

Two crises: Lessons for the Future

■ Dr T. K. Jayaraman

Early this week, the slide-down of the rupee was relentlessly continuing. Indian rupee fell to the lowest level on Monday, September 10, ₹ 72.67 per US dollar; on Tuesday, it reached yet another low at ₹ 72.70. It looks it may fall further soon to ₹ 75

The ongoing currency crisis is not new. We have seen crises of similar nature in yesteryear.

In 2008, the rupee fell from ₹ 39 to ₹ 49 per one dollar by 25% in six months; in 2011, the fall was from ₹44 to ₹54 by 23% in four months; in 2013 from ₹ 54 to ₹ 69 by 28%. In the latest fall in September 2018, the decline is to ₹ 72 per dollar from ₹ 63 in January by 14%.

The reasons are well known. Each day the media highlights the growing misery in headlines. One of the reasons is the widening trade deficit (difference between imports and exports of goods) and the current account deficit (negative net earnings from trade in goods and services interest and dividends, and transfers such as foreign aid).

India depends on petroleum crude oil imports: 80% of domestic crude oil requirements are met with imports; and 50% of total imports are crude. The current crisis is not an unusual phase of a cyclical pattern of supply and demand of oil: shortages of supply influenced global conflicts and expansionary or contractionary phases of world economic growth in a more liberalized world of economic interdependence. The latest crisis is triggered by the US policies of containing the growth of the domineering Chinese economy by protectionism: MAGA (make America great again). Every unsettling decision of the world's largest economy USA including the confrontational posture against Turkey with economic sanctions, rattling the Turkish Lira was the last straw. The fall in the value of Lira against the dollar on August 16 induced further decline in all currencies of developing countries.

Twin Deficits

India is one of the five "Fragile Emerging Economies", which have the common problem of twin deficits haunting them all the time. The twin deficits are fiscal deficits and current account deficits. Fiscal deficit (total government, inclusive of central and state governments, expenditures exceeding total revenues) always spills over into external sector which manifests itself as current account deficit (CAD).

India's CAD was \$13 billion or 1.9% of the GDP in the last quarter of 2017-18 as compared to \$2.6 billion or 0.4% of the GDP in the last quarter of 2016-17. Rising oil price during

2017-18 is the main cause of the trade deficit given the slow growth in exports and other net incomes. The trade deficit was \$108 billion in 2016-17, which increased to \$ 156.8 billion in 2017-18. In the period April-June 2018 it was \$63.0 billion as against \$51.5 billion. The oil price was at the lowest \$29.25 per barrel in Jan 2016 which rose to \$ 71.34 on September 4 and is now hovering around \$ 70. The CAD is now at a six year high, 2.5% of GDP.

Studies have estimated every \$10 increase in the price of crude oil would increase trade deficit by \$9 billion or by 0.3% of GDP. If oil price touches \$ 90 per barrel CAD will be 3.6% holding other net earnings constant. One always tends to look back and see how India coped with similar crises in the past.

	2012-13	2017-18	2018* (July)
Current A/c Deficit US\$ billion)	87.8	48.7	70.6
Current A/c Deficit (% of GDP)	4.8	2	2.8
Monthly Imports (US\$ billion)	41	39	43.8
Monthly Exports (US\$ billion)	25	25	22
Oil price/barrel (US\$)	92	54	70
Inflation (%)	8.4	4.6	5
Foreign Reserves (US\$ billion)	270	424.5	400
Imports equivalent (months)	6.5	10	7.50
FDI Equity (US\$ billion)	22	36	38.7
FPI Equity (US\$ billion)	25.8	3.9	NA
FPI Debt (US\$ billion)	5.2	18.4	NA
Total FPI inflows	31	22.3	0.9

Source: IMF Staff Report of Article IV Consultation Reports, 2018, 2017 and 2016

*Estimate

We had one of the worst crises in 2013.

About three months ago, when the current crisis of the falling rupee to the highest level of depreciation at ₹ 72 per dollar began to raise its ugly head, government officials comforted the nation, by referring to the highest level of India's foreign exchange reserves of \$426 billion (April 2018), which are sufficient to finance 10 months equivalent of imports. There were frequent announcements by officials that India was going through a phase of correction of exchange rate. They claimed it has been overvalued for the past few years and so it should be allowed to fall to its "natural value".

These needless pronouncements made the markets reconcile themselves to a situation of undeterred depreciation for some time. Further, the Reserve Bank's well known stand has been that it is only concerned with internal stability and domestic value of money or purchasing power and it does not target any specific exchange rate, real or nominal.

The markets have to live with the stand-off position of RBI. Feeble intervention, which is not unusual, under the guise of reducing the volatility in exchange rate had no lasting impact of a permanent nature. The efforts were of small magnitude and were certainly sustained. When compounded by the cavalier statement from Niti Aayog's Kumar that India was not worried about the falling value of the rupee, the market had to await further depreciation. Experts have argued currency depreciation would make domestic goods cheaper and attractive to foreigners. An IMF study has also shown currency depreciation by 20% would result in export going up in emerging economies by 10% over five years. It may be applicable elsewhere, not to India.

India is not China. Certainly not any way similar to Thailand or Malaysia. The ASEAN countries have been export oriented since the 1980s. They welcomed FDI wholeheartedly in their export sectors. Their export sectors got more diversified over the years. Indian exports are not diversified. As a result, none of the past depreciations in India have made Indian exports go up by leaps and bounds.

How then is CAD financed?

CAD has been financed by capital inflows: Foreign direct investment (which is in plant and machinery and of course, transfers of managerial skills and training of labour); foreign portfolio investment (FPI) by investors, individuals and institutions, which are of a short term nature, in stocks and bonds. These are most fickle and unreliable. They are pulled out easily once investors' perceptions are changed about the country's interest rate and exchange rate risks. Lastly, not least important: inward remittances by Indian Diaspora, ranging from the blue collared workers in the Gulf and West Asian countries to professionals on work permits and those of Indian origin. Annual remittances, now around \$70 billion are much more than FDI and FPI.

India's foreign reserves in recent years were built up by whimsical FPI. Episodes of appreciation of the Indian rupee were due to heavy inflows of FPI, when India was perceived to be a safe bet. For example about \$35 billion of FPI flowed for a period of 12 months (February 2017 to January 2018) when the rupee rose against dollar from ₹67 to ₹63.7. The reverse happened when FPI was pulled out soon after bad news trickled in about India's widening trade deficit and CAD in early 2018; more pull out in July-August 2018.

It is obvious that India's reserves have come to depend on fickle FPI.

The government knows it. More efforts are taken to attract FPI rather than increasing more jobs creating, labour intensive exports. The government knows dependency on FPI has landed the country in crisis. Finally, it is reported that government has asked RBI to stem the downward slide of the rupee by intervening more effectively. It is obvious Niti Aayog's advice was wrong! Other steps are likely to include looking again to NRIs for rescue. A deposit plan for overseas Indians is under preparation.

Politicians would now start all over again: They know the ultimate remedy: exports. The only country, which has a trade surplus is China. The communist nation knew well how to promote export sectors with capitalist measures. It developed the export sector with FDI. It humbled the US, which has a big trade deficit with China, exceeding \$ 375 billion: more than a billion per day!

One of the most famous maxims of the Chinese leader Deng Xiaoping, dating back to the years before the Cultural Revolution, states that "It doesn't matter whether a cat is black or white, as long as it catches mice".

Back to square one

Indian policy pronouncements would now focus on export promotion. The lip service will begin soon. We will get familiar with new, likely catchy slogans in English: "Export or Extinguish!" and appropriate versions in Hindi and regional languages. The same thing happened during the 2013 currency crisis. Everybody began to talk about promoting exports. Sophisticated economists were stressing the need for productivity of labour for reducing the cost of production in export sectors and making exports competitive to the rest of the world. Nothing sensational happened since then. Exports have not picked up since the last crisis. In fact, annual growth in exports declined in 2014-15 by 0.6%, and by 16% in 2015-16. There was a modest increase in 2016-17 by 5.2%.

We have to wait for good times. That is when the FPI picks up again, which would reflect the restoration of confidence in Indian economy through better governance and the speeding up of structural reforms. The latter should also deal with clearing the bad loan mess in the banking system.

The State Bank of India's Group Chief Economic Advisor is optimistic that once FPI inflows return to the pre-crisis level, the period of appreciation would be longer than the current period of depreciation of the rupee. That is the so-called asymmetrical behavior of exchange rate.

Anyway, at this stage who cares for symmetry or asymmetry? ■



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[The views expressed by the author in this article is his own.]