Asia Ex-Japan Comment

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India: GDP is taking off, but symptoms of overheating are rising

- The government's preliminary estimate is that GDP grew by 9.2% y-o-y in FY ending March 2007, stronger than expected.

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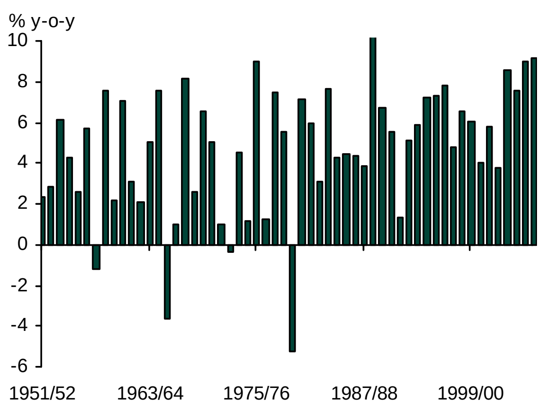
The Indian government released a preliminary estimate, showing GDP grew by 9.2% y-o-y in the financial year 2006/07 (April 2006 to March 2007), faster than expected (Consensus: 8.6%, Lehman 9.0%), and the fastest pace in 18 years (the second fastest pace on record) (Figure 1). The breakdown by industry shows that GDP growth in financial year 2006/07 continues to be led by services (banking, insurance and real estate +11.1%, trade, hotels and transport +13.0%) and manufacturing (11.3%). However, output in agriculture, which still employs over half the workforce, continues to languish, rising by just 2.7%.

India's economy is reaping the rewards from market-opening reforms undertaken since 1991, and a middle class is fast emerging in the cities, which is buoying domestic demand. However, the concern is that demand is running ahead of supply, creating bottlenecks. This is because essential reforms have been neglected, including the lack of physical infrastructure, shortages of skilled labour, an inflexible labour market and weak government finances. As a result, symptoms of overheating are emerging: wholesale price inflation has risen to over 6% y-o-y, credit is growing at about 30%, and India is the only Asian country whose current account has slipped into deficit (about 2.5% of GDP in 2006).

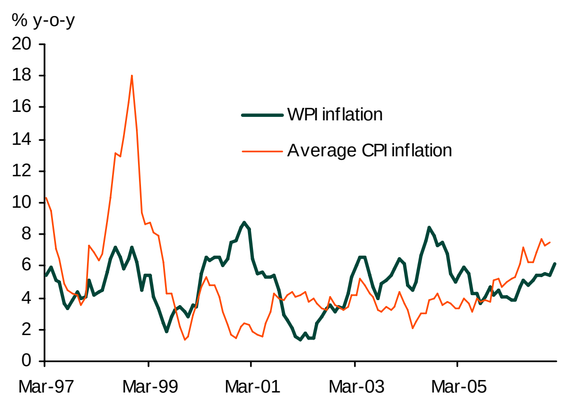
We doubt that India's policymakers (and politicians) want to end this demand-driven boom, as robust growth is needed to pull over half the population away from being close to, or below, the poverty line. We expect interest rates to rise by a further 75bp this year, but only in line with inflation, keeping real rates very low. So our base case is that India's economic boom will continue, with growth around 10% in financial year 2007/08, probably outpacing China's growth rate. However we also expect demand to continue to exceed supply, causing rising inflation, financial imbalances and, possibly, asset price bubbles. All this is likely to lead to increasing question marks over the sustainability of India's double-digit growth.▪

Figure 1. India's GDP (% y-o-y)



Source: CEIC and Lehman Brothers

Figure 2. Measures of Indian inflation (% y-o-y)



Source: CEIC and Lehman Brothers

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