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Date: 9/10/2014 11:04:58 AM
Subject: Fwd: EM Macro Daily - India: A positive start by the Modi government; removing our forecast for an RBI rate hike

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Goldman Sachs Global Macro Research

Emerging Markets : EM Macro Daily - India: A positive start by the Modi government; removing our forecast for an RBI rate hike

by Tushar Poddar
Published September 9, 2014

Bottom line: We assess the state of the economy and the reform measures undertaken by the Modi government, after 100 days in office. The biggest change under the new government, in our view, has been its more business- and investor-friendly mindset. The government has focused on three areas – boosting the investment climate, energising the bureaucracy, and emphasising manufacturing and infrastructure. We list the key reforms introduced. While we would have liked to see more progress on fiscal, land and energy reforms, these would require broader political support, and the participation of state governments. We expect growth momentum to improve gradually driven by investment and export demand. We continue to expect GDP growth to rise to 5.6% in FY2015 and to an above-consensus 6.5% in FY2016. Near-term risks to inflation have receded due to weaker oil prices and a significantly improved monsoon. We are therefore taking out our rate hike forecast for the remainder of the year. We also remove our rate cut forecast for H2 2015. We now expect the policy repo rate to stay at 8% for a protracted period of time – through 2014 and 2015. We continue to expect the INR to gain from capital inflows, with our 3-, 6- and 12-month USD/INR forecasts at 61, 62 and 63 respectively, well below the forwards. Our Equity Strategists remain overweight on Indian equities, with a 12-month Nifty target of 9000.

The first 100 days

The Modi government completed 100 days in office on September 2. Thus far, the trajectory of the economy and markets has generally been positive, in line with our views. Our base case was for a victory for the [BJP during the elections](#) and asset markets to trade with a positive bias as a result. Since the elections, India has received US\$7bn in equity inflows and US\$12.5bn in debt inflows. The benchmark Nifty is up 14%. Favourable external conditions, especially the continuing search for yield, and soft commodity prices have

been especially helpful in attracting inflows. We now look at the important economic measures that the new government has and has not taken, and at the current state of the economic cycle.

The biggest change under the new government, in our view, has been a more business- and investor-friendly mindset. This is evident in the number of steps taken to remove red tape and inertia, as detailed in Exhibit 1 below. Rather than radical change, we think the government has preferred incremental reform. We find that there is greater co-ordination among ministries, and faster decision-making to resolve economic issues. We identify the three areas that seem to be the focus of the new regime:

- *Boosting the investment climate* – bottlenecks for investment have been removed, especially environment approvals, which were a key hurdle. A number of government approvals have been moved online and made simpler. The labour reform process has begun and onerous procedures for compliance have been reduced.
- *Energising the bureaucracy* – the government has acted to remove the sense of ‘policy paralysis’, whereby decisions were delayed, affecting the investment cycle. A number of bureaucratic layers have been reduced, several ministries merged, unnecessary committees dissolved, and a clear focus on streamlining bureaucracy by making officials more accountable and efficient.
- *Focus on manufacturing and infrastructure* – the government has opened up railways to FDI, increased FDI limits in the defence sector, announced significant tax incentives for manufacturing, and progress is being made on bidding in highway contracts. Japan has announced a potential US\$35bn investment in India over the next five years.

There are areas where we would have liked to see more progress, such as [fiscal](#) reforms (including the GST), [energy reforms](#) (including a resolution of the gas pricing issue), land reforms and a reform of the agricultural economy. While there has been some movement on labour laws both at the state and central level, the government has still not broached the subject of reforming the Industrial Disputes Act, which would make it easier to hire and fire industrial workers.

Moreover, the ability of the government to pass legislation through Parliament has been hampered by the lack of a majority in the Upper House. For example, it was unable to pass legislation through the Upper House to increase FDI limits on insurance. This suggests to us that legislative action on reforms will be difficult. We think that, on the more contentious issues, the government is keen to seek broader political support, introducing reforms through the states, which are responsible for the majority of them.

Exhibit 1: Reforms introduced in the first 100 days

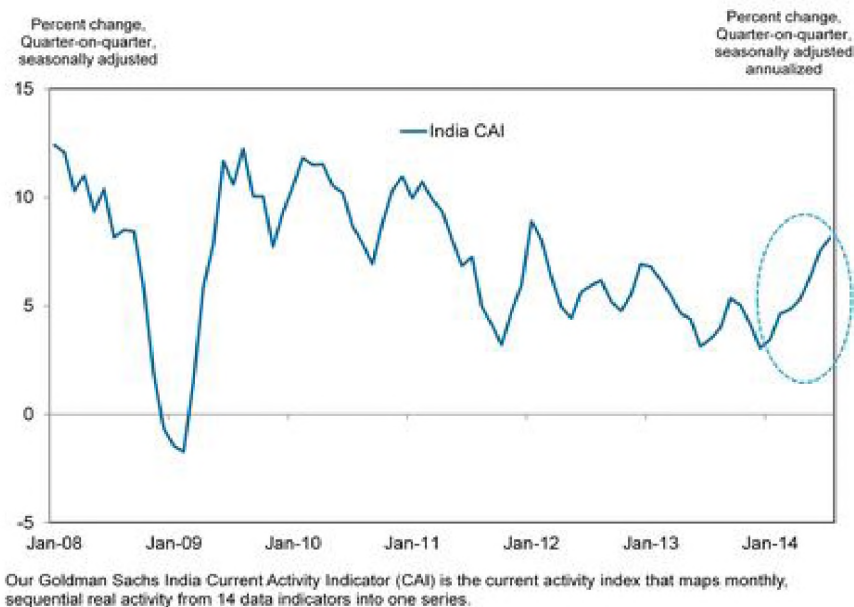
1) Boosting the business climate	
Self-attestation of documents, instead of requiring a legal notary, in all government departments	
Environment and forest approval process online	
Environment ministry eased rules for mining, roads, power and irrigation projects, cleared 30 projects	
E-governance and use of IT to reduce subjectivity in decision making; Digitisation of govt records	
Labour ministry to liberalise inspection for compliance with labour-related laws from September	
Unified portal for employers to file their annual returns and compliance & inspection reports from October	
Factories Bill and Apprentice Bill in Parliament for greater flexibility in working hours/hiring apprentices	
Panel to identify outdated laws that need to be repealed	
2) Energizing the Bureaucracy	
Govt. amended the All India Service (Conduct) Rules which list norms to make bureaucracy more citizen-friendly	
11-point agenda for govt. departments - includes the repeal of unnecessary rules/process, restricting decision-making up to four layers and improving conduct	
Abolished Groups of Ministers (GoM) and Empowered GoM (EGoMs) which were delaying decision-making	
Number of ministries reduced from 79 to 45, several ministries grouped together, such as coal and power	
3) Focus on Manufacturing and Infrastructure	
The project monitoring group to expedite project clearances; 163 projects cleared, worth US\$100bn	
5600 KMs of potential addition to highways in FY15, Target of 30KM per day of highways in next two years	
100% FDI in railway infrastructure; hiked passenger fares to reduce subsidy	
US\$35bn investment from Japan in infrastructure projects for next five years	
Exempted banks from reserve requirements to raise long-term funds for infrastructure lending	
Investment allowance of 15% to a manufacturing company that invests more than US\$4mn in any year	
Increased FDI limit in defence to 49% from 26% for manufacturing of defence equipment	
Others	
Financial inclusion plan to provide bank accounts to 75 million families in 6 months	
Diesel price hike continued	
Still do be done	
Land acquisition	GST
Agricultural Produce Market Committee (APMC) Act	Foods & Fertilizer subsidies
Gas Pricing	49% FDI in insurance

Source: Labour Ministry, Environment Ministry, Union Budget, PRS Legislative Research, Press Information Bureau, Goldman Sachs Global Investment Research

Activity picking up

India's April-June (Q1 FY2015) GDP growth surprised to the upside at 5.7%. The drivers of growth have been a recovery in investment demand, higher government spending and improving export growth. Our Current Activity Indicator (CAI), which includes 14 activity indicators, suggests that current activity accelerated from 4.3% in the March quarter to 6.4% in the June quarter. The recovery has continued in July, with our CAI tracking at 8.0%qoq annualised from 7.5% in June. The majority of components show an improvement, including the PMI, trade, air cargo handled, auto sales and tax revenues. The CAI confirms our view that activity bottomed out in H2 2013 and is picking up in 2014.

Exhibit 2: Our Current Activity Indicator suggests a pick-up in activity



Source: Goldman Sachs Global Investment Research

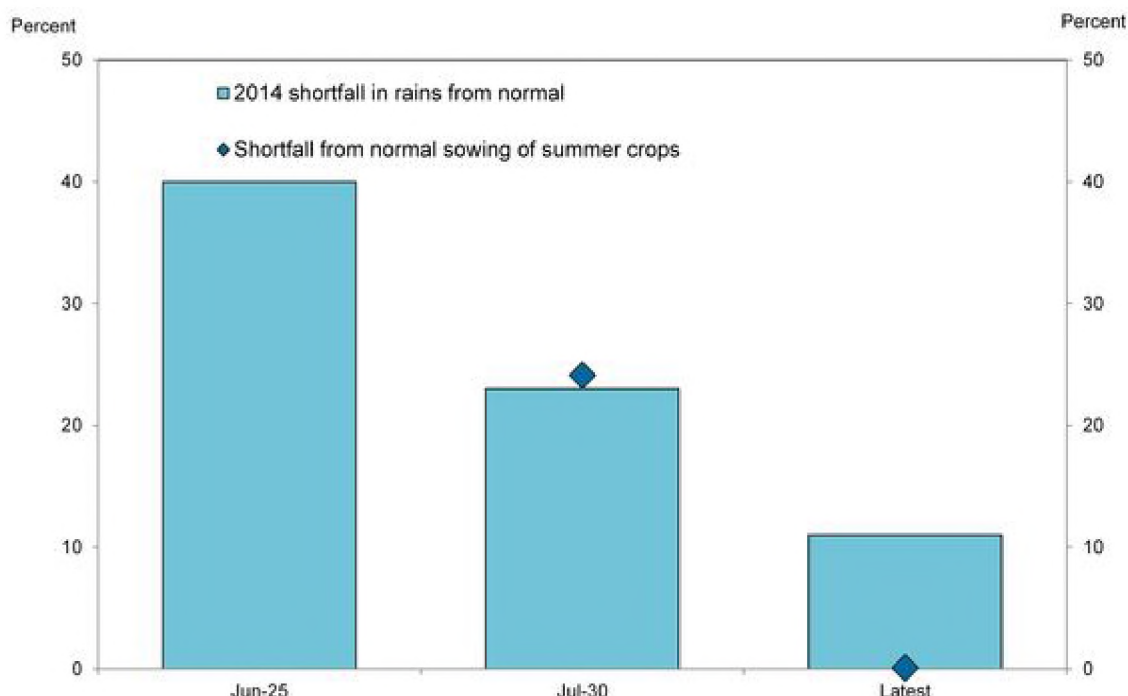
We forecast FY2015 GDP growth at 5.6%, rising from 4.7% in FY2014. While we continue to think the September and December quarters are likely to be softer than the June quarter on a yoy basis, owing to weaker agricultural growth and a pull-back in government spending, the recent improvement in the monsoons and the investment momentum that is now visible suggest upside risks to our FY2015 GDP forecasts.

We continue to expect GDP growth to accelerate to an above-consensus 6.5% in FY2016 driven by a further improvement in the investment cycle and stronger export demand. Investment demand is likely to increase as policy bottlenecks are removed, corporate sentiment continues to pick up and the availability of funding improves. While consensus forecasts have moved closer to ours, rising from 6.0% to 6.2% between April and July, they still need to move higher, in our view.

An improvement in monsoons, lower oil

While inflation remains elevated, two positive developments in the past few weeks may reduce near-term inflationary pressures. First, oil prices have been weak, correcting by US\$15/bbl since mid-June. As a result, diesel (45% of oil consumption) has seen the subsidy element reduced from an average of Rs6/litre in April/May to Rs0.08/litre on September 1. Our Energy analysts believe that monthly diesel price hikes of Rs0.5/litre will not be continued after October, well ahead of expectations. Second, the monsoons have recovered significantly in recent weeks. After a shortfall of 40% in monsoon rains in June, the current shortfall has been reduced to just 11%. The total crop sowing area is now in line with normal, after being almost 25% below normal at end-July.

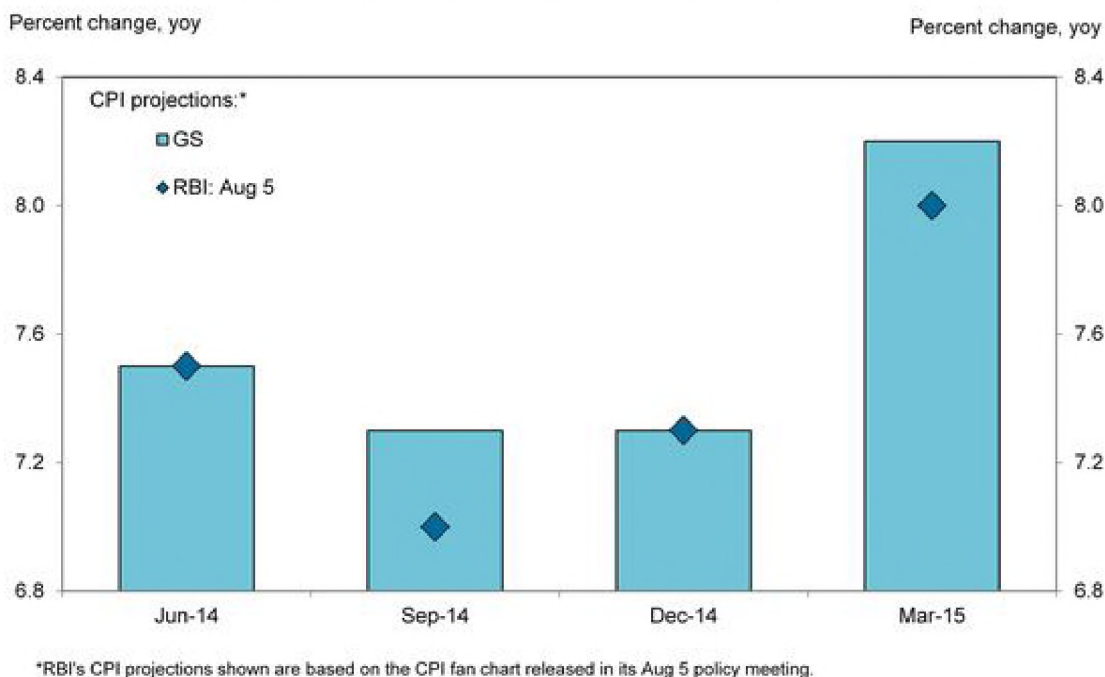
Exhibit 3: Rainfall deficit has reduced sharply, crop sowing area has improved to 'normal'



Source: Ministry of agriculture, Indian met department, Bloomberg, Goldman Sachs Global Investment Research

These developments reduce the upside risks to CPI inflation in the near term. Our August CPI forecast is 7.8% , with a downward trajectory through December due to helpful base effects. Our near-term forecasts are now much closer to the RBI's than earlier, and suggest that the RBI's target of 8% for January is likely to be reached.

Exhibit 4: RBI's CPI inflation target of 8% for January is likely to be reached



Source: RBI, Goldman Sachs Global Investment Research

We remove our forecast for an RBI rate hike

We are removing our rate hike forecast for the remainder of 2014. Our view, since the start of the year, has been for a hawkish RBI committed to the new inflation target. We have maintained this view, despite markets at various points having priced in between two and three rate cuts. Currently, while we think there is a risk the RBI may hike rates again, it is no longer our central case owing to weaker oil and better news on the monsoons, and thereby for food inflation. We think any further shock to food prices and the impact in terms of second-round effects and inflation expectations can raise the probability of a rate hike. While our base case is now for the RBI to remain on hold, we continue to think the probability of a rate hike is higher than that of a rate cut.

We are also removing our expectation of 50bp in rate cuts in H2 2015, as we think the risks to the RBI's *de facto* inflation target of 6% for January 2016 remain to the upside. Given our forecast that growth will pick up through 2015 and the Fed will hike rates, we think there is not much scope for the RBI to ease policy. Therefore, we think the 8% rate on repo is likely to be sustained through 2015. The near-term risks to this view are tilted towards rate hikes, while risks in H2 2015 are tilted to rate cuts.

INR to remain strong

Since the elections, the INR has generally traded strongly, in line with our expectations. We expected USD/INR to trade below 60 after the elections, and the INR touched our 3-month target of 58.5, and has remained in a narrow range, partly due to RBI intervention.

We expect the INR to remain strong, with our 3-, 6- and 12-month forecasts at 61, 62 and 63 respectively, due to strong capital inflows driving a balance-of-payments surplus. Our forecasts remain below the forwards. We expect a very gradual depreciation against the USD for three reasons. First, our Global Markets team forecasts significant USD strength. So, even with trade-weighted appreciation, we will see some weakness in the INR against the USD. For instance, our forecasts suggest a 3% appreciation against the Euro on a 12-month horizon. Second, in REER terms, the INR is trading above its long-term average, which suggests very modest overvaluation. Third, we think the RBI is unlikely to allow the INR to trade below 60, and use the opportunity to boost FX reserves. Sterilization costs are a second-order concern, and FX reserves at about 6.5 months of import cover are still not at very comfortable levels. The Governor of the RBI has stated several times the need for a bulwark against the impact of a Fed rate hike. Therefore, we think the INR will continue to trade in a narrow range, with the RBI intervening to prevent any sharp appreciation against the USD.

Tushar Poddar

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