India's Rich are the Problem

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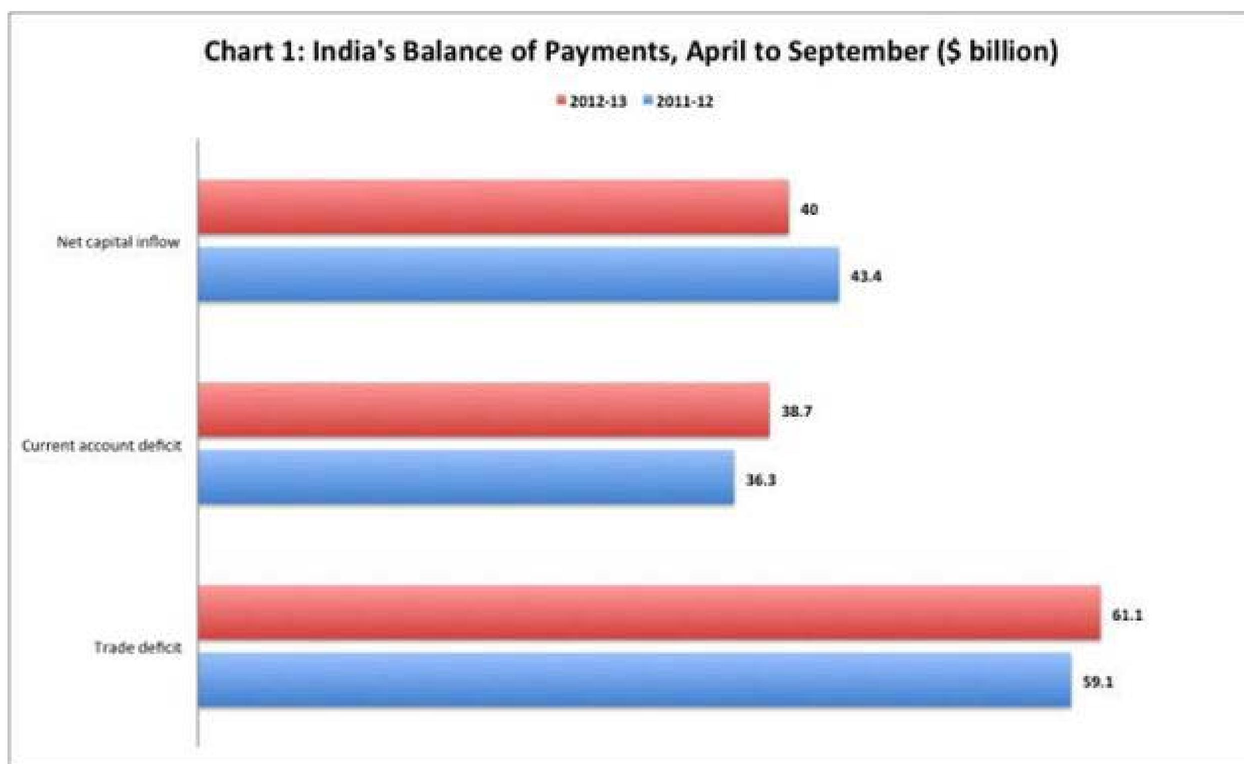
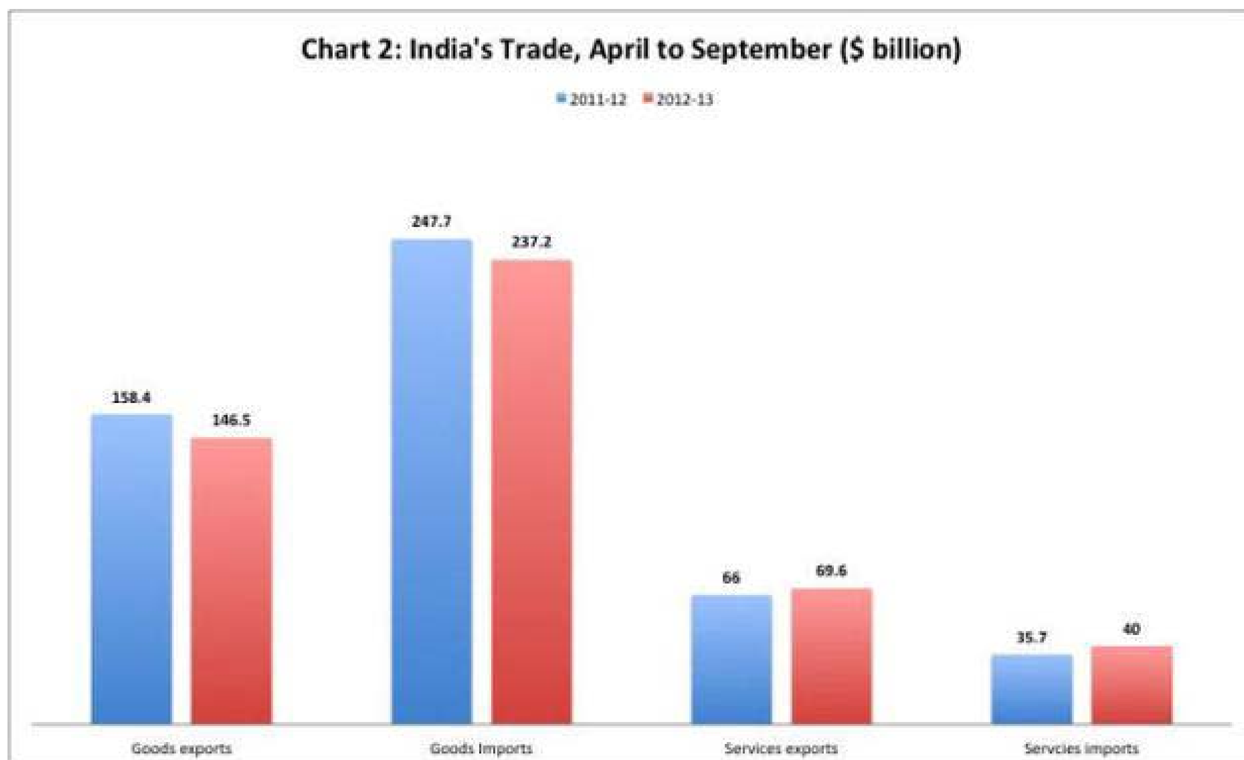
Even as the Reserve Bank of India (RBI) frets over the high rate of inflation and wards off pressures to cut interest rates, it is faced with another challenge. Balance of payments data for the second quarter of 2012-13 show that the current account deficit continues to rise, and has touched a record 5.4 per cent of GDP. Both of these developments that would be considered signs of "overheating" occur at a time when growth is slowing.

However, the high current account deficit to GDP ratio is not merely because the denominator – GDP - is lower than expected because of slower growth. It also reflects certain structural problems characterising the numerator- the current account deficit-which prevent its contraction when the economy grows more slowly.



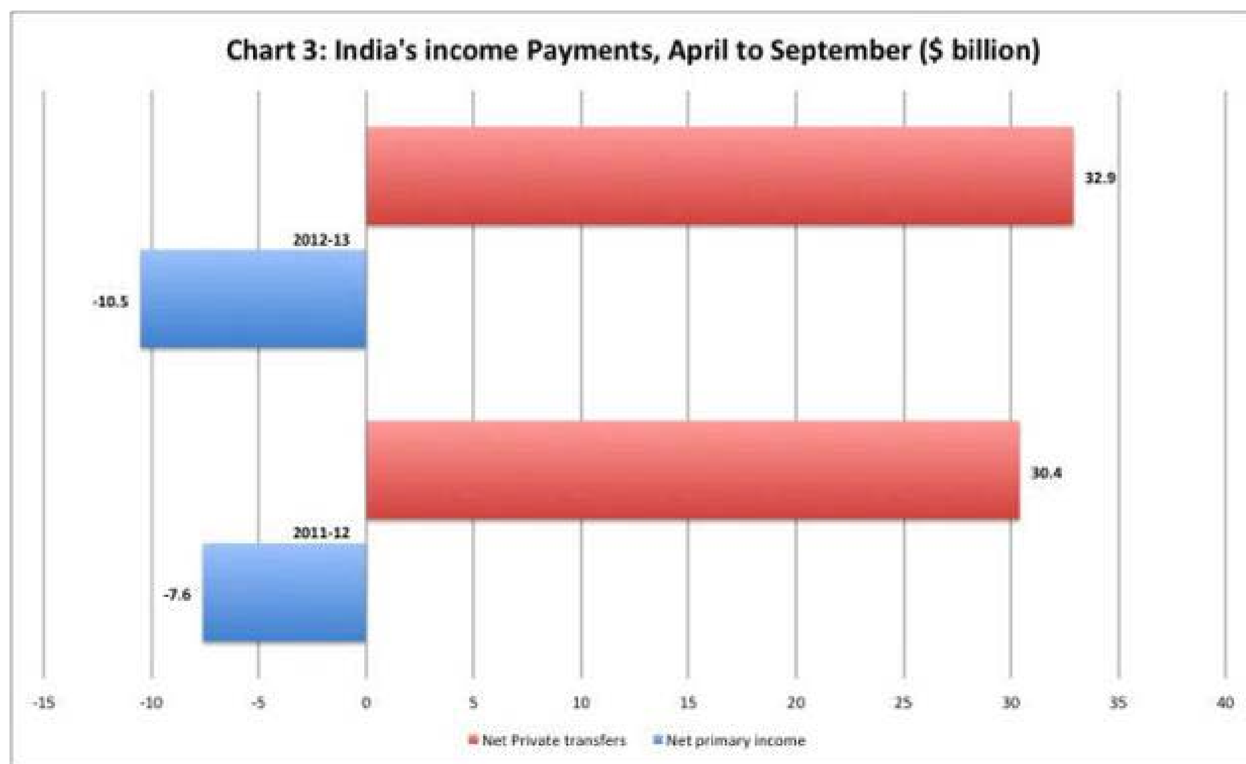
Consider figures for the first half of this financial year relative to the corresponding period of the previous year. As Chart 1 shows, the current account deficit is higher this year when compared to the previous one partly because the trade deficit has risen from $59.1 billion to $61.1 billion despite slowing growth. This has meant that despite absolutely large net capital inflows into the country, of as much as $40 billion over the first six months of this fiscal, India is just able to finance its current account deficit. The period when a large share of capital inflows went to buttress India's foreign exchange reserves seems to be over. In fact, if inflows shrink or the deficit widens, the rupee would be under much pressure.



This raises the question as to why the trade deficit remains high. One reason, emphasised by the government, is that exports, especially to Europe, have been adversely affected by the global recession. As Chart 2 indicates, goods exports over the first six months of this fiscal year have fallen with respect to the last and the increase in services exports has been inadequate to neutralise that fall. But this is not the only problem. While India's exports are sensitive to global income declines, India's imports have been less responsive to the slowdown in income growth. It is well known that two items of imports have played an important role in keeping India's import bill high- oil and gold. In the case of both these commodities, prices have declined in international markets during the period in question. However, in the case of oil the quantum of imports has increased to push up the import bill. And in the case of gold, though the decrease in the import bill is a noticeable 13.7 per cent, high growth rates and levels in the past have ensured that the outgo on this account has remained high.

In sum, the import bills on account of both oil and gold do not seem to fall much despite rising prices and slowing GDP growth. A feature of both these commodities, especially gold, is that it is the rich that largely account for the growth in their demand. Over the year ended September 2011, demand for gold in India was 1059 tonnes, as compared with 214 tonnes in the US and 770 tonnes in China, whereas per capita income in the three countries stood at $1,410, $48,620, and $4,940 respectively. The "average" Indian could not be responsible for such "excess demand" for gold. It is the rich who are clearly responsible. The incomes of the rich are not affected as much by the slowdown. And, the demands of the rich are relatively inelastic or non-responsive with respect to price changes. This structural feature influencing India's import bill is what accounts for the asymmetry in the response of exports and imports to world and domestic incomes respectively. What is needed is an effort at curbing such elite consumption. While this

may be difficult to implement through physical controls in the case of oil, it can easily be done in the case of gold.



With the government failing to do so, the balance in the trade in goods and services has turned increasingly negative. But that is not all. Corporate India, which has been borrowing heavily from international markets to exploit the lower interest rates prevailing there, has also begun tapping the nation's foreign exchange earnings to meet its foreign debt service commitments. As the RBI's Bulletin for March 2013 notes: "Net outflow on account of primary income not only continued in Q2 of 2012-13 but also showed an uptrend mainly on account of higher interest payments under external commercial borrowings (ECBs) and FII investments in debt securities." In the event, despite increase remittance receipts from Indian workers abroad (Chart 3), there has been a decline in net receipts from income payments.

The consequence of all of this is a worsening of the current account deficit, which the RBI sees as having entered the danger zone. Addressing this requires reining in the import bill, which in turn requires curbing elite consumption. India's rich are the real problem.

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