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Managing Current Account Deficit

Shahid Kardar

Institute of Public Policy
Beaconhouse National University

The recent appreciation of the rupee, despite weak fundamentals, is becoming controversial, with the same interest groups first extolling it as an outcome of good financial management and now complaining about its damage to exports and the competitiveness of the import substitution sectors!

Although the rupee is likely to be relatively stable for remainder 2014, current levels are unsustainable, being transient in nature. The can has merely been kicked down the road. The appreciation of the rupee has resulted from some easing in inflation (especillay of food items), greater stability in international oil prices, additional borrowings to pay for oil imports, inflows from multilateral donors and the IMF, the mysterious US$1.5 bln (with more to come?) for what only time will tell, the US$2 billion from the Eurobond offering, our Middle Eastern friends apparently agreeing to extend the credit period for oil imports from them, improved exchange reserves and thereby the availability of dollars in the market, forcing off-loading of currencies by speculators and exporters who were withholding the remittances of their receipts.

However, the medium-term outlook for the level of the rupee portends a secular decline, with our poor productivity, inflation being higher than that of our trading partners/competitors and considering the financing needs of our external obligations. It is likely to depreciate at a steady pace, although without a crisis like situation emerging, such is the peculiarity of our economy. The reasons are:

Our foreign exchange reserves have not been accumulated by running current account surpluses. They are built on non-durable crutches of remittances of Pakistanis living in other jurisdictions and of external capital like a) foreign portfolio investment in our stock exchanges against which there will eventually be outflows in the form of encashment (with gains), dividends, etc and which may actually be encouraged by the appreciation of the rupee.; b) money borrowed from whomsoever was willing to lend to us; and c) grants from 'special friends' in the M.East. Such inflows have kept the value of the rupee higher than it would be otherwise.
Despite these large foreign inflows (including remittances) which have 'resolved our balance of payments problems until June 2015', we have a current account whose deficit has not resulted from imports of plant and machinery that would expand the country's productive capacity. Had this been the main driver it would not be that worrying for the economy. This deficit is structural in nature, essentially arising from our exports being unable to finance our imports of consumable, requiring the rest of the world to finance it. Historically, this financing has come in the form of loans and grants from the West or by the IMF, the World Bank and ADB-partly owing

to a host of fortuitous global events like the Cold War, the Afghan War, 9/11, War on Terror, etc. that worked to our advantage. We have managed to leverage our geo-strategic location to extract 'rents' in the form of capital inflows or rescheduling of debts, although we have been poor at negotiating the size of this 'rent'.

These flows have provided 'temporary' relief, as will the Eurobonds. Our capacity to service these bonds from export receipts will be tested as the global economy slows down, the trade deficit widens owing to imports becoming cheaper and exports less price competitive and interest rates rise in developed economies in early 2015. This will eventually put pressure on the rupee, requiring a downward value adjustment. However, more disturbing is the deterioration in our international competitiveness-our ranking having dropped dramatically from 83 in 2007 to 133, suggesting that these current account deficits have risen partly from the profligate consumption of both the government and the private sector, poor quality investment projects and corruption related 'leakages'. And with reduced inflows of grants and cheap loans from 2015 we could be badly hit without better preparedness for these eventualities.
The hope for large volumes of Foreign Direct investment (except, perhaps those of Chinese origin, provided we relax our rules and regulations to accommodate such investments) looks optimistic. The reasons stem from the poor law and order situation in the country, country image, lack of energy-and at affordable prices- and the high cost of doing business.

The ideal solution is the closing of the current account deficit, requiring a narrowing of the differential between our higher rate of inflation and that of our trading partners/competitors (to prevent the overvaluation of the rupee in 'real terms'), unless we can enhance the productivity of our resources. With estimates of threshold inflation of around 7-8% a steady depreciation of the rupee will be unavoidable without a dramatic improvement in our productivity, a tough ask since we continue to be laggards in this area even within the region. For instance, between 2000 and 2011 our productivity grew by 1% per annum, compared with India's 6% and China's 9.5%. Again, in 1970 our productivity was half that of Indonesia and $1/4^{th}$ that of Malaysia. By 2007 Malaysia's productivity had become ten times ours and that of Indonesia three times.

Achieving the objectives of the proposal above will entail a shift in the current policy bias in favour of import substitution to exports and productivity improvements though better access to technology, complemented by adequate investment in high quality education and technical and vocational skills. Addressing these structural issues will take time and some doing.

The role of the exchange rate will always be much more important than incentives in the form of cheap credit, rebates, low corporate income tax on exports of low value-added products like yarn, and dubious subsidies like highly underpriced gas for energy and those being provided under the cover of Research and Development. Research shows that these incentives did little to promote exports. The size of the current account deficit will depend largely on the exchange rate. If we want a stable exchange rate we need to ensure its stable domestic value through better control over inflation and through policies incentivizing improvement in the productivity of all the sectors of the economy in general and the exporting sectors in particular (productivity can also be increased by shifting employment from agriculture to the more productive and modern industrial and services sectors).Otherwise, a stable exchange rate will remain an elusive and moving target.