20 April 2007

Macro
India Economics & Strategy

HSBC Global Research

India Watch (Issue 8)

Previewing the RBI meeting

- **RBI likely to raise the CRR another 50bp between meetings**
- **…before pausing for the rest of the year**
- **This issue contains FX and equity strategy contributions**

What happens next?

The RBI's annual policy statement in April last year saw the central bank predict GDP growth of 7.5-8.0% for 2006/07, inflation "contained within 5-5.5%", M3 growth of 15% and non-food credit growth of "around" 20%. In practice, all of these projections were too low, although headline WPI inflation did at least average 5.4% in the financial year as a whole, even though it ended it at 6.5%. We have argued that the key reason for the emerging cyclical excesses is that the interest rate stance was too loose, pushing demand growth above the increase in the productive potential of the economy. Moreover, despite the various rate rises through the course of the last 12 months, we believe this remains the case and GDP growth, although set to weaken somewhat to about 7.8% in 2007/08, will again exceed its sustainable rate.

In our view, there is a need to continue tightening for some time yet, and with WPI inflation at 6.1% in the latest week and no sign of a slowdown in lending growth, we still anticipate another 50bp hike in the CRR. Having last raised rates at the end of March, it may be a bit soon to anticipate another move at the 24 April meeting, but we doubt it will be delayed too long.

This may, however, be it for the rest of the year. A key development over the next few months is likely to be a fall in the rate of Wholesale Price Inflation, probably below 5%, as the lagged effects of the drop in metal and oil price inflation as well as the strong rupee start to be felt. Although the WPI is heavily determined by international factors, rather than being a good indicator of domestic price/overheating pressures, it is probably *the* key variable as far as the RBI is concerned. This is not to say that developments in money and lending growth are ignored by the Bank, but perhaps viewed mainly as intermediate targets towards the ultimate goal of bringing WPI inflation down.

The Annual Policy Statement itself will see the RBI forecast real GDP growth of perhaps 8.25%-8.75% in 2007/08 and a modest slowdown in the monetary aggregates. As a wildcard, we wouldn't rule out the Bank announcing a reduction in the current 5-5.5% target range for inflation as a further signal that it is serious about containing price pressures. The Finance Minister has been particularly vocal in suggesting that he would like to see inflation below 5%.

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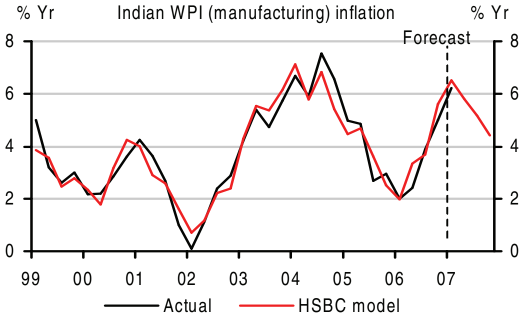
Indicators & Forecasts

Indicator watch

WPI inflation has peaked

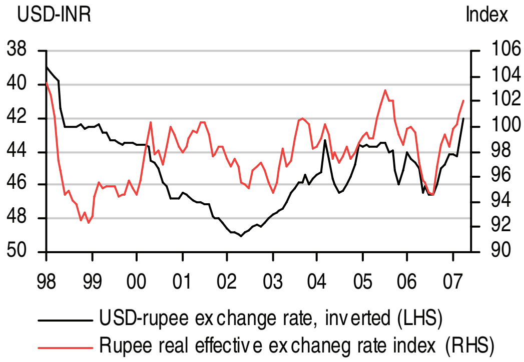


Source: HSBC, CEIC

Wholesale price inflation

- Our model of the manufacturing component of Wholesale Price Inflation suggests that the peak has now been reached and inflation is likely to drop from here.
- The model incorporates the year-on-year change in base metal prices, oil prices, the nominal effective exchange rate and the manufacturing output gap as explanatory variables. With the exception of the last of these, all of the series are starting to exert less upward pressure on WPI inflation.
- This could be important as the RBI targets the headline WPI rate at 5-5.5%. According to the model, there is a good chance that the manufacturing component at least (which represents nearly two-thirds of the headline index) will drop below the bottom of the current target range over the next 6 months.

Rupee on the march

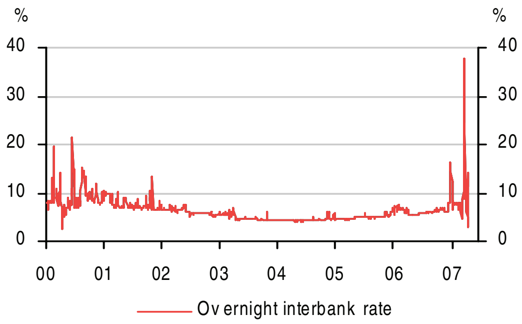


Source: CEIC

Exchange rates

- India's currency has appreciated more than 10% against the US dollar since August last year and is now at its highest level since mid-1998 (see chart, where we have inverted the scale).
- The rise in the real trade weighted exchange rate, using the broader basket of 36 currencies, has been slightly less dramatic, rising around 7% over the same period. As a result, however, it has moved 3% above its long-term average (based on data going back to 1993).
- It may well be that this appreciation partly explains the sharp downturn in Indian export growth that we highlighted in the previous edition of this publication. In the 3 months to February year-on-year export growth was just 7% in value terms, down from a high of 33% in July last year. The currency will continue to keep a firm lid on external demand.

Volatility continues



Source: Source: CEIC

Overnight interest rates

- The volatility in overnight rates, which began in mid-March, continues unabated. In the last 30 working days, the overnight rate has only closed within the RBI's interest rate corridor (as set by the repo & reverse repo rates) on 3 occasions.
- As the chart shows, the current degree of volatility is unusual and reflects a number of factors. Above all, the persistent strength of lending growth above the expansion in deposits has left banks close to the 25% SLR limit, meaning that they have little in the way of collateral to borrow from the RBI.
- Clearly, it is also proving extremely difficult for all banks, including the central bank, to forecast liquidity requirements on a daily basis. Some, however, have suggested that the RBI is not that unhappy about recent developments to the extent that it is serving to discourage bank lending.

Forthcoming economic releases

For the two weeks commencing 23 April

Date	Indicator	Previous	HSBC forecast	Comment
23-27	Exports (Mar)	7.9%	10.0%	Export growth has been grinding lower since the middle of last year, with the 3-month moving average of the year-on-year rate down to its weakest level since August 2003 in February of 7%. We are looking for a small improvement in March.
23-27	Imports (Mar)	25.1%	28%	Meanwhile, import growth has held up much better, rising by an average of 27% over the last 3 months. With little sign of a softening in domestic demand, we expect it to remain firm.
24	RBI Meeting & Annual Policy Statement	-	-	We expect all the main interest rates to be left unchanged, although it is a close call.
25	CPI (Urban non manual employees, Mar)	7.8%	7.8%	This has moved up from a sub-3% rate in early 2004 to 7.8% in February this year. We expect it to remain unchanged in March.
30	CPI (Industrial workers, Mar)	7.6%	7.6%	We also expect the industrial workers rate to stay at its February rate.
3 May	Manufacturing PMI (Apr)	53.0	53.3	India's manufacturing PMI has shown five consecutive declines from a high of 59.3 in October last year to 53.0 in March. We wouldn't be surprised to see some stability coming through now and the small rise in last month's export orders balance provides grounds for hope.

Source: HSBC

Key economic forecasts

- Year-on-year GDP growth of 8.6% in 2006Q4 was surprisingly soft in view of the preliminary estimate of 9.2% GDP growth given by the government for the 2006/07 fiscal year as a whole. Assuming no back revisions, y-o-y growth would have to be more than 10% in the January-March quarter to achieve this. This seems very unlikely on the basis of our own seasonally adjusted series, as it would imply an implausibly large 4% quarter-on-quarter increase.

- We are expecting 8.8% GDP growth for the 2006/07 fiscal year, slowing to 7.8% in 2007/08 and just 6.3% in 2008/09. The slowdown largely reflects the cumulative impact of the monetary tightening to date as well as negative net trade effects as capacity constraints continue to boost import growth. Clearly, after a prolonged period of above trend growth, one should expect a period of sub-trend growth.

- On interest rates, we are looking for the CRR to rise another 50bps this year to 7% (in the second quarter), with the repo rate up 25bp to 8% (also in the second quarter).

Key Indian macroeconomic forecasts (numbers in red show changes from previous report)

% Year	2006	2007	2008	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07
GDP (calendar year)	9.1	8.1	6.8	9.2	8.6	8.4	8.1	7.8	8.0
GDP (fiscal year)	8.8	7.8	6.3	-	-	-	-	-	-
Agriculture*	2.1	2.8	2.4	1.7	1.5	0.5	2.6	3.2	3.0
Industry*	9.7	6.6	5.9	10.3	9.9	9.5	8.2	7.0	6.3
Services*	10.8	9.7	7.5	10.8	11.3	10.8	10.6	10.0	9.5
Wholesale prices	4.8	5.7	5.5	5.1	5.5	6.4	5.8	5.5	5.0
Consumer prices**	6.2	7.5	8.5	6.6	7.0	7.3	7.6	7.7	7.9
Budget bal* (% GDP)	-3.2	-3.4	-3.7	-	-	-	-	-	-
Trade bal (% GDP)	-8.0	-8.8	-8.1	-	-	-	-	-	-
Current acc (% GDP)	-1.2	-4.0	-3.6	-	-	-	-	-	-
Cash Reserve Ratio***	5.25	7.0	8.0	5.0	5.25	6.0	7.0	7.0	7.0
Reverse repo (%)***	6.0	6.5	7.5	6.0	6.0	6.0	6.25	6.5	6.5
Repo rate (%) ***	7.25	8.0	9.0	7.0	7.25	7.75	8.0	8.0	8.0
10 year yield (%)***	7.6	8.0	8.9	7.7	7.6	8.0	8.0	8.0	8.0
INR/USD***	44.3	43.0	43.0	45.9	44.3	43.2	43.5	43.0	43.0

Source: HSBC. * Fiscal year numbers. ** Industrial workers CPI. *** End period

Strategy thoughts

FX strategy

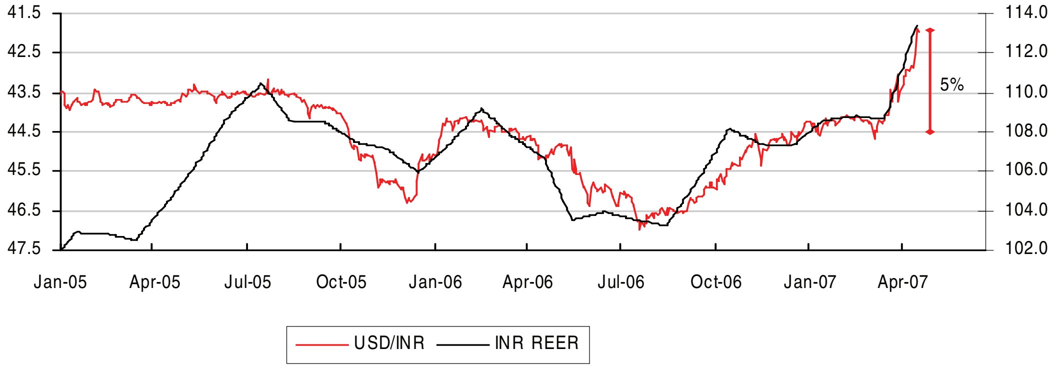
INR…appreciation to persist through the volatility

In the past month, INR has moved aggressively, appreciating about 5%, with half of that coming in the past few days:

While our broad view is for continued INR appreciation, recent market movements and news flow do bring up some pressing questions.

- **How much is the RBI willing to intervene?** One posited reason for the recent accelerated pace down in USD/INR is that the RBI had stepped aside after having intervened aggressively earlier, allowing the INR to gap down. While the RBI has been seen being comfortable fully intervening against speculative inflow, as we recently noted ("INR...still bullish", *EM FX Roadmap*, Feb-07), capital inflows are becoming less speculative and increasingly long-term (Chart 2).
  - Moreover, the RBI may also find it increasingly difficult to sterilise its large amounts of FX accumulation, without which, intervention would be highly undesirable, given the liquidity impact amid already above-target rates of inflation. It is also for this reason of inflation that lowering interest rates is not a policy option for easing appreciation pressure.
- Another factor posited for the apparent slowdown in intervention is the fact that the RBI is likely already pressing up against their sterilisation limit, as determined by a mandated ceiling to outstanding Market Stabilisation Securities (MSS) bonds allowed to be circulating at one time (set at INR800bn for FY06/07). While this may be a factor influencing RBI behaviour, we doubt it has been too constraining. If the policy imperative had been to continue to stem the rate of INR appreciation, we cannot see too many real hurdles to the RBI gaining an increase in their sterilisation limits.

1. USD/INR and INR REER



Source: Bloomberg, HSBC

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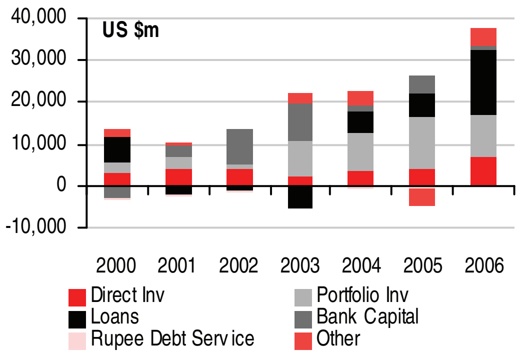
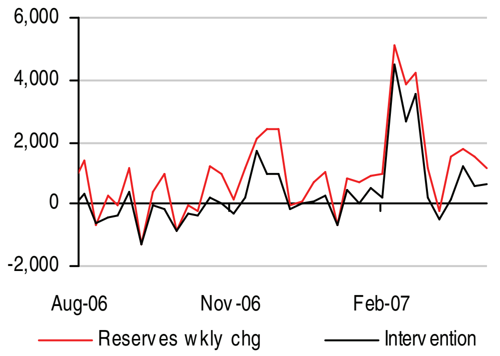
2. Breakdown of the capital account



Source: HSBC, CEIC

3. HSBC weekly intervention estimates

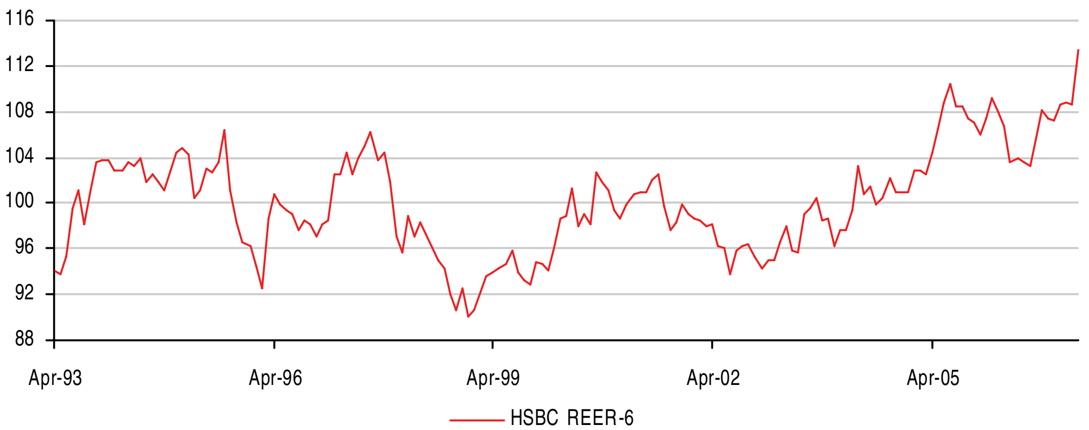


Source: HSBC, Bloomberg

- **How comfortable will the RBI be with further INR strength?** The 'political' dynamic around FX policy in India is, in many ways, unique in Asia. India does not possess the very vocal export lobby prevalent in many other Asian countries. Rupee strength, therefore, does not necessarily attract the same domestic outcry, although with REER pushing historic highs, competitiveness concerns will nonetheless become more acute. However, inflation (particularly in food prices), in the near term will be the dominant social and political issue. And so using a stronger currency to help ameliorate the recent inflation impulse would be consistent with this dominating policy focus.

- **What is the risk of regulatory action?** In a recent article published by the *India Economic Times*, a senior government official has suggested that the government and RBI are getting concerned with the strong external commercial borrowing inflows, and it has been suggested that fears of impending restrictions may have been driving frontloaded commercial flows back into INR in recent days. Significant regulatory changes, which could be interpreted as imposing capital controls, are highly unlikely. However, there may be some scope for tweaks to the current regulatory regime, in

4. INR REER



Source: Bloomberg, HSBC

terms of altering borrowing limits, increasing oversight, or mandating FX hedging of external borrowing. Indeed, there is legitimate concern for ensuring that external borrowing remains rationally tied to underlying economic activity, so as to prevent currency-mismatch and other corporate balance sheet vulnerabilities.

In essence, RBI is facing an increasingly familiar policy dilemma between further intervention, intervention costs, liquidity/inflation worries, competitiveness concerns, and the desire to retain free and open markets. All told, until clarity, or at least consensus is achieved on these questions, we are likely to see a more volatile market conditions prevail. Still, we continue to advise holding short USD/INR positions (or TWD/INR), and we recommend selling any bounces in USD/INR. 43.15 should provide strong resistance.

Equity strategy

Analyst target prices

If analysts' target prices are anything to go by, there is considerable upside for Indian stocks.

We have examined the recommendations of analysts for the stocks in BSE 500 index; including stocks which have at least five recommendations. This limits the universe to 163 stocks.

Analysts have a buy recommendation on 69% of stocks (113 stocks) and a sell recommendation on only 4% of stocks (6 stocks).

The upside for the stocks in the universe is 11.9% (free float adjusted); target prices have been revised up by 10% in the last 3 months and by 23% in last 6 months.

Looking at the target price upside, analysts are most bullish on real estate and travel & leisure, and least bullish on gas distribution, oil E&P and

Analyst recommendations and target prices: BSE 500 index

Sector	Analyst target price upside	3-month revision in target price	6-month revision in target price	Average recomm number	Recomm	% overweight stocks	% underweight stocks
Automobiles & Auto Parts	20.2%	4.0%	14.0%	2.2	Buy	56%	11%
Building Materials	17.0%	9.6%	15.7%	2.1	Buy	71%	0%
Chemicals	7.2%	16.9%	33.6%	2.1	Buy	58%	8%
Construction	15.3%	-10.1%	-10.2%	2.1	Buy	71%	0%
Consumer Goods	17.2%	4.7%	14.9%	2.0	Buy	74%	4%
Electric Utilities	8.2%	0.9%	1.2%	2.3	Buy	80%	0%
Engineering	8.0%	6.9%	17.6%	2.0	Buy	88%	0%
Financial Institutions	8.0%	9.6%	19.2%	2.3	Buy	75%	0%
Gas Distribution	0.1%	2.1%	0.5%	2.8	Hold	0%	0%
Healthcare	8.1%	5.3%	14.1%	2.3	Buy	63%	0%
IT Services	14.8%	13.0%	32.2%	1.8	Buy	100%	0%
Media	16.4%	3.7%	23.4%	2.0	Buy	100%	0%
Metals & Mining	16.5%	3.8%	6.1%	2.4	Buy	60%	10%
Oil – E & P	0.2%			2.8	Hold	0%	0%
Oil Integrated	11.6%	1.8%	12.0%	2.3	Buy	43%	14%
Real Estate	36.1%	-0.5%	12.0%	2.4	Buy	50%	0%
Retail	4.6%	10.8%	21.4%	2.9	Hold	0%	0%
Telecommunications	6.9%	32.6%	70.4%	1.9	Buy	83%	0%
Travel & Leisure	25.1%	3.0%	15.3%	1.9	Buy	67%	0%
Others	5.5%	-6.7%	-11.0%	3.2	Hold	33%	33%
BSE 500 Index	**11.9%**	**10.0%**	**23.0%**	**2.1**	**Buy**	**69%**	**4%**

Source: HSBC, Thomson financial

the retail sector.

The sectors with the most buy recommendations are IT services and media; the sectors with the most sell recommendations are others, oil integrated and metals & mining.

Despite the bullish stance of analysts (consensus view), we reiterate our cautious stance on equities due to peaking earnings growth, rich valuations and short-term economic risks.

Also, an upside of 11.9% is not consistent with a buy recommendation as it fails to meet the cost of equity, which we estimate at 13.2%.

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