Mixed Signals from the External Sector*

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A slew of numbers released recently point to rather peculiar and contrary trends in India's balance of payments. Exports have revived but the trade and current account deficits widen, pointing to an excess of foreign exchange expenditure relative to earnings. While the widening current account deficit points to a weakening balance of payments position, foreign exchange reserves are at record levels. The foreign exchange reserve increase is funded largely by capital flows, consisting of a very large share of investments in the debt market. Such large capital inflows are strengthening the rupee and undermining export competitiveness, which can worsen the current account position and create a vicious circle. Yet, since the increase in external debt is treated as "portfolio investment", the similarities of the current situation to that before the debt-driven balance of payments crisis of 1991 are being ignored. And for those who want to talk up the balance of payments, there is no shortage of comforting evidence.

The most encouraging trend relates to the rate of growth of dollar value of exports calculated relative to the corresponding month of the previous year. That figure has been consistently positive over the 12 months ending August 2017, which is a major improvement when compared with the evidence that exports were declining for 18 months in a row till May 2016. So, there is cause for celebration.

But a close look at the numbers reveals that there is also much cause for concern. India's trade deficit is widening significantly. As compared with a deficit of $23.8 billion during April-June 2016, the deficit has risen to $41.2 billion during April-June 2017 or by 73 per cent over a year. This even though over these three-month periods exports rose from $66.6 billion in 2016 to $73.7 billion in 2017. The trade deficit has widened not because exports are doing badly but because of a steep increase in the import bill from $90.5 billion during April-June 2016 to $114.9 billion during the corresponding period of the current year.

This rise in the import bill occurs despite favourable conditions on the import side. Principally, commodity prices, especially those of oil and petroleum products, are still at low levels. Oil imports have always been a major drain on India's foreign exchange resources. But despite the minor rise in oil prices in recent months, the import price of India's crude import basket is way below its past highs, keeping down the oil import bill. Over the April to June periods under consideration the deficit on account of petroleum, oil and lubricants rose by only $2.9 billion, which is just about 12 per cent of the $24.4 billion increase in the overall trade deficit. Thus, increases in non-oil imports must explain the deteriorating trade account.

The villain of the piece is once again gold, the appetite for which has returned. There has been a sharp increase in gold imports in recent months, from $5.08 billion in April-August 2016 to $15.24 during April-August 2017. The increase in the value of gold imports alone accounted for just above a quarter of the increase in the trade deficit during April-June 2017. This ability of a single commodity to so significantly affect the countries balance of trade is disconcerting because it could render more damaging the other reasons why the trade situation can deteriorate. Oil prices are climbing, even if gradually, and the import bill on this account could rise. And depressed global economic conditions can halt the recovery in India's exports. If developments like these affect foreign exchange earnings or expenditure, India's external trade position can deteriorate quite sharply and worsen the vulnerability stemming from increased gold imports.

The vulnerability involved is driven home by the deterioration in India's current account deficit, after taking services trade and other current flows into account. According to figures recently released by the Reserve Bank of India, India's current account deficit was at $14.3 billion or 2.4 per cent of GDP in Q1 of 2017-18, way above the $0.4 billion or 0.1 per cent of GDP it stood at in Q1 of 2016 -17 and $3.4 billion or 0.6 per cent of GDP in Q4 of 2016-17. In sum, current transactions need significantly larger access to capital inflows. This not only increases dependence on foreign capital, but renders the balance of payments vulnerable in the face of volatility in capital flows.

One reason why these rapid changes in the external trade situation has not attracted the attention it deserves is that this deterioration on the trade front remains embedded in and is partly concealed by what appears to be a strong overall balance of payments. An indicator of that is the sharp rise in India's foreign exchange reserves, that recently crossed the $400 billion mark from $360 billion at the end of March 2016 and $370 billion at the end of March 2017. Over the April-June 2017 quarter alone, on a balance of payments basis (i.e., excluding valuation effects arising from the impact of exchange rate changes), India's foreign exchange reserves increased by $11.4 billion. This compares with an increase of $7.0 billion during April-June of the previous year.

This huge contrary movement in the current account situation and the reserves position can have only one explanation, which is a huge inflow of capital. Capital inflows in the first quarter of 2017-18 are placed at $25.7 billion, as compared with $7.4 billion in the corresponding quarter of the previous year. Much of the increased inflow was on account of portfolio capital inflows which rose from $1.2 billion in April-June 2016 to $11.9 billion in April to June 2017. The corresponding figures for foreign direct investment were only $3.9 billion and $7.2 billion respectively.

Interestingly, portfolio flows (consisting largely of FII inflows) have been substantially in the form of debt rather than equity inflows. This is surprising, given the fact that this was a period when India's equity markets were buoyant because of large investments by domestic financial institutions. Clearly, foreign portfolio investors are finding the active equity markets too risky, but driven by their own pressures to invest abroad are opting for government and corporate bonds issued in India.

Over April-August 2017, while net FII inflows in the form of equity was just short of $700 million, net inflows in the form of investment in debt instruments amounted to $15.3 billion. This recent appetite for bonds, both government and corporate bonds, is noteworthy. In the case of sovereign bonds the reasons are obvious—they are secure and offer high returns by international standards. Investors risk losing out because of exchange rate depreciation, since the investment in bonds is made in rupee and converted back to foreign currency when repatriated. But so long as investors believe that the rupee would hold and not depreciate fast, bonds are an attractive target. The problem is that there are limits on their availability, not just because of the volume of issue but because the Reserve Bank of India sets ceilings on maximum foreign investments in the bond market. Ceilings are constantly breached in the case of government bonds, and are periodically raised. It was only after demonetization last year that investors pulled out of sovereign bonds, reducing investments to 70-80 per cent till May this year. Since then investors have been pushing investments again to the maximum permissible level.

If government bonds are not available, but the bond market is still seen by portfolio investors as a better option, they turn to corporate bonds. After a sharp rise in the volume of investment in corporate bonds relative to the ceiling during 2014-15, that ratio had settled in 70-80 per cent range till May. But since then investment in corporate bonds have also risen to touch the ceilings. On September 8, 2017, 99.58 per cent of the upper limit of central government securities of Rs. 187,700 crore and 99.68 per cent of the $51 billion limit on corporate bond purchases by FPIs had been exhausted. A significant share of corporate bonds purchased are from public sector corporations, possibly influence by the perception that there is implicit sovereign backing for such bonds.

One significance of these developments is that aggregate portfolio investments are turning less volatile. While investments in equity markets fluctuate violently, investments in bonds are quite stable. This would remain true so long as interest rates in India compare favourably with those in the developed countries from where investments originate, and so long as the rupee is stable. In fact, because of the large inflows the rupee has ruled strong, incentivizing investments in bonds even further. These trends are of significance since according to Bloomberg and Aberdeen Asset Management foreigners own less than 8 per cent of corporate and government debt in India, as compared to 30 per cent in Indonesia and Malaysia. That is, there is much room for further foreign investment penetration if the government chooses to relax its ceilings.

So there is a real possibility that even as India’s current account deteriorates, capital inflows into India would rule at high levels. Though such inflows are now substantially into debt markets, this would not show up in India’s external indebtedness figures. Since portfolio investments in debt markets require conversion of foreign exchange into local currency for investments in rupee bonds, they do not appear as foreign borrowing. But this not mean that India is not vulnerable. Foreign portfolio investors are allowed to repatriate earnings and capital as and when they wish, after converting them back to foreign currencies. If, for example, interest rates rise in the US and there is a loss of interest in Indian bonds, investors may choose to sell and exit en masse. Reserves can fall and balance of payments conditions can worsen. Meanwhile since because of earlier capital inflows, the rupee had strengthened, speculative attacks on the depreciating currency may trigger its collapse. This could encourage further capital flight.

Thus, there is much vulnerability underlying the mixed signals being sent by statistics on India’s external position. But since the signals are mixed they are conveniently ignored. When the consequences of such neglect unfold, the costs could be heavy. Clearly, slowing growth and large non-performing assets with the banks are not India's only major economic problems.

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