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Unstable Rupee, Floundering Economy

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Adverse sentiments by themselves are not the real source of the current problems being faced by the Indian economy, of which the weakening of the rupee is only one manifestation.

The slide in the value of the rupee over the last few months, dramatic though it has been, is actually hardly surprising. This was an eventuality that has been likely given the trends in India’s external balances over the last decade or so (Table 1). In 2003-04, as a period of subdued industrial growth was ending, India had a current account surplus which was 2.32% of her Gross Domestic Product, greater than it had ever been since at least 1950-51. By 2011-12, this had turned into a deficit of the magnitude of 4.25% of GDP, which too is a post-Independence record by a wide margin. In other words, there has been an adverse movement of over 6.5 percentage points over nine years. Moreover, this has not happened suddenly - it reflects a more or less steady trend through the period.

Item	**Trade balance**	**Invisibles, net**	**Current account**
2001-02	-2.41	3.13	0.72
2002-03	-2.11	3.36	1.25
2003-04	-2.30	4.62	2.32
2004-05	-4.68	4.31	-0.38
2005-06	-6.22	5.04	-1.18
2006-07	-6.52	5.49	-1.03
2007-08	-7.37	6.10	-1.27
2008-09	-9.81	7.52	-2.29
2009-10	-8.56	5.80	-2.76
2010-11	-7.56	4.98	-2.57
2011-12	-10.30	6.05	-4.25

Table 1: India's External Balances as Percentage of GDP at Market Prices, 2001-02 to 2011-12

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The initial shift from a current account surplus to a deficit situation accompanied the transition of the Indian economy's growth to a higher gear and the parallel dramatic rise in the investment rate. A sharp deterioration of the merchandise trade deficit to GDP ratio by over 5 percentage points between 2003-04 and 2007-08, as imports grew faster than even fast growing exports, was chiefly responsible. While oil imports did increase during this period, it was imports of manufactured products which were the main driver of the rapid increase in imports before the global crisis erupted. The impact on the current account of the trends in merchandise trade was, however, moderated somewhat by a simultaneous rise in India's invisibles surplus, to which growth of software services exports and private remittances were the principal contributors.

The trends in India's trade and current balances in the five years up to 2007-08 were contrary to the general picture amongst developing countries of improving balances and the associated phenomenon of capital flowing uphill - from developing to developed countries (UNCTAD 2008). Notwithstanding this, India too like many others rapidly accumulated foreign exchange reserves, which increased by more than three times. This was, however, on the basis of large capital inflows which also ensured that the rupee appreciated rather than depreciated during this period – the average exchange rate of the rupee vis-a-vis the US dollar was Rs. 40.24 in 2007-08 as compared to Rs. 48.40 in 2002-03. Capital inflows into India were dominated by volatile portfolio and portfolio-like investments, with a significant chunk of even what is classed as foreign direct investment (FDI) consisting of private equity and other kinds of financial investments (Chalapati Rao and Dhar 2011). The dependence on such flows to cover a consistently widening current account deficit meant that the strength of the rupee had a fragile basis and its sustainability was always in doubt. If this was the case even in the heady days of before the global economic crisis, things became worse thereafter.

After 2007-08, with a slippage in investment and recurrent phases of slow industrial growth the pressure on the trade balance from imports of manufactured products eased to an extent. Yet, the current account situation has remained under stress in every year because of one or the other of three factors – poor merchandise exports performance because of the global slowdown, a cutback in the invisibles surplus for the same reason, or rising oil and gold prices internationally. Capital inflows also slackened after the global crisis and were no longer sufficient to sustain accretion of foreign reserves in the manner that was happening earlier. In fact, till date India's foreign exchange reserves have not recovered from the hit they suffered in 2008-09. The stage was thus being set for the depreciation of the rupee. With the Indian growth now showing clear signs that it is losing steam even as the inflation rate remains stubbornly high and the unfolding crisis in Europe, there was nothing really left to sustain "sentiments" and delay the inevitable.

Origins of India's Crisis

Adverse sentiments by themselves are, however, not the real source of the current problems

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being faced by the Indian economy, of which the weakening of the rupee is only one manifestation. Powerful corporate and financial interests are of course pitching for the view that the real culprit is the so-called “policy paralysis” and carrying forward of the “reform” agenda is the answer to the difficulties being experienced. In policy circles too, the preoccupation seems to be with restoring positive perceptions about the Indian economy’s prospects by reiterating the government’s commitment to such reforms. However, no such simple fix is available and taking recourse to such options may only aggravate the situation. Just as the conditions underlying the instability of the rupee have been in the making for some time, the other problems confronting India’s macro economy also have a history. Neither of these are results of the economy going off some trajectory that it was earlier on. They are all instead the outcomes of that very trajectory.

One of the established features of India’s growth story over the last two decades has been the extraordinary contribution of services and construction to this growth, which has also been the source of its steadiness. While agriculture has on the whole done poorly, the industrial sector too has displayed great instability. Apart from the downturns in industrial growth of the recent past, a slowdown lasting six years occurred before 2003-04. Accompanying the ups and downs in industrial sector output was that of private corporate investment, a large chunk of which tends to be in the manufacturing sector. The period of extraordinarily rapid growth of corporate investment from 2003-04 to 2007-08 was preceded and succeeded by phases in which there was a collapse of such investment.

The volatility in investment and industrial growth reflect another well known feature of India’s corporate-led growth – the extremely narrow spread of its benefits (Mazumdar 2008). The absence of income increases amongst large sections of the population has prevented a broad-based expansion of demand for manufactured products. The continuous steep rise in food prices over the last six years or so, a product of the long neglect of the agricultural sector, far from reflecting growing demand has reinforced the income squeeze. Rapidly rising incomes at the upper end of the income ladder have, on the other hand, translated into diversification of demand such that an increasing proportion of consumption expenditure is on services. In such circumstances the dependence of manufacturing growth on demand generated by investment relative to consumption has increased. Since rapid growth of private corporate investment also tends to mean substantial investment in manufacturing, there exists an inbuilt tendency for capacity creation in manufacturing to outpace demand growth. Aggravating the market constraint for manufacturing has been India’s failure to emerge as a competitive location for production of a sufficiently large range of manufactured products. This tends to make Indian growth highly import-intensive in nature rather than export surplus driven, and the high trade deficit situation is a reflection of this structural feature.

Excessive dependence of industrial demand on corporate investment makes any investment boom in India prone to collapse. This is precisely what undid the spurt in corporate investment that occurred in the initial years of the 1990s. There was of course a dramatic

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revival of investment growth from 2003-04 onward which increased the dependence on investment expenditure to sustain demand. A collapse of this too was imminent even if the global crisis had not happened, since the imbalance between investment and output growth in manufacturing was a feature of this phase. Notwithstanding their coincidence, therefore, India's investment and growth slowdowns cannot be simply attributed to the adverse global economic scenario of the last four years. It has in fact been pointed out that the slowdown of growth and investment in India began even before the global crisis erupted in full force (Rakshit 2009, Ghosh and Chandrasekhar 2009). Indeed, the causal connections between the global and domestic economic contexts could actually be of a different kind. A 'favourable' international configuration that no longer exists may have contributed to triggering and sustaining the preceding boom despite the Indian economy's structural weaknesses.

Indian High-Growth and the Global Economy

Even if India's merchandise trade deficit eventually worsened on account of rapid growth of imports, Indian exports of both goods and services did increase substantially faster during the pre-crisis phase of high growth. The surge in exports also began before growth picked up. This was accompanied by significant changes in both the direction of Indian exports of goods as well as in its product composition. Indian exports benefited from the generally positive growth scenario of many developing and OPEC countries and the share of these countries in Indian exports increased quite sharply. This process was not driven by the items which traditionally dominated Indian exports, like textiles and gems and jewellery, but newer products. These new products – engineering goods (like iron and steel, metal manufactures, and transport equipment), chemical products, and petroleum products – involved greater requirements of capital per unit of output than the labour-intensive traditional exports. This and the export surge may have worked in conjunction to trigger the revival of corporate and manufacturing investment growth from 2003-04.

Since imports eventually outpaced exports even in the very same categories of products whose share in Indian exports was rising, if the trend in merchandise trade had been all that was there, the high growth would have been hard to sustain even for the period that it did. The parallel growth of India's services exports as well as the large inflow of remittances, also therefore played an important role. In particular by checking the expansion of the current account deficit, they were critical to maintaining the conditions necessary for the large capital inflows that occurred as part of a worldwide trend. The surge of portfolio capital inflows in turn resulted in a prolonged stock-market boom which gave an impetus to spending in the economy including the facilitation of corporate investment growth. Speculative sentiments also spilled over into the real estate sector and contributed to a construction boom – virtually the entire growth of the household sector's capital formation in this period was attributable to construction. This also expanded the demand for a range of manufacturing industries. High growth of corporate profits through its effect on corporate tax revenues enabled simultaneously both a faster growth of public expenditure

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than had been the case earlier as well as a shrinking of the fiscal deficit to GDP ratio. This reinforced the process of demand growth without making financial markets too nervous. All of these went into producing the conditions that resulted in rapid growth of output and investment till the breakout of the global crisis.

No Going Back: Policy Shift Needed

With the world economy in dire straits and India's investment boom having run its course, clearly the ingredients that made for the pre-crisis growth process in India are now absent and unlikely to reappear in the near future. No amount of talking up the economy and 'reforms' can alter this bald fact. That high growth because of it very nature in any case had contributed very little to ameliorating the employment and incomes crisis that afflicts the overwhelming majority of India's population. What the current problems of India's macro economy underscore is the following: employment generation and reduction of income-inequalities, apart from being laudable development objectives in themselves, are also necessary for imparting stability to the growth process. In the absence of a shift in the growth trajectory towards such a pattern, a slowing down of growth can only worsen the already existing incomes and employment crisis. The worrisome external sector situation also points towards the possibility that India's record of avoiding a foreign currency crisis could be brought to a swift end in the not too distant future. This would bring in its wake the severe additional economic pain that so many countries have experienced. Indian policymakers may be conscious of all these dangers. Their mindset, however, is resulting in actions that are making such outcomes more rather than less likely.

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