

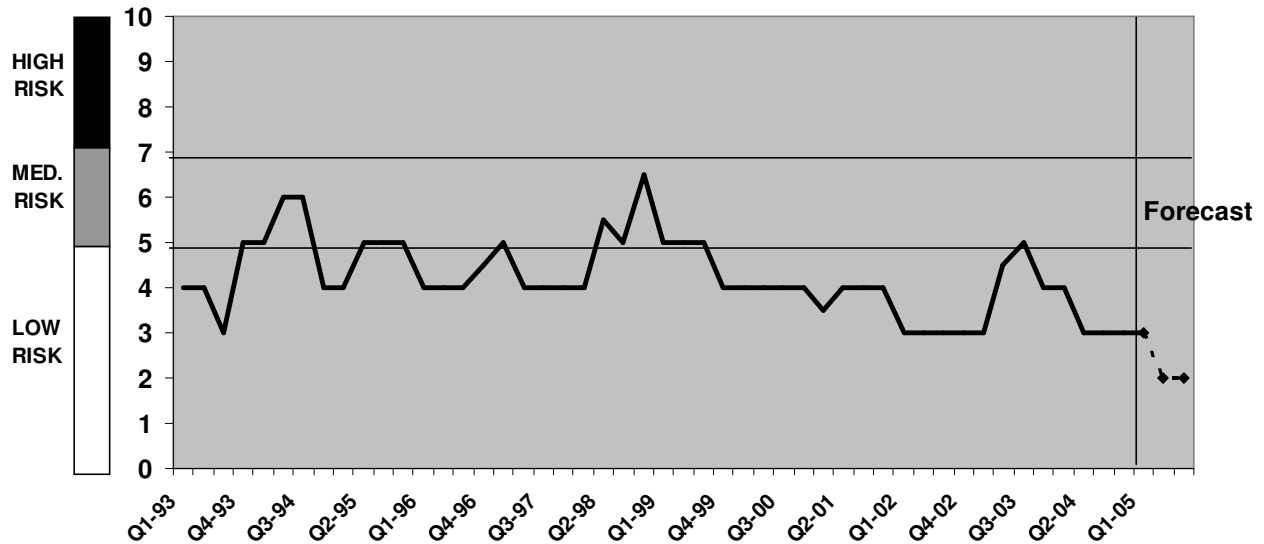
# INDIA

## *Economic Stress Model*

**October 2005**

| Score         | Change Last Quarter | eme comments  |
|---------------|---------------------|---|
| ○<br>Low Risk | No Change           | <ul style="list-style-type: none"> <li>▪ The economic risk in India is currently low, according to eme's Economic Stress Model. The twin budget and trade deficits remain long run threats, and political constraints limit expectations for any major change in direction until deep into the New Year.</li> <li>▪ Risk from external sources is low. The balance of payments deficit remains a source of concern. However, international reserves, the currency, and external debt are all manageable and do not pose risks at this time.</li> <li>▪ Risk from internal sources is moderate. Economic growth has accelerated and inflation is under control. The pace of improvement in the budget deficit has slowed, the banking system remains weak, and consumer credit expansion is a concern. Oil prices threaten inflation and government revenues.</li> <li>▪ We are forecasting a continuation of the low risk level for India, as its ESM score declines one point over the next two quarters.</li> </ul> |

**Economic Stress Model Score**



## ***Economic Outlook***

- **The Indian economy continues to perform better this year than last.** This despite challenges posed by rising oil prices, an overwhelming backlog of required infrastructure investments, and an uneven monsoon. A steady downward trend in GDP growth has been reversed so far in 2005, with growth estimated to have accelerated to over 8% in the third quarter, compared to 6.4% at the end of last year. The agriculture sector only comprises about one fifth of India's economy, yet it receives disproportionate attention since lack of irrigation leaves it heavily dependent on variable monsoons. As a result, poor July-September rains can act as an unpredictable and significant drag on growth – as occurred last year. This year, despite unusual timing and geographic variability, overall rainfall was normal and, with agriculture employing 67% of the population, should ensure consumer spending holds steady into 2006. The consumer sector otherwise appeared set to decline, as provision of new consumer credit has paused after significant expansion last year. Credit-fuelled consumer demand has been driving industrial production upward for four years and there are hidden risks to this approach. To ensure long-run growth, the country still requires difficult reforms to bring in the foreign capital necessary to see through major infrastructure and business investments. Also, one cannot underestimate the need to rein in the twin budgetary and current account deficits. For the foreseeable future, however, with high business confidence and unemployment trending downward, we project strong growth of 6.8% this calendar year.
- **Rising oil prices remain the largest external threat.** India imports over two-thirds of its crude oil consumption and the value of oil imports has increased by over 45% for the year ending March alone. The Government has adopted a policy of deliberately limiting consumer price increases. Maintaining this policy, imposed by the government's coalition partners, will not prevent the economic pressure from manifesting itself, however. Normally, higher international oil prices would mean higher consumer price inflation, which the central bank would attempt to curtail by slowing growth with higher interest rates. Currently in India, state-run refineries have been left to absorb the higher cost of crude, which will mean greater costs upon state treasuries. If state governments do not correspondingly cut spending, higher government borrowing will push up interest rates – driving down growth all the same.
- **Short run interest rates should stay relatively low, but rates will rise in the long run.** After a slight jump early last year, growth in wholesale prices has eased, while consumer price inflation continues to hover around 4% per annum, decelerating slightly according to the most recently available data. These rates are historically low and the current environment of overall macroeconomic stability should continue to promote a pro-growth economic climate. This benign short-run inflation outlook, and associated expectations of limited interest rate hikes this year, contrasts with expectations for higher interest rates in the long run. Higher oil prices, US rates and, especially, persistent government borrowing, will all put significant upward pressure on interest rates next year.
- **Consumer-led growth is worsening the already worrisome trade deficit.** Fuelled by consumption, import growth last year pulled both the non-oil trade balance and the current account balance into a deficit for the first time in four years. The trend is continuing this year: non-oil imports are expanding faster than both exports and oil imports. At a disturbing 5.6% of GDP, the trade deficit is at an all time high, ensuring the current account also remains in deficit. A current account deficit can be useful for building long-term growth if domestic and foreign savings are used for investments supporting long-term growth. India, however, appears to be borrowing from the world to fund consumption. The trade deficit, then, only increases the country's dependence on less stable external capital – weakening the country's ability to respond in the case of capital flight.
- **Political limitations are preventing fiscal improvements...** The Congress-led government remains stable through the continued support of populist and communist parties – which happen to be against much of Congress' reform agenda. As a result, the central government previously announced no new fiscal consolidations this fiscal year, despite its projection of a budget deficit equivalent to 4.3% of GDP. Although this figure has been trending downward for the past three years, this will not be a significant improvement on last year and remains

high enough to limit the government's ability to respond to any crisis. Over two-fifths of central government revenues are dedicated toward interest payments, and over two-thirds of new borrowing goes toward meeting the resulting revenue shortfall. Unfortunately, state government finances remain in a similar shape. India's total public debt is estimated around 80% of GDP. One recent positive reform is the creation of a debt-consolidation and relief facility set up by the central government for those state governments willing to reduce their deficit to three percent of GDP. Recent jumps in state government revenues seemed to indicate the introduction of VATs have been worthwhile, though closer examination reveals this is mostly due to strong corporate tax results. Much more needs to be done yet little change is on the horizon.

▪ **...While fiscal constraints prevent business investment and infrastructure improvements.**

Under pressure to increase health, education and other spending, the central government recently unveiled a plan to guarantee 100 days of work to every rural family. Such spending plans, coupled with the large budget deficit, prevent necessary infrastructure investments required to ensure long-run growth. One example is the much-needed modernization of Mumbai and Delhi airports, which the government finally set in motion this August, after long delays. August's "performance budget" is a welcome step toward increased transparency, but will not be sufficient to attract the foreign capital required. Over the past seven years, India's average investment rate has been just below half that of China's. This is largely explained by lower national saving in India. Political change to improve the fiscal situation is thus required before more stable investment-driven growth is possible. As excessive government borrowing persists, however, high demand for money will push up the price of money, or interest rates – which will act as a disincentive to sorely-needed business investment. This pattern of government borrowing indirectly inhibiting private investment is known as the "crowding out" problem.

▪ **Risks to the Indian economy are compounded by the rising tide of hot money.**




As India becomes increasingly reliant on rising short-term foreign investment, economic risk is heightened by the possibility these funds could flee the country at mention of the possibility of crisis. The Bombay Stock Exchange's Sensex has not stopped its relentless drive to record highs since the current foreign-fuelled bull market began in 2003.






▪ **Low short-term risk, measured by eme's Economic Stress Model, masks higher long-term risk.**

The three indicators of concern are the fragility of the banking system and the twin deficits: the current account and government budget. Other indicators are showing low risk. For example, the country is adding 9 billion dollars to its reserves this year, which will keep the external debt in check. So while most indicators are not of concern at the moment, there are significant long-term issues that must be addressed. In summary, despite movement in the right direction, much more aggressive action is required to reign in government borrowing for non-investment spending.



# Economic Stress Model Review

## External Risk

|   |             |     |               |
|---|-------------|-----|---------------|
|  | Low Risk    | +   | Improvement   |
|  | Medium Risk | -   | Deterioration |
|  | High Risk   | n/c | No Change     |

| Risk Factor                         | Score   | Change Last Quarter | Comments   |
|-------------------------------------|---|---------------------|--|
| Balance of Payments                 |    | No Change           | <ul style="list-style-type: none"> <li>The solidification of India's switch from a balance of payments surplus to a deficit is a risk. The trade deficit widened to \$17.43 billion April-August period and analysts it could hit a record \$47 billion by the end of the current financial year in March 2006.</li> <li>Higher oil prices are a contributing factor, but strong non-oil and less-strong export growth have had greater impact. The quarterly trade deficit remains in excess of 11 billion dollars.</li> <li>FDI, remains relatively low, despite much talk of increasing it. There has been a recent upward trend, but it is far too moderate. A significant increase – doubling, for instance – current FDI would constitute a beginning of the investment required.</li> </ul> |
| Risk of External Capital Flight     |    | No Change           | <ul style="list-style-type: none"> <li>The risk of external capital flight is low. Despite large external capital influxes, to the stock market, for example, international reserves are keeping pace. \$9 billion is to be added this year and at the end of August, India's foreign exchange reserves totalled \$143 billion. This remains about eight times short-term external debt – more than adequate protection.</li> </ul>  |
| Sustainability of Foreign Borrowing |   | No Change           | <ul style="list-style-type: none"> <li>Foreign borrowing appears sustainable for the time being. Short-term external debt is a small proportion of the total.</li> <li>However, there has been a sharp rise in external commercial borrowings, short-term credits and overseas borrowings by banks. Coupled with large foreign inflows into the Bombay Stock Exchange, heightens our concern of "hot money" flowing into the country. Rapidly rising ratios of short-term debt have been harbingers of past crises in other countries. We will continue to monitor.</li> </ul>   |
| International Competitiveness       |  | No Change           | <ul style="list-style-type: none"> <li>The economy is internationally competitive. The Rupee is under some depreciation pressure from rising world oil prices, but foreign capital inflows and RBI controls are holding it generally steady.</li> <li>After a small jump last quarter, inflation has been trending slightly downward. As the positive inflation differential between India and its major export markets shrinks, there is less of a threat to the effective exchange rate, which is targeted directly by the RBI</li> </ul>  |
| Flexibility of External Position    |  | No Change           | <ul style="list-style-type: none"> <li>Most government and corporate debt in India is held domestically, and India's external debt levels remain relatively low. This provides a fair amount of flexibility in the external position.</li> </ul>   |

## Internal Risk

| Risk Factor   | Score   | Change Last Quarter | Comments  |
|---|---|---------------------|---|
| Potential for Destabilising Domestic Capital Flight |  | No Change           | <ul style="list-style-type: none"> <li>At present, the potential for destabilising domestic capital flight is low. India has fairly stringent capital controls that should prevent capital flight from becoming destabilising. International reserves are high and should provide confidence in the RBI's ability to meet foreign exchange demand.</li> </ul>   |
| Sustainability of Fiscal Policy                     |  | No Change           | <ul style="list-style-type: none"> <li>We are concerned about the lack of movement in fiscal reforms. The current political arrangements combined with state elections next year and federal campaigning in 2007 leave expectations low for significant reforms in the foreseeable future.</li> <li>Despite some improvement in recent years the central government fiscal deficit for the 2005 fiscal year came to 4.1%, compared to the 3% recommended maximum for stability. Though state</li> </ul> |

| Risk Factor                                | Score | Change Last Quarter | Comments   |
|--|-------|---------------------|--|
|  |       |                     | governments are beginning to enjoy the benefits of successful introduction of the VAT, their deficits comprise and equivalent proportion of GDP. More worryingly, the fiscal deficit before interest payments continues to decline, such that borrowing is funding general spending. This is not sustainable.  |
| <b>Fragility of Banking System</b>         | ●     | <b>No Change</b>    | <ul style="list-style-type: none"> <li>▪ The banking system remains fragile. The banks have a large amount of government debt on their balance sheets, and are thus heavily exposed to a sovereign debt crisis. Non-performing loans to public sector corporations are also a problem.</li> <li>▪ The government continues to improve the weak banking sector, though there is much work to be done. The government has announced it will begin allowing 20 new foreign bank branches in the country per year (up from 12). It is also working to improve capital adequacy ratios by encouraging bank sector consolidation. Earlier in the year it announced the ability to raise preferred shares, and government officials have recently been musing about the creation of 6-7 national champions if market leaders acquire smaller rivals.</li> </ul> |
| <b>Macroeconomic Stability (inflation)</b> | ○     | <b>No Change</b>    | <ul style="list-style-type: none"> <li>▪ Despite some small upward pressures, last year's worsening trend in macroeconomic stability has been clearly reversed, with inflation down by over half of last year's 8.7% at this time.</li> </ul>  |
| <b>Strength of Economic Policy</b>         | ○     | <b>No Change</b>    | <ul style="list-style-type: none"> <li>▪ The governing coalition has shown it can maintain the current political stability until elections in two years' time. Growth has accelerated moderately and the stability of growth in recent years also decreases the likelihood of a crisis.</li> </ul>   |