Macroeconomics| FIRST CUT

Surge in banking capital majorly offsets wider first quarter CAD

September 2022

Import bill bleeds on high energy prices, higher services surplus and remittances provide some cushion

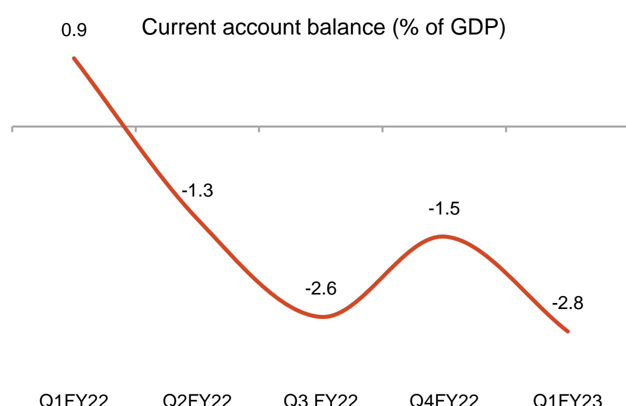
Spiraling international commodity prices on the back of the Russia-Ukraine war yanked wider open India's goods trade deficit in the first quarter of the current fiscal. As a result, the current account deficit (CAD) rose to a 15-quarter high of 2.8% of gross domestic product (GDP), from 1.5% in the fourth quarter of fiscal 2022. The CAD was in surplus at 0.9% of GDP in the year-ago quarter.

Higher surplus in services and the income account (owing to increased remittances) kept the deficit from deteriorating further.

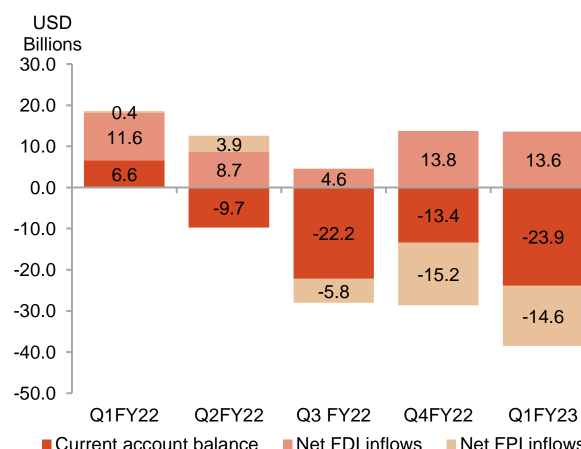
Under the financial account, foreign direct investments (FDI) and foreign portfolio investments (FPI) stayed somewhat stable on-quarter. A spurt in other investments (mainly banking capital) leding to a surplus on this account. That not only covered the shortfall in the current account but also led to a small accretion in forex reserves.

With goods exports declining rapidly, CAD is expected to deteriorate further in the second quarter of this fiscal

CAD slid again in the first quarter…



… but FDI and FPI flows were near-static



Source: Reserve Bank of India (RBI), CEIC, CRISIL

Balance of payments: Highlights

- CAD increased sharply to $23.9 billion in the first quarter of the fiscal from $13.4 billion in the previous quarter.

This was in sharp contrast to a surplus of $6.6 billion recorded in the year-ago quarter, when the economy had slowed down due to the second Covid wave.

- The worsening current account balance was largely a result of higher goods trade deficit at $68.6 billion, up from $54.5 billion in fourth quarter of fiscal 2022. Net outgo from the primary income account (reflecting investment income) also increased to $9.3 billion from $8.4 billion.
- On the other hand, higher surplus in services trade ($31.1 bilion vs $28.3 billion) and secondary income ($22.8 billion vs $21.2 billion) provided some cushion. The latter mainly represents foreign remittances.
- Gains from net FDI inflows of $13.6 billion in the first quarter were completely wiped out by net FPI outflows at $14.6 billion. But significantly higher net other investments ($31.5 billion vs $2.4 billion in fourth quarter of fiscal 2022) – a reflection of higher banking capital - not only returned the financial account[1] to surplus in the first quarter ($27.9 billion vs -$1.7 billion), it actually exceeded the current account deficit of $23.9 billion.
- This led to an accretion of $4.6 billion to forex reserves as opposed to a drawdown of $16 billion in the previous quarter.

Goods trade deficit worsened due to a higher import bill

- While both exports and imports rose sequentially in the first quarter, the latter grew much faster (11.0%) than the former (4.2%), resulting in a wider goods trade deficit. While exports momentum softened due to weakening global demand, imports remained elevated as: a) international commodity prices, especially of crude oil, a major import item for India, rose to an average $112.7/barrel vs $98.9/barrel, and b) recovery in GDP growth (to 13.5% on-year vs 4.1%) kept core i.e. non-oil non-gold demand buoyant.
- The services trade surplus rose $2.8 billion sequentially to $31.1 billion. This was a reflection of continuous improvement in India's information technology exports ($34.5 billion vs $32.8 billion) and lower drag from deficit in travel services (-$1.6 billion vs -$2.4 billion), as tourism activities gained traction with the economy opening up amid receding Covid fears.
- Net income receipts from abroad (primary and secondary income) improved on-quarter to $13.6 billion (vs $12.8 billion). This was a result of secondary income (mainly higher foreign remittances) rising $1.7 billion to $22.9 billion. Greater net outflows from primary income (reflecting lower investment income), however, capped the gains.

Banking capital surged, while ECBs dropped

- India's healthy growth prospects relative to a slowing global economy resulted in robust FDI inflows at $13.6 billion in the first quarter of the fiscal (similar to $13.8 billion a quarter ago)
- However, FPI outflows (at $14.6 billion) completely eroded gains from FDI inflows. Two factors drove the outflows: the Russia-Ukraine crisis leading to a risk-off sentiment, and the reversal of easy monetary policy as the US Federal Reserve started rate hikes prompting a rush to purchase dollar assets, and an exit from emerging markets like India
- India's net external commercial borrowings (ECBs) turned negative (-$2.9 billion) from a positive $3.3 billion the previous quarter, reflecting reduced attractiveness of foreign borrowings amid rising interest rates and the end of easy money abroad. NRI bank deposits too remained muted (at $0.3 bn vs $0.2 billion).
- What saved the quarter, however, was a sharp rise in net banking capital inflows (under 'other investments') to $19.2 billion from -$5.6 billion in the previous quarter.This helped financial account remain in surplus, which more

[1] Including capital account. Under BPM6 financial and capital account are considered as two separate heads

than covered for the shortfall in the current account. It is noteworthy that the banking capital has come as loans to India and are likely to reverse going ahead.

Outlook

The rise in international commodity prices, exacerbated by the Russia-Ukraine crisis, is expected to soften with the slowdown in global growth. Several key economies are on the brink of recession. Crude prices have already eased to below $85/barrel after remaining above $120/barrel in June. CRISIL recently lowered its Brent crude price forecast for this fiscal to $98-103/barrel from $105-110/barrel earlier. This should have a sobering effect on India's import bill, which is otherwise expected to remain elevated with domestic growth gaining momentum.

At the same time, India's exports face further headwinds, given the moderation in global growth. A greater slowdown in exports vis-à-vis imports, with services trade surplus too coming under mild pressure, will widen the CAD some more in the second quarter. But financing of CAD has not posed a challenge so far, with FPI flows showing a reversal since July.

Overall, we project India's CAD at 3% of GDP in the current fiscal, with risks tilted to the downside.

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