Economic Analysis

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IIP: Cutting growth 50bp FY09, 100bp FY10

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Industry: Cutting growth 50bp FY09, 100bp FY10

We have cut our industrial growth forecast by 50bp for FY09 and by 100bp for FY10E. After all, 1.3% August 08 IIP surprised even our modest 3.9% expectation, which had been substantially below consensus of 5.9% (see here). These cuts lead us to shave 10bp off FY09E GDP and 20bp off FY10E real GDP growth.

We continue to expect a weak recovery ahead, with 4.9% April-August 08 IIP growth shifting up to 5.6% FY09 MLe. September 08 IIP should see 6%: electricity generation has recovered to 4.2% from August's 0.8%. October will likely be hit by the base effect of FY07's double-digit growth.

What then of an India soft landing? There is no doubt that things have globally gotten far rougher than we thought. Yet Indian growth downgrades remain amongst the least. We have cut our FY09 real GDP growth forecast to 7.5% (consensus, 7.5%) from 8.4% (consensus, 8.6%) in November. We do not believe that India is slipping into a "recession".

Table 1: India: Likely soft landing, US$109/bbl

Variable	FY08	FY09E	FY10E
Macroeconomic parameters (%)			
Real GDP growth rate	9	7.5	7.6
Agriculture	4.5	3	3
Industry	8.1	5.6	5.8
Services	11.4	9.3	9.3
M3 growth rate	20.7	18	17
Commercial credit	21.9	20	20
WPI inflation rate	7.8	9.1	5.5
Center's fiscal deficit (% of GDP)	-3.1	-3.5	-3.5
Current account balance (% of GDP)	-1.5	-2.7	-1.9
Forex reserves (US$bn)	309.8	313.2	335.4
RBI's LAF reverse repo rate (%)	6	6	6.0
RBI's LAF repo rate (%)	7.75	9.0	8.75
Cash reserve ratio	7.5	8.5	8.5
10-year Govt yields (%)	8	8.5	8.25
Prime lending rate of PSU banks (%)	12.25-12.75	14.25-14.75	14.0-14.5
US$/INR	40	43.50	42.50*

*December.

Source: Government of India, RBI, ML estimates.

Is the worst over? Lead indicators suggest bottoming out

We expect Indian industry to settle down to 5.5-6% growth, as base effects of last year's double-digit growth wear off. Our lead indicators suggest bottoming out. First, real cash demand, a good gauge of transactions demand, is holding on. Second, credit offtake is also likely flat, adjusted for substitution from equity issues/external commercial borrowings. Finally, April-August 08 non-oil exports are still growing by 30%, still much higher than 20% MLe.

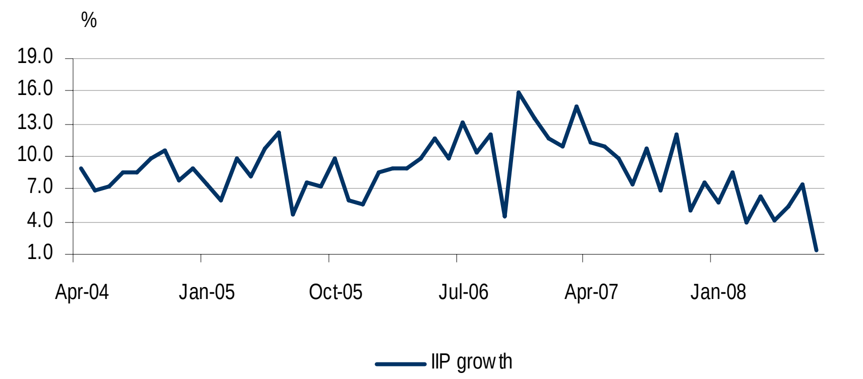
1.3% August 08 IIP: Slowdown yes, but base effects as well

How on earth could industrial growth crash to 1.3%? There is no doubt that Indian industry is slowing, pulled down by capacity constraints, higher metal prices, dearer money and slowing external demand. August 08 demonstrates that the slowdown is deeper than we thought: Table 3 shows 9/17 manufacturing segments recorded negative growth. But the picture was also exaggerated by base effects. While much is being made of 2.3% capital goods growth, this needs be viewed against August 07's 30.8% spike (Table 4). Similarly, 1.9% cement production need be seen against August 07's 16.9% (Table 5).

How bad could it get?

What if, clients ask these days, the whole world slipped into recession? Table 6 suggests that India could slip to 6% growth if we plug zero export growth into ML-Liq India, our liquidity model (see *Bloody but unbowed: Stress-testing US risk*, January 28, 08). Industry would then be relatively hard hit since 50% of its output is exported.

Chart 1: Industry likely to see a weak recovery ahead



Source: CSO.

Table 2: Industry dipped in August on base effects...and then some

Phase	Mining & quarrying	Manufacturing	Electricity	General index
Weight	10.5	79.4	10.2	100
High growth phase (FY1995-97)	5.9	10.2	6.9	9.4
Low growth phase (FY1998-2002)	2.2	5.3	5.5	5.0
FY 2004	5.2	7.4	5.1	7.0
FY 2005	4.4	9.2	5.2	8.4
FY 2006	1.0	9.1	5.2	8.2
FY2007	5.4	12.5	7.2	11.6
FY 2008	5.1	8.7	6.4	8.3
Aug-07	14.7	10.7	9.2	10.9
Aug-08	4.0	1.1	0.8	1.3
FY 2009F	4.0	5.8	5.7	5.6

Source: CSO, ML estimates.

Table 3: 9/17 industrial sectors recorded a decline in growth in August 08

Industry	Weight	High growth phase	Low growth phase	FY04	FY05	FY06	FY07	FY08	Aug-08
Food products	9.1	10.6	2.6	-0.5	-0.4	2.1	8.2	6.3	8.9
Beverages, tobacco and related products	2.4	9.9	11.3	8.5	10.8	16.3	11.3	11.8	5.7
Cotton textiles	5.5	7.2	0.4	-3.1	7.6	8.5	14.8	4.3	-5.4
Wool, silk and man-made fibre textiles	2.2	13.2	8.7	6.8	3.5	0.0	8.2	4.6	-14.9
Jute and other vegetable fibre textiles (except cotton)	0.6	-0.6	0.7	-4.2	3.7	0.5	-17.2	33.1	-6.7
Textile products (including wearing apparel)	2.5	14.5	2.7	-3.2	19.2	16.3	11.2	3.6	2.9
Wood and wood products; furniture and fixtures	2.7	10.2	-6.5	6.8	-8.4	-6.8	29.1	38.9	-8.1
Paper & paper products and printing, publishing & allied industries	2.7	11.1	4.6	15.6	10.5	-1.0	8.3	2.7	1.4
Leather and leather & fur products	1.1	3.2	8	-3.9	6.7	-5.6	0.3	11.7	-7
Basic chemicals & chemical products (except products of petroleum & coal)	14.0	7.1	8.6	8.7	14.5	8.2	9.2	10.6	-0.7
Rubber, plastic, petroleum and coal products	5.7	5.8	7.7	4.5	2.4	4.3	12.7	8.8	-8.4
Non-metallic mineral products	4.4	13.3	9.2	3.7	1.5	10.6	12.8	5.8	-0.1
Basic metal and alloy industries	7.5	11.9	2.2	9.2	5.4	15.7	22.8	12.1	8
Metal products and parts, except machinery and equipment	2.8	3.6	5.7	3.7	5.7	-1.1	11.4	-5.6	-12.3
Machinery and equipment other than transport equipment	9.6	13.2	6.7	15.8	19.8	11.8	14.0	9.5	4.5
Transport equipment and parts	4.0	14.3	6.6	17	4.1	12.7	14.9	2.8	11.2
Other manufacturing industries	2.6	19.7	0.8	7.7	18.5	25.0	6.5	19.8	-5.7

Source: CSO.

Table 4: Capital goods suffered from massive base effect of August 2007's 30.8% spike

Phase	Basic goods	Capital goods	Intermediate goods	Consumer goods Total	Durables	Non-durables
Weight	35.6	9.3	26.5	28.7	5.4	23.3
High growth phase	7.8	8.7	10.9	10.4	15.5	9.2
Low growth phase	4.1	4.7	5.8	5.5	10.7	3.8
FY2004	5.4	13.6	6.4	7.1	11.6	5.8
FY2005	5.5	13.9	6.1	11.7	14.4	10.8
FY2006	6.7	15.8	2.5	12.0	15.3	11.0
FY2007	10.3	18.2	11.9	10.1	9.2	10.4
FY2008	7.0	16.9	8.8	5.9	-1.0	8.3
August 2007	12.7	30.8	13.8	0.0	-6.2	2.4
August 2008	3.9	2.3	-6.2	5.1	5.1	5.1

Source: CSO.

Table 5: Infrastructure - especially, cement - also afflicted by base effects

Year	Electricity	Coal	Finished steel	Cement	Crude petroleum	Petroleum refinery products	Overall
Weight	10.2	3.2	5.1	2.0	4.2	2.0	26.7
High growth phase	6.2	5.3	11.3	10.1	1.8	4.9	6.9
Low growth phase	4.8	2.7	11.3	10.1	1.8	4.9	6.9
FY 2004	5.1	5.8	9.8	6.1	1.0	8.2	6.2
FY 2005	5.2	3.9	8.4	6.6	1.8	4.3	5.8
FY2006	5.1	6.6	11.2	12.4	(5.3)	2.1	6.2
FY2007	7.3	5.9	10.9	9.1	5.6	12.6	8.6
FY2008							
August 2007	9.2	8.0	9.6	16.7	6.5	8.2	9.5
August 2008	0.8	5.9	4.4	1.9	(0.1)	2.5	2.3

Source: CSO.

Table 6: A world recession - not our central scenario - pulls Indian growth down to 6% levels

	Share of GDP (%)	FY09E growth rate	Share in merchandise exports (%)	Merchandise exports (% of GDP)	Merchandise export content (% of GDP)	Export multiplier	Merchandise export content (% of GDP)	Services exports (% of GDP)	Non-export content (% of GDP)	Growth contribution
1	2	3	4	5	6 = 4*5	7	8 = 2 - (6*7)	9	10 = 8 - (7*9)	11 = 3*10
Agriculture	22.2	3	11.6	12	1.4	1.2	20.5		20.5	0.6
Industry	19.6	5.8	83.3	12	10.0	1.2	7.6		7.6	0.4
Services	58.2	9.3	5.1	12	0.6	1.2	57.5	4.5	53.0	4.9
Total	100	7.5	100	12	12.0		85.6		81.1	6.0

Source: ML estimates.

Analyst Certification

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