

CAMRI ROUNDTABLE DISCUSSION: MEETING SUMMARY

India's Malaise – Kim Sun Bae

Tuesday, 3 September 2013

(This is a meeting summary of the CAMRI Roundtable Discussion led by Dr Kim Sun Bae, NUS Business School Practice Professor and former Chief Asia Economist and Managing Director, Goldman Sachs.)

The Indian rupee has lost 20% of its value this year and has become one of the world's worst-performing currencies, exacerbated by the scaling back of US stimulus measures. The India story is a reflection of what happens when macroeconomic imbalances are synchronized with real exchange rate misalignment.

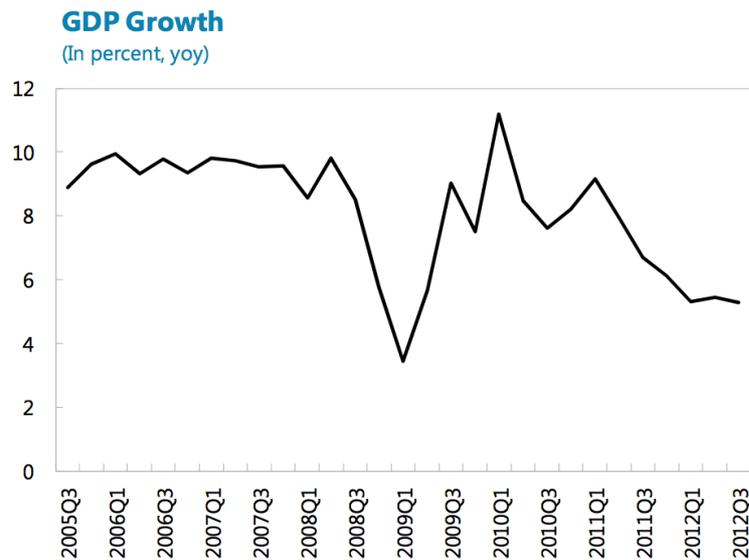
Symptoms

1. Slowing Growth

Between 2004 and 2008, India was called Asia's new tiger and enjoyed a growth rate of 8-9%. This growth suffered a sharp setback during the global financial crisis of 2008 but rebounded in 2009-10. However, the growth markedly lost momentum since 2011 (see Figure 1).

Data released for Quarter 2, 2013 shows that the growth rate has further decelerated to below 4%. On a quarter on quarter annualized basis, for the second quarter of this year, GDP growth in India was 3.5%. On a year on year basis it was just over 4%. So India's growth more than halved in a relatively short period of time.

Figure 1: India’s GDP Growth



2. Weakness in Demand

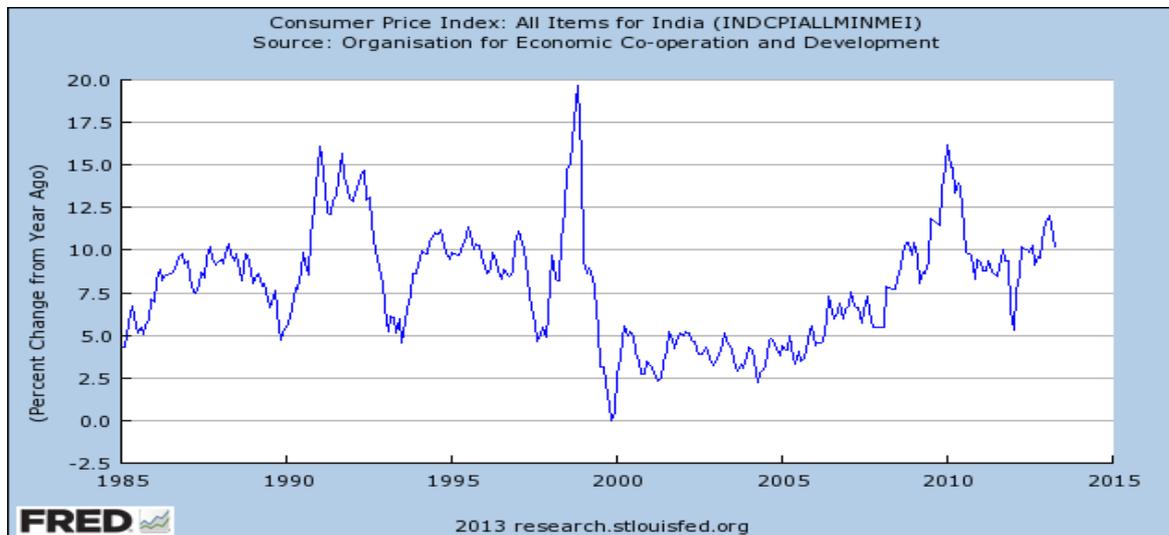
There has been a broadening of weakness in demand and the collapse in exports in 2012 which is unusually severe. Some of this is exaggerated by disguised capital flows. Many Indians, including the corporate sector, have been repatriating money out of India by under-invoicing exports and over-invoicing imports.

But the drop in demand may not entirely be reflective of the poor performance of exports. It may also be because private investment is retrenching, and the weakness is spreading to private consumption and will be more pronounced in other components of domestic demand.

3. High and Rising Inflation and Weak Currency

India enjoyed high growth rates and moderate inflation in 2000-2004. But this “goldilocks” economy soon gave way to accelerating inflation, which has persisted despite slowing growth (see Figure 2), giving way to stagflation in the economy.

Figure 2: Inflation in India, 1985-2013



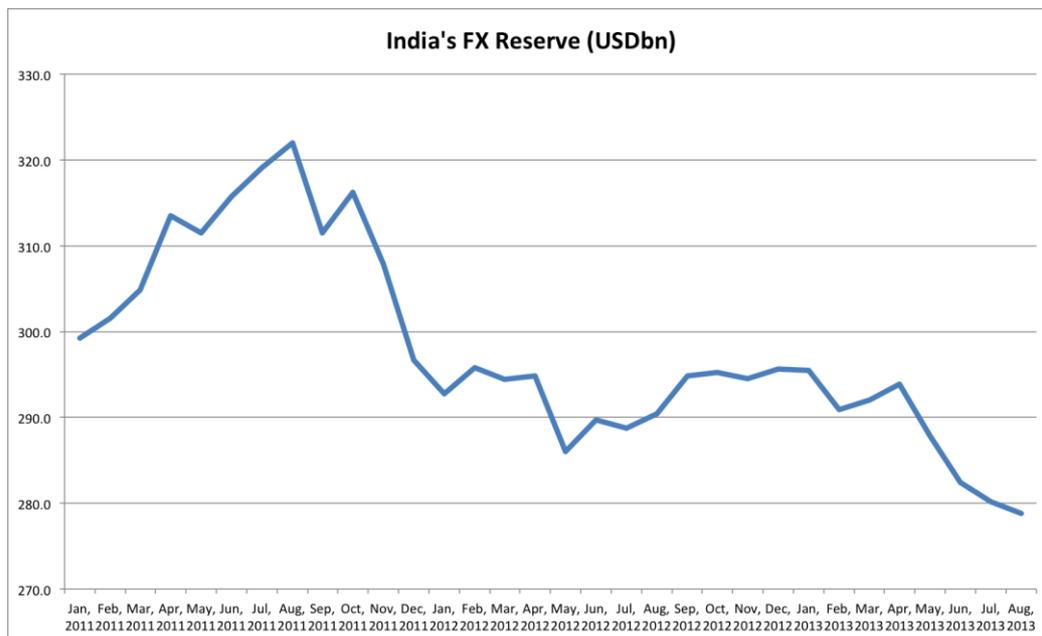
The rupee also has a long history of depreciation. This is a hallmark of a “soft currency” plagued by persistently high inflation. It was trading below 10 against the dollar in the 1970s, as of September 2013 the rupee is trading around 60 against the dollar. India has been running structurally a high inflation against some of its trade partners. If benchmarked against the US, at purchasing power parity measures, the inflation differential is offset by a weaker currency to keep the real exchange rate uncompetitive. The trend is that the rupee has been losing the vote of confidence, and it is not simply a currency drift to cancel the inflationary pressure. This “disorderly” sell-off raises the risk and stress of the balance of payments morphing into a full-blown crisis.

4. Continued FX Reserve Losses

FX reserves peaked at 320 billion US dollars in the summer of 2011. The reserves began to fall between September and December 2011 and continued thereafter till April 2012 (see Figure 3), although this did not spark a debate during the Roundtable.

It is important to remember that the data does not include the forward contract market which is off-balance sheet. The IMF however requires member countries to report forward contract books. The latest data shows this number as being - 280 billion US dollars, but the pressure is still downwards.

Figure 3: India’s FX Reserve (USD, Billions)



5. Muddled policy responses

Looking at how the rupee has traded since the beginning of the year, and the policy responses that followed, allows us to understand the present situation. Since March last year, there was an unexpected contraction in industrial production in India, which put pressure on the rupee. From May onwards, the Reserve Bank of India (RBI) required exporters to convert their foreign currency into Indian rupees. In January 2013, India raised taxes on gold imports. Due to a soft currency coupled with persistent inflation, gold in India has been a good inflation hedge, but lately has been blamed for contributing to the mounting current account deficit.

While all these responses led up to the current situation, a major event that got the fireworks started was the Fed tapering announcement on May 22, 2013. The pull back of liquidity from the global currency market hit India very hard. In fact, the two countries that were hit the most were the two countries with major current account deficits: India and Indonesia. On August 15, 2013, capital controls, including curbs on Indian firms investing abroad and a reduction of outward remittances, were introduced to restrict the outflow of foreign currency. This led to an even more precipitous decline in the already tumbling stock markets. Bank stocks fell sharply as they were thought to either have large portions of bad debts or shortages of deposit funding.

Prof Raghuram Rajan's appointment on September 2, 2013 as the new RBI governor may not bring much relief as India grapples with largely fiscal issues. It is clear that policy responses so far have focused on attacking the symptoms rather than mounting a response.

Diagnosis

1. Trimurti & the Hindu Dialectics:

An archetype Indian business cycle plays out in the following stages. Under Brahma — the Creator (“Thesis”), there is a cyclical expansion, and both private consumption and investment rises. Under Shiva — the Destroyer (“Antithesis”), there is a persistent structural budget deficit and rise in private demand, particularly investments that puts an upward pressure on interest rates. This leads to the classic crowding out of private sector demand. Finally, under Vishnu — the Preserver (“Synthesis”), a rise in interest rates crowds out private investment, and growth is restored to a (low) trend.

In normal times, the Indian cycle turns out to be very short. Because of the public sector deficit, any expansionary impulse on the private sector puts an upward pressure on interest rates, which snuffs out private sector expansion relatively quickly. This constraint was building for a long time because the private sector was relatively closed. Hence there was a limited pool of domestic savings in the system, with the government's structural deficit capping the duration and strength of private sector expansion.

The situation has been a little different in the last 5-7 years. There was tremendously high GDP growth until 2006-07, of around 8-9%. It was a result of the structural reform that India had undertaken in the early 1990's when the country last went through a balance of payment crisis. But not all the acceleration in growth was due to supply side improvements. A substantial part of it, though difficult to outline exactly how much, was a result of excess demand. In other words, growth was hovering above potential for an extended period of time. The symptoms were rising inflation, especially in the non-tradable sector, and a widening current account deficit. These are both external and internal factors that could be consistent with aggregate demand outpacing potential GDP. And both factors are symptomatic of an overvalued real exchange rate.

But India was able to go through an extended period of excess demand-led growth partly because there was a prolonged period of capital inflows. This was due to lax monetary policy in the core developed markets, especially in the U.S. There was eventually an unwinding of a lax monetary policy as high growth through excess demand isn't sustainable on an extended basis. Eventually, growth must "mean-revert" to trend (or potential), and often mean-reversion can overshoot on the downside, as it is happening now, which is the real danger in India.

Overall, the triggers for the present situation were a weak "pull" factor coming from doubts about domestic economic reform, and a weaker "push" factor through QE tapering & prospects of less easy money globally. A failure to export, failure to get the fiscal house in order, and supply bottlenecks has further magnified the problems.

2. Political economy arguments

Infrastructural issues in India have always impeded effective implementation of policy. To build better infrastructure, India needs resources like land. But land ownership is cumbersome, and the desire to control this valuable resource has increased crony capitalism in this sector. Supply-side investments have slowed down and to nullify public outrage, fuel subsidies and other deficit creating measures are being implemented, making the situation worse. Gov. Raghuram Rajan recently called the above situation a move from the "license raj" to the "resource raj".¹

On the monetary policy front, during the 1990's one of the key reforms was making it illegal for the central bank to finance government deficit. This was routinely done before the law was passed. But the government has recently been buying government securities off market, which is evidence that the above measure has been ineffective. The current inflation expectation is around 15-20%, given the demand for gold and an incredibly leaky capital account where people are repatriating. Other countries (USA, Korea, Japan and Germany) have handled prolonged periods of excess demand by tightening fiscal policy very severely. But in India, fiscal policy has gotten even looser.

With the worsening of external vulnerability, the Indian rupee remains overvalued. This is due to two reasons. First, the productivity growth in the

¹ <http://www.project-syndicate.org/commentary/what-happened-to-india>

tradable sector has slowed, which is a reverse of the *Balassa-Samuelson effect*. Second, the strength of capital inflows has reversed. These are two structurally enduring adjustments that India is facing. Since these indicators are not going to reverse anytime soon, it would indicate that the Indian rupee has to devalue in real terms to be in equilibrium. So in some sense there have been shifts in productivity growth and in capital flows in India that argue for a substantially weaker currency as an equilibrium adjustment.

When compared internationally, India has the worse inflation-budget deficit combination. While this is a problem- it could be the solution as well. A credible supply bottleneck easing program would be a win-win solution because in the short run, it adds to aggregate demand, and in the long run it adds to the social capital stock. Underlying this is a lot of inefficiency in government management – in other words, it's a political economy problem.

3. India's twin deficit problem

Slowing productivity in several sectors has translated into slowing growth. India's potential growth rate is 5-6% while India still believes that this is around 7-8%.

Domestically, the fiscal deficit is crowding out private investment and repressing potential growth. This will continue unless capital inflow is strong enough to keep interest rates down. Presently, interest rates are under tremendous upward pressure. The RBI is sterilizing capital outflow by adding liquidity into the banking system. If they do not intervene, interest rates would rise rapidly. Externally, less capital outflow will prevent interest rates increasing.

When the government savings is consistently negative (to the extent of 10% of GDP), the twin deficit problem is primarily driven by the public sector. If the private sector does not get crowded out because capital inflows underwrites low interest rates, then the private sector savings-investment gap also turns negative — that's exactly what happened in India from early 2000 till recently. The reason India's current account deteriorated so rapidly is because there is always a structural deficit from the government's savings-investment deficit. But because of strong capital inflows, which kept interest rates low, the private sector also ran a deficit. This story is thus very different from India's last balance of payment crisis in 1990-91. In that period, the savings-investment

gap was primarily within the public sector. This time around, it is a combination of the public and private sectors.

4. Stubbornly High Fiscal Deficit

Weak revenue collection capacity has led to a low “tax buoyancy”. On the spending side, subsidies doled out by the government have added to the burden. India enjoyed a favourable external environment post the reforms in the 1990’s, but once the sense of urgency disappeared a lot of the reforms, including the Fiscal Responsibility and Budget Management Act, which was India’s effort to structurally reign in the deficit, failed to gain traction. Subsequently, high fiscal deficit has crowded out private investment. This could hurt potential growth in the future unless the financing constraint is eased by stronger capital inflows.

5. Strong Capital Inflows Kept Domestic Interest Rates at Bay

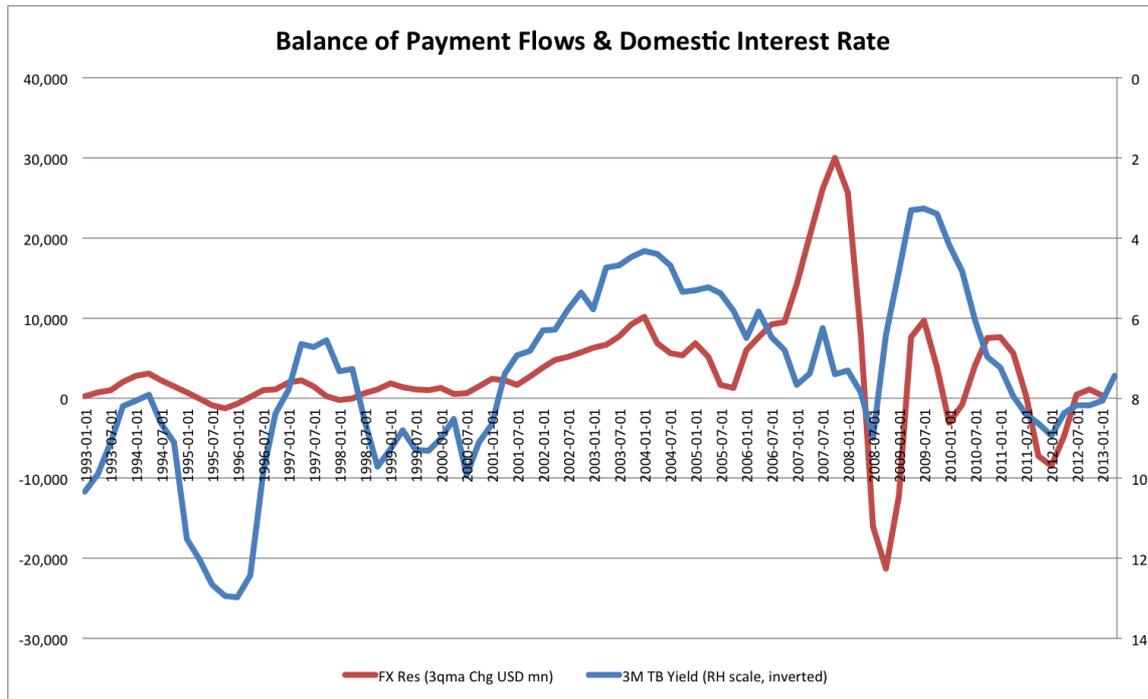
Figure 4 shows that during periods of strong capital inflows which leads to foreign exchange build up, India has enjoyed a fairly lengthy period of low interest rates. As a result of stronger capital inflows, India is looked at as Asia’s new Tiger. To a significant extent, stronger capital inflows punctuated by the global financial crisis may have allowed India to grow above its true potential through most of 2000s.

The imbalance, if India’s trend growth is nowhere near 8-9%, is that the extended period of low interest rates and strong demand both by the public and private sector is going to show up in the current account deficit which is what happened.

6. Widening Current Account Deficit

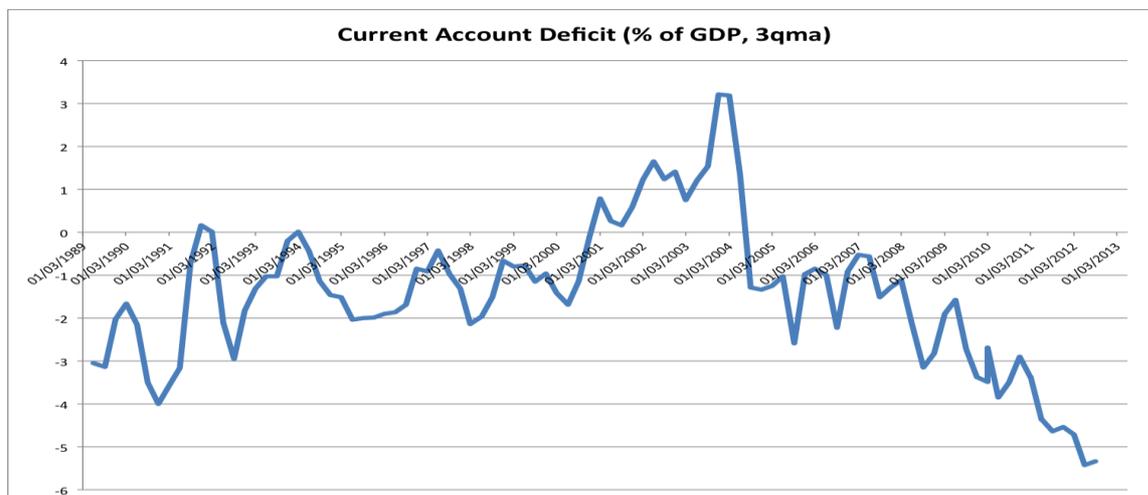
A widening current account deficit is the flip side of the twin deficit coin, the other side being the fiscal deficit. The current account deficit is now larger than in 1991, when India succumbed to a balance of payments crisis. Deterioration in current account may be “exaggerated” by disguised capital flight, as explained in previous sections. But the overall trend since mid-2000s is still consistent with an overvalued exchange rate and an overheating economy, i.e., aggregate demand exceeding potential GDP.

Figure 4: Balance of Payment Flows and Domestic Interest Rate



India is currently dealing with a current account deficit of roughly 5% of GDP that translates to 100 billion dollars a year. So this has to be funded since the country is essentially buying more from the rest of the world than it is selling. FDI used to be a substantial contributor to the current account deficit but these inflows have been slowing.

Figure 5: Current Account Deficit (% of GDP, 3 qma)

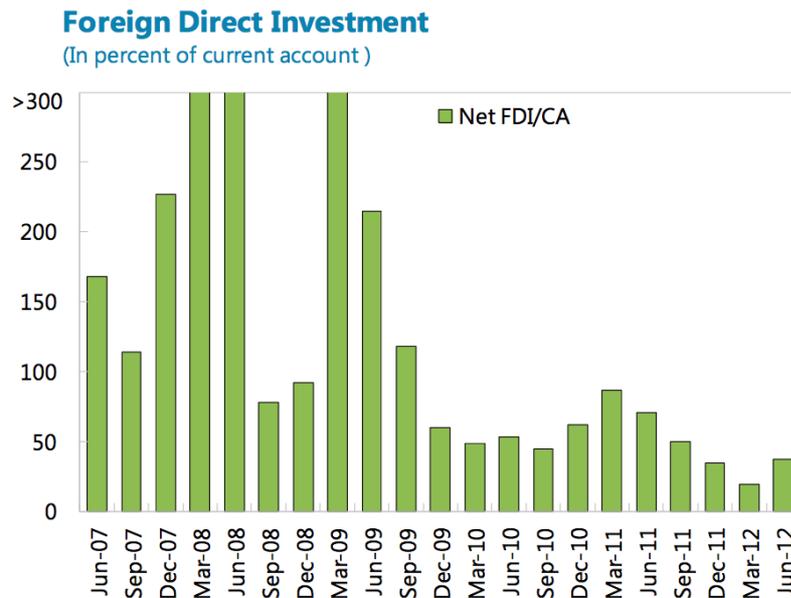


7. Slowing FDI Inflows and increase in “Hot Money” inflows:

In the second half of the 2000s, FDI inflows were sufficient to finance India’s current account deficits. Today, FDI is financing well under 50% of the current account deficit (see Figure 6).

The financing of current account deficit has increasingly fallen on inflows of “hot money” (non-FDI flows). Indian corporates have been aggressive borrowers. Recently, these hot money inflows have not been sufficient to cover the deficit on the current account. As a result, India’s foreign exchange reserves have declined.

Figure 6: FDI as a percentage of Current Account Deficit



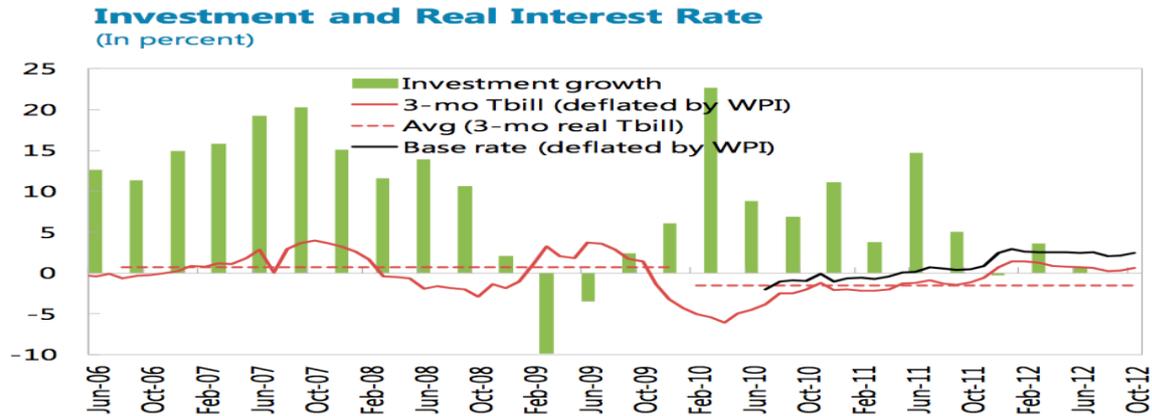
8. Rising Corporate Leverage and FX Exposure

External debt has risen by more than 50% in the past three years. The government has relaxed regulations of external commercial borrowing (ECB), increased the Foreign Institutional Investor (FII) debt quotas, and lowered withholding tax on INR corporate bonds. All of the above, combined with the low global interest rates, has pushed up external borrowing by Indian corporates, much of it on an unhedged basis. Most corporates that have borrowed foreign money have primary earnings in local currency, so there is a huge asset-liability mismatch. This high leverage and slowdown situation has led to increased corporate distress.

9. High Interest Sensitivity of Investment

For interest rates to be in the positive territory, high nominal rates are needed. The short term three-month real interest rate has mostly been in negative territory since mid- 2000 and is only recently rising gradually (see Figure 7). Real interest rates will need to rise a lot more to stabilize the rupee. This will raise the risk of a collapse in private investment with adverse consequences for aggregate demand (through the spending multiplier) and for longer term potential growth. But as the interest rate rises, investment follows. So there is a huge sensitivity among Indian corporates around interest rates, though it's unclear why this is the case. This is the dilemma facing Indian policymakers.

Figure 7: Investment and Real interest Rate



Policy Prescriptions

The overvaluation of the real exchange rate to the order of 30-35% has led to both external (widening current account deficit) and internal (excess spending & inflation) imbalances. The necessary adjustments therefore include depreciating the real exchange rate (in an orderly fashion) and reducing the fiscal deficit (without sinking the economy). Primarily, India needs to restore policy credibility on structural reform by taking measures to end crony capitalism. There is also an urgent need for the central bank to stop bailing out the government in times of distress. Inflation targeting is crucial and can be done easily, relative to other politically-dependent measures. This will stabilize confidence and improve capital flows. India is much more relevant in global financial markets today than it was in 1991; there is hence a greater sense of urgency to take these steps.