Macroeconomic Vulnerability and the Rupee's Decline

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The sharp depreciation of the rupee is only the latest symptom of the macroeconomic imbalance afflicting the Indian economy. There have been a host of other indications of the basic malady. The fact that the country is off its briefly experienced 'high growth trajectory' is the least of its problems. More troubling for the government is that symptoms of "overheating" such as a large current account deficit and high inflation paradoxically accompany the downturn or slowdown in growth. This stagflationary environment encourages, in turn, foreign investors and lenders to hold back or withdraw from the Indian market. It is because of this combination of circumstances that the rupee weakens and becomes subject to speculative attack. In the event, slow growth, high consumer price inflation, a wide current account deficit, and a weakening rupee, combine to make the country one of the poorest macroeconomic performers among its peers, aggravating the flight of capital out of India. This self-propelling downward spiral is taking the economy to the verge of a crisis, even while the government is in a state of denial.

The persistence and even widening of the current account deficit in a period of slowing growth is easily explained. Underlying that trend, as is to be expected, is the persistence and widening of the trade deficit, driven in substantial measure by imports of gold and petroleum and petroleum products. The ratio of gold imports to the total has been in the 9 to 13 per cent range in most recent quarters, despite the government's belated and hesitant effort to discourage such exports with duty increases. The latter policy has clearly not worked. Moreover, rupee depreciation rather than discouraging gold imports (by rendering it more expensive in rupee terms) spurs purchases of gold by making it a preferred asset which is a hedge against further depreciation and inflation. Yet the government is hesitant to impose quantitative restrictions on the import of the yellow metal, with adverse effects on the trade balance.

On the other hand, the large volume and high and volatile prices of petroleum imports, have kept the POL share of the total import bill at more than a third. Together gold and petroleum, which accounted for 40 per cent of the import bill in the second half of calendar year 2011, absorbed 47-48 per cent of the import bill in the second half of financial year 2012-13. As a result, despite a recent reduction in import payments for capital goods and export-related imports, resulting from the domestic downturn and the global recession, India's overall import bill and therefore its trade deficit have remained high. This makes for a high current account deficit as well.

The implication of that structural weakness is that India's accumulated foreign exchange reserves of around $280 billion are less significant than they seem, because they are in the nature of borrowed reserves, with associated servicing commitments and the right to exit in the future. While these capital inflows may be financing current account deficits, they do constitute a source of vulnerability. So are the reserves themselves, as they can deplete if foreign investors choose to sell out and exit the country.

Unlike the current account deficit, the persistence of inflation, as measured by the CPI, in a period of slowing growth is more difficult to explain. In fact multiple factors—administered price increases, demand and supply imbalances, imported inflation aggravated by rupee depreciation, and speculation—have combined to keep high inflation going. If there is an element common to them, it is that many of them are the outcomes of economic reform. India's vulnerability to the effects of changes in international prices has increased with trade liberalisation. Increased concentration due to the dilution of anti-trust measures and reduced regulation tend to encourage a profit driven escalation in the prices of certain manufactured goods, as exemplified by pharmaceuticals. Imbalances between demand and supply of primary products are accentuated by the government's reluctance to release more food through the public distribution system at BPL prices. The effort to reduce subsidies has resulted in a continuous increase in the prices of commodities such as petroleum and fertiliser that are administered. The list is long and almost endless. The processes of liberalisation and deregulation are creating a high inflation economy.

Thus the propensity to inflation and balance of payments (BoP) vulnerability in India are policy-induced and structural. But that raises the issue as to why they have become more of a problem in recent times and why the BoP deficit is seen as partly responsible for the close to 20 per cent depreciation of the rupee over two months. One reason is the relative magnitude of capital flows into India when compared to the size of the current account deficit. For a long period of time the ratio of net capital inflow to the current account deficit was more than one in most years. Many factors explained this tendency. India had been a favoured destination for foreign financial investors. Foreign direct investors also turned to India after liberalisation to benefit from the large and growing domestic market. And Indian firms have borrowed heavily abroad given the much lower interest rates in foreign markets and the liberalised conditions relating to external commercial borrowing. Moreover, services exports and remittances from workers providing services on location abroad have substantially covered the country's merchandise trade deficit.

In the event, cumulatively there had been a huge excess of capital inflow into the country when compared to its current account financing needs, partly reflected in the significant increase in India's foreign exchange reserves. This enhanced access to foreign finance over the two decades as a result of the expansion of global liquidity and liberalisation of rules regarding capital inflows led to a complacent view on what is an acceptable current account deficit, with 3 per cent of GDP seen as quite normal and easily financed. The problem here is that a 'normal' and acceptable current account deficit is defined by what would be considered a 'normal' and perennial level of capital inflow. The government had in the past considered such normal inflows to be in the range of 2.5 per cent of GDP. But an unusual surge after 2005 has induced an element of complacency. As a result inadequate attention has been paid to the structural weaknesses in the current account, with non-oil imports rising, driven not just by the Indian elite's obsession with gold, but also by a range of non-essential manufactured goods. This implies that any adverse shock in the form of a rise in oil prices with or without an accompanying deceleration in export growth can sharply widen the deficit (to as much as 6.7 per cent of GDP in the last quarter of 2012, for example) resulting in a high degree of volatility in the current account deficit in recent quarters.

In absolute terms the current account deficit has widened from around $9-12 billion per quarter to $15-20 billion a quarter. Simultaneously, capital inflows have steadied and even declined. This has meant that capital inflows are now just about adequate to finance the current account deficit, with reserves falling when the deficit is particularly high. This does draw attention to the structural deficit on the current account, leading to greater pressure on the currency.

The impact of weak fundamentals and speculation on the rupee's value is all the greater because of the uncertainty created by the substantial deceleration in GDP growth from more than 8 per cent to 5 per cent or even lower. High growth matters also because it provides the basis for expectations of increases in corporate earnings that support investments in the secondary market for equity, even when price-earnings ratios are already high. A significant share of such investment comes from foreign institutional investors, so any slackening in secondary market investments, even if not directly of relevance for physical capital formation, also aggravates balance of payments vulnerability.

It needs to be noted that the high growth of the 2004-08 period was surprising to say the least. This is because a number of factors should have made slow growth the long-term tendency under liberalisation. To start with, the declared objectives of neoliberal fiscal reform are a lenient tax regime (aimed at incentivising private savings and investment) and a substantially curtailed fiscal deficit. With revenues at any level of GDP lower than they could have been and the deficit target set low with respect to GDP, expenditure must necessarily be lower than it would be in a proactive fiscal regime. While the deficit target was not realised in the 1990s, the government has been assiduously working to achieve it over the last few years. The result must necessarily be a lower level of expenditure than would have otherwise been the case. In an accumulation regime that depended substantially on the stimulus provided by public expenditure this must have restrained growth significantly.

Advocates of liberalisation, besides referring to the effect on growth that the unleashing of "animal spirits" would have, expected exports (driven in particular by foreign investment) to emerge as an important inducement to private investment and stimulus to growth. That, however, has not happened. Rather, a defining feature of the high growth period has been the substitution of debt-financed private expenditure for tax and debt financed public expenditure as the principal stimulus for growth. The ratio of bank credit outstanding to GDP, which had remained at around 22 per cent for a decade starting 1989-90, rose thereafter to reach 44.4 per cent in 2005-06 and a remarkable 56 per cent by 2011-12. This increase in bank credit outstanding was accompanied by significant increases in the share of credit allocated to two segments: retail loans and infrastructure. The share of personal loans increased from slightly more than 9 per cent of total outstanding commercial bank credit at the end of March 1996 to more than 22 per cent by end-March 2007. While much of this credit went to support investments in housing, it also helped to substantially increase purchases of automobiles and consumer durables as well as general expenditures financed with credit card debt.

The other area that benefited from the credit boom was infrastructure. Given the government's push in this area, by the end of 2012 there were over 900 PPP projects at different stages of implementation in the infrastructure sector involving a total project cost of Rs.5430.45 billion. Clearly, the private sector was not capable of self-financing that kind of expansion. With the bond market inadequately active, the government decided to prod public sector banks into lending to this sector. Not surprisingly, bank lending to infrastructure rose from just 3.6 per cent of bank credit to industry and 1.6 per cent of total bank credit at end-March 2000, to as much as 35 per cent of bank credit to industry and 13.4 per cent of total bank credit by end-March 2013.

For quite sometime this credit financed spending increased demand and stimulated growth. However, more recently defaults have been on the rise. Such, defaults, in the housing and automobiles sectors, have been reported for long, but the number and proportion of defaults is rising. According to data from RBI and CRISIL, the value of suits filed against wilful defaulters of loans of over Rs. 25 lakh by banks and institutions has risen from Rs. 8727 crore in March 2009 to Rs 23,349 crore in March 2012. More importantly, corporate borrowers, especially in the infrastructural area, are finding it increasingly difficult to meet the interest and amortisation commitments associated with their large debts. This had gone unnoticed because, desperate to protect their books, banks have been restructuring their loans. As a result, while the ratio of Gross Non-performing Assets to total infrastructural loans has risen from 0.61 per cent to 1.45 per cent between March 2009 and March 2013, the ratio of gross NPAs and restructured advances to infrastructural loans has risen from 4.66 per cent to 17.43 per cent. That is quite ominous given the fact that that many restructured ‘standard’ advances have had to be characterised as non-performing subsequently.

With defaults on the rise, banks have turned cautious with regard to lending, and the Reserve Bank of India decision to maintain high interest rates in response inflation has also reduced credit offtake. In the event the credit stimulus to growth has weakened and is proving ephemeral, which possibly explains the observed slowing of growth. But this is no guarantee that defaults on past exposure would not rise. If they do banks too can be vulnerable. A Credit Suisse India report tracking borrowing by 10 leading Indian business groups that are among the biggest corporate borrowers, found that these groups (Adani, Essar, GMR, GVK, Jaypee, JSW, Lanco, Reliance ADA, Vedanata and Videocon) have been on a borrowing spree. Their liabilities have increased six-fold over the six years ending March 2013 to touch Rs. 6.31 trillion and they account for to close to 35 per cent of the gross bank credit outstanding from scheduled commercial banks to large industry, and 28 and 11 per cent respectively of bank lending to industry and all sectors. Bank exposure here is large enough to trouble the banks if the firms concerned are in trouble. This too must be encouraging a reduction in both credit and investment.

The resulting return to India’s structurally constrained, long-run, low growth trajectory has weakened investor enthusiasm leading to sluggishness in capital inflows and some capital exit as well. This intensifies rupee depreciation. And once depreciation begins, there is the danger of a speculative attack on the currency—a tendency aggravated by the impact of the liberalisation driven creation and expansion of the market for currency derivatives.

In its most recent Annual Report, the Reserve Bank of India notes that the volume of trading in exchange-traded currency derivatives increased from Rs. 2.6 billion in September 2008, when such trading was first permitted, to Rs. 234.4 billion in June 2013, and recognises the role of such speculation in influencing movements in the value of the rupee. According to RBI, econometric tests suggest “there is causality running from speculation to exchange rate volatility”. Given this conviction it has “banned proprietary trading by banks in the currency futures/exchange-traded currency options markets,” and “also tightened exposure norms for currency derivatives to check excessive speculation by increasing margin requirements and curtailing open positions on currency derivatives.”

But the efficacy of such measures is in question. So if such markets are allowed to persist the probability of a structurally induced depreciation of the rupee turning into a collapse of the currency is high. Recent experience only confirms that hypothesis.

As compared to this set of explanations for the dismal macroeconomic situation in India, the neo-conservative view is that it is a combination of stalled reform and adverse international developments that are responsible for the country's difficulties. However, it is difficult to blame depressed international demand either for slow growth or the widening current account deficit. In fact, after the immediate impact of the global crisis on Indian growth had been felt in 2008-09, GDP growth in India recovered even though the crisis persisted in the OECD and worsened in the European periphery. India's exports had been affected adversely, but domestic demand proved adequate to keep growth growing at a creditable rate. India did, of course, benefit from the flow of capital to emerging markets resulting from the infusion of liquidity into developed country markets in response to the crisis. But neither did this directly finance investment (taking the form instead of flows to secondary equity and debt markets), nor did it in itself raise local demand. So while depressed global conditions could adversely impact Indian economic performance, their role can only be one of aggravating difficulties created by domestic factors.

A similar argument would hold in the case of the current account deficit. Other than for the early 2000s (2001-04), India has through the liberalisation period recorded deficits in the current account of the balance of payments. That is, in this area as well, international factors only worsen a vulnerable balance of payments position resulting from more long-term structural factors. The argument that the Federal Reserve's retreat from quantitative easing (QE), has encouraged foreign investors to exit countries like India and opt for dollar denominated assets needs to be seen in that context. The tapering off of QE is said to be destabilising emerging markets because of its effects on capital and currency markets. But that destabilising influence has the impact it does partly because of the influence of more fundamental factors.

The government has, however, no plan to address those fundamental weaknesses. Having long ignored these tendencies, and paralysed by its neoliberalism, it now looks only to external help from private capital or the international institutions to address the problems at hand. Given the policy predilections of such agencies, they are likely to demand a turn to austerity in response to India's current difficulties. And even with austerity much new and additional capital may not be forthcoming. The argument that the rupee collapsed because of the government's decision to move the Food Security Bill, reflects this view that any welfare initiative involving public expenditure is to be avoided, and that austerity is the only way to redress macroeconomic imbalances. As developments in the European periphery show, that argument is deeply flawed. Austerity, by contracting incomes and reducing the government's revenues only worsens the fiscal imbalance even when expenditures are being curtailed. And to the extent that inflation and the current account deficit are structural rather than demand driven, even those imbalances remain uncorrected.

But that is not all. Even though the rupee's depreciation is a symptom of a deeper malaise, its effect is to worsen the ailment. A sharp depreciation increases the prices of imports, including that of universal intermediates like petroleum products, aggravating inflation. The rupee depreciation increases the interest and amortisation burden facing corporates and other entities that have borrowed from abroad in foreign currency in order to benefit from lower interest rates. So the probability of default and bankruptcy increases. If in addition austerity shrinks demand, the transition from a difficult macroeconomic situation to a full-fledged crisis may prove short.

The situation, to use the government's phrase, requires "harsh measures". An immediate requirement is measures to shrink the external deficit, with measures such as stringent quantitative restrictions on imports, not just of gold but a host of non-essentials. Given the adverse effect on domestic production and employment that manufactured imports have had, that would also serve to address the growth slowdown. Also required is a crackdown on markets, agents and instruments that serve to mediate a speculative attack on the rupee. These need to be combined with evidence that the RBI is serious about managing the rupee, which it must by using its reserves. To the extent that could encourage reserve depletion, it would be necessary to stop capital account flows on account of resident firms and individuals and impose capital controls involving some short term restrictions on exit by foreign investors and medium term measures to limit "unnecessary" or abnormal capital inflows, which encourage inaction with regarded to the structural deficit on the BoP. Measures such as these would inevitably need other supportive interventions, including efforts to ensure an orderly restructuring of doubtful bank loans. They would all elicit a sharp and adverse response from wealth-holders, the business community and the finance-dominated media. But an assertive state is likely to be successful in reining in these forces and returning to business as usual. A reticent state is likely to be seen as a willing host of a party for speculators.

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