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India – Be patient on growth, despite reform rush

- **We revise down our FY13 GDP growth forecast to 5.4% from 6.2%**
- **Industry is likely to remain anaemic; services to remain on a weak footing**
- **Recent reforms are a step in the right direction, but momentum needs to be maintained**

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Summary

We revise down our GDP growth forecast for FY13 (began 1 April 2012) to 5.4% from 6.2%, as investment activity has not picked up in the first half of the fiscal year and consumer spending is now slowing. Industrial growth has stalled, and we now expect services-sector growth – which has significantly lost momentum – to remain low for a while. Agriculture could also suffer from delayed monsoon rains this season. Quarterly GDP growth of 5.5% y/y in Q1-FY13 was marginally better than expected, but we cannot rule out the possibility of sub-5% prints for the rest of the year. A low base should help boost y/y growth readings in H2-FY13, but we do not see this as a big driver.

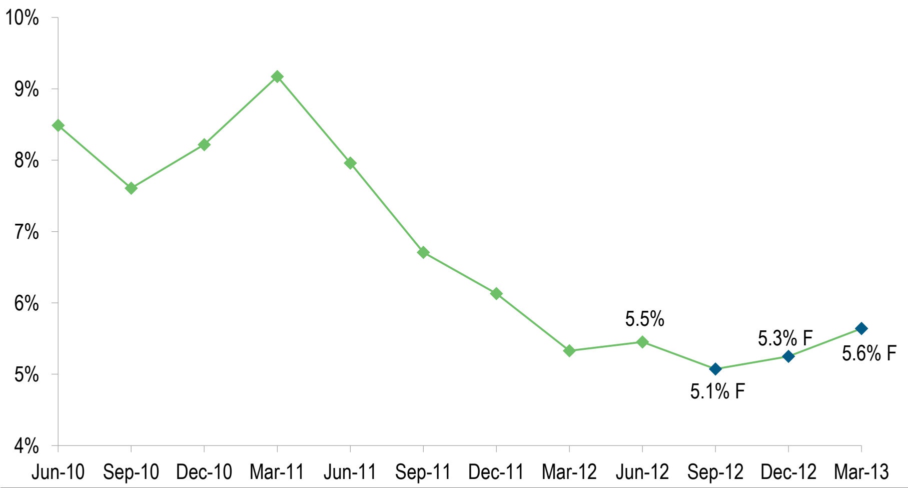
While India's macro backdrop remains challenging, a series of recently announced government reforms to contain the fiscal deficit and increase foreign participation in selected sectors has led to renewed optimism. While these measures will have a positive medium-term impact and will change the perception of policy paralysis in India, they may not have an immediate effect on growth. It will be important to maintain the reform momentum in order to put growth back onto an upward trajectory. Asset markets are likely to respond positively, and we expect improved sentiment to result in more inflows.

Lowering our GDP growth forecast

The slowdown in India's growth has been priced in for several quarters. However, the lack of steps to fast-track investment approvals has pushed growth expectations even lower, and the market is now prepared for another slowdown of the magnitude seen during the global financial crisis. In line with this, we see a bleaker outlook for the rest of FY13.

Figure 1: Growth slows, forming a flat bottom

% y/y



Sources: CEIC, Standard Chartered Research

We revise our FY13 GDP growth forecast sharply lower to 5.4% from 6.2% –despite the better-than-expected Q1-FY13 GDP print of 5.5% y/y, which was an improvement over the 5.3% reading in Q4-FY12. The downward revision reflects sharper-than-anticipated slowdowns in India's main growth drivers. We outline these in more detail below.

Anaemic industrial growth excluding construction

Strong construction activity (the highest in 17 quarters) was a key reason for the better-than-expected Q1-FY13 GDP print. Delayed monsoon rains probably helped the construction sector, providing a boost to headline GDP as the construction sector bucked the seasonal trend. Indeed, GDP growth ex-construction slowed to 5.0% from 5.4% y/y the previous quarter. Going forward, even with construction expected to remain resilient to macro headwinds (our Equity Research team expects FY13 cement demand to grow 8%, versus 6.5% in FY12), we do not expect the stellar performance of Q1-FY13 to be repeated.

Q1-FY13 GDP growth was supported by buoyant activity in the construction sector

Support from the industrial sector – which has grown at an average rate of only 0.8% in the past three quarters – is unlikely. The lack of steps to accelerate the approval process for investment projects has dimmed hopes of an imminent revival in activity, although a technical rebound from a low base is likely, especially in H2-FY13. Industry ex-construction grew at an average rate of 0.8% y/y in H2-FY12, slowing sharply from 4.6% y/y in H1-FY12.

We expect industry to grow 4.1% y/y in FY13, driven primarily by the construction sector. The lack of support from the government or the Reserve Bank of India – we expect first rate cut only in Q1-2013 – is also likely to keep other segments, such as mining and manufacturing, on a weaker footing.

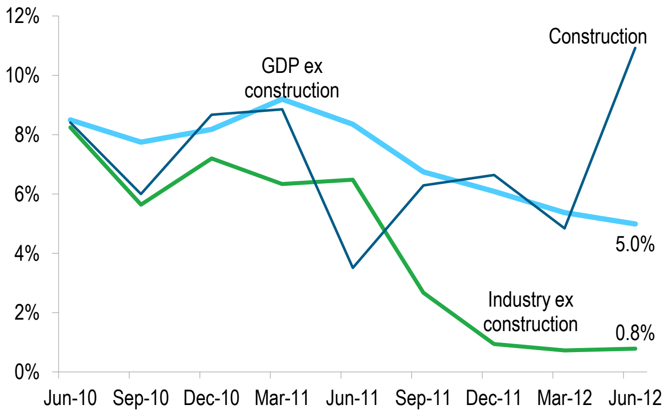
Services slowing sharply

We expect services and industry to remain on a weak footing for the rest of FY13

The services sector, which contributes c.60% of India's GDP, has previously provided consistent support to headline growth. However, it has buckled under the pressure of weaker industrial activity for the past several quarters. From 10.2% in Q1-FY12, services-sector growth slowed progressively to 8.9% in Q3-FY12, 7.9% in Q4-FY12 and 6.9% in Q1-FY13.

Figure 2: Construction-led growth

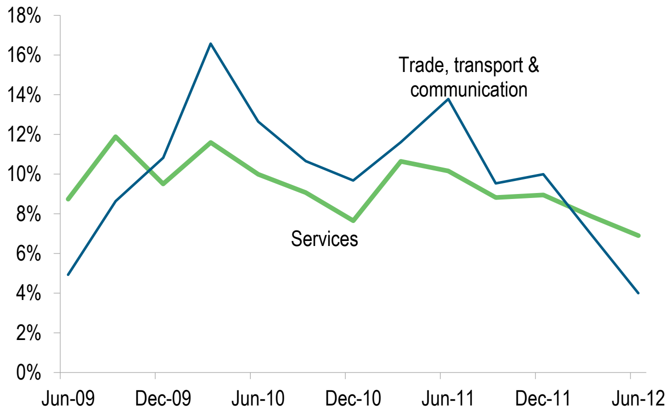
% y/y



Sources: CEIC, Standard Chartered Research

Figure 3: Services sector slips

% y/y



Sources: CEIC, Standard Chartered Research

Services-sector growth has slipped below 7% only twice (including in Q1-FY13) since the series began in FY05; the other time was in the immediate aftermath of the global financial crisis, when growth slowed to 6.4% y/y. The latest slowdown has been driven primarily by domestic trade (retail + wholesale), whose growth slumped to 4.0% y/y from 7% in Q4-FY12 and 10% y/y in Q3-FY12. Given that domestic trade is a good proxy for consumer strength, this indicates that consumers are quickly losing momentum, following the weak investment environment in a feedback loop

We expect the services sector to remain in a slump for most of FY13. During the financial crisis, growth in 'trade, transport and communication' (the largest component of the services sector) averaged just 3.8% y/y for three quarters, after bottoming out at 1%. The pain may last longer this time – while the slump in FY09 resulted primarily from an exogenous shock, this time, domestic issues remain unaddressed. Also, during the global crisis, India gained significantly from a crash in commodity prices; this time, such relief is not in sight.

Headline growth to get some support from a low base in Q4-FY13

While higher government spending or continued strong performance in the financial sector may provide a boost to the services sector, it is unlikely to offset sluggish performance in the 'transport, trade and communication' component. Indeed, strong growth in the 'financing, insurance, real estate and business services' component – which has continued to grow at a strong pace of c.11%, despite macro headwinds – may not be sustainable, in our view. While bank credit growth has been robust, anecdotal evidence does not point to similar strength in the real-estate or insurance sector.

We expect services growth to be a weak 6.9% y/y for FY13. We would not be surprised to see a further slowdown in the next quarter, before the low base provides some support at the end of FY13. Given the expected slowdown in services and industrial growth, GDP growth is likely to dip close to 5% over the next two quarters, before rising back to 5.6% in Q4-FY13 on the low base effect. While we expect growth to remain above 5% during this period (5.1% in Q2-FY13 and 5.3% in Q3-FY13), we do not rule out the risk of sub-5% growth in either quarter.

Reform steps to have a lagged impact

Spate of reform measures likely to change the perception of policy paralysis among investors and rating agencies

While India's macro backdrop remains challenging, the recent announcements of a series of reforms to contain the fiscal deficit and increase foreign investment have led to renewed optimism. While these reforms are unlikely to have an immediate positive impact on growth, they are critical to achieving more sustainable growth in the medium term. They will also help to change the perception of policy paralysis among investors and rating agencies. The latest announcements demonstrate that economic reforms can be pushed through via executive decisions rather than politically challenging legislative changes requiring parliamentary approval.

The latest measures send a signal to investors and rating agencies that the government is serious about reducing the fiscal deficit, even if it means taking politically difficult decisions. The opening up of FDI in sectors like multi-brand retail and aviation, and assurances that the government will reconsider contentious international taxation proposals, will also help to convince foreign investors that India welcomes foreign investment and can offer a stable policy framework. In our view, these reforms have the potential to revive business sentiment and attract equity inflows in the near term, and should prompt the rating agencies to reconsider possible rating downgrades.

We discuss the most important of these reforms in detail below, and outline other key reforms that will be needed to sustain the positive momentum. The prime minister has shown his resolve to stick to these decisions, even amid protests from both opposition parties and allies. Communicating the medium-term benefits of these tough decisions to average Indians will be crucial in allowing the government to continue with its reform agenda without suffering an electoral setback.

Measures to control the fiscal deficit

Fuel price increases and further divestment are positive steps towards fiscal consolidation, though they might not be enough to contain the FY13 deficit

Increase in fuel prices: The government announced revisions of administered fuel product prices on 13 September. We expect the increases in diesel and cooking gas prices to reduce the FY13 fiscal deficit by only 0.1ppt of GDP, after adjusting for the reduction in excise duty on petrol. The finance minister has also acknowledged that the subsidy bill (for food, fuel and fertiliser) is likely to be 2.4% of GDP in FY13, rather than the 1.9% envisaged when the budget was presented. However, even though the price increases will not have a material impact on this year's budget, they indicate the direction in which the government wants to move. They reduce the disparity between petrol and diesel prices and should encourage more balanced use of the two fuels. While higher prices will have the immediate effect of pushing up inflation (we estimate a direct impact of c.70bps, and a total impact of more than 100bps after incorporating the indirect effects of higher transportation costs), they should address the RBI's concerns about suppressed inflation in the system.

Divestment: After announcing no divestments in the first five months of FY13, the government announced the divestment of its stake in one company (c.INR 75bn), and approved the sales of four others in principle (c.INR 150bn). If the government approves the offer (c.INR 200bn) from a private-sector company to buy stakes directly in two other public-sector units, then it could raise more revenue via divestment than the initially budgeted INR 300bn. These share sales could result in substantial FII inflows if the government's proactive stance on reforms continues. Pushing the government-owned insurer to buy substantial shares in companies being divested (as was done in one case last year) will satisfy the objective of meeting the fiscal deficit target, but will not bring the required managerial efficiency to these public-sector companies.

Measures to boost foreign investment

FDI in retail: The government has finally allowed 51% FDI in multi-brand retail companies. It announced the decision earlier (in November 2011), but was forced to reverse it at the time amid opposition from some of its allies. The revised framework for FDI in multi-brand retail allows states to take the final decision on whether to allow FDI in retail in their respective states. Nine of 28 states have officially agreed. Others have reservations and have yet to decide. Retail stores with foreign investment will be limited to cities with populations of more than 1mn. At least 50% of the investment has to be in building back-end infrastructure, and 30% of the sourcing will have to be from local producers. The government thinks that these safeguards are sufficient to safeguard the interests of small retailers. This reform could considerably ease supply-side bottlenecks and reduce inflationary pressure. The associated investment in building retail infrastructure could also promote growth. However, meaningful investment is unlikely to occur in FY13.

FDI in retail is a critical supply-side reform that should help to reduce price pressures in the medium term and boost consumer spending

In a related development, the government has relaxed a critical condition for 100% FDI in single-brand retail, which was announced earlier. Meeting the 30% local sourcing requirement by buying from micro, small and medium-sized enterprises (MSMEs) is now “preferable”, rather than compulsory, as before. Some single-brand retailers are in the advanced stages of discussions with the government, and these investments are likely to occur before those by multi-brand retailers.

FDI in aviation: The opening up of this sector to 49% FDI might help to address the concerns of cash-strapped domestic airlines. Forward and backward linkages across the economy are limited in this sector, so this reform will benefit only a few companies, but it will clearly be viewed as a step towards liberalisation. The government has also allowed FDI in power exchanges and raised the limit on FDI in broadcasting services to 74% from 49%. We do not expect significant amounts of FDI in any of these sectors in the near term.

International taxation: A government committee looking into this issue has suggested that the application of General Anti-avoidance Rules (GAAR) be deferred by three years. This will allow foreign investors to better prepare for the change and avoid near-term uncertainty. FII inflows already began to pick up from July, after it became clear that the government would not introduce GAAR this fiscal year.

The way forward for reforms

The 12th Five Year Plan (for FY13-FY17) is in the final stages of preparation. The planning commission targets average growth of 8.2% over the period, with around INR 51trn of spending on infrastructure. Health and education are other sectors where a policy focus is expected, with increased public spending. Once the details of the plan become available, we may see more investment in some of these sectors.

Reform momentum needs to continue and be broad-based in order for growth to rebound

However, in our view, more policy action will be required to stimulate growth in the near term. The power sector requires urgent attention. Fuel supply agreements between coal miners and power producers need to be formalised immediately. Restructuring of State Electricity Board (SEB) losses (more than 1% of GDP) should also be a priority, since states have started increasing power tariffs. Media reports suggest that the finance minister is looking into accelerating large infrastructure projects that have been delayed for various reasons (including land acquisition and environmental clearances). Policy action on these fronts would have a more direct effect in kick-starting the investment cycle.

Investors will also look for a reduction in the withholding tax on debt investment by FIIs, a margin reduction/adjustment for FII investment in equities, and a decision to allow insurers to invest more in AA-rated paper. Any announcement on the timely implementation of the uniform goods and service tax (GST) would be an added bonus.

The reform process needs to continue, and there is no room for complacency. The government has provided a positive surprise to the market with the latest round of reforms, which change the perception of policy paralysis in India. It is now crucial to keep the reform momentum going so that growth can return to an upward path. In the meantime, patience will be required.

Disclosures Appendix

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