India – GDP Update (Dec Qtr 2013)

- **India's economic growth decelerated to 4.7% in the December quarter 2013, in year ended terms, from 4.8% in the September quarter.**
- **The standout was the Services sector (particularly Financial services and Community services), which grew by 6.7%, followed by Agriculture at 3.6%.**
- **The Industry sector contracted by 1.2%, due to weakness in manufacturing and mining.**
- **On a more positive note, Business Surveys indicate a pickup in manufacturing activity during the March quarter, 2014.**
- **By expenditure category, net exports was the most significant contributor, reflecting both export growth and import compression. Consumption came second, but Business investment contracted, indicative of weak domestic demand.**
- **These results suggest that export-led sectors such as Information Technology and Pharmaceuticals are likely to have been better performing than their domestic-focussed counterparts.**
- **The strong trade performance has resulted in a sharp compression in the Current Account Deficit, with the December quarter Deficit contained at 0.9% of GDP, a historical low.**
- **India's much improved external situation has led to a marked reduction in currency related volatility, ensuring continued Foreign Institutional Investor interest in Indian financial securities.**
- **There are stresses in parts of the banking system, particularly linked to lending in Infrastructure, Iron & Steel, Textiles and Aviation.**
- **Looking ahead, NAB Economics is forecasting growth of 5.2% in 2014, followed by a somewhat quicker 5.6% in 2015. The results of the upcoming elections, and its policy orientation will be crucial to future growth prospects.**

Indian GDP

GDP (P): By Sector

By sector, the standout has clearly been the services sector, which increased by 6.7% over the year to December, up from 5.8% over the year to September 2013. Agriculture decelerated to 3.6% from 4.6% as rainfall in October is likely to have partially damaged the kharif (summer crop). However, the industry sector was the laggard, and declined by -1.2% over the year, below the modest 1.5% expansion in the September quarter.

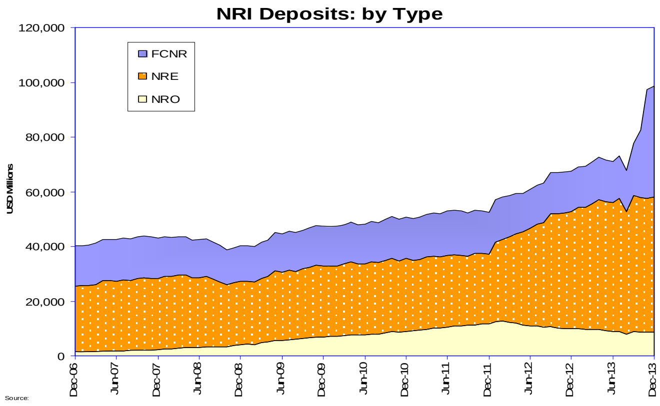
GDP Production and Expenditure

The Indian economy expanded by 4.7% over the year to December 2013, a touch lower than the 4.8% recorded in the September quarter. For calendar year 2013, the economy grew by 4.7%, marginally higher than the 4.6% in 2012, but well below the 7.5% expansion in 2011. The December quarter result is the 7th consecutive quarter in which growth was below 5%.

Taking a closer look at the fast growing Services sector, the *Finance, Insurance, Real Estate and Business Services* segment was the driving force, with a 12.5% increase, One factor has been the concessional swap facility that the RBI has provided to Banks to attract Foreign Currency Non Resident (FCNR –B) deposits. It is estimated that this facility garnered USD34 billion worth of deposits, and has gone some way in improving India's external position. Besides, business services may have benefited from improvements in IT exports, with the recovery in US and Eurozone economies.

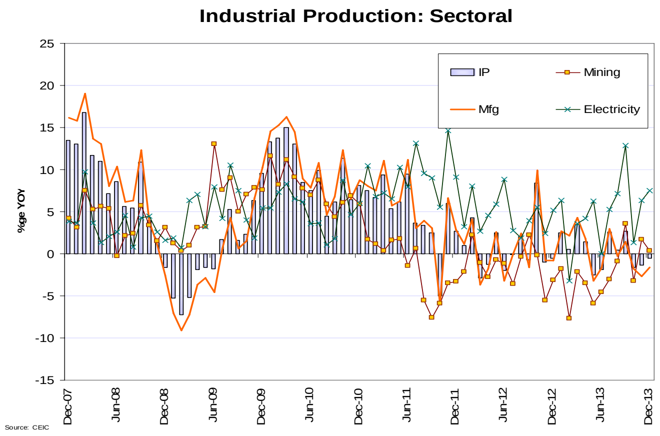
Government led spending on Community & Social services was the next best performing at 7%, whilst trade, hotels, transport and communication grew at a slower 4.3%. The slowest growing segment in the Services sector was Construction, which at 0.6% is symptomatic of weak domestic demand conditions in the Indian economy.

NRI Deposits



The weakness in the Industry sector was driven by falls in both mining (-1.6%) and manufacturing (-1.9%), although electricity, gas and water (5%) expanded. The mining sector continues to be afflicted by project delays, and the manufacturing sector is currently in recession. These results parallel trends in industrial production, with stronger electricity production insufficient to offset weakness in both mining and manufacturing.

Industrial Production

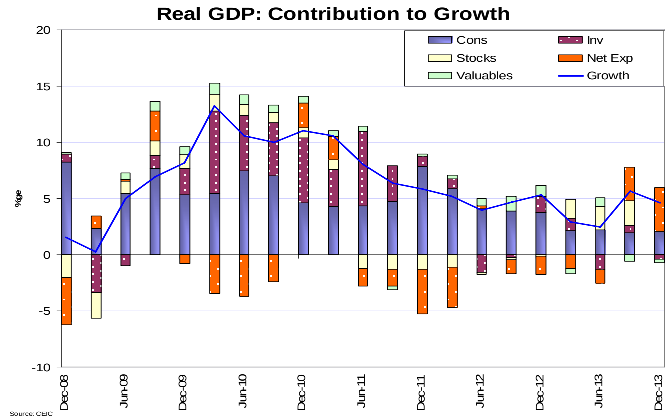


By expenditure, GDP at market prices decelerated by a percentage point (relative to the September quarter) to 4.6%. Some striking patterns emerge when one looks at contribution by expenditure: Net exports (3.1ppts) was the most significant contributor to overall growth, followed by consumption (2.1ppts). Conversely the weak business climate has led to a negative contribution from business investment (-0.4ppts).

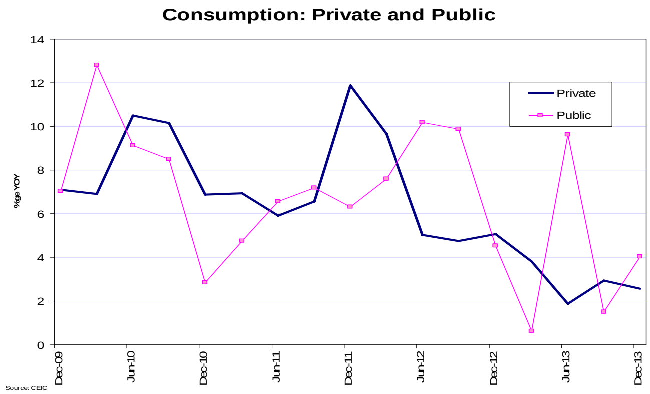
The strong net exports contribution for the December quarter reflects both export growth, as well as import contraction, particularly gold imports. This pattern of a positive contribution from net exports is evident in both the September and December quarters, quite unlike what was seen in previous quarters, where domestic demand (particularly consumption) was the contributor to growth.

Public consumption has been growing faster, and this mirrors the growth seen in *Community and Social services*. Private consumption has been hampered by higher inflation and interest rates, as well as concerns about employment in the current, slower growth environment. However, it is the weakness in the investment cycle that is most concerning. Finally, the flat contribution from inventories this quarter (unlike preceding quarters) reveals that *there is increased scope to expand output by raising production, as opposed to drawing down inventories – should demand lift.*

GDP Contribution by Expenditure



Private and Public Consumption



There are 2 broad themes to emerge from these results: the weak investment cycle and the divergence in performance between domestic and export-oriented firms.

With regard to the investment cycle, the IMF has identified policy uncertainty and weak business confidence as 2 critical factors behind the poor run of investment outcomes. With regard to policy uncertainty, project delays have been a significant deterrent. Some of these measures are being addressed through accelerated project clearances by the *Cabinet Committee on Investments,* although infrastructure-type projects tend to have long lead times, and will only be reflected in official accounts with a lag.

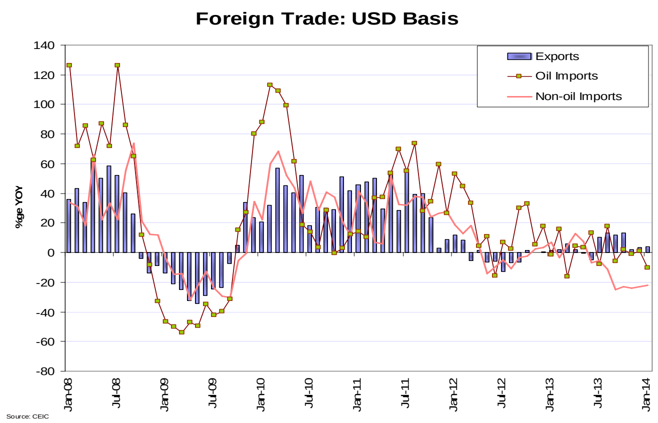
One encouraging development has been the recent signing of an agreement between the Central Government and the Maharashtra State Government to commence Phase-1 of the *Delhi-Mumbai Industrial Corridor*. This phase is expected to lead to development of an exhibition centre and multimodal logistics park around the Aurangabad region in Maharashtra.

The second key implication from this set of National Accounts is a likely divergence in performance across sectors in the economy. Export-oriented sectors such as IT and pharmaceuticals are likely to be better performing than their domestically-focussed counterparts.

Foreign Trade: A Closer Look

On a US-Dollar basis, exports rose by 3.5% over the year to January 2014. This is the 3rd month in a row that exports have increased by single digits. However, there has also been a steep decline in imports, which fell by 18.1%, with non-oil imports (-22%) particularly weak, having been so since the last 6 months. The January 2014 trade deficit was 48% lower than year-ago levels.

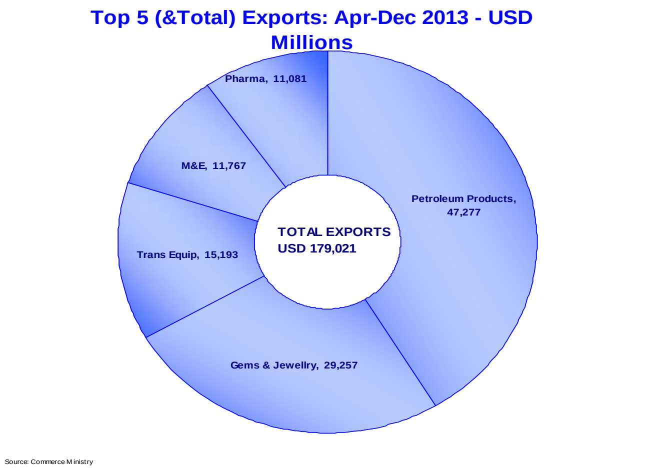
Foreign Trade



Looking more closely at data from the *Commerce Ministry* over the April-December period reveals that refined crude products and transport equipment were among the major export categories. Leading exporters of refined Crude products include: Reliance, HPCL and Essar Oil. Besides, engineering goods and cotton, yarn and textiles were among the fastest growing export categories.

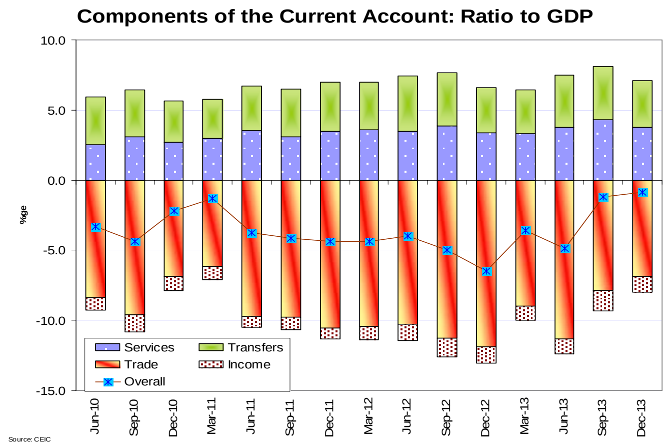
On the imports front, gold fell by 39%, no doubt impacted by restrictions from both the RBI and Central Government. Further, there were sharp declines in imports of machinery products, due to weak domestic demand.

Top 5 Exports



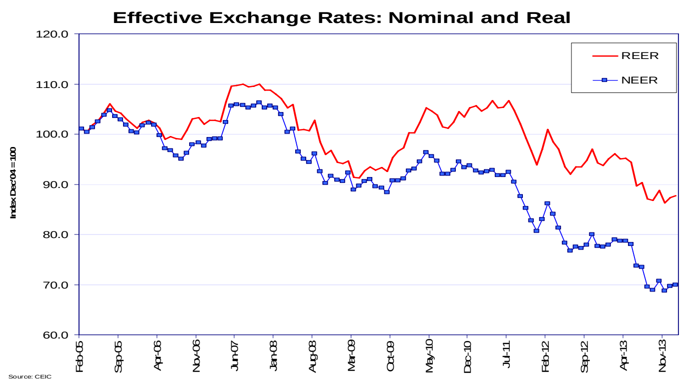
The strong trade data, as well as improvements in net services due to lower service-related payments, ensured the Current Account Deficit fell to a historic low. In the December quarter, the CAD fell to USD 4.2 billon, or -0.9% of GDP, better than the relatively low -1.2% deficit in the September quarter, and substantially better than the very high CAD (-6.5%) in December quarter 2012, when serious questions were raised about the sustainability of India's external position. In the first 9 months of the 2013-14 fiscal year, the Current Account Deficit amounted to USD 31.1billion (2.3% of GDP), against a deficit of USD 69.8billion in the previous fiscal year (5.2% of GDP). These positive results should lead to a well contained outcome for the Current Account during the 2013-14 fiscal year.

Current Account Deficit



Finally, it is worth pointing out that India's real exchange rate still remains low by historical standards, supporting its export performance. Recent stabilisation in the exchange rate has nudged both the real and nominal exchange rates higher. However, it is important to bring down the rate of inflation in order to ensure India's real exchange rate (and hence exports) remain competitive.

India's REER



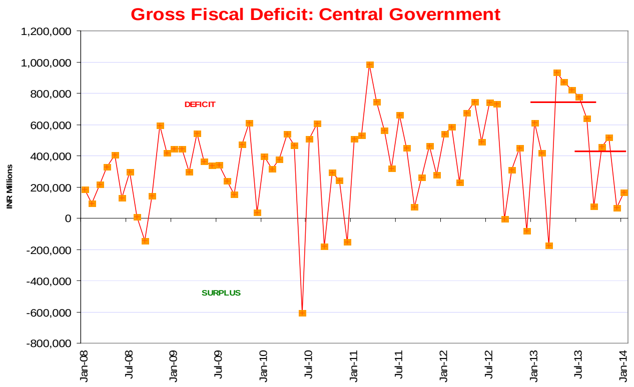
Fiscal Policy

The Central Government's fiscal deficit for the first 10 months (April-January) of the 2013/14 fiscal year amounted to INR 5.33 trillion. The deficit is 101.6% of the *Revised Estimates* (for the 2013-14 Financial Year) as set forth in the *Interim Budget* on the 17th February. Net tax receipts were INR 5.76 trillion, while total expenditure reached INR 12.7 trillion.

In light of the breach of the deficit target, the Government is likely to further compress *Plan Spending* (the spending component agreed with the Planning Ministry). Moreover, tax collections usually gather momentum towards the last couple of months of the fiscal year. Additionally, the Government will likely transfer allocation for subsidies from the 2013-14 fiscal year to the 2014-15 fiscal year, as well as benefit from non-tax sources such as from sale of spectrum auctions as well as dividends from Public Sector enterprises.

Taken together, the Government is likely to meet its original 4.8% Fiscal deficit target. However, in light of the weaker growth numbers, the revised 4.6% target envisioned in the Interim Budget could prove somewhat of a stretch.

Gross Fiscal Deficit

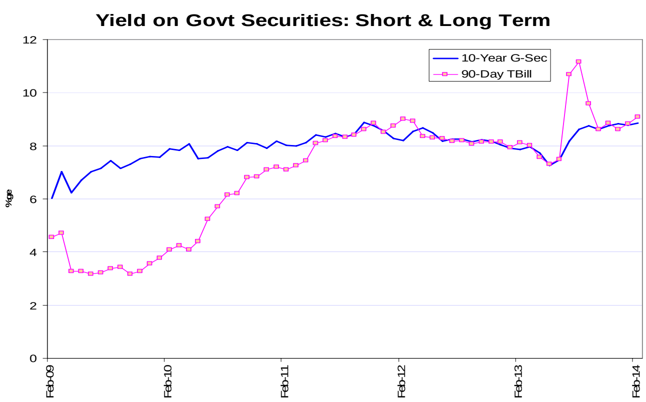


In order to boost the beleaguered manufacturing sector, the Interim Budget contained 3 changes to indirect taxation that will take effect for the 2014-15 FY, including:

- The excise rates on a number of capital and consumer goods to be reduced by 2% to 8%;
- Small cars, two-wheelers and commercial vehicles to enjoy a 4% drop in excise duty to 8%;
- Lower duties for mobile handsets and their components;

At the time of writing, India's 10 year bond yields and 90-Day T Bills were trading at 8.85% and 9.%, respectively. Broadly, this is indicative of a slightly inverted yield curve, and partly reflects the current tighter monetary policy, following the Repo rate increase on the 28th of January, 2014. Moreover, the general upturn in yields (at both the short and long ends) over the past month or so clearly reflects the RBI's preference for injecting liquidity through Repo operations, as opposed to Open Market Operations (OMOs). Over the month to 21st February, the RBI injected INR 7,378.9 bn of liquidity through Repo operations, against INR 94.77bn of bond purchases through OMOs.

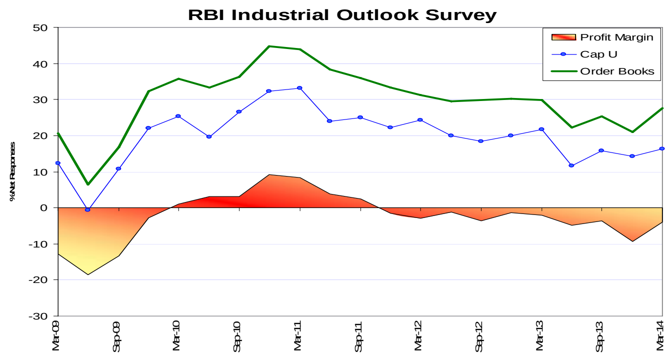
Government Short and Long Term Rates



Industrial Outlook – Modest Improvement expected

The RBI's latest *Industrial Outlook Survey* for the manufacturing sector, conducted in November-December 2013, clearly reflects a general improvement in the outlook for a number of key metrics: order books, capacity utilisation and profit margin. The latter, whilst improving, is still expected to remain in negative territory. Across industries, basic chemicals and rubber & plastic products were expected to have somewhat stronger profit margins; fertilizer and transport equipment manufacturers were forecast to have somewhat weaker profit margins.

Industrial Outlook : Expectations for Mar Qtr 2014



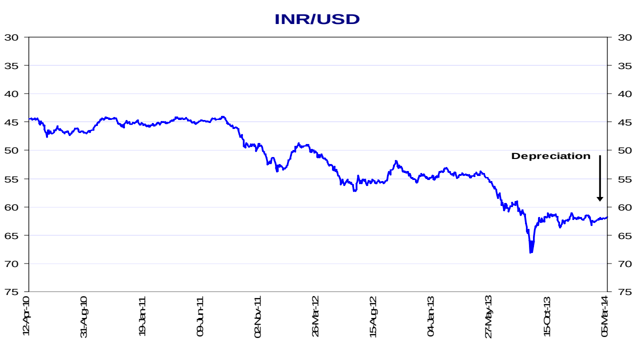
The major improvement though was in the *order books* component. This agrees with the results of other Surveys such as the HSBC's *Manufacturing PMI,* which showed that February's PMI rose to a one-year high of 52.5, building on January's 51.4 reading. The HSBC survey highlighted that the improvement in production as well as a rise in new orders (including for export orders) were behind the result. The RBI also indicated that Business Confidence from Surveys such as the NCAER Index improved (from 100.4 to 122.3), driven by improving sales, orders and investment prospects.

In summary, business surveys indicate a moderate improvement from the March quarter, driven by advances in new orders and production. However, high inflation and election uncertainty may dampen the overall improvement.

External and Financial

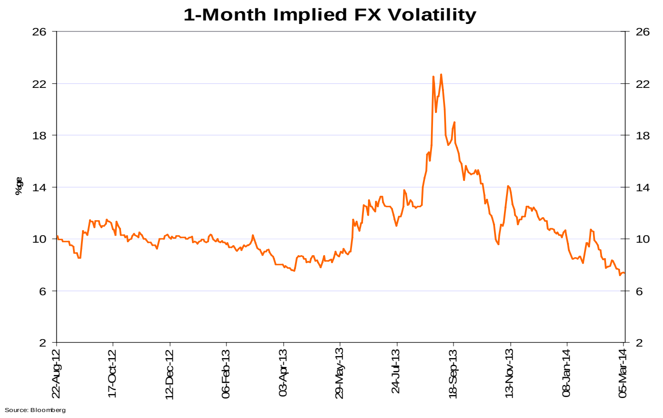
The Indian Rupee has been trading around 61.20/USD at the time of writing. The rather disappointing GDP release, as well as tensions in Ukraine have led to a modest depreciation in the INR. Some of these pressures have somewhat abated as the Indian Rupee, along with Global equities rallied, following a televised address by Russian President, Vladimir Putin, that tensions in the Crimea had 'dissipated'; the lower Current Account deficit too provided some support for the Rupee.

Indian Rupee to US Dollar



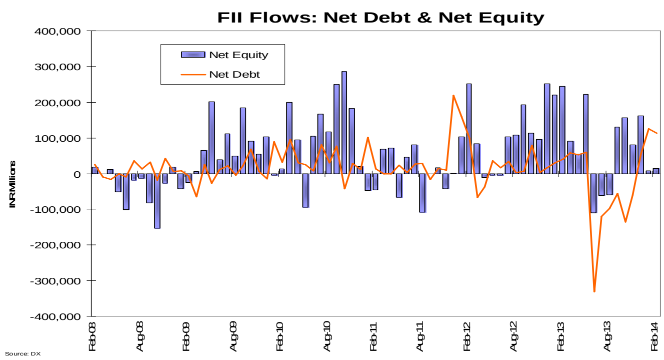
The Rupee has broadly stabilised around the USD61-63 range over the past 3 months, and reflects the improvements in the external situation over the past few months. Another measure closely watched by analysts and foreign investors is the *1-month implied FX volatility*. It is a measure of expected moves in the exchange rate used to price options, and was at 7.3% at the time of writing, below recent lows, and considerably lower than the 22.7% peak in September, 2013, when the Rupee was under considerable pressure on account of Fed's comments about commencing its tapering program.

FX Volatility: 1-Month Implied



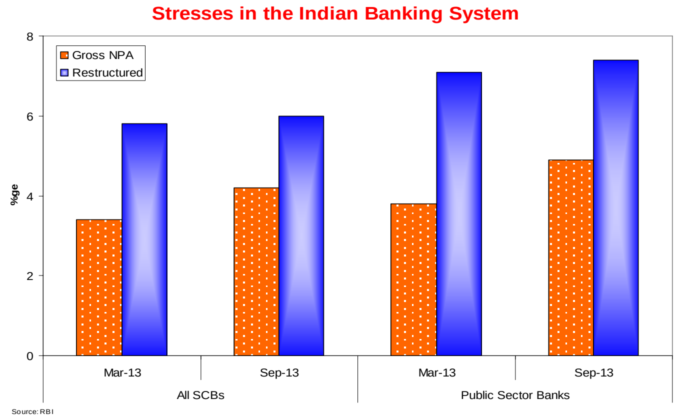
The stability in the foreign exchange market has led to sustained interest in Indian financial assets by Foreign Equity investors. Moreover, a more inflation –focussed RBI has also engendered confidence among International debt investors of late. As a result, there has been an acceleration in Foreign Institutional Investor purchase of Indian debt securities (particularly over the past 2 months). Paradoxically, the tight monetary settings, which are likely to have attracted overseas debt investors, may have dissuaded overseas equity investors, although Net Equity investments still continued to remain positive in January and February 2014.

FII Flow: Debt and Equity



One lingering concern is the high level of stress in the Indian banking system caused by India' low growth-high inflation environment. Stressed assets amounted to 10.2% of advances in the banking system as at September 2013, comprising both Gross Non Performing assets (4.2%) and Restructured assets (6%). The level of stressed assets was 9.2% at March 2013. Public sector banks have higher levels of stressed assets, at 12.3%, with *Union Bank of India* the worst impacted. In terms of sectoral distribution, 5 sectors have disproportionately high levels of stress: Infrastructure, Iron & Steel, Textiles, Aviation and Mining. These 5 sectors together contributed 51% of total stressed loans in the Indian banking system.

Stresses in Indian Banking



The RBI is acutely aware of the issue of Non-performing loans and has proposed a proactive approach to address this. They have suggested the formulation of a *Joint Lenders' Forum* to deal with distressed assets, including developing a Master agreement to expedite this process. Further, they also proposed measures for early identification and disposal of nonperforming assets to groups such as asset reconstruction companies. In the event that banks conceal the (stressed) status of some their accounts, they could find the RBI intervening and adopting accelerated provisioning measures. These new measures are forecast to take effect from the 1st of April. Finally, both the RBI and Finance Ministry are co-operating closely with regard to recapitalising Public Sector Banks, as well as addressing challenges confronting the *Union Bank of India*.

In response to the new measures, banks such as *State Bank of India* are investing in specialised early-warning software to detect stress across sectors. Other banks too are tightening their regulations, with the Indian Overseas bank, for example, indicating that it will not be providing loans to power companies without a committed fuel supply agreement in place.

Outlook

The actual December quarter GDP outcome of 4.7% for 2013 was in line our previous forecasts. Looking ahead, NAB Economics is forecasting a 5.2% expansion in 2014, followed by a somewhat quicker 5.6% in 2015. These results are indicative of a gradual recovery. Factors such as tight monetary policy settings, and high levels of stress in the banking system will limit the pace of improvement.

A critical factor is the upcoming election scheduled for April-May. The election of a stable, business-friendly Government is likely to boost business confidence and be supportive of growth. Conversely, a fractious coaltion government could be detrimental to growth prospects.

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