

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.
- This is triggered by the end of quantitative easing in the US and Europe.
- It is particularly by the hikes in policy interest rates in the US, making investments attractive.
- \bullet This has resulted in a sharp depreciation of the rupee relative to the dollar. $\mbox{\ensuremath{^{\text{h}}}}$

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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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 \bullet Credit at near zero interest rates was available to banks and financial agents. $\ensuremath{^{\backslash n}}$

- This was to lend or invest at low rates to record profits.
- It flooded markets with large volumes of cheap money in the process.
- Carry trade Under this, banks, financial institutions and investors borrowed cheap in the dollar market.
- 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.
- \bullet India's corporate sector utilised the cheap credit from foreign financial firms.
- 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 <u>rupee costs of imports</u>.

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• It also <u>increases the rupee equivalent of payments made to service foreign debt.</u>

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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.

• The **corporate bond market** which was inactive for long had turned active in recent years.

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- \bullet Financial institutions in the carry trade, experimented with corporate bonds.
- 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.
- They can choose to book profits or cut losses and leave.
- \bullet But this results in stress on the balance of payments and the rupee. \n

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What are the policy shortfalls?

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- The current vulnerability could have been prevented by policy decisions.
- 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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 \bullet Foreign investors have been given easy access to the country's debt markets. $\ensuremath{^{\text{h}}}$

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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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 \bullet Firstly, it can lead to ${\bf rupee}$ ${\bf depreciation}$ when investors choose to exit.

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- This intensifies any depreciation resulting from other factors.
- 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.
- But besides, it also arises from its likely concentration in a few firms. $\$
- **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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 \bullet This factor carries the enhanced debt-servicing burden for these few companies due to rupee depreciation. $\ensuremath{\backslash} n$

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Source: BusinessLine

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