http://www.atimes.com/atimes/South_Asia/NJ13Df01.html

Asia Times Online
www.atimes.com

South Asia

Oct 13, 2012

Indian 'reforms' fragile in face of poor growth outlook

By Kunal Kumar Kundu

NEW DELHI - October is proving to be very eventful month for India, with events swaying economic sentiment from one extreme to the other.

As the government continued to demonstrate its new-found reformist attitude by announcing its intention to raise the limits for foreign direct investment (FDI) in private insurance companies and pension funds (following up on the blockbuster decision to increase diesel prices and allow FDI in multi-brand retail), three international financial institutions came up with revised forecasts for the Indian, with drastic downgrades in their growth forecasts.

The International Monetary Fund (IMF) shocked all and sundry with one of its most radical downgrades, predicting India's gross domestic product (GDP) would clock a growth rate of a mere 4.9% year-on-year during the 2012 calendar year - down by 1.3 percentage points from its previous forecast of 6.2% yoy growth).

The Asian Development Bank (ADB) cut its forecast for the fiscal year 2013 (April 2012- March 2013) by 1.4 percentage points to a revised 5.6% yoy growth, down from its earlier forecast of 7%).

The World Bank was not to be left out of the downgrade party, though it came up with a slightly less severe forecast for the current fiscal year - revising it's outlook by less than one percentage point (from 6.9% yoy to 6% yoy).

It is important to note that the IMF's calculations are different from those of other agencies, and for that matter from how India does its own calculations. In fact, in a reported interaction via Facebook, an IMF staff member has explained that if its estimate for the calendar year is changed to the current fiscal year and if indirect taxes are not taken into consideration (the way India calculates its GDP [1]), then the IMF's forecast for India's GDP growth rate would be 5.6%, same as the ADB forecast.

All the three reports acknowledge the government's desire to kick-start the reform process and consider the recent decisions as positive, yet all of them are worried about how the political theater will play out in India. Added to that is the deteriorating global economic environment.

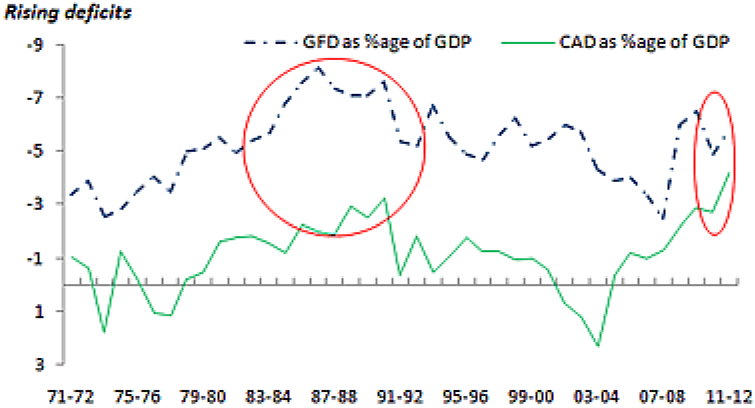
The common thread across all the reports is that, while the country recovered quickly, compared with its peers, from the financial crisis-induced global recession by 2009, India now lacks the firepower to consolidate that recovery; that is it lacks the fiscal and monetary space.

While global uncertainties are playing a significant role in impacting on the current account balance (leading to an unsustainably high current account deficit), rising fiscal imbalances and generally low business confidence caused by persistent lack of policy initiatives are exacerbating the problem.

Before the financial crisis erupted, India ended the fiscal year 2008 with a gross fiscal deficit of 2.5% of GDP and a capital account deficit of 1.3% of GDP; inflation was within central Reserve Bank of India's comfort zone of 5%. This gave India enough firepower to stimulate the economy.

Not surprisingly, India's economy recovered quickly. However, it ended the last fiscal year (to March 2012) with a fiscal deficit of 5.8% of GDP, a current account deficit of of 4.2% of GDP, inflation at 7.7% (average for the year being 9%) and a policy rate of 8.5%.

Rising deficits



Source: Govt. of India, Author's calculation

All three institutions mentioned above are deeply concerned as to how India will be able muddle through in the present situation at a time when global growth is again faltering again India's GDP growth is falling at alarming levels and when the country's politicians are acting as a major stumbling block rather than being facilitators of growth. As it is, India's deficits of March this year were not too different from just over two decades earlier, in March 1991, when the country was also courting crisis.

That year, 1991, marked a watershed period for the Indian economy, when the crisis then nudged policymakers into action and economic reforms were ushered in. Those reform proposals did face some political hurdles, but with a new government just come to power, and the leading coalition party - ie the Congress - having won as many as 233 seats, it was far easier for changes to be pushed ahead.

Back to the present and a new impending crisis. Previously, India expected its economy to grow at a 4% annual pace; now 5.5% y-o-y growth is considered to be disastrously poor. The time is therefore ripe for policy decisions and reforms that can put the economy back on track.

Certainly, the economy is not as vulnerable now as it was in 1991, when India needed a bailout. However, the persistence of fundamental problems (both domestic and external) can lead to increase in vulnerability to the point of bringing on a major crisis.

Another major difference in the present environment is in the political situation. This time, significantly, it has changed for the worse.

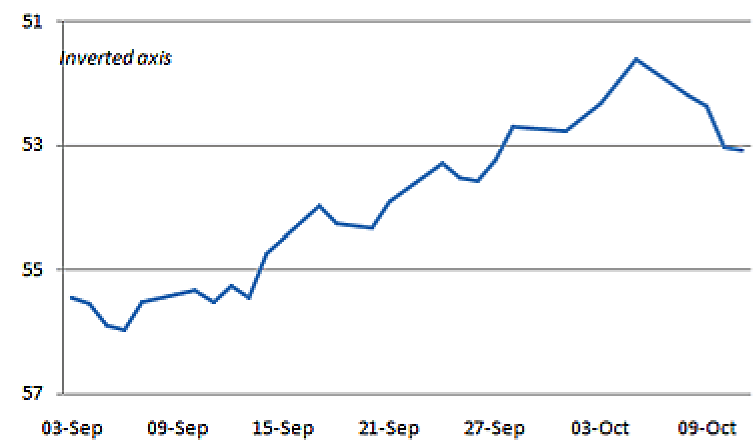
The Congress-led United Progressive Alliance government has been losing its political hold with every passing day. Its disastrous performance at recent state-level elections and a plethora of corruption skeletons tumbling out of cupboards with alarming regularity (with even the chairperson now needing to duck under claims of alleged corruption involving his son-in-law), the party is finding it difficult to manage its allies while the opposition is baying for blood.

And, with election barely a year and a half down the line, things are looking far more challenging than in 1991, when the freshly baked coalition government took charge with an aim to bring about change.

The political situation is now so fluid that, despite the series of measures announced recently, nobody - the markets or the international institutions such as the World Bank and International Monetary Fund - is willing to stick their neck out and say that this new reform drive is for real and here to stay.

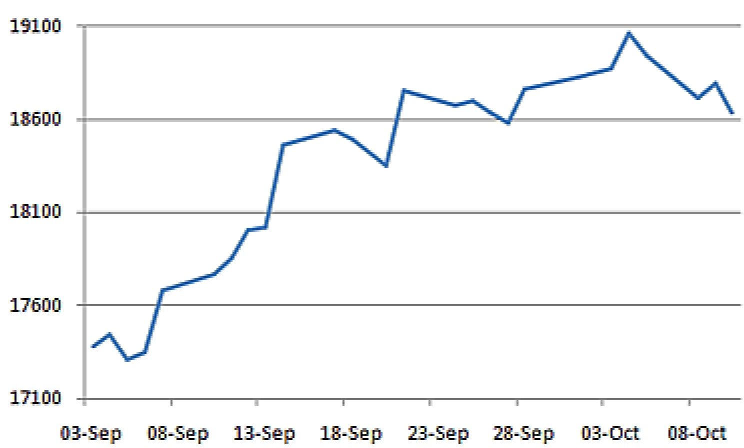
The positive sentiments generated by the policy announcements did lead to an increased inflow of foreign exchange, leading to a strengthening of the rupee and an improved stock market performance. These were, however, largely sentiment driven. Reality soon hit as the question of enforceability crept up, and both the currency and the stock markets started to give up gains.

Movement in INR/USD



Source: RBI

Movement of Sensex



Source: Yahoo Finance

Echoing such sentiments, Standard & Poor's reiterated its warning that, given the difficult external environment and even more debilitating domestic political environment (which directly impacts business mood), the threat of a downgrade by the credit rating company has not waned.

While one can still expect some sensible and less politically fraught policymaking over the next few months, 2013 is most likely to be a year stacked high with populist measures, as every party enters election mode.

Unless the government can prove otherwise (to ensure a revival of business confidence and investment), next year threatens to be unfortunately similar to the present.

Note:
1. GDP at factor cost - which is the conventional way of calculating GDP in India - excludes indirect taxes, since these are not considered to be payments made to a factor of production. The IMF includes these in its GDP calculation, as the institution calculates GDP at market price, which does include taxes.

Kunal Kumar Kundu*, Senior Economist & GM, India, RGE. The views expressed are those of the author.*