The Discreet Charms of Controlling Imports

Jayati Ghosh

Now that the balance of payments crisis has clearly set in for the Indian economy, all sorts of proposals for emergency measures fill the air. A panic-stricken government has been throwing what it can at the problem – to little avail, since each hurriedly announced measure seems to be followed by further capital outflow and further depreciation of the rupee. But given the loss of policy imagination that comes after two decades of manifestly open market policies, that is perhaps not so surprising.

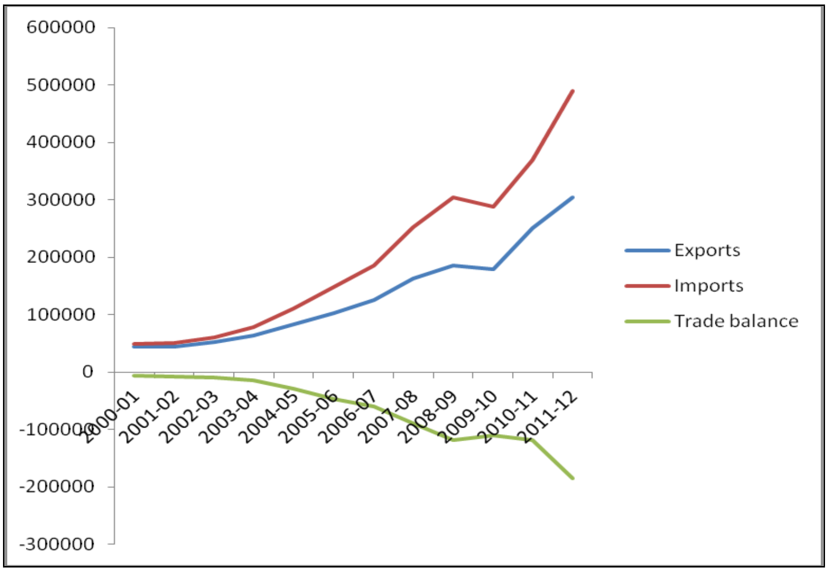
There are at least four problems with the nature of the central government's economic responses to the current crisis. The first is the tendency in official circles to blame most of the problem on external forces, rather than on the internal mess of the large imbalances within the economy and the lack of sustainability of private sector expansion in particular. Government representatives regularly appear before the public to blame everything on Mr Bernanke of the US Federal Reserve for threatening to raise US interest rates, or on the global economic slowdown for causing our exports to decelerate. But the truth is that our recent boom was a bubble waiting to burst – the external forces have influenced the timing rather than the unfolding of the process.

The second problem is the inability to recognise what should be obvious: that a crisis associated with hot money flows cannot be resolved by begging for further hot money flows. It should have been evident that running large and growing current account deficits financed with essentially short-term capital flows could never be a sustained strategy, and essentially characterised a temporary bubble that is now bursting. Instead of dealing with the source of the problem, the government is desperately trying to stem the crisis by somehow attracting the same capital back in by offering yet more concessions. But such concessions can never be enough to compensate for expected capital losses, if expectations of the value of the rupee and other domestic assets like stocks are on the downswing.

The third problem is that the responses look too much like what they are: nervous and jerky responses that try to apply quick-fix bandages without being part of a cohesive medium term economic strategy. So various different measures are tried out: rules for foreign direct investment are further liberalised; new bond issues are launched for NRI Indian investors; PSUs are encouraged (even pushed) to engage in more external commercial borrowing, even when this may turn out to be very costly for the country later; there is a bit of half-hearted intervention in the foreign exchange market by the RBI; gold import duties are raised slightly (though they are still far too low). None of this adds up to a clear plan that is likely to instil confidence – not just in the rupee, but in the wisdom of those at the helm of affairs, and therefore the economic future of the country.

The fourth, and possibly most significant, problem stems from the refusal to look seriously at the necessary counterpart of the capital inflows that were so celebrated during the boom years: the current account deficit. The true source of India's current balance of payments concerns is the burgeoning trade deficit, which has now turned so large that the current account deficit also could not be kept in check even with the largest inflows of workers' remittances in the world. And the critical matter with respect to the trade deficit is not simply the slowing down of exports, but the fact that imports have continued to increase even as the Indian economy slowed down.

The chart provides a look at the behaviour of the trade balance in the past decade (in US $ mn) and shows how imports ballooned after 2006-07 and particularly since the minor blip caused in 2009-10 by the global financial crisis.



Indeed, data from the first few months of the current fiscal year indicate that this pattern has broadly continued. While both exports and imports dipped in July, over the period April-July 2013 exports (in US dollar terms) increased by only 1.7 per cent while imports increased by 2.8 per cent. This cannot be ascribed only to high oil prices, since non-oil imports increased by 2.9 per cent. As a result, the trade deficit over this period was 8.4 per cent higher than in the same months in the previous year, despite a nominal rupee depreciation of nearly 20 per cent in the intervening period.

Just recognising this makes it quite evident what the crisis resolution must necessarily entail: systematic steps to reduce the import bill. Indeed, this is not only a temporary emergency measure, since it has implications for the pattern of output, employment growth in the economy as a whole. But how exactly is this to be done?

One obvious offender is gold imports, which currently account for nearly one-fifth of the total import bill, second only to oil imports (around one-third). Clearly, these levels of gold imports are unjustifiable and must be curbed. But given the inelastic nature of gold demand in India generally and particularly now in a time of economic uncertainty when it is still seen as a safe asset relative to volatile financial assets, small hikes in import duties are unlikely to do the trick. Much larger increases are called for, combined with much more stringent measures to clamp down on gold smuggling.

But this constitutes only part of the problem. There has been a huge increase not just in other "non-essential" imports, but in imports that have dramatically attacked the productive capacities of the country and wiped out lots of employment. Since 1991 and over the past decade in particular, the nature of economic expansion in India has systematically eroded the capacities and competitiveness of huge swathes of producers in agriculture and manufacturing.

Small and medium producers coping with terrible infrastructure, erratic provision of basic utilities, next to no access to affordable institutional credit and constantly rising prices of fuel (the basic intermediate good that enters into all costs) have been forced to compete with global production. In many cases they have been unable to do so, to the point that many have been decimated and others survive only by the skin of their teeth. Informal enterprises (which still account for the bulk of national output) have been the worst hit by the rising tide of imports, which has adversely affected both employment and livelihoods.

As a result, many commodities that were previously produced in India have simply disappeared from markets in the country, to be replaced with imports coming not just from China but many other parts of the world. Of course it is well known that toys, decorations and similar things increasingly come from China, and electronic goods from various parts of Asia. The shopping malls sell garments made in Guatemala and Morocco even though similar garments are made in India; builders use marble from Italy rather the stuff sold by small processors in Rajasthan and elsewhere; imports have replaced domestic production in the urban markets for many fairly standard goods that are very much part of mass consumption like pens, soaps, household goods and so on.

Of course all of this translates into employment losses. But it has possibly even more deadly implications for the future. The loss of some productive capacity does not just affect the producers involved in it: it means a social loss of knowledge, production capability and synergies that are absolutely necessary to build up manufacturing prowess. And surely by now it should have been understood that building up such manufacturing capability is essential, that India cannot simply leapfrog over to the next stage of service-led growth without first doing the hard work of industrialisation? The mindless pattern of import liberalisation has occurred without ensuring that Indian manufacturing producers have at least something like a level playing field in terms of access to infrastructure, credit and the like. Not surprisingly, they have suffered losses in terms of productive potential that may take years to reverse.

Similarly, the country is importing agricultural goods that it really need not do. This is certainly so for cereals and cereal products, where the imports indicate the poor management of the food economy in a sector in which the country should have a competitive advantage. In addition, the continuing import of pulses and oilseeds is a sad comment on the failure of agricultural strategy that has not addressed issues of viability of such production despite decades of government-sponsored “Missions”.

Obviously much more public investment in these basics like infrastructure and access to credit is required to move forward. But in the intervening period, some protection from imports is clearly necessary. India’s current tariff levels for most commodities are well below the tariff bindings declared at the WTO, and in any case the government could probably take advantage of the balance of payments exceptions in the current situation. But the noodle bowl of FTAs that India has signed with ASEAN and other trading partners create other constraints to import protection that need to be examined carefully.

What all this suggests is that, while the external sector is currently the weak link that has brought on the current crisis, it is precisely that – a link in a chain of economic policy that needs major reworking. Resolution of the crisis will not come from temporary measures to paper over the cracks and then hoping to proceed with business as usual. Current account balancing must be an essential focus – and if it can happen with the added advantage of reviving some domestic production, surely that is so much the better.

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