SUMMARY

- India's GDP growth, Manufacturing Spikes
- Special feature on the Seventh Pay Commission and its effect.
- FDI Reforms
- Modi visit: UK and G20

India's GDP growth, Manufacturing Spikes

GDP at market prices, total of consumption, investments, government spending, and net exports rose to 7.4% (y/y) in Q2 FY16 compared to 7% in the previous quarter.

GDP at gross value added, sectoral based measure taking into account agriculture, industry and services rose to 7.4% from 7.1% previous quarter, despite a slowdown on account of deficient rainfall and falling exports.

So what is driving India's economy?

Statistics show that growth in Q2 was driven more by public spending than private consumption. Private consumption growth slowed to 6.8% from 7.4% in Q1. Investments grew 6.8%, compared with 4.9% in Q1. A drought in parts of the country for the second straight year has hurt rural demand for both consumer and capital goods.

Manufacturing grew by 9.3% as compared to growth of 7.9 % in Q2 2014-15. Among major industries - electrical machinery, chemical products and motor vehicles production showed high growth due to high urban demand. The services sector as a whole grew at 8.8% as sectors like trade, transport, communication, financial, insurance, real estate and professional services grew at 9.7%. Construction, however, performed poorly as it witnessed just 2.6% growth, against 6.9% in the previous quarter. While there has been a pick-up in activity in the road and the railway sectors, key indicators, namely, production of cement and consumption of finished steel registered growth of 1.6% and 1.2%, respectively – an indication of a slowdown in infrastructure. On the flipside, agriculture grew by 2.2%, better than expected despite a second deficient monsoon which suggests that the impact may not be as severe as feared.

Seventh Pay Commission – Hike and Effect

The government constitutes the Pay Commission every 10 years to revise the pay scale of its employees. The Commission appointed in February 2014 by the previous congress led Government recently submitted its report. The recommendations will benefit about 10.4m government employees and may come into effect from January. They are expected to have a significant impact on macroeconomic parameters, such as the GDP, fiscal deficit, and inflation.

The Seventh Pay Commission proposes a 16% hike in basic salaries, and a 63% hike in allowances. The overall hike in salaries and pensions will be approximately 24%. This compares with the 35% salary hike on implementation of the Sixth Pay Commission, when the UPA government fixed a minimum basic salary of £66, now revised to £180. The salary hikes are expected to boost sales of affordable homes and consumer durables.

The total impact from implementation is expected to be £10bn increasing the fiscal deficit by 0.65% of GDP. But while the bill is huge, what goes out as pay and perks also comes back to some extent as tax revenue. Assuming an average tax rate of 20%, income tax alone will bring back a fifth of the payout. Further on the trickledown effect when this money is spent on consumer durables, homes, financial products, everyday necessities and travel, will improve indirect tax collection. Also as corporate profits improve, they will also pay the government more, resulting in higher tax collections.

The panel's recommendation will bring further financial strain as Government also has to manage its commitment to One Rank One Pension (OROP) - recently implemented pension and benefits for Indian Armed Forces. In sum, one could expect slippage in all fiscal targets as well as GDP growth on account of OROP and salary hikes, as both will require expenditure switching from capital to revenue.

The relatively restrained increases recommended (bearing in mind the 10 year cycle) may reduce the inflationary impact and ensuring better real income growth across the population. Lastly, the Commission has also made the important suggestion of undertaking pay revisions at shorter intervals.

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However nominal GDP growth (6%) – real GDP adjusted for inflation was much lower owing a drop in the GDP deflator. This may possibly lead to low tax collections - the tax collections however were just 55.8% compared to 58.6% last year.

The lower nominal GDP growth could further add to pressure on the government to meet the fiscal deficit target of 3.9% of (nominal) GDP for the year. However, performance in this area is improving. The fiscal deficit in the first seven months of FY16 reached £4.1bn (74%), of the Budget estimate. In the corresponding period last year, the deficit stood at 89.6% of the Budget estimate of 2014-15. However, the overall fiscal deficit target still seems challenging especially when the Seventh Pay Commission has recommended much higher salaries for central government employees. (See feature column)

FDI Reforms

The Government announced reforms in 15 major sectors in Foreign Direct Investment in November. The objective of the government is to ease the process of foreign investments in the country and bring substantial foreign investments under the automatic route in order to avoid the delay in FDI in India. Also, to achieve faster approvals on most of the proposals, the threshold limit for Foreign Investment Promotion Board (FIPB) approval was increased to £500mn from £300mn. Sectors affected include, manufacturing, defence, construction & development, retail, broadcasting, civil aviation and banking. Further conditionalities were eased out for company owned and controlled by NRIs and Limited Liability Partnerships.

Modi Visit: UK and G20

PM Modi wrapped up his five-day visit to Britain and Turkey (G20 Summit) in November after making a strong case for a united global fight against terrorism. The two-day G20summit was overshadowed by terror attacks in Paris.

In his earlier leg of the overseas visit in the UK, Modi met the Queen and addressed the Indian Diaspora at the Wembley stadium, along with his British counterpart David Cameron. On inking economic deals, the visit concerned signing of more than £9bn in deals including, India's creative and retail sectors, logistics, financial services, energy, information technology and cyber, healthcare, and education. PM Modi and Cameron also agreed that Indian Finance Minister Arun Jaitley and his counterpart, Chancellor of the Exchequer George Osborne, will work to expand cooperation at the next U.K.-India Economic and Financial Dialogue (to be held in January 2016 in India).

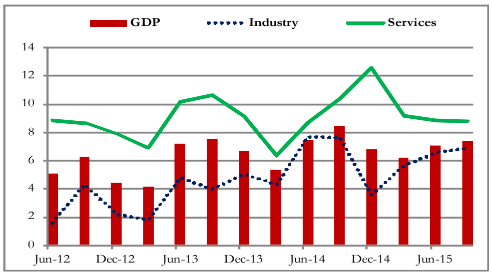
POLITICS

PM Modi's key economic reform bills, including the Goods and Services Tax (GST), remain in the balance in the ongoing winter session of Parliament. The session is scheduled from 26th November to 23rd December and began on a mellow note with the PM personally reaching out to Congress president Sonia Gandhi seeking her support on GST. But hopes for a consensus have now dimmed following a fresh stand-off between the Congress and BJP over a court case where the Gandhis – Sonia and her son Rahul – are alleged to have misused party funds. The Congress has accused the government of vendetta politics, a charge which the BJP has forcefully rejected.

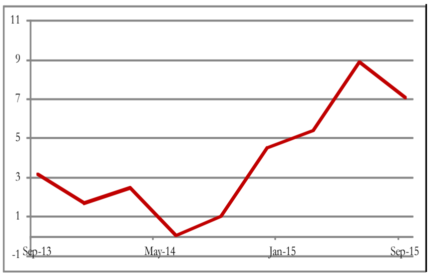
On the foreign policy front, India and Pakistan resumed their dialogue after months of diplomatic sniping. A brush by between PMs Modi and Sharif in Paris at the climate change conference led to a meeting between the respective National Security Advisers and Foreign Secretaries (=PUS) in Bangkok earlier this week. Terrorism, an Indian priority, and Jammu and Kashmir, top of the Pakistani agenda, were discussed. Bilateral talks will continue with External Affairs Minister Sushma Swaraj in Islamabad this week for a regional conference on Afghanistan.

GROWTH: *Manufacturing growth accelerates GDP*

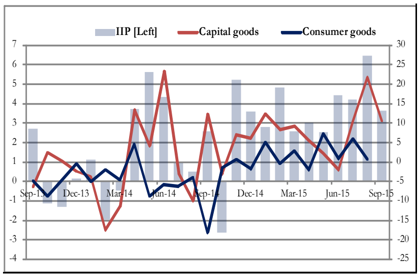
GDP



Projects Under Implementation

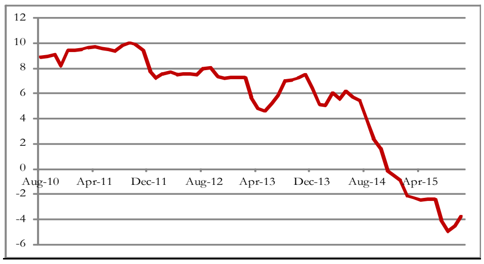


IIP/Capital/Consumer Goods

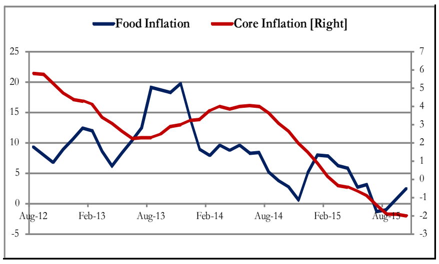


INFLATION: *CPI quickens due to rise in cost of food*

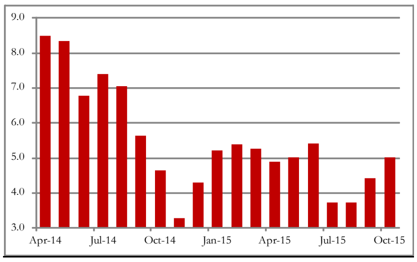
Wholesale Price Index (% y/y)



Food vs. Core Inflation (% y/y)

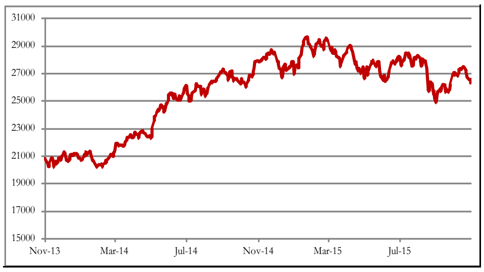


Consumer Price Index (% y/y)

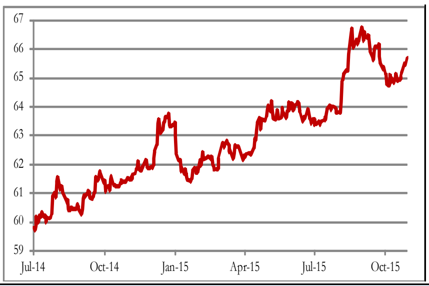


MARKETS: *Financial markets struggling as China's slump continues*

SENSEX



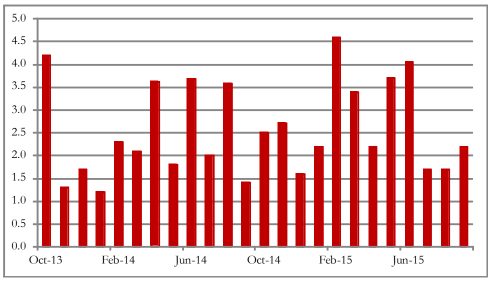
USD/INR



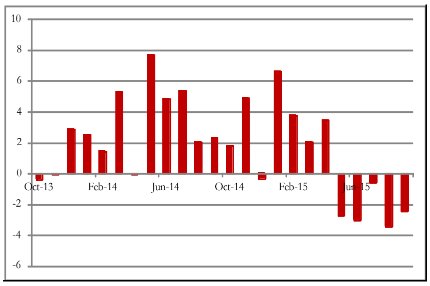
10yr Govt. Securities yield (%)

EXTERNAL: *FIIs trim exposure in July-September quarter.*

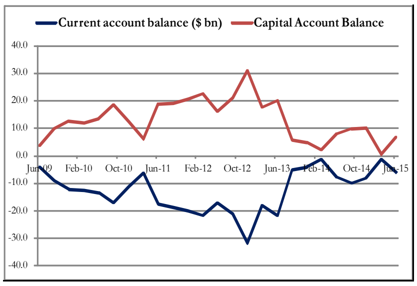
FDI ($ Bn)



FII ($ Bn)

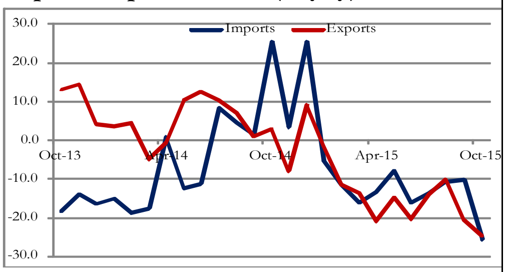


Current vs. Capital A/c ($ Bn)

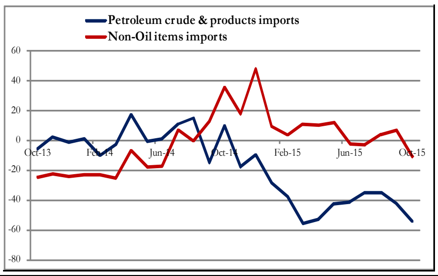


TRADE: *Low commodity prices and sluggish global economy continues to affect both, exports and imports.*

Export/Import Growth (% y/y)



Imports- Oil and Non Oil (% y/y)



Trade Balance ($ Bn)