

India in trouble

The reckoning

Why India is particularly vulnerable to the turbulence rattling emerging markets

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ON THE morning of August 17th most of India's economic policymakers gathered in the prime minister's house in Delhi. They were there to launch an official economic history of 1981-97, a period which included the balance-of-payments crisis of 1991. The mood was tense. India, said Manmohan Singh, the prime minister, faced "very difficult circumstances". "Does history repeat itself?" asked Duvvuri Subbarao, the outgoing head of the Reserve Bank of India (RBI). "As if we learn nothing from one crisis to another?"

The day before Indian financial markets had had their rockiest session for many years. The rupee sank and stockmarkets tumbled. Money-market rates rose. The shares of banks thought to be either full of bad debts or short of deposit funding fell sharply. The sell-off had been made worse by new capital controls introduced on August 14th in response to incipient signs of capital flight. They reduce the amount Indian residents and firms can take out of the country. Foreign investors took fright, fearful that India might freeze their funds too, much as Malaysia did during its crisis in 1998.

India's authorities have since ruled that out. But markets keep sliding. On August 20th the RBI said it would intervene to try to calm bond yields. The rupee has dropped to over 64 to the dollar, an all-time low and 13% below its level three months ago. It is widely agreed the country is in its worst economic bind since 1991.

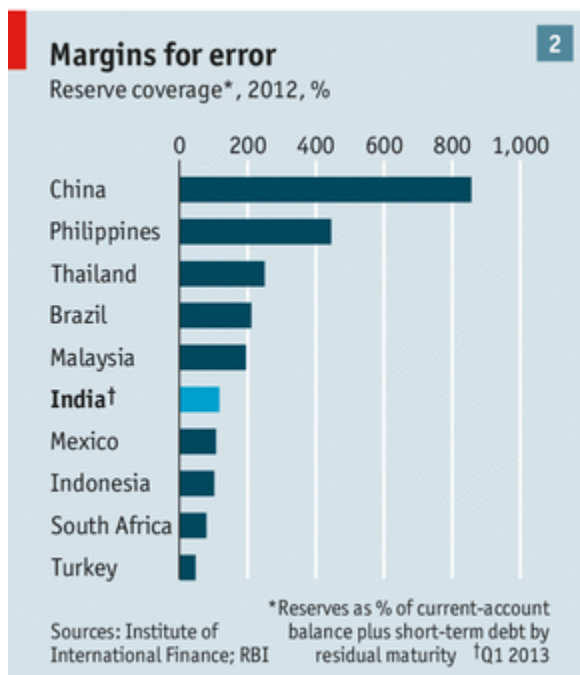
India is not being singled out. Since May, when the Federal Reserve first said it might slow the pace of its asset purchases, investors have begun adjusting to a world without ultra-cheap money. There has been a great withdrawal of funds from emerging markets, where most

currencies have fallen by 5-15% against the dollar in the past three months. Bond yields have risen from Brazil to Thailand. Some governments have intervened. On July 11th Indonesia raised its benchmark interest rate to bolster its currency. On August 21st its president said he would soon announce further measures to ensure stability.

India, Asia's third-biggest economy, is more vulnerable than most, however. Economic news has disappointed for two years, with growth falling to 4-5%, half the rate seen during the 2003-08 boom. It may fall further. Consumer-price inflation remains stubborn at 10%. A drive by Palaniappan Chidambaram, the finance minister, to push through a package of reforms and free big industrial projects from red tape has not worked. An election is due by May 2014, adding to uncertainty.



India's dependence on foreign capital is also high and has risen sharply. The current-account deficit soared to almost 7% of GDP at the end of 2012, although it is expected to be 4-5% this year. External borrowing has not risen by much relative to GDP—the ratio stands at 21% today—but debt has become more short-term, and therefore riskier. Total financing needs (defined as the current-account deficit plus debt that needs rolling over) are \$250 billion over the next year. India's reserves are \$279 billion, giving a coverage ratio of 1.1 times. That has fallen sharply from over three times in 2007-08 (see chart 1) and leaves India looking weaker than many of its peers (see chart 2).



It is therefore vital that foreign equity investors stay put. They own perhaps \$200 billion of shares at current prices. They have sold only about \$3 billion since May, but if they head for the exit India would have no defence.

This is not a repeat of 1991. When India last had a crisis Boris Yeltsin was about to stand on a tank in Moscow and Nirvana was hitting the big time. Things have changed in financial terms, too. Back then India had a fixed exchange rate, which the state almost bankrupted itself trying to defend—it had to fly gold to the Bank of England in return for a loan. Today India has a floating exchange rate and a government with almost no foreign-currency debt. A slump in the currency poses no immediate threat to the government’s solvency.

The pain will be felt in other ways. Private firms that owe most of India’s foreign debt will be under intense strain, particularly if the rupee drops further. Some will go bust. Market interest rates will stay high, causing a liquidity squeeze. All this makes life even tougher for India’s state-owned banks, which already have sour loans equivalent to 10-12% of their loan books. Inflation will rise. And the government’s finances will be under strain as the cost of its subsidies on imported fuel gets bigger.

There is probably little the authorities can do to shore up the currency in the short term. The rupee is one of the world’s most actively traded currencies and at least half the turnover is abroad. Privately, officials reckon the rupee’s fair value, taking into account India’s higher inflation and productivity over the past few years, is a little less than 60 per dollar, so the market has yet to overshoot wildly. Raghuram Rajan, the incoming governor of the RBI, is likely to take a hands-off approach.

That doesn’t mean the government will—or should. On August 19th it banned the import through airports of duty-free flat-screen TVs, which Indians can often be seen heaving through check-in at Dubai. It may seek to raise duties further on gold imports, which Indians are addicted to in part because it is seen as a hedge against inflation. Gross gold imports were 3% of GDP last year, blowing a huge hole in the external finances. History suggests the

higher taxes on gold imports are, the worse smuggling gets. But India imports 800-odd tonnes of bullion a year. That's a lot of gold to hide in suitcases.

The government will also try to persuade the Supreme Court to lift its ban on iron-ore exports, imposed after a series of corruption scams. At its peak this industry generated exports worth about 0.4% of GDP, although experts doubt that mothballed mines can be ramped up fast. The government may also cut fuel subsidies. That would reduce demand for imported fuel and help it hit a fiscal-deficit target of about 7% of GDP (including India's states).

The longer-term solution to the balance-of-payments problem may be to ramp up India's manufacturing sector, and thus its industrial exports. But that will take a big improvement in the business climate, not just a cheap currency. Despite the rupee's 27% tumble in the past three years there is scant sign of global manufacturers shifting production to India.

India's position could still get worse. But assuming things stabilise, when the official histories come to be written about 2013, what might they say? Most likely that the rupee's slump caused a severe shock to the economy that made a recovery in growth rates even harder. But perhaps, also, that it prompted a more serious debate about the policies that India needs to become less vulnerable to the whims of an unforgiving world.