

## INDIA

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## India Economics

### Impact of CNY Revaluation on India – Significant Step but Short Term Econ Impact Likely to be Limited

#### Key Points

- China bit the bullet yesterday and moved to a basket regime with a central parity initially represented by a USD/CNY value of 8.11 – representing a 2.1% bilateral revaluation against the US\$
- Although the exact timing was unknown, the CNY revaluation was imminent. Thus, while it is a significant step, the short term impact is likely to be limited as it has been largely priced in
- Following the CNY revaluation, the rupee strengthened from Rs43.5/US\$ to Rs43.2/US\$ - a six-year high - though it is currently trading at Rs43.38/US\$. While in the immediate near term we could see it overshoot, we maintain our year-end estimate of Rs42.5
- Given that the CNY appreciation has resulted in a modest appreciation across all Asian currencies, the net impact on exports is unlikely to be significant. The key to watch out for is the extent of rupee appreciation vs. the other currencies
- We could see a marginal improvement on the trade account as imports – especially of commodities such as oil - would become cheaper. This in turn would be positive for inflation and interest rates

#### Exchange Rates (Local Currency per US Dollar, period average)

	2005E	2006E	2007E	2008E	2009E
China	8.11	7.75	7.28	6.77	6.30
India	43.4	42.1	40.9	38.8	36.9

Source: Citigroup estimates.

### China's Renminbi Revaluation – Finally Biting the Bullet

After heightened external pressures, China announced an exchange rate policy reform yesterday. The move has been long expected and has been built into Citigroup economic forecasts. Our China Economist, Yiping Huang, expected a renminbi band widening within a +/-5% by July.<sup>1</sup> The revaluation is smaller than expected, which means it should be easy to adapt to. However, it may encourage more speculative capital flows.

#### The mechanism<sup>2</sup>

Essentially; the reform involves (1) one-step revaluation; (2) introduction of the basket reference; (3) crawling-peg going forward. Key details of the statement are:

- PBOC abandons CNY's single peg to the USD and switches to a managed floating exchange rate regime based on market demand and supply with reference to an unidentified basket of currencies;

<sup>1</sup> Please see 'Rolling our RMB Call to the Next Three Months', Yiping Huang and Don Hanna, dated 19 May 2005.

<sup>2</sup> For further details, please see 'China and Malaysia move to Managed Floats', by Yiping Huang and Don Hanna, dated 21 July 2005. To see the original statement, please visit the PBOC website at [www.pbc.gov.cn](http://www.pbc.gov.cn)

- PBOC will announce the closing price of a foreign currency, such as the USD, traded against the RMB in the inter-bank fx market after the closing of the market on each working day, and will make it the central parity for the trading against the RMB on the following working day;
- As the initial step, PBOC adjusted the USD/CNY rate to 8.11 from 8.278 at the time of 19:00 of July 21, 2005
- The daily trading price of the USD against the CNY in the inter-bank fx market will continue to be allowed to float within a band of +/-0.3% around the central parity published by the PBOC. Trading prices of the non-USD currencies against the CNY will be allowed to move within a band announced by the PBOC (not announced in the policy statement)

While the initial step is a 2% revaluation of the CNY against the USD, further revaluations are likely if the market conditions determine so. In an extreme case if the CNY moves to the strong side of the band (0.3% appreciation) every day, it could imply a move by 3% within ten days. However, our China economist Yiping Huang is of the view that the authorities will probably try to prevent sharp change to the value of the currency through intervention.

### **How does the Renminbi Revaluation affect India?**

Our currency strategists have for long viewed the breaking of the yuan peg as of minor consequence to short-term economic performance, but a strong potential catalyst for financial market speculation.<sup>3</sup> It should be noted that appreciation of the renminbi, within the context of broader weakening in the trade-weighted dollar (TWD), was long a part of the set of expectations built into Citigroup economic forecasts for the U.S. and abroad, and probably the views of many others. China's announcement does more to preserve the status quo in our forecast outlook than change it.

#### **Exchange Rates (Local Currency per US Dollar, period average)**

	2005E	2006E	2007E	2008E	2009E
Japan	105	90	89	84	79
Euro Area	1.28	1.44	1.46	1.48	1.50
<b>China</b>	<b>8.11</b>	<b>7.75</b>	<b>7.28</b>	<b>6.77</b>	<b>6.30</b>
<b>India</b>	<b>43.4</b>	<b>42.1</b>	<b>40.9</b>	<b>38.8</b>	<b>36.9</b>
Hong Kong	7.80	7.80	7.80	7.81	7.81
Korea	991	900	884	884	884
Singapore	1.63	1.55	1.50	1.46	1.42
Taiwan	31.30	30.30	28.60	27.20	25.80
Indonesia	9289	8922	8927	9122	9321
Malaysia	3.78	3.68	3.50	3.32	3.16
Philippines	55.0	56.8	55.4	53.7	52.1
Thailand	39.2	38.1	37.4	36.2	35.2
Vietnam	15864	15910	15900	15900	15900

Source: Citigroup estimates.

<sup>3</sup> For more details, please see "Asian Currency Sturm and Drang- Real Impact vs. Speculation". Steve Wieting, dated 21 July 2005.

### **Currency Revaluation – A quick primer**

Briefly, when a country revalues its currency, there are repercussions on both the current as well as its capital account. An appreciation in the home currency leads to its exports becoming less competitive, while its imports become more expensive thus resulting in a widening of its trade deficit. However exports of other countries become more competitive thus benefiting their trade balance. As far as the capital account is concerned, an appreciation results in lower interest rates in the home country, thus inducing capital flows to those countries where interest rates are higher.

### **What the revaluation means for India – A scenario analysis**

Given that the CNY appreciation has resulted in a modest appreciation across all Asian currencies (with Malaysia also moving to a managed float), the net impact on exports is unlikely to be significant. The key to watch out for is the extent of rupee appreciation vs. the other currencies.

#### **Scenario 1 : Rupee appreciates IN LINE with other Asian currencies**

Simplistically, an appreciation in the CNY is likely to result in a modest appreciation in all Asian currencies including the rupee. Thus the net impact on exports would likely not be significant. Moreover, India is a relatively closed economy as exports account for barely 12% of GDP. IT services is most sensitive to INR changes and are included under Invisibles in the Balance of Payments. However, our IT services analyst has factored in a rupee appreciation slightly higher than our 12M estimate of Rs42.5

#### **Scenario 2 : Rupee appreciates MORE than other Asian currencies**

This scenario could result in exports becoming slightly less competitive. As imports would be relatively cheaper, it could result in a worsening of the trade deficit

#### **Scenario 3: Rupee appreciates LESS than other Asian currencies**

This would be positive but seems least likely given the buoyancy in forex flows

#### **Exports by Commodity – A China India Comparison (2003, US\$bn)**

	China	India
<b>Agricultural products</b>	<b>22.2</b>	<b>7.9</b>
<b>Fuels and mining products</b>	<b>18.1</b>	<b>6.4</b>
<b>Manufactures</b>	<b>397.0</b>	<b>48.0</b>
Of which		
Iron and steel	4.8	2.9
Chemicals	19.6	7.3
Machinery and transport equipment	187.8	6.1
Textiles and Clothing	79.0	13.5
Others	105.8	18.2
<b>Total</b>	<b>437</b>	<b>62</b>

Source: World Trade Organization.

## Disclosure Appendix

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