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BoP Review

Volatile capital flows to enervate CAD buffer

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Alongwith widening CAD to 1.6% of GDP in Q2, the capital account balance also narrows down thereby resulting in depletion in forex reserves by USD 0.9bn. Sharp correction in global commodity prices and weak global demand deterred growth in trade of goods and services. Lead indicators such as FDI investment, FII and NRI deposits are suggesting that flows are trending downwards from their peaks in May'15. INR weakened much in line with our expectations, we believe further depreciation of INR to 68-70 is on cards. Large FII investments in Indian debt market in FY15, has compressed the carry spread close to historical low levels, implying that INR depreciation can trigger market volatility through rates markets, especially with Fed increasing the rates. This will further impact the volatility in the capital account balance.

Global trade remains sluggish

Merchandise deficit widened further to 7.4% of GDP in Q2FY16 from an 8-year low of 6.0% in Q4FY15 as plunge in exports was more pronounced compared to decline in imports. However, deficit has narrowed down so far in Q3FY16 due to sharp decline in non-oil imports. Overall capital goods trade remained lacklustre in 1HFY16 as engineering goods exports contracted by 12%, more sharply than the 2.2% decline in imports.

Forex reserve coverage has improved to ~10 months of import from a low of 6.6 months in Sep'13, aided by NRI deposit mobilisation in 2013 and subsequent surge in portfolio flows. This improvement in external sector stability indicator can, however moderate with rise in US rates going forward, which we believe can induce volatility in India's external capital flows.

Net services exports contracted by 5.5% YoY in Q2 due to decline in transport, insurance and pension services. This is despite a better performance of the IT services, which grew by 7.7% in Q2FY16.

Outflow on account of increase in FDI flows investment income has remained steady at USD5.4bn in Q2. Notable increase in investment inflows in India in the past will continue to elevate repatriation of investment income from India. Net compensation to employees surged to all time high level of USD400mn.

Banking capital contributes largely to capital flows

Capital account balance narrows down to nearly half in USD7.2bn i.e. 1.4% of GDP, reversal in FII debt inflows and repayment commercial borrowing contributed mainly to this slowdown. Net equity FII outflow was approximately USD6.1bn which led to sharp slowdown in total foreign investment which dropped near to 7 year low in this quarter. Outflow was observed in commercial borrowings with significant rise in repayments in last two quarters. We believe, external borrowings will continue to remain moderate with the slower than expected improvement in the private investment activity and rising CDS spreads. Net loans availed by banks witnessed an inflow USD7.3bn mainly on account of a sale in foreign currency assets held abroad. NRI deposits slowed down in Q2 USD4.2bn as compared to USD5.9bn in Q1.

Outlook: BoP vulnerability to rise

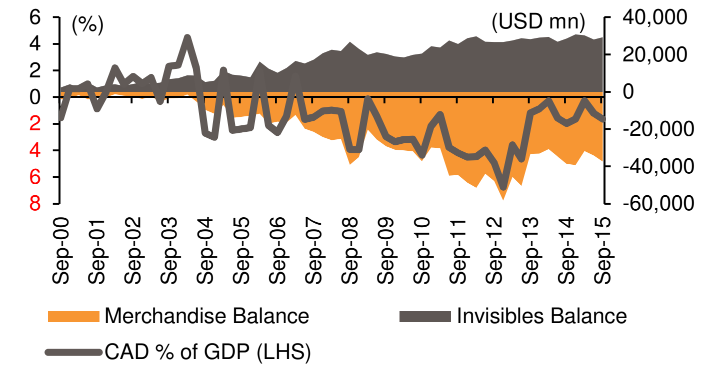
We believe, there would be inherent pressure on CAD- if counter cyclical policies are undertaken by the government, rising EM yields, volatility in the currency and lower external demand recovery. We estimate CAD to widen to 1.8% of GDP in FY16 from 1.4% in FY15 with limited improvement from the exports growth. Compressed carry cost to historical low levels implies that currency volatility can risk outflows from Indian debt market.

Exhibit 1: Sharp surge in Banking capital inflow

USD bn	Q2 FY16	Q1 FY16	Q2 FY15	1H FY16	1H FY15
FDI	6.6	10.1	8.0	16.7	16.2
FII	(6.6)	(2.7)	9.9	(9.4)	22.3
Commercial Borrowings	(1.1)	0.3	1.7	(0.9)	3.4
Banking Capital	7.3	11.0	(0.4)	18.3	(0.5)
Capital Account	7.2	18.1	18.7	25.4	38.5
Capital Account % of GDP	1.4	3.5	3.7	2.5	3.8
Net Accretion to Forex Reserves	(0.9)	11.4	6.9	10.6	18.1

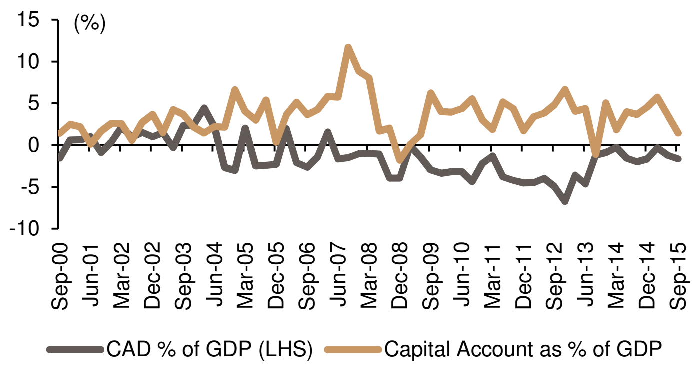
Source: RBI, Emkay Research

Exhibit 2: CAD widens to 1.6% of GDP



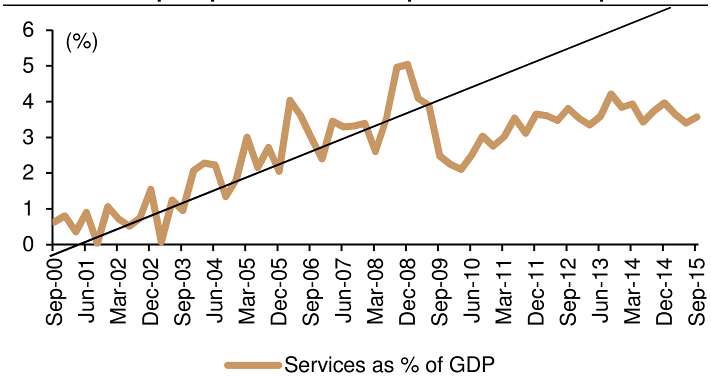
Source: RBI, Emkay Research

Exhibit 3: Capital account further narrows down to 1.4% of GDP



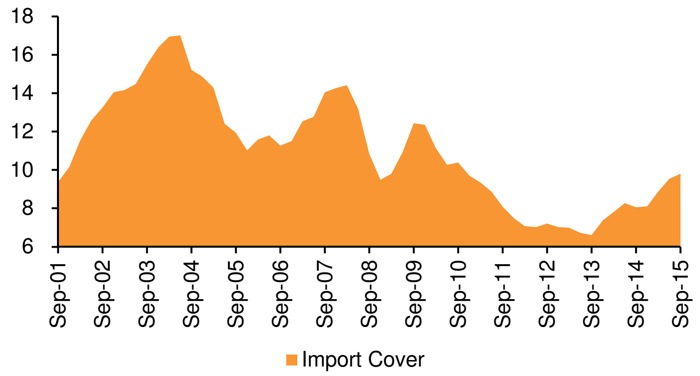
Source: RBI, Emkay Research

Exhibit 4: Sharp drop in net services exports in the recent past



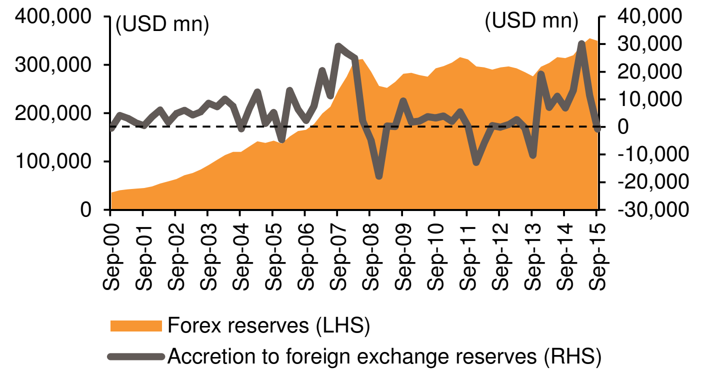
Source: RBI, Emkay Research

Exhibit 5: Import cover improves to 9.5 months



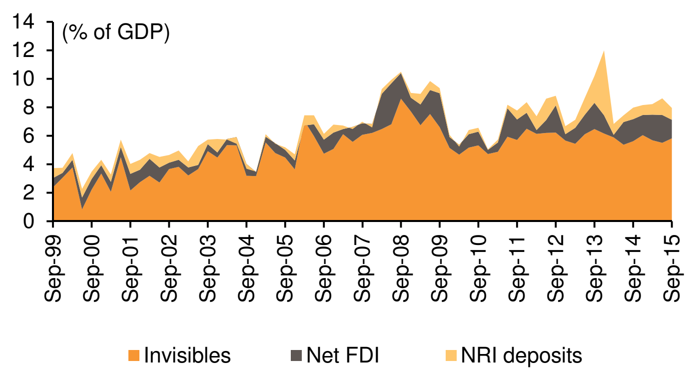
Source: RBI, Emkay Research

Exhibit 6: Shrinking in net forex reserves after 2 years of accretion



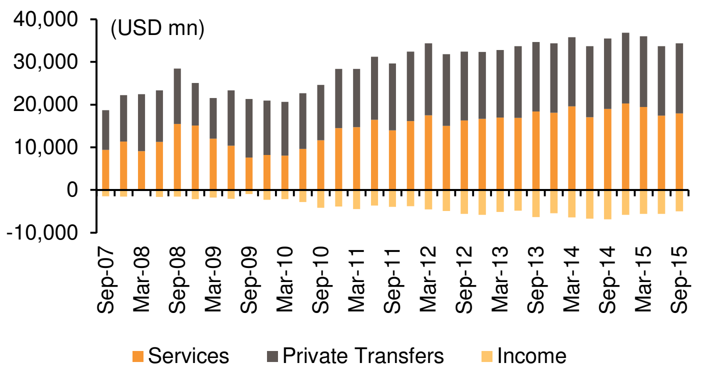
Source: RBI, Emkay Research

Exhibit 7: Decline in structural support could expose BoP to risk with reversal in capital flows



Source: RBI, Emkay Research

Exhibit 8: Invisibles remains flat in Q2



Source: RBI, Emkay Research

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