

India

- **Current account outcome bettered expectations last quarter as sizable invisible surplus limited the deficit**
- **Reserve Bank of India eases restrictions on capital outflows in order to check INR appreciation**
- **Impressive advance tax collection hints at continued strength in corporate earnings**

Economic data this week highlighted an improvement in the current account position, as a surplus in “invisible” (nonmerchandise) trade contained the overall widening of the deficit. In other news, the central bank further liberalized the controls on foreign exchange outflows with an objective of curtailing rupee appreciation.

Improved current account deficit

India's current account (CA) balance posted a deficit of US\$4.7 billion in April-June. The merchandise trade deficit for the quarter was a significant US\$21.6 billion, but a sizable surplus on invisibles (US\$16.9 billion) limited the overall worsening of the CA deficit. As in previous quarters, net private transfers (US\$8.3 billion) and net exports of software services (US\$7.9 billion) pushed up the surplus in invisible trade.

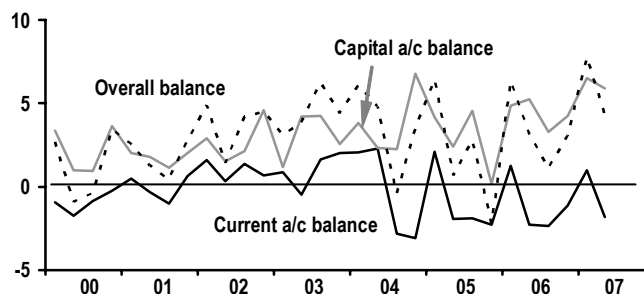
The capital account posted a surplus of US\$15.3 billion in 2Q07. The surplus was primarily driven by net portfolio investment (US\$7.5 billion) and external commercial borrowings (ECBs, amounting to US\$7.0 billion). Net portfolio investment and net ECBs together accounted for a considerable 95% of the capital account surplus, increasing India's vulnerability to any reversal of capital flows. While the restrictions on ECBs that became effective in early August will likely limit the inflow, portfolio investment continues to be strong.

Foreign direct investment (FDI) inflows remained strong at US\$6.4 billion, highlighting positive investor sentiment. FDI outflows (US\$6.0 billion) in 2Q07 almost kept pace with the inflows, resulting in a net inflow of only US\$0.5 billion. The overall balance of payments (BoP) posted a surplus of US\$11.2 billion in 2Q07.

Higher global crude oil prices and the recent significant INR appreciation will likely cause the CA deficit to widen further, to US\$13.6 billion (1.2% of GDP) in 2007-08 as a whole. However, strong capital inflows—especially of FDI—will more than offset the shortfall in the CA. Indeed, the overall BoP is poised to record another large surplus of

Balance of payments

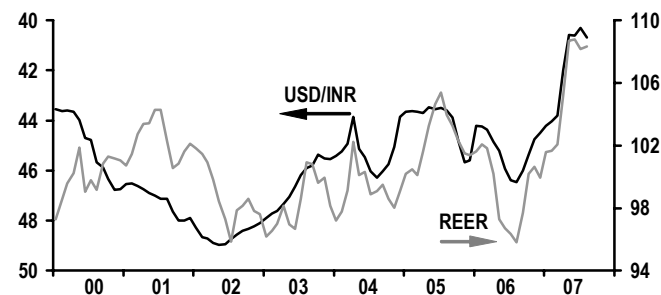
% of GDP, fiscal years beginning Apr 1



Spot exchange rate and JPMorgan real "broad" effective exchange

USD/INR, reverse axis

2000=100



US\$30-35 billion this year. JPMorgan expects further weakness in the US dollar to increase pressure on the rupee, causing USD/INR to appreciate to 39.5 by end-2007, and to gradually dip to 38 by 3Q2008.

Capital outflow rules liberalized

The Reserve Bank of India (RBI) has further liberalized controls on foreign exchange outflows for domestic companies, mutual funds, and individuals. The announcement marks a move towards implementing the third phase of the recommendations of the Tarapore committee for achieving fuller capital account convertibility in the balance of payments. The revised guidelines permit overseas investment in joint ventures or wholly owned subsidiaries by Indian companies of up to 400% of their net worth (up from an earlier 300%) under the automatic route that does not require permission from the RBI. The increased limit has also been extended to registered partnership firms.

The limit on listed companies making portfolio investments abroad has also been raised, to 50% of their net worth from the existing limit of 35%. The prerequisite of a 10% reciprocal shareholding in the listed Indian company for investment in these companies has been removed. Further, pre-

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payment of external commercial borrowings without the central bank's approval can now be made up to US\$500 million (previously US\$400 million), subject to compliance with the minimum average maturity period applicable to the loan. Mutual funds, registered with the Securities and Exchange Board of India (SEBI), are now allowed to make overseas investments worth US\$5 billion, up from US\$4 billion previously. However, the limit on investments up to US\$1 billion in overseas exchange-traded funds, by the limited number of qualified Indian mutual funds, continues to hold. Also, the limit on overseas remittances made by resident individuals has been enhanced from US\$1 million to US\$2 million in any fiscal year (April 1 to March 31).

The revised norms will allow greater capital outflow and are aimed at checking the rupee's appreciation. However, the impact of the revisions will probably be felt only over the medium term. In the near term, improving global risk appetite and the attractiveness of Indian financial assets will increase the appreciation pressure on the rupee, despite policymakers' view that the nominal appreciation of around 10.5% relative to the USD so far this year is overdone. We remain INR bulls over the medium term but expect aggressive fx intervention by the RBI to check INR appreciation in coming months.

Advance tax intake jumps

The government's advance tax collections grew 32%oya in April-September 21, 2007. Companies pay advance tax on their estimated earnings every year, breaking their payments into four installments instead of paying a lump sum at the end of the fiscal year. After factoring in refunds, the net direct tax take during the period was Rp1061 billion, against Rp755 billion a year ago. Corporate tax collections, at Rp672 billion, recorded growth of 42.4%oya. The impressive advance tax collections indicate continued strength in corporate earnings, which are likely boosting investor sentiment as well.

Data releases and forecasts

Weeks of October 1 - 12

During wk of Oct 1	Core infrastructure index			
	%oya, nsa			
	May	Jun	Jul	Aug
Overall	7.5	4.4	6.3	—
%m/m, sa	1.2	-0.4	1.3	—
Electricity	9.3	6.8	7.5	—
Coal	0.9	1.3	1.1	—
Finished steel	7.2	1.9	7.9	—
Crude petroleum	-1.6	-1.8	0.9	—
Petroleum refining	14.9	9.9	4.6	—
Cement	9.4	5.6	9.0	—

During wk of Oct 1	Merchandise trade			
	US\$ billion, nsa			
	May	Jun	Jul	Aug
Trade balance	-6.2	-7.3	-5.0	<u>-6.0</u>
Exports	11.9	11.9	12.5	<u>12.2</u>
%oya	18.1	14.1	18.5	<u>17.6</u>
Imports	18.1	19.2	17.5	<u>18.2</u>
%oya	26.4	36.7	20.4	<u>31.3</u>
Oil	4.7	5.7	5.0	—
Non-oil	13.3	13.5	12.5	—

Mon Oct 1	Foreign exchange reserves			
	US\$ billion			
	Jun	Jul	Aug	Sep 28
Total foreign reserves	213.5	229.3	229.3	—
Fx reserves ex gold	206.1	222.0	221.5	—

Fri Oct 5	Wholesale prices			
	%oya			
	Jun	Jul	Aug	Sep 22
Overall	4.5	4.4	4.0	<u>3.2</u>
Primary	7.4	9.7	9.2	—
Energy group	-0.8	-1.5	-2.0	—
Manufactured products	5.4	4.8	4.4	—

Fri Oct 12	Industrial production			
	%oya, nsa			
	May	Jun	Jul	Aug
Overall	10.9	9.0	7.1	<u>8.5</u>
%m/m, sa	0.6	-0.4	-1.2	<u>0.5</u>
Mining	3.6	1.5	4.9	—
Manufacturing	11.7	9.9	7.2	—
Electricity	9.4	6.8	7.5	—

Review of past week's data

Balance of payments (Sep 28)

US\$ billion	Oct-Dec			Jan-Mar		Apr-Jun	
Current account	-2.8	-2.0	-5.7	4.7			
Trade balance	-16.9	-15.2	-21.7	21.6			
Exports	30.7	34.0	—	34.7			
Imports	47.5	49.3	—	56.5			
Net invisibles	14.1	17.8	16.0	16.9			
Capital	10.5	17.1	—	15.3			
Overall balance	7.5	20.4	—	11.2			

See main essay.

Federal government fiscal balance (Sep 28)

INR billion	Jun			Jul		Aug	
Total receipts	388.8	311.6	—	693.7			
Revenue	385.3	308.6	—	687.9			
Tax (net)	357.5	224.4	—	194.5			
Nontax	27.8	84.2	—	493.5			
Total expenditure	891.5	481.6	—	433.0			
Plan	247.7	119.2	—	125.1			
Nonplan	643.8	362.5	—	308.0			
Interest payments	80.5	146.6	—	141.0			
Fiscal deficit	502.7	170.0	—	-260.7			
Revenue deficit	93.1	137.5	—	-288.9			
Primary deficit	422.2	23.4	—	-401.7			