

India Macro Newsletter

June 2014

MACRO ECONOMIC REVIEW

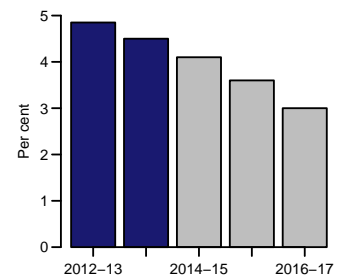
Industry: Index of Industrial Production (IIP) grew by 4.7 per cent in May, 2014, compared to the decline of 2.5 per cent in May, 2013.

Inflation: Wholesale Price Index (WPI) inflation declined to a four month low of 5.43 per cent in June 2014 due to lower inflation in some food items and fuel. Consumer Price Index-New Series (CPI-NS) fell to a 30-month low of 7.31 per cent as well.

Fiscal performance: Fiscal deficit budgeted to be contained at 4.1 per cent of Gross Domestic Product (GDP) in 2014-15. It is targeted to be 3.6 per cent of GDP in 2015-16, and 3 per cent in 2016-17.

External sector: Foreign exchange reserves at end-June 2014 were US\$ 316.1 billion. The monthly average exchange rate of the Indian Rupee in June 2014 was Rs.59.7 per US\$.

Capital markets: Indian markets reached historic highs on July 7th, 2014, with Sensex and Nifty breaching the 26,000 and 7,700 index levels respectively.



Source: Ministry of Finance

Figure 1: Fiscal deficit to GDP

Indicator	Period	Unit	Value	Change over previous period
GDP growth	FY 2013-14	%	4.7	0.2 ↑
IIP growth	Y-o-Y May 2014	%	4.7	1.3 ↑
WPI inflation	Y-o-Y June 2014	%	5.4	-0.58 ↓
CPI-NS inflation	Y-o-Y June 2014	%	7.3	-0.97 ↓
Fiscal Deficit	FY 2013-14	% of GDP	4.5	-0.4 ↓
Sensex	YTD 07-July-2014	Index	26100.1	6775.31 ↑
Nifty	YTD 07-July-2014	Index	7787.2	1975.6 ↑

Table 1: Key Macro-economic Indicators

- IIP:** Industrial production grew by 4.7 per cent in May, 2014 compared to the decline of 2.5 per cent in May, 2013. During April – May 2014-15, the monthly year-on-year industrial growth was 4.0 per cent, compared to the negative growth of 0.5 per cent during April – May 2013-14. Based on the broad-sector classification, the manufacturing sector grew by 4.8 per cent in May, 2014, compared to a decline of 3.2 per cent in May, 2013. Similarly, the mining sector grew by 2.7 per cent in May, 2014 compared to a decline of 5.9 per cent in May, 2013. Electricity production also grew significantly in May, 2014 increasing by 6.3 per cent. IIP estimates for May 2014 are in line with the [Purchasing Managers Index \(PMI\)](#) forecast. Capital goods and consumer durables also showed improvement as compared to previous months.

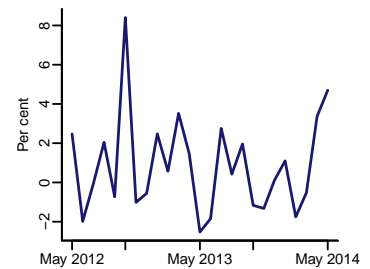


Figure 2: Monthly year-on-year growth rate of IIP

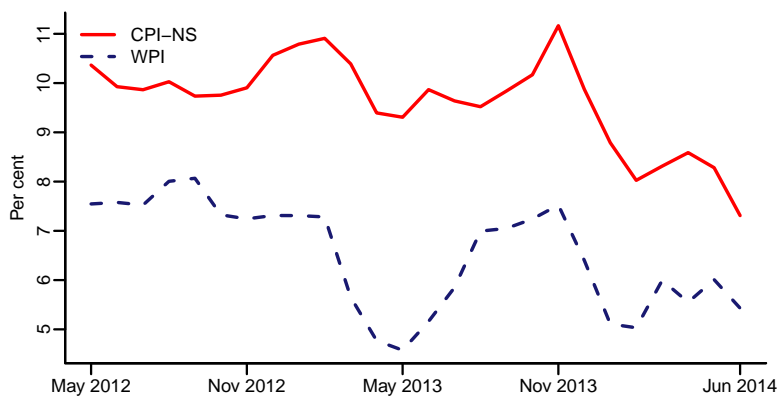


Figure 3: Inflation

Source: Central Statistics Office

- PMI:** The [PMI](#) witnessed a marginal increase to 51.5 during June 2014, from 51.4 during the previous month. This was mainly a result of the expansion in new orders and export orders (particularly of consumer goods), indicating an improvement in demand conditions, both domestically and abroad. Export orders for June 2014 were the highest in three months. The employment index expanded marginally during June 2014, marking the ninth consecutive month of expansion in this index. Input cost inflation was the highest in three months, and the output price inflation was the highest in eight months.
- Inflation:** The headline [WPI](#) inflation fell to 5.43 per cent in June 2014. Lower crude oil prices led to lower inflation in non-administered mineral oils. If bad monsoons impact food prices adversely, inflation may increase. Similarly, [CPI-](#)

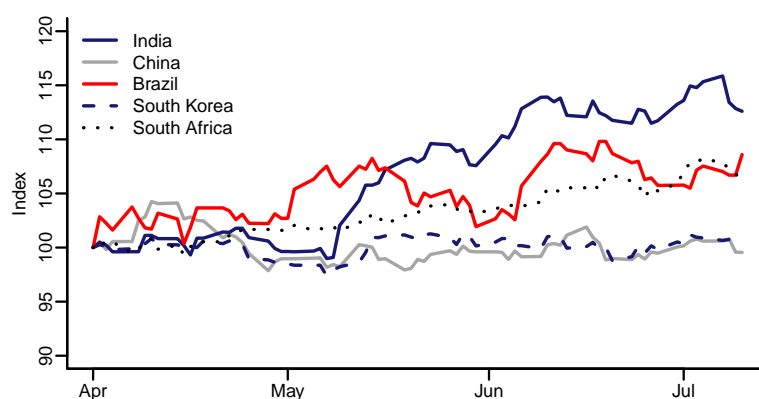
NS too has moderated in June 2014 to a 30 month low of 7.31 per cent (compared to 8.28 per cent in May 2014), mainly due to base effect. Moderation has been observed across the board for all major subgroups. However, the headline WPI inflation decreased as a result of food inflation, which has moderated to a 28 month low of 7.90 per cent, compared to 9.27 per cent in the previous month.

- **Fiscal consolidation:** A roadmap for fiscal consolidation has been outlined in the Union Budget 2014-15 with a fiscal deficit target of 3.6 per cent for 2015-16 and 3 per cent for 2016-17. Fiscal deficit will be contained at 4.1 per cent of GDP in 2014-15. This will be a challenge, considering the low GDP growth (especially industrial growth), the resultant moderation in the growth of indirect taxes, a large subsidy burden and not so encouraging tax buoyancy. This is proposed to be achieved by good revenue collection, disinvestment and expenditure reforms.
- **External sector and Trade:** The monthly average exchange rate of the Rupee appreciated by 2.1 per cent from Rs.61.01 per US\$ in March 2014 to Rs.59.7 per US\$ in June 2014. The annual growth of exports in June 2014 was 10.2 per cent. Imports in June 2014 were 8.3 per cent higher than in June 2013.



Source: SEBI

Figure 4: Monthly Net FII inflow



Source: Thomson Reuters

Figure 5: EM Stock market indices

- **Capital markets:** Indian stock markets continued to outperform emerging market peers in the April-July 2014 quarter with an index growth of 12 per cent. Indian markets reached historically high levels on July 7th, 2014, with Sensex and Nifty breaching the 26,000 and 7,700 index level respectively. Market capitalisation grew 16.4 per cent since April 2014. Foreign Institutional Investors (FIIs) net investment in the Indian markets was US\$ 15.3 billion during January 2014 –

May 2014, compared to US\$ 12.13 billion in the entire year of 2013.

UNION BUDGET 2014-15

Presented by Finance Minister Arun Jaitley on July 10, 2014, the Union Budget 2014-15 lays down the Central Government's strategy to achieve macroeconomic stability and 7-8 per cent inclusive GDP growth within the next 3-4 years. The Finance Minister accepted the challenge set by the [United Progressive Alliance \(UPA\)](#) government on fiscal consolidation. In relation to revenues, he focused on simplifying tax structures, broadening the tax base, committing to [Goods and Services Tax \(GST\)](#) and reviewing the [Direct Tax Code \(DTC\)](#). He announced the Expenditure Management Commission will be formed in order to achieve fiscal consolidation in the long run. The Finance Minister also announced policy measures for improving infrastructure and reviving investment in industry.

Road map towards fiscal consolidation

- The budget retained the fiscal deficit target at 4.1 per cent of GDP for 2014-15. The fiscal deficit target was fixed at 3.6 per cent for 2015-16 and 3 per cent for 2016-17.
- The budget proposed to overhaul the subsidy regime, including food and petroleum subsidies, and make it more targeted.
- The budget expressed the Government's commitment towards revamping the [Mahatma Gandhi National Rural Employment Guarantee Scheme \(MGNREGS\)](#) to provide wage employment through productive, asset creating activities and substantially link it to agriculture and allied activities.
- The budget proposed formulation of a new urea policy.

Initiatives to boost investment in the Union Budget 2014-15

Foreign direct investment

- The budget proposed raising the composite cap of foreign investment in the defence sector to 49 per cent,

with full Indian management and control through the [Foreign Investment Promotion Board \(FIPB\)](#) route.

- The budget proposed raising the composite cap in the insurance sector upto 49 per cent from the current level of 26 per cent, with full Indian management and control through the [FIPB](#) route.
- To encourage development of smart cities, the budget proposed reducing the requirement of the built up area and capital conditions for [Foreign Direct Investment \(FDI\)](#) from 50,000 square metres to 20,000 square metres and from USD 10 million to USD 5 million respectively, with a three year post completion lock in.
- To further encourage investment in this sector, the budget proposed that projects committing at least 30 per cent of the total project cost towards low cost affordable housing would be exempt from the minimum built up area and capitalisation requirements, with the condition of a three year lock-in.
- The budget proposed that the manufacturing units would be allowed to sell their products through retail including E-commerce platforms without any additional approval.

Bank capitalisation

To meet the requirements under the Basel III norms, the budget proposed that the capital of the banks would be raised by increasing the people's shareholding in a phased manner.

Tax incentives for [Real Estate Investment Trusts \(REITs\)](#) and [Infrastructure Investment Trusts \(InvITs\)](#)

- The budget proposed allowing tax pass-through status to [REITs](#).
- The budget envisaged [InvITs](#) as a modified [REITs](#) type structure for infrastructure projects. This structure is proposed to have a similar tax efficient pass-through status, for [Public Private Partnerships \(PPPs\)](#) and other infrastructure projects.
- The proposed initiatives aim to provide additional sources of capital for builders and aid in reducing the exposure of the Indian banking system to this sector.

Financial sector reforms

1. Capital market reforms

- To promote better governance and accountability the budget proposed to move ahead on the recommendations of the [Financial Sector Legislative Reform Commission \(FSLRC\)](#) (such as the enactment of the [Indian Financial Code \(IFC\)](#)), through consultations with all the stakeholders.
- The budget emphasised having a modern monetary policy framework to meet the challenges of a complex economy.
- The budget advised the financial sector regulators to take early steps to develop a vibrant, deep and liquid corporate bond market, and to deepen the currency derivatives market, by eliminating unnecessary restrictions.
- The budget proposed extending the liberalised scheme of 5 per cent withholding tax to all bonds issued by Indian corporates abroad for all sectors. The validity of this scheme was proposed to be extended to June 30th, 2017.
- The budget proposed liberalisation of the [American Depository Receipt \(ADR\)/Global Depository Receipt \(GDR\)](#) scheme to allow issuance of depository receipts on all permissible securities.
- The budget proposed allowing international settlement of Indian debt securities.
- The budget proposed to completely revamp the [Indian Depository Receipt \(IDR\)](#) and introduce a much more liberal and ambitious [Bharat Depository Receipt \(BhDR\)](#).

2. Banking reforms

- The budget proposed permitting banks to raise long term funds for lending to the infrastructure sector with minimum regulatory pre-emption, such as [Cash Reserve Ratio \(CRR\)](#), [Statutory Liquidity Ratio \(SLR\)](#) and [Priority Sector Lending \(PSL\)](#).
- The budget proposed that a framework for licensing small banks and other differentiated banks would be created by the [Reserve Bank of India \(RBI\)](#).

- The budget proposed setting up six new Debt Recovery Tribunals to develop effective means of reviving stressed assets.

3. Insurance sector

- The budget proposed taking steps towards deepening of the insurance sector.
- The budget proposed taking up the pending insurance laws (amendment) Bill for consideration by the Parliament.

4. Tax treatment of fund managers

With the aim of ending uncertainty surrounding tax treatment of fund managers, and to encourage these fund managers to shift to India, the budget proposed that income arising to foreign portfolio investors from transaction in securities would be treated as capital gains.

ECONOMIC SURVEY 2013-14

The Economic Survey 2013-14 was presented a day before the budget. It reviewed the slowdown in growth and discussed the challenges for policy makers.

GDP growth

GDP at constant prices is expected to grow within the range of 5.4–5.9 per cent in 2014-15. There are downside risks to the economy arising from a poor monsoon, the external environment and the poor investment climate. GDP growth slowed to below 5 per cent for two consecutive years, i.e. 2012-13 and 2013-14. The combination of domestic structural constraints, inflation pressures (particularly food inflation), and uncertainty in the global economy has affected growth and posed challenges for macroeconomic stability. The growth slowdown was broad-based, particularly affecting the industrial sector. Aided by favourable monsoons, the agricultural and allied sector grew at 4.7 per cent in 2013-14.

In 2013-14, industry grew at 0.4 per cent. The key reasons for poor performance have been contraction in mining activities and deceleration in manufacturing output. Manufacturing and mining sector GDP declined

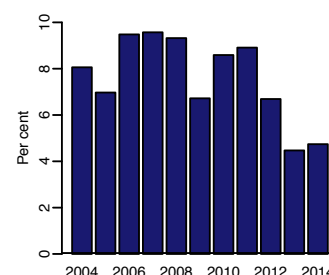


Figure 6: Annual year-on-year growth rate of GDP at constant prices

by 0.7 per cent and 1.4 per cent respectively in 2013-14. The underlying cause of the poor performance of these two sectors has been considerable deceleration in investment, particularly by the private corporate sector during 2011-12 and 2012-13. Issues of concern in infrastructure include delays in regulatory approvals, problems in land acquisition & rehabilitation, environmental clearances and time overruns in the implementation of projects.

Services grew at 6.8 per cent in 2013-14. The growth rate of the combined category of trade, hotels, and restaurants and transport, storage, and communications decelerated to 3.0 per cent while financing, insurance, real estate, and business services grew robustly at 12.9 per cent.

Inflation

Consumer Price Inflation (CPI) declined from 10.21 per cent during the Financial Year (FY) 2012-13 to 9.49 per cent in 2013-14. However, food inflation remained stubbornly high during FY 2013-14. The commodity sub-groups that contributed highly to food inflation were fruits and vegetables, as well as eggs, meat and fish.

Balance of Payments

India's balance-of-payments position improved in 2013-14, with Current Account Deficit (CAD) at US\$ 32.4 billion (1.7 per cent of GDP), compared to US\$ 88.2 billion (4.7 per cent of GDP) in 2012-13. India's exports at US\$ 312.6 billion grew by a positive 4.1 per cent compared to the previous year's growth of negative 1.8 per cent. Import growth decelerated from 0.3 per cent in 2012-13 to a negative (-) 8.3 per cent in 2013-14, due to fall in non-oil imports by 12.8 per cent primarily, as a result of restrictions on gold imports. Petroleum, Oil and Lubricants (POL) imports grew marginally by 0.7 per cent. Challenges to the external environment remain as the global environment remains uncertain.

Public Finance

In 2013-14, public finances faced serious challenges. These included a shortfall in tax revenues and disinvestment receipts, and higher than budgeted subsidies, interest and pension payments. Fiscal consolidation was

Sector	2013-14
Agriculture and allied activities	4.7%
Industry	0.4%
Services	6.8%

Table 2: GDP growth by sector



Source: RBI

Figure 7: Foreign exchange reserves

mainly achieved through a reduction in grants for the creation of capital assets and capital expenditure. The sharp increase in subsidies (from 1.42 per cent of GDP in 2007-08 to 2.56 per cent of GDP in 2012-13) has been an important factor in increasing the Centre's fiscal deficit, after 2008-09. For 2013-14 (revised estimate), the subsidy bill is 2.26 per cent of GDP.

Financial Sector

Two major concerns in the financial sector are the deteriorating asset quality of the banking sector, and the leverage placed by infrastructure firms. Gross **Non-performing Assets (NPA)** of banks increased from 2.36 per cent of total credit advanced in March 2011, to 4.40 per cent of total credit advanced in December 2013. Infrastructure, iron and steel, textiles, aviation and mining emerged as the stressed sectors. Reforming the financial sector would involve reducing financial repression (through which the state usurps a large share of households financial savings), financial sector regulatory reform, and changing the laws and regulations governing the flow of foreign capital into India. The milestones in financial sector reform for 2013-14 included 1) the passage of the **Pension Fund Regulatory and Development Authority (PFRDA) Act**; 2) the shift of commodity futures trading into the Ministry of Finance; and 3) the first steps towards adopting improved consumer protection and better regulatory practices proposed by the **FSLRC**.