Group Economics
Emerging Markets

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India Watch

Jewel in the crown again?

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With growth expected at 7.5%, India will surpass China as fastest-growing emerging giant this year. However, in terms of development, India lags behind its bigger Asian neighbor. This also illustrates India's catch-up potential, certainly if the country continues to push through reforms. Looking at the reform progress made by PM Modi's government, one year after its convincing victory, the glass is half full in our view. Meanwhile, external risks have fallen since the *tapering tantrum* in 2013, when India was classified as one of the *fragile five*. Despite these improvements, India remains vulnerable to turns in market sentiment, for instance triggered by a faster-than-expected Fed exit, while stalling reforms would pose another risk.

Jewel in the crown again?

During the *British Raj* (1858-1947), India was often referred to as 'Jewel in the Crown', as Britain had cheap access to the country's natural resources. Nowadays, India looks to be an Asian crown jewel once more, at least in terms of economic growth. As explained in last month's Asia outlook *India makes up for China slowdown*, GDP methodology revisions in mid-February lifted (estimated) growth rates in recent and coming years by 1.5 – 2 %-points. For 2015 and 2016 we now expect India to grow by 7.5%. Hence, already this year India will surpass China (where growth gradually slows to an estimated 7% in 2015-16) as fastest growing emerging giant.

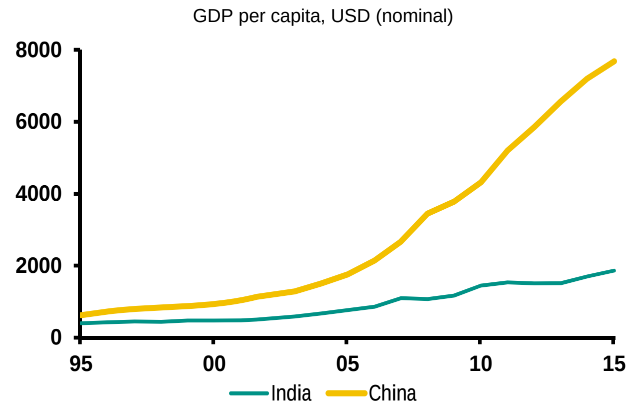
India now grows faster than China ...

Source: Bloomberg
NB: Since Q2-2012, Indian GDP growth data based on new methodology

India still lags China in terms of development

Still, China's development has progressed to a more advanced state than India's. Between 1995 and 2014, China's GDP per capita (in nominal USD terms) increased more than tenfold, whereas India's GDP/capita quadrupled. In 2014, China's GDP/capita was four times that of India. Moreover, poverty is still a bigger problem in India, as around 30% of the population lives below the (national) poverty line versus 13% in China. WHO data show that life expectancy at birth is 65 years in India versus 76 in China. India's literacy rate is 74% versus 95% in China. These differences in development stage also illustrate that there are catch-up gains in sight for India, certainly if it continues to push through reforms. Favourable demographics also support India's growth potential.

... but is still much less richer



Source: EIU

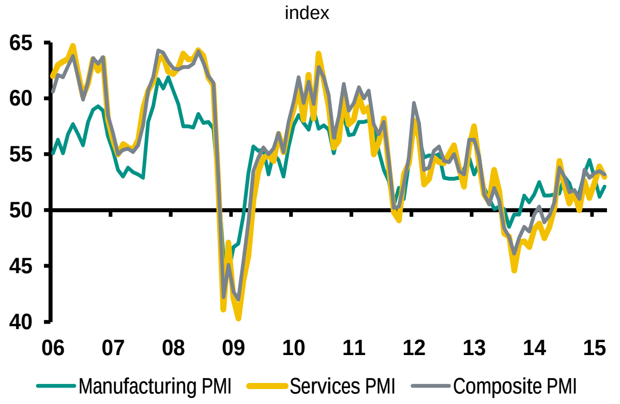
Growth rates also supported by politics and oil windfalls

Post-election dynamism leading to an improved momentum for growth and oil windfalls have also supported growth. Based on the new GDP methodology, annual growth jumped to a 3.5 year high of 8.2% yoy in Q3-2014, driven by a surge in private consumption. In Q4, growth slowed somewhat as private consumption cooled and exports contracted further, but at 7.5% remained relatively high by recent standards. Investment remains quite subdued, despite government efforts to boost infrastructure investment. Still, industrial production accelerated recently to 5% yoy in February, supported by rising growth in the manufacturing sector.

Business confidence is improving

The development of the forward looking PMIs show that business sentiment has improved since mid-2013. Although the Manufacturing PMI has fallen a bit compared to the three-year high of 54.5 reached last December 2014, at 52.1 the index still is at healthy levels. What is more, the Services PMI has climbed from below the neutral 50 mark since Q3-2013 (average 46.7) to an average of 53.1 in Q1 2015. As a result, the composite PMI has fluctuated around a decent 53.5 in recent months, up from below 50 levels one year earlier.

Business confidence on an improving trend



Source: Thomson Reuters Datastream

Modi-government has initiated several reforms

In its first year in office, PM Modi's government has made progress with reforms, as it has improved labor legislation and has laid the foundation for complex tax and subsidy reforms and for reforming and opening up state monopolies. Moreover, steps have been taken regarding fiscal consolidation, such as streamlining regional finances. Still, progress in several key (sensitive) areas such as land reform is less impressive.

Progress with reforms is sometimes blocked by the complex federal model of India. The BJP lacks a majority in the Senate, which has a say over key areas such as land reform. Moreover, state governments still play an important role. The light regional election calendar this year could help paving the way for further reforms. Still, although it remains to be seen whether existing reform plans will indeed be implemented, the current government is the most business friendly, growth-oriented in years and its mandate to introduce reforms remains quite strong. In that sense, the glass is half full in our view.

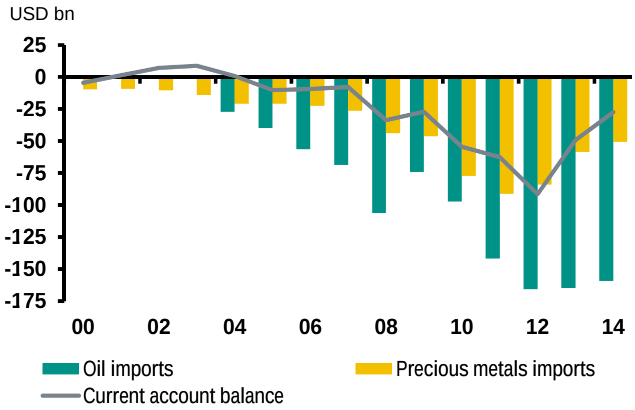
RBI maintains its easing bias

Falling commodity prices have contributed to inflation dropping from around 10% yoy in late 2013 to around 5% yoy currently. We expect inflation to fall from 7.2% in 2014 to 6% in 2015, remaining within the RBI target of 6% per early 2016. The RBI is to be praised for its prudent policies since mid-2013, making India less vulnerable to market turmoil. The RBI's two 25 bp rate cuts in January and March (to 7.5%) were expected, although the timing of the moves – made in interim meetings – was surprising. Still, Indian banks have not been keen to pass-through lower rates on to lenders so far, with credit growth remaining quite weak. In its regular April meeting, the RBI stayed on hold but kept its easing bias. We see some room for one or two additional rate cuts in 2015, but – to quote governor Rajan – further easing will be "conditioned by incoming data".

External position has improved

India's external position has clearly improved compared to several years ago. The current account deficit has fallen from 5% of GDP in 2012 to 1.3% of GDP in 2014. This was driven by monetary tightening, gold import restrictions and the sharp drop in oil prices. More recently, the trade deficit has widened as exports are contracting and gold imports are rising as import restrictions have been relaxed. The current account deficit is expected to remain around 1.5% of GDP, as a cheaper oil bill will help to contain imports. Moreover, the ongoing rise of FX reserves – which now cover around 6 months of imports and short-term external debt threefold – has further mitigated external financing risks.

Current account has improved since 2012



Sources: EIU, Thomson Reuters Datastream

In conclusion

India's vulnerabilities have fallen compared to the tapering tantrum in 2013. The momentum for reforms and the growth outlook have improved, while the external position is stronger. All this is illustrated by external rating developments. The three major rating agencies have kept India at the lowest investment grade since 2007. Whereas S&P and Fitch had a negative outlook in early 2013 their outlook is stable now, while Moody's recently changed its outlook to positive. Still, as India stays dependent on foreign funding to cover external deficits, it remains sensitive to shifts in market sentiment, for instance stemming from a faster-than-expected Fed exit. A stalling of reforms would pose a related risk. Hence, keeping reforms on track is key for India to become Asia's crown jewel once more.

Key forecasts for the economy of India

	2012	2013	2014e	2015e	2016e
GDP (% yoy)	5.1	6.4	7.2	7.5	7.5
CPI inflation (% yoy)	9.7	10.1	7.2	6.0	5.5
Budget balance (% GDP)	-4.9	-4.5	-4.0	-4.0	-4.0
Government debt (% GDP)	52	51	50	49	47
Current account (% GDP)	-5.0	-2.6	-1.5	-1.5	-2.0
Gross fixed investment (% GDP)	31.4	29.7	27.9	26.2	26.7
Gross national savings (% GDP)	29.1	29.6	29.7	27.8	27.4
USD/INR (eop)	54.8	61.9	63.3	64.0	65.0
EUR/INR (eop)	71.1	85.3	81.1	60.8	71.5

Budget balance, current acc. for 2014,2015 and 2016 are rounded figures
Source: EIU, ABN AMRO Group Economics

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