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Should We Worry About India's Twin Deficits?

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Thematic Report

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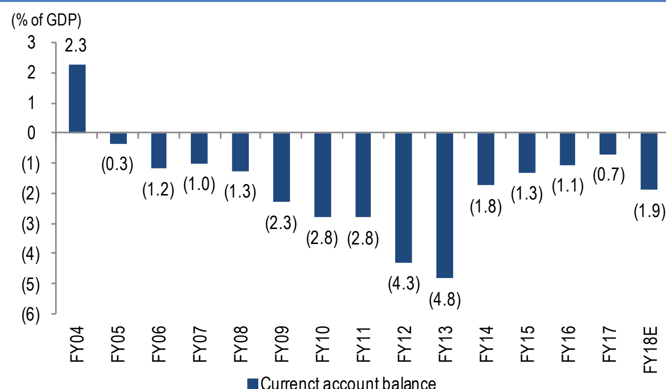
No Room For Complacency: Hard Won Gains Should Not Be Squandered

For a long time economic discourse in India largely centered on the twin deficits – fiscal and current account deficits. However, with the current account deficit coming in at a benign 0.7% of GDP in FY17 from a high of 4.8% of GDP in FY13, and the Centre's fiscal deficit having declined from a high of 6.5% in FY10 to 3.5% in FY17, and the combined deficit (Centre+States) falling from 9.4% of GDP in FY10 to an estimated 6.5% of GDP in FY17, the concerns have been allayed. With growth in the past two quarters falling below 6%, there are now calls for policy support – both monetary and fiscal. We believe that with interest rates near an all-time low, and inflation on a rising trajectory the room for further easing is limited. On the fiscal front as well there is not much headroom, and squandering hard-won gains is not really worth it. It may be noted that we are not against a mild counter-cyclical fiscal stimulus along the lines recommended by the N.K. Singh Committee, but warn against excesses. Looking back at history, excessive fiscal profligacy has often been the root cause, precipitating an external account crisis and resulting in loss of faith in the economy. Moreover, in an inflation-targeting regime, the potential inflationary risks associated with overstimulation may force tighter monetary policy, thereby negating potential gains. There have been tailwinds in India's favour such as the decline in global crude oil prices, a stable government that has attracted robust FDI flows, and an inflation-targeting central bank that has raised credibility with foreign investors. Equally, there are headwinds where we can draw parallels with previous crises such as a steep rise in imports, structural decline in remittances and services exports, heightened exposure to hot money flows, and global geo-political tensions which can tilt the balance of risks. In our view, the current account deficit is set to rise to about 1.9% of GDP in FY18 from 0.7% of GDP in FY17. Against this background, we believe there is no room for complacency and excessive fiscal profligacy to spur growth in the short term could potentially precipitate into an external account crisis down the line. With ghosts from the pasts looming large, India's twin deficit worries have not been entirely laid to rest.

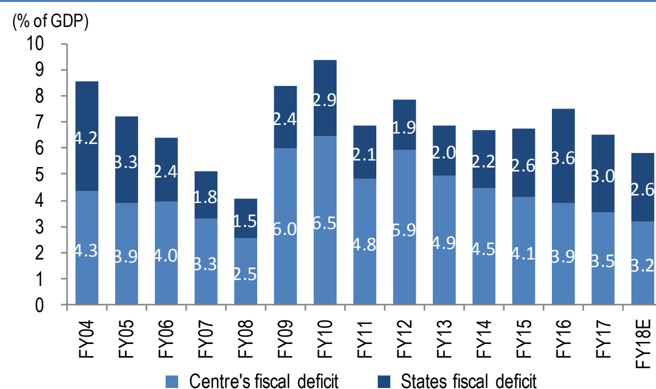
India has made great strides in fiscal and current account consolidation: Since the taper tantrum of 2013, India has made great strides towards consolidating its current account deficit (CAD). While lower global commodity prices have helped, steps towards improving domestic production of commodities such as iron ore and coal, and curbs on gold imports via higher import duties have also had a role to play. Although reports are rife on the smuggling of gold through unofficial channels on account of high import duty (currently at 10%), the current account deficit declined from 4.8% of GDP in FY13 to 0.7% of GDP in FY17 (Exhibit 1). Similarly, the combined fiscal deficit has declined from a high of 9.4% of GDP in FY10 in the aftermath of the global financial crisis to an estimated 6.5% of GDP in FY17 (Exhibit 2). It is, however, noteworthy that while the Centre has been on a consistent path of consolidation since FY12, the States have been loosening their purse strings. In fact, although States have budgeted for a fiscal deficit of 3% of GDP in FY17, and 2.6% in FY18 it is likely to be higher.

Exhibit 1: CAD declines from 4.8% of GDP in FY13



Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

Exhibit 2: Fiscal deficit declines from 9.4% of GDP in FY10



Source: RBI, Nirmal Bang Institutional Equities Research

Lessons from history: Fiscal profligacy led to crisis on the external account

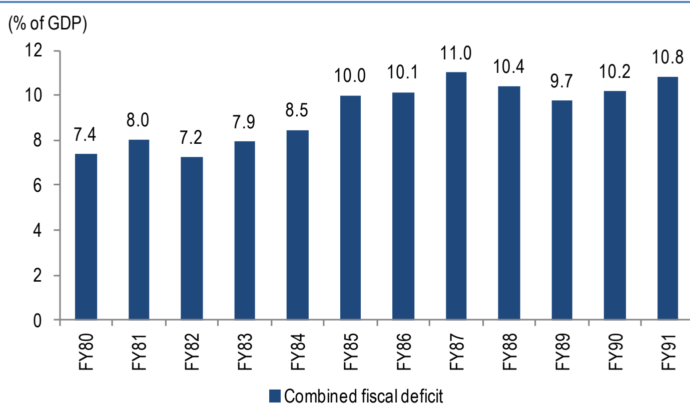
With growth in the past two quarters falling below 6%, there are now calls for policy support –both monetary and fiscal. We believe that with interest rates near an all-time low, and inflation on a rising trajectory, the room for further easing is limited. On the fiscal front as well we believe there is not much headroom, and squandering hard-won gains is not really worth it. The relationship between the twin deficits -fiscal and current account- is arguably tenuous. However, looking back at India's economic history, excessive fiscal profligacy has often been the root cause, precipitating an external account crisis and resulting in loss of faith in the economy. At the least, loose fiscal policy has preceded an external account crisis. Similarly, Bluedorn and Leigh (*IMF 2010*) using a developed market sample, and empirical analysts establish that 1% of GDP fiscal consolidation reduces the external current account deficit to GDP ratio by about 0.6 percentage points within two years.

Flashback 1991

The root cause of 1991 crisis: Former Reserve Bank of India (RBI) Governor Dr. Y.V. Reddy in his recently published book '*Advice & Dissent: My Life in Public Service*' recalling his days in the Ministry of Finance during the 1991 Balance of Payments (BoP) crisis notes " What were the origins of stress on our balance of payments that led to the crisis? The root cause can be traced to unsustainable fiscal policies in the 1980's …. In brief, political expediency to spur growth at any cost from 1982 led to an unsustainable situation by 1987."

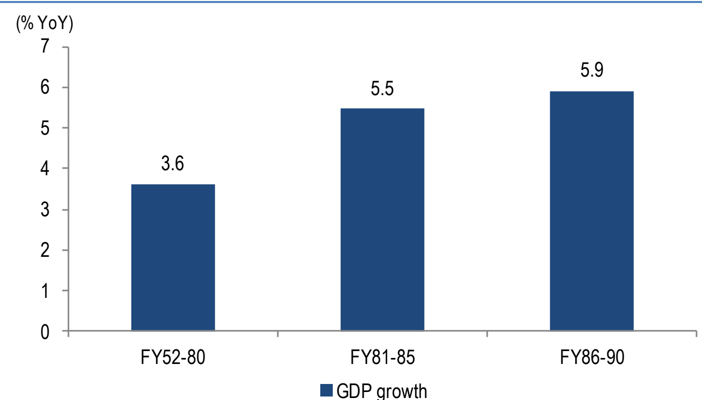
India's fiscal deficit rose in the 1980s - to spur growth: Till the early 80s, India was growing at an average of about 3.5%, termed the Hindu rate of growth. In the early 80s, there was a concerted effort to kick-start growth, which included expanding the fiscal deficit. The combined fiscal deficit, which averaged 5.4% of GDP between FY71-FY79, rose to 9.1% of GDP between FY80-FY90. The efforts of the government to spur growth yielded fruit, as a result of which the average growth rate rose from 3.6% in FY52-FY80 to 5.5% in FY81-FY85, and further to 5.9% in FY86-FY90 (Exhibit 4).Reforms undertaken in the mid to late 80s under the aegis of late Prime Minister Mr.Rajiv Gandhi also had an important role to play in spurring growth. However, to an extent, the growth was lopsided as it aggravated India's external account. While imports were liberalised, exports failed to keep pace primarily on account a fixed exchange rate which eroded India's export competitiveness. CAD increased, and India was dependent on capital flows, largely external commercial borrowing (ECB), and short-term borrowing by the government to fund its CAD.

Exhibit 3: Fiscal deficit expands in 1980s…



Source: RBI, Nirmal Bang Institutional Equities Research

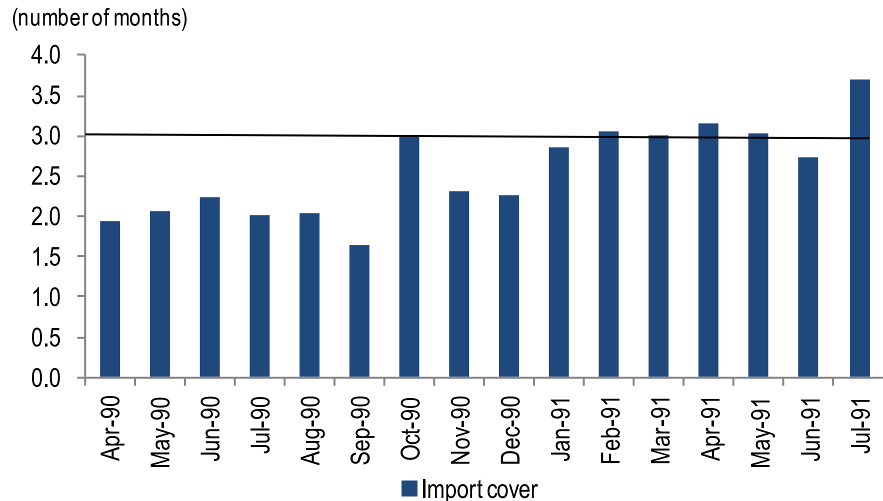
Exhibit 4: …to spur growth



Source: CSO, CEIC, Nirmal Bang Institutional Equities Research

The immediate cause was global and geo-political, with the Gulf war: The more immediate cause for India's 1991 BoP crisis was global geo-political crisis. Crude oil prices and, consequently, India's oil import bill rose sharply in 1990 on account of the Gulf war. As Dr. Reddy notes in his book, the oil import bill rose from an average of US$287mn per month in June- August 1990 to US$671mn in the next six months. While the oil import bill may seem minuscule at this point in time, the import cover was less than the recommended minimum safety level of three months. Moreover, the Gulf war impacted exports to the region. Workers' remittances took a hit as the Gulf region typically accounts for over 50% of remittances, and consequently the flow of non-resident Indian (NRI) deposits was also affected.

Exhibit 5: Import cover was below minimum safety level of three months for much of 1990



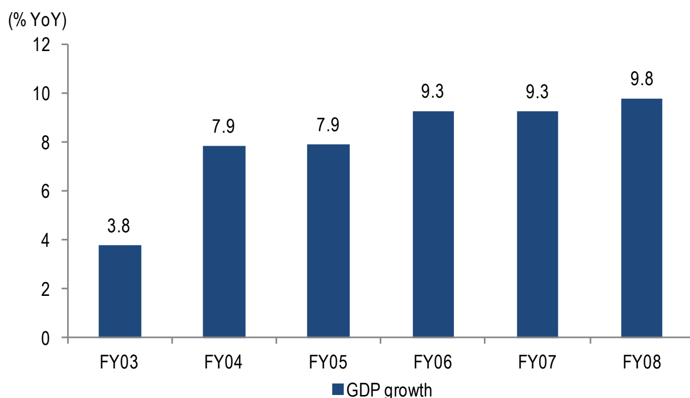
Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

Break-up of the Soviet Union also hit India: 1991 also saw the break-up of former Soviet Union, one of India's major trading partners, which again had an adverse impact. In a nutshell, global developments and geo-political crises exposed India's vulnerabilities on account of persistent twin deficits. While fiscal stimulus has the short-term benefit of spurring growth, it added to the domestic debt burden and drove up CAD, leading to reliance on externally borrowed capital to fund CAD.

Flashback 2013

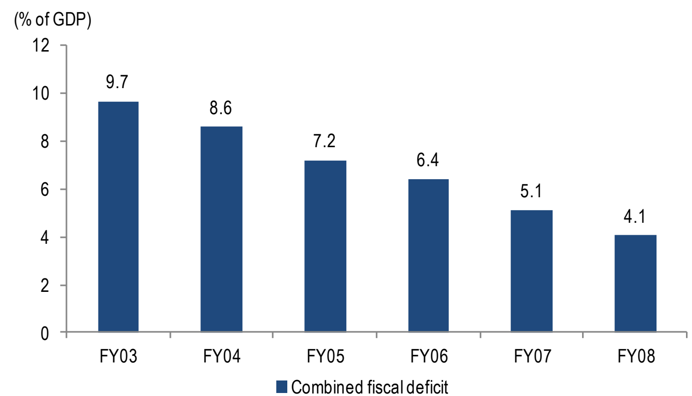
In the years prior to global financial crisis, India witnessed a growth spurt, which facilitated fiscal consolidation (Exhibit 6 and 7). In addition, growth was attracting capital flows into the country, even as India had a favourable current account balance on account of strong performance in India's invisibles surplus buoyed by services exports and remittances from abroad.

Exhibit 6: Growth spurt from FY04 to FY08….



Source: CSO, CEIC, Nirmal Bang Institutional Equities Research

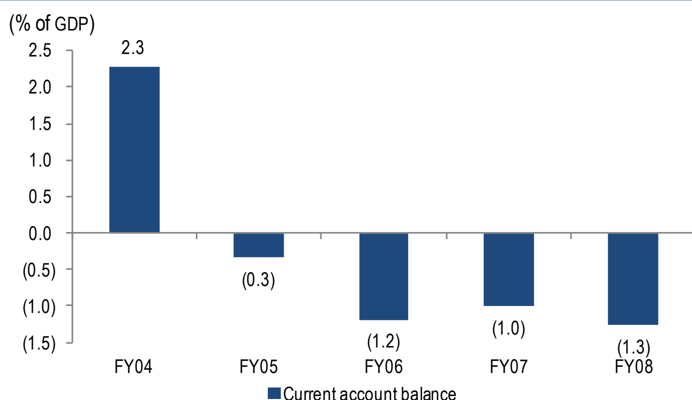
Exhibit 7: …resulted in fiscal consolidation



Source: RBI, Nirmal Bang Institutional Equities Research

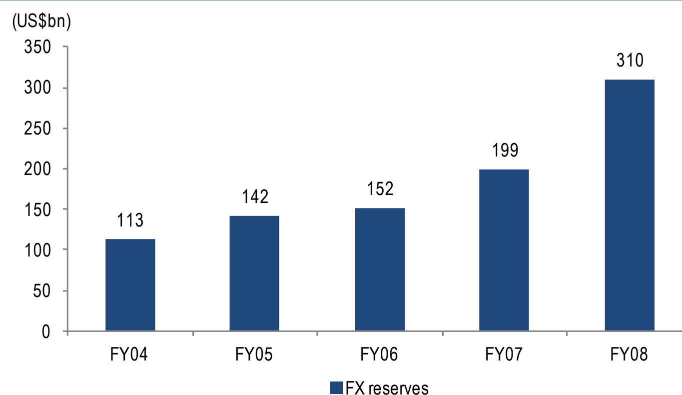
Consequently, in a bid to curb sharp appreciation of the Indian rupee and also to ward against external vulnerability, the RBI built up its war chest of reserves. India was seemingly in a safe place, and the macroeconomic fundamentals could not be better.

Exhibit 8: CAD was very tame between FY04 and FY08…



Source: RBI, Nirmal Bang Institutional Equities Research

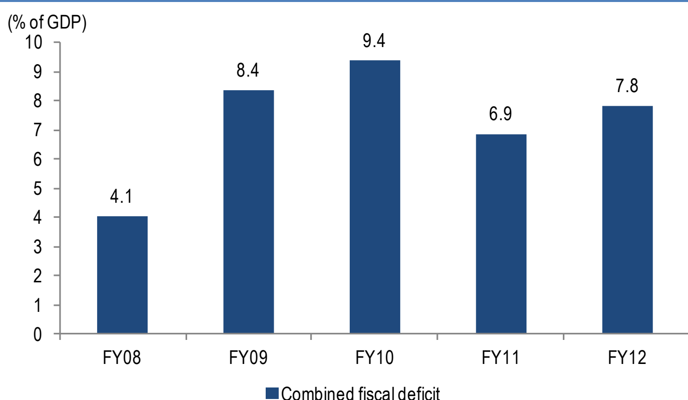
Exhibit 9: … as the RBI built up its FX reserves



Source: RBI, Nirmal Bang Institutional Equities Research

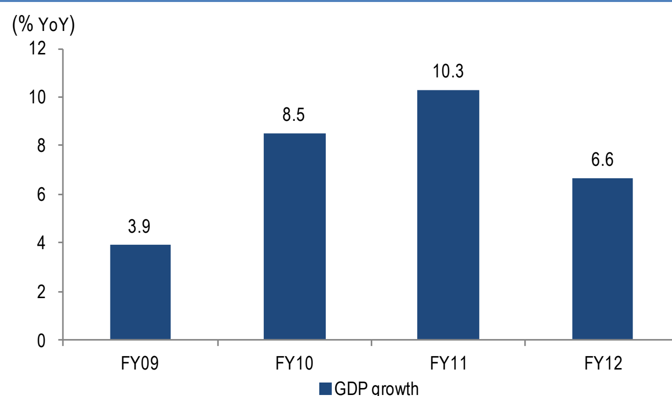
India resorted to fiscal stimulus to spur economic growth in the wake of the financial crisis: In 2008, the global financial crisis hit, and India was not completely immune. However, given India's relatively strong macro fundamentals, a tame fiscal deficit at 4.1% of GDP, a benign CAD at 1.3 % of GDP and a FX reserve pile of about US$310bn, the government decided to provide both monetary and fiscal stimulus to support growth. India's combined fiscal deficit doubled from 4.1% of GDP in FY08 to 8.4% of GDP in FY09, and further to 9.4% of GDP in FY10. On the other hand, growth which had hit a low of 3.9% in FY09 from 9.8% in FY08, sprung back to 8.5% in FY10 and 10.3% in FY11, before moderating to 6.6% in FY12.

Exhibit 10: Fiscal stimulus…



Source: RBI, Nirmal Bang Institutional Equities Research

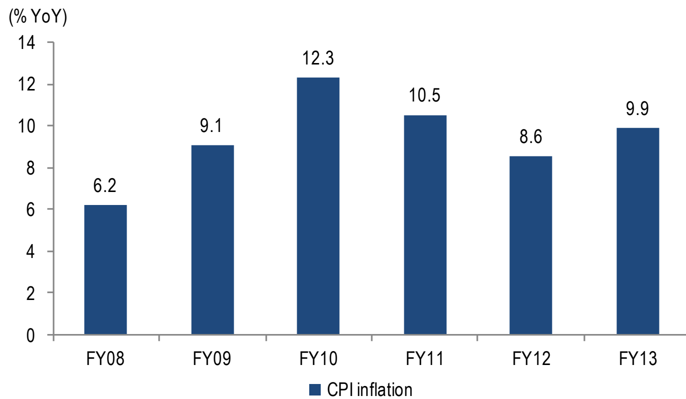
Exhibit 11: …succeeded in supporting growth between FY10-FY12



Source: CSO, CEIC, Nirmal Bang Institutional Equities Research

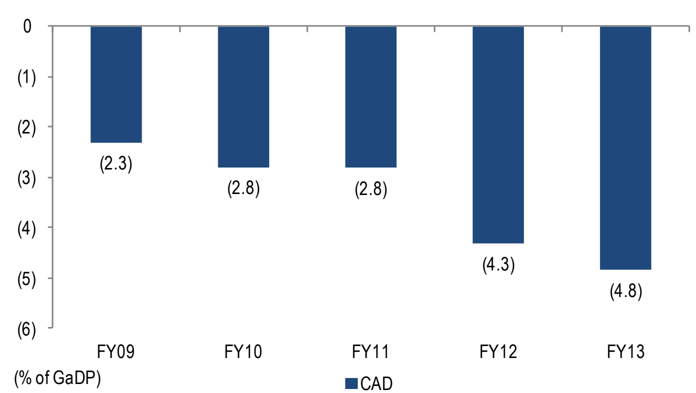
Growth recovered in the short run, but precipitated an external account crisis in FY13: Although growth recovered in the short run on account of the stimulus provided, it engendered high inflation. High inflation drove demand for gold as a hedge, pushing up gold imports and finally precipitated an external account crisis in FY13. CAD steadily rose to 4.8% of GDP in FY13 from 2.3% of GDP in FY09. Apart from gold imports, stalled domestic projects on allegations of corruption in allocation of resources such as coal and iron ore also pushed up imports of these commodities, thereby widening the CAD.

Exhibit 12: …but engendered high inflation…



Source: CSO, CEIC, Nirmal Bang Institutional Equities Research

Exhibit 13: …and pressured CAD precipitating in a crisis



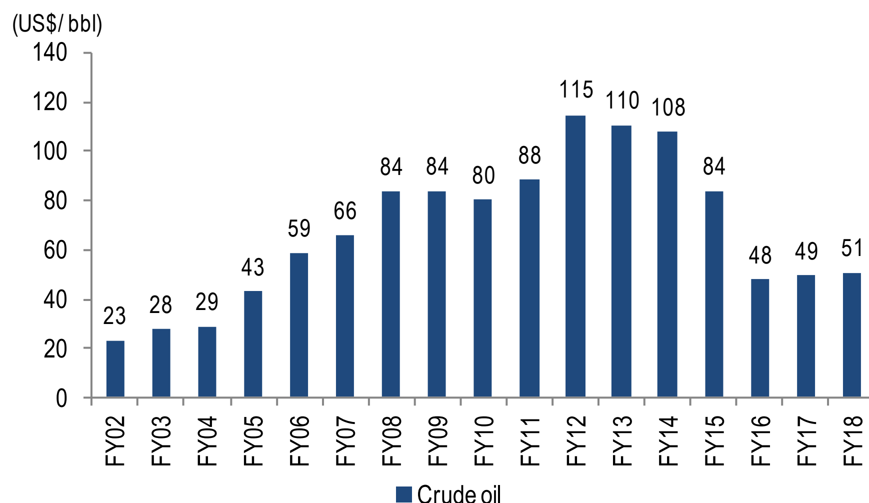
Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

As former RBI Governor Dr. Raghuram Rajan noted "India's slowdown paradoxically reflects the substantial monetary and fiscal stimulus that its policy makers …injected into its economy in the aftermath of the 2008 financial crisis…. The combination of excessive (with the benefit of hindsight) post-crisis stimulus and stalling large projects had consequences such as high internal and external deficits." Therefore, Rajan concluded that India's growth slowdown since FY12, and fiscal and current account deficits are not structural.

What has changed?

1. **The boon of lower crude oil prices**: The decline in crude oil prices since FY14 (Exhibit 14) has helped tame both India's fiscal and current account deficits. Lower crude oil prices helped the government reduce fuel subsidies by deregulating petrol and diesel prices (Exhibit 15). It also lowered the oil import bill, curbing the CAD (Exhibit 16).

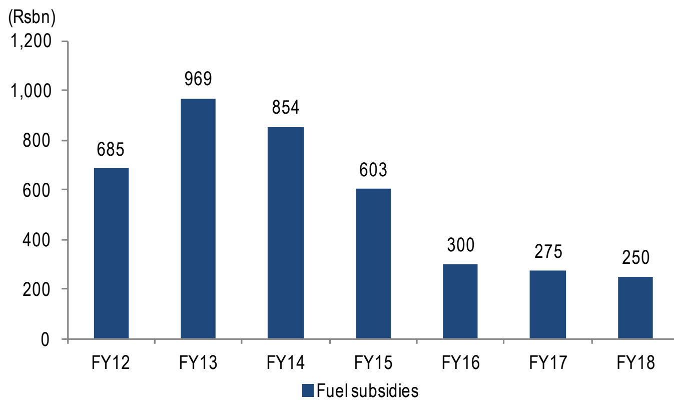
Exhibit 14: Lower crude oil prices have helped tame fiscal as well as current account deficit



Source: Bloomberg, Nirmal Bang Institutional Equities Research

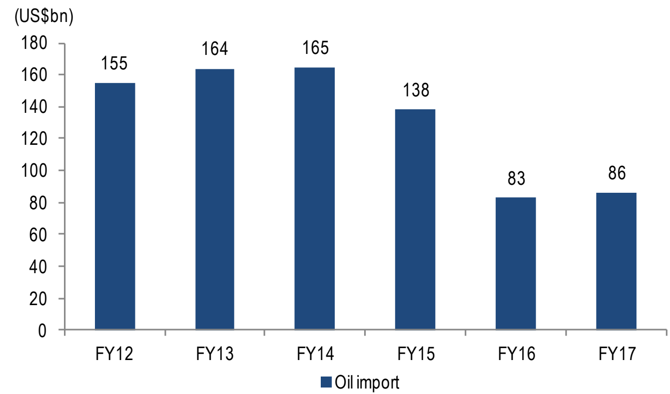
Crude oil prices have recently witnessed an uptick as the hurricanes in the US led to refinery shutdown, thereby pushing up refining margins across the world, but they are now normalising. Oil prices are largely expected to remain range-bound, even in the event of geo-political crisis or further cuts in production by the OPEC as US shale gas production capacity has increased, and the cost of extraction has reduced because of technological improvements and efficiencies. Relatively benign crude oil prices bode well for keeping India's twin deficits under check.

Exhibit 15: Lower crude oil prices have reduced fuel subsidy burden…



Source: Government of India, Nirmal Bang Institutional Equities Research

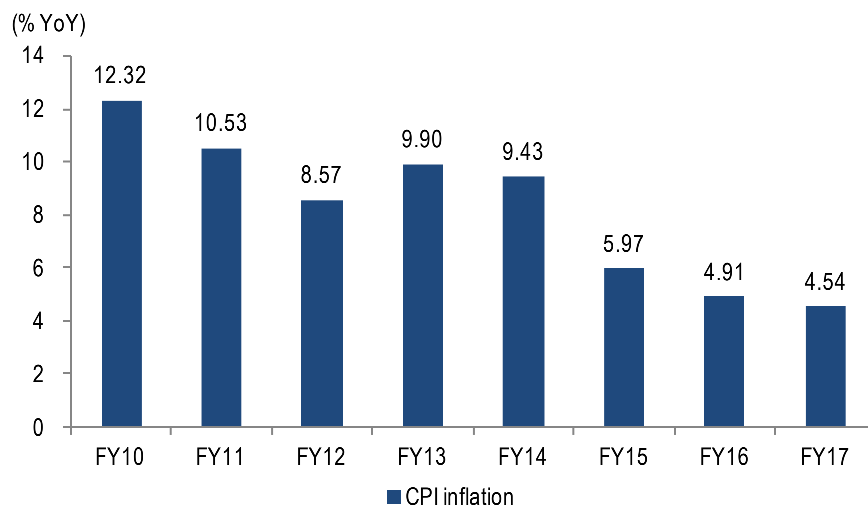
Exhibit 16: …and lowered the oil import bill



Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

2. **An inflation-targeting central bank:** India informally adopted an inflation-targeting regime in early 2014, and more formally with a legislative framework, and an inflation target of 4+/-2% in August 2016. Consequently, Consumer Price Index or CPI inflation declined from a high of 12.3% in FY10 to 4.5% in FY17. High inflation often renders the currency volatile, leading to external stress. In addition, high inflation also increases demand for real assets like gold as a hedge against inflation, which in a country like India reliant on gold imports pushes up CAD. Therefore, to that extent, an inflation-targeting central bank has improved its credibility and succeeded in anchoring expectations, particularly that of foreign investors, while also providing stability to the currency.

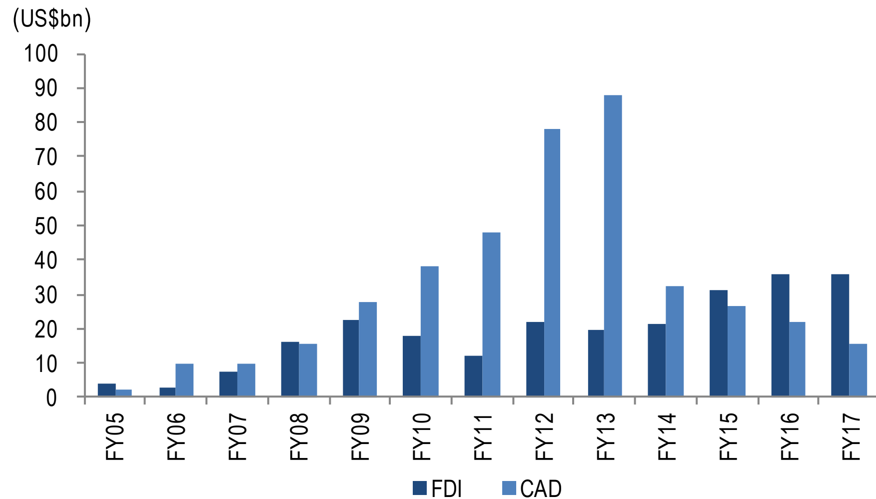
Exhibit 17: Inflation has declined under an inflation-targeting regime, improving credibility



Source: CSO, Nirmal Bang Institutional Equities Research

3. **Robust FDI flows:** Over the past few years, political stability, liberalisation of FDI norms and a reformist agenda have attracted robust FDI flows into India. Since FY15, net FDI flows have been more than sufficient to offset India's CAD. We expect a reversal in this trend in FY18, and believe that CAD is likely to be slightly higher than net FDI flow. Nevertheless, sustained growth in FDI flow does provide solace from external vulnerabilities.

Exhibit 18: FDI flows outpaced CAD in the past couple of years, although FY18 may see a reversal



Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

Why worry?

1. **Imports are rising led by consumer goods:** In recent months, import growth has outpaced exports. Moreover, it is not the traditional crude oil and gold imports that have been driving growth. Non-crude oil imports have been very strong, and imports of electronic goods for the most part exceed gold imports. For the period April-August 2017, while exports rose 8.4% YoY, imports rose 27.4%, while non-crude oil imports increased 29.6% YoY. Consequently, the trade deficit is widening. The trade deficit nearly doubled to US$41.2bn in 1QFY18 from US$23.8bn in 1QFY17.

Exhibit 19: Import growth has been outpacing exports …

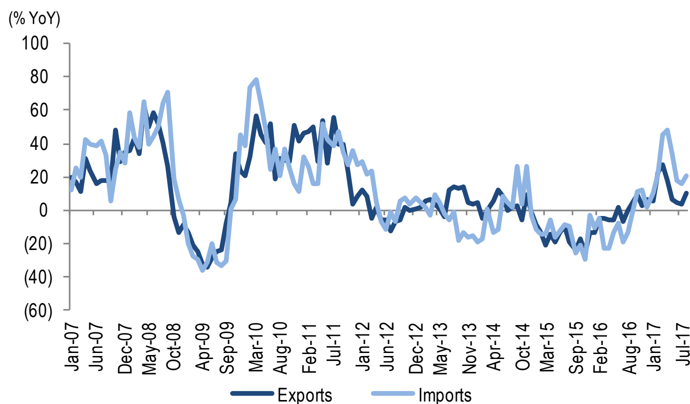
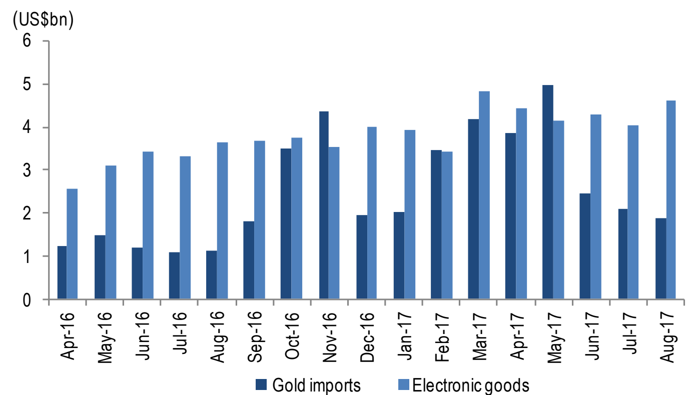


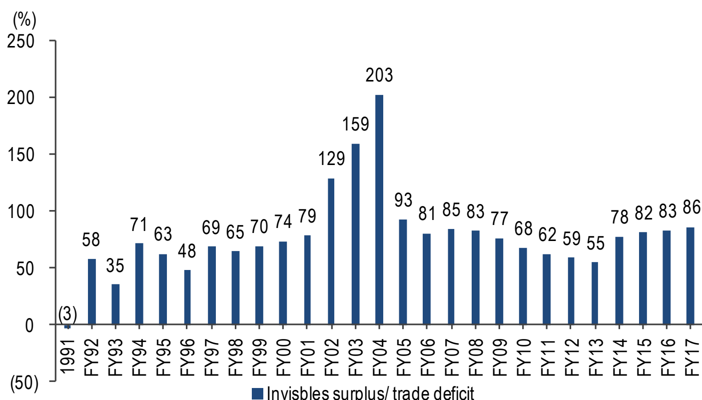
Exhibit 20: …and electronic goods imports exceed gold imports



ource: Ministry of Commerce, CEIC , Nirmal Bang Institutional Equities Research

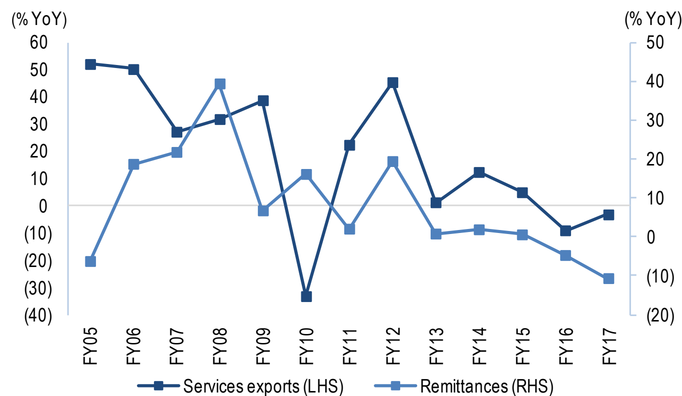
2. **Remittances and services exports are under pressure:** Moreover, what is worrying is that the trade deficit is widening at a time when the invisibles surplus, comprising services exports and remittances, which has traditionally offset the trade deficit has been on a secular decline (Exhibit 21 and 22). Service exports are under pressure, as the Indian IT industry, which accounts for nearly 50% of services exports is facing structural headwinds. Remittances, 50% of which come from the Gulf region, are also witnessing some slowdown on account of lower crude oil prices. Over the past two quarters, earnings from travel services have been buffering some of the slowdown in software exports, but it remains to be seen if travel services can completely offset software exports.

Exhibit 21: Invisibles surplus declining…



Source: Government of India, Nirmal Bang Institutional Equities Research

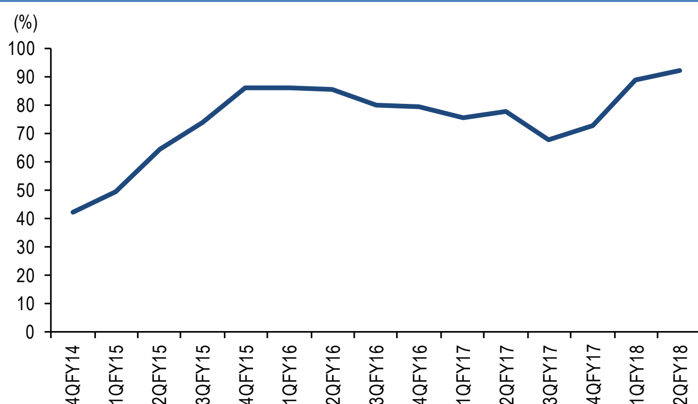
Exhibit 22: …as services exports and remittances slow



Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

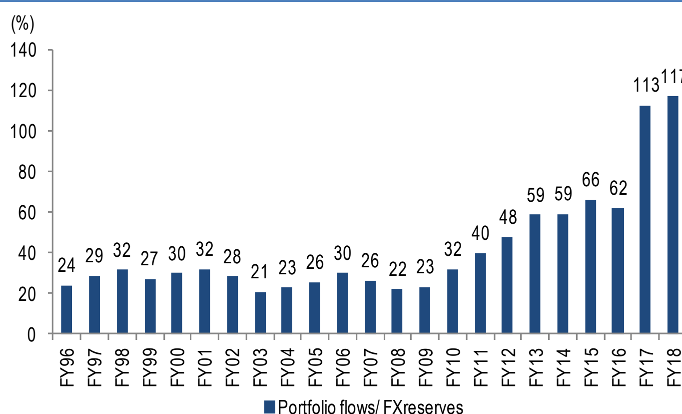
3. **India's exposure to 'hot money' has increased**: Since February 2017 India has seen strong foreign portfolio inflow into the debt market on account of high real interest rates under an inflation-targeting regime, and relatively strong macro fundamentals. Consequently, foreign holding on Indian debt now stands at an all-time high, with nearly 95% of available limits foreign investors utilised (Exhibit 23). Strong inflows into debt also supported the INR: Please read our report What aids the INR? . Although FPI debt flows have outpaced equity in recent months, India's exposure to volatile capital flows (both equity and debt) is at an all-time high, and has increased from about 22% of FX reserves in FY08 to over 117% of FX reserves in FY18 (Exhibit 24). To that extent, despite high level of FX reserves, India's exposure and vulnerability to 'hot money' flows has increased, also potentially increasing the volatility of the currency : Please read our report : Why the INR will be more volatile ? Global geo-political risks are not entirely at bay, and ensuing volatility poses risks to portfolio flows into India, both equity and debt. The US Federal Reserve (Fed) is also scheduled to begin its balance sheet reduction from October 2017, and while the Fed intends to make it as smooth as possible, India is not entirely immune. In fact, it was the announcement of taper by the Fed that triggered the crisis in 2013.

Exhibit 23: FPI debt limit utilisation at all-time high …



Source: NSDL, Nirmal Bang Institutional Equities Research

Exhibit 24: …as well as total exposure to volatile flows



Source: SEBI, NSDL, RBI, CEIC, Nirmal Bang Institutional Equities Research

Moreover while FDI flows have been sufficient to fund CAD in the past couple of years, with a widening CAD, India's dependence on portfolio flows is increasing.

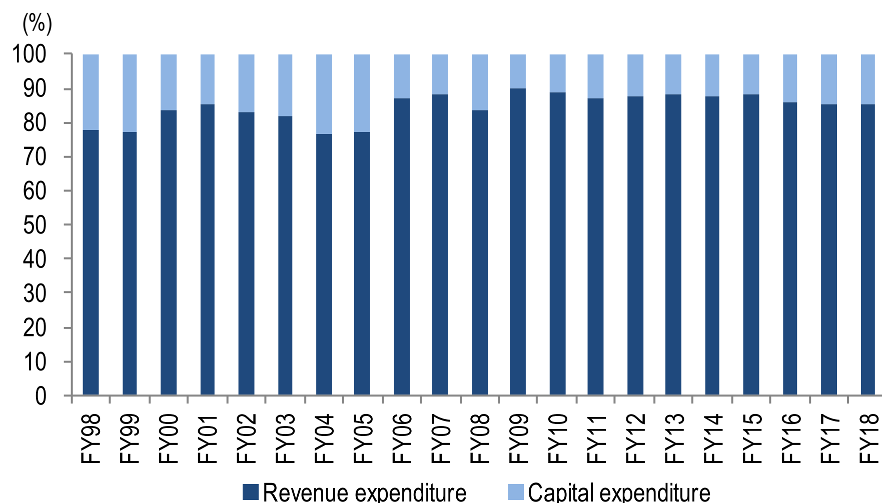
The final word: Growth at what cost?

Limited fiscal easing may be permissible in line with the recommendation of N.K. Singh Committee: We are not completely against some degree of fiscal accommodation as a counter-cyclical measure against the backdrop of slack private investment. The N.K. Singh Committee presented its report in early 2017 which laid down a set of fiscal rules, setting the fiscal deficit target at 3% of GDP for the next three years, while providing an escape clause which allows for deviation of about 0.5% of GDP. The trigger for the escape clause includes far reaching structural reforms in the economy with unanticipated fiscal implications. To that extent, the current fiscal deficit target of 3.2% of GDP is within prudential norms allowing limited headroom for fiscal expansion up to 0.3% of GDP. However, the states are likely to breach the fiscal deficit target of 3% of GDP budgeted for FY17 and 2.6% of GDP for FY18, limiting room for further fiscal expansion by the Centre. Moreover we note that since we are fast approaching an election cycle, some amount of populist spending is inevitable, which further reduces room for meaningful fiscal easing.

Crowding out impact is likely to be limited: One of the adverse impacts of a high fiscal deficit is the crowding out impact in private investment, but given slack private demand for credit, the crowding out impact is likely to be limited. Nevertheless fiscal excess could have adverse consequences, despite an immediate spurt in growth. Obviously raising taxes to fund higher government expenditure without hurting the fiscal deficit will do more harm than good in the current economic environment. Therefore, targeted relief for affected groups such as exporters and SMEs, which boosts economic activity, will be preferred.

Capital spending has improved, yet excessive spending to boost growth is not prudent: In the wake of the 2008 crisis, the increase in fiscal deficit was due to an increase in current expenditure rather than to pick-up in public investment, which meant that it fuelled consumption without increasing productive capacity in the economy, and resulted in external leakages, as some of the stimulus went towards higher imports. In the past few years, we have seen some pick-up in capital spending, which now constitutes over 14% of total expenditure, better than 10.2% in FY09 but still far lower than 20%+ levels in FY05.

Exhibit 25: Share of capital expenditure has seen some improvement, but far from optimal



Source: Government of India, CEIC, Nirmal Bang Institutional Equities Research

Possibility of an external crisis down the road: Therefore there remains a risk of higher fiscal stimulus feeding consumption expenditure, higher imports and consequently the CAD. Higher CAD often results in currency depreciation, while a higher fiscal deficit combined with a rapidly depreciating currency impacts business confidence, particularly that of foreign investors, and leads to capital flight.

Higher fiscal deficit will also push up yields and increase cost of borrowing: A higher fiscal deficit can also have the adverse impact of pushing up yields, which raises the cost of borrowing by corporations, both domestically and abroad. We had argued in our earlier report: Does a rating upgrade matter for India? , that India was on track for a rating upgrade by the turn of the decade if it continued on the path of fiscal consolidation. We had also noted that the biggest beneficiaries would be Indian corporations with overseas debt exposure as a rating upgrade would lower their cost of funds. Deviating from the path of fiscal consolidation may keep the cost of borrowing high for Indian industry in the medium term. Finally, in an inflation-targeting regime, the potential inflationary risks associated with overstimulation may force tighter monetary policy in the medium term, negating potential gains.

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