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TREASURY SERVICES

26th February, 2009

HIGHLIGHTS

Domestic Markets

Currency

In our 7th January 2009 report on **"Rupee outlook for 2009",** we had mentioned that ***"we expect the Rupee to remain under pressure in the rest of the current fiscal. There is a high probability of INR to re-test the previous lows of US$50.60/INR once more in the next three months".*** In the first week of January 09, (while we were writing our currency report), INR was trading around US$ 48.50-48.75/INR levels. The INR has currently breached the US$50.00/INR levels and is heading towards a re-test of its previous intraday lows of US$50.60/INR (traded on 1st December 2008).

Our depreciation bias for the rupee is strengthened as we feel that the worsening of the fiscal conditions, a high likelihood of a hung parliament post the general elections and also a risk of sovereign downgrade could lead to some adverse pressures on the Indian rupee. Moreover, the Dollar is expected to remain strong against the Euro in the first half of 2009 as risk aversion will continue for some more time. ***We expect Euro to head towards 1.20 levels in the next 3-6 months.*** That will also prove to be a Rupee negative factor. **The INR is expected to trade in a range of US$ 48- 51.00/INR in the next three months.**

However, over a longer period we would look at some reversal in this trend, mainly on the basis of Dollar weakening against major currency pairs rather than on the basis of Dollar flows into India that is still expected to remain on the weaker side. ***We expect INR to recover to US$ 46-47 / INR by end-December 2009.***

Rates

We expect the oversized market borrowings in FY10 to impact bond market sentiments negatively. We expect RBI to reduce the benchmark Reverse Repo rate by another 50 to 100 bps before the end of the current rate cycle. Despite this expectation, bond yields are unlikely to come off significantly from the current levels as the market witnesses around Rs 12,000 crore of Central Government supplies each week in the rest of this fiscal punctuated by large state government issuances. While in the current fiscal, the downward momentum of the bond yields was mainly on account of an easing monetary policy in the face of higher market borrowings, in the next financial year the higher borrowing programme will be the overriding factor as space for more monetary easing remains limited.

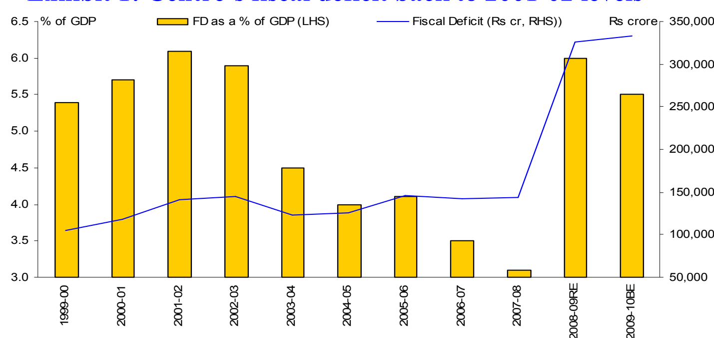
We expect the yield curve to gradually steepen on supply pressures. ***Broad range for the 10- Yr G-Sec for 2009-10 appears to be at 5.75-7.00%. With credit concerns continuing, the spread of AAA 5-year benchmark over the 5-year G-sec is unlikely to shrink significantly from the current levels of 280-300 bps.***

Indian Macroeconomic Outlook

Fiscal situation getting worse by the day

The interim budget announced by the UPA government on 16th February indicated Centre's fiscal deficit to be at a revised 6% of GDP for 2008-09 and is estimated at 5.5% in 2009-2010 (the Budget leaves a fiscal headroom of another 0.5-1.0% of GDP for next fiscal). Adding off-balance sheet items and state governments' fiscal deficit, the consolidated gross fiscal deficit is expected to be in the range of 10-12% in both the years.

Exhibit 1: Centre's fiscal deficit back to 2001-02 levels



Source: Budget Documents, Kotak Mahindra Bank

FRBM targets sacrificed in FY09 & FY10

Fiscal Deficit for FY09BE is expected to increase to 6% of GDP from 2.5% forecasted earlier due to higher expenditure on various subsidies and fiscal stimuli coupled with lower revenue receipts.

Exhibit 2: Deficit targets overshoot sharply in FY09

	Items	FY09BE	FY09RE	Difference	% change	Estimated Targets over FY08	Actuals achieved over FY08
1	**Revenue Receipts (2+3)**	**602,935**	**562,173**	**-40,762**	**-6.8**	**14.8**	**7.1**
2	Tax Revenue (Net)	507,150	465,970	-41,180	-8.1	17.5	7.9
3	Non-Tax Revenue	95,785	96,203	418	0.4	2.7	3.1
4	**Non-Debt Capital Receipts (5+6)**	**14,662**	**12,265**	**2,397**	**-16.3**	**-63.9**	**-69.8**
5	Recovery of Loans	4,497	9,698	5,201	115.7	-0.1	115.5
6	Other Receipts	10,165	2,567	-7,598	-74.7	-71.8	-92.9
7	**Total Receipts (1+4)**	**617,597**	**574,438**	**-43,159**	**-7.0**	**9.2**	**1.5**
8	**Non-Plan Expenditure**	**507,498**	**617,996**	**110,498**	**21.8**	**1.1**	**23.2**
9	On Revenue Account	448,352	561,790	113,438	25.3	8.6	36.0
10	On Capital Account	59,146	56,206	-2,940	-5.0	-33.4	-36.7
11	**Plan Expenditure**	**243,386**	**282,957**	**39,571**	**16.3**	**17.3**	**36.4**
12	On Revenue Account	209,767	241,656	31,889	15.2	19.5	37.6
13	On Capital Account	33,619	41,301	7,682	22.9	5.4	29.5
14	**Total Expenditure (8+11)**	**750,884**	**900,953**	**150,069**	**20.0**	**5.9**	**27.0**
15	**Fiscal Deficit (14-7)**	**133,287**	**326,515**	**193,228**			
	% of GDP	*2.5*	*6.0*				
16	**Revenue Deficit (9+12-1)**	**55,184**	**241,273**	**186,089**			
	% of GDP	*1.0*	*4.4*				
	Memo items						
	GDP at market prices (Rs cr)	**5,426,277**	**5,426,277**				

Source: Budget Documents, Kotak Mahindra Bank

As per the revised estimates for FY09, Gross Tax collection are estimated to slip by Rs 59,766 crores in FY09, leading to a yoy growth of just 7.3% RE against FY09BE of 17.5% yoy growth. Consequently, Revenue Deficit will jump to 4.4% of GDP (RE) in FY09 from the budgeted figure of 1.0% of GDP.

Exhibit 3 highlights that the largest slippages are expected from excise, customs and personal income tax collections.

Exhibit 3: Tax collections collapse in FY09

Items	2007-08	2008-09 BE	Estimated Targets over FY08	2008-09 RE	Slippage from FY09 BE	Actuals achieved over FY08
Gross Tax Revenue	**585,410**	**687,715**	**17.5**	**627,949**	**59,766**	**7.3%**
% of GDP	12.4%	12.7%		11.6%	1.1%	
Direct Taxes	**304,445**	**364,675**	**19.8**	**344,600**	**20,075**	**13.2%**
% of GDP	6.4%	6.7%		6.4%	0.4%	
Corporate Tax	186,125	226,361	21.6	222,000	4,361	19.3%
% of GDP	3.9%	4.2%		4.1%	0.1%	
Income Tax	118,320	138,314	16.9	122,600	15,714	3.6%
% of GDP	2.5%	2.5%		2.3%	0.3%	
Indirect Taxes	**279,316**	**321,264**	**15.0**	**281359**	**39,905**	**0.7%**
% of GDP	5.9%	5.9%		5.2%	0.7%	
Customs Tax	100,766	118,930	18.0	108,000	10,930	7.2%
% of GDP	2.1%	2.2%		2.0%	0.2%	
Excise Tax	127,947	137,874	7.8	108,359	29,515	-15.3%
% of GDP	2.7%	2.5%		2.0%	0.5%	
Service Tax	50,603	64,460	27.4	65,000	-540	28.5%
% of GDP	1.1%	1.2%		1.2%	0.0%	
Other Taxes	**1,649**	**1,776**	**7.7**	**1,990**	**-214**	**20.7%**

Source: Budget Documents, Kotak Mahindra Bank

Financing the deficits in FY09

Even after accounting for the additional borrowings of Rs 46,000 crores announced on 10th February 2009, there appears to be a resource gap of Rs 45,090 crores in financing the Fiscal Deficit gap for FY09.

Exhibit 4: Resource gap to be met from MSS fund transfers

	Items	**FY09RE**
1	Revised Fiscal Deficit (6% of GDP)	326,515
2	Repayments of dated securities	44,028
3	**Total financing required (1+2)**	**370,543**
4	Gross Borrowing announced till now	261,000
5	Other sources of financing	6,953
6	**Total financed till now (4+ 5)**	**267,953**
7	**Existing Gap**	**102,590**
8	***Less: To be funded by short-term borrowings (T-Bills)***	57,500
9	**Remaining gap that needs funding (7-8)**	**45,090**
10	**Total Gross Borrowing (Revised Estimates)**	**306,000**
11	***Less: Repayments of dated securities***	44,028
12	**Total Net Borrowing (10-11) (Revised Estimates)**	**261,972**

Source: Budget Documents, Kotak Mahindra Bank

The Memorandum of Understanding between RBI and the Government as regards the Market Stabilization Scheme (MSS) would be amended in order to use MSS funds to cover for the higher fiscal deficit. Originally, the MSS funds were not supposed to be meeting any fiscal gaps. Though no final word on this has been issued, the sense is that of a 1:1 conversion of MSS bonds into regular GOI market borrowings. This would enable the government not to go in for higher market borrowings to bridge the resource gap. For all practical purposes, conversion of MSS bonds into GOI securities is a **backdoor route of monetization of fiscal deficit.**

We think that the Rs 45,000 crore of MSS securities that might be converted into GOI bonds will have their redemptions due in FY11 and hence not impact the repayment schedule and the gross market borrowings of the Central Government in 2009-10. Gross borrowing in FY11 however will go up by an additional Rs 45,000 crores on account of redemption of these papers.

Exhibit 5: MSS redemption calendar: 2010-11

Security	Maturity	Face value (Rs crore)
7.55%GS2010	14-May-10	2,420
12.25%GS2010	2-Jul-10	7,000
11.30%GS2010	28-Jul-10	25,000
6.57%GS2011	24-Feb-11	12,000
Total		**46,420**

Source: RBI, Kotak Mahindra Bank

As indicated earlier, this arrangement will reduce the pressure on market borrowing for the moment but will keep the gross market borrowing higher in the coming years. The Government's assumption probably is that it will be able to lower the Fiscal Deficit in FY11 as expenditures on 6th Pay Commission and Farm Loan Waiver mostly get completed in 2009-10. Hence, pressure on market borrowings might not be significant even after adding the Rs 45,000 crore of additional redemptions. Such a scenario is contingent on a sharp revival of growth in 2010-11 which looks unlikely.

Fiscal Deficit estimated at 5.5% in FY10 – may be higher by end year

FY10 Fiscal Deficit targets have been set at 5.5% of GDP in FY10, lower than FY09RE of 6.0%. However, the government's Fiscal Stimulus-III (announced on 24th February09) of 2% tax cuts in Union Excise duties and Services tax, coupled with the extension of 4% reduction in CENVAT would lead to a revenue loss of roughly Rs 30,000 crores or 0.5% of the GDP. Therefore the FY10BE of Fiscal Deficit will be revised upwards to 6.0% from the 5.5% budgeted earlier. The FY10 Fiscal Deficit can be revised further up, if more fiscal measures are announced in the regular budget after the new Government takes charge. The interim budget had anyways built in headroom of additional plan expenditure of 0.5-1.0% of GDP when the regular budget is announced.

Exhibit 6: FY10 Fiscal Deficit targets

	Items	FY09BE	FY09RE	Actuals achieved over FY08	FY10BE	FY10BE over FY09RE (% yoy)
1	**Revenue Receipts (2+3)**	**602,935**	**562,173**	**7.1**	**609,551**	**8.4**
2	Tax Revenue (Net)	507,150	465,970	7.9	497,596	6.8
3	Non-Tax Revenue	95,785	96,203	3.1	111,955	16.4
4	**Non-Debt Capital Receipts (5+6)**	**14,662**	**12,265**	**-69.8**	**10,845**	**-0.1**
5	Recovery of Loans	4,497	9,698	115.5	9,725	0.3
6	Other Receipts	10,165	2,567	-92.9	1,120	-56.4
7	**Total Receipts (1+4)**	**617,597**	**574,438**	**1.5**	**620,396**	**8.0**
8	**Non-Plan Expenditure**	**507,498**	**617,996**	**23.2**	**668,082**	**8.1**
9	On Revenue Account	448,352	561,790	36.0	599,736	6.8
10	On Capital Account	59,146	56,206	-36.7	68,346	21.6
11	**Plan Expenditure**	**243,386**	**282,957**	**36.4**	**285,149**	**0.8**
12	On Revenue Account	209,767	241,656	37.6	248,349	2.8
13	On Capital Account	33,619	41,301	29.5	36,800	0.0
14	**Total Expenditure (8+11)**	**750,884**	**900,953**	**27.0**	**953,231**	5.8
15	**Fiscal Deficit (14-7)**	**133,287**	**326,515**		**332,835**	
	% of GDP	*2.5*	*6.0*		*5.5*	
16	**Revenue Deficit (9+12-1)**	**55,184**	**241,273**		**238,534**	
	% of GDP	*1.0*	*4.4*		*4.0*	
	Memo items					
	GDP at market prices (Rs cr)	**5,426,277**	**5,426,277**		**6,021,426**	

Source: Bloomberg, Kotak Mahindra Bank

Exhibit 7: FY10 tax collection expected to remain depressed as growth slowdown intensifies

Items	2008-09 RE	2009-10 BE	Estimated Targets over FY09RE	Actuals achieved in FY09 over FY08
Gross Tax Revenue	**627949**	**671,293**	**6.9**	**7.3**
% of GDP	11.6%	12.4%		
Less: Transfer to states & UT	**161,979**	**173,697**	**7.2**	
Net Tax Revenue	**465,970**	**497,596**	**6.8**	
% of GDP	8.6%	8.3%		
Direct Taxes	**344600**	**379,575**	**10.1**	**13.2**
% of GDP	6.4%	6.3%		
Corporate Tax	222000	244,200	10.0	19.3
% of GDP	4.1%	4.5%		
Income Tax	122600	135,375	10.4	3.6
% of GDP	2.3%	2.5%		
Indirect Taxes	**281359**	**289,691**	**3.0**	**0.7**
% of GDP	5.2%	4.8%		
Customs Tax	108000	110,187	2.0	7.2
% of GDP	2.0%	2.0%		
Excise Tax	108359	110,604	2.1	-15.3
% of GDP	2.0%	2.0%		
Service Tax	65,000	68,900	6.0	28.5
% of GDP	1.2%	1.3%		
Other Taxes	**1,990**	**2,027**	**1.9**	**20.7**
GDP at market prices	**5,426,277**	**6,021,426**		

Source: Bloomberg, Kotak Mahindra Bank

Lessons from the past

The current fiscal deficit levels are comparable with the period between 1999-2000 and 2001-2002, when the gross fiscal deficit had increased to 9.5-10% (Centre plus State) due to the adverse effect of the Fifth Pay Commission awards.

Exhibit 8: High fiscal deficit years and its impact on the real economy

	Macrovariables	1999-00	2000-01	2001-02
A	**Real GDP (%)**	**6.4**	**4.4**	**5.8**
B	**Gross Fiscal Deficit (centre + state) (% of GDP)**	**9.47**	**9.51**	**9.94**
C	Gross Domestic Savings (% of GDP)	24.8	23.7	23.5
a	Public savings (% of GDP)	-0.8	-1.8	-2.0
b	Household Savings (% of GDP)	21.1	21.6	22.1
c	Corporate Savings (% of GDP)	4.5	3.9	3.4
D	Gross Domestic Capital Formation (% of GDP)	25.9	24.3	22.8
a	Private Investments	17.9	16.6	16.7
b	Public Investments	7.4	6.9	6.9
E	Current Account Deficit (% of GDP) (C-D)	-1.0	-0.6	0.7
F	Capital goods (% yoy)	15.6	1.9	-3.5
G	Consumer goods (% yoy)	5.6	8.1	6.0

Source: RBI, CSO, Kotak Mahindra Bank

As shown in the adjoining table, fiscal deficit between 1999-2000 and 2001-2002 remained sticky at about 9.5-10%. Higher fiscal deficit meant a rise in public dissavings, which rose from -0.8% of GDP in 1999-2000 to -2% of GDP in 2001-02. On the other hand, corporate savings declined from 4.5% of GDP in 1999-2000 to 3.4% of GDP by 2001-02. The household savings component, however, rose in this 3-year period from 21.1% to 22.1% as households preferred to save more than spend in an uncertain economic scenario. But the steep fall in corporate savings and a sharp rise in public dissavings led to a fall in the overall gross domestic savings from 24.8% in 1999-2000 to 23.5% in 2001-02.

On the gross domestic capital formation (GDCF) front, public investments held up pretty well, consistently around 7% of GDP while private investments came down from 17.9% in fiscal 2000 to 16.7% in 2001-02 (due to crowding out effect), thereby dragging the overall GDCF down from 25.9% to 22.8% by the end of 2001-02.

The current account balance, which bridges the gap between domestic savings and investment turned from a deficit of -1% of GDP in fiscal 2000 to a surplus of 0.7% of GDP by 2001-02. This effectively meant that India turned from a net savings importing country to a net savings exporting country. In other words, domestic investment activity remained extremely weak during this period to even absorb the domestic savings fully, which led India to export part of its domestic savings abroad.

Weak investment sentiments were reflected in capital goods growth turning negative 3.5% by 2001-02 from a rise of 15.6% in fiscal 2000. Consumer goods growth, on the other hand, remained strong in this three-year period due to fiscal pump-priming. This is typical in an economic down cycle where the more volatile investment sector takes a bigger hit than the consumption sector as most of the government policies in an economic downturn are aimed at boosting consumer spending.

The overall impact of a higher fiscal deficit between fiscal years 2000 and 2002 was a sizable reduction in gross domestic savings and investment, which pulled down the real GDP growth from 6.4% in 1999-2000 to 4.4% in 2000-01 and 5.8% in 2001-02.

The visible negative effects of the previous high deficit period forced the government to pass the Fiscal Responsibility and Budget Management Bill in 2003, which later helped bring the Centre's fiscal deficit as a percentage of GDP down to 3.1% in FY08 from a peak of 6.1% in 2001-02. But most of this improvement was just on paper, brought about by a rapid growth in the nominal GDP during the FY03-08 period. However, on an absolute scale, India's fiscal deficit did not shrink at all and remained virtually unchanged in FY06, FY07 and FY08.

How will the present high levels of fiscal deficit impact the real economy in the coming years?

First, a sustained high fiscal deficit will result in crowding out of private investments. Capital goods sector growth has already fallen to 2.3% in December 2008 (the lowest since April 2002) on a three-month moving average basis from a peak of 24.2% in October 2007. With investment activity deteriorating rapidly, capital goods growth may even head towards negative territory in the next fiscal. Contra-cyclical fiscal and

monetary policy will, however, help support consumption growth. But, as investment growth plays a bigger role in maintaining the growth momentum in the economy, as witnessed in the last five-year boom period, the real GDP growth would dip as investments growth falls but consumption growth holds up.

Second, a shrinking investment demand will need lesser foreign savings to fund the investment growth. This will probably result in the current account deficit turning into a surplus over the next few years.

Third, a higher fiscal deficit may also result in a sovereign rating downgrade by international credit rating agencies, leading to more capital outflows and depreciation of the rupee. S&P has recently downgraded the ratings outlook from stable to negative, implying that India has been put on a ratings watch. There is a possibility that the global rating agencies would wait to see the constituents of the new government at the Centre and would watch out for the fiscal policy of the new government before deciding on reducing India ratings. The report of the 13th Finance Commission and the path it sets out for the second round of FRBM is also likely to be watched for any ratings decision. A high fiscal deficit and excessive monetary stimulus to prop up growth is bound to result in higher inflation pressures and needs to be watched carefully.

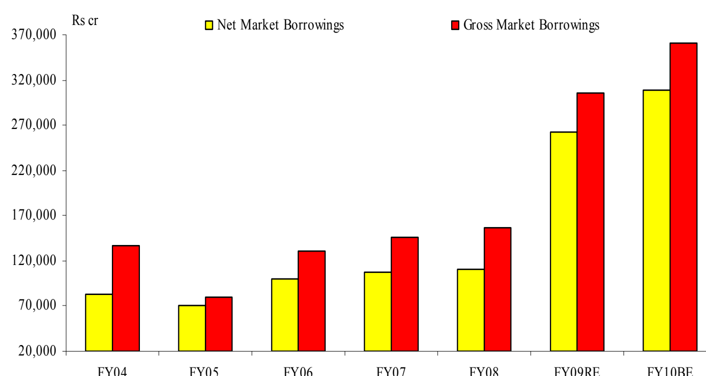
After the last economic down cycle, Indian economic growth revived primarily because of the global lax monetary policy that was followed between 2003 and 2006, which led to a humongous amount of capital flows coming into the Indian economy, thus helping to prop up investment demand. This time round, despite the various fiscal and monetary stimulus policies adopted by most developed nations, the revival in the global economy may be a long drawn process. This simply implies that India will most likely be rooted to a relatively lower growth (5.5-6.5%) trend-line trajectory in the coming years but with added pressures from the high fiscal deficit and the spectre of a high inflation.

Bond markets to remain under pressure in FY10

We expect the oversized market borrowings in FY10 to impact bond market sentiments negatively. We expect RBI to reduce the benchmark Reverse Repo rate by another 50 to 100 bps before the end of the current rate cycle. Despite this expectation, bond yields are unlikely to come off significantly from the current levels as the market witnesses around Rs 12,000 crore of Central Government supplies each week in the rest of this Fiscal punctuated by large state government issuances. While in the current fiscal, the downward momentum of the bond yields was mainly on account of an easing monetary policy in the face of higher market borrowings, in the next financial year the higher borrowing programme will be the overriding factor as space for more monetary easing remains limited.

We expect the yield curve to gradually steepen on supply pressures. ***Broad range for the 10- Yr G-Sec for 2009-10 appears to be at 5.75-7.00%. With credit concerns continuing, the spread of AAA 5-year benchmark over the 5-year G-sec is unlikely to shrink significantly from the current levels of 280-300 bps.***

Exhibit 9: Oversized government borrowings in FY09 and FY10



Source: Budget Documents, Kotak Mahindra Bank

Exhibit 10: Gross and Net Market Borrowings **Rs crore**

Items	FY09E	FY10E	Difference
Gross Brorrowings	**306,180**	**361,000**	54,820
Gross Brorrowings as % of FD	93.8	108.5	
Less: Repayments	***44,208***	***52,353***	8,145
Net Brorrowings	**261,972**	**308,647**	46,675
Net Brorrowings as % of FD	80.2	92.7	
Fiscal Deficit	**326515**	**332835**	

Source: Budget Documents, Kotak Mahindra Bank

Exhibit 11: Lesser demand relative to supplies likely to push up bond yields higher in FY10

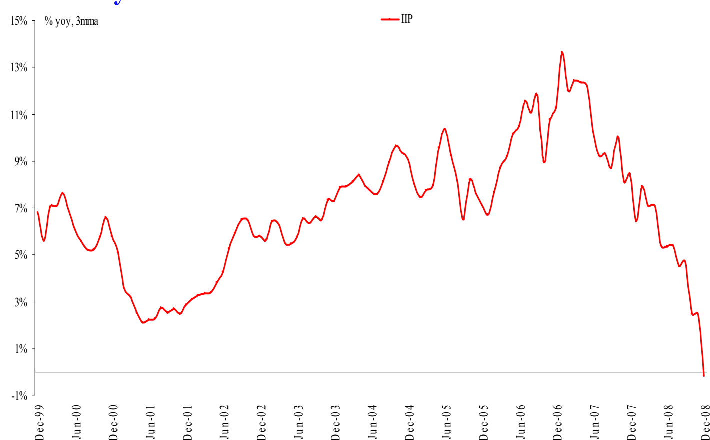
	Demand Supply balance of gilts	FY08	FY09E	FY10E
1	**Demand for SLR securities (2 to 4)**	**250500**	**265281**	**242472**
2	required from banks	181200	193281	169972
3	from insurance companies	53400	50000	50000
4	from others (PF+MF)	15900	22000	22500
5	**Supply of SLR securities (6 to8)**	**192500**	**395395**	**381907**
6	Net market borrowing of center	110700	261972	308647
7	T-bills financing	25600	57000	0
8	Net State Government issuances	56200	76423	73260
9	**Demand-Supply (1-5)**	**58000**	**-130114**	**-139435**
	To be met through			
10	MSS	105700	113446	57456
11	Outright OMOs	0	16668	20000
12	**Total**	**105700**	**130114**	**77456**
13	**Gap**	**-47700**	**0**	**-61979**

Source: Budget Documents, Kotak Mahindra Bank

December IIP collapses to a 16-year low

Industrial production growth for December 08 contracted sharply by 2.0% against market expectations of a 0.4% decline. This is by far the worst IIP number reported in the last 16 years. The November 08 number was also revised down to 1.7% from 2.4% reported in the provisional estimates. With December's contraction in IIP by 2.0%, IIP growth has collapsed to -0.2% on a 3 month moving average basis (September to December quarter), a multi-year low. The manufacturing sector shrunk by 2.5% in December 08, taking the 3 month moving average to a record low of -0.6%. On a cumulative basis, the IIP growth stands at 3.2% in FYTD09 compared to 9.0% in FYTD08. ***We expect the IIP growth to remain weak in the last quarter of the current fiscal as well.***

Exhibit 12: IIP growth (3 mma) collapses in December 08 to a 16-year low



Source: CSO, Kotak Mahindra Bank

Exhibit 13: Monthly IIP growth trend

Items	Wts.	Apr-08	May-08	Jun-08	Jul-08	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08	April - Dec FY09	April - Dec FY08
Sector												
IIP General Index	**100.0**	**6.2**	**4.4**	**5.4**	**6.4**	**1.7**	**6.0**	**-0.3**	**1.7**	**-2.0**	**3.2**	**9.0**
Mining & Quarrying	10.5	6.1	5.5	0.1	2.8	2.8	5.8	3.2	0.3	1.0	3.0	5.2
Manufacturing	79.4	6.7	4.5	6.1	6.9	1.7	6.2	-1.1	1.8	-2.5	3.3	9.6
Electricity	10.2	1.4	2.0	2.6	4.5	0.8	4.4	4.4	2.6	1.6	2.7	6.6
Use Based												
Basic Goods	35.5	4.0	3.0	2.2	5.3	3.9	5.0	3.1	2.1	1.7	3.4	7.8
Capital Goods	9.7	12.4	4.3	7.8	17.9	0.9	20.8	2.9	-0.1	4.2	7.7	20.4
Intermediate Goods	26.4	3.1	1.9	2.8	3.0	-5.5	-2.5	-4.0	-4.2	-8.5	-1.6	9.6
Consumer Goods	28.4	8.5	7.4	9.9	5.9	6.4	7.4	-2.2	7.3	-2.7	5.2	5.8
- Durable	5.1	3.2	2.8	4.6	13.9	3.9	14.7	-3.1	-4.2	-12.8	2.5	-1.4
- Non Durable	23.3	10.0	9.0	11.6	3.4	7.3	4.8	-1.8	11.2	-0.1	6.0	8.4

Source: CSO, Kotak Mahindra Bank

The contraction in the IIP was mainly on account of a sharp deterioration in the manufacturing sector growth which has an overall weightage of 79.4% in the IIP. 10 out of 17 industry groups among the manufacturing sector have recorded a decline with the most pronounced contraction seen in "Jute and other vegetable fibre textiles (-66.4%)", "Wood and wood products, furniture and fixtures (-20.0%)", "Leather and leather fur products (-11.4%)" and "Transport equipment and parts (-17.9%)". Except for the "Transport equipment and parts" industry, the other three industries which have seen the maximum contraction in December 08 are also the same industries whose growth have contracted the most between April to December 08 indicating a steady deterioration in these industries (Exhibit 14).

Exhibit 14: Details of manufacturing sector growth in Dec

Sub-segments of manufacturing sector	Weight	% yoy growth Dec-08	% yoy growth Apr-Dec 08
Food Products	9.1	-8.7	-1.8
Beverages, Tobacco and Related Products	2.4	9.0	16.7
Cotton Textiles	5.5	-6.1	-1.5
Wool, Silk and man-made fibre textiles	2.3	2.6	-2.0
Jute and other vegetable fibre Textiles (except cotton)	0.6	-66.4	-11.3
Textile Products (including Wearing Apparel)	2.5	2.5	4.7
Wood and Wood Products; Furniture and Fixtures	2.7	-20.0	-7.5
Paper & Paper Products and Printing, Publishing & Allied Industries	2.7	-1.9	3.4
Leather and Leather & Fur Products	1.1	-11.4	-6.5
Basic Chemicals & Chemical Products (except products of Petroleum & Coal)	14.0	-7.2	2.8
Rubber, Plastic, Petroleum and Coal Products	5.7	-4.6	-2.8
Non-Metallic Mineral Products	4.4	6.7	0.9
Basic Metal and Alloy Industries	7.5	3.8	6.0
Metal Products and Parts, except Machinery and Equipment	2.8	7.6	1.3
Machinery and Equipment other than Transport equipment	9.6	-4.1	7.0
Transport Equipment and Parts	4.0	-17.9	4.1
Other Manufacturing Industries	2.6	21.7	1.5

Source: CSO, Kotak Mahindra Bank

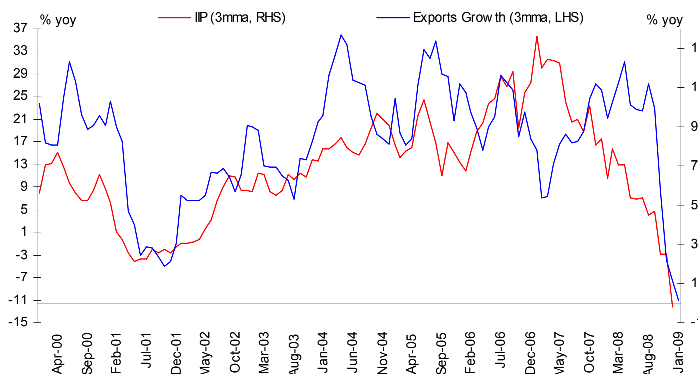
From a use-based classification, intermediate and durable consumer goods segments have performed the worst, contracting by 8.5% and 12.8% respectively. Intermediate goods segment had seen a surprise positive growth of 2.6% in November 2008. This segment was de-growing since August 2008 and now the November data stands revised lower at -4.2%, a contraction for the 5th month in a row. Cumulatively, intermediate goods growth has contracted by 1.6% in FYTD09 as compared to a positive growth of 9.6% in FYTD08. We expect this sector to remain depressed in the remaining three months of this fiscal as well due to high base effects of the last year and the lower demand for end use products.

Durable consumer goods segment contracted for the third month in a row with the highest contraction recorded in December 08 of 12.8%. This kind of contraction was last seen in March 03 when this segment had contracted by 12.2%. Uncertainty in the domestic real economy has probably led to households tightening their purse strings, despite the concerted effort by the Government and the RBI to provide fiscal and monetary stimulus to growth. This was reflected in sharp contraction in passenger car and commercial vehicles in December 08. The sales of automobiles did improve in January 09 (sales of automobiles generally pick up in January), to an extent helped by the Government announcement of a 4% CENVAT cut on 7th December 08. Overall, consumers sentiments are unlikely to revive soon even with the tax cuts in the Fiscal Stimulus package-III as domestic consumers remain risk-averse and reduce consumption. Export demand is also likely to stay weak as the global economy is moving into a deeper recession. Provisional estimates of exports growth for January 09 show a contraction of 22%. Given the strong correlation between exports and IIP growth, we do not expect the IIP growth to revive back anytime soon.

Surprisingly, the capital goods segment held reasonably strong with a 4.2% growth in December 08 (despite an adverse base effect). We expect the capital goods sector growth to show a steady downtrend in the next financial year, though in the next two months we expect capital goods growth to remain steady on a favourable base effect.

We remain bearish on the growth prospects of the Indian economy in the coming quarters and expect the industrial sector growth to fall below CSO's estimate of 4.8% for FY09. We expect industrial growth for FY09 to be slightly lower at 3% which leads us to forecast a full year GDP of 6.8% for FY09 as against CSO's estimate of 7.1%. For Q3 we expect GDP growth to print at 6.2%.

Exhibit 15: Exports and IIP growth (3mma) falling sharply since October 08



Source: Bloomberg Kotak Mahindra Bank

With WPI inflation heading towards a negative zone, industrial growth contracting and credit and M3 growth expected to come down further from current levels, the RBI will have more headroom to cut interest rates to prop up growth. We continue to expect RBI to cut Reverse Repo and Repo rates by 50-100bps before the end of this rate cycle.

Exhibit 16: Monetary measures taken so far

Date	Rev. Repo	Repo	CRR
30-Aug-08	6.00	9.00	9.00
11-Oct-08	6.00	9.00	6.50
20-Oct-08	6.00	8.00	6.50
25-Oct-08	6.00	8.00	6.00
3-Nov-08	6.00	7.50	6.00
8-Nov-08	6.00	7.50	5.50
8-Dec-08	5.00	6.50	5.50
2-Jan-09	4.00	5.50	5.50
17-Jan-09	4.00	5.50	5.00

Source: RBI, Kotak Mahindra Bank

Exhibit 17: Liquidity generated through monetary measures

Various liquidity enhancing measures	Rs crore
CRR reduction of 400 bps	160,000
MSS securities unwind	63,045
Term Repo facility	60,000
SPV for NBFC	25,000
Various refinance facilities	80,000
Actual/ potential liquidity enhanced by	**388,045**
1% permanent SLR cut	40,000

Source: RBI, Kotak Mahindra Bank

Exhibit 18: Fiscal Stimulus

Fiscal Stimulus 1: 7th December 08	Fiscal measures announced
Tax cuts	Cenvat rates cut by 4% across the board to boost additional spending
More expenditures	Plan expenditure to go up by Rs 20,000 crore in the current fiscal year
Infra development	India Infrastructure Finance Co Ltd (IIFCL) authorized to raise Rs 10,000 crore through tax-free bonds by March 2009 and would be permitted to raise further resources In particular, these initiatives would support a PPP programme of Rs 100,000 crore in the highways sector
Textile sector	To get an additional Rs 1,400 crore towards the entire backlog of Technology Upgradation Fund
SMEs Sector	To boost collateral free lending to SMEs that are facing a credit crunch, the government doubled the current guarantee cover for loans to up to Rs 1 crore from the existing limit of Rs 50 lakh Besides, the lock in period for loans covered under the existing credit guarantee scheme will be reduced from 24 to 18 months, to encourage banks to cover more loans under the guarantee scheme
Exports sector	Interest subvention of 2% up to March 2009 for pre and post-shipment export credit for labour-intensive exports like textiles, leather, marine products and SME sector
Housing sector	As part of efforts to boost the housing sector, the public sector banks would shortly announce a package for home loan borrowers in two categories -- up to Rs 500,000 and between Rs 5-20 lakh
Power Sector	The government has decided to completely lift import duty on naphtha for use in the power sector while export duty on iron ore fines will be eliminated

Fiscal Stimulus 2: 2nd January 09	Fiscal measures announced
ECB	Relaxation of ECB Guidelines - all in cost cap on borrowing removed
Corporate Bonds	Raising FII investment limit in corporate bonds from US$6 bn to US$15bn
NBFC sector	SPV for liquidity support to NBFCs of Rs 25,000 crores
Credit growth	Higher credit targets for PSU banks amounting to Rs 56,000 crores
State Govt.	Additional market borrowing for states of Rs 30,000 crores
Infra Development	Additional tax free bonds for IIFCL for infrastructure financing of Rs 30,000 crores (FY10)
Banking sector	Recapitalization of PSU banks amounting to Rs 20,000 crores (FY10) RBI credit line to EXIM bank amounting to Rs 5,000 crores
Automobile sector	Accelerated depreciation for purchases of commercial vehicles

Fiscal Stimulus 3: 24th February 09	Revenue losses due to duty cuts	Rs crore
Indirect Tax cuts	Service tax cut by 2%	14000
	Customs	6600
	Excise duties cut by 2%	8500
	Total	**29,100**
	% of GDP	**0.5**

Currency market outlook

- **INR is expected to trade in a range of US$ 48- 51.00/INR in the next three months**
- **We expect a trend reversal in 2H09 with INR trading at around US$ 46-47/INR levels by end December 2009**

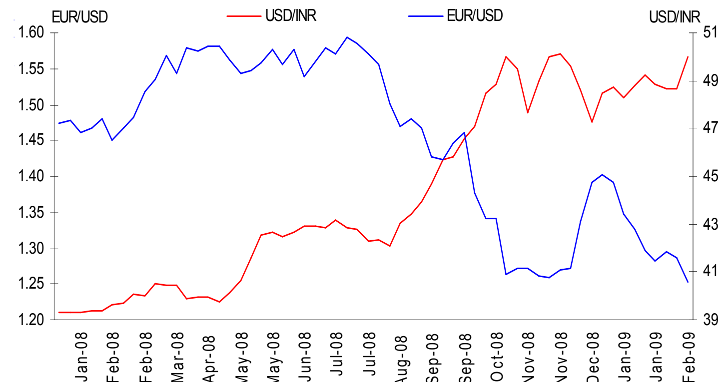
INR – breaches the US$50/INR mark once again

In our 7th January 2009 report on **"Rupee outlook for 2009",** we had mentioned that ***"we expect the Rupee to remain under pressure in the rest of the current fiscal. There is a high probability of INR to re-test the previous lows of US$50.60/INR once more in the next three months".*** In the first week of January 09, (while we were writing our currency report), INR was trading around US$ 48.50-48.75/INR levels. The INR has currently breached the US$50.00/INR levels and is heading towards a re-test of its previous intraday lows of US$50.60/INR (traded on 1st December 2008).

The precarious condition of India's fiscal deficit has led international credit rating agency Standard & Poors to revise the outlook on the sovereign credit rating of India from stable to ***negative*** while affirming "BBB-" long term rating and "A-3" short term sovereign credit ratings on India. The rapid pace of deterioration in the fiscal deficit is likely to lead to an increase in the Centre+State debt/GDP ratio to close to 80% (by end-March 2010) from the budgeted 73% levels of end-March 2009. As explained earlier, the rating downgrade for India can be delivered post elections. This could be bad news for the Rupee in the near to medium term. Moreover, the Dollar is expected to remain strong against the Euro in the first half of 2009 as risk aversion will continue for some more time. ***We expect Euro to head towards 1.20 levels in the next 3-6 months.*** That will also prove to be a Rupee negative factor. And last but not the least, concerns over Balance of Payments risks continue to be on the forefront (see our BOP forecast on the next page). **The INR is expected to trade in a range of US$ 48-51.00/INR in the next three months.**

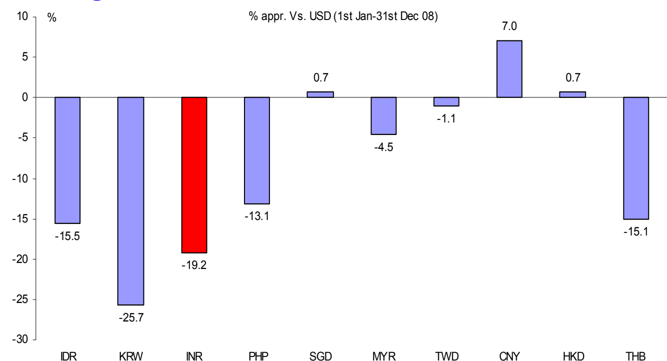
However, for a longer period we would look at some reversal in this trend, mainly on the basis of Dollar weakening against major currency pairs rather than on the basis of Dollar flows into India that is still expected to remain on the weaker side. ***We expect INR to recover to US$ 46-47 / INR by end-December 2009.***

Exhibit 19: INR depreciates with Euro depreciates



Source: Bloomberg, Kotak Mahindra Bank

Exhibit 20: INR – the second worst performing currency among the Asia-Pac countries in 2008



Source: Bloomberg, Kotak Mahindra Bank

Exhibit 21: Residual Maturity of External Debt outstanding as on end-June 2009

US$ mn

	Components	Short Term	Long Term			Total
		Up to 1 Yr	1-2 Yr	2-3 Yr	> 3 Yr	(2 to 5)
	1	2	3	4	5	6
1	Sovereign Debt	2,780	3,211	4,613	44,600	**55,204**
2	Commercial Borrowing (including export credit)	7,403	7,383	10,501	52,858	**78,145**
3	NRI Deposits	33,485	5,895	1,996	1,236	**42,612**
	FCNR(B)	10,356	2,600	844	201	**14,001**
	NRE (R)A	20,353	3,160	1,080	992	**25,585**
	NRO	2,776	135	72	43	**3,026**
4	Short term Debt (Original Maturity)	45,342	-	-	-	**45,342**
	Total (1 to 4)	**89,010**	**16,489**	**17,110**	**98,694**	**221,303**
	Memo items					
	Short term debt (Residual maturity as per cent of total debt)	40.2				
	Short term debt (Residual maturity as per cent of Reserves)	28.5				

Source: RBI

Exhibit 22: Balance of Payments Forecast

USD mn	2007-08	Apr-Sept 08	Oct-Mar 09E	2008-09E (oil at US$85/bbl)	% yoy	2009-10E (oil at US$50/bbl)	% yoy
Exports	166,163	96,732	73,268	170,000	2.3	170,000	0.0
Imports	257,789	165,913	128,366	294,279	14.2	272,590	-7.4
Oil imports	76,933	55,065	35,214	90,279	17.3	51,310	-43.2
Non Oil imports	171,589	99,681	92,319	192,000	11.9	209,280	9.0
Defence Imports	9,267	8,379	3,621	12,000	29.5	12,000	0.0
Trade Deficit	**-91,626**	**-69,181**	**-55,098**	**-124,279**	**35.6**	**-102,590**	-17.5
- as a % of GDP	*-7.7*			*-10.4*		*-7.5*	
Net Invisibles	**74,592**	**46,849**	**42,661**	**89,510**	**20.0**	**90,000**	0.5
- as a % of GDP	*6.2*			*7.5*		*6.6*	
Current Account	**-17,034**	**-22,332**	**-12,437**	**-34,769**	**104.1**	**-12,590**	-63.8
- as a % of GDP	*-1.4*			*-2.9*		*-0.9*	
Capital Account	**109,198**	**19,833**	**-19,033**	**800**	**-99.3**	**4,350**	443.8
- as a % of GDP	*9.1*			*0.1*		*0.3*	
Foreign Investment	**44,957**	**9,036**	**-2,036**	**7,000**	**-84.4**	**6,500**	-7.1
Portfolio Investment	29,556	-5,521	-7,479	-13,000	-144.0	-5,000	-61.5
Net FDI	15,401	14,557	5,443	20,000	29.9	11,500	-42.5
Loans (incl ext. debt)	**41,930**	**7,383**	**-15,883**	**-8,500**	**-120.3**	**-6,000**	-29.4
ECB	22,633	3,341	1,159	4,500	-80.1	2,000	-55.6
Short-term credit	17,183	3,173	-18,173	-15,000	-187.3	-10,000	-33.3
Banking Capital	**11,757**	**4,827**	**173**	**5,000**	**-57.5**	**3,000**	-40.0
NRI Deposits	179	1,073	927	2,000	1,017.3	2,000	0.0
Rupee Debt Service	**-121**	**-33**	**-117**	**-150**	**24.0**	**-150**	0.0
Other Capital	**9,470**	**-1,275**	**-1,275**	**-2,550**	**-126.9**	**1,000**	-139.2
Overall BOP	**92,164**	**-2,499**	**-31,470**	**-33,969**	**-136.9**	**-8,240**	-75.7
- as a % of GDP	*7.7*			*-2.8*		*-0.7*	
RBI's net forex intervention	**82,040**	**-9,499**	**-34,470**	**-43,969**	**-153.6**	**-15,240**	-65.3

Source: RBI, Kotak Mahindra Bank

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