Rabobank

Special Scenario Studies

INDIA 2020

Rise of the elephant

Photo courtesy: THE GENIUS OF THE ELEPHANT IN OVERCOMING DIFFICULTIES
Series of water colour paintings by Sir Robert Baden-Powell in Memories of India (1915), Chapter XIV, The Elephant as Gentleman.

Author: **Robin de Milliano**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-62768
R.Milliano@rn.rabobank.nl

(Page intentionally left blank)

MANAGEMENT SUMMARY

- In recent years, the Indian economy has shown an **excellent growth performance** with annual growth rates closing in on 9% per annum, a Chinese style growth rate. The rise of the elephant should come not come as a surprise, however, since India is merely reclaiming the role it played throughout much of history. Hence, it better be dubbed **a remerging market**.

- Even though India has an established reputation as a destination for outsourcing services, only in recent years has the country's full **economic potential** been in the spotlights. Several decades from now, India may have overtaken Japan and the four largest European economies, as the **world's third largest economy**, behind only China and the United States.

- Also on the demand side, the Indian market offers a tremendous upward potential. As spending power will rise dramatically, aggregate consumption is expected to quadruple to more than USD 1.5trn. Over the next two decades, India's middle class will grow more than tenfold to become the **world's fifth largest consumer market** with almost 600 million consumers.

- The living standards of the average Indian, however, will continue to lag behind its peers. To have the economic expansion deliver tangible benefits to the rural poor, the all-encompassing **long-term policy challenge** is to lift the structural growth rate and "**make growth inclusive**". The Millennium Development Goals provide a suitable policy anchor. So far, progress appears on target, but implementation is uneven.

- In order to sustain higher growth rates, Indian policymakers will have to develop multiple growth drivers and tackle the country's **structural challenges**. A key challenge is to **boost agricultural output** and **develop the food supply chain**. This requires investment in inputs, irrigation, transport links, warehousing, food processing and distribution with an important role for specialised financial intermediaries.

- Another major challenge concerns the poor state of the country's physical infrastructure. Frequent shortages make utilities like electricity and water unreliable and transport services are substandard in terms of price and coverage. The government's intentions are ambitious, but upto 2010, outlays are estimated to run about USD 123bn short of planned investment. To **overcome its infrastructural deficiency**, private sector involvement is essential. India offers public-private partnerships attractive to financial service providers that have expertise in project finance.

- A further challenge to the Indian authorities concerns the **delivery of public services**. This may cover an array of governance issues such as slashing corruption and cutting red tape, but also pertains to shaping up the country's health and education systems. Especially the latter is essential if India is to cash in its demographic dividend. **Labour market reform** would assist in creating employment and containing a war for talent. The success rate on most of these issues will depend on the government's financial resources, popular support and final implementation of its policies, but its overall policy direction is encouraging.

- Finally, a further **consolidation of public finances** would discharge the vast pool of captive savings and free up capital for more productive use. Currently, financial intermediaries use about 70% of the net savings they receive from households and foreign investors to finance the public sector. Fiscal reform is making headway, however, and the central bank has laid out a roadmap to **release the financial sector**.

- Whether India will be able to sustain significantly higher rates of economic growth well into the future will depend on assumptions about its economic structure and the success rate of government policy in steering the economy and addressing its structural challenges. This report envisions **four growth scenarios upto 2020**.

Summary growth scenarios

Scenario	Key assumptions	Outcomes 2020			Likelihood
		Real GDP (in bn USD)	Structural growth (10y av)	Real GDP per head (USD)	
I – Stable expansion	Growth acceleration sustainable	2,730	10%	2,128	30%
II – Cooling down	Growth acceleration unsustainable, policy contraction effective	2,326	8%	1,813	45%
III – Overheating	Growth acceleration unsustainable, policy contraction ineffective	2,106	7%	1,641	20%
IV – Adverse shock	Severe external distortion	1,683	6%	1,312	5%

- Even though the **stable expansion** scenario is the **most desirable** outcome, we believe the **cooling down** scenario is the **most likely** outcome, since this scenario is in accordance with the policy direction of balancing growth and inflation. The first signs of policy contraction cooling down the economy are already visible. If, however, too little progress is achieved in addressing the economy's structural challenges or policy contraction proves too little, too late, demand growth may run into supply constraints in the not-too-distant future. The potential unfolding of the **overheating** scenario risks a **suboptimal** outcome. The **adverse shock** scenario describes a **worst-case** scenario in which most of India's recent progress would be undone.

- Despite the daunting challenges India is facing, the country has a **tremendous upward potential**. In recent years, it appears to have found the stability and momentum to make real progress towards realising this potential. Since **most lights have turned to green**, therefore, the advice to any international firm should be to at least **consider an India strategy**.

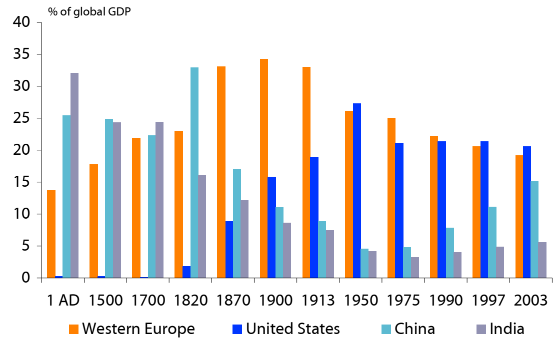
CONTENTS

INTRODUCTION – RISE OF THE ELEPHANT

Remergence of a giant

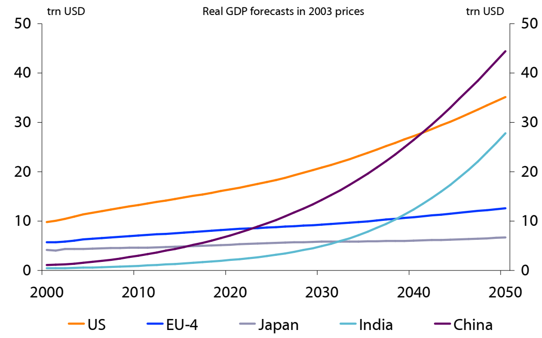
With over one billion inhabitants, 3.3 billion square kilometers of territory and 22 official languages, India is often said to be more of a continent than a country. The diversity in its dimensions is enormous: politically, economically and socially. As one of the cradles of humanity, the Indian subcontinent has a long and rich history. Colonisation and economic planning have caused it to underperform in recent centuries, but much like China, India is now on the way back to reclaim its place as a heavyweight in the global economy. Following the projections of the renowned Goldman Sachs report *"Dreaming with BRICS"* of 2003, India may have overtaken Japan and the four largest European economies by 2040, ranking the world's third largest economy behind only China and the United States.

Chart 1: India is a remerging market…



Source: Angus Maddison, Rabobank Nederland

Chart 2: … to become an economic heavyweight



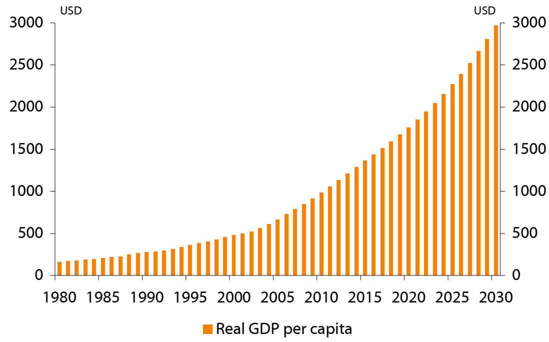
Source: Goldman Sachs, Rabobank Nederland

The Goldman Sachs report grouped together Brazil, Russia, India and China as "BRICs" by heralding the four countries for their enormous growth potential. Their common denominator consists of lagging standards of living, progress on economic reforms and a rich endowment of production factors, such as natural resources and labour. However, there are important differences in their economic structures and development prospects. A large part of Russian and Brazilian growth is to be traced to benevolent commodity prices. If these fortunes fade, their weak economic structures may appear to have improved disappointingly little. The case for India and China is rather different. They have in a sense "taken on" the West with the objective to regain the role in the world economy that they once played. To this end, these countries are overhauling their economic systems so that they will be able to compete for intellectual, financial and human capital on a global scale. Through its growth model of manufacturing for exports, China's rise as an economic powerhouse has long been established, but for long, India has only been in the spotlights for its diligence in services. It may well aspire to become the world's back-office, but has all the reason to look beyond. In recent years it finally found the growth impetus that its economy requires to catch up with its peers. To put living standards on a par, however, it still has a long way to go.

Growth imperative

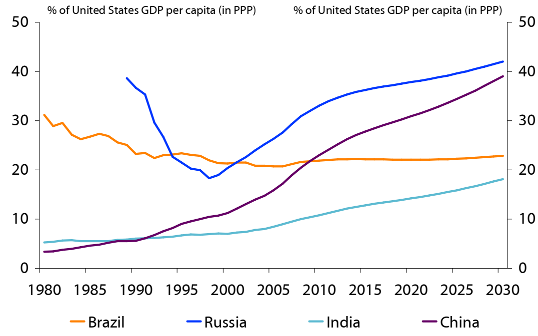
Ever since the current prime-minster, then finance minister, Manmohan Singh commenced reforms following the balance of payments crisis in 1991, the Indian economy has significantly upgraded its performance. It left the lethargic "Hindu growth rate" that endured during the era of economic planning and embarked on a growth path reminiscent of China's economic remergence. In recent years, India's economic perfomance has truly become of Chinese order with real growth rates accelerating to more than 9% in 2006.

Chart 3: Standards of living are improving…



Source: EIU, Rabobank Nederland

Chart 4: …but have a long way to catch up

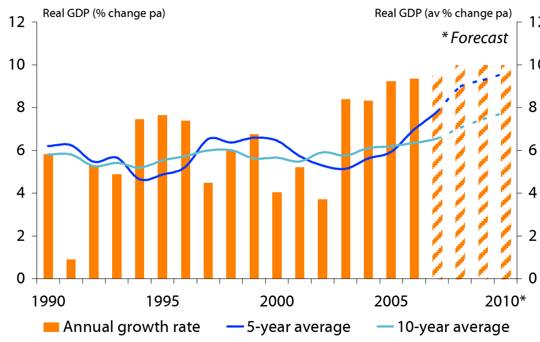


Source: EIU, Rabobank Nederland

Whether India will actually manage to achieve a double-digit growth rate, as predicted by finance minister Chidambaram, depends on the country's response to the challenges it faces. The government's all-encompassing challenge is to have the economy's expansion deliver tangible benefits to hundreds of millions of rural poor. Chart 3 shows that overall living standards are improving rapidly, but the division of wealth is very uneven. About a third of all Indians still lives below the poverty line. This implies that, in terms of purchasing power parity, about 350 million Indians have to get by on a budget of 1 USD per day. The long-term policy imperative, therefore, is to make growth "inclusive", so that economic growth will come to raise the standards of living of the rural poor.

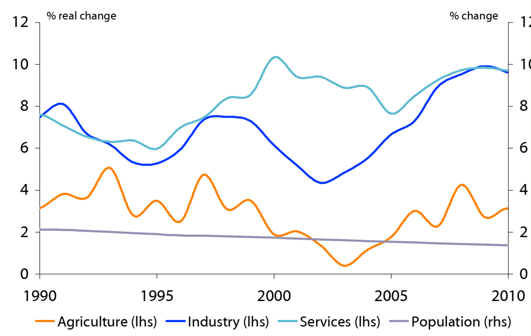
The only way to lift millions of Indians out of poverty is to raise the economy's structural growth path. This implies that India's growth acceleration is to be sustained over a longer time horizon. For this to happen, the economy needs to develop multiple growth drivers and resolve the bottlenecks restraining them. Over the last ten to fifteen years, economic growth has concentrated in the services sector, where the information technology (IT) and business process outsourcing (BPO) industries have led the way. Only in recent years has manufacturing output advanced substantially. This is important because industry has the propensity to create jobs and draw in portions of India's 130 million surplus workers in rural areas. Crucial to lifting the standards of living of most Indians, however, is unlocking agricultural growth. So far, it has only marginally outpaced population growth. Since about 60% of the workforce is dependent on crop revenues, boosting agricultural output is a policy imperative. Next to promoting "inclusive growth", the government will also have to remove more of India's bottlenecks, such as its infrastructure deficiency, weak public finances, energy dependence, ongoing state interference and failure in public service delivery. Fortunately, India also boasts many strengths. It has a young, competent and ambitious labour force, a competitive private sector and a strong entrepreneurial spirit. Furthermore, it can rely on sound institutions for policymaking and enjoys an excellent external financial position. The unfolding lift in measures of the economy's structural growth rate (see Chart 5) suggests that nowadays India is truly making headway.

Chart 5: Structural growth is gearing up…



Source: Rabobank, Ecowin

Chart 6: … but has yet to include agriculture



Source: Rabobank, Ecowin

MEET INDIA

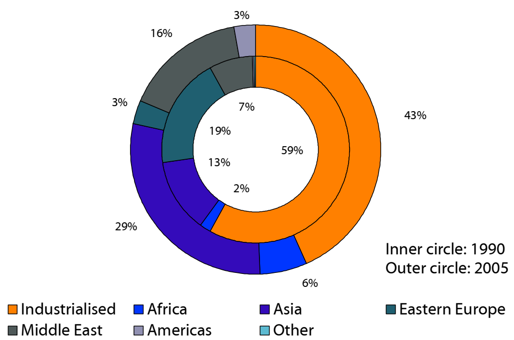
Political landscape

Ever since its independence from the United Kingdom in 1947, India has upheld democratic principles. As the Indian judicial system was drawn from the British, the constitution of the Republic of India guarantees fundamental rights and civil liberties, such as equality before law and freedoms of speech, expression and religion. Even though such rights are not always warranted in actual practice, or even deliberately compromised for sake of stability, India is far less repressive than many of its peers.

During most of India's modern history, the Indian National Congress party (INC or Congress) has led government. But in 1994, the National Democratic Alliance (NDA) of the Hindu nationalist Bharatiya Janata Party (BJP) took over with a reform agenda that would liberalise the Indian economy and greatly enhance its economic performance. However, as the masses of rural poor saw little of the benefits, the reign of BJP lasted for only a decade. In the general elections of 2004, its "India shining" campaign suffered an unexpected defeat. This shows that even though Indian elections imply a mammoth operation (almost 700 million voters are invited to cast their ballots!), the Indian democracy functions well enough to discipline its policymakers. On the surface, India's political arena may appear untransparent and chaotic, but the system as a whole has proven it can weather a storm or two.

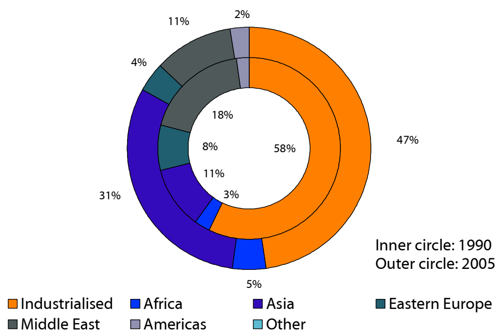
With the help of its leftist partners in the United Progressive Alliance (UPA), the Congress party returned to power in 2004, and has so far done a decent job. Prime-minister Singh is likely to complete his term, as he is strongly backed by Mrs. Sonia Gandhi, President of the INC. They are well aware that a push for policy reform will only survive if it results in tangible improvements in the living standards of millions of rural poor. Together, they are a strong tandem in which Dr. Singh leads the government and steers the country's reform agenda, whereas Mrs. Gandhi engages in party politics to keep the coalition together and sway public opinion. General elections, therefore, are not expected before 2009, and the UPA may very well earn another term. Given the rise in popularity of local parties, however, neither Congress nor the BJP may be able to gain a majority in future elections. This will imply even more political bickering and more distortionary policies directed at particular constituencies. So far, however, the successful local parties have neatly moulded in at the federal level by seeking alliances with the coalitions of either UPA or NDA.

Chart 7: Destination of exports



Source: IMF Direction of Trade Statistics

Chart 8: Origin of imports



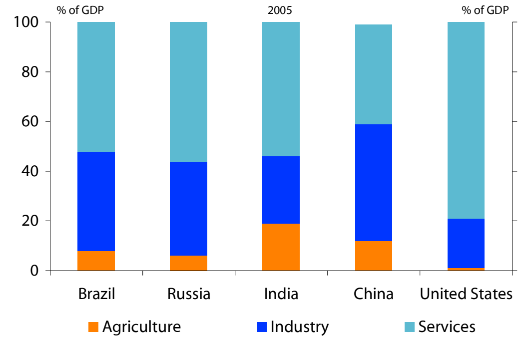
Source: IMF Direction of Trade Statistics

Internationally, India will continue to exercise caution in its foreign policy ambitions. Its role in global politics is lagging its role in the global economy. This is mainly because domestic challenges are far more pressing. India would first have to find solutions to its own border disputes with China and Pakistan. Relations with China have been slightly improving, as leaders on both sides exercise pragmatism in focusing on economic ties rather than political disputes. Although the conflict with Pakistan over Kashmir is far from solved, their rivalry has matured and poses less of a direct security threat. The controversial deal on nuclear cooperation between India and the United States signals that India has become an important ally in the region, both in economic and geopolitical sense. On the global stage, India and Brazil will continue to team up in voicing the interests of developing nations, which includes a tough stance towards the West in WTO-negotiations. The decreased dependence on foreign trade with industrialised nations (Charts 7 and 8) evidences India's broader economic development and reflects a changing balance of power in the world.

Economic structure

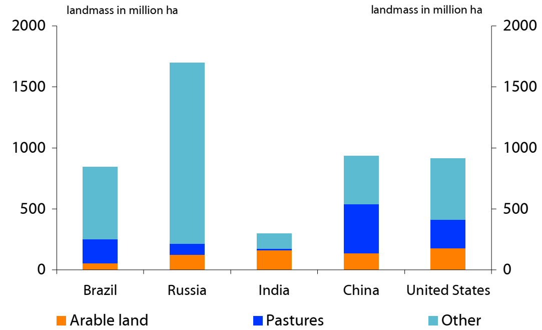
Even though the agricultural sector has been shown to underperform relative to industry and services, it plays an important role in the economy. It still accounts for 19% of GDP and earns the incomes of the majority of the population, albeit at the level of subsistence farming. Geographically, India is much smaller than the other BRICs, but since more than half of its landmass is arable, it nonetheless has an enormous potential for agricultural produce. In terms of natural deposits, India has its fair share, but is not as lavishly endowed as its peers. Plenty of mineral and metal ore deposits have been discovered, but remain largely undeveloped. If its full mining potential were developed, India could race to top 5 rankings on producer tables. Most of its hydrocarbon reserves concern coal, however, which is generally of substandard quality. This implies that India has to import no less than 70% of its energy needs.

Chart 9: Agriculture remains important sector



Source: EIU

Chart 10: India's landmass is small, but fertile

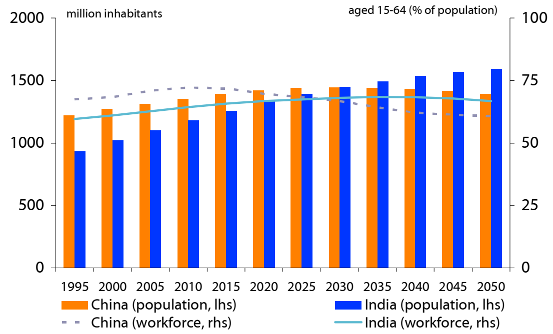


Source: UN Food and Agricultural Organisation

A great strength of the Indian economy is its labour potential. The Indian population is growing fast and will overtake China's by 2030. Since India's old-age dependency ratio shapes up favourably for the next few decades, the country does not face the consequences of population ageing long before China does. This phenomenon is often referred to as India's "demographic dividend". However, a large pool of labour as such is not a straighforward advantage, since India will have to create sufficient employment. Fortunately, India is well-equipped to capitalise on its population growth, since it has many high-skilled workers whose labour costs may act as a catalyst for investment growth. Educated job-seekers benefit from a good proficiency in Hindi and English, see little barriers to moving across the country and have a good, ambitious work ethic. Their employment conditions are rapidly improving, however, as salaries are rapidly increasing and job creation is doing well, particularly in services like IT and BPO. This has a distinctly positive effect on domestic demand, but it should be stressed that total employment in these sectors does not add up to more than 2 million. Therefore, if India is to cash in the demographic dividend and make growth inclusive, it needs to make work of creating substantial numbers of manufacturing jobs for the rural poor.

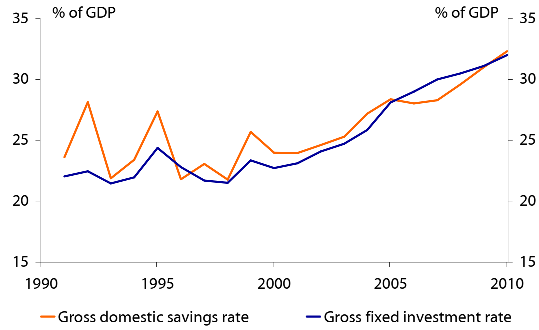
Currently, the Indian economy does not only benefit from a boost in confidence that spurs its growth momentum, but also from substantial improvements in structural indicators. Rising savings and investment rates, for instance, imply that more funds will be available for productive use. So far, the financial system does not yet allocate funds in an optimal way, but financial sector reform and development will ensure it to improve in the future.

Chart 11: Indians are many and young



Source: UN common database

Chart 12: Savings and investment swell



Source: EIU

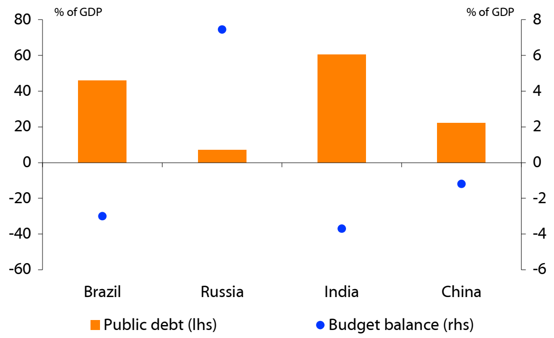
At present, the Indian banking sector is rather fragmented. No less than 90 financial institutions engage in commercial banking activities. The banks can be roughly divided into four categories. First come the large public sector banks, like the State Bank of India (SBI) and the Bank of Baroda. Their role can hardly be understated, as more than 70% of assets and liabilities in the sector belong to state-owned entities. They are large and bureaucratic, but reasonably capitalised and exposed to a secure line of business, government paper. In its drive for consolidation, the government stimulates the public sector banks to gear up, compete with private players and prepare for divestment. Second come the private banks, amongst whom ICICI and HDFC are the largest players. Their roots lie in corporate banking, but the private banks are rapidly building up branch networks to strengthen their retail arm. YES Bank, in which Rabobank holds a 20% stake, also aspires to be in this league. Third come the foreign banks. Hardly any international bank foregoes representation in India, but with only 7% of the market in their hands, they wield little clout. This is due to the regulatory requirements rather than lack of business opportunities, however. If the supervisory authorities would allow foreign banks to own meaningful stakes in domestic banks or roll out more of their own branches they would be more than happy to do so. Finally, there is a vast array of banks and credit cooperatives. Irrespective of their being urban or rural, local or regional, they are rather lemon than peach. Only few are well-capitalised with decent loan portfolios, but many are in need of financial restructuring.

The financial sector is supervised by both the Ministry of Finance and the central bank. The former is in favour of liberalising the sector, as its divestment from public banks will free up capital more, which may very well suit other purposes. The Reserve Bank of India (RBI), however, is more concerned about the stability of the banking sector and the financial system as a whole. In 2004, the RBI introduced a roadmap for reform to gradually liberalise the financial sector in accordance with the country's economic development. It is bound to allow more foreign involvement as of 2009, but it is not yet clear what the liberalisation will precisely consist of. It is likely to comprise a policy similar to China's in which smaller stakes in local banks are sold at a premium while keeping the majority vote firmly in public, at least domestic, hands.

Economic policies

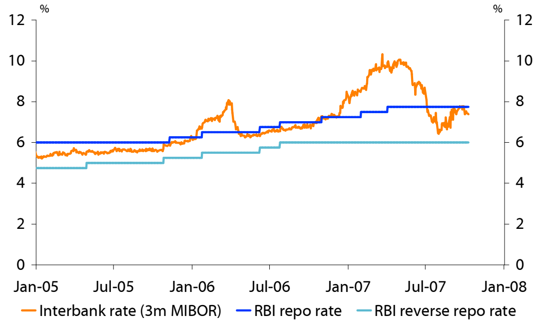
The coalition of PM Singh is on a mission of inclusive growth. His administration realises that economic liberalisation and development of the private sector is key to structurally higher growth. To maintain public support for his framework of economic policies, however, wealth has to spread beyond the metropoles. This results in a balanced policy agenda that includes both elements of liberalisation and social planning. Given the gargantuan bureaucratic system and considerable decentralisation of power, the implementation of reforms is often lethargic. At the federal level, policymakers can indicate the direction, but can hardly dictate the speed of reform.

Chart 13: Weak public finances



Source: EIU, 2006 data.

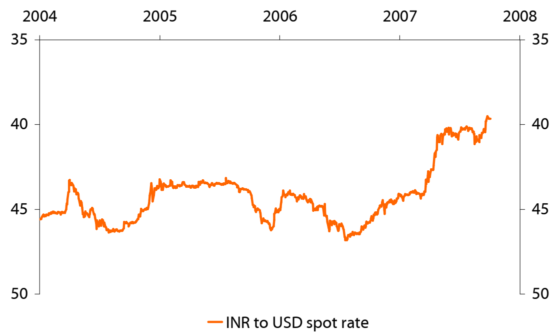
Chart 14: Monetary policy on track



Source: Ecowin, current as of 01/10/2007

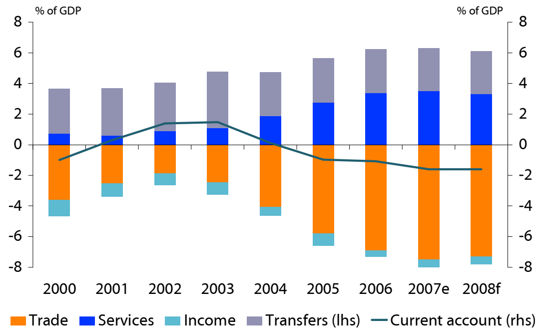
Indian public finances are a weak spot, as debt and deficit ratios are too high regarding its stage of economic development, and especially in comparison to its peers. Moreover, the figures of 60% and 4% of GDP (Chart 13) only concern consolidated records and may not take into account the liabilities and losses of local authorities and state owned enterprises. India's public finances are nonetheless proving sustainable, since the government has a very cautious attitude towards contracting foreign debt. Instead, the lion's share of public debt is financed on domestic markets by treasury holdings of state banks. The financial sector is regulated by an increasingly independent central bank, whose main objective is controlling inflation. In an effort to constrain price increases, the RBI has agressively hiked interest rates in recent years. Given the strength of India's export sector, the RBI has also come to show more appetite for currency appreciation and cut back intervention on foreign exchange markets.

Chart 15: Rupee on the rise



Source: Ecowin, current as of 01/10/2007

Chart 16: Slight current account deficit

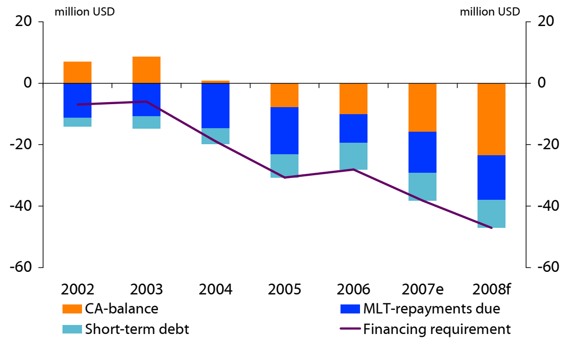


Source: EIU

External financial position

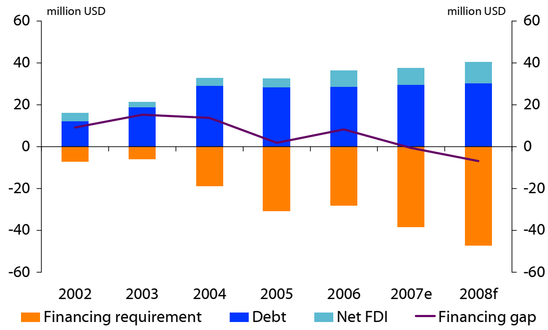
India's current account has come under pressure in recent years mainly because of the economy's hunger for investment goods and its thirst for expensive oil, which made its trade deficit increase. The services balance continues to post healthy surpluses, as India feeds well off tourism and the outsourcing of ever more activities by Western firms. The transfers balance benefits from significant flows of remittances by the Indian diaspora and overseas workers. Since these surpluses cannot match the merchandise trade deficit, however, India's foreign currency receipts run short of its expenses. This shortage is reflected in a growing financing requirement, which also takes account of repayments due on medium and long-term debt (both interest and principal) and the roll-over of short term debt (mostly trade credits). Most of India's foreign currency needs are financed by newly contracted debt obligations, but the role of net foreign direct investment (FDI) is increasing. A small financing gap appears luring (Chart 18), but this may easily be financed by attracting deposits from non-resident Indians and inward portfolio investment, which is left out of the equation here because of its volatile nature. Actually, the RBI is so confident in the country's external position that it currently promotes outward investment to relieve the upward pressure on the rupee.

Chart 17: Growing financing requirement



Source: EIU

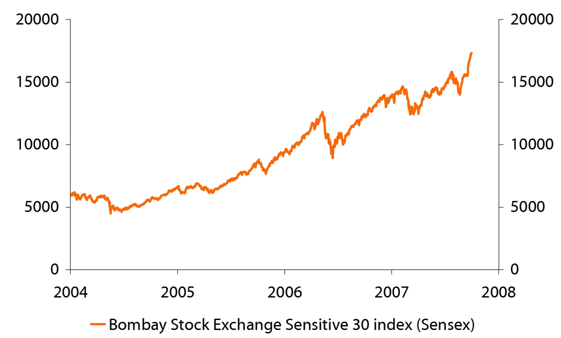
Chart 18: Sufficient sources of financing



Source: EIU

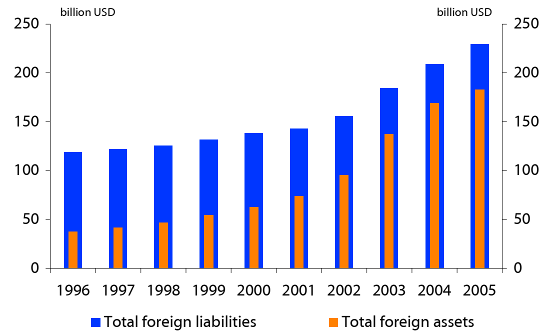
The strong appetite for portfolio investment in India is reflected in the booming sentiment on asset markets (Chart 19). Even if market sentiment were to turn around, India's external finances would not be under immediate pressure, because the country's international investment position has improved markedly since the turn of the millennium (see Chart 20). Today, foreign exchange reserves amount to more than USD 200bn and have come to overtake external debt obligations. In total, the latter amount to less than USD 150bn. Since this is no more than 15% of GDP and 60% of current account revenues, these figures underscore the government's cautious approach to foreign borrowing. Although this attitude may be criticised for being overly restrictive, its solid foreign debt position has served it well during the Asian financial crisis in the late 1990s. Overall, India's external finances are in an excellent shape and serve as a bedrock for further domestic development.

Chart 19: Strong sentiment on asset markets



Source: Ecowin, current as of 01/10/2007

Chart 20: Investment position improves



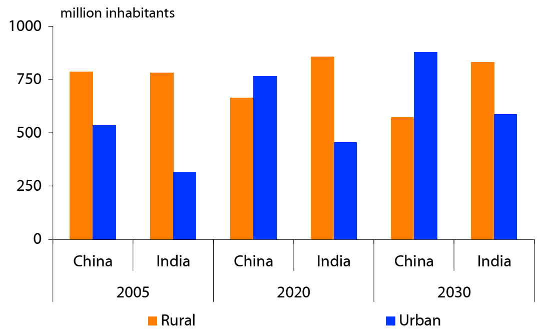
Source: IMF International Financial Statistics

KEY CHALLENGES

Make growth inclusive

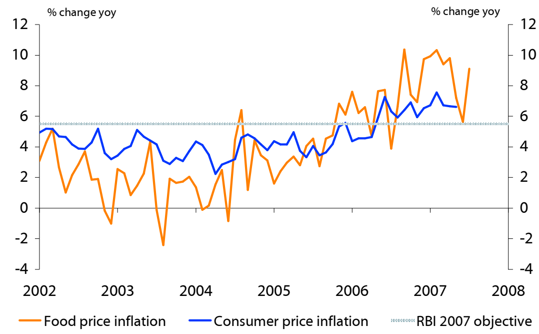
The dominant and all-encompassing challenge on the government's policy agenda is to ensure that the economic boom delivers tangible benefits to the rural poor. As a footing for policy, the authorities have embraced the Millennium Development Goals (MDGs). Given the size and poverty rate of the rural population, however, reaching these goals is not to be taken lightly. An immediate challenge is to reign in inflation of energy and food prices, so that the purchasing power of rural incomes increases. Furthermore, failures in the provision of public services, such as health and education have to be tackled. Another challenge is the poor state of India's physical and institutional infrastructure. Solving this is not only a matter of money, but also a matter of mentality. To leave less people socially excluded, much more employment has to be created and formalised. This requires a thorough revision of labour market institutions. The government should also pay attention to the financial consequences of spending on public services and utilities.

Chart 21: India will remain a rural society



Source: UN common database

Chart 22: Food price inflation is a policy priority



Source: Ecowin, current as of 01/10/2007

Boost agricultural output

The availability of food at reasonable prices is a pressing issue immediately affecting the lives of millions of rural dwellers. The government is well aware that its popular support is heavily influenced by the affordability of agricultural products. So, it frequently takes immediate measures to reign in bouts of unexpected inflation, such as reductions in import tariffs on foodstuffs. Sadly, shortages continue to drive up prices because harvests may fail and crops perish before they hit the market. Over the longer term, therefore, the agricultural sector requires much investment. One priority is irrigation, so that output becomes less dependent on adequate rainfall, but also transport links and warehousing need upgrading, so that enhanced connectivity and storage reduce waste of crops. Finally, the provision of rural credit should also be improved, so that farmers can live through a bad harvest without falling victim to loan sharks.

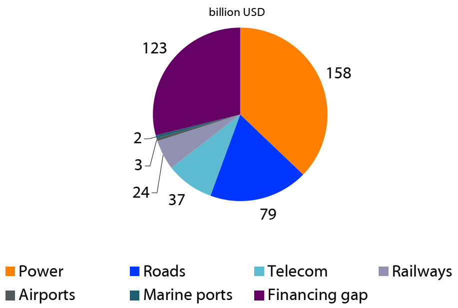
Part of the challenge for the government is to provide remunerative prices to farmers without incurring the additional burden of subsidies. This challenge could be addressed if the processing level and value addition of the agricultural raw produce can be enhanced to meet the growing demand for processed foods. Food processing would secure farmer incomes against a slump in prices, but also significantly reduce wastage by extending shelf-life. In addition, as a vibrant food processing industry would stabilise demand for agricultural output, farmers would more inclined to diversfy their crops. This, in turn, enhances supply. Agribusiness can play a significant role in tackling rural poverty. Aside from the impact on farmer incomes, food processing also leads to significant employment generation across the food supply chain.

Upgrade physical infrastructure

The infrastructure deficiency does not only bear on rural areas. Also in the main centres of commerce and industry, utilities like water and electricity suffer frequent shortages. No city in India can make water taps running around the clock. This is not due to inavailability of water, but because of failure to deliver. A similar diagnosis applies to power outages. There are too few power plants, and their efficiency level is precarious because of outdated installations and overdue maintenance. Furthermore, a third of generated electricity is lost from the grid owing to inefficient distribution and illegal tapping. Another fifth goes to farmers at highly subsidised rates. Also, transport links are not what they are supposed to be. The facilities of some sectors like aviation and shipping are being privatised quite successfully, but road and rail services lag behind. As a result, many infrastructural services, such as energy and transport are at least twice as expensive when comparing to China. This has a negative effect on the business climate and troubles foreign investment.

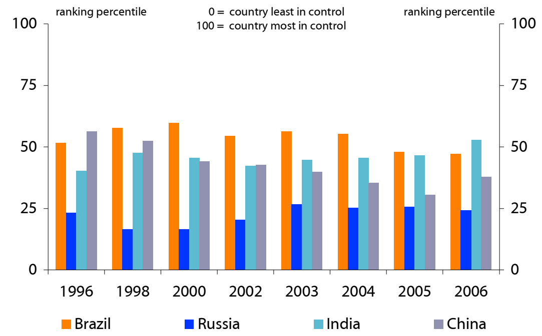
The government has laid out plans for investment in physical infrastructure, but the amount of funds available is dwarfed by China's, whose infrastructure spending is six to seven times higher. The World Bank estimates that government's investment plans upto 2010 run USD 123bn short of what the country really needs. This gap may be plugged by private investors, but this will be much more difficult to achieve for rail and road than for telecom and aviation. Commitments by foreign investors are rapidly increasing, but coming from a level that hardly makes a difference. To illustrate, India's total inflows of direct capital were less than USD 20bn last year. This sum pales to China's USD 78bn in FDI inflows during 2006.

Chart 23: Infrastructure investment plans upto 2010



Source: World Bank

Chart 24: Control of corruption ranking improves



Source: World Bank Governance Indicators

Decrease foreign energy dependence

Since India has to import 70% of its energy needs, it is rather vulnerable to the vagaries of international oil markets. Its terms of trade are heavily influenced by the oil price, and since oil markets are tight these days, the current account feels the squeeze. Furthermore, India faces a tripling of energy demand by 2020. This has not only led the elephant to roam the region, if not the planet, in search of strategic energy deposits, but also convinced the Indian government to spell out an energy diversification strategy. Be it oil, coal, gas, renewables or nuclear power, all options are on the table and their sector policies up for revision. Given the autorities' serious approach to the dossier, India's dependence on foreign energy sources is not likely to become a major obstacle to economic growth, but it could become an expensive nuisance when not adequately dealt with. More pressing though, is the state of its domestic energy infrastructure.

Empower the public

Being the world's largest, and one of its poorest, democracies is sometimes argued to stand in the way of economic development. Especially in comparison to the Chinese authorities, the Indian government may not be perceived to possess sufficient clout to adequately target the country's structural problems. It is not democracy, however, that is the problem, but rather its implementation. Especially at the local level, in rural towns and villages, Indian democracy boils down to political patronage. The ancient caste system is still vivid here and holds back people in their self-fulfilment. This is aggravated by an intransparent system of subsidies for basic necessities, such as food, water and energy. It creates dependent constituencies that lack the power to hold their suppliers accountable for delivery. This leads to a form of covert vassalage, which undermines the functioning of democratic principles. Despite this still being a significant problem, especially in rural areas, people are slowly-yet-steadily growing aware that it may be better to pay a decent price for a service that is actually delivered, than to stick with a gratuitous promise that remains unfulfilled. Real empowerment of the rural poor will take much time, but technological progress and the free media will speed up the process. The government could assist in improving the freedom of choice by deregulating more aspects of life. To illustrate, special quota for Dalits (i.e. untouchables or outcaste) appear conciliatory, but they decrease efficiency in the allocation of jobs and college seats. Political forces will determine, however, how many concessions need to be made.

Fight corruption and cut red tape

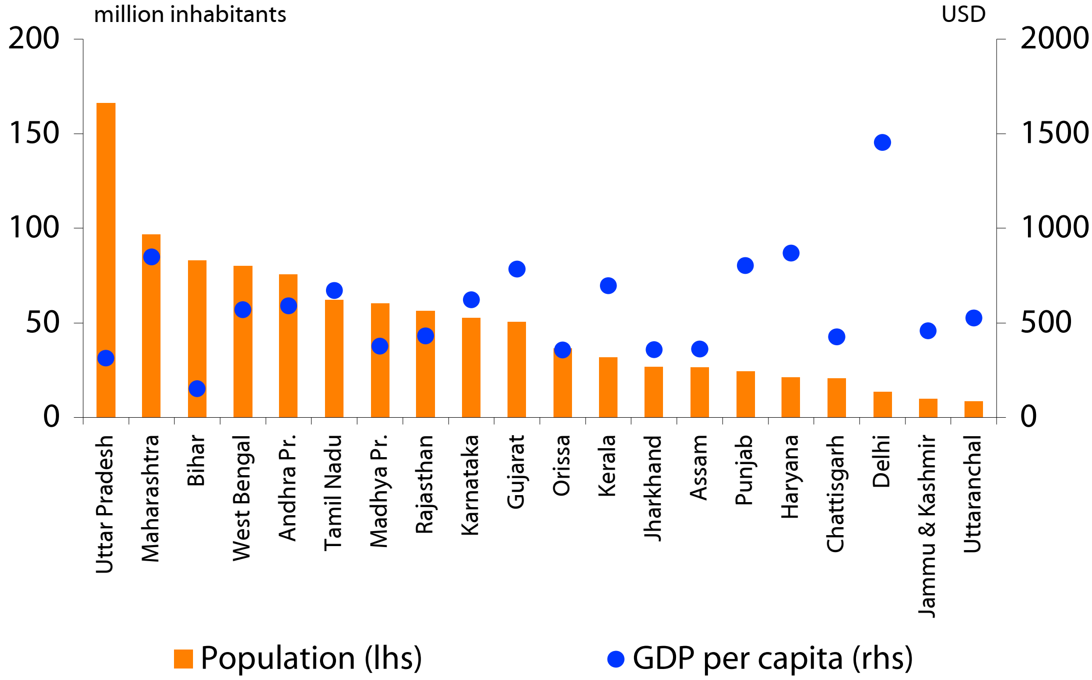
Generally, India's public institutions have a good reputation for independence and justice. The legal system is based on British law and the judiciary is of high quality. In actual practice, however, legal processes can be frustratingly slow. This also holds for the delivery of other public services. The problem is that public institutions suffer from a culture of "licence Raj". This term was coined to describe the difficult conditions under which the private sector had to do business in the planned economy that India chose to have from 1947-1990. The difficulty to obtain licenses under obscure regulations fed into corruption and graft, which is still around today. With almost 20 million employees, the Indian bureaucracy is vast and not easy to overhaul, but efforts to slash corruption and cut red tape are paying off. Chart 24 shows that India has come to outperform its peers in the World Bank's control of corruption rankings. When doing business in India, most corruptive practices boil down to day-to-day hazards in getting things done from local authorities. Companies are well-advised to price in such costs when seeking business in India. In dealings with private counterparties, corruption is less of an issue, even though Asian courtesy rituals are more enticing than the Western way of doing business. From a corporate social responsibility perspective, obviously, one would rather stay clear of high-level corruption, cronyism and outright bribery.

Improve public service delivery

Progress on the attainment of the Millennium Development Goals (MDGs) has been on target, but given the seriousness of India's poverty credentials, much remains to be done. The government has launched various programmes such as the Sarva Shiksha Abhiyan (SSA) for primary school enrolment and the Mid-day Meal Scheme (MSM) to improve child nutrition, but their effectiveness depends on implementation at the state level. The southern states, like Karnataka, Kerala and Tamil Nadu are performing well, whereas the more populous northern states like Uttar Pradesh, Bihar, Rajasthan and Madhya Pradesh are lagging. Income inequality across states (Chart 25) and a luring rural-urban divide will remain important in India's anti-poverty struggle.

A major challenge for the country's health services is containment of HIV/Aids. Last year, a report by the UN put the figure of infected cases at 5.6 million, which could mushroom to 20-25 million by 2010. An epidemic of this magnitude could knock as much as 1.5% off the structural growth rate by eroding the country's labour potential. The government, however, has agitatedly held the view that prevalence rates are much lower and received backing by this year's UN review. Owing to a more representative testing methodology, the figure of infected cases halved to 2.7 million and the prevalence rate dropped from 0.9% to 0.31%. Notwithstanding the importance of this good news, there is no place for complacency, however. Reporting will remain controversial and India still ranks high among the world's most affected countries. Moreover, the fact that the vast majority of HIV-bearers is unaware of their infection complicates prevention efforts. The government realises it remains a significant problem, and has freed up additional funds to contain this and other pandemic diseases.

Chart 25: Much diversity in living standards across India's 20 most populous states



Source: CSO, population data of census 2001, GDP data of 2003.

Failures in service delivery also occur in education. Even though 7 million secondary school students and 3 million university graduates complete their programmes every year, according to a report by McKinsey, only a fraction possesses the skills required by the labour market. This varies from 25% for engineers to 15% for the financial sector and only 10% for graduates in "general" programmes. The reason is that the Indian educational system faces a trade-off between quantity and quality. The sheer number of pupils implies that teaching is mainly done in a formal setting with students barely picking up practical skills. To illustrate, only 3% of India's secondary school students receive vocational training, whereas 52% of China's does. The potential shortfall in skills risks eroding India's competitive advantage in cheap, well-educated and English speaking labour potential. Because of the MDGs in universal school enrolment and adult literacy, government spending is mainly used for primary schooling. Higher education, therefore, needs more private sector involvement. For companies to commit greater resources to training, however, they would like to see employment restrictions lifted.

Reform labour market institutions

Management surveys repeatedly show that India's extremely restrictive labour regulations are viewed as a hurdle to higher growth. 40% of India's firms consists of so-called "mom-and-pop" shops of five to nine people, since companies with more than one hundred employees have to seek approval from the authorities to lay off workers. This implies that seasonal and cyclical businesses are very hesitant to hire workers during upturns. These are precisely the sectors that have employment opportunities for the poor and illiterate. The government's rural employment guarantee scheme that promises a minimum of 100 days' work at the minimum wage to every poor household, would be happily supported by many corporates if only they were able to stave off excess employment when necessary.

Consolidate public finances

Indian public finances form a serious drag on economic growth, as they hold private savings in a suffocating embrace. Chart 13 showed India's public finances at the federal level, but if one also includes budget deficits of state governments and the quasi-fiscal losses of state-owned enterprises, debt and deficit levels are of a different order. The overall budget deficit will more likely be somewhere between 8% and 10% of GDP. When including contingent liabilities of the financial sector, total public debt could be in the order of 80% of GDP. In addition, the central government still has a primary deficit, which implies that it has to borrow even to fund current expenditures.

In 2003, the central government committed to the Fiscal Responsibility and Budget Management Act (FRBMA), but since India's federal constitution grants the states a far-reaching autonomy, enforcing fiscal discipline is not an easy task. However, the FRBMA appears to work, as the states have followed suit. Furthermore, tax reforms, such as the introduction of VAT, have boosted revenues and compliance.

Release the financial sector

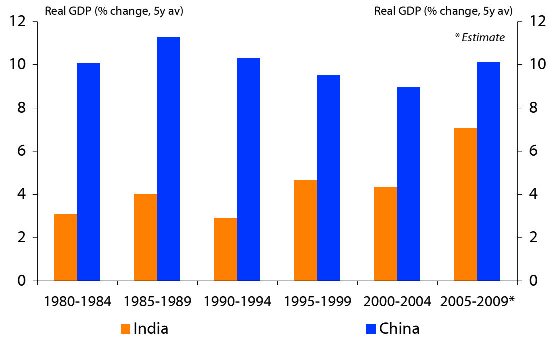
In order to finance public debt obligations, the government heavily influences lending and investment decisions. McKinsey estimates that regulations for financial intermediairies imply that 70% of the net savings they receive from households and foreign investors flows into the public sector. About a quarter of banking assets consists of government paper. For pension funds, the proportion of government securities to total assets runs upto 90%. The huge pool of captive savings ensures that the government can fund its debt obligations at bearable rates, but it takes out the market mechanism ensuring an efficient allocation of available funds. The fact that Indian corporates finance 80% of their investment out of retained earnings confirms that the public sector crowds out the private sector. Since Indian firms get better rates abroad, domestic capital markets remain rather shallow. Its corporate bond market, for instance, measures just 2% of GDP. The total stock of bank deposits, bonds and equities amounts to only 160% of GDP in comparison to 220% of GDP for China.

Besides banking, such drawbacks also hold for financial markets, as investments by insurers, pension and mutual funds are also heavily regulated. India has to find the courage to deregulate the financial system, deepen capital markets, and broaden asset makets. Then, a more efficient allocation of savings would further lift the structural growth rate. Greater foreign involvement would add to the pie. So far, the RBI has adopted a gradual approach to financial liberalisation in which it, quite rightfully so, does not wish to jeopardise stability. In the debates on full capital account convertibility and investment possibilities of official reserves, it does not deem the cushion that USD 200bn in foreign exchange reserves offers to be thick enough yet.

GROWTH SCENARIOS

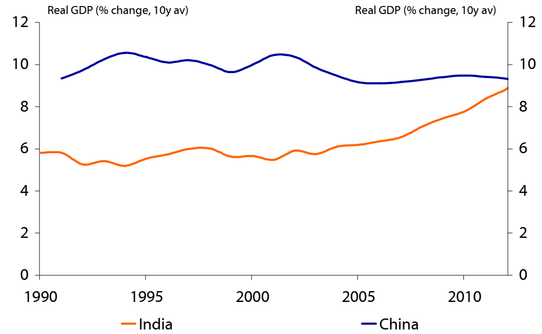
After having identified the main challenges facing the Indian economy, this chapter turns to four growth scenarios. The difference between the scenario's originates from assumptions about the country's structural growth rate and the effectiveness of government policy to tackle the economy's key challenges. First, one may recall that India's economic performance has truly been of a different order in recent years. The thesis that the structure of the economy is changing rapidly is confirmed by the real economy's average annual expansion over the last ten years, a measure of the structural growth rate. This rate will approach China's structural growth rate in the medium term if India continues to grow at its current pace (see Chart 27). Whether India can indeed sustain this expansion will be elaborated in the scenarios.

Chart 26: Recent growth of a different order



Source: EIU, Rabobank Nederland

Chart 27: Structural growth rate in the lift



Source: EIU, Rabobank Nederland

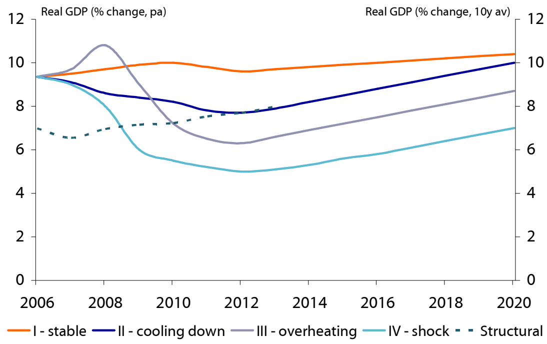
Structural growth

Generally, the structural growth rate is thought to reflect the maximum growth rate that an economy can extend over a longer period of time. Because it neglects cyclical patterns, current growth rates can be compared to the structural rate to investigate in which phase of the business cycle an economy finds itself. If, for instance, the current rate is substantially higher than the structural rate of growth, a deceleration of economic growth, or even recession, may be expected. This assumes, however, that the economy's structural growth rate is fairly stable. Because their economic fundamentals do not change much, this may apply to industrialised countries, but it is arguably not the case for India. Both its policy framework and economic structure have changed rapidly in recent years. This implies that the preconditions for economic activity are changing, which has a positive effect on the structural growth rate. It also implies, however, that the structural growth rate need not be indicative of the country's long-run sustainable growth rate.

Nobody expected China to be able to sustain a growth rate of 10% for a long period of time, but it has nevertheless done so since the early 1980s. Years of structural reform have enabled actual growth rates to consistently outpace estimates of its structural growth rate. This implies that in the process estimates of China's structural growth rate were lifted substantially and reside in a totally different league than India's. Precisely for this reason, it may be more realistic to assume an ongoing improvement in India's structural growth rate as well. After all, India is in an ongoing transition process. Irrespective of the specific assumptions in the various scenarios, therefore, the basic assumption is an upward sloping structural growth rate upto 2012. In Chart 28, this rate, which we measure as the average annual GDP growth rate over ten previous years, is depicted by the dotted line. What happens after 2012 depends on the government's ability to tackle the economy's structural problems.

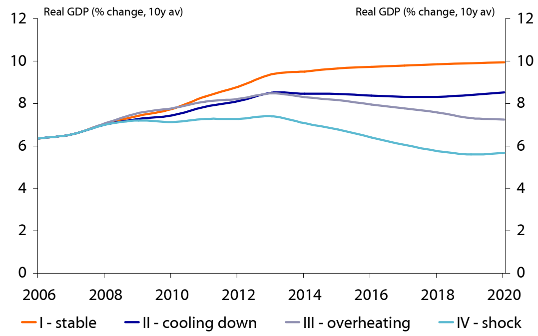
From 2012 onwards, the growth projections embark on a stable path, as cyclical influences are omitted. In all scenarios, the growth paths are upward sloping because of India's catching up process.

Chart 28: Real GDP growth scenarios



Source: EIU, Rabobank Nederland

Chart 29: Scenario impact on structural growth rate



Source: EIU, Rabobank Nederland

I – Stable expansion scenario (30%)

The first scenario assumes that India's growth acceleration will prove to be sustainable, even though it is much higher than the historical estimate of its structural rate of expansion. This is to say that the Indian economy follows the Chinese example and will continue to post growth rates above its 10-year average. Even though this may surprise economists who believe the structural rate to be its long-term potential, it would surely evidence that India is experiencing profound changes in its economic structure.

If this scenario comes true, the country's growth imperative is successfully adressed and the government manages to ease most of its bottlenecks. First, the potential growth of the agricultural sector is unlocked by productive investment in equipment, inputs and processes. It is further strengthened by improvements in transport, warehousing and trading mechanisms. Prices are becoming less volatile and the real incomes (i.e. spending power) of the rural masses are rising. This process is strengthened by attainment of the Millennium Development Goals. Easier access to better quality health and education systems will improve the productivity of India's labour potential. Reform of labour market institutions and liberalisation of financial sector enable investors to seize business opportunities and create employment. Foreign investors are attracted by improved investment conditions and inward investment will experience spectacular growth. The government gradually withdraws from ever more aspects of economic life and allows market mechanisms to function more efficiently. Where markets fail, intervention will be left to independent supervisors. Detached from politics, the supervisory authorities are experts in their fields adopting the least distortionary responses to market failures. Combined with tax reforms, the decreased role of the state will strengthen public finances with debt and deficit ratios returning to sustainable levels.

For this scenario to materialise, however, India has to create a virtuous circle in which most of the bottlenecks are successfully addressed. Since it is not very likely that the government will be able to tackle all challenges in an effective manner, we do not perceive this scenario as the most probable outcome. As this scenario will benefit from any pleasant surprises, however, it does have a reasonable chance to materialise. If, for instance, the consumer market develops faster than expected, export revenues boast stronger growth than anticipated, or the identified bottlenecks appear less restrictive to growth than projected, this works to the benefit of this positive scenario. Therefore, we put its likelihood at 30%.

II – Cooling down scenario (45%)

The starting point of both the second and third scenario is that the Indian economy cannot sustain its current growth rate over a longer period of time. This is based on the the assumption that many of the country's structural problems may not be fully resolved. Because of limitations to public support and financial resources, for instance, the government may only manage to implement piecemeal reforms on essential issues. Insufficient progress in consolidating public finances may continue to crowd out private investment. The financial sector could remain heavily regulated and fail to function as an efficient mechanism for the allocation of available funds. If the fights for reduction in corruption and red tape achieve little progress, much funds will continue to leak into unproductive use, and foreign investors will remain wary to invest in India. When inward investment stays far below potential, the country will not be able to raise sufficient capital to overhaul its infrastructure. This would imply that transport, energy and utilities remain costly and unreliable. It would also complicate reaching out to the rural poor and achieving better results in agricultural performance. If the educational system fails to deliver employable workers, India's labour potential may turn into a liability rather than an asset.

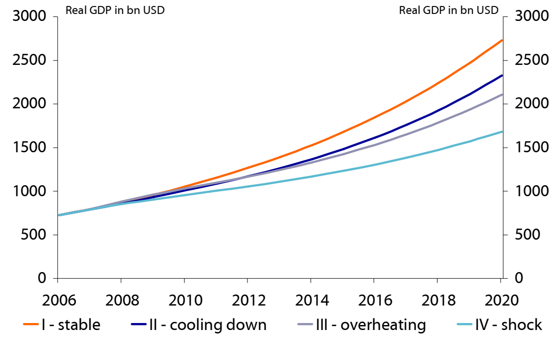
All of these issues may become significant supply-side restraints to growth, especially when aggregate demand continues to grow strongly. This is likely to happen because India's growth drivers are strong and broadly based. As the world economy and world trade are growing fast, so will foreign demand for Indian goods and servicies. Given the optimistic sentiment in India's major commercial centres, private consumption and investment are showing unrelenting growth. Government plans to invest physical and social capital will add to domestic demand. Therefore, the key risk in these two scenarios is that buoyant demand will run into supply constraints. This will create strong inflationary pressures and set back growth. The crucial difference between the cooling down and overheating scenarios lies in the determination and effectiveness of authorities' policy response. Key in the second scenario is that the government realises that it lacks the resources (financial and/or public support) to take on all of the economy's challenges in an effective manner. As it fears that the economy may appear unable to sustain today's growth rates over a longer period of time, it takes measures to cool it down. Both fiscal and monetary authorities will exercise restraint. The government sticks to its budget management and balances revenues and expenditures in a responsible manner. Likewise, the RBI will use its monetary and exchange rate instruments to balance the trade-off between growth and inflation.

The cooling down scenario is in accordance with the policy direction of the current government. If their policies are successful, the Indian growth rate will decelerate to sustainable levels. Hence, in our second scenario, the actual growth rate meets the structural growth rate by 2012 and then continues along this path. If growth drivers continue to surprise on the upside, however, government policies may fail to cool down current growth rates. This may have positive or negative consequences. If the government indeed manages more structural reform than it anticipates, its fear of overheating may prove ungrounded. Then, the economy's bottlenecks will not restrain growth as much, and higher growth rates appear sustainable. In that case, scenario I may materialise. On the other hand, if policies fail to cool down current growth rates and the government does not manage to push through the structural reform it anticipates, the economy's long-term growth perspective does not look so bright. Then it risks overheating, as described in scenario III. Since the Indian authorities are carefully balancing growth and inflation in order to sustain the economy's momentum, however, we feel confident that the cooling down scenario is the most likely to materialise. Hence, we assigned it a likelihood of 45%.

III – Overheating scenario (20%)

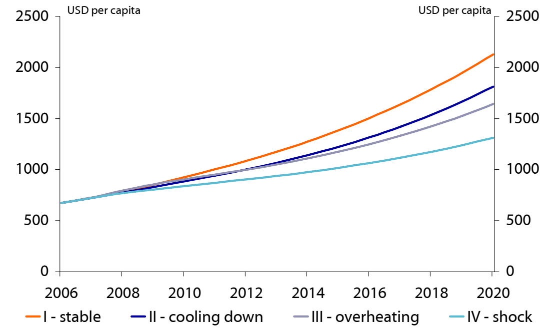
The overheating scenario also starts from the assumption that the Indian economy is growing faster than its structure is able to sustain. Similar to the cooling down scenario, it assumes that buoyant demand risks running into supply constraints. It does not predict, however, that the authorities will be able to control its exuberance. It rather assumes that efforts by policymakers to cool down growth are insufficiently effective. In this scenario, the economy will experience strong inflationary pressures because demand for too many a product and service is outgrowing its supply. The most pressing issue will be labour. The restricted pool of qualified workers will drive up wages and an unfolding war for talent will cost employers dearly. Next to labour costs, they also see their other costs rising. Cumbersome transport services and unreliable utilities complicate the business environment. The large demand for real estate in attractive locations will boast rents in the major cities. The costs of inputs will also rise due to higher demand and lagging supply. One may think about the failure to upgrade agricultural output or higher prices on world markets for essential imports such as oil and raw materials. Finally, monetary contraction will set interest rates higher, which increases the cost of capital. As inflationary pressures are building up, the period of unbridled growth will be short-lived. It will reach its peak in the foreseeable future and head for a much sharper deceleration in comparison to the cooling down scenario. Annual economic expansion will come to fall below the structural growth rate, and by 2012, India will more or less have to start over again and embark on a new path of structural growth.

Chart 30: Scenario impact on economic size



Source: EIU, Rabobank Nederland

Chart 31: Scenario impact on standard of living



Source: EIU, Rabobank Nederland

Assuming that the ultimate objective is to raise Indian living standards, Chart 31 shows the dilemma that the Indian authorities are facing, Clearly, the most desirable outcome in 2020 is reached in the first scenario. Too much confidence in the realisation of this scenario, however, could result in the unfolding of the overheating scenario. Therefore, policymakers choose to go for second-best and try to cool down the economy to have the second scenario materialise. Even though the overheating scenario has a reasonable chance to occur, we do not believe it is very likely to materialise. Both scenarios I and II are more probable because the authorities closely monitor the economic situation and stand ready to intervene when necessary. In recent years, the RBI has shown it is serious about combatting inflation, as it aggressively hiked interest rates and allowed the rupee to appreciate since early this year. The latter is a clear sign that it worries more about higher inflation than lower growth at this point in time. Since we believe the authorities possess sufficient economic clout to prevent the economy from overheating, we deem the overheating scenario less likely than the cooling down scenario. We assign it a likelihood of 20%.

IV – Adverse shock scenario (5%)

For the sake of completeness, the fourth scenario envisions the economy's response in the event of a severe adverse shock. Such a shock may have many causes. It could be the escalation of an external conflict or internal strife, but also the result of an international economic crisis that India does not manage to shake off. It could also arise from the structural challenges taking a turn for the worse, such as a widespread failure in agricultural output, a breakdown of vital infrastructure or an explosion of the HIV/aids pandemic. If such a worst case scenario unfolds, Indian growth would suffer a serious setback. It may even drop below the current structural rate of 6.5%. Consequently, it would have a much tougher time to recover from this setback and embark upon a new era of structural expansion.

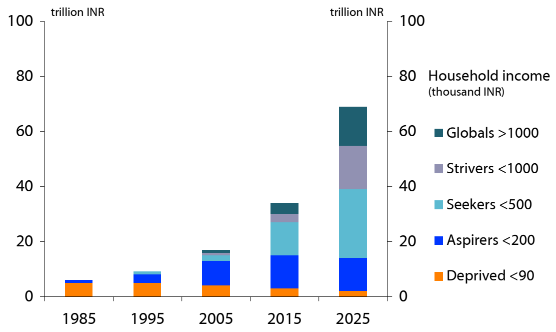
We assign a low likelihood to this scenario, since the Indian economy is well-positioned to weather a shock or two. So, for the adverse shock scenario to occur the aforementioned events would have to come together and reinforce each other. In addition, the policy response of the government may mitigate the impact of the shock on the real economy. Therefore, we put the likelihood of scenario IV at 5%.

We should stress that the growth rates as depicted in Chart 28 are the starting point for the scenario analysis. The developments of the other macro-economic indicators (structural growth, economic size and standard of living) can be derived from the assumed growth rates. Depending on the unfolding of a particular scenario, however, the figures of other macro-economic indicators (e.g. inflation, public finances, current account) may turn out very differently.

BUSINESS OPPORTUNITIES

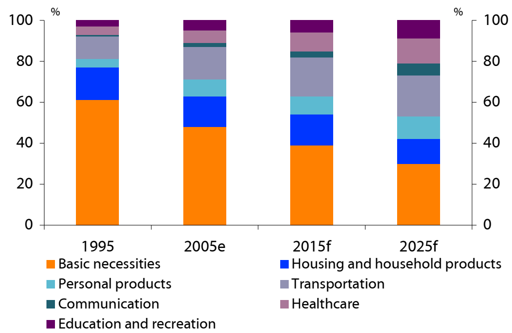
With the optimistic sentiment and can-do attitude thriving in India's commercial and industrial centres, the country has become big business. Most international firms have evolved from viewing India as a low-cost location to outsource back-office activities to viewing it as a vibrant consumer market with a tremendous upward potential. Not only will India's population overtake China's by 2030, its spending power will rise substantially. In the most likely scenarios, standards of living will almost triple over next two decades. A report by McKinsey predicts that this will lift almost 300 million people from desperate poverty into more sustainable patterns of life. Though fastest in urban areas, this growth will also spread beyond top-tier cities and come to benefit rural households. India's middle-class will grow more than tenfold to become the world's fifth consumer market with almost 600 million customers. Aggregate consumption is expected to quadruple to INR 70 trillion (more than USD 1.5 trillion). Basic necessities will continue to dominate the consumption basket, but communication and healthcare will gain in importance.

Chart 32: Jump in aggregate consumption



Source: McKinsey Global Institute

Chart 33: Average consumer basket changes



Source: McKinsey Global Institute

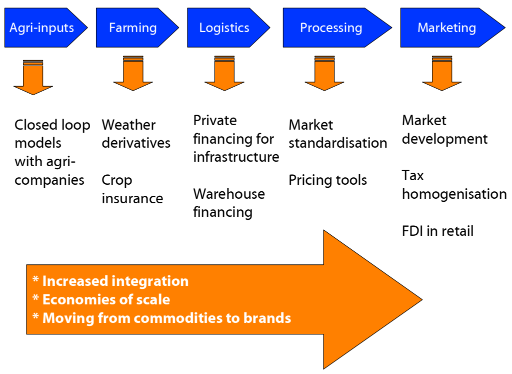
Besides market dynamics, also the government's policy imperative to tackle the economy's bottlenecks provides business opportunities. The remainder of this chapter will indicate the sectors whose development generates business opportunities for financial service providers.

Food and agriculture

Even though food and agriculture may not be the sexiest line of business in the Indian financial sector, its business potential (and economic relevance) cannot be understated. Agricultural growth still falters, but on a number of issues business conditions have certainly improved. The first concerns land and tenacy reform. Owing to the license Raj, India inherited a semi-feudal agrarian system with land ownership concentrated in the hands of a few powerful landlords. Laws governing land tenure have been reformed, but there are substantial differences in regulations for land holdings between states. Despite the loopholes that people are trying to exploit, reforms have been successful in many areas. Even though legal processes are cumbersome and lethargic, the reforms have enhanced security about the value of land as collateral and facilitated foreclosure procedures. Other risk mitigants include price subsidies that the government offers to its farmers and credit support from state-owned banks.

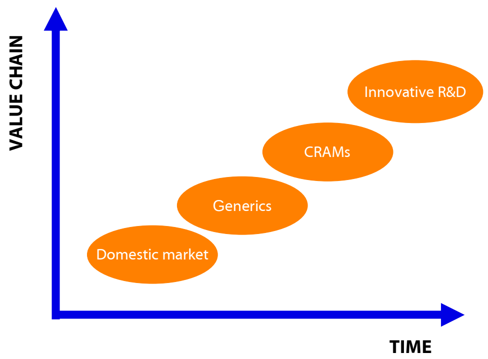
The opening up of the Indian economy has benefited the availability and quality of inputs. This also holds for agricultural inputs, such as seeds and fertilizers. Albeit slowly, also farming processes are becoming of higher quality. The food and agricultural sector offers opportunities to develop markets throughout the supply chain. This starts with cultivating relations with clients in seeds, fertilisers and other agri-inputs, but also pertains to providing financial products to farmers, such as weather derivatives and crop insurance. In the distribution of agricultural produce, financial intermediaries could assist by financing infrastructural projects and warehouse facilities. Food-processing clients face dynamic markets and demanding consumers that require them to streamline their processes, gain scale and invest in new technologies. Finally, much can be done to improve in the distribution of foodstuffs that is still to develop from a supply-driven marketing of commodities to a demand-driven marketing of brands.

Chart 34: Thinking the F&A supply chain



Source: Rabo India Finance.

Chart 35: Stages in the pharmaceuticals market



Source: Rabo India Finance

Having the ambition to become a leading financial player in food and agribusiness, Rabobank simply cannot afford to neglect India, the world's top producer of milk, tea and sugar, and runner-up in wheat, rice and fresh produce. Given India's need to upgrade its agricultural performance and develop its food supply chain, Rabobank's extensive knowledge of this sector is a valuable asset.

Healthcare and pharmaceuticals

India's burgeoning pharmaceuticals market grew by 17.5% to USD 7.3bn last year, and is projected to reach USD 25bn by 2010 according to government estimates. Since the drugs penetration rate is only 30%, the government is taking steps to enhance the availability of life-saving drugs at affordable prices. The resulting price controls, however, compound pressure on the margins of domestic drug manufacturers, as they have come to face fierce competition since January 1st, 2005. As of this date, India has had to comply with the WTO's regulations concerning Trade Related aspects of Intellectual Property Rights (TRIPS), which meant that India had to reintroduce product patents to prevent imitations of internationally patented drugs. Since the late 1970s, however, India had only known process patents, which caused domestic producers to focus on low-cost generic drugs. This explains why India may rank as the world's fourth largest pharmaceuticals producer in terms of volume, but only thirteenth in terms of value. With the introduction of TRIPS, however, the development of the Indian pharmaceuticals sector has truly gained momentum. Obviously, there are pitfalls in financing companies that may rely on outdated or unprotected drugs. Financiers will also have to deal with the ethical concerns related to drug testing by poor, illiterate people.

The development of the Indian pharmaceutical sector may be seen in four stages. First, the domestic market still remains largely untapped. Increased life expectancy, higher disposable incomes and changing lifestyles will result in a booming demand for cures and treatments of acute diseases and discomforts. The development of the Indian market will be driven by the product patent regime, as investment decisions by foreign players depend on the protection of their intellectual property rights. So far, launches remain troublesome, as it is not easy to gain patents, but if Novartis, a Swiss pharmaceutical giant, wins its case, this may convince other players to expand their India business. The second stage indicates the opportunities of domestic firms in the international arena. Patents in the order of USD 50bn on generic drugs are due to expire upto 2010. Indian pharmaceutical producers are well-positioned to take advantage of these changes, as it has the highest number of manufacturing plants approved by the US Food and Drugs Administration outside the United States. Furthermore, their large number of well-trained, English-speaking chemists and their technologically advanced and relatively low-cost research laboratories make them stand out among emerging market competitors. In the third stage, the margins on generic drugs will suffer under fierce international price competition. This will raise interests for both international conglomerates and domestic pharma firms to engage in closer cooperation via so-called Contract Research And Manufacturing tie-ups (CRAMs). For the pharmaceutical multinationals, the outsourcing of research and manufacturing activities enables them to cut costs across the value chain. For the Indian firms, CRAMs will offer welcome opportunities to generate expertise, capital and scale. In the final stage, the Indian pharmaceutical sector is expected to venture into more innovative research and development activities. After all, sustainable growth in the long term requires more investment in fundamental research aimed at new discoveries. Meanwhile, the pharmaceutical sector will be ready for consolidation. The growth in mergers and acquisitions will provide plenty of opportunities for financial service providers.

Infrastructure and utilities

The liberalisation of some infrastructure sectors is more successful than others. Civic aviation has been a enormous success as air traffic is growing at 20-25% annually. The country's main airfields in Delhi and Mumbai can barely manage the stream of passengers, but as ownership regulations have been eased, the prospects for airport development in terms of higher capacity and efficiency are brighter. India's seaport facilities are also being privatised quite successfully, as the average turnaround time has dropped from eight to three days. The coverage of India's road network, however, does not enable efficient transport links. Therefore, the government planned about USD 80bn in investments to improve the country's road network. USD 26bn is already committed to the National Highway Development Project (NHDP), which is to create an all-India highway coverage by establishing an East-West and North-South corridor, and by connecting the four metropoles via the "Golden Quadrilateral". In addition, USD 12bn is designated to a rural road programme connecting smaller towns and villages. In contrast to its roads, India's rail network is rather dense, another heritage of the British raj. Its efficiency has much to wish for, as trains are overcrowded and maintenance is long overdue. Rail transport is not very appealing to private investors, especially since freight used to subsidise passenger traffic. This regulatory link has recently been uncoupled, but it will nonetheless remain a daunting task to upgrade rail services.

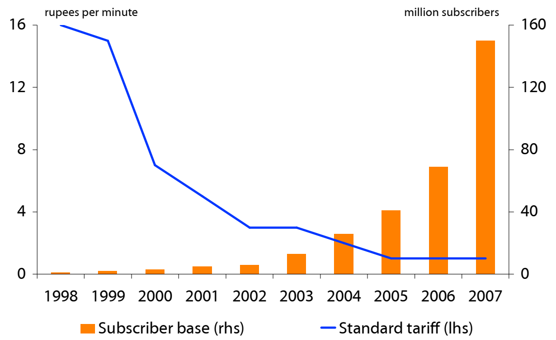
The infrastructure deficiency also holds for utilities like water and electricity. While 86% of Indians has access to an improved water source, only one in every three Indians has access to improved sanitation facilities. The water is not readily available, however, and all too often of poor quality. Investment in water and sanitation facilities is nonetheless rather high, but the institutions in charge of operating and maintaining the infrastructure are weak and lack sufficient revenues because of high subsidisation rates. This makes the provision of water a loss-giving venture, no matter how well operations are run. For understandable social reasons, the government can only introduce piecemeal reforms, but Indians will nevertheless have to get used to the idea that water (and also electricity) come at a price. This would not only make the provision of water a viable enterprise, but also reduce waste among consumers. Therefore, steps to decentralise the provision and take a more demand-driven approach are to be encouraged.

The combination of the government's determination to upgrade the country's infrastructure and the lack of funds to finance these mammoth projects provides ample opportunities for financial service providers. The government is willing to engage in public-private partnerships and provides tenders for numerous projects. Opportunities for project finance lie in consortia supporting construction companies, as the Build-Operate-Transfer concept (BOT) appears particularly suitable to realise highways and bridges. A private company which is specialised in building the project gains the ownership and is awarded with the profits during the first years of operation. When the project runs smoothly, ownership is transferred, for instance, to a government agency, which will run it from there. The government is freeing up ever more funds to tackle infrastructural deficiencies, but the problem is that much money is squandered because the Indian construction sector is notoriously corrupt. This poses a significant business risk to financial service providers, but financing the development of industry offers tremendous opportunities to foreign banks that have expertise in this sector.

Telecom, media and internet

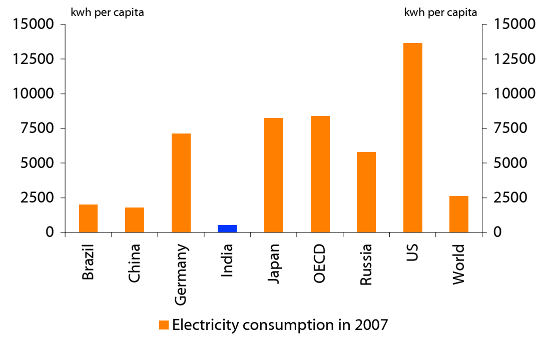
This year India overtook China as the world's fastest growing market for mobile telephony. Every month, mobile service providers add more than 6 million suscribers to their accounts. In three years, the total number of suscribers jumped from 30 to 150 million. The regulator has been successful in creating a level playing field as fierce competition drove down tariffs from fifteen rupees per minute in 1998 to only one rupee per minute today. Since the top-tier cities have achieved penetration rates in excess of 50%, most growth potential lies in the smaller cities and more remote areas. To reach these potential customers, the industry will have to focus on infrastructure deployment, while keeping an eye on affordability. New technologies, national roll-outs by smaller players and the entrance of foreign contenders will stimulate consolidation. The positive growth outlook with high efficiency levels, sound finances and good management quality generates pportunities for financial services providers.

Chart 36: Wireless telecom takes flight



Source: Telecom Regulatory Authority of India

Chart 37: Energy consumption still low



Source: International Energy Agency

Energy

If the Indian economy continues to grow at its present rate, its energy requirement will increase more than threefold upto 2020. To meet this need, the energy sector requires USD 120-150bn over the next five years. Since less than 20% of India's massive coal reserves is extractable through current technology, the economy relies on imports of crude oil from instable sources in the Middle-East and Africa. Because the current growth in coal extraction would exhaust its deposits within 45 years (with severe consequences for the environment), India will not only have to increase, but also diversify its energy base. Therefore, the authorities have laid out a broader energy diversification strategy, which includes important changes to regulations governing coal, oil, gas, renewables and nuclear fission. To develop these sectors, private investors need to be lured into energy projects. The emergence of independent supervisory bodies are to applauded as they will increase transparency and strengthen market mechanisms, such as competitive bidding. In oil and gas, for instance, new licensing policies have already successfully awarded dozens of exploration and production blocks to private players. Even though supporting nuclear development in a non-signatory to the non-proliferation treaty may be questionable, the sector may become commercially viable if the Indo-American deal on civil nuclear cooperation is pushed through. The country's potential for renewables is vast. Most technologies are on the verge of cost-effectiveness, but still depend on uncertain fiscal stimuli. However, investment opportunities are not only to be found in energy production, but also in its transmission and distribution. After all, India's energy deficit of 9% is to a large extent attributable to inefficient use and delivery. Since it is very hard to reform the politically sensitive energy price subsidies, however, it will remain difficult to engage the private sector.

Metals and mining

India's hunger for inputs to a rapidly growing economy is reflected in the dynamism of its metals and mining sector. Its industry currently ranks as the seventh largest steel producer (44 million metric tonnes in 2006) and is responsible for 4% of global copper production/consumption. India's domestic consumption growth, its proximity to China and its low cost of production underlie a strong competitive position. Generally, the metal business is experiencing strong long term growth with Indian and Chinese players rapidly gaining scale. It faces a period of consolidation in combination with high commodity prices and strong demand whereby players increase in size and integrate vertically to secure raw material supply. The largest Indian metal producers are able to co-lead this consolidation with prominent roles for Tata (with its acquisition of Corus), Mittal (Arcelor) and Hindalco (Novelis). These acquisitions clearly indicate that the Indian industrial conglomerates are highly competitive on the world stage. Their expansion will fuel demand for financial services generating plenty opportunities for international banks.

Banking

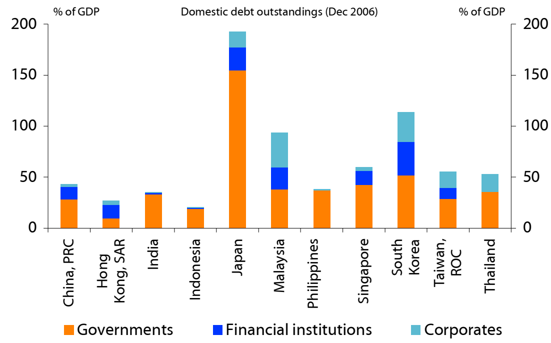
The financial sector itself also provides plenty of business opportunities generated by India's strong growth performance. The sector benefits from the combination of rising incomes, increasing consumption and growing business investment, as higher disposable incomes and corporate profits stimulate demand for financial products. As the burgeoning middle class in the major cities is less conservative in taking on debt, and house and car ownership ratio's are still low, consumer finance is taking flight. Despite a tightening stance of the RBI, consumer credit grows around 30% per annum. The state-owned banks will not be able to meet all the rising demand for private credit without reneging on capital adequacy, as they are obliged to continue funding the government's capital needs. Even though they have ample cushion to do so, the private banks are much better placed to respond to consumer needs and benefit from the increase in their demand for credit.

With all major international banks already present in India, the corporate banking market is by and large saturated. Also the retail space is getting crowed, especially in first-tier cities like Delhi and Mumbai. Whereas state banks are shaping up and start to deliver to their mass customer base, private banks like ICICI and HDFC have already turned into formidable competitors with rapidly expanding branch coverage. In the major cities, the markets are reportedly saturated and possibly overbanked. Opportunities in retail, therefore, are rather limited. However, they may still be found in second- and third-tier cities, where the middle class is growing and affluant customers demand better quality services for which they are willing to pay premium prices. Entering these markets will be difficult, however, as the RBI restricts the number of branch licenses to foreign banks. In rural areas, there is a clear demand for higher quality retail services, but banks entering these markets will come to face competition from local banks and credit cooperatives. Although these financial institutions are unprofitable and undercapitalised, a flurry of regulations and government support gives them substantial firepower.

Financial markets

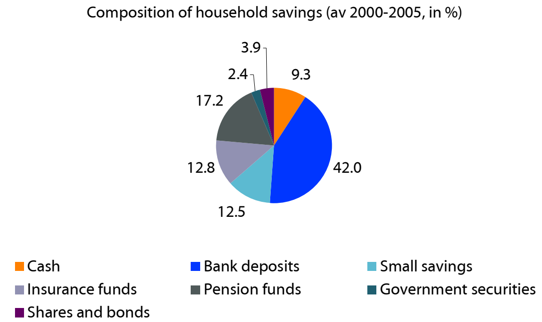
On the supply side of the financial system, debt markets could become a viable alternative to bank lending. Even though India has a credit rating industry and a reasonably liquid market for government securities of various maturities, the corporate debt market is not yet institutionalised. Market activity is highly concentrated on private placements for higher-rated issuers with only limited secondary trading. A similar analysis holds for the development stage of the structured finance market. Many asset classes have yet to emerge and there is hardly any market for subordinated tranches. Some 80% of total issues have been executed on behalf of the top 5 issuers. However, the ongoing development of domestic financial markets provides ample opportunities for financial intermediaries, both as an investor and as an arranger of issues. The limited access to foreign currency borrowings also encroaches on the corporate sector's ability to raise funds. Out of concern about uncontrolled capital movements, the RBI maintains strict guidelines on external commercial borrowings aiming to keep maturities long, costs low and purpose clear (i.e. speculation out). In a further discouragement, the authorities tax such borrowings. Gradual reform will develop foreign debt markets, but the RBI will remain cautious not to open Pandora's box. Even though rapid rupee appreciation may cause the RBI to postpone easing or even tighten capital restrictions along the way, the policy trend in the medium term will be to ease restrictions on foreign lending as the Indian financial system develops. This will open up interesting business opportunities for foreign banks, particularly in derivatives and other advanced financial product markets.

Chart 38: Indian debt markets to be developed



Source: BIS

Chart 39: Households careful with savings



Source: RBI, SEBI

Also the demand side of financial markets is still in an early stage of development. With a total of 177 million households (average head count 5.3), India offers a tremendous pool of potential investors. Households are also the economy's largest savers, as they account for 80% of aggregate savings. However, they are very conservative in their investment strategy. Half of their savings are kept in cash or callable bank deposits, while a further 12.5% is awarded to small savings programmes. These programmes entail direct claims against the government earning fixed returns between 3.5% and 9% per year. Another quarter of household savings flows into insurance and pension funds, whose investment strategies are heavily regulated and their remunerations close to guaranteed. This leaves just over 6% to be directly invested in market securities, a part of which consists of treasury paper again. The size of the assets that India's institutional investors manage confirms this diagnosis: in total, barely 25% of GDP. Only a fifth of this is managed by mutual funds and foreign institutional investors (FII), the remainder by insurance and pension funds. The many regulations and small size secondary debt markets limits fund managers' investment strategies. This way, they cannot fully exploit their portfolio's risk-return trade-off, which results in suboptimal wealth creation. However, asset allocation rules will be relaxed further and together with a rapidly increasing investor base (in terms of both number and value), this provides ample opportunities for financial service providers on the demand side of financial markets.

CONCLUSION – HOW HIGH WILL THE ELEPHANT FLY?

The excellent growth performance in recent years may suggest that the Indian economy has successfully launched itself into the league of Asian tiger economies. Despite the observable progress, however, the crucial question remains whether India's growth acceleration will prove sustainable. After all, one may quite rightfully wonder what could happen when an elephant takes wing.

This report has sought to interpret India's rise from a long-term perspective. First, it appears that, historically, the rise of the elephant should come as no surprise, since the Indian economy, so far, is merely reclaiming lost terrain. In the contemporary world economy, however, India is a relative newcomer likely to grow into a leading economic power. Several decades from now, India may have overtaken Japan and the four largest European economies, as the world's third largest economy behind only China and the United States. Rising spending power will quadruple aggregate consumption and turn the country into the world's fifth largest consumer market with almost 600 million consumers.

For this to become reality, however, the Indian leadership will have to overcome some key challenges that could block the way to structurally higher growth rates. The all-encompassing challenge is to make growth inclusive, so that the vast majority of impoverished Indians will come to feel the benefits of a booming economy. This demands a stronger agricultural performance, development of the food supply chain and achievement of the Millennium Development Goals. Furthermore, an overhaul of physical infrastructure and upgrading of public service delivery is required to prevent economic growth from running into supply constraints. Further consolidation of public finances and deregulation of the financial sector would free up a vast pool of captive savings and make India a more attractive destination to foreign investors. This would both enlarge the country's financial resources and make its use more efficient.

In recent years, India appears to make real progress towards realising its potential because the country put its act together on a number of issues. First, India's governance has become more sound. Its political arena may appear chaotic, but the system is stable and democratic principles are well-enshrined. Its current leadership acknowledges that their reforms will be short-lived if they lack popular support. Therefore, their policy agenda contains elements of economic liberalisation as well as social planning. This leads economic policymakers to pursue gradual reform while maintaining a close balance between growth and inflation. This cautious approach has resulted in strong external finances providing a welcome cushion in the event of an adverse shock. Second, the optimistic sentiment and thriving entrepreneurial spirit are nurturing a dynamic and highly competitive private sector offering a range of opportunities for India's young, ambitious and competent labour force. If the private sector manages to generate enough manufacturing jobs, India is poised to benefit greatly from its demographic dividend. Further integration with the global economy will cause Indian corporates to gain knowledge, capital, scale and access to markets. In return, foreign investors stand ready to pour in resources to benefit from India's development.

While projecting different growth scenario's upto 2020, the most likely outcome predicts a lift in India's structural growth rate to 8% per annum. Even though this outcome is higher than the latest external estimates of potential growth rates, we deem it reasonable to allow for an increase in the "speed limit" of the Indian economy during this period because of fundamental changes to its underlying structure. Since the economy is currently recording growth rates well in excess of 8%, policy contraction is aiming to cool down the economy in order to prevent it from overheating. Even though it may therefore be reasonable to expect a deceleration in the medium term, India has nonetheless found the stability and momentum to make real progress towards realising it tremendous upward potential. Despite the daunting challenges it still faces, most lights have turned to green, implying that any international firm should consider an India strategy.

SOURCES

Angus Maddison, University of Groningen
Bank for International Settlements
Brookings Institution
Confederation of Indian Industry
Census of India
Central Statistical Organisation of India
CRISIL Research
Deloitte Research
Deutsche Bank Research
The Economist
Economist Intelligence Unit
Federation of Indian Chambers of Commerce and Industry
Financial Times
Fitch Ratings
Global Insight
Goldman Sachs Research
IMA India
Institute of International Finance
International Monetary Fund
KPMG
McKinsey Global Institute
Ministry of Finance, Union Budget of the Government of India
Moody's Investors Service
National Council of Applied Economic Research
Rabo India Finance
Rabobank International
Reserve Bank of India
Reuters Ecowin
Securities and Exchange Board of India
Standard and Poor's
Telecom Regulatory Authority of India
Trusted Sources
United Nations Common Database
Wikipedia
World Bank
World Economic Forum
World Trade Organisation

ABBREVIATIONS

BIS:	Bank for International Settlements
BJP:	Bharatiya Janata Party, India's Hindu nationalist party, key challenger of INC
BOT:	Build-Operate-Transfer, financing concept for infrastructure projects
BPO:	Business Process Outsourcing
BRIC:	Brazil, Russia, India and China
CSO:	Central Statistical Organisation (of India)
EIU:	Economist Intelligence Unit
EU-4:	The four largest European economies: Germany, France, Italy and the United Kingdom.
F&A:	Food and Agri
FDI:	Foreign Direct Investment
FRBMA:	Fiscal Responsibility and Budget Management Act
GDP:	Gross Domestic Product
HDFC:	Housing Development Finance Corporation, the country's second largest private bank
HDI:	Human Development Indicators
ICICI:	Industrial Credit and Investment Corporation of India, the country's largest private bank
INC:	Indian National Congress party, India's incumbent political party
INR:	Indian rupee
IT:	Information Technology
MDGs:	Millennium Development Goals
MSM:	Mid-day Meal Scheme, government programme for child nutrition
NCAER:	National Council of Applied Economic Research
NDA:	National Democratic Alliance, coalition of BJP and junior partners
PM:	Prime Minister
PPP:	Purchasing Power Parity
R&D:	Research and Development
RBI:	Reserve Bank of India, the country's central bank
SBI:	State Bank of India, the country's largest public sector bank
SEBI:	Securities and Exchange Board of India
SSA:	Sarva Shiksha Abhiyan, government programme for primary school enrolment
TMI:	Telecom, Media and Internet
UN:	United Nations
UPA:	United Progressive Alliance, coalition of INC and junior, mainly leftist, partners
USD:	United States dollar
VAT:	Value-Added Tax
WTO:	World Trade Organisation

APPENDIX: INDIAN CITY STATUS

The following list describes the status of the largest Indian cities following a listing provided by the Government of India to allocate compensatory allowances to the cities in the country. The list classifies cities in India based on the Compensatory City Allowance (CCA) and the House Rent Allowance (HRA).

References to Tier-1 or Tier-2 cities may be traced to this classification. The first six cities may be regarded as first-tier cities, and the following seven as second-tier cities. From a macro-perspective, the distinction becomes less relevent from third-tier and beyond.

	City	CCA	HRA		City	CCA	HRA
1	Mumbai	A-1	A-1	26	Madurai	B-1	B-2
2	Delhi	A-1	A-1	27	Jabalpur	B-1	B-2
3	Kolkata	A-1	A-1	28	Jamshedpur	B-1	B-2
4	Chennai	A-1	A-1	29	Allahabad	B-1	B-2
5	Bangalore	A-1	A-1	30	Amritsar	B-1	B-2
6	Hyderabad	A-1	A-1	31	Vijayawada	B-1	B-2
7	Ahmedabad	A	A	32	Asansol	B-1	C
8	Pune	A	A	33	Dhanbad	B-1	C
9	Kanpur	A	A	34	Bhubaneshwar	B-2	B-2
10	Surat	A	A	35	Guntur	B-2	B-2
11	Jaipur	A	A	36	Aurangabad	B-2	B-2
12	Lucknow	A	A	37	Srinagar	B-2	B-2
13	Nagpur	A	A	38	Mysore	B-2	B-2
14	Patna	B-1	B-1	39	Bhilai	B-2	B-2
15	Indore	B-1	B-1	40	Solapur	B-2	B-2
16	Bhopal	B-1	B-1	41	Thiruvananthapuram	B-2	B-2
17	Vadodara	B-1	B-1	42	Ranchi	B-2	B-2
18	Ludhiana	B-1	B-1	43	Guwahati	B-2	B-2
19	Agra	B-1	B-1	44	Gwalior	B-2	B-2
20	Nashik	B-1	B-1	45	Chandigarh	B-2	B-2
21	Coimbatore	B-1	B-2	46	Jodhpur	B-2	B-2
22	Kochi	B-1	B-2	47	Tiruchirapalli	B-2	B-2
23	Vishakapatnam	B-1	B-2	48	Jalandhar	B-2	B-2
24	Varanasi	B-1	B-2	49	Kozhikode	B-2	C
25	Rajkot	B-1	B-2				

Source: Ministry of Finance, Department of Expenditure, Government of India.

DISCLAIMER

Economic Research Department online: www.rabobankgroep.nl/kennisbank