Disquieting Imbalance

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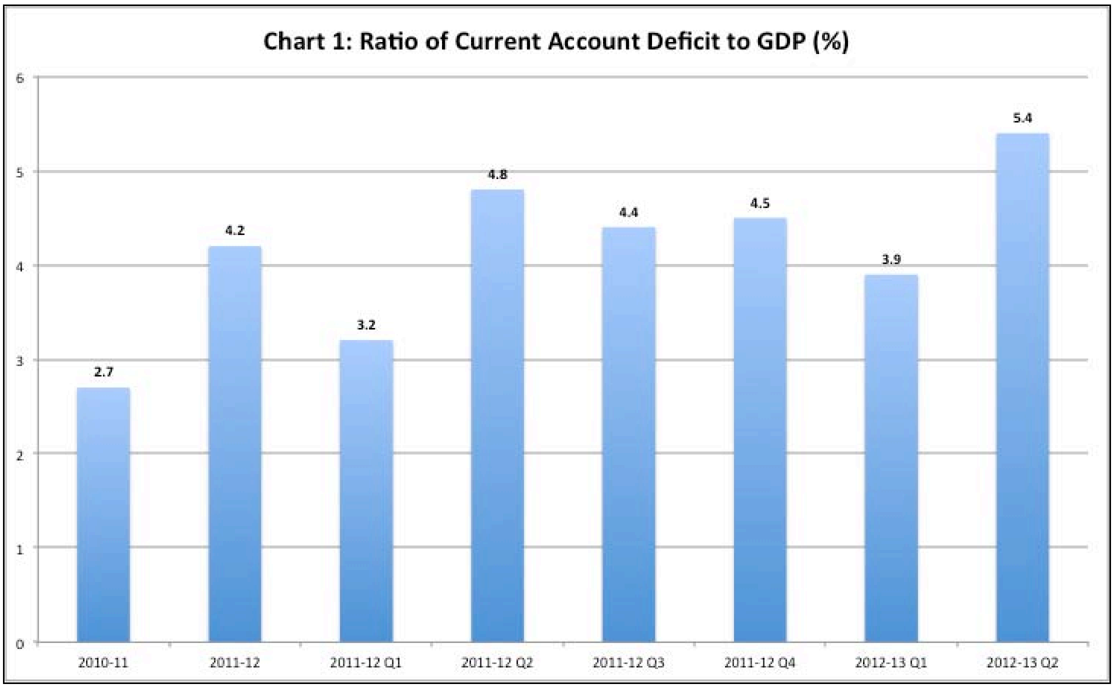
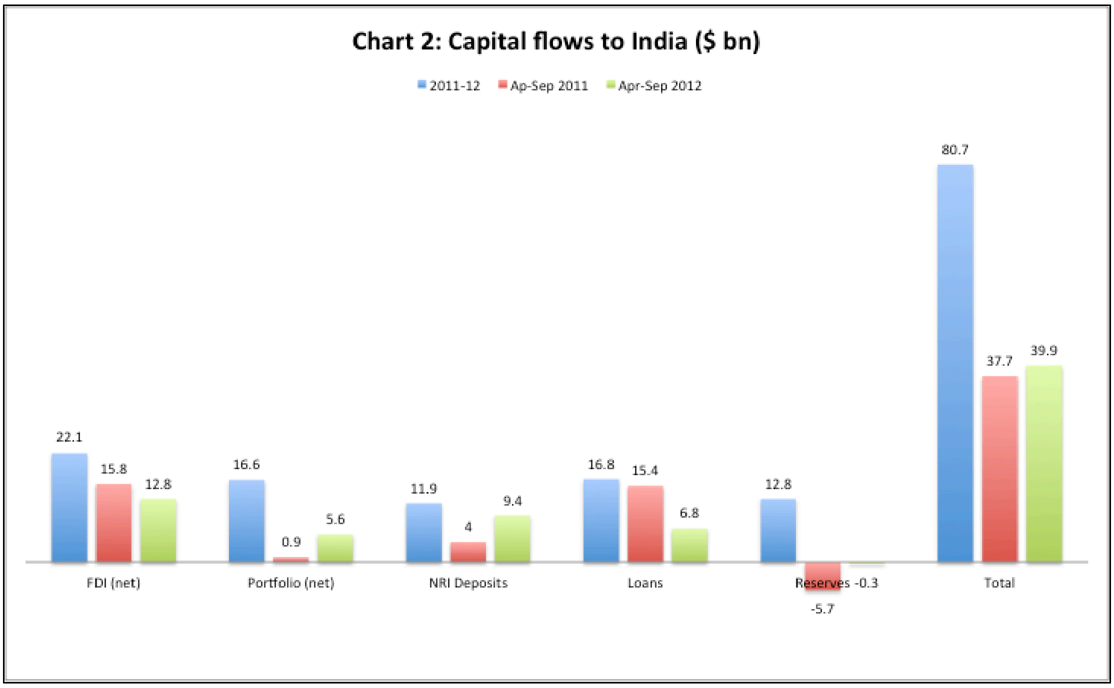
Addressing the convocation at the Indira Gandhi Institute of Development Research, Reserve Bank of India governor Duvvuri Subbarao made a strong case for caution on the economic front. He referred to three developments relating to the external sector in particular. The first was that the current account deficit (CAD), which had already risen from 2.7 per cent of GDP in financial year 2010-11 to 4.2 per cent of GDP in 2011-12 (Chart 1), is to be significantly higher this financial year. "It's going to be historically the highest CAD measured as a proportion of GDP," the Governor said.



The basis for his apprehension is clear. In the period since 1980, there has been only one year in which the current account deficit exceeded 3 per cent of GDP, and that was in 2010. So 4.2 per cent in 2011-12 was a thirty-year high. And this year the deficit is clearly going to be higher. The CAD to GDP ratio has risen sharply in recent quarters. It rose from 3.2 per cent in the first quarter of 2011-12 to an average of more than 4.5 per cent in the subsequent three quarters. On a year-on-year basis it rose from 3.2 per cent in the first quarter of 2011-12 to 3.9 per cent in the corresponding quarter of 2012-13 and from 4.8 to 5.4 per cent between the second quarters of those two years. To recall, in the three years preceding the balance of payments crisis of 1991, the current account deficit had touched only 2.4, 2.3 and 2.2 per cent respectively.

It could be justifiably argued that mere inter-temporal comparisons cannot be the basis for any assessments on fragility. In the 1980s India was dependent on debt to finance its current account deficit. Now it has access to a range of non-debt inflows. So financing a large deficit appears easier. Further, while after the recovery from the 1991 crisis India was receiving $4-6 billion in a year in the form of direct and portfolio capital inflows, it has recently received as much as $65 billion in a single year. The resulting increase in India's foreign exchange reserves, it could be held, are evidence of the need to adopt a more nuanced view on what an acceptable current account deficit would be.



Which is why the second note of caution struck by the governor is of relevance. The current account deficit, he noted, was being financed by volatile inflows. The reference here is clearly to the fact that portfolio flows, including investment in debt instruments, non-resident deposits driven by interest differentials, and loans (including short term credit) have come to constitute a significant share of total inflow on the capital account (Chart 2). The problem is much graver than suggested even by these figures, since the definition of foreign direct investment is arbitrary and includes all inflows in which a single foreign investor acquires 10 per cent of equity in the target. Many portfolio investors looking for capital gains do acquire equity of that magnitude, resulting in a lot of "volatile capital" being identified as FDI. Further, since India has for quite some time been consistently recording current account deficits, even the country's reserves are financed with capital inflows, a significant share of which is volatile. Such reserves give no cause for comfort when the current account deficit is widening.

The third and final note of caution struck by governor Subbarao relates to the prime cause of the widening current account deficit, which is the rising trade deficit. Being the excess of imports over exports, one reason why the trade deficit could widen can be the impact of the persisting global recession on India's exports. While India's exports had risen from $251 billion to $306 billion between 2010-11 and 2012-13, during the first nine months of 2012-13, exports at $214 billion were lower than the $227 billion recorded during the corresponding period of the previous year. Clearly lagged effects and the geographical distribution of the slowdown are affecting India's exports adversely.

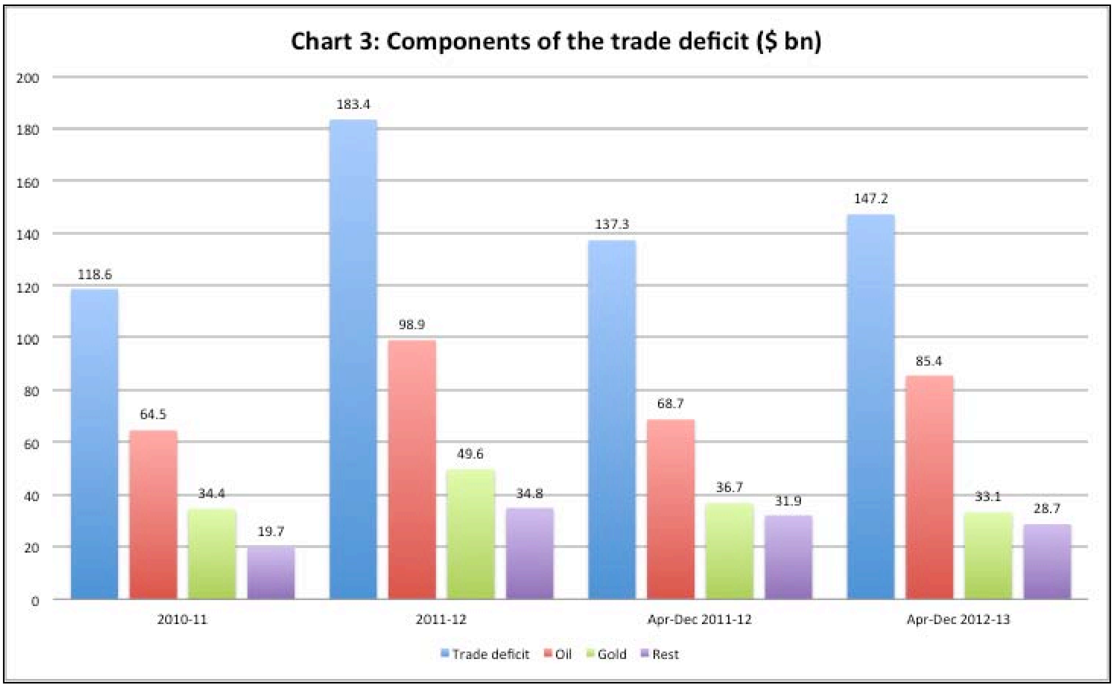
What is needed then is some adjustment in imports that help rein in the trade deficit. However, not only did India's import bill rise sharply from $370 billion in 2010-11 to $489 billion in 2011-12, but there has been no reversal since. Imports during the first nine months of 2012-13 were at $361 billion only marginally below the $364 billion figure for the corresponding period of the previous year. There is one exogenous factor contributing to this high import bill, which is the high international price of oil, though the fact that the government has done little to rein in petroleum products consumption has only worsened matters. That having been said, it is true that there is a strong relationship between the average price of India's POL import basket and India's POL import bill. This makes for an additional reason (besides the global recession) to ensure import restraint in other areas where that can be done.

The evidence suggests that there is inadequate effort in that direction. Nothing illustrates this more than the role of the other major contributor to India's high import bill: gold. According to official estimates, gold imports rose from $3.8 billion in 2002-03 to $10.5 billion in 2004-05, $28.6 billion in 2009-10 and an estimated $57.5 billion in 2011-12. The trend seems unrelenting with early estimates suggesting that India imported $39.5 billion worth of gold during April-December 2012. In fact, triggered by the expectation that government would hike the import duty on gold from 4 to 6 per cent, which it did on January 21, traders rushed to import gold. Market estimates suggest that imports amounted to 100 metric tonnes in January 2012, which is 40 per cent higher than the average monthly import during 2011. Though gold prices have come down since, expectations are that imports would average 60 tonnes a month this year.

According to estimates from the World Gold Council, 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, $4,940 and $48,620 respectively. Demand in India is exceptionally high.

The demand for gold is explained by many factors. There is the traditional obsession with the yellow metal as an adornment and an item of personal display. In this incarnation as a consumer durable, demand for it is seen as driven by a peculiarly Indian taste and by its role as a symbol of status. It has also been seen as an important investment, being a store of value that benefits from price appreciation, which is normally higher than the increase in the general price level and makes the commodity a good hedge against inflation. It is also the asset to which wealth-holders shift in search of safety, when times are uncertain. Gold is favoured because it is characterised by a high degree of liquidity (in the sense that it can be converted easily into cash of equivalent value), since it could either be sold or pawned without much difficulty. In recent years, the proliferation of 'loans against gold' schemes offered by banks and non-bank financial companies has made the metal even more liquid. While all these factors matter the recent spike in the demand for gold is explained by the desire to build a hoard. If that be the case, the two percentage point increase in import tariffs is unlikely to serve as an adequately effective curb on imports.

On the other hand, the government is fighting shy of imposing quantitative restrictions. A report from an RBI working group points to the soft touch the government seems committed to. The report argues that imports cannot be curbed beyond a point, either with tariffs or quantitative restrictions, since that would only encourage smuggling. So the search is for ways to satisfy the appetite for gold without having to import a good that is not produced in the country. If they existed, the market, it should be presumed, would have by now discovered them.



Thus, special factors such as the demand for oil and gold have an important role in explaining the rising trade deficit. This makes the deficit less responsive to changes in aggregate income. The high deficit persists despite the recent downturn in industrial and GDP growth. The importance of these factors can be gauged from the contribution of these two commodities and the rest of the countries trade basket to the deficit (Chart 3). Oil accounted for around 54 per cent of the trade deficit in 2010-11 and 2011-12, with the figure rising to 58 per cent during the first nine months of 2012-13. Though the contribution of gold has fallen from the 27-29 per cent levels of 2010-12, it still stood at 22.5 per cent in 2012-13.

If little is done to curb the contribution these commodities make to the trade deficit, the room for manoeuvre that the government has is restricted to the set of commodities that account for between 17 and 19 per cent of the total trade deficit. But given the large size of the non-oil, non-gold import bill, amounting to 60 per cent of the total, a reduction in the import bill can make a significant difference. But even here there seems to be no concerted action. Thus, between 2010-11 and 2011-12, the non-oil, non-gold import bill rose from $223 billion to $278 billion or by close to 25 per cent.

In the event, whatever adjustment occurs is dependent on income contraction that forces a reduction in the import bill. Thus slowing growth reduced the import bill during the first nine months of the financial year from $211 billion in 2010-11 to $198 billion in 2012-13 or by around 6 per cent. Since imports of oil and gold are known to be far less sensitive to income changes, in the absence of policy initiatives aimed at curbing the deficit, the magnitude of the income contraction has to be large for a significant reduction to occur. If that does not happen, the symptoms that point to a deep flaw in the system that is generating the fragility underlined by the RBI governor are likely to worsen with potentially grave implications. Unfortunately a government obsessed with growth and committed to reducing its fiscal deficit seems unwilling to take note.

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