

**BoP Data: Numerator and Denominator**

It is quite normal for the reader/viewer to be influenced by the manner in which data is described or presented. Conventional presentation often discourages looking at the issues from a different perspective. One example of this in relation to the reserves of foreign exchange is that they are generally compared to the imports, and the "...months' cover" they provide. The implicit assumption is that reserves are needed only to pay for imports. In the process, we overlook the possibility that, in certain circumstances, reserves may need to be used to meet other short term liabilities like debt servicing; outflow of portfolio investments; etc.

The reason that has provoked the above thought was the Balance of Payments data published in the last week of December. It is customary to report both the deficit on current account, as conventionally calculated, in absolute terms, and also as a percentage of the gross domestic product. The two numbers for the second quarter of the current fiscal year were respectively \$8.2 bn (negative), and 1.6% of GDP: the Financial Stability Report has claimed that *"the current account deficit (CAD) as a percentage of GDP has remained at comfortable level."*

The reason why the deficit is reported in GDP terms is that it represents a corresponding loss of domestic output: indeed, this could well be the reason why the convention came into being. The other side is that, as I have argued earlier in this column (*"Net External Liabilities and Output Loss"*, BS, November 12, 2015), for this we need to look at the current account deficit net of "secondary income". In Q2 this number was \$24.5 bn; in other words, the output loss was not 1.6% but almost 5% of GDP! (I recently found some confirmation of this way of looking at the output loss in *Crisis Economics* by Nouriel Roubini and Stephen Mihm, though they do not discuss the issue in detail since the number is significant only for countries who receive aid or private remittances from citizens working abroad, on a significant scale.)

Another problem in the conventional way of reporting the deficit, in absolute terms or as a percentage of GDP, is that it does not highlight the number as a percentage of the income. To elaborate, in our case, the deficit of \$24.5 bn (net of secondary income), is the difference between credits of \$ 110.2 and debits of \$ 134.7 bn: this works out to

22.2% of the earnings, surely a better measure of how uncompetitive we are than the deficit of 1.6% of GDP suggests.

As I have argued earlier also, we cannot afford to keep on spending and investing more than we produce year-after-year: the rest of the world does not owe us a living. (Only the US can afford the luxury because its currency is the world's principal reserve currency and it has the exorbitant privilege of getting its external deficits financed in its home currency.) Some developments in recent weeks have highlighted the kind of "tail risks" which our imbalance of payments could well face:

- ⇒ Oil prices shooting up. One cannot rule this out if the current cold war between Sunni Saudi Arabia and Shia Iran escalates into a hot war;
- ⇒ Portfolio flows reversing sharply. In fact, during the last six months foreign portfolio investments in the equity market have been negative, and the rupee has been softening. (To be sure, FPI in the debt market has remained positive so far). As it is, most FPIs are overweight on the Indian market, which is also expensive in terms of the price earnings ratio;
- ⇒ A change in sentiment about the e-commerce sector which has attracted huge foreign private equity investment;
- ⇒ The Chinese stock market continues to be weak and China has experienced huge capital outflows: given its level of reserves and net International Investment Position, it does not need to worry too much about this. Our net IIP is hugely negative;
- ⇒ The possibility of large redemptions from bond funds in the US should investors start incurring losses from steepening of the yield curve. This apart, commodity exporters like Saudi Arabia have already withdrawn huge amounts from the bond funds. And, given the contagion effect in financial markets, we are unlikely to be immune to global developments;
- ⇒ A negative surprise on the growth number. The core sector reported its sharpest contraction in November since April 2005, and the industrial output fell by 3.2 %!

A.V.Rajwade (avrajwade@gmail.com)