Balance of payments

1.41 The World Economic Outlook (WEO, IMF October 2007) observed that the recent expansionary phase in the global economy, with average growth of 5 per cent, was the longest since the early 1970s. The WEO update on January 2008 has, however, revised these estimates based on new PPP exchange rates from the 2005 international comparison programme (ICP). There is considerable uncertainty in quantifying the downside risk to global growth arising from the downturn in housing market and the sub-prime mortgage market crisis in the United States. Monetary policy actions by the United States and other developed countries seem to have contained its immediate impact, though more surprises in the next six months cannot be ruled out.

1.42 The Indian economy has been progressively globalizing since the initiation of reforms. Trade, an important dimension of global integration, has risen steadily as a proportion of GDP. Inward FDI has taken off and there is a surge in outward investment from a very low base, with net FDI continuing to grow at a good pace. The surge of capital flows in 2007-08 is a third indicator that testifies to the growing influence of global developments on the Indian economy. Capital flows, as a proportion of GDP, have been on a clear uptrend during this decade. They reached a high of 5.1 per cent of GDP in 2006-07 after a below trend attainment of 3.1 per cent in 2005-06. This is a natural outcome of the improved investment climate and recognition of robust macroeconomic fundamentals like high growth, relative price stability, healthy financial sector and high returns on investment. Even as the external environment remained conducive, the problem of managing a more open capital account with increasing inflows and exchange rate appreciation surfaced.

1.43 The current account has followed an inverted V shaped pattern during the decade, rising to a surplus of over 2 per cent of GDP in 2003-04. Thereafter, it has returned close to its post-1990s reform average, with a current account deficit of 1.2 per cent in 2005-06 and 1.1 per cent of GDP in 2006-07. The net result of these two trends has been a gradual rise in reserve accumulation to over 5 per cent of GDP in 2006-07. With capital inflows exceeding financing requirements, foreign exchange reserve accumulation was of the order of US$ 15.1 billion in 2005-06 and US$ 36.6 billion in 2006-07. Thus, the rupee faced upward pressure in the second half of 2006-07. Despite this, the rupee depreciated by 2.2 per cent on an overall yearly average basis. The excess of capital inflows has risen to 7.7 per cent of GDP in the first half of 2007-08. Foreign exchange reserves increased by US$ 91.6 billion to US$ 290.8 billion on February 8, 2008.

Components of Capital Account

1.44 The composition of capital flows is also changing. Among the components of capital inflows, foreign investment has been a relatively stable component, fluctuating broadly between 1 per cent and 2 per cent of GDP during this decade. However, it seems to have shifted to a higher plane from 2003-04 with the average for 2003-04 to 2006-07 roughly double that during 2000-01 to 2002-03. The relative stability of investment flows is primarily due to steadily rising FDI. In contrast, debt flows have fluctuated much more, with net outflows in the three years to 2003-04. The variations in debt flows have been primarily due to lumpy repayments on government guaranteed or related ECB. The ratio of debt flows to GDP was on a down trend till 2003-04 and a rising trend from 2004-05. Debt flows, primarily external commercial borrowings, shot up on a net basis in 2006-07 to a level of US$ 16.2 billion. The trend in net capital flows since 2003-04, therefore, seems to be broadly driven by the rising ratio of debt flows.

1.45 The most welcome feature of increased capital flows is the 150 per cent increase in net foreign direct investment inflows in 2006-07 to US$ 23 billion. The trend has continued in the current financial year with gross FDI inflows reaching US$ 11.2 billion in the first six months. FDI inflows were broad-based and spread across a range of economic activities like financial services, manufacturing, banking services, information technology services and construction. With FDI outflows also increasing steadily over the last five years, overall net flows (FDI balance in BoP) have grown at a slower rate.

1.46 The globalization of Indian enterprises and planting of the seeds for the creation of Indian multinationals have taken place in the last few years. Outward investment from India shot up to US$ 14.4 billion in 2006-07 from less than US$ 2 billion in the period 2003-04. The trend continued in the current year with outward investment of US$ 7.3 billion in April-September 2007. Net FDI flows were, therefore, a modest US$ 3.9 billion during this period. The proportion of payments to receipts under FDI into India was in the range of 0.7 per cent to 0.4 per cent in 2005-06 and 2006-07, respectively. This indicates the lasting and stable nature of FDI flows to India.

1.47 Increased volatility in Asian and global financial markets in 2006-07 affected the flow of portfolio investment. Net portfolio flows became negative in May-July 2006 (reflecting the slump in equity markets), picked up momentum in August-November 2006, only to slow again in March 2007. Net flows were, therefore, only US$ 7.1 billion in 2006-07 compared to US$ 12.1 billion in 2005-06. Euro equities, which were a relatively minor component of portfolio flows (less than a billion US dollars in the period 1997-98 to 2004-05), rose to US$ 3.8 billion in 2006-07 constituting 54.3 per cent of the total net portfolio flows. Net portfolio investment inflow was US$ 18.3 billion in April-September 2007, more than double the inflow during 2006-07. Underlying these were gross inflows of $ 83.4 billion and outflows of US$ 65.0 billion.

1.48 The rapid accretion of reserves and increased pressure on the rupee, necessitated raising the limit on the market stabilization fund. The annualized return on the multi-currency, multi-asset portfolio of the RBI was 4.6 per cent in 2006-07, indicating that the effective fiscal cost of sterilization may be 3.2 per cent. The fiscal costs of sterilization in 2007-08 is placed at Rs. 8,200 crore. The search for an appropriate policy mix for balancing a relatively open capital account, monetary policy independence and flexible exchange rate continues.

Current account components

1.49 The current account deficit (CAD) mirrors the saving-investment gap in the national income accounts and thus constitutes net utilized foreign savings. The challenge is to leverage foreign inflows (i.e. foreign savings and investment) to promote growth without having the long-term consequences of external payment imbalances. The distinction between gross capital inflows and net inflows is useful. As the latter must equal the CAD, there is no way in which net use of foreign saving can increase without an increase in the CAD. The gross inflow can, however, increase to the extent that it is offset by gross outflows in the form of build-up of foreign exchange reserves, reduction in government external debt or outward investment by entrepreneurs. Higher gross inflows have value even if net flows do not increase to the same extent, as they can improve competition in the real and financial sectors, improve the quality of intermediation and the average productivity of investment, and thus raise the growth rate of the economy. The challenge for policy is to maximize these benefits while minimizing the costs of exchange rate management.

1.50 The rise and fall of the current account balance (as a ratio to GDP) during this decade has been driven largely by the goods and services (G&S) trade balance, with the two having virtually the same pattern. The surplus from factor income including remittances, which fluctuated between 2 per cent and 3 per cent of GDP, has helped moderate the substantial deficit on the trade account. Both the trade (G&S) balance and the factor surplus improved between 2000-01 and 2003-04 leading to an improvement of the current account. Both reversed direction thereafter resulting in a declining trend in the current account. The peak values of the three as a proportion of GDP were -0.6 per cent, 2.9 per cent and 2.3 per cent. In the past two years the current account deficit, trade (G&S) deficit and factor surplus have averaged 1.15, 3.5 and 2.35 per cent of GDP, respectively.

1.51 The trends in the goods and services trade deficit have in turn been largely driven by the merchandise trade deficit since 2004-05. During 2000-01 to 2003-04 the merchandise trade deficit was around 2 per cent of GDP and the rising services surplus resulted in an improving trend in the overall G&S trade balance. From 2004-05 the merchandise trade balance has been deteriorating and despite the continued rise in the services surplus, the overall G&S balance had followed the deteriorating trend of the former.

1.52 Private transfer receipts (mainly remittances) shot up by 49.2 per cent in 2007-08 (April-September) over the first half of 2006-07 when they had increased by 19.2 per cent. Investment income (net), which reflects the servicing costs on the payments side and return on foreign currency assets (FCA) on the receipts side, grew by 60 per cent in 2007-08 (April-September) reflecting the burgeoning foreign exchange reserves. Net invisible surplus grew by 35.2 per cent to reach US$ 31.7 billion in 2007-08 (April-September), equivalent of 6.1 per cent of GDP. Thus, higher invisible surplus was able to moderate partly the higher and rising deficits on trade account. CAD was, therefore, placed at US$ 10.7 billion in 2007-08 (April-September), equivalent of 2 per cent of GDP for the half year.