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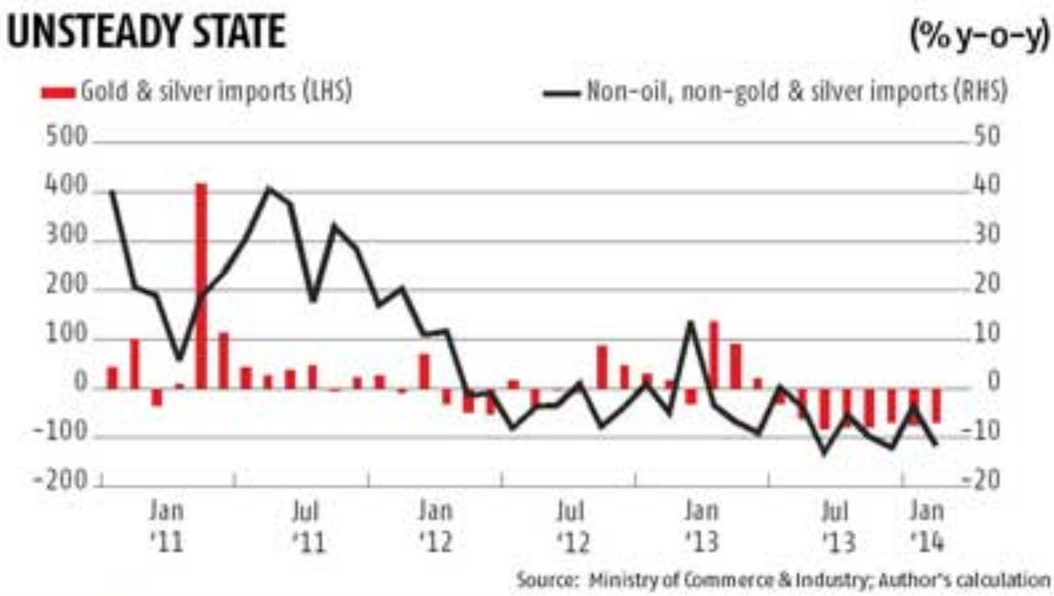
Kunal Kumar Kundu: The CAD mirage

The recent appreciation of the rupee, after remaining remarkably stable over the past few months, poses more questions than it answers. For sure, it coincided with increasing inflows, as the third quarter balance of payments (BoP) data showed that India's current account deficit (CAD) for the quarter came in at $4.1 billion, the lowest in 19 quarters. In fact, India could well end the current financial year with a CAD close to two per cent of gross domestic product (GDP), a remarkable achievement if one considers that the country's CAD during the previous year was as high as 4.7 per cent of GDP. Unfortunately, the steps taken to contain CAD reminds one of the multiple steps taken to keep the fiscal deficit contained within the target - a desperate attempt to cure the patient with nary a care for the symptoms of the ailment.

Just as the government opted for an easy way out by resorting to a massive cut in capital expenditure (at the cost of future growth potential of the economy) to keep its overall expenditure and hence fiscal deficit within limits, improvement in CAD was purely a result of severe clampdown on gold imports (the unintended consequence of which is a massive rise in incidences of smuggling of gold).

India's gold and silver imports contracted during each of the past eight months, with an average contraction of nearly 70 per cent a month. As a result, for the first 11-month period, India's cumulative gold and silver imports stood at $30.53 billion, down by nearly 42 per cent from $52.47 billion. As a result, India's trade balance (during the period) fell by nearly 29 per cent from $179.15 billion to $128.09 billion.



The fact is, any improvement in trade balance due to increasing exports is a welcome sign. Unfortunately, for India, such an improvement has been recorded due to shrinkage in imports. Of course, the slowing down of the economy helped, but that surely is an unhappy coincidence that India did not wish for. What is of critical importance here is that India's non-oil, non-gold and silver imports have been on a path of steady decline, a clear indication of a weak economy.

On the other hand, India's exports are also faltering. While the low base effect did rev up India's exports till October 2013, it expectedly started to decline thereafter, and by February, India's exports actually contracted - the first time since June 2013. Going forward, India's exports are likely to face further headwinds. As of January 2014, India has been excluded from the list of countries that come under the European Union (EU)'s Generalised Scheme of Preferences. Essentially, mineral products, textiles, motor vehicles, bicycles, chemicals and so on, which originate from India, will no longer get preferential treatment. This will mean that Indian exports will be subjected to higher duties in EU.

Surely, a weak economy and falling exports will come back to haunt India. While FY13 GDPgrowth was revised down from five per cent to 4.5 per cent, for the current financial year India would be lucky to best it. The data do suggest that the economy has likely bottomed out, however, recovery will be slow. Potential investors are waiting on the sidelines till the election results become clear. The recent appreciation of the rupee is a result of irrational exuberance in the equity and bond market since expectations regarding forthcoming election outcomes have run much ahead of what is warranted. Essentially, the run-up has been caused by a surge in volatile foreign institutional investor flows and not due to any meaningful uptick in more stable foreign direct investment inflows. In case of a less favourable electoral outcome, these flows will reverse trend as fast as they entered the country.

Essentially, a drastically falling CAD is not a sign of any economic improvement. Rather, in India's case, it is a clear symptom of economic weakness. And an appreciating currency will further reduce India's competitiveness. Worries don't cease, do they?

The author is vice-president and India economist, Societe Generale.
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