BALANCE OF PAYMENTS

CAD at all time high

India Equity Research | Economy

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BoP, in Q4FY12, showed a deficit (of ~USD5.7bn) for the second straight quarter, as capital flows (USD16bn, better than Q3) were inadequate to fund the widening CAD (~USD21.7bn, 4.5% of GDP). Trade deficit, which typically improves in Q4 due to year-end seasonality, remained elevated on account of higher crude and gold imports and only marginal improvement in exports. Invisibles, too, showed only a slight improvement. On the capital account side, recovery in global risk appetite (post ECB's LTRO) was well reflected in the sharp rise in portfolio flows, although debt-related flows remained weak, reflecting ongoing deleveraging by EU banks.

For FY12, CAD stood at an all-time high of 4.2% of GDP, which is clearly the vulnerability zone. However, as stated earlier, we see that factors are falling into place (declining crude prices, slowing gold imports and undervalued INR), which will pave the way for CAD narrowing to 3.2-3.3% of GDP in FY13.

CAD widens to ~4.2% of GDP in FY12

BoP, in Q4FY12, showed a deficit of ~USD5.7bn, as net capital inflows of ~USD16bn were insufficient to fund CAD that came at an elevated level of ~USD21.8bn (against expectation of ~USD20bn). The main reason for the increase in CAD is elevated levels of oil and gold imports (~USD16bn in Q4 FY12 vs ~USD12.7bn in Q3FY12), along with weak external demand. Because of these reasons, trade deficit increased to ~USD52bn in Q4FY12 from ~USD49bn in Q3FY12. Ironically, in Q4, trade deficit tends to narrow, reflecting year-end seasonality (as exporters tend to ramp up sales in Q4 to improve financial result).

Despite widening in trade deficit, invisibles - net service exports and remittances – broadly remained stable at ~USD30bn as both service exports and remittances remained unchanged. Within the services sector, software exports (which normally tend to improve in Q4 because of year-end seasonality) saw only a marginal improvement, reflecting faltering external demand. Meanwhile, NRI remittances remained healthy at ~USD17bn, reflecting attractive levels of INR.

With current quarter's data, FY12 CAD reached an all-time high of ~4.2% of GDP which is undoubtedly a very high level and much above RBI's comfort range of ~3% of GDP. However, things are falling into place, for instance - fall in crude/commodity prices, likely decline in gold imports and favourable effect of undervalued INR on trade balance (by boosting exports and encouraging import substitution), which mean that CAD could shrink to 3.2-3.3% of GDP in FY13 (refer "BoP: Stress to ease, dated May 25 , 2012).

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Table 1: Balance of Payments

	Q4FY12	Q3FY12	Q4FY11	Q3FY11	FY12	FY11
Exports	80.2	71.4	77.2	65.9	309.8	250.5
Imports	131.7	120.1	107.1	97.4	499.5	381.1
Trade Balance	**(51.5)**	**(48.7)**	**(29.9)**	**(31.5)**	**(189.8)**	**(130.6)**
Invisibles, net	**29.8**	**28.8**	**24.5**	**21.5**	**111.6**	**84.6**
of which:						
Software service earnings	16.9	15.8	16.7	14.0	61.0	53.3
Private transfers	16.9	16.2	13.9	13.4	63.5	53.1
Current account balance	**(21.8)**	**(20.0)**	**(5.4)**	**(9.9)**	**(78.2)**	**(45.9)**
Capital account*	**16.1**	**7.1**	**7.4**	**13.8**	**65.3**	**59.0**
of which:						
FDI	1.4	5.0	4.9	1.2	22.1	9.4
Portfolio investments	13.9	1.9	0.2	6.3	17.2	30.3
ECB	2.3	(0.3)	2.4	3.9	10.3	12.5
Short-term trade credit	0.2	0.6	2.7	1.3	6.7	11.0
Banking Capital	2.0	(5.5)	(0.8)	4.9	16.2	5.0
Accretion to reserves	**(5.7)**	**(12.8)**	**2.0**	**3.9**	**(12.8)**	**13.1**

Source: RBI

Capital flows improve, but still inadequate to fund CAD

Capital inflows improved during the quarter to ~USD16bn compared with ~USD7bn in Q3FY12, but remained inadequate to fund CAD of ~USD21.7bn. Improvement in capital flows was largely the result of global risk-on trade post ECB's LTRO in December 2011. Recovery in global risk appetite was reflected in substantial improvement in portfolio flows (~USD14bn against USD2bn in Q3FY12). However, debt-related flows while better than Q3, were relatively weak, particularly the short-term credit. In our view, weakness in debt-related flows reflects the ongoing trend of deleveraging in the EU banking system. Notably, NRI deposits improved during the quarter, attracted by higher interest rates offered by banks.

Going into June quarter, capital flows have remained subdued. The strength in portfolio flows seen in March quarter faded away in June quarter amidst rise in global risk aversion. Also, as EU debt crisis escalated, debt-related flows have also seen stress and this is evident in the sharp INR depreciation. However, with some stabilization measures undertaken in the EU summit, one can expect some improvement in global risk appetite and, hence, capital inflows to India in the coming months

External debt vulnerability on the rise

In FY12, debt receipts have been a major contributor to capital flows. Accordingly, external debt has risen to ~20% of GDP (~USD355bn) from ~18% of GDP in FY11 (~USD305bn). While the level by itself is not alarming, its recent rise has indeed increased the vulnerability of the economy. Further, susceptibility of the economy increases from the fact that the external debt raised is increasingly short term in nature (short term debt as % of total debt ~23% in FY12 vs ~21% in FY12).

Chart 1: BoP continues to be in deficit albeit lower

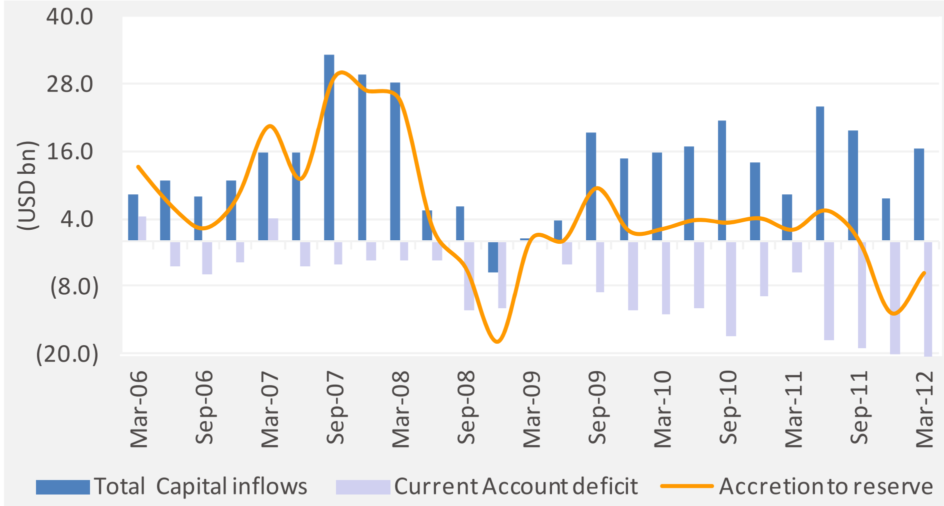


Chart 2: Undervalued INR (REER basis) to help narrow trade deficit...

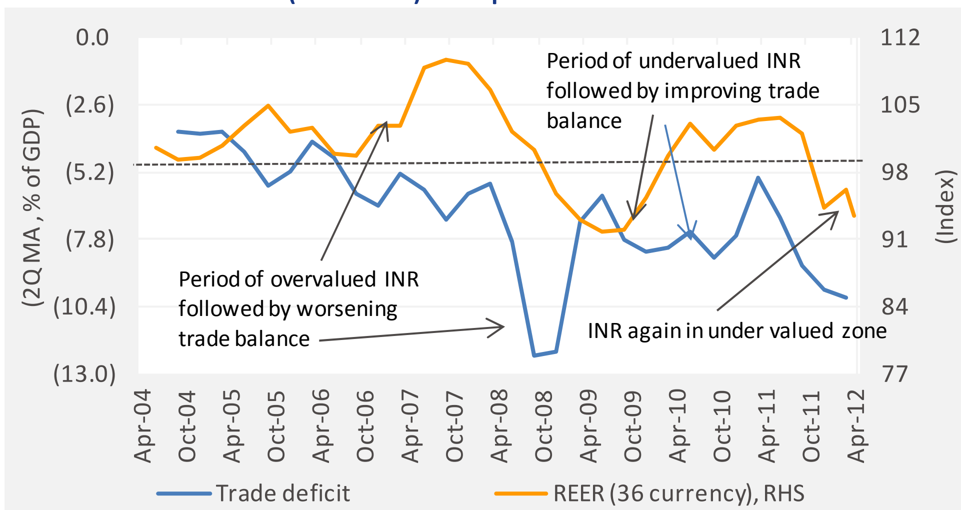
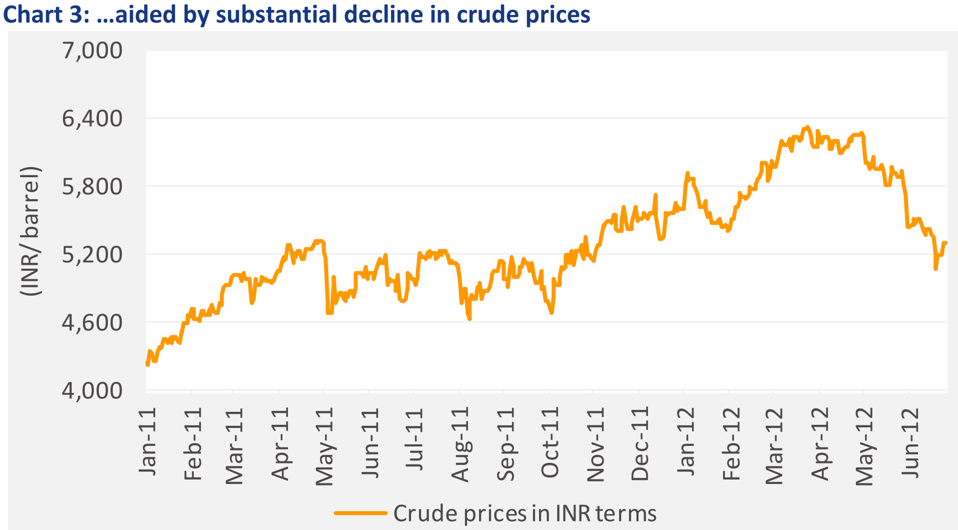


Chart 3: ...aided by substantial decline in crude prices



Source: RBI, Bloomberg, Edelweiss research

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