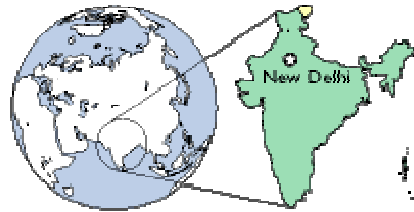


# Country Review

## Update

### India



12 March 2010

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**EULER HERMES COUNTRY RISK GRADE: B**

**Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.**

## Politics & International Relations

The Indian National Congress (INC)-led United Progressive Alliance government of Prime Minister Manmohan Singh appears likely to remain in office, at least until elections in 2014, thereby ensuring **broad policy continuity**. The latter suggests generally sound economic management will prevail, although the reform agenda is likely to remain slow. In February, the government resumed talks with Pakistan, following a 14-month hiatus resulting from the November 2008 terrorist attack in Mumbai, for which India holds Pakistan partly responsible. The negotiations provided nothing of substance but suggest that New Delhi and Islamabad are now willing to improve bilateral relations and attempt to limit regional security concerns.

## Recent Economic Developments

Industrial production and GDP data continue to surprise on the upside, suggesting that the **economic recovery is strong and sustainable**. Industrial output expanded by 16.8% yr/yr in December 2009—the most rapid growth in two decades—compared with 8.3% in June last year. Manufacturing was strong across the board—consumer durables, intermediate products and capital goods—providing further evidence of an upswing. Official forecasts are now for 7-7.5% GDP growth in 2009 (FY April-March) and policy statements appear geared towards a return to the annual 9% growth recorded in 2005-07. Calendar Q4 2009 GDP data were expected to be affected by earlier weak monsoon rains and associated reduced contribution to growth from the agricultural sector. Indeed, GDP expanded by 6% yr/yr in Q4, compared with 7.9% in Q3. However, both the manufacturing and services sectors continued to perform well and **improved climatic conditions will boost agriculture in the coming quarters so that the recovery will become more broadly based**.

There was little to suggest significant policy tightening in the 26 February national budget for FY2010/11, although **the aim is to cut the central government fiscal deficit to 5.5% of GDP from 6.9% in 2009/10**. The government remains committed to boosting the rural economy and upgrading infrastructure and revenue gains (including privatisation receipts) rather than expenditure cuts are meant to achieve the improvement. However, the track record on privatisation is lacklustre and the **overall fiscal deficit (including regional budgets) will remain stubbornly high at 6-10% of GDP**. Wholesale price data (used for inflation targeting) provides evidence of a build-up in inflationary pressures. The index was up 8.6% yr/yr in January and probably nearer 10% in February. Although high food prices are stoking inflation and improved winter crops (including sugar) will ease upward pressures from this source, a stronger economy is squeezing capacity and **core inflation is also rising**. Accordingly, monetary policy is likely to be tightened soon.

In early March, the Reserve Bank of India (RBI) signed an agreement to purchase up to USD10bn in IMF notes. This provides India with a safe investment instrument and at the same time boosts the Fund's capacity to help its members manage any adverse effects of the global financial crisis. In addition, it signifies the strategic importance of the country in relation to managing the global economy and its willingness to take a lead role through the IMF, as well as G-20.

## Economic Outlook

PMI data suggest that industry will provide a strong positive thrust to overall economic expansion in 2010 and government-led infrastructure projects (particularly transport and communication networks that will boost trade) will maintain investment growth. In addition, wage gains, low household debt and access to credit suggest that consumption growth will also contribute positively, despite some increased excise taxes introduced in the last budget. Accordingly, our **GDP growth forecasts have been revised upwards, with 6.8% in 2009 and 7.5% in 2010, followed by around 8% in 2011**. We remain on the conservative side of the consensus outlook for this year and next and the main risk to our forecast is that growth will be more rapid, partly because of the government's determination to boost growth – perhaps at the cost of too lax a policy stance. Our outlook is based on **a stepped withdrawal through 2010 of stimulatory policies adopted in the downswing**. Inflationary pressures and resurgent output suggest that the Reserve Bank of India will raise policy rates at (or possibly before) its 20 April meeting. So far in the current cycle, the RBI has tightened its stance mainly through increasing the cash reserve requirement but the next stage is **likely to include policy rates being increased by 25-50bps**, with a total increase of 100-150bps by year-end.

As Indian interest rates are likely to go ahead of tightening in the major markets, **we expect increased capital inflows (FDI and portfolio) and rupee appreciation**. By the end of 2010 we forecast the rupee will be around US\$1:INR44, having started the year at INR46. The **current account deficit is forecast to**

widen to 1.5-1.7% of GDP but this is unlikely to cause financing problems.

**FX increased to over USD250bn at end-2009**, compared with only USD67bn at end-2002 and import cover is currently around 7-10 months. External liquidity and solvency ratios remain relatively sound.

### Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	1,142,325	1,223,262	1,239,541	1,472,527	1,707,865
Population (mn)	1,165	1,181	1,198	1,214	1,231
GDP per capita (USD)	981	1,035	1,035	1,213	1,387
Real GDP growth (% yr/yr)	9.1	6.7	6.8	7.5	8.0
Inflation (% average)	4.9	9.0	2.5	7.0	5.0
Fiscal balance (% of GDP)	-3.4	-8.1	-10.0	-7.1	-6.6
Current account balance (% of GDP)	-1.0	-3.0	-1.1	-1.5	-1.7
External debt/GDP (%)	19.3	19.2	18.0	16.4	15.5
External debt/Exports of goods & services (%)	76.8	63.2	71.0	65.1	61.9
Debt-service ratio (%)	0.0	0.0	0.0	0.0	0.0
Foreign exchange reserves (USD mn)	266,553	246,603	258,583	250,000	260,000
Import cover (months)	11.1	7.6	10.3	8.3	7.3
Exchange rate assumption, INR:USD (av)	41.3	43.5	48.4	45.5	44.5
f: CRU central forecast					

Sources: Reserve Bank of India, IMF, World Bank, Euler Hermes Country Risk Unit

### Outlook

The economy has proved resilient against the global financial crisis and recession. We have adjusted our GDP growth forecasts upwards, with an annual 7.5-8% achievable in the ST. The authorities now have to judge the timing and pace of withdrawal of stimulatory policies introduced during the downturn. All the evidence suggests that economic management will remain prudent.

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