PANORAMA COUNTRY RISK

The Coface economic publications

Fall 2012

FOCUS INDIA

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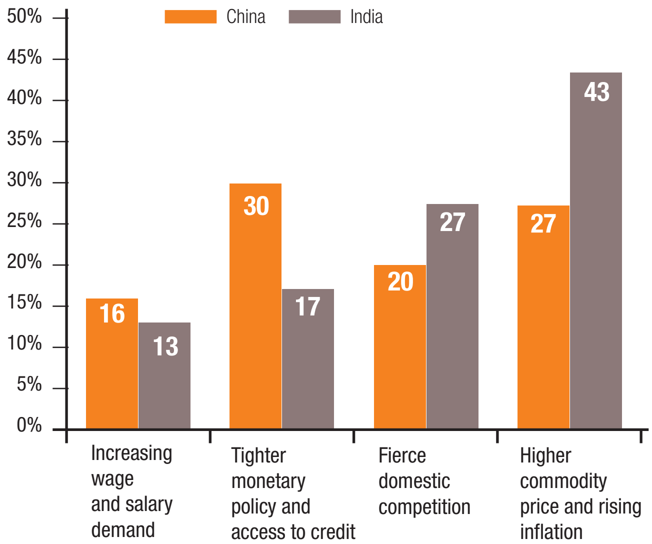
Economic slowdown
Companies hampered by slow pace of reform

The Indian economic engine is sputtering but continues to run: it suffers from persistent bottlenecks that the country and its companies have to contend in order to grow. Growth was only 5.3% in Q2 2012, its lowest level in nine years. Nonetheless, the effective implementation of reforms, which could open the country to a new cycle of vigorous growth, remains uncertain in view of political paralysis, making companies the potential collateral victims of these gridlocks.

In 1991, India experienced a currency crisis, which was at the origin of a wave of structural reforms that has allowed its economy to grow by an average of nearly 7% over the past 20 years (and by as much as 9% between 2004 and 2007). Today, India is confronting similar challenges: high budget deficit (almost 6% this year compared with over 8% in 1991) and current account deficit (about 3% in both cases). As in 1991, the current economic slowdown is pointing up structural weaknesses in the economy. However, India benefits from a relatively low degree of openness which makes it less vulnerable to external shocks and from a robust services sector (55% of GDP). The decline in activity is clearly in part due to the tightening of Indian monetary policy between March 2010 and October 2011, which penalises investment and credit. However, it also reveals the bottlenecks the economy suffers from, such as the lack of infrastructure and skilled labour, as well as persistent shortcomings in terms of the business climate. Economic recovery, in particular company investment, depends on the implementation of far-reaching reforms which political paralysis is making difficult and uncertain. How does this environment affect companies? How do these shortcomings act as a brake on corporate growth? To answer these questions, we rely, in particular, on the results of a survey of Indian businesses carried out by Coface India [1].

Key concerns for 2012



Source : Coface India

(1) Survey of 988 participating companies carried out by Coface India in December 2011 to study their payment behaviour and record their concerns for 2012.

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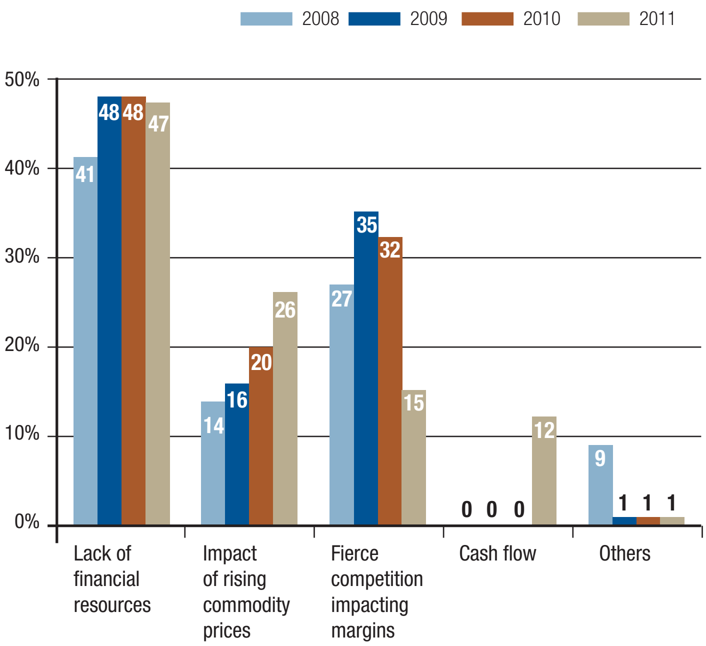
Concerns in the business sector about higher commodity price, rising inflation, fierce domestic competition …

India's energy dependency explains why the external accounts are very vulnerable to commodity prices, notably those of oil and coal used mainly for electricity production. The country does, however, have large coal deposits, but they have not been able to meet the rise in domestic demand of recent years. India therefore imports three quarters of its oil consumption, which represents 31% of imports in 2010/11. High oil prices (average price per barrel of Brent expected to reach $113 (2) in 2012 against $108 in 2011 and $80 in 2010) combined with the depreciation of the Indian rupee will increase energy costs for companies. This will affect their margins and lead to a rise in payment incidents.

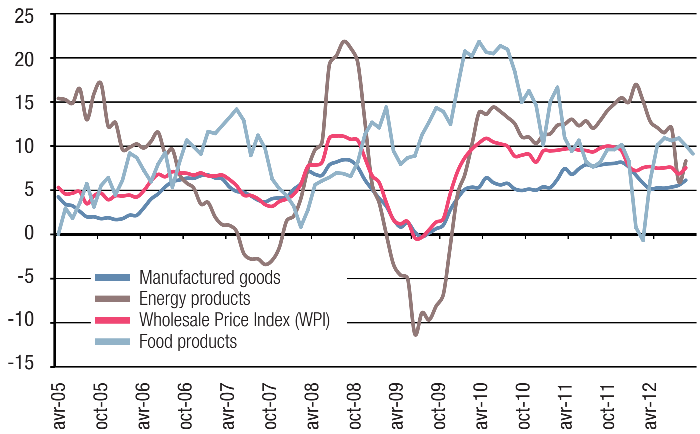
Main origins for buyer financial difficulties



Source : Coface India

High commodity prices contribute to the rise in imported inflation. But India also has a problem of structural inflation generated by a shortage in supply on the foodstuffs market. The emergence of a middle class has provoked and continues to provoke higher demand for food products, whereas there is only very slow progress in agricultural productivity. This situation is, moreover, exacerbated by an inefficient food distribution system. High inflation and the resulting volatile food prices have a knock-on effect on manufactured goods and services because of second-round effects linked to rising wages. The Wholesale Price Index (3) (WPI) remains relatively high (7.8% in September 2012) and in September the new Consumer Price Index was up by 9.7% over one year. With production costs rising and margins narrowing, this puts pressure on company investment decisions.

Inflation evolution



Source : Datastream

According to Coface India survey, 27% of companies reported that their difficulties had been compounded by strong domestic competition. Nonetheless, only 15% of companies surveyed in 2011 (versus 32% in 2010), reported that fierce competition was at the origin of the financial difficulties of their clients in default. This number reached 24.6% in China. But in China, overcapacities make local competition more intense, which seams to be less the case in India

… tightening of monetary policy and difficulties accessing credit…

Between March 2010 and October 2011, the Reserve Bank of India (RBI) raised interest rates thirteen times, which hit access to credit and consequently dampened company investment. These rate hikes were carried out in a context of high inflation. In response to the marked slowdown in growth, the RBI then slightly loosened its monetary policy in 2012: cut of 0.5 points in April in its main refinancing rate (8%) and two consecutive cuts of 0.25 points in September and October in the bank reserve requirement to 4.25%. This notwithstanding, key rates remain relatively high, reflecting the RBI's prudence in the face of the potential repercussions of recent American quantitative easing (4) on food prices and predicted rises in oil barrel prices. That is all the more true at a time when the price of diesel rose by 14% after the cut in subsidies announced by the government on 14 September 2012. Indeed, this measure amounts effectively to a 0.7 percentage point rise in inflation, as diesel represents 4.7% of the consumer basket.

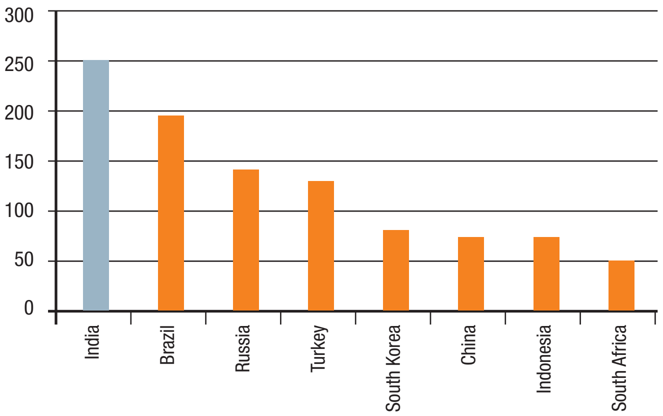
(2) Coface estimate.

(3) Inflation in India is measured by the Wholesale Price Index which is still the case despite the publication since 2011 of a new Consumer Price Index (based on year 2010).

(4) The Fed announced its fourth (with the Opreration Twist) economic stimulus plan (QE 3) on 13 September 2012, without specifying its duration or scope *(until labour market prospects improve)*.

But, apart from this monetary policy retightening, companies' persistent financial problems are mainly due to structural reasons. Indeed, the system of priority sector lending compels domestic and foreign banks [5] to grant 40% of loans to sectors deemed by the government to be a priority on account of their social and economic impact. These are chiefly the agricultural sector and small manufacturing businesses. They represent the majority of companies and job concentration (84% of manufacturing jobs compared with 25% in China) but account for only a third of total production.

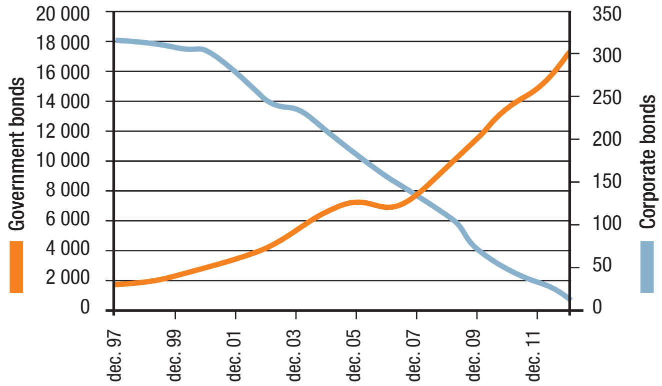
India: Comparison of firms debt to equity ratio (in %)



Source : FMI

Furthermore, company investment is heavily dependent on access to the international capital markets, a sign that the development of the domestic financial market is still limited [6]. Accordingly, it is mainly the large companies that access the international financial markets and raise increasing amounts of debts, thus contributing to the sharp increase in Indian external debt which has risen by 27% in absolute value in three years. This trend is enhanced by the fact that local banks are compelled to hold government bonds, up to 23% of the bank's net outstanding demand and term liabilities. This constraint limits the capacity of large companies to issue local currency bonds. This situation explains the vulnerability of Indian companies to capital flight (portfolio investments) in the context of economic and financial tensions in the euro zone.

Holdings of government and corporate bonds by Indian banks (billion rupees)

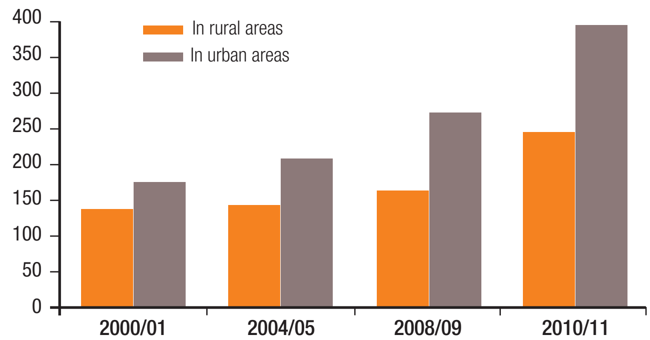


Source : Datastream

... rising wages...

In India as in China, wages have risen strongly in recent years, which has squeezed company margins and affected investment decisions. While in China these rises are steered by the government (wanting to support the Chinese consumer), in India it is the lack of a qualified workforce which is driving up salaries for the most qualified. Shortcomings in the area of education are significant: the literacy rate in India is 63% compared with 90% in China.

Average wages in rural and urban areas (in rupee per day)



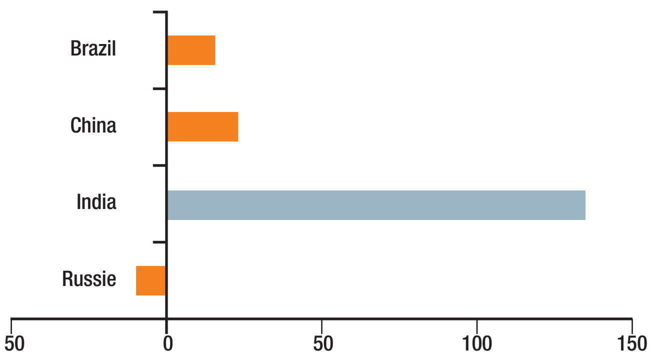
Source : Datastream

(5) In July 2012, the RBI announced that foreign banks (with at least 20 subsidiaries on the Indian territory) had to comply with this rule.

(6) Kiichi Tokuoka, "*Does the business environment affect corporate investment in India?*", IMF, March 2012.

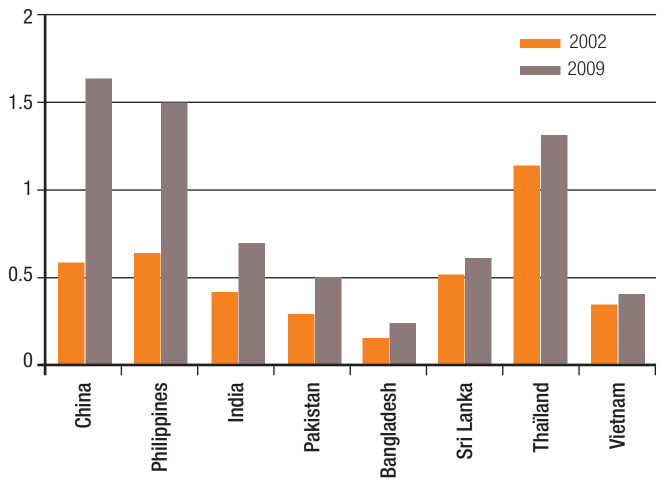
India, however, has the advantage of dynamic population growth whereas the Chinese authorities worry about an ageing population. Wage rises in China are likely to intensify in the years to come, as the economically active population falls, which is not the case in India.

Projected working population growth for 2010 to 2020 (million of persons)



Source : United Nations

Hourly labor cost in the industry ($) (million of persons)

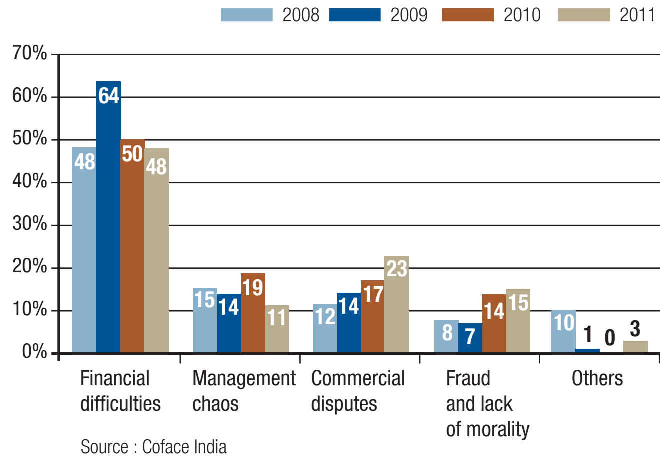


Source : Datastream

… infrastructure shortcomings and a difficult business environment.

In 2011, 26% of companies referred to “management chaos” and “fraud and lack of morality” as the origin for payment arrears. These concerns reflect the presence of several bottle-necks specific to India.

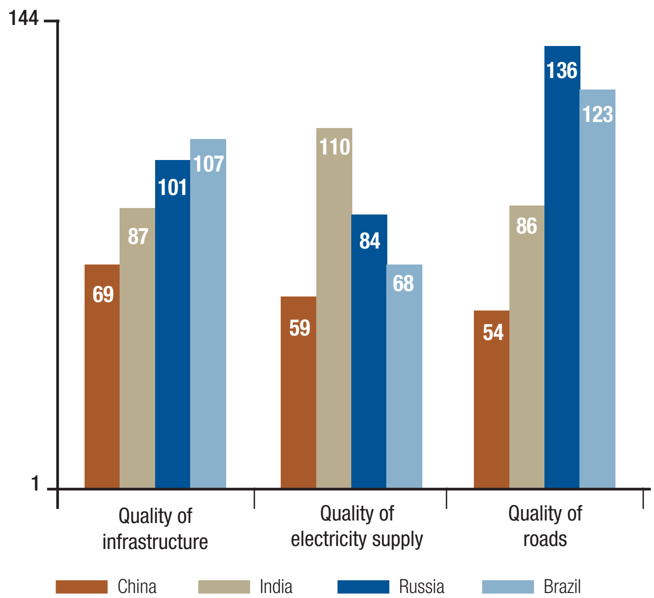
Payment defaults and the business environment weaknesses



Source : Coface India

First, India suffers from a lack of infrastructure, which hampers company operations and dissuades both local businesses and potential foreign investors from investing. In general, the quality of infrastructures in India is well below that of China. The electricity sector is particularly failing: blackouts are very frequent and at times massive, as illustrated by the general power outage in the summer of 2012 (600 million people left without power). Furthermore, the capacity shortages -both in the transport and distribution of electricity- place India far behind the other BRIC countries in terms of quality of supply.

Ranking of the BRICs according to infrastructure quality (the higher the index, the worse the quality)

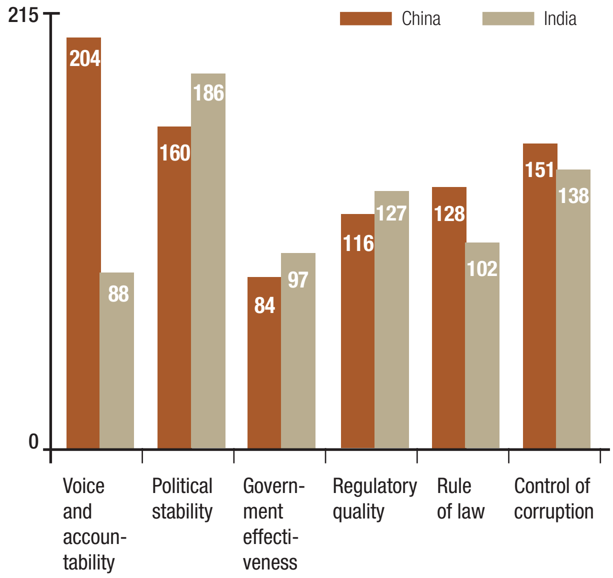


Source : Global Competitiveness Index, World Economic Forum

Second, several governance indicators point to persistent failings in the quality of the regulatory framework and a very high level of corruption, to the point that this prompted a huge protest movement marked by the use of hunger strikes by some activists like Anna Hazare. Foreign investors worry, notably, about a worsening quality of regulation (7) and about recent protests provoked by the government announcement 14 September over the opening up of the aviation and retail to foreign investors. Indeed, as was the case last year, the government could again postpone implementation of these reforms. However, the implementation of structural reforms attracting higher volumes of foreign direct investment is a necessary condition for curbing India's external (balance of payments) and internal (bottlenecks) imbalances.

Finally, the risk of political inaction remains high. The demonstrations in September were supported both by the opposition parties as well as by certain members of the governing coalition, anxious about the impact of these reforms on public opinion with local and parliamentary elections due in 2013 and 2014 respectively. At the beginning of this article, we referred to the currency crisis in 1991, which pushed the Indian authorities to undertake far-reaching economic reforms. In contrast, today the concerns of international investors regarding the Indian external imbalance led to only a temporary depreciation of the rupee rather than a fall in the currency resulting in a foreign exchange crisis. Indeed, the exchange rate has stabilised over the past four months. While these initial measures have allowed a currency crisis to be averted in the short term, they need to be implemented and followed by more reforms if the Indian economy is to embark on a new cycle of vigorous growth.

World Bank governance indicators
(the higher the index, the worse the governance)



Source : World Bank

(7) Postponement of the reforms on land acquisition laws and of the proposal concerning the retrospective application of a tax on *offshore* transactions of Indian assets.