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PANORAMA

June 2015

India: Happy Birthday Mr Prime Minister

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By Coface Group Economists

In May 2014, following 5 weeks of legislative elections, India's Bharatiya Janata Party (BJP) leader – Narendra Modi – became Prime Minister. Elected without the need for allies, this is the country's first non-coalition government for 25 years. Known to be pro-business, Mr Modi's election has instilled hopes for reforms in a country where bureaucratic impediments and poor infrastructure have been constraining private and public investments for years.

After only one year in power, the Modi administration has already initiated major measures, such as the Goods and Services Tax bill which is expected to boost growth and fiscal revenues, as well as increase the foreign direct investment ceiling in several sectors.

In 2015, India seems to be one the bright spot in the world's economy and Coface expects the country's GDP growth to reach 7.5%. But to what extent have Modi's reforms contributed to the recent pickup in growth?

To answer this question, we should first recap on the situation and context of the Indian economy when Mr Modi came to power. We will then review the major policy actions taken by the government so far and their impact on the economy, as well as the challenges that remain. Finally we will analyse sectorial issues, focussing on the sectors which are likely to benefit from the progress in the implementation of reforms – notably the infrastructure, steel and IT sectors.

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JUNE 2015

INDIA: HAPPY BIRTHDAY MR PRIME MINISTER

BY OUR ECONOMISTS

CHARLIE CARRÉ
Economist
Based in Paris

ROCKY TUNG
Economist, Asia Pacific
Based in Hong Kong

« The Indian economy is benefitting from rising confidence, but as the BJP still lacks majority in the Upper House of Parliament, potential problems with policy implementation can be considered as a major downside risk »

1 NARENDRA MODI CAME TO POWER IN A CONTEXT OF FALTERING GROWTH

In May 2014, after 5 weeks of legislative elections, India's Bharatiya Janata Party (BJP) leader, Narendra Modi, became Prime Minister. Without the need for allies, his party won 282 of the 543 seats at the *Lok Sabha* (Lower House of the Parliament). As Mr Modi, the former chief Minister of Gujarat, is known to be pro-business and market friendly, his election instilled many expectations - especially among foreign investors. The hope is that Mr Modi can transform his regional economic success in Gujarat[1] into a national one.

Narendra Modi came to power in a context of faltering growth. GDP growth lowered from an average of 7.4% in 2000-2011, to 5.3% in the fiscal year[2] 2012/13[3]. This deceleration was mainly due to supply constraints and, in particular, to very poor infrastructure. The slowing of the economy was also aggravated by the political paralysis which affected the former Congress government, led by Manmohan Singh as Prime Minister, for 10 years.

His government struggled to deliver the much-needed reforms, especially those related to foreign direct investments and infrastructures. (Chart 1)

India was also suffering from macroeconomic concerns. The Indian rupee was the currency most under attack during the confidence crisis wave against emerging markets, observed in the summer of 2013. The country's current account widened from -1.3% of GDP in 2007, to nearly -4.8% in 2012. Increasing energy bills (crude oil represented more than 33% of total imports in 2013) and the vivid appetite of Indians for gold (8% of imports in 2012, 6% in 2013), negatively affected the external balance. Moreover, the Consumer Price Index (CPI) index surged to 11% Year-on-Year (YoY) in March 2013. Finally, the budget deficit and public debt reached -7.4% and 65.4% of GDP[4] respectively. These levels were well above other emerging countries in 2014 where, according to IMF data, public deficit stood at 2.5% of GDP and public debt at 41.2% of GDP. (Chart 2)

[1] Narendra Modi was the Chief Minister of Gujarat between 2001 and 2014. He succeeded in attracting investment and promoting industrial growth. Gujarat stood first among all states for the number of new factories established
[2] Fiscal year: April – March
[3] These figures take into consideration changes in the GDP calculation method introduced in February 2015.
[4] Including federal public debt and debt for local authorities

Chart 1:
Logistics performance index: quality of trade and transport-related infrastructures

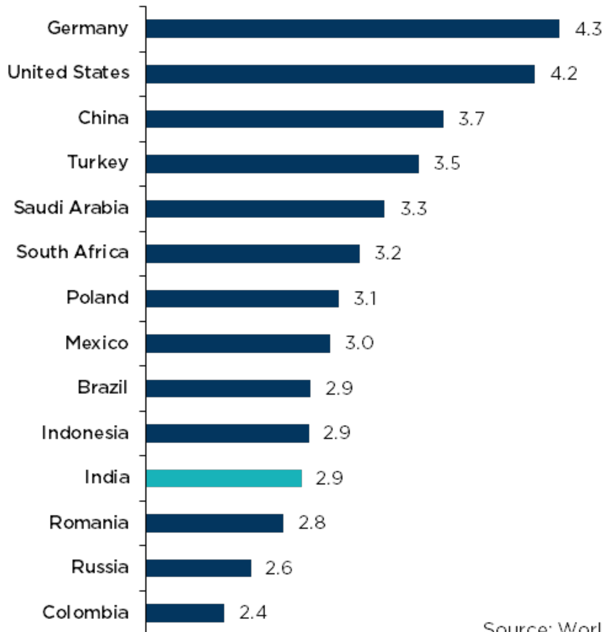
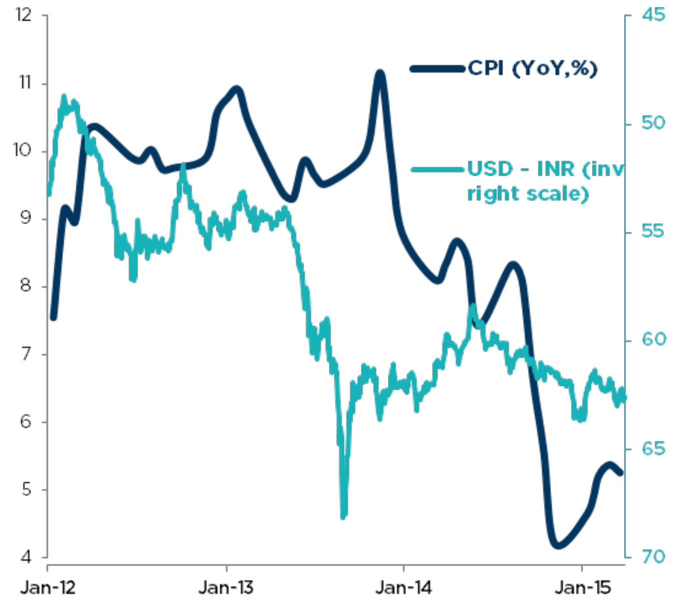


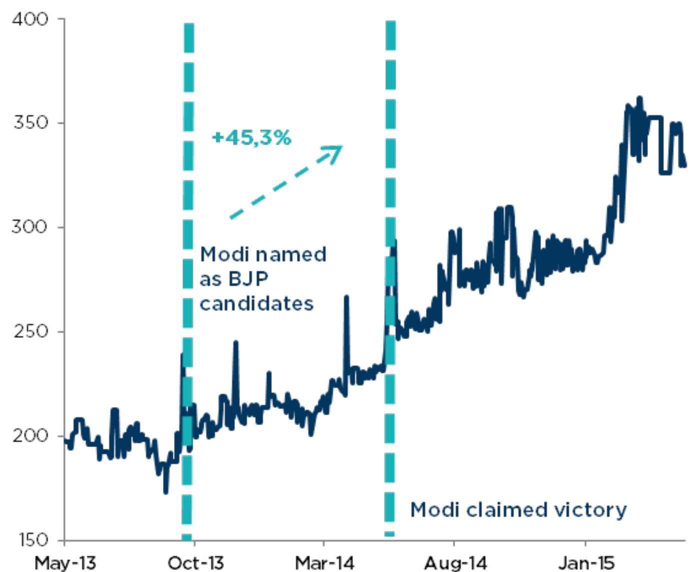
Chart 2:
Inflation and Indian rupee vs USD



The rupee's sharp depreciation halted with the arrival of Raghuram Raja as the new RBI[5] Governor (ex-IMF Chief Economist) in September 2013. This was thanks to clearer communications from the new governor, restrictions on gold imports, incentives for banks and corporates to hedge their foreign currency exposure and stricter targets focused on inflation assigned to the RBI. India also benefitted from the temporary halt of capital outflows from emerging markets.

Mr Modi's nomination as Prime Minister on the 26th of May 2014 generated hope. Between Narendra Modi's nomination as his party's candidate on September 2013 and the results of the elections on the 16th of May 2014, the BSE Sensex (Bombay Stock Exchange Sensitive Index) grew by more than 45%. Since then the stock market index has also increased, by almost 18%. This sharp rise can also be explained by the ample liquidity resulting from the US Federal Reserve's accommodative monetary policy. As a comparison, Jakarta's stock exchange rose by 14% and 5% during the same timeframe and the Philippines' stock exchange by 12% and 16%. Modi's manifesto set out many promises. He has pledged to create 10 million new jobs a year, to facilitate land, power and environment approvals in order to boost the development of infrastructures, to attract FDIs by easing restrictions and to consolidate public finances while bolstering development spending.

Chart 3:
Sensex index in Mumbay Stock exchange



[5] Reserve Bank of India

2 MAJOR POLICY ACTIONS TAKEN BY MODI'S GOVERNEMNT

Since its early days in office, the government has initiated a reformist programme aimed at reviving investments and alleviating supply-side constraints, with fiscal consolidation remaining a priority. The government is benefitting from the favourable macroeconomic situation, with low oil prices and inflation under control (4.9% Year-on-Year in April 2015, down from 11.2% in November 2013), which allows monetary easing. The RBI cut the repo rate by 25 bps in January, March and June 2015. As a large importer of crude oil, India is one of the countries which benefitted most from the fall in oil prices. This drop facilitated the fuel subsidy reform, helped to ease inflation and to rebalance external accounts. The current account deficit shrunk to 1.6% of GDP during the last quarter of 2014, down from a record high of 6.8% in Q4 2012. The government has thus taken a step-by-step approach and tried to develop consensus as much as possible.

A) ...To consolidate public finances without hindering growth

The government is committed to reducing the budget deficit, while increasing spending on development, and to raising tax revenues, while making the tax regime investor-friendly. With the public debt largely financed by Indian banks (which are mostly state-owned banks), public debt consolidation is key to boosting growth. Banks still have to invest at least 21.5% of their assets into Indian government bonds, which makes government borrowing a brake on corporate bonds and investment. This crowding out effect means that private investment is hampered by public debt. With a budget deficit target of 4.4% of GDP at central level, the budget adopted for 2015/16 (the first full- year of the Modi government) uses a gradual approach to reforms, but the stance appears to be positive.

Long-waited Goods and Services Tax

The centrepiece of the revenue measures relate to the Goods and Services Tax (GST). These measures, which should be implemented from April 2016, will harmonize the current mosaic of state and central levies into a national sales tax. Initially launched by the former Congress-led government, the implementation of the new GST should also boost GDP growth, as the current system pushes prices up. The GST legislation, which required a Constitutional amendment, was passed in the Lower House of Parliament *(Lok Sabha)* on the 6th of May. It attained the required majority of two-thirds of votes in the house, even though opposition parties asked for further discussions, demanding that the bill be reviewed by a parliamentary panel – and eventually they boycotted the vote. Following pressure from the opposition parties, the government was obliged to defer the passage of the GST bill to the Upper House of Parliament (where opposition parties enjoy the majority) and now has send the bill to a parliamentary committee for review. The Congress party is officially in favour of the bill, but has requested the postponement of parliamentary approval, so that a committee can review it again. Once passed in Parliament, the bill will need to be ratified by a majority of India's 29 states and 2 union territories, although the BJP and its partners are only holding power in 13 states. Compromises have been made to win approval from the states. For example, certain products, such as petroleum and alcohol, have been excluded from the bill and there are compensations for revenue losses.

According to the IMF, the implementation of the GST should result in gains of between 1 to 1.5% in India's GDP in the medium term, due to more efficient internal movement of goods and services.

Subsidy reform to increase development spending

The government took advantage of low oil prices to remove diesel subsidies last October and raised the excise duty on petrol and diesel in January. In addition, cooking gas subsidies were changed to direct cash transfers. The same system will be implemented for food subsidies but the government has not yet initiated the fertilizer subsidy reform.

Table 1:
Subsidies - Composition and changes

% change	2013/14	2014/15	2015/16
Food	-8.2	-33.3	-1.4
Fuel	-11.9	-29.4	-50.2
Fertilizer	2.1	5.4	2.8
Total subsidies	-1	-4.7	-8.6
Total subsidies (% of GDP)	2.2	2.1	1.7

The reduction in subsidies will help to contain current expenditure in order to boost capital spending for the development of much-needed infrastructure projects - especially power, road and rail networks. So far fiscal consolidation has been achieved by reducing expenditure, rather than raising revenues. However the budget for the 2015/16 fiscal year focuses on infrastructure and manufacturing, with the creation of a *National Investment and Infrastructure Fund*, long-term tax-free infrastructure bonds, privatisations and financial sector reforms.

The government is trying to attract private investment. Together with structural reforms, an increase in public investment should 'crowd in' private investment[6]. The medium term public investment multiplier for emerging economies is estimated to be between 0.5 and 0.9[7] by the IMF, but the scale depends on the efficiency of implementation.

B) ... To improve business confidence and private investment

In addition to funding issues, bureaucratic obstacles and restrictive legislation are also weighing on development and investments.

Investor-friendly taxation regime: stability and predictability

Communications from the government indicate that it is focused on restoring its "credibility", in order to encourage companies to invest. Whereas the previous government passed a bill on retrospective taxation in 2011, Modi's Finance Minister – Arun Jaitley – has declared that "that there will be no more retroactive tax actions in India". He also said that tax officials have been instructed not to file "frivolous" appeals so that verdicts were not challenged when the courts decided in favour of Vodafone and Shell in their tax disputes with the authorities. Although the government has not abolished the retroactive bill, they have announced that they "will not initiate any new claims under the law".

However *Cairn India* (an energy company), has been sentenced to pay $3.3 billion for gains made by its former parent company 8 years ago.
The government has countered that this case was initiated before they took office, but scepticism remains.

Simultaneously, the government has announced a cut in the corporate tax rate from 30% to 25% over 4 years, while removing the multitude of exemptions.

Increased foreign direct investment (FDI) ceiling

The new government has allowed full foreign ownership in railway infrastructures and the construction development sector, in order to boost infrastructure development and manufacturing. It has also raised the FDI ceiling for insurance and defence from 26% to 49%. Nevertheless, according to the FDI index calculated by the OCDE[8], India still has important statutory restrictions on FDIs. Modi's government actions have helped to restore investor confidence, but barriers to FDI are still very important. Many sectors are capped and/or require central government approval.

Table 2:
FDI: Sectors with caps

Sectors with caps	
74% - Teleports, cable networks (undertaking upgrading toward digitalisation and addressability), mobile TV and headend-in-the-sky broadcasting services - Non-scheduled air transport services - Ground handling services -civil aviation - Satellites - establishment and operation - Private sector banking - except branches or wholly owned subsidiaries - Credit information companies	**49%** - Petroleum refining by state-run oil companies - Cable networks - Air transport services - scheduled air transport - Private security agencies - Commodity exchanges - Infrastructure companies in securities market - Power exchange - Insurance and sub-activities - Defence
26% - Broadcasting content services - FM radio, uplinking of news and current affairs TV channels - Print Media dealing with news and current affairs	**20%** - Public banking sector

Source: Invest India

[6] IMF, Is it time for an infrastructure push? The macroeconomic effects of public investment, World Economic Outlook, October 2014
[7] A 1 percentage point of GDP increase in public investment spending increases the level of output between 0.5 and 0.9 percent
[8] FDI Index gauges the restrictiveness of a country's FDI rules by looking at the four main types of restrictions on FDI: 1) foreign equity limitations, 2) screening or approval mechanisms, 3) restrictions on the employment of foreigners as key personnel, 4) operational restrictions, e.g. restrictions on branching and on capital repatriation, or on land ownership.

Chart 4:
India: a bright spot for FDIs in 2014

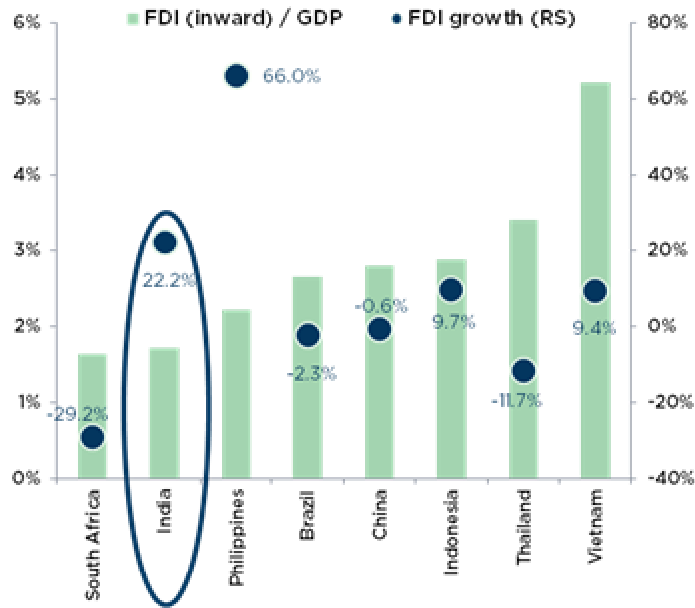
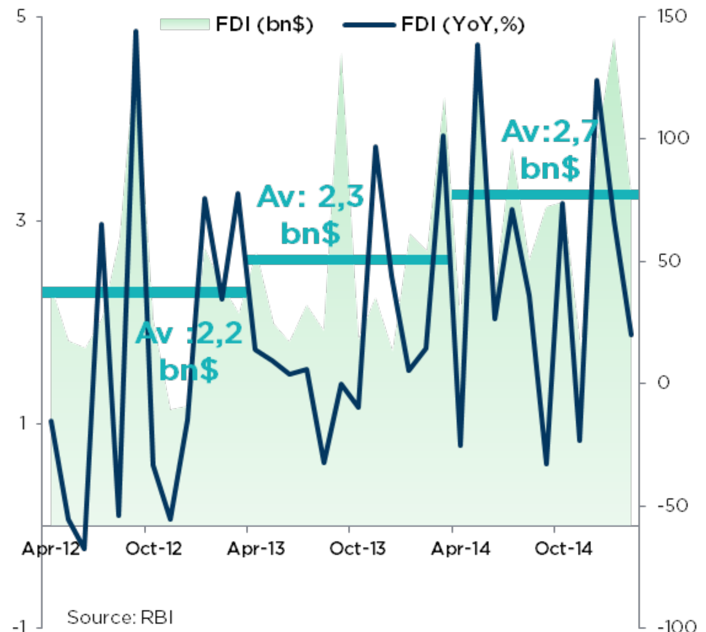


Chart 5:
Monthly FDI inflows to India



Portfolio investments, including corporate bonds and stocks, have been dynamic since Narendra Modi came to power and FDI has increased. These increasing financial flows need to translate into a durable pick-up of real investment, especially in the private sector. In addition, portfolio investments are highly volatile and may be vulnerable to market volatility and to US monetary policy tightening. (Chart 4)

Despite a decline in global inward flows of FDI (-8% in 2014), India was among the fastest growing destinations for FDI in 2014, with an increasing number of projects. The software and IT sectors are still receiving most of the FDIs, but the manufacturing sector's share is growing. After 2 years of decline, India's number of greenfield projects increased by 47% in 2014 (641 projects), while the number of projects in China have almost stagnated (+4%, 931 projects). India captured 7.1% of the investments directed towards Asia. (Chart 5)

Labour law reform to improve ease of doing business

Labour law in India is among the most rigid in the world[9] and Modi's government intends to amend this. As the country's states have primacy in labour law, the first reforms have been implemented by BJP-ruled States such as Rajasthan. One example of the reform is that companies are now allowed to lay off up to 300 employees without government permission[10]. Another example is that support from 30% of the workforce is now needed[11] to form a trade-union.

Other BJP-ruled States have implemented similar reforms and the government will introduce market reforms during the Parliament's monsoon season. These reforms include the *Small Factories Bill*, which will exempt factories with up to 40 workers from provisions of major laws - but worker's trade unions have already expressed concerns about this bill.

C) ...To enhance investment and infrastructure development

Narendra Modi has launched a programme entitled "*Make in India*", to revive investments and develop the manufacturing sector[12]. One of the programme's planned projects is to develop the industrial corridor between New Delhi and Bombay. Initiated by the previous government and co-financed by Japan, it is a large-scale project of USD 90 billion (4% of GDP), crossing 6 States. The cornerstone of this project is the construction of a dedicated railway line. In order to facilitate these projects, the government has already raised the FDI ceiling for the defence, insurance and rail sectors - but they also need to remove bureaucratic impediments and to alleviate bottlenecks in the power sector.

To speed up regulatory clearances for steel, mining and power projects, in June 2014, the government launched a single-window approval mechanism. This is centred around an online portal where investors are able to log in to seek all required clearances.[13] Single window clearance facilities are available in various states.

[9] India ranks 112th out of 144 in the Labour market efficiency Index produced by the World Economic Forum
[10] Up from the previous limit of 100 employees
[11] Initially the support of only 15% of the workforce was requested
[12] See also part 3 of the panorama
[13] Up to 100 clearances needed to set up an industry in India

Despite massive coal reserves (the world's 5th largest), India experiences chronic blackouts that impede its economic rise. Until now, only Indian power, steel and cement companies have been permitted to mine coal for their own consumption and only *Coal India* (a state-owned company) can mine and sell coal. However, in December 2014, Prime Minister Modi passed an executive decree to open up the coal industry - including for foreign players - and auctions have been launched. In August 2014, the Supreme Court cancelled over 200 coal mining licences given to private firms over the period from 1993 to 2009 and the PM has also initiated more transparent e-auctions. The government's coal reform aims to increase energy production and to improve transparency in pricing and auctioning.

Land acquisition bill amendment

Many projects have been stalled due to difficulties in obtaining property transfer approvals. The *Land Acquisition Act* was passed by the previous government in 2013. It provides that the consent of 70% of landowners is needed to transfer land acquired for public-private partnerships and 80% for private projects. In addition, a social impact study is conducted by independent experts to determine the economic, social and cultural impacts on the communities that will be affected. In December 2014, the government issued an ordinance removing these requirements for certain projects and re-promulgated the ordinance in April 2015. A bill was passed in the Lower House of Parliament in March 2015 but farmers and opposition parties protested against the project and the government subsequently decided to send it to a parliamentary committee. The bill will only be taken up during the next parliamentary session in July. The land ordinance will then be re-promulgated but executive decrees are temporary in nature and this situation is unlikely to inspire broader investor confidence.

Although the government has been winning more state elections, the BJP experienced its first electoral reverse, in a regional poll in Delhi in February 2015. The Congress Party will continue to dominate the Upper House until at least the end of 2015. This situation could delay the announced structural reforms that the business community is awaiting. The government could push reforms by having a joint session of both Houses of Parliament - but this could cost them significant political capital as this practice is very rare [14].

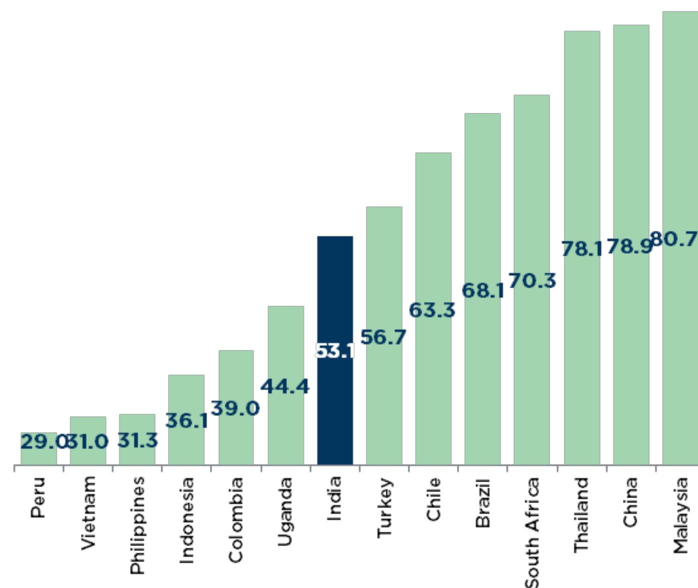
Banking reform

India's proportion of households with a bank account is very low compared to its peers, despite great progress in the increase in account ownership (+50% between 2011 and 2014). Increasing financial inclusion has been a key priority for the new government and it has a programme aimed at 150 million households with the goal of bringing banking to all unbanked households. This will be encouraged by gradually shifting social programme payments to these accounts, with access to insurance, debit card and overdraft facilities.

The government's banking reform is articulated around the four objectives of financial inclusion, improving long-term financing for infrastructure projects, decreasing the government's participation in public banks and improving governance. As regards the financing of infrastructure projects, the RBI has taken specific measures - notably making it easier for banks to provide long-term loans, by allowing more flexible structures.

Chart 6:

Bank accounts in percent of population age of 15 and over



Source: Global Findex, World Bank

[14] Joint sittings have been convened only 3 times in India's Parliament history

3 SECTORIAL ISSUES

In the sector analysis of this publication, we cover India's construction, steel and IT service sectors. As India is determined to move forward and increase its competitiveness as a manufacturer, the construction sector will benefit from the robust demand generated by the infrastructure plans. Learning from the experience in China, such wide-spread infrastructure investments will stimulate demand for materials including, but not limited to, steel. While India has been a strong IT services provider to the world for more than a decade, greater support from the government is needed as challenges increase from China, Malaysia and the Philippines.

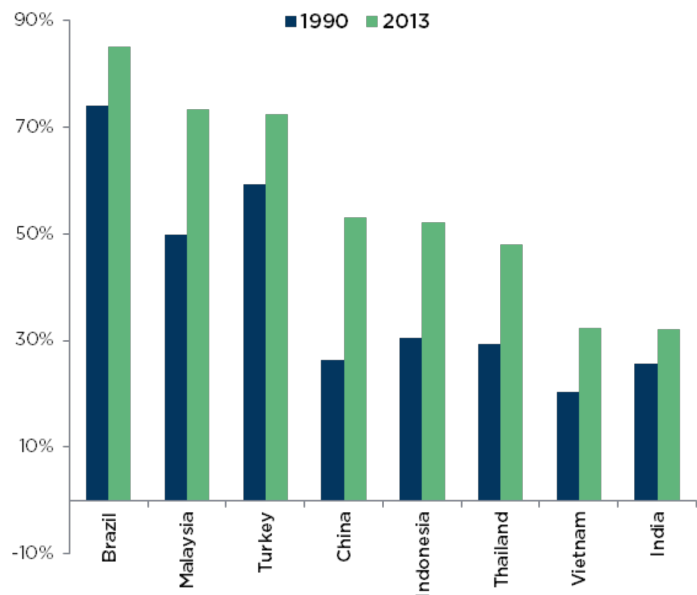
A) Broad-based infrastructure plans to boost the construction sector

According to the Logistics Performance Index (LPI) conducted by the World Bank, India is behind Asian countries with leading manufacturing capacities. The most notable of these comparisons is with China, which has a similar population but a higher LPI result. In order to catch up on its manufacturing capabilities, India will need to improve in certain areas. Currently, logistical bottlenecks mean that transport requirements are not being met for various infrastructure projects – including power and steel. Infrastructure improvements would thus also be beneficial to the construction sector in the medium-term.

The Indian government has massive, wide-reaching infrastructure plans, which should become growth drivers for the country and its 1.3 billion population. According to the World Fact Book of the Central Intelligence Agency, India's urbanisation rate was 32.4% as of the end of 2014 - far behind that of Brazil (85.4%), Russia (73.9%) and China (54.4%). The Modi government's plans to boost the country's infrastructure include 3 highly anticipated major projects - i) Freight corridors connecting the eastern and western regions, ii) 5 industrial corridors, iii) 100 smart cities.

Chart 7:

Urbanization rate of selected major emerging markets



Source: World Bank

The Dedicated Freight Corridors (DFC) are in two major areas. The Eastern Development Freight Corridors (EDFC) cover 1839km of electric tracks, while the Western Development Freight Corridors (WDFC) comprise 1483km. The key purpose of these DFCs is to facilitate faster and more efficient transportation of goods from ports (see table 3 below). Moreover, according to the DFC Corporation of India, as the DFCs will not directly connect the destinations and origins of all goods and passengers, traffic transfer connections to and from the already-existing Indian Railway Corridor have been included in the construction plans[15]. The enterprise, which is governed by the Ministry of Railways, has said that the two DFCs are expected to connect at Dadri and there will be various junction stations with the existing network.

[15] Dedicated Freight Corridors Corporation

Table 3:
Key traffic data of the DFCs

Key traffic
Western Development Freight Corridors (WDFC) - ISO containers from JNPT and Mumbai Port in Maharashtra and ports of Pipavav, Mundra and Kandla in Gujarat destined for ICDs located in northern India, especially at Tughlakabad, Dadri and Dandharikalan. Besides Containers, other commodities moving on the Western DFC are POL, Fertilizers, Food grains, Salt, Coal, Iron & Steel and Cement. - The rail share of container traffic on this corridor is slated to increase from 0.69 million TEUs in 2005-06 to 6.2 million TEUs in 2021-22. The other commodities are projected to increase from 23 million tonnes in 2005-06 to 40 million tonnes in 2021-22.
Eastern Development Freight Corridors (EDFC) - Coal for the power plants in the northern region of U.P., Delhi, Harayana, Punjab and parts of Rajasthan from the Eastern coal fields, finished steel, food grains, cement, fertilizers, lime stone from Rajasthan to steel plants in the east and general goods - The total traffic in UP direction is projected to go up to 116 million tonnes in 2021-22. Similarly, in the Down direction, the traffic level has been projected to increase to 28 million tons in 2021-22.

Source: Dedicated Freight Corridors Corporation of India

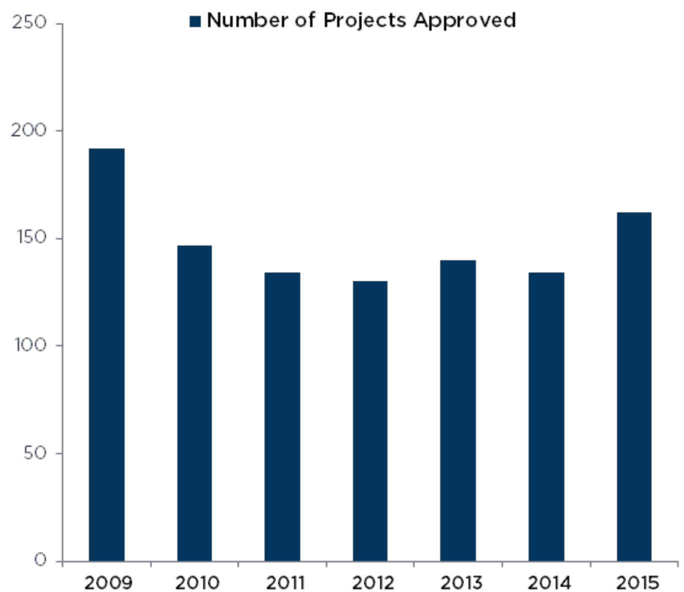
Besides the DFCs, the government of India has also put together a plan to build industrial corridors aimed at making India an important destination for manufacturing and investment. These industrial corridors are a key initiative within the new "Make in India" programme announced by the Modi government.

An example is the Delhi-Mumbai Industrial Corridor (DMIC), whose mission is to "increase the share of manufacturing in the country's GDP and to create smart sustainable cities where manufacturing will be the key economic driver"[16]. Covering 6 states including Uttar Pradesh, Haryana, Rajasthan, Madhya Pradesh and Gujarat and Maharashtra, the DMIC is set to leverage on the success of the 1483km WDFC and transform the region into a globally competitive manufacturing zone with a superior infrastructure. In order to minimize the impact of logistical issues during construction of the different projects, the government has planned the development of DFCs at the same time as the industrial corridors.

Other corridors that are in the pipeline include the Bengaluru-Mumbai Economic Corridor, the Amritsar-Kolkata Industrial Development Corridor, the Chennai-Bengaluru Industrial Corridor and the Chennai Vizag Industrial Corridor. With the exception of the DMIC that is already underway, the development of the other industrial corridors may still take some time. The planning of these projects has not yet been confirmed as at the time of completing this report.

A slight pickup can be seen in the number of housing and infrastructure project approvals. While they are not yet back to pre-crisis levels, the acceleration is welcomed and should be viewed as a positive sign. It is attention-worthy that housing prices have seen notable increases in the last few years. Compared to June 2010, as of the end of 2014 housing prices rose by 101%, 86%, 171%, and 87% in Ahmedabad, Bangalore, Delhi, and Mumbai, respectively. While housing prices in other areas appear to be growing at a more moderate pace, prices in Delhi continued to grow rapidly (+29%YoY). This suggests that demand for property is still robust. With construction cost growth[17] slowing to below 1%, developers could grasp the opportunity and capture the benefits of high demand growth.

Chart 8:
Acceleration of housing and infrastructure projects approval



[16] Make in India: Industrial Corridor
[17] Construction cost growth is according to the Construction Cost Index, which is compiled by Construction Industry Development Council. According to the Construction Industry Development Council, "the data pertains to construction materials, oil, fuel and lubricants, wages and salaries."

While these projects are likely to incite optimism in the near-term, reforms need to be carried out at both central and state government levels to facilitate procedures (including more efficient land acquisition), before the full potential can be tapped. The needs for reforms, for careful planning and for sources of funding (international funding and private sectors), will necessitate more time for the materialisation of these projects.

Financing of these vast infrastructure projects could be an issue. With the budget deficit weighing more than 7% of GDP (both at central and local level), the Indian government would not be able to finance these projects alone. This explains why discussions on of PPP (Public-Private Partnerships) are surfacing[18]. Investment from international partners could also contribute to financing needs. The DMIC is an example, as 26% of the project is funded by the Japan Bank for International Cooperation. This could also apply to some of the country's other infrastructure projects.

The total cost of these projects is difficult to estimate, but their potential overruns would certainly add to the costs. According to Bloomberg News, as of early March, there were approximately US$392 billion worth of projects with processes on hold, leading to at least US$33 billion worth of overrun costs for "some of the largest federal infrastructure projects"[19].

By introducing two major reforms (i.e. fuel and coal) within five months of the manifesto, the Modi administration has already demonstrated its strong intent to fulfil its promises. Nevertheless, time will be needed for these reforms to be carried out and fully executed. If these reforms are implemented effectively, the country should benefit in the medium-term.

B) Steel sector: helped or challenged by China?

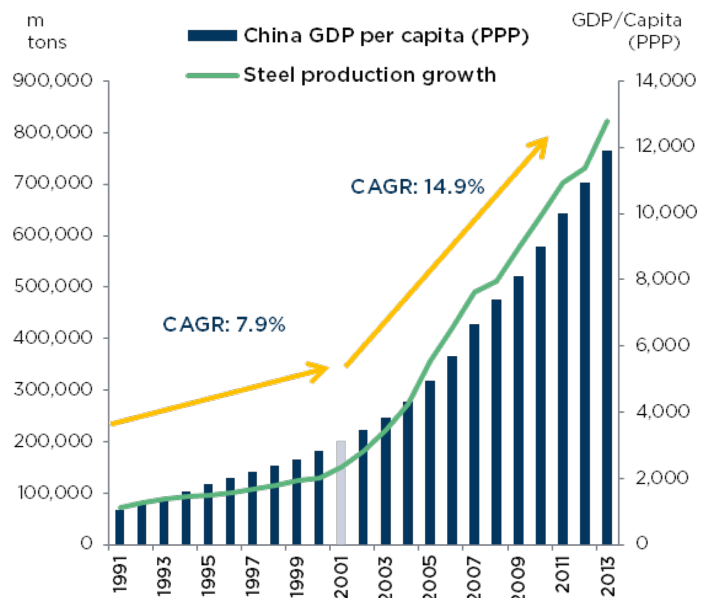
Wide-spread urbanisation and infrastructure investments are needed to improve the country's competitiveness. With the high requirements for materials – particularly in the cement and steel sectors for materials such as coal and iron ore – the demand for metals in India will rely on the Modi administration's successful execution of its heavy investment plans.

Using China's experience as an example, hefty investments in infrastructure will lead to significant growth in steel production and consumption[20]. In purchasing power parity (PPP) terms, China's GDP per capita was US$3131 in 2001.

It was at about this time that steel production began to pick up significantly and continued to do so during the following decade. China's steel production doubled from 71m tons in 1991 to 152m tons in 2001. The compound annual growth rate (CAGR) was around 7.9% for the period. Over the decade between 2001 and 2011, steel consumption grew 14.9% per annum, to reach 731m tons in 2011. These trends, if applied to India's steel market, should mean an acceleration of steel consumption growth is in sight.

Chart 9:

China's steel production and GDP per capita



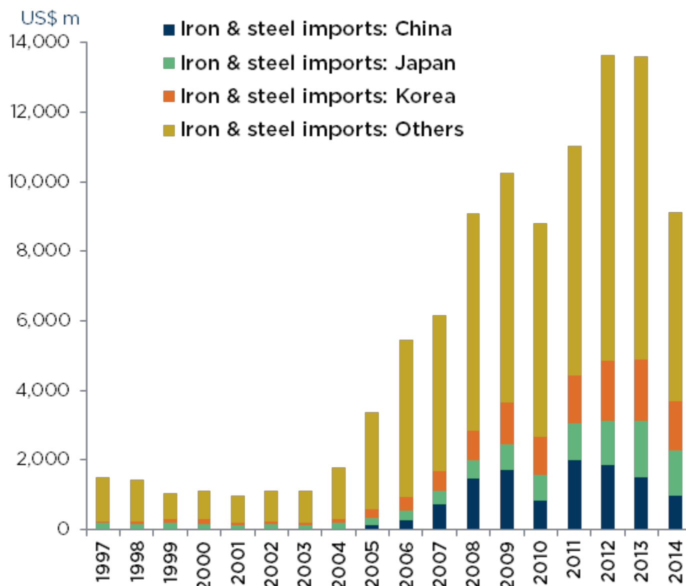
Source: CEIC data, Coface

India currently produces much of its domestic steel consumption - but there could be evolutions going forward. As of the end of 2013/14, India was a net exporter of iron and steel for the first time since 2004/05. However we could see a return to the former trend, as India requires more steel to facilitate its infrastructure projects. Some challenges to domestic steel makers could come from Chinese imports. Overcapacity issues in China (production capacity utilisation below 80%) have hurt its steel sector, by compacting prices and profitability to extremely thin levels (below 1%). These factors have led to an increase in Chinese steel exports in recent years – with Chinese steel exports recording 33% YoY growth in 2014 – as the industry tries to tackle its excess production capacity. India, with its huge potential demand, has become an export destination for Chinese steel.

[18] *Public Private Partnerships in India*
[19] India's $33 Billion Cost Overruns Spur Srei to Scout for Deals (April 2015) Bloomberg
[20] We should use consumption figures instead of production. However, as a result of high domestic usage of Chinese steel, together with the inconsistency of trade data, we use production data in this practice.

Chart 10:

Steel imports to India



Source: CEIC data, Coface

As an illustration of this, after discussion with industry participants in April 2015, the Hellenic Shipping News reported that the price of Chinese hot rolled coils was only around US$370 per ton. The landed cost of imported steel from China is thus cheaper by almost US$89 per ton than the prevailing domestic steel price.[21] While these prices reflect the effects of transaction costs (including exchange rates, transportation costs and duties), the price differentials of around 20% pose challenges to domestic steel makers.

Although some domestic players could be calling for more protective measures to curb competition from the neighbouring country, drastic development in the area will involve careful consideration among businesses and policy specialists, as international trade in the steel sector is globally liberalised. In an interview cited by DNA India, the Minister of State for Steel and Mines, Vishnu Deo Sai, was reported to have expressed that the country "is not contemplating a ban on steel imports from China, even as inward shipment from the world's largest steel producing nation has nearly trebled"[22]. Nevertheless, according to the Financial Express, Narendra Singh Tomar of the Steel Ministry is quoted as being "worried over dumping from China" and has discussed raising import duties on steel products with the finance minister[23].

In conclusion, while the steel demand outlook is positive in India due to the needs from vast infrastructure plans, challenges are expected in the near future. In the near-term, the strong upward trend of steel imports, particularly imports from China, will continue to put pressure on domestic steel prices. With the substitute-nature of steel products, the 20% of price difference between the domestic steel products and imported products from China poses challenges to domestic steel mills. This pressure on India's domestic steel mills will continue unless i) the government implements protective measures (such as banning low-quality steel imports, imposing higher import duties from the current 5-7.5% to a higher percentage or raising the maximum level of custom duties from its current 10%), or ii) the domestic steel industry can boost its efficiency, which is rather unlikely in the near-term.

Nevertheless, as we move on to the stage where reforms and massive infrastructure plans are carried out in the medium-term (a time frame of 2 to 5 years), the huge potential of steel consumption in India should be released and will then benefit the steel sector.

C) IT sector: still competitive but upcoming challenges in sight

This report would be incomplete without mention of India's information technology (IT) sector.

Bhatnagar (2006) points out that the development of the sector has driven substantial changes in economic policies and accelerated economic liberalisation of India's global engagements.[24] With its low-cost, high quality workforce (English speaking and trained), India's IT industry has developed a comparative advantage as an international IT hub. These trends have been evolving over time. For instance, Bhatnagar argues that Indian firms have climbed up the value chain through providing more value-added services (e.g. software development instead of programing). With the growing importance of Indian individuals in Silicon Valley within key US companies, Bhatnagar suggests that these individuals have utilised their networks to help expand the presence of Indian companies. These developments have led to improvements and evolutions in India's IT industry.

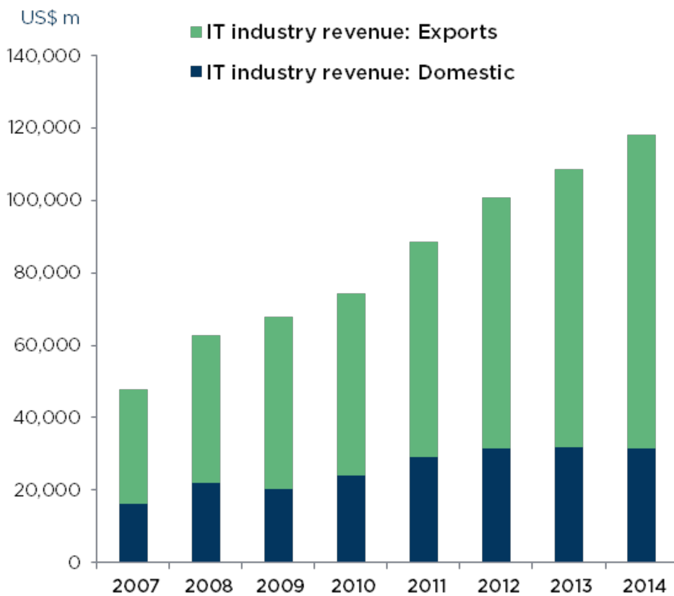
As of today, the IT sector in India is made up of 4 major subsectors - IT services, business process outsourcing (BPO), software & engineering, and hardware. In the financial year ended March 2014, these four subsectors together directly contributed US$118 billion to the Indian economy, representing some 6% of the country's GDP.

[21] *India: Steel imports up 71% in FY15* (April 2015) Hellenic Shipping News.
[22] *India not mulling ban on steel imports from China* (March 2015) DNA India.
[23] Priyadarshi Siddhanta (April 2015) *Steel imports: FinMin to decide on Chinese 'dumping'*. Financial Express
[24] Bhatnagar, S. (2006) *India's software industry*. In Technology, adaption, and exports: how some developing countries got it right. World Bank

Moreover, IT industry exports, at US$86.4 billion, already represented some 27.5% of total exports and 34.4% of non-oil exports in 2013/14. According to National Association of Software and Services Companies, incremental revenues of US$12-15 billion are expected for FY2014/15.

Chart 11:

IT export and domestic breakdown



Source: CEIC data, Coface

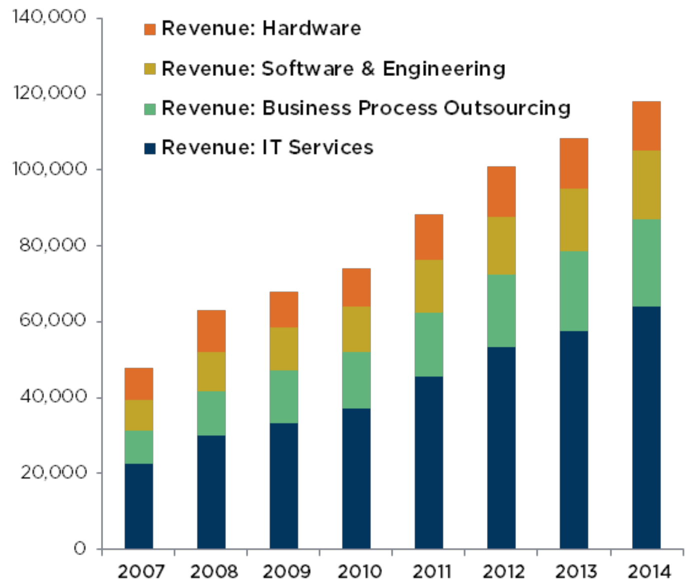
As illustrated in chart 12, IT services is the biggest subsector in India's general IT industry, representing 54% of total revenues. According to the India Brand Equity Foundation (IBEF), India's IT services are estimated to account for some 52% of the market share globally, and is the world's leading sourcing origin for IT services[25]. With its relatively low labour costs, at roughly a quarter to one-third of that in the US, the IBEF attributes this competitiveness as a significant contributing factor to the country's general economy, as the employer of some 10 million workers. (Chart 12)

While the strong US dollar can be attributed to recent weaknesses in India's IT sector, there are also other reasons. Malik & Malik (2014) argues that India's IT industry is now facing rising challenges from "China, the Philippines, Thailand, Argentina and so on", and urges the industry to differentiate from its peers[26]. The authors argue that India's IT sector is facing challenges, one of the most important being the global economic slowdown.

While the IT sector is widely recognised as one of India's value-added exports throughout the world, with disruptive technologies flooding the market, the sector is facing the rise of new challenges.

Chart 12:

Breakdown IT technology revenue



Source: CEIC data, Coface

For instance, besides acting as online-storage, cloud-computing now performs data analysis - although programme-writing jobs are not threatened by automation processes. These disruptive technologies are bringing material impacts to the industry's participants, including its workers. Sharma (February 2015) reported that weaker demand from export destinations and higher competition from other countries in Asia and Eastern Europe, being among the main reasons which have led to layoffs among companies in the IT sector[27].

To conclude, while the absolute advantage (i.e. wage differentials between Indian and US software engineers) plays a role in India's status as a world leading IT provider, it is the comparative advantage (the effectiveness of Indian labour) that is driving the success of its IT sector. While the sector will continue to be competitive globally, as long as wages are not raised substantially overnight, upcoming challenges from China, Malaysia, the Philippines should not be ignored. The government has seen the need to help the industry. In this year's budget, Finance Minister Arun Jaitley announced the disposal of the special additional duty on IT products. This measure is seen as a support for domestic tablet manufacturers. The Minister also lowered withholding tax rates for royalties (from 25% to 10%), to help the sector equip itself with up-to-date technologies for more advanced products. More support from the government could be on its way, including liberalisation of funding channels for the sector, which should benefit the country's smaller players.

[25] *IT & ITeS Industry in India* (February 2015) India Brand Equity Foundation. Sectorial Report.
[26] Malik, M.H. & Malik, S.H. (2014) *Determinants of software exports during global economic slowdown*. Journal of Science & Technology Policy Management. Vol. 5 Iss 3 pp. 212 - 230
[27] Jai Sharma (2015) *Mass layoffs shake India's IT industry*. WSWS

CONCLUSION - REVIVING ECONOMY: THANKS TO MODI'S GOVERNMENT?

Coface assessments	Country risk A4	Business climate B

Main economic indicators	2012/13	2013/14	2014/15(e)	2015/16(p)
GDP growth*(%)	5,1	6,9	7	7,5
Inflation (yearly average) (%)	10,7	6,7	5,8	6,1
Budget balance** (%GDP)	-7,1	-7	-6,8	-6,5
Current account balance (%GDP)	-4,7	-1,7	-1,2	-0,4
Public debt** (%GDP)	65,6	66,1	65,7	64,9

(e) : estimate ; (f) : forecast

*Take into consideration changes in GDP calculation method introduced in February 2015

**Includes federal public debt and debt for local authorities
Fiscal year: April - March

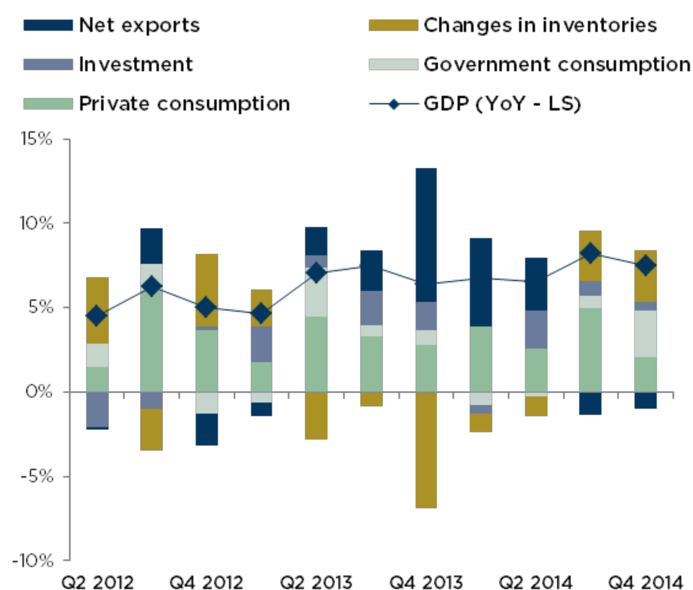
Since Narendra Modi came to power, the Indian economy is benefitting from rising confidence - as indicated by the large portfolio and FDI inflows. The PM's reform program should aid progressive recovery. Inflation control now allows gradual monetary easing. The central bank lowered its key rate in January and March 2015 and new rate cuts are expected in the course of the year.

Recent data indicates signs of recovery, but major changes in national accounts[28] make it difficult to precisely assess the magnitude of the rebound. Part of this rebound is also due to policy actions taken by the previous government and, as the 4th largest consumer of oil, India has been a big beneficiary of lower oil prices. According to Nomura, every 10 USD fall in oil prices per barrel can boost GDP growth by 0.1% points.

It is worth noting that private investment is still below potential and investment's contribution to GDP remains weak. This is due to corporate deleveraging, stalled projects and global uncertainty. Coface projects a GDP growth of 7.5% for the fiscal year 2015/16.

Chart 13:

India' Contributions to Real GDP Growth (Quarterly)



[28] The base year was shifted from 2004/05 to 2011/12 and changes in methodology associated with collecting economic growth data

Risks could also come from Indian corporates, as private investment is likely to be impacted by corporate deleveraging. According to the IMF, corporate debt increased by 9 GDP points between 2007 and 2014, to 47.5% of GDP - and 36.9% of this debt is at risk[29]. Moreover, corporates have become dependent on external borrowing.

In May 2015, the IMF highlighted India as “one of the bright spots in the global economy[30]”, thanks mainly to more effective policies and the resolution of political uncertainty. India’s increased growth, as well as the moderation of its domestic and external vulnerabilities are partly due to measures initiated by the previous government and the central bank, combined with the lower global commodity prices. However, the victory of Narendra Modi as Prime Minister and the economic reforms introduced by his government, have served to buoy investor confidence. Recent policy measures, such as the easing of land acquisition requirements by ordinance, are helping to ease supply-side constraints, but further reforms are required to boost much-needed investment and growth.

The Modi administration has demonstrated its strong intent to fulfil its promises. The reforms initiated, along with the “Make in India” programme, will benefit the country’s infrastructure and steel sector in the medium-term, while the IT sector will enjoy governmental support (notably though lowered withholding tax rates for royalties) in order to face upcoming challenges. Nevertheless, the government may face protests from civil societies and the BJP still lacks majority in the Upper House of Parliament, controlling only 13 of the 29 states and 2 union territories. This means that potential problems with policy implementation can be considered as a major downside risk to India’s rebound. The government may face fierce opposition in the Upper House, which could force N. Modi to postpone bills or use executive orders. Finally the BJP government has benefitted from an externally favourable macroeconomic environment, thanks to low crude oil prices and a gradual recovery in the European Union. The remaining global uncertainties are mostly potential surprises in US Fed tightening.

[29] The debt at risk is the debt owned by firms with relatively constrained repayment capacities in terms of interest – coverage ratios (ratio of earnings before interest, taxes, depreciation and amortization to interest expenses)
[30] IMF, Stabilizing and Outperforming Other Regions, Regional Economic Outlook: Asia and Pacific April 2015

RESERVATION

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