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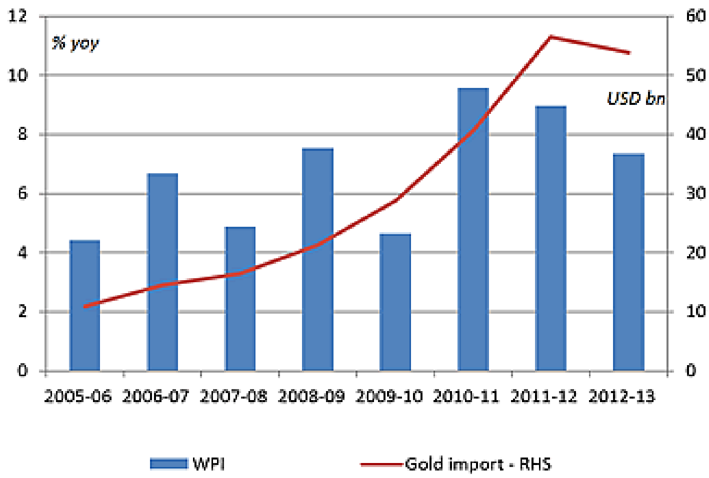
India's problem blacker than gold

By Kunal Kumar Kundu

NEW DELHI - A surprise improvement in India's balance of payments in the fourth quarter of the fiscal year that ended in March, with a rise in exports and decline in imports, was not enough to prevent the full-year current account deficit rising to a historic high compared with gross domestic product (GDP).

The full-year current account deficit (CAD) to GDP ratio hit 4.8%, up from 4.2% in the year to March 2012, even after a near 6% rise in exports in the fourth quarter from a year earlier and a 1% fall in imports. That brought the Q4 CAD deficit to 3.6% of GDP, down from 6.7% in the previous quarter.

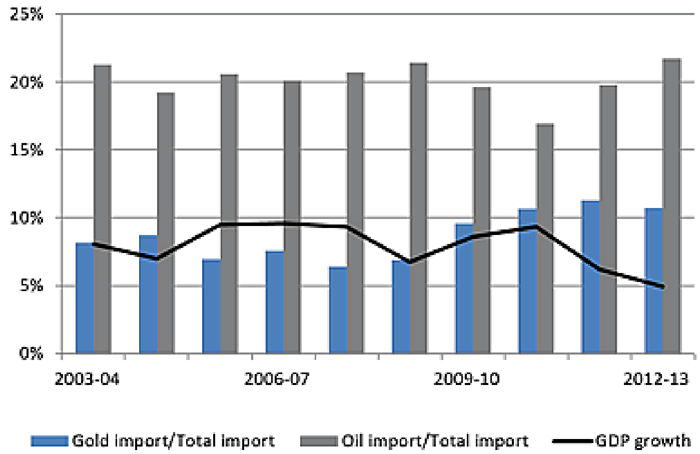
The government singled out gold imports as the most important reason for the ballooning CAD, and there is a grain of truth in the assertion. Gold imports have risen since 2010-11. Yet this phenomenon can be attributed mostly to high inflation in India, resulting in the real rate of interest in India being negligible and even negative. It is therefore natural for domestic savers to turn to gold for succor.



Source: CEIC

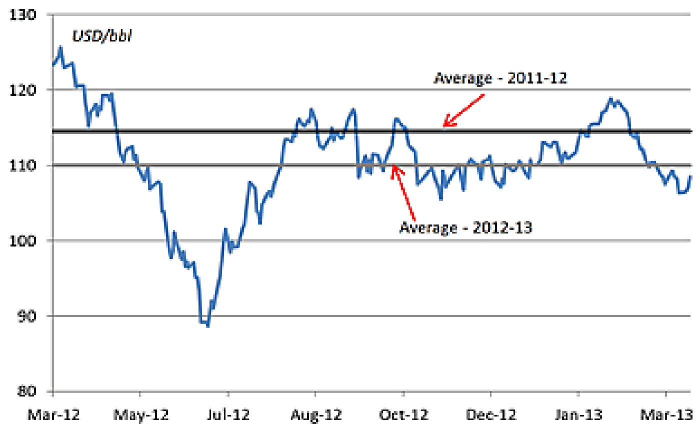
Having said that, gold imports in the 12 months to March this year actually declined 4.75% from the previous year, falling in all but the third quarter on an annualized basis. For the full year, India's non-gold imports remained stagnant.

What is significant is the spurt in oil imports, which rose 10.11% during this period - even as India recorded its lowest GDP growth in a decade ...



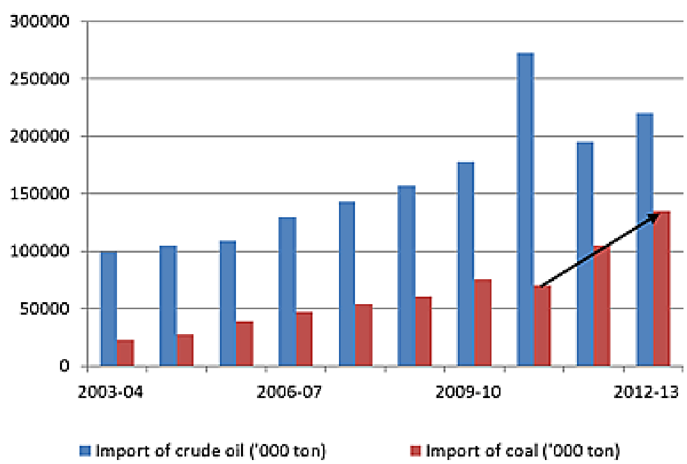
Source: CEIC, author's calculation

... and as oil prices were easing.



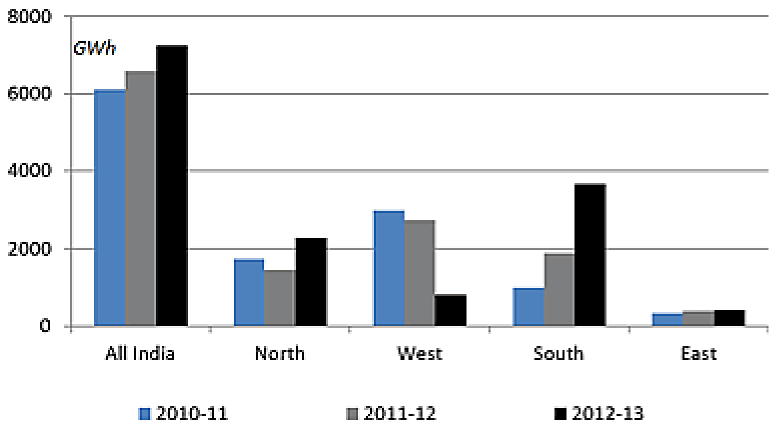
Source: CEIC, author's calculation

The rising volumes of oil and coal imports are two major reasons why India's CAD deteriorated to worrying levels.



Source: CEIC

The drastic increase in import of these two components can be linked to the woes faced by India's power industry. During 2012-13, India's average monthly deficit between production and supply of power was as high as 7,244 GWh, the highest in three years, with the states of south India accounting for more than 50% of the deficit.



Source: CEIC, author's calculation

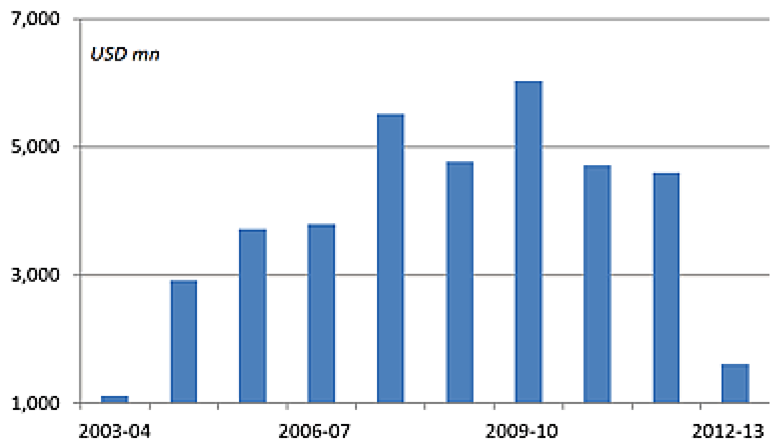
According to the Central Electric Authority, the southern states' power deficit is going to shoot up even further during 2013-14, while the deficit will remain at high levels in states like Punjab, Bihar, Assam and Andhra Pradesh.

While part of this deficit can be attributed to the poor fiscal health of the various state electricity boards and inordinately high transmission and distribution losses, fuel scarcity adds to the woes.

In India, thermal power plants account for 55% of total installed capacity and the country is facing an acute shortage of domestically available coal, despite having virtually 10% of global coal reserves. According to Ministry of Power data, India experienced a shortfall of approximately 46.75 billion units of power in the past four years due to the coal shortage, of which around 12.25 billion units were lost during 2012-13. It is, therefore, natural for coal imports to rise.

When the power deficit widens and is sustained at high level, it is natural that manufacturers resort to generating their own power rather than idle plants and risk facing even larger losses. It is not a surprise, therefore, that diesel demand has shot up.

Another policy issue that hobbled India during 2012-13 was the virtual collapse of the mining sector, afflicted by widespread corruption, land and environment issues and virtual policy paralysis. Not surprisingly, iron ore exports fell 65% during 2012-13 to a mere US$1.6 billion, the lowest since 2003-04.



Source: CEIC

In such circumstances, it is not a surprise to see deterioration in the current account deficit. For the government, shifting the blame to gold imports is a convenient way of deflecting scrutiny from its own inefficiency and economic mismanagement.

For the current fiscal year that will end next March, the CAD is likely to be anywhere between 4.5% and 5% of GDP. While official gold imports might decline (smuggling is already on the rise due to increased restrictions introduced by the government), oil and coal imports are unlikely to show much improvement as policy issues are not likely to be tackled any time soon.

This elevated level of CAD will mean that India will continue to face financing challenges. An even bigger challenge will be the composition of that financing.

While the US Federal Reserve is not likely to taper off its quantitative easing, one potential source of funds, in the near future, India is not in a position attract an increased flow of stable foreign direct investment.

Hot money (portfolio inflows) will continue to be the biggest financer of India's CAD. Even then, it is unlikely to prove sufficient, as corporate overseas borrowing might ease back given the huge hit they are likely to take because of their large and un-hedged external debt position on account of the decline in the value of the rupee.

While the spurt in short-term debt is indeed a matter of grave concern, that at least helps in maintaining a relative stability of India's foreign exchange reserves. The threat of high inflation and only a slow improvement in economic fundamentals will continue to exert pressure on the rupee, thereby making external debt much less attractive. While that might be positive in the medium term, the potential financing gap, with its concomitant implications, will remain a worry.

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