



Talking point



India's elections: Smaller parties will shine, but the economy may suffer

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This is the year of the small party. Although coalition politics have long been the norm in India, Congress and BJP have often been the power-brokers. Their dominance is currently being tested by the new strength of regional and ethnic parties. Pre-poll surveys showed that both Congress and BJP are expected to win fewer seats than in previous elections. In addition, their traditional allies have defected and are awaiting post-poll results before deciding any coalition allegiances. Thus, the stage is set for an unusually large and especially weak coalition government. This would be a disappointing outcome for both investors and markets. A new government built of too many parties with varied and specific interests will make it difficult to build consensus and create an economic agenda.

The emergence of a non-BJP or Congress government is an unlikely, but certainly possible outcome. A group of smaller parties, including the Communist Parties, has already banded together and called itself the 'Third Front'. Mayawati, the famous champion of the lower castes and leader of the Bahujan Samaj Party, has held off from making any alliances thus far, but she is expected to join any group (including this Third Front) if she has the potential to become Prime Minister. If such a group of smaller parties forms the next government, this would likely have a negative effect on the economy. These parties have few common interests to fall upon in formulating policy and the communist parties have generally opposed liberalization efforts such as de-regulation and privatization.

In our view, it is more likely that either the BJP or Congress will come back into power and preside over a tenuous coalition. Pre-poll indications gave Congress a slight lead. The two parties are not expected to differ significantly on economic plans. Both are likely to continue populist measures such as subsidized food and fuel for the poor and move forward with some measured liberalization policies.

Given that opinion and exit polls are banned during the election cycle (which runs from April 16 to May 13), the momentum of individual parties is difficult to gauge during this period. The key period to watch will be after the polls between May 16th and June 2nd, when alliance bargaining takes place to form the next government.

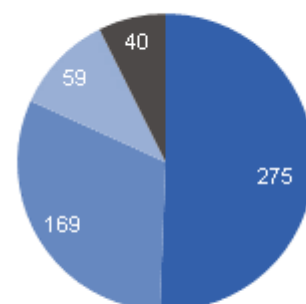
Once formed, the government must deal with several key issues, the most pressing of which is the economic slowdown.

The government must choose between additional stimulus measures or other solutions such as creating more private partnerships, attracting more foreign investment, etc. If it uses stimulus measures, the government must weigh the benefits of additional spending against the risks from further increasing the deficit and adding to public debt (estimated above 10% and 75% of GDP respectively). Similarly, the benefits of monetary measures such as interest rate cuts would need to be measured against the risks of increasing inflation. Although wholesale price data has fallen in recent weeks, consumer prices still remain high.

The second key issue is foreign investment reform. Although foreign inflows can boost growth and provide needed capital, potential outflows leave local industries vulnerable to refinancing issues and liquidity shortfalls. In light of the global crisis, the current government is now being praised for its caution, given that portfolio flows have flooded out of emerging markets in recent months. Going forward, the new government must decide whether to create new policies to attract inflows and if so, what is the appropriate timeline for investment liberalization.

Current composition of Parliament

Number of seats out of total of 543



- United Progressive Alliance (Congress)
- National Democratic Alliance (BJP)
- Left Front
- BSP & Others

Source: Financial Times

The third concern is infrastructure. Though this is a long-term issue, it is important for the government to tackle the matter immediately to lay the right foundation for growth. Improved physical infrastructure is essential to draw in foreign investment and enable local companies to thrive.

These are no small tasks. Even for a strong government with clear policy goals, preparing the right responses to the slowdown and formulating regulations take time. If the new government is a fractious coalition with various vested interests, moving forward on these critical economic issues could become a Herculean task. For now, we must wait until the polls close and the bargaining begins.

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