

A new government in India

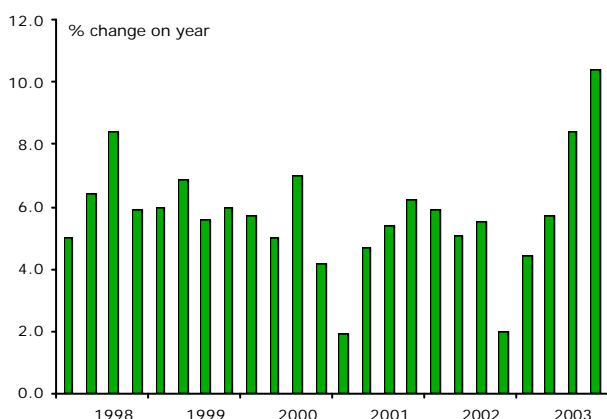
A more cautious approach to privatisation but economic reform is set to continue

The surprising election result in India and the replacement of a BJP-dominated coalition by one led by Congress has raised concerns about whether the economic reform process will be sustained. The new government has yet to reveal its economic priorities, but greater emphasis is likely to be placed on the needs of the agricultural sector and a more cautious approach to privatisation is expected. But over the medium-term the reform process is set to continue as offering the best prospect of boosting economic growth and raising living standards. India's growing importance in an integrating global economy is unlikely to be de-railed.

Background to the election

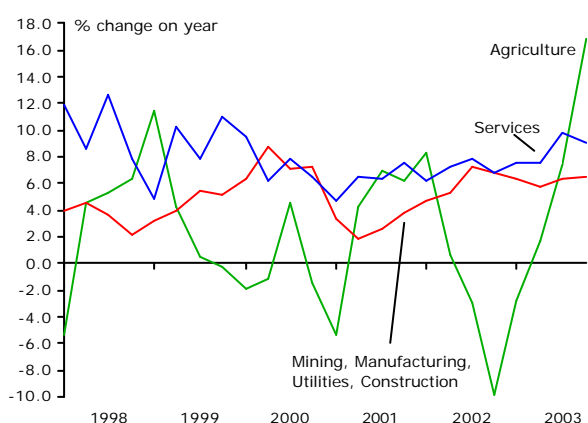
In the months leading up to the early general election in India in April/May 2004, most economic news was strongly positive. Annual real GDP growth rose sharply from 2.0% in Q4 2002 to 10.4% in Q4 2003, even faster than China's growth over the same period.

Strong GDP growth ..



Source: Datastream

.. is broadly based



Source: Datastream

The extremely poor result in late 2002 was mainly due to a sharp decline in agricultural output caused by bad weather and subsequent economic recovery also largely reflects much stronger agricultural

performance with output rising by almost 17% in the year to Q4 2004. However, while agriculture has been the main driver of strong GDP growth, the economic recovery has been broadly-based. Annual industrial sector growth has been fairly steady over recent quarters around 6-7%, while the services sectors have made a strong contribution with annual growth exceeding 9% in the second half of 2003.

Improved economic performance bolstered the confidence of the ruling coalition led by the nationalistic BJP party. The pace of economic reform has recently gathered some momentum and the government started extolling the benefits of its reforms to the electorate rather than generally keeping quiet about them. Prime Minister Vajpayee's initiative in making another attempt to improve relations with Pakistan also delivered results with improved transport and sporting links and fresh efforts to break the impasse concerning the future of Kashmir.

Prime Minister Vajpayee responded to the run of positive economic and political news by calling an early general election, several months before it was due. Its confidence was evident in the "India Shining" election campaign, but the election results reveal that this confidence was ill-founded with the campaign backfiring because it was judged as being exuberant in tone as well as far too smug. The campaign went down particularly badly with India's rural voters, most of whom have yet to see significant and lasting benefits from the recent improvement in economic performance. Living conditions for large parts of the rural population remain extremely tough with many lacking access to basic services, such as clean water, electricity and roads.

Election outcome

The outcome of the April/May 2004 elections for the 545-seat Lok Sabha, the lower house of parliament, is as follows:

Congress and its allies	216 seats
BJP and its allies	186 seats
Left parties	63 seats
Others	78 seats

The main left-wing parties, which secured their best-ever result, have pledged support for the Congress-led coalition, but will not actually join the government. Sonia Gandhi is supported by about a dozen centre and left-wing parties and the formation of a new government and her own appointment as prime minister appear imminent.

Outlook for Economic Reform

During the election campaign, most political commentators seem to have been swept along by the BJP's own confidence in its re-election. Most commentary focused on estimates of the likely scale of the BJP's victory and the increased political authority of Prime Minister Vajpayee within the BJP. A strong performance by the BJP was judged to be good for further and faster economic reform, while the moderate policies associated with Vajpayee himself were in the ascendancy over hardline nationalists within the party.

The view that a strong electoral performance by the BJP was good for further economic reform reflected the BJP's renewed enthusiasm for reform over recent months, including privatisation, and its efforts to promote the benefits of further reform. It also reflected the lacklustre attitude that Congress has generally displayed towards reform during its period in opposition, although whether Congress had become disenchanted with economic reform or was simply pursuing the usual role of the Opposition in opposing government reforms, at national and state level, is not clear. It does appear, however, that the view that Congress is necessarily bad for economic reform is rather simplistic. The economic reform process began under a Congress government in 1991 and it is worth remembering that during the politically unsettled period of the mid-1990s Congress was generally regarded as offering the best prospect of continued reform. There were lengthy periods during the BJP's own term in office that were characterised by a stop: start attitude towards reform.

It is likely to be some time before the new coalition government, led by Congress, sets out clear economic objectives. Congress will need to take account of the views of the left-wing parties that have pledged to support it. While these parties are not necessarily opposed to economic reform in all its guises, they are likely to be highly selective in their attitude to privatisation and will oppose divestment of profitable state businesses. They are also likely to be against long-overdue reforms that are needed to improve the flexibility of the labour market.

The new government is unlikely to overlook the major role that rural voters played in ousting the

BJP-led coalition. A key priority will be to deliver better services to rural areas. However, in order to create scope to increase spending on health and education, and to improve irrigation facilities, roads and other infrastructure, it will be necessary to raise additional government revenue, which will require tax reform, and to cut back heavy expenditure on defence. In this regard, it is encouraging that Prime Minister-elect Gandhi has quickly made it clear that better relations with Pakistan are a priority and that there has been a positive response from Pakistan. It is also possible that the new coalition, including the left-wing parties, will recognise that increased private, as well as public, investment will be vital to raising productivity in the agricultural sector and boosting farm incomes.

Congress recognises the need for reform to reduce the large fiscal with the general government deficit (which includes states and local governments, as well as the central government) close to 10% of GDP over recent years. Although Congress has not been specific about how it will reduce the deficit, it does accept the need for tax reform.

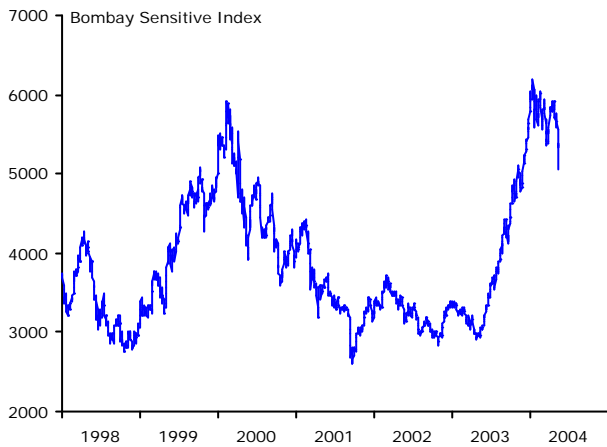
The new government is also likely to recognise the positive and potential role of foreign investment in bolstering economic growth and raising living standards, as the impressive performance of the services sectors in recent years, particularly the highly-competitive financial services and IT-related sectors, has clearly demonstrated the benefits of increased global integration to the Indian economy.

Building political support

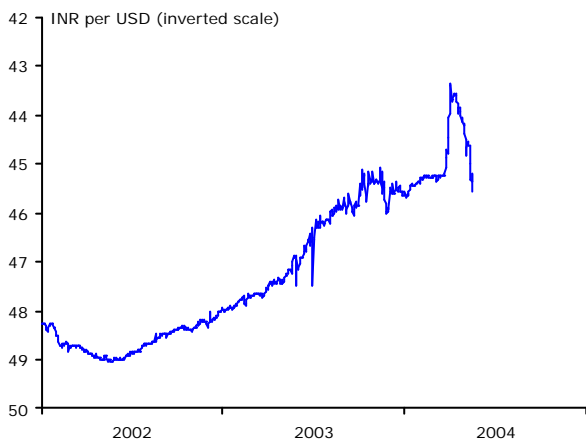
The political inexperience of Sonia Gandhi may be reflected in weak or indecisive government that initially seeks compromise in order to preserve its political support. The new government is likely to emphasise its determination to improve poor living conditions in rural areas and the need to reduce social and economic inequalities. It is quite likely that it will adopt populist policies to try to further these aims, but it also recognises that faster economic growth is necessary to tackle such problems and that, in turn, further reform will be needed to raise GDP growth from its recent path of 5-6% per annum to, say, 7-8% per annum.

If smaller parties within the new coalition oppose further economic liberalisation on principle, then Congress is likely to look for, and eventually find, political support elsewhere as there is broad support for economic reform across the political spectrum. If Congress itself opposes reform, or adopts a lukewarm attitude to it, then economic performance is likely to falter and its term in office is likely to be short-lived.

The stock market is worried about slower privatisation and economic reform



.. and the rupee has also fallen



The next few weeks are likely to be nervous times for financial markets in India. The pace and shape of the reform process will be closely re-examined and the new government is likely to adopt an even more cautious approach towards privatisation than its predecessor displayed during most of its tenure. It is only since early 2003 that the privatisation programme finally developed some momentum. A cautious and unenthusiastic attitude towards privatisation is likely to have an adverse impact on foreign investor sentiment towards India over coming months. But over the medium-term the reform process is set to continue as offering the best prospect of boosting economic growth and raising living standards. India's growing importance in an integrating global economy is unlikely to be de-railed.

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