Time for caution - on India's current account deficit

India's external balance sheet may have improved significantly since the infamous taper tantrum of 2013, but there are now signs that warrant more caution from policymakers. Last week, the current account deficit (CAD) widened to a four-year high of $14.3 billion in the first quarter of the current financial year, **standing at 2.4% of gross domestic product**, compared to 0.1% last year. The widening CAD was driven by a greater increase in merchandise imports than exports. A strong capital account surplus, however, has helped the country pay for its import bills without much trouble. Foreign investors starved of yield have been stepping up their investments in India, which remains one of the few places offering higher yields. Compared to last year, net FDI almost doubled to $7.2 billion in the first quarter, while net portfolio investment jumped about six times to $12.5 billion. The strong inflow of foreign capital has also led to a significant increase in foreign reserve holdings, thanks to the Reserve Bank of India which has been busy buying dollars to weaken the rupee. Forex reserves were at an all-time high of $400.7 billion for the week ending September 8, while the rupee has appreciated by over 6% against the dollar this year. Low global oil prices over the last two years have also helped contain a good portion of its import bills.

All this might change with the impending tightening of monetary policy by the U.S. Federal Reserve and other central banks. After all, emerging Asian markets have been the biggest beneficiaries of loose monetary policy in the West, so any change in stance would most definitely affect them. Indian companies, for instance, have aggressively tapped into the market for rupee-denominated foreign debt, which can work against them if the flow of foreign capital turns volatile. The RBI has been regulating the amount and quality of such borrowings, so it may seem like things are under control for now. Further, India's total external debt declined by 2.7% during the financial year 2016-17, standing at $471.9 billion, driven by a fall in external commercial borrowings and deposits by non-resident Indians. The World Bank, in fact, has said that India's external dynamics remain very favourable given the size of its economy and foreign reserve holdings. But a prolonged period of unfavourable trade balance when combined with volatile international capital flows can lead to unsavoury macroeconomic situations. According to a report by India Ratings & Research earlier this year, a 10% depreciation of the rupee combined with a 50 basis point interest rate hike can severely affect most Indian borrowers. It added that as much as 65% of foreign debt exposure of Indian companies may be unhedged. As the world looks to withdraw from an era of historically low interest rates, it would be wise for India's policymakers to be ready with an emergency plan to tackle a period of significant volatility.

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