Economic Research

KDN No: PP14787/11/2009(022771)

Malaysian Rating Corporation Berhad
(Company No. : 364803 V)

Vol.: ER/015/2009

Country Update: India

Nor Zahidi Alias
Chief Economist
+ 603 2092 5398
zahidi@marc.com.my

Mohd Afzanizam Abd. Rashid
Economic Analyst
+ 603 2092 5398
afzanizam@marc.com.my

Please read disclaimer on the last page of this report

Economic strength

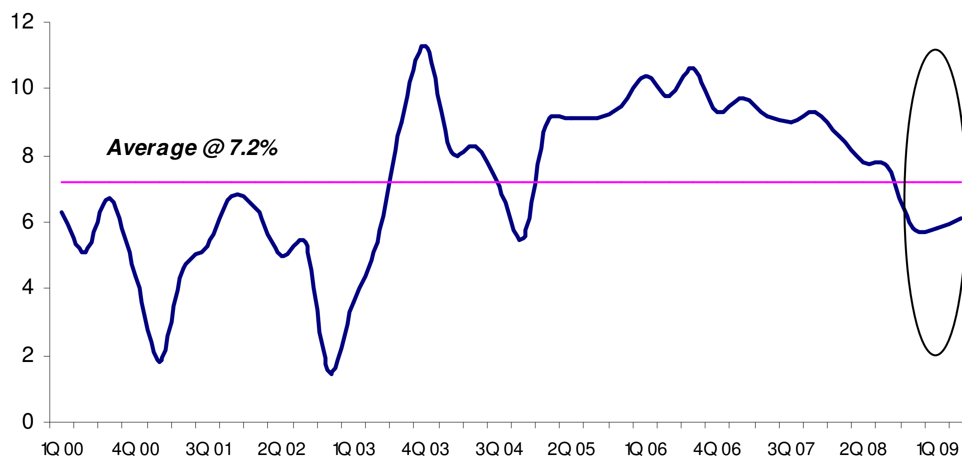
Long-term growth trajectory remains intact

Economic growth remained resilient, rebounding by 6.1% in 2Q2009 (1QFY2009-10) from 5.8% in the earlier quarter. Although not as robust as in other Asian countries, India's economy has been able to withstand external headwinds that pulled other economies into recessions. The economic strength lies in domestic demand that managed to offset the decline in its external trade. While policy makers have lowered India's long-term growth target to 7.8% from 9.0% for the five-year period to March 2012, the global economic recovery may push India's economic growth up more than expected as the economy benefits from a turnaround in investment and private consumption.

Domestic demand is also supported by the ongoing accommodative monetary policy and expansionary fiscal policy. An unprecedented monetary policy response has brought the repo rate from 9.00% in July 2008 to the present 4.75%, a massive 425 basis reduction within a short time frame. Fiscal policy has been expansionary, evidenced by a yawning budget deficit of 6.8% anticipated for the year ending March 2010. The economy will also likely benefit from the expected recovery in global trade following a milder contraction in the US economy and a recovery in European and Japanese economies. This is based on the fact that India's volume of trade as a percentage of GDP has risen to 48% in 2008-09, compared with only 21% of GDP in 1997-98.

All in all, the long-term growth story remains intact despite a seemingly bumpier road to recovery from the current slowdown. Short-term vagaries may cause volatility in its financial market as India's near-term outlook is affected by a bad monsoon season and softer consumer spending. Nonetheless, if one were to look beyond a one-year horizon, the consistency in policy reforms and the cohesiveness of the new government will likely result in greater foreign direct investment (FDI) inflows that will strengthen the macro foundation of India.

Chart 1: Quarterly GDP growth since 2000

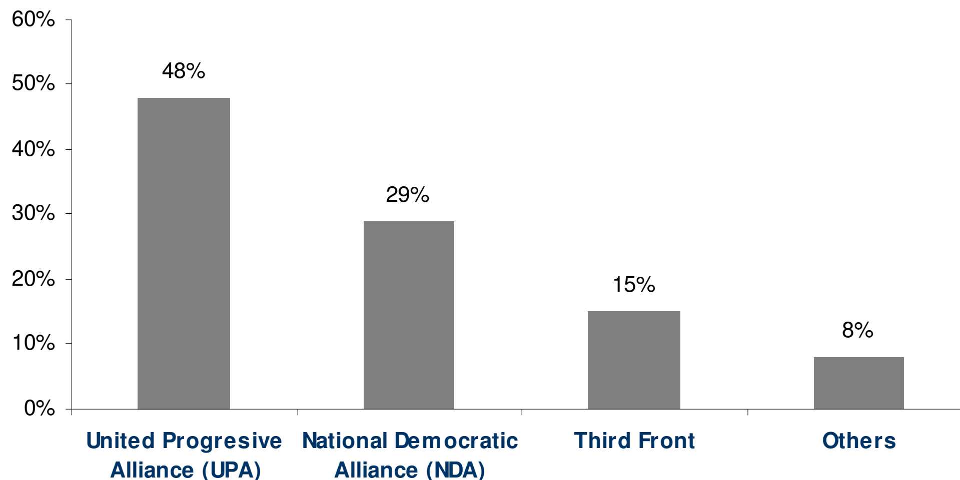


Source: Bloomberg

Cohesive and strong new government

A landslide victory for the Indian National Congress party under Prime Minister Manmohan Singh in the recent election in May has boosted the mandate for the government to continue economic reforms. The Congress Party and its electoral allies won 261 of 543 seats, and managed to secure a majority in India's 15th parliament. The party itself won 206 seats, crushing its main rival, the Hindu nationalist Bharatiya Janata Party (BJP), whose tally was the lowest in two decades. As a result, Manmohan Singh was reappointed as Prime Minister, making him the second person to be reappointed since India's first Prime Minister, Jawaharlal Nehru. From an economic point of view, the scale of the Congress' victory brings two important implications: firstly, given a strong mandate, the cohesive new government will likely be able to continue with reforms that it has been implementing without too many obstructions from the oppositions; and secondly, a continuity in economic policies will likely convince foreign investors to continue investing in India, be it through FDI or portfolio investments.

Chart 2: Percentage of parlimentary seats won



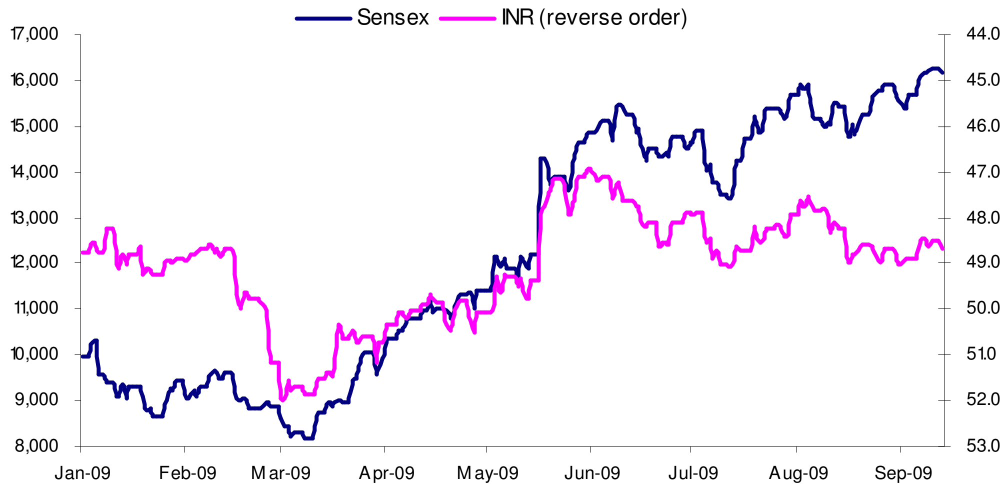
Source: HSBC, India Watch (Issue 51)

Return of capital inflows means less pressure on the rupee

Prior to the recent recovery in global equity markets, the rupee was under pressure, declining by 24% since April last year. The decline was not only attributed to the sell-off in the financial market, but also due to the fear of twin deficits faced by India. The turnaround in the global equity market since March, however, has capped the downside of the rupee following a 98% rebound in the benchmark Sensex index from its trough reached in March. According to the Securities and Exchange Board of India, overseas funds had bought Rp 417 billion (US$8.6 billion) of the nation's stocks between January and September 9, 2009, a stark contrast with record net sales of Rp 530 billion for the whole of 2008.

The uptrend in the Sensex index was also attributed to the landslide victory of the Congress party, which led to the reappointment of Manmohan Singh as Prime Minister. This is reflected in the 16.5% climb in the index since Singh started his second term on May 22, 2009. As for the outlook of the rupee, we see a limited downside in the medium term for the following reasons: firstly, a steady recovery in global equity markets will likely lead to inflows of capital into emerging markets by 2010; and secondly, an upturn in global trade will increase demand for the rupee as major economies start to raise their demand for commodities and other products. The downside risk, however, is the budget-current account matrix which will likely deteriorate if the government fails to exercise fiscal prudence in the medium term.

Chart 3: Sensex index vs the rupee



Source: Bloomberg

Stabilising property market

Various statistics seem to indicate that India's property market has hit the bottom, although the recovery has not been very broad-based. According to industry estimates, property prices have fallen 30%-45% from the peak of 2007. The recovery, however, has been limited to the low-end housing segment comprising house prices under Rs25 lakh, and this is confirmed by India's largest real estate developer DLF Ltd, who pointed out that although demand for properties has increased in recent months, prices have not rebounded. Notwithstanding, the slump in the housing sector has generally stabilised evidenced by rising sales which were up by 25%-30% since April, according to real estate consultancy companies.

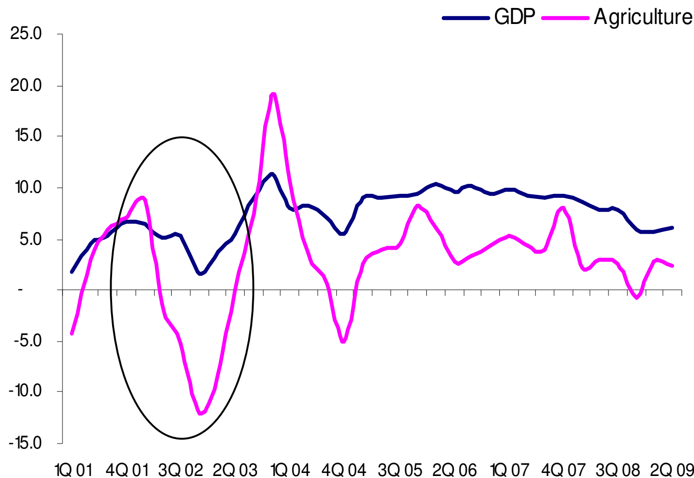
Key risk areas

Unfavourable weather may cause short-term weakness in growth

The short-term outlook for economic growth is clouded by unfavourable weather conditions which are currently affecting agriculture output. India's monsoon rains were reported to be 27% below average in August, as the country received only 189.9 millimeters (7.5 inches) of rain compared with a 50-year average of 262 millimeters between 1941-1990. The weak monsoon this year has caused drought in 278 out of 626 districts in India, damaging major crops such as rice, sugar cane and oil seeds. For instance, the country's sugar output is anticipated to decline by 44% to 14.8 million tonnes this year.

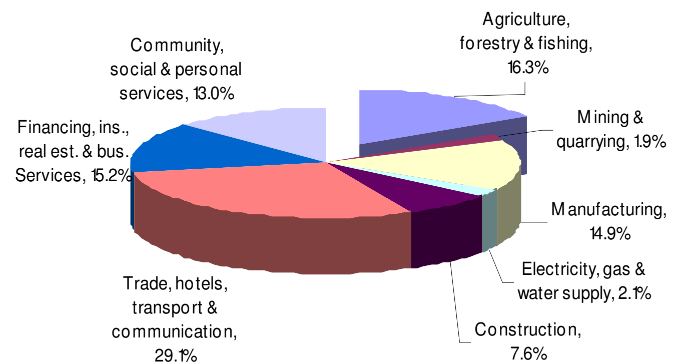
The drought, if it persists, will have a significant effect on the incomes of the rural population of 742 million and dent consumer spending in the near term. Adding to that, the expected rise in farm prices as a result of lower production of agriculture products may hit consumers through higher prices of end products. History has shown that India's economic expansion is highly sensitive to agricultural output. For instance, in 2002, growth skidded to 3.8%, the lowest in 11 years, due to drought.

Chart 4: GDP and agriculture growth



Source: Bloomberg

Chart 5: India's economic structure in 2Q2009



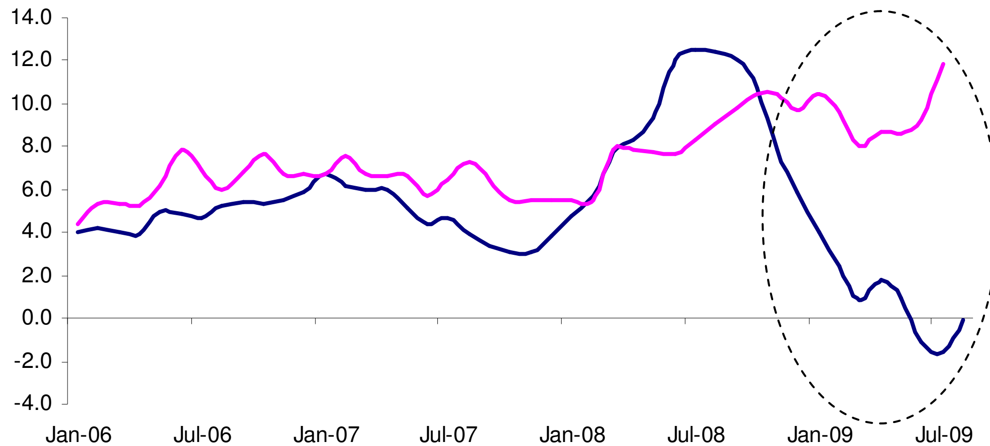
Source: Central Statistical Organisation (CSO)

Higher prices may complicate policy maneuvering

Although the benchmark wholesale price index (WPI) has remained in negative territory in recent months, the prospect of having higher consumer prices cannot be ruled out following the ongoing drought that is affecting agriculture output. The decline in WPI moderated to 0.12% in the final week of August after reaching its low of -1.58% in July, suggesting that the prices are likely on the upward bias in the near term. Other numbers have also raised fears about the possibility of a return of inflation: for instance, prices paid by farm workers jumped 12.9% year-on-year in July, inflation for rural workers rose 12.7% while consumer prices paid by industrial workers escalated by 11.9%. As the effect of severe drought is expected to unfold via higher consumer prices, India's Planning Commission is now looking at a possibility of seeing the WPI rise above the 4%-5% "comfort zone" by March 2010. In fact, private economists are forecasting the WPI to rise by as high as 8% by 2010.

An anticipated rise in the WPI will complicate policy maneuvering, evidenced by the hawkish tone from the central bank. The statement by the Reserve Bank of India (RBI) during the first week of September saying that it may have to reverse its monetary policy sooner than most countries suggests uneasiness among policy makers over the prospect of higher prices. Governor Duvvuri's remark was the clearest warning to date about a possible rise in interest rates in India. However, as the recent rise in prices is not demand-related, we are of the opinion that a withdrawal from policy accommodation will not be the answer to the rising inflation expectation. Instead, addressing supply side bottlenecks will be a better solution for the current problem. Nonetheless, the RBI may have different view in combating inflation expectation which is building up in the economy. If the rate hike comes earlier than expected , India's economic recovery may prove to be bumpier in the near term.

Chart 6: Wholesale price index (WPI) vs. Consumer price index (CPI)



Source: Bloomberg

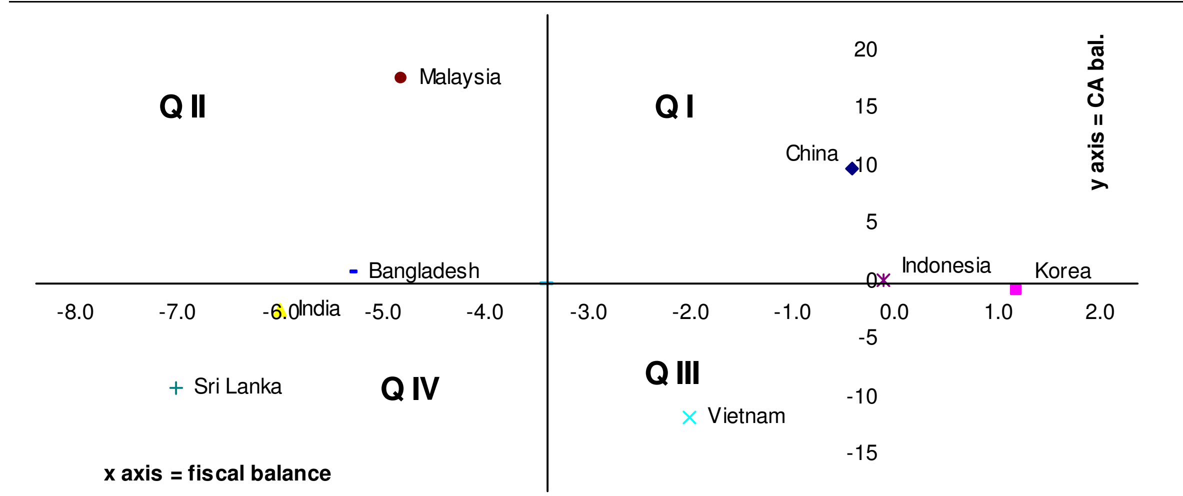
Unfavourable budget and current account matrix

India's problem of budget deficits has been highlighted by many quarters. However, the effect on foreign investors' sentiment is compounded by the fact that the country is also experiencing a negative trade balance due to falling demand from abroad. India's budget deficit is anticipated to reach a 16-year high of 6.8% of GDP in the year to March 2010 following the government's pump priming efforts to support the weakening economy. As a result, in July 2009, Finance Minister Pranab Mukherjee announced the government's plan to borrow a record Rp 4.5 trillion (US$93.3 billion) to fund spending aimed at boosting the economy. Other efforts to finance the deficit include the plan to sell the government's stake in state-owned ompanies, an effort that was previously blocked by several parties within the coalition.

India's unfavourable trade balance was reflected in recent export numbers that showed merchandise exports plunged by 28.4% year-on-year in July (June: -27.7%), a decline for a tenth straight month following weak demand from major economies. Exports had dropped by as much as 33.3% in March 2009, the sharpest decline on record. In the first four months of the fiscal year to July 31, exports slipped by 34.1%, while imports slumped by 32.5%. Considering that the World Trade Organization (WTO) is projecting a 10% drop in the volume of trade in goods for 2009, India's export performance will likely remain lackluster. As such, the problem of twin deficits will be a thorny issue for India in the near term.

Notwithstanding such a backdrop, we are not overly pessimistic about the budget and current account conditions for two reasons. First, the long term growth trajectory remains intact, despite being slightly lower than initially projected. This is due to a stable and robust domestic demand as a result of the government's fiscal stimulus measures and accomodative monetary policy. Second, the global economic recovery will likely lift the average growth for exports, as India is now more dependent on external trade. Thirdly, under the leadership of Prime Minister Manmohan Singh, India is not expected to have major macro imbalances as Singh is known to be a capable technocrat who was a former Governor of the Reserve Bank of India and a former Finance Minister of India.

Chart 7: Fiscal and current account balance as % of GDP in 2008



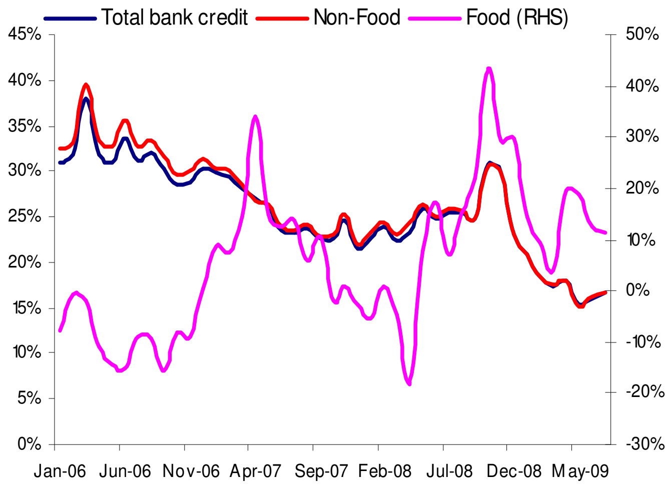
Source: Key Indicators 2009, Asian Development Bank (ADB)

Lending activities continued to moderate

The latest statistics showed that lending activities have not picked up pace, with total bank credit, growing by only 14.1% in August after staging a spectacular growth in excess of 30% in 2006. There are two possible explanations for this phenomenon. One might be that banks remained reluctant to lend as credit risks have not totally dissipated and the economy has yet to fully recover from previous slump. As of March this year, the net non-performing asset ratio edged up slightly to 1.05% from 1.00% registered in the previous fiscal year. The other reason could be the fact that demand for loans is still lacking as businesses remained cautious about the prospect of the recovery.

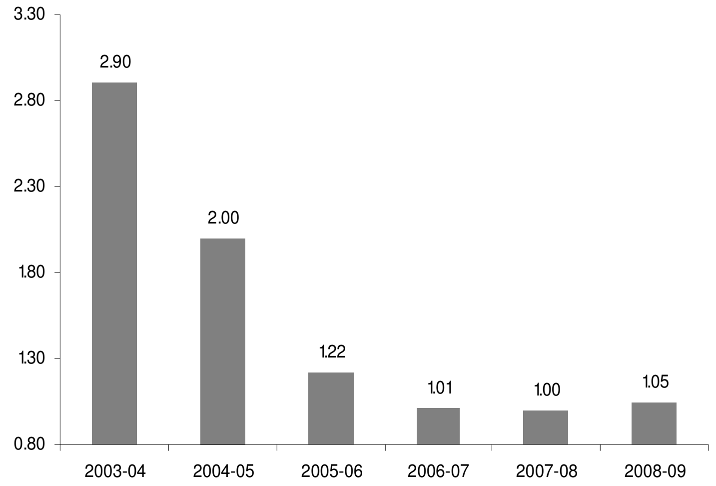
Judging by the decline in the prime lending rate by 240 bps since October last year and the drop in credit-to-deposit ratio to 68.98% in July (Highest: 75.43% in October 2008), we are more inclined to think that loan growth has actually softened because of a reduction in demand for loans rather than banks' unwillingness to extend credit to borrowers. This is not surprising as businesses are likely to hold back their future plans to increase production, especially during an early stage of economic recovery. As such, we are of the opinion that it is premature to tighten monetary policy at this juncture as it could disrupt the recovery process and hamper growth in the immediate term.

Chart 8: Bank lending is softening (Y-o-Y)



Source: Reserve Bank of India (RBI)

Chart 9: Net non-performing asset (NPA) ratio



Source: Reserve Bank of India (RBI)

Country Fact Sheet

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
National Account (growth %)									
Gross Domestic Product	**4.4%**	**5.8%**	**3.8%**	**8.5%**	**7.5%**	**9.5%**	**9.7%**	**9.0%**	**6.7%**
Supply side									
Agriculture	-0.2%	6.3%	-7.2%	10.0%	0.0%	5.8%	4.0%	4.9%	1.6%
Mining and quarrying	2.4%	1.8%	8.8%	3.1%	8.2%	4.9%	8.8%	3.3%	3.6%
Manufacturing	7.7%	2.5%	6.8%	6.6%	8.7%	9.1%	11.8%	8.2%	2.4%
Construction	6.2%	4.0%	7.9%	12.0%	16.1%	16.2%	11.8%	10.1%	7.2%
Services	5.7%	6.9%	7.5%	8.8%	9.9%	11.2%	11.3%	10.8%	9.4%
Demand side									
Final Consumption Expenditure	3.0%	5.3%	2.4%	5.4%	4.9%	7.0%	6.2%	8.3%	5.4%
-Private	3.4%	6.0%	2.9%	5.9%	5.2%	7.1%	6.3%	8.5%	2.9%
-Government	0.9%	2.3%	-0.4%	2.6%	3.6%	6.2%	5.5%	7.4%	20.2%
Gross Fixed Capital Formation	0.0%	7.4%	6.8%	13.6%	18.9%	17.6%	14.5%	12.9%	8.2%
Exports of Goods and Services	18.2%	4.3%	21.1%	9.6%	27.2%	17.6%	21.1%	2.1%	12.8%
Imports of Goods and Services	4.5%	2.8%	12.3%	13.8%	22.2%	41.1%	24.5%	6.9%	17.9%
Trade & Balance of Payments									
Total exports (USD Million)	44,560	43,827	52,719	63,843	83,536	103,091	126,414	163,132	168,704
Growth	21.0%	-1.6%	20.3%	21.1%	30.8%	23.4%	22.6%	29.0%	3.4%
Oil exports (USD Million)	1,870	2,119	2,577	3,568	6,989	11,640	18,635	26,904	n.a.
Growth	4706.4%	13.3%	21.6%	38.5%	95.9%	66.5%	60.1%	44.4%	n.a.
Non-oil exports (USD Million)	42,691	41,708	50,143	60,274	76,547	91,451	107,779	136,228	n.a.
Growth	16.1%	-2.3%	20.2%	20.2%	27.0%	19.5%	17.9%	26.4%	n.a.
Total imports (USD Million)	50,537	51,413	61,412	78,149	111,517	149,166	185,735	251,654	287,759
Growth	1.7%	1.7%	19.4%	27.3%	42.7%	33.8%	24.5%	35.5%	14.3%
Oil imports (USD Million)	15,650	14,000	17,640	20,570	29,844	43,963	56,945	79,715	93,176
Growth	24.1%	-10.5%	26.0%	16.6%	45.1%	47.3%	29.5%	40.0%	16.9%
Non-oil imports (USD Million)	34,886	37,413	43,773	57,580	81,673	105,203	128,790	171,939	194,583
Growth	-5.9%	7.2%	17.0%	31.5%	41.8%	28.8%	22.4%	33.5%	13.2%
Trade balance (USD Million)	(5,976)	(7,587)	(8,693)	(14,307)	(27,982)	(46,075)	(59,321)	(88,522)	(119,055)
Current account (USD Million)	(2,666)	3,400	6,345	14,083	(2,470)	(9,902)	(9,565)	(17,034)	(29,817)
% of GDP	-0.6%	0.7%	1.2%	2.3%	-0.4%	-1.2%	-1.1%	-1.5%	-2.5%
Capital account (USD Million)	8,840	8,551	10,840	16,736	28,022	25,470	45,203	107,993	9,146
% of GDP	1.9%	1.8%	2.1%	2.8%	4.0%	3.1%	4.9%	9.2%	0.6%
Overall balance (USD Million)	5,868	11,757	16,985	31,421	26,159	15,052	36,606	92,164	(20,080)
% of GDP	1.3%	2.5%	3.3%	5.2%	3.7%	1.8%	4.0%	7.8%	-1.8%
Government Finance									
Central government deficits (Rs. Crore)	(118,816)	(140,955)	(145,072)	(123,273)	(125,794)	(146,435)	(142,573)	(126,912)	(326,515)
% of GDP	-5.7%	-6.2%	-5.9%	-4.5%	-4.0%	-4.1%	-3.5%	-2.7%	-6.1%
State government deficits (Rs. Crore)	(87,923)	(94,260)	(99,726)	(120,631)	(107,774)	(90,084)	(77,509)	(107,958)	(112,653)
% of GDP	-4.2%	-4.1%	-4.1%	-4.4%	-3.4%	-2.5%	-1.9%	-2.3%	-2.1%
External Debt									
Gross External Debt (USD Million)	101,326	98,843	104,914	111,645	132,973	138,133	171,331	224,573	229,887
% of GDP	22.5%	21.1%	20.3%	17.8%	18.5%	17.2%	18.1%	19.0%	22.0%
Debt service ratio	16.6%	13.7%	16.0%	16.1%	5.9%	10.1%	4.7%	4.8%	4.6%
Money & Banking									
M1	11.2%	11.5%	12.0%	15.5%	16.7%	18.9%	20.3%	15.9%	14.5%
M3	15.9%	16.0%	16.1%	13.0%	14.0%	15.4%	20.5%	22.1%	20.4%
Deposit rates (1 to 3yrs)	8.50-9.50	7.50-8.50	4.25-6.00	4.00-5.25	5.25-5.50	6.00-6.50	7.50-9.00	8.25-8.75	8.00-8.75
Lending rates	11.00- 12.00	11.00-12.00	10.75-11.50	10.25-11.00	10.25-10.75	10.25-10.75	12.25-12.50	12.25-12.75	11.50-12.50
Inflation Rate									
Wholesale Price Index (WPI)	7.2%	3.6%	3.4%	5.5%	6.5%	4.4%	5.4%	4.8%	8.3%
Consumer Price Index (CPI)	3.7%	4.3%	4.1%	3.7%	4.0%	4.2%	6.8%	6.4%	9.0%

Source: Reserve Bank of India (RBI, Central Statisitcal Organisation (CSO)

THIS PAGE IS INTENTIONALLY LEFT BLANK

THIS PAGE IS INTENTIONALLY LEFT BLANK

Disclaimer

The Economic Research Report **is** the property of Malaysian Rating Corporation Berhad (MARC) and is protected by Malaysian and international copyright law and conventions. The Economic Research Report and all information contained herein shall not be copied or otherwise reproduced, repackaged, further transmitted, transferred, disseminated, redistributed or resold for any such purpose, in whole or in part, in any form or manner or by any means whatsoever, by any person without MARC's prior written consent. MARC does not make any warranties, express or implied, including, without limitation, those of merchantability and fitness for a particular purpose, with respect to the Economic Research Report and all information contained herein. The Economic Research Report and all information contained herein is provided on the basis of information believed by MARC to be accurate and reliable as derived from publicly available sources. MARC, however, has not independently verified such information and makes no representation as to the accuracy or completeness of such information. Any assignment of an analysis by MARC is solely to be construed as a statement of its opinion and not a statement of fact. An analysis is not a recommendation to buy, sell, or hold any security. No investment decision should be made solely on the basis of an analysis which does not, among others, comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Further, the Economic Research Report and all information contained herein may include inaccuracies or typographical errors. Moreover, MARC may make modifications and/or changes in Economic Research Report and all information contained herein at any time, for any reason. Any person using and/or relying on the Economic Research Report solely assumes the risk in making use and/or relying on the Economic Research Report and all information contained herein. Any person making use of and/or relying on the Economic Research Report and any information contained herein expressly absolves and releases MARC and its licensors and suppliers from any liability for any damages arising from the use of and/or reliance on the Economic Research Report or information contained herein. Under no circumstances will MARC or its affiliates be liable for any special, indirect, incidental or consequential damages of any kind, including, but not limited to, compensation, reimbursement or damages on account of the loss of present or prospective profits, expenditures, investments or commitments, whether made in the establishment, development or maintenance of business reputation or goodwill, cost of substitute materials, products, services or information, cost of capital, and the claims of any third party, or for any other reason whatsoever, even if MARC has been advised of the possibility of such damages. Any person making use of and/or relying on the Economic Research Report and all information contained herein hereby acknowledges that he has read this Disclaimer and has understood it and agrees to be bound by it.

© 2009 Malaysian Rating Corporation Berhad