INDIA UPDATE

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GROWTH FALLS SHORT OF HIGH HOPES, BUT POLICY FUNDAMENTALS ARE IMPROVING

Growth falls short of the last election cycle's great expectations

Indian growth is mired in a protracted slump. The global energy downturn, weakness in India's emerging market trading partners, and the strength of the rupee relative to currencies of other emerging and commodity-exporting economies are weighing on India's exports, which fell 6.5 percent in real terms in 2015. These headwinds also cut corporate profits and limit businesses' ability to fund capital investment from retained earnings. As in China, subdued investment has caused a slump for Indian production of cement, autos, and other capital goods. Real GDP growth will likely hold steady in 2016 and 2017 at about 7.2 percent. Also as in China, India's monthly industrial production and PMI data are considerably weaker than GDP, and suggest the economy's true rate of growth may be 1 to 2 percent slower than headline statistics indicate.

Tighter fiscal policy creates room for more commercial credit

This moderate growth falls short of the impossibly high hopes for economic revival that followed the Bharatiya Janata Party's (BJP) sweep of the May 2014 elections. The BJP, historically an opposition party, won a parliamentary majority by promising to streamline government, fast-track investment, and boost economic growth. So far, the government has succeeded in strengthening public finances: Central government revenue growth has outpaced public spending since the election, shrinking the deficit by 11.8 percent in 2015 from 2014. The BJP government has ended expensive subsidies for diesel fuel and removed political bottlenecks to energy production. The drop in global energy prices also bolsters public finances by reducing the cost for remaining public subsidies like the subsidy for household natural gas, which costs India roughly a quarter of a percent of GDP annually. As government borrowing shrinks, the government "crowds out" less borrowing by commercial banking customers, creating room for faster growth of credit to the private sector (See Chart 1). Unfortunately, the BJP has made less headway in breaking down bureaucratic obstacles to infrastructure investment – a stumbling block to faster growth. The government passed an ordinance

CHART 1: INDIA'S GOVERNMENT CUTS ITS BORROWING NEEDS, CREATING ROOM FOR MORE COMMERCIAL LENDING

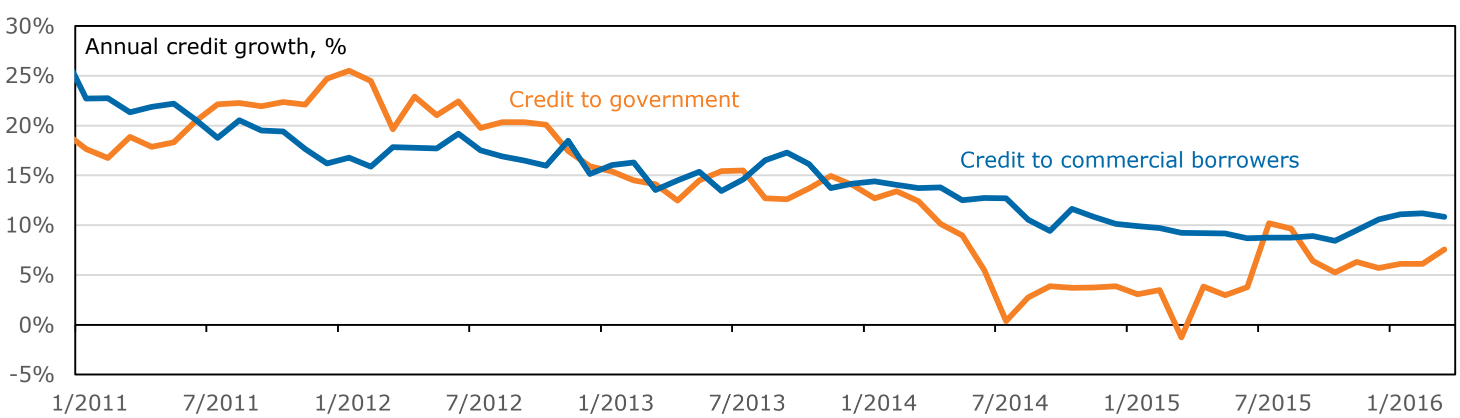


Chart sources: Reserve Bank of India, CEIC, The PNC Financial Services Group

India has still not cracked the code to accelerate investment, industrialization, or urbanization

(The Indian government's version of an American executive order) in December 2014 to simplify eminent domain rules governing its acquisition of land for infrastructure and industrial development. The ordinance lowered development costs and shortened the timeline for development – but accomplished it by limiting local communities' influence over development. Public opposition forced the government to reverse the ordinance in August 2015. India needs a politically viable path to faster and more cost-effective infrastructure development to imitate the Asian Tiger model of economic growth, in which urbanization, industrialization, and high capital investment fuel rapid growth in output per worker and rising standards of living.

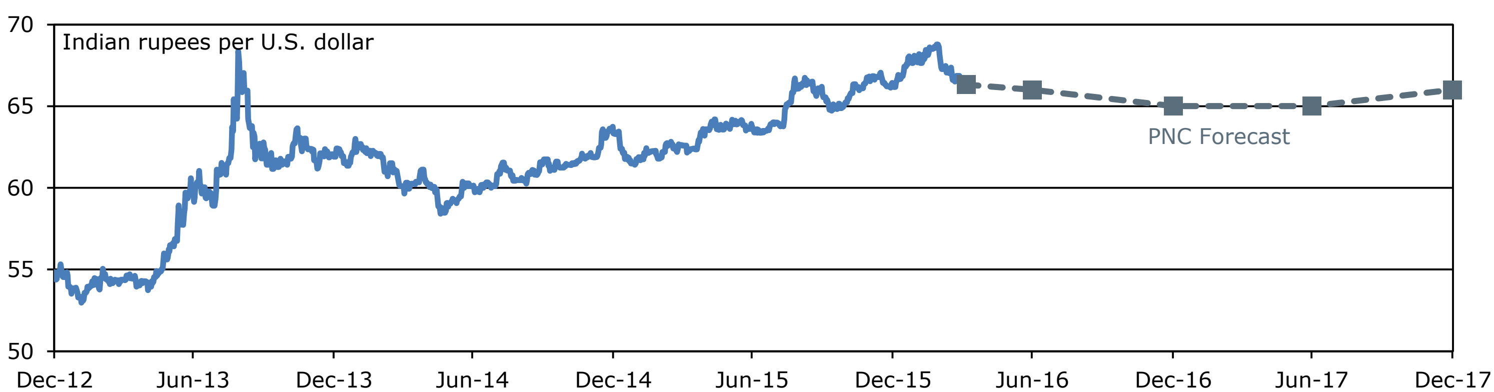
Smart monetary policy is lowering inflation expectations

Indian monetary policy is, like fiscal policy, a relatively bright spot. The Reserve Bank of India has pursued a highly effective inflation targeting regime under Governor Raghuram Rajan, lowering CPI inflation from over 10 percent when Rajan assumed his post in September 2013 to 5.2 percent from a year earlier in February 2016, close to the RBI's 5 percent medium-term target. Lower inflation is not only due to plunging oil prices. Annual CPI inflation excluding food, fuel and light also slowed by 3 percentage points between late 2013 and early 2016 as the RBI's rules-based monetary policy, smaller public deficits, and low global commodity prices lowered inflation expectations – creating room for the RBI to cut its policy repo rate 25 basis points to 6.5 percent at its most recent April 5 decision. If inflation expectations keep falling and monetary policy outside India remains accommodative, the RBI will likely make another one or two 25 basis point policy repo rate cuts in the second half of 2016.

The rupee could appreciate moderately in 2016, but the 2017 outlook is less clear

International developments – including the Federal Reserve's first interest rate hike in a decade, plunging oil prices, and the possibility of a Chinese devaluation – collectively fueled a bout of global aversion to emerging market risks and a sharp depreciation of the rupee in late 2015 and early 2016. The rupee has appreciated since February as these fears receded and as the Federal Reserve dialed back its forecast for U.S. interest rate hikes. As fears of a global recession fade, the rupee seems likely to appreciate further through the end of 2016 (See chart 2). However, the outlook for 2017 is less clear. Indian CPI inflation is substantially higher than inflation in the U.S. or other advanced economies, pressuring the rupee to trend weaker over the medium term. In addition, if the European Central Bank and Bank of Japan signal a high water mark for negative interest rates and quantitative easing in 2016, they could spur a repeat of the mid-2013 "taper tantrum" that roiled the rupee and other emerging market exchange rates.

CHART 2: RUPEE COULD APPRECIATE FURTHER THROUGH THE END OF 2016, BUT 2017'S OUTLOOK IS LESS CLEAR



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Sources: Reserve Bank of India, CEIC, The PNC Financial Services Group