Addressing India's External Vulnerability

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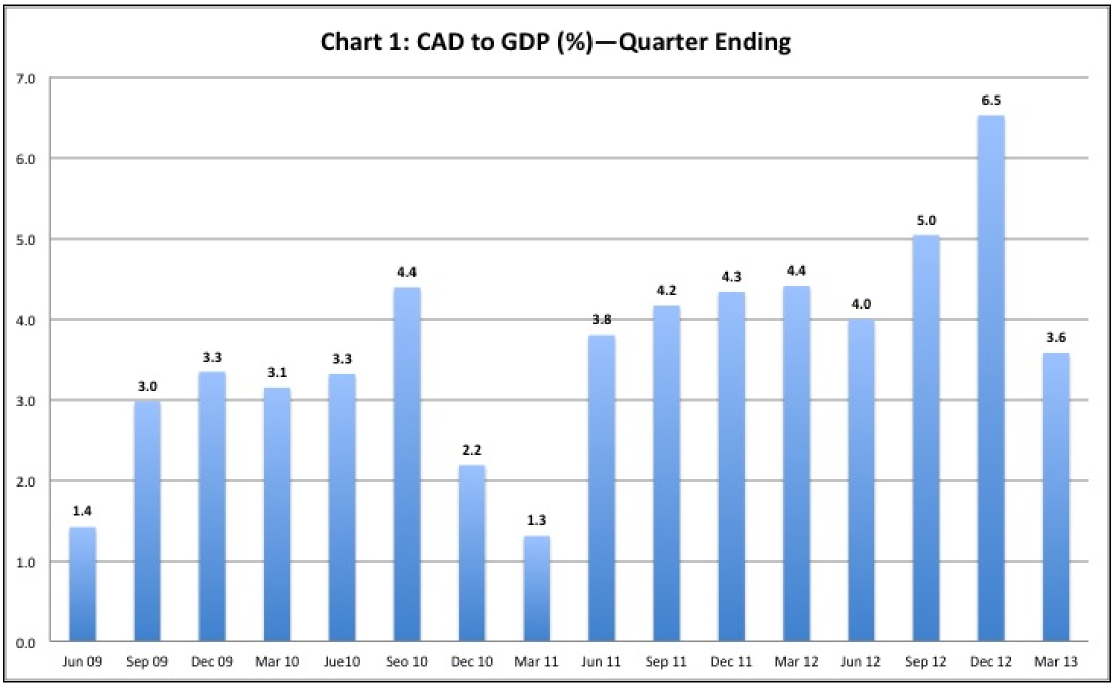
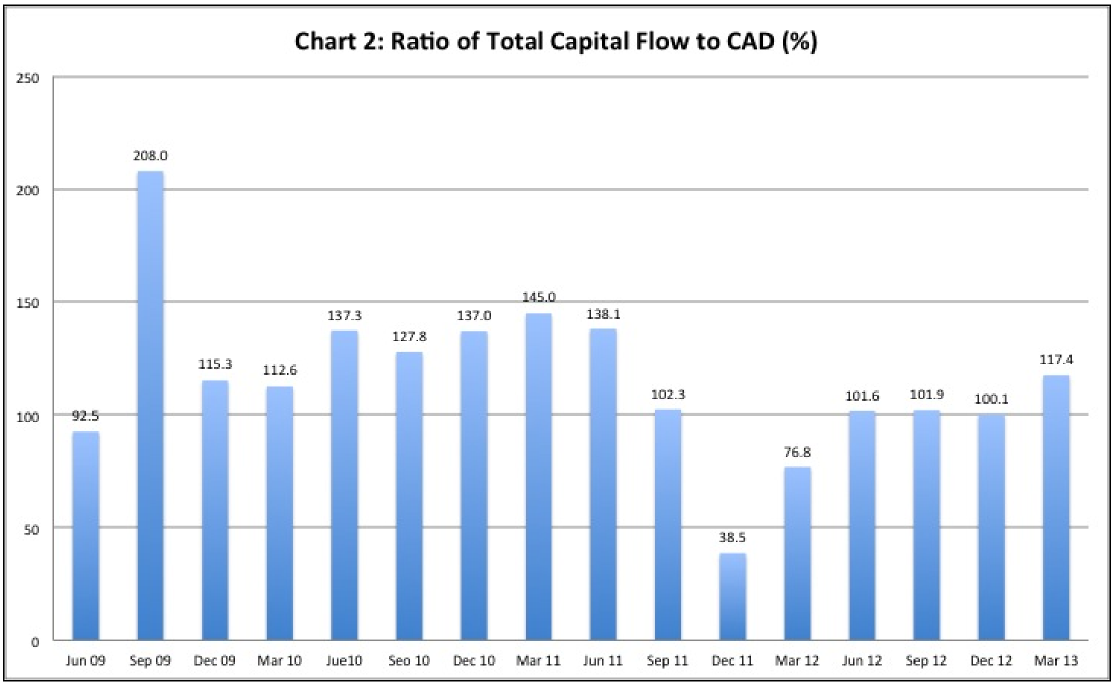
As the government gets down to addressing the economic difficulties India faces, its attention cannot but focus on the current account deficit (CAD)—the excess of foreign exchange expenditure relative to forex earnings and receipts such as remittances. It is that deficit that is the 'fundamental' that underlies the rupee's weakness and triggers collateral effects that threaten much damage. Over recent quarters (Chart 1) the deficit has not just been high but also rising relative to GDP, reaching a record of well above 6 per cent in the last quarter of calendar year 2012. Moreover, it is well above the 2.5 to 3 per cent of GDP the government believe can be financed with 'normal' capital inflows.



One consequence of this rising deficit has been that capital inflows of all kinds that are still substantial now seem less abundant when compared to the deficit they have to finance. If in the past such flows were well above current account financing needs, they are now just about adequate to cover that deficit. This implies that India's direct dependence on such inflows has risen, and the country cannot do without them. And if there is anything that contributes to widening the deficit or reducing the volume of capital inflows, the country will have to start eating into the reserves on which foreign investors have a claim. This is because not only did India 'borrow' from abroad to cover the current account deficit, but also to build its reserves. To that extent these reserves are less of a source of strength than they seem or have been made out to be.

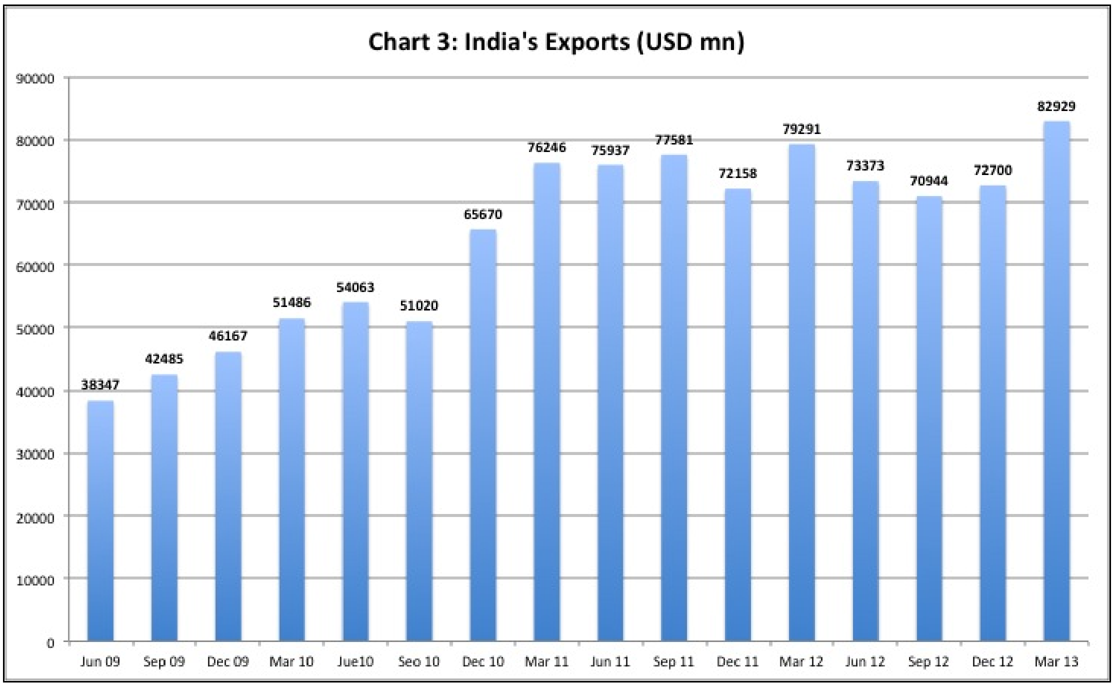
So a long-term solution to the problem cannot be one of borrowing more (through state guaranteed foreign debt incurred by public sector companies for example) or of wooing foreign investors and attracting more foreign capital. That would only increase the stock of legacy capital that has the right to exit, increasing vulnerability rather than reducing it. The latter requires reducing the current account deficit.

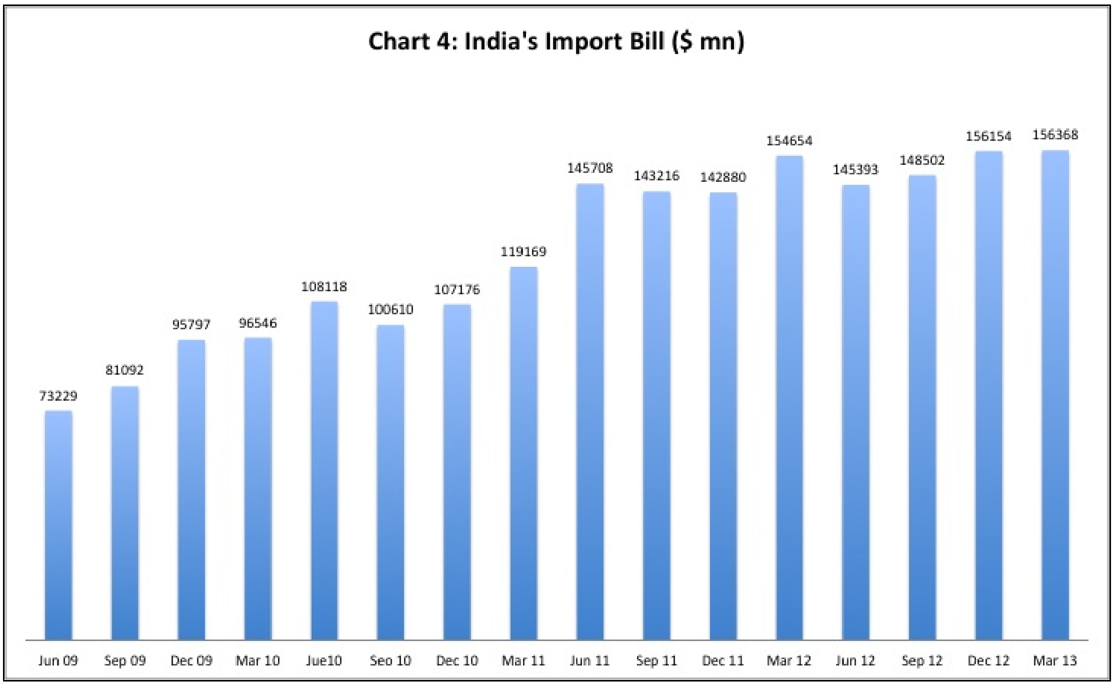


To understand what that would take, it would be useful to breakdown the CAD. Such an exercise is revealing. To start with, the current account deficit is overwhelmingly on account of the deficit in the trade in goods. While the trade in services delivered for India a surplus in all quarters from the one ending June 2009 to that ending March 2013, the deficit on account of goods has risen from Rs.26.4 billion in quarter ending June 2009 to Rs. 44.9 billion in the quarter ending June 2011, and then remained above that level in all but one of the subsequent quarters. What is more it spiked to touch Rs. 51.6 billion in the three months edning March 2012 and Rs.58.4 billion in the quarter ending December 2012. The net result has been that, despite relatively steady net services export earnings in the Rs.15-17 billion range in most recent quarters, the overall deficit was high and often rising.

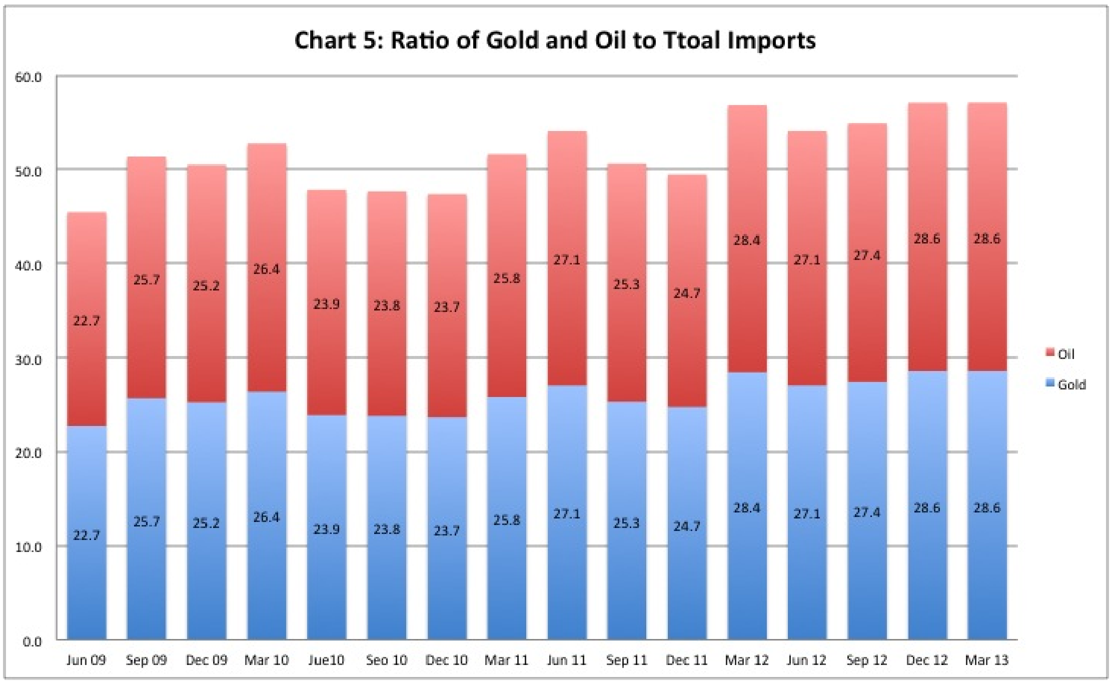
So the problem lies with the trade deficit. There are two sides to that deficit, and both have played a role, though imports have been more responsible for the higher CAD and the new challenges it poses. India's exports in dollar terms rose quite sharply in the aftermath of the crisis from April 2009 to March 2011, and more or less stagnated after that (Chart 3). However, while exports have not been booming, they have not shrunk either. Add on the slow depreciation of India's rupee and in local currency terms things would have even been a bit better. That is perhaps as much as can be expected when the world economy is in the midst of a recession. The problem therefore must lie with imports.

Imports too rose sharply after April 2009 and have continued to rise over the last two years, though at a slower pace (Chart 4). If anything is to be done to reduce external vulnerability, intervention must directed at this source. Digging deeper, it emerges that two sets of commodities—gold and petroleum and petroleum products, accounted almost equally for between 45 and 55 per cent of the merchandise trade deficit in most quarters (Chart 5). Petroleum imports are difficult to curtail, but gold imports can be easily reined in. A sharp reduction in gold imports is what the government needs to aim for. And if recent experience is any guide raising duties on gold imports does not seem to help much. In fact it seems to increase imports by those speculating that duties would rise even more. Stringent quantitative restrictions on the volume of permitted gold imports are a must.





The government should even go further. To make up for the fact that rationing petrol is difficult and petroleum prices may rise further because of geopolitical uncertainties, it must for balance of payments reasons aim to curb non-essential imports other than gold as well. Here too, given the inelasticity of demand with respect to prices, what is required are quantiative restrictions. That would partly take India back to the days when import controls were the norm. Given the influence of neoliberal thinking and of international capital such a shift would be difficult. But the numbers suggest that is the way to go. In the process Indian industry would receive a much needed spur and the problem of slowing growth may also be addressed.



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