Without big reforms, a vicious cycle awaits India

Given how India's dismal growth performance—at 4.4%, Q1FY14 GDP is the lowest in 16 quarters—just doesn't seem to be bottoming out with manufacturing PMI contracting to 48.5 in August and July services PMI at 47.9, India is in real danger of getting caught in a vicious downward spiral. It is not immediately clear how much RBI's actions in the last month contributed to this worsening, but it certainly didn't help—while bond yields hardened from 7.56% on July 15 to 9.24 on August 19 when incoming Governor Raghuram Rajan joined as an officer on special duty and signalled a partial withdrawal of measures, the rupee collapsed from 59.9 to the dollar to 63.13. Even after that, while 10-year GSec yields have stabilised a bit at 8.61%, the rupee fell to 67.6 on Tuesday. In which case, one of the first things Rajan needs to do is to extricate RBI from the mess it has got itself in. Most argue RBI has no option but to raise interest rates in the face of rising yields in the US but it is worth keeping in mind a 1 percentage point hike in US yields over a period of a few months is not what is going to materially affect India or the rupee. What is going to get India into a deep crisis, or keep it away from it, is what happens to FII investments in equity—these are currently valued at $138bn versus $28bn in debt. Equally important is the rolling over of $172bn of short-term debt in the next six months.

If things go to plan, all of this will get rolled over at reasonable spreads, and FII money will stay invested as the plunging rupee means their losses will multiply manifold on exit—between June and now, that is why FIIs have withdrawn just $3.5bn from equity. This is where the potential vicious cycle comes in—BoFAML economists point to India's financial vulnerability being as bad as in 1991, while the consequences like rising NPAs are still not near bottoming out. If industrial growth continues to fall, earnings downgrades will increase and will be accentuated by the rupee's collapse—each 1% depreciation in the rupee lowers Tata Steel's earnings by 2% and Bharti Airtel's by 0.9% for instance. If this happens, at some point, FIIs will want to cut their losses and rollover spreads for overseas debt will only worsen corporate distress.

Which is why, more than what Rajan does in terms of more open market operations to lower yields, what India needs is a big dose of reforms. Given the rupee's collapse, fortunately, this means a large part of reforms in terms of right-pricing the currency have already taken place and imports/exports are adjusting to this. Going to IMF would add to liquidity and, more important, ensure tough reforms like those on oil pricing get done; it also keeps at bay populism like the food and land Bills. Sadly Mr Rajan has categorically ruled that out. Something he may regret over the next few months.