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EDITORIAL ANALYSIS

India's BoP Challenge: Why the Capital Account Matters More Than the Current Account

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India's BoP Challenge: Why the Capital Account Matters More Than the Current Account

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INTERVIEW ANGLE

"India's current account deficit is modest, yet analysts speak of a BoP challenge. How can a country with a comfortable CAD still face an external-sector crisis, and what does this say about India's growth model?"

EDITORIAL SUMMARY:

Indian Express argues that India's 2026 balance-of-payments stress is structurally different from the 1991, 2008 and 2013 episodes because it is being driven not by an unsustainable current account deficit but by a collapse in net Foreign Direct Investment, with the West Asia conflict producing a "pincer effect" of higher oil prices and weaker capital flows. The CAD is a comfortable 0.6% of GDP, reserves are at a record $700 billion, but net FDI collapsed from $28 billion (FY23) to just $0.96 billion (FY25) — a 96% fall — even as gross FDI rose to $81 billion, with FY26 net FDI recovering only modestly to $7.65 billion (RBI release May 22, 2026). The fix is FDI-friendly structural reforms, calibrated rupee management, and avoidance of premature fiscal tightening — not a 2013-style emergency response.

THE WRONG DIAGNOSIS WILL PRODUCE THE WRONG CURE

The instinctive frame for any Indian balance-of-payments stress is 1991 — gold pledged, IMF bailout, reserves at two weeks of imports. A second frame is 2013 — the "Fragile Five" tag, a current account deficit of 4.8% of GDP, panic capital outflows. Both frames center on the current account. Both reach for emergency monetary tightening and emergency fiscal restraint.

The 2026 stress is structurally different. The current account is comfortable. Reserves are at record levels. Inflation is contained. The problem is the capital account — specifically, the steady decline in net Foreign Direct Investment, layered against the West Asia oil shock. The wrong diagnosis will produce the wrong cure.

THE BOP ARCHITECTURE

The balance of payments has two main accounts.

Current Account captures the goods trade balance, the services trade balance, primary income (investment income) and secondary income (remittances and transfers).

Capital Account captures foreign direct investment, foreign portfolio investment, external commercial borrowings and other capital flows.

The change in foreign exchange reserves equals the sum of the current account and the capital account. A country can run a current account deficit indefinitely as long as the capital account is in surplus. A country with a comfortable current account but a weakening capital account can still face external-sector stress.

INDIA'S FY25 BOP PROFILE

The numbers tell a specific story.

INDICATOR	FY25
Current Account Deficit	~0.6% of GDP
Goods trade deficit	-$280 billion
Services surplus	+$160 billion
Remittance inflows	+$135 billion (world #1)
Gross FDI inflows	~$81 billion (FY25, up 13.7% YoY)
Net FDI inflows	~$0.96 billion (FY25, down from ~$28 billion in FY23 and ~$10 billion in FY24); recovered to ~$7.65 billion in FY26 per RBI data released May 22, 2026
Net FPI flows	±$20 billion (volatile)
Forex reserves (May 2026)	~$700 billion
Rupee against USD	84.6 (2024) → 88.5 (2025)
IMF April 2026 WEO ranking	6th nominally at $4.15 trillion (slipped from projected 4th)

The current account is healthy. The services surplus is at a record level, driven by IT, business services and the Global Capability Centres (GCCs) ecosystem. Remittances are at $135 billion — India is the world's largest recipient. The CAD is a sustainable 0.6%.

The capital account is the issue. Net FDI collapsed from about $28 billion (FY23) to about $10 billion (FY24) to just $0.96 billion (FY25) — a 96% fall — even as gross FDI rose 13.7% to $81 billion in FY25. The arithmetic difference is repatriation by foreign firms and a sharp rise in outward FDI by Indian companies (around $29 billion in FY25). RBI data released May 22, 2026 showed net FDI recovering to about $7.65 billion in FY26 — better, but still well below the FY23 peak, with repatriation elevated at $53.58 billion. Net FPI flows are volatile in both directions. The rupee has depreciated by about 4.6% in the past year.

THE PINCER EFFECT

The 2026 stress has two arms.

Arm 1: Capital account weakness. Net FDI has collapsed despite gross FDI rising. The arithmetic difference is repatriation by foreign firms — exits by departing MNCs, profit repatriation, divestments — plus a surge in outward FDI by Indian companies (about $29 billion in FY25). The reasons are familiar — tariff uncertainty, tax disputes (the Vodafone retrospective amendment from 2012 remains a reference point), land and labour rigidities, and slow dispute resolution.

Arm 2: Oil shock. The West Asia crisis, with Brent at $90-plus, layers an additional $10-20 billion onto India's oil import bill. This widens the goods trade deficit and pressures the current account. By itself, this would be manageable. Combined with the capital account weakness, it produces stress.

The "pincer" frame matters because a CAD-only response (fiscal tightening, rate hikes) addresses only one arm and damages growth without solving the FDI problem.

COMPARING THE 2026 STRESS WITH PAST BOP EPISODES

The comparison clarifies the diagnosis.

YEAR	TRIGGER	CAD (% OF GDP)	RESERVES	INFLATION	RESPONSE
1991	Gulf War oil shock + fiscal deficit	~3%	2 weeks of imports	High	IMF bailout, liberalisation, rupee devaluation
2008	Lehman/global financial crisis	~2.4%	Adequate	Moderate	Monetary easing, fiscal stimulus
2013	Bernanke taper tantrum + oil	4.8%	~$275 billion	9-10%	Rate hikes, NRI deposit scheme, capital controls
2026	West Asia oil + capital account drying	~0.6%	~$700 billion	~4-5%	(Under discussion)

In 2013, the CAD was high, reserves were low, and inflation was double-digit. The natural response was monetary tightening and capital account restrictions. In 2026, the CAD is low, reserves are at a record, and inflation is contained. The same response would damage growth without addressing the underlying FDI problem.

THE RUPEE TRILEMMA

The rupee dynamics in 2026 reflect a classic open-economy trilemma — the impossibility of simultaneously achieving capital mobility, exchange-rate stability, and an independent monetary policy. India typically chooses capital mobility and independent monetary policy, allowing the rupee to depreciate gradually.

The RBI uses forex reserves to manage volatility — not to peg the rupee. With $700 billion in reserves, the buffer is more than adequate to smooth depreciation. The 4.6% depreciation from 84.6 to 88.5/USD over 2024-25 is well within historical norms.

Forex intervention should remain calibrated. The 2013 lesson — defending a specific exchange rate level depletes reserves and ultimately fails — should be remembered.

WHY NET FDI IS DECLINING

The decline in net FDI is structural, not cyclical. Five drivers are well-documented:

1. **High tariffs** — despite WTO commitments, India's average MFN tariffs have risen in recent years; this raises the landed cost of imports for export-oriented FDI.

2. **Tax uncertainty** — the legacy of the Vodafone retrospective amendment (2012) continues to shape investor perception. The 2021 abolition of retrospective amendments was a positive signal but the precedent remains a reference point.
3. **Land and labour rigidities** — the slow implementation of the four labour codes (2019-2020) and continued state-level variation in land acquisition have constrained large-scale industrial FDI.
4. **Slow dispute resolution** — commercial dispute resolution timelines remain among the longest in major economies.
5. **No single-window FDI clearance** — sectoral approvals, environmental clearances and state-level permissions add friction that competing destinations (Vietnam, Indonesia) have streamlined.

Sectoral liberalisation has continued. 100% FDI is permitted in most sectors via the automatic route; 74% for defence (raised in 2024 to include satellites); 49% for launch vehicles; and insurance was raised to 100% in Budget 2025. But sectoral opening without process simplification is producing diminishing returns.

STRATEGIC AUTONOMY IN EXTERNAL FINANCE

The Indian Express editorial warns against excessive dependence on any single geopolitical bloc in capital flows. The post-2022 environment has shown that US-dependent capital channels can be disrupted by sanctions, tariff disputes or political cycles.

The diversification strategy includes:

- **FTAs** — the UK FTA signed in 2025; the EU FTA under active negotiation with a target conclusion in 2026; further FTAs with GCC, ASEAN+ and Latin America in the pipeline.
- **INSTC and IMEC** — the International North-South Transport Corridor and the India-Middle East-Europe Economic Corridor as alternative trade and capital channels.
- **Global pension fund reform** — enabling longer-tenor inflows from sovereign wealth funds and global pension funds, which are less volatile than FPI.
- **Bilateral currency swap arrangements** — to reduce dollar-denomination risk on selected trade flows.

THE WAY FORWARD

The Indian Express editorial's prescription is structural rather than cyclical.

FDI-friendly reforms:

- Predictable tax regime (no retrospective amendments in spirit)
- Single-window FDI clearance

- Faster commercial dispute resolution
- Labour code implementation
- Land acquisition predictability

Macroeconomic management:

- Calibrated RBI rupee intervention
- Avoid premature fiscal tightening
- Avoid 2013-style capital controls

External-sector resilience:

- SPR build-out to 90-plus days of import cover
- INSTC and IMEC activation
- FTA conclusion with EU; deepening with UK
- PLI manufacturing to substitute imports
- Diversification of capital flow partners beyond US channels

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UPSC MAINS ANALYSIS

GS Paper 3 / GS Paper 2 — Economy, External Sector, International Relations

- **CAD (FY25):** ~0.6% of GDP.
- **Goods trade deficit (FY25):** -$280 billion.
- **Services surplus (FY25):** +$160 billion (IT, business services, GCCs).
- **Remittances (FY25):** +$135 billion (India world #1).
- **Gross FDI (FY25):** ~$81 billion (up 13.7% YoY).
- **Net FDI:** $28 billion (FY23) → ~$10 billion (FY24) → ~$0.96 billion (FY25) → ~$7.65 billion (FY26 per RBI release May 22, 2026) — FY25 marked a 96% fall from FY23; FY26 partial recovery but repatriation still elevated at $53.58 billion.
- **Net FPI:** ±$20 billion, volatile.
- **Forex reserves (May 2026):** ~$700 billion.
- **Rupee:** 84.6/USD (2024) → 88.5/USD (2025) — ~4.6% depreciation.
- **IMF April 2026 WEO India ranking:** 6th nominal at $4.15 trillion (slipped from projected 4th).
- **Past BoP crises:** 1991 (IMF bailout), 2008 (Lehman), 2013 (Fragile Five with CAD 4.8%).
- **FDI policy:** 100% automatic route in most sectors; 74% defence; 49% launch vehicles; 100% insurance in Budget 2025.

- **Vodafone retrospective amendment:** 2012; abolished 2021.
- **FTAs:** UK signed 2025; EU under active negotiation, target conclusion 2026.
- **Trilemma:** capital mobility + exchange rate stability + monetary independence — pick two.
- **Sovereign credit:** India retains investment-grade rating.

Mains Questions:

1. "India's 2026 BoP challenge is a capital account problem, not a current account problem." Examine.
2. Discuss the structural drivers of declining net FDI in India and the policy levers to reverse the trend.
3. Compare the 2013 Fragile Five episode with India's 2026 external-sector stress, and identify the differences in appropriate policy response.
4. Evaluate the role of FTAs, INSTC and IMEC in diversifying India's capital flow partners.

Keywords: Balance of payments, current account, capital account, net FDI, FPI, gross vs net FDI, repatriation, services surplus, remittances, forex reserves, rupee depreciation, trilemma, Fragile Five, 1991 crisis, 2008 crisis, 2013 taper tantrum, IMF April 2026 WEO, $4.15 trillion, Vodafone retrospective amendment, single-window FDI, labour codes, FTAs, UK FTA 2025, EU FTA 2026, INSTC, IMEC, SPR, PLI manufacturing.

> *The deeper lesson of the 2026 BoP stress is that diagnosis matters. A country that mistakes a capital account problem for a current account problem will reach for the wrong instruments — rate hikes that damage growth, capital controls that frighten investors, fiscal tightening that compresses demand — without addressing the underlying driver. India's external sector in 2026 is not the external sector of 1991, 2008 or 2013. The CAD is comfortable. The reserves are abundant. The inflation is contained. What is fragile is the capital account, and what fixes the capital account is structural reform — tax predictability, single-window clearance, faster dispute resolution, deeper FTAs, more diversified capital partners. The crisis architecture of an earlier era will not solve a different crisis. The work of 2026 is to read the BoP correctly, and then to respond accordingly.*

Sources: Indian Express , RBI

KEY ARGUMENTS AT A GLANCE

Indian Express argues that India's emerging balance-of-payments stress is structurally different from past episodes because it is being driven not by an unsustainable current account deficit but by a collapse in net Foreign Direct Investment, with the West Asia conflict producing a "pincer effect" of higher oil prices and weaker

capital flows; the response must be FDI-friendly structural reforms, calibrated rupee management and avoidance of premature fiscal tightening, while warning against excessive dependence on any single geopolitical bloc.

- India's FY25 external accounts show a modest current account deficit of around 0.6% of GDP, a goods trade deficit of about $280 billion, a services surplus of about $160 billion driven by IT, business services and Global Capability Centres, record remittance inflows of about $135 billion (India is the world's largest recipient) and forex reserves of around $700 billion in May 2026 — the current account is not the problem.
- Net FDI inflows have collapsed from about $28 billion in FY23 to about $10 billion in FY24 and just $0.96 billion in FY25 — a 96% fall — even as gross FDI rose to $81 billion in FY25, meaning repatriation by foreign firms and outward investment by Indian companies have surged; net FPI flows remain volatile at plus-or-minus $20 billion; and the West Asia crisis layers an additional $10-20 billion oil-import bill at $90-plus Brent, widening the trade deficit.
- The comparison with 2013 is instructive but limited — 2013 had a CAD of 4.8% of GDP, low reserves and high inflation; 2026 has a CAD of around 0.6%, record reserves of $700 billion, contained inflation, but a capital account that is drying; the rupee has slid from 84.6/USD (2024) to 88.5/USD (2025), a depreciation of about 4.6%; and the IMF April 2026 WEO has ranked India 6th nominally at $4.15 trillion, slipping from a projected 4th.
- The structural drivers of declining net FDI are well-known — high tariffs despite WTO commitments, tax uncertainty (the legacy of the Vodafone retrospective amendment), land and labour rigidities, slow dispute resolution, and the absence of a single-window clearance for FDI; sectoral liberalisation has continued — 100% FDI in most sectors via the automatic route, 74% for defence, 49% for launch vehicles, and insurance increased to 100% in Budget 2025 — but the macro signal has weakened.

A counter-reading holds that the FDI decline is cyclical rather than structural — that gross FDI remains healthy, that GCC and services inflows are at record levels, that India's $700 billion reserve buffer is more than adequate to manage any short-term capital-account stress, and that the West Asia oil shock will moderate as Hormuz tensions ease. This view risks under-pricing the long-term cost of weakening manufacturing competitiveness and the structural drift toward services-only growth.

→ **WAY FORWARD**

Deliver FDI-friendly structural reforms — predictable tax regime, single- window FDI clearance, faster dispute resolution; manage the rupee through calibrated RBI intervention rather than premature fiscal tightening or capital controls; diversify capital flow partners beyond US-dependent channels; deepen FTAs — the UK FTA signed 2025, the EU FTA in active negotiation with target conclusion in 2026; scale PLI manufacturing to substitute imports; build SPR to 90-plus days; activate INSTC and IMEC for trade diversification; and allow longer-tenor inflows through global pension fund reform.

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MAINS ANSWER FRAMEWORK

QUESTION

"India's 2026 balance-of-payments stress is structurally different from the 1991, 2008 and 2013 episodes — it is driven by the capital account, not the current account." Examine this proposition with reference to FDI trends, the West Asia oil shock and India's reform options. (250 words)

INTRODUCTION

Indian Express argues that India's 2026 balance-of-payments stress is structurally different from past episodes because it is being driven not by an unsustainable current account deficit but by a collapse in net Foreign Direct Investment, with the West Asia conflict producing a pincer effect of higher oil prices and weaker capital flows.

BODY

India's FY25 external accounts show a modest current account deficit of around 0.6% of GDP, a goods trade deficit of about $280 billion, a services surplus of about $160 billion driven by IT, business services and GCCs, record remittance inflows of about $135 billion (India is the world's largest recipient), and forex reserves of around $700 billion in May 2026. The current account is not the problem.
The capital account is. Net FDI inflows have collapsed from about $28 billion in FY23 to about $10 billion in FY24 and just $0.96 billion in FY25 — a 96% fall — even as gross FDI rose to $81 billion in FY25; net FPI flows remain volatile at plus-or-minus $20 billion; and the West Asia crisis layers an additional $10-20 billion oil-import bill at $90-plus Brent.

The comparison with past BoP episodes is instructive. 1991 saw gold pledged and an IMF bailout with reserves at two weeks of imports; 2008 saw Lehman-driven capital outflows; 2013 saw the Fragile Five tag with a CAD of 4.8% of GDP; 2026 has a CAD of around 0.6%, record reserves of $700 billion, contained inflation, but a capital account that is drying. The rupee has slid from 84.6/USD (2024) to 88.5/USD (2025), a 4.6% depreciation, and the IMF April 2026 WEO has ranked India 6th nominally at $4.15 trillion, slipping from a projected 4th.

The structural drivers of declining net FDI — high tariffs despite WTO commitments, tax uncertainty (the Vodafone legacy), land and labour rigidities, slow dispute resolution — are policy choices, not external shocks. Sectoral liberalisation has continued — 100% FDI in most sectors via the automatic route, 74% for defence, 49% for launch vehicles, insurance increased to 100% in Budget 2025 — but the macro signal has weakened.

CONCLUSION

The way forward is FDI-friendly structural reforms — predictable tax regime, single-window FDI clearance, faster dispute resolution; calibrated RBI rupee management rather than premature fiscal tightening or capital controls; diversification of capital flow partners beyond US-dependent channels; deeper FTAs (UK signed 2025, EU under active negotiation with 2026 target); PLI manufacturing to substitute imports; SPR build-out to 90-plus days; activation of INSTC and IMEC for trade diversification; and global pension fund reform to allow longer-tenor inflows. India's BoP challenge will not be solved by cyclical management — it will be solved by structural reform.

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