India: positive cyclical development and political confidence allow monetary easing

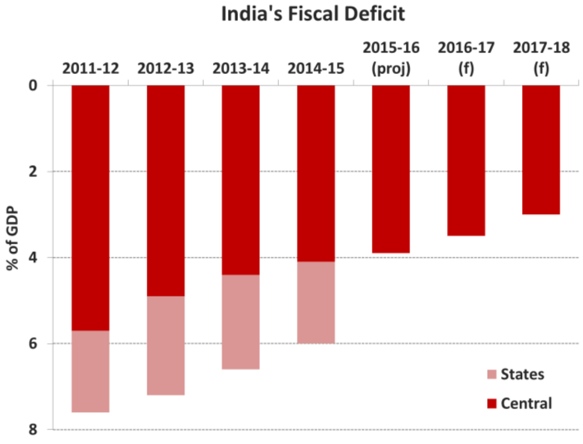
Recent revisions in national accounts showed that India managed to attain high growth figures during the past few quarters, while inflation receded substantially on the back of lower oil prices and stabilization in the currency. This in turn enabled the government to focus on the structural reforms in the Union Budget FY16 with greater emphasis on infrastructure investment. In parallel, lower inflation and declining external deficits encouraged the central bank to cut policy rates without significant impact on the exchange rate. The outlook is favorable and India should be quite resilient to international turbulences over the next few quarters.

Union Budget: Push towards structural reforms

Amid benign global economy, macro-economic performances of India have significantly improved since the Bhartiya Janta Party (BJP) won parliamentary elections with an absolute majority in May 2014. In political terms, this did not prevent the BJP from loosing the local elections in Delhi elections in February 2015 (where the anti-corruption party Aam Aadmi Party won a quasi-unanimous victory), but helped in winning those in Jammu & Kashmir for the first time on the back of its promises to splurge growth in a span of nine months. When the new government presented its interim budget on July 10, 2014, it attempted to avoid superficial politically correct policies with reassurance that it will move towards more business friendly reforms. The BJP also produced a vision of nationalistic and strong willed foreign policy for the nation built upon investment and trade interests.

During the nine months of PM Narendra Modi's government, lower inflation, stable political environment and low oil prices helped to reduce the fiscal deficit, accelerate domestic demand and stabilize the currency.

However, dampening the expectation of big bang reforms, the finance minister Arun Jaitely addressed the Union Budget on February 28, 2015 with focus on public investment. Despite a 10 percentage point higher devolution of tax receipts to States, the fiscal deficit has been eased to -3.9% for 2015-16 (earlier -3.6%), from -4.1% in 2014-15 to allow for larger capital expenditure. The government sticks to the fiscal deficit target of 3%, however, it is delayed to 3 years from the earlier target of 2 years. The emphasis on infrastructure investment is critically welcome as this has been identified as one of the most serious medium-term constraint on Indian development.



Sources: RBI, Union Budget 2015-16, TAC ECONOMICS

On taxation front, a 5 percentage point cut in corporate tax (from 30% to 25% over 4 years), rationalization of custom duties, wealth tax replaced by 2% surcharge for super rich, deferral of GAAR provisions by two years (April 2017) and assurance on introduction of GST from April 2016 were announced in favor of investors. However, service tax has increased from 12% to 14% impinging the consumers' pocket, while savings are encouraged with higher income tax exemptions. The finance minister proposed to replace the different forms of foreign investment, especially FPI and FDI with a composite cap for various sectors to attract foreign investment.

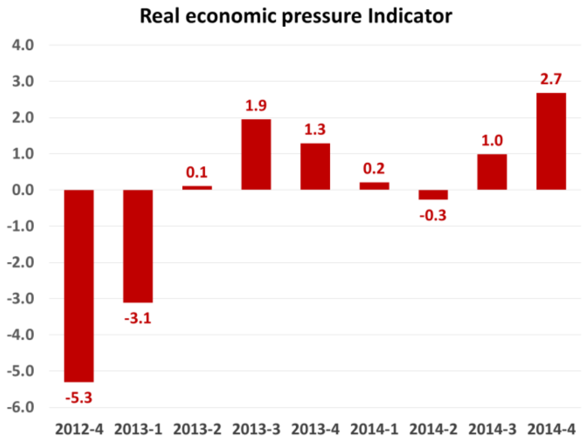
The government may however face difficulties in implementation of certain proposals which are subject to a vote in both houses of Parliament. Although the BJP-led National Democratic Alliance holds undisputable strength in the lower house, the upper house can pose some difficulties.

New National Income series suggesting greater growth momentum

Significant improvement in the macro-economic indicators measured by the new statistical series of national income (shift in base from 2004-05 to 2011-12) reveals higher GDP growth (estimated at +7.4% y/y for 2014-15), with figures for 2011-12 and 2012-13 also been revised upwards to +5.1% and +6.9% respectively, from +4.7% and +5.0% earlier. The improved methodology calculates the national income at constant market prices with enhanced coverage of corporate sector in manufacturing and services as well as financial sector. As per the new base, growth is projected at 8.1%-8.5% in 2015-16, which would undoubtedly makes India the fastest large emerging economy in the world in 2015.

The growth momentum is validated by our leading index of *real economic pressure*, which has picked up over the recent quarters and moved above the neutral threshold since 2014Q2. This is now translating into higher growth for industrial production and retail sales, and the momentum should continue to strengthen.

Moreover, recovery in non-POL (Petroleum, Oil and Lubricants) and non-gold and silver imports (+7.8% y/y in April 2014 to January 2015 following contraction in the previous two years) further supports the favorable growth outlook going forward.



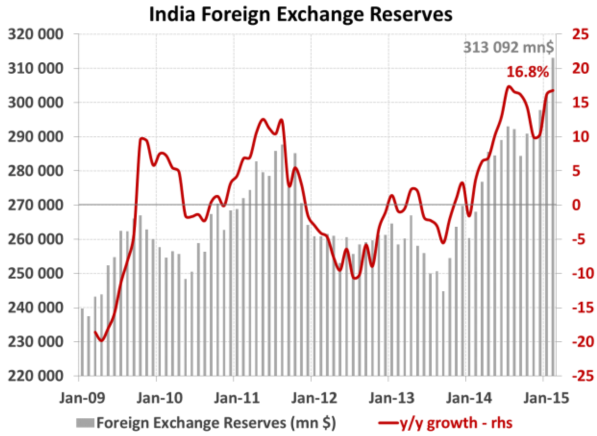
Source: TAC ECONOMICS

In parallel, inflationary pressures have abated owing to decline in international oil price and domestic food prices (CPI inflation eased to +5% y/y from +8.3% in May 2014 and WPI to -0.4% compared to +6.2% in May 2014). The easing inflationary pressures prompted the central bank to initiate the monetary easing in January 2015 when the key interest rate was cut by 25bps to 7.75%; and further by 25bps to 7.5% on March 4, 2015. India has formally adopted a flexible inflation targeting based on CPI (target of below 6% by January 2016 and 4% thereafter with a band of +/- 2%). Despite potential upward pressures on inflation by the end of 2015 if / when oil price increase again and relatively higher government spending fuel extra demand, the monetary authorities have a scope to further ease the policy rate (25-50bps) before stabilizing in 2015-16.

As shown over the last few days, high financial instability and increasing downward pressures on EM currency rates would impose a temporary pause in the easing process, and any substantial decline in rates will become much more difficult once the US Fed starts rising the Fed Fund rates, probably in June this year.

Improved external sector performance

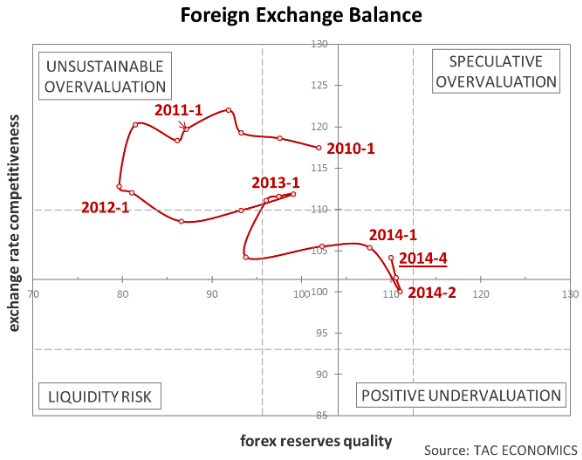
Steep decline in oil prices enabled the current account deficit to improve markedly (estimated at 1.3% of GDP in 2014-15) with pick-up in both exports and imports. The reform drive of the Modi government helped in improving the credibility of economic policy and long-term development strategy of the country, which facilitated large foreign investment inflows (+15% increase in FDI and +14% in foreign portfolio inflows between June to September 2014).



Source: TAC ECONOMICS, Datastream

This in turn assisted foreign exchange reserves accumulation (USD +22bn since May 2014 to USD 314bn on February 20) and led stability to the India rupee which has been hovering between INR 60-64 per USD (as correctly anticipated in TAC Flash Comment#74 in July 2014).

Positive dynamics of fx reserves enabled the country to move rightwards crossing the vertical threshold of *forex reserves quality* on the Foreign Exchange Balance in 2014.



Source: TAC ECONOMICS

We maintain our outlook of relative stability between (INR/USD) 60-65 for this year. Given higher reserves accumulation and improved domestic and external performances, the increase in the US interest rate should not have a significant impact on the currency dynamics.