

Revised Prognosis for Indian Economy- FY16

The Indian economy began on a very confident note in April and there were expectations that the economy would be on the upward trajectory of growth with both investment and consumption taking off. The Union Budget for FY16 took a more conservative stance of targeting a relatively higher fiscal deficit number of 3.9% of GDP for the year compared with 4.1% FY15, with continued focus on both social spending and growth. However, with 6 months having passed there have been certain developments, both on the global and domestic fronts, which have come in the way of these projections. Enumerated below are some of the major developments that have or are to have a bearing on the domestic economy.

1. Global growth has slowed down and the initial anticipated growth is unlikely to materialize. In particular, China has slowed down and the prospects do not look too encouraging. Moreover, unlike in recent years global growth is hinging on the developed economies with emerging economies being rather suppressed. All this has adversely impacted our exports and the trade balance.
2. China had devalued the Yuan which had an impact on various currencies, viz. the emerging and developing economy currencies, which also declined in harmony. The rupee performed relatively better which also meant that the potential gain in export competitiveness was muted.
3. The monsoon turned out to be deficient by 16%, this season. Moreover, the rainfall has been erratic across the meteorological zones impacting the country in a disparate manner. Further, the subnormal monsoons have come after the country was impacted by unfavorable weather conditions (i.e. unseasonal rains) last fiscal that impacted agricultural output and incomes. This will have a bearing on household spending.
4. The persistent risk associated with the Federal Reserve's likely increase in US interest rates have in a way kept central banks all over the world circumspect and the capital markets (viz. of emerging markets) volatile. Although, it is widely expected that the Federal Reserves may hike the rates in December, one cannot still be sure.
5. The continued decline in commodity prices. Although, India has gained from the decline in crude oil prices, the decline in the other major commodities has adversely impacted domestic producers in terms of pricing power.
6. Continued low capital utilization that has been impacting fresh investments. Although, there have been announcements that the government has been reviving stalled projects, there are yet to be reflected in the financial sector (i.e. borrowings) as well as in the real (physical) sector.

The Indian economic growth has as a result of these, not been on the earlier envisaged path. Various domestic economic indicators have been significantly affected.

- I. Sharp contraction in exports
- II. Volatility in domestic currency
- III. Limited revival in Investments
- IV. Subdued corporate performance in Q1-FY16
- V. Contraction in Wholesale price inflation

These factors have put pressure on the Indian economy, causing considerable volatility in the market place. Taking all this into account as well as the information available so far on various economic indicators, the revised Prognosis has been drawn up for the Indian economy.

A. GDP growth

The picture obtained so far is that agriculture would be performing lower than expected with the kharif output expected to be lower this year. Industry has shown some signs of a pick-up though a clearer picture will emerge in the second half. With the government also expected to work within the fiscal targets set, allocating additional expenditure to boost the economy may be a challenge. Under these conditions, we expect GDP growth to be between **7.5-7.6%** in FY16. This is lower than our earlier estimate of 7.8-8% growth.

B. Agricultural production

The first advance estimates for kharif crop does indicate a shortfall in case of foodgrains and cotton besides sugarcane. This will moderate the overall output growth for the year given that around half of the country's agricultural output is harvested in this season. To add to that, reports of crop damages could further worsen the situation. The Rabi crop status is too early to gauge and while the reservoir levels are down, the late rains in September could help to provide moisture for this crop. Overall agriculture sector growth is likely to be around a low **0.5 - 1%** this year (0.2% in FY15) assuming a normal Rabi crop that may compensate for the slippage in kharif crop output. The other segment of agriculture i.e. forestry, logging, etc. is expected to contribute towards this growth.

C. Industrial production

Growth in the index of industrial production was up by 4.1% in the first 5 months of the year as against 3.0% last year. Capital goods and consumer durable goods have led this growth with a 7.4% and 7.7% increase respectively. We believe that while there are definitely some early signs of pick up in investment especially from the side of the government, boosting capital goods output, private investment has yet to resurface to maintain this tempo of growth. Further, consumption spending has still to pick up in an aggressive way as favorable consumer durable goods growth number are being propelled by a low base effect (in statistical terms), the effect of which is likely to wear-off by early 2016.

The crucial test for this sector would be the October-December period when consumer spending should improve with festive demand and infrastructure projects especially in areas like roads and railways should begin in a big way following the monsoon. The announcements made by the Ministries of Roads and Railways on investment are encouraging and the recent measure to provide a one-time fund infusion for road projects would accelerate the process.

With the agriculture sector experiencing subdued growth and thereby rural incomes being strained, rural demand situation is likely to be muted. As such, this could pull down the industrial sector. The sector would have to rely on government spending to fuel its growth. Government spending would provide for the necessary backward linkages that could boost overall industrial output. Further, possible improvements in urban demand could provide additional growth support.

Overall industrial growth in FY16 should be in the range of **4-5%**.

D. Fiscal target

The government has shown remarkable resolve to adhere to the fiscal deficit target of 3.9% set for the year, and we believe that this target will be maintained. There are major benefits that have come beyond what was targeted in terms of:

1. Fuel subsidy would be lower than what was budgeted and there could also be savings on fertilizers given that crude oil prices have come down. Global prices for fertilizers also have shown a downward tendency which should get reflected in savings on the subsidy front too. For the year, Rs 30,000 cr and Rs 72,968 cr were budgeted for subsidies for fuel and fertilizers. There could be a combined savings of between Rs 5,000-10,000 cr here.
2. The tax collections have been much higher so far across all headings so far till August. Services tax would be the main driver going ahead followed by excise if industry maintains momentum.

However, the major risk factor for the government's fiscal position could come from its disinvestment target of Rs 69,500 cr. With limited progress here of just around Rs 13,000 cr till August, it would be a challenge to reach the slated target. In addition to this, in case the government is to make provisions for increased pension allowances for defense (one rank one pension scheme), it could further weigh on government finances. The repercussion of a shortfall in the revenue is that it could impact the capital spending of the government (which has been going as per schedule so far this year, with Plan capex being higher than that last year) and thereby on industrial output given the industrial growth noticed by far can be largely credited to government spending.

E. Banking : Credit and deposits

Growth in banking business has been subdued during FY16 so far. For the period April-October 2nd, growth in deposits was 7.4% (6.9% for same period last fiscal) and credit 4.5% (4.1% in same period in FY15). While bank deposits growth would pick up during the course of the year, bank credit will be impacted as there has been substitution to a certain extent for short term funds through the CP market and long term funds through the corporate debt market. While the latter has been mainly from the NBFC segment, companies prefer these debt market routes as RBI interest rate cuts have been transmitted in a more efficient manner in these markets as opposed to the banks. Under these conditions bank deposits may be expected to increase by around **12%** this year while bank credit growth would be in the region of **10%**, same as in last the fiscal. Further, the demand would be higher from the retail segment.

F. Inflation

Wholesale price inflation was expected to remain low. However, a sharp deviation into the negative territory has had a mixed effect on the economy. The manufacturing sector has been buffeted through loss of pricing power. This continues to impact corporate profitability. WPI inflation has been in the negative zone for 11 months now and will remain benign for the rest of the year. Pressure would be more on the primary articles side with lower agricultural output pushing up prices, the number could turn marginally positive by March 2015.

Fuel prices could be affected to the extent of Rupee depreciation (global oil prices are expected to remain stable) and manufacturing prices are likely to remain largely stagnant. Low global commodity prices would continue to exert favourable pressures on prices though companies at the micro level would get affected in terms of their pricing power. A marginal increase in the WPI index on a month-on-month basis can be expected with the base effect waning in Jan-Feb'16, which could eventually result in a **1%** increase, with an upward bias of up to **2%** in WPI by end March'16.

CPI inflation, which will be the main number to be tracked, had come down to the 3-4% region before increasing to 4.4% in September once the base effect wore off. The precise impact of the lower kharif harvest on specific crops as well as the base effect will keep CPI inflation elevated in the 5% region and based on our own expectations of both kharif and rabi output, as well as the movement of crude oil prices (which would be largely

stable at around \$48-52/bbl given the comfortable supply situation vis-à-vis demand), CPI inflation would range between **5-5.5%** by year end.

G. Monetary policy

The RBI has displayed varied trends during the calendar year, with cuts in interest rates in between policies as well as cuts during the policies. While underlying conditions had not changed when the September policy was announced compared with those in August, the RBI did cut the rates aggressively by 50 bps to spruce up growth. With inflation control being the major objective and the CPI being the target, we expect another **25 bps cut** in interest rates once there is more comfort on inflation which could go up to **50 bps** depending on prices conditions. Hence, while the next policy could be agnostic to rate cuts, the same could be invoked subsequently.

H. Foreign trade

Both exports and imports have been declining during the year which was not expected at the start of the year. Imports have declined by 14.2% during the first 6 months of the year, and the decline in global commodity prices especially oil has helped in bringing down the value of imports. Oil imports had declined from around \$ 82 bn to \$ 48 bn.

However, exports too had declined by a larger amount of 17.7% during this period which was on account of two reasons. The first is that with the global economy slowing down, there was less demand for our exports. Second, the lower crude oil prices also impacted our exports of refinery products, which declined in value terms.

Trade balance has been more or less stable at \$ 67.9 bn hence making the CAD stable.

We expect both exports and imports to retain the current declining trend. We estimate **exports to contract by 8 to 10% and imports to contract by 4 to 6% in FY16**. Trade balance would be largely stable at levels of FY15.

The current account deficit however would be comfortable in the region of around **1.5% of GDP** for the year.

I. Foreign investment flows

FDI flows have been very much positive so far, with DIPP reporting around \$ 9.5 bn in the first quarter of the year. With the same momentum being maintained we expect FDI to range between **\$ 35-40 bn** for FY16.

India has been affected significantly however by the uncertainty in the Fed rate decision as well as other developments in the world economy. FPI flows in FY15 were \$ 24 bn. However, for the first 6 months of the year, there has been a net outflow of forex on this score at \$ 3 bn with equity being - \$ 2.3 bn and debt -\$ 0.7 bn. While the government and RBI have tried to incentivize such investments in the GSec market by way of increasing the investment limits in government securities, we do believe that the pull flow away from emerging markets would tend to dominate and assuming flows turn positive in the next 6 months aided partly by increase flows into the debt segment, FPIs would aggregate up to **\$ 5 bn** this year. We should be prepared for some outflows when the Fed increases rates.

J. Forex reserves

During the year there has been a net accretion of \$ 9 bn to our forex reserves taking the total up to \$ 352 bn as of October 2. Assuming stable CAD and further net accretions in the balance of payments on account of foreign

investment, we expect forex reserves to close at **\$ 360 bn** by the year end. The assumption is that the rupee will also remain stable at **Rs 65-66/\$** with possible bias of strengthening to the \$ 64-65 range at times.

However, the stronger forex position of India did act as a buffer against recent currency markets turbulences viz. the Yuan devaluation and while the rupee witnessed depreciation, it was successful in attaining sustained equilibrium.

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