INDIA: Growth risk and policy space

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Agenda

- Global Recession
- Why India got hit
- How the adjustment might look
- Growth risks
- Policy space
## Recession goes global

<table>
<thead>
<tr>
<th>Global Real GDP</th>
<th>% over year ago</th>
<th>% over previous period, saar</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2009</td>
</tr>
<tr>
<td>United States</td>
<td>1.3</td>
<td>-1.8</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.4</td>
<td>-5.7</td>
</tr>
<tr>
<td>Euro area</td>
<td>0.8</td>
<td>-2.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0.7</td>
<td>-2.9</td>
</tr>
<tr>
<td>Asia ex. Japan</td>
<td>6.0</td>
<td>3.4</td>
</tr>
<tr>
<td>China</td>
<td>9.0</td>
<td>7.2</td>
</tr>
<tr>
<td>India</td>
<td>6.2</td>
<td>5.5</td>
</tr>
<tr>
<td>Latin America</td>
<td>4.1</td>
<td>-0.4</td>
</tr>
<tr>
<td>Emerging Europe</td>
<td>4.6</td>
<td>-1.1</td>
</tr>
<tr>
<td>Global</td>
<td>1.7</td>
<td>-1.7</td>
</tr>
<tr>
<td>Developed markets</td>
<td>0.8</td>
<td>-2.6</td>
</tr>
<tr>
<td>Emerging markets</td>
<td>5.2</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Source: JP Morgan Datawatch January 31, 2009
Global downturn deep but short-lived; at least for now!

Source: J.P. Morgan economics. Chart shows real GDP growth QoQ saar. Shaded area forecasts.
Why India got hit?

TED Spread and India Call Money Rate

TED (LHS)
Call money (RHS)
Sudden stop in external financing: part coincidental, part structural

- Dependence of corporates and banks on external funds
- Dependence of non-bank financials (NBFCs) and mutual funds (MFs) on domestic money market and corporate investments
- Dependence of SMEs, real-estate, and consumers on NBFCs and MFs
- Segmented domestic financial market—regarded as a buffer to shocks—became a key vulnerability, exacerbating price volatility
Decoupling anyone? external openness has increased sharply

India's trade openness has doubled since the early 2000s
% of GDP

India's capital account openness has quadrupled since the early 2000s
% of GDP

Growth has been increasingly correlated to global conditions
%q/q, saar

Partner country wtg avg growth
India

J.P.Morgan
How the adjustment might look: a V-shaped recovery still likely ...

**GDP: expenditure-side details**
% y/y, fiscal year beginning April 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Private cons</th>
<th>Government spending</th>
<th>Investment</th>
<th>Exports</th>
<th>Imports</th>
<th>GDP</th>
<th>Inflation</th>
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<tbody>
<tr>
<td>2001-02</td>
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<td>8.5</td>
<td>12.1</td>
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<td>2009-10f</td>
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<td>4.8</td>
<td>3.7</td>
<td>3.4</td>
<td>5.5</td>
<td>0.7</td>
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<tr>
<td>2010-11f</td>
<td>6.5</td>
<td>9.0</td>
<td>14.0</td>
<td>15.0</td>
<td>19.0</td>
<td>7.7</td>
<td>3.1</td>
</tr>
</tbody>
</table>

**Non-farm GDP growth**
% point change from T-3

Average of past downturns

Projected current
... on investment dynamics
Inflation to fall and stay low

[Graph showing manufacturing inflation and its components over time, with a focus on raw material, energy, and manufacturing price indices.]

[Graph showing inflation rate changes from T-3 to T+3, with a projected current trend and average of past downturns highlighted.]
Q4 BOP carnage unlikely to be repeated; CA to take over INR dynamics

Capital inflows excluding trade balance, FDI, FII portfolio, and ECB

US$ billion

Change in balance of payments

% of GDP

Capital account
Current account
Credit growth to slow appreciably

Credit has slowed compared to deposit growth as % of Deposits

Real non-food credit growth
% point change from T-3

Average of past downturns

Projected current
GOI yields to fall; corporate bond could be a pleasant surprise

**10-year GOI bond yield**

- Jan-08: 8%
- Mar-08: 8%
- May-08: 8%
- Jul-08: 9%
- Sep-08: 8%
- Nov-08: 7%
- Jan-09: 6%

**Long term corporate bond yields have softened**

- % difference from GOI bond yield
- 1-Y commercial paper
- 5-Y corporate bond

Jan-08: 2%
Feb-08: 2%
Mar-08: 2%
Apr-08: 2%
May-08: 2%
Jun-08: 2%
Jul-08: 2%
Aug-08: 2%
Sep-08: 2%
Oct-08: 2%
Nov-08: 2%
Dec-08: 2%
Jan-09: 2%
Growth risks: protracted global recession

GDP and industrial production

Transportation indicators confirm the slowdown

As do demand indicators

And bank credit growth

J.P. Morgan
Slow price adjustment: rentals and interest rates

### Real interest rate

- **% point change from T-3**
- **Current (based on expected inflation)**
- **Average of past downturns**

### Growth-Interest rate differential

- **Average investment growth**
- **Growth-interest rate gap**
- **Current expected growth-interest gap**

#### Time Periods

- **1980-91**
- **1993-2001**
- **2003-08**
Other risks:

- **Will banks lend?** Bank debt restructuring and RBI forbearance important

- **Who will bear the risk?** Expecting banks to take all the risk unreasonable and unwise. Corp bond market needs to be supportive

- **Coming elections:** overplayed; but monetary policy only effective lever until new gov forms

- **Security concerns:** so far restricted to tourism
Policy Space: rate cuts and more

Undertaken

- Repo rate cut from 9% to 5.5%
- Reverse repo cut from 6% to 4%
- Cash reserve ratio (CRR) cut from 9% to 5%
- Statutory liquidity ratio (SLR) cut
  - 100bp permanently
  - 100bp for 90 days
  - 150bp for loans to NBFC & MFs
- Dollar-swap arrangements with banks
- Extension of forbearance: Lower risk weight, lower provisioning, easier loan classification
- Special refinance for NBFCs, MFs, real-estate and SMEs
- Easier export credit terms

Expected

- Repo rate cut another 100-150bp by April
- Reverse repo another 100bp by April
- CRR cut 100bp by April
- SLR not binding at present, cut only if needed
- More forbearance: needed to encourage debt restructuring
- More refinance facilities for specific sectors
Monetary policy transmission weak but still effective

RBI's Discount Window Operations

Money market and policy rates

Monetary conditions and industrial growth

J.P. Morgan
Fiscal policy: more space than meets the eye

**Undertaken**
- October: 3.3% of GDP
  - 1.9% of GDP in cash
  - 1.4% of GDP in bonds
- December: 0.5-0.7% of GDP
  - Expenditure 0.4% of GDP
  - Tax cuts of 0.15% of GDP
  - Support for export, textile, housing, SME
  - Cuts in retail gasoline price
- January: 1.5-1.8% of GDP (budget + other)
  - Infrastructure refinancing Rs 400bn
  - SPV for NBFCs worth Rs 250bn
  - State borrowing Rs 300bn
- Central government deficit could rise to 6.5% of GDP from 3.7% of GDP last year
- Borrowing in Q1 09 Rs1.1tn (3% of deposit)
- Window for more support closed for FY09

**Expected**
- FY10 budget deficit 6.2-6.5% of GDP
- Less oil and fertilizer subsidy opens up 1.5-2% of GDP space
- Debt high (82% of GDP by FY09), but so are assets; divesting when cash strapped typically weakens political opposition
- Lower GOI interest rates will help stabilize debt dynamics
- Fears of crowding out overplayed in H1 FY10, concern in H2 FY10
- FRBM-II likely in FY10
- Consolidation not before FY11
- Divestment important to balance stimulus with sustainable debt
Capital controls: time for regime change

**Undertaken**

- Cap on ECB interest removed but approval still needed
- ECB extended to NBFCs to refinance infra loans
- Cap on NRI deposit raised
- FII limit on corporate bond raised to $15bn from $6bn

**Expected**

- Gradual removal of NRI deposit cap
- Gradual removal of FII limit in corporate bonds
- Some increase in FII limit in GOI bonds (likely with SLR reduction)
- Gradual removal of sector restrictions for VC and PE
- Move towards QFI from FII regime