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# Emerging Markets Economics Research

Emerging Markets • Economics • Asia

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## India: Overheating concerns seem overdone

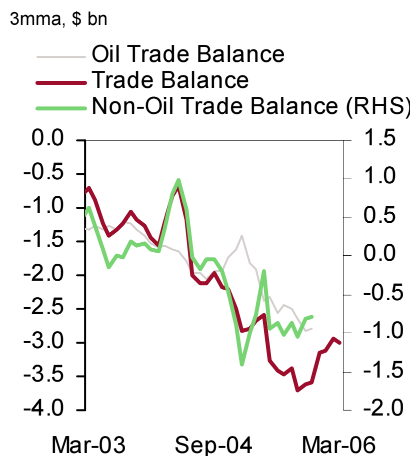
We forecast that GDP in India will grow by 8.1% in FY05/06 and 8.5% in FY06/07 versus consensus forecasts of 7.5% and 7.3%, respectively. Our view on India is more optimistic than the market's in large part because we do not see the constraints on growth many in the market fear. In particular:

- We judge India's current account deficit to be sustainable and not a constraint on growth. The most recent trade data suggest that the rapid deterioration in the trade deficit since H1 2004 is stabilizing. Portfolio flows only account for 35% of total capital flows and one of the main determinants is GDP growth. We expect the balance of payments to improve in FY06/07. We are revising our USD/INR forecast to 43-43.5 from 44.5 by end-2006.

- Our analysis suggests that the central bank (RBI) will be able to manage liquidity conditions over the next three to six months to prevent a credit crunch. This is despite credit growth of over 30% year on year compared to 18% yoy deposit growth. Fiscal and monetary policy tools on the part of the state governments and central bank are available to inject liquidity in the next three to six months.

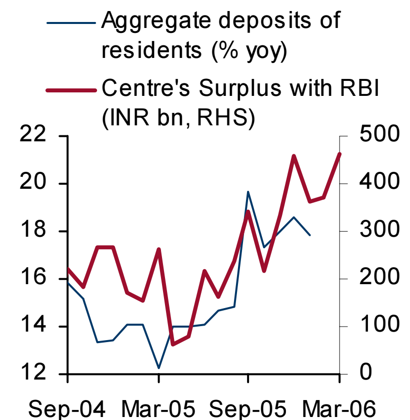
**Exhibit 1: Trade deficit showing signs of a trend-wise decline**

3mma, $ bn




Source: CEIC, Credit Suisse

**Exhibit 2: If the government starts spending, liquidity may ease**




Source: CEIC, Credit Suisse

FOR IMPORTANT DISCLOSURE INFORMATION, including analyst certification, please refer to the Disclosure Appendix.

## Macro risks highlighted by consensus are too bearish

**We remain bullish on the Indian economy and maintain our above consensus GDP growth forecasts.** We forecast GDP growth of 8.1% in FY05/06 and 8.5% in FY06/07 versus consensus forecasts of 7.5% and 7.3%, respectively. We are more optimistic than the market on India in large part because we do not see the constraints on growth many in the market fear. In particular:

- First, we judge India's current account deficit to be sustainable and not a constraint on growth. The most recent trade data suggest that the rapid deterioration in the trade deficit since 1H 2004 is stabilizing. Portfolio flows only account for 30% of total capital flows and one of the main determinants is GDP growth.
- Second, our analysis suggests that the central bank (RBI) will be able to manage liquidity conditions over the next three to six months to prevent a credit crunch. This is despite credit growth of over 30% yoy compared to 18% yoy deposit growth. Fiscal and monetary policy tools on the part of the state governments and central bank are available to inject liquidity conditions in the next three to six months.
- Third, with our expectation that liquidity conditions are likely to be ample in FY06/07, the key drivers of growth may be consumer spending in second-tier cities and rural areas, along with investment spending by the private sector.

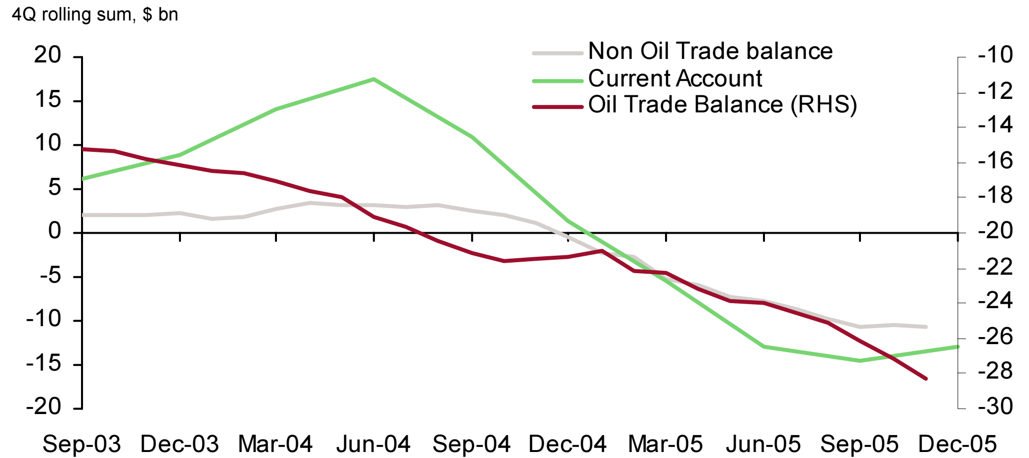
**In this report we focus on the GDP growth constraints for which consensus expectations have been wary, rather than the sources of GDP growth.** We discuss the outlook for external liquidity conditions, domestic liquidity conditions, and USD/INR. The key downside risk to our bullish assessment is that average WTI oil prices exceed our baseline assumption of $62.5 per barrel in 2006, state governments continue to underspend their budgeted allocations, and portfolio flows start to show signs of significant weakness.

## Current account deficit showing signs of stabilizing

**Concerns about the deterioration of the trade balance since March 2004 (Exhibit 3) and the current account posting deficits of $3.5-5.4 bn for most quarters since Q3 2004 compared to surpluses before this period have been rising since H2 2005.** We are not particularly worried. We expect the quarterly current account deficit to remain stable in the $4-5.5 bn range over the next 12 months. The monthly trade deficit is likely to hover around $3 bn compared to the $3.5-4.0 bn posted in Q2 FY05/06.

**Exhibit 3: Current account deficit seems to be bottoming out …**

4Q rolling sum, $ bn

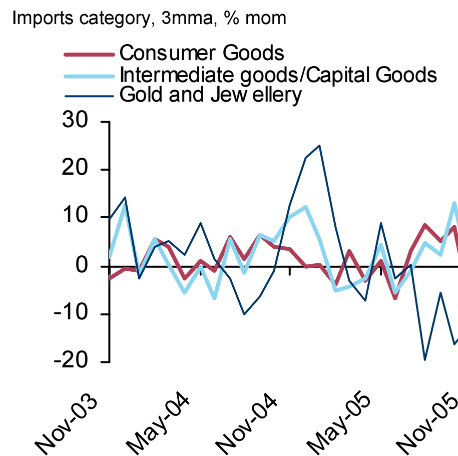



Source: Credit Suisse

**The rise in the oil and petroleum products trade deficit, along with unusually strong imports of capital goods, intermediates, & raw materials, has been the main driver of the deterioration in the current account balance since Q1 FY04/05 (Exhibits 4, 5 and 6).**

**Exhibit 4: … due to slower import growth of consumer goods, capital goods, gold ...**

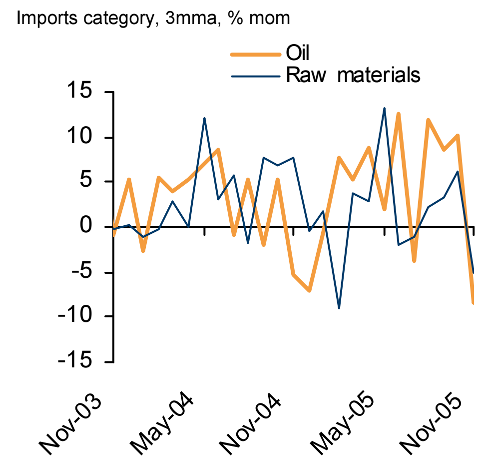
Imports category, 3mma, % mom




Source: CEIC, Credit Suisse

**Exhibit 5: … oil, and raw materials …**

Imports category, 3mma, % mom

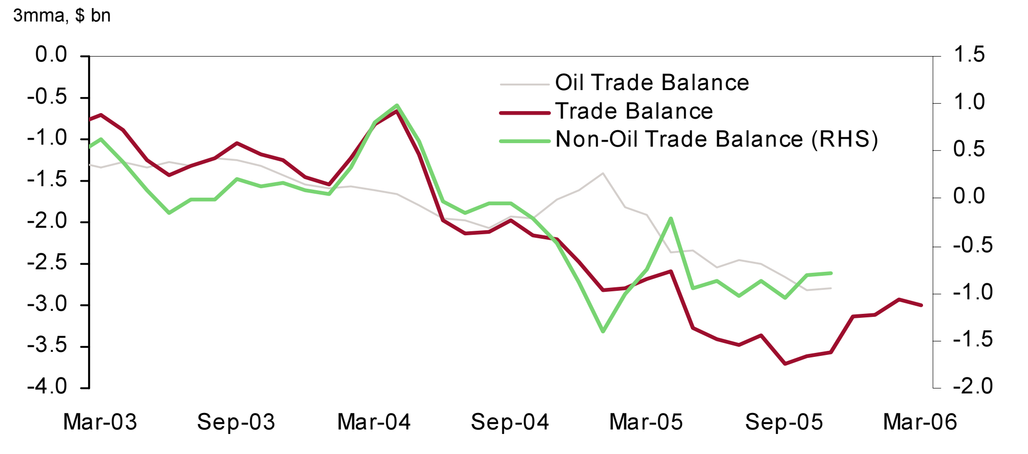



Source: CEIC, Credit Suisse

**However, on a trend-wise basis, we note a decline in the trade deficit since August 2005 (Exhibit 6).** In particular, the non-oil trade balance has moderated on a monthly basis to around $0.5-1 bn from around $1-1.5 bn. The most recent trade data suggest that the rapid deterioration in the trade deficit may be close to a bottom. On a month-on-month basis, imports of consumer goods, gold and jewellery, raw materials, capital goods, and oil have shown signs of slowing (Exhibits 4 and 5). Capital goods probably accelerated in the first three quarters of 2005 due to the government's policy change which allowed used capital goods to be imported starting in H2 2004 and larger incentives to import new capital

goods which may be used in the production of heavy equipment and machinery for export purposes. The exceptionally high growth of gold and jewellery imports in H1 2005 was caused by illegal importation of low value-added products feeding into gold and jewellery production.

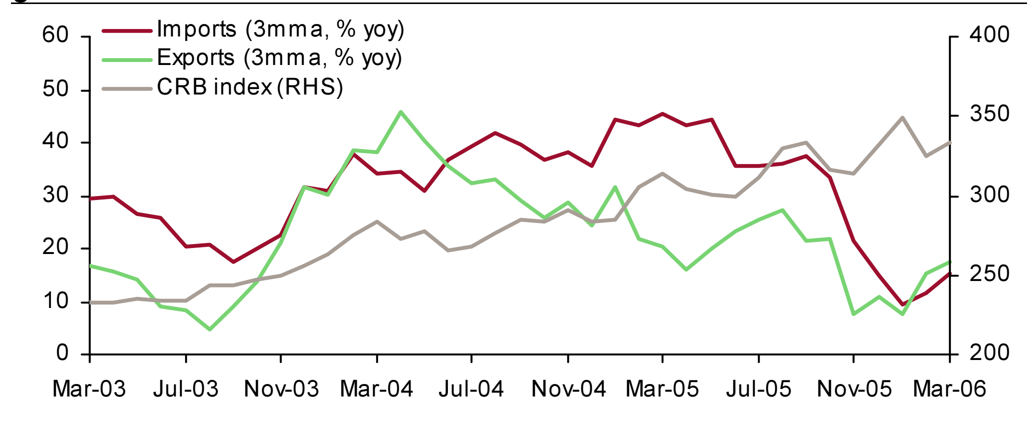
**Exhibit 6: … which is causing non-oil trade deficit to fall**




Source: Commerce and Industry Ministry, CEIC, Credit Suisse

**Lastly, overall import growth probably picked up significantly in H1 2005 due to speculation that commodity prices would continue to rise (Exhibit 7).**

**Exhibit 7: H1 2005 hoarding caused by expectations that commodity prices may rise substantially may be less in FY06/07, implying slower pace of import growth**

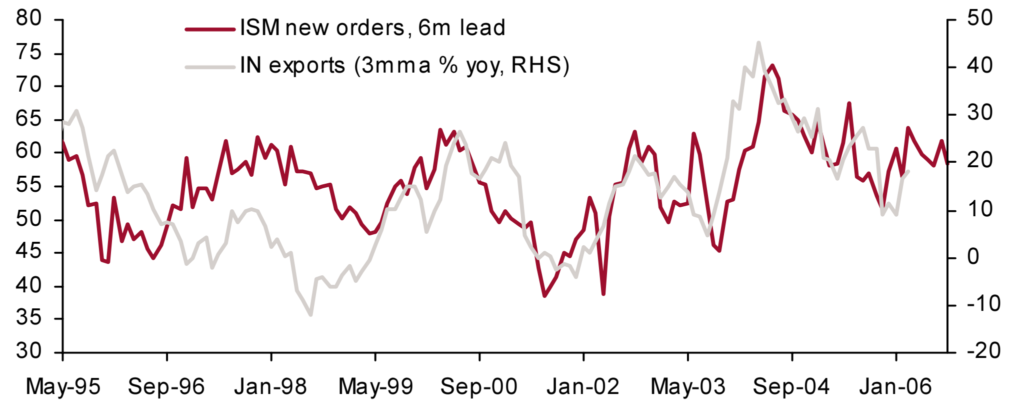



Source: Bloomberg, Commerce and Industry Ministry, CEIC, Credit Suisse

**Looking ahead, monthly import growth may trend at 20-30% yoy versus the highs of 35-45% observed in late 2004 to mid-2005.** We expect monthly export growth to remain robust in the 25-35% yoy range due to our expectations that global growth remains robust in 2006 at 4.9% and 4.6% in 2007. The US may be the key driver of global growth. We proxy US growth by the ISM index, which leads Indian exports by six months (Exhibit 8). We believe the lagged effects of trade policy changes on capital goods imports may start abating, the government's measures to control illegal imports of gold and jewellery is likely to be successful, and the large inventory build-up on the back of speculation that

commodity prices may rise is likely to be of a lower magnitude. As a result, some of these factors may become less of a stimulant to import growth. We are revising our FY05/06 current account deficit forecast to $17.6 bn (2.5% of GDP) from $23.5 bn (3.3% of GDP). For FY 06/07, we are revising our current account deficit forecast to $22 (2.7% of GDP) from $27 bn (3.4% of GDP).

**Exhibit 8: Exports likely to be robust on back of strong global growth**

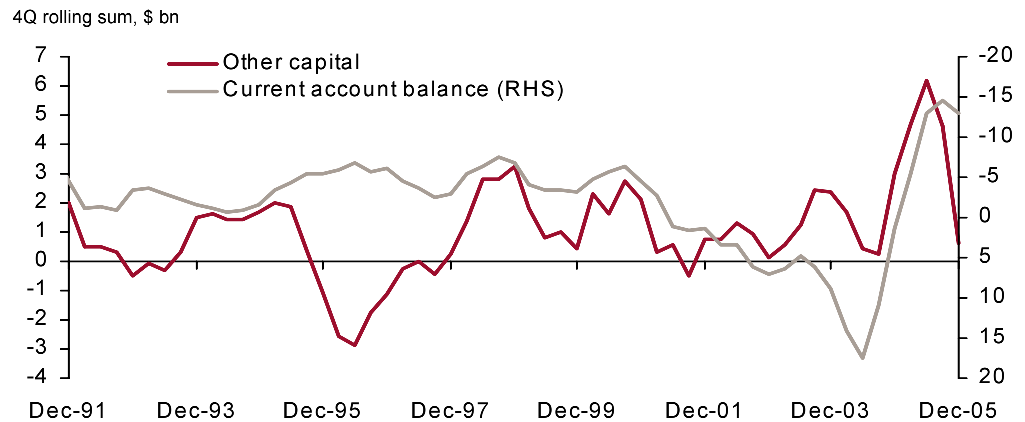



Source: CEIC, Credit Suisse

**We expect future current account deficit data points to be revised down due to problems in the timely recording of export and import payments.** The Q2 FY05/06 current account deficit was revised down to $5.1 bn from $7.7 bn, while the Q1 FY05/06 current account deficit was revised down to $4.6 bn from $5.3 bn. The Q3 FY05/06 current account deficit was around $3.9 bn. The main revision in the Q1 FY05/06 current account balance was higher exports revenues compared to the initial estimate. In Q2 FY05/06, the current account deficit was revised down due to stronger exports and higher tourism-related inflows compared to the initial estimate. The reason why the export data were revised up was that the other capital line item in the capital accounts refers to export and import payments that have not been accounted for in the trade account. In other words, the other capital line item is like an errors and omission line item. That is the reason why other capital and the current account deficit are positively related (Exhibit 9).

**Exhibit 9: Current account balance data may be prone to revisions**

4Q rolling sum, $ bn




Source: CEIC, Credit Suisse

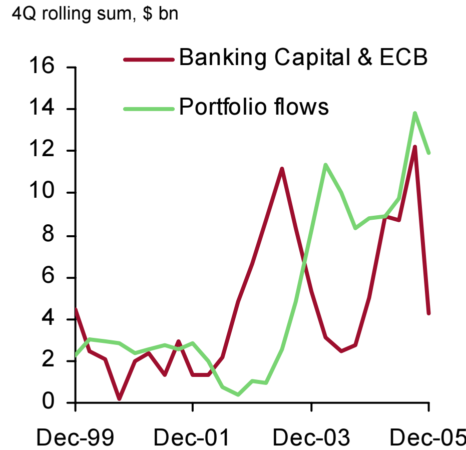
Note: Other capital refers to unaccounted export and import payments in balance of payments

## Not just inflows to the stock market which are financing the current account deficit

**Consensus concerns have focused on the possibility of reversals of portfolio flows to the stock market and a significant weakening in the balance of payments. Portfolio flows to the stock market account for only around 35% of total capital flows (as of Q3 FY05/06).** However, another 51% of capital flows in the form of external borrowings are expected to remain robust over the next 12 months.

**Exhibit 10: There are other large capital flows besides …**

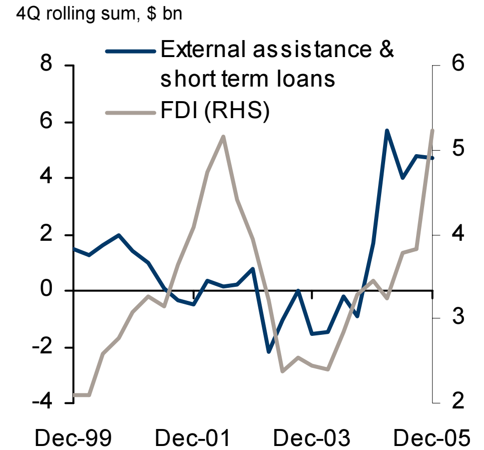
4Q rolling sum, $ bn




Source: CEIC, Credit Suisse

**Exhibit 11: … portfolio flows to the stock market**

4Q rolling sum, $ bn

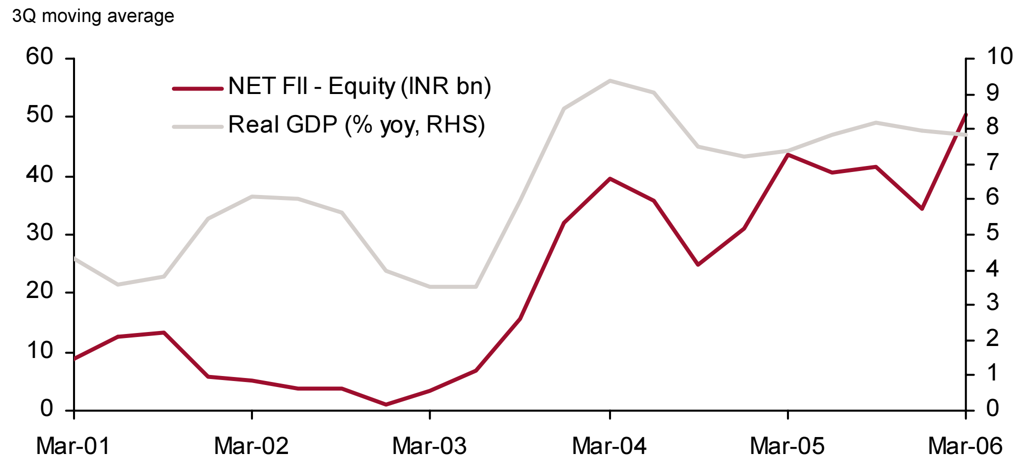



Source: CEIC, Credit Suisse

**We believe that as long as GDP growth remains robust, portfolio flows to the stock market may remain resilient (Exhibit 12).**

**Exhibit 12: Portfolio flows may remain resilient due to strong GDP growth outlook**

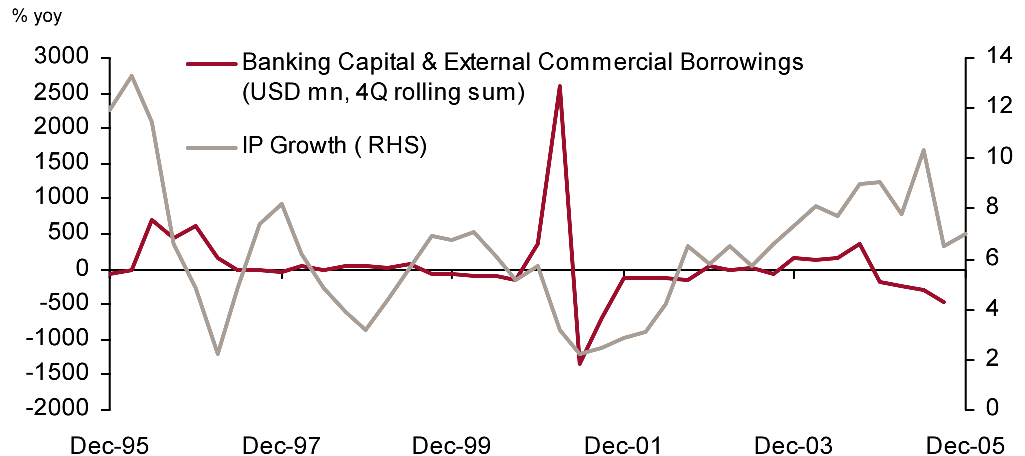
3Q moving average




Source: CEIC, Credit Suisse

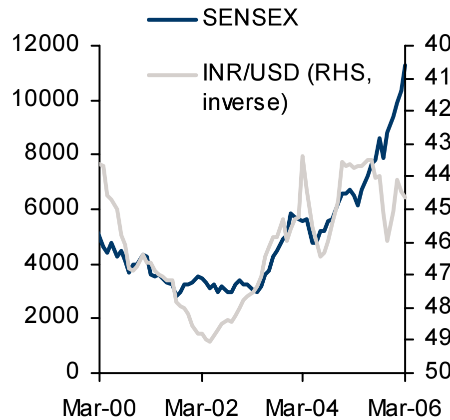
**Banking capital and external commercial borrowings accounted for 34% of capital flows in Q3 FY05/06.** These loans are being utilized to finance industrial investment rather than speculation (Exhibit 13). Around 17% of capital flows is accounted for by FDI. The Q3 FY06/07 capital flows data were distorted by the $7 bn redemption of the India Millenium deposits and a slowdown in portfolio flows to the stock market. One of the reasons why portfolio flows slowed to the equity market in Q3 FY 05/06 was in our view excessive concerns related to the current account deficit.

**Exhibit 13: External borrowings are being used to finance industrial sector investment and may not be prone to reversals**



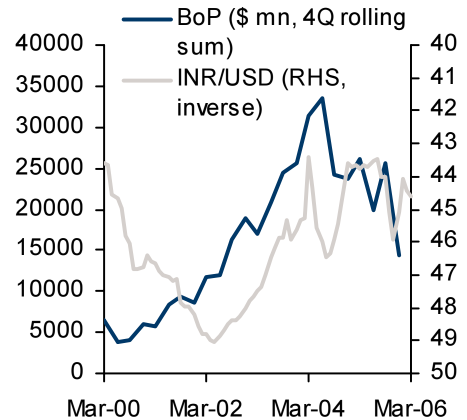

Source: CEIC, Credit Suisse

**Exhibit 14: USD/INR correlates well with the stock market …**




Source: CEIC, Credit Suisse

**Exhibit 15: … and balance of payments**

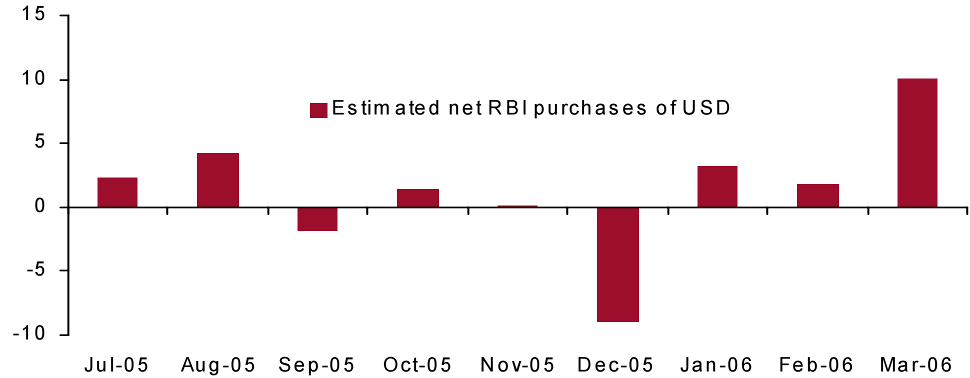



Source: CEIC, Credit Suisse

**We believe the balance of payments surplus may rise to $21.6 bn in 2006 from $14.4 bn in 2005.** The improvement in the current account balance and resilient portfolio, bank capital, and external commercial borrowing flows form the basis for this forecast. Resilient portfolio flows and an improvement in the balance of payments are supportive of a fall in USD/INR (Exhibits 14 and 15). In addition, as we discuss below, domestic liquidity conditions are likely to improve. As a result, the current injection of INR into the financial market by the RBI via purchases of USD in the foreign exchange market (Exhibit 16) may

abate. Note also that export growth has been on an uptrend since late 2005 after having moderated from mid- to late 2005 (Exhibit 8). This may induce the RBI to tolerate a stronger INR. Our Emerging Market Fixed Income Strategy Team's quantitative model indicates that the INR may be undervalued by 34.8%. Based on these considerations, we are revising our end-2006 USD/INR forecast to 43-43.5 from 44.5.

**Exhibit 16: In addition to fundamentals, for our positive call on INR to materialize, we also expect the RBI to slow its purchase of USD**

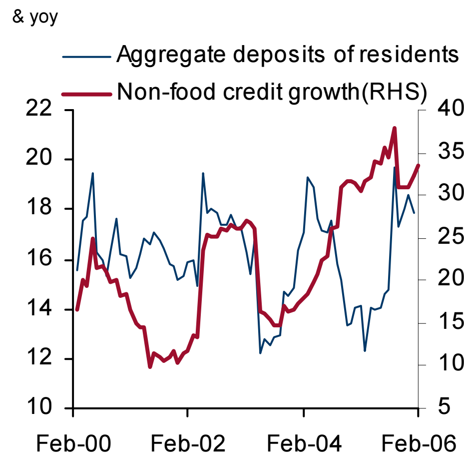



Source: Credit Suisse

## Limited signs of a credit bubble

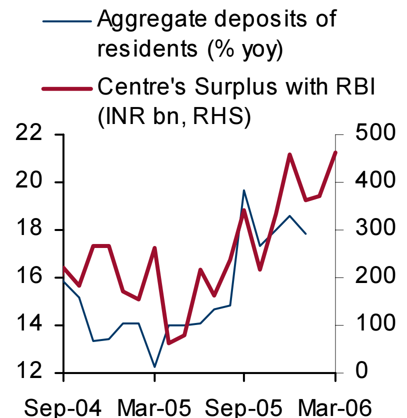
**In addition to consensus concerns on tightening of external liquidity conditions, the possible emergence of a credit bubble in the near term has also been highlighted.** We foresee limited risks of a credit bubble ensuing and dampening GDP growth in FY06/07. Some market participants have indicated that with credit conditions likely to tighten in the next 12-24 months, GDP growth may revert to the 6% yoy average experienced during the 2000-05 period versus the 7.5% consensus GDP growth forecast for FY05/06.

**Exhibit 17: Strong credit growth likely to continue. Partially …**




Source: CEIC, Credit Suisse

**Exhibit 18: … supported by some spending by the government**




Source: Ministry of Finance, CEIC, Credit Suisse

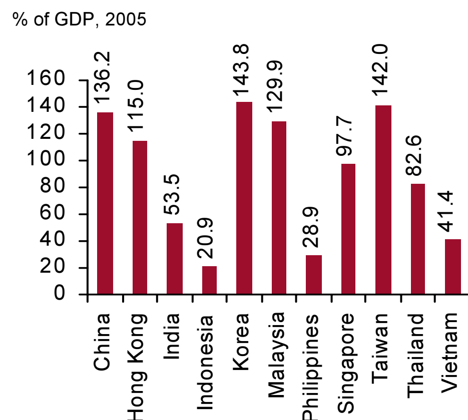
**Watch for policy announcements to ease domestic liquidity conditions.** Deposit growth of 19% yoy is currently lagging the strong non-food credit growth of around 33% yoy. However, we have noticed that the central government's cash surplus with the RBI was at a historical high of around INR 460.4bn on 24 March 2006 compared to INR 50bn at end-March 2005 (Exhibit 18). Around 80% of the central government's cash surplus is actually the state governments' cash surplus. State governments have been slow to spend on development projects and have also been very cautious in order to meet the twelfth finance commission's fiscal targets. We believe state governments may accelerate their pace of spending on development projects over the next one to three months and this may drive incremental deposits in the banking system up by around 5-10%. In addition, the ability of the central bank to pump in liquidity through the repo market and the strong pace of capital inflows imply that monetary conditions may not tighten massively and slow down the pace of credit growth and domestic demand.

**Another factor that could help to stimulate deposit growth may be that the current strength of GDP growth in the metropolitan areas may broaden to second-tier cities and rural areas over the next two years.** This may induce stronger income growth in second-tier cities and rural areas, where current nominal income growth may be in the 5-10% range compared to around 10-15% yoy in major cities. Second, bank penetration rates remain fairly low in rural India and financial intermediation is at an early stage of development. As a result, incremental deposit growth may emanate from second-tier cities and rural areas in the next few years.

**We expect further capital account liberalization by end-2006/early 2007 to help ease liquidity conditions. Watch for our forthcoming detailed report on prospective capital account liberalization measures.**

**Exhibit 19: On a regional basis, domestic credit to the private sector and …**

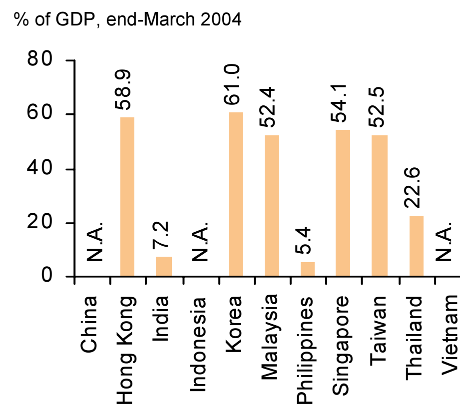
% of GDP, 2005




Source: CEIC, Credit Suisse

**Exhibit 20: … household credit are still low**

% of GDP, end-March 2004

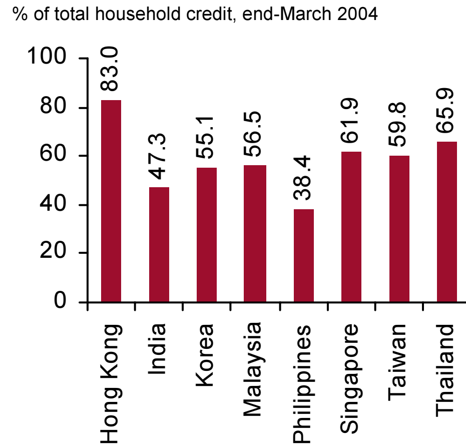



Source: IMF, Credit Suisse

**On a regional basis, financial intermediation in India is still at very low levels and delinquency rates are low.** Hence, our view that fiscal and monetary policy may help ease liquidity conditions implies that fears of an emerging credit bubble are a bit too bearish. From a supply-side perspective, India's domestic credit to the private sector as a percentage of GDP of 53.5% is far below the regional average of 94% (Exhibit 19). Similarly, other indicators such as the household credit to GDP ratio, mortgage loans to household credit ratio, and credit card debt to household credit ratio are also low in comparison to other Asian economies (Exhibits 20, 21, 22).

**Exhibit 21: Mortgage loans and …**

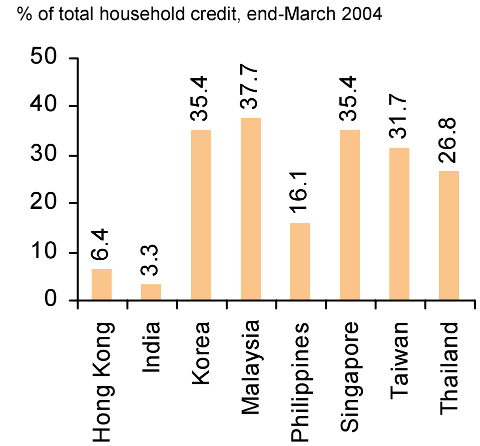
% of total household credit, end-March 2004




Source: IMF, Credit Suisse

**Exhibit 22: … credit card debt on a regional basis are also low**

% of total household credit, end-March 2004

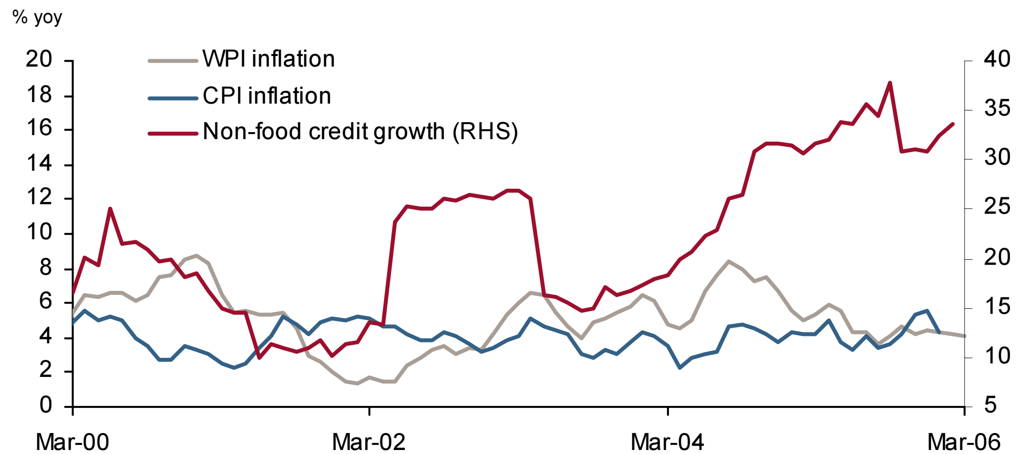



Source: IMF, Credit Suisse

**Non-performing loans stand at around 7% in India compared to around 11% in the rest of the region.** The central bank has already implemented numerous measures in the consumer and housing loan, commercial real estate, and capital markets to contain future risks. From a demand-side perspective, low effective interest rates of around 3.5-4.5% on home loans may lead to further increases in the demand for residential property. Anecdotally, we find that in major cities the home ownership rate is less than 13%, while in other areas it may be as low as 5-8%. Automobile ownership rates may be less than 10%. Property prices in even the most impoverished areas in the east and north-east are rising by 10-20% yoy, albeit at a lower rate compared to growth in major cities of around 30-40% yoy. Hence, low ownership rates in automobiles and homes, and the expectation that property prices may continue to accelerate imply that growth in demand for credit may continue to hover above 20% over the next one to two years.

**Exhibit 23: In spite of strong credit growth, inflation has remained well contained**

% yoy




Source: CEIC, Credit Suisse

**In spite of the strong pace of credit growth, various measures of inflation such as the WPI and CPI indicate well contained price pressures in the 4.5-5.5% yoy range (Exhibit 23).** This implies that strong credit growth has not been a major stimulant to price pressures and thus alleviates some concerns relating to overheating of the Indian economy. Fiscal and trade policy reforms in the form of lower taxes and import tariffs over the past few years may have acted as a counter-balancing force to strong credit growth fueling inflation. We expect these trends to continue in FY 2006/07. Import tariffs on manufactured goods may fall further as the government tries to match the low tariff environment in the rest of the region. Taxes on petroleum products may be reduced further at gasoline stations if the refinery price of fuel is raised. This may provide some cushion to upward pressure on inflation from a rise in the price of petroleum products. In addition, as we discussed above, external liquidity conditions are likely to improve in FY06/07. Meanwhile fiscal and monetary policies may be used to ease domestic liquidity conditions. As a result, we foresee overall price pressures to remain well contained. We are forecasting average WPI inflation of 4.8% in FY 2006/07 versus 4.5% in FY 2005/06. However, to prevent a liquidity crunch to ensue two to four quarters in the future on the back of strong credit and GDP growth, which may cause upside risks to inflation in FY07/08, we foresee the reverse-repo rate rising to 6.25% by end-FY06/07 versus the current 5.5%.

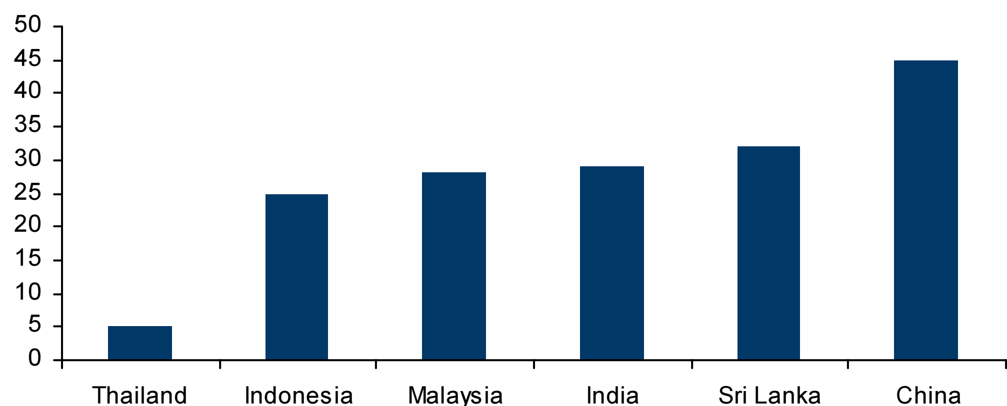
## Downside risks

**The main downside risks to our positive outlook on India are that oil prices rise at a faster rate than we are assuming currently, the state governments continue to underspend, and large portfolio flow reversals occur in the next 12 months.**

If the average WTI oil price exceeds our $62.5 per barrel assumption significantly, our current forecast of a 14% rise in fuel prices in FY06/07 in India may be too conservative. Note that India still has significant fuel subsidies in place (Exhibit 24). However, on a global basis India is not that large a consumer of oil (Exhibit 25). This may pose some downside risks to our aggressive GDP growth of 8.5% and benign inflation forecast of 4.8% for FY06/07.

**Exhibit 24: High oil price the main downside risk …**

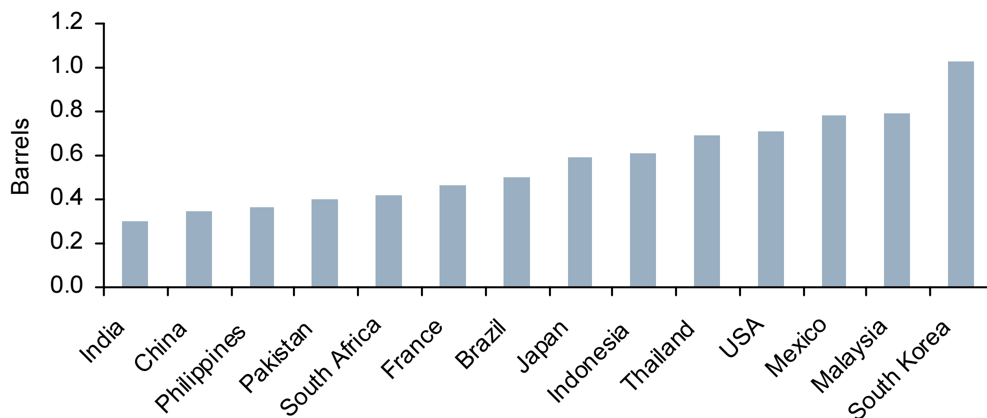
Price change required for full pass through of oil prices (%, estimated)




Source: IMF, Credit Suisse estimates

**Exhibit 25: … however, the impact may not be particularly bad as India is not that large a consumer of petroleum products**

Oil Consumed per $1,000 of GDP at PPP, 2003




Source: IMF, Credit Suisse

If state governments continue to underspend their allocated expenditure, this may lead to a tightening of liquidity conditions. As a result, upside risk to our reverse-repo rate forecast of 6.25% by end-FY06/07 and downside risk to our FY06/07 GDP growth forecast of 8.5% may emerge. Lastly, if a large fall in global equity markets arises in FY06/07, this may lead to a fall in portfolio flows to India. Under this scenario, our 2006 balance of payments surplus forecast of $21.6 bn may be too aggressive. In addition, our USD/INR forecast of 43-43.5 may also be too optimistic.

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