India Reports Record High Current Account Surplus Amid Demand Drop

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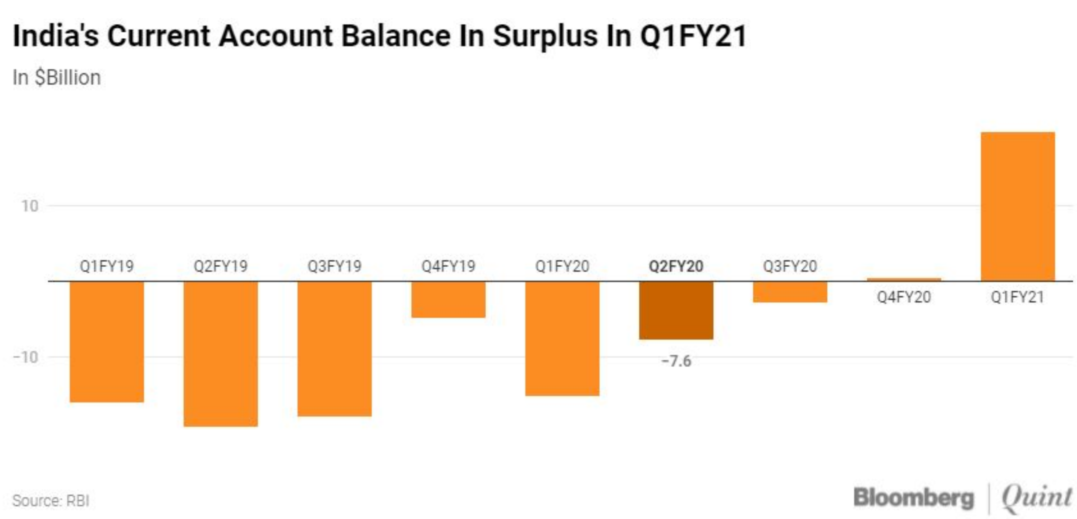
India saw a record high current account surplus — a rarity for the economy — in the April-June quarter as a precipitous drop in local demand led to sharper fall in imports compared to exports. The quarter also saw net portfolio and foreign direct investment flows slow to a trickle, while remittances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

Word Count: 750

The article discusses the high current account surplus observed in India(and its causes) during the April-June quarter of 2020, due to a decrease in local demand for imports. A current account surplus occurs when the exports of goods and services, income and receipts from abroad(inflows) are greater in value than imports of goods and services, and income and receipts sent abroad(outflows).

Figure 1: Impact of current account surplus on exchange rate

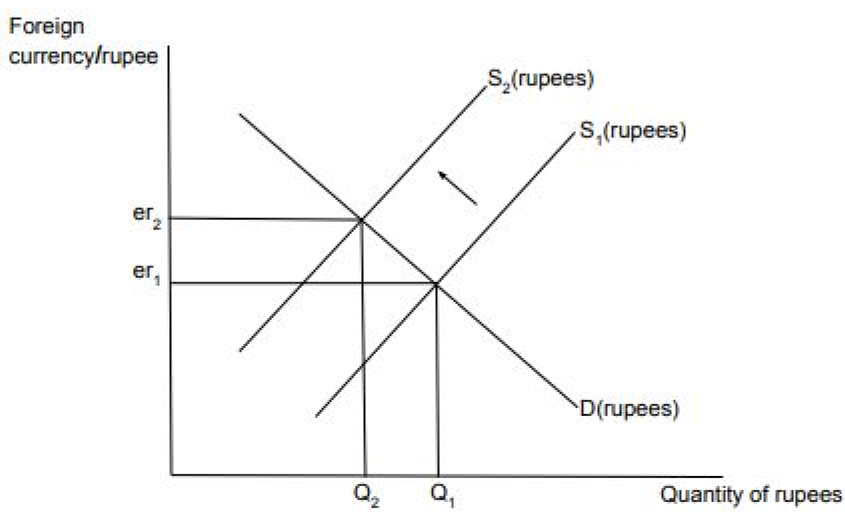


Figure 1 shows the impact of the current account surplus on the rupee. Since the local demand for imports decreased, it can be said that demand for foreign currency decreased. Consequently, the supply of rupees (to exchange for foreign currency) decreased as well, as shown through the leftward shift of the supply curve($S_1 \rightarrow S_2$). This would lead to an appreciation of the rupee which can be seen in the increase in exchange rate from er_1 to er_2. This appreciation can have multiple effects on the Indian economy. An appreciation would reduce India's foreign debt (as it is now easier to pay). It would also make exports more expensive resulting in reduced export competitiveness. As exports decrease, the value of exports minus imports would also decrease, consequently decreasing aggregate demand. This would decrease output and result in unemployment.

Aside from appreciation, the persistent current account surplus can have other effects on the Indian economy as well. Balance of payments can be defined as a record of all transactions between residents of a country with residents of other countries, consisting of all payments from abroad and all payments to abroad over a year. It consists of the financial, capital, and current account and its value is always equal to zero. In order to balance the current account surplus, funds would have to leave India through the financial account(debits). This can be seen in the article when it states that the net portfolio investment(component of financial account) decreased to $0.6 billion from $4 billion in 2019, and India's commercial earnings saw a net outflow of $1.1 billion compared to the inflow of $6 billion a year ago. Since funds are leaving the financial account, this would result in lower domestic investment spending, decreasing aggregate demand. Combined with the downward pressure on AD due to export competitiveness, this could lead to bad deflation, where both output and prices decrease.

<u>Figure 2: Deflation as a consequence of current account surplus</u>

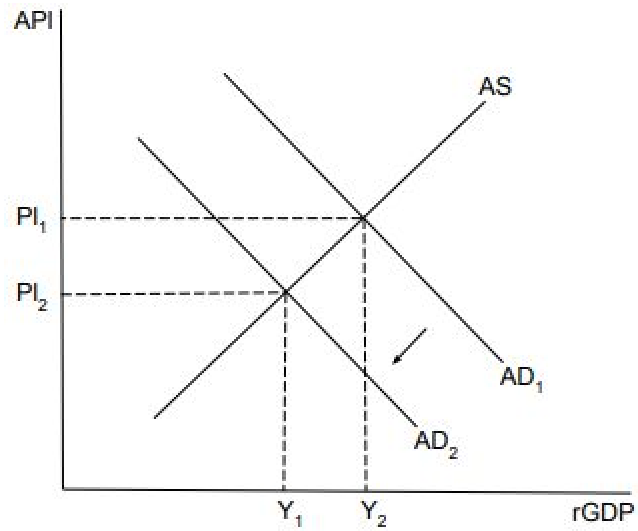


Figure 2 shows deflation which can be seen by the decrease in price level from PI_1 to PI_2 and the deflationary gap created by the leftward shift of AD($AD_1 \rightarrow AD_2$).

An effect that the current account surplus has had on the Indian economy is the increase in forex reserves(mentioned in the article). As of September 25th, 2020 the Central Bank of India(RBI) held forex reserves valued at $545 billion. This implication can have numerous positive impacts on the economy. Due to the surplus, India would be able to pay off any remaining foreign debts. In addition, the government would be able to implement interventionist supply-side policies by increasing investments in infrastructure, health and education. In doing so, it would improve the quality and quantity of labor, consequently shifting potential output and encouraging economic growth.

In order to reduce the current account surplus, the government of India can implement expenditure-switching policies such as appreciation. While the rupee may appreciate automatically in a freely floating exchange rate system(as shown above), the RBI could intervene to appreciate the rupee by decreasing the supply of the rupee in the foreign exchange market. The government could also implement expenditure-increasing policies such as an expansionary fiscal policy. The government could cut down personal income taxes, consequently leaving consumers with a greater amount of disposable income. As a result, the demand for imports will increase. As the number of imports increase, the outflow of money from the economy will increase, reducing the current account surplus. Through an alternative route, the RBI could implement an expansionary monetary policy. By increasing money supply, and consequently decreasing interest rates, the RBI would be able to increase consumer spending and therefore increase demand for imports. However, while this may reduce the current account surplus, increasing the supply of the rupee would lead to depreciation of the rupee.

Therefore, upon comparing the effectiveness of each policy, the best solution to the problem would be a combination of expenditure-switching policies(appreciation) and an expansionary fiscal policy. However, since the rupee will automatically appreciate in a freely-floating exchange rate system, the government could implement the expansionary fiscal policy as a supporting policy. Through this, the government would increase disposable income, consequently increasing demand for imports and reducing the current account surplus.