India GDP & Monetary Policy

by Group Economics

December 2015

Summary & Overview

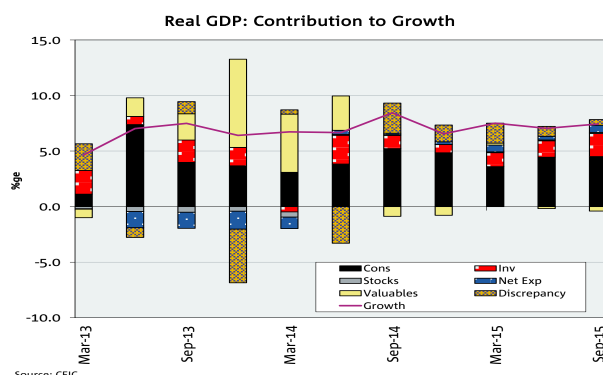
- India's economy accelerated in the September quarter 2015, with Real GDP growing by 7.4% yoy, up from 7% in the June quarter.
- By expenditure, there was a clear improvement in investment spending. Manufacturing, finance and electricity were the standout industry sectors.
- India's exports have declined through 2015; lower energy prices have contained the trade deficit.
- NAB Economics is forecasting a 7.5% expansion in 2015, followed by 7.6% in 2016.
- Headline inflation accelerated to 5% in October, driven partly by rising costs of pulses.
- The RBI held the policy rate at 6.75% in its December meeting, with an accommodative stance.
- To facilitate quicker transmission, it is finalising the methodology to allow banks to price loans based on marginal funding costs.
- NAB Economics is forecasting a further 50bp reduction in the policy Repo rate during 2016 to 6.25% by the end of 2016.
- The inflationary impact of the Pay Commission's proposals and outlook for food and energy prices are factors that might influence this outcome.

GDP: Outcome, Partials & Outlook

Indian economic activity accelerated in the September quarter, with yoy real GDP rising to 7.4%, up from 7% in the June quarter. Nominal GDP, however, rose by 6%, reflecting a -1.3% contraction in the GDP deflator.

In terms of contribution, consumption contributed 4.5% (out of a 7.4%) to real GDP, a similar magnitude as in the June quarter. Looking ahead, the 7th Pay Commission is proposing a 23.55% increase in wages and allowances for government employees; this has the potential to raise future consumption expenditure. The contribution of investment picked up, rising to 2.1%, up from 1.5% in the June quarter, partly driven by stronger public investment

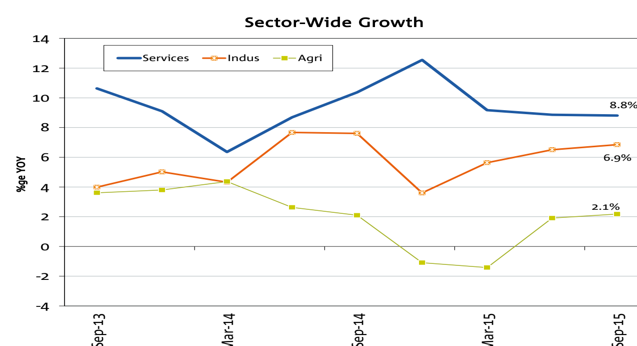
India GDP by expenditure



Net exports (0.7%) increased, largely reflecting weaker energy prices. Elsewhere, inventories were stable, and there was a lower statistical discrepancy.

Looking at growth by sector, services (8.8%) was the strongest, followed by industry (6.9%), with agriculture (2.1) the laggard.

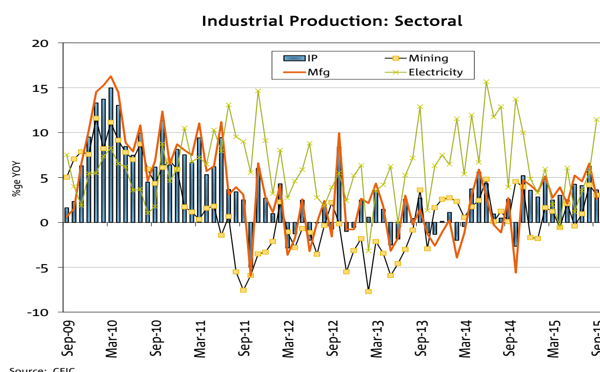
GDP: Sector Wide growth



In terms of relative movements, the higher GDP outcome was driven by stronger results in manufacturing (9.3% yoy c.f. 7.2% in June quarter); electricity (6.7% vs. 3.2%); finance, business and property services (9.7% vs. 8.9%) and public administration/defence (4.7% vs. 2.9%). The improvement in the manufacturing sector has been most remarkable, although it remains to be seen how sustainable this is, with the manufacturing PMI falling to a 25-month low – albeit still remaining positive – of 50.3 points in November.

There was also a deceleration in some sectors: construction (2.6% vs. 6.9% in June); mining (3.2% vs. 4% in June); and trade, hotels and transport (10.6% vs. 12.8%). The agricultural sector remained broadly stable, despite a 15% shortfall in the monsoon rains. This outcome was largely driven by allied sectors such as livestock, forestry and fisheries.

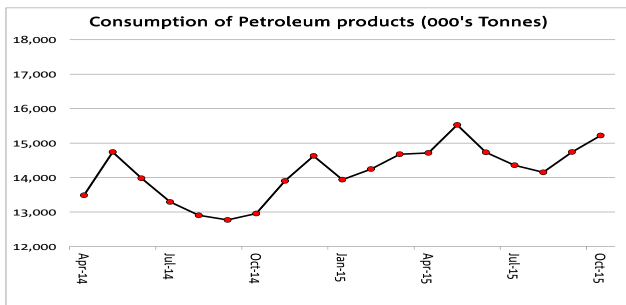
Industrial Production

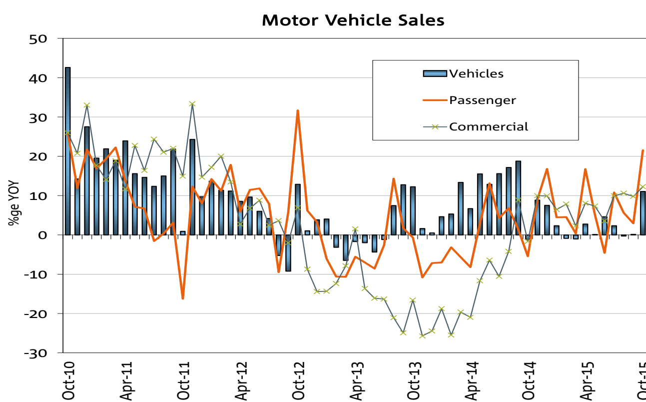


Partial indicators also provide some evidence of the stronger September quarter activity. Industrial production

for the September quarter was 4.6% higher on a yoy basis, a pickup from the June quarter's 3.3% outcome. Further evidence of improved activity can be seen in statistics for petroleum consumption and commercial vehicle sales. The volume of petroleum consumption increased by 11%yoy in the September quarter, up from 6.7% in the June quarter. Commercial vehicle sales accelerated to 10.1% in the September quarter (from 6.2% in June). Passenger vehicles too (6.3% yoy) recorded solid growth, reflecting strength in urban demand; rural demand remained subdued, with sales of light goods vehicles down -6.9%(yoy).

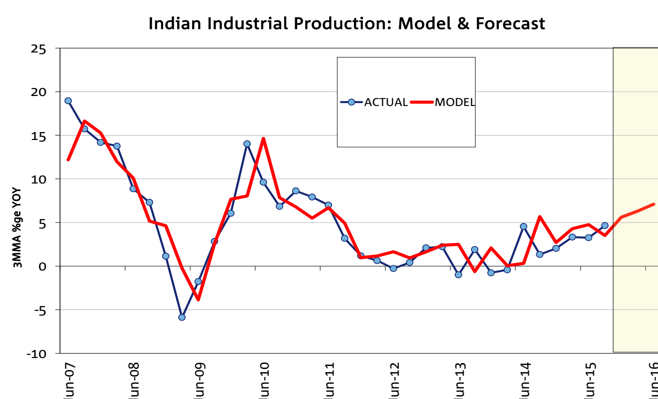
Petroleum consumption and Motor vehicle sales





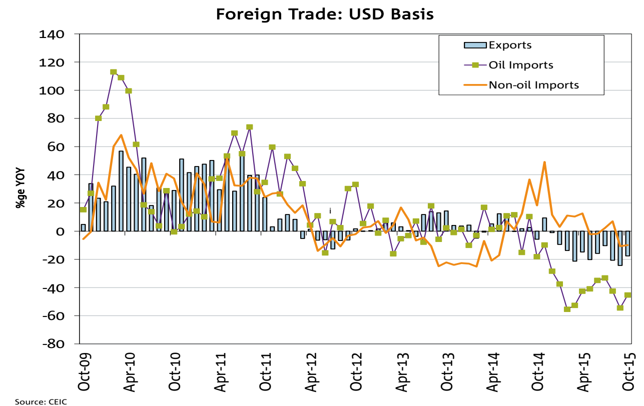
Looking ahead, modelling by NAB Economics using leading indicators suggest an improvement in the coming quarters. Industrial production is expected to pick up, and grow by 7% in yoy terms by the June quarter, 2016. This will, of course, depend on progress made in reducing supply bottlenecks and reform measures such as the *Goods and Services Tax*.

Leading indicator for Industrial Production



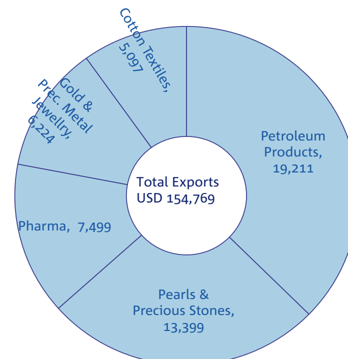
Foreign Trade: A closer look

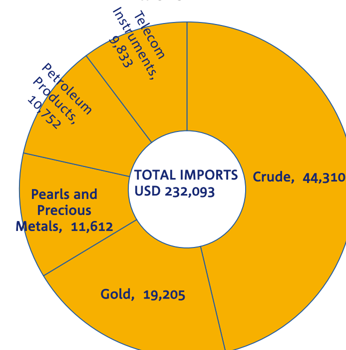
Merchandise trade



The National Accounts provide an incomplete picture of overall trade activity. Net exports (in real terms) contributed 0.7% to GDP in the September quarter. However, exports have fallen (in yoy terms) in every month of 2015. Against that, weak commodity prices (notably energy) have kept imports and hence the trade deficit in check. Over the 6 months to September, 2015 the trade deficit contracted by -6.1%: imports declined by -14.2%, and exports fell by -17.9%.

Major export and import categories: India





In exports, the biggest decline (over the April to October 2015 period) was in the petroleum products category (-51.2%). This was mirrored by a -45% decline in crude oil imports, and reflects the current weakness in energy prices. Exports of gold, jewellery and precious stones also

contracted. Pharmaceuticals & biologics (13.2%) was the bright spot. Elsewhere, iron & steel and related products also contracted, but motor vehicles (2.1%) showed a slight improvement. In imports, gold was flat. The most significant category though, was imports of telecommunications equipment, which surged 15.8%. Leading Telco provider, *Bharti Airtel* recently indicated it was planning to spend INR60bn over 3 years to boost its network capacity and offer high speed voice and data services. This reflects an increasingly competitive environment among India's 4 major Telco operators.

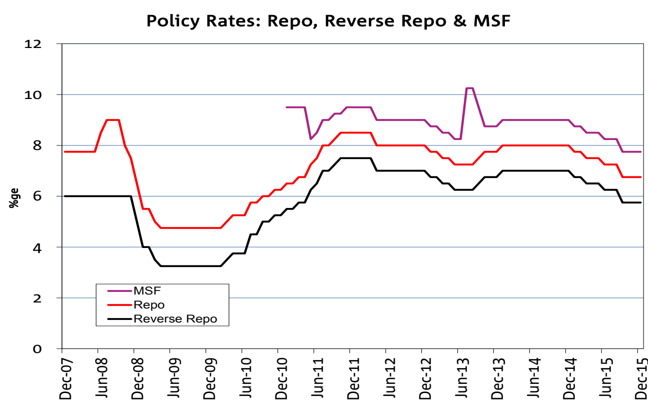
RBI's Decision

At its monetary policy meeting on the 1st of December, the RBI decided to:

- Maintain the policy Repo rate at 6.75%. The Reverse Repo and Marginal Standing facility were maintained at 5.75% and 7.75% 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 bank wise Net Demand and Time Liabilities; 0.75% to be provided for under 14-day and longer term repos.

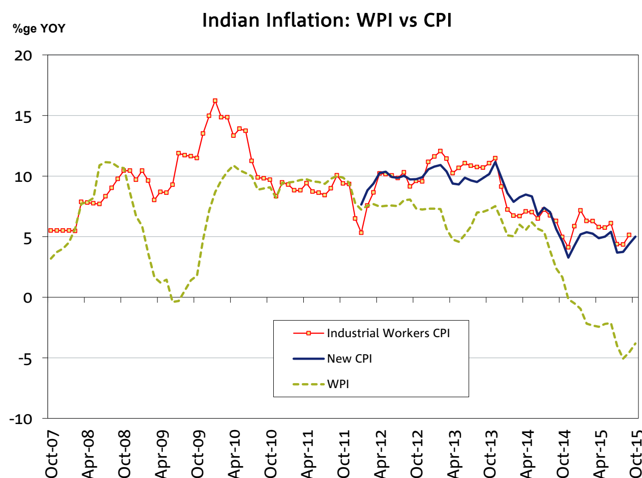
The announcement was broadly expected by NAB Economics and other market participants. The RBI has thus far delivered 125bps of cuts in 2015, the most recent being the 50bp cut in the September meeting.

Policy rates



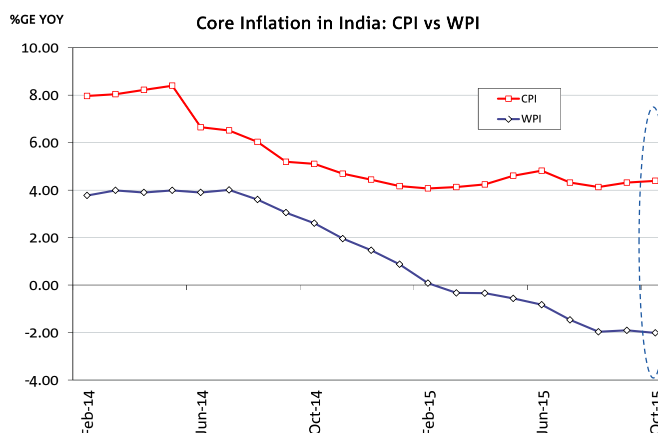
Inflation remains a central focus of monetary policy. The most recent data revealed that Headline CPI accelerated to 5% yoy in October, the fastest since June 2015. One of the key drivers has been a pickup in food prices: they rose to 5.3% in October, up from 3.9% in September. Food is a significant category, accounting for 45% of India's CPI basket. The increase was largely driven by higher prices of pulses, which rose by 42.2% over the year to October. This has resulted from a deficient monsoon, resulting in a 2 million tonnes fall in production in the 2014-15 crop year (July-June). The Government has indicated it might import more pulses to keep prices in check. Elsewhere, prices of other food categories remain broadly restrained: cereals (1.5%); fruits (2%); vegetables (2.4%) and milk (4.8%). The RBI highlighted the need for effective food supply management in light of modest early indicators of the *rabi* (winter) crop sowing.

Headline inflation indicators



Another closely watched indicator is core CPI, i.e. excluding food and energy. This can be thought of as a measure of underlying inflationary pressures in the economy. It has increased consecutively over the past 3 months, and rose by 4.4% over the year to October. Whilst not a high figure, the upward trend would have caused some concern at the RBI. Higher costs for housing, recreation & amusement and personal care & effects have underpinned the recent rise in core inflation.

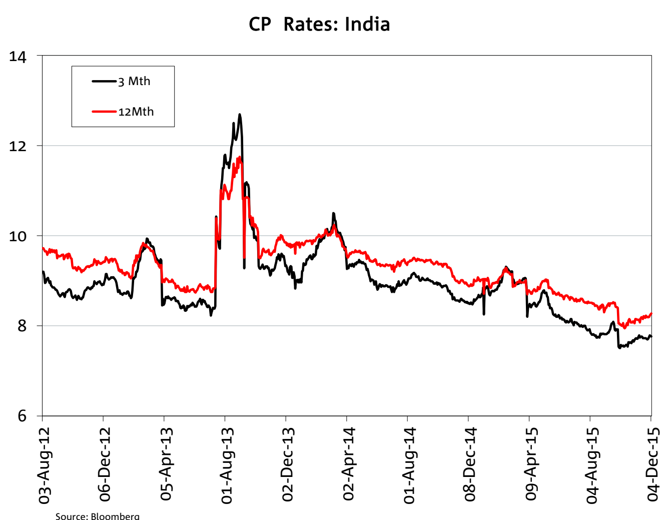
Core inflation indicators



Finally, the RBI highlighted that less than half of the 125bps of cumulative rate cuts were transmitted by banks. It indicated that it was working on a methodology to link base rates (minimum lending rates) of banks to the marginal costs of funds, as opposed to average costs. This would facilitate quicker transmission of policy rates to lending rates. The Government was also considering linking small savings rates to market interest rates. This would also reduce the banks' cost of funds, and, in turn, enable them to lower their lending rates.

Banks typically compete with the Commercial paper market in segments such as working capital management. Commercial paper rates (particularly at the 3-mth end) have declined over the past year. Adopting a marginal cost of funds pricing model, will help banks better compete with the Commercial paper market, although it would entail bolstering their capabilities in working capital management.

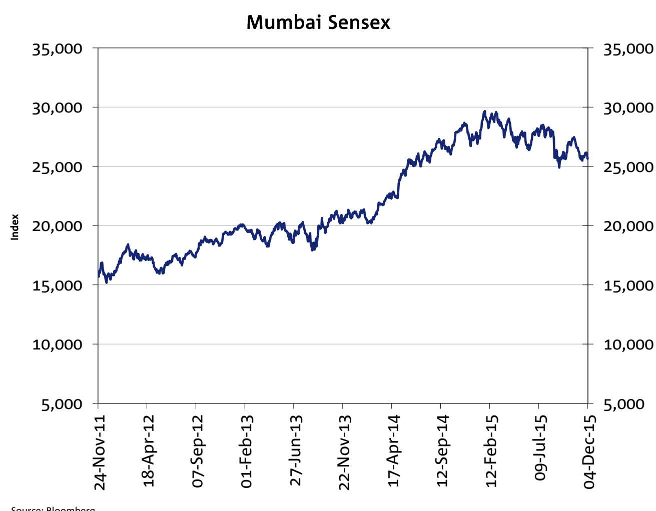
Commercial paper rates



External and Financial

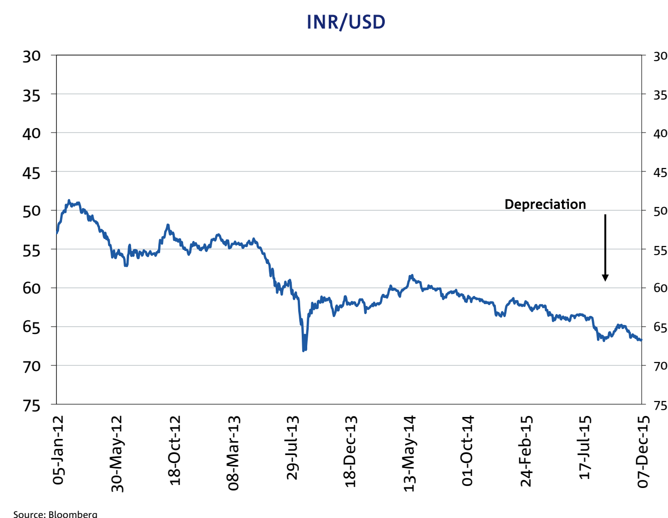
India's equity market has fallen about 10% over the past year. This partly reflects over-exuberance from markets about India's prospects since the election of the Modi Government in 2014, and the surge in equity prices that generated. The markets have recovered somewhat since the sharp falls in August and September, when equities, particularly EM equities fell sharply on concerns for China and global growth. India's growth story remains positive for equities, although equities may be impacted if sentiment towards Emerging markets sour further.

EQUITIES

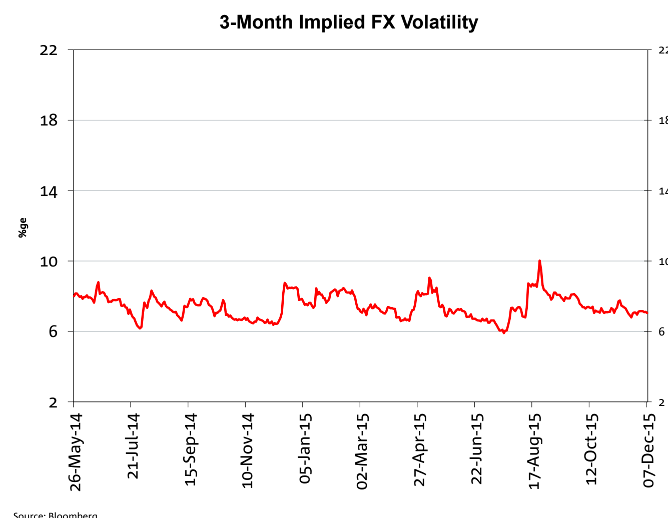


The Indian rupee (INR) was last trading around 66.8/USD. The INR has been one of the best performing EM currencies on a Total return basis (along with the Renminbi), in stark contrast to other currencies such as the Malaysian Ringgit, Brazilian Real, South African Rand and Turkish Lira – which have largely struggled. Further, except for the period during late August-early September, when EM currencies were under severe pressure, volatility in the Indian rupee has broadly been well contained. Volatility is an important consideration for both investors and Indian businesses with overseas borrowings in foreign currency. The RBI has indicated that it stands ready to intervene in financial markets to curb excess volatility, although it ruled out specifically targeting a certain level for the rupee. The expected rise in the US Fed funds rate could generate near term volatility in the rupee.

FX Rate:



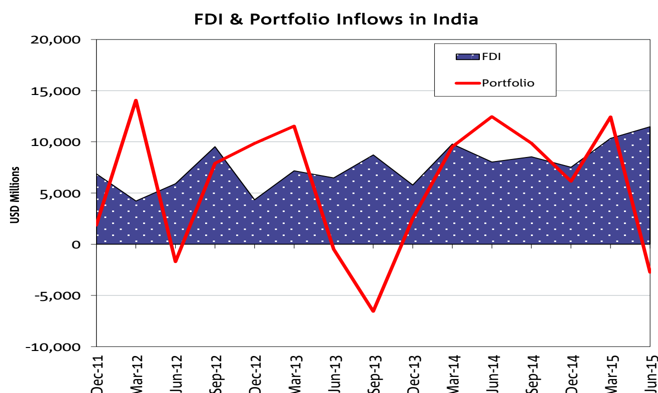
FX volatility



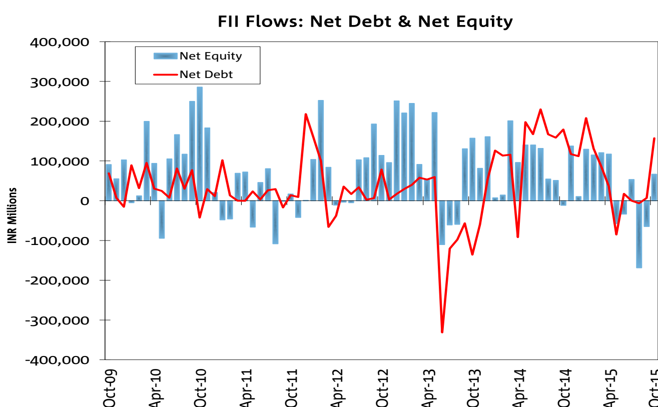
India has also benefitted from high levels of Foreign Direct Investment during 2015. Mauritius, Singapore, UK, Japan, Netherlands and the USA have been the principal source countries of FDI investments in India. By sector, services (17%) including financial, business process outsourcing and technology testing were the largest beneficiary. Other sectors to receive significant shares of FDI include: construction development (9%), including townships;

computer software and hardware (7%); telecommunications (7%) and automobiles (5%).

Foreign Institutional Investor inflows

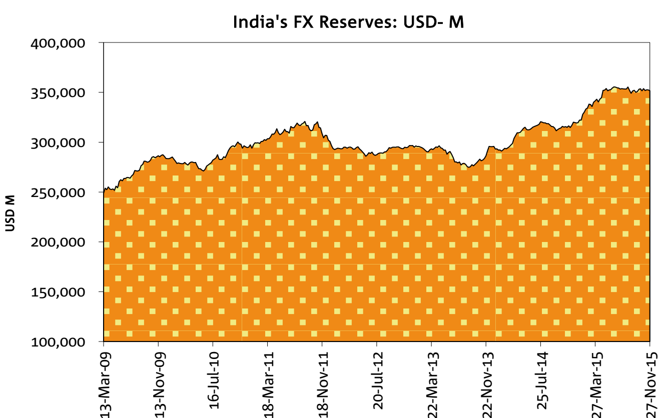


Portfolio investment



During 2015, there has been strong foreign portfolio interest in Indian financial instruments, particularly for debt securities. Over the year to date, there have been INR182.6bn invested in India's equities and INDR513.5bn invested in Indian debt securities by foreign portfolio investors. This, combined with FDI inflows, a contained current account deficit (~1.2% of GDP), and NRI inflows (particularly from NRE and FCNR categories) have boosted India' FX reserves to USD351.6bn, ensuring it is well positioned to handle external shocks.

FX Reserves

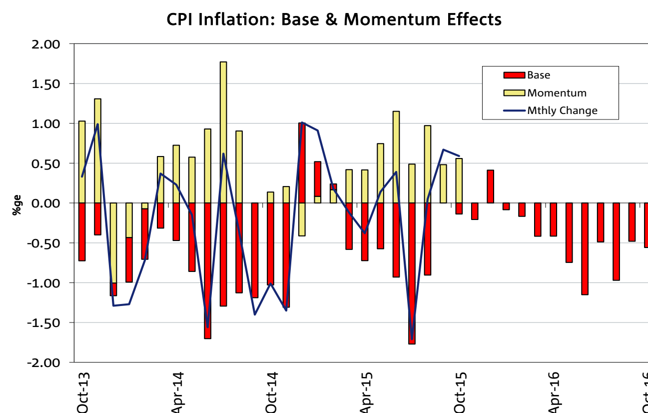


Outlook

On growth, we (NAB Economics) have marginally improved our near-term forecasts. **We are now forecasting 7.5% in 2015 (previously 7.4%), followed by a slightly stronger 7.6% in 2016 (previously 7.5%).** These reflect an improvement in the capital investment cycle, supported by a lower interest rate environment. **Further ahead, we are forecasting 7.4% in 2017.**

On interest rates, the RBI maintained an easing bias, but was focussed on achieving the 5% inflation target by March, 2016. In their words: 'The Reserve Bank will use the space for further accommodation, when available, while keeping the economy anchored to the projected disinflation path that should take inflation down to 5% by March 2017'.

CPI Inflation: Base & Momentum Effects



NAB Economics is forecasting a further 50bp of a rate cuts in 2016. This will lower the Repo rate to 6.25% by the end of 2016.

The RBI has indicated its intention to maintain real interest rates at around 1.5 to 2%, using the 1-year T Bill rate. The latter is usually 25-50bp higher than the policy Repo rate. Further, base effects are anticipated to remain favourable, particularly around the middle of 2016. This should provide the opportunity for rate cuts – although the RBI has not ruled out out-of-cycle cuts. The impacts of the Pay Commission's recommendations on the inflation trajectory; the upcoming Union Budget and the Government's fiscal stance; as well as possible commodity price shocks (in fuel and energy) and external developments are factors that the RBI will likely consider in setting future interest rates.

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