

India: Approaching a BoP Cliff?

Macro economists are getting increasingly concerned about India's twin deficits: fiscal and current account. Overall, the rating agencies seem more concerned about the fiscal deficit rather than the external deficit, and have cautioned that India may face a downgrade of its sovereign rating unless the former is reduced: one is somewhat surprised that they do not seem to be equally, if not more, concerned about the galloping deficit on the current account. In any case, rating companies' record on balance of payments crises has not been very reassuring: to give just one example, the widening current account deficits in East Asia were, broadly speaking, ignored until the crisis erupted in 1997.

The other side is that, to my mind, the fiscal deficit should be less of a concern than the external deficit. For one thing, the rate of growth of the nominal GDP has been much more than the rise in government debt (however, GDP data on expenditure basis evidences a stagnant nominal GDP from Q1 to Q2 of 2012-13). And, the debt to GDP ratio is hardly alarming. In any case, as Voltaire, the great 17th century French philosopher/financier/businessman cautioned, *"any state that borrows from its own people is no poorer for it"*; a corollary is that a state needs to be much more concerned about external indebtedness.

What of India? Thanks to the huge and growing external deficit, India's net International Investment Position (IIP) has been deteriorating rapidly. As per the latest data, the net negative number jumped from \$ 224 bn at the end of June 2012 to \$ 272 bn by end September: this is the amount we owe to the rest of the world on a **net** basis, i.e. after taking credit for our reserves and investments abroad. The number will keep growing as the deficits on current account show no signs of dropping. The policy-makers seem to be keeping faith in the old adage of continuing to dance, until the music goes on: the problem of course is that, some day, the music of overreliance on external funding does

stop. The fact that the deficit has been financed so far by capital inflows, thanks to the herd instinct of investors and global interest rates, should not make us complacent. As economist Rudiger Dornbush said in the euro zone context, any *“crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought.”*

In my view, the external deficit is a reflection more of the un-competitiveness of the exchange rate. To quote from the 46th A.D. Shroff Memorial Lecture on “G20 and India” delivered by the Governor on November 20, 2012, *“deficit economies.... need to depend for growth more on external demand which calls for a real depreciation of their currencies.”* Instead, we seem to be continuing to depend on a market-determined exchange rate, rather than achieving “real depreciation” as the Governor propounded: on the contrary, recent reports suggest that the RBI has been selling dollars to halt the rupee’s fall! This apart, the trade weighted exchange rate index calculated by the central bank, is not a good measure of the competitiveness of the tradable sector. A more logical index would be against invoicing currencies, or even just USD, given that more than 80% of our external transactions are invoiced in the US currency. By my estimate, and taking 2001-02 as the base, the wholesale price index in India and the consumer price index in the US as measures of inflation, the nominal rate needed to be somewhere very close to Rs. 70 per dollar by end March 2012, for the real rate to be where it was 10 year back!

Instead of correcting the exchange rate and following a policy aimed at a viable external account and promoting growth and jobs, we seem to be considering increasing import duty on gold. In my view, this would do little to cure the basic problem: remember, until the crisis of 1991, there were no gold imports, at least officially, and yet the crisis occurred. Gold is, at least partially, a financial asset and the normal demand supply curves in economics textbooks too often do not apply to financial assets. (And, if price rises are supposed to reduce demand, there is a far stronger case to remove all subsidies on petro-products.)

One excuse trotted out for falling exports is state of the global economy: in the same global economy, however, Chinese exports keep growing. Net negative exports not only reduce growth and output, but much needed jobs, particularly in labour intensive businesses.

The other side of what I am advocating, a depreciation of the rupee in real terms and removal of subsidies, would lead to a jump in the inflation rate. It is, however, better to swallow that pill rather than wait for a crisis to occur leading to our having to take the bitter medicine of deflationary macroeconomic policies imposed by external creditors. And, as in all crises, the burden of adjustment falls unduly on the shoulders of those least able to bear it.

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