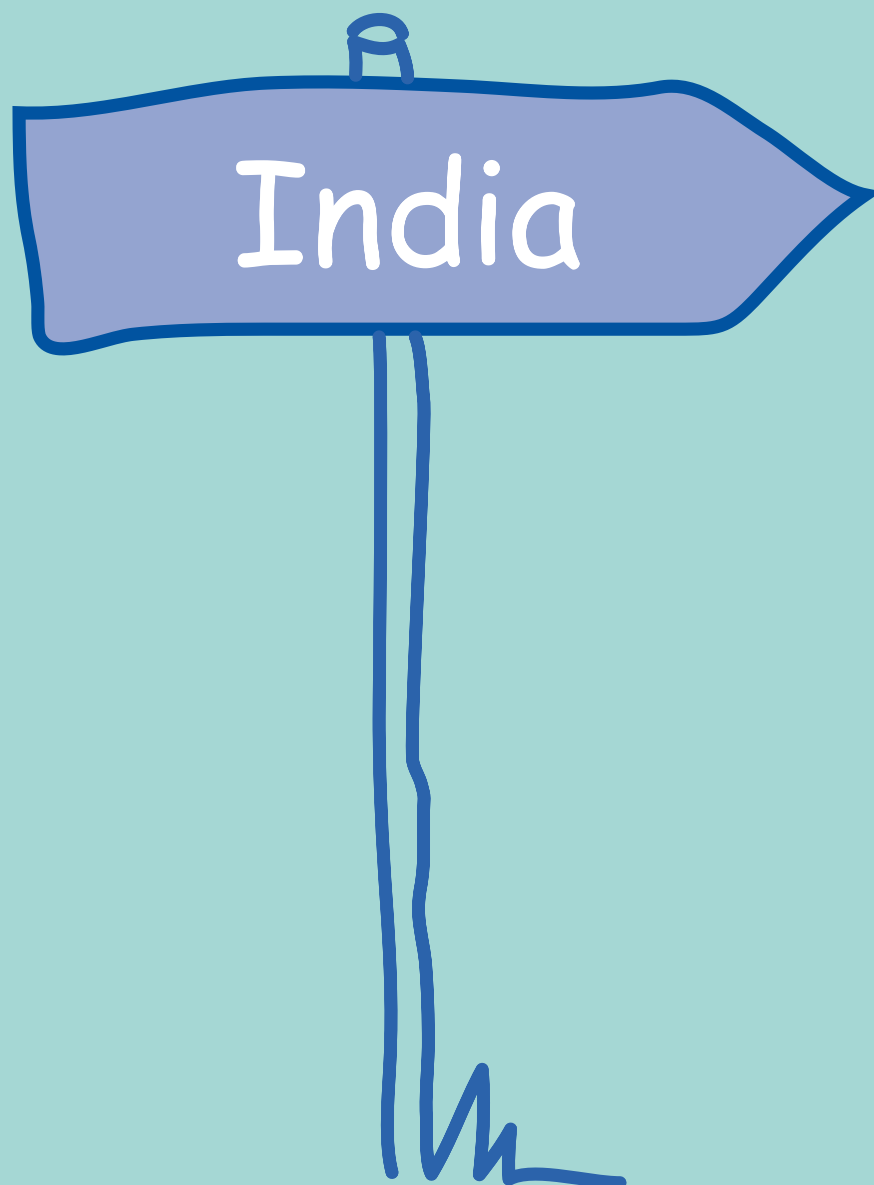
BBVA

Country Report

Economic Research Department

First Semester 2009



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This publication was coordinated by:

Alicia García-Herrero alicia.garcia-herrero@bbva.com.hk

Contributors:

Ya-Lan Liu yalan@grupobbva.com

Tatiana Alonso Tatiana.alonso@grupobbva.com

David Mathieson David.mathieson@grupobbva.com

Ramón de la Rocha ramondelarocha@bbva.com.hk

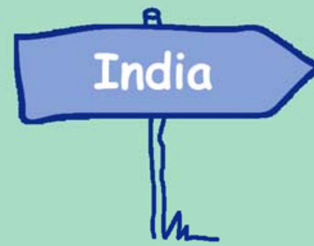
Kamolika Chowdhury

Angel Melguizo

Ionela Pipirig

Andrew Tsang

BBVA



Economy

Economic background

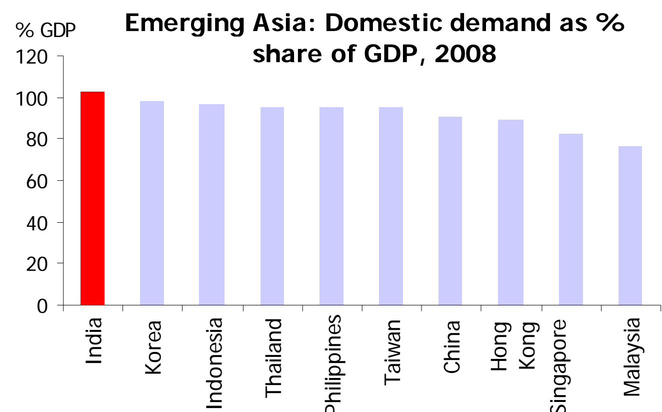
During the past 20 years, India´s economy has gradually evolved from a planning system towards a more market oriented one. Until the early 1980s, the Indian economy was virtually a closed one. The exchange rate was not market-determined and cross-border movements of foreign exchange were tightly regulated. Financial markets in India were highly segmented and bank credit to the private sector was regulated, with administered interest rates and directed credit to priority sectors at highly subsidized interest rates. Furthermore, the prices of a significant number of commodities were administered in India at that time and thus, government subsidies were often necessary to sustain these prices at a steady level, leading to a chronic budget deficit.

The mounting fiscal deficit in India and the nature of its financing dominated the monetary policy, hindered the development of the financial markets and reflected in growing macroeconomic instability. The economy suffered a major balance of payments crisis in 1990-91, urging the authorities to undertake fiscal correction and financial sector reforms. The reform agenda provided for a legal and institutional framework to lower fiscal deficits (Fiscal Responsibility and Budget Management Bill), ceilings to the government borrowing from the central bank on fiscal and monetary policy. In the financial sector, the reforms focused on the gradual deregulation of the interest rate structure, a market-determined exchange rate system and the gradual convertibility of the current account.

Economic structure

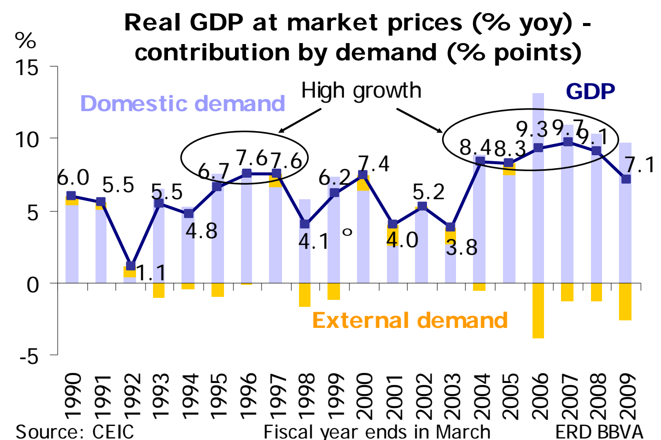
India's story is rather different to much of Emerging Asia. The Indian economy suffers from substantial twin deficits, both in the fiscal and current account balances, while it remains relatively dependent on international finance for long-tenor funding, in particular, for investment plans. On the other hand, compared to peers in the region, India has one of the highest domestic consumption/GDP shares in the region at over 100% of GDP and its aggregate demand is primarily domestically driven, albeit exports have been progressively gaining higher importance in recent years (Graph 1).

Graph 1.



After the crisis in 1991, India´s economy has experienced two major growth cycles. A first period of recovery from 1993-94 until the Asian financial crisis in 1997-98, and a second phase beginning in 2003, which has registered an average real GDP growth of 8.9% until 2008, mostly driven by the domestic demand (Graph 2).

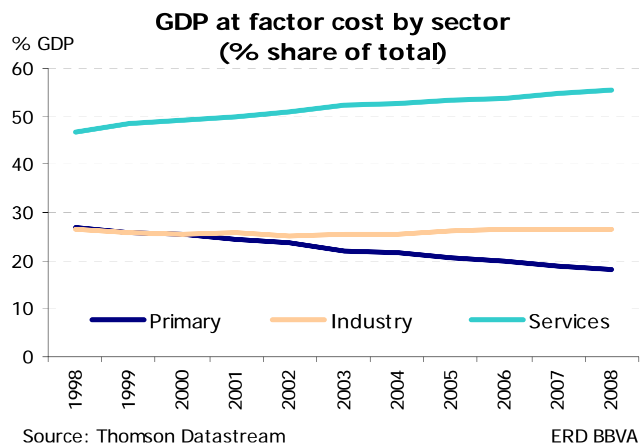
Graph 2.



Ya-Lan Liu
yalan@grupobbva.com

By industry, share and contribution of agriculture and allied services to GDP declined at the expense of the non-primary sectors like manufacturing, construction, trade and hotels and financial sectors. As a result of this growth in non-primary sectors, industry has clearly taken over the agricultural sector since 2001, with a 26% share of total GDP (at factor cost) contributing to 30% of growth during 2001-2008, while the services sector has increased its share from 49% to around 55% of aggregate output in the period and contributed to more than 65% in average to real GDP growth (Graph 3).

Graph 3.

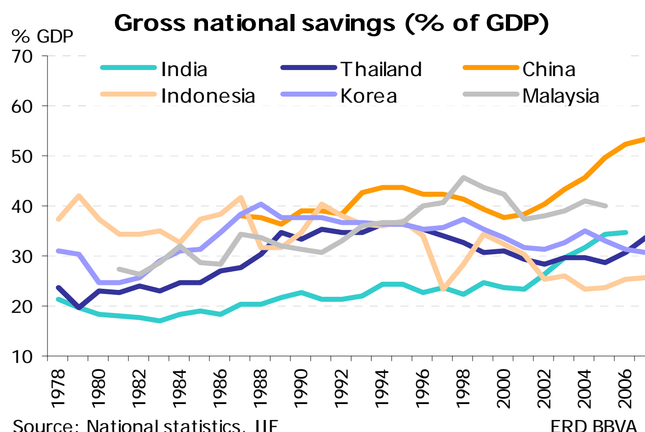


The potential growth of the Indian economy is hard to estimate due to lack of data on the unorganized sector, capacity utilization and employment. The official surveys[1] show that the bulk of India's total workforce is employed in the primary sector (over 40% in the past three years), even though it has been steadily declining at the expense of services (35% of total workforce), while employment growth in the industry sector has been mostly stagnant.

A rough measure of productivity by measuring the real growth in output per person employed shows that India's labor productivity rose at a faster pace than other Emerging countries excluding China, averaging 4.9% annual growth since 2000. However, looking ahead India is expected to suffer a significant slowdown in productivity growth from 6.1% in 2007 to 4.4% in 2008. In 2009, as the economy slows down and the employment situation deteriorates considerably, India's labor productivity growth is likely to fall to its lowest levels since 1995. This in a stark contrast with China's rebound in labor productivity growth but it probably reflects India's less flexible labor market as employment growth does not adjust as quickly to the deteriorating economy.

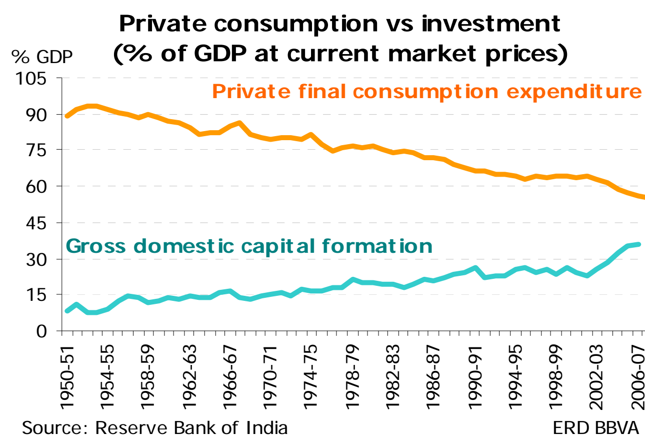
Another key difference in India compared with most Asian economies is that, historically, Indians have tend to save less than their counterparts in the region and do not have as consistently high a savings rate as its main peers in Emerging Asia (Graph 4).

Graph 4.



India's historical low savings rate resulted in low investment rates, which was the main reason for the country's weak economic growth for most of the second half of the twentieth century. Since then, there has been a constant improvement in the investment rate -with its sharpest rise in the last five years-, at the expense of the consumption rate. Accordingly, a key issue for India to maintaining high levels of economic growth is whether its recent higher investment and savings rate levels of 30-35% of GDP could be sustained (Graph 5).

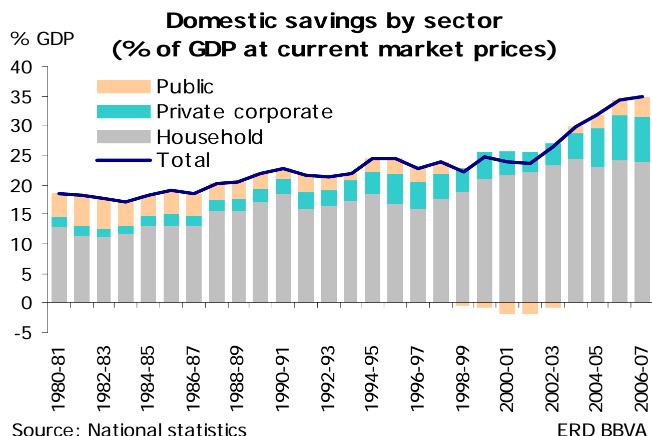
Graph 5.



By composition, more than 85% of the recent improvement in the domestic savings rate -from 23.5% of GDP in 2001 to 34.8% of GDP in 2007- was driven by the savings of the private corporate and the public sector. However, both sectors tend to be more pro-cyclical than household savings and hence, they usually lead to higher fluctuations in the aggregate savings and investment rates and, ultimately, lead to higher variation in aggregate output growth (Graph 6).

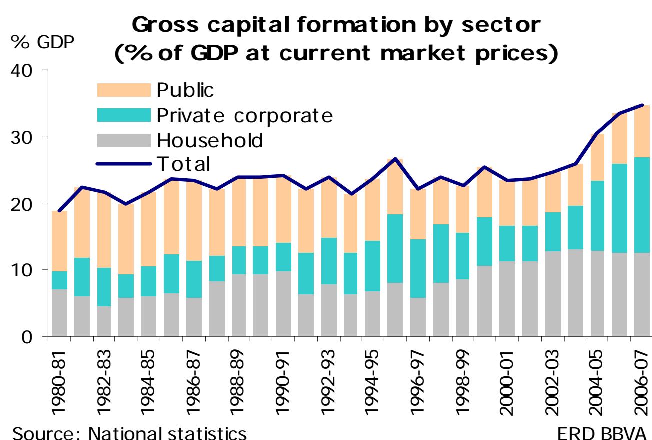
[1]Most reliable estimates of India's total workforce are limited to the years covered by six quinquennial household surveys that were conducted over the period of fiscal year ending-March 1973 to end-March 2000. Annual estimates for the aggregate economy can only be obtained by interpolations of the results from those surveys.

Graph 6.



Such fluctuations of the savings rate are likely to have even more of a negative impact on growth due to India's already high current account deficit and weak fiscal position: in the event of a sudden decline in growth or domestic savings rate, India's economy has no room for counter-cyclical policies. In this case, India would need to draw on more external funds to finance its domestic savings-investment gap or alternatively, investment would drop dramatically. Until recently, the rise in the savings rate and capital inflows from abroad, accompanied by low levels of risk aversion among investors, fueled a rapid growth in private corporate investments, in particular, long-duration investment projects (Graph 7). This had created a positive momentum for consumption and other economic sectors but, at the same time, led to the deterioration of India's external imbalances. As result of the recent global financial turmoil, most of the long-term funding sources for corporate India have now dried up and seem unlikely to return in the near term.

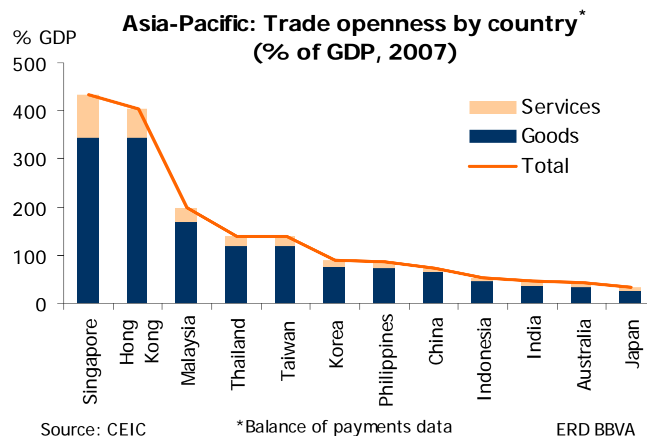
Graph 7.



External sector

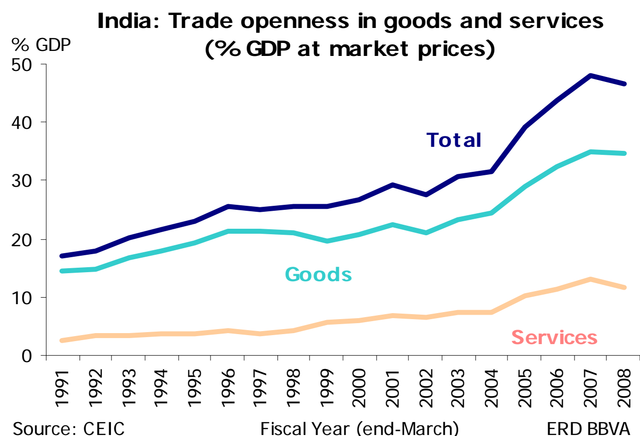
India is relatively closed in terms of foreign trade, even after including cross-border receipts of services. At only 48% of GDP (at market prices), India's overall trade openness (services and goods) is lower than the median of 88% of GDP among major peer economies in Asia (Graph 8).

Graph 8.

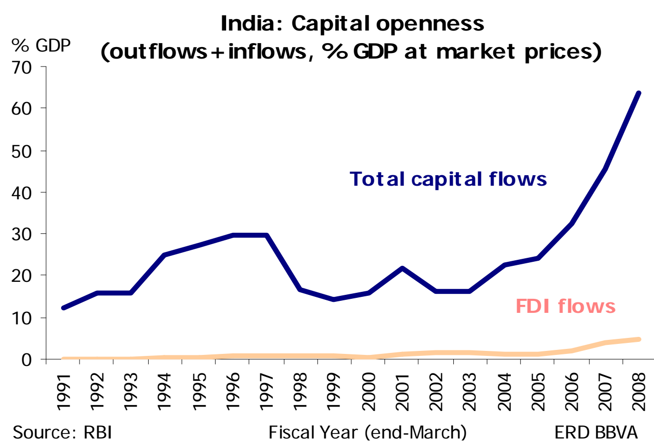


Yet India's economy has become increasingly exposed to the global environment, not only in terms of trade but mostly in terms of capital flows. Trade openness rose from 17% of GDP in 1991 to near 50% in 2008 (Graph 9), while the sum of capital outflows and inflows increased from 12% of GDP to 64% of GDP during the same period (Graph 10). Of overall capital flows in 2008, less than 10% were related to foreign direct investment (FDI) inflows/outflows totaling some USD54 billion at end-March, while USD700 billion flows (82% year-on-year rise) were related to portfolio investments and other international finance such as cross-border loans, banking capital and rupee debt service. As a result, unlike most of emerging Asia, India´s economy seems largely less vulnerable to the contraction in external demand, even though the Indian industry is to bear the brunt of the slowdown as it is largely export oriented. Notwithstanding, India will be one of the hardest hit in the region by the credit pullback. The squeeze in international credit markets dried up capital flows to India while raising the cost of capital and both factors will dampen domestic investment plans compounding the economic slowdown.

Graph 9.

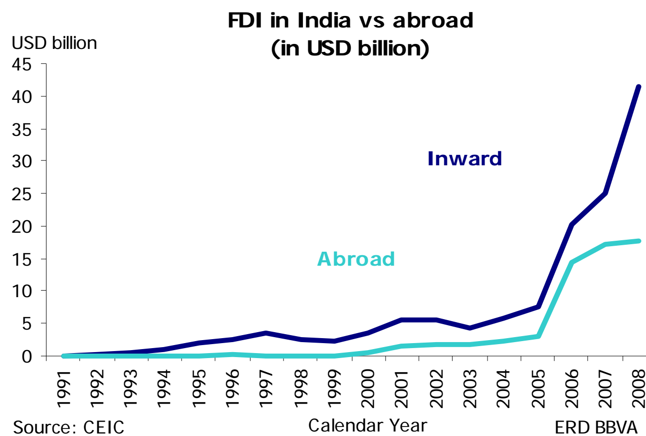


Graph 10.



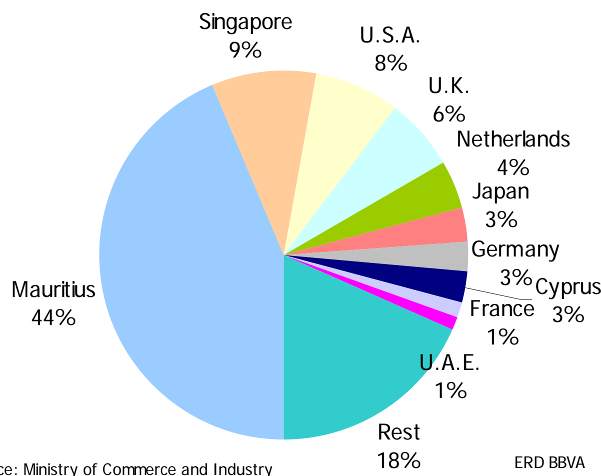
In terms of cross-border direct investment, foreign direct investment (FDI) inflows to India have surged from USD2 billion in 1991 to USD34 billion in the year ending March 2008, while residents direct investment abroad have risen even more rapidly from nil to USD19 billion during the same period (Graph 11). While foreign portfolio investments showed substantial outflows of USD15 billion during 2008 (January to December), FDI inflows continued to increase to USD41 billion in the period or 73.3% yoy. The main FDI transactions included a USD4.6 billion deal by Japan's Daiichi Sankyo Co. for a controlling stake in Ranbaxy Laboratories Ltd., India's largest pharmaceutical company, which was completed in early January 2009 with an appraisal loss of around USD3.9 billion by the Japanese acquirer. Another major acquisition was the USD2.7 billion purchase of a 26% stake in India's Tata Teleservices Ltd by the Japanese top mobile operator NTT DoCoMo in mid-November 2008.

Graph 11.



The liberalization measures post-1991 permit 100% foreign ownership in several industries and majority ownership in all except banks, insurance companies, telecommunications and airlines. Procedures for acquiring permissions have been simplified with some sectors listed for automatic approval while others have to await the approval of the Foreign Investment Promotion Board. Mauritius, as an off-shore center, is the top FDI investor in India with 44% share, followed by Singapore (9%), US (8%) and UK (7%) (Graph 12).

Graph 12.



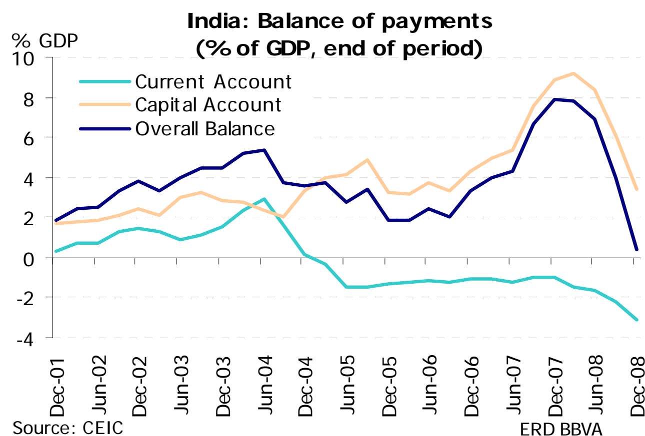
In 2006, further measures to attract FDI included the extension of automatic routes, removal of restrictions, increasing the cap on equity investment and simplifying procedures to facilitate FDI inflows. Sectors which permit 100% FDI include hotels and tourism (automatic approval), drugs and pharma (automatic route except when subjected to licensing under certain clauses), construction of road, ports, highways & bridges, manufacture and consultancy of pollution control equipment and systems (automatic route), aircraft maintenance and repair operations among others.

Analyzing the sector-wise distribution of FDI inflows, services, inclusive of both financial and non-financial segments, held the top-most position at 22% of cumulative inflows, followed by computer software and hardware (11%) and telecommunications (8%) as of end-January 2009. By recipient cities, Mumbai (34% of total cumulative), New Delhi (16%), Ahmedabad (7%), Bangalore (7%) and Chennai (6%) were the top FDI attracting destinations in India.

On the liberalization of portfolio flows, a major reform was undertaken in 1993 when foreign institutional investors (FIIs) were permitted to purchase shares of listed Indian companies in the stock market. FIIs' investment in securities has surged from USD72 billion in 1996 to more than USD770 billion at end 2008. Notwithstanding, the trend of FIIs equity flows reversed from net inflows into India of USD19.5 billion in 2007 to net outflows of more than USD10 billion in 2008.

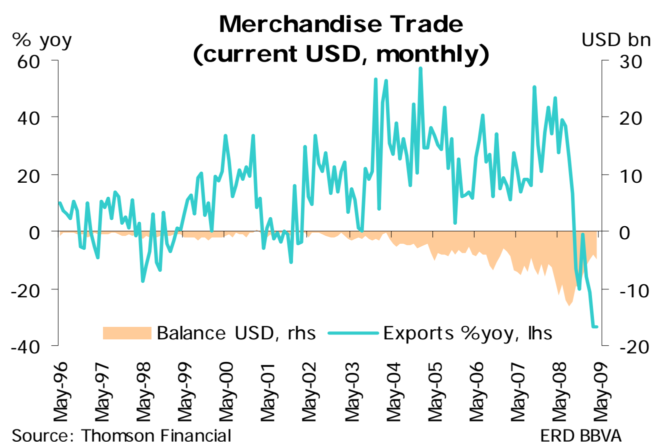
As net capital flows declined sharply, the overall balance of payments position turned negative in the last two quarters of 2008, for the first time since 1998. Net portfolio outflows totaled USD15 billion during 2008, reversing a record net portfolio inflow of USD35 billion in the previous year. Moreover, India's current account deficit widened considerably to 3.2% of GDP at end 2008, due to a sharp decline in the merchandise trade balance, compared with less than 1% of GDP a year ago. Net invisibles balance held up in 2008 driven by services income and private transfers receipts, but could not offset the 56% year-on-year increase in the merchandise deficit of USD128 billion during the year (Graph 13).

Graph 13.



Export growth turned negative (in US dollar terms) in the last quarter of 2008 for the first time since 2001. Export growth continued declining in 2009, to -33% yoy in March and April (-15% and -16% yoy, respectively, in rupee terms). Imports contracted even faster, as a result, merchandise trade deficit shrank to USD5 billion in the month of April as against USD7.6 billion in December (Graph 14).

Graph 14.



On balance, higher current account deficit in 2008 coupled with the decline in capital inflows led to a decline in the accumulation of foreign exchange reserves. The foreign exchange reserves on balance of payment (BoP) basis (i.e., excluding valuation changes) declined in the last two quarters of 2008 due to the widening of the current account deficit combined with net outflows under the capital account. For the full year, the variation in FX reserves on BoP basis was of USD4.6 billion in 2008 as a whole, compared to an increase of USD87.7 billion during the same period of the previous year (Table 1).

Table 1.

Summary of the balance of payments

% of GDP at market prices	2005	2006	2007	2008
A. Current account	-1.3	-1.1	-0.9	-3.2
Trade balance	-6.0	-7.1	-7.3	-10.8
Services	2.5	3.5	3.6	4.0
Investment Income	-0.9	-0.6	-0.6	-0.4
Transfers	3.0	3.1	3.3	4.0
B. Capital account	3.2	4.4	8.7	3.1
FDI	0.6	0.8	0.7	1.7
Portfolio investments	1.5	1.1	3.1	-1.3
C. Errors and omissions	-0.1	0.0	0.1	0.1
D. Overall balance	1.8	3.3	7.9	0.0
E. Change in foreign exchange reserves* (US$ million)	-41.5	-68.3	-87.7	-4.6

* Excluding valuation changes; negative sign means increase in reserves
Source: Thomson Financial ERD BBVA

India's accumulated foreign exchange reserves declined by USD25.2 billion in 2008, but they have since increased USD0.4 billion to USD242 billion as of end-April 2009 (not adjusted by net forward sales of USD2 billion outstanding at end-April 2009). The fall in 2008 was the sharpest decline in FX reserves among major economies in Asia during the same period only after Korea. The decline in 2008 mostly reflected valuation losses (due to the depreciation of major currencies against the US dollar) and intervention of the central bank in the foreign exchange markets to defend the rupee, in addition to the current account deficit and net outflows under FIIs. The Reserve Bank sold 11.4 billion US dollars during 2008, as against net purchases of 75 billion US dollars in the

previous year. Even though India's official reserves position looks comfortable in absolute level, it provides relatively less of a cushion at merely 20% of GDP as compared to most peer economies in the region (Table 2).

Table 2.

Asia-Pacific: FX Reserves (minus gold)*

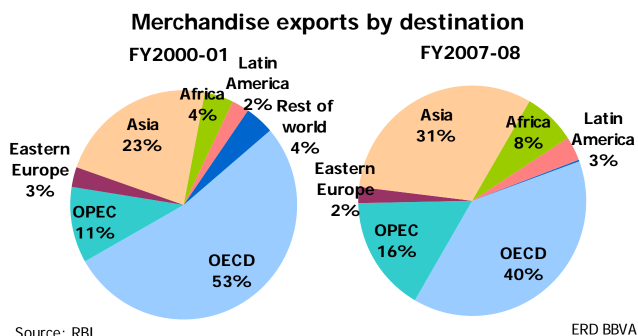
Rank	Country	US$ billion	% GDP	At end of
1	Hong Kong	193	90	Apr-09
2	Taiwan	305	78	Apr-09
3	Singapore*	170	66	Apr-09
4	China*	1,954	45	Mar-09
5	Thailand	114	42	Apr-09
6	Malaysia	82	37	Mar-09
7	Korea	212	22	Apr-09
8	Philippines	35	21	Apr-09
9	India	242	20	Apr-09
10	Japan	983	19	Apr-09
11	Australia	34	17	Apr-09
12	Indonesia	53	10	Mar-09

* Not adjusted by net forward FX contracts. China, Singapore including gold

Source: Thomson Financial, National statistics ERD BBVA

On a more positive note, the economy will benefit of lower oil prices in 2009 over a year ago, particularly because India imports most of its oil requirements. Moreover, on the export front, India's export markets are more diversified away from the developed economies this time around, which should provide more of a cushion against the fall in demand from industrialized countries (Graph 15).

Graph 15.

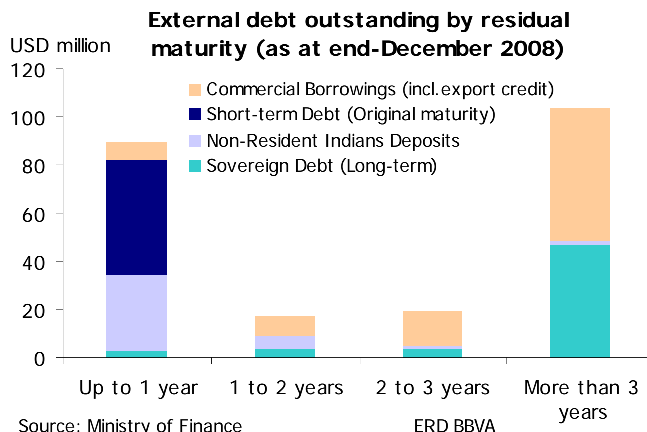


The reversal of capital flows rose concerns about India's management of its balance of payments, particularly in relation to outstanding short-term external debt. India's external debt with residual maturity up to one year was estimated at around USD90 billion, according to the Ministry of Finance, comprising of sovereign debt, commercial borrowings, non-resident Indian (NRI) and foreign exchange deposits of USD32 billion, short-term trade credit and others, as at end-December 2008 (Graph 16).

The share of non-Government debt in total external debt has increased steadily since March 2003, representing over 75% of total at the end of December 2008. Overall short-term debt increased in the last quarter over the previous quarter mainly due to increase in short-term trade credit, foreign institutional (FII) investments in government securities and corporate debt instruments. The Indian authorities raised the cumulative debt investment limit from USD3 billion to USD6 billion for FII investment in corporate debt in October 2008 and further to USD15 billion in January 2009, in order to boost dollar liquidity. Overall external debt stood at USD230.8 billion as of end-December 2008 or 19% of GDP (at market prices), recording a marginal increase of USD6.1 billion over end-March 2008 primarily on account of higher level of long-term debt. Over the quarter ended December 2008, the long-term debt recorded an increase of USD 9.4 billion due to USD4.6 billion increase in commercial bank borrowings, while the short-term debt declined by USD 3.2 billion.

By components, as at end-December 2008, commercial borrowings accounted for 28.7% of external debt, plus trade credits for 6% of total, followed by non-resident Indians deposits for 17.5% and multilateral loans for 17.3%. Indian corporations have commercial borrowings outstanding of USD66 billion as of end-December 2008, comprised of external borrowings of maturities between 3 to 10 years for allowed transactions, such as imports of capital goods and investment expenditure in domestic currency. Trade credits of USD43.8 billion were due within a year and USD13.9 billion over a year, while short-term liabilities of commercial banks halved to USD600 million at end-December 2008. The bulk of India's external debt continued to be denominated in US dollar at 53.1% of total, slightly lower than in June 2008 at the expense of an increase in Japanese yen to 15.9% from 11.3% during the period, followed by Indian rupee at 15.8% and euro´s share of 3.8% at end-December 2008.

Graph 16.



India's overall foreign debt indicators at end 2008 seem largely at comfortable levels (Table 3). India´s foreign exchange reserves at end-December 2008 provided a cover of 105% to the total foreign debt stock, though the ratio of short-term to total foreign debt increased rapidly to 20.6% from less than 8% in 2006. There are concerns about short-term contingent obligations such as external commercial borrowings (ECB) repayments, redemption of

short-term NRI deposits by residual maturity (USD31.8 billion as at end-December 2008) and large foreign debt inflows in the pipeline on account of commitments of buyers' credit by Indian importers and oil companies. In order to hold these pressures, the Reserve Bank of India raised in October 2008, the ceiling rate of interests paid on NRI deposits by 50 basis points to retain depositors and, to facilitate the financing of external commitments, it raised the all-in-cost ceiling for trade credits of maturities of 'up to one year' and 'above one year up to three years' from 75 and 125 basis points, respectively, to LIBOR plus 200 basis points each.

Table 3.

Indicators of external vulnerability

As of end of period	1997	2001	2005	2007	2008
Current account/GDP (%)	-0.7	0.3	-1.3	-0.9	-3.2
Merchandise exports/GDP (%)	-3.6	-2.5	-6.0	-7.3	-10.8
Net invisibles*/GDP (%)	2.9	2.8	4.7	6.3	7.6
Capital flows/GDP (%)	2.4	1.7	3.2	8.7	3.1
Debt service Ratio** (%)	23.0	13.7	5.9	4.8	5.4
Short-term/Gross foreign debt (%)	7.2	3.6	13.3	16.4	20.6
Gross foreign debt/Current account receipts (goods and services) (%)	227.3	164.6	87.4	82.4	93.2
Gross foreign debt/GDP (%)	24.6	21.6	17.3	17.8	21.3
FX reserves/Foreign debt (%)	31.4	45.3	99.0	129.6	105.3
FX reserves/Imports (months)	22.0	21.6	10.9	10.2	9.4
Foreign debt (US$ bn)	93.5	101.3	133.0	171.4	224.8
Foreign exchange reserves (US$ bn)	24.2	45.3	131.2	266.9	241.7

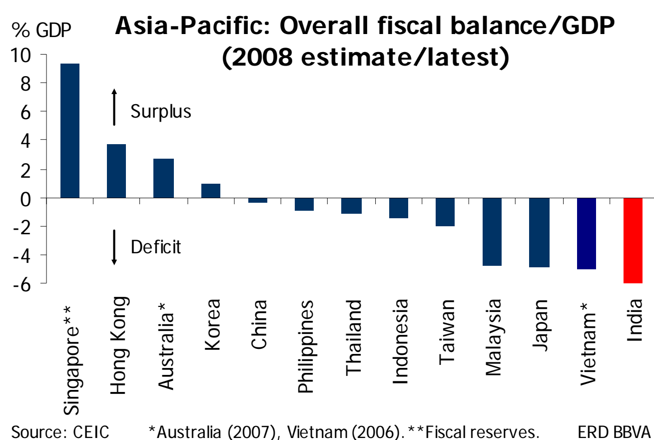
*Net balance of services, income and transfers;**Debt-service ratio is the proportion of gross debt service payments (only in respect of long-term debt) to External Current Receipts (net of official transfers). Latest as of end-March 2008.

Source: Thomson Financial, RBI ERD BBVA

Public finance

India's gross fiscal deficit remains the highest among major Asian economies (Graph 17) and, recently, government disbursements have been increasing at an alarming rate.

Graph 17.



Source: CEIC *Australia (2007), Vietnam (2006). **Fiscal reserves. ERD BBVA

The combined finances of the Central and State governments for 2008-09 were budgeted to improve with the key fiscal indicators planned to decline, both in absolute terms and as percentage of GDP. Primary balance was initially budgeted to record a surplus of 1.1% of GDP in 2008-09, as compared with 0.9% in the previous fiscal year. However, the sharp decline in the domestic economy that triggered fiscal stimulus measures (Annex 2), combined with lower than expected revenue growth, led to the upward revision of the previous budget estimates to primary deficits of 2.5% of GDP in 2008-09 and of 1.8% of GDP in 2009-10. Under the revised scenario, gross fiscal deficit is budgeted to surge to 6% of GDP in 2008-09 from 2.5% of GDP in the previous year[2] and moderate to 5.5% of GDP in 2009-10, but still far higher than the mandated target of 3% of GDP. The Centre government is expected to suffer revenue losses from lower direct tax collection as result of the slowing domestic economy but also, further losses worth about 0.6% of GDP due to cuts in excise and customs duties, as well as the VAT, in late 2008. Corporate and personal income tax rates have been kept unchanged for the fourth successive budget, while the excise and service taxes have been lowered by a further 200 basis points to 8% and 10%, respectively, in late February 2009.

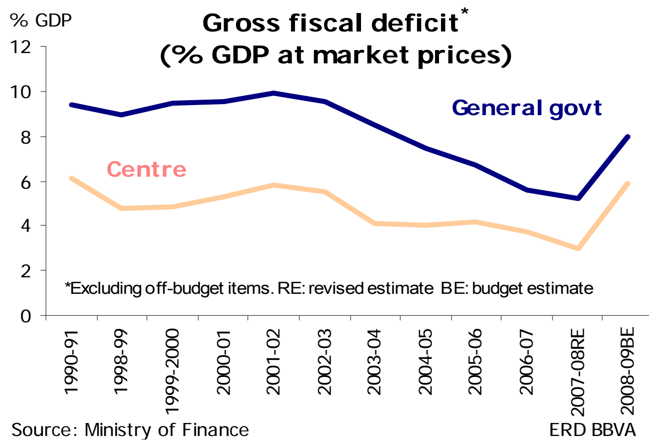
During April 2008-January 2009, the Centre has seen a disproportionate growth in expenditure, due to a large debt-waiver for farmers of INR717 bn (USD15 bn), a big wage hike for civil servants (worth 0.4% of GDP), and an unprecedented rise in subsidies for food, fuel and fertilizers from 2% of GDP initially budgeted to a revised estimate of 4% of GDP in 2008-09. Domestic fuel prices were adjusted 12% in early June to raise the effective price of gasoline and diesel in line with international prices, though kerosene and cooking gas continue to be heavily subsidized. Taking into account the additional expenditure coupled with foregone revenue, the Centre fiscal deficit is expected to rise from 2.5% to 6% of GDP in the revised budget for 2008-09 and to decline to 5.5% of GDP in 2009-10.

In addition to the subsidy bill, the Centre also issued special bonds amounting to 1.1% of GDP to oil marketing companies and fertilizer companies during 2008-09 (up to January 23, 2009). These bonds are considered to be fiscal deficit neutral since they do not involve cash flow and are, therefore, not treated as part of budgetary expenditure/receipts. However, these bonds have fiscal implications as they add to the fiscal liabilities of the government, and also as interest payments on such bonds increase fiscal expenditure and, therefore, the fiscal deficit. Interest payments as a percentage of total revenue receipts (net) of the Centre are expected to increase from 31.5% in 2007-08 to 34.3% in 2008-09 and further to 37% in the 2009-10 budget estimates. As a result, the consolidated fiscal deficit of the Centre (budget plus off-budget programs) is being placed at 8% of GDP in the year ending March 2009. The consolidated fiscal deficit of the States is expected to rise to 2.6% of GDP, due to the economic downturn as well as to post-budget expenditure commitments such as payment of arrears resulting from the wage hike to civil servants.

[2] Union Budget 2009-10 (interim).

Combined government budget deficit is officially projected to rise from below 6% in 2007-08 to 8% of GDP in 2008-09 (11% of GDP including off-budget expenditure) (Graph 18). To counter the economic slowdown, fiscal stimulus packages were announced on December 7, 2008 and January 2, 2009 providing tax relief to boost demand and increasing expenditure on public projects, with both packages together amounting to about 3% of GDP. Even though, India's direct fiscal stimulus amounts to just 1.5% of GDP in terms of actual new spending, the increased public expenditure will mean a deviation from the roadmap laid out by the Fiscal Responsibility and Budget Management (FBRM) Act[3], reversing the fiscal consolidation process of the last several years.

Graph 18.



Source: Ministry of Finance ERD BBVA

In pursuing fiscal consolidation, the tax policy in recent years has been guided by the objective of increasing tax revenue to GDP. On the direct taxes front, the main strategy of the Central government has been to broaden the tax payers' base by keeping the tax rates moderate.

On the indirect taxes front, the strategy has been to integrate the taxes on goods (central excise) and services. To meet this end, the main Central Value Added tax (CENVAT) rate was cut down from 16% to 14% in early 2008, further to 10% in December and to 8% in late February 2009, as part of the government fiscal stimulus package. Service tax was also lowered by 200 basis points to 10% in February 2009. Service tax is another major source of revenue for the government; from only 3 items covered under the service tax regime in 1994-95, the total number of items taxed extended to 100 in 2007-08. The States governments have also seen their financial positions improved with the introduction of the Value Added Tax (VAT) in mid-2005. The objective of VAT is to abolish sales tax at the state level and harmonized tax rates across all the States and Union Territories.

However, it is critically important for a medium-term strategy, that the Centre and State governments continue abiding by a fiscal rule[4], even under the prevailing circumstances, in order to discipline spending, and to improve its composition towards more efficient and growth-supporting purposes, such as health, education, and infrastructure. With improvement in the economic scenario, the government expects the process of fiscal consolidation to be back on track from 2010-11.

The Central government had initially targeted a net domestic market borrowing of INR990 billion (USD20.5 billion) in 2008-09 (10.6% less than in 2007-08) to finance 70% of the budget deficit (Table 4). Subsequently, the government presented two supplementary demands, as a result of which the net market borrowing program of the Central government was raised to INR1753.7 billion (USD36 billion). Against this increased borrowing program, the Central government has raised a net amount of INR1687.1 billion (USD34.5 billion) during 2008-09 (up to February 9, 2009). Moreover, the State governments have borrowed a net amount of INR463.3 billion (USD9.5 billion) up to January 23, 2009, and above originally budget of INR447.4 billion for the fiscal year ending March-2009.

Table 4.

Combined government finance summary

As of end-March, Rs billions	2005	2006	2007	2008(BE)
1. Total Receipts (2) + (3)	6350.4	7203.0	8787.4	11080.0
2. Revenue Receipts	6156.4	7070.5	8770.8	10551.7
i) Tax Revenue	4924.8	5766.0	7240.2	8733.0
3. Non-Debt Capital Receipts	194	132	17	528
of which: Disinvestment proceeds	44	16	24	445
4. Total Disbursements	8697.6	9598.6	11091.7	13558.3
of which:				
i) Interest Payments	1923	2040	2308	2637
ii) Loans and Advances	260.5	209.0	194.2	215.8
5. Gross Fiscal Deficit (GFD) (4) - (1)	2347.2	2395.6	2304.3	2478.3
6. Gross Primary Deficit (5) - (4i)	424	356	-4	-159
Financed by:				
A. Domestic	2199.7	2320.9	2219.6	2378.6
1. Bank	139	164	692	728
of which: Net RBI credit to government	-629	343	-42	-1,156
2. Non-Bank	2,061	2,157	1,528	1,650
B. Foreign, net	147.5	74.7	84.7	99.7
Memo:				
Domestic market borrowings, net (% GFD)	36.4	50.7	55.5	70.3
Foreign financing (% GFD)	6.3	3.1	3.7	4.0
Interest service (% of revenue)	30.3	28.3	26.3	23.8
Gross fiscal deficit (% GDP)	7.5	6.7	5.6	5.2
Gross primary deficit (% GDP)	1.3	1.0	0.0	-0.3
Revenue receipts (% GDP)	19.5	19.7	21.2	22.3
Expenditures (% GDP)	27.6	26.8	26.9	28.7
Interest payment (% GDP)	6.1	5.7	5.6	5.6

BE: Budget estimate Source: Reserve Bank of India ERD BBVA

For the year 2009-10, the Centre´s gross market borrowing program for the year 2009-10 is INR3.6 trillion (USD74 billion) or around 6% of GDP, as compared to gross borrowing of INR3.06 trillion (USD63 billion), about 5.6% of GDP in 2008-09, of which INR910 billion were announced since February 2009. In order to counter the increase in yields, the central bank started buying government bonds through open market operations since February. It has bought bonds worth INR3.66 trillion since

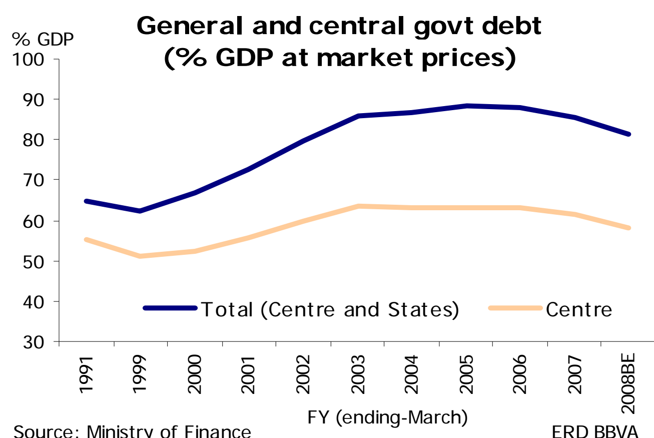
[3] Act No. 39 of 2003 [26th August, 2003].

[4] The FRBM Act mandated a reduction in the central fiscal deficit by 0.3% per year. The target was to cut the fiscal deficit to 3% of GDP by 2008-09.

February 19, 2009. In addition, increased recourse to the World Bank and the ADB is expected to raise net foreign borrowing to INR161 billion (USD3.3 billion), about 0.3% of GDP in 2009-10.

The increased government borrowing adds to already high government debt burden and will keep interest rates high. The legacy of continuous primary and overall deficits has been the buildup in the government liabilities. India's government total liabilities to GDP are high by international standards. Despite some improvement in recent years, combined centre and states liabilities (domestic, external debt and other liabilities) represent above 80% by end March-2008, which is the second highest ratio among major Asian economies, only after Japan (Graph 19).

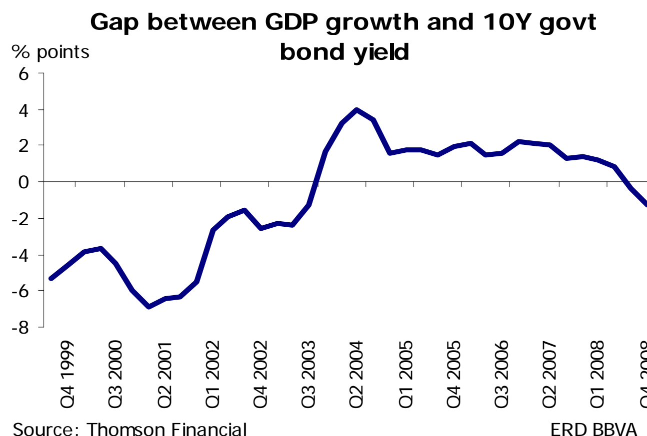
Graph 19.



The conditions for debt sustainability, however, have considerably improved in recent years. The general government primary deficit has reverted to a small surplus in both 2007 and 2008, the debt stock has edged down and the growth rate-interest rate differential even turned positive since 2003 (Graph 20). The trend, however, has clearly reverted since September 2008, on the back of increased government finance requirement and lower economic growth.

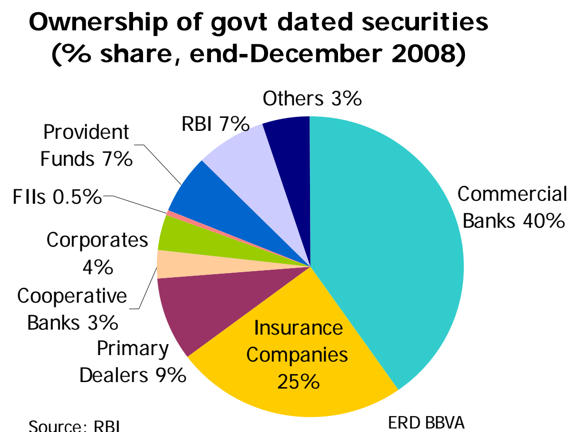
Liabilities of the central government have declined from 63% of GDP (at market prices) to 58% between March 2004 and 2008, which includes outstanding government securities under the Market Stabilization Scheme (MSS) of 4.1% of GDP in 2007-08 to 2.2% in 2008-09 (revised estimates). The reduction is due to the central bank´s net redemptions of the stock of these special bonds, which were initially issued to drain excess liquidity arising from the balance of payment surplus, in response to the recent reversal in the balance of payments position.

Graph 20.

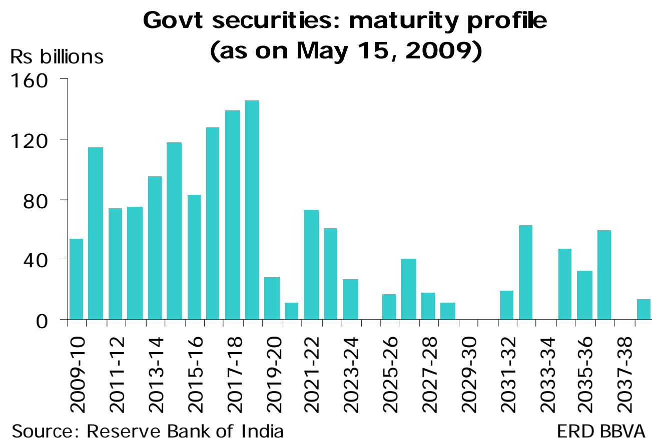


Internal debt remains the largest component of the outstanding liabilities of the Central government (61.3% of the total debt at end-March 2008), followed by liabilities due to the national small savings funds (NSSF) and public provident funds (22.2% of total debt). The higher share of debt in internal liabilities can be attributed to the increase in market borrowings. Domestic market borrowings account for around 50% of total debt, of which government dated securities (GOI) amounting to INR15.4 trillion were outstanding on May 15 2009. At end 2008, commercial banks and insurance companies were holding 75% of outstanding GOIs, followed by primary dealers (9%) and provident funds (7%), while foreign institutional investors (FIIs) accounted for just 0.5% of total (Graph 21). By maturity, less than 4% of the total amount is maturing from now until end March-2010, another 31% in the following five years and a further 34% before end-March 2020 (Graph 22). Owing to India's high revenue deficit, a considerable portion of the liabilities is utilized to meet the current expenditures.

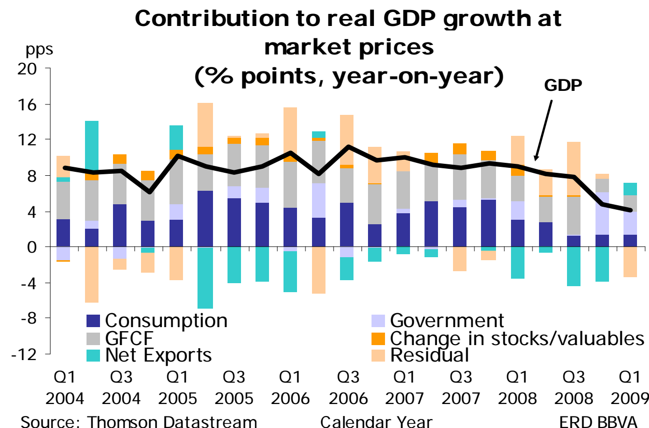
Graph 21.



Graph 22.



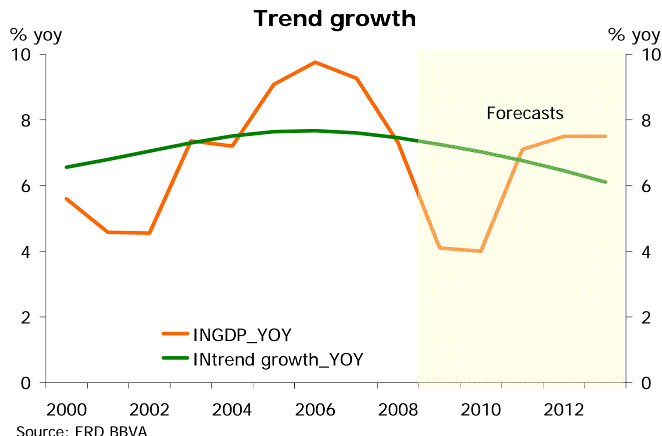
Graph 24.



Recent developments

Our trend calculations show that the Indian economy has been growing above its estimated potential rate of 6.1% since 2005 (Graph 23). This above-trend growth eventually reflected in rising domestic inflationary pressures and was aggravated in early 2008 by the pass-through of high international crude oil and commodity prices to domestic prices.

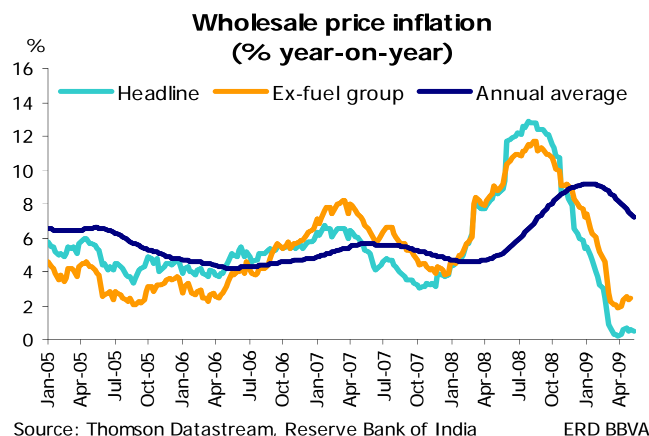
Graph 23.



The Indian economy was undergoing a cyclical slowdown in growth before the global downturn intensified by late 2008. Real GDP growth fell in April-September 2008 (first half of FY2008-09) to 7.7% year-on-year growth from 9.2% in the same period a year ago. It declined to 4.8% yoy (revised upwards) in October-December 2008, and further to 4.1% yoy in January-March 2009, the lowest quarterly growth since 2003, led by a slowdown in investment[5] (Graph 24).

Meanwhile, India´s headline inflation based on the wholesale price index (WPI) increased to a multi-year peak of 12.91% year-on-year (yoy) in August 2008. Since then, headline has sharply dropped to 0.51% in mid-May 2009. WPI excluding fuel, electricity and coal, fell to 2.48% from its peak of 11.71% in August 2008, confirming a rapid disinflationary trend. The annual WPI inflation rate (52-week average) reached a peak at 9.16% in January 2009, with disinflation continuing at least until the third quarter on the back of increasing slack in domestic demand, cuts in excise duty rates, and a high statistical base of comparison (Graph 25). However, the decline in domestic prices may be partly offset by the rupee depreciation vis-à-vis other currencies, which makes prices of imports more expensive, by the fact that administered fuel retail prices have being kept unchanged amid the previous downward correction in global crude oil prices and, most recently, by the rebound in commodity international prices.

Graph 25.

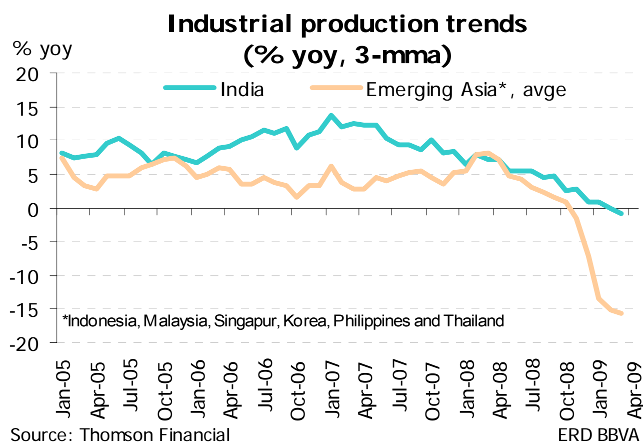


The effects of the global financial crisis have been transmitted to the Indian economy through several ways: (i) net capital outflows increased since September 2008 due to large foreign equity sales; this contributed to the drop in the stock market BSE Sensex index to a three-year low in mid-March 2009; (ii) international credit

[5] Errors and omissions tend to correspond to adjustments on India's consumption data.

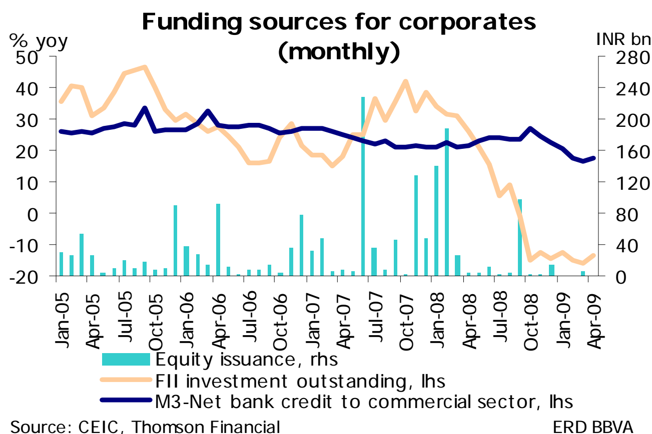
channels continue to be constrained; (iii) capital market valuations remain low; (iv) industrial production growth plummeted, albeit still less than that of other Emerging Asian economies (Graph 26); (v) export growth in US dollars turned negative since last quarter of 2008; and (vi) overall business sentiment deteriorated reflecting weaker demand conditions.

Graph 26.



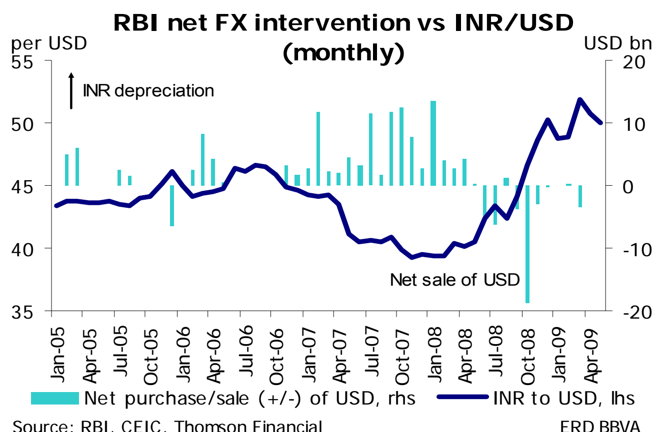
Even though bank credit growth accelerated in the last part of 2008, external sources of corporate funding such as equity issuances and security investments by foreign institutional investors (FII) dried up and are unlikely to return in the same fashion as previously under the current global environment (Graph 27).

Graph 27.



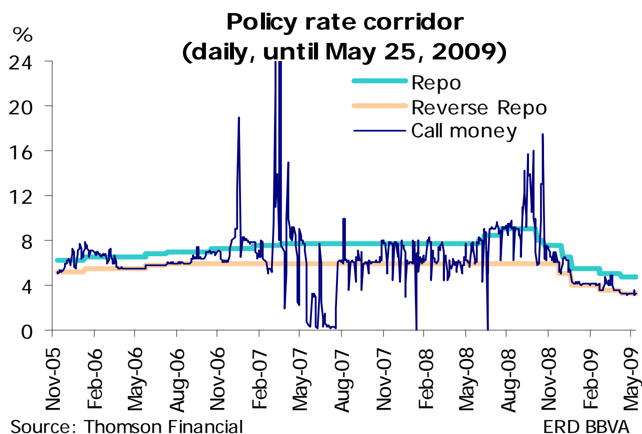
Prior to the financial turmoil in international markets, domestic liquidity was already tightening as a result of successive hikes in the policy (lending) rate and cash reserve ratio (CRR) by 125 basis points and 150 basis points, respectively, since May 2008 to end-September 2008. During that period, the Reserve Bank of India (RBI) was intervening to slowdown the appreciation of the rupee via net purchases of US dollars in the foreign exchange market; this eventually aggravated the dollar liquidity squeeze in the domestic market. Since then, the RBI has sold over USD25 billion net up to end-March 2009, in order to stem the depreciation of the rupee (Graph 28). The sharp deterioration of financial conditions prompted the RBI to a reversal of its tightening stance (in place since 2004) in mid-October into relaxing its monetary policy.

Graph 28.



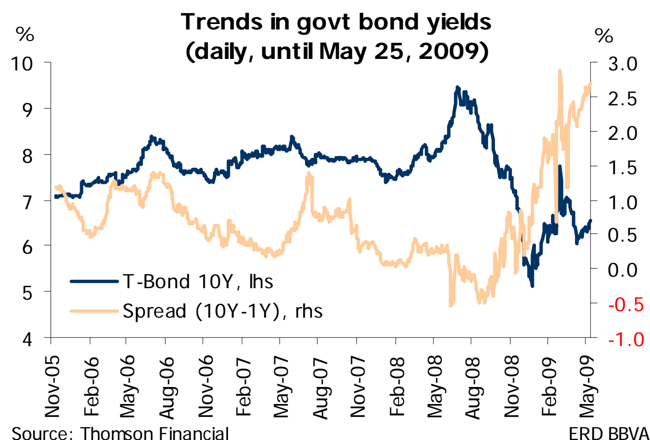
Moreover, the knock-on effects of the collapse of Lehman Brothers reflected in the overnight interest rate (call money) rising to 16% at the end of September from 6% a month earlier. Thereafter, the overnight interest rates mostly breached the ceiling of the policy rate corridor till November 3, 2008, reflecting tight domestic liquidity conditions. To alleviate the liquidity pressures, the RBI has been the most aggressive central bank in the region in cutting interest rates. Since mid-October 2008 until mid-May 2009, the RBI has cut the repo (lending) rate from 9% to 4.75% and the reverse repo (borrowing) rate from 6% to 3.25%. It has also slashed the cash reserve ratio by 400 basis points from 9% to 5% during the same period. Additionally, banks saw their statutory liquidity ratio (SLR), which is the portion of eligible deposits they must hold in government securities, cut by 100 basis points to 24% from a decade-old 25%; this measure released an estimated 400 billion rupees (USD8 billion) into the banking system. Following the successive monetary easing policy actions by the RBI (Annex 1), overnight interest rates declined and have since remained below the upper bound of the policy rate corridor, as an indication of improved liquidity conditions (Graph 29).

Graph 29.



Source: Thomson Financial ERD BBVA

Graph 30.



Source: Thomson Financial ERD BBVA

The contagion of the global financial turmoil was also felt in the government securities market, with the 10-year bond yields swinging from an intra-day peak of 9% to 5.5% at end-2008. However, bond yields have rebounded since then to 6.5% as of May 25, 2009 and the yield curve has kept steepening, as the markets anticipate not only more rate cuts but also a deterioration of fiscal deficits leading to a significant rise in market borrowings by the government (Graph 30).

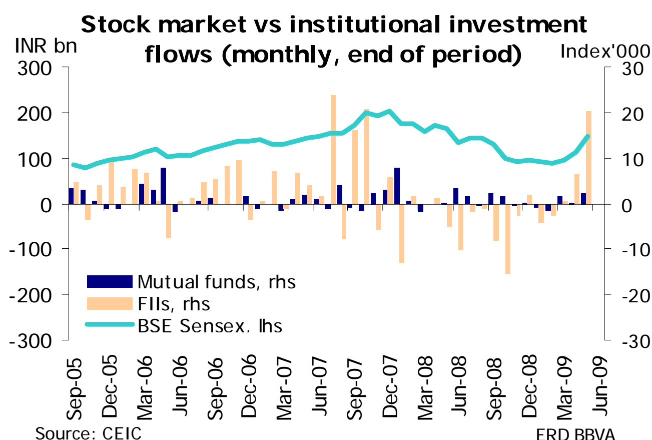
In view of the large government market borrowing program, the RBI announced last March 26 that it would purchase government securities under its open market operations in the amount of INR800 billion (USD16 billion) between April and September 2009. In addition, it will also unwind the MSS (market stabilization scheme) bonds to the tune of INR420 billion (USD8.4 billion) over the same period. These measures result in a net injection of liquidity in the system increasing money supply as well as lowering bond yields. They also can be viewed as ´active quantitative easing´ or non-conventional monetary policy in the line of the measures introduced by the US, UK or Japan. Although in the case of India, this is carried out in a much smaller scale and, interestingly, with policy rates well above zero aiming to flatten the yield curve, which has reached historical highs. The risk is clearly that the RBI increases the size of its open market purchases, particularly if bond yields remain high and do not fall in line with policy rate cuts. If this risk materializes, it could have an adverse impact on the foreign exchange market and widen the government fiscal deficit, which could result in a downgrade of its sovereign debt rating. Currently, India´s sovereign rating is at the last notch within the investment grade category with a negative outlook. Any downgrade would push India´s rating below investment grade.

In the equity markets, the impact was felt both in the primary and secondary market segments. The primary market was weak in the last quarter of 2008 and total capital raised during April-December 2008 fell 70% yoy; the number of new issues declined to 40 compared to 91 in the previous year and it has roughly dried out in 2009; there were only five new capital issues in the first three months of this year.

Mutual funds were under pressure in the wake of redemption demands and registered net outflows of 304 million rupees (USD6.2 million) during April-December 2008, compared to net inflows of 1.2 billion rupees (USD25 million) during the corresponding period a year ago. However, in the first five months of 2009, mutual funds registered net inflows over 3.4 trillion rupees (USD69.5 billion), almost all during April-May. Total mutual funds of private and public sectors (excluding fund of funds schemes) held net assets of 5,935 billion rupees (USD121.1 billion) at end-April 2009, as compared to 5,052 billion rupees (USD102.9 billion) in March 2008.

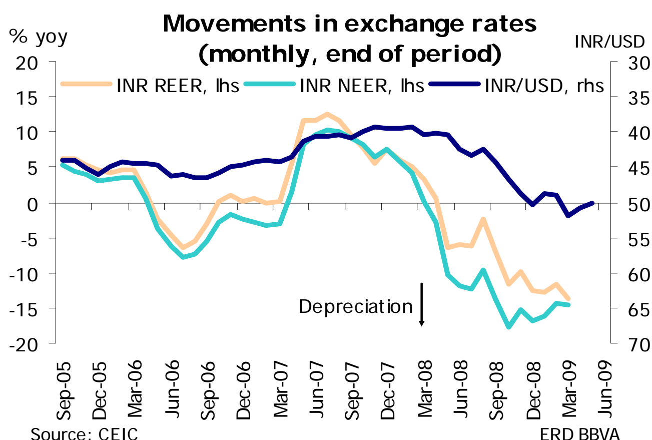
As of May 26, 2009, the benchmark Sensex stock index has risen 6% since end-September 2008 but fell by 17% over a year ago. Yet, it has performed better than MSCI Asia ex-Japan (USD), which is falling 5% and 35% since end-September 2008 and over a year ago, respectively. The recent rebound of the Sensex since March this year, has been driven by the return of foreign institutional investors (FIIs) buying, once cleared the specter of political stability, and following large sales of common stocks in late 2008. Mutual funds made net sales during the January-February 2009 but reverted to a cumulative net purchase of nearly USD300 million at end-May, as compared to USD1.27 billion net purchase in the same period over a year ago (Graph 31).

Graph 31.



The impact in the foreign exchange market was reflected in the sharp depreciation of the Indian rupee (INR) against major currencies. The INR moved in a range of Rs.39-43 during most part of 2008 and depreciated sharply since August 2008 to hit a record low against the US dollar of Rs.52/USD in early March 2009. The rupee has since strengthened to Rs.47.3/USD as of May 26, 2009 but still accumulates over 12% nominal depreciation vis-à-vis the US dollar over a year ago. In nominal and real effective terms, the rupee depreciated in 2008 nearly 17% and 13%, respectively, against its 6 major trading partners, as compared to almost 8% appreciation in 2007. As of end-April 2009, the rupee nominal and effective real exchange rate has depreciated 14.5% and 13.7% year-on-year, respectively (Graph 32). There was a fear that an unstable government, including the market-unfriendly Left parties, would ensue after the general elections. Such fears, however, have now been alleviated with the resounding victory of the Congress-led coalition, removing months of uncertainty, and placing the re-elected administration better than ever to carrying out structural reforms. We expect the equity and FX markets to react positively to the election outcome. Cyclical sectors should benefit the most, while we think increased capital inflows due to the removal of uncertainty will benefit the INR.

Graph 32.



Risk and challenges ahead

Our model estimates[6] show that India could become the world third largest economy by 2025, and also that India will grow at a faster pace than China, mainly due to its "demographic bonus". Yet, having the potential and actually achieving it are two separate things. There are still many key areas where reforms are crucial in order to place India in a position to deliver its growth potential.

- Governance

India's governance problems rule over all its other shortcomings. Without better governance, efficient delivery and implementation and better coordination of the Centre versus States, India will find it difficult to address the supply constraints in the economy, in order to sustain rapid growth. Governance problems arise from the lack of adequate accountability of politicians coupled with the increasing inability of public institutions to deliver the public services demanded by the population. The cause of the problem should not be attributed to India's democracy but rather to what it has been called the "democracy deficit", that is, the malpractice of democracy which results in its ill-functioning.

- Education and labor market

Education spending remains low and efficiency weak, which results in an increasing skill inequality, especially in the urban areas. More resources should be devoted to raising educational standards, with a stronger focus on secondary, higher and technical education in order to better align with market needs and to limit the widening income disparities. FDI is not even allowed in the education sector. Additionally, more flexible labor regulations could increase formal sector employment, which has stagnated even as employment in the informal sector grows. The reallocation of labor from weaker performing to stronger sectors could generate substantial productivity gains, while extending the benefits of growth to a larger share of the population.

- Fiscal and public debt sustainability

India's gross fiscal deficit and debt to GDP remain one of the highest in the region. At these high levels, government borrowings crowd out private-sector credit, keeps interest rates high and compromises economic stability. Furthermore, the composition of spending is undesirable, as it consists mainly of subsidies and wages rather than productive investment, especially in much-needed areas such as health, education and infrastructure. A credible tight fiscal stance is critical for India to provide fiscal space for priority social and infrastructure spending, allow the central bank an independent monetary policy (as it would be unburdened from providing large amounts of financing to the

[6] ERD Global Trends. Where should your firm go? Forecasting economic growth. 18 December 2008. http://serviciodeestudios.bbva.com/KETD/fbin/mult/ITEND_081217_globaltrends_16_tcm348-183830.pdf

government), better management of inflationary pressures under rapid capital inflows and allow for increased credit to the more dynamic private sector.

- Liberalization of financial markets

India's financial sector remains small and underdeveloped. The state dominates the sector, holding over 70% of banking assets, a majority of insurance funds and the entire pension sector. Broader and deeper markets in corporate debt, currency and derivatives onshore are crucial to funding India's large investment requirements and better intermediate capital inflows. In addition, the efficiency of financial institutions can be enhanced by opening up further to foreign banks, phasing out directed lending, further loosening interest rate restrictions, and reducing banks' statutory liquidity requirements. Further liberalizing FDI in financial services sector should boost competition and speed up innovation and new technologies.

- Improve infrastructure

Major shortcomings in infrastructure are estimated[7] to reduce India's GDP growth by 1% per annum. There is both a stock and a flow problem. On one hand, infrastructure gaps such as power shortages are acute and growing. On the other hand, incremental demand for infrastructure will continue to rise due to economic growth and urbanization. Currently, only 30% of India is urbanized and, according to UN projections, this may increase to 60% in 2050, adding 700 million people to live in cities. This would add an enormous pressure on the provision of urban infrastructure such as transportation, water and sewage and low-income housing. The government is relying on public-private partnerships to help build the infrastructure, with some successes in attracting private investment to telecom, ports and road sectors. To encourage more private infrastructure investment, regulatory constraints like FDI limits and institutional barriers, especially at the State level, should be removed. In addition, to help resolve financing issues, India needs to develop its capital markets and put in place financial sector reforms such as deregulation of pension and insurance markets, and allow more foreign participation in the banking sector. Institutional hurdles (licensing and tender awards) and lack of detailed planning are to blame for excessively high project costs and long time lines.

- Agricultural productivity

Increasing agricultural growth is critical not only to sustain India's growth, but also to move rural population out of poverty. Indian agriculture doesn't have adequate irrigation facilities and continues to be heavily dependent on monsoons. Both production and productivity in the agricultural sector are unable to keep pace with the consumption demand and yields are a fraction of those of its peers in the region. The sector faces two additional problems: (i) the loss of arable land for non-agricultural uses as India industrializes and urbanizes and; (ii) soil erosion due to intensive farming and depletion of natural resource. Furthermore, no major measures have been initiated by governments in the direction of improving the agriculture situation at the State level. The most urgent issues are those pertaining to land management, irrigation and watershed management programs, and deregulation. Agriculture deregulation would allow greater commercialization and economies of scale: (i) the government sets minimum purchase prices for about 25 commodities, which eliminates prices signals and distorts incentives to innovate; (ii) taxes on inter-state movement of goods should be eliminated; (iii) farmers should get access to sell directly to organized retail and; (iv) removal of restrictions on land holdings to reduce the sector's fragmentation and increase productivity.

- Trade liberalization

Indian exports currently account for less than 2% of global trade, far below the average of major economies in Asia. Even so, India's trade openness has been rising rapidly in the past decade or so. Tariff reductions lowered the costs of capital goods and raw materials, and coupled with structural reforms they spurred domestic competition and pushed Indian firms to compete globally. Indian trade has potential to grow faster taking advantage of its geographical situation, close to sizeable emerging economies with large populations, in particular, China. In its Foreign Trade Policy report for 2004-09, India announced ambitious goals for international trade such as reaching 5% of world trade by 2020, and included specific measures to boost trade of specific sectors: agricultural products, handicraft, gems and jewelry, leather and marine products. Given the rapid growth in labor projected for the coming years, India could target a major increase in trade of labor intensive production. In any case, productivity needs to be bolstered and supply constraints removed in order to maintain competitiveness globally.

[7] IMF, 2007 Article IV Consultation. December 26, 2007.

Annex 1: Major policy measures of the Reserve Bank since mid-September 2008

Category	Date	Measure
Monetary Measures	Mid Oct 08 - Jan 09	**Repo rate cu**t 350bps to 5.5% since mid October 2008 under LAF.
	6-Dec-08 to 4-May-09	**Repo rate cut** 100bps, 100bps, 50bps and 25bps in 6 Dec, 2 Jan, 4 Mar and 21 Apr respectively from 7.5% to 4.75%.
		Reverse repo rate cut 100bps,100bps, 50bps and 25bps in 6 Dec, 2 Jan, 4 Mar and 21 Apr respectively from 6.0% to 3.25%.
		CRR cut by **400bps of** Net Deposit and Time Liabilities (NDTL).
conventional monetary	26-Mar-09	The central bank will **purchase government secutiries under its open market operations of Rs 800 billion (USD16 billion) between Apr-Sep 2009.** The central bank will also **unwind the MSS bonds of Rs 420 billion (USD8.4 billion) during Apr-Sep 2009.**
Rupee Liquidity/ Credit delivery	24-Oct-08 to 30-Jun-09	**New Refinance facility**. **All SCBs** (including RRBs) are **provided refinance** by **Reserve Bank** at **LAF repo rate** for up to 90 days and up to 1 % of each bank's NDTL.
	Until 30 Jun 2009	**Institution of term repo** facility of **Rs. 600 million** under LAF to meet liquidity requirements of MFs., NBFCs, HFCs with associated SLR exemption of 1.5% of NDTL.
	01-Nov-08	**SLR reduced 100bps** to 24%.
		Introduction of mechanism to **buy back dated** securities issued under the MSS.
		Extension of period of entitlement of pre-shipment **rupee export credits at concessional interest rate.**
		Increase in the eligible limit of the **ECB facility** for banks from 15 to 50% of outstanding export credit eligible.
	11-Dec-08	**RBI** provides **refinance facility of Rs.160 million** to NHB, EximBank and SIDBI.
	02-Jan-09	**RBI will provide a credit line of Rs. 50 million to Exim Bank.**
	02-Jan-09	**SPV will provide Rs. 250 million support against investm-grade paper** to NBFCs fulfilling certain conditions.
		Guarantee cover by Credit Guarantee Fund Trust **increased to 85%** for credit facility up to Rs 0.5 million for micro and small enterprises.
		Govt. will infuse Rs 200 million ecapitalisation for banks in the next two years
	06-Oct-08	**MoF expands definition of infrastructure companies** to including mining, exploration and refining companies to ensure they can raise funds abroad.
		SEBI lifts ban on issuance of participatory notes (PNs) by FIIs and capping their exposure to PNs at 40% for both cash and derivative segment.
FOREX Liquidity / ECB norm	07-Oct-08	**RBI to institute special market operations** to meet forex requirements of **public sector oil** marketing companies against oil bonds.
	up to June 30, 2009	**Enhancement of all-in-cost** ceiling for trade credits less than 3 years to 6 months.
		Temporarily **allowing systemically important NBFC's and housing finance** companies to **raise short-term foreign currency borrowing** as long as they comply with capital adequacy and exposure requirements.
		Increase in interest rates ceiling on FCNR and NR(E)RA(B) deposits by 175bps.
		Proposal from Indian companies to **prematurely buy back their FCCBs** to be considered subject to compliance with certain stipulated conditions.
		ECBs up to USD 500 million per borrower per financial year were permitted for rupee and foreign currency expenditure for permissible end-uses.
		The **requirement of all-in-cost** ceiling for ECBs over average maturity of 3-5 years and over 5 years was removed.
		Mining, exploration and refinery sectors **included** in the definition of **Infrastructure** for **ECB availing.**
		Entities in the **service sector, *viz*, hotels, hospitals and software companies** were permitted to **avail ECBs up to USD 500 million** per borrower per financial for rupee and foreign currency expenditure for permissible end-uses.
		NBFCs **exclusively involved in financing of the infrastructure sector** were permitted to **avail of ECBs** under the approval route from multilateral /regional financial institutions and government owned development fund.
		To enhance credit flows, foreign institutioanal investor investments limit in rupee-denominated bonds increased from USD 6 billion to USD 15 billion.
	05-Feb-09	**Availability of forex swap facility extended** from 30 Jun 09 to 31 Mar 10.
Regulatory	01-Nov-08	**Reduction of provisioning requirements** in all standard assets to a **uniform level of 0.40% from 2%, except in case of direct advances to the agriculture and SME sector, where the provisioning requirement is 0.25%.**
		Downward revision of risk weights on banks' exposures to certain sectors: (i) the commercial real-estate industry to 100% from 150%; (ii) all unrated claims on companies will attract a uniform risk weight of 100%as against the risk weight of 150% for such exposures prescribed earlier, which was applicable to exposures above (Rs 500 million from April 1, 2008 and for exposures above Rs 100 million from April 1, 2009.
	06-Dec-08	**Exceptional regulatory treatment of retaining assets classification** of the restructured standard accounts in the standard category **extended to commercial real estate** restructured up to 30 Jun 09. This will have a positive impact on reducing banks´ NPA and thus encourage lending to the real estate sector.
	11-Feb-09	**Direct investments by Foreigner/NRIs would now be considered as FDI, while funds routed through** an entity owned or controlled **by a resident Indian or an Indian company would be considered domestic investment**.

CRR	Cash Reserve Ratio
FII	Foreign Institutional Investor
HFC	Housing Finance Companies
IIFCL	India Infrastructure Finance Company
LAF	Liquidity Adjustment Facility
MF	Mutual Funds
MSS	Market Stabilization Scheme
NBFC	Non Banking Financial Companies
NDTL	Net Demand and Time Liabilities
NHB	National Housing Bank
SEBI	Securities Exchange Board of India
SIDBI	Small Industries Development Bank
SLR	Statutory Liquidity ratio

Source: RBI, ERD BBVA (as of May 4, 2009)

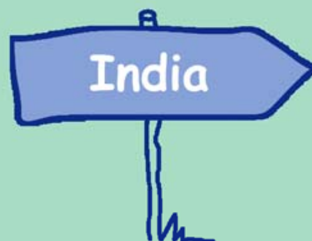
Annex 2: Major post budget fiscal stimulus measures

Date	Description
20-Oct-08	**Supplementary demand for grants** provided for a gross expenditure amounting **to Rs. 2,37,286 crore** with net cash outgo of **Rs.1,05,613 crore** mainly to finance scheme/plan announced in the Union Budget for 2008-2009 although **no provisions were made.**
24-Oct-08	**Special Economic Zones granted to boost infrastructure lending in those areas.**
7-Dec-08	**The three major *ad valorem*** rates of central excise duty applicable to **non-petroleum products** r**educed by 4 percentage** points each.
	Pre and post shipment export credits for **labour intensive exports** made **more attractive** by providing an interest rate **subvention of 2%** up to March 2009 subject to minimum 7 % p.a. interest rate.
	Allocation of Rs. 20.000 crore to **additional expenditure** in current fiscal year to provide counter-cyclical stimulus.
	Additional allocation of Rs. 1.400 crore to TUF scheme to clear backlog in textile sector.
	IIFCL authorized to **raise Rs. 10.000** crore through tax-free bonds by March 31, 2009 in order to **support infrastructure schemes.**
	Import duty on naphtha used in the power sector cut to **zero.**
	Export duty on iron ore fines eliminated and on lumps cut to 5%.
19-Dec-08	**Second supplementary** demand for grants provided for **gross expenditure** amounting to **Rs. 55,60**5 crore with **nest cash outgo of Rs. 42,820 crore.**
02-Jan-09	**IIFCL is be allowed to borrow Rs 30,000 crore by tax-free bonds to increase refinance for infrastructure,** three times more than the initial sanctioned amount in Dec.2008. To the same purpose, NBFCs is allowed to access external commercial borrowing under approval route of RBI.
	State govt. is allowed to **borrow additional 0.5% of their Gross State Domestic Product**, about 30,000 crore, for capital expenditure. IIFCL can access in tranches an additional Rs 30,000 crore through tax-free bonds over the next 18 months.
24-Feb-09	**General excise duty reduced further** from 10% to 8%. 4% excise cut announced in late 2008 will continue beyond 31 Mar 09, indefinitely.

TUF Technology Up-Gradation Fund
IIFCL Indian Infrastructure Finance Company Limited

Source: RBI, ERD BBVA

Economic Research Department



BBVA

Banking

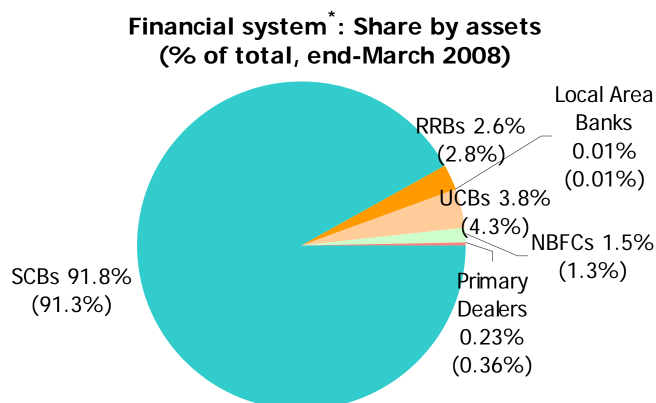
Financial system

India's financial system consists of banking institutions engaged in general commercial banking, specialized financial institutions and investments institutions, such as insurance companies and mutual funds. The Reserve Bank of India is the monetary authority, acts as regulator and supervisor for banks and non-banking financial companies, and as debt manager for the central and state governments.

The banking group consists of commercial banks (see sector structure in Annex 1), which account for around three-fourths of the total assets of all financial institutions and more than 90% of the assets of the banking system (excluding the Reserve Bank) (Graph 1). Total banking system assets (including the central bank) were 118% of GDP[8] in 2008, with the largest shares held by commercial banks (85% of GDP) and the central bank (26% of GDP). The specialized financial institutions (FIs) consisting of non-commercial financial institutions, state-level non-bank institutions and others, hold total assets of less than 4% of GDP, while insurance companies and mutual funds' investments accounted for 16% and 8% of GDP, respectively. Besides the financial institutions, the stock and government bond markets play also a relevant role in the Indian financial system. The combined market capitalization of the stock exchanges[9] was 120% of GDP and that of the debt market[10] was 51% of GDP, of which government securities and corporate bonds represented 34% and near 2% of GDP, respectively, at end-2008.

Non-banking financial companies (NBFCs) provide leasing finance and loans on a retail basis. They account for 1.5% of the financial system's assets (excluding financial and investment institutions). On the other hand, the insurance sector in India has been traditionally dominated by state-owned Life Insurance Corporation and General Insurance Corporation and its four subsidiaries. Insurance companies are regulated by the Insurance Regulatory and Development Authority[11] (IRDA) and mutual funds and securities market by the Securities and Exchange Board of India (SEBI)[12]. The Government of India has now allowed FDI in the insurance sector with foreign shareholding allowed to 26% of equity capital. Since then, a number of new foreign joint venture private companies have entered into life and general insurance joint-ventures (19 and 11, respectively[13]).

Graph 1.



Note: SCBs: scheduled commercial banks, RRBs: regional rural banks, UCBs: urban commercial banks, NBFCs: non-banking financial companies, FIs: financial institutions

[8] Ratios calculated in % of GDP at market prices.
[9] Bombay Stock Exchange (BSE) and National Stock Exchange (NSE)
[10] Comprised of government securities, T-bills, State loans, bank, other financial institutions and corporate bonds, public sector units bonds and others

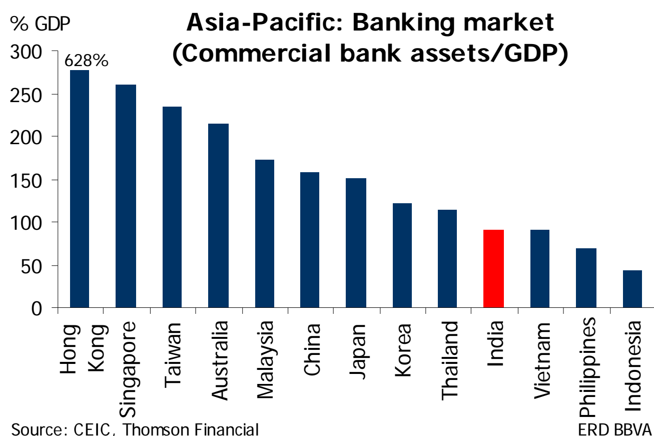
[11] Insurance Development and Regulatory Authority Act, 1999
[12] Securities and Exchange Board of India Act, 1992
[13] Annex 2 for the list of joint ventures as of April 2009

Ya-Lan Liu yalan@grupobbva.com

India´s banking system in perspective

In a cross-country comparison, India's commercial banking market size ranks among the smallest in relative terms, only ahead of Vietnam, Philippines and Indonesia, at less than 100% of GDP (at market prices) (Graph 2). In absolute levels, India's commercial banks' assets of USD883 billion is just one seventh of China's USD6.2 trillion market at end-March 2008.

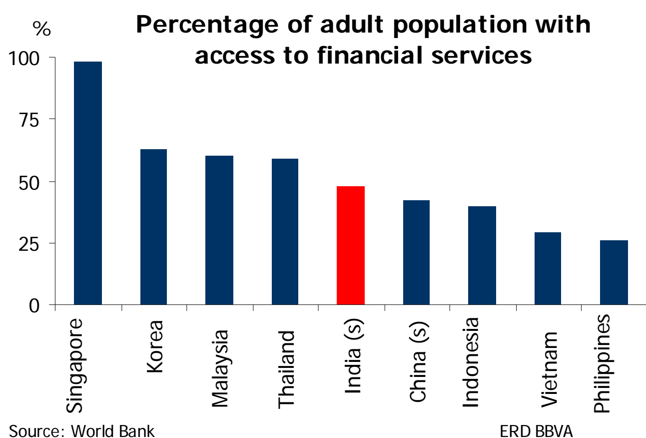
Graph 2.



Different measures of bancarization in India render a favorable picture in terms of potential scope for the development of the commercial banking sector.

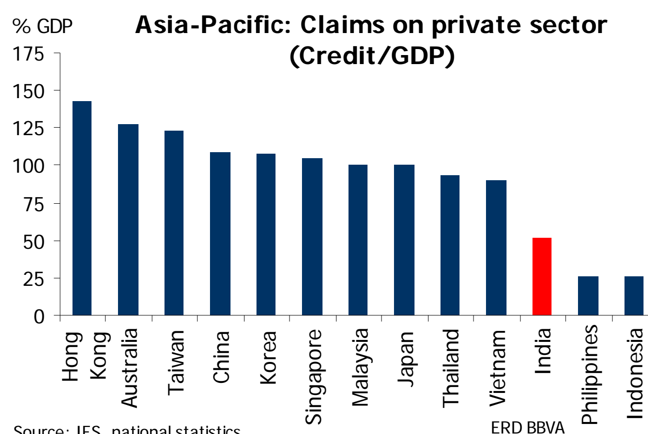
Estimates of bankable population[14] rank the Indian market among the emerging Asian countries with the lowest share of adult population with access to financial services. According to the World Bank, over 50% of India´s adult population has no access to formal sources of credit, only ahead of China, Indonesia, Vietnam and Philippines among major peers in the region (Graph 3).

Graph 3.



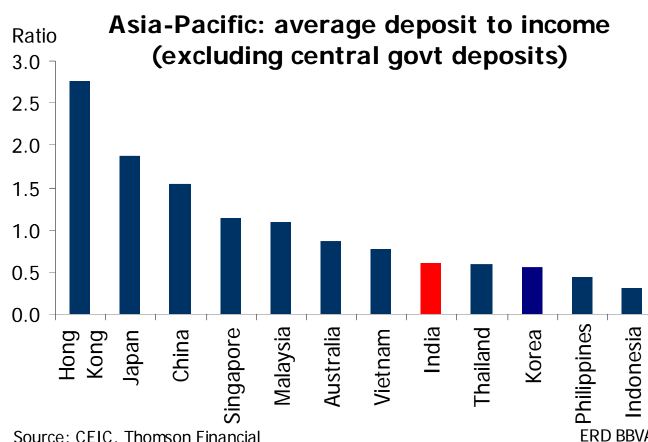
Furthermore, India´s financial depth lags far behind its peers in the region, which is evident from the fact that total credit to private sector (bank credit and securities) reached 52% of GDP at end-December 2008, as compared to 108% of GDP in China or 143% of GDP in Hong Kong (Graph 4). Therefore, banks, specially the private ones, face challenges in developing their business in the short-term on the lack of credit penetration and the geographic concentration of bank credit, as the five states having the highest proportion of per capita credit enjoy 55% of the total credit disbursals in the country.

Graph 4.



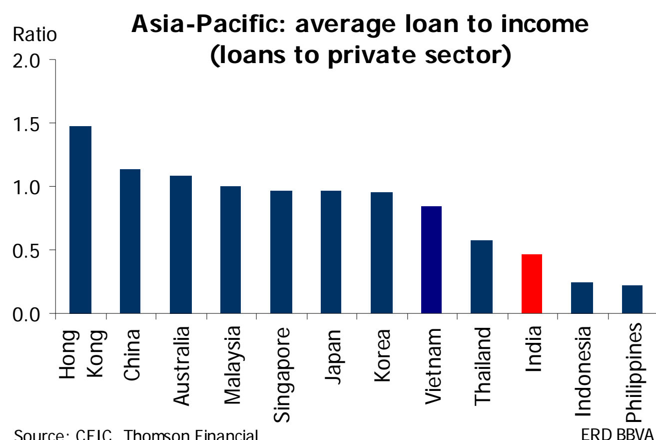
India is also a rapid growing economy with a largely under-banked population as the use of banking services remains low relative to its per capita income. By product, the use intensity of banking services in India shows a higher use in deposits than in borrowings (Graph 5 and 6). This result is not surprising, considering that as much as a mandated 30% of commercial banks´ liabilities are immobilized either in the central bank or in government securities.

Graph 5.



[14] A composite indicator measures the percentage of the adult population with access to an account with a financial intermediary. For any country with data on access from a household survey, the surveyed percentage is given and denoted by ´s´. For other countries, the percentage is constructed as a function of the estimated number and average size of bank accounts. These numbers are not directly comparable and subject to estimation error

Graph 6.



Source: CEIC, Thomson Financial

The role of foreign banks

Foreign banks and financial institutions' [15] shareholding in private banks is capped at 5% while large industrial or investment houses can be allowed to acquire, by way of strategic investment, shares not exceeding 10% of the paid-up capital of a bank—subject to the Reserve Bank of India´s (RBI) approval, with an overall limit of 74% of the paid-up capital. Regardless the stake in the Indian bank, foreign investors voting rights are capped at 10%, which is a major deterrent to gain management control.

The Reserve Bank of India (RBI) has recently put on hold the liberalization of the sector indefinitely[16]. Therefore, foreign banks must continue to grow organically, namely via business expansion and increased client coverage per branch. RBI has also lifted the licensing requirements for opening ATMs (automated teller machines) since April 2009, which should allow banks to reach a much larger number of customers despite the prevailing restrictions on branch licensing. Further, the Indian Ministry of Commerce and Industry recently revised the rules in relation to the cascading effect of foreign shareholding in an Indian company on its downstream investments[17].

The RBI retains considerable discretionary powers in granting foreign financial entities access to local business. Currently, foreign banks are permitted to establish their presence by setting up branches, setting up a wholly-owned subsidiary (WOS), or converting existing branches into WOS, under the concept of "single presence". This means a foreign bank can be present in India in only one form: either as a branch or a subsidiary. As a result, most foreign banks in India have been operating through minority stakes in domestic banks, a limited network of branches and/or taking the Non-Banking Finance Company (NBFC) channel; the latter two routes largely relying on bank funding and retained profits to grow.

In 2005, the government and the RBI released the 'Roadmap for presence of foreign banks in India', which was divided into two phases, the second phase set to begin in April 2009. RBI, however, has decided to put off the second phase of the sector opening up without setting a new date pointing out[18] that it was not appropriate at the current scenario due to the global financial conditions.

At end-March 2008, government figures showed that foreign financial institutions (FFIs) had shareholdings in 20 out of 28 public sector banks, with their stakes broadly unchanged from a year ago. In private sector banks' FFIs shareholding was more than 20% of capital in nine banks, of which FFI holding was more than 60% in four new private sector banks (Table 1).

Table 1.

Foreign financial institutions[1] (non-resident) shareholding in Indian banks

(Number of banks)

Shareholding as at end-March	Public Sector Banks		New Private Sector Banks		Old Private Sector Banks	
	2007	2008	2007	2008	2007	2008
Nil	8	8	-	-	4	2
Up to 10 %	5	5	-	-	9	2
More than 10 and up to 20 %	13	13	-	-	-	2
More than 20 and up to 30 %	2	2	1	1	1	4
More than 30 and up to 40 %	-	-	-	1	1	2
More than 40 and up to 50 %	-	-	1	1	-	-
More than 50 and up to 60 %	-	-	3	1	1	2
More than 60 and up to 70 %	-	-	2	4	-	-
More than 70 and up to 80 %	-	-	1	-	1	1
Total	**28**	**28**	**8**	**8**	**17**	**15**

[1] Banks and non-banking financial companies

Source: RBI

Foreign banks also picked up small stakes in private sector banks and others, like HSBC initially bought larger stakes (close to a 15% of UTI Bank in 2003) but had to bring down its stake within the 5% limit. ING is the only foreign bank with a substantial stake in a mid-cap private bank, 43.93% in ING Vysya Bank through two investment arms domiciled in Mauritius[19]. Other Indian banks with significant foreign shareholding are Yes Bank Ltd, one of the smallest private banks, and Axis Bank Ltd (Table 2). Indirectly, Citigroup has a 12.3% stake in Housing Development Finance Corp. (HDFC), a big mortgage and holding company which holds a 23.3% stake in HDFC Bank (HDFC Bank recently acquired Centurion Bank of Punjab in March 2008).

[15] Foreign investment in the banking sector is governed by a Press Note, issued Mar.5, 2004 by the Government of India, Ministry of Commerce and Industries. The guidelines also include investment by non-resident Indians (NRIs) and authorized foreign institutional investors (FIIs) in the banking sector

[16] Since 2007, India and the European Union (EU) are negotiating a free trade agreement (FTA). The negotiations do not merely cover trade in goods but also include liberalisation of trade and investment in banking services

[17] Government of India, press release 11-February-2009. Certain sectors such as insurance, telecom, and broadcasting will continue to be covered under the method of calculation of total foreign investment outlined in their sector-specific regulations

[18] Annual Policy Statement for the year 2009-10, RBI 21-04-2009

[19] This is possible because ING had surrendered its banking license to operate two branches in 2004, and merged its operations with the Indian bank.

Table 2.

Foreign stake in domestic Indian banks
(as of end-March 2008)

Indian bank	Foreign shareholder	Stake (%)	Assets (% total)
ING Vysya Bank Ltd	ING Mauritius Holdings	34.06	0.59
	ING Mauritius Investments	9.75	
	International Finance Corporation	4.72	
Yes Bank	RaboBank International	13.47	0.39
	Holding BV	4.71	
	HSBC Financial Services Middle East Ltd	4.9	
	Orient Global Tamarind Fund Pte Ltd	4.95	
	FID Fund Mauritius Ltd	3.19	
	Swiss Reinsurance Company	3.88	
	Titiwangsa Investments Mauritius Ltd	4	
AXIS Bank Ltd	HSBC Financial Services (Middle East Ltd)	4.93	2.53
	Titiwangsa Investments Mauritius Ltd	4.7	
Federal Bank Ltd	HSBC Financial Services Middle East Ltd	4.98	0.75
	Standard Charterd Pvt Equity Mauritius Ltd	3.68	
Karnataka Bank Ltd	HSBC Financial Services (Middle East) Ltd	4.98	0.45
	Citigroup Global Markets Mauritius Pvt Ltd	2.72	
HDFC Bank	JP Morgan Asset Management Europe SARL	1.01	3.08
	DBS Bank Ltd	2.73	
Bank of Rajasthan Ltd	ABN Amro Bank NV London Branch	1.99	0.37
	Goldman Sachs Investments Mauritius I Ltd	1.7	
	Merill Lynch Capital Markets Espana	1.3	
Allahabad Bank	Citigroup Global Markets Mauritius Pvt Ltd	2.29	1.92
	Swiss Finance Corporation Mauritius Ltd	2.11	
Indusind Bank Ltd	Sociate Bancaire Privee Sa	3.5	0.20
ICICI Bank Ltd	Deutsche Bank Trust Company Americas	27.12	9.24
City Union Bank Ltd	Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V.	4.69	0.17
Indian Overseas Bank	Citigroup Global Markets Mauritius Pvt Ltd	1.67	2.35
Central Bank of India	Morgan Stanley Mauritius Company Ltd	1.35	2.87
Dena Bank	Merrill Lynch Capital Markets Espana ASV	1.1	0.89
		Total	**25.80**

Source: Bombay Stock Exchange, CEIC, ERD BBVA

As for setting up domestic branches, foreign banks are required to bring an assigned capital of USD25 million up front at the time of opening the first branch in India. At end-June 2008, there were 30 foreign banks operating in India from 21 countries, with 279 branches (Table 3). In addition, 41 foreign banks operate in India through representative offices.

Table 3.

Foreign bank branches in India
(as at end-June 2008)

	Name of Bank	Country of Incorporation	No. of branches
1	ABN -AMRO Bank N.V.	Netherlands	28
2	Abu Dhabi Commercial Bank Ltd.	UAE	2
3	AB Bank Ltd.	Bangladesh	1
4	American Express Banking Corporation	USA	1
5	Antwerp Diamond Bank N.V.	Belgium	1
6	Bank Internasional Indonesia	Indonesia	1
7	Bank of America	USA	5
8	Bank of Bahrain & Kuwait BSC	Bahrain	2
9	Bank of Nova Scotia	Canada	5
10	The Bank of Tokyo- Mitsubishi UFJ Ltd.	Japan	3
11	BNP Paribas	France	8
12	Bank of Ceylon	Sri Lanka	1
13	Barclays Bank PLC.	United Kingdom	5
14	Calyon Bank	France	5
15	Citibank N.A.	USA	40
16	Chinatrust Commercial Bank	Taiwan	1
17	Deutsche Bank	Germany	11
18	DBS Bank Ltd.	Singapore	2
19	HSBC Ltd	Hong Kong	47
20	J.P. Morgan Chase Bank N.A.	USA	1
21	JSC VTB Bank	Russia	1
22	Krung Thai Bank Public Co. Ltd.	Thailand	1
23	Mizuho Corporate Bank Ltd.	Japan	2
24	Mashreq Bank PSC.	UAE	2
25	Oman International Bank SAOG	Sultanate of Oman	2
26	Shinhan Bank	South Korea	2
27	Standard Chartered Bank	United Kingdom	92
28	Sonali Bank Ltd.	Bangladesh	2
29	Societe Generale	France	2
30	State Bank of Mauritius	Mauritius	3
	Total		**279**

Source: RBI

Business-wise, foreign banks were traditionally focused on investment banking, with an increasing presence as market makers in the domestic derivatives market, corporate loans (syndications), wealth management services and consumer finance (car loan, mortgage and credit cards). However, foreign banks' market share in India has been under pressure, especially from new private sector banks such as ICICI Bank, HDFC Bank and UTI Bank; even in the credit card business, Citibank, that pioneered plastic money in India, has been overtaken by ICICI Bank. The growth, in terms of loans issued, for the 30 foreign banks slowed to 4% in the year to March 27 2009, against 28.5% a year ago, according to Reserve Bank of India (RBI) data. Also, their year-on-year deposit growth shrunk to 7.8%, from 29.1% during the same period. In contrast, the growth of public sector banks, in terms of loans issued, was 20.4%, slightly down from 22.5%, and their deposit growth remained stable at 24.1%. A slowdown in activity growth will see foreign banks lose market share and lower profit margins. All of them remain committed with the Indian market so far, despite rumours earlier in the year that Royal Bank of

Scotland would dispose its Indian operations after it sold part of its stake in Bank of China. Anticipating pressure on capital, foreign banks have sought RBI's permission to tap the local debt market for their Tier II capital, in line with Indian banks, pending a final decision.

Out of the foreign banks operating in India, Citibank is the largest in asset volume at USD17.2 billion at end-March 2008, and among the most profitable with a RoA of 2.1%. Standard Chartered has the most extensive network with 92 branches, total assets worth of USD15 billion and a RoA of 2.3% in financial year 2008. In 2008, HSBC overtook Standard Chartered as the second largest foreign bank in India in asset book size, even though it still brought in a lower RoA than peer group at 1.6% (Table 4).

Table 4.

Top 10 foreign banks in India by asset size (at end-March, USD millions)

2008 Rank	2007 Rank	Foreign bank name	Assets 2008	Loans 2008	Deposits 2008	RoA 2008
1	**1**	**Citibank**	**17218**	**7880**	**9471**	**2.15**
2	*3*	HSBC	15589	6149	8752	1.57
3	*2*	Standard Chartered	15081	6848	7589	2.32
4	*4*	ABN Amro Bank	7519	4185	3883	0.77
5	*5*	Deutsche Bank	5075	1840	2824	1.56
6	*12*	Barclays Bank	2655	1568	1417	0.05
7	*8*	DBS Bank	1866	485	1046	0.72
8	*6*	Bank of America	1668	709	861	3.76
9	*7*	JP Morgan Chase Bank	1663	218	680	3.07
10	10	BNP Paribas	1558	774	664	1.72

Source: CEIC, ERD BBVA

Foreign banks had a share of 8.4% of total assets and 70.8% of the off-balance sheet business of the Indian banking system at end-March 2008. Nine EU-based banks together controlled 65% of total assets of foreign banks in India in 2008. By asset size, out of the top 10 foreign banks in India, six are European. Overall share of foreign banks in the banking system's combined on- and off-balance sheet items (on a notional principal basis), reached 24%, as compared to 18.5% in financial year (FY) 2007. Group-wise, the balance sheet of foreign banks registered the fastest expansion year-on-year by 32.7%, as compared to 25% for commercial banks (SCBs). Paid-up capital stood at 6.1% of assets, up from 4.7% of assets a year ago; this represents a 71% yoy growth, faster than a 35% yoy rise for SCBs. Capital adequacy ratio was 13.08% as of end-March 2008, as compared to 12.51% of public sector banks and 14.4% of new private sector banks.

Though the operating and net profits increased across all bank groups in FY2008, the growth was more pronounced in the case of foreign banks and second to that of old private banks, at 44% yoy growth in after-tax profits and 1.8% in return on assets (RoA). Cumulative provisions and contingencies also rose to 2% of assets, while public sector banks saw the ratio declining slightly to 0.8% over a year ago. However, cumulative provisions as percentage of gross non-performing assets (NPAs) of 51.7% were still below those of public banks and old private sector banks (Table 5).

Table 5.

Operating profit and net profit by bank group (% of assets)

% to total assets	Operating Profit			Net Profit		
	2005-06	2006-07	2007-08	2005-06	2006-07	2007-08
SCBs*	1.95	1.91	1.93	0.88	0.90	0.99
Public Sector Banks	1.88	1.75	1.67	0.82	0.83	0.88
Private Sector Banks	1.71	1.84	2.05	0.87	0.87	1.01
Foreign Banks	**3.34**	**3.51**	**3.84**	**1.54**	**1.67**	**1.82**

Provisions and spread by bank group (% of assets)

% to total assets	Provisions and contingencies			Net interest income		
	2005-06	2006-07	2007-08	2005-06	2006-07	2007-08
SCBs*	1.07	1.01	0.95	2.81	2.58	2.35
Public Sector Banks	1.06	0.92	0.79	2.85	2.55	2.15
Private Sector Banks	0.84	0.97	1.03	2.40	2.24	2.41
Foreign Banks	**1.80**	**1.83**	**2.03**	**3.58**	**3.76**	**3.79**

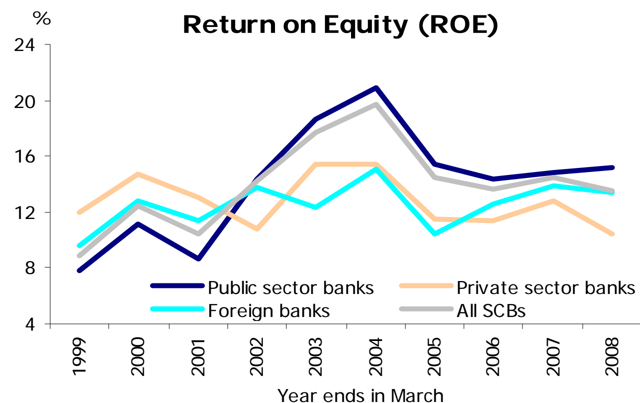
*Scheduled commercial banks

Source: RBI, CEIC, ERD BBVA

Return on equity (ROE) declined in the case of foreign banks in contrast to public banks, mainly due to higher increase in resources raised from the capital market and in reserves and surplus. ROE came in at 49% yoy and 81% yoy for foreign and private sector banks versus 29% yoy for public banks (Graph 7).

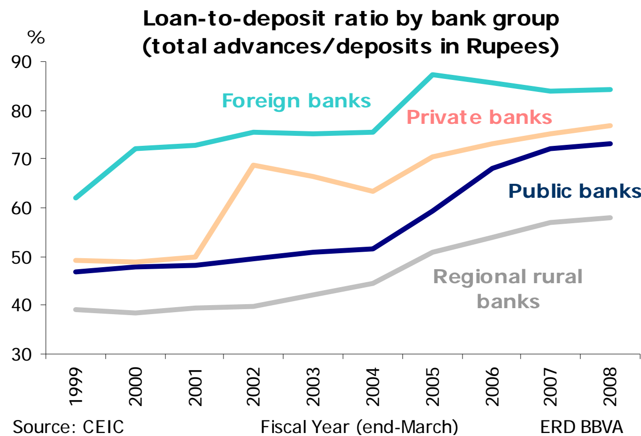
The credit-deposit ratio remained the highest among bank-groups, reflecting strong credit growth and low deposit base. The loan-to-deposit ratio was over 84% at end-March 2008, as compared to a 75% average ratio for the other commercial banks and to the 58% of regional rural banks (Graph 8).

Graph 7.



Source: Balance sheets of respective banks ERD BBVA

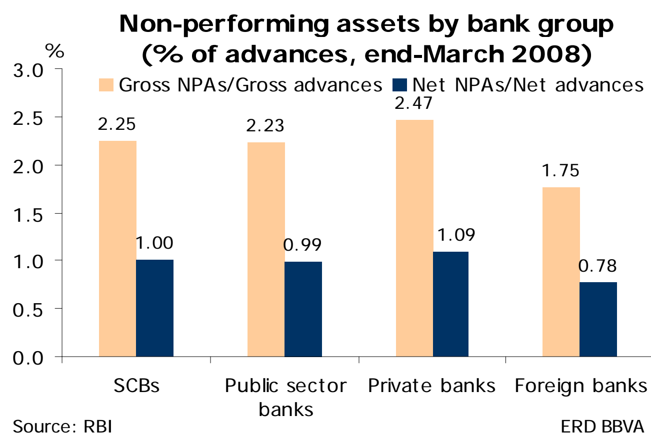
Graph 8.



Foreign banks´ lending to the priority sector constituted 39.5% of their adjusted net bank credit/credit equivalent amount of off-balance sheet exposures, of which nearly 60% was export credit and the remaining to the small-scale industries[20]. This is far above their regulatory target of 32% (40% for domestic commercial banks) and higher than in FY2007.

In terms of the ratio of gross non-performing assets (NPAs) to gross advances, foreign banks posted the highest among bank groups at 1.21%, up from 0.97% at end-March 2007 (Graph 9). The share of the increase in gross NPAs (in absolute value) was more noticeable in respect of foreign banks and new private sector banks, which have been more active in the real estate and housing loans segments. The net NPAs ratio (net NPAs to net advances) of foreign and new private sector banks increased marginally during the year, while that of all other bank groups declined.

Graph 9.



As the opening up of the banking sector looked uncertain, foreign banks have been using the non-banking financial company (NBFC) route to grow their balance sheet and expand their activities in India (Table 6). This is possible since under the foreign direct investment norms, no restrictions exist regarding the establishment of non-deposit NBFC subsidiaries for 19 activities[21] under the automatic approval route (without approval of the government). These activities include most banking functions except accept deposits, run savings accounts or using a debit card, but unlike banks, non-deposit NBFCs can do acquisition financing. Norms pertaining to capital adequacy, income recognition and asset classification among others, are the same as for their Indian counterparts, but non-deposit NBFCs were until recently subject to a relatively less stringent regulatory and prudential framework than banks.

Foreign banks, however, may no longer find it easy to float NBFCs. In November 2006, the Reserve Bank of India not only disallowed banks from holding more than 10% of the equity of any NBFC; it also limited any bank's credit exposure to all NBFCs to 40% of the bank's net worth. These two measures will effectively frustrate foreign banks' use of NBFCs as de facto branches. Further, the banking regulator is requiring NBFCs to adhere to capital adequacy norms, restricting the size and structure of their loan portfolio, and also regulates NBFCs promoted by the parents of foreign banks operating in India on a consolidated basis, and not as independent entities. Non-deposit NBFCs with asset size over INR2 billion (approximately USD41 million) need to achieve a 12% CRAR ratio since March 2009 against RBI's earlier norms[22], and a CRAR level of 15% by March 2010 as against the earlier date of April 1, 2009.

Table 6.

Foreign banks participacion in NBFC

Select NBFCs acquisitions by foreign banks	
Foreign Bank/Group	**Acquired NBFC (stake)**
Credit Suisse	Bokdia Marketing and Finance (91%), renamed Credit Suisse Finance (India) Pvt Ltd
BNP Paribas	SREI Infrastructure Finance (50%)
DBS Bank	Cholamandalam Finance (37.48%)
Barclays	Rank Investments and Credits (99.96%)
Societe Generale	Apeejay Finance Group Ltd (75%)
Fullerton Financial Holding (Temasek subsidiary)	First India Credit Company-former Dove Credit (98%)
Goldman Sachs	Shriram Credit (20%)
	Pratham Investment & Trading Pvt Ltd (100%)
Lehman Brothers	Edelweiss Capital (26%)
AIG Capital	Vivek Hire Purchase (75%)
Citibank (joint venture)	Maruti Udyog Ltd. (74%)
Select wholly-owned NBFCs by foreign banks	
Foreign Bank/Group	**Fully-owned NBFC (year of licensing)**
Credit Suisse	Credit Suisse Finance (India) Pvt Ltd (2008)
Deutsche Bank	Deutsche Investments India-Deutsche Finance (2007)
Fullerton Financial Holding Ltd.	Fullerton India Credit Company (2006)
GE Capital	GE Money Financial Services India Ltd (2004)
Standard Chartered	Prime Financial, Standard Chartered Investments & Loans Ltd (2003)
Citibank	CitiFinancial Consumer Finance India Ltd (CCFIL) (2000)

Source: press, ERD BBVA

[20] As per revised guidelines on lending to priority sector, broad category of advances under priority sector include agriculture, micro and small enterprises, retail trade, micro-credit, education and housing

[21] No.FEMA. 94/2003-RB, annexure (B), dated June 18, 2003

[22] RBI/2008-09/116. DNBS (PD). CC. No. 125/03.05.002 / 2008-2009

Credit defaults registered by NBFCs have been on the rise during the last year, primarily due to a bout of interest rate hikes and a crackdown on collections. This has led the NBFCs to restructure their operations such as closing branches since late 2008. Foreign banks are also reportedly facing rising delinquencies on the retail business front.

Nonetheless, there's a feeling that foreign banks, starved of branches, would still consider acquiring weak private sector banks. In recent years, both Citi and StanChart had put in applications for picking up weak banks, but their applications were not considered. Various banks from China, Japan and the Middle East have showed interest in buying controlling stake in Indian banks in the past. Looking ahead, the central bank may not be in a position to give a go-ahead to allow foreign banks in the country to expand freely by increasing branch networks or acquiring a private sector bank, given that more comprehensive banking reforms have not been implemented.

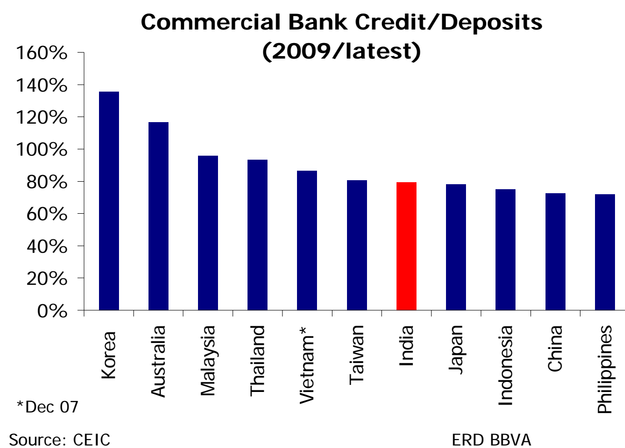
Recent bank developments

The Indian banking system has, however, entered the current economic slowdown in relatively better shape than it was prior to the slowdown in the late 1990s. Indian banks have very limited indirect exposure to the US mortgage market or failed institutions, capital ratios look more resilient than in the past, NPA ratio is at historical lows, and improved creditor rights should lead to faster and increased recovery expectations.

Even so, Indian financial markets –equity markets, money markets, forex markets and credit markets- have all come under pressure mainly because of what can be called ´the substitution effect´. As credit markets overseas went dry, some of the credit demand earlier met by cross-border financing was shifting to the domestic credit sector. The reversal of capital flows taking place as part of the global de-leveraging process put pressure on India´s forex markets. Together, the global credit crunch and de-leveraging were reflected in the domestic markets through the sharp fluctuation in the overnight money market rates in October 2008 and the ongoing depreciation of the rupee.

Overall liquidity has been less of a concern for commercial banks in India relative to others in the region, except for seasonal shortages. Indian banking system´s 74% loan to deposit ratio (as of end December 2008), stands lower than the average of peers in the region, which provides with a base of lower cost funding (Graph 10).

Graph 10.



Source: CEIC ERD BBVA

Furthermore, Indian banks' investments in government securities and cash and balances with the central bank (33% of borrowings in January 2009) provide them with some flexibility for repo borrowing to manage short-term liquidity gaps. At the end of FY2008, Indian banks' overseas borrowings were still low at 3.8% of total assets/liabilities (55% of total borrowings), as compared to 3.3% of assets in the FY2007. By contrast, Indian banks nearly halved their offshore call money and bank balances to 2.5% of total assets at end-March 2008 from 4.6% a year ago, probably, reflecting increased risk aversion on the soundness of overseas banks.

The squeeze on foreign funding by the end of 2008 reflects the difficulty Indian banks have had in rolling over their external liabilities, which progressively spread beyond the banking system to fixed-income mutual funds and non-banking financial institutions (NBFCs). While the Indian government has not guaranteed banks' external liabilities, it has adopted several measures to provide banks and non-bank financial institutions with foreign currency liquidity. Measures aimed at managing forex liquidity include upward adjustment of the interest rate ceilings on non-resident foreign currency deposits, substantial relaxation of the external commercial borrowing regime, allowing non-bank financial companies (NBFCs) and housing finance companies access to foreign borrowing and allowing corporations to buy back foreign currency convertible bonds to take advantage of the discount in the bearish global markets. The RBI has also instituted a rupee-dollar swap facility for banks with overseas branches to help them in managing their short term funding requirements until June, 2009. Further, in February, the RBI appointed Industrial Development Bank of India Stressed Asset Stabilization Fund (IDBI-SASF) as a special purpose vehicle to provide liquidity support to non-deposit taking finance companies (NBFCs) (Economy: Annex 1 for more details).

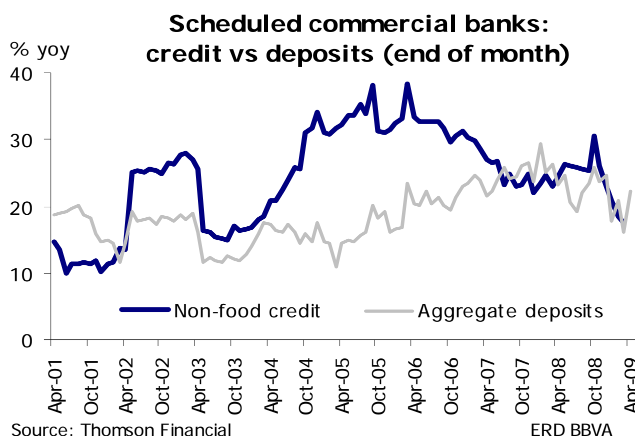
The authorities have also eased prudential norms, which were previously tightened in a counter-cyclical way to prevent the economy´s overheating over the past years. The easing measures included a reduction of credit risk weights (from 150% to 100% for certain bank claims) and

of general provisioning requirement (from 1%-2% to 0.4% for personal and services sector loans), which would provide some relief to the strained balance sheets of banks in the current fiscal year. In December 2008, the central bank announced another ´exceptional regulatory treatment´ until June 2009, which allowed banks to restructure an eligible loan for a second time if necessary and continue to treat it as a performing loan; it also included a one-time restructuring for commercial real estate loans (not allowed before). As a result, the increase in loan delinquency in the near-term will not be immediately reflected in the banks´ NPA ratio.

Following the reduction in policy rates and liquidity injections since October 2008, the adjustment in market interest rates gets reflected with some lag. Bank lending rates have been more resistant to the policy easing and the reduction in the range of term deposit and prime lending rates has been less than that of the policy rates.

Aggregate deposits slowed down from 24% yoy in both 2008 and 2007 to 22% yoy at end-April 2009 (Graph 11). Time deposits grew 24% yoy (similar to a year ago) but demand deposits slowed down to 11% yoy (21% yoy over a year ago), probably as a result of the reduction in the remuneration of bank demand deposits.

Graph 11.



The slower monetary transmission to the credit market is somewhat due to several structural rigidities; among others, the persistence of large volumes of market borrowing by the government to finance increasing fiscal deficits, which rise interest rate expectations and thus, makes harder to lower lending rates.

Non-food credit from the banking sector has been slowing down since a peak of 30.5% yoy growth in October 2008, to 17.5% yoy at end-March 2009. The changes in credit flow could be attributed to several factors. First, the demand for bank credit increased sharply during April-October 2008 as Indian corporations found that their external sources of credit had dried up, and shifted that demand to domestic credit. Second, there was a sharp increase in credit to oil marketing companies by USD7.2 billion during the same period as compared to a decline of USD229 million the previous year. Subsequently, the demand for credit moderated reflecting the slowdown of the economy in general and the industrial sector in particular. The demand for credit by oil marketing companies also moderated, while working capital requirements declined because of lower commodity prices and drawdown of inventories by the corporations.

Further, Indian banks have tightened lending standards, as asset quality pressures are building up –it began with unsecured consumer loans in 2007 and spread to SMEs-, especially reflected in lower credit expansion by private and foreign banks. Even so, bank credit is not likely to fall sharply, supported by corporations seeking local currency loans to replace offshore funding to some extent, as well as for infrastructure financing demand.

Available information as at February 2009 shows that about 48.2% of year-on-year incremental commercial credit, which accounts for the bulk of bank credit, was absorbed by the industry sector (Table 7). Therefore, risks lie mostly in this sector (41% of commercial loans), of which SMEs account for nearly 15% and infrastructure projects for 10%. Moreover, a severe fall in property prices could affect the banks´ residential (11% of commercial loans) and commercial property lending (3% share) portfolio. Lending to sensitive sectors (real estate, capital market and commodities) by bank group shows that new private sector banks had the largest exposure in FY2008 in terms of their share in total loans and advances. This is on top of new private banks´ exposure to non-bank financial companies (3.5% of loans), whose financial standing has deteriorated sharply.

Table 7.

Non-food bank credit by sector and bank group

Item	Variation (y-o-y) (%)					
	Public Sector Banks		Private Sector Banks*		Foreign Banks*	
	As on Feb-15 2008	As on Feb-27 2009	As on Feb-15 2008	As on Feb-27 2009	As on Feb-15 2008	As on Feb-27 2009
Non-food Gross Bank Credit (1 to 4)	**22.3**	**23.9**	**19**	**9.1**	**28.8**	**1.6**
1.Agriculture	**19.3**	**19.2**	**-1.3**	**39**	**NA**	**NA**
2.Industry	**23.2**	**31**	**35.2**	**7.4**	**35**	**6.5**
3.Personal Loans	**15.6**	**11.6**	**8.5**	**7.4**	**14.5**	**-8.1**
of which:						
Housing	13.2	10	13.5	4.9	-2.1	-4.4
4.Services	**28.6**	**24.4**	**28.5**	**4.5**	**41.2**	**6.9**
of which:						
Real Estate Loans	47.9	79.1	6.9	13.9	-36	40.5
NBFCs**	53	44.8	14	38.1	64	20.8
Memo Item						
Small Enterprises***	49	36.7	209.5	23.2	190.4	59.5

*The share of some private sector banks and foreign banks in total bank credit to agriculture and small scale enterprises is small.
**Non-Banking Financial Companies
***Includes small manufacturing and service enterprises.
NA: Not Available.

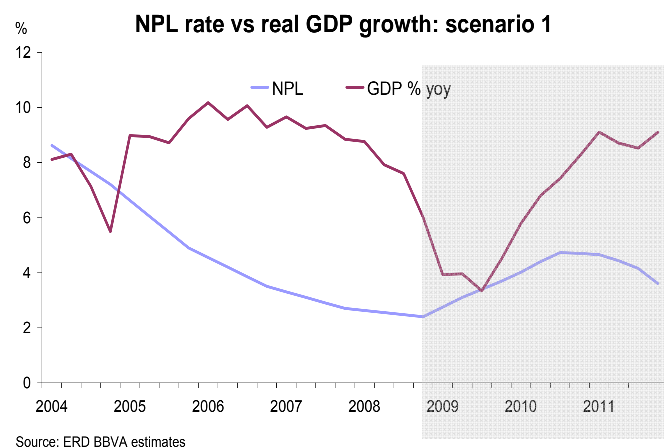
Source: RBI, ERD BBVA

Even though the Indian banking system does not have a high level of non-performing assets (NPAs) -a measure which includes retail non-performing loans (NPLs)-, asset quality is likely to deteriorate with the slowdown in the economy. Gross NPAs of the banking system were falling

progressively to 2.4% of total loans at end-2008 from 7.2% at end-2004. Also, large equity issuances in recent years by several banks have improved their loss absorption capability and hence their resilience in the face of downside risks. At end-March 2009, the gross NPA level is reportedly higher at two banks, ICICI Bank and Kotak Mahindra Bank—holding around 4.3% gross NPAs each—and Federal Bank, carrying 5.57% gross NPAs. In fact, 25 of 35 banks that have announced their earnings in 2009 so far, have less than 1% of their advances categorized as net NPAs (i.e., gross NPAs minus provisions) and 10 of them even have less than 50 basis points net NPAs. Reportedly, only two banks have at least 2% net NPAs: Kotak Mahindra Bank Ltd (2.39%), and ICICI Bank (2.09%). State Bank of India, the country's largest lender, has 1.76% net NPAs. Indeed, the Reserve Bank of India's forbearance on restructuring those loans where borrowers are not in a position to pay on time has helped banks to slowdown the rise of stressed assets.

According to our model projections (Annex 4 for details), under a baseline assumption of a 4% real GDP growth in average from January-December 2009, gross NPA ratio could rise to 3.7% at end-December 2009 (Graph 12). According to the RBI stress test results[23], under its worst-case scenario of a 150% increase in gross NPAs (3.7% NPA ratio as per our estimates), the overall capital adequacy position of the banking sector would have declined to 10.6% in September 2008 – still above the regulatory requirement of 9%. In our alternative scenario, where real GDP growth recovers more slowly while real interest rates rise faster, gross NPA ratio jumps to 4.5% of total advances, to levels last seen in early 2006 (Graph 13). The gross NPA ratio, however, will vary from bank to bank, with regional banks the most vulnerable due to higher sectoral concentrations. Most concerning is the low ratio of provisioning for bad loans which makes the banking system vulnerable to shocks. The provisioning to gross NPA ratio of Indian banks was 52.4% at the end-March 2008, even lower than the 56.1% over a year ago.

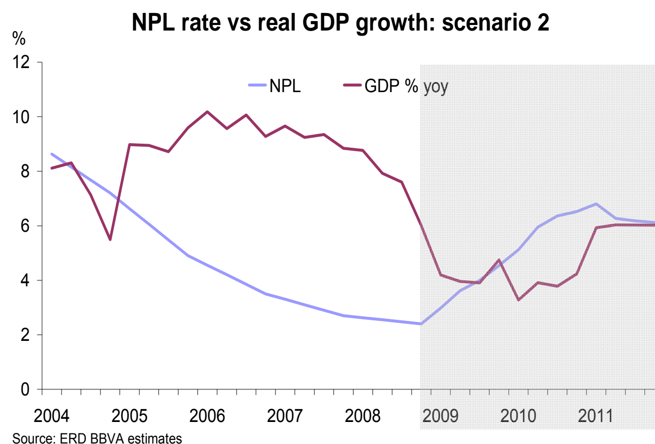
Graph 12.



Source: ERD BBVA estimates

[23] Report of the Committee on Financial Sector Assessment 30 March 2009

Graph 13.



Source: ERD BBVA estimates

Furthermore, the profitability of the Indian commercial banks remains low, as reflected in a return on assets (RoA) of 1% during 2007-08, marginally improved from 2006-07. The net interest margin of Indian banks came under pressure in the first half of 2008 as loan growth was higher than the growth in deposits, leading to the banks´ increasing dependence on wholesale funding at higher cost for incremental loans. Since October 2008, the interest rate cuts and the reduction in cash reserve and statutory liquidity ratios, has helped improve banks´ net interest margins by increasing the amount of disposable funds to grant loans, and has also provided fixed-income trading opportunities.

Net profits of 35 banks reportedly rose 27.20% in the fiscal 2009. Public sector banks, as a group, performed better than their counterparts in the private sector, collectively posting close to a 31% increase in their net profits while private banks' profits on an average have gone up by 16.75%. At least nine banks' net profits have gone up by 50% or more in 2009 and only four in the 35 banks that have so far announced their earnings have shown a drop in their net profits. They are ICICI Bank and Kotak Mahindra Bank in the private sector and Allahabad Bank and Vijaya Bank in the public sector. However, RoA may come under pressure going forward due to a rise in loan loss provisions, particularly as the cumulative provisions remain very low.

Mark-to-market impact on the offshore investments has been limited to a few larger banks with a more active international presence. Except for ICICI bank, this impact has been low limited to Indian credit exposures. ICICI eventually sold early in the year its more volatile non-India offshore investment portfolio but during the March quarter of 2009, the mark-to-market losses of its UK subsidiary rose to USD163.9 million, from USD71 million at the end of December 2008. Although, the impact of the market risk on the offshore investments of Indian banks has not been significant so far, the underlying corporations face refinancing risks on their overseas borrowings and repayment risks due to foreign exchange depreciation; hence, Indian banks may need to charge higher provisions on their corporate loan portfolio. An additional

risk would be the rising contingent liabilities of Indian commercial banks, especially in new private and foreign banks. As banks took increasing leveraged positions in derivatives as a means of diversifying income and more clients used derivatives as tools for risk mitigation, the total off-balance sheet exposure of commercial banks in India was more than three times the size of their consolidated balance sheet at end-March 2008 or an 88% year-on-year increase. Given the huge exposure to the risk of defaults on contingent liabilities by clients, banks may need to significantly increase the amount of provisioning, which reportedly covers only 0.02% to 0.05% of total contingent liabilities in private banks.

Overall capital adequacy ratio (CRAR) of commercial banks remained at 13.1% by end-December 2008 from 13% by end-March 2008. The aggregate Tier I ratio was at 8.5% by end-September 2008, comprising almost entirely of common equity (over 95% of major Tier I capital of the larger banks). These ratios were still above RBI`s requirement of total capital adequacy of 9.0% and Tier-1 of 6.0% and thus, considered to be sound. At the individual level, the CRAR of 77 banks was above 10%, and the balance 2 banks were in the range of 9 to 10% at end-March 2008. In fiscal 2009, reportedly 28 out of the 35 banks that have announced their earnings so far, have at least 12% CRAR or more and some of them even a far higher capital cushion (e.g., Federal Bank Ltd has 20% CRAR; Yes Bank Ltd 17% CRAR; and ICICI Bank Ltd 15.53% CRAR). All commercial banks in India were Basel II[24] compliant as on March 31, 2009.

The government announced in early 2009 its intent to help government banks maintain the total capital ratio at 12%, presumably by subscribing to hybrid Tier I and Tier II capital if necessary, and its plans to inject capital up to INR200 billion (USD4 billion) over the next two years. For that purpose, it has earmarked the bulk of a USD4 billion World Bank aid to inject INR38 billion into three public sector banks in FY09 and FY10 (UCO Bank, Central Bank of India, Vijaya Bank) and other 11 public sector banks. Out of these, five banks have been identified for recapitalization earlier this year, including Dena Bank, Oriental Bank of Commerce, Andhra Bank, United Bank of India and Bank of Maharashtra, which had a CRAR between 10%-11%. The other six banks, which are also in line for recapitalization, had a relatively higher CRAR of 11%-12%.

The quality of capital will therefore be an important differentiator between Indian banks in the next few years as banks focus on capital conservation while their performance comes under pressure due to a rise in bad loans, increased capital charges and declining profitability. However, the government support to recapitalize public sector banks, the reduction of credit risk weights and restructuring of the loan portfolio in 2009, in addition to a timely infusion of common equity by the larger private and public banks in 2008, should provide an adequate buffer to absorb short-term losses, barring a sharp deterioration in their credit profile.

Future developments

To the extent to which India´s banking and non-banking financial sector were aggressive in disbursing credit at unusually low rates to marginal borrowers at cycle-peak GDP growth, they are now facing a rise in non-performing assets. So far, the first round of growth shock is causing an increase in NPAs in the non-banking as well as banking system, mainly in the real estate sector, unsecured personal loans and SME loans. With the real activity showing signs of further slowdown and the cost of capital still high, NPAs will likely rise further. However, "reported" NPA ratios may temporarily be understated due to regulatory forbearance extended to ´restructured´ accounts that are permitted to be classified as performing until end-June 2009. In case of a prolonged and deeper than expected slowdown, this could lead to a large proportion of these restructured accounts to being classified as NPAs over the next two to three years; NPAs would therefore reach levels above 6%, highest since 2005. The risk clearly lies in Indian banks low NPA coverage, which would continue declining unless they raise specific provisions. Otherwise, NPA coverage is likely to decline ahead as result of tepid credit growth and regulatory forbearance since November 2008, such as lowered general provisioning requirements and risk-weights on vulnerable segments, just when higher non-performing loans provisioning and capital cushion is more desirable in times of economic uncertainty.

If an asset quality crisis develops in Indian state-owned banks, the government´s plan to inject INR200 billion (USD4 billion) would only be about 0.64% of risk-weighted assets, according to some estimates. In order to achieve a minimum total CRAR of 12% for public sector banks, they would need to raise equity capital under difficult market conditions along with restrictions of a minimum 51% of government shareholding. In the case of certain public sector banks in which the government shareholding is close to the statutory minimum, the Indian government seems up to now, more inclined to push for mergers between banks rather than lifting or revising the shareholding restrictions.

We do not expect for the time being a liquidity crisis in the banking sector, as Indian banks generally have a stable funding profile, with almost 75% of their liabilities funded by deposits and high statutory reserve requirements. Moreover, the RBI could if necessary relax the collateral requirements for banks to inject liquidity, in addition to its regular market operations and the unwinding of sterilization bonds issued under the market stabilization scheme (MSS). Indian banks reliance on foreign currency denominated borrowings is limited and, upon the global financial turmoil, the RBI has also committed to provide foreign currencies to local banks for maturing offshore borrowings. Therefore, the government has not seen the need to introduce a blanket deposit guarantee, as in other peers in the region, despite anecdotal evidence of deposit

[24] Standardized Approach for credit risk and the Basic Indicator Approach for the operational risk

outflows from some private banks to public sector banks in the last months of 2008. This, however, has led to the possibility of an increase in the maximum insured amount of USD2,000 under the local deposit insurance scheme, which is reportedly being examined by the authorities.

Overall, banks´ balance sheet and profit margins will be under increasing pressure in the next two years, arising from higher credit defaults amid sluggish economic activity, and lower mark-to-market gains on the government securities portfolio as interest rates fall less going forward.

On the foreign banks´ role in India, the general view has been that a larger presence of foreign banks can increase the vulnerability of the domestic economy to foreign developments. In particular due to significant liquidity and capital shocks to the parent foreign bank, it can be forced to scale down its operations in India, aggravating the shrinkage in domestic credit supply during crisis episodes. As the RBI put on hold the long-awaited liberalization of the banking sector to foreign investment and, upon the majority victory of the ruling coalition, we do not expect any significant progress in the near term.

Political constraints to carry out the reform agenda may have lessened but not disappeared. The re-elected government is still short of majority in the upper house of the parliament, which is critical in the passage of all financial bills, including the budget. Therefore, the government is unlikely to overload its near-term economic agenda. Reforms that could not be completed due to political constraints during the previous five years are likely to be pushed in the next few months in what is being called the 100-day program. There is high expectation that the program will be made public early and contain market-friendly reforms, but details are not known and it is also not clear that a consensus has been reached within the government. Most of the market reforms are likely to focus on pushing through legislations already in progress. The pension, insurance, and banking reform legislation may be back on the agenda. These include: (i) the Insurance Bill, which authorizes an increase in foreign investment in insurance and more flexibility for state insurance companies to raise capital, it has already been introduced in the upper house of parliament, and after getting majority there can be brought to the lower house; (ii) the Banking Regulations (Amendment) Bill, which allows greater voting rights to shareholders in banks and therefore, favoring more private participation; and (iii) the Pension Fund Regulatory & Development Authority Bill, for the setting up of an independent regulator to drive pension reforms. The success of the government in passing these reforms will be critical for investor sentiment and to continue with future bolder reforms.

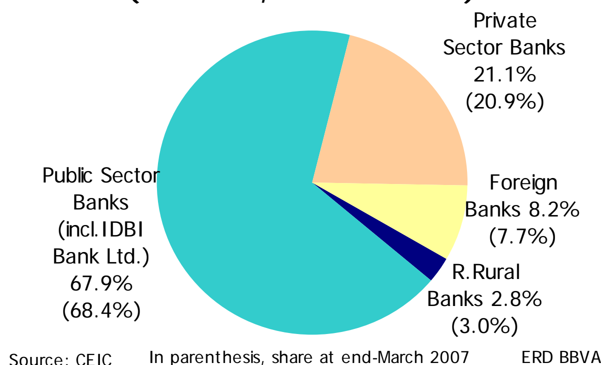
Annex 1: Banking sector structure

The competition in the banking sector is high as there are public sector banks, private sector and foreign banks along with non banking finance companies competing in similar business segments. Additionally, Indian banks compete with the government´s small savings schemes (Annex 3 for details) in mobilizing resources from depositors.

At end-December 2008, India´s banking sector was comprised of 165 scheduled[25] commercial banks (SCBs), down from 172 over a year ago as result of the sector consolidation process. These commercial banks included 30 foreign banks, 22 private banks, 4 local area banks[26] and 109 banks in the public sector[27]. Public sector banks still hold nearly 70% of the commercial banking sector but have actually lost market share on account of private sector banks (21% share), especially new private banks, and foreign banks (8% share) (Graph 1).

Graph 1.

Scheduled Commercial Banks: Asset share (% of total, end-March 2008)

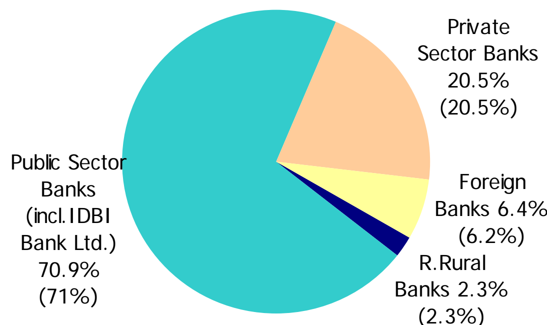


Source: CEIC In parenthesis, share at end-March 2007 ERD BBVA

The combined share of public sector banks in commercial banks' advances was 71% at end-March 2008, unchanged from previous year. Private sector banks and foreign banks share accounted for 21% and 6.4%, respectively, while the regional rural banks maintained a 2.3% share (Graph 2).

Graph 2.

Scheduled Commercial Banks: Loan share (% of total, end-March 2008)

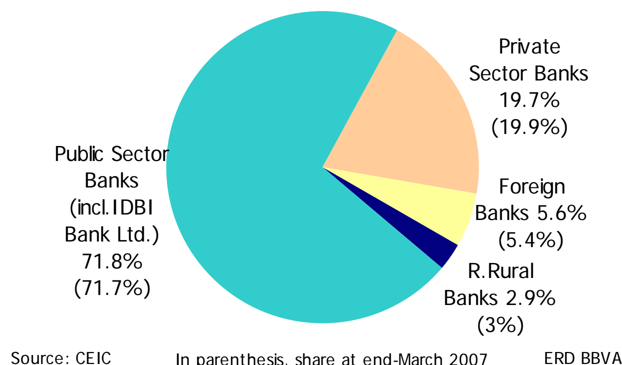


Source: CEIC In parenthesis, share at end-March 2007 ERD BBVA

As for deposits, public sector banks hold the largest share of 71.8% at end-March 2008, marginally increased from a year ago. Private sector banks and regional rural banks, however, showed a slight decrease in deposit share to 19.7% and 2.9% during 2007-08 from 19.9% and 3%, respectively. Foreign banks´ share in aggregate deposits increased marginally to 5.6% from 5.4% a year ago (Graph 3).

Graph 3.

Scheduled Commercial Banks: Deposit share (% of total, end-March 2008)



[25] Scheduled banks are those with a paid-up capital and reserves of an aggregate value of not less than INR500,000 (USD10,000), as per RBI Act, 1934. There has not been any non-scheduled bank in the country since May 1997.

[26] Capital Local Area Bank Ltd., Coastal Local Area Bank Ltd, Krishna Bhima Samruddhi Local Area Bank Ltd., Subhadra Local Area Bank Ltd

[27] The public banks consist of 81 regional rural banks (RRBs).,19 nationalized banks, 8 banks in State Bank of India group and the Industrial Development Bank of India Limited (IDBI Ltd)

Annex 2: Foreign joint-ventures in the insurance sector

	Life Insurers
1	Bajaj Allianz Life Insurance Company Limited .
2	Birla Sun Life Insurance Co. Ltd
3	HDFC Standard Life Insurance Co. Ltd
4	ICICI Prudential Life Insurance Co. Ltd
5	ING Vysya Life Insurance Company Ltd.
6	Max New York Life Insurance Co. Ltd
7	Met Life India Insurance Company Ltd.
8	Kotak Mahindra Old Mutual Life Insurance Limited
9	SBI Life Insurance Co. Ltd
10	Tata AIG Life Insurance Company Limited
11	Aviva Life Insurance Company India Limited
12	Sahara India Life Insurance Co, Ltd.
13	Shriram Life Insurance Co, Ltd.
14	Bharti AXA Life Insurance Company Ltd.
15	Future Generali India Life Insurance Company Limited
16	IDBI Fortis Life Insurance Company Ltd.,
17	Canara HSBC Oriental Bank of Commerce Life Insurance Company Ltd.
18	AEGON Religare Life Insurance Company Limited.
19	DLF Pramerica Life Insurance Co. Ltd.
	Non-Life Insurers
1	Bajaj Allianz General Insurance Co. Ltd.
2	ICICI Lombard General Insurance Co. Ltd.
3	IFFCO Tokio General Insurance Co. Ltd.
4	Tata AIG General Insurance Co. Ltd.
5	Cholamandalam MS General Insurance Co. Ltd.
6	HDFC ERGO General Insurance Co. Ltd.
7	Star Health and Allied Insurance Company Limited
8	Apollo DKV Insurance Company Limited
9	Future Generali India Insurance Company Limited
10	Universal Sompo General Insurance Co. Ltd.
11	Bharti AXA General Insurance Company Limited

Source: IRDA, ERD BBVA

Annex 3: India´s small savings schemes

At present, there are 10 small savings schemes in India framed by the Central Government, which play a major role in attracting deposits with the dual purpose of providing an instrument for the small savers from rural and semi urban areas and of helping to finance the government.

The current small saving schemes in operation include: Post Office Savings Account, Post Office Time Deposits (1, 2, 3 & 5 years), Post Office Recurring Deposit, Post Office Monthly Income Account, and contractual savings schemes, which are made mainly to provide for old age and complement the Government's social welfare, such as Senior Citizens Savings Scheme, National Savings Certificate (VIII-Issue), Kisan Vikas Patra and Public Provident Fund (PPF). Two non-statutory deposit schemes for retired / retiring employees, namely: Deposit Scheme for Retiring Government Employees and Deposit Scheme for Retiring Employees of Public Sector Companies, were also being run by the Central Government. However, fresh deposits under both retirement savings schemes have been stopped with effect from the 10th July, 2004. Also, no interest accrues on these deposits in the existing accounts, on completion of the maturity period of three years, on or after September 13, 2004.

These savings schemes offer incentives like a higher interest rate than other competing instruments and a sovereign guarantee. Contributions to certain schemes carry tax concessions while returns on almost all schemes have some tax-exemptions. Such advantages make this kind of saving more appealing creating a distortion in the interest rate structure of commercial banks and other savings accounts.

As of April 1, 2008 total deposits outstanding amounted to INR6.7 trillion, up from INR5.6 trillion a year ago, as compared to total demand and time deposits with the commercial banks of INR31.97 trillion at the end of FY08 from INR26.1 trillion in FY07. All deposits under small savings schemes are credited to the "National Small Savings Fund" (NSSF), established in the Public Account of India with effect from April 1, 1999. All withdrawals by the depositors are made out of the accumulations in this Fund. The balance in the Fund is invested in special Government securities as per norms decided from time to time by the Central Government.

The maturity period of the small saving schemes, currently in operation, varies from a very short period (saving deposits) to over fifteen years (PPF). Certain schemes such as Post Office Savings Account, Post Office Recurring Deposits, Post Office Monthly Income Scheme, Post Office Time Deposits are similar to commercial bank deposit schemes, subject to ceilings in some cases. Schemes like National Savings Certificates and Kisan Vikas Patra have maturity of 6 to 7 years. For Public Provident Funds, the minimum initial maturity is 15 years while for National Savings Schemes it is 4 years. Prevailing interest rates on small savings varies between 3.5% for the post office savings account to 8% under the post office monthly income account. Rates for Public Provident Fund (PPF) and Senior Citizen savings scheme are 8% and 9% respectively. However, there have been net withdrawals from these schemes since December 2007 and transferred to commercial banks due to more attractive nominal rates. Commercial banks are paying as much as 8.25-11% for term deposits of 1-4 years as of January 2009 compared to 8.25-9.75% at end March 2008.

Resource mobilization through small savings is a major source of finance for the Government. The advantage of fund mobilization through small savings is its medium to long-term maturity profile and as such it could be used to finance projects having long gestation period. According to Budget Estimate of 2007-08, the share of small savings (net) in the financing of Centre's gross fiscal deficit (GFD)

was of 15.4%, while that of provident funds (State, Public and non-government) was declining to 4% of the total.

Annex 4: Non-performing loans model

NPL projections as result of a model estimated in state space form, considering real GDP growth, real interest rate and time lags.

Model specifications:

Yt: depending variable

Xt: exogenous variable

μt, δt: stochastic trend

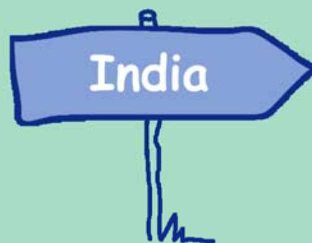
measurement equation

$$Y_t = \mu_t + \beta X_t + \varepsilon_t \qquad \varepsilon_t \sim N(0,\sigma^2)$$

state equation

$$\mu_t = \mu_{t-1} + \delta_t$$
$$\delta_t = \delta_{t-1} + w_t \qquad w_t \sim N(0,\Theta^2)$$

The measurement equation relates the observable Y_t to the regression component (βX_t) and the unobservable state (μ_t). The state equation describes how the unobservable state evolves over time, in this case as a stochastic trend. v_t and ε_t are shocks to the transition and measurement errors parameters estimated in the model.

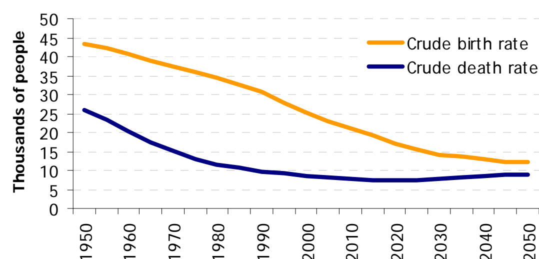


Demography

Demographic projection

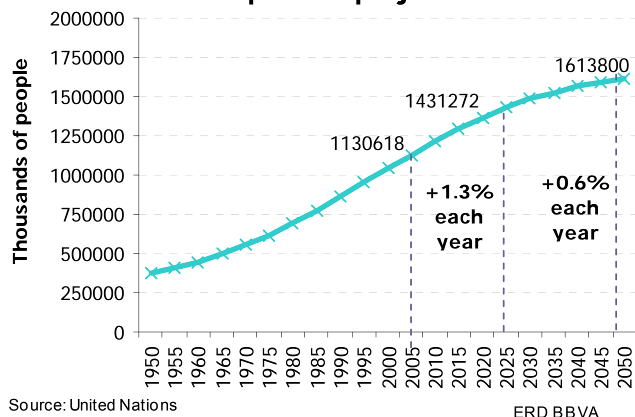
According to the latest official estimations by United Nations, the Indian population will reach 1.124 million people in 2010. The National Commission on Population has come out with more cautious figures in the medium run. In both cases, in 2025/2030, the population of India is projected to surpass that of China, and both will account for more than one third of the world population. By 2050, the Indian population will reach almost 1,614 million people, just slightly below previous projections, and stabilize in line with the National Population Policy (2000) goals.

Birth and death rate 1950-2050



Source: United Nations ERD BBVA

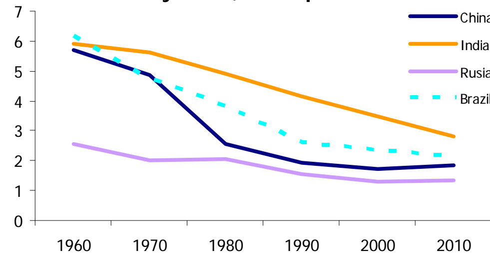
Populaton projections



Source: United Nations ERD BBVA

The differential demographic dividend of India vs. other BRICs (Brazil, Russia, India and China) countries stems from the higher fertility rate.

Fertility rates, birth per woman



Source: United Nations ERD BBVA

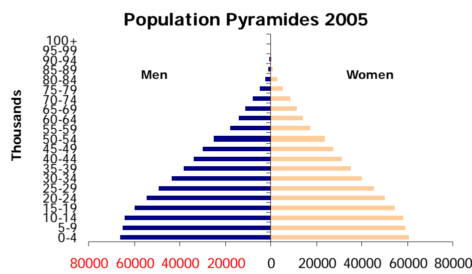
Demographic transition

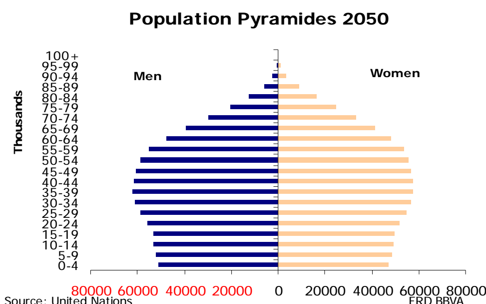
India is concluding the "second stage" of the demographic transition, since both mortality and birth rates have declined sharply. Still, despite official efforts (education, contraception, increase of female age at marriage) until 2050 the average birth rate is expected to be higher than the mortality rate, so vegetative growth will remain positive.

Population by sex and age

During the demographic transition, along with the rate of growth, there will be changes in the population age structure. UN estimations indicate no significant gender imbalance, although females do not exceed the number of males, which is untypical. This is due to higher infant mortality rate for girls and the abortion female fetuses.

Ionela Pipirig
Ángel Melguizo





Population by States

There are marked demographic differences between the states in India, both in size and in growth rates. The most populated states (Bihar, Uttar Pradesh, Madhya Pradesh, Rajasthan in the North, and Orissa), which nowadays constitute 44% of total Indian population in 1995, will exhibit very high growth rates, and may cope 48 per cent in 2016.

Concerning age structure, the population pyramids of Kerala resembles that of developed countries, while that of Uttar Pradesh resembles the developing countries.

The city of Mumbai with a population of 16.4 million remains the most populous city in India and is set to replace Tokyo as the world's most populous city by 2020.

Pension and health system

Despite recent reforms efforts, India's pension system is fragmented, insufficient and costly. There are five basic mandatory pension schemes in operation: Civil Services Pension Schemes (CSP), Employees' Provident Fund (EPF), Employees' Pension Scheme (EPS), Public Provident Fund (PPF) and New Pension Scheme (NPS). The CSP is a traditional pay-as-you-go defined benefit system for civil servants (both Central and State governments) recruited up to 2003. From 2004, civil servants are ascribed to the NPS scheme, which relies on individual accounts and defined contribution principles. The EPF scheme is an individual defined contribution scheme, while the EPS is defined benefit, both of them mandatory for all workers of the organized sector who joined the labor force from 1995. The PPS meant to cover unorganized sector workers is, in practice, a tax planning vehicle for high-incomers (due to favorable tax treatment). The development of the voluntary pension pillar is still limited.

This fragmented regulatory, which reflects the particular features of the India's labor market, generates significant income and regional inequities. Non-coverage is pervasive not only in the unorganized sector, but also in the formal economy. According to different sources, nearly 90% of the working population is not covered by any form of retirement benefit scheme. More than 80 percent of those covered are under the EPF&EPS schemes, and 15% under civil servants schemes. Finally, defined benefit schemes, especially CPS, are in fiscal stress due to ageing. According to the Federation of Indian Chambers of Commerce and Industry and KPMG (*Pension reforms in India. A perspective*. 2006), its implicit debt may exceed 60% of GDP.

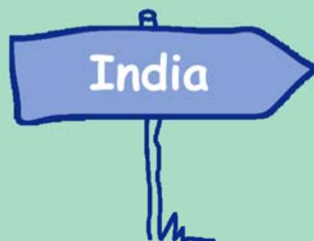
The aforementioned demographic scenario provides some leeway in the short-term to pursue further pension reforms. The dependency ratio (population>64/population 15-64) will remain around 12 until 2015 (soaring afterwards, up to 26 in 2050).

Concerning health, total spending in India reaches approximately 5% of GDP. Public spending is among the lowest in the world (around 1.2% of GDP), while the proportion of private spending on health is one of the highest (75%, i.e. 3.5% of GDP).

According to the Planning Commission, there have been great advances in the availability of secondary and tertiary health care facilities in India. The number of government hospitals increased from 4,571 in 2000 to 7,663 in 2006 (the number of beds increased from 430 thousand to nearly half million). The growth of private hospitals was encouraged by Central and State governments by offering tax exemptions and land at concessional rates, in return for provision of free treatment for the poor.

The Eleventh Five Year Plan will aim for inclusive growth by introducing National Urban Health Mission (NUHM) and National Rural Health Mission (NRHM). The NRHM 2005-2012 envisages increasing public expenditure on health, and a reduction of regional imbalances in health infrastructures. The plan is set especially for rural population, poor, women and children. The NUHM (still to be launch) will provide integrated health service delivery to the increasing urban poor. Initially, the focus will be on urban slums (in Mumbai, 60% of the population live in slums, which cover only 6% of the city's land).

Economic Research Department



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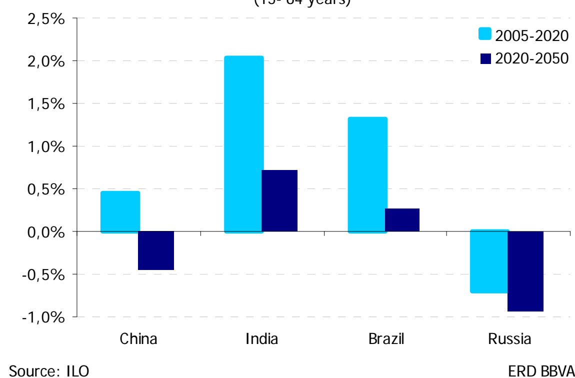
Labor Markets

Working age population

Working-age population in India will grow steadily in the coming decades according to UN projections. The projected growth rates (2.0% up to 2020, and around 0.7% until 2050) indicate that the Indian economy will benefit from a notable "demographic dividend".

This evolution is the most favorable among the so-called BRICs economies (Brazil, Russia, India and China). Currently, India has the youngest population in the world; in the year 2000, the median age of its population was less than 24 years compared to 38 for Europe, 41 years for Japan and 30 years for China. The demographic structure leaves India in a favorable position vis-à-vis other developed and developing economies with a more aging population.

Working-age population growth
(15- 64 years)

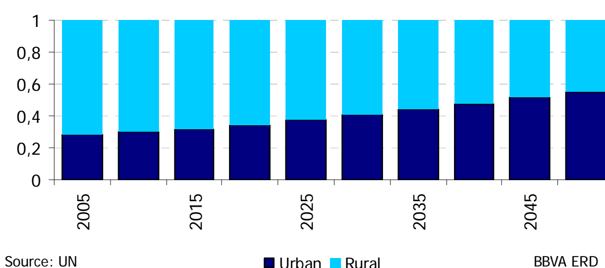


Source: ILO ERD BBVA

In addition, India exhibits the lowest urbanization rate among BRIC countries (28.7% in India vs 39.9% in BRICs in 2005). This so-called urbanization bonus should help maintain growth in the future in as far as India continues to allow a growing percentage of the population to live in urban areas.

The UN projects an increase in the urban share of the population, up to 34.2% in 2020 (55.2% in 2050), that will impact positively productivity growth (fostering clusters of firms and knowledge diffusion among workers).

Urbanization bonus in India

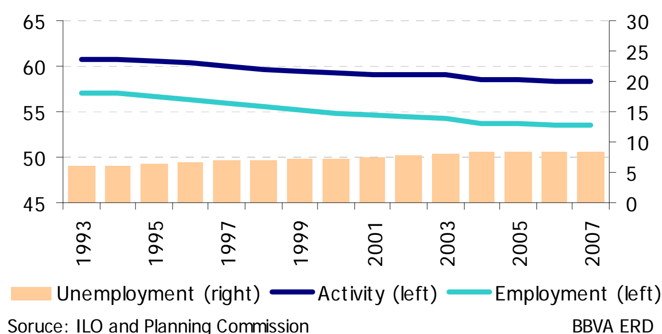


Source: UN BBVA ERD

Employment rate

Labor market has deteriorated in the last decade. Participation rate (over population 15-64 years) shows a decreasing trend since the mid nineties, reaching levels below 60% at present. Furthermore, unemployment has increased more than two p.p., and now exceeds 8%. As a result, the employment rate has decreased markedly, and now stands at 53.4%, more than ten p.p. lower than the BRICs average. This differential slack is mainly due to the low female participation rate (especially among women under 55 years in urban areas).

Labor market rates in India



Soruce: ILO and Planning Commission BBVA ERD

Labor flexibility

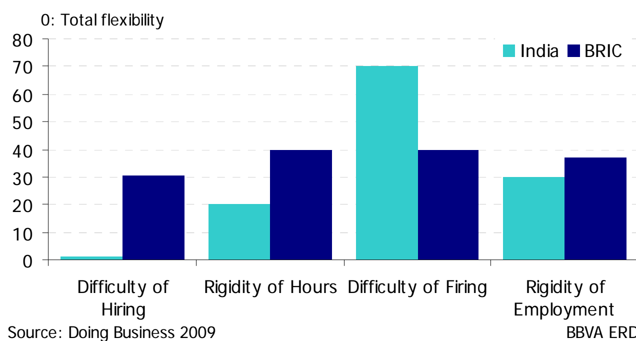
The demographic dividend and the urbanization bonus (as well as taking advantage of the employment slack)

Angel Melguizo

will sustain economic growth only if market reforms keep pace.

The overall starting point in labor regulation seems promising. Labor market institutions in India are slightly more flexible than in other BRICs. *Doing Business 2009* indicators (World Bank) show that this is due to fully flexible hiring regulation, the easiness to adjust working hours and its low non-wage costs. Actually, Indian regulation is in a more favorable position in the labor issues than in the global *Ease of Doing Business Rank* (89th vs 122th). The main disadvantages are concentrated in the public sector undertakings and in firing restrictions. The difficulty of firing index (both due to restrictions and costs), is the highest of the BRICs, and and may be limiting the benefits of the rest of regulations.

Employing workers in India



Source: Doing Business 2009 BBVA ERD

However, this picture veils a significant gap between regular and informal employment. The OECD *Employment Protection Legislation* indicator for indefinite regular workers ranks India among the highest in the world, only surpassed by the Czech Republic and Portugal. This partially explains why, according to the *Eleventh Five Year Plan 2007-2012*, 92.4% are informal workers. Informality is very high and increasing in the organized sectors (defined as establishments hiring more than ten workers), reaching 44.6% in 2004-2005, and massive in the unorganized one (99.6%). These figures are worse than those registered in other BRICs, and are consequently dampening labor productivity levels

Human capital

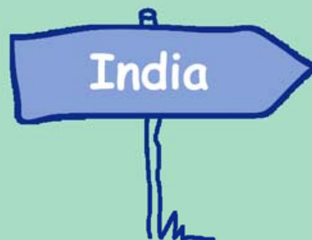
Human capital is not being accumulated at a sufficiently fast pace. According to the World Development Indicators (World Bank), the average years of schooling of adults in India are 3.7 years (vs. 4.4 years in Brazil and 5.1 years in China). The overall level of spending on primary and secondary education is similar to that in developed OECD countries. However, it is very unevenly distributed across income levels and sex. Finally, outlays on tertiary education are low.

Labor indicators summary

India. Main labor market indicators

	1996-2000	2001-2005	2006	2007
Population				
Million	987.066	1.070.695	1.119.538	1.135.614
Active population				
Million	384.145	422.906	446.883	455.348
Employment				
Million	357.217	389.120	409.524	417.281
Unemployment rate				
Per cent	7,0	8,0	8,4	8,4
Informality				
% Employment (a)	37,8	46,6		
% GDP	23,1	25,2	---	---
Rigidity				
Doing Business Ranking	---	---	89 / 181	89 / 181
Human capital				
PISA Ranking	---	---	---	---
Secondary	---	---	---	---
Tertiary	---	---	---	---

(a) In the organized sector
Source: ILO, WB-Doing Business 2009, Schneider (2007) and Planning Commission



Energy

General overview

India is ranked as the world's seventh largest energy producer and the fifth largest consumer of primary energy. With an average economic growth of 9% p.a., over the past four years, India's fuel requirements have been pushed up commensurately. India's consumption of primary energy grew at an average annual rate of about 5% from 2002-07. The Indian economy is pushing up rapidly its energy needs. Primary energy demand and electricity consumption growth rates have been approaching 10% in the last years. The potential for future increases is very big as the economy continues to grow.

India's energy demand is already high in absolute terms (four times that of Spain) in spite of having a population equivalent to 85% of China's, it has one of the lowest per capita energy consumption rates in the world, which is less than a third of the energy consumed in China).

Primary energy statistis for selected countries (2005)

	India	China	OECD
Total Primary Energy Supply (TPES) (Mtoe)	537	1717	5548
TPES per capita (toe/capita)	0.49	1.32	4.74
TPES/GDP (toe/000 2000 US$)	0.83	0.91	0.20
TPES/GDP (PPP) (toe/000 2000 US$ PPP)	0.16	0.22	0.18
Electricity consumed per capita (kWh/capita)	480	1781	8365
CO_2* per capita (t CO_2/capita)	1.05	3.88	11.02
CO_2/GDP (kg CO_2/2000 US$)	1.78	2.68	0.45
Net Imports (Mtoe)	122	100	1813

Source: International Energy Agency

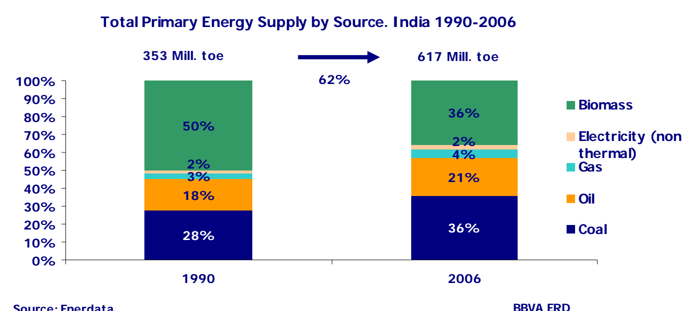
**CO_2 Emissions from fuel combustion only.*

The low energy consumption can be explained by two factors – higher usage of traditional fuel sources and poor accessibility to electricity. First, according to the International Energy Agency (IEA), more than 70% of the Indian population relies on traditional biomass to cater to their daily energy needs, which comprises of fuelwood, dung and agricultural residues. Also according to the IEA, a staggering 38% of the population did not have access to electricity in 2005, implying an electrification rate in India was 62%, which is considerably lower than the 73% seen in developing countries in Asia and 99% in China). Urban consumers with higher incomes consume more electricity and LPG, compared to lower income households.

As the country develops economically, the demand for commercial forms of energy (electricity, oil, gas) is expected to increase across different segments of the population. While this will clearly reinforce the economic development process, it will also intensify India's vulnerabilities in the chapters of energy import dependence and CO_2 emissions. After China, it is expected that India will experience the greatest increase in energy consumption and carbon emissions globally and, although its per capita emissions remain low by regional comparisons, the country already faces severe environmental challenges.

Energy resources and production

The primary energy requirements of the Indian economy are met primarily by coal and traditional biomass. The following graph indicates that the share of biomass in the energy mix is decreasing, whereas that of fossil energies is increasing, especially for coal and oil.



In order to meet the growing fossil energy needs, India must import 75% of the oil (mainly from Saudi Arabia and Nigeria), 15% of the gas (mainly LNG from Qatar) and 12% of the coal consumed (mainly from Indonesia).

Tatiana Alonso

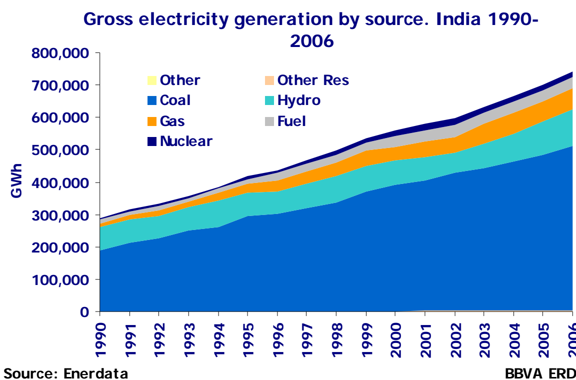
tatiana.alonso@grupobbva.com

While oil consumption has more than doubled since 1990, production has been flat and there are no prospects that this could change in the future given the limited reserves.

There are better prospects for expanding natural gas production (after a series of large off-shore discoveries), but most analysts expect that domestic energy demand will continue to outstrip production in the future. Imports of Liquefied Natural Gas (LNG), which started from Qatar in 2004, are set to grow substantially in the future as new regasification terminals are built.

Conversely, India is well endowed with coal, ranking third in coal reserves and production globally. However, its net coal imports have been accelerating since the mid nineties due to increasing domestic demand, the low quality of its depleting reserves and slow reforms in the coal sector. It is estimated that India will import 22% and 32% of is coal needs by 2015 and 2030 respectively.

Gross electricity generation by source. India 1990-2006



Source: Enerdata BBVA ERD

India has low uranium reserves and it is not a signatory of the Non Proliferation Treaty so uranium availability is an issue. However, if ongoing negotiations with the US are successful, India will be able to import uranium from the US. Moreover, India has launched a program aimed at developing a technology using the vast indigenous thorium resources for electricity generation.

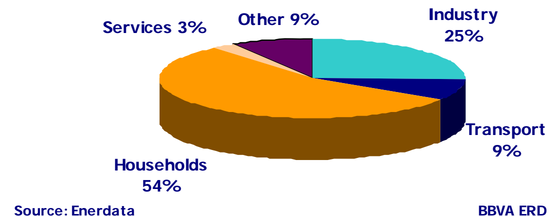
As for renewables, the country is endowed with large renewable energy resources and the authorities seem decided to tap them. At present India is already the 5th biggest producer of wind power in the world (although it may be surpassed by China soon) and it is considered by many analysts to be one of the top leading renewable power markets in the future. India has recently approved a national biofuel policy that aims to raise the proportion of biofuels from 5% to 20% in transport fuels by 2017, using non-edible plant sources like *jatropha curcas*.

Energy consumption

In 2006 51% of the energy used by final consumers (final energy) corresponded to biomass. Next to it, oil covered 26% of the final energy needs followed by coal and power (around 10%) and gas (2%).

The biggest consuming sectors are the residential one and the industry. 76% of the residential sector energy needs are covered with biomass, 15% with fossil energies (mainly oil) and 9% with electricity. In the industry, roughly two thirds of the energy needs are covered with fossil energies (coal and oil), the other third being spread among biomass, electricity and others. Transportation uses almost exclusively oil (conversely nearly 50% of all the oil consumed is used for transportation).

Final energy consumption by sector. India 2006



Source: Enerdata BBVA ERD

With nearly 145 GW, India ranks fifth in installed power capacity globally. However, this capacity is clearly insufficient to cover the electricity needs of such a big country (for comparison, China has 720 GW installed). With a gap between supply and peak demand around 15%, power outages are a commonplace even in big metropolis, affecting consumers at all levels. Moreover, theft and technical factors operating during the transmission and distribution stages cause very big losses.[28] The main reason for this situation is an insufficient investment. Under-pricing, and poor bill collection (around 40% to 60% of total potential revenue is lost) have been identified as the fundamental causes for this underinvestment problem.

Market structure and regulatory reforms

The energy sector is largely dominated by state-owned companies. In general, private firms have been cautious in entering the Indian energy sector due to the preferential treatment given to state-owned firms and the slow progress of tariff reforms. In 2005 the percentage of public ownership exceeded 75% in virtually all energy activities, from power generation to oil and gas production.

Coal India produces 85% of domestic coal whereas the Oil and Natural Gas Corp. and Oil India Ltd. are the dominant players in the upstream oil and gas sectors. The Indian Oil Corp. is the largest firm for downstream oil whereas the Gas Authority of India Ltd. holds a de facto monopoly on natural gas transmission and distribution. All these companies are state-owned, as well as 85% of power generators. State Electricity Boards (SEBs), which are state-owned companies responsible for buying electricity from other companies and selling it to the final customers, account for 95% of retail electricity sales.

Notwithstanding this, recent regulatory reforms have helped increase the private participation, particularly in oil and gas. At present, private and foreign firms are allowed

[28] Although trending down, around one third of all the electricity generated is lost and this percentage is even higher in some states.

to participate in exploration and production (mainly through production sharing contracts) and private participation is also possible in downstream activities. According to the IEA, 14% and 20% of oil and gas exploration and production was under the control of private capital or public-private partnerships in 2005, as well as more than 25% of oil refining capacity.

Foreign investment is also allowed in the coal sector although subject to approval from the authorities and restricted to a 50% maximum stake. The Electricity Act of 2003 allows private investment and promotes competition by unbundling generation from transmission and distribution. However, progress in implementation has varied widely across states.

Another particularity of the Indian energy sector is the big number of actors sharing responsibilities for policy making (five different ministries and several government commissions and agencies). In addition, State governments have substantial responsibilities, especially in the power sector where the Indian Parliament cannot legislate over certain aspects. As in most federal systems, the states are responsible for implementing national laws but can also issue regulations applicable in their territory. Consequently, the progress of power-sector reforms and the diffusion of renewables vary widely among states.

Prices and energy efficiency

Energy pricing in India is chaotic. Most of the energy is sold at regulated prices and for those which are not there has been much speculation and arbitrary escalation. Subsidies are provided at the expenses of companies (mostly public but also private ones), incurring them in financial losses. Not only high subsidies fail to help the poor consumers but also disincentive energy efficiency practices and crowd out funds for capital investment.

The largest energy subsidies are for kerosene, liquefied petroleum products (LPG) and electricity.[29] According to the IEA, total subsidies amounted to USD 9 billion in 2006, both in the case of electricity and oil products. However, some reforms have already been undertaken in gas and electricity and the 11th Plan foresees phasing out subsidies on kerosene and domestic LPG except for those clients below the poverty line.

The highly distorted prices and the extended use of inefficient energy sources (such as biomass) are the main causes for the low degree of India's energy efficiency. Although the energy intensity (TPES/GDP, see table 1) has barely decreased since 1990, a significant potential for improvements exists as modern forms of energy become more extended, subsidies are banned and old industry and energy production infrastructure is refurbished or renewed.

Investment Outlook

India' energy needs may multiply by 3 or 4 by 2030. Energy demand is increasing very rapidly and shortages are already common place, especially in the power sector. The country will thus have to undertake a massive investment effort, not only in energy infrastructure (power plants, transmission and distribution networks, LNG terminals, pipelines, etc) but also in supporting infrastructures such as ports, roads and railways. The poor financial health of the public utilities suggests that public-private partnerships will become standard in the future.

According to estimations by the IEA, India will have to invest around USD 1.3 trillion until 2030, or roughly USD 60 billion per year (6% of the projected world energy investment). This investment will be needed both to expand supply capacity and to replace those supply facilities that are retired during the projection period. The oil sector will need around USD 179 billion on aggregate, more than 75% of it in the refinery segment. Gas will need around USD 60 billion, half of it in the upstream business and the rest to build LNG terminals and pipelines. Similarly, investment in the coal-mining industry will be close to USD 60 billion.[30]

But the lion's share of the energy investment will be taken by the electricity industry. Three quarters of the projected investment will be allocated to this sector, more than half of it going to reinforcing and extending the network. Achieving this rate of investment will be very difficult in the absence of a reform aimed at reforming prices, enhancing bill collection and management and reducing losses.

India's 11th Five Year Plan calls for a big expansion of transmission and distribution networks and for roughly 100 GW new power capacity to be installed between 2007 and 2012. The Planning Commission estimates the total cost at USD 245 billion (70% more than the volume planned for the transport sector). More than 50% of the new generation will come from coal, 15% for large hydro and 13% for other renewables.

Compared to the 21 GW built during the previous five year Plan, this new target represents a huge challenge. In spite of spectacular failures to meet the targets of previous plans (the 10th plan only achieved half of its target), industry and government are confident that things will be different this time because there is the recognition that power is absolutely necessary for sustained GDP growth in the future. The long-term goal is to increase capacity from the current 146 GW to more than 500 GW by 2030.

[29] Notwithstanding this, due to heavy taxation, final oil products are usually more expensive than the OECD average.

[30] Coal mining is much less capital intensive than the other energy sectors.

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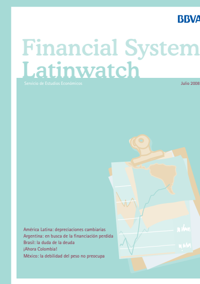

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