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India Economics

Preview: RBI's Monetary Policy + Chartbook of Trends

- **The backdrop of RBI's Oct 30 Monetary Policy** is a relatively benign macro-environment with managing dollar inflows remaining the key concern for policy officials. While our FY08 macro forecasts have factored in a rate cut as well as a CRR hike, the timing is uncertain as the RBI may wish to see the impact of the SEBI P-Note proposals on dollar inflows. In any case, the RBI has the flexibility and has been effecting inter-policy measures.

- **Five key reasons why we believe rates should be lower:** (1) As mentioned in our previous notes, investment growth is twice that of consumption, thereby resulting in capacity constraints getting slowly but steadily addressed. (2) Credit growth and inflation at 20.9% and 3.07% are below the RBI's target of 24-24.5% and 5%. (3) While overall industrial production remains buoyant, up 9.8% this fiscal year, the rate sensitive durables sector contracted 2.3%. (4) The case for lower rates gets stronger as higher rates have resulted in more reliance on foreign currency debt and higher inflows. (5) On the global front, our US team expects the Fed to cut rates twice more.

- **Policy rates headed lower but reserve requirements likely higher:** With forex reserves up US$57bn this fiscal year and the rupee already gaining 9% since April07, liquidity management has posed a dilemma for the authorities. While the RBI has already hiked the ceiling on the issuance of the market stabilisation scheme (MSS) if the surge in dollar inflows continues, one can expect (1) A further hike in the MSS ceiling, (2) Sell-buy swaps and (3) A CRR hike such that the cost of sterilisation is shared. (*A 1% hike in the CRR would result in liquidity to the tune of US$7bn being sucked out of the system.*)

- **Capital Inflows: Likely to remain the top policy priority:** Measures to rein in flows this year include (1) Tightening the norms for external commercial borrowings, (2) Encouraging dollar outflows, and (3) Recent P-Note proposals[1]. If the surge in dollar inflows continues and there is pressure to keep rupee appreciation in check, we could expect the government/RBI to (1) Further monitor inflows coming in including those into real estate, (2) Lower domestic rates to discourage inflows, and (3) More measures to encourage outflows.

- **Maintaining our macro forecasts:** We reiterate our positive stance on the economy with GDP growth likely to come in at 9.3%, inflation to remain sub 5%, the rupee to continue its appreciating trend and the 10-year bond likely to trade in a narrow range. The fiscal deficit[2] is the one macro variable which is turning negative largely on the back of the rise in off-balance-sheet items, the recent announcement of the extension of the National Rural Employment Guarantee Program and higher interest payments due to an increase in the issuance of market stabilisation bonds.

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[1] See https://www.citigroupgeo.com/pdf/SAP10152.pdf for details on SEBI's P-Note proposals dated 17 October 2007

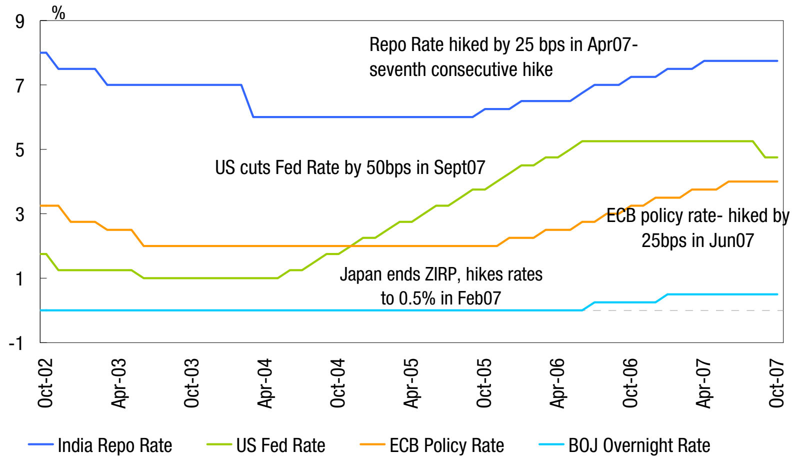
[2] See https://www.citigroupgeo.com/pdf/SAP10100.pdf for details on the rise in expenditure pressures dated 16 October 2007.

Interest Rates – Next move to be down

The Global Environment

- **In the U.S,** given that adjustments in housing pose a additional risk, our team expects to see further easing with a 25bp cut this year and another cut next year, taking the Funds Rate to 4.25%
- In the **Euro area**, our team expects official rates to stay at 4% given that the perceived upside risks to inflation are offset by downside risks to growth
- In **Japan**, the rate hike from 0.5% to 0.75% will possibly be delayed till 1Q08 as uncertainties surrounding the economic outlook have increased
- In **China**, downside risks appear limited. However, inflation peaks could have an effect on monetary policy in coming months.

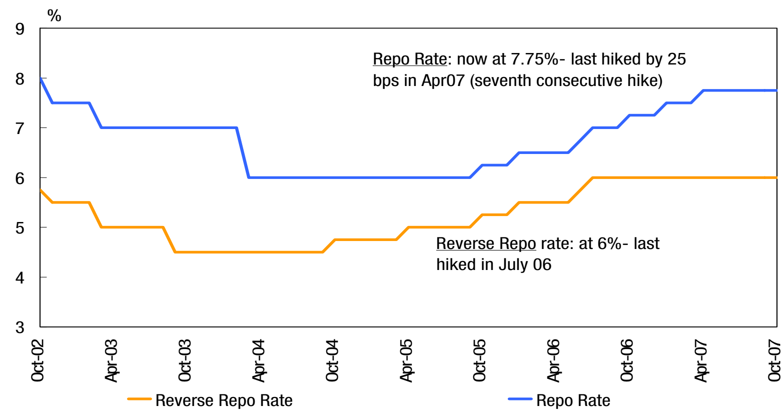
Trends in Key Global Policy Rates (%)



Key Domestic Policy Rates

- **Reverse Repo Rate** (the liquidity absorbtion rate) = **<u>6%</u>** (hiked six times by 25bps each, in Oct04, April05, Oct05, Jan06, Jun06 and Jul06)
- **Repo Rate** (the liquidity injection rate/lending rate) = **<u>7. 75%</u>** (hiked seven times, by 25bps each in Oct05, Jan06, Jun06, Jul06, Oct06, Jan07, and Apr07)

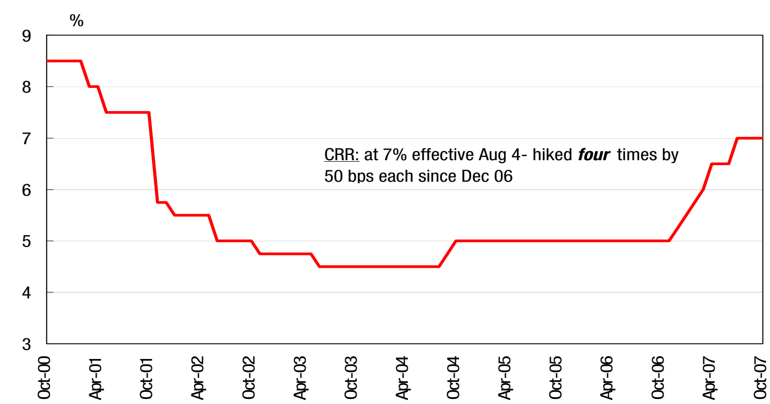
Trends in Domestic Interest Rates (%)



Cash Reserve Ratio – A <u>liquidity absorption</u> tool rather than a rate signal

- **Cash Reserve Ratio** = 7% (hiked four times by 50bps each, in Dec06, Jan06 , Mar07 and Jul07)
- Higher capital inflows have posed a liquidity problem. We thus expect the RBI to continue to hike the **Cash Reserve Ratio** as a ***liquidity absorption tool rather than a rate signal***
- A 1% CRR hike would result in liquidity to the tune of Rs300bn (US$7.5bn) being drained out of the system

Long-Term trends in the CRR



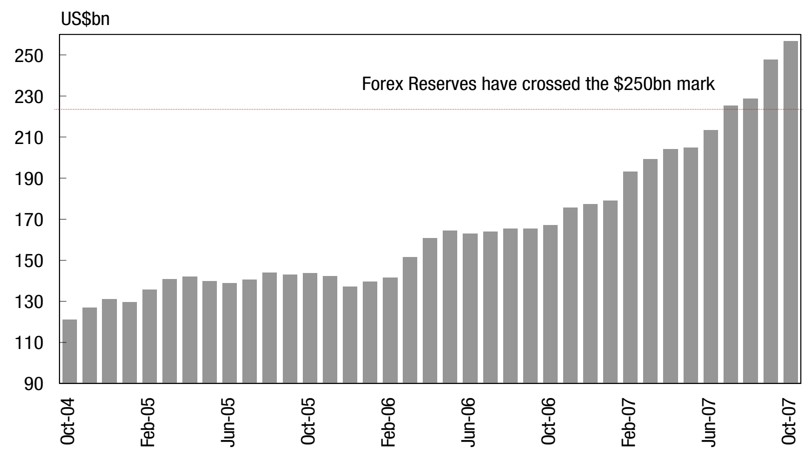
Source: RBI, Reserve Banks of, US, Japan, EU

Liquidity – Poses a big problem for authorities

FX Reserves have seen a surge in recent months

- Forex reserves have increased by US$57bn during the current fiscal with total reserves currently at US$257bn.
- This is reflective of the RBI's intervention in the FX market which has helped cap the rupee's upside.
- With dollar inflows increasing, the options for the RBI are either to let the rupee appreciate or mop up the additional dollars. The latter would then result in an increase in domestic liquidity.

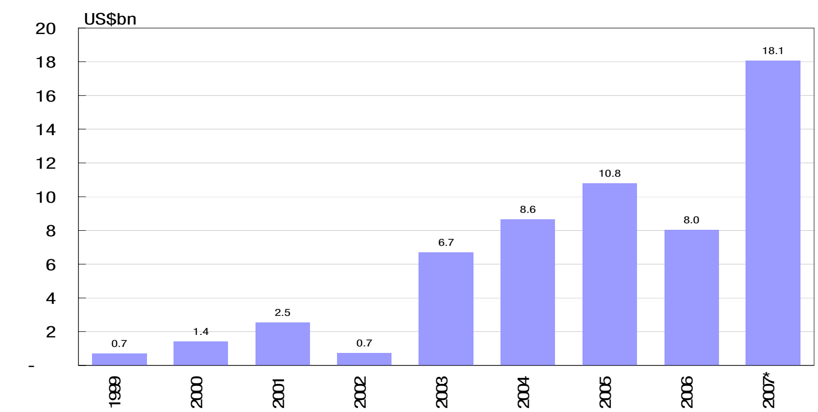
Trends in Outstanding FX Reserves (US$bn)



FII Flows have been a key reason for higher liquidity

- India, along with many other emerging markets, has seen unprecedented foreign inflows this year with the Indian market seeing a stunning rebound since August lows, with Sensex up 32% since then.
- Taking into account recent outflows, Net FII inflows are at US$16.7bn for 2007 YTD (vs. only US$8bn in 2006), while FDI inflows have also been robust (US$11.4bn till June 2007, equal to FDI for the whole of 2006). US$8.5bn in FII inflows have come in just after the Fed rate cut on 18-Sept.

Trends in FII Flows (US$bn)

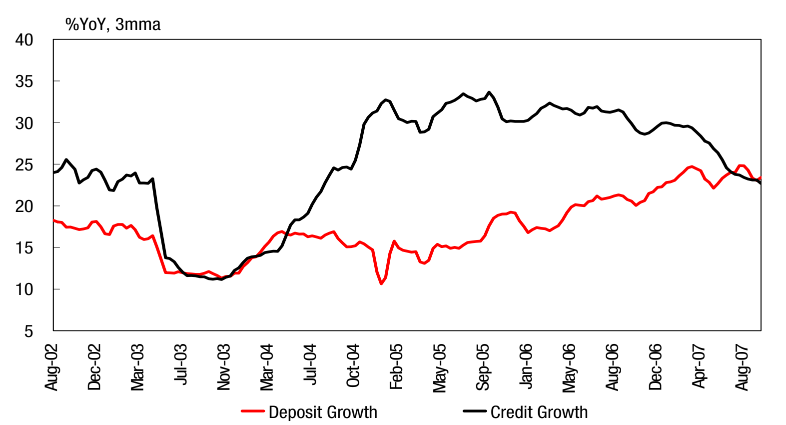


*Fiscal YTD

Trends in Deposit and Credit Growth

- **Credit growth** continues to see moderation, with growth coming in at 20.9% as on September 28. this is largely a result of lower retail loans (a result of RBI targeting asset price inflation) while lending to the industrial sector remains on track, indicative of the ongoing capex cycle
- **Deposit growth** remains buoyant, up 23.9%, outpacing loan growth. In absolute terms, fiscal YTD, deposits were up Rs2560bn while loans were Rs965bn, thereby adding to liquidity.

Trends in Deposit and Credit Growth (%YoY, 3mma)



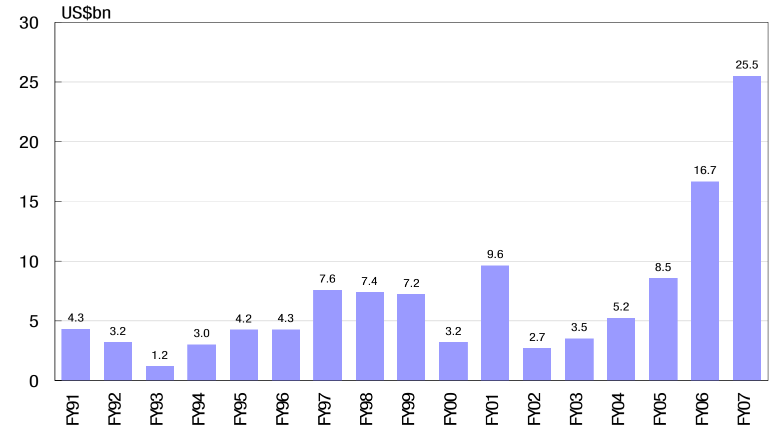
Source: RBI, SEBI

What has the Government/RBI done to stem liquidity?

#1: Curbing Capital Inflows

- To curb capital inflows, the govt has taken a number of measures this fiscal.
- The first of these include further restrictions on External Commercial Borrowings (ECBs) limiting offshore borrowing to $20m offshore for use onshore. The overall US$500mn company ceiling remains, but this would have to be used for expenditure offshore.
- More recently, SEBI published a discussion paper to monitor investments by FIIs through PNs[3]

Annual Trends in ECBs (US$bn)



#2: Encouraging Capital Outflows

- In a bid to encourage forex outflows and tame the rupee's rise, the RBI has introduced a number of measures recently.
- While the measures announced in line with the recommendations on fuller capital account convertibility, we believe these measures are unlikely to have a significant impact on the currency; given the magnitude of dollar inflows

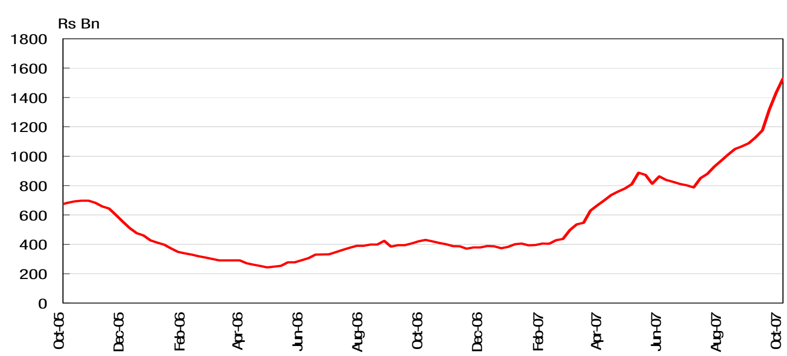
Recent Changes Encouraging Capital Outflows

	Earlier Position	Revised Policy
External Commercial Borrowings	1) ECBs up to US$500mn per financial year permitted under the automatic route with end-use restrictions. Overall limit fixed at US$22bn. 2) Prepayment of upto US$400mn allowed without prior approval	1) Overall limit at US$500mn. Changes limiting the use of ECBs to US$20mn onshore were made last month. 2) Prepayment without approval raised to US$500mn
Portfolio Investments overseas	Listed companies could invest 35% of the net worth into portfolio investts abroad	Limit raised to 50% of net worth. Requirement of 10% reciprocal share holding in company by overseas company removed
JVs/Wholly Owned Subsidiaries	Indian companies could invest up to 200% of their net worth in overseas bodies	Overall limit raised to 400% of net worth under the automatic route
MF Investments overseas	Aggregate ceiling was fixed at US$4bn, individual ceiling decided by SEBI	Aggregate ceiling raised to US$5bn
Financial Capital transfers	Residents permitted to remit US$100,000 per calendar year	Limit raised to US$200,000 per calendar year

#3. Raising the Ceiling for the Market Stabilization Scheme (MSS)

- In a bid to keep liquidity in check, the RBI has resorted to the issue of bonds via the MSS
- More recently, the RBI raised the ceiling for outstanding MSS from Rs1.5trillion to Rs2trillion. With outstanding MSS currently at Rs1.53trillion, the RBI can absorb another US$11bn of dollar inflows via MSS issuances.
- We could see a further hike in the MSS ceiling, although rising interest payments are a concern

Trends in Outstanding MSS Issuances (Rs Bn)



Source: RBI

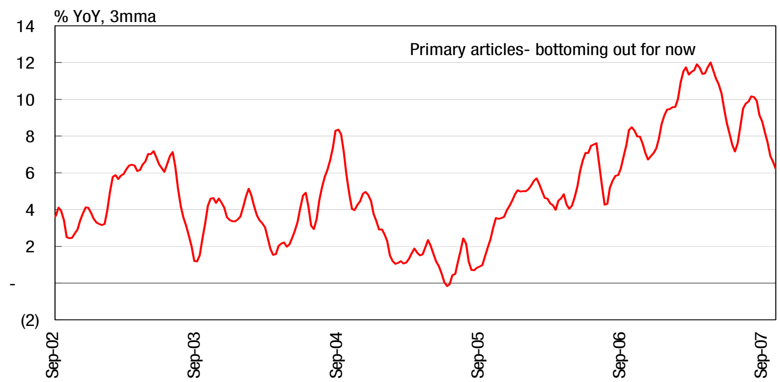
[3] For more details on the P-Note proposal pls see https://www.citigroupgeo.com/pdf/SAP10152.pdf

Inflation – Benign Trends to Continue

Government measures bring down primary product prices

- Primary product inflation which comprises 22% of the WPI has seen a moderation from 10% growth earlier to 6% levels currently.
- The government has taken a number of measures to curtail food prices, including restrictions on exports of commodities such as wheat, wheat flour, non-basmati rice as well as onions
- However, higher food prices remain a key threat to inflation – a result of – global production shortages, coupled with an increasing demand for bio-fuels

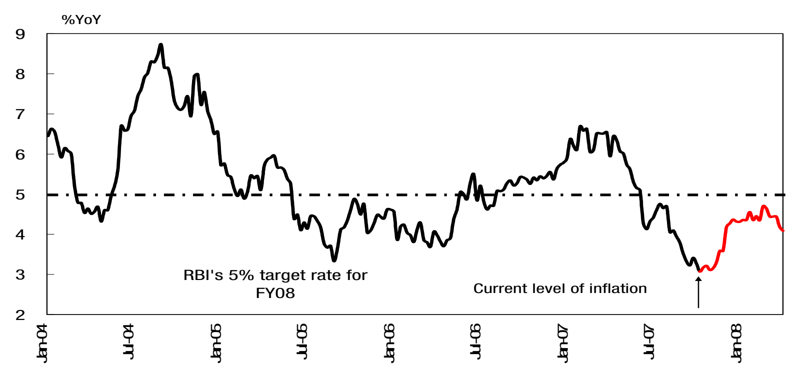
Trends in the Primary Articles Index (%YoY, 3mma)



Trends in Wholesale Price Index

- As a result of lower primary product prices coupled with artificially low fuel prices, inflation has remained in the 3-3.5% range
- We expect inflation to trend below 5% levels for the next few months (the RBI's target rate for FY08). However, latent inflationary pressures – oil, wages and rentals – continue to persist.
- If prices of petrol and diesel are adjusted, inflation would rise by 70bps but still be lower than the RBI's 5% target level

Likely Trends in the WPI



Trends in the CPI reflect higher primary product prices

- The CPI for industrial workers rose from 5% in April to a high of 7.3% while the CPI for rural labour is up 8.5%yoy
- The growing divergence between the CPI and the WPI is reflective of the fact that while primary (food) products account for 60% of the Index, they comprise just 22% of the WPI.
- But given the recent measures to bring down primary product prices, we expect the CPI to come off in the coming months.

Components of the Wholesale Price Index (WPI)

	FY94=100	Latest WPI Reading* (%YoY)
I. Primary Articles	**22.0**	**5.6**
(A) Food Articles	15.4	3.7
(B) Non-Food Articles	6.1	12.7
(C)Minerals	0.5	0.7
II. Fuel, Power Light & Lubricants	**14.2**	**-2.3**
III. Manufactured Products	**63.7**	**4.1**
(A) Food Products	11.5	3.7
(B) Beverage Tobacco & Tobacco Products	1.3	9.4
(C)Textiles	9.8	-1.6
(D)Wood & Wood Products	0.2	7.1
(E) Paper & Paper Products	2.0	3.0
(G)Rubber & Plastic Products	2.4	5.2
(H)Chemicals & Chemicals Products	11.9	5.2
(I) Non-Metallic Mineral Products (incl cement)	2.5	8.9
(J) Basic Metals, Alloys & Metal Products	8.3	4.1
(K)Machinery & Machinery Tools	8.4	7.1
(L)Transport Equipment & Parts	4.3	1.3
All Commodities	**100.0**	**3.1**

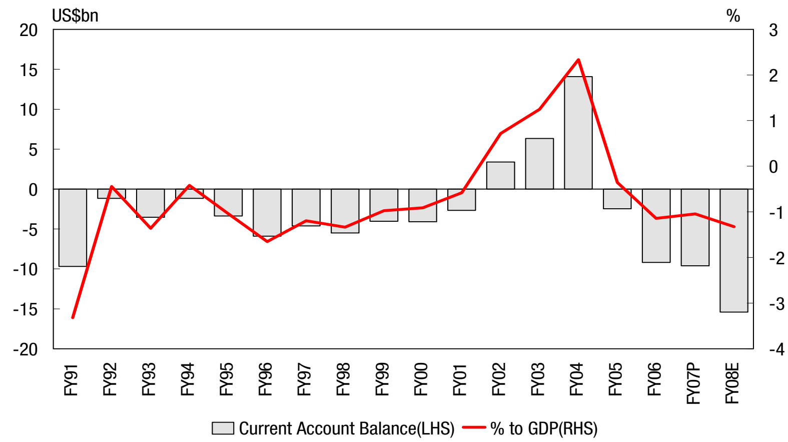
* As on 6 Oct 2007. Source: Office of the Economic Advisor, Bloomberg, Labor Bureau

External: Higher capital inflows offset a widening current a/c deficit

Current Account Deficit- Likely to See Further Widening

- We expect India's trade deficit to widen to US$82bn in FY08 vs. US$64.9bn in FY07.
- This is due to (1) slower export growth (2) An increase in the oil import bill (assumes 10% volume growth and Dubai crude at US$70/bbl).
- As a result, despite buoyant invisibles, India's CAD is estimated to widen to US$14.7bn (1.3% of GDP).

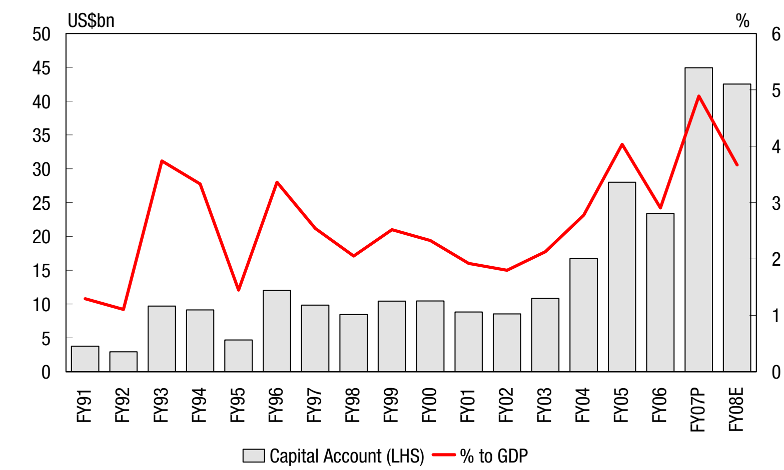
Trends in the Current Account (US$bn, % GDP)



Capital Account- Remains Robust

- While recently imposed tighter ECB norms could slow down loan flows, taking into account higher portfolio flows, we expect overall capital flows to come in at US$42.5bn during FY08.

Trends in the Capital Account (US$bn, % GDP)



External Sector: Still Positive

- We remain overall comfortable on the external sector since:

1. **The size** of India's CAD is well under 2% of GDP
2. **The composition** indicates that over 70% of the rise in non-oil imports is due to capital goods and industrial raw materials –essential, given that India has moved from a 6% growth to 8%+.
3. **Financing:** Even if so-called hot money (portfolio flows + NRI deposits) flows are excluded, India has more than enough capital flows to finance the CAD and still add to FX reserves

Trends in the BOP (US$bn,)

	FY04	FY05	FY06	FY07P	FY08E
a. Trade Balance	-13.7	-33.7	-51.8	-64.9	-82.3
b. Invisibles	27.8	31.2	42.7	55.3	67.6
1. Current A/c Balance (A+B)	**14.1**	**-2.5**	**-9.2**	**-9.6**	**-14.7**
c. Loans	-4.4	10.9	6.1	21.1	13.5
d. FDI(Net)	2.4	3.7	4.7	8.4	9.4
e. Portfolio Investment	11.4	9.3	12.5	7.1	17.0
f. Banking Capital	6.0	3.9	1.4	2.1	2.0
NRI Deposits	3.6	-1.0	2.8	3.9	1.0
g. Rupee Debt Service	-0.4	-0.4	-0.6	-0.2	-0.4
h. Other Capital	1.7	0.7	-0.7	6.4	1.0
2. Capital A/c (c:h)	**16.7**	**28.0**	**23.4**	**44.9**	**42.5**
Errors and Omissions	0.6	0.6	0.8	1.3	0.0
3. Overall Balance (1+2)	**31.4**	**26.2**	**15.1**	**36.6**	**27.8**

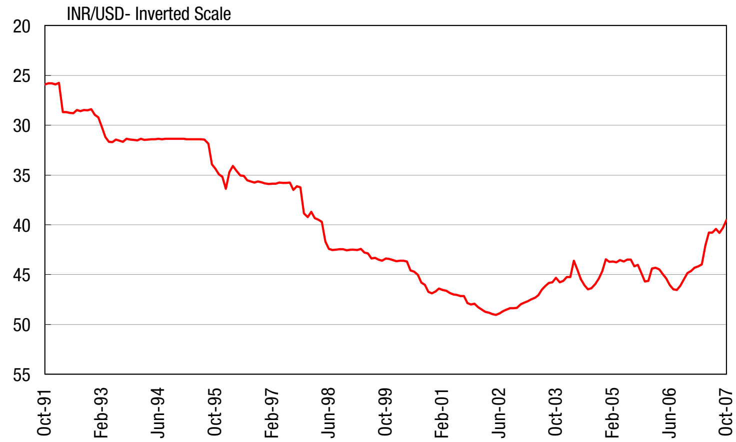
Source: RBI, Citi Estimates

Currency: Appreciation Trend Likely to Continue

Tracking the Rupee

- The rupee, which has been a depreciating currency, changed course in 2002. While trends since then have not been uni-directional, the pace of appreciation has accelerated in 2007, with the currency gaining 9% this fiscal
- The RBI is likely caught in the trap of the 'impossible trinity', given its attempts to have an independent monetary policy simultaneously targeting exchange rates, with a partially-open capital account.
- The recent sharp appreciation in the INR could have a near term impact on exports, employment and profit margins, although efficient companies should be able to withstand a stronger INR[4]

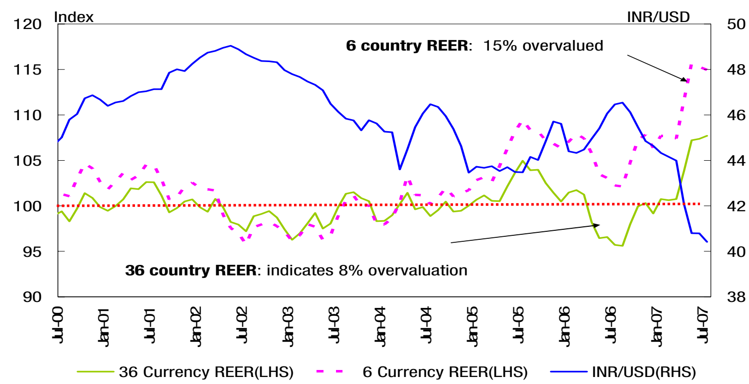
Long Term Trends in the Rupee



Trends in the Real Effective Exchange Rate

- The 6-country REER indicates that the rupee is currently overvalued by 15%.
- However, the 36 country model which is a wider basket indicates that it is 8% over-valued.
- REER does not capture invisibles or capital flows – both of which have gained significance since 2003

Trends in the Real Effective Exchange Rate and the Rupee



Long-Term Rupee Story Holds

- Based on global and domestic factors we expect the INR likely to average Rs38/US$ in 2008. As resource constraints ease and India moves on to a higher growth trajectory, the rupee should maintain a steady appreciation trend, similar to the most other rapidly growing Asian economies.
- Risks that could disrupt currency appreciation trend include sharp deterioration of the current account, prolonged fall in asset prices or economic collapse. But these scenarios are not in our base case.

Exchange Rate Forecasts

	Exchange Rates(Average)				
	2007	2008	2009	2010	2011
United States	NA	NA	NA	NA	NA
Japan	116.0	114.0	109.0	100.0	94.0
Euro Area	1.35	1.43	1.44	1.45	1.45
China	7.61	7.00	6.65	6.32	6.00
India (NEW)	**40.2**	**38.00**	**36.00**	**35.00**	**34.00**

Source: RBI, Citi Estimates;

[4] For more details please see India Macroscope: India Inc- Surviving a Stronger Rupee at https://www.citigroupgeo.com/pdf/SAP10100.pdf

Disclosure Appendix

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