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INDIA

Asia Macro Views

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Rupee's Long-Term Appreciation

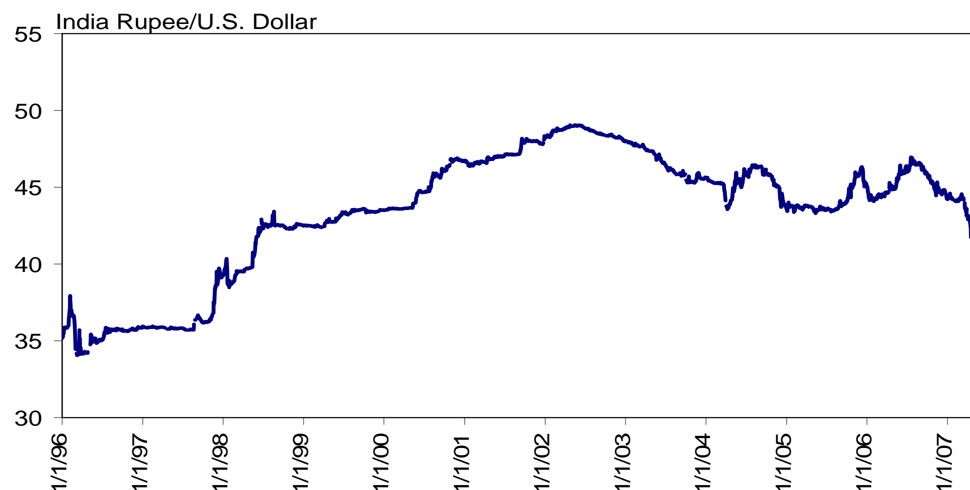
Key points

- Despite recent market jitters we expect rupee to stay on a long-term gradual appreciation path, although the forward market continues to predict a weakening trend for the currency
- Rupee appreciated sharply over the past weeks, surpassing even our non-consensus call. But the currency's near-term outlook could be clouded by deceleration in exports and possible measures to stem capital flows in the upcoming RBI monetary policy meeting
- If India can tame overheating pressures and sustain 8-10% GDP growth over the coming decade as we expect, then the rupee should maintain a steady appreciation trend, much the same as the experiences of most other rapidly growing Asian economies
- The key risk factors that could disrupt the currency appreciation trend include sharp deterioration of the current account, prolonged burst of asset price bubbles or collapse of the economy. But none is in our base case

Discussions

Our forecasts for rupee have been a non-consensus call and we maintain our expectation of steady appreciation over time despite recent market jitters. On April 17, the Indian rupee/U.S. dollar exchange rate fell below the 42-mark for the first time in almost ten years (see Figure 1). Two days later, it eased back to above-42 level. Only a month ago, the exchange rate was still above 44. Ironically, for months the forward market has been expecting the rupee to depreciate, predicting weakening of the exchange rate from 42.80 in 1-month to 44.33 in 12-months.

Figure 1. Daily Indian Rupee/U.S. Dollar Bilateral Exchange Rate, January 1996 – April 2007



Source: CEIC Data Company and Citigroup estimates.

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Overheating of the economy was probably the key reason in Reserve Bank of India's (RBI) latest tolerance of a sharply stronger rupee. In a report published on October 31, 2006, RBI defined an "overheating" economy as one that is "growing so rapidly that its productive capacity cannot keep pace with resulting demand pressures". Today, the Indian economy suffers from a full range of "overheating" symptoms. WPI rose to 6.7% in February from 4% a year ago, while CPI increased to 7.6% for industrial workers and 9.5% for rural labor. Data on asset prices, wage pressures and infrastructure bottlenecks also convey the same message. RBI hiked the repo rates five times during the past nine months and has recently refrained from active currency intervention. Currency appreciation is an important means to tighten the monetary conditions.

Equally important, both the economy and markets remained resilient, despite the tightening policies. While the tightening policies pose downside risks to economic growth and asset prices, so far they have had limited impact on economic momentum. Stock prices still rose by 8.3% during the past month and growth of industrial production and infrastructure activity remained robust. Abundant liquidity conditions, evidenced by rapidly growing money supply and bank credit, also imply that risks of immediate collapse of asset prices are not high. Tightening measures taken so far, with the prospects of more, should help prevent a hard landing. During the past years, Asian equity markets experienced at least three important sell-offs, but each time the Indian equity markets regained strength remarkably quickly. Against such a backdrop, rises in interest rates may be seen as an incentive for more capital inflows, which, in turn, should add further upward pressure on the currency.

However, recent deceleration in exports may cloud the near-term outlook for the currency. Export growth slowed from around 25-30% during the first eleven months of last year to below-10% levels after December. Trade deficits during the first two months of 2007 surged by 78% from a year ago (see Figure 2). If this trend continues, India's current account could deteriorate rapidly, adding downward pressure on the currency. More importantly, worsening of the external account balances may soon encourage RBI to step up its intervention. Recently escalated concerns about "overheating" and expectations of further tightening policies could point to downside risks for economic growth and thereby generate additional downward pressure.

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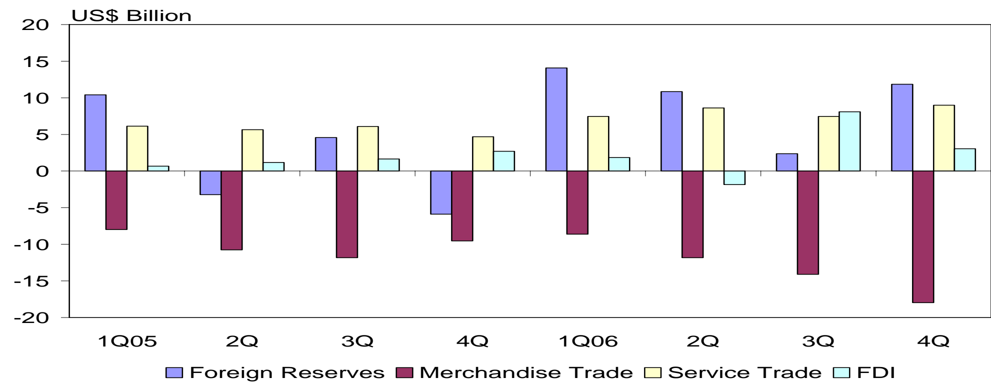
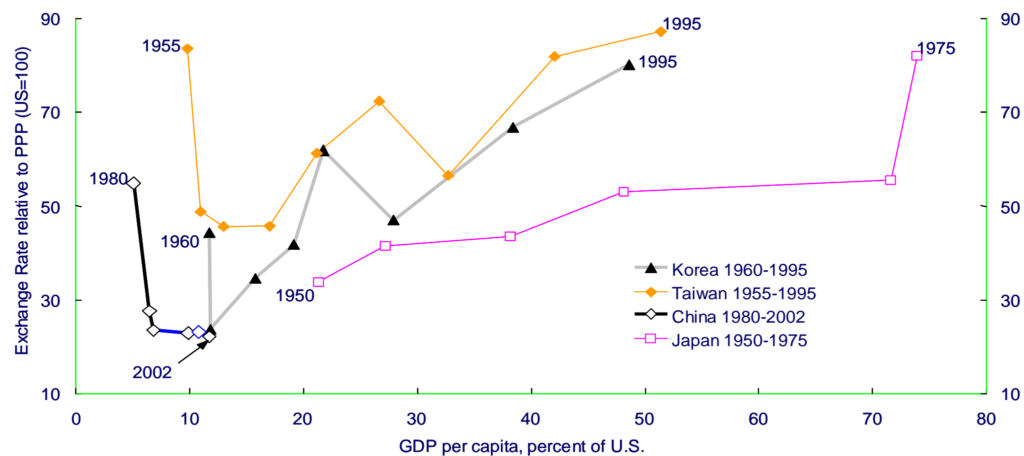
Figure 2. Quarterly Reserve Accumulation, Trade Balances and FDI Inflows, 1Q05 – 4Q06 (US$ Billion)



Source: CEIC Data Company and Citigroup estimates.

Over time we expect the rupee to remain on a gradual strengthening path, on our relatively upbeat macroeconomic outlook. At the current growth rate of above-9%, the economy is probably expanding too rapidly, compared with its growth potential, likely at around 8%. We believe that is why India is suffering from the overheating problems. But for the past two decades, India has successfully lifted its growth potential from around 4.5% in the 1990s to 6% in the 1990s and again to around 8% currently. So with continued reforms and investment, India might be able to ease the overstretched resource constraints and to promote productivity growth. Eventually, India's growth potential may shift to around 10%. But even in a relatively less optimistic scenario in which India's growth potential remains at 8%, its growth should still at least double the pace of the world economy. Experiences of other Asian economies have shown that currency would often appreciate steadily if the economy maintains rapid growth (see Figure 3). This was certainly the case for Japan, Korea and Taiwan in the past. China has started to show the beginning of the same process. And India should not be an exception.

Figure 3. Currency Appreciates as Strong Growth Continues: Japan, Korea, Taiwan and China



Source: CEIC Data Company and Citigroup estimates.

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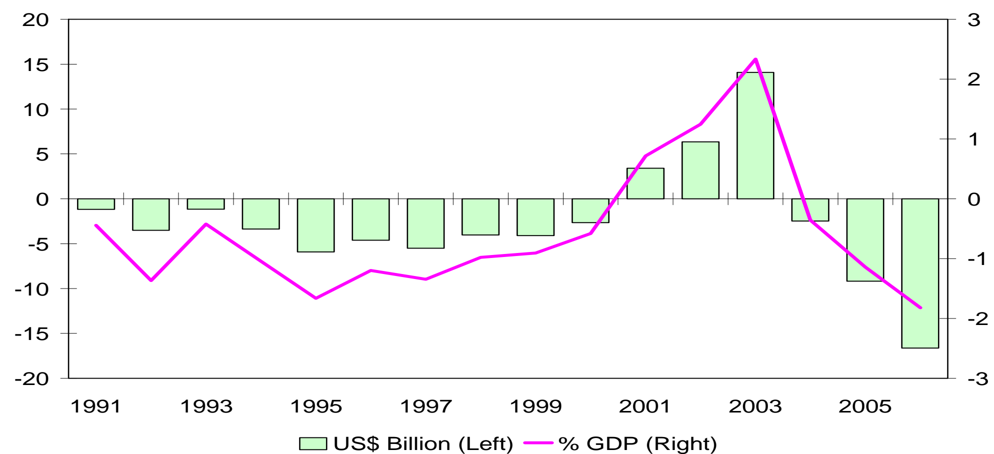
At least what happened to the currency market since July last year has been generally consistent with our expectation, not the consensus view. While rupee strengthened by 10% against the dollar during the past nine months, half of that appreciation occurred during the past month.

However, if the current account deteriorates persistently, it could become a major drag on the currency. The shift of the current account from surplus to deficit during the past years was a major concern for market participants (see Figure 4). While current account deficits could challenge sustainability of India's rapid growth, the risk is probably limited in the medium term. It is not entirely surprising why a rapidly growing emerging market economy like India needs to import capital. The deficits have stayed at below-2% of GDP for the past two years. And strong capital inflows help maintain a healthy position for India's balance of payment. An open question is what happens over time. If India's growth pattern does not support stronger export growth, then current account deficits could persist and even widen. Then macroeconomic risk could rise significantly if capital inflows become less stable.

Figure 4. Current Account Balances, 1991-2006 (US$ and % GDP)



Source: CEIC Data Company and Citigroup estimates.

We expect the rupee/dollar exchange rate to trade in a range of around 41.50 to 42.50 in the next three months. Near term risks to the outlook include possible measures to stem capital flows in the RBI's monetary policy due on April 24. These include tightening overseas borrowing norms and reducing interest rates on NRI deposits. Possible factors that might potentially disrupt the long-term appreciation trend include sharp deterioration of the current account, prolonged burst of asset bubbles and collapse of the economy. These are the risk factors that we should monitor closely, but they are not in our base case scenario.

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