

India's external sector: the ghosts of 1991

Is India really vulnerable to a balance-of-payments crisis of the sort last seen in 1990-91? Or are fears overstated?

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Will recently the external sector was widely considered a pillar of strength of the Indian economy, even as it faltered at times on the domestic front on inflation, fiscal deficit and bold structural reforms. External debt ratios had declined sharply. Being much more domestically driven, the economy was less vulnerable to external demand shocks than other major emerging markets. Its current-account deficit was within the prudent limits recommended for developing economies. Capital inflows far exceeded levels required to finance this deficit. To prevent runaway appreciation the country accumulated a big stockpile of reserves that acted as external shock absorbers.

Lately, some critical external sector parameters, particularly the current account deficit, external debt and the exchange rate, have weakened significantly. Concerns are being expressed in the financial media that India may have become as vulnerable to external shocks, or a balance of payments crisis, as it was in the early nineties (T C A Srinivasa Raghavan, writing in *The Hindu* on May 31, 2013). The *Business Standard* also speculated in an editorial on April 1, 2013, whether it was time for India to open negotiations with the IMF for a flexible credit line.

Fresh concerns regarding a run on the rupee and "sudden stops" have surfaced in the wake of the general flight of capital from emerging markets following indications given by the US Federal Reserve that it is assessing the possibility of scaling back its asset purchases or quantitative easing. *The Hindu* highlighted the large amount of external debt maturing over the next year in its June 29, 2013 edition. While all major emerging markets currencies have suffered, the Indian rupee has suffered more because of its larger current account deficit and greater dependence on volatile capital flows.

Some of these fears are overblown, as the recovery in advanced economies is far from secure. Advanced country central banks are also constrained to keep monetary policy loose as the fiscal position in these countries remains weak. The Bank of Japan and the European Central Bank are expanding their asset purchases. Be it as it may, emerging markets like India need to be prepared for "QEExit" and the tightening of monetary policy in reserve issuing countries. History indicates that tightening by the US Fed can lead to "sudden stops" in emerging markets. Sudden stops, however, need not result in balance of payment crises of the kind India suffered in 1991-92. The pertinent question therefore is whether the recent worsening of external sector parameters combined with US monetary tightening makes India vulnerable to a balance of payments crisis at the current juncture.

The spurt in growth in recent years was based on a sharp increase in both domestic savings and growth. However, investments have increased faster than savings, and also

declined less, making the trade and current account deficits larger than what they were in the nineties. As a result, India's reliance on external funding as a proportion of the national income is also greater.

The accompanying Table compares major macro-economic indicators relevant for the management of the external sector as they stood in 1990-91, the year immediately preceding the balance of payments crisis, and in 2012-13.

The following conclusions can be derived from the Table. First, the most dramatic deterioration is in the trade deficit, mostly on account of oil and gold imports. This was largely counterbalanced by an equally dramatic increase in the invisible trade surplus (mostly service exports and remittances), which was non-existent in 1991. Even so, the current account deficit is now 60 per cent bigger.

Second, the most dramatic improvement is in the capacity to finance the current account deficit. Net capital flows have increased sharply, both absolutely as well as a percentage of the national income. The accumulation of large foreign currency reserves despite persistent current account deficits is the lagged effect of large inflows over and above what was required to finance the current account deficit over an extended period.

Third, foreign-currency reserves, both in absolute terms and when measured in number of months of cover for the current account deficit, have increased over ten times. There is therefore a much greater cushion against external shocks.

Fourth, the share of ODA in financing external deficits has declined sharply and become negligible, as capital inflows have become commercial in nature. Since the supply of ODA is in long-term decline, this gives the country greater room and flexibility to grow and more policy independence, while subjecting it to market discipline.

Fifth, there is legitimate concern that the country has accumulated a large stock of volatile external liabilities, namely FII and short-term debt, and continues to be

dependent on them. The volatility of FII flows is however overstated, as past experience indicates that FII equity outflows are self-limiting because of the prospect of steep capital losses. The changed definition of short-term debt to include short-term trade credits, which presently comprise almost 90 per cent of short-term debt, also makes the years 1990-91 and 2012-13 non-comparable. While the stock of these liabilities as a proportion of foreign currency reserves is far lower today than what it was in 1990-91, at over 100 per cent, this ratio is nevertheless uncomfortably high. Indeed, the stock of FII, short-term debt and long-term debt maturing over the next twelve months is about 137 per cent of foreign currency reserves. There is therefore scope for further accumulation of reserves when good times return.

Sixth, India's external debt in 1990-91 was not overly high. The BOP crisis was one



A TALE OF TWO CRISES

Parameters	1990-91	2012-13
Trade deficit/GDP	-2.9	-10.6
Current account deficit (CAD)/GDP	-3.0	-4.8
Trade deficit excluding gold and oil	-1.3	-2.1
Fiscal deficit (Centre)/GDP	7.6	5.2
Fiscal deficit (combined)/GDP	9.1	(-6.9)**
Wholesale inflation	10.3	7.4
CPI inflation (CPI-W)	11.6	10.4
GDP growth	5.3	5.0
Debt-GDP ratio	68.9	(-64.7)**
External debt/GDP	25.7	21.2
Overseas development assistance (ODA) debt/GDP	12.9	5.5
External commercial debt/GDP	10.2	10.5
Short-term external debt/GDP	2.6	5.3
ODA/total external debt	50.1	25.7
Commercial/total external debt	39.7	49.5
Short-term external debt/total external debt	10.2	24.8
Debt-service ratio	35.3	5.9
Foreign currency reserves (FCR) (\$ billion)	2.2	259.7
Months of forex cover for CAD	2.8	35.4
Savings/GDP	22.9	31.7
Investments/GDP	24.9	35.5
Net capital account (NCA)/GDP	3.1	5.0
Net FII-inflow/NCA	0.1	30.0
Net commercial debt inflows/NCA	(-23.4)*	30.7
Net ODA inflows/NCA	(89.4)*	-2.4
FII stock/FCR	0.3	70.6
FII stock+short-term debt/FCR	382.4	107.9

* 1991-92 ** 2011-12

of liquidity rather than insolvency. Professors Reinhart and Rogoff have recently determined on the basis of cross-country comparisons that, historically, external debt-to-GDP ratios above 60 per cent have made developing countries more vulnerable to crises. Be it as it may, over the last two decades nominal GDP has grown faster than overall public debt as well as external debt, as a result of which both parameters have improved. The debt service ratio, or interest payments on external debt as a percentage of total external receipts, has declined very sharply.

The broad conclusion is that the worsening of some external sector parameters, especially those relating to the current account, should be a matter of concern. Urgent corrective steps are needed to reduce the trade deficit, especially minimising oil and gold imports. However, overall, the external sector is in much bet-

ter shape, and the country better cushioned against external shocks, than what it was in 1990-91, and therefore less vulnerable to a BOP crisis. The transition to a floating exchange rate has also given the country a new shock absorber which automatically compresses imports and makes exports more competitive as the rupee depreciates, and also makes inward remittances more attractive. The trend increase in savings, investment and growth should make India an attractive destination for investment over the medium to long-term, the current cyclical downturn — which is part of a global trend — notwithstanding. India remains, and is likely to remain, one of the fastest-growing large economies. This is perhaps the biggest difference between 1990-91 and now.

The writer is a civil servant. These views are his own