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Indian Rupee: Forecast Revisions

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- **Recent rupee strength:** Lack of RBI intervention coupled with the rupee being used as a tool against inflation saw the currency appreciate more than 5.5% since March, surpassing even our non-consensus call. While the currency's near-term outlook could be clouded by deceleration in exports, we expect the rupee to stay on a long-term gradual appreciation path, although the forward market continues to expect a weakening trend for the currency.

- **Adjusting long-term rupee forecasts:** Taking into account the recent move in the rupee coupled with no draconian measures in the monetary policy announced today (*see https://www.citigroupgeo.com/pdf/SAP04737.pdf for details*), we are adjusting our long-term annual average rupee forecasts.

Currency Forecasts (Annual Averages)

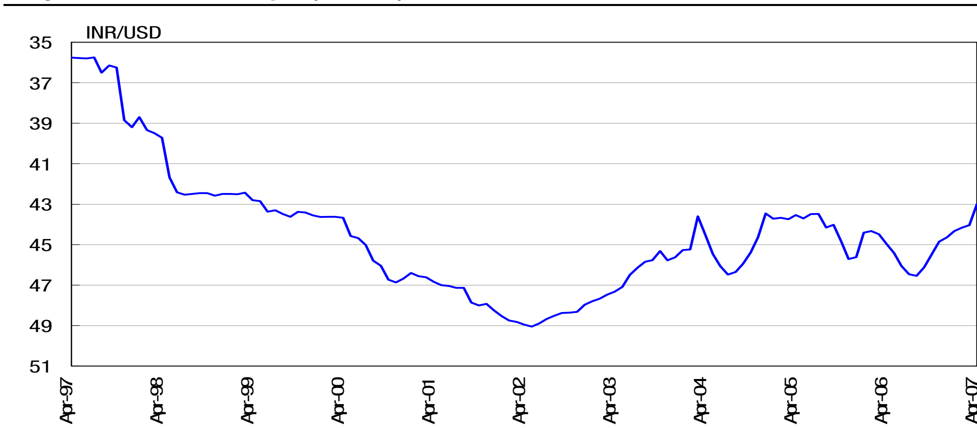
	2007	2008	2009	2010	2011
Euro (EUR/USD)	1.25	1.23	1.26	1.27	1.27
Japan (USD/JPY)	120.00	114.00	104.00	98.00	94.00
China (RMB/USD)	7.40	7.00	6.70	6.46	6.28
India (INR/USD) New	***41.75***	***40.00***	***39.0***	***37.50***	***36.00***
India (INR/USD) Old	43.20	42.00	41.50	41.00	40.50

Source: Citigroup estimates

- **Long-term rupee story holds:** Although economic indicators suggest a possibility that growth could be hitting a speed limit[1], the good news is that continued economic reforms and investments may over time ease overstretched resource constraints that should help lift India's growth potential to 10% in the near future. This should enable the rupee to maintain a steady appreciation trend, similar to the experiences of most other rapidly growing Asian economies.

- **Key risk factors** that could disrupt the currency appreciation trend include sharp deterioration of the current account, a prolonged decline in asset prices or a collapse of the economy. None of these scenarios are in our base case.

Long Term Trends in the Rupee (INR/USD)



Source: RBI

[1] For details please refer to the India Macroscope - Overheating and the Question of Growth Potential"; 18 April 2007 https://www.citigroupgeo.com/pdf/SAP04614.pdf

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Rupee's Long-term Appreciation – Asia Macro Views[2]

Price stability is likely a key reason behind the Reserve Bank of India's (RBI) recent tolerance of a sharply stronger rupee. With the *WPI rising to 6.7% in Feb and CPI rising to 7.6% for industrial workers and 9.5% for rural labor, coupled with a rising* current account deficit, higher asset prices, wage pressures and infrastructure bottlenecks, the RBI hiked the repo rate *five times during the past nine months. More recently,* the RBI has refrained from active currency intervention. Currency appreciation is an important means to tighten monetary conditions.

Equally important is that both the economy and markets have remained resilient, despite tightening policies. With 5 of the 7 repo rate hikes taking place in the last nine months, the near-term outlook appears clouded and much further tightening poses downside risks to our forecasts. However, tightening has had a limited impact on economic momentum so far. Stock prices still rose by 8.3% in the past month and growth of industrial production and infrastructure activity remained robust. Abundant liquidity conditions, evidenced by rapidly growing money supply and bank credit, also imply that risks of immediate collapse of asset prices are not high. Tightening measures taken so far, together with the prospect of even further tightening, will likely prevent a hard landing. In past years, Asian equity markets have experienced at least three important sell-offs, but each time the Indian equity markets have regained strength quite quickly. Against such a backdrop, rising interest rates may be seen as an incentive for more capital inflows, which, in turn, should add further upward pressure on the currency.

However, recent deceleration in exports may cloud the near-term outlook for the currency. Export growth slowed from around 25-30% in the first eleven months of last year to below-10% levels after December; the trade deficit during the first two months of 2007 rose 78% from a year ago. If this trend continues, India's current account could deteriorate rapidly, adding downward pressure on the currency. More importantly, a worsening external account balance could soon encourage RBI to step up its intervention. Furthermore, concern about "overheating" and expectations of further tightening could point to downside risks for economic growth and thereby generate additional downward pressure.

We expect that over time the rupee will remain on a gradual strengthening path, given our relatively upbeat macroeconomic outlook. At the current growth rate of above-9%, the economy may appear to be hitting a speed limit on growth, which possibly explains why the economy is facing symptoms of overheating. However, for the past two decades, India has successfully lifted its growth potential from around 4.5% in the 1980s to 6% in the 1990s and again to around the 8% level currently. So, with continued reform and investment, India might be able to ease overstretched resource constraints and promote productivity growth. Eventually, we think India's growth potential may shift to around 10%. However, even in a

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[2] See Asia Macro Views for more details : Rupee's Long Term Appreciation; 20th April 2007 at https://www.citigroupgeo.com/pdf/SAP04614.pdf

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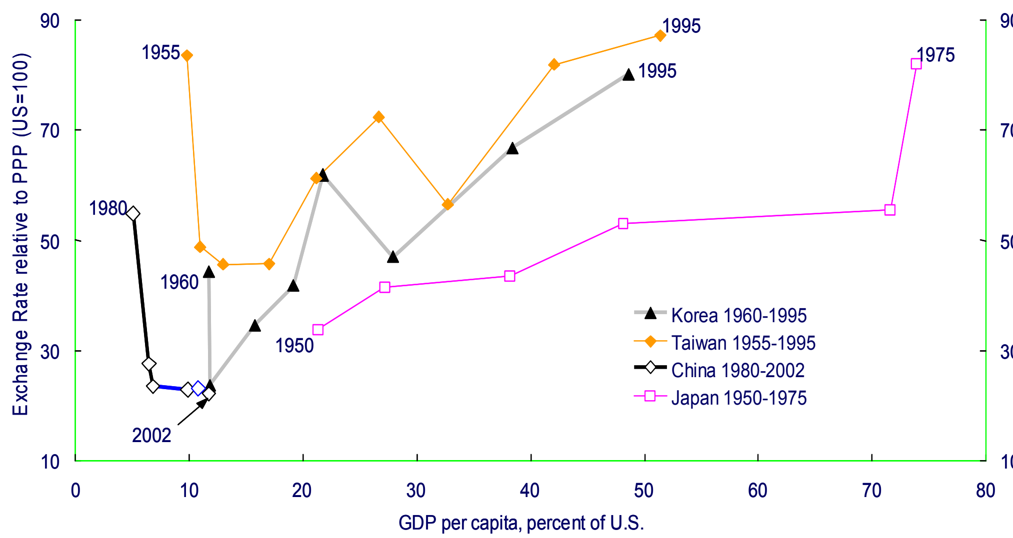
relatively less optimistic scenario in which India's growth potential remains at 8%, its growth could still at least double the pace of that of the world economy. Experiences of other Asian economies have shown that currencies often appreciate steadily if the economy maintains rapid growth (*see figure below*). This was the case for Japan, Korea and Taiwan in the past. China has started to show the beginning of the same process. We believe India will not be an exception.

Currency Tends to Appreciate as Strong Growth Continues: Japan, Korea, Taiwan and China



Source: CEIC Data Company and Citigroup estimates.

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

We expect the rupee/dollar exchange rate to trade in a range of around 41.20 to 40.7 in the next three months. The key risk factors that could disrupt the currency appreciation trend include sharp deterioration of the current account, a prolonged decline in asset prices or a collapse of the economy. None of these scenarios are in our base case.

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FY08E KEY POINTS

***Export** growth likely to decelerate to 15% levels in FY08*

Oil price assumptions: US$65/bbl Dubai crude in FY08),

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 1.6% of GDP in FY08E*

***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*

***Forex reserves** also continue to provide strong cushion against external shocks, @US$200bn currently*

Trends and Forecasts in the Balance of Payments (US$ mn, %)

US$ Mn, %)	FY01	FY02	FY03	FY04	FY05	FY06	FY07E	FY08E
CURRENT ACCOUNT								
Exports (RBI)	**45,452**	**44,703**	**53,774**	**66,285**	**85,206**	**105,152**	**125,657**	**144,505**
Y/Y%	21.1	(1.6)	20.3	23.3	28.5	23.4	19.5	15.0
% of GDP	9.9	9.4	10.6	11.0	12.3	13.1	13.4	13.5
Exports- Customs	44,560	43,827	52,719	63,843	80,700	100,600	120,720	139,069
Y/Y%	21.0	-1.6	20.3	21.1	26.4	24.7	20.0	15.2
Imports (RBI)	**57,912**	**56,277**	**64,464**	**80,003**	**118,908**	**156,993**	**193,101**	**219,170**
Y/Y %	4.6	-2.8	14.5	24.1	48.6	32.0	23.0	13.5
% of GDP	12.6	11.8	12.7	13.3	17.1	19.5	21.1	20.4
Imports-Customs	50,576	51,448	61,385	78,200	106,700	140,200	179,000	206,290
Y/Y %	1.9	1.7	19.3	27.4	36.4	31.4	27.7	15.2
Oil	15,676	14,048	17,685	20,600	29,900	43,800	56,000	55,000
Y/Y %	24.1	-10.4	25.9	16.5	45.1	46.5	27.9	-1.8
Non-Oil	34,900	37,400	43,700	57,600	76,800	96,400	123,000	151,290
Y/Y %	-5.7	7.2	16.8	31.8	33.3	25.5	27.6	23.0
a. Trade balance (RBI)	**-12,460**	**-11,574**	**-10,690**	**-13,718**	**-33,702**	**-51,841**	**-67,445**	**-74,665**
% of GDP	-2.7	-2.4	-2.1	-2.3	-4.9	-6.4	-7.2	-7.0
Trade Balance (Customs)	-6,016	-7,621	-8,666	-14,357	-26,000	-39,600	-58,280	-67,221
Difference	-6,444	-3,953	-2,024	639	-7,702	-12,241	-9,165	-7,444
b. Invisibles	**9,794**	**14,974**	**17,035**	**27,801**	**31,232**	**42,655**	**52,800**	**59,300**
Non-factor services	1,692	3,324	3,643	10,144	15,426	23,881	32,000	37,000
Of which: Software	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	25,000	26,000
Official transfers	252	458	451	554	260	182	300	300
1. Current a/c (a+b)	**-2,666**	**3,400**	**6,345**	**14,083**	**-2,470**	**-9,186**	**-14,645**	**-15,365**
% of GDP	-0.6	0.7	1.2	2.3	-0.4	-1.1	-1.6	-1.4
CAPITAL ACCOUNT								
c. Loans	**5,264**	**-1,261**	**-3,850**	**-4,364**	**10,909**	**6,113**	**13,500**	**9,000**
External assistance	410	1,117	-3,128	-2,858	1,923	1,682	1,500	1,000
Comm borrowings*	4,303	-1,585	-1,692	-2,925	5,194	2,723	10,000	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**
Com. 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 (a::h)	**8,842**	**8,551**	**10,840**	**16,736**	**28,022**	**23,400**	**36,100**	**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**	**21,455**	**17,735**
Forex								
Forex assets (excl gold)	39.6	51.0	71.9	107.5	135.6	145.1	191.9	213.1
months of imports (Rhs)	8.2	10.9	13.4	15.9	13.6	11.1	11.9	11.7
Exchange rate								
Rs/US$ - annual avg	45.7	48.0	48.3	45.9	45.0	44.3	44.9	41.75
% depreciation	5.3	5.0	0.6	-5.0	-2.0	-1.6	1.4	-7.0

*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

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