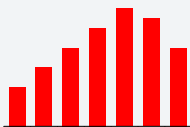


India GDP

Group Economics

June Quarter 2014



5 September 2014

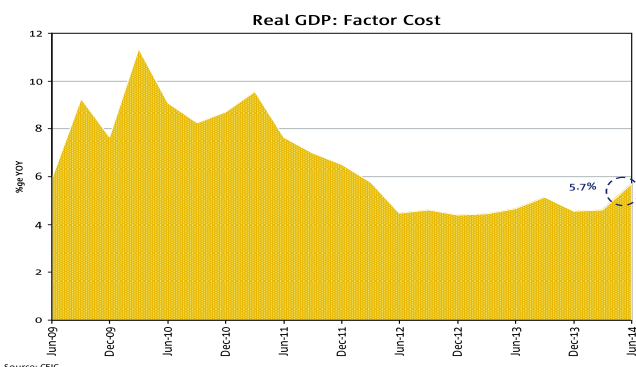
Summary & Overview

- The Indian economy expanded by 5.7% in the June quarter, the fastest pace in over 2 years.
- By sector, Services (Financial & Community services) and Industry were better performing; Agriculture eased due to weaker monsoon conditions.
- The improvement in Industry was welcome as it marked a return to growth for the previously beleaguered manufacturing and mining sectors.
- By Expenditure, Consumption, Net Exports and Investment were the main contributors to growth.
- India's Current account deficit remained well contained at 1.7% of GDP, assisted by improvements in the trade balance.
- Volatility has abated in both the foreign exchange and equity markets.
- We have maintained our forecasts of 5.2% in 2014 and 5.8% in 2015, with an upside bias.
- Leading indicators point to an improvement in growth. Besides, there has been progress made in clearing stalled investment projects.
- Near term risks include the decision of the Supreme Court with regard to the allocation of the coal blocks and the extent of the monsoon deficiency.

GDP Production & Expenditure

The Indian economy expanded by 5.7% over the year to June, 2014 – the fastest pace since March 2012. This was ahead of analyst expectations, and considerably stronger than both a quarter ago (4.6%) and a year ago (4.97%).

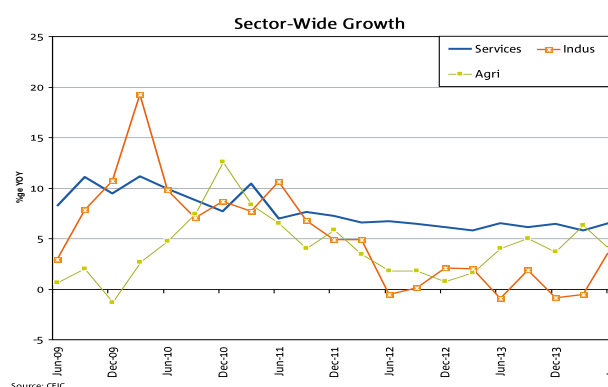
Indian GDP



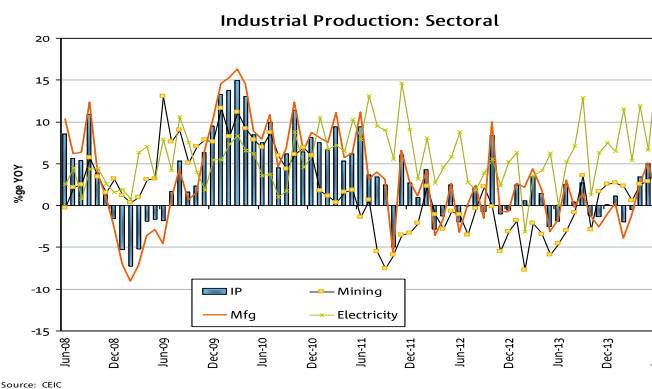
In terms of the performance across sectors, *Services* (6.7%) was the standout, driven largely by Financial services (10.4%) and Government-led Community and other Services (9.1%). Construction (4.8%) has also shown a welcome improvement from the previous quarter (0.7%), and should benefit from recent measures in the Budget supportive of housing and Real Estate Investment Trusts. Trade, hotels and transport grew by a disappointing 2.8%.

The Government has recently launched a new campaign, *Jan Dhan Yojana* (People's Bank Account) to boost financial inclusion and to generate bank accounts for 75 million families by January, 2015. This would involve using the domestic *RuPay* card network, and has the potential to free up lower income people from the reliance on moneylenders, boost consumption and streamline subsidies through direct transfers.

GDP (P): By sector



Industrial Production: Sectoral

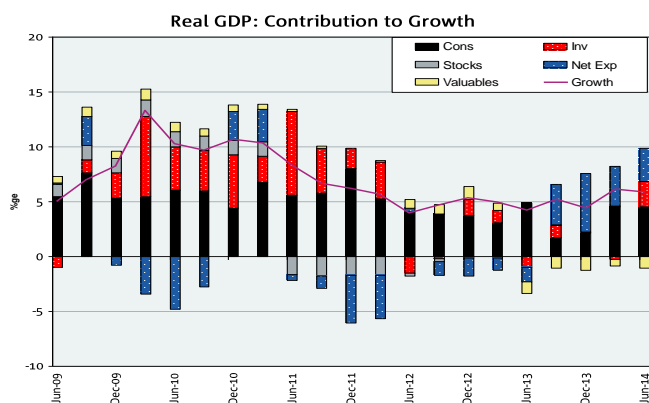


A key development this quarter has been improvement in the *Industry* sector: from a -0.5% contraction last quarter, it has improved to 4% this quarter. Whilst driven by a surge in electricity production (10.2%), manufacturing (3.5%) and mining (2.1%) showed a welcome return to growth this quarter. These trends were also mirrored in recent *Industrial production* data. Interestingly, on 3mth moving average basis, Industrial production in June was the highest since August, 2011.

The *Agricultural* sector (3.8%) was the only sector to decelerate this quarter, due to the weaker than normal monsoon. According to the *IMD* (Indian Meteorological Department), the overall deficiency this monsoon season is expected to be around 13%. In terms of crops, the country's farm commissioner expects lower output primarily in

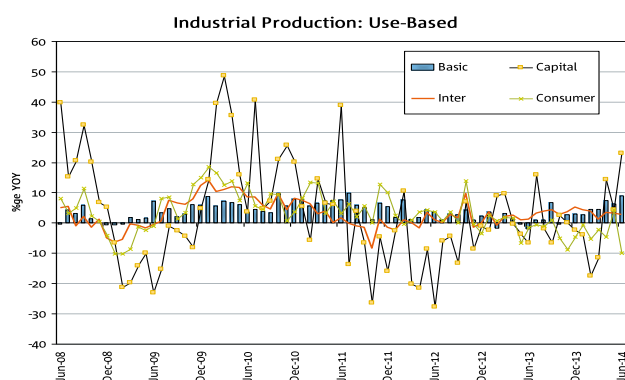
millets and pulses; the rice crop is unlikely to be adversely impacted.

GDP: Expenditure Based



Source: CEIC

Industrial Production: Use Based



Source: CEIC

In terms of expenditure categories, Consumption, Net exports and Investment have been major contributors to growth this quarter. The positive contribution from investment has been a welcome development, and is consistent with trends in the (highly volatile) capital goods production segment in Industrial production. The consumption data has been driven by stronger public consumption (8.6%) growth, whilst private consumption (5.6%) has grown in line with overall activity. The decline in Valuables reflects a fall in investment in gold and jewellery.

Activity Indicators

Besides Industrial production, there have been a number of other data releases providing a further insight into the Indian economy.

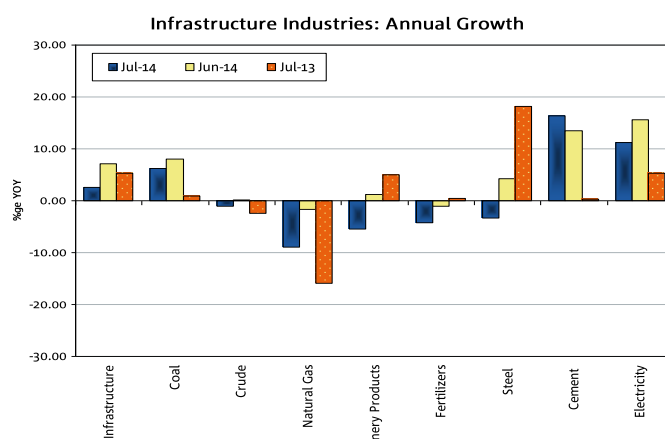
The production of the 8 *Infrastructure* sectors has eased from 7.2% over the year to June to 2.6% in July. While impacted partly by base effects, the data does indicate that the economy is yet to reach high gear, despite recent improvements. Sectors such as Cement and Electricity were better performing, Natural gas and Refinery products contracted.

Separately, *HSBC's Manufacturing PMI* revealed manufacturing output in India expanded for the 10th consecutive month, although the indicator eased from 53.0

in August to 52.4 in July. There was an improvement in order books, including those for export orders.

A potential area of concern is the decision by the *Supreme Court of India* to declare illegal all coal block allocations between 1993 to 2010 illegal. The Government, for its part, is petitioning that 46 coal mines – including 40 fully functioning with attached power/steel plants – be exempt from the decision. It suggested the 46 blocks could pay INR295/TONNE of coal to compensate the Indian Exchequer for losses, and sign long-term agreements with State power grids. The decision by the Supreme Court has caused concerns through the Metals, mining and power sectors, as well as for banks that have lent to them. The Supreme Court will likely take up the case on 9th September for a final decision.

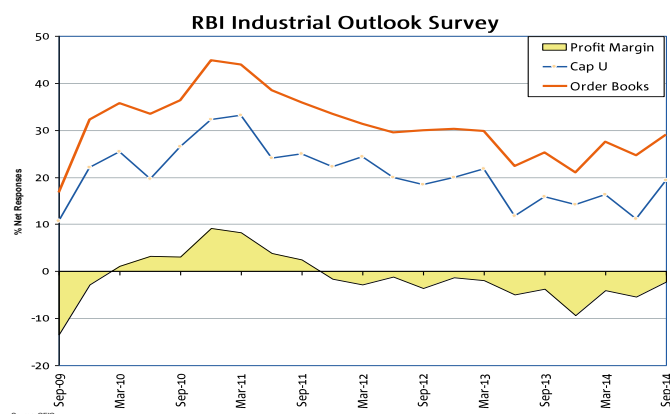
Infrastructure Industries



Source: CEIC

The RBI's latest *Industrial Outlook* survey points to increasing optimism of businesses in the manufacturing sector. With regard to the September quarter, 2014 Indian manufacturing businesses were more optimistic with regard to their overall business situation, production, order books, and capacity utilisation. They were less pessimistic with regard to their profit margins and cost of finance.

Industrial Outlook Survey

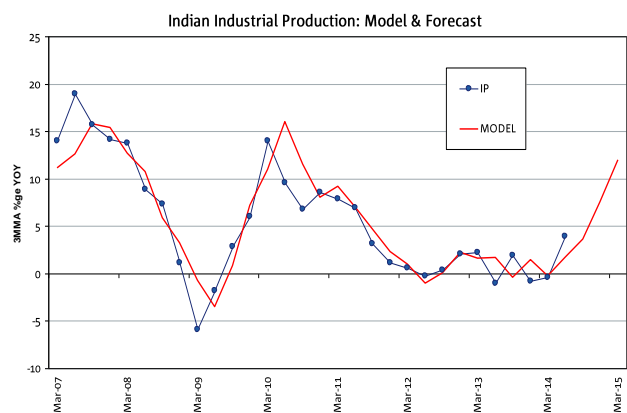


Source: CEIC

Looking further ahead, the prognosis for the Indian economy is positive. NAB Economics has modelled industrial production using a 'leading indicator' type approach. Our analysis suggests that industrial production

is expected to gain traction going forward, with double-digit growth in Industrial production expected in the first quarter of 2015 (see chart below).

Industrial Production: Model & Forecasts

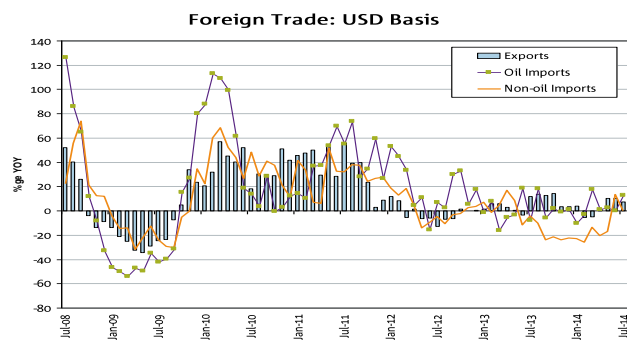


Source: NAB Economics/CEIC

External

India's trade balance continues to improve due to weak non-oil imports and steady export growth. Over the June quarter, the trade deficit has improved by 27.2% in USD terms. These trends have continued into July, although both exports and imports (reflecting an improving economy) have picked up during the month.

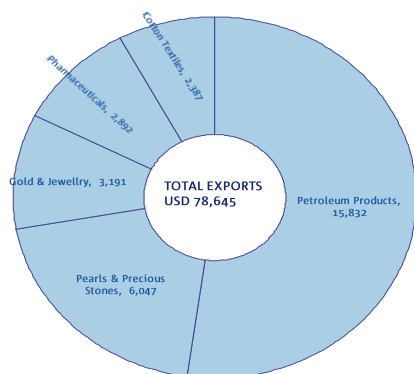
Foreign Trade



Source: CEIC

Key Exports

Top 5 (& Total) Exports: April-Jun 2014 - USD Millions



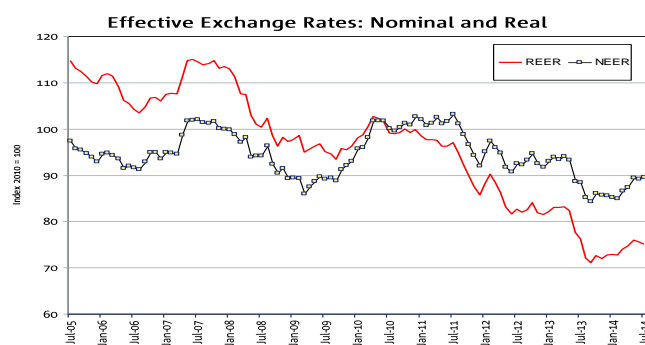
Source: Commerce Ministry

Petroleum products, Gold and jewellery, Pharmaceuticals and Cotton textiles were among the key merchandise

exports categories. Other significant (and fast growing) segments include: Iron and steel and Transport equipment (boats, motor vehicles, and aircraft equipment). On the imports side, the main news item has been the continued weakness in Gold imports (-56%); this may reverse somewhat going ahead as demand for gold increases over the *Diwali* festive season.

India's exports have also been assisted, in part, by its competitive Real exchange rate (a TWI adjusted for inflation differentials), although the latter has risen somewhat in sympathy with the Nominal exchange rate. It is critical that inflationary pressures remain contained to curb adverse (higher) movements in the real exchange rate.

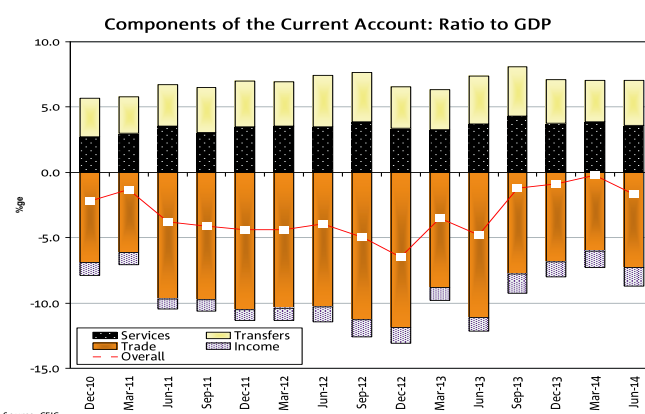
Effective Exchange Rates



Source: BIS

India's Current account deficit remained contained in the June quarter at 1.7% of GDP, a considerable improvement on the 4.8% deficit a year ago. This was driven mainly by a contraction in the trade deficit. Looking forward, an improving economy would likely result in higher imports and exert some pressure on the Current account, underscoring the need to maintain export competitiveness.

Current account deficit



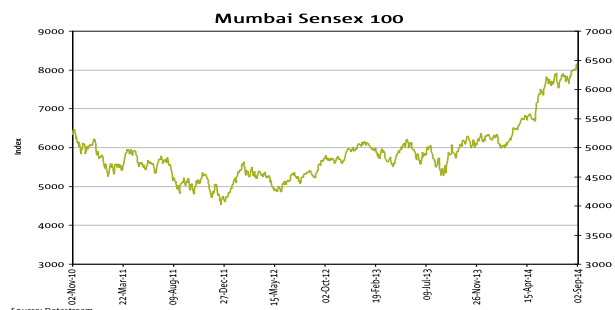
Source: CEIC

Financial flows

The GDP release has been positive for India's equity markets, which have risen over 10% since Narendra Modi was declared the victor in India's Parliamentary elections on the 16th of May. According to data from the *Economic Times of India*, there have been strong performers in stocks across a range of sectors over this period: IT, Pharmaceuticals, Chemicals, Petrochemicals, Banking and Autos, highlighting the rally has been broad-based. Foreign

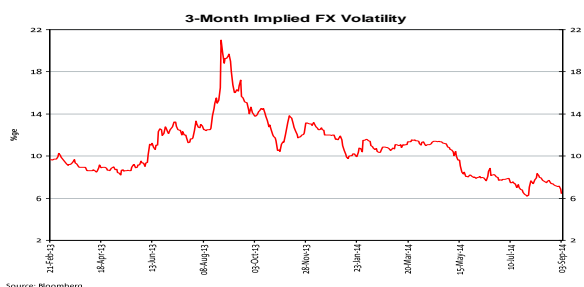
investors continue to show interest in Indian equities, which has buoyed equity markets. Further, the Indian VIX Index, a measure of market volatility, has also eased considerably.

Equity Markets



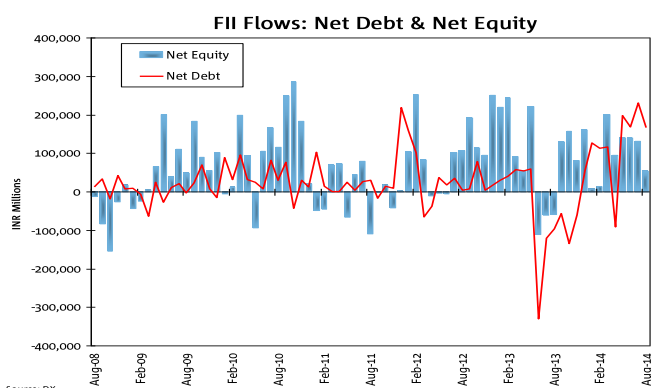
The Indian rupee was trading a 60.40-60.70/USD at the time of writing. A strong GDP release, which further ignited foreign investor interest, as well as dollar selling by exporters, precipitated the recent rise in the INR. FX volatility has also eased with the 3-month implied volatility, a measure of exchange rate swings used to price options, fell to a monthly low of 6.41, according to Bloomberg data.

FX Volatility



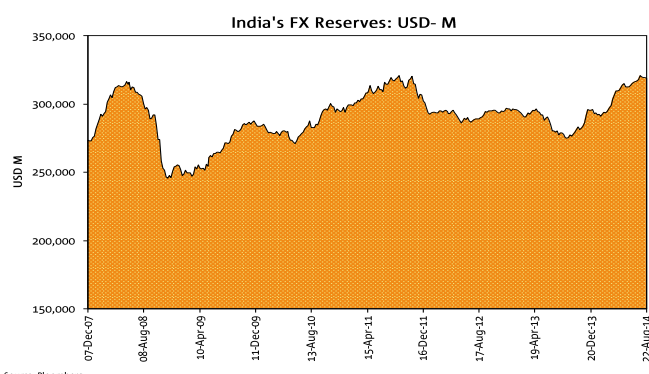
India continues to be an attractive investment destination for foreign portfolio investors. Whilst equity investors continue to show interest, there has been a recent surge in foreign debt investors. This reflects monetary policy credibility, a stabilisation in the external situation as well as general optimism about India's growth prospects. The flip side of this surge in foreign debt flows is the need to maintain prudent monetary and fiscal settings and to boost external resiliency, so as to avoid a souring in investor sentiment and capital flight.

FII Inflows



The recent visit by PM Narendra Modi to Japan has been a welcome development, as it will generate \$35bn FDI in Indian infrastructure over the ensuing 5 years. FDI flows are considered to be more stable and enduring than Portfolio inflows.

FX Reserves



Monetary policy is expected to tighten in the United States. NAB Economics is predicting a rise in the Fed Funds rate in the June quarter, 2015. Whilst concerns abound over the fallout for Emerging Markets, India is far more secure now than a year ago. One metric which succinctly depicts this is the rise in India's Foreign exchange reserves, which are close to USD 320bn.

Outlook

We have maintained our forecasts at 5.2% for 2014 and 5.8% for 2015 with upside risks. Leading indicators point to a faster pace of expansion going forward. Besides, there has been progress made in clearing and commencing stalled projects.

In the near term, there remain risks surrounding the Supreme Court Decision on coal block allocations, although the Government and Supreme Court are likely to achieve some sort of compromise on the issue. There also remains uncertainty about the monsoon, and its impact on the agricultural sector. Further ahead, the execution of structural reforms, as well as global economic and geopolitical factors will determine the pace of expansion in the Indian economy.

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