

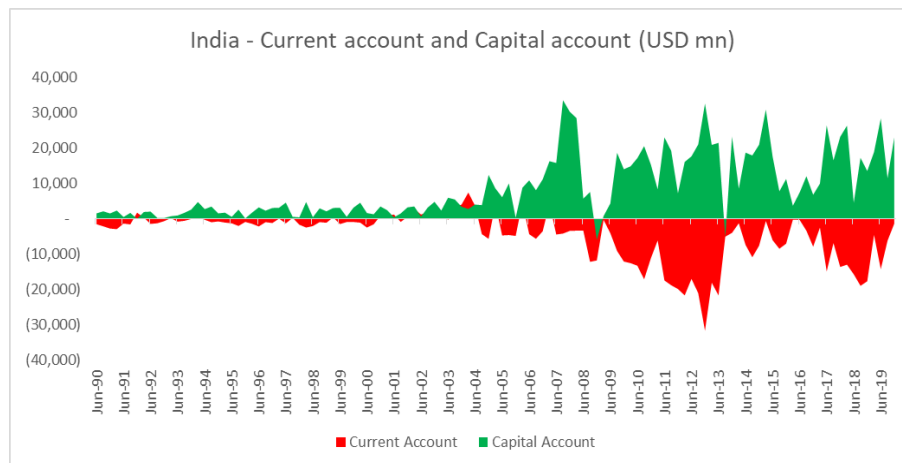


Krushii Parekh, June-2020

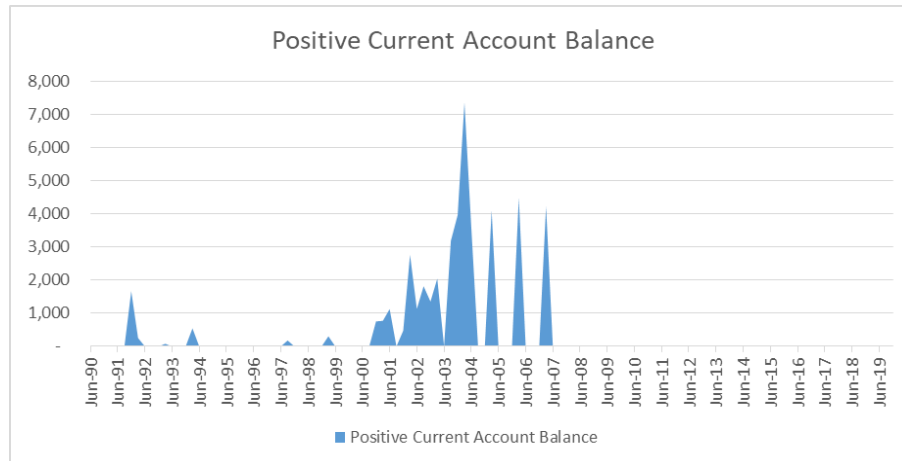
### In the past...

India traditionally has been net-importer of goods and services. It has been balancing its foreign exchange trade deficit by attracting capital flows. India's high GDP growth rate and demographic dividend story has attracted lots of foreign investments as well which has helped it amass large foreign exchange reserves over the years.

Capital account flows has been higher than current account flows during 95% of the quarters in last 40 years. India has been current account deficit country in 82% of the quarters over last 40 years.

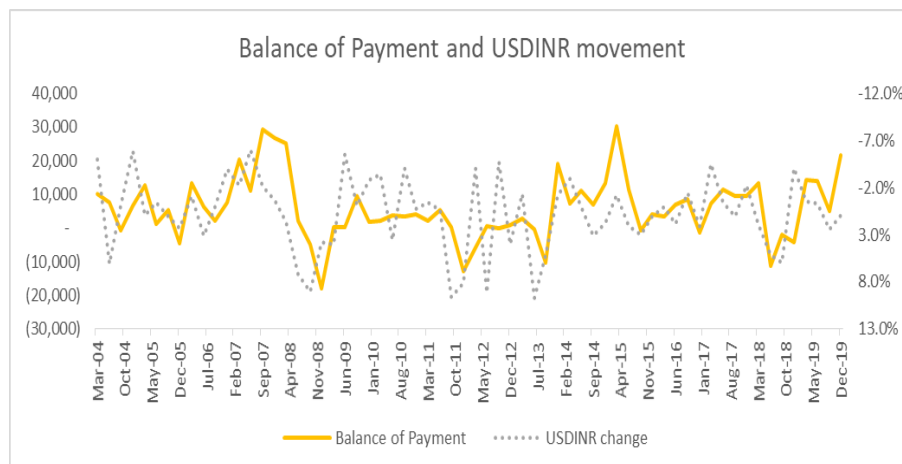


Only time when India had seen positive current account balance (on a consistent basis) was between 2001 and 2004. This is when India's services exports (IT exports) were growing at rapid pace.



Rest of the time, India has remained net importer of goods and services which was funded by attracting foreign capital.

There are no prizes for guessing that India's Balance of Payment and USD-INR rates are highly related. Below chart suggests when Balance of Payments was positive (i.e. net forex inflows) INR has seen appreciation and vice versa.



*Balance of Payments = Current Account Balance + Capital Account Balance + Other transfers (refer annexure for details)*  
*USDINR change on right hand side is inverted chart. Negative mean INR appreciation and positive RHS means INR depreciation.*

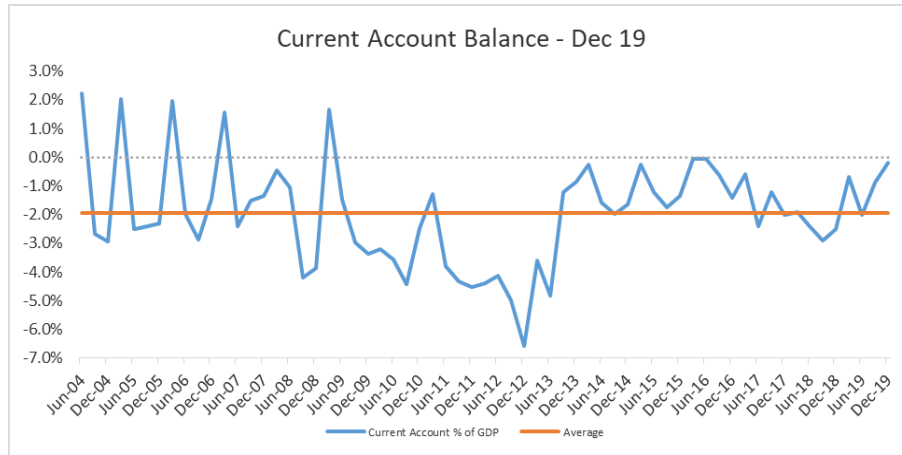
Over short term, trade balance & current account, can have an impact on USD-INR movement. However, based on above, we can say that INR movement over longer term is largely dependent upon levels of capital inflows.

Thus, when we are talking about global [US\\$ shortage and structural issues with Eurodollar bond markets](#), it becomes important to understand where India stands currently with respect to its foreign exchange position.

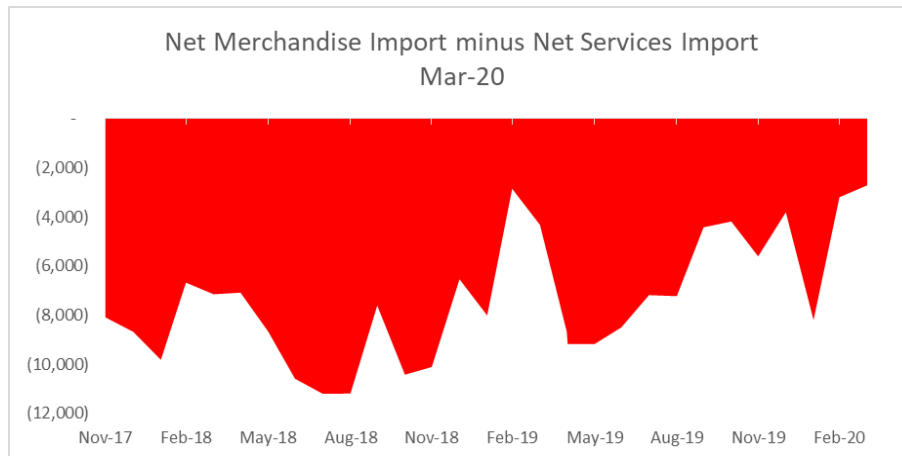
## What does indicators say currently?

### A. Current Account Deficit

Was near 0% as at Dec-19



With slowing global and Indian economy, the deficit appears to have shrunk. India's services exports continued to earn at its regular monthly rate during March-20 at least. This has resulted in net trade and services deficit to decrease to less than \$3 bn a month from a peak of \$ 11 bn a month. This has led to lower foreign exchange outflows from India on account of trade.



We will need to see if services exports can sustain the momentum going forward in slowing global GDP and help keep current account deficit lower.

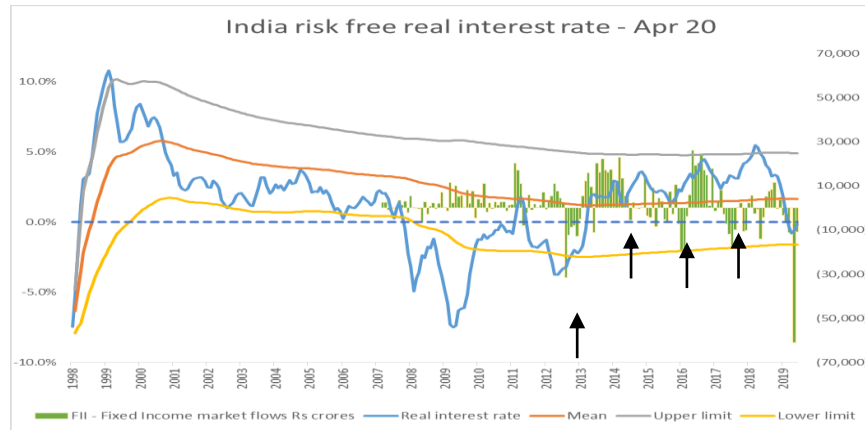
### B. Capital Account Surplus

Capital flows into India have primarily been by way of Foreign Direct Investments (FDI), Foreign Portfolio Investments (FPI), Deposits by Non-Resident Indians (NRI deposits), etc. Prevailing interest rates and GDP growth rates can have a major impact on these flows.

#### 1. Real risk-free rate

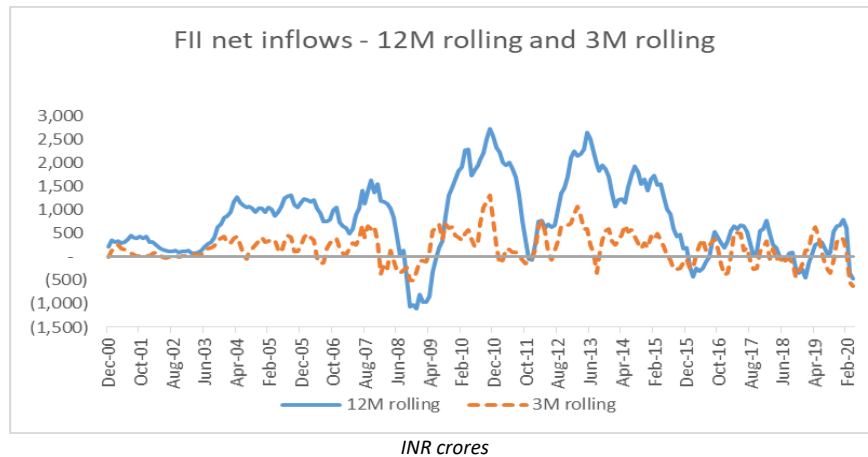
We can see that declining real risk-free rates have led to outflows of foreign institutional money from India's debt market, at

least over last 10 years (with some lag). India's real risk-free rate has turned negative very sharply recently and we have seen major outflow of FPI outflows from India's debt market.



## 2. FII – Equity

Foreign flows into India's equity (cash) markets have also remained negative / low. In low growth world (at least over shorter term), one must consider how attractive India is for foreign investors.

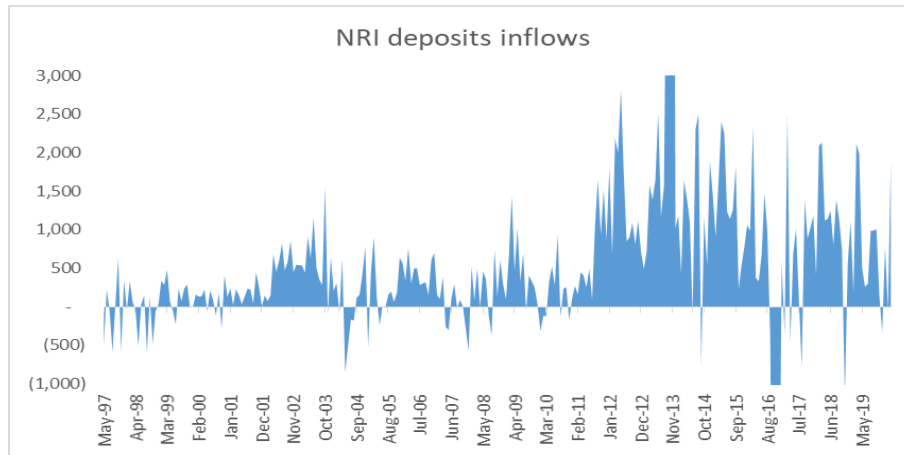


S&P 500 vs. MSCI Emerging Markets also suggests continued strength, suggesting preference for developed market equities over emerging ones for the time being. This can continue to result in sluggish FPI flows into India.



### 3. NRI Deposits

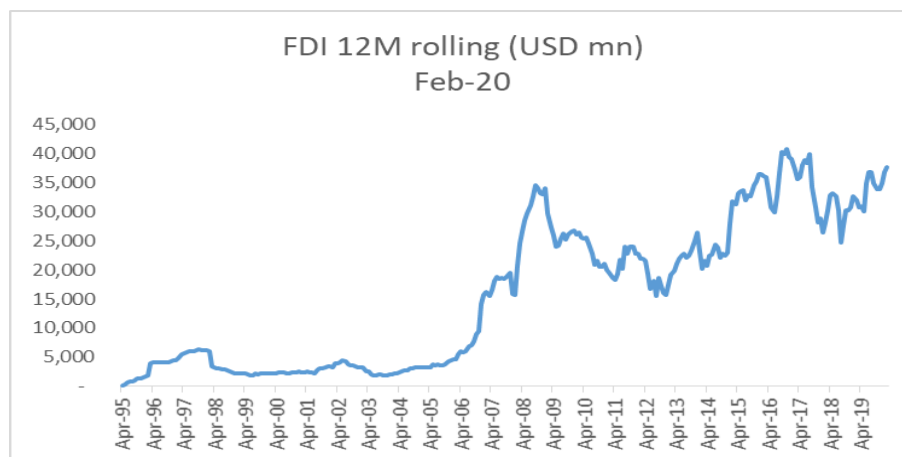
Deposits by non-resident Indians has been a major source of foreign exchange inflows for India over years. We can see higher cumulative flows in QE era. While QE continues, it remains to be seen if NRI flows would be adequate to fill the gap for lower FII inflows, especially with negative real interest rates.



### 4. Foreign Direct Investments

India had been a beneficiary in QE era with rising FDI. It remains to be seen if risk taking by Private Equity, Venture Capital funds and global MNCs remains at as elevated a level going forward, especially if we are looking at a low growth world for the time being.

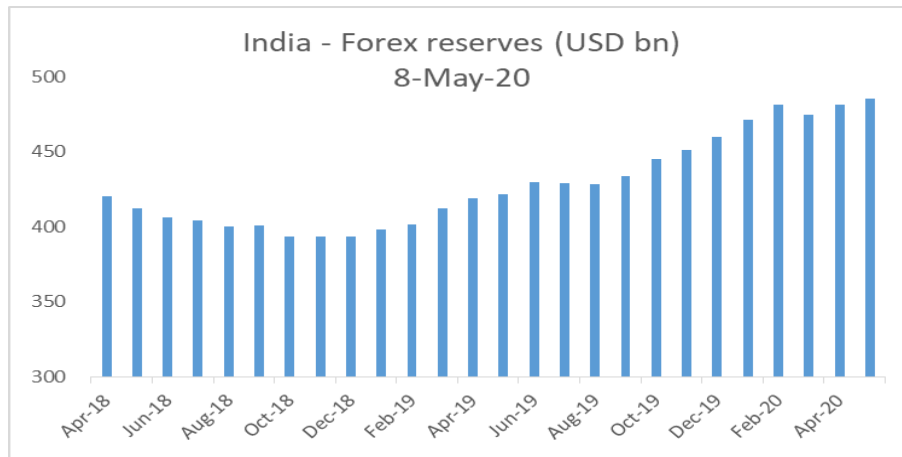
Though on a flip side, there are opportunities to attract FDI considering world is looking to diversify its supply chain away from China.



Overall, there is nothing to suggest that what we have seen in last 40 years to change. At structural level, INR remains a depreciating currency.

## How comfortable is India's forex position as of now?

India's forex reserves have remained steady at ~\$485 bn. Thus far, it has managed to escape a plunge in foreign exchange reserves despite capital flight (FII). Lower oil prices have come to India's rescue with India's oil basket price declining to \$20 per barrel for Apr-20.

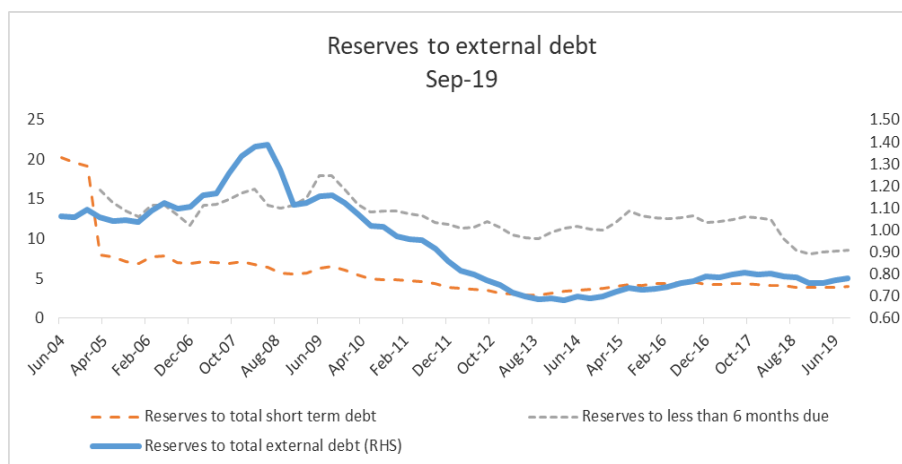


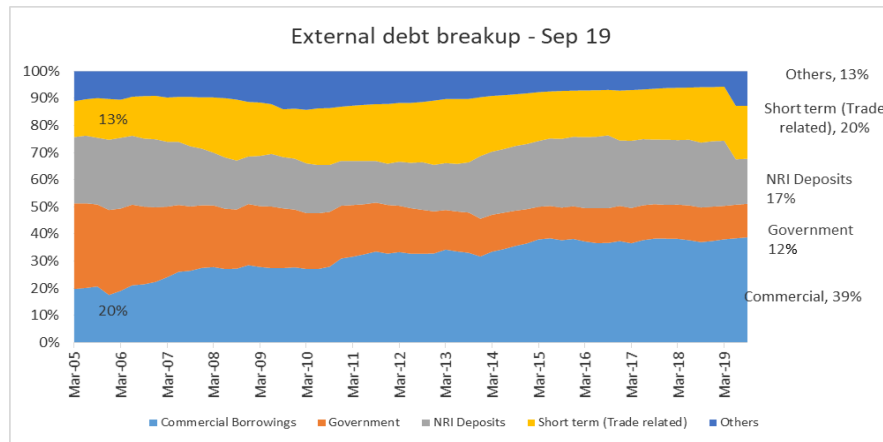
These reserves were accumulated by way of capital inflows, including borrowings. There are liabilities against these reserves. And liabilities come with an expiry date.

India's external debt grew by 2.7x over last 12 years on higher commercial borrowings and short-term trade related borrowings. This has resulted in India's external debt to forex reserves ratio to decline (become adverse).

While India appears to be covered when it comes to short term debt, forex reserves are only to the extent of ~80% of total external liabilities.

Meaning, if it had to pay all its liabilities today, India does not have adequate reserves to pay all of them.





Below table gives India's foreign exchange liabilities coverage. As at Dec-19, it had only twice as much reserves to cover its short-term liabilities.

Maturity of India's external debt					
USD bn	Repayable within				Total
	1 year	2 years	3 years	>3 years	
<b>As at Dec-19</b>					
Sovereign debt	6	8	9	87	<b>110</b>
Commercial borrowings	34	25	31	125	<b>215</b>
NRI Deposits	92	20	13	9	<b>133</b>
Short term debt	107				<b>107</b>
<b>Total</b>	<b>238</b>	<b>53</b>	<b>53</b>	<b>220</b>	<b>564</b>
<b>Debt / Reserves</b>	<b>51.8%</b>				<b>123%</b>
<b>Forex reserves as at Dec-19</b>	<b>460</b>				

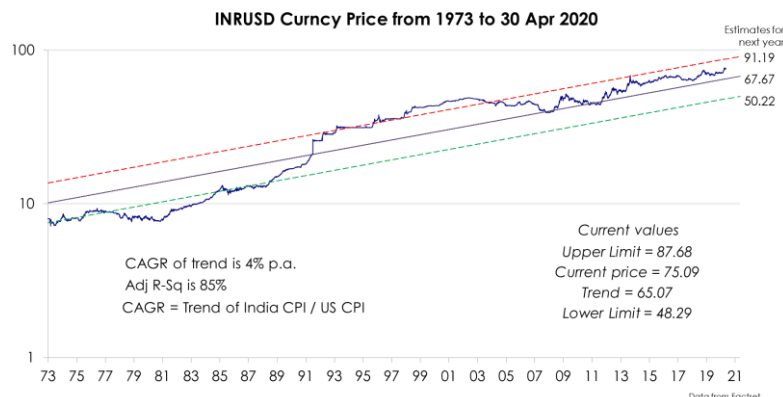
Source: DEA, Short term debt = Trade related and other short duration borrowings.

India lost some of its forex reserves during March-20, but subsequently appears to have regained it during April and May of 2020 because of lower oil prices and trade deficit.

However, this repayment schedule brings out a vulnerability with respect to India's dependence on short term money.

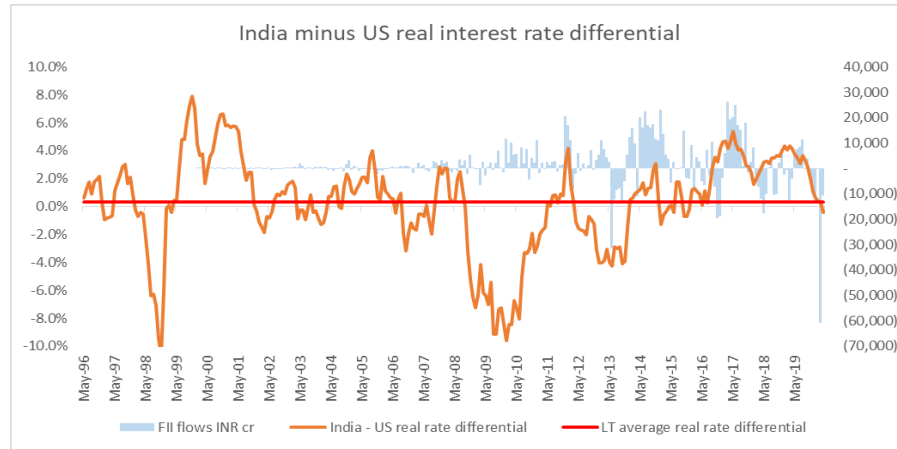
## Structural problem of INR

INR remains a structurally depreciating currency as of now. India remains a net importer of goods and services that are offset by capital inflows.



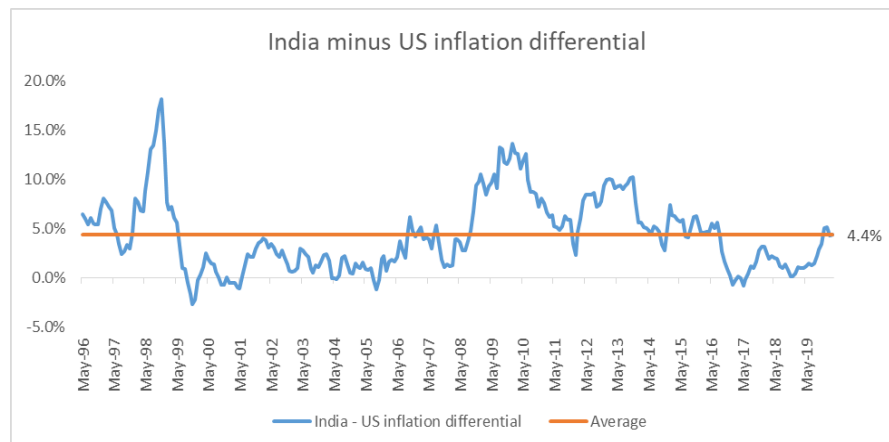
The issue with India is partly structural and can be seen from the real interest rate differential with the US (red line in below chart). Over the long term, it has averaged near 0% i.e. real interest rate in India is same as that in US over long term!

India receives large amounts of FII, FDI and NRI deposit flows to balance its net imports and build forex reserves. Large proportion of that came in post 2013/14, when the real interest rate differential was positive, and India promised a "growth story". With real interest rates turning negative and GDP growth slowing down, capital flows especially FPI's can be a risk.



Long term real interest rate differential with US near 0% also probably tells us that over long term, India has attracted foreign capital for its high GDP growth rate potential.

This also tells us about India's structural inflation problem that surfaces in some years. India's inflation differential with US has stayed high at 4.4% over long term (has started to rise again now). This inflation problem is rooted in its sustained fiscal deficit. Basically, government is taking resources and not paying adequately for that from savings, resulting in inflation spurts every few years. A borrower cannot support high real interest rates to attract capital if the productivity (low) does not compensate for the high real rate !



For a trade deficit country like India, foreign capital can be attracted structurally by way of improving productivity. Investments chase improved productivity. Higher output at lower input costs. If an economy has high productivity, high interest rates, are sustainable attracting people and capital. There is some evidence of countries like Taiwan, South Korea, Thailand, etc. being able to do it and have high real rates. Maybe we will try to dig a little deeper in this area in a separate follow up piece.

But for now, we should expect things to remain the same. We may get occasional INR appreciation when some input factors aiding INR (like lower oil prices) excite market participants. But the larger trend for INR remains that of a depreciating currency. We can expect government policies directed towards attracting foreign capital to balance its foreign exchange reserves to give it



financial flexibility, especially during a time of US\$ shortage.

### To conclude...

1. INR remains a structurally depreciating currency at this point. It remains a net importer of goods and services to support its growth, that are offset by capital inflows.
2. A large amount of capital inflows is by way of US\$ borrowings. In negative real interest rate scenario, attracting and rolling over forex borrowings can be a risk.
3. Low/slow growing economy also poses a risk with respect to FII-Equity and FDI flows into India.
4. Currently, India has adequate reserves to meet its short-term obligations (~52% of reserves held). Coverage is only ~80% of total foreign exchange obligations giving it vulnerable to capital flight from past FPI investments. This ability has deteriorated over a period. INR therefore remains dependent upon incremental flow of US\$ loans and investments to support a higher growth rate that is not matched by domestic financial savings.
5. Over near term, important indicators to monitor will be the trade and services deficit, NRI deposits and FII flows in equity and bond markets.

### Annexure:

India Balance of Payment break up:

Balance of Payment	Over last 40 years	Component	Includes	India generally has been	Last 10 years cumulative USD bn
Current Account	<b>Negative or Deficit 82% of the time</b>	Merchandise Trade	Tangibles import and export of goods.	<b>Net forex payer.</b>	<b>-1,538</b>
		Invisibles	Software exports, business services, travel, tourism, etc.	<b>Net forex receiver.</b>	<b>1,088</b>
<b>~Current Account Balance</b>					<b>-451</b>
Capital Account	<b>Has been higher than Current Account 95% of times.</b>	Foreign Investments	Primarily net Foreign Direct Investments and Foreign Portfolio Investments.	<b>Net forex receiver.</b>	<b>444</b>
		Foreign Loans	Commercial borrowings (medium term and long term), short term credit and external assistance.	<b>Net forex receiver.</b>	<b>142</b>
		Banking Assets	Movement in forex asset and liabilities of Banks. Non-Resident Deposits (NRI deposits) are important driver of this.	<b>Net forex receiver.</b>	<b>203</b>

### Multi-Act Equity Consultancy Private Limited

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##### **General risk factors**

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