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Asia
Other

Equity Research

Industry Overview

India: An Eye To The Election

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Sector View:

New: 0-Not Rated
Old: 0-Not Rated

Investment Conclusion

- The upcoming general election in India is likely to be surrounded by political uncertainty which could unsettle markets.

Summary

- India is moving into pre-election mode even though the next election need not be until 2009 (but may be earlier). Post-election, we look for further structural reform consistent with India's quest for more inclusive growth.

INDIA AT AN INFLEXION POINT

Although India does not need to hold a general election until May 2009, we expect the current Indian National Congress-led (INC) government to move increasingly firmly into pre-election mode in the first half of 2008 – especially since we judge there to be at least a possibility that the election may be as early as the second half of next year. This is likely to result in further structural reform legislation being put on "hold".[1] That said, we anticipate that the government will continue its programme of public/private partnerships (PPPs) in infrastructure development, consistent with the aim of the soon-to-be-published 11th Five-Year Plan of US$492bn total expenditure on infrastructure in FY07-FY12 (of which at least 30% is set to fall to the private sector). Furthermore, we expect to see significant private sector-led progress with the creation of Special Economic Zones (SEZs) – despite push-back in some states – which have the potential to provide a boost to labour-intensive manufacturing in India by working round the country's labour laws; similarly, with the expansion of a formal retail sector via roll-out of supermarkets.

On foreign policy, we judge that – despite resistance from its communist party allies – the current government is likely to ratify the stalled India/US civil nuclear agreement before it leaves office. But a question mark remains over whether it will be able to do so in time to conclude related agreements with Nuclear Suppliers Group members and to secure ratification by the US Congress before President Bush leaves office.

Closer to home, India will follow events in **Pakistan** closely as political turmoil there looks set to continue through 2008.

Fiscal Temptation…

Not least with an eye to the election, the government may be tempted to take advantage in its 2008 budget of India's recent success with fiscal consolidation. While there may be some latitude taking the budget in isolation, there are two additional related factors which markets at least should take into account. First, in early 2008 the Sixth Pay Commission is expected to submit recommendations on central government and military pay. The Pay Commission's previous report in 1997 resulted in a one-step 31% salary hike.[2] Figure 1 illustrates the fiscal slippage which followed the implementation of that recommendation. Second, the Indian government is currently subsidising imported oil to hold the price in-market at $50pb. The authorities have committed not to ease the subsidy in the foreseeable future despite rising world oil prices. We believe sustained slippage in fiscal consolidation would put at risk the government's ability to meet its projected share on infrastructure spending; similarly with health care, education and rural development central to India's quest for more

[1] *The points outlined in this article are explored in considerably greater depth in our Report "India: Everything To Play For" which was published in October 2007.*
[2] *The Pay Commission's recommendations are not binding on the state authorities; but, generally, the individual states do follow them.*

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inclusive growth. Furthermore, we believe it risks crowding out the private sector, stymieing its ability to drive economic growth when India is rapidly reaching the point where more government/policy facilitation is needed, rather than less.

…And Monetary Challenges

Although the government and the Reserve Bank of India (RBI) did an admirable job countering inflation this year – and although retaining the oil subsidy arguably helps keep inflation in check – fiscal largesse could complicate the RBI's task in managing what we anticipate will continue to be significant capital inflows, as follows:

"Like most Asian countries, India faces the 'impossible trinity'. This holds that, at any given time, a country can have a combination of only two of three conditions: a fixed exchange rate, an open capital account and an independent monetary policy. With the rupee still a managed float and the capital account *de facto* open, the… strategy of raising interest rates to tackle liquidity risks attracting even stronger capital inflows. We believe this poses a policy dilemma for the RBI because letting the rupee appreciate risks crimping export competitiveness, while resisting rupee appreciation can compromise the autonomy of monetary policy and raise the risk of excess liquidity fuelling asset price bubbles."[3]

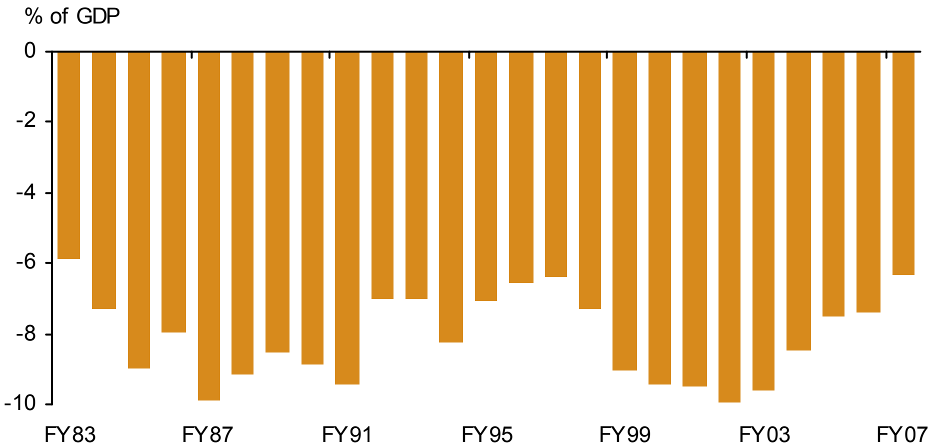
After The Votes Are Counted

Whatever its timing, we expect the next general election to be surrounded with political uncertainty consistent with the – often protracted – difficulties inherent in predicting an election outcome and consequent policies where the leading party has to negotiate with several other smaller parties to establish a government, as has become the norm in India. That said, as things stand, we judge that – India's propensity for "revolving door" politics notwithstanding – the INC is probably favourite to retain power and form the next government (albeit with probably no more than around 25% of the total vote). In that event, markets will look to see Manmoham Singh retained as prime minister; or, failing that, the promotion of someone with an equally sound grasp of economics. But there will almost certainly be pressure from some of the INC's probable coalition partners to be given a turn at the top job in government – with some possible candidates likely to be perceived as negative for reform prospects.

Nevertheless, we judge that India's political classes are seized of the boost to growth which structural reforms have brought in the past two decades in particular; and that continuing with those reforms is essential to sustaining – and even boosting – growth consistent with the drive to more inclusiveness in India's success story. In sum, that:

"India's economy is nearing an important inflexion point. It has the potential to raise its economic growth rate to 10% or so over the next decade. In realising that goal, continued structural reforms and prudent macro policies will be critical. India therefore has 'everything to play for'."[4]

Figure 1: General government's consolidated fiscal balance



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Source: CEIC, RBI and Lehman Brothers research.

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[3] *See our Report "India: Everything To Play For", Lehman Brothers 2007, page 45. Based on the challenges facing the RBI, the Report forecasts rupee appreciation to INR33 = US$1 over the next five years coupled with India's foreign exchange reserves swelling to US$900bn over the next decade.*
[4] *Ibid, page 90.*

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