

BoP Prospects for 2011-12

As I argued in the last column, India's net external liabilities have gone up sharply in recent years, thanks to a continued deterioration of the current account. This, in turn, is the inevitable result of rupee appreciation in real terms. The increase in liabilities is the consequence of capital flows in excess of the current account deficit, which have not been sterilized, as they used to be in an earlier era: such excess inflows can only inflate asset prices – principally the currency, which has become an asset class, equities and real estate.

This apart, there are few prospects of any improvement in the current account, in 2011-12. Yes, exports are showing a sharp growth, over the last four months, including in April 2011, for which there does not seem to be any convincing explanation. Again, the Ministry data do not capture defense imports which do not pass through customs – and, India has become the world's largest importer of arms. So keep the fingers crossed and wait for the balance of payments data for the whole year.

More than half the rise in GDP in Q4 of 2010-11 was accounted for by increased private consumption: if this continues, it implies lower household savings. And, the public sector's negative savings will go up, thanks to the increasing burden of subsidies, paid or unpaid, to which the government is committed, and to which the National Advisory Council wants to add more. (Recently, a group of eminent economists has addressed an open letter to the Council's Chairperson, cautioning about the weaknesses in the NAC proposals as they stand.) Petrol and diesel subsidies borne by crude oil producers (ONGC, OIL, etc) also reduce their profitability and hence public sector savings. Although investments have been falling, the savings investments imbalance could worsen in 2011-12, which also points to a higher current account deficit. The question is whether there will be enough capital inflows to finance a deficit of the order to perhaps \$ 60/70 bn, (as conventionally calculated). Nor should we forget the possibility of a further rise in oil price.

Foreign Direct Investment has been falling: and no wonder. On the one hand, deflationary monetary policy (both interest and exchange rate) does not make for an attractive investment climate. Nor do the problems in land acquisition, or governance in general: one example, in the World Bank's "Ease of doing business" index of 183 countries, we are the second lowest in enforcement of contracts! No wonder: corruption, less than clear rules and regulations, and delays are endemic. And, like developed countries' exchange rate policies, we have also adopted their environmental concerns overlooking that they started worrying about them only after they became rich. The experiences of POSCO, Cairn and Vodafone (tax case) are hardly an advertisement for FDI in India!

Nor am I very optimistic on portfolio inflows. A slowing economy does not make an attractive investment destination even for portfolio investors: note that GDP growth has fallen steadily in 2010-11 – from 9.3% in Q1 to 7.8% in Q4 (8% p.a. does not seem to the revised "Hindu rate of growth", which can be taken for granted and will continue whatever we do or do not do). Investment growth too has been steadily falling in 2010-11 – from 17.4% in Q1 to 11.9% in Q2 to 7.82% in Q3 and less than 0.5% in Q4. Given the various factors inhibiting FDI, which I have listed above, the slump in investment may well continue in 2011-12. And, lower investment today means lower growth in the future.

The infrastructure deficit will also start impacting growth. In a recent speech, Dr. Montek Singh Ahluwalia estimated the investment needs at \$ 1 trn over the coming five years: in the same forum Dr. Subbarao estimated that government and bank funding may not generate more than half the amount! One nagging doubt remains: is financing the real bottleneck?

We need capital inflows not only to meet the deficit on current account but also to meet maturing debt obligations. Assuming that the latter is met through fresh borrowings, net FDI and portfolio inflows may not be sufficient to meet the gap. So downward pressure on the rupee is quite likely, but that will make portfolio investment (for the investor) and short term borrowings (for the borrowers) less attractive. Yes, reserves built up under a different policy regime are adequate to take care of any shortfalls provided there is no major outflow of portfolio investments or short term loans. But it is worth emphasizing the risks of becoming

overdependent on continued inflows of foreign capital to bridge the savings investment, or external earnings expenditure, gap – the example making daily headlines is the southern countries in the eurozone. There is a difference of course: they have no control on a supranational currency's exchange rate; we have, but have chosen to give it up!

We should not forget the difficulties democracies have in selling a cut in public services to people, once they become used to “entitlements” – look once again at the eurozone. The costs of policy-makers being wrong in estimating sustainable levels of current account, or fiscal, deficits can be very high.

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