

No Case for Complacency*

C.P. Chandrasekhar

Though restricted to a single day, the 1625-point collapse of the Sensex on 24 August 2015, which was the largest single-day decline in six years, appears to be a signal that all is not well with the Indian economy. More troubling is the steep depreciation of the rupee from Rs. 63.8 to Rs. 66.7 to the dollar over the fortnight ending August 25. The government has tried to brush these developments under the carpet claiming that the disease is global and the Indian economy is strong enough to resist contagion. All that is needed is to stick with reform, it argues.

What emerges, however, is that as a result of continuous and incremental liberalisation, including of transactions on the capital account, the Indian economy is extremely vulnerable to even minor shocks such as flagging growth in parts of the world economy or policy measures such as an interest rate hike that encourage the exit of investors from financial markets in developing countries. That makes the current global environment one that can be extremely damaging for India.

The world's investors are on the run, away from equity, to gold and bonds, especially US Treasury bills, indicating that the flight is to safety. The result has been a collapse in equity markets worldwide. Given the whimsical behaviour of investors, this may be seen as of little consequence. But the fears that have overcome investors this time seem more significant because of the factors prompting them. These include: evidence and implications of a major slowdown and crisis in China; the consequences of that for emerging markets, especially commodity producers and countries that have attracted large capital flows during the period that followed the financial crisis of 2008-09; and, the resulting spin-off effects on the US, and the negative feedback loop that would be triggered by the likely US response to its predicament.

The China trigger

The immediate provocation for a renewed round of investor panic was the sharp depreciation of the Chinese yuan over three days starting August 11, which brought its value down by a little more than three per cent relative to the US dollar. Even though the Chinese government had taken the yuan off its erstwhile implicit dollar peg in 2005, the government and the central bank had managed the currency such that: (i) it on average appreciated vis-à-vis the dollar, reflecting the country's large and persistent current account surplus (or excess of its export earning over its import spending); and (ii) it recorded only small or marginal changes at any given point in time. Over the medium term the currency did register significant appreciation. Thus, the Trade Weighted Exchange Rate of the yuan (or its rate relative to the currencies of its major trading partners weighted by their importance in its trade basket) has appreciated by as much as 50 per cent since 2005.

This made the sudden depreciation in August a surprise. China still records a surplus on its current account (\$76.6 billion in the second quarter of 2015), even if that has fallen in magnitude in recent times. This should normally keep the currency strong. China's problem, however, has been a recent surge in net capital outflows from the country. According to [Bloomberg](#), the net amount of assets leaving China totalled \$450 billion in the past four quarters, after adjusting for changes in the valuation of foreign exchange reserves. Clearly, investors are expecting returns from China to fall, prompting an exit. This has created a situation, argue some observers, wherein if the government does not intervene in the market to stabilise the yuan, depreciation is an inevitability. On the other hand, blinded by its reform-driven desire to internationalise the RMB (or yuan) and ensure its inclusion in the basket of currencies that are used to value the SDR, or the IMF's unit of account, the Chinese

government reportedly allowed market forces to operate in its foreign exchange market. The result, according to this view, was the sharp depreciation witnessed in August. This argument is strengthened by China's own declaration that what had happened with the yuan was a result of a shift to a more market-friendly regime.

There are others who have a different view on the matter. This is that China was consciously engineering a depreciation of the yuan either with proactive open market operations (in which it bought dollars in an already stringent market) or by holding back on intervention at a time when it was conscious that market forces would precipitate a depreciation. The fact that the central bank could (and did) intervene to stabilise the RMB after the initial sharp depreciation of the currency, suggests that the latter could have probably been the case.

The engineered depreciation of the yuan, it is held, indicates that, despite talk of rebalancing Chinese growth by reducing the extent of engagement with external markets through exports and by ensuring a shift from investment to domestic consumption as the driver of growth, the Chinese government has decided to address its growth problem by spurring exports and restricting imports through a devaluation of its currency. Currency devaluation increases the local currency prices of imports and reduces the dollar prices of exports. Resort to such an engineered depreciation is indicative of an aggressive thrust into global markets.

Such an assessment seems warranted since a number of indicators point to worsening economic conditions in today's China. First, while growth has slowed to 7 per cent from its erstwhile 9-10 per cent range in recent years, this cannot be explained as being merely the result of a "necessary correction" in an overheated economy. In fact, that deceleration seems to be part of a persisting trend with the Purchasing Manager's Index falling at the fastest pace and to its worst level in six years in August 2015. The Chinese economy, some argue, seems headed for a "hard landing" rather than just settling at a lower rate of growth. Second, the bust in China's housing and real estate markets has not ensured that property prices have bottomed out, with the index of housing prices for 70 cities [dropping](#) nearly 10 percent by May 2015 compared to the beginning of 2014. Third, when the property bubble busted, investors were encouraged to turn to the stock market. In the words of [Matt O'Brien](#) of The Washington Post penned in March: "China's housing bubble is starting to pop, so, right on cue, its stock bubble is starting to re-inflate." But the stock boom resulting from this asset migration on the part of speculative investors has also more recently collapsed.

Riding on bubbles

What these trends possibly point to is that while China's growth lost steam some time back, speculative bubbles first in the housing and real estate markets and then in the stock market shored up the growth process. Asset price inflation sustains an investment boom in areas like housing and commercial real estate, and encourages private spending because of the "wealth effect"—asset holders feel wealthier and are more willing to loosen their purse strings. The asset bubbles themselves were the result of a credit boom engineered by the Chinese government, beginning with its decision to launch a massive debt-financed stimulus package to address the effects of the global financial crisis on an export-intensive economy. Between 2007 and 2014, total absolute debt in nominal RMB terms in China went up four times, and the debt-GDP ratio nearly doubled. At around 282 per cent of GDP, this makes debt in China relatively much larger than in, say, the United States. Corporate debt increased to reach 125 per cent of GDP; provincial governments are also highly leveraged for infrastructure investment; and debt held by households has gone up nearly threefold to a high 65 per cent of GDP. As much as half of the debt was oriented directly or indirectly towards the real estate market and housing finance, fuelling property bubbles in major Chinese cities that began to burst around a year ago.

The bursting of those bubbles has led to asset price deflation, affecting both housing and real estate markets and the stock markets. This comes in the context of an overall slowdown in GDP growth driven by poor export performance in the past year, which is already having negative multiplier effects across the economy. The impact of the property market downturn on investment, which at around 50 per cent of national income was the principal driver of growth in the Chinese economy, is immediate. And asset price deflation through its “wealth effects” makes households feel poorer and encourages a reduction of consumption.

The resulting slowdown in growth initially encouraged the Chinese government to give up on its rebalancing policy and seek to shore up investment, even if speculative. It has been cutting interest rates, reducing down payment requirements for loans to not just first, but also second home buyers, and has withdrawn its restrictions on securitising home loans by banks. But this has not stalled the downturn in the property market.

Similarly, when the Shanghai Composite Index collapsed after June 2015, in the aftermath of an eight-month long speculative boom, the government stepped in to shore up the markets with unorthodox manoeuvres. It infused cheap liquidity into the system by lowering the reserve requirement for banks and cutting an already trimmed interest rate. It suspended trading in 800 odd shares. It directed controlling shareholders, senior executives of companies and State controlled brokers not to sell their holdings. It announced that state-controlled China Securities Finance would be provided liquidity by the central bank to finance (through brokerages) purchases of stocks. That stalled the market’s decline, but persuaded none that this was sustainable. The decline continued despite more efforts by the Chinese central bank to reduce interest rates and augment liquidity to reverse the decline.

Global implications

It was in this background that, in a desperate move to revive growth, the Chinese government seems to have decided to engineer currency depreciation. For the rest of the world the depreciation of the yuan comes at the worst time possible. Not only is Japan still trapped in recession, but the crisis in Europe clearly extends well beyond Greece that grabs the headlines. The recovery in the US, if present at all, is halting. US GDP figures for the first two quarters of 2015 pointed to growth rates of 0.6 per cent and 2.3 per cent, as compared to positive growth rates of 2.4, 5.0 and 4.6 per cent in the three preceding quarters. US growth is, therefore, likely to remain in the 2 to 2.5 per cent range, making it difficult for the Fed to deliver on its decision to get out of the excessively long phase when interest rates have been near zero. And of course there is no possibility whatsoever of reducing rates to spur the recovery.

Finally, emerging markets other than China have been performing extremely poorly with a few exceptions. Part of the reason is that the capital surge to these countries resulting from liquidity infusion in the developed countries in response to the Great recession is unwinding. According to an estimate by investment bank NN Investment Partners [reported by the Financial Times](#) (19 August 2015), net capital outflows from the 19 largest emerging markets amounted to close to a trillion (940.2 billion) in the 13 months to the end of July. That was double the \$480 billion that flowed out these countries during the worst three quarters of the 2008/09 crisis. It is also about a half of the net \$2 trillion capital inflow into these 19 markets in the six years following the crisis from July 2009 to end June 2014. A combination of poor performance of these economies and fears of a rate rise in the US is responsible for this exodus of capital.

The exodus has reduced liquidity in financial markets and adversely affected debt-financed demand growth in these economies. It has also weakened currencies in these markets substantially, increasing the pressure to reduce the current account deficit and manage potential inflation. Russia, Turkey, Malaysia and Taiwan, for example, have seen their currencies hit by worsening market sentiment. That too affects growth prospects adversely.

Further, currency depreciation is likely to damage the balance sheets of corporations in emerging markets that sought to exploit the low interest rates in the US and elsewhere to borrow in dollars to finance domestic spending. The domestic currency costs of their debt burden will affect profits and investment adversely and even precipitate bankruptcies. And these problems have been compounded by the collapse in commodity prices, led by oil and copper, and driven by poor growth in China and elsewhere in the world.

It is at this inopportune moment that China has chosen to resort to currency depreciation. This would force further depreciation in other countries, in order to neutralise the impact of the Chinese move on imports into their economies and on the competitiveness of their exports. The result would be further disruption in financial markets and even slower growth in the aggregate. The depressing effect this would have on global demand would impact the weak US recovery, especially given the fact that the dollar is now gaining strength against all currencies, besides the yuan.

The implication is clear. The Chinese decision to use depreciation as an instrument to address its own crisis can trigger a chain of events that converts the creeping recession the world has been trapped for six years after the 2008-09 calamity, into another deep and full-fledged crisis, recovery from which would be even more difficult. We could be at a turning point that many recognise, but few want to talk about.

Given that context India, with its substantially open economic borders, cannot be immune from contagion. Over the first 25 days of August foreign institutional investors had engaged in transactions that amount to net sales of Rs. 9385 crore in equity markets and Rs. 187 crore in debt markets. Moreover, investor expectations that a depreciation of the rupee is inevitable, accelerates capital exit.

The direct impact of the depreciation of the rupee would be on corporates that have in recent years accumulated debt denominated in dollars, encouraged by the low interest rates abroad. External commercial borrowing by the private sector has risen rapidly in India. Depreciation would mean that the rupee cost of servicing this debt (much of which is not hedged against currency risk) would now be much higher, damaging corporate profit and loss accounts and balance sheets. Corporates planning to make investments involving imported capital goods would also be affected because of the sudden and sharp increase in the rupee values of such imports.

In addition capital and currency market developments can depress domestic demand in multiple ways. Market volatility and rupee depreciation is likely to affect investor sentiment adversely and slow growth significantly. Growth would also fall because of the adverse impact that the capital exodus would have on the state of liquidity and the availability of credit, and therefore credit financed expenditures and demand. With the government committed to fiscal consolidation the burden of reviving demand would fall on monetary policy. But the RBI would find it difficult to reduce interest rates to spur growth, assuming that would work. Lowering interest rates could accelerate capital outflows and drive down the already falling rupee. That prospect may restrain the central bank.

So, the government's optimism notwithstanding, lower growth seems to be the least daunting prospect for the Indian economy. Financial turmoil and a steep recession cannot be ruled out. The difficulty is that a return to recovery mode at a global level seems unlikely in the near future. So capital exit from the so-called "emerging markets" like India is likely to continue. That could intensify competition among countries to get a larger share of a slowly growing, stagnant or shrinking world market, triggering a race to the bottom. In which case, the consequence may be much more disruption than even what the pessimists expect.

* This article was originally published in the Frontline, Print edition: September 18, 2015.