

INDIA

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India Economics

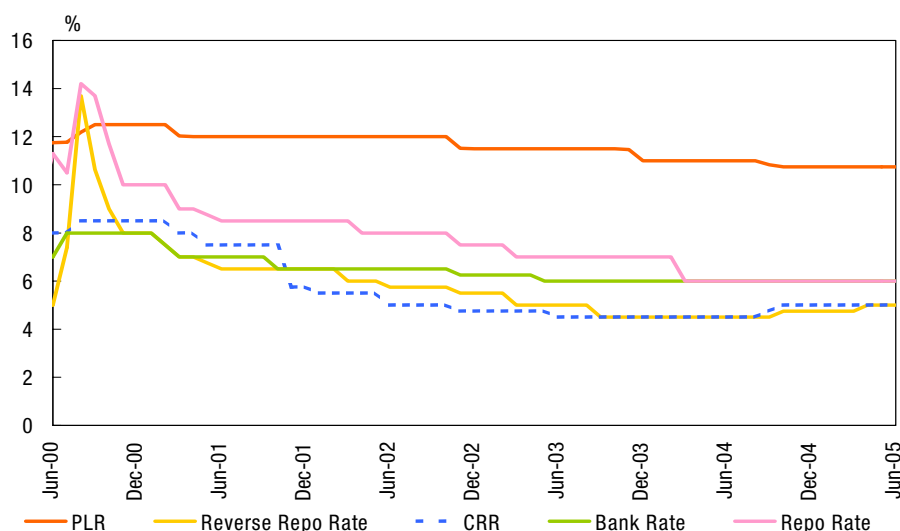
Monetary Policy: RBI Maintains Status Quo on Rates but Addresses Concerns on Asset Market Bubbles

- **No change in rates:** In what appears to be a prudent decision in not wanting to upset the current momentum as the economy moves to a higher growth trajectory, the Reserve Bank of India (RBI) has left all interest rates unchanged in its first quarter review of the annual monetary policy for FY06
- **Addresses concern on asset market bubbles:** Recognizing the risks of unchecked high growth in certain sectors, the RBI has raised the risk weightings for all outstanding *commercial real estate and capital market* exposures of banks from 100% to 125%. We think this again is a positive move
- **Monetary policy stance unchanged:** ie, Provision of *appropriate* liquidity to meet credit growth while placing equal emphasis on price stability, and pursuing an interest rate environment conducive to maintaining growth momentum.
- **Financial market impact:** As a section of the market was expecting a 25bp rate hike, bonds reacted positively with the 10-year trading at 7.0%, from 7.16% prior to the policy announcement, while the rupee strengthened a little to Rs43.50/US\$1.
- **Macro forecasts for FY06:** While recognizing global uncertainties (oil, interest rates and RMB appreciation), the RBI is positive on prospects for the economy in FY06, with growth with GDP growth likely to be around 7%, inflation from 5.0%-5.5% and money supply growth at 14.5%. This is largely in line with our positive view on the economy with non-farm growth likely to trend closer to 9%

CURRENT INTEREST RATES

1. **Cash Reserve Ratio = 5%**
Unchanged since October 2004
2. **Bank Rate = 6%**
Unchanged since May 2003
3. **Reverse Repo Rate = 5%** (hiked twice by 25bps in Oct 04 and April 05)
4. **Repo Rate = 6%** unchanged since March 04
5. **Prime Lending Rate = 10.8%**.

Trends in Key Interest Rates¹



Source: RBI

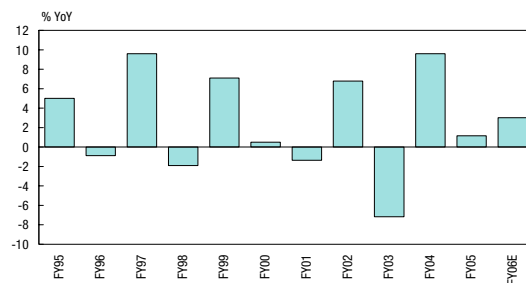
¹ CRR = banks need to maintain a minimum of 5% of demand and time liabilities in cash with the RBI. Bank Rate (6%) = Rate at which RBI lends to commercial banks. The Reverse Repo rate (5%) is the rate at which RBI absorbs liquidity from the system, while the Repo Rate (6%) is the rate at which it injects liquidity into the system

Key takeaways from RBI's first review of annual monetary policy

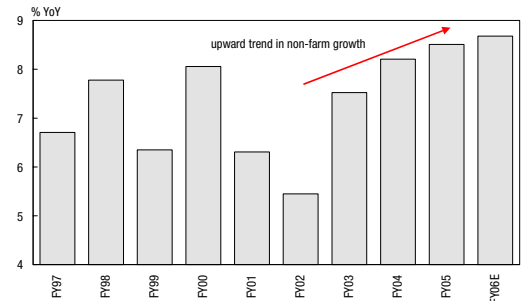
The RBI has begun having quarterly instead of biannual reviews of its monetary policy. The bank's governor, Dr Reddy, made interesting observations on developments in the economy in the first monetary policy review today. We believe these will be the key factors that will determine whether to expect a rate hike in the next review due on 25 October 2005. These include:

- **Buoyant growth prospects:** The RBI said that while agricultural production depends entirely on the monsoon, industrial growth prospects for FY06 are bright. This is supported by an improvement in corporate expectations for production, increase in order books, capacity utilization and working capital finance requirements. *This fits with our view that the economy is not overheating and that non-farm growth is likely to trend close to 9% in coming years*

Erratic Trends in Agricultural Growth...



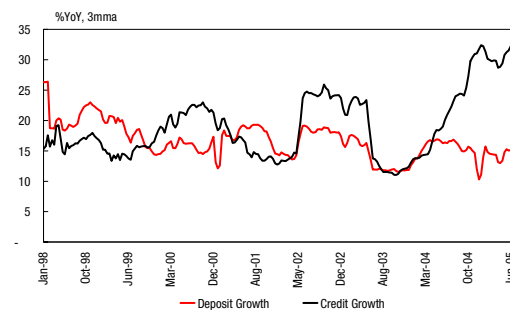
...Make focusing on Non-Farm Growth vital



Source: CSO, Citigroup

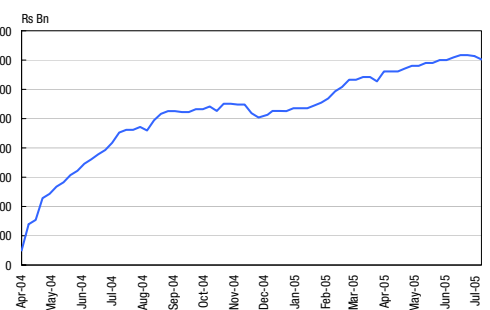
- **Liquidity management — remains a key challenge:** Despite higher credit offtake, an increase in the borrowing program and lower capital inflows, the RBI has made sure that there has been enough liquidity in the system. It is doing this via lower absorption through the Market Stabilisation Bonds. Thus, despite the higher offtake, the liquidity overhang in the system is close to Rs1000bn. *This supports our view that the MSBs are an insurance against tightening and that the RBI has sufficient ammunition to inject liquidity in the system*

Despite higher credit growth...



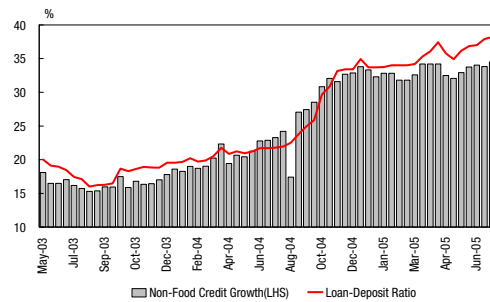
Source: RBI

Outstanding MSS Bonds will help manage liquidity

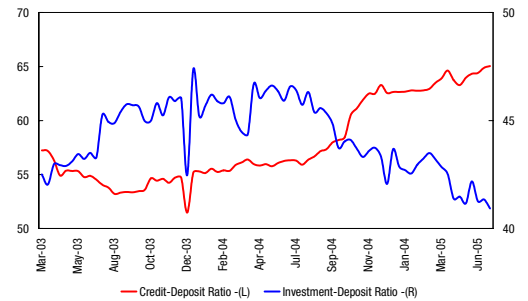


- **Concern about rising demand for housing and real estate loans:** The RBI has been expressing concern about this for the past year or so and has raised further the risk weightings for all outstanding commercial real estate² and capital market³ exposures of banks from 100% to 125%. *We think this is positive and addresses concerns on potential bubbles in the asset markets*

Buoyant Trends in Non-Food Credit ...



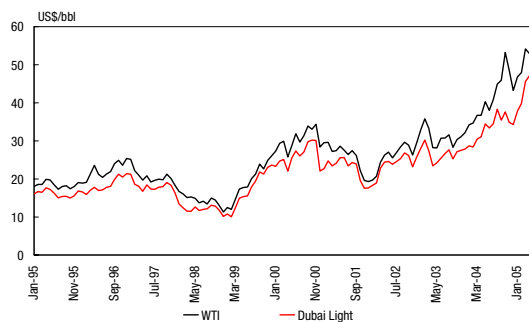
... Continue to drive the Credit Deposit ratio up



Source: RBI

- **Oil remains the most critical factor in determining inflation:** As regards inflation, while acknowledging that fiscal and monetary measures have kept prices in check, the RBI highlights that the oil-price pass-through remains incomplete, especially given the narrowing gap between WTI and Dubai crude. *We maintain our view that since India's crude imports comprise mainly the Dubai category, the recent spike in oil prices will warrant a further adjustment in domestic prices*

With a narrowing gap between Dubai Crude and WTI ...



... The impact on inflation is likely to be greater



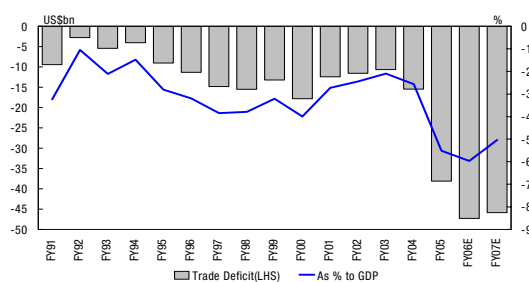
Source: CEIC, Office of the Economic Advisor

² **Commercial real estate exposure** is defined as fund based and non-fund based exposures secured by mortgages on commercial real estates (office buildings, retail space, multi-purpose commercial premises, multi-family residential buildings, multi-tenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction. It also applies to investments in mortgage-backed securities in the above

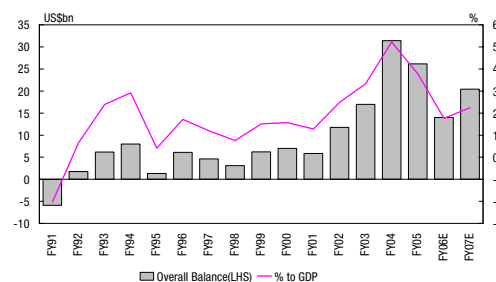
³ **Capital market exposure** includes direct equity investments, advances against shares for investment in equity, bonds and debentures as well as advances and guarantees to stockbrokers

- **External sector – positive despite current account deficit:** While the RBI highlighted the deterioration in the trade account; it stated that much of this has been offset by buoyant invisibles, and capital flows and thus the *trade deficit is manageable and the current account deficit sustainable*. Moreover, the RBI stated that the rise in non-oil imports indicates an upturn in industrial activity. *This is in line with our positive stance on the external sector due to healthy export growth coupled with buoyant capital flows which even after excluding so called ‘hot-money’ (FII + NRI deposits) should be more than sufficient to finance the current account deficit*

Trends in the trade deficit appear disconcerting...



However overall BoP remains positive



Source: RBI, Citigroup

- **Global uncertainties persist:** Besides oil, other global uncertainties include the direction of interest rates and Chinese exchange rate policy. The extent of change in the above variables in the coming months is an unknown factor and will have a bearing on future domestic interest rates.

Taking into account the above domestic and external variables, we are maintaining our macro forecasts for FY06

Trends and Forecasts in Key Indicators (%)

Year -end 31 March	FY00	FY01	FY02	FY03	FY04	FY05	FY06E	FY07E
Real GDP growth (%)	6.0	4.4	5.8	4.0	8.5	6.9	7.5	7.4
Agriculture growth (%)	0.5	-1.4	6.8	-7.2	9.6	1.1	3.0	3.0
Industry growth (%)	5.3	6.5	3.3	6.8	6.6	7.7	8.0	8.3
Services growth (%)	9.7	6.2	6.6	7.9	9.1	8.9	9.0	8.6
Inflation - WPI avg	3.3	7.2	3.5	3.4	5.4	6.5	5	4.5
PLR - Year end	11.3	11.5	11.3	10.8	10.3	10.0	10.0	10.0
Currency - Year end	43.6	46.5	48.9	47.5	43.6	43.5	42.5	42.0
Fiscal Deficit - % to GDP	5.4	5.7	6.2	5.9	4.5	4.5	4.3	4.0

Source: CSO, Budget Documents, RBI

Financial Market Forecasts

Currency Forecasts and Forwards

	Range in Jun	Spot 20-Jul	1 Month		3 Months		6 Months		12 Months	
			Forecast	Forward	Forecast	Forward	Forecast	Forward	Forecast	Forward
Versus USD										
Japan YEN	106.72-110.81	112.97	112.00	112.64	108.00	111.92	100.00	110.80	95.00	108.52
Euro EUR	1.2038-1.2329	1.2083	1.1700	1.2096	1.2000	1.2129	1.2800	1.2187	1.3300	1.2309
China RMB	8.2765-8.2765	8.2764	8.2800	8.2219	7.8650	8.0994	7.8650	7.9889	7.8650	7.7989
Hong Kong HK\$	7.769-7.7837	7.7772	7.7750	7.7761	7.7800	7.7728	7.7850	7.7647	7.7900	7.7469
India INR	43.488-43.742	43.56	43.50	43.68	43.50	43.80	43.00	43.90	42.50	44.21
Indonesia IDR	9544-9768	9845	9900	9895	9850	10005	9750	10160	9400	10420
Malaysia MYR	3.8-3.8	3.8000	3.8000	3.7977	3.8000	3.8010	3.7200	3.7778	3.7200	3.7515
Philippines P	54.5-55.96	55.950	56.500	56.090	56.250	56.320	55.250	56.740	56.300	57.610
Singapore SGD	1.6605-1.6856	1.6905	1.6900	1.6883	1.6700	1.6831	1.6200	1.6745	1.5800	1.6570
South Korea KRW	1003.5-1035	1043.6	1040.0	1043.2	1020.0	1042.9	980.0	1041.9	950.0	1038.9
Taiwan TWD	31.218-31.615	31.999	32.200	31.936	31.750	31.764	31.250	31.554	30.500	31.144
Thailand THB	40.525-41.325	42.095	42.750	42.153	42.500	42.155	42.000	42.075	41.000	41.970
Vietnam VND*	15849-15875	15873	15895	15934	15920	16055	15940	16235	16000	16549

Note: * State Bank of Vietnam Forward Ceiling Rates
Source: Datastream, Citigroup estimates.

Interest Rate Forecasts

	Range in Jun	20-Jul	In 1M	In 3M	In 6M	In 12M
US Fed Fund Rate	2.87 - 3.37	3.06	3.25	3.50	3.75	4.00
10-Year Treasuries	3.88 - 4.10	4.19	NA	NA	NA	NA
EU Repo Rate	2 - 2	2.00	2.00	2.00	2.00	2.25
10-Year Bunds	3.11 - 3.31	3.28	NA	NA	NA	NA
JP Call Money	-0.004 - 0.001	0.00	0.00	0.00	0.00	0.00
10-Year JGBs	1.17 - 1.31	1.28	NA	NA	NA	NA
CN PBOC base rate (3-Month)	3.6 - 3.6	3.60	3.60	3.60	3.60	3.85
Bond repo rate (7-Day)	1.08 - 1.14	1.22	1.25	1.50	1.75	2.50
Government bond yield (5-Year)	2.58 - 2.89	2.75	3.00	3.25	3.75	4.25
HK 3-Month Interbank Rate	3.15 - 3.38	3.42	3.55	3.70	4.00	4.10
5-Year Exchange Fund Note	3.23 - 3.39	3.53	3.45	3.65	3.85	3.70
IN Bank Rate	6 - 6	6.00	6.00	6.00	6.00	6.00
91-Day T Bill	5.2 - 5.37	5.49	5.50	5.75	5.75	5.75
10-Year Gilt	6.79 - 6.94	7.18	7.25	7.30	7.38	7.50
ID O/N FASBI	NA	8.50	8.75	9.00	9.25	9.75
FR0026	11.08 - 11.19	11.45	11.30	11.10	10.95	11.25
MY Overnight Policy Rate	2.7 - 2.7	2.70	2.70	2.70	2.95	3.25
5-Year MGS 4/04	3.42 - 3.55	3.40	3.45	3.55	3.65	3.90
PH O/N Rate	7 - 7	7.00	7.00	7.50	7.75	8.25
5-Year T Bond	10.52 - 10.98	10.75	11.25	10.50	10.75	10.25
SG 3-Month Interbank Rate	2.04 - 2.12	2.00	2.10	2.15	2.25	2.50
10-Year SGS	2.51 - 2.73	2.67	2.80	2.90	3.10	3.20
KR Overnight Rate	3.25 - 3.25	3.25	3.25	3.25	3.25	3.50
5-Year Treasury	3.78 - 4.27	4.53	4.30	4.40	4.50	4.70
TW Overnight Rate	1.26 - 1.26	1.33	1.33	1.42	1.50	1.50
10-Year Government Bond	1.80 - 1.94	2.04	2.05	2.15	2.24	2.15
TH 14-Day Repo Rate	2.25 - 2.5	2.75	2.75	3.00	3.25	3.25
10-Year Government Bond	3.90 - 4.14	4.39	4.35	4.50	4.75	5.50
VN 3-Month Interbank Rate	7.44 - 7.61	7.52	7.65	7.75	7.75	8.00

Source: Primark Datastream, Citigroup estimates

Disclosure Appendix

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