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State of the Indian Economy

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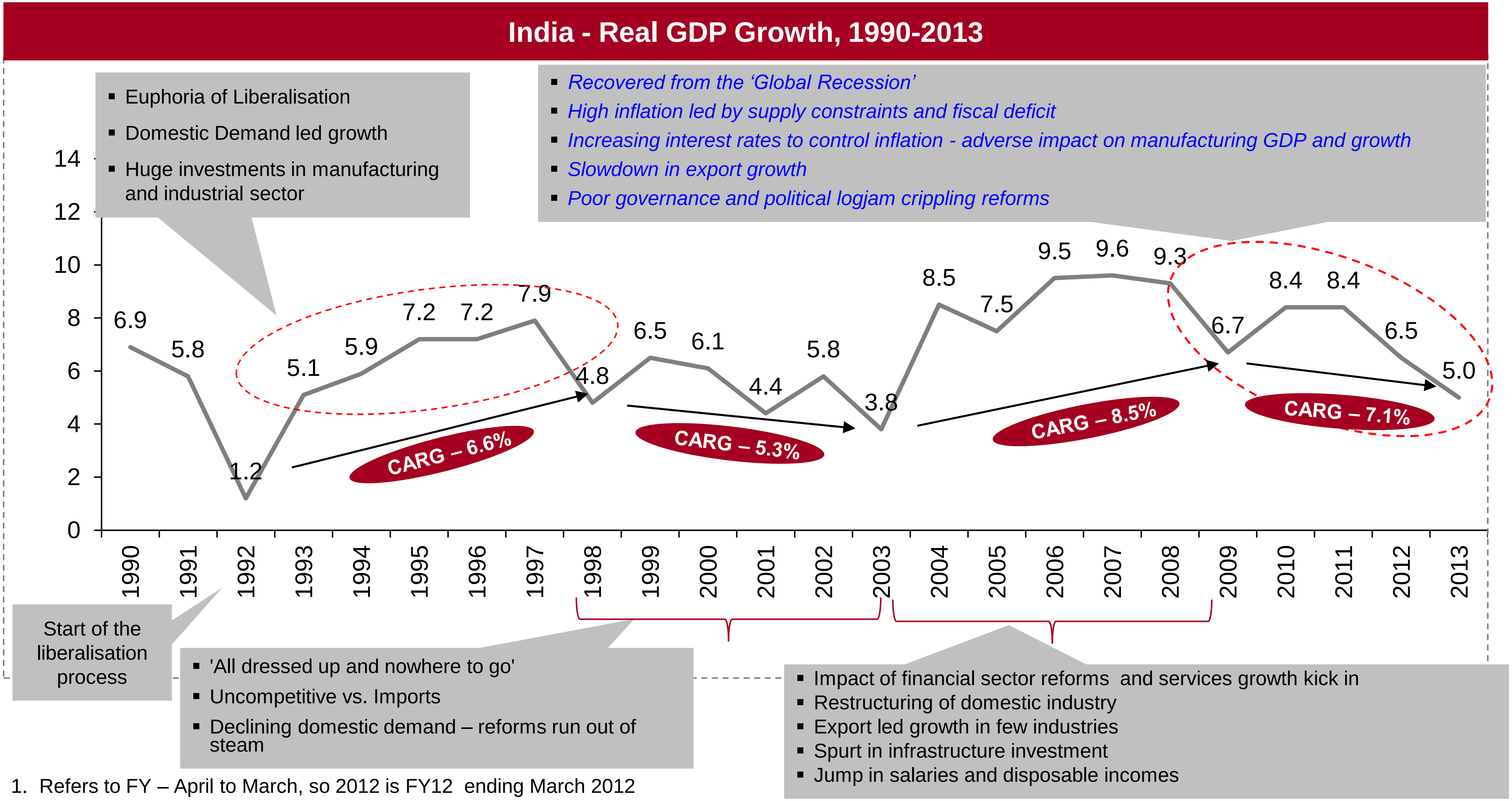
India recovered smartly from the global recession but ran into the headwinds of high inflation, interest rates and poor governance which slowed down growth

Real GDP Growth (%) – 1990-13



1. Refers to FY – April to March, so 2012 is FY12 ending March 2012

Source: Ministry of Finance, Avalon Consulting Research and Analysis

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Turnaround of the Indian economy is expected, albeit slowly

Prospects for Indian economy in 2013-14

Organizations	Month	GDP forecast for 2013-14	Previous projections
Credit Suisse	December 2012	6.9%	7.2%
Reserve Bank of India (RBI)	January 2013	6.5%	6.6%
International Monetary Fund (IMF)*	January 2013	5.9%	6.0%
Economic Survey of India (Govt of India)	February 2013	6.1-6.7%	-
World Bank	March 2013	6.0%	-
Morgan Stanley	March 2013	6.0%	6.2%
HSBC	March 2013	6.0%	6.2%
Asian Development Bank	April 2013	6.0%	-
CRISIL Research	April 2013	6.0%	6.4%
Reuters Poll	April 2013	6.0%	6.4%
Goldman Sachs	April 2013	6.4%	6.5%

"Growth continued to slow down in 2012-13, but (we) could witness a ***slow-paced recovery*** *later this year contingent on improved governance and concerted action to resolve structural bottlenecks especially in the infrastructure sector."*

- D Subbarao, RBI Governor

"The measures taken by the government will lead to economic ***growth of at least 6%*** *in the current financial year against a decade-low growth of 5% in 2012-13. The impact of the government measures would be felt from the second quarter or* ***second half of the year.***"

- C. Rangarajan, Prime Minister's Economic Advisory Council (PMEAC) chairman

Source: Avalon Consulting Research and Analysis

Forecasts of recovery of the Indian economy hinge on four major assumptions

Assumptions underpinning economic recovery

Assumptions for economic recovery

- **Favourable monsoon and its impact on various sectors**
- **External factors**
- **On-going reforms**
- **Interest rate revisions**

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An improved monsoon in 2013 is expected to boost the economy

Impact of monsoon

Assumptions for economic recovery

- **Favourable monsoon and its impact on various sectors**
- **External factors**
- **On-going reforms**
- **Interest rate revisions**

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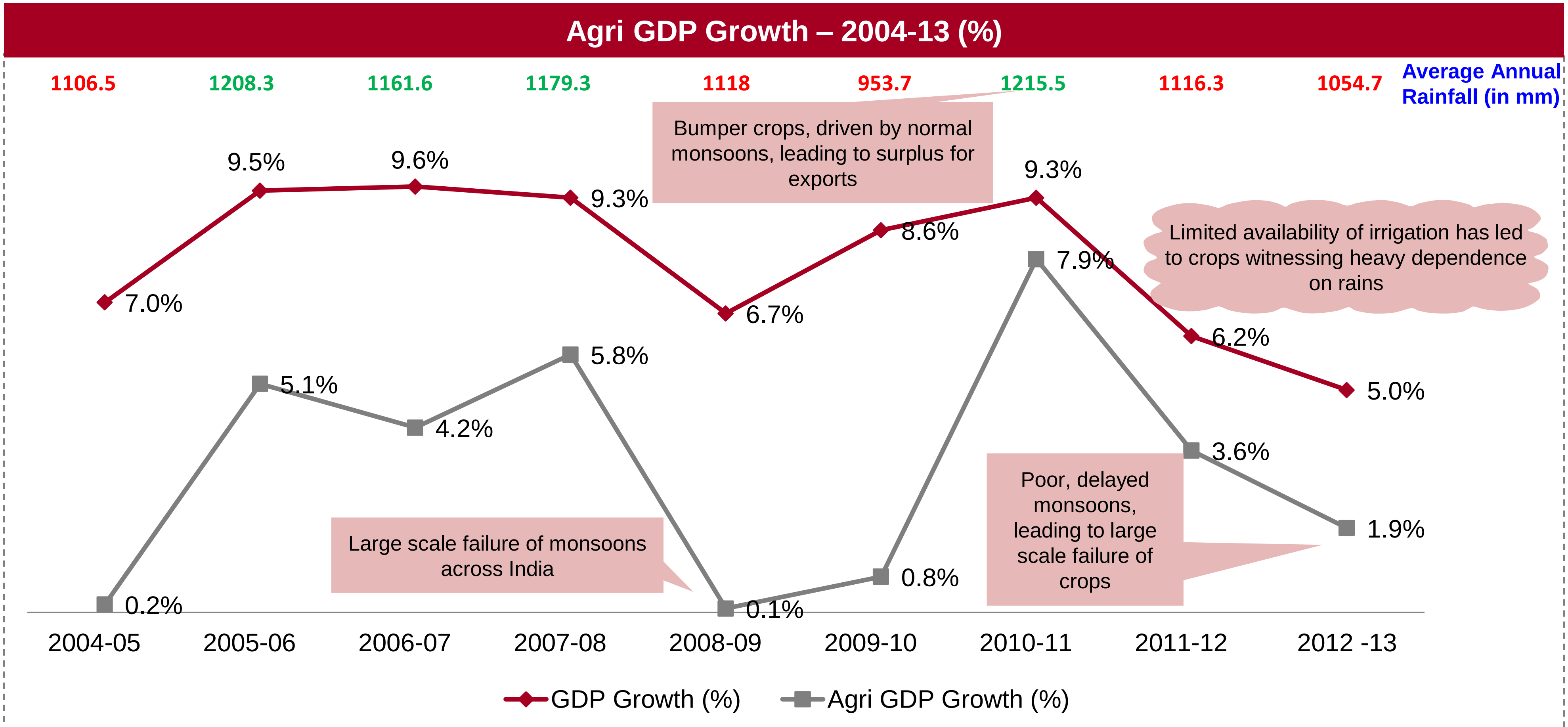
Agricultural GDP is significantly correlated with monsoons

Agricultural GDP Growth (%)- 2004-13



Source: CMIE - Sectoral Gross Domestic Product at Constant Prices : Base Year 2004-05, Data.gov.in, Avalon Consulting Research and Analysis

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Favourable monsoon in FY 14 will impact the agricultural sector and have a perception led impact on the overall economy

Overall impact of monsoon

Normal Monsoon Rainfall → **Bumper Harvests** → **Increase in food supply** → **Boost to rural incomes** → **Higher demand for consumer goods**

*A long-range forecast released in late April 2013 by the India Meteorology Department (IMD) has **predicted for near-normal seasonal rainfall** for the all-important rainy months of June through September 2013. YTD experience is consistent*

Other advantages are:

- Increased hydroelectric production
- Replenishment of water bodies and underground aquifers
- Increased urban water supply
- ***Positive impact on agri related industries such as fertilizers, agrochemicals, agricultural equipment***
- High performance of consumer goods companies typically has perception led impact on overall economy

Currency depreciation and Current Account Deficit (CAD) issues are serious in the short term, but are expected to ease out

Assumptions for economic recovery

- Favourable monsoon and its impact on various sectors
- External factors
- On-going reforms
- Interest rate revisions

The recent sharp weakening of rupee was not triggered by India's fundamentals, but by external factors impacting all emerging markets…

Impact of weakening rupee

RBI's currency reserves (~ USD 291 bn) cover only 6 - 7 months of imports, intervention is limited to smoothening the volatility, not protecting a level

"***Rupee depreciation should act as demand stimulus***…domestic producers will gain competitiveness…should expand exports and contract imports…" - RBI

INR
USD

- *Secular depreciation trend expected with volatility as developed world recovers*
- *Counterbalancing FDI flows like Unilever increasing stake (~ USD 5 bn.) are also expected*

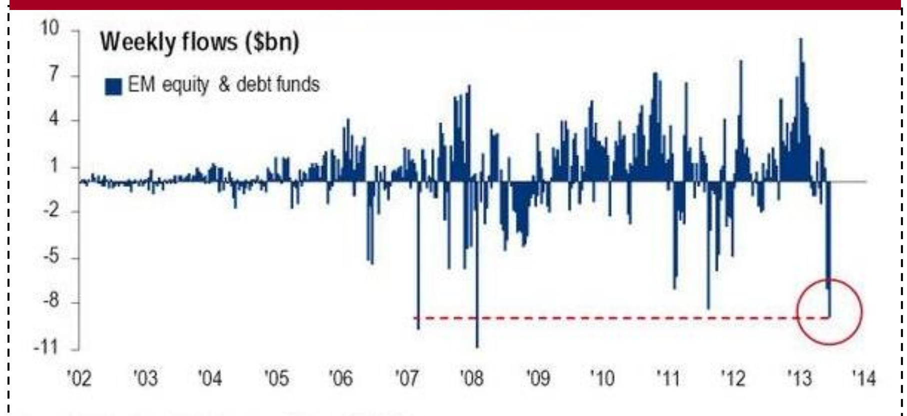
Pull-out of overseas funds of $1.5 billion from domestic shares in June '13

Cut in rupee debt holdings by $5.1 billion in June '13

U.S. new-home sales and consumer confidence exceeded economists' estimates. Federal Reserve Chairman Ben S. Bernanke said that the central bank may phase out a stimulus program this year. ***Real interest rates are surging in the US, re-attracting hot money from emerging markets***

Weakening INR vs. USD

Outflow from assets in emerging markets



Source: XE.com, BoA Merrill Lynch Global Investment Strategy, EPFR Global

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Our Current Account Deficit (CAD) situation, though serious, is expected to improve (as commodity prices are expected to decline)

Impact of external factors on Current Account Deficit

	Why was CAD high in FY ’13 ?	How did CAD drop in Jun ’13 ?	How will CAD end in FY ’14 ?
CAD	4.8% (as high as 6.5% in Q3 FY ‘13)	3.6%	~ 4%
Expense on Imports	• Petroleum imports going up by 9.3 per cent • Surge in gold imports • Oil and gold together were 45% of the imports	• Meltdown in gold prices • An abatement in gold imports growth • Fall in global crude prices between Mar – June 2013 • ***Decline in commodity prices has outpaced currency depreciation impact in this period***	• Continued abatement of gold imports from the record levels seen in FY ’13 • Continued ***decline in commodity prices (likely to outpace currency depreciation)*** • Currency depreciation could make domestic producers more competitive and counteract non-oil, non-gold imports
Revenue from Exports	• Decline in merchandise exports by 1.1 per cent	• Pick-up in exports growth (currency depreciation could have made exports more competitive)	• Further ***improvement in exports growth*** as U.S. economy recovers
Payments made to foreign investors	• Sharp increase in investment income payments		

Source: Avalon Consulting Research and Analysis

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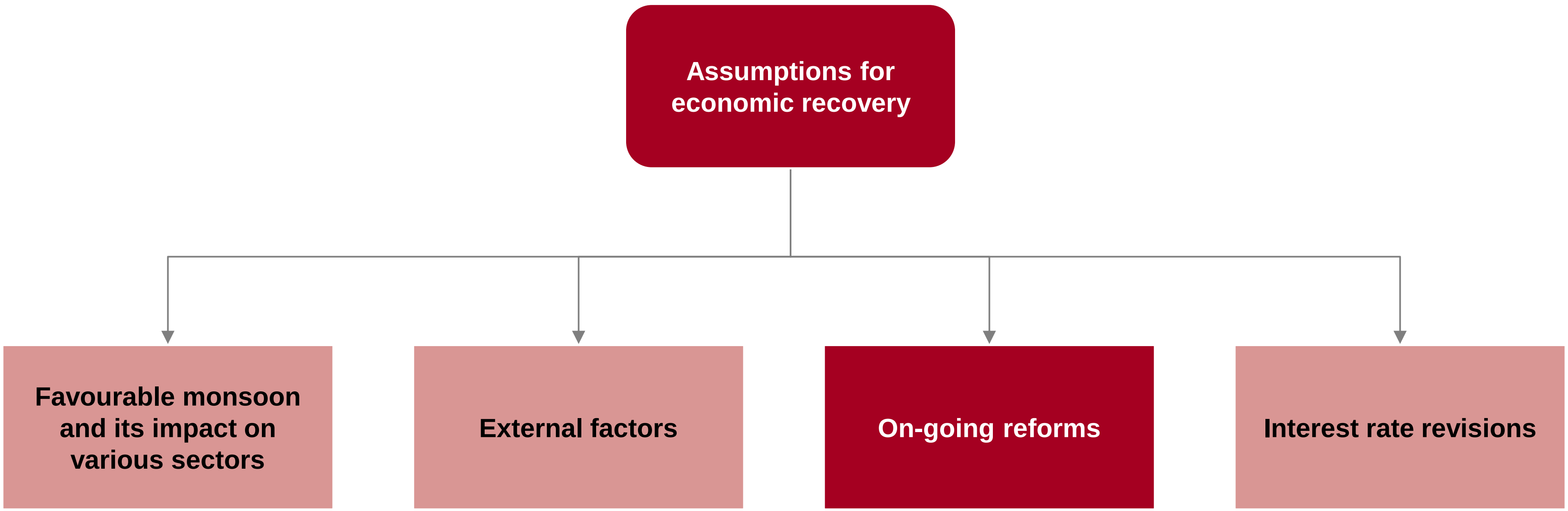
On going reforms are expected to give a boost to economic recovery

Ongoing reforms



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Policy changes are underway in FY 14, which can alter India's growth trajectory and change perceptions / mood of despondency in the short term

Ongoing and likely reforms in FY 14

Illustrative – Not Exhaustive

	Reform	Objective	Likelihood
Fiscal	Disinvestment	■ 8 companies identified, FY target maybe raised from Rs 300 bn	Ongoing
Fiscal	Subsidy transfer	■ ~USD 5.5 bn.	Ongoing
Infrastructure	Fast-track infra projects	■ Establish national investment board to fast-track infrastructure projects over Rs 10 bn	Ongoing – yet to see impact
Infrastructure	Railways	■ Hike in fares	Ongoing
Infrastructure	National Manufacturing Policy	■ To increase manufacturing growth to 12-14% per year	Announced – yet to see impact
Infrastructure	Road Projects	■ Target of awarding 8800 km of road projects in FY 12-13	Ongoing
Infrastructure	Coal availability	■ To pool imported coal price with that of domestic coal to meet domestic demand	Ongoing
Others	Boost public investment through cash-rich state companies	■ To ensure cash-rich state companies stick to investment targets	Likely
Others	Companies Bill	■ To improve transparency and regulation of business houses	Likely

Source – Union Budget Speech 2013-14

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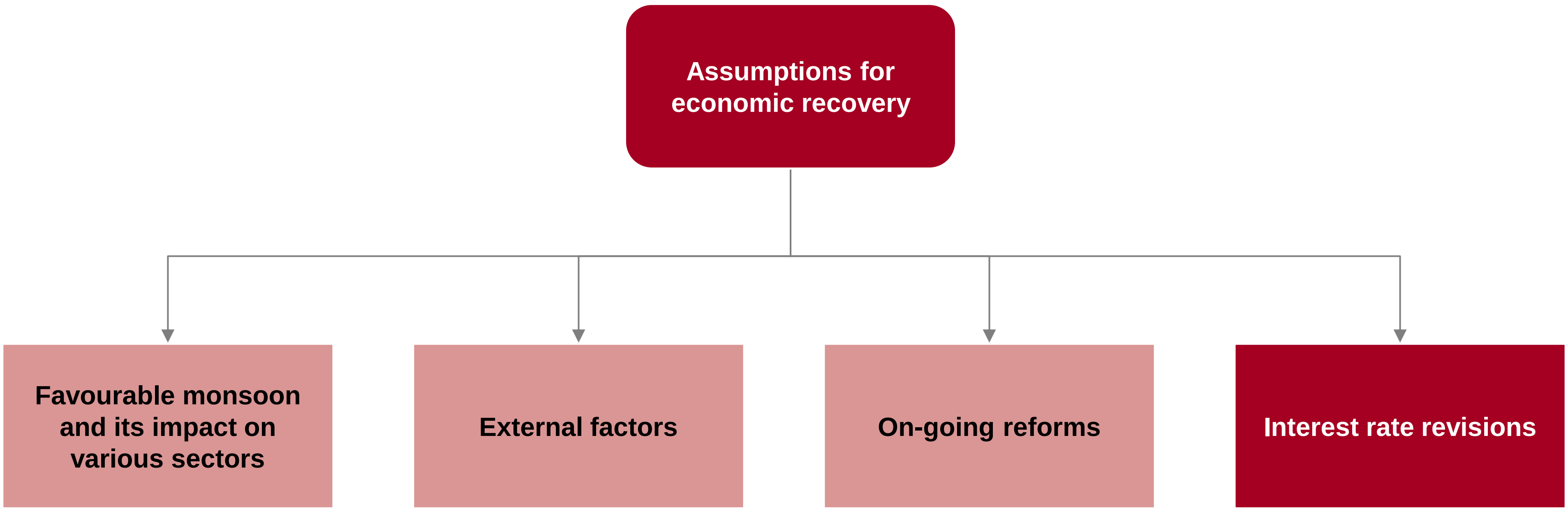
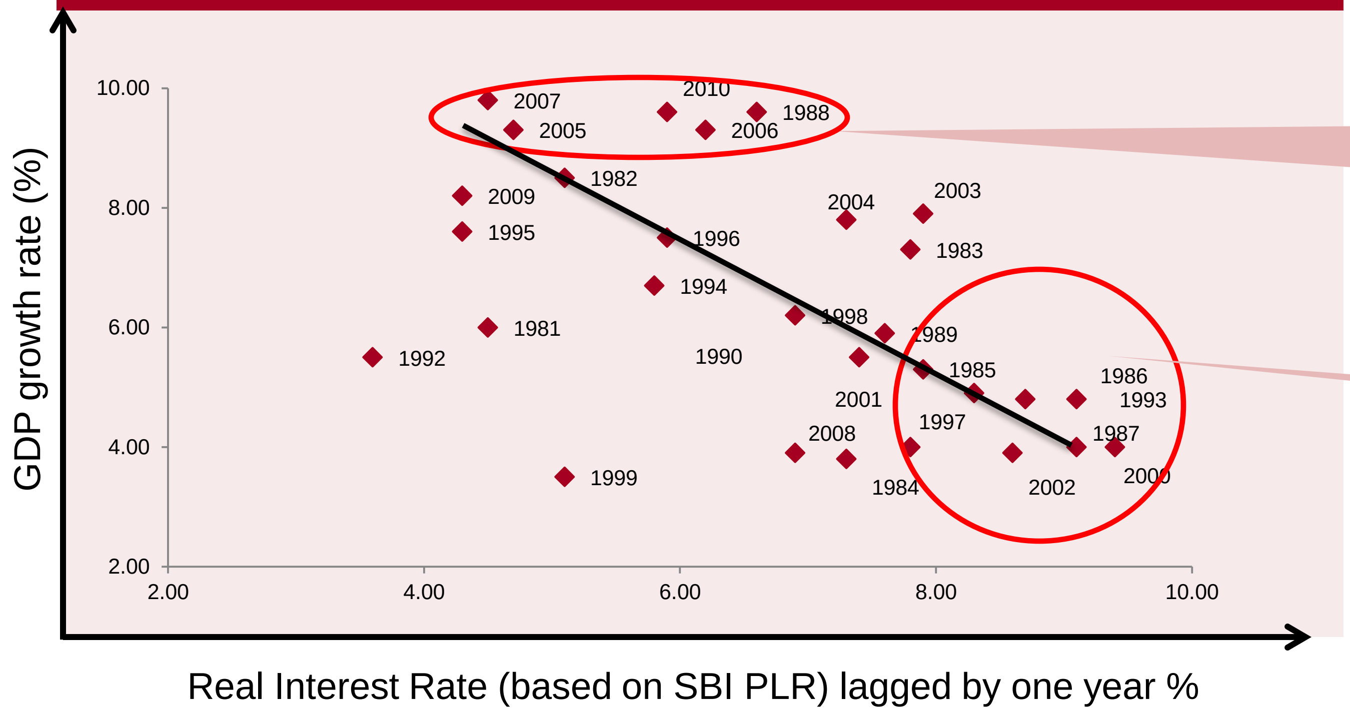
A low real interest rate regime could give a significant boost to economic recovery but needs policy rethink



Low real interest rates have a strong correlation with high growth of the economy

Impact of interest rates on GDP growth

Impact of interest rates on GDP growth in India (1980-2010)



- While interest rate is not the only factor, clearly low interest rate in the sub 7% range impacts GDP growth significantly

- High interest rates impeding GDP growth

- ***Data for the last 30 years*** *suggests that interest rates have a significant impact on GDP growth*
- *The impact of interest rate was an increase in GDP growth of 0.44 percentage points (ppt) for each 100 basis points reduction in interest rates*
- ***Real lending rates have been about double what has been prevailing in China***

Source: Do interest rates affect growth? – Surjit Bhalla (2012)

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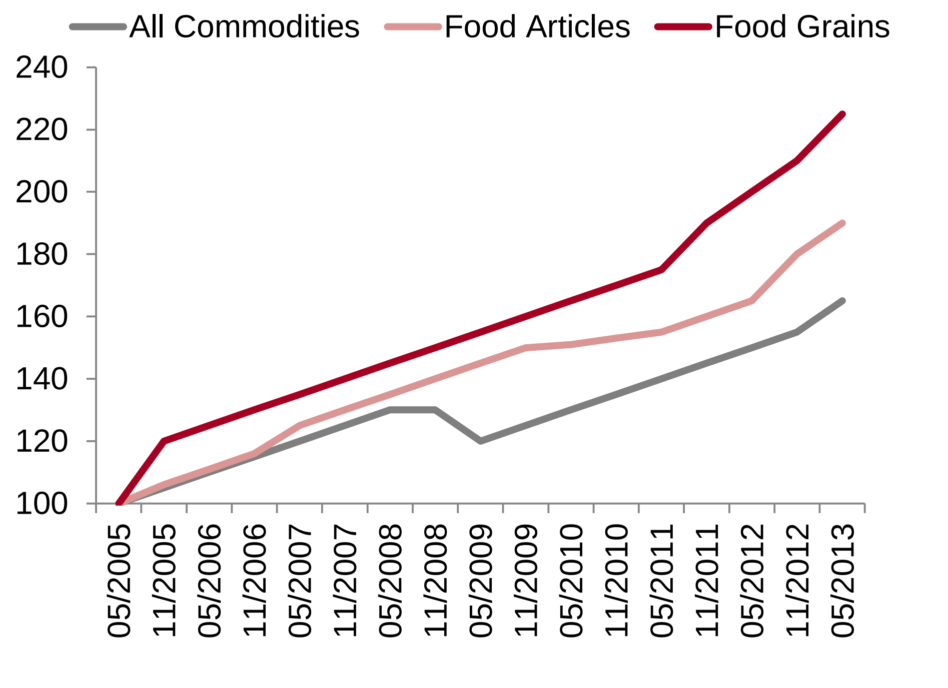
RBI is wary of dropping interest rates to boost growth; since inflation is already high (on account of food inflation)

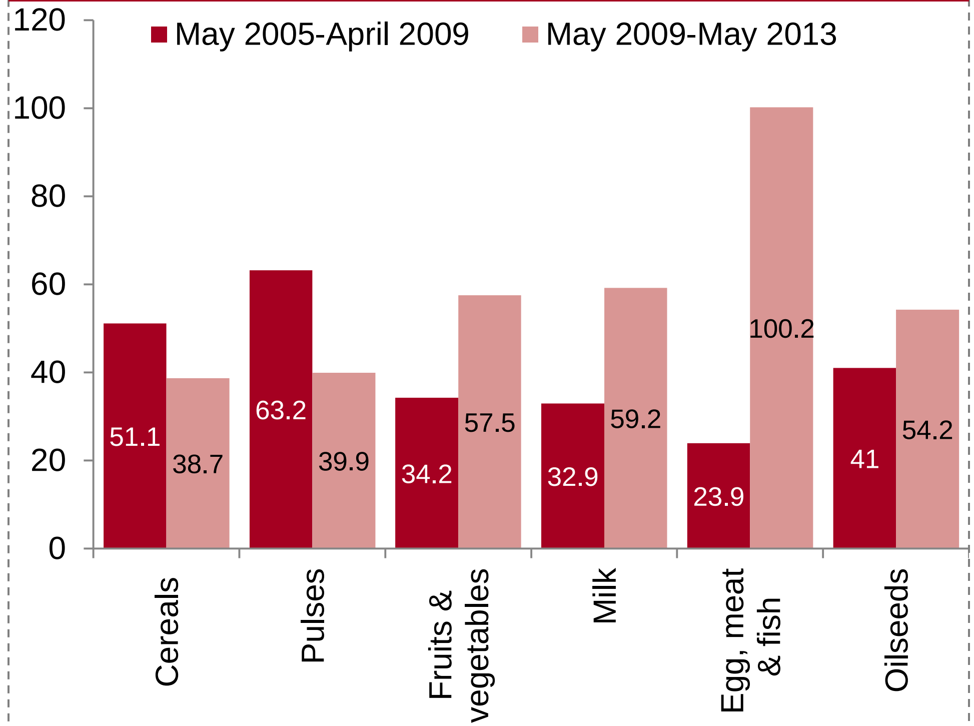
Inflation (CPI) - %

Historical Inflation Trends - India

Wholesale price indices since May 2005



Food Price increases during the two UPA Governments (in %)



- ***RBI, June 18, 2012 – "Further reduction in interest rates, at this juncture, rather than supporting growth could exacerbate inflationary pressures. Our assessment is that there are several other factors responsible for the slowdown in activity"***

Source: CSO statistics, Business Line

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Food inflation is fuelled by popular inclusive policies; respite is unlikely

Impact of MGNREGS on inflation

MGNREGS

Higher rural employment

Higher rural wages

Higher crop prices

Higher M.S.P. fixed by government (>10% CAGR on rice, wheat since 2006)

Higher food inflation

RBI holding/hiking interest rates

- The ***Food Security Bill*** seeks to provide food security to 75 per cent people in rural areas and 50 per cent in urban areas by providing ***subsidised rice at Rs 3 per kg, less than 10% of current retail prices***, and wheat at Rs. 2 per kg
- The bill also provides for ***Food Security Allowance***, in case the government fails to give cheap food
- The bill will ***guarantee at least 25 kilograms of subsidised food grains*** every month to a family of 5 persons

- *Higher demand for food grains relative to the normal increase in supply*

- ***Higher annual grain procurement demand would require MSPs for key crops to be raised (OR supported by increased imports, as required)***

- ***Spill over to market prices of food grains (food inflation)***

- *Higher food subsidy burden on the budget, raising the fiscal deficit and potential upward pressure on inflation. (Govt. is confident that fuel subsidy reduction advantages will kick in to finance some of this deficit)*

Source: Avalon Consulting Research & Analysis

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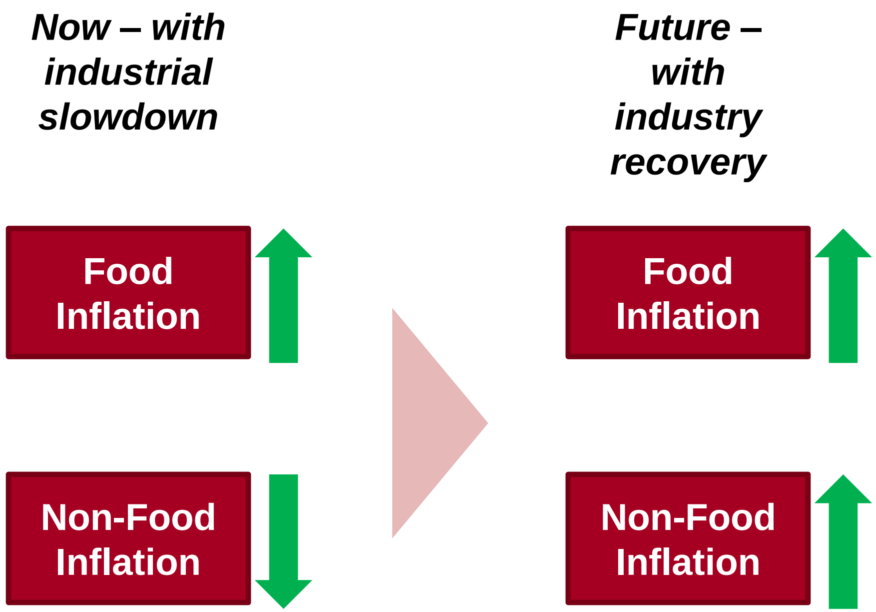
Serious policy rethink on inflation and interest rates is required to balance economic growth and inclusivity agendas

RBI Intervention to support growth



Empirical data shows that (food) inflation seems weakly correlated with interest rates (CPI inflation decreased from a 13.7 % in April-June 2009 (repo rate - 4.75 %) to 10.6 % (repo rate - 8.5%) in October 2011. CPI inflation remains close to its 10 % plus level today, even though repo rate is lower at 7.75 %. In this period, non-food inflation has been subdued)

- *As the economy improves, non-food inflation is likely to rise (fuel subsidy phase out, increase in commodity imports)*
- *Food inflation will not abate unless MSP increase is controlled for food grains*
- *With high overall inflation, RBI could intervene further through monetary policy measures to control inflation (interest rate hike, hike in CRR, hike in SLR, etc.)*
- *However higher interest rates will drag down both investment and domestic consumption, slowing down the recovery process*

Economic recovery cannot be taken for granted

Assumptions underpinning economic recovery

Economic recovery is contingent upon favorable policies and responsible governance

- **Good monsoon will significantly boost the rural economy**
- **CAD is likely to improve as global commodity prices fall more rapidly than currency depreciation**
- **The pace of reforms has picked up and must not slow down due to election year pressures**
- **Favourable interest rate revisions are critical for recovery and policy rethink is essential on inflation**

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