Motilal Oswal Investment Services

EcoScope
The Economy Observer

India's CAD likely to narrow sharply in CY23/FY24

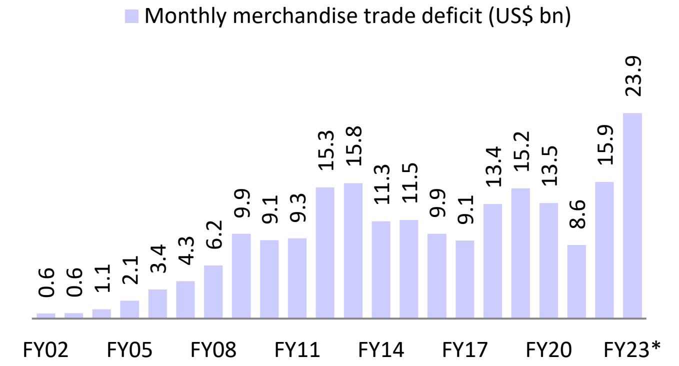
INR could weaken to 85/USD before retreating

- **In the first nine months of FY23, India's merchandise trade deficit widened to USD215b from USD136b in 9MFY22. It means that the merchandise trade deficit stood at 8.6% of GDP in 9MFY23, the worst in a decade and higher than 6% of GDP in FY22. In Jan'23, however, it narrowed substantially and unexpectedly to USD17.7b, compared to the Bloomberg consensus of USD23.5b. Is this a one-off or could it narrow substantially in CY23/FY24? We believe the latter is true and this note explains why.**
- **A look at details suggests that as much as 86% of the widening in the trade deficit in 9MFY23 was attributed to commodities – 55% by energy (fuel & coal) and another 31% by non-energy items (including edible oil, fertilizers, base metals and plastic & rubber). The deficit in precious metals (i.e., valuables) narrowed by USD4b to USD30b in 9MFY23.**
- **Assuming that commodity prices in the near future stay where they were in Feb'23 (since risks are balanced), there will be sharp contractions in prices of energy (-24%), fertilizers (-18%) and edible oil (-6%), with a modest rise in prices of precious metals and base metals (+2-3%). This should keep India's merchandise imports down for the next 6-8 months. With expectations of weak economic environment, we expect India's merchandise imports to fall faster than exports, keeping the trade deficit subdued.**
- **Further, services exports witnessed a sudden surge in Dec'22, leading to a record-high trade surplus of USD15.5b. Although exports eased in Jan'23, the surplus remained high at ~USD14b. With a combined average monthly deficit of goods & services (G&S) at USD12b in the past 15 months, a reduction to USD6.6b in Dec'22 and further to just USD4b in Jan'23 is unexpected but extremely welcome. Although we are skeptical about the sustainability of such a high services surplus at this stage, the recent trends are certainly encouraging and point to a further narrowing of the external deficit in coming quarters.**
- **Accordingly, we continue to believe that India's current account deficit (CAD) could narrow to ~3% of GDP in 3QFY23 and further ~2% of GDP in 4QFY23 v/s 4.4% of GDP in 2QFY23. We expect CAD to remain at ~2% of GDP in FY24.**
- **However, we do not expect INR to strengthen. Amid expectations of a global economic slowdown, we continue to expect INR to cross 85/USD by mid-CY23 before retreating in late CY23 and early CY24.**

Monthly trade deficit widened to USD24b in 9MFY23, 50% higher than the monthly deficit in 9MFY22

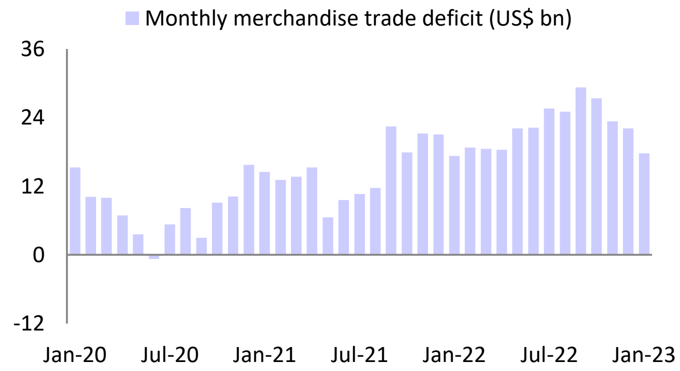
In 9MFY23, India's merchandise trade deficit widened to USD215b from USD136b in 9MFY22. It means that the monthly trade deficit widened to USD24b in 9MFY23, 50% higher than the monthly deficit in 9MFY22 *(Exhibit 1)*. As % of GDP, it stood at 8.6% in 9MFY23, the worst in a decade and compared to 6% of GDP in FY22.

Exhibit 1: India's monthly merchandise trade deficit widened to USD24b in FY23*…



* 9MFY23 Source: Ministry of Commerce, CEIC, MOFSL

Exhibit 2: …but it narrowed sharply and unexpectedly to USD18b in Jan'23



Source: Ministry of Commerce, CEIC, MOFSL

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In Jan'23, however, the merchandise trade deficit narrowed substantially and unexpectedly to USD17.7b, compared to the Bloomberg consensus of USD23.5b *(Exhibit 2)*.

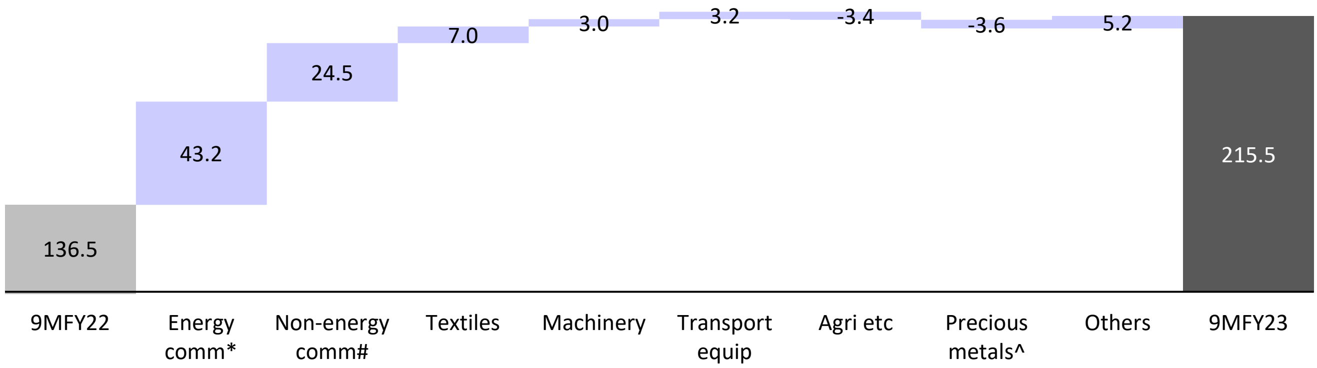
What led to widening of trade deficit in 9MFY23?

In order to understand if the lower deficit in Jan'23 is sustainable or not, it is important to analyze the drivers of the higher trade deficit in 9MFY23 and then the cause of the lower deficit in Jan'23.

86% of the widening in merchandise trade deficit in 9MFY23 was attributed to commodities – 55% by energy items and 31% by non-energy items

A break-up of India's exports and imports in eight major baskets, which account for almost the entire trade deficit, confirms that as much as 86% of the widening in the merchandise trade deficit in 9MFY23 was attributed to commodities – 55% by energy items (fuel & coal) and 31% by non-energy items *(Exhibit 3)*.

Exhibit 3: What explains the rise in merchandise trade deficit in 9MFY23?



* Energy items include fuel & coal
# Non-energy comm include edible oil, fertilizers, base metals and plastic & rubber
^ Precious metals include gold, silver and other previous stones
Source: Ministry of Commerce, CEIC, MOFSL

A 9% rise in the merchandise deficit was attributed to a lower surplus of USD18b in textiles in 9MFY23 v/s USD25b in 9MFY22. It implies a monthly surplus of only USD2b in 9MFY23, the lowest in at least past 13 years and compared to its peak of USD2.9b in FY22. The remaining 5% deficit was attributed to capital goods such as machinery, transport equipment etc., which are partly offset by a higher surplus in agricultural trade & precious metals.

What drove the narrowing in Jan'23?

The fall in the trade deficit in Jan'23 was led by energy and valuables

The fall in the trade deficit in Jan'23 to USD17.7b (v/s an average of USD24b in the past few months) was led by energy and valuables. The trade deficit on energy declined to USD12.3b in Jan'23 compared to an average of USD14b in CY22 and there was a negligible surplus in valuables v/s an average deficit of USD3.2b in CY22.

Fall in commodity prices could bring down trade deficit substantially in CY23/FY24:

Going forward, we believe that global commodity prices (energy, non-energy, edible oil, fertilizers, base metals and precious metals) could fall in CY23/FY24 due to weak growth in the Western economies, which could be offset by a recovery in China. The risks to global commodity prices, thus, are balanced.

If commodity prices in CY23/FY24 remain unchanged at Feb'23 levels, it implies sharp contractions in energy (-24%), fertilizers (-18%) and edible oil (-6%) prices

If we assume that commodity prices in CY23/FY24 remain the same as the Feb'23 levels, it implies sharp contractions in prices of energy (-24%), fertilizers (-18%) and edible oil (-6%). At the same time, there will be modest growth in precious metals (+3%) and industrial metals & minerals (+2%). Overall, since India's import basket is more commodity-driven, lower prices should bring own the merchandise trade deficit. An **expectation** of a weak economic environment will further help to keep the merchandise trade deficit subdued.

Strong surplus in Services account to further reduce CAD in coming quarters: The surplus on the services account, along with lower India's merchandise trade deficit, could also help reduce CAD.

India's service exports have grown tremendously in the post-Covid period. From a monthly average of USD17-18b in CY18-CY19, services exports increased to USD20b per month in CY21 and further to USD25.8b per month in CY22 *(Exhibit 4)*. Average growth in services exports stood at 27% YoY in the past 20 months, and it does not seem to have softened in recent months.

Surplus on services increased to USD15.5b/13.8b in Dec'22/Jan'23, as against a monthly average surplus of USD11b in CY22

Although monthly data is provisional and is likely to undergo revisions when the quarterly Balance of Payments (BoP) data is released, services exports crossed USD30b in Dec'22 for the first time on record, before easing to USD28b in Jan'23 (the third highest on record). Imports, on the other hand, remained sticky at USD15bn during the two months, implying that the surplus on services increased to USD15.5b/USD13.8b in Dec'22/Jan'23, as against a monthly average surplus of USD11b in CY22 *(Exhibit 5)*.

Exhibit 4: Services exports have increased tremendously in the post-Covid period…

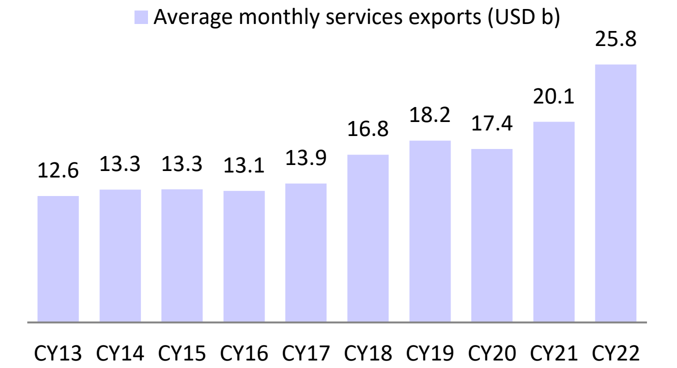
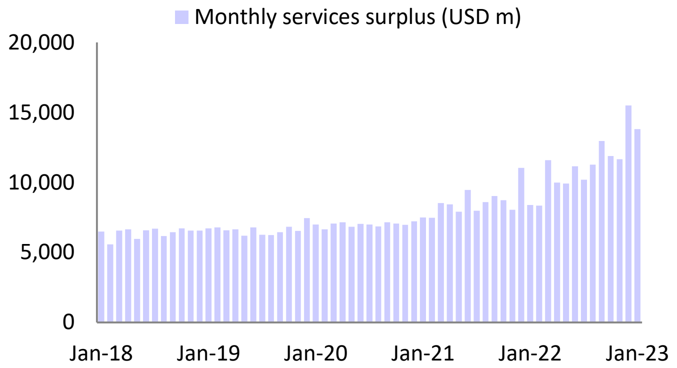


Exhibit 5: … pushing services surplus higher in CY21/CY22, compared to pre-COVID period



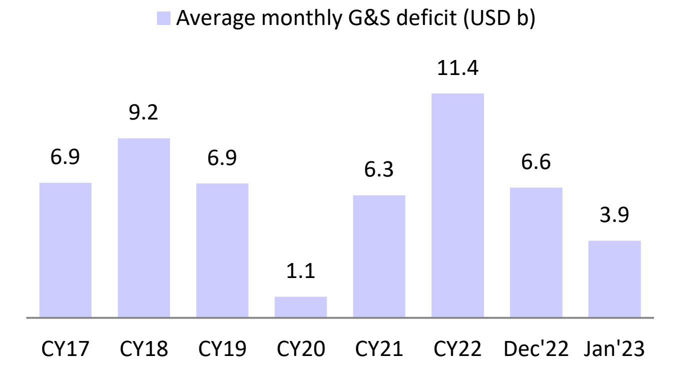
Source: RBI, Ministry of Commerce, MOFSL

A reduction in G&S trade deficit to USD6.6b in Dec'22 and further to just USD4b in Jan'23 is extremely welcome

With a combined average monthly deficit of USD12b on G&S during the past 15 months, a reduction to USD6.6b in Dec'22 and further to just USD4b in Jan'23 is extremely welcome *(Exhibit 6)*. Although we are skeptical about the sustainability of such a high services surplus at this stage, considering our expectation of a US recession in CY23, the recent trends are certainly encouraging and will further bring down the external deficit in coming quarters.

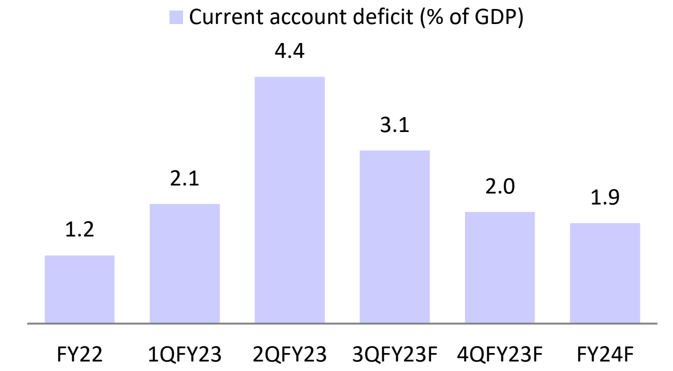
Accordingly, we continue to **believe** that India's CAD could narrow to ~3% of GDP in 3QFY23 and further to about 2% of GDP in 4QFY23 v/s 4.4% of GDP in 2QFY23. We expect it to remain at ~2% of GDP in FY24 *(Exhibit 7)*.

Exhibit 6: Monthly G&S deficit fell to just USD4b in Jan'23 from USD12b in the past 15 months



Monthly services trade data are provisional

Exhibit 7: We expect India's CAD to narrow to ~2% of GDP in CY23/FY24



Source: RBI, CEIC, MOFSL

Does it mean that INR will strengthen? No. As highlighted **earlier**, INR is highly correlated with foreign capital flows, rather than CAD or trade deficit. We stated in our note released in mid-2020 that foreign portfolio/institutional investment (FPI/FII) flows, driven by sentiment, are more important in determining INR movement than crude oil prices (or current account balance).

We continue to expect INR to cross 85/USD by mid-CY23, before retreating in late-CY23 or early-CY24

Although we expect CAD to narrow to ~2% of GDP in FY24, foreign capital flows may also weaken substantially, as has always been the case during the global economic slowdown. Therefore, we continue to **expect** INR to cross 85/USD by mid-CY23. However, with 2024 general elections, domestic fundamentals may take precedence over global factors in determining INR. Accordingly, if the BJP is expected to retain power for the third term in 2024, INR may retreat and strengthen in late-CY23 or early-CY24.

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