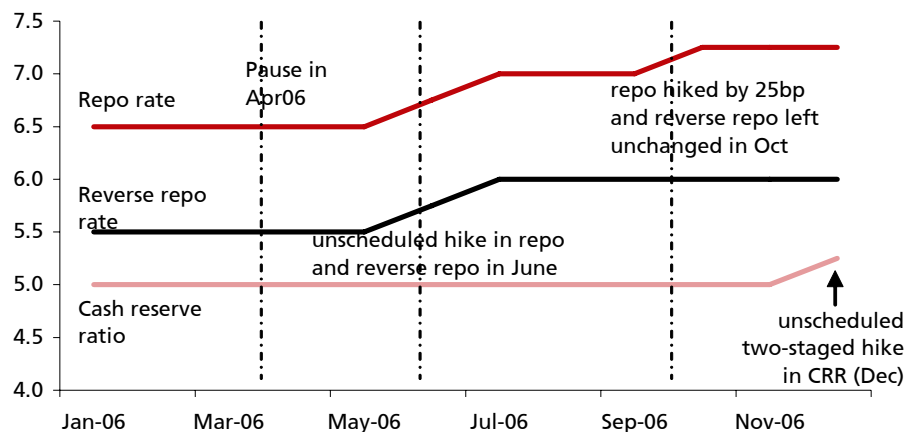


India: More Tightening Ahead

Summary

- It's going to be that time of the year again, when the RBI holds one of its scheduled policy meetings on Jan 31. So, the crucial question now is: Will they or won't they hike rates? Going by the data, a rate hike seems a near certainty. However, as always, there exists a slight concern that the RBI may pause this time round. This is especially so since the Government issued an ordinance allowing the RBI to vary the Statutory Liquidity Ratio (SLR) as and when financial conditions change. The SLR is the ratio of liquid assets to demand and time liabilities that a bank is required to hold at the close of business every day, and was earlier set at 25%. By passing the buck of "fine-tuning" the SLR to the RBI, the government seems to be hinting to the central bank that it would like to see an increase in credit availability to further fuel the rapidly growing economy.
- Looking back on last year's monetary policy decisions, we find two instances where the RBI 'paused' during their regular meetings, but later held unscheduled meetings to hike rates (**Chart 1**). The net result of the six meetings last year (four scheduled and two unscheduled) was a total hike of 50bp in the reverse repo rate, 75bp in the repo rate and 50bp in the cash reserve ratio.
- Yet price pressures continue to remain strong, with inflation having crossed the RBI's comfort level of 5.50% in the last week of Dec06 and first week of Jan07. We note though that with upcoming state elections this year, there is likely to be more pressure on the RBI to lean towards growth rather than containing inflation. In this regard, what can we expect from the RBI at the end of this month?

Chart 1: Scheduled, unscheduled meetings and policy rate hikes

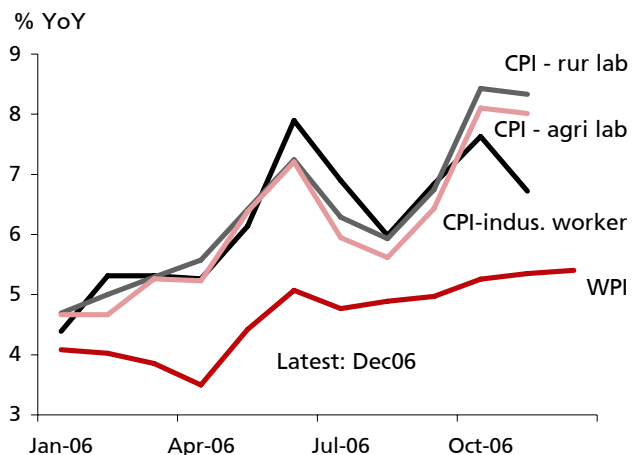


Source: DBS, CEIC, RBI

Why should the RBI tighten?

- As mentioned in DBS' 1Q07 quarterly report, the WPI, the official measure of inflation, has been outstripped by the CPI numbers. One reason is because of the differences in the weightage of the food component between the WPI and the CPI - food has a 50% weight in the CPI, against 27% in the WPI. Given the volatility of food prices, the gap between the two WPI and CPI indices is thus unavoidable.
- We note however that last week the WPI hit 6.12% YoY, crossing 5.50% - the upper limit of the RBI's inflation projection for this financial year. The WPI has also been previously underestimated, with the observations for previous weeks having been lifted.
- The latest revisions shifted the WPI more in line with the CPI, which has been ranging between 6.7%-8.3% YoY. More importantly, both the WPI and CPI are now painting a consistent picture: that inflation has become

Chart 2: Divergence between the WPI and CPI indices



Source: DBS, CEIC, RBI

elevated and inflationary pressures are building (**Chart 2**). In this regard, it is useful to look more carefully at where exactly the price pressures are coming from.

- For the past few weeks, we find that inflation pressures have been building up in both manufactured goods and primary products (**Chart 3**). To be sure, the government has initiated some measures to contain the inflation stemming from agricultural products, and agricultural prices might also stabilise once the new crop of wheat and other products hit the markets. But opponents of further policy tightening argue that to properly quell inflation, food supply constraints need to be permanently addressed and more help should be given to the rural sector to tide over its 'agricultural stagnation'. Indeed, while physical shortages did account for the price increments of some of basic necessities, the expectation of higher prices could also lead to speculative buying and hoarding behaviour, which in turn aggravates

Chart 3: Manufacturing prices are going up

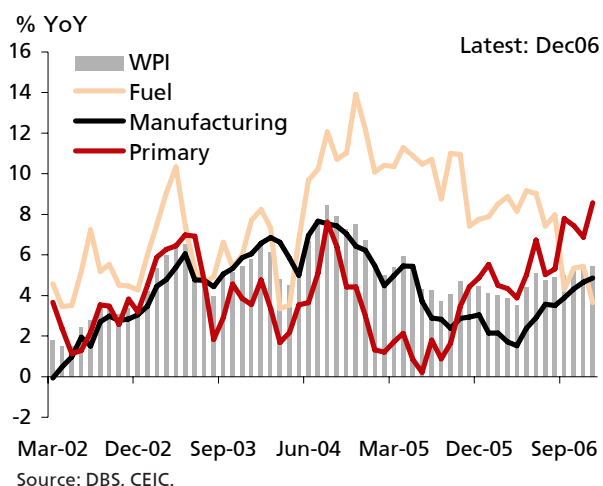
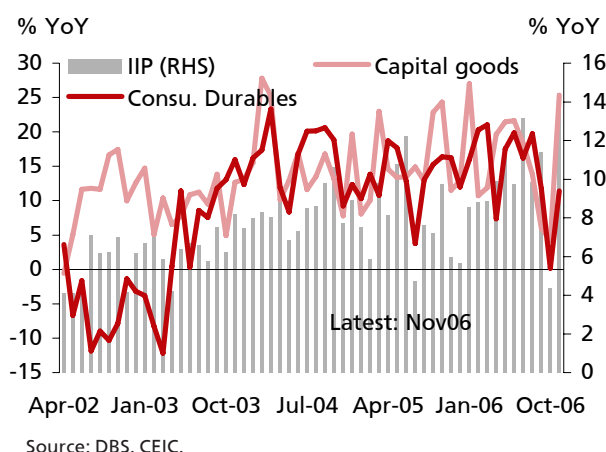


Chart 4: Capital goods grow faster than consumer durables



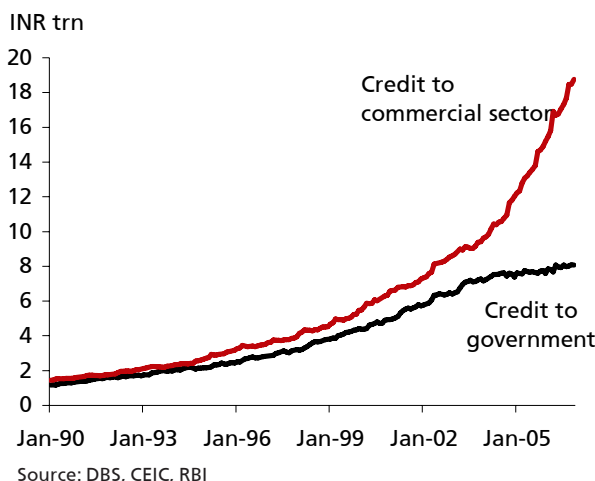
price pressures.

- As for manufactured products, the government last night slashed customs duties on eleven items, including capital goods, project imports and raw materials. The government's intention seems to be reducing the cost of manufacturing in basic industries and helping infrastructure development. With the Budget just around the corner, it is quite interesting that the tariffs have been slashed. This could mean either that the Finance Ministry is genuinely concerned about runaway inflation, or that the tariff cuts are deliberately aimed at politically key industrial states.
- Even without the physical food shortages, price pressures will remain strong as a result of robust economic growth and rapid credit creation. Industrial production rose 10.0% YoY in the Apr-Oct06 period, compared to 8.6% a year ago; in Nov06 output surged 14.0%, pretty much sealing the case for an interest rate hike at the end of this month. Manufacturing rose 11.5% in Apr-Nov06, supported by the mining and electricity sectors as they bounced back after contracting a year ago. The buoyancy in industrial activity is also apparent when we look at use-based industrial output - growth in capital goods production has overtaken that of consumer goods (**Chart 4**), and capital goods imports have been very strong (up 39.0% in Apr-Sep06).
- Proof of this buoyancy also lies in credit growth within the commercial sector. Non-food credit has accelerated (up 29.1% YoY as of Dec 8), primarily on the back of commercial borrowing (**Chart 5**). According to RBI data, real-estate related loans more than doubled in the three months to Jun06, with growth in housing loans up 54.0%. This underscores the boom in the real estate market.
- All the above factors, combined with the 20.2% growth in money supply as of Dec 8, concludes our case for a 25bp hike in the reverse repurchase rate this month.

Why then the concern about "will they won't they"?

- As we mentioned earlier, the freedom given to the RBI in dictating the SLR points to a government keen on increasing growth through greater credit expansion. But with state elections coming up in March the line between rational economics and populist policy is also blurring. For

Chart 5: Lending to commercial sector on the rise



instance, the Petroleum Ministry has proposed continuing government subsidies on cooking gas and kerosene beyond March, even though it had targeted to phase out these subsidies by April. Officials have also been talking about a possible reduction in petrol prices, if global oil prices stabilise. Against this backdrop it is difficult to envisage an interest rate hike, which would lead to banks increasing interest rates on loans.

- This is not to say that the RBI will cut the SLR on the government's indirect hints. Our belief is that after hiking the Cash Reserve Ratio (CCR) by a whopping 50bps (in Dec06) to suck out excess liquidity, the RBI is unlikely to undo its work by cutting the SLR. We do think however, that the Government's ordinance will help the RBI control liquidity conditions later. At present, with inflationary pressures rising, escalating real estate prices and credit growth slowing only marginally, the conventional remedy seems to be for the RBI to increase interest rates. The past hikes in interest rates did not have an adverse impact either on growth or fiscal balances. Economic growth touched 9.2% in the second quarter, tax collections are at a record high and recently-released third quarter corporate earnings are robust, reflecting no apparent ripples from the previous interest rate hikes. On the other hand, credit growth still remains relatively high at around 30.0% and the inflationary pressure is on.
- The bottomline is that while growth takes precedence over inflation for the Government, the opposite is true for the RBI. Given this, a 25bp hike in the reverse repo rate is likely on the cards. Given current inflationary pressures and a desire to curtail money supply, we think the RBI might also try a different policy measure in the future - something akin to the unexpected change in the CRR last December.

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