Financing the Indian Current Account Deficit

THE CURRENT ACCOUNT deficit has fallen from 4.9 per cent of Gross Domestic Product (GDP) in 2013–14:Q1 to 1.3 per cent in 2013–14:Q2. It (current account as a per cent of GDP or CAGDP) averaged 4.3 per cent between 2010–11:Q1 and 2013–14:Q1. Research suggests that a CAGDP between 2.4 and 2.8 is sustainable for GDP growth rates between 6 to 8 per cent, respectively i.e. the nation is able to finance its current account gap on an ongoing basis by normal capital flows[1].

Further, both FDI and portfolio flows have financed the current account deficit almost equally – 28 per cent and 31 per cent, respectively, after 2010–11.

This article examines the type of capital flows that have financed the current account deficit in the volatile period after the global financial crisis starting from the financial year 2010–11:Q1 to the latest available data 2013–14:Q1. This question is important because short-term capital flows (as opposed to long-term capital flows such as Foreign Direct Investment or FDI) tend to be volatile and their sudden outflow would endanger the sustainability of the CAGDP. The 2013–14:Q2 has been left out of the analysis. There was considerable turbulence in this quarter due to the announcement that the Federal Reserve would be tapering off. It is marked by significant capital outflows along with a sharp fall of the current account deficit.

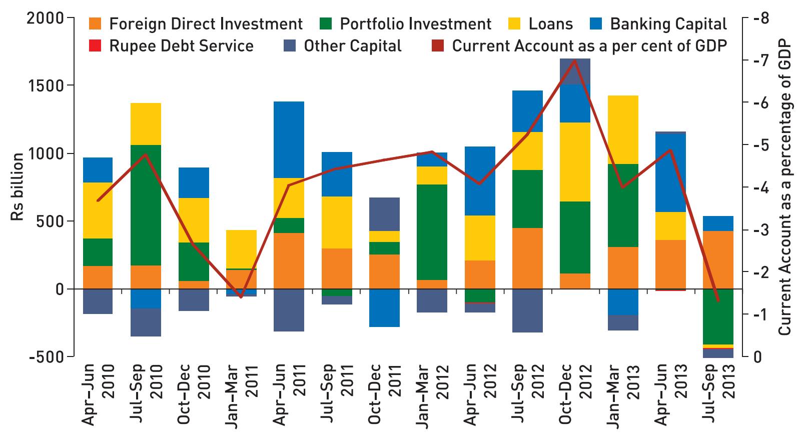
Overall, net capital flows as a percentage of GDP averaged around 4.4 per cent of GDP between 2010–11:Q1 and 2013–14:Q1, resulting in the rundown of foreign exchange reserves in this period. The capital account mainly consists of five items – foreign investment, loans, banking capital, rupee debt service and other capital. Foreign investment and banking capital are the biggest components that finance the current account (Figure E.1). On average, foreign investment financed 59 per cent of the current account deficit during the period of this study and banking capital formed 20 per cent (out of which, non-resident deposits formed 15%).

Foreign investment, in turn, consists of FDI and portfolio investment (PI). On average, FDI financed 28 per cent of India's current account deficit (CAD) during the period of this study. PI mainly consists of Foreign Institutional Investment flows into India that, in turn, come through two routes-equity or debt. On average, the PI has financed 31 per cent of the current account deficit during this period. The first two quarters of 2013–14 have only seen portfolio outflows, mainly because of debt outflows.

Non-resident deposits, which are counted under banking capital, financed, on average, 15 per cent of the current account deficit between 2010–11:Q1 and 2013–14:Q1.

Both, FDI and portfolio flows have financed the current account deficit almost equally – 28 per cent and 31 per cent, respectively, after 2010–11. However as the Asian Development Bank Outlook April 2013 mentions, it was debt flows that drove the portfolio inflows after the global financial crisis. This increases the burden of servicing debt in the future. Surprisingly, FDI has been resilient during 2013, going up in the three quarters of 2013 even when there was a reversal of PI. The short run looks tough but India seems to have survived for the time being.

Figure E.1: Current Account as a per cent of GDP and Components of Capital Account, 2010–11:Q1 to 2013–14:Q2



Source: Reserve Bank of India.

1. Goyal, R. 2012. Sustainable level of India's Current Account Deficit. RBI Working Paper Series W P S (DEPR): 16 / 2012. www.rbi.org.in