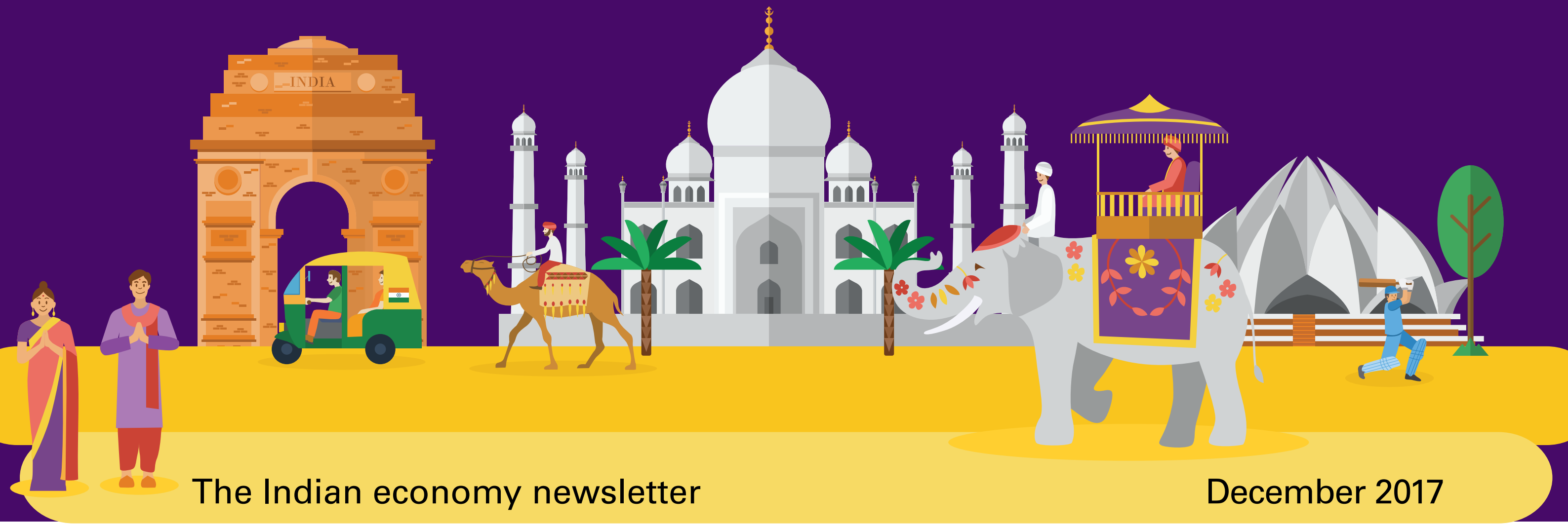
India Insights



The Indian economy newsletter

December 2017

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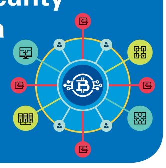

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India at a glance

Q2FY17-18

Macroeconomy

- Gross Domestic Product (GDP) accelerated to 6.3 per cent in Q2FY17-18, up from from a three-year low of 5.7 per cent in Q1FY17-18. The rise indicates that the Indian economy has shaken off the lingering effects of demonetisation last year and GST rollout on 1 July, 2017[1]
- Both manufacturing and services Purchasing Manager's Index (PMI) are back in expansionary territory from September 2017 onwards[2]
- Export growth re-accelerated by 25.67 per cent in September 2017 to USD28.61 billion vis-a-vis September 2016[3]
- The continued recovery in demand may lift capacity utilisation rates and, coupled with improving corporate balance sheets, could lend support to a private capex recovery by 2018[4]
- The government's recently announced plans to infuse USD32 billion of capital into state owned banks, will help accelerate the Nonperforming Loan (NPL) resolution process, improve the headroom for growth and boost investors' and corporate sentiment. This will help cement the growth acceleration and capex recovery[5]

Government finances

- Fiscal deficit at the end of H1FY17-18 (April-September) touched 91.3 per cent of the budget estimate, mainly due to rise in expenditure. The government may have to sell bonds to raise finance for the extra expenditure, while also sticking to the fiscal target [6]
- Trade balance turned positive, (USD8.98 billion), with growth in exports surpassing that of imports in September 2017.[7]

Inflation

- India's retail inflation measured by measured by the Consumer Price Index (CPI) was recorded flat at 3.28 per cent in September 2017, compared to 3.28 per cent in August 2017, after rising over the last two months from 1.5 per cent in June 2017[8]
- The annual rate of inflation, based on monthly Wholesale Price Index (WPI) rose to 2.6 per cent in September 2017 compared to September 2016, slower than provisional 3.24 per cent recorded in August 2017, aided by a sharp fall in food and vegetable prices[9]

Foreign Direct Investment

- India received Foreign Direct Investment (FDI) worth USD25.34 billion from the period April-September 2017 vis-à-vis USD21.62 billion during the same period last year, a rise of 17 per cent from last year.[10]

Forex

- Foreign Exchange Reserves stood at USD399.65 billion as on 29 September 2017[11]

1. India's GDP growth rebounds to 6.3% in September quarter; Livemint; 30 November 2017
2. India Economics - Macro Indicators Chartbook – A clear runway for growth; Morgan Stanley Research; 31 October 2017
3. Key Economic Indicators; Office of Chief Economic Advisor; DIPP, updated as on 16 November 2017
4. India Economics - Macro Indicators Chartbook – A clear runway for growth; Morgan Stanley Research; 31 October 2017
5. India Economics - Macro Indicators Chartbook – A clear runway for growth; Morgan Stanley Research; 31 October 2017
6. India's fiscal deficit at 91.3% of full year target in September; Livemint; 31 October 2017
7. Key Economic Indicators; Office of Chief Economic Advisor; DIPP, updated as on 16 November 2017
8. Consumer Price Index Numbers on Base 2012=100 for Rural, Urban and Combined for the month of September 2017; Ministry of Statistics & Programme Implementation; PIB; 12 October 2017
9. Index Number of Wholesale Price Index in India (Base 2011-12); Review for the month of September, 2017
10. Quarterly Fact Sheet, Fact Sheet on Foreign Direct Investment (FDI); DIPP; December 2017
11. Foreign Exchange Reserves, Weekly Statistical Supplement, Reserve bank of India, 29 September 2017

Economy bytes

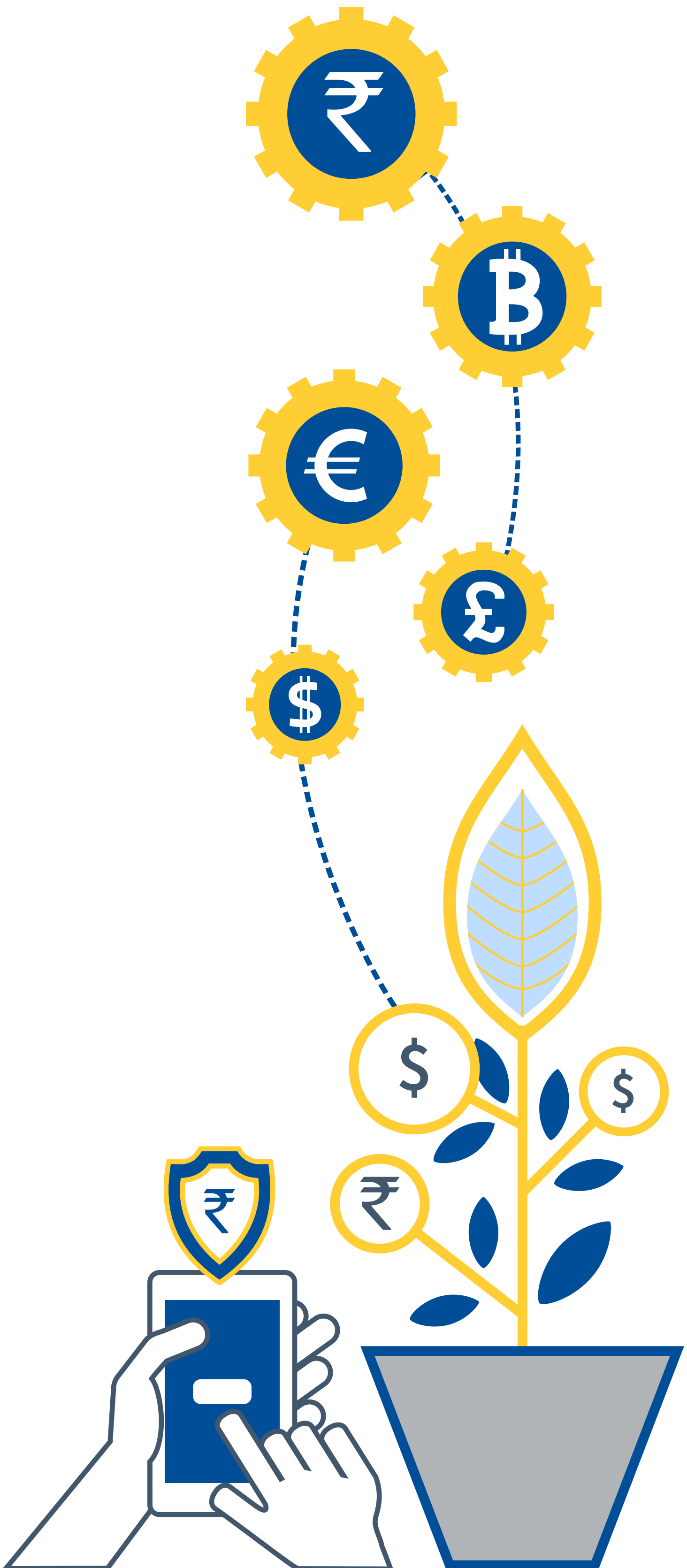
India makes it to top 100 in World Bank's report on ease of doing business[1]

India's ranking in the World Bank's Doing Business 2018 flagship report, titled **'Reforming to Create Jobs'**, climbed a record 30 notches to 100, as a range of regulatory and policy reforms put in place by the union and state governments over the past four years have started delivering results. The rise to the 100 position from 130 last year made India one of the top 10 best-improved countries in this year's assessment, having implemented reforms in eight out of ten doing business indicators. Among these, the biggest improvement in rankings was seen in the category of paying taxes where India managed to reach the 119 position from the 172 position earlier.

On the **'Distance to Frontier (DTF) Metric** (which measures how far the country is from global best practices), one of the key indicators in the survey, India's score went from 56.05 in Doing Business 2017 to 60.76 in Doing Business 2018. This indicates that the country is continuing its steady shift towards best practice in business regulation.

The annual report, could not have come at a more opportune time for the government that is battling to help the economy claw out of the recent slowdown.

The improvement in ranking sends a positive message to the investor community and comes as a major breakthrough in terms of ease of doing business in India. For instance, the Insolvency and Bankruptcy Code, 2016 was always a major concern for investors, both domestic and international, where we have improved. As some of the cases get resolved over the course of time the full impact of the code will get reflected in the next year's rankings. The report has also recognised improvement in time taken and costs for trading across borders, even though India's rank has not improved in that front. The DIPP is now charting out a plan to climb higher next year. To this effect the government needs to ensure that around 122 reforms that were not counted this year are felt on ground for users so that the World Bank can consider them in the rankings next year, when the effects of the landmark Goods and Services Tax (GST) will also be taken into account.



1. Doing Business 2018 Reforming to Create Jobs; World Bank

India has notched up a sharp improvement in its position in World Bank's report on ease of doing business[2]

India in top 100

Countries ranked

190

India's rise

Year	Overall rank	DTF score
53.93	56.05	60.76
130	130	100
2016	2017	2018

The new order

Country	2017 Rank	2018 Rank
New Zealand	**1**	1
Singapore	**2**	2
Denmark	**3**	3
Korea, Rep	**5**	4
Hong Kong	**4**	5
USA	**8**	6
Russia	**40**	35
China	**78**	78
South Africa	**74**	82
India	**130**	**100**
Brazil	**123**	125

Top ten gainers

Countries that record best improvement

Brunei Darussalam, Thailand, Malawi, Kosovo, India, Uzbekistan, Zambia Nigeria, Djibouti, El Salvador

This is how India scored

Country	2017 Rank	2018 Rank	Change in Rank
Starting a business	155	156	-1
Construction permits	185	181	4
Getting electricity	26	29	-3
Registering property	138	154	-16
Getting credit	44	29	15
Protecting minority investors	13	4	9
Paying taxes	172	119	53
Trading across borders	143	146	-3
Enforcing contracts	172	164	8
Resolving insolvency	136	103	33
Overall	130	100	30

Key reforms World Bank has counted

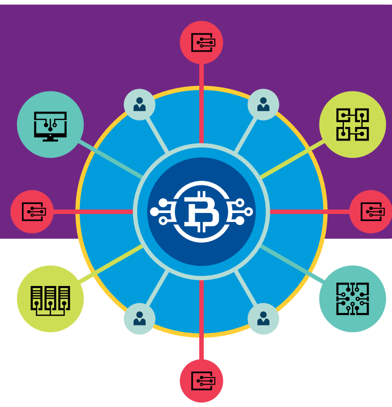
Permanent Account Number (PAN), Tax Deduction or Collection Account Number (TAN) applications merged, put online to make starting biz easier	Time cut for building permit and online process	Getting credit easier
More remedies for minority investors in case of prejudicial transactions between invested parties	Paying taxes easier via electronic PF payment, easier corp tax rules	Import rules eased at Nhava Sheva port
National judicial data grid has made enforcing contracts easier	Resolving insolvency easier due to new insolvency law	

Key implications

- India has managed to establish its reformist credentials
- Provide impetus to more reforms
- FDI may get a boost
- Encourage domestic investments

2. Doing Business 2018 Reforming to Create Jobs; World Bank

Tune in



Blockchain as a means to strengthen cybersecurity in India

Prevailing economic factors and India's reputation as a technology hub are playing a pivotal role in the adoption of blockchain as a technology. Andhra Pradesh has become the first state in the country to pilot blockchain technology in two departments and plans to deploy it across the administration.[1]

Blockchains are a specific type of distributed ledger which has a way of ordering and verifying transactions into blocks with various protections against tampering and revision. The key for blockchain is distributed ledger, which implies there is no single centralised authority (such as clearing house), and the ledger is replicated among many different nodes in a peer to peer network. Each transaction is uniquely signed with a private key.

Further, blockchains use consensus mechanism to authenticate and validate a value or transaction without the need of central authority to provide trust or provide assurance. This mechanism is key to operation of the blockchain/Distributed Ledger Technology (DLT). Consequently, there is no need to have middleman between the parties during any transaction.

With these characteristics, blockchain has emerged as a new disruptive technology and has garnered significant attention due to increased popularity of Bitcoin (blockchain being underlying technology of Bitcoin). Blockchain has the following key traits which is providing opportunity to be seen as evolutionary replacement of traditional cybersecurity tools:

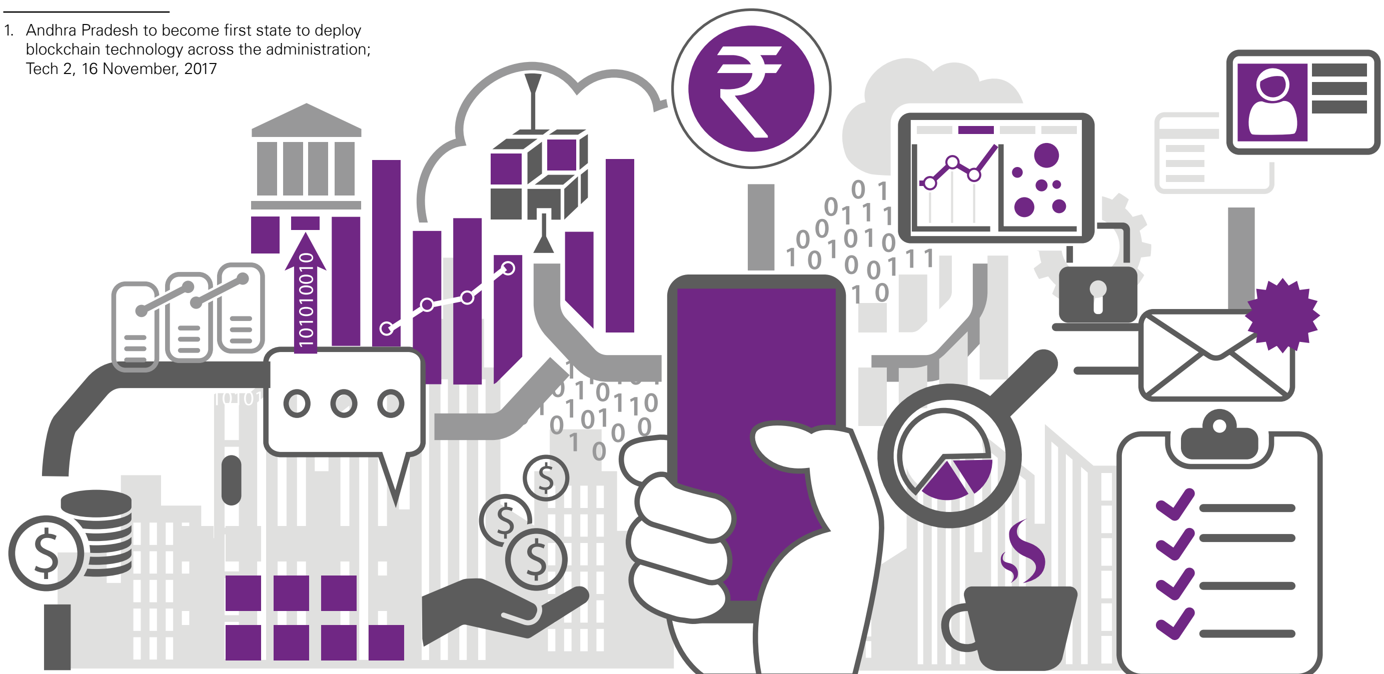
- Cryptography
- Privacy
- Autonomy
- Fault tolerance

Blockchain may prove to be a boon for identity management, safeguarding data integrity and an effective means of digital record keeping for businesses. Its use of decentralised security model as compared to traditional centralised cybersecurity models, eliminates the perils of the single point of breach. Every new block of information being added to a chain is encrypted with a part of the previous chain, making the historical data unchangeable. Blockchain technology offers a feature wherein identity of a user can be tied to a tamper-proof hash, making it almost impossible for someone to copy the identity.

Blockchaining India's digital future

India is witnessing a digital growth as never before with increased mobile penetration, digital wallets gaining traction, cross-linking Aadhaar identities with banks and mobile accounts. Such widespread digitisation with multiple cybersecurity incidents, raise

1. Andhra Pradesh to become first state to deploy blockchain technology across the administration; Tech 2, 16 November, 2017



the question of having robust and secure technology environment. Blockchain comes across as one of the good options which can provide the required level of security along with an opportunity to be ready to address the requirements of the immediate future.

The U.S. and European capital markets have already begun moving to blockchain platforms. Closer to home, the Reserve Bank of India's (RBI) Institute for Development and Research in Banking Technology published a white paper on the applications of blockchain to the banking and financial sector in India and concluded, 'the time is ripe for its adoption'. Andhra Pradesh and Telangana are the first few states in the country to pilot blockchain technology in two departments (land record and transport department) and plan to deploy it across the administration.

Although adoption of blockchain-based technology as an alternative to the traditional methods of security is at a nascent stage in India, its use cases have started evolving. One of India's marque technology firms for example has started using blockchain-based infrastructure to provide data protection and privacy. Several private banks have started specific accelerator programs running specifically for blockchain related applications.

Another key element for increased adoption of blockchain will be the views taken on technology by regulators. There are multiple use cases where blockchain can support a country as large and diverse as India to fight voter fraud and public services such as land registrations, public-private contracts and other Service Level Agreements (SLA).

Blockchain might be inherently secure but is it foolproof?

While blockchain technology may sound to be the solution to multiple challenges, but the big question is that is it really foolproof. Two recent incidents, decentralised autonomous organisation incident and Betfinex breach, made it clear that attackers can exploit security oversights within individual organisation while simultaneously using the fundamental strengths of blockchain technology.

Following are the examples where blockchain can be compromised:

- **Cryptographic key theft:** An attacker with access to private key can make fraudulent transactions, including withdrawals
- **Consensus mechanism override:** A group of attackers can achieve consensus on a transaction that is beneficial only to themselves
- **Anonymity:** Member of a public blockchain can hide their identity, making it difficult to find attackers

Blockchain might be fundamentally secure, however, it alone cannot guarantee to safeguard enterprises from cyber threat unless an effective security and risk management framework to identify and respond to security threats and technology risks are applied.

Conclusion

As blockchain continues to build significant momentum and reality sets in, companies cannot turn a blind eye to security and risk management any longer. Blockchain technology provides answers to many challenges including cybersecurity risks, but one has to be cautious that its adoption is performed with no false sense of inherent security through core features around cryptography and immutability.

In India, we have only scratched the surface of blockchain use-cases and much more remains to be done. Blockchain coupled with effective risk management framework seems to provide a ray of sunshine for the cybersecurity world.

Atul Gupta

Partner and Head
Cyber Security
KPMG in India

Spotlight

Should recapitalisation lead to credit growth?

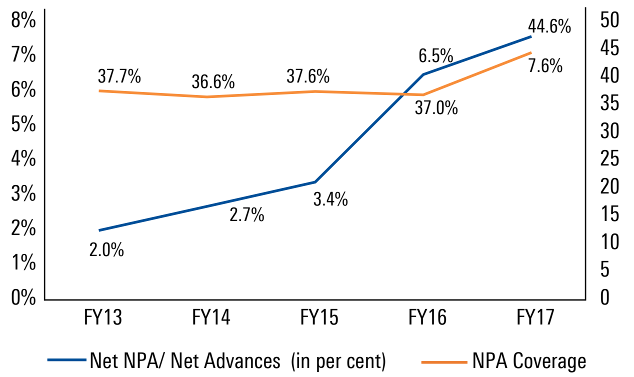
Haunted with the twin challenges of highly-geared corporate sector and wide-spread toxic assets in the state-controlled banks, the government's bail-out programme of USD32 billion (INR2.11 trillion) is widely seen as an attempt to inject new lease of life in the public sector banks.[1] The announcement of recapitalisation by honourable Finance Minister Arun Jaitley, during the 24 October press conference, resulted in an irrational exuberance in banking stocks to the extent of over 50 per cent growth for a few large Public Sector Banks (PSBs).[2] Most of the other PSB stocks also witnessed a rise of over 20 per cent post the announcement. This indicates that investors are positive about the future prospects of the banking sector in the country, however the public awaits results of the drive. The result expected is surge in credit growth; however, history indicates that credit cannot expand immediately. Structural changes needs to be followed in order to get the desired results.

The aim of recapitalisation is widely being seen as a way to 'bailout banks'. However, if we look at the capital adequacy ratios of PSBs, all banks are at least two percentage points over the current minimum capital adequacy requirement of 9 per cent. Hence, the primary aim of the government is to provide banks with a comfortable capital position above the minimum capital requirement, where they find it prudent to take risks in lending. In addition, resolving the issues of Non-Performing Asset (NPA) via partial write-offs is another motive that the government has in order to strengthen the banking sector.

NPA issue dominates the Indian banking sector

The PSBs in the Indian banking sector have been burdened with the issues of NPA for many years. This burden has only increased over the years, as represented by the chart below:

Increasing NPA burden on Indian PSBs

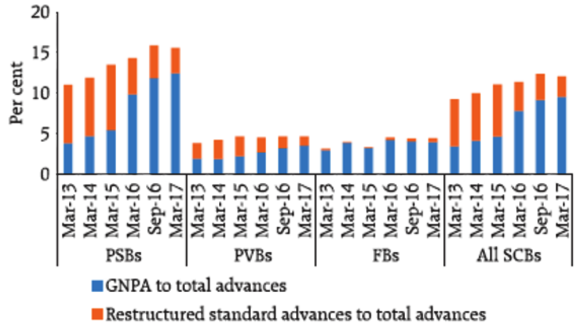


(Note: the above data is an average of FY17 figures of top 20 PSBs)

The NPAs of PSBs have almost doubled over the last five years. This has led to banks increasing their provisions and in turn taking a significantly hit on profitability. In fact, PSBs capture a significant high share in total stressed assets and NPAs portfolio as compared to their private and foreign peers.

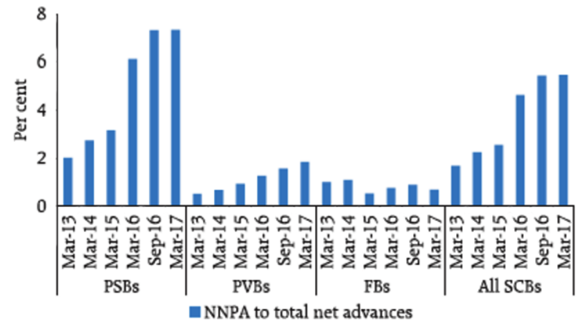
1. India to Inject $32 Billion Into State Banks to Boost Loan Growth; Bloomberg; 24 October 2017
2. Arun Jaitley announced the recapitalisation of banks and the stock prices increased greatly. Is it possible for the likes of Arun Jaitley to leak this information so that stocks can be bought before the announcement to sell later at higher prices?; Quara; accessed on 24 October 2017

Stressed advances



Source: Financial Stability Report June 2017; Reserve Bank of India; 30 June 2017

Net Non-Performing Advances (NNPAs)



Source: Financial Stability Report June 2017; Reserve Bank of India; 30 June 2017

Bank slowdown corporate lending – question on banks' willingness to lend

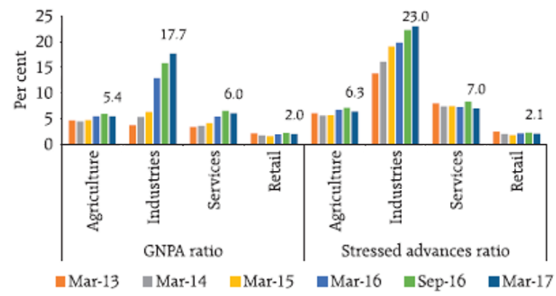
Recapitalisation is majorly being aimed at increasing banking activities, particularly in the corporate lending space that is witnessing an all-time-low currently. However, the primary question is whether banks still cannot lend or do not want to lend. The question of 'cannot lend' is a big 'no' as recapitalisation and other NPA resolution programmes that the government is running in parallel leaves enough capital at banks' disposal to increase lending. This leaves us with the moot question about banks' willingness to lend. Past records suggest that the accumulated NPA figures are a result of 'aggressive funding' by banks in these years. As a result, the main reason for the current slowdown in lending is significant decline in credit to the risky sectors such as telecommunications, iron and steel, textiles, construction and power. Unfortunately, these are also the sectors that have garnered maximum borrowings in the past. The chart below restates the sharp decline in bank credit across all industries, except the micro and small. Interestingly, personal loans or retail lending had a comparatively small decline as compared to the other larger industries.

Retail lending being preferred by banks over corporate lending

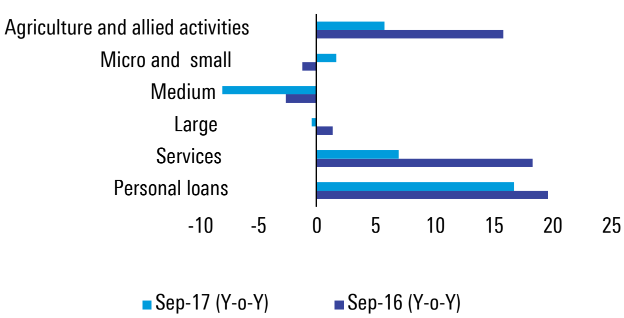
Stressed assets of banks majorly lie in the agriculture sector and the industrial sector. In the industrial sector, textiles, paper, cement, metal, transport and construction sub-sector contribute bulk of the stressed assets. Retail sector, in comparison has the smallest amount of stressed assets and hence is being preferred by banks today. However, the economics of GDP growth lies in growth of credit and private investment in agriculture and industrial sector, rather than on retail spending that drains out disposable income.

Asset quality of broad sectors

Per cent to total advances of the respective sector

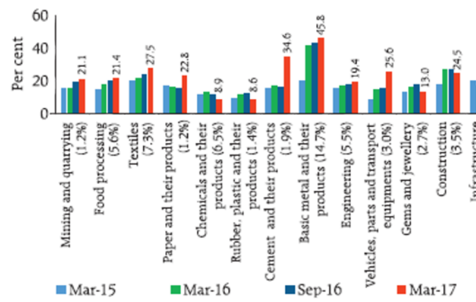


Growth in Y-o-Y bank credit



Source: Centre for Monitoring Indian Economy

Stressed advances ratio of major sub-sectors within industry



Source: Financial Stability Report June 2017; Reserve Bank of India; 30 June 2017

Future prospects of banking in India

In the next couple of years, banks will require further capital to build the 11.5 per cent Capital to Risk Assets Ratio (CRAR) by 2019 or 2020 (if the dates get deferred).[3] The government has helped banks with resolving their stressed assets problems in more than one way. While recapitalisation is recent, the right to unveil names of stressed assets, setting up Insolvency and Bankruptcy Code, 2016 and Strategic Debt Restructuring scheme are other measures announced. In fact, RBI identified 12 accounts in June 2017 for insolvency proceedings with each of them having over approx USD0.78 billion (INR50 billion) of outstanding loans, accounting for 25 per cent of total NPAs of banks.[4] However, there are other structural changes required before we can stop the vicious cycle of recapitalisation that has been going on for over a decade now. Asset liability duration mismatch in banks, limited expertise to assess infrastructure projects and lack of a treasury market are some pressing issues that the banking sector faces.

Apart from banking, the different sectors also have long-standing structural issues which restricts bank's ability to lend to them. For example, in the agriculture sector, the number of waivers provided to borrowers under different government regimes has deteriorated the credit culture to such an extent that borrowers do not want to pay-off the loans and await another waive-off drive during elections. Another example of sector incompetency lies with state power boards that are running into perpetual losses, affecting their capability to repay loans.

A number of other countries such as China, have dealt with pressing issues of NPAs via the recapitalisation method. However, the success was visible only when the scheme was run in parallel with incentive-based capital allocation, aggressive loan recovery laws, and availability of credit to priority sectors that have multiplier effect on fiscal benefits and a strong base of asset reconstruction companies.

Conclusion:

In light of heavy NPAs, banks are not yet psychologically ready to take new risks. In the larger interest of banking, it is prudent and essential that banks should take a pause, review their systems, upgrade their technology, improve their credit monitoring, sharpen their credit assessment skills, learn from foreign counterparts, innovate and then embark upon credit expansion phase. In normal course, this realignment and system re-orientation could take two to three years post which credit expansion will follow.

Additionally, PSBs need to build their own competitive advantage by treating data as a strategic asset. Analysing structured data to formulate business strategies around cost optimisation, new products and risk aversion is inevitable and the bank that uses data more efficiently is likely to have the most sustainable growth lifeline.

3. RBI allows banks to expand capital base to meet Basel III norms; Business Standard; 2 March 2016
4. RBI says 12 accounts with 25% of bank bad loans identified for bankruptcy proceedings; Livemint 15 June 2017

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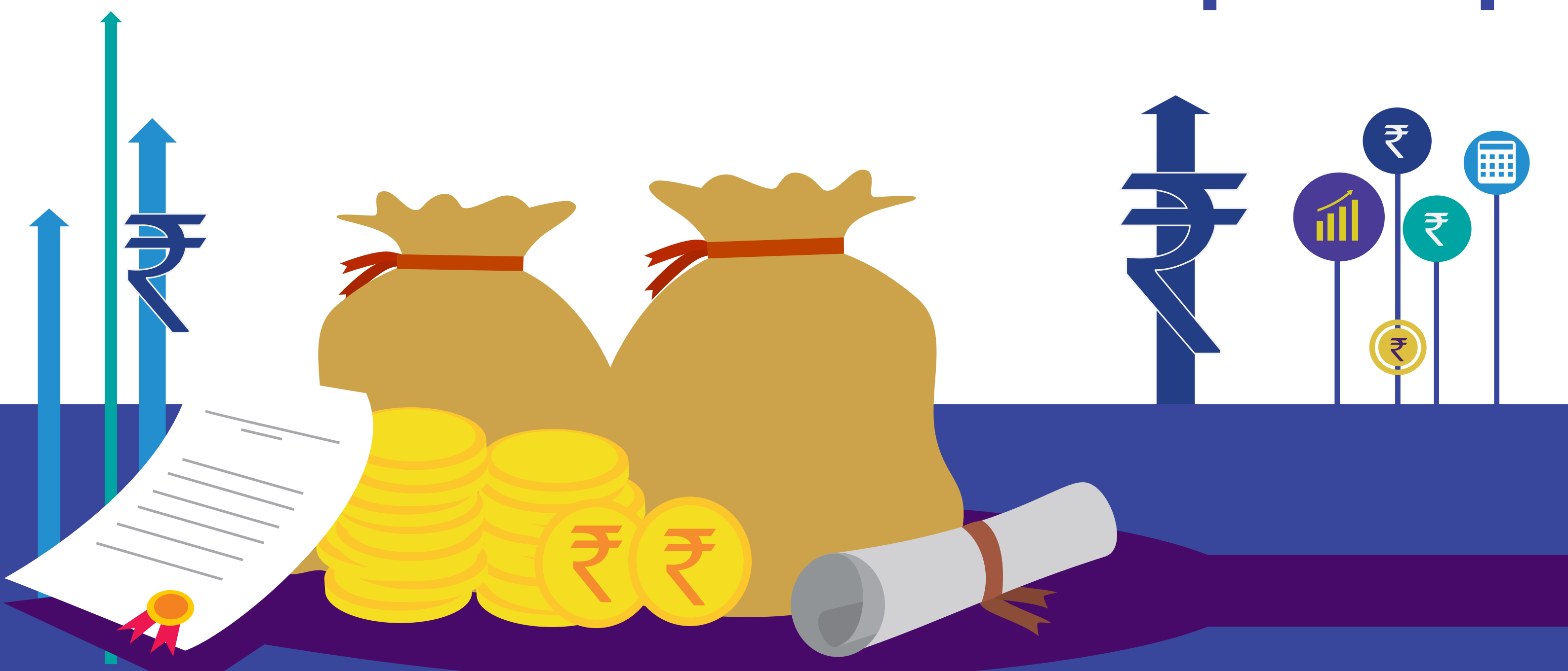

KPMG in the news

"I strongly believe in the need for more women in leadership"| CFO India Magazine, October 2017

"Empirical studies show that the presence of women makes a difference in the work culture. My firm and I strongly believe in the need for more women in leadership. I think most firms have a long way to go." – **Arun M Kumar, Chairman and CEO, KPMG in India**

Fixing stressed assets needs more than just bank recapitalisation | Business Standard, 12 November 2017

"In sum, both a well-capitalised banking system and vibrant corporate bond market are essential to create conducive environment for business investment. With the recapitalisation package, the government has done well to address the issues long plagued the banking system. Going forward, reforming governance at state-owned banks, divesting government stake in those banks, and making India's corporate bond market more vibrant should be given priority." - **Akhil Bansal, Deputy CEO, KPMG in India**

Corporate governance will become more equitable: KPMG's Arun M Kumar| Business Standard | 16 October 2017

"Corporate Governance in a field where you have to move forward through evolution rather than revolution. The committee has made a number of recommendations that relate to independent directors and board engagements, among others. These will help make corporate governance more equitable for minority shareholders, as well as create long-term value creation for all shareholders" —Arun M Kumar, Chairman and CEO, KPMG in India

Featured publications

Illicit trade: Fueling terror financing and organised crime

The report discusses the socio-economic impact of illicit trade on global and Indian economies, with focus on smuggling, counterfeiting and piracy. Further, the estimation of smuggling of goods such as gold, electronics, machinery etc. has been done. The report additionally illustrates the measures taken by government and industry in dealing with the problem of illicit trade in India, and provides recommendations on the way forward for the same.

Click here for the report

The India - U.S dynamic – Better together

The report attempts to provide an overview on the Indian economy and the factors which have propelled the country to become one of the fastest growing economies in the world today. It offers interesting insights into the evolving India-U.S. business dynamic and provides directional insights on some key sector opportunities that exist for the U.S. based companies who are looking to leverage opportunities in India across sectors such as Aerospace and Defence/Cybersecurity/Energy/Information Communication Technology/ Pharmaceuticals/Retail/ Financial Services/Smart cities

Click here for the report

Quality in agile teams – Testing in the driver's seat

With the need for better quality being the major driver for agile adoption, the report deconstructs the role of testing and how testing has transformed in agile teams – from being in the back seat to now being in the driver's seat. The report also explores the role of test automation and tools in agile teams. The report provides key takeaways for improvising quality in agile teams.

Click here for the report

The intelligent economy

This thought leadership report discusses in detail about the role of digital technology in transforming our economy. The report also highlights the roles played by key players in the transformation of our economy, viz. consumers, businesses and the government. This report also focuses on the latest concepts and developments in technology such as IOT, Robotic Processes Automation, Blockchain, Big Data analytics, Artificial Intelligence, etc.

Click here for the report

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