India's External Resilience

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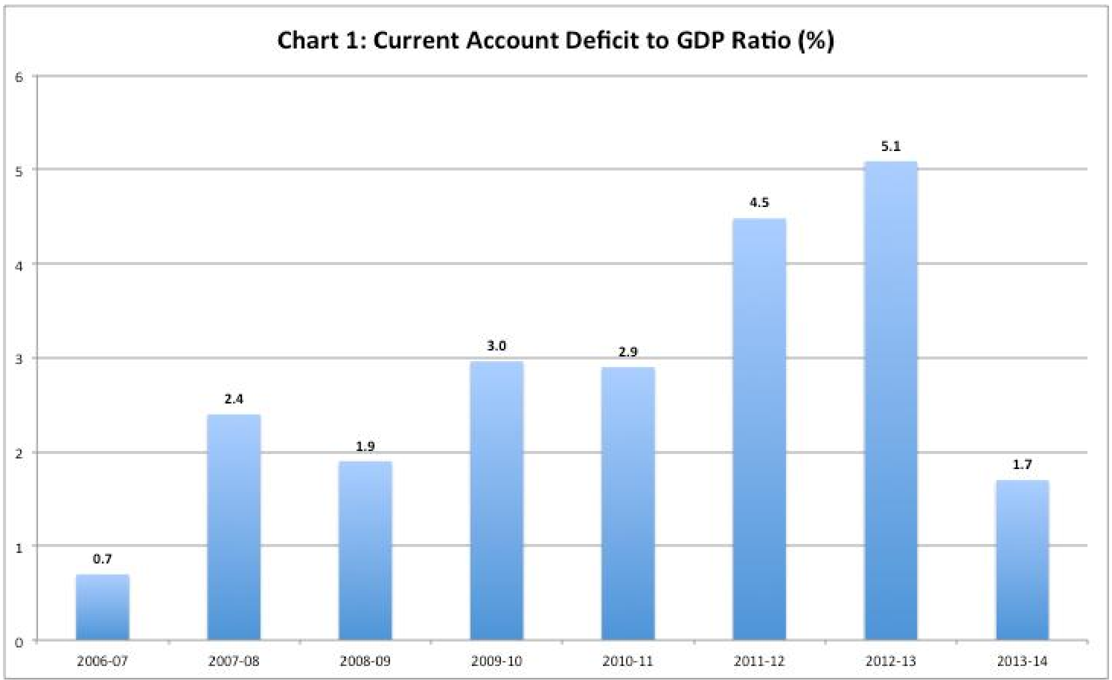
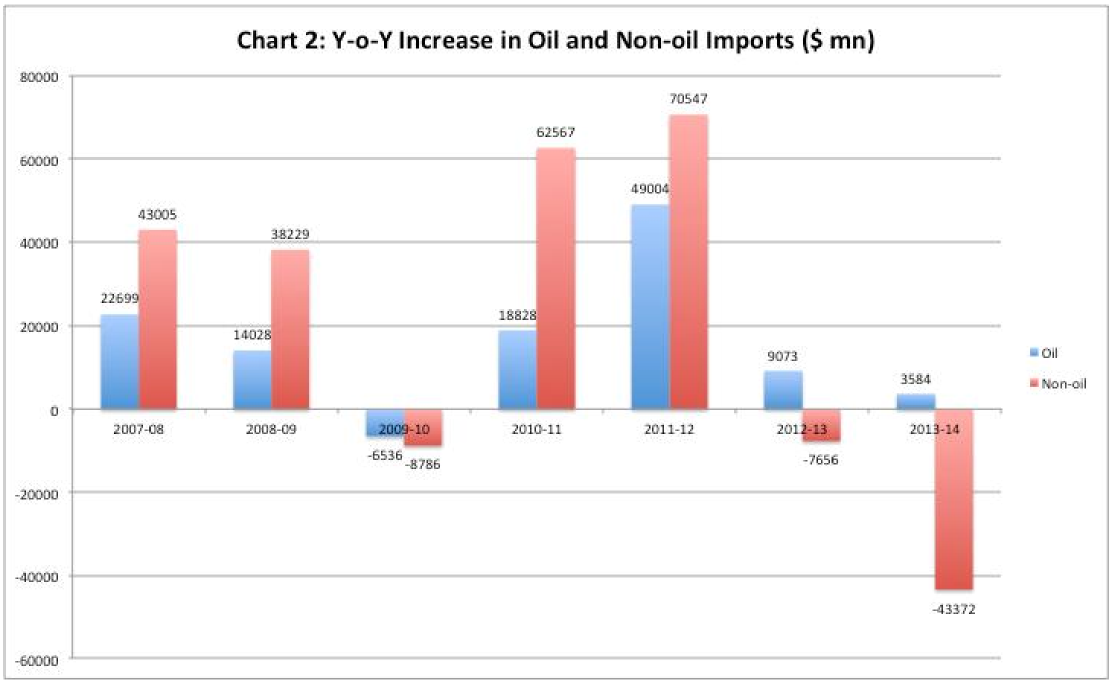
Amidst the abundance of bad news that greets the new government on the economic front is one significant cause for comfort. The deficit on the current account of India's balance of payments, or the excess of foreign exchange expenditures over India's non-capital foreign exchange receipts, has shrunk substantially. As Chart 1 shows, over the financial years ending March 2012 and 2013 the current account deficit rose sharply from 2.9 per cent of GDP (in 2010-11) to 4.5 and 5.1 per cent of GDP. As compared to that, the figure for 2013-14 reflects a sharp fall to 1.7 per cent of GDP, pointing to a significant strengthening of the balance of payments.



Underlying the decline in the current account deficit is a sharp fall in the trade deficit. After having risen from $118.6 billion in 2010-11 to $183.4 billion in 2011-12 and $190.3 billion in 2012-13, the excess of India's merchandise imports over its exports fell to $138.6 billion in 2013-14. That decline, in turn, was the result of a small $12 billion rise in exports and a substantial $36 billion fall in imports. Thus, since there is unlikely to be any major export boom in the near future given the still depressed global environment, the persistence of a low current account deficit is predicated on imports not rebounding from their depressed levels in 2013-14.

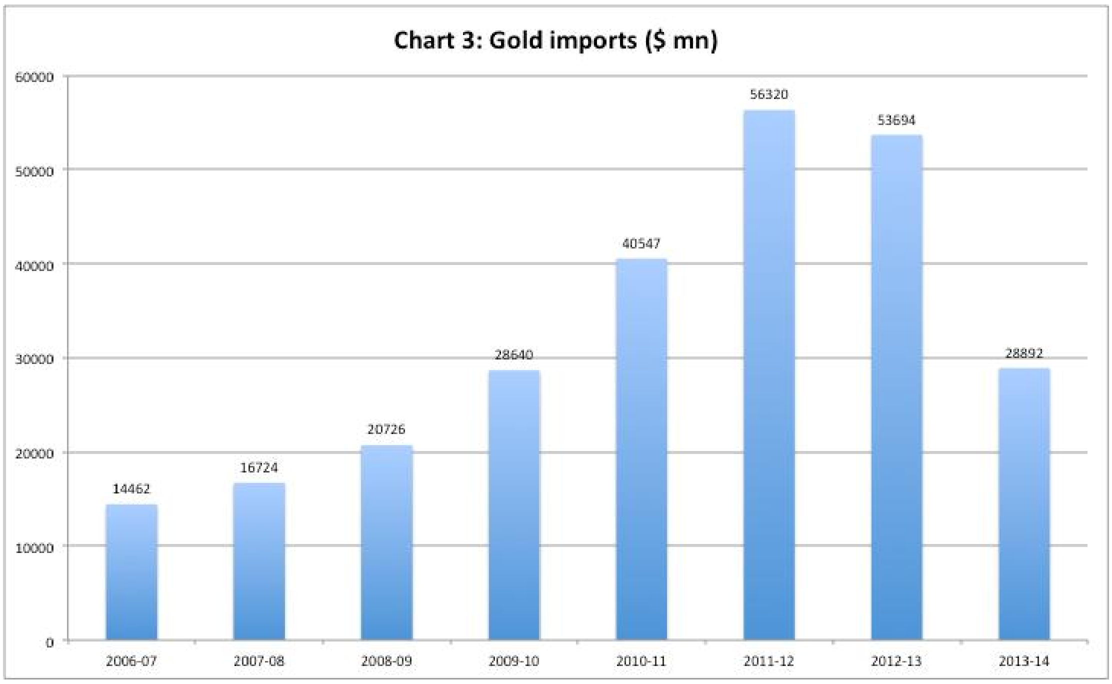
This depends on what happens with respect to two sets of commodities that are largely responsible for India's balance of payments turnaround: petroleum products and gold. Chart 2 gives the year-on-year *increase* in oil and non-oil imports in recent times. It is clear that increases in both these categories of imports in 2010-11 and 2011-12 contributed to the significant worsening of

India's current account position by the latter year. And since in 2012-13 the value of both these categories remained close to their high levels, the balance of payments condition deteriorated even further.



It must be noted that the contribution of oil to changes in the trade deficit has been marginal in recent years. The average price of oil in the OPEC reference basket rose from a low of $61.1 per barrel in 2009 to $77.5 in 2010, $107.5 in 2011 and $109.5 in 2012. It has since then slipped to $105.87 in 2013 and 104.81 in 2014. As a result India's oil import bill rose from $87.1 billion in 2009-10 to $155 billion in 2011-12 and stayed at $164 billion and $167.6 billion in 2012-13 and 2013-14. The spike in India's oil import bill in 2010-11 and 2011-12 was clearly related to the increase in international oil prices. However, since then India has benefited from the fact that oil prices have moderated, so that despite rising import volumes the oil import bill has not risen sharply. But high (even if declining) prices have kept oil a dominant area of foreign exchange expenditure.

The other factor contributing to India's soaring import bill, and underlying the rise in non-oil imports during 2010-11 and 2011-12, is a sharp increase in the imports of gold from $28.6 billion in 2009-10 to $40.5 billion in 2010-11 and $56.3 billion in 2011-12 (Chart 3). Even in 2012-13 gold imports remained at the extremely high level of $53.7 billion. Together with the consistently high levels of India's oil imports, this was the other factor contributing to the rapid rise in the current account deficit and its ratio to GDP.



It is in this light of these developments that the sudden and sharp improvement in the current account position during the recently ended financial year 2013-14 needs to be assessed. As should be clear from Chart 2, because international oil prices had fallen marginally in that year the increase in India's oil import bill was relatively small. On the other hand, gold imports fell by a huge $43.3 billion in 2013-14.

The sharp decline in gold imports was largely the result of policy initiatives that sequentially hiked the duty on gold over a one-and-a-half year period as well imposed quantitative restrictions on imports of gold. The Union Budget 2012-13 had increased the basic customs duty on standard gold (of purity 99.5% & above) from 2 per cent to 4 per cent. Subsequently, the duty was raised to 6 per cent on 21st January 2013 and thereafter to 8 per cent on 5th June 2013 and 10 per cent on 13th August 2013. By way of quantitative restrictions, in July 2013 banks and trading houses that were exporters of jewellery were barred from importing gold and under the 20:80 scheme, importers were required to ensure that at least one-fifth, or 20 per cent, of every lot of imported gold was reserved for export production and only the balance put to domestic use. It is clear now that it was only when import duty touched 8 per cent and these quantitative restrictions were put in place that the speculative demand for gold was brought under control.

These developments point to the fact that there are two diverse influences that are determining India's balance of payments position. One is global in the form of the prices of international oil. The other is domestic, in the form of the demand for gold. The government could do little about the former, whereas it clearly can do much about the latter and arrest the demand for gold which results from a combination of an obsession with the yellow metal and speculative demand for it as an investment and as a hedge against inflation.

What we have is evidence that driven to the unsustainable level of the current account deficit in 2012-13 the government decided to adopted so-called "harsh" measures to curb the demand for gold. It was successful here and that success was not neutralised by a spike in international oil prices, because of depressed global demand and increased supply of oil and gas from traditional and unconventional sources.

Given this background, what is the likelihood that the turnaround in the balance of payments observed in 2013-14 would be sustained? Expectations are that international oil prices would remain stable or even decline since demand is likely to remain depressed and the supply of oil and its substitutes may ease further. The real uncertainty is with regard to gold imports, because the evidence seems to be that the government would reverse the measures it adopted to curb excessive and damaging gold imports. On May 20th, in a signal of what is to come, the RBI eased gold import norms by allowing star trading houses and some banks to import the precious metal reversing the quantitative restrictions imposed about a year earlier. And expectations are rife that the new government would reduce import duties from their current 10 per cent level in the coming budget. If that happens and the demand for gold surges, the current account deficit could widen sharply once again, wiping out the only cause for comfort in the current economic scenario. That would be the result of a policy error.

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