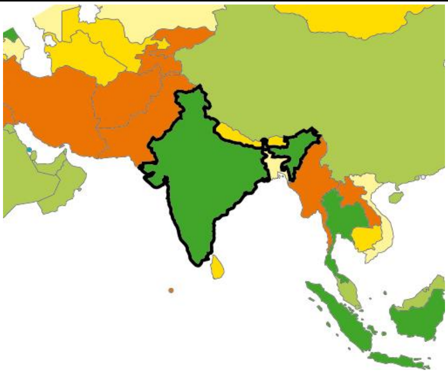
COUNTRY RISK ANALYSIS

India

CREATING CONFIDENCE IN YOUR EXPORTS

ekn



COUNTRY RISK CATEGORY

3/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES TO THE COUNTRY

SHORT-TERM TRANSACTIONS: SEK 8 MILLION

MEDIUM AND LONG-TERM TRANSACTIONS: SEK 17,510 MILLION

DATE

24-10-2014

Slow recovery

The Hindu nationalist party BJP won a landslide victory in the parliamentary elections in May and now has its own majority in the lower house. The prospects for being able to pursue successful and efficient polices thus look better than in a long time. The expectations that Prime Minister Modi will repeat the economic successes he achieved as the leader of the state of Gujarat on the national level are high. Modi is however taking over the reins of an economy characterised by structural problems and stubbornly high inflation in spite of tight fiscal and monetary policies. This limits the scope for quickly increasing the low growth rate India has had in recent years. The prospects for creating a more robust economy in the long term, mainly via structural reforms and thus renewed confidence from international investors, are looking better.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- Strong support for Prime Minister Modi to pursue economic reforms
- Strong external balance
- Dynamic private corporate sector
- Well-established democracy with regional influence

Weaknesses

- Weakened state-owned banks
- Weak public finances
- Difficulties creating enough jobs
- Difficult bureaucracy and widespread corruption

EKN'S POLICY

Policy in brief

EKN has placed India in country risk category 3, for both short and long guarantees – an assessment made in collaboration with the other OECD countries. For transactions with counterparties in the private sector, such as banks and companies, each transaction is assessed on its own merits. The same applies to transactions with central government debtors, such as the Central Bank or the Ministry of Finance.

For other types of public buyers, such as line ministries, municipalities or states, EKN's approach is more restrictive. EKN normally seeks sovereign guarantees for such transactions, and in cases where they are not available, EKN applies higher requirements for aspects such as good financial transparency.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made less restrictive in the event of

- Greater opportunities for the private sector to expand via a better business climate
- Continuing consolidation of the public finances and reforms to reduce vulnerability

The policy may be made more restrictive in the event of

- A deterioration of the public finances
- Deficient implementation of structural reforms
- A deterioration of the external balance

EKN'S EXPOSURE AND EXPERIENCE

Large single exposure dominant

EKN's exposure in India is dominated by just a handful of large transactions which account for the majority of the total exposure of SEK 17.9 billion. Outstanding guarantees are divided between two sectors, power and telecom. EKN's delays and claims with respect to transactions in India are very minimal in proportion to the exposure.

COUNTRY ANALYST

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POLITICS

Strong mandate for BJP

The Hindu nationalist party BJP won a landslide victory in the parliamentary elections in May 2014 and now has its own majority in the lower house. The prospects for being able to pursue successful and efficient polices are thus looking better. The expectations that BJP's Prime Minister Modi will repeat the economic successes he achieved as the leader of the state of Gujarat on the national level are high. Gujarat is often brought up as a good example of a market-driven economy, with a strong manufacturing industry that attracts both domestic and foreign investment. Growth has been consistently stronger in this state than on the national level over the past years. In its election campaign, BJP primarily used Modi's economic experience as a strength and toned down its Hindu nationalist profile. Modi is however a controversial person, partly referring to his alleged inaction related to the religious riots in 2002. This could make it difficult for Modi to implement his policies.

Indian domestic policies are increasingly characterised by issues and special interests driven by state or regional parties. The relatively high level of autonomy of the states vis-à-vis the central government can provide an opportunity to satisfy regional interests. For domestic policies, this means that differences between states on certain issues are growing, since some states can and will go further. Per capita income differs significantly, from USD 529 in Bihar to USD 3,600 in New Delhi.

Many challenges and deficiencies that inhibit the national Indian economy are of a structural nature, where measures in the present situation lead to better prospects in the long term. To at least partially meet expectations, it is probable that Modi will go for measures that will have a rapid effect, in parallel with more long-term initiatives. Already during his first months in office, measures have been initiated to complete the sale of state ownership in companies and the limit for foreign ownership has been raised in several industries.

The BJP's foreign policies were relatively high profile during its most recent term of office (1998-2004). A higher degree of assertiveness on the regional level than under the Congress party's term could be justified to counterbalance China's increasing influence in nearby countries that India has traditionally had a strong influence over, such as Bhutan, Nepal and Sri Lanka. Signs that relations with Pakistan may deteriorate under the BJP's leadership are already being seen in the form of cancelled high-level talks.

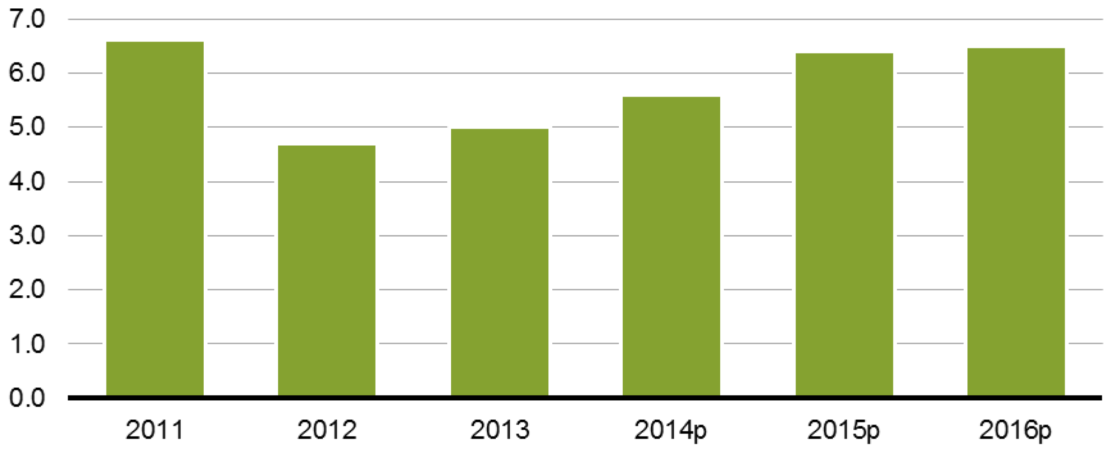
The BJP's reform agenda is focused on domestic policies and that is where the power and the expectations behind its strong mandate lie. Modi therefore needs to balance increased regional influence with the needs for action demanded by domestic policies. Far too active foreign policies at the expense of domestic policies would weaken BJP quickly, if the expectations of change in the country's economic situation are not met simultaneously.

ECONOMY

More of a slow recovery than a rapid return

The decline in the Indian economy over the past three years has been substantial. The rate of growth has fallen, partially as a result of political paralysis. Modi won the confidence of the voters thanks to his strong economic visions and successfully implemented market reforms on the state level. This creates optimism about the country's future economic growth. GDP growth is expected to increase to over six per cent in 2015 and slightly more the following year.

GDP GROWTH, %



The recovery is expected to level out at around 6.5-6.7 per cent, in anticipation of when the results of structural reforms have an impact. (Source: IMF, WEO Oct 2014)

One key factor for both higher growth and higher employment is the development of the manufacturing industry. India has good prospects for expanding its industrial sector, which can provide employment opportunities for the approximately twelve million Indians who enter the labour market each year. Already established manufacturing industries, such as the production of textiles and pharmaceuticals, chemicals industries and the manufacturing of car components, have shown that India is a competitive destination for investment.

India's industry accounts for around 15 per cent of GDP. This number has remained unchanged over the past years. As opposed to the surrounding countries, where industry represents a higher share of their GDP, much of the industrial production in India takes place in small companies with low productivity. This low productivity is partially a result of deficient infrastructure, cumbersome bureaucracy and the regulatory environment.

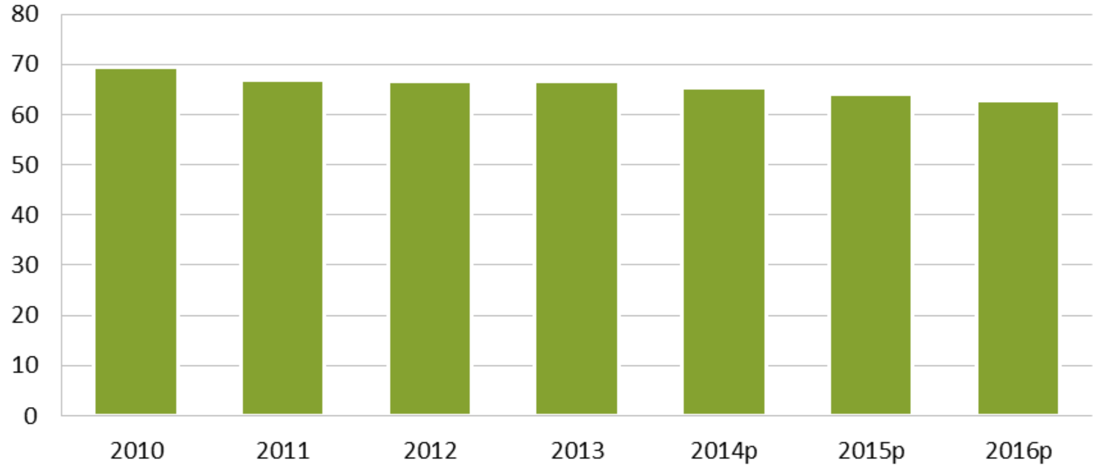
The public finances will be front and centre for analysts and investors in the coming year, since this is a crucial point for India. Good budgetary discipline will be interpreted as a sign of strength, while the opposite will cast doubt on the government's ability to pursue responsible economic policies and its ability to implement reforms. Growth will recover slowly and interest rate cuts cannot be brought up until the rate of inflation is under control, perhaps in the second half of 2015. One expected development is a consolidation of the budget deficit to 4-4.5 per cent, a slowly falling ratio of public debt to GDP and growth of over six per cent in the coming years.

Weak public finances

Indian's public finances have weaknesses in terms of both revenues and expenses. Tax revenues are around 16 per cent of GDP, which is low in comparison to other developing and emerging countries. This is due to generous exemptions, the difficult-to-tax agricultural sector and an extensive informal economy. The plans in existence to increase revenues and broaden the tax base will not have an impact until further down the road. Other measures, such as auctions for telecom licences or sales of public companies, will only provide one-time revenues.

The gap between the public revenues and expenses leaves a substantial budget deficit. India has thus far mainly financed this deficit via the domestic banking system. The total public debt is 64.5 per cent of GDP, which is a reduction from past years and in line with coming years. Given India's favourable profile with the majority of its borrowing in the domestic banking system and with long terms, the debt is still considered manageable. Nevertheless, interest payments comprise a significant expense in the budget, on average equal to nearly 25 per cent of total public revenue over the past five years.

PUBLIC DEBT, % OF GDP



The public debt consists nearly exclusively of domestic borrowing (source: IMF, WEO April 2014)

If it is to be able to continue with the consolidation initiated after a period of expansionary fiscal policies in connection with the global financial crisis, the central government will need other sources of financing. India was relatively early to adopt public–private partnerships (PPP), but the hard part has been finding a model that works. One option to realise the infrastructure projects that have already been approved, or those awaiting approval, is to expand on modified PPP models.

Modi is taking over the reins of an economy that has weakened over the past years. The economy is characterised by weak public finances, high public debt and high inflation. There is therefore no scope for large-scale expansionary monetary and fiscal policies. The public investment expenditure of last year is being cut down to meet the deficit target of 4.5 per cent of GDP. India urgently needs to strengthen its revenues and limit its costs. Increased turbulence in the Middle East may however result in the state's expenditure for fuel subsidies being higher than estimated.

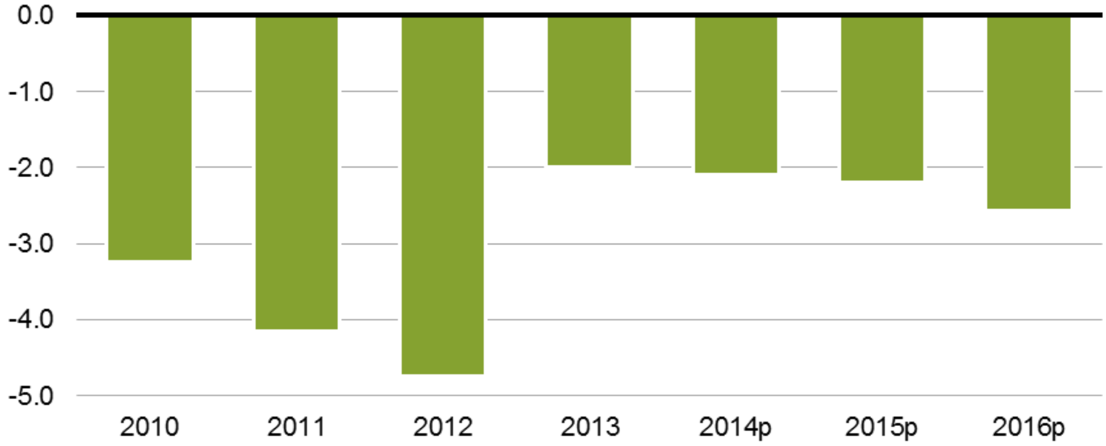
BALANCE OF PAYMENTS AND DEBT ISSUES

Current account deficit nearly cut in half

India's exports are increasing, but they are still relatively low as a percentage of GDP. Its exports consist of textile, mining and agricultural products, as well as chemical products and pharmaceuticals. The outlet market for India's export products is mainly the EU and the US, markets which are now beginning to recover. In the neighbouring region, India's trade is mainly with China. India has a substantial negative trade balance in this relationship. As a result of increased wages in China, there may be more room for the Indian textile industry to gain market shares. India has surpassed textile exporters like Italy and Germany and is now the second largest textile exporter in the world after China. While the sector grew globally by six per cent in 2013, India's market share increased by nearly 18 per cent. In ten years, the Indian textile and clothing sector is hoping to be able to create 35 million jobs and account for an increasingly important portion of export earnings.

In 2013, there was a correction of the sizable external imbalances The trade deficit was reduced via both an increase in exports, thanks to a recovery on India's largest outlet markets, and a reduction in imports as a result of lower demand and import restrictions on gold.

CURRENT ACCOUNT DEFICIT, IN % OF GDP



The current account deficit is expected to stabilise at a level of around 2.5 per cent of GDP. (Source: IMF, WEO 2014)

A slight increase in the current account deficit is expected for this year, as import demand has increased slightly. A slightly increased deficit, equal to two or three per cent of GDP, is no problem for India to finance via capital inflows.

Foreign debt accounts for over 20 per cent of GDP, the majority of which is private debt. Indian company groups have increasingly borrowed abroad as a result of the high domestic interest rates. The Indian government has not increased its exposure to foreign loans in a corresponding manner and foreign loans are no threat to the government. The state instead finances itself via the domestic banking system. As the exposure of the banks to the government increases, this will also result in a reduction in credit for private loan-financed investments.

Overall, the economy has experienced a positive development. The measures taken to stabilise the situation during the turbulence of the past year in combination with the new political leadership has instilled new confidence in the country among investors. In spite of very large current account deficits and reduced capital inflows in previous years, the country has substantial international reserves equal to nearly six months of imports.

CURRENCY POLICY

India uses a managed float, which means that the central bank intervenes to influence the exchange rate. The Indian rupee experienced a sharp fall in value against the dollar in 2013, similarly to other currencies in emerging countries. Thanks to the reduction in the previously sizable current account deficit, the depreciation pressure against the rupee has been lower in 2014. Capital inflows from the beginning of the year until mid-August 2014 totalled USD 25.8 billion, which, in comparison to the same period the past year, is a net outflow of USD 4.8 billion. The renewed large inflow, together with central bank measures, has contributed to keeping the exchange rate stable.

However, the rapid outflow in 2013 shows that the country is vulnerable via its external balance and its dependence on foreign capital flows. Expectations of US's tapering along with the large current account and budget deficits, led the rupee to fall more than several other currencies. Future liquidity contractions are expected to be incorporated in the exchange rate and not impact the exchange rate to the same extent as in 2013.

EKN can assess the possibility of issuing guarantees for transactions in local currency, but does not have any experience of that yet. The rupee is convertible for current account transactions, i.e. trade in goods and services. However, the currency is not fully convertible and may not be transferred outside the country. There is a trend toward liberalisation, but in light of the country's vulnerabilities, it is likely that restrictions will remain in place in the long term.

FINANCIAL SECTOR

High government influence

India's banking sector will change in the coming years, with a focus on the state-owned banks. The intention has been made clearer by the relatively new central bank head Rajan, who says that the direct interest of the government should be reduced, competition strengthened, regulation improved and conditions, such as in the form of national credit registers, strengthened. The weak financial performance of the state-owned banks and continuous needs for capital contributions from the government are indicative of the need for change. There is also a political agenda for all Indian households to have access to a bank account. The reason for this is for the government to be able to fight poverty and manage government social security payments more effectively and transparent. At present, it is estimated that roughly half of the Indian population of 1.2 billion do not have a bank account.

The Indian banking sector has advanced toward being more split in terms of the credit rating of the banks. The state-owned banks, which dominate the sector with cumulative assets of 75 per cent, have seen a virtually headlong decline in the quality of their loan portfolios. Overall, these banks have experienced a drop in profits due to higher provisions for bad loans, lower interest rates and higher borrowing costs. The amount of capital contributed by the government has not been enough to compensate the banks, whose capital has instead been depleted.

The private banks are partially experiencing the same trend as the state-owned ones, but to a lesser extent. For example, bad debts in private banks amounted to an average of 3.8 per cent of total assets as of March 2014, while the corresponding figure for the state-owned banks exceeded ten per cent.

This trend should be juxtaposed with the relatively good starting position and the still relatively moderate extent of the country's banking sector. Total loans were equal to 53 per cent of GDP in March 2013, an increase from 45 per cent in 2007. It is estimated that there is great potential for the banking sector to grow in the long term and develop positively in India, even though the state-owned banks and their deficiencies are currently more of a roadblock to growth. The private banks are expected to be the drivers of the growth potential and dynamics in the sector, since they have the capacity to grow and the drive to expand their business. Competition in the banking sector is high.

BUSINESS ENVIRONMENT

Indian companies are going through a rough period. This can be seen in a report from the IMF that indicates falling earnings in relation to the interest burden in the corporate sector since 2006, with a sharp acceleration in 2011-2013. The proportion of companies that experienced a sharp increase in their debt/equity ratio[1] has also nearly tripled in the same period. A large portion of this borrowing has taken place abroad and is concentrated to a few groups of companies, mainly in the manufacturing and construction industry. Falling profitability can be explained by both external factors, such as lower export demand from India's main export markets, and domestic factors. Lower domestic demand, high interest rates, heavy depreciation of the currency in 2013, a cautious investment attitude in anticipation of the elections in May and increased costs have all contributed to the pressure on profitability. The IMF's conclusion is that Indian companies have not been in such poor shape financially since the first years of the 21st century.

Measures have been taken to address and minimise the risks in the ongoing situation. A new law, the Companies Act, was adopted in 2013. Its provisions include an increase in reporting requirements for companies. Proposals for joint national databases with credit information are also to be drafted. New increased requirements for classification and provisions for weak loans have been implemented for banks. Given the fact that the economy is expected to recover relatively slowly, it is estimated that the credit ratings of companies will remain weak for a time to come.

The regulatory environment in India has become more unpredictable in recent years. This opinion is based on the many revoked licences in the telecom sector and most recently in the mining sector. Corruption, deficient compliance with the terms of licences and incorrect procedures when allocating licences have been the main reasons for the revocations. In the mining sector, is it still unclear what will happen with the voided licences.

Weaknesses of companies in India are also reflected in India's hardly flattering ranking in the World Bank's 2014 ease of doing business index. India wound up in 134th place (out of 189), which is worse than India's neighbours Bangladesh (130), Pakistan (110) and Sri Lanka (85). This ranking is also three places worse than the previous year. India has been ranked very poorly in particular in areas such as conducting licensing or bankruptcy processes and

[1] The debt/equity ratio is defined as companies whose debt exceeds more than five times their equity.

conducting legal proceedings. The law gives borrowers substantial rights, which often makes it difficult for collateral pledged for loans to be realised in the event of payment problems. The fact that the bureaucracy is complicated and hard to understand creates a hotbed for corruption.

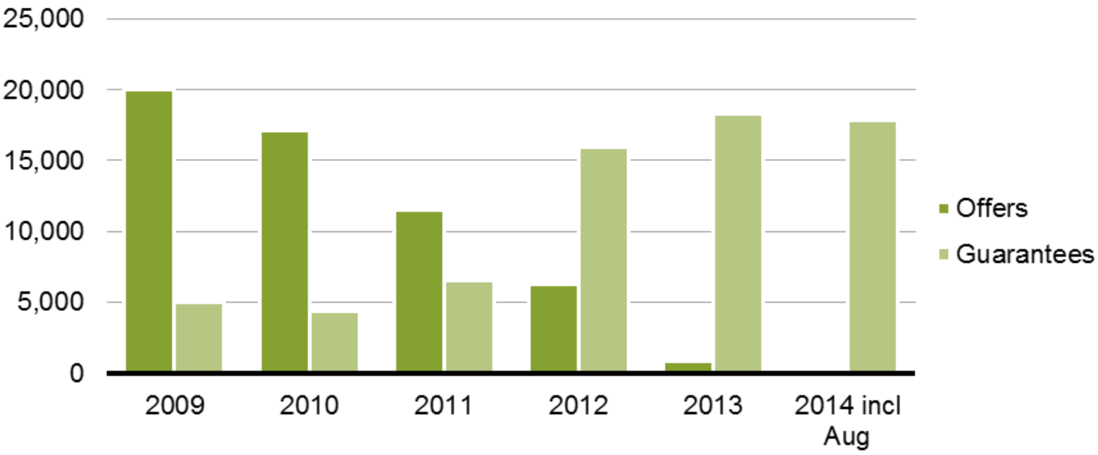
Sweden has a bilateral investment protection agreement with India and the country is a party to the New York Convention (*The Convention on the Recognition and Enforcement of Foreign Arbitral Awards*), which is positive for the opportunities of businesses to insure investments with EKN's investment guarantee.

EKN'S EXPOSURE

Large single exposure dominant

EKN's exposure in India is dominated by just a handful of large transactions which account for the majority of the total exposure of SEK 17.9 billion. The majority of the exposure is made up of guarantees, SEK 17.5 billion. Outstanding guarantees are mainly divided between two industries, power and telecom. EKN's exposure in India consists mainly of long-term loss on claim guarantees.

OFFERS AND GUARANTEES AS OF 31 DEC FOR THE RESPECTIVE YEAR



EKN's total exposure, offers and guarantees, totals nearly SEK 18 billion. (Source: EKN)

PAYMENT EXPERIENCE

Good experience of transactions

EKN's delays and claims with respect to transactions in India are very minimal in proportion to the exposure. Imports on open credit are common in small transactions and EKN has overall positive experience of this. Delays occur to a limited extent and often with minor, or small, private debtors. The delays thus far in 2014 are approximately in line with those of the past year.

There are claims in four transactions which, for EKN, amount to over SEK 29 million. Efforts to recover these paid claims are ongoing. EKN's experience is unfortunately that the recovery processes can take a very long time in cases where the debtor is not cooperative. This is due to several factors. The legal system is overburdened, while there are simultaneous attempts to work down the number of unprocessed cases. The result is that completely straightforward cases can be pushed through and thus improve the statistics. But even the smallest complication results in it potentially taking a very long time, even when using the fast-track procedure. Complicated procedures, outdated regulatory frameworks and lacking resources in the legal system are other factors. The rate of recovery is worse in India than the average for South Asian countries in the World Bank's ease of doing business index.

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

Area: 3,288,000 km² (7.3 times Sweden)

Population: 1,250 million (2013e)

Population growth: 1.4% (average per year 2005-2010)

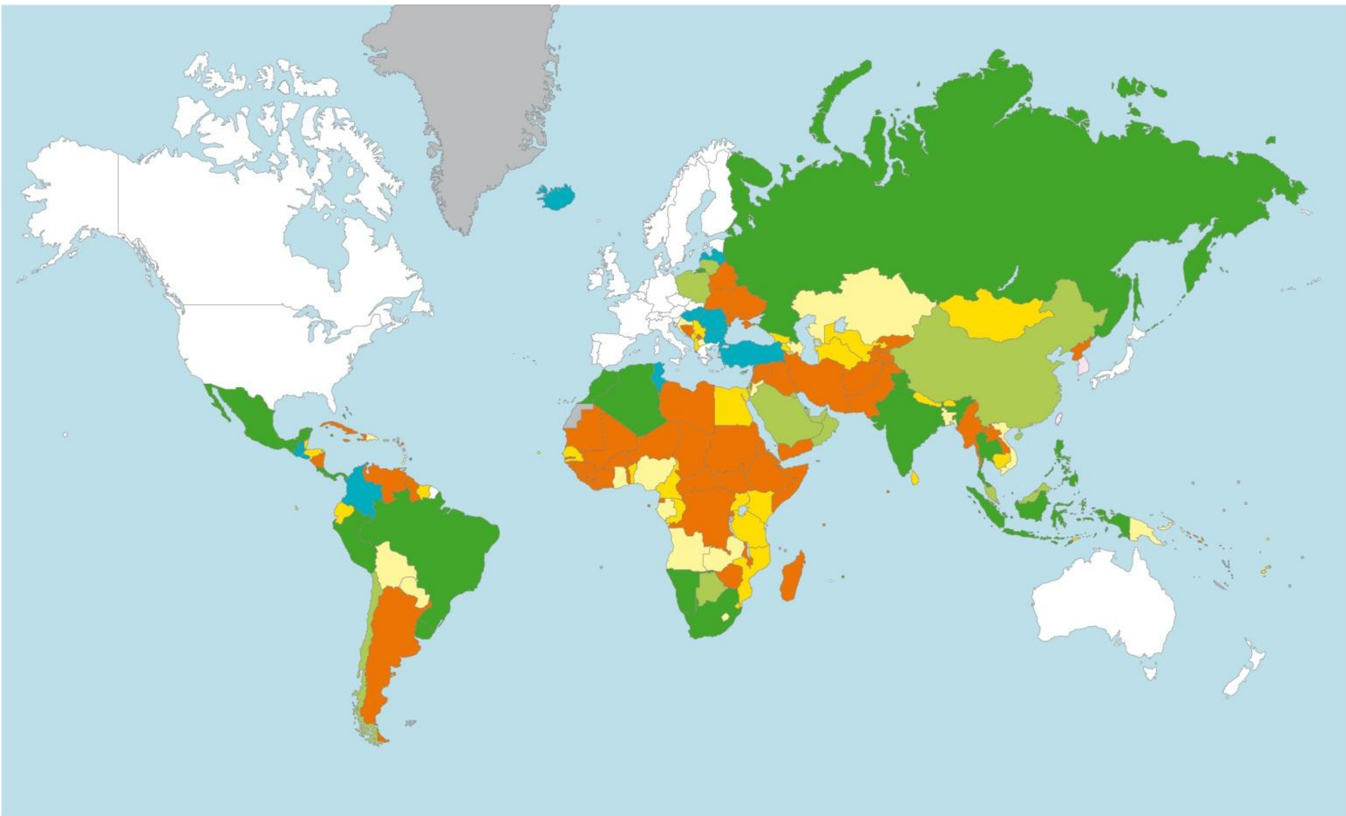
GDP: USD 1,877 billion in 2013e (Sweden USD 557.9 billion in 2013)

GDP/capita: USD 1,499 in 2013e (Sweden USD 59,130 in 2013)

CREDIT RATINGS

	COUNTRY CEILING	SOVEREIGN RATING
Moody's:	Baa2	Baa3/stable
S&P:	BBB+	BBB-/stable
Fitch:	BBB-	BBB-/stable

EKN'S VIEW OF THE WORLD



The country risk categories range from 0 to 7.
The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7 No Policy Fixed

EKN – CREATING CONFIDENCE IN YOUR EXPORTS

EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management.
Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

The Swedish Export Credits Guarantee Board
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