Opinions

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Ways for India to Escape from the Fragile 5

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Since the possibility of curtailing quantitative easing became a real issue May of last year, the so-called "Fragile 5" nations have come to be seen as the troublemakers in the global financial markets. As some emerging economies were added to the list in 2014, Fragile 5 became Fragile 8 and then Fragile 9. India is included in this Fragile 5, which has become a list of the countries that need immediate attention from the global financial market.

Fortunately, India's stabilization is relatively fast-paced since last September, but from June to August of last year, India topped the Fragile 5 nations in terms of volatility of financial market. FRB Chairperson Bernanke's announcement of curtailment of quantitative easing at the end of May sent the INR/USD exchange rate soaring. By the end of August, the exchange rate broke the record of INR 68, marking approximately 26% rise since the end of May 2013 alone. The stock prices tumbled and yields on government bonds (10-year maturity) also rose 2%p during the same period. The foreign investment in the Indian stock market during this period was outflowed approximately USD 13 billion.

After Raghuram Rajan took the helm of the Reserve Bank of India as the “special lifeguard,” the Indian financial market quickly found stability. The foreign exchange rates are sustained at the INR 61~62 level since the end of the 2013 Q3 and stock prices reclaimed the old high in the meantime; government bond yields also stabilized at 8% level. Even when the tapering of quantitative easing was gaining momentum at the end of January 2014, and when the financial markets in the emerging markets were fluctuating, India was an exception. It appears that even the Indian government considers the country is somewhat removed from the turbulence of the U.S.’s tapering of quantitative easing. However, this is no time to be complacent. In retrospect, the cause of the 2013 financial instability was rooted in complacency.

In the second half of 2008, when the unprecedented financial crisis touched off in the U.S. was spreading throughout the globe, India showed resilience by implementing exit strategies faster than any other country, along with Australia. It was thanks to its economic structure centered on domestic demand, and also keeping high-interest and fiscal austerity policy in order to curtail high growth and high inflation, until the eve of financial crisis. Accordingly, when the crisis broke out, India repo rate of 9% was reduced by half. By raising the budget deficit to GDP ratio from 2.5% to 6%, it was able to realize the so-called “V-shape” economic recovery. The growth rate bottomed out at 3.5% in the first quarter of 2009 and proceeded to rise to 9.3% in the third quarter and then rose to 11.4% in the first quarter of 2010. With economic recovery, the Indian government took a sudden turn toward high interest rate policy and stepped up its austerity policies, including abolishment of gasoline fuel subsidies, in order to reduce budget deficit. Up to this point, India has shown its impeccable capability in managing the macroeconomic policies.

But could it have been a hare that outran the tortoise? Since then, the Indian government’s management of the fundamentals became very loose. Even the curtailment of subsidies for diesel fuel took a turn for gradual tapering in a dramatic departure from the original plan. More than anything else, no sufficient attention was paid to the management of current account deficit. The ratio of current account deficit to GDP, which was 2.8% in 2010, shot all the way to 4.8% in 2012. Most of this was due to the sudden influx of crude oil and gold. Crude oil, which takes up 33% of total import, is understandable as India is only 25~30% self-sufficient. However, gold is a different story. The import volume of gold in 2013 was approximately USD 54 billion, a jump by almost twofold from 2010, accounting for 11% of the total imports, second only to crude oil. Only 20~30% of the imported gold are being processed for export with the remainder consumed in India. The Indian government, however, did nothing about it. Import customs tax on gold was increased only little by little, from 2% to 4%, then to 6% and to 8% in order. As hike in customs tax was expected, smart Indian consumers actually bought even more gold.

In late August of 2013, when the financial instability in India was at its height, the lower house of the Indian legislature passed the Food Security Act that could not help but necessitate additional budget spending. This was the wrongest policy that bartered in the economic fundamentals for the people’s votes. Owing to this, the foreign exchange rate at that time broke the record high at INR 68. In addition, when the current account deficit ratio almost doubled in the last two years and inflation also rose every year by approximately 10%, while the foreign exchange rate rose by only 17%, the Indian government should have pondered more seriously on its economic state. First, it should have detected that foreign exchange rate was not rising sufficiently even as foreign investment flowed in excessively from the stock markets as a result of the quantitative easing in the U.S. Then it should have responded more aggressively to improve its fundamentals. As a matter of fact, when India’s stock market was bullish in 2007, the average monthly foreign institutional investment balance was USD 1.7 billion. However, after the third quantitative easing in the U.S., the figure jumped to USD 3.8 billion. It can only be concluded that the watch on the fundamentals became lax, if momentarily, due to excessive foreign currency liquidity.

Fortunately, it appears that India has woken up from its slumber just in time. Along with deregulation for foreign investment in airline, retail distribution, defense, and finance industries, the Reserve Bank of India has already raised the repo rate three times, strengthening its management of inflation and foreign exchange rates. After the customs tax on gold has risen to 15% in just a step, the import of gold has, in effect, all but stopped. On top of that, as the abnormally low foreign exchange rate was normalized, the export has increased and import has declined, enabling the Indian government to forecast that the current account deficit will fall to as low as 2.5% by March 2014.

With the 2014 general elections and the inauguration of a new government on the horizon, it is anticipated that improving budget deficit will not be easy. However, the next government and politicians must overcome the temptations of populism. As much as it has benefitted from the U.S.'s quantitative easing, it would not be fair to complain about the tapering now. It would be better to just remind itself once again that there is no such thing as free lunch. India should take this crisis as an opportunity to strengthen its fundamentals, deregulate and improve the competitiveness of its manufacturing industry. Whether India will remain the top contender among the emerging economies or fall into the abyss of confusion and disappointment depends not so much on the U.S.'s quantitative easing as the choices it will be making. KIEP