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India Business Forecast Report Q3 2014

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Abstracts

Core Views

There remains a high degree of uncertainty over the end results, due to increased factors driving a fragmentation of the vote, in India's lower house elections being from April 7 to May 12. We maintain our expectations for the opposition (and more market-friendly) Bharatiya Janata Party (BJP) to lead the next coalition government. Fuelled by the disappointment rule of the United Progressive Alliance (UPA)'s second term in office, this had initially had significant realisation potential. However, since the impressive vote win in the state of Delhi, the BJP now faces threats from both its old adversaries such as the Indian National Congress, as well as new competition from up and coming parties such as the Aam Adani Party (AAP).

India's painful process of external rebalancing is almost complete, and this will set the stage for an economic growth revival in FY2014/15 (April-March). The pace of recovery will depend on the timing of monetary easing, as well as a decisive and business-friendly outcome to the 2014 general elections. We are optimistic on both these fronts and expect investment activity to pick up materially over the course of the year. Our constructive outlook is reflected in our 2014 real GDP growth forecast of 5.6%, which sits above consensus expectations of 5.4%.

Although headline inflation has eased somewhat in India, it remains at elevated levels, amongst the highest in the region. Acute food price pressures, as supplies often constrained by logistical inefficiencies and prices, further boosted by minimum support levels dictated by the government, lie at the heart of the problem. Expansionary government policy further exacerbates these pressures. Short of a major reduction in subsidies and minimum support prices for agricultural goods, both of which are unlikely even post-election, there is a risk that the Reserve Bank of India (RBI) may be forced to keep interest rates tight for longer in FY2014/15.

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The Indian rupee remains one of our favourite currencies in the region currently. We expect the unit to average INR58.00/USD in 2014, roughly 6.3% above the current spot of INR61.90/USD, as external risks recede and investors turn their attention to the significant value on offer. Bolstering our case is India's increasingly constructive macroeconomic outlook, which should see the economy embark on a growth recovery in the second half of the calendar year.

Major Forecast Changes

We have pushed back our interest rate expectations for India. We now expect the RBI to remain on hold for the rest of FY2013/14, before delivering monetary easing worth 25bps in the second half of the following fiscal year.

Owing to the possibility of that the RBI will roll back its current restrictions on gold imports, we have pared back our expectations for the pace at which India narrows its current account deficit.

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We note that the present response from 11 minority political parties in India to create a political alternative, known as the 'Third Front', could marginally erode the advantage of leading opposition Bharatiya Janata Party (BJP). However, we maintain our view that the BJP will muster the largest number of seats and form the next government (with the help of coalition partners).

While India's 60-year-old democracy has withstood the test of poverty, the coming decade will show whether it can withstand the test of rising prosperity. Against a backdrop of economic growth, India's government will need to work even harder to combat poverty and inequality; invest in education and infrastructure; and clamp down on corruption in order to satisfy an increasingly cognisant electorate. Meanwhile, icy relations with neighbouring Pakistan and growing competition with China will continue to dominate India's international agenda.

We have revised down our forecasts for India's real GDP growth for FY2013/14 to come in at 4.4%, on the back of a weak GDP print for the October to December quarter of 4.7% y-o-y. This downgrade was, in part, due to significant downward revisions made to Q1FY2013/14 data, but also reflects our dim outlook for capital investment.

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Table: ECONOMIC ACTIVITY

Fiscal Policy

Political Costs, Structural Deficiencies Limit Upside For Fiscal Accounts

Despite our projection for India's GDP growth to improve in FY2014/15, we believe that the government will struggle to implement fiscal reforms, which will limit the upside for the country's fiscal accounts. This is due to the high political costs to roll back expensive income support and subsidy programmes, as well as the lack of infrastructure to improve tax collection.

Table: FISCAL POLICY

Monretary Policy

Hawkish And Reform-Centric RBI Less Likely To Cut Rates

We have pared back our dovish expectations on Indian interest rates, forecasting the RBI to cut its policy rate by 25bps by end-FY2014/15 (April-May) compared to our previous projections of 50bps. In addition to a pick-up in new orders that could provide a temporary boost to economic activity, the RBI maintains a hawkish stance on rates despite easing inflationary pressures. Moreover, we note that reforms to improve the transmission mechanism of monetary policy currently underway should improve the effectiveness of future rate cuts.

Table: MONETARY POLICY

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Removal Of Gold Curbs To Widen Current Account Deficit

We believe that the current restrictions on gold imports will be partially rolled back by H1FY2014/15 (April-March), although the elevated import tariffs are likely to remain unchanged. This will likely lead to a resurgence in gold imports, which we expect to result in the widening of the current account deficit in FY2014/15 to 3.7% of GDP versus a projection 3.4% of GDP for the current fiscal year.

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Improving demographics, structural reforms and trade liberalisation in India during the 1990s set the stage for an explosion in the country's domestic savings rate, which, in turn, ignited economic growth in the 2000s. Going forward, favourable demographics and trade integration should remain strong tailwinds. However, should India's reform momentum continue to disappoint, the country could struggle to generate sufficient savings growth to finance its investment needs, with headline economic growth suffering as a result. With this in mind, we are happy to maintain a sanguine, if cautious,

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