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Economic Review

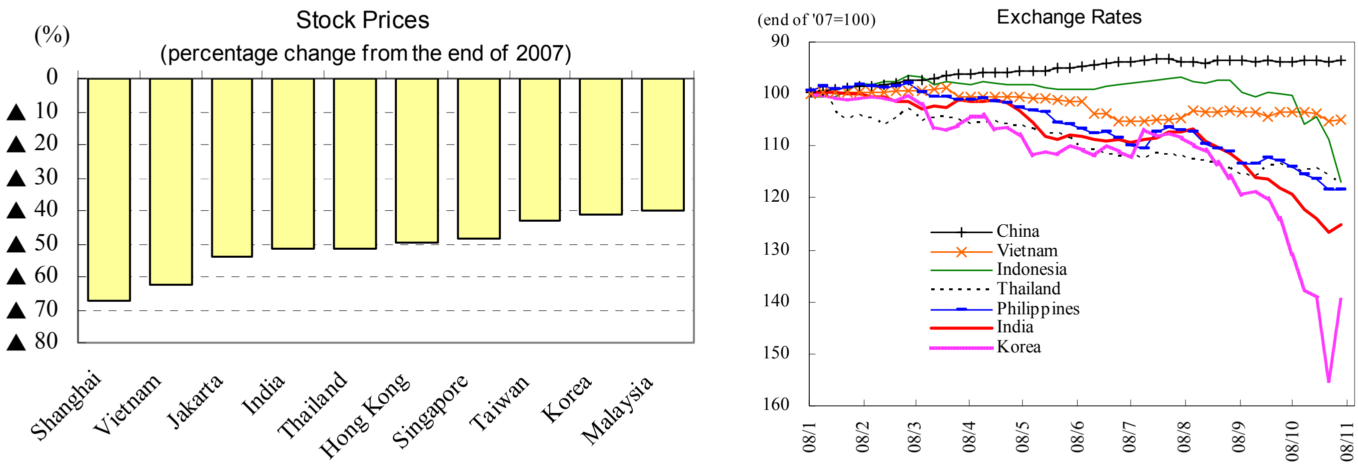
Global Financial Crisis and Changes in Capital Flows of India

Amid the continuing turmoil in the global financial markets triggered by the financial crisis in the United States, major Asian markets have continued to be volatile, with stock prices and currencies dropping further (Figure 1).

Under these circumstances, the Reserve Bank of India (RBI: central bank of India) has been forced to take unusual steps such as easing of regulations to facilitate capital inflows and emergency monetary easing, in reaction to liquidity crunch in the money market as well as to a significant drop in stock prices and the value of its currency.

This paper examines the challenges facing India, based on the changes in cash flows of India and the external balance.

Figure1: Stock Prices and Exchange Rates in Major Asian Economies



Note: as of the end of October 2008.
Source: Compiled by the BTMU Economic Research Office based on Bloomberg data.

1. Indian stock market continues to be adjusted

The Indian stock market has continued to be adjusted significantly since the start of this year, reflecting the global move to reduce risk assets triggered by the financial crisis that started in the United States, as well as increasing uncertainties on the economy such as inflation and sluggish economic growth. SENSEX stock index (Mumbai Stock Exchange) hit its all-time high at the 20,000 point range at the start of the year, but thereafter dipped below the 10,000 points, falling to half its peak (Figure 2).

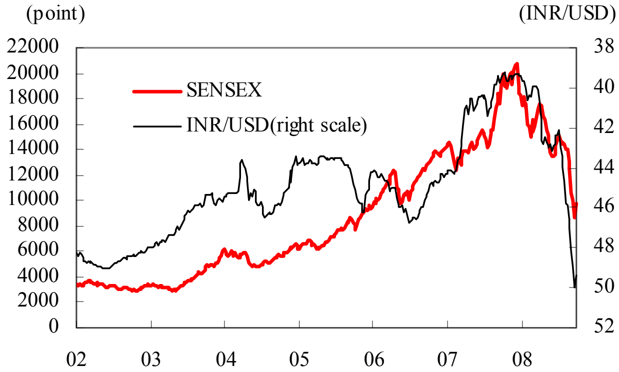
Looking at developments in investment by foreign institutional investors (FIIs) (Note1), the value of stocks sold by FIIs during the period from the start of the year through the end of September reached 9.5 billion dollars, leading to a decline in total FII investment balance by about ten percent from the end of 2007, although the rate of decline in net FII investment amount has been decreasing (Figure 3).

It appears that the slowdown in FII investment has been affected by tightened regulations by the government. In October 2007, Securities and Exchange Board of India (SEBI) introduced a ban, in principle, on indirect stock investment through participatory notes (P-Notes) (Note 2) in a bid to moderate surging inflows of investment funds from abroad and to ensure the transparency of relevant transactions. FIIs were required to wind up the existing position of P-notes against underlying derivatives in 18 months (by April 2009), which appears to have pushed stock prices down. SEBI, however, lifted the ban on P-notes in October with an aim to encourage the flagging stock market.

Note1: India allows only foreign institutional investors (FIIs) who are registered with SEBI (Securities and Exchange Board of India), to invest in Indian stock markets. There are about 1,400 registered FIIs as of the end of June 2008. The number of FIIs increased by more than 400 for the past six months from the end of last year, as SEBI broadened the criteria for FII registration (to include hedge funds) and simplified the registration procedure.

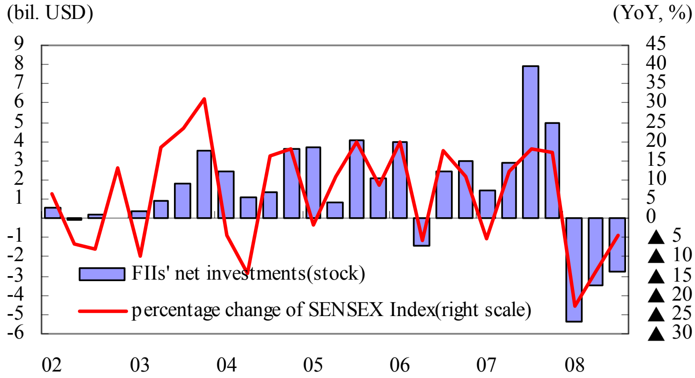
Note2: Participatory Notes (P-Notes) are Indian stock index-linked beneficiary certificates that are issued by FIIs who are permitted by SEBI. FIIs purchase India-based stocks and then issue participatory notes based on the stockholder's rights (including dividends) to foreign investors. Hedge funds that are not given FII status can indirectly invest in Indian securities through P-Notes. SEBI couldn't keep track of P-Note transactions due to the unclear nature of P-Notes which were purchased or sold on a negotiated basis, not through the stock exchange.

Figure2: Stock Prices and Exchange Rates



Source: Compiled by BTMU Economic Research Office based on Bloomberg data

Figure3: Portfolio Investment into India by Foreign Institutional Investors(FII)



Source: Compiled by BTMU Economic Research Office based on CEIC data.

2. Changes in Capital Flows of India

(1) Capital inflows into India has been declining as a trend

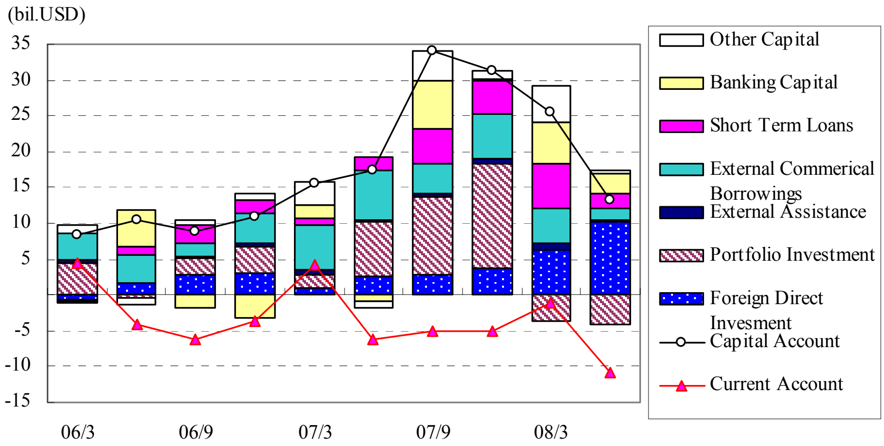
The rate of India's capital account surplus has been declining as a trend since the latter half of last year (Figure 4). In recent years, the country's capital account surplus had continued increasing against the backdrop of growing cash inflows from abroad through securities investment, external commercial borrowing (ECB) (Note), and direct investment. In particular, inflows of capital through securities investment amounted to 29.3 billion dollars in fiscal 2007 (April 2007 through March 2008), more than four times the amount for last year (7.1 billion dollars), contributing to an increase in capital account surplus. Since the start of this year, however, capital outflow has surpassed capital inflow.

External commercial borrowings (ECBs) have shown signs of slowdown, in reaction to the global risk aversion and the declining lending ability of financial institutions in the United States and Europe. Recently, fund-raising through ECBs had grown, on the back of increased demand for funds due to robust capital spending in the country and active M&A transactions abroad. In many cases, ECBs are offered to Indian firms through syndicated loans from multiple banks. While major Indian banks offer loans at 13 percent average interest (fiscal 2007), the interest rate on ECB is only 4.7 percent, which enables borrowers to raise funds at low costs and thus makes ECB advantageous over other loans. In last May, Reliance Industries Ltd., India's top private oil refiner and petrochemical maker, raised 2 billion dollars to fund the expansion of its facilities. Tata Motors also raised 3 billion dollars in total through a syndicated loan from banks both in India and abroad including two Japanese banks to fund its acquisition of high-end British brands, Jaguar and Land Rover, from the U.S. Ford Motor Company.

Meanwhile, both outward and inward foreign direct investments (FDIs) have increased, with net inflow of FDI surpassing the outflow. Inward FDI for fiscal 2007(April 2007 through March 2008) recorded its all-time high at 32.3 billion dollars. The figure for the April-June period of fiscal 2008 stood at 10.1 billion dollars, rising above the 10 billion-dollar mark for the second consecutive period (previous period: 13.7 billion dollars). Industries that have been firm include infrastructure-related industries such as housing/real estate, construction, electricity, communications and petroleum refinery and the service industry including finance. The manufacturing sector, which eyes expansion of its domestic market, has also seen an increase in investment.

Note: External commercial borrowings (ECBs) include borrowings from overseas banks, suppliers' and buyers' credit, and Indian companies' bonds issued overseas, with minimum average maturity of three years, respectively. Restrictions are placed on the qualification for loan application, loan amount/period, interest rate ceiling and usage of funds.

Figure 4 : Balance of Payments



Source: Compiled by BTMU Economic Research Office from Reserve Bank of India

(2) Actions by the authorities

The Indian rupee has depreciated against the dollar (Figure 2) due to fund outflows from stock markets and decreased capital inflows through ECBs, as well as growing demand for dollars resulting from increased oil companies' import bill. The rupee has declined to 50 rupee range against the dollar, its historically low level, after having risen to the 39 rupee range to the dollar until the start of the year on the back of active inflows of funds from abroad.

Against this background, the Reserve Bank of India (RBI: central bank of India) has hammered out a series of measures to facilitate capital inflow-- such as dollar-selling intervention aimed at curbing the rapid drop in the rupee's value in the foreign exchange market, lifting of deposit interest rates for non-resident Indians (NRIs) and relaxation of the ECB regulations.

As for ECB, in order to curb the rupee's appreciation due to growing inflows of foreign currencies, the government tightened the rules on ECB in August 2007 by lowering the limit for borrowings from 500 million dollars to 20 million dollars and by mandating prior approval from RBI. However, the ECB norms have been eased, in reaction to decreased capital inflows, thereafter. Toward May and June of this year, the government raised the limit for ECB from 20 million dollars to 50 million dollars and allowed ECB up to 100 million dollars for service businesses (hotels, hospitals and software companies), which had not been eligible for ECB so far, and infrastructure investments such as electricity, communications, and building of roads, ports and industrial parks. Thereafter, the loan limit was gradually raised up to 500 million dollars by October.

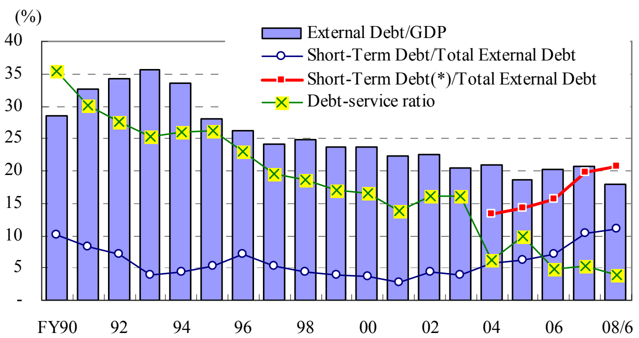
Furthermore, in October, as a result of tight financial market liquidity due to the effect of the global credit crunch, emergency measures to bolster market liquidity were taken: large-scale monetary easing, gradual lowering of cash reserve rate (CRR) to 5.5 percent (3.5 percent in total) and cutting of repo rate (lending rate to commercial banks) for the first time in about four and a half years to 6.5 percent (2.5 percent in total).

3. Capital liberalization and external solvency

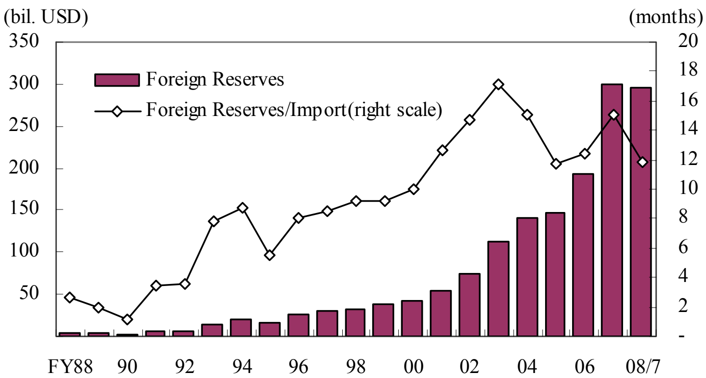
(1) Foreign currency liquidity is sufficient enough

Given the size of India's external debt and the level of its foreign currency reserves, we view that foreign currency liquidity is sufficient enough, despite the turmoil in the money market (Figure 5). The balance of India's external debt is 18 percent of GDP (as of the end of June 2008), remaining at a low level relative to other Asian countries (Indonesia: 32 %; Malaysia: 29%; Thailand: 25%; Philippines: 39 %; and Korea: 39% as of the end of 2007), although it has been increasing mainly in private sector borrowings. Although the ratio of short-term external debt to the entire external debt has risen to about 20 percent mainly due to increasing trade credit, debt service ratio has been extremely low at 3.9 percent. India has adequate foreign currency reserves, twelve-month's worth of imports, although they have declined to the 280 billion dollar range (as of the end of September) from its peak in April of this year (305 billion dollars), owing to decreased capital inflows from abroad and aggressive dollar-selling intervention by RBI. Thus, it seems unlikely that the ratio of short-term external debt to the entire external debt will reach forty percent, leading to a worsening of foreign currency liquidity position and a weaker currency, as in Korea.

Figure5: External Solvency



Note: Short-term external debt(*) includes suppliers credit (above 180 days maturity) and buyers credit.
Source: Compiled by BTMU Economic Research Office from Reserve Bank of India



Source: Compiled by BTMU Economic Research Office from Reserve Bank of India

(2) Balance of payment crisis in 1991 and capital liberalization

India faced a balance of payment crisis in 1991 and has worked on the improvement of its external balance by undertaking structural adjustments ever since.

Although the Indian economy in the 1980s was based on import-substituting industrialization which placed priority on the public sector and heavy industry, partial liberalization of trade and investment increased macro-economic imbalances such as the current-account deficit and financial deficit (Figure 6 and Figure 7), the current account deficit was mostly financed by international aid and short-term funds centered on remittances from workers working in the Middle East. Under these circumstances, in the wake of the Gulf War in August 1990, trade deficit rapidly grew due to soaring crude oil prices, while workers' remittances from the Middle East declined at a fast pace. Therefore, India suffered from a scarcity of foreign exchange reserves in January 1991 (about 0.7 billion dollars-- two- week's worth of imports).

Thereafter, India has begun its structural adjustment including economic and capital account liberalization, in line with emergency loans by the IMF and the World Bank. India achieved the liberalization of current account transactions in phases (international trade payments, interest payments on foreign currency-denominated loans and foreign currency remittances such as overseas travel fee, etc.) and became an Article 8 nation of IMF in 1994.

Meanwhile, India is moving very cautiously on the liberalization of capital account transactions, based on the lessons learned from the balance of payment crisis in 1991 and the Asian currency crisis in 1997 (Note). Although capital inflows into India through direct investment or portfolio (stock) investment have been liberalized to some extent, there are still many regulations regarding borrowings from abroad and capital outflows. Regulations regarding capital account transactions have been relaxed in phases aided by a committee, which was formed in 2006 for the purpose of liberalizing such transactions (to be completed in March 2011). RBI raised the ceilings on individual overseas remittance (from 25 thousand dollars to 100 thousand dollars per annum), and external direct investment by Indian enterprises (from 200 percent to 300 percent of equity capital). RBI also broadened the options of external investment by domestic investment trusts, lifted the upper limit of investment amount (from 2 billion dollars to 4 billion dollars), and enhanced the limit for advanced payment of ECBs, without RBI's prior approval (from 300 million dollars to 400 million dollars). However, ECB guidelines are being flexibly liberalized according to changes in capital flows: some regulations on ECB have been strengthened while others are partially eased. We view that the Indian government will continue to liberalize the ECB norms cautiously, based on environmental changes in the global financial market.

Note The Indian government established a committee on capital account convertibility in February 1997 and had worked to promote the liberalization within a three-year target period. However, an Asian currency crisis has hampered the liberalization for the time being.

Figure6: Fiscal Deficit

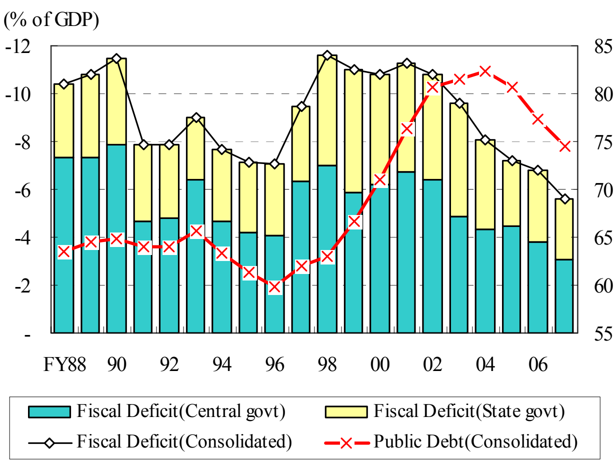
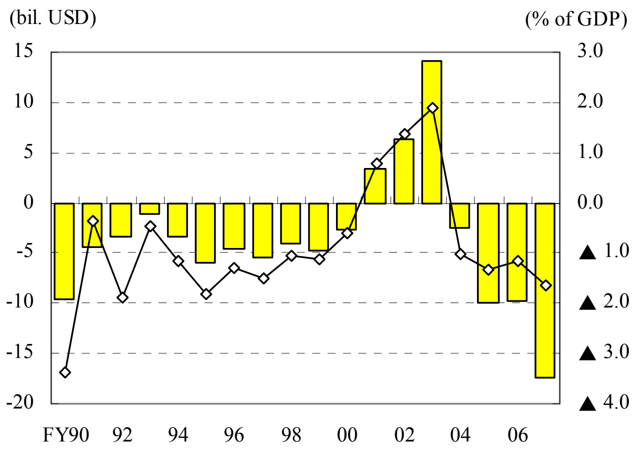


Figure7: Current Account



Source: Compiled by the BTMU Economic Research Office based on CEIC data.

4. Impact of the global financial crisis on Indian economy and its future challenges

Looking ahead, there are growing concerns that the turmoil in the global financial market will adversely affect the Indian economy, although its foreign currency liquidity is unlikely to worsen significantly. If firms will have difficulty raising funds needed for business fixed investment due to worsened financing environment through initial public offering (IPO) in India or ECBs, investments could be reduced in size or put off, exerting more downward pressure on the economy. However, looking at private firms' capital spending by type of funding source, about eighty to ninety percent of the total external financing was bank loans (actual figure for 2007) and thus the turbulence in the global financial market seems to have limited impact on the investment as a whole.

Factors that could negatively affect the future capital flows of India include a worsening of the fiscal position and a rise in current account deficit, to which attention should be paid.

As for fiscal balance, the government has worked on reducing the fiscal deficit in accordance with "Fiscal Responsibility and Budget Management Act (FRBMA)" and the fiscal position has improved in the medium and long terms. However, it is unavoidable that the fiscal position will worse temporarily toward the next year. While revenues are expected to decrease in line with the slowing growth, the government could increase its spending on measures that are focused on agricultural villages and the poor, in advance of a general election slated to be held by May 2009. With a debt relief program for farmers implemented and civil service salaries raised, the fiscal deficit stood at 1,170 billion rupee as of the end of August, reaching 88 percent of the target for this fiscal year (1,330 billion rupee, from April 2008 through March 2009). Therefore it seems difficult to attain the deficit target for this fiscal year (2.5 percent of GDP). The point is whether the new administration after the election will maintain the policy of fiscal discipline.

In recent years, India's current account deficit has continued to be in deficit, reflecting the trade deficit stemming from growing domestic demand. However, current account deficit has been contained to a minimum, remaining in the 1 percent range of GDP so far, supported by the growing services account surplus mainly in the exports of IT services and increased overseas workers' remittances. India posted a current account deficit of 10.7 billion dollars in the April-June period, marking the first rise above 10 billion dollars in four quarters, as a result of the rapid growth in trade deficit due to high crude oil prices. From the latter half of the year, trade deficit is expected to stop its significant decline due to falling international resource prices such as crude oil, but on the other hand, there's concern that the services account surplus will decrease, reflecting the worsening economy of the United States, which accounts for sixty percent of India's IT services exports. Therefore, the current account deficit may temporarily increase to about 2-3 percent of GDP.

Considering several factors such as the general election in India, higher oil prices and the worsening global economy centered on the United States, the fiscal deficit and current-account deficit, which are projected to grow toward the next year, will unlikely follow a deteriorating path in the medium and long terms. However, the worsening of the fundamentals amid the intensified global credit crunch will likely prompt further declines in stock prices and the currency. Furthermore, an increase in firms' fund-raising costs due to the unstable domestic monetary market and sluggish investment could put downward pressure on the growth, to which attention should be paid.

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