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India to face strong headwinds

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India's gross domestic product grew at 7.4 per cent during the financial year (FY) 2009-10, aided by the strong performance of the manufacturing and the farm sectors during the fourth quarter, which touched a 8.57 per cent year-on-year high. Clearly the Indian economy is standing out as an oasis in the desert of gloom and doom.

When the crisis was blowing all over the globe, India's FY09 GDP growth rate dipped, but only to 6.7 per cent. This year the growth rate improved to 7.4 per cent when there are splashes of red all round, especially in the developed world. The reason India managed to stay afloat (nay swim against the tide) has a lot do with prudent regulation and an economic structure that is not as dependent on external demand. While the domestic consumers buoy the economy, they continue to repose faith on the virtues of savings, rather than leveraged consumption.

Heightened economic activity is manifest in strong growth by mining and manufacturing. Even the private service held up nicely, growing by more than 10 per cent. The most heartening aspect of the current growth is the spurt in investments. During the fourth quarter, capital formation grew by 17.68 per cent. This is not surprising since the capital goods sector has been showing elevated levels of activity over the last seven months, growing at an average of nearly 29 per cent each month.

Hence the official optimism on economic prospect is on the overdrive, with the current year's growth being pegged at around 8.5 per cent and is expected to exceed the 9 per cent plus growth thereafter.

To me, this is not grounded in reality. The biggest question is the ability of the heightened level of activity to sustain itself, unless both domestic and external demand picks up pace. The strongest headwind facing external demand is the sovereign debt crisis in Europe. Not only is this likely to fester for some more time to come and possibly manifest itself in a few sovereign defaults along the way, it will also impact the overall global GDP growth on the downside. Add to that the likely slowdown in the Chinese economy, and the prospects do not seem to be too bright.

On the domestic demand front, the continual worry is the lack of it. Domestic demand grew by a meager 2.65 per cent during last quarter, the lowest ever recorded during the last five years and follows anemic growth rates of 2.85 per cent, 6.4 per cent and 5.28 per cent during the previous quarters. It, therefore, seems that while some of the economic activities are leading to capacity creation (which is good), other activities are possibly adding to inventories (which can act as a drag in the future). Also, a lot of domestic demand is attributable to the tax breaks that were provided as part of the stimulus packages leading to front loading of demand. Now, as the stimulus is being withdrawn, domestic demand is likely to face rough weather, especially given a stubbornly high inflation. Even if the monsoon is normal this year, food price inflation can only moderate. It is unlikely to come down drastically given the inherent structural issues. Add to that the withdrawal of tax breaks and impending rise is fuel price and it is difficult to visualize a sobering inflation scenario, which even the government has recently acknowledged. High inflation, cannot but be followed by rising interest rates, which will further reduce the propensity to consume.

Additionally, government consumption demand is starting to wane as the exit from stimulus takes concrete shape. As compared to the first two quarters when government expenditure propped up the economy, hardly any support was visible during the final two quarters.

It is important to remember that the average 9 per cent plus growth rate recorded between 2003 and 2007 had a lot to do with structural factors like high liquidity, low inflation and low interest rates (due to severe under pricing of risk) which propelled growth globally. Under the current circumstance when global growth is at stake, risk perception is heightened, liquidity will move in fits and starts and domestic inflation remains high, India's GDP growth is expected to hover between 7.5 and 8 per cent. Any intent to prop up the growth toward 9 per cent would require substantial monetary easing which will lead to additional inflationary pressures that can have debilitating impact on the economy.

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