Diagnosis of the faltering Indian economy

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The Indian economy has been tumbling recently. India's exchange rate had been fluctuating from the end of last year, and earlier this year it plunged. This was a fatal blow to India's real economy, which had already been faltering in the wake of the European financial crisis. Its economic growth rate was 5.3% in the fourth quarter of FY 2011.

Global credit rating agencies are adding fuel to the fire. On May 14, 2012, Moody's downgraded the hybrid ratings of India's three largest private sector banks, ICICI Bank, HDFC Bank, and Axis Bank, from Baa3 to Baa2. Moody's alluded that the ratings of the private banks were deeply related to the sovereign rating of the nation, indirectly suggesting that India's sovereign rating had declined. On June 11, Standard & Poors (S&P) warned that India may lose its investment grade rating, dropping from investment grade to speculative grade. India's current sovereign credit is rated BBB-, the lowest level for investment. If India loses its investment grade, it will fall into junk status (speculative grade). S&P warned that India may become the first among the BRICs countries to break the trend of high growth. Why is the Indian economy faltering so severely?

Inflation, the main culprit of the recent depression

As the global financial crisis broke out in 2008, economic growth rates across the world nosedived, and the sense of urgency was amplified. One after another, countries around the world adopted policies for fiscal expansion and monetary expansion, dragging down interest rates significantly.

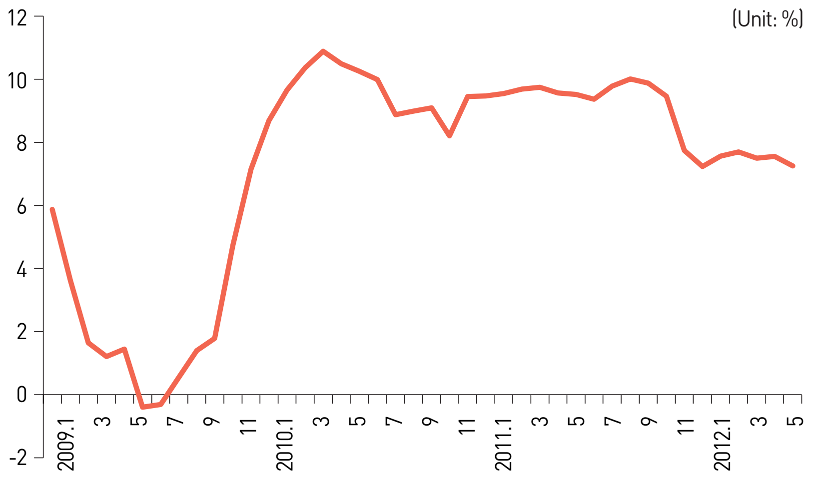
India's benchmark interest rate declined continuously from July 3, 2008, when it recorded at 9%, to 4.75% on March 19, 2010. The Indian government's fiscal expansion and interest rate cut led to ample liquidity in the market, resulting in rapid inflation. The wholesale price increase rate, which was negative in June of 2009, rose continuously, exceeding 10% in early 2010, and remained above 9% for almost two years, causing commodity prices to fluctuate.

The Indian government returned to a tight monetary policy and continued to raise interest rates. An interest rate hike, which started on April 20, 2010, stopped as late as April 17, 2012, pushing up the benchmark rate from 4.75% to 8.5%. As the rate increased, the growth rate naturally declined. India's quarterly growth rate fell from 9.3% in the first quarter of 2010 to 5.3% in the fourth quarter of 2011. The Reserve Bank of India (RBI) has set out to raise interest rates in order to curb excessive inflation. When economic growth rates fell more sharply than expected, however, the RBI eased its tight policy and cut its interest rate slightly on April 17, 2012.

The wholesale price increase rate is currently stable at around 7%, but the figure is still burdensome. India's economic growth rate has plummeted in line with the European financial crisis, deepening the Indian authorities' agony.

In the end, the RBI curbed inflation by raising interest rates and seemed

Wholesale price increase rates



Source: Indian Ministry of Statistics and Programme Implementation

to partially succeed in inflation control. Despite the decline in growth rates, the outcome is not negative politically, considering the economic impact of inflation on the common people. If inflation subsides and the European financial crisis is addressed, Indian economic growth will very likely get back on track. However, the persistence of pessimistic outlooks coming from both inside and outside of India is worrisome.

External confidence diminished by government incompetence

The continuous devaluation of the rupee, which started last year, has been attributed to external factors, such as an increasing preference for safe assets since the European financial crisis, and European capital outflows from India to Europe, the epicenter of the crisis. However, given that other Asian currencies did not plunge as deeply as the Indian rupee, the problem is not that simple.

The biggest problem is India's current account deficit. India's current

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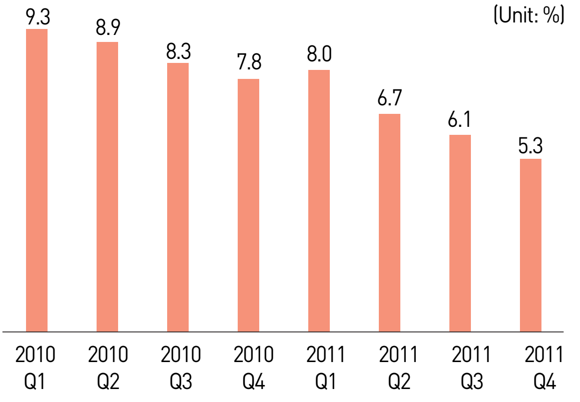
account deficit was USD 27.9 billion during the 2008 financial crisis, but surged to USD 78.1 billion in 2011. What is worse, its deficit continues to grow. The main culprit of the current account deficit is India's trade balance deficit, which stood at USD 189.7 billion in 2011. India's strengths—IT software export and foreign remittance—are not enough to reduce the trade balance deficit, so the current account deficit is continuously growing. The increase in trade balance deficit was mainly caused by oil price hikes, but rising imports of manufactured goods also played a role. As industrialization proceeds in India, imports of capital goods and intermediate goods, which are necessary for industrialization, are increasing. Imports of consumer goods are also on the rise. With the Indian economy expanding, India has become dependent on imports of capital goods, intermediate goods, and even consumer goods, making the current account deficit even bigger. It is questionable why India cannot develop import replacement industries.

According to a report by the Indian Council for Research and International Economic Relations (ICRIER), India's weak manufacturing is attributed to its inadequate infrastructure and labor laws, which are an impediment to the nurturing of manufacturing industries. As India's labor laws are rigid, labor-intensive light industries have difficulty prospering. Inadequate infrastructure leads to an increase in manufacturing overhead costs, hindering the development of heavy industries. Manufacturing should be promoted in order to replace imports and nurture export industries; however, labor law reform and dramatic infrastructure development are just hollow government propaganda. In reality, nothing has changed.

How have measures for labor law reform and infrastructure improvement been implemented? In the 2009 general elections, the ruling

India's quarterly economic growth rates



Source: Indian Ministry of Statistics and Programme Implementation

United Progressive Alliance (UPA) retained power. In the process, leftist groups, who had always opposed the government's reform policies, left the Cabinet. Expectations of reform measures ran high. However, what happened afterwards suggests that the current UPA government was lethargic and incompetent, lacking any will. The party even complained that the former UPA party was better than it was. Following the forced eviction of migrant workers for the Commonwealth Games 2010, the 2G spectrum scandal of 2011 and a series of other scandals in both the central and local governments occurred. Amid mounting populism, politicians have rushed to lay down policies for maintaining the status quo, rather than seeking long term benefits for residents. For example, in order to improve the lot of residents, backward mountainous areas should be developed by improving infrastructure to give access to residents, supplying electricity to improve their living standard, and introducing companies to help create jobs and raise incomes. In reality, however, politicians are making countless policies to nullify development projects out of fear of resident opposition, and using the tight budget for pork barrel measures. This is a vicious cycle that makes backward areas more backward.

The Special Economic Zones (SEZ) have fallen prey to populism. The Indian government's decision to impose an minimum alternate tax (MAT) on the developers of SEZ's and lift tax exemptions for dividend income makes people doubt the government's will to develop the zones. The development of SEZ's is often hampered by the difficulty of land acquisition, thus the Indian government's decision caused a loss of market confidence. In addition, inconsistent policies on the opening of the Indian market to mega distributers, and the imposing of retroactive taxes on Vodafone, disregarding a ruling by the Supreme Court, clearly show who should take the blame for the loss of market confidence.

A silver lining

The news is not all bad. Foreign direct investment (FDI) in India is not declining. Excluding reinvestment, new FDI inflows into India totaled USD 35.8 billion in 2011, a significant increase from USD 22.2 billion a year ago. Moreover, India has successfully overcome both the 1998 and 2008 financial crises. Perhaps the Indian economy has resistance to external variables because it is dependent on domestic demand. Now is the time for the Indian government to think hard about ways to boost domestic demand. C

Automakers in India should revamp product lineup and improve sales skills

Park Sang-min
Head of Export Group of Hyundai Motor India

The BRIC's countries have been driving global economic growth for the last five years; however, their economic conditions look dismal these days. India, a BRIC's member, is having hard times in the wake of the European economic crisis. India's economic growth had a 9-year low of 5.3% in the fourth quarter of FY 2011 (January-March of 2012). International rating agencies have downgraded India's economic outlook one after another. Among the many suggested reasons for the instability of the Indian economy, two explanations are the most plausible: outflows of European hot money and uncertainty about the Indian government's policies.

Aggravating external conditions in the auto industry

The Indian government's deteriorating budget balance is casting a dark cloud over the country's medium- to long-term economic outlook. The worsening fiscal deficit creates a vicious cycle of dwindling public expenditure and tax hikes.

Annual automotive industry outlook

(Unit: 10,000)

	2011	2012 (e)	2013 (e)
Production capacity	390	417	442
Sales Volume	292	311	338
Domestic demand	243	257	278
Export	49	57	60

Statistics on 16 carmakers (Tata Nano excluded)
Source: Hyundai Motors India

The situation is particularly bad for the automotive industry. After the release of the FY 2012 budget, India's goods and services taxes (GST) increased by 2-5%, and potential consumers delayed their purchase of cars, leading to falling demand. After March and April of 2012, some local governments raised vehicle registration taxes by 2-4%, and increased other vehicle-related taxes. In addition, the central government raised gasoline prices by 13% on May 24, adding to the woes of the automotive industry.

No more high growth in the auto industry

In the past, the Indian automotive market was dominated by three major automakers, Maruti Suzuki, Hyundai, and Tata Motors, which accounted for about 80% of the market. However, late movers, such as Toyota, Nissan, Volkswagen, and Renault, have changed the competition landscape with a variety of lineups and customer services, making competition fiercer. Amid this fierce competition, the Indian automotive market has maintained an annual average growth rate of 14.3% for the last five years. The automotive industry is seeking to expand investment and production capacity in order to cope with industrial demand effectively.

Despite harsh economic conditions, automotive demand in the first half of this year is expected to grow by 4.8% year-on-year, with a passenger

Percentage of Sales Volume by Fuel Type

(Unit: %)

		Hyundai	Maruti	Tata Nano	Toyota	GM	VW	Others	Average
2011	Gasoline	83	70	36	65	61	34	38	62
	Diesel	17	30	64	35	39	66	62	38
2012 (Jan.-Jun.)	Gasoline	76	62	41	23	30	31	41	55
	Diesel	24	38	59	77	70	69	59	45
	Comparison to average	-21	-7	14	32	25	24	14	
Comparison to the previous year		7	8	-5	42	31	3	-3	7

Source: Society of Indian Automobile Manufacturers (SIAM)

vehicle sales estimate of 2.54 million units. However, the forecast will inevitably change if the European financial crisis spreads, the Indian government further raises taxes on diesel cars, or the price of diesel fuel increases.

The Indian automotive market in the first half of this year can be summed up by a rapid increase in sales of diesel cars and UV's (SUV and MPV). Since the second half of 2011, the Indian government has continued to increase gasoline prices in order to reduce oil consumption, widening the gap between diesel and gasoline prices. The price of gasoline has increased by 27% since 2010, while the price of diesel has increased by less than 8%. In its recently released budget, the Indian government decided to increase taxes on both gasoline and diesel cars by 12%; however, it has not actually imposed taxes on diesel cars, leading to further distortion in the automobile fuel market. Based on the Indian government's fuel policies, automakers are expanding diesel-related investment: Maruti Suzuki has built a diesel engine plant, and Honda has launched the Honda Brio diesel model. Since Toyota, Volkswagen,

India’s automotive demand outlook

(Unit: 10,000 units; %)

		2011	Current outlook				If the eurozone crisis spreads		
			2012	Growth rate	2013	Growth rate	2012	2013	Growth rate
IHS Outlook	Passenger cars	195	206	5.6	235	14.1	206	235	14.1
	UV (incl. vans)	48	49	2.1	68	38.8	49	68	38.8
	Total	243	255	4.9	303	18.8	255	303	18.8
HMI Outlook	Passenger cars	195	202	3.6	212	5.0	195	201	3.1
	UV (incl. vans)	48	52	8.3	66	26.9	50	57	14.0
	Total	243	254	4.5	278	9.4	245	258	5.3

Source: Hyundai Motors India

and Skoda revamped their sales lineups to include diesel vehicles a few years ago, they have been absorbing much of the demand for diesel vehicles.

Due to substandard road conditions, large families, and increasing household incomes, demand for UV’s is rising in India. The rapid growth of UV’s means a change in the Indian automotive market, which has been dominated by low-cost small cars. The low-cost UV market has served as a growth base for local car brands, such as Tata Motors and Mahindra & Mahindra, which have been producing UV’s for years. For example, Mahindra & Mahindra, which had only UV and passenger car lineups in the past, had a whopping 28% increase in sales year-on-year in the first half of 2012, thanks to increasing sales of diesel vehicles and rising demand for UV’s. Toyota is also growing fast in India, with increasing sales of strategically developed compact car Etios Sedan and its diesel variant, the Etios Liva hatchback.

Targeting rural areas with low cost models

Automakers in India are experimenting with various measures in response to changes in the automotive market. Toyota, Honda, and Volkswagen, which are highly dependent on auto parts imports, have slashed production of gasoline models, by reducing or suspending operations, while rushing to diversify diesel models and advance the scheduled launching of low-cost UV models. Nissan is planning to launch low-cost compact models under the Datsun brand name, and is seeking to expand sales by shifting from medium- and high-cost models to low-cost models.

During an economic slowdown, nothing is more important than maintaining appropriate stockpiles and meeting production targets.

Some automakers are actively expanding dealer networks and boosting marketing in rural areas with a strong preference for gasoline models. Accordingly, Maruti Suzuki plans to expand its sales in rural areas from around 30% up to 50%. It is also trying to reduce stockpiles of gasoline vehicles by expanding exports. Between March and April, India's exports of gasoline vehicles rose by 9% year-on-year. In particular, exports of Toyota's Etios, Maruti Suzuki's Ertiga, and Nissan's Micra have grown significantly.

Hyundai's response strategies

During an economic slowdown, nothing is more important than maintaining appropriate stockpiles and meeting production targets. To this end, Hyundai is implementing various measures to ensure sustainability, while focusing on maintaining its sales momentum to keep its previous production output.

In the short term, Hyundai plans to increase its supply of diesel models

Models to be launched in 2012

Maker	Model	Type	Launching date
Mahindra & Mahindra	Mini Xylo	MPV	7
	Verito		9
Tata Motors	Safari Storme	SUV	10
Renault	Duster	SUV	7
Force Motors	Force One	SUV	9
GM	New Cruze		6
	Sail		12
Maruti Suzuki	Ertiga	MPV	4
	Replace	Compact	12

in line with the increasing sales of diesel models, and launch a new model equipped with a diesel engine in order to increase sales. It seeks to push up sales by extending dealer networks from urban areas to rural areas with a relatively low preference for diesel vehicles. Hyundai has developed various promotional programs to meet customer needs, such as promotional programs related to second-hand car sales. It has developed training programs for dealers and salespeople to strengthen sales skills for qualitative growth. It is currently operating a program to designate best-selling dealers as platinum dealers, together with a special education program for the next generation of dealers who will become a main pillar of next-generation dealer management. Hyundai offers field trips to all salespeople at all dealerships in India to boost their pride in the company, and gives the best salespeople an opportunity to visit the headquarters and plants in Korea and experience Korean culture, helping them learn Hyundai’s philosophy, values, and spirit. Hyundai also endeavors to boost brand awareness by strengthening public relations and marketing through corporate social responsibility, corporate advertisement, and sports marketing. As the largest automaker in India, which accounted for 49% of India's total exports of passenger cars in 2011, Hyundai Motor India is making efforts to secure a stable supply of production and boost profitability by expanding exports, making the most of the devaluation of the rupee.

In the medium- to long-term, Hyundai is spurring development of UV's in response to increasing demand. It is also systematically developing automotive financing solutions in order to provide customers with better payment plans.

Proper risk management is important in the slowing Indian economy. In order to strengthen the fundamentals of the company, it is essential to establish long-term strategies, such as improving the capability of salespeople, developing internal systems to redouble sales skills, and developing new products to meet future customer needs. C