

CAD narrows despite higher trade deficit

India's current account deficit narrowed to 1.2% of GDP in Q2FY25 from 1.3% of GDP in Q2 FY24. While the trade deficit was higher, buoyant services exports as well as continued strength in remittances underscored the lower CAD. A surge in gold imports can explain the higher trade deficit, even though oil imports were largely in check. Capital account surplus expanded, led by FPI inflows, while FDI outflows were recorded higher. As a result, BoP surplus was recorded higher at US\$ 18.6bn compared with US\$ 2.5bn in Q2 FY24. Going ahead, a surge in gold imports is likely to push CAD for Q3 FY25 to above 2% of GDP. However, this is likely to be cushioned by services and remittances receipts. Overall, we expect CAD at 1.2-1.5% of GDP in FY25, with US trade policies being a key risk to the outlook. Sluggish FPI inflows along with a stronger dollar will continue to exert pressure on INR. We expect a range of 84-84.5/\$ for the domestic currency in the near-term.

Current account in deficit:

India's current account narrowed marginally from US\$ 11.3bn in Q2 FY24 to US\$ 11.2 bn in Q2 FY25. This was despite the fact that the merchandise trade deficit was higher at US\$ 75.3bn in Q2 FY25 compared with US\$ 64.5bn in the same period last year. The higher trade deficit can be explained by higher non-oil imports. Notably, while oil-deficit increased by US\$ 2.3bn on a YoY basis, non-oil deficit was higher by US\$ 8.5bn. Notably, gold imports were higher by US\$ 5bn between Q2 FY25 and Q2 FY24 which can explain the higher deficit. On the other hand, net services balance was recorded at US\$ 44.5 compared with US\$ 39.9bn in Q2 FY24. Software and business services exports noted a significant pickup. Net transfer receipts were also higher, led by a pickup in private transfers to US\$ 29.3bn in Q2 FY25 from US\$ 25.1bn last year. Outflows on account of primary income moderated, further supporting the CAD.

Capital account surplus:

Capital account surplus increased to US\$ 11.9bn in Q2 FY25 compared with US\$ 10.3 bn in Q2FY24. While FDI outflows exacerbated to US\$ 2.2bn this year, compared with outflows of US\$ 0.8bn in Q2 FY24, other segments saw an improvement. Most notably, FPI inflows surged sharply to US\$ 19.9bn compared with US\$ 4.9bn in the same period last year. Inflows into NRI deposits were also higher at US\$ 6.2bn versus US\$ 3.2bn last year. Even net ECB inflows saw an improvement to US\$ 5bn compared with net outflows of US\$ 1.9bn in the same period last year.

Overall, India's balance of payments recorded an accretion of US\$ 18.6bn in Q2 FY25, compared with US\$ 2.5bn in Q2 FY24. This was supported by robust inflows from FPIs, ECBs and NRI deposits.

Outlook:

India's external sector outlook has not changed materially in the last few months. While the sharp surge in trade deficit in Nov'24 has raised some concerns, this is likely to be a one-off, as the deficit

was almost entirely driven by a surge in gold imports. Even so, growth in merchandise imports continues to outpace the growth in goods exports which has led to a widening of trade deficit on a FYTD basis (Apr-Nov'24). On the positive side, services exports have been resilient, which has been the primary driver of keeping CAD contained at comfortable levels. Remittances too have been resilient despite lower oil prices. Increased threats of a protectionist trade policy being implemented by the incoming US President, will be a key threat for the external sector outlook. On balance, we expect CAD to remain in a manageable range of 1.2-1.5% of GDP in FY25. Pressures on the funding side have emerged with FPI inflows still not recovering in a significant way and FDI inflows seeing only a nascent recovery. This coupled with a stronger dollar is likely to keep the rupee under pressure. We expect INR to trade with a depreciating bias in a range of 85-85.5/\$ in the near future.

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