Deepak Mohanty: Perspectives on India’s balance of payments

Speech by Mr Deepak Mohanty, Executive Director of the Reserve Bank of India, at the School of Management, KIIT University, Bhubaneswar, 7 December 2012.

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I thank Professor Sar for inviting me to address this young audience. In the recent years, India’s integration with the global economy has increased significantly. This is reflected in our expanding volume of external trade and financial transactions. While this process has several benefits arising from wider access to consumption and investment, there is attendant cost of periodic instability. Over the last two years, the Reserve Bank has been drawing attention to the widening current account deficit (CAD) in our balance of payments (BoP). The risks to our BoP have increased both in the global and domestic context: first, following the global financial crisis trade volumes have slumped and capital flows have become volatile; second, slowing domestic growth coupled with a large fiscal deficit alongside a high CAD poses twin deficit risks. In this context, I propose to capture the evolution of India’s BoP in the historical context and trace how did we respond to risks to external stability from time to time?

Let me start from the basics. What is BoP? It is our transaction account with the rest of the world. It can be better appreciated in terms of the national income accounting identity: GDP = C+G+I+X-M. In other words, domestic output (GDP) is equal to private consumption (C), plus government consumption (G), plus domestic investment (I), plus net exports (X-M). If net exports of goods and services (X-M) are negative, the domestic economy is absorbing more than it can produce. In other words, absorption (C+G+I) by the domestic economy is greater than domestic output (GDP). This is reflected in current account deficit (X-M) which needs to be financed by external borrowings and/or investments. In normal times external finance may not be a problem. However, it could be challenging if both the global and domestic economic outlook are not very favourable. Against this background, my scheme of presentation will be as follows: identify the key events those shaped India’s BoP since independence; examine the changes in the composition of capital inflows; and in conclusion highlight a few risks and make some suggestions to reinforce India’s BoP.

India’s BoP evolved reflecting both the changes in our development paradigm and exogenous shocks from time to time. In the 60 year span, 1951–52 to 2011–12, six events had a lasting impact on our BoP: (i) the devaluation in 1966; (ii) first and second oil shocks of 1973 and 1980; (iii) external payments crisis of 1991; (iv) the East Asian crisis of 1997; (v) the Y2K event of 2000; and (vi) the global financial crisis of 2008. I will analyse the BoP trend in this sequence.

The first phase can be considered from the 1950s through mid-1960s. In the early 1950s, India was reasonably open. For example, in 1951–52, merchandise trade, exports plus imports, accounted for 16 per cent of GDP. Overall current receipts plus payments were nearly 19 per cent of GDP. Subsequently, the share of external sector in India’s GDP gradually declined with the inward looking policy of import substitution. Moreover, Indian export basket comprised mainly traditional items like tea, cotton textile and jute manufactures. Not only the scope of world trade expansion in these commodities was less but additionally India had to face competition from new emerging suppliers, such as Pakistan in jute manufactures and Ceylon and East Africa in tea.

During this period, policy emphasis was on import saving rather than export promotion, and priority was given to basic goods and capital goods sector. It was argued that investment in heavy industries would bring in saving in foreign exchange, as output from such industries would replace their imports in the long-run. Import-substituting strategies were expected to gradually increase export competitiveness through efficiency-gains achieved in the domestic economy. But this did not happen. Hence, exports remained modest. In fact our external sector contracted in relation to GDP from the level observed in the early 1950s. By 1965–66, merchandise trade was under 8 per cent of GDP and overall current receipts and payments were below 10 per cent of GDP (Table 1).

Table 1: Trend in External Openness

(Percent of GDP)

	Merchandise Exports plus Imports	Receipts plus Payments (Current Account)	Total Receipts plus Payments (Current and Capital)
1951-52	15.8	18.5	19.7
1965-66	7.7	9.9	14.1
1973-74	7.8	12.1	17.8
1990-91	14.6	19.4	31.5
1999-00	20.6	31.2	46.8
2008-09	40.6	60.6	111.6
2011-12	43.8	61.5	109.6

Notwithstanding the contracting size of the external sector, as imports growth outstripped exports growth, there was persistent current account deficit (CAD). Emphasis on heavy industrialisation in the second five year Plan led to a sharp increase in imports. On top of this, the strains of Indo-China conflict of 1962, Indo-Pakistan war of 1965 and severe drought of 1965–66 triggered a major BoP crisis. India's international economic relations with advanced countries came under stress during the Indo-Pak conflict. Withdrawal of foreign aid by countries like the US and conditional resumption of aid by the Aid India Consortium led to contraction in capital inflows. Given the low level of foreign exchange reserves and burgeoning trade deficit, India had no option other than to devalue. Rupee was devalued by 36.5 per cent in June 1966.[1]

Though India's export basket was limited, the sharp devaluation clearly increased the competitiveness of India's exports. Concurrently, India had to undertake a number of trade liberalising measures. Even though the net impact of devaluation was a contentious issue among the leading economists,[2] data show that exports growth, though modest, outpaced imports growth (Chart 1).

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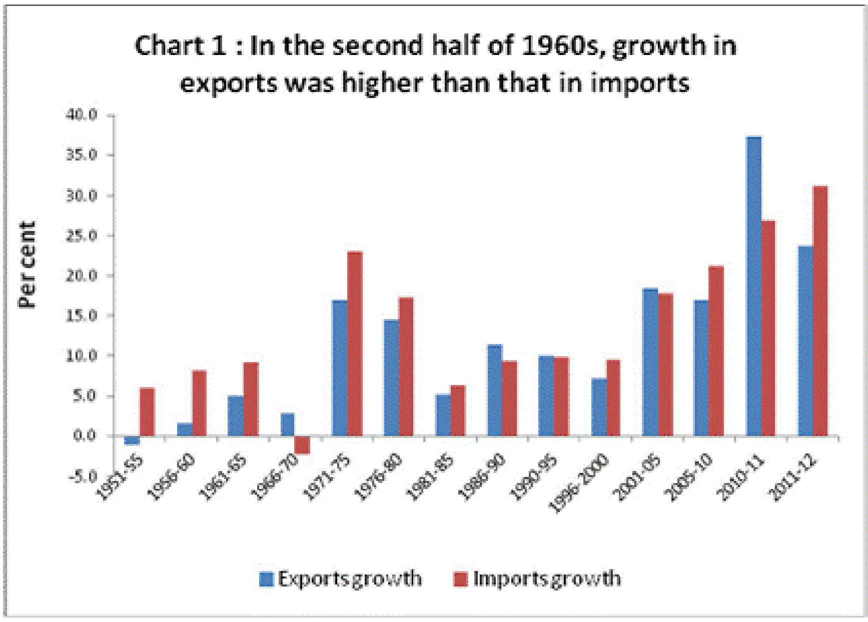
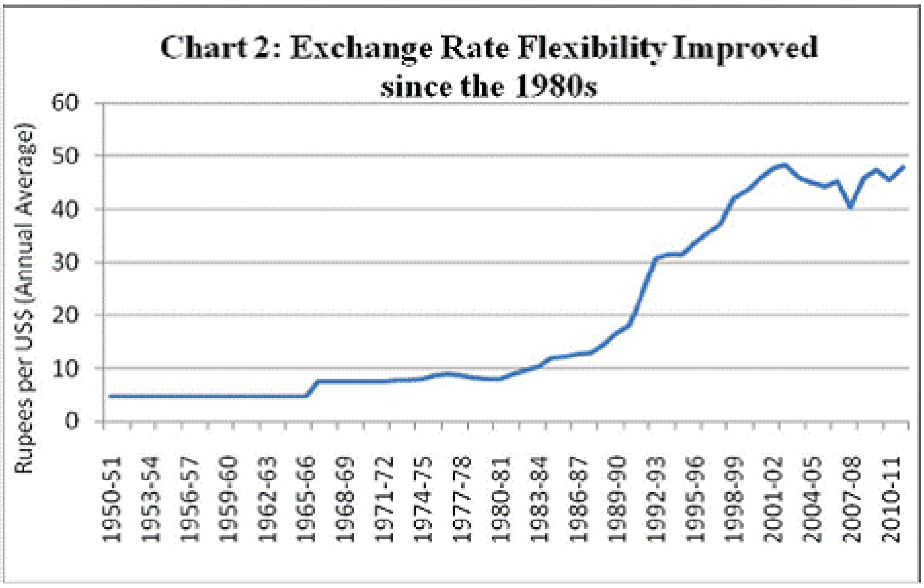
1 Official rate increased from Rs.4.76 per US dollar to Rs.7.50 per US dollar.

2 For example, Bhagwati and Srinivasan (1975) argued that the effective devaluation was more for imports than the exports. "Foreign Trade Regimes and Economic Development: India", *National Bureau of Economic Research, New York*.



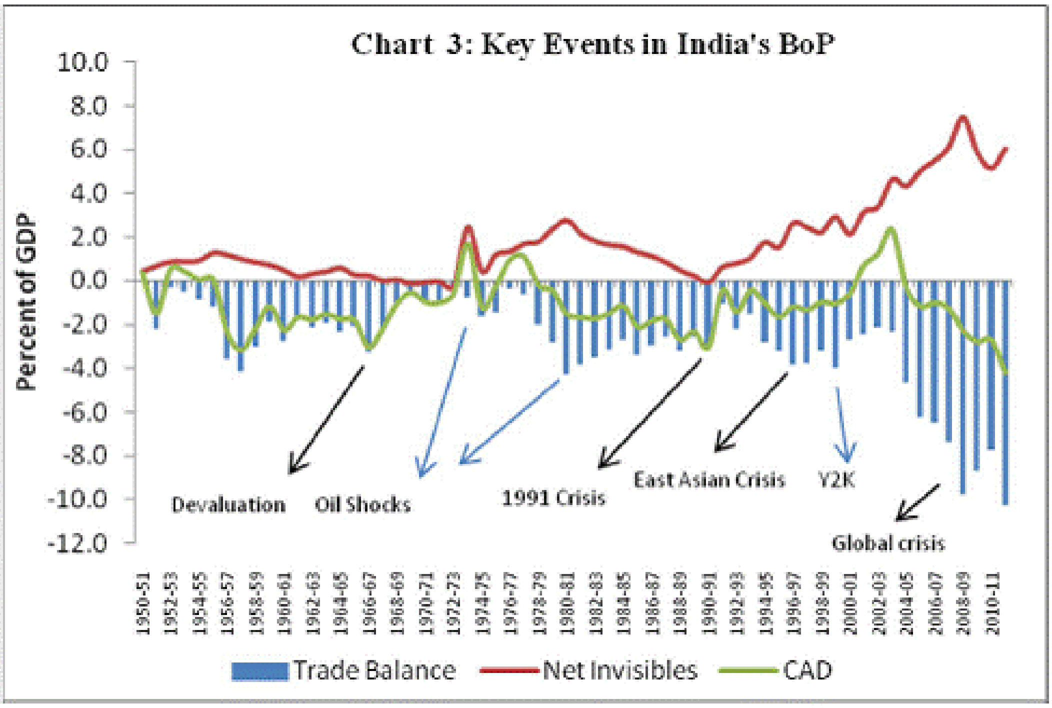
In fact, the current account turned into a surplus in 1973–74 as not only the exports growth was significant but invisible[3] receipts also showed a sharp turnaround from deficit to surplus mainly on account of official transfers which largely represented grants under the agreement of February 1974 with the US Government on the disposition of PL 480 and other rupee funds. Since surplus in current account balance (CAB) was used for repaying rupee loans under the same agreement with the US, accretion to reserves was only marginal.

Surplus in India's CAB was, however, short-lived as the first oil shock occurred by October 1973. Sharp rise in international oil prices was evident in higher imports growth in 1973–74 and 1974–75. The share of crude oil in India's import bill rose from 11 per cent in 1972–73 to 26 per cent by 1974–75. As exports improved, particularly to oil producing Middle-East countries, BoP recovered quickly from the first oil shock. By this time, the Indian rupee, which was linked to a multi-currency basket with pound sterling as intervention currency, depreciated against the US dollar (Chart 2).

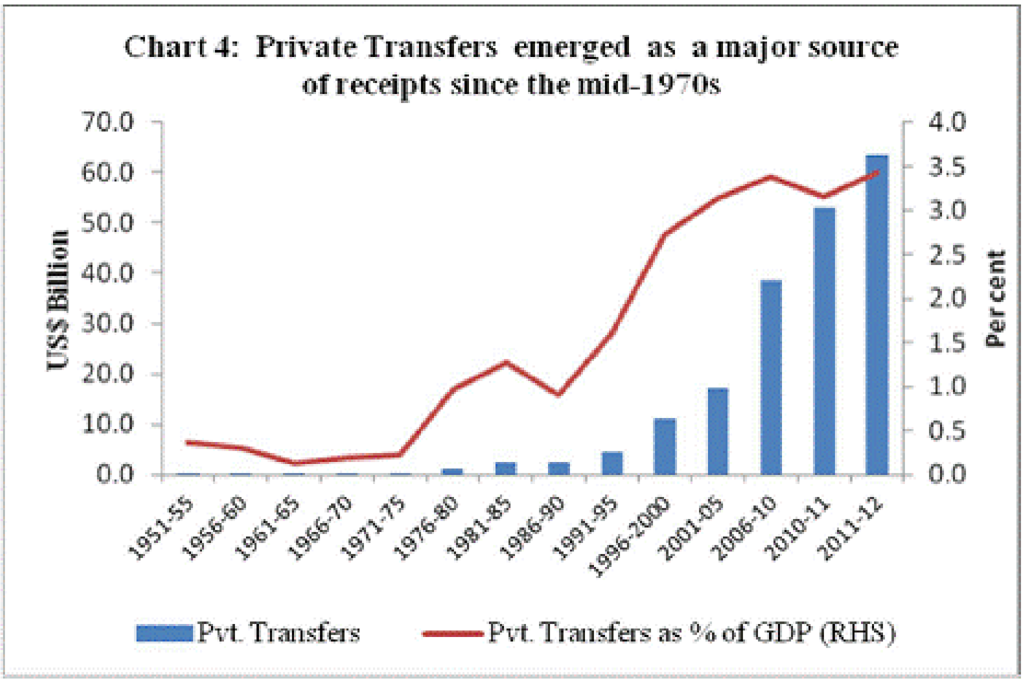


[3] Comprises services, transfers and income.

Depreciating rupee along with other policy incentives to exporters acted as a supporting factor for India's exports. At the same time, invisible receipts grew sharply stemming from workers' remittances from the Middle East. Consequently, the current account balance turned into surplus in 1976–77 and 1977–78 (Chart 3).



Thus, the private transfers added a new positive dimension to India's BoP after the first oil shock. Further, with the official exchange rate nearly converging to market exchange rate, there was not much incentive for routing remittances through unofficial exchange brokers. The rapid growth of private transfers reinforced the trade account adjustment to make the current account situation much more comfortable (Chart 4).



During the 1980s, BoP again came under stress. The second oil shock led to a rapid increase in imports in early 1980s. Oil imports increased to about two-fifths of India's imports during 1980–83. At the same time, India's external sector policy was changing towards greater openness. Various measures were undertaken to promote exports and liberalise imports for exporters during this period. However, several factors weighed against external stability. First, despite a number of export promotion measures, the subdued growth conditions in the world economy constrained exports growth. Second, the surplus on account of invisibles also deteriorated due to moderation in private transfers. Third, the debt servicing had increased with greater recourse to debt creating flows such as external commercial borrowings (ECBs) and non-resident Indian (NRI) deposits. Fourth, deterioration is the fiscal position stemming from rising expenditures accentuated the twin deficit risks.

Given the already emerging vulnerabilities in India's BoP during the 1980s, the incipient signs of stress were discernible which culminated in the BoP crisis in 1991 when the Gulf War led to a sharp increase in the oil prices. On top of that, a slowdown in the world trade following the recessionary conditions in industrialised countries and the economic disruption in Eastern Europe including the erstwhile USSR had begun to affect India's exports. A large number of Indian workers employed in Kuwait had to be airlifted to India and their remittances stopped. Foreign exchange reserves had already dwindled due to significant drawdown for financing of CAD in earlier years. During 1990–91, at one point of time, the foreign currency assets had dipped below US$ 1.0 billion, covering barely two weeks of imports. With increasing recourse to the borrowings on commercial terms in the previous years, financing of CAD had also become more sensitive to creditors' confidence in the Indian economy.

Short-term credits began to dry up and the outflow of NRI deposits was also very substantial. Downgrading of India's credit rating below the investment grade also constrained India's access in the international markets for funds, especially ECBs and trade credit. Even though the stress in India's BoP was unprecedented, the Government decided to honour all debt obligations without seeking any rescheduling (Reddy, 2006).[4]

In response to the BoP crisis, a combination of standard and unorthodox policies for stabilisation and structural change was undertaken to ensure that the crisis did not translate into generalised financial instability. Such steps included pledging gold reserves, discouraging of non-essential imports, accessing credit from the IMF and other multilateral and bilateral donors. While dealing with the crisis through an IMF programme, a comprehensive programme of structural reforms was undertaken simultaneously with special emphasis on the external sector.

The broad approach to reform in the external sector was laid out in the Report of the High Level Committee on Balance of Payments (Chairman: C. Rangarajan, 1993). Trade policies, exchange rate policies and industrial policies were recognised as part of an integrated policy framework so as to boost the overall productivity, competitiveness and efficiency of the economy. In addition, to contain the trade and current account deficits and enhance export competitiveness, the exchange rate of rupee was adjusted downwards in two stages on July 1 and July 3, 1991 by 9 per cent and 11 per cent, respectively. A dual exchange rate system was introduced in March 1992 which was unified in March 1993. Subsequently, India moved to current account convertibility in August 1994 by liberalising various transactions relating to merchandise trade and invisibles.

The impact of policy changes was reflected in lower CAD and its comfortable financing in subsequent years. India could manage the external shocks that emanated from the East Asian crisis in 1997 and subsequently, the rise in international oil prices and bursting of

[4] Reddy, Y.V. (2006), "Dynamics of Balance of Payments in India", Speech at the first Diamond Jubilee lecture of the Department of Commerce, Osmania University on December 16.

dotcom bubble in 1999–2000. Indeed, the Indian economy remained relatively insulated from the East Asian crisis owing to the reforms undertaken in previous years and proactive and timely policy measures initiated by the Reserve Bank to minimise the contagion effect. Monetary tightening coupled with flexible exchange rate and steps to bolster reserves through issuance of Resurgent India Bonds (RIBs) helped in stabilizing the BoP.

The BoP came under some stress again in the first half of 2000–01 due to a sharp rise in oil prices and increase in interest rates in advanced countries. At the same time, India's software exports got a boost following the demands to address the Y2K challenges. This also encouraged migration of Indian software engineers to the advanced countries. As a result, the surplus in the services exports and remittance account of the BoP increased sharply which more than offset the deficit in the trade account. Software exports rose from 0.9 per cent of GDP in 1999–2000 to a peak of 3.8 per cent of GDP by 2008–09. Private remittances also rose from 2.7 per cent of GDP to 3.8 per cent during this period. Thus, in the 2000s software exports and private remittances emerged as two main financing items for the current account mitigating to a large extent the merchandise trade deficit (Tables 2 & 3). Owing to a combination of factors, in fact, the current account recorded a surplus during 2001–04. Subsequently, as international oil prices started rising and domestic growth picked up, deficit in current account re-emerged during 2004–05 to 2007–08 *albeit* remained range bound.

Table 2: Trend in Net Invisibles

(Per cent of GDP)

	1950-80	1980-90	1990-00	2000-09	2009-12
1. Services (Net)	0.3	0.4	0.3	2.1	3.0
2. Software (Net)	-	-	-	2.3	3.3
3.Other Services (Net)	0.3	0.4	0.3	-0.2	-0.3
4. Private Transfers (Net)	0.4	1.1	2.2	3.2	3.5
5. Total Invisibles (Net)	0.7	1.4	1.6	4.6	5.6

Table 3: Composition of Current Account Balance

(Percent of GDP)

Period	1970s	1980s	1990s	2000-09	2009-12
1. Oil TB	-1.2	-1.7	-2.0	-3.5	-4.5
2. Non-Oil TB	0.4	-0.9	0.6	-0.8	-3.9
3.Non-oil CAB	1.1	-0.1	0.8	3.3	1.3
4. CAB	-0.1	-1.8	-1.3	-0.3	-3.3

TB: Trade Balance, CAB: Current Account Balance, (-): Implies deficit

After a period of stability, India's BoP came under stress in 2008–09 reflecting the impact of global financial crisis. As capital inflows plummeted, India had to draw down its foreign currency assets by US $ 20 billion during 2008–09. Stress since the collapse of Lehman Brothers largely emanated from decline in India's merchandise exports and deceleration in growth in services exports. Though there was some improvement during 2010–11 on the back of a strong pick-up in exports mainly led by diversification of trade in terms of composition as well as direction, it proved to be short-lived. BoP again came under stress during 2011–12 as slowdown in advanced economies spilled over to emerging and developing economies (EDEs), and there was sharp increase in oil and gold imports. Let me now turn to the financing aspects of the current account.

India's openness, both in terms of trade flows and capital flows which increased in the 1990s accelerated in the 2000s (Chart 5). This was made possible due to substantial liberalisation of the capital account and greater openness to private capital.

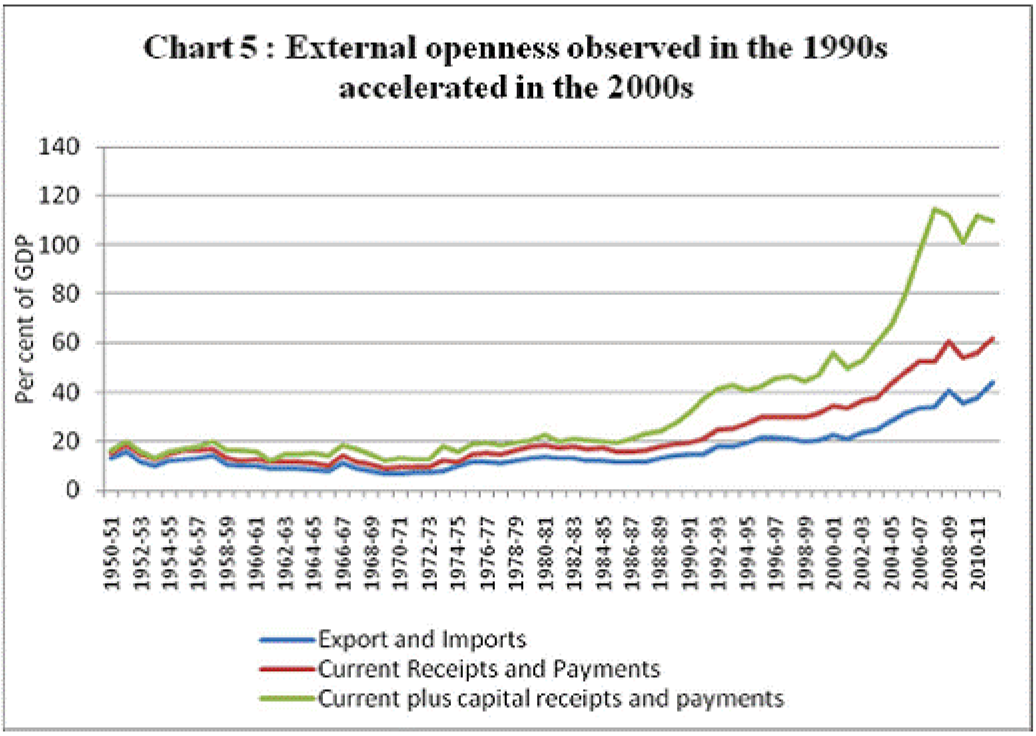
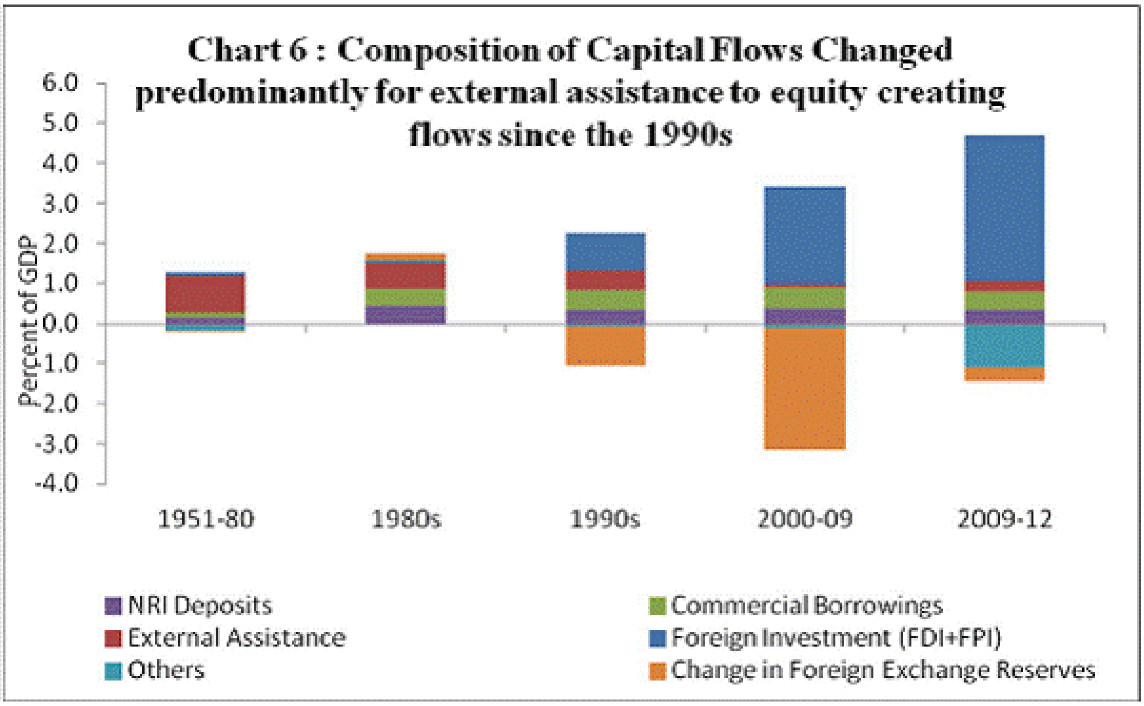


Chart 5 : External openness observed in the 1990s accelerated in the 2000s

In the first three decades after the independence, CAD was mainly financed by external assistance and drawdown of forex reserves. Since much of India's planning strategy was conceived in terms of a closed economy theoretical framework, private investment inflows into the economy were not encouraged much. Therefore, foreign resources came primarily in the form of official transfers. The private investment came mainly through technology transfer, but played a minuscule role. During this period, the development efforts and stress on BoP from time to time led India to tap diverse aid sources for specific projects.

In the 1980s, as the traditional source of official concessional flows dried up there was a need to access private capital. But, this came in the form of debt creating flows though costly external commercial borrowings (ECBs) and NRI deposits. The limitations of financing CAD through debt creating flows were exposed in the 1991 crisis. Subsequent reforms and opening up the capital account to non-debt creating flows of foreign direct investment (FDI) and portfolio equity flows not only completely transformed the sources of financing of the BoP but it also resulted in substantial addition to reserves in the 2000s (Table 4 & Chart 6).

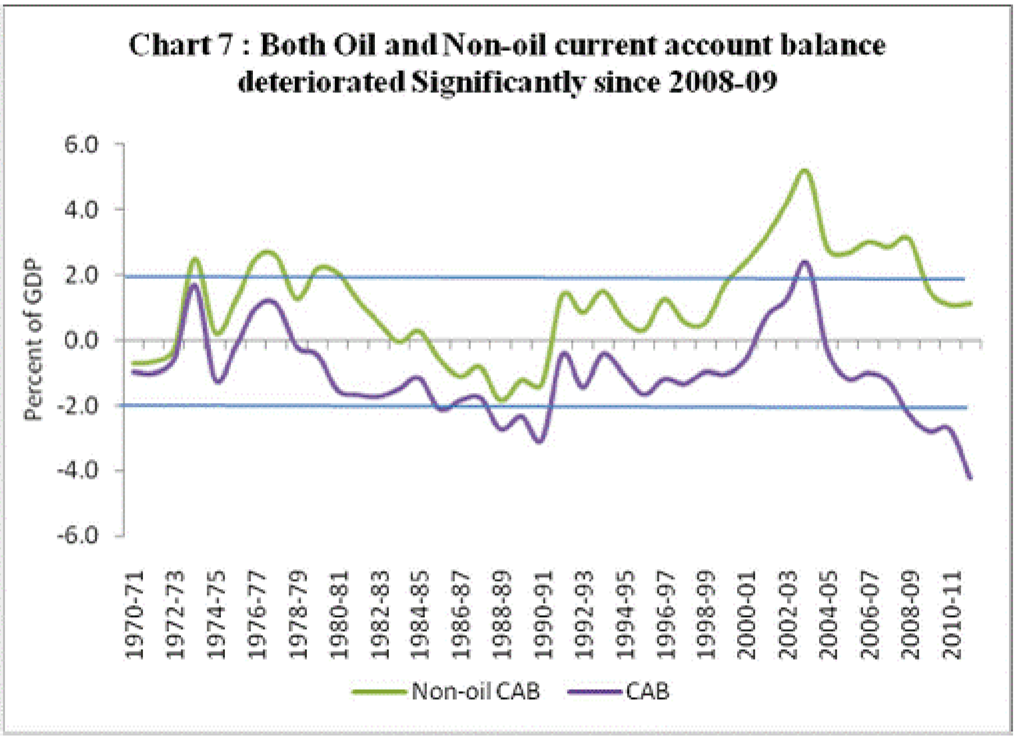
Table 4: Composition of Capital Flows					
Period	1951-80	1980s	1990s	2000-09	2009-12
1. NRI Deposits	0.1	0.4	0.4	0.4	0.4
2. Commercial Borrowings	0.1	0.4	0.5	0.6	0.5
3. External Assistance	0.9	0.6	0.5	0.0	0.2
4. Foreign Investment (FDI+FPI)	0.1	0.0	0.9	2.5	3.6
5. Others	-0.2	0.0	-0.1	-0.1	-1.1
6. Change in Foreign Exchange Reserves*	0.0	0.2	-1.0	-3.0	-0.4
*: (-) implies increase and (+) implies decrease					



Concluding remarks

With the gradual external liberalisation of Indian economy, not only the size of BoP has increased manifold, but the pattern of current and capital account has changed. Even though the reform process has strengthened resilience of India's external sector, at the same time vulnerabilities arise with greater exposure of the economy to the rest of world through liberalised trade and investment environment.

India's current account particularly remains vulnerable to developments in the trade account. It is evident from the size of trade deficit growing from 0.5 per cent of GDP during 1951–55 to 8.7 per cent during 2007–12. In 2011–12, the current account deficit has widened to a record 4.2 per cent of GDP (Chart 7). Over the years, current account derived some resilience from surplus generated by invisibles, particularly software exports and private transfers, but trade deficit continues to dictate the overall trend in the current account. Whenever trade account worsens reflecting downswings in the global business cycle or rise in international oil prices, the current account also comes under stress as is evident in the present context. Going forward, since India's linkage with the world economy, in terms of trade and finance, is likely to grow further, it is important that resilience in its trade account is built up mainly by promoting productivity based export competitiveness and improving domestic fundamentals that are supportive of least costly non-debt creating flows, particularly foreign direct investment (FDI). In this context, I make a few suggestions.



First, the current level of CAD is far above the level sustainable for India. As per estimates, at a nominal growth rate of about 13 per cent, the sustainable current account to GDP ratio is 2.3 per cent (Rangarajan, 2012).[5] Reserve Bank's own research shows that economy can sustain CAD of about 2.5 per cent of GDP under a scenario of slower growth (RBI, 2012).[6] A slowing global economy and protracted high levels of unemployment in advanced economies make it difficult to boost services exports in the short run. If the slowdown continues, it could also have an adverse impact on inward remittances. Hence, there is a need to reduce imports and boost merchandise exports to bring the CAD to sustainable levels.

Second, structural policy measures are needed to reduce vulnerability emanating from high oil and gold imports. While oil has been a major component of India's imports, the sharp increase in demand for gold has put an additional pressure. During 2008–09 to 2011–12, on average, the net gold imports stood at about 2 per cent of GDP, almost double the level recorded during 2004–05 to 2007–08. Thus, during the same period, CAD-GDP ratio, excluding net gold imports, would seem less problematic at 1.1 per cent as compared to a surplus of 0.2 per cent. In addition to the traditional motive of gold demand for jewellery, gold seems to have become a safe investment asset and a hedge against inflation as is observed in other advanced economies. Its dematerialisation like any other financial product can

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[5] Rangarajan, C. (2012), "India's External Sector: Do We need to worry", ECGC Business Commencement Commemorative Lecture at Export Credit Guarantee Corporation of India Ltd., Mumbai on October 3.

[6] Reserve Bank of India (2012), Annual Report, 2011–12.

reduce its physical imports (Gokarn, 2012)[7]. Furthermore, inflation indexed bonds could also be another option to offer investors the inflation linked returns and detract them from gold investments. In the case of oil, we need to become more energy efficient to reduce our dependence on oil imports. Stepping up of production of electricity could reduce oil demand from backup generation systems. Moreover, the domestic pricing of oil should be aligned further to the international prices to rationalise oil consumption.

Third, current policies towards further diversification of India's export basket, both destination and products, needs to be stepped up. Indian exporters need to accelerate efforts to move up in the value chain at the global level.

Fourth, given the global uncertainties and volatility in capital flows, the resilience of capital account needs to be further enhanced by encouraging FDI inflows.

To conclude, the Indian economy is much more open and globalised now than ever before. The periodic pressures on BoP have been addressed through policy changes. While the BoP has again come under stress since 2011–12 as emphasised by Governor Dr Subbarao, the situation is not as serious as it was in 1991.[8] This is because the structure of the economy has changed in a fundamental way with flexible exchange rate and greater depth in financial markets, besides much larger foreign exchange reserves than those in 1991. However, there is a need to bring the CAD to sustainable levels in the short run and over the medium-term to accelerate efforts towards structural reforms that help boosting our competitiveness, raise growth potential and bring in more stable flows into the economy.

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7 Gokarn, Subir (2012), "India's Gold Problem: Finding Solution through Financial Products", speech at BANCON, on 25th November, 2012 at Pune.

8 Subbarao, D., "Macroeconomic Situation Assessment and Prospects", Speech delivered at Indian Merchants' Chamber, Mumbai on June 19, 2012.