3 November 2011

## India Equity Strategy

# What if GDP growth trend slows to 7%?

**What if India's GDP growth trend slows to 7%?**
While we note a trend GDP growth rate of 8-9% has been embedded in investor expectations of India's earnings growth/ROE trajectory, policy uncertainties, the conflicting demands and compulsions of a popular democracy on the government and India Inc's growing discouragement, are increasing the risk of India's - medium term - GDP trajectory slowing towards 7%. In this note we have attempted a sensitivity analysis to assess the impact of slowing growth on BSE Sensex earnings and answer questions associated with a slowing GDP growth trend. However, a 7% GDP growth trajectory is not our base case scenario with our economists forecasting a 8% average GDP growth over next two years.

**What will be the impact of a slowing growth on India's valuation multiples?**
We confess that India is beginning to lose some of its investor goodwill accumulated over the past five to seven years. The perception of a slowing GDP growth trend, could result in a further de-rating of the country's valuation multiple and a compression in its average premium to MSCI Asia nudging investors into an even more cautious posture. Over the past few months we have seen a 260bps compression in India's PE valuation, driven by rising risk aversion (due to global factors) and worries over policy uncertainties. While it is difficult to quantify the extent of future valuation compression, we would think that valuations could get reset to a level of 11x to 12x, which prevailed in the late nineties and first half of previous decade (corresponding fair value range of 14500-16000 for the Sensex).

**Moderate 3% downside risk to Sensex FY13 earnings**
Our India research team's extensive bottom up sensitivity analysis suggests a downside of 3.2% to our current BSE Sensex earnings expectation for FY13, taking earnings growth for FY13 to 12.5% from our current estimates of 16.3%. While the downside risk to FY13 earnings sensitivity may appear muted, this could be attributed to our analysts having already cut FY13 earnings estimates by 12% since Apr'11 (relative to a 9% cut for FY12).

**Highest downside risk to Capital Goods, Autos, Telecom**
**Capital Goods/Construction** companies could witness the sharpest downside risk (-11%) driven by 13% drop in **L&T's** earnings and 11% drop in **BHEL's** earnings. **Autos** earnings could be impacted by ~7% led by Maruti (12%), M&M (8%) and TAMO (6%). **Telecom** earnings could decline by 6%. For **Banks**, slowing GDP growth would lead to asset quality concerns, with our Banking analyst getting more worried on asset quality in the power and SMEs segments. However, banks could likely restructure their power assets rather than classifying them as NPLs which may lead to valuation multiple contraction.

**What could allay downside concerns?**
Bold policy actions on state electricity board reforms (power tariff hikes), addressing supply side bottlenecks in coal, preventing any runaway increase in fiscal deficit (through raising fuel and fertilizer prices) and most importantly assuaging India Inc's high pessimism, remain critical, in our opinion, to ensuring that India's investor goodwill is not impaired. Expectations of slowing global growth and increasing regulatory focus on commodities may well be a silver lining for government finances, if commodity (particularly oil) prices continue to ease.

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# What if GDP growth trend slows to 7%?

With India's real GDP growth averaging 8.4% over past five years, a trend growth rate of 8-9% has now been embedded in investor expectations. We think this is not a wrong assumption with India's savings rate averaging 34%, forming the bedrock of the 8% growth trajectory.

India has generated considerable attention as an investment destination driven by its unique domestic consumption model, attractive demography and low correlation with global GDP growth. Barring the global economic crisis years (2008-2009), India's GDP growth has averaged 9% over past 5 years. The 8-9% GDP growth trajectory has been broadly embedded in India's earnings growth/ROE trajectory expectations and as a corollary its valuation bands. This trend has now embedded expectations of a structural BSE Sensex earnings growth expectation of 20 to 25%, which has manifested in the country commanding an average valuation premium of 300bps over the benchmark MSCI Asia.

While we are not forecasting a slowdown in India's long term GDP growth trajectory, we believe that policy uncertainties, the conflicting demands of a popular democracy on the government (particularly during busy state election years) and India Inc's rising despondency, are increasing the risk of India's - medium term - GDP trajectory slowing towards the 7% level from the average 9% over past five years (ex- crisis period). These concerns can be alleviated and the risk reduced considerably if (1) global commodity prices come off (2) clarity emerges on coal supply bottlenecks and revision in power tariffs by state electricity boards (3) return of India Inc's business confidence and inclination to invest. Currently, consumption from the Indian hinterland is doing the heavy lifting for the Indian economy. The Government's politically strategic inclusive growth initiatives are driving prosperity in the Indian hinterland.

While investors are still hopeful over India's attractive long term fundamentals, we are now increasingly being asked about the impact of a slowing GDP trajectory on earnings growth, sector positioning and valuation multiples.

We confess that it appears India is beginning to lose some of its investor goodwill accumulated over the past five to seven years from its conscious attempt to improve its public as well as private balance sheets, the government's successful, preemptive efforts in stimulating the domestic economy during the global economic crisis and its vibrant investment story (domestic fixed capital formation grew at a CAGR of 16% over FY04-08).

In this note we have attempted to answer most of the questions we are being asked by investors in the context of a slowing GDP growth trend. *We reiterate that a 7% GDP growth trajectory is not our base case scenario with our economists forecasting a 8% average GDP growth over next two years.* Bold policy actions on addressing supply side bottlenecks in coal, preventing any runaway increase in fiscal deficit (raising fears of a crowding out of private sector) and most importantly reducing India Inc's high despondency remain critical to ensuring that India's investor good will is not impaired.

## Figure 1: Trend of key parameters over the past decade

| | Real GDP Growth (%) | Sensex EPS growth (%) | Average 1yr Fwd PE | Average ROE (%) | Average MSCI India PE Premium | Fiscal Deficit (% of GDP) | 10 yr average Bond Yields |
|---|---|---|---|---|---|---|---|
| FY-01 | 4.4% | -23% | 19.2 | | | 5.7% | 10.9% |
| FY-02 | 5.8% | 9% | 13.3 | | | 6.2% | 8.8% |
| FY-03 | 3.8% | 15% | 10.1 | | | 5.9% | 6.9% |
| FY-04 | 8.5% | 28% | 10.0 | 19% | 129 | 4.5% | 5.4% |
| FY-05 | 7.5% | 29% | 10.5 | 21% | 217 | 3.9% | 6.2% |
| FY-06 | 9.5% | 16% | 12.3 | 22% | 327 | 4.0% | 7.1% |
| FY-07 | 9.8% | 37% | 14.9 | 22% | 445 | 3.3% | 7.8% |
| FY-08 | 9.0% | 16% | 18.5 | 21% | 458 | 2.6% | 7.9% |
| FY-09 | 6.8% | -3% | 14.3 | 21% | 89 | 6.0% | 7.6% |
| FY-10 | 8.0% | 2% | 17.0 | 18% | 260 | 6.3% | 7.2% |
| FY-11 | 8.6% | 23% | 17.1 | 16% | 367 | 5.1% | 7.9% |
| FY-12E | 8.0% | 17% | 14.4 | 17% | 262 | 5.5% | 8.3% |

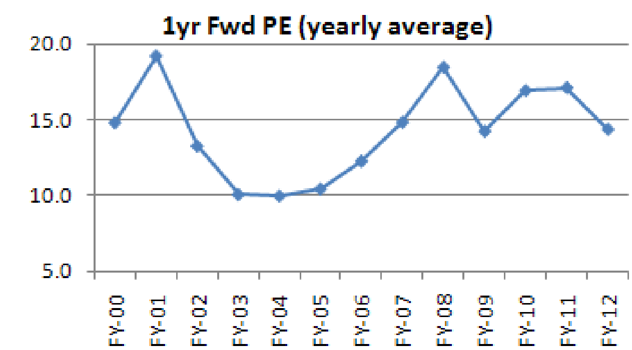
*Source: Deutsche Bank, CMIE, Bloomberg Finance L.P.*

## What will be the impact of a slowing growth trajectory on India's valuation multiples?

Over the past five years India has traded at an average forward PE multiple of 16x and an average premium of 298bps over the benchmark MSCI Asia multiple. India's broadly consistent valuation premium over MSCI Asia can be attributed to its higher ROE's and more importantly to its high relatively higher earnings growth. India's earnings growth over past five years has averaged 24% (barring the crisis period of FY09/FY10).

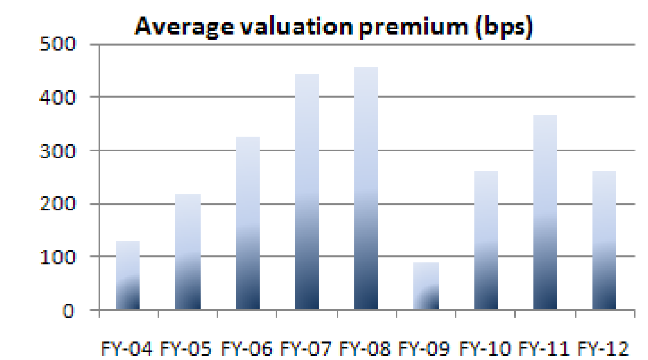
The perception of a slowing GDP growth trend and as a corollary slowdown in earnings growth could result in a further de-rating of the country's valuation multiple and a compression in its average premium's to MSCI Asia. Any alteration in investor expectations of a slowdown in trend GDP and earnings growth could nudge investors into an even more cautious posture which may result in a further compression in its valuation multiples. Over the past few months we have seen a 300bps compression in India's PE valuation (vs. average of past 5 years) driven by rising risk aversion (due to global factors) and worries over policy uncertainties.

**Figure 2: India's average 1 yr fwd PE multiple**




*Source: Deutsche Bank, Bloomberg Finance L.P.*

**Figure 3: MSCI India's premium to MSCI Asia ex Japan**

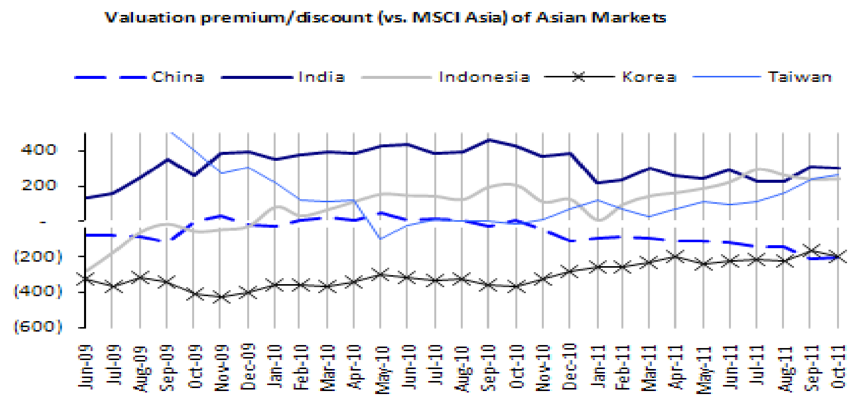



*Source: Deutsche Bank, Bloomberg Finance L.P.*

While it is difficult to quantify the extent of future valuation compression, we would think that valuations may get reset to a level of 11x to 12x which prevailed in the late nineties and first half of previous decade, in the event of a slowdown in economic growth and earnings trajectory.

Valuing FY13 EPS at 11x-12x would result in a corresponding fair value range of 14500-16000 for BSE Sensex, if growth were to slip to a trend 7%.

**Figure 4: Valuation Premium/Discount of key Asian markets (vs. MSCI Asia)**




*Source: Deutsche Bank, Bloomberg Finance L.P.*

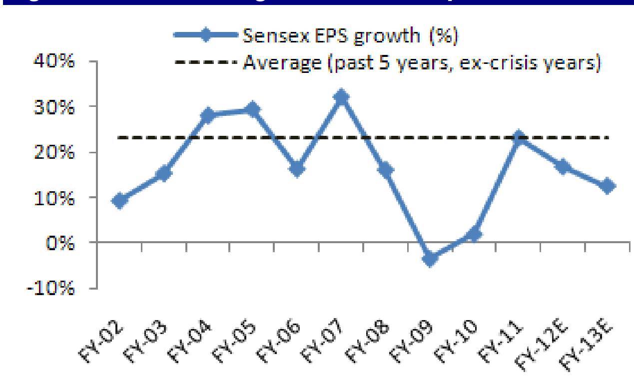
## What will be the impact of slowing growth on BSE Sensex earnings

**Limited risk to FY13 Sensex earnings..:**

Our India research team's extensive bottom up analysis suggests a downside of 320bps to our current BSE Sensex earnings expectation for FY13, taking earnings growth for FY13 to 12.5% from our current estimates. BSE Sensex aggregate EPS in FY13 would amount to 1323- relative to our current expectation of 1367.

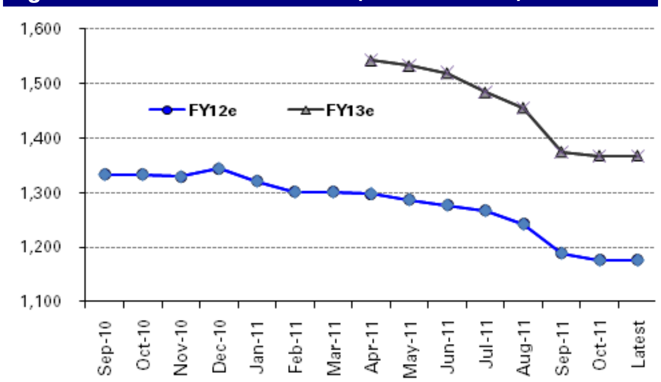
**… as analysts have already cut FY13 earnings estimates sharply :** While the risk to FY13 earnings may appear muted, this could be attributed to our analysts cutting FY13 earnings estimates aggressively. Our analysts have cut earnings expectations for FY13 by 12% since Apr'11 (relative to a 9% cut for FY12). In addition with ~40% of Sensex earnings driven by global factors (IT, Oil&Gas, Pharma, JLR, Corus etc.), the impact of a domestic slowdown is tempered.

**Figure 5: Sensex EPS growth over the years**




*Source: Deutsche Bank, Bloomberg Finance L.P.*

**Figure 6: Trend in Sensex EPS (DB estimates)**




*Source: Deutsche Bank, Bloomberg Finance L.P.*

In the table below we lay out our analysts' assessment of the impact on the current FY13 earnings estimate if India's GDP growth were to slow down to 7% in FY13.

**Figure 7: Likely impact on Earnings of Sensex companies in the scenario that India's GDP growth slips to 7%**

| Company | FY13 Net Profit (INR mn) | | | Comments |
|---|---|---|---|---|
| | CURRENT | UNDER 7% GDP Growth | % change | |
| **AUTO** | **198,557** | **184,665** | **-7.0%** | |
| Bajaj Auto | 33,235 | 31,317 | -5.8% | We have assumed domestic 2W growth at 6.5% (vs 11% earlier) whereas export growth remains unchanged at 22%. 3W growth has been reduced from 12% to 8%. EBITDA margins have been reduced by 60bps. |
| Hero MotoCorp | 24,520 | 23,202 | -5.4% | We have assumed volume growth at 10% (vs 13% earlier). EBITDA margin expected to fall by 30bps. |
| Mahindra & Mahindra | 34,733 | 32,020 | -7.8% | We have assumed UV volume growth to slow down to 9% vs 15% and small CV growth to slow down from 25% to 18%. Tractor growth is expected at 10% (vs 12% earlier). EBITDA margins have been reduced by 50bps |
| Maruti Udyog | 26,445 | 23,292 | -11.9% | We have assumed volume growth at 9% vs 14% in the base case. We have also factored EBITDA margins to contract by 60 bps due to weaker INR (stronger JPY). |
| Tata Motors | 79,624 | 74,834 | -6.0% | We have made no changes to our JLR estimates. JLR currently constitutes 65% of TAMO's consolidated EBITDA. For MHCVs we have reduced our FY13E growth forecasts to -8% vs 0% and for LCVs we have reduced our growth from 15% to 5%. Our India revenue and EBITDA get reduced by 9% and 13% respectively. |
| **METALS** | **214,689** | **203,230** | **-5.3%** | |
| Jindal Steel & Power | 59,080 | 58,080 | -1.7% | Steel volumes lowered by 0.1 mn tonnes. Company's cost competitiveness in power and merchant rate at INR 3.5/unit is unlikely to impact power volumes. |
| Sterlite Industries India | 67,891 | 69,833 | 2.9% | Sterlite's earnings are more aligned to the global growth than domestic growth factors; though premium on sales is likely to go down in case of domestic slow down, the resultant depreciation of INR will more than make up for the adverse impact |
| Tata Steel | 87,718 | 75,317 | -14.1% | Steel pricing in India will likely come under pressure, thus, suppressing the profitability of Indian operations of Tata Steel to US$350/t from our present assumption of US$400/t |
| **IT SERVICES** | **272,930** | **272,930** | **0%** | |
| Infosys Technologies | 91,116 | 91,116 | 0% | No meaningful impact |
| Tata Consultancy Services | 121,406 | 121,406 | 0% | |
| Wipro | 63,437 | 63,437 | 0% | |
| **OIL & GAS / PETROCHEMICALS** | **573,389** | **573,389** | **0%** | |
| Oil & Natural Gas Corp | 294,923 | 294,923 | 0% | Negligible impact as fortunes are dependent on global oil price and Government's policy on subsidy sharing |
| Reliance Industries | 278,466 | 278,466 | 0% | Limited impact as global refining and petchem margins will not be impacted by a slowdown in India |
| **FINANCIAL SERVICES** | **384,428** | **361,654** | **-5.9%** | |
| HDFC Bank | 67,668 | 65,994 | -2.5% | Loan growth at 300bps below base case. For banks - 25% of sensitive loans (power, SME, CRE) and 25% of these slip to NPL. 20% provisions on these additional NPLs. For HDFC assumed 25% higher NPL provisions than base case |
| HDFC | 50,337 | 48,286 | -4.1% | |
| ICICI Bank | 74,362 | 67,177 | -9.7% | |
| State Bank of India | 192,060 | 180,198 | -6.2% | |

*Source: Deutsche Bank*

**Figure 7: Likely impact on Earnings of Sensex companies in the scenario that India's GDP growth slips to 7% (Continued)**

| Company | FY13 Net Profit (INR mn) | | | Comments |
|---|---|---|---|---|
| | CURRENT | UNDER 7% GDP Growth | % change | |
| **CAPITAL GOODS** | **123,084** | **109,498** | **-11.0%** | |
| BHEL | 61,018 | 54,110 | -11.3% | revenues to fall by 5% due to delays in execution in slow moving orders |
| Jaiprakash Associates | 11,367 | 11,214 | -1.3% | Fall in cement volumes by 1%. |
| Larsen & Toubro | 50,700 | 44,174 | -12.9% | E&C revenues to fall by 10% due to delays in execution in slow moving orders |
| **PROPERTY** | **23,955** | **21,679** | **-9.5%** | |
| DLF | 23,955 | 21,679 | -9.5% | Demand is a LT structural story driven by robust GDP growth, demographics and significant unmet demand. This will be supported by low base (FY11 revenues, EBIDTA and PAT was ~34%, 61% and 79% respectively below FY08 peaks) and weakening of interest rates but significantly constrained by weak sentiments constraining near-term demand. |
| **FMCG** | **102,436** | **100,387** | **-2.0%** | |
| Hindustan Unilever | 30,951 | 30,317 | -2.0% | Limited impact due to low demand elasticity to economic cycle |
| ITC | 71,500 | 70,070 | -2.0% | Cigarette sales are highly inelastic and hence there would not be any material impact |
| **POWER UTILITIES** | **309,317** | **309,215** | **0.0%** | |
| NTPC | 114,208 | 114,208 | 0% | Negligible impact as India is power deficit |
| Tata Power Co | 22,696 | 22,594 | -0.4% | Assumed lower generation volumes on GDP adjusted power demand for marginal (read merchant) power |
| Coal India | 172,412 | 172,412 | 0% | No Change as domestic coal prices are at a discount to international prices and India has coal shortage. |
| **TELECOM** | **146,690** | **137,418** | **-6.3%** | |
| Bharti Airtel | 146,690 | 137,418 | -6.3% | We have assumed wireless minutes growth at 10% vs 12% earlier and tariff hike of 2.5% vs 3.5% earlier. We have also assumed an increase in interest costs due to depreciation of the rupee. |
| **PHARMA** | **35,541** | **34,799** | **-2.1%** | |
| Cipla | 12,141 | 11,868 | -2.3% | Demand is largely independent of economic conditions. While price cuts in most markets would be a drag, they would be partially neutralised by weaker input prices. Demand in India (~45% of revenues) may be impacted marginally due to slowdown. |
| Sun Pharma | 23,265 | 22,931 | -1.4% | Demand is largely independent of economic conditions. While price cuts in most markets would be a drag, they would be partially neutralised by weaker input prices. Demand in India (~43% of revenues) may be impacted marginally due to slowdown. |
| **Sensex** | **2,385,015** | **2,308,864** | **-3.2%** | |

*Source: Deutsche Bank*

## We see highest risk to earnings in Capital Goods, Property, Autos, Telecom and Banks

Bottom up analysis of our analysts' estimates suggest that in case of India's GDP growth slowing down to 7% purely on domestic factors, Capital Goods, Autos, Telecom and Banks exhibit the highest downside in earnings from current levels:

- Earnings of **Capital Goods/Construction** companies could witness the sharpest downside risk (-11%) driven by 13% drop in **L&T's** earnings and 11% drop in **BHEL's** earnings. Our sector analysts have factored in a 5%/10% decline in revenues of BHEL/L&T, mainly as could slow down, particularly driven by deceleration in slow moving orders. However, the impact of slowing order book growth could be partially moderated by lower global commodity prices.

- **Autos** earnings could be impacted by ~7%(in case GDP growth slows down to 7%), with **Maruti** likely to see sharpest decline in FY13 earnings of 12%, as it could get dually impacted by (i) significantly lower volume growth of just 9% (vs. our base case of 14%) and (ii) a 60bps hit on EBITDA margins due to expectations of weaker INR vs. JPY. **Mahindra & Mahindra** could be impacted by 8% as its UV and small CV segment could likely see a sharp cut in volume growth, even as tractor growth should not be materially impacted. For **Tata Motors**, domestic operations could take the biggest hit in the auto pack (with MHCVs expected to de-grow by 8% and LCVs growth falling sharply by 10% points), but the overall impact on earnings is moderated to just -6% due to no change to its international operations (i.e. JLR, accounting for 65% of TAMO's consol EBITDA).

- **Telecom's** (represented by **Bharti** only) earnings could face a downside risk of 6%, as there could be a decline of 200bps in minutes growth and a shrinkage in tariff hike from 3.5% to 2.5%. Additionally, Bharti's finances will also be hit by higher interest costs, on account of depreciating INR.

- For **Financials**, there could be a downside risk of 6% to our base case estimates, with ICICI Bank most at risk (-10%), and HDFC Bank being least affected (-3%). Our banking analyst Manish Karwa notes:

  In case of slower economic growth, we believe that following could happen – (a) loan growth could decelerate by ~200-300 bps (vs. base case of 18%), (b) on margins, we believe that the industry is playing very rationally and despite a slower growth, we do expect the system to make reasonably strong margins, (c) Asset quality will however be the biggest concern and we are now getting slightly more worried on this especially in the power and SMEs segments. While power sector continues to be plagued by problems of its own, it is actually the SME/mid market segment which may see higher delinquencies. SMEs roughly account for about 25% of the loan book, wherein, likely NPLs could be 10-15% higher than general expectations. However, the impact of slowdown may be staggered. Further, we believe that banks will most likely go for restructuring their power assets rather than classifying it as NPLs. Thus, while reported NPLs may not rise much, restructured asset are likely to be higher which may lead to multiple contraction (d) Despite a slowdown, we are not much concerned on retail loans and loans to large corporates which roughly constitute about 50-55% of total loans in context of asset quality, but reiterate that growth may be slower in these segments.

## IT Services, Oil & Gas, Utilities, Pharma and FMCG likely to be least impacted

- We do not see any meaningful impact on IT Services or Oil & Gas companies, as our analysis envisages endogenous growth slowdown only. However, among other sectors we see Utilities, FMCG and Pharma to be impacted only modestly:

- For **Utilities** we expect no impact on earnings as India continues to remain in power deficit mode with demand far outstripping the supply (despite robust growth of 9-10% in electricity production over last 3 quarters). The current power deficit stands at ~10%. Therefore, unless demand growth moves down to zero (a highly unlikely event, even if GDP growth slows down to 7%), India will continue to remain power deficient, and hence there should not be any impact on power utility companies in Sensex. Our Utilities analyst Abhishek Puri notes further that:

  We estimate that under demand slowdown, power spot rates could well settle at INR 3.5/unit. The most impacted players from demand slowdown would be marginal contributors to the sector, or merchant power projects, as the spot tariffs could be impacted negatively on reducing power deficit- highest exposure in FY13E will be for JSPL (1.8GW), JSW Energy (1.6GW) and Adani/Lanco Infra (1.2GW) – but the impact on JSPL could be moderates given that it is the lowest cost producers.

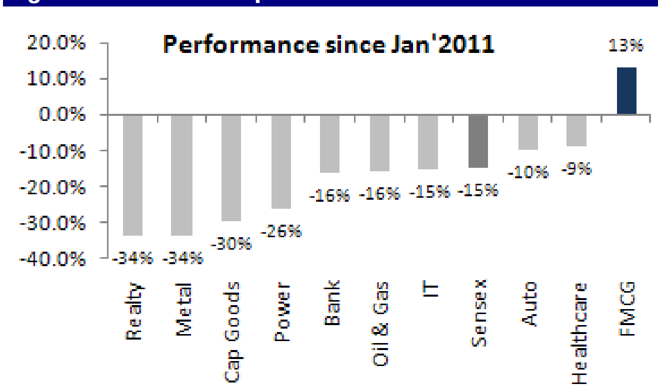
For Coal India, we do not foresee a decline in volume growth, and impact, if any, could probably be through lower e-auction prices, bringing down Coal India's earnings by 1% only.

- For **FMCG** too, the likely impact on earnings is limited to -2%, as ITC's cigarette sales remains relatively inelastic to economic cycles, while for HUVR, the margin pressures could be partially offset by lower raw material costs.
- **Pharmaceuticals** earnings could also remain insulated from domestic headwinds (with ~55% of Sensex pharma companies' revenue coming from export). On domestic revenue too, demand is largely secular in nature and independent of economic conditions and hence we only see a likely 2% downside risk in earnings.

## How might investors be positioned?

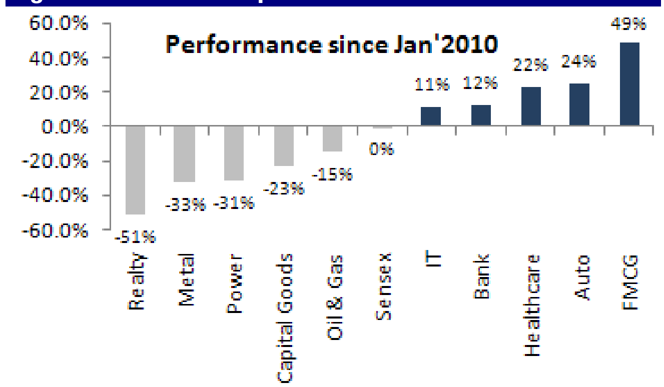
**More of the same**: In an environment of slowing capital formation but with an undercurrent of robust consumption growth, investors should brace for more of the same, i.e. we believe that Consumer Discretionary (especially Autos - 2 wheelers, tractors) and Consumer Staples are likely to outperform despite high valuations. Infrastructure and Utilities along with real estate and metals are likely to be key under performers if we continue to see a prolonged delay in the return of the investment cycle.

**Figure 8: Sector wise performance YTD 2011**




Source: Deutsche Bank, Bloomberg Finance L.P.

**Figure 9: Sector wise performance since Jan 2010**




Source: Deutsche Bank, Bloomberg Finance L.P.

# Impact of slowing growth on macro economic factors

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We present below a "what if analysis", showing how high frequency macro indicators such as inflation, fiscal deficit, balance of payments and rupee could be affected in FY12/13, if real GDP growth were to slow down below its trend rate of 8% - 8.5% to 7%. We reiterate that these are not our base case forecasts FY12/13, as we continue to expect growth to stay supported around 8% (though with some downside risks), but should be seen as an exercise with the objective to determine the amount of stress that the Indian economy may be subjected to, if growth were indeed to fall sharply in the next fiscal year.

In our analysis, we assume the growth slowdown driven primarily by domestic factors (such as continued policy inaction on the government's front and lagged impact of RBI's previous rate hikes), rather than led by a deep recession or financial market collapse in advanced countries. For the purpose of the sensitivity analysis, we have assumed global crude oil prices to average around USD100/barrel through the course of FY12/13.

**Figure 10: Implications on key macro parameters if GDP growth falls to 7%**

| FY12/13 | BASE CASE | WHAT IF |
|---|---|---|
| **Real, %yoy** | | |
| Real GDP | 8 | **7** |
| Private consumption | 7 | **5** |
| Gross fixed investment | 10 | **7** |
| Exports | 17 | **12** |
| Imports | 17 | **10** |
| **Monetary** | | |
| Inflation, %, ave | 6.5 | **6** |
| Bank credit , %yoy | 18 | **15** |
| **Fiscal** | | |
| Central govt balance, % of GDP | -4.8 | **-6** |
| Consolidated balance, % of GDP | -7.5 | **-9** |
| **External** | | |
| Trade balance, % of GDP | -7.5 | **-7** |
| Current account balance, , % of GDP | -3 | **-2.6** |
| FDI, USD bn | 32.5 | **25** |
| Portfolio, USD bn | 25 | **15** |
| FX reserves, USD bn | 275 | **270** |
| **Financial markets** | | |
| Repo rate, eop | 7.5 | **7** |
| INR/USD, eop | 46.5 | **47** |

*Source: Deutsche Bank*

## Impact on consumption, investments and BoP

Our calculation suggests that for a 7% real GDP growth, private consumption growth would have to moderate to 5% (from a likely 7% growth in FY11/12) and investment growth should ease to 7% (from an already low growth expectation of 8.0% in FY11/12). Exports and imports growth should also moderate by 7-8%, with a likely bigger slowdown in imports component, to reflect weak momentum in the domestic economy. As a result, trade deficit should narrow by 50bps to 7.0% of GDP, helping the current account deficit to also shrink somewhat and thereby supporting a modest appreciation of the rupee from current levels. However, in a low growth scenario, there would be lesser scope for the rupee to appreciate sharply, as foreign capital inflows (both FDI and portfolio investment) would be expected to remain muted, compared to its historical trend.

## Impact on inflation and the likely response of RBI

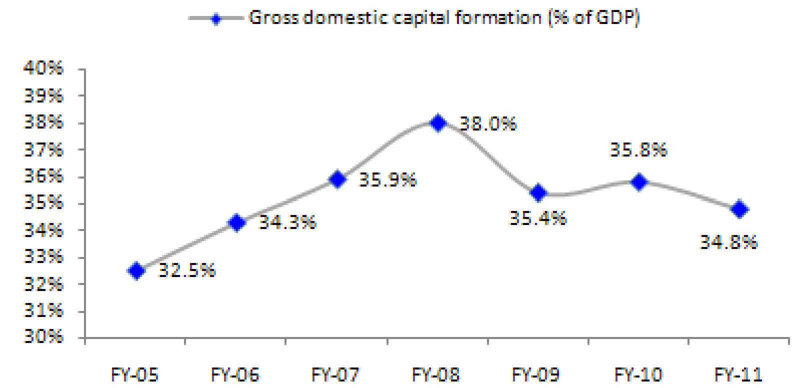
Intuitively, a low growth scenario also implies a reasonably lower inflation outturn through the course of FY12/13. However we are not factoring any sharp deceleration in WPI inflation, even under a 7% growth assumption. Given that part of India's inflation has become structural in nature (owing to supply bottlenecks in both infrastructure and agricultural sector) and given our assumption that global crude oil prices would not fall sharply below the USD100/barrel mark, WPI inflation in such a scenario would only moderate close to the RBI's comfort range of 5-5.5%, but unlikely to dip substantially below this level. Bank credit growth would slow down to around 15%, reflecting weak economic activity, but unlikely to fall to a single digit level owing to continued borrowing demand from oil marketing companies (with government subsidy payments compensating loss making OMC'S with substantial lags). In such a low growth-stable inflation scenario, RBI would have the window to entertain rate cuts of 100-125ps, to bring the real policy rate close to the neutral level, in our view.

## Impact on fiscal deficit

However, the biggest negative impact would be on the fiscal position, as a low growth scenario would mean lower revenues, without any commensurate decline in expenditure due to the government's focus on inclusive growth (reflected in increased expenditure on food and fertilizer subsidies) and the demands of a popular democracy. Oil subsidies could also remain high, if global crude oil prices remain anchored at USD100/barrel, thereby providing little respite on the expenditure front, despite a lower growth scenario. This potentially could push up the centre's fiscal deficit to 6.0% of GDP in FY12/13, from a likely 5.5% of GDP in FY11/12.

## Appendix

**Figure 11: Capital formation as % of GDP**

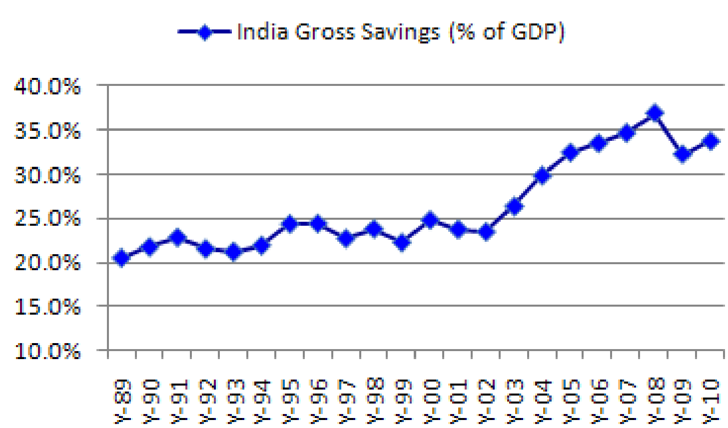



*Source: Deutsche Bank, CMIE*

**Figure 12: India's GDP growth rate (%)**


*Source: Deutsche Bank, CMIE*

**Figure 13: India's savings rate**




*Source: Deutsche Bank, CMIE*

# Appendix 1

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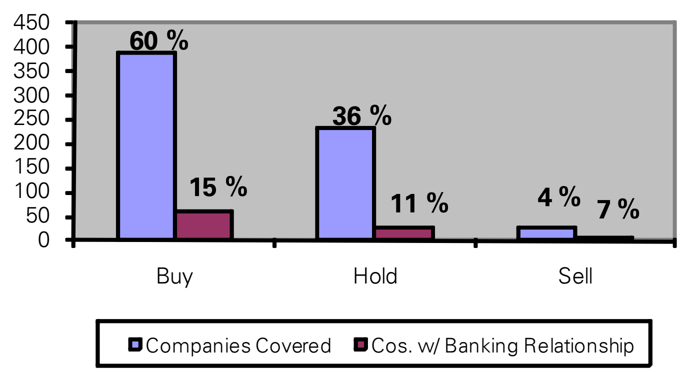


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