Deutsche Bank

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# India Economics Weekly

## RBI meeting, growth & fiscal outlook, monsoon, PMI, IP

Economics

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- **RBI meeting takeaways.** While recent turmoil in the global markets need to be taken into account, our impression from recent meetings with key RBI officials is that their inclination remains to hike the repo rate by 25bps on 16 Sep and then pause. We concur with the central bank's assessment that despite some moderation in the interest rate sensitive parts of the economy, conditions are still conducive to deliver 8% real GDP growth in FY11/12.
- **Fiscal update.** The government has sought approval from the parliament to spend an additional INR347.2bn through the first supplementary demand for grants. The authorities have clarified that the additional expenditure would be met through savings or enhanced receipts and should not lead to a breach in the fiscal deficit target of 4.6% of GDP for FY11/12. Our analysis however suggests that a higher fiscal deficit outturn is almost inevitable.
- **Monsoon watch.** Cumulative monsoon rainfall deficit has widened to 6% as on 3rd August but we take comfort from the fact that most of the deficient rainfall is concentrated in north-east region, which is less critical for agricultural production.
- **PMI (July).** India's composite PMI index rose to 54.8 in July, from 54.4 in June. Services PMI rose to 58.2 (from 56.1 in June), while manufacturing PMI fell to 53.6 (from 55.3 in June). While the manufacturing PMI reading is worrisome, the improvement in the services PMI mitigates some of the concerns on growth.
- **Industrial production forecast (June).** We incorporate the June readings of core infrastructure sector growth (5.2%yoy) and manufacturing PMI (55.3) to forecast IP growth of 5.8%yoy, slightly higher than the May outturn of 5.6%yoy.

**Key forecasts**

| Year ending 31 March | FY10 | FY11 | FY12F | FY13F |
|---|---|---|---|---|
| Real GDP (YoY %) | 8.0 | 8.5 | 8.5 | 8.5 |
| Central Govt. fiscal deficit, % of GDP | -6.4 | -4.7 | -5.5 | -4.8 |
| Consolidated fiscal deficit, % of GDP | -9.8 | -7.6 | -8.1 | -7.4 |
| WPI (YoY%) avg | 3.9 | 9.6 | 8.8 | 7.5 |
| WPI (YoY%) eop | 10.4 | 9.7 | 7.0 | 7.3 |
| Current account balance, % of GDP | -2.8 | -2.5 | -3.0 | -3.0 |

| | 2009 | 2010 | 2011F | 2012F |
|---|---|---|---|---|
| Trade balance, % of GDP | -8.4 | -8.0 | -7.8 | -7.2 |
| Current account balance, % of GDP | -2.0 | -3.1 | -3.3 | -3.1 |
| INR/USD, eop | 46.7 | 44.8 | 43.5 | 42.5 |

*Source: CEIC, Deutsche Bank*



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# Data monitor

## Key macro variables – monthly trend

| **Real sector (% yoy)** | **May-10** | **Jun-10** | **Jul-10** | **Aug-10** | **Sep-10** | **Oct-10** | **Nov-10** | **Dec-10** | **Jan-11** | **Feb-11** | **Mar-11** | **Apr-11** | **May-11** | **Jun-11** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Industrial production | 8.5 | 7.5 | 10.0 | 4.5 | 6.2 | 11.4 | 6.4 | 8.1 | 7.5 | 6.7 | 8.8 | 5.8 | 5.6 | |
| Mining and quarrying | 7.8 | 7.0 | 8.7 | 5.9 | 4.3 | 6.1 | 6.9 | 5.9 | 1.7 | 1.2 | 0.3 | 1.3 | 1.4 | |
| Manufacturing | 8.9 | 7.9 | 10.8 | 4.6 | 6.8 | 12.4 | 6.5 | 8.7 | 8.1 | 7.5 | 10.4 | 6.3 | 5.6 | |
| Electricity | 6.2 | 3.6 | 3.7 | 1.0 | 1.8 | 8.8 | 4.6 | 5.9 | 10.5 | 6.8 | 7.2 | 6.5 | 10.3 | |
| Capital goods | 15.8 | 3.7 | 40.7 | 4.7 | 7.2 | 21.0 | 25.7 | 20.2 | 5.4 | -5.7 | 15.4 | 7.3 | 5.9 | |
| Consumer goods | 7.4 | 13.3 | 5.8 | 4.6 | 9.7 | 9.4 | 0.7 | 3.6 | 8.3 | 13.4 | 11.7 | 4.3 | 5.4 | |
| Core infrastructure production | 7.4 | 4.5 | 5.7 | 4.4 | 3.3 | 7.2 | 3.6 | 6.2 | 6.4 | 5.2 | 6.3 | 4.5 | 5.3 | 5.2 |
| Auto sales | 32.2 | 33.5 | 32.8 | 25.6 | 21.9 | 43.8 | 14.5 | 27.7 | 19.9 | 22.1 | 19.5 | 23.9 | 15.6 | 14.7 |
| Cement sales | 8.6 | 3.7 | 4.5 | 3.4 | 8.0 | 19.3 | -6.3 | -4.9 | 0.1 | 7.1 | 4.5 | -1.8 | -1.1 | 1.1 |
| Manufacturing PMI | 59.0 | 57.3 | 57.6 | 57.2 | 55.1 | 57.2 | 58.4 | 56.7 | 56.8 | 57.9 | 57.9 | 58.0 | 57.5 | 55.3 |
| Services PMI | 58.2 | 64.0 | 61.7 | 59.3 | 55.6 | 56.2 | 60.1 | 57.7 | 58.1 | 60.2 | 58.8 | 59.2 | 55.0 | 56.1 |
| **Monetary sector (%yoy)** | | | | | | | | | | | | | | |
| WPI inflation | 10.5 | 10.3 | 10.0 | 8.9 | 9.0 | 9.1 | 8.2 | 9.4 | 9.5 | 9.5 | 9.7 | 9.7 | 9.1 | 9.4 |
| Primary articles | 20.4 | 20.1 | 19.1 | 16.0 | 18.2 | 18.1 | 14.7 | 18.4 | 18.4 | 15.9 | 13.4 | 12.0 | 11.3 | 12.2 |
| of which: Food | 21.4 | 21.0 | 18.5 | 15.0 | 16.3 | 14.6 | 10.1 | 15.1 | 16.7 | 11.0 | 9.5 | 8.7 | 8.4 | 8.4 |
| Fuel & power | 14.4 | 13.9 | 13.3 | 12.5 | 11.1 | 11.0 | 10.3 | 11.3 | 11.4 | 12.4 | 12.5 | 13.3 | 12.3 | 12.8 |
| Manufactured products | 5.9 | 5.6 | 5.8 | 5.2 | 5.0 | 5.1 | 5.0 | 5.4 | 5.3 | 6.3 | 7.4 | 6.2 | 7.3 | 7.4 |
| CPI inflation | 13.9 | 13.7 | 11.3 | 9.9 | 9.8 | 9.7 | 8.3 | 9.5 | 9.3 | 8.8 | 8.8 | 9.4 | 8.7 | 8.6 |
| M3 (broad money supply) | 14.5 | 14.6 | 15.3 | 15.1 | 15.2 | 15.9 | 16.2 | 16.5 | 16.2 | 16.5 | 17.0 | 17.6 | 17.3 | 17.1 |
| Credit to commercial sector | 16.8 | 17.8 | 20.3 | 18.3 | 19.0 | 21.0 | 22.9 | 24.4 | 21.9 | 22.0 | 21.1 | 21.7 | 20.0 | 20.2 |
| Aggregate deposits | 14.9 | 14.3 | 14.9 | 14.4 | 15.0 | 15.3 | 15.0 | 16.5 | 15.9 | 16.4 | 15.8 | 17.3 | 18.2 | 17.7 |
| **External sector (% yoy)** | | | | | | | | | | | | | | |
| Exports | 34.2 | 46.5 | 12.5 | 22.6 | 22.8 | 19.6 | 35.0 | 55.2 | 32.5 | 49.8 | 43.9 | 34.4 | 56.9 | 46.4 |
| Imports | 32.5 | 16.4 | 25.9 | 22.1 | 20.3 | 11.8 | 1.4 | -0.3 | 13.1 | 21.2 | 17.3 | 14.1 | 54.1 | 42.4 |
| Trade Balance (USD bn) | -10.0 | -6.9 | -11.2 | -10.8 | -7.9 | -11.3 | -5.2 | -2.6 | -8.0 | -8.1 | -5.6 | -9.0 | -15.0 | -7.7 |
| FX Reserves (USD bn) | 272.0 | 277.0 | 284.2 | 282.8 | 291.6 | 298.0 | 294.0 | 297.3 | 299.2 | 300.8 | 303.5 | 313.5 | 310.2 | 315.7 |
| INR/USD | 46.5 | 46.6 | 46.5 | 47.1 | 44.9 | 44.5 | 46.0 | 44.8 | 46.0 | 45.2 | 44.7 | 44.4 | 45.0 | 44.7 |

## GDP and Balance of Payments – quarterly trend

| **National accounts, % yoy** | **Q4-2008** | **Q1-2009** | **Q2-2009** | **Q3-2009** | **Q4-2009** | **Q1-2010** | **Q2-2010** | **Q3-2010** | **Q4-2010** | **Q1-2011** |
|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP (production side) | 5.8 | 5.9 | 6.3 | 8.6 | 7.3 | 9.4 | 9.3 | 8.9 | 8.3 | 7.8 |
| Agriculture | -3.3 | 1.2 | 1.8 | 1.2 | -1.6 | 1.1 | 2.4 | 5.4 | 9.9 | 7.5 |
| Industry | 2.8 | 1.4 | 2.9 | 6.3 | 10.0 | 13.7 | 11.3 | 9.0 | 6.2 | 5.3 |
| Services | 10.0 | 8.5 | 8.5 | 10.8 | 9.2 | 10.1 | 10.3 | 9.5 | 8.6 | 8.6 |
| **Balance of Payments, $bn** | | | | | | | | | | |
| Exports | 39.4 | 38.5 | 39.2 | 43.4 | 47.1 | 52.4 | 55.3 | 52.0 | 65.9 | 77.2 |
| Imports | 73.5 | 58.7 | 64.8 | 73.0 | 78.1 | 83.9 | 87.2 | 89.3 | 97.4 | 107.1 |
| Trade balance | -34.1 | -20.2 | -25.6 | -29.6 | -31.0 | -31.5 | -31.9 | -37.3 | -31.5 | -29.9 |
| Net invisibles | 22.4 | 19.0 | 21.2 | 20.4 | 18.9 | 18.5 | 19.8 | 20.5 | 21.5 | 24.5 |
| Current account | -11.7 | -1.2 | -4.5 | -9.2 | -12.2 | -13.0 | -12.1 | -16.8 | -10.0 | -5.4 |
| Capital account | -6.1 | 1.4 | 4.0 | 19.3 | 14.7 | 16.1 | 15.8 | 20.1 | 14.0 | 7.4 |
| of which: FDI | 0.4 | 3.2 | 6.1 | 7.5 | 3.9 | 3.2 | 2.9 | 2.6 | 2.1 | 0.6 |
| Portfolio investment | -5.8 | -2.7 | 8.3 | 9.7 | 5.7 | 8.8 | 4.6 | 19.2 | 6.3 | 0.2 |
| BoP Balance | -17.9 | 0.3 | 0.1 | 9.4 | 1.8 | 2.1 | 3.7 | 3.3 | 4.0 | 2.0 |

*Source: CEIC, Bloomberg Finance LP, RBI, CSO, various ministries of Government of India, Deutsche Bank*

# RBI meeting takeaways

## Rate hike cycle nearing its end

Our takeaways from recent meetings with key RBI officials:

- **Two considerations which will influence the RBI's near-term policy path are demand side inflation and global commodity prices.** The RBI would like to see core WPI inflation moderate from the current 7%+ level to its long-term trend of 4%. Though this might take significant time, the key is if a moderating trend is detected in the next few months. On commodities, the central bank is tracking the net long non-commercial positions of commodities such as oil, soybeans, copper etc. closely. Since we expect inflation pressure to sustain in the coming months and global commodity prices to hold at current levels, we do not anticipate any change in RBI's monetary policy stance, at least for the 16 September monetary policy review. According to our forecasts, WPI inflation will probably peak in August at about 10%, with core inflation hovering around 7%. **This would likely nudge the central bank to raise the policy rate by 25bps on 16 September. However, beyond the September review, it is unlikely that the RBI would hike rates any more** given that inflation would start moderating thereafter, albeit gradually and from a high base, and given that lagged impact of previous rate hikes will tend to reduce demand side pressure. **The move in September could also be postponed if global economic unrest spreads further.**

- **The central bank expects growth to remain around 8%.** Monetary transmission of previous rate hikes and tight liquidity are affecting the growth momentum of rate sensitive sectors, but a broad based slowdown is yet to materialize. Exports growth has been exceptionally robust in recent months, services sector growth seems to be holding up, bank credit growth is still above the targeted rate of 18% and private and government consumption expenditure trend continues to be buoyant. For FY11/12, the RBI expects services sector to maintain a growth rate of 9-10%. This should be consistent with 8% real GDP growth, even with lower growth in agriculture sector (3-4% compared to 6.6% in FY10/11) and some slowdown in manufacturing. With respect to corporate performance, the central bank's view is that profitability has slowed down somewhat, though not to the extent that would prompt the central bank to abandon its anti-inflationary stance at this stage. This is a critical area to continue monitoring, in the central bank's view.

- **While in this fiscal year (FY11/12), there are risks of fiscal slippage (around 1% of GDP)** due to over shooting of fuel subsidies, the next union budget would be crucial as it will indicate the government's resolve to carry with fiscal consolidation, as envisaged in the Fiscal Responsibility and Budget Management Act. While fiscal contraction can reduce demand to some extent in the near term, it will definitely help to improve the longer-term growth outlook, both in terms of sustainability as well as quality. In the absence of material fiscal improvement, investment demand could take a further hit and pose to be a threat for the growth outlook even beyond FY11/12.

# PM's advisory council reduces growth forecast

## Prime Minister's Advisory Council's report in line with our economic forecast

According to the Prime Minister's Advisory Council's report (released on 1st August), the Indian economy will slow somewhat in 2011/12. The Council sees real GDP to grow by 8.2% during the fiscal year, which is within our 8-8.5% forecast range. The outcome will be achieved through 3% growth in agriculture, while the industrial sector would expand by 7% and service sector by 10%. The report projects inflation to ease to 6.5% by March 2012 (we believe it will be about 7%), the current account deficit to be under 3% of GDP, largely financed by foreign investments (FDI + portfolio) and loans, and a consolidated budget deficit of slightly under 7% of GDP.

The report cites three key challenges to the outlook: (i) a pick-up in investment (fairly lackluster so far this year) is essential for the GDP growth momentum to be maintained; (ii) inflation would come down only if the food production outlook improves and fiscal policy restraints are put in place; and (iii) the fiscal outlook is particularly worrisome as energy subsidies have soared, contingent liabilities have risen (owing to disruptions in the power sector), and delays continue in the passage of GST.

**We maintain the view that growth would be in the 8-8.5% range, as well as broadly share the concerns raised by the report.** If the risks highlighted above are not mitigated, growth could readily fall below 8%, in our view.

**FY11/12 GDP growth forecast of Prime Minister's Economic Advisory Council**

| % yoy | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 Proj.* |
|---|---|---|---|---|---|---|---|
| Agriculture, Forestry and Fishing | 5.1 | 4.2 | 5.8 | -0.1 | 0.4 | 6.6 | 3.0 |
| Mining and Quarrying | 1.3 | 7.5 | 3.7 | 1.3 | 6.9 | 5.8 | 6.0 |
| Manufacturing | 10.1 | 14.3 | 10.3 | 4.2 | 8.8 | 8.3 | 7.0 |
| Electricity, Gas and Water Supply | 7.1 | 9.3 | 8.3 | 4.9 | 6.4 | 5.7 | 7.0 |
| Construction | 12.8 | 10.3 | 10.7 | 5.4 | 7.0 | 8.1 | 7.5 |
| Trade, Hotels, Transport and Communication | 12.2 | 11.6 | 11.0 | 7.5 | 9.7 | 10.3 | 10.8 |
| Financing, Insurance, Real Estate & Business Service | 12.7 | 14.0 | 11.9 | 12.5 | 9.2 | 9.9 | 9.8 |
| Community, Social and Personal Services | 7.0 | 2.9 | 6.9 | 12.7 | 11.8 | 7.0 | 8.5 |
| **Gross Domestic Product at Factor Cost** | **9.5** | **9.6** | **9.3** | **6.8** | **8.0** | **8.5** | **8.2** |
| | | | | | | | |
| **Memo items** | | | | | | | |
| GDP (factor cost) per capita | 7.8 | 7.8 | 7.6 | 5.0 | 6.2 | 6.8 | 6.4 |
| GDP market & current prices in USD Billion | 834 | 949 | 1241 | 1223 | 1385 | 1732 | 1994 |
| Population in Million | 1108 | 1126 | 1145 | 1164 | 1183 | 1202 | 1222 |
| GDP market prices per capita in current USD | 753 | 842 | 1084 | 1051 | 1171 | 1441 | 1632 |

*Source: CSO, Deutsche Bank. * Economic Advisory Council forecast*

# April-June fiscal update

## Fiscal arithmetic looks challenging

The first quarter (April-June) fiscal data for FY11/12 show the following trend:

- Both gross (14.6%yoy FY11/12 vs. 16.5%yoy FY10/11) and net tax revenue (11.8% vs. 14.9%) collection rate as a % of budget estimate is weaker compared to the corresponding period of the last year
- Within taxes, direct tax collection rate (10.7% vs. 15.5%) as a % of budget estimate is lower in Q1FY11/12 compared to Q1FY10/11 (with both corporate and income tax collection being weaker than last year), while indirect tax collection trend (19.3% vs. 17.2%) is stronger across the board (see table below).

**Tax collection trend – April-June**

| Items | % of FY11/12 budget | % of FY10/11 budget |
|---|---|---|
| **Gross Tax Revenue** | **14.6** | **16.5** |
| **Direct Taxes** | **10.7** | **15.5** |
| Corporate Tax | 9.0 | 15.1 |
| Income Tax | 14.5 | 16.4 |
| **Indirect Taxes** | **19.3** | **17.2** |
| Customs | 25.9 | 21.6 |
| Excise | 14.6 | 14.1 |
| Services | 16.7 | 15.0 |
| Others | 76.2 | 79.9 |

*Source: Controller General of Accounts, Deutsche Bank*

- Non-tax revenue, disinvestments and total revenue receipts were all lower in 1QFY11/12, compared to last year, while non-plan and total expenditure were higher. Plan expenditure, which is mainly for developmental purposes, was lower in the first quarter (see table).
- Finally, all deficit indicators (measured as a % of budget estimate) were higher in 1QFY11/12 compared to the corresponding period of the last year.

**Fiscal position – April-June**

| Items | % of FY11/12 budget | % of FY10/11 budget |
|---|---|---|
| Revenue Receipts | 11.5 | 25.5 |
| Tax Revenue (Net) | 11.8 | 14.9 |
| Non-Tax Revenue | 9.7 | 52.6 |
| Non-Debt Capital Receipts | 13.9 | 6.9 |
| Recovery of Loans | 43.3 | 12.5 |
| Other Receipts | 2.9 | 4.7 |
| **Total Receipts** | **11.7** | **24.8** |
| Non-Plan Expenditure | 21.7 | 18.8 |
| Of which: interest payments | 18.7 | 16.7 |
| Plan Expenditure | 19.1 | 22.3 |
| **Total Expenditure** | **20.8** | **19.9** |
| | | |
| **Fiscal Deficit** | **39.4** | **10.0** |
| Revenue Deficit | 43.8 | 3.9 |
| Primary Deficit | 77.7 | 0.0 |

*Source: Controller General of Accounts, Deutsche Bank*

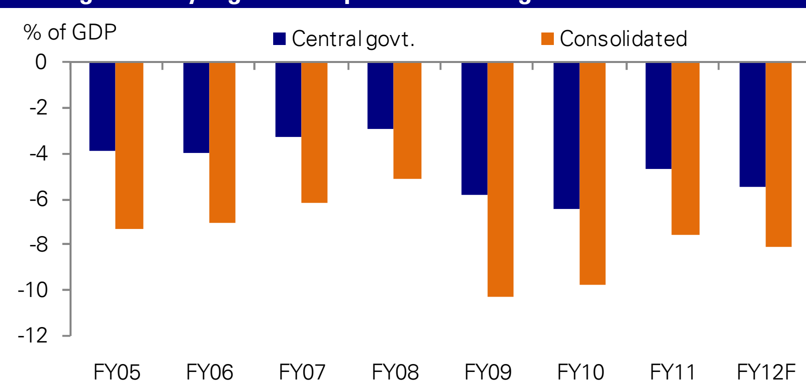
The government has recently sought approval from the parliament to spend an additional INR347.2bn through the first supplementary demand for grants. The authorities have clarified that the additional expenditure would be met through savings or enhanced receipts and should not lead to a breach in the fiscal deficit target of 4.6% of GDP for FY11/12.

In contrast, as maintained for a few months, we see substantial risk of fiscal slippage in FY11/12. Firstly, on fuel subsidies, recent easing of commodity prices and local fuel price adjustment still fall well short of plugging the budget gap. The government has already nearly exhausted the current year's provision for fuel subsidies (INR236bn) in paying for last fiscal year's losses (INR200bn). We estimate around INR650bn fuel subsidy bill this year, most of which must be paid out this year. Further, there are risks related to fertilizer and food subsidies. Second, the revenue outlook has worsened with a slowing of economic activities, ad hoc tax cut measures (i.e. 0.4% of GDP of cuts in excise and customs duty to reduce the loss of oil companies), and diminished prospects for disinvestment (given financial market turmoil globally).

Can the government cut spending to meet its budget target, despite rising subsidies and weak revenues? Note that the government has taken quite conservative spending estimates in its budget calculation (see table on the next page); on the non-plan expenditure side, the only category the government can aim to cut spending is the "other non-plan expenditure" category (expenditure on items other than interest payments, defence and subsidies). But the government has already pencilled in a 9.4%yoy contraction in this category and attempting further substantial reduction would be challenging. Another option would be to cut spending on plan-expenditure items (11.8%yoy), but there are doubts about how aggressively the government can go in this path given the growth-critical nature of plan-spending.

**Overall, India's fiscal prospects for FY11/12 are challenging, and the risk of a fiscal slippage is substantial, in our view.** According to our calculation, the upside risk to fiscal deficit is at least 1% point, which could push it up to 5.5% of GDP (as against the budget estimate of 4.6% of GDP).

**Fiscal deficit significantly higher than pre-crisis average**



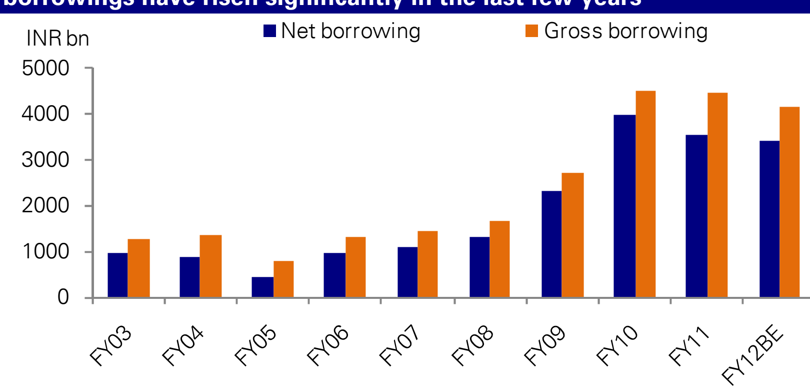

*Source: Budget document, Deutsche Bank*

## Budget projections for 2011/12

| | INR bn | % yoy | % of GDP |
|---|---|---|---|
| Gross Tax Revenue (1 = 2+3) | 9324 | 18.5 | 10.4 |
| Direct Taxes (2) | 5320 | 19.4 | 5.9 |
| Corporation Tax | 3600 | 21.5 | 4.0 |
| Taxes on Income | 1720 | 15.4 | 1.9 |
| Indirect Taxes (3) | 4004 | 17.3 | 4.5 |
| Customs | 1517 | 15.1 | 1.7 |
| Union Excise Duties | 1641 | 19.1 | 1.8 |
| Service Tax | 820 | 18.2 | 0.9 |
| Less - Transfer to States(4) | 2680 | 20.1 | 3.0 |
| Centre's Net Tax Revenue ( 5 = 1- 4 ) | 6645 | 17.9 | 7.4 |
| Non Tax Revenue (6) | 1254 | -43.0 | 1.4 |
| Non-Debt Capital Receipts (7) | 550 | 73.3 | 0.6 |
| of which: disinvestments | 400 | 75.9 | 0.4 |
| Total receipts ( 8 = 5+6+7 ) | 8449 | 3.6 | 9.4 |
| | | | |
| **Non-Plan Expenditure (9)** | 8162 | **-0.7** | 9.1 |
| of which: interest payments | 2680 | 11.3 | 3.0 |
| defence | 1644 | 8.5 | 1.8 |
| **subsidies** | 1436 | **-12.5** | 1.6 |
| of which: **petroleum** | 236 | **-38.4** | 0.3 |
| **fertilizer** | 500 | **-9.1** | 0.6 |
| **food** | 606 | **0.0** | 0.7 |
| **other** | 94 | **-8.2** | 0.1 |
| **Other non plan expenditure** | 2402 | **-9.4** | 2.7 |
| **Plan Expenditure (10)** | 4415 | **11.8** | 4.9 |
| Central Plan | 3355 | 12.4 | 3.7 |
| Central assistance for states/ UT | 1060 | 10.0 | 1.2 |
| Total expenditure ( 11 = 9 + 10 ) | 12577 | 3.4 | 14.0 |
| | | | |
| Fiscal Deficit (12 = 8 - 11) | 4128 | | 4.6 |
| Primary Deficit | 1448 | | 1.6 |

*Source: Budget document, Deutsche Bank*

## Market borrowings have risen significantly in the last few years




*Source: Budget Documents, Deutsche Bank*

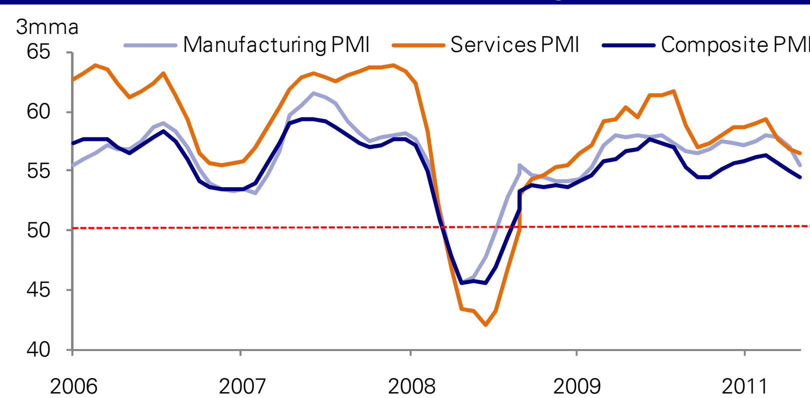
# Data releases

## PMI, core infra, weekly WPI, monsoon watch

PMI (July). India's composite PMI index rose to 54.8 in July, from 54.4 in June. Services PMI rose to 58.2 (from 56.1 in the previous month), while the manufacturing PMI fell to a 20-month low of 53.6 (from 55.3 in June). On a 3-month moving average basis, all the indices – manufacturing (55.5 vs. 56.9), services (56.4 vs. 56.8) and composite (54.5 vs. 55.0) – fell in July from June (see chart below).

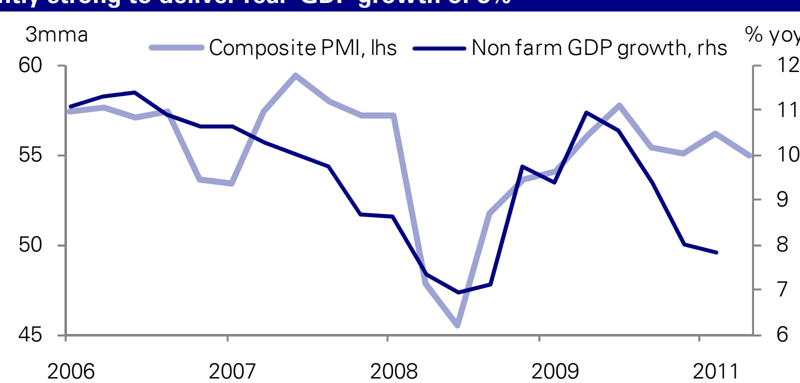
Improved service sector figures reflect continued rise in trade and tourism activities. Indeed, both the new business (59.3 vs. 57.1) and outstanding business (52.5 vs. 49.1) sub-components recorded a sharp rise in July compared to June. In contrast, the weak manufacturing PMI suggests subdued activities on the back of rising interest rate and input cost. New orders (54.5 vs. 60.1), output (57.2 vs. 58.4), new export orders (49.2 vs. 53.2) all recorded a lower outturn in July compared to June. Input prices rose substantially in July, driven by higher raw material costs, which has adverse implication for corporate profitability and cost-push inflation. While the manufacturing PMI reading is worrisome, the improvement in the services PMI mitigates some of the concerns on growth.

**PMI trend indicates mild slowdown in non-farm sector growth**




*Source: Haver Analytics, Deutsche Bank*

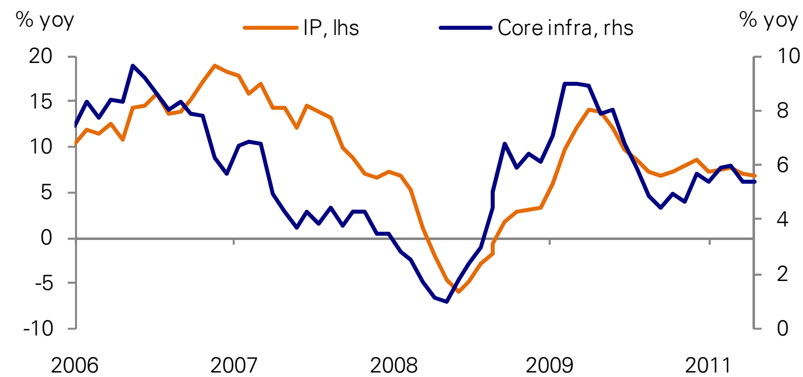
**Non-farm sector GDP growth has trended lower in the last few quarters, but remain sufficiently strong to deliver real GDP growth of 8%**




*Source: Haver Analytics, Deutsche Bank*

**Core infrastructure production (June).** Core sector production grew by 5.2%yoy in June (5.3% in May), with the 3-month moving average trending slightly lower to 5.0%, from 5.4% in May. Coal (-3.3%), natural gas (-11.7%), fertilizer (-2.4%) and cement production (+0.8%) remained soft, while steel (+12.5%), crude oil (+7.7%), electricity (+8.2%) and refinery (+4.7%) production was fairly robust. During April-June 2011/12, the core sector registered a growth of 5.0% as against 6.8% during the corresponding period of the previous year. Note that the eight-industry core infrastructure sector index has a combined weight of 37.9% in the overall IP and therefore has significant bearing on the trend of the IP growth (see chart below). **We incorporate the June readings of core sector growth and manufacturing PMI to forecast IP growth of 5.8%yoy, a tad higher than the May outturn of 5.6%yoy.**

**Core infrastructure sector and industrial production growth trend**




*Source: CEIC, Deutsche Bank*

**Core infrastructure production growth – monthly trend**

| % yoy | Weight | Apr-11 | May-11 | Jun-11 | Apr-June 2010 | Apr-June 2011 |
|---|---|---|---|---|---|---|
| **Overall** | **37.9** | **4.5** | **5.3** | **5.2** | **6.8** | **5.0** |
| Coal | 4.4 | 2.8 | 1.1 | -3.3 | -0.6 | 0.2 |
| Crude oil | 5.2 | 10.9 | 9.7 | 7.7 | 5.9 | 9.5 |
| Natural gas | 1.7 | -9.3 | -9.6 | -11.7 | 37.0 | -10.2 |
| Refinery products | 5.9 | 6.6 | 4.6 | 4.7 | 5.3 | 5.3 |
| Fertilizers | 1.3 | -1.4 | 7.3 | -2.4 | -2.6 | 1.1 |
| Steel | 6.7 | 4.8 | 6.1 | 12.5 | 8.6 | 7.8 |
| Cement | 2.4 | -1.1 | -2.3 | 0.8 | 7.0 | -0.9 |
| Electricity | 10.3 | 6.4 | 10.3 | 8.2 | 5.7 | 8.3 |

*Source: CEIC, Deutsche Bank*

**Core infrastructure production growth – annual trend**

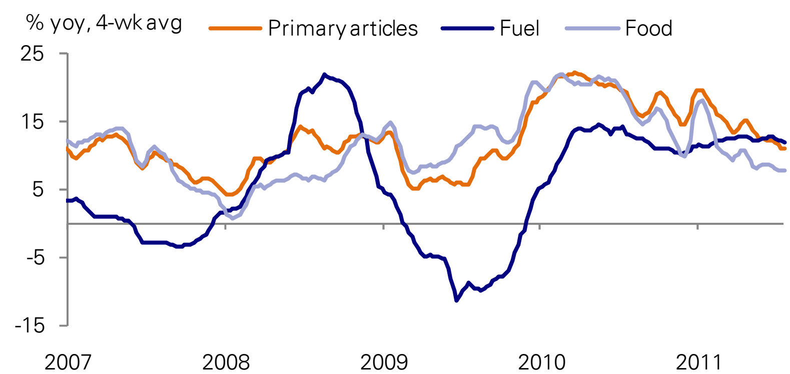
| % yoy | Weight | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 |
|---|---|---|---|---|---|---|---|
| **Overall** | **37.9** | **3.9** | **8.4** | **5.2** | **2.8** | **6.6** | **5.7** |
| Coal | 4.4 | 6.6 | 5.9 | 6.3 | 8.0 | 8.1 | -0.3 |
| Crude oil | 5.2 | -5.2 | 5.6 | 0.4 | -1.8 | 0.5 | 11.9 |
| Natural gas | 1.7 | 1.4 | -1.4 | 2.1 | 1.3 | 44.6 | 10.0 |
| Refinery products | 5.9 | 2.1 | 12.9 | 6.5 | 3.0 | -0.4 | 3.0 |
| Fertilizers | 1.3 | 0.6 | 3.1 | -7.9 | -3.9 | 12.7 | 0.0 |
| Steel | 6.7 | 7.0 | 12.8 | 6.8 | 1.9 | 6.0 | 8.9 |
| Cement | 2.4 | 12.4 | 9.1 | 8.1 | 7.2 | 10.5 | 4.5 |
| Electricity | 10.3 | 5.1 | 7.3 | 6.3 | 2.7 | 6.2 | 5.5 |

*Source: CEIC, Deutsche Bank*

**Weekly WPI (week ending 23 July).** Despite some moderation in prices of food (-0.6%wow; +8%yoy vs. +7.3%yoy) and primary articles (-0.6%wow; +11%yoy vs. +10.5%yoy) in the current week, the year on year inflation rate of these components trended higher compared to the previous week, led by a negative base effect. However, non-food articles inflation (-0.9%; +15.6%yoy vs. +16.1%wow) was lower both on a week on week as well as a yoy basis. The weekly decline in food inflation was led by lower prices of fish-marine & poultry chicken (-3%wow each), fruits & vegetables (-2%wow) and eggs (-1%wow), while non-food inflation moderated on lower prices of flower (-18%wow). Meanwhile, fuel inflation rate remained unchanged from the last week (+12.1%yoy).

We note that the base effect will remain negative for food inflation in the next three weeks, which could push up the yoy food inflation rate above 9% once again. The weekly inflation trend in July so far suggests that the monthly WPI inflation rate would be similar to the June outturn of 9.4%, thereby providing little scope for RBI to abandon its ant-inflationary stance.

**Weekly inflation trend**




*Source: CEIC, Deutsche Bank*

**Monsoon watch.** Latest data from Indian Meteorological Department (IMD) shows that cumulative monsoon rainfall deficit has widened to 6% for the period between 1st June and 3rd August. Note that monsoon rain was in surplus territory in June, but turned deficient in July, as was anticipated by the IMD in its June forecast. Going forward, the IMD forecasts the cumulative rainfall in the second half (August to September) of the monsoon season to be below normal (86 to 94% of long-period average), resulting in a below average rainfall for 2011(June-September) as a whole. While this raises some uncertainty regarding near-term growth-inflation outlook, we take comfort from the fact that most of the deficient rainfall is concentrated in the north-eastern region, which is less critical for agricultural production (see table below). Moreover, as we have repeatedly pointed out in our earlier reports, the relative importance of monsoon dependency in influencing key macrovariables have reduced substantially in recent years, thanks to ongoing structural reforms within the agricultural sector and the overall economy. We will however continue to monitor the monsoon trend closely over the next few weeks.

**Cumulative monsoon rainfall trend – deviation from normal range (%)**

| Region | June 1 to June 29 | June 1 to Aug 3 |
|---|---|---|
| **India total** | **11** | **-6** |
| North-west | 65 | -5 |
| Central | 17 | -1 |
| South Peninsular | 3 | -2 |
| North-east | -11 | -18 |

*Source: Bloomberg Finance LP, IMD, Deutsche Bank*

# Data, forecast and charts

## National accounts: production and expenditure side GDP

| % yoy | FY08/09 | FY09/10 | FY10/11E | FY11/12E | FY12/13E |
|---|---|---|---|---|---|
| **Production side GDP** | | | | | |
| **Real GDP** | **6.9** | **8.0** | **8.5** | **8.5** | **8.5** |
| Agriculture | 2.2 | 0.4 | 6.6 | 4.1 | 5.0 |
| Industry | 3.8 | 8.3 | 7.8 | 10.3 | 9.9 |
| Services | 9.2 | 9.7 | 9.2 | 8.8 | 8.8 |
| **Expenditure side GDP** | | | | | |
| Consumption exp. | 7.4 | 8.6 | 8.0 | 7.5 | 7.6 |
| Private | 6.5 | 7.5 | 8.6 | 7.9 | 7.9 |
| Government | 12.3 | 14.6 | 4.8 | 5.5 | 6.0 |
| Investment | 2.6 | 7.4 | 8.6 | 11.5 | 12.8 |
| Exports | 15.0 | -6.8 | 17.9 | 15.8 | 15.7 |
| Imports | 22.5 | -2.1 | 9.2 | 14.9 | 17.0 |

*Source: CSO, CEIC, Deutsche Bank*

## Fiscal operations

| % of GDP | FY08/09 | FY09/10 | FY10/11E | FY11/12E | FY12/13E |
|---|---|---|---|---|---|
| **Central government balance** | **-5.8** | **-6.4** | **-4.7** | **-5.5** | **-4.8** |
| Government revenue | 10.3 | 9.3 | 10.5 | 9.5 | 10.1 |
| Government expenditure | 16.1 | 15.6 | 15.2 | 15.0 | 14.9 |
| Central primary balance | -2.4 | -3.1 | -1.7 | -2.5 | -1.8 |
| Consolidated deficit | -10.3 | -9.8 | -7.6 | -8.1 | -7.4 |
| **Memo** | | | | | |
| Central | -5.8 | -6.4 | -4.7 | -5.5 | -4.8 |
| State | -2.6 | -3.2 | -2.9 | -2.6 | -2.6 |
| Oil | -1.4 | -0.2 | 0.0 | 0.0 | 0.0 |
| Fertilizer | -0.4 | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | | |
| **Debt/GDP** | **71.0** | **69.5** | **63.4** | **62.2** | **62.6** |

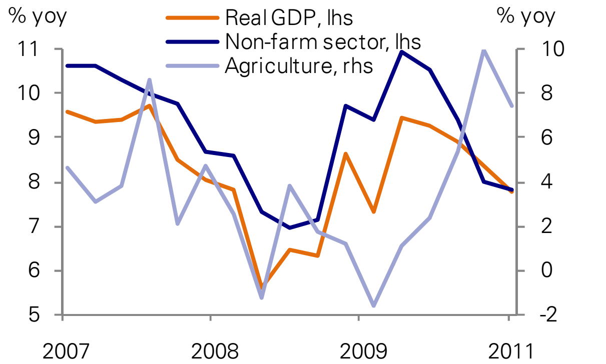
*Source: Controller General of India, Government of India, Deutsche Bank*

## Balance of Payments

| USD bn | FY08/09 | FY09/10 | FY10/11E | FY11/12E | FY12/13E |
|---|---|---|---|---|---|
| 1. Exports | 189.0 | 182.2 | 250.5 | 288.1 | 325.5 |
| 2. Imports | 308.5 | 300.6 | 380.9 | 443.7 | 503.7 |
| **3. Trade Balance (1-2)** | **-119.5** | **-118.4** | **-130.5** | **-155.7** | **-178.1** |
| % of GDP | -9.8 | -8.6 | -7.5 | -7.4 | -7.2 |
| 4. Invisibles, net | 91.6 | 80.0 | 86.2 | 93.8 | 104.1 |
| **5. Current Account Balance** | **-27.9** | **-38.4** | **-44.3** | **-61.8** | **-74.1** |
| % of GDP | -2.3 | -2.8 | -2.5 | -3.0 | -3.0 |
| **6. Capital Account Balance** | **7.8** | **51.8** | **57.3** | **62.0** | **75.0** |
| % of GDP | 0.6 | 3.7 | 3.3 | 3.0 | 3.0 |
| **7. Overall BOP (5+6)** | **-20.1** | **13.4** | **13.1** | **0.2** | **0.9** |

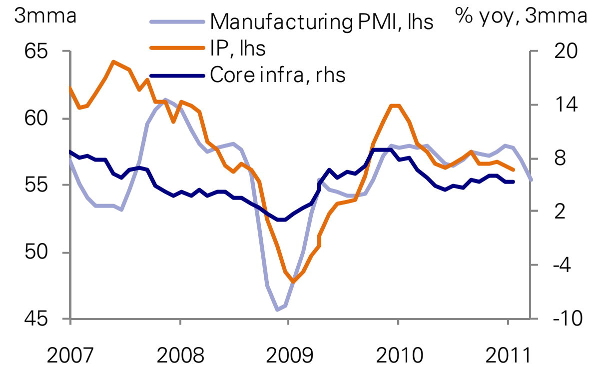
*Source: RBI, CEIC, Deutsche Bank*

**GDP growth eased to 7.8% in Jan-March'11, due to data revisions and modest slowdown in non-farm growth**



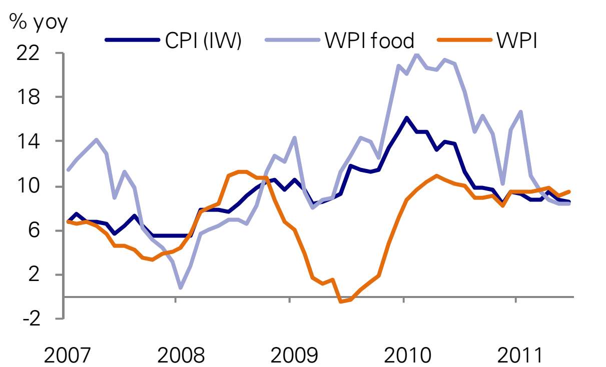

Source: CEIC, CSO, Deutsche Bank

**Industrial sector growth momentum is waning led by negative base effect and RBI's tight monetary policy**



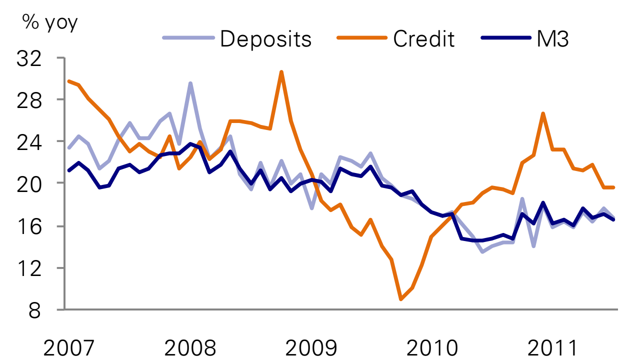

Source: CEIC, Bloomberg Finance LP, Deutsche Bank

**Both CPI and WPI inflation remain at uncomfortably high level**



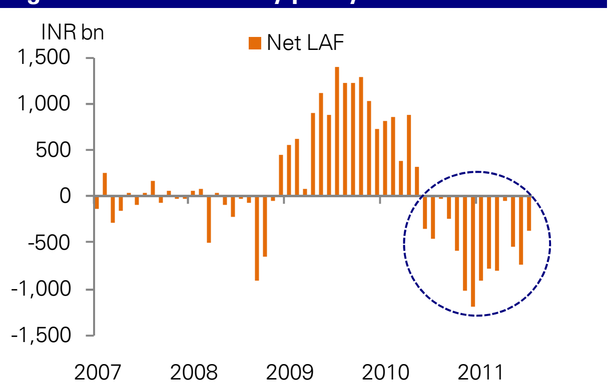

Source: CEIC, RBI, Deutsche Bank

**Gap between credit and deposits growth persists, though it has narrowed in recent months**



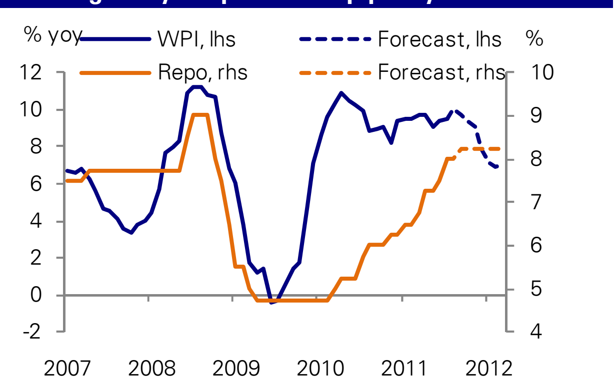

Source: CEIC, RBI, Deutsche Bank

**Liquidity conditions in money market remain tight, lending traction to monetary policy transmission**



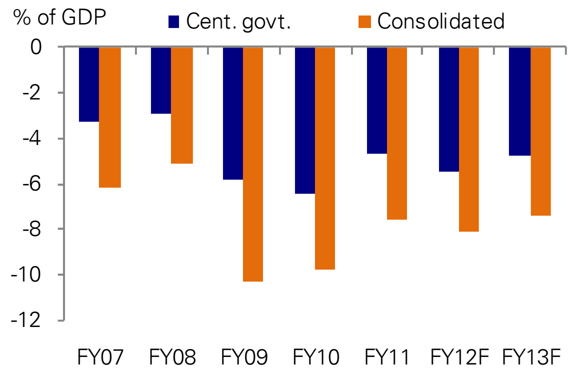

Source: Bloomberg Finance LP, Deutsche Bank

**Barring any external shock, we expect RBI to hike repo rate once again by 25bps in its Sep policy review**



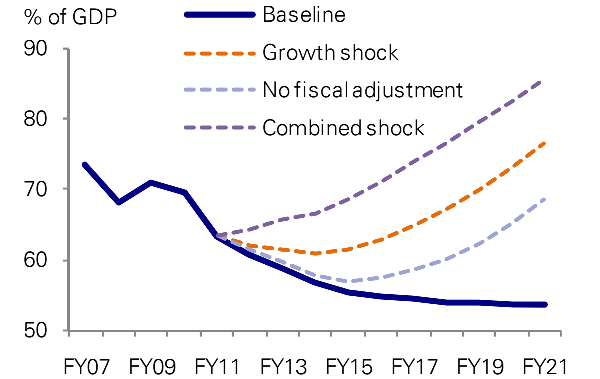

Source: CEIC, RBI, Deutsche Bank

**Large deficits remain features of the central and general government**



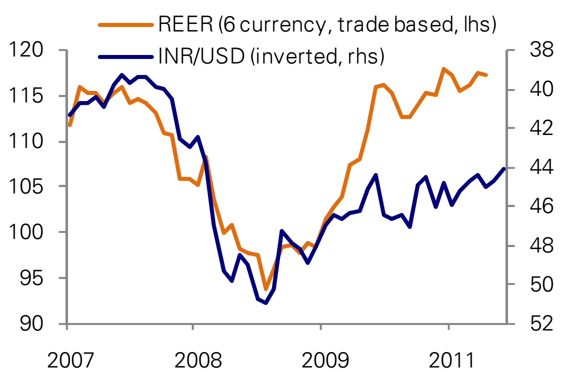

*Source: CEIC, Budget documents, Deutsche Bank*

**However, debt sustainability is not a big issue as long as economic growth remains robust**



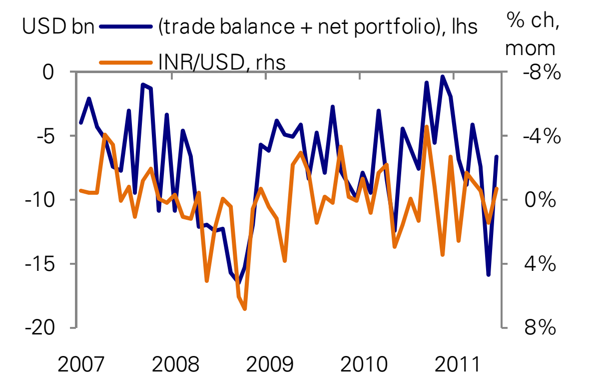

*Source: CEIC, Budget documents, Deutsche Bank Combined Central and State level debt. Interest rate shock entails real interest rate on public debt rising to 3%. Growth shock entails real GDP growing by 6.7%. Combined shock scenario consists of a rise in real interest rate, a slowing of real growth, and a worsening of the primary balance by ¼ standard deviation each.*

**The rupee has appreciated more in real terms than nominal terms owing to high inflation**



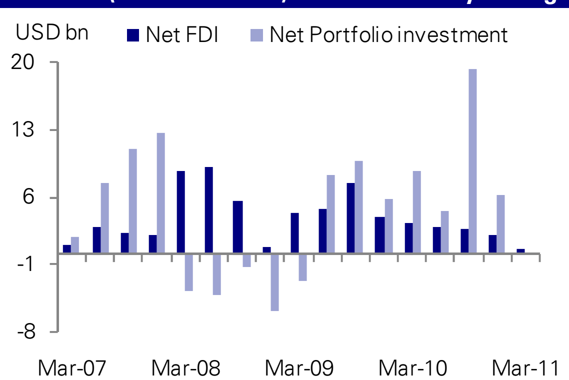

*Source: CEIC, RBI, Deutsche Bank*

**Rupee's movement is closely interlinked with the sum of trade deficit and net portfolio flows**



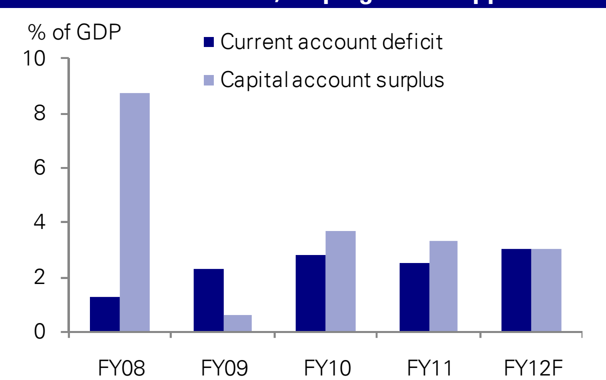

*Source: CEIC, RBI, Deutsche Bank*

**Barring a risk aversion led FII outflows in 2008, foreign investments (FDI + Portfolio) have been fairly strong**




*Source: CEIC, RBI, Deutsche Bank*

**Capital account surplus will be just enough to finance the current account deficit, helping INR to appreciate**




*Source: CEIC, RBI, Deutsche Bank*

# Appendix 1

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