India GDP& Monetary Policy

by Group Economics

June 2015

National Australia Bank

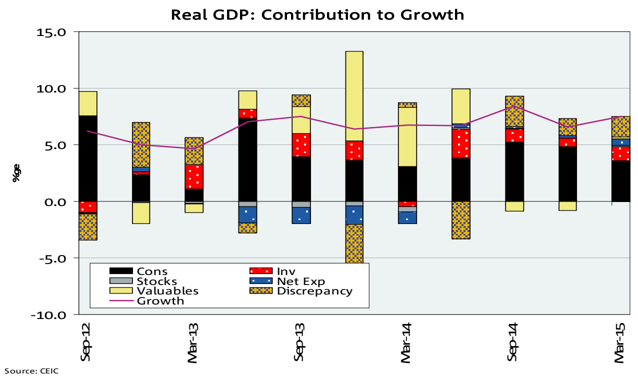
Summary & Overview

- The Indian economy expanded by 7.5% over the year to March 2015.
- Services (9.2%) was the best performing, particularly Hospitality and Financial services.
- Industry (5.4%) was the next best performing, but Agriculture (-1.4%) contracted, raising concerns about an urban-rural divide.
- Partial indicators don't reflect this optimism, although industrial production activity is expected gain momentum in the second half of the year.
- NAB Economics is forecasting a 7.8% expansion in 2015, followed by 8% in 2016.
- The RBI cut the Repo rate by 25bp to 7.25% in its June 2 meeting.
- The RBI has since announced more aggressive measures that banks can employ to recover doubtful assets.
- Indian equity markets have remained weak, with debt-burdened companies among the worst impacted.
- NAB Economics is forecasting the Repo rate to remain on hold at 7.25% by the end of the year.
- A further rate cut would depend on favourable commodity (food & fuel) price developments.

GDP: Outcome, Partials & Outlook

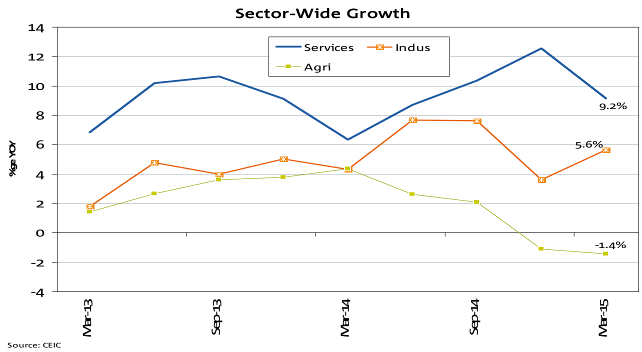
In the March quarter 2015 the Indian economy grew (in real terms) by 7.5% yoy. For the 2014-15 Financial year, the economy expanded by 7.3% (as against 7.4% in the February, 9th estimate). While solid, the numbers are affected by computational factors. The GDP data is measured at market prices - adding taxes and subtracting subsidies from GVA at basic prices. Taxes increased by 5.7%, while subsidies declined by 2.2%, somewhat impacting the overall outcome. *The Government has set up a panel under the aegis of the National Statistical Commission to closely examine the GDP series.*

India GDP contribution



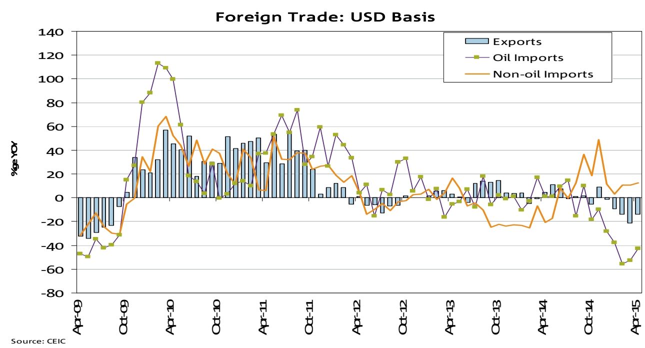
Looking at the contribution by expenditure, private consumption (3.6% vs. 4.8% in Dec. qtr), Investment (1.3% vs. 0.8% in Dec. qtr) and Net exports (0.6% vs. 0.2% in Dec. qtr) were the major contributors to growth. Double-digit growth in medium to heavy (goods) commercial vehicle sales (26.5% yoy) was also indicative of generally improving investment conditions. The contribution from stocks was minimal, suggesting limited oversupply pressures. The wide statistical discrepancy (1.8%) does raise some questions about data quality though.

GDP: By Sector



In terms of sectoral contribution, services (9.2%) was the fastest growing segment, followed by industry (5.6%); agriculture (-1.4%) contracted, and reflects lower crop production. Growth in the services sector was driven primarily by the trade, hotel, transport & communication sector (14.1%) and the finance, property and business services (10.2%) sector. Public administration was flat, as the Government achieved a 4% fiscal deficit for the 2014-15 year. In Industry, all 3 components recorded positive growth, with manufacturing (8.4%) the best performing, followed by electricity (4.2%) and mining (2.3%).

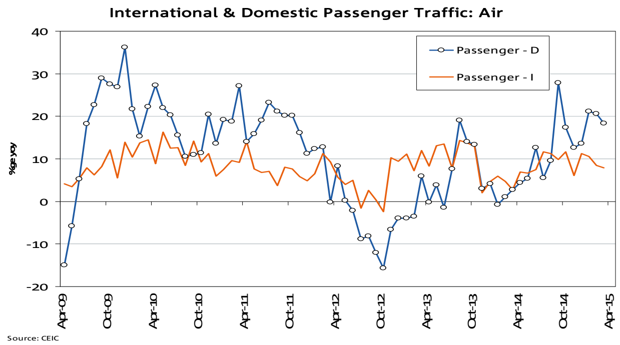
Foreign trade

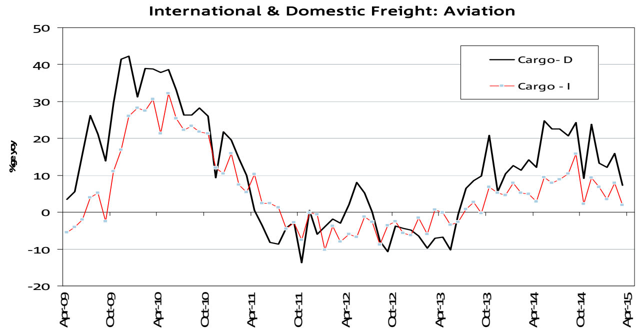


Looking at the pattern of foreign trade, export growth has contracted through 2015 due to weak global demand. However, lower oil prices have helped contain the trade deficit. *Going forward, there is likely to be limited stimulus* *from net exports; domestic demand will need to be the main driver of growth.*

There has been a recent surge in gold imports, rising by 78% to USD3.1bn in April 2015 (year-ended basis), driven by festival demand and easing in gold import restrictions. The Government is aiming to create a gold *monetisation* scheme, whereby citizens can deposit their gold holdings in return for tax free interest – but they need to have their gold holdings melted down and recycled. The aim it to tap into the vast gold holdings, and reduce India's gold import purchases.

Aviation

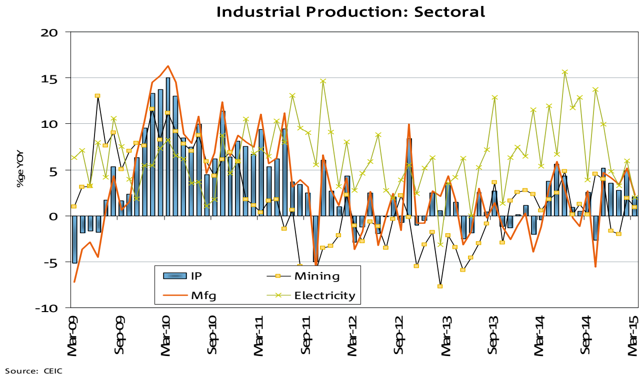


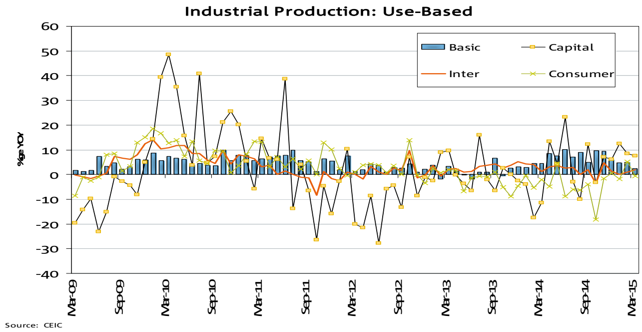


Higher frequency indicators only partly corroborate the National Accounts data. Evidence was strongest in the case of aviation, especially domestic freight and passenger traffic growth. Corporate profits and industrial production (discussed further below), don't exactly chime with the National Accounts results. However, the National Accounts and the partial indicators both confirm weak rural conditions conditions. Sales of two-wheelers (-0.6% yoy) and light goods vehicles (-8.6%yoy) – which tend to be favoured in rural areas- have been weak.

For the corporate sector, the 2014-15 financial year has been muted, at best. According to the *Business Standard*, the combined net sales of 1,700 companies revealed net sales growth at 5.9% on a year-on-year basis, the slowest in 2 years. Operating profit (excl. other income) contracted by 0.5%. Profits would have been lower were it not for weak raw material prices, primarily crude and metals. Note the GDP data includes both the incorporated and the unincorporated sectors, which may partly explain this variance in corporate performance and GDP.

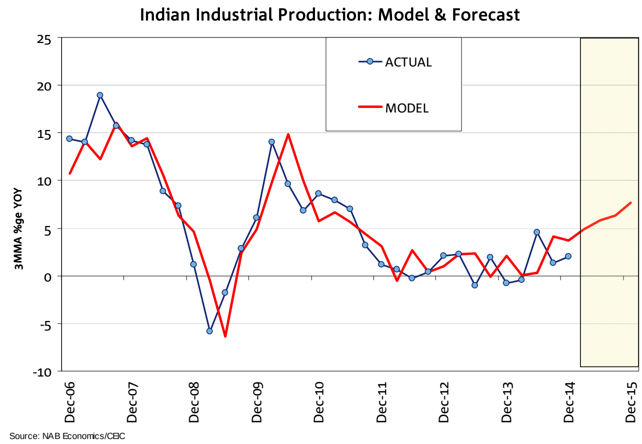
Industrial Production – Sectoral, and By Use





Industrial production, while improving, was not as strong as suggested by the National Accounts data. It grew by 2.1% over the year to March 2015. On a more positive note, capital goods production has been solid through 2015, although it is premature to indicate that investment has turned the corner. Consumer durables production remained weak. By sector, positive outcomes were recorded for mining (largely coal related) and manufacturing – in contrast to previous quarters – although the electricity sector was somewhat subdued, albeit still positive.

Leading Indicator



The Indian economy is expected to maintain momentum going forward, with rising incomes, the lagged impact of prior rate cuts and a gradual recovery in the capital investment cycle. The largely transparent process of coal block allocation process is testament to an improving business environment.

Modelling by NAB Economics suggest that industrial production is expected to record 7.8% yoy growth by the December quarter. However, it is critical that the Government continues with its reforms process with regard to taxes, make progress on stalled investment projects and improve the business environment.

NAB Economics has slightly raised its growth profile for India. For 2015 we now expected 7.8% (previously 7.7%), rising a touch to 8% in 2016 (previously 7.9%). Lack of progress on reforms and possible weakness in the agriculture sector are downside risks to the growth outlook.

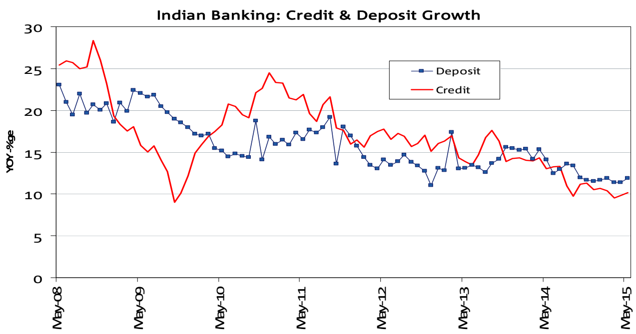
RBI's Decision

At its monetary policy meeting on the 2nd of June, the RBI decided to:

- Cut the Repo (policy) rate by 25bp to 7.25%. The Reverse Repo and Marginal Standing facility were also cut by 25bp to 6.25% and 8.25% respectively.
- Maintain the Cash reserve ratio (proportion scheduled banks park with the RBI) at 4%.
- Continue to provide liquidity through overnight repos at 0.25% of bankwise Net Demand and Time Liabilites; 0.75% to be provided for under 14-day and longer term repos.

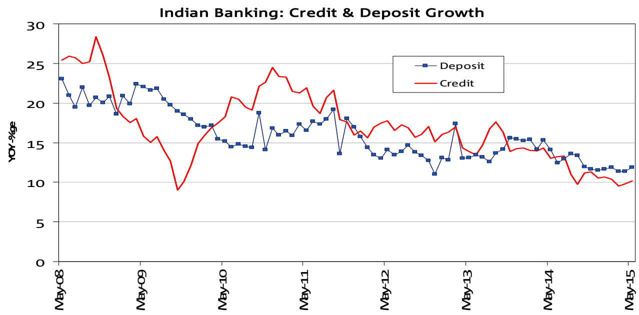
The announcement was broadly expected by NAB Economics and other market participants. According to the RBI statement, 'With low domestic capacity utilization, still mixed indicators of recovery, and subdued investment and credit growth, there is a case for a cut in the policy rate'. Capacity utilisation in the manufacturing sector – according to the RBI – was 71.7% in the December quarter (latest available), below year-ago levels (73.5%). Further, bank credit growth remains largely tepid, rising a touch above 10% in April's reading.

Credit and Deposit Growth



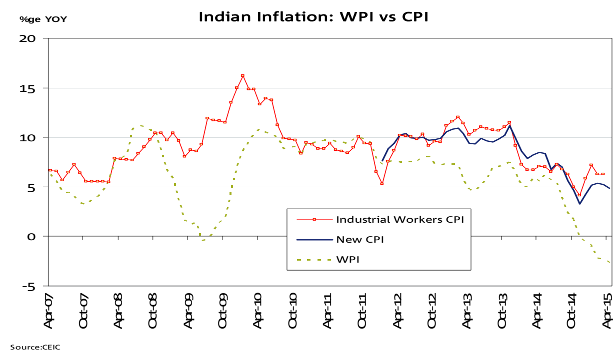
The RBI has cut the policy (Repo) rate by a cumulative 75bps since January. However, only 30bps worth of cuts have been passed on. In fact, following the most recent announcement only 3 banks have so far passed any cuts at all: State Bank of India, Allahbad Bank and Punjab and Sind Bank. Both the RBI and Finance Ministry have expressed concern about this limited pass-through. The RBI indicated the need to move to a marginal cost of funding model, so that banks are better able to respond to changes in the policy rate. Governor Rajan also mentioned that corporate customer would be more likely to tap the Commercial paper market (where interest rates are below 9%), as they are lower than the Base rate (minimum lending rate) offered by banks. The State Bank of India's Base rate was 9.7% at the time of writing. A possible loss of market share might compel banks to pass on a greater share of the RBI cuts. The Finance Ministry, for its part, indicated that it would quiz banks as to why they were not fully passing on the recent RBI rate cuts.

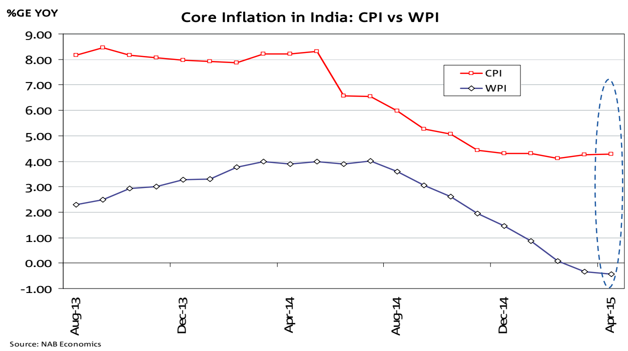
Commercial Paper rates



The recent cut in the Repo rate has been facilitated by improved inflation outcomes. The headline CPI eased to 4.9% yoy in April, the lowest outcome since December, 2014. Importantly, food prices eased to 6.1%, suggesting that the impact of recent unseasonal rains had not yet had an impact. There was a deceleration in fruit (5.1%) and vegetable (6.6%) prices. However, meat and fish (5.5%) as well as pulses (12.5%) accelerated. Core CPI (ex food and fuel), rose a touch to 4.24%, but still remains well contained. Wholesale prices contracted (both in headline and core terms) due to falling fuel prices.

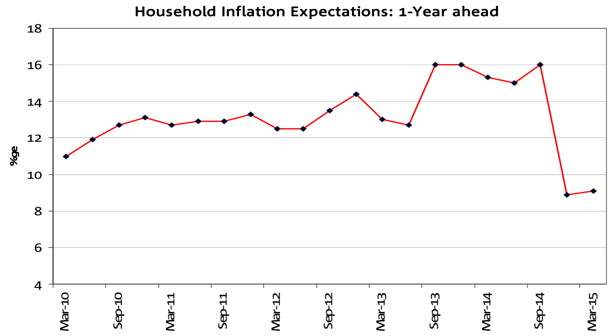
Headline & Core inflation





Inflation expectations also remain under 10%. Recent inflation outcomes may push it marginally lower. The latest Industrial Outlook Survey revealed that input and output price pressures remain muted.

Inflation Expectations



Source: RBI

A potential concern is the outlook for the *monsoon*. The Meteorological Department of India indicated that rainfall during the important monsoon season will be around 88% of long-term average. The timing and distribution of rainfall will be critical. Further, it is also important that the Government undertakes measures such as improving the food supply chains, releasing buffer stocks and clamping down on hoarding to mitigate against the possible adverse effect of the monsoon. The Government indicated that it has a contingency plan in place for 600 (out of a total of 676) districts across the country. Further, it was undertaking measures to stabilise prices of important crops such as pulses, rice and wheat.

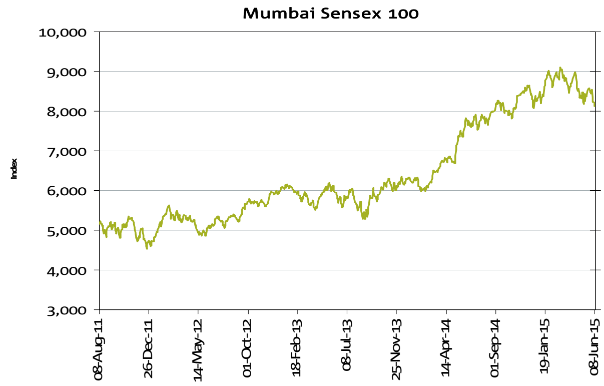
Another important point that was highlighted in the RBI meeting was the need to infuse *capital* in public sector banks which have a high proportion of stressed assets. Stressed assets (Gross Non performing assets plus restructured loans) were estimated at 10.7% of total loans as at September 2014 – according to RBI data. This was particularly high for Public sector banks at 12.9%; by contrast, the stressed assets ratio for Private sector banks was a more contained 4.4%. Governor Rajan clarified in the post-Monetary policy press Conference that there was not an *immediate* need for capital in public sector banks. However, the additional capital would be critical going forward: to absorb future provisions that need to be made, and to support lending as the economy picks up.

More recently, the RBI has launched the *Strategic Debt Restructuring Initiative*. As part of this process – which was demanded by banks – banks could gain control of defaulting companies if restructuring initiatives fail. They can use convert their debt stakes into equity, infuse new management and potentially sell their stakes when the situation permits. It is believed the threat of losing control of their company might compel the business owners to co-operate with banks. Further details can be found in the link below:
https://rbi.org.in/Scripts/NotificationUser.aspx?Id=9767&Mode=0

External and Financial

India's equity markets have fallen about 10% since early April. The recent Monetary policy announcement also continued this downward trend. The markets took the cue that uncertainty about the monsoon was likely to stay the RBI's hand. Besides, there were concerns about the strength of the economy, pace of reforms, and possible Emerging market volatility stemming from expected higher US rates, which got a boost from the favourable jobs report. In terms of the sectors, consumer durables, metals, fast moving consumer goods (FMCGs) and oil and gas have been worst impacted. An analysis by the *Mint* publication also reveals that firms with high debt burdens (particularly in the small and mid-cap sectors) were hart hit. Equity markets are likely to remain volatile during the monsoon season. The possible inclusion of China Class-A shares in the MSCI Index may lure some funds away from India to China.

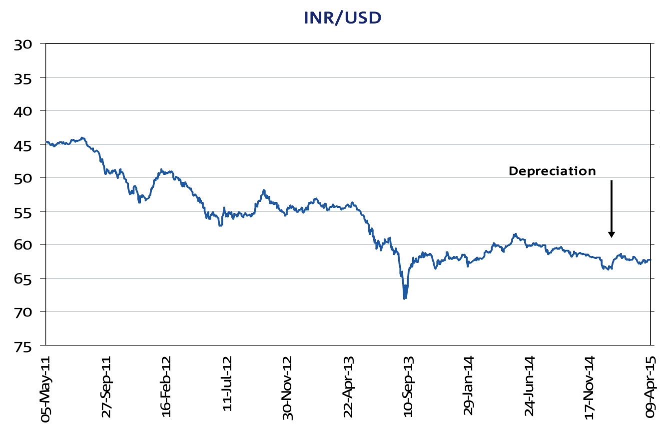
EQUITIES



Source: Datastream

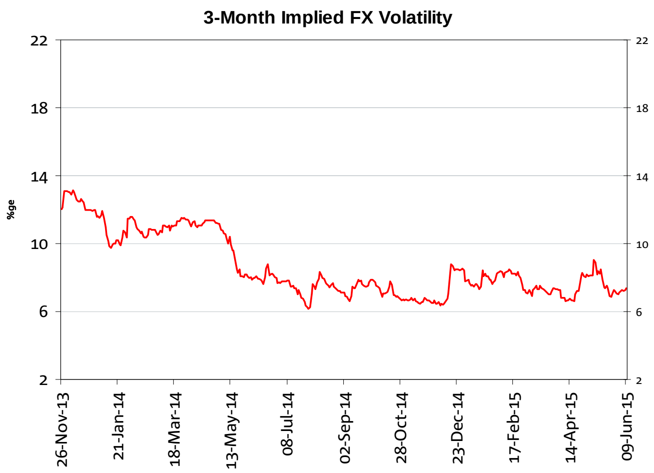
The Indian rupee has been trading around the 64 INR/USD mark. The recent weakness reflects increased USD demand from importers and banks, as well as selling of Indian securities from Foreign Institutional Investors (FIIs). While the Rupee has weakened, foreign exchange volatility has remained broadly contained, reflecting improved external fundamentals (see discussion on FX reserves).

FX Rate:



Source: Bloomberg

FX volatility

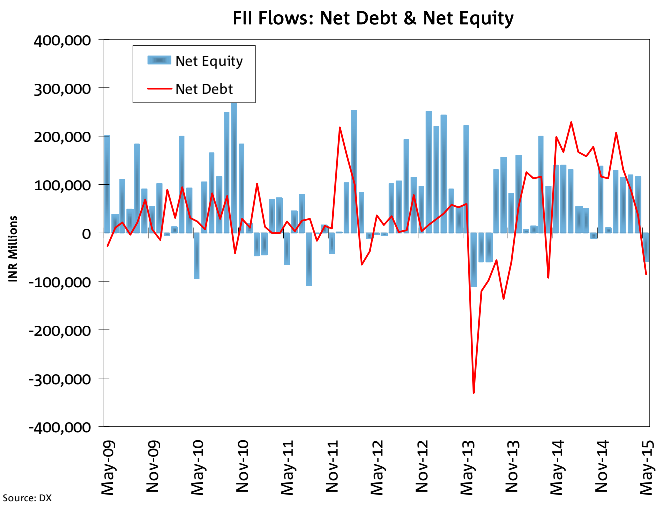


Source: Bloomberg

There has been waning interest in Indian debt and equity instruments among Foreign Portfolio Investors (FPIs). Concerns about the pace of reforms, the state of the economy, and the imposition of Minimum Alternate Tax (MAT) on previous' years capital gains has taken the sheen off Indian investments. FPIs such as Aberdeen have taken the issue to court to protest against the developments. The Government has set up a Committee under the auspices of AP Shah, the current chair of the Law Commission, to report on this as soon as possible. Note that the MAT will not be applicable on capital gains from April 1, 2015 onwards.

Despite recent outflows, FPIs are likely to maintain interest in India. India is expected to remain one of the strongest performing economies, and its 10-year bonds offer attractive yields (7.8%, at the time of writing) – which should attract overseas investor interest.

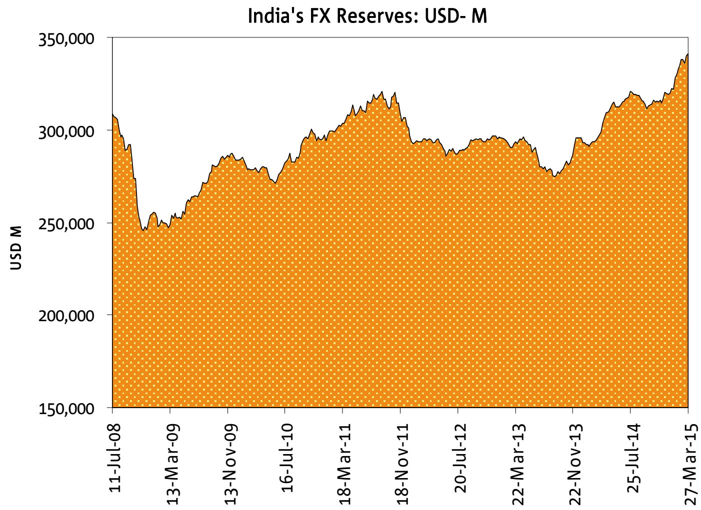
Foreign Institutional Investor inflows



Source: DX

India's foreign exchange reserves have swelled to a record high of USD352.4bn. These high levels of reserves, will help insulate the Indian economy from potential volatility – which will likely emerge – when the US Federal Reserve raises rates later in the year. When India was afflicted by the 'taper tantrum' in May 2013, its foreign exchange reserves were under USD 290bn. Further, India's policy settings have also improved. It has moved towards a formal inflation-targeting regime and has shown intent in improving the business environment, and fast tracking stalled projects.

FX Reserves

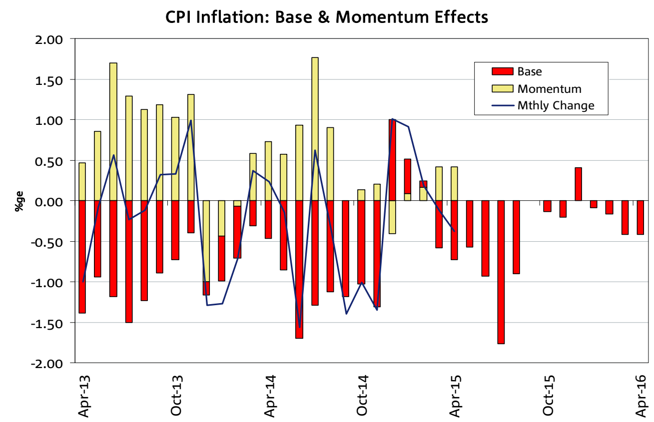


Source: Bloomberg

Outlook

The RBI indicated that any future moves are likely to be data-dependent. It also highlighted that it is aiming for a real repo rate between 1.5-2%, as it strikes a good balance between savers and borrowers. Moreover, it indicated that favourable base effects are likely to ensure that inflation pressures remain restrained till August, but rise thereafter. The RBI raised its inflation (headline CPI) forecast for January,2016 to 6%. The outlook for base effects is shown below.

CPI Inflation: Base & Momentum Effects



Source:NAB Economics

Given possible upside inflationary risks, NAB Economics is forecasting the RBI to remain on hold for the remainder of 2015, maintaining the Repo rate at 7.25%.

An additional rate cut cannot be ruled out, but will crucially depend on three factors. These include: the impact of the monsoon – and subsequent Government response - on food prices (which account for close to

50% of the CPI basket); and volatility in crude oil prices; external volatility, stemming from an expected Fed rate hike, and the attendant impacts on emerging markets.

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

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

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

Phin Ziebell
Economist – Australia
+61 (0) 4 55051024

Amy Li
Economist – Australia
+(61 3) 8634 1563

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

Karla Bulauan
Economist – Industry Analysis
+(61 3) 86414028

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

Tapas Strickland
Economist
+61 2 9237 1980

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

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

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

Kymberly 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

Asia

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