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Opinion: India faces new economic challenges

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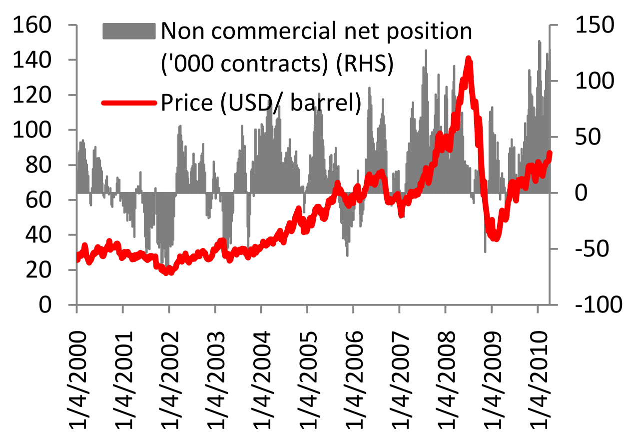
With final revenue numbers likely to be even lower than the revised estimates, the Indian government's fiscal constraint will weigh heavily on the growth prospects. A lot will depend on the success of the disinvestment of public sector units (PSUs) as well as the 3G spectrum auction. What will also be important is the timeline of the stimulus withdrawal. In India's case, a stimulus exit has already started on both the fiscal and monetary front, with the roll back of duty cuts, the increase in reserve requirements and an interest rate hike. There is all likelihood that there will be another rate increase in the forthcoming monetary policy meeting and the tightening will continue for some time to come.

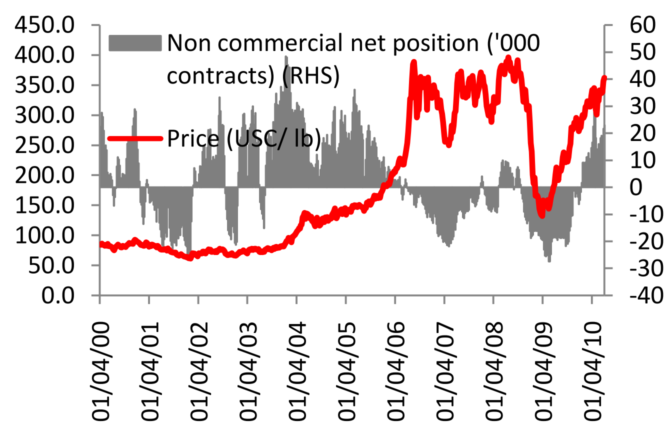
The strongest headwind that the economy is facing is that of inflation, which closed at a 9.9 per cent high in the last financial year. That, to a great extent, was a result of high food prices. While food inflation is likely to be somewhat tamed (mainly through improved foodgrain arrivals), there are clear signs that non food inflation will jack up. Here's why:

•The recent budget proposal to rollback earlier duty cuts

•Increase in oil prices, the full effect of its pass through to inflation is yet to be seen and with oil inching closer to $90 a barrel, another round of price hike is in the offing

•Commodity prices are rising and this has nothing much to do with economic fundamentals but with the heightened speculative activities (non-commercial net position indicates speculation) and rising commodity price will lead to inflation. In the charts below, I have considered oil and copper as two commodities to highlight the situation





Source: Commodity Futures Trading Commission (CFTC)

•Steel producers have already announced increase in their product prices. With commodity prices likely to remain at elevated levels, rising input costs will feed through to inflation

•After a lull during last year, corporate India is going to experience one of the highest salary hikes this year

With demand led inflation resulting in increased pricing power for the Indian corporates, as they seek to pass on the rising cost to the final price, monetary policy will be an important tool to fight runaway inflation. A fortnight ago, the borrowing plan as revealed by the Reserve Bank of India shows that higher government borrowing will come during the second half of the financial year. This is likely to lead to higher pressure on interest rate then.

Another headwind would be currency appreciation. Even if Indian gross domestic product growth oscillates between 7 and 7.5 per cent during the current financial year, it would still be very high by global standards. And, given the likely inflation level, India's nominal GDP growth would be around 14 per cent, a staggering figure. Given this growth differential, India will continue to be an attractive destination for global liquidity flows, putting upward pressure on the Indian rupee. While no sharp spike in the exchange rate is expected as the RBI ought to be intervening in the currency market, the appreciation will be gradual. Although this might help in reigning in inflation a tad, it will hit exporters. And with the global economy likely to slowdown during the second half of 2010 after a bout of technical recovery, Indian exports would also likely lose steam.

Industrial production is likely to feel the impact of high base effect during the second half of this financial year as the last few months have seen a really strong resurgence in the IP numbers.

Add to this rate hikes and the likely impact of the government borrowing needs on the interest rate (unless disinvestment and 3G auction proceeds hugely exceed expectation), and things do not seem to be hunky dory.

Another unknown is the monsoon. While India has not generally faced two consecutive years of bad rain, the rainfall in March has been quite below expectation. During March, rainfall was about 50 per cent down from normal. While the situation can change for the better going forward, another bout of deficient rainfall will deal a new blow to growth prospects.

Globally, sovereign default remains a big risk. And with strained government finances, exit from stimulus is no longer a choice. This, in itself, will reduce future growth. Add to this the vulnerability of Europe, which is more susceptible to a double dip recession, and it is clear that this year - for India - will prove to be quite challenging.

The writer is Sr. Practice Lead (Process and Domain Consulting) at Infosys Technologies. Views are those of the author.

(Note: The charts in this article are not in the original article as published by FT, since they could not upload the same due to some technical problems)