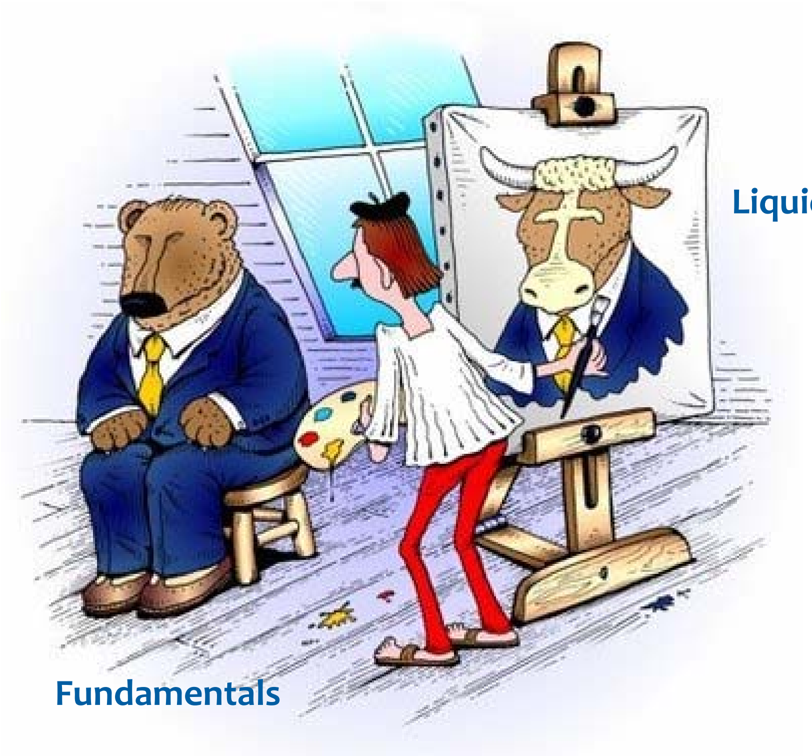
ENAM Securities
India Research

India: Revisiting assumptions



Source: www.ritholtz.com

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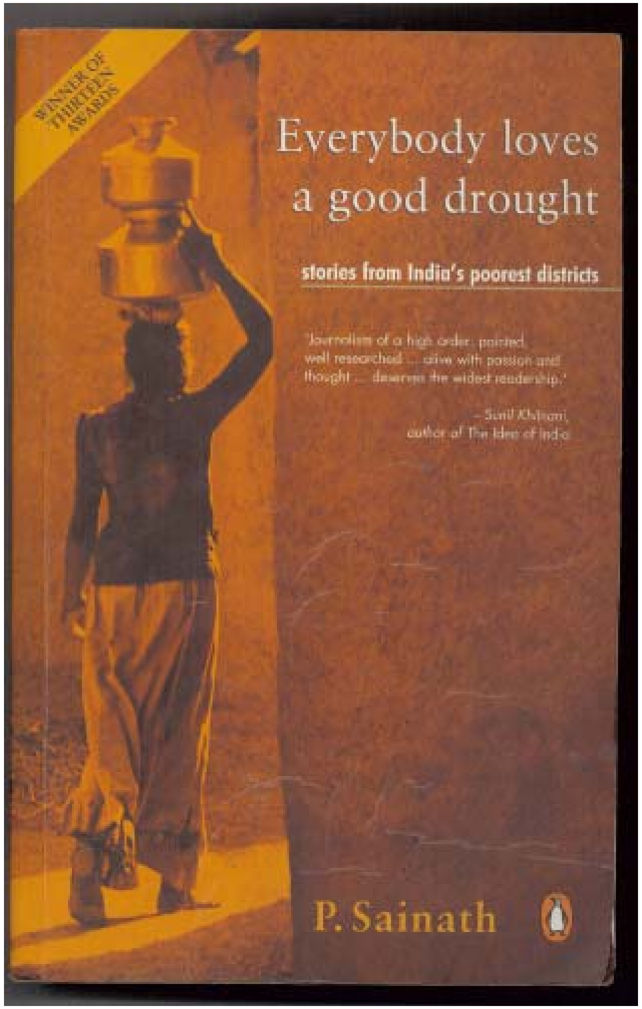
Executive Summary

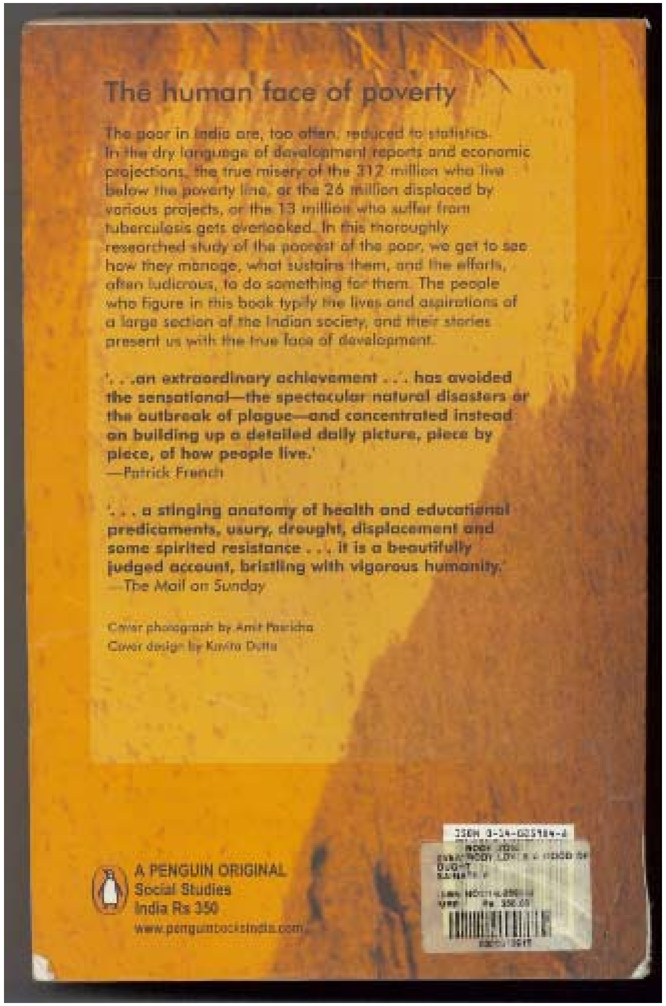
- **Global liquidity continues to secularly flood EMs, due to lack of alternatives. While this may continue to over-ride 1-time, though serious, concerns of a drought, we revisit our Indian macro assumptions**

- **<u>ST Macro deterioration</u>: Rationale for the following detailed in this report.**
  - **Inflation to breach 7% by end FY10 & touch ~9% by July 2010**
  - **GDP growth to stall, but by just 50-100 bps (vs 2% in 2003) depending on govt response and balance showers** (ref slide 9)
  - **RBI will keep interest rates low through FY10, but expect ~50 bps hike in Q1FY11**
  - **Fiscal Deficit impact unlikely to be >0.5%**
  - **INR to face downward pressure through H1FY10 but gradually recover with govt reform milestones**

- **<u>Sectoral impact</u>: IT & Power, & also Pharma & Gas, to take away defensive premium from FMCG**
  - **Consumption sectors** (**FMCG, Auto, Cement, Telecom**) **could be hit by input inflation + demand fall**. However, that will partially depend on whether the govt will do a full blown rural stimulus or focus on drought-affected areas alone; and on sector-specific & other factors eg credit availability, 2nd installment of 6th pay commission, etc.
  - **Interest rate sensitives**: **Public sector banks** could take a hit if govt directs credit at a lower cost, stalling of recovery of assets, and rise in NPAs. **Engineering & Construction** to not get affected immediately, due to order backlog, and the world next year, when interest rates may harden – well, it's a different world then !
  - **Liquidity-driven sectors**: Realty, Developers and other capital intensive sectors, whose fundamentals are partly driven by cash-injection availability, are indeterminate at this point, due to the interplay of abundant global liquidity vs domestic macro concerns

Everybody loves a good drought !





And this old classic also answers: Who ACTUALLY makes money from Droughts?

Sectoral impact of deficient monsoon

- Impact to play out in the following chronological order in the Real eco (markets may discount differently)*:
- Temporary increase in **freight rates due to urgent intrastate movement of food grains (politically sensitive)**
- **Water Shortage: Power (hydro), Chemicals, Cement. Thermal plants are not affected** as the proportion of closed-cycle plants (water) has increased over the years. And this time, **merchant plants will benefit** from the **weak hydro output of late, apart from the increased need to draw from the water table**
- **FMCG:** Demand fall may lag by 1 qtr though nowhere near the impact of the durables. Rise in input costs (Oilseeds, milk, sugar, tea etc) could impact operating margins
- **Rural Demand:** Durables incl **Auto, Farm Equipment, Cement: Effect is usually after 3-6 months (esp as Rabi crop & Govt stimuli also decisive)**
- **Interest rate hardening** by next fiscal: **Banks, Auto, Cement.** Of these, **PSBs could get impacted more immediately, by forced lending, NPAs, etc.** Note that **Capital Intensives and Engg** have current order book growth, which will protect their volume momentum in the near term, and other factors are more important for them vs just interest rates
- **Competition between state govts to get various districts labeled "drought-affected" for Central aid:** leakage (eg to contractors), capital misallocation, political noise & bickering etc. Note that IF drought is VERY wide-spread, the Govt may provide another huge overall **rural stimulus package** rather than just target specific districts
- Note that in the short term, **IT & Power would specifically benefit:** IT from INR depreciation, and Power as above

* **More detailed** impact notes **being released today for** individual sectors, to cover various **sector-specific factors too**

Fiscal deficit could rise but fundable

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- **Monsoon failure will put pressure on Fiscal Deficit which at 6.8% of GDP is at a 16 year high; add 0.5% B/S subsidies and another 3.3% for states and the combined deficit jumps to an unsustainable ~10.6%!**
- **The concern is that India can manage either its fiscal deficit OR its GDP growth, not both:**
  - As P&L of India as well as balance sheet of India is linked to the value of INR to USD, which in turn is linked to the perceptions of India being able/ unable to manage this deficit properly
  - If the perception is that expenditure is largely wasteful and will not cause any turnaround in growth then funds could flow out of India (see slide Liquidity Vulnerabilities) , which depreciates INR, raises interest rates (nullifying RBI's actions thus far) and that in turn creating a vicious cycle that increases the hurdle rate of investing into India further impeding funds flow
- **Growth: India needs~$199 bn to grow at ~7% & manage its huge fiscal deficit (borrowings of ~$112bn to fund it's fiscal deficit and ~$87 bn for credit growth). Of the borrowings requirement it has already borrowed ~$40 bn requiring ~$73 bn more during remainder of FY10**
- **Can RBI meet this requirement? We believe a** combination of SLR ($32bn, Rev Repo liquidity ($32bn) & MSS unwinding ($7bn) & OMO would be adequate ***(Ref slide 22). The fact that India will have a comfortable BOP position owing to far lower crude oil prices will add to comfort level besides being INR +ive (Ref slide 15)***
- **But what if growth does not pick up in FY11 even after exhausting almost all fiscal & monetary options?**
  - India's revenues will move up by ~1% of GDP even without any significant growth pick up in FY11 due to a move towards GST
  - Govt will also have to raise non tax revenues (Divestment of ~$20 bn pa) else India could face a liquidity crunch
- **Factors to be monitored as we go along: a) Policy pronouncements** (Divestment/ Subsidies/ Tax reforms, FDI **etc** b) Rainfall in key kharif states (UP, Punjab & Haryana, Maha & AP) till end Aug

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Sec I: Monsoon, Inflation, Int rates & growth

Timeline of RBI exit strategy: Expect rate hikes in Q1FY11

	H2 - FY10		H2 - FY10		H1 - FY11	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP	Gradual IIP recovery but GDP growth <6%		Broad based IIP recovery GDP growth ~6%		GDP growth ~7%	
Inflation	Base effect keeps inflation sub-zero		WPI moves into +ive in Q3 But rises faster in Q4		Base effect amplifies WPI	
Int Rates	Policy rates unchanged PLRs will continue to fall		RBI turns hawkish, begings to wind up spl windows for refinance etc		CRR, Repo & Rev Repo **hike~50 & 25 bps resp**	
INR	To remain ~48/$ due to fisc overhang		Current A/c, cap flows & relative GDP growth will be INR +ive. FY10 avg 47/$		**INR to continue to strengthen**	

Source: ENAM Reseacrh

India staring at a drought !

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- **<u>Monsoon Outlook</u>: <u>25% deficient so far; India headed towards one of the worst Droughts!</u>:**
  - Cumulative rain deficit for mid-June to August 5th stood at 25%. Historically, a rain deficit of 20%+ is declared as a "drought year" which enables affected districts to compete to access Central aid.
  - Till end July, there has been 353 mm of rainfall; hence to achieve a less than 15% overall deficiency (which practically is an outright drought), we need 403 mm more, ie August and September achieving 90%+ of their average.
  - Met currently has forecast a 101% of average for August. But, till Aug 5th only 24 mm of manna has dropped (deficit of 65%)

Rainfall	Long period Avg (mm)	Long period Avg Share (%)
Full season: mid June to end Sept	890	100
June	144	16
July	293	33
August	262	29
September	191	21

- **Sowing has improved dramatically in the last two weeks (was held back, earlier) with all kharif (summer) crops except paddy, covering >2/3rd of their normal area under coverage.**
- **Therefore, for a good harvest, the August rainfall is most critical. The food bowl of India continues to face drought-like conditions and the impact could be severe in states of UP & Bihar as they happen to be highly populated, poorly irrigated and hugely dependant on agri economy (see appendix slides 29 & 30)**

Monsoon still a big game-changer, but there are cushions

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Mitigation: Why GDP fall could be limited nearer to 1% vs earlier 2%?

- Share of Agriculture in GDP has come down to ~18% vs 25% earlier
- Share of Kharif has come down to 53% vs 60% earlier
- **Water Reservoir levels are higher than last year** (53 bcm vs 47 bcm), as main catchment areas in Central & Southern India recieved much higher rainfall than last year. This, and the water table effect (which we will know only by September) affect the Rabi (winter) crop prospects which is ~47% of total food grain production
- **Rural India is far richer than ever before:**
  - 4 consecutive years of good rains & Agri-debt waiver strengthened the B/S of small farmers to withstand a poor monsoon.
  - Min Support Prices (MSP) of crops in the last 4 years have increased >10% CAGR.
  - Rural expenditure has doubled since FY07, incl FY10 Budget allocations for key schemes (NREGS by 45%, Bharat Nirman by 144%)
- Connectivity & Tech: Since the previous drought, the penetration of Roads, Telecom, Credit & IT has increased many fold

Empirical evidence of impact of monsoons on output and prices has been mixed

Drought year

Normal Monsoon

FY	Monsoon Deviation (%)	Kharif production change (%)	Food Grains Prod.	Food Grain price (WPI)	Agri Credit Growth	Agri GDP growth (%)
2001	(8)	(3)	(6)	(1)	14	(0.3)
2002	(7)	10	8	(1)	18	6
2003	(21)	(22)	(18)	1	63	(7)
2004	2	34	22	1	23	10
2005	(12)	(12)	(7)	1	35	0.1
2006	(1)	6	5	5	42	6
2007	(1)	1	4	10	32	4
2008	5	9	6	5	19	5
2009	(2)	0	(2)	9	N.A.	1.6

Source: Ministry of Agriculture, Economic Times, ENAM Research, CMIE

- **Govt response in 2003 was a combination of supply-augmenting measures, imports, cheaper credit etc**
- **Currently 161 districts drought hit but We will have to wait till end Aug for the final verdict and govt response**

What could the govt do?

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Options

Fiscal

Distribution

- **Use buffer**: Stocks of ~55MT through PDS making available food grains to needy
- **Crop Husbandry:** make higher yield variety seeds/ inputs available
- Ensure availability if **Electricity at subsidized rates or Diesel** where electricity not available

Administrative measures

- Price controls, check hoarding, invoke Essential Commodities Act (ECA)
- **Selective Ban on experts**
- **Ban on Future trading for selected commodities**

Imports

- Import Pulses, Sugar, Oilseeds
- Imports to be given sops/ Subsidized

Monetary

- **RBI to keep Interest rates low/ steady**
- **Enhance credit availability**
- **Interest rate subvention**
- **Enhance Corpus or special funds for RRBs, Nabard etc**
- **Allow affected states to borrow additionally from RBI**

Expect higher allocation & coverage for NREGS as safety net as Imports could be costlier as demand-supply mismatches esp in Sugar, Pulses etc. Global prices shoot up as India tries to import in a last ditch attempt

Inflation will breach 7% by end FY10 & touch ~ 9% by July due to supply side issues

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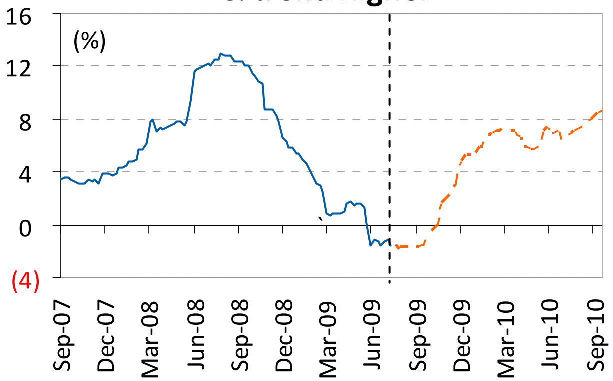
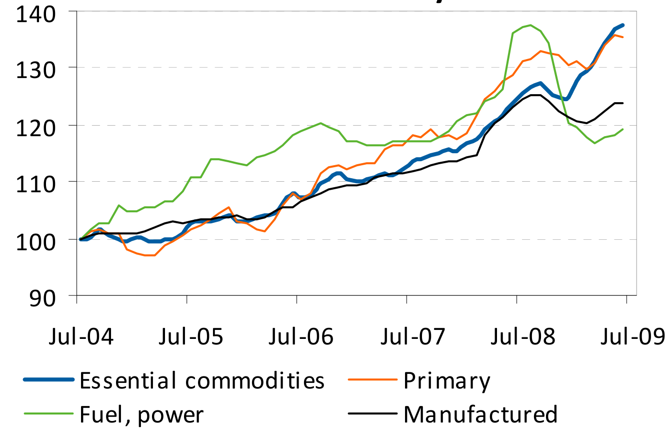
Inflation: To cross ~7% by end March & trend higher



Essential commodities have already leapfrogged, monsoon failure will only worsen it



RBI added Liquidity = ~9% of GDP thus far & will add ~3.5% more in FY10 thru OMO & MSS unwinding !

Measure/Facility	(Rs bn)
CRR Reduction	1,600
Unwinding/Buyback/De-sequestering of MSS Securities	156
Open Market Operations (purchases)	80
Term Repo Facility	60
Increase in Export Credit Refinance	27
Special Refinance Facility for SCBs (Non-RRBs)	39
Refinance Facility for SIDBI/NHB/EXIM Bank	16
Liquidity Facility for NBFCs through SPV	25
Total	**562**
Memo:	
Statutory Liquidity Ratio (SLR) Reduction	40

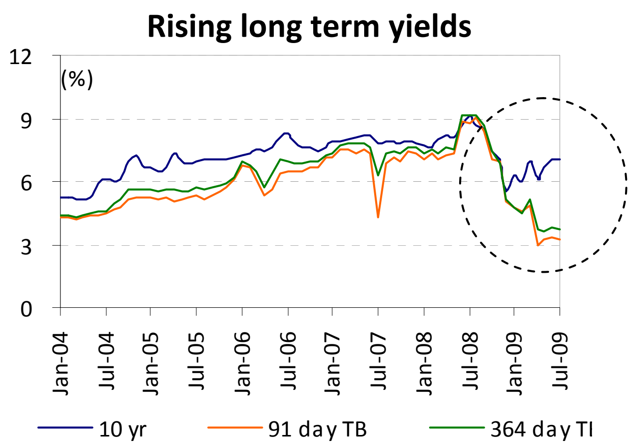
- **Govt Stimulus: Fiscal policy will add to fuel cost push (MSP, NREGS spending) pressures while Monetary policy (RBI liquidity moves) will accentuate demand pull inflation**
  - Govt spending on Social schemes ie ~$10 bn pa
  - RBI has added ~9% potential liquidity already and in FY 10 OMO + MSS unwinding will add 1500 bn (equal to 3.5% cut in CRR)
- **Empirical evidence shows that while govt deficit does little to boost GDP, a 1% change in government deficit leads to about 1.06 % expansion in the reserve money, which in turn fuels inflation (*Ref appendix slide 35)***

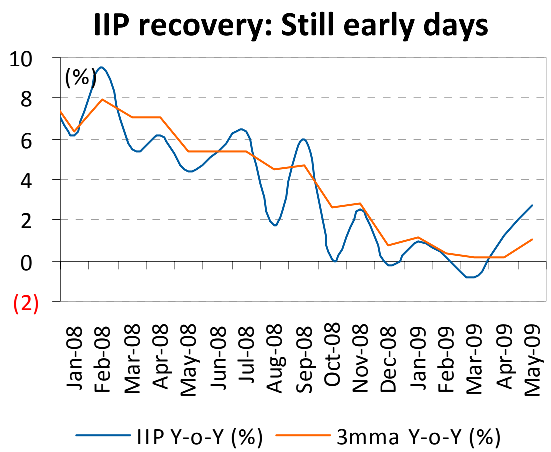
Demand pull (excess liquidity) and global commodity prices will also start exacerbating pressures in H2FY10

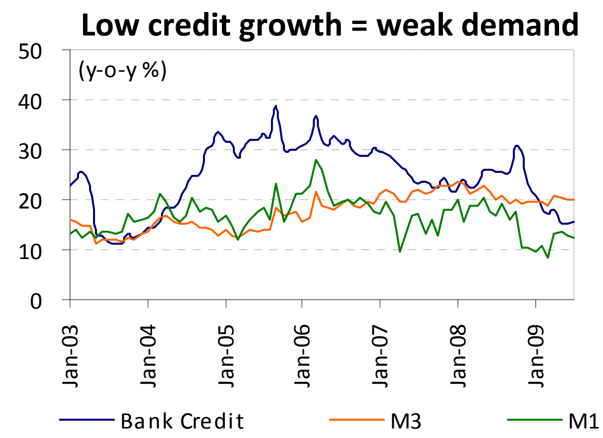
Source: RBI, CMIE, ENAM Research

...Forcing an uptrend in interest rates eventually

- **RBI will refrain from raising rates in FY10 as:**
  - **Inflation will initially be a supply side problem**
  - **Growth will be IFFY**
    - IIP growth CYTD is <2% and only consumer durables segment has shown a steady up tick
    - Monsoon failure can shave off ~100 bps from GDP
    - Services sector growth still trending down
  - **Credit growth**: Adjusting for lending to realty, credit offtake is – 17% **indicating weak demand conditions**
  - **Govt will have to pull off a huge borrowing programme**
- **However, we expect policy rates to rise in Q1FY11 due to**
  - Demand pull pressures from huge govt stimulus as growth revives
  - While short end of the yield curve could remain soft through FY10, long end of the Curve **is** likely to harden to ~7.2% by H2FY10 **due to govt borrowings**







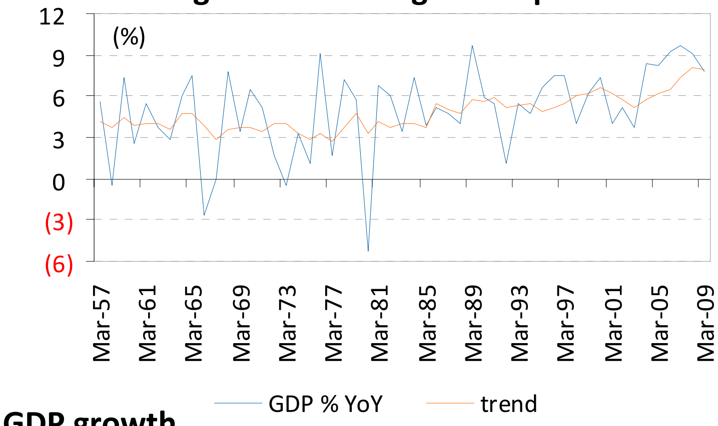
We expect RBI to maintain Neutral stance through FY10. However, by Q1FY11, as growth picks up & demand pull inflation creeps up, expect 50 bps hike in CRR

Source: Bloomberg

Overall Growth could take a hit of 0.5-1%

- **Agriculture:** Pricing driven incentive (MSP) for key crops; enhanced rural employment guarantee & further dole outs will cushion rural demand & agri growth
- **Industry:** To recover to ~ 5% in FY10 as demand picks up from H2 FY10 :
  - **Lagged impact of softer interest rate environment**
  - **Disbursal of balance 60% arrears for central employees**
  - **Adoption of 6th Pay Commission reco by PSUs and state govts**
  - **Lower input costs**
- **Services:** We factor in a softening in services growth, which will reflect industrial deceleration with a lag of ~9 months
- **Upside risk:** If agriculture growth picks up, Banks cut interest rates further and make credit available and the global scenario improves, growth may surprise on the upside

GDP growth trending below potential



GDP growth

			FY10E		
(%)	Weight	FY09	Worst case	Base case	FY11E
Real GDP growth		**6.7**	5.5	**6.2**	**7**
- Agri growth	*18.5*	*4.5*	-2	*0.7*	*2.5*
- Industry growth	*19.5*	*8.8*	5.3	*5.9*	*6.6*
- Services growth	*62.0*	*10.4*	8.0	*8.4*	*8.9*

Govt exp has rescued growth but crowding out pvt sector

Dd for funds	% chg	share of total
Pvt Consumption	2.9	55.5
-Govt Consumption	20.2	11.1
Gross Capital Formation	8.2	32.2
Net Exports	(-) 41.2	(-) 5.8

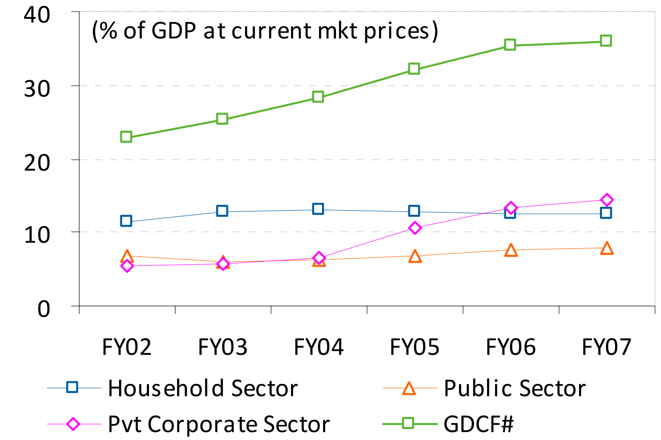
Source: ENAM Research

Govt response and further rains in Aug-Sep holds the key

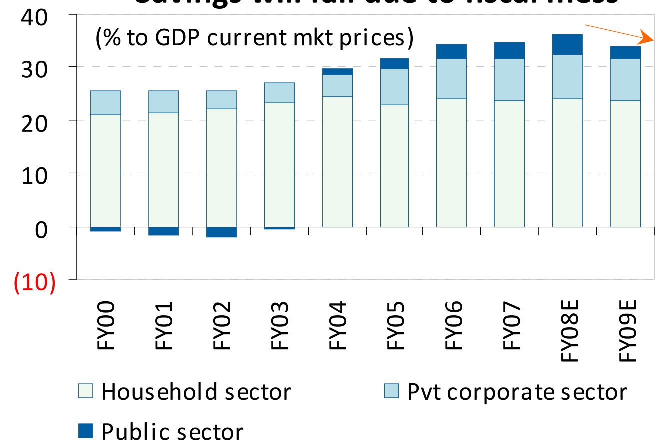
Savings & investments though declining, will still be adequate to support growth

- **Investments (36%of GDP in 2009E)**
  - Investments: Cost of credit still impeding investments
  - Marginal capacities unviable at current interest rates
- **Slowing of investment rate inevitable**
  - Growth rates in high teens not sustainable. Even high single digit growth enough to keep up the growth cycle
- **Savings rate (34% of GDP in 2009E)**
  - Rose by ~10% since 2004 (avg. 33% of GDP vs 23%)
  - Largely caused by spurt in Private (60%) & Public (40%) - increment of 5.1% & 3.4% respectively
  - **With govt dissavings & corporate slowdown, savings rate set to fall ~2% pa in FY09 & 2010**
- **With an ICOR of ~4, even if investment & savings ratio decline by ~4% in the next 2 years, a baseline line growth of ~6-7% possible**

Investments peaked



Savings will fall due to fiscal mess



Source: CSO, ENAM Research

Fiscal overhang to weigh on INR, but Current Account to move in surplus

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- INR is likely to remain weak in H1FY10 due to drought and fiscal overhang
- INR likely to appreciate H2 onwards on favourable fundamentals:
  - **Trade balance will improve despite poor exports** :
    - Oil imports will be lower & non oil imports will mirror export fall
    - Crude oil price outlook remains muted thereby reducing pressure on India's CAD that may turn +ive
  - **Growth**: Baseline growth seen settling ~6-7% and relative growth differential vs US remains intact.
  - Pro-reform policies will be +ive for capital flows
  - INR: Fairly valued in REER terms
- External: Aggressive quantitative easing by the Fed & poor growth prospects will keep USD weak
- **Risks:** Rising Indian Fiscal deficit & **Changes in** global risk appetite

External Sector	FY09	FY10E
Exports (US$ bn)	**175**	**166**
Imports (US$ bn)	**294**	**245**
Of which oil	93	57.0
& non oil	195	187.4
Trade Bal (US$ bn)	**(119)**	**(78)**
As a % of GDP)	(9.7)	(5.8)
Invisibles, net (US$ bn)	89	85
Software	46	42
Remittances	45	38
% of GDP	7.3	6.3
Current A/c Bal (US$ bn)	**(29.4)**	**7.6**
Current A/c Balance as % of GDP	(2.4)	0.6
Capital Account		
FDI (US$ bn)	17	14
Portfolio Invst (US$ bn)	(15)	7.5
Capital Inflows - % of GDP	0.2	1.6
Loans	8	12
Banking capital	(8)	7.5
Of which NRI	4	5
Rupee debt service	(0.5)	(0.5)
Other capital	4	5
Capital account	**9**	**47**
Overall balance	**(27)**	**54.7**
Forex Res excl. Gold (US$ bn)	235	289
Months of Imports	9	14

Source: ENAM Research

Assumed a 5% degrowth in exports & imports given recession in US/EU

- Trade bal. will shrink due to falling crude, KG Gas substitution & lower non-oil imports
- Crude price assumed at $65 (vs 90 in '09)

Assumed fall in software earnings & remittances

FDI flows expected to shrink in line with pvt global flows but FII lows will make a comeback

Fx Reserves build up in FY10 as capital flows limp back to normalcy

Expect INR to strengthen towards the 2nd half as key reforms get unveiled - thereby attracting higher capital flows. Expect INR to avg ~47 for FY10. Note every $10 move in crude prices impacts India's CAD by ~0.5%

Sec II: Fiscal Deficit & liquidity vulnerabilities

The long & short of it

Indian external liquidity vulnerabilities

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- Total short term (excl FII) money at risk is ~$45bn
- **Net** FII holding **is at ~$108bn in equity ~$6bn in bonds, aggregating ~$114bn. If the ST money at risk of ~45 bn is added, total money at risk is ~$159bn.** Even if all investment by foreigners is pulled out, India would still be left with ~$107bn ie Fx Reserves $266bn – $159bn liabilities. Thus, the **risk of BoP or currency crisis is extremely unlikely**.
- RBI's liquidity arsenal against the above:
  - **Unwind MSS: $18bn** buffer and this can be unwound at times of crises
  - **Interest rates could be raised to attract capital flows**
  - **Float a bond issuance ie IMD through State owned banks such as SBI**
- Can this liquidity crisis turn into a solvency crisis? **It is unlikely, as Demand largely sustainable in India as it is an** underinvested country **(Investment rate > savings). Thus,** RoI > RoW, thus attracting global liquidity**.**
  - **Corporate:** No widespread overcapacity, relatively low leverage though certain sectors may have higher
  - **Banking:** Currency, Fx Risks as a percentage of banking system liabilities stand at ~2% & ~7% of total

An attempt to determine ST liquidity draw downs is made below:

Money at risk	Actual liability ($ bn)	Realistic extent ($ bn)
NRI Deposits	29	7*
ST loans	17	17
Bank liabilities	11	11
Amortization	10	10
Total	**67**	**45**

Source: ENAM Research;
** Assumed 2/3rd NRI money to get rolled over*

If foreign investor confidence in India's ability to face the drought or fund its fiscal deficit collapses and even if they withdraw all their monies, there is enough liquidity leeway to prevent a BoP or liquidity crisis

Fisc: Short term

Magnitude of the problem

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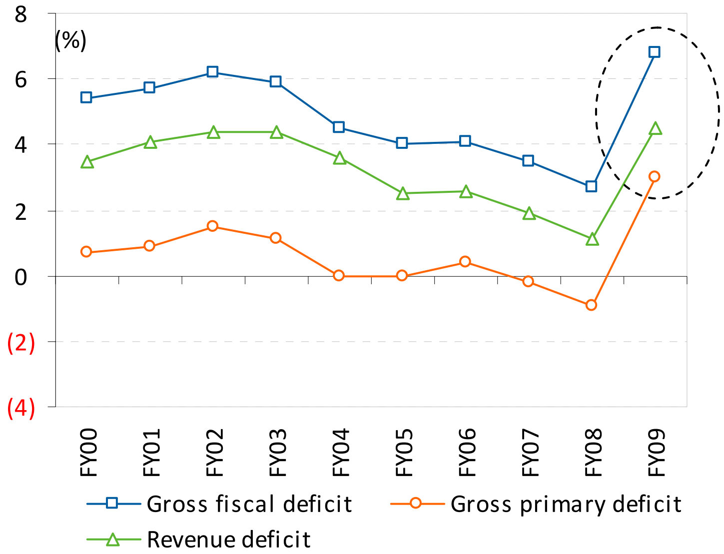
Fiscal deficit has spiked and Rev Deficit is highest since 1991



Source: GoI docs, ENAM Research

Finmin target is to slash deficit by ~3% in next 2 yrs

	FY09RE	FY10 BE	FY11E	FY12E
Revenue Deficit	4.4	4.8	3	1.5
Fiscal deficit	6	6.8	5.5	4
Gross tax revenue	11.6	10.9	11.9	12.4
Total outstanding liabilities	59.6	61.4	60.1	57.2

- **Govt talks of a reduction of ~3% by 2011/12. Half of this 2.8 % correction is expected from higher tax revenues – Is it possible?**
- **Correction of 1.5 % of GDP in two successive years has never been achieved**
- **Even at a time when GDP growth was ~9% it took govt 4 yrs to reduce Fiscal deficit from 4.5%of GDP in FY04 to 2.5% in FY09**
- **Govt borrowings in FY10 of ~Rs 5.4 trn vs FY09 total bank deposits of Rs 6.5trn (~84%)**
- **Combined deficit of 10.8% is almost equal to total household financial savings of ~12%**

Crux of the problem

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Revenue Expenditure has bloated

(Rs bn)	2007/08	2008/09	2009/10 B.E.	FY10/08 abs chg
Revenue Receipts	**5,419**	**5,621**	**6,145**	**726**
(a) Taxes (net to Centre)	4,395	4,659	4,742	347
(b) Non-Tax Revenue	1,023	962	1,403	380
Revenue Expenditure of	**5,944**	**8,034**	**8,972**	**3,028**
of which :				
~Int payments	1,908	1,926	2,255	347
~Defence	575	736	868	293
~Subsidies	714	1,292	1,122	408
~Pensions	250	326	350	100
~Social services	103	281	334	231
Revenue Deficit (2-1)	**526**	**2,412**	**2,827**	**2,302**
Revenue Deficit (% of GDP)	1.1	4	4.8	
Fiscal Deficit (% of GDP)	2.7	6	6.8	

Source: GoI docs, ENAM Research

Revenue growth just about enough to meet only interest liabilities

Rs 350 bn 3 G Rev + 250 bn RBI dividend

Expenditure has grown ~10x of revenue & ~2/3rd of the expenditure is irreversible & not related to temporary fiscal Stimulus that can be withdrawn

Revenue deficit has grown 5.5x & Fiscal Deficit by ~3x

Nearly all of this rise in Deficit is to be funded through domestic borrowings placing a severe burden on the financial system

Possible policy options to garner funds

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Liquidity Management

Short term

- **SLR:$33bn** potential availability
- **Unwind MSS** : **$18 bn** outstanding
- **Rev Repo liquidity**: **$32bn**
- **Open Market Operations**

Long term

- **Tax Revenues**: To rise because of move toward GST, Direct Tax code
- **Expenditure**: Subsidy targetting - Oil & Fertilizers
- **Divestment**: **$20-25bn p.a possible**
- **Savings/ GDP**: Steady source of funds - $220-250bn as financial savings out of total savings $340-360bn

Policy

- **Structural reforms: Labour, Agri, Capital markets**
- **Encourage capital flows through:**
  - **Relax ECB norms further**
  - **Raise FDI limits**
  - **Financial Sector reforms**
  - **Debt market reforms**

Govt's requirement of ~83 bn could get funded as above, albeit at a slightly higher cost. However, LT resolution will require broader economic reforms and also Tax & expenditure reforms

RBI can manage borrowings w/o a spike in yields..

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Ample system liquidity for FY10

Dd for funds	(Rs bn)	Source of funds	(Rs bn)
Net Govt borrowings	3,979	**Bank SLR** (net of CRR)	1,603
State govt borrowings	1,400	**Rev Repo bal**	1,558
Total govt requirement	**5,379**	**MSS**	330
less: already borrowed	1,879		
Net govt requirement (centre + state)	**3,500**	**Availability for govt**	3,490
Reqd for Credit growth	**4,163**	**Deposits** (net of SLR)	5,318
Gross fund requirement	**9,542**	**Total fund availability**	**8,808**
Net fund requirement	**7,663**	**Shortfall**	734

Source: RBI

Next year could be a challenge and will also depend on global scenario

Overall fund availability is adequate

Could be met by OMOs/ Addl MSS available ~470bn

Even if India's savings rate falls for the next 2 yrs by 2% pa there will be significant buffer

(USD bn)	2009	2010E
Gross Dom Savings	**418**	**445**
Total Financial savings :	**221**	**250**
Bank deposits	230	245
Eqty /MF	21	22
insurance	38	40
Provident & pension funds	42	44

Source: ENAM Research

Steady and captive funds for the domestic economy

… Despite a challenging H2

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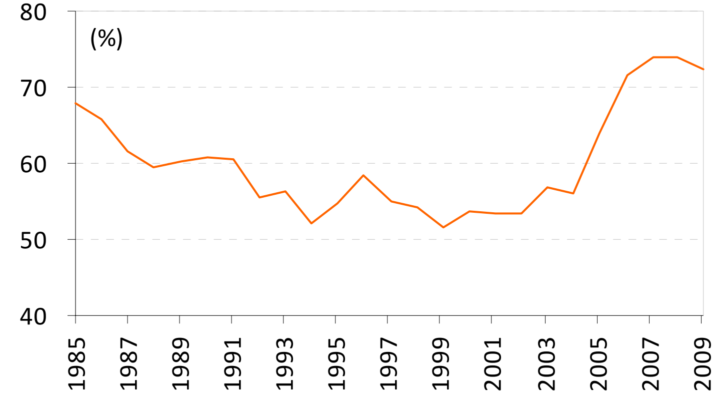
Govt Borrowings: Almost through for H1FY10…

Item (Rs bn)	Apr-Sep (FY10) Borrowings 2008-09	Revised	Actual so far	Balance
Gross Market Borrowings	1,060	2,990	2,010	980
Less: Repayment	440	330	330	0.0
Net Market Borrowings	619	2,659	1,679	980
Less: OMO Purchases	0	800	334	465
Add: MSS (Net)	52	(420)	(385)	(35)
Net Supply of Fresh Securities	672	1,439	959	479

Source: RBI

But CD ratio is higher vs 2003 cycle = Even w/o govt borrowings int rates could rise in H2



Credit growth –ive, netted for realty. But may pick up in H2…

Sector	As on May, 2008 (y-o-y) (Rs bn)	Variation (%)	As on May, 2009 (y-o-y) (Rs bn)	Variation (%)
Agriculture	427	19	650	25
Industry	1,829	27	1,818	21
Real Estate	170	38	323	52
Housing	317	14	130	5
NBFCs	275	62	227	32
Overall Credit	4,232	24	3,835	18

.. Hence market conditions critical for funding needs

(Rs bn)	Full Year 2007-08	FY09	Financial Year 09	10
Banks	4,448	4,211	306	57
Other Sources*	5,877	4,669	1,285	850
Total	**10,325**	**8,880**	**1,591**	**907**

* Includes borrowings from financial institutions (including LIC) and NBFCs as well as resources ie ECBs, FCCBs, ADRs/GDRs, FDI and short-term credit

RBI needs to resolve the key mismatch between the perceptions of Corporates (credit is not forthcoming) vs Banks (there are no takers for credit) for a credit up tick in H2

Deficit to come off due to `technicalities' in FY11

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Govt: Positive / negative surprises in FY10

(Rs bn)	Positive surprises		Negative surprises
Addl tax revenue	300	Higher allocation	300
Divestment	250	to states	
Addl transfer of RBI Reserves	250		
Dividends/ profits from PSUs	75		
Lower MSS int outgo	25		
Total	**900**		**300**

- **Tax revenues**: Will move up by at least **Rs 300 bn ie 0.5% of GDP even without any major economic recovery** on account of partial roll back or move towards GST
- **Non Tax Rev**: **Divestment & dividend from RBI** could fetch ~Rs 250 bn each or **0.8% of GDP**
- However, states may have to be compensated by ~0.2% for their revenue loss due to GST. 13th Finance Commission Report, due in Oct 2009, will provide a clear revenue share formula

- **Expenditure:** We believe revenue expenditure could come off largely on account of lower subsidies and flattish defense spending enabling ~200 bn savings ie 0.3% of GDP
- Thus, Fiscal deficit could come down to Rs 3.7 trn or 5.7% for FY11E

Fiscal deficit to see a 1.1% correction in FY11

(Rs bn)	FY10E	FY11E
Gross Tax Revenue	**6,411**	**7,062**
Corporation tax	2,567	2,824
Income tax	1,128	1,241
Excise duty	1,065	1,129
Customs duty	1,102	1,168
Service tax	650	650
Other tax revenues	42	50
b. (-) Devolvement to States &	1,620	1,701
c. Net tax revenues (a-b)	**4,976**	**5,361**
d. Non tax revenues	1,402	1,500
e. Net revenue receipts (c+d)	6,378	6,861
f. Non-debt capital receipts	53	340
Recovery of loans	42	90
Divestment	11	250
g. TOTAL REVENUES (e+f)	**6,144**	**7,201**
h. Revenue expenditure	**6,956**	**7,443**
Interest	2,255	2,400
Defense	868	795
Subsidies	1,112	1,077
Pensions	250	260
Grants to States	485	485
Admin and social services	900	1,280
Plan expenditure	2,783	3,000
i. Capital expenditure	**467**	**400**
l. TOTAL EXPENDITURE (h+i)=(j+k)	**10,208**	**10,923**
m. Fiscal deficit (l-g)	**4,009**	**3,722**
% to GDP	*6.8*	5.7

We believe Fiscal deficit could be lowered to ~5.7% in FY11 largely due to a spurt in Revenues as GST kick off would involve a move towards a higher, single rate and tax cuts will have to be rolled back even if in phases

Longer term

Reforms by stealth may cap expenditure

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Subsidies ← **Unique Identification No**

Fertilizer

- **Fertilizers**: Shift allocation from product pricing regime (wherein price is fixed but subsidy keeps varying) to a nutrient based subsidy scheme
- Subsidy, based on actual usage of Nitrogen, Phosphorus & Potassium (NPK) would be directly transferred to bank accounts of farmers.
- Roll out to commence in Oct

Oil

- Weed out the easier Auto-fuel under-recoveries through mkt-based prices in a particular band ie upto~$80
- The politically sensitive issue ie LPG & Kerosene, will be tackled through issuance of oil bonds in the ST and direct subsidies ie vouchers for BPL etc in the medium to long term

Unique Identification No

- Will help better subsidy targetting:
- For eg India has multiple cards and fake users:
  - 65 mn Kisan credit cards
  - 97 mn BPL cards vs only 58 mn BPL families !!

Enormity of problem: The US is by law prevented from issuing a national ID card
  - Australia gave up the idea after adopting it, as did some Asian countries,
  - Britain, which decided in 2005 to issue all citizens is yet to issue the first card
  - China has now begun to go down this path—but sans biometric systems

Key challenges : Imperfect administration, and illegal immigration from neighboring countries
  - Issue of cards that assume citizenship can be an operational nightmare

Revenues: Will rise due to tax reforms as also due to the denominator effect

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Tax & Non Tax Revenues

Non Tax

Divestment

- **Value of govt owned cos is >$400 bn and even 10-20% dilution can fetch $10-20 bn pa**
- GoI avoided any mention of divestment quantum or targets leaving it to a **right time** and **right price**
- Constrained to include divestment receipts as laws require divestment funds be parked in a **National Investment Fund (NIF)**, and use it only for investments in education and health. The govt is likely to alter the NIF requirement suitably

Indirect tax

- **GST**: Could add ~1% to GDP once fully implemented
- A singular tax rate at 12 or 14% will raise centre's revenues by ~1% at least
- Leakages will be plugged
- Overall price levels will come down in the LT. However, prices tend to rise in the ST
- Could dramatically enhance volume growth for corporates

Direct Tax

Direct Tax Code

- Will bring about simplicity and stability to the tax regime and shield it from annual tinkering
- Will weed plethora of exemptions etc (Ref revenues forgone table below)
- Buoy overall revenues

Revenues forgone: Direct tax code and GST could enable huge savings

(Rs bn)	2007-08	% of total taxes	2008-09	% of total taxes
Corporate tax	622	11	689	11
Income-tax	381	6	396	7
Excise	875	15	1,283	21
Customs	1,536	26	2,258	37
Total	**3,413**	**58**	**4,625**	**76**

Source: Various IMF reports and authors' own estimates

Appendix

Monsoon: Quantum & dispersion, both an issue

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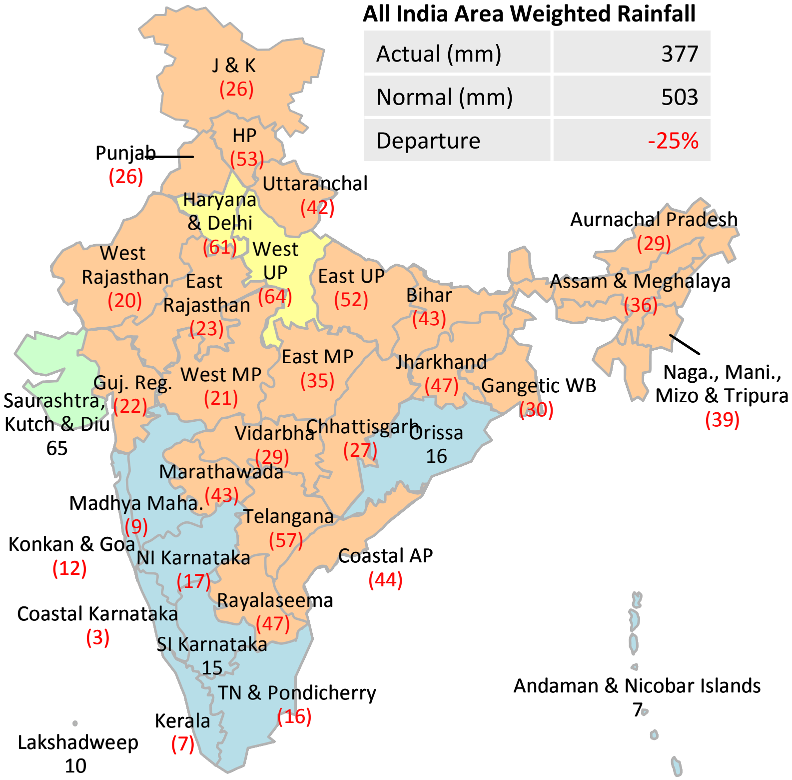
Rainfall dispersion (during 1st June – 5th Aug'09)

All India Area Weighted Rainfall

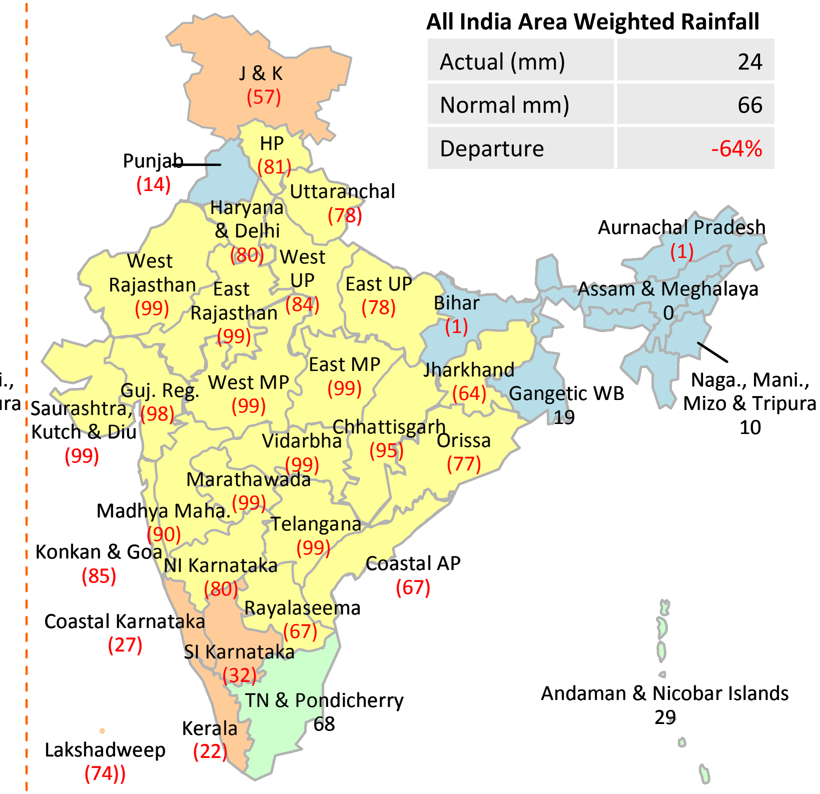
Actual (mm)	377
Normal (mm)	503
Departure	-25%



(30th July – 5th Aug'09)

All India Area Weighted Rainfall

Actual (mm)	24
Normal mm)	66
Departure	-64%



Excess (E) + 20% or More
Normal (N) +19% to -19%
Deficient (D) -20% to -59%
Scanty (S) -60% to -99%

State wise dispersion & sowing pattern

Kharif crop production vs. rainfall: Top 5 States that contribute >65% have recd less rains

	Kharif Crop Production (%)*	Rainfall deficiency (%)
Uttar Pradesh	26	-57
Maharashtra	14	-18
Tamil Nadu	10	-15
Punjab & Haryana	9	-43
Andhra Pradesh	9	-51
West Bengal	7	-27
Karnataka	6	+1
Gujarat	4	-22

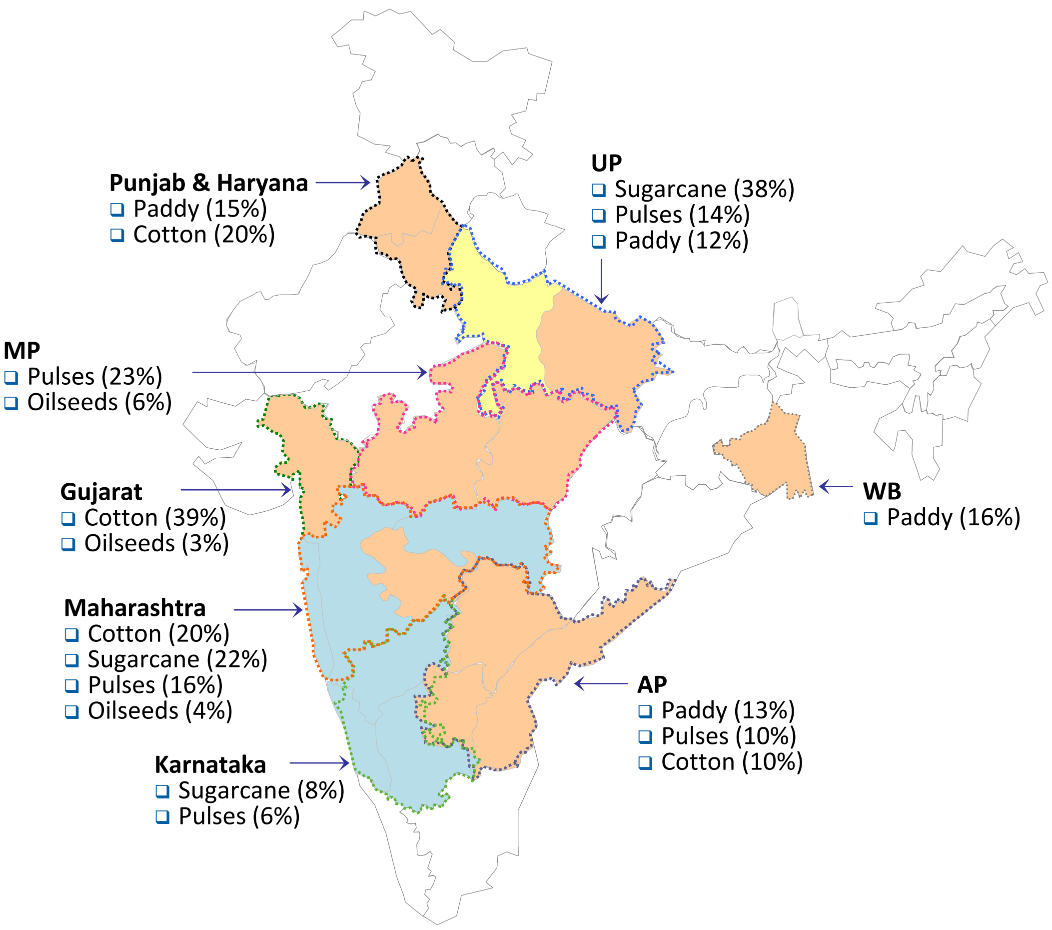
Source: CMIE, IMD, ENAM research; Note: Value weighted*

Kharif sowing season

(mn ha)	Normal Area	Area sown reported This Year	Area coverage of normal (%)
Rice	39	19	49
Pulses	11	7	66
Oilseeds	16	14	84
Cotton	8	8	>100
Sugarcane	4	4	>100

Source: Crops & TMOP Divisions, DAC

Top producing states (volume) for major crops



Notes: Figures in brackets denote the state's share of total production (%) of the crop

Budget arithmetic: Revenues

(Rs bn)	FY09 RE	Actual YoY 09RE/ 09BE	FY10 BE (Interim)	FY10BE	FY10 BE (Interim)/ 09RE	FY10 BE /FY09RE	Comments
Gross Tax Revenue	**6,279**	**(9)**	**6,713**	**6,411**	**7**	**2**	**Some room for upside surprise as nominal GDP growth assumed at 10%**
- Corporation tax	*2,220*	*(2)*	*2,442*	*2,567*	*10*	*16*	*Slightly aggressive assumptions*
- Income tax	*1,226*	*(11)*	*1,354*	*1,129*	*10*	*(8)*	*More realistic assumptions now*
- Customs	*1,080*	*(9)*	*1,102*	*980*	*2*	*(9)*	*Weak investment demand & global activity could aggravate fall*
- Union Excise Duties	*1,084*	*(21)*	*1,106*	*1,065*	*2*	*(2)*	*Impact of stimulus measures continues*
- Service Tax	*650*	*1*	*689*	*650*	*6*	*0*	
Net Tax Revenue	4,660	(8)	4,976	4,742	7	2	In sync with reality
Non-Tax Revenue	962	0	1,120	1,403	16	46	Scope for +ive surprise
Total Revenue Receipts	**5,622**	**(7)**	**6,096**	**6,145**	**8**	**9**	**Divestment could spur the total pie**
A. Non-debt Receipts	123	(16)	108	53	(12)	(56)	
B. Debt Receipts to finance Fiscal Deficit	3,265	145	3,328	4,010	2	23	
- Market Loans	*2,620*	*160*	*3,086*	*3,980*	*18*	*52*	***Huge increase in market borrowings, to put pressure***
- Short term borrowings	*575*	*363*	*…*	*…*	*-*	*-*	***on bond yields***
Total Capital Receipts (A+B)	**3,388**	**129**	**3,437**	**4,063**	**1**	**20**	
Total Receipts	**9,010**	**20**	**9,532**	**10,208**	**6**	**13**	

Source: Budget Document, ENAM Research

Contd…

Budget arithmetic: Expenditure

(Rs bn)	FY09 RE	Actual YoY09RE/ 09BE	FY10 BE (Interim)	FY10BE	FY10 BE (Interim)/ 09RE	FY10 BE /FY09RE	Comment
Non-Plan Expenditure							
Interest Payments and	*1,927*	*1*	*2,255*	*2,255*	*17*	*17*	*Continue to be a problem*
Defence	*736*	*28*	*869*	*869*	*18*	*18*	
Subsidies	*1,292*	*81*	*1,009*	*1,113*	*(22)*	*(14)*	*May rise further on global comm prices*
Capital Expenditure	562	(5)	683	769	22	37	
- Defence	410	(15)	548	548	34	34	
Total Non-Plan Expenditure	**6,180**	**22**	**6,681**	**6,957**	**8**	**13**	**6th Pay Comm related expenses key**
PLAN EXPENDITURE	**2,830**	**16**	**2,851**	**3,251**	**1**	**15**	**Increase augurs well and will support demand**
TOTAL EXPENDITURE	**9,010**	**20**	**9,532**	**10,208**	**6**	**13**	
Revenue Deficit	**2,413**	**-**	**2,385**	2827	**-**		
% of GDP	(4)	-	(4)	4.8	-		
Fiscal Deficit	**3,265**	**-**	**3,328**	4009	**-**		
% of GDP	**(6)**	**-**	**(6)**	**6.8**	**-**		
Primary Deficit	**1,338**	**-**	**1,073**	1754	**-**		
% of GDP	(3)	-	(2)	(3)	-		

Source: Budget Document, ENAM Research

GST: Comparisons

Country	Year	Standard Rate %	Consumption % of GDP	C Efficiency	Revenue Productivity
Canada	2005	7.0	74.8	0.5	0.3
Japan	2004	5.0	75.5	0.7	0.5
New Zealand	2005	12.5	76.0	0.9	0.7
Singapore	2004	5.0	54.2	0.7	0.4

Debt to GDP will rise but will be manageable

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Scenarios: Terminal val of debt/GDP of central govt

		Nominal GDP growth (%)				
		8	9	10	12	14
Interest rate (%)	6.5	67	64	61	56	50
	7.0	68	65	62	57	52
	8.0	72	68	65	60	54
	9.0	75	72	68	62	57

Source: Crisil, ENAM Research

Chg in D = PD/ GDP + (i-g) * D
Where, D= Debt/ Nominal GDP ; PD= primary deficit (deficit –int)
i = nominal int rate ; g = nominal GDP growth

Tax buoyancy will be a challenge

(%)		Tax buoyancy				
			Direct tax		Indirect tax	
	GDP growth	Gross tax	Corporate tax	Income tax	Custom+ Excise	Service tax
FY94 - 97	6.8	1.15	1.35	1.55	1.06	3.72
FY98 - 03	5.2	0.92	1.83	1.67	0.76	2.11
FY04 - 09	8.6	1.36	1.96	1.67	0.63	3.61

Source: Crisil, ENAM Research; Note: Service tax was introduced in 1994-95

Debt dynamics of the central government

(%)	FY93-97	FY98-03	FY04-08	FY09
Average cost of govt debt	9.4	9.6	7.1	6.7
Nominal GDP growth	16.3	10.1	14.0	14.9
Primary deficit/GDP for a stable debt ratio	3.7	0.3	3.6	4.9
Actual primary deficit/GDP	1.4	1.3	0.0	2.5
Internal debt/GDP	54 - 49	51 - 64	63 - 61	59.6

Source: Crisil, ENAM Research

We believe nominal GDP growth > nominal interest rates on govt borrowings, hence Debt/ GDP will be manageable

Inflation components

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Inflation: To breach RBI tolerance levels

	Weight (%)	2008-09	2009-10E
Primary articles	22.03	10	16
Fuel, power, light & lubricant	14.23	7.4	2
Manufactured products	63.75	8	4
Food products	11.54	9.7	16
Beverages tobacco & tobacco products	1.34	9.5	7
Textiles	9.8	6.1	4
Wood & wood products	0.17	8.8	2
Paper & paper products	2.04	4.4	2
Leather & leather products	1.02	1.1	0
Rubber & Plastic products	2.39	4.6	(2.5)
Chemicals & chemical Products	11.93	7.1	2
Non-metallic mineral products	2.52	3.7	0.5
Basic metals alloys & metals products	8.34	14.3	3
Machinery & machine tools	8.36	4.7	3
Transport equipment & parts	4.29	5.2	2
All commodities	100	8.3	6.4

Every 5% spike in in primary articles will inflate WPI by 1.3%

	wt	Inflation in June	5% inflation
Primary articles			
# Cereals	4.41	12.4	0.2
# Pulses	0.6	14.8	0.03
# Other food articles	10.39	5.8	0.5
Manuf products			
- Food products	8.78	18	0.4
- Bev, tobacco & tobacco prod	1.34	5.8	0.07
Total WPI		11.36	1.3

Impact of Import price inflation on domestic inflation

Year	Import price Inflation	Domestic Inflation (WPI)	Imports/ GDP Ratio	Effect on WPI	Non agri Imports/ GDP Ratio*	Effect on WPI (%)
1970s	14.7	9	6	0.89	12.3	1.81
1980s	8	8	8.7	0.7	15.9	1.27
1990s	7.2	8.1	11.8	0.85	20	1.45
2000s	4.8	5.1	16.8	0.81	25.8	1.24
2003-07	3.4	5.5	19.9	0.67	29.7	1
2003-08	4.7	5.3	19.9	**0.94**	29.7	**1.4**

1% rise in imports causes a 40 bps impact on domestic inflation

Hence, if crude or commodity prices were to rise, WPI can spike rapidly subject to the extent of pass through

*Source: ENAM Research , * : Excluding agriculture and allied activities and community and personal services.*

Govt spending only fuels inflation

- **Globalization has altered the financing pattern of govt deficit leading to a change in the asset profile of RBI B/S thus it was believed that the relationship between fiscal deficit and 'net RBI credit to government' and the latter with broad money supply (M3) do not exist and, therefore, concluded that fiscal deficit is no longer relevant for stabilization**
- **However, govt deficit may now cause reserve money expansion through the incomplete sterilization of Net Foreign Assets (NFA) accumulation intended to enable adequate market subscription to Government borrowings, replacing the erstwhile channel of 'net RBI credit to the Govt'**
- **1% change in government deficit leads to about 1.06 % expansion in the reserve money.**

Impact of govt spending

Explanatory/Dependent	LP	LDRM	LM3	LM3
1	2	3	4	5
Constant	12.73	-1.85	3.58	-11.2
	(6.8) *	(-5.5) *	(2.1) **	(-3.5) *
Trend	0.05		0.08	
	(6.2) *		(2.4) **	
LM3	0.43			
	(6.5) *			
LY	-0.94			1.03
	(-5.6) *			(3.1) *
LP				1.43
				(6.5) *
LRM			0.57	
			(2.4) **	
LGD		1.06		
		(29.6) *		

** and ** denote significance at 1%, and 5%, respectively*

Source: RBI, ENAM

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