Euler Hermes Economic Research

Country Risk Analysis

India

Structural weaknesses highlighted

General Information

GDP	USD1841.717bn (World ranking 10, World Bank 2012)
Population	1236.69 million (World ranking 2, World Bank 2012)
Form of state	Federal Republic
Head of government	Manmohan SINGH
Next elections	2014, legislative

Strengths

- Stable democracy, with peaceful changes in government.
- Large internal market, providing some insulation from the global business cycle.
- Successful diversification into manufacturing (motor vehicles) and services (including call centres, IT and biotechnology).
- High annual GDP growth (annual average +7.9% in the ten years up to end-2012).
- External debt is low relative to earnings and repayment capacity.
- Strong FX reserves (around USD270 billion).

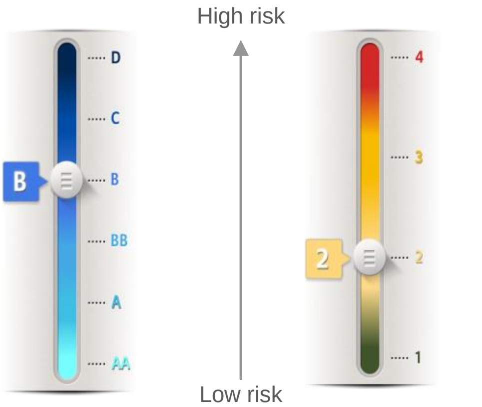
Weaknesses

- Vulnerable to natural disasters (including tsunami, drought, floods and earthquakes).
- The Kashmir region remains volatile and the source of potential conflict.
- The political system tends to engender coalition governments that lack the ability to push through economic reforms.
- Poverty remains pervasive and income distribution uneven.
- Structural weaknesses include inadequate infrastructure for a country of its status, current and fiscal account deficits and state involvement crowds out private sector initiatives in some sectors.
- Weak structural business environment.

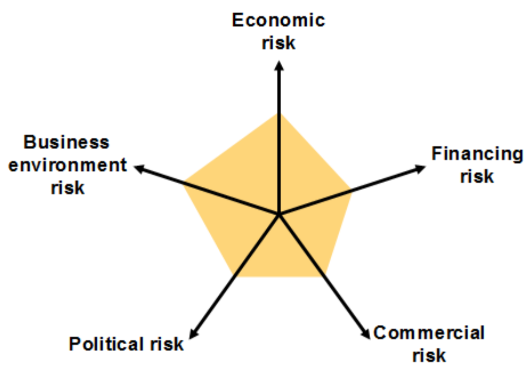
Country Rating

B2

Country Grade **Country Risk Level**

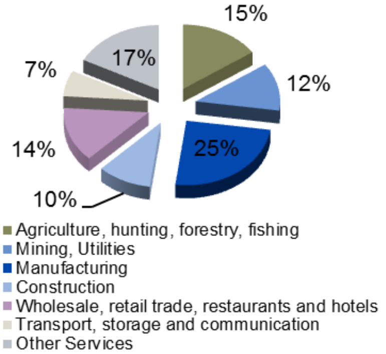


Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2011)



Sources: Chelem, UnctadStat, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2011)

By destination/origin

Exports		Rank		Imports
Other Gulf	15%	1	20%	Other Gulf
United States	11%	2	14%	China
China	9%	3	6%	Saudi Arabia
Singapore	4%	4	4%	United States
Germany	3%	5	4%	Germany

By product

Exports		Rank		Imports
Refined Petroleum Products	19%	1	26%	Crude Oil
Jewellery, Works Of Art	13%	2	8%	Jewellery, Works Of Art
Basic Organic Chemicals	4%	3	5%	Non-Monetary Gold
Pharmaceuticals	4%	4	4%	lecommunications Equipment
Yarns Fabrics	4%	5	3%	Coals

Economic Forecast

	2009	2010	2011	2012	2013f	2014f
GDP growth (% change)	8.5	10.5	6.3	5.0	4.7	5.5
Inflation (%, end-year)	15.0	9.5	8.0	10.6	8.5	7.6
Fiscal balance (% of GDP)	-10.1	-8.7	-8.4	-8.3	-8.8	-10.0
Public debt (% of GDP)	33.9	33.4	32.9	32.4	31.9	31.4
Current account (% of GDP)	-2.9	-2.8	-4.1	-5.0	-4.4	-4.1
External debt (% of GDP)	19.1	17.0	17.4	18.1	19.3	19.4

Sources: HIS Global Insight, National sources, Euler Hermes

Economic Growth

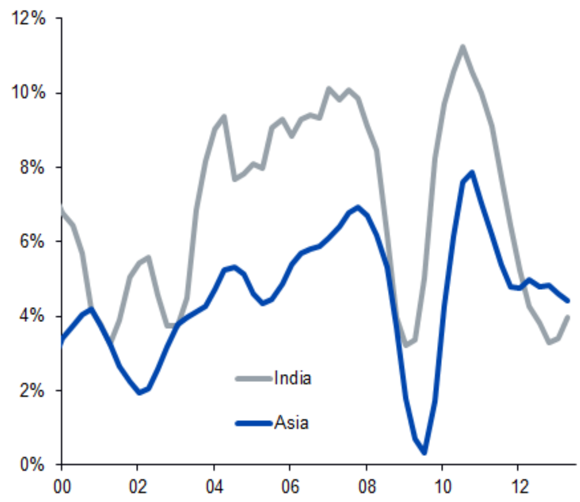
Growth weakens, reflecting domestic rigidities, as well as global factors

In the ten-year period up to end-2012, annual real GDP growth was +7.9% y/y, a rate generally above the regional average and that made India one of the most vibrant of the major global economies. However, GDP growth in April-June 2013 (Q1 of 2013 and Q2 of FY2013/14) was +4.4% y/y, a four-year low. Recent rapid depreciation in the INR and large capital outflows partly reflect international concerns (including the prospect of Fed tapering in the US) but are not the cause of the downturn in India. A weakening in the economy was evident before the recent run on emerging markets and reflects domestic factors, including policy inertia (lack of reforms) and structural impediments (weak infrastructure and current and fiscal account deficits). In turn, these reflect a weak central government and power of the individual states, which makes governance slow and difficult.

Outlook is for below-potential growth in H2 2013 and in 2014

The structural rigidities indicated above, particularly inability to implement reforms, are likely to continue into 2014 (an election year). The economy is therefore forecast to grow at a below-potential rate, even if global conditions improve. EH expects GDP growth to be +4.7% in 2013 and +5.5% in 2014.

GDP growth (y/y, 4 qtrs cumulated %)



Sources: IHS Global Insight, Euler Hermes

Economic Policies

The downturn evident in GDP data in Q1 FY2013/14 (see above) and currency weakness (INR depreciation of around 10% in August 2013), with associated loss of confidence, are likely to result in worse data to come, although export performance should improve. Monetary policy will now tend towards tightening (limiting growth potential), import costs are higher and government finances will deteriorate. EH does not expect a full-blown financial or current account crisis (for one thing, FX reserves are currently around USD270 billion), although corporate insolvencies and NPLs will increase. A new governor at the central bank may encourage an impetus for a new round of reforms.

Inflationary pressures remain a policy concern

The wholesale price index (used for official inflation targeting) increased by 5.8% y/y in July 2013, up sharply from 4.9% in the preceding month. INR weakness was partly responsible, suggesting that inflationary pressures are likely to rise in the next few months as the higher cost of imported goods feeds through into the price chain. Consumer price inflation remains more elevated, with the CPI index up 9.6% y/y in July, down from 9.9% the previous month. With the central bank's focus on limiting inflationary pressures, there is little scope for further easing in monetary policy. The central bank cut the key policy interest rates by a cumulative 75 bps in H1 2013 but adopted emergency measures in July in an attempt to drain liquidity from financial markets and limit the INR depreciation. Furthermore, in August, some capital controls were implemented on residents, reducing the amount of net worth Indian firms can invest abroad and the amount that individuals can send out of the country. EH expects monetary policy to be on hold through to end-2013 but a tightening phase (through interest rates) may ensue if INR weakness continues.

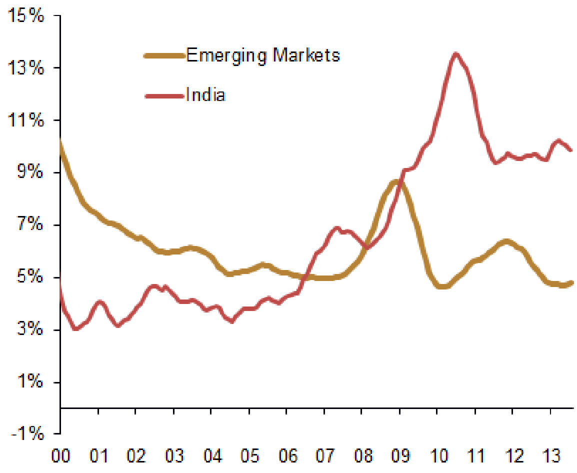
Rapid INR depreciation during emerging market sell-off in mid-2013

The INR depreciated by more than 12% between the beginning of May and end-August 2013. The central bank has intervened to smooth the progress of the currency's fall and has the resources to defend the INR, in need (FX reserves of around USD270 billion).

Fiscal policy is limited by political/social considerations

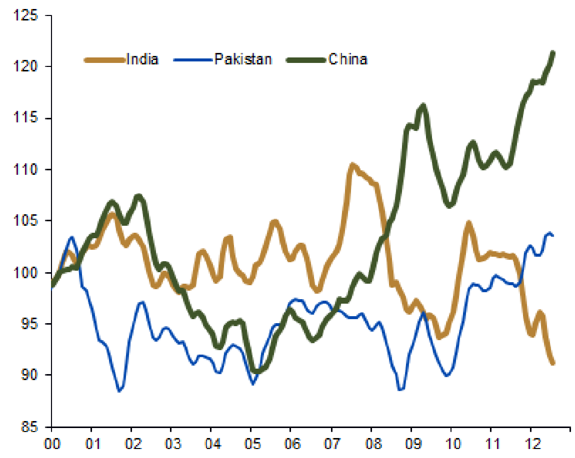
A significant structural weakness in the economy is the propensity to record large fiscal deficits. Indeed, regular consolidated fiscal deficits (state and federal) pose a significant risk to macro-economic stability. The government's deficit finance requirements have tended to crowd out private sector investment while adding to a significant public debt stock (over 30% of GDP). Moreover, governments have a natural populist tendency because of the pervasiveness of poverty, particularly in the large rural hinterland. EH expects the annual fiscal deficit to remain at the high end of the recent range (around 8-10% of GDP).

Inflation rate (%)



Sources: IHS Global Insight, Euler Hermes

Real effective exchange rate



Sources: IHS Global Insight, Euler Hermes

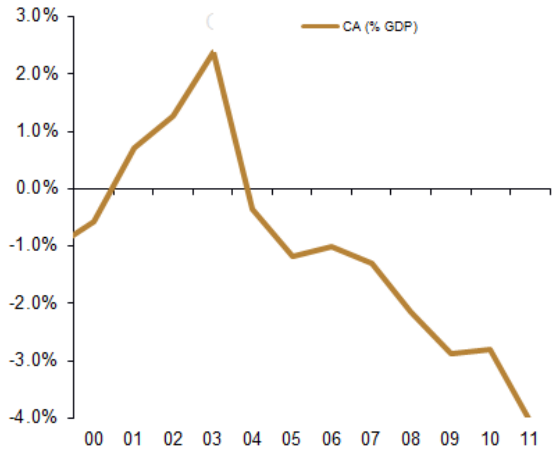
Current account deficits

Exports and imports remain low in comparison to overall GDP (equivalent to around 25% and 30%, respectively), thereby providing some shelter from extraneous events. However, the economy is becoming more outward focused and annual current account deficits have expanded to over -4% of GDP, compared with around -1% in 2005-07. Current account deficits largely reflect a high oil import bill (crude oil and petroleum products account for around 29% of total merchandise imports) and a propensity of nationals to buy gold (8% of imports).

EH expects the current account deficit will be -4.4% of GDP in 2013 and -4.1% in 2014, with the risk on the downside if import costs cannot be limited and structural factors inhibiting exports are not lifted (including restrictions on exports of iron ore).

Current account deficits are usually financed through high levels of inflows of international capital attracted by a large domestic economy and strong growth potential. Recently, capital outflows (partly reflecting the prospect of Fed tapering in the US) suggest that deficits will be challenging to finance, representing a potential risk of a return to current account crises. However, unlike in the 1990s, when recourse to the IMF was required) FX reserves are substantial (see below) and economic management is generally more sound. Moreover, it is uncertain that the capital outflows will continue and a new reform agenda could again result in substantial inflows.

Current account (% of GDP)

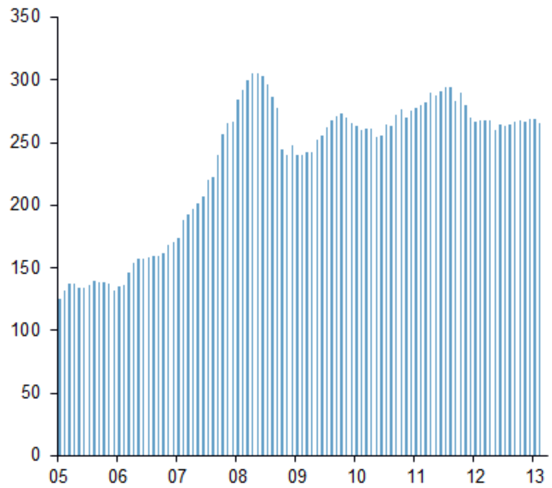


Sources: IHS Global Insight, Euler Hermes

External debt stock and repayment obligations are low

Foreign exchange reserves amounted to over USD268 billion at end-2012 and remain in excess of USD250 billion and, at such levels, exceed total foreign debt stock and provide import cover of over five months, compared with an international ‘safe’ guideline of three months. Foreign debt ratios are relatively low, with debt/GDP of around 19% and debt/export earnings of around 70%. Moreover, the external debt service ratio remains comfortably below 10%.

FX reserves (USDbn)



Sources: IHS Global Insight, Euler Hermes

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