India: Ample liquidity to support growth

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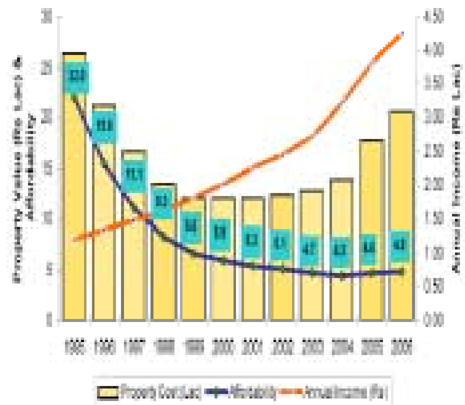
- **We forecast FY06/07 GDP growth of 8.5% versus consensus of 7.3%.** Our view on India is more optimistic than the market's in large part because we do not see the constraints on growth many in the market fear.
- **The main risks to our bullish FY06/07 GDP growth forecast are rising interest rates and inflation.** On external liquidity, we judge India's current account deficit to be sustainable and may have a limited constraint on growth. Although domestic liquidity conditions are tightening, we believe that fiscal and monetary policy tools on the part of the state governments and central bank are available to inject liquidity into the financial markets in the next six to 12 months.
- **Banks may raise monthly payments for housing loans. This may pose limited downside risks to consumer spending.** We believe nominal wage growth may accelerate to around 14% in FY06/07 versus 12% in FY05/06 and may offset some of the pressures on consumer spending from rising interest rates and inflation. Until recently, with interest rates on floating housing loans tracking higher, banks could extend the tenure of housing loans and keep the monthly payments constant. However, for some individuals their monthly payments for housing loans may rise since the tenure of the loan could exceed their working life.
- **However, we see the downside risks from rising mortgage interest rates to the property market and GDP growth as low.** Housing penetration rates are probably below 10%, the affordability ratio is still fairly stable, and the mortgage to GDP ratio is fairly low at 3%.
- **The impact of inflation on consumer spending is mixed, according to a recent survey.** An *Economic Times* survey of consumers in major cities such as Delhi, Mumbai, Bangalore, Chennai, and Kolkata indicated that the evidence was mixed on how rising prices could affect future consumer spending. In Bangalore and Delhi, respondents seemed relatively less affected by rising inflation, while in Kolkata and Chennai consumers felt the pressures from inflation on spending much more. Consumers in Mumbai seemed to have mixed opinions. The results of the survey also indicated that fuel prices may have been the key catalyst behind rising inflation.
- **On investment growth, we remain positive.** Recent data points on Industrial production indicate strong growth in the basic, consumer, and intermediate goods sectors. Capital goods IP growth peaked in September 2005 on a year-on-year basis, mainly due to domestic capacity utilization rates being over 85% and limiting the ability of firms to supply capital goods. We expect capacity ramp-ups to kick-in in H2 2006 and induce a recovery in capital goods IP growth. Early 2006 tightening of liquidity conditions may induce a moderate pick up in the prime lending rate (PLR) by 50bps to 11.5%. We doubt that the pick-up in the PLR will induce a negative impact on investment growth since firms may be able to pass on the rising costs of production to end-users. The PLR bottomed at 10.5% in April 2006.
- **Monetary and fiscal policy may work hand-in-hand to stabilize domestic liquidity conditions.** We see limited signs of a credit crunch emerging in the next 6-12 months. This is despite deposit growth of 21% yoy currently lagging the strong non-food credit growth of around 33% yoy. Looking forward, we expect the RBI to continue injecting liquidity through the repo window, the lock in period for five-year time deposits (which are entitled to tax exemptions) may be reduced to three years, time deposit rates may rise as the RBI continues to hike the reverse repo rate, and state governments accelerate the pace of spending on development projects. We also expect further capital account liberalization by end 2006/early 2007 to help ease liquidity conditions. These policy adjustments may stabilize domestic liquidity conditions and support robust GDP growth in FY06/07.

- **We believe state governments' spending over the next one to three months may drive incremental deposits in the banking system up by around 5-10%.** State governments have been slow to spend on development projects and have also been very cautious in order to meet the twelfth finance commission's fiscal targets. We have noticed that the central government's cash surplus with the RBI was at a historical high of around INR 580bn at end-March 2006 compared to INR 50bn at end-March 2005. Around 80% of the central government's cash surplus is actually the state governments' cash surplus.
- **Our average FY06/07 WPI inflation forecast is revised to 5.3% versus our previous forecast of 4.8% and FY05/06 4.5%.** We expect WPI inflation to remain in the 5-5.5% yoy range in the next two to four months. June inflation is running at around 5.3% yoy compared to the 4% average posted in the January-May 2006 period and 4.8% in 2005. The pick-up in inflation has been partly due to an acceleration of the food sub-component of the WPI. Food grain stocks being at multi-year lows, higher transport costs, and hoarding by food distributors may have been the reasons behind the rise in the food sub-component of the WPI. We expect these trends in food prices to continue in the next few months. A 9.2% hike in petrol prices and a 6.6% hike in diesel prices were implemented on 5 June. The pass-through from higher petrol prices to the manufacturing, transport, and food sectors may continue over the next four months. On 22 June, the government allowed firms to import wheat, pulses and sugar under easier terms to help bring down the continuous rise in food prices since H2 2005.
- **We are revising our end-FY06/07 reverse repo rate forecast to 6.75% from 6.25%.** The focus of monetary policy in H2 2006 may be to stabilize USD/INR in order to temper imported inflationary pressures. In our view, the pickup in WPI inflation raises the probability of a 50bps hike by the RBI of the reverse repo rate to 6.25% at the 25 July Economic Policy Review meeting. Recent statements by the Ministry of Finance (MoF) and the Reserve Bank of India (RBI) have been hawkish.
- **We are revising our FY06/07 current account deficit forecast to 2% of GDP from 3.4% of GDP.** Strong manufacturing and software growth, remittances inflows, and an abatement of outflows of investment income are the key factors behind our forecast change for the FY06/07 current account deficit. We expect the quarterly current account deficit to remain stable in the $3.5-4.5 bn range over the next 12 months.
- **The Q4 FY05/06 current account balance and capital flows readings were encouraging.** The current account balance came in at an unexpected surplus of $1.8 bn versus the previous quarter's revised deficit of $3.8 bn. Q2 and Q3 FY05/06 current account deficits were revised down significantly. The FY05/06 current account deficit rose to $10.6 bn (1.5% of GDP) from $5.4 bn (0.9% of GDP) in FY04/05. On the capital account, net FDI inflows jumped to $2.0 bn in Q4 FY05/06 from $1.4 bn in Q3 FY05/06. The overall balance of payments (BoP) position improved to a large surplus of $13.2 bn in Q4 FY05/06 from a $4.7 bn deficit in the previous quarter. With the BoP showing incremental improvement and the RBI continuing to raise interest rates, USD/INR may fall to 44.5 by end-FY06/07.
- **On the fiscal front, we expect a one notch foreign currency sovereign rating upgrade by S&P as early as Q4 2006.** Strong GDP growth, continued fiscal consolidation, stable external liquidity conditions, and accelerating FDI may be the key drivers behind the foreign currency sovereign upgrade.

Positive investment growth and limited downside risks to consumer spending.

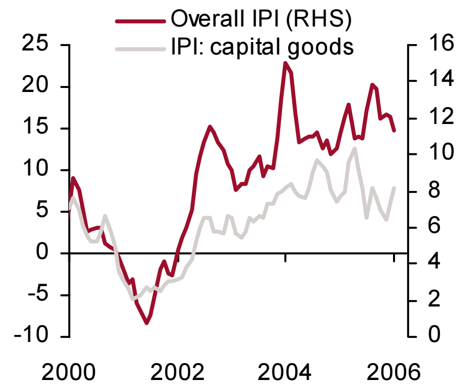
Exhibit 256: Rising interest rates may be offset by strong income growth



Source: HDFC, Credit Suisse

Exhibit 257: Investment spending outlook still positive

% yoy

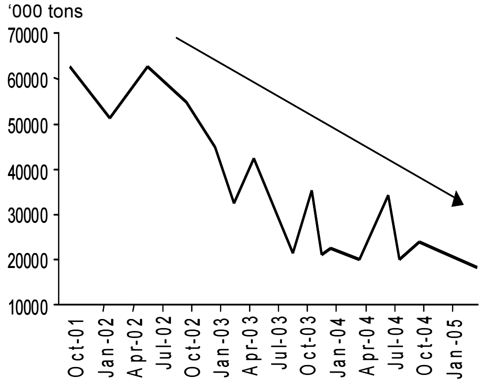


Source: CEIC, Credit Suisse

WPI inflation to remain in the 5-5.5% yoy range in the short term.

Exhibit 258: Multi-year low food grain stocks …

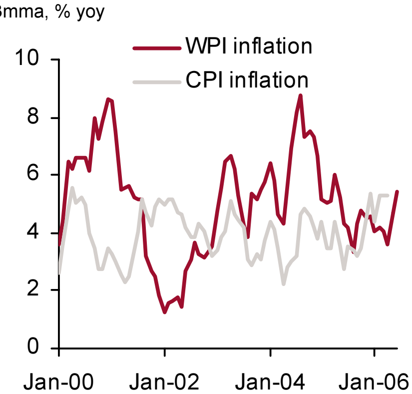
'000 tons



Source: CRIS INFAC, Credit Suisse

Exhibit 259: … may be partially pushing inflation up

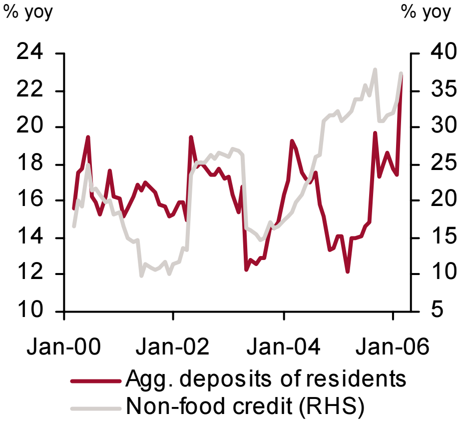
3mma, % yoy



Source: CEIC, Credit Suisse

Stable liquidity conditions.

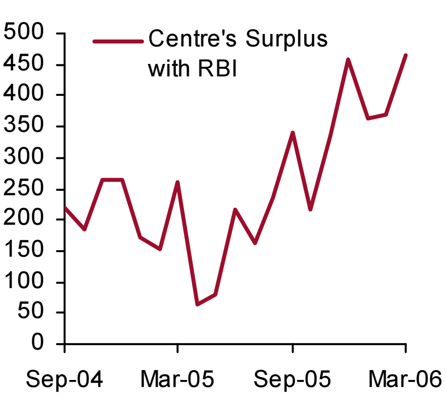
Exhibit 260: Recovery in deposit growth and …



Source: CEIC, Credit Suisse

Exhibit 261: … increased government spending may stabilize liquidity

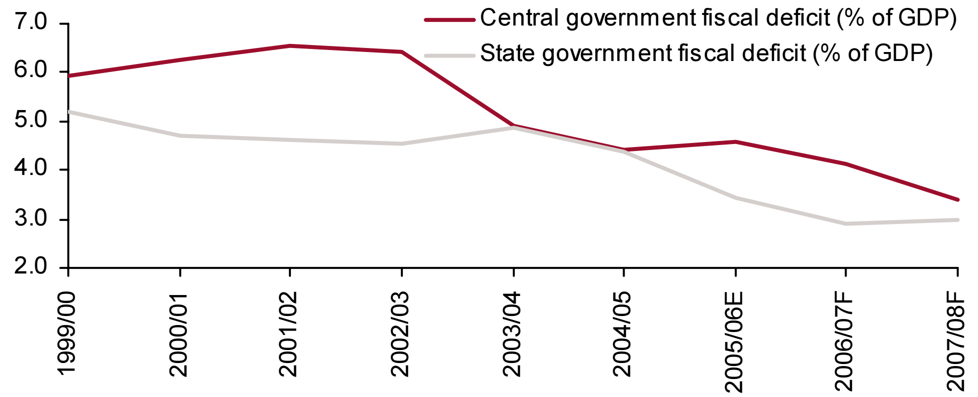
INR bn



Source: CEIC, Credit Suisse

Fiscal improvement may fuel a one notch rating upgrade in Q4 2006.

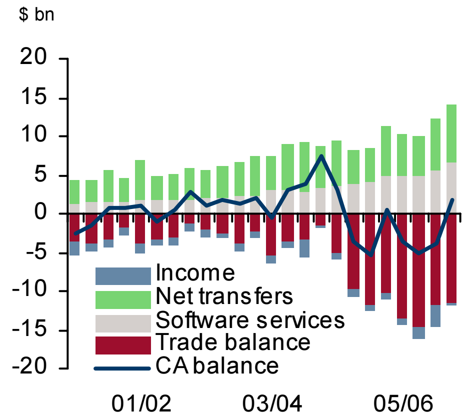
Exhibit 262: Continued fiscal consolidation



Source: CEIC, Credit Suisse

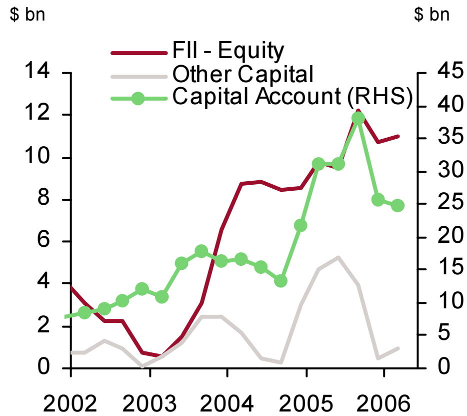
An unexpected current account surplus in Q1 2006.

Exhibit 263: Balance of payments …



Source: CEIC, Credit Suisse

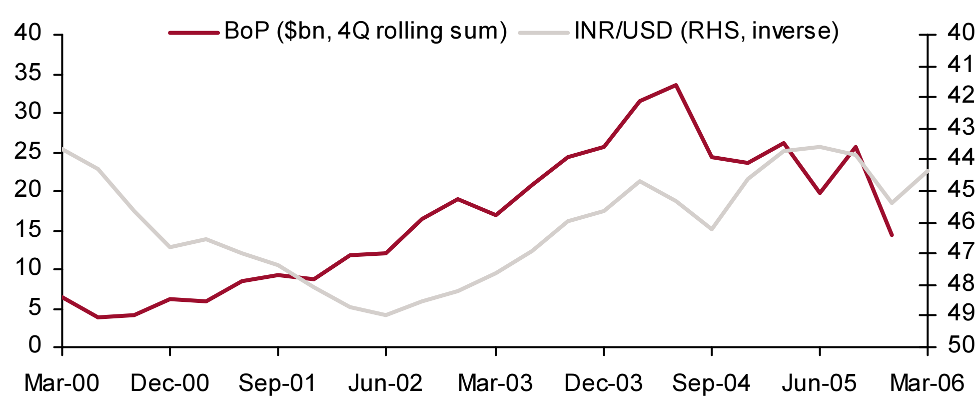
Exhibit 264: … stabilizing …



Source: CEIC, Credit Suisse

Positive USD/INR outlook.

Exhibit 265: … which implies USD/INR may track lower to 44.5 by end-FY06/07



Source: CEIC, Credit Suisse

India: Selected economic indicators

(Fiscal year beginning April)	1999	2000	2001	2002	2003	2004	2005	2006F	2007F
Population, national accounts and unemployment									
Population (mn)	1,015.0	1,033.0	1,051.0	1,068.0	1,086.0	1,097.0	1,116.7	1,136.8	1,153.9
Nominal GDP ($bn)	406.6	416.6	436.4	465.9	548.4	630.0	697.2	800.6	948.0
GDP per capita ($)	407.5	409.0	418.5	436.4	509.7	574.2	624.3	704.2	821.6
Real GDP growth (%)	6.1	4.0	5.3	3.6	8.3	8.5	8.4	8.5	8.5
Growth in private consumption (%)	6.0	2.8	5.8	1.6	7.8	6.5	7.1	7.5	7.7
Growth in government consumption spending (%)	13.2	0.3	1.7	-0.6	2.4	9.2	4.0	4.5	4.3
Growth in fixed investment spending (% of GDP)	9.3	0.0	5.0	9.9	11.3	6.5	10.0	9.5	9.8
Fixed investment (% of GDP)	23.3	22.4	22.4	23.7	24.4	23.9	24.4	24.6	24.9
Prices, interest rates and exchange rates									
WPI inflation (%, Fiscal year - March over March)	6.5	5.5	1.6	6.5	4.6	5.1	4.3	5.5	5.1
WPI inflation (% change in average index for the year)	3.3	7.1	3.6	3.4	5.5	6.5	4.5	5.3	5.4
Exchange rate (INR per USD, end-year)	43.59	46.62	48.74	47.64	45.02	43.69	45.00	44.50	42.00
Exchange rate (INR per USD, average)	43.33	45.68	47.69	48.40	45.95	44.93	45.70	45.00	43.00
REER (% change, March over March)(1)	3.2	-0.6	1.4	-4.8	0.9	0.7	na	na	na
Nominal wage growth (% year-on-year) (2)	11.1	12.5	9.8	11.3	16.4	18.8	11.8	14.0	na
Reverse repo rate (end-year, %)(3)	na	7.00	6.00	5.00	4.50	4.75	5.50	6.75	7.25
Fiscal data(4)									
General government budget balance (% of GDP)	-11.1	-10.9	-11.2	-10.9	-9.8	-8.8	-8.0	-7.0	-6.4
General government primary fiscal balance (% of GDP)	-3.5	-3.0	-3.1	-2.7	-1.6	-1.2	-1.0	-0.7	-0.5
General government expenditure (% of GDP)	22.7	23.4	23.0	24.3	26.4	26.7	24.9	23.0	21.2
General government revenue (% of GDP)	46.9	17.1	17.4	18.3	18.7	17.9	16.1	15.7	15.8
Gross general government debt (Rs bn, end-year)	11,628	13,397	15,778	18,039	20,410	23,210	25,904	29,235	32,848
Gross general government debt (% of GDP, end-year)	66.0	70.4	75.8	80.0	81.0	82.0	81.3	81.0	80.0
Financial sector and credit									
Domestic credit to the private sector (% of GDP)	39.5	42.2	43.2	46.8	46.6	50.7	na	na	na
Balance of payments									
Exports (goods and services, $bn)	53.3	61.7	61.8	74.5	93.2	128.2	175.9	214.6	281.9
Imports (goods and services, $bn)	67.0	72.5	70.1	81.6	96.7	150.6	217.8	252.1	330.3
Exports (goods and services, % increase in $ value)	12.1	15.9	0.2	20.5	25.0	37.6	37.3	29.8	31.4
Imports (goods and services, % increase in $ value)	14.5	8.1	-3.3	16.4	18.6	55.7	44.6	29.5	31.0
Exports (goods and services, % of GDP)	13.1	14.8	14.2	16.0	17.0	20.3	25.2	26.8	29.7
Imports (goods and services, % of GDP)	16.5	17.4	16.1	17.5	17.6	23.9	31.2	31.5	34.8
Net balance of factor income ($bn)	-3.6	-5.0	-4.2	-3.4	-4.5	-3.8	-5.1	-5.0	-5.0
Net transfers ($bn)	12.6	13.1	15.9	16.8	22.2	20.8	23.5	26.5	29.7
Current account balance ($bn)	-4.7	-2.7	3.4	6.3	14.1	-5.4	-10.6	-16.0	-23.7
Current account balance (% of GDP)	-1.2	-0.6	0.8	1.4	2.6	-0.9	-1.5	-2.0	-2.5
Net FDI ($bn)	2.1	3.3	4.7	3.2	2.4	3.2	5.0	6.0	6.4
Scheduled external debt amortization ($bn)	na	na	na	na	na	na	na	na	na
Foreign debt and reserves									
Foreign debt ($bn)	98.3	101.3	98.8	105.0	111.7	123.3	130.1	135.6	147.6
Foreign debt (% of GDP, end-year)	24.2	24.3	22.6	22.5	20.4	19.6	18.7	16.9	15.6
Foreign debt (% of exports of goods and services)	184.5	164.2	159.8	140.8	119.9	96.2	73.9	58.3	47.8
Central bank gross FX reserves ($bn)	38.0	42.3	54.1	76.1	113.0	141.5	144.5	154.6	156.6
Central bank net FX reserves ($bn)	38.4	43.0	54.6	72.7	100.4	128.9	131.9	142.0	144.0

(1) Real effective exchange rate, increase indicates appreciation. (2) Annual income. (3) Note that RBI changed the policy rate from bank rate to reverse repo rate in 2004. (4) General government data refer to the sum of center and state government figures.

Source: Reserve Bank of India, CEIC and Credit Suisse