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Stepping up structural reform?

- **Pace of reform may disappoint an expectant audience**
- **Left of Congress party and debate over the appropriate economic model imply a cautious approach will continue**
- **Significant labour market reform remains unlikely**

Now that the dust has settled after India's surprising general election results, we can consider the prospects for reform. With the Congress-led government in a far more comfortable position in Parliament, many expect the pace of change to pick up. Such optimism no doubt helps to explain the post-election leap in Indian markets.

But before we all get too carried away, a couple of observations are worth making. First, while the Prime Minister and many of his cabinet are reform-minded, Sonia Gandhi and her son Rahul are also crucial to decision-making, and they stand to the left of the Congress party. We suspect their priority is not so much business and financial-sector change as promoting the welfare of the hundreds of millions of people in rural areas and the urban poor. Many attribute the party's electoral success to measures such as the farm loan-waiver scheme and the rural workers employment-guarantee programme.

Second, in view of the acute problems in the West, a global debate is taking place over the merits of a highly liberalised financial system. During the election campaign, many in the UPA coalition suggested one reason India had outperformed during the worldwide recession was precisely because it hadn't liberalised as much as some, but had maintained a large state-owned banking sector and limits on foreign investment in certain areas.

This is not to say the government will ignore reform during its next five-year term. But it is likely to remain slow and cautious, in our view. In particular, we would be surprised to see labour-market changes intended to make it easier to hire and fire workers. Greater privatisation and cuts to government bureaucracy would provide a much-needed boost to government revenue, but they may be considered a step too far for now. That raises the question of how the huge budgetary shortfall will be addressed. So far, the new finance minister, Mr. Mukherjee, has argued things will look better once the recovery gets under way. He is correct, of course, but recent events have taught us the country doesn't have just a cyclical budget problem – it has a structural one as well.

Robert Prior-Wandesforde*
Economist
The Hongkong and Shanghai Banking Corporation Limited Singapore Branch
+65 6239 0840
robert.prior-wandesforde@hsbc.com.sg

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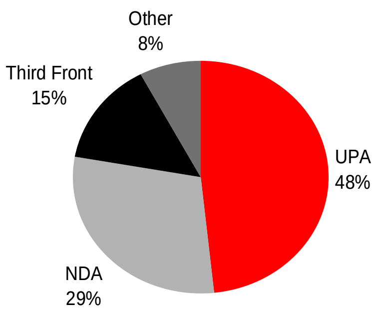
Indicators & forecasts

Indicator watch

UPA victory: Percentage of Parliamentary seats won

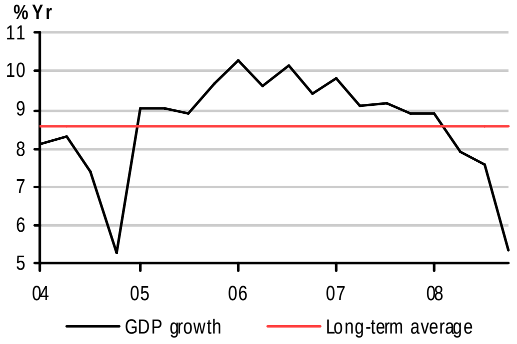


Source: HSBC

General election

- India's general election saw the governing United Progressive Alliance (UPA) coalition gain 262 seats in the Lok Sabha, up 79 from the 2004 election and just 10 seats shy of an overall majority. The UPA has subsequently gained the support of several other parties, giving the Congress-led government 322 seats in total and an extremely comfortable position. This bodes well for political stability in the country.
- The main loser was the so-called Third Front, which included the communist parties. The group won just 79 seats – down 30 from the last election.
- The BJP-led National Democratic Alliance (NDA) won 159 seats, compared with 176 in the last Parliament. That was well below the number suggested by exit polls which had indicated a close result between the UPA and NDA.

Government will try and re-invigorate growth...

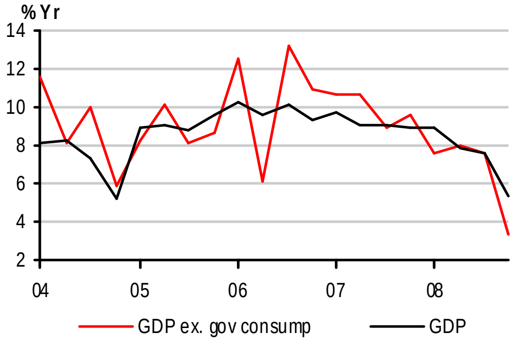


Source: CEIC

GDP growth

- Indian real GDP growth averaged 8.6% during the five years of the last Parliament. This is well below China's 11% rate but still impressive and the best period of growth the country has enjoyed since independence.
- The new government is, however, faced with the challenge of turning the economy around again, after growth slowed to 5.3% in the final three months of last year – matching the low of four years previously.
- A 5% growth rate is most unlikely to be enough to absorb the increase in the working population, which is expanding rapidly, thereby risking a sizeable and unpopular rise in unemployment.

...but without too much help from its own spending



Source: CEIC, HSBC

Government consumption

- If government consumption hadn't picked up, GDP growth would have been just 3.4% in Q4 2008, not 5.3%. With the budget deficit rising as rapidly as it is, however, the government will not be able to afford such increases in spending much longer.
- This highlights the dilemma facing the government – how to turn the economy around, while keeping a lid on the fiscal shortfall.
- It will be important to see how the issue is tackled in the budget, which the finance minister has said will be announced in the first week of July. Too much in the way of giveaways would lead to a further sell-off in the bond market as well as threatening India's sovereign credit rating. Too little and the government may stand accused of failing to fulfil its election promises. Mr. Mukherjee has an unenviable job.

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Forthcoming economic indicators

For the 2 weeks commencing 1 June

Date	Indicator	Previous	HSBC f'cst	Comment
1	Exports (Apr)	-33%	-28%	Despite a difficult base effect, we look for an improvement in export growth to -28% following the largest year-on-year contraction on record in March. Some hope is given by the up move in the PMI (see below)
1	Imports (Apr)	-34%	-30%	Imports have been falling even faster than exports thanks largely to the collapse in commodity prices
1	Trade balance (Apr)	-USD4.0bn	-USD5.9bn	January, February and March have all shown year-on-year improvements in the trade balance and April is likely to continue the trend. The country's trade deficit has clearly peaked
1	Manufacturing PMI (May)	53.3	54.0	India's manufacturing PMI jumped decisively back above the 50 boom/bust line to 53.3 in April. We expect more limited progress in May to 54.0
12	Industrial Production (Apr)	-2.3%	-0.5%	The dismal 2.3% decline in March industrial production may prove the low point for the current cycle. We look for an improvement to -0.5% in April and a move into positive territory from May

Source: Bloomberg, Indian Ministry of Statistics

Key economic forecasts

- The second half of 2009 should see an improvement in the ex-agriculture economy reflecting the combined effects of a regional trade recovery, India's fiscal impetus, sharply weaker commodity prices and higher oil and gas output.

- The collapse in commodity (particularly oil) prices has already driven headline wholesale price inflation close to zero and we expect it to remain low in the short term before moving higher again in the final few months of the year. Consumer price inflation is proving more stubborn but has now peaked and is starting to close the gap with the WPI rate.

- Dr. Subbarao, governor of the RBI, has delivered 400bps of cuts in the cash reserve ratio since mid-September, taking it down to 5%, with the repo rate lowered by 425bps, also to 4.75% and the reverse repo by 275bps to 3.25%. We are looking for just one more 25bp reduction in the repo and reverse repo rates, coming after the June budget and assuming the latter is broadly neutral. With liquidity ample, the interest rate ball is more in the court of the commercial banks, with the central bank keen for them to pass on more of the policy rate cuts. We believe some success is likely.

HSBC Key Indian Economic Forecasts

% Fiscal Year	2008/09	2009/10	2010/11	Jul-Sep 08	Oct-Dec 08	Jan-Mar 09	Apr-Jun 09	Jul-Sep 09	Oct-Dec 09
GDP	6.5	6.2	8.0	7.6	5.3	5.5	5.3	5.6	6.8
Agriculture	1.1	2.7	2.6	2.7	-2.2	2.5	3.0	2.6	2.6
Industry	2.3	1.7	6.6	4.7	0.8	-1.2	0.2	1.2	2.0
Services	9.7	8.4	9.8	9.6	9.9	9.3	7.7	8.2	8.8
Budget bal (% GDP)	-6.3	-7.0	-6.0	-	-	-			
% Calendar year	**2008**	**2009**	**2010**	**Jul-Sep 08**	**Oct-Dec 08**	**Jan-Mar 09**	**Apr-Jun 09**	**Jul-Sep 09**	**Oct-Dec 09**
GDP	7.4	5.8	7.6	7.6	5.3	5.5	5.3	5.6	6.8
Wholesale prices	9.1	-0.3	3.4	12.5	8.6	2.9	-1.2	-2.1	-0.5
Consumer prices*	8.3	6.9	4.7	9.0	10.2	9.5	7.5	6.0	5.0
Trade bal (% GDP)	-10.6	-9.2	-8.6	-	-	-	-		
Current acc (% GDP)	-3.4	-2.4	-1.6	-	-	-	-		
Cash Reserve Ratio**	5.5	5.0	6.0	9.0	5.5	5.0	5.0	5.0	5.0
Reverse repo (%)**	5.0	3.0	4.0	6.0	5.0	3.5	3.0	3.0	3.0
Repo rate (%) **	6.5	4.5	5.5	9.0	6.5	5.0	4.5	4.5	4.5
10 year yield (%)**	5.3	6.5	7.3	8.7	5.3	6.5	6.5	6.5	6.5
INR/USD**	48.8	54.0	54.0	46.9	48.8	51.0	52.0	53.0	54.0

Source: HSBC. *Industrial Workers CPI. ** End-period rates

Disclosure appendix

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Issuer of report

The Hongkong and Shanghai Banking Corporation Limited Singapore Branch

21 Collyer Quay #03-01
HSBC Building
Singapore 049320
Website: www.research.hsbc.com

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Global Economics Research Team

Global

Stephen King
Global Head of Economics
+44 20 7991 6700 stephen.king@hsbcib.com

Stuart Green
+44 20 7991 6718 stuart1.green@hsbcib.com

Europe

Janet Henry
Chief European Economist
+44 20 7991 6711 janet.henry@hsbcib.com

Astrid Schilo
+44 20 7991 6708 astrid.schilo@hsbcib.com

Germany
Lothar Hessler
+49 21 1910 2906 lothar.hessler@hsbctrinkaus.de

France
Mathilde Lemoine
+33 1 4070 3266 mathilde.lemoine@hsbc.fr

United Kingdom
Karen Ward
+44 20 7991 3692 karen.ward@hsbcib.com

North America

Ian Morris
+1 212 525 3115 ian.morris@us.hsbc.com

Ryan Wang
+1 212 525 3181 ryan.wang@us.hsbc.com

Stewart Hall
+1 416 868 7523 stewart_hall@hsbc.ca

Global Emerging Markets

Philip Poole
+44 20 7992 3683 philip.poole@hsbcib.com

Wietse Nijenhuis
+44 20 7992 3680 wietse.nijenhuis@hsbcib.com

Asia Pacific

Qu Hongbin
+852 2822 2025 hongbinqu@hsbc.com.hk

Robert Prior-Wandesforde
+65 6239 0840 robert.prior-wandesforde@hsbc.com.sg

Frederic Neumann
+852 2822 4556 fredericneumann@hsbc.com.hk

Seiji Shiraishi
+81 3 5203 3802 seiji.shiraishi@hsbc.co.jp

Prakriti Sofat
+65 6230 2879 prakritisofat@hsbc.com.sg

Song Yi Kim
+852 2822 4870 songyikim@hsbc.com.hk

Christopher Wong
+852 2996 6917 christopherwong@hsbc.com.hk

Yukiko Tani
+81 3 5203 3827 yukiko.tani@hsbc.co.jp

Sophia Ma

Sun Junwei

Emerging Europe, Middle East and Africa

Juliet Sampson
+44 20 7991 5651 juliet.sampson@hsbcib.com

Kubilay Ozturk
+44 20 7991 6045 kubilay.ozturk@hsbcib.com

Alexander Morozov
+7 495 783 8855 alexander.morozov@hsbc.com

Murat Ulgen
+90 21 2366 1625 muratulgen@hsbc.com.tr

Simon Williams
+971 4507 7614 simon.williams@hsbc.com

Latin America

Jonathan Heath
Chief Economist, Latin America
+52 55 5721 2176 jonathan.heath@hsbc.com.mx

Argentina
Javier Finkman
Chief Economist, South America ex-Brazil
+54 11 4344 8144 javier.r.finkman@hsbc.com.ar

Ramiro D Blazquez
Senior Economist
+54 11 4348 5759 ramiro.d.blazquez@hsbc.com.ar

Brazil
Andre Loes
Chief Economist
+55 11 3371 8184 andre.a.loes@hsbc.com.br

Tatiana G Gomes
Senior Economist
+55 11 3371 8183 tatiana.g.gomes@hsbc.com.br

Mexico
Lorena Dominguez
Economist
+52 55 5721 2172 lorena.dominguez@hsbc.com.mx

Central America
Sergio Martin
Chief Economist
+52 55 5721 2164 sergio.martinm@hsbc.com.mx