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Research Update:

Outlook On India Revised To Negative On Slow Fiscal Progress, Deteriorating Economic Indicators; 'BBB-' Rating Affirmed

Primary Credit Analyst:
Takahira Ogawa, Singapore (65) 6239-6342;takahira_ogawa@standardandpoors.com

Secondary Contact:
Elena Okorochenko, Singapore (65) 6239-6375;elena_okorochenko@standardandpoors.com

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Overview

- India's investment and economic growth have slowed, and its current account deficit has widened, resulting in a weaker medium-term credit outlook.
- Standard & Poor's expects the government to face headwind in implementing policy measures to improve its fiscal and macroeconomic parameters in the near future, given the current unfavorable political environment.
- We are revising the outlook on the long-term ratings on India to negative to reflect at least a one-in-three likelihood of a downgrade if the external position continues to deteriorate, growth prospects diminish, or progress on fiscal reforms remains slow.
- We are affirming our 'BBB-' long-term and 'A-3' short-term sovereign credit ratings on India.

Rating Action

On April 25, 2012, Standard & Poor's Ratings Services affirmed the 'BBB-' long-term and 'A-3' short-term unsolicited sovereign credit ratings on India. We also revised the outlook on the long-term rating to negative from stable. At the same time, we affirmed our transfer and convertibility assessment for India at 'BBB+'.

Rationale

The outlook revision reflects our view of at least a one-in-three likelihood of a downgrade if the external position continues to deteriorate, growth prospects diminish, or progress on fiscal reforms remains slow in a weakened political setting.

India's favorable long-term growth prospects and high level of foreign exchange reserves support the ratings. On the other hand, India's large fiscal deficits and debt, as well as its lower middle-income economy, constrain the ratings.

We expect India's real GDP per capita growth will likely remain moderately strong at 5.3% in the current fiscal year ending March 31, 2013, compared with about 6% on average over the prior five years, but down from 8% in the middle of the last decade. India's favorable demography and the increasing middle-class population will undergird its medium-term growth prospects, which

in turn will support the sovereign ratings.

India's external position remains resilient despite the deterioration in the past two years. The country's foreign currency reserves cover about six months of current account payments, down from eight months in 2008 and 2009. Similarly, the country's net external liability position has risen to about 50% of current account receipts, but more than half is related to foreign direct investment and portfolio equity flows, which are less problematic than debt in most scenarios. Currency flexibility also offers a buffer against volatile external flows.

However, the current account deficit widened significantly to an estimated 3.7% of GDP in fiscal 2011-2012 from 2.6% the year before. We expect it will remain at the same level in fiscal 2012-2013. As a result, the country's ratio of gross external financing needs to current account receipts plus international reserves will increase to 92% in fiscal 2012-2013 from our estimate of 88% in fiscal 2011-2012. Higher dependency on external portfolio equity flows increases the vulnerability of the Indian economy to external shocks. The government's policy reversals, such as liberalization of foreign direct investments in the multi-brand retail sector and the taxing of prior offshore transactions involving Indian assets, could diminish foreign investors' confidence in India, at least temporarily.

High fiscal deficits and a heavy debt burden remain the most significant constraints on the sovereign ratings on India. Given the political cycle--with the next elections to be held by May 2014--and the current political gridlock, we expect only modest progress in fiscal and public sector reforms. Such reforms include reducing fuel and fertilizer subsidies, introducing a nationwide goods and services tax, and easing of restrictions on foreign ownership of various sectors such as banking, insurance, and retail sectors.

The 13th Finance Commission recommended that the general government deficit be reduced to 5.4% of GDP and the debt burden to 68% of GDP by the fiscal year ending March 2015. The central government's own medium-term fiscal policy envisages reducing its deficits to 4.5% in fiscal 2013-2014 from fiscal 2011-2012's estimate of 5.9%. However, in our opinion, these targets may be beyond the reach of the current government, particularly if global oil prices increase significantly. We use a broader concept of public finances than the Finance Commission. Under our definition, we expect the general government (central and state governments) fiscal deficit to reduce to 8.0% of GDP in the fiscal 2012-2013, from our estimate of 8.4% in fiscal 2011-2012, and continue its gradual decline in the medium term. We expect the consolidated gross general government debt to fall to 71% of GDP in fiscal 2012-2013 (by our basis of calculation, which is different from the government's), on the back of 14.5% nominal GDP growth. Interest payments will likely consume about 25% of general government revenue. This fiscal profile is a credit weakness for India.

In our opinion, high inflation--despite some moderation--remains a risk to derailing India's macroeconomic growth and moderately low real interest rate

environment. The wholesale price index, which peaked at 12.4% in 2009, remained high at 9% in 2011. A new consumer price index series, which started January 2012, shows somewhat higher growth, but we expect inflation to improve to 7.2% this year. Despite the recent announcement of the Reserve Bank of India (RBI, India's central bank) to ease monetary policy, we believe the RBI will be able to keep inflation in the single digits. Some of the recent price increases are not cyclical, but represent structural changes, such as India's growing middle class (with the resulting changes in diet patterns across the country) and the large borrowing requirements of the government.

Outlook

The negative outlook signals at least a one-in-three likelihood of the downgrade of India's sovereign ratings within the next 24 months. A downgrade is likely if the country's economic growth prospects dim, its external position deteriorates, its political climate worsens, or fiscal reforms slow.

On the other hand, the ratings could stabilize again if the government implements initiatives to reduce structural fiscal deficits and to improve its investment climate. Fiscal measures could include an increase in domestic prices and a more efficient use of fuel and fertilizer subsidies, or an early implementation of the goods and service tax.

Related Criteria And Research

- Outlooks: The Sovereign Credit Weathervane, 2011/2012 Update, April 18, 2012
- Several Factors Could Weigh On India's Current Stable Sovereign Rating In 2012, Feb. 6, 2012
- Sovereign Government Rating Methodology And Assumptions; June 30, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
India (Republic of) (Unsolicited Ratings)		
Sovereign Credit Rating	BBB-/Negative/A-3	BBB-/Stable/A-3
Transfer & Convertibility Assessment	BBB+	

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