Economics

# DBS Flash

## India's current account math to improve

DBS Group Research

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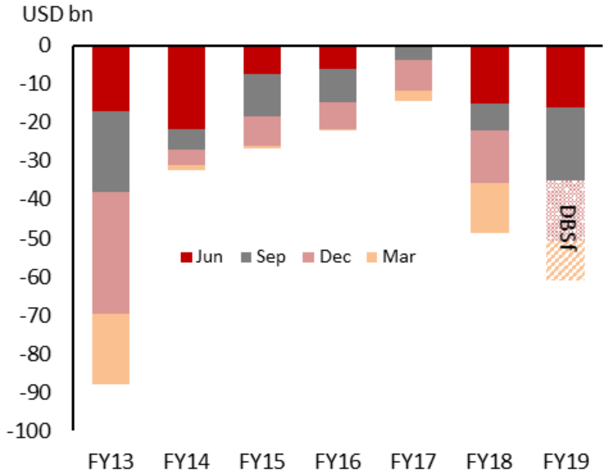
- *India's current account deficit has peaked*
- *Exports have moderated, but a recent increase in shipments to China is striking*
- *Current account deficit is likely to narrow to below 2.0% of GDP in second half of FY19, taking full year CAD to -2.3%. FY20's deficit is seen at a manageable 2.1% of GDP*
- *Financing of the current account gap has turned favourable as flows resume*
- *Supportive steps have been initiated to encourage portfolio (including a pre-set increase in FPI ceiling) and broader dollar flows*
- *The funding mix is tilting back towards volatile portfolio flows vs FDI*
- *The US Fed's dovish pivot and our expectations for Asia to benefit from carry interests is likely to favour India*

**The peak in the deterioration of India's current account deficit (CAD) is likely behind us.** CAD in Q1 FY19 i.e. June 2018 quarter rose from 2.6% of GDP to 2.9% in Q2 (July-September), marking a peak.

The deficit is likely to narrow to below 2.0% of GDP in second half of FY19, taking full year CAD to -2.3% (USD60bn).

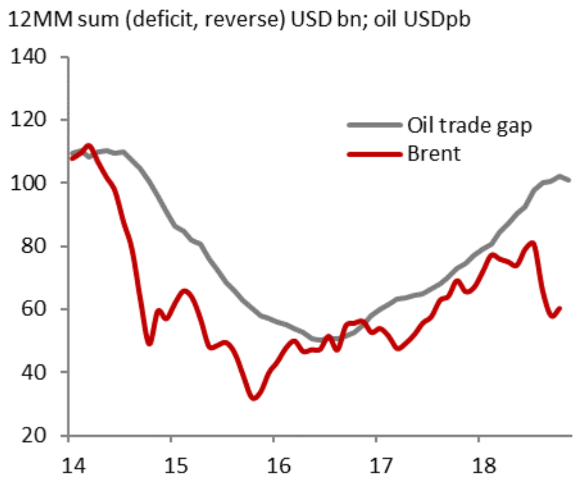
**Current account balance to improve in 2HFY19**




*Source: CEIC, DBS Group Research*

**India's trade balance benefited from tailwinds in second half of FY19**, key amongst which was a correction in global oil prices. Brent hit a high of USD85pb in October 2018 but have since swooned; an initial dip was followed by a rebound. Even at current levels, oil is still ~20% below 2018 highs. Monthly oil imports, as a result, moderated from USD14bn in October 2018 to USD9bn in February 2019 (helped by a firmer rupee), even as the annual oil bill is on course to surge 32% YoY in FY19, building on an 25% increase year before. Encouragingly, the twelve-month trailing net oil deficit is also beginning to turn down, as the chart highlights.

**Net oil trade deficit peaks**




*Source: CEIC, DBS Group Research*

**Secondly**, gold imports have moderated this year, barring seasonal volatility. High metal prices and a weak rupee, in midst of a benign price outlook, lowered the allure of the asset as an inflation hedge. **Next**, non-gold non-oil imports have slowed, primarily due to a decline in key segment of electronics (likely due to high import duties), transport equipment, chemicals etc. In part this also reflects a broader slowdown in growth, as easing consumption and is accompanied by weakening momentum in sectors previously serviced by non-bank funding support. **Finally,** there was also some marginal and seasonal support from exports, but higher shipments to China was the most striking (see here), which likely reflects benefits of better market access in recent months.

**Despite the anticipated improvement in 2H, the annual goods deficit is likely to end the year at a five-year high of USD180bn vs FY18's USD162bn.** This will be characterised by a weak CAD balance in 1HFY19 and better 2H. Accordingly, we expect the current account deficit to correct from -2.6% of GDP in 1H to below 2% in the second half, leaving the full-year CAD at -2.3% of GDP (revised down from our earlier estimate of -2.6%).

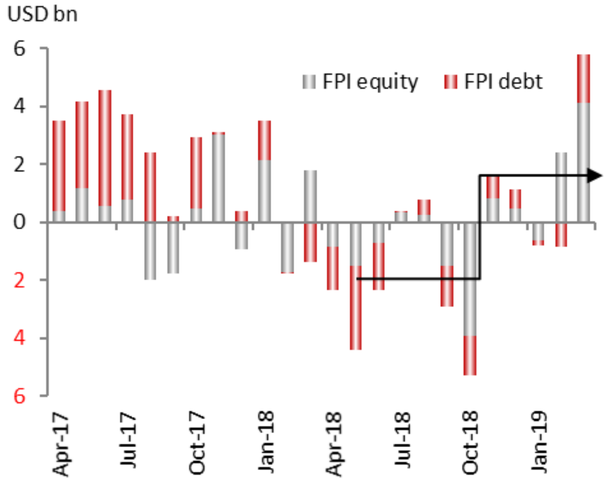
**Into FY20**, the CAD is likely to stay manageable at -2.1% of GDP, as a moderation in exports due to a challenging global environment, is offset by moderate imports owing to lower oil prices and softening demand.

## Financing mix turns favourable

**Equally important will be financing mix to fund the CAD.** Under the capital account, foreign portfolio investors were net sellers in the first two quarters of FY19, while FDI flows remained stable. The tide reversed in 2H as a decline in global yields drew interests back to the high-yielding EM assets, including the INR asset markets (see chart on right). For instance, foreign inflows (equity and debt) in the March 2019 quarter surged to USD6.7bn, reversing from the USD2.5bn outflows in the quarter before. While portfolio flows are historically more volatile than non-debt creating investment interests, nonetheless, improved sentiments have placated fears over a deterioration in India's balance of payments.

**Authorities have taken supportive steps to increase FPI flows (and USD inflows in general) into the Indian markets.** Recent highlights include -

**FPI flows make a strong comeback**




*Source: CEIC, DBS Group Research*

i) Introduction of the **Voluntary Retention Route (VRR)** for FPIs to invest in government and corporate debt, for an aggregate investment limit of INR400bn and INR350bn respectively. These will face a minimum retention period of three years but enjoy better operational freedom;
ii) Relaxing the **investor-wise concentration limits** on FPIs in corporate bonds;
iii) Higher limits for FPIs kick in. As laid out in April last year, **limits for FPIs will rise to 6% of outstanding bonds** in FY20 vs 5.5% in FY19. The cap will rise to INR6.98trn in H1FY20 and INR7.46trn (USD108bn) in H2 from INR 6.5trn in FY19 (USD94bn). We note that the current caps are still to be met (see table), with the incremental increase to translate into better flows when the risk environment turns supportive.

**Limits for FPI debt investments**

| Category | Limits as of end-FY19 | Revised* (INR bn) |
|---|---|---|
| Government bonds (general) | 2233 | 70 |
| Government bonds (long-term FPIs) | 923 | 42.5 |
| State Devel Loans (general) | 381 | 6.5 |
| State Devel Loans (long-term FPIs) | 71 | 0 |

*Source: CCIL, DBS Group Research*

iv) **Improve access of non-residents** to hedge their INR exposure onshore. This serves the dual purpose of lowering spillover rigidity in market prices due to a sizeable non-deliverable/offshore market and improving participation/volumes onshore. A case in point was the Mar 27 move to permit non-residents to access the onshore Overnight Indexed Swap (OIS) market, which was in addition to access for hedging their INR rate risk. An offshoot of a recent swap measure, directed to improving INR liquidity, also helped to lower forward premia and overall hedging costs.

v) **Expanding the external commercial borrowings framework** to a wider pool of borrowers and investors, including non-banks, which helps diversify their funding risks and sources.

**FDI inflows started the year on a strong note but look likely to end the year nearly flat – first three quarters of FY19 FDI equity totalled USD33.5bn vs USD35.9bn same time last year**. The breakdown reveal that flows from a key investor - Mauritius declined 55% YoY in April-December18, partly reflecting the effect of tighter taxation regulations after the bilateral treaty with India underwent significant changes two years back. Flows might moderate further as full capital gains tax kicks in April 2019, after a two-year transition period. Even as part of this fall has been offset by a 40% jump from Singapore, overall flows are expected to moderate, owing to exogenous factors like protectionist external policies and slowing global growth. **This might keep the basic balance of payments (CAD+FDI) under pressure.**

**Where does this leave the overall balance of payments? We expect the BOP deficit in H1 FY19 to swing to a modest surplus in the final quarter of FY19.** This improvement is also reflected in higher FX reserves and better rupee performance. **For FY20,** the BOP position might remain in a small surplus, if financial flows sustain, assuming markets’ recessionary concerns risks prove to be over-pessimistic and oil prices stabilise around USD65-70bp range. Domestically, India’s twin deficits are under control and inflation, while likely to be higher from this year, is unlikely to be a threat to overall price stability in FY20. Factoring in a modest recovery in growth, portfolio and investment inflows are expected to return, supporting the BOP position.

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**Sources**: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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