

RATING PERSPECTIVE

Republic of India

Slight damage to the Indian economy amid global financial and economic crisis

Introduction

The Indian economy for FY2008 (April 2008-March 2009) slowed down from the previous fiscal year's high growth, but grew steadily, with the impact of the global financial crisis affecting the world real economy. Although the pace of recovery in the Indian economy is likely to be at a lower level in FY2009 (April 2009-March 2010) due to sluggish exports and agricultural damage from low rainfall, the Indian economy has good potential to grow at the level of 7% per year on average over the medium term. The country's foreign liquidity position has been at a sound level and its external balance is less of a problem at the moment. On the other hand, although the country's fiscal position had improved against a background of the country's high economic growth till FY2007 (April 2007-March 2008), the country's fiscal deficit widened markedly in and after FY2008 due mainly to the needs created by the global financial crisis and JCR considers it necessary to pay attention to its development.

On the political front, the Congress Party, leading a ruling coalition of the United Progressive Alliance (UPA), won a resounding victory in the Lok Sabha (Lower House) election held from the end of April to early May. Although the first UPA government was often plagued by a relationship with the leftist parties which supported the government from outside the cabinet, the UPA this time has secured a comfortable parliamentary majority without their support. Although

continuous attention should be paid to frequent terrorist attacks, the UPA's electoral victory is expected to contribute to the country's political stability. JCR will watch how the second UPA government led by Prime Minister Manmohan Singh will address and achieve sustainable economic growth while striking a balance between consideration for the poor and reforms.

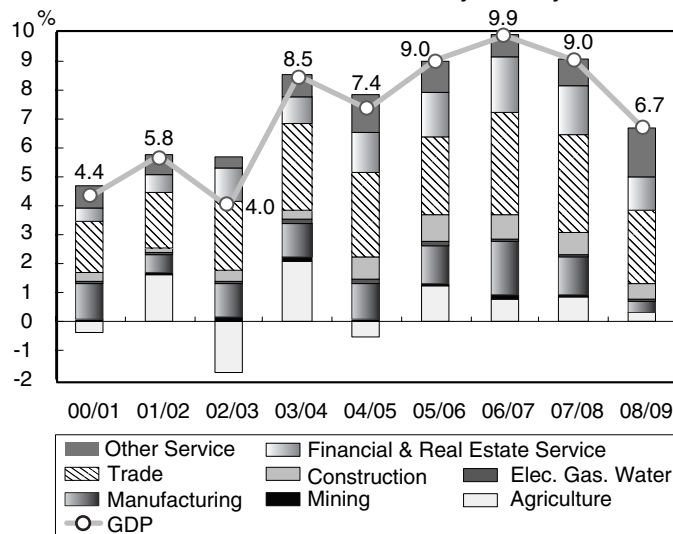
1. Macro economy

1.1 Current economic conditions and short-term outlook

Thanks to the government's fiscal expenditures in addition to its easy monetary policy promptly taken by the Reserve Bank of India (the country's central bank) after the Lehman shock in September 2008, the Indian economy grew 6.1% (y-o-y) in the first quarter of FY2009 following year-over-year 5.8% growth in the previous quarter, which showed its resilience to the impact of the global financial and economic crisis, with such impact affecting the world economy. The annual growth rate in FY 2008 was a solid and moderately high 6.7%, although down from a 9.0% level in the previous fiscal year. The growth rate in FY2009 will likely be in a range of 6.0 to 6.5% due to sluggish exports and agricultural damage from low rainfall (Charts 1, 2, 3 and 4).

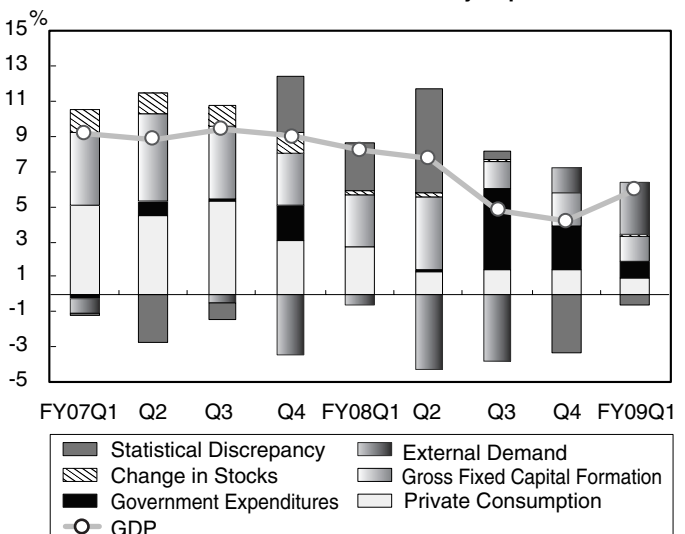
Disposition of nonperforming loans went smoothly with relevant laws and regulations enacted. The NPL ratio of the scheduled commercial banks fell to 2.4% on a gross basis (1.1% net of allowances and provisions) at the end of March

Chart 1. Contribution to Real GDP Growth by Industry



Source: Central Statistical Organization

Chart 2. Contribution to Real GDP Growth by Expenditures



Source: Central Statistical Organization

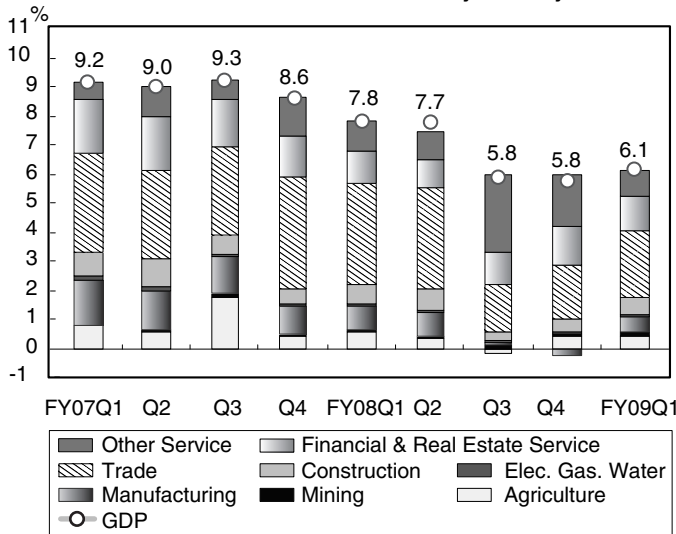
2009, from a peak of 15.7% on the same basis as above (8.2% on the same basis as above) at the end of March 1997. Their capital adequacy ratio remained relatively high at 13.0% at the end March 2008. Those indicate that the stability of the country's financial system has been enhanced and that the impact of the global financial crisis has been slight.

1.2 Issues in order to achieve sustainable growth and the medium and long term economic prospects

JCR considers it difficult to sustain high 9.0 % growth over the medium and long term, as envisaged in the government's

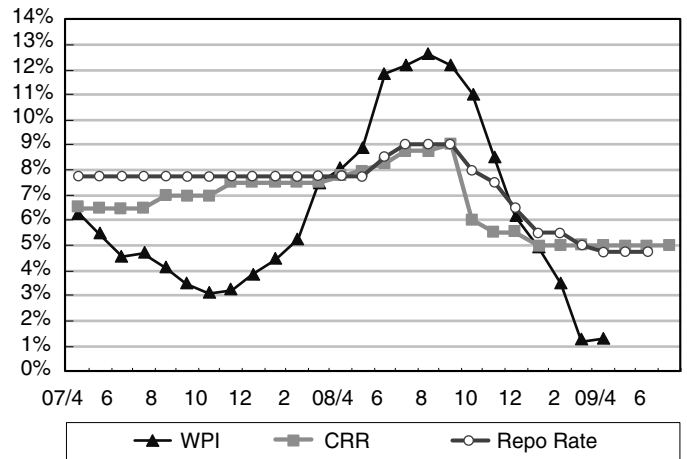
11th five-year plan (FY2007 to FY 2011), given the following factors: (a) the agricultural sector's vulnerability to weather conditions, (b) infrastructural bottlenecks, (c) its structural fiscal deficit, (d) the bloated and inefficient public sector, (e) a delay in building educational infrastructure and (f) a chronic shortage of water supply. However, the Indian economy has strong potential to grow at more than 7% annually over the medium and long term, supported by the following factors: (a) expanding private consumption resulting from the rise of middle-class with greater purchasing power, (b) growing foreign direct investment in the Indian

Chart 3. Contribution to Real GDP Growth by Industry



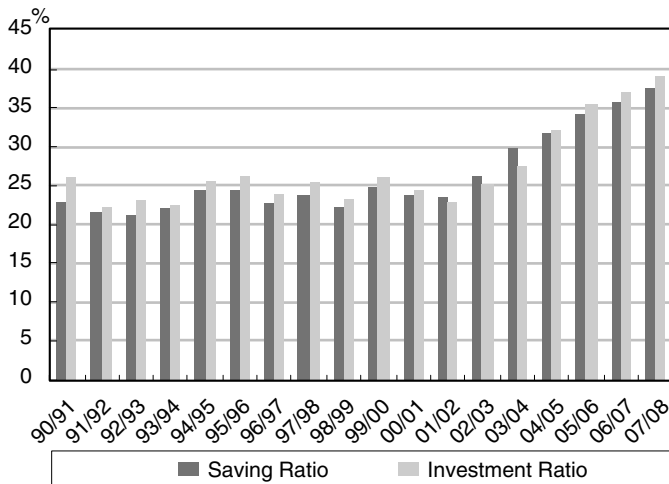
Source: Central Statistical Organization

Chart 4. Trend of WPI, Cash Reserve Ratio and Repo Rate



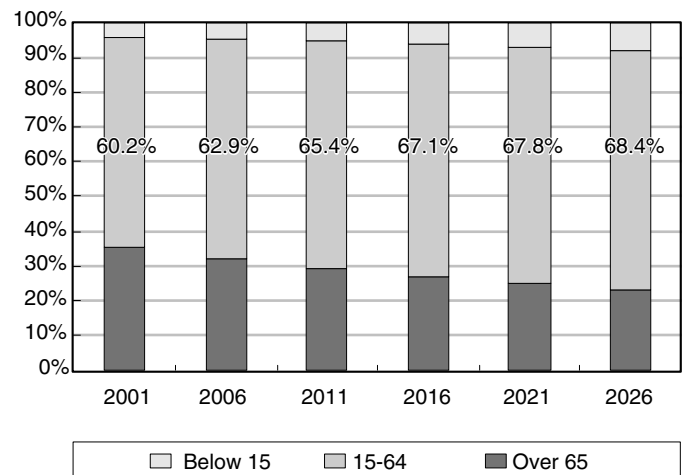
Source: Reserve Bank of India (RBI)

Chart 5. Trend of Saving and Investment Ratio



Source: Ministry of Finance (Economic Survey 2007-2008)

Chart 6. Trend of Population Composition by Age



Source: Ministry of Finance (Economic Survey 2006-2007)

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automobile and steel industries, (c) sustained growth of the services sector, especially its software services sector, (d) the rise of promising export industries such as auto parts, electrical machinery and electronics, pharmaceuticals, textiles and specialty chemicals on the back of ongoing corporate restructuring and foreign capital inflows, (e) a rising savings ratio amid high economic growth in recent years, and (f) a long-term uptrend in the ratio of working age population (ages from 15 to 64), which stood at 62.9% in 2006 (Charts 5 and 6).

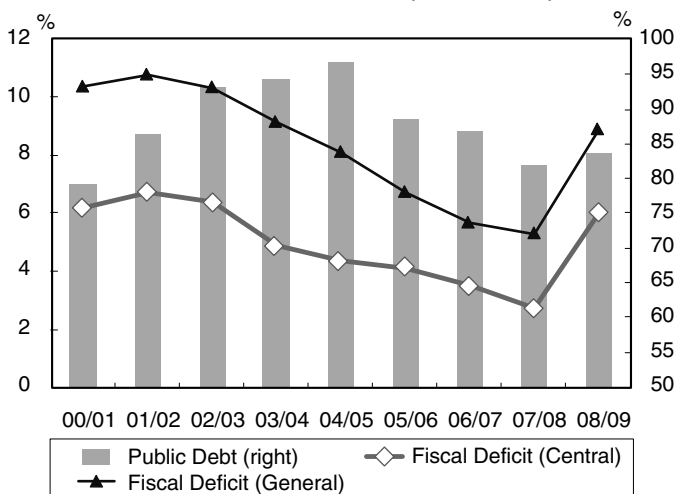
1.3 Fiscal situations

The expected fiscal deficit/GDP ratio was set at 6.8% in the FY2009 budget plan announced on July 6, 2009. In the previous fiscal year, the ratio reached 6.0% on a revised estimate basis, far exceeding the initial target of 2.5%. This was caused by its slumping tax revenue as a result of weak business conditions, increased fiscal expenditures for stimulus packages to bolster the economy and swollen subsidies prompted by higher oil and food prices, with the impact of global financial and economic crisis rapidly expanding in the global economy. The fiscal deficit will further widen in FY 2009 as the government plans to increase expenditures to stimulate the economy. The budget put its total revenue excluding debts at Rs. 6.2 trillion (approximately 10.7% of GDP). Of which, tax revenue was put at Rs. 4.7 trillion (76.5 % of the total revenue), a 1.7 % increase compared with the previous year on the same revised estimate basis. Although the tax revenue grew at a high rate of 25.2% (y-o-y) in FY 2007, the growth rate slowed significantly to 6.0% (y-o-y) in FY 2008 on the same basis. The tax revenue growth in FY 2009 is expected to slow further as a result of a slowdown in the economy. The budget put its total expenditures at Rs. 10.2

trillion, a 13.3% increase compared with the previous year on the same revised estimate basis (approximately 17.6% of GDP). The expenditure growth for FY 2009 will remain at a higher level following FY 2008 for the purpose of supporting the economy. Of which, current expenditures were put at Rs. 9.0 trillion (87.9% of the total expenditures), an 11.7% increase (y-o-y). Remaining capital expenditures were put at Rs. 1.2 trillion (12.1% of the total expenditures), a significant increase of 26.8% (y-o-y). Interest expenses, which have been increasing because of growing debt burden caused by its continuous fiscal deficit, were put at Rs. 2.3 trillion, a 17% increase (y-o-y), accounting for 22.1% of total expenditures. The ratio of interest expenses to total revenue excluding debts rose to 36.4% from 33.5% in the previous year on the same basis. Subsidies, which had increased sharply in FY 2008 on the back of worldwide soaring oil and food prices, decreased to Rs. 1.0 trillion, a 14.2% fall (y-o-y), representing 10.0% of total expenditures from 13.3% in the previous year on the same basis. Defenses expenditures increased to Rs. 1.4 trillion, a 23.7% rise, accounting for 13.9% of total expenditures from 12.7% in the previous year on the same basis (Chart 7 and Table 1).

It appears that the total amount of the country's combined fiscal deficit of the central and state governments and the outstanding balance of Subsidy Bonds issued by the central government for national oil and fertilizer corporations for the purpose of compensating for their losses reached a level equivalent to more than 10% of GDP in FY2008. In addition, the ratio of the public debt consisting of debts of the central and state governments (excluding the states debts from the central government and the central government's debts under the Market Stabilization Scheme) to GDP, which had been on the decrease in recent years, appears to have started

Chart 7. Fiscal Deficit and Public Debt (As % of GDP)



Source: Ministry of Finance. JCR's forecast

Table 1. The Central Government Budget 09/10
(Unit: R bn, %)

	FY08/09 (Estimated Result)	FY09/10 (Budget)	Change (%)
Revenues	5,744.4	6,198.4	7.9
Tax revenue	4,659.7	4,742.2	1.8
Non-tax revenue	962.0	1,402.8	45.8
Capital revenue	3,387.8	4,063.4	19.9
Expenditures	9,009.5	10,208.4	13.3
Non-plan expenditure	6,180.0	6,956.9	12.6
Interest expenditure	1,926.9	2,255.1	17.0
Plan expenditure	2,829.6	3,251.5	14.9
Primary balance	-1338.2	-1754.9	31.1
Fiscal balance	-3265.2	-4010.0	22.8
Interest expenditure/Revenues (%)	33.5	36.4	
Primary balance/GDP (%)	-2.5	-3.0	
Fiscal balance/GDP (%)	-6.0	-6.8	

Source: Ministry of Finance

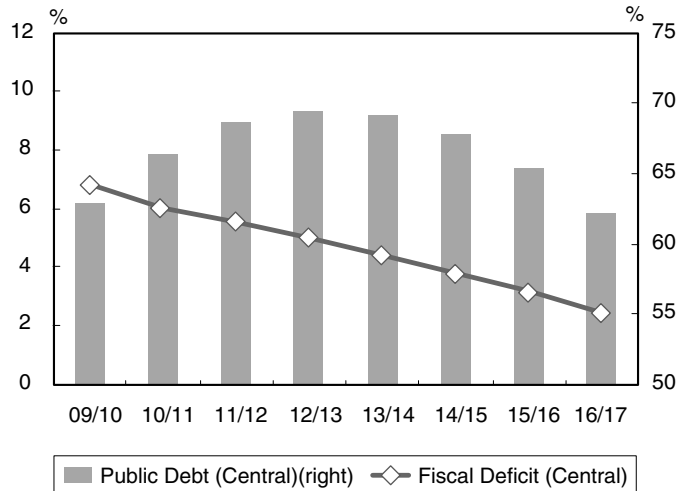
rising after hitting a bottom of 71.7% at the end of March 2008. These indicate that it will be critical for India to improve its fiscal position over the medium and long term. Although the government plans to lower the fiscal deficit/GDP ratio to 5.5% in FY2010 and 4.0% in FY2011, a successful outcome will depend on India's future economic growth as well as future trends of oil and food prices. Also whether the Indian government can expand its tax revenue base and control fiscal expenditures is a key factor. In case the tax revenue increases at approximately 17.8% (an average rate of tax revenue increase for periods from FY2003 to FY2007) and fiscal expenditures grow at approximately 11.8% (an average increase rate for the same periods) under the government's control, it will be possible to continue to drive down the fiscal deficit/GDP ratio over the medium and long term. Therefore, in our view, the Indian economy has potential to put its fiscal position on a track to recovery over the medium and long term, judging from its fiscal performance in the past. JCR will watch the government's measures, the performance of the Indian economy and the impact of such performance on the government's fiscal position (Chart 8).

1.4 External balance

India has experienced a swelling trade deficit since 2004, due to a steep increase in the imports including oil on the back of strong domestic demand. As a result, the current account deficit also continued to widen, rising to US\$29.8 billion or 2.7% of GDP in FY2008 from US\$17.0 billion or 1.7% of GDP in FY2007. However, the imports have been shrinking faster than the exports since early 2009, due mainly to an economic slowdown and a fall in oil prices. With the trade deficit narrowing, the current account deficit is expected to decrease substantially in FY2009. Meanwhile, India's savings ratio has

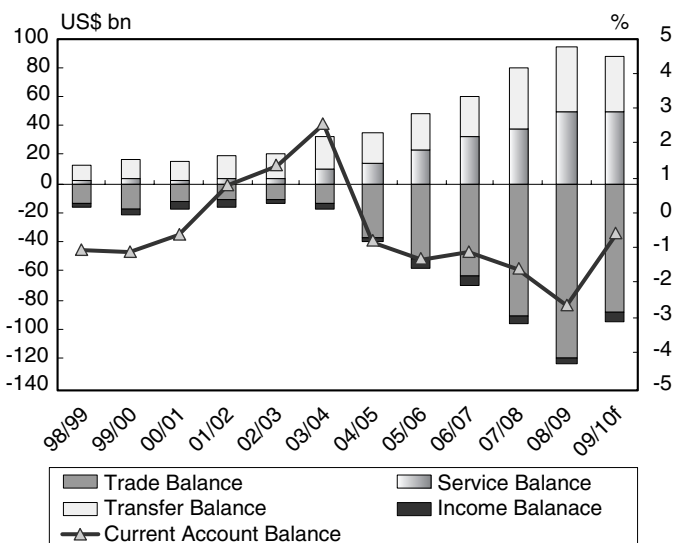
been rising steadily in recent years against the background of the country's high economic growth and stable deposit mobilization by the banking system. In light of saving-investment balance, the country's current account deficit will be maintained at manageable levels over the medium term. On the other hand, the country's exports of IT software, which have increased stably and have attracted the attention of worldwide IT companies in recent years, decreased sharply in FY 2008 and contracted compared with a year earlier in the fourth quarter of FY 2008, with advanced economies in the North America and Europe, the country's main export partners, falling into a recession (Charts 9 and 10).

Chart 8. Long-Term Projection of Fiscal Position (As % of GDP)



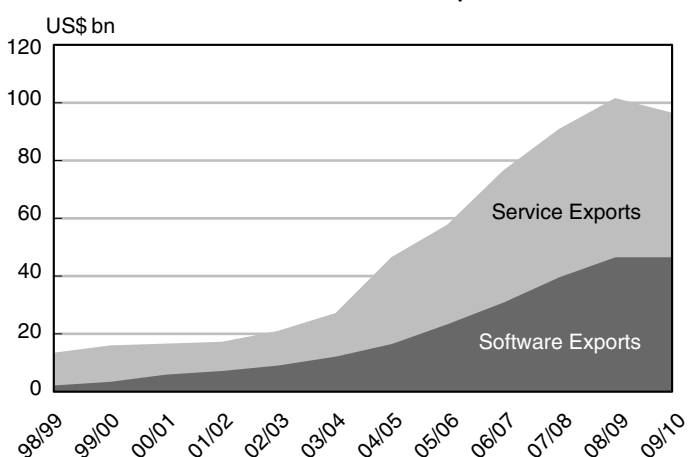
Source: Ministry of Finance. JCR's forecast

Chart 9. Trend of Current Account



Source: RBI. JCR's forecast

Chart 10. Trend of Service and Software Exports



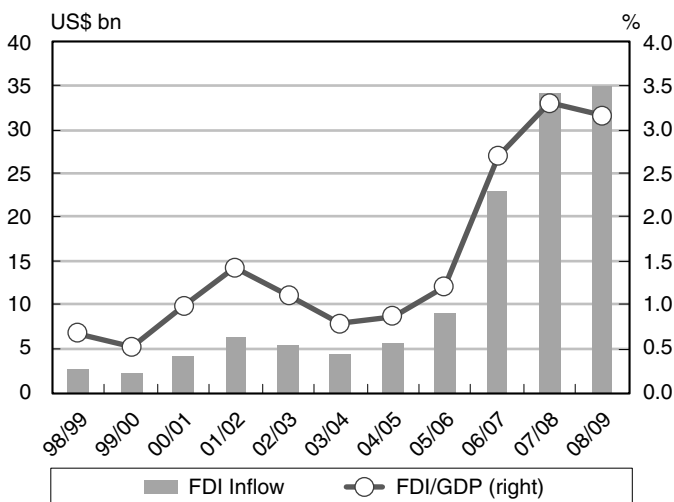
Source: RBI, NASSCOM

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FDI is important for India to finance its current account deficit and ensure the development of Indian industries and its sustained economic expansion. The growth of FDI inflows accelerated markedly from FY2006 through the first half of FY2008. However, the growth contracted significantly in the second half of FY2008 compared with a year earlier, with the impact of the global financial and economic crisis affecting the world economy. FDI inflows in the full-year (FY 2008) grew only 2.2% to US\$35.0 billion on a gross basis (y-o-y) (US\$17.5 billion on a net basis, up 13.6% (y-o-y)). However, given India's high growth potential over the medium and long term, FDI inflows will likely rebound again hereafter (Chart 11).

India significantly improved its external balance through conservative management of external debt and on the back of steady growth of exports, after the 1991 foreign currency liquidity crisis in India as a result of the Persian Gulf War. The external debt/GDP ratio started to fall after the peak of 38.7% in FY1991 and dropped to 17.2% at the end of March 2006. However, India's outstanding external debt has been expanding at an annualized rate of around 19% from FY2006 to FY2008 due mainly to increased external borrowings by the private sector and the swollen short-term external debt. As a result, the external debt/GDP ratio has also begun to rise moderately. The short-term external debt has increased sharply in recent years because of the expansion of trade finance, with its ratio to the total external debt rising to 21.5% at the end of March 2009 from 20.9% a year earlier. However, there is no immediate concern over India's foreign currency liquidity position, given its lower debt service ratio and ample foreign exchange reserves exceeding US\$250 billion (Charts 12 and 13).

Chart 11. Trend of FDI Inflow



Source: RBI

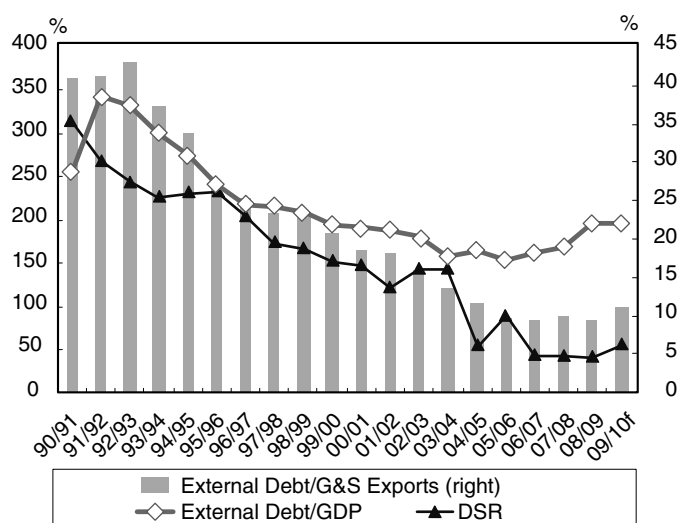
2. Political situation

2.1 India's political situation: An era of coalition government

India has entered an era of coalition government. Such assumption is indispensable to understand India's current political situation. Although the Congress Party unexpectedly won a resounding victory in the Lower-House election called from the end of April to the beginning of May, the party chose to act as the United Progressive Alliance ("UPA") and formed a coalition government thereof not a single-party government. It is likely that coalition governments continue if a future general election brings about another change of power.

Major backgrounds of the rise of coalition government are pointed out as follows. First, regionalism based on unique languages and culture has emerged, when Indian states were realigned by languages in 1957. In this connection, India has two official languages (Hindi and English) and 21 states' official languages. And the number of languages spoken in India including dialects at the moment is over 800. Second, unsuccessful socialistic economic development policies by the Congress Party resulted in lower public confidence in the Congress Party amid spreading political corruption under the Congress Party government over a long period of time. Third, growing regionalism which was linked to declining power of the Congress Party triggered the gradual advance of regional parties in the central political scenes. Fourth, confrontation between India and Pakistan in addition to such emergence of regionalism caused the upsurge of nationalism in the Hindu belt (the northern part of India where Hindi is spoken). Such movement resulted in the rise of the Hindu supremacist party, the Bharatiya Janata Party in the northern districts. The Hindu supremacist party

Chart 12. Trend of External Debt Position



Source: Ministry of Finance, RBI. JCR's forecast

became influential rapidly after 1989 against a background of people's hope of a stable government. Lastly, "other backward class," which has not been covered by any protection policy, entered the political world on the back of improvements in their rising economic power.

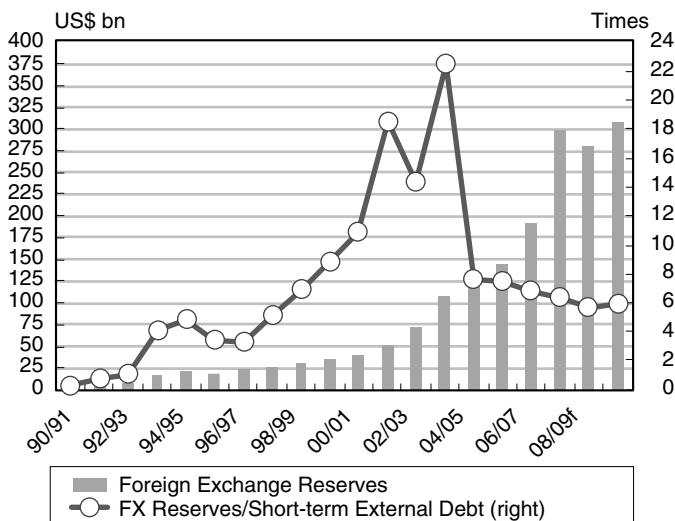
India's era of coalition government reflects its political and social situations, which have culturally and socially complex backgrounds, both more noticeably and appropriately than ever. In that sense, India's democracy has matured without diverging from such realistic prospects. However, it appears that there have been more times when more negative aspects of the coalition government, than positive, surfaced. It is likely that any ruling coalition will face difficulty in guiding the country, with politically tough situations continuing in the era of coalition government, including extremely complex factors, such as the emergence of the regionalism, religious diversity, economic divide between regional areas (rural communities) and urban areas, and problems of the caste system. On the other hand, India still has to deal with many challenges and implement structural reforms in order to sustain high economic growth over the medium and long term. Such structural reforms to destroy vested interests are accompanied by pain and therefore may easily become a political issue. A strong leadership, supported by political stability, is needed in order to accomplish such reforms. At the same time, JCR considers, an exceptional ability of policy making and accomplishing such reforms is necessary, given the difficulty in such reforms under a slumping economy which requires balancing with policies for the recovery. Thus India is facing a challenge, that is, exercising political leadership in the era of coalition government.

2.2 UPA coalition government's second term in office after clearing up difficulties

Five years have passed since the UPA led by the Congress Party won in a general election in April, 2004 and took office, overturning the previous general expectations that the election campaign would proceed favorably to the National Democratic Alliance ("NDA") led by the Bharatiya Janata Party ("BJP"). A Lower House general election was held from the end of April to the beginning of May in 2009 again with winning of the Congress Party. Its coalition government is deemed to have played a certain role in achieving India's political and economic stability and a relatively high economic growth as it completed its full five-year term of office, despite some expectations at the start of the government in 2004 that it would collapse within three years. In this election, similarly as the previous one, there were fewer expectations that the Congress Party would win. The Congress Party was often defeated in state legislature elections in 2008. Also the BJP, the largest opposition, gained seats significantly in the state legislature election of the Karnataka State in May 2008 and took power in the state. It was often pointed out that the issue for the BJP was to become a true national political party based on the "diversity of India," rather than a large regional political party rooted in the northern part of India. The BJP's win in the Karnataka State, the southern part of India, was considered signs of the party's steady progress. On the other hand, the Congress Party had faced a problem of soaring inflationary pressures which continued until September in 2008, just before "Lehman shock." Leaders of the Congress Party were concerned about the problem as an unfavorable factor which might affect the results of the Lower House general election, since such inflationary pressures could directly hit the daily lives of common people including farmers who comprised a main constituency of the Congress Party. Meanwhile, leftist parties, which had supported the government from outside the cabinet, decided to withdraw from such non-cabinet corporation in July 2008, as a result of the confrontation with the government with respect to the nuclear cooperation pact between India and the US. Prime Minister Manmohan Singh requested regional political parties to support the government and could manage to avoid a collapse of his government.

Under such circumstances occurred incidents which could change India's political situation. In November 2008, multiple simultaneous terrorist attacks took place in Mumbai, the largest business city in India and many people were killed and injured. Public-opinion polls implemented in India's major cities after the incidents clearly showed that there was increasing dissatisfaction with Prime Minister Manmohan Singh in consequence to the incidents. Also, Indian authorities who had evidence proving the involvement of Pakistan's extremists in the attacks after their investigations, demanded the extradition of suspects in the Mumbai attacks, but this demand was rejected by the Paki-

Chart 13. Trend of Foreign Currency liquidity Position



Source: Ministry of Finance, RBI. JCR's forecast

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stani government. As a result, the attacks had dire effects on the relationship between India and Pakistan as well as India's domestic political situations, and increased the military tension between two countries. Initially the attacks were considered to have negative effects on the Congress Party because of direct criticism on the government's anti-terrorism measures. However, contrary to most expectations, the Congress Party won in the four out of six state legislature elections, which were held at around the time of the Mumbai attacks. Especially, the Congress Party's victories in three state elections after the attacks were significant, as the opposition parties were using the Mumbai attacks as ammunition against the government. These results may well have reflected the will of the nation who observed situations calmly and feared further intensified confrontation between India and Pakistan and a revival of the government led by the Hindu supremacists.

The Congress Party, the largest ruling party, tried to stay in power by demonstrating results of the high economic growth in recent years and gave its campaign pledges of stimulus packages and measures for the relief of the poor and rural communities, its important constituency, as its electoral campaigns for the 2009 Lower House general election. On the other hand, the BJP, the largest opposition party, tried to take power by criticism on the anti-terrorism measures taken by the government and the ruling parties, and an issue of building a Hindu temple on the site of a razed 16th-century mosque, in addition to presenting measures for the relief of the poor and rural communities. Another important factor in the election was the rise of a third party consisting of the leftist parties including the Communist Party of India and the All India Anna Dravida Munnetra Kazhagam, which became more influential. The election became unpredictable as a result of the unsuccessful corporation in the rural elections between the Congress Party or the BJP and other regional political parties, on top of such a three-cornered battle.

However, the result of the election was that the ruling coalition led by the Congress Party won a resounding victory. The coalition government led by the Congress Party, which upset most electoral predictions and won in the previous 2004 election, has been carrying out a balanced policy between the reforms and the consideration for the poor and weak, while leftist parties, which supported the government from outside the cabinet, opposed the reforms. JCR considers that most people supported the coalition government for its five years of performance, even with the Mumbai attacks in August, 2008 influencing them psychologically. In our view, the UPA's victory in the election will contribute to the political stability of India, although repeated terrorist campaigns should be paid attention to. It appears that the transition to an era of stable coalition government from unstable one is taking place in India. JCR will watch how the second UPA government led by Prime Minister Manmohan Singh, which gained a comfortable

majority, will address the issue of sustainable economic growth and deliver the results by carrying out its balanced policy between the reforms and the consideration for the poor. 