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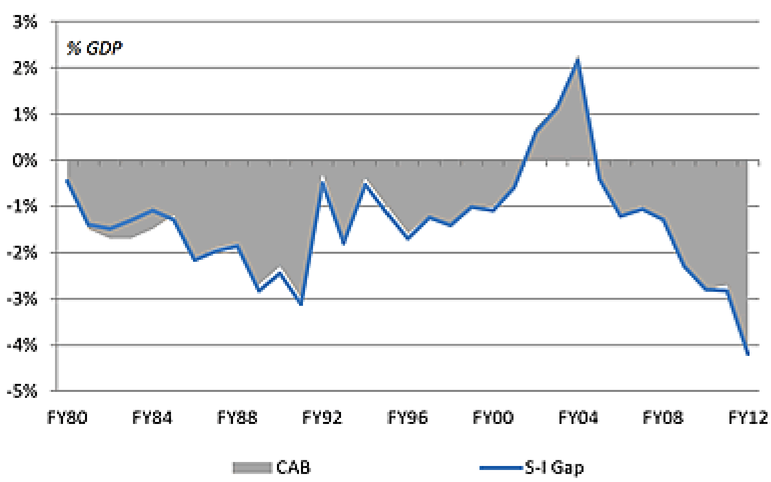
India facing current account deficit bulge

By Kunal Kumar Kundu

Never before has India's current account deficit (CAD) exceeded 4% of gross domestic product (GDP) as it did for two continuous years - 4.2% in the fiscal year that ended in March 2012 and 4.8% in the 12 months to March 2013. The previous highest CAD was 3% of GDP in FY '91, when India courted crisis. While the Indian economy is on a much sounder footing now than it was in 1991, and hence nobody is talking about crisis now, the situation is nevertheless quite worrying.

But why has the situation come to such a pass? A look at the trend in savings rate brings forth the reasons behind the bulge. A gap between savings and investment leads to a rise in current account deficit. Essentially, it means that if domestically available resources are not sufficient to finance a country's investment needs, then there's an increasing dependence on foreign financing.

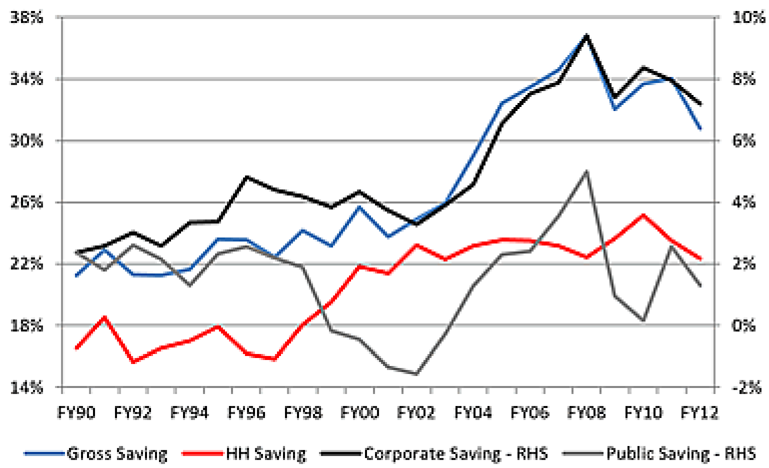


Note: CAB - Current Account Balance. Negative figure indicates deficit. Source: CEIC, author's calculation.

Since FY2008, when the savings rate peaked at 36.8% of GDP and the investment rate at 38.1%, both savings and investment have fallen. However, savings fell at a much faster pace than did investment, and by FY2012, while the share of investment had fallen by 3% of GDP, the savings rate was down by as much as 6%. As of FY2012, gross domestic capital formation (GDCF), used to calculate investment, was still high at 35%. Important to recognize here is that the investment rate has actually not plummeted - the conventional belief. Rather, the efficiency of capital has fallen drastically, with a large chunk of investment sunk in projects that are stuck at various levels of completion and hence are non-productive. As per estimates, 7 trillion rupees (US$118 billion) worth of bank funded projects are stuck for various reasons.

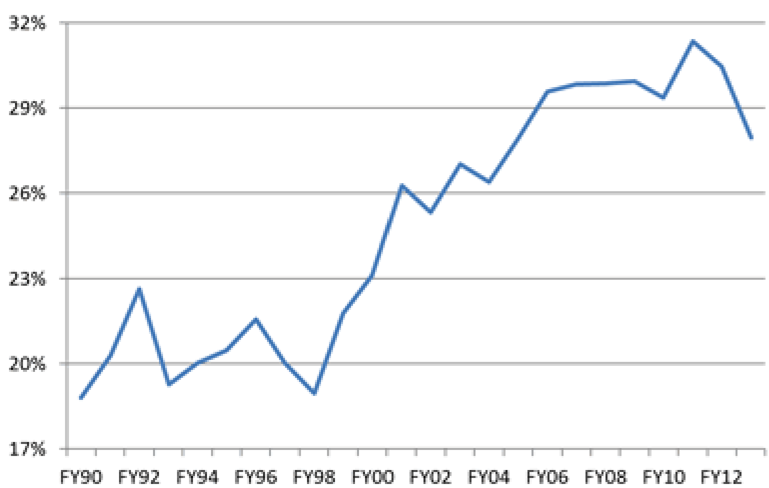
However, what gave in is savings. By FY2012, the savings rate had fallen to 30.6% of GDP. While FY2013 data is not yet available, there is a possibility that the investment rate might have eased at bit to less than 35%, given that gross fixed capital formation (GFCF), which is a part of GDCF, has fallen by 1% of GDP as compared to FY12. Given that the current account deficit for FY2013 has come in at 4.8% of GDP, the savings rate must have fallen below 30% of GDP for the first time since FY2004.

Savings has three components - household, government, and corporate saving. Inefficient to downright abominable government policies have resulted in a drastic fall in household savings, while public savings remain perpetually low.



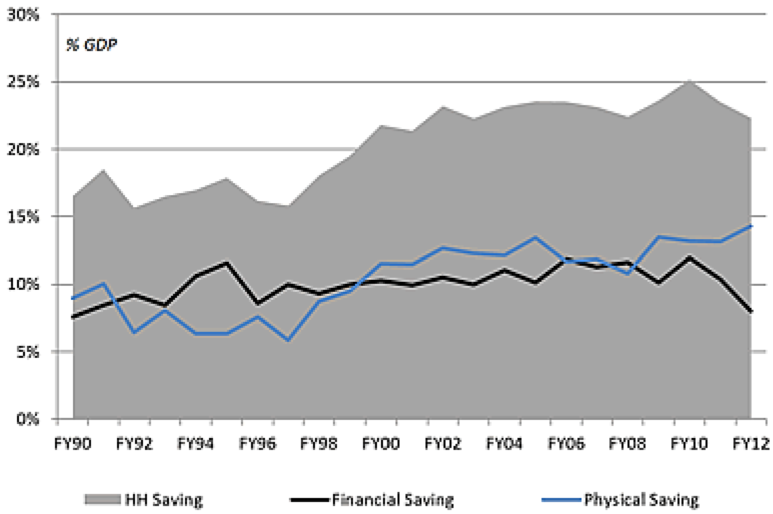
Note: RHS - right hand side; HH - household. Source: CEIC, author's calculation.

Between FY2010 and FY2012, household savings fell from 25.2% of GDP to 22.3% of GDP. High inflation during this period has resulted in falling household savings, as can be seen from the lower proportion of savings to disposable income ratio.



Source: CEIC, author's calculation.

Not only are households being forced to save less as inflation eats into their disposable income, they have moved away from financial saving to physical savings in an effort to preserve the value of those savings they can make. While of financial savings of households dropped as a portion of GDP by nearly 4 percentage points (to barely above 8%), that of physical savings increased by a little more than 1 percentage point of GDP (to 14.31%) during the same period. Part of this increase in physical savings has (not surprisingly) gone to gold, which is what the government has been blaming for the rising current account deficit rather than its own numerous policy missteps. For FY2013, financial savings of households would have definitely dipped below 8% of GDP - the lowest since FY1990.



Source: CEIC, author's calculation.

On the other hand, an increasing focus on social sector spending and ill-advised and ill-targeted subsidies by the government (not matched by recurrent revenue streams) has led to an increasing fiscal deficit, thereby bringing down the overall level of public savings.

Unfortunately, it is not just the publicly stated deficit figure that eventually matters but also the unstated one - arrived at through creative accounting methods. After the government decided to hold the Fiscal Responsibility and Budget Management Act in abeyance in FY2006, having introduced it with much fanfare in the previous fiscal year, it resorted to accounting jugglery - through such devices as the issue of oil bonds, fertilizer bonds and food bonds - to keep the deficit within acceptable limits.

Overall, oil bonds to the tune of 1.4 trillion rupees were issued between FY2006 and FY2010. Food bonds worth 162 billion rupees (during FY2007) and fertilizer bonds worth 275 billion rupees (between FY2008 and FY2009) were also issued. While the government claimed credit for keeping the fiscal deficit under check, it in fact issued in five years bonds worth a total of 1.9 trillion rupees. The cumulative outstanding amount of bond issued, as of FY2010, was the equivalent of 2.9% of GDP. Not surprisingly, by FY2008, public savings had shot up to 4.99% of GDP and domestic savings peaked at 36.82%. Otherwise, the savings rate would have stagnated at around 34% of GDP while the current account deficit for the year would have been above 3% of GDP.

However, these bonds still need to be serviced and when that's done, the fiscal deficit will rise and public savings will drop.

After having stopped issuing the bonds, the government started forcing the oil companies to absorb a larger share of oil subsidy burden. It plans in the current financial year to pay only 200 billion rupees out of the estimated oil subsidy of 800 billion rupees, thereby forcing the oil companies to shoulder 75% of the burden. This will only go up since the rupee, which was trading at around 54 to the dollar at the time of the budget earlier this year, is now below 60 and growing weaker.

In essence, while previously the savings rate was higher than what it should have been, going forward, it will be under pressure as past sins catch up and profligacy continues. While India desperately needs economic reforms to kick-in to remove the structural constraints that peg back the economy, at present it is more important that government finds workable solutions to various issues such as land acquisition, environment, availability of natural resource etc that has resulted in investments getting stuck. That will help improve capital efficiency and hence reduce investment needs, thereby keeping a check on the savings investment gap.

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