

India Macro Stance

June 9, 2009

Goldman Sachs Global Economics,
Commodities and Strategy Research
at <https://360.gs.com>

Tushar Poddar
tushar.poddar@gs.com
+91 22 6616 9042

Pranjul Bhandari
pranjul.bhandari@gs.com
+91 22 6616 9169

Inflationary pressures on the horizon

We have re-christened our weekly product to 'India Macro Stance' from India Weekly Liquidity Watch. Since we started the Weekly Liquidity Watch in October 2008 during the depths of the financial crisis to monitor developments in banking, money, bond, and currency markets, our weekly product has become more than a 'Liquidity Watch.' It has contained in-depth analysis of one topical issue, tradable ideas, and more generally, our views on the macro-economy. The re-naming of the product also suggests that it is inherently forward-looking and will continue to reflect our stance on topics of macro-economic importance. This week we look at inflation.

We think inflationary pressures are sequentially building up. Recent data on both the WPI—the preferred official measure, and CPI show a sequential bottoming out between February-April. With our expectation that domestic demand will pick up from October 2009, in part due to the positive tail winds from the election outcome and the easing of financial conditions, a majority of the factors that impact inflation in India¹, the output gap, money supply, and commodity and asset prices, are suggesting a building up of inflationary pressures in the second half of FY10, even though in the very near term, yoy prices will likely be in negative territory due to a high base effect. Only the strengthening INR is working against it. We are therefore revising our end-FY10 WPI forecast significantly to 6.5% from 3% earlier. We think policy easing is at an end, and the first rate hikes may come in early-2010 as monetary policy moves from being very loose to a more neutral stance.

Latest readings of price indices are showing a bottoming out of inflation. Since the start of the credit crunch in September we have argued that declines in output below potential will drive prices lower, and a temporary period of negative yoy changes in WPI inflation will likely happen in mid-2009 partly due to base effects. Indeed, one of our Top 4 macro themes for 2009 was disinflation (see *India: Four macro themes for 2009*, Asia Economics Flash, January 20). Now that we are in mid-2009, a pulse check on inflationary pressures in the economy is warranted. Recent evidence from the WPI suggests a bottoming out of inflation (see Exhibit 1). Food and energy prices are contributing to the sequential increase (see Exhibit 2). The CPI for industrial workers, is also showing a bottoming out, with the current April inflation reading at 1.5% qoq and 8.7% yoy (see Exhibit 3).

With a recovery in domestic demand on the horizon, we believe the output gap will continue to shrink, exerting upward pressures on prices. Demand has remained relatively resilient through the crisis and easing financial conditions suggest a further shrinking of the output gap going forward (see *Weekly Liquidity Watch: Resilient growth*, India Views, June 1). Further, the overall output gap hides inter-sectoral differences. Thus, there is more spare capacity in the tradable sectors such as IT and BPO services, textiles, and gems and jewellery, than there is in the

Goldman
Sachs

¹ See *India: Fuel, fiscal and foreign flows—can they make inflation bite?* Asia Economics Analyst 07/23, December 17, 2007.

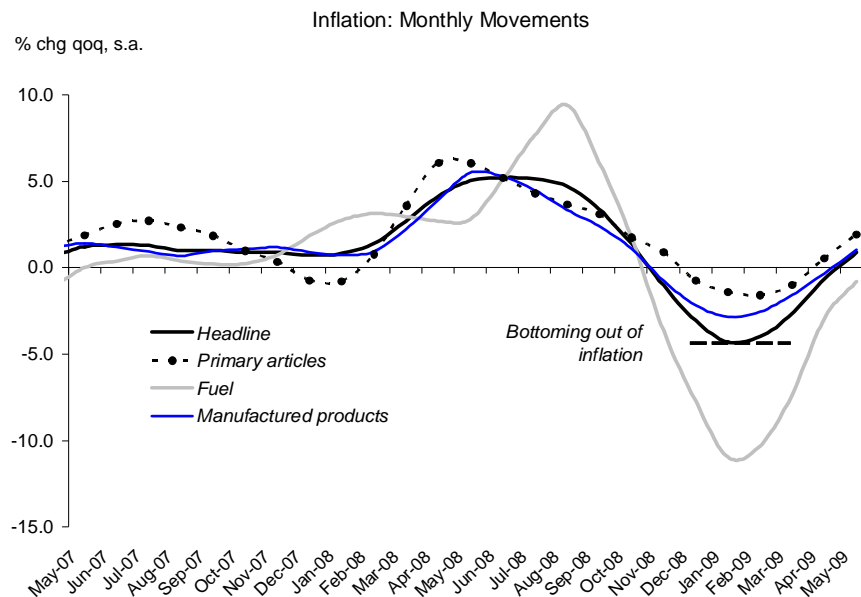
non-tradable sectors such as domestic services and infrastructure sectors. This is already being reflected in prices—the CPI which includes services has fallen by less than the WPI, which excludes services. Indeed, the ‘miscellaneous’ component of the CPI which includes services has been about 150 bp higher than other non-food components of CPI in recent months. Given that India’s non-tradable sector is relatively larger, the overall output gap likely overstates the current gap between domestic demand and domestic output, and by implication, the WPI which excludes a large proportion of non-tradables, likely understates current inflationary pressures.

Commodity prices are headed higher. Our Commodities Research Team has increased its WTI oil forecast from US\$65/bbl to US\$85/bbl in end-2009 and have an end-2010 target of US\$95/bbl. India is particularly vulnerable to oil prices as it imports a majority of its oil needs. According to our estimates, a 10% increase in the administered price of crude oil increases WPI inflation by 0.6 percentage point. In addition, any increase in agricultural and metal prices will also put upward pressures on inflation. Our Commodities Research Team has recently also raised their price forecasts of several metals. Asset prices, especially equities, have also rallied dramatically in the last few weeks, and there may be spill-overs into inflation in the second half of FY10.

Policy remains very loose. The policy repo rate has been reduced by 425 bp and the policy reverse repo rate by 275 bp respectively; while fiscal policy has eased dramatically. Broad money (M3) growth, at 20.5% yoy at end-May remains higher than long-run averages and the central bank’s target of 17% yoy. This has also been in part due to increased inflows and monetary accommodation of the fiscal deficit. The system is awash with liquidity, with banks depositing an average US\$27 billion per day at the Reserve Bank of India. We think excess money growth will likely exert upward pressure on prices going forward.

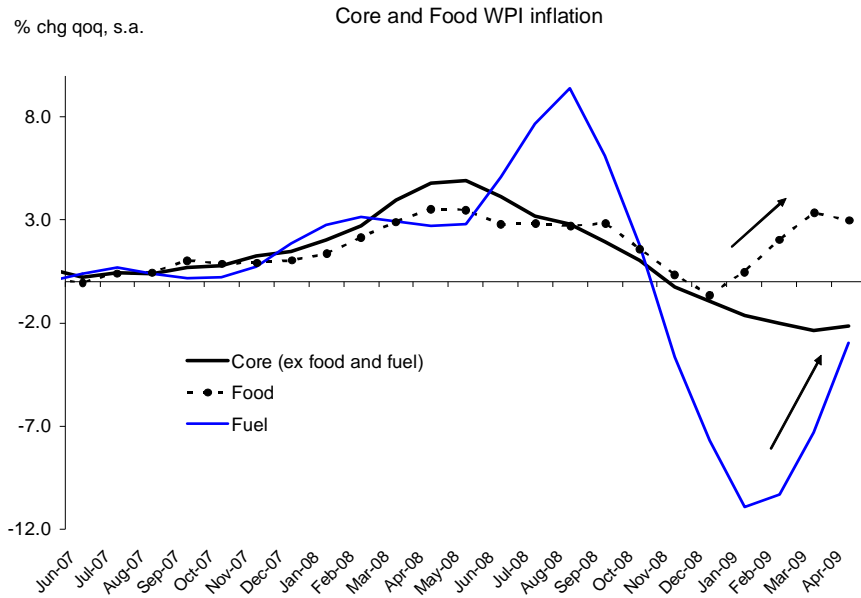
Given the outlook on inflation, we think that policy rates may start going up in early-2010. In the near term, although there is a small probability that the central bank may choose to err on the side of boosting demand and provide a token cut in short-term policy rates to boost investment after the elections, we think that the policy easing is done. We think that given the long lags in the transmission between policy rates and activity, additional cuts would be a mistake as it would affect demand when it is already rising, and risk stoking inflationary pressures. With the caveat that a good monsoon and significant currency appreciation may keep inflationary pressures subdued for a while longer, we think that monetary policy will start increasing rates by early-2010 to start the process of moving from a very loose to a more neutral stance. We think the OIS curve will flatten as a result.

Exhibit 1: The WPI suggests a bottoming out of inflation



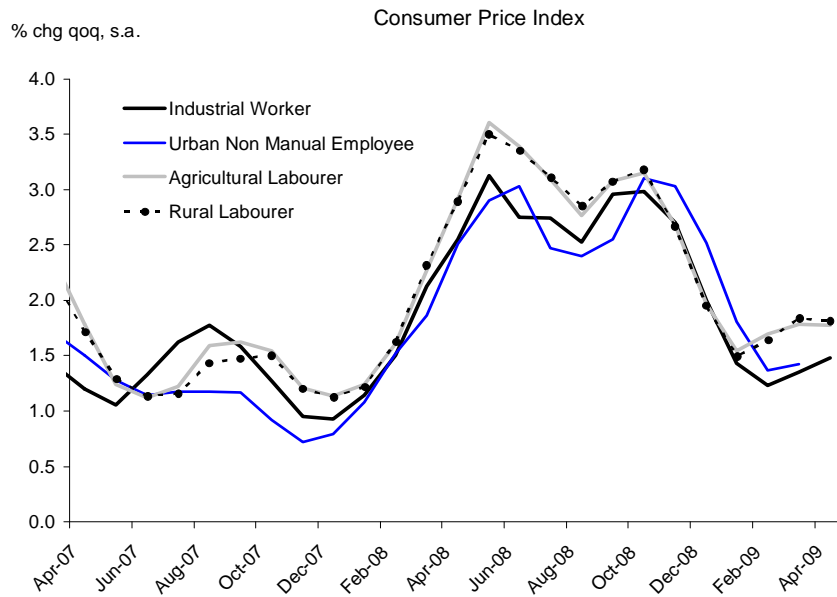
Source: CEIC, GS Global ECS Research.

Exhibit 2: Food and energy prices are contributing to the sequential increase



Source: CEIC, GS Global ECS Research.

Exhibit 3: The various CPIs are also beginning to rise sequentially



Source: CEIC, GS Global ECS Research.

Copyright 2009 The Goldman Sachs Group, Inc. All rights reserved.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of The Goldman Sachs Group, Inc. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide to future performance. Future returns are not guaranteed, and a loss of original capital may occur. The Goldman Sachs Group, Inc. does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment. Certain transactions - including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only.

We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives (including options) thereof of companies mentioned herein. For purposes of calculating whether The Goldman Sachs Group, Inc. beneficially owns or controls, including having the right to vote for directors, 1% of more of a class of the common equity security of the subject issuer of a research report, The Goldman Sachs Group, Inc. includes all derivatives that, by their terms, give a right to acquire the common equity security within 60 days through the conversion or exercise of a warrant, option, or other right but does not aggregate accounts managed by Goldman Sachs Asset Management. No part of this material may be (i) copied, photocopied, or duplicated in any form by any means or (ii) redistributed without The Goldman Sachs Group, Inc.'s prior written consent.

The Global Investment Research Division of Goldman Sachs produces and distributes research products for clients of Goldman Sachs, and pursuant to certain contractual arrangements, on a global basis. Analysts based in Goldman Sachs offices around the world produce equity research on industries and companies, and research on macroeconomics, currencies, commodities and portfolio strategy.

This research is disseminated in Australia by Goldman Sachs JBWere Pty Ltd (ABN 21 006 797 897) on behalf of Goldman Sachs; in Canada by Goldman Sachs Canada Inc. regarding Canadian equities and by Goldman Sachs & Co. (all other research); in Germany by Goldman Sachs & Co. oHG; in Hong Kong by Goldman Sachs (Asia) L.L.C.; in India by Goldman Sachs (India) Securities Private Ltd.; in Japan by Goldman Sachs Japan Co., Ltd, in the Republic of Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch; in New Zealand by Goldman Sachs JBWere (NZ) Limited on behalf of Goldman Sachs; in Singapore by Goldman Sachs (Singapore) Pte. (Company Number: 198602165W); and in the United States of America by Goldman, Sachs & Co. Goldman Sachs International has approved this research in connection with its distribution in the United Kingdom and European Union. This material has been issued by The Goldman Sachs Group, Inc. and/or one of its affiliates and has been approved for the purposes of section 21 of the Financial Services and Markets Act 2000 by Goldman Sachs International, which is regulated by the Financial Services Authority, in connection with its distribution in the United Kingdom, and by Goldman Sachs Canada, in connection with its distribution in Canada. Goldman Sachs International and its non-US affiliates may, to the extent permitted under applicable law, have acted on or used this research, to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risk and are not suitable for all investors. Please ensure that you have read and understood the current options disclosure document before entering into any options transactions.

Further information on any of the securities mentioned in this material may be obtained on request, and for this purpose, persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 2 Queen's Road Central; persons in Australia should contact Goldman Sachs JBWere Pty Ltd. (ABN 21 006 797 897), and persons in New Zealand should contact Goldman Sachs JBWere (NZ) Ltd. Persons who would be categorized as retail clients in the United Kingdom, as such term is defined in the rules of the Financial Services Authority, should read this material in conjunction with the last published reports on the companies mentioned herein and should refer to the risk warnings that have been sent to them by Goldman Sachs International. A copy of these risk warnings is available from the offices of Goldman Sachs International on request. A glossary of certain of the financial terms used in this material is also available on request. Derivatives research is not suitable for retail clients. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.