

General Political Environment: The Indian National Congress and its allies in the United Progressive Alliance (UPA) have been in government since the 2004 elections. The coalition depends on the outside support of the Left Front, India's communist parties, in order to pass legislation. If it is to remain in power for the next one to two years as it sees out its mandate, the UPA will need to find a balance between its economic reform agenda and its relationship with the Left Front and influential regional parties that form the 19-party UPA. Regional parties and the Left Front's allies performed well in elections held in 2006 and 2007 in several states, often at the expense of Congress. These results are growing evidence of the waning power of strong national parties and the rise in influence of regional parties through their participation in coalition governments. While these results have unsettled the UPA coalition in Delhi it has not undermined it in any significant way.

The BJP was badly wounded in the 2004 election and has since been sidelined by an ongoing debate in the party over leadership and ideological direction, including its degree of commitment to Hindu nationalism or *Hindutva*. Indeed, a clear division has emerged between younger technocrats in the party and the older *Hindutva* cadre, which is supported by *Hindutva*'s guiding organisation the *Rashtriya Swayamsevak Sangh* (RSS). The February 2007 vote in Punjab provided a fillip to the BJP even though they are the junior partner to the Akalis. The BJP continues to languish in opposition.

The civilian nuclear agreement reached by India and the United States in 2006, which will involve significant American support for India's civilian nuclear programme, has been met with fervent resistance from the Left Front, as well as the opposition BJP. Several parties within the governing alliance have threatened to withdraw their support over the issue, which could lead to the government calling early elections to break the deadlock. While this remains a possibility, given the widespread popular support for the agreement in India, it remains likely that the government will see out its term. However, a weakening of the coalition over the agreement could have an impact on the pace of economic reform.

Investment Environment: Despite India's foreign investment policy allowing 100% FDI in most sectors, India has thus far failed to reach its full potential as a destination for FDI. Sectors that are closed to foreign investment include agriculture, retail trade, atomic energy and railways. The government's goal is to increase FDI inflows to USD 10 billion annually; in 2004 they stood at only USD 3.4 billion. The main impediments include: 1) pervasive corruption and an unwieldy and obfuscating bureaucracy; 2) a significant deficit in critical infrastructure, and 3) policy unpredictability inherent given India's governance model. India is known for diverse operating environments with regulations varying from state to state. In particular, there are varying degrees of commercial morality, legal efficacy, and receptiveness to foreign investment across the country.

The inefficiency of India's bureaucracy and its legal system merits some note as these are likely the greatest operational challenges investors face. Although the Indian legal system is respected for its impartiality and emphasis on the rule of law, it is woefully slow with the current backlog of cases numbering an astounding 30 million. Investors are strongly advised to retain an Indian solicitor and to provide for international arbitration in contracts.

Political Violence: Hindu/Muslim communal violence has broken out on various occasions. Although some regions are more prone to communal violence, any area within India is susceptible to an outbreak. The Maoist (Naxalite) insurgency in eastern India continues unabated and is a persistent source of political violence in several poorer eastern states such as Andhra Pradesh and Orissa. Naxalite violence resulted in approximately 740 deaths in 2006. Tensions with Pakistan have threatened regional stability since 1947. Several years of peace talks on the contentious issue of Kashmir have resulted in little progress, yet many observers are cautiously optimistic. Ongoing separatist insurgencies in the northeastern states of Assam and Manipur remain sources of instability in that part of the country.

Political

Political Structure

Federal State
Parliamentary Democracy

President

Pratibha Patil

Prime Minister

Manmohan Singh, Indian
National Congress (INC)

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)
- Communist Party of India-Marxist (CPI-M)

Last Elections

April/May 2004

Next Elections

By the end of 2009

Press Freedom Survey:

- 2006 Score: 37 - partly free (0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:

- 2006 Score: -0.21 (-2.5: Worst; +2.5: Best)
worldbank.org

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Political Outlook

The sustainability of Manmohan Singh's government depends on whether the different interests in the UPA will be able to agree on policy. Elections at the state level bring coalition partners into competition with one another, which has the potential to strain alliances in Delhi. India's new closeness with the US over nuclear cooperation will test the alliance between Congress and the Left Front. Despite these tensions, PRAD anticipates continued stability; however early elections are a possibility. There is an ongoing risk of terrorist attacks by Kashmiri militants throughout the country. Naxalite violence will continue to affect several eastern states.

Economic

Credit Agencies

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

Nominal GDP (2006)

USD 877.7bn

Population (2006):

1,095.3 million

Total Trade / GDP:

35.1%

Currency:

Indian rupee

Exchange regime:

Managed float

Merchandise imports from Canada (Domestic 2006):

CAD 1.529 bn

Main sources of Foreign Exchange (excl. FDI):

Manufactured products


Largest Merchandise Trading Partner:

United States (18%)

Main imports:

Manufactured goods (32%)
Mineral fuels (10%)

Risks to the Outlook

 Higher than expected export and industrial growth

 Inflation remains above central bank's target levels

July 2007

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Market Spotlight: India's economy continues its rapid expansion with GDP growth of 9.4% in 2006/2007 (April/March), slightly higher than the 8.3% pace set in 2005. But the rapid economic growth coupled with supply-side constraints, rapid credit growth and growing current account deficit have raised fears that the economy is overheating, prompting a reaction by the Central Bank to cool the economy through successive interest hikes to 7.75% as well as increasing reserve requirements. Moving forward, indications are that the current growth path is unsustainable and hence is expected to cool in 2007/08.

Recent Economic Developments: Real GDP growth maintained its blistering pace in 2006/07 at 9.4% y/y bolstered by strong domestic demand and export growth of nearly 18% backed by notable gains in service sector output. Industrial production grew by a heady 13.6% yoy in April 2007, down slightly from the 14.4% yoy growth registered in March, but higher than the 12% registered in the three-month period from December through February 2007, and higher than the 11.5% averaged in the second half of calendar 2006. India's manufacturing sector accounts for nearly three quarters of industrial output and around 15% of GDP, has been one of the key drivers of the country's impressive economic expansion in recent years.

Monetary Policy: Growing inflation has resulted in India's Central Bank (RBI) to hike the benchmark bank rate to 6% and the reverse repo rate to 7.5% - their highest levels in over a year. The RBI has also increased reserve requirements on three separate occasions since December, to a high of 6.5%. But the authorities are keeping a watchful eye on the value of the currency, which this winter appreciated to 40-41 rupee per USD, far higher than the authorities' preferred level of 44-47 per USD. Overall, slowing growth should result in a softening of the currency vis-à-vis the USD over the next 12-18 months.

Reserve requirements: The Bank continues to maintain its tightening bias on monetary policy on concerns about the rapid credit growth, strains on credit quality and elevated asset prices. Latest inflation data (April/May 2007) shows inflation trending at almost 8% y/y in all four consumer inflation indexes tracked by the authorities, higher than the RBI target of 5.0-5.5%. The RBI is concerned that further interest rate rises may dampen the momentum of economic growth and initiate a surge in bad loans and thus hamper confidence. Given that 60% of India's population generates income from the primary sector, which depends heavily on cyclical factors like monsoon rains, a rise in defaults would be damaging to the economy and hence the possibility of a forthcoming bad loan crisis has drawn particular attention to the ratio of non-performing loans in one of the weakest segments of the economy. Concerned with these implications, the central bank appears hesitant about further rate hikes. It is not unlikely that the RBI could use alternative tools to tighten policy, like an increase in reserve requirements.

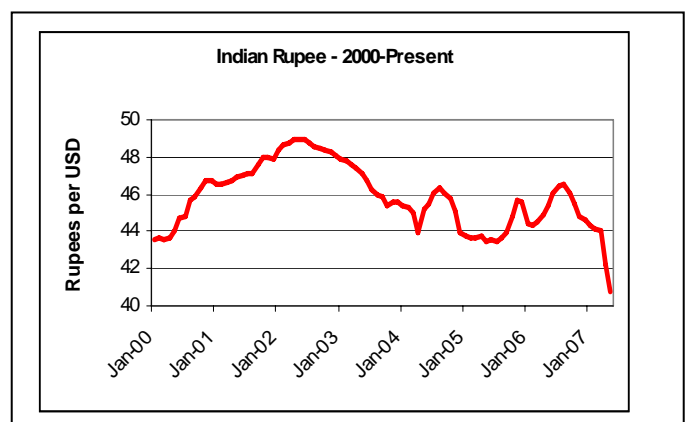
Fiscal Policy: In its 2007/08 budget presented in early March, the authorities called for the overall fiscal deficit to decline to 3.3% in 2007/08, and further to 3.1% in 2008/09. On the expenditures side, the authorities are curbing the more onerous expenses (fuel and food subsidies) as well as curbing the chronic fiscal excesses of the component states. On the revenue side, the authorities are hiking revenues, mainly by bringing the domestic software industry into the tax net.

Outlook: India's recent economic growth has created a conundrum of sorts for the authorities. While they would like to maintain present enviable rates of growth, inflation is far too high for comfort, and the authorities are seeking to dampen growth. Surging FDI inflows has boosted the value of the Indian rupee far above its historical band to slightly above 41 per USD, higher than the authorities' preferred level of 44-47 per USD. Overall, the potential for overheating, coupled with the grow infrastructure squeeze, remains another downside risk.

Economic Indicators**

	01-05 avg.	2006	2007(f)	2008(f)
GDP (% growth, real)	6.8	9.4	8.5	8.0
Inflation (%)	4.0	6.2	6.2	4.8
Fiscal Balance (% of GDP)*	-4.9	-3.7	-3.3	-3.1
Exports (% growth)	19.0	17.7	15.9	16.6
Imports (% growth)	20.0	24.9	21.6	17.4
Current Account (% of GDP)	0.5	-1.1	-1.6	-1.8
Reserves (month of imports)	9.4	4.9	8.2	7.5
External Debt (% of GDP)	18.7	15.4	12.3	11.0
Debt Service ratio	13.1	6.7	7.2	6.6
Currency (Per USD, year-end)	46.1	44.0	41.4	41.0

*Strictly federal government. State government deficits result in a consolidated budget of 8% of GDP. **Refers to fiscal year ie, 2005 is fiscal 2005/06 (April-March), etc.



Source: Bloomberg