Perils of Borrowed Prosperity

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The continuing depreciation of the rupee and widening external deficit seems to have at last forced the Finance Minister and the RBI to wake up to the dangers confronting the Indian economy. However, the steps recently announced by Mr. Chidambaram in the parliament along with his projections not only betray a degree of complacency but are also incongruous with the economic realities of the day.

India's current account deficit – the excess of imports of goods and services over exports, factor incomes and transfers from overseas – reached its historic peak at $88 billion in 2012-13, amounting to 4.8% of its GDP. This made India the country with the second highest external deficit in the world, after the United States. The US can afford to run very high levels of external deficit because of its hegemonic position in the world economy. Its currency, the dollar, is globally considered to be the reserve currency by sovereigns and private wealthholders alike. For developing countries like India, running high levels of external deficit inevitably leads to dwindling confidence in their currencies and capital flight. That is precisely what we have witnessed over the past two years; the rupee which was trading at around 45 per dollar till August 2011, fell to Rs. 55 per dollar by August 2012 and has further slided to its historic low of Rs. 61 per dollar in July-August 2013.

Many other 'emerging' economies have also experienced currency depreciations in recent times, after the US Fed Chairman indicated in May 2013 that the easy money policy in place since the 2008 financial crash will start tapering soon, leading to a flight of capital towards the US. It is noteworthy that the largest capital flights and currency depreciations have been experienced by those 'emerging' economies like Brazil, India, South Africa, Turkey and Indonesia, which have significant external deficits. India's currency depreciation since May 2013 has been the sharpest, after Brazil. Net outflows from India on account of FIIs – particularly from the debt segment – have been to the tune of over $12 billion between end-May and mid-August 2013.

It is in this backdrop that the Finance Minister and the RBI have unfolded their external rebalancing strategy. The official policy mix has two components: (a) compressing import of gold, silver, oil and other 'non-essential' items by increasing customs duties (b) attracting more capital inflows by raising interest rates and liberalizing the norms for external borrowing. With these steps Mr. Chidambaram expects to restrict the current account deficit for the present financial year to $70 billion and attract sufficient capital inflows to finance the deficit and also marginally add to the foreign exchange reserves.

While the economic logic behind the first component of Mr. Chidambaram's strategy as a short-term measure is unexceptionable, the 2% hike in import duties on gold and other precious metals is too frail to solve the structural problems underlying the high current account deficit. For instance, the demand for gold in India has risen significantly over the past few years because wealthholders are preferring gold to other assets in an inflationary and uncertain environment. Unless the speculative appetite for gold is addressed domestically through steps to curb inflation and

channelize domestic savings into productive investment avenues, piecemeal hikes in import duties will fail to rein in gold imports, as has been the case so far.

The structural problems with the Indian economy arise out of the skewed pattern of consumption, investment and economic growth which has led to growing concentration of income and wealth. That is why the growth process, rather than spurring domestic investment and mass consumption, has led to an increase in the import intensity of domestic production and consumption, leading to the burgeoning import demand for commodities like oil and gold. To make matters worse, India's export performance has been nowhere compared to China or the ASEAN countries. The only two major foreign exchange earners for India have been software services exports and private transfers in the form of remittances. These sectors too have failed to compensate for the widening trade deficit in recent times, owing to weak global demand.

It is clear from the Finance Minister's pronouncements that he is oblivious to these structural aspects underlying India's external deficit. He seems to believe that the current account deficit can be contained by minor tinkering with customs duties, or perhaps that the economic slowdown would itself squeeze import demand and narrow the deficit; the main policy challenge is only to ensure adequate financing of the deficit by attracting capital inflows. Consequently, interest rates have been hiked and external borrowing norms further liberalized. But this is precisely where Mr. Chidambaram is treading choppy waters.

Financing the current account deficit by attracting more debt-creating capital inflows will only imply growing external indebtedness for the Indian economy. In fact, India's stock of external debt which stood at $306 billion at end-March 2011 (17.5% of GDP) has already risen quite significantly to $390 billion by end-March 2013 (21.2% of GDP). The proportion of short-term debt in total external debt has also risen, with the ratio of short-term debt (residual maturity) to foreign exchange reserves increasing sharply from 42% in March 2011 to 59% in March 2013. Short-term debt is a volatile component whose flows are subject to sudden reversals. The rise in the proportion of short-term debt signifies an increase in India's external vulnerability, which can result in a painful denouement.

As per IMF's projections, India will need over $266 billion external financing in 2013 to pay for its current account deficit and repay past debt. This is the highest gross external financing requirement for any 'emerging' or major developing country. Although the experiences of the South East Asian and Latin American economies over the past two decades have repeatedly shown the perils of relying on such borrowed prosperity, the Finance Minister - like the Bourbons - seems to have learnt nothing and forgotten nothing.

The RBI often reiterates its preference for stable and non-debt creating capital inflows to finance the external deficit. Despite such a stated policy stance, however, debt and FII inflows have dominated capital inflows into India over the past decade. FDI inflows have on average been only around 35% of net annual capital inflows and much of that was in the form of short-term private equity. Moreover, while the aggregate net FDI inflows into India between 2000-01 and 2011-12 was around $225 billion, net FDI outflow by Indians during the same period was almost half that amount at $110 billion. The short point is that once the economy gets drawn into the

vortex of global finance, it becomes very difficult for policymakers to regulate the quality and quantity of capital flows. Rather, it is policy which has to keep adjusting to the vagaries of finance; especially for neoliberal regimes like India's, whose entire legitimacy is staked on economic growth based on short-lived asset price bubbles and debt-financed consumption of the elites.

The state of the Indian economy today reflects that predicament. Continuing on the present trajectory on the one hand will continue to augment the external deficit and indebtedness, which is clearly unsustainable. A reduction in external deficit and indebtedness on the other hand, will necessitate a break from the present growth trajectory. Perhaps, the ideological predilection of the Finance Minister is coming in the way of acknowledging the gravity of the situation and making the hard choices. What he needs to do is to: (a) utilise the entire policy space available for import tariff hikes on non-essential commodities to shift the trajectory of consumption and investment towards a less import-intensive path and (b) impose strong and effective controls on the inflows and outflows of capital. Such a course would of course require courage to stand firm in the face of blackmailing by the speculative players in the market.

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