



Outlook for the Indian Economy worsens

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Key Expectations

- ICRA expects the pace of growth of the Indian economy to have declined to 7% in Q2FY12 from 7.7% in Q1FY12, led by an easing of manufacturing growth, contraction in mining & quarrying output and a mild moderation in the pace of growth of the services sector.
- In light of the dampening business sentiments, sluggish domestic industrial growth in Q2FY11, intensifying macroeconomic headwinds, and the likelihood of lower monthly merchandise exports in H2FY12, ICRA has revised its forecast for the pace of GDP growth in FY12 to 7.3-7.5% from the earlier expectations of a 7.5-7.7% expansion.
- While the execution of ongoing projects and healthy order books may support growth in the current year, investment growth is likely to moderate substantially in FY13 unless policy issues are addressed and there is a substantial pick up in the pace of implementation of big ticket economic reforms.
- ICRA expects headline inflation related to the wholesale price index (WPI) is likely to have peaked and would decline to around 7.0% by March 2012, unless commodity prices increase sharply in the coming months. However, a further depreciation of the Indian rupee beyond current levels would exacerbate inflationary pressures.
- Given the anticipated moderation in growth of tax revenues; low likelihood that Government of India (GoI) would meet its disinvestment target; and the additional expenditure proposed under the two Supplementary Demands for Grants, ICRA expects the fiscal deficit for FY12 to worsen to around 5.5% of GDP. However, if further compensation is provided to the Oil Marketing Companies (OMCs) for under-recoveries incurred in H2FY12, ICRA expects the fiscal deficit may rise to as high as 5.8% of GDP in FY12.
- The anticipated rise in the fiscal deficit relative to the budgeted levels suggests that GoI may need to further revise its target for market borrowings for H2FY12. In light of the tight systemic liquidity situation since the second week of November 2011, ICRA expects the Reserve Bank of India (RBI) to announce further open market purchases of Government securities (G-sec) of around Rs. 50,000-60,000 crore in H2FY12 to infuse systemic liquidity and ensure availability of funds for economic growth.
- Despite the moderating economic growth and anticipated easing of headline inflation, ICRA expects the Central Bank to keep the repo rate unchanged until at least April 2012, in order to signal its intention to contain inflation, unless there is a substantial external shock or credit event.

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Growth Outlook: Growth impulses and business sentiments have weakened in India in the recent months on account of a host of factors. Regulatory issues related to environmental clearances and land acquisition have dented business confidence and a marked slowdown in announcements of fresh projects and capacity enhancement has taken place. Considerable monetary tightening to combat the sustained high inflation has resulted in a substantial hardening of interest rates. This has dampened consumer demand and affected the viability of infrastructure and other projects. Although fiscal policy remains expansionary, higher outgo towards items such as subsidies (particularly towards fuel) and salaries (reflecting enhanced rates of dearness allowance), limit the fiscal space available for boosting infrastructure spending to support investment growth. While the execution of ongoing projects and healthy order books may support growth in the current year, investment growth is likely to moderate substantially in FY13, unless policy issues are addressed and there is a substantial pick up in the pace of implementation of big ticket economic reforms. The services sector is expected to continue to support economic growth in the ongoing fiscal year, although the pace of growth may ease somewhat over the course of the current fiscal year, in line with the moderate outlook for industrial growth. A favourable monsoon rainfall is likely to boost agricultural output in FY12; nevertheless the pace of growth is likely to be moderate given the high base effect.

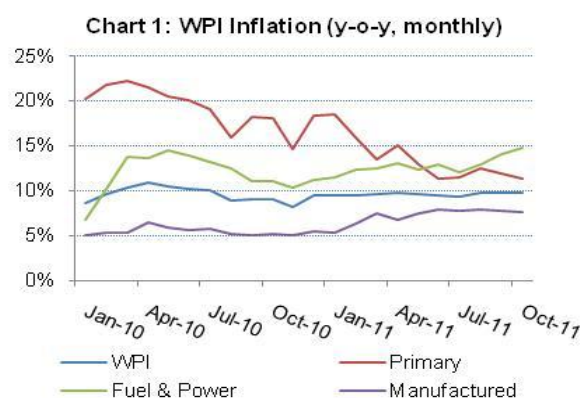
Moreover, the global economic environment remains bleak owing to the deepening sovereign debt crisis in Europe, it's uncertain impact on global trade and financial flows, and lack of clarity regarding when a stable solution will emerge. Heightened risk aversion, flight to assets perceived to be safe and a structural merchandise trade deficit characterised by substantial oil imports have aided the recent sharp depreciation of the Indian rupee relative to major currencies including the US dollar, Euro etc. While the depreciation of the Indian rupee may help maintain the competitiveness of Indian merchandise exports, demand for the same is likely to suffer in light of the uncertain growth outlook for the Advanced Economies, which continue to account for a substantial share on Indian exports.

ICRA expects the pace of growth of the Indian economy to have declined to 7% in Q2FY12 from 7.7% in Q1FY12, led by an easing of manufacturing growth, contraction in mining & quarrying output and a mild moderation in the pace of growth of the services sector. In light of the dampening business sentiments, sluggish domestic industrial growth in Q2FY11, intensifying macroeconomic headwinds, and the likelihood of lower monthly merchandise exports in H2FY12, ICRA has revised its forecast for the pace of GDP growth in FY12 to 7.3-7.5% from the earlier expectations of a 7.5-7.7% expansion

Constant 2004-05 prices	FY12
Agriculture	3.4%
Industry	4.4%
Services	9.8%
GDP	7.3-7.5%

Source: ICRA Estimates

Inflation and Policy Rates: Headline WPI inflation continues to remain elevated, at 9.7-9.8% in the months between August-October 2011. WPI inflation excluding fuel and food items declined to 8.3% in October 2011 from 9.0% in September 2011, benefiting from the sharp decline in inflation relating to non food primary articles. Inflation related to non food manufactured products rose mildly to 7.63% in October 2011 from 7.55% in September 2011 on a year-on year basis while eight of the 11 sub-groups of non-food manufactured products displayed a rise in a month-on-month terms in October 2011, partly reflecting the impact of the depreciation of the India rupee on prices of imported inputs.



ICRA expects WPI inflation is likely to have peaked and would decline to around 7.0% by March 2012, unless commodity prices increase sharply in the coming months. Nevertheless, a further depreciation in the Indian rupee may exacerbate inflationary pressures.

Notwithstanding the moderating economic growth and anticipated easing of headline inflation, ICRA expects the Central Bank to keep the repo rate unchanged until at least April 2012, in order to signal its intention to contain inflation, unless there is a substantial external shock or credit event.

Fiscal Situation: Data released by the Controller General of Accounts (CGA) indicates that Gol's tax collections¹ expanded by 14% in H1FY12, slower than the 18% growth forecast by Gol's Budget Estimates for 2011-12². While the latter was based on an assumption of 9% real economic growth, ICRA expects the Indian economy to expand at a substantially slower pace of around 7.3-7.5% in FY12. Moreover, elevated input prices, higher interest rates and a depreciating rupee are likely to compress the margins of producers. Accordingly, collections of excise duty and corporation tax are likely to display a moderate growth in H2FY12. Lower growth of non-oil imports in the coming months in addition to the revenue loss (annual impact estimated by Gol at Rs. 49,000 crore) related to the changes in the duty structure for crude oil and petroleum products introduced by Gol in June 2011 are expected to dampen the pace of growth of customs duty collections in FY12. Additionally, prevailing market conditions suggest that Gol may fall considerably short of its disinvestment target of Rs. 40,000 crore in the current fiscal.

At the same time, Gol's expenditure is likely to exceed the Budget Estimates for 2011-12. As compared to the 5% growth of total expenditure forecast by Gol's Budget Estimates for 2011-12², data released by the CGA indicates an 11% growth of total expenditure in H1FY12. So far, Gol has laid two Supplementary Demands for Grants before the Parliament in 2011-12. The First Supplementary (August 2011) involves a net cash outgo of Rs. 9,016; however, Gol indicated that this would be offset through savings related to other expenditure. The Second Supplementary (November 2011) entails an additional net cash outgo of Rs. 56,848 crore, dominated by additional subsidies towards fuel (Rs. 30,000 crore), fertiliser (Rs. 13,779 crore) and food (Rs. 2,298 crore).

Data published by the Central Bank reveals that the Central Government has so far accessed ways and means advances (WMA) from the RBI in 29 weeks in 2011-12. This stands in contrast to the pattern in 2009-10 and 2010-11, when Gol accessed WMA only in the first quarter, for 10 weeks and 8 weeks, respectively. This trend indicates amplified liquidity mismatches in the current fiscal year.

Overall, the fiscal deficit in H1FY12 reached 68% of the Budget Estimates for the year, which pegged the deficit at 4.6% of GDP. Given the anticipated moderation in growth of tax revenues; low likelihood that Gol would meet its disinvestment target; and the additional expenditure proposed under the two Supplementary Demands for Grants, ICRA expects the fiscal deficit for FY12 to worsen to around 5.5% of GDP. However, ICRA expects the compensation to be provided to the OMCs for their likely under-recoveries in H2FY12 to overshoot the Budget and Supplementary estimates for fuel subsidies, which may result in the fiscal deficit rising to 5.8% of GDP in FY12. An early rollout of the entitlements under the National Food Security Act may exert further pressure on the fiscal deficit.

Gol's Borrowing Requirement: Primarily reflecting the shortfall in receipts from the National Small Savings Fund (NSSF) in the current fiscal year, Gol's market borrowing programme for H2FY12 was enhanced by nearly Rs. 53,000 crore. The recent decision to increase the rate of interest under some small savings schemes may enhance the attractiveness of the same while the reduction in the minimum share of the State Governments in net small savings collections in a year, to 50% from 80%, may result in higher financing being available to Gol from this source. Nevertheless, the anticipated rise in the fiscal deficit relative to the budgeted levels suggests that Gol may need to further revise its target for market borrowings for H2FY12. This would exert upward pressure on yields and strain the liquidity situation.

Amidst rising yields, a portion of the borrowings have devolved on the primary dealers in six of the seven auctions held since October 2011, which has emerged as an area of concern. The systemic liquidity deficit under the Liquidity Adjustment Facility (LAF) has averaged over Rs. 94,000 crore and exceeded Rs. 1 lakh crore on nine occasions in November 2011, substantially in excess of the RBI's stated comfort zone of +/-1% of net demand and time liabilities (NDTL). In November 2011, against an announced purchase of Rs. 10,000 crore of G-sec, the RBI bought Rs. 9,435.5 crore to ease the liquidity situation. ICRA expects the RBI to announce further open market purchases of G-sec of around Rs. 50,000-60,000 crore in H2FY12 to infuse systemic liquidity and ensure availability of funds for economic growth. At the same time, ICRA expects the RBI to keep the repo rate unchanged in order to signal its intention to contain inflation.

Budget Estimates	417,128
Announced Borrowings	470,000
Borrowings Completed so far	341,000
Devolvement in H1FY12	2,232
Devolvement in H2FY12	8,706

Source: RBI, ICRA Estimates

¹ Gross of devolution to States

² Relative to the Provisional Accounts for 2010-11



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