May 2014

CRISIL Economy First Cut

BOP: CAD to widen to 2.2% of GDP in fiscal 2015

Overview: India's current account deficit (CAD) narrowed sharply to $32.4 billion (1.7% of GDP) in fiscal 2014 from $87.8 billion (4.7% of GDP) in fiscal 2013. The correction in CAD was primarily due to a contraction in merchandise imports coupled with a rise in service exports. Capital inflows at $48.8 billion – buffered by a surge in inflows under foreign currency non-resident (FCNR) deposits - were more than sufficient to finance the CAD, resulting in a $15.5 billion accretion to India's foreign exchange reserves.

In fiscal 2015, we now expect CAD to widen to $47 billion (2.2% of GDP) as restrictions on gold imports, imposed since July 2013, are gradually withdrawn. The Reserve Bank of India (RBI) has already begun to take steps in this direction by allowing large private gold importers to resume importing gold and permitting nominated banks to give gold metal loans to jewellery manufacturers. Imports of capital and consumption goods (non-oil, non-gold imports) are also expected to rise this year as GDP growth picks up to 6%. Despite pressure from rising imports, the upside to CAD is likely to be capped due to faster growth in exports led by a global recovery.

Financing CAD however, may pose a challenge in fiscal 2015 as global liquidity declines with continued tapering of US Fed's bond purchase program. There will also no longer be a cushion from FCNR deposits as in the last year. Under these circumstances, the government's ability to revive investor sentiment and lift growth will be key to attracting portfolio and FDI flows.

- The reduction in CAD in fiscal 2014 was led by a (1) sharp fall in merchandise trade deficit to $147.6 billion (7.5% of GDP) from $195.7 billion (10.5% of GDP) in fiscal 2013 and (2) a 12.4% growth in net services receipts in fiscal 2014.
- While merchandise exports growth at 3.9% provided some support, the dramatic narrowing of the merchandise trade deficit was driven by a 7.2% decline in imports. Gold imports fell to $28.9 billion in fiscal 2014 from $53.8 billion in the previous year and imports excluding oil and gold also declined by 4.3% year-on-year due to weak domestic demand.

Figure 1: NRI deposits help finance the CAD in FY14

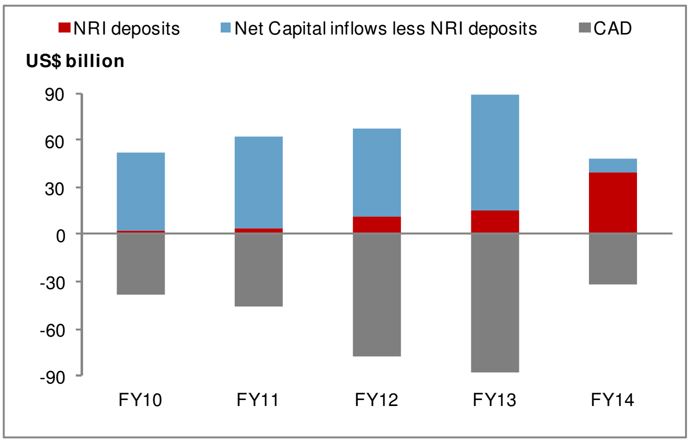
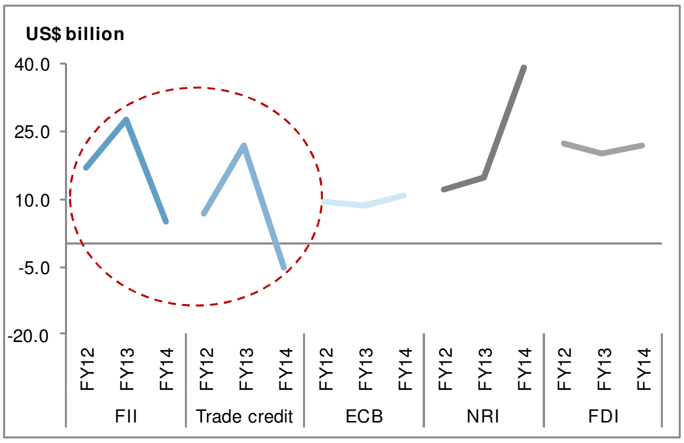


Figure 2: Short-term net capital flows decline



Source: Reserve Bank of India

- In fiscal 2014, despite a sharp slowdown in growth, there was a marginal pick-up in longer-term and less volatile capital flows such as net FDI (to $21.6 billion from $19.8 billion) and external commercial borrowings (to $10.7 billion from $8.6 billion). In contrast, short-term inflows such net FIIs and trade credit declined sharply. Net FII inflows fell to $5 billion (5-year low) in fiscal 2014 from $27.6 billion in fiscal 2013 and there were net outflows of $5 billion on trade credit and advances in fiscal 2014 as compared to net inflows of $21.7 billion in the previous year. The decline in trade credit was mainly due to lower inflows on account of a sharp decline in merchandise imports in fiscal 2014.
- Net Capital inflows received a significant boost from FCNR deposits mobilised in Q3 under the swap scheme offered by the RBI. FCNR deposits more than doubled to $38.9 billion in fiscal 2014 from $14.8 billion in fiscal 2013.
- At end-December 2013, India's external debt stood at $ 426 billion – 5.2% higher than its level of $404.9 billion at end-March 2013. The rise was mainly due to an increase in long-term debt driven by higher NRI deposits. Share of short-term external debt in total external debt fell to 21.8% in end-December 2013 from 23.9% at end-March 2013 due to a decline in short-term trade credit and advances.

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Last updated: May, 2013

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