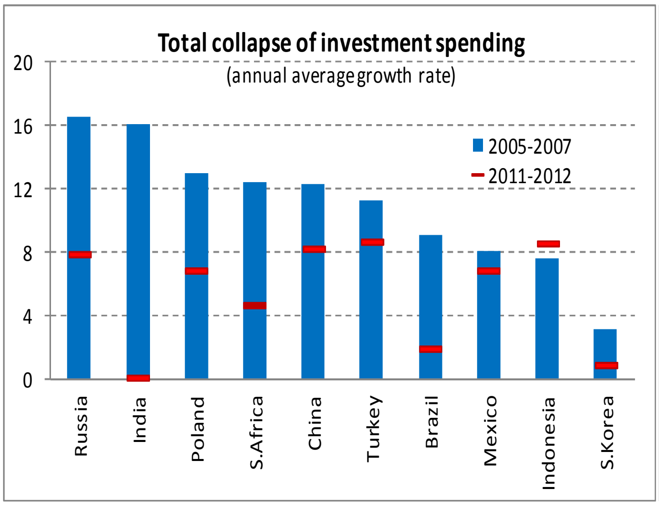
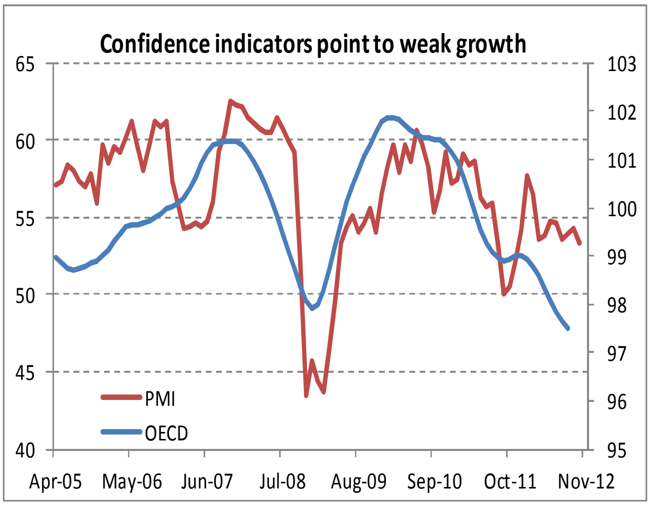
Indian economy still troubled

26 November 2012

Economic activity in India has been disappointing for several quarters and leading indicators continue to paint a bleak picture. There is not much room to support economic growth as both inflation and the public deficit remain at uncomfortably high levels. Meanwhile, despite some recent steps in the right direction, the overall investment climate and public finances are in poor shape. More reforms are needed to get India back on the right trajectory. However, with the 2014 elections already in sight, the chances of a broad set of reforms are very small. This puts India's credit rating (still investment grade) increasingly at risk.

Following a rapid recovery after the 2008-2009 crisis, the Indian economy has slowed down significantly. Growth in Q2 came in at a disappointing 5.5% (yoy). Meanwhile, leading indicators continue to deteriorate. This contrasts heavily to the pre-crisis growth levels (average of 8.7% between 2003 and 2008). Although the slowdown is cyclical in nature (weak global economic environment) to some extent, this is only part of the story. What's equally (if not more) important is the structural component of the slowdown. Over the last two years investment spending in India has totally collapsed (from the very high growth rates between 2005-2007) on the back of huge policy paralysis after the 2009 elections. As a result, investment projects have been postponed or even cancelled because the required land and environmental approvals have not been provided.



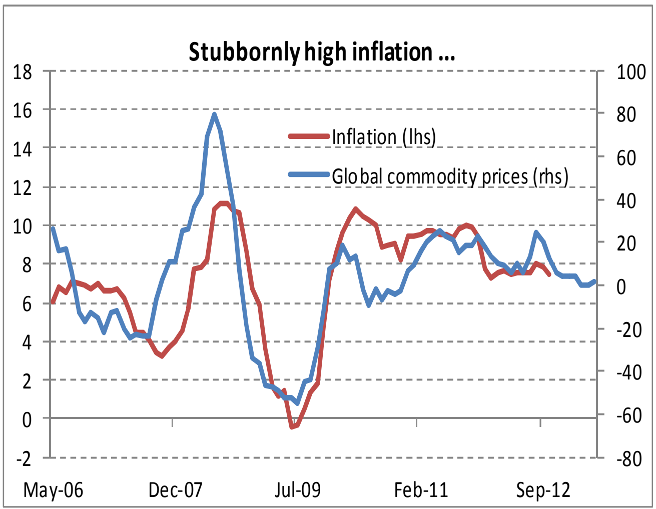


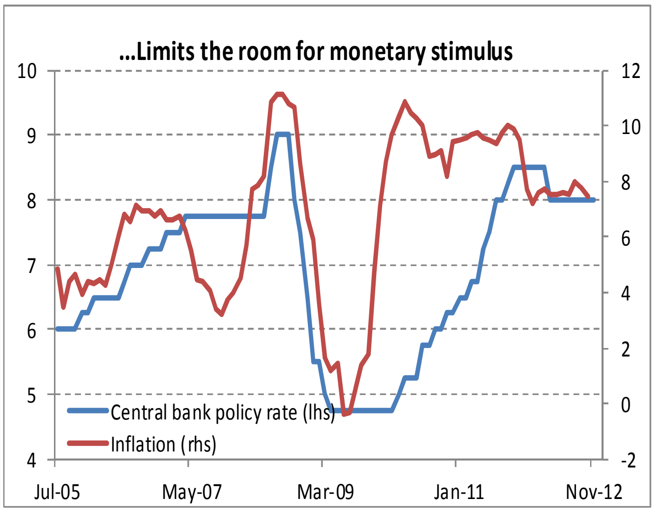
While most EM have reacted to the global slowdown with monetary stimulus measures, India finds itself in a far less enviable situation. After raising the policy rate by 375bp between the beginning of 2010 and October 2011, the Reserve Bank of India (RBI) has only cut the policy rate once because stubbornly high inflation (around 8%) limited the room for more monetary stimulus. Indian inflation contains an important structural component as the goods distribution system is far from efficient, adding to supply constraints. Although inflation should ease somewhat in 2013, it will remain at relatively high levels (on current global commodity prices). This means that a monetary stimulus driven recovery should not be expected. There is no room for budgetary policy easing either. In coming years, the IMF expects the public deficit to stay around the current high levels (around 9% of GDP). Moreover, budgetary stimulus would deteriorate the already worrying outlook for inflation.

The combination of weak growth, unsustainable public finances, high inflation and bad investment climate has caused S&P's to cut the outlook for India's credit rating (currently BBB- and the lowest investment-grade rating) in April this year (Fitch and Moody's hold on to a stable outlook for now). This leaves India no other option than to move ahead with structural reforms. The mid-September policy announcements are a step in the right direction. These measures include:

- Reduced subsidies for diesel to curb the widening fiscal deficit
- Retail and aviation sectors more open to foreign investors (to up to 49% of total ownership)
- Partial privatization of 4 state-owned companies

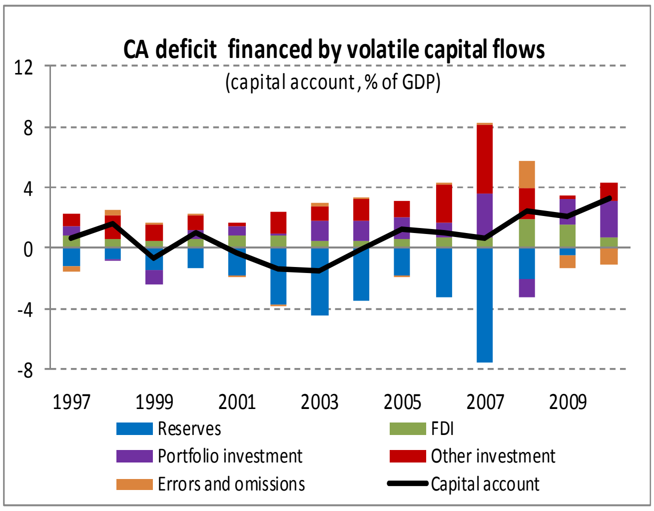
Though welcome, these measures are not sufficient to get India back on the track of sustained growth. More reforms will need to be put in place to bring down inflation (and thus interest rates) and put public finances on a sustainable trajectory. Also, the announced measures by no means tackle India's most persistent problems: widespread corruption and a malfunctioning government (policy paralysis and bureaucracy). In the absence of further reforms, investment growth is likely to remain sluggish.

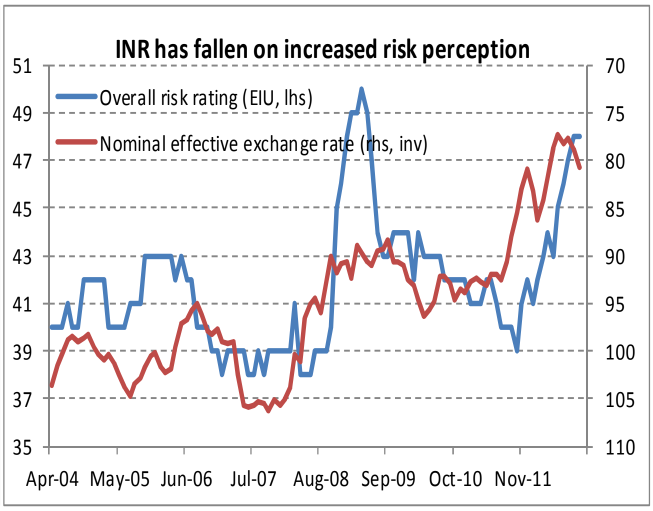




The upcoming 2014 elections risk postponing further (substantial) reforms. While it is too early to predict who will be in power in 2014, it is expected that small regional parties will continue to gain power vis à vis the traditional parties. This means India's next government will probably be even more fragmented than the current one. That, in turn, does not bode well for policymaking.

On top of these problems, India runs a current account deficit of 3.2% of GDP. Of course, a current account deficit is not necessarily a concern if it can be financed in a structural way. However, to a large extent, India's current account deficit is financed by portfolio and other investments. These types of investment flows are clearly more volatile in nature than FDI. As risk perception rapidly deteriorated since the end of 2011, this has caused the INR to depreciate significantly. Because the chances of substantial policy reforms in the near-term are small, the INR is expected to remain extremely fragile.





Conclusion

The Indian economy finds itself in a catch 22 situation. With stubbornly high inflation and unsustainable public finances there is close to no room to stimulate economic growth. To get growth back on a higher growth path, India should proceed with structural reforms. Lower inflation and a supportive investment climate could refuel investments. The mid-September announcements are a step in the right direction but almost certainly not enough to do the job. More reforms are needed but it is highly doubtful that sufficient progress will be made in the near future. The 2014 elections risk complicating any significant political deal. Moreover, India's next government is expected to be even more divided than the current one. This puts India's credit rating (still investment grade) increasingly at risk.