The current account

The last three months' increases in exports have come as a pleasant surprise: in fact, as per preliminary data, February exports have gone up as much as 50% compared to the number a year back. This has led the Commerce Ministry to forecast a much lower trade deficit in the current year than earlier apprehended. In a way, the data are puzzling. The world economy is hardly in a great shape, and the exchange rate has appreciated very sharply, particularly in real terms, over the last two years. Economic research from RBI some time back had identified global demand and the level of the exchange rate as the two most important drivers of export growth. And, this stands to reason: most of our exports consist of non-differentiated goods which are principally traded on comparative prices in the invoicing currency, which, in turn, are a function of the exchange rate.

However, as reported by Mint (March 11), the Government has admitted that recent merchandise import data were underestimated due to a technical glitch. Could a similar error, but in the opposite direction, have occurred in the exports data? One needs to keep one's fingers crossed.

I am also puzzled by the recent strengthening of the rupee, even as FII money has kept going out. One wonders whether remittances have gone up sharply after the unrest in Tunisia, Egypt, Yemen, Bahrain, Libya, etc. Indeed, some recent visitors to Dubai have reported that many Indians working there are transferring their savings back. This can give a one time boost to the supply of dollars even as the longer term prospects for inward remittances would worsen, should the unrest and social/political instability in that part of the world continue. This, as also the price of oil, would have an important bearing on the prospects for the current account deficit in fiscal 2011-12.

Another relevant issue is the sharply reduced rate of taxation on dividends earned from foreign companies, proposed in the Finance Bill. Under the existing provisions, such dividend income is taxable at the marginal rate of tax (30%). The rate is now proposed to the brought down to 15%. It is understood that a number of large business houses having significant investments abroad, had lobbied for the change. But one cannot help wondering whether there is a little more to it than meets the eye. In other words, is it an effort to bring the much publicized unaccounted money supposed to be held by Indians abroad? An amnesty scheme in disguise? It would not be very difficult for such moneys to be used to inflate the profits of foreign companies and remitted to India as dividend income taxable at the lower rate of 15%.

While on the subject of the current account, I recently read the IMF Staff Discussion Note, March 1, 2011, by Olivier Blanchard and Gian Maria Milesi-Ferretti, titled “(Why) Should Current Account Balances Be Reduced?” This is obviously in response to the G20 decision to entrust the development of “indicators” to be monitored in the context of the global imbalances. The paper claims that deficits can arise because of “financial regulation failures fueling credit booms” and the “mis-behaviour of fiscal authorities”. It argues that “correcting these distortions” is generally desirable. There is no acknowledgement of the role an overvalued exchange rate plays in creating deficits. Again, while discussing surpluses, it claims that “*These distortions will typically be reflected in a more depreciated real exchange rate*”. Surely, the cause and effect is the other way round: undervalued currencies lead to surpluses for exporters of undifferentiated goods, and hence the pressure on China to appreciate its currency? But the IMF obfuscates the point cleverly. The reason is simple: acknowledging the factual position would lead to the corollary of managed exchanged rates and controls on capital flows, which are ideologically unacceptable. There is an oblique reference to the so-called “Dutch decease”, the phenomenon where large exports of oil or other natural resources lead to the appreciation of a currency. The “Dutch decease” has nothing to do with excess capital flows appreciating a currency as has happened in case after case in the developing world over the last couple of decades.

The IMF seems to argue that it is domestic savings and investment alone that determine the current account surplus or deficit. While arithmetically the two are equal, it needs to be emphasised once again that these variables are not independent of the exchange rate. Economics 101 teaches that net exports are a component of GDP and, to the extent this is negative, the resultant deficit represents a loss of output, jobs and savings. The IMF does not refer to this implication, while discussing the current account deficits and surpluses. Sadly, our own policy makers seem to subscribe to the IMF view, preferring to look at the deficit from the angle principally of its financeability, rather than as a reflection of lost output and jobs. But surely the objective of macroeconomic policy is precisely growth and job creation?

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