ISAS Brief

No. 72 – Date: 7 July 2008

469A Bukit Timah Road
#07-01,Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isasijie@nus.edu.sg
Website: www.isas.nus.edu.sg

India's Trade Deficit: Increasing Fast but Still Manageable

Amitendu Palit[1]

India's trade deficit, which reflects the excess of its merchandise imports over exports, has reached 7.7 percent of its gross domestic product (GDP). According to the Balance of Payments (BOP) statistics for the year 2007-08 recently released by the Reserve Bank of India, the deficit has increased from US$63.2 billion in 2006-07 to US$90.1 billion in 2007-08. This increase of almost US$27 billion has resulted in the deficit swelling from 6.9 percent of GDP in 2006-07 to 7.7 percent in 2007-08.

Is this increase a cause for worry? The answer depends on the determinants of the deficit. For an expanding economy like India that is growing at more than nine percent per year, a trade deficit can arise from virtuous forces like heavy demand for raw material and intermediate imports from a robust domestic industry. This has indeed been happening in recent years, with capital goods leading the import rally. If industrial imports push the deficit, then there is little cause for concern. The deficit can also widen due to exchange rate movements. An appreciation in the value of the Rupee vis-à-vis other major currencies can make Indian exports dearer and imports cheaper. Depreciation in the Rupee will have the opposite effects. The eventual impact of exchange rate movements on the trade balance will depend upon relative price-sensitivities of Indian exports and imports. Adverse impacts of such exchange rate movements (if any) in a globalised world are usually short-lived as market forces tend to impact interest rates and capital flows in a manner that is self-equilibrating.

Enlarging deficits usually become a cause for concern if they are produced by chronic structural deficiencies. For developing countries, structural trade deficits can be difficult to finance, making them unsustainable after a point in time. This is because the chronic nature of the problems leaves little scope for policy intervention. The situation worsens if the deficiencies are accentuated by adverse circumstances. A typical example is the dependence on oil imports. The dependence on crude oil imports is chronic for most industrialising developing countries. The problem is also structural as their current resource utilisation pattern does not contain alternatives to imported crude. Furthermore, in a situation of unabated rise in oil prices, like now, the problem tends to get compounded.

---

[1] Dr Amitendu Palit is a Visiting Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He can be reached at isasap@nus.edu.sg.

Does this mean that high oil prices are making India's trade deficit unsustainable? Are there are other structural factors contributing as well? A closer look at the recent BOP numbers reveals the following:

1. India's exports increased from US$128.1 billion in 2006-07 to US$158.5 billion in 2007-08. This year-on-year increase of US$30.4 billion was superseded by imports, which increased by as much as US$57.2 billion from US$191.3 billion in 2006-07 to US$248.5 billion in 2007-08. The sharp rise in imports impacted the final size of the trade deficit.

2. One of the possible reasons behind a progressively-widening trade deficit could be a decline in exports accompanied by an increase in imports. But it has not been so in India's case. Exports grew by 23.7 percent in 2007-08, which was higher than their growth of 21.8 percent in 2006-07. But the import growth of 29.9 percent in 2007-08 was far higher than the 21.8 percent growth in the previous year. So the rise in trade deficit can be attributed to a much faster rise in imports compared with exports.

3. What are the reasons behind the rapid rise in imports? Imports can be divided into two broad groups: oil and non-oil. The BOP statistics do not disaggregate oil imports as a separate category. According to the data made available by the Directorate General of Commercial Intelligence and Statistics of the Ministry of Commerce, India's oil imports during 2007-08 were US$77.04 billion. This represented an increase of 35.3 percent over US$56.9 billion in the previous year. Further, the year-on-year growth in oil imports in 2007-08 was higher than the growth of 30 percent in 2006-07. In sharp contrast, non-oil imports, despite growing at a higher rate of 23.5 percent in 2007-08, compared with 22.2 percent in 2006-07, show a much lower rate of growth than oil imports. There is no doubt that high growth in oil imports has been the main factor behind the sharp rise in imports.

4. It's common knowledge that global crude prices are rising at an unprecedented rate. The prices have substantially inflated India's import bill. India's crude imports comprise a basket of three varieties – Brent, Dubai and Oman. Given the composition, even if one among the three experiences sharp increases in prices, the overall price of the basket does not get affected by the same extent. But during last year, all the three crude varieties saw their prices rising fast. The average price of the Indian basket varied between US$65.5 and US$99.8 per barrel, yielding an average price of US$79.5 per barrel for the year. This was a steep jump vis-à-vis US$62.5 per barrel in 2006-07. Interestingly, the volume of oil imports experienced a lower growth of 11.8 percent in 2007-08 vis-à-vis 14.5 percent in 2006-07. Thus, the increase in oil imports was primarily value-driven and not volume-driven.

5. Excluding gold and silver, among other non-oil imports, capital goods experienced the fastest growth in 2007-08. Edible oil, fertilizers, iron and steel, chemicals, textile and coal were the other leading imports. It must be noted that along with crude oil, global prices of most of these imports too have gone up. Thus, the impact of the world commodity price boom has been felt across the board by Indian imports.

High crude prices, therefore, have been the main determinants of India's rising trade deficit. Given India's chronic dependence on oil imports, with the latter accounting for almost one-

third of the country's total imports, the Indian economy's import bill and trade balance will continue to remain sensitive to movements in world oil prices. With global crude prices inching close to US$150 per barrel, the import bill and trade deficit are likely to increase further. Data for the first two months of 2008-09 clearly shows this happening. During April-May 2008, oil imports amounted to US$16.5 billion, showing a 48.5 percent increase over US$11.1 billion during April-May 2007. The trade deficit has also increased to US$20.6 billion during April-May 2008, whereas it was only at US$13.9 billion during April-May 2007.

Assuming that oil prices will continue to rise in the near future, will the trade deficit become unsustainable? This depends on the Indian economy's capacity to finance the deficit. The high trade deficit has resulted in an increase in the current account deficit as well. From 1.1 percent of GDP in 2006-07, the current account deficit has increased to 1.5 percent of GDP in 2007-08. However, the balance of payments is yet to come under stress, due to a healthy capital account surplus. The current account deficit of US$17.4 billion in 2007-08 was more than compensated by a capital account surplus of US$108 billion. The result was net addition of more than US$90 billion to India's foreign exchange reserves, which have now risen to more than US$300 billion.

If capital flows continue to remain as robust as they were in 2007-08, then despite widening, the trade deficit will continue to be financed and is unlikely to create any adverse impact on the BOP. Sustaining the deficit should not be a problem even if it increases to much higher levels. The only downside risk that can be perceived is a reversal in the direction of short term capital flows. India's large capital account surplus in 2007-08 had much to do with heavy portfolio investment inflows. However, latest trends suggest that the capital market is passing through a relatively bearish phase and foreign institutional investor (FII) inflows have significantly moderated. This, however, might be a temporary phase with the flows reacting to alignments among global foreign exchange markets. A more stable outlook following adjustment of inflationary expectations can very well see resumption in FII investment.

As of now, notwithstanding India's chronic dependence on oil imports and the fact that such imports underline a structural deficiency in India's natural resource utilisation pattern, the economy looks capable of managing the trade deficit. Notwithstanding the prospect of oil prices zooming to untouched highs!

oooOOOooo