

Dimensions of India's External Sector Resilience

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The international environment is clouded with very challenging conditions. Global growth is slowing down and central banks across the world are bracing up to counter it by easing monetary policy; but there is no recession as yet. Trade wars have pushed world trade into contraction and threaten to morph into tech and currency wars, with no evidence of any significant gains accruing to anyone. Meanwhile, global commodity prices have weakened, with collateral benefits to net commodity importers and terms of trade losses for commodity exporters. The developments emanating from drone strikes on Saudi oil facilities are, however, still playing out. Sporadic flights to safety are driving capital flows out of emerging markets into advanced economy assets; but the universe of negative yielding bonds is growing disconcertingly large, posing a potential threat to financial stability.

Strengths and Weaknesses

2. In this hostile environment, India's external sector has exhibited resilience and viability. The current account deficit has averaged 1.4 per cent of GDP over the last 5 years and remains comfortably financed in spite of global spillovers imparting risk-on-risk-off volatility to portfolio flows. The level of foreign exchange reserves was at US\$ 429 billion on September 13, 2019, sufficient to cover close to 10 months of imports or 21 months of debt of residual maturity up to 1 year. The Indian economy remains a preferred habitat for foreign direct investment (FDI) and is among the top 10 destinations for greenfield projects (*Source: FDI Report, Financial Times, 2018*). Net foreign direct investment at US\$ 18.3 billion in April-July 2019 was higher than US\$ 11.4 billion in the corresponding period of 2018-19.

3. Significant progress has been made in external debt management since the external payment difficulties encountered in 1990 which triggered wide-ranging structural adjustments and reforms. The level of external debt at 19.7 per cent of GDP and the debt service ratio (principal repayments and interest payments as a ratio of current earnings) at 6.4 per cent of GDP are among the lowest in emerging market peers. This places India among the least externally indebted countries of the world, by the World Bank's classification. In terms of a broader measure of external liabilities – the net international investment position (NIIP) which

includes both debt and equity liabilities, net of foreign assets – India’s exposure declined to 15.9 per cent of GDP at end-March 2019 from a peak level of 18.3 per cent at end-March 2015. Foreign exchange reserves covered 76 per cent of external debt and 94.6 per cent of the NIIP at end-March 2019, up from 68.2 per cent and 89.3 per cent, respectively, at end-March 2014. Short-term debt by residual maturity declined to 57 per cent of foreign exchange reserves at end-March 2019 from a peak level of 59 per cent at end-March 2013. Short-term debt by original maturity constitutes barely 20 per cent of total external debt.

4. These healthy developments are underpinned by the innate strength of India’s underlying fundamentals. The degree of openness of the economy, measured by the ratio of exports and imports of goods and services to GDP, has risen from 20 per cent in the first half of the 1990s to 44 per cent in the latest five-year period from 2014-19. The share of India’s merchandise exports in world exports has gone up from 0.5 per cent in 1990 to 1.7 per cent in 2018.

5. In line with the expanding share of services in domestic output, India’s services exports have grown rapidly over the past two decades. In fact, India’s services exports have shown a higher degree of resilience to global shocks than merchandise exports. At US\$ 81.9 billion, net services exports financed 45 per cent of India’s trade deficit in 2018-19. In the area of traded services, India remains a world leader in software exports and information technology (IT) enabled services, accounting for around 12 per cent of world software exports. India’s IT sector, which earned US\$ 78 billion through net exports in 2018-19, is leapfrogging into new technologies including artificial intelligence, machine learning and robotics. The Indian diaspora is among the largest in the world and reflecting this, India currently receives the highest amount inward remittances in the world from Indians working abroad. Alongside, accretions to non-resident deposits have provided stable and reliable support to the balance of payments over the years. Financial openness, measured by the ratio of gross capital inflows and outflows to GDP, has increased three-fold from 15 per cent in the first half of the 1990s to 45 per cent during 2014-19.

6. Notwithstanding these achievements, there are several areas of concern as well which occupy centre-stage in the conduct of external sector management. First, merchandise exports have lost momentum under the weight of the slump in world trade. In spite of export volume growth averaging 4.2 per cent during 2013-18 (UNCTAD, 2019), India’s export growth in US dollar terms has weakened – as in a host of emerging and advanced economies - to 2.2 per cent over the same period, as falling

unit value realisations have taken their toll. The slowdown in global demand has affected our exports of petroleum products as well – they constitute 14 per cent of total merchandise exports. Second, the deceleration in domestic demand has pulled imports, especially non-oil non-gold imports, into contraction and this has reduced the inflow of intermediates, capital goods and technology that is vital for modernising our infrastructure and industry. Third, portfolio flows, which on average account for about 23 per cent of external financing in a normal year, have turned highly volatile, with net outflows of US\$ 0.6 billion in 2018-19. During 2019-20 so far (up to September 13), portfolio equity outflows were of the order of US\$ 1.4 billion but lower than US\$ 2.9 billion in the corresponding period a year ago. Net inflows into the debt market of US\$ 4.1 billion have, however, provided relief. Moreover, these portfolio capital movements have turned out to be conduits of global spillovers, impacting domestic equity, debt and forex markets, and asset prices. Nonetheless, the underlying resilience of India's external sector, anchored by the positive features I set out earlier, have cushioned these shocks and insulated the domestic economy.

Managing the External Sector

7. Against this backdrop, I would like to turn to several recent initiatives undertaken by the Reserve Bank of India and the Government of India to fortify India's external position and improve the capacity of the economy to deal with the headwinds that confront us in these testing times.

Exports

8. Exports hold the key to a sustainable balance of payments position. In the final analysis, liabilities in the form of debt and even equities cannot entirely substitute for foreign exchange earnings from exports of goods and services that create import purchasing power and liability servicing capacity. Over the years, the policy endeavour has been to secure a wide diversification in India's export profile in terms of both products and destinations. In particular, product diversification has enabled India to broaden its export basket relative to BRICS peers and reduce its vulnerability to trade shocks. Apart from diversification, India is now exporting sunrise products like electronics, chemicals and drugs and pharmaceuticals for which demand is expanding at the global level. In the smart phone segment of electronic goods, India has transformed itself from being a net importer to an exporter with the impetus from the phased manufacturing programme.

9. Looking ahead, several initiatives have been put in place and others are being launched on an ongoing basis to enable export industries to regain productivity and cutting edge competitiveness. They include upgradation of export facilities, integration of Indian farmers and their products with global value chains, and trade facilitation measures. More recently, efforts are going into reimbursement of taxes and duties, including electronic refund of input tax credits in GST. An action plan for 12 'champion' services sectors, including IT, tourism and hospitality, and medical services has been developed since February 2018. The Reserve Bank and the Government are actively engaged in the promotion of e-commerce platforms that will boost the exports of both merchandise and services. All these steps seek to create a more conducive climate for exports.

Capital Flows

10. With regard to capital flows, India has adopted an approach marked by progressive liberalisation but calibrated to the realities of the domestic situation, including the evolution of financial markets. A diverse range of instruments for managing exchange rate risk for an expanding investor base has come into play. India's hierarchical policy approach – preferring equity flows over debt flows, and preferring FDI flows over portfolio flows within equity flows and long-term debt flows over short-term flows within total debt flows – has influenced the composition of capital flows.

11. Turning to equity flows, FDI policy has been progressively liberalised across various sectors in recent years to make India an attractive investment destination. Sectors that have been opened up in recent years include defence, construction development, trading, pharmaceuticals, power exchanges, insurance, pensions, financial services, asset reconstruction, broadcasting and civil aviation. 100 per cent FDI has also been allowed in insurance intermediaries. In August 2019, FDI norms in single-brand retail trade have been further liberalised. FDI up to 100 per cent has been permitted under the automatic route in contract manufacturing and coal mining.

12. With regard to foreign portfolio investment (FPI), several measures have been undertaken to create an investor-friendly regime and to put in place a more predictable policy environment. FPI limits are now being revised on a half yearly basis under the medium-term framework. FPI has been allowed in municipal bonds within the limits set for State

Development Loans (SDLs).¹ Greater operational flexibility has been granted to FPIs under a Voluntary Retention Route (VRR) which facilitates investment in G-secs, SDLs, treasury bills and corporate bonds while allowing investors to dynamically manage their currency and interest rate risks. The initial response to the VRR scheme has been encouraging. The Union Budget 2019-20 proposed to ease KYC norms for FPIs and also merge the NRI portfolio route with the FPI route for seamless investment in stock markets. Outward direct and portfolio investment have also been progressively liberalised to give Indian entities a global scan and presence.

13. External borrowing norms have also been simplified under two tracks: foreign currency denominated ECBs; and rupee denominated ECBs. The list of eligible borrowers has been expanded to include all entities eligible to receive FDI, registered entities engaged in microfinance activities, registered societies/trusts/cooperatives and non-government organisations. A rule-based dynamic limit for outstanding stock of ECBs at 6.5 per cent of GDP is in place. Rupee denominated bonds or Masala bonds under the ECB route offer an opportunity to domestic firms to borrow from international markets without the need for hedging exchange rate risk. ECBs up to US\$ 750 million or equivalent per financial year are permitted under the automatic route. Recently, end-use restrictions relating to external commercial borrowings have also been relaxed for specific eligible borrowers for their working capital requirements, general corporate purposes and repayment of rupee loans. The mandatory hedging requirement had earlier been reduced from 100 per cent to 70 per cent for ECBs with minimum average maturity period between 3 and 5 years in the infrastructure space. Net disbursement of ECBs rose to US\$ 7.7 billion in April-July 2019, as against net repayments of US\$ 0.8 billion in the corresponding period of 2018-19.

Exchange Rate

14. Before concluding, it is only fair to say a few words about the exchange rate of the rupee. Over the last couple of years, the exchange rate has seen large two-way movements with considerable volatility imparted mainly by global spillovers. During 2019-20 so far, the rupee has traded in a narrow range, with modest appreciation in Q1 giving way to some depreciation in August and the first half of September, accentuated by drone attacks on Saudi oil facilities on September 14, 2019. In its External Sector Report of July 2019, the International Monetary Fund

¹The limits for FPI investment in Central Government securities (G-secs), State Development Loans (SDLs) and corporate bonds are fixed currently at 6 per cent, 2 per cent and 9 per cent of respective outstanding stocks of securities for FY 2019-20.

(IMF) has employed a suite of models to assess the alignment of currencies with their fundamentals. For the rupee, the IMF estimates the REER gap to be zero, implying that the currency is fairly valued and broadly in line with fundamentals. India's exchange rate regime is flexible and market-driven, with the exchange rate being determined by the forces of demand and supply. The RBI has no target or band for the level of the exchange rate. Interventions are intended to manage undue volatility. This is reflected in the two-sided interventions conducted during the past two years – net purchases in 2017-18, followed by net sales in 2018-19. In fact, it is in recognition of this flexibility that the US Department of the Treasury has removed India from its watch list relating to currency manipulation.

Conclusion

15. Overall, the outlook for India's external sector is one of cautious optimism, *albeit* with some downside risks accentuated at this juncture. Among them, deepening of the global slowdown and escalation of trade and geopolitical tensions appear to be the most significant. Volatile international crude prices also continue to pose potential risks to the viability of the current account balance through trade and remittances channels. Yet, there are underlying strengths that can be built upon to buffer the external sector from these risks. The search for new export markets and new niches must go on so as to reap the benefits of changing dynamics of global value chains. Indian IT companies need to accelerate market diversification and invest in new skills and technologies to hone their comparative advantage. Remittances and non-resident deposits are likely to remain shock-absorbers over the medium term and need to be assiduously cultivated, including by ease of remitting/depositing and reducing transaction costs.

16. Ultimately, the strength of the external sector derives from domestic macro-fundamentals. Investors and markets need to be credibly assured of our ability to maintain macroeconomic and financial stability through continued focus on these areas. At the same time, we need to persevere with structural reforms in various sectors of the economy to unlock productivity and competitiveness gains. The overarching objective should be to keep the current account deficit within sustainable limits and financed by a prudent mix of debt and equity flows. As I stated earlier, the global environment is challenging, but it offers opportunities as well. By the IMF's assessment, India will account for a sixth of global growth in 2020. Trade wars are presenting new business relocation avenues that seem to be favourable to India from the point of view of the economies of scale and scope. Indian entrepreneurship, the rupee and our people are

progressively but inexorably internationalising. Since 2018, India's working age population has grown larger than the dependent population, and this demographic advantage is expected to last till 2055. In this milieu, prudent external sector management with a close and continuous vigil on areas of external vulnerability assumes critical importance and will continue to receive RBI's close attention.

Thank you.