

T-A-C

**RiskMonitor**<sup>2</sup>  
A Country Risk Assessment Service provided by TAC

*RISK\_DIAG*

*February 2005*

**INDIA**

This is an illustration of a Risk\_Diag that includes only part of the actual document - A complete Risk\_Diag would be a 11-page document, with a customized *Executive Summary* integrating the conclusion derived from the Risk\_Diag from the specific perspective of each customer, and two pages for *Short Term Fundamental Balances - External*, and another two pages for *Short-Term Fundamental Balances - Domestic*, constructed in the same way as the *Structural Fundamental Balances* presented in this illustration

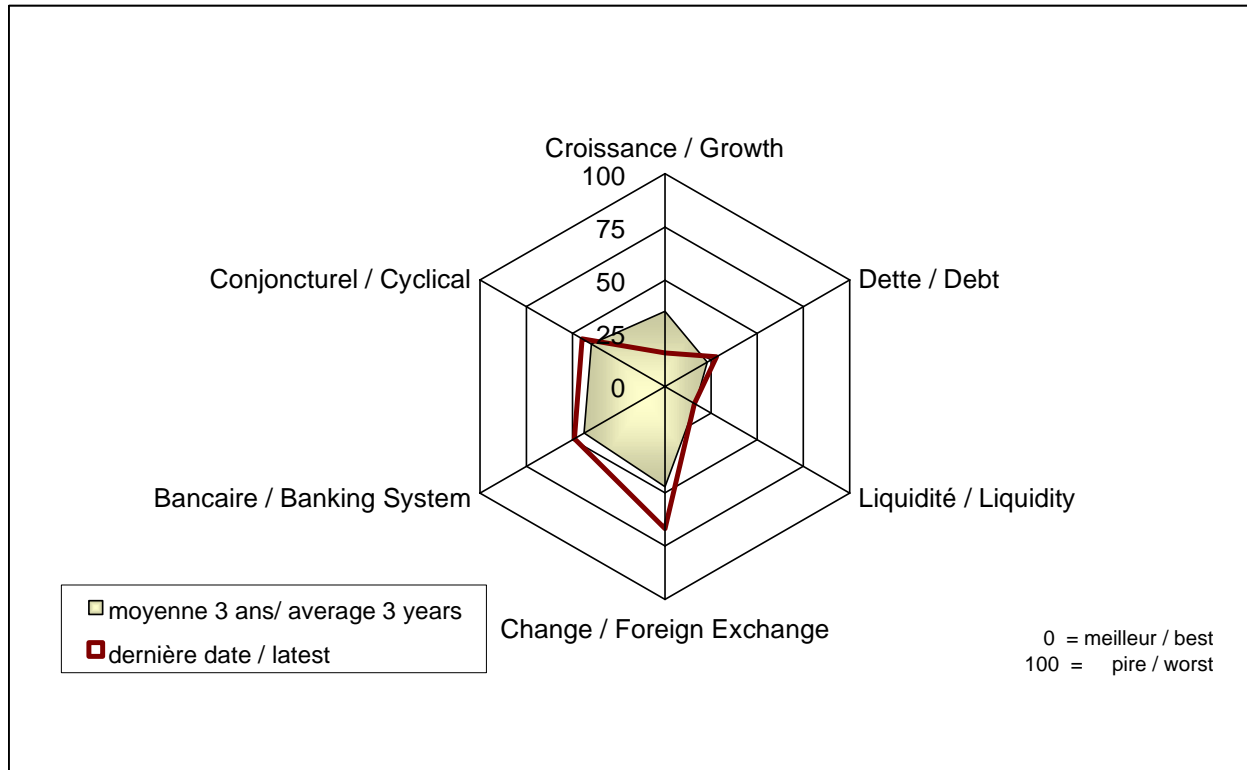


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Applied Economic & Financial Research



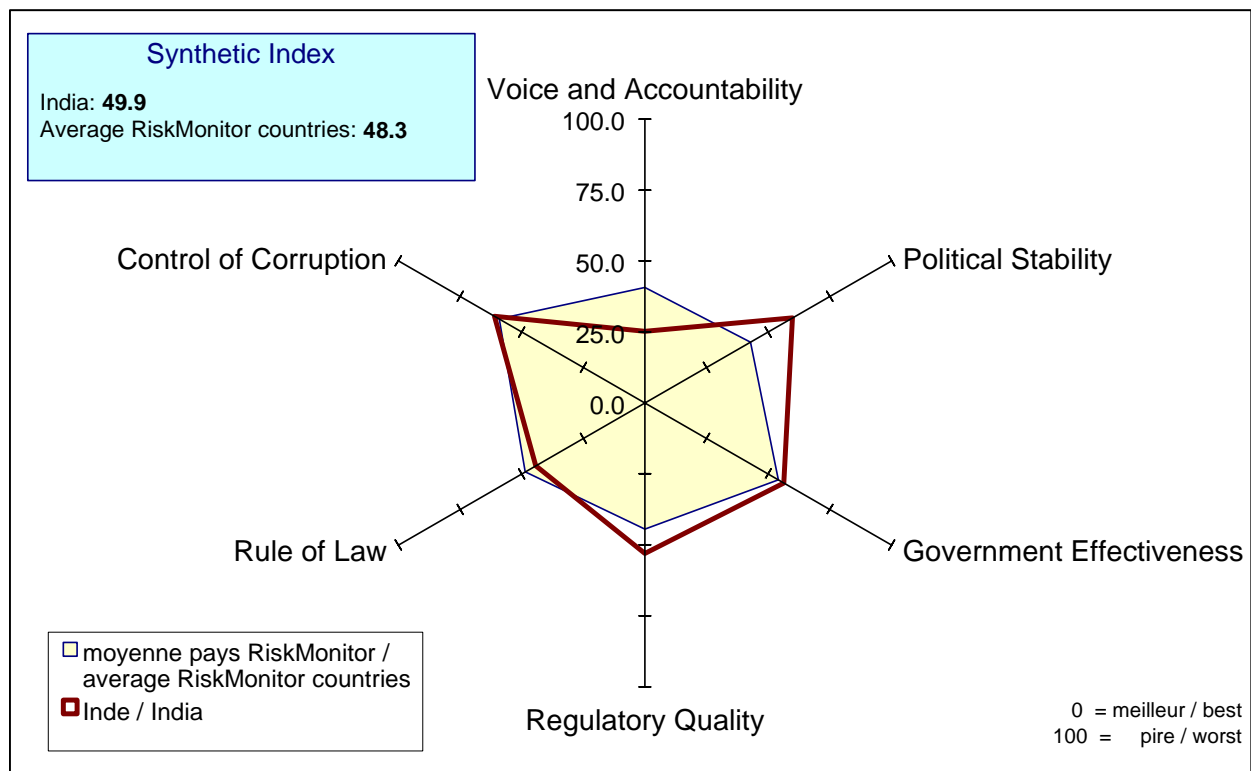
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**RESUME QUANTITATIF / QUANTITATIVE SUMMARY****NOTES PAR EQUILIBRE / SCORES FOR FUNDAMENTAL BALANCES****NOTATIONS PAYS / COUNTRY RATINGS (0-100 and A-B-C-D-K)**

	< 1 an		1 - 3 ans		3 - 5 ans	
Cyclical	35.2	B	35.1	B	33.6	B
Exchange rate	35.8	B	33.5	B	41.4	C
Solvability	36.8	B	34.0	B	30.5	B

**SIGNAUX DE CRISES / CRISIS SIGNALS**

Cyclical	No signal
Exchange rate	No signal
Solvability	No signal

**INFORMATION DE BASE / BACKGROUND INFORMATION****NOTES POLITIQUES / POLITICAL SCORES****ELEMENTS POLITIQUE / POLITICAL INFORMATION**

The federal parliamentary democratic republic of India has a two-party -plus alliance system, characterized by coalition politics, fragmented governance and deficient administrative capabilities. Despite globally favourable economic performances for years, the May 2004 legislative elections revealed large dissatisfactions from rural areas; with a very clever political campaign and well-chosen local alliances, the United Progressive Alliance led by the Indian National Congress party was able to beat the incumbent National Democratic Alliance led by the BJP.

The government now has to meet the rising demand for public resources, correct chronic fiscal imbalances and reinforce the current improvement in relations with Pakistan (the Kashmir issue remaining a fundamental one), while trying to develop a consensus within the 19-party coalition. Indeed, if this specific political scheme notably has the advantage to temper any extremist impulses within the government, it has also boosted regional dynamics - and parties - in the heart of the national politics design (with its consequences in terms of fiscal "discipline"), while asymmetric interests within the coalition limit both the scope and the pace of implementation of needed structural reforms. For the current time and probably the next two years, it appears that none of the ruling coalition partners has an interest in creating a conflict situation that could lead to early elections. The Prime Minister M. Singh will probably try to move the hottest issues sooner than later, even if this causes vocal complaints, notably by the Left Front (so-called Marxist parties that are supporting the coalition without taking part in the government).

Lastly, this month is characterized by polls in three states (of which Bihar), which can be seen as a test for the Congress-led alliance.

**INFORMATION DE BASE / BACKGROUND INFORMATION****DONNEES ECONOMIQUES DE BASE / BASIC ECONOMIC DATA**

	1996	1997	1998	1999	2000	2001	2002	2003
GDP (%)	7.4	4.5	6.0	7.1	3.9	5.2	4.6	8.3
Inflation (%)	9.0	7.2	13.2	4.7	4.0	3.7	4.4	3.8
Exports (bn \$)	33 737	35 702	34 076	36 877	43 132	44 612	50 701	59 600
Imports (bn \$)	-43 789	-45 730	-44 828	-45 556	-59 423	-57 358	-62 742	-75 053
Current account (bn \$)	-5 956	-2 965	-6 903	-3 228	-4 348	177	5 816	8 357
External debt (bn \$)	93 466	94 317	97 637	98 313	99 098	97 516	104 429	129 674
ST debt (% of total)	7.2	5.4	4.4	4.0	3.5	2.8	4.4	5.2
Fx reserves (bn \$)	20 170	24 688	27 341	32 667	37 902	45 871	67 666	98 938
Exchange rate (avg) -USD	35.43	36.31	41.26	43.06	44.94	47.19	48.61	46.58
Exchange rate (avg) -EUR	44.93	41.18	46.21	45.93	41.53	42.26	45.91	52.68

**ELEMENTS D'ENCADREMENT ECONOMIQUE / BACKGROUND COMMENTS**

- The development process has led to very disparate regional results, then carrying important political risks.
- India suffers recurring fiscal deficits, with a globally slow pace of budgetary consolidation, leading to still important contagion risks to external accounts.
- However, the potential sensitivity to potential bouts in international confidence is quite thin, owing to a strong external liquidity situation. More globally, India's ability to cope with adverse economic conditions is strengthening.
- Indeed, if economic growth performances remain highly dependant on agricultural sector output, GDP growth is likely to trend 6% over the medium-term.

**ELEMENTS A SUIVRE A COURT TERME / POINTS TO MONITOR IN THE SHORT TERM**

- The 2005/06 budget, to be released this month (and possible upgrades from Fitch and S&P into Investment Grade in case of far-reaching and concrete tax measures announcement).
- Inflation and monetary policy developments, with likely further interest rate hikes (but probably not before the next April 2005 monetary committee, and moderate).
- With the rupee deviating from its "neutral target", bouts of volatility in the exchange rate market have to be awaited.
- Possible instability within the governmental coalition after the February elections in three states (in addition to a possible oust of the Rashtriya Janata Dal party from the leading alliance after a corruption scandal).
- Next points in our Cyclical Balance, with slightly higher levels of *real economic pressure* expectable; moreover, the rise in the *foreign financing* of the Banking System Balance has to be closely watched.

## EQUILIBRES STRUCTURELS / STRUCTURAL BALANCES

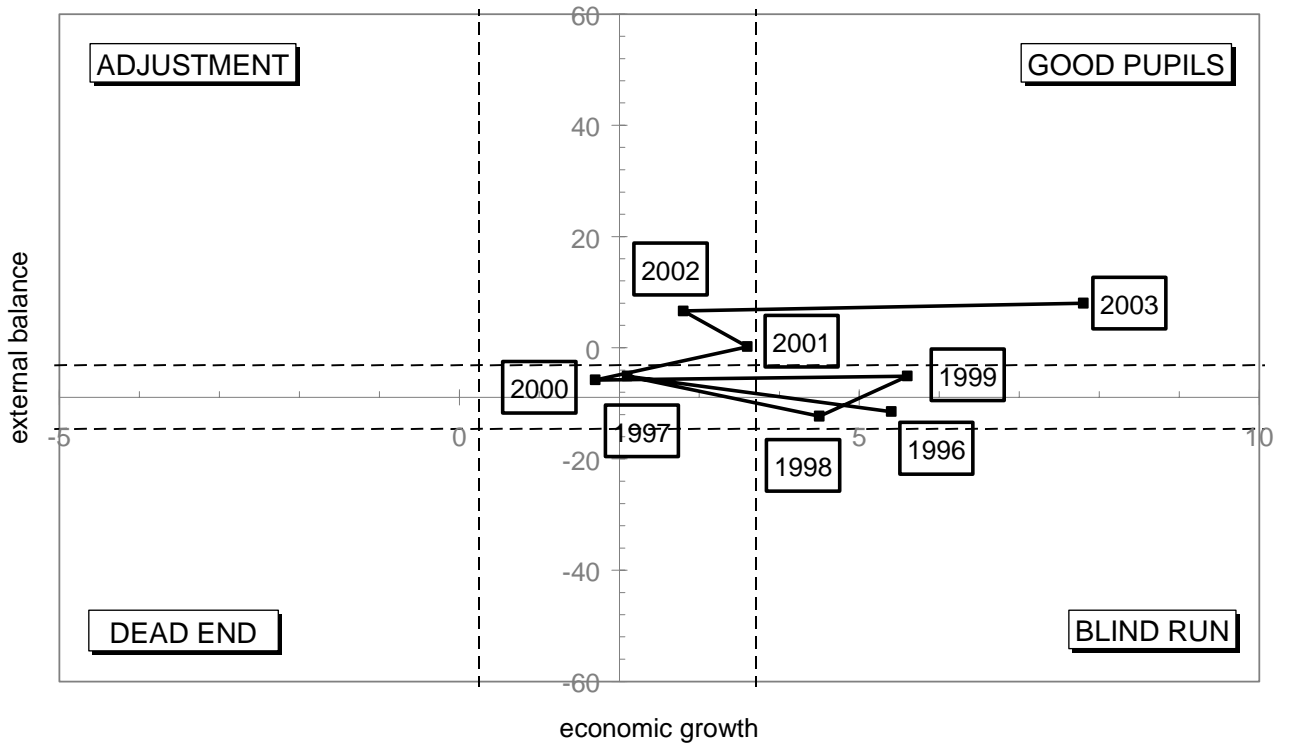
The Indian paths in our Structural Balances highlight a satisfactory performance for economic activity (average annual GDP growth rate between 1996 and 2003 has reached 5.9%), a clear improving trend in external accounts and a very low weight of external commitments in the Debt Balance, where most of the risk factors come from *financing stability* moves.

Recent years' performances in the Growth Balance reflect the combination of the sensitivity to agriculture output, the effects of oil prices fluctuations, changes in international environment and the positive consequences of the structural transformations that have been implemented for more than a decade. After showing a current account surplus for the first time in decades in 2001, the *external balance* pursued its upward trend in 2002 (current account surplus of USD 4.6 bn, after USD 1.8 bn in 2001). On the opposite, the relatively bad July 2002 monsoon impaired agriculture performance and overall economic activity (GDP growth rate achieved 4.6% in 2002/03 against 5.2% the previous fiscal year), pushing the Indian path back in a moderate *adjustment* position. This negative move of the *economic growth* reverted again sharply in 2003: the indicator improved critically (+8.3% for GDP, the highest growth rate in 10 years) on the ground of a highly favourable monsoon backing up buoyant industry and services, supported by strong growth in consumer spending. Besides, the current account surplus continued on its improving trend (USD 8.4 bn), despite a strong deterioration in the trade balance (imports in dollars increased by 20% between 2002 and 2003 on the account of higher oil prices and booming domestic demand). India moved deeper in the *good pupils* area, thus improving the ability to manage broad political tensions.

Simultaneously, the *debt service* indicator in our Debt Balance has significantly decreased over the period: this reflects both limited current account deficits - and even a large amelioration between 2000 and 2003 - and the ability of the country to finance its borrowing needs with foreign direct or portfolio investments, within a still highly regulated capital circulation. Indeed, total external debt has increased only mildly, over the past decade (from USD 94 bn at the end of 1993 to USD 104 bn at the end of 2002, before a sharper increase in 2003: USD 130 bn), while, on average, foreign currency revenues and GDP were recording much more rapid growth. Overall, the ratio of total external debt to exports of goods and services declined from 287% at end-1993 to 120% at end-2003; even when using a more stringent definition of external liabilities, including Non-Resident Indians (NRIs) deposits (estimated at USD 10.9 bn at the end of April 2004, according to the RBI, and excluding NRIs' rupee denominated deposits), this ratio remains well below 150%. The *financing stability* indicator registered more ambiguous moves: despite a continuous improvement in FDI inflows (from USD 2.6 bn in 1998 to USD 4.6 bn in 2003), the path has moved very close to the risk threshold between 2001 and 2003, indicating a higher increase in "unstable" capital inflows over the period, attracted by structural reforms on stock markets and the growing openness to international financial investors, while persistent administrative constraints left FDI inflows well below the country's potential.

In the short-term, the very favourable position in the Growth Balance should not be challenged, with GDP growth rate expected to remain above 6%, associated with limited decline in current account surplus. These favourable results warrant the following comments: (1) There has been a major improvement in India's external performances during the past period, a direct result of very positive growth in export earnings achieved through improved competitiveness, better integration into world trade flows and a spectacular development in software exports. Combined with the *good pupils* position in the Financing Balance, this shows that external finance issues are a limited concern for the overall Indian country risk. (2) Conversely, average performance in economic growth remain dependent on weather conditions and agriculture output, clearly highlighting both the need to sustain the structural engines of growth and the corresponding social and political risk in the long term, in turn related to the issue of fiscal deficits. (3) At the same time, FDI should progress rapidly, in the wake of a clearer strategy to attract foreign investors, which has so far been deepened by the new administration. Such a move thus seems to emphasise a weakening in the traditional opposition of most Indian political representatives to foreign entry in their economy. In that sense, the *financing stability* should not cross the risk threshold, a clear sign of both an improving country risk, and more attractive opportunities in terms of banking services to corporate customers.

1 - Growth Balance



2 - Debt Balance

