Macroeconomics | FIRST CUT

CAD trims sharply as trade deficit narrows

June 2023

Higher FDI flows lead to some forex accretion in the fourth quarter

India's current-account deficit (CAD) narrowed sharply to 0.2% of gross domestic product (GDP) in the fourth quarter of fiscal 2023 from 2.0[1]% in the third quarter, thanks to a drop in merchandise-trade deficit and higher surplus in services trade. But the quarter saw some sequential softening in remittances.

Not only did the CAD narrow in the fourth quarter, but also financial flows were more than sufficient to fund CAD, leading to an accretion in foreign exchange reserves. The magnitude, however, was less than in the previous quarter. This was largely a result of an uptick in foreign direct investments (FDI), even as foreign portfolio investments (FPI) fell, and other investments (largely banking capital) declined on-quarter.

The decline in merchandise trade deficit and higher services surplus helped reduce CAD substantially in the fourth quarter

Balance of payments: Highlights

CAD narrowed sharply to $1.3 billion (0.2% of GDP) in the fourth quarter (Jan-Mar) of fiscal 2023 from $16.8 billion (2.0% of GDP) in the third quarter of fiscal 2023 and $13.4 billion (1.6% of GDP) in the fourth quarter of fiscal 2022.

This was a result of a noticeable fall in goods trade deficit — to $52.6 billion from $71.3 billion in the third quarter (as exports rose and imports fell on-quarter), helped by moderation in international energy prices, such as crude oil, coal and natural gas. To be sure, non-energy prices (particularly metals and minerals) and gold prices firmed up during the quarter.

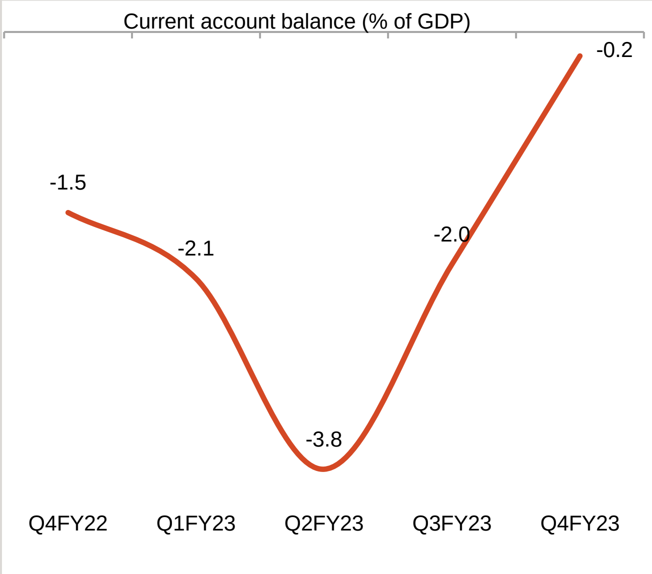
At the same time, services trade surplus rose to $39.1 billion from $38.7 billion in the third quarter, thanks to continued uptick in 'computer' and 'professional, management and consulting' services. The travel services, which registered a surplus for the first time in third quarter of fiscal 2023 since the pandemic began in 2020, remained in the green. But the surplus reduced as the sequential rise in spending by Indians on holidays abroad outpaced those by foreigners in India.

Interestingly, secondary income (which largely represents personal transfers from abroad), while remaining in surplus and supporting the overall current account balance, saw some moderation, as was reflected in net secondary income surplus assuaging to $24.7 billion in the fourth quarter, from $28.5 billion in the previous quarter. Within this, worker remittances came down to $14.7 billion from $17.7 billion. This could be the reflection of a) setting in of slowdown and tighter monetarty conditions in the advanced economies; and b) correction in oil prices,

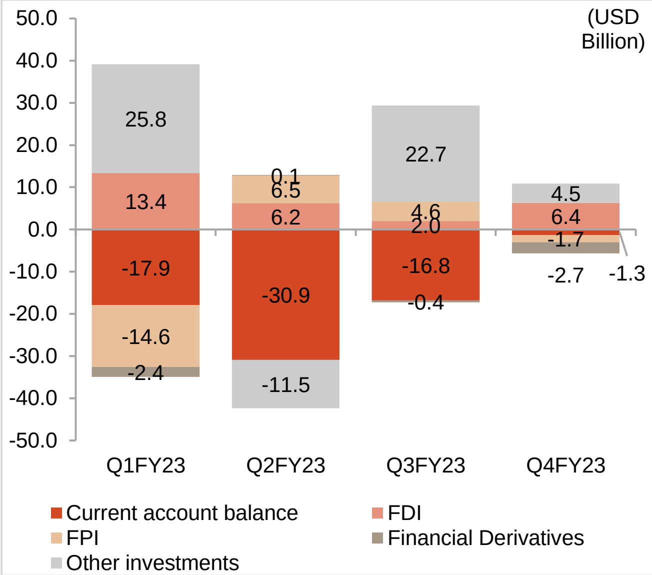
[1] As per RBI, Q3 FY23 CAD has been revised downwards from US$ 18.2 billion (2.2% of GDP) to US$ 16.8 billion (2.0% of GDP) due to downward adjustment in Customs data

which has a bearing on the economic performance of Middle East countries that remain a dominant source of remittances to India.

CAD sharply down in the fourth quarter…



…and financial flows more than funded it



Source: RBI

Financial flows funded the CAD, thanks to higher FDI

While net financial flows also declined on-quarter, they were more than sufficient to finance the deficit in the current account, thereby leading to a mild accretion of foreign exchange (forex) reserves during the fourth quarter.

Net inflows under the financial (sum of FDI, FPI, financial derivatives and other investments) and capital accounts amounted to $6.5 billion in the fourth quarter, down from $28.9 billion in the previous quarter. But given that CAD during the quarter was only $1.3 billion, $5.7 billion of forex reserves accretion happened in the fourth quarter.

The slowdown in financial flows was led by net FPI inflows, which turned into deficit (-$1.7 billion) in the fourth quarter from a surplus ($4.6 billion) in the third. Likewise, surplus in 'other investments' fell sharply to $4.5 billion from $22.7 billion. This was once again the result of a reversal in banking capital (or 'deposit-taking corporations, except the central bank'), which has been a highly volatile form of financial flows for some time. It plunged to -$7.7 billion in fourth quarter from a positive $12.0 billion in the third.

Within 'other investments', however, non-resident Indian (NRI) deposits continued to rise (to $3.6 billion from $2.6 billion) thanks to favourable policy changes by the Reserve Bank of India in the past. External commercial borrowings (ECB) also returned to surplus in the fourth quarter (at $1.7 billion) after remaining in deficit in the previous three quarters.

The major improvement in financial flows was in FDI, which rose to a net $6.4 billion in the fourth quarter from $2.0 billion in the previous quarter.

Outlook

While CAD fell substantially in the fourth quarter, for the full fiscal 2023, it rose to $66.9 billion on-year (2.0% of GDP) from $38.7 billion in fiscal 2022 (1.2% of GDP), thanks to a wider trade deficit.

With the correction in international commodity prices, especially in the energy space and support from healthy services exports and remittances, CRISIL expects CAD to soften to 1.8% of GDP this fiscal. That said, there has recently been some softening in services export momentum and remittances, and hence performance on these two fronts will be monitorable.

Given weakening global growth and tighter monetary policies in advanced economies, financial flows are expected to be volatile. CAD should be manageable and its financing is unlikely to be a major concern if there are no major setbacks.

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