

INDIA

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India Economics

What to look for in RBI's 1Q review + Chart book of monetary trends

- **Monetary Policy Review on July 26:** Unlike the past, the Reserve Bank of India (RBI) will have quarterly instead of bi-annual reviews of its monetary policy, with its 1Q review due on Tuesday, July 26. The review is likely to be interesting as it comes at a time when industrial growth has crossed 10%, oil prices have touched new highs, the current account is back into a deficit and inflation has touched a 22-month low
- **Interest rate dilemma:** With current policy rates¹ at 5% for the reverse repo and CRR, and 6% for the repo and bank rate, there is a lot of speculation on what Dr Reddy, Governor of the RBI, will do on the interest rate front.
- **Case for a rate hike could be justified** on the grounds of a need to cool the economy, further stabilize inflationary expectations and aid inflows. Apr-Jun data that supports this includes:
 1. Buoyant **industrial growth** at 9.6%, compared with 7.9% last year
 2. **Bank credit** increasing by Rs610bn, or 32% yoy, compared with Rs381bn last year
 3. **Non-oil imports** rising US\$37bn, or 40% yoy, compared with US\$23bn
 4. **FX reserves** in the current fiscal year have declined by US\$4.6bn, compared with an increase of US\$7.8bn last year
 5. **Oil price** pass-through on inflation not fully accounted for
- **Case for no hike** could be justified on the grounds of benign headline inflation, the economy moving to a higher growth trajectory, thus allaying fears about overheating
 1. **Benign headline inflation** of 4.1% — a 22-month low
 2. **High government borrowing** program of Rs1720bn, compared with Rs1,060bn in FY05
 3. Apart from retail, **credit expansion could be justified**, as companies are operating at close to capacity requirements
 4. Risk of upsetting the growth momentum — high oil prices and interest rates would be a double whammy
- **Tough call:** Given the above, we think there is a possibility of a 25bp tinkering in rates. However, taking into account the possible reasons for not raising rates, government pressure as well as mixed signals on the international front, in our view a prudent decision would be to wait and watch indicators for another three months and hike rates in October

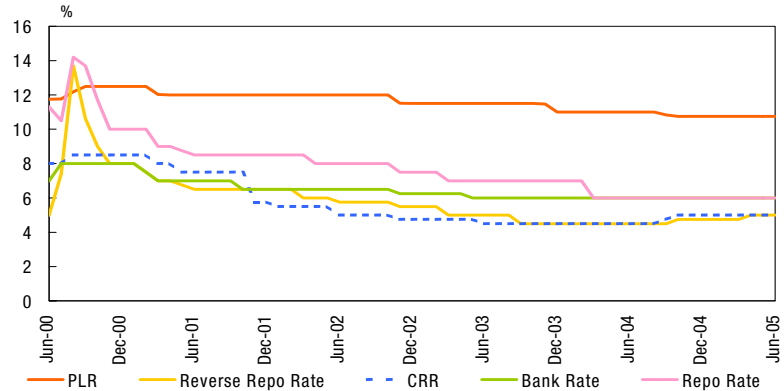
¹ CRR = banks need to maintain a minimum of 5% of demand and time liabilities in cash with the RBI. Bank Rate (6%) = Rate at which RBI lends to commercial banks. The Reverse Repo rate (5%) is the rate at which RBI absorbs liquidity from the system, while the Repo Rate (6%) is the rate at which it injects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

Interest Rates – Small Upward Bias

Trends in Policy Rates

- Cash Reserve Ratio = 5%** - unchanged since October 2004, when it was 4.75%
- Bank Rate = 6%** since May 2003
- Reverse Repo Rate = 5%** (hiked twice by 25bps in Oct 04 and April 05)
- Repo Rate = 6%** since March 04
- Prime Lending Rate = 10.8%**.

Trends in Key Policy Rates

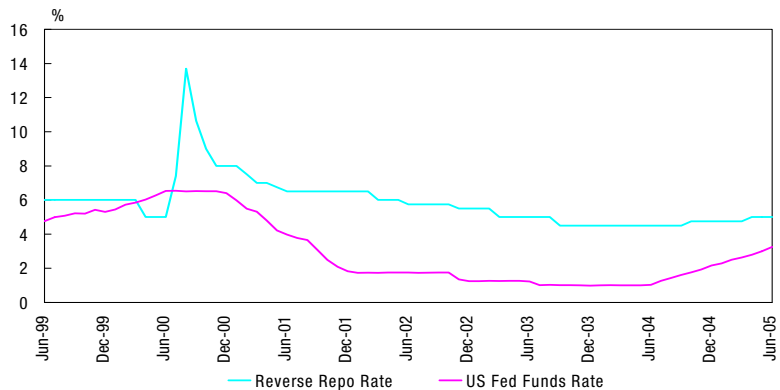


Source: RBI

Will the RBI hike because the Fed has?

- Greenspan's testimony stressed that despite a number of uncertainties the outlook favors solid growth ahead and contained inflation provided the Fed continues to raise short-term rates.
- This is consistent with our house view of a rise in the fed funds rate to at least 4%

Trends in the Reverse Repo Rate and the US Fed Funds Rate

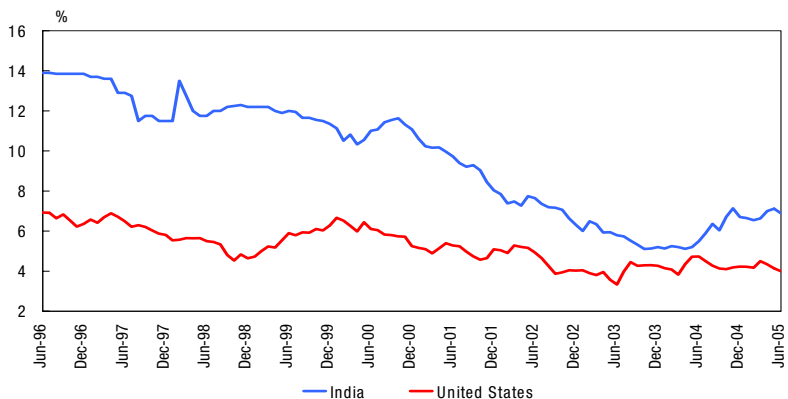


Source: CEIC, RBI

Trends in 10 Year G-Sec Yields

- On the back of higher inflation and supply side pressures, Indian bond yields have inched up while US yields have flattened due to dampening inflationary expectations
- We maintain our 12-month view of the 10-year yield touching 7.5%, due to our positive growth outlook, coupled with banks drawing down their excess SLR requirements to fund credit growth

Trends in 10 Year G-Sec Yields- US and India



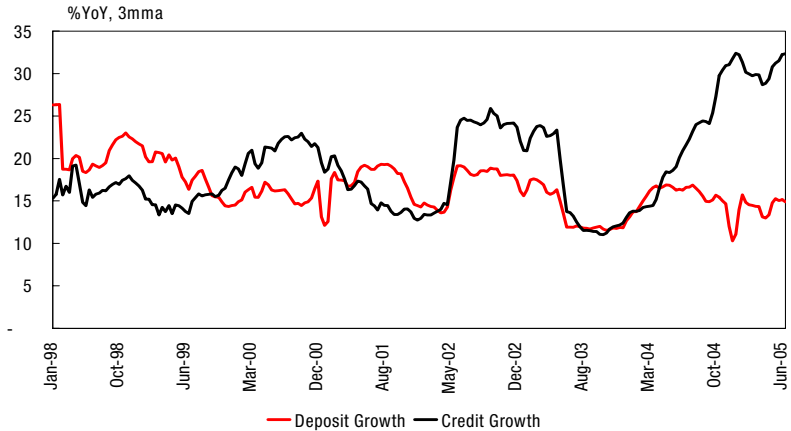
Source: CEIC

Liquidity – Comfortable for now

Buoyancy in Banking continues

- Banking trends remain positive, with incremental credit from 1 April-24 June up Rs610bn, or +32.1% yoy compared with Rs381bn last year
- Encouragingly, deposit growth has seen a pickup this year, with incremental deposits during 1 April-24 June up Rs897bn, or 14.0% yoy compared with Rs580bn last year

Trends in Deposit and Credit Growth

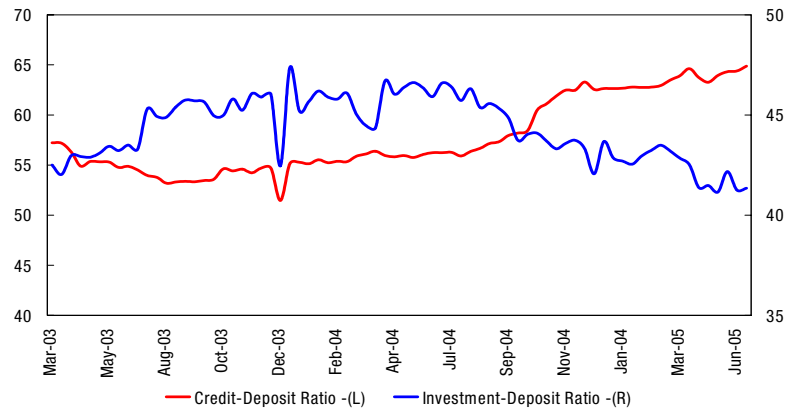


Source: RBI

Credit and Investment Deposit Ratios

- With the credit deposit ratio touching 64.8% (an all-time high), banks have been drawing down on their investments.
- Investment in government securities has fallen by Rs39bn fiscal YTD, compared with a rise of Rs400bn last year

Trends in the Credit and Investment Deposit Ratios

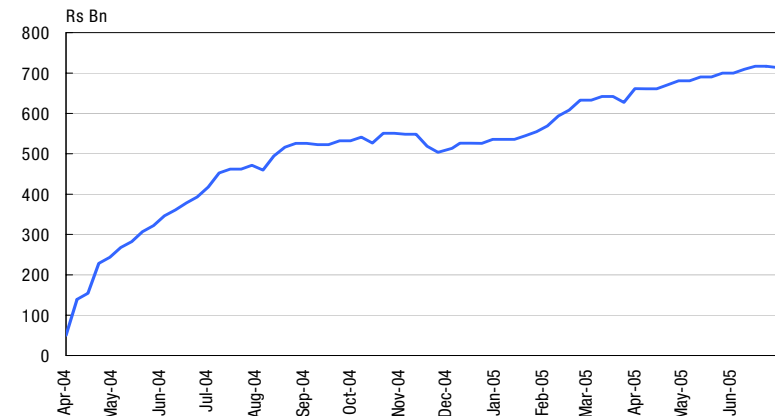


Source: RBI

MSBs - Insurance against tightening

- The RBI has sufficient ammunition by way of its market stabilization bonds to inject liquidity in the system
- The amt outstanding in these bonds is over Rs700bn and they have a maturity of less than a year
- To inject liquidity, all that the RBI has to do is not re-issue these bonds.

Trends in Outstanding Market Stabilization Bonds (Rs Bn)



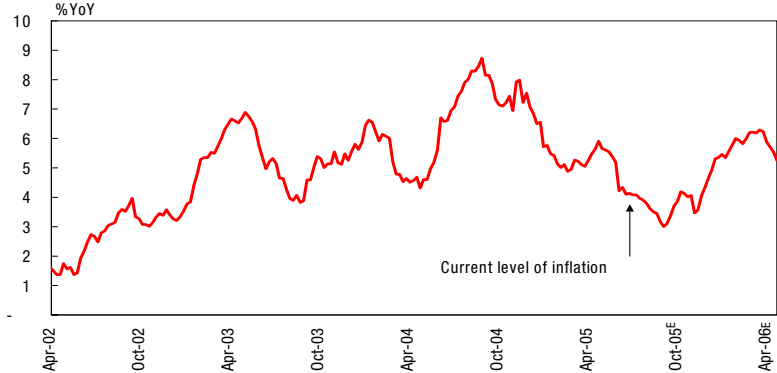
Source: RBI

Inflation – Adjustment in Domestic Oil Prices Remains Key

Benign trends for now

- Last month, the government implemented long-overdue hikes in the prices of petrol and diesel by Rs2.50 and Rs2 per liter, respectively
- The direct impact of the 6% hike results in inflation rising 17bps, with an indirect impact of another 17bps.
- Given the supportive base effect, headline inflation is likely to remain benign in the coming weeks

Likely Trends in Inflation

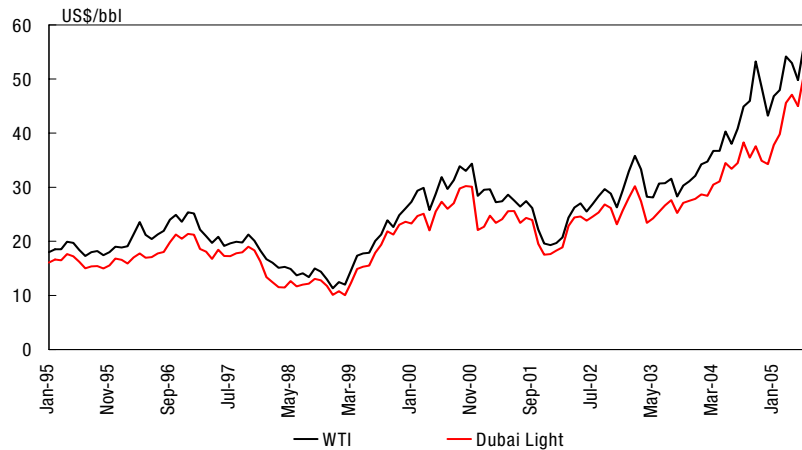


Source: Office of the Economic Advisor

Differential between WTI and Dubai crude narrows

- Last year, while WTI prices rose significantly, the Dubai oil blends lagged with the price differential as high as US\$15.7/bbl.
- However, Dubai crude prices have risen, resulting in the price differential now coming down to US\$5.4/bbl.
- As India's crude imports comprise mainly the Dubai category, the recent spike in oil prices will warrant a further adjustment in domestic prices

Trends indicating Difference between WTI and Dubai Light oil prices

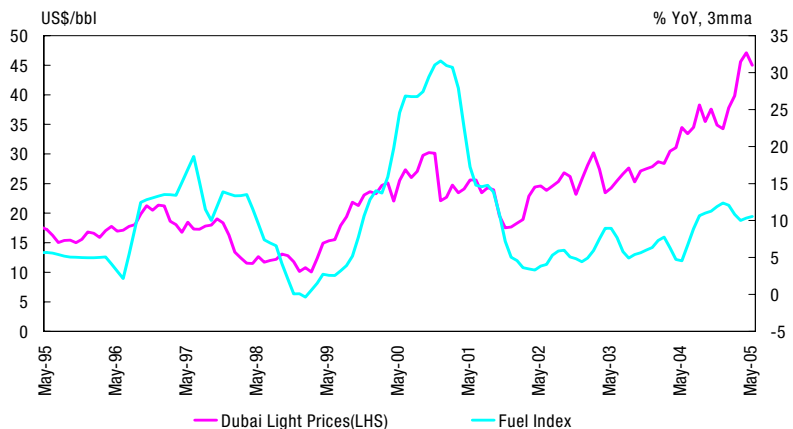


Source: CEIC

Further Adjustment Needed, but will Politics Allow that?

- While the government increased prices of petrol and diesel by Rs2.50 and Rs2 per liter, oil companies were lobbying for a Rs5 increase to enable them earn a reasonable return on their auto-fuel businesses
- If the entire oil price hike was effected, the headline inflation number would have risen by close to 80bps (40bps direct impact + 40bps pass-through)

Trends in Prices and the Fuel Index



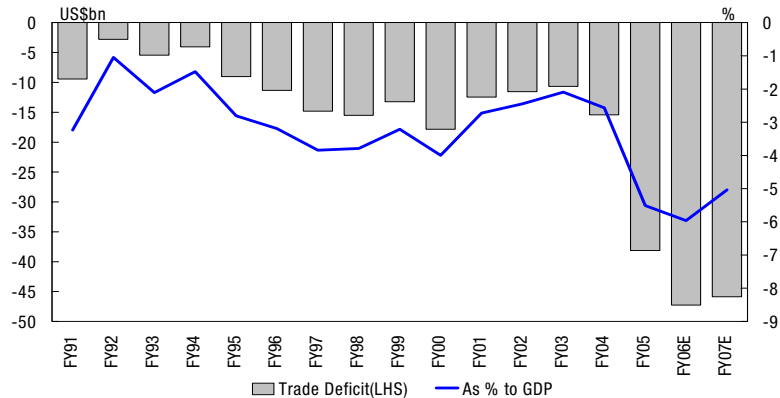
Source: CEIC, Office of the Economic Advisor

External Sector— Deteriorates but Fundamentals Intact

Trade Deficit - An all-time high

- The Trade Deficit widened to US\$38.1bn in FY05, an alarming increase from US\$15.5bn a year ago
- However, much of the rise in non-oil imports has come from an increase in capital goods and raw material imports, and a bunching up of defense
- The rise in non-oil imports supports our view of the investment cycle turn-up

Trends in the Trade Deficit

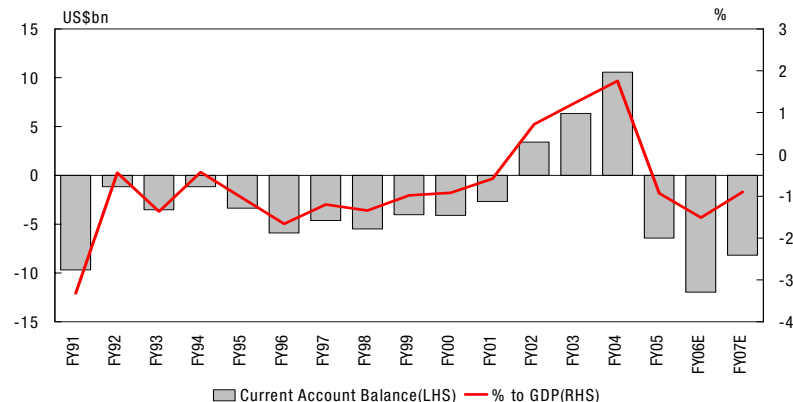


Source: RBI

Current Account - In the Red

- India's current account fell back into the red in FY05
- We expect this trend to continue, but it is due to the widening of the trade deficit — as a result of higher oil, non-oil and defense imports
- The key point to note is that growth in exports and invisibles remains buoyant, while capital flows are more than sufficient to finance the current account deficit, and the net accretion to reserves is likely to be at least US\$14bn

Trends in the Current Account

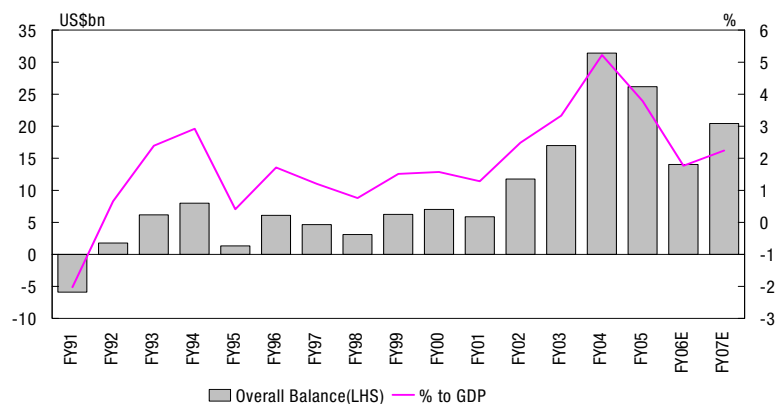


Source: RBI

Maintain our positive stance on the external sector due to:

- 20%-plus export growth for three consecutive years
- Buoyant capital flows — even after excluding so called 'hot-money' (FII + NRI deposits), flows are more than sufficient to finance the current account deficit
- Forex reserves of US\$139bn, which are sufficient to finance more than 14 months of imports

Trends in India's Overall Balance of Payments



Source: RBI

Disclosure Appendix

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