Research

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Current account benign on falling imports

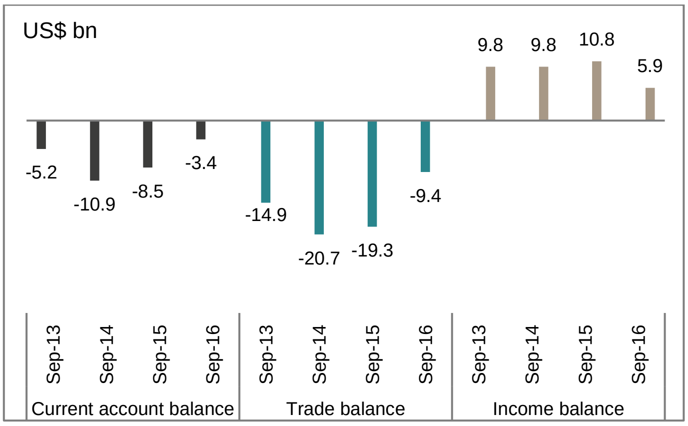
CRISIL Economy First Cut – Balance of Payments

December 2016

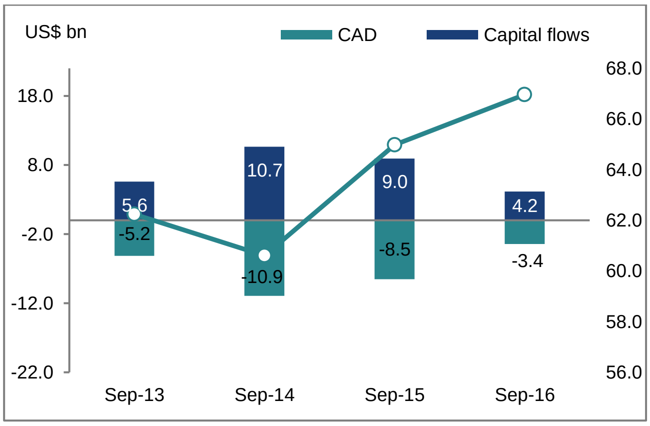
Overview

- India’s current account deficit (CAD) narrowed to 0.6% of GDP in the second quarter of this fiscal (Q2 FY17), compared with 1.7% of GDP for the second quarter of last fiscal (Q2 FY16). However, the deficit in the second quarter was wider than in the first, when CAD had reached a decade-low of 0.1% of GDP.
- The decline in CAD was caused by reduction in trade deficit (on goods and services). While exports showed modest improvement, the steep fall in imports led to the decline. Sliding remittances from workers abroad also continues to be a persistent phenomenon.
- However, recent data suggests that the period of falling imports – the main factor that has brought down the CAD – may soon be over. In the first two months of the third quarter of fiscal 2017, goods imports have grown 9.3% on-year on average. While exports growth has also strengthened to 5.9%, it lags behind import growth. Export growth, we believe, will remain tepid through fiscal 2017, given that global growth forecasts have edged lower. In addition, growing protectionism globally will also have a bearing on Indian exports. The recent pickup in oil prices is another threat that can push up import growth in the Indian economy.
- Nevertheless, the recent demonetisation exercise will cap import growth in the second half of this fiscal. The Indian government’s startling announcement on November 8 of withdrawing legal tender of Rs 500 and Rs. 1000 notes effectively took away 86% of the currency in circulation by value. Replacement of the withdrawn currency has been sluggish so far, which has choked the transactions in the economy. Assuming that the situation will take at least a couple of months to normalise, consumption demand will take a hit in the second half, which will adversely impact import growth.
- ***Given the reduction in CAD in first half of fiscal 2017, and the expected negative cascade of demonetisation on imports, CRISIL Research forecasts CAD to be lower at 0.9% of GDP for fiscal 2017, down from 1.1% for fiscal 2016.***

CAD declines on the back of reduced trade deficit



..but rupee stays weak on lower capital inflows



Source: RBI, CEIC, CRISIL Research

Declining imports kept CAD low in Q2 FY17

- India’s CAD narrowed to $3.4 billion (0.6% of GDP) in Q2 FY17, from $8.5 billion (or 1.7% of GDP) a year ago.
- The CAD shrunk owing to a sharp reduction in trade deficit. Trade deficit declined to $9.4 billion in Q2 FY17 from $19.3 billion in Q2 FY16. Exports increased 1.6% on-year in Q2 FY17 compared with 0.1% on-year decline in Q1. On the other hand, imports continued to decline at 6.6% on-year, albeit slightly lesser than 6.9% decline in Q1. A 60% on-year drop in gold imports in Q2 caused the decline.

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- Services trade surplus fell 8.8% on-year to $16.3 billion in Q2 FY17. Exports growth, at 4.7% on-year, strengthened from Q1. However, import growth, at 16.1%, was also higher, driven by faster growth in air transport (both passenger and freight), personal travel, financial services, intellectual property charges and telecom, computer and information services.
- Net income receipts from abroad (primary and secondary) also declined to $5.9 billion in Q2 FY17 from $10.8 billion in Q2 FY16. Falling remittances from Indian workers abroad has been a key contributor to this. Q2 FY17 marked the fifth quarter of declining remittances, when they fell 12% on-year. More than half of workers' remittances to India come from the Gulf of Cooperation Council, comprising Saudi Arabia, UAE, Kuwait, Oman, Qatar and Bahrain. Economic stress in the region due to low oil prices has put pressure on migrants' earnings.

Capital flows on the slide

- While CAD declined in Q2, capital flows needed to finance the CAD also fell. On a net basis, capital flows (comprising of capital account and financial account balance) more than halved, to $4.2 billion in Q2 FY17 from $9 billion in Q2 FY16.
- This meant that the rupee could not strengthen despite narrowing of CAD. The value of rupee vis-à-vis the US dollar weakened 3.6% on-year in Q2 FY17, on average.
- The major capital inflows in the economy in Q2 FY17 were foreign direct investments (FDI). Net FDI was at a record high at $17.2 billion, almost four times the net inflows seen in Q1, and 2.6 times that in Q2 FY16. Net foreign portfolio investment inflows were $6.1 billion in Q2 FY17, compared with net outflow of $3.5 billion a year ago. India has seen a significant amount of capital inflows from foreign investors in the first half of fiscal 2017, thanks to ample liquidity prevailing in the global economy on the back of massive quantitative easing programmes initiated by major central banks. However, now that the US Federal Reserve has raised policy rate on December 4, 2016, it remains to be seen whether India will survive the capital flight from emerging market economies to the US economy.
- Outflows from the economy can be attributed to other foreign investments such as loans, and trade credit. Loans saw a net outflow worth $11.6 billion in Q2 FY17, compared with $1.2 billion net inflow in Q2 FY16. Reserve assets also saw an outflow worth $8.5 billion, compared with $856 million inflow.

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