Ostrich-like in Peacock Nation*

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In the midst of a crisis reflected in a collapsing rupee, India's BJP government is acting ostrich-like, burying its head in the ground. Nothing illustrates this better than its much-delayed response to the collapse of the rupee with a set of measures that are the opposite of what is needed. Having fallen from just below Rs.64 to the dollar to close to Rs.73 to the dollar between the beginning of 2018 and mid-September, the rupee has depreciated by about 14.3 per cent with respect to that currency. But it is not relative to the dollar alone that the rupee has fallen. Over the same period It depreciated by 10.2 per cent vis-à-vis the euro and 10.4 per cent vis-à-vis the pound. To salvage the rupee, the government has decided to accelerate capital inflow into the economy by making it easier for domestic agents to borrow abroad and for foreign agents to invest in and lend to the country.

There are two presumptions implicit in this response. One is that foreign financial investors are withdrawing from India not because of higher interest rates and tighter monetary policies in the developed countries and worry created by India's widening current account deficit, but because India's policies on foreign investment and borrowing are not liberal enough. The other is that a widening current account deficit is not the problem, but rather the absence of adequate capital inflow to finance that deficit. Both those presumptions are faulty.

The measures inspired by these misplaced presumptions are anaemic to say the least. In the past, the government had encouraged borrowing long-term and pushed for hedging of foreign borrowing, or insuring against the adverse effects of currency volatility, to insulate borrowers from the risk of rupee depreciation. If short-term debt is contracted to finance longer-term projects, creditors may refuse to roll-over that debt making financing uncertain. So borrowing long term was seen as prudent. But, depreciation during that period of exposure increases the rupee cost of a given debt-service commitment denominated in foreign currency, and increases the debt burden. So hedging of long term debt is crucial.

Going against this standpoint, the new measures involve a review (as a prelude to abolition) of mandatory hedging of external commercial borrowing for infrastructure. They also permit domestic companies to borrow short-term sums of up to $50 million. The minimum maturity period for such borrowing has been reduced to one year in order to reduce hedging costs, doing away with the earlier three year maturity period. The idea is to reduce borrowing costs, even if it increases the risk of losses on account of depreciation and heightens the danger of capital withdrawal.

Foreign investors in debt instruments are also to be given greater space. The currently prevailing ceiling on exposure to a single corporate group in the bond basket of foreign portfolio investors is to be reduced and the limit of 50 per cent on the exposure to any single corporate bond issue is to be reviewed. And in an effort to cajole foreign lenders (rather than the domestic borrower) to bear the currency risk, the withholding tax of 5 per cent applicable on borrowing abroad against rupee-denominated (masala bonds), is to be done away with, and Indian banks are allowed to help such issues by acting as market-makers including underwriters. If the bonds don't sell despite the tax benefit, which is quite likely given the ongoing depreciation of the rupee, the currency risk would be carried by the underwriter.

It should be clear that the thrust of the government's response is to stall and reverse the exit of foreign portfolio investors, especially from debt markets. Yet, the claim is that the measures are principally aimed at reducing India's rising current account deficit, projected to cross 3 per cent of GDP in 2018-19. The only element mentioned in the response-package aimed at reducing the current account deficit is a promise to curb non-essential imports, with no concrete measures to back it. Thus, the measures are actually a desperate attempt to attract foreign investment in lean times to finance a rising deficit.

The counterproductive nature of this intervention becomes clear when we consider the factors driving the depreciation of the rupee visa-a-vis the dollar, euro and the pound sterling, among other currencies. Government spokespersons, who speak in different voices but say the same thing, argue that rupee depreciation is not a problem but a feature of the global conjuncture. All emerging markets are facing this difficulty, and relative to them even on the currency movement front India is doing better, is the claim. That is, however, not all factual. In fact, the rupee is the worst performing currency among Asian emerging markets. Even the Indonesian rupiah, which has been singled out from Asia for international media attention has fallen by a smaller 9.2 per cent over the period when the rupee depreciated by more than 14 per cent.

So the sources of comfort by comparison are the really poorly performing countries elsewhere on the globe, such as Argentina (where the peso depreciated by 114.8 per cent), Turkey (with the lira down 68.5 per cent), and Brazil (with the real down 27.3 per cent). India looks comfortable in comparison. What is missed in this complacent assessment is that these countries are in crisis, and saying that India is afflicted by a problem similar to theirs, even if not so severely, is no comforting prognosis.

What this message seeks to convey is that the problem is not of the government's creation, and would therefore not cause harm and eventually go away. But that assessment misses out on three different trends that underlie India's current vulnerability. First, since 1991, consecutive governments have liberalised India's capital account, inviting foreign financial investors to enter and invest in India's equity and debt markets. This did not matter much when the flow of capital into India and the stock of such investments in India were small. This was true during much of the 1990s when returns in India relative to the riskiness of investment were not too high. All that changed during the 2000s, when central bank policies increased hugely the volume of cheap liquidity in international financial markets. That was also the time when the Indian government adopted policies, such as the abolition of long term capital gains taxation, aimed at making investment in India more attractive. The result was a surge of portfolio capital inflow into India and a rapid accumulation of the stock of portfolio investments in the Indian market. Looking for high profits, that capital was likely to withdraw at the first sign of an economic setback in India or if the cost of capital mobilised to finance these investments rises, squeezing profit margins. That is precisely what is happening now as India's current account deficit widens and the cheap money policy adopted by developed country governments is being unwound. In sum, financial liberalisation has made India vulnerable to capital flight and currency crises, triggered by developments abroad.

The second disconcerting trend is that the promises of the advocates of liberalisation notwithstanding, “economic reform” did not result in a significant increase in India’s exports. Exports were expected to spike post-liberalisation as a result of the international competition-induced restructuring of domestic capacity to make it globally competitive, and because of the inflow of relocative foreign investment seeking to use India as a base for world-market production. The result of export failure was that large remittances from Indian working abroad and substantial receipts from exports of services helped rein in the current account deficit and stabilise the balance of payments in normal years. But when the import bill rose above ‘normal’ the current account deficit tended to widen quickly. That is what is happening currently because of the rise in global oil prices, on the one hand, and increase in outflows on account of coal imports, on the other. The international price of Brent crude has risen from $29 a barrel in mid-January 2016 to close to $80 a barrel by mid-September 2018. Rapid growth in coal-based thermal power generation and demand from captive power plants has also resulted in a coal shortage that is driving up imports, increasing the import bill. As a result the current account deficit is likely to cross the 3 per cent of GDP mark in 2018-19.

Finally, in the years after the 2008 crisis, when massive amounts of cheap liquidity were pumped into the system, the government kept raising the ceiling on portfolio investor holdings of both government and corporate bonds. This encouraged the carry trade in which foreign investors borrowed at near-zero interest rates in international markets and invested in relatively, high-yielding bonds in India. Simultaneously, Indian corporations chose to exploit the opportunity to borrow cheap abroad to finance domestic operations, despite the risk that rupee depreciation would increase the debt service burden in rupee terms. This tendency has accelerated after the 2008 crisis. According to the Bank of International Settlements, external debt securities issued by non-bank entities from India rose from $14 billion in the last quarter of 2012 to $35 billion in the last quarter of 2017.

The vulnerability implicit in this liberalisation-driven accumulation of foreign portfolio investments in India manifested itself when developed country central banks decided to unwind their quantitative easing policies and raise interest rates. Since this policy turn undermines the basis of carry trade investments in emerging markets, the exit of foreign investments in equity and debt markets has begun. This has affected India as well. According to the Reserve Bank of India, the net outflow of portfolio capital amounted to $8.1 billion in the first quarter of 2018-19, as compared with an inflow of $12.5 billion in the corresponding quarter of the previous year. This was draining India’s foreign exchange reserves which had fallen by $25 billion from its recent peak of around $425 billion.

Since this was occurring at a time when India’s current account deficit was widening (for reasons discussed earlier), the pressure on the rupee has increased, resulting in its sudden decline. Declines of large magnitude spur speculation with exporters and other increasing their holdings of dollars in the expectation of a steeper depreciation, which then realises itself. Given the obvious links between trade and capital account liberalisation and this vulnerability, measures to address the crisis must seek to stop the foreign exchange bleed, rather than find suspect ways of increasing capital inflows to compensate for the outflow. But measures to woo reluctant foreign investors, incentives to borrow for domestic agents and mere promises of import curbs are all the government has to offer, pointing to the fact that its neoliberal commitment has trapped it in a vulnerability of its own creation.

Meanwhile, firms that have borrowed in dollars, and are inadequately hedged, are beginning to feel the strain, as the debt servicing burden in rupees rises steeply. Default and bankruptcies are a real danger. As and when they occur the asset deflation that would follow would rein in investment and growth, even as rising import costs stir up inflation. “Stagflation” is a real possibility, at a time when the government is still battling a veritable currency crisis.

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