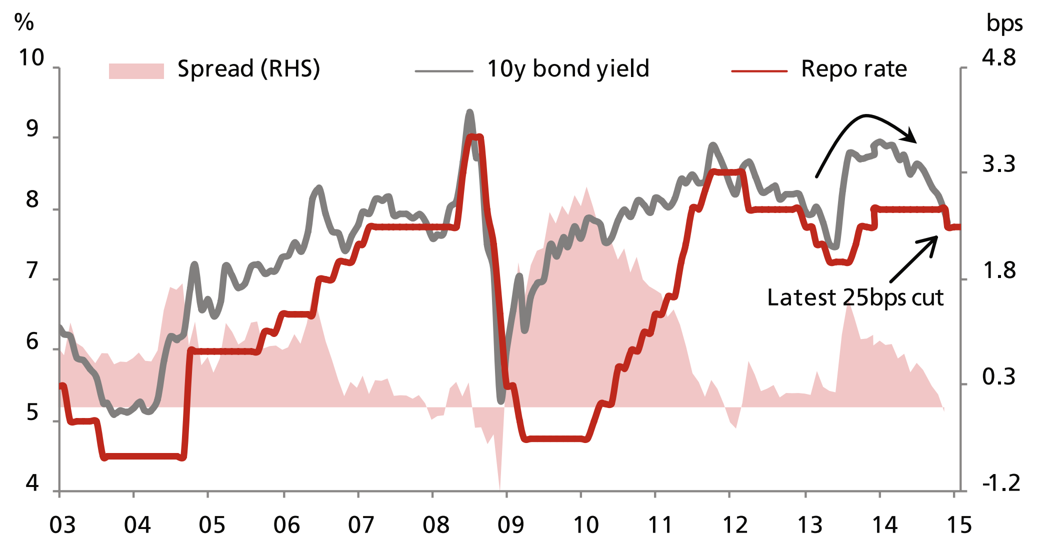
Slowing inflation has been a notable development for India. From 9.5% in FY13/14, consumer price index (CPI) inflation slowed to 5.0% by December 2014 helped by a sharp

fall in crude prices, the limited impact from below normal rains, a small rise in minimum support prices and subdued demand. Of note, every US$10 per barrel fall in the Brent crude price lowers CPI inflation by 20 basis points, according to the central bank. With prices now down 50% since June 2014, favourable pass-through could push the FY15/16 CPI below 6%.

We note that the CPI inflation series has been rebased to 2012 (from 2010), with the basket weights based on the Consumer Expenditure Survey of 2011-12. We don't expect much impact on the CPI trends, given the modest shift out of the headline and into the core basket. To some extent, this signals more emphasis on demand-led forces rather than cost-push pressures.

The favourable inflation outlook led the RBI to undertake an off-cycle rate cut in January 2015. This demonstrated the central bank's confidence in the evolving inflation outlook, much of it due to the way global commodity prices are shaping up. Households' inflation expectations also corrected to single digits for the first time in five years.

2 **Policy repo rate and 10 year bond yields**



Source: Bloomberg, DBS Group Research

…there is room to cut another 50 basis points by the June quarter

Here on, policy direction revolves around the government's ability to deliver high quality fiscal consolidation and achieve deficit targets, with a view on the FY15/16 budget. Given the prospect of sub-6.0% CPI inflation in FY15/16 and a central bank that is keen to keep the real policy rate at 150-200 basis points, there is room to cut another 50 basis points by the June quarter. Notably, the RBI is still to factor in the revised growth estimates, which might alter its policy stance. An unexpected rebound in commodity prices, a new policy framework, a lagged impact of below-par rains on the winter crop and a faster than anticipated rebound in aggregate demand pose risks to the inflation outlook.

Twin Deficits

Worries over India's twin deficits might soon become a problem of the past

Worries over India's twin deficits might soon become a problem of the past. The current account deficit more than halved to 1.7% of GDP in FY13/14 and will hold near steady at 1.6% in FY14/15. Crude prices have fallen by over 50% from mid-2014 levels and, if these levels sustain, the FY15/16 current account deficit might narrow sharply to below 1% of GDP.

Gold imports have corrected after the festive boost and oil import payments will get a hand from low oil prices. However, higher investment-led imports will limit the extent of correction in the trade balance. Meanwhile, strong capital inflows have eased funding concerns and mitigated worries over any balance of payments concerns.

The fiscal balance – the other leg of the twin deficits – was looking out of shape by December 2014, though steps were taken to curtail expenditure and boost non-tax revenues to meet the 4.1% of GDP deficit target.

Realistic budgetary projections in FY15/16 could see the deficit target set higher than the indicative 3.6% of GDP. Rating agencies will keep faith in government commitments to fiscal consolidation goals, while external imbalances remain in check.

Radhika Rao
India Economist
DBS Group Research

Currency: Indian Rupee

Optimism in India continues to be reflected more in its stock market than its nominal USD/INR exchange rate. Against the greenback, the Indian rupee did not buck the globally strong US dollar environment that emerged in the second half of 2014, a trend that is likely to extend into 2015.

As the Eurozone and Japan weaken their currencies via quantitative easing, the US is widely expected to raise rates later this year for the first time since the 2008/09 global financial crisis.

In reality, the rupee is not a weak currency

Noting India's improved fundamentals, we do not expect a repeat of the sharp 22% depreciation suffered by the rupee during the Fed taper tantrums in May-August 2013. Our end-2015 target of 66.5 for USD/INR represents a smaller 6% depreciation from the 62.18 rate seen on February 10.

In reality, the rupee is not a weak currency. While its value is lower against the US dollar, the rupee has appreciated against many of its trading partners. Between May 2014 and January 2015, the rupee's real effective exchange rate appreciated 4.1% even though USD/INR rose 4.7%. Hence, we expect the RBI to be pre-occupied with ensuring the rupee's competitiveness even while it accumulates foreign reserves to safeguard its stability.

Philip Wee
Senior Currency Economist
DBS Group Research

Rates: Front-End to Benefit More

With the European Central Bank (ECB) embarking on quantitative easing, developed market bond yields have hit new lows while the reach for yield has been beneficial for Asia's sovereign bonds. Against the backdrop of falling oil prices and a dovish stance by the RBI, Indian government bonds have had additional tailwinds.

We think the front-end of the yield curve is likely to benefit more from a projected additional 50 basis points in rate cuts by mid-2015. Two-year and ten-year yields are likely to drift toward 7.2% and 7.5%, respectively, in the short term. Sharply lower oil prices are favourable to the economy as it eases external funding concerns while also reducing price pressures. Estimates indicate that West Texas Intermediate (WTI) crude will average US$62 per barrel in 2015 (the forward space is implying WTI crude will reach US$54 per barrel this year while consensus expects the price to be closer to US$72 per barrel).

Our sensitivity impact shows every US$10 per barrel fall in oil prices narrows the current account deficit by 0.5% of GDP. This suggests scope for further compression in the current account deficit once low oil prices show up in the import numbers. Meanwhile, the feed-through of low oil prices on inflation indices is already apparent with on-year wholesale price index inflation close to zero for two consecutive months. CPI inflation has also been trending down and will undershoot the RBI's 6.0% target for early-2016.

With fundamentals looking much better, there is scope for the spread of ten-year India government yields over ten-year US Treasury yields – which track India's current account deficit closely – to narrow. However, towards the second half of the year, increased India government bond issuances and the prospect of higher US Treasury yields should provide a lift to India government yields.

Eugene Leow
Fixed Income Strategist
DBS Group Research

3 **10 year Indian Government yield and WPI**

Source: Bloomberg, DBS Group Research

Are Falling Oil Prices Good or Bad?

- Low crude prices carry broad benefits for India
- Weak commodity prices provide the fiscal and monetary space to boost growth
- Positives will quickly be overshadowed if weak demand rather than strong supply underlies the decline in oil prices
- Indian equity markets have historically moved closely with crude prices, but have diverged of late. Will this continue?

On the face of it, the sharp fall in oil prices should be good news for India, which is a big net importer of petroleum.

It should allow the government to accelerate economic reforms and redirect precious fiscal resources to productive purposes. Households should have higher discretionary incomes, while businesses, including manufacturers and farmers, should enjoy lower costs. Because oil makes up more than one-third of India's total imports, the terms of trade should improve. In short, low oil prices are good for both growth and inflation.

Low oil prices are good for both growth and inflation

But there could be another side to this rosy story. What if faltering global economic conditions – not just surging global oil production – is driving down oil prices? If that proves to be the case, concerns over global growth will outweigh the benefits. Further, what will happen if oil prices rebound?

So when it comes to cheaper oil, should Indians see the glass as half-full or half-empty?

The Half-Full View

Here are some likely benefits of cheaper oil for India:

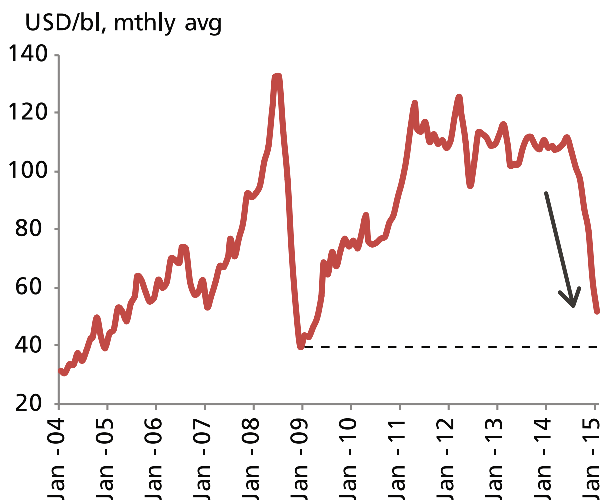
- **Fiscal balance**: Low oil prices and diesel deregulation will help eliminate fuel subsidies worth 0.3% of GDP. This has been factored into the FY14-15 Budget, so the full benefit might not appear until FY15-16. When it does, there should be savings of 0.4%-0.5% of GDP for every US$10 per barrel fall in Brent prices.

- **Growth:** It will be a positive impetus. Households will enjoy higher discretionary incomes, while businesses, including manufacturers and farmers, will enjoy lower input costs.

- **Inflation/Rates:** The direct impact on the consumer price index (CPI) inflation will be limited as the CPI basket gives higher weightage to food and non-tradable non-food products. The Reserve Bank of India (RBI) reckons a US$10 per barrel price drop can lower headline CPI by 20 basis points (bps). It should have a greater effect on wholesale price index (WPI) inflation -- which has a higher weightage of tradables -- of between 30 and 90bps in the short and medium-term. Easing inflation rates and an improvement in the twin deficits will make room for monetary and fiscal stimuli. The RBI lowered the benchmark rate by 25bps in mid-January and another 50bps could be trimmed off by June.

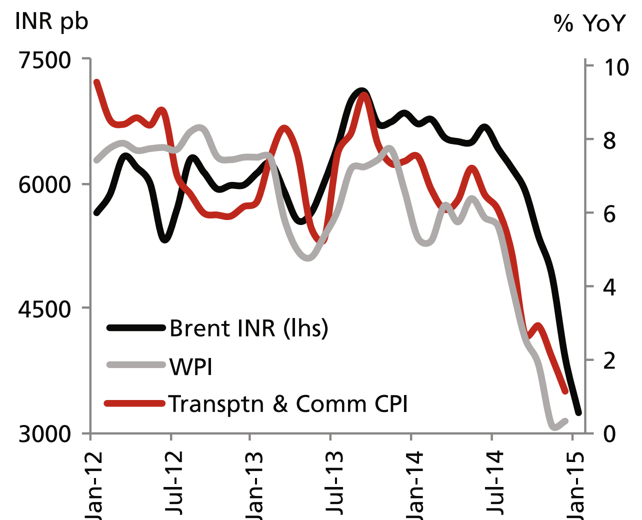
- **Current account:** Oil imports made up more than one-third of total imports in FY13/14, equal to 8.8% of GDP. For every US$10 per barrel fall, the current account balance can improve by 0.4-0.5% of GDP.

4 **Brent prices heading to 2009 lows**



Source: Bloomberg, DBS Group Research

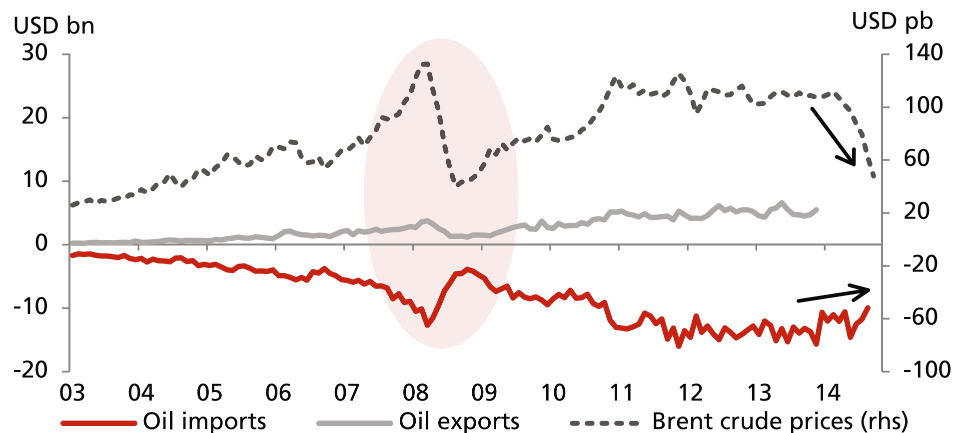
5 **Low crude prices to improve CPI/WPI profile**



Source: Bloomberg, CEIC, DBS Group Research

- **Currency:** Thankfully, it is unlikely to significantly affect the rupee. A strong Indian currency would work against the government's export-oriented manufacturing policy and would hinder the RBI's quest to build up foreign exchange reserves.

6 **Fuel price vs oil trade balance**



Source: CEIC, Bloomberg, DBS Group Research

Low Oil Prices Present an Opportunity

The pullback in commodity prices gives the Indian government space to make some crucial reforms. Low oil prices help tame inflation, repair fiscal books and lower the current account deficit. The RBI should be able to move ahead with its rate-cutting cycle. CPI inflation is expected to average 6.1% next year, with downside risks if crude prices remain soft.

At the same time, it is important that fiscal savings are redirected towards capital spending (now around 1.5% of GDP) instead of funding more food subsidies (now around 0.9% of GDP). February's FY15/16 Budget should outline plans to re-allocate funds.

The Half-Empty View

There's the question of how long will it last

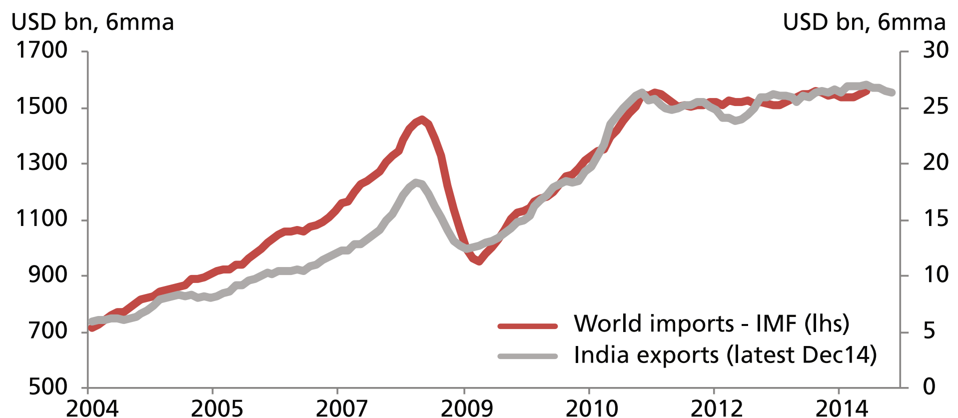
As with most things, there could also be a downside. Falling oil prices will not be so beneficial if it turns out that they are being driven down by weak demand rather than a spurt in global supply. The surge in US shale oil production in 2014 amounted to only 1% of total global demand. How that could trigger a 60% fall in prices remains an open question. It is not coincidental that commodity prices have eased when the Eurozone and Japan are stagnating, China is lowering growth targets, and US growth is grumbling along at around 2.25%.

India's exports depend on robust global demand and, if oil prices are low because no one is buying oil, the implications for external demand are clear.

Next, there's the question of how long will it last. In a January 19, DBS Market Focus Report – 'Global Crude: Low for Long?' – our Chief Economist David Carbon wrote: "The US shale oil revolution isn't as revolutionary as it sometimes sounds. In 2014, Asian demand absorbed 60% of the surge in US supply. In 2015, it will 'absorb' 135% of it. The demand-supply gap will have reversed. A V-shaped recovery (in oil prices) isn't as far-fetched as it may sound."

For India, a sharp oil price rebound would be a negative trade shock that would test the government's resolve to keep fuel prices market-linked and not revive state intervention.

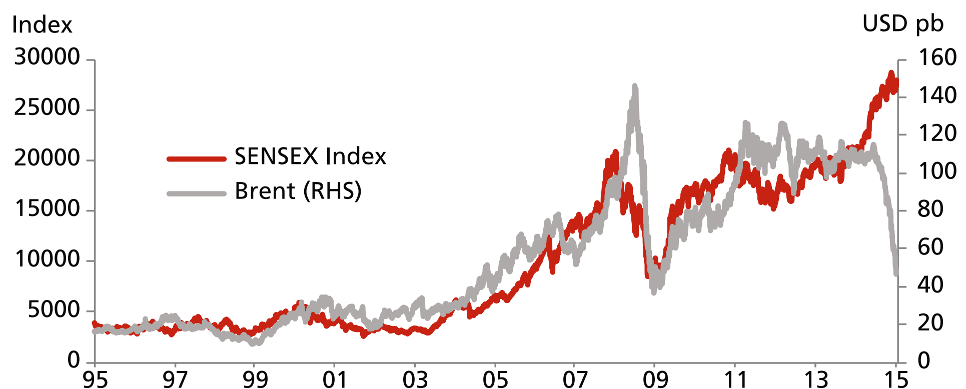
7 **Global imports vs India exports**



Source: CEIC, Bloomberg, DBS Group Research

Finally, contagion from financial market volatility is still a risk. Indian equity markets have historically been in lockstep with crude prices. But they have diverged of late largely due to accommodative global central bank policies. This could change if the markets feel that weak demand is behind the easing commodity cycle, or if expectations of US interest rate hikes are brought forward.

8 **SENSEX stock index vs Brent prices**



Source: Bloomberg, DBS Group Research

Summary

Overall, lower crude prices should be good for India's economy. But it needs to be balanced against the risk that oil's dramatic fall might be due to weak global demand. As the developed world grapples with the threat of deflation, such worries are bound to grow.

9 **Impact of crude price decline on key economic variables***

Every USD 10pb fall in Brent prices	
Current account	To lower the current account by ~0.4-0.5% of GDP
Inflation/ Monetary policy	CPI inflation to be lower by 20bps
	WPI inflation to be lower by 30-90bps (immediate and long-run)
	Opens room for rate cuts; DBSf cumulative 75bps cuts in 2015 calendar year (includes Jan15 surprise cut)
Fiscal deficit	Lower crude prices and diesel deregulation helps shield the government's balance sheet from volatile commodity prices. Fiscal deficit to narrow by 0.5% of GDP; includes elimination of diesel subsidy (~0.3% of GDP)

*assumptions: i) all other variables are constant; ii) impact on full-FYperformance

Source: DBS Group Research

HAMILTON

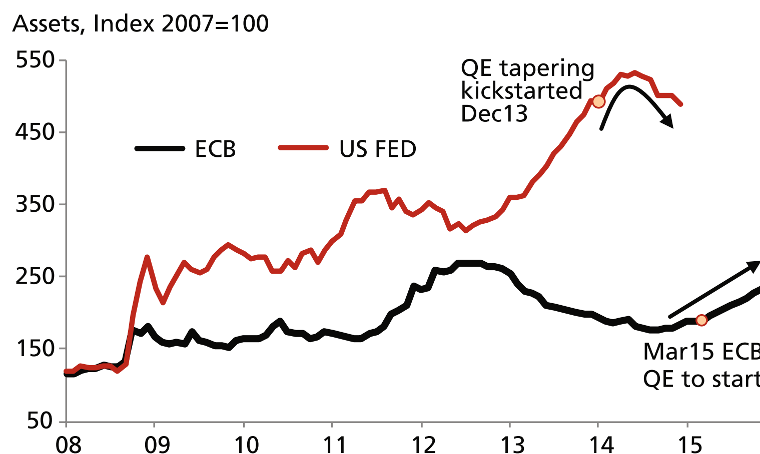
Coping With Europe's QE and the Strong Dollar

The European Central Bank (ECB) announced formal quantitative easing (QE) soon after the US Federal Reserve exited its QE program amid talk of an interest rate lift-off. The dollar has strengthened sharply as a result. How will these developments affect the Indian economy? We think the impact will be mixed.

Modest Boost to Flows Likely

The European Central Bank (ECB) is expanding its balance sheet by a record 1.1 trillion euros. But, unlike the previous boost to capital inflows from the US Federal Reserve's QEs, Indian markets should only expect a marginal uplift.

10 **ECB poised to expand balance sheet, while US Fed halts**



Source: CEIC, DBS Group Research

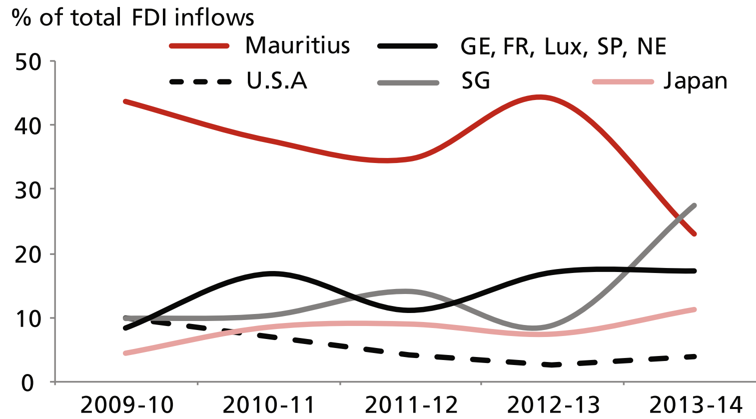
Portfolio inflows from the Eurozone accounted for only 10% of inflows into India last year. So a large liquidity spurt on the back of the ECB's QE seems unlikely. Also, it's not clear how and where Europe's banks will deploy QE-generated funds. If these are deposited back with the ECB (as the case was with US banks post-QE), the net impact for India will be negligible.

Indian exporters should not bank on an export bonanza to Europe

We are sceptical that the ECB's QE can generate enough economic activity for European companies to invest offshore. But if it does, European foreign direct investment (FDI) flows to India might receive a modest fillip.

Finally, Indian exporters should not bank on an export bonanza to Europe. The share of India's trade with the EU has fallen steadily since the 1990s. And, with the euro's sharp decline, Europe will want to export more, rather than increase imports.

11 **FDI destination-wise inflows**



Source: RBI, DBS Group Research

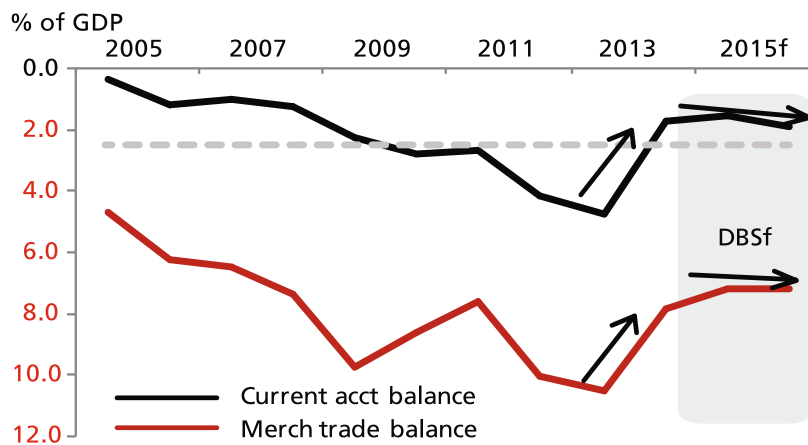
Implications of the Strong Dollar

A strong dollar and/or a bout of weak foreign sentiment are likely to hit economies with large current account deficits, low foreign reserves, or large foreign borrowings. India is well-placed on the first point, but less so on the other two. While its current account balance has improved significantly, its reserves remain low and its debt high.

The Positives

India's current account deficit (CAD) halved to 1.9% of GDP between April and September 2014, from 4.8% in FY12/13. The full-year 2014 deficit should narrow to 1.6% of GDP to

12 **CA deficit <2% of GDP; to narrow on oil**



Source: CEIC, DBS Group Research

stay within the official comfort level of 2.5% of GDP for the next two years, despite the likelihood of higher investment-led imports.

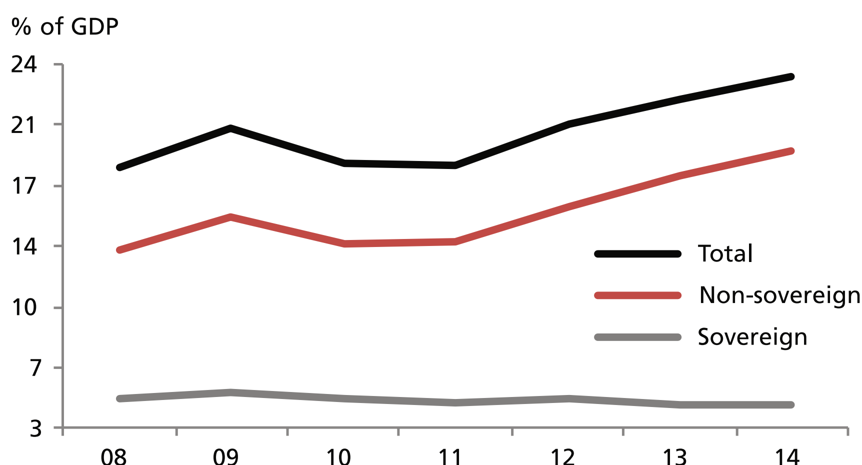
Falling oil prices and a decline in gold imports can only help the trade balance

Falling oil prices and a decline in gold imports can only help the trade balance. With every US$10 dollar drop in oil prices, India's external balance should improve by 0.5% of GDP. So the deficit could be considerably smaller than our forecast of 1.9% of GDP for FY15/16. Meanwhile, strong capital inflows have eased concerns over funding and balance of payments. The fiscal deficit target of 4.1% of GDP should be met, although a 3.6% target for the following year seems a stretch.

Areas Of Concern

External borrowings have been rising, pushing total external debt (TED) up from 18% of GDP in 2008 to 23.5% in 2014. Long-term debt accounts for more than three-fourths of the total.

13 **Non-govt external debt on the rise**



Source: RBI, DBS Group Research

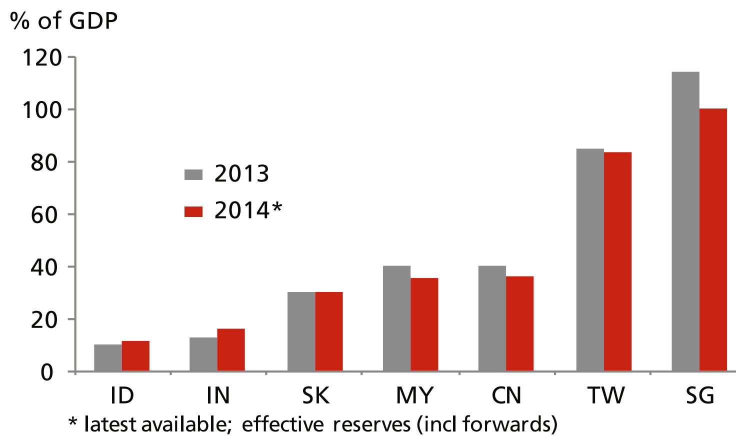
...the growing share of non-government external debt is a concern

Of the total, the growing share of non-government external debt is a concern. Government external debt has run between 4% and 5% of GDP since the Global Financial Crisis (GFC). But the non-government share is now at 19%, up from 13%, and is responsible for the rise in overall external debt since the crisis. The biggest and fastest rising component of non-government / private sector debt is external commercial borrowings, including bank loans, notes and bonds raised overseas. These have grown two and half times since 2008 in dollar terms and now amount to 8% of GDP.

A second point of concern is foreign reserves. The Reserve Bank of India (RBI) has been building them up as a buffer against capital outflows and they now cover eight months

of imports compared with the global norm of three months. Even so, India's reserves as a percentage of GDP are low for Asia10. At 16% of GDP, India leads only Indonesia at 11%. Most other countries have reserves within the 30%-50% range.

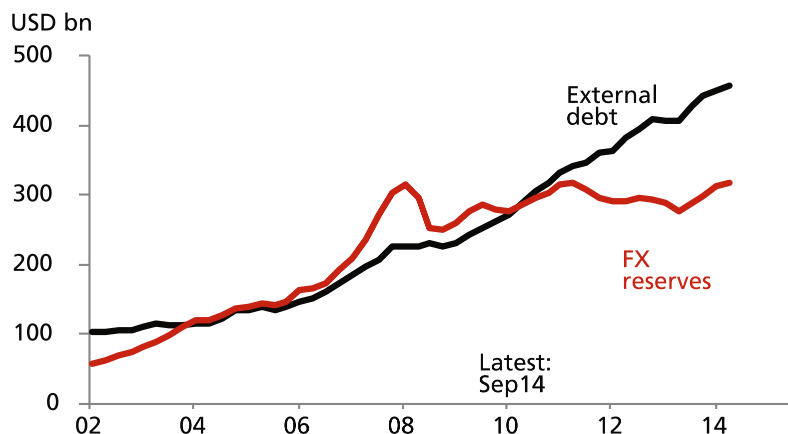
14 **India's reserves small vs Asian peers**



Source: DBS, Asia vulnerability dashboard, 19Dec14

India's reserves relative to external debt are also among the lowest in Asia. The reserves coverage ratio fell to 70% of TED in 2014 from over 130% in 2008. With private-sector debt making up more than three-fourths of total debt, reserves fall short here too. Encouragingly, at 27% of foreign reserves, short-term external debt is on-par with other Asian countries. But, based on residual maturity (the part of total debt that matures within one year), short-term debt is high at 58% of total debt.

15 **External debt exceeds FX reserves**



Source: CEIC, DBS Group Research

Not a Red Flag But Warrants Attention

All should be well for India as long as global liquidity remains ample, global rates stay low, and the dollar is stable. But financial stability could be at risk if any of these factors deteriorate.

With this in mind, the RBI has urged corporates against leaving foreign liabilities unhedged. The hedge ratio for offshore borrowings declined from 34% in March 2014 to 15% in August 2014 (versus 40-45% in wake of the GFC). That means 85% of borrowings are now exposed to currency swings, up from 50% earlier. With foreign reserves falling short of TED, India remains vulnerable to bouts of weak sentiment.

Currency Implications

Indian authorities can tolerate a weakening of the rupee against the dollar, provided volatility is low and its depreciation is gradual. A weaker currency will benefit the government's export-oriented manufacturing policies and also help the RBI build even higher foreign reserves.

...the RBI should keep the door ajar for further rate cuts

A rupee that stays down against the dollar would also offset its climb against a basket of currencies of its other major trading partners. On a real effective exchange rate (REER) basis, the rupee was up 8% on-year in December 2014. This reflects how the rupee has risen 16% against the euro, 11% against the Japanese yen, and around 3% against the Chinese yuan, while it has been flat against the dollar.

Stimulus policies in these economies will keep their currencies down and so make the rupee comparatively stronger. Concerned with rupee's strength, the RBI should keep the door ajar for further rate cuts, with the need to also offset pressure from strong capital inflows.

Summary

The Indian economy has become more resilient in recent times. But complacency is not an option and pre-emptive measures will be needed to deal with potential external shocks. We expect the RBI to keep building up its reserves, and absorb strong short-term foreign inflows to guard against external volatility and arrest any undue rupee appreciation.

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