The Other Side November 12, 2015

**Net External Liabilities and Output Loss**

After the Bihar election results, both the stock market and the rupee fell sharply on Monday morning. It is too early to say whether this is a reflection of the more cautious foreign portfolio investors walking out – let alone whether this could become a flood. Portfolio investors are well known for their herd instinct – and the feedback loops this leads to. (Analysts have estimated that net capital outflows from emerging economies were of the order of $ 250 bn in the third quarter of this year.) Our financial stability is particularly vulnerable to capital outflows, given our net external liabilities of the order of $ 360 bn (see *The Other Side*, November 5th).

India's international investment position has deteriorated from (-) $80 bn to (-) $350 bn over the last seven years, thanks to persistent deficits on the current account: the increase is the aggregate of the deficits on current account, or a measure of the domestic expenditure financed by creating external liabilities. In other words, the output loss represented by the deficits is of the order of say 2% p.a. of GDP. I am probably old-fashioned enough to believe that exchange rates matter to global competitiveness – and persistent deficits are a clear evidence of an overvalued exchange rate. In the last article I had referred to the permanent damage overvalued exchange rates can cause by "hysteresis": markets, domestic or foreign, once lost are difficult to regain!

But to come back to the current account balance, we need to look at its composition: arguably, in our case, the output loss on the external account is significantly more than the current account deficit, thanks to the very significant contribution of the "Secondary Income Account" to the overall balance. The IMFs balance of payment manual separates current external receipts and payments in three parts:

- ⇒ Goods and services, in our case a deficit of $ 17 bn in Q1 of 2015-16, despite a surplus of the same order on services;
- ⇒ Primary income, a deficit of $ 6 bn, mainly because of investment income: no wonder, given the net external liabilities;
- ⇒ Secondary income, a surplus of $ 16 bn mainly because of personal transfers (private remittances).

The IMF's BoP manual makes a distinction between "exchanges and transfers". An exchange involves *"provision of something of economic value"* (export/import of goods or services), while a transfer provides "*no corresponding return of an item of economic value*". In other words, transfers included under secondary income are not the result of corresponding economic output.

Technicalities apart, empirical evidence of the effect of private transfers or remittances from abroad on economic activity comes from Kerala, the state in India which has sent a very large number of its people to work in the Gulf countries. The money they remit is equal to 36% of the state's domestic product as per a report prepared by the Centre for Development Studies. The result is that Kerala's per capita income is about 50% higher than the country as a whole, although it has very little manufacturing or information technology businesses, unlike neighbouring Karnataka and Tamil Nadu. (The only activity that is flourishing seems to be real estate and construction.) In other words, the "secondary income" from abroad correspondingly reduces the need for domestic output and employment, without hampering consumption.

At the macro level, remittances make overvalued exchange rates more "affordable", by hiding at least a part of the true output gap originating in the external sector. I have often wondered whether one reason for the gap between GDP estimates on gross value added (GVA) and expenditure bases is this "secondary income": the gap between the two numbers was $ 33.5 bn in Q1. We should perhaps aim at balancing our current account net of remittances to optimise output and employment, and create a Sovereign Wealth Fund by transferring to it the "secondary income" from abroad each year. What will our reserves be then?

One other point occurs to me: the draft Indian Financial Code (IFC) says very little about the management of the external value of the currency. We should perhaps consider giving the central bank a mandate to so manage the rupee's external value as to keep the current account balance, net of secondary income, below a particular percentage of GDP.

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