Asia Insights

Fixed Income | Asia Ex-Japan

NOMURA

FIXED INCOME RESEARCH

27 JUNE 2013

India: Financing is the main challenge

Economists

Sonal Varma
+91 22 4037 4087
sonal.varma@nomura.com

Aman Mohunta
+91 22 6617 5595
aman.mohunta@nomura.com

Strategists

Craig Chan
+65 6433 6106
craig.chan@nomura.com

Prateek Gupta
+65 6433 6197
prateek.gupta@nomura.com

This report can be accessed electronically via: www.nomura.com/research or on Bloomberg(NOMR)

- The current account deficit (CAD) narrowed to 3.6% of GDP in Q1 2013 from 6.5% of GDP in Q4 2012, better than expected and largely due to a seasonal moderation in the trade deficit.
- Net capital inflows have also moderated, but were sufficient to finance the current account deficit, leading to an overall balance of payment surplus. Elsewhere, external debt rose to 21.1% of GDP in Q1 2013 from 20.6% in Q4 2012.
- We expect the CAD to widen again to 5.5-6.0% of GDP in Q2 2013, but narrow to 4.3% of GDP in FY14 (4.8% in FY13). However, we reckon that financing the deficit will remain challenging this year.
- **FX INR strategy:** We are currently maintaining our short bias towards INR (vs. IDR) because of India's external vulnerability and lack of policy response.

Current account deficit narrows

India's CAD narrowed to USD18.2bn (3.6% of GDP) in Q1 2013 from an all-time high of USD31.8bn (6.5%) in Q4 2012, and was better than expected (Consensus: USD21.0bn, Nomura: USD21.3bn). The surprise was due to a lower-than-expected merchandise trade deficit, while the invisibles surplus came in largely in line with expectations (Figure 1).

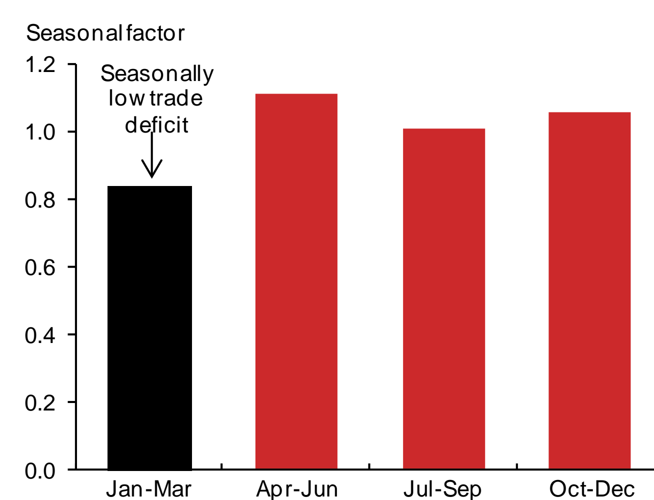
The merchandise trade deficit moderated to USD45.6bn in Q1 2013 from USD58.4bn in Q4 2012. Though a large part of the USD12.7bn q-o-q moderation in trade deficit was seasonal (Figure 2), the narrower-than-expected deficit suggests defence imports also moderated. By contrast, invisibles remained weak as remittances and service exports were lower than their year ago levels and on account of investment income outflows due to rising interest payments. For full year FY13, the CAD rose to a record high of 4.8% of GDP (up from 4.2% in FY12), while the merchandise deficit rose to 10.6% of GDP (10.1%).

Fig. 1: Balance of payment summary

USD bn	Q3 12	Q4 12	Q1 13	FY12	FY13
Current Account	**(21.1)**	**(31.8)**	**(18.2)**	**(78.2)**	**(88.2)**
Merchandise	(47.8)	(58.4)	(45.6)	(189.8)	(195.7)
Invisibles	26.7	26.6	27.5	111.6	107.5
Services	16.3	16.6	17.0	64.1	64.9
Transfers	15.9	15.8	15.7	63.5	64.0
Investment Income	(5.6)	(5.8)	(5.2)	(16.0)	(21.5)
Capital Account	**20.7**	**31.5**	**20.5**	**67.8**	**89.3**
Net FDI	8.2	2.1	5.7	22.1	19.8
Portfolio Investments	7.7	9.8	11.3	17.2	26.9
Commercial borrowings	1.0	2.8	4.2	10.3	8.5
Short-term loans	4.1	7.7	4.5	6.7	21.7
Banking capital	5.5	5.2	(3.6)	16.2	16.6
Others	(5.7)	3.9	(1.6)	(4.7)	(4.1)
Overall BoP	(0.2)	0.8	2.7	(12.8)	3.8
Current account (% of GDP)	**5.0**	**6.5**	**3.6**	**4.2**	**4.8**

Source: CEIC and Nomura Global Economics

Fig. 2: Seasonality in merchandise trade deficit



Source: CEIC and Nomura Global Economics estimates

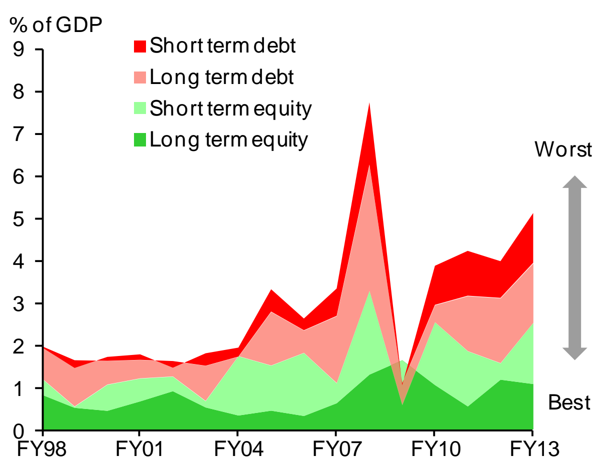
…so does capital account surplus

Net capital inflows moderated to USD 20.5bn in Q1 2013 from USD31.8bn in Q4, but still more than offset the CAD, resulting in an overall balance of payments surplus of USD2.7bn in Q1. Worryingly, portfolio flows accounted for 55% of total capital flows and the recent reversal in portfolio flows indicates increased vulnerability on the capital account in the coming quarters. For full year FY13, India managed to more than finance the CAD and clocked a BoP surplus of USD3.8bn. However, the quality of flows is concerning. Net FDI inflows – the most stable form of inflows – moderated to USD19.8bn in FY13 from USD22bn in FY12, while the most vulnerable short-term debt flows rose to USD21.7bn in FY13 from USD16.2bn in FY12 (Figure 3), increasing the burden of financing repayments on top of an already elevated CAD.

External debt deteriorates further

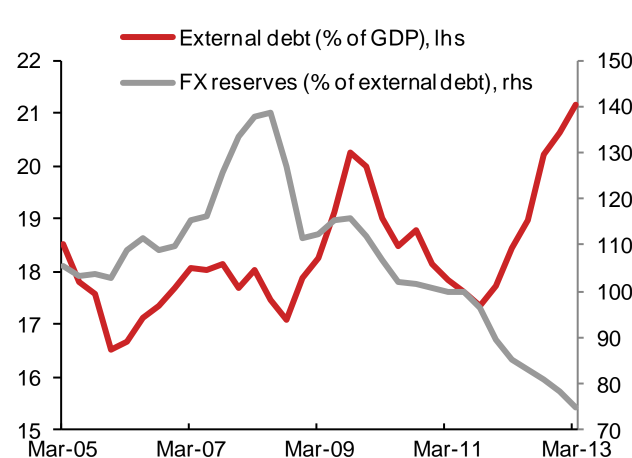
Total external debt increased to 21.1% of GDP (USD 390bn) as of March 2013 from 20.6% of GDP (USD376.3bn) at end-December 2012, mainly due to a sharp increase in external commercial borrowings, short-term trade credit and NRI deposits. The FX reserves cover of total external debt fell to 75% in Q1 from 85% a year ago (Figure 4).

Fig. 3: Capital flows



Source: CEIC and Nomura Global Economics

Fig. 4: External debt



Source: CEIC and Nomura Global Economics

Outlook

In the near term, we expect the CAD to worsen again to around 5.5-6.0% of GDP in Q2 2013 on a wider merchandise trade deficit (seasonality and higher gold imports in April-May). However, we expect the trade deficit to start improving from June due to lower gold imports. A weak currency bodes well for private transfers, but rising investment income outflows and weak services demand will be a drag on invisibles. For the full year we expect the CAD at 4.3% of GDP in FY14 from 4.8% in FY13. Despite a narrower CAD, we expect financing to be a challenge for the following reasons: 1) the risk of a reversal of portfolio inflows; 2) the sharp rise in short-term trade credit has raised rollover risk (see: *India: Short-term external debt on the rise*, 27 June 2013) and 3) NRI deposits are unlikely to be as strong. Because of the increased volatility in global financial markets, financing the deficit will be difficult.

FX Strategy

We are currently holding onto our short INR (vs. IDR) recommendation despite a better-than-expected improvement in the Q1 2013 current account deficit to USD18.2bn after hitting a record high of USD 31.8bn in Q4 2012. Although the narrower current account deficit (3.6% of GDP) is headline positive for INR, it is seen as largely seasonal and should widen back out to 5.5-6.0% of GDP in Q2 2013. In addition, the rationale we highlighted for INR weakness remains intact (see First Insights: USD/INR: Remain long USD, but watchful of potential measures, 26 June 2013). Those include INR remaining notably overvalued at around 17.6% (based on filtered FEER and SEER model) despite the recent INR depreciation. Foreign portfolio positioning in local asset markets remains high and especially in the equity market ,where we estimate that foreign ownership as a percentage of market capitalization is close to the all-time high at 23.2%. This is despite the USD1.5bn worth of foreign equity outflows this month (1-25 June). In addition, our economists now expect the RBI to be on hold for a prolonged period because of the negative impact of INR depreciation on import prices, which is likely to be negative for the growth outlook and hence foreign equity inflows.

However, we remain wary of the government/RBI announcing new measures to support the INR, which could include further FDI liberalization and NRI bond issuance. The latter, if announced and successfully managed, could cause a sharp, but temporary rally in INR. However, unless global risk conditions stabilise and there are structural reforms, continued RBI intervention is unlikely to bear any fruit given India’s weak external position. Furthermore, reduced FX reserves raises doubts about the sustainability given the low FX reserve coverage ratios (around 6 times imports and 3 times short-term external debt).

Disclosure Appendix A-1

ANALYST CERTIFICATIONS

We, Sonal Varma, Aman Mohunta, Craig Chan and Prateek Gupta, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Issuer Specific Regulatory Disclosures

The term \"Nomura Group\" used herein refers to Nomura Holdings, Inc. or any of its affiliates or subsidiaries, and may refer to one or more Nomura Group companies.

Issuer	Disclosures
REPUBLIC OF INDIA	A1,A2

A1 Nomura Securities International, Inc has received compensation for non-investment banking products or services from the issuer in the past 12 months.

A2 Nomura Securities International, Inc had a non-investment banking securities related services client relationship with the issuer during the past 12 months.

Important Disclosures

Online availability of research and conflict-of-interest disclosures

Nomura research is available on www.nomuranow.com/research, Bloomberg, Capital IQ, Factset, MarkitHub, Reuters and ThomsonOne. Important disclosures may be read at http://go.nomuranow.com/research/globalresearchportal/pages/disclosures/disclosures.aspx or requested from Nomura Securities International, Inc., on 1-877-865-5752. If you have any difficulties with the website, please email grpsupport@nomura.com for help.

The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by Investment Banking activities. Unless otherwise noted, the non-US analysts listed at the front of this report are not registered/qualified as research analysts under FINRA/NYSE rules, may not be associated persons of NSI, and may not be subject to FINRA Rule 2711 and NYSE Rule 472 restrictions on communications with covered companies, public appearances, and trading securities held by a research analyst account.

Nomura Global Financial Products Inc. (“NGFP”) Nomura Derivative Products Inc. (“NDPI”) and Nomura International plc. (“NIplc”) are registered with the Commodities Futures Trading Commission and the National Futures Association (NFA) as swap dealers. NGFP, NDPI, and NIplc are generally engaged in the trading of swaps and other derivative products, any of which may be the subject of this report.

ADDITIONAL DISCLOSURES REQUIRED IN THE U.S.

Principal Trading: Nomura Securities International, Inc and its affiliates will usually trade as principal in the fixed income securities (or in related derivatives) that are the subject of this research report. Analyst Interactions with other Nomura Securities International, Inc. Personnel: The fixed income research analysts of Nomura Securities International, Inc and its affiliates regularly interact with sales and trading desk personnel in connection with obtaining liquidity and pricing information for their respective coverage universe.

Valuation methodology - Fixed Income

Nomura's Fixed Income Strategists express views on the price of securities and financial markets by providing trade recommendations. These can be relative value recommendations, directional trade recommendations, asset allocation recommendations, or a mixture of all three.
The analysis which is embedded in a trade recommendation would include, but not be limited to:
• Fundamental analysis regarding whether a security's price deviates from its underlying macro- or micro-economic fundamentals.
• Quantitative analysis of price variations.
• Technical factors such as regulatory changes, changes to risk appetite in the market, unexpected rating actions, primary market activity and supply/ demand considerations.
The timeframe for a trade recommendation is variable. Tactical ideas have a short timeframe, typically less than three months. Strategic trade ideas have a longer timeframe of typically more than three months.

Disclaimers

This document contains material that has been prepared by the Nomura entity identified at the top or bottom of page 1 herein, if any, and/or, with the sole or joint contributions of one or more Nomura entities whose employees and their respective affiliations are specified on page 1 herein or identified elsewhere in the document. The term "Nomura Group" used herein refers to Nomura Holdings, Inc. or any of its affiliates or subsidiaries and may refer to one or more Nomura Group companies including: Nomura Securities Co., Ltd. ('NSC') Tokyo, Japan; Nomura International plc ('NIplc'), UK; Nomura Securities International, Inc. ('NSI'), New York, US; Nomura International (Hong Kong) Ltd. ('NIHK'), Hong Kong; Nomura Financial Investment (Korea) Co., Ltd. ('NFIK'), Korea (Information on Nomura analysts registered with the Korea Financial Investment Association ('KOFIA') can be found on the KOFIA Intranet at http://dis.kofia.or.kr); Nomura Singapore Ltd. ('NSL'), Singapore (Registration number 197201440E, regulated by the Monetary Authority of Singapore); Nomura Australia Ltd. ('NAL'), Australia (ABN 48 003 032 513), regulated by the Australian Securities and Investment Commission ('ASIC') and holder of an Australian financial services licence number 246412; P.T. Nomura

Indonesia ('PTNI'), Indonesia; Nomura Securities Malaysia Sdn. Bhd. ('NSM'), Malaysia; NIHK, Taipei Branch ('NITB'), Taiwan; Nomura Financial Advisory and Securities (India) Private Limited ('NFASL'), Mumbai, India (Registered Address: Ceejay House, Level 11, Plot F, Shivsagar Estate, Dr. Annie Besant Road, Worli, Mumbai- 400 018, India; Tel: +91 22 4037 4037, Fax: +91 22 4037 4111; SEBI Registration No: BSE INB011299030, NSE INB231299034, INF231299034, INE 231299034, MCX: INE261299034) and NIplc, Madrid Branch ('NIplc, Madrid'). 'CNS Thailand' next to an analyst's name on the front page of a research report indicates that the analyst is employed by Capital Nomura Securities Public Company Limited ('CNS') to provide research assistance services to NSL under a Research Assistance Agreement. CNS is not a Nomura entity.

THIS MATERIAL IS: (I) FOR YOUR PRIVATE INFORMATION, AND WE ARE NOT SOLICITING ANY ACTION BASED UPON IT; (II) NOT TO BE CONSTRUED AS AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY ANY SECURITY IN ANY JURISDICTION WHERE SUCH OFFER OR SOLICITATION WOULD BE ILLEGAL; AND (III) BASED UPON INFORMATION FROM SOURCES THAT WE CONSIDER RELIABLE, BUT HAS NOT BEEN INDEPENDENTLY VERIFIED BY NOMURA GROUP.

Nomura Group does not warrant or represent that the document is accurate, complete, reliable, fit for any particular purpose or merchantable and does not accept liability for any act (or decision not to act) resulting from use of this document and related data. To the maximum extent permissible all warranties and other assurances by Nomura group are hereby excluded and Nomura Group shall have no liability for the use, misuse, or distribution of this information.

Opinions or estimates expressed are current opinions as of the original publication date appearing on this material and the information, including the opinions and estimates contained herein, are subject to change without notice. Nomura Group is under no duty to update this document. Any comments or statements made herein are those of the author(s) and may differ from views held by other parties within Nomura Group. Clients should consider whether any advice or recommendation in this report is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. Nomura Group does not provide tax advice.

Nomura Group, and/or its officers, directors and employees, may, to the extent permitted by applicable law and/or regulation, deal as principal, agent, or otherwise, or have long or short positions in, or buy or sell, the securities, commodities or instruments, or options or other derivative instruments based thereon, of issuers or securities mentioned herein. Nomura Group companies may also act as market maker or liquidity provider (within the meaning of applicable regulations in the UK) in the financial instruments of the issuer. Where the activity of market maker is carried out in accordance with the definition given to it by specific laws and regulations of the US or other jurisdictions, this will be separately disclosed within the specific issuer disclosures.

This document may contain information obtained from third parties, including ratings from credit ratings agencies such as Standard & Poor's. Reproduction and distribution of third party content in any form is prohibited except with the prior written permission of the related third party. Third party content providers do not guarantee the accuracy, completeness, timeliness or availability of any information, including ratings, and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such content. Third party content providers give no express or implied warranties, including, but not limited to, any warranties of merchantability or fitness for a particular purpose or use. Third party content providers shall not be liable for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including lost income or profits and opportunity costs) in connection with any use of their content, including ratings. Credit ratings are statements of opinions and are not statements of fact or recommendations to purchase hold or sell securities. They do not address the suitability of securities or the suitability of securities for investment purposes, and should not be relied on as investment advice.

Any MSCI sourced information in this document is the exclusive property of MSCI Inc. ('MSCI'). Without prior written permission of MSCI, this information and any other MSCI intellectual property may not be reproduced, re-disseminated or used to create any financial products, including any indices. This information is provided on an "as is" basis. The user assumes the entire risk of any use made of this information. MSCI, its affiliates and any third party involved in, or related to, computing or compiling the information hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. MSCI and the MSCI indexes are services marks of MSCI and its affiliates.

Investors should consider this document as only a single factor in making their investment decision and, as such, the report should not be viewed as identifying or suggesting all risks, direct or indirect, that may be associated with any investment decision. Nomura Group produces a number of different types of research product including, among others, fundamental analysis, quantitative analysis and short term trading ideas; recommendations contained in one type of research product may differ from recommendations contained in other types of research product, whether as a result of differing time horizons, methodologies or otherwise. Nomura Group publishes research product in a number of different ways including the posting of product on Nomura Group portals and/or distribution directly to clients. Different groups of clients may receive different products and services from the research department depending on their individual requirements. Clients outside of the US may access the Nomura Research Trading Ideas platform (Retina) at http://go.nomuranow.com/equities/tradingideas/retina/

Figures presented herein may refer to past performance or simulations based on past performance which are not reliable indicators of future performance. Where the information contains an indication of future performance, such forecasts may not be a reliable indicator of future performance. Moreover, simulations are based on models and simplifying assumptions which may oversimplify and not reflect the future distribution of returns.

Certain securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment.

The securities described herein may not have been registered under the US Securities Act of 1933 (the '1933 Act'), and, in such case, may not be offered or sold in the US or to US persons unless they have been registered under the 1933 Act, or except in compliance with an exemption from the registration requirements of the 1933 Act. Unless governing law permits otherwise, any transaction should be executed via a Nomura entity in your home jurisdiction.

This document has been approved for distribution in the UK and European Economic Area as investment research by NIplc. NIplc is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. NIplc is a member of the London Stock Exchange. This document does not constitute a personal recommendation within the meaning of applicable regulations in the UK, or take into account the particular investment objectives, financial situations, or needs of individual investors. This document is intended only for investors who are 'eligible counterparties' or 'professional clients' for the purposes of applicable regulations in the UK, and may not, therefore, be redistributed to persons who are 'retail clients' for such purposes. This document has been approved by NIHK, which is regulated by the Hong Kong Securities and Futures Commission, for distribution in Hong Kong by NIHK. This document has been approved for distribution in Australia by NAL, which is authorized and regulated in Australia by the ASIC. This document has also been approved for distribution in Malaysia by NSM. In Singapore, this document has been distributed by NSL. NSL accepts legal responsibility for the content of this document, where it concerns securities, futures and foreign exchange, issued by their foreign affiliates in respect of recipients who are not accredited, expert or institutional investors as defined by the Securities and Futures Act (Chapter 289). Recipients of this document in Singapore should contact NSL in respect of matters arising from, or in connection with, this document. Unless prohibited by the provisions of Regulation S of the 1933 Act, this material is distributed in the US, by NSI, a US-registered broker-dealer, which accepts responsibility for its contents in accordance with the provisions of Rule 15a-6, under the US Securities Exchange Act of 1934.

This document has not been approved for distribution to persons other than 'Authorised Persons', 'Exempt Persons' or 'Institutions' (as defined by the Capital Markets Authority) in the Kingdom of Saudi Arabia ('Saudi Arabia') or to clients other than 'professional clients' (as defined by the Dubai Financial Services Authority) in the United Arab Emirates ('UAE') by Nomura Saudi Arabia, NIplc or any other member of Nomura Group, as the case may be. Neither this document nor any copy thereof may be taken or transmitted or distributed, directly or indirectly, by any person other than those authorised to do so into Saudi Arabia or in the UAE or to any person other than 'Authorised Persons', 'Exempt Persons' or 'Institutions' located in Saudi Arabia or to clients other than 'professional clients' in the UAE. By accepting to receive this document, you represent that you are not located in Saudi Arabia or that you are an 'Authorised Person', an 'Exempt Person' or an 'Institution' in Saudi Arabia or that you are a

'professional client' in the UAE and agree to comply with these restrictions. Any failure to comply with these restrictions may constitute a violation of the laws of the UAE or Saudi Arabia.
NO PART OF THIS MATERIAL MAY BE (I) COPIED, PHOTOCOPIED, OR DUPLICATED IN ANY FORM, BY ANY MEANS; OR (II) REDISTRIBUTED WITHOUT THE PRIOR WRITTEN CONSENT OF A MEMBER OF NOMURA GROUP. If this document has been distributed by electronic transmission, such as e-mail, then such transmission cannot be guaranteed to be secure or error-free as information could be intercepted, corrupted, lost, destroyed, arrive late or incomplete, or contain viruses. The sender therefore does not accept liability for any errors or omissions in the contents of this document, which may arise as a result of electronic transmission. If verification is required, please request a hard-copy version.
Nomura Group manages conflicts with respect to the production of research through its compliance policies and procedures (including, but not limited to, Conflicts of Interest, Chinese Wall and Confidentiality policies) as well as through the maintenance of Chinese walls and employee training.
Additional information is available upon request and disclosure information is available at the Nomura Disclosure web page:
http://go.nomuranow.com/research/globalresearchportal/pages/disclosures/disclosures.aspx
Copyright © 2013 Nomura Financial Advisory and Securities (India) Private LTD. All rights reserved.