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India Macro Flash

Economic Survey FY09 – Focus on Growth and Fiscal Consolidation

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- **Growth is the #1 priority** — The government's Economic Survey[1] released today indicates that getting growth back on track is the key priority since this '*is critical to generate the revenues needed for meeting social welfare objectives …and ensuring inclusive growth*'. Assuming global economies bottom out later this year and the govts '*capacity to push through policy reforms in the coming months'*, the Survey expects GDP to come in the 6.5-7.5% range in FY10.

- **Fiscal consolidation** — The survey highlights two areas that need to be addressed to restore the centre's deficit to 3% of GDP. These include (1) restructuring the tax and expenditure policies and (2) enhancing transparency to further improve fiscal consolidation. Key reforms on the anvil include (1) better targeting of fuel and fertilizer subsidies, (2) divestments aimed at generating Rs250bn p.a., (3) reviewing custom duty exemptions; phasing out surcharges/cesses and (4) Implementation of GST (*see pg 3 for detailed list*).

- **Inflation – Concern on discrepancy between the CPI and WPI**: The survey points out the discrepancy suggests that the *'existing supply chain is unable to cope with accelerating growth in income and consumer demand'*. Thus key reforms that could rectify this include (1) land and real-estate sector reforms and (2) strengthening the public transport and food supply chain *(see pg 4)*.

- **Positive reform agenda – implementation is Key** — The reform agenda mapped out includes (1) decontrolling the sugar and fertilizer industry, (2) setting up a single regulatory body for the transport sector, (3) private sector entry into provision of railway services, (3) linking small savings rate to government debt instruments, (4) corporatization of commercial departmental enterprises (e.g., port trusts minus land) and (5) higher FDI in insurance, defense and banking. While some of this is old news, in totality these bode well for improving the investment environment, but implementation will be key.

- **We maintain our macro forecasts** — We maintain our macro forecasts, which include (1) growth coming in at 6.8%, (2) combined deficit at 8.5%, (3) INR to appreciate to Rs46/US$, (4) WPI Inflation to cross 4% by year-end and (5) the RBI to reverse its easy money policy early next year.

[1] The Ministry of Finance presents the Economic Survey annually to Parliament on the eve of the budget. This provides a reference for the priorities of the government in the year ahead.

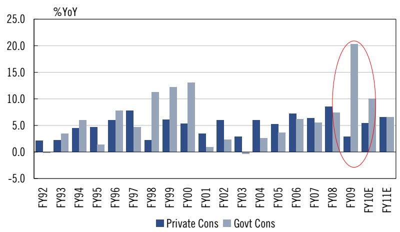
Growth: On the Path to Recovery

GDP likely to be in the 6.5-7.5% range

Capturing the UPA's endeavor to achieve higher growth in order to '*generate revenues and meet social welfare objectives*', the Economic Survey sees a 'U-shaped' recovery for growth in the year ahead. Bearing in mind the '*capacity to push through policy reforms in the coming months*', the Survey expects GDP to come in the 6.5-7.5% range in FY10.

The survey highlights underlying domestic strengths – including the high contribution of services, strong rural incomes, a rising savings rate, thrust for infrastructure, and buoyancy in FDI – as key factors supporting growth. This would be further aided by a current account surplus *(see. p. 4 for details)*. In the medium term, the Survey expects growth to return to the trend rate of 8.5-9% – *provided policy and institutional bottlenecks are removed.*

Trends in Private and Government Consumption (%YoY)



Source: CSO, Citi Investment Research and Analysis

Private Consumption – Why did growth slow?

The Survey mirrors our earlier concerns on private consumption (*see https://www.citigroupgeo.com/pdf/SAP27911.pdf*) , which dipped to just 2.9% in FY09 vs. 8.5% in FY08; thus dragging headline consumption to 5.4% in FY09 from 8%+ levels earlier. Growth would have been lower were it not for the 20% rise in public consumption. A quick recap: private consumption accounts for over 80% of total consumption and slumped to the lowest levels since FY98. Low private consumption numbers were particularly surprising given the fiscal stimulus and anecdotal evidence of a pickup in rural consumption. The Survey posits four key factors that may be behind the slowdown: (1) a negative wealth effect due to declining equity and property prices, (2) labor market uncertainty, (3) lower consumer credit offtake by private banks/NBFCs and (4) a deferral in spending decisions by consumers.

While the Survey has highlighted concerns on capital formation, this is largely on the back of the lag impact of monetary tightening and high real rates. We believe investment could recover with an improvement in global risk appetite, a thrust on infrastructure, and benign trends in inflation.

Reform Agenda is encouraging…but implementation is key

In line with campaign promises, the Economic Survey has mapped out a number of encouraging reform initiatives *(see table below)*. As we have mentioned earlier, these bode well for improving the investment environment, but implementation will be key.

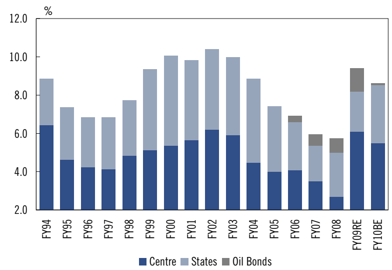
Reform Agenda

	Key Measures
1	Passage of the PFRDA (Pensions)Bill
2	Raising Foreign equity in insurance to 49%
3	FDI in multi-format retail
4	Raising FDI in defense to 49% from 26%
5	Decontrolling the sugar and fertilizer industry
6	Pvt sector entry into provision of railway services
7	Corporatization of commercial departmental enterprises
8	Pvt entry into coal mining
9	Increasing FDI limits in banks
10	Linking small savings rates to govt debt instruments/bank deposits

Source: Economic Survey FY09

Fiscal Policy – Key to Promote Medium-Term Growth

Trends in the Combined Fiscal Deficit



Source: Budget Documents, CIRA

Path to Fiscal Consolidation – 3% target to be restored at the earliest

Acknowledging the ~4% fiscal slippage last year, which resulted in the headline centre's deficit coming at 6.2% of GDP, the Survey has said that deficit would have to be restored to 3% at the earliest. In addition to the reforms highlighted below, the government expects that this would be achievable as (1) the pay commission arrears would be all accounted for by FY10, (2) only a marginal amount of farm waiver expenditure would be pending beyond FY10, (3) the cyclicality of tax collections and (4) proposed introduction of GST.

Policy – Aimed at restructuring policies and more transparency

In addition to being a countercyclical tool, fiscal policy is necessary to promote medium growth. To this end, the survey highlights two issues that need to be addressed. These include (1) restructuring the tax and expenditure policies and (2) improving fiscal transparency.

The Survey also mentions that while the government's tax policies have typically been toward simplifying and widening the tax base, this has not *always* been so. It highlights instances wherein *'revenue imperatives have led to the imposition of surcharges and cesses, and new taxes such as the STT, FBT and DDT have reversed the move toward a simpler system'*.

Key Fiscal and Tax Measures

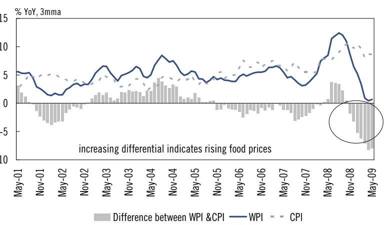
	Key Measures
1	FRBM-2: Examining the possibility of a 0% Fiscal Def target on a cyclically adjusted basis
2	Reforming oil, fertilizer and food subsidies to improve targeting
3	Revitalizing the disinvestment program and aim to generate Rs250bn p.a through stake sales of 5-10% in non-navratnas; listing PSUs and selling a minimum of 10 of equity to the public.
4	Introducing a new Income Tax Code with a neutral corp tax regime
5	Phasing out surcharges, cesses, transaction taxes
6	Implementation of GST
7	Reviewing customs duty exemptions, moving to a uniform duty structure
8	Auctioning 3 G spectrum
9	Converging Plan Schemes with a focus on outcomes
10	Decontrolling petrol/diesel prices; developing a policy response system when prices rise above US$80/bbl

Source: Economic Survey FY09

We maintain our view that the government would aim to keep the centre's deficit near the interim budget estimates of 5.5% of GDP. We expect better growth prospects, higher non-tax revenues and divestments to likely offset expenditure on the rural and social sector.

Other Take-aways: Inflation and External

Trends in the WPI and CPI (%YoY)



Source: Citi Investment Research and Analysis

Inflation – Addressing the discrepancy between WPI and CPI

On the inflation front, a key concern is the growing discrepancy between the consumer price index (CPI) and the wholesale price index (WPI). While the WPI is now in negative territory, the CPI continues to remain at close to double-digit levels (8.6% in May09), largely on account of primary product price pressures. The food group has a weightage of 24.5% in the WPI, 46% in the CPI for industrial workers and 69% in the CPI for agricultural workers. The Survey points out that this suggests that the '*supply chain is unable to cope with accelerating growth in income and consumer demand'*.

Key reforms to rectify the discrepancy include (1) land and real-estate sector reforms, (2) strengthening the public transport and food supply chain; to promote modernization and competition and (3) the introduction of an updated WPI with FY05 the base year *(this has been long pending*).

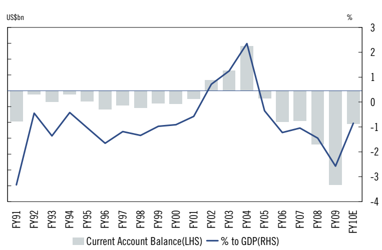
Differences in WPI and CPI Indices

	WPI	CPI-IW
Base year	FY94	2001
No: of items covered	435	120-360
No: of centres/quotations	1918*	78
Time lag	2 Weeks	4 Weeks
Treatment of Services	Included	Excluded
Basis	Wholesale transactions	Consumer expenditure surveys
Price quotations	Bulk transactions	Purchase price paid by the consumer
Nature of the index	Single, national	Weighted average of the centre indices
Weighting diagram	Country-wide, unique	Summation of wts of centre-specific indices
Capital & intermediate goods	Included	Excluded
Frequency	Weekly	Monthly

* Indicates quotations. Source: Economic Survey

External Sector – Survey sees Current A/c Surplus in FY10

Trends in the Current Account (US$bn)



Source: RBI, Citi Investment Research and Analysis

On the back of a narrowing trade deficit as well as continued resilience in remittance flows, the Survey expects a current account surplus to the tune of 0.3-2.8% of GDP in FY10. This factors in a scenario of crude prices averaging US$70-80/bbl. With a recovery in FII flows, this would result in both the capital and current account coming into positive territory for the first time since FY04.

Expects remittances to stay robust: While our forecasts factor in the current account remaining in the red, we expect to see a significant narrowing in the deficit to -0.9% of GDP in FY10 vs. -2.6% in FY09. Our forecasts are less optimistic than those projected by the Economic Survey, largely due to a moderation in invisibles (*the Survey expects the 'home bias' factor coupled with fiscal stimulus packages in migrant-destination countries to result in remittances staying robust). (see https://www.citigroupgeo.com/pdf/SAP28694.pdf for detailed BoP forecasts)*

Private Capital Flows…Possibility of a Pigouvian Tax

Another key highlight is the Survey's take on private capital flows. While it sees these as providing '*critical risk capital with long-term benefits for the economy'*, their volatile nature implies a need for the imposition of a tax to weed out negative externalities. The Survey suggests that this could be along the lines of the auction of External Commercial Borrowings introduced in 2006.

Appendix A-1

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