CRISIL RESEARCH

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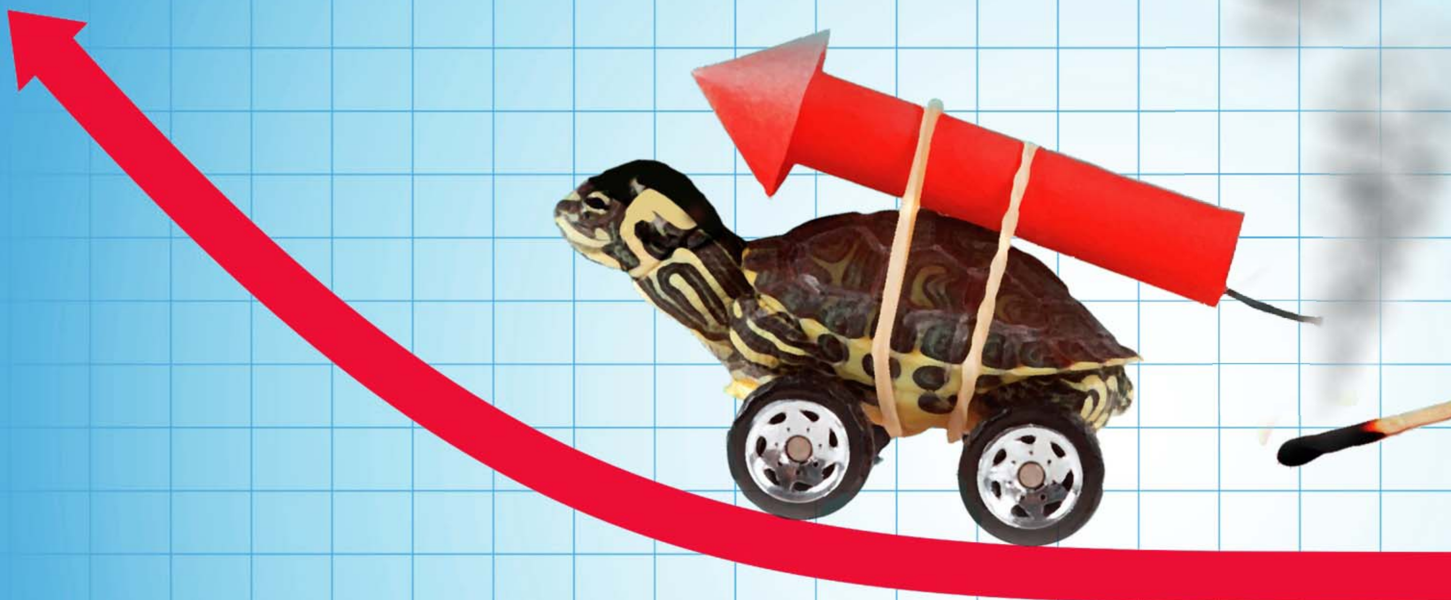

No fireworks in 2014-15

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CRISIL RESEARCH

India Economic Forecast

No fireworks in 2014-15

Monetary, fiscal policies can do little to boost growth, launching stalled projects critical

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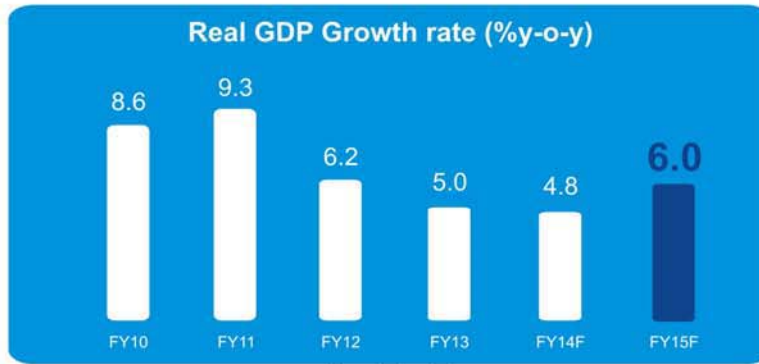
CRISIL forecasts a 6% GDP growth for 2014-15
compared with an expected 4.8% for 2013-14.

The forecast is premised on normal monsoons,
continuation of the recent reform process
and widely anticipated global recovery.

On the downside
growth could weigh in below 5%
yet again if the above assumptions do not play out.

2014-15: A year of fragile recovery

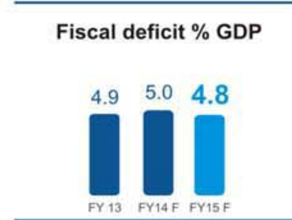
Continuation of the recent reform process, normal monsoons, and a global recovery will support GDP growth in 2014-15 (FY15)



Overall inflation to moderate as food & fuel inflation decline

Higher import growth due to removal of restrictions on gold imports and improved consumption, to widen CAD

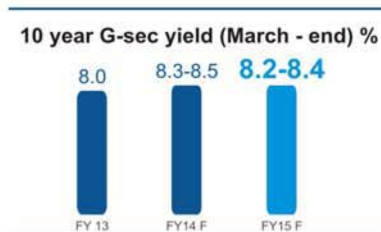
Higher GDP growth will lift tax revenues supporting a lower fiscal deficit (as % of GDP) for FY15



With a higher CAD, attracting sufficient capital inflows will remain a challenge

As inflation stays above the central banks' target, downside to the repo rate will be limited. This will act as a floor for 10 year G-sec yields

Higher level of absolute fiscal deficit will require higher market borrowings, creating upside pressure on 10 year G-Sec yields



Growth will print higher next fiscal

Economic growth is likely to accelerate in the next fiscal as the reform process continues and begins to bear fruit, and the low base of this fiscal and the last lends a halo to the numbers.

We now believe growth will print at 6% for 2014-15, up from our 4.8% estimate for 2013-14.

The pick-up will be aided by implementation of stalled projects, debottlenecking of the mining sector and a recovery in industry on higher external demand.

We also expect some rebound in services growth in 2014-15 led by higher exports as well as a positive rub-off from higher industrial growth.

Finally, we assume a normal monsoon year, which will cushion growth and help in taming inflation.

The table below shows the view from our perch:

Outlook	2012-13*	2013-14 Forecast	2014-15 Forecast
Total GDP (y-o-y %)	**5.0**	**4.8**	**6.0**
Agriculture	1.9	4.5	3.0
Industry	2.1	1.0	4.0
Services	7.1	6.5	7.6

Note: *Provisional actuals

Source: Central Statistical Office, CRISIL Research

The growth forecast is also supported by improved global outlook. Standard and Poor's expects US GDP growth to rise to 2.8% in 2014, up from 1.7% in 2013, while the Eurozone economy is forecast to expand by 0.9% after two years of recession.

However, there is no saying yet whether we have seen the beginning of a decisive, sustainable recovery. On the downside, we feel growth could remain below 5% yet again should risks manifest.

There's reason for hope

The GDP forecast for the next fiscal is driven by a partial unclogging of domestic policy logjam as well as improved global growth prospects. This, together with improved private consumption demand, will trigger a mild revival in industrial growth to 4% in 2014-15. Sectors such as consumer durables, automobiles and textiles will especially gain from this revival.

The mining sector, which has been plagued by policy issues since July 2011, is also forecast to expand for the first time in three years. The mining ban on iron ore in Karnataka and Goa has already been lifted and mining growth will pick up, boosted by a low base and as firms obtain relevant clearances and resume operations. We believe that the recent momentum on resolving mining issues will continue into 2014-15 and will help address supply-side constraints for industries, particularly in the steel and power sectors. The integration of south India into the national power grid will help improve power availability for industries in the region.

Higher industrial growth will also have a positive rub-off on some services sectors such as trade, transport and banking. Higher exports growth, especially by the IT/ITES sector, will provide additional thrust. Overall, we expect the service sector growth to lift to 7.6% in the next fiscal.

Pick-up in consumption from its current lows on the back of moderation in inflation and as a bumper rabi crop harvested in 2014 raises farm income will help begin a recovery.

So why are we cautious?

The upside is limited because, even with an improvement in private investment climate due to the recent policy momentum, the benefits will take time to flow at the ground level because of the long gestation periods involved and a sharp narrowing of project pipelines. In addition, the financial sector is not in a position to aggressively bankroll growth unless significant cleansing of balance sheets (especially infrastructure loans) is undertaken.

The downside risks to our forecast include a failure to debottleneck the economy (clearing stalled projects and boosting mining) and sub-par monsoons and a slippage in global growth from an assumed 3.6% for 2014.

If the RBI accepts the recommendations of the Urjit Patel committee, interest rates are unlikely to come down in 2014-15 even if the RBI removes its current restriction on bank borrowing through the repo window. The Committee has recommended that RBI should bring down CPI inflation to 8% over the next 12 months, and to 6% over the next 24 months before formally adopting the recommended target of 4% inflation with a band of +/- 2%. The Committee has also advocated that the real policy rate should be positive, implying that the repo rate (currently at 7.75%) should be higher than the expected CPI inflation (expected to average around 8.5% in 2014-15). In other words, there is little scope for monetary policy to boost growth in 2014-15.

Any recovery in investments therefore, will be largely driven by clearance of stalled projects.

We do not envision a sharp pick-up in private corporate sector investments in manufacturing during 2014-15 as capacity utilisation rates are very low in most industries. New project pipeline by the private sector can at best, hit the ground only in 2015-16 and that too, will be contingent on a stable policy environment after the elections along with a sustainable recovery in demand – both domestic consumption as well as exports.

If progress on the policy front does not manifest as envisioned, GDP growth could linger around current levels in 2014-15. Therefore, the cost of policy inaction would be very high for the economy.

Elections can be a game changer

Next fiscal could be a year of new leadership and old challenges. The outcome of general elections in May could swing the medium term growth outlook either way. Political uncertainty is, therefore, a huge weight on the economy at this juncture.

A decisive mandate can speed up the resolution of policy bottlenecks (a big drag on India's growth), hasten pending reforms, improve private sector sentiment by sending a strong signal and lay the foundation for India's entry into a phase of healthier growth.

A fragile political outcome, in contrast, could further delay long-pending critical reforms, particularly in agriculture, manufacturing, education and skill development. This will completely dent investment sentiment and derail growth. The cost of a fragile mandate will be high over the medium run as we will not be able to build on the mild upturn in 2014. The resulting 'slow policy action' and uncertainty can trap India in sub-par growth environment over the medium run.

Elections, therefore, will be the most closely watched event of 2014.

However, we believe that policy failure is a low probability risk to our growth outlook as a partial resolution of some of the issues is already underway. Policy reforms could gain further momentum after elections if there is a decisive mandate. Even with a fragile political outcome, we believe that the reforms that are already underway are unlikely to be reversed and will begin to bear fruit in 2014.

Macros to remain a mixed bag

Outlook	2012-13	2013-14 Forecast	2014-15 Forecast
WPI inflation (average, %)	7.3	6.2	6.0
Fiscal deficit (% of GDP)	4.9*	5.0	4.8
10 year G-sec yield (March-end)	8.0	8.3-8.5	8.2-8.4
Current account deficit (% of GDP)	4.8	2.5	3.0
Rs per $ (March-end)	54.5	60	62

Note: * Provisional estimates

Source: Ministry of Commerce & Industry, Ministry of Finance, The Reserve Bank of India, CRISIL Research

Headline inflation to moderate a little

Though the growth outlook for the next fiscal is better than the current one, we expect headline inflation, as measured by the wholesale price index (WPI), to remain marginally lower. WPI inflation is expected to average 6% over the course of the next fiscal.

Over the next fiscal,

i) Food inflation will be low as the positive impact of good monsoon and healthy reservoir levels in 2013 plays out next year. Expected normal monsoons in 2014 will also help keep food inflation low.

ii) Fuel inflation to remain low despite continued pass-through given lower global crude oil prices.

iii) Upside to core inflation is limited due to the lagged impact of slow growth of 2013-14.

During 2014-15, global crude oil prices are expected to average $102 per barrel compared with $108 per barrel in the current fiscal due to higher oil production in Latin America and increasing switch to gas from oil globally which lowers demand for oil. This can bring down fuel inflation.

Upward risks to inflation could emanate from higher spending due to impending elections or a sharp rise in food prices due to monsoon failure and those resulting from oil prices due to geopolitical risks. Though we expect the rupee to be weaker in 2014-15 compared with the current fiscal, weak global commodity prices will help tame imported component of inflation.

The Urjit Patel Committee has suggested CPI inflation as the new nominal anchor for monetary policy. If its recommendations are adopted by the RBI, it will shift its focus on taming retail inflation to 8% over the next 12 months. We currently expect CPI inflation to moderate to 8.5% in 2014-15.

Fiscal deficit to be a concern

Fiscal deficit as a percentage of GDP is forecast at 4.8%, significantly higher than the 4.2% target for 2014-15 envisioned in the government's medium-term fiscal consolidation statement. Although higher GDP growth will lift tax revenues, a significant improvement in tax to GDP ratio in 2014-15 is unlikely unless key reforms such as goods and services tax (GST) are implemented in the first half of the fiscal year – a low probability event at this juncture. The one-time tax surcharge on the high-income bracket implemented in Budget 2013-14 is also expected to be removed next year. While a stable rupee and recent progress toward deregulation of diesel prices could lower fresh accruals on petroleum subsidies in 2014-15, rollover of diesel and fertiliser subsidies from the current fiscal year will limit the downside to overall subsidies. Food Security Bill, if rolled out across several states, could further inflate the subsidy outgo of the government.

Benchmark yields to stay sticky

The 10-year benchmark G-sec (the 8.83% bond due to mature in 2023) is expected to settle at yields of 8.2-8.4% by March-end 2015. The forecast is premised on a complete unwinding of the liquidity tightening measures, latest by the first quarter of 2014-15. Currently, banks can borrow only up to 0.5% of their deposits at the repo rate and any borrowing in excess of this limit must be done at the higher term repo or marginal standing facility rate. An unwinding of this restriction would lower the cost of borrowing for banks and create downward pressure on yields. We also expect the RBI to manage liquidity through open market operations and auctions of longer term (7-, 11- and 14-day) repos as is already being done.

Despite these efforts, the downside to yields will be limited due to halt to a repo rate cut during 2014-15 given that CPI inflation will continue to hover above the 8% mark. Furthermore, government borrowings are expected to rise sharply as (1) fiscal deficit in absolute rupee terms is forecast to be higher in 2014-15 compared with the current fiscal year and (2) a significant portion of the short-term debt issued during the crisis years (2008-09 and 2009-10) will be due for redemption next year. Around Rs 1,680 billion worth of government bonds will be maturing in 2014-15 as compared to only Rs 202 billion in 2013-14 (Public Debt Management, 2012-13). Most of this outstanding debt is likely to be refinanced through longer term borrowing, thereby creating upward pressure on 10-year government bond yields. If the US Fed accelerates

the pace of its tapering or if interest rates in the US rise significantly, it could trigger FII outflows from Indian debt market and create upside risk for our G-sec yield forecast.

Current account gap to widen

In 2014-15, we expect India's external account to begin losing the initial benefits of a sharp correction in current account deficit (CAD), which is likely to expand to about $58billion in 2014-15 – or almost $13 billion more than in this fiscal. At that level, CAD will be about 3.0% of GDP.

In 2013-14, CAD is estimated to have fallen to $45 billion (2.5% of GDP) from $88 billion (4.8% of GDP) in the previous year. An improvement in CAD this year was a result of; (i) the curbs on gold imports, ii) a sharp slowdown in domestic demand pulling down consumption and investment goods' imports, and (iii) a weak rupee and recovery in US benefiting exports.

Despite the sharp reduction in CAD this year, we believe the nature of improvement is unsustainable. Much of the easing is from lower gold imports that is enforced, and from other non-oil imports, which naturally slow with weak domestic demand. As and when the curbs on gold import are gradually removed, import demand is likely escalate once again. Also, as the economy recovers, investment and consumption goods' imports will pick-up. A pick-up in domestic growth is also expected to push oil imports higher due to higher volume demand. This is despite an expected decline in global crude oil prices to $102 per barrel in 2014 from $108 per barrel in 2013.

In 2014-15, a sharp pick-up in world growth and a weak rupee could keep the momentum in overall merchandise and services exports high. However, sectors like petroleum could see some decline in exports. In 2013-14, petroleum exports surged due to commissioning of new refineries which left substantial surplus for exports. In 2014-15, with no new refining capacity expected to be commissioned, and in view of higher domestic demand for petroleum products, exports of these could see lower growth. A fall in global crude oil prices will also weigh on petroleum exports in value terms.

Rupee seen at 62 per US dollar in March 2015

We expect the rupee to settle at 62 against the dollar by March-end 2015 as a higher CAD and an environment of volatile capital inflows to finance it will weaken the rupee in 2014-15.

Several factors will impede capital flows in India and other emerging markets. First, the US economy will see a sharp pick-up in 2014, while the Eurozone will see expansion after 2 years of recession. India's reduced growth differential with the advanced economies especially in the last 3 years -- about 250 bps average between 2012 and 2014 compared with over 600 bps in 2010 and 2011 -- suggests that attracting foreign investment will be a big challenge. Second, a gradual withdrawal of the Federal Reserve's quantitative easing programme will also reduce available global liquidity. And third, with no cushion from non-resident deposits in 2014-15 (the scheme was operational between September and December 2013 and drew $26 billion), foreign capital required to finance the wider CAD will now have to flow in the form of portfolio inflows and foreign direct investment.

In 2013-14 till date (April to November) both net portfolio investment (FII) inflows and net foreign direct investment (FDI) inflows have been much lower at $9 billion compared with $24 billion a year ago. Therefore, despite the correction in CAD, the rupee fell steeply in 2013-14.

A decisive mandate in 2014 general elections will improve sentiments and make it easier to finance CAD. This, in addition to the likelihood of including Indian bonds in the emerging market benchmark indices can attract some investments and create a strengthening bias for the rupee versus the dollar.

Global recovery bets rising

Five years after the financial crisis, the advanced world, particularly the US, is beginning to see signs of economic recovery. This optimism was validated by the US Federal Reserve recently, as it started to taper its monetary stimulus programme based on positive signals from the economy. The IMF forecasts global growth to pick up to 3.6% in 2014 from approximately 2.9% in 2013.

United States

In the US, a resilient private sector pushed growth up in 2013. The economy is on a solid footing and political uncertainty has abated with the 2-year budget framework agreement in December 2013. Factors that will drive US growth in 2014: i) A reviving job market boosting household incomes, ii) expanding energy production, iii) increase in manufacturing activity, iv) better conditions for US exports and v) a rebounding housing market.

Eurozone

The Eurozone climbed out of recession in the second half of 2013. Recovery is on the cards, albeit at a slow pace, in 2014. The core countries are all expected to log growth, led by Germany. The European Commission estimates that the negative impact of fiscal austerity on growth will come down from 0.75% in 2013 to 0.2% of Eurozone GDP in 2014. Weak private sector growth and high unemployment will, however, continue to limit recovery. In addition, decelerating inflation poses a deflation risk for the region, requiring further corrective measures.

Asia

In Asia, two risks that haunted the region in 2013 will narrow this year, namely, a hard landing in Chinese growth and outflow of capital due to Fed tapering. Overall growth will be slightly better in 2014 as global economic recovery picks up pace. This will benefit the Asian Tiger economies the most as global trade improves (Korea, Hong Kong, Singapore, and Taiwan). In China, growth is expected to remain on its current path 7–7.5% (S&P).

Global Economic Outlook for 2014

	IMF		World Bank		S&P	
y-o-y (%)	2013	2014	2013	2014	2013	2014
World	3.0	3.7	2.4	3.2	2.6	3.5
US	1.9	2.8	1.8	2.8	1.7	2.8
EMU	-0.4	1.0	-0.4	1.1	-0.7	0.9
UK	1.7	2.4	-	-	-0.7	2.3

Source: IMF, World Bank, S&P, CRISIL Research

Analytical Contacts:

Dharmakirti Joshi
Chief Economist

Vidya Mahambare
Principal Economist

Dipti Deshpande
Economist

Neha Duggar Saraf
Junior Economist

Sakshi Gupta
Junior Economist

Anuj Agarwal
Economic Analyst

Media Contacts:

Manasi Apte
Manager, Communications and Brand Management
Email: manasi.apte@crisil.com
Phone: +91 22 334 21812

Jyoti Parmar
Communications and Brand Management
Email: jyoti.parmar@crisil.com
Phone: +91 22 334 21835

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Our Offices

Ahmedabad
706, Venus Atlantis
Nr. Reliance Petrol Pump
Prahladnagar, Ahmedabad - 380015, India
Phone: +91 79 4024 4500
Fax: +91 79 2755 9863

Bengaluru
W-101, Sunrise Chambers
22, Ulsoor Road
Bengaluru - 560 042, India
Phone: +91 80 2558 0899
+91 80 2559 4802
Fax: +91 80 2559 4801

Chennai
Thapar House
43/44, Montieth Road, Egmore
Chennai - 600 008, India
Phone: +91 44 2854 6205/06
+91 44 2854 6093
Fax: +91 44 2854 7531

Gurgaon
Plot No. 46
Sector 44
Opp. PF Office
Gurgaon - 122 003, India
Phone: +91 124 6722 000

Hyderabad
3rd Floor, Uma Chambers
Plot No. 9&10, Nagarjuna Hills
(Near Punjagutta Cross Road)
Hyderabad - 500 482, India
Phone: +91 40 2335 8103/05
Fax: +91 40 2335 7507

Kolkata
Horizon, Block 'B', 4th Floor
57 Chowringhee Road
Kolkata - 700 071, India
Phone: +91 33 2289 1949/50
Fax: +91 33 2283 0597

Pune
1187/17, Ghole Road
Shivaji Nagar
Pune - 411 005, India
Phone: +91 20 2553 9064/67
Fax: +91 20 4018 1930

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CRISIL Limited
CRISIL House, Central Avenue
Hiranandani Business Park, Powai, Mumbai - 400 076. India
Phone: +91 22 3342 3000 | Fax: +91 22 3342 8088
www.crisil.com

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