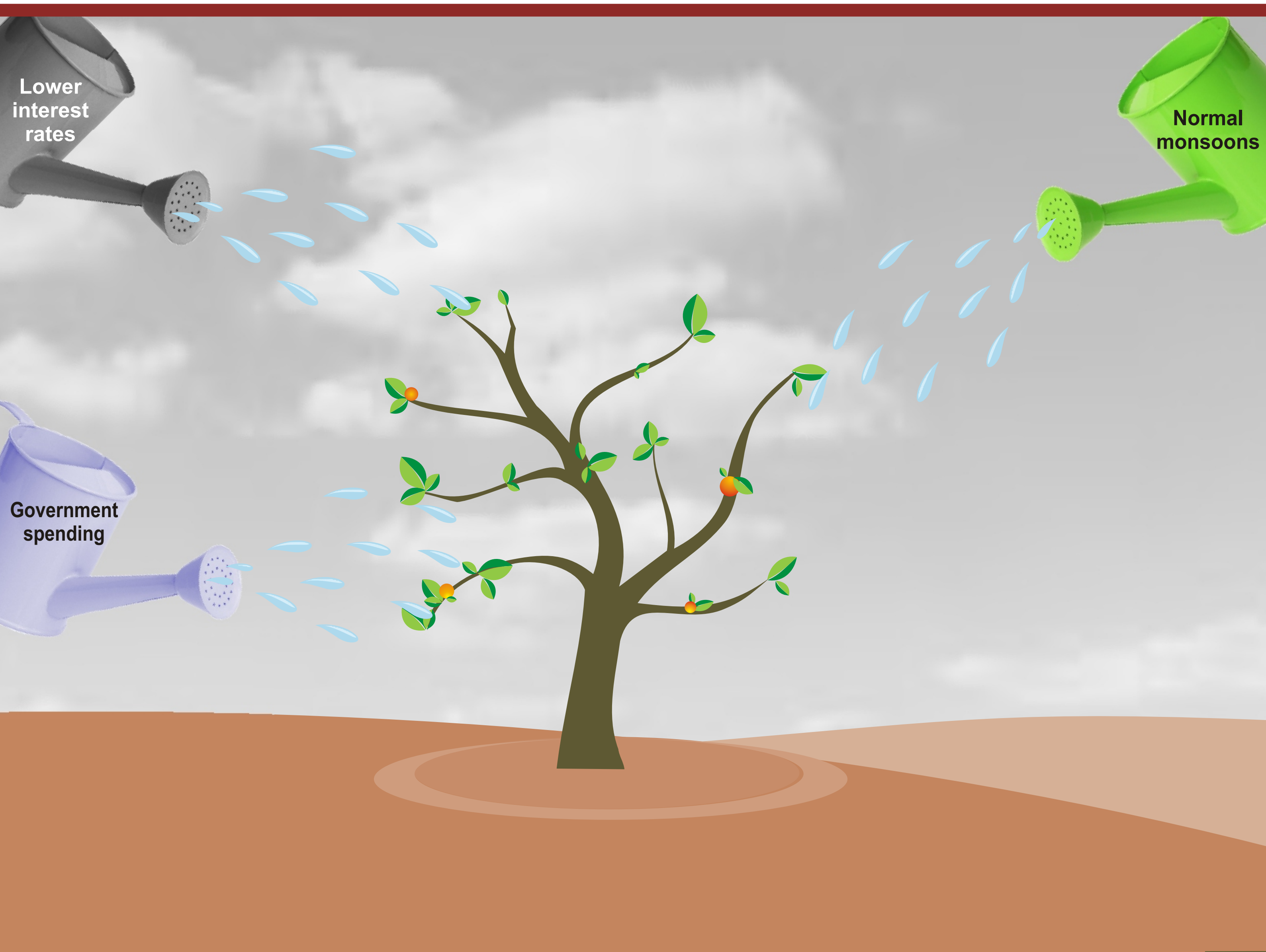
January 2013

CRISIL Insight



India to see a consumption-led recovery in 2013-14

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CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

About CRISIL Research

CRISIL Research is India's largest independent and integrated research house. We provide insights, opinions, and analysis on the Indian economy, industries, capital markets and companies. We are India's most credible provider of economy and industry research. Our industry research covers 70 sectors and is known for its rich insights and perspectives. Our analysis is supported by inputs from our network of more than 4,500 primary sources, including industry experts, industry associations, and trade channels. We play a key role in India's fixed income markets. We are India's largest provider of valuations of fixed income securities, serving the mutual fund, insurance, and banking industries. We are the sole provider of debt and hybrid indices to India's mutual fund and life insurance industries. We pioneered independent equity research in India, and are today India's largest independent equity research house. Our defining trait is the ability to convert information and data into expert judgements and forecasts with complete objectivity. We leverage our deep understanding of the macroeconomy and our extensive sector coverage to provide unique insights on micro-macro and cross-sectoral linkages. We deliver our research through an innovative web-based research platform. Our talent pool comprises economists, sector experts, company analysts, and information management specialists.

India to see a consumption-led recovery in 2013-14

Improved agriculture, lower interest rates and higher government expenditure to revive growth

- GDP growth to lift to 6.7 per cent and WPI inflation to moderate to 7 percent in 2013-14
- Improved agriculture to account for 60 per cent of the pick-up in GDP growth in 2013-14, under the assumption of normal monsoon.
- Higher agricultural incomes, lower interest rates and higher government expenditure to raise private consumption growth and improve capital utilisation in the economy.

Summary

With advanced economies expected to record only a slight improvement in growth and depleted domestic investment pipeline, India's GDP growth in 2013-14 will be dependent on the revival of private consumption growth. The latter would be aided by higher growth in agriculture (assuming normal monsoons), pre-election welfare spending by the government and lower interest rates. Higher private consumption growth will improve capacity utilisation in the economy rather than create new capacities. India's macroeconomic outlook for 2013-14 presented here will be reviewed in early March 2013, after the Union Budget 2013-14 in February-end.

Our base case scenario for India's outlook for 2013-14 is based on the following assumptions for the global economic environment:

1. Growth in the Euro-zone will be almost flat (0.1 per cent) in 2013 (S&P baseline forecast)
2. The United States' economy will grow around 2.2 per cent in 2013 (S&P baseline forecast)
3. International crude oil price (Europe Brent) will average around US$100 per barrel in 2013-14

On the domestic front, we have made the following assumptions:

4. Normal monsoons
5. A 75-100 basis points cut in repo rate from now till March-2014, with rate cuts being front-loaded beginning from the later part of January 2013
6. Pre-election welfare spending, which will boost government expenditure

Table 1: Outlook for key macroeconomic parameters

		2012-13 Forecast	2013-14 Forecast
GDP growth	Agriculture	0.6	3.5
	Industry	3.7	5.4
	Services	7.5	8.0
	Total	**5.5**	**6.7**
Inflation	WPI Average	7.7	7.0
Interest Rate	10-yr G-sec(March-end)	8.1	7.7-7.9
Exchange Rate	Re/US$ (March-end)	53	51-52
Fiscal Deficit	% of GDP	5.8	5.5

Source: CRISIL Research

Revival in agricultural growth will account for around 60 per cent of the pick-up in GDP growth which is expected to reach 6.7 per cent in 2013-14, from 5.5 per cent forecast for 2012-13. This estimate considers the direct impact of normal monsoons on agriculture growth (3.5 per cent in 2013-14) and the positive spillovers of higher agricultural growth to industry and services sectors. The balance increase in growth (40 per cent) could be attributed to other factors, such as higher consumption growth premised on pre-election welfare spending by the government, lower interest rates and a tepid recovery in exports, riding on a marginally improved global outlook. The downside risks to GDP growth would stem from a failure of monsoons in 2013 and deterioration in global economic prospects.

Notwithstanding some progress on the passage of the Land Acquisition Bill, the National Investment Board set up for fast-tracking infrastructure projects and other reform measures likely to be undertaken in 2013, CRISIL Research does not forecast a strong investment upturn in 2013-14. We believe that the investment pipeline has been substantially impaired and will take time to recover. CRISIL Research's survey (July 2012) noted that while, investments by private firms could drop as much as 35 per cent in nominal terms in 2012-13, a number of companies have also shelved and deferred investment projects.

Global Economic Scenario

While global economic prospects for 2013 are fraught with downside risks, most forecasts point towards a marginal recovery in global growth this year. The likelihood of a recession in the Euro zone and the United States (US) in 2013 is now lower. The 'fiscal cliff' in the US has been managed for the time being, through extension of tax cuts on middle-income households and spending cuts deferred for two months. We have assumed 0.1 per cent growth in the Euro zone and 2.2 per cent growth in US in 2013, as per the Standard & Poor's baseline scenario. The slowdown in China appears to have bottomed out.

The European Central Bank's announcement of unlimited support to government borrowings has significantly lowered borrowing costs for Spain and Italy. The banking union across the European Union - atleast in some form - seems to be in the horizon. Fiscal deficits have reduced and in fact, few peripheral countries are now running primary budget surpluses (fiscal deficit, excluding interest payments). These developments have lowered the risk of recession in the Euro zone in 2013. However, a reduction in government spending and structural reforms needed to lower budget deficits and restore competitiveness in periphery countries are expected to continue in 2013. This is likely to lead to near zero growth and keep financial markets volatile in 2013.

In the US, the recent deal on managing the 'fiscal cliff' has postponed spending cuts on domestic and defence programmes for two months, mitigating any immediate risk of a policy-induced recession in 2013. The continuation of Bush-era tax-cuts for middle-income households (having incomes less than US$ 450,000) and extension of unemployment benefits will help the economy to avert a recession. While some spending cuts are likely to be implemented after further negotiations during the year, we expect that the situation will be 'managed'.

Table 2: Global Economic Outlook for 2013

	IMF	World Bank	S&P
World	**3.6**	**2.6**	**-**
United States	**2.1**	**2.4**	**2.2**
Euro Area	**0.2**	**0.7**	**0.1**
China	**8.2**	**8.1**	**8.0**

Source: World Bank (June, October 2012), International Monetary Fund (October 2012), Standard & Poor's (December 2012, January 2013)

India to grow at 6.7 per cent in 2013-14

Uncertain global economic prospects do not bode well for India's exports and will limit external stimulus to its economy. India's growth prospects in 2013-14 will, therefore, be largely shaped by domestic factors.

An improvement in private consumption growth would be critical to revive GDP growth in 2013-14. Higher agriculture income - driven by normal monsoons, pre-election welfare spending by the government and lower interest rates will be key drivers of private consumption in 2013-14. Improvement in growth, driven by higher consumption growth will therefore come from higher capacity utilisation rather than capacity creation. This will help the economy inch closer to its potential growth rate of 7.0 per cent (the Reserve Bank of India's estimate) and narrow the output gap in 2013-14. We do not expect a strong upturn in investment growth in 2013-14 since the investment pipeline has been impaired. New project pipeline will be created in 2013-14 if the private investment climate turns favourable and consumption growth picks up as forecast. Passage of policy reforms such as Land Acquisition Bill and National Investment Board as well as resolution of mining related issues will lead to higher investments and strengthen the growth momentum in the following fiscal (2014-15).

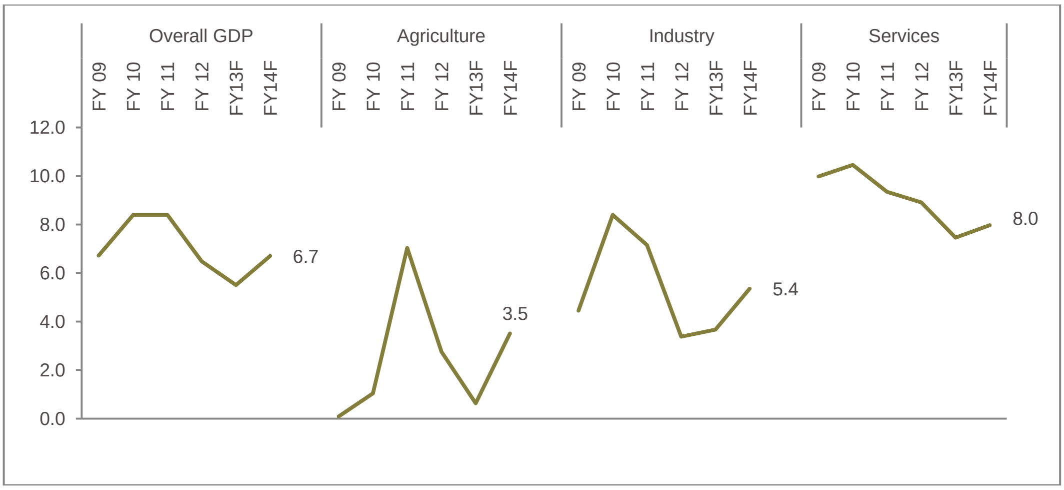
Overall, India's GDP growth should pick-up to 6.7 per cent in 2013-14, from 5.5 per cent projected for 2012-13. Normal monsoons will boost agricultural GDP growth to an above trend rate of 3.5 per cent in 2013-14, also gaining from a lower base in 2012-13. Further, this will have a positive spillover effect on growth in the industry and services sectors. Monsoons (June-September rains) are critical for agricultural growth in India, given that over 50 per cent of the cultivated area is non-irrigated. CRISIL Research forecasts that delayed and non-uniform monsoons in 2012 will lower growth in agricultural GDP growth to 0.6 per cent in 2012-13, compared to an annual trend rate of around 3 per cent.

In 2012-13, the industrial sector has been plagued by a slowdown – both in investment and consumption - driven by a policy logjam. The industry has been particularly hit by disruptions to mining output for most part of the current fiscal. The manufacturing sector has been adversely impacted by declining private consumption, corporate investment as well as export demand. In 2013-14, however, we foresee a revival in industrial growth to 5.4 per cent from 3.2 per cent, in the first half of 2012-13, due to growth in private consumption and modest recovery in exports. However, despite this recovery, the projected industrial growth will still remain below its 20-year average of 6.9 per cent and 10-year average of 7.9 per cent.

Pre-election welfare spending by the government, lower interest rates, moderation in inflation and higher farm incomes (assuming normal monsoons) will boost household spending and thereby, benefit sectors such as consumer durables, automobiles, media and entertainment, community and social services, and financial services. Higher external demand, as a result of marginal recovery of global growth, could also raise India's exports, especially IT/ITeS. Overall, we expect the service sector growth to remain healthy at 8.0 per cent in the next fiscal.

Due to its high current account deficit, India has become increasingly vulnerable to global macroeconomic developments, through trade and financial channels. If the outlook for the Euro zone or the US deteriorates significantly from our base case scenario, it could create downside risks to our GDP growth forecast of 6.7 per cent for 2013-14.

Figure 1: Real GDP growth, Sector-wise, y-o-y (%)



Source: Central Statistical Organization (CSO), CRISIL Research

WPI inflation to ease to 7.0 per cent in 2013-14

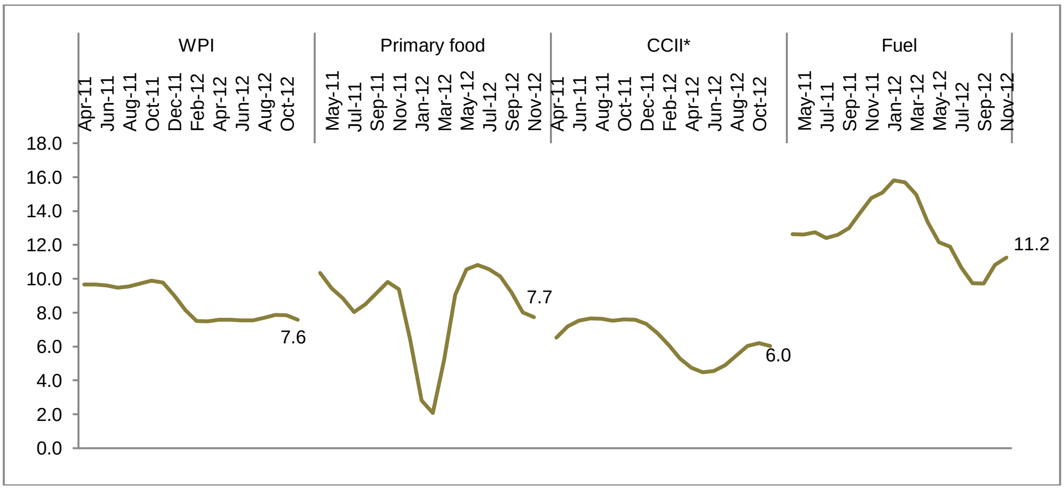
Despite our improved growth outlook, we expect average WPI inflation to be lower at 7.0 per cent in 2013-14, as against 7.7 per cent forecast for 2012-13. Inflationary pressures are expected to ease on the back of normal monsoons, a stronger rupee, lower crude oil prices and continued weakness in demand-side pressures, following a sharp slowdown in GDP growth in 2012-13. However, likely upward revision of administered fuel prices and persistent excess demand for food-articles, would limit the downside to overall WPI inflation.

The lag between GDP growth and core inflation – a measure of demand-side pressures in the economy - has historically been around one year in India. A sharp slowdown in GDP growth to around 5.5 per cent in 2012-13, has limited the pricing power of corporates and should keep average manufacturing inflation under 5.0 per cent in 2013-14. Relative appreciation in the rupee will further lower cost-push pressures on manufacturing inflation, particularly in industries having a high imported component.

While we expect continued pass-through in administered fuel prices, the extent of upward revision could be limited due to political considerations and the impending elections. Despite the pass-through, average overall fuel inflation could be lower as other components of fuel, such as aviation turbine fuel, bitumen, naptha, furnace oil, which are directly linked to international crude oil prices, will see lower inflation. The lower prices of these non-administered fuels will be a result of relative appreciation in the rupee and moderation in global crude oil prices (Europe Brent) to $100 per barrel. The latter would be driven by higher shale gas production in the US, expected removal of sanctions imposed on Iran and significant capacity additions in Iraq, resulting in increased supply.

Upward risks to inflation could emanate from higher-than-expected government spending due to impending elections or a sharp rise in commodity prices resulting from continued monetary easing in advanced economies and higher-than-anticipated oil prices due to geopolitical risks.

Figure 2: Sectoral Inflation, 3-month moving average, y-o-y, %



Note: CCII*CRISIL Core Inflation Indicator- manufacturing inflation excluding base metals inflation

Source: Ministry of Commerce, CRISIL Research

Rupee to settle around 51-52 per US$ by March-end 2014

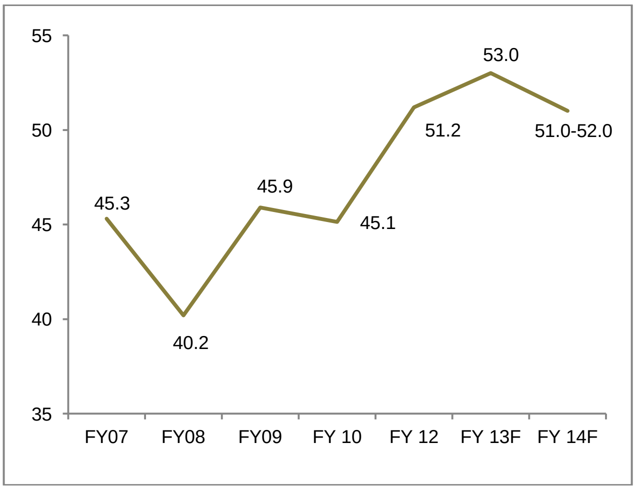
The rupee is expected to settle at around Rs 51-52 per US dollar by March-end 2014, from the current levels of around Rs 55 per US dollar. The exchange rate is determined by the demand for US dollars, as reflected in the current account deficit relative to the supply of US dollars, as mirrored in the foreign capital inflows into the economy. We believe that while capital inflows will remain volatile due to an uncertain global economy, they will nonetheless be sufficient to cover the current account deficit of 3.2 per cent of GDP forecast for 2013-14. As per the latest data, in the second quarter of 2012-13, capital inflows almost matched the high current account deficit of 5.4 per cent of GDP.

With the probability of a recession in the Euro zone in 2013 significantly lowered and the US poised to avert the impending fiscal cliff, we expect capital inflows to remain buoyant in 2013-14. An improved domestic economic situation – higher FDI limits in several sectors, clarifications with regards to GAAR norms, and higher GDP growth in India should boost the inflow of dollars and thus, aid an appreciation of the rupee.

Moreover, external debt repayments, which largely comprise external commercial borrowings, are projected to fall by almost 30 per cent in 2013-14 to US$ 20 billion, further easing downward pressure on the rupee.

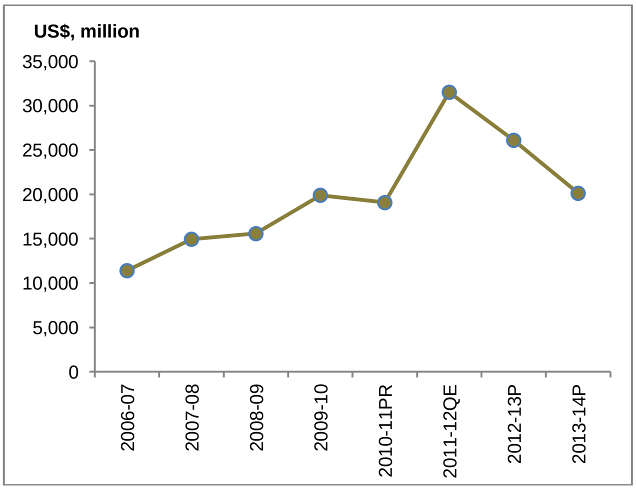
The vulnerability of the rupee to an external shock such as a sudden outflow of portfolio investment, however, continues to remain high. It arises from a relatively high current account deficit, decline in import cover of foreign exchange reserves through 2012-13 (at 6.6 months in Q2 2012-13) and a high external debt servicing burden of the corporate sector. Higher the vulnerability, greater will be the impact on the rupee of a shock -in terms of a sudden outflow of foreign capital arising from an adverse event in the global economy (such as a deeper recession in the Euro zone or an unsuccessful resolution of the fiscal negotiations in the US) and/or ambiguity over domestic reforms and tax-related regulations. Such events may cause the rupee to depreciate to below 52 by March 2014.

Figure 3: Currency movements, Rupee per US$ (March-end)



Source: RBI, CRISIL Research

Figure4: Corporate debt payments, US$ million



Note: PR- partially revised, QE-quick estimates, P: projected, MOF

Source: Ministry of Finance (MOF)

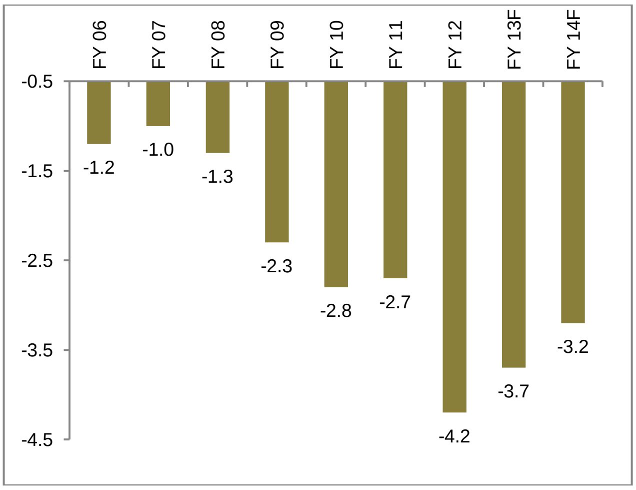
Current account deficit to GDP expected to ease to 3.2 per cent in 2013-14

CRISIL Research expects current account deficit to settle at around 3.2 per cent of GDP in 2013-14. The lower current account deficit as a share of GDP in 2013-14 relative to the current year (4.7 per cent in 1H 2012-13) is premised on lower crude oil prices, which should curb growth in imports. Brent crude oil prices are expected to decline to an average $100 per barrel in 2013-14, from $109.3 per barrel in April-December 2012-13 due to an increase in supply. We expect a marginal recovery in exports in 2013-14, due to an improved economic outlook, mainly for the US.

Despite efforts to lower gold imports by imposing higher import duties, gold imports continue to remain a significant contributor to India's current account deficit. While demand for gold moderated last year, the share of gold in India's overall imports remains unchanged as prices have risen sharply, on account of an uncertain global outlook and quantitative easing in advanced economies. Moreover, recent data from the

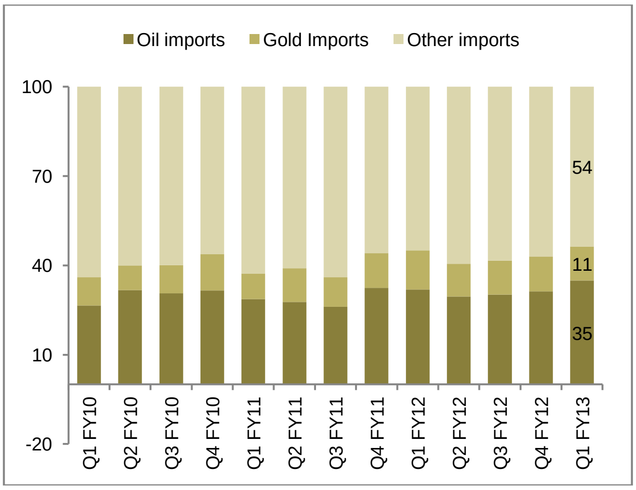
World Gold Council suggests that demand for gold has recovered. Gold imports in Q3 2012-13 were around 9 per cent higher in the volume terms on a y-o-y basis, driven by growth in investments as well as demand for jewellery.

Figure 5: Current account deficit as a percentage of GDP



Source: RBI, CRISIL Research

Figure 6: Share of gold and oil in overall imports



Source: RBI, CRISIL Research

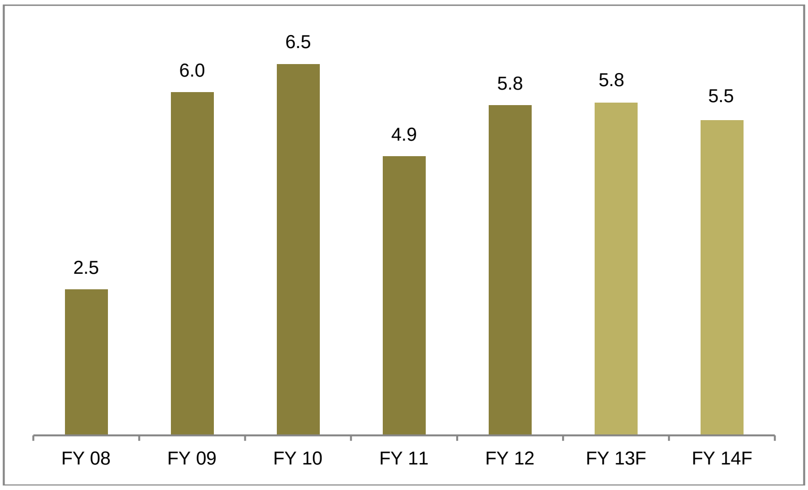
Fiscal deficit to remain high at 5.5 per cent of GDP in 2013-14

CRISIL Research expects fiscal deficit to settle at around 5.5 per cent of the GDP during 2013-14, compared to its forecast of 5.8 per cent for 2012-13. The decline in fiscal burden is based on the assumption that the government would continue to make efforts towards fiscal consolidation.

The government's revenue growth is expected to see some improvement in 2013-14, due to higher GDP growth. The Union Budget, to be presented in February, will provide some clarity on the implementation of the goods and services tax which could augur positively for tax collection. Revenues generated via disinvestment and spectrum sale is largely expected to remain at par with levels seen in the current fiscal. As of December 2012, the total amount raised by means of the 2-G spectrum reallocation was only Rs 94 billion against a targeted Rs 400 billion and the revenue generation via disinvestment was around Rs 70 billion, as against a targeted Rs 300 billion.

On the expenditure side, the subsidy burden is expected to ease slightly, due to lowering of international crude oil prices and further pass through of these prices to domestic consumers. Our fiscal deficit forecast assumes an average crude oil (Europe Brent) price of US$100 per barrel in 2013-14 and an 8-10 per cent pass-through in domestic fuel prices. While the subsidy burden of the government will remain below 2.0 per cent of the GDP (in our fiscal projections), pre-election welfare spending is likely to keep the fiscal deficit high.

Figure 7: Fiscal deficit as a percentage of GDP



Note: F- CRISIL Forecast

Source: Ministry of Finance, CRISIL Research

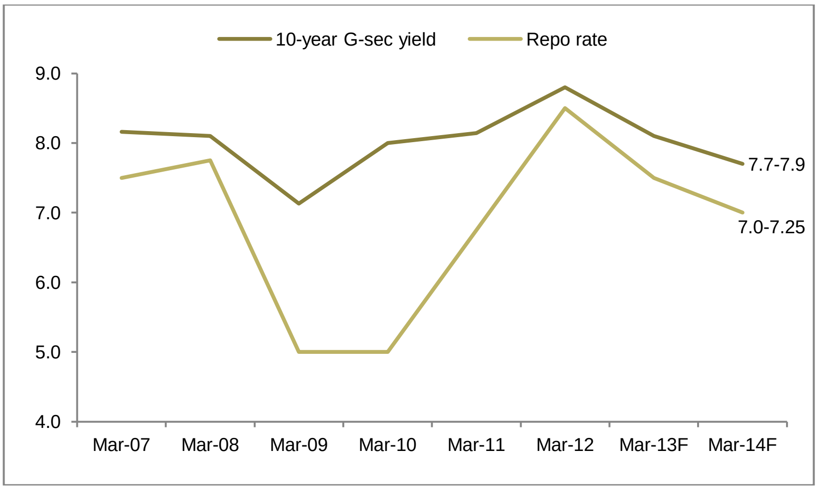
G-sec yields to soften to around 7.7-7.9 per cent by March-end 2014

Inflation now appears to be on a downward trajectory and more importantly, core inflation has shown significant moderation in recent months. Decline in core inflation and the recent momentum on domestic reforms, to improve the investment climate, has created space for monetary policy easing by the RBI. With the Indian economy forecast to grow below potential at 6.7 per cent in 2013-14 and core inflation expected to remain at current low levels, we expect the RBI to shift its focus towards supporting growth and reversing its monetary policy stance in early 2013. We expect a 75-100 basis point cut in repo rate from now until March 2014, with rate cuts being front loaded beginning from the later part of January 2013.

The repo rate forms the floor for G-sec yields in the bond market. Rate cuts from the RBI will lower this floor. While the quantum of government borrowings and credit growth is expected to increase in 2013-14 vis-à-vis the current fiscal, an increase in deposit growth (CRISIL Research forecasts deposits to grow by 17-19 per cent in 2013-14, compared to an expected 14.5 per cent growth in 2012-13) and lower inflationary expectations, are likely to cap the upward pressure on the G-sec yields. In addition, RBI's liquidity management through open market operations would keep the liquidity deficit in the banking sector under control. We therefore expect the yield on the benchmark 10-year G-Sec to soften to around 7.7-7.9 per cent by March-end 2014.

An unforeseen rise in global commodity prices could pose an upside risk to the above forecast, as it would increase the government's subsidy burden and thereby, raise its borrowing requirements.

Figure 8: Yield on the 10-year government security and repo rate (March-end) (%)



Note: F- CRISIL Forecast

Source: Ministry of Finance, CRISIL Research

CRISIL Research's macroeconomic forecasts set out here are based on our view of the domestic and global factors that shape up macroeconomic outcomes. However, we do recognize that our outlook on India's macroeconomic variables are strongly linked and dependent on our assumptions and can pan out differently, if these assumptions do not turn out to be true. Our macroeconomic outlook for 2013-14 presented here will be reviewed in early March 2013, after the Union Budget 2013-14.

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