India

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Short-term outlook

The planned introduction of the goods and services tax (GST) may finally help revive investment, which continues to weigh on growth. Real fixed investment contracted for the second consecutive quarter, pulling India's overall growth down to 7.1% in the June quarter—the first quarter of fiscal year (FY) 2016/17—from 7.9% in the previous quarter.Dragged down by persistent corporate-sector stress and risk aversion in the banking system, private investment remains weak. A difficult external environment—reflected in crumbling demand and soft commodity prices—has also disrupted corporate investment plans, putting the onus of reviving the investment cycle on the government. The government's initial progress with structural reforms has allowed it to accelerate public investment in FY 2015/16, and the latter will likely remain the growth driver in the near term. Private investment, on the other hand, is unlikely to recover much before FY 2017/18, when investor sentiment may get a fresh boost from the government's planned introduction of the GST. One of the most critical reforms, the new GST is meant to replace myriad existing indirect taxes, eliminating double taxation, significantly reducing the logistical cost on businesses, and increasing returns to investment across much of the economy. Already delayed beyond the government's initial target of 2016, the reform has finally received some traction after the Indian parliament approved the GST constitutional amendment bill in August. With more than half of Indian states having already approved the amendment, the government has a target of implementing the GST by April 2017, but the rate negotiations among states and technical requirements make this timeline challenging. Our forecast for growth, investment, and inflation is currently based on the assumption of GST implementation in June 2017.

Industrial-sector performance remains weak, but there are initial signs of improvement. India's industry data remain extremely volatile from month to month and exhibit mixed signals. The index of industrial production (IIP) has contracted for three out of seven months in 2016, mostly on the back of manufacturing-sector weakness. However, the manufacturing purchasing managers' index (PMI) looks a bit more resilient, while GDP data have shown 9.3% and 9.1% year-on-year (y/y) manufacturing growth during the March and June quarters, respectively. While there is a conceptual difference between the two indicators—GDP data measure value-added, while the IIP measures volume of production—the conditions on the ground continue to point to the manufacturing sector's weakness. Weak capacity utilization and a steep decline in exports are strongly deterring investment and production. Access to finance is another major issue. Despite the central bank's efforts to boost credit and ease liquidity conditions, the disbursement of credit to industry has nearly come to a halt, particularly by public-sector banks. Even as monetary policy from the Reserve Bank of India (RBI) remains accommodative, credit growth will likely remain slow, hampered by the ongoing asset quality review of public-sector banks initiated by the RBI. Commodity prices and external demand are also unlikely to recover quickly, implying that weakness in manufacturing and investment is bound to persist through the rest of 2016 and much of 2017.

A reversal of foreign capital inflows and returning balance-of-payments pressures remain key risks for the rupee in the near term. The overwhelmingly

TABLE 1

India: Monthly Interim Forecast Overview
(Percent change from a year earlier, unless otherwise specified)

	Historical Data Edge	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17
Consumer Price Index	Jul-16	5.8	5.8	6.1	5.7	5.5	5.1	5.1	5.1	5.1
Wholesale Price Index	Jul-16	1.2	1.6	3.5	3.8	3.2	3.1	3.0	3.2	4.1
Exchange Rate (Month-end, per US dollar)	Aug-16	67.20	67.62	67.03	66.98	67.45	67.84	67.95	68.10	68.33
Exchange Rate (Monthly average, per US dollar)	Aug-16	66.91	67.30	67.22	66.93	67.17	67.74	67.94	67.96	68.24
Money Supply, M1	Aug-16	12.2	13.8	14.0	15.0	14.2	13.8	14.5	14.5	15.5
Broad Money Supply	Aug-16	9.8	10.6	10.5	10.3	11.1	11.2	11.9	12.2	12.2
Policy Interest Rate (Percent)	Sep-16	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.25	6.25
Short-Term Interest Rate (Percent)	Aug-16	9.50	9.50	9.50	9.50	6.89	7.92	7.74	7.66	7.83
Long-Term Interest Rate (Percent)	Jun-16	7.48	7.51	7.61	7.63	7.62	7.52	7.49	7.48	7.51
Nominal Retail Sales		NA	NA	NA	NA	NA	NA	NA	NA	NA
Industrial Production	Jun-16	1.1	2.1	2.4	4.0	3.8	3.9	7.9	1.0	4.0
Trade Balance (Billions of US dollars, SA)	Jul-16	-5.2	-8.1	-5.1	-5.3	-5.5	-6.0	-6.1	-6.1	-5.6

Note: Historical data from selected national and international data sources. All forecasts provided by IHS Economics. Table updated on the 15th of each month from monthly forecast update bank (GIIF). Written analysis may include references to data made available after the release of the GIIF bank.
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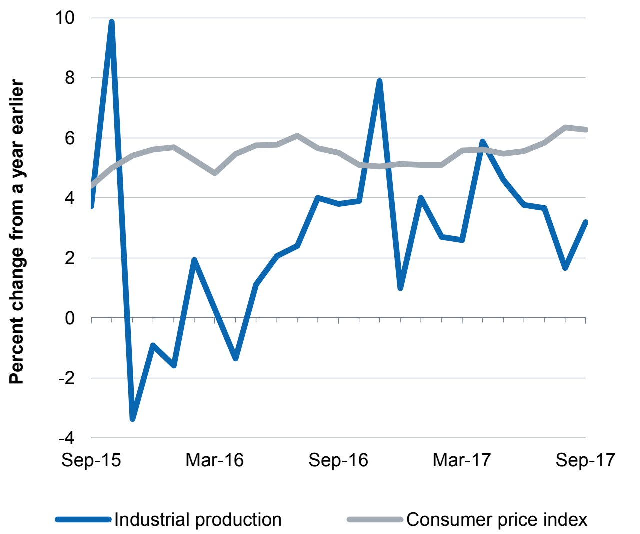
Source: IHS

Output and prices



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positive market reaction to the election of the reformist government of Prime Minister Narendra Modi has sparked fresh capital inflows into India, making the Indian rupee one of the most resilient emerging-market currencies in 2015. However, even the rupee appears to not be immune to the recent emerging-market currency selloff and may be unable to avoid near-term volatility. With several global risks looming on the horizon, including China's slowdown, Brexit-related uncertainty, and the upcoming US presidential election, global risk aversion will likely intensify in the coming months, drawing more funds from India and elsewhere. More fundamentally, trade and current-account dynamics are expected to become less positive. Recovering domestic demand and easing restrictions on gold imports will partially offset import gains from weak global oil and commodity prices, while export performance will remain poor because of muted external demand in key export markets. That being said, the fundamentals now appear to be much stronger than in 2013, and a repeat of the Indian rupee crisis of the recent past is not anticipated.

Assumptions

- Despite the government's difficulties in pushing through its ambitious reform agenda, a number of important measures focusing on business facilitation, manufacturing revival, and infrastructure spending will be implemented during its current tenure, helping the growth recovery and improving business and consumer sentiment. Nonetheless, delays are likely with implementation of critical reforms, including the nationwide goods and services tax (GST) and the land acquisition bill. IHS currently assumes the GST will be implemented no earlier than June 2017.

- A better 2016 summer monsoon season helps agricultural-sector recovery, supports stable inflation, and improves rural household spending.

- Following four interest-rate cuts in 2015 and the 25-basis-point cut in April 2016, the monetary policy stance of the Reserve Bank of India (RBI) remains accommodative. However, growing inflation and currency pressures may make it difficult to further cut rates; an anticipated 25-basis-point cut before end-2016 may be the last in the current policy cycle.

TABLE 2

India: Quarterly Interim Forecast Overview
(Percent change from a year earlier, unless otherwise specified)

	Historical Data Edge	2015-Q4	2016-Q1	2016-Q2	2016-Q3	2016-Q4	2017-Q1	2017-Q2
Real GDP	2016-Q2	8.1	6.9	7.4	7.9	7.7	7.7	6.6
Consumer Price Index	2016-Q2	5.3	5.3	5.7	5.7	5.1	5.3	5.5
Wholesale Price Index	2016-Q2	-2.3	-0.8	1.2	3.5	3.1	4.4	3.1
Exchange Rate (Quarter-end, per US dollar)	2016-Q2	66.33	66.33	67.62	67.45	68.10	68.69	69.19
Exchange Rate (Quarterly average, per US dollar)	2016-Q2	65.93	67.51	66.89	67.11	67.88	68.42	68.95
Money Supply, M1	2016-Q2	12.3	13.5	13.8	14.2	14.5	14.6	15.2
Broad Money Supply	2016-Q2	10.7	10.1	10.6	11.1	12.2	13.4	13.9
Policy Interest Rate (Percent)	2016-Q3	6.75	6.75	6.50	6.50	6.25	6.25	6.25
Short-Term Interest Rate (Percent)	2016-Q2	9.50	9.50	9.50	8.63	7.77	7.86	8.01
Long-Term Interest Rate (Percent)	2016-Q2	7.79	7.56	7.48	7.62	7.50	7.52	7.55
Nominal Retail Sales		NA	NA	NA	NA	NA	NA	NA
Industrial Production	2016-Q2	1.7	0.2	0.6	3.4	4.1	3.1	4.7
Merchandise Exports	2016-Q2	-19.2	-8.2	-2.1	1.4	4.4	12.7	9.1
Merchandise Imports	2016-Q2	-19.1	-13.9	-15.3	-16.9	-9.5	3.4	6.7
Trade Balance (Billions of US dollars, SAAR)	2016-Q2	-120.8	-87.1	-72.1	-63.7	-73.0	-66.7	-70.6

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- Given the strong fundamentals and reliance on domestic demand, the Brexit vote's effects on India's growth should be fairly limited and will depend on the extent of prevailing uncertainty in the markets, which would affect the rupee's value, investment, and credit conditions. Additionally, weaker European demand would exacerbate and prolong the ongoing exports contraction, also constraining growth.

- Despite increased volatility in the near term, foreign direct investment and other capital inflows will continue rising in the medium and longer term as India continues to pursue structural reforms.

Alternative scenarios

- India's direct exposure to China's slowdown is relatively limited (its share of merchandise exports to China in total exports amounted to less than 4% in 2015). However, further retrenchment in China's growth would alter demand from many of India's other trade partners, particularly in the Association of Southeast Asian Nations (ASEAN), and affect global commodity prices and financial markets, threatening India's export performance and financial stability.

- An unexpected sharp rise in global oil prices—as a result of supply disruptions from one or more major oil-exporting countries and other factors—would affect our outlook for India's inflation, economic growth, and fiscal and external balances.

- The return of sustained inflationary pressures, coupled with worse-than-anticipated government finances or a deterioration of balance of payments, could bring forward the Reserve Bank of India (RBI)'s shift to policy tightening, resulting in slower growth in the near term.

- The opposition from state governments and the parliament's upper house, where the Bharatiya Janata Party (BJP) does not have a majority, will stall the reform momentum, which would translate into weaker investment recovery, lower foreign capital inflows, higher inflation, and slower growth.

- Further deterioration of corporate and banks' balance sheets, especially those of public banks, could destabilize India's financial system, freeze already weak credit growth, and put further strain on public finances, diverting resources from much-needed investment.

Growth

Private consumption and public investment should support the economy, but falling business investment and weaker external demand will put more pressure on fiscal year (FY) 2016/17 growth. Real GDP growth slowed beyond projections to 7.1% year on year (y/y) during the June quarter—the first quarter of the Indian FY 2016/17—from 7.9% y/y in the March quarter. Real growth was held back by further contraction in real fixed investment, while private consumption growth also moderated. The June quarter release brings India's GDP data closer to the reality painted by conditions on the ground, where weak corporate investment, uneven household demand, and

TABLE 3

India: Annual Interim Forecast Overview
(Percent change from a year earlier, unless otherwise specified)

	Historical Data Edge	2013	2014	2015	2016	2017	2018	2019
Real GDP	2015	6.6	7.2	7.5	7.5	7.4	7.7	7.8
Nominal Per Capita GDP (US dollars)	2014	1,460	1,545	1,573	1,657	1,817	2,037	2,378
Consumer Price Index	2015	9.6	6.7	4.9	5.4	5.8	5.1	5.0
Wholesale Price Index	2015	6.3	3.8	-2.7	1.8	4.5	4.5	4.9
Exchange Rate (Year-end, per US dollar)	2015	61.90	63.33	66.33	68.10	69.76	69.59	68.22
Exchange Rate (Annual average, per US dollar)	2015	58.59	61.03	64.15	67.35	69.09	69.79	68.55
Money Supply, M1	2015	9.7	10.0	12.3	14.5	14.9	14.1	13.6
Broad Money Supply	2015	14.7	10.7	10.7	12.2	14.0	15.4	14.8
Policy Interest Rate (Percent)	2015	7.75	8.00	6.75	6.25	6.75	7.25	7.25
Short-Term Interest Rate (Percent)	2015	10.03	10.13	9.85	8.85	8.11	8.53	8.65
Long-Term Interest Rate (Percent)	2015	8.15	8.56	7.77	7.54	7.59	7.76	7.88
Nominal Retail Sales		NA	NA	NA	NA	NA	NA	NA
Industrial Production	2015	0.5	1.8	3.2	2.1	4.3	7.6	8.2
Trade Balance (Billions of US dollars)	2015	-115.0	-85.6	-117.3	-143.0	-157.6	-134.1	-130.7
Current Account Balance (Percent of GDP)	2015	-2.7	-1.3	-1.1	-1.3	-1.8	-2.6	-2.4
Fiscal Balance (Percent of GDP)	2015	-7.7	-7.0	-7.2	-6.0	-4.9	-5.0	-5.5

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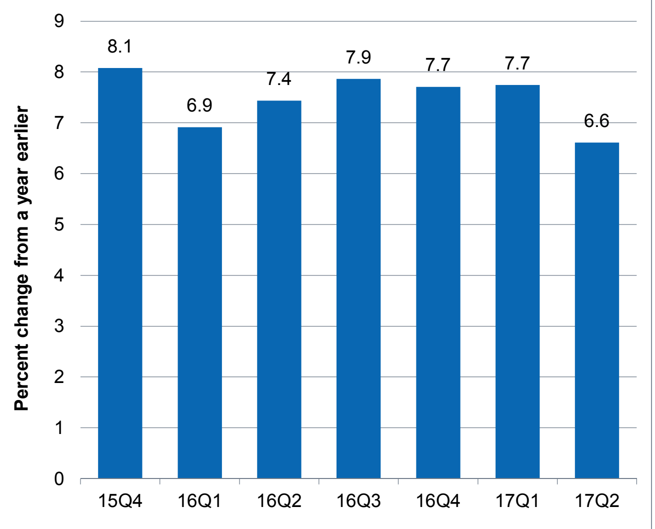
weak external trade continue to hold back economic activity. On the other hand, public investment spurred by government reforms and still relatively strong household spending provide enough resilience to the economy, even in an environment of increased global headwinds. On these grounds, the June quarter slowdown in private consumption growth is now a risk, although we believe that private consumption will improve during the rest of the FY, supported by a better monsoon season and the civil servants wage hikes recommended by the seventh pay commission. As a result, our current real GDP forecast for FY 2016/17 remains unchanged at 7.5%. Risks to the near-term outlook are now scattered more toward FY 2017/18, where global developments, including Brexit procedures, could yet distort the financial and commodities markets, having an impact on India's currency, inflation, investment, and exports. Meanwhile, domestically, the implementation of the goods and services tax (GST) may be a major variable. The government targets to implement the GST by April 2017, but the tax-rate negotiation among states and technical requirements make this timeline challenging. Our forecast for growth, investment, and inflation is now based on the assumption of June 2017 GST implementation.

Manufacturing weakness is bound to persist through 2016. Following an already strong March quarter, the manufacturing sector recorded a 9.1% y/y expansion in the June quarter—the first quarter of FY 2016/17. This is in sharp contrast to indications provided by the industrial production index (IIP), in which the manufacturing component shrank 0.8% during the quarter and a further 3.4% y/y in July. The large divergence between the two indicators is likely due to an unusually sharp drop in input costs in 2015 and early 2016. While GDP calculates the value added in the manufacturing sector (which was boosted by the falling input costs), the IIP calculates only volume growth. This ultimately means that the actual performance of the manufacturing sector remains far behind the positive GDP readings, and that the fading impact of lower input costs on value addition would likely lead to lower manufacturing readings in GDP going forward in absence of significant improvement in demand and credit conditions. Access to finance is particularly concerning, given the bad shape of India's public-sector banks and persistent corporate-sector stress.

The economy should regain momentum in the medium term, but the growth rates achieved in the last decade might still be out of reach. The formation of a stable pro-reform government in 2014 has brought back the prospects of India's economic revival, although

Real GDP growth



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the implementation of structural policy reforms remains a key to future growth. Even including three years of below-trend growth (using the 2004-05 base-year methodology), the economy has the potential to keep expanding at rates above 7% during the medium-to-long term, thanks to its favorable demographics and abundant labor, strong exports potential, and greater contributions from the service and construction sectors. To bring the economy back on track and fully realize its potential, though, India will have to speed up investment, liberalize its stiff labor market, eliminate wasteful subsidies, and diversify from IT-enabled services into value-added manufacturing and financial services. Given the complexity and scope of the required reforms, the roadblocks ahead of the Bharatiya Janata Party (BJP) government are unavoidable and many of the issues that stalled the reform process in the past threaten to derail or dilute the new government's reformist agenda. It remains to be seen whether the BJP's election promises translate into actual reform outcomes that would accelerate India's long-term growth.

Inflation

Inflation is on the rise but will likely ease toward the end of 2016. After easing considerably in 2015, India's consumer price index (CPI) inflation has started to edge up in 2016. Driven by global trends, fuel prices remain soft, but food inflation has picked up significantly, reaching a 24-month high in July. The much-anticipated impact of the monsoon rains finally brought food price pressures down in August and will likely determine food price dynamics in the coming months. While generally positive, the outlook for food prices is still subject to some risks, given that the monsoon rains appear to be less abundant than projected in certain states. Nonfood, nonfuel prices also remain sticky. The civil servants' salaries and pensions hike with a retroactive effect of 1 January would insert additional inflationary pressures. Nonetheless, consumer price inflation remains well below historical rates and will continue to benefit from low international commodity prices during the rest of 2016.

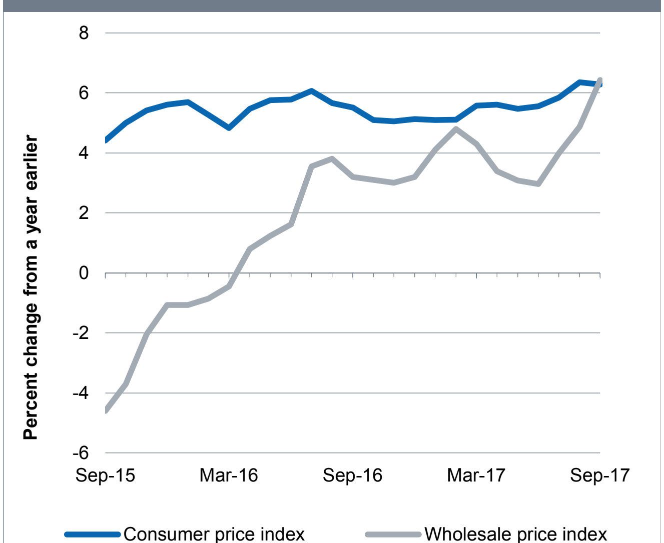
Initiated reforms targeting structural supply- and demand-side imbalances should help sustainably reduce inflation over time. Food inflation remains elevated even as it is off its peaks. Historically, food inflation has played a big role in India's overall inflation, given the large weight of food prices in the overall consumer price basket (around 46% under the new base-year 2012 index). Food prices are being driven by structural factors, such as demand for protein, not necessarily only by seasonal monsoon and farm output trends. The food supply is mostly unorganized, leading to nontransparent pricing, an inefficient distribution chain, excessive wastage, opportunistic profiteering, and high overall costs. Addressing these factors requires significant supply-side policy reforms directed at improving agricultural sector productivity and eliminating inefficiencies within distribution channels. If successful, the ongoing government reform efforts would improve the supply efficiency over time, while the central bank's commitment to bring inflation down could reinforce these gains.

Exchange rates

A reversal of foreign capital inflows and returning balance-of-payments pressures remain key risks for the rupee in the near term. The overwhelmingly positive market reaction to the election of a pro-reformist government of Prime Minister Narendra Modi in 2014 and his reform initiatives in the past two years have sparked fresh capital inflows into India, making the Indian rupee one of the most resilient emerging-market currencies. Barring some temporary volatility in the first months of 2016 and the Brexit vote-related spike in July, the Indian rupee has remained largely stable, particularly as foreign institutional investors returned to emerging markets equity and bonds. However, the rupee is not entirely immune and may yet see greater volatility in the coming months. With China's ongoing slowdown on one side, and with the heightened financial-market volatility resulting from the United Kingdom's Brexit vote on the other, global risk aversion is likely to intensify in the coming months, drawing more funds from India and elsewhere. More fundamentally, the trade and current-account dynamics are expected to become less positive, albeit still favorable, as both exports and imports are unlikely to recover soon. That being said, the fundamentals now appear to be much stronger than in 2013, and a repeat of the Indian currency crisis of the recent past is not anticipated. On balance, we now expect the rupee to mildly depreciate in 2016 and further in 2017.

Renewed investment prospects suggest a slightly stronger path for the rupee during the medium term. Albeit slower than many anticipated, the

Inflation



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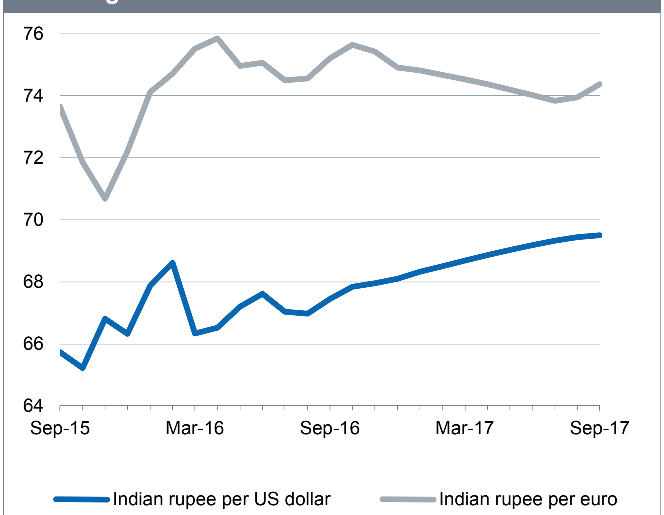
Exchange rates



Month-end value
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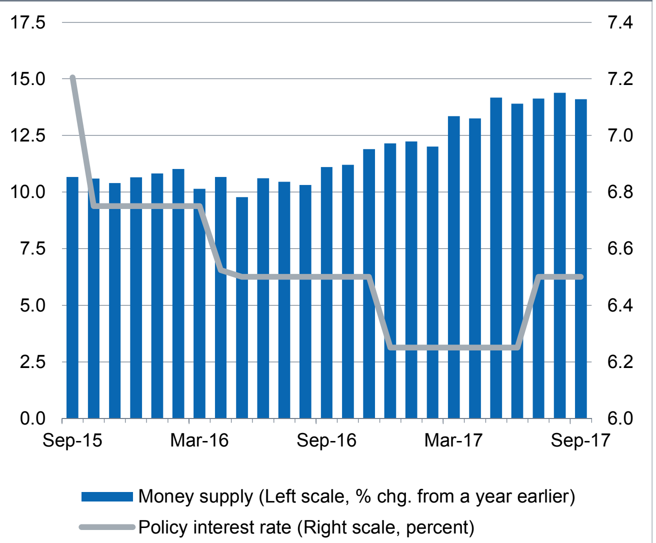
government's structural reforms are moving forward, reinvigorating investors' optimism about India's future growth prospects and business environment. Should the progress with reforms continue, foreign investment into India is likely to accelerate, creating a stronger path for the rupee than was previously expected. Nonetheless, much will depend on the actual reform outcomes and the speed of their implementation. Meanwhile, with developed markets expected to continue gradually withdrawing monetary support, global financial markets will remain volatile, weighing on the Indian rupee exchange rate.

Monetary policy

One more rate cut is possible before the end of 2016. The appointment of Urjit Patel as the Reserve Bank of India (RBI)'s next governor, following Raghuram Rajan's departure is September, should ensure a smooth transition and policy continuity at India's central bank. By elevating the deputy governor, the government has allayed investors' fears that someone less independent would replace Rajan, undermining the outgoing governor's legacy. Patel, however, is already known as a broad supporter of Rajan's policies, including the recently introduced inflation targeting framework, of which Patel was an architect. In his new role as the RBI's governor, Patel will likely continue these policies, although monetary policy decisions will be now taken by the newly formed six-member monetary policy committee. As for the short-term monetary policy direction, the latest GDP, industrial production, and balance-of-payments data all indicate falling growth momentum, which could add weight to the argument in favor of an additional policy rate cut. However, the RBI will likely wait to assess the full impact of the monsoon on inflation, with the next rate cut more likely in December than during the next RBI policy meeting in October.

The effectiveness of the RBI's formal inflation targeting will ultimately depend on the government's supply management policies. Under the newly adopted (February 2015) formal inflation target, the RBI seeks to keep consumer price index (CPI) inflation under 6% by January 2016 (achieved) and bring it down to 4% by April 2018, keeping it within a band of 4% plus or minus 2% thereafter. With the RBI's shift toward consumer prices as India's main inflation barometer (which tends to run higher than wholesale price inflation), achieving a sustained moderate level of inflation may require an acceleration of policy efforts to unclog the supply side of key inputs, including power and land. Even as the current inflation scenario

Monetary policy



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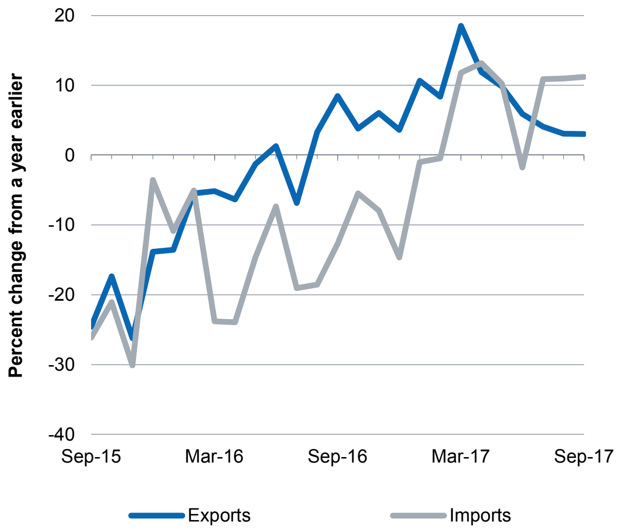
has opened up some room for policy easing, a drastic reduction in policy rates is unlikely in the medium term.

External sector

Already weak merchandise exports will likely continue to suffer in the near term as demand from the European Union gets hit by the post-Brexit-vote uncertainty. India's merchandise exports have been shrinking continuously since December 2014 and returned to contraction after a brief improvement in June 2016, making the current episode of exports weakness more severe than the nine-month spell during the financial crisis of 2008-09. Its geographic spread is also much wider, with weak demand registered across nearly all of India's export markets, including Northeast and Southeast Asia, as well as South Asia and the Middle East, in addition to the US and EU markets. The British referendum results and the uncertainty over the Brexit decision will likely put more pressure on Indian exports, given that around 17% of goods exports go to the European Union, particularly as the United Kingdom moves further with its Brexit procedures, which will likely be in 2017 or 2018. Still, the country's trade balance appears to remain on a solid footing thanks to an even steeper contraction in imports. With India being a net importer of oil, softer global oil prices are helping offset the protracted weakness in exports. On the downside, turmoil is no longer the main reason for India's imports contraction, with the latter now driven largely by weak capital goods purchases—an indication of weak investment demand. The latter is unlikely to recover

Merchandise trade



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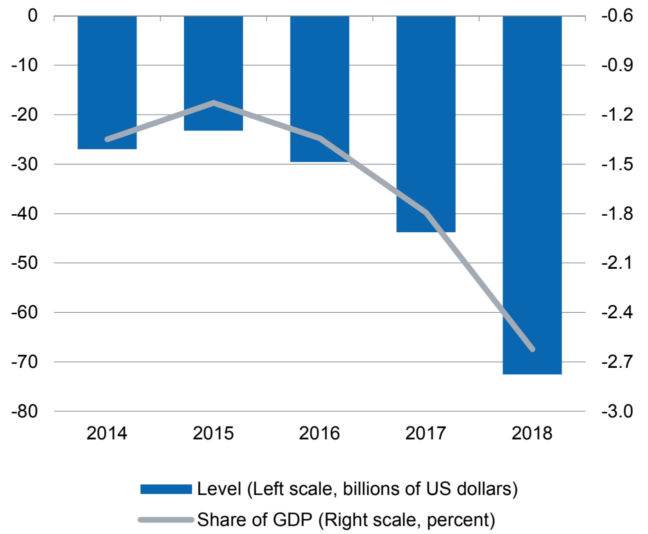
Current account balance



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soon, which will keep India's trade and current-account deficit contained under 2% of GDP in 2016 and 2017.

Foreign direct investment (FDI) inflows are losing momentum but will likely pick up in 2017. Net FDI inflows more than halved to USD4.1 billion in the June 2016 quarter from USD8.8 billion in the March quarter, reflecting investors' concerns over slowing growth. However, the new wave of FDI reforms announced by Prime Minister Narendra Modi in June 2016—which further liberalized foreign investment in 15 major economic sectors—should sustain this momentum, helping to offset any potential portfolio outflows amid increased global financial volatility. The planned introduction of the goods and services tax (GST) in 2017 will further boost investment sentiment, ensuring that FDI inflows remain strong over the medium term.