India Macro Weekly

Preview: Monetary Policy + Chart Book of Macro and Monsoon Trends

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- **Domestic Macro Backdrop Justifies Higher Rates…** — The domestic macro backdrop ahead of the RBI's monetary policy tomorrow is that of (1) Strong trends in growth with industrial production averaging 14% this fiscal, loan growth currently up 21.7% and non-oil imports up 28.2%YoY. (2) Inflation remaining in double-digits for five consecutive months with the concern being continued stickiness in primary articles up 16.3%YoY and the uptrend in non-food manufactured product inflation. (3) Other concerns include the rise in asset prices as well as mounting wage pressures.

- **…But Global Factors to Likely Result in Continuing Baby Steps** — Domestic factors do call for a faster pace of normalization *(During the crisis, the RBI cut the reverse repo by 275 bps to 3.25%, and repo by 425 bps to 4.75%. Since 2010 rates have been cumulatively raised by 75bps).* However, key issues on the global front include (1) Less than optimistic near term prospects with our global team recently downgrading GDP for the **US** ('10E -40bps to 2.8%, '11E -20bps to 2.6%), **China** ('10E -1% to 9.5%; '11E -50bps to 8.8%) and **Japan** ('11E now 1.9% vs prev 2.1%) and (2) Delaying rate hike timing expectations

- **So what should we expect tomorrow?** — **(1) Rates:** We expect the RBI to hike the repo (liquidity injection) and reverse-repo (liquidity absorption) rate by 25bps to 5.75% and 4.25% respectively. **(2) Liquidity Measures:** Given that in addition to frictional liquidity tightening there are signs of 'structural' liquidity tightening *(see pg 4)* as well as M3 running below targets, we could see cognizance from the RBI that measures may be needed to make liquidity available at the right price to support growth. **(3) Guidance on Macro Variables:** We expect to see an upward revision to both the GDP and inflation forecasts.

- **Maintain our macro forecasts** — We maintain our 8.4% GDP estimate for FY11 which factors a further minimum 50bps rate hike in 2010. But, given the growth and inflation outlook the risk to rates is on the upside. A point to note is that the last time non-food manufactured production crossed 8% was in mid-2008 and at that time interest rates were 350bps higher than current levels. *(see India Macroscope at https://www.citigroupgeo.com/pdf/SAP38360.pdf for details)*

Figure 1. RBI Projections vs. Current Data

Variable	RBI Targets for FY11 (April Policy)	Latest Data
GDP	8% with upside bias	8.6% during 4QFY10
WPI*	5.5%YoY	10.6%YoY in Jun10
Non-Food Credit	20%YoY	22.3% as on Jul 2nd
Deposit Growth	18%YoY	14.9% as on Jul 2nd
Broad Money (M3) Growth	17%YoY	15.3% as on Jul 2nd

ALSO INSIDE:

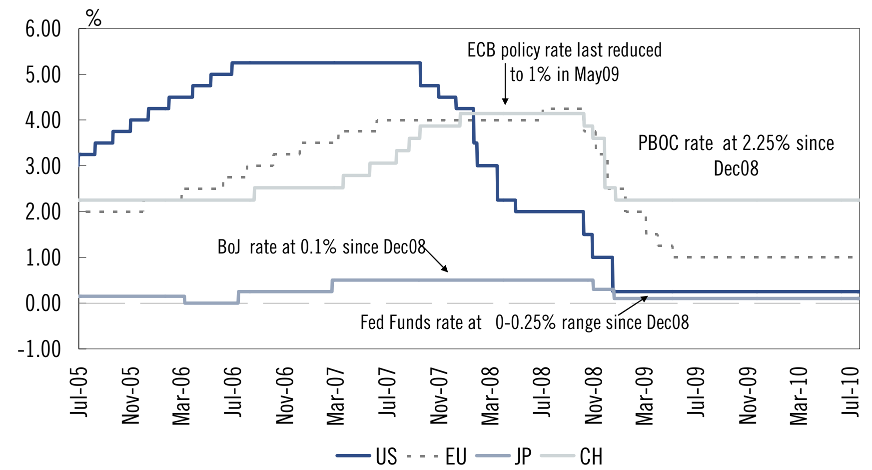
Global and Regional Rate Scenario

GLOBAL RATES LIKELY TO STAY ON HOLD THROUGH 2010

Given sluggish industrial growth, our global team expects that the Fed, ECB, BoE and BoJ are all likely to keep rates on hold to the end of this year.

They now also expect the PBOC to keep rates on hold, whereas previously the expectation was that the PBOC would hike once in H2 this year

Figure 2. Trends in Policy Rates – US, EU, Japan & China (%)



Source: CEIC Data Company, Bloomberg

ASIAN CENTRAL BANKS HAVE BEGUN PROCESS OF 'NORMALIZATION'

Following the inter-policy hike in India in June, the mkt was surprised by a 12.5bps hike by Taiwan's central bank, and more recently, BoK and BoT's earlier-than-expected 25bps hikes in July. Bank Negara Malaysia also followed with a 25bps hike.

Going forward, our regional team expects gradual rate hikes going into 2011 as Asian central banks continue to de-link from US Fed policy

Figure 3. Asia Policy Rates and Movement

			Last Move		Likely Next Move		Year-End(2010)
		Spot 22-Jul	Date	Amount (bp)	Date	Amount (bp)	Forecast
China	1-Year Deposit Rate	2.25	Dec-08	-27	Sep-11	+27	2.25
India	**Repo Rate**	**5.50**	**Jul-10**	**+25**	**Jul-10**	**+25**	**6.00**
Indonesia	SBI 28-days	6.50	Aug-09	-25	Jun-11	+50	6.50
Korea	BOK Policy Rate	2.25	Jul-10	+25	Sep-10	+25	2.75
Malaysia	Overnight Policy Rate	2.75	Jul-10	+25	Jul-11	+25	2.75
Philippines	O/N Policy Rate	4.00	Jul-09	-25	Dec-10	+25	4.25
Taiwan	Re-discount Rate	1.375	Jun-10	+12.5	Sep-10	+12.5	1.63
Thailand	Overnight Repo Rate	1.50	Jul-10	+25	Aug-10	+25	2.25

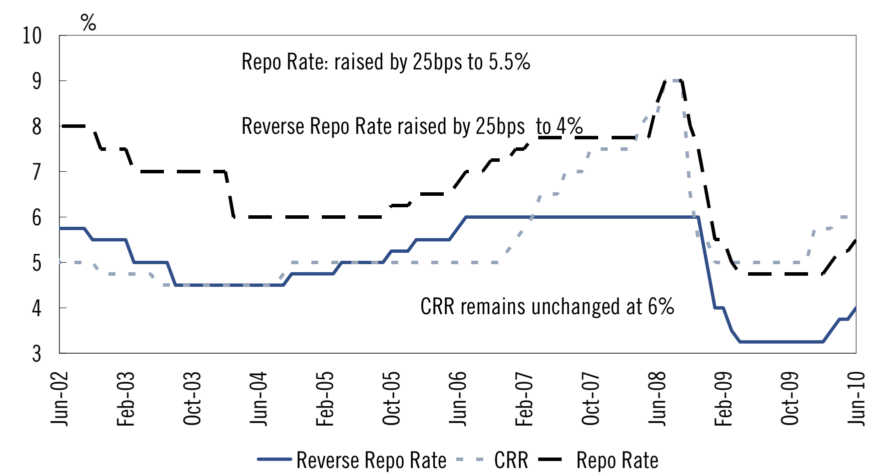
Source: Bloomberg, CIRA

INDIA...WHERE DO WE STAND?

With growth gaining momentum and inflation becoming more generalized, the RBI hiked rates late last month in an inter-policy move.

Given the inflation and growth outlook, there is an upside risk to our estimates of an additional 50bps of tightening in 2010. As mentioned earlier, this would depend on the monsoons, global developments and non-food manufactured product inflation

Figure 4. Trends in Key Domestic Interest Rates (%)



Source: RBI

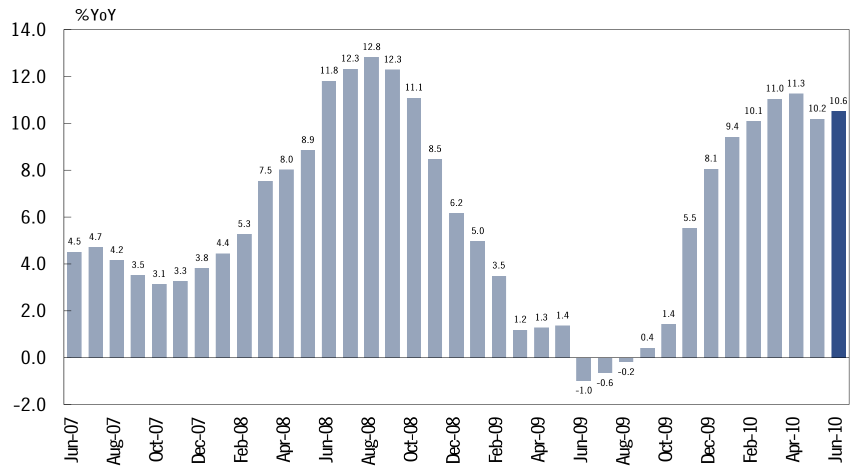
Domestic Rates – Policy Normalization to Continue

INFLATION REMAINS STICKY

Inflation has remained in double digits for five consecutive months. Key concerns include a continued uptrend in non-food manufactured products inflation, high primary product inflation and the sharp revisions in historical data (e.g. April data was revised from 9.6% to 11.2%)

Going forward we expect inflation to remain sticky for the next few months but moderate to the end of the year as the base effect turns favorable.

Figure 5. Trends in the WPI (%YoY)



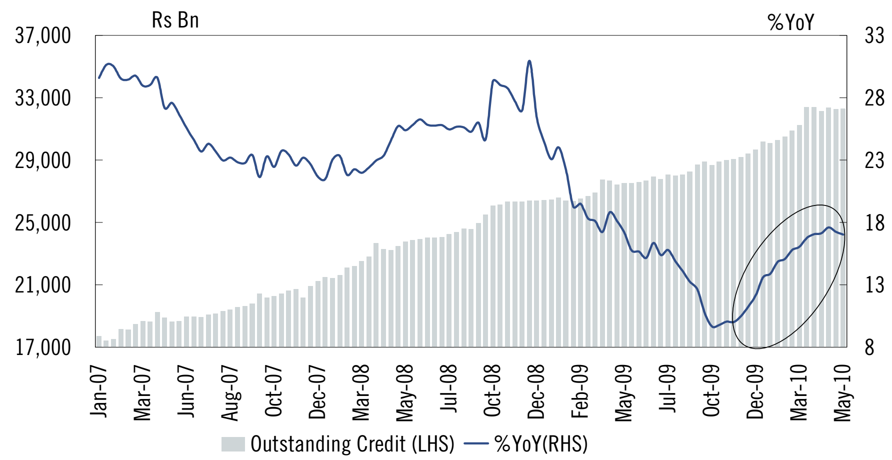
Source: Office of the Economic Advisor

CREDIT GROWTH POSTING AN UPTICK

Credit growth has posted a steady uptick, up 21.7%YoY currently vs. 15.2% last year. On a cumulative basis (Apr-July2), incremental loans were Rs1576bn v/s Rs200bn in the same period last year

Besides loans to the telecom sector (due to 3G spectrum auctions), the uptick in loan offtake bodes well for the growth story

Figure 6. Trends in Loan Growth (Rs Bn, %YoY)



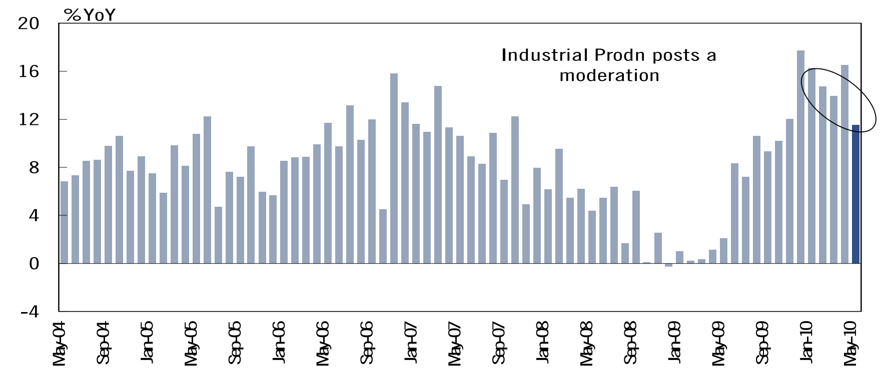
Source: RBI

MACRO DATA INDICATES A RECOVERY

Data trends both at the macro (loan growth, non-oil imports) and sectoral front (auto, cement, and diesel) are healthy

Despite the favorable base effect on industrial output beginning to fade away, we believe that there is no need for undue concern as and we maintain our FY11 GDP estimate of 8.4%

Figure 7. Trends in Industrial Production (%YoY)



Source: CSO

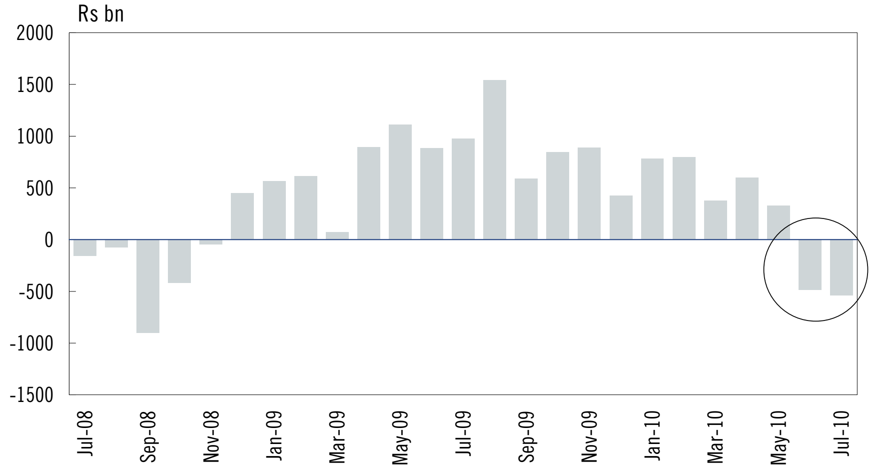
Liquidity & Banking Trends

FRICTIONAL LIQUIDITY – STILL TIGHT

Liquidity conditions have been tight since early June, due to outflows against the 3G/BWA auctions and advance tax payments.

In July, banks borrowed an average of Rs550bn on a daily average basis from the LAF window, while call money rates have been trading closer to 5.8%, at the upper end of the LAF corridor.

Figure 8. Trends in Repo/Reverse Repo Transactions (Rs Bn)



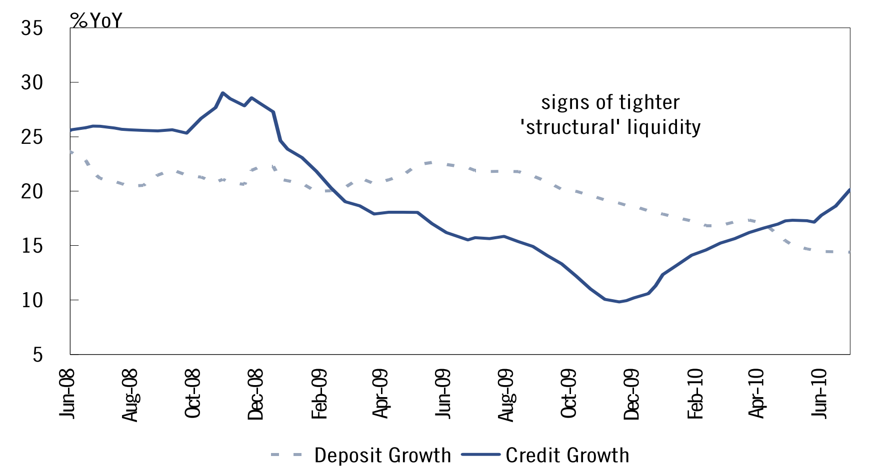
Source: RBI

...ALSO SIGNS OF TIGHTENING STRUCTURAL LIQUIDITY

In addition to tightening 'frictional' liquidity there are also signs of tightening 'structural' liquidity.

This is reflected in the continued uptrend in credit growth as well as the deceleration in deposit growth. As per latest available data, outstanding credit growth is up 21.7%YoY while deposit growth has decelerated to 14.9%YoY. The moderation in deposit growth is partly due to corporates withdrawing surplus deposits parked in banks, as projects delayed during the slump period are now restarting.

Figure 9. Trends in Credit and Deposit Growth (%YoY)



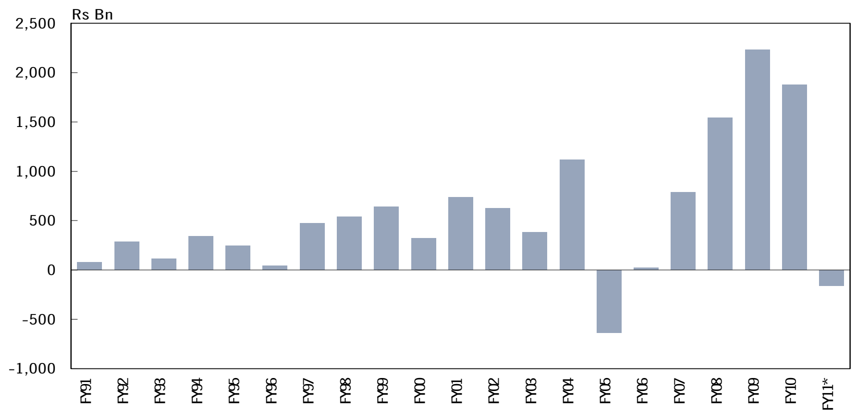
Source: RBI

INCR CREDIT MORE THAN DEPOSITS FOR THE FIRST TIME SINCE FY05

On a cumulative basis (Apr-July2), incremental loans were Rs1576bn v/s Rs200bn in the same period last year, reflecting an increase of 21.7%YoY. Incremental deposits were Rs1398bn v/s Rs1969bn last year (up 14.9%YoY).

The last time that credit was more than deposits was in FY05. An offset would be capital flows.

Figure 10. Trends in Incremental Deposits Less Credit (Rs Bn)



* Incremental so far this fiscal (Apr-Jul2) Source: RBI

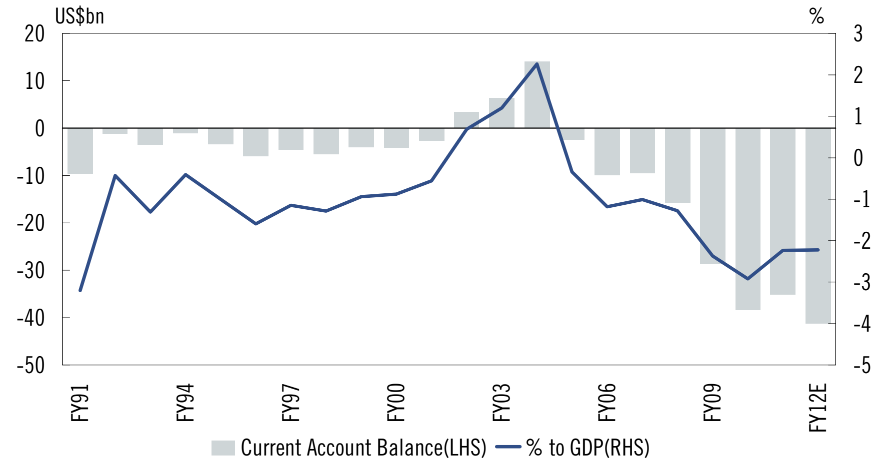
External Flows Key As CAD Rises

CURRENT ACCOUNT TO STAY OVER US$30bn+ in FY11

We expect the current a/c deficit to come in at US$35.1bn or 2.2% of GDP in FY11 vs. 1.6% estimated earlier and 2.9% in FY10*.

This incorporates (1) higher non-oil imports due to the upturn in the investment growth, (2) export growth unchanged at 15% and (3) assume continued buoyancy in remittances and software.

Figure 11. Trends in the Current Account Deficit (US$Bn, % GDP)*



*For note on revisions pls see https://www.citigroupgeo.com/pdf/SAP37730.pdf : Source: RBI

...BUT CAPITAL FLOWS COULD STAY HEALTHY

Given the underlying growth story, we expect capital flows led by FDI to remain healthy at US$57.3bn in FY11.

However, even excluding the so-called "hot-money" flows i.e portfolio, capital flows are more than sufficient to finance the CAD.

Figure 12. Trends in the Capital Account (US$bn)

	FY06	FY07	FY08	FY09	FY10	FY11E	FY12E
a. Borrowings	7.9	24.5	40.7	8.7	12.2	12.0	17.0
External Assistance	1.7	1.8	2.1	2.6	2.0	1.0	1.0
Commercial Borrowings	2.5	16.1	22.6	7.9	2.5	8.0	10.0
Short-term credit	3.7	6.6	15.9	-1.9	7.7	3.0	6.0
b. FDI	3.0	7.7	15.9	17.5	19.7	21.7	23.7
c. Portfolio Investment	12.5	7.1	27.4	-14.0	32.4	17.0	15.0
d. Banking Capital Net	1.4	1.9	11.8	-3.2	2.1	6.0	6.0
of which NRI deposits	2.8	4.3	0.2	4.3	2.9	4.5	2.5
e. Other capital	1.2	4.2	11.0	-1.5	-12.7	1.0	1.0
f. Rupee debt service	-0.6	-0.2	-0.1	-0.1	-0.1	-0.4	-0.4
Capital Account (c:g)	**25.5**	**45.2**	**106.6**	**7.2**	**53.6**	**57.3**	**62.3**

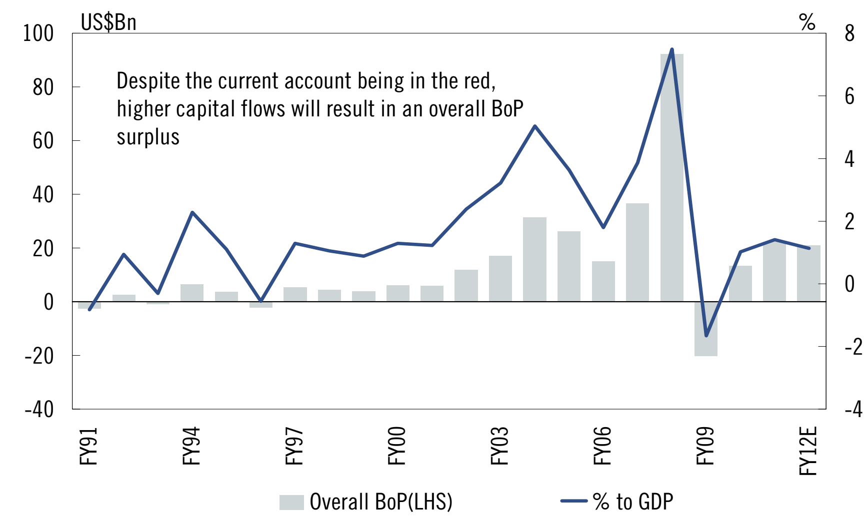
Source: RBI

OVERALL BALANCE TO REMAIN IN SURPLUS, but TEMPERING RUPEE APPRECIATION PACE

We expect an overall BoP surplus of US$22.1bn in FY11

Based on CAD estimates, we recently revised our fcst to 45.5/$ in Mar11 vs. Rs43.5/$ earlier. However, we still maintain our view of an appreciating currency given: (1) the underlying growth story (2) imports primarily led by industrial/capital goods, (3) capital flows led by more stable FDI flows and (4) flows more than sufficient to finance the CAD

Figure 13. Trends in the Overall Surplus (US$bn, %)



Source: RBI

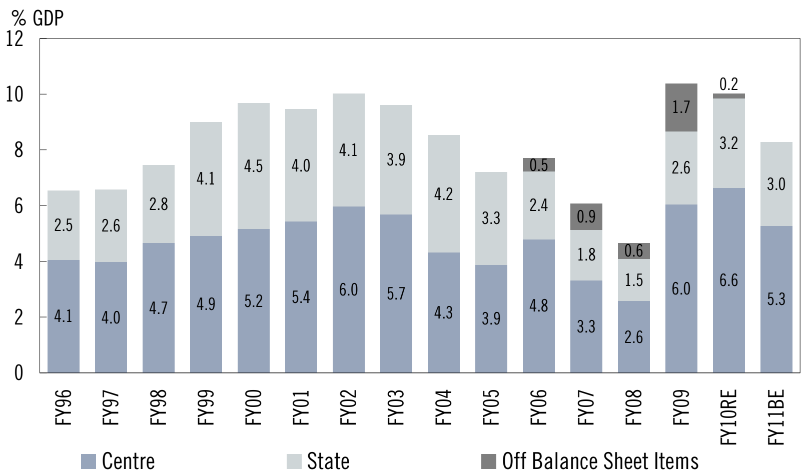
Concluding on a Positive Note…Rays of Light on the Fiscal Front

AFTER 3G REVENUES…MORE POSITIVES ON THE FISCAL

The fiscal situation, which has already benefited from higher telecom revenues, has got brighter with (i) The government's fuel price measures; (ii) Possibility of increasing free-float to 25%; (iii) Upgrade in local currency outlook; and (iv) Recently released road-map on GST

The headline deficit is likely to come in lower than the budgeted 5.5% of GDP for FY11

Figure 14. Trends in the Combined Fiscal Deficit (% GDP)



Source: Ministry of Finance

FUEL SUBSIDIES

The government's recent de-regulation of petrol prices and hikes in diesel, kerosene, and LPG prices would result in gross under-recoveries coming off from Rs770bn to Rs530bn in FY11.

While there is still no clarity on subsidy-sharing in a recent interview, India's oil secretary said that upstream companies would bear 1/3rd of FY11 gross under-recoveries, with the government bearing ~50%. If implemented, this would wipe out almost half the surplus telecom revenues

Figure 15. Fuel: Subsidy Sharing Mechanism (Rs Bn)

Rs bn	FY07	FY08	FY09	FY10	FY11E
a. Gross under-recoveries	**494**	**771**	**1,033**	**461**	**600**
Petrol	20	73	52	52	20
Diesel	188	352	523	93	200
LPG	107	155	176	143	195
Kerosene	179	191	282	174	185
b. less: Upstream contribution	**205**	**257**	**320**	**144**	**200**
% share	*42%*	*33%*	*31%*	*31%*	*33%*
c. Less: Govt compensation (oil bonds/cash)	**241**	**353**	**713**	**260**	**300**
Net under-recovery (a-b-c)	**48**	**161**	**-**	**57**	**100**
Brent (US$/bbl)	64	82	85	70	75

Source: CIRA Estimates

GST ROADMAP – MORE HEADWAY IN THE RIGHT DIRECTION

In a 3-year roadmap for the Goods and Service Tax (GST) released recently, the Finance Minister has proposed that the tax rates on services would be fixed at 8% for both the centre and states.

For goods, the recommendation is to fix a standard rate and a special (lower) rate that varies each year. Both rates would finally converge to 8% by the 3rd year

Figure 16. Proposed GST Rates (%)

		Central GST	State GST	Total Liability
Apr-11	Goods (lower rate)	6	6	12
	Goods (standard rate)	10	10	20
	Services	8	8	16
Apr-10	Goods (lower rate)	6	6	12
	Goods (standard rate)	9	9	18
	Services	8	8	16
Apr-13 onwards	Goods (standard rate)	8	8	16
	Services	8	8	16

Source: Ministry of Finance

Monsoon Monitor

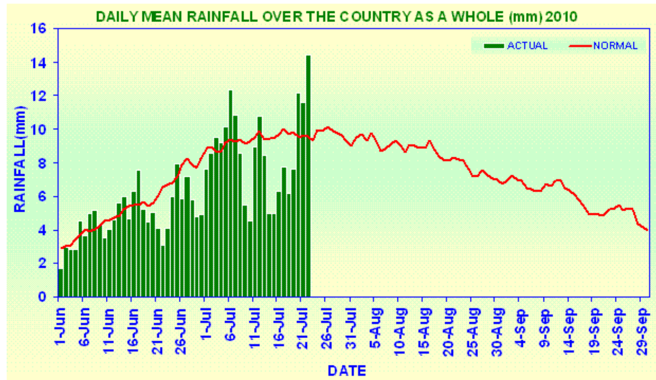
Monsoon Update

– Rainfall dipped back into the red for the w/e 21th July, coming in at 17% below normal (vs. 24% below normal the previous week). On a cumulative basis, rainfall during 1 Jun-21 July was 14% below normal.

– Due to weak rainfall, water level in reservoirs was 35% below the last 10-year average on July 22. Total water stock in 79 of the 81 reservoirs stood at 28.7bcm, vs. 37bcm last year

River basin	This year	Average of last 10 years	% departure
Ganga	3.0	5.2	-41.7
Indus	3.6	5.1	-29.6
Narmada	1.3	2.3	-43.0
Tapi	1.4	2.2	-34.7
Mahi	0.6	1.2	-48.9
Sabarmati	0.0	0.2	-89.0
Rivers of Kutch	0.1	0.2	-69.3
Godavari	1.1	2.5	-57.6
Krishna	9.1	12.0	-24.2
Mahanadi & east-flowing rivers	2.3	4.4	-48.3
Cauvery & east -flowing rivers	2.8	3.3	-15.7
West flowing rivers of south	3.3	5.2	-35.7
Total	**28.7**	**43.8**	**-34.6**

Figure 17. Daily Rainfall Trends



	Long Range Forecast (% of LPA)	Actual Rainfall (% of LPA) 1 June- 21July
Country as a whole	**102 ±4**	**-14**
Northwest India	102 ±8	-12
Central India	99 ±8	-19
South Peninsula	102 ±8	9
North East India	103 ±8	-21

Figure 18. Weekly Rainfall : 15 July -21 July: 17% BELOW Normal

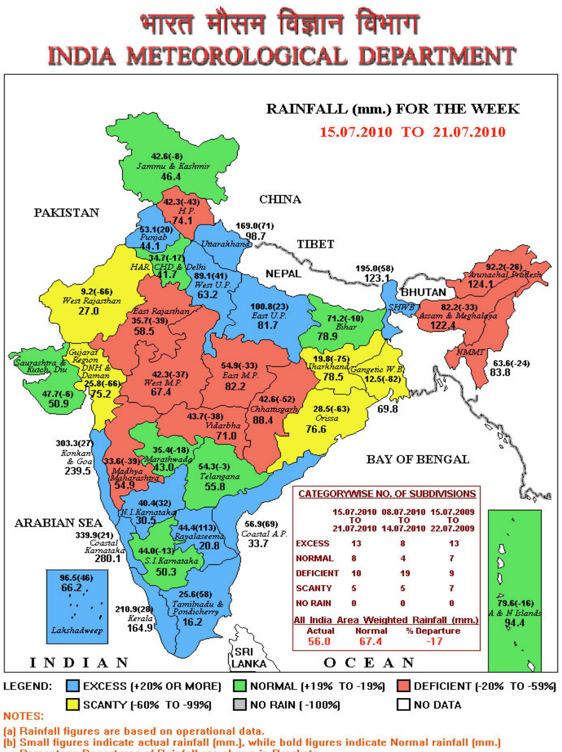
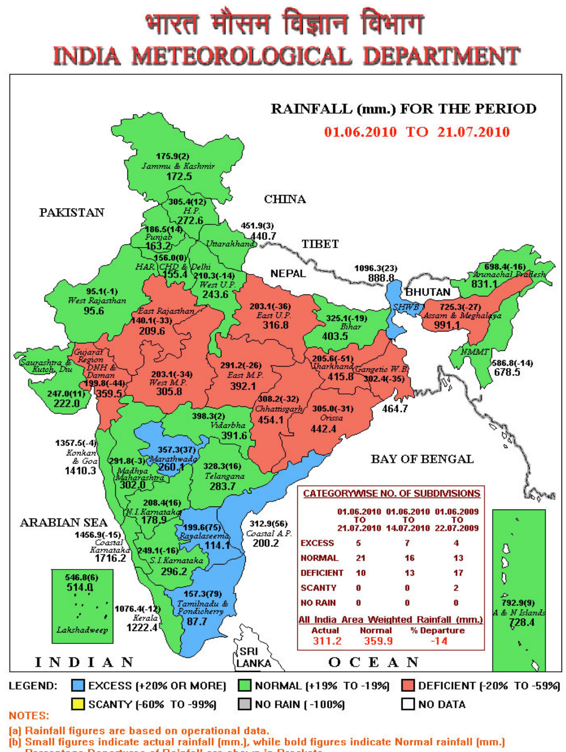


Figure 19. Seasonal Rainfall : 1 June -21 July: 14% BELOW Normal



Source: IMD, CWC

Appendix A-1

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