The State of the Economy - A Perspective

September 4, 2013

Premchand C
Executive Director

Recap from July 2 Meeting: We had concluded that recovery of the Indian economy is contingent on four underlying factors playing out – lets see how these are faring

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**

We had especially emphasized the need for real interest rates to drop in India to support a sustained recovery – especially manufacturing growth

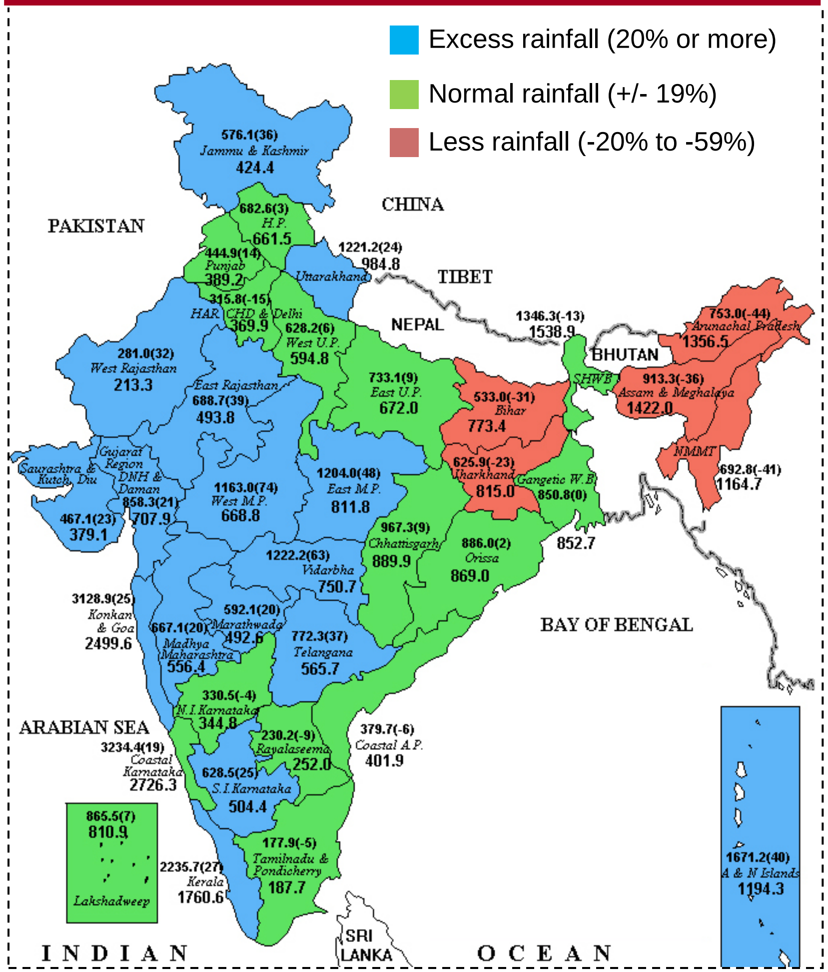
Source: Avalon Consulting Research and Analysis

AVALON Consulting

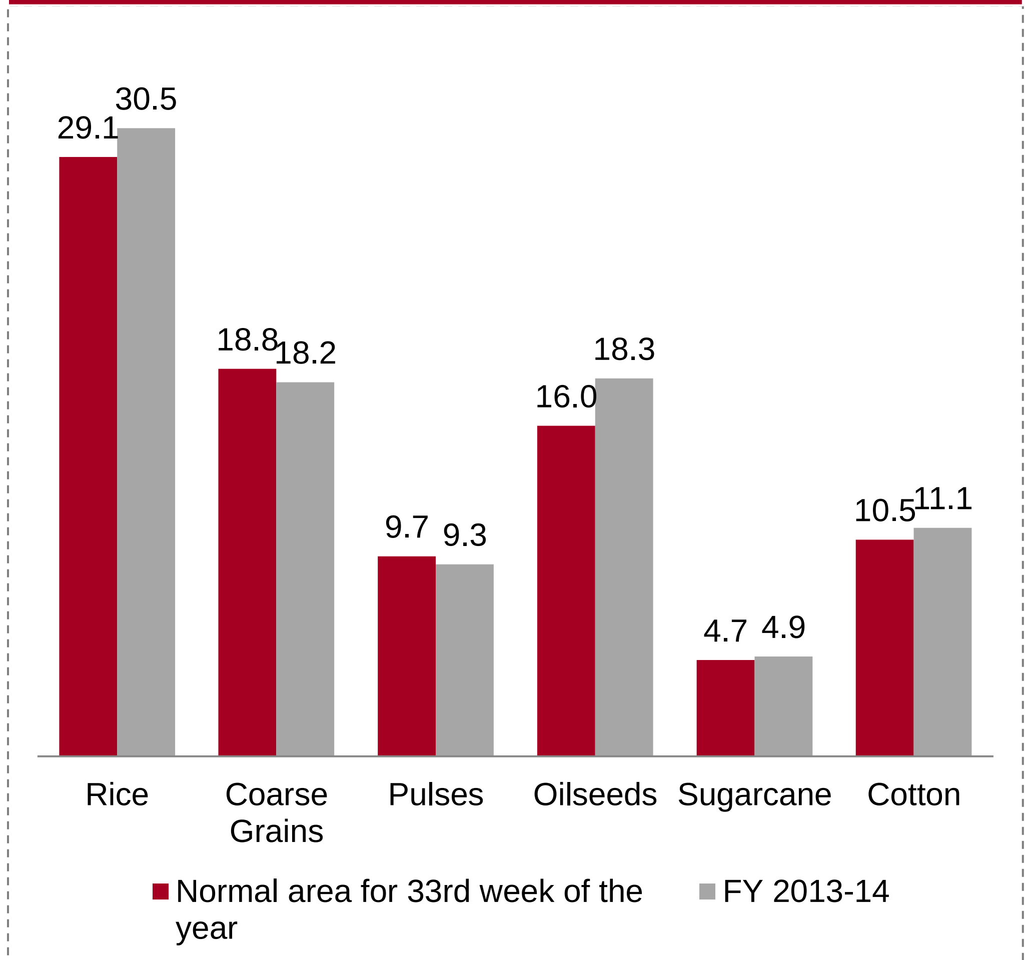
Good monsoon has been a saving grace; a good harvest will favorably impact rural consumer demand – however prices of food products may not abate as they are driven by administered prices which continue to rise

Monsoon 2013

India: Rainfall from June 1 to August 14, 2013



All India Crop Planting Progress (Mn ha of crop planted)



Source: India Meteorological Department, Avalon Consulting Research and Analysis

AVALON Consulting

Rural economy and agricultural GDP will grow faster in FY14

Assumptions underpinning economic recovery

Economic recovery is contingent upon favorable policies and responsible governance

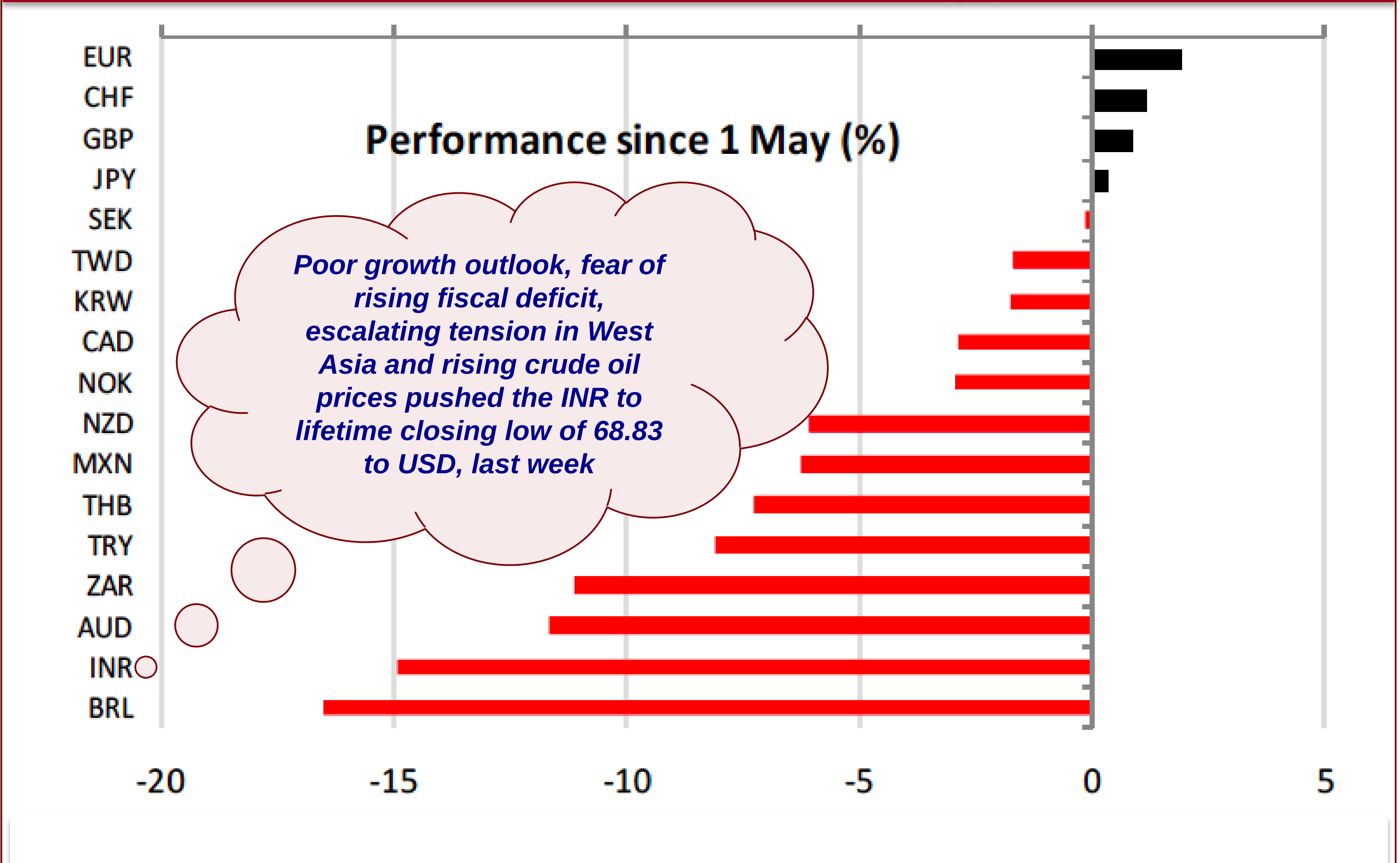
- **Good monsoon will significantly boost the rural economy**
- **CAD is likely to improve as global commodity prices fall more rapidly than currency depreciation**
- **The pace of reforms has picked up and must not slow down due to election year pressures**
- **Favourable interest rate revisions are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

Source: Avalon Consulting Research and Analysis

The depreciation of the Indian rupee has been part of a larger global trend in emerging economies, worsened by domestic macroeconomic issues

Performance of Global Currencies Since 1st May 2013

Global Currencies Performance since 1st May (%)



- *Rupee continued to fall as investors braced for a possible withdrawal of the U.S. Federal Reserve's QE program*

Source: Avalon Consulting Research and Analysis

AVALON Consulting

RBI measures to tighten liquidity to control forex volatility have not helped on this count and have actually increased interest rates and hurt recovery

Effect of RBI measures to control liquidity

July 2013 - Steps taken by RBI to control the free fall of the rupee

1. Limit on the amount of cash banks could borrow (at policy lending rate of 7.25%)
2. Banks to keep aside a portion of their deposits in cash on a daily basis
3. Selling short-term cash-management bills to drain liquidity from the system
4. Restrictions on the amount individuals and businesses can remit or invest overseas & levied import duties on non essential goods
5. Oil Companies to buy dollars through RBI directly through swaps, thereby reducing demand for dollars in open markets

The timing of some measures were not right and ended up creating panic

- Impact on currency depreciation was limited, since global factors were overridingly supporting the flight of capital, especially from bond markets
- Bond prices fell - depreciating the investment portfolio of commercial banks – and resulted in investors (mainly FIIs) dumping these shares in the stock market
- ***Lower bond prices has led to hardening of long term yields which has impacted Government borrowing***
- Liquidity crunch has led to commercial banks raising short term deposit and lending rates
- This has had a ***negative impact on business as well as consumer borrowing***
- ***Capital controls created negative sentiment and created panic***
- ***Crude oil purchase through swaps has only postponed the problem - about $8bn will need to be paid back through borrowings in a future period by OMCs***
- *This has forced RBI (Aug 23) to announce counter measures like bond repurchase programs and relaxation in norms for recording losses (notional / MTM) in bond portfolios for banks*

Source: Press reports, Avalon Consulting Research and Analysis

AVALON Consulting

We can expect both the RBI and Government to continue to intervene in an attempt to manage exchange rate volatility but chances of significantly reversing the trend (to <Rs. 60/$) are limited

Measures to control currency speculation

RBI is working to curb exchange rate volatility

- Banning proprietary trading by banks in currency trading markets
- Increasing margin requirements for currency derivatives
- Curtailing open positions on currency derivatives
- *RBI's foreign exchange swap window for OMCs has tempered the currency drop to some extent (OMCs' demand for USD is about 1.75 bn USD per week)*

Yet, RBI cannot control NDF markets

- NDF markets of foreign banks are outside the regulatory purview of the RBI
- Domestic banking entities had specific open position and gap limits for their foreign exchange exposures
- Foreign banks and corporate entities with an international presence also participated in NDF market

- Other possible initiatives from RBI / Government:-
  - RBI has a swap facility with the Bank of Japan. It can draw 20% of that ($3 billion out of a $15 billion facility)
  - Bilateral trades in local currency invoices (already started with Iran) – difference in exports vs. imports alone can be settled in dollars
  - Bonds can be floated for overseas borrowing (including NRIs) but need for Government / RBI to underwrite some of the currency depreciation risk. *Floating NRI bonds will increase the foreign debt to GDP ratio, which was already high at 21% in 2012-13 and could increases chances of a downgrade by rating agencies*

- ***The only way out of this currency morass is to stimulate the economy back to a high growth path by reviving manufacturing growth, and implementing supporting reforms to attract investment – sentiment can improve in the short term and actual impact will be felt in the medium term***

Source: RBI Annual Report 2012-13, Avalon Consulting Research and Analysis

Sabre rattling on Syria has already started impacting oil – reversing the trend of stable / declining prices

Impact of Syrian tensions on oil prices

Brent crude oil contract (October '13)

Heating oil contract (Jan '14)

- The US's threat of a potential military intervention in Syria shot up Brent crude price to more than $117/barrel. This could go up to ***125 – 130 $/barrel if US launches a strike*** and further to ***150 $/barrel if crisis spreads to oil producing countries*** in the Region and the Strait of Hormuz (key for sea trade via Persian Gulf and Arabian Sea)
- **The implication for emerging economies like India is that, their already decimated currencies will weaken further, as they have to pay higher dollar prices**

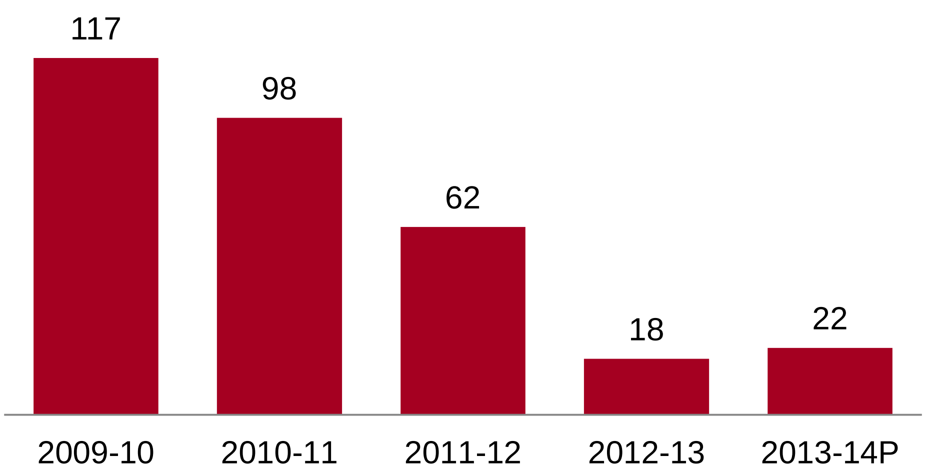
Source: Press reports, Avalon Consulting Research and Analysis

AVALON Consulting

CAD in FY14 will continue to suffer due to the drop in exports of iron ore and production of coal – both of which were caused by policy logjams and a weak Government inviting judicial intervention

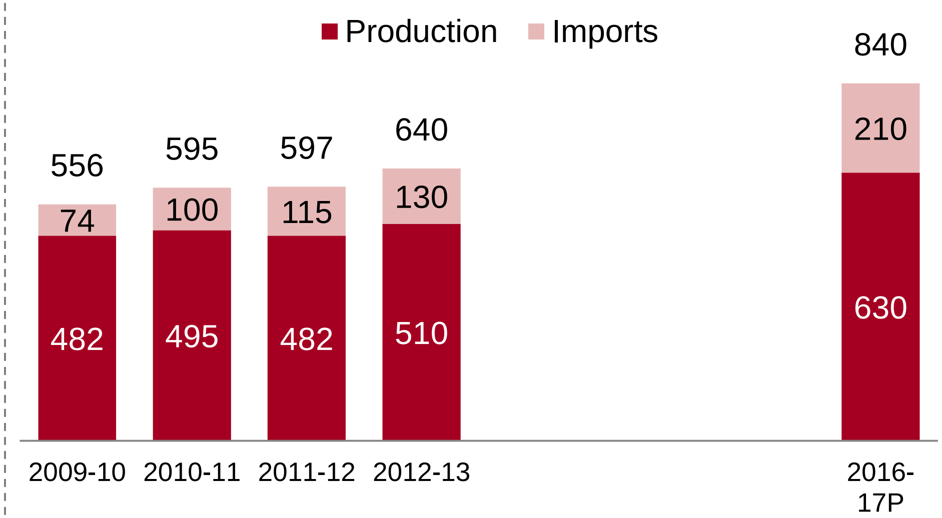
Iron ore & coal situation

India iron ore exports (in Mn T)



- In 2012-13, India's iron ore exports declined mainly due to court ban in Goa, Karnataka and restrictions on mining in Odisha
- Export duty of 30 per cent and differential freight policy of the Indian Railways also contributed to decline in exports
- Iron ore production fell from 219 Mn T to 140 Mn T in FY 13
- Rise in prices of iron ore in international markets and depreciating rupee has led to a slight increase in exports this year. Blanket ban could be lifted by courts, if Government takes appropriate action

India coal use (in Mn T)



- India's failure to mine coal quickly led to exacerbation of chronic power shortages, curbing of economic growth and companies turning towards costly imports
- This year, the government recently awarded coal mining rights for 14 blocks, to yield about 159 million tonnes of coal a year
- To further ramp up production, the government will next auction mining rights for seven explored coal blocks to private companies

Source: Press reports, Avalon Consulting Research and Analysis

AVALON Consulting

Given these developments, restricting imports and hence hoping to control CAD will continue to be a challenge – dictated by global events and not by India

Signs of Economic Distress

Imports likely to increase faster than anticipated due to two factors

Indian rupee has fallen the fastest of any emerging market currency in the last month, down 8.1 percent driven by global factors and poor prospects for the economy in the short term

Hardening of imported commodity prices – especially oil - on the back of Syria & related issues

Source: Avalon Consulting Research and Analysis

AVALON Consulting

While our CAD could improve, doubts exist about our ability to control it to the $70 bn level – exports will have to out perform, given the pressures from a rising import bill

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

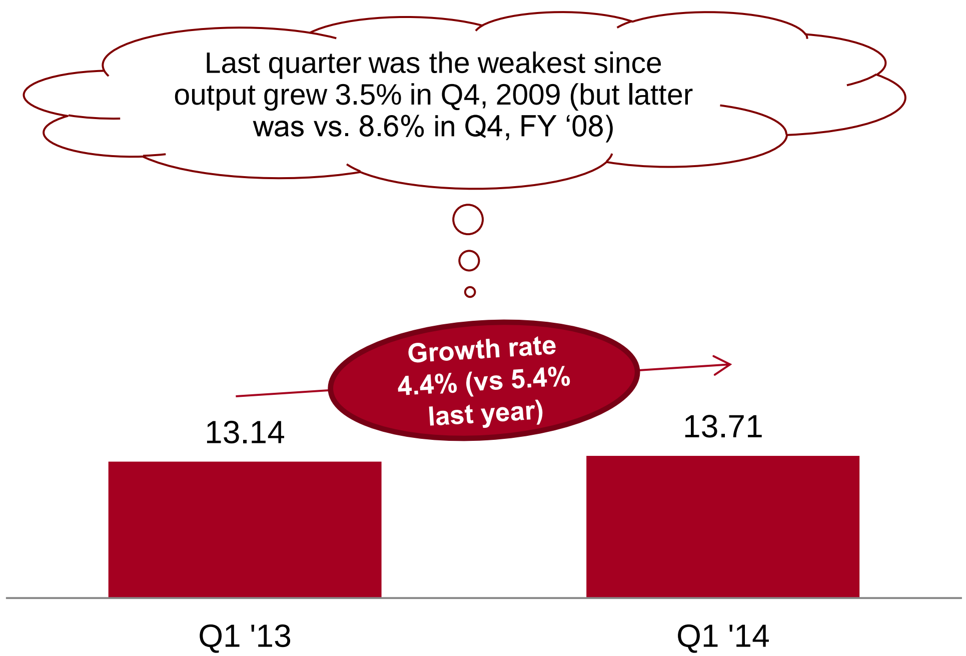
Government is confident of restricting the CAD at 70 bn USD in FY 14 which is lower than actual in the last FY. However, while the CAD is likely to reduce, whether it will touch this figure will be dictated by global events around Syria

Source: Avalon Consulting Research and Analysis

Q1 figures reveal a dismal picture - growth of the Indian economy has slowed down significantly, especially in the manufacturing and mining sectors

India GDP growth

India GDP quarterly GDP growth (Rs lakh Cr.)



Source: MOSPI, CSO, Avalon Consulting Research and Analysis

- **GDP numbers at factor cost and at constant 2004-05 prices show that 90% of the growth in the June quarter was contributed by the services sector**
- **Agriculture and allied sectors contributed over 8% to GDP growth**

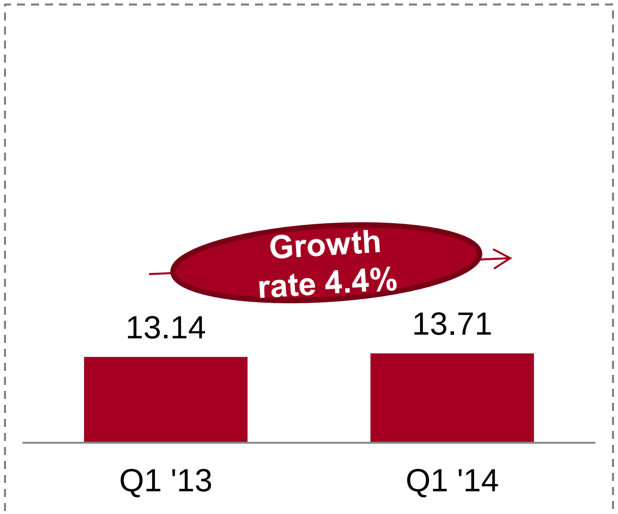
Industry	% change over Q1 '13
Agriculture, forestry & fishing	2.7
Mining & quarrying	***-2.8***
Manufacturing	***-1.2***
Electricity, gas & water supply	3.7
Construction	2.8
Trade, hotels, transport & communication	3.9
Financing, insurance, real estate & Business services	8.9
Community, social & personal Services	9.4
Services (overall)	***5.9***
GDP	**4.4**

AVALON Consulting

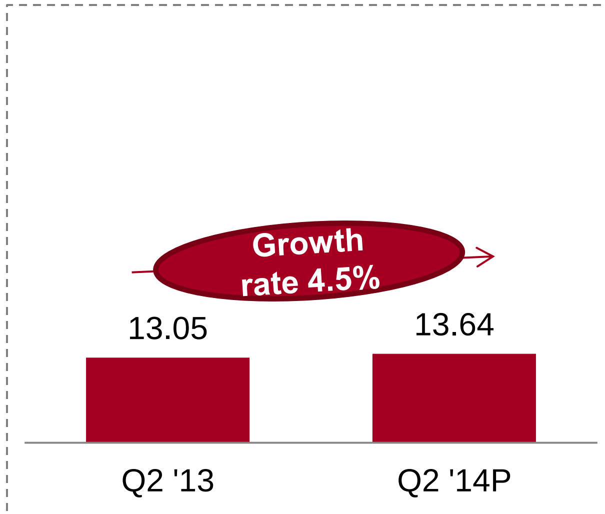
Given this performance and the evidence of Q2, GDP growth target of 5.5% looks unlikely as it requires extraordinary turnaround in manufacturing & mining

India GDP growth (Rs Lakh Cr.)

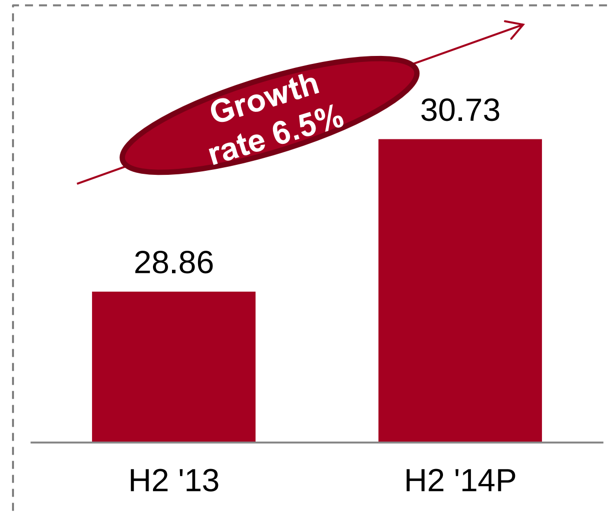
India's GDP grew dismally in Q1 '14



Q2 '14 is expected to grow at almost same rate as Q1 '14



Economy has to grow at 6.5% in H2 '14 to hit the 5.5% annual growth target



Even if mining sector is reformed in Q2, impact could be felt only in Q4, manufacturing outlook is negative and attracting investments and kick starting revival will be a challenge in the short term

Manufacturing, Mining

Needs to grow at

3%+

if

Agriculture

Optimistically grows at

3%

Services

Optimistically grows at

8%

AVALON Consulting

There are also worries of the fiscal deficit breaching its target 4.8% for FY 2013-14, despite the option of trimming expenditure. Perceptions on this count have also been hurt by the passing of the Food Security Bill

India fiscal deficit

Last year, absolute fiscal deficit was controlled by slashing planned expenditure

India's fiscal deficit target was set at 5.2% of GDP

Fiscal deficit reached 51.5% of the full year target in Q1

FM slashed plan spending by nearly Rs 92,000 Cr during the year

India's fiscal deficit last year was contained at 4.9% of GDP

2012 -13

This year, while the FM again plans to control fiscal deficit by slashing expenditure, slower nominal GDP (10.5 % against a budget of 13%) growth will increase risk of fiscal deficit breaching the 4.8% budget target

India's fiscal deficit target was set at 4.8% of GDP

The timing of the Food security bill has worsened sentiment

Fiscal deficit for Q1 is already 62.8% of the full year target

Government is looking to trim plan and non-plan expenditure to ensure that fiscal deficit is reined in at 4.8% of GDP

2013-14

Source: Press reports, Avalon Consulting Research & Analysis

Fiscal slippage fears could result in downgrade of India's sovereign debt to almost junk status soon, and the economy could enter a more vicious cycle

India sovereign rating

Downgrade fears on India's sovereign rating (as of Sep '13)			
Agency	S&P	Moody's	Fitch
Rating	BBB-	Baa3	BBB-
Outlook	Negative	Stable	Stable
Warning	High deficit could face more turbulence	Food Security Bill as credit negative	Fiscal slippage could trigger negative rating action

Further downgrades would result in

1. Dramatic widening of bond yields
2. Increase in funding costs for corporates
3. Additional pressure on banks, due to downward asset quality
4. Funding squeeze as foreign investors will try to exit lower grade investments
5. Larger downturn in the stock market

Source: Credit Rating reports, Avalon Consulting Research & Analysis

Fiscal stability can be restored significantly by raising fuel prices and reducing the revenue loss due to under recovery

Expected fuel price hikes

How did rupee downfall affect subsidised fuel?

A 25% drop in rupee value has resulted in:

- Losses on diesel sales - Rs 10.22 per litre
- Losses on Kerosene - Rs 33.54 a litre
- Losses on LPG - Rs 412 per cylinder

Why is fuel price hike mandatory?

Fuel subsidy budget allocation in FY 14 was Rs 65000 cr. But actual under-recovery (revenue loss) could reach Rs 180,000 cr this year

How can Government plan to tackle the fuel subsidy burden?

Sharp price increases are to be expected in this FY (Immediate term expectation :-
Diesel prices may be hiked by Rs 3-5 per litre,
Kerosene by Rs 2
LPG by Rs 50 per cylinder)

Source: Press reports, Avalon Consulting Research & Analysis

Big ticket infra projects should continue to be fast tracked. Quick clearances will create a positive sentiment for attracting more investment

Delays in Infrastructure project clearance

- The project management group (PMG) set up by the union government has plans to expedite 62 delayed projects worth Rs 3.93 lakh crore.
- The infrastructure projects are each of a size of Rs 1,000 crore or more
- 27 projects are in the power sector. These include
  - Rs 33,000-crore Jaitapur civil nuclear energy plant
  - Reliance Power's Jharkhand Integrated Power project
  - Several large projects of Tata Power, Essar, Lanco, and Adani groups
- The projects are delayed because of issues like land acquisition, fuel supply and environmental clearances, mining.
- The PMG gave clearance to 17 large infrastructure projects in the last two weeks of July 2013
- It is expected that this urgency will continue & result in kick starting a significant number of delayed projects

Source: Press reports, Avalon Consulting Research and Analysis

Judicious fiscal & favorable reform policies will improve investor sentiment. Impact will be in the medium term but even in the short term, H2 should be better than H1

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**

Government will continue to push and fast track big ticket infra projects. Hard decisions on oil subsidies and controlling expenditure will be critical for H2 to be better than H1 and fiscal deficit to reach close to its target. Despite these measures, GDP growth of 5.5% for FY14 looks unlikely

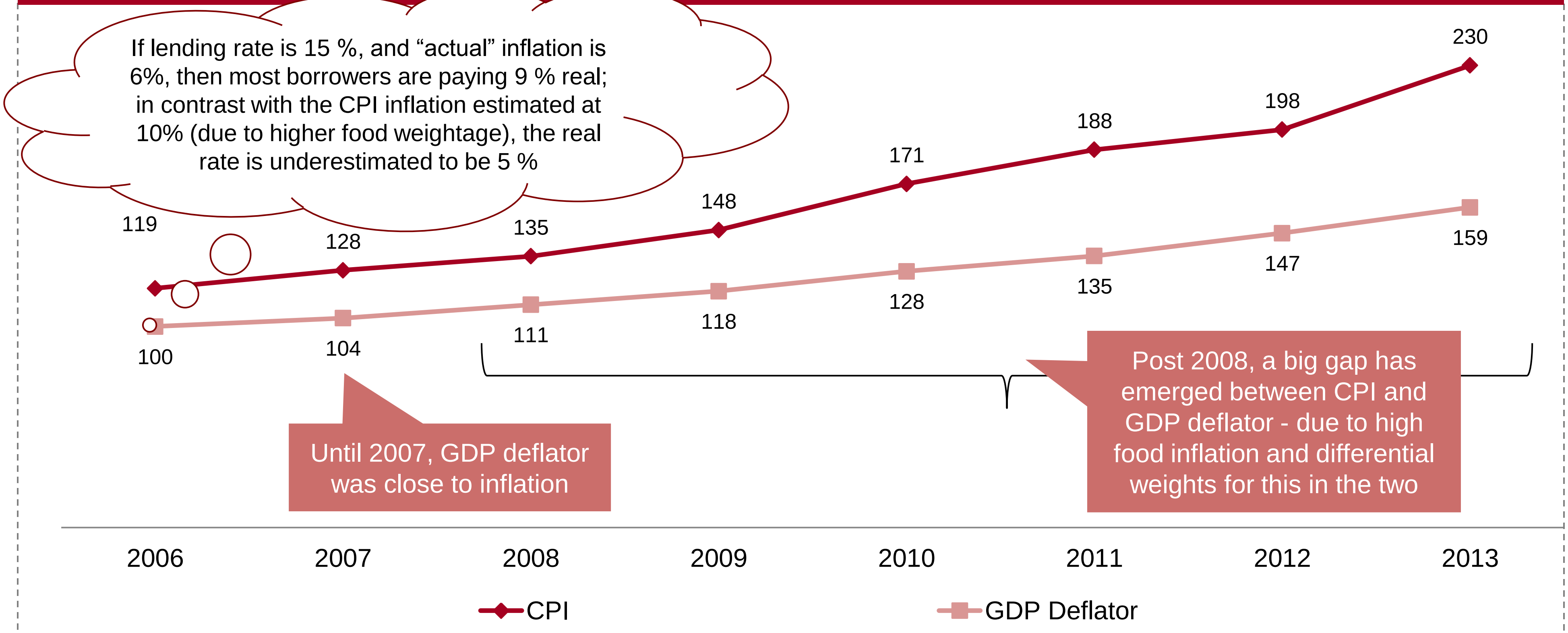
Source: Avalon Consulting Research and Analysis

Favourable real interest rate revisions after factoring actual inflation based on GDP deflator will kick start investments and manufacturing growth

India CPI vs GDP deflator

The divergence between the GDP deflator and the CPI since 2007 means that actual inflation is significantly lower than what is reported

India CPI vs GDP Deflator (units in their respective indices)



Source: MOSPI, Avalon Consulting Research & Analysis

There is an urgent need for policy level decoupling of interest rates from CPI inflation rates and to bring down real interest rates to kick start the economy

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** ?

There is an urgent need for decoupling of interest rates from CPI inflation (at the policy level) and reduce interest rates despite a possible increase in inflation in the coming months

Source: Avalon Consulting Research and Analysis

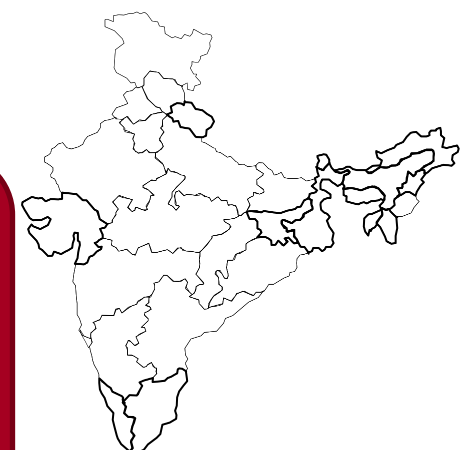
AVALON Consulting

New leadership at the RBI is welcome: already showing early signs of adapting to the needs of the dynamic environment

RBI recently postponed its mid quarter review, to wait and watch for the moves of U.S. Fed on its stimulus program

- US Federal Open Market Committee (FOMC) meeting is scheduled on 17-18 Sep ’13
- FOMC will indicate when the US Fed would start tapering its stimulus programme
- This would decide the fate of Indian rupee’s strength, along with other emerging markets’ currencies

- RBI is expected to hold its mid-quarter review on monetary policy a few days after the FOMC
- If tapering of the stimulus program is announced, RBI will rework its measures to stabilise the rupee further
- RBI is also expected to revise interest rates



Source: Reserve Bank of India, Avalon Consulting Research and Analysis

Indian companies may also need to quickly recalibrate their short term strategy and adapt their business models

Recalibration Facets

- What are the changes needed to manage higher cost of RM and fuel? – import vs. local vs. substitutes, currency risk management mechanisms, captive / alternative fuels, etc.
- How can companies survive in a low demand environment especially in industries where the recovery will be late and / or industry cycles are frequent?
- How can companies manage the higher short term interest rates and longer working capital cycles typical in an economic slowdown?
- How can companies diversify their product / service / customer / geography portfolio to manage risk of downturn in core product markets?
- How can companies exploit the new weak currency regime? – selective export market development, compete better against other LCCs like China

Source: Avalon Consulting Research and Analysis

For further information:

Premchand C., Executive Director
✉ premchand.c@consultavalon.com
☎ +966 553335188
☎ +91 9841069590