Emerging Market Focus

India: current account deficit hole plugged?

- **RBI closed its special foreign currency non-resident (FCNR) deposit scheme on Monday, and early reports are that the scheme attracted over USD100bn worth of inflows into India. If true, this number greatly exceeds the estimate of RBI Governor Sanjay Malhotra at USD80bn.**
- **These greater inflows are needed to plug the growing current account deficit gap India faces from the ongoing closure of the Strait of Hormuz as well as growing downside risks to the country's agricultural exports from El Nino.**
- **Updating our long-term USD/INR fair value model for the latest current account, oil price and trade data as well as the higher-than-expected capital inflow from the FCNR deposit scheme places the central long-term fair value of USD/INR at around 96.00. This estimate is in the event RBI uses these capital inflows for FX intervention rather than retiring its forward book, which so far looks potentially the case. We are maintaining our forecasts for USD/INR in H226 at 96.00.**
- **If RBI begins unwinding its forward book using the inflows, this central estimate rises to 97-98.**

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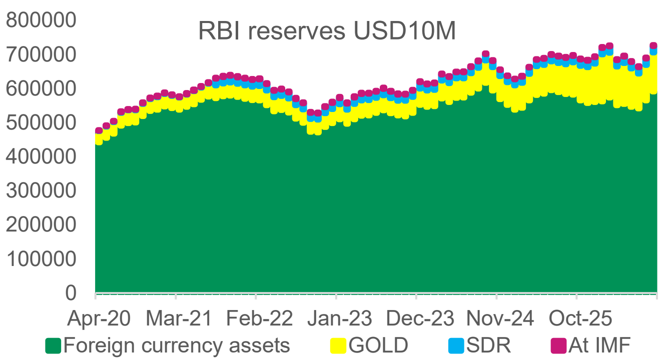
RBI's bigger war chest – it is needed

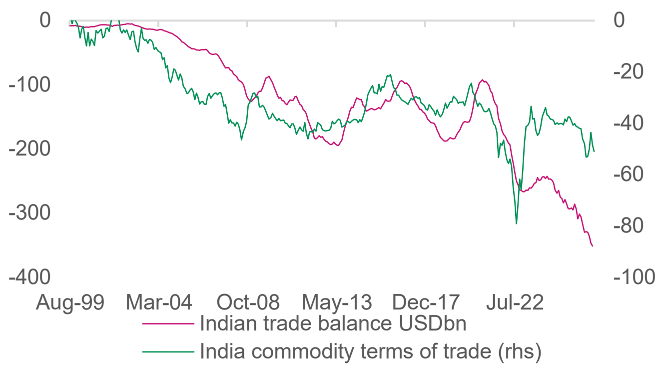
The RBI closed its special FCNR deposit scheme on Monday, and reports are emerging about how much capital inflow the scheme generated. According to press reports, the FCNR inflows could have exceeded USD100bn. If correct, this number would be significantly above the last official figure of USD65.39bn reported by RBI as well as the USD80bn estimate given by Governor Sanjay Malhotra. The rush of inflows have pushed India's FX reserves to a record USD729.3bn (Figure 1).

Fig 1. FCNR deposit inflows have built RBI a record war chest to defend the INR…



Source: CEIC, Crédit Agricole CIB

Fig 2. …but oil prices are keeping downward pressure on India's terms of trade and trade balance…



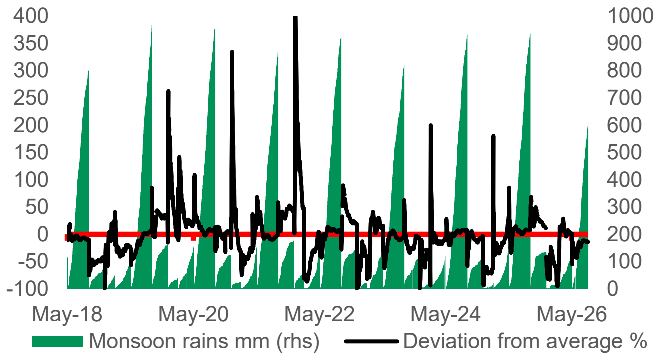
Source: CEIC, Crédit Agricole CIB

The USD100bn inflow will help plug the current account deficit hole caused by the US-Iran war, which is pushing India's import bill higher due to rising oil prices but also curtailing the country's exports to the Middle East. Importantly, we continue to think the FCNR deposit scheme as well as changes to foreign investor investment and tax regulations are unlikely to lead to a rally in the INR for several reasons:

1. **Current account:** in India: plugging the current account hole & our forecasts we estimated the current account hole to be USD80bn, but the ongoing closure of the Strait of Hormuz, which we assumed would be temporary means. This

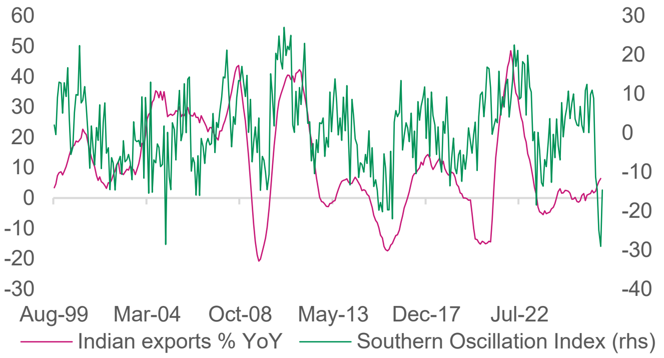
number is now likely closer to USD100bn. Indeed, the ongoing closer of the Strait of Hormuz along with gathering risks around an El Nino event place even greater demands on capital inflows to help balance India's balance of payments placing further challenges in front of the INR (Figures 2-4). In all, India will likely record a BOP surplus this year meaning the current account hole has been plugged.

Fig 3. …so too is a weak monsoon season…



Source: Bloomberg, Crédit Agricole CIB

Fig 4. …and likely weaker exports



Source: CEIC, Crédit Agricole CIB

2. **Capital inflows:** outside of the FCNR deposit scheme, there are few signs India is re-attracting foreign investors back to its capital markets. There has been some pick-up in foreign inflows into bond markets; equity outflows continue to swamp these inflows (Figure 5).

Fig 5. Limited signs of a turnaround in capital inflows into India's capital markets

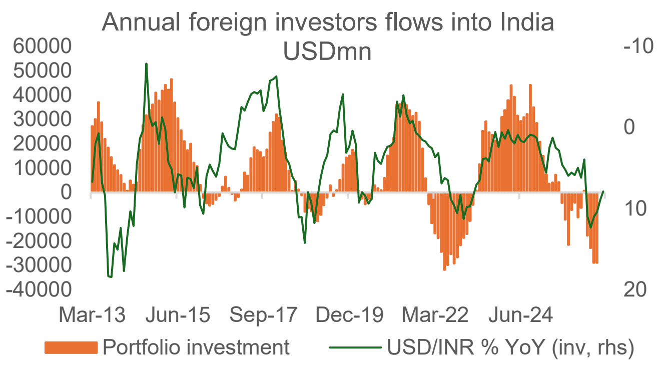


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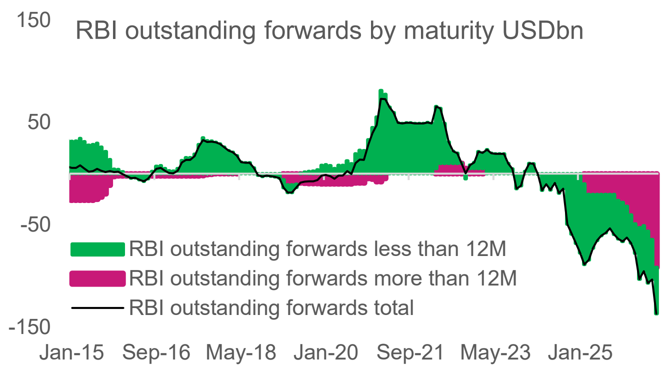
Fig 6. RBI using its bigger war chest to defend the INR and increase its outstanding forward book



Source: CEIC, Crédit Agricole CIB

3. **RBI still defending the currency:** data from RBI suggests that the central bank is using the capital inflows to intervene further in the FX market to support the INR. Indeed, RBI's forward book has grown by over USD30bn since May. While forwards less than 12M have been reduced by over USD5bn, those over 12M have grown by over 35bn (Figure 6). The fact that the central bank must continue defending the currency is not a good sign.

Crunching some numbers

We update our long-term USD/INR model for the latest current account, oil price and trade data. We also raise our estimates for capital inflows from USD95-130bn initially to USD110-150bn. Note that while the inflows from RBI's FCNR deposit scheme have surprised to the upside, changes to foreign investor regulations and taxes look like they could underwhelm. USD/INR's long-term fair value varies between about 93-100 in the situation where the RBI does not capture inflows to unwind its forward book (Figure 7). This looks like the prevailing scenario with the

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central bank using the inflows to help defend the currency and places the central fair value of USD/INR at around 96.00. If RBI begins unwinding its forward book using the inflows this central estimate of USD/INR's long-term fair value rises to 97-98. We are maintaining our forecasts for USD/INR in H226 at 96.00.

Fig 7. Scenario analysis for USD/INR fair values based on capital inflows & the RBI's forward book unwind

	Without RBI unwind of forwards			With RBI unwind of forwards 12M or less			With RBI unwind of all forwards		
	Low	Average	High	Low	Average	High	Low	Average	High
Estimated capital inflows USDbn	110	130	150	110	130	150	110	130	150
RBI unwind of forwards USDbn	0	0	0	-44.6	-44.6	-44.6	-95.3	-95.3	-95.3
Net capital inflow less RBI unwind USDbn	110	130	150	65.4	85.4	105.4	14.7	34.7	54.7
Net capital inflow less RBI unwind % GDP	0.7%	0.8%	1.0%	0.4%	0.6%	0.7%	0.1%	0.2%	0.4%
USD/INR fair value	96.70	96.46	96.21	97.25	97.00	96.76	97.87	97.38	97.62
USD/INR fair value +1.5SD	100.32	100.07	99.83	100.86	100.62	100.38	101.48	101.00	101.24
USD/INR fair value -1.5SD	93.08	92.84	92.59	93.63	93.38	93.14	94.25	93.76	94.00

Source: Crédit Agricole CIB, RBI

Conclusions

RBI closed its special foreign currency non-resident (FCNR) deposit scheme on Monday and early reports are that the scheme attracted over USD100bn worth of inflows into India. If true, this number greatly exceeding the estimate of RBI Governor Sanjay Malhotra at USD80bn.

These greater inflows are needed to plug the growing current account deficit gap India faces from the ongoing closure of the Strait of Hormuz as well as growing downside risks to the country's agricultural exports from El Nino.

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If RBI begins unwinding its forward book using the inflows, this central estimate rises to 97-98.

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