INDIA GDP & MONETARY POLICY
JUNE 2017

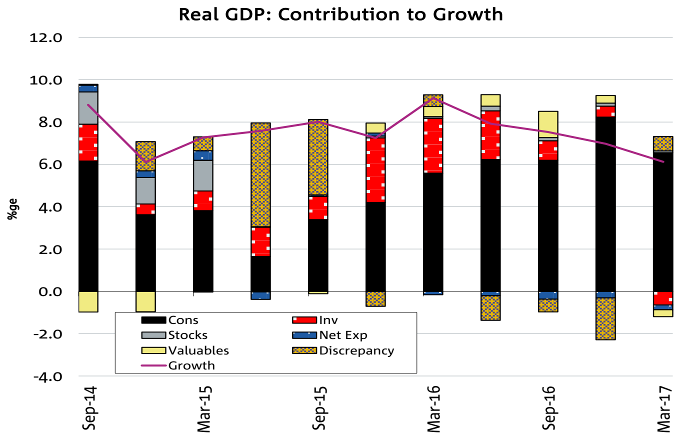
NAB Group Economics

The Indian economy experienced a demonetisation-induced slowdown in growth to 6.1% in the March quarter, with investment spending contracting. The RBI held the benchmark Repo rate at 6.25%, despite the weak GDP print. NAB Economics is forecasting the economy to grow by 7.3% and 7.2% in 2017and 2018, respectively. On interest rates, we are forecasting one final 25bp rate cut to 6% in October.

GDP Outcome

Indian economic growth decelerated in the March 2017 quarter, with real GDP expanding by 6.1% in yoy terms. In the previous (December) quarter, the economy grew by 7%. It is likely that this outcome reflected the lagged impacts of India's demonetisation program. If we look at GVA (gross value added) – which basically removes the impact of taxes and subsidies- then activity was an weaker 5.6%, the 4th consecutive quarterly decline.

GDP by expenditure

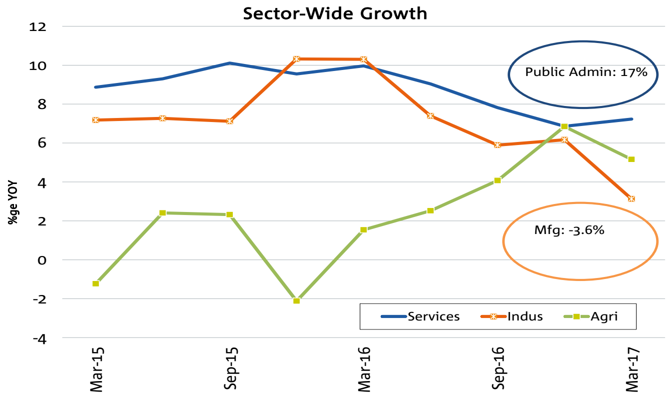


Source: CEIC

In terms of the components by expenditure, consumption was the strongest, contributing 6.5%, although it was less than the December quarter outcome, 8.2%. The next biggest contributor was the statistical discrepancy. The most disappointing figure was investment, which detracted 0.64% from growth. Net exports too detracted from growth. While one would have expected the demonetisation impact to have been felt more keenly in the December quarter, activity in that quarter seems to have been supported by favourable base effects and festive season spending.

The impact of demonetisation is more apparent when we examine growth by sector. The worst performing sector was Industry, growing by 3.1%. Within industry, the labour-intensive construction sector (-3.7%) went into reverse, and manufacturing slowed from 8.2% to 5.3%.

GVA by sector



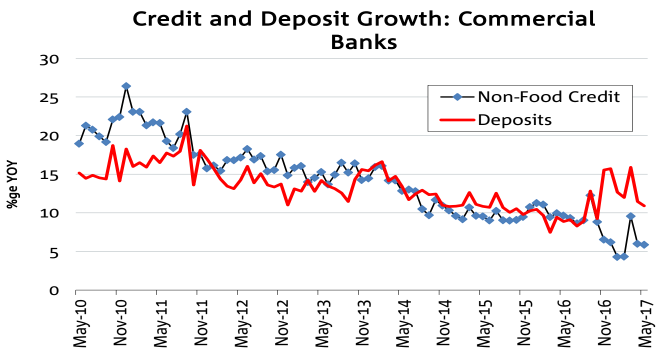
Source: CEIC

Agriculture slowed from 6.9% to 5.2%, perhaps impacted by weak spending in India's major agri distribution centres ('mandis') during the demonetisation period. Services was the best performing, but here Government-related spending recorded a very strong 17% expansion. In fact, if we exclude this sector, growth would have fallen to 4.1%, reflecting an economy losing momentum.

Financial services (2.2%) was also weak, continuing on from weakness in the March quarter. This largely reflects very weak credit growth, which was most visible in the months of January, February. Although credit growth picked up sharply in March, it has come back in April and May. While credit growth has been subdued, the demonetisation program led to a surge in deposits, as customers rushed to meet deadlines to deposit their old notes.

Date **June 2017** | Author **John Sharma**–Economist – Sovereign Risk

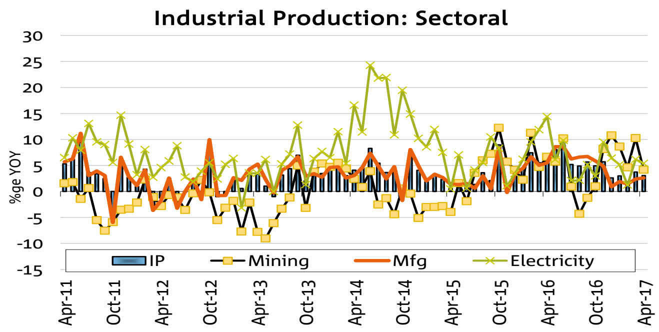
Banking sector



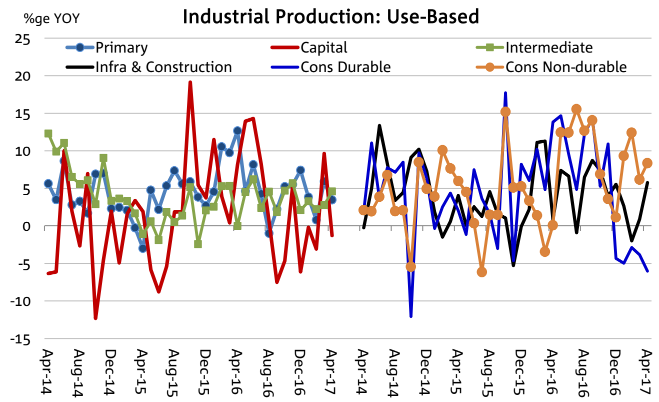
Partial Indicators

Industrial production (IIP) broadly lined up with the weak GDP outcome. Yoy growth in IIP for the March quarter averaged 2.9%. The April reading showed only a modest uptick to 3.1%. The IIP use-based data reveal interesting trends. Capital and consumer durables output remain weak, while consumer non-durable output was robust. These trends broadly align with the weak investment and stronger consumption in the GDP series.

IIP: Sectoral and Use



Source: CEIC

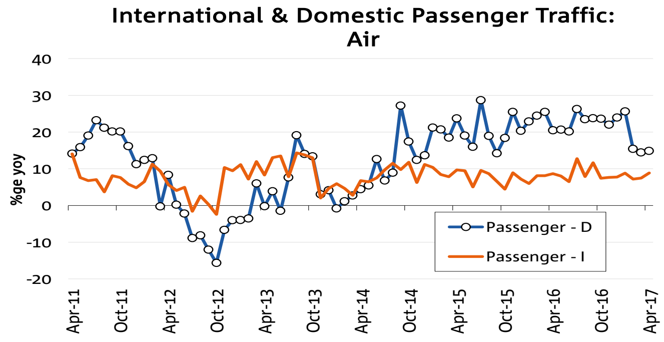


Source: CEIC

Elsewhere, activity indicators reveal a generally mixed picture. International tourist arrivals and visitor speding held up. Solid visitor arrivals growth helped cushion the declines in hospitality sector spending, which eased from 8.3% to 6.5% in the March quarter. Further, international and domestic air traffic growth has been steady, although the latter has slowed somewhat from the brisk growth rates evident in the second half of 2016.

International tourism and air traffic

Source: CEIC



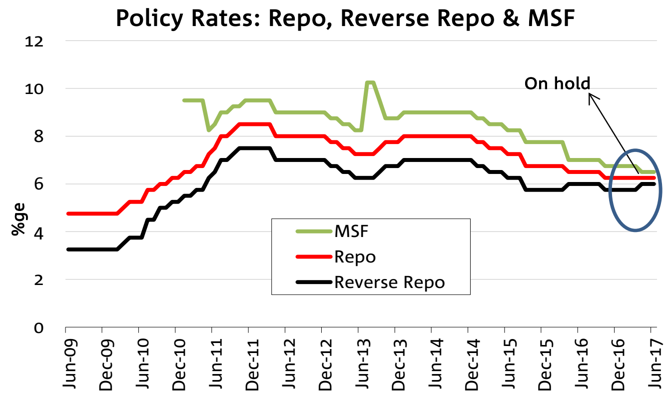
Source: CEIC

Monetary policy decision

At its 7th June Monetary policy meeting, the RBI:

- Maintained the policy (Repo) rate at 6.25%
- Held the Reverse repo and MSF rate at 6%, and 6.5% respectively

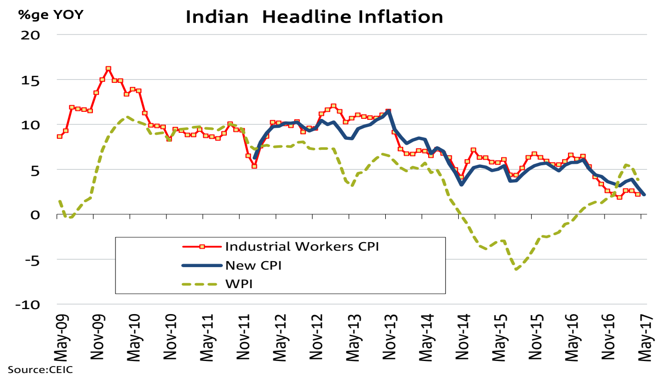
India policy rates

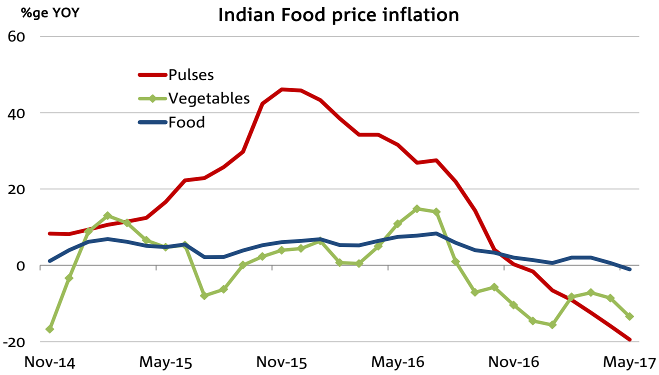


Source: DX/RBI

Prices remain subdued, with CPI falling to a record low of 2.2% in May, 2017. This was largely due to a fall in food prices, with food inflation recording a negative outcome in May. Pulses have fallen -20% yoy and reflect a combination of including production, imports and improved food management. The deflation in the prices of pulses is in stark contrast to the rapid price growth seen in late 2015. High levels of food production and low prices have led to stresses among debt-laden farmers. Farmers have been clamouring for farm-loan waiver programs, such as those announced in Uttar Pradesh. Such programs were criticised by the RBI as lacking fiscal discpline and potentially inflationary.

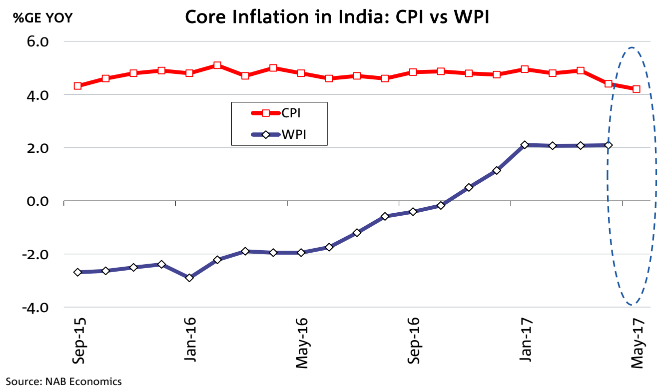
India headline and food inflation





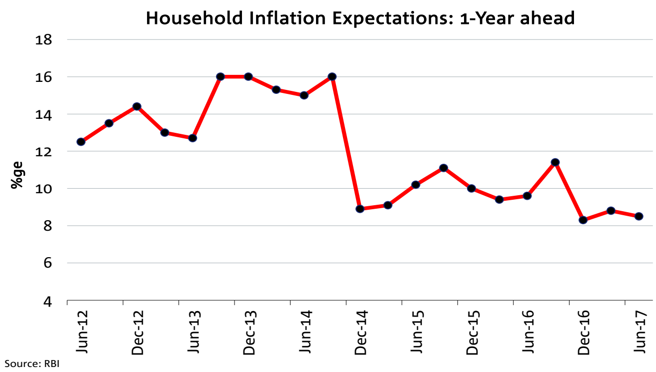
Core inflation (ex food and fuel) has also reduced, but not as much as the RBI would have wished. Core CPI has declined to around 4.2%yoy in May. In the core inflation category, the declines have been most visible in the transport and personal care sub-segments. Slight declines were also noted in health, education and recreational goods. Housing and household goods have remained broady steady. The RBI will monitor trends in core inflation in order to gauge the sustainability of recent price falls.

Core inflation



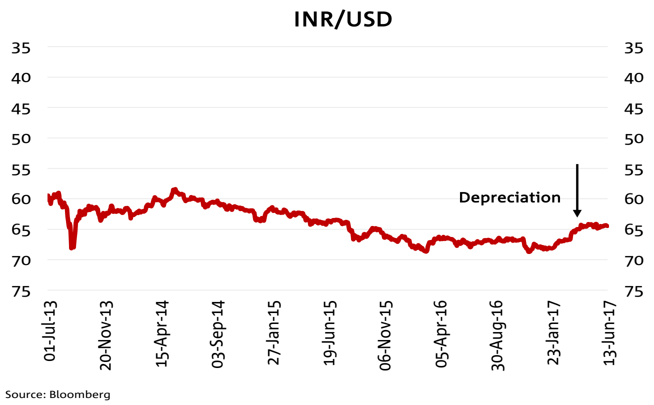
Lower inflation outcomes, particularly for food, have led to consumers lowering their inflation expectations for both the next 3 months, as well as the year ahead..

Inflation expectations



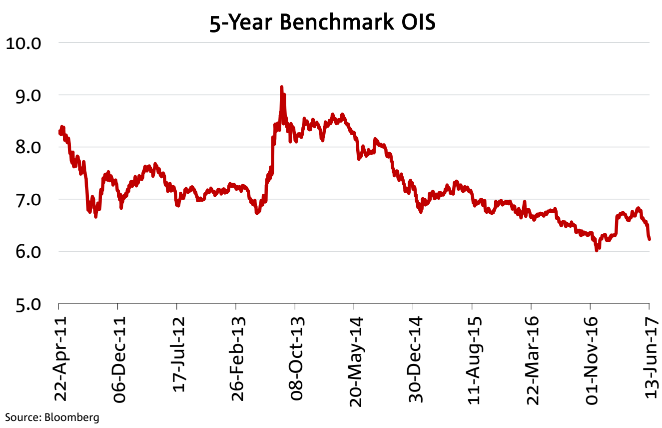
Besides, the Indian Rupee has been strong, supported by lower inflation outcomes, and the RBI lowering their inflation forecasts. A stronger rupee leads to lower imported inflation.

Indian Rupee



The lower inflation and growth outcomes, have led to increased market expectations for a rate cut. Benchmark 5-year Overnight indexed swaps (exchanging variable rates for a fixed rate) have fallen since the recent high in April. This indicates that traders expect increasing odds of a rate cut, going forward.

5-Year OIS rate

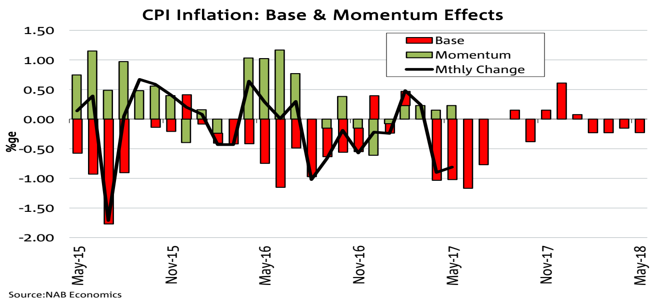


Outlook

NAB Economics is forecasting a 7.3% growth outcome in 2017 and 7.2% for 2018. The demonetisation induced slowdown should abate, with the removal of withdrawal restrictions and additional cash infusions. This should assist consumption expenditure, and be particularly supportive of the unorganised, cash-reliant sector of the economy. Further, lowering of banks' lending rates, and structural reforms such as the Insolvency and Banking Code and the upcoming GST (which will take effect from the 1st of July, 2017), should be supportive of growth. Against that, stresses in India's banking system could provide a headwind to growth - mentioned in the RBI's monetary policy statement.

The RBI has lowered its projections for both growth (10 bps) and inflation. With regard to the latter, it projected headline CPI in the 2-3.5% range (4.5% in the April meeting) during the period to September 2017, and 3.5-4.5% during the October 2017 to March 2018 (previously, 5%) period - provided inflation evolved in line with April's outcome. Further, it indicated that risks were 'evenly balanced', in contrast to last meeting, where there were 'upside risks' to the baseline projections.

Inflation projections



NAB Economics is forecasting one more rate cut from 6.25% to 6% (possibly in October), which would be last of the current rate cutting cycle.

While we expect the economy to improve from its 1st quarter softness, an additional rate will certainly help Indian's growth prospects, particularly given weak investment. We have postponed our rate cut estimate from August to October. By October, the RBI would have access to August's inflation reading. This would provide the RBI with sufficient time to observe and assess the evolution of the monsoon rains (which the Indian weather bureau expects to be in line with long-term averages) and the impact of the GST on inflation. Finally, the RBI can evaluate if its inflation projections for the 1st half of the fiscal year (April to September) are in line with actual outcomes.

The risks to our forecasts are evenly balanced. A faster-than expected decline in inflation could prompt the RBI to move in August, particularly if activity indicators remain muted. Conversely, upside risks from fiscal slippages (e.g. from the farm loan waiver programs), imported inflation due to global economic and financial factors, and the impacts of the 7th Pay Commission might stay the RBI's hand. The GST is expected not to have a significant impact on inflation, as most of the items in the CPI basket are expected to attract a lower tax impost than is currently the case. The RBI's tone with regard to GST is instructive: they indicated it would 'not have a material impact', a contrast to the April meeting when it saw possible 'upside risks' on account of the GST.

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