

### **The Balance of Payments**

Southern Europe is a live example of what happens when countries lose global competitiveness at a given exchange rate, and start incurring unsustainable deficits on the current account, becoming ever more dependent on foreign investors for financing them. And investor sentiment can change very quickly. (Ireland is a good example of the latter phenomenon, although the problem was a banking crisis and consequent fiscal deficits, see World Money 13<sup>th</sup> December 10. As recently as till mid-September it had no problem in getting its bonds subscribed). Could investor sentiment change for India as well?

Our current account deficit will likely exceed significantly the official forecast of around 3% of GDP. Goldman Sachs in a recent research report has forecasted a deficit of \$ 67bn, or 4% of GDP, in the current fiscal year, i.e. even larger than the U.S.'s (and even higher than that in 2011-12): this number seems to me to be more realistic. And, this still considers remittances as current "income" – as I have argued earlier, the gap between the domestic economy's external earnings and expenditure is even higher at something's like 8% of GDP in 2010-11 itself! The output loss in the tradeables sector has been going up year after year.

As oil prices have increased in recent weeks, the actual deficit could well go up further. The Reserve Bank Governor, in his post-policy interview last month (Business Standard, November 3), cautioned that "*a sustained current account deficit beyond 3 per cent year after year will be difficult to manage by flows that are not of a stable nature*". Note the focus on the possible difficulty in managing the deficit by flows, not about the huge output loss it represents.

Curiously, even while raising questions about possible difficulties in managing the deficit, the authorities have refused to tackle the root cause: the appreciation of the rupee in real effective terms because of capital inflows, with no intervention in the market or any steps to curb the inflows. (Obviously, for government intervention to be justified, airfares are far more important than the exchange rate!) Are we worried about the impact on equity prices and FII sentiment? If so, it is difficult to appreciate this pandering to finance capital. As Dr.Y.V.Reddy said some time back (see Business Standard July 13) *“If public policy is itself scared of the financial markets, the financial markets will know that it can pressure them against controls. If public policy is determined to manage, it can be managed better”*. Far more competitive, and surplus, economies in Asia, and elsewhere, have announced measures to curb capital inflows – and many economists are advocating this, from Joseph Stiglitz and Michael Spence to the World Bank. But we are made of sterner stuff and have no hesitation in sacrificing the real economy’s output and jobs through the deficits on the current account, in the interests of the financial economy. After all, as an aspiring superpower of the 21<sup>st</sup> century, should we not follow the policies advocated by the superpowers of the 19<sup>th</sup> and 20<sup>th</sup> centuries, and their faith in financial market efficiency, in market-determined exchange rates, etc.? If that means a huge loss of output in the tradables sector, this is only a manifestation of the “creative destruction” on which capitalism thrives. If exchange rate appreciation is a cause, so be it! After all, have not the erstwhile superpowers de-industrialised over the last three decades, even as their financial economies thrived, at least until the crisis? Our concern should be with the financiability of the deficit, not the output loss.

Is such complacency about the exchange rate in order so long as we are confident of financing the consequential deficit on the current account? And, what are the prospects for capital flows next year? Personally, I am not very optimistic:

⇒ As it is, portfolio investors are getting to be cautious about the Indian market. And, it is difficult to see the sentiment changing in the next year, particularly as with the tight liquidity and the deflationary exchange rate policy, margins and growth could be hit next year. It is worth bearing in mind that, just as portfolio

investors rush in, they can rush out when the outlook for the currency or economy changes -- as too many emerging markets have experienced over the last two decades.

- ⇒ Again, the more stable FDI inflows have dropped significantly in the current year. In sectors where they can come in quickly (retail, insurance, etc.) we do not want them. POSCO evidences the difficulties is coming in; Cairn the difficulties in getting out; and Vodafone and Dow the difficulties after the investor has come in.
- ⇒ The corruption and governance problems, which have made headlines in the global media over the last three months, are hardly an advertisement. Indeed, these could drive major Indian industry to invest abroad rather than in India: net FDI inflows could fall even more than the gross inflows.

What is the extent of the overvaluation and what can be done? I shall revert in a later article.

A.V.Rajwade

Email [avrajwade@gmail.com](mailto:avrajwade@gmail.com)