India's Balance of Payments: On borrowed time?*

C.P. Chandrasekhar

Figures on India's balance of payments in financial year 2023-24, recently released by the Reserve Bank of India, have added to the hype on India's growth story. India's current account deficit, or the surplus of current foreign exchange expenditures and outflows over current foreign exchange earnings and receipts, fell to $23.2 billion from a much higher 67 billion in 2022-23. A lower merchandise trade deficit and higher receipts from export of services and transfers, especially of remittances from workers abroad, explains that improvement.

In the same financial year 2023-24, net FDI inflows totalled $9.8 billion, net portfolio inflows $44.1 billion and net inflows of banking capital (including NRI deposits of 14.7 billion) $40.5 billion These capital receipts were well in excess of sums needed to finance the deficit in the current account. In the event, India accumulated the surplus inflow as foreign exchange reserves, which rose by around $64 billion after adjusting for valuation changes. This 'vote of confidence' on the part of foreign investors and the resulting rise in reserves are seen as signalling that things are bright on the external front.

However, underlying these figures are trends that should give cause for concern. The first is that, as reported above, an overwhelmingly large share of net capital inflows was on account of inflows of portfolio capital and banking capital. Foreign portfolio investors who appeared to be exiting from India's markets in the run up to the parliament elections are now rushing. The Sensex has risen from just below 74,000 at the end of end of May to close to 79,500 at the beginning of July. The Press Trust of India reports that market capitalisation of BSE-listed companies has touched an all-time high of Rs. 443 lakh crore. And the price earnings ratio of the 30 companies included in the Sensex fluctuates between 24 and 25. But this is not all good news. These are at unsustainable levels and the market could unwind at any time, led by foreign institutional investors who have repeatedly shown themselves to be fickle-minded and footloose. If that happens, NRI depositors and other banking capital sources will retreat as well.

The full implication of such an exit can be gauged from the fact that in 2023-24 alone net inflows of foreign institutional investment and banking capital totalled $85 billion. This meant that capital inflows not only helped finance the $23 billion current account deficit but contributed an additional $62 billion which almost equalled the increase in India's reserves. Reserves accumulate because of the entry of footloose capital. These capital inflows are also liabilities, with different kinds of future payments commitments associated with them. Foreign exchange reserves are being shored up with resources that are not assets as media reporting often implicitly suggests.

Evidence on India's international investment position indicates that assets held abroad by resident agents rose from $918.5 billion in March 2023 to $1028.3 billion in March 2024, or by around $110 billion over that year. Of that increase, the contribution of reserve assets, consisting of foreign currency and investment in low return and liquid securities was as much as $68 billion. Since those reserve assets are being built by contracting liabilities, the latter rose from $1285.7 billion to $1390 billion, or by $104 billion. The yields on these liabilities for foreign investors are bound to be high, implying that India is accessing costly capital to hold much of that money in low- or no-return assets. It incurs that cost by playing host to a kind of capital that is footloose and can leave at anytime. This is not true just of last year, but for the many years over which India has been building a stock of legacy foreign financial capital. The nature of that capital and the reserves it contributes gives no cause for celebration whatsoever.

Underlying the celebratory responses to these balance of payments trends is the expectation that the inflows would never stop and reverse themselves, and the viewpoint that the inflows are good for India's growth. The expectation of persistence is belied not just by the experience across low- and middle-income countries over time, but also by the Indian experience since the 1991 balance of payments crisis. And the view that these flows are good for growth ignores the fact that these investments are not in productive assets and are not long term in nature but yield-thirsty capital looking for speculative gains.

If there is any way in which these flows contribute to growth it is by injecting liquidity into the system and providing the basis for a credit boom that can prove to be a bubble. The large volumes of liquidity infused into the system as a result of a surge in capital turn up as deposits in the banking system, which needs to lend or invest that money. In the high growth years after 2004 such lending was to infrastructure—areas like power generation and distribution, roads, ports, and civil aviation. Many of those projects failed to take off or did not earn the expected returns, leading to loan defaults and a spike in non-performing assets. Banks soon held back on lending to infrastructure.

But with large capital inflows into bond and equity markets persisting, the pressure of enhanced liquidity in the banking system has not eased. In response, the banks have diversified away from lending to infrastructure into lending to the retail sector. In recent times the credit surge in India has been focused on areas varying from housing investments and automobile purchases to accumulation of credit card receivables. Non-bank financial companies have added their share to such lending.

The consequence of this credit surge is that borrowers who were earlier excluded from access to retail lending are now being wooed by the banks, increasing the number of weaker borrowers in whose case the probability of default is higher. Fears that a significant share of those loans could turn bad are being expressed even in official circles. If that happens that could be the trigger that sets off an exodus of capital.

Thus, India's large foreign exchange reserve speak not of balance of payments strength but are reflective of processes that simultaneously increase external and domestic vulnerability. Either of those vulnerabilities can give, leading to a scenario in which reserves shrink and the rupee depreciates with economy-wide implications. If that happens, many wizards of the financial world would also pay a price. But that does not deter those players or the government that backs from ignoring the true nature of the foreign reserve bonanza.

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