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THE ECONOMIC TIMES
Wed, 18 Jul-12; Economic Times - Mumbai; Size : 542 sq.cm.; Page : 17

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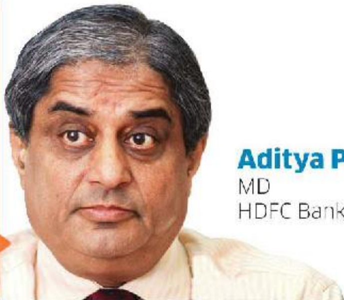
Reining In Deficit Entails Revamp of our Exim Policy

Guest Column



Aditya Puri
MD
HDFC Bank

The relentless pressure on the rupee over the past few months has been a constant reminder of the fact that we are running an unsustainable Current Account Deficit (CAD). This has made us hostage to the ebb and flow of global risk appetite.

When global capital flows improve, the rupee gets a temporary reprieve only to be battered down again as global sentiment turns. If we believe that a more stable, somewhat stronger currency is the answer to some of our macroeconomic problems — high inflation for one — then efforts to rein in the CAD should be as critical as attempts to spur capital flows. In fact, one could argue that reining in the CAD is perhaps more important at this stage.

We run the risk of a downgrade in sovereign credit rating by the premier rating agencies. Were that to happen, the quantum of capital flows would dwindle sharply as institutions like pension funds, that use these ratings directly in their investment allocation, will be forced to pull out of Indian markets.

Let's be clear, the CAD is a structural problem, not merely a cyclical uptick driven up by strong domestic growth. The data should make this abundantly clear. In 2011-12 we posted the lowest GDP growth rate of 6.5% in the last nine years. Yet, we simultaneously recorded the highest CAD-to-GDP ratio (4.2%) in post-independence history. In short, the CAD is not the result of high imports to fuel high growth — it is instead a manifestation of unsustainable structural imbalances.

The solution is also 'structural' in nature and entails a revamp of our export and import policy.

The biggest contributor to the ballooning CAD has been gold whose imports rose from $35 billion in 2010-11 to $62 billion 2011-12. In fact, if we take gold imports (adjusted for re-exports) out of the current account, the deficit drops all the way to 2% of GDP. The distinction made between gold imported to use as jewellery and for investment is purely academic. Gold purchases have increasingly become a key element of the portfolio choice of households who are using it both as a hedge against inflation and a safe haven in times of macroeconomic uncertainty. Given this feature of gold purchases, the argument that since it constitutes a portfolio decision its imports should be classified in the capital account, is legitimate. However, reclassification might give us better perspective on how big the CAD really is but the fact remains that gold imports will continue to be a drag on our overall balance of payments.

Apart from pushing up the CAD, gold imports have another adverse macroeconomic impact. By holding gold, households shift their savings away from what would potentially be a financial asset (mutual funds, bank deposits) to a 'sterile' asset and does not augment domestic investment resources. If we assume that only half of gold imports (or $30 billion) are 'savings' by nature then that is a straight loss of 1.6% of GDP of potential financial savings. We simply cannot afford this.

Raising import tariffs on gold will help only to a degree. We may need to, at least temporarily, put a complete curb on gold imports. The idea that 'gold smuggling' is the cost of banning gold imports, while true, may be a price worth paying to correct our balance of payments. Also, the quantum of gold smuggling will depend on the efficacy of the controls we put on gold — if the controls are effective, it will push up the cost of smuggled gold and discourage purchases.

Secondly, the ban need not be permanent. However it can buy us much needed time to put our house in order. If smuggling does appear to get out of hand, we can always return to a free import regime.

What about other imports? Can we put in place a strategy that leads to a sustained compression in imports and improves the trade balance over the medium to long term? For a start, we need to review our trade relationship with China. China is now our biggest trading partner and has helped in our goal of diversifying exports away from the West. But let us not forget two important things. First, we run a massive trade deficit with China of around $40 billion (21% of our total trade deficit in 2011-12). Our exports to China of about $18 billion are about a third of our imports from China. That is, our trade with our neighbour is extremely unbalanced. A significant portion of China's imports come into relatively low-technology areas — electrical goods, toys, locks (recently I came across a Ganpati idol made in China) — where it competes with our domestic labour-intensive, small-scale sector. The gush of imports from China, thus, is not only bloating the trade deficit, it is also killing off a critical segment of our manufacturing economy.

The current account deficit is a structural problem. It is not merely a cyclical uptick that has been driven up by strong domestic growth

Second, China is known to follow aggressive market-share expansion policies (dumping backed by heavy government subsidies to manufacturers being the common example) that violate international trading arrangements. This is not merely with respect to India but its bigger trading partners as well, such as the US.

Thus we need to ask two questions in reviewing Indo-China trade? Are we getting adequate market access to China or can we redress this imbalance and ramp up our exports? Also, are the excess imports from China partly the result of aggressive, anti-market practices? Can we take more active recourse to entities like the World Trade Organisation or unilateral import curbs to prevent this? It is likely that if we take a more guarded approach to our trade with China, it would help correct our trade gap to a significant extent.

The other question that we need to answer is the following: is our import policy and import duty structure in sync with our existing industrial structure and our goal of greater industrialisation going forward? Are we, instead, so influenced by the dogma of an open trade regime that we are giving domestic manufacturing short shrift? Take the case of defence imports or those related to power generation. While we have extensive domestic production capacity, we currently import a variety of equipment (such as boilers and turbines) at a piffling import duty of 7.5%. These imports both hurt domestic manufacturers as well as the balance of payments (a conservative estimate of defence imports would be about $15 billion last year). These 'unnecessary' imports are not confined to defence but are likely to be found in sectors across the economy.

Thus, in formulating a strategy for compressing the current account, we will have to think of ways to replace these 'unnecessary' imports through domestic sourcing. The way to do this is to take a fresh look at our import duty structure and hike tariffs where needed. It is useful to keep in mind the fact that India has reduced import duties for a number of industrial items unilaterally. The actual duty levels are much lower than the committed levels of tariff or 'bindings' to the WTO. Thus in most cases, there is no risk of facing retaliatory action under international trade laws.

That said, it is quite likely that if we raise import tariffs on some items, we risk being branded as 'protectionist'. If the simple principle of aligning our trade regime with existing local capacity and making the most efficient use of local resources is labeled 'protectionist', so be it.

Finally a strategy of import compression has to be combined with a drive to push up exports. A lot has been written on the various elements that are key to higher and sustained export growth — better infrastructure, diversified markets and easy financing. There is another things that might help export growth in the near term — lifting the ban on export items, particularly in agriculture. Clearly, the curbs on agricultural exports can only be lifted after a careful analysis of the impact of lifting them. We cannot, for example, lift the curbs on the exports of pulses immediately given the current domestic shortage. However the same does not apply to the curbs on the export of non-basmati rice or wheat (banned since April 2007). With current buffer stocks running at about 65 million tonnes or 30 million tonnes above the optimal stocking norm (a good fraction of which is rotting), there seems to be no rationale to continue with the ban. In fact, we should export surplus items aggressively to enable us to import items like pulses and oilseeds that are in short supply.

A more rational trade policy serves many purposes. It could help bring down the massive CAD and take the pressure of the rupee. This in turn could harness 'imported' inflation. The RBI could then think of focusing on ramping up growth through rate cuts and monetary expansion. A revamp of the trade regime would also align our export and import patterns with domestic capacity and resource availability. In short, a win-win situation for the economy.