Asian Currency Research

Indian rupee - strength to strength

DBS Group Research **26 October 2007**

Forecast upgraded

USD/INR broke below the psychological support level at 40 on September 20, two days after the US Federal Reserve triggered a global sell-off in the US dollar with a 50bps cut in the Fed Funds Rate to 4.75%. By Oct 11, the rupee had strengthened to 39.275, its strongest since 1998. Since then, USD/INR has range-traded between 39.27 and 39.96.

Sentiment towards the rupee grew increasingly positive in second half of 2006 as its strength against the US dollar became more evident. This was best reflected by the Sensex overtaking the Dow Jones Industrial Average, and the Reserve Bank of India continued to hike rates after the Fed hike cycle stopped in June 2006.

INR strength is due to India's stronger fundamentals relative to the US

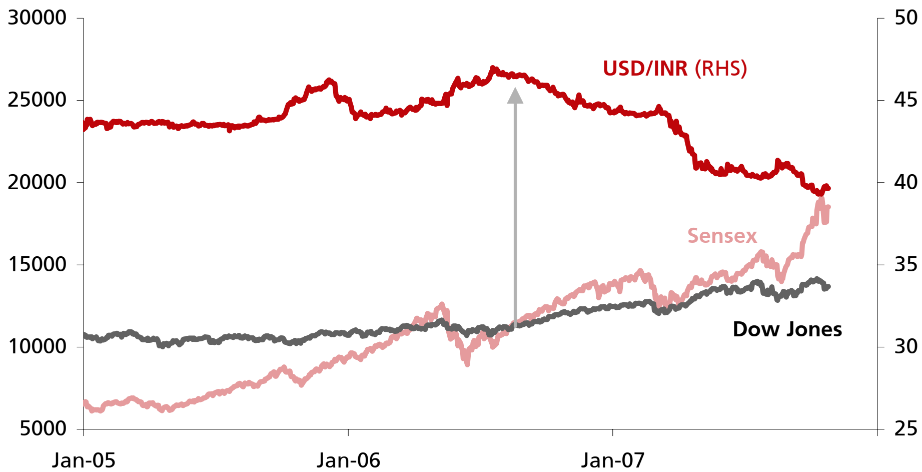
Like other Asian currencies, we expect the rupee to strengthen against US dollar heading into the US presidential election in 2008. But that's not why we are upgrading the forecast. We like the rupee because of India's stronger fundamentals vis-a-vis the US. Some of the positive factors include higher interest rates with a tightening bias, a strong balance of payments aided by foreign direct investment and an improving fiscal position that could lead to more upgrades in sovereign debt ratings.

USD/INR outlook

Market	Oct 25	4Q07	1Q08	2Q08	3Q08	4Q08
DBS New	39.56	39.5	39.0	38.5	38.0	37.0
DBS Old	--	40.2	40.0	39.8	39.7	39.6
NDF fwd	--	39.6	39.7	39.8	39.9	40.0
Consensus	--	39.5	39.5	39.1	39.1	39.0

INR has been strong since the Sensex overtook the Dow

Sentiment has been INR positive since Sensex overtook Dow Jones



Sources: Reuters, DBS Research

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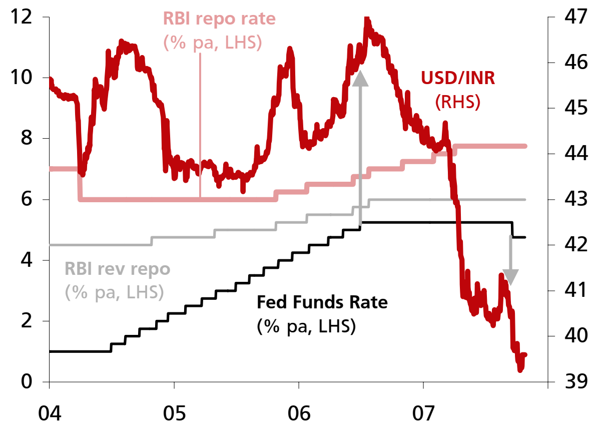
US-India interest rate differential favors the rupee

An important source of strength for the Indian rupee comes from India's relatively high interest rates and hawkish monetary policy bias. The start of the rupee's ascent in 2H06 coincided with the end of the Fed hike cycle in June 2006, and a more aggressive RBI tightening cycle to address overheating concerns in the Indian economy.

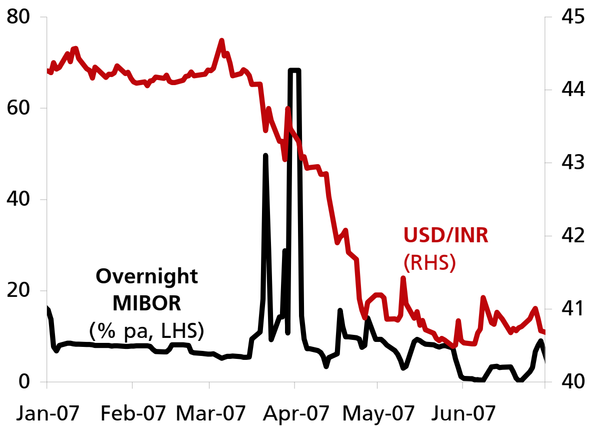
For the record, US Fed Funds Rate peaked at 5.25% on Jun 29, 2006. Since then, the RBI has hiked its reverse repo (borrowing) rate once by 25bps to 6.00% in July 2006. The lifting of the repo (lending) rate was more aggressive, resulting in four hikes totalling 100bps to 7.75%.

Policy interest rates favor INR over USD



Sources: Bloomberg, DBS Research

RBI discovers the impossible trinity



Sources: Bloomberg, DBS

The last repo rate hike was implemented in late March 2007, when the central bank discovered the impossible trinity. Its attempt to rein in inflation and to curb the rupee appreciation at the same time led to a cash crunch that sent overnight Mibor to as high as 70%. This was instrumental in triggering the sharp appreciation in the rupee from 44 towards 40 against the US dollar during the March-May period.

From April, the RBI has resorted to four increases in the ceiling on intervention bonds and three increases in the cash reserve requirement (CRR) to facilitate interventions. These measures coupled with falling WPI inflation allowed the RBI to keep USD/INR bound within a tight range, mostly between 40.20 and 41.40.

That is, until the larger-than-expected 50bps cut in the Fed Funds Rate to 4.75% on September 18 triggered broad-based US dollar weakness. This event alone was responsible for pushing USD/INR below the psychological 40 level, where it has stayed since.

More rate hikes in India in 2008

Looking ahead, we are still expecting the next move to be up for Indian interest rates. The repo rate should rise again next year, in 3Q08 and 4Q08, by a total 50bps to 8.25%. For now, inflation has eased, allowing the central bank to keep rates on hold.

WPI inflation eased to 3.3% YoY in Sep07 from its peak of 6.6% YoY in Mar07. CPI inflation for industrial workers rose to 7.3% YoY in Aug07, its highest level since the 7.6% posted in Oct06. CPI inflation for agricultural labourers firmed to 8.8% YoY in Aug07 from the year's low of 7.8% in Jun07, staying above 7% YoY for the twelfth straight month.

Ratings upgrades underscore India's economic strength

The start of the rupee's present appreciation path from mid-2006 also coincided with upgrades in the country's sovereign ratings into investment grade territory by international ratings agencies. By January 2007, Standard & Poor's and Fitch both had a rating of "BBB-" rating for India, while Moody's rating was one-notch higher at "Baa2".

Indian sovereign debt is now investment grade

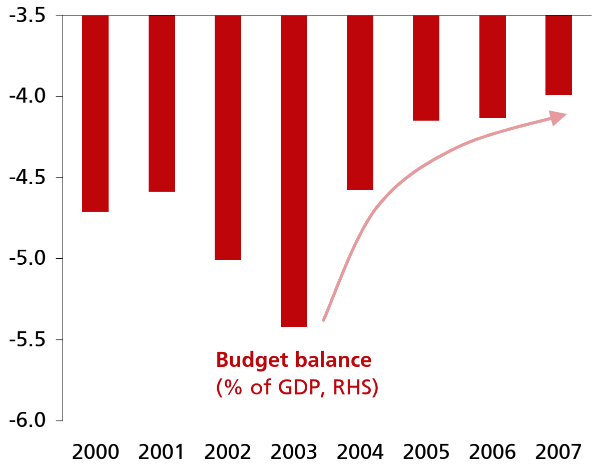
India's long-term sovereign ratings enter investment grade from 2006

Moody's		Standard & Poors		Fitch	
Rating	Effective	Rating	Effective	Rating	Effective
Baa1		BBB+		BBB+	
Baa2	24-May-06	BBB		BBB	
Baa3	22-Jan-04	BBB-	30-Jan-07	BBB-	1-Aug-06
Ba1	3-Feb-03	BB+	2-Feb-05	BB+	21-Jan-04
Ba2	14-Nov-02	BB	22-Oct-98	BB	21-Nov-01
Ba3		BB-		BB-	

Sources: Bloomberg, DBS Research

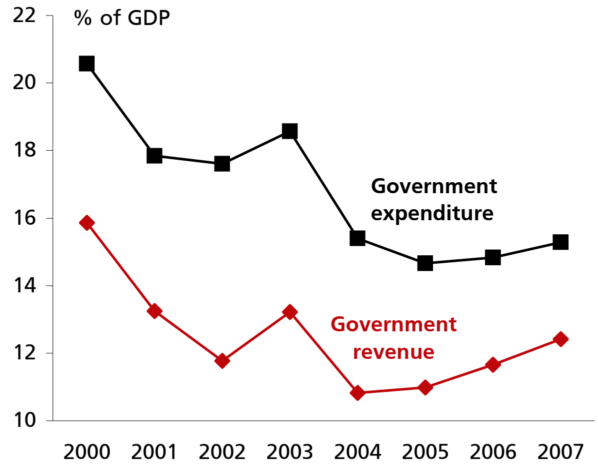
For three straight fiscal years into March 2007, India maintained a steady fiscal deficit of around 4.0% of GDP. The government is targeting the fiscal deficit to narrow to 3.3% of GDP for this FY ending March 2008. Federal law requires India to lower the fiscal deficit to 3.0% of GDP by FY ending March 2009. Finance Minister Palaniappan Chidambaram is optimistic that this will be achieved, a view shared also by the Organisation for Economic Cooperation and Development (OECD).

Fiscal finances are improving



Sources: CEIC, DBS Research

Govt revenue is rising faster than expenditure



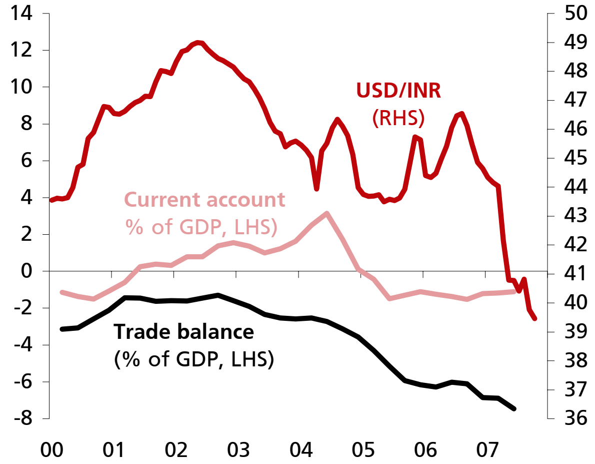
Sources: CEIC, DBS Research

A healthy balance of payments despite a widening trade deficit

Over the past two-and-a-half years, India's merchandise trade deficit more-than-doubled to 7.5% of GDP in 2Q07 from 3.6% in 2004. Normally, this would have sounded alarm bells. But thanks to robust surpluses in the invisibles account, the current account deficit remained narrow at 1.1% of GDP as at 2Q07, its lowest level since 4Q05.

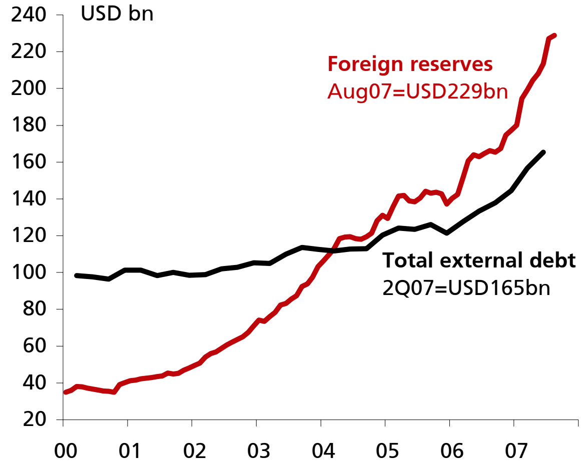
More importantly, foreign reserves have exceeded total external debt since 1Q04. On a 4-quarter rolling basis, the positive reserves-debt gap widened to USD56bn in 2Q07, covering 85.5% of the trade deficit. The rapid rise in foreign reserves implies a balance of payments fuelled by huge inflows - both direct and portfolio - into its capital accounts.

Current a/c stable despite wide trade deficit



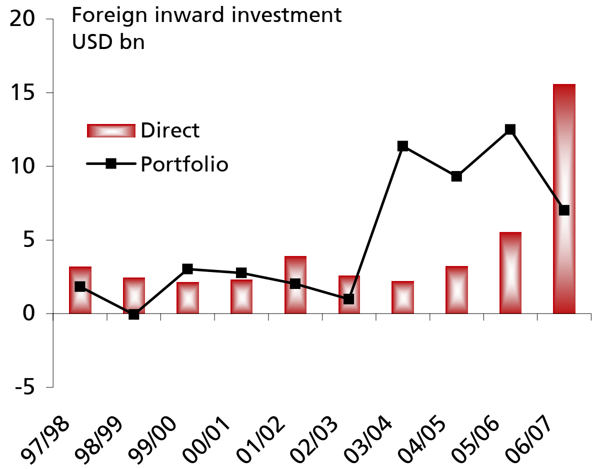
Sources: CEIC, DBS Research

FX reserves > Total external debt in India



Sources: CEIC, DBS Research

Foreign inflows turn more sustainable



Sources: CEIC, DBS Research. Data is for FY ending March

The most important development in 2006 was the emergence of more sustaintable direct investment in 2006. Based on the World Investment Report for 2007 by the United Nations Conference on Trade and Development (UNCTAD), India's foreign direct investment (FDI) rankings improved significantly in 2006. India's inward FDI performance index improved eight notches to 113 in 2006 from 121 in 2005. Not only was this the largest one-year jump posted by India, it came on the back of a seven-notch fall in China's index to 69. The report noted that FDI was growing as a share of gross fixed capital formation, from 1.9% in 1999-2000 to 2.6% in 2005 to 8.7% in 2006.

According to its "Economic Survey of India, 2007" published in October 2007, the OECD has advocated many reforms for India to achieve its growth targets. For the purpose of this paper, we will only focus on those reforms that are needed to boost foreign direct investment (FDI). Briefly, they include the relaxation of labour laws; the removal of caps on foreign investment in the insurance sector; the lifting of the ban on FDI in the retail sector; the privatisation of Indian state-banks to increase the efficiency of the financial sector, e.t.c.

US-India trade & investment relations are set to deepen

The US is keen to open up India more

Looking ahead, we need to pay more attention to US trade and investment policies pertaining to India. The US Treasury is looking to broaden its international agenda, which has been dominated by China so far, to include India. Owing to a lacklustre US economy hobbled by housing woes, the US Treasury is keen to open up fast-growing emerging economies in order to create opportunities for US companies in overseas markets.

Two key areas of cooperation – infrastructure investment and financial market development

In India, the US Treasury is keen to participate in broad initiatives - infrastructure investment and financial market development - that will help India achieve its high economic growth and development goals. US Treasury Secretary Henry Paulson has met with India's government officials and policymakers to discuss how the US can help the country to develop Mumbai into an international financial centre, as well as ways to boost financing for India's infrastructure needs.

On Oct 29, Paulson will heading to Mumbai to attend the US-India CEO Infrastructure Forum that seeks to introduce US companies to infrastructure investment opportunities in the country. On Oct 30, Paulson will be in New Delhi for the Fortune Global Forum on India's rise as an economic power. During these visits, Paulson will be meeting local business and domestic political leaders.

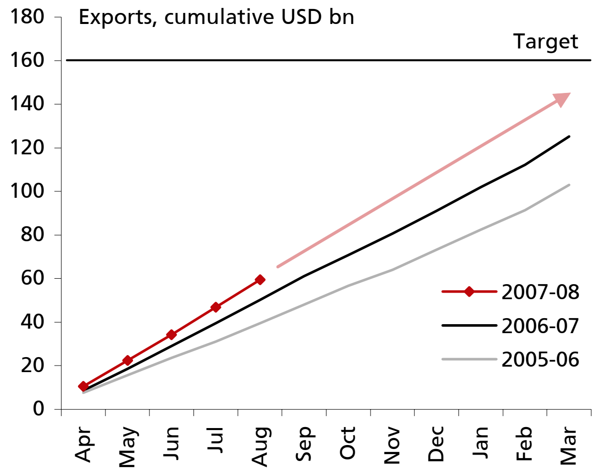
Government worrying about a strong rupee

Within the Indian government, there are several concerns regarding the rupee's strength this year.

The government is worried about competitiveness

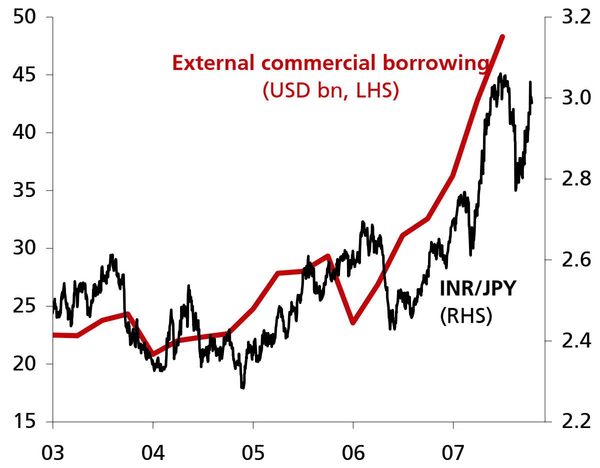
On the merchandise trade front, the government is worried that exports are losing their competitiveness. In late August, Commerce Secretary Gopal K Pillai was optimistic that exports would meet the government's target of USD160bn for the fiscal year ending March 2008. On October 9, Pillai warned that this would no longer be the case. What has changed then and now is the secretary's outlook for the rupee. Unlike August, Pillai now expects USD/INR to fall to 38 instead of a stable rate around 40-41.

Exports to fall short of official USD160bn target



Sources: CEIC, DBS Research

ECB surge on strong INR vs USD & JPY



Sources: CEIC, DBS Research

On the monetary front, the central bank has acknowledged that the enduring nature of capital inflows has been complicating its conduct of monetary policy. One major concern is the excess liquidity finding its way into unproductive sectors that risk fuelling asset inflation in the equity and property sectors.

Other problems with a stronger rupee are:

(1) excessive liquidity & asset inflation;

(2) rising external debt in the commercial sector

Another challenge is the accumulation of external debt notably in the commercial sector. Since the start of calendar year 2006, external debt has been rising with foreign reserves, albeit at a faster pace. In particular, the commercial sector has been keen borrowers because of the rupee's strength against both the US dollar and the Japanese yen, as well as India's relatively higher interest rates and more hawkish monetary policy.

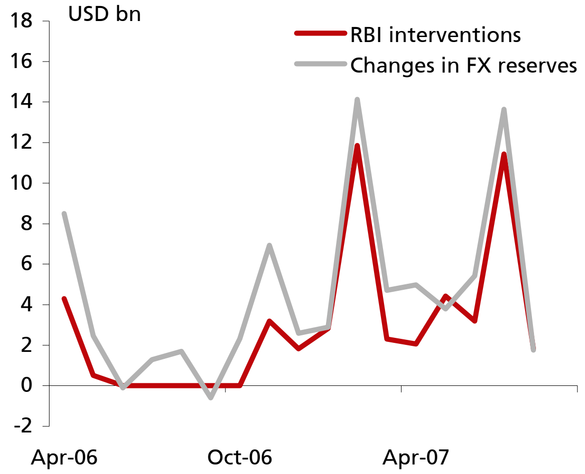
External borrowing in the commercial sector surged to USD42.8bn in FY ending Mar07, compared USD27-28bn in the previous two fiscal years. Within a mere three months, external commercial borrowing increased rapidly to USD48.3bn by Jun07. This represented 29.2% of total external debt, up from a share of 23.3% a year ago.

Key measures to curb rupee appreciation in 2007

(1) Market Stabilisation Scheme (MSS)

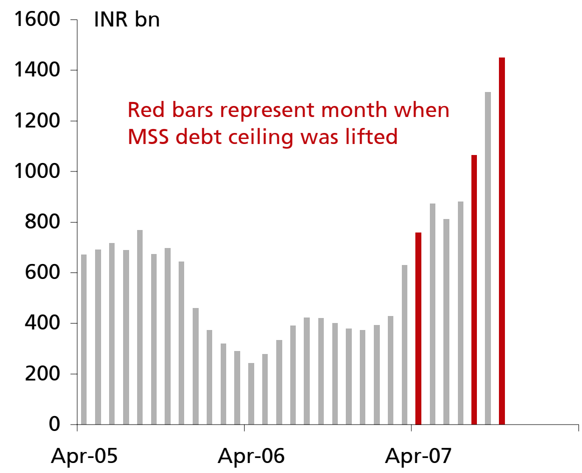
In the first five months of FY07/08 to August 2007, cumulative purchases of US dollars by the RBI amounted to USD22.9bn (INR933bn). This was 85% of the USD26.8bn (INR1190bn) bought for the whole of FY06/07 ending March 2006. Since the start of FY06/07, the rise in foreign reserves have been attributed mostly to currency interventions to absorb the capital inflows.

FX reserves surge on RBI intervention



Sources: CEIC, DBS Research

Outstanding MSS debt



Sources: RBI, DBS Research

MSS limit raised 4 times

To facilitate the interventions, the ceiling for outstanding intervention bonds under the Market Stabilisation Scheme (MSS) was increased four times in FY07/08 - twice in April and once each in August and October. In all, the ceiling for fiscal year ending March 2008 was raised to INR2.0trn from an initial limit of INR800bn. The RBI said that a new limit would be considered if MSS bond issuance exceed INR1.85trn in the future. The MSS scheme was introduced in April 2004. Essentially, the RBI issues MSS debt to soak up excess liquidity from currency interventions.

(2) Raise cash reserve requirements (CRR)

7 hikes in CRR since Dec06

Since December 2006, the RBI has increased the cash reserve requirement (CRR) seven times from 5.00% to 7.00%. The last hike in August 2007 was the largest at 50bps, while the previous six increases were carried out at 25bps apiece. The objective of raising the CRR is also to absorb the excess liquidity from capital inflows finding its way into the financial system, and eventually into inflation.

(3) Curb external commercial borrowings (ECB)

Two attempts by the Finance Ministry to address rising ECB in May and August

In May, the Finance Ministry prohibited the use of ECBs to build integrated townships, aimed at discouraging private equity inflows into the real estate sector under the guise of foreign direct investment. On ECBs by Indian firms, the ceiling for loans with maturities of 3-5 years was lowered to 6M Libor+150bps from 6M Libor+200bps, while those with maturities of more than 5 years were cut to 6M Libor+250bps from 6M Libor+350bps. The lower ceiling was aimed at encouraging only credit worthy Indian companies to borrow funds abroad.

Three months later, it became evident that more direct measures were needed to restrict ECBs. In August, the RBI tightened overseas borrowing rules for local companies, affecting mostly small- and medium-sized firms. Funds raised

Measures to curb rupee appreciation & RBI monetary measures

Announced on	Reverse repo bps ch	Reverse repo Rate, %	Repo bps ch	Repo Rate, %	CRR bps ch	CRR Rate, %	SLR bps ch	SLR Rate, %
16-Oct-07	SEBI proposed to curb FII investments via Offshore Derivative Instruments							
4-Oct-07	RBI raised ceiling on intervention bonds to Rs2.0 trn from Rs1.5 trn for FY ending Mar08							
25-Sep-07	RBI raised ceilings on overseas investment by Indian companies and mutual funds							
8-Aug-07	RBI raised ceiling on intervention bonds to Rs1.5 trn from Rs1.1 trn for FY ending Mar08							
7-Aug-07	Fin Min further tightened overseas borrowing rules for corporates							
4-Aug-07	-	-	-	-	+50	7.00	-	-
20-Jul-07	RBI allows clearing houses of stock exchanges to accept foreign securities as collateral from overseas investors who want to invest in Indian derivatives							
12-Jul-07	Government extends help to exporters							
28-Apr-07	-	-	-	-	+25	6.50	-	-
27-Apr-07	RBI raised ceiling on intervention bonds to Rs1.1 trn from Rs950 mn for FY ending Mar08							
24-Apr-07	RBI raised ceiling on intervention bonds to Rs950 mn from Rs800 mn for FY ending Mar08							
14-Apr-07	-	-	-	-	+25	6.25	-	-
30-Mar-07	-	-	+25	7.75	-	-	-	-
3-Mar-07	-	-	-	-	+25	6.00	-	-
17-Feb-07	-	-	-	-	+25	5.75	-	-
31-Jan-07	-	-	+25	7.50	-	-	-	-
6-Jan-07	-	-	-	-	+25	5.50	-	-
23-Dec-06	-	-	-	-	+25	5.25	-	-
30-Oct-06	-	-	+25	7.25	-	-	-	-
25-Jul-06	+25	6.00	+25	7.00	-	-	-	-
8-Jun-06	+25	5.75	+25	6.75	-	-	-	-
24-Jan-06	+25	5.50	+25	6.50	-	-	-	-

Notes: CRR is cash reserve requirement; SLR is statutory liquidity requirement

overseas in excess of USD20mn can only be used abroad. ECBs of up to USD20mn for use in India must obtain the approval of the RBI. On September 10, RBI rejected the application by Power Finance Corp to borrow overseas USD200mn worth of yen-denominated loans.

(4) Ease capital outflow rules

Encouraging capital outflows

On September 25, the RBI raised the ceilings on overseas investment by Indian companies and mutual funds. The limit that listed Indian companies can invest overseas was raised to 50% from 35% of their net worth in portfolio investments. The ceiling on prepayment of ECBs by Indian companies without central bank approval was lifted to USD500mn from USD400mn. The amount that Indian individuals can take out of the country for investment was doubled to USD200,000.

The Indian rupee has been convertible on the current account since 1994. Based on the Tarapore report, India is working towards fuller capital account convertibility, which will be carried out in three phases, by the end of fiscal year ending March 2011. Moving towards capital account convertibility is an important step for India to develop Mumbai into an international financial centre.

(5) Curb inflows into the stock market

Slowing capital inflows

On October 16, the Securities and Exchange Board of India (SEBI) announced proposals to restrict investments by Foreign Institutional Investors (FIIs)/Sub Accounts into Indian equities through Offshore Derivative Instruments (ODIs) such as Participatory Notes (PNs), Equity Linked Notes, Capped Return Notes, Participating Return Notes, e.t.c.

Between March 2004 and August 2007, the number of FIIs/Sub Accounts that issued ODIs jumped from 14 to 34, while the notional value of PNs surged 11-fold to INR3,534bn from INR319bn. Market capitalisation on the Bombay Stock Exchange increased by 3.8 times to INR45,380bn during the same period.

For more on the issue, please refer to our latest Economic Focus **"India: Restraining inflows"** by my colleague, Ramya, published on October 18. Ramya believes that these measures are unlikely to alter inflows in the medium- and longer-term. In fact, she does not rule not more controls if these measures fail to slow overall inflows.

India's major challenge ahead is not rupee strength, but more reforms to strengthen its economy and financial system

India should not be overly pre-occupied with curbing rupee strength

Not surprisingly, the market is preoccupied with linking these measures primarily as attempts to curb the rupee's appreciation. A closer look will also reveal that policymakers in India are seeking to avoid repeating the mistakes of the 1997/98 Asian financial crisis, especially those pertaining to duration and currency mismatch for the funding of its economic and business activities.

Owing to India's negative savings-investment gap (or current account deficit), India will need to tap foreign savings to achieve its economic growth targets and development goals. Given the constraint to meet its fiscal targets, the government will find a greater urgency to encourage more foreign investments, especially in infrastructure.

India's "pro-growth, pro-investment" policies promotes rupee strength...

One drawback from this "pro-growth, pro-investment" economic policy is the accompanying excessive capital inflows, which not only led to a stronger rupee against both the US dollar and the Japanese yen, but also to a tighter monetary policy. It is, therefore, understandable why more Indian companies have preferred increasing external debt for their funding needs in recent years, to take advantage of the improved investor climate from the country's return to investment grade for its sovereign debt ratings.

As long as this economic policy is in place, we expect the rupee to remain under appreciating pressure, especially if US policymakers and US companies start to pay as much attention towards tapping India's potential, as they do China.

...as well as balance sheet imbalances...

...that require more focus on reforms that strengthen fundamentals via more competition

While we sympathize with the government's frustration with the rupee's inevitable strength, we feel that more attention needs to be paid towards reforms that strengthen the country's fundamentals and the financial sector. In economies that experienced credit boom fuelled by excessive capital inflows, it is often not a surprise to find imbalanced bank and corporate balance sheets. Given today's high connection between the real economy and global financial markets, this renders the country vulnerable to market risks. It is in this regard India should strive to open up its economy to more competition, which in turn, would encourage more efficiency in resource allocation, as well as better corporate governance.

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