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India: the essentials

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- **India is further ahead in the economic cycle than most believe, in our view. Capacity expansion will be the order of the day, boosting credit growth. Underlying price pressures are building and interest rates have a lot further to rise**

Investment boom…

Industry is booming, with production up 13% in Q4 2009 and around 16% in Q1 2010. Production of capital goods rose by an extraordinary 56% y-o-y in January, which is the highest rise since the series began three decades ago. Our analysis shows that growth in this sector has consistently proven to be a strong coincident indicator of fixed capital formation in India.

In our view, the capex cycle is showing a vigorous, V-shaped recovery which could see real investment growth reach at least 20% in y-o-y terms later in calendar 2010. It is also worth noting that, in the past, capex growth of 20% has been associated with credit growth of 30%.

We believe that the Indian economy is further advanced in the economic cycle than the consensus view; a very high level of capacity utilisation is evidence in this regard.

…could overheat the economy

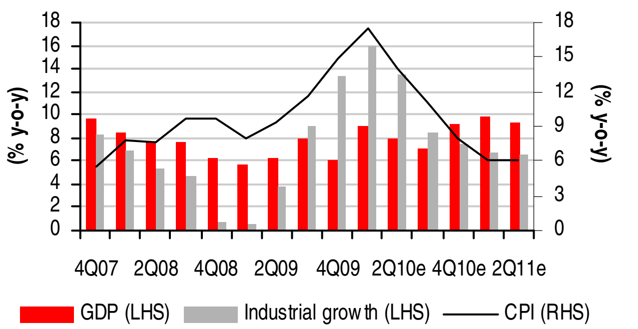
While capital investment growth is picking up and is likely to surprise on the upside in FY2011 (ending April) it will take months for the capacity additions to come on stream, eating up scarce resources in the meantime. This then suggests that imports will increase drastically to support domestic demand (see our comments on external trade below). In a sense, India is a victim of its own success. Having survived the global credit crunch well, it has not taken much of a bounce back in the economy to see capacity constraints re-emerge, particularly in the industrial sector. This puts India in a rather different position from the more trade dependent economies of the region which felt the full force of the recession in the US and Europe.

	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010e	Q2 2010e	Q3 2010e	Q4 2010e	Q1 2011e	Q2 2011e
GDP (% y-o-y)	5.8	6.1	7.9	6.0	9.0	7.9	7.1	9.1	9.8	9.3
Industrial production (% y-o-y)	0.5	3.8	9.0	13.3	16.0	13.5	8.5	7.5	6.7	6.6
CPI, end quarter (% y-o-y)	8.0	9.3	11.6	15.0	17.5	14.0	11.0	8.0	6.0	6.0
WPI, end quarter (% y-o-y)	1.2	-1.0	0.5	7.3	10.5	9.9	8.0	5.0	5.0	5.0
Trade balance (% GDP)	-7.4	-9.4	-11.1	-8.4	-6.8	-9.1	-11.2	-8.7	-7.4	-8.9
Current account (% GDP)	-0.4	-2.2	-4.4	-1.7	-0.9	-3.1	-6.1	-1.9	-1.4	-2.8
International reserves (USDbn)	241.4	254.1	264.4	281.5	298.1	307.3	305.1	317.4	328.0	333.3
Policy rate, end quarter (%)	5.0	4.7	4.7	4.7	5.0	5.2	5.7	6.0	6.3	6.5
5-yr yield, end quarter (%)	6.7	6.5	7.0	7.3	7.5	7.7	7.9	8.0	8.1	8.3
INR/USD, end quarter	50.60	47.75	47.74	46.41	44.83	45.00	44.50	44.00	43.50	43.50
INR/EUR, end quarter	67.18	66.98	69.78	66.58	60.65	60.75	62.30	63.80	63.08	63.08

Measured inflation to decline …

Strengthening demand is likely to bump up against capacity constraints in the economy, which in turn could intensify underlying inflationary pressures. That being said, we believe that inflation, as measured by the WPI, has peaked at 10% y-o-y in March and is expected to decline to 5% by year end. This is largely a reflection of improvements in the domestic food supply as a result of better weather conditions and the anticipated decline in international commodity price inflation. Our analysis shows that domestically-driven price pressures may not be properly captured by the widely followed inflation metric; wholesale price index (WPI) and consumer price index (CPI). Both price indices have a large food component, 46% for CPI and 28% for the WPI; the normal monsoon being forecast by the MeT improves the outlook for food price inflation.

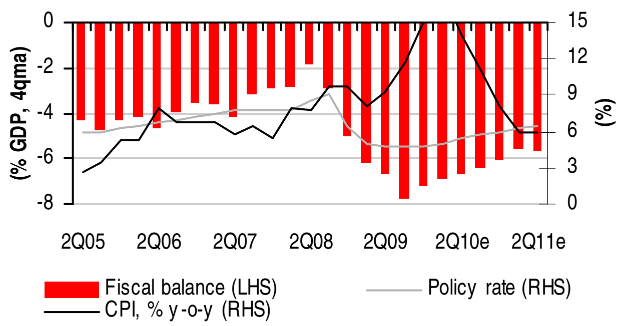
Activity & inflation



… but policy makers need to tighten further

With all this in mind, the Reserve Bank of India is right to be tightening monetary policy, as it did again at the end of April. We continue to believe, however, that it should have done more than it has so far, bearing in mind the lags with which monetary policy works. There are plenty more hikes to come and we continue to look for a total of 200bps of repo and reverse repo rate increases by mid-2011, of which we have had just 50bps so far. More than 60% of the debt issuance will be done in H1 of FY2011; creating a 36% rise in fresh government paper. This is likely to play an important role in deciding the speed at which key policy rates are tightened. We think the government can achieve its fiscal deficit target of 5.5% of GDP albeit through cyclical factors (strong revenue growth) and one-offs rather than structural tightening.

Policy stance



Source: Central Bank, Thomson Reuters Datastream, Bloomberg, HSBC estimates and forecasts

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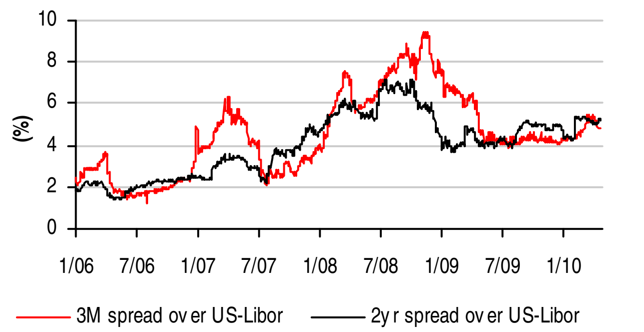
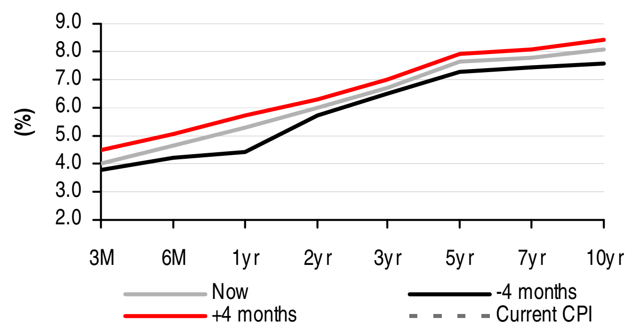
India: at a glance

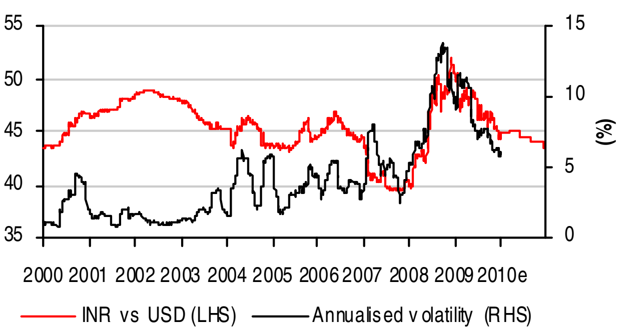
Interest rate spread (vs USD Libor)



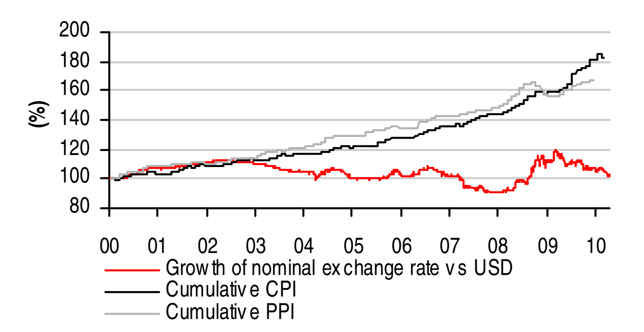
Yield curve dynamics



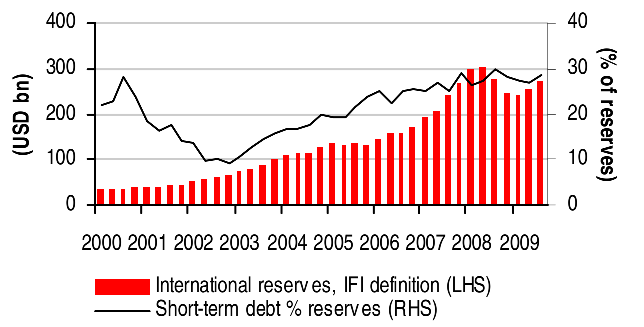
Exchange rate dynamics



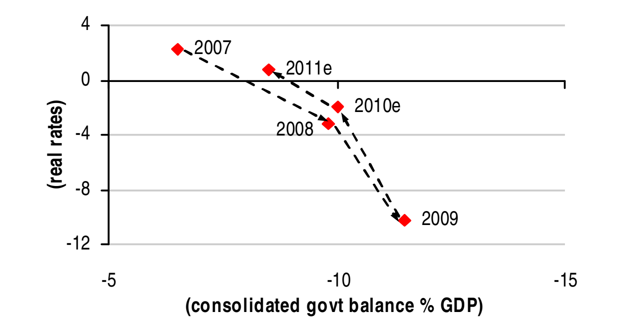
Exchange rate and inflation



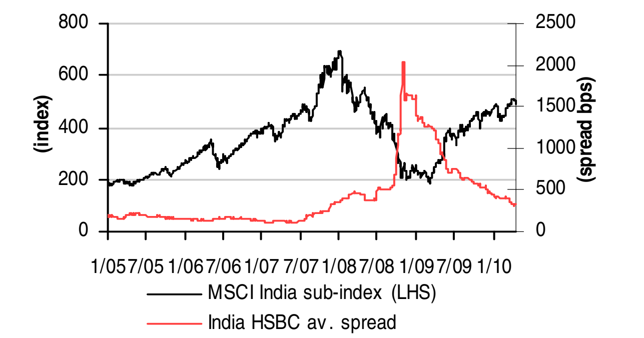
International reserves & liquidity ratio



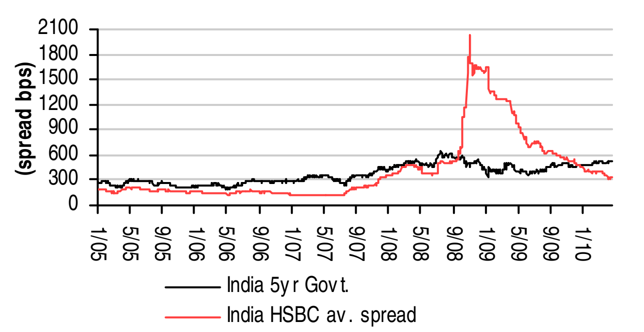
Policy dynamics



Equity vs fixed income



Local vs convertible currency yields



Source: Central Bank, Thomson Reuters Datastream, Bloomberg, HSBC estimates and forecasts

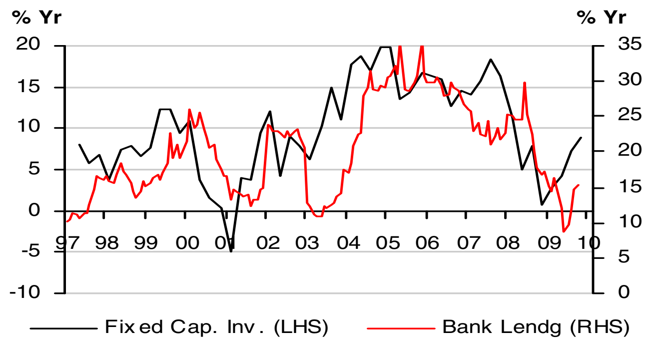
India: local knowledge/global drivers

- **Imports are rising rapidly once again as demand is outpacing the growth in supply. In our view, the economy is showing some early signs of overheating**

Expanding capacity…

In the past there has been a close relationship between growth in fixed capital investment and bank lending with the latter tending to lag the former. Companies probably meet their initial investment requirement through retained cash. If we are right in suggesting that fixed capital investment growth will average 16% in FY2011 then history would suggest that this will be associated with roughly 30% credit growth. Data collated from companies suggest that USD 190bn or 17% of GDP will be spent by companies on expanding capacity this fiscal year. However, this additional capacity will likely take months to come on board, therefore stretching scarce resources still further.

Capex growth and lending

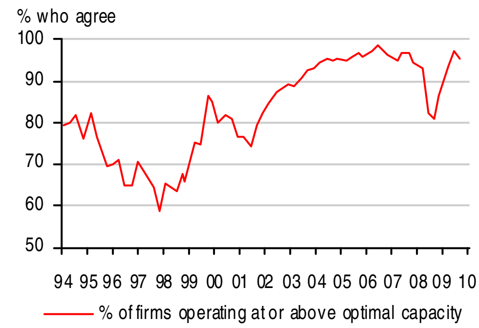


Source: CEIC

…with little or no slack left in the economy

It may come as a surprise to those who thought that India has plenty of spare capacity, but a look at the latest survey from NCAER suggests otherwise. Although the survey does not measure capacity utilisation directly, it indicates that 95.8% of companies were 'operating at or above an optimal level of capacity' in April this year. This is a touch below the 97.4% recorded in January but still very close to an all-time high of 98.6% recorded in January 2007. Other surveys also suggest that there is a growing shortage of skilled labour in the country. Unfortunately, India does not have measures of capacity utilisation or wages, and therefore we are left with survey-based measures to gauge demand pressures in the product and labour markets.

Survey indicates tightness in product markets

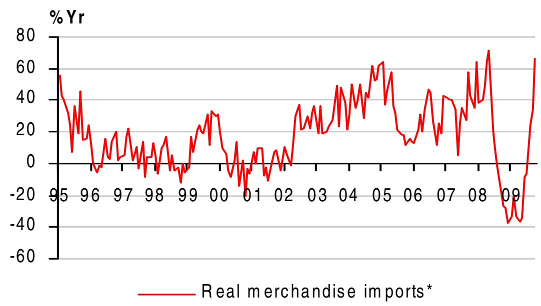


Source: NSCAER

India sucking in imports

Imports contracted sharply during the recession of 2008-09 but have bounced back with a vengeance in recent months, outpacing export growth by 20-30 percentage points in January and February this year – one of the largest differences ever. Suggesting that the entire growth in value of imports has been boosted by commodity prices would be untrue; ex-oil import growth and our measure of real import growth (derived by substituting WPI inflation from the overall value numbers) presents a very similar picture (see chart below). We expect that some of the strength in imports relative to exports reflects the impact of capacity constraints in India. Such constraints mean that on-shore companies may be struggling to keep pace with demand.

Surge in real imports

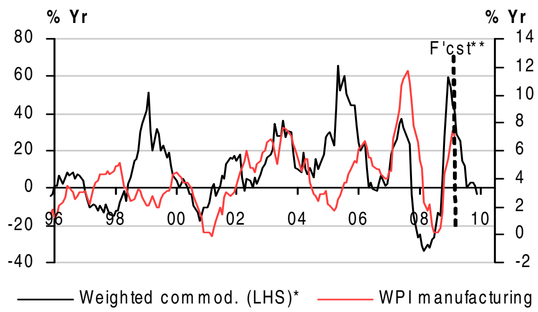


Source: CEIC, HSBC. * Merchandise import values deflated by wholesale price inflation

Improved pricing power as demand strengthens…

There is growing evidence that producers are facing mounting cost pressures and are now more willing to pass on these increases to consumers; the input price component in the manufacturing PMI survey reached a series high in March, and similar indications were seen in the services PMI. The likely decline in food prices in the WPI index means that inflation in non-food components will take prominence in the months ahead. The non-food manufacturing component of the WPI rose from 1.3% y-o-y in December 2009 to 5.1% y-o-y in March 2010, the central bank is expected to keep a close watch on this series. But our work suggests that even WPI manufacturing is a poor indicator of domestic price pressures with international commodity prices playing the dominant role.

…but cost pressures likely to decline



Source: HSBC, CEIC. * Economist food, metal & oil price index in INR terms. ** Assumes level of Economist index remains unchanged

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India: macro framework

	2004	2005	2006	2007	2008	2009	2010e	2011e
Production, demand and employment								
GDP growth (% y-o-y)	7.4	9.5	9.7	9.2	6.7	7.2	8.5	8.3
Nominal GDP (USDbn)	677.4	784.7	877.3	1,114.8	1,175.1	1,174.5	1,478.2	1,735.7
GDP per capita (USD)	638	727	800	1,001	1,039	1,023	1,269	1,468
Private consumption (% y-o-y)	1.3	9.0	8.2	9.8	6.8	4.1	6.5	6.3
Government consumption (% y-o-y)	2.7	8.3	3.8	9.7	16.7	8.2	3.0	3.0
Investment (% y-o-y)	20.9	15.3	14.3	15.2	4.0	5.2	16.0	13.0
Industrial production (% y-o-y)	8.4	8.2	11.5	8.5	2.7	6.4	11.3	6.6
Gross domestic saving (% GDP)	32.5	33.8	34.8	35.6	32.6	35.0	36.5	37.5
Prices & wages								
CPI, average (% y-o-y)	3.9	4.0	6.3	6.4	8.3	10.9	13.6	6.0
CPI, end-year (% y-o-y)	4.2	5.3	6.7	5.5	9.7	15.0	8.0	6.0
WPI, end-year (% y-o-y)	6.7	4.4	5.7	3.8	6.1	7.3	5.0	5.0
Money, FX & interest rates								
Broad money supply M3 (% y-o-y)	14.1	16.1	19.6	21.9	20.4	19.4	18.0	19.0
Real private sector credit growth (% y-o-y)	25.0	19.9	18.4	15.6	14.0	6.8	12.0	15.0
Policy rate, end-year (%)	6.0	6.8	7.8	7.8	6.5	4.7	6.0	6.8
5-yr yield, end-year (%)	6.4	6.7	7.5	7.7	5.3	7.3	8.0	8.5
INR/USD, end-year	43.45	45.03	44.17	39.41	48.56	46.41	44.00	43.50
INR/USD, average	44.77	44.07	45.21	40.85	44.70	48.31	44.92	43.56
INR/EUR, end-year	59.05	53.11	58.25	57.61	67.50	66.58	63.80	63.08
INR/EUR, average	58.20	54.87	56.81	56.78	65.09	67.51	62.32	60.33
External sector								
Merchandise exports (USDbn)	77.9	102.2	123.8	153.8	198.6	159.8	185.0	206.6
Merchandise imports (USDbn)	106.0	149.4	184.9	231.6	323.1	266.4	318.6	358.8
Trade balance (USDbn)	-28.0	-47.3	-61.2	-77.8	-124.5	-106.5	-133.5	-152.2
Current account balance (USDbn)	0.8	-14.7	-9.3	-8.1	-31.0	-25.7	-44.1	-50.0
Current account balance (% GDP)	0.1	-1.9	-1.1	-0.7	-2.6	-2.2	-3.0	-2.9
Net FDI (USDbn)	3.6	4.6	6.0	8.2	22.9	22.3	23.0	18.0
Net FDI (% GDP)	0.5	0.6	0.7	0.7	2.0	1.9	1.6	1.0
Current account balance plus FDI (% GDP)	0.6	-1.3	-0.4	0.0	-0.7	-0.3	-1.4	-1.8
Exports (% y-o-y)	28.0	31.1	21.1	24.3	29.1	-19.5	15.8	11.7
Imports (% y-o-y)	40.3	41.0	23.8	25.2	39.5	-17.5	19.6	12.6
International FX reserves (ex gold) (USDbn)	135.6	131.0	170.2	266.6	246.6	281.5	317.4	335.4
Import cover (months)	15.4	10.5	11.0	13.8	9.2	12.7	12.0	11.2
Public and external solvency indicators								
Commercial banks' FX assets (USDbn)	148.4	162.8	209.5	324.3	265.4	270.0	300.0	320.0
Gross external debt (USDbn)	134.0	139.1	172.4	224.4	224.6	235.0	250.0	270.0
Short term external debt (% of int'l reserves)	6.0	6.6	7.0	16.4	19.5	16.0	13.9	14.9
Consolidated government balance (% GDP)	-8.7	-9.2	-7.0	-6.5	-9.8	-11.5	-10.0	-8.5
Central government balance (% GDP)	-4.1	-4.2	-3.6	-2.8	-6.3	-6.9	-5.5	-4.8
Primary balance (% GDP)	-0.4	-0.7	-0.1	-0.1	-3.0	-3.2	-2.5	-2.2

Note: Data pertains to fiscal year starting April
Source: Central Bank, Thomson Reuters Datastream, Bloomberg, HSBC estimates and forecasts