

## INDIA

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## India Economics

### BOP<sup>1</sup> Update: CAD in line with estimates, Capital Flows led by FDI to result in higher reserve accretion

- **2QFY07 Current Account:** Despite buoyant exports, higher imports and a slight slowdown in invisibles resulted in India's current account deficit (CAD) rising to US\$6.9bn v/s US\$4.8bn in 1Q. While this is an all-time high, it is largely in line with our full year CAD estimate of US\$16.6bn as we expect a similar trend in 3Q but a surplus in 4Q as seen in previous quarters. (This is due to a bunching up of invisible receipts in the fourth quarter of the fiscal year).
- **2QFY07 Capital Account:** Capital flows remained buoyant at US\$8.6bn led by foreign investment (both FDI and FII), loans (companies borrowing overseas) and other capital. A key point to note is the uptrend in FDI – up US\$2.5bn. We expect FY07 to be the year when FDI breaks out of its historic US\$3-4bn range and touches US\$9bn. We are thus revising our estimate on capital flows higher to US\$33bn to reflect this as well as due to more companies borrowing overseas.
- **Maintain our Positive View on the External Sector:** We maintain our comfortable stance on the external sector as: 1) capital flows are more than sufficient to finance the CAD; 2) the CAD is mainly due to higher non-oil imports (raw-materials, capital goods), which is indicative of the on-going economic activity; 3) FX reserves (including gold) are at a comfortable US\$176bn.
- **Financial Market Impact:** Higher reserve accretion bodes well for our rupee appreciation view with the USD/INR expected to average 43.2 in 2007. In addition, depending upon how much the RBI sterilizes, higher reserve accretion is positive for domestic liquidity conditions.

### India's Balance of Payments (US\$bn) For details, please refer to page 3.

	FY07		FY06		Full Year		
	Q1	Q2	1H	1H	FY06	FY07E	FY08E
Exports	29.7	30.9	60.6	49.3	105.2	126.4	149.1
Imports	46.9	48.8	95.7	76.4	157.0	189.8	216.4
<b>a. Trade Balance</b>	<b>-17.2</b>	<b>-17.9</b>	<b>-35.1</b>	<b>-27.1</b>	<b>-51.8</b>	<b>-63.4</b>	<b>-67.2</b>
b. Invisibles	12.5	11.0	23.5	19.9	42.7	46.8	51.3
<b>Current Account (a+b)</b>	<b>-4.8</b>	<b>-6.9</b>	<b>-11.7</b>	<b>-7.2</b>	<b>-9.2</b>	<b>-16.6</b>	<b>-15.9</b>
c. Loans	4.3	3.1	7.4	4.3	6.1	10.5	9.0
d. Foreign Investment	1.2	4.7	5.8	7.5	17.2	15.5	17.5
of which FII	-0.5	2.1	1.6	5.4	12.5	6.5	6.5
e. Banking Capital Net	5.0	-1.8	3.2	2.8	1.4	6.5	6.0
Commercial Banks(Net)	3.8	-2.6	1.1	2.5	0.4	4.0	3.5
of which NRI deposits	1.2	0.8	2.0	0.2	2.8	2.5	2.5
f. Other capital	0.3	2.7	3.0	-1.4	-0.7	1.0	1.0
g. Rupee debt service	-0.1	0.0	-0.1	-0.1	-0.6	-0.4	-0.4
<b>Capital Account (c:g)</b>	<b>10.7</b>	<b>8.6</b>	<b>19.3</b>	<b>13.0</b>	<b>23.4</b>	<b>33.1</b>	<b>33.1</b>
Errors & Omissions	0.4	0.5	1.0	0.7	0.8	0.0	0.0
<b>Overall Balance</b>	<b>6.4</b>	<b>2.3</b>	<b>8.6</b>	<b>6.5</b>	<b>15.1</b>	<b>16.5</b>	<b>17.2</b>

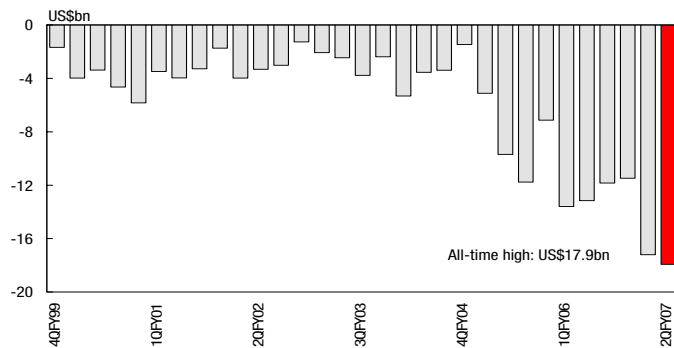
Source: RBI, Citigroup

<sup>1</sup> BOP = Balance of Payments; CAD = Current Account Deficit

## India - Quarterly BOP in Pictures

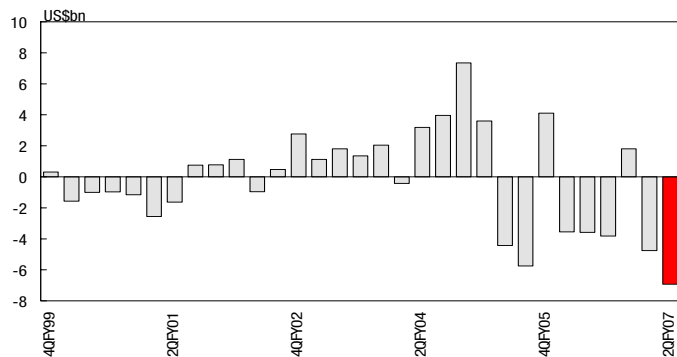
With Imports posting record-high growth at US\$49bn during 2QFY07 and outstripping exports (at US\$30.9bn), the trade deficit rose to an all-time high of US\$17.9bn

Quarterly Trends in the Trade Deficit(US\$bn)



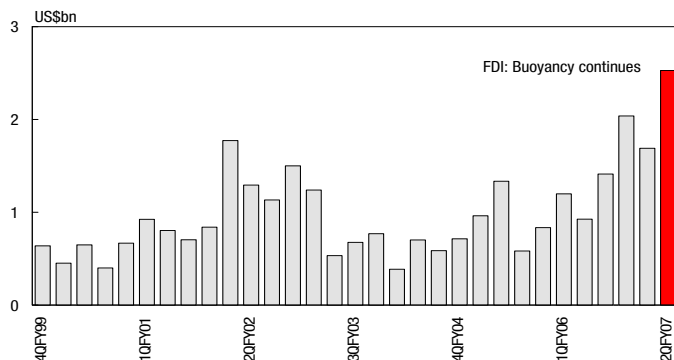
... The burgeoning trade deficit resulted in the current account posting a deficit of US\$6.9bn - the highest in 10 quarters

Quarterly Trends in the Current Account Deficit(US\$bn)



FDI remained a major contributor to capital flows, at US\$2.5bn during 2QFY07. Looking ahead, the Ministry of Commerce has estimated FDI flows to cross US\$11bn in FY07

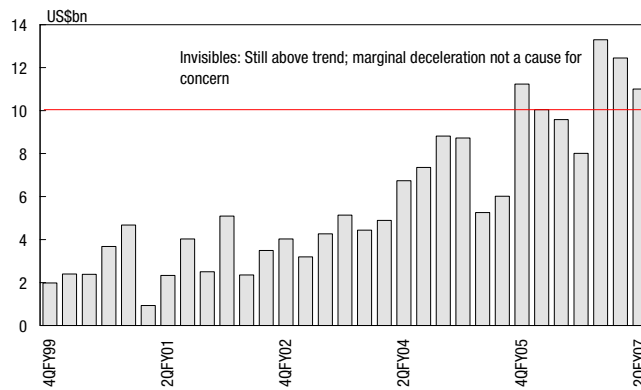
Quarterly Trends in Foreign Direct Investment (US\$bn)



Source: RBI, Citigroup

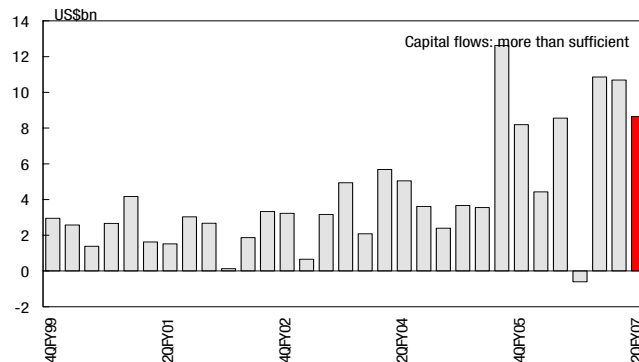
Although invisibles remained a saving grace - crossing US\$11bn during the quarter, led by remittances and software services...

Quarterly Trends in Invisibles(US\$bn)



Capital flows came in at US\$8.6bn - slower than seen in previous quarters, but more than sufficient to offset the rising CAD

Quarterly Trends in Capital Flows (US\$bn)



Sources of Accretion to Foreign Exchange Reserves (US\$bn)

US\$bn	April-September FY07	April-September FY06
<b>I. Current Account Balance</b>	<b>-11.7</b>	<b>-7.2</b>
<b>II. Capital Account (net) (a-f)</b>	<b>20.3</b>	<b>13.7</b>
a. Foreign Investment	5.8	7.5
<i>Of which FDI:</i>	4.2	2.1
b. Banking Capital	3.2	2.8
<i>Of which: NRI Deposits</i>	2	0.2
c. Short term credit	1.9	1
d. External Assistance	0.4	0.4
e. External Commercial Borrowings	5.1	2.9
f. Other items in capital account	3.9*	-0.9
<b>III. Valuation change</b>	<b>5.1</b>	<b>-5</b>
<b>Total (I+II+III)</b>	<b>13.7</b>	<b>1.5</b>

### FY07E KEY POINTS

**Export** growth likely to sustain at 18-20% levels with new export areas – capital goods, pharma, auto opening up, as well as the impact of textile quota removal

However, **Imports** are higher due to higher oil prices (assumes US\$70/bbl Dubai crude), non-oil imports as well as defense

Difference between RBI and Customs data is a proxy for defense imports

**Invisibles** remain healthy due to software exports and remittances

But due to a high trade deficit, the **current account** is likely to remain in the red, at 1.9% of GDP in FY07E

**Commercial borrowings** increase due to attractive market conditions

Policy reform could boost **FDI**

**Banking Capital** will likely see a big upside given new RBI norms on hybrid capital+ more banks borrowing money from overseas

...As a result, total **Capital Flows** sufficient to offset rising CAD

**Bottom Line; Accretion to Reserves** at US\$16.4bn in FY07E and US\$17.2bn in FY08

**Forex reserves** also continue to provide strong cushion against external shocks, @US\$176bn currently

### India- Balance of Payments: A Detailed Breakdown (US\$m)

	FY02	FY03	FY04	FY05	1H FY06	FY06	1H FY07	FY07E	FY08E
<b>CURRENT ACCOUNT</b>									
Exports	44,703	53,774	66,285	85,206	49,255	105,152	60,550	126,382	149,131
Y/Y %	(1.6)	20.3	23.3	28.5		23.4	22.9	20.2	18.0
Exports- Customs	43,827	52,719	63,843	80,700	48,286	100,600	58,928	120,720	147,278
Y/Y %	(1.6)	20.3	21.1	26.4	34.9	24.7	22.1	20.0	22.0
Imports	56,277	64,464	80,003	118,908	76,364	156,993	95,691	189,805	216,377
Y/Y %	-2.8	14.5	24.1	48.6		32.0	25.3	20.9	14.0
Imports-Customs	51,448	61,385	78,200	106,700	70,550	140,200	83,336	175,500	202,625
Y/Y %	1.7	19.3	27.4	36.4	48.4	31.4	18.1	25.2	15.5
of which:									
Oil	14,048	17,685	20,600	29,900	20,948	43,800	28,664	55,000	52,000
Y/Y %	-10.4	25.9	16.5	45.1	44.3	46.5	36.8	25.6	-5.5
Non-Oil	37,400	43,700	57,600	76,800	49,602	96,400	54,672	120,500	150,625
Y/Y %	7.2	16.8	31.8	33.3	50.6	25.5	10.2	25.0	25.0
<b>a. Trade balance (RBI)</b>	<b>-11,574</b>	<b>-10,690</b>	<b>-13,718</b>	<b>-33,702</b>	<b>-27,109</b>	<b>-51,841</b>	<b>-35,141</b>	<b>-63,422</b>	<b>-67,246</b>
% of GDP	-2.4	-2.1	-2.3	-4.9		-6.5		-7.2	-6.4
Trade Balance (Customs)	-7,621	-8,666	-14,357	-26,000	-22,264	-39,600	-24,408	-54,780	-55,347
Difference	-3,953	-2,024	639	-7,702	-4,845	-12,241	-10,733	-8,642	-11,900
<b>b. Invisibles</b>	<b>14,974</b>	<b>17,035</b>	<b>27,801</b>	<b>31,232</b>	<b>19,949</b>	<b>42,655</b>	<b>23,458</b>	<b>46,800</b>	<b>51,300</b>
Non-factor services	3,324	3,643	10,144	15,426	11,726	23,881	14,298	27,000	29,000
Of which: Software Services	6,884	8,863	11,750	16,400	9,842	22,262	12,085	27,605	34,230
Investment income	-4,206	-3,446	-4,505	-4,979	-2,278	-5,510	-2,051	-4,500	-4,000
Remittances	15,398	16,387	21,608	20,525	10,489	24,102	11,157	24,000	26,000
Official transfers	458	451	554	260	12	182	54	300	300
<b>1. Current a/c balance (a+b)</b>	<b>3,400</b>	<b>6,345</b>	<b>14,083</b>	<b>-2,470</b>	<b>-7,160</b>	<b>-9,186</b>	<b>-11,683</b>	<b>-16,622</b>	<b>-15,946</b>
% of GDP	0.7	1.3	2.3	-0.4		-1.2		-1.9	-1.5
<b>CAPITAL ACCOUNT</b>									
<b>c. Loans</b>	<b>-1,261</b>	<b>-3,850</b>	<b>-4,364</b>	<b>10,909</b>	<b>4,281</b>	<b>6,113</b>	<b>7,389</b>	<b>10,500</b>	<b>9,000</b>
External assistance	1,117	-3,128	-2,858	1,923	409	1,682	358	1,500	1,000
Commercial borrowings*	-1,585	-1,692	-2,925	5,194	2,925	2,723	5,093	7,000	6,000
Short-term credit	-793	970	1,419	3,792	972	1,708	1,938	2,000	2,000
<b>d. FDI (Net = a-b)</b>	<b>4,734</b>	<b>3,217</b>	<b>2,388</b>	<b>3,713</b>	<b>2,129</b>	<b>4,730</b>	<b>4,218</b>	<b>9,000</b>	<b>11,000</b>
(a) FDI - To India	6,125	5,036	4,322	5,987	3,284	7,661	5,693	11,000	13,000
(b) FDI - Abroad	-1,391	-1,819	-1,934	-2,274	-1,155	-2,931	-1,475	-2,000	-2,000
<b>e. Portfolio investment</b>	<b>1,952</b>	<b>944</b>	<b>11,356</b>	<b>9,287</b>	<b>5,413</b>	<b>12,494</b>	<b>1,614</b>	<b>6,500</b>	<b>6,500</b>
<b>f. Banking Capital</b>	<b>2,864</b>	<b>10,425</b>	<b>6,033</b>	<b>3,874</b>	<b>2,778</b>	<b>1,373</b>	<b>3,165</b>	<b>6,500</b>	<b>6,000</b>
Commercial Banks (Net)	110	7,447	2,391	4,838	2,545	442	-2625	4,000	3,500
NRI deposits	2,754	2,978	3,642	-964	233	2,789	2,029	2,500	2,500
<b>g. Rupee debt service</b>	<b>-519</b>	<b>-474</b>	<b>-376</b>	<b>-417</b>	<b>-142</b>	<b>-572</b>	<b>-67</b>	<b>-400</b>	<b>-400</b>
<b>h. Other capital**</b>	<b>781</b>	<b>578</b>	<b>1,699</b>	<b>656</b>	<b>-1,409</b>	<b>-738</b>	<b>3,016</b>	<b>1,000</b>	<b>1,000</b>
<b>2. Capital a/c (c+d+e+f+g+h)</b>	<b>8,551</b>	<b>10,840</b>	<b>16,736</b>	<b>28,022</b>	<b>12,986</b>	<b>23,400</b>	<b>19,335</b>	<b>33,100</b>	<b>33,100</b>
Errors & Omissions	-194	-200	602	607	651	838	994	0	0
<b>Overall balance (1+2)</b>	<b>11,757</b>	<b>16,985</b>	<b>31,421</b>	<b>26,159</b>	<b>6,503</b>	<b>15,052</b>	<b>8,646</b>	<b>16,478</b>	<b>17,154</b>
<b>Forex</b>									
Forex assets (US\$b)	51.0	71.9	106.1	135.1	136.9	145.1	158.3	161.6	178.7
FCA to months of imports (Rhs)	10.9	13.4	15.9	13.6		11.1		10.2	9.9
<b>Exchange rate</b>									
Rs/US\$ - annual avg	48.0	48.3	45.9	45.0	43.6	44.3	46.0	45.3	43.2
% depreciation	5.0	0.6	-5.0	-2.0		-1.6		2.3	-4.6
Rs/US\$ - year end	48.9	47.5	43.6	43.8	44.0	44.6	45.9	44.5	43.2
% depreciation/(-) app	5.2	-2.9	-8.2	0.3		2.0		-0.3	-2.9

\* Includes US\$4.1bn of the Resurgent Bond Issue repaid in September 2003 and the US\$5bn repayment of India Millennium Bonds in FY06.

\*\* Includes delayed export receipts, advance payments against imports. Source: RBI, Citigroup estimates

## Disclosure Appendix

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