India Macro Stance

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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 India [1]*, 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

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

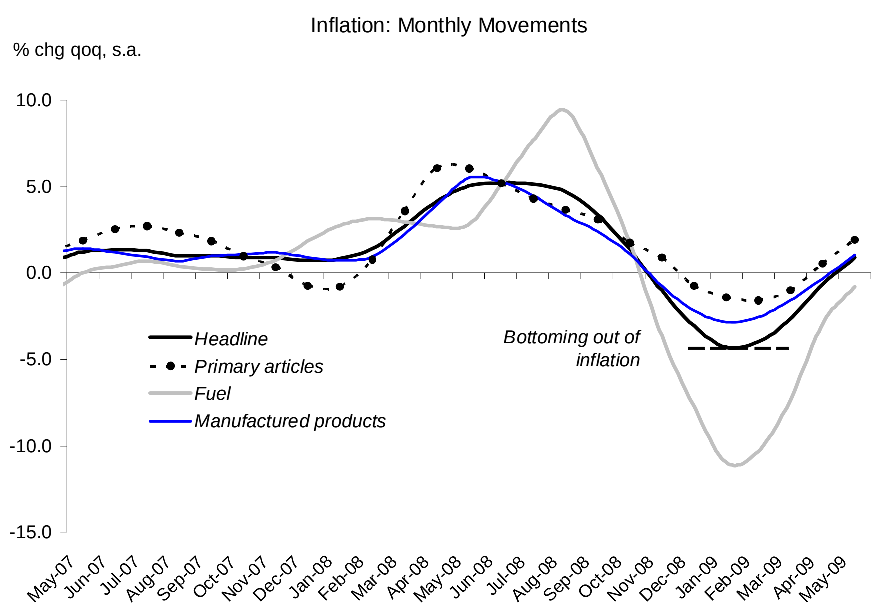
non-tradable sectors such as domestic services and infrastructure sectors. This is already being reflected in prices—the CPI which includes services has fallen by less than the WPI, which excludes services. Indeed, the 'miscellaneous' component of the CPI which includes services has been about 150 bp 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.

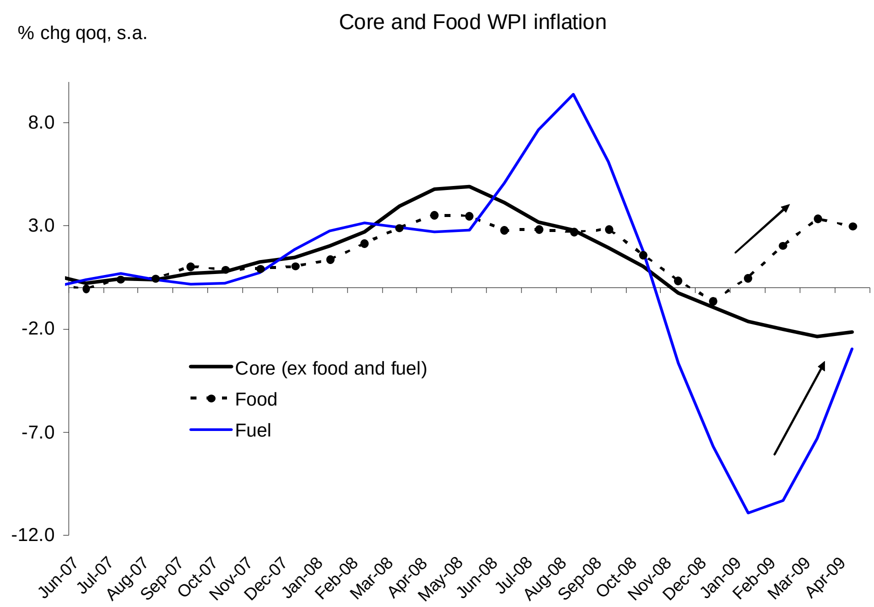
Given the outlook on inflation, we think that policy rates may start going up in early-2010. In the near term, although there is a small probability that the central bank may choose to err on the side of boosting demand and provide a token cut in short-term policy rates to boost investment after the 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



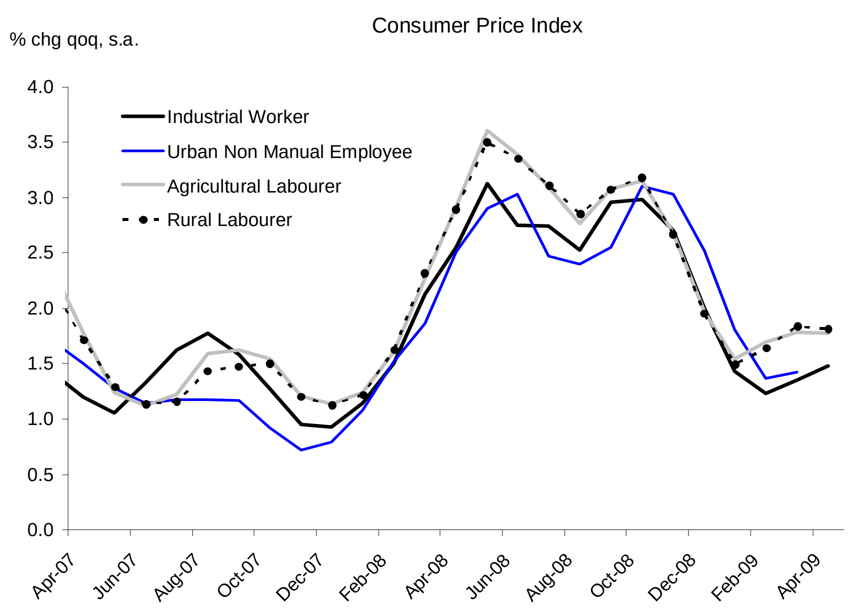
Source: CEIC, GS Global ECS Research.

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.