**Brief/Talking points on India’s ‘External Sector Vulnerabilities’**

1. ***Introduction***

* Global economic slowdown and the Euro zone crisis have brought to the fore the external sector challenges facing the emerging market economies including India. Emerging markets are facing uncertainty about external economic conditions that impinge on their economic performance.
* The spillover effects have been through the trade as well as finance channels. There has been differential impact on emerging market economies (EMEs) based on their external profile. Some that have a large export orientation have been impacted directly through lower contribution of net exports to GDP. Others with large CAD have been impacted through less than adequate financing resulting in sharper depreciation. But such an adjustment that corrects the exchange markets has been made arduous by the weak external demand.
* EMEs are also increasingly more vulnerable to spillovers from the economic developments in advanced economies particularly euro area. Fiscal uncertainties in the United States also present a latent risk to financial stability of the global system.
* Vulnerability is usually termed with reference to either a ‘sudden-stop’ of capital flows to a country or worldwide as it is perceived to have happened for a short period in September-October 2008 following the Lehman collapse or with reference to less than adequate financing of the current account deficits of EMEs owing to country specific or general risk repricing.
* There are some traditional indicators of the vulnerabilities like forex cover for imports, external debt etc. on the one hand and the external financing needs as represented by external financing needs for rolling over short term external debt in one year.
* The external sector vulnerability of India rests on weak growth in merchandise exports, large import dependence on crude oil and other intermediates, moderation in and volatile nature of capital flows, particularly the portfolio variety.

1. **Vulnerability of External Sector – causative factors**

* It is important to note that the vulnerabilities of EMEs are more a result of the volatile financial market conditions rather than a deterioration in the current account balances of the EMEs. Following a surge in capital flows since the middle of 2012 to May 2013, a reversal was there since 2013 on account of market perceptions of FED tapering its asset purchases.
* Fragile financial market conditions have dented investor confidence and consequently, capital flows to EMEs remain volatile. As per the Research Note of the Institute for International Finance, October 2013, global private capital flows to EMEs are projected at US$ 1062 billion in 2013 as against US$ 1215 billion in 2012.
* Current account surplus of the EMEs is estimated to have fallen to US $ 249 billion in 2013 as against a level of US$ 280 billion in 2012. Reserve increase has broadly been at the same levels.
* However, compositionally some EMEs like India had experienced a sharp rise in CAD in 2012. This owes to the fact that even with weak global recovery, global commodity prices, especially energy, have remained elevated and volatile. Recently the threats emanating from the likely action on Syria has resulted in a spurt in prices, which seems to have waned presently.
* The large liquidity being injected by major advanced economies and geo-political tensions could exert further pressure on oil prices. This could threaten both growth and inflation in EMEs. The sharp rise in global food prices is another major challenge that many EMEs, especially those which are already facing inflationary pressures, may have to contend with.
* Slowing global demand has adversely affected industrial activity and exports in emerging economies including India. The unfolding of the euro zone crisis and the uncertainty surrounding the global economy have impacted the Indian economy causing drop in growth, elevated level of current account deficit, moderation in capital inflows and depreciation of rupee.
* The IMF in its Global Financial Stability Report (April 2012) highlighted that many countries, particularly in Asia and Latin America, have higher stocks of reserves than they held at the onset of the Lehman crisis in 2008. However, a reversal of capital flows as a consequence of financial deleveraging and waning risk appetite could put severe strain on countries that have received large inflows and accumulated high short-term external debt.

***US Quantitative Easing***: Recently, the decision by the US Federal Reserve to hold off tapering has buoyed financial markets but tapering is inevitable. Financial markets however could be re-pricing risks factoring in the inevitability of monetary stimulus getting withdrawn at some stage. It is pertinent to mention that many emerging economies have witnessed large capital outflows since late May, 2013 when the prospect of Fed tapering first emerged. The foreign exchange market witnessed increased signs of volatility, reflecting concern about financing current account deficit, amplified by capital outflows precipitated by anticipated tapering of asset purchases by the US Federal Reserve.

**2.1 Movement of India’s Key External Sector Indicators**

India’s external sector vulnerability indicators exhibited signs of further deterioration in 2012-13, reflecting impact of deepening euro zone sovereign debt crisis and rising uncertainties in the global economy, together with slowdown in advanced economies, moderating growth in emerging market economies and weakening domestic economy. This is reflected in (i) declining reserve cover for imports (7.0 months in 2012-13), (ii) falling reserve cover for external debt (74.5 per cent at end-March 2013); (iv) increasing magnitude of short-term debt and its share in total debt (24.7 per cent); and (v) weakness in country’s balance sheet as reflected in international investment position with rising and relatively higher share of debt liabilities in total international financial liabilities.

***2.1.1 Level of Current account Deficit***

In India, external sector vulnerabilities came to the fore in 2012-13, as its current account deficit widened to a historic peak of 4.8 per cent of GDP vis-à-vis already high of 4.2 per cent in the previous year. Even though CAD has been higher during Q1 of 2013-14 on account of higher trade deficit, it is moderating thereafter. After sharp increase in first two months of the current fiscal year, trade deficit has narrowed considerably. Going forward, the CAD is expected to see correction due to trade policy measures taken to curb gold imports and price adjustments effected to moderate consumption of fuel products. (**See Annex 1 detailing the latest projections of the STBOP Group**)

**2.1.2 *Indebtedness and Risks of Rollover***

The elevated level of current account deficit (CAD) in 2011-12 and 2012-13 has resulted in increasing the financing requirements from both debt and non-debt capital flows. While non-debt capital flows continue to remain the major source of financing, increasingly debt flows are assuming importance in the financing of CAD. This resulted in a rise in India’s external debt during 2012-13. External debt increased to US$ 392.1 billion at end-March 2013 from US$ 345.8 billion at end-March 2012. At end-June 2013, India’s external debt at US$ 388.5 billion however witnessed some moderation reflecting the impact of valuation gain and lower level of external commercial borrowings debt. *Short-term debt based on residual maturity accounted for 43.8 per cent of total debt and 60.2 per cent of reserves at end-June 2013.*

**2.1.3 *Volatility in Rupee Exchange Rate***

The rupee exchange rate has witnessed significant volatility, particularly after the credit downgrading of USA in August 2011 and deepening of the euro zone crisis. India has traditionally been a current account deficit country, with a few exceptions, has been financed fully by capital flows. The decline in the rupee value reflects pressure due to widening current account deficit coupled with moderation in capital flows. In the pre-crisis years and also before the onset of euro-zone crisis, India had capital flows in excess of current account deficit that was creating pressure on the rupee to appreciate. The volatility in the value of rupee impairs investor confidence and has implications for overall macroeconomic management, especially given the size of India’s balance of payments, which has increased substantially over the years. A sharp fall in rupee value may be explained by the supply-demand imbalance in the domestic foreign exchange market due to widening current account deficit and moderation in capital flows.

***2.1.4: Shock of Commodity Price***

The composition of India’s imports indicate substantial share of crude oil. Accordingly, substantial volatility in prices could increase the external sector imbalances through trade and current account deficit. In view of subdued global demand, the oil prices are expected to somewhat soften in 2013. However, there could be upside risks from geo-political factors and supply disruptions.

Despite weak global recovery, global commodity prices, especially energy, have remained elevated and volatile. Geo-political tensions, large liquidity being injected by major advanced economies may exert further pressure on oil prices. This could threaten growth and inflation in EMEs.

**3. A critical assessment of the vulnerability analysis and indicators**

While there is some broad directional value in terms of analyzing traditional indicators of vulnerability, there is need for caution in reading too much into such ratios. India’s CAD had indeed widened to a high level in 2011-12 and 2012-13, it is expected to moderate in 2013-14. This is testimony to the measures that have been taken to compress imports of inessential items like gold through higher tariffs and augment capital flows. The following are important in the context of assessing India’s vulnerability.

* India has now moved to a flexible exchange rate mechanism and the broad two way movements of the exchange rate of the rupee indicates that the primary correcting force to address vulnerability concerns is in place. While the recent short-term movements owe largely to external factors and perceptions as detailed above, with better clarity on the FED’s programme, the outlook for the external sector is better today. The medium term fundamentals remain strong and as such investors should focus on such factors rather than be guided by noisy short-term fluctuations.
* While the traditional forex reserve cover is falling with respect to imports or external debt, both overall as well as short-term, these are as yet more than adequate to meet any contingency. The falling cover itself owes to the market determined exchange rate policy that has been in place since 2008-09, which means that RBI ought not intervene in the forex market except by way of mitigating volatility. As such, unless the exchange rate volatility so warrants purchase by RBI, the forex cover would not go up significantly. It is nobody’s case that the RBI should go on adding to the reserves so that the traditional indicators look better.
* India has adequate forex reserves to cope with any sudden stop occurrence owing to global events. Even in the face of a major global crisis in 2008-09, which some analysts call a near-sudden stop, the reserve drawdown on BoP basis was minimal.

3.1 Short-term debt by residual maturity (or external financing needs) is seen as a key indicator of the vulnerability.

* Short term debt includes (i) Trade credit up to 180 days as well as above 180 days and up to 1 year, (ii) FII investments in Government Treasury Bills and corporate securities, (iii) investments by foreign central banks and international institutions in Treasury Bills, and (iv) external debt liabilities of central bank and commercial banks. Short term debt by residual maturity of US$ 170.0 billion at end June 2013 include short term debt by original maturity (US$ 96.8 billion) that accounts for 57 per cent of short term debt and long-term debt payable within one year.
* While short-term debt by residual maturity of US$ 172 billion at end-March 2013 looks large, being a stock figure on a particular date, it would be useful to look at the biggest component, namely, trade credit in terms of flows on a day-to-day basis. Trade credits account for US$ 86.8 billion of external debt, which represents only the repayment side of the flows. On a day-to-day basis, some trade credits accrue on a gross basis that help in the repayment of these obligations contracted earlier. On BoP basis in 2012-13, India repaid US$ 101.7 billion of trade credits from a fresh inflow of trade credits of US $ 122.7 billion, yielding a net inflow of US$ 21.7 billion. The following table gives the details of the financing of CAD by short-term trade credits after servicing the obligations contracted earlier.

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| Table : Disbursements and Principal Repayments under Short-term Trade Credit  (US$ million) | | | |
| Year | Disbursements | Principal Repayment | Net |
| **1** | **2** | **3** | **4** |
| 2008-09 | 41,765 | 43,750 | -1,985 |
| 2009-10 | 53,264 | 45,706 | 7,558 |
| 2010-11 | 76,776 | 64,742 | 12,034 |
| 2011-12 PR | 102,754 | 96,087 | 6,668 |
| 2012-13 QE | 122,734 | 101,077 | 21,657 |
| PR: Partially Revised; QE: Quick Estimates.  Source: Reserve Bank of India, Balance of Payment data. | | | |

* With the exception of 2008-09 when there was a diminution in inflows relative to outflows, there has been a net inflow under short-term trade credits on BoP basis. In 2008-09 the net outflows for the year as a whole were minimal, despite what many analysts call a near ‘sudden stop’.
* A significant part of the short-term debt by residual maturity is NRI Deposits (US$ 48 billion) which are typically rolled over and largely denominated in rupee. As such, the concern over the external financing needs is over stated by the indicator of short-term debt by residual maturity.

3.2 International comparison based on World Bank's 'International Debt Statistics 2013' indicates that India continues to be among the less vulnerable countries and India’s key debt indicators comparing well with other indebted countries. India’s key debt indicators, especially debt to gross national income ratio, debt service ratio, short-term to total external debt and the cover of external debt provided by foreign exchange reserves continue to be comfortable (**Annex 2**).

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