India – GDP Update (Sept Qtr 2013)

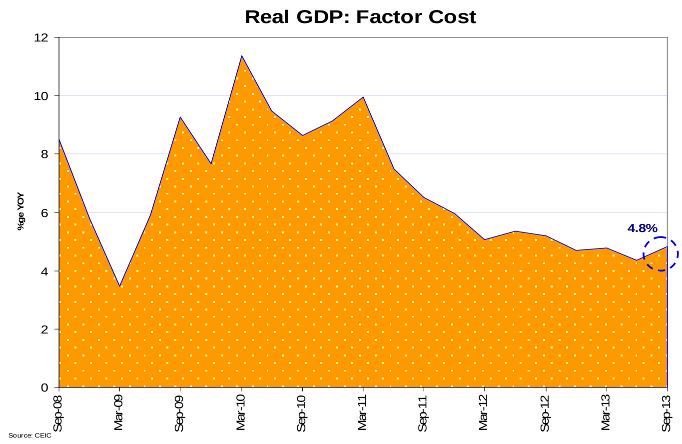
National Australia Bank

- **Indian growth accelerated to 4.8%, in year ended terms, in the September Quarter, up from 4.4% in the June quarter.**
- **An improvement in the agricultural sector (up to 4.6% from 2.7%), due to a favourable monsoon season, helped drive the improved outcome. The industry sector moved into positive territory (1.6% from -0.9%) owing to a surge in electricity production. Services decelerated (5.8% c.f. 6.2%) on account of a slowdown in the government-supported Community services, although Financial services expanded.**
- **By expenditure, Net Exports was the standout, and contributed 70% to growth. Both consumption (mainly private) and investments contributed positively, albeit to a much lesser extent than Net Exports.**
- **There was a sharp increase in exports of refined fuel products; conversely, gold imports fell steeply due to Government and RBI restrictions.**
- **An improvement in the trade balance and improved service sector receipts led to the Current Account Deficit contracting to a low of -1.2% of GDP. When combined with the USD34Bn of inflows stemming from the RBI's Concessional Swap facilities for FCNR (Foreign Currency Non Resident) deposits and Banks' Overseas Borrowings, external vulnerabilities have lessened considerably.**
- **Reflecting improved confidence in the External situation, the RBI has also withdrawn the Swap window offered to Oil Marketing companies, although it has left open the possibility of resuming this facility in exceptional circumstances.**
- **NAB Economics has raised its growth forecasts following the September Quarter GDP result. We are now forecasting a 4.7% expansion in 2013, followed by a stronger 5.1% outcome in 2014.**
- **Improved agricultural production and net exports should be supportive of growth, whilst tight fiscal and monetary policy would provide headwinds.**

GDP Production and Expenditure

The Indian economy accelerated in the September quarter, expanding 4.8% over the year to September 2013, outpacing the 4.4% expansion over the year to June 2013. Whilst a sub 5% number, this is a welcome improvement from the situation in July-August when an unenviable combination of weak growth, deteriorating external accounts and a currency in freefall generated heightened pessimism about the state of the Indian economy.

Indian GDP



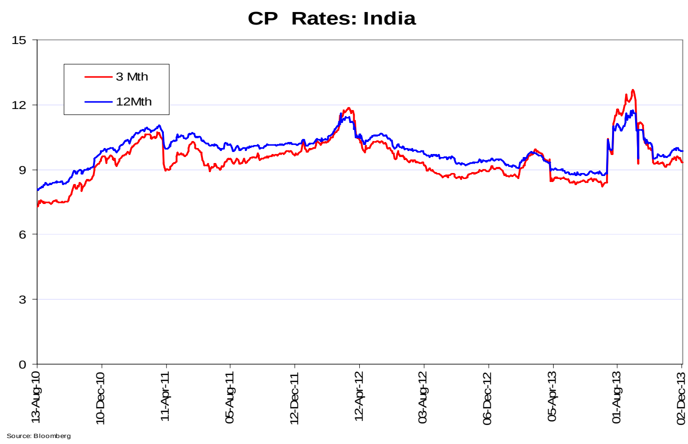
GDP (P): By Sector

By sector, the most significant development has been the improvement in the Agriculture sector, which accounts for 17.6% of GDP. Over the year to September, Agricultural production accelerated to 4.6%, up from 2.7% in the June quarter, and is the strongest outcome since June 2011. The results have been driven by a favourable monsoon season, resulting in an increase in the kharif (monsoon) crop output. Industry moved into positive territory, up 1.6% (c.f. -0.9% contraction over the year to June). Electricity production (7.7%) was the standout in the industry sector, with manufacturing marginally positive and mining marginally negative, although both these 2 sectors improved from the June quarter.

The Services sector decelerated to 5.8% (from 6.2%), driven by a sharp deceleration in the Government-supported Community, Social and Personal services sector: it fell from 9.4% in the June quarter to 4.2% in the September quarter. Against that, Financial services rose to 10%, up from 8.9% in the June quarter.

Construction recorded a modest improvement, and the Trade & Hospitality sector was broadly steady. The increase in financial services can be traced to the very high Commercial Paper rates, which deterred firms from issuing their own paper, and compelled them to resort to short-term borrowings from banks over the July-September period.

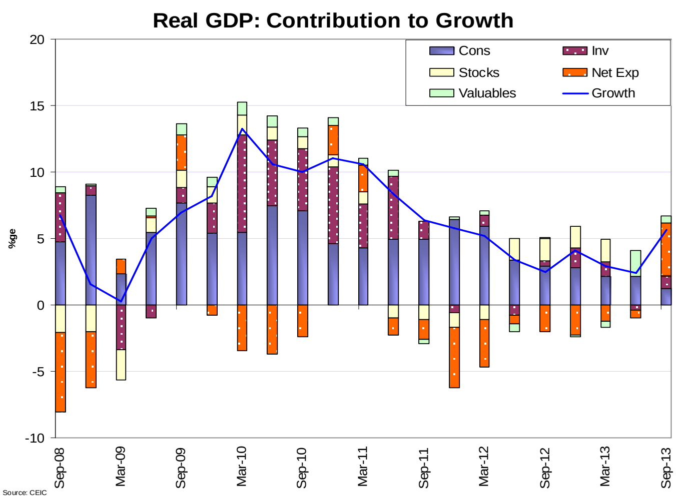
Commercial Paper Rates



By expenditure, GDP at Market prices (including taxes, less subsidies) surged to 5.6%, up from 2.4% over the year to June. Net exports contributed a touch over 70% of GDP in the September quarter, as exports expanded by 16.3% over the year to September Quarter, against a restrained 0.4% expansion in imports.

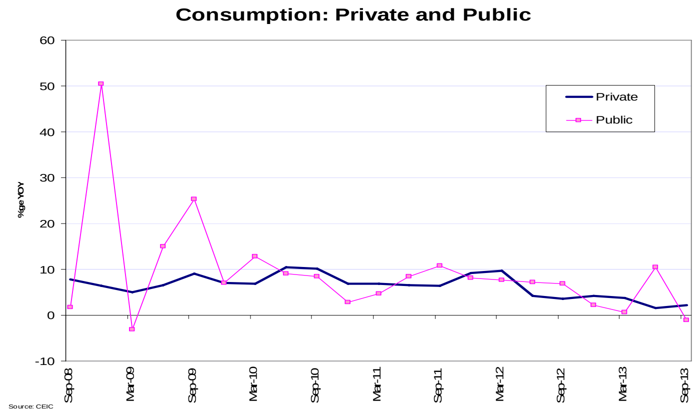
Consumption and investment also contributed positively, albeit significantly less than the contribution from net exports. The net exports result clearly reflects a strong improvement in exports, driven, in part, by favourable currency movements, combined with import-restraint as a result of weak domestic demand.

GDP Contribution by Expenditure



Consumption expenditure revealed some divergent trends: Private consumption expenditure increased by 2.2% over the year to September 2013; however, public consumption fell by -1.1% over the same period. The weakness in public consumption broadly mirrors trends in the Services sector, particularly the weakness in the Community services segment.

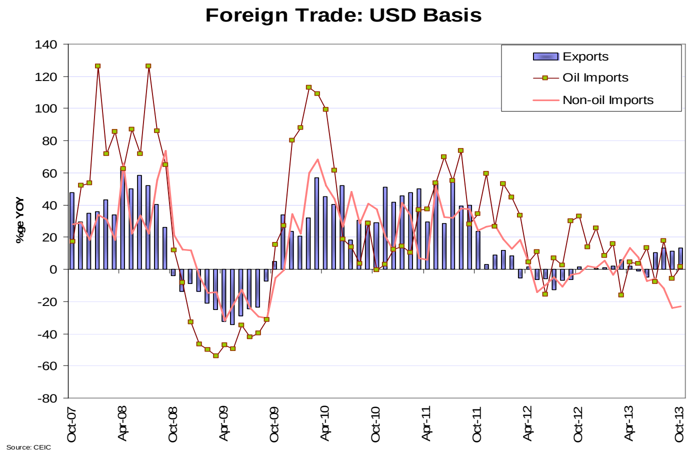
Private and Public Consumption



Foreign Trade: A Closer Look

On a US-Dollar basis, exports rose by 13.5% over the year to October, 2013. Conversely, imports contracted by -14.5%, driven largely by a -22.8% decline in non-oil imports. Oil imports rose by 1.7%. Taken together, these numbers led to a -47.8% compression in the trade deficit for the month.

Foreign Trade



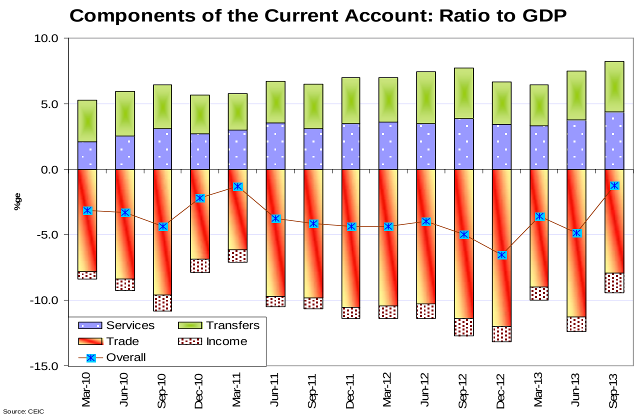
Looking more closely at the trade data from the Commerce Ministry over the April-October period, production of refined fuel products (the largest contributor to exports) rose by 11.6%; transport equipment by 11.1%; cotton yarn by 26.4% and plastic and chemical products by 11%. Whilst India is an importer of crude, it is also an exporter of refined fuel products. There have been recent additions to refining capacity such as BORL refinery in Bina, Madhya Pradesh and HMEL in Punjab. Leading exports of refined Crude products include: Reliance, HPCL and Essar Oil.

On the imports front, there was a -20.9% contraction in gold imports due to higher import duties and import restrictions. Machinery imports also contracted sharply, reflecting weaker domestic demand in the Indian economy.

Top 5 Exports

An improvement in the trade balance, combined with an expansion in services exports (largely computer services), drove a sharp improvement in the Current Account Deficit (CAD). In the September quarter, the CAD fell to a historic low of -1.2% of GDP, a marked improvement from the June quarter (-4.9%), and a significantly better outcome than the very high CAD (-6.5%) in December quarter 2012, when serious questions were raised about the sustainability of India's external position. *These positive results should lead to a well contained outcome for the Current Account during the 2013-14 fiscal year*.

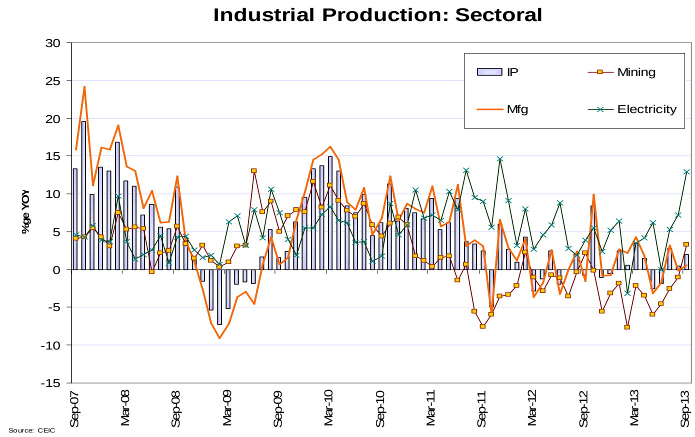
Current Account Deficit



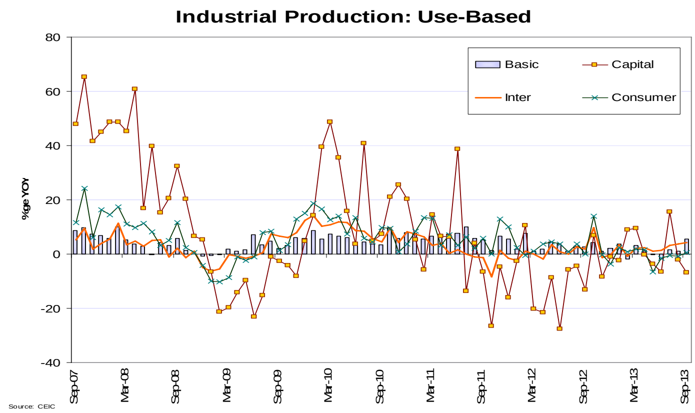
Partial Indicators

Partial indicators paint a mixed picture for the Indian economy. Over the year to September, 2013 industrial production expanded by 2%, driven largely by a 12.9% increase in electricity production. Manufacturing and mining recorded modest improvements. By use, the fall in volatile capital goods production (-6.8%) was disappointing, and reveals that investment spending is yet to gain traction. Consumer durables reversed the previous months' contraction to record a modest, positive outcome for the month. Intermediate goods production – a measure of downstream demand –grew by 4.1%, the highest for the year. <u>The intermediate goods segment has been the best-performing component of industrial production by use, and indicates there remains growth potential in the economy, although it has yet to be realised on a consistent basis</u>.

Industrial Production: Sectoral

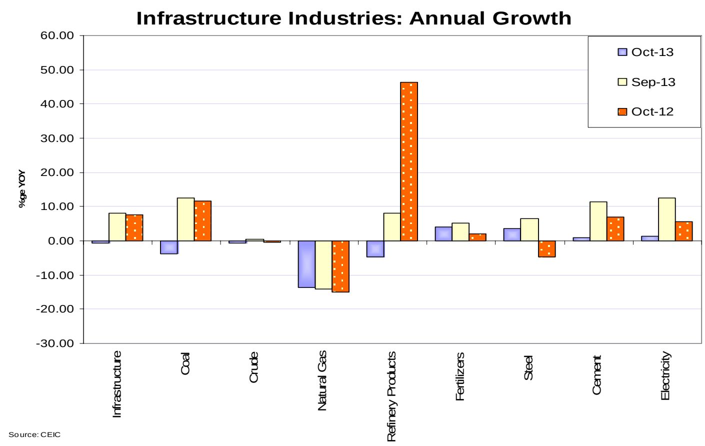


Industrial Production: User-Based



The performance of the 8 Infrastructure sectors for October was disappointing, although was impacted somewhat by 'base effects'. It contracted by -0.6% over the year to October, 2013, although this follows from a strong outcome in October 2012, when the sector expanded by 8%. This time around, weakness was concentrated in mining and energy related sectors (e.g. coal, natural gas). Other segments such as steel, cement, fertilizers recorded a modest upturn.

Infrastructure Sector Growth



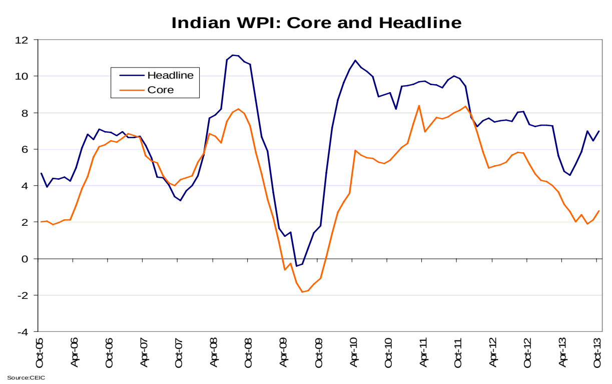
One bright spot has been the positive reading for India's manufacturing sector, as revealed by *HSBC's Manufacturing PMI for November.* It rose to 51.3 in November, up from October's 49.6. A reading of 50 or above indicates an expansion. Among the positive indicators from this reading was an improvement in the domestic new orders segment as well as levelling off in both input and output costs.

Inflation

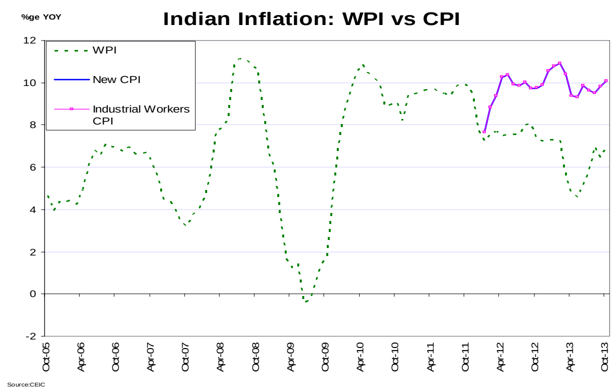
Inflationary pressures resurfaced in October, with the Wholesale Price Index rising by 7% over the year, the fastest pace since February 2013. This was largely driven by rises in food prices (18.2%), particularly vegetable prices (78.3%); and rises in fuel and power (10.3%), driven largely by surging electricity prices (23%). Non-food manufactured inflation (Core inflation) also gained momentum, up from 2.1% in September to 2.6% in October.

Consumer Price inflation too accelerated, to 10.1% over the year to October. The CPI places a higher weight on food than the WPI and also includes non-tradeables such as housing, transport, education and healthcare, and is a more relevant indicator of costs actually faced by consumers. The RBI is likely to keep monetary policy tight in order to rein in inflationary pressures. It is also expected to launch Retail-inflation linked bonds in late December, which will pay a coupon based on the CPI in the previous quarter, with an additional 1.5% added on. The interest will be compounded on a half-yearly basis and added to the principal at maturity. These products are aimed to protect consumers from inflation, and reduce their reliance on products such as gold.

Headline and Core inflation



Wholesale and Consumer Inflation



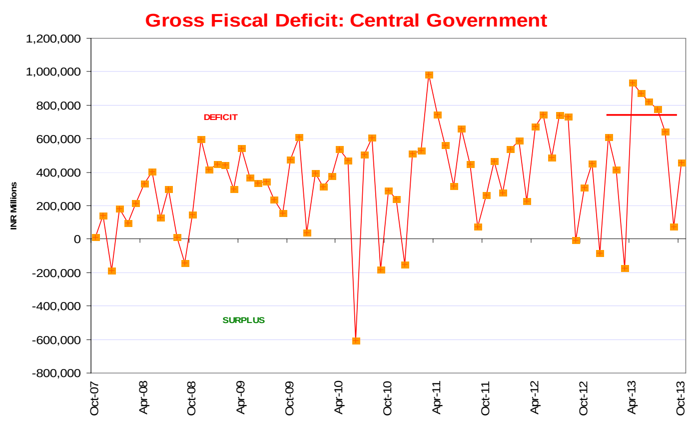
Fiscal Policy

The Central Government's *Gross Fiscal Deficit* swelled to INR 4.57 trillion over the April-October period, 84% of Budget Estimates for the 2013-14 fiscal year. Higher expenditure and weaker revenues due to a slower economy have been responsible for this result. The wider deficit over the April-July period is evident in this fiscal year, compared with the previous fiscal year (2012-13).

The Finance Ministry has committed to maintaining a 4.8% deficit target for the fiscal year. However, this will be difficult to achieve in the absence of expenditure cuts. It is expected that non-Plan (e.g. Subsidies) expenditure will be cut by 10%; however, Plan Expenditure (agreed by the Planning Ministry) too will need to be restricted.

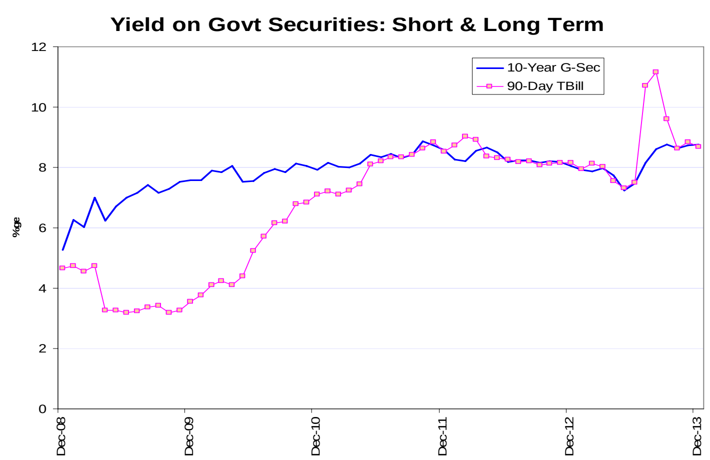
Restrictive fiscal policy settings will be difficult to achieve in an election year. Further, with the economy below potential, fiscal drag will likely weigh on growth. The Government is likely to seek dividends from Public Sector undertakings and banks and request surplus monies to be transferred from the Reserve Bank in order to boost its coffers.

Gross Fiscal Deficit



At the time of writing, India's 10 year bond yields were trading at 8.77%, and the 90-Day T-Bill at 8.69%. Broadly, this is indicative of a flat yield curve, in sharp contrast to the situation around August, when the exceptional liquidity measures adopted by the RBI led to a highly inverted yield curve.

Government Short and Long Term Rates

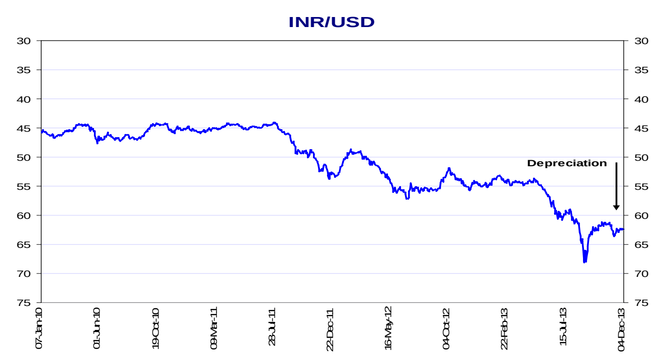


External and Financial

The Indian Rupee has been trading around 62/USD. The RBI has now withdrawn the special swap window that it provided for oil marketing companies. It has suggested they smooth out their daily FX demand through the use of FX Forwards as well as using revolving lines of credit from banks. It has, however, indicated that it will be willing to resume the swap facility on those 'rare' occasions, when there is a sudden 'spurt' in demand.

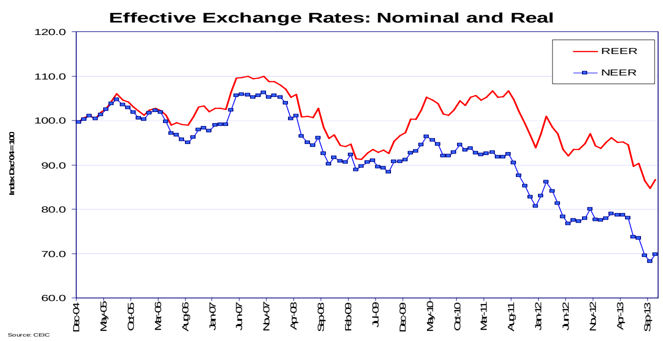
The removal of the swap facility for oil marketing companies is a further indication of stability returning to the external sector, following the ructions in currency markets, with the rupee plunging close to 69/USD in late August.

Indian Rupee to US Dollar



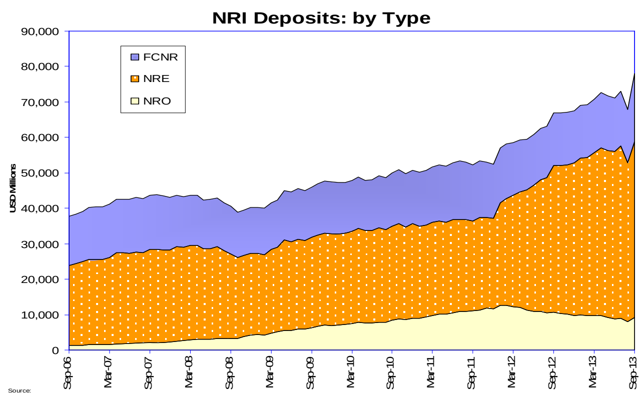
Despite a slight uptick in October, India's real effective exchange rate remains at historic lows. This has been a significant factor in boosting India's exports, along with modest improvements in the US and European economies. *It is critical that inflationary pressures remain contained so as to maintain export competitiveness*.

India's REER



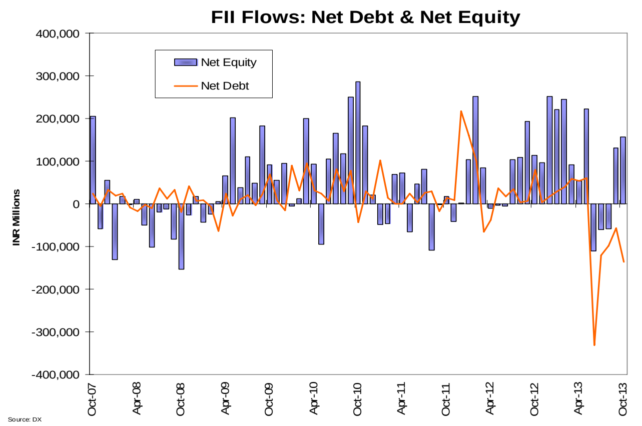
In order to assuage concerns about funding India's Current Account Deficit, the RBI offered a Concessional swap facility to attract FCNR (B) deposits, as well as offered banks the opportunity to borrow from overseas up to 100% of their Core Capital and swap it with the RBI at a discounted 3.5% rate. These facilities have been very beneficial, generating USD34 billion of funding. These swap facilities have since closed, although banks will be able to use this facility to borrow against their core capital up to 31st December, provided the relevant bank has negotiated the arrangements by the 30th of November.

FII Flow: Debt and Equity



Foreign Equity Investors continue to plough funds in the Indian market. However, debt investors are not that sanguine, and remain net sellers of Indian debt, concerned by the high inflationary environment in the country. Overall, inflows remain significantly higher relative to the June-August period, when investor pessimism was aggravated by India's external difficulties.

FII Flows: Debt and Equity



Outlook

Following the release of the September quarter accounts, NAB Economics has upwardly revised its Indian growth outlook. We are now forecasting a 4.7% expansion in 2013, followed by a stronger 5.1% outcome in 2014. In 2015, the pace of expansion is expected to pick up further to 5.4%.

The beneficial effects of the monsoon on the agriculture sector, continued export growth, enhanced liqudity support to SMEs and a modest rise in investment due to faster project clearances from the Cabinet Committte on Investments should support the growth outlook. Against that, tight fiscal and monetary policy settings will act as headwinds.

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