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Q3 CAD rises by 11.2% YoY

Continued weakness in invisibles a concern

India's Q3FY17 CAD rose 11.2% YoY to US$ 7.9bn (1.4% of GDP), surprising positively (US$ 12bn estimated). Remittances and service export earnings continued to decline, a key concern amid the increase in merchandise trade deficit. FII outflows and FCNR(B) redemptions led to a net reserve decretion of US$ 1.2bn. We expect the FY18 CAD to deteriorate to 1.7% of GDP (FY17E: 0.9%) and the INR to weaken to ~70 against the USD by FY18-end.

REPORT AUTHORS

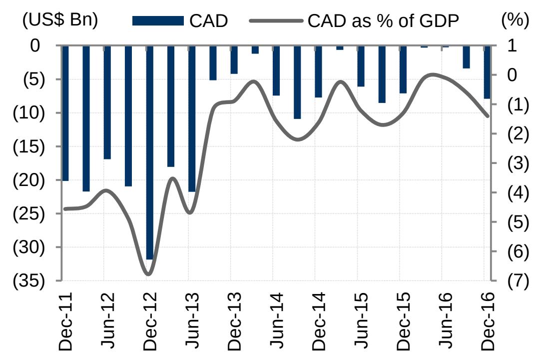
Rahul Agrawal
India Economist
+91 22 6766 3433
ag.rahul@religare.com

- **Q3 CAD surprises:** India's CAD rose by 11.2% YoY to US$ 7.9bn (1.4% of GDP) in Q3FY17, rising for the first time in last eight quarters. While higher YoY, Q3 CAD came in sharply lower than market expectations; as per a Bloomberg poll, it was expected to shoot up to US$ 12bn from an average US$ 1.3bn during the first three quarters of 2016. The YoY increase was driven by a decline in remittances and service exports.
- **Remittances drop to a 5.5-year low:** Net remittances to India fell by 8.9% YoY to a 5.5-year low of US$ 13.9bn in Q3FY17, declining for the seventh straight quarter. The slump in remittances reflected the impact of sharply lower oil prices on the Middle Eastern economies. About ~55% of remittance flows to India come from the oil-dependent Gulf economies. With oil prices unlikely to recover significantly in the near term, the outlook for remittances remains weak.

  Earnings from net exports of services stayed weak, down 2.1% YoY to US$ 17.6bn on lower earnings from software and financial services, and higher charges for intellectual property rights. Sluggish growth in advanced economies (~80-85% of India's service export earnings) has hurt India's service export earnings in the last six quarters.
- **Merchandise trade deficit surges QoQ:** India's Q3FY17 merchandise trade deficit declined marginally by 2.1% YoY to US$ 33.3bn, but was sharply higher than the average quarterly deficit of US$ 24.7bn for the last three quarters. The sequential increase is driven by a surge in gold imports owing to seasonal demand. Besides, non-oil, non-gold imports touched a two-year high in the quarter.
- **FII outflows, FCNR redemption hurts capital flows:** India saw record FII outflows of US$ 11.4bn during Q3. Of these, US$ 6.6bn were from debt securities given the (a) a sharp rise in US (and global) bond yields post US election results and (b) a slump in India's bond yields owing to demonetisation. As largely anticipated, a net of US$ 18.5bn exited the country due to FCNR(B) redemptions in Q3. ECB outflows continued for the sixth straight quarter, as repayments exceeded fresh issuances by US$ 1.8bn. On a positive note, FDI inflows remained healthy at US$ 9.8bn in Q3, in line with the average for the last six quarters.

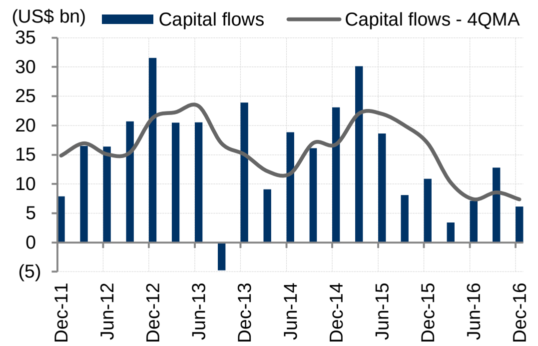
  Owing to the slump in capital flows, India witnessed a net reserve decretion of US$ 1.2bn in Q3 vs. an average quarterly accretion of US$ 7.7bn/US$ 4.5bn during H1FY17/FY16.

CAD rises to US$ 7.9bn in Q3FY17



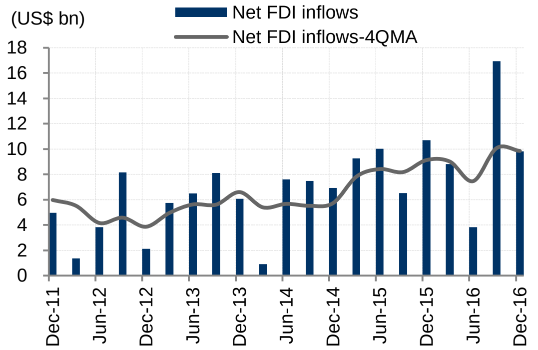
Source: RBI, RCML Research

Capital flows remain weak in Q3FY17



Source: RBI, RCML Research

FDI inflows continue to remain healthy



Source: RBI, RCML Research

- **CAD to worsen in FY18:** India's CAD halved to 0.7% of GDP for 9MFY17 from 1.4% for the year-ago period. The improvement was entirely led by a fall in the oil and non-oil merchandise trade deficit with remittances and service export earnings continuing to decline. We expect the Q4FY17 CAD to deteriorate YoY as savings in net oil trade dissipate due to the low base effect (average oil prices in Q4FY16: US$ 33/bbl) while remittances and service exports continue to decline. We expect the full-year FY17 CAD number to come in at 0.9% of GDP (FY16: 1.1%). The sharp fall in CAD should lead to an accretion of ~US$ 18bn in FY17, in line with that seen during FY16.

  We expect the CAD to deteriorate to ~1.7% of GDP in FY18 on a higher merchandise trade deficit and a continued weakness in remittances. Capital flows are also unlikely to improve significantly given that the India-US interest rate differential has narrowed by ~50-60bps over the last five months, falling below the long-term average; this in turn would hurt all forms of debt flows. This differential may narrow further with impending Fed rate hikes and expectations of an expansionary US fiscal policy. Besides, events such as Brexit, elections across Europe (Netherlands, France, Germany) and changes in the US trade policies could also lead to a risk-off globally, hurting capital flows to India.

- **INR set to weaken against USD:** We believe the recent strength in the INR is largely due to strong flows post the UP election results, and the currency should witness a depreciating bias given deterioration in the BOP and a declining interest rate differential. We expect the INR to weaken to ~70 against the US dollar by end-FY18.

Fig 1 - Quarterly trends in India's BOP

(US$ bn)	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Apr-Dec'15	Apr-Dec'16
Current account as % of GDP	(0.2)	(1.2)	(1.7)	(1.3)	(0.1)	(0.1)	(0.6)	(1.4)	(1.4)	(0.7)
Current account balance	(0.6)	(6.1)	(8.5)	(7.1)	(0.3)	(0.3)	(3.4)	(7.9)	(21.8)	(11.6)
Merchandise trade deficit	(31.6)	(34.2)	(37.2)	(34.0)	(24.8)	(23.8)	(25.6)	(33.3)	(105.3)	(82.8)
Exports	71.8	68.0	67.6	64.9	65.8	66.6	67.4	68.8	200.5	202.8
Imports	103.4	102.2	104.7	98.9	90.6	90.5	93.1	102.0	305.9	285.5
Invisibles	30.9	28.1	28.6	26.9	24.4	23.6	22.2	25.4	83.6	71.2
Services	20.1	17.8	17.8	18.0	16.1	15.7	16.3	17.6	53.6	49.7
Primary Income	(5.6)	(5.9)	(5.5)	(6.4)	(6.6)	(6.2)	(7.9)	(6.2)	(17.8)	(20.3)
Secondary Income	16.4	16.2	16.3	15.3	15.0	14.0	13.9	13.9	47.7	41.8
Capital flows	12.5	(0.1)	(3.5)	0.6	(1.5)	2.1	6.1	(11.4)	(3.0)	(3.2)
Direct investments	9.3	10.0	6.5	10.7	8.8	3.8	16.9	9.8	27.2	30.6
Portfolio investments	12.5	(0.0)	(3.5)	0.6	(1.5)	2.1	6.1	(11.3)	(3.0)	(3.2)
Accretion(+)/decretion (-) to reserves	30.1	11.4	(0.9)	4.1	3.3	7.0	8.5	(1.2)	14.6	14.2

Source: RBI, RCML Research

RESEARCH TEAM

ANALYST	SECTOR	EMAIL	TELEPHONE
Varun Lohchab (Head – India Research)	Consumer, Strategy	varun.lohchab@religare.com	+91 22 6766 3470
Siddharth Vora, CFA	Auto, Auto Ancillaries, Cement	siddharth.vora@religare.com	+91 22 6766 3435
Navin Sahadeo	Cement, Auto, Auto Ancillaries	navin.sahadeo@religare.com	+91 22 6766 3439
Aman Chaplot	Cement, Auto, Auto Ancillaries	aman.chaplot@religare.com	+91 22 6766 3459
Prashant Tiwari, CFA	Capital Goods, Infrastructure, Utilities	prashant.tiwari@religare.com	+91 22 6766 3485
Manish Poddar	Consumer	manish.poddar@religare.com	+91 22 6766 3468
Aditya Joshi	Consumer	aditya.joshi@religare.com	+91 22 6766 3469
Rohit Ahuja	Energy	ahuja.rohit@religare.com	+91 22 6766 3437
Akshay Mane	Energy	akshay.mane@religare.com	+91 22 6766 3438
Parag Jariwala, CFA	Financials	parag.jariwala@religare.com	+91 22 6766 3442
Vikesh Mehta	Financials	vikesh.mehta@religare.com	+91 22 6766 3474
Akash Nainani	Financials	akash.nainani@religare.com	+91 22 6766 3466
Rumit Dugar	IT, Telecom, Media	rumit.dugar@religare.com	+91 22 6766 3444
Pritesh Jani	Metals	pritesh.jani@religare.com	+91 22 6766 3467
Arun Baid	Mid-caps	arun.baid@religare.com	+91 22 6766 3446
Manish Mahawar	Mid-caps	manish.mahawar@religare.com	+91 22 6766 3471
Saurabh Rathi	Mid-caps	saurabh.rathi@religare.com	+91 22 6766 3451
Praful Bohra	Pharmaceuticals	praful.bohra@religare.com	+91 22 6766 3463
Aarti Rao	Pharmaceuticals	aarti.rao@religare.com	+91 22 6766 3436
Rahul Agrawal	Economics & Strategy	ag.rahul@religare.com	+91 22 6766 3433

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