
# India Economic Insight
2016

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**Editorial closing: March 13, 2016**

# Executive Summary

### Recent Developments

- India's real GDP growth has risen sharply from 5.5% in 2011/12 to 7.2% in 2014/15 and 7.3% in the third quarter of 2015/16, driven by rising consumption and investment
- Inflation moderated from 10.0% in 2013/14 to 4.5% in H1 2015/16 on falling global commodity prices, but has picked up more recently as poor harvests have led to higher food prices
- The current account deficit narrowed from 1.8% of GDP in 2013/14 to 1.4% in H1 2015/16, mainly due to the decline in oil prices, but was also helped by policies to restrict gold imports
- Fiscal consolidation is on track but the deficit remained elevated at an estimated -6.6% of GDP in 2015/16
- Balance sheets and profits are deteriorating at state banks as rising nonperforming loans (NPLs) lead to higher provisioning and lower credit growth; private banks are performing better

### Macroeconomic Outlook

- Reforms could make India the fastest growing major economy; we expect real GDP growth to progressively accelerate to 7.3% in 2017/18 and 7.5% in 2018/19
- Inflation is expected to rise to 5.2% in 2016/17, but may moderate thereafter on lower food prices as harvests normalise
- The current account deficit should narrow progressively to 0.9% by 2018/19 on a weaker Indian Rupee (INR) and fiscal consolidation
- We expect the fiscal deficit to narrow from 6.6% of GDP in 2015/16 to 5.2% of GDP by 2018/19 on subsidy cuts, tax increases and privatisations
- We expect growth in banking assets to slow to 9.0% in 2016/17 before picking up to 10.0% in 2017/18 and 11.0% in 2018/19 as state banks' balance sheets are cleaned up and as the sector is recapitalised

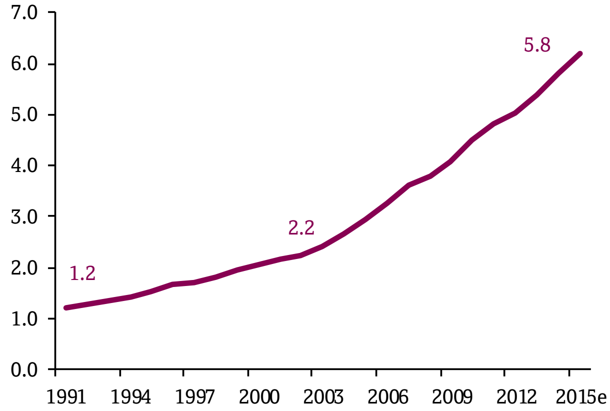
# Background

### The liberalisation of the Indian economy in 1991 improved economic performance in the subsequent two decades

India's economic reforms in 1991 led to a significant improvement in its economic performance. The reforms came in the middle of an acute balance of payments crisis which left India with reserves barely sufficient to fund oil imports for two weeks. In response, the government devalued the currency, reduced regulation, dismantled bureaucratic control over licensing, opened up the economy to foreign investments and cut trade tariffs. The results were startling. Income per capita increased fivefold from USD1.2k to USD6.2k today on a purchasing power parity (PPP) basis as India became one of the engines of the global economy with growth of 6.8% in the two decades after 1991. The share of people living in poverty (defined as USD1.9 per day on a PPP basis) was halved from 46.1% in 1993 to 21.3% in 2011. Life expectancy increased from 58 years in 1990 to 68 in 2013.

**Nominal GDP Per Capita**

(PPP, k USD)



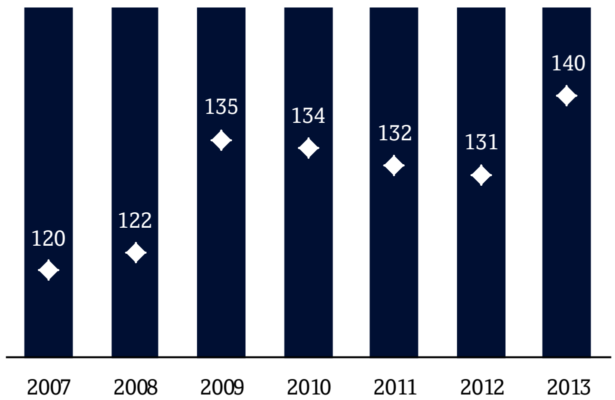

Sources: International Monetary Fund (IMF), Haver Analytics and QNB Economics

### But as the impact of the 1991 liberalisation dissipated, the need for a new round of reforms became apparent

As a result of rapid growth since 1991, supply bottlenecks have built up, with overburdened transport infrastructure and power shortages. The persistent inflation problem, a result of supply bottlenecks, was further exacerbated by government policies aimed at increasing rural wages and easy monetary policy. India's ranking in the World Bank's Ease of Doing Business Index deteriorated from 120 out of 189 in 2007 to 140 in 2013, lagging behind Sri Lanka, Nepal, Bhutan and Pakistan. India lost competitiveness and the current account balance deteriorated from a surplus of 2.3% of GDP in 2003 to a deficit of 4.8% in 2012. The weaknesses were exposed in the taper tantrum of 2013. When the US tapered quantitative easing, EMs were hit by capital flight with India amongst most severely impacted. India was in need of a new wave of reforms to address its vulnerabilities and kick-start growth.

**Ease of Doing Business Ranking**

(1: most business-friendly, 189: least business-friendly)




Sources: World Bank, Haver Analytics and QNB Economics

### Modi and Rajan have revitalised a number of reforms

The election of Narendra Modi to the prime minister's office in May 2014, and the appointment of Raghuram Rajan as the governor of the central bank in September 2013 have supported continued reforms and lower oil prices made it easier to cut energy subsidies. Modi's government has also increased capital spending to boost India's ailing infrastructure, eased restrictions on foreign direct investment, promoted further financial inclusion, taken measures to reintroduce a uniform goods and services tax (GST) and promoted better governance through an anti-corruption drive. Rajan adopted a coherent and explicit monetary policy framework based on inflation targeting. These reforms efforts currently have helped stabilise the economy. However, more is needed to increase labour market flexibility, improve education, address land acquisition laws, and tackle bad assets in the banking system, which have inhibited investment.

**Key Reforms Implemented**

| Reform | Impact |
|---|---|
| ***Government*** | |
| Energy subsidy cuts | Narrower fiscal deficit |
| Increase capital spending | Higher growth |
| Easing foreign direct investment restrictions | Higher growth; more stable currency |
| Ease of doing business | Higher growth |
| Increase financial inclusion | Higher growth; more efficient public spending |
| ***Central Bank*** | |
| Inflation targeting regime | Stable inflation |
| Increase competition in the banking system | Higher growth |

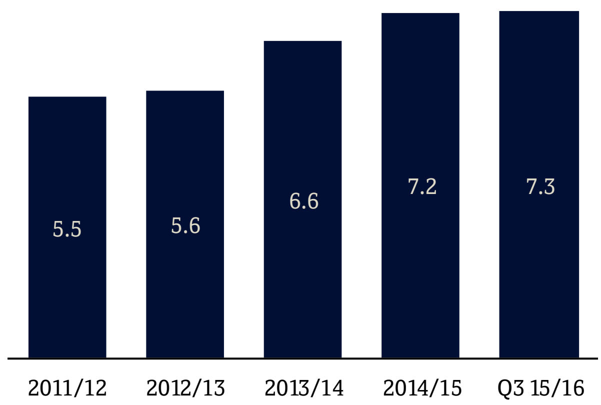
Source: QNB Economics

# Recent Developments (2014-16)

### India is now the fastest growing major economy in the world, driven by rising consumption and investment

Following the rebasing of the GDP series in January 2015, GDP growth has been revised up, with India now overtaking China as the world's fastest growing major economy. India's real GDP growth has risen from 6.6% in 2013/14 to 7.2% in 2014/15 and 7.3% in the third quarter of 2015/16. The acceleration in growth was driven by domestic factors as the contribution of net exports was broadly neutral. Private consumption has been the largest contributor to growth since 2014/15 due to the near 70% decline in oil prices, which freed up income for consumers to spend on other items. Investment has been the second major contributor since 2014/15, boosted by the government's reform drive and easier monetary policy. Meanwhile, the contribution of government consumption fell, reflecting the administration's fiscal consolidation efforts.

**Real GDP Growth**
(%, year-on-year)

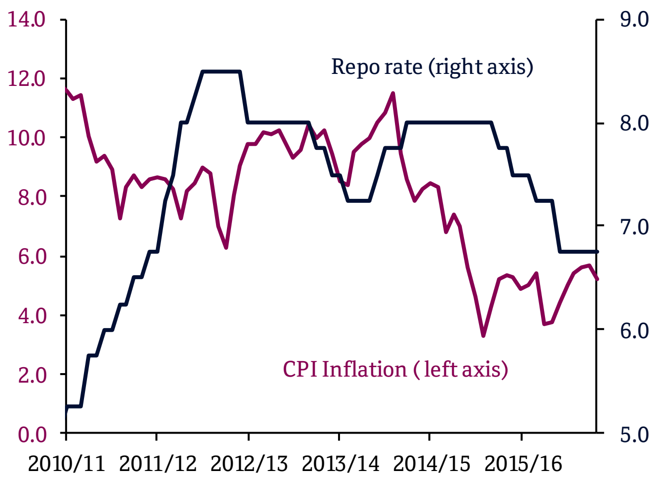



Sources: Central Statistical Office (CSO), IMF, Haver Analytics and QNB Economics

### Inflation has moderated leading to lower RBI policy rates

Inflation has declined from 10.0% in 2013/14 to 4.5% in H1 2015/16. To tackle high inflation in 2013/14, the RBI adopted an informal inflation-targeting regime, aiming to reduce inflation to 6.0% by January 2016. It raised interest rates and kept monetary policy tight until December 2014, before cutting rates after inflation had moderated. Various other factors brought down inflation. First, the sharp decline in commodity prices, particularly oil prices. Second, having risen at 15-20% previously, rural wage growth stabilised at ~5% after 2013/14 as increases in government minimum support prices for food grains were cut. Third, the trade-weighted exchange rate appreciated after 2013/14, lowering import prices. However, recently, inflation has picked up, reaching 5.7% in January. This was mainly due to rising food inflation, which accounts for 46% of the CPI basket and contributed 3.1 percentage points to overall inflation. Most food is produced domestically and India has suffered two consecutive years of poor monsoons, leading to disappointing harvests and higher prices.

**Policy interest rates and inflation**
(%)

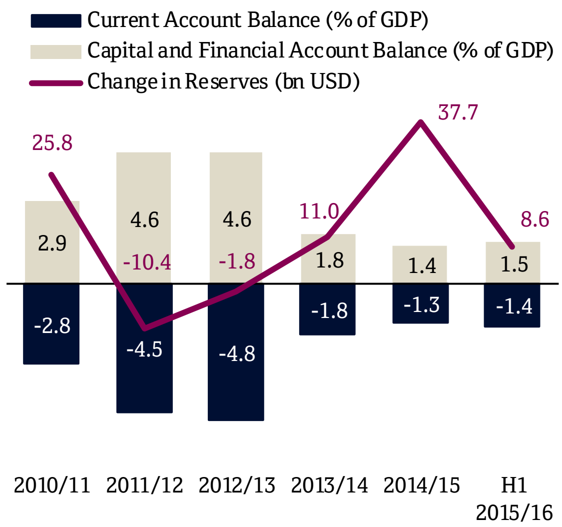



Sources: Ministry of Statistics & Programme Implementation (MOSPI), Reserve Bank of India (RBI), Haver Analytics and QNB Economics

### The current account deficit narrowed on lower oil prices

The current account deficit narrowed from 1.8% of GDP in 2013/14 to 1.4% in H1 2015/16, mainly due to falling oil prices, but also helped by policies to reduce gold imports. Meanwhile, the capital and financial account surplus narrowed from 1.8% of GDP in 2013/14 to and 1.5% in H1 2015/16. Portfolio flows into India were weak due to elevated EM capital flight. Weak portfolio flows were offset by other flows on the financial account. First, India continued to receive steady foreign direct investment (FDI) inflows of around 2% of GDP thanks to its strong economic performance. Second, inflows of deposits from non-resident Indians stabilised at an average of 1% of GDP in H1 2015/16. This resulted in a balance of payments surplus and led to an increase in international reserves from USD304bn in March 2014 to USD352bn at end-2015. Since late 2013, the RBI has been actively accumulating international reserves, with a view to building a sufficiently large buffer to withstand the impact of higher US interest rates.

**Balance of payments**

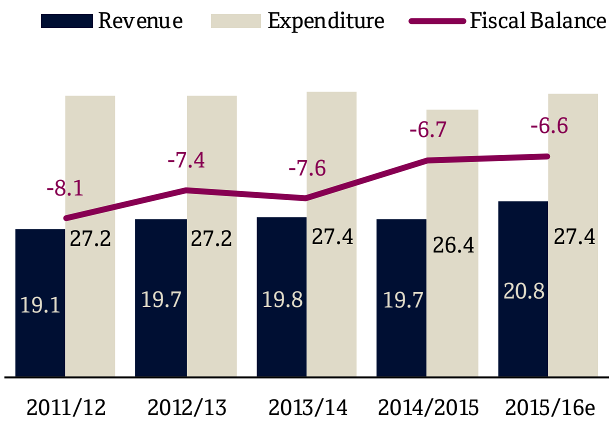



Sources: CSO, RBI, Haver Analytics and QNB Economics

## The budget deficit is narrowing, but remains elevated

The general government deficit (central and state budgets) narrowed to an estimated 6.6% of GDP in 2015/16 from 6.7% of GDP in 2014/15. The central government deficit was 3.9% in 2015/16 compared with a state deficit of 2.7%. For the central government, current expenditures have decreased (11.4% of GDP in 2015/16, compared with 11.7% in 2014/15) aided by cuts in subsidies (predominantly fuel and fertilisers) and lower oil prices. However, this has been partially offset by rising capital spending for infrastructure, as per the reform programme, by the central government (1.8% of GDP in 2015/16, compared with 1.6% of GDP in 2014/15) and an increase in state budget expenditure, which accounts for just over half of general government expenditure. Revenues have been boosted by rising tax collections owing to a large increase in excise duties (mainly on fuel products) as well as an increase in service tax rates (12.4% to 15.0%). Public debt as a share of GDP rose to an estimated 68.2% of GDP in 2015/16 from 66.1% in 2014/15 owing to the fiscal deficit.

**Fiscal Balance**
(% of GDP)

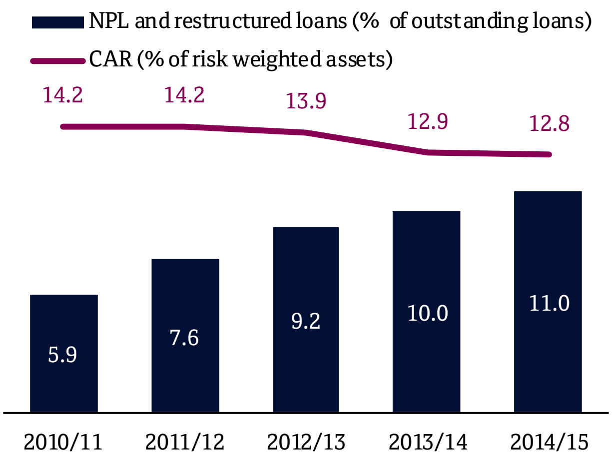



Sources: IMF, Ministry of Finance, Haver Analytics and QNB Economics
2015/16e refers to estimates

## Balance sheets and profits are deteriorating at state banks

While private sector banks are performing well, the sector is dominated by state banks (75% of assets), which have become undercapitalised due to a build-up of stressed assets. The capital adequacy ratio was 11.4% at state banks at end 2014/15, compared with the RBI's requirement of 12%, and 14.8% at private banks. State banks have over-lent to large industrial and infrastructure projects that have gone awry, particularly as investment projects have stalled. As a result, total NPLs are rising and reached 11.0% of total loans at the end of 2014/15 (including restructured loans). Official NPLs at state banks (5.4%) are considerably higher than at private banks (2.4%). Rising NPLs have led to higher provisioning and worsening profitability, particularly at state banks. Return on equity (ROE) fell from 10.8% in 2013/14 to 9.6% in 2014/15 for the banking sector as a whole. State banks ROE was around 8.9% in 2014/15 compared with 17.0% for private banks, based on estimates from listed securities.

**Stressed assets and capital adequacy**

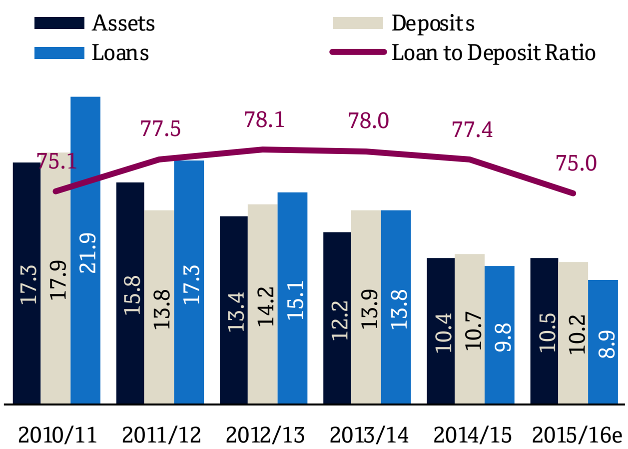



Sources: IMF and QNB Economics

## Banking sector growth has slowed as state banks have been pressed to clean up their balance sheets

Banking system penetration is low (total assets were 77.2% of GDP at end 2014/15), compared with an average of ~183% for similar emerging economies (China, Indonesia, Malaysia, Philippines, Thailand, Vietnam, Turkey, Brazil and Russia), leaving room for growth. Credit growth has slowed from 9.8% in 2014/15 to an estimated 8.9% in 2015/16, with growth among state banks slowing from 12.9% to 7.2%. The RBI has pressed state banks to strengthen their balance sheets and they have cut back on lending as a result. Meanwhile, lending among private banks picked up from 15.9% to 17.4% as they benefited from the accelerating economy, unencumbered by bad assets. Deposit growth has slowed on lower interest rates and as banks have been less aggressive in pursuing deposits due to a slowdown in credit growth. The government has just begun initiating reforms to address banking system vulnerabilities and more reforms are expected this year.

**Banking Sector Growth**
(% year on year, %)




Sources: RBI, Haver Analytics and QNB Economics

# Macroeconomic Outlook (2016-19)

## Reforms are planned but implementation could be tough

The government plans a raft of key reforms, but some will face political opposition. Reforms that are highly likely to be adopted are cuts to subsidies and higher infrastructure spending in critical sectors (railways, roads and power) as these are already part of the budget. The 7th Pay Commission, a 10-yearly reappraisal of public pay and pensions, is likely to lead to higher wages and military pensions, also included in the budget. Also expected in 2016 are: higher FDI limits in a number of sectors, including banking; the introduction of GST; and banking reforms, including plans to raise the capitalisation of state-owned banks by injecting USD10.4bn by 2019/20. Central bank reforms are also progressing. The RBI is adopting a formal inflation target from 2016/17 and monetary policy will be set by an independent MPC. However, some key reforms may be challenging to implement as Modi's party lacks a majority in the upper house. Resistance to land acquisition, labour and bankruptcy laws is particularly strong.

**Key Reforms**

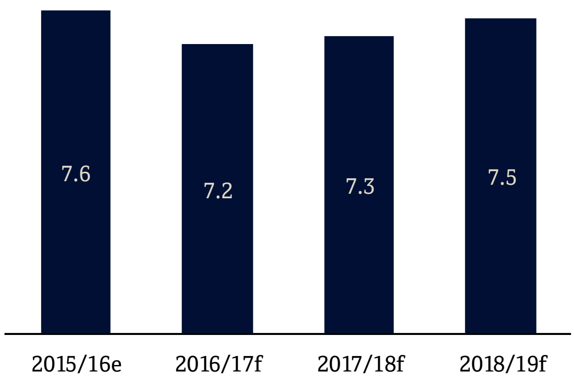
| Reform | Impact |
|---|---|
| ***Government*** | |
| Budget Subsidy Cuts | Narrower fiscal deficit |
| Increase Capital Spending | Higher growth |
| Ease of Doing Business | Higher growth |
| FDI Liberalisation | Higher growth |
| Goods and Services Tax (GST) | Higher growth |
| Land acquisition laws | Higher growth |
| Labour laws | Higher growth |
| ***Central Bank*** | |
| Monetary Policy Committee (MPC) | Low and stable inflation |
| Formal inflation target | Low and stable inflation |
| ***Banking Sector*** | |
| Recapitalisation | Higher growth |
| Bankruptcy Code | Lower NPL, Higher growth |

Source: QNB Economics

## Reforms could maintain India's position as the fastest growing major economy

We forecast real GDP growth to progressively accelerate to 7.3% in 2017/18 and 7.5% in 2018/19. Growth should be driven by domestic reforms, despite implementation challenges. The GST, if implemented, would improve the flow of goods and services between regions by unifying the state tax codes. Higher FDI limits and restarting stalled investment projects would drive growth both directly, as well as indirectly, by encouraging the participation of the private sector and foreign investors. Recapitalisation and reform of banks should support lending and growth in the near to medium term. We expect interest rates to remain low, offsetting the drag from tighter fiscal policy. Finally, higher expected oil prices may reduce consumers' disposable income, but the increase in prices is projected to be small and would be more than offset by increases in wages and pensions from the 7th Pay Commission.

**Real GDP Growth**
(% year on year)

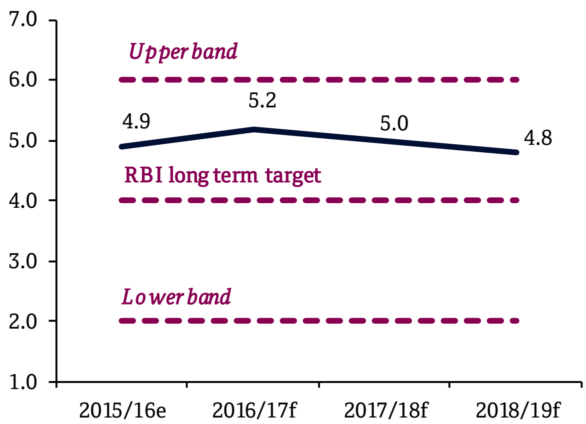



Sources: CSO, Haver Analytics and QNB Economics forecasts

## Inflation is expected to increase this year, then moderate

A number of temporary factors are expected to lift inflation to 5.2% in 2016/17, which are expected to moderate thereafter. The temporary factors include higher rent allowances for public sector workers (part of the 7th Pay Commission), higher power tariffs, and an increase in the services tax rate. Some important factors will keep inflation down throughout the forecast period. A normalisation of harvests should bring down food inflation, and the increase in oil prices is expected to moderate each year and will, therefore, have a lesser impact on inflation. Finally, in March 2015, the RBI announced an inflation target of 4% with an upper and lower limit (+/- 2%) to be effective from April 2016. With inflation above this target, monetary policy should continue to help lower inflation. As a result, inflation should fall to 5.0% and 4.8% in 2017/18 and 2018/19 as these factors fade away.

**Inflation**
(%)



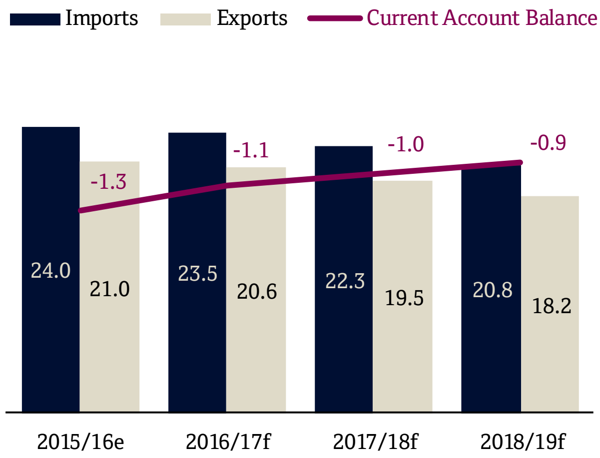

Sources: MOSPI, RBI, Haver Analytics and QNB Economics forecasts

## The current account deficit should narrow slightly on a weaker currency and fiscal consolidation

We expect the current account deficit to narrow from 1.3% in 2015/16 to 0.9% by 2018/19. Although gradually higher oil and commodity prices may increase the import bill, this should be more than offset by three factors. First, fiscal consolidation should lower government spending, which would reduce imports. Second, the RBI is likely to allow INR to depreciate slightly further to enhance competitiveness, supporting exports and inhibiting imports. Third, government is introducing schemes to monetise India's large gold holdings by encouraging banks to lend gold to jewellers and by issuing government bonds with repayments based on the gold price. This should reduce physical gold imports (~10% of imports). A narrower current deficit would reduce the need for borrowing on the financial account. Additionally, other capital inflows are likely to keep the balance of payments in surplus and the RBI is expected to continue its policy of accumulating international reserves.

**Balance of payments**

(% of GDP)



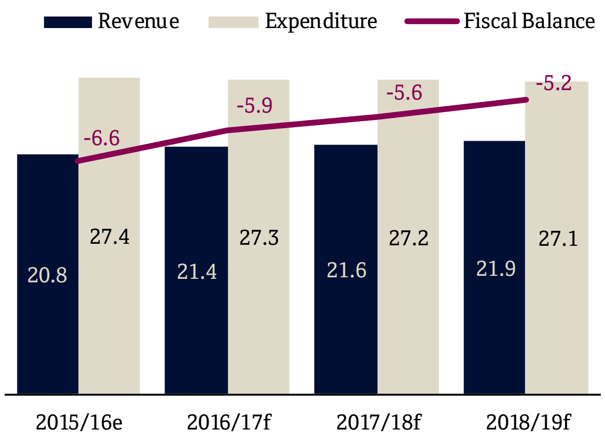

Sources: CSO, RBI, Haver Analytics and QNB Economics forecasts

## Fiscal consolidation is planned to continue

We expect the fiscal deficit to narrow from 6.6% of GDP in 2015/16 to 5.2% by 2018/19. The central government is targeting a deficit of 3.5% of GDP in 2016/17, which is expected to result in a general government deficit of 5.9%. Current expenditure may fall due to subsidy cuts (mainly on food) offsetting the costs of a rural jobs programme and higher wages and pensions related to the 7th Pay Commission. Capital spending may rise as the government increases infrastructure spending. On the revenue side, taxes should increase due to higher excise duties and a raise in the services tax rate. Non-tax revenue is also expected to increase, primarily due to proceeds from telecommunication auctions and proposed privatisations. The government plans to raise USD8.4bn from divestments (including USD3.2bn from Coal India). As a result of the narrowing fiscal deficit and rapid economic growth, public debt is expected to fall as a share of GDP to 66.1% of GDP in 2018/19 from 68.2% of GDP in 2015/16.

**Fiscal Balance**

(% of GDP)



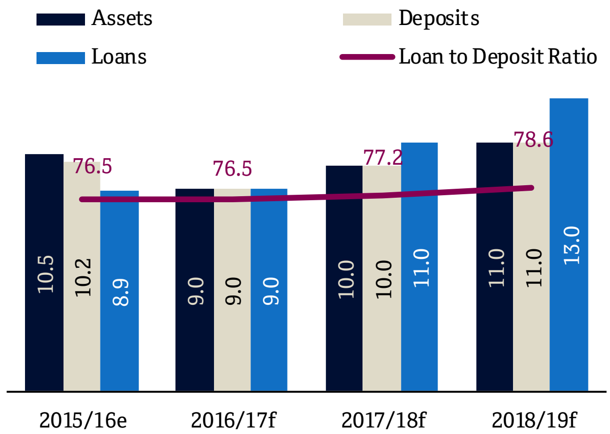

Sources: IMF, Ministry of Finance, Haver Analytics and QNB Economics forecasts

## The clean-up of balance sheets will drive bank growth

In 2016/17, the RBI is expected to press banks to address NPLs, which will be a drag on growth and profitability. However, once banks have cleaned up their balance sheets, growth and profitability should improve. Additionally, the government plans to inject USD10.4bn into state-owned banks over the next four years, frontloaded to 2016/17, which should help to support a recovery in growth by 2017/18. Changes to RBI accounting rules should also help improve the capitalisation of banks. As a result, we expect lending growth to slow to 9.0% in 2016/17, but then recover to 11.0% in 2017/18 and 13.0% in 2018/19 as banks' balance sheets strengthen. The loan to deposit ratio was estimated at a low 76.5% at end 2015/16 so should not constrain lending growth. Deposit growth should rise on economic recovery and higher wages and pensions from the 7th Pay Commission. Although profitability could be depressed in 2016/17, the recovery in lending growth and the clean-up of NPLs should support a gradual improvement in profits in 2017/18 and 2018/19.

**Banking Sector Growth**

(% year on year, %)




Sources: RBI, Haver Analytics and QNB Economics forecasts

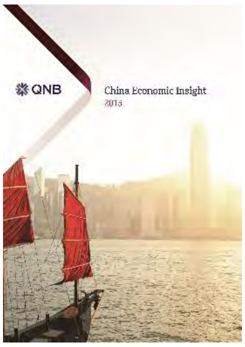
# Key Macroeconomic Indicators

| | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16e | 2016/17f | 2017/18f | 2018/19f |
|---|---|---|---|---|---|---|---|---|
| **Real sector indicators** | | | | | | | | |
| Real GDP growth (%) | 5.5 | 5.6 | 6.6 | 7.2 | 7.6 | 7.2 | 7.3 | 7.5 |
| Nominal GDP (bn USD) | 1,756.7 | 1,844.1 | 1,836.3 | 2,015.0 | 2,077.7 | 2,221.7 | 2,461.7 | 2,729.8 |
| Growth (%) | 2.2 | 5.0 | -0.4 | 9.7 | 3.1 | 6.9 | 10.8 | 10.9 |
| GDP per capita (PPP, k USD) | 4.8 | 5.0 | 5.4 | 5.8 | 6.2 | 6.7 | 7.2 | 7.8 |
| Consumer price inflation (%) | 9.4 | 10.2 | 10.0 | 5.9 | 4.9 | 5.2 | 5.0 | 4.8 |
| **Budget balance (% of GDP)** | -8.1 | -7.4 | -7.6 | -6.7 | -6.6 | -5.9 | -5.6 | -5.2 |
| Revenue | 19.1 | 19.7 | 19.8 | 19.7 | 20.8 | 21.4 | 21.6 | 21.9 |
| Expenditure | 27.2 | 27.2 | 27.4 | 26.4 | 27.4 | 27.3 | 27.2 | 27.1 |
| Public debt | 68.1 | 67.5 | 65.8 | 66.1 | 68.2 | 67.5 | 66.9 | 66.1 |
| **External sector (% of GDP)** | | | | | | | | |
| Current account balance | -4.5 | -4.8 | -1.8 | -1.3 | -1.3 | -1.1 | -1.0 | -0.9 |
| Goods and services balance | -7.2 | -7.1 | -4.1 | -3.4 | -3.0 | -3.0 | -2.8 | -2.6 |
| Exports | 25.7 | 24.5 | 25.6 | 23.5 | 21.0 | 20.6 | 19.5 | 18.2 |
| Imports | -32.8 | -31.6 | -29.7 | -26.9 | -24.0 | -23.5 | -22.3 | -20.8 |
| Income balance | -0.9 | -1.2 | -1.3 | -1.2 | -1.5 | -1.2 | -1.0 | -0.8 |
| Transfers balance | 3.6 | 3.5 | 3.6 | 3.3 | 3.2 | 3.1 | 2.8 | 2.6 |
| Capital and Financial account balance | 4.6 | 4.6 | 1.8 | 1.4 | 1.4 | 1.2 | 1.1 | 1.0 |
| International reserves (months of import cover) | 6.1 | 6.4 | 6.7 | 8.2 | 7.9 | 7.6 | 7.4 | 7.2 |
| External debt | 20.5 | 22.2 | 24.3 | 23.6 | 24.6 | 24.5 | 23.7 | 23.0 |
| **Monetary indicators** | | | | | | | | |
| M3 growth | 13.8 | 13.8 | 13.6 | 10.8 | 8.2 | 12.4 | 12.3 | 12.3 |
| Policy Rate (%) | 8.5 | 7.5 | 8.0 | 7.5 | 7.5 | n.a. | n.a. | n.a. |
| Exchange rate USD:INR (av) | 50.3 | 54.2 | 61.8 | 62.2 | 65.3 | 68.6 | 69.6 | 70.5 |
| **Banking indicators (%)** | | | | | | | | |
| Return on equity | 13.4 | 13.8 | 10.8 | 9.6 | n.a. | n.a. | n.a. | n.a. |
| NPL ratio | 2.9 | 3.4 | 4.1 | 4.6 | 4.2 | 3.9 | 3.7 | 3.6 |
| Capital adequacy ratio | 14.2 | 13.9 | 12.9 | 12.8 | n.a. | n.a. | n.a. | n.a. |
| Asset growth | 15.8 | 13.4 | 12.2 | 10.4 | 10.5 | 9.0 | 10.0 | 11.0 |
| Deposit growth | 13.8 | 14.2 | 13.9 | 10.7 | 10.2 | 9.0 | 10.0 | 11.0 |
| Credit growth | 17.3 | 15.1 | 13.8 | 9.8 | 8.9 | 9.0 | 11.0 | 13.0 |
| Loan to deposit ratio | 77.5 | 78.1 | 78.0 | 77.4 | 76.5 | 76.5 | 77.2 | 78.6 |
| **Memorandum items** | | | | | | | | |
| Population (m) | 1220.0 | 1235.0 | 1251.0 | 1267.0 | 1282.4 | 1297.8 | 1313.2 | 1328.9 |
| Growth (%) | 2.9 | 1.2 | 1.3 | 1.3 | 1.2 | 1.2 | 1.2 | 1.2 |

Sources: Bloomberg, CSO, IMF, Ministry of Finance, MOSPI, RBI, Haver Analytics and QNB Economics forecasts

# QNB Group Publications

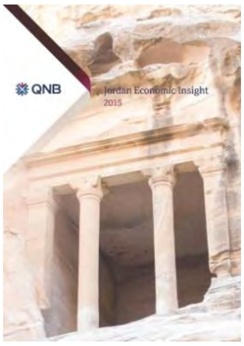
### Recent Economic Insight Reports



China 2015

Vietnam 2015

Indonesia 2015



Jordan 2015

KSA 2013

Kuwait 2015

Oman 2013

Qatar - Sep 2015

Qatar - Feb 2015

UAE 2013

### Qatar Reports

Qatar Monthly Monitor

### Recent Economic Commentaries

Is the Fed really as dovish as markets think?
ECB, big gun but running out of ammunition?
Markets set the stage for Fed rate hikes
Modi is ushering in a second wave of reforms in India
Economic consequences of Brexit
Can interest rates go even further into negative territory?
How many times should the Fed hike rates this year?
Where is the US economy heading in 2016?
A brighter outlook bolsters Indonesia amidst the global turmoil
China's currency dilemma
Are markets overreacting to weak global economic data?
China's devaluation creates spillover risks in some EMs
Oil scenarios for 2016
What caused the latest drop in oil prices?
Qatar's food price inflation to remain low on falling international prices
Fed interest rates after the lift-off
Diverging monetary policies spell a weaker euro ahead
Assessing currency pegs in the GCC
Indonesia between the Chinese rock and the Fed's hard place
Singapore: From Third World to First

# QNB International Branches and Representative Offices

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