In charts: As the rupee touches 80 against the dollar, what does this mean for India’s economy?

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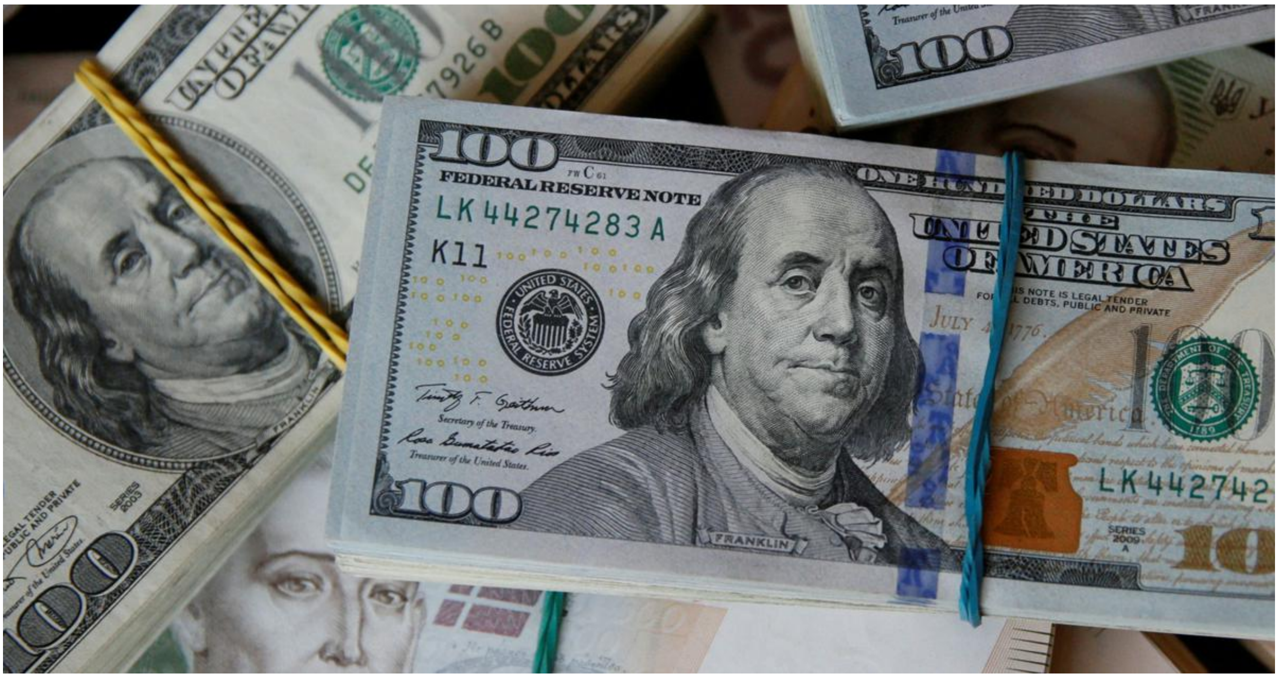

Representative image. | Reuters

The Indian rupee touched a historical low, trading almost at Rs 80 against the US dollar on Wednesday. A knee-jerk, macro-analytical response studying India’s currency performance would mistakenly see this trend in isolation, while projecting a weakening of macro-economic fundamentals to be leading towards a depreciation.

Figure 1.1: Indian Rupee's Performance vs the US dollar. Credit: India-Trading Economics

Looking closely at the numbers it does seem to be the case but India's macro-economic woes are being accentuated by external factors. For example, a tightening of the US Federal Reserve's short-term interest rates – due to high inflationary expectations – has occurred at a time when the dollar is strengthening in its relative value, influencing weaker currencies, like the Indian rupee.

Figure 1.2: US dollar's performance over the past five years. Credit: India-Trading Economics.

A weakened rupee means Indian goods should be cheaper to buy in the international market. This is more so in case of an economy that has strived for its manufacturing sector to be competitive, regionally or globally, as the Narendra Modi-led government has done so through economic policies over the past eight years.

In figure 2, Indian exports can be seen to be trending upwards from 2020, but so are Indian imports, which means that one pays more rupees or international currency – from the dollar to the yuan to the euro – for everything that India imports.

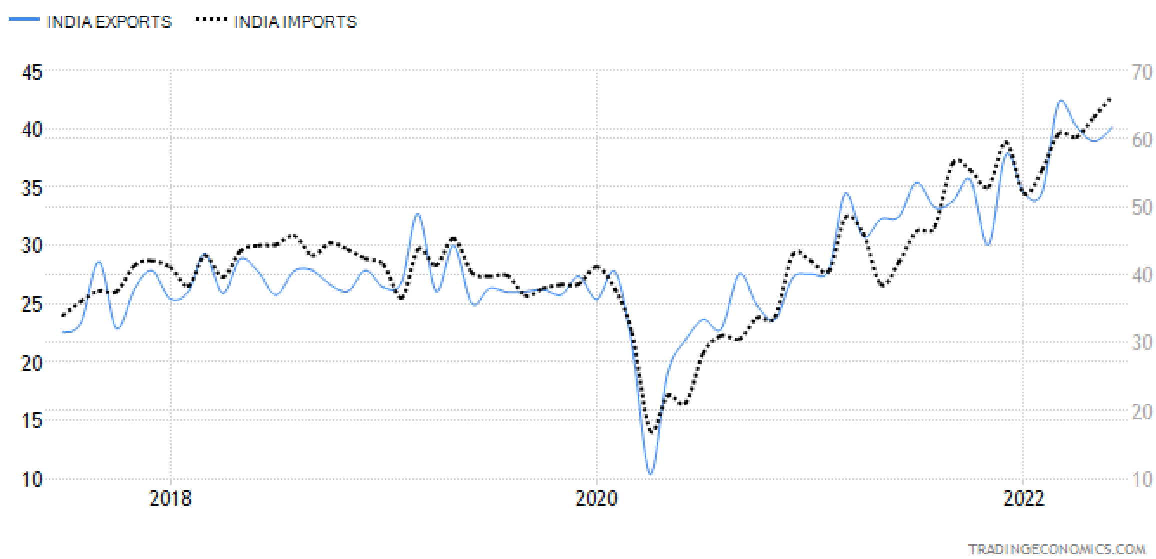

Figure 2: Foreign Exchange Reserves in US dollars. Credit: India-Trading Economics.

Costlier imports and the widening of the current account deficit is likely to eat into India's foreign currency exchange reserves. That is also happening. See Figure 3 below.

Figure 3: Foreign Exchange Reserves in US dollars. Credit: India-Trading Economics.

Worse, foreign currency reserves are depleting not only because of the widening current account deficit but largely due to a capital account imbalance: foreign institutional investors have been pulling their money out, mostly in the form of portfolio investment, from the Indian market leading to a capital flight.

One reason for this could also be because in a situation as a result of higher Federal Reserve interest rate monetary policy in the US, the US dollar and American market may appear as a more lucrative market to invest short-term capital in.

This has not been a recent trend though.

> 🇮🇳 #IndianRupee strengthens against the British Pound, Japanese Yen, and the Euro.
>
> 🔸 British Pound, Japanese Yen, and the Euro have weakened more than the Indian Rupee, against the US Dollar.
>
> Source: Ministry of Finance @FinMinIndia pic.twitter.com/YD5IwddtH0
>
> — Ministry of Information and Broadcasting (@MIB_India) July 20, 2022

In Indian markets, foreign institutional investors have sold shares worth Rs 2,14,217 crore from the beginning of financial year 2021-'22 till mid-June, data from National Securities Depository Limited showed.

The magnitude of sell-off by foreign investors has been huge. They have sold 78% of the equity holdings of what they had invested in the financial year 2020-'21, according to an analysis of the National Securities Depository Limited. This reflects weak private investor confidence in the Indian market.

Foreign Portfolio Investors continued to pull out money from the Indian market in the current fiscal, according to data released by the National Securities Depository Limited as per the records of the Centre for Monitoring Indian Economy. Between April 1-June 13, foreign portfolio investors sold Indian equity and debt instruments worth $10.5 billion.

All of this is also happening at a time when the economy's inflation has been high – on the retail and wholesale end – and growth is weak.

External debt

India has persistently faced a high ratio of public debt to the gross domestic product, or GDP, during the past decades, far higher than the long-term debt-GDP ratio – below 60% – of different Finance Commissions. This rising trend has generally been accompanied by an expansion in the size of governments.

The persistence of high debt to GDP ratio, according to economist Ranjan Kumar Mohanty and researcher Sidheshwar Panda in a 2019 paper, implies that public debt, especially domestic debt, has become an important means of the government to mobilise financial resources to meet its growing expenditure needs.

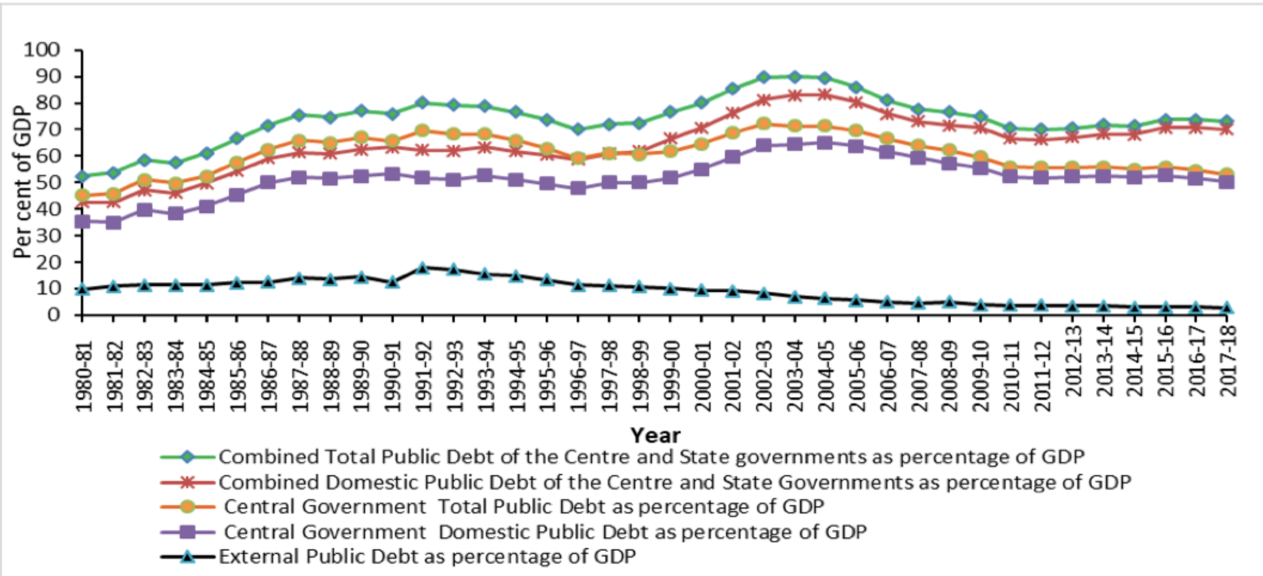

Figure 4: India's public debt (% of GDP) 1980-2018. Credit: Mohanty and Panda.

But, in India, domestic debt makes up nearly 95% of the aggregate public debt, while external debt constitutes a small share – 5%. In Sri Lanka, this situation was reversed and it was external debt that triggered the economic crisis.

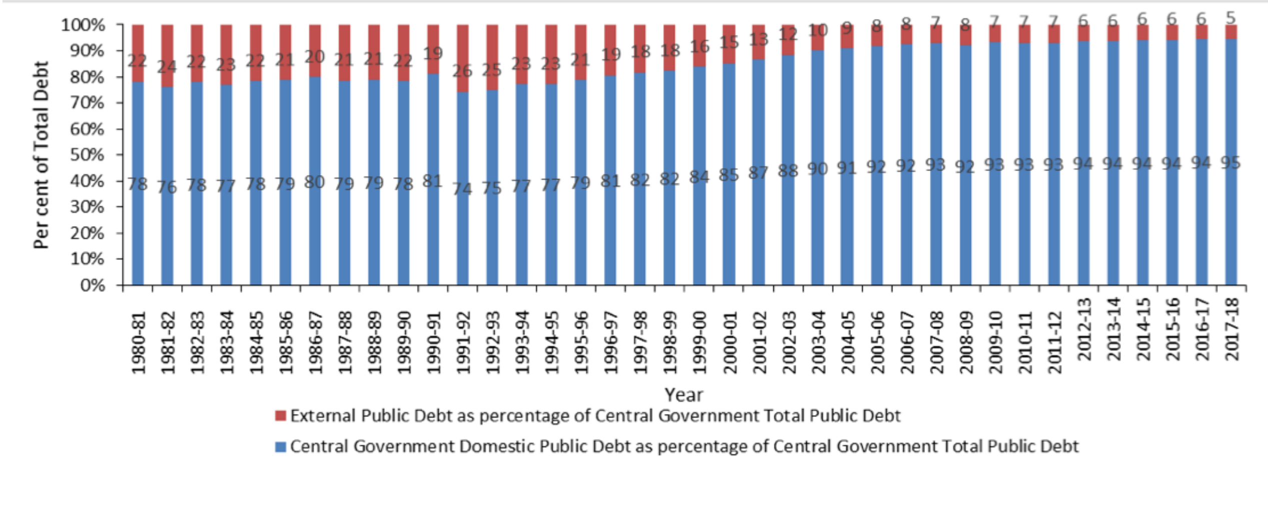

Figure 5: Domestic debt vs external debt comparison (% of Total Debt). Credit: Mohanty and Panda.

India's case resembles that of China's, with high internal debt, than Sri Lanka's external debt explosion. However, it must be noted that China has more foreign currency reserves than India – see Figure 6 and here – so comparisons need to be put in perspective.

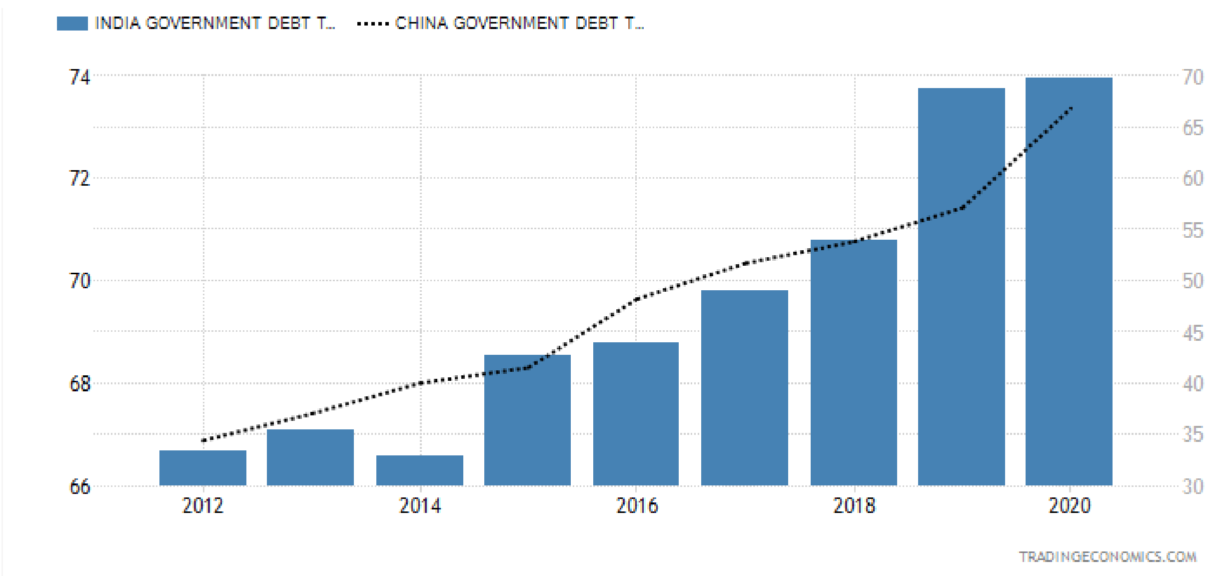

Figure 6.1: India-China Comparison (Foreign Exchange Reserves and Debt to GDP Ratio). Credit: Trading Economics.

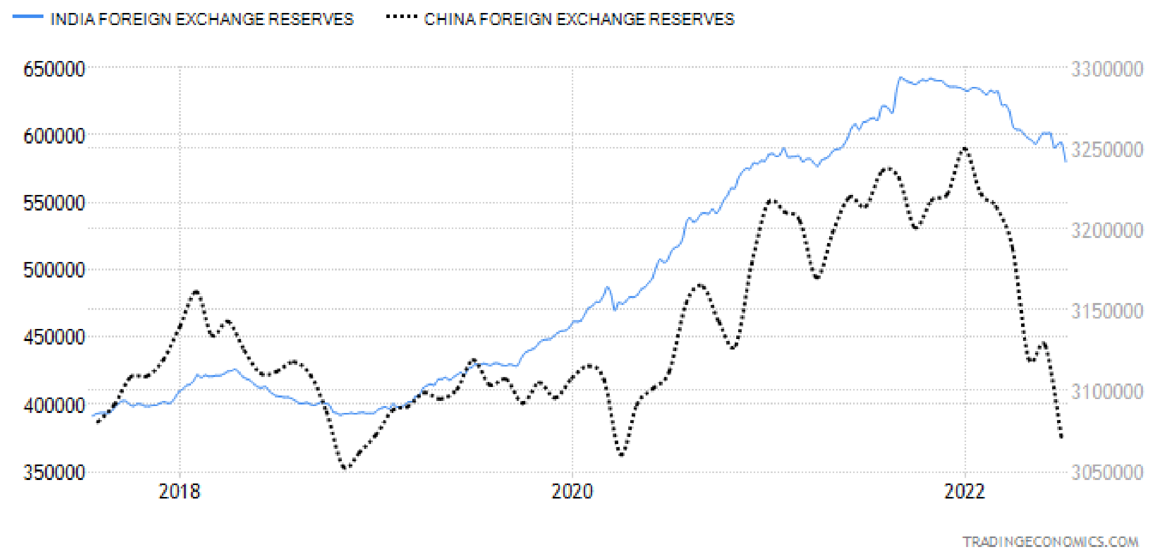

Figure 6.2: India-China Comparison (Foreign Exchange Reserves and Debt to GDP Ratio). Credit: Trading Economics.

Nevertheless, the persistent accumulation of public debt, even by domestic means as seen in India's case, may still result in higher policy uncertainties – reduction of essential revenue expenditure – and affect economic growth adversely. It may also affect various macro variables such as the interest rate, inflation, investment and others.

Another important channel through which the accumulation of public debt can affect economic growth is that of long-term interest rates. Higher long-term interest rates, resulting from more debt-financed government budget deficits, can crowd out private investment, thus dampening potential output growth.

Still, an increasing burden of public debt also depends on how the borrowed funds are used when mobilised through different sources. If public debt funds are wasted on relatively unproductive activities, such as financing current expenditure or paying interest on borrowed money, it becomes deadweight due to its adverse effects on capital accumulation as well as productivity.

This is where things got difficult for Sri Lanka and the country ended up borrowing excessively to finance its domestic expenditure. Sri Lanka could not generate enough domestic growth over time – and/or domestic tax revenue – to pay off what it owed in foreign currency denominations given its high import bill.

A large public debt and weakening of macro-economic fundamentals might also create debt overhang. This is a situation in which investment is reduced or postponed since the private sector anticipates that the returns from their investment will serve to pay back creditors, as argued by economist Paul Krugman in 1988.

In times of a recession, or a low GDP growth-credit growth-domestic private investment cycle, accompanied by a poorer balance of payment position – as observed in India now – a furthering of the denominator's weakness may not ensure a more balanced outlook for its rising public debt accumulation levels.

It is therefore a sticky wicket to be on for too long and India's macroeconomic policy response may warrant an immediate response with a medium-to-long term action plan. This would help in also calming down anxious investors, domestic and foreign, who seem to be worried about the rupee's slide to a level never seen before.

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- Dollar
- Rupee
- Economy
- Deficit