Structural reforms needed to fix CAD challenges

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India is currently facing challenges in the management of its external account, reflected in worries about rupee depreciation, and concerns about the current account deficit (CAD).

India's CAD is structural. Growth is not driven by exports. Domestic growth drivers - investment, and in recent times, consumption - are import intensive. The immediate strategy to address this has been to a) finance the current account deficit by encouraging foreign direct and portfolio inflows and b) accept that a structural CAD would require a continuing, orderly depreciation of the rupee, which would eventually reduce the pace of import growth and encourage export growth.

The long-term ambition would be to moderate the CAD by orienting India's domestically driven growth to foster import substitution, foster an increase in exports, and maintain a stable macro-policy environment, such that the CAD would either be eliminated or would stabilise at levels which our growing mega-economy would easily finance by attracting stable capital inflows.

How do recent developments impact the immediate strategy?

The widening of the current account deficit was expected. The IMF projected the CAD to be 2.6% of GDP this financial year. When compared with other emerging economies, amidst global uncertainty, India is well within parameters. The headlines are motivated by the Q2-2018 CAD being $0.8 billion higher than in Q2-2017. Almost all of this increase is because the value of oil imports has risen, even though these have been substantially offset by increases in net factor incomes from abroad. I would not, therefore, view this single data point as a cause for structural concern.

With respect to the depreciation of the rupee, I have little faith in arguments based on real effective exchange rates as these rest on didactic theoretical premises. I prefer the analytics used in the Nomura Damocles Index which scores countries on their vulnerability to an exchange rate crisis in the next twelve months. India scores 25- below China (37) - and well within the safety threshold score of 100.

Absent external shocks, it is reasonable to expect the Indian rupee to annually depreciate by 4-6% against the dollar. The recent depreciation outside these parameters can happen because of a) an attempt by speculators to "short" the rupee b) weakening demand for the rupee because of stronger US growth c) "contagion:" downward changes in allocative algorithms of financial sector players following negative events in emerging markets like Argentina and Turkey. Here the first priority is to ensure that "shorters" fail and that the algorithmic changes impact the rupee in an orderly fashion. On this count, extreme vigilance continues to be required, and the situation has been well managed so far.

I am, therefore, confident that with careful vigilance, effective communication (in particular, avoiding reactive and contradictory statements by public officials that confuse the markets), and continuing the explicit policy stance of government, that the macroeconomic task is to minimize volatility and avoid contagion to other macro-policies (like widening the fiscal deficit by lowering taxes, using interest rates as a tool for exchange rate management etc.), the present challenge can be effectively dealt with.

And what of the ambition?

What the current challenge does highlight is that the Indian economy remains structurally vulnerable to external shocks. Banal statements like “the rupee must find its own level” are unhelpful. A depreciating rupee should result in a fall in import demand and a rise in export demand through the price effect. This does not work in India. Most exports respond mainly to improvements in productivity and to changes in global demand, and are highly inelastic to exchange rate depreciation. So are oil imports which, I calculate, have an elasticity of (-) 0.24. Since 1991, import intensity of the Indian economy has risen steadily. Key sectors growing in sectoral importance (like defence, aviation, and electronics) have failed to secure significant import substitution. New import-intensive sectors have emerged. India now imports cheap clothing from Bangladesh and Vietnam, mobile phones from everywhere, and solar panels from Japan and China.

Further, some things that used to be non-tradeables are now being imported. In 2013 foreign exchange spent on education and recreational travel abroad was $176 million; in 2017 it was $5.4 billion. These are warning signs of increasing structural weakness on the external account that aggravate exogenously driven short-term challenges such as the one we are currently facing.

The structural external account challenge is yet another reflection of something I have been repeatedly stressing in these columns: the quality and composition of India’s growth story is raising sustainability challenges. Growth since 1991 has been fuelled by increased elite prosperity and a benevolent attitude to their luxury consumption needs. As a consequence, our production and consumption patterns are increasingly import intensive, and our exports sluggish. Import intensive production and consumption is compounded by the media-cheered hands-off approach to the desire of the wealthy to import the best available, from mobile phones to foreign education. Instead of using foreign exchange to import food and items of mass consumption to provide these at affordable prices, the external account is lavished on luxuries for the rich, and the exchequer is pressurised by a strident urban elite to lower petrol prices to fill the tanks of their personal vehicles. Fixing this requires structural reforms, and an explicit willingness to intervene to change this undesirable market outcome, something every economic nationalist should advocate across political lines.

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