Breathtaking Complacency

It is much cheaper to learn from others' experience than repeating the mistakes ourselves. But the Balance of Payments data released recently make me wonder whether there is a possibility that we could fall in the same trap as Mexico (1994-95), East Asia (1997-98), Brazil (1998): fast growth attracting large capital inflows; and an appreciation of the currency in real terms leading to ever larger deficits on the current account. The cycle obviously cannot continue forever. One day, inevitably, the music stops (as it did for all these countries); the cycle starts spinning in the reverse direction; and a crisis results. Argentina too allowed a sharp appreciation of its currency to control inflation, until the inevitable BoP crisis (2001).

Look at some specifics of the data recently released. On the "flow" side:

⇒ The trade deficit in H1 of the current year has gone up to $ 67 bn from $ 56 bn in the corresponding period last year, even as net invisibles have fallen from $ 42.5 bn to 39 bn, more than doubling the current account deficit from $ 13.3 bn to $ 27.9 bn;

⇒ Nor do the prospects for the rest of the year look much better, particularly as oil prices, almost 30% of India's imports, have crossed $ 90, and commodity prices too have gone up.

⇒ Some trends in the current account numbers between the first half and the full year are interesting: in 2006-07, the latter number was actually less than the former; in the next two years, the annual deficit was higher by 80%; in the last year, the annual number was higher by 190%! While the trend of the ratio is unmistakable, what could it be in the current year? Goldman recently estimated the full year deficit at $ 67 bn.

The picture is equally dark also on the "stock" side:

⇒ For the first time in seven years, external debt exceeds the country's reserves. And, more worryingly, short term debt has gone up even faster than the total external debt. It now amounts to something like $ 66 bn;

⇒ India's net external liabilities have more than doubled in one year (tripled in two years!) to $ 185 bn at the end of June 2010. (Paragraph 2.35, RBI's Financial Stability Report);

⇒ The composition of the inflows has become increasingly riskier with a sharp increase in debt, particularly short term debt, and in portfolio investments, even as net FDI inflows have fallen from $ 12.3 bn (H1 2009-10) to just $ 5.3 bn in H1 2010-11.

In short, there are too many negative factors on both the flow side and the stock side.

The breathtaking complacency of the policymakers in the face of such numbers makes me wonder whether there has occurred an "intellectual capture" of their thinking on the virtues of a liberal capital account and market-determined exchange rates, by market fundamentalists. At one place in the Mid-Year Analysis 2010-11 placed before Parliament by the Ministry of Finance, it is conceded that "*The main implication of such large capital flows to India has been buoyancy in stock markets and appreciation of the rupee vis-a-vis the US dollar. The currency appreciation further encourages capital flows as FIIs often expect this to persist and so to make capital gains due to the appreciating rupee, besides benefiting from the stock market rise. The appreciating rupee can have adverse impact on the earnings of exporters and makes exports less competitive in the international market … appreciation of local currency could lead to cheaper imports at the cost of domestic goods, which may have* ***adverse impact on domestic employment and growth****.*" (3.15 & 3.16, emphasis mine) But it immediately pleads helplessness, quoting some research by the Inter-American Development Bank to the effect that "*capital controls work temporarily, but start hampering growth and productivity and cannot fully prevent the flows and therefore need to be complemented by other tools, including macro-*

prudential financial safeguards.” – as if there are no ways to influence the exchange rate short of capital controls! This apart, it should not be forgotten that, as far as the objectives of employment and growth are concerned, the risk: reward relationship of a liberal capital account and market exchange rate, is grossly skewed in the direction of risk.

While on the topic of capital flows, I came across a study on illicit financial flows from India (1948-2008) published recently by Global Financial Integrity, a U.S. based NGO. It estimates that, over 61 years, such outflows aggregated $ 213 bn (1.5 % of GDP on average); compounding the flows at the T-bill rate, the present value is estimated at $ 462 bn. The equation for estimating the illicit outflows (paragraph 28, World Bank Residual model) seems to ignore portfolio flows altogether: in our case, these have been extremely large over the last couple of decades. This apart, the study claims that the illicit assets comprise72.2 percent of “India’s underground economy” in 2008, estimated at $ 640 bn. Is underground economy synonymous with undeclared assets?

A. V. Rajwade
Email avrajwade@gmail.com