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India seeks to shed ‘fragile five’ tag as economy improves

By Victor Mallet in New Delhi and James Crabtree in Mumbai

By some measures India’s supposedly fragile economy has rarely looked in better shape, as the politicians prepare for next month’s general election.

The rupee was trading near eight-month highs at Rs60.17 to the US dollar on Thursday morning in London, having clawed back about half of the losses it has suffered since May last year, when investors took fright at the likely effect of the “tapering” of the US Federal Reserve’s asset purchases.

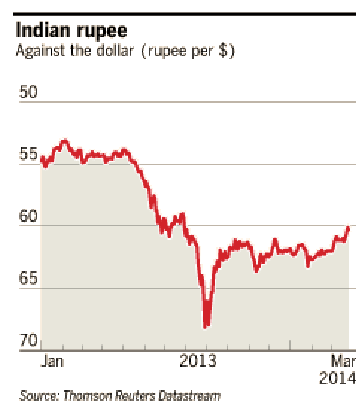
The benchmark Sensex stock index, meanwhile, closed above 22,000 for the first time on Monday, reaching a record 22,055.

Nor is good news visible only in volatile financial markets. Stubbornly high inflation is moderating, while the current account, the greatest source of anxiety during last year’s rapid devaluation, fell to just 1 per cent of gross domestic product in the three months to December, its lowest level in four years.

India’s redemption is related in part to a broader shift in market sentiment which has benefited all emerging markets. In Indonesia, the rupiah has strengthened significantly prompting Bambang Brodjonegoro, deputy finance minister, to argue earlier this month that his country deserved to shed its membership of the so-called “fragile five” club, which, alongside India, also includes Brazil, South Africa and Turkey.

Delhi’s improvement, however, remains striking. “Among the fragile five, India is now one of the least vulnerable,” says HSBC economist Leif Eskesen. “I don’t think we’ll get a rerun of what we saw last summer.”

Analysts agree that Indian stocks and the rupee have recovered mainly for two reasons.



First, investors predict that Narendra Modi, leader of the relatively business-friendly opposition Bharatiya Janata Party, will become prime minister, replacing the Congress-led coalitions that have governed for the past decade. Foreign portfolio investors in particular have poured money into the stock market, betting on higher economic growth and increased infrastructure investment of the sort seen in Mr Modi’s home state of Gujarat.

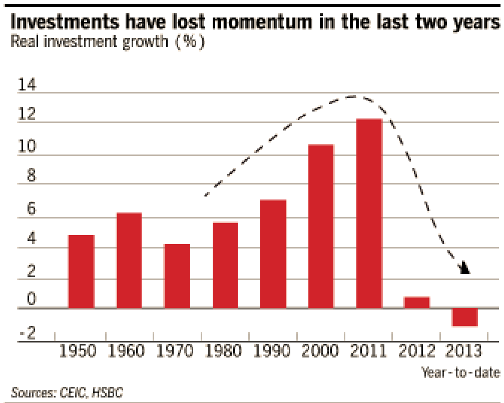
Second, the Indian economy seems to have hit the bottom and is now picking up. “Growth has bottomed out. Inflation has topped out. Interest rates have peaked,” Surjit Bhalla, managing director of Oxus Research and Investments, told the annual conference of the Confederation of Indian Industry this week.

This second explanation is favoured by Palaniappan Chidambaram, India’s finance minister. He argues that his own measures to cut the fiscal and current account deficits underlie the market rebound.

For all this investor euphoria, most analysts say India’s next government – of whatever hue – will have its work cut out to revive investment, keep inflation and interest rates down and relaunch long-delayed reforms to liberalise the economy.

In spite of recent improvements, growth is still below 5 per cent annually, its lowest level in more than a decade, while Indian banks are burdened by bad loans. Anxious bosses of heavily indebted companies complain bitterly about high interest rates and the current government’s reluctance to push ahead with infrastructure projects.

The main factor behind the slowdown has been a “slump” in infrastructure and corporate investment, which grew by just 1 per cent in the past two years against an average growth of 12 per cent over the decade, according to International Monetary Fund economists, Rahul Anand and Volodymyr Tulin.



Subir Gokarn, a former deputy governor of the Reserve Bank of India, says the rupee has been strengthened largely by measures to suppress gold imports and a strong inflow of foreign portfolio funds, while both the economy and the currency remain vulnerable to inflation, low capital spending and a lack of jobs.

He draws parallels between economic reforms launched during the 1991 balance of payments crisis and those he believes are needed in 2014, even if foreign exchange reserves back then fell to the critically low level of two weeks worth of imports, rather than seven or eight months today.

“We had to break through then, and we have to break through now,” Mr Gokarn said, pointing to the “structural bottlenecks” that are throttling the Indian economy.

It is likely to take months before even a sharp change of direction lifts India out of the mire. “The Indian economy is back on an even keel, but I don’t think there is much wind in the sails yet,” says Eswar Prasad of the Brookings Institution. “I suspect that some of this optimism is going to wither away too, unless there is a strong mandate for Mr Modi.”

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