



FERTILE GROUND?

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Touted as a powerhouse of global economic growth, India has fared better than many during the downturn. Is an early and strong recovery on the cards, or something more muted? And, when the recession has played out, will India still be a land of opportunity for UK mid-corporates?

The Indian economy may not have shown the strongest growth during the global downturn, but it is not far off. Real GDP rose 5.3 per cent year-on-year in the last quarter of 2008 while, excluding the volatile agricultural sector, output was up more than seven per cent.

Some sectors have, of course, performed better than others. In particular, hopes that India had finally embarked on a strong, sustained period of industrial expansion have been dashed. Output growth in the industrial sector has slowed from a double-digit rate in 2006-07 to zero. Meanwhile, agricultural

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production, which still accounts for about 20 per cent of GDP, slumped more than two per cent in the year to Q4 of 2008.

In contrast, the remarkable success story of India's service sector remains firmly intact; activity grew 9.9 per cent in the final three months of last year, having slowed only slightly from its recent high. Fortunately, there is also no evidence to suggest that industrial production leads service sector growth in the country.

What, then, might the next few years have in store for the Indian economy? Some have pointed to recent improvements in a number of economic indicators as a sign that the recovery has already begun. This, in turn, has contributed to the huge bounce in the Sensex since its early March low.

However, I would advise caution. Motor vehicle sales, cement production and steel output have, indeed, all improved in the last few months. The trouble is none of these have

a particularly good track record as indicators of what is happening in the wider economy, let alone providing an early warning of what might happen to growth. Meanwhile, the Dun & Bradstreet “all sectors business optimism index”, which is the most useful survey-based measure we can find, suggests that the economy as a whole will soften further during the first half of this year.

Reasons for hope

That's the bad news. The good news is there are reasons to believe that the second half of 2009 will see the economy embark on a robust recovery that will probably exceed most expectations. My own growth forecast for 2009-10 is 6.2 per cent, rising to eight per cent in 2010-11, with a number of key drivers.

First, as a major importer of commodities, India will benefit from the unprecedented collapse in commodity prices. At present, this is helping companies more than individuals as, due to elevated food prices, consumer price inflation has yet to drop significantly. However, it looks to be only a matter of time before this happens. Our expectation is that, factoring this in, GDP growth will be boosted by some 1.5 per cent.

Second, India will be pumping more of its own oil and gas over the coming quarters. We estimate that this will add 0.3 to 0.5 per cent to real GDP growth each year over the next couple of years as output gradually steps up.

The benefits of strong inward foreign direct investment (FDI) should also be felt over coming months and years. Such

FDI amounted to \$33bn in 2008, more than double the record of \$16bn set in the previous year. Although recent months have seen something of a slowdown in such flows, they



have certainly not collapsed. In time, outward FDI may also yield some surprising benefits. It might sound like a strange argument, but it is by no means clear that such investment would have happened in India regardless. This kind of investment is generally used to acquire skills, which are then transferred home in order to boost productivity.

A fourth factor will be the easing of fiscal policy announced by the government. This is worth around 2.5 per cent of GDP and should have a similar impact on growth, particularly if the Reserve Bank of India (RBI) is successful in keeping a lid on long-term interest rates.

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in the final three months of 2008. This contrasts with bleaker news from the agricultural sector, where production has slumped more than two per cent in the year to Q4 2008.



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The main measures include the farm loan waiver scheme, public sector pay hikes, fuel and import duty cuts and additional infrastructure spending on roads, ports and utilities.

Fifth, the rupee has declined sharply in real terms against a basket of other currencies. The “real effective” exchange rate is down 15 per cent since the end of 2007 and is nearly ten per cent below its long-term average. This suggests that India’s exports are very competitive in world markets, which in turn bodes well when global demand begins to improve.

Lastly, although the RBI hasn’t been altogether successful in persuading the commercial banks to pass on the sizeable policy rate cuts (at the time of writing, the repo rate had been cut 425bps to 4.75 per cent; the reverse rate down 275bps to 3.25 per cent and the Cash Reserve Ratio by 400bps to five per cent), the Prime Lending Rate has at least dropped by nearly two per cent and will almost certainly fall further. As monetary policy always takes at least a year to impact the real economy, we should begin to feel the effects in 2010.

Overall, we estimate that the potential addition to GDP from these various factors to be worth more than five per cent over the next couple of years. This should be seen in the context of what we believe is a seven per cent trend or sustainable growth rate – the kind of growth one would expect if policy and commodity price effects were neutral and the global economy was also expanding at its trend rate.

Double deficit?

One of the most frequently cited risks to India’s growth prospects is the presence of sizeable twin deficits, the likes of which haven’t been witnessed since the crisis year of 2001. We expect the current account deficit to have comfortably exceeded three per cent of GDP in 2008-09, the highest in more than 50 years. Meanwhile, the combined central and state government budget deficit may be close to double digits as a ratio of GDP.

For a developing country such as India, it is perhaps surprising that an external deficit of more than three per cent is actually quite so high by historical standards. Aren’t such economies meant to generate relatively high returns on investment, making it easy to finance the gap between domestic savings and investment?

Unfortunately, this hasn’t always been the case in India given the perceived disadvantages of investing in the country, such as poor infrastructure and rigid labour markets. At times of heightened risk aversion, funding problems may also arise, potentially leading to a sharp drop in the currency and/or a big draw on foreign exchange reserves. At the height of the 1991 Balance of Payments crisis, for example, India was left with reserves equivalent to just three weeks of imports.

The country is in a vastly different situation now, however. Reserves are currently equivalent to

nearly a year’s worth of imports. And, to make matters better, the current account shortfall is now peaking, thanks mainly to the huge drop in commodity prices.

Unfortunately, India’s fiscal position is not so comfortable. The combination of the fiscal easing measures and the economic slowdown has seen the general government budget deficit jump from little more than five per cent of GDP in 2007-08 to an expected 9.8 per cent in 2008-09. In effect, it took just 12 months to undo most of the improvements in the public finances that had been achieved over the previous six years.

The clear implication of recent developments is that the earlier improvement in the deficit was mainly cyclical (a function of strong growth) rather than structural in nature. In other words, much more should have been done to improve the underlying fiscal position when growth was strong during the middle of the decade.

The current level of the budget deficit is consistent with a rising level of general government debt, which is already relatively high at close to 80 per cent of GDP. Against this backdrop – and with the rating agencies no doubt keeping a close eye on the new government in the June budget – I suspect that a further loosening of the purse strings this year would do more harm than good (one credit downgrade would see India lose its investment-grade status).

As soon as the economy has started to regain strength, the government should look to tighten fiscal policy. This needn’t be an aggressive move, but should be the start of a progressive squeeze. The last thing India needs is to enter another slowdown with the budget deficit still at a high level. As has been the case in other countries recently, including the UK, the government may then be forced to tighten policy, thereby exacerbating the downturn.

If fiscal policy is tightened, it will be very important to watch exactly how that is done. In my view, it should involve a widening of the tax base as well as a clampdown on tax evasion and cuts in government bureaucracy. However, this is easier said than done, and politicians often find it politically more

palatable to reduce capital spending instead. The trouble is this would only serve to damage India’s long-term growth potential and, as such, should be avoided at all costs.

People power

The argument that India offers huge economic potential is hardly a controversial one. After all, the country has a very young population. This is expected to rise by more than 300 million over the next 20-25 years, similar to the current size of the US and enough for India to overtake China as the most populous country in the world.

With such a low GDP per head, India also has immense catch-up potential. The much bigger question, however, is to what extent

will it exploit the opportunities? After all, the so-called demographic dividend could turn into a demographic disaster if people are not educated or there are insufficient jobs to go around.

On balance, there’s reason to be optimistic about India’s long-term future; it could easily grab a far larger share of the global economic pie. It seems to me that India’s greatest strengths are the dynamism of its people and their determination to succeed, often against the odds. Apart from helping to improve the physical and educational infrastructure, the government’s priority now should be removing the obstacles to those wanting to do business in India. Where this has happened, such as in IT services, the benefits are clear.



THE BENEFITS OF STRONG FDI
are likely to be felt by India over the coming years.
Foreign direct investment totalled around \$33bn

in 2008, which was more than double the record levels in the year before. Recent months have seen a drop off in the pace of investment flows, although they cannot be said to have collapsed.