The Economist

The rupee's tumble continues to grip India. On August 29th Duvvuri Subbarao, the departing boss of the central bank, told an audience in Mumbai of the widespread "dismay about the ferocity of the depreciation". Today, on August 30th, I spoke to the boss of a big hotel in the city who says he is preparing to dollarise his business. The rupee is too flaky to operate in, he said. "It's just like Russia and Indonesia in the 1990s." Shortly after this, Manmohan Singh, the prime minister, addressed parliament on the matter. While part of the currency slump is a "natural" correction to reflect high inflation, he said, "foreign exchange markets have a notorious history of overshooting. Unfortunately this is what is happening".

That statement looks correct on a three-day time horizon. The rupee almost breached 69 per dollar earlier this week. On August 30th it bounced back to 65.7, making it the best-performing big currency worldwide that day, though still leaving it down 16% year-to-date. The vote by Britain's parliament against military action in Syria has helped push down oil prices. That is helpful for India, a big energy importer. And some of the Reserve Bank of India's tweaks have calmed nerves. On August 28th the central bank said it would provide dollars directly to India's big oil-importing firms. That will stop them having to sell rupees in the spot market. It is an indirect way for the RBI to use its reserves to support the exchange rate.

Whether India's currency has stabilised is another matter. There is plenty to worry about. The prospect of the Federal Reserve ending its purchases of bonds draws ever closer, especially with good news from the American economy this week. That means the "Great Exit" of money from emerging markets may continue. Both Indonesia and Brazil raised interest rates this week to protect their currencies, making India relatively less attractive. A foreign investor in town told me at he would not invest in India until it raised its rates. He had arrived in India expecting to allocate more funds to it now prices have fallen, but after several days he felt more pessimistic and reckoned that the slump had further to go.

As if to confirm that view, GDP figures were released on August 30th for the quarter to June. Growth slowed to 4.4%, from 4.8% in the preceding quarter. Manufacturing contracted. These figures do not yet reflect the credit crunch that has taken place over the last two months, so it seems likely that GDP growth will slow even further. A good monsoon may boost farming, but the formal, industrial bit of the economy is in dire condition. On August 27th Palaniappan Chidambaram, the finance minister, said that the government had fast-tracked $27 billion of power and other projects stuck in red tape. But I have yet to find a full account of these proposals. In the past such announcements have contained far more hype than substance, as we explained in an article in June.

That credit crunch is still pronounced, even if the rupee has recovered a little. Most measures of stress in the financial system are still flashing red, reflecting Indian banks' bad debt problem. Credit default swaps on State Bank of India, which measure its risk, have soared. Short-term market interest rates have not come down. The government has yet to show much desire to clean up banks' dud loans and is instead putting more pressure on them to "extend and pretend".

Even as mayhem stalks the currency market, the election campaign is ramping up. India's legislators may be lousy at making decisions about economic reform, but they are remarkably decisive at passing more populist measures. Early this week a new programme to increase food subsidies was agreed. Moody's, a credit rating agency, warned that this will put more pressure on the public finances. Then the lower house of parliament approved a new law on land reform. It replaces a decrepit act that is over a century old. But businesses say the new rules will make it even harder to buy land to set up factories, with long delays becoming the norm.

If the rupee still looks vulnerable, India has three options, none very palatable. One is to let the currency fall further. In most countries a cheaper currency would boost exports and help close the current-account deficit. But India's manufacturing industry is too small and too bound in red tape to ramp up quickly. So a turn-around in the balance of payments may take time during which investors could panic. Meanwhile the weaker currency may destabilise the domestic economy by adding to inflation and increasing the government's subsidies on fuel and thus its borrowing.

The second option is to do the opposite and increase interest rates to attract more foreign money in, following the path of Indonesia and Brazil. But this would further hammer Indian industry, which is already in poor shape, and probably increase bad debts at banks too. If the economy slowed further as a result, equity investors might begin to worry about corporate earnings declining and pull out their roughly $200 billion of investments in listed shares. Inducing a credit crunch in India might make things even worse.

The last option is to lower government borrowing. It is running at 7% of GDP (including India's states) and has stoked excess demand in the last few years, widening the current-account deficit. The populist political mood doesn't make big spending cuts easy, though, and while it is often accused of epic profligacy, India's central government has pretty low expenditure relative to GDP—about 15%. There is simply no way it can cut its way to a balanced budget. What India really needs is more tax revenues. But with a narrow tax base—only 3% of Indians pay income tax—this might mean concentrating tax rises on the formal economy, which is already reeling.

For now my sense is that the authorities' plan is to let the rupee trade freely but hold out the threat of an interest rate rise or direct intervention in the currency market to try to scare off speculators. At the same time they will squeeze borrowing as much as is possible during an election and use administrative measures, such as higher duties, to try to cap imports. It is a bet that the economy will pick up soon and that growth will make India’s problems fade away. The trouble is that the economy is still decelerating.