India: Growth moderation extends into Q1 2011, GDP growth edges down to 7.8% yy

Growth surprises in Q1 2011 across most Asian economies, including China, Singapore, HK, Thailand and Taiwan, have been significantly positive. India's growth performance in Q1 2011 is in contrast to the broader picture of strong start to economic activity by most of Asia. India's GDP growth extended its trend of steady moderation, further into Q1 2011; clocking 7.8% yy, lower than consensus expectations of 8.2%. The latest outturn is very much in line with our expectations of 8.1% yy growth in 2011. On a seasonally adjusted quarter on quarter (QoQ) basis, India's GDP growth has edged down marginally to 1.91% in Q1 2011 as against 1.93% in Q4 2010. Growth had clocked an average of 2.1% QoQ seasonally adjusted in the first two quarters of last year.

The robust growth momentum in India over the first half of 2010 faced hiccups in the second half from domestic as well as external front. The domestic macro environment was clouded by several concerns such as political indecision on important issues due to parliamentary freeze, governance/ corruption related issues, issues on the environment and land acquisition front, regulatory delays, inefficiencies in the government's food procurement and distribution policy, problems in coal procurement and transportation, and delays in project clearances. These bottlenecks weighed on aggregate growth as they dogged down investment demand and fuelled price pressures in the food basket. An unfavourable global environment, amidst geopolitical risks in the MENA region, did not augur well for India's external sector as the Current account balance worsened in Q4 2010 due to surging oil prices.

These headwinds have gained traction since then, albeit at varying degrees. Containing high and sticky inflation has emerged as the most pressing concern for Indian policymakers as they endeavour to preserve the long term sustainability of India's healthy economic growth. Against the backdrop of high and volatile global commodity prices, an ultra hawkish policy stance combined with fiscal consolidation and regulatory bottlenecks points towards a mid-cycle moderation India's robust growth momentum over 2011.

However, we believe that while the ongoing adjustments within the Indian economy, both from the policy as well as regulatory perspective, will weigh on growth over the near term, they are critical for upholding a steady acceleration in India's long term trend growth rate. India still remains one of the fastest growing economies in the world. Notwithstanding the challenges, we do not expect growth to derail from the trend rate and believe that the underlying structural drivers of economic growth in India are strong enough to support a stable near trend growth outlook over the coming years. These long term drivers favourable demographics, a high savings and investment ratio, skilled labour, rapid urbanisation, rising income levels, and a dynamic corporate and financial sector.

Deciphering the growth dynamics:

A) Supply Side:

Growth continues to be hinged upon services sector performance:

- From a supply perspective, India's growth continued to be hinged largely upon the services sector, which contributed 5.0 percentage points (64%) to headline GDP growth in Q1. The sector grew by 8.7% yy in Q1 2011, a tad above 8.4% in Q4 2010, but still lower than average growth of 10.3% yy in the first three quarters of last year.

- Given the resumption of the fiscal consolidation process, services sector growth has ebbed down steadily over the past year, reflective of a lower contribution to services growth from community, social and personal services (a proxy for government spending) at 0.9 percentage points (pp) compared to 1.1 pp in Q1 2010. Still, the sub-sector grew by a higher rate at 7.0% yy in Q1 compared to 5.1% in Q4 2010. This wasnt a big surprise given that government spending is usually clustered towards the last quarter of the fiscal year ending in March. Relatively lower fiscal support was partly offset by strong growth in the trade, hotels, transport and communication segment (9.3% yy vs 8.6% in Q4 2010).

Industrial growth dogged down by sluggish investment activity:

- While the outlook on services remains relatively stable, that on industrial growth has been dogged down due to sluggish investment activity on account of regulatory issues, transportation delays, hurdles in project clearances, and governance/corruption related issues and increasing margin pressures amidst high input as well as borrowing costs. Industry growth has steadily decelerated over the past four quarters from 12.4% yy in Q1 2010 to 6.1% yy in Q1 2011. The manufacturing sector, which constitutes about 60% of Industry, depicted a marked downtrend from 15.2% yy in Q1 2010 to 5.5% yy in Q1 2011, driven partly by a high base effect. Over the same period, growth in construction activity (29% of Industry) has slowed from 9.2%yy to 8.2% yy.

- We expect industrial growth to moderate further in Q2 2011 on the back of high base effect along with prevailing concerns on the inflation and regulatory front. We expect industrial growth to recover gradually from Q4 2011 onwards on account of base effect, an improvement in overall regulatory environment, moderation in price pressures and a steady recovery in investment activity.

Agriculture growth to remain stable in 2011:

- Meanwhile, agriculture sector and allied activities posted 7.5% yy growth in Q1 (1.1% in Q1 2010), driven by a favourable base effect and higher winter crop produce. The sector contributed 1.1 pp to headline GDP growth in Q1. We expect agriculture growth to be relatively stable in 2011, based on the assumption of a normal monsoon.

Against this backdrop, we expect GDP industry to moderate in H2 2011 while services maintain there trend growth. On the agriculture front, we expect a growth to remain stable on the back of normal monsoon.

B) Demand Side

Urgent need to boost investment activity for sustaining high growth:

- Growth in gross fixed capital formation (GFCF), a better gauge for examining current trends in overall investments, declined noticeably in Q1 2011 to a snail’s pace of 0.4% yy compared to 7.8% in Q4 2010. While a high base effect weighed on investment growth in Q1 (19.2% yy in Q1 2010), the setback is also attributed to several bottlenecks, including project disputes and delays, parliamentary indecision on important policies, governance/corruption issues and inflation concerns. Contribution of investment demand to headline growth has seen a one-way downtrend since 2010; 73 in H1 2010, 37% in H2 2010 and just 3.6% in Q1 2011. This doesn’t not bode well for India’s overall growth outlook in 2011 given that high investment demand was a key enabler of India’s impressive growth during the 2003 to 2007 period, contributing about 71% to headline GDP growth in 2007.

- Looking forward, we expect the investment upturn to be delayed given ongoing concerns, but gradually reinstate its earlier momentum from the last quarter of 2011. With 2012 being the last year of the 11th five year plan, infrastructure spending is expected to pick up and there should be an improvement in the overall regulatory outlook over the next four quarters.

Private consumption growth remains robust:

- Meanwhile, private consumption expenditure gained 8.0% yy in Q1 2011 (8.6% in Q4 2010), contributing 55% to headline GDP growth. Consumer goods have been the dominant factor driving industrial growth in India since 2010, while capital goods growth has remained soft. We expect private consumption to sustain its ongoing growth momentum in 2011. Key factors driving private consumption in India going ahead are rising wage incomes in rural as well as urban India, greater government spending in rural areas, and wealth effect due to higher earnings from Gold holdings and a booming property market.

Support from government spending to be subdued amidst fiscal consolidation:

- As expected, government consumption supporting real GDP growth in Q1 2011 despite the resumption of fiscal consolidation process. Q1 2011 happens to be the last quarter of fiscal year ending 2011 and therefore benefits from higher government spending, which is usually clustered towards the last quarter of the fiscal. In addition, subsidy spending as well as pension payments under the third supplementary grant will help boost aggregate consumption albeit crowding out investments to a certain extent. However, from an overall trend perspective, we expect government consumption expenditure to be relatively subdued in 2011 given the Government's focus on fiscal consolidation, particularly on the expenditure front.

Strong external sector, a crucial driver of growth in Q1 2011:

- A steady improvement in India's trade balance has supported India's growth momentum post the crisis period. Net exports contributed 38% to headline GDP in Q1 2011, as exports grew at a fast clip of 25% yy, its strongest growth since September 2008. Imports posted a 10.3% yy growth in Q1 2011, weighed down by a high base effect. A closer look reveals that India's exports composition as well as destinations has changed over the past years. The composition of India's exports has shifted from traditional primary products and light manufacturing goods (textiles, leather) to capital intensive engineering good and petroleum products. This has been a key driver of robustness in India's exports in addition to governments fiscal stimulus measures. Composition of India's export destinations has also seen a shift over the recent years, away from the US and EU, to Middle East, Asia and other emerging market economies.

- The buoyancy in exports is expected to remain going ahead, albeit to a lesser extent than present, given the headwinds from both external as well as internal front apart from a high base.

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Chart 1: Growth continues to be hinged upon services sector performance

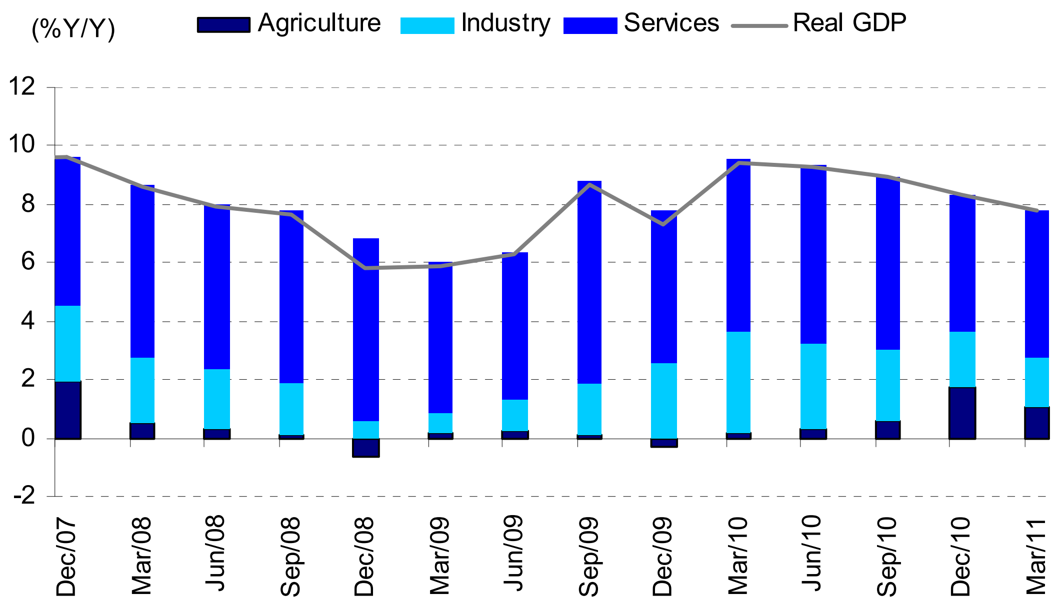


Chart 2: Urgent need to boost investment activity for sustaining high growth

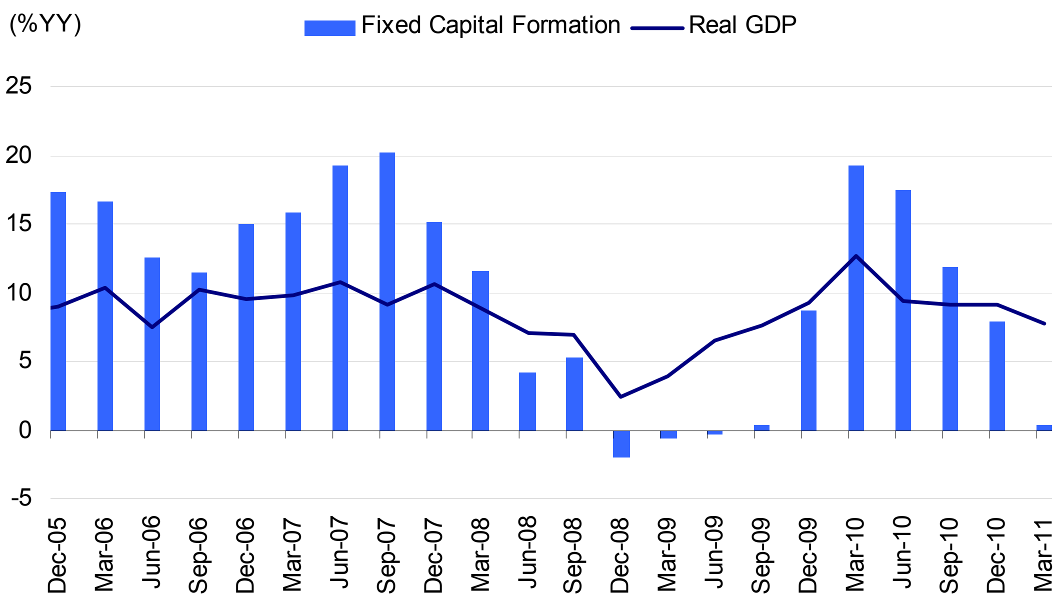
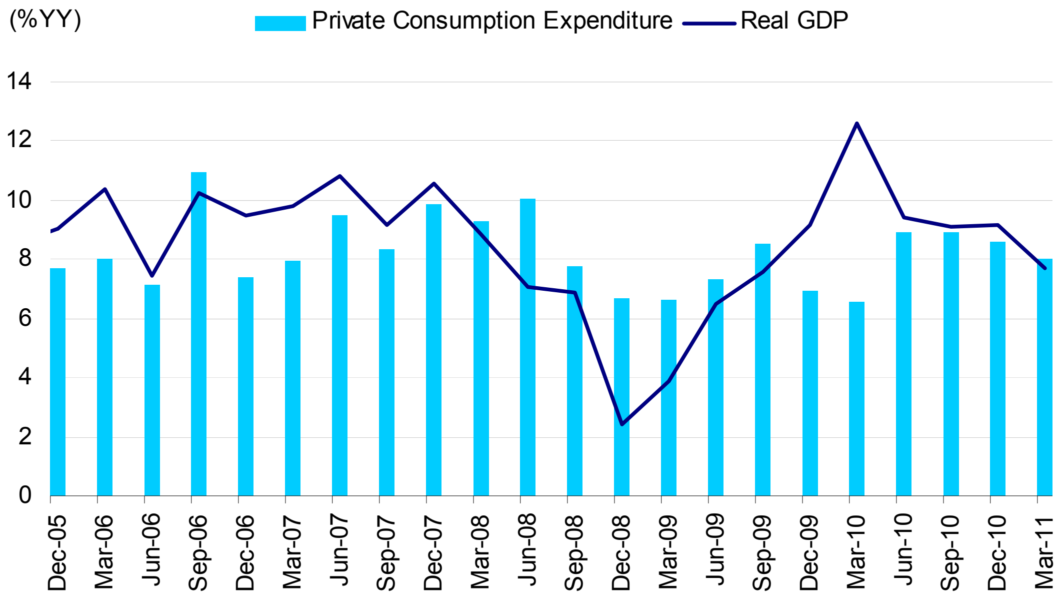


Chart 3: Private consumption growth remains robust



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