Vulnerability due to Depreciation

What is the issue?

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- The current rupee depreciation is likely to contribute to the vulnerability of the economy.
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- A look at the causes (policy shortfalls) and the consequences of it becomes essential.
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What are the recent developments?

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- Foreign investors are exiting from India's financial markets.
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- This is triggered by the end of quantitative easing in the US and Europe.
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- It is particularly by the hikes in policy interest rates in the US, making investments attractive.
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- This has resulted in a sharp depreciation of the rupee relative to the dollar.
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What led to this?

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- **Crisis** - The US and Europe infused liquidity after the 2008 financial crisis.
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- Credit at near zero interest rates was available to banks and financial agents.
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- This was to lend or invest at low rates to record profits.
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- Thereby it facilitated resolving their balance sheet hit by the crisis.
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- It flooded markets with large volumes of cheap money in the process.
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- **Carry trade** - Under this, banks, financial institutions and investors borrowed cheap in the dollar market.
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- But they invested in assets denominated in other currencies for higher returns.
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- The rush of funds shored up these currencies and even resulted in appreciation.
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- India was a country that benefited from flows of this kind.
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- India's corporate sector utilised the cheap credit from foreign financial firms.
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- **Impact** - This has resulted in a high proportion of outstanding foreign bank claims.
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- India is now paying the price for this legacy of debt.
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- Clearly, depreciation raises the rupee costs of imports.
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- It also increases the rupee equivalent of payments made to service foreign debt.
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How has the bond market been?

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- The channels through which credit has been flowing into the country has changed.
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- Clearly, the share of bank loans and deposits has come down from 2013 to

2017.
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- While, the share of debt securities has increased in the same period.
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- The **corporate bond market** which was inactive for long had turned active in recent years.
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- Financial institutions in the carry trade, experimented with corporate bonds.
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- This suited Indian corporates as bond issues are likely to have less intensive scrutiny.
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- However, exit is much easier for bond investors.
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- They can choose to book profits or cut losses and leave.
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- But this results in stress on the balance of payments and the rupee.
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What are the policy shortfalls?

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- The current vulnerability could have been prevented by policy decisions.
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- The corporates should have not been encouraged to exploit that supply-side push.
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- But, the ceilings on external commercial borrowing have been relaxed hugely over the liberalisation years.
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- Foreign investors have been given easy access to the country's debt markets.
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How do these make India vulnerable?

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- The debt exposure allowed by the above has now created two kinds of vulnerabilities.
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- Firstly, it can lead to **rupee depreciation** when investors choose to exit.

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- This intensifies any depreciation resulting from other factors.
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- Secondly, depreciation increases the rupee costs of **servicing foreign debt.**
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- It can lead to losses and push firms to default on both domestic and foreign debt.
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- Vulnerability that legacy debt creates arises from the volume of exposure.
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- But besides, it also arises from its likely concentration in a few firms.
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- **How** - Firm reputation influences access to foreign credit markets and institutions.
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- It is thus likely that foreign debt would be concentrated in a small number of firms.
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- This factor carries the enhanced debt-servicing burden for these few companies due to rupee depreciation.
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Source: BusinessLine

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