India Update - GDP

National Australia Bank

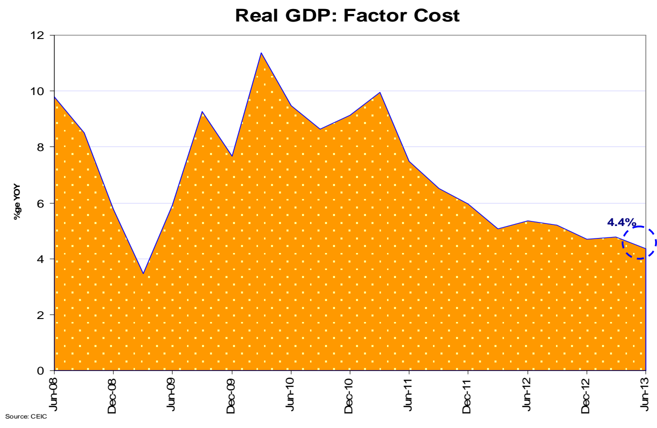
- **The Indian economy (Production, at factor cost) grew by only 4.4% over the year to the June quarter, 2013. This is the slowest pace of growth since March 2009.**
- **By Production, services (primarily financial and agriculture) were the mainstay; in contrast, mining and manufacturing contracted.**
- **Consumption (primarily Government) and Investment were the main contributors to GDP by Expenditure. Net exports and Gross fixed capital formation deducted from growth.**
- **The recent trade numbers for July were encouraging, with a 11.6% expansion in exports and a compression in the trade deficit. Such estimates need to be sustained, and should receive support from the fall in the real exchange rate.**
- **The Indian Rupee remains weak and volatile and reflects the general pattern of deteriorating EM currencies among countries with high Current Account Deficits, such as India's (4.8% of GDP).**
- **Recent RBI measures to open a Foreign Exchange Swap facility to assist oil marketing companies have eased pressure in currency markets.**
- **The Finance Minister, Panaliappan Chidambaram, has outlined a 10-point agenda to improve India's economic prospects. These are very useful measures, but need to be acted on urgently.**
- **Standard & Poor's negative outlook on India is a reminder of the need to proceed with reforms.**
- **NAB Economics has a modest outlook on India: 4.4% in 2013, followed by a slightly higher 4.6% in 2013. Business and consumer caution, stressed balance sheets as well as limited support from future Government spending will weigh on growth prospects. The silver lining is the favourable monsoon.**

GDP Production and Partials

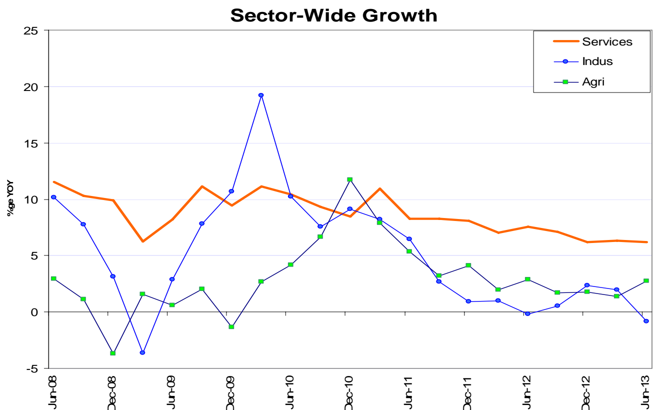
The Indian economy expanded by 4.4% over the year to June quarter, 2013. This is the slowest pace in 4 years, and is indicative of a slowing trend in the Indian economy. The previous low was the 3.5% outcome in March 2009, during the Global Financial crisis.

The results are even weaker than the 5% growth recorded over the 2012-13 financial year, which itself was the lowest in a decade, and is a considerable slowdown from the headier days of 2010 and 2011.

Indian GDP Growth



GDP (P): By Sector



In terms of the various sectors, the *Agriculture* sector expanded by 2.7%, the *Industry* sector contracted by 0.9% and the Services sector, the mainstay of growth, expanded by 6.2%.

The Agricultural sector accelerated from 1.4% in the March quarter. A favourable monsoon season should be beneficial for the production of the *kharif* (monsoon) crops such as rice as well as horticultural crops. It is expected that agricultural production (~14% of Real GDP) will accelerate in the coming quarters, providing a bright spot in a challenging economic situation.

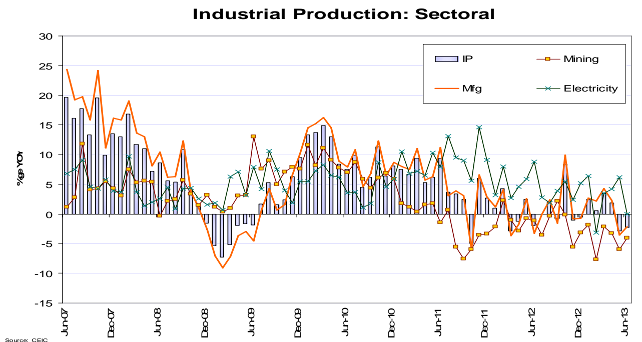
The 0.9% contraction in *Industry* is disappointing, and follows the 2% increase in the March quarter. Within the industry sector, mining declined by -1.1%. Manufacturing fell by -1.2%; when one considers the 1% fall in the June quarter of 2012, manufacturing activity in the June quarter 2013 is even weaker than activity a couple of years ago.

Electricity production improved by 3.7%, somewhat better than the 2.8% in the March quarter, and was the best performing segment in the industry sector.

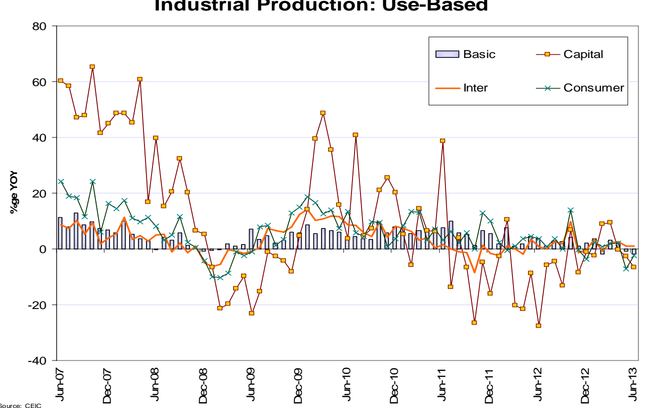
The manufacturing situation continues to remain grim with the HSBC PMI figure for August at 48.5, indicating a contraction, and representing the weakest outcome since March 2009. The weak PMI figures reflect poor order flows from both domestic and international sources.

The *Services Sector* was the best performing: it grew by 6.2%, a touch lower than the 6.3% recorded last quarter. Within the services sector, there was a performance differential among the various components. Construction decelerated to 2.8% (from 4.4%); trade, transport and hotels was a muted 3.9% (6.2% previously); finance, insurance and real estate recorded a robust 9% expansion (9.1% in the previous quarter) and Community, social and personal services surged 9.4% (4.1% in the previous quarter).

Industrial Production - Sectoral



Industrial Production – Use Based

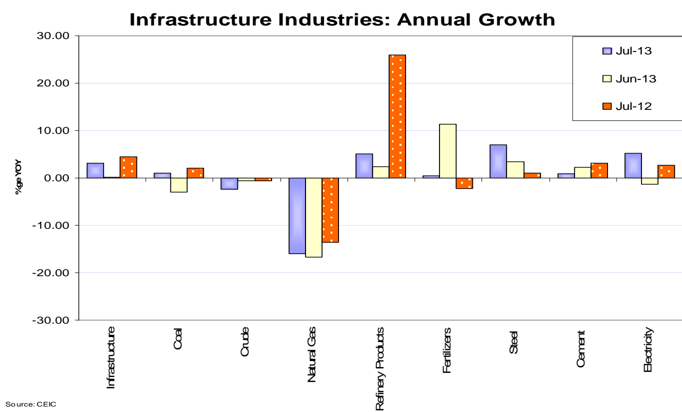


Partial indicators also confirm the weakness, particularly in Industry. Over the year to June 2013, industrial production contracted by 2.2%, the second consecutive month of negative growth. There were declines in both mining and manufacturing, whilst electricity production was flat.

By use, the contraction in capital goods production was particularly disconcerting, as it reveals poor near term investment prospects. Consumer durables production also contracted, reflecting weak demand, although consumer non-durables held up reasonably well. Intermediate goods production –a measure of downstream demand – showed a slight increment, reflecting positive, albeit very moderate downstream demand.

The one encouraging development was the performance of the *infrastructure sector*, which consists of 8 core industries. The infrastructure industry group grew by 3.2% over the year to July 2013, the fastest since January 2013 and considerably better than the flat outcome in June 2013. Within the components, steel, electricity, and, to a lesser extent, refinery products were better performing. Even coal recorded a marginal improvement. Against that, natural gas, fertilisers and cement output were weak.

Infrastructure Industries: Growth



In summary, the performance of the infrastructure sector is a welcome relief to the set of disappointing numbers.

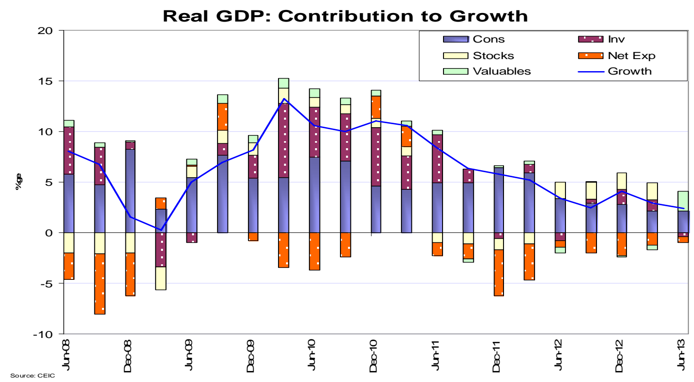
GDP by Expenditure

By expenditure, GDP at market prices increased by 2.4% over the year to June 2013. Valuables (1.96%) and Consumption (2.1%) were the main positive contributors to GDP growth. Net exports (-0.6%) and disconcertingly, Gross fixed capital formation (GCFC) (-0.4%) detracted from growth. The fall in GCFC is broadly consistent with recent trends in industrial production, which has been recording weak capital goods production over the past 3 months.

Looking more closely at the consumption data, we can see the surge in public consumption (10.5%), which outweighed the expansion in private consumption (1.6%). The latter reflects increased consumer caution. The rapid increase in public consumption largely accords with the increases in community and social services.

The increase in Government spending has led to a widening of the Central Government's Gross Fiscal Deficit (GFD). For the 4 months to July 2013, the GFD amounted to INR3.41 trillion, 63% of the full year target and almost 29% higher than the previous corresponding period. The front loading of expenditure implies that the GFD is typically highest in the first 4-monthly period. That said, there remains limited scope for the Government to keep supporting the economy, given its commitment to contain the fiscal deficit, which could overshoot the 5% mark as we are in an election year.

GDP Contribution by Expenditure



Private and Public Consumption

Consumption: Private and Public

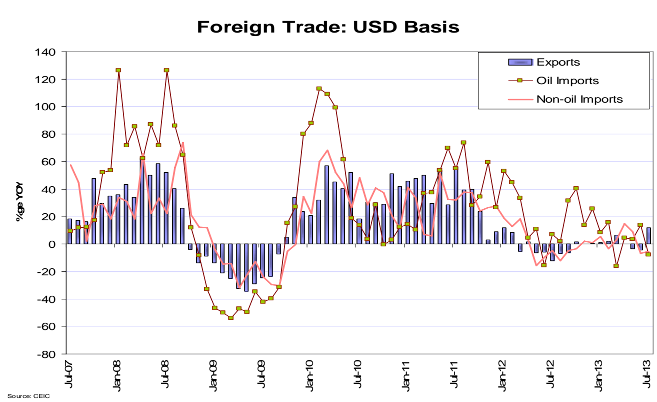
Source: CEIC

The recent improvement in merchandise trade is encouraging. Over the year to July 2013, USD exports grew by 11.6%, whilst imports contracted by 6.2%. Oil imports fell by 8.0%. Sectors such as textiles, leather, engineering and handicrafts are showing some promising signs, as they tend to have a lower import content. Pharmaceuticals is another area which could benefit, as is IT, although the latter will be reflected in services exports. The trade deficit recorded a 29.8% improvement over the year.

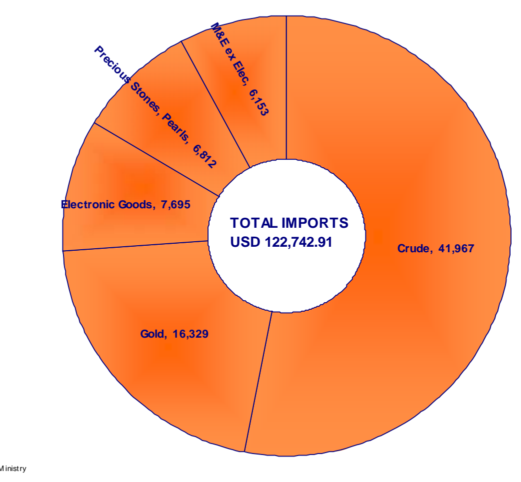
India's merchandise trade imports are dominated by oil and gold. Indian authorities are considering increasing their crude purchases from Iran, away from Saudi Arabia so as to save on valuable foreign exchange. They have also increased duties on gold and placed limitations on borrowing against gold. The Commerce Ministry is also considering elevating export sector credit to that of a priority sector, which would ensure export credit is available at a cheaper rate, helping to augment exports.

The importance of improving the trade balance can be seen in India's wide Current Account Deficit (CAD), which totalled 4.8% over the 2012-13 financial year. The negative trade balance is by far the largest factor contributing to India's structurally high CAD. The Government is considering lowering export duties as well as lobbying the Supreme Court to resume iron ore mining. To underscore the magnitude of the problem, Indian iron ore exports plunged from 117 million tonnes in 2009-10 to 18 million tonnes in 2012-13.

Growth in trade

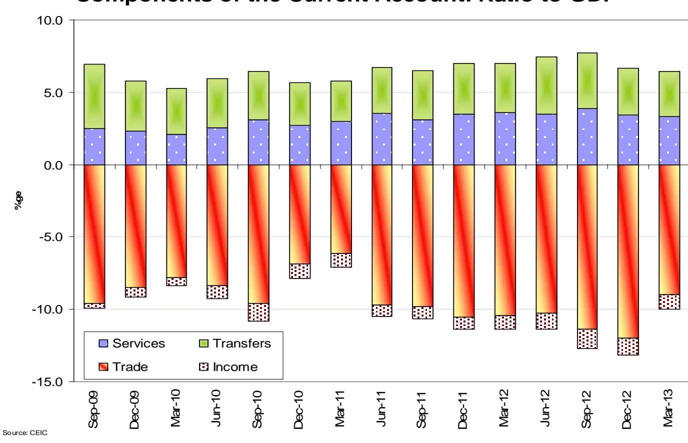


India's key imports



Source: Commerce Ministry

Current Account Deficit



Source: CEIC

Given the contribution of the high CAD to India's current economic malaise, all efforts to improve the CAD should be undertaken as a matter of urgency.

Corporate performance & Industrial Outlook

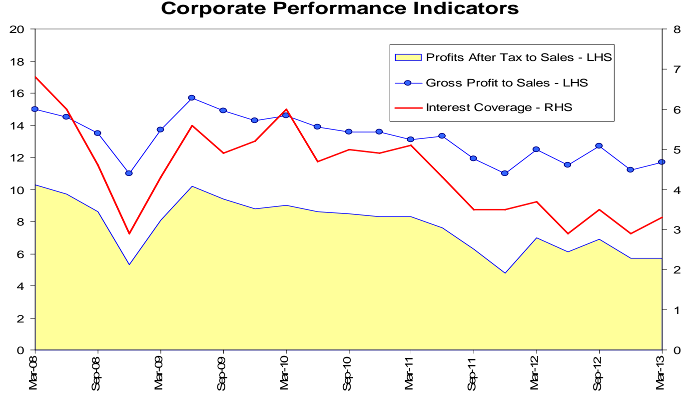
Indicators of corporate performance also remain challenging. There has been a steady decline in profitability and a rise in interest costs over the last few years. The March quarter, however, witnessed some improvement in profitability and an improvement in interest cover. Businesses would have also benefited from lower interest rates, with the RBI cutting the repo rate by 25bp in January and March.

However, the recent turmoil that has affected the Indian Rupee as well as tightening liquidity measures from the RBI, would likely have exerted considerable strains on Indian corporate balance sheets. Short term commercial paper rates have rise considerably, and Indian corporates with unhedged FX loans would be under considerable pressure – particularly those without offsetting export revenues.

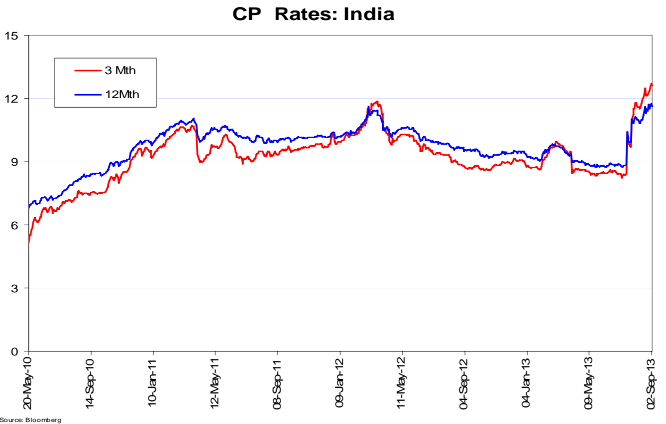
A recent study by *Credit Suisse* revealed that ten of India's most heavily indebted conglomerates had combined gross debts of USD 102bn, as at the end of March 2013, 15% higher than the year before. The average of net debt to earnings before interest, tax, depreciation and amortisation was 5.6; a ratio above 5 is

indicative of potential payment difficulties. Companies in the infrastructure sector were considered somewhat more susceptible.

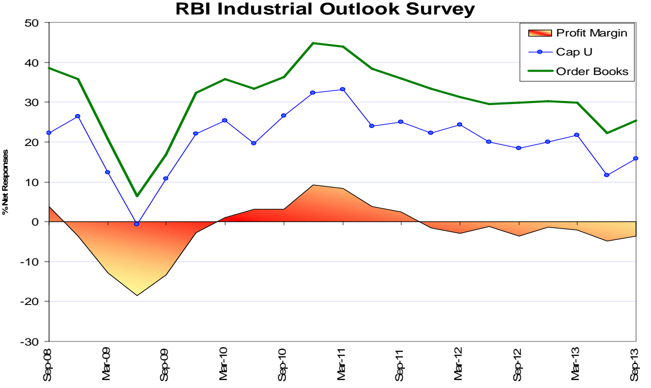
Corporate Performance



Short term Commercial Paper Rates



Industrial Outlook



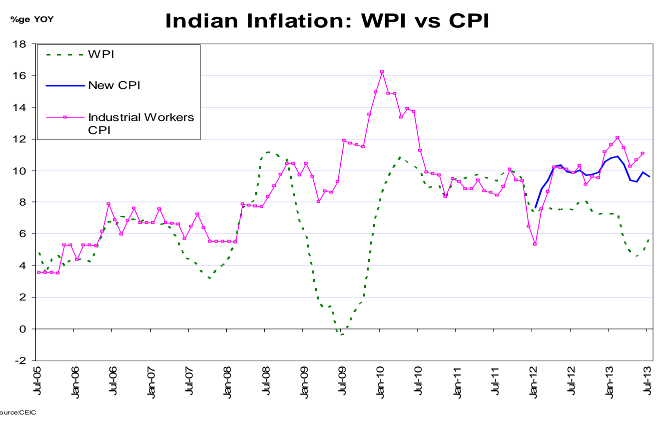
The RBI's *Industrial Outlook Survey* for the manufacturing sector for the September quarter 2013 revealed that businesses were a touch more optimistic with regard to capacity utilisation and order books in the September quarter. The one major downside was the outlook for profit margins, which was negative, implying a pessimistic profit outlook. This negative outlook for profits was most prevalent in basic metals, cement, electrical and other machinery. By contrast, the profit outlook was more buoyant in pharmaceutical, basic chemicals, fertilizers and rubber & plastic products. *To summarise, forward looking surveys do not indicate any significant near-term improvement.*

Inflationary pressures

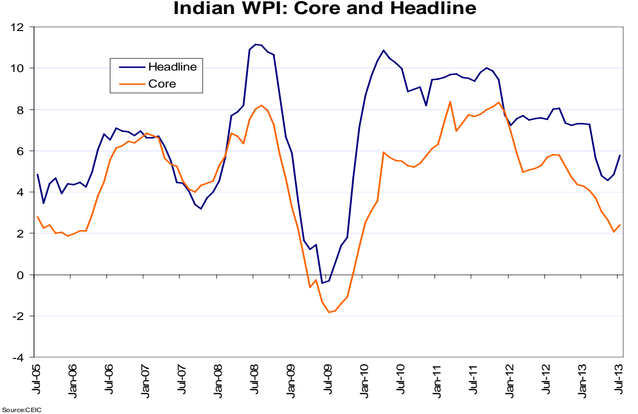
Over the year to July 2013, inflationary pressures have remerged, with the Wholesale price index rising by 5.8%. Core inflation, as measured by non-food manufactured inflation also accelerated to 2.4%, although remains contained. The recent slide in the rupee has led to rising import price inflation.

The All India CPI (new CPI) is tracking much higher than the WPI, and is close to 10%. The CPI is generally higher than the WPI, as it places a greater weight on food. Food prices remain high in cereals as well as vegetables such as onions. We are likely to see upward inflationary pressure as the lower exchange rate flows through higher fuel and energy prices.

Wholesale and Retail Prices



Core and Headline Inflation



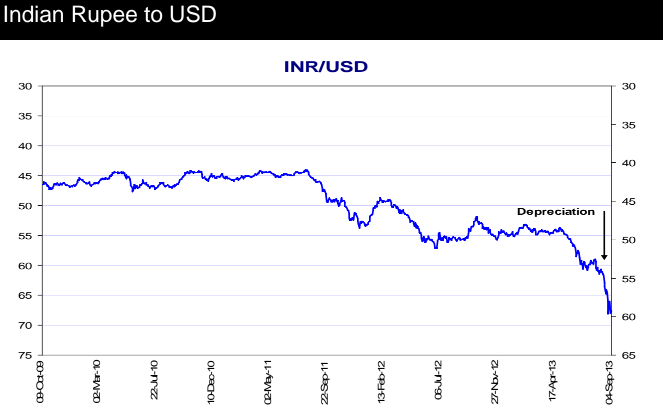
External & Financial

India's wide current account deficit and structural weaknesses have led to a sharp decline in the Indian rupee, which commenced when the Federal Reserve first mentioned tapering its QE program on the 22nd of May. The INR plunged to a historic low of 68.85/USD on concerns about tensions in Syria, the fiscal repercussions of the *Food Security Bill* and general concerns about the health of the Indian economy. The RBI's decision to open a Foreign Exchange Dollar-Rupee Swap arrangement with 3 public sector oil marketing companies – Bharat Petroleum, Hindustan Petroleum and Indian Oil Corporation – through a designated bank, have helped assuage some concerns. However, the possibility of a US strike on Syria and a warning from S&P that India's negative outlook indicates a one in three chance of a downgrade reignited market jitters.

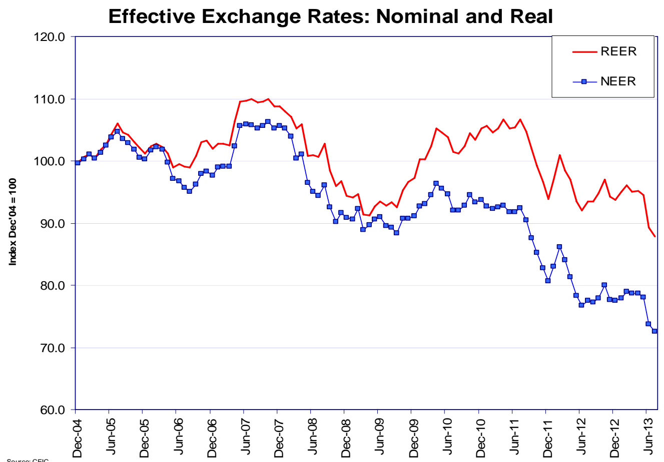
The newly appointed Governor of the RBI, Raghuram Rajan, has also offered banks that provide FCNR (Foreign Currency Non Resident) deposits for a tenor of 3 years or more, a swap facility

at a fixed rate of 3.5% during the term of the deposit. The facility is available till the 30th of November, 2013. *This move will lead to rising foreign currency denominated NRI deposits that will be available to fund the CAD.*

Indian Rupee to USD

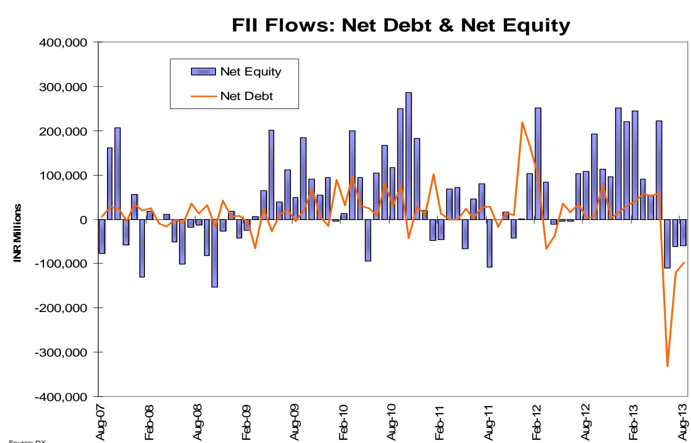


Effective Exchange Rates

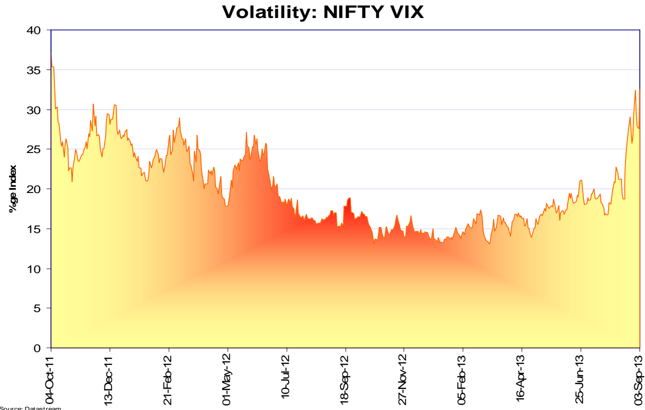


A beneficial impact of the recent plunge in the Rupee has been the decline in the *Real Exchange rate*. This should boost the competitiveness of Indian exports. The Indian Real Exchange rate has fallen somewhat less than the Nominal exchange rate as India's inflation rate is higher than its trading partners. I*t is critical for Indian enterprises to capitalise on these favourable real exchange rate movements to bolster their exports, and thereby help reduce the country's Current Account deficit.*

Portfolio Inflows



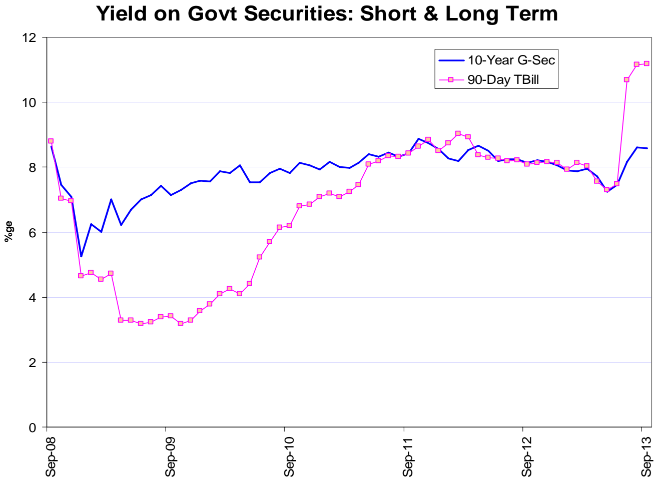
Volatility Index



The Indian growth story is losing is allure among foreign institutional investors (FIIs), a segment vital for funding India's current account deficit as well as lifting the fortunes of the Indian equity markets. Over the June-August period, FIIs have shed USD 3.7bn of Indian equities; over the 5 months to May they made net purchases worth USD15.1 billon. The recent convulsions in the foreign exchange market have also been reflected in volatility measures. The Nifty VIX (Volatility Index), which measures market volatility over the ensuing 30 days based on option prices, rose to a high of 32.49 in early September, the highest (most risky) reading since October 2011.

India's foreign exchange reserves were around USD277bn; the level of short term debt by residual maturity current stands around USD172 billion. As such, the level of foreign exchange reserves remains broadly sufficient, at least for the coming year. The RBI is unlikely to use the precious foreign exchange reserves to defend the Indian Rupee as it could be a fruitless exercise. It will instead use its reserves to smooth volatility and undertake tactical measures such as supporting oil companies with their foreign exchange needs.

Government Yields: Short and Long Term



The yield on government securities has also risen in sympathy with the gyrations in the currency market. Short term (90-day T Bills) yields are considerably higher than the benchmark 10-year G-Sec yields. This 'inverted' yield is partly a result of deliberate policy action by the RBI to keep short rates higher. That said, there been a considerable jump in 10-year yields since May 2013. Government bond yields jumped to a record high of 9.24% on the 19th of August, underscoring the vulnerability of borrowing costs.

The Government has moved to expedite the clearing of private investment projects. Nine projects worth INR 851.41 are scheduled to be reviewed by the Prime Minister headed Cabinet Committee on Investments (CCI). Rigid deadlines have been set, and these projects are expected to be reviewed by Cabinet in September. These private sector projects are spread across a number of sector and include projects by Sasan Power, L&T Metro Rail and Jaiprakash Power Ventures among others.

The Finance Minister Panaliappan Chidambaram had recently set out a 10 point agenda to bring the economy back on track. These include: contain the fiscal deficit; controlling the CAD; enhancing reserves; resuscitate the investment cycle, including efforts from the CCI; recapitalising public sector banks; support manufacturing; enhancing exports; end the standstill in iron ore and coal production; hasten capital expenditure program of public enterprises and leverage the favourable monsoon.

The above policies cover the key issues which adversely affect the economy. However, the main issue is one of actual implementation of the above measures. The downgrade threat by S&P is a reminder of the challenges facing the Indian economy.

Outlook

NAB Economics has lowered its outlook for the Indian economy. The economy is forecast to expand by *4.4% in 2013, edging higher to 4.6% in 2014, before rising to 4.9% in 2015*. Weak corporate balance sheets, tight monetary conditions and poor investment intentions indicate continued challenges for the Indian economy, against a backdrop of a weak rupee and deteriorating confidence. The fall in the real exchange rate should support exports, and the favourable monsoon is a clear silver lining. *A committed, sustained process to ease the supply bottlenecks and usher in a growth-supportive environment is needed.*

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