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### Relevance

*Current account deficit*  
*FDI*  
*Oil*  
*Rupee*  
*Trade*

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## The current account deficit faces structural widening

### *Rising dependence on short-term flows poses financing risks but raises the likelihood of reform*

A recent recovery in export growth has eased immediate concerns about a dramatic widening of India's current account deficit. However, the changing composition of capital inflows – with a stronger bias towards short-term financing – signals the increased vulnerability of India's balance of payments to potential outflows. A weaker macroeconomic outlook due to inflation, monetary tightening and higher oil prices adds to the difficulties of managing this structural problem.

### Key judgments

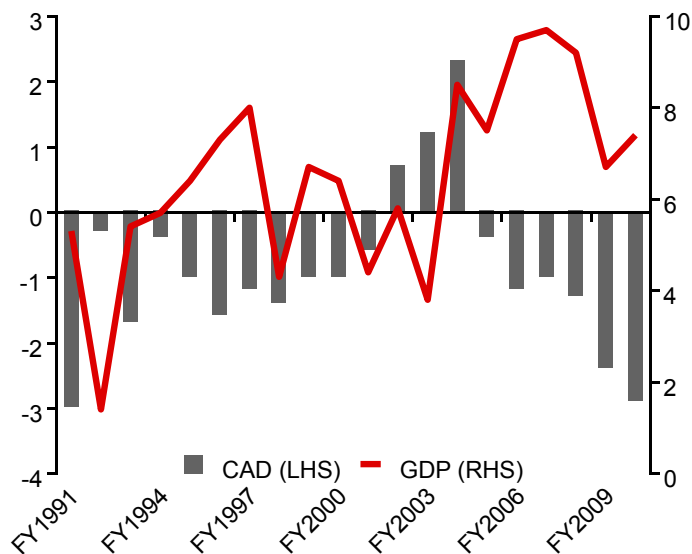
- We believe increased short-term external vulnerability is still acceptable due to India's healthy FX reserves, but a sustained large current account deficit that is financed predominantly by volatile capital flows poses greater medium-term risks, especially if investors get cold feet.
- For the next year, we believe that the wide current account deficit combined with continued monetary tightening will deter the predominantly equity-focused investment flows to India and thereby put depreciation pressure on the rupee.
- The government has no short-term solutions for narrowing the current account deficit but measures to improve the broader macroeconomic outlook such as fiscal consolidation will likely reassure investors and provide support to the currency, keeping it in a narrow trading band.
- India needs more stable FDI inflows to finance the deficit. Recent comments from senior government officials lead us to believe that FDI liberalization is on the cards.
- Sectors that stand to benefit from a more open FDI regime are the agriculture supply chain, food retail, insurance, banking and infrastructure.

# Context

India's stronger-than-expected economic rebound at a time when external demand remains tentative has kept its current account deficit (CAD) in FY11 at unsustainably high levels. After initial concerns that the deficit might widen to 3 per cent of GDP or higher from an already elevated 2.9 per cent in FY10, the latest estimate by the Reserve Bank of India (RBI) puts the CAD at 2.5 per cent of GDP thanks to a recent recovery in merchandise export growth. Although this number is at face value not particularly concerning, the worrying trend is the composition of deficit financing, which has become even more biased towards short-term capital flows at a time when the CAD has become more structural in nature.

The deterioration in India's macroeconomic outlook and growing doubts about the economy's ability to expand at 8 per cent-plus levels without high inflation and massive government spending raise the probability of accelerating portfolio outflows. This in turn would create difficulties in financing the CAD and increase India's external vulnerability, with negative implications for the country's stock market and the rupee. Although a weak currency may help exports India needs a stable rupee because of its import dependency (particularly on oil), which exposes it to imported inflation particularly at this time of sharply rising global commodity prices.

**Chart 1: Current account balance, FY1991-2010 (per cent of GDP)**



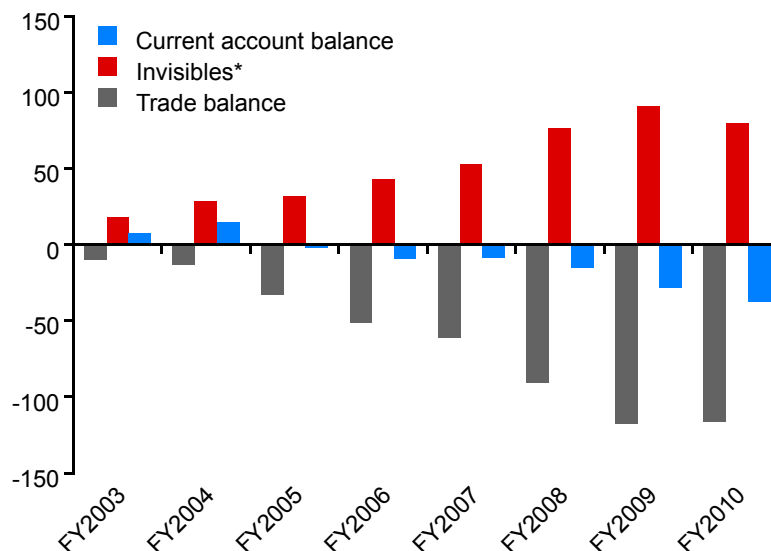
Source: RBI.

As Chart 1 above shows, India's current account deficit is at its widest since 1991, when the economy was on the brink of a balance of payments crisis. India's economy is of course much stronger now – on a higher growth trajectory, with more liberal policies in place and having accumulated large FX reserves. However, the bad news is that the recent widening of the CAD is more structural in nature and not just a short-term cyclical phenomenon.

Among the biggest contributors to this development is the mushrooming trade deficit, which the Commerce Ministry estimates will more than double to US\$278.5 billion by FY14 from US\$108.2 billion in FY10 (to 12.8 per cent of GDP from 7.6 per cent in FY10). Even in the Commerce Ministry's "optimistic" scenario outlined in a February 2011 paper, the trade deficit is expected to

expand to 12 per cent of GDP by FY14. India's services trade surplus covers more than 40 per cent of the deficit in the merchandise account, but the Commerce Ministry warned that slower global growth will create a "challenging environment" for India's services exports.

**Chart 2: India's trade and current accounts, FY2003-2010 (US\$ billion)**



\* Invisibles mainly comprise services exports and foreign remittances.  
Sources: RBI, Commerce Ministry.

The downside risks to the CAD and the broader macroeconomy are numerous. On the external front, political tensions in the Middle East and North Africa are spurring already elevated global oil prices – a highly sensitive trend for India as oil accounts for a third of its total imports. Every US\$10/bbl increase in crude prices expands India's CAD by around half a percentage point.

The as-yet-modest economic recovery in the developed world is also capping growth in India's services exports, around 80 per cent of which go to the US and Europe. India's merchandise export basket is more diversified geographically and those exports have risen to a surprising extent since late 2010. However, the sustainability of strong outbound shipments is in doubt not only because of risks to global demand due to higher oil prices but also because of the questionable reliability of India's trade data (the government admitted in March that the country's imports are being underestimated). Meanwhile, a sharp drop in net external income due to low interest rates overseas has resulted in a moderation of the net invisibles surplus.

**Table 1: Balance of payments, Apr-Dec 2009 - Apr-Dec 2010**

|                         | Oct-Dec 2009 (US\$ billion) | Oct-Dec 2010 (US\$ billion) | % yoy |
|-------------------------|-----------------------------|-----------------------------|-------|
| Trade balance           | -86.8                       | -102.1                      | 17.6  |
| Net invisibles          | 61.2                        | 63.2                        | 3.3   |
| Current account balance | -25.5                       | -38.9                       | 52.5  |
| Net capital account     | 36.8                        | 50.0                        | 35.9  |

Source: RBI.

On the domestic side, the Indian government's focus on rapid GDP growth is maintaining the high momentum for non-oil imports. At the same time, oil imports have risen both in volume and in value. With a medium-term economic

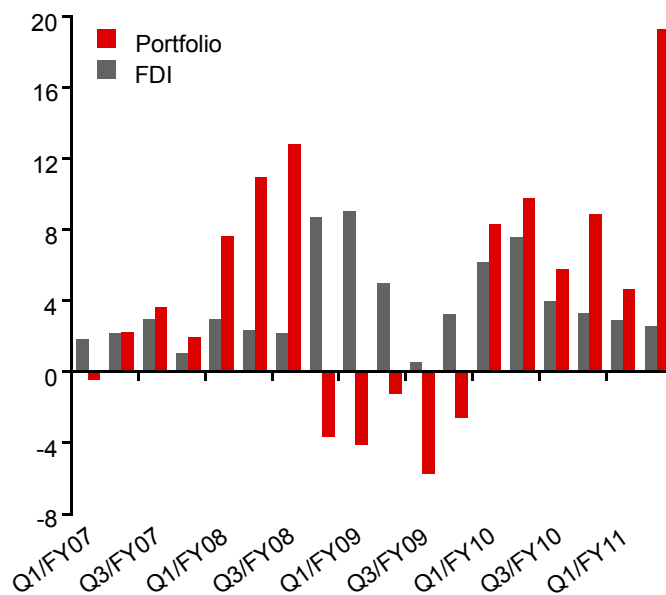
growth target of 9 per cent and domestic supply shortages ranging from food to fuel, high import growth – in the government’s own words – is “unavoidable”.

The solution proposed by the Commerce Ministry is not going to help. It wants to narrow the trade deficit by doubling exports in the three years to FY14 to US\$450 billion. If this is to be achieved, exports must grow at a compound annual growth rate of 26 per cent, compared to an average growth of slightly less than 20 per cent between FY03 and FY10. These numbers are overambitious, like most of the Indian government’s estimates, and signify policy direction rather than realistic growth targets. But the Commerce Ministry paper was quite accurate in saying that a widening trade deficit would result in the bloating of the CAD and in turn increased dependency on short-term capital flows needed to fund the gap.

### The rupee faces depreciation pressures ...

The unpredictable nature of portfolio investments leads to volatility in equity prices and the exchange rate. Our thesis that movements in the Indian rupee are more a factor of capital flows than of trade flows still holds as India’s dependence on portfolio flows became more evident in FY11, when FDI fell significantly – down 25 per cent year on year to US\$17.1 billion in the April 2010 – January 2011 period. Of the net capital flows to India in H1/FY11, equity flows comprised 79 per cent, of which the share of foreign institutional investment was 77 per cent.

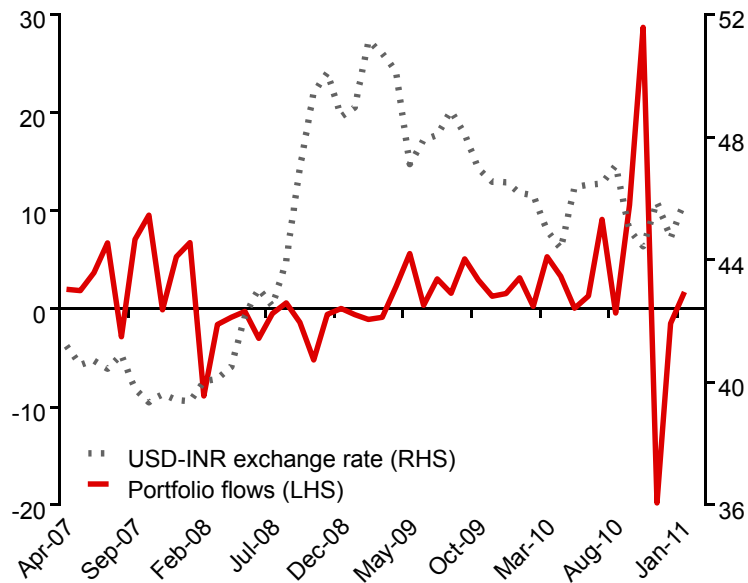
**Chart 3: FDI vs portfolio investment, Q1/FY07-Q2/FY11 (US\$ billion)**



Source: RBI.

These portfolio flows have risen a little over 25 per cent (to US\$31.8 billion) so far in FY11 but with the macroeconomic environment deteriorating and interest rates rising as the RBI continues to combat stubbornly high inflation, we believe equity-focused capital flows will likely slow sharply and may even turn negative. The RBI’s latest 25 bps policy rate hike on 17 March 2011 – following a jump in February’s non-food manufactured (core) inflation – was another step in what we believe will be a prolonged fight against price pressures.

**Chart 4: Portfolio flows vs rupee, April 2007 – January 2011 (US\$ billion)**



Sources: RBI, Bloomberg.

## ... but potential for upside surprises due to policy positives

The potentially positive outcome of the deteriorating macroeconomic situation is that it will provide the impetus for policy reform, a point we highlighted in our recent note [Economic policy outlook more positive amid macro headwinds](#). We expect these reforms to range from encouraging FDI to modifying regulations and improving the economic climate to attract portfolio investors.

But the most interesting change in government policy mindset over the past six months is the attitude towards FDI, with capital inflows via this route viewed as important to manage the CAD. The fall in FDI during FY11 has raised concerns in policy circles: officials from the Planning Commission to the RBI have emphasized the need for these stable inflows to offset the volatility posed by the dominance of portfolio flows. In our March 2011 report [Food inflation to spur agriculture supply-chain investment](#), we highlighted why the policy momentum to allow multi-brand stores to enter food retail is stronger than it has ever been before. Meanwhile, a bill to raise the FDI ceiling in the insurance sector to 49 per cent from 26 per cent that has been pending in parliament since 2008 is also getting renewed attention from Finance Minister Pranab Mukherjee, who said on 28 March that he has begun discussions with various political parties to drum up support for this legislation. Earlier in March, Mukherjee said the government also plans to further liberalize FDI regulations in the infrastructure sector.

The government is also taking steps that would likely help to improve the climate for portfolio investors, starting with the ambitious fiscal consolidation plan outlined by Finance Minister Mukherjee in his February 2011 budget. Although his targets are certainly too bullish, they signify positive policy direction even if it is more medium term in nature and does not quite get the fiscal deficit down to the FY12 budgeted 4.6 per cent of GDP. Any narrowing in the budget deficit implies a lower market-borrowing programme, which not only helps keep a lid on interest rates but also relieves some of the pressure from

the RBI to tighten policy rates to compensate for loose fiscal policies. India needs low interest rates in order for its capex cycle to pick up, which in turn will result in greater domestic investment and thereby reduce dependence on non-oil imports in the medium to long term.

The big positive in the FY12 budget is the divestment programme, which seeks to raise Rs400 billion (US\$8.8 billion). Although the government undershot a similar target for FY11, it will have no option but to go ahead with stake sales in its majority-owned companies during FY12 in the absence of any windfall revenue gains such as the telecom auctions held in the previous year. Roadshows for its first sale in FY12 with a Rs60 billion (US\$1.3 billion) public offer in Power Finance Corp (POWF:IN) are scheduled to begin on 27 April and the issue is slated for 10 May. The equity offerings in several companies, such as those proposed for Oil and Natural Gas Corp (ONGC:IN), the Steel Authority of India (SAIL:IN) and Indian Oil (IOCL:IN), will attract foreign inflows given their blue-chip status in the market. This in turn will help reduce the CAD financing risk in the short term. A simple back-of-the-envelope calculation shows that the US\$8.9 billion the government plans to raise in FY12 would be equal to 0.5 per cent of the GDP in FY11.

The government's determination to control its fiscal deficit was also evident when it introduced a constitutional amendment bill in parliament on 22 March 2011 as an important step towards implementing the [goods and services tax \(GST\)](#). This important tax reform will be implemented only in FY13 at the earliest but the government is also taking other more immediate steps, such as the likely decision to deregulate prices of nitrogenous fertilizers by June 2011. As my colleague Amitabh Dubey outlines in his [report](#), this move will not only help reduce the government's fiscal deficit but it also shows the government's willingness to push ahead with long-delayed reforms.

# Conclusion

The Indian government's strong emphasis on rapid economic growth in the absence of any meaningful reform has had several unintended consequences, ranging from a stubbornly high inflation rate to the unsustainably large fiscal and CAD. While inflation is expected to ease somewhat and the government has promised to narrow its budget gap, the current account deficit faces structural widening due to rising imports amid difficulties in ramping up export growth.

Although the widening of the CAD is not so dangerous as to bring India to the verge of crisis, as it did in 1991, the worrisome point is that it will remain well beyond the comfort zone of 1.5-2 per cent of GDP that India has been used to over the past two decades and has funded through short-term inflows. The RBI estimates that India can run such a wide CAD for about two years but vulnerability will increase beyond that timeframe.

Steps to reduce medium-term weaknesses in the CAD and India's balance of payments have to be taken now through efforts to change the composition of sources that finance the deficit. The list of possible actions is long but we believe that even if some of these steps are taken, particularly with regard to FDI liberalization, investors will be reassured of the sustainability of India's high growth potential. Most of these steps are likely to be taken only after a few crucial state elections in April-May but the government's serious intention at least to get the momentum started was evident on 22 March 2011 when it introduced important new legislation in parliament to reform the banking sector and amend the constitution as a precursor to implementing the GST.

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