

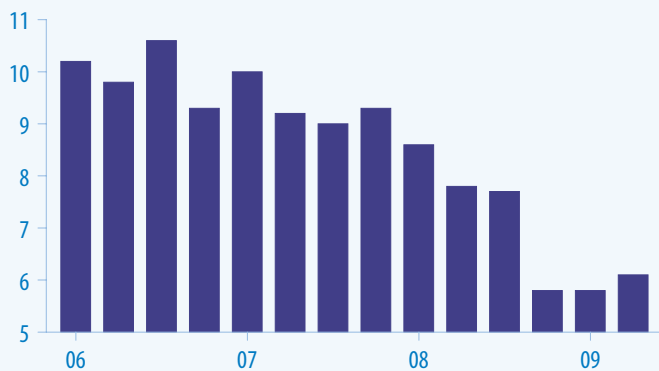
## India – Economic Update

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**CHART 1**  
**GDP GROWTH HAS EASED...**

India (y/y % chng)

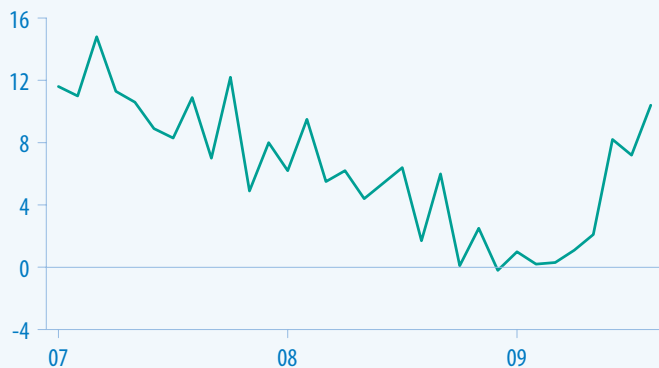
Real GDP



**CHART 2**  
**...BUT INDUSTRIAL PRODUCTION REBOUNDING**

India (y/y % chng)

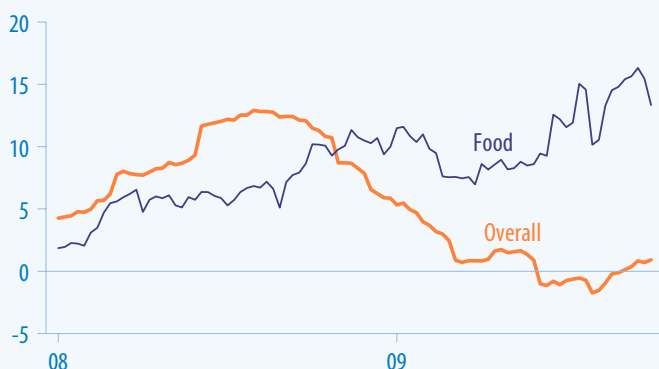
Industrial Production



**CHART 3**  
**WHOLESALE PRICE INFLATION RISING**

India (y/y % chng)

Wholesale Price Index



India entered the global credit crisis as one of the world's high-flyers with growth averaging nearly 9% in the five fiscal years ending March 2008 (*Chart 1*). Unlike much of the rest of Asia, domestic demand was the main driver, with net exports acting as a drag on growth. But the economy did not prove immune to the global economic crisis as growth slowed to 6.7% in FY2009 from 9% in the prior year. Manufacturing was hard hit and, on the expenditure side, consumer spending growth was slashed to less than 3% from 8.5%. Investment spending skidded to 8.3%. Hefty fiscal stimulus propelled government spending 20% on the year, providing some offset. Growth has since improved modestly, with GDP up 6.1% y/y in the April-June quarter, reflecting a revival in manufacturing. But personal spending remained weak, investment growth eased again, and government spending slowed. Net exports boosted growth, but only because the plunge in imports doubled the fall in exports.

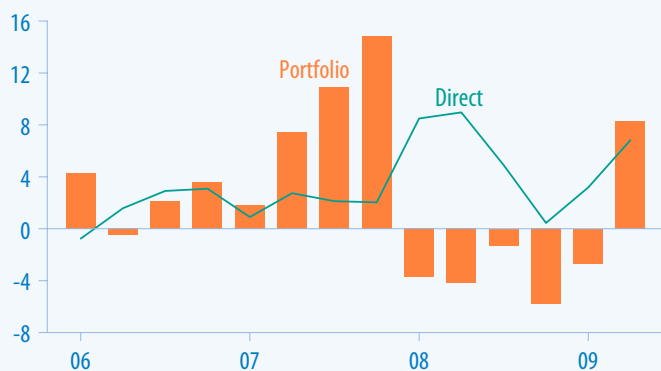
Key indicators suggest the economy has turned the corner. Most notably, industrial production has surged over 10% y/y as of August (*Chart 2*). However, overall growth will be constrained after grain production was slashed due to drought-like conditions in many regions (60% of agricultural land is rain-fed). The June-September monsoon, which provides about 80% of the country's rainfall, was 23% below the long run average, the worst since 1972. This also hit rural demand, as agriculture accounts for 55% of the labour force.

The drought also raised food costs about 15% y/y in August, stoking inflation fears, although grain stocks from recent bumper crops and commodity imports will have a moderating impact. Nevertheless, food prices will put pressure on wholesale prices (*Chart 3*). With last year's high oil prices dropping out of the year-ago calculation, wholesale inflation may rise from 0.9% now to 7.5% by March 2010.

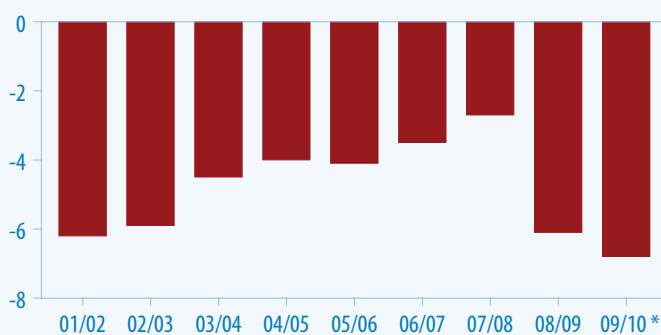
India is benefiting from a narrowing current account gap and rebounding capital inflows due to stronger risk appetite and May's election results which saw a surprisingly solid showing for the reform-oriented Congress Party. Improved prospects for renewed economic reforms bolstered net foreign direct and portfolio investment, both of which

**CHART 4  
CAPITAL INFLOWS REBOUNING**

India (US\$ billions)

**Net Foreign Direct and Portfolio Investment**

**CHART 5  
FISCAL BALANCES DETERIORATING**

India (% of GDP)

**Central Government Balance**


\* Budget estimate

**TABLE 1  
INDIA ECONOMIC INDICATORS**

| Fiscal Years Beginning April          | 07/08 | 08/09  | 09/10f | 10/11f |
|---------------------------------------|-------|--------|--------|--------|
| GDP Growth (%)                        | 9.0   | 6.7    | 5.8    | 7.5    |
| Wholesale Inflation (% avg)           | 4.7   | 8.4    | 2.3    | 6.5    |
| Wholesale Inflation (% eop)           | 7.7   | 0.8    | 7.5    | 5.0    |
| Central Government Balance (% of GDP) | -2.7  | -6.1   | -7.0   | -6.2   |
| Central Government Debt (% of GDP)    | 62.1  | 61.5   | 62.0   | 64.0   |
| Trade Balance (US\$ billions)         | -91.6 | -119.4 | -106.0 | -119.1 |
| Current Account (US\$ billions)       | -17.0 | -29.8  | -11.7  | -18.3  |
| % of GDP                              | -1.7  | -2.7   | -1.0   | -1.3   |
| FX Reserves (US\$ billions)           | 299.7 | 242.3  | 280.0  | 300.0  |

exceeded the current account deficit (Chart 4). The strong inflows seem to have continued, lifting foreign reserves to \$270 bln, recently. And India is diversifying its reserves, with its 200 tonne gold purchase in November the first big step.

Nonetheless, the government faces challenges tackling the rapidly worsening fiscal accounts. The fiscal deficit soared to over 6% of GDP in FY08/09 as surging government spending bolstered growth (Chart 5). This year, continued stimulus and the poor monsoons may widen the deficit further. Political resolve will be critical to implement fiscal restraint and contain the urge for populist measures such as the recent rural employment guarantees, debt relief for poor farmers and last year's 21% increase in civil servant wages. A strengthened government should help.

The Reserve Bank of India eased aggressively during the economic downturn, slashing the repo rate 425 basis points from October 2008 to 4.75% currently. Reserve requirements were also lowered to free up liquidity. Rates have been on hold since April; but, at October's monetary policy meeting, the RBI raised its inflation forecast and withdrew special liquidity measures and raised statutory liquidity ratios. India is likely to be a relatively early rate hiker, with the first moves expected before the end of the fiscal year.

Monsoon-induced headwinds will likely restrain growth in July-December and keep FY09/10 growth below 6%. However, substantial fiscal and monetary stimulus should still be feeding growth through year end and, combined with an improving external environment and assumed normal rains, spur a substantial growth boost to 7.5% in 2010/11 (Table 1). Inflation is expected to moderate next year despite stronger growth as a normal harvest helps contain food prices. On the external side, lower oil prices and improving exports should reduce the current account deficit this year to around 1% of GDP before an improving domestic economy and a commodity price revival leads to a modestly wider deficit in 2010/11.

A return to the 9% pre-crisis economic growth may prove challenging given India's poor infrastructure and lingering structural impediments. A reform push under the newly strengthened Congress-led government would be useful, particularly in areas such as labour reforms, privatizations and opening up India to foreign investment.

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