ECONOMIC AND
MARKET ANALYSIS:
INDIA

Economics

13 March 2007

Asia Pacific

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India Macroscope

Weighing the Odds…Global Developments and India – A scenario Analysis

- **In times of an increase in risk aversion, countries with twin deficits, inflation and political challenges – all of which India faces – tend to be viewed with caution**
- **The recent sell-off thus prompts us to examine the impact of three scenarios – a US Slowdown, the China Factor and continued unwinding of the carry trade – were they to play out, on India**
- **While India is no longer an insulated/defensive economy, we believe that an important factor that could support optimism on India is that its growth story is largely domestic-oriented**
- **This, coupled with its relatively sound external position, should sustain investor confidence**
- **We are currently maintaining our macro forecasts of 9%+GDP; inflation easing to 5% and a long-term appreciation trend for the rupee**

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Investment Summary

Following the recent sell-off, our theme in the March Macroscope prompts us to examine the impact a US Slowdown, the China Factor and carry trade unwinding were they to play out, on India. We conclude that given the closed nature of the economy, India is likely to be relatively less impacted

Weighing the Odds of Possible Global Developments on India

In response to a confluence of factors, global financial markets experienced a sharp re-pricing of risk that resulted in a synchronized sell-off across markets. Our house view is that asset volatility is unlikely to dissipate immediately, but as the correction has NOT been caused by underlying economic fundamentals, all forecasts have been unaltered. However, the sell-off prompted us to examine the impact of three possible scenarios – a US slowdown, China Factor and continued unwinding of the carry trade – were they to play out, on India.

A US Slowdown

Given that the US accounts for 28% of world GDP and 12.5% of world trade, a slow down in the US could take its toll on trade and financial flows. What supports optimism on India is that its growth story is domestic-oriented, which provides better insurance (than many other Asian neighbors have) at a time if/when global growth slows. This, coupled with its relatively sound external position, should sustain investor confidence.

The China Factor

Analysing the impact of lower Chinese growth on India, we find that the share of India's exports to China has risen to 6.5%. Though still small, it could take its toll on the composition of commodity exports, such as iron-ore and alumina, which have benefited from the ongoing investment expansion in China

Further Yen Appreciation

Besides the impact of leveraged investors offloading high yielding assets, which would then impact the stock market and INR, Indian corporates could also potentially lose if the yen appreciates significantly. The reason being that the Indian corporate sector has also been a party to the carry trade game – directly via taking ECB/trade credit in JPY as well as via the derivative route.

We Maintain our Macro Forecasts

We expect inflation to trend towards 5% levels by May due to monetary and fiscal measures, the base effect and political pressure. However, given that inflation, bank credit and money supply are still running ahead of RBI targets currently, we expect one more rate hike this year. On growth, we maintain our 9.3% GDP estimate for FY08 due to the continuation of the key growth drivers coupled with all the macro/sector trends remaining supportive.

Financial Markets

While near-term rupee trends are likely to remain choppy, given the strong external account, we are maintaining our long-term rupee appreciation view. As regards bonds, we do not expect much further rise in the 10-year yields (currently at 8%) given the demand-supply mismatch for long-tenor bonds.

Statistical Snapshot

Figure 1. India — Macroeconomic Summary, FY98-08E (Percent)

Year -end 31 March	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08E
National income indicators											
Nominal GDP (Rs bn)	15,224	17,409	19,520	21,024	22,811	24,581	27,655	31,266	35,672	41,006	46,337
Nominal GDP (US$ bn)	409	413	450	460	475	509	603	695	805	913	1073
Per Capita GDP (US$)	422	418	451	457	467	495	584	673	769	859	994
Real GDP growth (%)	4.8	6.5	6.0	4.4	5.8	3.8	8.5	7.5	9.0	9.2	9.3
Agriculture growth (%)	-2.4	6.2	0.5	-0.2	6.3	-7.2	10.0	0.0	6.0	2.7	3.0
Industry growth (%)	4.3	3.7	4.1	6.3	2.7	7.1	7.4	9.8	9.6	10.0	10.3
Services growth (%)	9.8	8.4	10.8	5.7	7.2	7.4	8.5	9.6	9.8	11.2	10.9
Real indicators (% Y/Y)											
Cement dispatches	10.6	6.4	14.1	0.1	8.6	11.1	6.5	9.3	10.3	10.0	10.0
Commercial vehicle sales	-33.2	-11.2	22.0	-11.9	-4.5	27.9	38.1	24.0	13.0	24.0	9.0
Car sales	1.1	-0.9	54.9	-6.9	4.5	7.6	32.8	18.7	7.0	15.0	12.0
Two-wheelers	-3.7	5.0	-5.4	-28.1	-3.1	-13.1	10.6	16.8	15.0	14.0	13.0
Diesel consumption	3.5	3.7	5.5	2.0	-3.5	3.0	4.5	5.5	3.0	5.0	5.0
Tele-density	1.9	2.2	2.8	3.5	4.3	5.2	7.4	9.4	12.7	16.2	17.2
Monetary indicators											
Money supply	18.0	19.4	15.0	16.4	14.1	14.7	16.7	12.3	21.2	18.0	18.0
Int rate PLR - year end	13.0	12.0	11.3	11.5	11.3	10.8	10.3	10.0	10.3	10.5	10.0
Inflation - WPI	4.4	5.9	3.3	7.2	3.5	3.4	5.4	6.5	4.5	5.3	4.5
CPI	6.8	13.1	3.4	3.8	4.3	4.0	4.0	4.5	4.0	6.0	5.0
Bank credit growth	16.4	13.8	18.2	17.3	15.3	23.7	15.3	30.9	30.0	23.0	20.0
Deposit growth	18.4	19.3	13.9	18.4	14.6	16.1	17.5	13.0	17.0	15.0	15.0
Fiscal Indicators											
Centre's fiscal deficit	4.9	5.1	5.4	5.6	6.2	5.9	4.5	4.0	4.1	3.7	3.3
State fiscal deficit	2.9	4.3	4.7	4.3	4.2	4.2	4.5	3.5	3.2	2.7	2.5
Combined deficit (Centre+State)	7.2	8.9	9.4	9.5	9.9	9.6	8.5	7.5	7.4	6.3	6.0
Combined domestic liabilities	62.0	63.0	66.6	71.0	76.4	80.7	81.5	82.4	78.7	75.8	73.4
Combined o/s guarantees	9.7	9.9	11.1	12.2	11.5	11.2	11.0	9.9			
External Sector											
Exports (US$bn)	35.7	34.3	37.5	45.5	44.7	53.8	66.3	85.2	105.2	126.4	147.9
% YoY	4.5	-3.9	9.5	21.1	-1.6	20.3	23.3	28.5	23.4	20.2	17.0
Imports (US$bn)	51.2	47.5	55.4	57.9	56.3	64.5	80.0	118.9	157.0	189.8	216.4
%YoY	4.6	-7.1	16.5	4.6	-2.8	14.5	24.1	48.6	32.0	20.9	14.0
Trade deficit (US$bn)	-15.5	-13.2	-17.8	-12.5	-11.6	-10.7	-13.7	-33.7	-51.8	-63.4	-68.5
Invisibles (US$bn)	10.0	9.2	13.7	9.8	15.0	17.0	27.8	31.2	42.7	46.8	51.3
Current Account Deficit (US$bn)	-5.5	-4.0	-4.1	-2.7	3.4	6.3	14.1	-2.5	-9.2	-16.6	-17.2
% to GDP	-1.3	-1.0	-0.9	-0.6	0.7	1.2	2.3	-0.4	-1.1	-1.8	-1.6
Forex reserves (excl gold) (US$bn)	26.0	29.5	35.1	39.6	51.0	71.9	106.1	135.1	145.1	161.6	177.5
Months of imports	6.1	7.5	7.6	8.2	10.9	13.4	15.9	13.6	11.1	10.2	9.8
Exchange rate											
Rs/US$ - annual avg	37.2	42.2	43.4	45.7	48.0	48.3	45.9	45.0	44.3	44.9	43.2
% depreciation	4.8	13.4	2.8	5.3	5.0	0.6	-5.0	-2.0	-1.6	1.4	-3.8
Rs/US$ - year end	39.52	42.4	43.6	46.5	48.9	47.5	43.6	43.8	44.6	44.5	43.2
% depreciation	10.4	7.3	2.8	6.7	5.2	-2.9	-8.2	0.3	2.0	-0.3	-2.9

Source: CSO, RBI, Ministry of Finance, Citigroup estimates

Theme: Weighing the Odds of Possible Global Developments on India

- **In response to a confluence of factors, global financial markets experienced a sharp and broad re-pricing of risk, which resulted in a synchronized sell-off across markets**
- **Our house view is that while asset volatility is unlikely to dissipate immediately, the correction has NOT been caused by underlying economic fundamentals, and we have thus left all forecasts unaltered[1]**
- **However, the sell-off prompted us to examine the impact of three possible scenarios – a US slowdown, China Factor and continued unwinding of the carry trade – were they to play out, on India**

Scenario #1: The US economy slows down

Base Case – Positive: Our US economists expect growth to come in at 2.7% in 2007 marginally lower than its 3% long-term potential growth[2]. As regards concerns on sub-prime delinquencies, our US economists believe that they are unlikely to trigger a general credit tightening that increases the risk of an economic downturn.[3]

Market – Divided: However, the market is divided on the outlook and recent comments from former Fed chairman- Alan Greenspan- coupled with weak data have fuelled further conjectures of a possible slowdown.

What if?

While there are arguments which talk about "Switching Engines" in the world economy, as well as the growing importance of "intra-regional trade"; given that the US economy comprises 28% of world GDP, and 12.5% of world trade, we believe a slowdown could take its toll on trade, investment flows, exchange and commodity price movements. However, the extent would depend on the openness and policy flexibility of an economy.

Thus in the case of India, given that the economy is largely a domestically-driven one, with domestic consumption accounting for nearly 70% of GDP, the impact of a 1% reduction in US growth from the base case would have the smallest impact on GDP growth as compared to the region. This takes into account the rising share of trade (including software) from less than 14% of GDP to close to 20% currently. Examining the sectors- we see a few areas that are likely to be impacted given their dependence on exports to the US: gems and jewelry, textiles, and software exports.

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[1] See "*Déjà Vu: Sell-Off Not Fundamental*" by Hak Bin Chua, Yiping Huang, Sim Moh Siong dated 28 Feb 07; and "Asia Economic Outlook and Strategy — China-Triggered Market Jitters" dated 5 March2007

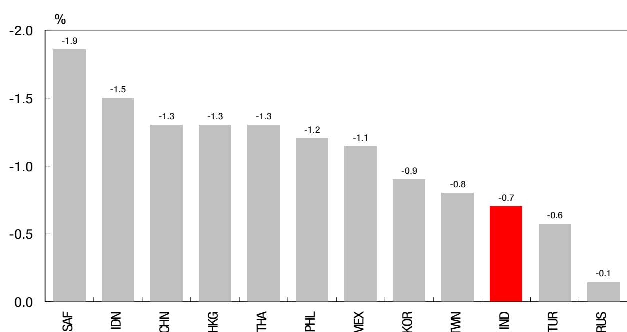
[2] **US GDP Growth:** The 2.7% GDP estimate for 2007 incorporates the recent 6% decline in orders – the biggest in three years and 2.7% fall in shipments – the fourth in five consecutive months; both of which can be attributed to the recent softening in investment in the face of an uncertain housing outlook. However, our US team believes that the US expansion is weathering the housing downturn, buoyed by a temporary lift from lower energy bills and the effect of strong profits on job growth

[3] **Sub-prime delinquencies:** Our US team says that rising loan delinquencies at this point of the interest rate cycle are not surprising and are a **lagging**, not leading, indicator. Higher interest rates always have a more pronounced impact on marginal credits given the more limited ability of those borrowers to repay obligations. This cycle's spike in late payments to date is consistent with the 425bp increase in short rates More over, this is unlikely to weaken the balance sheets of major intermediaries, as sub-prime mortgages comprise only 8% of the total mortgage market

While the impact on growth and exports can be quantified, the impact on currency and capital flows is not as clear. The reason is that despite India being a domestic-driven economy with strong macro fundamentals, in times of an increase in risk aversion, countries with twin deficits, inflation and political challenges tend to be viewed with caution. In addition, a lot would also depend on monetary policy responses (both of the Fed and the RBI) as asset re-allocation could result in inducing capital flows to those countries where interest rates are higher.

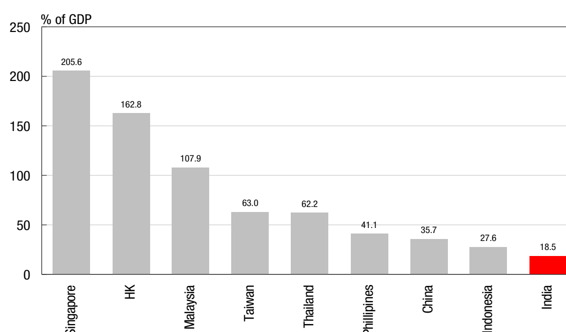
While there may be near-term volatility, we believe that given India's strong external position – a result of the high forex reserves (US$195bn), the size and composition of its current account deficit (currently at 1.9% of GDP, with close to 70% of the imports being investment oriented), and strong capital flows (as reflected in the scale change in FDI v/s portfolio), the long-term rupee appreciation story still holds.

Figure 2. Impact of a 1% Slow-Down in the US economy (% Change from Base)



Source: Oxford Economic Forecasting

Figure 3. Share of Exports as a % of GDP



Source: CEIC Data Company

Scenario #2: The China Factor

The 9% drop in the A-Share Shanghai Index[4] on February 27, which sent ripples throughout global equity markets, is the first time that China's global influence extended from the real economy to the financial markets. While our Asian Regional Economist – Yiping Huang – believes that China's influence is likely to increase as the Chinese economy grows and its capital markets open up, he says that barring major policy mistakes, China's economy and markets show no immediate risks and that the economy should perform strongly and policies should stay accommodative.

What if?

While our China team estimates that growth should continue in the 10% range, and that real interest rates are likely to remain negative given that Chinese monetary policy is restricted by its unwillingness to see a fast currency appreciation, investors are concerned on the impact of lower growth led due to: (1) a possibility of tightening in policy on the back of overheating concerns, which could slow down investment; and (2) slower export growth due to a moderation in growth in the US.

Analysing the impact of lower Chinese growth on India, we find that though India's exports to China have risen over *twelve times* since FY00, as a percentage of total exports, the share remains low at 6.5%. What is important to note is that a significant

[4] **Chinese Stock Market:** China's A-share market plunged 9% on speculation that the CSRC Chairman was leaving, a potential interest rate hike, and potential implementation of capital gains tax

chunk of these exports comprise commodities- such as iron-ore and alumina, which have benefited from the ongoing investment expansion in China. Thus, in the event of a slowdown, one could see a pull-back in exports of these commodities.

Scenario #3: The Yen Appreciates Further

Among the many triggers that led to re-pricing of risk, and consequently the significant sell-off, was the appreciation in the yen, which resulted in a partial unwinding of the carry trade[5]. The BoJ raised its policy rate by 25bps to 50bps on February 21. While the yen carry still trade remained attractive, the key point to note is that the BOJ raised short-term rates to 0.50% at a time core inflation dropped back to zero. This implied a notable increase in real short-term interest rates in Japan after a long time. Consequently, highly leveraged investors who had borrowed low-interest yen to finance higher interest rate assets were forced to offload assets to repay yen loans, thereby creating a vicious cycle of falling asset prices.

What if?

If we see a significant appreciation in the yen, besides the impact of leveraged investors offloading high yielding assets to repay yen loans, which would result in capital outflows (thus impacting stocks and the INR), the Indian corporate sector has also been a party to the carry-trade game – directly via taking ECB/trade credit in JPY as well as via the derivative route (taking INR loans and converting them synthetically in Yen). However, two caveats to this are: (1) to the extent that the rupee doesn't weaken more than the interest differential, the JPY credit benefits the borrower; and (2) anecdotal evidence indicates that most of these deals were done at USD/Yen level of 110-115.

Figure 4. Currency and Interest Rate Forecasts (End of Period, Unless Specified), as of Mar 1, 2007

	Mar 1, 2007	1Q 07 Forecast	2Q 07 Forecast	3Q 07 Forecast	4Q 07 Forecast
United States: Federal Funds	5.25%	5.25%	5.25%	5.00%	5.00%
10-Yr. Treasuries (Period Average)	4.56	4.80	4.90	4.95	4.95
Euro Area: US$/€	1.32	1.28	1.26	1.26	1.25
Euro Repo Rate	3.50%	3.75%	3.75%	4.00%	4.00%
10-Yr. Bunds (Period Average)	3.97	3.90	3.90	3.95	3.95
Japan: Yen/US$	118	119	120	120	119
Call Money	0.50%	0.50%	0.50%	0.50%	0.75%
10-Yr. JGB (Period Average)	1.64	1.70	1.80	1.90	2.00
India: Rs/US$1*	44.33	44.50	43.85	43.25	43.00

* Currency as on March 8th. Source: Citigroup forecasts as of Mar 1, 2007.

Conclusion

Unlike the May 2005 sell-off, the current correction resulted in a correction across all markets and all asset classes. India too was affected, but relatively less so (stock markets correcting 14% since the high of 14652 and the rupee falling to Rs44.64). An important factor that could support optimism on India is that its growth story is domestic-oriented, which provides better insurance (than many other Asian neighbors have) at a time if/when global growth begins to moderate. This, combined with its relatively sound external position, should help sustain investor confidence.

[5] **Yen Carry Trade:** The carry trade involves borrowing in a low interest rate currency (eg the yen, Swiss franc) and investing the proceeds in higher interest rate assets keeping the exchange risk open. It is profitable as long as the yen does not appreciate against the invested currency more than the interest differential.

Real Indicators

- **Industrial production rose 10.9% in January with continued buoyancy across all sectors. This bodes well for the govt's 9.2% GDP estimate for FY07 as well as our FY08 GDP estimate of 9.3% led by services (11%), industry (10.4%) and agriculture (2.8%)**
- **Besides the continuation of the key drivers, the growth story is supported by an uptrend in both savings and investment both touching new highs of 32.4% and 33.8% of GDP, respectively**
- **Key risks remain unchanged – infrastructure, the human resource paradox (creating more jobs coupled with the talent shortage), inclusive growth, politics and much further monetary tightening**

Industrial production continues to surprise on the upside:
Industrial growth rose 10.9% in Jan – lower than the November and December data, but higher than ours as well as consensus expectations and the 8.5% growth seen in the same period last year. This is positive and bodes well for the govt's 9.2% GDP estimate for FY07.

Key Highlights in Jan Data: (1) **Growth on a sectoral basis** was led by manufacturing up 11.6%, electricity and mining up 8.5% and 6.0%; (2) Continued buoyancy across the **use-based classification** – led largely by basic goods (11.6%), intermediate goods (12.7%) and consumer goods – especially non-durables; (3) However, capital goods production came in at 8.6%, which can be attributed partially to the base effect (27% in Jan06).

Interest Rate Implications: On the back of the strong IIP data coupled with the fact that we expect inflation to remain in the 5.5-6.5% range until March/April, we expect policy rates to rise by 25bps in April. While concerns on overheating in sectors remains, we do not anticipate policy rates to rise much further as significantly higher rates could result in more dollar inflows and thus make currency management difficult.

KEY DATA REVISIONS

Dec IIP revised upward from 11.1% to 12.5%

Key revisions include:

Manf from 11.9% to 13.4%

Mining from 3.8% to 5.9%

Consumer Goods- from 7.4% to 10.2%

Non Durables from 8.7% to 12.4%

Figure 5 Trends in Industrial Production (% YoY)

	WTS	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06	Jan-07	Jan-06	Apr-Jan FY07	Apr-Jan FY06
Sectoral Classification										
Mining	10.5	-1.7	4.3	5.9	8.0	5.9	6.0	2.0	4.5	0.6
Manufacturing	79.3	11.9	12.7	3.8	16.7	13.4	11.6	9.4	11.9	9.0
Electricity	10.2	4.1	11.3	9.7	8.7	9.3	8.5	6.4	7.6	5.0
General	**100**	**10.3**	**12.0**	**4.5**	**15.4**	**12.5**	**10.9**	**8.5**	**11.0**	**8.0**
Use-based Classification										
Basic goods	35.5	4.8	11.5	10.5	11.9	12.3	11.6	7.5	10.0	6.2
Capital goods	9.7	16.6	9.5	6.5	29.2	20.9	8.6	27.0	16.8	16.8
Intermediate gds	26.4	8.7	13.8	5.9	17.5	12.2	12.7	3.6	11.4	2.4
Consumer gds	28.4	15.0	12.1	-2.8	12.8	10.2	9.9	8.0	9.9	11.9
Durables	5.1	19.0	11.8	0.2	10.3	3.1	6.8	15.9	10.9	14.2
Non-durables	23.3	13.6	12.2	-4.1	13.7	12.4	10.9	5.7	9.4	11.2

Source: CSO

Poverty in India

Although touted as one of the fastest growing economies in the world, India is also one of the poorest as there are nearly 250m people below the poverty line[6]. Though trends indicate an improvement with the latest National Sample Survey pegging the poverty rate at 22% in FY05, down from 26% seen in FY00; as the Planning Commission points out, this is at best a modest rate of decline given the high absolute levels. This is due largely to the poor agricultural performance as despite its falling contribution to GDP, it continues to remain an important source of livelihood for the rural sector.

On a positive note, the government is taking wide ranging measures to improve the situation. This is reflected in an improvement across social sector indicators, as seen in the rankings of the UNDP's Human Development Index. The '*farm to retail*' model, is also likely to result in higher rural incomes. Moreover, India has a low Gini Coefficient, which is an indicator of income equality; although it is important to note that this is not an efficient yardstick of poverty.

Gini Coefficient: Not really an efficient yardstick of poverty

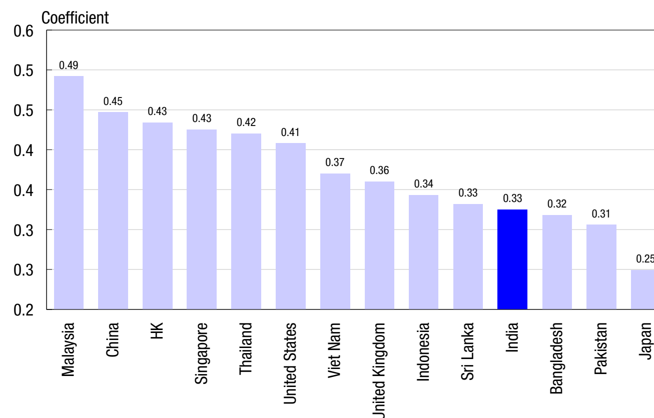
With several states growing faster than others, inclusive growth is a growing concern for India. However, interestingly, the Gini Coefficient, which is an income inequality metric that ranges between 0 to 1, where a score of 0 implies complete income equality and 1 indicates perfect inequality, indicates that India's Gini Coefficient is 0.32- lower than that of most SE Asian economies. However, it is important to note that the Gini coefficient does not capture the gender and social inequalities that persist in India, which can constrain the extent to which groups in the population are able to participate in and benefit from the process of economic growth.

Figure 6 Trends in the Poverty Ratio

	Number of Poor (Mns)	% of Popn
FY74	321	54.9
FY84	323	44.5
FY94	320	36.0
FY00	260	26.1
FY05	~250	22.0

Source: Human Development Report, 2006; RBI, NSS

Figure 7 Gini Coefficient - India and Comparative



Source: Human Development Report, 2006; RBI, NSS

[6] **Poverty Line**: In India, poverty lines correspond to a total household per capita expenditure sufficient to provide, in addition to basic non-food items a daily intake of 2400 calories per person in rural areas and 2100 in urban areas. Individuals who do not meet these calorie norms fall below the poverty line. In the FY00 survey, the criterion used was monthly consumption of goods below Rs211 for rural areas and Rs454 for urban areas

Monetary Indicators

- **We expect inflation to trend towards 5% levels by May due to monetary and fiscal measures, the base effect and political pressure**
- **We expect one more rate hike in 2007 as inflation, bank credit and money supply are still running ahead of RBI targets**

Inflation: Now top priority with the RBI and government

Inflation has been a concern since it breached the RBI's target of 5.5% in October, and touched a high of 6.73% for the week ended February 3. The latest data pegs it at 6.1% yoy, for the week ended February 24 led by the index for primary articles up 11.5%, manufactured products up 5.9%, while the fuel index was up by just 1.1%.

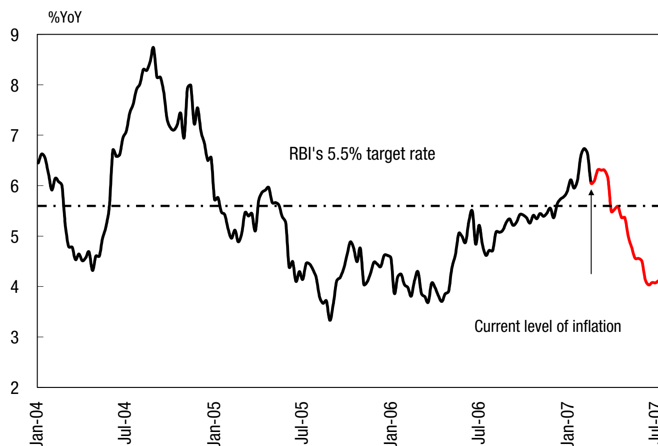
Inflation to come off to 5% levels by May:

We expect headline inflation numbers to remain in the 5.5-6.5% range for the next three months. However, we maintain our view that on the back of monetary and fiscal measures, the base effect as well as political pressures, headline inflation is likely to come off to 5% levels by May. Key measures to control inflation include:

1. **Monetary:** Besides policy interest rates moving up 150bps since October 04, the RBI has raised the CRR by 100bps in two hikes of 50bps each. In addition, there has been a shift in monetary policy stance in the January 31 policy from an equal emphasis on price stability and growth, to one of reinforcing just price stability with immediate monetary measures.

2. **Fiscal:** The government has reduced customs duties on capital goods, metals and cement, permitted imports of wheat and sugar. It banned exports of pulses, sugar, skimmed milk powder and forward trading in certain food grains – measures we see as regressive. Besides introducing a dual-excise structure for cement that penalizes producers who charge more; it has also issued a directive to cement companies to freeze prices for a year.

Figure 8. Likely Trends in Inflation (%YoY)



Source: Office of the Economic Advisor; Citigroup

Figure 9. Components of the Wholesale Price Index

	FY94=100	%YoY (as on 24Feb 07)
I. Primary Articles	**22.0**	**11.1**
(A) Food Articles	15.4	10.3
(B) Non-Food Articles	6.1	11.5
(C)Minerals	0.5	21.6
II. Fuel, Power Light & Lubricants	**14.2**	**1.3**
III. Manufactured Products	**63.7**	**6.2**
(A) Food Products	11.5	3.3
(B) Beverage Tobacco & Tobacco Products	1.3	7.6
(C)Textiles	9.8	2.0
(D)Wood & Wood Products	0.2	3.5
(E) Paper & Paper Products	2.0	7.0
(G)Rubber & Plastic Products	2.4	8.0
(H)Chemicals & Chemicals Products	11.9	3.1
(I) Non-Metallic Mineral Products (incl cement)	2.5	10.2
(J) Basic Metals, Alloys & Metal Products	8.3	16.1
(K)Machinery & Machinery Tools	8.4	8.0
(L)Transport Equipment & Parts	4.3	1.5
All Commodities	**100.0**	**6.1**

Source: Office of the Economic Advisor; Citigroup

Policy Implications:

We expect inflation to remain in the 5.5-6.5% range until March/April, and maintain that policy rates could rise by 25bps in April. We expect 2007 to be the year of multiple policy instruments wherein if liquidity conditions ease (either via government spending or capital flows), we could see the RBI not hesitating to hike the CRR again to absorb excess liquidity, but to sustain the growth momentum, the possibility of an SLR reduction remains high.

Current trends in Banking Indicators: Deposits picking up

Bank credit remains buoyant with incremental credit this fiscal year (April 1-February 16) at Rs3,056bn – up 29.5% as compared with Rs2,471bn in the same period last year. While this is much higher than the targeted growth of 20% envisaged this fiscal, growth has moderated from 31% levels seen earlier in FY07.

While **incremental deposits** remain buoyant at Rs3,411bn during April 1-February 16 vs. Rs1,851bn seen in the same period last year, deposit growth which had lagged behind credit growth has been slowing inching up to the 24% levels – largely attributed to the attractive interest rates being offered on term deposits.

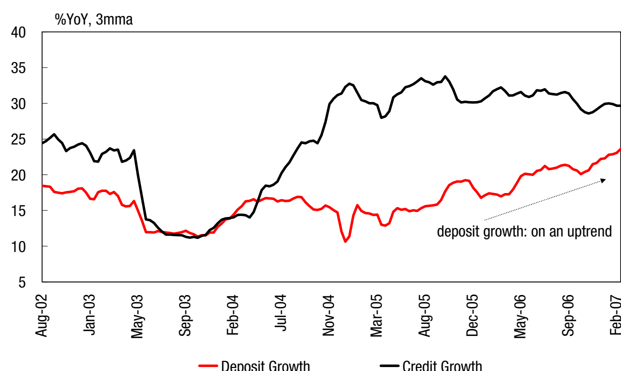
Money supply growth at 21.8% has been running far ahead of its target of 15.5%. This is due to both a rise in both its components: (1) currency with the public; and (2) growth in demand deposits. While the rise in deposits is due to higher rates, the rise in currency reflects the cash spending. These numbers are generally higher during elections, festivals or post the harvest, with strong numbers indicating spending power – and reflecting the underlying buoyancy in the economy.

Figure 10. Trends in Bank Credit and Deposits (Rupees in Billions, % YoY)

	Outstanding	Incremental to date		YoY%	Total			
	March 06	FY07	FY06		FY06	FY05	FY04	FY03
Bank Credit	**15,071**	**3,056**	**2,471**	**29.5**	**3,961**	**3,114**	**1,116**	**1,394**
Food	407	27	5	7.1	7	41	-134	-46
Non-Food	14,664	3,029	2,466	30.2	3,954	3,074	1,251	1,440
Bonds & Debentures	667	3,029	2,466	-11.0	-135	15	-4	61
Deposits	**21,091**	**3,411**	**1,851**	**24.4**	**3,875**	**2,807**	**2,236**	**1,775**
GOI Investments	7,175	536	-261	8.0	-116	617	1,300	1,093

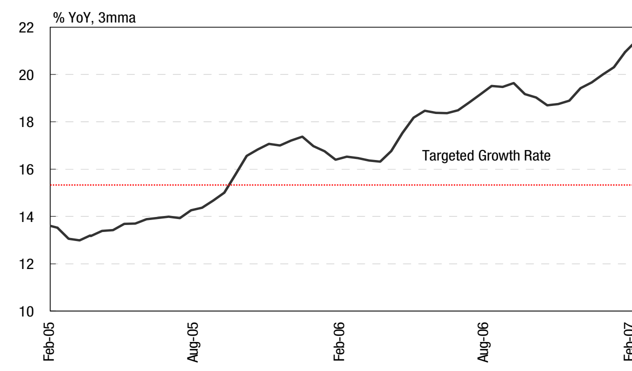
Source: RBI.

Figure 11. Trends in Deposit and Credit Growth (%YoY, 3mma)



Source: RBI

Figure 12. Trends in Money Supply (%YoY, 3mma)



Source: RBI

Fiscal Indicators

- **On the macro front, the FY08 budget posted no surprises and continued with the process of fiscal consolidation, measures to tame inflation and efforts towards inclusive growth through initiatives on the rural economy, agriculture and social fronts**
- **The FY08 deficit target of 3.3% is based on the assumptions of nominal GDP growth at 13% and gross tax collections at 17%. We believe these are conservative and provide a cushion for unforeseen expenditures.** *(see page 21 for detailed budgetary arithmetic)*

Budget continues with the process of fiscal consolidation

The Budget continued with the process of fiscal consolidation by adhering to the FRBM targets, phasing out exemptions and widening the tax base. While the FY07 fiscal deficit came in at 3.7%, the deficit for FY08 has been targeted at 3.3% of GDP, which is in line with the FRBM targets. We believe that the budget arithmetic which assumes gross tax collections rising by 11% and nominal GDP growth of 13% [7] is realistic and actually provides for a cushion for unforeseen expenditures.

Measures aimed at widening the tax base are positive.

In line with long-term objective of phasing out tax exemption, the tax base has been widened by extending Minimum Alternate Tax (MAT) to software technology parks, export-oriented units; and imposing Fringe Benefit Taxes (FBTs) on Employee Stock Options (ESOPs). While the service tax rate has been left unchanged at 12%, the tax has been extended to several new services - including renting of immovable property for use in commerce/business. While in the near term, the removal of this may be negative for specific sectors, it bodes well for overall deficit reduction.

Containing inflation has become a key policy objective.

Measures to tame inflation in the budget included a reduction in import duties, and introducing a dual excise structure for cement, which rewards producers with a lower price and penalizes those who charge more. Excise duty reduction on petrol and diesel should give some relief to oil companies. We maintain our view that given the various fiscal and monetary measures coupled with the base effect coming into play, inflation should head towards 5% by May.

Inclusive growth now a new policy mantra

Other initiatives targeted the agriculture/rural sector and promoting inclusive growth. Stressing the need to raise agriculture growth to 4% and to enable an easing of supply side constraints, the budget raised outlays for irrigation, rural infrastructure and set targets for farm credit. In line with the government's priority towards

[7] Under the **FRBM Act**, beginning FY05, the central government has to reduce its fiscal and revenue deficit by 0.3% and 0.5% of GDP a year so as to eliminate the revenue deficit by 2009. Nominal GDP growth assumptions are based on real GDP of 8.5-9% and inflation of 5-5.5%

inclusive growth, a bulk of the increase in outlays was to the 8 flagship programs[8]. The budget also provided social security benefits for unorganized workers. In addition, outlays for urban as well as rural infrastructure projects such as the National Urban Renewal Mission[9] and the Bharat Nirman Project[10] which again ties in with the government's promotion of "inclusive growth".

Removal of Tax Exemptions likely to remain a key objective

While the FY08 budget saw the extension of MAT being imposed on software companies, FBTs being imposed on ESOPs and the service tax being widened, we believe much more needs to be done given that tax exemptions still account for over 50% of total revenues. This is possibly one of the key reasons why India's Tax-GDP ratio, despite the improvement in recent years, still remains lower on a comparative basis with other countries in the region and is much lower than the full tax potential.

A bulk of exemptions are on customs/excise duty benefits

As per the latest budget documents, tax exemptions, which can also be classified as subsidy payments to preferred taxpayers, totaled Rs2067bn in FY06- or 56% of gross tax collections, and are expected to rise further in absolute numbers to Rs2352bn (50% of grow tax collections). A majority of the revenue foregone is due to exemptions on customs and excise duties at 34.9% and 18.2% of gross tax collections, while corporate tax benefits comprised 11% of gross tax collections. The revenue forgone is largely on account of benefits to SEZs and infrastructure development, while exemptions on personal income tax are minor, and targeted at senior citizens and women.

Phasing out exemptions should be a key goal to improve Tax-GDP and enhance compliance

While rationalizing tax exemptions is a positive step, some studies suggest that they need to be phased out completely. As a Kelkar Committee Report points out, '*removing exemptions would have two key benefits: (1) a higher tax-GDP ratio; (2) it would enhance GDP growth, since tax exemptions and deductions distort allocative efficiency, undermine equity (both horizontal and vertical), increase compliance costs, impose administrative burdens, and encourage corruption*'.

Figure 13. Estimates of Revenue Foregone Due to Tax Incentives/Deductions (Rs Bn, %)

	FY06		FY07	
	Revenue Foregone (Rs Bn)	% to Gross Tax Collections	Revenue Foregone (Rs Bn)	% to Gross Tax Collections
Corporate Income Tax	346	9.5	501	10.7
Personal Income Tax	136	3.7	155	3.3
Co-operative Sector related	16	0.5	Nil	-
Excise Duty	668	18.2	997	21.3
Customs Duty	1,277	34.9	1,237	26.4
Total	**2,442**	**66.7**	**2,889**	**61.8**
Less Export credit related	376	10.3	538	11.5
Total	**2,067**	**56.4**	**2,352**	**50.3**

Source: Budget Documents

[8] These include the Sarva Siksha Abhiyan, Mid-day Meal Scheme, Rajiv Gandhi Drinking Water Mission, Total Sanitation Campaign, National Rural Health Mission, Integrated Child Development Services, National Rural Employment Guarantee Scheme and Jawaharlal Nehru National Urban Renewal Mission

[9] The **NURM** program aims to help large metropolises in the country to tackle the fast pace of urbanization and migration from rural areas that have strained civic amenities. It covers the seven mega cities, all cities with a population of over a million, and some other towns. Initiatives include the Mumbai Metro Rail Project, the Mumbai Trans Harbor Link, the Mumbai Western Expressway Sealink Project

[10] The **Bharat Nirman Project** is a four-year time-bound plan that aims to achieve goals in six areas of rural infrastructure (irrigation, water supply, housing, roads, telephony, and electrification) should greatly unlock the potential of rural India.

External Sector

- **India's trade deficit is likely to increase further in the current fiscal and in theory poses a challenge for the current account and currency**
- **However, higher invisible inflows (software exports and remittances) coupled with strong capital flows will limit the rise in the CAD to 1.8% of GDP in FY07 and FY08 and should keep the currency on the slow appreciation trend**

Single-digit export growth to continue for a while

With the base effect coming into play, export growth in Jan-07 remained in the single-digit range for the second consecutive month up 5.5% (US$9.6bn). We expect this trend to continue for the next few months given that export growth during the period Jan06-Aug06 averaged closed to 30% YoY. On the import front, due to lower oil prices, we expect a moderation in import growth and hence a narrowing in the trade deficit. We maintain our full-year estimates of exports touching US$120.7bn (20%) and imports up US$177bn (26.2%) resulting in the customs trade deficit widening to US$56.3bn in FY07 as compared with US$39.8bn in FY06.

Figure 14. India Trade: April- January 2007 (US$bn, %YoY)

	Jan-07	%YoY	Apr-Jan07	%YoY	FY07E	%YoY
Exports	9.6	5.5	99.2	20.1	120.7	20.0
Imports	15.4	23.2	149.7	27.2	177.0	26.2
Oil	4.8	15.1	48.6	36.4	56.5	27.9
Non-oil	10.6	27.3	101.1	23.3	120.5	25.0
Trade Balance	**-5.8**		**-50.6**	**-7.1**	**-56.3**	

Source: DGCI&S

Composition of trade comes out with a two-month lag. Export growth in the current fiscal has been led by engineering goods and petroleum products. As regards imports, besides oil, over 70% of the rise in non-oil imports is due to capital goods, industrial raw materials – all of which support the investment story.

Figure 15. Commodity composition of Exports (Apr-Oct, US$bn, %)

	FY07	FY06	%YoY
Agricultural & allied products	6.4	5.2	21.0
Ores & minerals	3.4	3.1	8.1
Manufactured Goods	46.3	40.7	13.8
Leather & leather manufactures	1.6	1.6	4.1
Chemicals & related products	6.2	5.4	15.5
Engineering goods	16.0	11.7	36.9
Textiles	4.7	4.4	7.8
Readymade Garments	4.8	4.7	3.2
Gems & Jewellery	9.1	9.5	-4.4
Other manufactured goods	3.8	3.5	9.4
Petroleum & crude products	11.3	6.1	84.7
Other commodities	3.6	1.5	141.8
TOTAL EXPORTS	**70.9**	**56.7**	**25.2**

Source: DGCI&S

Figure 16. Commodity Composition of Imports (Apr –Oct, US$bn, %)

	FY07	FY06	%YoY
Petroleum crude & products	35.1	24.4	43.9
Non-Oil Imports	**68.9**	**58.0**	**18.9**
Food & related items	2.3	2.2	6.6
Textiles (incl.RMG)	1.3	1.2	6.6
Chemicals & related products	8.1	6.6	21.8
Capital goods	13.9	9.8	41.6
Gold & Silver	8.9	7.4	20.7
Pearls precious & semiprec. Stones	4.3	6.2	-31.4
Electronic Goods	9.2	7.1	29.8
Coal, coke briquettes	2.5	2.1	20.9
Other(iron & steel,ore,cement, etc)	15.9	12.2	30.7
Other commodities	2.6	3.2	-20.4
TOTAL IMPORTS	**104.0**	**82.4**	**26.3**

Source: DGCI&S

Using FX Reserves for Infrastructure Financing

The proposal to use forex reserves for infrastructure funding, which has long been debated in the country, received a bit of mention in this year's budget with the FM's budget speech mentioning that the Deepak Parekh committee set up last year to review financing for infrastructure projects has suggested setting up two overseas subsidiaries of the Indian Infrastructure Finance Corp Ltd (IIFCL)[11].

These entities could serve two purposes:

1. To borrow funds from the RBI and lend to Indian companies implementing infrastructure projects in India, or to co-finance their ECBs for such projects, solely for capital expenditure outside India; and
2. To borrow funds from the RBI, invest such funds in highly rated collateral securities, and provide 'credit wrap'[12] insurance to infrastructure projects in India for raising resources in international markets.

In simple terms, the financing mechanism would involve the IIFCL borrowing FX reserves from the RBI, to invest them in AAA/AA bonds. On the back of these assets, the IIFCL would give loans to domestic companies to raise loans overseas and fund infrastructure projects. On RBI's balance sheet, this would involve replacing forex reserves with government securities, thus leaving money supply unchanged.

Likely Impact

Rating agencies are generally not in favour of a country using its foreign exchange reserves and view it as a way of getting around the fiscal rules. They believe that this could potentially lead to a spillover from domestic finances on to the external account. However, the planning commission and others believe that India's reserves at US$193bn are well above optimal levels required to meet external payments, ensure exchange rate stability and export competitiveness (Short-term debt to reserves is just about 5.5%, while reserves currently cover over 12 months of imports).

While the mechanism being debated is still in its nascent stages, it could lead to a slightly higher deficit as the SPV (in this case IIFCL), would issue securities to the RBI in exchange for part of the reserves. This would increase debt, and the interest on the debt would lead to an increase in the deficit. Moreover, unless the entire amount raised is used for imports of infrastructure equipment, there would be an injection of liquidity into the system, which would lead to inflationary pressure.

[11] **The IIFCL** is a special purpose vehicle set up by the government to meet *long-term financing requirements of potential investors.* Corporatized early in 2006, the IIFC is expected to provide financial support through long-term debt either by way of re-finance to banks and financial institutions or by direct lending to project companies. It raises funds from both domestic and external markets against government guarantees, the limit of which is prescribed each year.

[12] **A Credit Wrap** is an insurance to bear the burden of the loan in the even of default. One article in the Economic Times, dated 7th May defines it as 'the addition of a third party guarantee, letter of credit, surety bond, bond collateral, or other backing in order to improve the credit worthiness of an investment"

Financial Markets

- **Volatility in global financial markets has resulted in a marginally lower rupee. While near-term trends are likely to remain choppy, given the inherent strengths of the external account, we are maintaining our INR appreciation view**
- **As we expect inflation to remain in the 5.5-6.5% range until March/April and given that both credit and money supply are running ahead of targets, policy rates could rise by 25bps in the April**
- **We re-iterate that 2007 is likely to be the year of multiple policy instruments. If liquidity conditions ease (either via government spending or capital flows), we could see the RBI not hesitating to hike the CRR again to absorb excess liquidity but to sustain the growth momentum, the possibility of an SLR reduction remains high**
- **10-year bond yields currently around 8% are unlikely to see a further rise, given the inherent demand-supply mismatch for long tenor bonds**

Forex Markets

- The rupee weakened to Rs44.50/US$ from Rs44.2/US$ in the previous month. This was largely on the back of recent volatility in global financial markets, which also resulted in net FII sales of Indian equities. While near-term trends are likely to remain choppy, we maintain our 12M estimate of Rs43.2/US$1.
- The recently announced liquidity absorption measures are likely to divert short-term liquidity to the inter-bank money market. This is likely to bring down the overnight call money rate, but also could have a currency implication as it would reduce the incentive to go short USD/INR. (Easy call money would keep forex points in the short term subdued and force the shorts out).

Figure 17. Currency Forecasts and Forwards

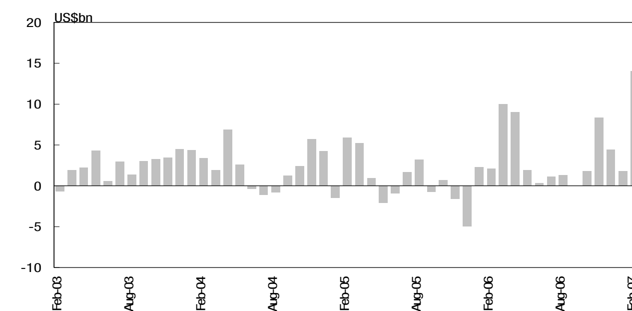
	Range in Feb	Spot 8-Mar	I Month		3 Months		6 Months		12 Months	
			Forecast	Forward	Forecast	Forward	Forecast	Forward	Forecast	Forward
Versus USD										
India INR	43.95-44.18	44.33	44.50	*44.40*	44.00	*44.63*	43.50	*44.93*	43.00	*45.57*

Source: Reuters, Citigroup estimates.

Figure 18. Trends in the Rupee (INR/USD)

Source: RBI.

Figure 19. Monthly Increase in Foreign Exchange Reserves



Source: RBI.

Bond markets

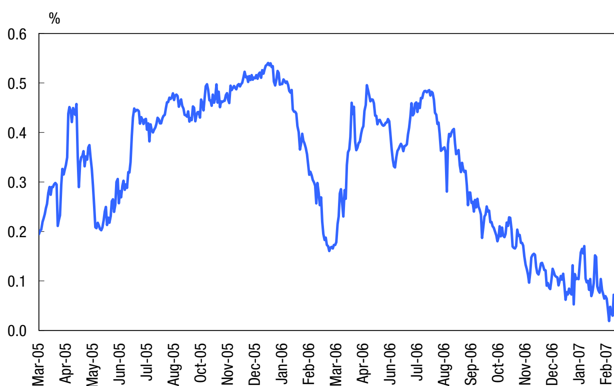
- Bond markets were relatively less impacted by the global financial turmoil with the benchmark ten-year yield closing marginally higher at 7.94% from 7.93%.
- Though budget estimates were in line with the FRBM targets and measures to ease inflationary pressures continued, the RBI announced a series of measures earlier this month to absorb excess liquidity to contain inflation. Measures include: (1) Capping the amount of money they will absorb through reverse-repos to Rs30bn on a daily basis which possibly was done to discourage banks to fulfill their SLR requirements by borrowing G Secs in repo; and (2) Modifying the market stabilisation scheme (MSS scheme) – which would now use a mix of T-Bills and dated securities to and T-bills under the (MSS).
- These measures are likely to divert short-term liquidity to the inter-bank money market thus bringing down the overnight call money rate. The reverse-repo window being limited to Rs30bn could see increased demand for bonds in the short tenors upto 1 year and in excess liquidity conditions could result in a steepening of the curve. Moreover, greater shifting of sterilisation money to MSS would mean that the government pays the cost for MSS while reverse repo window cost is borne by RBI.

Figure 20. India Market Monitor

	Units	Latest	Previous	1M ago	3M ago	12M ago
Interest Rates						
Overnight	%	5.60	6.10	6.50	6.20	6.70
1 year Treasury Bill	%	7.73	7.84	7.70	6.94	6.80
1 year OIS	%	7.74	7.84	7.65	6.86	6.54
1 year MIFOR	%	8.32	8.50	8.63	7.41	7.44
5 year Corp AAA spread over GOI	%	1.54	1.5628	1.34	1.15	1.08
10 year GOI	%	7.99	7.942	7.80	7.39	7.39

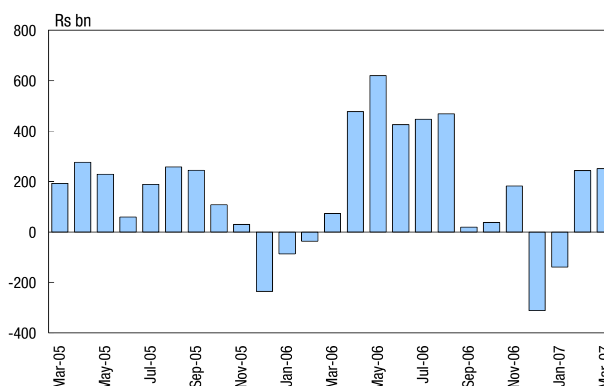
Source: RBI.

Figure 21. India — Trends in the 10-Year GOI Bond (Percent)



Source: RBI, Citigroup.

Figure 22. India — Trends in Reverse Repos/Repos (Rs bn)



Source: RBI, Citigroup.

Recent Developments

State Assembly Elections – Implications

Assembly elections held in the two north-western states- Uttarakhand[13] and Punjab - saw the opposition- the Bharitya Janata Party (BJP) oust the Congress, while in Manipur, the Congress was able to secure a clear majority. With exit polls predicting this outcome, results have not taken the country by surprise. The Congress's loss was led by grievances on account of rising prices of essential commodities, FDI in retail, the Quattrochi imbroglio, discontent over the land acquisition issue for the Special Economic Zones in the region by land acquisition, and a history of anti-incumbency in these states.

Impact of the Election Results

While the election results are in themselves not significant, they set the stage for upcoming elections in Uttar Pradesh. Currently, the Samajwadi Party (led by Mulayam Singh Yadav) - which provides outside support to the Congress at the centre, is the ruling party in UP. The other contenders in the fray for the 403 seats are the BJP (led by Kalyan Singh at the state level), the BSP (led by Mayawati) and the Congress. While the BSP is the dark-horse, it is believed that the BJP's resurgence could lead to a Muslim consolidation behind the Samajwadi Party, which could potentially dent the Congress's plan to regain its vote bank of minorities.

Being the largest state in terms of population and the number of MPs in Parliament, the UP state elections will be a crucial factor in shaping politics at the Centre as our strategist, Ratnesh Kumar, has pointed out, the Congress needs to make a strong comeback in UP in order to push through economic reforms. With the Samajwadi Party close to left, a strong win in UP would make reforms even more difficult and could make the formation of the third front a reality.

Our base is that of the government completing its current term but given the structure of the coalition, we have not factored any upside from reform implementation.

Figure 23. Structure of the Government at the Centre. Total Elective Seats are 543; 272 seats are required to form a majority

TOTAL UPA= 224+96=320				TOTAL OPPOSITION=221	
Congress + Allies		**Outside Support**		**NDA**	
Congress	145	CPI-M	43	BJP	138
RJD	21	CPI	10	BJD	11
DMK	16	Other Left	7	Others	32
NCP	9	Samajwadi Party	36	**Total**	**185**
PMK	6			**Other Opposition**	
TRS	5			BSP	19
Others	22			Others	19
Total	**224**	**Total**	**96**	**Total**	**36**

Source: Citigroup, Election Commission of India

Figure 24. State Election Results

Punjab		Manipur	
Election Held	**116**	**Election Held**	**60**
SAD-BJP alliance	67	Congress	29
Congress	44	NCP	6
Others	5	MPP	5
Uttarakhand		CPI	4
Election Held	**69**	NPP	3
BJP	34	RJD	3
Congress	21	Others	10
BSP	8		
UKD	3		
Others	3		

Source: Citigroup, Election Commission of India

[13] Uttarakhand (also known as Uttaranchal) was carved out of Uttar Pradesh- India's most populous state- in 2000.

Monthly Macro Monitor

Figure 25. India —Key Monthly Economics Indicators (Percent Change from a year ago unless otherwise stated)

Monthly Macro Snapshot	FY06			FY07										
	Jan 06	Feb 06	Mar06	Apr 06	May 06	Jun 06	Jul 06	Aug06	Sept06	Oct06	Nov06	Dec06	Jan07	Feb07
Consumption Trends														
Two-Wheelers	14.7	16.6	18.2	12.7	20.4	23.6	19.7	3.5	19.1	10.3	14.5	6.9	10.9	
Passenger Car Sales	7.3	5.4	20.4	19.9	25.8	25.4	20.5	13.9	19.8	15.9	25.8	25.7	24.2	
Commercial Vehicle Sales	16.4	20.5	24.8	77.1	41.2	30.9	38.6	28.9	33.1	22.6	44.3	42.9	33.6	
Investment Trends														
Infrastructure Index	8.3	9.3	6.9	6.3	6.3	6.9	9.9	4.9	9.6	9.0	9.5	8.3		
Cement Dispatches	14.3	15.9	15.4	10.3	6.5	12.2	13.0	3.2	17.4	8.0	13.1	10.8	7.7	
Diesel Consumption	3.7	11.3	-1.9	10.4	15.1	-2.9	3.9	-1.2	15.0	3.5	10.8	7.0	8.2	
Steel Production	2.1	1.8	5.3	8.3	7.9	6.0	15.6	6.8	8.4	7.7	9.1			
Aluminum Production	0.8	18.0	19.0	22.7	21.9	15.6	27.9	19.8	22.4	26.1	26.2			
Ind. Production Index														
General	8.5	8.8	8.9	9.9	11.7	9.7	13.2	10.3	12.0	4.5	15.4	12.5	10.9	
Manufacturing	9.4	9.2	10.1	11.0	13.3	10.7	14.3	11.9	12.7	3.8	16.7	13.4	11.6	
Basic Goods	7.5	9.6	8.5	9.3	9.1	8.5	10.0	4.8	11.5	10.5	11.9	12.3	11.6	
Capital Goods	27.0	10.7	11.9	19.6	21.4	21.6	18.3	16.6	9.5	6.5	29.2	20.9	8.6	
Intermediate Goods	3.6	2.2	3.3	8.5	12.5	11.2	10.7	8.7	13.8	5.9	17.5	12.2	12.7	
Consumer Goods	8.0	12.5	12.4	8.9	10.5	6.1	16.8	15.0	12.1	-2.8	12.8	10.2	9.9	
Services														
Port Traffic	6.2	3.6	4.8	-3.0	5.1	14.2	6.5	5.4	6.6	9.7	17.0	10.6		
Railway Freight	15.6	15.1	11.2	11.0	7.6	11.0	11.7	7.3	10.8	10.0	11.0	7.5		
Tourist Arrivals ('000)	444	407	391	310	259	273	349	303	281	394	472	547		
Cellular Subscribers (Mils.)	62.0	65.2	69.2	72.1	75.3	78.5	82.4	86.6	91.0	95.5	100.8	105.4		
Banking Trends														
Money Supply	16.1	16.5	16.3	18.2	18.3	18.3	19.2	19.5	19.2	18.8	19.0	19.8	20.8	21.6
Loan Growth	30.5	31.7	31.1	32.1	30.7	31.8	31.4	31.5	30.6	28.9	28.6	29.6	29.9	29.6
Deposit Growth	17.1	17.1	17.3	19.8	20.0	20.5	20.8	21.3	20.8	20.3	21.0	22.2	22.9	23.8
Non-Food Credit	32.1	32.2	31.0	32.0	30.7	30.1	30.9	30.2	28.4	28.0	27.5	27.3	27.3	26.7
Inflation														
CPI (IW)	5.0	4.9	4.9	5.0	6.3	7.7	6.7	6.3	6.8	7.3	6.3	6.9	7.1	
WPI	4.5	4.2	4.3	3.5	4.5	5.2	5.0	5.7	5.9	5.4	5.2	5.4	5.7	6.3
Mfg Products Inflation	2.1	2.4	2.0	1.5	2.4	2.9	3.5	4.0	4.3	4.6	4.5	4.9	5.8	5.8
Interest Rates (Avg, %)														
Call Money Rate	6.5	6.8	6.4	5.5	5.5	5.7	5.8	6.0	6.2	6.6	6.6	8.4	8.0	8.1
91-Day T-Bills	6.3	6.6	6.6	5.6	5.7	6.1	6.4	6.4	6.5	6.6	6.7	7.0	7.2	0.0
10-Year Government Bond	7.1	7.3	7.4	7.5	7.6	7.9	8.3	8.1	7.7	7.6	7.5	7.6	7.7	7.9
Trade - Customs Data														
Exports	30.8	30.0	27.9	13.1	26.1	31.9	40.9	25.8	27.6	11.4	33.6	7.7	5.5	
Imports	21.9	41.2	23.0	16.4	17.2	24.9	28.2	18.8	34.0	36.8	42.9	31.1	23.2	
Oil	45.7	72.5	26.7	34.7	28.4	54.5	54.7	27.2	25.8	-27.8	48.3	29.6	25.5	
Non-Oil	13.7	29.1	21.5	9.1	13.1	13.7	16.4	14.9	38.0	151.3	40.5	31.8	22.3	
Brent Prices ($/bbl)	62.9	59.7	61.6	70.5	69.7	68.6	73.7	72.9	61.4	57.8	58.7	62.5	53.7	
Foreign Investment (US$ Mils.)														
FII	773	1,693	1,509	118	-1,630	106	252	1,000	1,166	1,736	2,037	-797	113	1,620
FDI	482	127	1,240	661	538	523	1,127	619	916	1,698	1,151			
Exchange Rate and Reserves														
US$ Exchange Rate Average	44.4	44.3	44.6	45.0	45.4	46.0	46.5	46.5	46.1	45.4	44.8	44.6	44.3	44.3
US$ Exchange Rate Mnth End	44.1	44.4	44.5	45.0	46.4	46.1	46.6	46.5	45.9	45.0	44.7	44.3	44.2	44.2
Forex Res Inc.Gold (US$ Bils.)	139.5	141.6	151.6	160.7	164.5	162.9	164.0	165.3	165.3	167.1	175.5	177.3	179.1	193.1

Source: CSO; CMIE, RBI, DGCI&S; CMA; SIAM.

Summary of Balance of Payments

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** likely to be 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 1.8% 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$16.5bn in FY07E and US$15.9bn in FY08*

***Forex reserves** also continue to provide strong cushion against external shocks, @US$195bn currently*

Figure 26. Trends and Forecasts in the Balance of Payments (US$Mn, %)

	FY01	FY02	FY03	FY04	FY05	FY06	FY07E	FY08E
CURRENT ACCOUNT								
Exports	45,452	44,703	53,774	66,285	85,206	105,152	126,382	147,867
Y/Y%	21.1	(1.6)	20.3	23.3	28.5	23.4	20.2	17.0
% of GDP	9.9	9.4	10.6	11.0	12.3	13.1	13.8	13.8
Exports- Customs	44,560	43,827	52,719	63,843	80,700	100,600	120,720	147,278
Y/Y%	21.0	-1.6	20.3	21.1	26.4	24.7	20.0	22.0
Imports	57,912	56,277	64,464	80,003	118,908	156,993	189,805	216,377
Y/Y %	4.6	-2.8	14.5	24.1	48.6	32.0	20.9	14.0
Imports-Customs	50,576	51,448	61,385	78,200	106,700	140,200	177,000	203,625
Y/Y %	1.9	1.7	19.3	27.4	36.4	31.4	26.2	15.0
of which:								
Oil	15,676	14,048	17,685	20,600	29,900	43,800	56,500	53,000
Y/Y %	24.1	-10.4	25.9	16.5	45.1	46.5	29.0	-6.2
Non-Oil	34,900	37,400	43,700	57,600	76,800	96,400	120,500	150,625
Y/Y %	-5.7	7.2	16.8	31.8	33.3	25.5	25.0	25.0
a. Trade balance (RBI)	**-12,460**	**-11,574**	**-10,690**	**-13,718**	**-33,702**	**-51,841**	**-63,422**	**-68,510**
% of GDP	-2.7	-2.4	-2.1	-2.3	-4.9	-6.4	-6.9	-6.4
Trade Balance (Customs)	-6,016	-7,621	-8,666	-14,357	-26,000	-39,600	-56,280	-56,347
Difference	-6,444	-3,953	-2,024	639	-7,702	-12,241	-7,142	-12,163
b. Invisibles	**9,794**	**14,974**	**17,035**	**27,801**	**31,232**	**42,655**	**46,800**	**51,300**
Non-factor services	1,692	3,324	3,643	10,144	15,426	23,881	27,000	29,000
Of which: Software Services	5,750	6,884	8,863	11,750	16,400	22,262	27,605	34,230
Investment income	-5,004	-4,206	-3,446	-4,505	-4,979	-5,510	-4,500	-4,000
Remittances	12,854	15,398	16,387	21,608	20,525	24,102	24,000	26,000
Official transfers	252	458	451	554	260	182	300	300
1. Current a/c balance (a+b)	**-2,666**	**3,400**	**6,345**	**14,083**	**-2,470**	**-9,186**	**-16,622**	**-17,210**
% of GDP	-0.6	0.7	1.2	2.3	-0.4	-1.1	-1.8	-1.6
CAPITAL ACCOUNT								
c. Loans	**5,264**	**-1,261**	**-3,850**	**-4,364**	**10,909**	**6,113**	**10,500**	**9,000**
External assistance	410	1,117	-3,128	-2,858	1,923	1,682	1,500	1,000
Commercial borrowings*	4,303	-1,585	-1,692	-2,925	5,194	2,723	7,000	6,000
Short-term credit	551	-793	970	1,419	3,792	1,708	2,000	2,000
d. FDI (Net = a-b)	**3,274**	**4,734**	**3,217**	**2,388**	**3,713**	**4,730**	**9,000**	**11,000**
(a) FDI - To India	4,031	6,125	5,036	4,322	5,987	7,661	11,000	13,000
(b) FDI - Abroad	-757	-1,391	-1,819	-1,934	-2,274	-2,931	-2,000	-2,000
e. Portfolio investment	**2,590**	**1,952**	**944**	**11,356**	**9,287**	**12,494**	**6,500**	**6,500**
f. Banking Capital	**-1,961**	**2,864**	**10,425**	**6,033**	**3,874**	**1,373**	**6,500**	**6,000**
Commercial Banks (Net)	-4,277	110	7,447	2,391	4,838	442	4,000	3,500
NRI deposits	2,316	2,754	2,978	3,642	-964	2,789	2,500	2,500
g. Rupee debt service	**-617**	**-519**	**-474**	**-376**	**-417**	**-572**	**-400**	**-400**
h. Other capital**	**292**	**781**	**578**	**1,699**	**656**	**-738**	**1,000**	**1,000**
2.Capital a/c (c+d+e+f+g+h)	**8,842**	**8,551**	**10,840**	**16,736**	**28,022**	**23,400**	**33,100**	**33,100**
Errors & Omissions	-305	-194	-200	602	607	838	0	0
Overall balance (1+2)	**5,871**	**11,757**	**16,985**	**31,421**	**26,159**	**15,052**	**16,478**	**15,890**
Forex								
Forex assets	39.6	51.0	71.9	106.1	135.1	145.1	161.6	177.5
FCA to months of imports (Rhs)	8.2	10.9	13.4	15.9	13.6	11.1	10.2	9.8
Exchange rate								
Rs/US$ - annual avg	45.7	48.0	48.3	45.9	45.0	44.3	44.9	43.2
% depreciation	5.3	5.0	0.6	-5.0	-2.0	-1.6	1.4	-3.8
Rs/US$ - year end	46.5	48.9	47.5	43.6	43.8	44.6	44.5	43.2
% depreciation/(-) appreciation	6.7	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 repayment of India Millennium Bonds in FY06.

** Includes delayed export receipts, advance payments against imports.

Source: RBI, Citigroup estimates.

Snapshot of Government Finances

BUDGET FY08: KEY HIGHLIGHTS

No change in direct taxes, reduction in the peak customs tariffs from 12.5% to 10%. Additional surcharge of 1% for education + removal of exemptions will help shore up revenues

Tax Revenue growth assumption @17%yoy is conservative

Privatization and Disinvestment estimates include Rs400bn on account of transfer of RBI's stake in SBI

Higher Defense outlays, interest payments, subsidies and wages have driven up non-plan expenditure…

…however, outlays on expenditure on National Urban Renewal Mission, Bharat Nirman Project raised by 31%- will encourage 'inclusive growth'

FY08 Fiscal Deficit at 3.3%- in line with FRBM targets

Figure 27. India's Central Government Finances (Rupees in Billions, Percent to GDP)

	FY03	FY04	FY05	FY06RE	FY07RE	FY078BE
a. Gross Tax Revenue	**2,163**	**2,543**	**3,050**	**3,662**	**4,678**	**5,481**
% to GDP	8.8	9.2	9.8	10.3	11.4	11.8
Corporation tax	462	636	827	1,013	1,465	1,684
Income tax	369	414	493	636	825	988
Excise duty	823	908	991	1,112	1,173	1,302
Import duty	449	486	576	651	818	988
Service tax*	61	100	163	250	398	520
b. (-) Devolvement to States & UTs	577	674	802	959	1,219	1,443
c. Net tax revenues (a-b)	1,585	1,870	2,248	2,703	3,460	4,039
d. Non tax revenues	723	769	812	772	774	826
e. Net revenue receipts (c+d)	**2,308**	**2,639**	**3,060**	**3,475**	**4,233**	**4,864**
f. Non-debt capital receipts	373	841	665	122	60	432
Recovery of loans	342	672	620	106	55	15
Privatisation*	32	170	44	16	5	417
g. TOTAL REVENUES (e+f)	**2,682**	**3,480**	**3,725**	**3,597**	**4,293**	**5,296**
% YoY	21.3	29.8	7.0	-3.4	19.4	23.4
h. Revenue expenditure	**3,387**	**3,621**	**3,843**	**4,398**	**5,068**	**5,579**
Interest (1)	1,178	1,241	1,269	1,326	1,462	1,590
Defence	407	432	439	482	515	541
Subsidies	435	443	460	475	535	543
Pensions	144	159	183	203	222	235
Grants to States	133	137	148	305	362	384
Admin and social services	374	422	470	488	526	543
Plan expenditure	716	786	875	1,119	1,446	1,744
i. Capital expenditure	**745**	**1,092**	**1,139**	**664**	**749**	**1,226**
Defence	150	169	320	323	345	419
Loans	197	487	371	52	123	500
Plan expenditure	399	436	448	288	281	307
j. Plan expenditure on rev & cap a/c	1,115	1,223	1,323	1,406	1,727	2,051
k Non Plan expen on rev & cap a/c	3,018	3,490	3,660	3,655	4,089	4,754
l. TOTAL EXPENDITURE (h+i) = (j+k)	**4,132**	**4,713**	**4,983**	**5,061**	**5,816**	**6,805**
% YoY	14.1	14.0	5.7	1.6	14.9	17.0
Deficit trends						
m. Fiscal deficit (l-g)	**1,451**	**1,233**	**1,258**	**1,464**	**1,523**	**1,509**
% to GDP	5.9	4.5	4.0	4.1	3.7	3.3
n. Revenue deficit (h-e)	**1,079**	**982**	**783**	**923**	**834**	**715**
% to GDP	4.4	3.6	2.5	2.6	2.0	1.5
o. Primary deficit (m-1)	**273**	**-8**	**-12**	**138**	**61**	**-80**
% to GDP	1.1	0.0	0.0	0.4	0.1	-0.2
Financing the deficit						
Market borrowings	976	889	460	953	1,075	1,096
PPF & special deposits	139	50	-4	60	50	50
Small savings	0	0	0	0	30	105
Net external assistance	-119	-135	148	75	79	91
Others	436	468	736	584	180	167
Cash Surplus	19	-39	-82	-209	109	0
Total financing	**1,451**	**1,233**	**1,258**	**1,464**	**1,523**	**1,509**
Memo items (% to GDP)						
Centre	5.9	4.5	4.0	4.1	3.7	3.3
State	4.2	4.5	3.5	3.2	2.7	2.7
Combined	9.6	8.5	7.5	7.4	6.3	6.0

BE- Budgeted Estimated; RE- Revised Estimates. Source: Budget Documents.

Global Economic Forecasts

	GDP Growth			CPI Inflation			Current Balance (% of GDP)			Fiscal Balance (% of GDP)		
	2006E	2007E	2008E	2006E	2007E	2008E	2006E	2007E	2008E	2006E	2007E	2008E
United States	3.3	2.7	3.2	3.2	1.8	2.0	-6.5	-6.2	-6.1	-1.9	-1.4	-1.3
Japan	2.2	2.4	2.4	0.1	0.0	0.3	3.5	3.8	3.9	-3.7	-2.8	-2.5
Euro Area	2.8	2.4	2.4	2.2	1.8	1.8	-0.2	-0.1	-0.1	-2.0	-1.6	-1.5
China	10.7	9.8	10.7	1.5	3.0	4.5	6.8	6.5	5.3	-1.0	-1.8	-2.0
India(Inflation is WPI)	**9.2**	**9.3**	**9.4**	**4.8**	**4.5**	**4.5**	**-1.8**	**-1.6**	**-0.9**	**-6.3**	**-6.0**	**-6.0**

Note: GDP and CPI are expressed as year-to-year percent change. Source: Citigroup estimates.

Short-Term Forecasts

	Vs. US$					Policy Rates (%)					Long-term Rates (%)				
	Current	1 Month Forecast	3 Month Forecast	6 Month Forecast	12 Month Forecast	Current	1Q07 Forecast	2Q07 Forecast	3Q07 Forecast	4Q07 Forecast	Current	1Q07 Forecast	2Q07 Forecast	3Q07 Forecast	4Q07 Forecast
United States	NA	NA	NA	NA	NA	5.25	5.25	5.25	5.00	5.00	4.50	4.80	4.90	4.95	4.95
Japan	116.13	119.00	120.00	120.00	118.00	0.53	0.50	0.50	0.50	0.75	1.62	1.70	1.80	1.90	2.00
Euro Area	1.30	1.28	1.26	1.26	1.24	3.50	3.75	3.75	4.00	4.00	3.92	3.90	3.90	3.95	3.95
China	7.74	7.70	7.63	7.47	7.30	6.12	6.12	6.39	6.39	6.39	1.45	1.90	2.00	2.20	2.50
Hong Kong	7.81	7.82	7.81	7.80	7.79	4.24	4.40	4.65	4.46	4.45	4.13	4.09	4.37	4.62	4.60
India	**44.33**	**44.50**	**44.00**	**43.50**	**43.00**	**6.00**	**6.00**	**6.25**	**6.25**	**6.25**	**7.96**	**8.00**	**8.00**	**8.00**	**8.00**
Malaysia	3.51	3.52	3.50	3.47	3.45	3.50	3.50	3.50	3.50	3.75	3.60	3.70	3.80	3.80	3.90
Philippines	48.68	49.00	48.50	48.00	47.85	7.50	7.50	7.50	7.50	7.50	5.75	5.50	5.70	5.25	5.00
Singapore	1.53	1.53	1.53	1.51	1.48	3.19	3.33	3.25	3.25	3.20	3.04	3.15	3.18	3.22	3.25
Korea	948	940	935	935	920	4.50	4.50	4.50	4.50	4.50	4.83	4.95	4.95	5.00	5.00
Taiwan	32.94	32.90	32.70	32.20	31.80	1.70	1.71	1.73	1.74	1.75	1.96	1.99	2.00	2.10	2.18
Thailand	35.20	35.00	34.75	34.85	34.50	4.50	4.50	4.50	4.50	4.50	4.45	4.50	4.50	4.50	4.50

Source: Citigroup estimates.

Long-Term Forecasts

	GDP Growth(%)					Exchange Rates(Average)					Long-term Rates(%)				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
United States	3.1%	3.3%	2.7%	3.0%	3.0%	NA	NA	NA	NA	NA	4.90	4.95	4.90	5.00	5.10
Japan	2.3	2.6	0.8	1.8	2.1	119	113	104	98	94	1.88	2.25	2.00	2.50	2.75
Euro Area	2.2	2.5	2.0	1.8	1.7	1.25	1.24	1.26	1.27	1.27	3.53	3.75	3.50	3.50	3.50
China	9.8	10.7	10.0	9.8	9.5	7.57	7.11	6.75	6.48	6.22	NA	NA	NA	NA	NA
India	**9.3**	**9.4**	**9.8**	**9.7**	**9.7**	**43.2**	**42.0**	**41.5**	**41.0**	**40.5**	**8.00**	**7.50**	**7.50**	**7.50**	**7.50**

Source: Citigroup estimates.

India's Place in the World: GDP Rankings, Nominal and PPP Basis (Top 15 countries,2005,US$bn)

Ranking	Country	GDP-PPP Basis	Ranking	Country	Nominal GDP
1	United States	12,409	1	US	12,455
2	China	8,573	2	Japan	4,506
3	Japan	3,944	3	Germany	2,782
4	***India***	***3,816***	4	China	2,229
5	Germany	2,418	5	UK	2,193
6	United Kingdom	1,927	6	France	2,110
7	France	1,830	7	Italy	1,723
8	Italy	1,668	8	Spain	1,124
9	Brazil	1,627	9	Canada	1,115
10	Russian Federation	1,560	10	Brazil	794
11	Spain	1,134	11	Korea	788
12	Canada	1,061	***12***	***India***	***785***
13	Korea	1,056	13	Mexico	768
14	Mexico	1,052	14	Russian Fed	764
15	Indonesia	847	15	Australia	701

Source: World DevelopmentIndicators,2005.

Disclosure Appendix

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