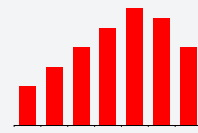


India GDP & Monetary Policy

by Group Economics

December 2014



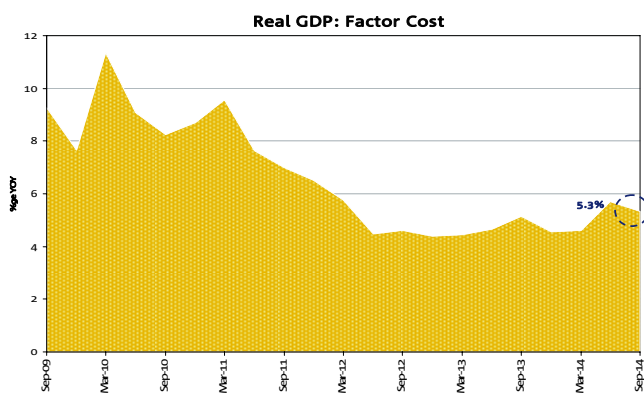
Summary & Overview

- The Indian economy expanded by 5.3% over the year to the September quarter.
- Whilst lower than the June quarter's (5.7%) result, it is the second successive quarter of above-5% growth, and reflects a gradual upturn in the Indian economy.
- Financial services and Community services were the best performing sectors, whilst manufacturing was tepid.
- NAB Economics is forecasting a 5.3% real GDP outcome in 2014, followed by a quicker 6.3% expansion in 2015.
- The RBI held its policy rate at 8%, despite a deceleration in the inflation rate (driven partly by lower oil prices) and weak industrial production.
- NAB Economics is forecasting 75bps worth of cuts in the policy rate during 2015, bringing the Repo rate down to 7.25% by the end of 2015.
- Financial market indicators such as interest rate swaps and the yield curve are also pricing in cuts during 2015.
- Risks to our interest rate projections include limited progress on fiscal consolidation, a weak monsoon and possible re-emergence of higher fuel & commodity prices.

GDP Outcome

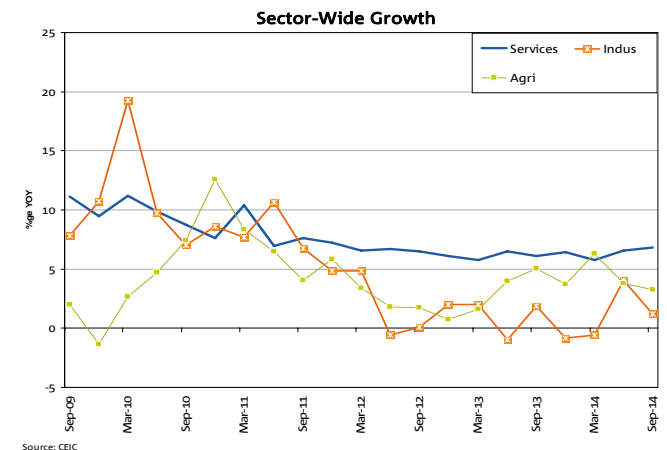
The Indian economy expanded by 5.3% over the year to September quarter 2015. While slightly lower than the June quarter outcome (5.7%), it is the second consecutive quarter of above 5% growth, indicating a gradual recovery in the Indian economy.

Indian GDP



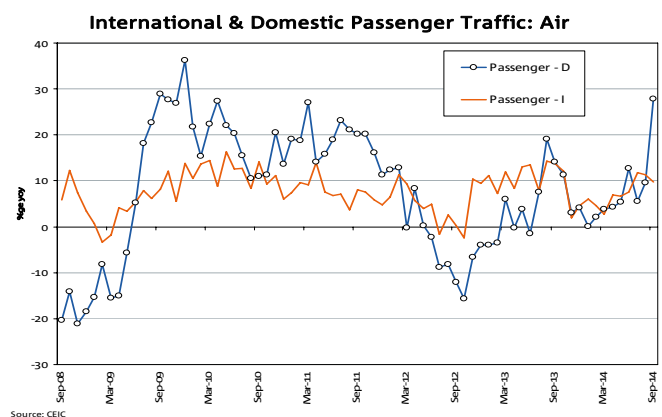
By sector, growth was driven primarily by Services, which expanded by 6.8%. Agriculture grew by 3.2%, while Industry recorded a very modest 1.2% expansion.

GDP (P) by sector



The Services sector contributed 89% of the growth this quarter. In the Services segment, strong growth was recorded in Finance, Business Services & Real Estate (9.5%), as well as Community and Personal Services (9.6%). The latter may not provide as much support in subsequent quarters as the Government will look to rein in the fiscal deficit. The Hospitality & Transport sector expanded by 3.8%, with some segments such as domestic passenger aviation (see chart below) growing strongly. Construction (4.6%) was buoyed largely by cement production.

Airline Passenger Traffic

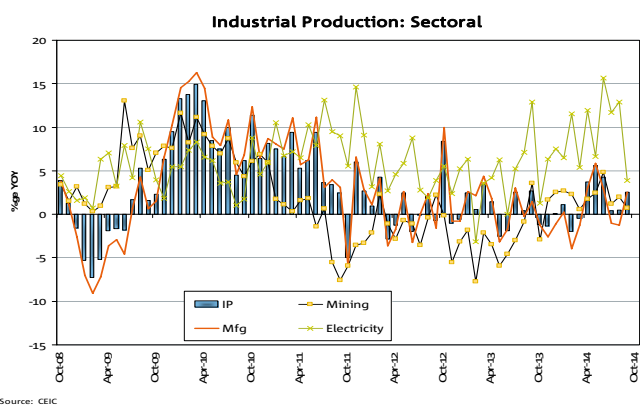


Agriculture eased due to weaker output from the summer (kharif) crop. However, the improvement in the monsoon in September meant that the expected easing (from 3.8% to 3.2%) in Agriculture was not as bad as previously feared. The one weak spot, this time, has been the performance of the Industry sector: recording an unexceptional 1.2% growth. Within Industry, the important Manufacturing sector (0.1%) was virtually flat, Mining expanded by 1.9% and Electricity was the standout (8.7%).

The GDP results accord broadly with the industrial production data. During the year to the September quarter, Industrial production, on average, expanded by a sedate 1.1%. Mining improved moderately; electricity was the standout, although it eased somewhat in the month of September; Manufacturing contracted in two of the three months in the quarter, helping explain the weak manufacturing results in the National Accounts.

More recent data from the HSBC Manufacturing PMI revealed it reached a 21-month peak of 53.3 in November. The sub-index for output grew the fastest since February, 2013. It remains to be seen if this momentum can be sustained and translate into faster growth.

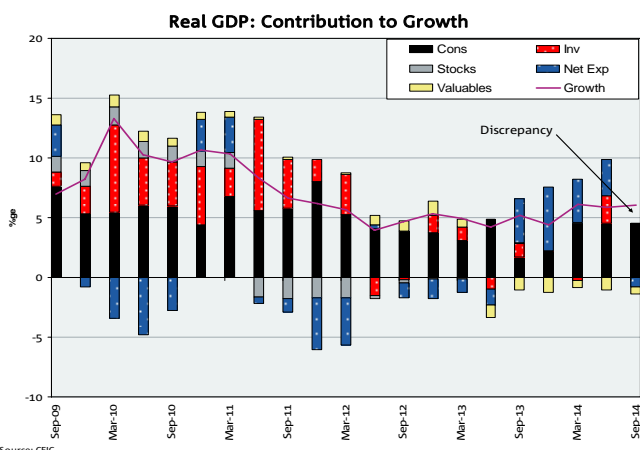
Industrial Production - Sector



Source: CEIC

National Accounts data by expenditure reveal that Consumption (4.5%) was the main contributor to growth. There was very strong growth in Public Consumption (10.1%) – in line with the strong spending on Community and Social Services – and, to a lesser extent, Private Consumption (5.8%). The contribution of both Investment and Stocks was basically flat; Net Exports (-0.8%) detracted from growth. The high Statistical discrepancy (2.9% contribution) raises some issues as to the quality of the expenditure data.

GDP – By Expenditure

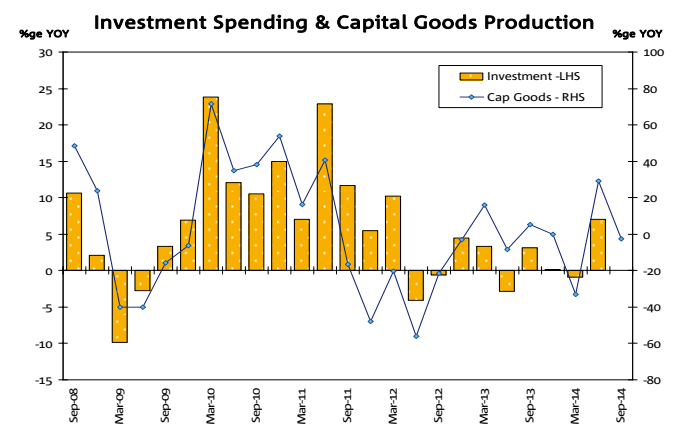


Source: CEIC

Data on industrial production by use also indicated that Capital goods was weak (contracting in 2 out of 3 months) in the September quarter, and Consumer goods production was very weak (driven by consumer durables), reflecting

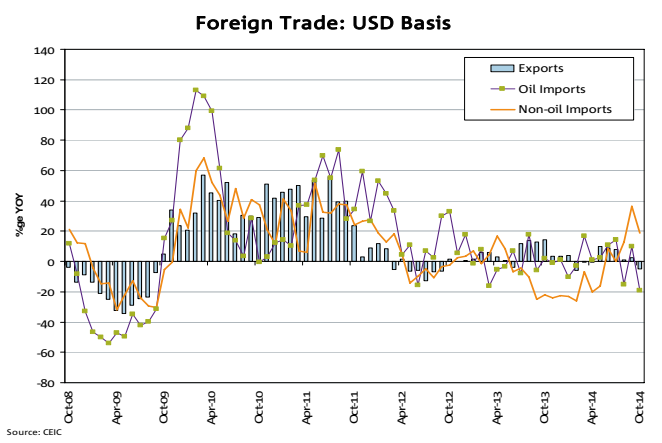
some measure of consumer caution with regard to big ticket items. This trend maybe reversing, with an improvement in passenger vehicle sales in November across key automobile brands: Maruti Suzuki, Hyundai, Honda and Tata Motors.

Capital Goods and Investment Spending



The capital goods sub-index in industrial production (by use) bears a close relationship with Investment spending in the National Accounts. The relative weakness in Investment spend in the September quarter is clearly visible in the Capital Goods production data. According to FICCI (Federation of Indian Chamber of Commerce & Industry), despite positive investor sentiment, businesses remain cautious about increasing their investment spending due restrained demand and spare capacity. According to the RBI's *OBICUS* Survey, the latest capacity utilisation rate is 70.2%, well below 75% level observed in previous surveys.

Trade Indicators



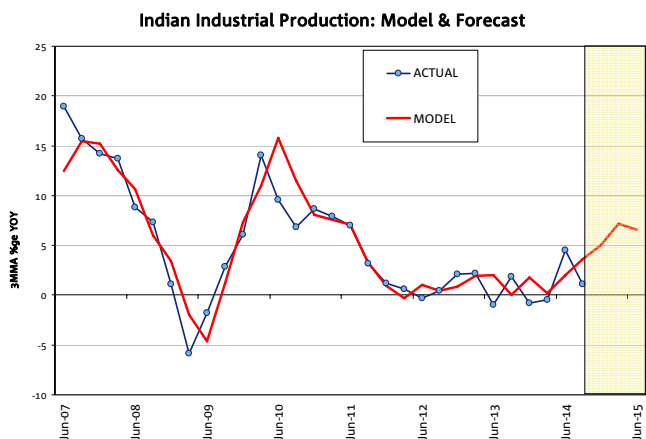
Source: CEIC

Exports have been weak since August 2014 – confirming the trend observed in the National Accounts data. In fact, exports contracted by -5% over the year to October, 2014. The decline in exports has been broad based, including engineering goods and refined petroleum products. This partly reflects slower global demand, given weakness in Japan and Eurozone, and a slower pace of expansion in China. The impact on the trade balance is mitigated somewhat due to the sharp decline in the *value* oil imports. Crude oil prices, as measured by the Indian Crude basket, fell by 12% over the June-September period.

The sharp drop in crude prices has led the RBI to drop the '20:80' gold import rule, which was introduced in August 2013 to curb India's ballooning Current Account deficit. According to the rule, traders had to export 20% of the gold sourced from overseas. The discontinuation of this rule should cool domestic gold prices, and boost demand for gold during the crucial wedding season. Data from Bloomberg revealed that imports of gold in October rose to 150 tonnes, the highest, thus far, in the 2014-15 fiscal year.

Leading indicators point to a pickup in Industrial production in 2015. Modelling by NAB Economics using the OECD Leading Indicator for India suggest Industrial production should rise close to 7% in 2015, well above the 1.7% average over the year to September, 2014. These outcomes crucially depend on the quality of reform efforts by the Government over the coming months.

Outlook – Industrial Production

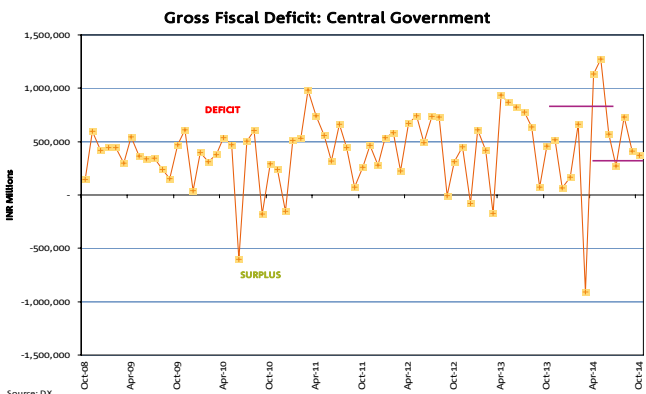


Source: NAB Economics/CEIC

Fiscal Position

India's fiscal deficit for the April-October period totalled INR4.76 trillion, 89.6% of the full year's deficit. By contrast, the deficit for the previous corresponding period was 84.4%.

India's Deficit



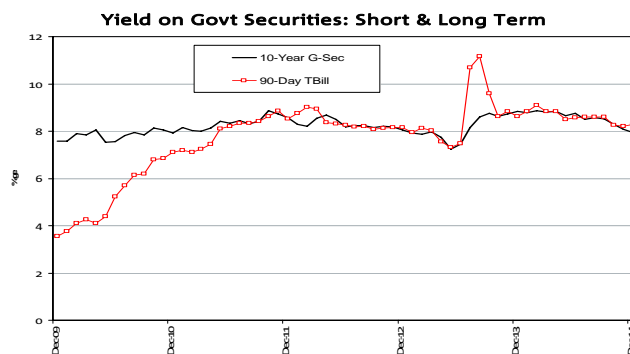
Source: DX

The deficit figures imply that it will be very difficult to achieve the 4.1% Budgeted fiscal deficit for the 2014-15 year. The shortfall was driven primarily by lower than expected net tax receipts (37.7% of estimates) as well as a very poor outcome with regard to non-debt capital receipts

The latter includes very limited progress on the disinvestment front. It is likely the Government will move to accelerate disposal of assets, including stakes in Government-owned banks. While fuel subsidies should fall in line with fuel prices, the Government might be compelled to curtail capital spending if it is to meet its deficit target.

India's borrowing costs have also fallen steadily. This should put downward pressure on India's fiscal deficit by lowering interesting payments.

Indian Bond Yields

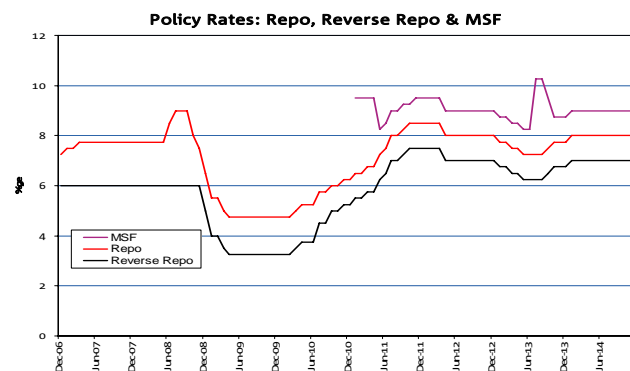


RBI's Decision

At its December, 2nd meeting, the RBI:

- ❖ Maintained the policy Repo rate at 8%; the MSF (Marginal Standing Facility) and Reverse Repo Rate were held at 9% and 7% respectively;
- ❖ Kept the Cash Reserve ratio at 4%'
- ❖ Continued providing liquidity under overnight repos at 0.25% of banks' NDTL (Net Demand & Time Liabilities), and 7-day and 14-day term repos at 0.75% of banks' NDTL.

Indian Policy Rates

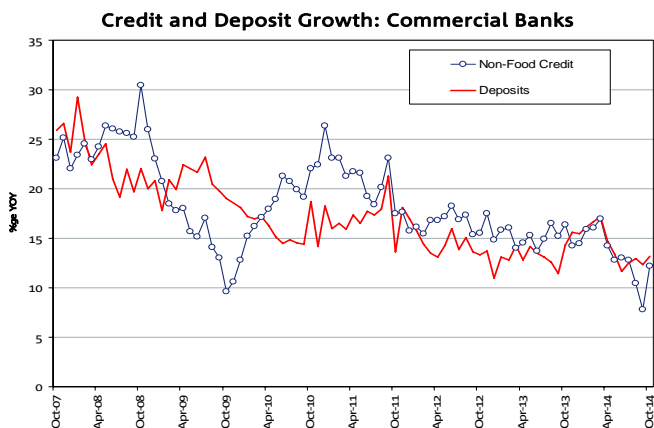


Source: DX/RBI

Despite the clamour for rate cuts, the RBI held – as we expected – the Repo rate at 8%. While acknowledging the deceleration in inflation and weak industrial production numbers, it indicated that it was 'premature' to cut rates at this stage given still high inflation expectations and the need for greater surety around actual inflation outcomes. Further, with credit growth still modest, and outstripped by deposit growth, the incidence of a rate cut would largely

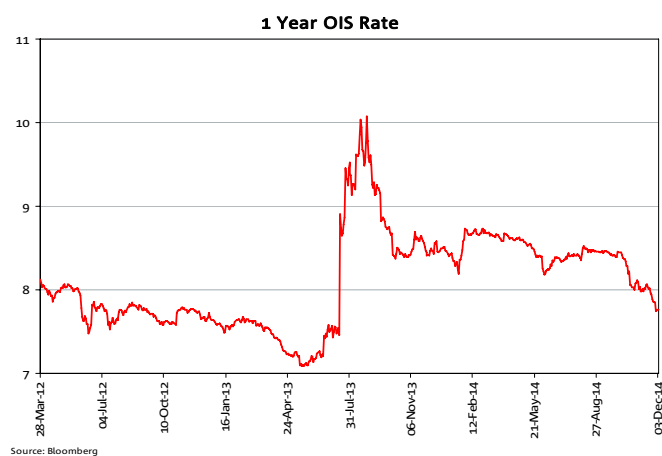
have a 'signalling' effect rather than cause any meaningful growth in lending.

Credit & Deposit growth



The tone of the Statement, however, was more dovish. Firstly, it revised down the central outlook for inflation (headline CPI) to 6% by March 2015. Secondly, it indicated that it expected inflation to hover around 6%, and the risks of achieving this outcome in January 2016 were 'evenly balanced'. This is in contrast to the previous meeting when the risks to the target were to the upside.

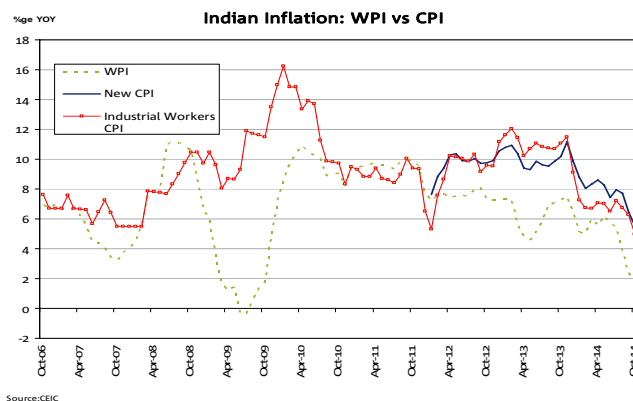
Overnight Index Swap Rate: 1 Year



One-year OIS rates (derivative instruments used to lock in interest rates) remained stable in the aftermath of the policy announcement. However, they have fallen around 70bps since the last meeting on the 30th September. Put another way, financial markets are expecting a 70bp fall in the policy rate over the ensuing year.

Inflation indicators continue to head in the right direction. Headline indicators for both the Consumer Price Index and the Wholesale Price Index have reached recent lows. Over the year to October, 2014 the headline consumer inflation rate expanded by 5.5%, the lowest increase since the series was constructed. Headline wholesale prices grew by 1.7%, the slowest since October 2009.

Headline inflation

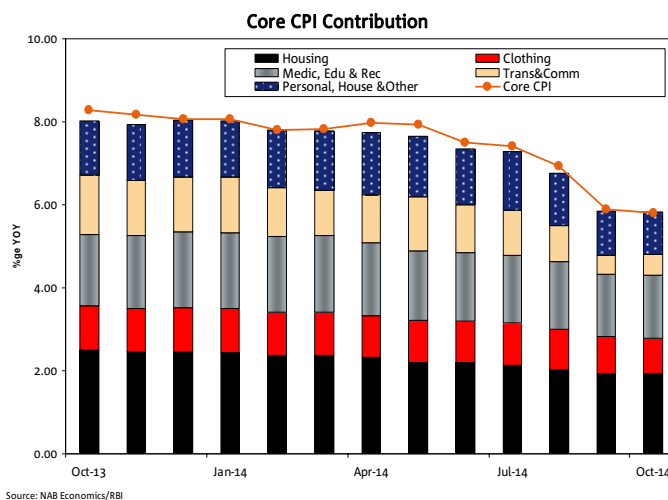


The important food inflation segment (which accounts for close to 50% of the index) decelerated to 5.8% over the year to October, compared with 7.6% in the previous month. Food inflation may have been contained due to lower Minimum Support Prices set by the Government, as well as the Government's policy of releasing food stocks.

Vegetable prices retreated sharply, and fruit prices also eased. Against that, the prices of milk and protein rich products remained a touch high. According to the RBI, there could be some upward pressure on the prices of cereals given uncertainty surrounding the extent of the North East monsoon and the somewhat lower foodgrain production during the summer planting season.

Fuel price inflation has been in steady decline, with the Fuel and Light sub-category expanding by 3.3% over the year to October, the lowest on record. More recent data from the Indian Petroleum Ministry revealed that the *Global price of India's fuel basket* was around USD70/bl, almost 40% below prices prevailing in June.

Core Inflation



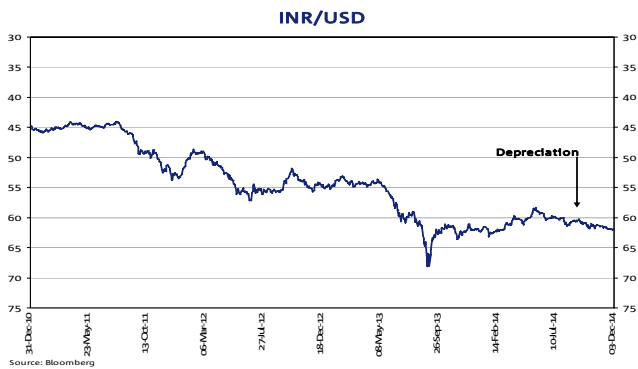
Core CPI inflation (ex fuel and food) remained steady at 5.8% over the year to October 2014. The transport component has shown the most marked decline over the past few months, owing to weaker fuel prices. However, clothing and medical expenses have remained steady. The

RBI follows the Core measure closely, as it is a good indicator of inflation persistence.

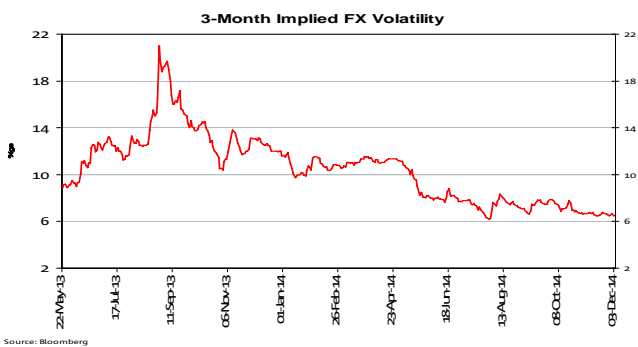
External and Financial

The Indian rupee has remained broadly stable against the greenback, trading a touch under 62/USD. The RBI's decision to keep interest rates on hold at its December meeting only seemed to reconfirm this trend. Further, 3-month FX volatility, a measure of expected moves in the exchange rate used to price options, was around recent lows at 6.5%.

Indian Rupee to the USD

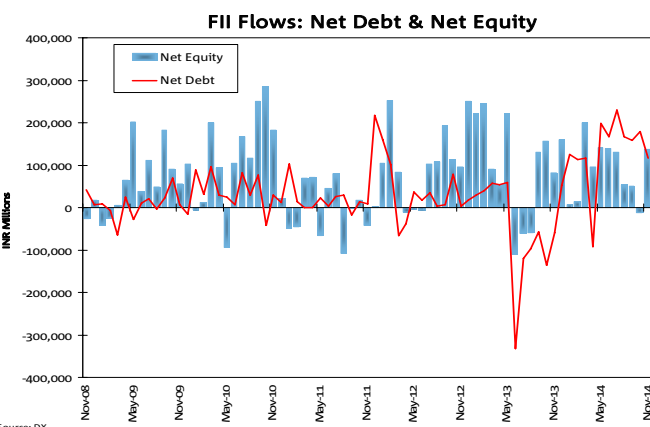


FX Volatility



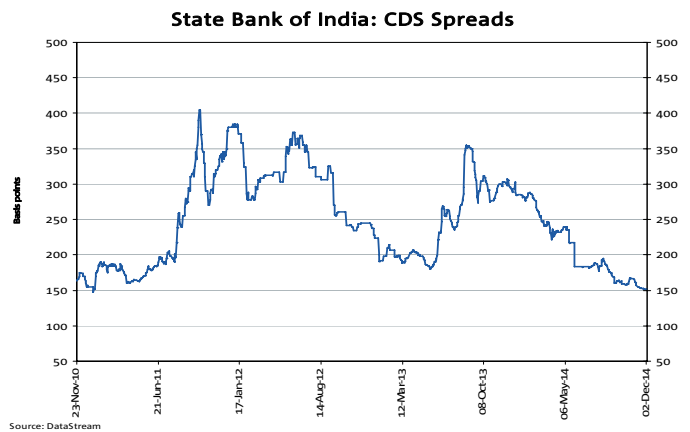
India continues to attract strong debt and equity inflows from overseas. During November, there were USD 1.9bn of debt inflows, and USD 2.2bn of equity inflows. These positive trends have continued into December, with USD 575m and USD 481m of debt and equity flows, respectively.

FII Inflows



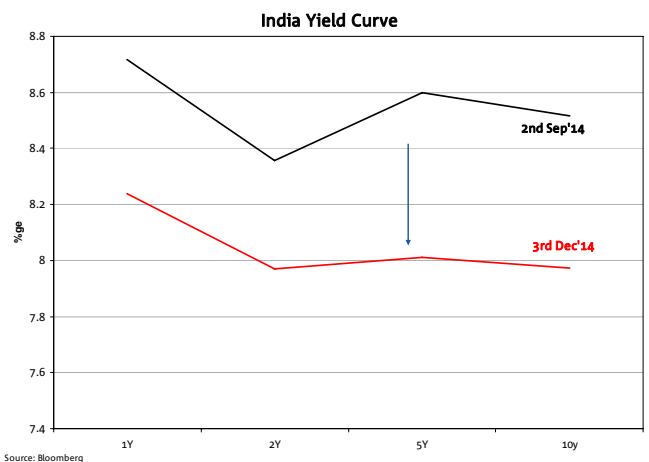
India's improved external settings, stable monetary policy regime, and general enthusiasm about the current Modi administration have resulted in a decline in India's sovereign risk perception. State Bank of India CDS Spreads – a proxy for India's sovereign risks – have continued to fall, and remain substantially below levels seen in August-September 2013, when there were serious concerns about India's external position.

Sovereign Risk Perception: India



India's yield curve has shifted lower over the past couple of months. This shift is visible right across the yield spectrum; benchmark 10-year yields, in fact, have fallen below the 8%. Clearly, markets are anticipating lower Government borrowing costs. This could spur increased investor interest in Indian debt securities, and also lower the cost of borrowings for Indian corporates, to the extent that corporate bonds are priced off the Sovereign.

Yield Curve



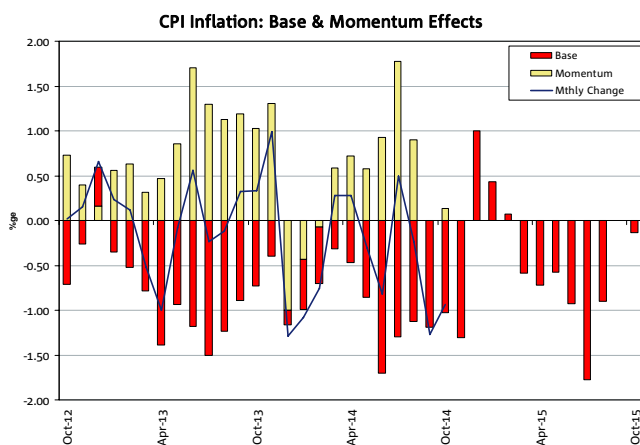
Outlook

NAB Economics is maintaining its growth forecast of 5.3% in 2014, followed by a pickup to 6.3% in 2015. Leading indicators point to an improvement in activity in 2015. Further, the economy should be supported by expected rate cuts in 2015. The sustainability of India's growth outlook depends crucially on the scope of Government reforms. A more investor-friendly taxation regime (including progress towards a Goods and Services tax);

moves to amend rules on land acquisition and creating a more favourable environment for investment in coal and power sectors will positively impact on India's growth prospects.

On interest rates, we are forecasting 75bps worth of cuts in 2015. Tentatively, we expect 50bps in the June quarter (25bp in April and June), and, following a pause, another 25bps in the December quarter. The RBI indicated in its December Monetary policy Statement that 'once the monetary stance shifts, subsequent policy actions will be consistent with the changed stance'.

CPI Inflation: Base & Momentum Effects



With regard to the timing, we believe the current favourable 'base-effects' are expected to reverse over the next couple of months. The RBI will likely wait to see how inflation outcomes materialise over the next few months, before cutting rates. We don't rule out the possibility of a cut either in February, or a non-scheduled cut in March (post-Budget), if inflation surprises on the downside.

However, the risks to our interest rate projections are not one-sided. Factors that could cause upside risks to our forecasts include: limited progress on fiscal consolidation; a weak monsoon in 2015; the emergence of geopolitical risks and higher commodity prices in 2015.

John Sharma

Economist – Sovereign Risk

john.sharma@nab.com.au

Tom Taylor

Head of International Economics

Tom_Taylor@national.com.au

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Agribusiness
+(61 3) 8634 0198

Karla Bulauan
Economist – Australia
+(61 3) 86414028

Industry Analysis

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

International Economics

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy

Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy

Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research

Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Equities

Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

Distribution

Barbara Leong
Research Production Manager
+61 2 9237 8151

Asia

Christy Tan
Head of Markets
Strategy/Research, Asia
+852 2822 5350

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymerly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web
Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX
Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532

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