

How Should We Deal with the Current Account Deficit?

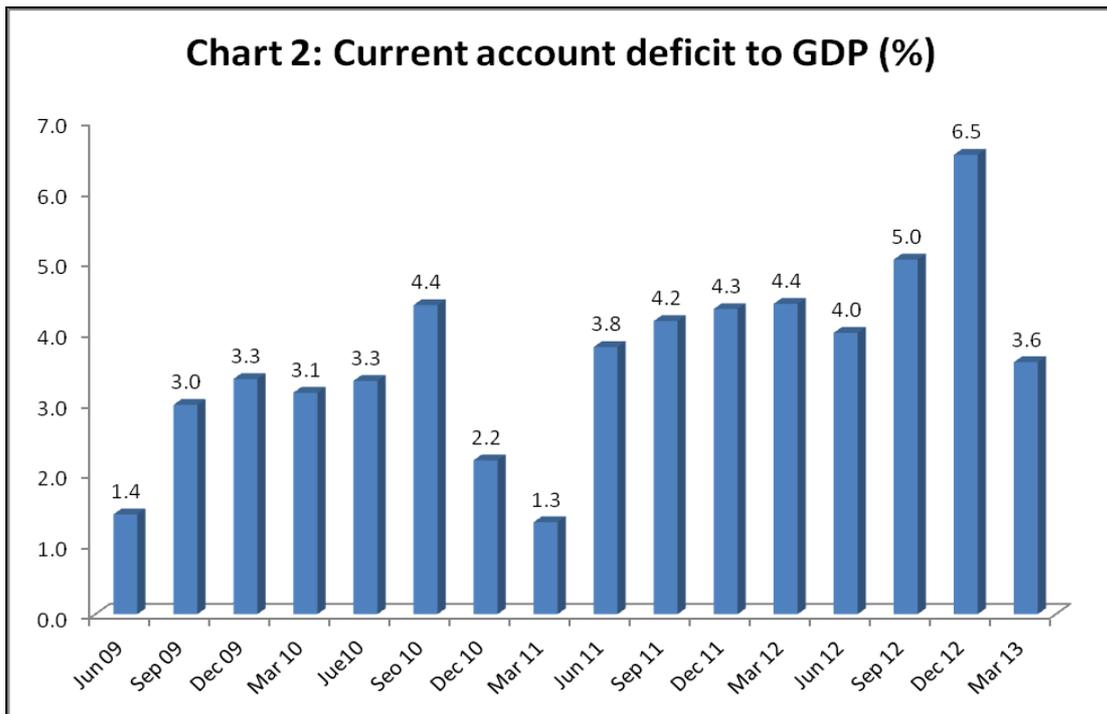
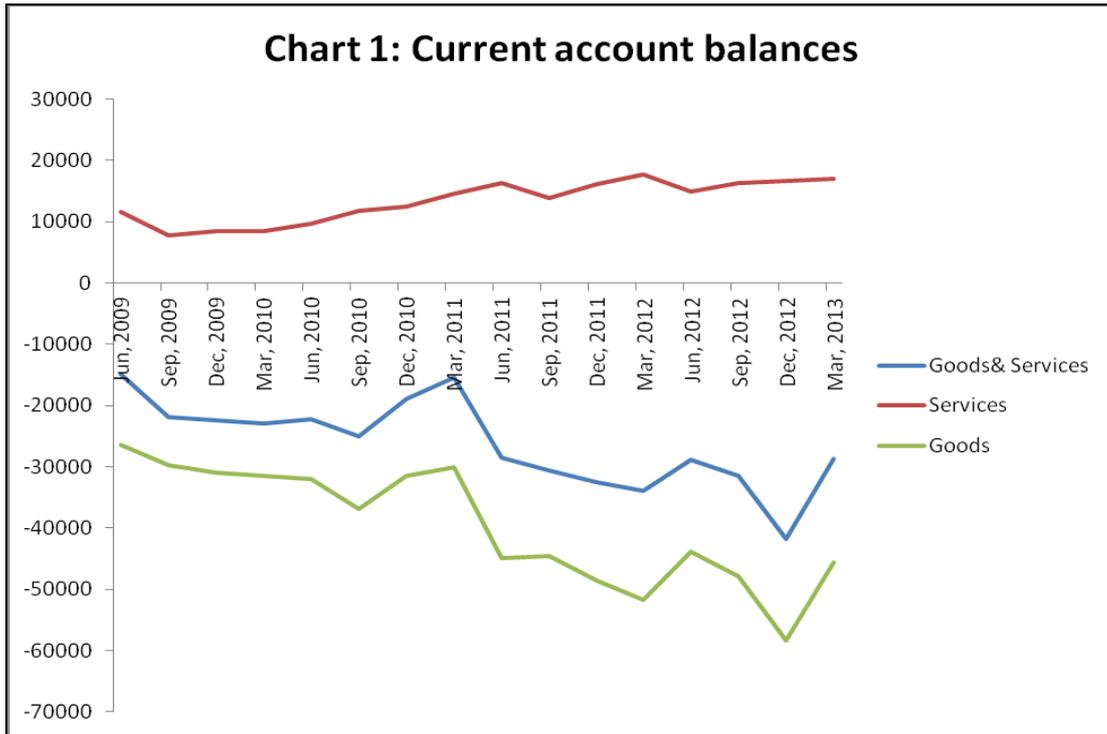
C.P. Chandrasekhar and Jayati Ghosh

Clearly, despite the very recent slight recovery in the external value of the rupee, India's problems on the balance of payments front are far from over. And they are likely to fester for a while, and also to escalate into a full blown crisis, if corrective measures are not taken quickly. But what exactly are the required corrective measures?

For India's official economic decision makers, the required actions appear to be in the capital account. They seem to have decided that the basic way to deal with India's ongoing external crisis is to somehow placate and woo investors who can choose between Indian and global financial assets. Various measures have been announced, from easing the terms for NRI bond holders to allowing [FIIs to access securities purchases directly](#) without waiting for monthly auctions. In a remarkably short-sighted strategy, Public Sector Enterprises are being encouraged (or forced?) to take on external commercial borrowing that will bring dollars flowing back into the country, even if this may become expensive or impossible to repay later. Vague promises are being made of future liberalisation of rules for FDI and other capital inflows.

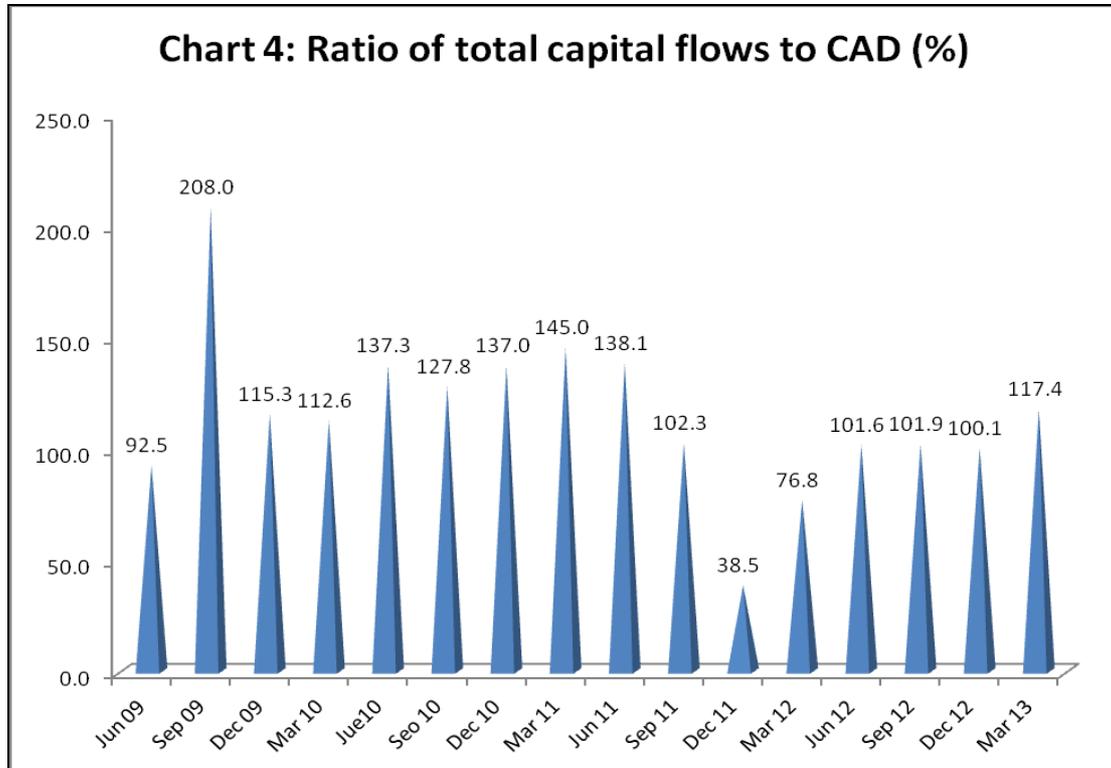
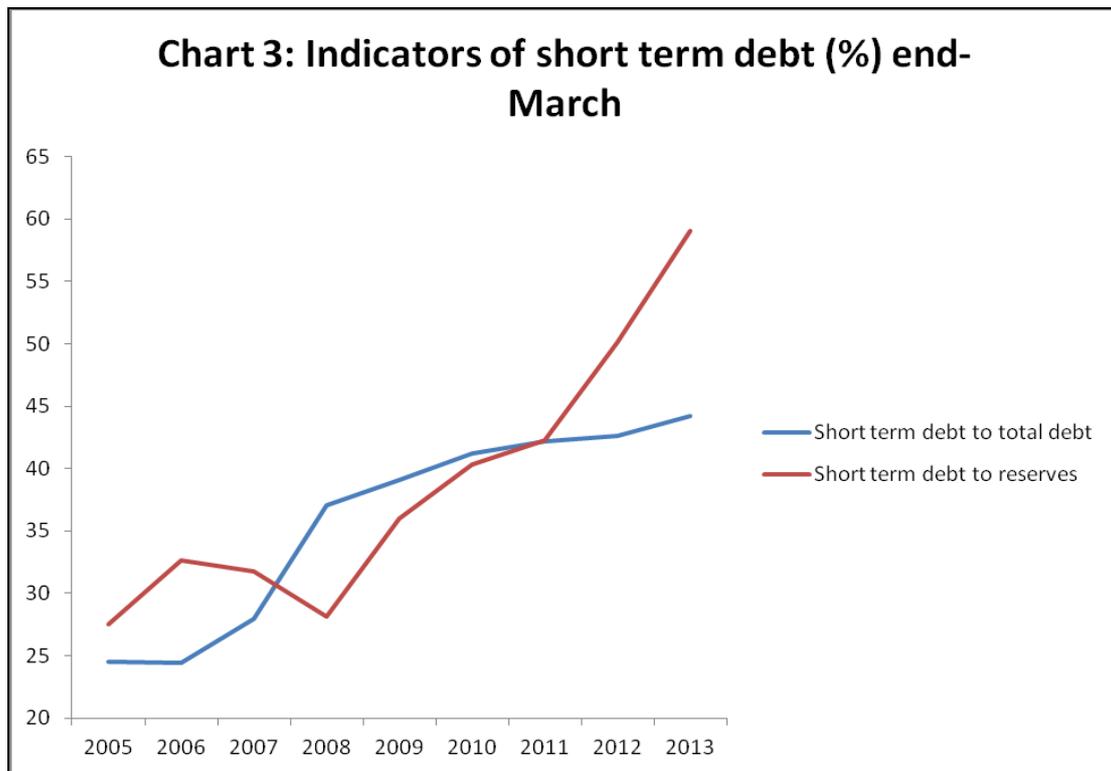
Yet all of these are measures that do not address - and could even worsen - the basic source of the problem: the huge current account deficit. Chart 1 shows that in dollar terms this has been growing significantly in the past few years. It is clearly led by the deterioration in the trade account, since the surplus on services has increased (albeit only very slightly) even in recent years. The decline has been particularly steep since the middle of 2011.

This has in turn been associated with historically high ratios of the current account deficit to GDP, which even reached 6.5 per cent in the last quarter of 2012 (Chart 2). There has been a slight reduction since then, but the figures remain disturbingly high. Certainly the deficit is way above the level of 2.5 per cent that defines the government's own perception of sustainability and is a major assumption underlying the projections of the Twelfth Five Year Plan.



In such a situation, seeking to attract more capital inflows in whatever manner possible not only postpones the day of reckoning, but may add quite substantially to the eventual price to be paid. Thus, the more the external borrowings that are taken on, the greater the burden of debt and the larger the problems of debt servicing, especially in a context of currency depreciation. The greater the short term capital in the form of portfolio finance that is somehow attracted back into the country, the greater the eventual negative impact when they exit, as is only too likely given the prevailing market uncertainties. And the more the capital that flows in, the greater the

macroeconomic tendencies to shift domestic incentives away from tradable to non-tradable activities, which in turn, has its counterpart in larger current account deficits!



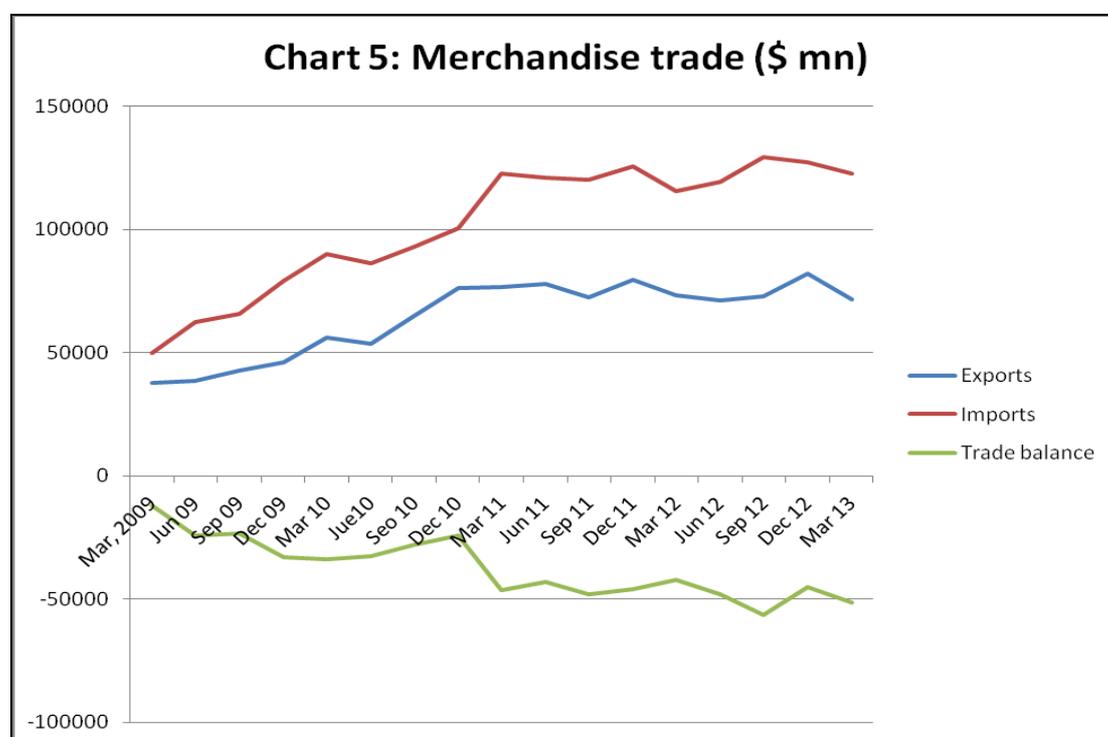
As is evident from Chart 3, there has already been a very significant increase in the country's short term debt dependence in the recent past. The ratio of short term debt to total debt has increased rapidly and consistently since 2006, while the ratio of short

term debt to foreign exchange reserves has positively exploded since 2008. These are unhealthy tendencies in any economy, but when it is these flows that are financing the current account deficit, that should send alarm bells ringing in policy circles. And far from encouraging more of such inflows, the aim should be to reduce such dependence and contain the vulnerability of the economy to potential outflow.

In any case, even much of the build-up of external reserves that has been so celebrated by the government was also related to short term (and therefore unreliable) capital inflows. Contrary to countries like China whose reserve expansion has been driven by large current account surpluses, India's reserve build up was the result of capital inflows. Therefore, to some extent they have been borrowed rather than earned - and unfortunate position to be in when the reckoning for other borrowing becomes too large. Chart 4 shows even in the past four years, capital inflows have exceeded the current account deficit in most quarters.

The change in the past year is that while in the past such flows were well above current account financing needs, they are now just about adequate to cover that deficit. So 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.

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. A viable and more permanent solution requires reducing the current account deficit.

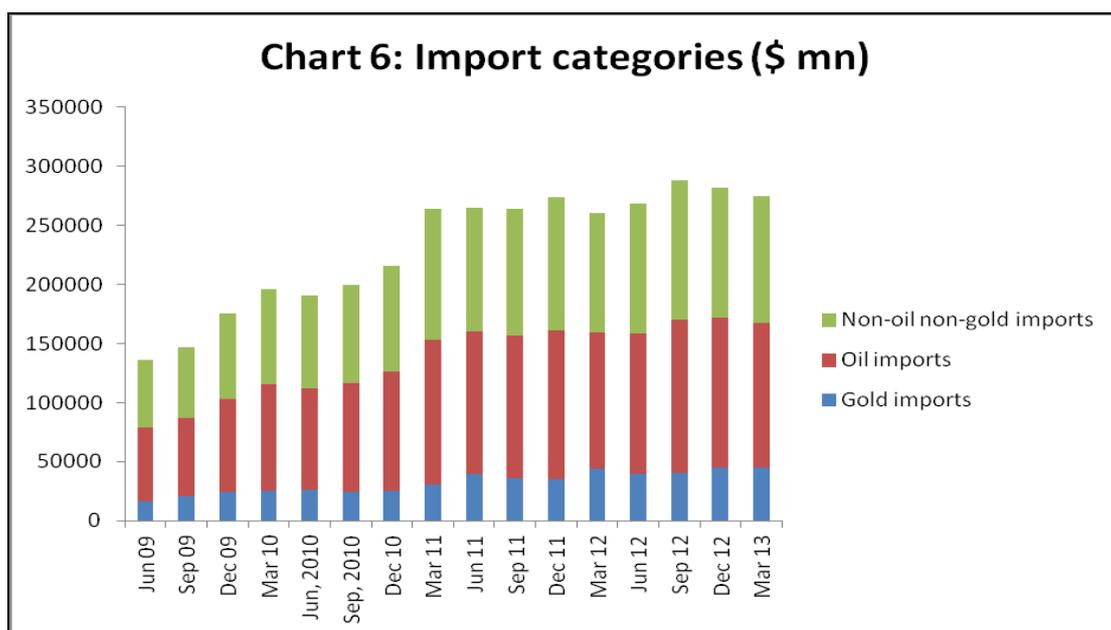


As was shown in Chart 1, the problem in the current account lies squarely with the trade deficit. As evident from Chart 5, imports have risen faster than exports since early 2009 and have stayed at higher levels. It is true that India's exports in dollar terms rose quite sharply in the aftermath of the crisis from April 2009 to March 2011, and more or less stagnated after that. But while exports have not boomed, they have not shrunk either. If we factor in the depreciation of India's rupee over this period, we can note that 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, at a slower pace than earlier but still faster than exports. If anything is to be done to reduce external vulnerability, intervention must be directed at this source.

It is often claimed that because India's import bill is so affected by the need to import oil, it is hard to curtail. However, oil is both imported and exported, as private oil refining companies take advantage of differential prices to maximise their own profits without regard for the broader national interest. Surely at such a time of balance of payments stringency, it is necessary to reconsider such a perverse system of incentives that has been created by the government's own misguided policies.

Also, it turns out that oil is not the only culprit responsible for the rising import bill in recent years. A more disaggregated look at imports (as provided in Chart 6) shows that while oil imports still dominate, a significant part of the recent increase in non-oil imports has been accounted for by gold, which 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; indeed 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. We should remember the decontrol of gold imports is a fairly recent phenomenon, and that such decontrol has served little or no productive purposes within the economy.



It is possible to go even further. There has also been a huge increase not just in other “non-essential” imports, which has attacked the productive capacities of the country and wiped out lots of employment. Over the past decade in particular, trade patterns have systematically eroded the capacities and competitiveness of huge swathes of producers in Indian agriculture and manufacturing. 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. There is therefore also a strong case for quantitative restrictions on those imports that are not only "non-essential", but whose substitution could help the economy to regain crucial production capacity and with it, the elements of manufacturing potential.

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