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India Economics

Preview: RBI's Monetary Policy + Chartbook of Monetary Trends

- **The Backdrop of the RBI's April 24 monetary policy** is continued buoyancy in the economy reflected in strong trends in industrial production and GDP growth. Although credit and inflation have both moderated from their highs of 31% and 6.73%, respectively, to 27.6% and 5.74%, they are still higher than the targeted growth of 20% for credit and 5%-5.5% for inflation. While our macro forecasts have factored in one more rate hike, the timing is uncertain as the RBI has been effecting frequent inter-policy measures.

- **Repo rate[1] timing uncertain:** We believe that with inflation and bank credit growth both moderating, the bias should be for the RBI to keep rates on hold. Moreover, monetary transmission works with a lag of around 18 months and the RBI has hiked repo rates five times in FY07 taking it to 7.75% currently.

- **However, the RBI's actions are difficult to predict:** Thus, there is a 50:50 chance that the RBI will hike its policy rates on April 24 rather than waiting. Key justifications for this could be that inflation is likely to remain over its target range of 5%-5.5% till the week ending May 5 coupled with both money supply and credit running ahead of targets.

- **Possibility of measures to stem flows:** Forex reserves have touched US$200bn of which US$47bn has come in FY07. The RBI has been voicing concerns on capital flows. Therefore we could see measures that could result in a tightening of External Commercial Borrowing norms[2], reduction in interest rate on NRI deposits, etc.

- **Maintain our 2007 monetary policy stance:** However, while we expect only one more policy hike, we maintain that the RBI will continue to use the cash reserve ratio (CRR) – which has already been increased 150bps from 5% to 6.5% – to keep liquidity tight on the back of forex intervention. Not wanting to upset the growth momentum, it could lower statutory liquidity ratio (SLR) in 2H07 to ensure credit availability for the real sector.

- **No change in our macro forecasts:** The near-term growth outlook is a bit clouded given the RBI's recent tightening measures coupled with the government's semi-regressive measures to dampen inflationary expectations (price controls, etc). But, given the continuation of the key growth drivers as well as the uptrend in savings and investment – at 32.4% and 33.8% of GDP respectively, we expect GDP to sustain around 9% levels in FY08. Key risks to the outlook would be politics and much further monetary tightening.

[1] The 2 key policy interest rates are the **Reverse Repo** and **Repo Rate**. The Reverse Repo rate (6.0%) is the rate at which RBI absorbs liquidity from the system, while the Repo Rate (7.75%) is the rate at which it injects liquidity into the system.

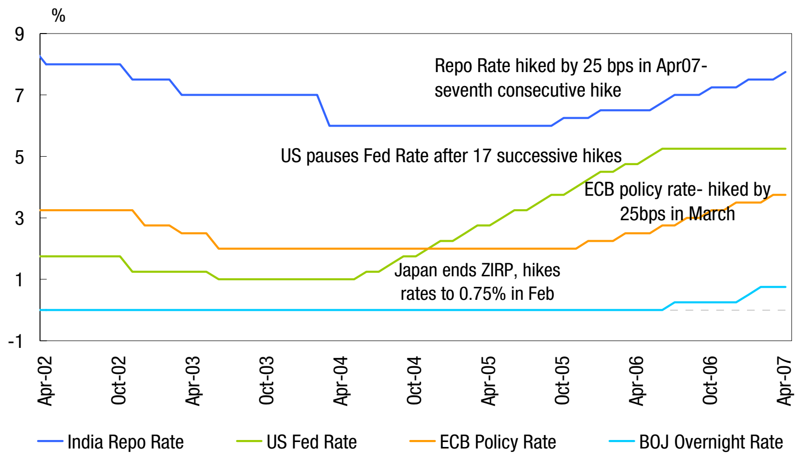
[2] **ECBs** which include loans, buyers/suppliers credit, securitized instruments and Foreign Currency Convertible Bonds (FCCBs) have a minimum average maturity of 3 years (for ECBs below US$20mn) and 5 years (for ECBs over US$20mn). In FY07, the ECB ceiling was raised from US$18 billion to the current $22 billion. Under the current policy, ECB can be raised only for investment (such as import of capital goods, new projects, modernisation/expansion of existing production units) in industrial sector, including small and medium enterprises (SME) and infrastructure sector.

Interest Rates – Domestic Monetary Policy to Remain Tight

The Global Environment

- **U.S:** Growth is likely to slow to 2.4% in 2007 v/s 3.3% in 2006, but inflation remains stubborn. We see one 25bps rate cut in 3Q 07 from 5.25% to 5%.
- **Euro Area:** Following the 25bps hike in March, our house view is of **the ECB** raising rates once more in 3Q07 from 3.75% to 4%.
- **In Japan,** strong GDP growth resulted in a 25bps hike in rates during the Feb07 policy. We expect another hike in 4Q07 from 0.5% to 0.75%
- **In China,** we expect the central bank to raise reserve requirements twice, and another 27bps increase in base lending rates this year; to tackle issues of overheating and inflation.

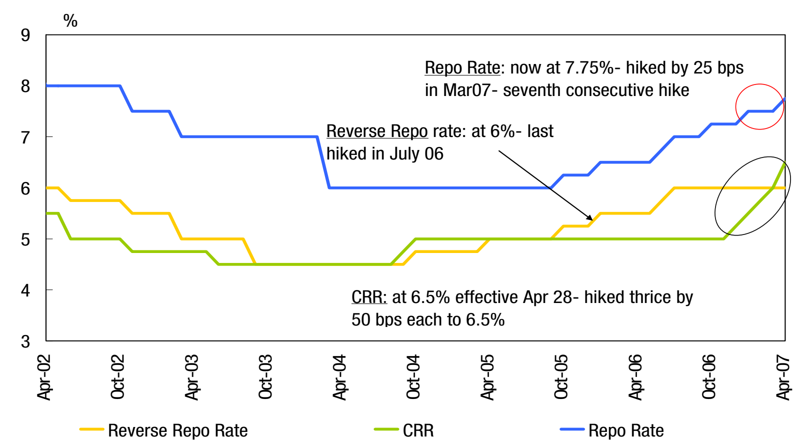
Trends in Key Global Policy Rates (%)



Key Domestic Policy Rates

- **Cash Reserve Ratio** = 6.5% (hiked thrice by 50bps in Dec06, Jan06 and Mar07)
- **Bank Rate** = 6% since May 2003
- **Reverse Repo Rate** = 6% (hiked six times by 25bps each, in Oct04, April05, Oct05, Jan06, Jun06 and Jul06)
- **Repo Rate** = 7. 75% (hiked seven times, by 25bps each in Oct05, Jan06, Jun06, Jul06, Oct06, Jan07, and Mar07)

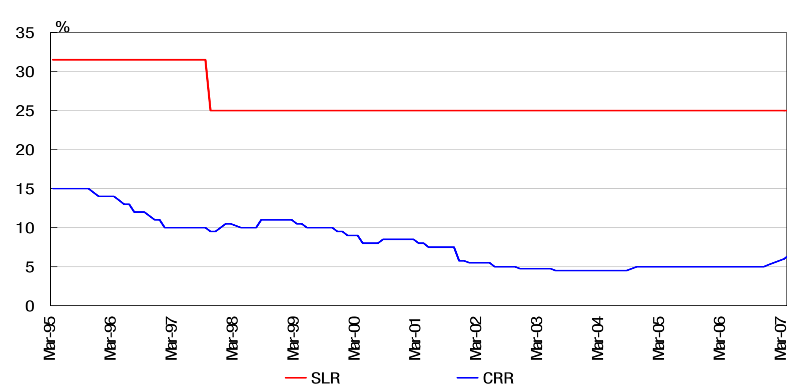
Trends in Domestic Interest Rates (%)



2007 : A year of multiple policy instruments

- While we think policy rates are likely to peak shortly, we could see the use of multiple policy instruments in 2007:
- **CRR:** The RBI will continue to use the cash reserve ratio (CRR) – which has already been increased by 150bps from 5% to 6.5% – to keep liquidity tight
- **SLR:** The RBI could also lower the statutory liquidity ratio (SLR) in 2H07 to ensure credit availability for the real sector.

Long Term trends in the CRR and the SLR



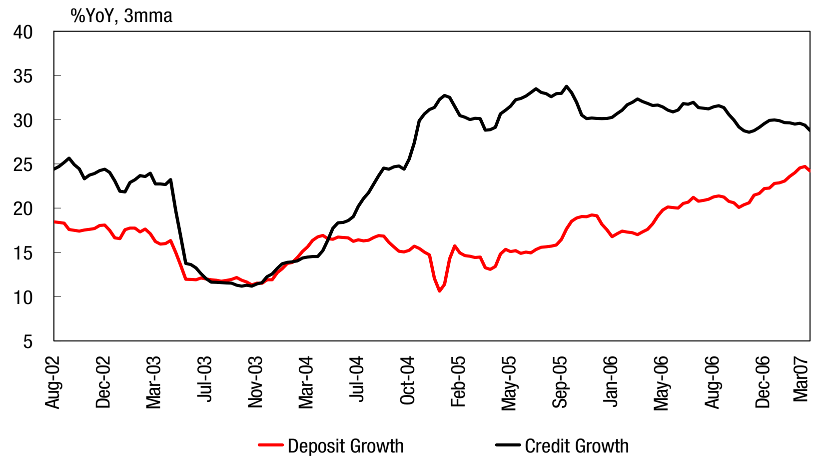
Source: RBI, Reserve Banks of, US, Japan, EU

Banking Trends – Indicate a Moderation

Trends in Deposit and Credit growth have moderated

- Following the RBI's tightening stance in FY07 resulting in attractive interest rates on term deposits, deposit growth picked up from 19% to 23%.
- The rise in rates impacted credit as well, with credit growth decelerating from 31% to 27.6% - though still higher than the targeted growth of 20% envisaged for FY07.

Trends in Deposit and Credit Growth (%YoY, 3mma)



Banking Trends

- Following two consecutive years with credit exceeding deposits, the situation reversed in FY07
- Incremental deposits in FY07 were Rs4,852bn while credit offtake stood at Rs4,161bn

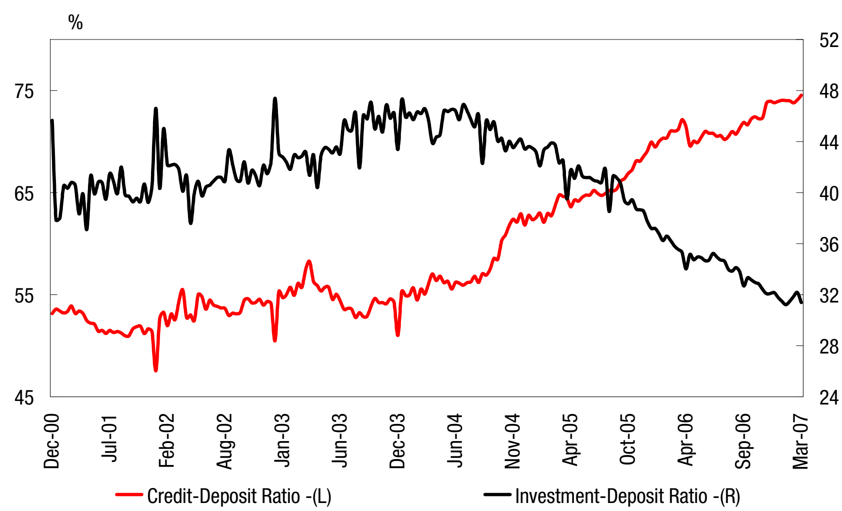
Banking Trends (%YoY, Rs Bn)

	Outstanding	Incremental to date		YoY%	Total			
	March 06	FY07	FY06		FY05	FY04	FY03	FY02
Bank Credit	**15,071**	**4,161**	**3,549**	**27.6**	**3114**	**1116**	**1394**	**783**
Food	407	58	7	14.3	41	-134	-46	140
Non-Food	14,664	4,103	3,542	28.0	3074	1251	1440	643
Bonds & Debentures	667	-47	-122	-10.5	15	-4	61	34
Deposits	**21,091**	**4,852**	**3,239**	**23.0**	**2807**	**2236**	**1775**	**1407**
GOI Investments	7,175	747	-228	10.4	617	1,300	1,093	681

Trends in Investment and Credit Deposit Ratios

- Despite robust growth in deposits, the continuation of strong trends in credit resulted in the credit-deposit ratio touching 75%.
- Due to higher deposits, bank's investments in government securities rose to Rs747bn up 10.4% in FY07 as compared to a draw-down of Rs228bn in FY06.

Trends in Credit Deposit and Investment Deposit Ratio (%)



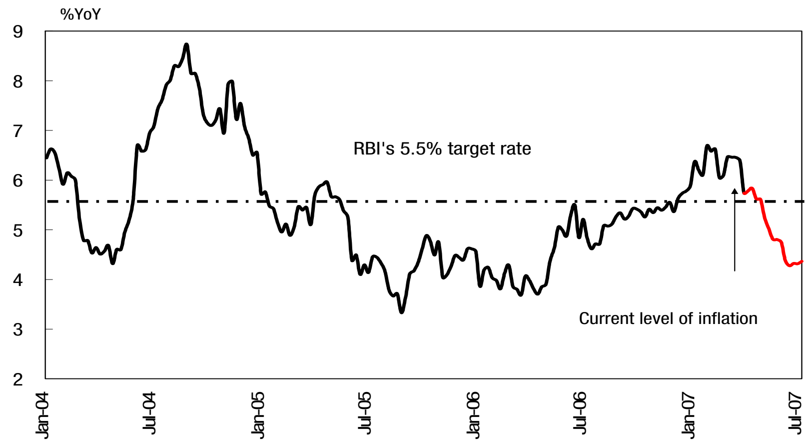
Source: RBI

Inflation – To remain top priority with the RBI and government

Trends in Wholesale Price Index

- In line with expectations, inflation which was hovering over 6% levels since October fell to 5.74% levels for the week ending March 31.
- This can be attributed to the strong base effect, RBI's tightening stance and fiscal measures
- Going forward, we expect inflation to remain over its target range of 5.5% till the week ending May 5. After which we expect it to remain under 5.5% levels due to the base effect and monetary/fiscal measures +expectations of a good monsoon

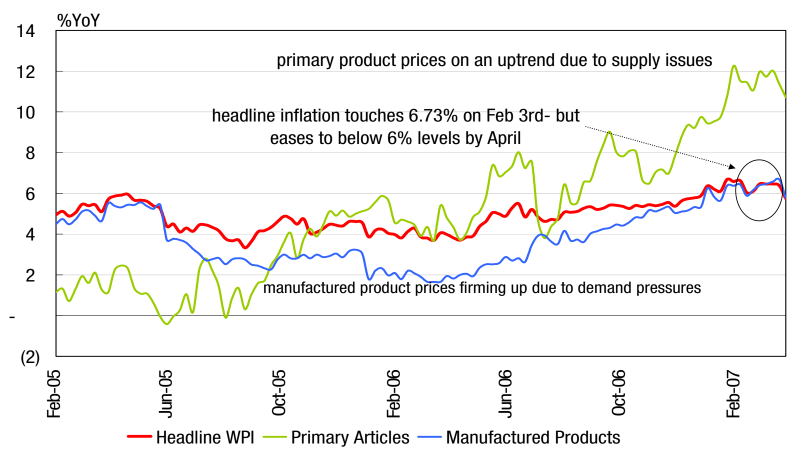
Likely Trends in the WPI



Primary and Manufactured product prices have fuelled inflation

- Inflation has been driven by primary products - a rise in prices of wheat, edible oils, pulses – which in turn is a result of supply side issues.
- Prices of manufactured products have also risen; largely due to higher basic metals prices, and indicative of the global commodity price cycle.
- However, we think the rise in prices of other manufactured products is largely transitional, given that the Indian capex cycle began in 2003 and there is evidence that new capacities will likely kick in over the next 12-15 months

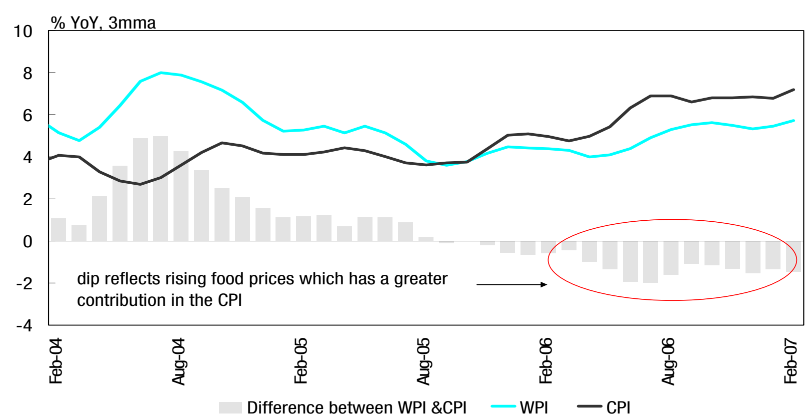
Trends in the WPI and Primary Articles Index (%YoY, 3mma)



Rising CPI is indicative of higher food prices

- The CPI for industrial workers rose from 5% in April to a high of 7.6% while the CPI for rural labour has risen even higher to touch 9.5%.
- The growing divergence between the CPI and the WPI is reflective of the fact that while primary (food) products account for 60% of the Index, they comprise just 22% of the WPI.

Trends in the CPI and WPI (%YoY, 3mma)



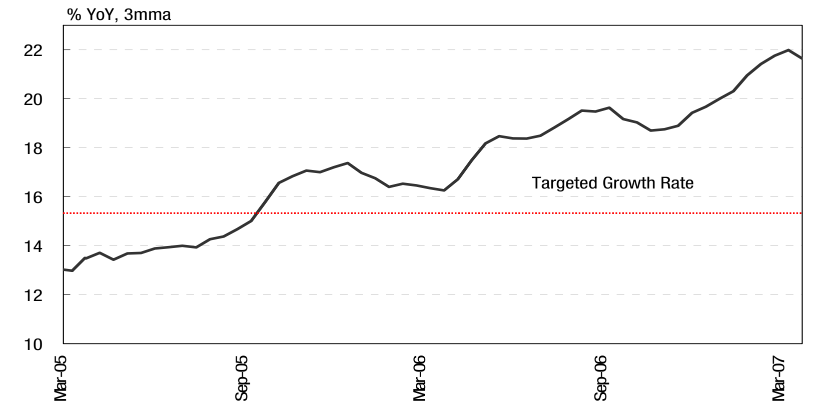
Source: Office of the Economic Advisor, Bloomberg, Labor Bureau

Liquidity – Rise in reserves makes liquidity management difficult

Trends in Money Supply

- Money supply has been running far ahead of RBI's target of 15.5% (YoY growth in money supply closed the year at 21%).
- A significant part of the expansion in monetary base is a result of dollar-buying by the RBI.

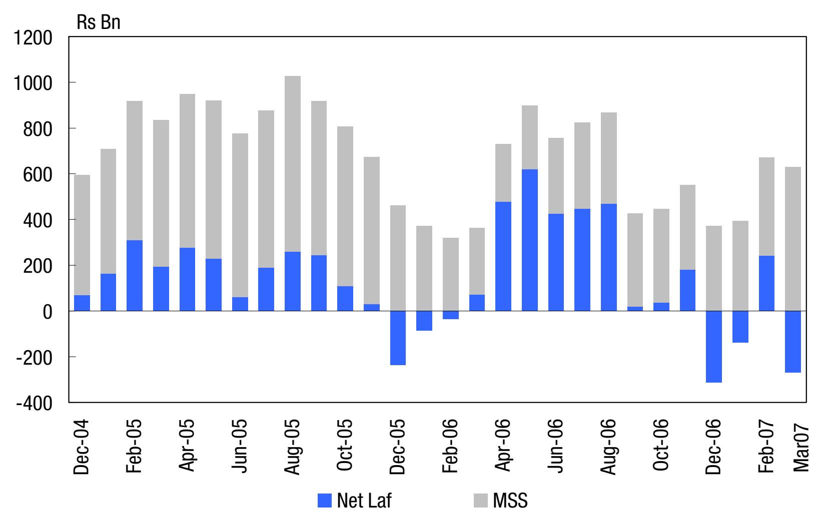
Trends in Money Supply (%YoY, 3mma)



Trends in Banking Sector Liquidity

- Trends in surplus liquidity saw a decline towards the year end as advance tax outflows resulted in a liquidity squeeze
- Tight liquidity resulted in call money rates shooting up to as high as 60%
- Liquidity injection by the RBI through the LAF during Mar07 amounted to Rs269bn, as compared to absorption to the tune of Rs269bn in Feb
- At the start of FY08, we saw liquidity conditions easing with LAF absorption rising to Rs324bn

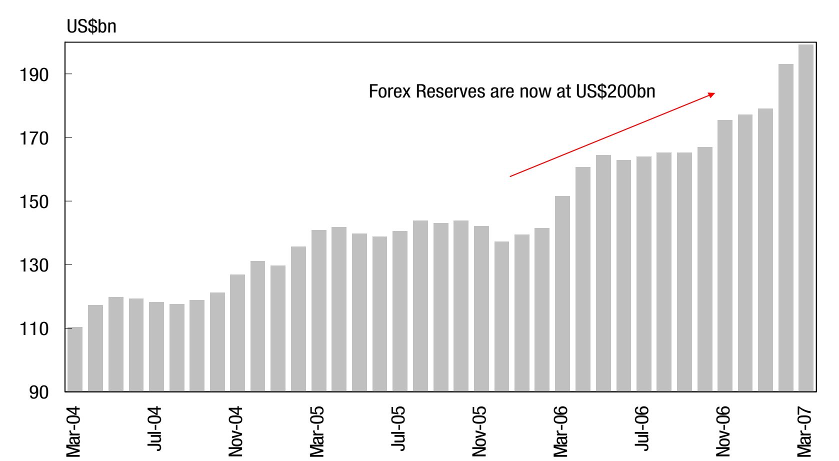
Trends in Surplus Liquidity as measured by Outstanding MSS Bonds and LAF



Trends in Forex Reserves

- Forex reserves have risen by US$47bn during FY07 and ended the year at US$199.2bn. Total reserves currently stand at US$200bn
- While reserves play a significant cushion toward reducing India's vulnerability to global developments; dollar-buying by the RBI is likely one of the key factors that has led to an expansion in the monetary base and fuelled liquidity

Trends in FX Reserves (US$bn)



Source: RBI

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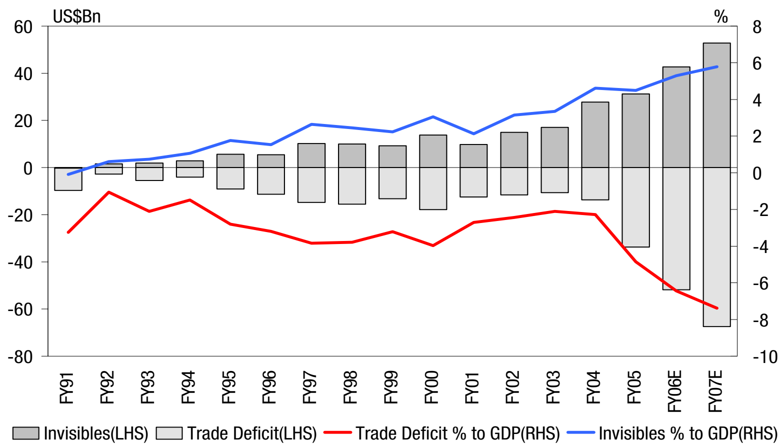
BOP: Trade deficit a worry, but Overall BoP still comfortable

Current Account Deficit- limited due to buoyancy in Invisibles

- Export growth which has been averaging 20%+ for the last five years is likely to decelerate to sub-15%yoy levels on the back of a moderation in the US, a high base effect and a lack of new export initiatives.
- However, imports are also likely to slow to 13.5% levels. This assumes stable oil prices, but continuation of 20%+ non-oil imports.
- While this will result in an increase in the trade deficit, given continued buoyancy in invisibles – remittances and software exports – we expect the CAD to remain around 1.5% of GDP.

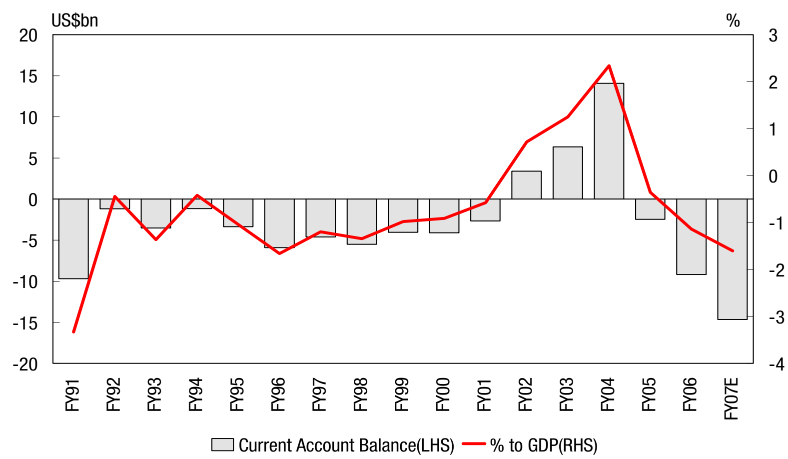
Trends in Invisibles and the Trade Deficit (US$bn, % GDP)



Points to consider about India's CAD:

1. Its **size**; which is well under 2% of GDP
2. Besides oil, the widening of the trade deficit is largely due to **non-oil imports** of which over 70% is due to capital goods and industrial raw materials – essential- given that India has moved from a 6% growth to 8%+
3. The rise in **invisibles** earnings partially offsets the trade deficit
4. **Capital flows** – excluding the so-called hot money (portfolio flows + NRI deposits) are more than sufficient to finance it

Trends in the Current Account (US$bn, % GDP)



Overall BOP: Still Comfortable

- We expect the CAD to widen to US$15.4bn (1.4% of GDP). However we continue to remain comfortable on the external sector since:

1. Capital Flows are sufficient to finance the CAD
2. Buoyant FX reserves - currently at US$200vn - provide a cushion against external shocks

Trends in the BOP (US$bn,)

	FY04	FY05	FY06	FY07E	FY08E
a. Trade Balance	-13.7	-33.7	-51.8	-67.4	-74.7
b. Invisibles	27.8	31.2	42.7	52.8	59.3
1. Current A/c Balance (A+B)	**14.1**	**-2.5**	**-9.2**	**-14.6**	**-15.4**
c. Loans	-4.4	10.9	6.1	13.5	9.0
d. FDI(Net)	2.4	3.7	4.7	9.0	11.0
e. Portfolio Investment	11.4	9.3	12.5	6.5	6.5
f. Banking Capital	6.0	3.9	1.4	6.5	6.0
Commercial Banks (Net)	2.4	4.8	0.4	4.0	3.5
NRI Deposits	3.6	-1.0	2.8	2.5	2.5
g. Rupee Debt Service	-0.4	-0.4	-0.6	-0.4	-0.4
h. Other Capital	1.7	0.7	-0.7	1.0	1.0
2. Capital A/c (c:h)	**16.7**	**28.0**	**23.4**	**36.1**	**33.1**
Errors and Ommissions	0.6	0.6	0.8	0.0	0.0
3. Overall Balance (1+2)	**31.4**	**26.2**	**15.1**	**21.5**	**17.7**

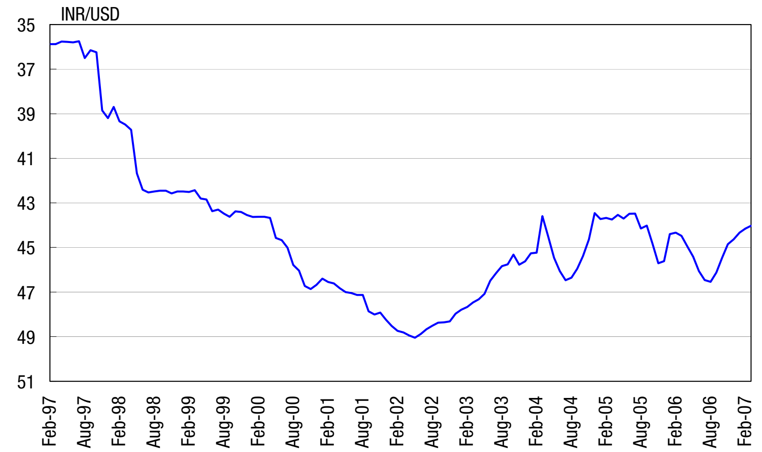
Source: RBI

Currency: Tracking the Rupee, What's Next?

Tracking Trends in the Rupee: What's behind the move?

- The rupee has strengthened 5% in the last month from Rs44.5/$1 to 42/$1 levels currently. While the move from 44.5 to 43/$ was triggered by banks selling dollars due to higher than expected advance tax collections, the move from Rs43 to Rs41.9 has largely been driven by flows
- **Reasons behind the move** include: lack of RBI intervention, an increase in the supply of dollars as exporters got stopped out at the technical level of Rs42.75/$, and a reduction in demand for dollars from importers due to rise in premia. The rupee is also being used as a tool against inflation by the RBI, Finally, it is being seen as a carry currency given rising domestic interest rates.

Long Term Trends in the Rupee (INR/USD)

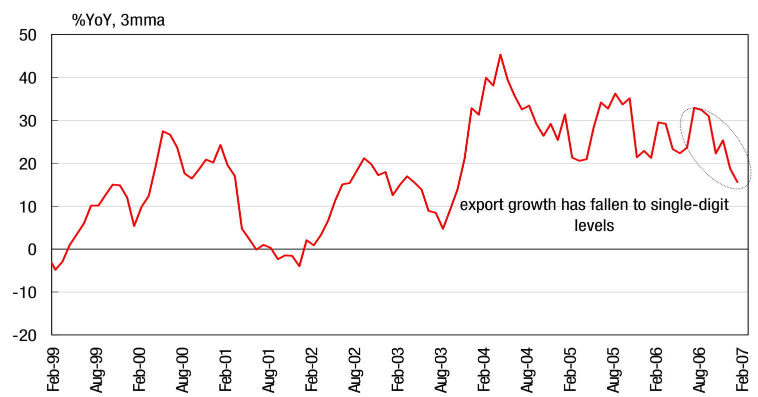


Note: Values are plotted on a reverse scale such that an increase in the plotted line indicates a depreciation and vice versa. Source:RBI

What's Next?

- While there is a possibility of the rupee even going to 40.5 levels, we believe that the rupee could bounce back to around Rs42.50 levels.
- A key reason for this is a deceleration in export growth during the last 3 months to the 5-7% range, compared with 20%+ levels seen earlier. On trade adjusted terms – i.e., looking at the REER- the rupee is 9% overvalued (However, this only takes into account trade flows)
- Other reasons include strong trends in capital flows

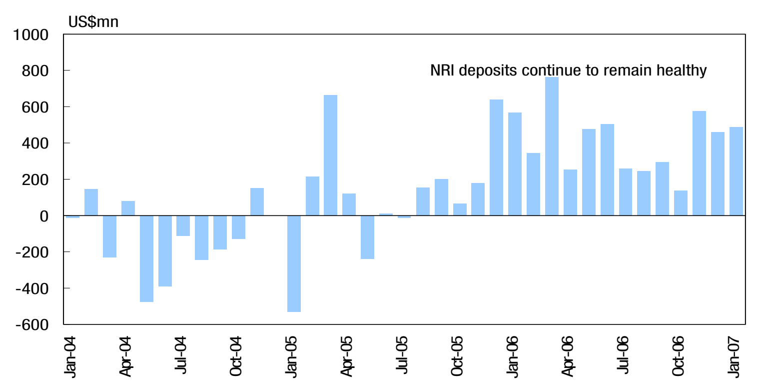
Monthly Trends in Exports (%YoY, 3mma)



Policy Measures could aim at stemming capital flows

- We could thus see measures such as tightening of ECB norms, and lower interest rates on NRI deposits
- On the back of rising domestic interest rates, overseas borrowings have become an attractive option for Indian corporates. **Loans including Commercial Borrowings** totaled US$11.4bn in during 9MFY07 v/s 1.6bn during 9MFY06.
- Interest rates on **NRE Deposits** are capped at 25bps over Libor; while those on FCNR Deposits are capped at Libor minus 25bps. NRI deposits during Apr-Jan07 amounted to US$3.7bn vs US$1.7bn last yr

Monthly Trends in NRI Deposits (US$mn,)



Source: RBI

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