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Indian Economy: Prognosis FY16

GDP growth

GDP growth, by the new methodology adopted by the CSO, is expected to be 7.4% in FY15 compared with 6.9% in FY14. Growth in gross value added for some sectors was as follows: agriculture 1.1%, manufacturing 6.8%, trade, transport & communications 8.4% finance 13.7% and public administration 9%.

With agriculture being susceptible to a lower monsoon, there could be a negative impact of such an eventuality on farm production. But assuming that output will not be affected perceptibly on this score, **the projections for FY16 are 8% growth in GDP with a downward bias** depending on the monsoon impact finally. This will include 8-8.5% growth in industry with all three segments (mining, manufacturing & electricity) contributing to this growth and services (including construction) growing by 9-9.5%. Agricultural growth would be between 2.5-3% but a monsoon failure could push it down to 1-1.5%, thus bringing down GDP growth to 7.7-7.8%.

However, growth in IIP which is the physical version of the corresponding value addition in GDP will be lower at between 5-6%. For the first 11 months of FY15, it was 2.8%.

Capital formation has been a major problem for the economy with a slowdown in investment by both the private sector and government. The gross fixed capital formation (GFCF) rate at current prices has come down continuously from 33.6% in FY12 to 28.6% in FY15. It may be expected that with a revival in demand and the stalled projects getting back on-stream, the **GFCF rate would improve and increase to 29.5% of GDP in FY16.**

Inflation

The CPI inflation number is the critical inflation indicator from the point of view of monetary policy as it will determine all future action of the RBI. The RBI has targeted CPI of 6% by January 2016 and from a theoretical standpoint has fixed a rate of 4% with a band of 2% on both sides.

CPI inflation was 5.2% in March 2015 and the monthly number would have to be tracked closely from the policy perspective. With food inflation (6.1% in March) still the dominant component and being the one susceptible to monsoon disturbances; this will continue to be the focus area assuming crude oil prices to be stable. The World Bank has indicated benign commodity prices for 2015 which indicates that global influences on both the farm and manufactured goods would be subdued this year. Within domestic factors, food would continue to be the important part as prices are driven by domestic demand-supply factors. Supplies in the past have been affected by deficient and excess rainfall and even though confined to specific products, could lead to generalized inflation.

As the IMD has forecast that the monsoon will be sub-normal there would be some pressure on prices. But given that last year prices remained stable with food inflation coming down even when output levels were lower for most crops, it is expected that **CPI inflation would continue to remain within range and would be between 5-6% this year.**

WPI inflation, which has a relatively lower share of primary products (weight of 20.1%) and dominated by manufactured products (weight of 65%), would witness a lower increase under conditions of benign metal prices. Fuel products with weight of 14.9% is expected to witness low inflation as long as global crude oil prices remain range bound. **This being the case, WPI inflation would be in the region of 3-4% in FY16.**

Fiscal scene

The government has targeted a higher than expected fiscal deficit ratio of 3.9% for FY16 as against 4.1% in FY15. We believe that the government has assumed a pragmatic ratio as well as level of fiscal deficit which will be attained. This will also mean that the government will stick to the projected gross borrowing programme of Rs 6 lkh crore. Also, it will be raised in a non-distorting manner and hence both liquidity and interest rates are not likely to be affected by this borrowing.

The risk factors are more on the revenue side of the disinvestment target of Rs 69,500 cr not being met. However, in the past shortfalls have been made up by sharp expenditure cuts and hence the sanctity of the fiscal deficit ratio is retained.

But, with GDP growth expected to be in the 8% range, tax revenue collections could be more than expected and hence provide a cushion for the deficit.

Monetary sector

In FY15 growth in bank credit and deposits had slowed down. The former was on account of lower growth in industry in particular as well as investment which had caused less demand for loans. Growth in credit was 9.5% compared with 13.9% in FY14. More importantly within various sectors growth was lackluster in case of manufacturing (3.6% for first 11 months) and services (3.3%). Retail loans were the only segment that witnessed impressive growth of 13.5%. However, last year, corporates did substitute bank borrowings with commercial paper, with the outstanding amount increasing from Rs 106,610 crore in March 2014 to Rs 193,270 crore in March 2015.

Growth in bank deposits too was muted as cumulative inflation over the years has affected the real income of households which spent a larger part of their income on food items thus having less left over for financial savings. Growth in deposits was 11.4% against 14.1% in FY13.

For the coming year, growth in deposits can be expected to pick up on two grounds:

- Higher demand for credit for payments for the spectrum auctions as nearly ¾ of the amount would be paid in FY16 for the auctions conducted last year. The total collections have been reported to be between Rs 1.1-1.2 lkh crore.
- Pick-up in industrial growth in FY16 will necessitate an enhanced amount of credit especially from both industry and services.

Based on these assumptions, growth in **bank credit may be expected to be in the range of 14-15%.** The CP market would continue to be attractive as long as the transmission of policy rates to lending rates is sluggish.

Bank deposits on the other hand would also tend to pick up as with lower inflation, the real income of households would increase and money will be diverted to bank deposits. However, given that there will still be competition

from small savings including provident funds as well as the new pension scheme of the government, the pick-up will be moderated and growth would be in the range **of 14-15% during the year**.

	o/s March 2015	Growth FY15 (%)	Growth FY16 (P) (%)
Deposits	Rs 85.85 lkh cr	11.4	14-15
Credit	Rs 65.64 lkh cr	9.5	14-15

Monetary policy

The RBI would be targeting CPI inflation primarily as per the agreement with the Government of India. The CPI inflation number is expected to be within its own range of 6%, and hence **the RBI may be expected to lower the repo rate by another 50 bps this year to 7%.** A rate cut of 25 bps is possible in the first half of the financial year followed by another one by 25 bps in the post-harvest period in October depending on the progress of the monsoon and its impact on CPI inflation.

The risk factor for this move would be the adverse monsoon which has been forecast to be 93% of normal as against 88% of normal in FY15. However, even though the monsoon was below normal last year, the impact of food inflation was limited with CPI inflation coming down to 5.2% by the end of March even though food inflation has been higher around 6-7%. A high base year has also helped statistically in keeping inflation low. In case the below normal monsoon does impact farm output significantly to push up prices, there would be a tendency for the RBI to reconsider its moves.

Interest rates

The 10 years GSec rate has been around 7.78-7.83% even after the RBI reduced the rates twice in this calendar year. The present concerns are:

- Monsoon prospects
- Fed rate hike
- ECB easing
- Expected inflation

With repo rate being lowered to 7% by the end of the year, the **10 years yield would be between 7.4-7.6% with a downward bias.**

Trade outlook and CAD

FY15 has been a mixed picture for India's trade where both exports and imports have declined. Exports at $ 311 bn had declined by 1.2% while imports at $ 448 bn had declined by 0.6%. The lower imports were due to two reasons:

- Lower crude oil prices which compressed the oil bill
- Low growth in industry which lowered demand for non-oil imports as well as subdued gold demand.

Exports on the other hand were affected by both low demand conditions as global growth was subdued in almost all pockets with China also witnessing moderation in growth as well as lower crude oil prices as petroleum refinery products are a major constituent of our exports basket. Further at the margin, a stronger rupee came in the way of export competitive advantage.

The future course of trade numbers will depend largely on global economic conditions, which are expected to be marginally better with USA leading the way even as the Euro region and China remain in the moderation zones. Also the crude oil price will have a bearing on the movement in imports. While the futures prices do indicate that the price of $ 60-62 by March 2016, there are also views expressed that the price will move up if demand increases and shale production cannot keep pace internally for the USA thus adding to demand. The reason put forward is that future investment for drilling oil has been put on hold given the low prices as the cost may not be sustained if low prices prevail for long. A worst case scenario talks of crude oil prices touching $ 70/barrel.

Based on stable crude oil prices and increase demand for non-oil imports, **imports may be expected to increase by 12-14**%. **Exports would grow by 8-10%** based on the premise that demand picks up in the major markets such as USA, UK, Gulf countries, China and other East Asian markets.

With imports growing faster than exports, **the CAD could be expected to be higher in FY16 at between 1.7-2% of GDP.** The services exports as well as other income from remittances have tended to be stable and around $ 65 bn each which can see the software component improve with a turnaround in global economic prospects.

FII flows

In FY15 the flow of FII funds into both the equity and debt segments was significant, with the preference being for debt. Total net flows into equity were $ 18.4 bn and $ 27.4 bn in debt summing to $ 45.7 bn. This is one of the highest amounts of FII flows into the economy.

While the equity flows may be expected to continue to flow given that the economy is expected to perform better at 8% growth, the flow to the debt segment will depend a lot on how the Fed behaves and the timing of the rate hikes. Presently the direction of movement of interest rates in India is opposite to what is likely to happen in the USA. There could hence be some moderation in these flows, which was also the case when the Fed announced its tapering programme in 2013.

The overall flows of **FII would be moderated to the range of $ 40-45 bn in FY15** with debt receiving a lower quantum of funds. The risk factors are:

- Uncertainty on policy front on taxation for FII (FPIs)
- A more immediate increase in interest rates in the USA and by a higher margin of 50 bps instead of 25 bps.

FDI

For the first 10 months of the year, total equity flows of FDI in FY15 was $ 25.5 bn ($ 38 bn if reinvested earnings are also considered) as against $ 18.7 bn during the same period of last year.

Last year the government had expanded the scope for FDI in railways infrastructure and defence equipment, which does hold potential for higher flows in the coming year. Further, the passage of the insurance bill will be positive as some of the companies are contemplating expanding the limit to 49%. This is more likely to fructify in the immediate future compared to the other two sectors.

As India continues to be a very important destination for foreign investment, it may be expected that the upward trajectory will continue in FY16 too and the flow would be in the region **of $ 30-35 bn for the year.**

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Foreign exchange reserves

In FY15, there were net accretions of almost $ 37 bn in foreign exchange reserves which reached $ 341 bn. This was on account of higher FII, FDI and lower CAD. With the momentum being maintained in foreign investment and slightly higher CAD, the **reserves are projected to be between $ 360-370 bn by the year end**. A lot will also depend on how the RBI intervenes in the forex market to stabilize the rupee at certain periods of time.

The risk factors are:

- Lower FII inflows
- Higher trade deficit and hence CAD.

Exchange rate

The rupee has ranged between Rs 60/$ to Rs 62.5/$ during FY15 and has been largely stable. On an average basis for the year, there has been depreciation of round 1% and on monthly basis was 3.4%.

The rupee has been particularly vulnerable to external factors like the euro-dollar relationship. As the status of the euro is still under pressure with the Greek crisis still lingering, the dollar would tend to strengthen. Further the inherent strength of the dollar would also put pressure on other currencies, including the rupee. While the rupee has fared better than the other emerging market currencies in FY15, with a slightly lower increment in forex reserves, the level of rupee depreciation could be in the region of 3-4%. **This would keep the rupee in the range of Rs 64-65 by the end of the year.** Such a modest depreciation may also be viewed as being necessary to maintain the competitiveness of our exports.

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