The Rupee's Decline

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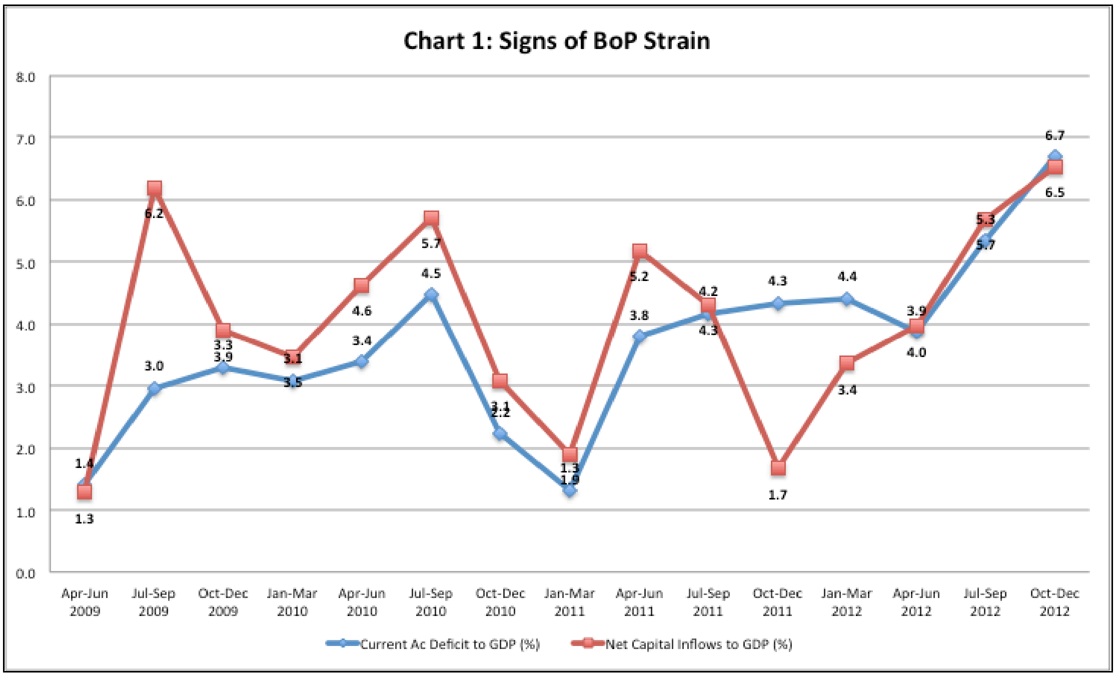
When the rupee crossed the 60-to-a-dollar barrier on June 26, official and corporate concern was palpable. This was not because everybody was a loser in this game. Exporters, especially those locked into longer-term deals struck in dollars and those looking to expand sales by holding rupee prices (and therefore reducing dollar prices) would benefit. If yet, the mood of concern was more generalised, the reason was that after slow growth, persisting consumer price inflation and a difficult balance of payments situation, this was one more indicator that the post-2003 boom was a short-term blip rather than a sustainable new trajectory of high growth.

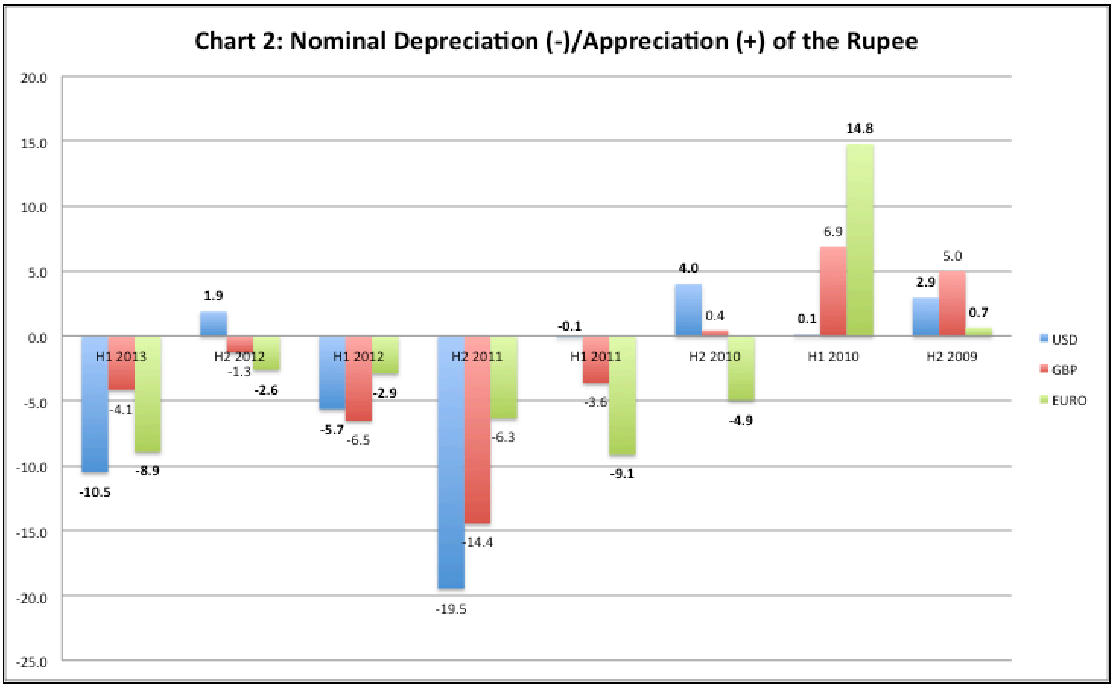
The government on its part should have expected the rupees decline. Though fluctuating, the ratio of the current account deficit to India's GDP has, since the beginning of financial year 2009-10, been unusually high in most quarters (Chart 1)—well above the levels that ratio touched at the time of the 1991 balance of payments crisis. India has been over the medium term spending far more foreign exchange every quarter than it was earning through exports and obtains through other routes such as remittances. This was true from years well before the 2008 crisis, though the deficit has tended to widen sharply in more recent times as a result of large payments for imports of oil and gold.

Persistent current account deficits are conventionally the basis for the weakening of a country's currency. In the past, expectations were that the resulting currency depreciation, by raising the rupee value of imports and dampening demand for them, would help correct the imbalance. But in India's case more recently, structural factors, embedded in the kinds of demands that inequality generates, have meant that currency depreciation has not reduced demand for and foreign exchange outflows on account of imports of petroleum products and gold, despite increases in prices and/or duties, besides the cost increases resulting from currency depreciation.



One reason why the government could afford to ignore this adverse trend on the external payments front was that India, like many other emerging markets, was favoured by large capital inflows. An easy money policy and low interest rates in many developed country markets, ensured by active central banks, fed a carry trade in which funds were borrowed at low interest rates in hard currency markets to be invested in asset markets in these emerging economies. The net was an asset market boom and an appreciation of the target country's currency, the feedback effects of which only increased the volume of inflows, leading to a capital inflow surge. On more than one occasion emerging market countries stretching from Thailand to Brazil have complained about the adverse effect that loose monetary policy in the US is having on their currencies and their export competitiveness. Inasmuch as the surge in capital inflows results in the accumulation of legacy portfolio capital in these countries, creating the possibility of a sudden and destabilising exodus of capital, that adverse effect is long term in nature.

In India too, over much of the last decade capital inflows have been well in excess of the current account deficit. Like many other developing countries, India became a victim of the dollar carry trade, in which international players borrowed in dollar markets, where liquidity was ample and interest rates low, and invested in equity, debt and real estate in developing country markets, where returns were high, in order to make huge profits from the differential between the cost of debt and the return on investment. In fact, even when the crisis hit the developed countries, after a short period in which India experienced a net outflow of capital, the infusion of liquidity by developed country central banks restored flows to India. As a result in every quarter starting with the second quarter (July-September) of 2009-10, and till the second half of 2011-12, inflows exceeded the deficit on the current account of India's balance of payments (Chart 1). As a result, during the second half of 2009 and throughout 2010 the rupee appreciated vis-à-vis the dollar, even if by a small proportion.



However, since July-September 2011, while the current account deficit has been high and rising, touching 6.7 per cent of GDP during the last quarter of 2012, capital inflows have either fallen short of or just about matched current account financing requirements. This had put downward pressure on the rupee, even earlier. In fact during the second half of 2011 the rupee depreciated by as much as 19.5 per cent vis-à-vis the dollar and 14.4 per cent vis-à-vis the pound (Chart 2). Even then, fears that capital inflows may dry up and force a reduction in reserves seems to have played a role in the rupee's depreciation.

Thus, if we went back to April-June 2011, the rupee was in fact at a local high vis-à-vis the dollar, setting off concerns about the currency's overvaluation. The rupee had weakened during the financial crisis, when foreign portfolio investors chose to book profits and take money out of the country to cover losses they had suffered or commitments they needed to finance at home. From less than Rs. 40 to the dollar in April 2008 the rupee fell to Rs. 52 to the dollar at the beginning of March 2009. But, thereafter, once central banks in the US and elsewhere in the developed world chose to infuse cheap liquidity into the system as a response to the crisis, capital once again started flowing into emerging markets.

The resulting appreciation of the rupee, many argued at that time, was adversely affecting the competitiveness of India's exports. There was much pressure on the central bank to intervene to prevent appreciation by buying dollars and augmenting its foreign exchange reserves, and criticism that it was not doing enough on this front. The appreciating trend continued for sometime. But from around August 2011, the rupee has once again been depreciating on average, despite brief periods of appreciation in January and September 2012.

This medium-term decline was disconcerting because this was a period when the United States, and some other central banks, continued with a policy of quantitative easing, or the infusion of cheap liquidity in the system. In fact, countries such as Brazil complained during those months that the US was indulging in a currency war by engineering capital flows to emerging markets that were driving up their currencies and adversely affecting their trade balance. This has forced the government to resort to a host of measures to attract capital, even in the form of debt into the domestic market. The result is that India's external debt has risen by more than 13 per cent over the last financial year, with short term debt accounting for a rising share. Yet as noted above aggregate net capital inflows have been either short of or just matched the volumes needed to finance the current account deficit, resulting in downward pressure on the rupee. The Reserve Bank of India too appears reluctant to retrench a part of its foreign exchange reserves to stall the rupee's depreciation. It possibly wants to avoid sending out the signal that reserves are depleting and is permitting the depreciation with only marginal intervention through sale of reserve foreign exchange. Left to itself the economic situation seemed to warrant depreciation of the rupee, and even moderately good capital inflows did not help to stall that decline. This points to a high degree of vulnerability.

In the event, any trigger is enough to set off a downward spiral that also renders the currency vulnerable to a speculative attack. The rupee's recent decline has been attributed to US Federal Chairman Ben Bernanke's suggestion that the era of quantitative easing is nearing its end, and its effect of triggering a return flow of investments into the US and dollar-denominated assets. The fact of the matter is, the rupee's depreciation has been visible with respect to other currencies as well. Over the first half of 2013, while the rupee has depreciated by 10.5 per cent against the dollar, it has fallen by 4.1 per cent vis-à-vis the pound and 8.9 per cent vis-à-vis the weak euro as well.

In sum, the weakness of the rupee is a result of a deterioration of India's economic performance, especially the deterioration of its balance of payments. Such weakening in an economy that through liberalisation has made itself dependent on foreign financial only leads to heightened instability. When the rupee hit 58 to the dollar, Finance Ministry mandarins chose to appear in public to declare there is no need to panic. That may be something to tell the public, even if ineffective. But it is perhaps time they themselves panicked and did something in the short run to correct the deterioration of India's balance of payments and in the medium term to reduce the country's dependence on foreign finance.

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