

Economic

Credit Agencies

Moody's: Baa3
S&P: BBB-
Fitch: BBB-

Nominal GDP (2011)

USD 1,843.4 billions

Population (2011)

1,206.9 million

Total Trade / GDP (2011)

45.0%

Currency

Indian rupee

Exchange regime

Managed float

Merchandise imports from Canada (2010)

CAD 2,017.4 millions

Main sources of Foreign Exchange (excl. FDI)

Remittances
Software services

Main Merchandise Export Destination

US (17 %)

Main imports

Mineral fuels (37%)
Industrial M&E (16%)
Precious metals & gems (11%)

Risks to the Outlook



Greater than expected FDI; Food inflation falls



External financing vulnerable; lack of fiscal consolidation

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MARKET SPOTLIGHT: GDP growth continued to slow in Q3-11, rising 6.7% y/y, largely as a result of weaker investment and personal consumption spending. • Under pressure from various scandals, the government showed little interest in fiscal consolidation in 2011, but we expect the issue to return to the table in the next budget. • Inflation finally showed signs of abating and reversing in December, but with inflation still hovering above 9% y/y monetary loosening will need to wait a bit more. • Exports have received a boost from the weakening rupee, which has been depreciating since mid-2011. The debt crisis in Europe has pushed European banks to pull back financing from India, contributing to the rupee depreciation and the drop in FX reserves.

Recent performance: GDP growth continued to slow in Q3-11, rising 6.7% y/y, largely as a result of weaker investment and personal consumption spending. On a seasonally adjusted basis, q/q real GDP was only 2.5% annualized, slowing for the third consecutive quarter. Exports again provided a strong contribution to growth, supported by the falling rupee, which closed 2011 at a record low against the USD. While government infrastructure spending remains at high level, the pace of growth has levelled off after the ramp up initiated in 2010. Business confidence has fallen rapidly since reaching an all-time high in the 3rd quarter of 2010, with monetary and credit tightening affecting credit availability. Industrial activity slowed considerably in the third quarter with a deterioration in manufacturing activity. With manufacturing output largely domestically oriented, the depreciating rupee will support the sector.

Fiscal policy: The central government's deficit, as a share of GDP, has shown some improvement in recent quarters, but remains substantial. Revenues are falling well short of last year, which received an important boost from the sale of 3G licenses, and weaker privatization receipts. As a result, the deficit this year should only improve marginally on the 5.8% recorded last year. At the same time, expenditures are rising 10-15% y/y. Under pressure from various scandals, the government has shown little interest in fiscal consolidation this year, but we expect the issue to return to the table in the next budget. The expected introduction of the VAT should also give a boost to revenue collection. Nonetheless, high inflation and sufficiently strong economic growth have kept the public debt to GDP on a declining trend, expected to reach 62% by the end of the year.

Monetary policy: Inflation has finally shown signs of abating and reversing in December, with food inflation dropping to 6% y/y from 10.7% in November. But with inflation still hovering above 9% y/y, sustained by rising housing prices, monetary loosening will need to wait a bit more. At this stage, the RBI's main focus remains clearly on inflation rather than growth. Nonetheless, with the December report, the RBI stance will shift away from a tightening bias, after raising the repo rate by 325 basis points in 2011. Inflation has been resilient, driven not only food supply constraints but also strong private demand for credit, which accelerated to over 20% y/y in mid-June. The RBI has little impact on food and fuel prices through monetary policy, but the rise in other categories as well as credit growth is of concern.

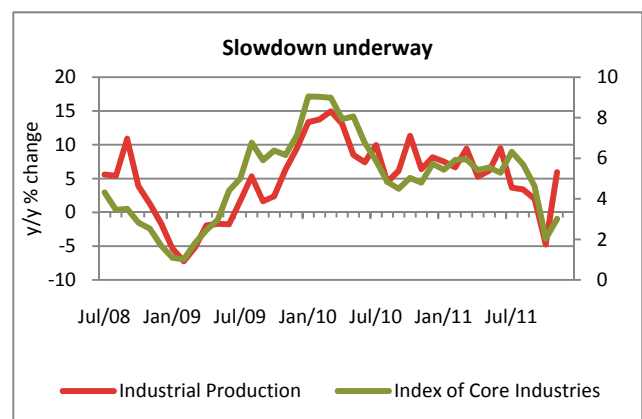
External sector: Exports received a boost from the weakening rupee, which has been depreciating since mid-2011. However, higher imports, boosted by oil prices, kept the trade and current account balances in the red, with the deficit reaching 4.0% of GDP in Q3. The debt crisis in Europe has pushed European banks to pull back from India, contributing to the rupee depreciation and the drop in FX reserves. Going forward, we expect an adjustment on the trade balance as import demand eases with the slowing economy and with declining oil prices. The level of foreign exchange reserves fell to US\$ 270 billion at the end of December, representing 5.8 months of import cover.

Outlook: Real GDP growth will accelerate to 7.2% in 2012 from 7.0% last year. The lagged impact of monetary tightening in 2011 will keep credit conditions tight, constraining private investment, while the problems in Europe limit export growth despite the weaker rupee.

Economic Indicators

	06-10 avg.	2010	2011	2012
GDP (% growth, real)	8.4	9.9	7.0	7.2
Inflation (% , year-end)	8.8	12.0	8.9	7.8
Fiscal Balance (% of GDP)	-4.6	-4.7	-5.4	-5.8
Exports (% growth)	18.9	34.1	37.0	3.5
Imports (% growth)	20.3	30.3	24.5	10.8
Current Account (% of GDP)	-1.8	-3.0	-2.7	-3.8
Reserves (month of imports)	8.5	7.1	6.4	6.5
External Debt (% of GDP)	16.7	14.6	14.0	13.7
Debt Service ratio	8.5	8.9	7.2	7.1
Currency (per USD, year-end)	44.7	44.8	50.7	49.9

Sources: EIU, EDC Economics



Source : Haver Analytics

Political

Political Structure

Federal State
Parliamentary Democracy

President

Pratibha Patil

Prime Minister

Manmohan Singh, Indian
National Congress

National Legislative Bodies

- Lok Sabha (Lower House)
545 members (chosen through direct election)
- Rajya Sabha (represents interests of Indian states)
245 members (233 elected, 12 appointed by President)

Major Parties

- Indian National Congress (INC)
- Bharatiya Janata Party (BJP)
- Samajwadi Party
- Bahujan Samaj Party
- Communist Party of India-Marxist (CPI-M)

Last Elections

April/May 2009

Next Elections

April/May 2014

Press Freedom Survey

- 2011 Score: 35 - partly free (0: Free; 100: Not Free)
FreedomHouse.org

Control of Corruption Index

- 2010 Score: -0.52 (-2.5: Worst; +2.5: Best)
[World Bank Governance Indicators](http://WorldBankGovernanceIndicators)

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General Political Environment: Democracy is well entrenched within India's political system, but is complicated by tensions over religion, ethnicity and a deep-rooted patronage system. Varied political cultures and ideologies across the country reflect the extreme diversity within India's socio-economic environment. India is a federal state, so states enjoy significant autonomy and the legislative environment can vary considerably between states. Coalitions led by either the Indian National Congress (Congress) or the Bharatiya Janata Party (BJP) have traditionally dominated federal level politics.

In power since 2004, the Congress-led United Progressive Alliance (UPA) surprised observers with a strong win in 2009 that secured a near majority in the legislature. The UPA further strengthened its position with several wins in state elections. The opposition coalition led by the BJP finished a distant second. In general, the ruling coalition is comprised of one of the Congress or BJP plus a collection of regionally-based parties.

The UPA was expected to implement important and much anticipated reform programs given its strong position, yet significant reforms have been elusive due to the complex nature of Indian coalition politics as well as diverging views within the UPA.

Corruption scandals have drained government resources and nearly paralyzed the legislative process in recent months. India has been buffeted by scandals erupting one after the other through 2011; the 2G Telecom licenses sales, Commonwealth Games, the 'Cash for Votes' and the most recently the Karnataka mining affair. Activist Anna Hazare's hunger strike in August and popular demand for change put these concerns on the world stage. With the government's image tarnished, BJP-led opposition groups see an opportunity to challenge the government during state elections, five of which will be held between January and March.

Controlling rising costs of essential food items has also been a challenge for authorities. The UPA came to power on a pro-poor platform and therefore has to balance liberalization efforts with the immediate needs of segments of the population most vulnerable to price shocks.

Investment Environment: Despite India's foreign investment policy that allows 100% foreign ownership in most sectors, India has failed to reach its full potential as an FDI destination. Government attempts to increase FDI inflows have been slowed by the opposition, pervasive corruption, uncertain regulations and a critical infrastructure deficit.

Corruption in India is widespread, especially in the public sector; contributing factors include bureaucracy, weak governance, and long-standing, deep patronage systems. India's Supreme Court has lately taken an active stance in fighting corruption. The judiciary, especially at the higher levels, is considered competent and fair. Recent judicial sector reforms are said to have increased efficiency but cases are resolved only in years or decades.

Regulatory uncertainty, both at the federal level and between federal and state levels continues to pose challenges. South Korean company POSCO struggled for five years to start a steel mining project in Orissa; this was emblematic of the lack of regulatory clarity between the Federal government and states. The eventual approval of the project in February 2011, albeit with strict environmental conditions, may prove a way forward for large high profile projects.

Political Violence: Several terrorist attacks in recent years in major cities highlight the threat posed by domestic and foreign Islamist militant groups. Multiple blasts across Mumbai in July 2011 and the explosions at the Delhi courts in September 2011 have brought the specter of terror back as a reminder of the 2008 Mumbai attacks in which over 180 people died.

Tensions with Pakistan have threatened regional stability since 1947. Several years of peace talks on the disputed Jammu - Kashmir territories have resulted in little progress. The Mumbai attacks led to deterioration in Indo-Pakistani relations due to Indian government allegations that Pakistani government agencies were involved in the attacks.

The ongoing Maoist (Naxalite) insurgency operates across large swaths of rural states and have targeted security forces, government infrastructure and extractive companies. The government may be forced to take on more responsibility in tackling the Naxalites, an issue that has hitherto been considered an internal matter for individual states to deal with. Hindu/Muslim based communal political violence issues remain as well in certain parts of India.

Political Outlook

Despite the recent scandals, the Congress-led UPA governing coalition is very likely to govern through to the end of its mandate in 2014. The vibrant press and civil society will probably maintain pressure on the government if further scandals emerge, and criticism over the government's inability to pass important reforms will probably sharpen if the government is not seen to be actively managing these obstacles to India's rapid development. The government may however refrain from pursuing unpopular reforms throughout much of 2012 in order to restore a more positive public image.