Kotak Institutional Equities

# Economy

## India

**INDIA**

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**Mandate mania will not avert fiscal challenges.** Governance, and not the unexpected mandate given to the new government, will decide the fate of the Indian economy with its significant fiscal challenges. We expect the GFD/GDP ratio to exceed 7.0% in FY2010E unless corrective measures are initiated by the new government. The three main tasks for the new government are—(1) present a credible budget with new FRBM rules and GFD/GDP ratio not exceeding the interim budget (5.5%), (2) push for a disinvestment program of Rs400 bn in FY2010E and (3) make a budgetary provision of Rs500 bn p.a. for infrastructure investment.

### Market euphoria currently ignoring harsh realities

We believe the markets may be ignoring the five harsh macro-economic realities in the current mania generated by the unanticipated mandate given to the UPA coalition. We are concerned that the fiscal position of the government is slipping out of control and may generate an interest rate shock, which may nip any nascent recovery in the bud. The global recovery looks shaky and trade contractions are likely to become a drag on growth as well as government revenues.

### Economy headed for fiscal trap —six-step course of action imperative

We believe the GFD/GDP ratio budgeted at 5.5% for FY2010E may overshoot to 7.0% if the full budget does not introduce corrective measures. We would be reassured if the government acted decisively to limit the GFD/GDP at 5.5% in the FY2010E budget by reducing revenue expenditure, even while providing a fiscal stimulus of Rs500 bn of additional public investment spending on infrastructure. We believe the Indian government would be prudent to cut the subsidy bill, partially withdraw tax cuts and disinvest Rs800 bn over three years.

### Interest rate shock likely if fiscal position does not improve

Large fiscal gap and borrowing requirements in FY2011E could generate an interest rate shock that could, in turn, delay recovery. Inflation may return to 8.0% by end-FY2010E and may prompt the central bank to tighten monetary policy in 2HFY10. Also, volatile capital inflows could cause real exchange rate appreciation. In our view, RBI is likely to intervene to prevent this and use MSS, OMO or CRR to sterilize the resultant liquidity (already excess by Rs1.3 tn).

### Rupee appreciation may be capped by the impact of fiscal stress on BOP

Notwithstanding the large fiscal gap, we do not expect a problem of twin deficits. On the contrary, we expect the CAD/GDP ratio to fall to 1.5% in FY2010E from 2.8% in FY2009E with a BOP surplus of about US$30 bn. However, large fiscal gaps may prevent a sharp appreciation of the Rupee. We expect the INR/USD to average 48.0 in FY2010E and 47.75 in FY2011E.

**INSIDE**



Mridul Saggar
mridul.saggar@kotak.com
Mumbai: +91-22-6634-1245

Amit Kumar
amit.ckumar@kotak.com
Mumbai: +91-22-6634-1392

Kotak Institutional Equities Research

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# MANDATE MANIA MISPLACED

**The market mania generated by the unexpected electoral mandate to the United Progressive Alliance (UPA) is not in sync with harsh macro-economic realities. We expect (1) likely continued large fiscal slippage with centre's GFD/GDP at 7.0% in FY2010E, (2) headline inflation at about 8.0% by end-FY201E, (3) possible reversal of interest rate cycle in 4QFY10E on the back of rising inflation, fiscal slippage and monetary tightening and (4) real GDP growth at 6.0% in FY2010E versus potential of 7.5% on back of investment slowing down. In contrast, the euphoria that followed the election results saw Indian equity markets hit the circuit breaker, rupee appreciate by 3% and 10-year benchmark gilt yield drop by 13 bps.**

## Challenging macro-economic realities for policy and governance

The Indian economy faces five harsh macro-economic realities.

- Fiscal gaps have become too wide for comfort. The combined fiscal deficit is likely to exceed 10% of GDP for the second consecutive year in FY2010E (see Exhibit 1). The Centre's budget deficit is likely to slip to 7.0% in FY2010E from 5.5% budgeted in the Interim budget. Standalone, this suggests a net market borrowing of Rs3.8 tn (against FY2010BE of Rs3.1 tn) by the centre and an additional Rs1.3 tn by the States. In sum, the net market borrowing is likely to be around Rs5.1 tn (US$106 bn), up from Rs2.1 tn in FY2009. Furthermore, this could stay at Rs4.5 tn in FY2011E with the GFD/GDP ratio declining modestly to under 6.0%. We explain later in this report why this may cause an interest rate shock in FY2011E.

**Exhibit 1: Fiscal deficits to remain wide in FY2010E and FY2011E**
GFD/GDP ratios in India, March fiscal year-ends, 2007-2011E (%)

| | 2007A | 2008A | 2009E | 2010BE | 2010E | 2011E |
|---|---|---|---|---|---|---|
| Centre | 3.4 | 2.7 | 7.8 | 5.5 | 7.3 | 6.5 |
| on-budget | 3.4 | 2.7 | 6.0 | 5.5 | 7.0 | 5.9 |
| off-budget | NA | NA | 1.8 | NA | 0.3 | 0.6 |
| State | 1.9 | 2.3 | 2.7 | NA | 3.3 | 2.9 |
| **Total** | **5.3** | **5.0** | **10.5** | **NA** | **10.6** | **9.4** |

Source: Ministry of Finance, RBI, Kotak Institutional Equities estimates

- Inflation is likely to come back in a big way to 8.0% in 4QFY10E from 0.5% currently led by (a) strong base effects, (b) likely reversal of global commodity price cycle with large global liquidity chasing commodity as asset prices in a run-up to real economy recovering, and (c) building up of pressures of general increase in price level with large surplus domestic liquidity (currently central bank is absorbing Rs1.3 tn of surplus liquidity at its daily window). With inflation rising, nominal interest rates, including gilt yields can be expected to harden.

- Monetary policy easing options may have run their course with a likely comeback of inflation and large surplus domestic liquidity. On the back of a sudden surge in capital inflows or on fears of return of inflation, the central bank may start withdrawing excess liquidity gradually in 2HFY10E and possibly signal monetary tightening through its policy rate(s) or CRR, for reasons explained in Part III of this report.

- Growth in FY2010E is likely to be 6.0% as against potential output of about 7.5%. Financial markets are currently buoyant, but the downturn in the fixed investment cycle is just about half a year old (see Exhibit 2). In our assessment, it may take about two years for the investment climate to generate traction again. Business confidence may improve only moderately following the stronger-than-expected mandate for the UPA.

Evidence on the ground suggests that capex has been impacted, though hasn't fallen off the cliff. In particular, road projects are impacted. NHAI's bidding process has been floundering pots-Lehman collapse. In our view the key to stimulating investment lies in this environment is to encourage Public Private Partnership (PPP-based) infrastructure projects by reducing the return uncertainty. As the road projects on BOT-toll basis are not attracting sufficient interest, the government need to urgently consider wither increasing the Viability Gap Funding (VGF) even further or offer BOT-annuity based projects.

**Exhibit 2: India's real GDP growth likely at 6.0% in FY2010E; recover modestly to 7.3% in FY2011E**
Growth in real GDP at factor cost and components, March fiscal year-ends, 2007-2010 E (%)

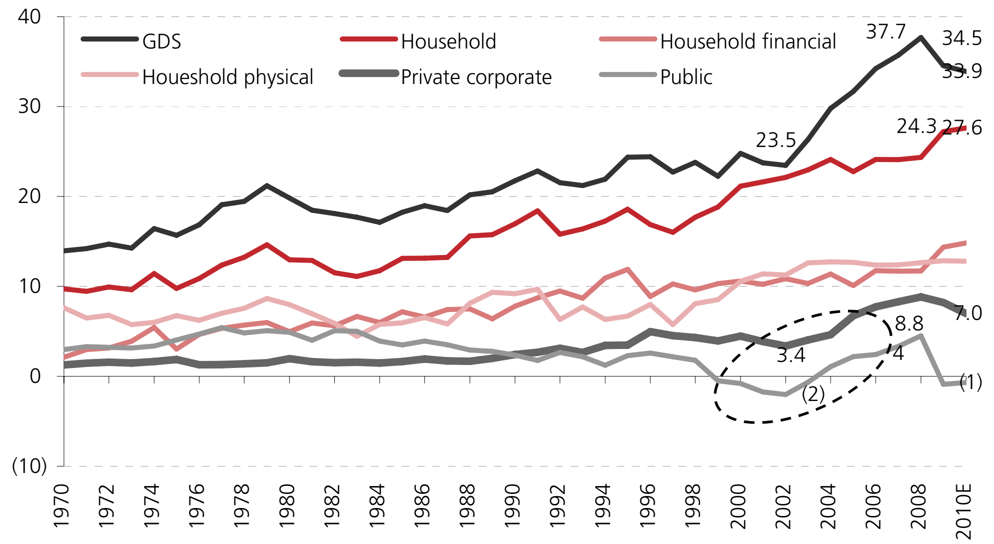
| Sector | 2007 | 2008 | 2009AE | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|---|
| **Agriculture and allied activities** | **4.0** | **4.8** | **2.6** | **0.1** | **3.4** | **3.0** |
| **Industry** | **10.7** | **7.3** | **4.2** | **2.9** | **4.8** | **6.7** |
| Mining and quarrying | 8.8 | 3.7 | 4.7 | 3.4 | 7.5 | 8.3 |
| Manufacturing | 11.8 | 8.1 | 4.1 | 2.8 | 4.3 | 6.5 |
| Electricity, gas and water supply | 5.3 | 5.5 | 4.3 | 3.1 | 5.6 | 6.6 |
| **Services** | **11.3** | **10.7** | **9.2** | **9.4** | **7.1** | **8.5** |
| Construction | 11.8 | 11.2 | 6.5 | 8.7 | 5.9 | 7.0 |
| Trade, hotels, transport, storage and communication | 12.8 | 12.0 | 10.3 | 8.9 | 6.5 | 9.8 |
| Financing, insurance, real estate and business services | 13.8 | 11.7 | 8.6 | 9.0 | 5.5 | 9.1 |
| Community, social and personal services | 5.7 | 6.8 | 9.0 | 11.5 | 10.8 | 6.0 |
| **Real GDP at factor cost** | **9.7** | **9.0** | **7.1** | **6.5** | **6.0** | **7.3** |

Note: 2009AE are CSO's Advance Estimates
2009E, 2010E and 2011E are Kotak Institutional Equities estimates

Source: Central Statistical Organisation, Government of India, Kotak Institutional Equities estimates

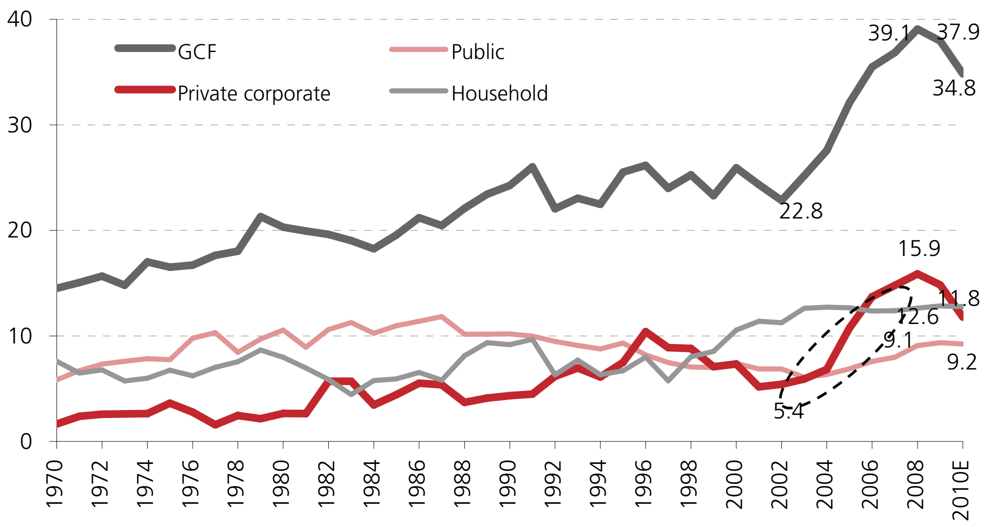
- Lower-than-potential growth may be accompanied by a sharp dip in aggregate saving rate in the economy by 4 ppt over two years to FY2010E (see Exhibits 3 and 4). This may result in financing constraints for investment even with overall surplus liquidity. Aggregate investment rate may decline by 4 ppt as a result. We expect the public sector saving rate to turn negative and corporate saving rate to also drop significantly.

**Exhibit 3: Saving rate at new high; likely to drop sharply ahead**
Sector-wise gross domestic saving rates as ratios of GDP, March fiscal year-ends, 1970-2010E (%)




Source: Central Statistical Organisation, Kotak Institutional equities estimates

**Exhibit 4: Investment rate may have peaked but likely to drop over next two years**
Sector-wise gross capital formation rates as ratios of GDP, March fiscal year-ends, 1970-2010E (%)




Source: Central Statistical Organisation, Kotak Institutional equities estimates

## Policies and governance, not mandate in itself that matters

In face of harsh macro-economic realities it is important to recognize that a stable coalition is necessary but not sufficient to bring back growth to above the potential rate of 7.5%. The economy faces serious economic challenges in FY2010E and FY2011E. Fiscal slippage could constrain overall macro-economic conditions, scuttling any quick recovery. We view the strong mandate to the UPA to help bring back growth, but gradually. We expect:

- Broad continuity of economic policies as the mandate is for continuity of the social agenda and not for pro-market reforms as markets seem to be currently mistaking
- Moderate pace of pro-market reforms, mainly on disinvestment and foreign investments
- Improved governance with less survival issues for the government
- Sea change in market and business confidence, which may have some impact on investment demand and growth if it sustains

## Major initiatives needed to reduce fiscal gaps

With the strong mandate, the government needs to set in motion the stringent measures it needs to tackle the fiscal gap. In the absence of this, we could see interest rates hardening, which may scuttle the chances of recovery. Economic policies since 2HFY09 have risked far too much on growth returning from 2HFY10E. If this fails to happen, the economy may fall to the fiscal trap (we use this term to denote both the impact of GFD on interest rates and the debt sustainability itself). If for any reason effective governance eludes there could be a large negative domino impact.

## Budget should aim at infrastructure investment by cutting subsidies

We believe the government is well placed to use its mandate to implement reform proposals. It can focus on massive public infrastructure spending (offsetting this increased expenditure by cutting revenue expenditure, especially subsidies). This would spur private investment demand and realize growth.

## Mandate of the masses, for the masses

Financial markets may be misreading the electoral mandate as one primarily for pro-market reform. In our assessment, the UPA has been voted in again for its promise of inclusive growth aimed at removing the urban-bias from economic policies, which is reinforced by the manifesto of the Indian National Congress (INC). The key economic programs in the INC manifesto for 2004 and 2009 are enumerated in Exhibit 5, along with our broad assessment of likely implementation. The salient features are as follows.

- **INC's manifesto promises suggest fiscal restraint**. As explained in our '*Elections 2009*' economy report, the INC's manifesto was more carefully drafted than others and its implementation is likely to cause the least fiscal drag with expenditures rising by about 1% of GDP as against 2.0-2.4% in the case of the CPM or BJP manifestos. However, in our view, this in itself is not enough and the new government should look at steps beyond manifesto which would be needed to bring fiscal situation under control.

- **INC's economic agenda aims at correcting the urban-bias in policies.** In our view, the mandate has come out of its reasonable success in implementation of the National Rural Employment Guarantee Scheme (NREGS) and other flagship programs of Bharat Nirman. As such, the INC is likely to continue implementing them from the start of its new tenure. These expenditures are unlikely to be reduced significantly and in fact can be stepped up in line with its manifesto promises.

- INC's earlier governance record was mixed. The government was able to push investment in power sector, education as well as growth and employment, but failed to live up to promises in the area of disinvestment and SME financing. During its first term, it attracted 5X the foreign investment managed by the previous government. However, faced with opposition from the Left parties on whom it depended for majority support in the Parliament, it was not able to fully implement its liberalization plans. Its implementation record on infrastructure investment, where there were no major political constraints, also fell short of expectations, especially in the area of roads, ports, airports, and railways. Urban infrastructure creation in the area of transport, health and education also lagged.

- INC's 2009 manifesto suggests that attracting private and foreign investment in minerals industry may be the new thrust area. INC's manifesto talks about attracting private and foreign investments for mineral exploration, especially coal and iron ore, on the lines of oil and gas exploration. We believe that with UPA retaining power it would come up with a New Minerals policy, the draft of which is already believed to have been prepared by the existing government but was not pushed through for want of consensus amongst coalition partners.

- Planned introduction of Goods and Services Tax (GST) from April 1, 2010 is likely to be the centerpiece of tax reforms contemplated. The tax would replace all central and state level indirect taxes such as excise duty (CENVAT), services tax, entertainment tax, etc. In our view, introduction of GST would increase fiscal revenues for the government but may still not be able to plug the big fiscal hole that has been dug from the counter-cyclical policies of tax cuts and increased spending.

Exhibit 5: Key highlights of 2004 and 2009 manifestos' agenda of the Indian National Congress (INC)

| Issue | INC 2004 manifesto agenda | INC 2009 manifesto agenda | Our comment |
|---|---|---|---|
| **Areas where progress was muted** | | | |
| Divestment | **Approach privatization and divestment selectively** to expand social development programs of the government. | **Divest minority stakes in PSEs** in the manufacturing and financial sector to the Indian public even as the government retains majority control. | **Part-privatization program came to a standstill** in earlier tenure in view of strong opposition of the Left parties. The mandate now frees government from Left-dependence but government may still be bale to push this only on a moerate scale due to labor opposition and legal constraints |
| Foreign investment | **System of approvals for foreign investment to be made more transparent**. | **Attract foreign investment in mineral sector such as oil, coal and iron ore**. Focus of foreign investment in local value-addition and export potential. | **Government likely to give a fillip** by liberalizing foreign investments in mineral, insurance and some other sectors. However, flows may continue to be moderate in view of global risk aversion and recognition of India's fiscal problems |
| Education | **Raise public spending in education to at least 6% of GDP**, primarily in primary and secondary education; impose a cess to finance the same. | **Pledges a scholarship or education loans to all** students admitted to any recognized course in any recognized college/ university. | Enabled largest education loan program in India for tertiary education. Further **steps likely to increase bank finance to education**, but sticky loans could rise if additional job creation lags |
| Small enterprises | **Address the concerns of labor-intensive and export-oriented industries and SMEs** such as shortage of working capital, lack of technology and marketing etc. | **New Deal' for Indian SMEs with greater access to collateral-free credit and liberation from multiplicity of laws and forms**. | **Credit flows to SME are unlikely to improve** substantially in the current leg of the NPA cycle as SME past dues are likely to rise |
| Power | Significantly expand the existing public investment program to **add at least 6000-8000 MW of power generation capacity every year**. | Momentum seen in power generating capacity in last two years of government. **Target power capacity addition of 12,000-15,000 MW every year through a mix of sources—coal, hydel, nuclear etc**. | The government is **likely to achieve this** but would need to focus on ensuring timely financial closures for major power projects |
| **Areas where progress was made** | | | |
| Economic growth | **Aim for double-digit economic growth** and spread the same over all sectors, notably agriculture. Accelerate employement generation. | **Delivered five years of record economic growth.** Stepped up government spending on education and health, agriculture and rural development and infrastructure. **Focus on faster and more inclusive growth**. | **Likely to pursue more inclusive growth,** but under the current and likely future cyclical condditions the economy is unlikely to return to 9% plus growth |
| Employment | Enact a **national Employment Guarantee Act to ensure at least 100 days of employment for every rural household**. | **Enacted National Rural Employment Guarantee Act**. Expand NREGA to everyone and **provide 100 days of work at real wage of Rs100**. | **NREGA has been a reasonable success and is likely to be focal point of inclusive growth.** |
| Agriculture | **Take steps to ease the burden of debt and high interest rates on farm loans**. Double the flow of agricultural credit and coverage through institutional lending. | **Enacted large loan waiver scheme for farmers, reduced interest rates on agricultural loans and increased credit from banks by three-fold**. **Extend interest relief to all farmer that pay their loans on time**. | **Any large loan waiver scheme, if repeated at such a short interval can impact credit discipline** and impact bank stocks negatively. |
| Tax reforms | **Increase the Tax:GDP ratio without increasing tax rates**. Significantly increase tax compliance and expand the base of taxpayers. | **Successfully implemented VAT** throughout the country. **Pledges to imtroduce a moderate GST from April 01, 2010** to create a seamless national common market for agriculture, industry and services. | **Introduction of GST by April 2010 is by no means a certainty** and any delay can adversly impact the tax revenues. Even if introduced, GST in itself is unlikley to make a large impact on fiscal gap. |
| Urbanization | **Comprehensive program of urban renewal with particular emphasis on urban transport**, water supply and sanitation. | **Initiated Jawaharlal Nehru Urban Renewal Mission for infrastructure upgradation** and provision of basic services like urban transport, water supply and sanitation. **Undertake programs for low-cost housing**. | **Its implementation is likely to be market-positive** and also help in boosting investment demand. |

Source: Source: Indian National Congress 2009 and 2004 manifestos, compiled by Kotak Institutional Equities

- **Power capacity additions.** The manifesto promises creation of another 12-15 thousand megawatt of power capacity per annum through a mix of coal, hydro, nuclear and renewable energy. We find this as a reasonable target, considering that the 11th Five Year Plan (FY2008-2012E) already envisages a capacity addition of 78.6 thousand megawatt, of which 55.6 thousand megawatt is planned to be created in the last three years, i.e. the post-election period. Considering that the investment cycle has turned and financial closures of infrastructure projects are becoming increasingly difficult, meeting even this scaled-down target would be challenging.

# INDIA'S FISCAL CHALLENGE

**Taking account of the likely shortfall in tax revenue of over Rs400 bn in FY2010E and likely added fiscal stimulus expenditure of 1% of GDP, we expect the GFD/GDP ratio to overshoot to 7.0% from 5.5% in the interim budget. The government needs to bring back new FRBM rules and keep the Interim budget target GFD/GDP ratio of 5.5% when it presents a full budget. We suggest six-steps for fiscal correction to achieve this. It includes aggressive disinvestment of about Rs800 bn over three years.**

## Centre's on-budget Gross Fiscal Deficit (GFD) likely to overshoot to 7.0% of GDP

Simple but unpleasant fiscal arithmetic suggests that on-budget GFD/GDP ratio for the centre is likely to overshoot to 7.0% in FY2010E from 5.5% FY2010BE (see Exhibit 6). This overshooting may be the product of (1) added fiscal stimulus of Rs500 bn or nearly 1% of GDP, (2) tax revenue shortfall about Rs443 bn or 0.75% of GDP and (3) a partial offset from nearly Rs250 bn from divestment proceeds and Rs100 bn from additional non-tax revenue though subsidies bill may overshoot.

Exhibit 6: Fiscal deficit likely to deteriorate in FY2010E and improve only modestly with growth in FY2011E
Major central government budgetary items (Rs bn)

| | FY2008A (Rs bn) | FY2009RE (Rs bn) | FY2010BE (Rs bn) | FY2010E (Rs bn) | FY2010FP (Rs bn) | FY2011E (Rs bn) | Growth (%) FY09RE/ FY08A | FY10BE/ FY09RE | FY10E/ FY09RE | FY11E/ FY10E |
|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue receipts** | 5,419 | 5,622 | 6,096 | 5,796 | 6,229 | 6,777 | 3.7 | 8.4 | 3.1 | 16.9 |
| Tax revenues (gross) | 5,932 | 6,280 | 6,713 | 6,270 | 6,453 | 7,303 | 5.9 | 6.9 | (0.2) | 16.5 |
| **Direct taxes** | 3,125 | 3,450 | 3,800 | 3,642 | 3,642 | 4,254 | 10.4 | 10.1 | 5.6 | 16.8 |
| Corporation tax | 1,929 | 2,220 | 2,442 | 2,298 | 2,298 | 2,735 | 15.1 | 10.0 | 3.5 | 19.0 |
| Tax on income | 1,193 | 1,226 | 1,354 | 1,340 | 1,340 | 1,514 | 2.8 | 10.4 | 9.3 | 13.0 |
| Others | 3 | 4 | 4 | 4 | 4 | 5 | 7.7 | 6.3 | 0.0 | 25.0 |
| **Indirect taxes** | 2,790 | 2,814 | 2,897 | 2,628 | 2,811 | 3,050 | 0.8 | 3.0 | (6.6) | 16.0 |
| Customs duty | 1,041 | 1,080 | 1,102 | 1,010 | 1,010 | 1,212 | 3.7 | 2.0 | (6.5) | 20.0 |
| Excise duty | 1,236 | 1,084 | 1,106 | 985 | 1,102 | 1,143 | (12.3) | 2.1 | (9.1) | 16.0 |
| Service tax | 513 | 650 | 689 | 633 | 699 | 695 | 26.7 | 6.0 | (2.6) | 9.8 |
| Less: | | | | | | | | | | |
| States' share in tax revenue | 1,518 | 1,602 | 1,712 | 1,652 | 1,652 | 1,896 | 5.5 | 6.9 | 3.1 | 14.8 |
| Transfer of UTs taxes and duties | 13 | 34 | 41 | 42 | 42 | 47 | 156.8 | 20.9 | 23.9 | 11.9 |
| **Net tax revenue to centre** | 4,414 | 4,660 | 4,976 | 4,576 | 4,759 | 5,360 | 5.6 | 6.8 | (1.8) | 17.1 |
| **Non tax revenues** | 1,024 | 962 | 1,120 | 1,220 | 1,470 | 1,417 | (6.0) | 16.4 | 26.8 | 16.1 |
| **Capital receipts (net)** | 1,708 | 3,388 | 3,437 | 3,676 | 3,826 | 3,510 | 98.3 | 1.4 | 8.5 | (4.5) |
| **Market borrowings (net)** | 1,318 | 2,620 | 3,087 | 3,787 | 3,787 | 3,498 | 98.8 | 17.8 | 44.6 | (7.6) |
| Disinvestment | 388 | 26 | 11 | 250 | 400 | 145 | (93.4) | (56.4) | 872.8 | (42.0) |
| **Total receipts** | 7,127 | 9,010 | 9,532 | 9,583 | 10,016 | 10,843 | 26.4 | 5.8 | 6.4 | 13.1 |
| **Non-plan expenditure** | 5,077 | 6,180 | 6,681 | 7,010 | 6,522 | 7,602 | 21.7 | 8.1 | 13.4 | 8.4 |
| Non-plan revenue expenditure | 4,209 | 5,618 | 5,997 | 6,330 | 5,842 | 6,747 | 33.5 | 6.8 | 12.7 | 6.6 |
| Interest payments | 1,710 | 1,927 | 2,255 | 2,380 | 2,290 | 2,610 | 12.7 | 17.0 | 23.5 | 9.7 |
| Subsidies | 709 | 1,292 | 1,009 | 1,196 | 777 | 1,319 | 82.2 | (21.9) | (7.5) | 10.3 |
| Food | 313 | 436 | 425 | 550 | 396 | 590 | 39.3 | (2.6) | 26.1 | 7.3 |
| Fertilizers | 196 | 275 | 164 | 200 | 100 | 250 | 40.6 | (40.4) | (27.3) | 25.0 |
| Petroleum | 28 | 29 | 31 | 31 | 31 | 34 | 2.1 | 8.0 | 7.6 | 9.7 |
| Others | 129 | 552 | 390 | 415 | 250 | 445 | 327.2 | (29.5) | (24.9) | 7.2 |
| Centre's grant to States & UTs | 384 | 384 | 466 | 466 | 466 | 498 | 0.0 | 21.4 | 21.3 | 6.9 |
| Non-plan capital | 867 | 562 | 684 | 680 | 680 | 855 | (35.2) | 21.6 | 21.0 | 25.7 |
| Defense expenditure (revenue+capital) | 917 | 1,146 | 1,417 | 1,465 | 1,465 | 1,510 | 25.0 | 23.6 | 27.8 | 3.1 |
| **Plan expenditure** | 2,051 | 2,830 | 2,852 | 3,021 | 3,010 | 3,241 | 38.0 | 0.8 | 6.8 | 7.3 |
| Plan revenue (central plan incl. assistance to states & UTs) | 1,736 | 2,417 | 2,484 | 2,501 | 2,490 | 2,773 | 39.2 | 2.8 | 3.5 | 10.9 |
| Plan capital (central plan incl. assistance to states & UTs) | 315 | 413 | 368 | 520 | 520 | 468 | 31.1 | (10.9) | 25.9 | (10.0) |
| **Total expenditure** | 7,127 | 9,010 | 9,532 | 10,031 | 9,532 | 10,843 | 26.4 | 5.8 | 11.3 | 8.1 |
| **Revenue expenditure** | 5,945 | 8,035 | 8,481 | 8,831 | 7,981 | 9,520 | 35.1 | 5.6 | 9.9 | 7.8 |
| **Capital expenditure** | 1,182 | 975 | 1,052 | 1,200 | 1,552 | 1,323 | (17.5) | 7.8 | 23.1 | 10.3 |
| **Select fiscal indicators** | | | | | | | | | | |
| Gross fiscal deficit (GFD) | 1,269 | 3,265 | 3,328 | 4,127 | 3,195 | 3,891 | 157.3 | 1.9 | 26.4 | (5.7) |
| Revenue deficit (RD) | 526 | 2,413 | 2,385 | 3,035 | 1,752 | 2,743 | 358.9 | (1.1) | 25.8 | (9.6) |
| Primary deficit (PD) | (441) | 1,338 | 1,073 | 1,747 | 905 | 1,281 | (403.3) | (19.8) | 30.5 | (26.6) |
| GDP | 47,234 | 54,263 | 60,214 | 58,611 | 58,611 | 66,412 | 14.9 | 11.0 | 8.0 | 13.3 |
| **Gross fiscal deficit/GDP (%)** | 2.69 | 6.02 | 5.53 | 7.04 | 5.45 | 5.86 | | | | |
| **Revenue deficit/GDP (%)** | 1.11 | 4.45 | 3.96 | 5.18 | 2.99 | 4.13 | | | | |
| **Primary deficit/GDP (%)** | (0.93) | 2.47 | 1.78 | 2.98 | 1.54 | 1.93 | | | | |
| **Gross tax/GDP (%)** | 12.56 | 11.57 | 11.15 | 10.70 | 11.01 | 11.00 | | | | |
| **Total expenditure/GDP (%)** | 15.09 | 16.60 | 15.83 | 17.11 | 16.26 | 16.33 | | | | |

Notes:
A: actuals, RE: Revised estimates, BE: Budget estimates, E: Kotak Institutional Equities esyimates and FP: Kotak Institutional equities suggested fiscal plan

Source: Ministry of Finance, compiled by Kotak Institutional Equities

## Tax revenue likely to fall short by Rs440 bn in FY2010E

In our assessment, the tax revenue may shortfall by Rs 443 bn in FY2010E from budgeted gross revenues of Rs6.7 tn in the Interim budget. This shortfall is likely to arise from:

- CENVAT tax reduction of 4-ppt being continued in FY2010E but not budgeted
- Services tax reduction of 2-ppt that was not budgeted
- Lower customs duty collections as we expect non-oil imports to contract by 13% and exports by over 9% in FY2010E
- Marginal nominal growth of 3.5% in corporate tax revenues on the back of our flat corporate earning growth projections against 10% growth assumed in the budget

## Additional fiscal stimulus of 1% of GDP in FY2010E may be a misplaced priority

In our view, the government's indication of an added fiscal stimulus of nearly 1% of GDP post-elections may be a misplaced priority as the fiscal position is already precarious. Since the stimulus may end up being funded by additional market borrowing, it may crowd out private investment and raise interest rates in the economy, negating the monetary stimulus which has begun to work now. If the quality of the earlier fiscal stimulus is any indication, it is raising consumption temporarily without addressing investment demand. Since recent growth has been supported by an unprecedented capex cycle, the priority should be limit the fall in capex in new projects as well as pipeline investment.

## Six imperatives for a budget aimed at containing GFD/GDP at 5.5%

It is difficult to present a credible budget that limits GFD/GDP ratio to 5.5% (as budgeted in the interim budget) but it isn't impossible. A government re-elected on a popular mandate may find it difficult to risk destroying its new found goodwill with the masses. Yet, the macro-economic reality is that if the economy has to maintain soft interest rates, the government has little choice but to display strong political will and proceed. We suggest the following six steps in the forthcoming budget:

1. Modify tax cuts by (1) reducing CENVAT tax reduction to 2-ppt from 4-ppt and (2) reversing the 2-ppt service tax reduction as the sector would be better positioned to cope with the cyclical shock.

2. Put in place an FRBM II regime at the earliest taking into account structural and cyclical components of the deficits.

3. Design additional fiscal stimulus purely for capital expenditure to finance additional Rs500 bn of public investment in infrastructure projects.

4. Finance the above by switching from revenue expenditure to capital by about Rs500 bn. This may be hardest to achieve as it would require curtailing the subsidies bill sharply. It cannot be put in place unless the government displays a strong political will to tackle interest groups and revamp the existing food security and fertilizer policies, besides implementing at least partial deregulation of oil sector pricing.

5. Additional non-tax resource mobilization of Rs250 bn to partly cover likely tax shortfall. As Rs200 bn of non-tax revenue is already budgeted against the likely 3G auctions, this would require additional efforts for enhancing the operating and non-operating surpluses of the PSUs.

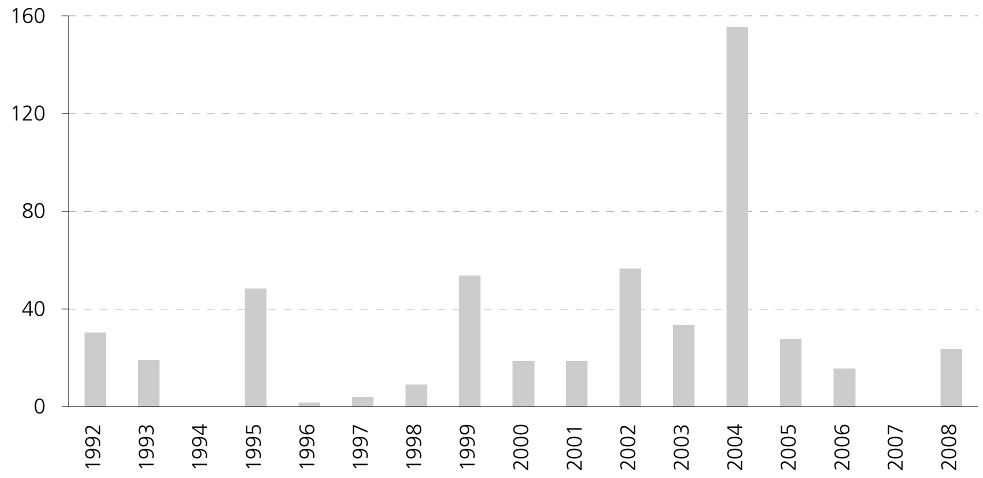
6. Disinvestment of Rs400 bn in FY2010E against Rs11 bn budgeted in the interim budget and Rs200 bn in each of the next two years. GST by 2011 is another imperative.

## Disinvestment—necessary but may not be sufficient

Financial markets are pinning far too much hope on the role of disinvestment in controlling the India's fiscal gap. In our assessment, we can at best expect disinvestment to reduce GFD by mere 0.4% of GDP in 2010E against a gap that is likely to be as wide as 7.0%. Nonetheless, we do expect the new Indian government to take a more pragmatic approach to disinvestment in order to improve its fiscal situation.

We calculate the money that can be raised by disinvestment of 5-10% stakes in listed 'known' entities at a little over Rs700 bn and nearly Rs100 bn can be raised from non-listed space over a three-year period (Rs400 bn in FY2010E and Rs200 bn each in FY2011E and FY2012E). We see disinvestment in researched and well-understood companies as a practical strategy in the near term though disinvestment in 'unknown' (100% government-owned) companies may be pursued as a long-term strategy. Nonetheless, we believe even Rs400 bn of disinvestment, which is very high by historical standards in India (see Exhibit 7), may not be enough to bridge the fiscal gap significantly in FY2010E. Also, disinvestment process is rarely smooth and prone to event risks—(1) employee resistance, (2) market conditions and (3) 'private profits, public costs' syndrome.

Exhibit 7: Receipts from disinvestment in India, March fiscal year-ends, 1992-2008 (Rs bn)




Source: Department of Disinvestment, compiled by Kotak Institutional Equities

## Use of disinvestment proceeds to lower GFD is creative budgetary accounting

Strictly in technical terms, disinvestment should be treated as a below-the-line item and should not contribute to reduction of GFD. However, in extant budgetary practices in India disinvestment does affect GFD. We believe that Rs800 bn disinvestment would help in reducing fiscal stress irrespective of the accounting treatment.

## Disinvestment strategy to continue to be about small stakes

The government's strategy is still likely to focus on small disinvestment rather than ownership change. It remains to be seen if the government would now be bold enough to push disinvestment in 'Navratana' companies which are the flagship PSUs. In our view, small (5-10%) stake transfers in a few non-controversial companies will likely help push disinvestment in a timely and practical way. We model Rs700 bn of possible disinvestment in listed public companies (see Exhibit 8) over three years (Rs400 bn in FY2010E and Rs200 bn each in FY2011E and FY2012E, with possibly another Rs100 bn from non-listed space in that year). This could be a realistic target given as small stake changes are less likely to face opposition from other political parties including INC's own allies.

Exhibit 8: Key companies and likely receipts from disinvestment by the government of India (Rs bn)

| Company | Valuation | Method | Government stake (%) | Likely divestment Dilution (%) | Likely divestment Proceeds | Maximum possible Dilution (%) | Maximum possible Proceeds |
|---|---|---|---|---|---|---|---|
| **Listed companies** | | | | | | | |
| Oil and Natural Gas Corp. (ONGC) | 2,026 | Market price | 74.1 | 5.0 | 101 | 23.1 | 468 |
| National Thermal Power Corp. (NTPC) | 1,704 | Market price | 89.5 | 10.0 | 170 | 38.5 | 656 |
| Metals and Minerals Trading Corp. (MMTC) | 1,006 | Market price | 99.3 | 10.0 | 101 | 48.3 | 486 |
| State Bank of India (SBI) | 1,001 | Market price | 59.4 | — | — | 8.4 | 84 |
| Bharat Heavy Electricals Ltd (BHEL) | 986 | Market price | 67.7 | 5.0 | 49 | 16.7 | 165 |
| Steel Authority of India Ltd (SAIL) | 612 | Market price | 85.8 | 10.0 | 61 | 34.8 | 213 |
| Indian Oil Corporation (IOC) | 609 | Market price | 78.9 | 10.0 | 61 | 27.9 | 170 |
| Power Grid Corp. (PGC) | 493 | Market price | 86.4 | 10.0 | 49 | 35.4 | 174 |
| GAIL (India) Ltd | 388 | Market price | 57.3 | — | — | 6.3 | 24 |
| Hindustan Zinc Ltd (HZL) | 260 | Market price | 29.5 | 29.5 | 77 | 29.5 | 77 |
| Power Finance Corp. (PFC) | 226 | Market price | 89.8 | 10.0 | 23 | 38.8 | 88 |
| Punjab National Bank (PNB) | 207 | Market price | 57.8 | — | — | 6.8 | 14 |
| National Aluminium Co. (NALCO) | 200 | Market price | 87.2 | 10.0 | 20 | 36.2 | 72 |
| Bharat Petroleum Corp. (BPCL) | 154 | Market price | 54.9 | — | — | 3.9 | 6 |
| Bank of India (BOI) | 153 | Market price | 64.5 | — | — | 13.5 | 21 |
| Bank of Baroda (BOB) | 145 | Market price | 53.8 | — | — | 2.8 | 4 |
| Container Corporation of India (CCIL) | 124 | Market price | 63.1 | 5.0 | 6 | 12.1 | 15 |
| **Total listed companies** | | | | | **718** | | **2,736** |
| **Unlisted companies** | | | | | | | |
| Bharat Sanchar Nigam Limited (BSNL) | NA | NA | 100.0 | NA | NA | NA | NA |
| Oil India Limited (OIL) | NA | NA | 100.0 | NA | NA | NA | NA |
| National Aviation Company of India (NACIL) | NA | NA | 100.0 | NA | NA | NA | NA |
| National Mineral Development Corp (NMDC) | NA | NA | 100.0 | NA | NA | NA | NA |
| National Hydel Power Corp (NHPC) | NA | NA | 100.0 | NA | NA | NA | NA |
| Coal India Ltd (CIL) | NA | NA | 100.0 | NA | NA | NA | NA |
| Tata Communications - land bank | NA | NA | 51.0 | 51.0 | NA | 51.0 | NA |
| Bharat Aluminium (BALCO) - call option | NA | NA | 49.0 | 49.0 | NA | 49.0 | NA |

Source: Kotak Institutional Equities estimates

## Possible disinvestment targets

We see the maximum ease of disinvestment in large companies that have been through one or more rounds of disinvestment (such as BHEL, ONGC, NTPC and SAIL) and are well-known to the market (see Exhibit 8). We also expect the government to disinvest small (5-10%) stakes in these companies. This would be the fastest and least controversial route to pursue disinvestment and raise funds, in our view. The government may also sell its balance shareholding in previously-privatized assets such as BALCO, Hindustan Zinc and Tata Communications (erstwhile VSNL) to the major shareholders (Sterlite and Tata group).

However, valuation of the government's residual value has been an issue for some time and as such, it may not be very easy to sell the government's residual ownership in these companies. Similarly, it will be difficult for the government to quickly place 100%-owned entities such as BSNL, NMDC etc. in the capital markets given volatile markets and little appreciation of financials of unlisted companies which may result in a long-drawn IPO process. The government may be willing (under extraordinary circumstances) to sell small stakes in these companies but with realizations likely at a discount to fair value. We expect disinvestment in 'unknown' (100% government-owned) companies to be pursued as a long-term strategy.

## Key risks—employees, markets and privatization

We see disinvestment and privatization of publically-owned companies as a viable funding gap measure, which may be helpful in providing some support to government financials in such extraordinary global economic environment. However, disinvestment process is rarely smooth and beset with multiple roadblocks, notably in 'unknown' 100% government-owned companies that are coming to the capital markets (or strategic investors) for the first time, which we explain below.

- **Employee resistance.** A large part of the workforce in public companies is unionized, with affiliations to various political parties, which tends to complicate restructuring or retrenching exercises.

- **Market conditions and liquidity.** We expect market conditions and liquidity to play an important role in the ability of the government to undertake Rs800 bn of disinvestment. The historical trends suggest (see Exhibit 7) that this would be an ambitious target.

- **'Private profits, public costs' syndrome.** Privatization and disinvestment can still leave onus on the government to support these companies. Delhi and Mumbai airports and Oil Marketing Companies (OMCs) are good examples. Government had to pitch in with Airport Development Fees (ADF) and oil bonds in these cases.

- **Investment, not disinvestment.** Unless the government agrees to ownership change, it does not have scope for disinvestment in some of its majority-owned companies, notably banks, where its stake is already low at around 55-60% levels. Given the recent experience of bailouts of private banks in US, government is unlikely to try an ownership change. On the contrary, the government may be forced to pitch in with capital.

### Introduction of GST moderately positive

In our view, the financial markets and the government are placing too much hope that introduction of Goods and Services Tax (GST) from April 2010 would help bridge the fiscal gap in FY2011. We believe GST introduction may be moderately revenue enhancing and growth positive. Nonetheless, even with the diligent ground work being done, we do not expect the introduction to be smooth. Opposition-ruled States (first layer of sub-national government) may delay falling in line unless the 13th Finance Commission award explicitly provides carrots to encourage adoption of GST by the States.

Since the CENVAT rates have been altered as a counter-cyclical measure, the issue of settling a uniform GST rate can become more cumbersome. There could be temptation to set this rate on the basis of current lower tax rates, but fiscal experts carefully need to evaluate its long-term resource implications. Also, the GST in India is unlikely to produce a single uniform tax rate for all goods and services. A dual structure can be taken as something of a given as the central GST may differ from State GST. Multiplicity of rates could still prevail as certain category of products such as cigarettes, liquor and petroleum are likely to attract a different rate.

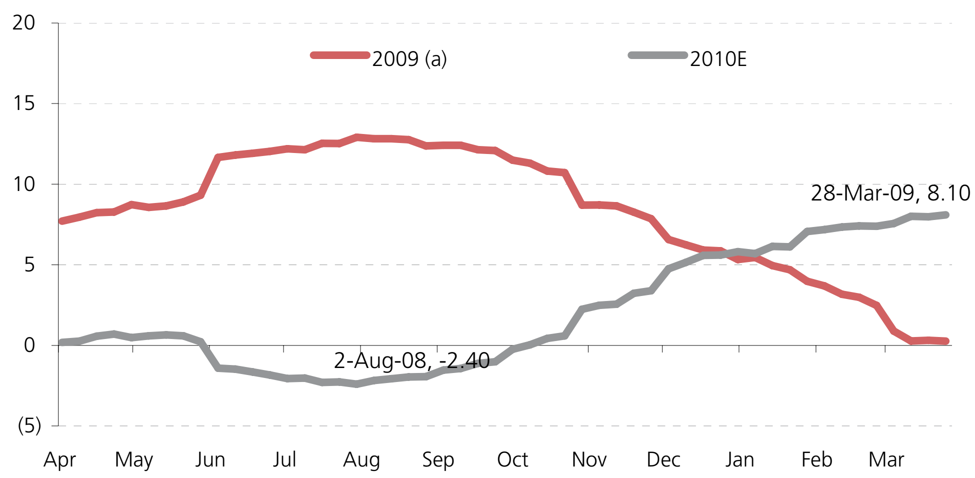
## INTEREST RATE SHOCK POSSIBLE IN FY2011E

We see a strong possibility of an interest rate shock in FY2011E unless fiscal correction is undertaken. Large net market borrowing of over Rs5.0 tn in FY2010E is being funded by liquidity infusion through monetary easing, inter alia, through MSS unwinding and OMO purchases. With likely return of high inflation and monetary tightening, it may not be possible to fund the fiscal gap in FY2011E through large market borrowing of about Rs4.5 tn. Yields may rise sharply as a result. In the event of a surge in capital inflows, sterilized FX-interventions to control exchange rate appreciation may also add to interest rate pressures. However, we do not see stress on BOP and expect exchange rate to appreciate modestly.

### Inflation comeback likely in 2HFY10E

We see headline inflation at 8.0% or more by end-FY2010E (see Exhibit 9). As explained earlier, inflation is likely to come back in a big way in 4QFY10E due to strong base effects, reversal of global commodity price cycle and large excess liquidity globally and at the domestic level. With inflation coming back, nominal interest rates, including gilt yields, can be expected to harden.

**Exhibit 9: Inflation likely to comeback back sharply in 2HFY10E**
Headline inflation rate, March fiscal year-ends, 2008-2010E (%)




Source: Government of India, Kotak Institutional Equities estimates

### Monetary policy tightening can add to interest rate reversal

Markets may face a monetary policy surprise at some point of time in FY2010E that can sharply raise interest rates. With the likely return of inflation and large surplus domestic liquidity, the chances are that even moderate recovery or sudden surge in capital flows can trigger monetary tightening. Two scenarios can occur:

- If capital flows improve moderately, but are not patchy, the central bank may start withdrawing excess liquidity gradually in 2HFY10E and possibly signal monetary tightening through its policy rate(s) or CRR in 2HFY10E with inflation coming back. In such a scenario, gilt yields could rise sharply in 2HFY10E.

- If there is a sudden surge in capital inflows over next month or two, the interest rates may still not soften as the central bank may need to come in to prevent rupee appreciation as SME exporters already reeling under global trade contraction may get hurt. In such a scenario, dollar-buying interventions would add to already excessive rupee liquidity, which would then need to be sterilized through one of the following three options:

- Renewed issuance of MSS bonds which would add to supply of SLR (gilt) securities and raise yields,
- Withdrawal or down-scaling of outright open market operations (OMO) purchases currently indicated to the tune of Rs800 bn in 1HFY10E and if necessary undertaking OMO sales later in 2HFY10E. In either case it adds to the net supply of fresh SLR securities and would harden yields, or
- Raising of CRR to sterilize excess liquidity arising from central bank buying dollars, which does not directly add to SLR supply but decreases demand for gilts and raise yields.

## Interest rate view: Possibility of a shock rise in FY2011E

We expect the 10-year benchmark gilt yield to stay in a 6-6.5% band in 1HFY10E, rising to 7.5% by the end-FY2010E and 9% in FY2011E. Our interest rate view is that the large fiscal deficit and consequent large market borrowing, mixed with the return of inflation and monetary tightening, opens up the possibility of a shock rise in interest rates in FY2011E. This can be avoided if the fiscal correction is introduced in the forthcoming full budget in FY2010E and carried further in FY2011E. Our view that interest rates will rise, starting 2HFY10E and rising more sharply in 4QFY10E when government may resort to large extra market borrowing, is based on:

- Excess supply of SLR securities (gilts) in relation to demand, both in FY2010E and FY2011E (see Exhibit 10).
- Possible sharp increase in excess supply of gilts in case lumpy capital flows prompts central bank to lean against rupee appreciation through sterilized intervention. Excess supply could be as large as Rs1.7 tn in FY2010E and Rs2.4 tn in FY2011E in such a case.
- Renewed MSS could be a possible choice of instruments if dollar-buying interventions are made. However, the impact would be similar in case OMO purchases or discontinuation of OMO sales are used as an alternative tool.

**Exhibit 10: Excess supply likely to exert moderate pressure on yields in FY2010E; interest rate shock in FY2011**
Demand and supply of SLR securities, March fiscal year-ends (Rs bn)

| | | | base case | | optimistic | |
|---|---|---|---|---|---|---|
| | 2008 | 2009E | 2010E | 2011E | 2010E | 2011E |
| **1. Demand for SLR securities (2+3+4)** | **2,505** | **2,658** | **2,835** | **2,989** | **2,835** | **2,989** |
| 2. required from banks | 1,812 | 1,658 | 1,652 | 1,589 | 1,652 | 1,589 |
| 3. from insurance companies | 534 | 760 | 915 | 1,100 | 915 | 1,100 |
| 4. from others | 159 | 240 | 268 | 300 | 268 | 300 |
| **5. Supply of SLR securities (6+7+8)** | **2,919** | **2,777** | **3,382** | **4,648** | **3,862** | **5,368** |
| 6. Net market borrowing of center | 1,107 | 2,620 | 3,787 | 3,498 | 3,787 | 3,498 |
| 7. T-bills financing | 256 | 850 | 50 | 200 | 50 | 200 |
| 8. State government issuances | 562 | 1,038 | 1,300 | 950 | 1,300 | 950 |
| 9. MSS | 1,057 | (803) | (650) | 0 | (170) | 720 |
| 10. OMO | (62) | (928) | (1,105) | 0 | (1,105) | 0 |
| **11. Excess demand/(supply) (1-5)** | **(414)** | **(118)** | **(547)** | **(1,659)** | **(1,027)** | **(2,379)** |
| | | | | | | |
| *Memo items* | | | | | | |
| NDTL | 34,813 | 41,721 | 48,606 | 48,606 | 48,606 | 48,606 |
| SLR ratio (% of NDTL) | 25 | 24 | 24 | 24 | 24 | 24 |

Note:
(1) base case scenario is in accordance with our other macro-projections; optimistic scenario is based on additional capital capital flows of US$10 bn in FY2010E and US$15 bn in FY2011E than our BOP projections

Source: Kotak Institutional Equities estimates

We also see the possibility of interest rates hardening in FY2011E on account of large excess demand of credit (see Exhibit 11). Credit growth is likely to continue exceeding available resources with banks to fund credit growth, putting pressures on lending rates. Hardening gilt yields could add to these pressures.

**Exhibit 11: We see no significant demand-supply imbalances in credit market in FY2010E but interest rates to rise in FY2011E**
Sources and uses of bank funds, March fiscal year-ends, 2008-2010E (Rs bn)

| | 2008 | 2009E | 2010E | 2011E |
|---|---|---|---|---|
| **1. Total usable sources (2 to 4)** | **6,139** | **6,502** | **6,559** | **8,409** |
| 2. Deposits | 5,802 | 6,320 | 6,310 | 8,019 |
| 3. Call/term funding | 200 | 138 | 168 | 247 |
| 4. Overseas foreign currency borrowings | 136 | 44 | 81 | 142 |
| 5. Capital | 251 | 572 | 726 | 1,207 |
| 6. Other liabilities | 573 | (436) | 117 | 237 |
| **7. Uses (net of credit) (8 to11)** | **2,586** | **2,071** | **2,629** | **2,925** |
| 8. Investment in Govt. securities | 1,812 | 1,930 | 1,652 | 1,589 |
| 10. Non-SLR investments | 281 | 202 | 94 | 317 |
| 11. Net foreign assets | (276) | 128 | 106 | 164 |
| 12. Balances with RBI | 769 | (189) | 777 | 855 |
| **13. Sources-uses (net of credit) (1-7)** | **3,552** | **4,431** | **3,930** | **5,483** |
| 14. Credit offtake/demand | 4,173 | 4,215 | 4,429 | 6,747 |
| **15. Credit gap (13-12)** | **621** | **(216)** | **499** | **1,263** |
| *Memo items* | | | | |
| NDTL | 34,813 | 41,721 | 48,606 | 57,355 |
| SLR ratio (% of NDTL) | 25 | 24 | 24 | 24 |
| CRR ratio (% of NDTL) | 7.5 | 5.0 | 6.5 | 7.0 |
| Deposit growth (%) | 22.2 | 21.5 | 15.0 | 18.0 |
| Credit growth (%) | 21.6 | 17.0 | 15.8 | 21.0 |

Source: Kotak Institutional Equities estimates

## Volatile capital flows in FY2010E may add to woes

In our understanding, FY2010E may be marked by volatile capital flows. This may add to financial volatilities and may cause unexpected monetary tightening in events of lumpy inflows.

The sentiment change following the unexpectedly stronger political mandate for the UPA government with current view being bullish for the entire 5-year term for the new government. However, in our view, the capital flow uncertainty is considerable with likelihood of unpredictable surges and reversals in capital flows. For instance, it is possible to conjecture the following event risks as the base case:

- Sudden surge in capital inflows led by about US$7.0 bn or more of FII inflows in 1QFY10E.
- Euphoria dying down quickly following the presentation of the full budget in July 2009 with capital flows reversing or petering out, if it falls short of expectations.
- Continued capital flow volatility in either direction triggered by news flow related to policy changes on disinvestment and foreign investment.
- Possible large capital flow reversal in 4QFY10E, when the macro-economic environment is expected to deteriorate on the back of higher inflation, extra market borrowing and central bank tightening liquidity in face of rising inflation.

FY2008 was marked by strong and excessive capital inflows and FY2009 by a sudden stop of capital inflows, while FY2010E is likely to be marked by volatile capital flows in both directions which could be large and unpredictable.

## BOP likely to improve on back of CAD shrinking, capital flows improving

In face of large fiscal gaps, we do not expect the possibility of twin deficits to arise soon as absorption impact may come with a lag due to current depressed aggregate demand. On the contrary, in our assessment, BOP may improve distinctly on the back of (1) CAD shrinking to 1.5% of GDP and (2) overall capital flows improving, though remaining moderate in relation to FY2008 (see Exhibit 12).

**Exhibit 12: Current account deficit likely to shrink, capital flows likely to improve but be volatile in FY2010E and FY2011E**
India's quarterly balance of payments, March fiscal year-ends, 2008-2011E (US$ bn)

| | 1QFY09 | 2QFY09 | 3QFY09 | 4QFY09E | 1QFY10E | 2QFY10E | 3QFY10E | 4QFY10E | 2008 | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Current account** | **(9.0)** | **(12.8)** | **(14.6)** | **4.2** | **2.1** | **(6.4)** | **(7.3)** | **(5.4)** | **(17)** | **(32)** | **(17)** | **(13)** |
| GDP | 299 | 295 | 288 | 287 | 274 | 285 | 324 | 337 | 1,173 | 1,167 | 1,116 | 1,313 |
| CAD/GDP (%) | (3.0) | (4.3) | (5.1) | 1.5 | 0.8 | (2.3) | (2.3) | (1.6) | (1.5) | (2.8) | (1.5) | (1.0) |
| Trade balance | (31) | (39) | (36) | (18) | (17) | (26) | (26) | (26) | (92) | (123) | (95) | (105) |
| Trade/GDP (%) | (10.2) | (13.0) | (12.6) | (6.3) | (6.3) | (9.0) | (8.2) | (7.6) | (7.8) | (10.6) | (8.5) | (8.0) |
| - Exports | 49 | 48 | 37 | 37 | 36 | 37 | 39 | 42 | 156 | 170 | 154 | 181 |
| - Imports | 80 | 86 | 73 | 55 | 54 | 62 | 66 | 68 | 250 | 294 | 250 | 286 |
| o/w Oil imports | 29 | 33 | 17 | 12 | 14 | 18 | 20 | 21 | 73 | 92 | 73 | 94 |
| o/w Non-oil imports | 50 | 53 | 56 | 43 | 39 | 44 | 45 | 47 | 175 | 202 | 176 | 192 |
| Invisibles (net) | 22 | 26 | 22 | 22 | 19 | 19 | 19 | 20 | 75 | 91 | 78 | 92 |
| - Services | 10.7 | 13.6 | 12.8 | 12.0 | 10.6 | 10.5 | 10.7 | 11.1 | 38 | 49 | 43 | 50 |
| o/w Software | 10.8 | 11.3 | 10.2 | 10.5 | 9.6 | 9.5 | 9.7 | 10.1 | 37 | 43 | 39 | 45 |
| - Transfers | 11.6 | 12.9 | 10.5 | 11.1 | 9.9 | 9.6 | 9.8 | 10.5 | 42 | 46 | 40 | 47 |
| - Other invisibles | (0.9) | (0.8) | (1.7) | (0.8) | (1.1) | (0.9) | (1.3) | (1.2) | (4.9) | (4.1) | (4.5) | (5.7) |
| **Capital account** | **11.1** | **7.9** | **(3.7)** | **2.1** | **13.4** | **11.6** | **15.3** | **6.7** | **108** | **17** | **47** | **60** |
| Foreign investment | 4.8 | 4.3 | (5.0) | 0.7 | 10.7 | 6.1 | 6.3 | 0.0 | 45 | 5 | 23 | 33 |
| - FDI | 9.0 | 5.6 | 0.8 | 4.2 | 3.7 | 4.1 | 3.8 | 2.6 | 15 | 20 | 14 | 19 |
| - FII | (5.2) | (1.4) | (5.8) | (3.5) | 7.0 | 1.8 | 2.1 | (3.2) | 21 | (16) | 8 | 10 |
| - ADRs/GDRs | 1.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.2 | 0.4 | 0.6 | 8.7 | 1.1 | 1.2 | 4.4 |
| Banking capital | 2.7 | 2.1 | (5.0) | (1.0) | (0.9) | 0.8 | 1.5 | 1.2 | 11.8 | (1.1) | 2.6 | 3.8 |
| - NRI deposits | 0.8 | 0.3 | 1.0 | 1.0 | 0.8 | 1.1 | 1.0 | 0.9 | 0.2 | 3.1 | 3.8 | 0.4 |
| Short-term credit | 2.4 | 1.3 | (3.1) | (2.1) | (1.3) | (0.8) | 1.0 | 1.3 | 17.2 | (1.6) | 0.2 | 5.9 |
| ECBs | 1.5 | 1.8 | 3.9 | 1.0 | 2.7 | 3.0 | 4.1 | 1.9 | 23 | 8 | 12 | 10 |
| External assistance | 0.4 | 0.5 | 1.0 | 0.9 | 0.8 | 1.1 | 1.2 | 0.8 | 2.1 | 2.8 | 3.9 | 2.0 |
| Other capital account items | (0.6) | (2.1) | 4.5 | 2.6 | 1.4 | 1.3 | 1.2 | 1.5 | 9.3 | 4.5 | 5.4 | 5.6 |
| E&O | 0.1 | 0.2 | 0.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 1.2 | 0.8 | 0.0 | 0.0 |
| **Overall balance** | **2.2** | **(4.7)** | **(17.9)** | **6.3** | **15.6** | **5.1** | **8.0** | **1.3** | **92** | **(14)** | **30** | **47** |
| **memo: RBI's net forex purchases** | **(0.8)** | **(8.9)** | **(22.1)** | | | | | | | | | |
| **Assumptions** | | | | | | | | | | | | |
| Average exchange rate (Rs/US$) | 41.6 | 43.8 | 48.8 | 49.8 | 48.6 | 47.8 | 47.8 | 48.0 | 40.3 | 46.0 | 48.0 | 47.8 |
| Average Indian crude basket price (US$/b) | 119.1 | 114.6 | 54.7 | 44.8 | 50.0 | 53.0 | 57.0 | 60.0 | 78.2 | 83.3 | 55.0 | 65.0 |

Source: Reserve Bank of India, Kotak Institutional Equities estimates

- CAD is unlikely to be bridged but may shrink despite a fall in invisibles.
- Notwithstanding the current market behavior, the liquidity driven momentum rally may not sustain and total FII flows could still remain modest. In the event of a sovereign rating downgrade, the flows could abate again. However, we expect stable government to improve FDI flows significantly.
- We, however, recognize that upside risks to our portfolio flow numbers exist if current momentum sustains.

## Exchange rate view: modest but not runaway appreciation

Given our BOP scenario, we expect a modest rupee appreciation in FY2010E and FY2011E. We have accordingly revised our exchange rate forecasts, presented in Exhibit 13.

**Exhibit 13: Rupee likely to appreciate moderately in FY2010E and FY2011E**
INR/USD and USD/EUR exchange rates; appreciation/depreciation (%), March fiscal ends, 2007-2011E

| | 2007 | 2008 | 2009E | 2010E | 2011E | 1QFY09 | 2QFY09 | 3QFY09 | 4QFY09E | 1QFY10E | 2QFY10E | 3QFY10E | 4QFY10E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Average Rate** | | | | | | | | | | | | | |
| INR/USD | 45.25 | 40.26 | 45.99 | 48.03 | 47.75 | 41.65 | 43.76 | 48.76 | 49.78 | 48.55 | 47.75 | 47.80 | 48.00 |
| USD/Euro | 1.28 | 1.42 | 1.43 | 1.31 | 1.41 | 1.58 | 1.50 | 1.32 | 1.31 | 1.33 | 1.30 | 1.29 | 1.32 |
| USD/GBP | 1.89 | 2.01 | 1.72 | 1.54 | 1.70 | 1.98 | 1.89 | 1.57 | 1.44 | 1.51 | 1.52 | 1.53 | 1.59 |
| Yen/USD | 117.0 | 114.3 | 100.0 | 94.3 | 101.0 | 102.7 | 107.6 | 96.0 | 93.7 | 97.0 | 92.8 | 92.0 | 95.5 |
| **Average depreciation (+)/appreciation (-)** | | | | | | | | | | | | | |
| INR/USD | 2.2 | (12.4) | 12.5 | 4.2 | (0.6) | 4.5 | 4.8 | 10.3 | 2.0 | (2.5) | (1.7) | 0.1 | 0.4 |
| USD/Euro | 5.1 | 9.9 | 0.5 | (9.0) | 7.1 | 4.1 | (4.8) | (13.9) | (0.8) | 1.5 | (2.3) | (0.8) | 2.3 |
| USD/GBP | 5.7 | 6.0 | (16.8) | (11.9) | 9.5 | (0.3) | (4.6) | (20.6) | (9.3) | 5.0 | 0.5 | 0.7 | 3.8 |
| Yen/USD | 3.2 | (2.3) | (14.3) | (6.0) | 6.6 | (0.7) | 4.6 | (12.1) | (2.5) | 3.4 | (4.6) | (0.8) | 3.7 |
| **End-period Rate** | | | | | | | | | | | | | |
| INR/USD | 43.47 | 40.11 | 50.74 | 48.50 | 47.00 | 43.06 | 46.98 | 48.68 | 50.74 | 47.00 | 48.50 | 47.25 | 48.50 |
| USD/Euro | 1.34 | 1.58 | 1.33 | 1.35 | 1.46 | 1.58 | 1.41 | 1.40 | 1.33 | 1.32 | 1.28 | 1.30 | 1.35 |
| USD/GBP | 1.97 | 1.98 | 1.43 | 1.63 | 1.76 | 1.99 | 1.78 | 1.46 | 1.43 | 1.54 | 1.50 | 1.55 | 1.63 |
| Yen/USD | 117.8 | 99.7 | 99.0 | 97.0 | 105.0 | 106.2 | 106.1 | 90.7 | 99.0 | 95.5 | 90.0 | 94.0 | 97.0 |
| **End-period depreciation (+)/appreciation (-)** | | | | | | | | | | | | | |
| INR/USD | (2.7) | (8.4) | 20.9 | (4.6) | (3.2) | 6.8 | 8.4 | 3.5 | 4.1 | (7.9) | 3.1 | (2.6) | 2.6 |
| USD/Euro | 9.3 | 15.2 | (18.8) | 1.5 | 7.5 | (0.2) | (11.8) | (0.9) | (5.1) | (0.8) | (3.1) | 1.5 | 3.7 |
| USD/GBP | 11.7 | 0.8 | (38.5) | 12.1 | 7.4 | 0.4 | (11.9) | (21.7) | (2.1) | 7.0 | (2.7) | 3.2 | 4.9 |
| Yen/USD | 0.0 | (18.2) | (0.7) | (2.0) | 7.6 | 6.1 | (0.1) | (17.0) | 8.4 | (3.6) | (6.1) | 4.3 | 3.1 |

Source: Bloomberg, Kotak Institutional Equities estimates

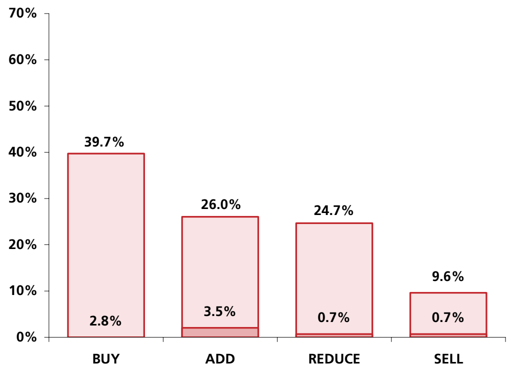
We do not expect large appreciation and expect RBI to buy dollars in case of strong inflows.

- A stronger rupee may be unacceptable as exporters are already facing global trade contraction.
- FY2010 can see competitive trade devaluations by several competing emerging markets.
- The current sharp movement can see importers cancelling and re-booking contracts and exporters going for fresh hedges which could halt the current momentum.

"I, Mridul Saggar, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

**Kotak Institutional Equities Research coverage universe**

Distribution of ratings/investment banking relationships




Percentage of companies covered by Kotak Institutional Equities, within the specified category.

Percentage of companies within each category for which Kotak Institutional Equities and or its affiliates has provided investment banking services within the previous 12 months.

* The above categories are defined as follows: Buy = We expect this stock to outperform the BSE Sensex by 10% over the next 12 months; Add = We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months; Reduce = We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months; Sell = We expect this stock to underperform the BSE Sensex by more then 10% over the next 12 months. These ratings are used illustratively to comply with applicable regulations. As of 31/03/2009 Kotak Institutional Equities Investment Research had investment ratings on 146 equity securities.

Source: Kotak Institutional Equities

As of March 31, 2009

# RATINGS AND OTHER DEFINITIONS/IDENTIFIERS

## Definitions of ratings

**BUY.** We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

**ADD.** We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

**REDUCE.** We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

**SELL.** We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

## Other definitions

**Coverage view.** The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: Attractive (A), Neutral (N), Cautious (C).

## Other ratings/identifiers

**NR = Not Rated.** The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

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**NA = Not Available or Not Applicable.** The information is not available for display or is not applicable.

**NM = Not Meaningful.** The information is not meaningful and is therefore excluded.

Corporate Office

Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices

Kotak Mahindra (UK) Ltd.
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc.
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel: +1-914-997-6120


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