THE FINANCIAL EXPRESS
READ TO LEAD

Price rise exposes problems in the financial sector resulting in exodus of investors from India

Can there be a reason to feel happy about finiteness of resources? This finiteness often brings sanity in the economic system. Scarcity of crude oil is one such example.

Can there be a reason to feel happy about finiteness of resources? This finiteness often brings sanity in the economic system. Scarcity of crude oil is one such example. It often exerts such pressure on the economic system that the prevalent irregularities start popping out of the economic system. For instance, the world GDP saw galloping growth of 4.3% and 4.23% in 2006 and 2007, respectively. Rapid income growth fuelled energy demand and the scarce crude oil got priced to a high of $147 per barrel in July 2008. By September 2008, Lehman Brothers collapsed, and the prevalent irregularities of the financial world came to the fore.

Ten years later, in India, oil prices seem to be staining the shining Modinomics. The beginning of the financial year 2018-19 saw crude oil priced at $52.49 per barrel. In just six months, it gained more than $30 and started exerting pressure on the hitherto comfortable current account, taking the deficit to 2.4% against 1.9% of last year's.

People saw the worsening of current account deficit (CAD) triggering a slide in the value of the rupee. The impact of the falling rupee accentuated withdrawal of FII funds from the debt and equity markets. There were reports in the media that foreign investors withdrew $3.69 billion and $7.65 billion from the equity and debt markets, respectively. It can be seen that the withdrawal is much higher from the debt market. This is largely attributed to the declining interest rate differential between the US and India. The differential between 10-year bonds of the US and India has declined from 6% in May 2014 to about 5.13% in August 2018. It has further declined to 4.88% in October 2018.

Going by interest rate parity, it is natural for capital flows to move out of India and into the US. If it were so simple, then why didn't RBI increase the interest rate in the recent monetary policy and stop the rupee from falling? RBI did increase the rate in the previous two monetary policy announcements. But that could also not stem the declining value of the rupee.

So, can we blame the expected crude oil price rise, due to the sanctions on Iranian oil, for the declining rupee? It does not look like that. Saudi Arabia has announced that the expected shortfall, arising from the absence of Iranian oil, has already been met through its increased production. Russia has also increased production. Kuwait and Saudi Arabia have decided to produce more from the oilfields which are common between the two producers. India and China have decided to continue buying more oil from Iran despite the sanctions. Hence, the rising price of crude oil due to the absence of Iranian oil could be seen as a temporary effect. But the temporary price rise has been instrumental in exposing other problems of the financial sector, resulting into exodus of investors from India.

The inflationary pressure on the economy started building with the rise in crude oil prices, which can be seen in increases in repo rates by RBI in its monetary policy statements of June and August. The new bond purchasers must be hence expecting higher interest rates. Earlier, in March, IL&FS Transportation Networks had to postpone raising $350 million through bonds as they found investors asking for more due to the rising yields in the US. As inflationary pressures build, it became increasingly difficult to arrange for funds and, eventually, it defaulted on payments in June. Ravi Parthasarathy, the chairman for the last 30 years, resigned on health grounds. Skeletons started tumbling down from IL&FS cupboard.

Incidentally, it is not just IL&FS which saw leadership resigning. We have seen several changes in leadership of prominent banks in India this year, and all of these have been associated with some or the other kind of irregularities—Chanda Kochhar of ICICI Bank, Rana Kapoor of YES Bank, Shikha Sharma of Axis Bank, Usha Ananthasubramanian of Allahabad Bank and Sriram Kalyanaraman of National Housing Bank. Five prominent banks losing their chairpersons within an year is bound to create an insecurity among foreign investors. As investors flee in insecurity, the economy bleeds and the currency falls. Crude oil price simply tests the stress in the economy.

VP Singh (Professor of Economics, and Director, PGDM, Great Lakes Institute of Management, Gurgaon)

The article can read online, here.