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June 22, 2007

India Economics

Soft Landing Underway

What's new: After sustaining strong growth for about nine quarters, there are clear signs that growth trend is starting to moderate. Key cyclical growth indicators reflecting this include truck sales, two-wheeler sales, passenger vehicle sales, bank credit, goods export growth and rail freight traffic trends.

Conclusion: The twin-effect of aggressive monetary tightening via policy rate/cash reserve ratio hikes and sharp appreciation in the currency is likely to result in further deceleration in domestic demand in the second half of 2007. As a result, we expect GDP growth to slow to 7.7% in F2008 from 9.4% in F2007.

Implications: We believe the slowdown in demand will reduce the concerns on overheating, particularly for inflation and the trade deficit. Hence, if the current slowdown trend and pace is maintained, we believe that the Central Bank may not have to initiate any more policy rate hikes. However, the RBI is likely to hike the cash reserve ratio/announce fresh measures to sterilize the continued inflow of foreign capital, ensuring that previous tightening measures remain effective.

Upside Risks: With the global capital market environment remaining supportive, there is a chance that capital inflows increase way above the average amount received over the past 12 months. Indian companies are planning fresh equity issuances worth over US$19 billion (including the recent DLF and ICICI Bank equity issuances) in the next six months. If all these equity issuances do come through and if the ECB/FCCB issuances spike up further, this would only increase domestic liquidity, challenging the RBI's efforts to slow domestic demand.

For important disclosures, refer to the Disclosure Section.

Soft Landing Underway

Summary
Our base case scenario of a soft landing seems to be materializing with various indicators pointing to a moderation in overall growth trend. The twin-effect of aggressive monetary tightening via policy rate/cash reserve ratio hikes and sharp appreciation in currency have begun to show their impact on domestic demand indicators and goods export growth. We believe GDP growth will likely slow to 7.7% in F2008 from 9.4% in F2007. We believe the slowdown in demand will reduce the concerns on overheating, particularly for inflation and the trade deficit.

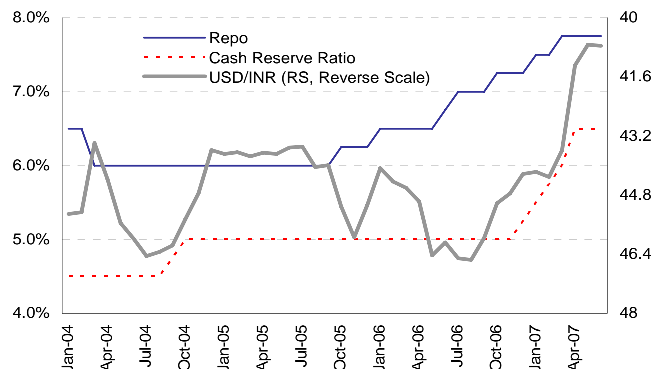
Clear Signs of Soft Landing in Growth Cycle Emerging
After sustaining strong growth for about nine quarters, there are clear signs that growth trend is moderating. Key cyclical growth indicators reflecting this are:

Automobile Sales: The earliest indicator to reflect the slowdown has been automobile sales growth. Growth in all three segments – passenger, two-wheeler and commercial vehicles – has decelerated significantly (Exhibit 2). Indeed, two-wheeler sales growth has been declining on a YoY basis for the past two months now, while passenger car and commercial vehicle sales growth have dipped to single-digit levels.

Bank Credit: Bank credit growth has moderated to 26.3% as of end-May (the last available data point) from 29.8% as of end-February and 30.1% as of end-December (Exhibit 3). Indeed, the key driver to the slowdown has likely been mortgage and other retail credit growth. Data from six key private and public sector banks indicated that retail credit growth had slowed 30.5% in the quarter ended March 2007 (QE Mar-07) from 35.9% in QE-Dec 2006. We believe that there would have been further moderation over the next four months.

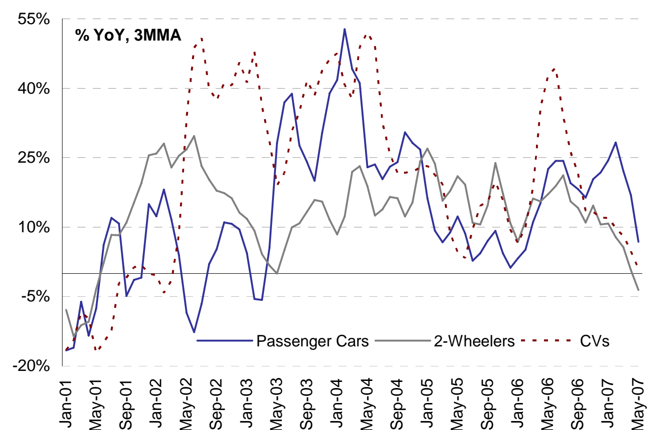
Goods exports: Three-month moving average goods exports growth in rupee terms has slowed to an average of 9% in the four months ending April 2007 from 18.3% during the QE-December 2006, reflecting the slower growth in the US, stretched domestic capacity utilization in select sectors and weakening competitiveness due to the rupee appreciation. On a real effective exchange rate basis (REER, trade-weighted rupee adjusted for inflation differentials with trade partners), the rupee is now about 12.3% above its 10-year mean. Indeed, we believe that full impact of the appreciation in the rupee against the US$ (well ahead of other regional currencies) of

Exhibit 1
Twin Effect of Aggressive Monetary Tightening



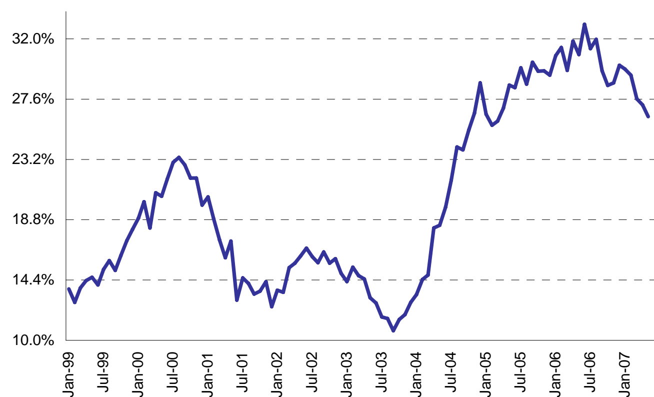
Source: RBI, Morgan Stanley Research

Exhibit 2
Auto Sales Growth



Source: Bloomberg, Morgan Stanley Research

Exhibit 3
Bank Credit Growth



Source: RBI, Morgan Stanley Research

8.5% in last three and a half months is yet to be reflected in export growth due to the usual lag from the time orders are received to execution.

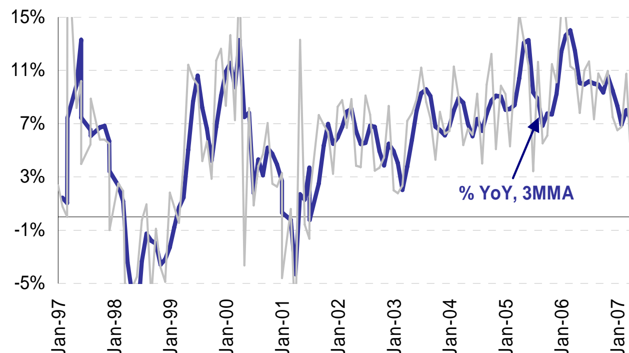
Rail freight traffic: The combined impact of weakening domestic demand and slowing exports is reflected in the deceleration in rail freight traffic growth. Railways freight traffic growth has slowed to an average of 5.8% in April-May 2007 from 8.1% in QE-Mar 2007 and 9.4% in QE-Dec 2006 (Exhibit 4).

Recent Policy Moves To Ensure Firm Control on Overheating

Although the Reserve Bank of India (RBI) has been gradually tightening since the second half of 2004, the pace picked up sharply in December 06-March 07. In this period, the Central Bank announced a 50 bps increase in the repo rate and a 150 bps increase in the cash reserve ratio. Indeed, this resulted in mortgage lending rates, which we believe is a good proxy to the overall interest rate environment, increasing by 250 basis points between December and March. This has taken the cumulative rise in mortgage lending rates to 450 basis points from the bottom. Mortgage lending rates are now closer to 2001 levels (Exhibit 6). Similarly, in our view, banks' lending rates for cars, trucks and two-wheelers have increased by 500-600 basis points from the bottom. We believe the last round of tightening between December 2006 and March 2007 will ensure that domestic demand remains firmly on the path of deceleration.

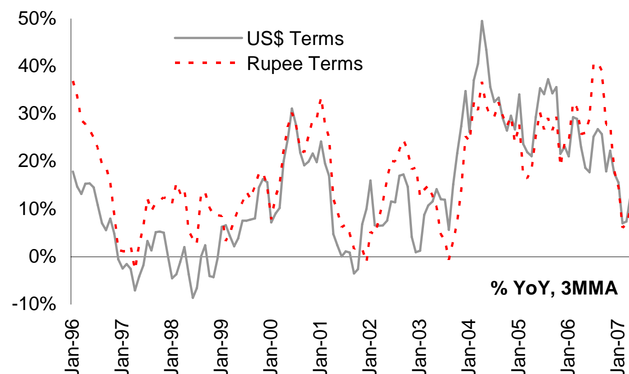
In addition to monetary tightening, since early March, the Central Bank has shifted its exchange rate management approach, allowing faster appreciation of the currency. The rupee has appreciated by about 8.5% against the US$ since early March, compared with only 3.7% in the preceding six months. Indeed, the appreciation since March has been much higher than that in other regional currencies. Appreciation in the exchange rate is helping reduce the overheating pressures. *Firstly,* it results in a rapid reduction in global commodity-linked products' prices in rupee terms. Global commodity-linked product prices (including oil) have a 37% weighting in the wholesale price index. *Secondly,* it will reduce pressure on domestic capacity utilization, as exports growth decelerates. Although, one can argue that controlling overheating through currency appreciation will not be sustainable and the ideal outcome, considering the given mandate of achieving rapid control on inflation, RBI has limited tools. Moreover, we believe it is imperative that the RBI allows appreciation in the exchange rate to ensure that its monetary policy is effective in an environment where the country is a recipient of large capital inflows.

Exhibit 4
Rail Freight Growth (% YoY)



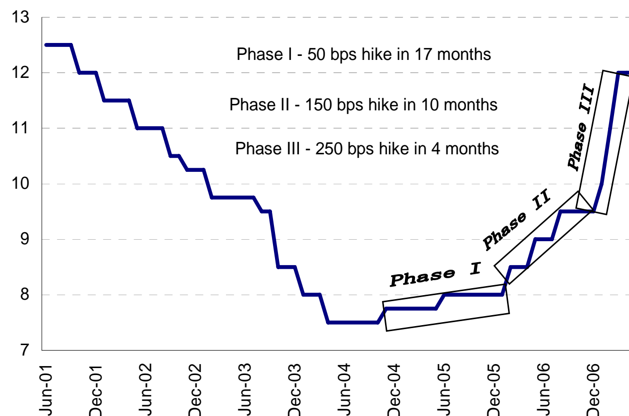
Source: Ministry of Railways, Morgan Stanley Research

Exhibit 5
Exports Growth



Source: Ministry of Commerce, CEIC, Morgan Stanley Research

Exhibit 6
Trend in Mortgage Lending Rates



Source: Morgan Stanley Research

Slowdown Likely to Continue

We believe that the rise in lending rates during December 2006-March 2007 is likely to be fully reflected with a lag in domestic demand in the second half of 2007. Similarly, the appreciation in the rupee since early March will also only be reflected in exports from July-August 2007. The Federation of Indian Export Organizations believes that exports for processed foods and agricultural items, electronics, electrical and steel products are likely to fall by 20-25% given the sharp rise in the rupee. The Ministry of Commerce has suggested a compensation package to help control the damage on account of the appreciating rupee. However, given the fiscal costs associated with the package (Rs330 billion or 0.7% of GDP – as per press reports) we believe that not all of these measures will be implemented soon.

Given that this slowdown in demand will reduce the concerns on overheating, particularly for inflation and the trade deficit, we believe that Central Bank measures going forward are likely to be targeted towards maintaining the banking lending rates at current levels as opposed to raising lending rates further. Hence, if the current growth slowdown trend and pace is maintained, the Central Bank may not have to initiate any more policy rate hikes. However, the RBI is likely to hike the cash reserve ratio/announce fresh measures to sterilize the continued inflow of foreign capital, ensuring that previous tightening measures remain effective. Indeed, recent capital inflows have already resulted in a surplus of US$10-12 billion in the money market, leading to a drop in interbank call money rates to 0.25-0.5%.

Upside Risk Comes from Large Capital Inflows

With the global capital market environment remaining supportive, there is a chance that capital inflows increase way above the average amount received over the past 12 months. Indian companies are planning fresh equity issuances worth over US$19 billion (including the recent DLF and ICICI Bank equity issuances) in the next six months. If all these equity issuances do come through and if the ECB/FCCB issuances spike up further, this would only increase domestic liquidity, challenging the RBI's efforts to slow domestic demand. However, we believe that, under such a scenario, the RBI may demonstrate its commitment to maintaining control over inflation via further tightening, largely in the form of aggressive cash reserve ratio hikes and some administrative measures related to bank lending, but highlighting the temporary nature of these moves. The RBI could also initiate tighter control on debt-related capital inflows.

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