

Title: Is INDIA the UnKnown DUCK?

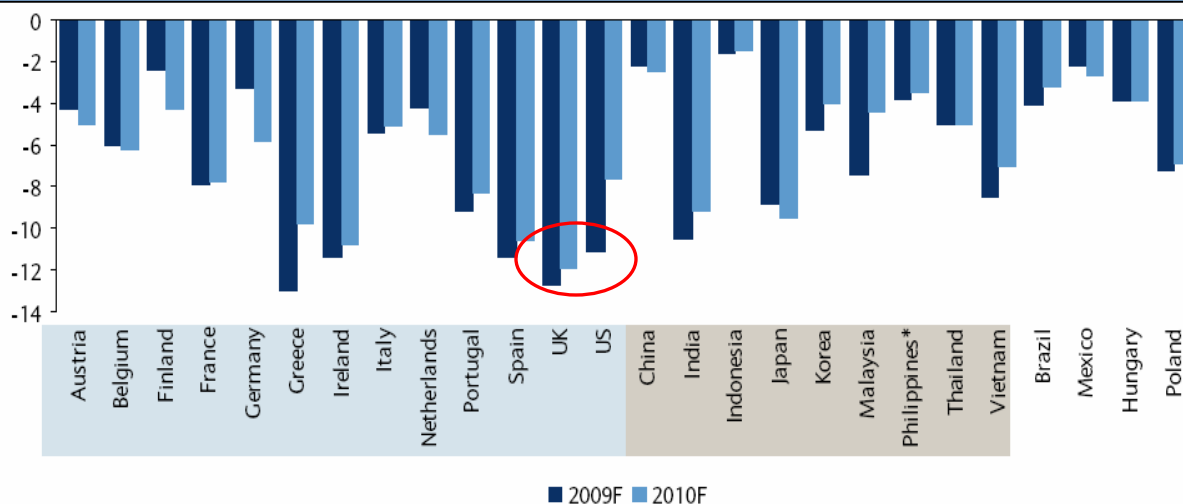
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In recent times the advent of the European sovereign crisis (after Dubai) is clouding the skies which were opening up a little as far as the global economic growth is concerned. In global markets the term “PIIGS” was coined as an abbreviation for the European countries that have been hit by the sovereign crisis viz unsustainable budget deficits and public debts and the inability to fund (roll over) the later, leading to credit downgrades of some of the countries.

P=Portugal I=Italy I=Ireland G=Greece S=Spain: That’s “PIIGS” for you.

Now these are the set of PIIGS which are “known”. But what about the unknowns? Donald Rumsfeld, the ex defense secretary of US had described risks in a different perspective yet more applicable to the current situation. To quote him: “There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. **But there are also unknown unknowns. There are things we don't know we don't know.**” So to my understanding the risks are the highest from “UNKNOWN UNKNOWN”. I would term these unknown unknowns as the “DUCKS”, with no abbreviation reference to any specific countries.

Chart I: Budget Deficits as a % of GDP of the PIIGS and DUCKS



Source : Barclays Capital (incl off balance sheet items)

How the scenario evolves on the sovereign credits in Greece and other European nations remains critical for the global risk appetite and thus to Indian stock markets via the FII flows link. And there are numerous possibilities subject to the EU treaty such as an Outright Default, Bail out or Loan Guarantees by Germany/France or IMF with stringent conditions, Debt Rescheduling/Restructuring, Breakaway from EU leading to its breakdown, Devaluation of EURO, runaway inflation so on & so forth. But the Sovereign risk is not going to fade easily in the short run. As can be noted from the Chart I, *US and UK might turn out to be the DUCKS, with its high level of budget deficits and Public debts.*

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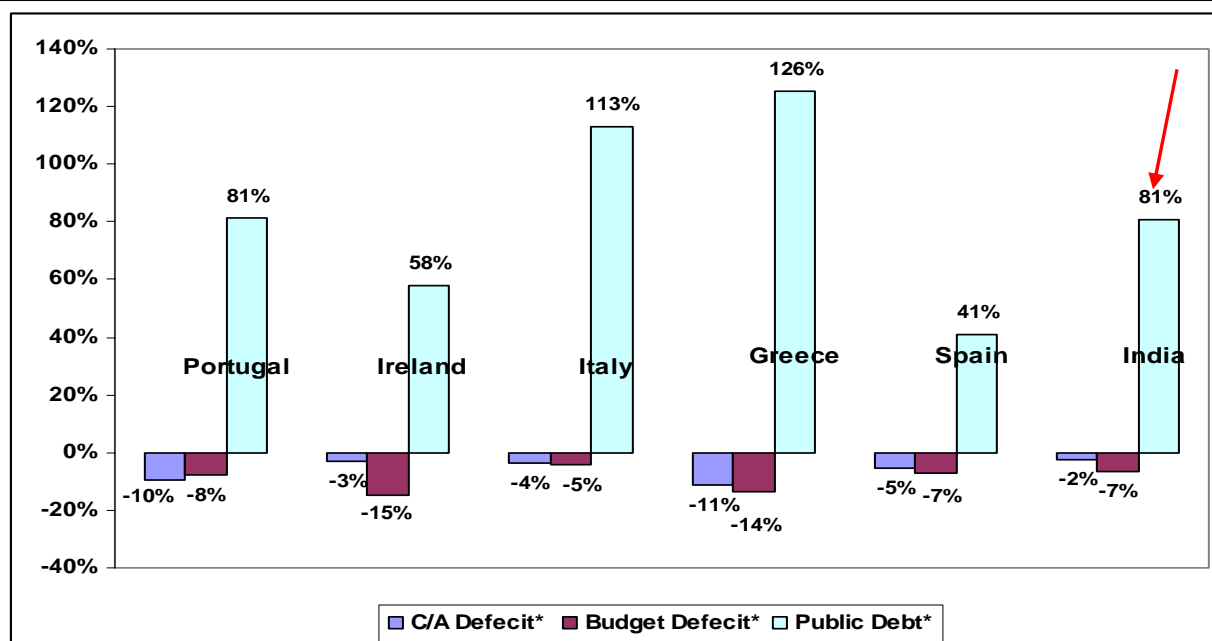
Is India one of the Unknown Unknowns, the DUCKS? Let's analyze the factors and the economic variables that go behind a deteriorating sovereign credit quality or increasing sovereign risk. In other words, what do Global Credit rating agencies such as Moody's, S & P etc track before downgrading a country or giving a negative outlook on the same?

To start with let's understand what "Debts" are for a country and its inhabitants:

1. **Public Debt** is the net accumulated money or credit owed by any level of government, from central to state. It's basically the net cumulative fiscal deficits of a country for the past years.
2. **External Debt** of a country is defined as the total public and private debt owed only to nonresidents repayable in their foreign currency, goods or services. India's external debt stands at USD 242.8 bn, (~20% of GDP) which mainly consists of External Commercial borrowings, NRI Deposits and Bilateral debt. India is comfortably positioned on its external debt since its short term debt component is only 17% of the total and the country's foreign exchange reserves are at USD 279 bn.
3. **Private debt** is the money or credit owed by private households or private corporations based in the country. The private debt in India was never alarming, though the latest authentic figures were not available.

We did review the Public Debts situation globally in detail. Our report on the same can be read by clicking here <http://www.dgp.co.in/DGPR-TheUSD36trnburden.pdf>.

Chart II: Why the PIIGS are known PIIGS and is India a DUCK?



Source: Bloomberg. *All figures as a % of GDP.

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Now we try and analyze the factors that are crucial to assess the extent sovereign risk or vulnerability of the PIIGS and DUCKS. The major factors are enumerated in Table I though they are not exhaustive. And they are also not in any particular order of importance. We have also given the numbers for India. As well as the numbers for PIIGS wherever they were available.

Table I: Sovereign Risk Factors and India

Factors	INDIA	For Sovereign Risk	PIIGS
1. The ratio of Public Debt to GDP	~80%	Lower the better	Greece 125%,Italy 113%
2. The ratio of Budget Deficit to GDP	-6.8% (excl off balance sheet items)	Lower the better	Ireland-15%,Greece -14%
3. The Interest paid to Gross Revenue receipts Ratio	36% (BE 2009-10)	Lower the better	Ireland 13%,Greece 16%,Italy 12%
4. The difference between the Nominal GDP growth rate and the 10 year GOI Yield.	More than 6%	Higher the better	Ireland-5.1%,Greece -3.2%, Spain -3%,Portugal-2.3%
5. The proportion of foreign holdings in the Public Debt.	Less than 4%	Lower the better	Spain~50%,Ireland~80%, Greece ~83%
6. The Maturity pattern of Public debts outstanding, especially when the foreign holdings are higher.	~9.77 yrs	Higher the better	Portugal 6.5 yrs, Spain 6.7 yrs, Ireland 6.8 yrs,Italy 7.2 yrs
7. The Primary deficit level (before interest payments) to GDP	-4.5 % (BE 2009-10)	Lower the better	Ireland-9.6%,Spain-9.5%,Greece -7.7%

Source: Delta Global Partners Research, the Economist & various other sources

Let's quickly review the above 7 factors vis a vis the Indian scenario.

The first 3 factors are interlinked: Higher the budget deficit over years, higher the government borrowing, higher is the accumulated public debt and thus higher is the interest paid on the public debt in the subsequent years. As the public debt mountain rises, more and more of the revenue goes into servicing the debt (interest) thus choking off the flows towards other developmental and productive activities. *As Reinhart & Rogoff (2010) in a exhaustive paper on Public debt concluded that" Above 90%*

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threshold level of Debt/GDP ratio, the median growth rates fall by 1% and average growth rates fall considerably more. When External Debt reaches the threshold of 60% of GDP, annual growth rate declines by around 2%; for higher levels, growth rates are roughly cut by half. For emerging market, inflation rises sharply as public debt increases". In short higher deficits and debt results in lowering the economic growth as well as enhancing the inflation. The crowding out effect will raise the interest rates too.

India is little vulnerable on factors 1 to 3. Its Public debt ratio is at 80%. Though it's not increasing rapidly, it's closer to the 90% threshold of Reinhart & Rogoff. Budget deficits, if the off balance sheet items are included, stands at 10.2%, not very far from the PIIGS who are at 11-15%. 36% of India's gross revenues go to pay the interest costs. Of all the 3 factors, when compared to PIIGS, India is on a sticky wicket as far as the interest cost is concerned. PIIGS are at 12-16% whereas India is at 36% of the gross revenue, which is disturbing. The need of the hour for India is some serious efforts and road map on Fiscal Consolidation with India's economic growth remaining buoyant. And it runs the "Credibility Risk" in the global and domestic markets if it doesn't.

Factor no 4: If the average rate of interest paid by the government on its public debt is higher than the nominal GDP growth rate, the public debt would continue to rise in every year that the government runs a budget deficit. As the public debt rises, bigger surpluses supported by higher economic growth would be required to bring it down. India's higher economic growth is a big advantage on this count taking the factor to higher levels above 6% whereas the PIIGS are vulnerable due to the factor being negative at -3% to -5%.

Factors 5 & 6: These factors relate to the foreign holdings or ownership in the Public Debt. Higher proportion of foreign ownership carries the risk of a run on the public debt due to events such as global risk aversion and the ensuing interest rate and currency crisis. The refinancing or rollover (liquidity crisis) of the Public Debt becomes an issue when the foreign ownership is high and the average maturity of the public debt is lower. Countries like US, Australia, Spain and Ireland face this huge roll over risk in coming years. This liquidity and rollover risk is also faced by Greece now even though it can manage its debt servicing. Sovereign crisis thus often manifests itself in form of Currency or a Liquidity crisis.

India is very comfortable on both of these factors. The foreign ownership of Government of India (GOI) bonds is almost negligible which substantially reduces the external refinancing risk. India's fiscal deficits are domestically financed. Moreover the average maturity of the GOI bonds remains higher. The refinancing risk that GOI bonds carries comes in form of higher domestic interest rates demanded by domestic investors such as banks, primary dealers and insurance companies. Moreover the mandatory demand from banks reduces the refinancing risk considerably.

Factor 7: The primary deficit (before interest payments) of a country is similar to the Net Loss before interest for a corporate. It signifies the debt service ability of a country.

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So the deficit has to be as low as possible. India is lower at -4.5% of GDP as compared to the PIIGS or even US and UK who are at -8.6% and -10.7% respectively. It should be an endeavor of the GOI to bring down the primary deficit at reasonable levels since Interest along with defence and subsidies are at almost 2/3rds of the Gross Revenue and moreover are "politically inflexible".

Analyzing all the above 7 factors together, *India doesn't seem to be fall in the category of Unknown "PIIGS" or "DUCKS" as of now.* As explained earlier, it's well placed and comfortable in many of the factors where the PIIGS have been hit badly.

But India does remain a little vulnerable in coming years to the rising deficits, public debts and the interest burden (Factors 1 to 3 above), especially if no credible action is taken on fiscal consolidation. But a robust economic growth for India will mitigate some of these negatives. And the global rating agencies will closely monitor India's response to normalize the fiscal deficits and public debts. As Moodys puts it "well articulated and well executed exit plan" to cut the budget deficits with adequate help from stronger economic growth (higher tax/non tax revenues, divestments, 3G auctions), will increase the chances of a local currency debt rating (now Ba2) upgrade. And INDIA must grab this opportunity.

Let's wait and watch the global scenario for the "UnKnown DUCKS" that may emerge as a result of the deteriorating sovereign credit quality on the other side of the Atlantic.

Devendra Nevgi

**Delta Global Partners
Founder & Principal Partner
deven@dgp.co.in
Tel: + 91 9867 277 977**

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