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India's CAD-averous Problem

By Kunal Kumar Kundu

Rajanish Kakade/Associated Press
A woman looked at a display of gold jewelry at a shop in Mumbai, Feb. 14.

India's third quarter balance of payments figures, released late last week, weren't pretty. For the quarter ending December, the current account deficit was 6.7% of gross domestic product, widening from 3.9% in the first quarter and 5.4% in the second. The CAD for April-December is 5.4% of GDP, way above 4.2% in financial year 2011-12.

Most analysis around the data focused on the deteriorating external condition (leading to worsening trade deficit.) A disproportionately large amount of blame was put on high imports of gold, a precious metal so loved by Indians. But real data tell a different story.

Despite a jump in gold imports in the third quarter, overall imports of gold for April-December shrunk more than 9% from a year earlier to around $38 billion, according to research firm CEIC Data. In the same period, the merchandise trade deficit widened by about 10% to $150.3 billion from $137.2 billion.

Clearly, there's more to the problem of India's CAD than gold. The preference for the yellow metal is actually a rational choice given that the government continues to run a high deficit, leading to elevated levels of inflation and debasing the local currency. Gold is the best hedge against inflation and governance failure.

In the nine months through December, as India's economy slowed, non-oil imports declined nearly 6% from the previous year, while oil imports rose nearly 15%. In the quarter through December, when international oil prices were relatively stable, India's oil imports rose 27.7%.

Despite recent price revisions, diesel is about 40% cheaper than petrol in India. Demand for diesel remains relatively strong as there's no price pressure to force efficiency.

In India, diesel is also an important source of power generation. The power sector is faced with peak shortages and a large number of uncompleted projects. Power shortages in much of the country, especially in the south, force manufacturers to turn to diesel to generate captive power so that their production doesn't grind to a halt. The balance sheets of some companies show distinct signs of stress on this count.

The Indian government has announced several reform measures since September, including allowing foreign investment in multi-brand retail, but nothing much has come to fruition. Unable to attract adequate FDI, the government is trying to attract portfolio flows to help finance the deficit, including liberalizing investment by foreign institutional investors in debt instruments.

Net portfolio inflows have risen steadily, exceeding FDI inflows in April-December. This way of financing, however, is the least desirable option. Even the relative attractiveness of the Indian economy remains questionable, at least until the 2014 elections. If the situation doesn't improve, FIIs might beat a hasty retreat from India. In such a situation, forex reserves will dwindle, the rupee will depreciate and inflation will remain elevated.

The author is an economist based in New Delhi. These are his personal views. For more from Mr. Kundu, go to his website.