India Reports Record High Current Account Surplus Amid Demand Drop

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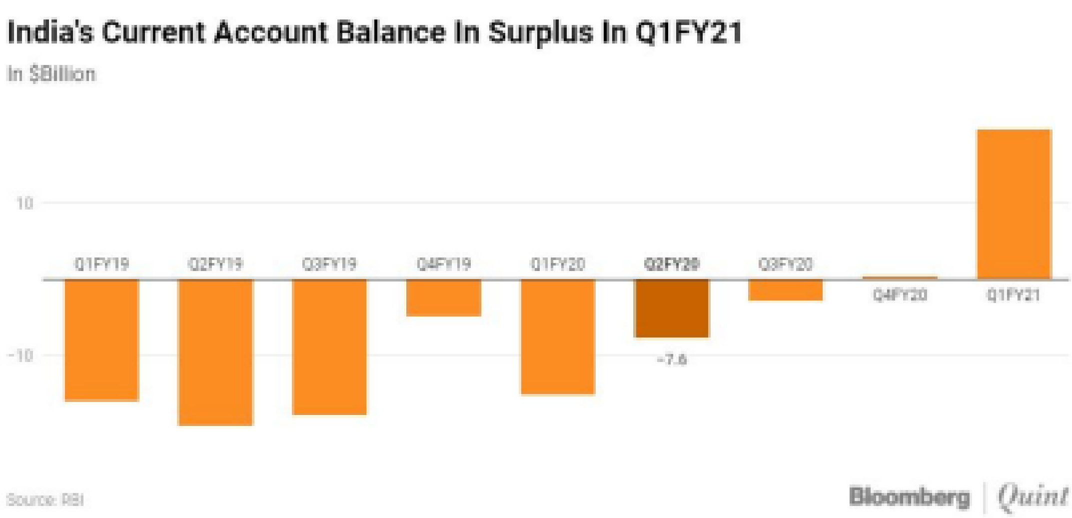
India saw a record high current account surplus — a rarity for the economy — in the April-June quarter as a precipitous drop in local demand led to sharper fall in imports compared to exports. The quarter also saw net portfolio and foreign direct investment flows slow to a trickle, while remittances from foreign workers fell.

Balance of payments data released by the RBI showed:

- India's current account balance recorded a surplus of $19.8 billion in the April- June 2020 quarter, compared to a surplus of $0.6 billion in the preceding quarter. ● As a percentage of the GDP, current account balance rose 3.9% in the April- June 2020 quarter, compared to 0.1% in the preceding quarter.
- Forex reserves saw an accretion of $19.8 billion in BoP terms during the quarter as compared to $14 billion in the previous quarter.

This is the second consecutive quarter that the economy has seen a current account surplus. It is also the highest on record.



Among key components, private transfers fell as expected:

- Private transfer receipts, mainly remittances, fell 8.7% in the April- June 2020 quarter from a year ago.
- Net FDI recorded outflow of $0.4 billion in the April- June 2020 quarter vs an inflow of $14 billion a year ago.

- Net portfolio investment was at $0.6 billion compared to $4.8 billion a year ago. ● With repayments exceeding fresh disbursal external commercial borrowings also saw a net outflow of $1.1 billion in Q1 as against an inflow of $ 6.0 billion a year ago.

> “ The current account surplus in Q1 FY21 was well above our expectations, as the fall in remittances was remarkably muted, despite the adverse economic conditions globally amid the ongoing pandemic. With the domestic and global lockdowns to fight Covid-19 exuding a differentiated impact on exports and imports, the merchandise trade deficit shrunk to just $10.0 billion in Q1 FY21, most of which was accounted for by the net oil balance.
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> **Aditi Nayar, Principal Economist, ICRA**

Neelkanth Mishra of Credit Suisse pointed out that high current account surplus was expected given the low trade deficit of just $10 billion. Capital flows, meanwhile, were near zero, a trend seen before only during the global financial crisis and the taper tantrum of 2013.

“The $17 billion quarter on quarter and $28 billion year-on-year decline in capital flows was broad-based: gross FDI was strong at $11 bn, but so was FDI repatriation, resulting in near-zero net FDI. NRI deposits kept coming (+$3 billion) but foreign loans saw $1.6 billion of outflows ($5-6 bn of inflows/quarter last year). Weak net FPI inflows were known,” Mishra wrote in a note.

Credit Suisse expects the current account surplus to shrink, but a deficit is unlikely.

Implications of Current Account Surplus

The temporary shift from a current account deficit economy to one with a current account surplus could be two-fold.

First, the surplus has allowed the Reserve Bank of India to build its stockpile of forex reserves. As of September 25, forex reserves stood at $545 billion, as the central bank has chosen to mop up foreign exchange flows from the market. In a report ahead of the data release, IDFC First Bank said they expect forex reserves to at around $570-575 billion by the end of the year. This is based on the expectation that India will report a current account surplus for the full financial year as well.

As the RBI absorbs dollars, it has continued to supply rupee liquidity to the market. This, in turn, may suggest that there is a wider pool of local savings that could support an increased borrowing programme from the government. “Given the current account surplus, there are more savings in the economy than we think. So, India may be able to absorb a higher level of borrowing that most believe,” said Sajjid Chinoy, chief India economist at JPMorgan in a recent interview with BloombergQuint.

Commentary:

The article examines India's significant current account surplus during the April-June quarter of 2020, primarily attributed to a reduction in local demand for imports. A current account surplus arises when the value of exports of goods and services, along with income and receipts from abroad (inflows), exceeds the value of imports of goods and services, and income and receipts sent abroad (outflows).

Figure 1: Impact of current account surplus on exchange rate

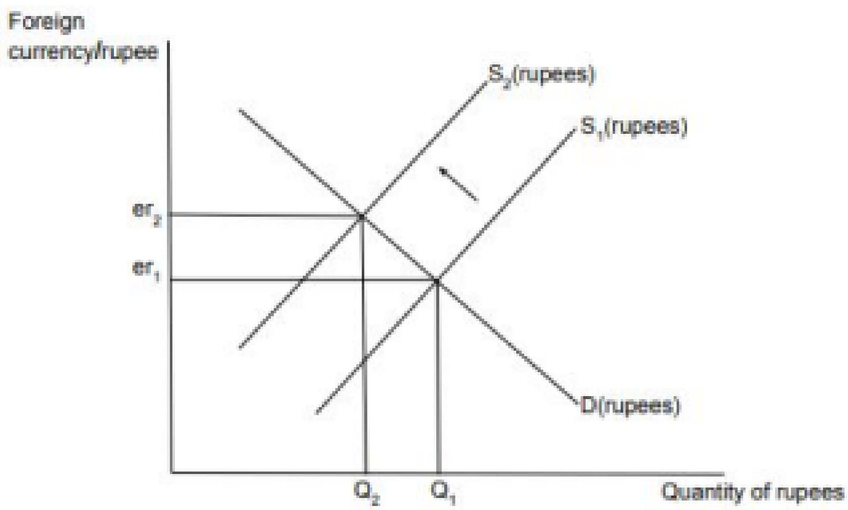

Figure 1 illustrates the impact of the current account surplus on the rupee. Due to the decreased local demand for imports, the demand for foreign currency also declined. Consequently, the supply of rupees for foreign currency exchange decreased, as depicted by the leftward shift of the supply curve (S1 → S2). This shift leads to an appreciation of the rupee, evident in the rise of the exchange rate from er1 to er2.

This appreciation can have several effects on the Indian economy. An appreciating rupee would reduce the burden of foreign debt, as it would become easier to repay. However, it would also make exports more expensive, reducing their competitiveness in international markets. As a result, exports would decline and consequently decrease the net export value (exports minus imports), ultimately lowering aggregate demand. This reduction in aggregate demand may lead to decreased output and higher unemployment.

Aside from currency appreciation, a persistent current account surplus can have other significant effects on the Indian economy. To understand these effects, it is important to understand the concept of “balance of payments”.

The balance of payments is a comprehensive record of all economic transactions between a country's residents and the rest of the world over a year. It includes payments made to and received from abroad, encompassing the financial, capital, and current accounts, and is always balanced to zero.

In order to offset the current account surplus, funds must exit through the financial account (debits). This is mentioned in the article which states that net portfolio investment, a component of the financial account, decreased to $0.6 billion from $4 billion in 2019. Additionally,India's commercial earnings saw a net outflow of $1.1 billion compared to the inflow of $6 billion the previous year.

As funds leave the financial account, domestic investment spending declines, leading to a decrease in aggregate demand. This, combined with the downward pressure on aggregate demand due to reduced export competitiveness, can result in detrimental deflation, i.e. where both output and prices fall.

Figure 2: Deflation as a consequence of current account surplus

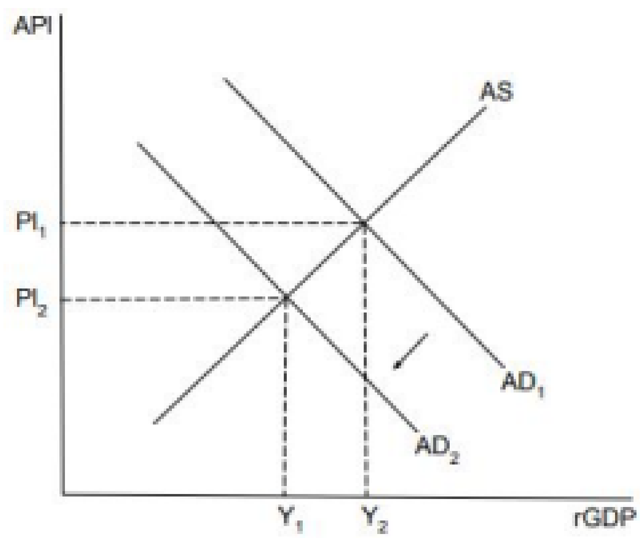

Figure 2 shows deflation which can be observed by the decrease in price level from PI_1 to PI_2 and the deflationary gap created by the leftward shift of AD ($AD_1 \rightarrow AD_2$).

The current account surplus has positively impacted the Indian economy by increasing its forex reserves, as mentioned in the article. As of September 25th, 2020, the Reserve Bank of India (RBI) held forex reserves valued at $545 billion. This surplus can have several beneficial implications for the economy.

Firstly, with ample forex reserves, India could pay off any remaining foreign debts, enhancing its financial stability and creditworthiness. Additionally, the government can leverage these reserves to implement interventionist supply-side policies, increasing investments in infrastructure, health, and education. These investments would improve the quality and quantity of labor, consequently shifting potential output upwards and encouraging long-term economic growth.

To reduce the current account surplus, the government of India can implement expenditure-switching and expenditure-increasing strategies.

It can implement the former through currency appreciation. While the rupee may appreciate automatically in a freely floating exchange rate system, the RBI can also intervene to appreciate the rupee by decreasing its supply in the foreign exchange market.

The government can implement that latter through expansionary fiscal measures. For instance, reducing personal income taxes would leave consumers with more disposable income, increasing the demand for imports. As imports rise, the outflow of money from the economy will increase, thereby reducing the current account surplus.

Alternatively, the RBI could adopt an expansionary monetary policy. By increasing the money supply and consequently lowering interest rates, consumer spending would rise, boosting demand for imports. While this approach may reduce the current account surplus, it would also increase the supply of the rupee, leading to its depreciation.

Therefore, upon comparing the effectiveness of each policy, the optimal solution would be a combination of expenditure-switching policies, such as currency appreciation, and an expansionary monetary policy. In a freely-floating exchange rate system, the rupee would naturally appreciate, so the government can focus on implementing an expansionary monetary policy to regulate this process. By increasing money supply, the government would increase consumer spending, increasing demand for imports. This rise in imports would increase the outflow of money from the economy, effectively reducing the current account surplus.