Economics

Economic Analysis

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Stimulus II: No harm in trying, you know

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Slowdown unavoidable, lower rates support 2H bottom out

We do not believe there is a magic wand to avoid a slowdown given the scale of the global recession. Nonetheless, monetary/ fiscal stimuli – the last until March 09 - should help the economy bottom out in 2HFY10 (see, Appendix). Charts 1 - 2 shows that cycles typically peak/bottom up when real lending rates pierce/dip below neutral, as defined by the trend growth rate. Mercifully, 100bp MLe PLR cut will push real lending rates, now 7.25%, well below our estimated 8% trend.

Preemptive RBI easing: 50bp rate/CRR, 100bp SLR/PLR cuts

We think the bulk of monetary easing is done with today's 100bp rate cuts (expected by April) and 50bp CRR cut (as expected). While the RBI is typically reluctant to cut rates below the 5% average inflation rate, we expect Delhi to push a 50bp cut in April given summer 09 polls. We continue to expect an additional 50bp CRR cut in April and a 100bp SLR cut in 4QFY09. Delhi will likely push public sector banks into a parallel 100bp PLR cut – 50bp now. We also expect the RBI to hike non-resident deposit rates 100bp to retain the ~US$30bn maturing by September 09. The RBI also offered banks regulatory relaxations in NPL norms.

Government: Limited sectoral incentives given fiscal deficit

We have long argued that significant fiscal stimulus is difficult given the high fiscal deficit. Within this constraint, Delhi has expectedly offered incentives to autos, exporters, and non-bank financial companies, liberalized external commercial borrowings, and proposed upward revision in public sector bank credit targets and recapitalization and additional US$6bn of infrastructure IIFCL bonds.

US$9bn hike in FII corp bond limit: + INR, infra, corp bonds

We think Delhi's decision to allow hike the FII investment limit on corporate bonds – which we long expected - by US$9bn to US$15bn should be positive INR: read Steve and me, here. We factor in US$5bn inflow in our BoP estimates by FY10 (Table 2). Second, the resultant development of a corporate debt market should augur well for infrastructure funding. Finally, this reinforces our bullish stance on PSU/AAA bonds – read Ashish and me, here – even after IIFCL bond issuance.

Bonds: Party now, but 2H supply pressures building up

We continue to expect rate cuts to likely sustain the gilt rally with the 10y slipping to 4.5% (see, here). We cut our March 09 10y forecast to 5.5%. Drawdown of MSS sterilization bonds will, after all, fund the proposed additional State borrowing (Rs300bn/US$6bn, higher than above-consensus US$4bn MLe) (Table 3). And yet, a revenue collapse – December advance taxes reportedly fell 22% – buttresses our expectation of supply build up by 2HFY10, once the MSS run out.

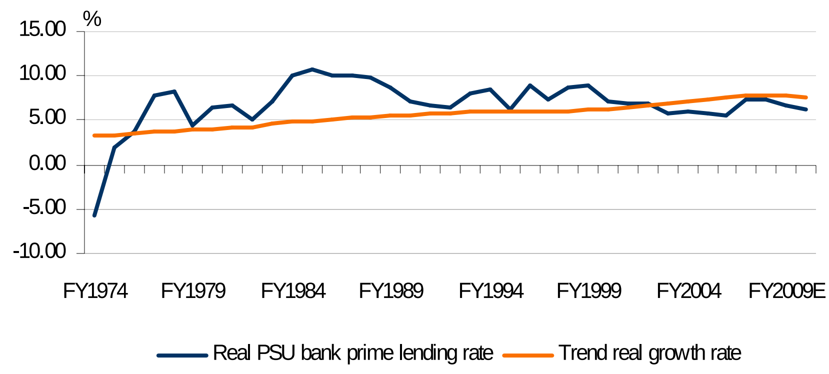
Table 1: India - the gathering storm

Variables	FY08E	FY09E	FY10E	FY11E
Real GDP growth rate	9	7.2	5.8	7.5
Agriculture	4.5	3	3	3
Industry	8.1	4.6	3.3	6.9
Services	11.4	9.1	7.3	8.8
M3 growth rate	20.7	18	16	16
Commercial credit	21.9	20	15	17.5
WPI inflation rate	7.8	2.0	5	5.5
Center's fiscal deficit (% of GDP)	-3.1	-4.1	-5.3	-4
Current account balance (% of GDP)	-1.5	-2.2	-2.1	-1.8
Forex reserves (US$bn)	309.8	240	250	275
RBI's LAF reverse repo rate	6	4.0	3.5	6
RBI's LAF repo rate	7.75	5.5	5.0	7
Cash reserve ratio (% of bank book)	7.75	5	4.5	7
10-year Govt yields	8	5.5	7	7.5
Prime lending rate of PSU banks	12.25-12.75	11.75-12.5	11.25-11.75	12.25-12.75
US$/INR	40	50	47	45.5*

Source: GoI, RBI, ML estimates. Refers to December 10.

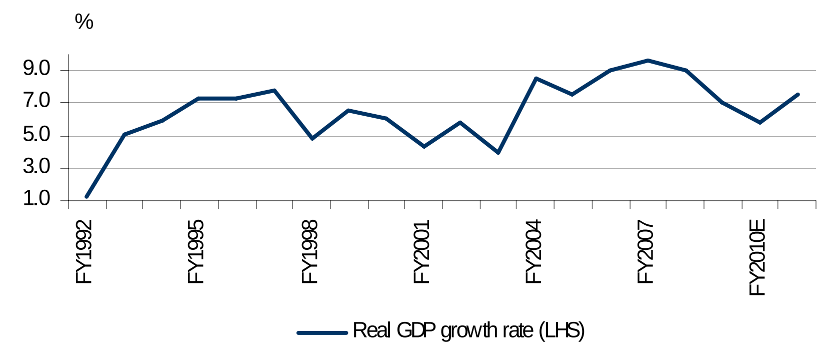
Refer to important disclosures on page 7.

Chart 1: Real lending rates slipping below the trend real GDP growth rate



Source: CSO, RBI, ML estimates.

Chart 2: Supporting a 2HFY10 bottom out in growth, although recovery will take longer



Source: CSO, ML estimates.

The Market Stabilization Scheme (MSS) essentially sterilizes capital flows. The RBI generates rupee liquidity when it buys FX to contain the INR. The government mops this up with a parallel gilt auction under the MSS. The proceeds are locked up in an RBI account till maturity. With capital flows drying up, the RBI is rolling back MSS bonds either by maturity/ repo/ buyback. This offsets the additional issuance from fiscal slippage and oil/fertilizer bonds.

Table 2: Expect US$5bn of FII corp bond investment by FY10

Item	FY07	FY08	FY09 (US$85/bbl)	FY10 (US$50/bbl)
Current Account	-9.8	-17.4	-27.3	-25.7
% of GDP	-1	-1.5	-2.2	-1.9
Trade balance	-63.2	-90	-112.3	-115.7
- Exports	128.1	158.5	179.5	179.5
- Imports	191.3	248.5	291.8	295.2
o/w Oil imports	57.3	77	88.4	75.2
Invisibles	53.4	72.6	85	90
o/w income from forex reserves	8		8	6
Capital Account	46.2	109.6	0.5	35
Foreign investment	15.5	44.8	1	17
- FDI	8.4	15.5	15	10
- FII+	7.1	29.3	-14	7
Banking capital	1.9	11.7	2.5	10
- NRI deposits	4.3	0.2	5	7.5
Short term credit	6.6	17.7	-10	-2
ECBs	16.2	22.3	2	5
Others	6	13.1	5	5
Overall balance	36.6	92.2	-26.8	9.3
Memo				
RBI's forex intervention	26.8	78.2	-34.8	3.3

Source: RBI, ML estimates.

Table 3: MSS sterilization bond rundown funding fiscal overrun, supporting fixed income

	Item	FY08	FY09MLE (US$85/bbl)	FY09MLE (US$85/bbl) 3G case
1	Borrowing (a+b)	1750	2200	2200
a	Center	1100	1450	1450
b	States	650	750	750
2	Oil bonds (a-b)	350	250	250
a	Oil bonds issued	350	700	700
b	Subscribed by the RBI	0	450	450
3	Fertilizer bonds	75	600	350
4	MSS bonds (maturity/repo)	1054	-1,035	-1,035
5	Repo	-367	-299	-299
	Total	2862	1,716	1,466

Source: Ml estimates.

Appendix: Delhi's Stimulus II

RBI measures
Reduction in (1) the LAF repo rate 100 bp to 5.5%, (2) the reverse repo rate under 100bp to 4% and (3) the cash reserve ratio (CRR) 50bp to 5% effective January 17, 09. This injects additional liquidity of around Rs200bn/US$4bn.

Supervisory incentives
Specified accounts, essentially real estate etc, which were standard accounts on September 1, 2008, would continue to be treated as standard accounts on restructuring provided the restructuring is taken up on or before January 31, 2009 and the restructuring package is put in place within a period of 120 days from the date of taking up the restructuring package. The period for implementing the restructuring package has been extended from 90 days to 120 days. This special regulatory treatment will also be available to specified standard as well as sub-standard accounts even where full security cover for working capital term loan (WCTL) is not available, subject to the condition that provisions are made against the unsecured portion as under:

- Standard Assets: 20%.
- Sub-standard Assets: 20% during the first year and to be increased by 20% every year thereafter until the specified period (one year after the first payment is due under the terms of restructuring).
- If the account is not eligible for upgradation after the specified period, the unsecured portion will attract provision of 100%.

Government initiatives
1. Liberalization of the policy on External Commercial Borrowing (ECB) includes (1) removal of the 'all-in-cost' ceilings on such borrowing; (2) allowing funding for 'development of integrated townships' as eligible end-use of the ECB; and permission to NBFCs, dealing exclusively with infrastructure financing, to access ECB from multilateral or bilateral financial institutions, all under the RBI's approval route.
2. In order to give a boost to the corporate bond market, FII investment limit in INR-denominated corporate bonds in India would be increased from US$6bn to US$15bn.
3. Measures to enhance credit flow include:

(i) Designation of a special purpose vehicle (SPV) to provide liquidity support (up to Rs250bn/US$5bn) against investment grade paper to NBFCs.

(ii) An arrangement will be worked out with leading PSU banks to provide a line of credit to NBFCs specifically for purchase of commercial vehicles.

(iii) Credit targets of PSU banks would be revised upward to reflect the needs of the economy in the present difficult situation.

(iv) Special monthly meetings of State Level Bankers' Committees would be held to oversee the resolution of credit issues of micro, small and medium enterprises by banks.

(v) Recently the guarantee cover under Credit Guarantee Scheme for micro and small enterprises on loans was extended from Rs5mn to Rs10mn with a 50% guarantee cover. In order to enhance flow of credit to micro enterprises, it has been further decided to increase the guarantee cover extended by Credit Guarantee Fund Trust to 85% for credit facility upto Rs5mn. This will benefit about 84% of the total number of accounts accorded guarantee cover.

4. State Governments are facing constraints in financing expenditure because of slower revenue growth. To help maintain the momentum of expenditure at the state government level, states will be allowed to raise in the current financial year additional market borrowings of 0.5% of their Gross State Domestic Product (GSDP), amounting to about Rs 300bn crore, for capital expenditures.

5. India Infrastructure Finance Company (IIFCL), which has already been authorized to raise Rs.100bn through tax free bonds by March 09 for refinancing bank lending of longer maturity to eligible infrastructure bid based PPP projects, will be accessing the market next week for raising the first tranche of the amount. This will enable the funding of mainly highways and port projects on hand of about Rs.250bn. To fund additional projects of about Rs.750bn at competitive rates over the next 18 months, IIFCL would be enabled to access in tranches an additional Rs.300bn by way of tax-free bonds once funds raised in the current year are effectively utilized.

6. Incentives to support exports include:

(i) Taking into account the fact that the INR has appreciated nearly 4% against the dollar since November 2008, it has been decided to restore DEPB rates to those prevailing prior to November 2008. In order to provide predictability and stability of regime in the short term for future contracts, the DEPB Scheme would be extended till December 31, 09.

(ii) Duty drawback benefits on certain items including knitted fabrics, bicycles, agricultural hand tools and specified categories of yarn are being enhanced retrospectively from September 1, 08.

(iii) Exporters have raised a number of procedural issues where modification of procedures could reduce delays faced by exporters. To consider these and similar problems, Government has decided to constitute a Committee under the chairmanship of the Finance Secretary including Secretaries of the Departments of Revenue and Commerce to look into and resolve these issues on a fast-track basis.

(iv) EXIM Bank has obtained from RBI a line of credit of Rs.50bn9IS$1bn and will provide pre-shipment and post-shipment credit, in rupees or dollars, to Indian exporters at competitive rates.

7. Other measures include:

(i) Exemptions from CVD on TMT bars and structurals, and from CVD and Special CVD on cement, which were given to contain inflation, are being withdrawn. Full exemption from basic customs duty on zinc and ferro alloys, which was also provided to contain inflation, is being similarly withdrawn.

(ii) The government will work with state governments to encourage them to release land for low income and middle income housing schemes.

(iii) States, as a one time measure upto June 2009, will be provided assistance under the JNNURM for the purchase of buses for their urban transport systems.

(iv) Accelerated depreciation of 50% will be provided for commercial vehicles to be purchased on or after January 2009 upto March 2009.

8. The government is closely monitoring its spending to expedite the pace of expenditure for all schemes and programmes. It will set up a fast track monitoring committee to ensure expeditious approval and implementation of central projects. Chief Ministers are being advised to do the same.

9. The measures outlined above taken together with steps taken earlier constitute a substantial counter-cyclical stimulus in the current year. The government does not envisage any further measures in the current fiscal year. However, the government is aware that the measures required to provide an economic stimulus to the economy have to extend beyond the current financial year. Towards this end, it is finalising Plan and Non-Plan expenditure that will be required in the next financial year to maintain the tempo. The Plan for the next year will include proposals for recapitalization of the public sector banks. The recapitalization is expected to be of the order of Rs.200bn over the next two years. This will help to ensure that the banking system will not suffer from capital adequacy constraints in order to provide credit growth needed to sustain the economic momentum in 2009-10.

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