India Equity Strategy

SLR Flexibility Is Pro Growth; Still Expect Credit Moderation

Ratnesh Kumar[1]
+91-22-6631-9888
ratnesh.kumar@citigroup.com

Tirthankar C Patnaik[1]
tirthankar.patnaik@citigroup.com

- **Approval on flexibility to lower SLR floor a positive for growth** — The government has okayed legislative changes to give the RBI flexibility to lower the SLR (mandated bank investments in government bonds) from the current 25%. After the President signs the order — a formality — it would give the central bank substantial flexibility to manage an environment of high credit growth.

- **Our bank analysts see it as a structural kicker** — Our India bank analysts see the move as a structural kicker as banks (1) can lend more (every 1% lowering of the SLR can support 1.3% more credit growth), (2) get a better yield than on government bonds, and (3) get greater flexibility in managing their asset books.

- **Expect credit moderation in 2007** — As and when the RBI follows up with SLR cuts, it would indeed be quite supportive of growth, in bank credit as well as the overall economy. Nonetheless, we still hold the view that credit growth should moderate from the heady 35% levels of the past couple of years to 20-25% in coming months, due to the following: (1) the structural shift in the credit-deposit ratio is largely over; (2) higher interest rates; and (3) a cautious central bank.

- **We remain underweight credit-sensitive sectors** — Very rapid credit expansion has been one of the cornerstones of above-estimate domestic growth in India in the past couple of years. Until credit moderation (to a more normal 20-25%) plays out in coming months, we prefer remaining underweight in credit-sensitive sectors, i.e. automobiles and banks.

See page 5 for Analyst Certification and important disclosures.

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The government's approval to an ordinance that will give flexibility to the central bank to cut SLR (Statutory Liquidity Reserve) from the current 25% is pro growth — in bank credit as well as for the Indian economy. We still argue that credit growth will moderate from the heady 35% levels seen in the past couple of years, and remain underweight key credit-sensitive sectors, i.e. automobiles and banks.

SLR flexibility is welcome for growth

Late last week, the Indian government approved an ordinance to give the RBI flexibility to adjust the SLR in line with credit requirements. Currently, the SLR is 25% and the RBI does not have the power to reduce it. The President still needs to sign the order for it to be effective, which should be a formality. Thereafter, it would be the RBI's decision on when and by how much it should reduce the SLR.

Our India economist, Rohini Malkani, has noted that an even 1% reduction in the SLR would free up Rs230bn for lending to the corporate sector (refer *India Economics – RBI to Get Flexibility to Adjust the Statutory Liquidity Ratio, 12 Jan 2007*). She has also noted that while a reduction in the SLR could result in bond yields inching up (already up 20-30bps since this announcement), we maintain our view that 10-year yields are unlikely to cross 8%.

Our India banks analyst, Aditya Narain, has noted that every 1% reduction in the SLR should support additional loan growth of around 1.3% (refer *Indian Banks – SLR Flexibility – Structural Kicker, 12 Jan 2007*). To support a growing loan demand, banks have been scrambling for deposits, with a significant rise in deposit rates in recent months. Hence, as and when the RBI does go ahead with an SLR reduction, it would be very supportive of banks' ability to push for robust growth in credit.

We still expect credit growth moderation

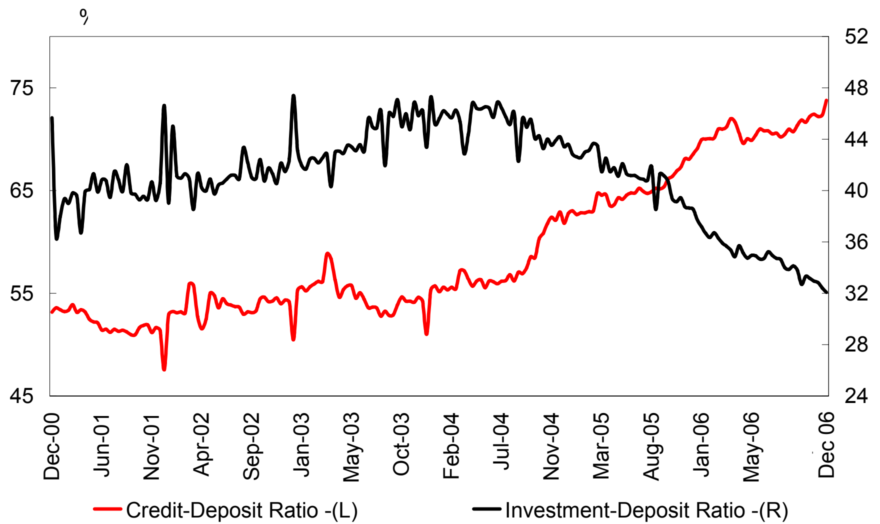
In a recent report (refer *India Equity Strategy – Outlook 2007, 7 Dec, 2007*), we highlight credit growth moderation as one of the headwinds for 2007. While potential SLR cuts would assuage the situation somewhat, we still continue to see moderation in credit growth to 20-25%, from the heady 35% seen in the past couple of years.

We see multiple reasons for credit moderation: (1) the structural shift of credit-deposit ratios being done. CD ratios were below 50% three years back vs. a maximum allowed 70% and banks were able to push most of the incremental deposits into credit during this period. Now that the CD ratio is already close to the maximum, credit growth has to moderate; (2) Higher interest rates; and (3) RBI's caution toward certain ultra-high growth segments such as mortgages and the capital market.

We have also argued in the above mentioned report that moderation in credit growth to a more manageable 20-25% would be welcome to maintain healthy banking sector liquidity and avoid potential bad loan problems in future from over-aggressive growth.

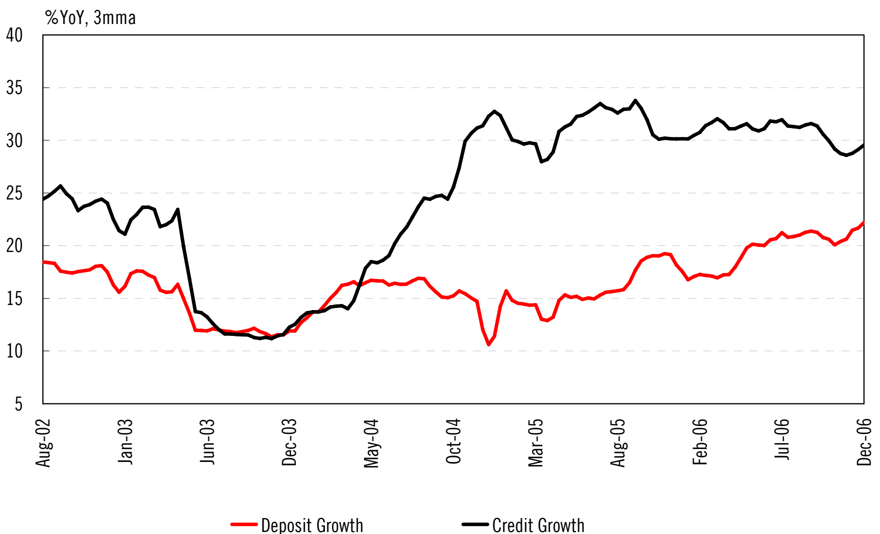
A moderation in credit growth, together with greater flexibility with the central bank to manage this growth through SLR cuts, would probably avoid further significant escalation in interest rates, which would be positive for sustainability of the recent growth momentum.

Figure 1. Trends in Indian Credit and Investment Deposit Ratios (Percent)



Source: Citigroup Investment Research

Figure 2. India Credit and Deposit Growth (Percent YoY, 3mma)

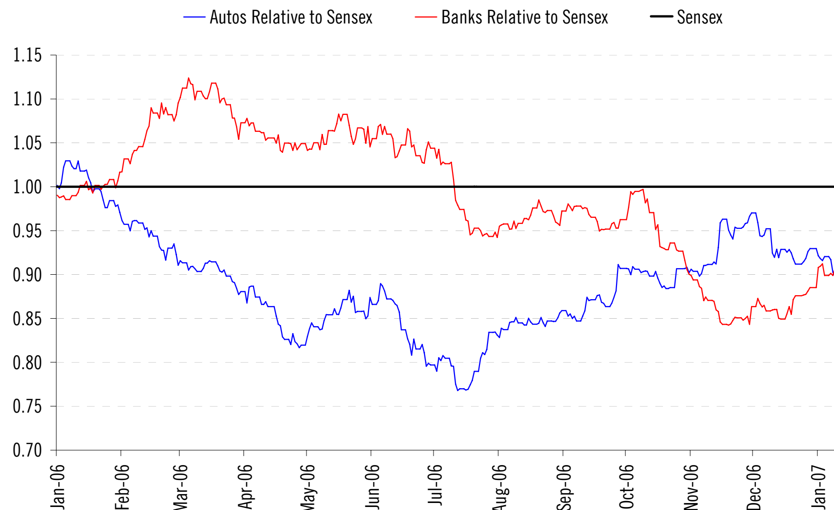


Source: Citigroup Investment Research

Remaining underweight credit-sensitive sectors

Part of the growth surprises in the domestic economy over the past couple of years is attributable to significantly above-expectation credit growth during this period. As credit growth moderates to a more sustainable 20-25% plays out in coming months, we are concerned about the potential negative impact on growth estimates and earning forecasts in credit-sensitive sectors such as automobiles and banks. In our India model portfolio, we remain underweight these sectors, at least until credit moderation has mostly played out.

Figure 3. India Banks, Autos Performance Relative to Sensex (Multiple)



Source: Bloomberg

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