Country update **INDIA**

Summary

Economic growth in 2011/12 slowed to 6.5% from 8%+ growth figures in the two years before. For this fiscal year, economic growth is expected to be around 6% to 6.5%, although downside side risks are very present. A drought, which is expected this year, or a messy Greek exit could depress growth. If economic growth slows further, the large deficits on the fiscal and current account balances become even more prominent. The budget target of 5.1% of GDP is likely to be missed, while the current account deficit is expected to be close to 4% of GDP this year. Worries on the fiscal situation are partly mitigated by the fact that the domestic banking system continues to support the government by generously buying bonds. Meanwhile, the government is seen as all important to kick-start economic growth, as policy inaction and uncertainty are often mentioned as the main culprits of waning investor confidence. However, the ruling UPA is a lame duck, due to differences within the coalition. A new finance minister could provide a boost to reforms, but the window of opportunity is short as the (state) election season is expected to start this November and run until the national elections in 2014.

Things to watch:

- Reform drive and national parliamentary elections in 2014
- Economic growth, fiscal and current account deficits
- Inflation

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India

National facts	
Type of government	Federal republic
Capital	New Delhi
Surface area (thousand sq km)	3,288
Population (millions)	1,130.0
Main languages	Hindi (30%)
	English
Main religions	Hindu (80.5%)
	Muslim (13.4%)
	Christian (2.3%)
Head of State (president)	Pranab Mukherjee
Head of Government (prime-minister)	Dr. Manmohan Singh
Monetary unit	Indian rupee (INR)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	1856	2.68
Nominal GDP at PPP	4508	5.67
Export value of goods and services	446	2.02
IMF quotum (in mln SDR)	5822	2.68
Economic structure	*2011*	*5-year av.*
Real GDP growth	6.9	8.1
Agriculture (% of GDP)	17	18
Industry (% of GDP)	26	28
Services (% of GDP)	56	54
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1544	14
Nominal GDP per head at PPP	3750	30
Real GDP per head	1096	13

Social and governance indicators	rank / total
Human Development Index (rank)	134 / 187
Ease of doing business (rank)	132 / 183
Economic freedom index (rank)	123 / 179
Corruption perceptions index (rank)	95 / 183
Press freedom index (rank)	131 / 178
Gini index (income distribution)	36.8
Population below $1.25 per day (PPP)	33%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
UAE	11	China	12
US	10	UAE	8
China	5	Saudi Arabia	6
Singapore	5	US	5
Main export products (%)			
Engineering goods			23
Petroleum products			15
Textiles & textile products			14
Gems & jewellery			14
Main import products (%)			
Petroleum products			32
Electronic goods			10
Gold & silver			9
Machinery			8
Openness of the economy			
Export value of G&S (% of GDP)			24
Import value of G&S (% of GDP)			30
Inward FDI (% of GDP)			1.8

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

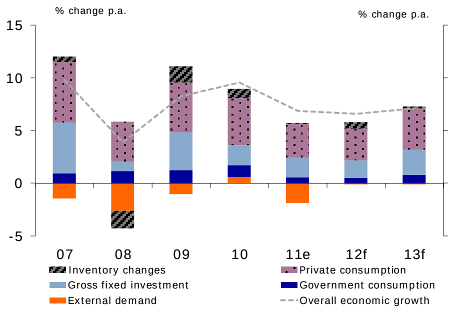
Introduction and update

Economic growth in 2011/12 – India's fiscal year (FY) runs from April through March – slowed to 6.5% from 8%+ growth figures in the two years before. India's economy thus ended at the lower end of the band forecast in our Country Risk Report of February 2012. Especially the 5.3% growth in the fourth quarter of the fiscal year (Jan-March 2012) was disappointing. The slowdown is broad based, as the agricultural, mining, construction and utility sectors all grew by less than 5% in that quarter, while manufacturing production even shrunk 0.3% year-on-year (yoy). Going forward, economic growth is not expected to rebound sharply, as the key factors hampering growth are unlikely to be removed shortly (policy uncertainty, tight monetary policy, twin deficits, weak external demand) and this year's monsoon is expected to be below average (see sections below). For FY 2012/13, economic growth is expected to be around 6% to 6.5%, although the downside side risks are very present. A messy Greek exit could push growth below 6%, for example, while a severe drought could shave up to 1 percentage point off economic growth. RBI, India's central bank, recently lowered its official forecast for this year's GDP growth from 7.3% to 6.5%.

Twin deficits are closely watched

The large deficits on the fiscal and current account balances are a worry, especially if economic growth slows further. For FY 2012/13, the government aims to reduce the central government budget deficit to 5.1% of GDP from 5.7% of GDP last year, mainly by raising taxes. The government missed the budget target by 1.1% of GDP last year, on the back of high subsidies and lower than expected economic growth. The current budget is similarly (too) optimistic, as it is based on an economic growth of 7.5%. Moreover, the minister of finance promised to keep subsidies below 2% of GDP, but announced little concrete measures. Also, the costs of the new food security bill are still vague, while subsidies could rise in light of the expected drought this year. The risks of the fiscal situation are partly mitigated by the fact that the domestic banking system continues to support the government by generously buying bonds. The statutory liquidity ratio, which indicates the minimum share of banks' deposits that need to be invested in government securities, currently stands at 23%. However, the actual rate is well above 30%, suggesting that banks still find government bonds attractive.

Figure 1: Economic growth



Source: EIU

Figure 2: Rupee volatility

Source: Ecowin

The current account deficit widened from 2.8% of GDP in 2008/09 to around 4% of GDP in 2011/12, among others due to the high prices of oil and gold. However, the current account deficit seems to have peaked, as it dropped to a 15-month low in June. A fall in crude oil prices and the doubling of the import duty on gold imports have reduced the import bill, while the depreciation of the rupee and the weaker economy also depressed import demand. Still, the current account deficit is expected to be around 3-4% of GDP in 2012/13. Foreign capital inflows are recovering after the government announced a number of measures. But, investor confidence in India remains rather sensitive to more policy uncertainty from the Indian government as well as global economic turmoil. This is also reflected in the volatile path of the rupee in the past months – up in the early months of 2012, sharp decline in the second quarter and cautious recovery lately.

Cabinet reshuffle unlikely to boost reforms

The government is seen as all important to kick-start economic growth, as policy inaction and uncertainty are often mentioned as the main culprits of waning confidence with both foreign and domestic investors. However, the ruling UPA (United Progressive Alliance) coalition, led by the Indian National Congress (INC) party, is a lame duck, due to differences with the UPA and even within the Congress party. The coalition seems to lack a common platform, thereby hindering any progress on issues such as liberalization and foreign investment in the retail sector and insurance, reducing the subsidy bill by raising fuel prices and implementation of the anti-corruption bill.

Added to the policy paralysis is the policy uncertainty. For example, in this year's budget, the government proposed the anti-avoidance rules (GAAR), which targets tax evasion, partly by making it more difficult to route investment through tax havens like Mauritius. However, foreign investors felt like the Indian government changed the rules of the game while playing. Especially the retrospective element of GAAR, which would allow the government to tax certain (foreign) investments up to 50 years back, has received much criticism. In June, the implementation of GAAR was postponed to April 2013 and the retroactive aspect was reduced to six years back (or not even at all retroactively as proposed in the latest guidelines), but investor confidence has been shaken and the uncertainty remains.

Domestically, the UPA coalition is losing support over several large-scale corruption scandals in the past two years. Among others, in April, a draft report of India's auditor stated that the government potentially missed out on USD 210bn by allocating coal fields through a committee rather than via auctioning. This report comes a few months after the government got burned by selling mobile phone licenses too cheaply in the 2G scam. Also, the widespread electricity blackout in July, which left about half the population in the dark for two days, gives the feeling that the government is unable to address India's major issues.

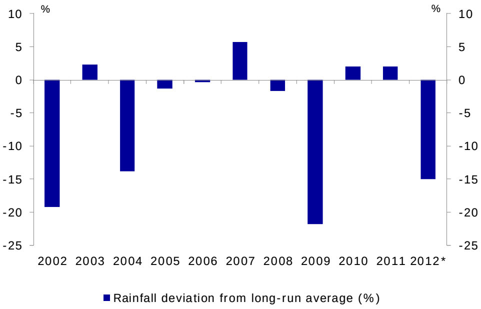
In July, Mr. Pranab Mukherjee was elected as the next president of India. As this role is largely ceremonial, this is hardly newsworthy. Of more interest is the fact that Mukherjee had to step down as finance minister to be able to run for president. A cabinet reshuffle put Mr. Chidambaram in the position of finance minister. It is his third time in this position and he is generally regarded better suited for the job than his predecessor. Still, the window of opportunity to boost reforms seems short. In November 2012, the start of a series of state elections is expected, which will run until the national parliamentary elections in 2014. It is very likely that coalition parties are more interested in positioning themselves favorably during the long election season than in supporting reforms.

When it rains, it doesn't pour

Early August, India's Meteorological Department stated that the rainfall in this year's monsoon, which lasts until September, is expected to come in at 85-90% of the long-run average. In some states, the rainfall deficiency currently is more than 50%. This comes after two years of ample rain. While the economy is less dependent on agriculture than it once was (now 14% of GDP), a poor monsoon can still have a major impact on rural welfare, as about 60% of the population directly or indirectly depends on the agricultural sector. For that sector the monsoon is important, because more than half of the agricultural land in India is still rain fed. Still, the impact on overall economic growth and inflation might be less than intuitively expected. Consumer spending in rural areas is expected to be depressed, depending on the rest of the monsoon season. But, the government will likely compensate part of the loss of agricultural income through extra subsidies on agricultural inputs and refrain from raising fuel prices (diesel is widely used for irrigation). This will make it very likely that the central government will overshoot its budget target, although it is difficult to say by how much. This not only depends on the measures taken, but also on economic growth (if the budget is expressed in relative terms). Estimates suggest that a drought could shave 50 to 100 basis points off economic growth. The actual impact also depends on how much water can be stored in reservoirs. This water is used for hydro power production, which accounts from about 15% of power generation in India, and irrigation of the winter season crops. If hydro power capacity is reduced, this will temporarily aggravate the structural issue that the generation capacity is unable to keep up with India's development.

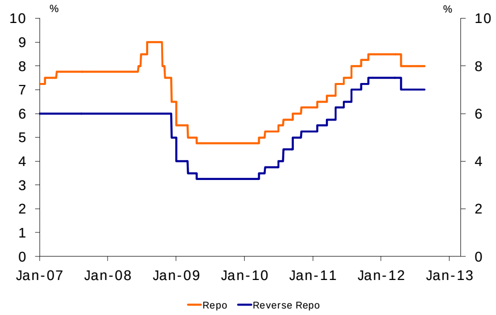
Inflation has been a headache for the Reserve Bank of India (RBI, India's central bank). Headline wholesale price index (WPI), the general measure of inflation in India, was 6.9% yoy in July, the lowest level since late 2009. While this is lower than last year, when WPI was around 9%, it is still high, especially considering the slowdown of economic growth. Food prices are an important reason why inflation remains stuck around 7%, hindering a further loosening of monetary policy. While a poor monsoon and rising global food prices (with a deprecation of the rupee making imported food products even more expensive) are expected to keep prices elevated, the main problems are more structural. Distribution bottlenecks and sharp increases in government-set minimum support prices push prices up. The government is expected to disburse some of its healthy stock of cereals. Therefore, a bad monsoon will not help to bring food prices down, but attributing inflation just to a bad monsoon is too much credit for the weather. RBI has recently put its inflation expectation at 7% for this year, up from the earlier expected 6.5%, and has kept its policy rates unchanged since a bold 50 basis points rate cut to 8% in April.

Figure 3: Rainfall



Source: India Meteorological Department
*data up to 15 August 2012.

Figure 4: Monetary policy



Source: Ecowin

India

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	9.8	3.9	8.2	9.6	6.9	6.6	7.1
Consumer prices (average % change pa)	6.4	8.3	10.8	12.0	8.9	8.4	7.6
Current account balance (% of GDP)	-0.6	-2.5	-2.7	-3.2	-2.5	-4.8	-4.0
Total foreign exchange reserves (mln USD)	266988	247419	265182	275277	271285	243480	268960
Economic growth							
GDP (% real change pa)	9.8	3.9	8.2	9.6	6.9	6.6	7.1
India, Gross fixed investment (% real change pa)	15.3	2.6	10.8	5.7	5.7	5.3	7.5
India, Private consumption (real % change pa)	9.8	6.5	7.9	7.5	5.5	5.2	6.7
India, Government consumption (% real change pa)	9.0	11.4	11.5	9.8	5.0	4.9	7.1
India, Exports of G&S (% real change pa)	5.2	15.2	-6.9	23.9	15.4	16.5	15.6
India, Imports of G&S (% real change pa)	9.9	22.4	-2.2	15.5	18.5	13.1	12.6
Economic policy							
Budget balance (% of GDP)	-2.5	-6.0	-6.4	-4.8	-5.7	-5.5	-5.0
Public debt (% of GDP)	57	56	54	51	49	51	51
India, Money market interest rate (%)	7.8	6.5	4.8	6.3	8.5	7.8	7.1
M2 growth (% change pa)	22	20	18	18	16	9	16
Consumer prices (average % change pa)	6.4	8.3	10.8	12.0	8.9	8.4	7.6
Exchange rate LCU to USD (average)	41.3	43.5	48.4	45.7	46.7	53.7	53.2
Recorded unemployment (%)	8.9	9.4	9.7	10.0	9.8	9.9	9.9
Balance of payments (mln USD)							
Current account balance	-7466	-31802	-36879	-52981	-46912	-86810	-84590
Trade balance	-77845	-124452	-107167	-131823	-168075	-202840	-225730
Export value of goods	153784	198599	168059	225916	307195	345820	408400
Import value of goods	231629	323051	275226	357739	475270	548650	634130
Services balance	39370	47436	38711	42561	60952	69610	88200
Income balance	-6135	-3539	-17185	-15828	-18713	-20320	-26160
Transfer balance	37144	48753	48762	52109	60211	66740	79110
Net direct investment flows	8356	24105	19383	11019	21831	8210	10000
Net portfolio investment flows	23403	-16784	15959	27646	15867	15300	34830
Net debt flows	43395	22733	18428	38557	-7071	19050	6810
Other capital flows (negative is flight)	30065	-18087	3753	-1163	16443	12810	55420
Change in international reserves	97754	-19835	20644	23079	158	-31420	22480
External position (mln USD)							
Total foreign debt	202929	225994	249993	290282	287388	305190	310310
Short-term debt	36093	43821	46603	56448	63190	72980	75760
Total debt service due, incl. short-term debt	64464	67057	60324	66684	112185	99360	117780
Total foreign exchange reserves	266988	247419	265182	275277	271285	243480	268960
International investment position	-74766	-85880	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	335780	332167	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	410546	418047	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-6.5	-9.8	-8.0	-7.9	-9.1	-11.1	-10.7
Current account balance (% of GDP)	-0.6	-2.5	-2.7	-3.2	-2.5	-4.8	-4.0
Inward FDI (% of GDP)	2.1	3.4	2.6	1.6	1.8	1.4	1.5
Foreign debt (% of GDP)	17	18	19	17	15	17	15
Foreign debt (% of XGSIT)	69	61	80	71	56	53	46
International investment position (% of GDP)	-6.2	-6.7	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	22	18	19	16	22	17	17
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	1	2	1	1
FX-reserves import cover (months)	11.5	7.8	9.7	7.5	5.9	4.6	4.4
FX-reserves debt service cover (%)	414	369	440	413	242	245	228
Liquidity ratio	157	134	143	131	115	109	109

Source: EIU