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Title: Turbulent Times for Indian Economy: a perspective

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ABSTRACT

The dramatic depreciation of the Indian Rupee raised alarm bells. It also made the Indian Government who was in denial mode, wake up and take note of the crisis India is in. The primary reason for India's current economic crisis is a deceleration of growth. All the economic growth indicators have reached decadal lows.

Was it all avoidable? There are ways of looking at India's present economic woes marked by a rapid fall in the value of the rupee caused by persistent inflation of the past few years and the high current account deficit (CAD) of about \$85 billion (4.5 per cent of GDP) which needs to be funded through uncertain capital inflows year after year. Although the Union government has undertaken some reforms, more needs to be done. What India really needs and desperately so is an environment where unnecessary regulation, corruption and red tape is done away with. The failure of public private partnership has been the key reason for India's infrastructure story not making any headway. But once the government shows some resolve to sort out bureaucratic hurdles in time bound and transparent manner, investments in both infrastructure and manufacturing will become forthcoming. And that would automatically kick start the chain of economic activity the country has been starved of over past two years.

Keywords: Indian economy, economic growth, economic policy, CAD, GDP

The Indian economy is in a dangerous position today and the situation can potentially spiral out of control. International rating agencies have also been critical of the government's functioning placing India almost at the bottom of all socio-economic indices. Inflation is too high. The twin deficits (Current account and fiscal) are at alarming levels and need to be brought down.

And yet, there seems to be light at the end of the tunnel. The Indian economic scenario may not be, after all, that dark and disappointing. In fact, according to the RBI chief, Raghuram Rajan, India is not facing any economic crisis. Although the economy has slowed, the country's forex reserves are large enough. He also said that there is no chance of India needing the help from IMF for the next five years. India's external debt to GDP is 22%. India has reserve of US \$280 bn which is 15% of GDP. This means, the country can pay three-fourth of its debt from its forex reserves. Currently short term external debt stands at 10% of GDP. So, the country has enough reserve to take care of that.

Is the balance of payments crisis facing the Indian economy today as bad as the crisis faced in 1990-91? India's current account deficit (CAD) worsened to 6.7 per cent of the GDP in the October-December quarter of 2012. This is well beyond the comfort level of 2 or 2.5 per cent of the GDP. The widening trade deficit is the primary cause of the deterioration in the CAD. What is worse, the relatively low level of invisibles surplus: net invisibles surplus declined from \$81.8 billion in April-December 2011 to \$78.3 billion in April-December 2012. Unless strong policy correctives are introduced now, the crisis of 2013-14 would turn out to be worse than the crisis of 1991-92.

We are seeing firsthand what happens when the macro-economy is sick and it would be a mistake to underestimate the severity of economic problems, as many policy makers are doing, confronting us today. It is conceded that the economy is in a much better state today than what it

was in 1990-91. We have adequate foreign exchange reserves, equivalent to some seven months' imports, in sharp contrast to only one month's reserves in 1990-91. There is no threat of international payments default, which appeared imminent in 1991. In contrast to 1991, today we have adequate food stock, mainly rice and wheat, with the Food grains Corporation of India (FCI). In fact, the net availability of food grains at 203 million tonnes in 2011 is at an all-time high.

Argument to be worse than 1991:

Despite these strong points, why is it that we argue that the crisis in 2013-14 may turnout out to be worse than the 1991 crisis? The most disturbing factor is that the Indian economy has now become extremely vulnerable to external factors. This was not so in 1991. Three factors may be highlighted in this context; first, in absolute terms, the current account deficit may translate into some \$100 to \$110 billion. What is of great concern is that the bulk of this deficit, of say, 75 per cent, is financed by essentially short-term money, namely portfolio investment, external commercial borrowing (ECB) and trade credit – all of which are unstable. Only 25 per cent is financed by Foreign Direct Investment (FDI) and other long-term flows. Second, the total external debt amounted to some \$375 billion at the end of December 2012, and the alarming feature is that about 40 per cent of external debt matures within a period of one year. At best, foreign exchange reserves provide a cover of less than 80 per cent of external debt.

CAD:

A current account deficit occurs when a country is importing more goods and services than it is exporting (if the reverse was true, it would be in a surplus). India's current account deficit has exploded 1125 per cent since 2007, going from \$8 billion to \$90 billion. In other words, India is importing \$90 billion more than it is exporting.

However, in 2007, India had \$300 billion in foreign exchange reserves. It could cover its current account deficit 37.5 times over. Currently, India's foreign exchange reserves have gone down to \$275 billion: it can only cover its current account deficit 3 times.

India's current account deficit has grown steadily throughout the past 5 years: it did not just balloon up overnight. Furthermore, two additional factors will be at play here. Firstly, the push in interest rates in the United States and overseas creates higher incentives for international investors to invest abroad versus India. Already, the impact is being felt. Since March of this year, foreign exchange reserves have already dropped by \$14 billion due to investors opting to invest in the US and other countries versus India.

Secondly, it is important to note that a current account deficit cannot be labeled as "bad" just because it is not a current account surplus. After all, most developed countries run high current account deficits. A high current account deficit can be required if a country is growing and requires imports to fuel growth. A way to measure the health of a current account deficit is to compare it to the country's GDP. Academic studies suggest that a current account deficit which is 2.5 per cent of a country's GDP is sustainable.

What makes India's situation dangerous is that it is currently at almost 5 per cent of its GDP.

Furthermore, economists polled around the world are expecting India's GDP to drop even further this fiscal year.

FII:

Foreign Institutional Investments (FIIs) in India, which had invested some Rs.91, 364 crore since November 2012, are slowly reversing the flows. This reversal was a result of India's deteriorating external economy and rising global risks, like the Euro zone crisis and the messing

up of rescue operations of Cyprus. Time alone will tell whether this reversal is a temporary phenomenon or part of an emerging trend.

What does this all mean? Ultimately, the faith the marketplace places on its economy is what gives it reassurance. Sentiments run the market. What are the current signs pointing to?

1. Rupee weakness

Further weakening of the rupee due to a lower supply of dollars and higher interest rates abroad.

2. GDP growth

Economists predicting a lower GDP for the current fiscal year, a disastrous sign since we just witnessed a GDP drop from 6.2% to 5% from the last fiscal year to the current fiscal year.

3. Current account deficit

A further rise in, India's current account deficit.

4. Foreign reserves

The government signaling that within months it might run out of foreign reserves.

5. Short-term debt

\$170 billion in short-term debt to pay, while in 2008 it was just \$80 billion.

6. FII investment

From May to August 2013, FII investments in India having gone down by \$2 billion.

7. Elections

Both the private and public sectors staying clear on investment strategies until this year's elections.

External Factors:

After 2010, excess global liquidity flowing from the West, the consequent high international oil and commodity prices fed seamlessly into India's domestic mismanagement of the supply of key resources such as land, coal, iron ore and critical food items to create a potent cocktail of high inflation and low growth, and a bulging CAD. The key difference between 1991 and 2013 is the availability of global financial flows. In 1991, western finance capital had not significantly penetrated India. Now, a substantial part of western capital is tied to India and other emerging economies where OECD companies have developed a long-term stake. The broader logic of the global capital movement is that it will seamlessly move to every nook and corner of the world where unexploited factors of production exist and there is scope to homogenize the modes of production and consumption in a global template. This relentless process may indeed gather steam after the United States shows further signs of recovery. Indeed, some experienced watchers of the global economic scene have said that a recovery in the U.S. will eventually be beneficial for the emerging economies. This basic logic will sink into the financial markets in due course. At present, the prospect of the U.S. Federal Reserve withdrawing some of the liquidity it had poured into the global marketplace is causing emerging market currencies to sharply depreciate.

There is a more important structural factor. India's gross domestic savings declined sharply from 36.8 per cent of GDP in 2007-08 to 30.8 per cent in 2011-12. Consequently, gross capital formation or investment declined from 38.1 per cent to 35 per cent. If India could survive the global economic crisis of 2008, it was largely because India's growth was sustained largely by domestic savings and depended much less on inflows of foreign capital. This strength has now been eroded. To restore the high saving and investment rates should therefore form an important

part of our future policy-mix. Compressing the size of the CAD to sustainable levels has therefore become imperative. This is as important as financing the CAD. Two policy recommendations in this context are: cut down drastically on imports of gold and coal. India imported a staggering quantity of 1,112 tonnes of gold at a cost of \$61 billion in 2012-13. India now consumes about one quarter of total global supplies of gold. This large import bill contributes about 30 per cent of our trade deficit. In a sense, this is a self-inflicted wound – gold imports should be restricted to a small amount, say of \$5 billion.

The irony is that now that the American and Japanese economies have fully recovered in past two quarters and Europe is showing signs of recovery, the Indian economy is going through a tailspin. In other words, while India did reasonably well when the US economy was reeling under the worst global recession since the Great Depression of 1935, India could not simply cope with the after-effects of the US recovery. As the American economy staged a complete recovery, the US Fed decided to stop pumping in dollars into its economy as the investors' confidence was restored and investors found the US a better destination and a better bargain than emerging economies like India, Brazil, Russia, Indonesia and Malaysia. Consequently the currencies of these emerging economies started a free fall against US dollar. In 1991, it was India which was in a crisis; not the world. Today, most of the world is in a crisis and the Indian economy is better off than many other emerging economies. And yet, the situation is far grimmer this time as this time the common man is feeling the pinch directly. In contrast, in 1991, India's crisis was largely a government crisis which did not affect the man on the street as much. Economic experts point toward a contrary phenomenon: that the fall of the rupee is good for the Indian economy.

The argument is that the rupee's fall will rein in the Current Account Deficit, denoting much larger imports as compared to exports. The rupee's depreciation will also inevitably provide a

big and quick boost to India's overseas remittances as Indians working overseas would send more dollars back home. Secondly, discretionary imports, like fine foods, personal care products and so on will be discouraged. Third and perhaps most important, gold imports would inevitably be squeezed now. Gold imports have been a huge drain on Indian foreign exchange reserves and the government has already taken steps to ensure that importers of gold are reined in with higher customs duties. The Indian government can ease the burden on the rupee and ensure the currency to bounce back by clearing developmental projects far more quickly so that more money gets pumped into the system. India also needs to release part of its 78-million-tonne food reserves into the markets as it will generate more money into the economy and rein in the spiraling food inflation.

Positive Aspects:

India is considered to be the most attractive investment destination in the world, according to a survey by global consultancy firm Ernst & Young (EY). The Indian economy is expected to grow at 3.4 per cent in the current fiscal, a slight increase from 3.3 per cent in FY 2012–13, as per projections from the Organisation for Economic Co-operation and Development (OECD). The growth is estimated to be even greater in FY 2014–15 (5.1 per cent) and FY 2015–16 (5.7 per cent).

India's exports have also been doing well, touching US\$ 303 billion in FY 2012–13, almost double of what it managed (US\$ 167 billion) four years ago. Experts express confidence that the figure will scale US\$ 325 billion by the end of the current fiscal. The US\$ 1.2 trillion investment planned in the infrastructure sector will go a long way in boosting export performance of Indian companies and the Indian growth story, according to the Commerce and Industry Ministry, Government of India. The HSBC Trade Confidence Index, the largest trade confidence survey in

the world, has positioned India at the top with 142 points. The increasing demand due to its population makes the country a good market for consumption goods, according to the report. India's industrial economy is gathering momentum on the back of improved output of eight core sector industries – coal, crude oil, refining, steel, cement, natural gas, fertilizers and electricity – which, at 8 per cent in September 2013, rose at its fastest pace in a year.

The Cabinet Committee on Investments (CCI) has approved the speedy execution of 36 infrastructure projects entailing investments of Rs 1,830 billion (US\$ 29.28 billion) to boost investor confidence.

Conclusion:

There are short and medium term actions which need to be taken. There is a need for fiscal correction in the form of reduction in tax exemptions and tax evasion, and keeping a check on expenditure. Along with cuts on wasteful expenditure, it is also important to bring about an increase in other important expenditures such as infrastructure and direct assistance for priority sector. This can pave the way for a reduction in mandatory bank lending to the priority sector. With fiscal correction, the government can gradually reduce the SLR and CRR and, hence, financial repression in banks. The banking sector can then grow faster and play a greater role in economic development. We need to explore if FII's can be exempt from short term capital gains tax. Foreign investments in the retail sector can be brought in through the creation of a Real Estate Investment Trust and most importantly we need to ensure that no part of the government announces any measures, which would be viewed as business unfriendly. Over the medium term – we need to address the issue of current account deficit by building a robust exports sector and a strong domestic manufacturing base. RBI can also provide inflation-indexed bonds more meaningfully than is the case at present. This can reduce demand for gold and help in other

ways. RBI can also set an example by not buying more gold, if not by selling its existing gold stock. This will give it greater moral authority to advise the public not to buy gold.

End

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