Deloitte.

India Economic Outlook

March 2018

State of the Economy: India Outlook

Introduction

The year 2017 was marked by a number of key structural initiatives to build strength across macro-economic parameters for sustainable growth in the future. The growth in the first half of the year suffered despite global tailwinds. However, the weakness seen at the beginning of 2017, seems to have bottomed out as 2018 set in. Currently, the economy seems to be on the path to recovery, with indicators of industrial production, stock market index, auto sales and exports having shown some uptick (shown below). We believe that India's economic outlook remains promising for FY17-18 and is expected to strengthen further in FY18-19. However, the signs of green shoots should not be taken for granted as downside risks remain.

Production prints on an upswing (3mma, y-o-y, %)

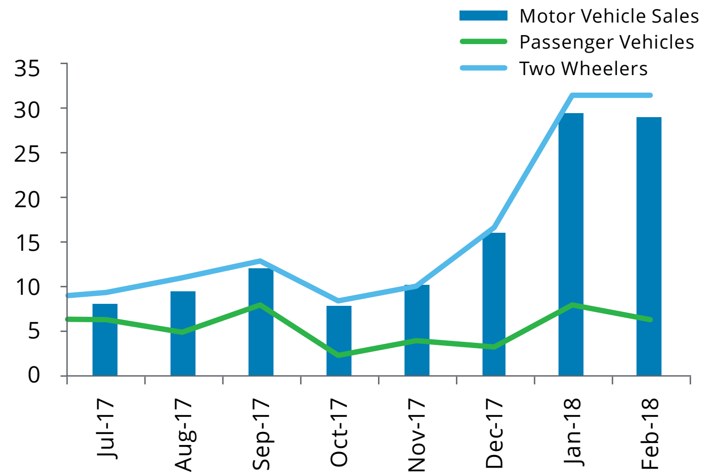
Industrial Production
Manufacturing
Capital Goods Production (RHS)

Source: CEIC, Deloitte

Movement of Nifty (2015 - 2018)

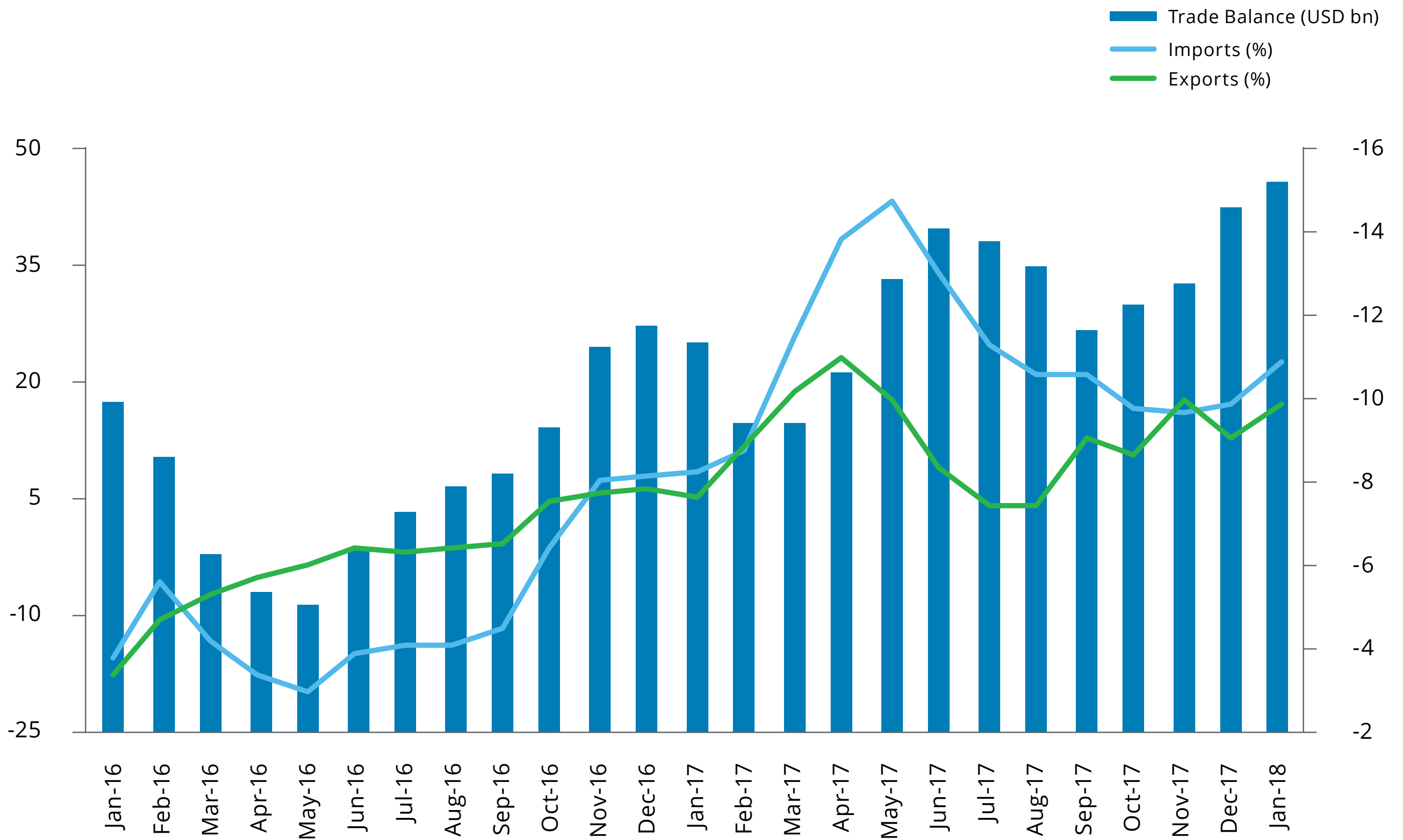
Source: CEIC, Deloitte

Rural sector shows some uptick (3mma, y-o-y, %)



Source: CEIC, Deloitte

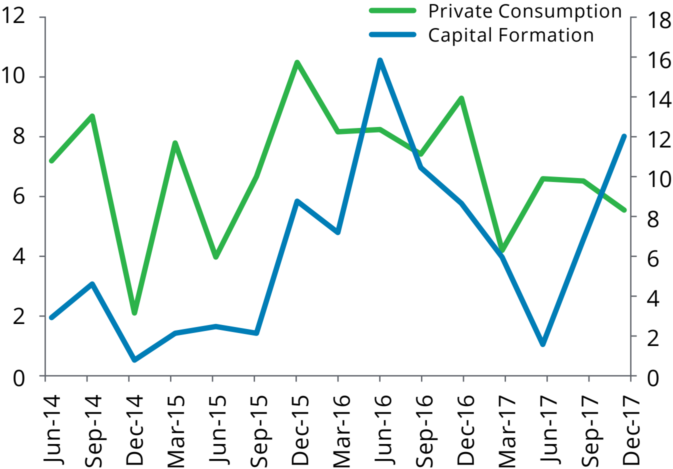
Trade activity seeing some rise (3mma, y-o-y, %)



Source: CEIC, Deloitte

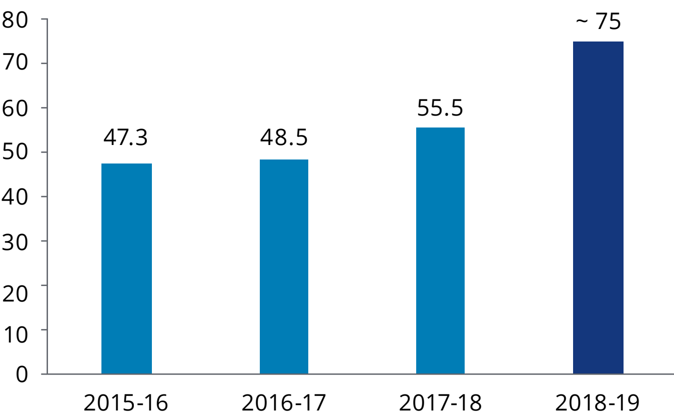
The biggest challenges for 2018 are as to how the economy can maintain its recovery in the face of increasing inflationary pressures, coupled with a higher fiscal deficit as well as an increasing debt burden. The key to this conundrum lies in the revival of consumer demand and private investment.

Private Consumption and Capital Formation (y-o-y, %)



Source: CEIC, Deloitte

Crude Prices (USD/Barrel, Average)



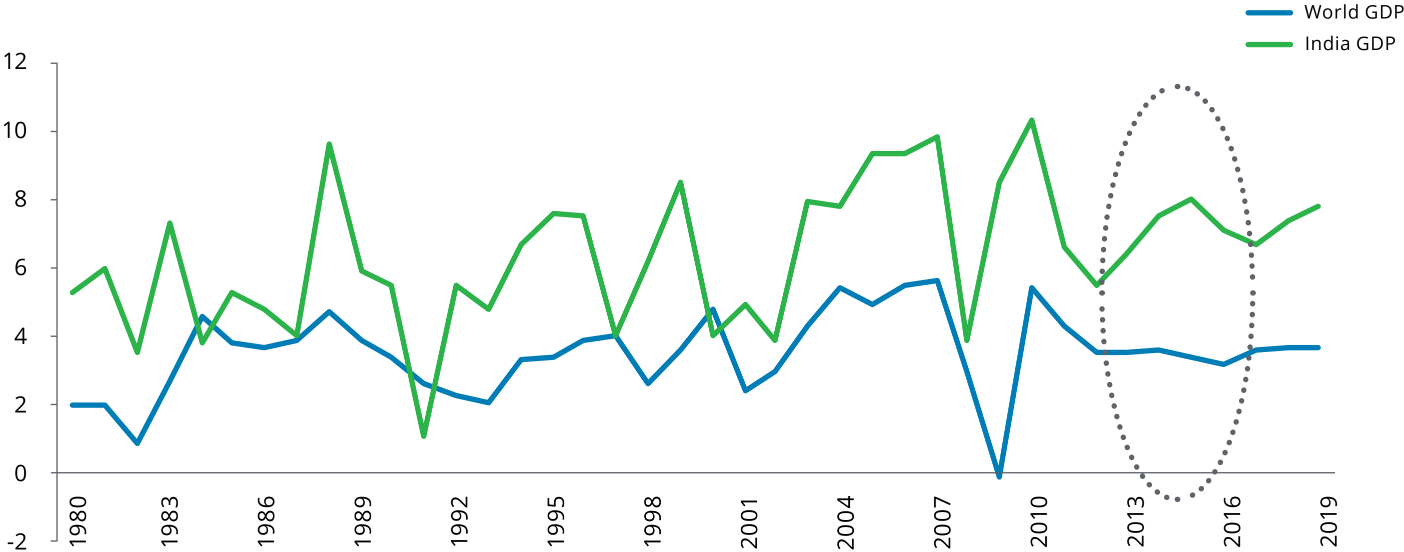
Source: CEIC, Deloitte

The objective of this paper is to present an analysis of the current Indian economic scenario along with the expectations from the period ahead.

Decoupled, but still one of the fastest growing economies:

Over the last few quarters, what has become increasingly evident is the divergence between Indian and global growth. This decoupling largely happened as India's growth was hit on account of mega policy announcements.

India - World Decoupling (GDP, %)



Source: IMF, Deloitte

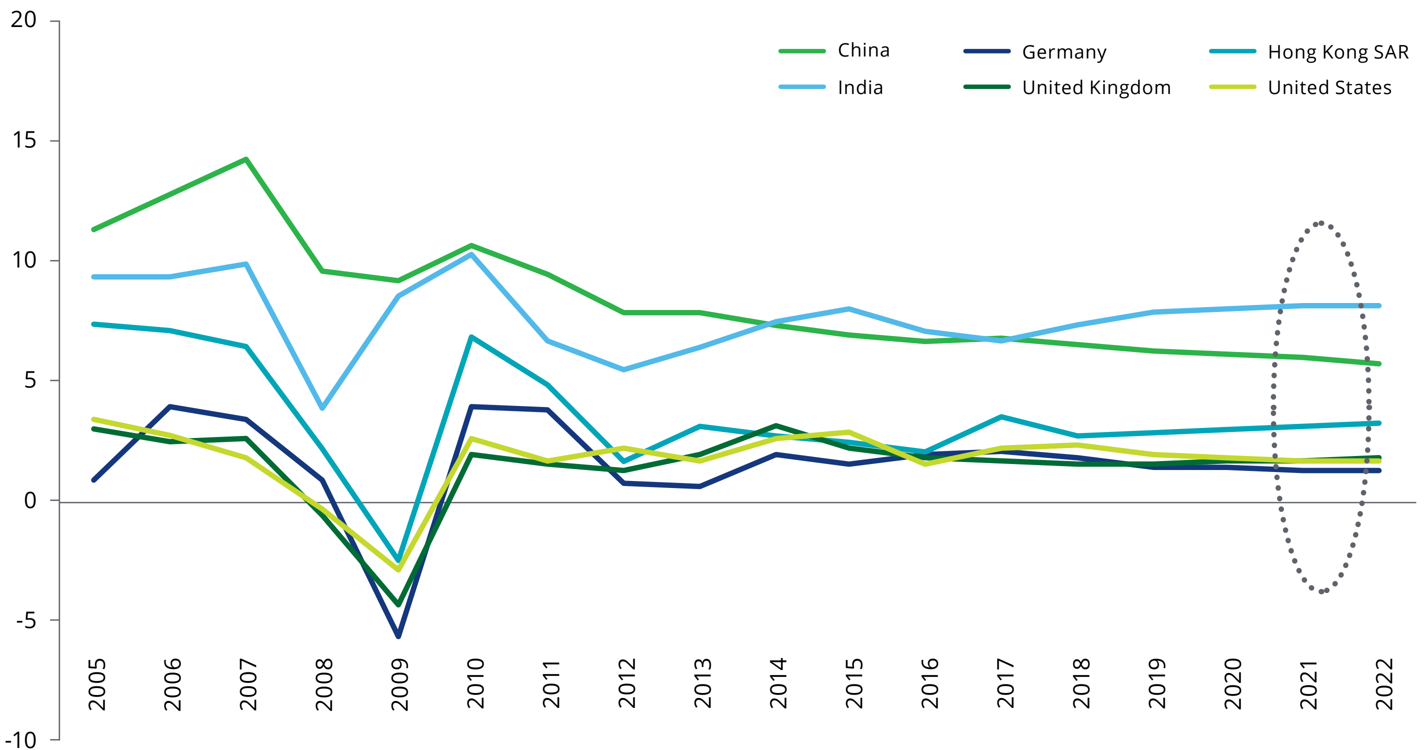
One of the other reasons for this can possibly be attributed to shifting real interest rate trends. During 2016, India's real interest rates followed a downward global trend. However after this the rates started shifting upwards which affected investment activity, led to currency appreciation and resulted in subdued export activity.

In contrast to the economic situation in India, global economic conditions have gained momentum and have possibly created a ripple effect across regions. International Monetary Fund (IMF) has estimated global growth to have grown faster at 3.7% in 2017 against what was earlier projected, with revival largely apparent across Europe and Asia[1]. With broad based recovery on the cards, global growth forecast has been moved up by 0.2 percentage points to 3.9% for 2018 and 2019[2].

Growth outlook for the US has been estimated to be positive due to improvement in domestic demand as well as the anticipated boost to the economy by way of U.S. tax policy changes. Across other developed economies, the Euro area saw further expansion on the back of falling unemployment rates, investment optimism, and lower interest rates which have stimulated consumption further, while the effects of strong external demand were visible in Japan where manufacturing activity moved to the upside.

Looking ahead, for 2018, it is widely expected that this decoupling will not continue. As per IMF and World Bank, world economy is expected to grow at 3.7% and 3.1%[3] in 2018 while the Indian economy is expected to grow at 7.4% and 7.3%, respectively[4] for 2018. We expect India to grow by 6.7% in FY2017-18 and further by 7.2% in FY2018-19 on account of uptick in investment activity and broader market adjustments to previous market disruptions. Currently, India is the world's seventh-largest economy at USD 2.2 trillion, sitting between France and Italy. A report by World Economic Forum has projected that by 2050, the Indian economy is expected to be the world's second-largest, behind only China.

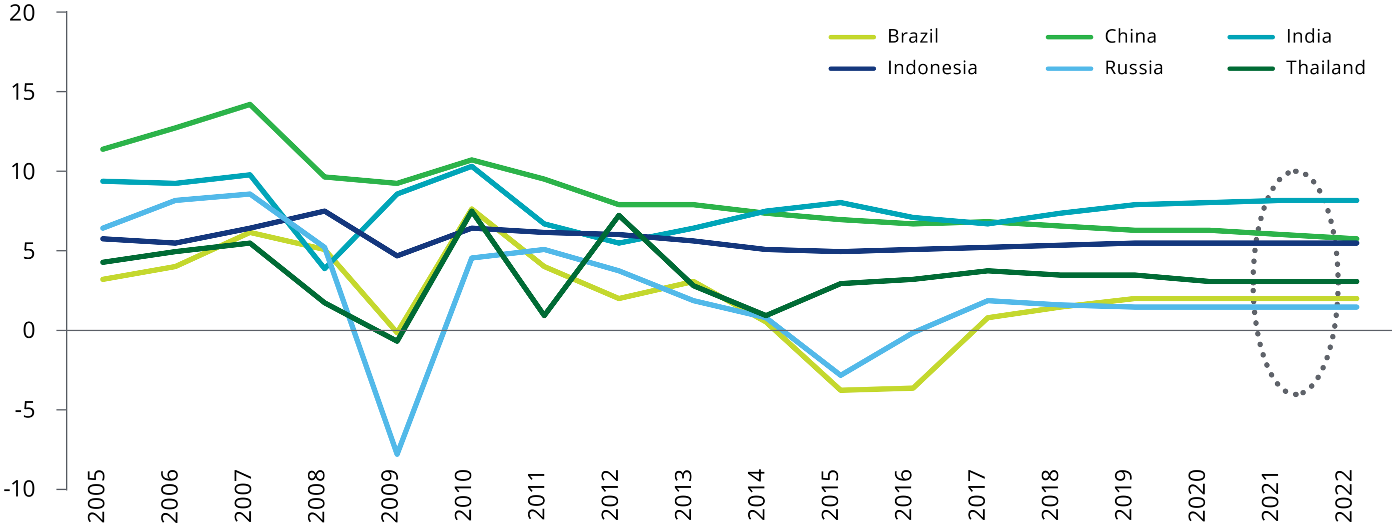
GDP Trends (Top FDI Destinations, CY, y-o-y)



Source: World Bank

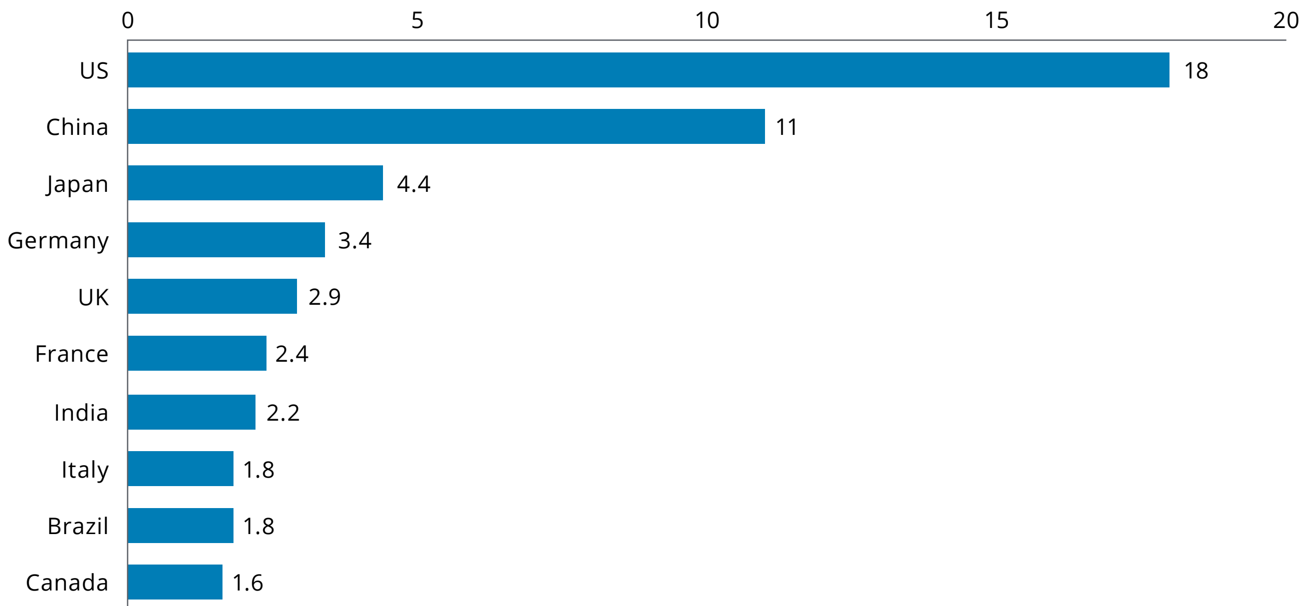
1. https://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018
2. https://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018
3. http://www.livemint.com/Politics/EykbGSLQXmXFGiPN3SzOsK/IMF-cuts-Indias-2017-growth-forecast-but-sees-medium-term.html
4. http://www.worldbank.org/en/publication/global-economic-prospects

GDP Trends (Key EMs, CY, y-o-y)



Source: World Bank

Top 10 largest economies (GDP, USD trillion, 2015)

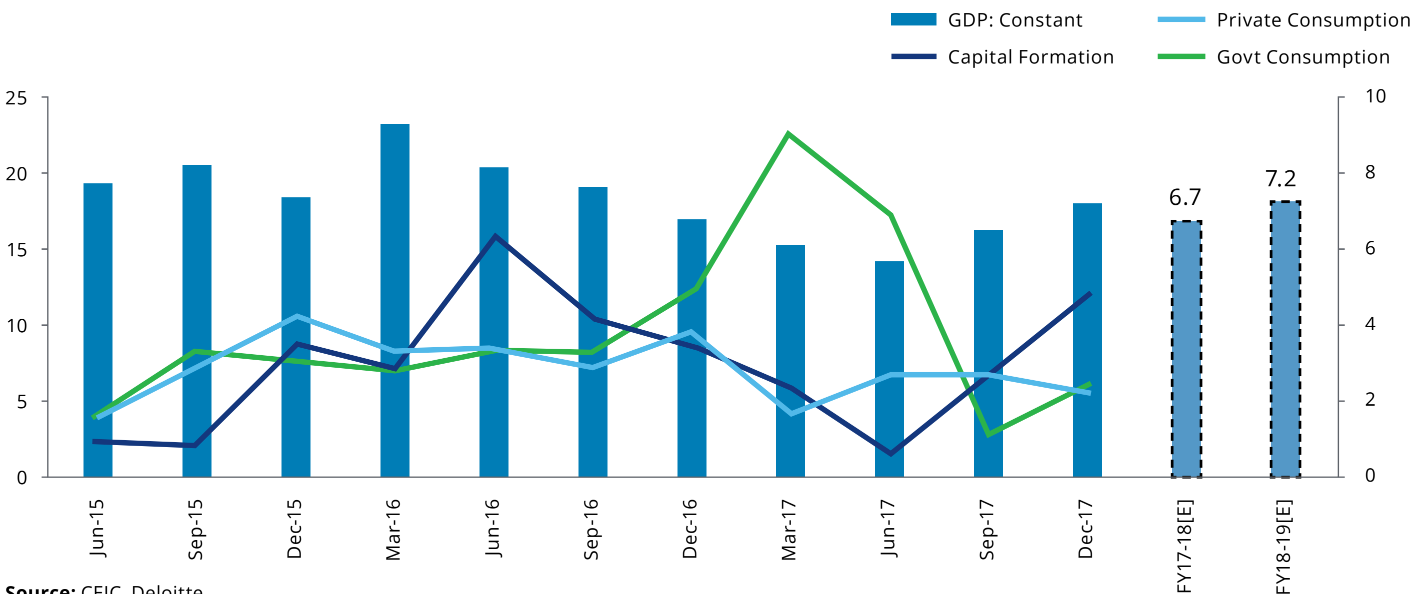


Source: World Economic Forum, Deloitte

Recent GDP Trends

The recent data on GDP growth in Q3 of FY 2017-18 has again revived expectations that the deceleration in the economic activity because of GST and demonetization may have bottomed out. Some of this good news is also mirrored in the data on corporate earnings as well. **Even with the slowdown in 2017, recent data suggests that the GDP has grown by an average of 6.4%[5] in the first three quarters of FY17-18.**

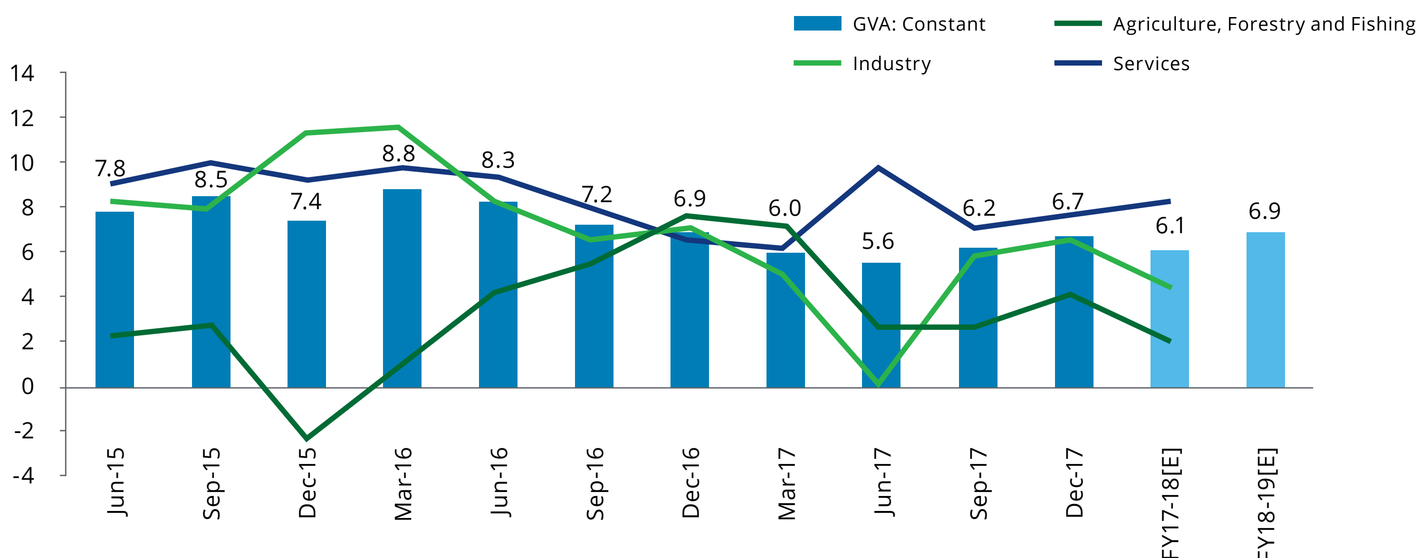
GDP Growth Rates (y-o-y, %)



Source: CEIC, Deloitte

5. CEIC Data and Deloitte Analysis

GVA Quarterly growth rates (y-o-y, %)



Source: CEIC, Deloitte

As can be seen from the above, the services sector continued to show a stable rate of growth. The agriculture sector suffered from a price crash following over-production during the kharif season, while erratic monsoon during the latter part of the year led to some crop destruction resulted in falling farm incomes. Looking ahead, the agriculture segment is expected to grow higher than the estimated 2.1% in the current fiscal possibly following positive prospects on rabi harvest.

Moreover, some improvements on the industry sector emanatd from a steady rise in utilities and a revival in manufacturing activity. Industry growth recorded a further upswing from 5.9% in 2QFY18 to 6.8% in 3QFY18. On a positive side, manufacturing growth showed a reversal rising by 8.1% in 3QFY18 as compared to -1.8% in 1QFY18, while utilities remained steady at 6.1% growth in 3QFY18.

IIP and PMI

The recent data on overall industrial production (IIP) showed signs of recovery reflecting a possible strengthening of domestic demand and a further build-up in global trade activity. Manufacturing sector rose 9.3% on a 3mma (3 month moving average) basis in Jan'18 compared to 7% rise as of Dec'17. The turnaround in production levels is possibly a reflection of turning consumption demand as also suggested by an upswing in vehicle sales, cement and diesel

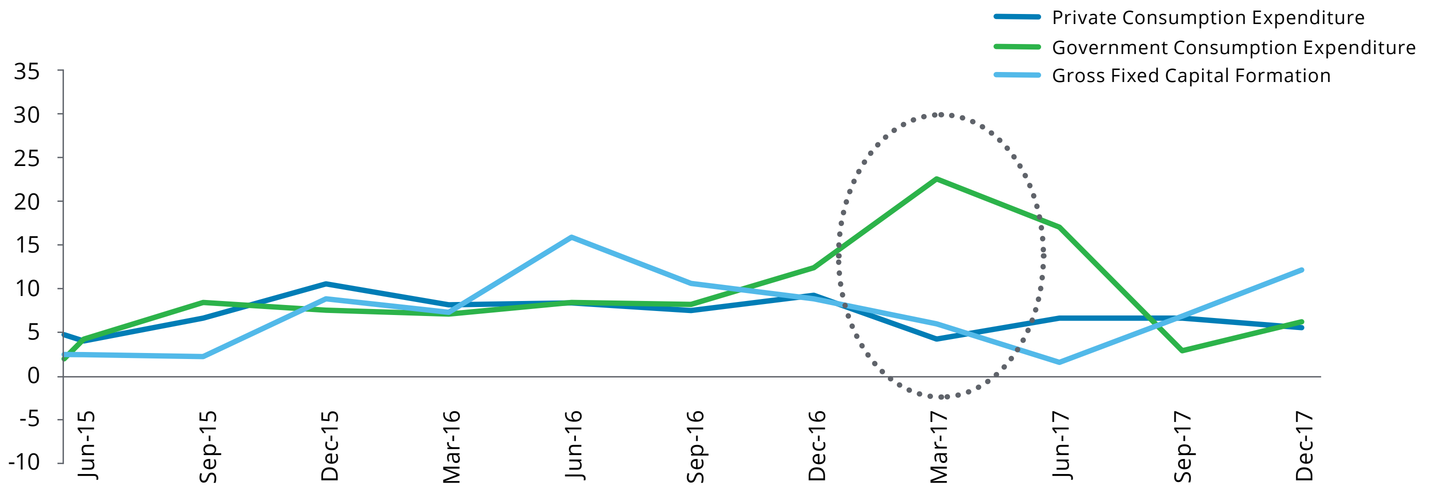
production. Significant gains in capital goods production is an encouraging sign while positive prints on consumer durables is likely to boost economic growth.

The overall purchasing manager's index (PMI) number's also showed an expansion in business conditions driven largely by manufacturing PMI even as services PMI showed relative weakness. The upturn in manufacturing PMI likely came on the back of increasing output and new orders while the services side contracted for the first time since November on account of rising price pressures. Given the overall optimism in consumption behaviour and trade activity, PMI numbers are expected to gain strength in the period ahead.

Demand side analysis

A detailed look at the expenditure side suggests that the demand behaviour has seen some improvement. However there remains some discrepancy in private consumption and consumer durables data. While private consumption grew at an average of 6.3% in the first three quarters of 2017-18[6], consumer durables have contracted through most part of the year. Importantly, it has largely been the increases in private consumption and government spending that has stimulated growth. However, the recently released Q3 data which showed an unexpected jump in investment has revived hopes that private investment sentiment may also turn positive.

GDP Quarterly growth rates (y-o-y, %)



Source: CEIC, Deloitte

6. CEIC Data and Deloitte Analysis

Recent Policy Measures to Boost Growth

a. Goods and Services Tax

- Launched in July 2017 with the aim to consolidate all other indirect tax laws (save a few) and to also bring a harmonized tax structure and uniform compliance practices both by regulators and businesses.
- Food items have been placed in zero or the minimum slab while luxury items get taxed more. The government ruled out having a single rate for all commodities under the Goods and Services Tax (GST)
- Many items which were earlier in the 28% bracket were brought into the 18% bracket and this process of rationalization would continue.
- The committee shall recommend changes to be made in the process of filing of returns in GST, including the threshold, if any, for quarterly filing.

b. Insolvency and Bankruptcy Code

- Launched in December 2016, it is a one-stop solution for resolving insolvencies which at present is a long process and does not offer an economically viable arrangement.
- The code will be able to protect the interests of small investors and make the process of doing business simpler.
- Statistics show that the recovery is only 20% in India and in global ranking, the country is ranked in the 136th position with respect to the time taken for resolving disputes.
- As per RBI, the total outstanding amount for top 50 stressed borrowers, funded by scheduled commercial banks, stood at INR 3.7 trillion as on 30 Sep'17.

c. Jan Dhan Yojana and Aadhaar

- As on Dec 6, 2017, a total of 307 million accounts have been opened under PMJDY, including 180 million accounts opened in rural/semi-urban areas.
- During the period between 8.11.2016 to 30.12.2016. INR 421.8 billion had been deposited in 3,74,14,844 PMJDY accounts.
- A World Bank paper has noted a 10% gender gap in opening accounts under the country's flagship financial inclusion programme — Jan Dhan Yojana — with 73% men applying for accounts against 63% women.

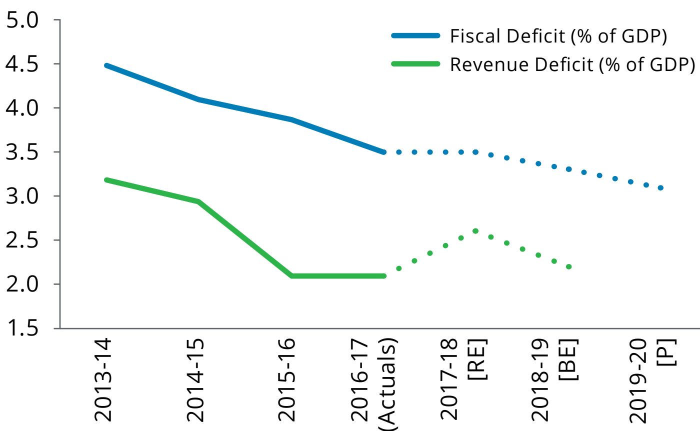
d. Ayushman Bharat

- The government announced two major initiatives in health sector during the Union Budget 2018-19. The program is aimed at addressing health holistically, in primary, secondary and tertiary care systems, covering both prevention and health promotion.
- **Health and Wellness Centre:** The National Health Policy envisions Health and Wellness Centres as the foundation of India's health system. Under this initiative, about 1.5 lakh centres will be created to bring health care system closer to the poor. For this purpose, the Budget has allocated INR 12 billion and the centers will provide health care, including for non-communicable diseases and maternal and child health services.
- **National Health Protection Scheme:** This scheme is aimed at providing health cover up to INR 0.5 million per family per year for secondary and tertiary care hospitalization and will cover over 100 million poor and vulnerable families (approximately 500 million beneficiaries).

Fiscal Consolidation: The story behind the math[7]

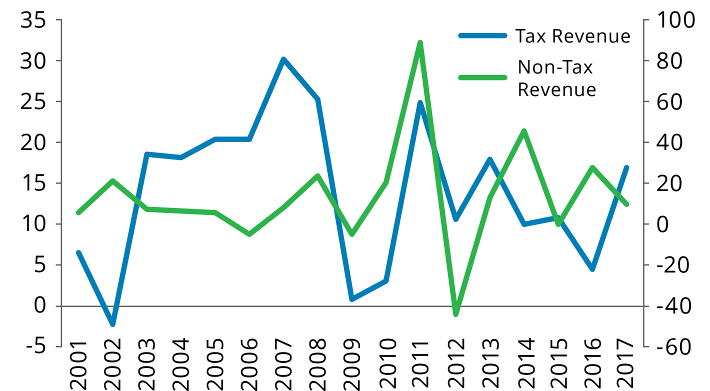
India's fiscal deficit has steadily declined over the years. However, the path to reach the target of 3% has been extended. If we analyse the revenue trends, then, it can be seen that the gross tax to GDP ratio is likely to have risen by 0.2% to 11.6% in FY17-18 and tax revenues are expected to grow by 16.6% in FY19 as compared to 15.3% in FY18.

Fiscal Deficit and Revenue Deficit (% of GDP)



Source: CEIC, Deloitte

Tax and Non - Tax Revenue (y-o-y, %)



Source: CEIC, Deloitte

Between Apr-Dec 2017, close to 80% of the total receipts of the government were generated from tax revenues. The total tax income of INR 9 trillion in the first 9 months of FY17-18 represented a growth of close to 25%[8]. Here, direct tax revenue grew by 19.4% in the first 9 months compared to a rise of 13.8% in FY16-17, while indirect tax revenues grew only by 18.6%, against a sharper 24.8% rise in FY16-17. The upswing in direct tax revenue, if sustained, could signal a rising tax base of the economy.

However, about 13% of the total receipts of the government were generated from non-tax revenues in the first 9 months of the current fiscal: Non-tax revenues recorded a decline of 12% between Apr-Dec 2017-18 over the last year as compared to a growth of 9% in FY16-17 with total collections of only INR 1.1 trillion. The government has budgeted for INR 4.4 trillion in FY18 factoring in an average monthly inflow of INR 400 billion.

Despite the healthy rise in tax revenues, the sharp deceleration in non-tax revenue pulled the overall strength down. The non-tax revenues essentially constitute spectrum auction proceeds, dividends and profits of state-owned enterprises and the Reserve Bank of India. Part of the shortfall in revenues was met via disinvestments and looking at the success of disinvestment proceeds of the previous fiscal, the government hopes to breach the target set for FY17-18 by collecting INR 1 trillion and further expects to raise INR 800 billion in FY18-19[9], including gains from privatization of Air India Ltd. For FY19, the government expects GST inflows to improve substantially and have factored in INR 620 billion on a monthly basis.

Fiscal Math for FY 2018-19

For the coming fiscal year, the government is assuming a further enhancement in gross tax to GDP ratio to ~12.1% for FY18-19, essentially on the back on a meaningful rise in indirect tax collections. That said, the Budget math also accounts for a higher direct tax buoyancy as the government expects improved tax compliance in the coming year.

On the expenditure side, the government has budgeted a 10% growth for FY19 as compared to a growth of 12.3%[10] in FY18. Prima facie, this number looks credible though the fine print does suggest that there could be some overruns. Given that we are in a pre-election year, slippages in rural and urban development expenditure would not be a complete surprise while limiting oil subsidies at 2% growth might also be challenging.

Based on these estimates, the government has estimated that the fiscal deficit in FY 2017-18 will be 3.5% of GDP. Furthermore, the glide path for fiscal deficits has also been changed as now the government intends to hit 3.3%[11] of GDP next year and reach the target of 3% by FY21.

7. http://www.indiabudget.gov.in/ub2018-19/frbm/frbm2.pdf
8. CEIC Data and Deloitte Analysis
9. http://www.business-standard.com/article/economy-policy/niti-aayog-preparing-new-list-of-sick-psus-for-disinvestment-amitabh-kant-118022200081_1.html
10. http://www.indiabudget.gov.in/ub2018-19/rec/annex1.pdf
11. http://www.indiabudget.gov.in/ub2018-19/frbm/frbm2.pdf

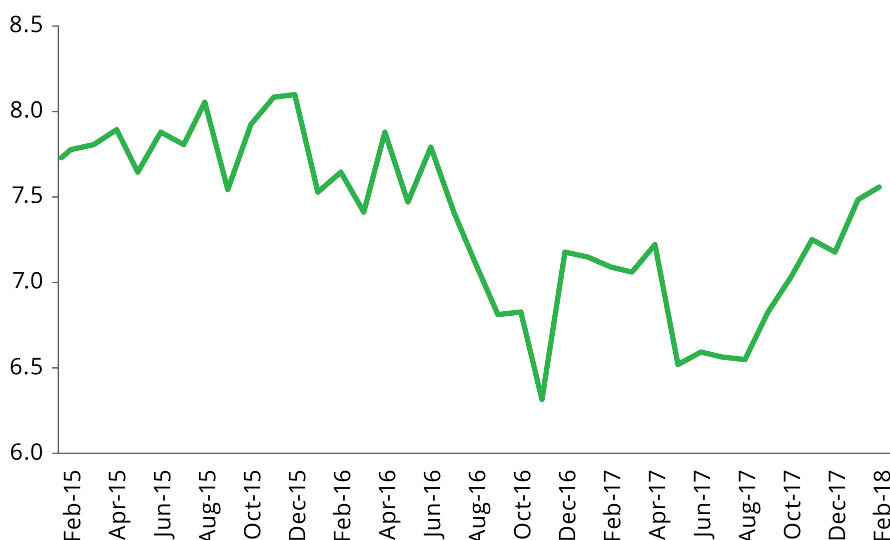
Bond Market Risks

Fiscal slippage will most likely bring in financial market volatility, especially in terms of cost of borrowings which have already hardened over the last few months.

Post the Budget, the benchmark 10-year yield hit a 22-month high to close at 7.6% and is currently trending at 7.68% as of the last close on 15 March, 2018[12], having gained close to 6% since the Budget. Since the RBI announcement to inject INR 1 trillion into the system saw bond yield dipping nearly 15 basis points on 12 March after hitting a high of 7.78%. However, we believe that the domestic bond market have risks to the upside and may get affected due to expectations of rising oil, re-capitalisation, and likely shortfall in GST collections.

The rise in bond yields are also signalling that interest rates have already hit their trough and are likely to be on an upward trajectory in the upcoming fiscal year. This rise is in consonance with global rates as most important global central banks have signalled an end to the ultra-loose monetary policy. The US Fed is on course to increase its benchmark rates further while the European Central Bank has also hinted at a winding up of its stimulus program faster than expected. These global factors combined with possibility of higher inflation and growth is likely to result in the 10-year yield moving further north over the course of the year.

Government Securities Yield (10-year)



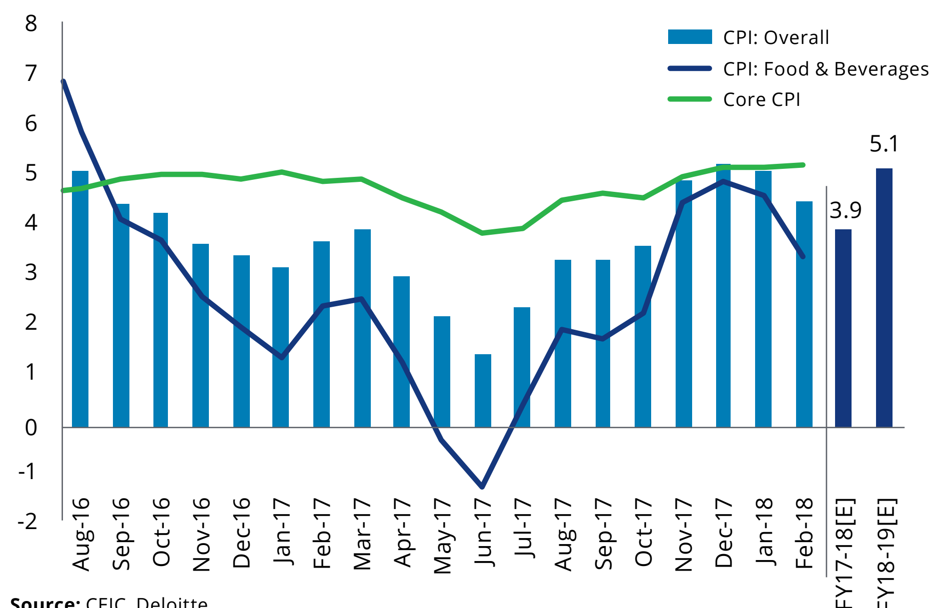
Source: CEIC, Deloitte

Inflation: largely under control though risks have emerged

One of the major positives over the past few years has been the declining inflation levels. Consumer price inflation has in fact, fallen to multi year lows during the last fiscal. This has been possible on account of falling or stable global commodity prices and better management of supply shortages in the agrarian economy. That said, inflation pressures did reverse during the latter part of 2017 as crude oil prices have started moving up and favourable base effects have waned. During this period, some increase in food prices along with one-time modifications on account of pay revisions in the public sector and housing rent allowance being revised upwards have also led to rising inflation.

However, it seems that inflation pressures are weakening. The latest reading for Feb'2018 saw larger than expected easing that came on the back of a slowdown in the more volatile food price inflation. Also, only marginal uptick in core inflation was recorded possibly on the back of lower base effect and a likely pass-through of input costs. The main challenges this year are likely to come due to rising crude oil prices on account of global oil output cuts. Further

Components of Consumer Price Index (y-o-y, %)



Source: CEIC, Deloitte

12. CEIC, Bloomberg and Deloitte

to this, the Budget has announced 50% higher MSP than cost even though there exists some ambiguity on how costs will be calculated. A higher MSP generally tends to provide a floor for prices thereby pushing inflation on food prices. It will be important to analyse what the impact has been of a hike in MSP over the last year. As such, we are likely to witness a year of higher inflation and macroeconomic management due to these challenges.

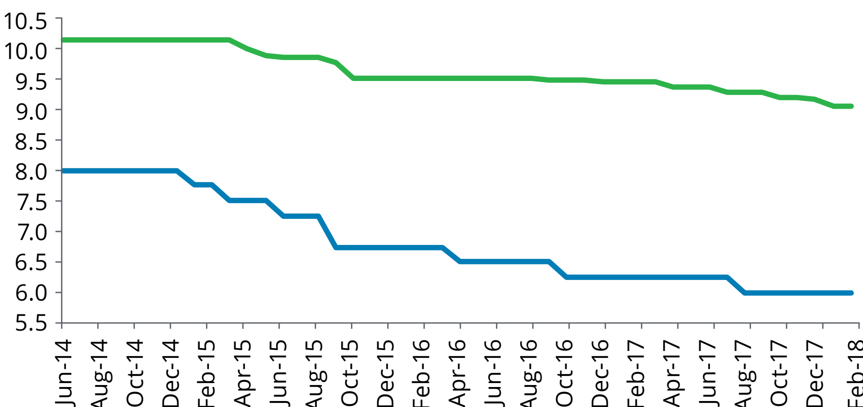
CPI inflation for FY18-19 is likely to come in at an average of around 3.9%[13] for the full fiscal year, slightly below the RBI's long-term target of 4%. We expect inflation to remain high in the range of 5-6% during the first six months of the current calendar year after which we are likely to see a decline as relatively higher base is expected to cushion against higher inflationary readings.

Monetary Policy and Outlook

The RBI had steadily cut the repo rate from 7.25% in Aug'15 to 6% in Aug'17. Since then the RBI has held the policy rate steady with more emphasis on reviving domestic growth. In the current economic scenario, with world economy having built further momentum and with the anticipation of a further escalation in global commodity prices, the space for monetary manoeuvring has become limited. Since its Aug'17 policy meet, the RBI has maintained its stance citing concerns on inflation front as well as spill-over risks from global policy changes. Importantly, household expectations on inflation has seen a rise and separately concerns on fiscal slippage have increased, especially on account of implementation of farm loan waivers, partial roll back of excise duty for petroleum products, and a fall in revenue collections, all of which are likely to have implications for inflation.

In its last bi-monthly monetary policy for the fiscal year 2018 in Feb'18, the Monetary Policy Committee (MPC) in Feb 2018 said inflation has been stipulated to remain around 5.1-5.6% in the 1HFY19 and then ease to 4.5-4.6% in the 2HFY19[14], and with the yearly estimate set at 4.5% it can be expected that any monetary action by the RBI will be data dependent. In our view there remains some upside risks to inflation which may become visible in the second half of FY18-19 on account of oil price hike, and possible rise in input costs. The important question for FY 2018-19 is whether and when the RBI will announce an increase in the repo rate.

Repo Rate and Base Rate (%)



Source: CEIC, Deloitte

Twin Balance Sheet Problem and NPAs

The credit growth has remained subdued due to the twin balance sheet problem that India has been facing. The issue here is that balance sheets of Indian companies and banks both have been under stress. While Indian companies remain over-leveraged,

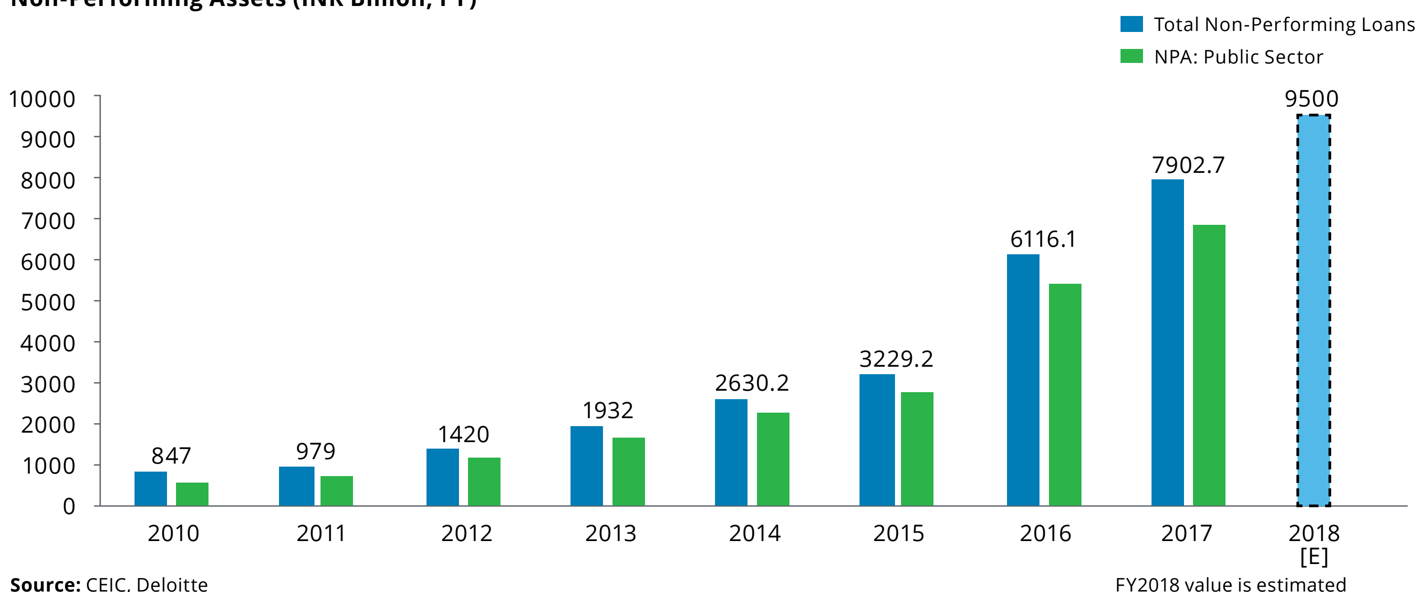
13. CEIC Data and Deloitte Analysis

14. https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=43078

the banks are reeling under high non-performing assets. The banking sector is expected to see a further rise in its stressed assets base for FY17-18 to about INR 9.5 trillion from about INR 8 trillion in FY16-17[15]. As per the stress tests (Financial Stability Report, RBI 2017)[16], in the baseline scenario, Gross NPAs (non- performing assets) of the banking sector may rise from 10.2% of gross advances in September 2017 to 10.8% in March 2018 and further to 11.1% by September 2018[17].

The new Insolvency and Bankruptcy code (IBC) and the bank recapitalisation plan are the two-pronged policy responses that have been formulated to tackle this issue. The twin balance sheet problem has been long-standing and while the new Insolvency and Bankruptcy code (IBC) will possibly help, we believe it requires complementary reform measures to alleviate unviable banks and allow greater private sector participation. Looking ahead, the falling share of private investments necessitates pro-active measures to stimulate investment sentiment and we believe that the expected push toward infrastructure development along with recapitalisation of public sector banks will likely have a positive impact on investment demand.

Non-Performing Assets (INR Billion, FY)

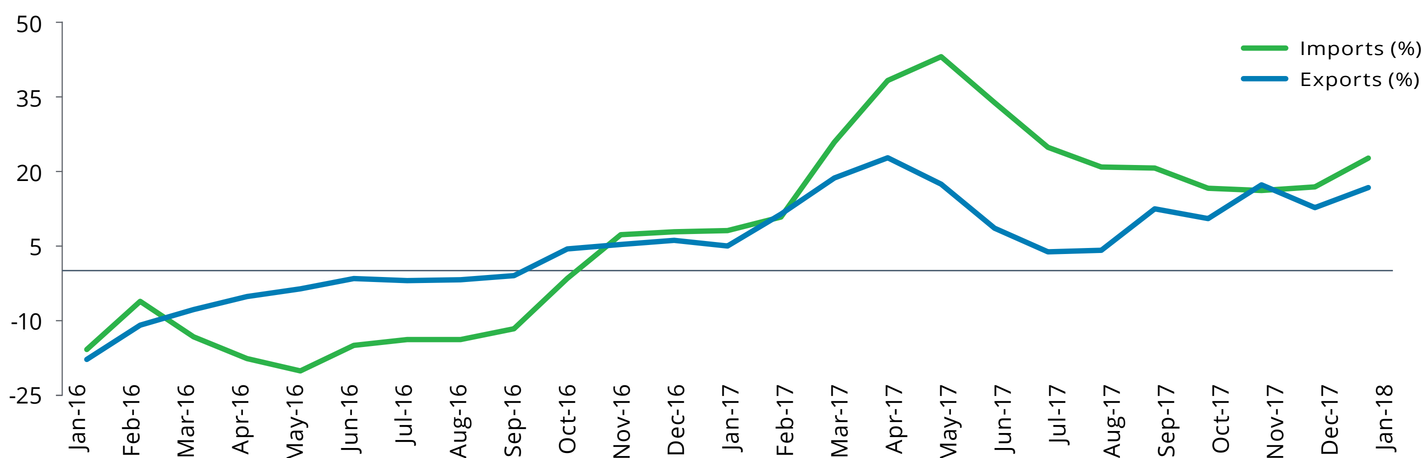


Source: CEIC, Deloitte

FY2018 value is estimated

Trade and Investment

Exports and Imports (3mma y-o-y, %)

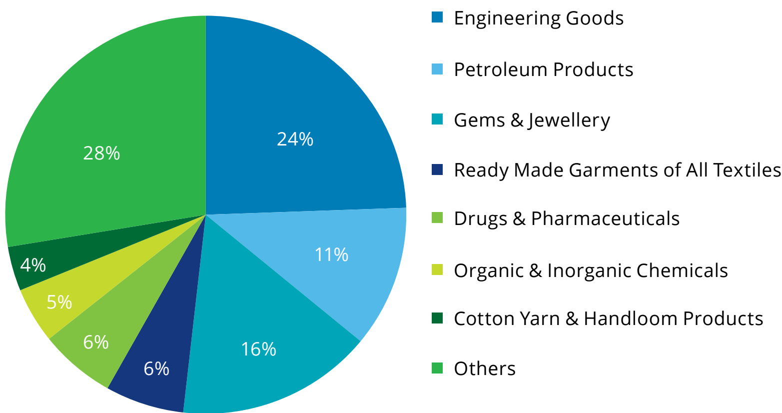


Source: CEIC, Deloitte

15. http://www.assocham.org/newsdetail.php?id=6696
16. https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/0FSR201730210986ADDA44E2A946A3F6C4408581.PDF
17. CEIC Data and Deloitte Analysis

Looking at the real data, the external sector has remained rather muted despite the global economy performing well. Indian exports grew only by 11.2% between Apr-Jan 2017-18[18]. If we look at the details of the exports, highest growth has been seen in sectors such as gems and jewellery, mineral fuels, machinery, pharmaceuticals, organic chemicals, electrical machinery textiles among others.

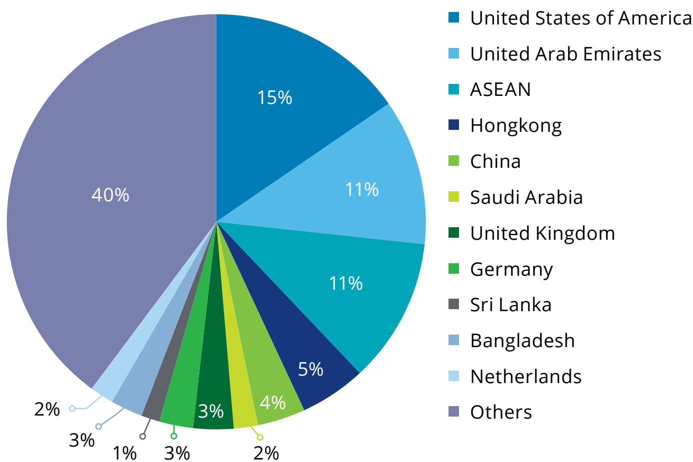
Export by Principal Commodities, FY2016-17



Exports: USD 275 bn
Source: CEIC, Deloitte

Further, economies including US, United Arab Emirates, ASEAN, Hong Kong, and China continued to be our largest export destination, followed by UK, Germany and Sri Lanka.

Export by Country, FY2016-17



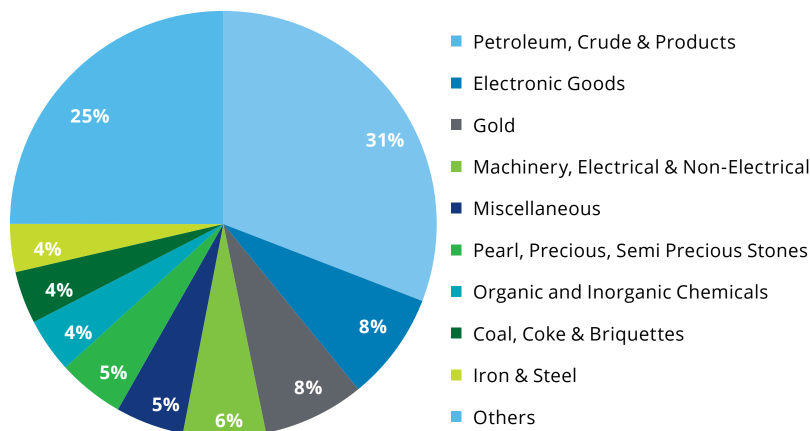
Exports: USD 275 bn
Source: CEIC, Deloitte

18. CEIC Data and Deloitte Analysis
19. CEIC Data and Deloitte Analysis

In contrast, total imports showed considerable strength over the better part of the year, growing at a double digit pace – maintaining an average of 23% from Apr-Dec 2017 as compared to an increase of merely 1.9% in FY16-17[19]. While, the uptick in imports in part suggests resilience of domestic demand as they largely started seeing an upswing around the time of demonetization.

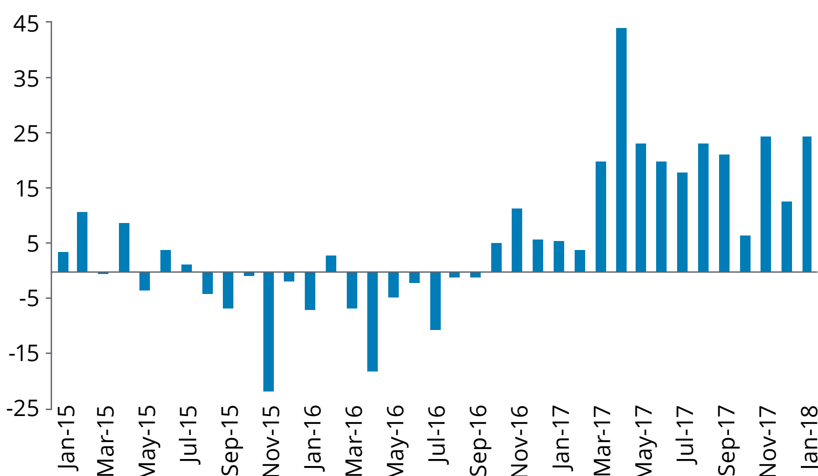
Importantly, non-oil, non-gold (NONG) imports, proxy for domestic demand, have seen a healthy growth over last year. Between Apr-Dec 2017, NONG imports grew an average of 20% as compared to a 1% rise over the previous full fiscal year. Of the major categories, imports witnessed double digit growth across ores and minerals, electronics, machinery, base metals, chemical and products, paper and products, and plastic and rubber.

Import by Principal Commodities, FY16-17



Exports: USD 380 bn
Source: CEIC, Deloitte

Non-oil non gold imports (y-o-y, %)



Source: CEIC, Deloitte

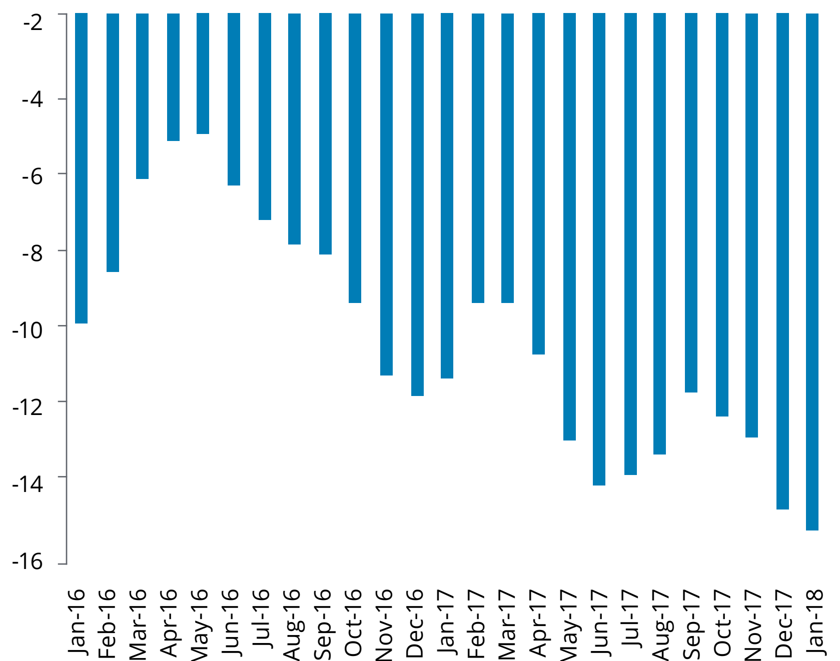
19. CEIC Data and Deloitte Analysis

Growth in oil imports has marked an upswing in the last six months to Dec'17. In contrast, gold imports have remained muted.

Overall trade deficit has risen close to $117 billion between Apr-Dec 2017 as compared to $78 billion in the same period last year[20]. Despite a continuous rise in trade deficit, it is expected to remain under control over the coming period as exports mark a rise on the back of upswing in external demand and diminishing impact of disruptions.

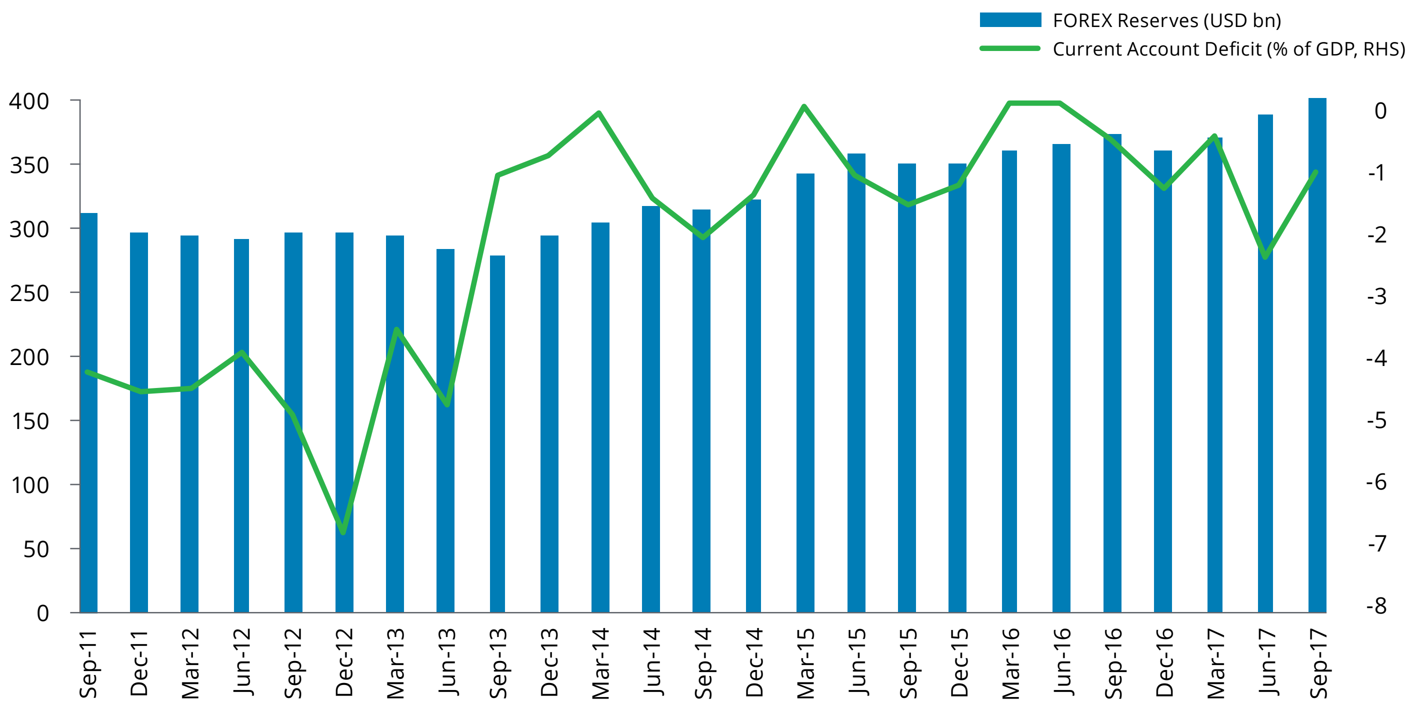
At the same time, the Current Account Deficit (CAD) is largely expected to remain under control and print in around 2% for the current year. India remains cushioned by impressive investment inflows which puts India in more than a comfortable state to finance the deficit. That said, India maintains a surplus in trade of services that has in part helped in containing CAD. Stable long term flows coupled with high market inflows have meant a further rise in forex reserves which have increased to $400 billion in the 1HFY2017-18 as compared to $370 billion FY2016-17[21].

Trade Deficit (USD bn)



Source: CEIC, Deloitte

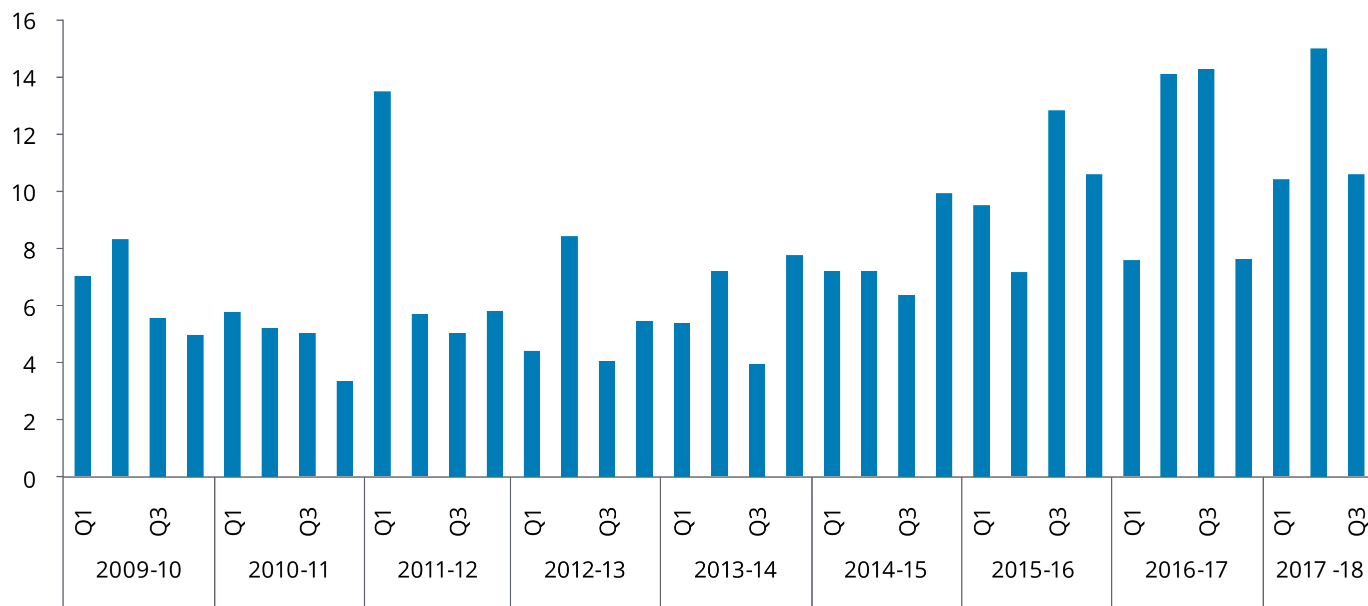
CAD and FOREX (%, Actuals)



Source: CEIC, Deloitte

20. CEIC Data and Deloitte Analysis
21. CEIC Data and Deloitte Analysis

Foreign Direct Investment: Inflow (Quarterly, USD bn)

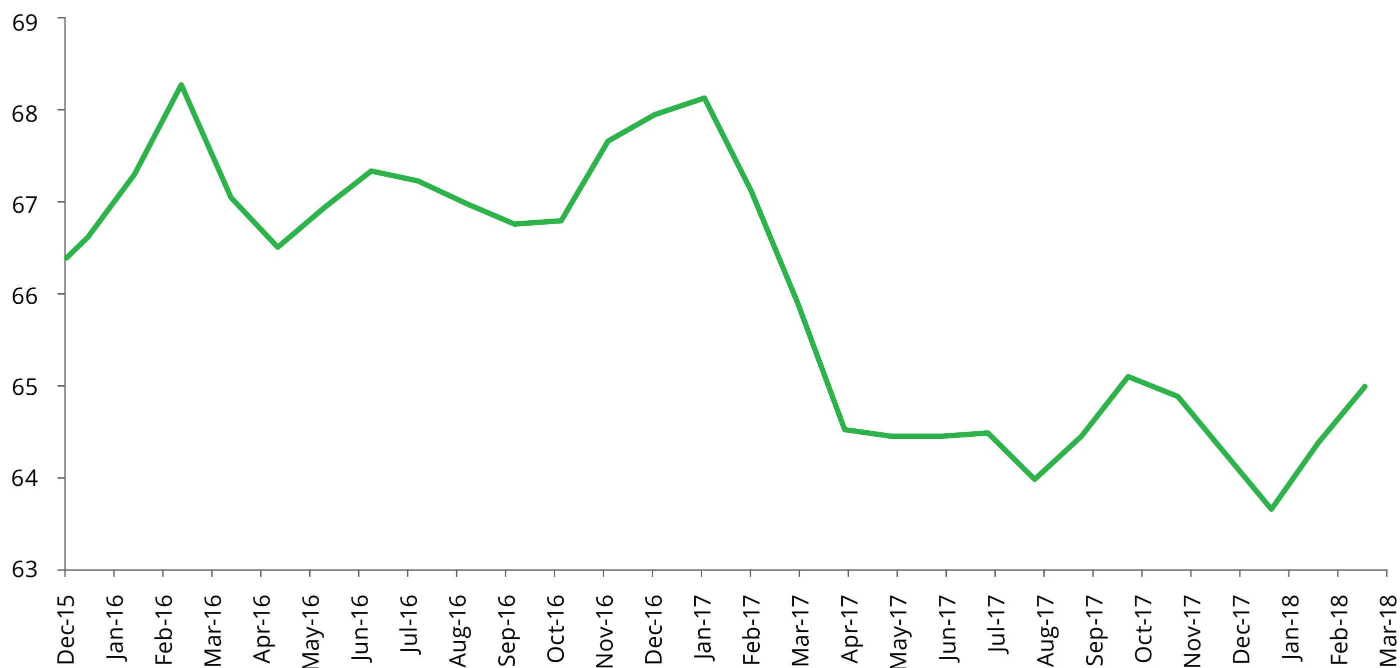


Source: CEIC, Deloitte

What's in store for the rupee?

The Indian rupee (INR) has shown tremendous strength over the better part of 2017, especially looking at the past trend when it had seen a fall for almost six years. At the year-end, the domestic currency broke above the 64 handle coming in at 64.64 to the US dollar as of 19 Feb 2017[22]. The remarkable rise in INR could have been prompted by strong foreign flows, proactive policy initiatives, and relative weakness in US dollar.

Exchange Rate Movement (INR/USD)



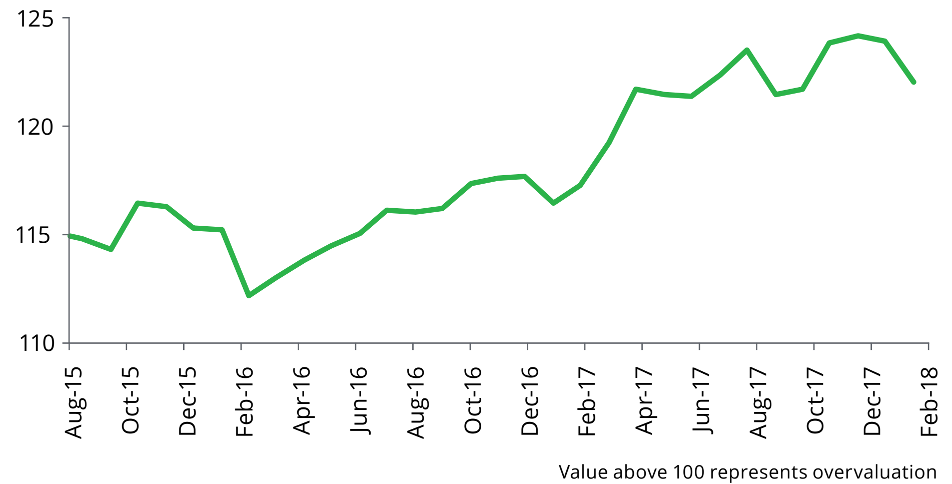
*March value is as of 13 Mar'18

Source: CEIC, Deloitte

22. CEIC Data and Deloitte Analysis

However a rising INR is not always welcome for all sectors. As long as the real value of INR is higher than the real value of currencies of other competing nations, Indian exports will be outpriced in the global markets. In 2017, apart from appreciating against the dollar, the rupee has also appreciated against the currencies of Indonesia, Brazil, and Turkey, while depreciating against nations such as Thailand, and Malaysia. It is important to acknowledge that rising real exchange rate (REER) remains above 100, which suggests that the Indian currency remains overvalued at current levels. We believe that while the rupee will see some stability in the near term, it is likely to depreciate orderly over the year.

Real Effective Exchange Rate (Export based weight)



Source: CEIC, Deloitte

Conclusion

While the last year saw a number of changes to the system, the impact of these have largely waned as new equilibria has started to set in. The Indian economy has once again regained the tag of the "fastest growing economy". How sustainable this momentum will be and by when our economy can cross the 8% Rubicon, will depend on how effectively the various policies, especially with respect to structural and infrastructure related reforms are implemented.

Disclaimer

a. Sources where not mentioned have been taken from CEIC and Deloitte.
b. The data taken into consideration for the analysis ends in February 2018.

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