Country report

INDIA

Summary

India is showing very robust economic growth, after a mild slowdown during the global financial crisis. The economy is estimated to have expanded by 9.1% yoy in 2010 and grow by 9.0% yoy in 2011. The largest country risks are found in the political and social situation. While the political situation is stable, it is plagued by frequent conflicts. Last year, prominent political scandals highlighted the fact that corruption is deeply embedded. The social situation remains precarious, as mass protests frequently take place all over the country regarding a wide range of issues. Also, the Maoist insurgency remains the largest threat to India's domestic security. The fiscal position is improving as consolidation efforts have been successful but seem ambitious for the coming year. The external position is very healthy.

Things to watch:

- Political conflicts hindering progress on reforms
- Possible escalation of the Maoist insurgency
- Fiscal consolidation efforts

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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
Main languages	Hindi (30%)
	English
Main religions	Hindu (80.5%)
	Muslim (13.4%)
	Christian (2.3%)
Head of State (president)	Mrs. Pratibha Patil
Head of Government (prime-minister)	Dr. Manmohan Singh
Monetary unit	Indian rupee (INR)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	1645	2.64
Nominal GDP at PPP	4180	5.65
Export value of goods and services	334	1.79
IMF quotum (in mln SDR)	4158	1.91
Economic structure	*2010*	*5-year av.*
Real GDP growth	9.1	8.5
Agriculture (% of GDP)	17	18
Industry (% of GDP)	28	29
Services (% of GDP)	59	54
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1389	14
Nominal GDP per head at PPP	3530	30
Real GDP per head	1061	13

Social and governance indicators	rank / total
Human Development Index (rank)	119 / 169
Ease of doing business (rank)	134 / 183
Economic freedom index (rank)	124 / 179
Corruption perceptions index (rank)	87 / 178
Press freedom index (rank)	122 / 178
Gini index (income distribution)	36.8
Population below $1.25 per day (PPP)	42%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
UAE	12	China	10
US	10	US	6
China	6	UAE	6
Hong Kong	4	Saudi Arabia	5
Main export products (%)			
Engineering goods			23
Petroleum products			15
Gems & jewellery			14
Textiles & textile products			13
Main import products (%)			
Petroleum products			31
Electronic goods			10
Gold & silver			9
Machinery			8
Openness of the economy			
Export value of G&S (% of GDP)			20
Import value of G&S (% of GDP)			26
Inward FDI (% of GDP)			1.5

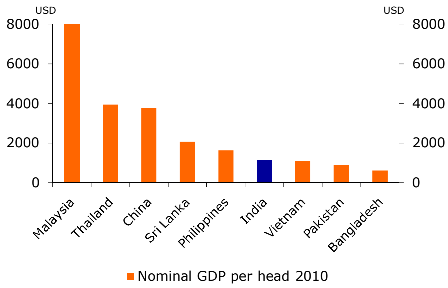
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

India enjoys a very rich culture and history. Around 1500 B.C., Aryan tribes infiltrated India from the northwest; their merger with the earlier Dravidian inhabitants created the classical Indian culture. The country prospered during its Golden Age (4^{th} to 6^{th} century A.D.), which saw a blossoming of Indian science, art and culture. India was invaded by Turks and Afghans in the 10^{th} and 11^{th} century. They established the Delhi Sultanate and ruled for several centuries. In the 16^{th} century, the Turkish/Mongol Mughal Dynasty was established by emperor Babul. By the 19^{th} century, the British had taken over the rule of India and neighboring countries until India became independent in 1947. The current demarcation of the landmass was established that same year after years of communal violence, leading to the creation of the two separate states of India and Pakistan.

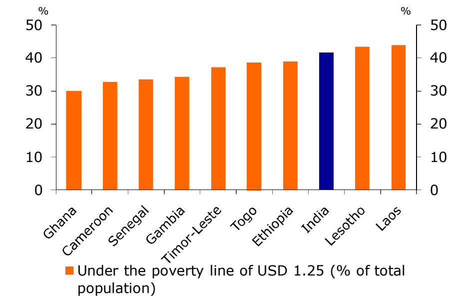
Since the start of this century, the Indian economy has been booming. Even so, the country still faces large structural weaknesses. The level of infrastructure is very low, roads and railways need a lot of improvement. The energy sector is inefficient and a lack of irrigation infrastructure hinders optimal agricultural output. While India does have several internationally acclaimed universities, the overall educational level is very poor and high quality education is inaccessible for the majority of the population. This has resulted in very low literacy rates; 73.4% of the male and 47.8% of the female population over 15 years old can read and write. In comparison, the literacy rates of India's neighbors Sri Lanka and China lie around 90%, making India's record exceptionally poor. This is reflected in the UN's human development indicator, which ranks India 119^{th} out of 169 countries, meaning a medium to low level of human development. This has resulted in a very low income

Chart 1: Income level



Source: EIU

Chart 2: Under the poverty line



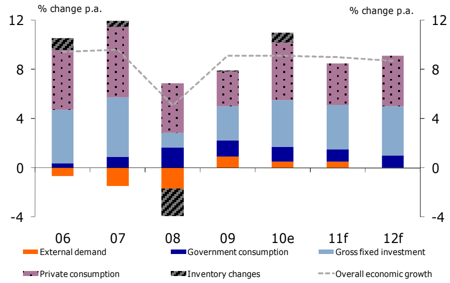
Source: World Bank

level with a nominal GDP per capita at of USD 1,389 and a whopping 42% of the entire population living below the poverty line of USD 1.25 a day. This is extremely high, and as is shown in chart 2, and ranks India among the poorest African countries according to the World Bank.
However, India's economy is expanding at a rapid pace to rise up from the low level of development. Real GDP growth has averaged 8.5% yoy in the past five years. The largest contributor to the economy is the services sector led by a world class IT sector, contributing 59% to GDP in 2010. The agricultural sector contributes only 17% to GDP, but is very important as approximately 60% of the population earn their livelihood from this sector. For 2010, the economy is estimated to have grown 9.1% yoy, driven by gross fixed investment and by private consumption. For 2011, GDP growth is forecasted at 9.0% yoy. Domestic demand in particular is booming in India, as the middle-class grows and the country enjoys favorable demographics to sustain this robust domestic demand in the coming decades. Government expenditures have contributed less to economic growth in 2010 than in previous years, since the government's fiscal stimulus packages have expired. Government expenditures will decrease even more in 2011 as the government has embarked on a path of fiscal consolidation. External demand also contributed to economic growth last year, but only to a small extent compared to domestic demand as the economy is not very open. The openness of the economy (combined value of imports and exports divided by GDP) is only 46%, which is relatively low. In comparison, the economies of India's Asian neighbors such as Malaysia, Vietnam, Taiwan and Thailand, all boast an openness of the economy of well over 100% of GDP. Even so, exports are on an upward trend; the latest data shows exports increased by 31% yoy in January. India's main export products are engineering goods, textile products and gems and jewelry. The country's largest trade partners are the UAE, the US and China.
The Indian banking sector is very tightly regulated by the government and state-owned banks dominate the sector when measured in market capitalization. Adverse effects from the global financial crisis have been minimal due to limited exposure to US subprime loans. Overall, the banking system is very stable.

Political and social situation

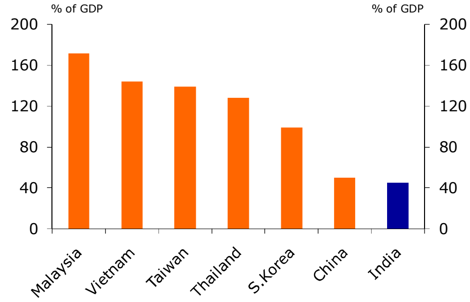
While India prides itself on being the largest democracy in the world, it does not alter the fact it is beset with political uncertainty, embedded corruption and social tensions. The United Progressive Alliance (UPA), led by Sonia Gandhi, is the ruling coalition. The UPA won the 2009 general elections by a landslide. Despite this convincing victory, it has failed to make significant progress on reforms as opposition is fierce. Especially in 2010, the main opposition party, the Bharatiya Janata Party (BJP) has gained traction. In reaction to unpopular government measures, the BJP organizes mass street protests. One example is the fuel price hike, after which the BJP immediately questioned the

Chart 3: Growth performance



Source: EIU

Chart 4: Openness of the economy



Source: EIU

UPA's commitment to its pro-poor program, on which it had so convincingly won the 2009 elections. The tendency of the opposition to walk out of parliamentary sessions last year has obstructed significant progress on reforms and privatization in particular. Apart from the fierce opposition, several large corruption scandals have resulted in a loss of popularity for the UPA. The most prominent one has been the telecom scandal. The auctioning of mobile phone air waves has been marred with bribery and fraud, resulting in the resignation of the telecommunications minister. The fraud is estimated to have resulted in a loss of revenues for the government of USD 40bn. Corruption has cost India dearly, according to a recent report by the US-based Global Financial Integrity Group. It states that India has lost over USD 462bn in illicit assets from 1948-2008 due to corruption, bribery, tax evasion and other financial crime. Note that this figure would exceed USD 500bn if it included last year's telecom scandal. Despite the frequent political conflicts and the loss of popularity the UPA has endured, we expect it to complete its full five year term, as the opposition remains weak.

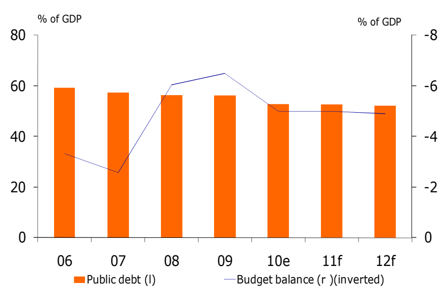
The social situation remains precarious, as mass protests frequently take place all over the country regarding a wide range of issues. A structural source of unrest are the elevated food prices and high food price inflation. It is no surprise this can easily spark riots given that 41% of the population still lives below the poverty line. Another large source of social unrest is the Maoist insurgency, which PM Singh called the single largest threat to India's domestic security. The Maoists are a left wing group who claim to represent the rural poor. Their methods have been extremely violent and have spread in half of India's 28 states. Crimes such as an attack on a police station resulting in the murder of over 70 police officers in a single night and publishing a death list for politicians have become common acts of Maoist rebels. The response of the government in 2009 had been to form a comprehensive anti-Maoist offensive. So far, this approach has been met with criticism from state governments that have been crying out for military deployment. The federal government remains reluctant to implement a full-scale retaliation and instead continues its negotiation efforts. In response to the local governments' pleas, the government has adjusted and expanded the offensive, but not to the extent desired. If they actually decide to counterattack the Maoist rebels, it will no longer be an offensive but an actual war.

International relations of India with the west have been steadily improving since 2001, as the country is striving to increase its global presence as an emerging superpower. Last year, it has mainly strengthened ties with the US. India kick-started the US-India Economic and Financial Partnership Initiative in April 2010 and the visit of President Barack Obama to India in November 2010 has served to further strengthen ties. Relations with Pakistan are still tense, mostly since India remains frustrated with Pakistan's incapacity and reluctance to speed up efforts to find and convict the militants responsible for the 2008 Mumbai terrorist attacks.

Economic policy

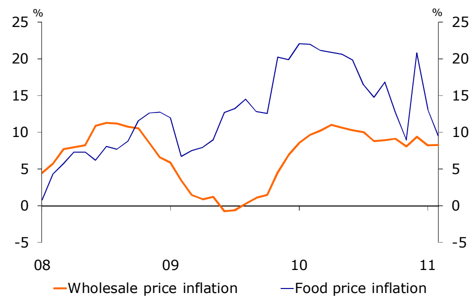
The fiscal position has improved last year as the fiscal consolidation targets were met. The government aims to bring the budget deficit down to 4.6% of GDP in fiscal year 2011/12.
This target is slightly lower than the 4.8% target proposed by the Thirteen Finance Commission, the budget allocation advisory commission of the government. The target seems rather optimistic for several reasons. One being that the Finance Minister decided not to further increase the rate of the excise tax. This tax had been cut to boost the economy in the face of the global crisis. It was expected that it would be gradually raised from the current rate of 10% back to the pre-crisis rate

Chart 5: Public finances



Source: EIU

Chart 6: Inflation



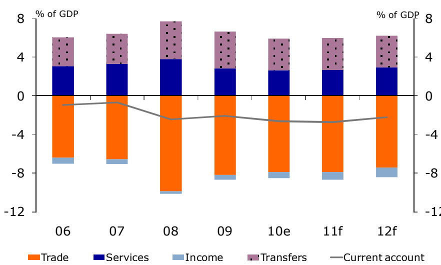
Source: Bloomberg

of 12%. This makes the targeted 18% increase in total tax revenues more difficult to meet, but not unachievable given the expected rise in nominal GDP. The government projected expenditure to rise by only 3.4% this year in nominal terms, which might prove difficult to achieve. Actually, government expenditures will fall to 14% from 15.4% of GDP last year. The majority of the savings are expected to come from deciding not to repeat one-off payments such as agricultural debt relief. The government also pledged to control costs by reducing the rate of growth of subsidies. In practice, it might prove difficult for the government to resist political pressure for more one-off spending, especially as five state elections are due and as food prices remain high. However, the government has shown its commitment to decrease the budget deficit last year by reducing fuel subsidies in the face of public protests. Thus, while the targeted budget deficit might prove difficult to meet, we believe the government is on the right track concerning fiscal consolidation.
Monetary policy is conducted by the Reserve Bank of India (RBI), India's central bank. RBI has been in tightening mode since April 2010, when inflation began to rise. The repo rate has been raised by 175bps since then to 6.5%, and the reverse repo by 225bps to 5.5%. Inflation has averaged 12% in 2010 and according to the latest reading of February 2011 inflation stood at 8.3% yoy. Food prices are the main inflation driver, as the agricultural sector remains highly inefficient and distribution channels are very antiquated. If international food prices remain elevated, these will add to upward inflationary pressures. Another upside risk to inflation is the higher international oil prices. These have risen on the back of the turmoil in the Middle East and will push inflation higher as India is a large net oil importer.
RBI intervenes in the foreign currency markets to stabilize the exchange rate. Last year, it has successfully intervened to stem rapid appreciation of the domestic currency. This has resulted in an accumulation of FX-reserves, which have grown to USD 300bn at end March 2011, from USD 265bn at end 2009.

Balance of Payments

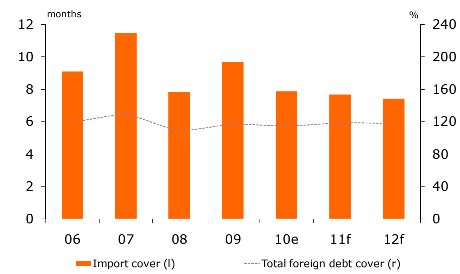
The current account has posted a moderate deficit of 2.6% of GDP in 2010. The main drag on the current account has historically been the trade balance, in 2010 with a deficit of 7.9% of GDP. India imports more than it exports as it is a large oil importer; petroleum related imports constitute 29% of total imports. Electronic goods, gold and silver are the country's other large import products. Total imports increased by 13% yoy in January 2011. Even though the domestic demand momentum is positive, imports are expected to rise only moderately throughout the year as the monetary tightening cycle continues. Exports have picked up and recorded a 32% yoy gain in January. The largest pickup of external demand was for India's engineering goods and gems and

Chart 7: Current account



Source: EIU

Chart 8: Covers offered by FX-reserves



Source: EIU

jewelry. With 2.6% and 3.3% of GDP, the services and transfer balances contributed positively to the current account balance in 2010. If the global economic recovery is sustained, these will again provide a positive contribution to the current account. The income balance posted a 0.7% of GDP deficit in 2010. It has historically posted slight deficits, and is expected to do so again in 2011. This will result in a current account deficit of 2.6% of GDP this year which needs to be financed via external borrowing and/or foreign investment. In 2010, FDI inflows were sufficient to fill the gap left by the current account deficit. FDI inflows stood at USD 24bn in 2010 and expected to increase in 2011 as the government has announced reforms relaxing the regulations on FDI inflows in certain business sectors.

External position

The external position of India is sound. Total foreign debt stood at USD 260bn in 2010 and is expected to rise to USD 280bn in 2011, as the government plans to relax the external commercial borrowing limits for the private sector. The Indian government itself mostly issues bonds on the domestic markets, less than 10% of its total debt is external debt. The private sector is the larger external debtor, with 66% of total external debt. Private external borrowing is heavily regulated by the RBI; external private debt can only be issued via the External Commercial Borrowings policy. The policy is aimed at keeping maturities long, to limit foreign currency refinancing risks for the private sector. As only 25% of India's total external debt is short term, the policy is effective and refinancing risks are low. The country has ample FX-reserves, recording USD 300bn at end March 2011. This results in an import cover of over 10 months and a total foreign debt cover of 114%, both comfortable levels.

India

Selection of economic indicators	2006	2007	2008	2009	2010e	2011f	2012f
Key country risk indicators							
GDP (% real change pa)	9.4	9.6	5.1	9.1	9.1	9.0	8.7
Consumer prices (average % change pa)	6.2	6.4	8.4	10.9	12.0	7.4	5.0
Current account balance (% of GDP)	-1.0	-0.7	-2.5	-2.1	-2.6	-2.7	-2.2
Total foreign exchange reserves (mln USD)	170738	266988	247419	265182	275457	307630	330710
Economic growth							
GDP (% real change pa)	9.4	9.6	5.1	9.1	9.1	9.0	8.7
Gross fixed investment (% real change pa)	14.4	15.3	3.6	8.4	11.5	10.8	11.8
Private consumption (real % change pa)	8.2	9.8	6.9	4.7	8.3	6.0	7.4
Government consumption (% real change pa)	3.6	8.7	16.1	11.6	10.0	8.9	8.5
Exports of G&S (% real change pa)	22.3	5.2	19.9	-6.4	13.3	11.8	12.1
Imports of G&S (% real change pa)	22.0	10.1	22.8	-8.2	8.9	8.3	10.8
Economic policy							
Budget balance (% of GDP)	-3.3	-2.6	-6.0	-6.5	-5.0	-5.0	-4.9
Public debt (% of GDP)	59	57	56	56	53	53	52
Money market interest rate (%)	7.3	7.8	6.5	4.8	6.3	6.7	6.7
M2 growth (% change pa)	22	22	20	18	23	16	16
Consumer prices (average % change pa)	6.2	6.4	8.4	10.9	12.0	7.4	5.0
Exchange rate LCU to USD (average)	45.3	41.3	43.5	48.4	45.7	45.7	45.0
Recorded unemployment (%)	10.4	9.8	10.4	10.7	10.8	10.6	10.6
Balance of payments (mln USD)							
Current account balance	-9299	-8077	-30955	-27027	-43247	-50570	-47850
Trade balance	-61176	-77846	-124452	-106494	-129431	-146900	-161060
Export value of goods	123768	153784	198599	168110	219137	251600	280640
Import value of goods	184944	231629	323051	274604	348568	398500	441700
Services balance	29406	39142	48044	36907	42762	50100	63200
Income balance	-6245	-6136	-3542	-6651	-10846	-15420	-21520
Transfer balance	28716	37143	48751	49219	54268	61650	71530
Net direct investment flows	5992	8202	22945	20730	11333	18000	24000
Net portfolio investment flows	4162	23703	-16783	23516	35358	34080	31490
Net debt flows	23714	60577	22338	-6906	14846	17260	21090
Other capital flows (negative is flight)	15510	13349	-17380	10331	-4502	14400	-4640
Change in international reserves	40079	97754	-19835	20644	13789	33170	24080
External position (mln USD)							
Total foreign debt	143402	204992	230611	225603	241420	259840	280470
Short-term debt	10015	38229	45246	46276	58999	69190	80020
Total debt service due, incl. short-term debt	23722	49051	69305	80896	79003	92420	104640
Total foreign exchange reserves	170738	266988	247419	265182	275457	307630	330710
International investment position	-59682	-74766	-85880	-122901	n.a.	n.a.	n.a.
Total assets	231642	335780	332167	380924	n.a.	n.a.	n.a.
Total liabilities	291324	410546	418047	503825	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-6.4	-6.6	-9.9	-8.2	-7.9	-7.9	-7.4
Current account balance (% of GDP)	-1.0	-0.7	-2.5	-2.1	-2.6	-2.7	-2.2
Inward FDI (% of GDP)	2.1	2.1	3.3	2.7	1.5	1.8	2.1
Foreign debt (% of GDP)	15	17	18	17	15	14	13
Foreign debt (% of XGSIT)	62	70	62	70	60	56	53
International investment position (% of GDP)	-6.2	-6.3	-6.8	-9.5	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	10	17	19	25	20	20	20
Interest service ratio incl. arrears (% of XGSIT)	2	2	2	2	2	1	2
FX-reserves import cover (months)	9.1	11.5	7.8	9.7	7.9	7.7	7.4
FX-reserves debt service cover (%)	720	544	357	328	349	333	316
Liquidity ratio	155	164	133	139	131	129	128

Source: EIU