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## India kicks the can down the road - again

By Kunal Kumar Kundu

NEW DELHI - A decline in the rupee to historic lows against the US dollar, combined with a widening current account deficit, has prompted the Reserve Bank of India and the Indian government to take the unusual step of acting in tandem.

The current account deficit (CAD) - the difference between what India imports in the way of goods and services and what it exports - has widened to the point where financing the deficit has become a major concern. This, aided and abetted by a weak economy and an even weaker business sentiment, has led to a weakening rupee - now down more than 10.5% against the US dollar this year.

India's outgoing RBI governor Duvvuri Subbarao, who steps down next month to be replaced by Raghuram Rajan, has done his reputation little good by targeting the rupee at a level that is indefensible given the macroeconomic realities. To top this, his statements and actions at times have been at cross purposes, raising the level of confusion in the market.

The extreme measure of sucking up of liquidity and targeting the shorter end of the yield curve has had two consequences: interest rates have hardened, especially at the shorter end (which will create further headwinds against economic growth) and India's yield curve has remained inverted for a fairly long period (an indication of stress in the economy).

These measures worked, albeit for a short period, and the rupee strengthened to less than 59 to the US dollar after sliding below 60. However, basic concerns remained and it was only a matter of time before these resurfaced and the rupee weakened again to above the 60 mark and it shows no sign of reversing course. The currency was trading this week at 61.5 to the dollar.

Given the possible impact of the weak rupee on inflation while exports fail to increase significantly (as declining competitiveness engendered by years of neglect of the manufacturing sector nullifies the benefits of a falling rupee), thereby failing to improve the trade balance much, India's woes are compounding.

The RBI this week took new steps to rectify matters. On Wednesday, it moved to reduce foreign exchange outflows by restricting remittances by resident individuals to US$75,000 per financial year, down from an annual $200,000, and barred the use of remittances for purchasing property outside India. The RBI also cut the limit for new overseas direct investments under what is termed the automatic route to 100% of the Indian party's net worth, down from the previous maximum of 400%.

This limit will also apply to remittances by Indian companies setting up unincorporated entities outside the country in the energy and natural resources sectors, with certain exceptions.

The government for its part this week set a 10% tariff on imports of non-essential items (notably gold, silver and platinum) after gold imports picked up in July, and followed that up by banning imports of gold coins and medallions. Finance Minister P Chidambaram told parliament on August 12 that the government also planned to curb demand for imported crude oil.

The big question is will these measures really work? It does not seem likely, though they may bring temporary relief. The problems faced by India are purely structural in nature, the result of years of inappropriate policy decisions - be it neglect of the domestic manufacturing sector, a high dependency on energy imports, falling competitiveness due to policy logjams, high levels of fiscal deficit and so forth.

Even now, the government has displayed its preference for kicking the can down the road by refusing to take politically difficult (though economically imperative) decisions while opting for softer and quite often symbolic steps.

Finance Minister Chidambaram believes that the steps taken so far will ensure that the current account deficit for the financial year ending April 2014 can be restricted to $70 billion (much lower than the general expectation of $85 billion) and will result in a CAD to GDP ratio of 3.7% as against 4.8% achieved during the year that ended March 31, 2013.

Even if for arguments sake one accepts that the deficit can be contained within $70 billion, the expectation of that being 3.7% of GDP seems to be too optimistic. A simple calculation will explain this.

For a CAD of $70 billion to account for 3.7% of GDP, the nominal GDP for the year should be about $1.9 trillion. The rupee in the financial year that started in April has averaged 58.45 per dollar and is currently trading at 61.5 per dollar. If we (optimistically) assume the rupee averages 60.5 per dollar over the rest of the year, this would mean that the average rate through to next April would be around 59.25.

This roughly translates into a GDP (at market price) of 112.1 trillion rupees, which would mean a near 12% growth in nominal GDP this financial year.

For the first four months of the current financial year, India's official inflation, based on the Wholesale Price Index (WPI), averaged 5% per annum.

Even if we assume that inflation as gauged by the WPI picks up over the next few months and that it averages 6% for the full year, real growth in GDP would also be 6%. (Here we are talking about India's demand side GDP - and not income side GDP - which grew at 3.24% during the just concluded financial year ending March).

Given the extent of demand destruction we have already seen in the economy, evidenced in rising levels of inventory, achieving a 6% real growth in GDP is well nigh impossible. With slippage expected on both fronts (the CAD would be higher than targeted, while GDP would be lower), India's CAD for the current financial year will likely be around 4.5% of GDP.

The current draconian measures to contain the fall in value of the rupee will equally likely further choke economic growth. All in all, things do not look good for India.

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