Balance of Payments review

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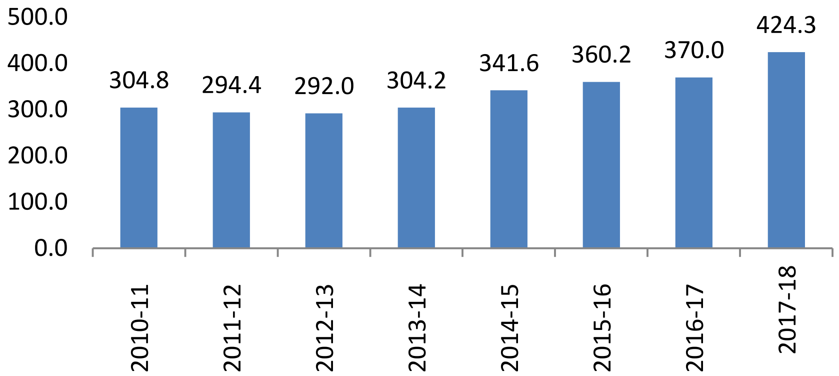
India's external account continued to remain comfortable in FY18 notwithstanding an increase in the current account deficit to 1.9% of GDP from 0.6% in FY17. The current account deficit has been under control for the last five years and has been less than 2%. In FY12 and FY13, which was the time when the crude oil price had peaked in global markets, the deficit was at 4.2% and 4.8% respectively. Low crude oil prices have kept the current deficit in check as the invisibles account was largely stable. Between FY14 and FY17, there was a continuous decline in the current account deficit which had gotten reversed in FY18. With strong support coming from the capital account the forex reserves too have been increasing at a steady pace.

Forex reserves ($ bn)



Source: RBI

As can be seen from the graph, from 2013-14 onwards, there has been a continuous increase in forex reserves which were resilient even when the FCNR (B) deposits were redeemed. This was made possible on account of the strength of both the current and capital accounts.

Table 1 below provides information on the detailed balance of payments statement for the last 5 years. Some of the main highlights from the current account story are:

1. The trade deficit has peaked in FY18 after being on the decline between FY15-FY17.
2. The current account deficit too has peaked this year at $ 48.7 bn.
3. The two major components of the invisibles pool are software receipts and remittances. In case of software receipts there were no signs of a slowdown on account of the perceived restrictive practices being pursued in the USA on account of the change in guard.

Clearly this does not come out from the data which shows that this fear may not be founded. It is also true that the IT sector has diversified its markets too - with other regions in Europe, Asia and Africa finding space on their strategic maps.

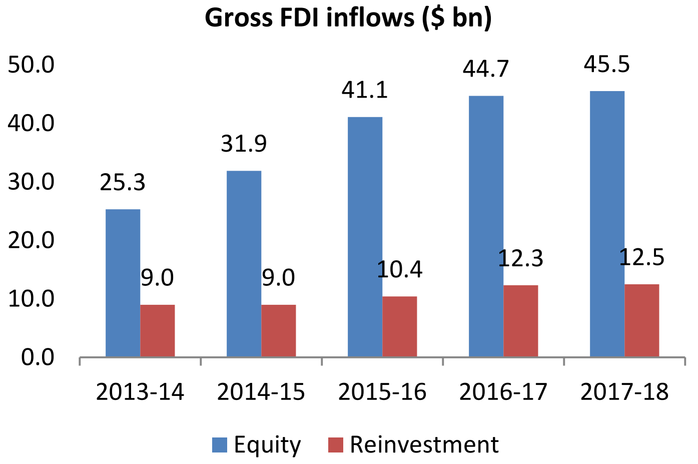
Interestingly the receipts from remittances were also buoyant in FY18 and recovered to the FY16 level after dipping in FY17. But they are still lower than that in FY14 and FY15. The lower growth in the West Asian economies on account of depressed oil prices impeded fresh investments by the oil companies which came in the way of hiring more labour.

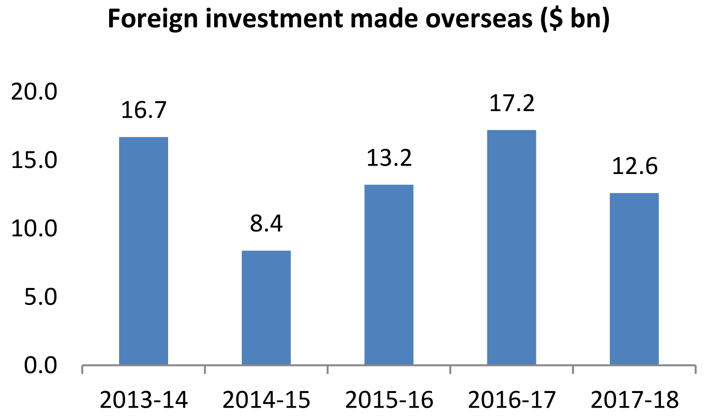
India's Balance of Payments: FY14 to FY18 ($ bn)

A. CURRENT ACCOUNT	2013-14	2014-15	2015-16	2016-17	2017-18
I. MERCHANDISE	***-147.6***	***-144.2***	***-130.1***	***-112.4***	***-160.0***
II. INVISIBLES (a+b+c)	***115.2***	***116.2***	***107.9***	***97.1***	***111.3***
a) Services	73.0	75.7	69.7	67.5	77.6
Of which :					
Software Services	67.0	70.4	71.5	70.1	72.2
b) Transfers	65.3	65.5	62.6	56.0	62.4
c) Income	-23.0	-25.0	-24.4	-26.3	-28.7
Total Current Account (I+II)	**-32.4**	**-27.9**	**-22.2**	**-15.3**	**-48.7**
B. CAPITAL ACCOUNT					
1. Foreign Investment (a+b)	***26.4***	***73.6***	***31.9***	***43.2***	***52.4***
a) Foreign Direct Investment (i+ii)	21.6	32.6	36.0	35.6	30.3
b) Portfolio Investment	4.8	40.9	-4.1	7.6	22.1
2.Loans (a+b+c)	***7.8***	***3.4***	***-4.6***	***2.4***	***16.7***
a) External Assistance	1.0	1.6	1.5	2.0	2.9
b) Commercial Borrowings(MT&LT)	11.8	2.7	-4.5	-6.1	-0.2
c) Short Term To India	-5.0	-0.9	-1.6	6.5	13.9
3. Banking Capital (a+b)	***25.4***	***11.6***	***10.6***	***-16.6***	***16.2***
of which: Non-Resident Deposits	38.9	14.1	16.1	-12.4	9.7
4. Rupee Debt Service	***-0.1***	***-0.1***	***-0.1***	***-0.1***	***-0.1***
5. Other Capital	***-10.8***	***1.4***	***3.3***	***7.6***	***6.2***
Total Capital Account (1 to 5)	**48.8**	**90.0**	**41.1**	**36.5**	**91.4**
C. Errors & Omissions	-0.9	-0.6	-1.1	0.4	0.9
D. Overall Balance (A+B+C)	15.5	61.4	17.9	21.6	43.6

Source: RBI

The capital account as can be seen in the table has become stronger in FY18 with $ 91.4 bn coming in net terms. More than half has come from foreign investment (58%) and around 18% each from loans and banks (which cover NRIs). The FDI story is interesting as there are two sides to it which comes out from the net numbers which rose till FY16 and then declined in the subsequent two years. Gross inflows have been buoyant in the region of $ 60 bn in the last two years which is remarkable as it had risen from $ 36 bn in FY14 to $ 44 bn in FY15 and $ 55 bn in FY16. Around a quarter of these flows are in the form of reinvestment of earnings which reflects the commitment of the investors to the Indian growth story.

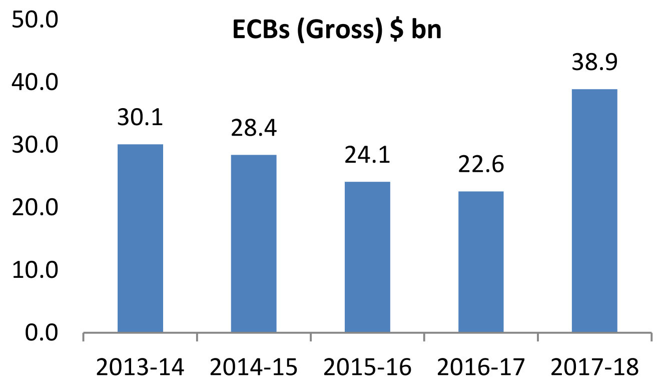




Source: RBI

The other aspect is that there is substantial overseas investment being made by Indian companies. This is significant when weighed with the observation that gross domestic capital formation has been stagnant in the last three years. Such investment has been in the form of either further investment in overseas operations or takeovers.

FPIs have been very volatile as they are driven by different factors. After being negative in FY16, they have turned positive in the subsequent two years contributing more in FY18 and equity in FY17. Therefore, while these flows are very critical, they tend to get whimsical too which affects the overall flows. FDI is definitely proved to be more stable with direction.



Source: RBI

ECBs have been another source of finance for corporates over the years. The major factor driving this decision is the interest rate differential and currency stability. While these flows came down in FY15-FY17, there was an increase of almost 170% in FY18. However, in net terms the accretion has been low due to commensurate amount of repayments being made every year. The same holds for short term loans for trade credit /export credit which however increased sharply in FY18. The stress in the Indian banking system and liberalization of borrowing on this front by the RBI were also factors that made this market popular.

NRIs have also been an important part of the BOP and have contributed significantly in the past. As can be seen in the table, in net terms the quantum would be in the range of $ 10-16 bn. A factor driving these deposits is the growth in income of NRIs in the country of residence. Hence, overall economic environment in these countries is an important aspect of these flows.

Prospects for FY19

The prospects for FY19 can be analysed in terms of individual components of the balance of payments as the trends in the same are quite clear.

- The trade deficit will hold the clue for the overall balance of payments as it will influence the CAD significantly. Presently the imports are increasing at a faster pace than exports due to higher commodity prices. This will tend to increase the trade deficit. Exports will increase at the margin due to a weaker currency but will have to compete harder with other country currencies which are also declining.

- Software receipts may be expected to be stable in the $ 70-75 bn range and a rapid recovery in the USA should augur well for this sector.

- Remittances will be driven by the state of the Gulf economies in particular as this is an important source of such flows. A higher oil price leading to more investment will increase the demand for labour which in turn will provide these flows. A range of $ 60-65 bn may be expected.

- FPI flows would be witnessing contrary forces. On the one hand RBI has enlarged the scope for their operations in the debt segment. On the other hand, higher rates in the USA and a weaker rupee will hinder such decisions. The equity segment would be more progressive but these funds could just prefer the western markets as these economies are in an upswing which can lead to a diversion of funds always form emerging markets.

- FDI should continue to move in the same range and should be steady this year in the region of $ 60 bn in gross terms.

- ECBs would be attractive given the stress in the banking system and the possible slower flow of funds with several PSBs entering the PCA framework. However, the interest rate differential would widen with the US rates going up. Therefore, there may not be too much momentum here.

- NRI deposits too would reconsider options of saving in their place of residence with rates moving up even as their incomes may increase. Domestic interest rates need to be higher to remain attractive.

On the whole we do expect that the CAD will be range bound at the 2-2.5% level in FY19 while forex reserves will increase, albeit at a lower quantum of $ 10-15 bn. As the rupee will be under pressure, sale of forex by the RBI would be necessitated periodically which supports the belief that there will be moderation in the improvement of the balance of payments.

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