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Government deficit – a cloud hanging over India's robust growth

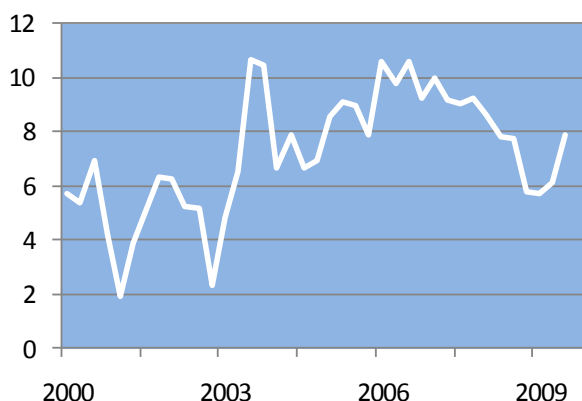
Economic crisis hits domestic demand

India, like other developing economies, was hit by the international economic crisis. Real GDP growth slowed in fiscal year 2008-09 (Apr 2008 - Mar 2009) to 6.7%, compared to 9% in the previous year. The slowing was of the same magnitude as that which followed the bursting of the technology bubble at the onset of the decade (chart).

The economic crisis had a major impact on investment and private consumption. India's financial sector has been rapidly integrating in recent years into the global financial markets. According to the IMF, already 25% of India's business finance comes from foreign loans and FDI. The drying up of external finance for banks and nonfinancial corporations has had a marked effect on investment during the crisis.

The collapse of international trade only had modest impact on India's growth, largely because India's economy is relatively closed and mainly dependent on domestic demand. Even though the importance of foreign trade for India increased during the last decade, its exports of goods and services amounted to only 24% of GDP in 2008. India's most important trade partners are the EU, United Arab Emirates and USA.

India's real GDP, %-change on previous year



Source: IMF

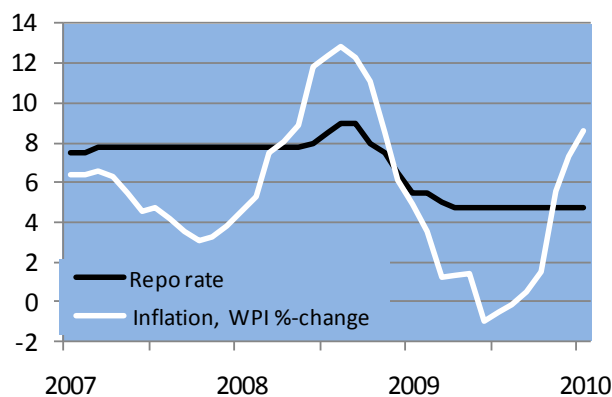
India reacted to the crisis with stimulus measures

India's central bank, Reserve Bank of India (RBI), lowered its policy rate, the repo rate, by a total of 4.25 percentage points to 4.75% in the course of the crisis. The Indian rupee depreciated nearly a fifth

against the dollar in 2008, but it has been appreciating moderately since April of last year, as international investors find their way back to the Indian markets. Indian officials have continued their managed-float policy by intervening in the exchange markets from time to time.

Inflationary pressures, which receded during the crisis, are again on the rise (chart). The key inflation indicator (wholesale price index, WPI) is already signaling inflation in excess of 8% pa.

India's inflation and monetary policy repo rate



Source: CEIC

The size of the fiscal stimulus comes to 1.5% of GDP. The primary measures are cuts in indirect taxes and improvements in social security and rural area infrastructure. The current fiscal-year budget includes sizable increases especially in public investment in infrastructure and in the rural-area employment program. That program, the National Rural Employment Guarantee Scheme, guarantees 100 days of work per year to one member of every below-poverty household.

India's investment rate has risen substantially

Industrial output has rebounded rapidly since the crisis; already in December it was nearly 17% higher than a year earlier. Robust growth of industrial output is vital for employing India's oversized rural population and for fully benefiting from country's growth potential.

Badly needed investments in industry have been supported by an increase in the savings ratio from 25% to over 35% in the last decade. The investment ratio has climbed to nearly 37%, boosted by rapid

lending growth even in comparison with other Asian countries. Investment will be key to both realized and potential growth in the coming years.

Little leeway for public finances

India's fiscal-policy options are tightly constrained by its public debt (ca 80% of GDP, mainly domestic) and chronic deficits. Public finances are heavily burdened by subsidies for fuel and food. These off-budget items amounted to almost 2% of GDP in fiscal year 2008-09.

The combined deficit for the central and state governments will probably be in the region of 10% in the current fiscal year. The running deficits are largely structural, and economic policies have not forthrightly tackled the problem of deficit reduction. The deficits will also restrict the fiscal-policy potential to stimulate the domestic economy should the world economy fail to achieve the expected faster growth rate.

A coalition headed by India's Congress Party won a sizable parliamentary majority in the 2009 elections, and it would appear on the surface that economic reforms will be easier to pass, given that the party need not rely much on leftist party support. But, on the other hand, a continuation of Congress Party leadership means a continuation of the previous economic policy, which does not bode well for rapid reform.

India's swift recovery from the economic crisis has induced a spate of upward revisions of forecasts of economic growth. The IMF predicted 7.7% growth for 2010 in its January forecast. Forecasts by the investment banks are generally of the same magnitude.

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