INDIA MACRO PICTURE

Consumption and investments strong, external sector in focus

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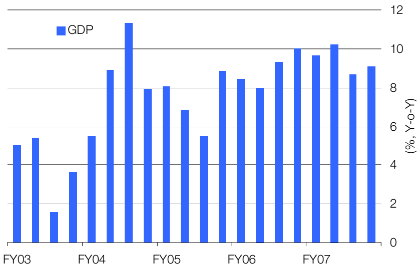
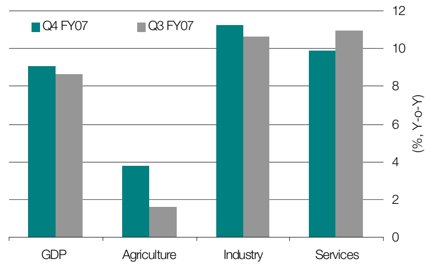
Strong GDP growth continues



Source: CSO

Industry and services support



Source: CSO

Part I: What do the trends tell us?

The last one week witnessed a series of significant releases for the Indian economy – GDP, trade, government finances and inflation.

What picture do the releases put together paint for the economy? There are three points to note with respect to the Indian economy-

(i) **Domestic consumption story stays strong:** Strong FY07 GDP numbers and buoyancy in agriculture in Q4 suggest that demand will sustain. Good growth in tax collections and non-oil imports also point in the same direction. While the rise in interest rates over the last one year will likely temper growth from its current levels, agriculture support could provide an upside surprise.

(ii) **Capital formation continues:** The investment drive in the economy remains firmly underway. This is evident from the rising proportion of gross capital formation in GDP, due to double digit growth in investments. This is further corroborated by the still strong capital goods' production index.

(iii) **The central bank's dilemma- CRR hike likely:** The RBI is faced with two parallel situations: (i) On the domestic front, growth remains strong, while inflation and credit have started softening and (ii) On the external front, USD/INR has appreciated steeply over April and May, which is reflected at least in part in the widened April trade deficit. We believe that the RBI will intervene more aggressively in the currency markets later in the month. However, with the inflation situation only just in control, is likely to hike the CRR yet again to sterilize the liquidity creation.

Part II: Data trends in detail

(i) **GDP** - FY07 GDP surprises at 9.4% Y-o-Y. Strong agriculture growth in Q4.

(ii) **Government finances** – Fiscal deficit/GDP comes in at a lower than expected 3.5%.

(iii) **Inflation** – Inflation continues to cool off, we expect it to fall below 5% in June.

(iv) **Merchandise trade** – Trade deficit rises to an all time high of USD 7 bn in April.

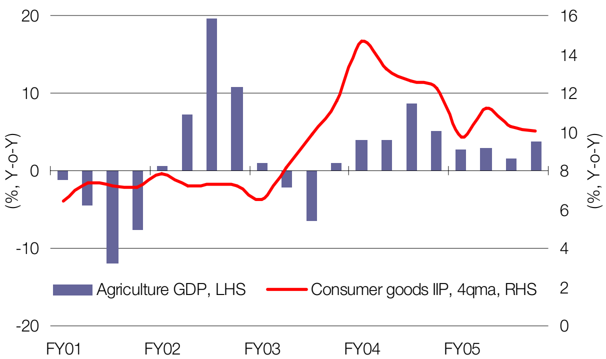
Part I: What do the trends tell us?

The previous week saw the release of significant economic data for India – GDP, trade, inflation and fiscal situation. In sum, the data points to the following trends:

- Domestic demand sustains

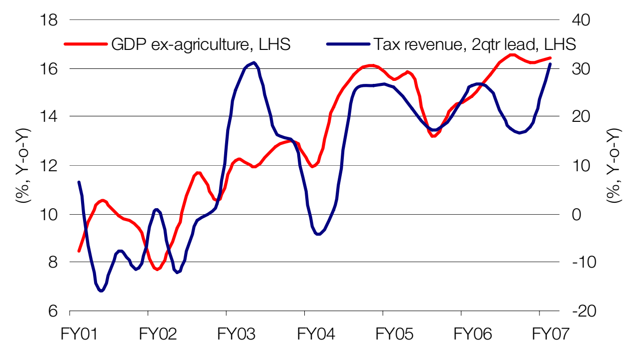
  Majority of domestic demand indicators still point to sustained growth. FY07 GDP figures at 9.4% Y-o-Y reflect continued strength in industry and services, with agriculture providing an upside in Q4. The 3.8% Y-o-Y growth in agriculture for Q4 FY07 suggests a good rabi season, which will spill over to growth numbers for Q1 FY08 as well. Since agriculture growth impacts rural demand, the latter should be a source of support. Strong rise in non-oil imports of USD 1.4 bn in April from March as well as robust tax collections point towards sustained demand. The only indication of some cooling off in demand figures so far is evident in the consumer durables' production index, possibly due to rising interest rates.

Strong agriculture sustains consumption demand



Source: CMIE

Tax revenues grow on strong earnings

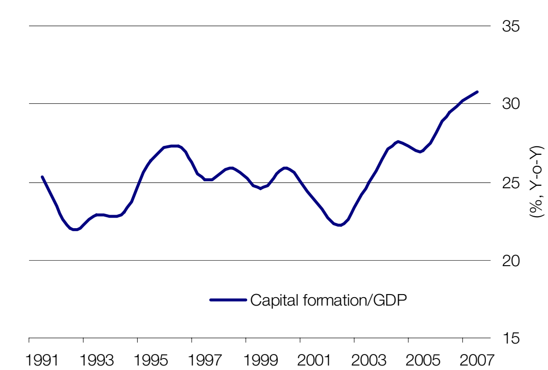


Source: CMIE, CGA

- Capital formation remains underway

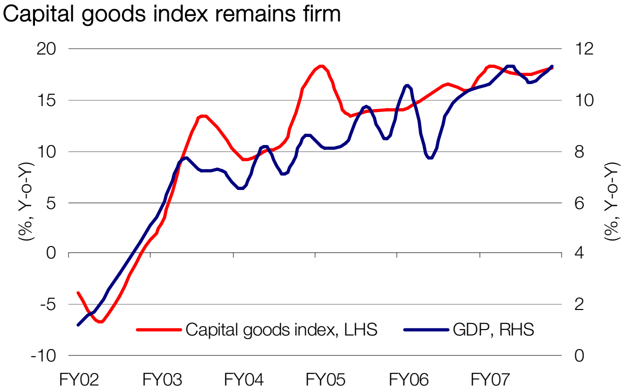
  The share of capital formation in overall GDP is on the rise – it now accounts for over 30% of India's GDP. The share has largely been on the rise since the start of FY02. The fact is also evident from the sustained upturn in capital goods index, which is still reflecting double digit growth. In so far as capital formation is a lead indicator for demand, this reflects a positive trend for growth going forward as well.

Rising share of capital formation



Source: CSO, CMIE

Capital goods index remains firm

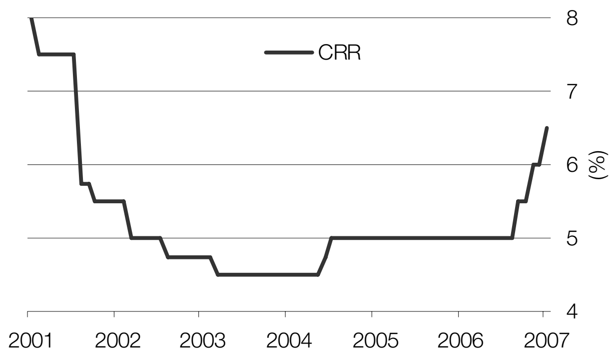


Source: CSO, CMIE

- The central bank's dilemma- CRR hike likely

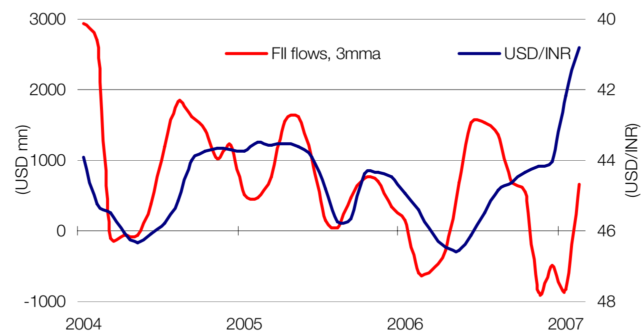
The RBI is faced with two parallel situations: (i) On the domestic front, growth remains strong, while inflation and credit have started softening and (ii) On the external front, USD/INR has appreciated steeply over April and May, which is reflected at least in part in the widened April trade deficit. Till FY07 the RBI managed to hold the currency down by infusing liquidity into the system. It started to hike the CRR in December 2007 as a means to sterilize this liquidity, when the liquidity infusion started leading to overheating concerns.

CRR hikes underway



Source: RBI

Continued flows could put further pressure on the rupee



Source: Bloomberg

However, with continued strong external flows, the RBI decided to change its policy stance in FY08. It kept a hands-off approach from the currency market, in the first two months of the current fiscal year leading to a sharp appreciation in the rupee. This has, however created concerns with respect to exports. India is still a largely domestically driven economy, with export promotion as one of the policy objectives. Anecdotal evidence suggests that the sharp recent rupee appreciation has begun to hurt exporters, and is likely to reflect in May trade figures as well. Moreover, the currency is expected to come under further stress later in the month as there are external inflows on account of equity issues by DLF and ICICI. We expect the RBI to intervene more aggressively in the currency markets going forward to (i) check any further appreciation in the rupee and (ii) possibly bring the rupee further down from its current level to address exporters' concerns.

While it has some comfort on inflation at present, the credit growth numbers are still the RBI comfort level of 25%. In such a scenario, we expect it to raise the CRR to sterilize the liquidity creation.

Part II: Data trends in detail

GDP

- India continued to show strong growth for the fourth consecutive year; with FY07 ending at a high of 9.4% Y-o-Y. Our estimates as well as street expectations had indicated a growth of 9.0% Y-o-Y. The upside on growth has come in on account of upward revision to growth in the previous three quarters, with the number being close to our forecasts for Q4 FY07. Q4 growth came in at 9.1% Y-o-Y, up from 9.2% as per estimates.

- The break up of FY07 growth across components reveals continued strong industry and services performance. Within industry, manufacturing showed a strong 12.3% growth. 'Electricity, gas and water supply' and construction sectors provided support as well. Services' components showed strong growth across the board. 'Trade, hotels, transport and communications' showed acceleration in growth from FY06. In Q4 FY07, however showed some deceleration in services growth over the previous quarter, on a softening across all three segments. Industry growth however remained strong in Q4 as well. Agriculture, in particular, provided an upside to Q4 growth – increasing by 3.8% Y-o-Y, up from 1.6% Y-o-Y during the previous quarter.

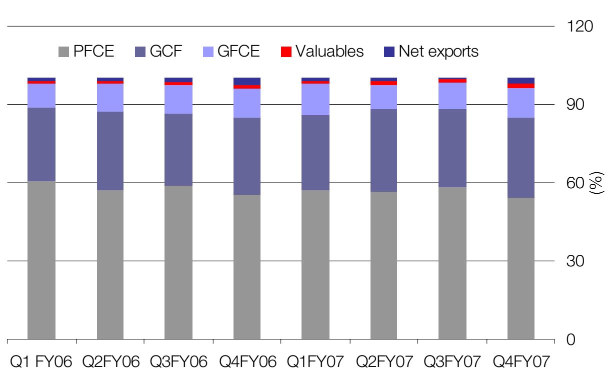
GDP growth by components (%, Y-o-Y)

	FY07	FY06	Q4 FY07	Q3 FY07	Q4 FY06
GDP	9.4	9.0	9.1	8.7	10.0
Agriculture	**2.7**	**6.0**	**3.8**	**1.6**	**6.2**
Industry	**10.9**	**9.6**	**11.2**	**10.6**	**10.4**
Mining	5.1	3.6	7.1	5.5	5.2
Manufacturing	12.3	9.1	12.4	11.8	9.4
Electricity, gas & water supply	7.4	5.3	6.9	9.1	6.1
Construction	10.7	14.2	11.2	10.0	16.1
Services	**11.0**	**9.8**	**9.9**	**11.0**	**11.1**
Trade, hotels, transport & communication	13.0	10.4	12.4	13.1	11.8
Financing, insurance, real estate & business services	10.6	10.9	9.3	11.2	14.2
Community, social & personal services	7.8	7.7	5.7	6.7	7.2

Source: CSO

- For the first time, the CSO reported quarterly GDP estimates by expenditure components. In terms of proportions, the capital formation remains on a strong footing, contributing now to a little over 30% of the GDP. This is primarily at the cost of a loss in consumption's share to about 54% for Q4 from over 57% in Q1. This is largely because of strong growth in investments (14.2% Y-o-Y in Q4), while consumption growth remained largely stable at 6.2% Y-o-Y.

Rising share of GCF



Source: CSO

Growth across expenditure components

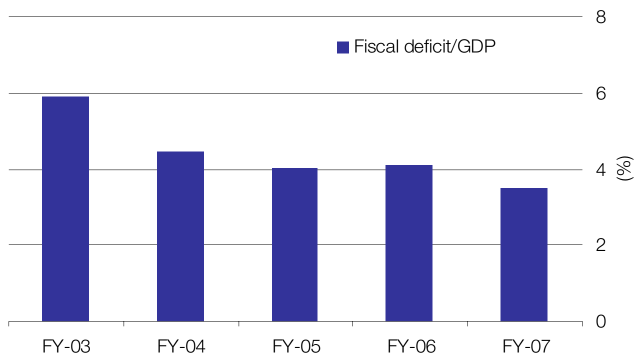
	Q3FY07	Q4FY07	FY07
Private final consumption expenditure	6.0	6.0	6.2
Govt final consumption expenditure	0.4	6.6	9.0
Gross capital formation	15.0	13.7	14.2

Source: CSO

Central government finances

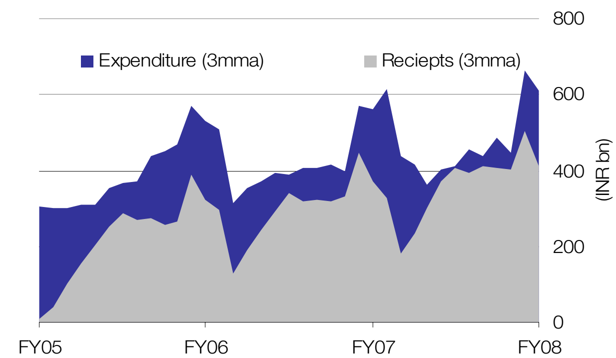
- The fiscal deficit-GDP ratio came in at 3.5% for FY07, lower than government estimates of 3.7% and 4.1% in FY06. The lower than anticipated ratio is on account of (a) strong revenue growth (b) curtailment in expenditure and (c) higher than expected GDP base.

Fiscal situation improves



Source: CGA, CMIE

Sustained revenue collection



Source: CGA, CMIE

- Tax revenue remained particularly strong throughout FY07. FY07 gross tax revenue grew by a strong 30.1% Y-o-Y, up from 19.3% Y-o-Y growth in FY06. The share of direct and indirect taxes in total tax revenue remains largely unchanged (43% direct taxes and 57% indirect taxes). Under direct tax heads, both corporate and income tax have grown at a robust 15.8% Y-o-Y and 27.3% Y-o-Y respectively. For indirect taxes, the growth is not strong across the board – customs collections and other taxes (which includes service tax) grew at a good 32.7% and 63.8% respectively, while excise collections lagged behind at 5.8% Y-o-Y.

Inflation

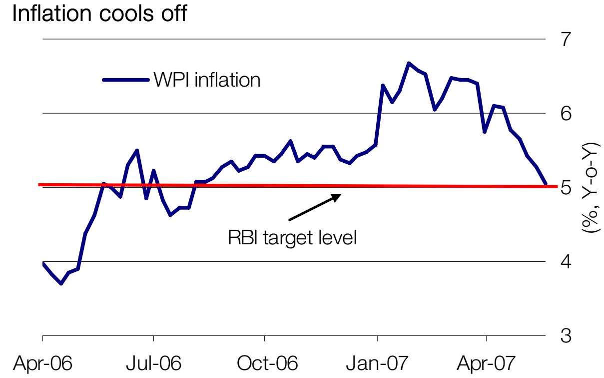
- Inflation for the week ended May 19 fell to a low of 5.06% Y-o-Y, down from 5.27% Y-o-Y during the previous week. It was largely in line with our and street expectations of 5.04% Y-o-Y. The drop came because of a come off in primary articles inflation to 9.35% Y-o-Y, down from 10.57% Y-o-Y during the previous week. Fuel group inflation continued to support overall inflation drop, while manufactured products inflation rose over the previous week.

- The steady decline in inflation numbers is likely to continue. We expect inflation to be in the 4.5-5% range before the end of June.

Inflation	(%, Y-o-Y)		
	19-May-07	12-May-07	20-May-06
Headline inflation	5.06	5.27	5.05
Primary articles	9.35	10.57	7.38
Fuel group	0.50	0.63	9.35
Manufactured products	5.20	5.02	2.52

Source: Bloomberg, Office of Economic Advisor, CMIE

Inflation cools off

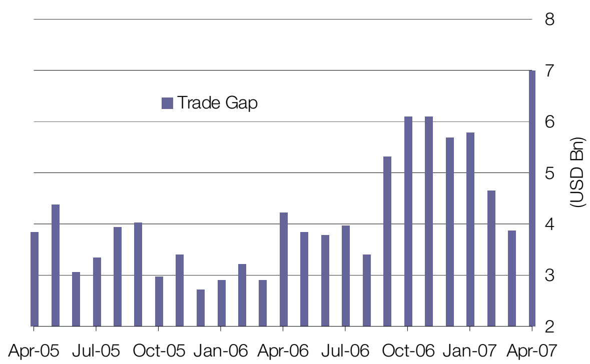


Source: Bloomberg

Goods trade

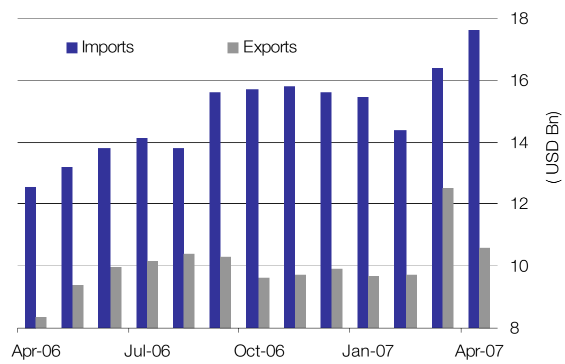
- Trade deficit for April FY07 rose to its highest ever of USD 7 bn, possibly reflecting the impact of a sharp rise in the exchange rate. The rupee appreciated by 4.3% over March, in comparison to the FY07 average monthly appreciation of 0.08%. The trade deficit number is likely to acquire significance over FY08 due to recent trends seen in the rupee. The rupee is likely to remain under pressure to appreciate as (i) India's growth remains robust, particularly in the context of a vulnerable global economy and (ii) External flows are expected to remain strong. If we continue to see a rising trade deficit, it would potentially cap appreciation.

Trade deficit rises



Source: Ministry of Commerce

Imports rise, exports remain steady

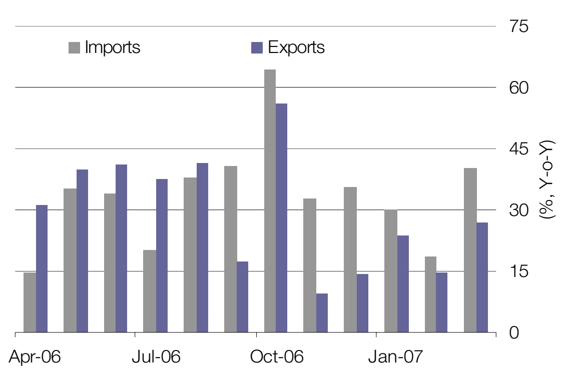


Source: Ministry of Commerce

- The absolute figure for imports stands at USD 17.6 bn, up from USD 16.4 bn from the previous month. Exports have fallen since March; the figure is at USD 10.6 bn, down from USD 12.5 bn. It needs to be noted however, that exports were above average in March, and the April figures are still above the previous 12-months' average of USD 10 bn. Imports, however, are stronger than the 12-month average of USD 14.7 bn. The data suggests that so far, we may have seen only one side of the story – only imports have risen, while exports have not fallen significantly. Coming months' data will likely indicate impact on exports as well.

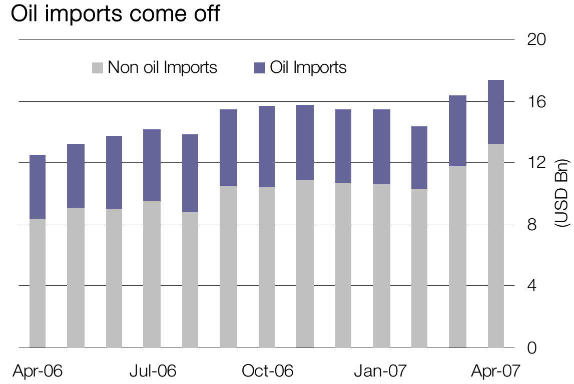
- Growth over the previous year remains strong for both imports and exports. Imports grew by a strong 40% Y-o-Y, much above the 12-month average of 32%, while exports grew by 27% Y-o-Y, a tad below the 12-month average of 29.5%. Growth data also corroborates the fact that so far the impact of a rising rupee on exports is not visible.

Growth remains strong



Source: Ministry of Commerce

Oil imports come off



Source: Ministry of Commerce

- The breakup of imports in oil and non-oil shows continued strength in non-oil imports, while oil imports have fallen marginally. Non-oil imports rose to USD 13.2 bn in April, from USD 11.8 bn in March, while oil imports fell to USD 4.2 bn from USD 4.5 bn in March. The strength in non-oil imports is a positive, since it reflects sustained domestic consumption demand.

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period