Business Standard

A long haul

The wide current account deficit is structural in nature and only structural responses will work

Subir Gokarn June 16, 2013 Last Updated at 21:50 IST

The behaviour of the rupee in recent weeks has brought the size of India's current account deficit into very sharp focus. The estimates for the fourth quarter of 2012-13 and for that full year will be published on June 28. The expectations are that these numbers will bring a little relief after the shock of the third quarter. However, they will still underscore the massive widening that has occurred after the global financial crisis of 2008. Most observers will accept the view that there is a strong structural component to this and it will not correct on its own.

This leaves the rupee vulnerable to the kind of large and rapid adjustments that have been seen not just in recent weeks, but on three other occasions after August 2011. Of course, all four episodes have seen policy responses that have contributed to some stabilisation, but the repeated occurrences obviously indicate that these responses have really not addressed the structural factors behind the widening current account deficit and, consequently, the vulnerability of the rupee to both external and domestic shocks.

Looking back at the trend in the current account deficit since 1990 will help provide some perspective on its structural characteristics. Until 2011-12, when the current account deficit exceeded four per cent of gross domestic product (GDP) for the first time in this period, the highest it ever got to was three per cent in 1990-91. It remained a deficit until 2000-01, but usually below two per cent of GDP, and in the last three years, at one per cent or less. From 2001-02 until 2003-04, the deficit turned into a surplus, which in the last year was above one per cent of GDP. It slipped back into deficit mode in 2004-05, small at first, but widening rapidly. It remained below three per cent of GDP until 2010-11, but has gone into uncharted territory since then.

Over this entire period since 1991-92, except for the crisis year of 2008-09, capital inflows have been more than sufficient to finance the current account deficit. Whatever currency volatility was seen, therefore, was the result of temporary mismatches between supply and demand. As the current account deficit narrowed and moved into surplus territory, capital inflows grew significantly, resulting in persistent rupee appreciation up until the crisis. This pattern has clearly reversed itself since the crisis. While capital inflows have certainly not stopped, the cushion they provided has reduced considerably. More so, their volatility has increased, which translates into more pressure on the currency.

The key lesson can be articulated through a simple equation: impact = shock x vulnerability. In these episodes, when the shock has been external - the US ratings downgrade, upheavals in the euro zone and, most recently, the prospect of a quantitative rollback by the US Federal Reserve - it has been more or less uniformly felt around the world. But the impact across countries has been vastly different. In the case of emerging market economies, measured by the extent of currency depreciation, it has clearly been closely correlated with the size of the current account deficit. When the shocks were domestic - policy actions or

political developments - the rupee depreciated sharply as well, while other currencies didn't. Either way, for a given shock, the magnitude of the impact reflects the extent of the vulnerability, which, in turn, largely stems from the current account deficit.

A structural widening of the current account deficit can be addressed in a number of ways. One is to let spontaneous correction take place, that is, a depreciated currency will soon lead to higher exports and lower imports. For this to take place, certain conditions relating to the price elasticities of demand for exports and imports have to be satisfied. Given the current state of the global economy and keeping in mind that many of India's competitors in the global market for goods have also seen their currencies depreciate, the prospects for a sharp revival in exports don't seem too bright in a business-as-usual scenario.

On imports, two dominant components in today's basket, as everybody knows, are oil and gold. On the first, right pricing and conservation are necessary components of a long-term strategy but have limited short-term scope. On gold, as recent patterns suggest, its dual character as a consumption and investment good makes for rather complex relationships between price and demand.

The second is to revert to a restrictive trade regime. Fortunately, even under relatively high stress, this option has not found expression in the mainstream policy debate. The risks of protectionist responses to the crisis of 2008 and the collective resolve to avoid them were a visible part of the global discussion after the crisis, and for very good reasons. Unilateral action, however tempting, could lead to retaliation. However, given the compulsion to be seen to be responding, trade and tariff barriers have been imposed on gold. Even allowing for the possibility that they may have some short-term impact, they should not be viewed as a structural solution.

The third and, in my view, unavoidable approach is to directly address the structural impediments to a narrower current account deficit. Just as the explosive growth in information technology and IT-enabled services exports helped narrow the gap before the crisis, Indian exports need a boost from a new engine. Will it come from agriculture, manufacturing or other services? We need to identify the top few potential opportunities and remove the constraints that prevent them from bring realised.

On gold, the priority must be to "de-materialise" gold investments - that is, to allow people to get the perceived benefits of investing in gold but without the requirements of physical imports. This will require rapid product development and significant marketing initiatives. In effect, the financial system has to compete more effectively against the neighbourhood jeweller.

One recent source of stress on the current account deficit has been the reversal in the mineral trade balance, as a result of dropping iron ore exports and increasing coal imports. Given India's endowments in both minerals, this seems an anomaly, even after allowing for full compliance with environmental and social regulations.

To sum up, we need to come to terms with the fact that a small current account deficit is not an entitlement. It is the outcome of a dynamic combination of facilitating conditions, which need to be created and sustained. A return to the comfort zone of the pre-crisis period requires a structural approach. It will be a long haul, but there is no alternative; and it will be worth it.

The writer is director of research, Brookings India, and former deputy governor of the Reserve Bank of India. These views are personal