ICRA

EXTERNAL SECTOR OUTLOOK

Current account deficit expected to narrow to 1.2% of GDP in FY2020 from 2.1% of GDP in FY2019

December 2019

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HIGHLIGHTS

- *India's current account deficit narrowed sharply to US$6.3 billion (0.9% of GDP) in Q2 FY2020 from US$19.0 billion (2.9% of GDP) in Q2 FY2019, and printed modestly lower than our forecast (US$8-9 billion). Moreover, the current account deficit narrowed in sequential quarters in Q2 FY2020 from US$14.2 billion (2.0% of GDP) recorded in Q1 FY2020.*

- *The year-on-year (YoY) decline in the current account deficit was primarily driven by a narrower trade deficit, and to a smaller extent, higher secondary income flows and a mild improvement in services trade surplus. Lower crude oil prices, a sharp contraction in gold imports, and subdued domestic growth and demand contributed to the decline in the merchandise trade deficit in Q2 FY2020.*

- *India's foreign exchange reserves rose by US$5.1 billion (excluding changes in valuation) during Q2 FY2020, in contrast to the decline of US$1.9 billion in Q2 FY2019.*

- *Based on the available trends for merchandise trade for October-November 2019, we expect the current account deficit to shrink to ~US$4-6 billion in Q3 FY2020 (0.7% of GDP) from US$17.7 billion in Q3 FY2019, on the back of the YoY correction in crude oil prices as well as subdued domestic demand.*

- *For FY2020, ICRA expects merchandise exports and imports to decline to US$332-337 billion and US$493-498 billion, respectively, in FY2020 from US$337.2 billion and US$517.5 billion, respectively, in FY2019. Accordingly, the merchandise trade deficit is likely to narrow considerably to ~US$160-165 billion in FY2020 from US$180.3 billion in FY2019.*

- *The anticipated narrowing in the merchandise trade deficit in FY2020 reflects the decline in merchandise imports on account of the subdued global commodity prices, and shrinking in gold demand at prevailing prices, and also reflects muted domestic consumption and industrial demand, rather than a healthy trend in merchandise exports.*

- *ICRA expects the services surplus to improve mildly to US$83-85 billion in FY2020 from US$81.9 billion in FY2019. Remittances are expected to rise by around 4-5% in FY2020 from the level in FY2019, whereas primary income outflows are projected to worsen by ~2-3% in FY2020 relative to FY2019.*

- *Reflecting the anticipated decline in the merchandise trade deficit, the current account deficit is forecast by ICRA to narrow sharply to a three-year low US$34-36 billion (1.2% of GDP) in FY2020 from US$57.2 billion in FY2019 (2.1% of GDP).*

OVERVIEW

Balance of Payments for Q2 FY2020: India's current account deficit narrowed to US$6.3 billion (0.9% of GDP) in Q2 FY2020 from US$19.0 billion (2.9% of GDP) in Q2 FY2019, and printed modestly lower than our forecast (US$8-9 billion). Moreover, the current account deficit narrowed in sequential quarters in Q2 FY2020 from US$14.2 billion (2.0% of GDP) recorded in Q1 FY2020 (refer Exhibit 1 and 2).

The YoY decline in the current account deficit was driven primarily by a narrower trade deficit, and to a smaller extent, higher secondary income flows and a mild improvement in services trade surplus. Lower crude oil prices, a sharp contraction in gold imports, and subdued domestic growth and demand contributed to the decline in the merchandise trade deficit in Q2 FY2020.

The merchandise trade deficit (on a BoP basis) narrowed considerably to US$38.1 billion in Q2 FY2020 from US$50.0 billion in Q2 FY2019. The easing in the merchandise trade deficit was led by a sharp 11.5% contraction in merchandise imports to US$118.1 billion in Q2 FY2020 from US$133.4 billion in Q2 FY2019, which outpaced the 4.1% YoY decline in merchandise exports to US$80.0 billion in Q2 FY2020 from US$83.4 billion in Q2 FY2019, respectively. Net oil imports declined to US$19.3 billion in Q2 FY2020 from US$23.5 billion in Q2 FY2019, following the correction of 17.6% in crude oil prices between these two quarters. Moreover, gold imports halved to US$4.4 billion in Q2 FY2020 from US$9.2 billion in Q2 FY2019, with demand dampened by the rise in gold prices in US$ terms, as well as the imposition of higher import duty on gold since July 2019. Further, non-oil non-gold imports declined by 5.4% to US$84.1 billion in Q2 FY2020 from US$88.9 billion in Q2 FY2019, reflecting subdued domestic investment and consumption demand.

Additionally, the net inflow of secondary income rose to US$20.0 billion in Q2 FY2020 from US$19.4 billion in Q2 FY2019, led by an uptick in worker remittances to US$15.0 billion from US$13.5 billion, respectively. The services trade surplus posted a marginal uptick to US$20.4 billion in Q2 FY2020 from US$20.3 billion in Q2 FY2019, led by higher net earnings related to telecom, computer and information services. Notably, the outflow of primary income stood at US$8.6 billion in Q2 FY2020, in line with the same in Q2 FY2019.

India's capital and financial account balance fell to US$6.9 billion in Q2 FY2020, from US$18.5 billion in Q2 FY2019 and US$13.0 billion in Q1 FY2020. Notably, there was a deterioration in the magnitude of net inflows in Q2 FY2020 relative to Q2 FY2019 for NRI deposits (to +US$2.3 billion from +US$3.3 billion), financial derivatives (to +US$0.3 from +US$1.3 billion), and trade credit and advances (to -US$0.6 billion from +US$4.8 billion). In contrast, loans (to +US$0.1 billion from -US$0.7 billion), and portfolio investment (to +US$2.5 billion from -US$1.6 billion) recorded an improvement in Q2 FY2020 relative to Q2 FY2019, whereas net FDI inflows remained unchanged at US$7.4 billion during the two quarters. Significantly, foreign exchange reserves rose by US$5.1 billion (excluding changes in valuation) during Q2 FY2020, in contrast to the decline of US$1.9 billion in Q2 FY2019.

Exhibit 1: Trends in India's Balance of Payments

Figures in US$ billion	Q2 FY2019	Q3 FY2019	Q4 FY2019	Q1 FY2020	Q2 FY2020	FY2018	FY2019	FY2020 ICRA exp.
Merchandise Exports	83.4	83.1	87.4	82.7	80.0	309.0	337.2	332 to 337
Merchandise Imports	133.4	132.4	122.6	128.9	118.1	469.0	517.5	493 to 498
Merchandise Trade Balance	**-50.0**	**-49.3**	**-35.2**	**-46.2**	**-38.1**	**-160.0**	**-180.3**	**-160 to -165**
Net Services	20.3	21.7	21.3	20.1	20.4	77.6	81.9	83 to 85
Primary Income	-8.6	-7.6	-6.9	-6.1	-8.6	-28.7	-28.9	-29 to -30
Secondary Income	19.4	17.4	16.2	18.0	20.0	62.5	70.0	72 to 74
Current Account Balance	**-19.0**	**-17.7**	**-4.6**	**-14.2**	**-6.3**	**-48.7**	**-57.2**	**-34 to -36**
Percentage of GDP	*-2.9%*	*-2.5%*	*-0.7%*	*-2.0%*	*-0.9%*	*-1.9%*	*-2.1%*	*-1.2%*

Source: RBI; ICRA research

Exhibit 2: Trends in Merchandise Trade Deficit and Current Account Deficit

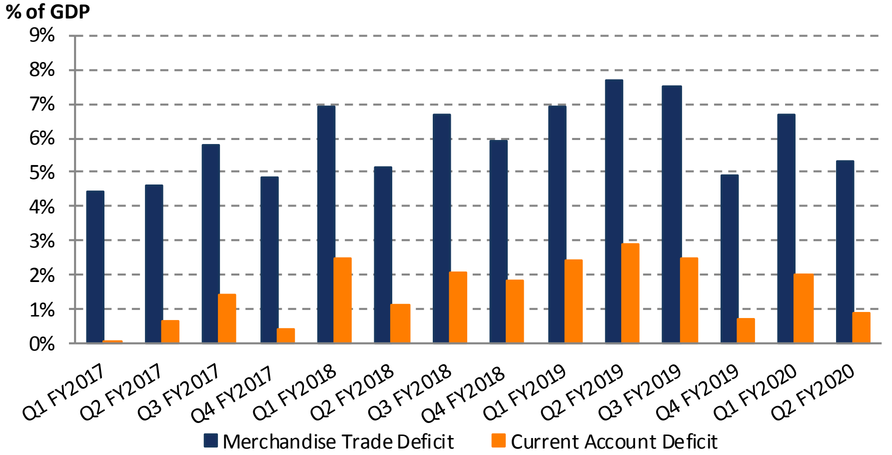
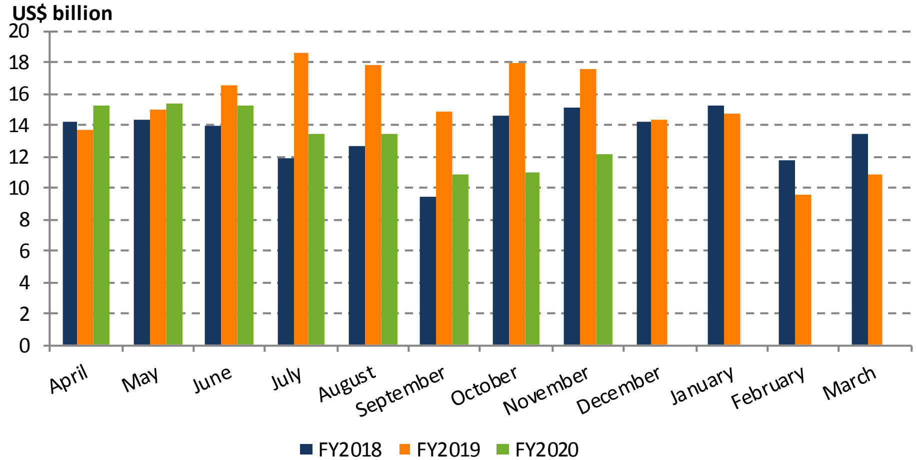


Exhibit 3: Monthly Trends in Merchandise Trade Deficit



Source: RBI, Ministry of Commerce and Industry, GoI; ICRA research

Exhibit 4: Monthly Trends in Merchandise Exports

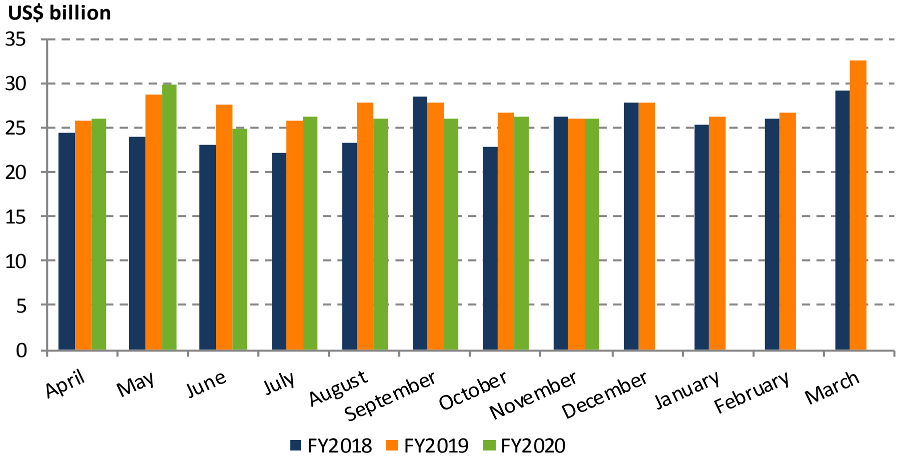
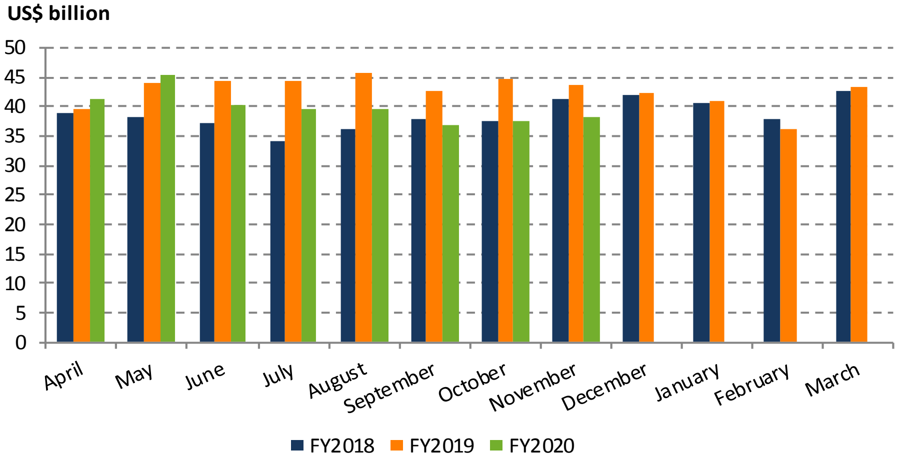


Exhibit 5: Monthly Trends in Merchandise Imports



Source: Ministry of Commerce and Industry, GoI; ICRA research

Trends for October-November 2019: The initial data released by the Ministry of Commerce and Industry indicated that merchandise exports declined by 0.7% to US$52.4 billion in October-November 2019 from US$52.7 billion in October-November 2018 (refer Exhibit 4), led by a considerable 13.8% dip in oil exports (to US$7.7 billion from US$9.0 billion), even as non-oil exports recorded a mild 1.9% rise (to US$44.6 billion from US$43.8 billion). The YoY decline in the value of oil exports was driven by the substantial 16.0% correction in the price of the Indian crude oil basket to US$61.1/barrel in October-November 2019 from US$72.8/barrel during October-November 2018.

In contrast to the decline in oil exports, non-oil exports rose, albeit by a muted US$0.9 billion on a YoY basis in October-November 2019, led by sectors such as electronic goods (+US$0.7 billion; +42.3%), drugs and pharmaceuticals (+US$0.5 billion; +16.6%), engineering goods (+US$0.5 billion; +3.7%), and iron ore (+US$0.1 billion; +42.8%). However, exports of sectors such as plastic and linoleum (-US$0.2 billion; -13.2%), and textiles (-US$0.1 billion; -4.3%) recorded a YoY decline in October-November 2019.

Merchandise imports recorded a broad-based contraction of 14.5% to US$75.5 billion in October-November 2019 from US$88.3 billion in October-November 2018 (refer Exhibit 5). The aforesaid fall in oil prices led to oil imports contracting by a sharp 25.2% to US$20.7 billion in October-November 2019 from US$27.6 billion in October-November 2019. Moreover, non-oil non-gold imports declined by 11.0% (-US$6.2 billion) in October-November 2019, led by industrial inputs such as transport equipment (-US$1.5 billion; -32.2%), coal (-US$1.2 billion; -26.0%), organic and inorganic chemicals (-US$0.9 billion; -22.8%), iron and steel (-US$0.6 billion; -20.2%), and non-ferrous metals (-US$0.4 billion; -14.1%), as well as consumer sectors such as electronic goods (-US$0.7 billion, -6.5%) and silver (-US$0.7 billion; -78.5%). In contrast, gold imports rose by 5.9% to US$4.8 billion in October-November 2019 from US$4.5 billion in October-November 2018, partly driven by a rise in gold prices on a YoY basis. Moreover, gold imports in these two months exceeded the value for Q2 FY2020 (US$4.4 billion), led by some uptick in demand related to the festive season and subsequent restocking.

Based on these trends, the merchandise trade deficit fell considerably to US$23.1 billion in October-November 2019 from US$35.6 billion in October-November 2018 (refer Exhibit 3), according to the data released by the Ministry of Commerce.

Expectations for Q3 FY2020: Based on the available trends for merchandise trade for October-November 2019, we expect the current account deficit to shrink to ~US$4-6 billion in Q3 FY2020 (0.7% of GDP) from the revised US$17.7 billion in Q3 FY2019 (2.7% of GDP), on the back of the YoY correction in crude oil prices as well as subdued domestic demand.

Expectations for FY2020: Merchandise imports have contracted by a considerable 8.7% so far in FY2020, on account of factors such as muted commodity prices and weak domestic demand. Moreover, merchandise exports have recorded a mild YoY decline of 2.2% driven by subdued global demand.

In October 2019, the IMF projected global economic growth to soften appreciably from 3.6% in 2018 to 3.0% in 2019, before picking up pace to 3.4% in 2020. The IMF has revised its growth forecasts for 2019 and 2020 down by 20 bps and 10 bps, respectively, in October 2019, relative to the forecasts released in July 2019, given the muted outlook for global demand, rising geopolitical tensions and the US-China trade war. Significantly, IMF has projected the growth rates in the US and the Euro Area, which are the major export destinations for India, to moderate in 2019 and 2020. However, some de-escalation of US-China trade tensions has lifted sentiments about the global growth trajectory. This, in conjunction with the correction in the INR on an REER basis from 120.2 in July 2019 to 118.1 in November 2019, may modestly support exports.

In contrast, lower crude oil prices in FY2020 relative to FY2019 may hamper remittances as well as demand for Indian goods from the OPEC group, particularly the Middle Eastern countries. Moreover, higher gold prices may restrain demand for gems and jewellery exports, which have recorded a YoY contraction of 6.1% in April-November 2019.

We are cautiously optimistic that the recent YoY rise in non-oil merchandise exports may sustain in December 2019-February 2020, although an unfavourable base effect may result in a contraction in March 2020. Overall, ICRA expects merchandise exports to decline on a YoY basis by 0-2% in FY2020, driven by a contraction of ~1.5-2.0% in oil exports (assuming an average oil price of US$64.5/barrel), and ~0.5-1.0% in non-oil exports.

ICRA expects merchandise imports to contract by 4-5% in FY2020. While a pickup in the prices of crude oil and gold, as well as the base effect, may arrest the pace of contraction in imports in the coming months, the impact of this on the overall trade deficit is likely to be limited. The relative weakness in commodity prices, and subdued consumption and investment demand are expected to restrain the growth of non-oil non-gold imports in FY2020. Following the recent uptick in crude oil prices, our baseline projection factors in an average crude oil price of US$64.5/barrel in FY2020 (US$69.7/barrel in FY2019) and a ~5% rise in net import volumes. In this scenario, net oil imports are projected to decline by ~3% to US$91 billion in FY2020 from US$93.8 billion in FY2019.

The value of coal imports (in US$ terms) has contracted by 11.4% in April-November 2019, compared to April-November 2018. This was led by a fall in the international price of coal, which offset the rise in the import volume by 6.9% to 167.6 million tonnes from 156.8 million tonnes, respectively. On the domestic front, coal output had recorded a contraction on a YoY basis in August-November 2019 due to flood-related disruptions, as well as labour issues. The weather-related bottlenecks to coal production are likely to have ebbed after the easing in the volume of rainfall, although labour issues in some mines remain an area of concern. ***Given the fall in global coal prices, and some expected pickup in the volume of domestic coal production, the value of coal imports is likely to continue to contract on a YoY basis in the remainder of FY2020.***

Additionally, the import of electronic goods contracted by 2.6% in April-November 2019, partly on account of subdued consumption demand in the country as well as some import substitution. ***Given that the outlook for economic growth and consumption demand is unlikely to pick up sharply in the remainder of FY2020, we expect the import of electronic goods to remain muted.***

Gold imports contracted by 10.4% on a YoY basis in H1 FY2020, dampened by the imposition of higher import duty and the considerable rise in gold prices. With some sequential softening in prices (although prices remained higher on a YoY basis), gold imports rebounded in October-November 2019, led by a pickup in demand during the festive/marriage season, and the subsequent re-stocking. We do not expect the uptick in gold imports in October-November 2019, to sustain in December 2019, following a further rise in prices. However, if a subsequent fall in global gold prices materialises, it could trigger a replenishment of inventories in Q4 FY2020. ***Overall, ICRA expects the value of gold imports to decline to ~US$30-32 billion in FY2020 from US$32.9 billion in FY2019.***

Overall, merchandise exports and imports are likely to decline to US$332-337 billion and US$493-498 billion, respectively, in FY2020 from US$337.2 billion and US$517.5 billion, respectively, in FY2019. Accordingly, the merchandise trade deficit is likely to narrow considerably to ~US$160-165 billion in FY2020 from US$180.3 billion in FY2019. The anticipated narrowing in the trade deficit in FY2020 reflects the decline in merchandise imports on account of the subdued global commodity prices, and shrinking in gold demand at prevailing prices, and also reflects muted domestic consumption and industrial demand, rather than a healthy trend in merchandise exports.

While services exports have recorded a healthy 8.5% growth in April-October 2019, services imports have expanded at a higher pace of 13.5%, as a result of which the services surplus has risen by a marginal 0.4% to US$45.4 billion in that period from US$45.2 billion in April-October 2018. ***ICRA expects the services surplus to record a mild improvement to US$83-85 billion in FY2020 from US$81.9 billion in FY2019.***

Remittances are expected to improve by around 4-5% in FY2020 from the level in FY2019, whereas primary income outflows are projected to worsen by ~2-3% in FY2020 relative to FY2019. Reflecting the anticipated decline in the merchandise trade deficit, the current account deficit is forecast by ICRA to narrow sharply to a three-year low US$34-36 billion (1.2% of GDP) in FY2020 from US$57.2 billion in FY2019 (2.1% of GDP).

ICRA

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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