# India –GDP & Monetary Policy

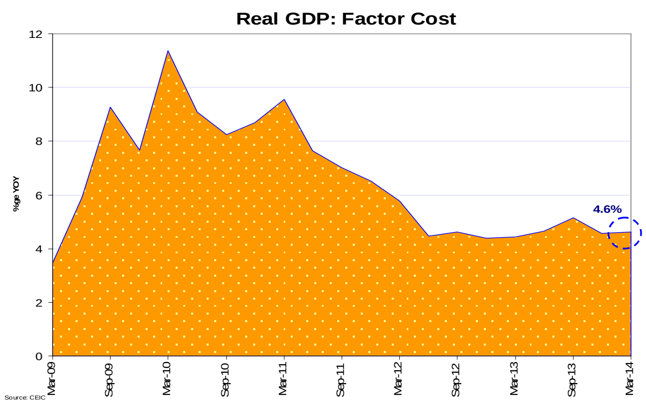
National Australia Bank

- **India's economy expanded by 4.6% during the year to March quarter 2014; it increased 4.7% over the 2013-14 financial year.**
- **By industry, agriculture and financial services were the strongest performing; manufacturing and mining remained in recession.**
- **By expenditure, consumption and net exports have been the strongest. Investment detracted from growth.**
- **The strong net export performance helped to compress the Current Account Deficit to USD32.3bn, 1.7% of GDP.**
- **The RBI held the policy Repo rate at 8% in its latest meeting.**
- **The RBI also indicated that Foreign Portfolio investors will now be able to hedge their Indian exposures in the Domestic FX market.**
- **On growth, NAB is forecasting a 5.2% outcome for 2014, followed by a somewhat quicker 5.8% in 2015, an upgrade from the previous 5.6% estimate.**
- **We are also forecasting the RBI to remain on hold at 8% over the course of the 2014-15 Financial year, with risks evenly balanced.**

## GDP Outcome

The Indian economy expanded by 4.6% over the year to March quarter 2014, a similar pace to the December quarter, but slightly faster than year ago levels (4.4%). For the 2013-14 fiscal year, the economy grew by 4.7% - the second consecutive financial year of sub-5% growth.

### Indian GDP



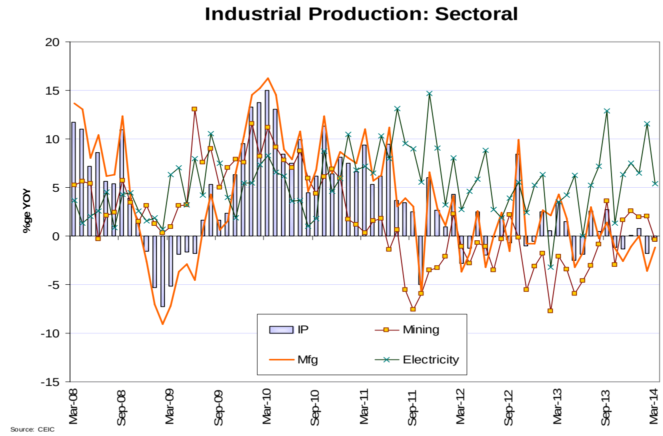

Examining the sector-wide performance of the economy, the improvement in the agriculture sector is clearly the standout. Growth in the agriculture sector accelerated to 6.3% (up from 3.7% the previous quarter), and has been the strongest since June 2011. Services was the next best performing at 5.8%, although growth was somewhat lower than in the previous quarter, 6.4%. With regard to services, there was a dichotomy between the performance of the financial services sector and the rest. The financial sector grew by 12.4% over the year to March, 2014. By contrast, other segments were somewhat lacklustre: construction (0.9%); trade, hotels and transport (3.9%); community and social services (3.3%).

### GDP (P): By Sector


The biggest disappointment, however, was the industry sector, which contracted by -0.5%, a slightly lesser pace than the last quarter's -0.9% decline. Manufacturing (-1.4%) and mining (-0.5%) are facing recessionary conditions. However, the electricity sector (7.2%) was the standout, and helped prevent a weaker outcome for the industry sector.

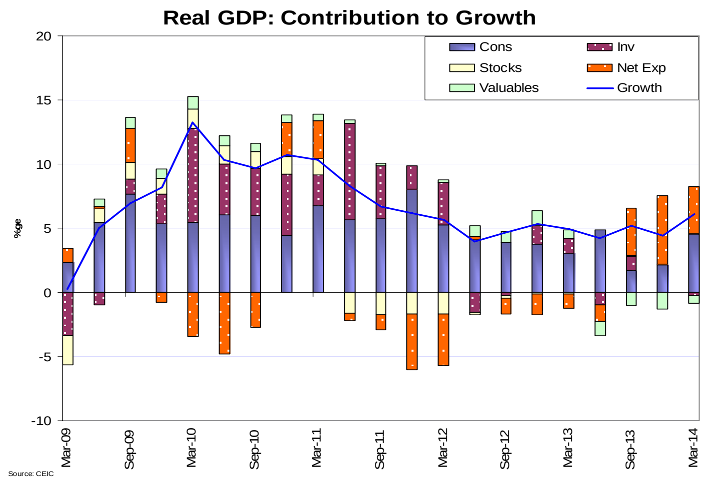
The results broadly align with other higher frequency indicators of the Indian economy. Industrial production contracted in each of February and March 2014, driven by weakness in the manufacturing sector; the utilities sector was the standout performer.

### Industrial Production: Sectoral

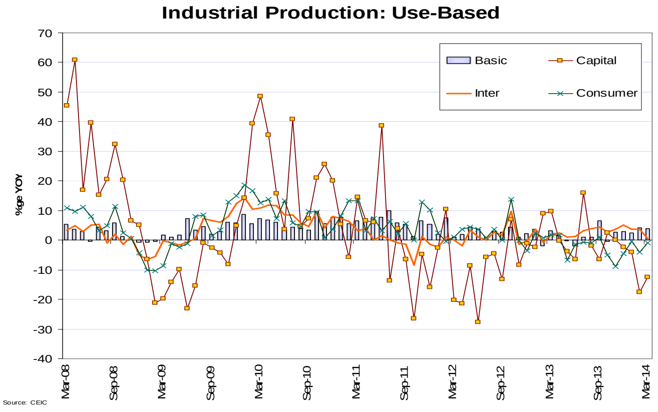


In terms of expenditure components, consumption and net exports were the main contributors to growth. The most disappointing results were in the weak investment numbers, which detracted from growth. The investment outcome reflects demand issues, higher interest rates as well lengthy delays in Government approval of projects. According to data from the *Planning Commission*, private corporate sector investment has fallen from 17.3% of GDP in 2007-08 to 9.2% in 2012-13 (the latest available year). These weak results on the Expenditure side are also borne out in the Use-based Industrial Production data, which reveal very weak spending on capital goods.

## GDP by Expenditure

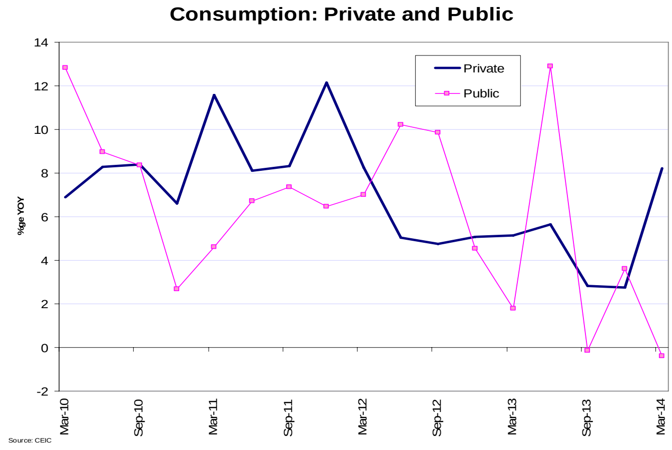



## Industrial Production: Use Based




The Consumption numbers reveal a discrepancy between public and private consumption. Public consumption fell by 0.4% over the year to March; private consumption, on the other hand, forged ahead by 8.2%. The public consumption numbers are broadly consistent with the numbers in Community Services, and reflect the efforts at fiscal consolidation by the previous Government. However, the private consumption numbers are somewhat puzzling, given the prevailing weak demand. These results could have been influenced by motor vehicle sales, with the volume of sales increasing by 7.6% during the year to March: the strongest since June, 2012. Further, the RBI's *Consumer Confidence Survey* indicated an improvement in current household perceptions with regard to income and inflation in the March quarter.

## Consumption: Private & Public

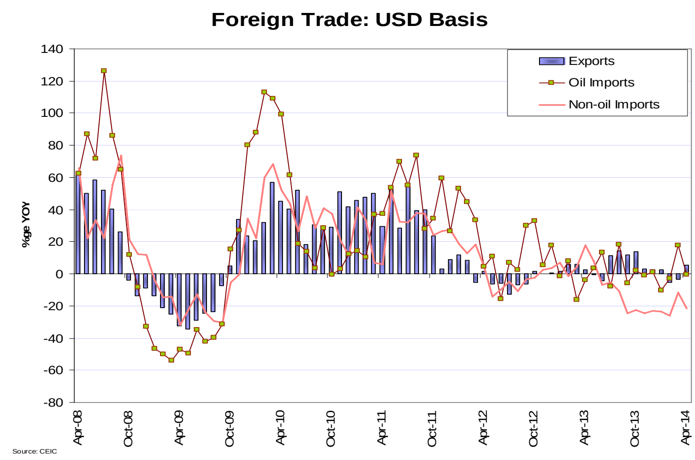



India's Net Exports performance has been positive over the last 3 quarters. This is also reflected in the trade and current account balances. The trade deficit contracted by 28% over the 2013-14 financial year, driven largely by a 13% fall in non-oil imports. There was a 46.3% drop in gold imports (impacted by Government and RBI restrictions), as well as double-digit declines in the import of machinery and equipment, due to weak investment activity. The authorities have partially removed some of these restrictions, including allowing jewellers to take out loans to purchase gold, as opposed to paying in full upfront.

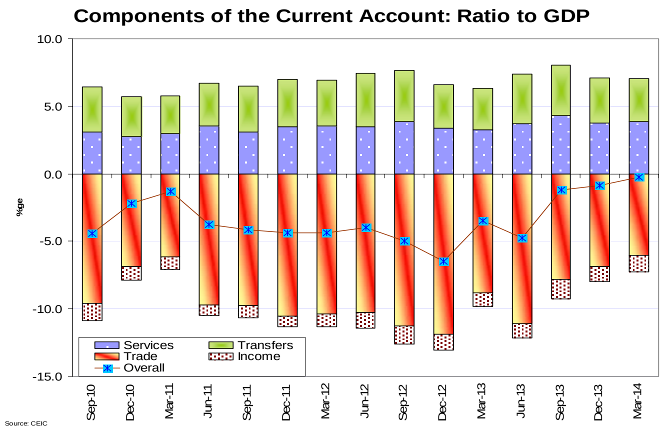
Export growth was restrained during the 2013-14 period but positive overall (4.1%). This was evident in sectors such as oil refining, pharmaceuticals and transport equipment. The positive trends in trade have carried forward to into April, 2014.

The trade balance contributed to a sharp improvement in the Current account balance: it contracted to USD32.3bn (1.7% of GDP) in 2013-14 from USD87.8bn (4.7% of GDP) in the previous financial year. India's vastly improved Current account position has substantially reduced its vulnerability to external shocks.

## External Trade



## Current Account



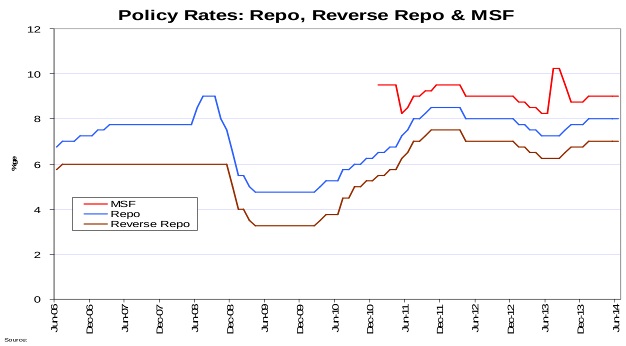

## RBI's Decision

At its Monetary policy meeting on the 3rd of June, the RBI:

- Maintained the policy repo rate unchanged at 8%;
- The Reverse Repo rate was held at 7%, and the MSF (Marginal Standing facility) rate at 9%;
- The Statutory Liquidity ratio (SLR) of Scheduled Commercial banks was cut by 50bps to 22.5%, effective June 14;
- Maintained the Cash Reserve Ratio at 4%;
- Reduce the liquidity available under the Export Credit refinance facility from 50% to 32%;
- To compensate the above measure, a special term repo facility of 0.25% of Net Demand and Time Liabilities is expected to be introduced.

As per our and the market projections, the RBI maintained the policy rate at 8%. It reiterated its commitment to a disinflationary path, wherein growth in the Consumer price index falls to 8% by January 2015, and further to 6% by January 2016.

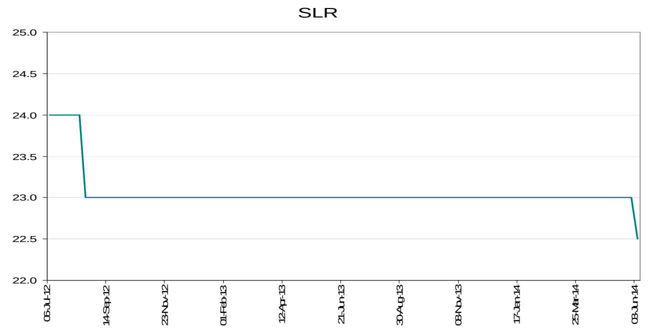
## RBI Decision



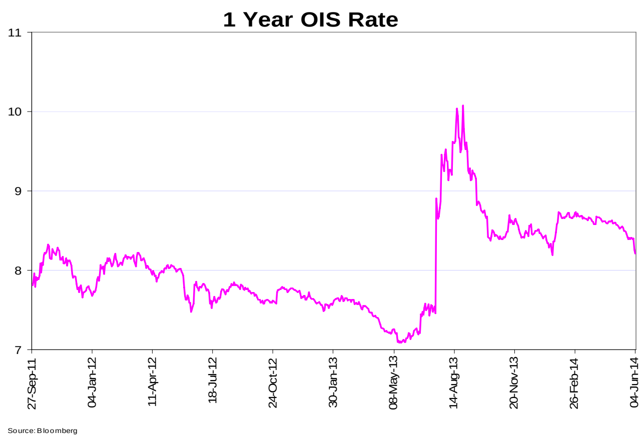

What was interesting this time around though was the slight dovish undertone in the comments of the Reserve Bank Governor, Rajan. More specifically, "*If disinflation, adjusting for base effects, is faster than currently anticipated, it will provide headroom for an easing of the policy stance*". The decision to cut the *Statutory Liquidity ratio* lends credence to the aforementioned statement. The latter measures the share of Deposits that Commercial banks need to invest in Government of India securities.

By cutting the rate, the RBI is freeing INR350 billion of liquidity that Banks can lend in the event of improving economic conditions – implicitly indicating increasing confidence in India's future growth prospects. Further, this measure also nudges the Government to engage in fiscal consolidation, a precursor for easing monetary conditions. Markets responded to these cues, with the 1-Year interest rate swap (the cost of insuring against 1-year borrowings) declining 15 basis points following the RBI announcement.

## Statutory Liquidity Ratio

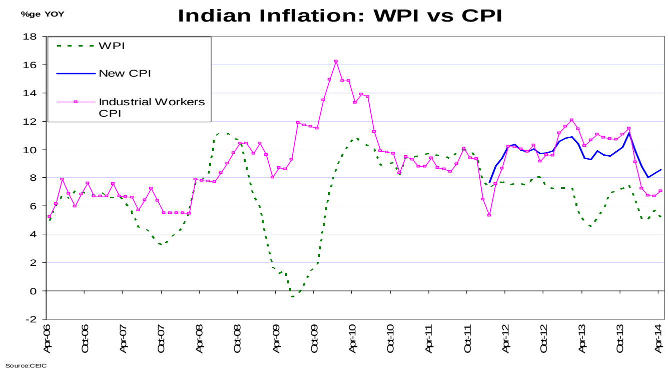



## 1-Year Interest Rate Swap

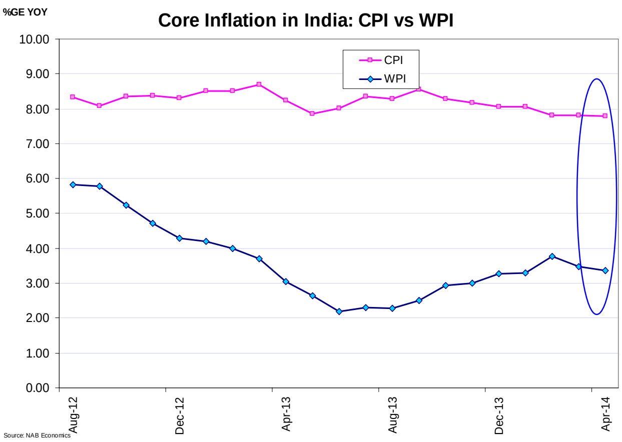



On inflation, whilst Wholesale prices eased to 5.2% in April (from 5.7% in March), Consumer prices accelerated from 8.3% to 8.6%. The increase in Consumer prices was largely driven by food related items such as milk, fruits, vegetables and spices. More significantly, there wasn't an acceleration in *Core* prices. Core WPI (non food manufactured inflation) in fact, declined a touch, whilst the important Core CPI indicator remained broadly stable at 7.8% over the year to April 2014, something which would have provided some solace to the RBI.

## Headline Inflation



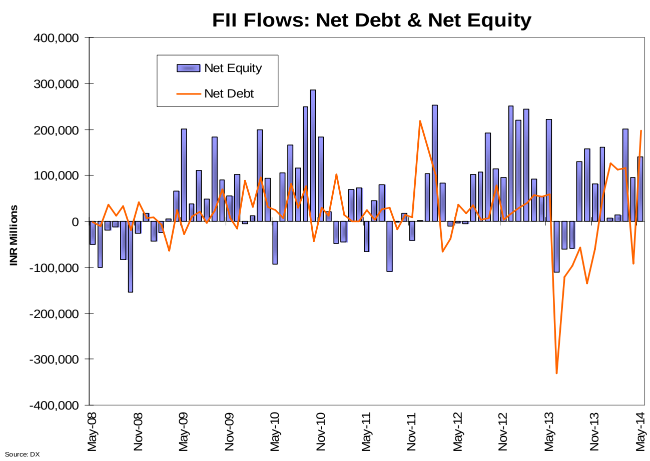
## Core Inflation




The RBI has continued its focus on providing liquidity under 7-day and 14-day term repo facilities up to 0.75% of Net Demand and Time Liabilities in the banking system, as well as phasing down sector specific (in this case exports) refinance in favour of a more generalised provision of liquidity. The aim is to ensure better liquidity transmission across the interest rate spectrum and assist financial institutions in their treasury management activities.

There has been a surge in FII (Foreign Institutional Investor) interest in Indian equity and debt securities, bolstered by the election results. The RBI has also introduced measures that allow Foreign Portfolio investors to basically hedge their exposures by allowing them to participate in the domestic exchange-trade currency derivatives market. They will be allowed to hedge their underlying exposure, as well as an additional USD 10 million. Such measures will likely enhance the allure of investing in Indian securities, as well as boost the depth and liquidity of the domestic foreign exchange market. It is expected that domestic entities will also be allowed similar facilities in the currency derivatives market.

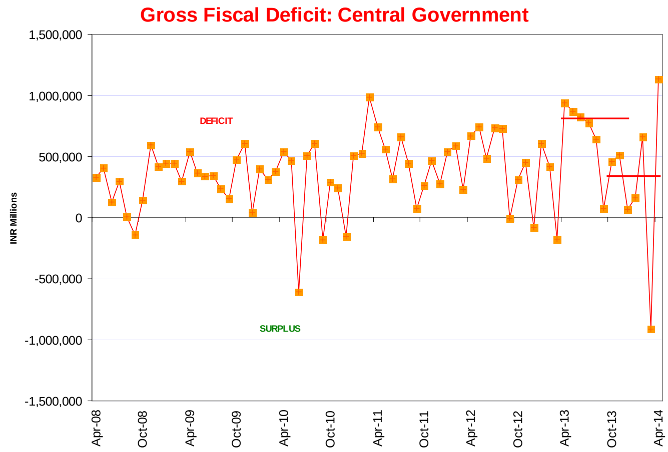
## FII Investments




## Fiscal Situation

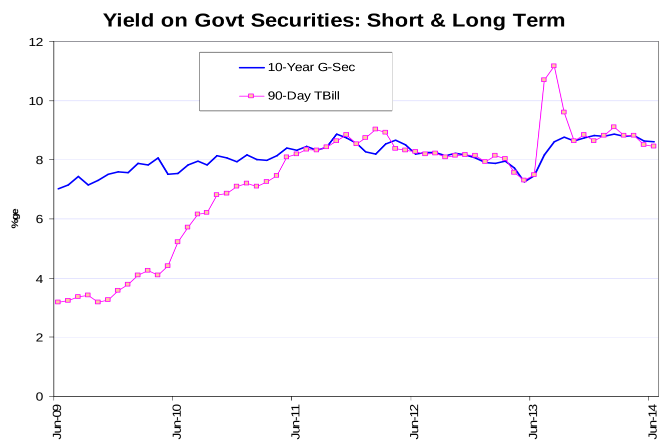
The Central Government's fiscal deficit came in at 4.5% of GDP for the 2013-14 financial year, better than expectations. This was largely due to improved tax collections in March as well as a compression in Plan Expenditure (used for Centrally sponsored asset creation programs).

## Fiscal Deficit




Following the release of the Monetary policy review, there was a decline in bond yields, with market participants encouraged by the RBI Governor about possible easing if inflation falls faster than anticipated. Going forward, a key event will be the upcoming Budget in July. A cut in subsidies, whilst maintaining capital expenditure would be supportive of higher growth and lower inflation outcomes in the coming quarters.

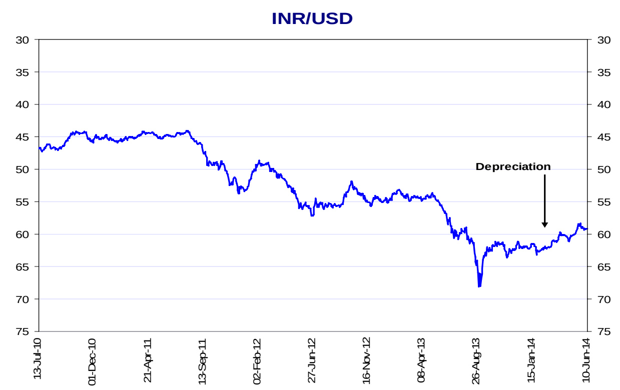
## Yields on Government Papers




# External and Financial

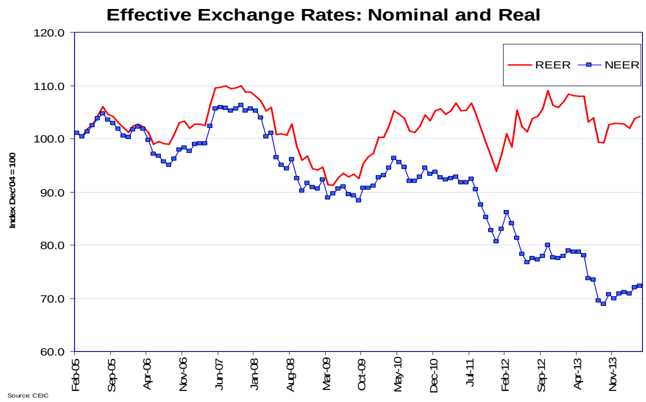
The Indian Rupee has been trading around INR59/USD. This reflects increased Institutional demand for Indian financial instruments from FX investors, as well as purchases of US dollars by the Reserve Bank of India. The Indian rupee appreciated to a recent high of INR58.38/USD, following the outcome of the election results.

## FX rate



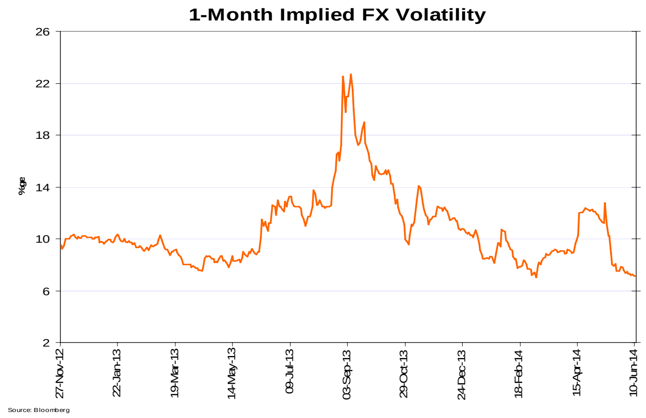

The RBI's decision to purchase foreign exchange reserves is astute, as it serves the dual purpose of bolstering India's external liquidity buffers, as well as preventing the exchange rate from appreciating sharply. The latter should be seen in the context of India's rising REER (Real effective exchange rate), which would make imports such as energy cheaper (and lessen imported inflationary pressure), whilst at the same time reduce the competitiveness of India's critical export categories such as IT and pharmaceutical products.

## REER

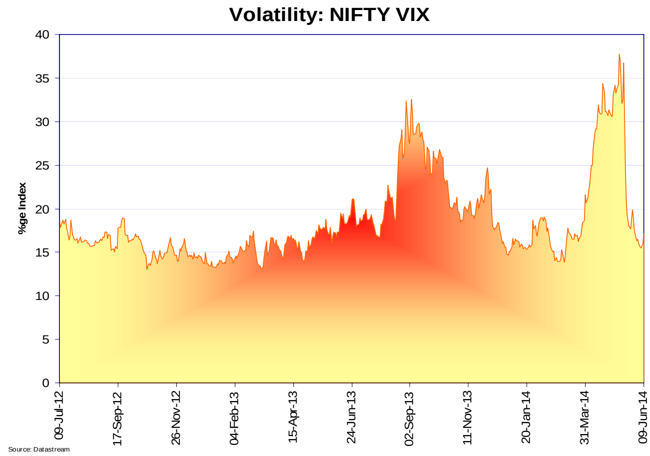



Volatility in financial markets has come down markedly post elections. One-month implied FX volatility, a measure of expected moves in the exchange rate which is used to price options, fell to 7.1%, close to 2014 lows. Moreover, the VIX Index, an indicator of equity market volatility has also come down dramatically post elections. The latter indicator rose sharply in the weeks preceding the election (a typical response), but is markedly lower.

## FX Volatility

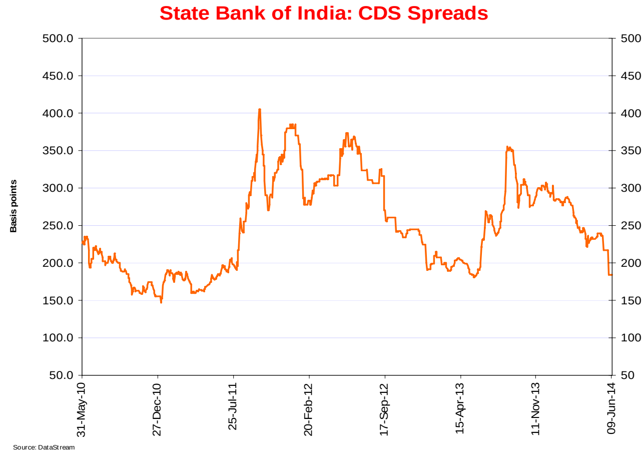



## VIX – Equity Market Volatility




State Bank of India's 5-year CDS spreads – a proxy for India's Sovereign risk – has contracted to 183bps, the lowest in a year. Positive sentiment toward the economy following the election results, as well as an improvement in India's external position, has helped India's risk profile. Moreover, the CDS data also reflect a better than expected results from the State Bank of India: Gross Non performing assets fell 78 basis points to 4.95% of total assets, exceeding market estimates, and reflects gains emerging from SBI's redesigned risk management framework.

## Sovereign Risk Indicator




# Outlook

**On growth, we are forecasting a 5.2% outcome for 2014, followed by 5.8% in 2015**. The 2015 result is an upgrade from our earlier 5.6% estimate. It is driven by an expectation of an improvement in economic conditions, stemming from the launch of Prime Minister Narendra Modi's 10-point agenda encompassing faster completion of projects, and expected improvements in governance. Having said that, there remain potential headwinds from policy implementation risks and stresses in the banking system.

**With regard to Monetary policy, we are forecasting the RBI to stay on hold at 8% through the 2014-15 Financial year, with risks evenly balanced.** We have removed the slight upside bias in the previous Monetary policy report, encouraged by explicit comments by Governor Rajan about the possibility of cutting rates if disinflationary process turns out faster than expected. Furthermore, potential monsoon disruptions (and higher food prices) form a weaker monsoon as well as Government measures, in terms of food supply as well as the quality of fiscal consolidation, will remain key influencers on future monetary policy outcomes.

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