Chapter 6

Balance of Payments

The India's balance-of-payments (BoP) position improved dramatically in 2013-14, particularly in the last three quarters. This owed in large part to measures taken by the government and the Reserve Bank of India (RBI) and in some part to the overall macroeconomic slowdown that fed into the external sector. Current account deficit (CAD) declined sharply from a record high of US$ 88.2 billion (4.7 per cent of gross domestic product [GDP]) in 2012-13 to US$ 32.4 billion (1.7 per cent of GDP) in 2013-14. After staying at perilously unsustainable levels of well over 4.0 per cent of GDP in 2011-12 and 2012-13, the improvement in BoP position is a welcome relief, and there is need to sustain the position going forward. This is because even as CAD came down, net capital flows moderated sharply from US$ 92.0 billion in 2012-13 to US$ 47.9 billion in 2013-14, that too after a special swap window of the RBI under the non-resident Indian (NRI) scheme/overseas borrowings of banks alone yielded US$ 34.0 billion. This led to some increase in the level of external debt, but it has remained at manageable levels. The large depreciation of the rupee during the course of the year, notwithstanding sizeable accretion to reserves in 2013-14, could partly be attributed to frictional forces and partly to the role of expectations in the forex market. The rupee has stabilized recently, reflecting an overall sense of confidence in the forex market as in other financial markets of a change for better economic prospects. There is a need to nurture and build upon this optimism through creation of an enabling environment for investment inflows so as to sustain the external position in an as yet uncertain global milieu.

Global economic environment

6.2 Global economic recovery appears to have strengthened in recent months and is expected to further improve. The recent uptick in global growth is mainly concentrated in advanced economies and some emerging market and developing economies. The easier financial market conditions and gradually improving consumer and business confidence have supported growth. Stronger external demand from advanced economies would help lift growth in emerging market economies (EME).

6.3 The International Monetary Fund's (IMF) *World Economic Outlook* (WEO) (April 2014) projects growth in the global economy to strengthen from 3.0 per cent in 2013 to 3.6 per cent in 2014 and further to 3.9 per cent in 2015. Advanced economies are expected to improve their growth significantly to 2.2 per cent in 2014, while emerging and developing economies are projected to grow at 4.9 per cent in 2014, which is marginally better than the outcome in 2013 (Table 6.1). In line with the expanding economic activity, world

Table 6.1 : Overview of the World Economic Outlook Projections

Percentage change year-over-year

			Projections	
	2012	2013	2014	2015
World output*	3.2	3.0	3.6	3.9
Advanced economies	1.4	1.3	2.2	2.3
United States	2.8	1.9	2.8	3.0
Euro Area@	-0.7	-0.5	1.2	1.5
Japan	1.4	1.5	1.4	1.0
United Kingdom	0.3	1.8	2.9	2.5
Emerging and developing economies	5.0	4.7	4.9	5.3
China	7.7	7.7	7.5	7.3
India#	4.7	4.4	5.4	6.4
World trade volume (goods and services)	2.8	3.0	4.3	5.3

Source : IMF, *World Economic Outlook*, April 2014.

Notes : * The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.

@ Excludes Latvia.

For India, data and forecasts are presented on a fiscal year basis and output growth is based on GDP at market prices. Corresponding growth forecasts for GDP at factor cost are 4.6, 5.4, and 6.4 percent for 2013, 2014, and 2015, respectively.

trade is also projected to gradually recover, albeit at a slower than pre-global financial crisis pace.

6.4 EMEs are adjusting to a more difficult external financial environment in which international investors are more sensitive to policy weakness and vulnerabilities given prospects for better growth and monetary policy normalization in some advanced economies. Growth in EMEs is expected to pick up modestly. Notwithstanding the boost from stronger external demand, prospects for some EMEs are somewhat uncertain, with continuance of domestic weakness. Financial market contagion is a clear risk. Volatile capital flows and higher interest rates remain key concerns and a persistent tightening of financial conditions could undercut investment and growth in some countries given the corporate vulnerabilities. According to the IMF (WEO, April 2014), global recovery is still fragile, despite improved prospects, and significant downside risks remain. These include geopolitical risks, risk of contagion, and renewed bouts of high risk aversion on the part of investors which could result in further financial turmoil. In the stressed euro area, growth is projected to remain weak and fragile as high debt and financial fragmentation hold back domestic demand.

6.5 The financial situation in developed countries is posing challenges in many EMEs. Bond markets are now more sensitive to changes in accommodative monetary policies in advanced economies because foreign investors have crowded into local markets and can withdraw at the slightest hint of adverse circumstances. Emerging market fundamentals have weakened after a protracted interval of credit expansion and rising corporate leverage. Managing the risks of transition to a more balanced and sustainable financial sector, while maintaining robust growth and financial stability, will be a key challenge confronting policymakers.

6.6 The Indian economy witnessed substantial improvement on the external sector front, which has become more resilient in

recent months. India's BoP situation witnessed a turnaround during 2013-14 as merchandise exports increased modestly amidst strong global recovery and a depreciating rupee, while imports declined primarily due to a sharp fall in gold imports owing to a series of measures taken by the government and RBI to limit gold imports and a significant fall in international gold prices. With a lower CAD and build-up of foreign exchange reserves, the downward pressure on the currency and the volatility in the Indian rupee began to subside.

6.7 India is getting increasingly integrated with the global economy as is evident from the size of its two-way external-sector transactions which reached about 113 per cent of the country's GDP in 2013-14. The volatilities in global financial markets could be transmitted through various channels such as trade, finance, and confidence. Thus any adverse/unexpected developments in advanced economies could strain the BoP.

BoP DEVELOPMENTS

Overview of India's BoP

6.8 A sharp improvement was seen in the outcome during 2013-14 with the CAD being contained at US$ 32.4 billion as against US$ 88.2 billion and US$ 78.2 billion respectively in 2012-13 and 2011-12. The stress in India's BoP, which was observed during 2011-12 as a fallout of the euro zone crisis and inelastic domestic demand for certain key imports, continued through 2012-13 and the first quarter of 2013-14. Capital flows (net) to India, however, remained high and were sufficient to finance the elevated CAD in 2012-13, leading to a small accretion to reserves of US$ 3.8 billion. A large part of the widening in the levels of the CAD in 2012-13 could be attributed to a rise in trade deficit arising from a weaker level of exports and a relatively stable level of imports. The rise in imports owed to India's dependence on crude petroleum oil imports and elevated levels of gold imports since the onset of the global financial crisis. The levels of non-petroleum oil lubricant (POL) and non-gold and silver imports declined in 2012-13 and 2013-14.

6.9 Capital flows (net) moderated sharply from US$ 65.3 billion in 2011-12 and US$ 92.0 billion in 2012-13 to US$ 47.9 billion in 2013-14 (Table 6.2). This moderation in levels essentially reflects a sharp slowdown in portfolio investment and net outflow in 'short-term credit' and 'other capital'. However, there were large variations within quarters in the last fiscal, which is explained partly by domestic and partly by external factors. In the latter half of May 2013, the communication by US Fed about rolling back its programme of asset purchases was construed by markets as a sign of imminent action and funds began to be withdrawn from debt markets worldwide, leading to a sharp depreciation in the currencies of EMEs. Those countries with large CADs saw larger volumes of outflows and their currencies depreciated sharply. As India had a large trade deficit in the first quarter, these negative market perceptions led to sharper outflows in the foreign institutional investors (FIIs) investment debt segment leading to 13.0 per cent depreciation of the rupee between May 2013 and August 2013.

Table 6.2: BoP (US$ million)

Sl. No.	Item	2009-10	2010-11	2011-12PR	2012-13PR	2013-14P
I	Current account					
1	Exports	182442	256159	309774	306581	318607
2	Imports	300644	383481	499533	502237	466216
3	Trade balance	-118202	-127322	-189759	-195656	-147609
4	Invisibles (Net)	80022	79269	111604	107493	115212
	A. Services	36016	44081	64098	64915	72965
	B. Transfer	52045	53140	63494	64034	65276
	C. Income	-8038	-17952	-15988	-21455	-23028
	Current account balance	-38180	-48053	-78155	-88163	-32397
II	Capital account					
i.	External assistance	2890	4941	2296	982	1032
ii.	External commercial borrowings	2000	12160	10344	8485	11777
iii.	Short-term debt	7558	12034	6668	21657	-5044
iv.	Banking capital of which	2083	4962	16226	16570	25449
	Non-resident deposits	2922	3238	11918	14842	38892
v.	Foreign investment	50362	42127	39231	46711	26386
	A. FDI	17966	11834	22061	19819	21564
	B. Portfolio investment	32396	30293	17170	26891	4822
vi.	Other flows	-13259	-12484	-7008	-5105	-10813
	Capital account balance	51634	63740	67755	89300	48787
	Capital account (including errors & omissions)	51622	61104	65323	91989	47905
III	Errors & omissions	-12	-2636	-2432	2689	-882
IV	Overall balance	13441	13050	-12831	3826	15508
V	Reserves change (-indicates increase, +indicates decrease)	-13441	-13050	12831	-3826	-15508

Source : Reserve Bank of India (RBI).
Notes : PR: partially revised; P: preliminary.

6.10 The government swiftly moved to correct the situation through restrictions in non-essential imports like gold, customs duty hike in gold and silver to a peak of 10 per cent, and measures to augment capital flows through quasi-sovereign bonds and liberalization of external commercial borrowings. The RBI also put in place a special swap window for foreign currency non-resident deposit (banks) [(FCNR (B)] and banks' overseas borrowings through which US$ 34 billion was mobilized. Thus, excluding one-off receipts, moderation in net capital inflows was that much greater in 2013-14. The one-off flows arrested the negative market sentiments on the rupee and in tandem with improvements in the BoP position, led to a sharp correction in the exchange rate and a net accretion to reserves of US$ 15.5 billion for 2013-14.

Current account developments in 2012-13

6.11 After registering strong growth in both imports and exports in 2011-12, merchandise trade (on BoP basis) evidenced a slowdown in 2012-13 consisting of a decline in the levels of exports from US$ 309.8 billion in 2011-12 to US$ 306.6 billion and a modest rise in the level of imports to reach US$ 502.2 billion. This resulted in a rise in trade deficit from US$ 189.8 billion in 2011-12 to US$ 195.7 billion in 2012-13. The decline in exports owed largely to weak global demand arising from the slowdown in advanced

economies following the euro zone crisis, which could only be partly compensated by diversification of trade. Non-PoL imports declined only marginally whereas PoL imports held up resulting in relatively stronger imports. Net imports of PoL shot up to US$ 99.0 billion in 2011-12 initially on account of a spurt in crude oil prices (Indian basket) and remained elevated at US$ 103.1 billion and US$ 102.4 billion in the next two years. Similarly, gold and silver imports rose to a peak of US$ 61.6 billion in 2011-12 and moderated only somewhat in 2012-13. Hence the wider and record high trade deficit in 2012-13.

6.12 With relatively static levels of net inflow under services and transfers, which are the two major components (at about US$ 64 billion each), it was the net outflow in income (mainly investment income), which explained the diminution in level of overall net invisibles balance. Net invisibles surplus was placed at US$ 107.5 billion in 2012-13 as against US$ 111.6 billion in 2011-12. Software services continue to dominate the non-factor services account and in 2012-13 grew by 4.2 per cent on net basis to yield US$ 63.5 billion with other services broadly exhibiting no major shifts. In 2012-13, private transfers remained broadly at about the same level as in 2011-12. Investment income which comprises repatriation of profits/interest, etc., booked as outgo as per standard accounting practice, has been growing at a fast clip reflecting the large accumulation of external financing of the CAD since 2011-12. Investment income (net) outgo constituted 25.4 per cent of the CAD in 2012-13.

6.13 With trade deficit continuing to be elevated and widening somewhat and net invisibles balance going down, the CAD widened from US$ 78.2 billion in 2011-12 to US$ 88.2 billion in 2012-13. As a proportion of GDP, the CAD widened from 4.2 per cent in 2011-12 to a historic peak of 4.7 per cent in 2012-13. This rise also owes to the fact that nominal GDP expressed in US dollar terms remained at broadly the same level of US$ 1.8 trillion in both the years due to depreciation in the exchange rate of the rupee.

Current account developments in 2013-14

6.14 In terms of the major indicators, the broad trend witnessed since 2011-12 continued through to the first quarter of 2013-14. With imports continuing to be at around US$ 120-130 billion per quarter for nine quarters in a row and exports (except the last quarter of the two financial years) below US$ 80 billion for most quarters, trade deficit remained elevated at around US$ 45 billion or higher per quarter for nine quarters till April-June 2013. The widening of the trade deficit in the first quarter mainly owed to larger imports of gold and silver in the first two months of 2013-14. In tandem with developments in the globe of a market perception of imminence of tapering of asset purchases by the US Fed, the widening of the trade deficit led to a sharp bout of depreciation in the rupee. This essentially reflected concerns about the sustainability of the CAD in India. The government and RBI took a series of coordinated measures to promote exports, curb imports particularly those of gold and non-essential goods, and enhance capital flows. Consequently, there has been significant

improvement on the external front. (The Mid-Year Economic Analysis 2013-14 of the Ministry of Finance contains a detailed analysis of sustainability concerns and measures taken.)

6.15 The measures taken led to a dramatic turnaround in the BoP position in the latter three quarters and for the full fiscal 2013-14. There was significant pick-up in exports to about US$ 80 billion per quarter and moderation in imports to US$ 114 billion per quarter in the latter three quarters. This led to significant contraction in the trade deficit to US$ 30-33 billion per quarter in these three quarters. Overall this resulted in an export performance of US$ 318.6 billion in 2013-14 as against US$ 306.6 billion in 2012-13; a reduction in imports to US$ 466.2 billion from US$ 502.2 billion in 2012-13; and a reduction in trade deficit to US$ 147.6 billion, which was lower by US$ 48 billion from the 2012-13 level. As a proportion of GDP, trade deficit on BoP basis was 7.9 per cent of GDP in 2013-14 as against 10.5 per cent in 2012-13.

6.16 A decomposition of the performance of trade deficit in 2013-14 vis-à-vis 2012-13 indicates that of the total reduction of US$ 48.0 billion in trade deficit on BoP basis, reduction in imports of gold and silver contributed approximately 47 per cent, reduction in non-PoL and non-gold imports constituted 40 per cent, and change in exports constituted 25 per cent. Higher imports under PoL and non-DGCI&S (Directorate General of Commercial Intelligence and Statistics) imports contributed negatively to the process of reduction to the extent of 12 per cent in 2013-14 over 2012-13.

6.17 Net invisibles surplus remained stable at US$ 28-29 billion per quarter resulting in overall net surplus of US$ 115.2 for 2013-14. Software services improved modestly from US$ 63.5 billion in 2012-13 to US$ 67.0 billion in 2013-14. Non-factor services however went up from US$ 64.9 billion in 2012-13 to US$ 73.0 billion partly on account of business services turning positive in all quarters with net inflows of US$ 1.3 billion in 2013-14 as against an outflow of US$ 1.9 billion in 2012-13. Business services have earlier been positive in 2007-08 and 2008-09. Private transfers improved marginally to US$ 65.5 billion in 2013-14 from US$ 64.3 billion in 2012-13. However, investment income outgo was placed at US$ 23.5 billion in 2013-14 as against US$ 22.4 billion in 2012-13. There has been an elevation in the levels of gross outflow in recent quarters reflecting the large levels of net international investment position (IIP), which is an outcome of elevated levels of net financing requirements in 2011-12 and 2012-13.

6.18 As an outcome of the foregoing development in the trade and invisibles accounts of the BoP, the CAD moderated sharply in 2013-14 and was placed at US$ 32.4 billion as against US$ 88.2 billion in 2012-13. In terms of quarterly outcome, the CAD was US$ 21.8 billion in April-June 2013 and moderated to around US$ 5.2 billion in July-September 2013, US$ 4.1 billion in October-December 2013, and further to US$ 1.3 billion in January-March 2014. As a proportion of GDP, the CAD was 1.7 per cent in 2013-14, which when adjusted for exchange rate depreciation compares favourably with the levels achieved in the pre-2008 crisis years.

Capital/Finance Account in 2012-13

6.19 In terms of macroeconomic identity, the resource expenditure imbalance in one sector needs to be financed through recourse to borrowing from other sectors and the persistence of high CAD requires adequate net capital/financial flows into India. Any imbalance in demand and supply of foreign exchange, even if frictional or cyclical, would lead to a change in the exchange rate of the rupee. For analytical purposes, it would be useful to classify these flows in a 2X2 scheme in terms of short-term and long-term, and debt and non-debt flows. This scheme of classification can be analysed in terms of the nature of flows as stable or volatile.

6.20 In the hierarchy of preference for financing stable investment flows like foreign direct investment (FDI) and stable debt flows like external assistance, external commercial borrowings (ECBs), and NRI deposits which entail rupee expenditure that is locally withdrawn rank high. The most volatile flow is the FII variety of investment, followed by short-term debt and FCNR deposits. While FII on a net yearly basis has remained more or less positive since the 2008 crisis, it has large cyclical swings and entails large volumes in terms of gross flows to deliver one unit of net inflow. Given this, it can be seen that post-1990 and prior to the global financial crisis, broadly the CAD remained at moderate levels and was easily financed. In fact the focus of the RBI immediately prior to the crisis was on managing the exchange rate and mopping up excess capital flows. Post-2008 crisis, the CAD has remained elevated at many times the pre-2008 levels.

6.21 In 2012-13, net capital inflows were placed at US$ 92.0 billion and were led by FII inflows (net) of US$ 27.6 billion and short-term debt (net) of US$ 21.7 billion. There were, besides, large overseas borrowings by banks together indicating the dependence on volatile sources of financing. On a yearly basis, FII (net) flows remained at high levels post-2008 crisis on account of the fact that foreign investors had put faith in the returns from emerging economies, which exhibited resilience to the global crisis in 2009. There was some diminution in net inflows in 2011-12 on account of the euro zone crisis. On an intra-year basis, there was significant change in FII flows due to perceptions of changing risks which had a knock-on effect on the exchange rate of the rupee given the large financing need.

6.22 While the declining trend in net flows under ECB since 2010-11 continued in 2012-13, growing dependence on trade credit for imports was reflected in a sharp rise in net trade credit availed to US$ 21.7 billion in 2012-13 from US$ 6.7 billion in 2011-12. In net terms, capital inflows increased significantly by 40.9 per cent to US$ 92.0 billion (4.9 per cent of GDP) in 2012-13 as compared to US$ 65.3 billion (3.5 per cent of GDP) during 2011-12. Capital inflows were adequate for financing the higher CAD and there was net accretion to foreign exchange reserves to the extent of US$ 3.8 billion in 2012-13. However, intra-year in the first three quarters, though there were higher flows quarter-on-quarter, the

levels of net capital flows fell short or were barely adequate for financing the CAD but in the fourth quarter while the levels of net capital flows plummeted, the CAD moderated relatively more sharply leading to a reserve accretion of US$ 2.7 billion.

Capital/Finance account in 2013-14

6.23 Outcomes in 2013-14 were a mixed bag. The higher CAD in the first quarter of 2013-14 was financed to a large extent by capital flows; but the moderation observed in the fourth quarter of 2012-13 continued through 2013-14. The communication by the US Fed in May 2013 about its intent to roll back its assets purchases and market reaction thereto led to a sizeable capital outflow from forex markets around the world. This was more pronounced in the debt segment of FII. In the event, even though there was a drastic fall in the CAD in July-September 2013, net capital inflows became negative leading to a large reserve drawdown of US$ 10.4 billion in that quarter. FDI net inflows continued to be buoyant with steady inflows into India backed by low outgo of outward FDI in the first two quarters. In the third quarter, while there was turnaround in the flows of FIIs and copious inflows under NRI deposits in response to the special swap facility of the RBI and banks' overseas borrowing programme, there was some diminution in the levels of other flows. This led to a reserve accretion of US$ 19.1 billion in the third quarter notwithstanding that the copious proceeds of the special swap windows of the RBI directly flowed to forex reserves of the RBI. In the fourth quarter, while FDI inflow slowed, higher outflow on account of overseas FDI together with outflow of short-term credit moderated the net capital inflows into India.

6.24 Thus for the year as a whole, net capital inflow was placed at US$ 47.9 billion as against US$ 92.0 billion in the previous year. While net FDI was placed at US$ 21.6 billion, portfolio investment (mainly FII) at US$ 4.8 billion, ECBs at US$ 11.8 billion, and NRI deposits at US$ 38.9 billion, there were significant outflows on account of short-term credit at US$ 5.0 billion, banking capital assets at US$ 6.6 billion, and other capital at US$ 10.8 billion. The net capital inflows in tandem with the level of CAD led to a reserve accretion of US$ 15.5 billion on BoP basis in 2013-14. The accretion to reserves on BoP basis helped in increasing the level of foreign exchange reserves above the US$ 300 billion mark at end March 2014.

Foreign Exchange Reserves

6.25 Change in foreign exchange reserves can be decomposed into change in reserves on BoP basis and valuation changes in the assets held by the RBI, which are denominated in US dollars. As against a reserve accretion of US$ 15.5 billion on BoP basis as at end March 2014, foreign exchange reserves in nominal terms increased by only US$ 12.2 billion as there was a valuation loss in the non-US dollar assets held owing to cross-currency movements and the decline in gold prices. As at end May 2014, foreign exchange reserves stood at US$ 312.2 billion (Table 6.3).

Table 6.3 : Summary of Changes in Foreign Exchange Reserves (US$ billion)

Sl No.	Year (at end March)	Foreign exchange reserves	Total increase(+)/ decrease(-) in reserves over previous year	Increase(+)/ decrease(-) in reserves on BoP basis	Increase(+)/ decrease (-) in reserves due to valuation effect
1	2008-09	252.0	(-)57.7	(-)20.1	(-)37.6
2	2009-10	279.1	(+)27.1	(+)13.4	(+)13.7
3	2010-11	304.8	(+)25.7	(+)13.1	(+)12.6
4	2011-12	294.4	(-)10.4	(-)12.8	(+)2.4
5	2012-13	292.0	(-)2.4	(+)3.8	(-)6.2
6	2013-14	304.2	(+)12.2	(+)15.5	(-)3.3

Source : RBI.

6.26 Foreign exchange reserves were placed at US$ 304.2 billion at end March 2014 as against a level of US$ 292.0 billion at end March 2013. Foreign currency assets are the main component of foreign exchange reserves and were US$ 276.4 billion at end March 2014. A second major component of the reserves was gold valued at US$ 21.6 billion at end March 2014, lower than at end March 2013. Special drawing rights (SDRs) and the reserve tranche position in the IMF were at US$ 4.5 billion and US$ 1.8 billion respectively at end March 2014.

6.27 India continues to be one of the countries that have sizeable foreign exchange reserves particularly considering that some of the other major reserve holders are nations with large current account surpluses (Table 6.4). Intervention in the foreign exchange markets by the RBI so as to manage the exchange rate of the rupee and guard against volatility without targeting a specific rate is behind the accumulation of reserves generally; in the specific context of developments in 2013-14, the intervention was to provide a measure of comfort against the elevated levels of vulnerability indicators which are expressed as proportions of reserves.

Table 6.4 : Foreign Exchange Reserves of Some Major Countries

Sl No.	Country	Foreign exchange reserves at end March 2014 (US$ billion)
1	China	3950.0#
2	Japan	1325.1
3	Switzerland	546.6
4	Russia	486.2
5	Brazil	363.9
6	Republic of Korea	354.4
7	China P R Hong Kong	331.6
8	India	304.2
9	Germany	207.8
10	France	173.4
11	Thailand (December 2013)	171.1
12	Italy	154.3

Source : IMF Except China and India.
Note : # www.pbc.gov.cn, Trading Economics.

Exchange Rate

6.28 The vulnerability of the rupee as well as the currencies of other emerging market and developing economies came to the fore in May 2013 as a result of the announcement by US Fed about tapering of its asset purchases. While capital flows on a net basis continued to be broadly adequate at that time, the rupee depreciated sharply on the vulnerability concerns affecting expectations on the rupee emanating from the confluence of factors of elevated CAD and large withdrawal from the FII debt segment. However, the rupee became resilient when the US Fed taper actually happened subsequently.

6.29 In 2013-14, the rupee started to depreciate on a month-on-month basis starting May 2013. This process of depreciation was more pronounced in June 2013 and August 2013 when there were large depreciation in excess of 5 per cent on a month-on-month basis. The average exchange rate of the rupee reached a peak in September 2013 at ₹ 63.75 per US dollar. Thereafter, on the strength of the measures taken by the government to reduce the CAD and the RBI and government to boost capital flows, the rupee rebounded to reach an average level of ₹ 61.62 per US dollar in the month of October 2013. The rupee has subsequently been range bound and stable in 2013-14 (Table 6.5).

Table 6.5 : Exchange Rate of Rupee per Foreign Currency and RBI's Sale/ Purchase of US Dollar

Year/month	Average exchange rates[a]				RBI net sale(-)/ purchase(+) (US$ million)
	US dollar	Pound sterling	Euro	Japanese yen*	
2012-13	54.41	85.98	70.07	65.85	-2601
(annual average)	(-11.9)	(-11.2)	(-6.0)	(-7.8)	
2013-14	60.50	96.30	81.17	60.40	8992
(annual average)	(-10.1)	(-10.7)	(-13.7)	(9.0)	
2013-14 (monthly average)					
April 2013	54.38	83.20	70.77	55.71	518
	(0.04)	(-1.4)	(-0.2)	(3.1)	
May 2013	55.01	84.11	71.38	54.51	-107
	(-1.1)	(-1.1)	(-0.9)	(2.2)	
June 2013	58.40	90.47	77.07	59.99	-2252
	(-5.8)	(-7.0)	(-7.4)	(-9.1)	
July 2013	59.78	90.78	78.20	60.00	-5976
	(-2.3)	(-0.3)	(-1.4)	(-0.02)	
August 2013	63.21	97.87	84.18	64.57	-2464
	(-5.4)	(-7.2)	(-7.1)	(-7.1)	
September 2013	63.75	101.10	85.12	64.27	-3548
	(-0.8)	(-3.2)	(-1.1)	(0.5)	
October 2013	61.62	99.20	84.10	63.00	3928
	(3.5)	(1.9)	(1.2)	(2.0)	
November 2013	62.63	100.88	84.53	62.63	10087
	(-1.6)	(-1.7)	(-0.5)	(0.6)	
December 2013	61.91	101.40	84.82	59.83	3483
	(1.2)	(-0.5)	(-0.3)	(4.7)	
January 2014	62.07	102.27	84.56	59.68	-1929
	(-0.3)	(-0.9)	(0.3)	(0.3)	
February 2014	62.25	102.97	84.97	61.02	-530
	(-0.3)	(-0.7)	(-0.5)	(-2.2)	
March 2014	61.01	101.41	84.36	59.65	7782
	(2.0)	(1.5)	(0.7)	(2.3)	

Source : RBI.

[a] FEDAI market indicative rates. Data from May 2012 onwards is the RBI's reference rates.

* Per 100 Yen.

Note : Figures in parentheses indicate appreciation (+) and depreciation (-) over the previous year/month in per cent.

6.30 The annual average exchange rate of the rupee went up from ₹ 45.56 per US dollar in 2010-11 to ₹ 47.92 per US dollar in 2011-12 and further to ₹ 54.41 per US dollar in 2012-13. It rose to reach an average of ₹ 60.50 per US dollar in 2013-14. The intra-year levels of depreciation have been sharper in some months; but exhibit two-way movements within the broad rising trend. While the depreciation could in part be explained by the levels of CAD and its financing by net capital flows, the movement in monthly average exchange rates in the latter half of 2013-14 also reflects the levels of intervention by the RBI to shore up its reserves, which had been rundown in the initial parts of the year. The exchange rate in 2014-15 reflects the same pattern as in the latter half of 2013-14 with a surge in FII flows impacting the foreign exchange and equity markets favourably; but the rupee appreciation has been limited relative to the rise in equity indices. The levels of the rupee exchange rate ought to reflect the fundamentals of the BoP as per the tenets of 'equilibrium exchange rate' and in this regard, real exchange rates are indicators that need to be looked at.

6.31 The real effective exchange rate (REER) is a measure of real exchange rate and is defined as a weighted average (geometric mean) of nominal exchange rates adjusted for relative price differential between India and its major trade partners. The REER

is an indicator of the competitiveness of the country. Earlier, as there was no single composite consumer price index (CPI) in the country, the RBI used the wholesale price index (WPI) as the measure in the price ratio to publish the REER. With the CPI new series of the Central Statistics Office (CSO) being made available, the RBI has used it to compute the REER indices of the Indian rupee.

6.32 The rupee is considered to be fairly valued if the REER is close to 100 or the base-year value. Other things remaining same, higher domestic inflation vis-à-vis its trade partners will reflect in appreciation of the REER and hence there is a view that the nominal exchange rate should depreciate to keep it at base-year levels. As evident from movements in the REER (base 2004-05 = 100) based on the CPI, there is overvaluation of the rupee even though there is a broad depreciating trend in the first half of the year (Table 6.6). The levels of overvaluation are much higher in terms of six-currency export-based weights. However, in terms of the REER with base year 2012-13, there is depreciation and consequently the rupee is undervalued. Therefore, the choice of base year and currencies used in the basket is important in the context of analysis of the REER. A recent article in *Business Standard* (OP-Ed dated 23.6.2014) by Martin Kessler and Arvind Subramanian applying the purchasing power parity (PPP) approach and using the latest PPP estimates of the World Bank finds that the rupee is persistently undervalued in excess of 30 per cent of its equilibrium value. As the net capital flows that were incentivized to shore up the exchange rate of the rupee were of the debt variety, this had implications for the level of external debt.

Table 6.6 : Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) Indices of the Indian Rupee (6-Currency Trade-based Weights)

Base 2004-05 (April-March)=100

Month average	NEER	Appreciation (+)/ depreciation (-) in NEER over previous period/month (%)	REER	Appreciation (+) depreciation (-) in REER over previous period/ month (%)
March 2012	81.60		118.88	
March 2013	76.01	-6.9	120.72	1.5
2013-14 (P)				
April 2013	75.97	-0.1	120.87	0.1
May 2013	75.29	-0.9	121.20	0.3
June 2013	70.51	-6.3	114.22	-5.8
July 2013	68.89	-2.3	112.99	-1.1
August 2013	64.61	-6.2	107.56	-4.8
September 2013	63.95	-1.0	107.64	0.1
October 2013	65.57	2.5	111.11	3.2
November 2013	64.78	-1.2	111.61	0.5
December 2013	65.27	0.8	111.34	-0.2
January 2014	65.14	-0.2	109.88	-1.3
February 2014	64.90	-0.4	109.41	-0.4
March 2014	66.27	2.1	112.29	2.6

Source : RBI.
Notes : Exchange rate is based on monthly average—new CPI; P: provisional.

External Debt

6.33 India's external debt has remained within manageable limits due to the external debt management policy with prudential restrictions on debt varieties of capital inflows given the large interest differentials. India's external debt stock at end March 2013

stood at US$ 404.9 billion (₹ 2,200,410 crore), recording an increase of US$ 44.1 billion (12.2 per cent) over the end March 2012 level of US$ 360.8 billion (₹ 1,844,167 crore). External debt (both at end March 2013 and end March 2012) is higher than reported earlier in various publications owing to the inclusion of securitized borrowings of banks as reported by the RBI in its external debt statistics. Component-wise, long-term debt increased by 9.1 per cent to US$ 308.2 billion at end March 2013 from US$ 282.6 billion at end March 2012, while short-term debt (refers to such debt in terms of original maturity unless otherwise stated) increased by 23.7 per cent to US$ 96.7 billion from US$ 78.2 billion at end March 2012, reflecting elevated levels of imports.

6.34 India's external debt stock went up by about US$ 21.1 billion (5.2 per cent) over the end March 2013 levels to reach US$ 426.0 billion at end December 2013. The rise in external debt is largely composed of long-term debt, particularly NRI deposits. A sharp increase in NRI deposits reflected the fresh FCNR (B) deposits mobilized under the swap scheme during September-November 2013 which has been detailed in earlier sections of this chapter.

6.35 India's external debt continues to preponderantly consist of long-term borrowings. Long-term external debt at US$ 333.3 billion at end December 2013, accounted for 78.2 per cent of total external debt, the remaining 21.8 per cent being constituted of short-term debt. Long-term debt at end December 2013 increased by US$ 25.1 billion (8.1 per cent) over the level at end March 2013, while short-term debt declined by US$ 4.0 billion (4.1 per cent), reflecting the fall in the levels of imports.

6.36 ECBs, NRI deposits, and multilateral borrowings, which are the major components of long-term debt, accounted for 67.0 per cent of total external debt, while the other components (namely bilateral borrowings, export credit, and IMF and rupee debt) accounted for 11.2 per cent. Thus long-term debt, all its components taken together, accounted for 78.2 per cent of total external debt, while the remaining 21.8 per cent comprised short-term debt at end December 2013 (Table 6.7).

Table 6. 7 : Composition of External Debt

(per cent to total external debt)

Sl. No.	Component	March 2012PR	March 2013PR	September 2013PR	December 2013QE
1	Multilateral	14.0	12.7	13.1	12.3
2	Bilateral	7.4	6.2	6.2	5.6
3	IMF	1.7	1.5	1.5	1.4
4	Export credit	5.3	4.4	4.1	3.9
5	Commercial borrowings	33.3	33.5	32.6	31.5
6	NRI deposits	16.2	17.5	18.7	23.2
7	Rupee debt	0.4	0.3	0.3	0.3
8	Long-term debt (1 to 7)	78.3	76.1	76.5	78.2
9	Short-term debt	21.7	23.9	23.5	21.8
10	Total external debt (8+9)	100.0	100.0	100.0	100.0

***Source*:** Ministry of Finance and RBI.
***Notes* :** PR: partially revised; QE: quick estimates.

6.37 The dominance of US dollar-denominated debt in the currency composition of India's total external debt at end December 2013 continued with such debt at 63.6 per cent of the total, followed by debt denominated in Indian rupee (19.4 per cent), SDR

(7.1 per cent), Japanese Yen (5.0 per cent), and Euro (3.1 per cent). The currency composition of government (sovereign) external debt presents a different picture with predominance of SDR-denominated debt (39.3 per cent), which is attributed to borrowing from the International Development Association (IDA), the soft loan window of the World Bank under multilateral agencies and SDR allocations by the IMF, followed by government debt denominated in US dollar (27.9 per cent), Japanese yen (16.5 per cent), Indian rupee (12.4), and Euro (3.9). At end December 2013, government (sovereign) external debt was US$ 76.4 billion, accounting for 17.9 per cent of India's total external debt, while non-government external debt was US$ 349.5 billion, accounting for 82.1 per cent of the total.

6.38 Over the years, India's external debt stock has witnessed a structural change in composition. The share of concessional in total debt has declined on account of the shrinking share of official creditors and government debt and the surge in non-concessional private debt. The proportion of concessional debt in total debt declined from 42.9 per cent (average) during the period 1991-2000 to 28.1 per cent in 2001-10 and further to 10.6 per cent at end December 2013. The increasing importance of non-government debt is evident from the fact that such debt accounted for 65.6 per cent of total debt during the 2000s as against 45.3 per cent in the 1990s. Non-government debt accounted for over 70 per cent of total debt in the last five years and stood at 82.1 per cent as at end December 2013.

6.39 As there were renewed concerns about external vulnerabilities in the context of monetary policy action in systemically important economies, it would be useful to look at some key external debt indicators (Table 6.8), some of which are traditional indicators

Table 6.8 : India's Key External Debt Indicators (per cent)

Year	External debt (US$ (billion)	Total external debt to GDP	Debt service ratio	Foreign exchange reserves to total external debt	Concessional debt to total external debt	Short-term external debt* to foreign exchange reserves	Short-term external debt* to total external debt
1990-91	83.8	28.7	35.3	7.0	45.9	146.5	10.2
1995-96	93.7	27.0	26.2	23.1	44.7	23.2	5.4
2000-01	101.3	22.5	16.6	41.7	35.4	8.6	3.6
2005-06	139.1	16.8	10.1#	109.0	28.4	12.9	14.0
2006-07	172.4	17.5	4.7	115.6	23.0	14.1	16.3
2007-08	224.4	18.0	4.8	138.0	19.7	14.8	20.4
2008-09	224.5	20.3	4.4	112.2	18.7	17.2	19.3
2009-10	260.9	18.2	5.8	106.9	16.8	18.8	20.1
2010-11	317.9	18.2	4.3	95.9	14.9	21.3	20.4
2011-12	360.8	20.5	6.0	81.6	13.3	26.6	21.7
2012-13PR	404.9	21.8	5.9	72.1	11.2	33.1	23.9
2013-14QE (End-Dec)	426.0	23.3	-	69.0	10.6	31.5	21.8

Source : Ministry of Finance and RBI.
Notes : PR: partially revised; QE: quick estimates.
* Short-term debt is based on original maturity.
\# Works out to 6.3 per cent, with the exclusion of India Millennium Deposits (IMDs) repayments of US$ 7.1 billion and pre-payment of US$ 23.5 million. Debt-service ratio is the proportion of gross debt service payments to external current receipts (net of official transfers).
\- Not worked out for the broken period.

and only provide a sense of comfort. India's foreign exchange reserves provided a cover of 69.0 per cent to the total external debt stock at end December 2013 vis-à-vis 72.1 per cent at end March 2013. The ratio of short-term external debt to foreign exchange reserves was 31.5 per cent at end December 2013 as compared to 33.1 per cent at end March 2013. The ratio of concessional debt to total external debt declined steadily and was 10.6 per cent at end December 2013 against 11.2 per cent at end March 2013.

International Comparison

6.40 A cross-country comparison of total external debt of the 20 most indebted developing countries, based on the World Bank's International Debt Statistics 2014 which contains data on external debt for the year 2012, showed that India's position was *third* in terms of absolute external debt stock, after China and Brazil. The ratio of India's external debt stock to gross national income (GNI) at 20.8 per cent was the *fourth* lowest with China having the lowest ratio at 9.2 per cent (Table 6.9). In terms of the cover of external debt provided by foreign exchange reserves, India's position was *seventh* at 71.4 per cent.

Table 6.9 : International Comparison of Top 20 Developing Debtor Countries 2012

Sl. No.	Country	Total external debt stocks(US$ million)	Total debt to GNI(per cent)	Short-term debt to total external debt(per cent)	Foreign exchange reserves to total debt(per cent)
1	China	754009	9.2	67.6	441.8
2	Brazil	440478	19.9	7.4	83.9
3	India	379099	20.8	24.6	71.4
4	Mexico	354897	30.7	20.4	45.2
5	Turkey	337492	43.1	29.9	29.6
6	Indonesia	254899	29.9	17.6	42.7
7	Hungary	203757	173.4	11.2	21.8
8	South Africa	137501	36.6	20.3	32.0
9	Kazakhstan	137014	79.0	6.8	16.2
10	Ukraine	135067	77.9	25.7	16.8
11	Thailand	134223	38.2	42.4	129.1
12	Romania	131889	78.9	20.5	31.2
13	Argentina	121013	26.3	11.6	33.0
14	Malaysia	103950	35.5	45.2	132.5
15	Colombia	79051	22.4	13.5	46.1
16	Venezuela	72097	19.4	26.9	13.7
17	Pakistan	61867	25.5	4.2	16.6
18	Philippines	61390	24.6	13.8	119.7
19	Vietnam	59133	44.1	16.7	43.2
20	Peru	54148	29.4	15.8	115.1

Source : World Bank's International Debt Statistics 2014.

Notes : Countries are arranged based on the magnitude of total external debt presented in the Table. India's position was fourth in external debt stock in absolute terms, after China, the Russian Federation, and Brazil in 2011. The Russian Federation is excluded from the regional analysis because it is now classified as a high-income country.

Outlook

6.41 The improvement in the BoP position during the latter half of 2013-14 was indeed swift and owed to exceptional measures like restrictions on non-essential imports and limited period incentives for certain varieties of capital flows and the impact of overall economic slowdown on imports. Sustaining the robust outcome in

the medium term is a challenge as some of the restrictions need to be gradually withdrawn and there is need to adjust to not merely the asset purchase taper by the US Fed but also to the eventual exit from the accommodative monetary policy stance by the advanced economies. Given the as yet uncertain global environment and the frequent bouts of flight to safety of capital on aversion to all kinds of risks, there is need to put in place a mechanism for closely monitoring developments and assessing vulnerabilities so as to take measures to cope with the situation.

6.42 The elevated levels of the twin deficits owe to both external and domestic factors. The focus of policy attention should be on fuller pass-through of global oil prices to domestic markets and putting in place alternative instruments for incentivizing domestic savings and lessening thereby the appetite for gold bullion as investment option. One of the important lessons of the turmoil in BoP position in 2013-14 was that the levels of CAD (by implication trade deficit) are important and in the immediate term the need is to ensure that it is limited to sustainable levels that are easily financed by stable sources of capital flows.

6.43 While the pick-up in growth in the advanced economies offers some comfort for growth of exports, a pick-up in GDP growth in the domestic economy, less than adequate pass-through of global oil prices to domestic consumers, and a complete withdrawal of restrictions on non-essential imports could potentially strain the BoP position. With close monitoring and policies calibrated to emerging contexts upfront, it is likely that the CAD may be limited to around US$ 45 billion (2.1 per cent of GDP) in 2014-15, which is likely to be fully financed by stable sources of capital/financial flows leading to a stable exchange rate environment without the need for any major intervention in this regard.