

EXTERNAL SECTOR

Impact of change in ECB norms



The Finance Ministry has tightened External Commercial Borrowing (ECB) norms on Tuesday, in a move aimed at curbing capital inflows into the economy and keeping the rupee from appreciating further.

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The move aims at keeping rupee expenditure under ECBs under check. Rupee expenditure under USD 20 mn is now subject to approval, in contrast with the automatic route earlier. Rupee expenditure over USD 20 mn has, in effect, been disallowed.

As per our estimates, capital flows worth USD 2.5 bn will likely be impacted. We have analyzed how far this move will impact the economy from five perspectives: (i) Total capital flows (ii) Domestic liquidity (iii) Exchange rate (iv) Credit offtake and (v) Interest rates.

Our analysis suggests that at a broad macro-economic level, the impact on capital flows and exchange rate will be marginal. Domestic credit, is however likely to see a rise as a result of the change in norms.

At a sectoral level, the move will largely be neutral. Since the impact on USD/INR is expected to be negligible, IT sector will not be impacted. The banking sector, however, will likely see a positive impact as credit creation rises. To the extent that capital goods imports' will replace domestic supplier, there will be a negative impact on domestic capital goods' manufacturers. For infrastructure requirements that need debt, there could be a negative impact, since they will now have to borrow at a higher cost in the domestic market.

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The change in ECB norms raises the following questions:

- How far will capital flows into India get impacted?
 - What will be the resultant impact on domestic liquidity?
 - What will be impact on USD/INR?
 - How far will the latest move affect domestic credit creation?
 - What will be the impact on domestic interest rates?
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- ◆ **Impact on capital flows:** India recorded gross capital flows of USD 227 bn in FY07, of which ECB flows were USD 21.2 bn. Our estimates suggest that rupee expenditure (including purposes which include rupee expenditure as only part of the total) for FY07 was roughly at about USD 3 bn. The rupee expenditure is little over 1% of gross capital flows into the country, and 13% of gross ECB flows. It does need to be noted, however, that rupee expenditure higher than USD 20 mn is over 80% of total rupee expenditure at USD 2.5 bn, while rupee expenditure up to USD 20 mn is USD 0.5 bn.

Assuming that all flows under rupee expenditure up to USD 20 mn get approved, rupee expenditure of over USD 20 mn is still not allowed. *This implies that the new ECB norms would shave off 1% of annual gross capital flows into the Indian economy.*

- ◆ **Impact on domestic liquidity:** For measuring the impact on domestic liquidity, we consider that all flows through rupee expenditure have been sterilized so far. This amounts to INR 101 bn (at the current exchange rate) lesser being created as domestic liquidity in a financial year. This compares with average daily bids received in the financial year so far at INR 30 bn.

Short-term liquidity (as measured amount sucked out by daily reverse repo auctions) will get lowered by 1.5% as a result of the new ECB norms.

The impact on systemic liquidity (as measured by broad money or M3) will be negligible.

- ◆ **Impact on USD/INR:** The USD/INR opened at a low of 40.9 the day after the announcement, possibly reflecting the impact on sentiment. It climbed back during the day, however, to close at USD/INR 40.5.

We expect negligible impact on USD/INR as a result of the changed ECB norms. However, in the short-term it lends a strong bias to our forecast that USD/INR will slip to the range of 41.1-41.3 in Q2 FY08.

- ◆ **Impact on domestic credit creation:** In the event that all rupee expenditure ECBs over USD 20 mn get directed to the domestic credit market, we do not see a significant dent on the overall credit outstanding in the system. Credit outstanding at the end of FY-07 was at INR 19.2 trn, implying that the change in norms will add only 0.5% to total credit creation. Incremental credit would increase by 2.1% annually.

The increased credit off take would add 0.6 percentage points to credit growth. In other words, credit growth could roughly increase from the current levels of 23.7% Y-o-Y to 24.3% Y-o-Y.

- ◆ **Impact on domestic interest rates:** How far domestic interest rates get impacted by increased credit creation will be a function of liquidity in the banking sector going forward. Recently, we have witnessed deposits growth rates over taking credit growth rate. Deposits growth rate picked up in Q4 FY07, when banks started hiking interest rates on deposits. However, with rising liquidity in the system, deposit rates have been cut by major commercial banks.

We consider a worst case scenario – (i) a decline in deposits growth rate to average FY07 levels of 21.3% and (ii) a rise in credit growth rate to 24.3% hereon. The credit-deposit ratio could get stretched over 75% because of this – up from the current level of 70.1%. Though the scenario is highly unlikely- since both the decline in deposits growth and credit creation will happen with a lag - the situation could put *upward pressure on lending rates in the system.*

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Recent Research

Date		Title
06-Aug-07	FOMC Decision	A look at the US economy in July
03-Aug-07	Inflation	Inflation softens
03-Jul-07	RBI Watch	Hawkish stance
31-Jul-07	Economy Release Calendar	
29-Jul-07	Pre-policy	Expect calm
27-Jul-07	Inflation	Inflation on the rise

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	95	40	24	6	175

* 10 stocks under review / rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	76	67	32

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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