MOTILAL OSWAL

2 April 2012

EcoScope

The Economy Observer

3QFY12 BoP shows first major deficit post Lehman crisis

FY12 CAD/GDP to touch nearly 4%; INR may remain weak

3QFY12 BoP worsens

- 3QFY12 trade volume degrows
- Trade/GDP at 11% and CAD/GDP at 4.4%;
- Capital flows halved; overall BoP deficit of USD11b;
- Dependence on capital flows implies weakness in INR

- RBI's data release on balance of payments indicate significant deterioration in India's external sector situation.
- 3QFY12 trade volume degrew marginally, while trade deficit expanded to the highest ever in any quarter.
- Near static invisible surplus translated that to highest ever current account deficit (CAD). The keenly watched CAD/GDP ratio reached its second highest level ever to -4.4%, reflecting rapid deterioration from half of that level during 3QFY11.
- Near halving of capital flow resulted in an overall BoP deficit of USD11b which had to be met by drawdown on forex reserves.
- While the situation possibly improved somewhat in 4QFY12, the YTD (Apr-Dec FY12) picture suggests FY12 would possibly end with highest ever trade and current account deficit of ~10% and ~4%, respectively.
- The scenario is unlikely to improve much in FY13 due to multiple headwinds including weaknesses in west, high oil prices, etc.
- Rising dependence on capital flows to bridge CAD coupled with uncertain domestic investment climate point to INR remaining weak in the near term.

Trade gap and reduced capital inflow causes first major BoP deficit in 12 quarters

- **Export growth slows down to 8%:** Merchandise (goods) trade scaled down to USD190b in 3QFY12 from the peak of USD196b in 2Q. While exports growth slowed down to a mere 7.9% (v/s a robust 47.2% in 2Q), import growth was resilient at 22.2% (v/s 35.4% in 2Q).
- **Trade deficit at USD48b, highest ever:** As a result, trade deficit widened to its highest ever quarterly level of USD48b, i.e. USD4b higher than the previous highest level of 2QFY12, and USD9b higher than the Lehman quarter high in 2QFY09. Also, trade deficit as percentage of GDP at 10.8% inched closer to the Lehman quarter high of 13.0% and 11.7% of 3QFY09. Excluding these two instances, trade deficit as % of GDP is highest ever since 1QFY00, the earliest quarter for which data is available.
- **CAD at USD20b, again highest ever:** Net invisible surplus was placed at USD28b. This is marginally higher than previous peak of USD27b achieved as far back as 2QFY09 (i.e. Lehman quarter). Since then invisibles haven't really grown. Thus, expanded trade deficit directly resulted into higher current account deficit (CAD) which at USD20b was the highest level ever. CAD has deteriorated successively during the first three quarters of FY12 – from USD16b in 1Q to USD18b in 2Q and USD20b in 3Q. 3QFY12 CAD/GDP ratio jumped to the second highest level ever of 4.4% (a notch lower than the all-time high of 4.5% in 2QFY11). The ratio has nearly doubled vis-à-vis 2.2% in 3QFY11, and moved up by 1% of GDP from 1QFY12 level of 3.5% of GDP.
- **USD11b BoP deficit:** As a further downside, 3QFY12 net capital flow nearly halved to USD8b v/s USD17b in 2Q. This was inadequate to bridge CAD, resulting in an

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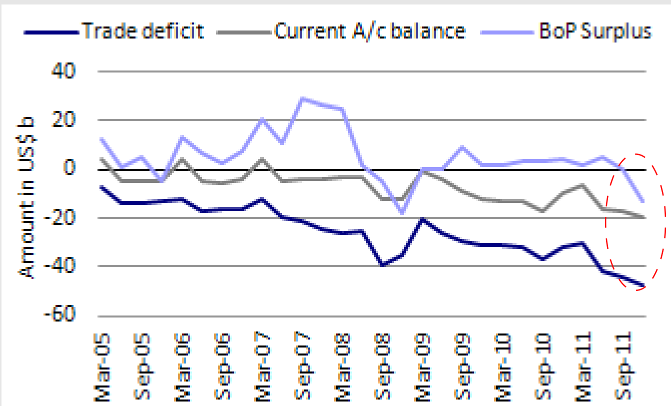
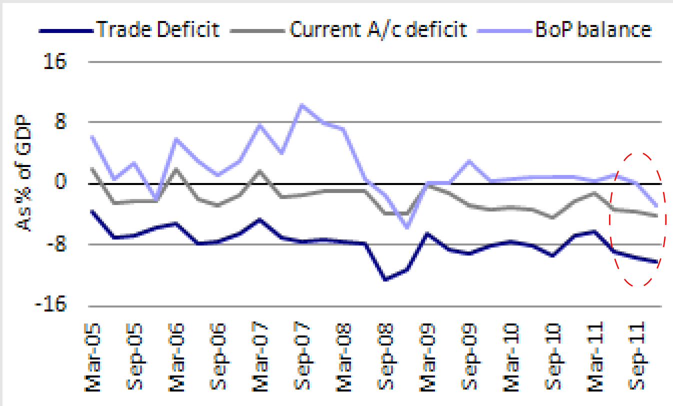
overall BoP deficit of USD11b for the quarter. This was the first significant overall BoP deficit since USD17b of 3QFY09 and USD5b in 2QFY09. Overall BoP was marginally deficit even a quarter back.

- **YTD CAD at 4% of GDP:** YTD, trade and current account deficit are at 9.9% and 4.0% of GDP, respectively, their highest level ever. While the crisis year of FY09 indeed saw trade deficit closer to this level of 9.8%, CAD was far more manageable at only 2.3% due to significant invisible surplus. The previous highest CAD/GDP ratio was 3.0% in the crisis year of FY91.

Significant deterioration in overall balance of payments position



Marked deterioration as % of GDP too



Source: RBI/MOSL

Expect CAD/GDP to deteriorate nearly to 4% of GDP and overall balance of payments deficit in FY12 and FY13

	3Q FY11	1Q FY12	2Q FY12	3Q FY12	Apr-Dec FY11	Apr-Dec FY12	FY10	FY11	FY12E	FY13E
In USDb										
Exports	66	74	76	71	173	222	182	251	300	345
Imports	97	116	120	119	274	354	301	381	475	546
Trade balance	-31	-41	-43	-48	-100	-132	-118	-130	-175	-201
Invisibles	21	26	25	28	61	79	80	84	105	120
Current A/c balance	-10	-16	-18	-20	-40	-54	-38	-46	-70	-81
Net capital flow	14	22	17	8	53	48	52	62	60	70
BoP overall	4	6	-1	-11	13	-6	13	16	-10	-11
As % of GDP										
Exports	14.3	16.6	17.4	16.1	13.9	16.7	13.4	14.9	16.8	17.1
Imports	21.1	25.9	27.2	26.8	22.0	26.6	22.1	22.6	26.6	27.0
Trade balance	-6.8	-9.2	-9.9	-10.8	-8.1	-9.9	-8.7	-7.7	-9.8	-10.0
Invisibles	4.6	5.7	5.7	6.3	4.9	5.9	5.9	5.0	5.9	5.9
Current A/c balance	-2.2	-3.5	-4.2	-4.4	-3.2	-4.0	-2.8	-2.7	-3.9	-4.0
Net capital flow	3.0	5.0	3.9	1.8	4.2	3.6	3.8	3.7	3.4	3.5
BoP overall	0.8	1.4	-0.3	-2.6	1.1	-0.5	1.0	1.0	-0.6	-0.6

Source: RBI/MOSL

Invisibles and capital accounts also show major weaknesses

- **Invisibles in static mode:** Among invisibles, trade in services, factor income and remittances are in a static mode for fairly long period of time. Only software services and private transfers displayed moderate growth largely nullified by increased factor payments on foreign investments in India.

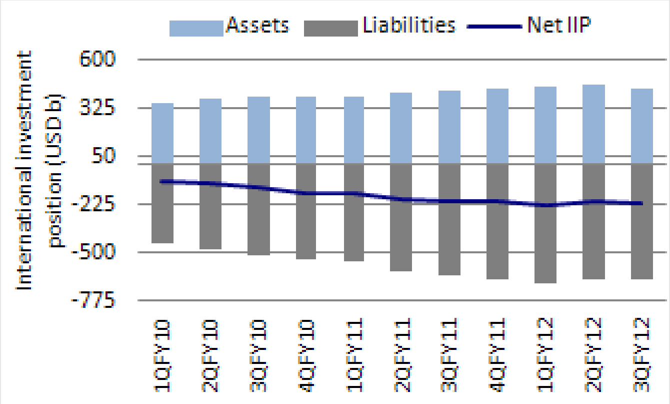
- **FDI up, portfolio investments down:** Within the capital account, FDI to India revived while outbound FDI remained low. This improved net FDI flows to India. However, portfolio flows came to a trickle while debt flows barring NRI deposits floundered too.
- **USD13b reserves drawdown:** This necessitated a drawdown of USD13b during 3QFY12 from forex reserves. However, overall BoP surplus in 1HFY12 limited the Apr-Dec FY12 forex drawdown to USD7b. In contrast, there was a accretion of USD11b in the forex kitty during the corresponding period of the previous year.
- **Net investment position steady:** The secular decline in net investment position (a comprehensive measure of foreigners claims over India vis-à-vis India's claims on abroad) has somewhat been steadied in the last two quarters. This primarily reflects the slowdown in foreign capital inflow. Notably, India's investment largely comprised official reserves and outbound FDIs, and Indians invest less in foreign financial instruments.
- **Share of debt liabilities on the rise:** The composition of liabilities were more even between FDI, FII and debt, with debt comprising the biggest chunk. However, the equity investments have been treated at face value and their outstanding value could be much higher having implications for greater servicing cost in future. Of late, foreigners have slowed down both FDI and FII investments while Indians continue to venture abroad, may be in part a reflection of uncertain domestic investment climate. This is also reflected in the higher share of debt flows in 3QFY12.

Expanded current account deficit as invisible (transfer) fell short of trade gap; while dwindling portfolio flows resulted in inadequate capital flows

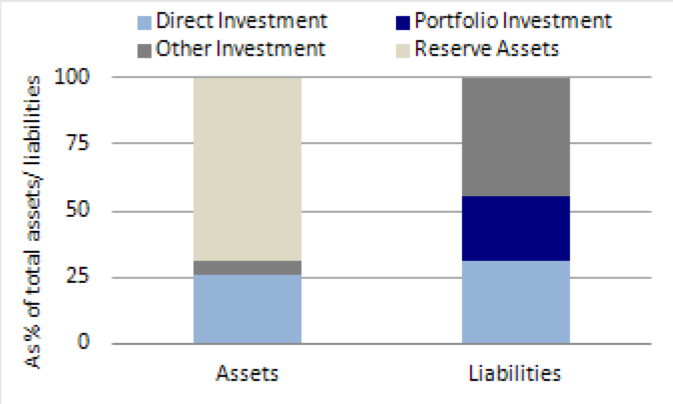
Current A/c and invisibles	3Q	3Q	Apr-Dec		Capital flow and Financial A/c	3Q	3Q	Apr-Dec	
	FY11	FY12	FY11	FY12		FY11	FY12	FY11	FY12
1. Goods, net (merchandise)	**-31**	**-4**	**-100**	**-132**	**1. Direct Investment (net)**	**1**	**5**	**8**	**16**
2. Services, net	**13**	**15**	**34**	**44**	1.a In India	6	6	20	27
2.a Transport	0	0	-1	1	1.b By India	-5	-2	-12	-11
2.b Travel	2	2	3	3	**2. Portfolio Investment (net)**	**6**	**2**	**28**	**3**
2.c Construction	0	0	0	0	2.a In India	7	2	30	3
2.d Insurance and pension	0	0	0	1	2.b By India	-1	0	-1	0
2.e Financial Services	0	-1	-1	-2	**3. Other investment**	**7**	**2**	**16**	**29**
2.f Intellectual property	-1	-1	-2	-2	3.a Other equity (ADRs/GDRs)	0	0	2	1
2.g Telecom, computer and info	14	16	38	44	3.b Currency and deposits	0	3	2	7
2.h Prsnl, cultural and recreational	0	0	0	0	NRI Deposits	0	3	2	7
2.i Government goods & services	0	0	0	0	3.c Loans	10	-6	18	19
2.j Other Business services	-1	-1	-3	-3	i To India	9	-6	18	18
2.k Others n.i.e	-1	-1	-1	2	Deposit-taking corporations	5	-9	4	7
3. Primary Income, net	**-5**	**-5**	**-13**	**-14**	General government	1	1	4	2
3.a Compensation of Employees	0	0	-1	1	Extrnl Cmrcl Brrw (ECB)	4	1	10	9
3.b Investment Income	-4	-5	-12	-14	ii By India	0	1	0	1
4. Secondary Income, net	**13**	**18**	**40**	**48**	3.d Trade credit	1	0	8	6
4.a Personal Transfers	13	17	38	46	3.e Other A/cs	-5	5	-13	-4
4.b. Other Current Transfers	0	1	1	2	**4. Reserve assets**	**-4**	**13**	**-11**	**7**
5. Current Account (1+2+3+4)	**-10**	**-20**	**-40**	**-54**	**5. Financial Account (1+2+3+4)**	**10**	**21**	**42**	**55**

Source: RBI/MOSL

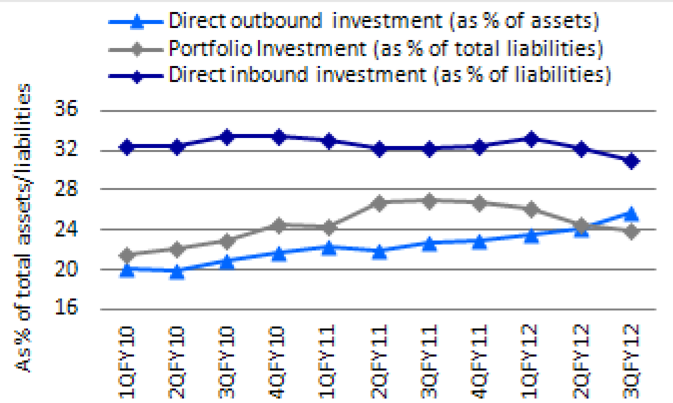
Net external liabilities have stabilized



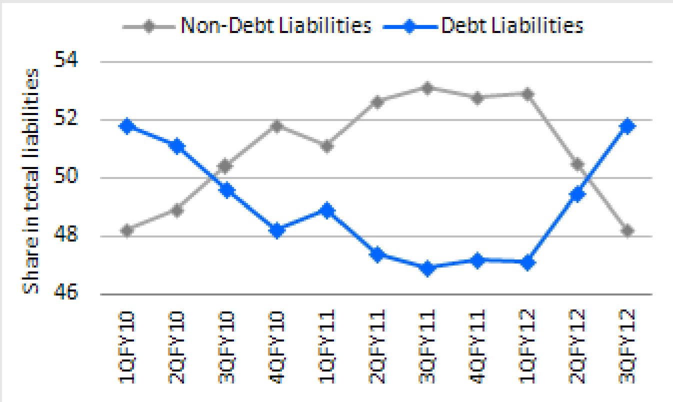
Indian investment abroad is largely FDI while foreign investment is a mix of debt, FDI and FII



While foreigners lower investment, Indian companies are going abroad



Share of debt liabilities has shot up again and now exceeds non-debt liabilities



Source: RBI/MOSL

External debt at USD335b, 19% of GDP

- **External debt at 19% of GDP:** Reflecting the higher inflow of debt in BoP, India's external debt too increased. However, it remained steady as a percentage of GDP at 19%.
- **Share of short-term debt creeping up:** The official debt comprised nearly a quarter of total outstanding debt with the rest comprising private debt. However, while official debt mostly comprised long-term debt, the private sector debt had a higher proportion of short-term debt. Overall short-term debt as a percent of total debt however, remained limited to 23.3% during 3QFY12, though the ratio increased from 19.3% in FY09. Past trend suggests that during periods of crisis, the longer term debt in the nature of external commercial borrowing may face sudden stop while NRI deposits may face withdrawal pressure.

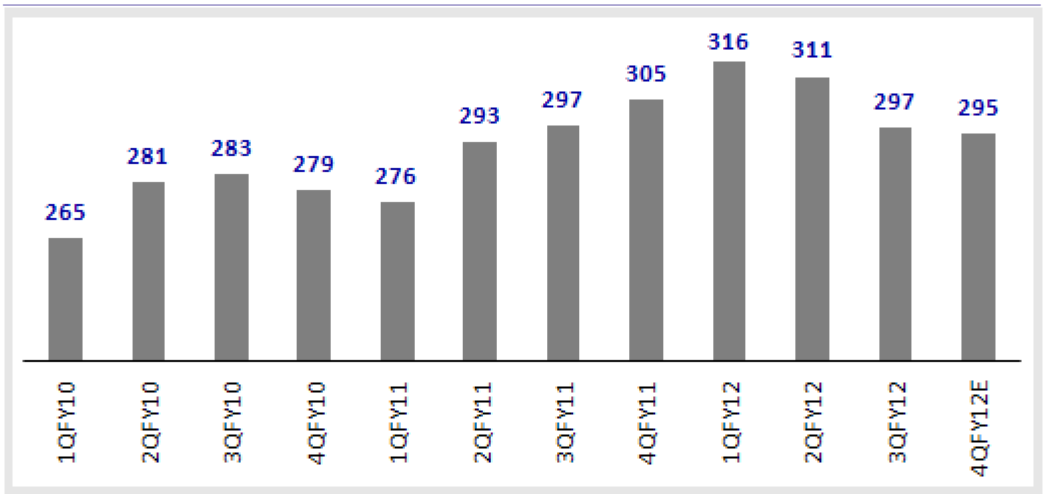
External debt is rising, but is stable as % of GDP (USD b)

	FY09	FY10	FY11	1QFY12	2QFY12	3QFY12
Long-Term Debt	181	209	241	248	252	257
of which						
ECB	62	71	89	93	97	100
NRI deposits	42	48	52	53	52	52
Short-Term Debt	43	52	65	68	72	78
of which						
Trade credit	14	17	19	19	19	20
Total external debt	**224**	**261**	**306**	317	324	335
GDP	1216	1362	1684	1789	1761	1773
As % of GDP						
Long-Term Debt	14.9	15.3	14.3	13.9	14.3	14.5
of which						
ECB	5.1	5.2	5.3	5.2	5.5	5.6
NRI deposits	3.4	3.5	3.1	3.0	3.0	3.0
Short-Term Debt	3.6	3.8	3.9	3.8	4.1	4.4
of which						
Trade credit	1.2	1.2	1.1	1.0	1.1	1.1
Total external debt	**18.5**	**19.2**	**18.2**	**17.7**	**18.4**	**18.9**

Note: GDP annualised for quarterly projections

Source: Govt./MOSL

Forex reserves declined reflecting the sharp deterioration in BoP in 3Q and remained steady in 4QFY12



Source: RBI/MOSL

External sector outlook deteriorates further, see CAD/GDP at 4.0% for FY12 and FY13

- **Jan-Feb 2012 trade deficit high, but reserves stable:** The recent trade data reflect continued high trade deficit of USD15b in Jan-12 and Feb-12. However, there has been some revival of foreign investment flows including FDI, FII and NRI deposits in first two months of CY12. 4QFY12 also saw a marginal decline of USD1b in forex reserves. Thus, while trade deficit remained high, overall balance of payments was perhaps evenly poised during 4QFY12.
- **Widening CAD reflects multiple headwinds:** These include (i) lower growth prospect in the west, (ii) high and still uncertain oil prices, (iii) disagreement regarding tariff regime and trade disputes, (iv) higher servicing cost of foreign

investment in India, and (v) push to import-led industrial revival proposed by the Union Budget. Countering this would be higher tariff on gold imports that stood staggering at nearly USD55b in FY12 or two-thirds of India's CAD.

- **Expect FY12 and FY13 CAD/GDP of 4%:** We have revised CAD/GDP for FY12 to 3.9% of GDP from 3.5% estimated earlier. We also place our FY13 CAD/GDP estimate at 4%.
- **Risks to foreign capital inflows:** This leaves Indian external position vulnerable to volatility in capital flows. While uncertain investment climate weighs on foreign capital flows, debt flows too may slow down if India faces any rating action on account of challenging fiscal situation. NRI deposits too may slow if the scope of interest rate arbitrage reduces on RBI rate cuts.
- **Expect INR to remain weak:** Rising dependence on capital flows to bridge CAD coupled with uncertain domestic investment climate point to INR remaining weak in the near term.

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March/April 2012

2 April 2012

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3QFY12 BoP worsens

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- Dependence on capital flows implies weakness in INR

28 March 2012

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Five tasks for RBI

#1 Deal with the inflationary consequence

#2 Kickstart private investment

#3 Keep the liquidity tap on

#4 Control the government's cost of borrowing

#5 Finally, manage the INR

15 March 2012

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RBI mid-3QFY12 policy review

- Key policy rates and reserve ratios unchanged
- CRR cut of 75bp on 9-Mar-12 effective in containing the LAF borrowing at INR1.3t on 15-Mar-12
- Expect at least 50bp cut in policy rates in Apr-12 policy
- Liquidity to remain tight on high government borrowing and lower capital inflow but mitigated by slower credit demand

March 2012

14 March 2012

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Jan-12 WPI inflation

- Jan-12 WPI inflation at 26-month low of 6.6%
- Primary, fuel and manufacturing inflation falls; however, index rises for all three
- Mar-12 inflation target of 7% likely to be overachieved
- Expect RBI to cut CRR by 25 but hold rates on Mar 15th

12 March 2012

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Jan-12 IIP at 6.8%, YTDFY12 at 4%

- Higher than expected growth explained entirely by 42% growth in consumer non-durables that explained 7.8% overall IIP growth
- The empty middle industrial structure broadens with lackluster performance of basic goods
- FY12 IIP revised to 4%, may still prompt RBI to defer rate cuts till Apr-12

7 March 2012

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State Elections Review

- Decisive mandate in four out of five state elections, is expected to facilitate development
- More than expected sweep for Samajwadi Party in UP despite spirited campaigning from Congress led by Rahul Gandhi
- Anti corruption message of the voters highly visible. Regional parties make significant gains at the cost of national parties
- No direction for the market that would focus on Budget now

February 2012

28 February 2012

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State Elections Preview

- 5 State elections - Manipur, Punjab, Uttarakhand, UP & Goa
- Early signals: high turnout, suggesting anti-incumbency
- Key questions: (1) Will the Congress-led UPA emerge stronger? (2) Will voters deliver an anti-corruption message?
- Our views: (1) Regional parties may remain dominant (2) UPA's RS equation unlikely to alter (3) Post polls, immediate reform rollout unlikely

14 February 2012

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10 February 2012

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Dec-11 IIP at 1.8%, YTDFY12 at 3.6%

- Sharp de-growth in mining, intermediate and capital goods shave off 3.4% of IIP
- The empty middle accentuates; performance of upstream basic goods and downstream consumer contrasts with de-growth in intermediate and capital goods
- FY12 IIP growth placed at 3.7%; however, expect continued MoM volatility in 4QFY12
- Expect RBI to defer rate cuts to Apr-12

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