Macroeconomics| FIRST CUT

CAD zooms as merchandise trade deficit widens

December 2022

Wider current account deficit, lower financial flows depleted forex in the second quarter

Merchandise exports fell in the second quarter of this fiscal sequentially given weakening demand abroad, while merchandise imports continued to rise on domestic demand, leading to an increase in merchandise trade deficit.

Deficit in the primary income account, too, widened during the quarter. As a result, current account deficit (CAD) shot up to a 37-quarter high of 4.4% of gross domestic product (GDP)[1] in the second quarter from 2.2% (revised down from 2.8% earlier) in the first quarter of this fiscal and 1.3% in the year ago quarter.

A surplus in services and secondary income accounts (owing to increased remittances) prevented CAD from deteriorating further.

Foreign exchange reserves declined as inflows under the financial and capital account were insufficient to cover the shortfall in the current account. Within the financial account, while net foreign portfolio investments (FPI) turned positive in the second quarter (after remaining negative in the first), foreign direct investments (FDI) declined sharply and other investments (mainly banking capital) saw net outflows as opposed to high net inflows in the previous quarter. Therefore, overall, financial flows were not only lower on-quarter, but were also inadequate to fund the shortfall in the current account .

Slowing domestic growth momentum, softening international commodity prices and robust services exports should help narrow CAD in the second half of this fiscal to ~3%

Balance of payments: Highlights

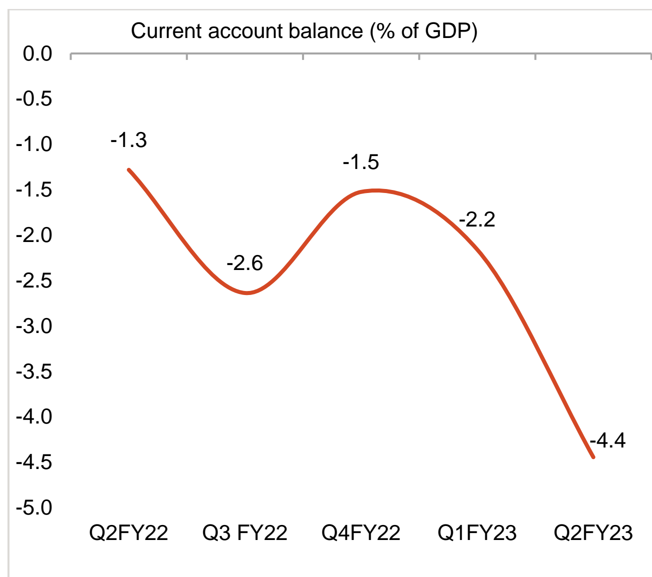
- CAD increased sharply, doubling to $36.4 billion in the second quarter of this fiscal from $18.2 billion in the first quarter. It was also almost four times more than the $9.7 billion CAD recorded in the second quarter of fiscal 2022. With this, CAD in the first half of this fiscal stood at $54.5 billion (or 3.3% of GDP) in sharp contrast to a mild $3.1 billion CAD (0.2% of GDP) in the year ago period.
- CAD worsened in the second quarter, largely owing to a surge in goods trade deficit, which widened to $83.5 billion from $63.0 billion in the first quarter of this fiscal. Net outgo from the primary income account (which largely reflects investment income) also increased to $12.0 billion from $9.1 billion.
- On the other hand, higher surplus in services trade ($34.4 billion versus $31.1 billion) and secondary income ($24.8 billion vs $22.8 billion) did some counterbalancing. The latter mainly represents foreign remittances.
- Gains from net FPI inflows (which turned positive at $6.5 billion in the second quarter versus -$4.6 billion in the

[1] CAD was recorded at 4.7% of GDP in the first quarter of fiscal 2013

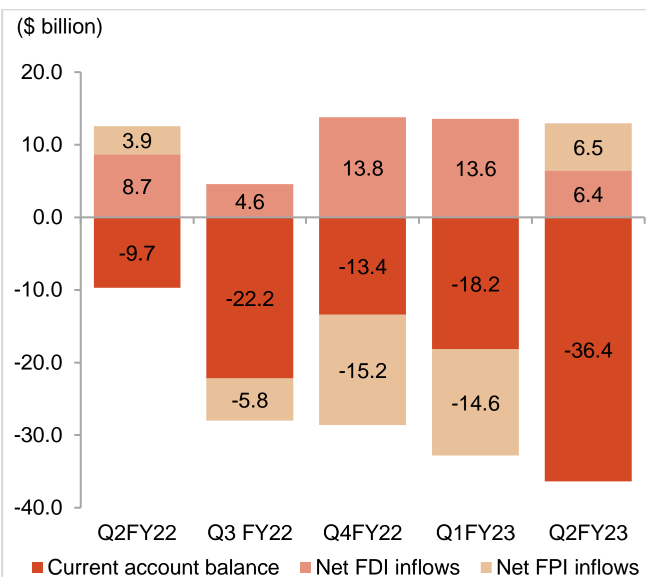
first quarter) were completely wiped out by lower net FDI inflows, which almost halved (to $6.4 billion in the second quarter from $13.6 billion in the first quarter) and other investments turning negative (-$6.2 billion) in the second quarter from a significant positive ($25.6 billion) in the first quarter. Together, net inflows under the financial (sum of FDI, FPI, financial derivatives and other investments) and capital account only amounted to $6.9 billion in the second quarter compared with a net outflow of $36.4 billion under the current account.

- This meant a drawdown of $30.4 billion from the forex reserves in the second quarter to balance the shortfall in the current account as opposed to an accretion of $4.6 billion to forex reserves in the first quarter. Looking at it from another perspective, this also indicates the use of forex reserves (i.e. sale of US dollars) by the central bank to intervene in the forex market to arrest the sharp depreciation of the rupee during the quarter. The rupee averaged 79.8/$ in the second quarter, compared with 77.2/$ in the first quarter.

CAD deteriorated in the second quarter…



…and financial flow remained insufficient



Source: RBI

Goods trade deficit worsened owing to a higher import bill

- Goods trade deficit widened in the second quarter as imports rose to $195.6 billion from $185.8 billion in the first quarter whereas exports declined to $111.9 billion from $122.4 billion. While exports' momentum softened because of the weakening global demand (as reflected in the fall in core exports in the second quarter vis-à-vis the first quarter), imports remained elevated owing to recovery in the domestic economy, in sync with higher core (non-oil non-gold) imports in the second quarter over the first quarter. To be sure, some pressure also came from costlier natural gas imports, whose prices almost doubled during the second quarter ($60.2/MMBtu versus $31.6/MMBtu in the first quarter). It is noteworthy that India's goods import bill rose despite prices of key import items such as crude oil and gold softening[2] during the quarter, which again points towards higher import demand amid domestic economic recovery.
- Services trade surplus rose $3.4 billion sequentially to $34.4 billion in the second quarter, a reflection of continuous improvement in India's information technology exports ($32.7 billion versus $30.7 billion) and professional and management consulting services ($9.8 billion versus $8.3 billion). On the other hand, wider deficit in travel services (-$1.8 billion versus -$1.6 billion), both business and personal (suggesting Indians going

[2] Brent spot averaged $99.2/bbl in the second quarter of this fiscal compared with $112.7/bbl in the first quarter; gold averaged $1726/troy oz in the second quarter versus $1874/troy oz in the first

abroad outpaced foreigners visiting India) restricted overall gains to some extent

- CAD also worsened as primary income deficit widened to $12.0 billion in the second quarter, from $9.1 billion in the first quarter as net 'compensation of employees' fell ($7.8 billion in the second quarter versus $9.1 billion in the first quarter) and there was a greater net outflow of investment income abroad (-$13.5 billion versus -$10.8 billion). On the other hand, higher secondary income surplus ($24.8 billion versus $22.9 billion), owing to robust remittances, provided some cushion.

Banking capital receded, while ECBs and NRI deposits improved

- Under the financial account, FPI inflows staged a comeback as India recorded net FPI inflows of $6.5 billion in the second quarter against a net outflow of $14.6 billion in the first quarter, suggesting India's relatively better growth prospects among the major emerging market economies.
- However, net FDI fell sharply in the second quarter (to $6.4 billion from $13.6 billion in the first quarter) as FDI inflows reduced and outflows rose.
- Other investments also displayed a sharp reversal, turning to -$6.2 billion in the second quarter from a huge $25.6 billion inflow in the first quarter. This was primarily the result of a slump in banking capital inflow (loans taken by *deposit-taking corporations, except the central bank*) to $1.6 billion in the second quarter from an unusually high $37.3 billion in the first quarter. On the other hand, NRI deposits improved to $2.5 billion in the second quarter from $0.3 billion in the first and net external commercial borrowing (ECB) outflows came down sharply to $0.3 billion from $3.0 billion (as inflows increased and outflows reduced). Higher NRI deposits and lower ECB outflow in the second quarter likely reflect the impact of relaxation measures announced by the RBI in July to boost foreign capital inflows.

Outlook

India's merchandise exports face headwinds, given the moderation in global growth. At the same time, given India's relatively better growth prospects, imports are expected to remain buoyant. This means pressure on goods trade and, therefore, CAD. That said, with international commodity prices softening, and domestic growth momentum which is expected to moderate in sync with the subdued global economic scenario, CAD has likely reached its peak at 4.4% of GDP in the second quarter and is expected to moderate in the second half of this fiscal. Overall, we project India's CAD at 3.2% of GDP in the current fiscal (it is expected to come down to ~3% in the second half from 3.3% in the first), compared with 1.2% in fiscal 2022. Services exports and remittances have so far remained resilient and have provided cushion to CAD. These will remain monitorable as global growth slows. Financing of CAD this fiscal, too, could remain challenging if FDI flows do not revive and FPI inflows recede again.

Going ahead, a bigger hit to domestic growth in the next fiscal is likely to temper our core imports. Along with this, further correction in international crude oil and raw material prices in view of the softening global demand would also narrow the trade deficit. Given these factors, we expect CAD to decline to 2.4% of GDP in the next fiscal.

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