Datamonitor expects BPO services to expand at a CAGR of 12% during 2008-2013

CII survey and HSBC Markit Business Activity Index shows that service sector is witnessing strong revival

IIP decline for the first time in 15 years in December 2008

Economy Overview

Services sector – growth engine of the Indian economy

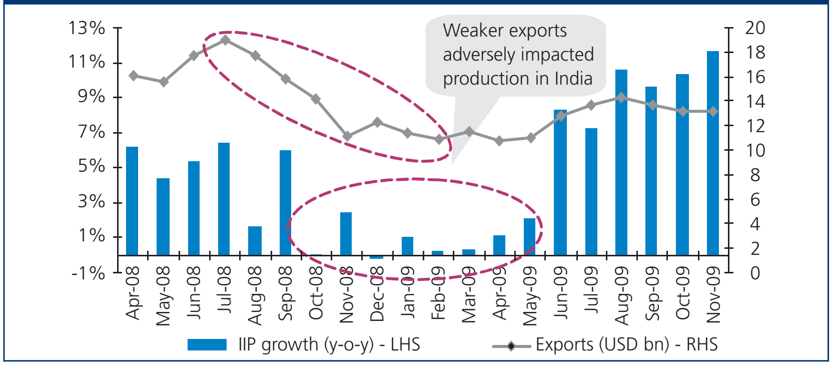
The Indian services sector, which contributed approximately 56% to the GDP in 2008–09, continues to capitalise on factors such as steady rise in outsourcing, strong technical capabilities in information technology and IT-enabled services (ITES), and growing hospitality sector. India's cost-competitiveness, skilled manpower and strategic advantage (in terms of language skills) have helped it emerge as a strong contender to leverage these opportunities. The significant inflow of business process outsourcing (BPO) services has benefited the country. As per Datamonitor, BPO services are estimated to expand at a CAGR of 12% during 2008–13 and reach USD5.7bn in 2013.

India's services sector showed resilience to the economic crisis; on a year-on-year basis, community services grew 13% in 2008–09, while the transport and communication sector and financial & other services sector expanded 9.0% and 7.8%, respectively, during the same period. A survey conducted by the Confederation of Indian Industry (CII) indicated that the services sector gained momentum during April–October 2009. While 12% of the surveyed companies grew 20% relative to the 12.5% rise during the same period last year, over 30% of the sub-sectors reported growth in the range of 10–20% in the first seven months of 2009–10 compared to 24% in the comparable period last year. HSBC Markit Business Activity Index, an index based on the survey of 400 Indian services companies, rose to 57.41 in December 2009—the highest since September 2008—and exhibited that business activity was at its fastest pace in December 2009 during September 2008 to December 2009 period.

Manufacturing sector back on growth trajectory

India is establishing itself as a global manufacturing centre on the back of cheap and skilled manpower. The government's policy initiatives, such as abolition of license raj, liberalisation of the manufacturing sector and removal of cap on foreign ownership, and 100% FDI through the automatic route, fuelled the sector's growth. However, the manufacturing sector, which recorded a growth of 9.0% during 2007–08, was adversely impacted by the global economic slowdown. The sector grew 2.75% in 2008–09. Although the rise in domestic consumption supported production, India's Index of Industrial Production (IIP) turned negative for the first time in 15 years in December 2008, primarily due to a decline in exports.

India's IIP growth and exports



Source: Bloomberg, Aranca Research

Backed by government stimulus, manufacturing sector is gaining momentum

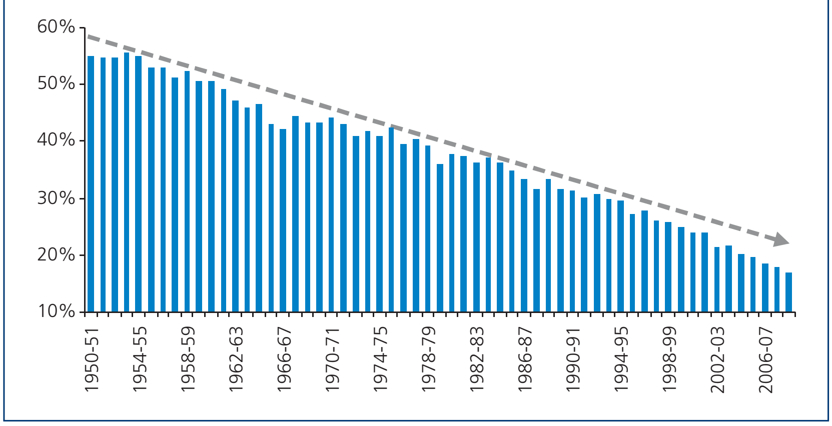
Nonetheless, the manufacturing sector, backed by the government stimulus, is showing signs of revival. In order to provide a fillip to the sector, the government lowered the excise duty and service tax by 6% and 2%, respectively, along with a reduction in key interest rates. Furthermore, an increase in exports in November 2009 (for the first time in 14 months) lifted the IIP. India's exports moved up 18.2% to USD13.2bn during the same month. The Markit Economics Purchasing Managers' Index (PMI) climbed to 55.6 in December 2009 from 53 in November 2009, indicating an increase in factory production. Furthermore, the Indian government is expected to introduce a national manufacturing policy by the end of June 2010, which is expected to augment investment in the sector.

Agricultural sector – a long way to go

Almost 60% of India's workforce either directly or indirectly depends on agriculture for livelihood

The Indian economy has transformed from an agriculture-based to a services- and manufacturing-based economy. As a result, the contribution of agriculture to total GDP has decreased from 55.1% in 1950–51 to 17.0% in 2008–09. However, agriculture continues to be a prominent sector as almost 60% of the country's workforce either directly or indirectly depend upon the same for their livelihood.

Contribution of Agriculture to India's GDP (at factor cost)



Source: RBI Handbook of Statistics, Aranca Research

Agriculture sector incurs an estimated annual loss of USD16 bn due to poor infrastructure

Even after years of technological advancements, the agriculture sector continues to be affected by factors such as lack of infrastructure facilities (like irrigation, food processing and storage) as well as technological hindrances. The sector is estimated to incur an annual loss of over USD16bn (INR76.5 bn) per year due to poor infrastructure facilities. Furthermore, the sector primarily depends on the monsoon rains on account of the lack of adequate irrigational facilities. Scarcity of monsoon rains in 2009 had an adverse impact on the sector's performance. The Department of Agriculture and Cooperation estimates the total area under major Kharif crops to decrease 5.4% year-on-year to 104.2 million hectares in 2009–10, while the Economic Advisory Council estimates the sector to decline 2% during the same period.

In order to enhance the income of rural India and improve food security in the country—along side containing the food price inflation, which has spiralled to double-digits—the government intends to improve the sector's performance. The

11th Five Year Plan aims to boost the agriculture growth to 4%

11th Five Year Plan (2007–2012) aims to accelerate the agricultural growth to 4%. The government's policy initiatives include: (i) a one-time bank loan waiver for over 40 million farmers translating to almost USD14.6bn; (ii) approval of 60 agricultural export zones; and (iii) approval of a 2% interest subsidy on farm loans to fuel the sector's growth. Though the government is focusing on the revival of the agricultural sector, a number of challenges and fundamental constraints need to be addressed before it can witness robust growth relative to the services or manufacturing sectors.

Infrastructure sector – plethora of investment opportunities

11th Five Year Plan aims to boost the agriculture growth to 4%

Inadequate infrastructure, rapid economic growth and government's increasing focus on infrastructure development has led to several investment opportunities for private and public enterprises. The government has planned an investment of USD500bn over the period 2007–12 for infrastructure development.

India, with the fifth-largest power generation capacity in the world, has one of the lowest per capita consumption worldwide (and half of that in China). Power demand in India continues to outstrip supply. In order to bridge the demand-supply gap, additional 78,000 MW of power capacity is required by 2012. To facilitate the same, the government has permitted 100% FDI in generation, transmission and distribution, income-tax holidays, as well as exempted import duty on capital goods (for mega projects).

The government aims to award road contracts worth USD20 bn by June 2010

Surface transport is another area poised for rapid growth. Despite having the second-largest road network in the world (3.3 million km), India is facing the acute problem of inadequate road network and poor road quality. Although road development faces challenges, such as acquisition of private land, it has not deterred the government from making and implementing ambitious investment plans. From November 2009 until January 2010, the government has awarded contracts worth USD12bn. It has a target of building roads of 7,000 km per year (20 km per day), and plans to award additional contracts worth USD20bn by June 2010. While 100% FDI in road development projects and income-tax benefits are considered to be the key features of these contracts, the National Highway Authority of India (NHAI) provides viability gap funding.

India's aviation sector is poised for a take off. Additional passengers are opting for air transport, driven by rising income, and lower tariffs due to rising competition and changing travel requirements. In 2009, domestic passenger traffic grew 7.9% to 44.5 million. As the year drew to a close, airlines clocked a passenger load factor of 75%. The aviation sector is estimated to require an investment of USD120bn by 2020. To cater to the burgeoning air traffic, India would need: (i) about 1,000 aircraft by 2020; (ii) modernisation and upgrade of airports (USD10bn per annum investment opportunity); (iii) greenfield airport projects (nearly 11); and (iv) investments in maintenance, repair and overhaul capacity.

Indian ports are likely to miss their 2012 target of 1.02 tonnes of cargo handling by a huge margin

The infrastructure investment story has its share of hiccups. Due to the credit crisis and dwindling demand for commodities owing to the global recession and sluggish global trade, India is expected to achieve up to 743 million tonnes of cargo handling at major ports by 2012 as against its target of 1.02 billion tonnes. However, as economic recovery is underway throughout the world, investment prospects in ports for a country with 7,517 km of coast line are getting brighter. The

National Maritime Development Programme (NMDP) for modernising the port sector includes 276 ports, and 111 shipping and inland projects at a total investment of approximately USD22bn (INR1.0tr) by 2012. These include construction and upgrade of berths, procurement of equipment, and dredging and deepening of approach channels and berth areas.

The Indian rail sector is also changing over to the fast track. It is the second-largest rail network in the world under a single management as well as the second-largest profit making public sector unit. Encouraged by this factor, investments were stepped up as witnessed by the three-fold increase in planned expenditure to USD50bn over the period 2007–12. Investment opportunities primarily exist for laying new tracks, gauge conversion, new rail bogies, safety and signalling systems, IT, and setting up infrastructure facilities at and near railways stations. The rail sector is also pursuing an ambitious plan of a dedicated freight corridor (worth USD90bn) to streamline freight movements across eastern and western corridors, by carrying heavier cargo loads at faster speeds.

Energy security gaining prominence

Indian possesses only 0.5% of the global proved oil reserves

Ensuring the availability of energy at competitive prices continues to be a key challenge for policymakers in India. As per the BP Statistical Review of the World Energy June 2009, India possesses only 0.5% of the global proved oil reserves, but is the fourth-largest consumer of oil with a 3.4% share in oil consumption worldwide. Oil imports at USD93.2bn alone comprised about 32.4% of total imports in 2008–09. Considering the consumption pattern and availability of energy resources, energy security has emerged as a priority for the government.

India's power consumption is expected to double from current level of 600 TWh by 2020

India continues to face power shortages as demand for power continuously outpaces growth in power generation capacity. India's per capita electricity consumption increased at a CAGR of 4.4% to 704.2 kilo watt hour (kWh) over the period 2002–03 to 2007–08. As per KPMG estimates, India's power consumption would double from the current level of 600 terawatt hour (TWh) per annum by 2020 primarily due to growing economic activity, and increase in wealth and population as well as infrastructure developments. KPMG also estimates that India would need to increase its generation capacity to 241 giga watt (GW) from the current 156 GW. Furthermore, fuel shortages and other factors, such as lower rainfall adversely impacting hydro power generation, continue to affect India's power generation. As a result, the country's peak power deficit is expected to increase to 12.6% in 2009–10 from 11.9% in 2008–09.

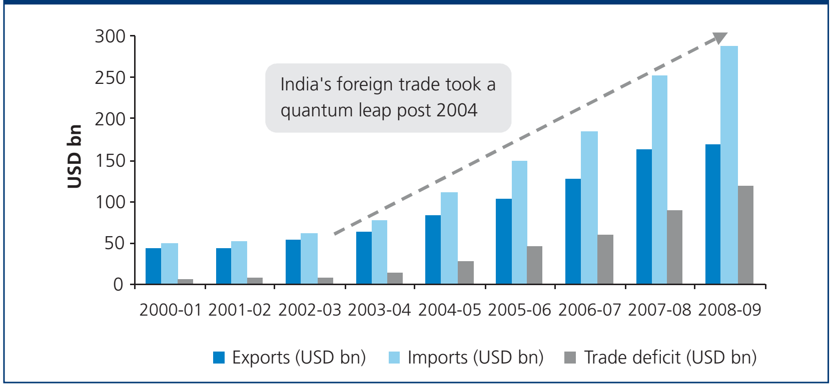
In order to attain energy security, the government undertook several policy initiatives including diversification of the oil and gas supply base, intensification of upstream activities to increase domestic supply of oil, acquisition of a stake in overseas oil fields, focus on renewable sources of energy and adoption of an integrated energy policy in December 2008. India entered into a nuclear deal with the US in October 2008 that enabled it to access high-grade uranium ore, a major roadblock to the development of its indigenous nuclear programme. Moreover, Jawaharlal Nehru National Solar Mission, launched in November 2009, aims to deploy 20,000 MW of solar power by 2022. The National Mission for Enhanced Energy Efficiency aims to reduce India's annual energy usage by 5% by 2015.

India's foreign trade policy (2004-09) boosted trade activity and generated over 14 mn jobs

Foreign Trade – a special policy focus to boost trade

Foreign trade in India was plagued by strict bureaucratic controls in the pre-liberalisation era. The Government of India's Statement on Trade Policy in Parliament in August 1991 marked the beginning of a new era in the country's foreign trade policy; thus, the focus shifted to promotion and development of foreign trade from controls and regulations. The Indian Foreign Trade Policy (2004–09) led to a surge in trade activity and generated over 14 million jobs during 2004–09. India's exports increased to USD168.7bn in 2008–09 from USD63.8bn in 2003–04 led by policy initiatives. As per World Trade Organisation (WTO) data, the country's share in the global merchandise trade expanded to 1.45% in 2008 from 0.83% in 2003. Growth in imports outpaced that in exports and further widened the trade deficit. India's imports increased to USD287.8bn in 2008–09 from USD78.1bn in 2003–04. Consequently, the country's trade deficit rose to USD119.1bn from USD14.3bn during the same period.

India's Exports, Imports and Trade Deficit



Source: RBI Handbook of Statistics, Aranca Research

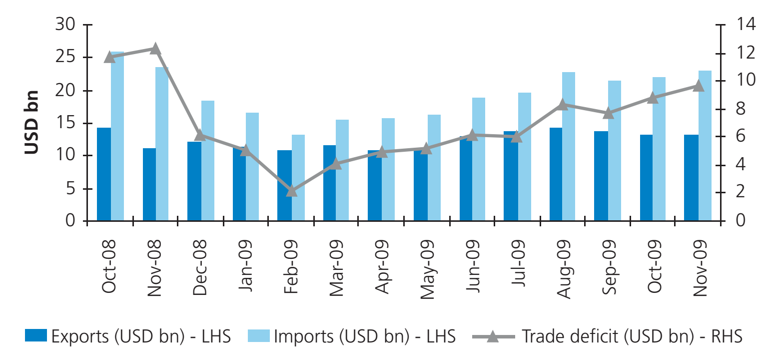
India's export grew 3.4% in 2008-09 compared to 25% in earlier years due to decline in global trade

However, the economic crisis had an adverse impact on foreign trade in 2009. While the WTO estimates global foreign trade volumes to have declined 9%, IMF estimated a fall of 11% during the same period. In line with the decline in global trade, the growth rate in exports slowed down to 3.4% in 2008–09 from an average growth rate of 24.6% over the period 2002–03 to 2007–08. India's monthly exports continued to fall on a year-on-year basis (during October 2008 to October 2009) due to weakness in global economies. Nonetheless, with the global recovery setting in and major developed nations emerging out of the recession coupled with stimulus to boost exports, India's exports reversed 13 months of decline and grew 18.2% year-on-year to USD13.2bn in November 2009. Furthermore, India's exports rose to USD14.6bn, a 15-month high, in December 2009 due to growing demand from developed nations, primarily due to festivities. Additionally, lower oil prices kept India's imports flat compared to 2008 levels. Consequently, the trade deficit lowered to USD9.7 bn in November 2009 compared to USD12.3 bn in November 2008.

FTP 2009-14 aims to increase India's exports to USD200 bn by March-2011

Stimulus package likely to widen India's fiscal deficit to 6.8% in 2009-10

India's Monthly Exports, Imports and Trade Deficit



Source: Bloomberg, Aranca Research

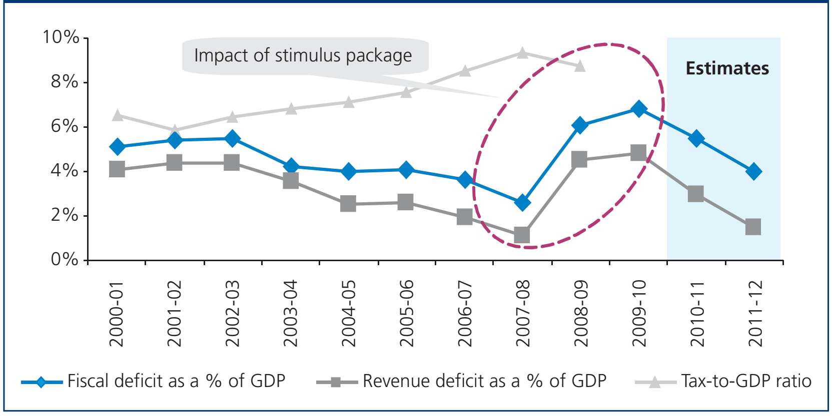
In order to further strengthen its foreign trade, India in its Foreign Trade Policy 2009-14 (FTP 2009-14) has taken several policy initiatives. The FTP 2009-14 aims to improve the infrastructure related to exports, reduce transaction costs and refund indirect taxes and levies. The policy targets an annual growth of 15% in total exports and expects to increase them to USD200 bn by March-2011. Further, the plan targets a growth rate of 25% in the country's exports during March-11 to March-14 and aims to double the country's export of goods and services. In line with its targets under the plan, the government has agreed to extended Duty Entitlement Pass Book (DEPB) scheme till December 2010, income tax benefits under Section 10(A) for IT industry and under Section 10(B) for 100% export oriented units by one more year till March 2011 among others. Additionally, India plans to reduce its dependence on the US and Europe, which account for over 40% of its exports, and inked trade agreements with South Korea and Association of Southeast Asian Nations (ASEAN) in August 2009. These agreements are likely to facilitate trade between India and member countries.

Fiscal Deficit – stimulus package to widen deficit in 2009–10

India has successfully reduced its fiscal deficit by introducing the Fiscal Responsibility & Budget Management Act (FRBM) in 2004. While fiscal deficit declined to 2.6% of GDP in 2007–08, revenue deficit stood at 1.1% during the same period. The tax-to-GDP ratio, which increased to 9.3% in 2007–08 from 5.9% in 2001–02, led to the fall in fiscal deficit. The FRBM, which entailed elimination of revenue deficit and reduction of fiscal deficit to 3% of GDP by 2009, appeared to be on course, until derailed by the economic crisis. In order to stimulate growth, the government announced tax incentives; as a result, the tax-to-GDP ratio declined to 8.8% in 2008–09, while the revenue deficit surged to 4.5%. Furthermore, the government increased its spending during 2008–09 to augment demand. Consequently, the country's fiscal deficit moved up to 6.1% of GDP in 2008–09. Higher government spending coupled with the stimulus package could raise the fiscal deficit to 6.8% in 2009–10.

With improvement in global economic condition, India's fiscal deficit is expected to reduce drastically

India's Fiscal Deficit, Revenue Deficit and Tax-to-GDP ratio



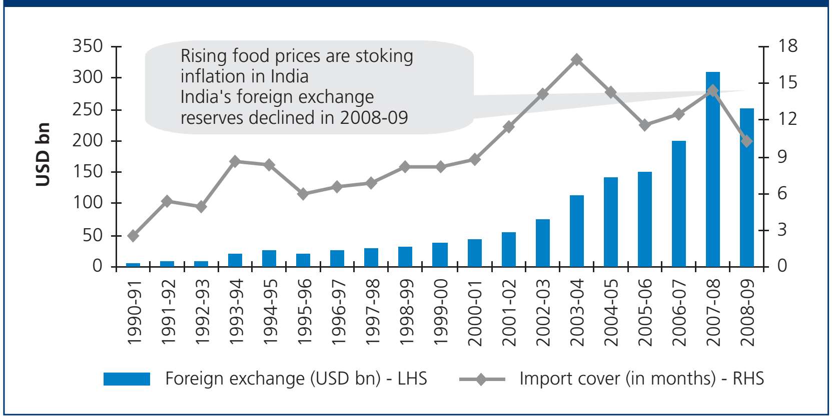
Source: RBI Handbook of Statistics 2008-09, News Articles, Aranca Research

With the sustenance of economic recovery, the government is expected to withdraw the stimulus package and the FRBM is expected to be on track. The government aims to reduce the fiscal deficit to 5.5% and 4.0% of GDP in 2010–11 and 2011–12, respectively. Furthermore, the revenue deficit is estimated to be 3.0% and 1.5%, respectively, during the same period.

Forex reserves continue to rise

India has come a long way in the last two decades—from the verge of a default in 1991 (the country was forced to utilise its gold holdings to secure a loan in order to pay its international debt) to a global financial powerhouse in 2010. The open door policy marked the beginning of growth in the Indian economy. The country's foreign exchange reserves increased from USD5.8bn in 1990–91 to USD252.0bn in 2008–09. Furthermore, the import cover moved up from 2.5 months in 1990–91 to 10.3 months in 2008–09.

India's Foreign Exchange Reserves and Import Cover

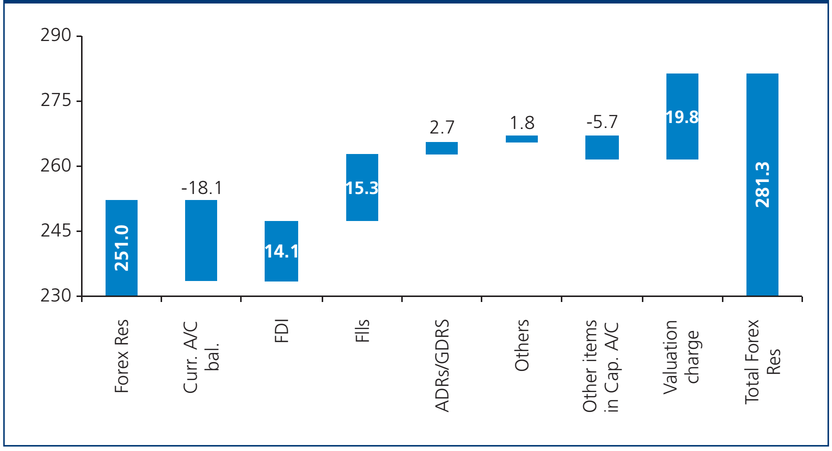


Source: RBI Handbook of Statistics 2008-09

Higher foreign investments and valuation gains boosted India's foreign exchange reserves by USD29.3 bn

India continues to record impressive growth in foreign exchange. Foreign exchange reserves rose by USD29.3bn during April to September 2009 due to higher foreign investments and valuation gains. The country has attracted significant foreign investments on account of its spectacular performance, especially during the global economic slowdown. During April to September 2009, foreign investment in India stood at USD32.1bn, of which FDI and portfolio investments comprised USD14.1bn and USD17.9bn, respectively. Valuation gains due to depreciation of the US dollar vis-à-vis other currencies added USD19.8bn to the country's reserves during the same period. Furthermore, IMF's additional allocation of Special Drawing Rights (SDRs) in two tranches increased the total foreign exchange reserves by USD5.2bn.

India's Foreign Exchange Reserves Movement April-September 2009 (USDbn)



Source: RBI Handbook of Statistics 2008-09, RBI Bulletin January 2010, Aranca Research

India bought 200 tonnes of gold from IMF to diversify its reserves away from weakening US dollar

Further, foreign exchange reserves increased to USD283.5 bn in January 2010. India's impressive growth coupled with policy initiatives are leading to a surge in capital inflows. However, huge capital inflows coupled with low interest rate scenario in the US are resulting in strengthening of the rupee against the US dollar. India rupee appreciated 6.0% against the US dollar in 2009. Appreciation of rupee against the US dollar erodes the value of India's reserves as majority of India's reserves are held in dollar denominated assets. In order to diversify its reserves from the weakening US dollar, India in November 2009 purchased 200 metric tonnes of gold from the IMF for USD6.7 bn, which is estimated to have boosted the proportion of gold to its total reserves to almost 6% from 4% earlier.

The US dollar is expected to slump further in 2010 against major currencies due to grim US economic outlook and loose monetary policy. JP Morgan Chase expects US dollar to fall to a record low in 2010 as the US Fed is likely to keep the interest rates to near zero until 2011. Further, it expects that countries will try to diversify their reserve holdings away from dollar, which will aggravate the situation. With the US dollar expected to weaken further, policymakers in India are likely to diversify their reserve holdings away from the US dollar in 2010.

Important Notice