

### **The Imbalance of Payments and the Exchange Rate**

The balance of payments data for the first three quarters of 2011-12 was released a couple of weeks back. The trade and current account deficits are as bad as was to be expected, thanks primarily in my view to the exchange rate policy of the last few years. And, the trade data for the following two months (January and February 2012) released by the Commerce Ministry evidence that the trend is continuing: the trade deficit has widened to \$ 166.8 bn in the first 11 months (\$ 123.3 bn in the first nine months as per the BoP data), and may well cross \$ 180 bn for 2011-12 as a whole!

I have also argued that an overvalued exchange rate not only impacts the current account directly, but also the savings:investment imbalance by reducing savings: these have dropped from 37% of GDP in 2007-08 to 32% in 2011-12.

How long can we continue incurring deficits on the current account? The answer depends on the quality and quantity of our reserves on the one hand, and capital and financial flows on the other. As for the former, while the quantity looks adequate (but falling), the quality is poor – financed by a build up of external liabilities, and not “earned”: India’s International Investment Position is negative in excess of \$ 200 bn.

Turning to financial flows, foreign investors need clarity, stability and predictability of the regulatory and tax regimes. The former was poor in any case; the latter has been undermined badly by the changes in the last budget: the retrospective changes in tax laws; the GAAR; the uncertainties over the tax liability on P-notes; on Mauritian investments; etc. (Reports suggest that many existing foreign investors are voting with their feet – or preparing to do so.) As for debt, the aggregate exceeds the reserves – and the proportion of short term debt is growing quarter after quarter.

As for retrospective tax/regulatory changes, let me recall the case of Ravi Tikoo. Back in the 1970s, he was employed by a shipbroking firm in London and had hardly

any resources. Taking advantage of the then existing tax and shipping regulations aimed at adding to British tonnage, he structured a deal to buy two, then-largest tankers from Japanese yards. He controlled the very nominal equity, the rest of the money coming from redeemable preference capital and shipyard credit. After the deal was finalized and received publicity, the U.K. government plugged the loopholes used by Mr. Tikoo, but not with retrospective effect – though Mr. Tikoo was obviously a foreigner who had suddenly become a multimillionaire using the loopholes. The case speaks for itself.

During the recent BRICS Summit in New Delhi our Prime Minister is reported to have requested his Chinese counterpart to help reduce the bilateral trade imbalance with India. To my mind, the imbalance is the direct fallout of the kind of floating exchange rate regime we have followed for the last few years, perhaps at American behest, ignoring the obvious impact on the competitiveness of the tradables sector of our economy. Interestingly, in a February 2011 speech Ben Bernanke, Chairman of the U.S. Federal Reserve, observed that “*Those countries that have allowed their exchange rates to be determined primarily by market forces have seen their competitiveness erode relative to countries that have intervened more aggressively in foreign exchange markets.*” (Don’t ask me how this reconciles with his advocacy of liberal crossborder capital flows and market determined exchange rates – or do western policymakers slip occasionally and speak the truth?)

It is sad that this huge imbalance should have occurred when the government is headed by an economist who, in the 1960s, was a lone voice arguing that India’s exports would grow given a proper exchange rate: the then accepted wisdom was export pessimism, and hence the import substitution, high duty regime which hobbled the economy for four decades.

Would the recent fall of the rupee help reduce the trade deficit? Unlikely, as far as fiscal 2012-13 is concerned. One reason, of course, is that exchange rate changes affect trade flows with a lag of anywhere from a year to two. There is also what economists refer to as the “hysteresis” effect: the tendency of a temporary

change to have long term impact. Increased imports of coal and gas may further add to the deficit. Given the diminishing prospects of capital inflows as argued above, and the poor quality of our reserves, the possibility of financial instability in the external sector can hardly be wished away. What could be the “tipping point”? An Israeli attack on Iran ostensibly to destroy its nuclear bomb making facilities? The Israeli government is headed by a hawk, who may well be tempted to do so during the pre-occupation of the U.S. in the presidential election.

One suggestion about the case involving The Children’s Investment Fund and Coal India: why not ask LIC to buy the TCI holdings at a suitable off-market price, and end the dispute? If ONGC is okay, why not Coal India?

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