ISAS Brief

No. 92 – Date: 6 January 2009

469A Bukit Timah Road
#07-01,Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

India's External Sector: Emergence of New Structural Trends

Amitendu Palit[1]

The Reserve Bank of India (RBI) released India's latest balance of payment (BOP) estimates on 31 December 2008. The estimates are for the first six months of the financial year 2008-09 (that is, April-September 2008). It is evident that India's BOP has undergone some significant structural changes in the current year. Most of these changes are attributable to the global financial crisis. If the changes deepen further during the rest of the year, then India's BOP and external sector are likely to look much different from what they did in recent past.

The most striking feature of the current BOP estimates is the development on foreign exchange reserves. After a long time, India has not experienced any net addition to its outstanding stock of foreign exchange reserves. The latter went down by US$23.4 billion during April-September 2008. On a comparable basis, India's foreign exchange reserves had increased by US$48.6 billion during April-September 2007. As a result of no net accretion, India's total outstanding stock of foreign exchange reserves has come down from US$309.7 billion as on 31 March 2008 to US$286.3 billion as on 30 September 2008. The development does not indicate a weakening of external sector fundamentals since, at their current level, the reserves cover import requirements for more than 11 months. However, they do point to the onset of interesting structural changes in India's BOP and external sector.

Why did the reserves decline during the current year? An important reason is valuation loss. The value of India's foreign exchange reserves – as determined by their currency composition – experiences significant gains or losses depending upon the movement of the United States dollar (USD) vis-à-vis other major currencies. Gains accrue if the USD weakens against others and vice-versa. During April-September 2008, the USD gained against major currencies of the world. Between 2 April 2008 and 29 September 2008, the USD appreciated against the Great Britain pound, the Euro and the Japanese yen by 7.9 percent, 7.3 percent and 3.9 percent respectively. These trends have been reflected in the movement of the Indian rupee (INR) vis-à-vis the major global currencies as well. During April-September 2008, the INR depreciated the most against the USD (17.4 percent) compared to the Great Britain pound (7.6 percent), the Euro (7.5 percent) and the Japanese yen (10.3 percent). With the USD gaining against other currencies, Indian reserves have experienced significant valuation losses. Such losses during April-September 2008 were as

[1] Dr Amitendu Palit is a Visiting Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He can be reached at isasap@nus.edu.sg.

much as US$20.9 billion. This was in sharp contrast to valuation gains of US$8.1 billion during April-September 2007, a period when the USD was weakening against other currencies.

While global cross-currency movements partly explain the drop in India's foreign exchange reserves, the other reasons are more structural to India's BOP. In this context, it is essential to look at the structural features of India's BOP. India has traditionally had a current account deficit accompanied by a capital account surplus. During the external sector crisis of 1990-91, the current account deficit increased to three percent of its gross domestic product. A progressively greater services-orientation of the economy from the 1990s, coupled with outward-oriented external sector reforms, led to 'invisibles' assuming a larger role in the current account. Invisibles include receipts from services (software, communication, business and professional services, and travel), exports and inward remittances. Buoyant services receipts and heavy remittance flows slowly brought down the current account deficit until India achieved a current account surplus in 2001-02. On the other hand, the capital account surplus kept enlarging due to higher external commercial borrowings (ECBs), non-resident deposits in commercial banks and larger portfolio and foreign direct investment (FDI) flows. The twin surpluses resulted in steady accretion of reserves from the early years of the current decade. Reserve build-up gathered momentum as the capital account surplus expanded fast on account of a deluge of foreign institutional investor (FII) inflows precipitated by a robust capital market since 2003-04. The capital account surplus more than compensated the current account deficit that resurfaced from 2004-05. As a result, reserve accretion continued unabated with India's reserves crossing US$300 billion by the end of 2007-08.

With reserve growth showing a departure from its rising trend in the current year, it is important to revisit the current and capital account dynamics. At the end of the first six months of 2008-09, the current account showed a deficit of US$22.3 billion. This was more than double the deficit of US$11.0 billion in April-September 2007. The deficit has swelled mainly on the account of an increase in trade deficit (US$69.2 billion in April-September 2008 compared to US$43.3 billion in April-September 2007), which has expanded due to the stiff rise in prices of oil imports. Though invisible surplus also increased due to robust inflow of remittances during this period, the trade deficit grew faster leading to a larger overall deficit in the current account.

While a bigger current account deficit was expected, the contraction in the magnitude of the capital account surplus was somewhat unexpected. The latter was only US$19.8 billion during April-September 2008. This is in sharp contrast to a surplus of US$51.4 billion in April-September 2007. The drop in the size of the capital account surplus vis-à-vis the increase in the current account deficit has exacerbated the decline in reserves. Indeed, had the capital account surplus more than compensated the current account deficit, as it used to in the past, then the reduction in reserves would have been much less than the reported US$23.4 billion in spite of valuation losses.

The capital account of the BOP for the current year reflects some major structural transformations. The most important of these is in the nature of flows dominating the account. Unlike previous years, when portfolio investment flows made up a major part of the capital account balance, the situation is different this time around. Portfolio flows have turned into net outflows. During April-September 2008, net portfolio investment amounted to US$-5.5 billion, reflecting a larger outflow of such investment vis-à-vis inflow. While this has contracted the capital account, the effect has been reinforced by drops in ECBs and short-

term trade credits that are mostly used for financing imports. These declines have not been compensated by an equivalent increase in longer-term FDI flows and have led to a significant reduction in the size of the capital surplus.

The changes in India's BOP are correlated to the volatility in global financial markets observed since the beginning of the current financial year. The first quarter (April-June) of 2008-09 saw an accretion of US$2.2 billion to the existing stock of foreign exchange reserves. During the second quarter (July-September), the reserves dropped by US$4.7 billion.[2] However, the difference in accretion to reserves between the two quarters masks the prevalence of some similar trends during both periods. Capital outflows had gathered momentum during the first quarter itself. Net portfolio investment was an outflow of US$-4.2 billion during April-June 2008. This outflow reduced to US$-1.3 billion in the next quarter. However, the lower outflow should not be taken as a signal of revival of domestic capital markets. On the contrary, it probably reflects a marked dip in gross FII inflows as well as lower resource mobilisation through American depository receipts and Global depository receipts by Indian companies on the account of the liquidity crunch affecting global markets.

The most significant structural development in India's external sector, as reflected in its BOP, is the inability of the capital account to overcome the deficit in the current account. As a result, after a long time, there has not been any addition to foreign exchange reserves. In a related development, the quality of the capital account in terms of nature of flows is undergoing a structural transformation. Short-term and relatively 'volatile' flows like FII investments that have been dominating India's capital account are reducing in importance. It is the same for debt-creating flows such as ECBs and trade credits. The capital account for the first six months of the current year has had longer-term FDI flows as the most significant contributors.

What is the outlook for the BOP in the remaining part of the year? The year is unlikely to experience a significant reserve accretion. There are two reasons for this. First, in spite of the global recession, the USD has kept on strengthening against major currencies of the world.[3] Investors have been picking up United States dollars by selling large chunks of emerging market securities. This has increased the demand for the greenback. Dollar demand has also gone up due to higher purchases of United States Treasury bonds that are being considered as the 'safest' investments. A northward-bound dollar means valuation losses for India's reserves. The cross-currency trends after September 2008 clearly point to more such losses. Second, India's trade and current account deficits are likely to widen with exports slowing sharply. However, the higher current account deficit is unlikely to be compensated by a corresponding increase in capital surplus. There are little chances of portfolio inflows increasing significantly in the next couple of quarters due to depressed sentiments in global and domestic capital markets. At the same time, liquidity problems are unlikely to see an increase in ECB inflows. The stimulus package announced on 22 January 2008 has relaxed end-use restrictions for ECBs by allowing their use in integrated townships. The FII investment ceiling in corporate bonds has also been hiked. However, these measures are likely to work with a lag and the effects are unlikely to manifest before the next year.

During the current year, longer-term FDI flows have been 73 percent of net capital flows compared to only 9.5 percent in the corresponding period of 2007-08. While other capital

[2] The accretion figures for both quarters exclude valuation changes.

[3] The sharpest appreciations have been against the Great Britain pound and the Euro during October-December 2008. It has weakened slightly against the Japanese yen.

inflows have shown a declining trend in the current year, FDI flows have been exceptions. Greater dominance of these flows might make the capital account more 'stable' compared to relatively volatile portfolio flows. But whether the former will be large enough to make the capital surplus cover the current account deficit is doubtful. That will require a further deepening of the structural change that has commenced in India's BOP and is unlikely to happen this year. Thus, there are strong possibilities of 2008-09 being the first year after 1995-96 when India's foreign exchange reserves are unlikely to increase from their previous year levels.

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