



Financial Markets & Banking Update —Vol. 3: FY2011-12

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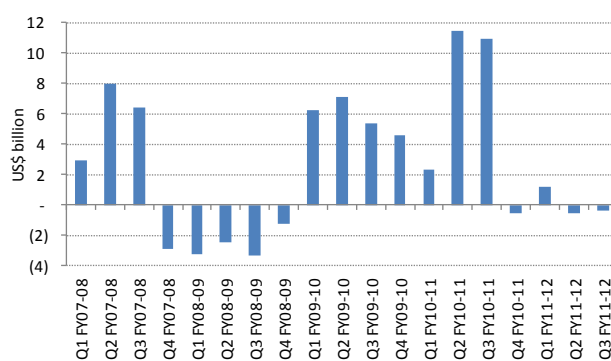
Highlights during quarter ended December 2011

- Sharp rise in Foreign Institutional Investors (FIIs) inflows backed by FII debt investments; FII equity flows remain marginally negative.
- Inflows from Foreign Direct Investment (FDI) moderate in Q2FY12 and Oct-Nov 2011 after a spike in Q1FY12; however, FDI inflows in April-Nov FY12 exceed inflows for the previous financial year.
- Inflows from External Commercial Borrowings (ECBs) remain strong. Flows may moderate going forward on account of increasing risk aversion. Volume of inflows from Foreign Currency Convertible Bonds (FCCBs) remains insignificant.
- Repo rate increase of 25 basis points (bps) instituted by the Reserve Bank of India (RBI) in October 2011, followed by a pause in monetary tightening in December 2011.
- Headline inflation eases in December 2011 led by a favourable base effect. Although inflation related to non-food manufactured products eases in December 2011, a sequential rise of 0.5% in the index level indicates inflationary pressures persist.
- Consumption and investment growth decline in Q2FY12; economic growth expected to moderate to 6.8-7.0% in FY12 from 8.5% in FY11.
- Credit growth slows to 16% in December 2011, lower than RBI's projected levels of 18%.
- Systemic liquidity tightens despite a moderation in year-on-year (y-o-y) credit growth, strong deposit growth and open market purchases of bonds carried out by the Central Bank; substantial planned Government borrowings may keep liquidity tight in Q4FY12.
- Corporate bond issuance remains steady boosted by Non-Bank Finance Companies (NBFCs).
- Short term Corporate bond spreads widen whilst remaining volatile; yields on longer maturities soften.

Equity flows remains marginally negative in Q3FY12

The net quarterly equity inflows from Foreign Institutional Investors (FIIs) remained negative in Q3FY12 as a result of global uncertainties. The benchmark NIFTY index declined 13.2% in Q3FY12 and 20.7% since March 2011, a weaker performance as compared to other markets during this period. According to data released by the Securities and Exchange Board of India (SEBI), the net equity FII outflow in Q3FY12 was US\$0.4 billion, as compared to an outflow of US\$0.6 billion in Q2FY12 and an inflow of US\$11.0 billion in Q3FY11. Gross FII inflows remained low in November and December 2011 despite Rupee depreciation of almost 9% (to Rs. 53.27/US\$ on December 31, 2011 from Rs. 48.93/US\$ on September 29, 2011). For the nine-months ended December 2011, the magnitude of equity inflows was marginally positive at US\$0.15 billion compared to US\$24.81 inflow during the same period of the previous fiscal.

Chart 1: Net Quarterly FII Equity Inflows



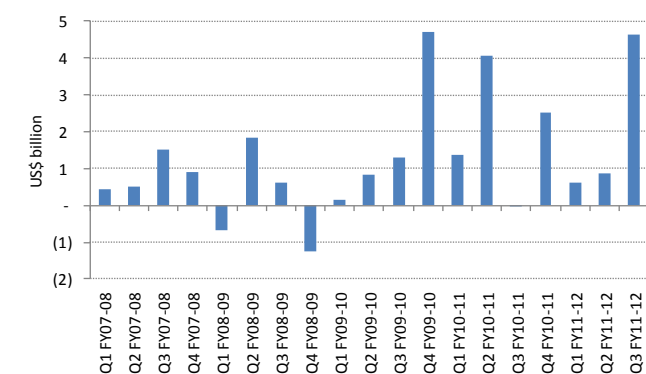
Source: SEBI

Debt inflows improves sharply in Q3FY12 aided by higher yields and regulatory relaxations

FII inflows into the debt market increased sharply to US\$4.65 billion in Q3FY12 from US\$0.87 billion in Q2FY12 and an outflow of US\$0.02 billion in Q3FY11. This was led by the attractive prevailing yields, notwithstanding a moderation of yields for Government securities (G-sec) in December 2011, which was related to the open market purchases of bonds carried out by the RBI.

SEBI revised the FII ceiling for investment in G-sec upwards by US\$5 billion in November 2011 as that the earlier ceiling had been fully utilised, even as the borrowing programme of Gol for H2FY12 remained considerable. As on December 30, 2011, FIIs had utilised 79%¹ of the enhanced limit of US\$15 billion limit for investment in Government Securities. Gol had initially budgeted for a gross borrowing programme of Rs. 417,128 crore for FY12, while the announced

Chart 2: Net Quarterly FII Debt Inflows



Source: SEBI

borrowings have been revised upward in two tranches to Rs. 510,000 crore. While Rs. 394,000 crore had been raised in April-December 2011, Gol's remaining borrowing programme for Q4FY12 was significant at Rs. 116,000 crore. Accordingly, another round of hike in the FII debt ceiling cannot be ruled out.

The limit on FII investment in Indian Corporate bonds was also increased by US\$5 billion to US\$45 billion in November 2011 with a sub-limit of US\$20 billion in Corporate bonds (including Debt-oriented Mutual Funds), and the remaining US\$25 billion in infrastructure companies and debt funds. Subsequently, given the moderate FII interest in long term papers, the initial lock-in period of 3 years was reduced to 1 year, but subject to the overall bond maturity of at least 5 years. The utilisation levels in Corporate bonds increased sharply to 72% as on December 30, 2011 from 40% as on September 30, 2011 mainly backed by investments in bonds issued by infrastructure companies following the reduction in lock in period. The utilisation levels in Corporate bonds continue to remain moderate compared to G-Sec, with an overall utilisation level of 38% as on December 30, 2011. However, within the overall limit, investors preferred short term investments (72%) over Infrastructure debt funds (7%) with lock-in period of 1-3 years. SEBI's decision to remove the reinvestment facility² of Corporate debt limits is expected to reduce the volatility in the bond markets due to FII actions and also pave way for guidelines to get long term FIIs to invest in Indian debt capital markets. The

¹ As per data as on Dec-11 published by SEBI

² As per SEBI circular dated January 3, 2012

regulations could prompt FIIs to hold their investments over a longer horizon provided they are able to lock-in attractive yields, given the acquisition cost while bidding for the fresh investment limits. In any case, we expect the flows to remain buoyant in the short term as the FIIs reinvest their limits before the new regulations come into force.

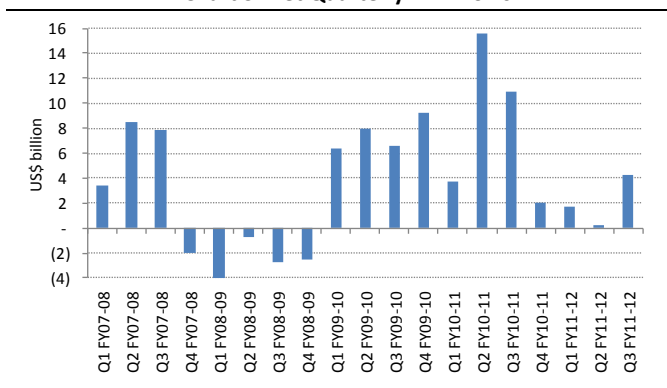
The outlook for FII flows into domestic debt markets remains favourable given the benign global interest rates while yields on domestic treasury bills, G-sec and Corporate bonds are expected to remain attractive in the near-to-medium term, particularly given the reduction in the sovereign risk perception following the unification of the long term foreign currency and local currency ratings (previously Ba1 positive) of the bonds of Government of India at Baa3 and the upgrade of its local currency short-term rating to P-3 from NP by Moody's Investor Services in December 2011. At the same time, efforts continue to be made by the GoI and the regulators to improve the Corporate bond market by gradually removing the bottlenecks would aid in improved debt flows over a period of time.

Total FII flows supported by higher debt flows

Despite the moderate net equity outflows, the sharp rise in debt inflows in Q3FY12 led to an increase in total FII inflows to US\$4.24 billion from US\$0.28 billion in Q2FY12. However, total FII investments in Indian markets were significantly lower than the level of US\$10.96 billion in Q3FY11.

In the absence of a credible and lasting solution to the sovereign debt crisis in Europe, risk aversion is likely to remain high. However, most Advanced Economies are likely to report sluggish economic growth in the coming fiscal, particularly as several may attempt greater fiscal tightening prompted by the recent downgrades of sovereign debt. Although the Indian economy is expected to expand at a slower pace in FY12 and FY13 relative to the 8.5% recorded in FY11, the pace of growth is likely to sharply exceed growth in the Advanced Economies. The attractive returns, at least in the debt market in the near term, could ensure that FII debt flows are strong in the next 1-2 quarters.

Chart 3: Net Quarterly FII Inflows

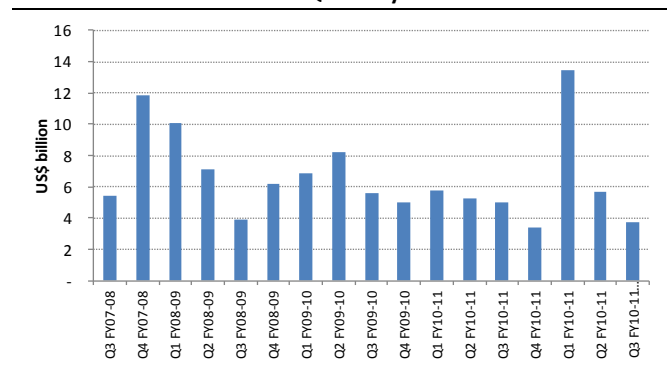


Source: SEBI

Moderation in FDI flows in post Aug-11

After strong inflows in Q1FY12, FDI inflows in Q2FY12 and October-November 2011 moderated to US\$5.70 billion and US\$3.7 billion, respectively. The cumulative inflows in the months of April to November in 2011 at US\$22.8 billion were a sharp 63% higher than the US\$14.0 billion during the same months in 2010 and exceeded the total inflows in FY11. While Mauritius (34%) and Singapore (16%) remained the top source of FDI inflows up to October 2011, the share of inflows from U.K. and Japan increased in the current fiscal to 13% (US\$2.6 billion) and 9% (US\$1.8 billion), respectively, while the share of inflows from USA fell sharply to 3%. Apart from services (18% of total FDI inflows in YTD October 2011), pharma (15%) and telecom (10%) were the other industries which attracted significant foreign investments. While the FDI inflows in Q1FY12 might have been driven by certain lumpy inflows, partly related to the US\$7.2 billion deal between

Chart 4: Net Quarterly FDI Inflows



* Data for Q3FY12 is only upto Nov-11

Source: Ministry of Commerce and Industry

British Petroleum and Reliance Industries Limited, the moderation in economic growth, policy related issues and the slowdown in investments may result in a delay/deferral of some FDI proposals going forward.

Slight moderation in ECB inflows after strong H1FY12; FCCB flows remain modest

Gross inflows through External Commercial Borrowings (ECBs) in the current fiscal remained buoyant at US\$21.5 billion up to November 2011, the highest in the corresponding period in at least the past five years, reflecting the high domestic borrowing cost as well as measures undertaken by the RBI to encourage ECB inflows. Nevertheless, ECB inflows have moderated to an extent after July 2011. Gross inflows of Foreign Currency Convertible Bonds (FCCBs) remained modest at US\$837 million in FY12 up to November 2011, as compared to US\$1.07 billion in April-November 2011.

Chart 5: Gross Quarterly ECB Inflows

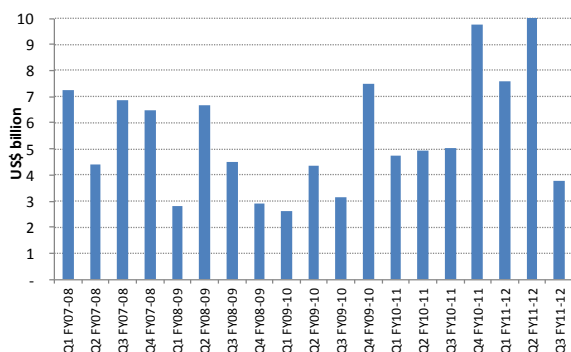
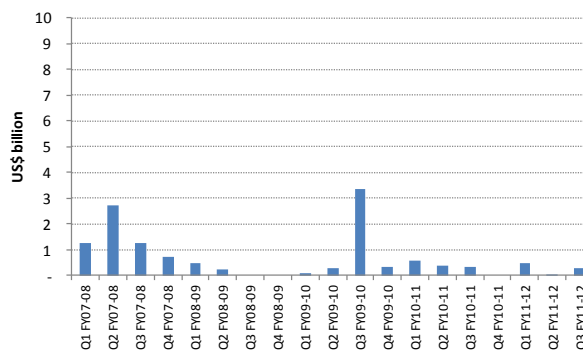


Chart 6: Gross Quarterly FCCB Inflows



* Data for Q3FY12 is up to Nov-11
Source: RBI

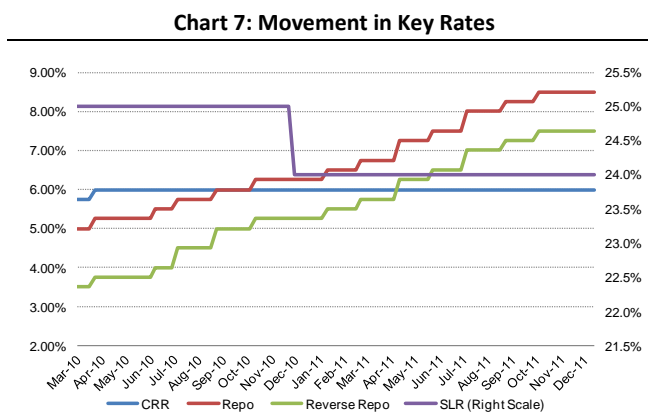
As part of the RBI’s efforts to liberalise the ECB route to raise overseas funds, the RBI enhanced the all-in-cost ceiling by 50 bps for ECBs with average maturities of 3-5 years to LIBOR+350 bps. Further, several changes were introduced in recent quarters to encourage inflow of funds through ECB route, such as an increase in the automatic approval limit to US\$750 million from US\$ 500 million each year and permission to raise yuan-denominated debt up to US\$ 1 billion.

Several large issuances of ECBs were made in April-November 2011, primarily for purchase of capital goods, refinance of rupee loans, onward lending by financial institutions and new projects in power, telecom, roads and port sectors. The major issuers during September-November 2011 included several public sector entities such as Hindustan Petroleum Corporation Limited (US\$465 million), ONGC Mangalore Petrochem Limited (US\$250 million) and Indian Railways Finance Corporation Limited (US\$200 million). The large private sectors issuers included Bhushan Power and Steel Limited (US\$449 million), Reliance Power Limited (US\$300 million), Mundra Port & Special Economic Zone Limited (US\$238 million), Tata Teleservices Limited (US\$200 million) and Infrastructure Development Finance Company Limited (US\$200 million).

With domestic interest rates expected to remain high in relation to Advanced Economies, which are persisting with easy monetary policies, Indian Corporates are likely to continue to tap the ECB route in the near term to take advantage of the interest rate differential. However, premiums for currency forward contracts have increased significantly owing to the recent volatility in the exchange rate of the rupee relative to various currencies, which could increase the all-in-cost of ECBs on a fully hedged basis. Moreover, the availability of funds from European lenders, as well as their risk appetite, is expected to diminish in the wake of the ongoing uncertainties in the Euro area. FCCB flows are likely to remain volatile and dependent on equity capital markets over the next few quarters.

Repo rate hiked by 25 bps in October 2011 followed by a pause in December 2011; systemic liquidity tightens

The RBI hiked the benchmark Repo rate by 25 bps in October 2011, the thirteenth hike since March 2010. Subsequently, the Central Bank kept the Repo rate unchanged at 8.50% in its recent policy review in December 2011, in line with ICRA’s expectations, and signalled a peaking of the interest rate cycle. Banks continue to hold their base lending rates at elevated levels, which in conjunction with the moderating investment and consumption growth, has impacted the pace of growth of credit off-take in the recent months. In y-o-y terms, non-food credit growth slowed to 15.8% on December 30, 2011 from 21.2% on September 30, 2011, lower than RBI’s indicative projection of 18%.

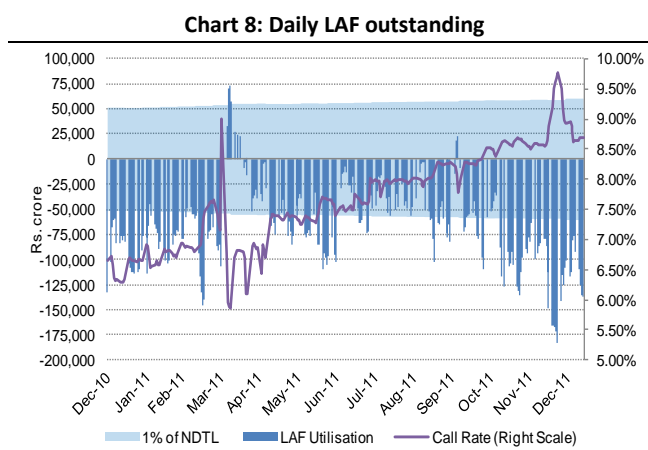


Source: RBI

While inflation and inflationary expectations remain above the RBI’s comfort zone, the moderating economic growth prompted the RBI to issue a guidance that further rate hikes may not be warranted and that subsequent monetary policy actions are likely to ease the policy rate. In ICRA’s view, while the interest rate cycle has peaked, the RBI is unlikely to loosen its monetary policy in the immediate term. With inflation related to non-food manufactured products remaining elevated (at 7.7% in December 2011), the RBI is expected to leave the Repo rate and the Cash Reserve Ratio (CRR) unchanged in the upcoming policy review, despite the marginal 1% growth of the Index of Industrial Production (IIP) in Sept-Nov 2011.

Systemic liquidity tightened towards the end of Q3FY12 on account of various factors. The magnitude of market borrowings undertaken by Gol in that quarter (Rs. 144,000 crore) exceeded the levels in Q1FY12 (Rs. 120,000 crore) and Q2FY12 (Rs. 130,000 crore). In addition, while advance tax payments created temporary stress in mid-December 2011, a slower pace of Government expenditure added to the strain on liquidity. Moreover, the sale of foreign currency assets by the RBI to stabilise the value of the rupee drained the rupee liquidity in the system. Liquidity conditions remained tight despite the purchase of over Rs. 41,200 crore of securities by the RBI through open market operations (OMOs) in November-December 2011 in order to infuse liquidity.

Reflecting these factors, the average borrowings under the Liquidity Adjustment Facility (LAF) increased to around Rs. 101,000 crore in November-December 2011, substantially exceeding the RBI’s stated comfort zone of +/-1% of NDTL (~ Rs. 60,000 crore) in those months. Banks’ excess SLR levels dropped to Rs. 2.4 lakh-crore as on December 30, 2011 from nearly Rs. 3 lakh-crore in October 2011. Since its introduction in May 2011, the Marginal Standing Facility (MSF) had been utilized on only one day each in June 2011 (Rs. 100 crore) and July 2011 (Rs. 4,105 crore). This facility was utilized on six different occasions in December 2011, for an average amount of Rs. 3,258 crore, highlighting the prevailing liquidity tightness. Despite the usage of this facility, the inter-bank call rates, which had hovered close to the Repo rate in the recent months, increased to more than 9.5% (the prevailing MSF rate) in the second half of December 2011.



Note: Negative amounts indicate injection of liquidity by RBI

Source: RBI

Although credit growth has moderated in the recent months, the substantial remaining market borrowing programme of GoI may strain systemic liquidity in Q4FY12. However, a faster pace of Government expenditure growth may ease the liquidity situation somewhat. Additionally, it is unclear at what level the rupee would settle in the near term given the uncertainties regarding the European sovereign debt crisis and associated levels of risk aversion; the price of petroleum imports following the geo-political tensions regarding Iranian crude oil; the substantial current account deficit; as well as the positive impact of various measures undertaken by the RBI including freeing the interest rates on NRI deposits. Nevertheless, the recent appreciation of the rupee has diminished the requirement for further sales of foreign exchange assets by the RBI.

ICRA expects the RBI to announce further open market purchases of G-sec of around Rs. 40,000-50,000 crore (although the amount accepted by the RBI is likely to be lower) in various tranches in the balance portion of Q4FY12³ to infuse liquidity, bring LAF utilisation within the stated comfort zone and ensure availability of funds for economic growth. Moreover, ICRA does not anticipate that the RBI would employ a CRR cut in the near term to infuse liquidity, as the same may weaken its focus on inflation management and hamper the credibility of its communications strategy.

Headline inflation eases to a 24-month low in December 2011, benefitting from favourable base effect

Headline wholesale price index (WPI) inflation eased for the third consecutive month to 7.5% in December 2011 as compared to 10% in September 2011, 9.9% in October 2011 and 9.1% in November 2011, nevertheless remaining in excess of the RBI's comfort zone. The decline in WPI inflation in December 2011 was led by a sharp slowdown in primary food inflation to 0.7% in December 2011 from 8.5% in November 2011. This was led by a 34.2% decline in vegetable prices in y-o-y terms in December 2011, which was aided by a favourable base effect as well as a cooling of prices subsequent to the harvest. Moreover, there was a mild easing of inflation related to cereals (to 1.9% in December 2011 from 2.4% in November 2011) and pulses (to 13.6% in December 2011 from 13.9% in November 2011). However, inflation related to non-vegetarian protein items and milk remained largely unchanged at 11.9% and 11.0%, respectively, in December 2011. Prices of non-vegetarian protein items are likely to continue to impart a structural rigidity to food inflation given changing consumption patterns and an unlikely short-term supply response.

The rate of inflation related to non-food manufactured products declined somewhat on a y-o-y basis to 7.7% in December 2011 from 8.1% in October 2011 and 8.0% in November 2011. Nevertheless, it remained elevated, indicating that demand-side pressures are yet to abate. The index levels for textiles and paper & paper products declined by around 0.3% each on a month-on-month (m-o-m) basis. However, the index levels increased or remained unchanged for nine of the 11 sub-groups of non-food manufactured products on an m-o-m basis in Dec 2011, highlighting the persistence of inflationary pressures, partly related to the depreciation of the Indian rupee.

Fuel inflation eased to 14.9% in December 2011 from 15.5% in November 2011, led by various non-administered items including petrol, naphtha, ATF etc. Nevertheless, the index level rose on an m-o-m basis (to 172.6 in December 2011 from 171.6 in November 2011). Moreover, higher crude oil prices following the ongoing geopolitical concerns may exacerbate fuel inflation in the coming months.

Y-o-y inflation related to minerals accelerated (to 21.9% in December 2011 from 18.0% in November 2011), as the index level rose substantially on a sequential basis (to 318.5 in December 2011 from 310.5 in November 2011), highlighting the adjustment of prices following the depreciation of the Indian rupee.

³ In the current fiscal year, the RBI has completed purchases of over Rs. 61,400 crore as on 13th January, 2012 and announced another round of OMO of Rs. 12,000 crore on 20th January 2012

Chart 9: WPI Inflation (y-o-y, Monthly)

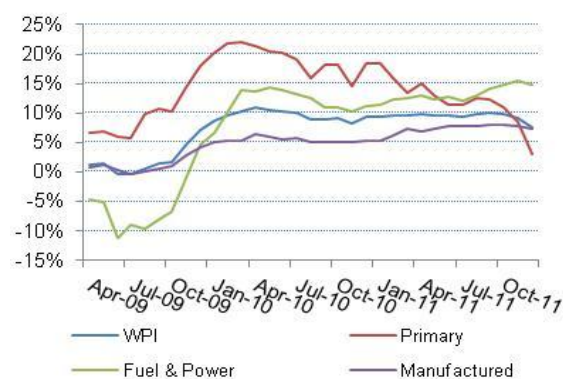


Chart 10: Food Inflation (y-o-y, Weekly)



Source: Office of the Economic Advisor, Ministry of Commerce and Industry, Government of India

The initial estimates of WPI inflation were revised upwards in both September 2011 (0.28%) and October 2011 (0.14%), led by a correction in the price levels for minerals and non-food manufactured products. ICRA expects WPI inflation for November 2011 to be revised upwards as well, led by an anticipated revision in the minerals index. Nevertheless, ICRA continues to expect headline inflation to ease to around 7% by March 2012, following an anticipated moderation in demand-side pressures in line with the slowing economic growth. However, a reversal in the recent appreciation of the rupee may exacerbate prices of imported commodities and inputs, fuelling inflationary pressures. Food inflation is expected to remain below 1% in January 2012, given the base effect, before rising to around 6-6.5% in March 2012.

GDP growth eases to 6.9% in Q2FY12; muted 0.5% IIP growth for Oct-Nov 2011 indicates continuing sluggishness in business confidence and economic activity

The growth of gross domestic product (GDP) at factor cost (constant prices) moderated to 6.9% in y-o-y terms in Q2FY12 from 8.4% in Q2FY11. Industrial growth slowed significantly led by manufacturing (2.7% in Q2FY12, 7.8% in Q2FY11) and construction (4.3% in Q2FY12, 6.7% in Q2FY11) as well as a 2.9% contraction in mining & quarrying output. However, the pace of growth of the electricity, gas & water supply sub-sector improved considerably to 9.8% in Q2FY12 from 2.8% in Q2FY11. Despite the healthy monsoon rainfall, growth of the agricultural sector eased to 3.2% in Q2FY12 from 5.4% in Q2FY11, reflecting the base effect. Growth of the services sector eased mildly to 9.3% in Q2FY12 from 9.6% in Q2FY11.

Table 1: Growth of GDP & Components (in %, constant 2004-05 prices, y-o-y)

	Q2 2010-11	Q2 2011-12
Agriculture & Allied	5.4%	3.2%
Industry	7.1%	3.2%
Services	9.6%	9.3%
GDP at factor cost	8.4%	6.9%
PFCE	9.0%	5.9%
GFCE	6.4%	4.0%
GFCF	10.3%	-0.6%
Exports less Imports	10.5%	27.4%
GDP at market prices	8.6%	6.7%

Source: Central Statistics Office (CSO), ICRA Estimates

Growth of GDP at market prices (at constant 2004-05 prices), reflecting demand-side factors, slowed to 6.7% in Q2FY12 from 8.6% in Q2FY11. In a worrying trend, gross fixed capital formation displayed a de-growth of 0.6% in Q2FY12, as compared to an expansion of 10.3% in Q2FY11. The investment scenario has deteriorated, reflecting dampened business confidence, policy related issues and the cumulative impact of rising interest rates, which have resulted in a slowdown in execution of planned projects as well as new projects announcements. Moreover, issues related to availability of inputs have resulted in a delay in the pace of capacity addition in certain sectors, for instance thermal and gas-based power plants. Additionally, the pace of growth of both private final consumption expenditure (PFCE) and government final consumption expenditure (GFCE) moderated in Q2FY12 relative to Q2FY11. During Q2FY12, GDP at market prices expanded at a pace of 6.7% relative to the 6.9% growth of GDP at factor cost, with indirect taxes less subsidies expanding by 5.2%. The low growth of the latter is likely to partly reflect the

changes in the duty structure for crude oil and petroleum products introduced by GoI in June 2011 as well as the refunds of direct taxes.

The IIP recorded a de-growth of 4.7% in October 2011 followed by an expansion of 5.9% in November 2011. This rebound was led by an easing of the adverse base effect (11.3% in October 2010, 6.4% in November 2010) and a number of temporary factors had dampened output in October 2011 (including a considerable number of holidays on account of the festive season, the Telangana agitation, and strikes in certain coal-mining regions) and is unlikely to sustain in the coming months. In ICRA's view, the average growth recorded in October-November 2011 provides a more meaningful representation of the growth trends. On average, IIP growth declined to 0.5% in October-November 2011 from 3.0% in Q2FY12, led by a weaker performance of all use-based categories except consumer non-durables. The contraction in capital goods worsened to 16.2% in Oct-Nov 2011 from 5.8% in Q1FY12. Although this partly reflects an adverse base effect (with a robust 22% growth in Q3FY12), it nevertheless highlights the prevailing sluggish investment demand conditions. Intermediate goods contracted by 3.9% in Oct-Nov 2011 after recording a marginal 0.1% growth in Q2FY12. The pace of growth moderated in Oct-Nov 2011 as compared to Q1FY12 for basic goods (to 3.8% from 6.6%) and consumer durables (to 5.3% from 8.0%). In contrast, the pace of growth of consumer non-durables improved to 7.8% in Oct-Nov 2011 from 1.1% in Q2FY11, which may reflect healthy rural incomes and demand following the *kharif* harvest.

The performance of the mining & quarrying sub-sector worsened in October-November 2011, with a de-growth of 5.2% relative to the same months in 2010. This partly reflected strikes in various coal mining areas and late withdrawal of the monsoon rainfall in October 2011. In addition, various other factors have dampened output during 2011-12, such as low output of natural gas from the Krishna-Godavari basin and restrictions placed by the Supreme Court on mining of iron ore in Karnataka. The growth outlook for this sector remains bleak given various regulatory and environmental issues that have faced the sector in recent months. The impaired mining activity in recent months has also impacted the pace of growth of other sectors in the economy.

Chart 11: Growth of IIP & Sub-Sectors (y-o-y)

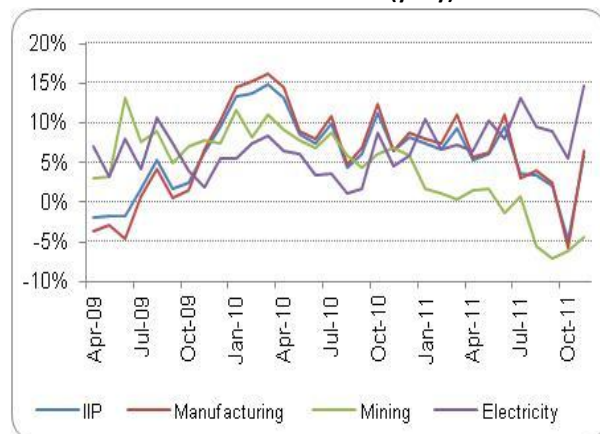
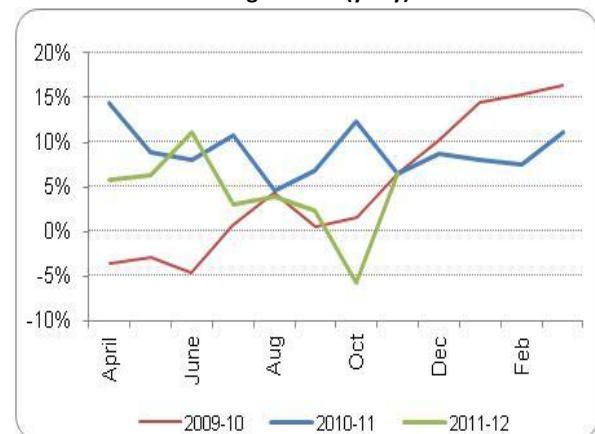


Chart 12: Manufacturing Growth (y-o-y)



Source: CSO

Provisional data released by Government of India (GoI) indicates that the volume of merchandise exports rose by 25.8% on a y-o-y basis to reach US\$ 217.6 billion in April-December 2011, led by engineering goods, petroleum products, gems & jewellery, drugs & pharmaceuticals and electronics; and aided by a diversification strategy to less-established trading partners in Latin America, Asia and Africa. However, the pace of growth has declined to single digits in November and December 2011. Moreover, the volume of exports has eased in absolute terms, from around US\$ 26.7 billion in July 2011 to around US\$ 22.3 billion in November 2011, before rising to US\$ 25 billion in December 2011. Although the rupee has appreciated in January 2012 relative to the levels in mid-December 2011 (Rs. 54.24 to a US\$ on December 15, 2011), it remains one of the worst performing Asian currencies since August 2011. While this may help Indian exporters improve their market share going forward, the deepening of the sovereign debt crisis in Europe, which remains an important trading partner, and the likely fiscal tightening by European Governments going forward, would limit the demand for

Indian exports. ICRA expects merchandise exports to rise to around US\$ 285 billion in 2011-12, falling short of the target of US\$300 billion set by Gol for 2011-12.

ICRA expects economic growth to moderate in the second half of the current fiscal from the 7.3% growth recorded in H1FY12, given the unfavourable trends regarding manufacturing and mining growth. Additionally, available data regarding sowing trends for the *rabi* season indicates that the shortfall in the area sown under pulses, oilseeds and coarse cereals is not offset by the higher area covered under wheat and rice as on January 6, 2012 relative to 2011. Moreover, poor precipitation over substantial parts of southern India may cause damage to other crops as well, thereby impacting rural incomes and demand in certain areas. The services sector is broadly expected to support economic growth. Overall, ICRA expects growth to moderate from 8.5% in FY11 to 6.8-7.0% in FY12.

Given the slowdown in concrete announcements of fresh projects and capacity enhancement in the recent months and the likely delay in commissioning of certain projects, particularly in the power sector, investment growth is expected to remain sluggish in FY13. Economic growth may ease further in the coming fiscal, even if the monsoon conditions are favourable.

Deposits growing faster than RBI’s indicative projection of M3 growth of 15.5%

The total deposits of the Indian Banking System stood at Rs. 58.28 lakh-crore as on December 30, 2011, registering a y-o-y growth of 17.2% compared to a broad money growth of 15.6%. In absolute terms, deposits have increased by Rs. 6.23 lakh-crore since March 2011 (as compared to Rs. 4.85 lakh-crore during the same period in FY11), largely fuelled by the growth in term deposits following several rounds of interest rate hikes by Banks since Q3FY11.

The share of low-cost CASA deposits remained stable at 36.3% as on September 30, 2011 relative to 36.1% as on June 30, 2011. Savings account balances increased to 26.2% from 25.1% of aggregate deposits during this period. However, current account balances declined sharply to 10.1% as on December 2011 from 11% as on September 2011 and 12.3% as on March 2011. It is likely that Corporates’ used their own funds for their working capital requirements or moved their surplus funds to debt funds (including fixed maturity plans) given the attractive yields.

Most Banks, including the larger ones, have increased their peak deposit rates by nearly 175-250 bps in the past 18 months and continue to hold rates at relatively higher levels. Given that other asset classes are likely to generate moderate returns, ICRA expects the overall deposits growth to remain strong at 17-18% in FY12, stimulated by term deposits. Further, RBI deregulated the interest rates on savings deposits in its monetary policy review in October 2011, and certain private sector Banks have raised interest rates up to 6%. Although PSU Banks have not changed the interest rates as yet, competition from private players may trigger a rise in savings rates.

Deposit Growth Trends

Chart 13: Deposits Growth (Financial year-to-date)

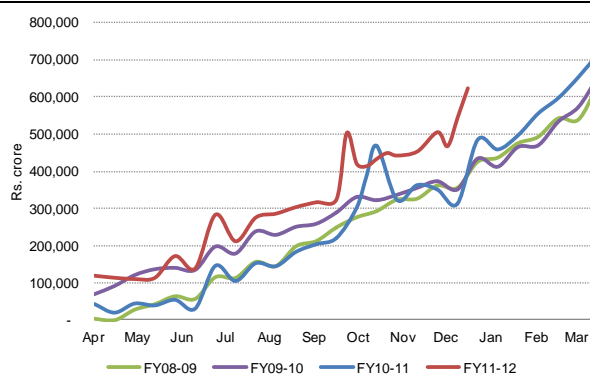
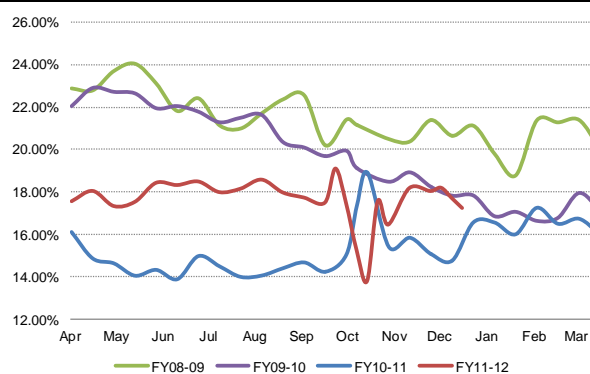


Chart 14: Deposits Growth (Year-on-year)



Source: RBI; ICRA Research

Credit growth moderates in Q3FY12

Systemic credit growth moderated to 15.8% (y-o-y) as on December 30, 2011 from 21% as on September 30, 2011, in a lagged response to the series of rate hikes effected by RBI since March 2010. Systemic non-food credit stood at Rs. 42.81 lakh-crore as on December 30, 2011 registering YTD growth of 10.5% compared to 15.8% during the same period in FY11. Credit off-take is expected to remain modest in Q4FY12 given the paucity of new project announcements. ICRA expects that the Central Bank is unlikely to cut rates in the current fiscal and accordingly, the credit growth in FY12 is expected to be in the range of 16-17%.

Credit growth expanded by 5.6% in the current fiscal (up to November 18, 2011 relative to end-March 2011),⁴ largely driven by credit to industry (9.3% YTD growth), retail housing (7.6%), trading (8.3%) and NBFCs (6.6%). However, credit to agriculture, telecom, consumer durables and sugar declined during this period. Within industry, a large chunk of the incremental credit extended in the current fiscal has been absorbed by the power sector (13.9% growth), iron & steel (10.4%), roads (14.8%) and other infrastructure sectors. The large industrial sectors registered a strong YTD growth of 10.1%, while the small and medium industries registering growth of 6.9% and 6.8%, respectively, continue to attract a greater share of Bank funding as compared to services and retail loans.

Non Food Credit Growth Trends

Chart 15: Credit Growth (Financial year-to-date)

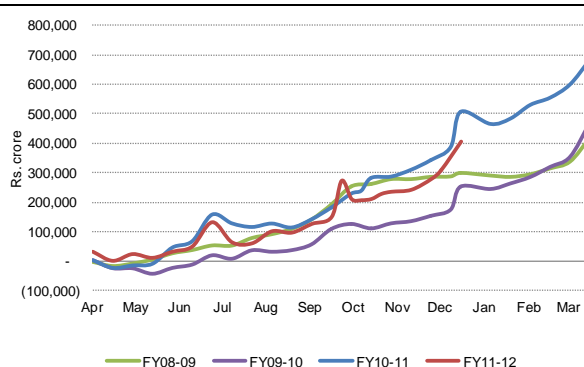
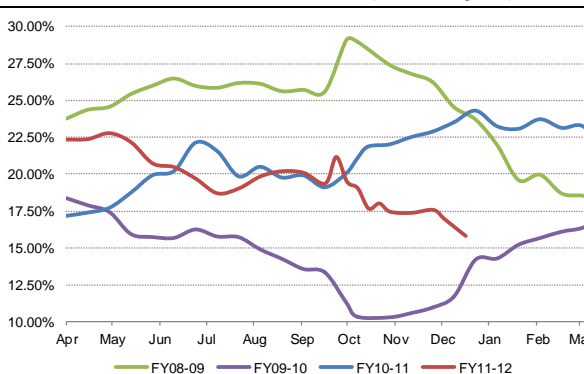


Chart 16: Credit Growth (Year-on-year)



Source: RBI; ICRA Research

⁴ As per data sectoral credit data published by RBI

Corporate debt issuances remain stable in Q3FY12 over sequential quarter with issuances by Non Bank Finance Companies

Chart 17: Corporate Debt Issuances

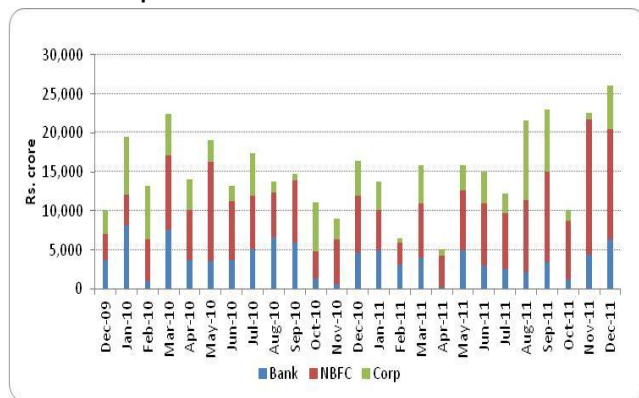
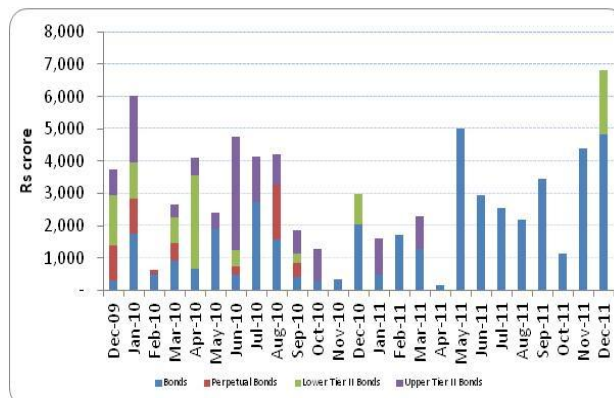


Chart 18: Bank Debt Issuances



Source: NSE, BSE, ICRA

According to ICRA estimates, the bond issuances during Q3FY12 stood at around Rs. 59,000 crore as compared to around Rs. 57,000 crore in Q2FY12 and Rs. 37,000 crore in Q3FY11. Debt issuances by Banks and NBFCs accounted for around 87% of the total issuance during Q3FY12. The issuance in the last quarter is expected to be robust on the back of tax-free bonds launched by NHA and PFC in end December 2011, expected issuance of infrastructure bonds by Infra NBFCs and addition to bonds being raised by Banks and NBFC for meeting their business needs and regulatory capital requirements.

Corporate bond spreads widen in December for shorter maturities

The AAA Corporate bond yield curve hardened in October and November 2011 across maturities, in response to the Central Bank's tight monetary stance, but moderated by end-December 2011. The yield curve flattened in December with short term yields hardening by ~ 20 bps while the yields in the longer end of the curve softened by ~ 22 bps; the spread between the longer end and the shorter end of the curve was negligible. Despite softening, the 10-year yields were marginally higher in December 2011 than in September 2011, as systemic interest rates continue to remain relatively high. Interest rates in the commercial paper market remained steady in Q4FY12, while Banks' cost of CD issuances hardened marginally. Market evidence suggests that Corporates have started raising short term funds through commercial paper; the total commercial paper outstanding increased to Rs. 176,069 crore as on November 15, 2011 from Rs. 144,621 crore as on September 30, 2011. Fresh monthly commercial paper issuances also increased to ~ Rs. 47,000 crore (approx) in FY12 (up to November 15, 2012) compared to Rs. 32,000 (approx) in Q4FY11.

Chart 19: AAA Corporate Bond Yield Curve

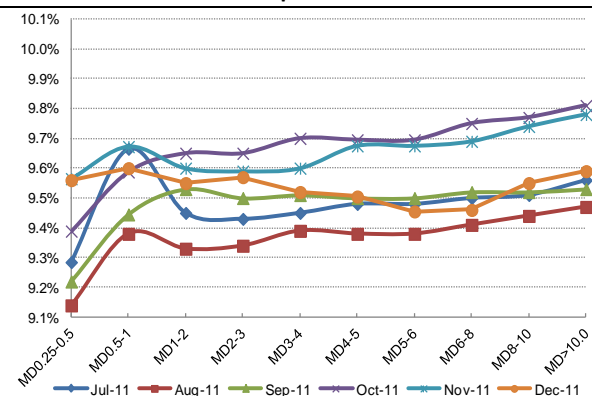
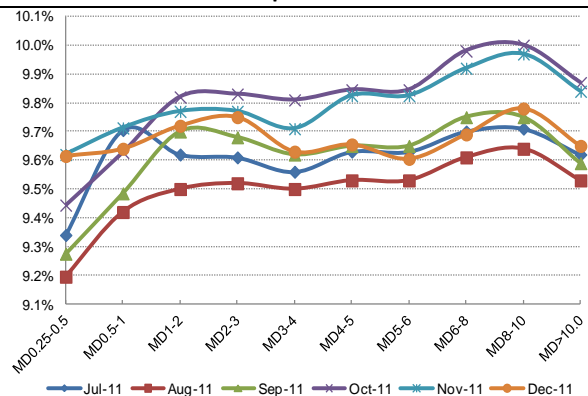


Chart 20: AA+ Corporate Bond Yield Curve



Source: IMAcS

Corporate bond spreads in the shorter maturities widened sharply in December 2011 to 132 bps (AAA; MD1-2) from 70 bps on November 14, 2011. The spreads for longer maturities remained range bound in Q3FY12 after declining in up to September 2012, on the back of less aggressive bulk deposit mobilisations by Banks and moderation in the pace of growth of credit off-take. Several Corporates stayed away from issuing long term bonds on account of the high prevailing rates and their expectations of yields softening in the later part of the year. Instead, Corporates sought to meet their financing requirements by issuing short term commercial papers or availing floating rate long term loans from Banks.

Chart 21: AAA Corporate Bond Spreads

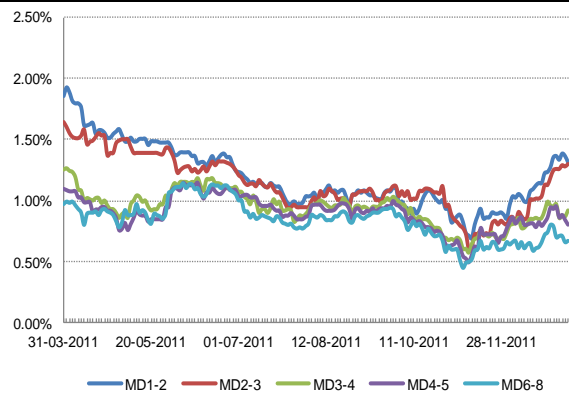


Chart 22: AA+ Corporate Bond Spreads



Source: IMAcS

ICRA expects that the RBI may hold on to the Repo rate at current levels during Q4FY12, before it starts loosening its monetary policy; accordingly, the Corporate bond spreads (at the shorter end) would remain volatile for some more time before stabilising. The remaining planned Government borrowing programme for Q4FY12 may lead to crowding out in the bond market, and long term bond issuance are expected to remain muted till there are some signs of easing of interest rates.

Annexure

Table A1: Capital and Financial Market Indicators

Period	Net Growth in Non Food Bank Credit (Rs lakh-crore)	Fresh CP Issuance including rollover (Rs crore)	Fresh Bonds issuances (Rs crore)	Net FII - Debt (US\$ bn)	Equity Issues (IPO+FPO+ Rights) Issue (Rs crore)	Equity QIP (Rs crore)	Net FII Equity (US\$ bn)	Net FDI (US\$ bn)	Gross ECB (US\$ bn)	Gross FCCB (US\$ bn)
Q1FY10	(0.02)	40,223	30,447	0.16	324	12,232	6.27	6.91	2.64	0.07
Q2FY10	1.09	55,510	39,579	0.83	14,191	11,768	7.10	8.24	4.33	0.28
Q3FY10	1.44	59,101	32,781	1.30	6,932	10,675	5.33	5.61	3.14	3.37
Q4FY10	2.17	45,654	55,195	4.71	32,550	5,093	4.55	4.97	7.48	0.36
Q1FY11	1.56	68,008	46,267	1.37	6,936	6,492	2.33	5.81	4.74	0.57
Q2FY11	0.24	92,486	45,873	4.05	8,833	8,744	11.50	5.23	4.92	0.40
Q3FY11	3.25	129,206	36,415	(0.02)	29,468	5,943	10.99	5.03	5.02	0.32
Q4FY11	1.77	97,718	35,958	2.53	9,922	2,419	(0.52)	3.39	9.78	-
Q1FY12	1.32	143,565	35,844	0.60	6,998	603	1.15	13.44	7.57	0.49
Q2FY12	1.41	140,031	56,904	0.87	4,642	330	(0.59)	5.70	10.19	0.05
Q3FY12	1.33	70,366*	58,688#	4.65	0	107	(0.41)	1.16^	3.76 [@]	0.30 [@]

Note: Source NSE, BSE, RBI, Prime Database, ICRA

* Data available only up to November 15, 2011. Hence data not strictly comparable with previous quarters

Based on data disclosed by NSE, BSE as on date. There would be few bond issuances prior to December 30, 2011 that are not yet listed in BSE/NSE and hence data not strictly comparable with previous quarters.

^ Data available only for October 2011. Hence data not strictly comparable with previous quarters

@ Data available only till November 2011. Hence data not strictly comparable with previous quarters

Table A2: Macro Economic Indicators

	GDP Growth	IIP Growth (quarter ending)	WPI Inflation (quarter ending)	INR-USD rate (quarter ending)
Q1, 2008-09	7.9%	8.5%	10.9%	42.95
Q2, 2008-09	7.7%	10.9%	10.8%	46.94
Q3, 2008-09	5.8%	-1.6%	6.7%	48.45
Q4, 2008-09	5.9%	-5.2%	1.6%	50.95
Q1, 2009-10	6.3%	-1.8%	-0.4%	47.87
Q2, 2009-10	8.6%	1.6%	1.4%	48.04
Q3, 2009-10	7.3%	9.5%	7.1%	46.68
Q4, 2009-10	9.4%	14.9%	10.4%	45.14
Q1, 2010-11	8.8%	7.4%	10.3%	46.6
Q2, 2010-11	8.4%	6.1%	9.0%	44.92
Q3, 2010-11	8.3%	8.2%	9.4%	44.81
Q4, 2010-11	7.8%	9.4%	9.7%	44.65
Q1, 2011-12	7.7%	9.5%	9.5%	44.72
Q2, 2011-12	6.9%	2.0%	10.0%	48.92
Q3, 2011-12			7.5%	53.27



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