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OPINION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Foreign capital, Foreign Trade & BoP

The rupee is weaker by 15% since the start of this year. Crude prices are nearly double in the past 12 months and there is a strong possibility that they will touch $100 per barrel this quarter. This scenario represents a double whammy. Every extra rupee on the exchange rate translates into an additional import burden of nearly 12,000 crore on the current account (on an annualized basis). And every extra dollar per barrel is an additional outgo of 8,000 crore.

The escalation in oil and gas prices impacts both the current account and fiscal deficit. The current account deficit (CAD) this year may cross 3% of gross domestic product (GDP) and, in absolute terms, will be higher than the 5% recorded in 2013. It has also been made worse by surging imports of coal, iron ore, fertilizer, electronic goods and gold, as also the rising payment for foreign education. The fiscal deficit is also impacted by higher oil prices, because of implied higher subsidies for kerosene and cooking gas, as also because of politically necessary cutbacks in excise on petrol and diesel.

Additional worries are in financing the balance of payments, which will be negative $30-40 billion. This is the shortfall in capital inflows, which are not able to offset the CAD. The balance of payments is turning negative for the first time in six years. There is talk of floating a dollar bond for non-resident Indians, at handsome rates, with an added incentive of partial insurance against rupee depreciation. This will entail a fiscal cost. To encourage more capital inflows, the government relaxed conditions on dollar borrowing. It will add to India's total foreign debt, which is currently about $540 billion, of which $222 billion is due for repayment by March 2019.

Under normal circumstances, much of this short-term debt maturing in March, would have been rolled over by refinancing it. As global liquidity conditions are tightening, this rollover will neither be easy nor cheap. Further, as the rupee has depreciated rather sharply in recent months and the yield gap between US and India's sovereign bonds has narrowed, foreign investors in India's bonds may make a sudden U-turn. They have more than $70 billion invested in bonds, so even if one-fourth of it decides to leave, it can impact the exchange rate and the yield—interest rates—quite significantly.

To make them stay back, we need a stable to slightly appreciating currency and a significant yield gap with US treasuries. Both of these conditions require tradeoffs, which are not easy. Defending the rupee requires running down the stock of foreign exchange and is usually a losing game. Keeping the gap with US treasuries large, requires much higher policy rates here, which may not be warranted by inflation, as indeed was endorsed by the monetary policy committee of the Reserve Bank of India. But raising rates may become imperative not just to fend off inflation, which is benign now, but to combat risk to the overall financial stability, which is not the mandate of the rate setting committee.

Higher rates discourage outflow of debt funds, provide some breathing space to banks' net-interest margin as they are laden with non-performing assets and provide the right market signal of tightening liquidity conditions. As such, the credit markets are in danger of freezing, unless the IL&FS situation is strictly contained and swiftly resolved. Of course higher interest rates will hurt the biggest borrower in the system, which is the government of India. Every 25 basis points increase in borrowing rate, is an additional burden of about 20,000 crore on an annualized basis. Higher rates can hurt interest sensitive sectors, which are in recovery mode, such as construction, housing and commercial real estate.

The macro headwinds are because of external factors of crude prices and investors' punishing currencies of emerging market economies. This is aggravated by the ongoing trade war between the US and China. As the latter imports much less from the former, it cannot match tit-fot-tat tariff hikes on imports. Hence it may choose to retaliate against US tariffs on Chinese goods, by an across the board devaluation of its currency. But this will have a disastrous effect on Asian economies, and India too will be badly affected. Remember that the 1997 Asian crisis was the long shadow of China's steep devaluation of 1994.

Added to the external macro headwinds are internal challenges to the fiscal situation. The government has made considerable unbudgeted promises recently. This excludes populist spending impulses, which are bound to emerge as we get closer to elections. The hike in minimum support prices accompanied by full quantity assurance across all crops, the full coverage of large populations under health insurance, the sugar bailout or ethanol subsidy are some example of underfunded promises. Added to this are the loan waivers in many states. Thus the combined fiscal deficit of the centre and states could well be close to 7% of GDP this year.

The rupee, oil and the twin deficits represent tough challenges and an ever narrowing circle of feasible responses. Most of these responses, such as a hike in import duty of non-essential items, or encouraging short-term dollar debt, or cutting excise on petrol and diesel have significant trade-offs. It looks like a long winter is coming. We need to hunker down.

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