No Support for the Rupee*

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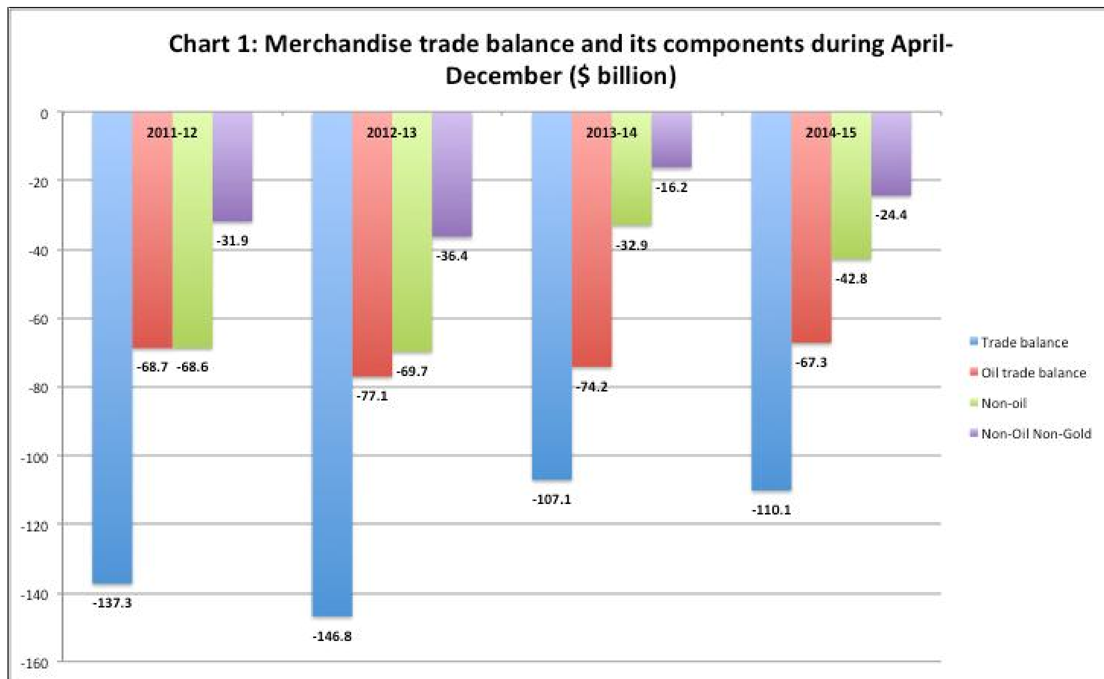
With the rupee falling below Rs. 64 to the dollar, which is a twenty-month low, the confidence of the government with respect to the state of India's external sector is being questioned. There is near unanimity that the principal reason for the rupee's slide is the exit of foreign investors from India's equity and debt markets, to the tune of Rs.9221 crore in six days. Since much of this outflow was the result of an equity sell-off, it could signal a reversal of the long surge in foreign institutional investments into India.

But in terms of magnitude the outflow of capital is as yet marginal. Outflows equivalent to the six-day figure of around Rs. 9,200 crore referred to above, even if sustained for a month, would extract just Rs. 46,105 crore, or a miniscule fraction of India's foreign currency assets of Rs.20,27,700 crore, and foreign currency reserves totalling Rs. 21,81,000 crore (including gold, SDRs and holdings with the IMF). Moreover, an outflow of that magnitude could not have resulted in a supply-demand imbalance in the market for foreign exchange that would be adequate to explain the quick depreciation of the rupee. Speculation clearly played a role here.

This has two implications. First, it raises the possibility that the large foreign reserves which the central bank proudly holds in its kitty may not be good enough to support the rupee if and when real capital flight occurs. In fact, any signal that the RBI plans to defend the rupee by running down its reserves could spur intensified speculation that need not be good news for the value of the currency.

Secondly, despite talk of an improvement in India's net trading position that has reduced the trade and current account deficits on the balance of payments, it appears that those deficits and the likely adverse movements in them are such that they offer no support for a currency that can be easily damaged by even a small capital outflow.

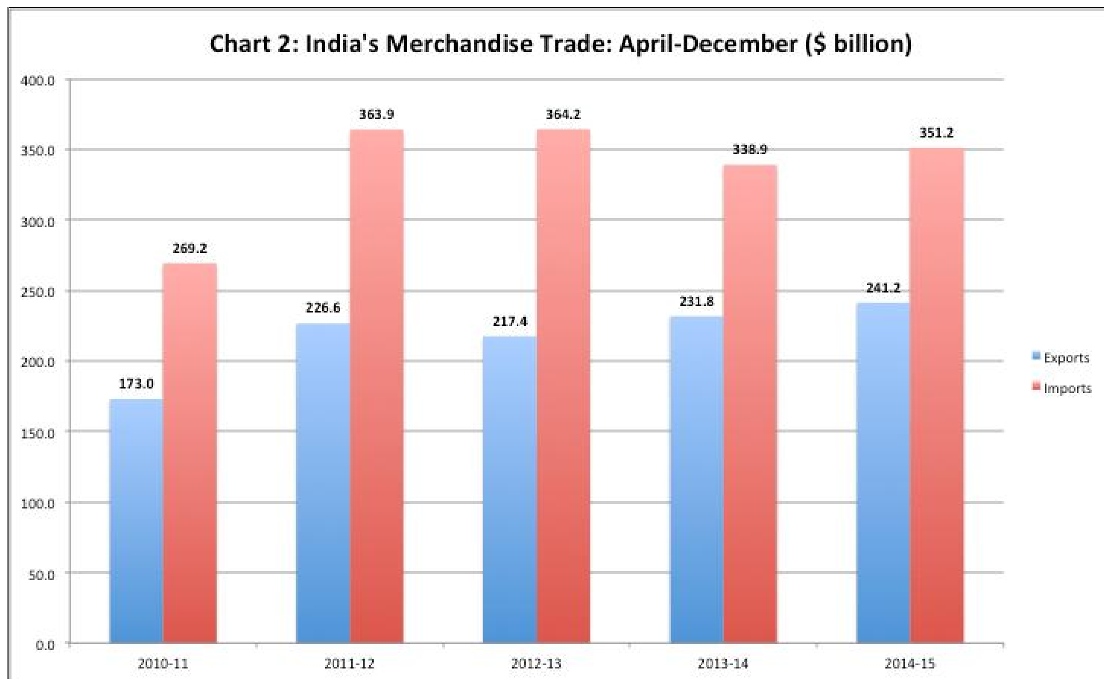
The government has recently released its numbers on merchandise trade performance during April to December 2014. The good news is that the merchandise trade deficit, which came down sharply, from $147 billion to $107 billion between April-December 2012 and April-December 2013, has remained at $110 during April-December 2014 (Chart 1). That is, the most recent data on merchandise trade do suggest that the improvement in India's trade balance during the first half of 2013-14, was sustained during the first half of the last financial year.



A breakdown by components of the trade balance over these periods is revealing. To start with, the reduction in the trade balance during April-December 2013 relative to the corresponding period of 2012 was not on account of a fall in the deficit in the oil trade (due to a fall in oil prices). Rather, it was due to a $36 billion fall in the non-oil trade deficit, only $20 billion of which was due to the fall in net gold imports, consequent to government action aimed at curbing excessive imports. A reduction in the non-oil, non-gold trade deficit also had a role to play in the improvement in India's balance of payments during the first half of 2013-14.

An improvement in the merchandise trade balance can occur either because of an increase in exports or a fall in imports (or both). However, during April-December 2013-14, while exports rose by $14.4 billion relative to the corresponding period of the previous year, the improvement in the trade balance was as much as $39.7 billion (Chart 2). This implies that a decline in imports played an even more important role in shoring up the balance of payments. On the other hand, during April-December 2014-15, while exports rose by $9.4 billion relative to the previous year, the trade balance improved by just $3 billion. A small increase in imports neutralised a significant part of the advantage that a modest improvement in exports delivered.

Thus, as of now much of the play is on the imports side. This has given rise to the view that much of what has happened to the balance of payments in recent times is on account of developments with respect to oil and gold. The conventional understanding is that it is in the case of these commodities that the adjustment tends to be largely of imports. Specifically, the decline and subsequent persistence at a low level of the merchandise trade deficit is attributed to a change in the quantum of gold imports in 2013-14 (after a hike in import tariffs and imposition of quantitative restrictions), and the fall in international prices of oil in 2014-15.



However, as Chart 3 shows, in the first half of 2013-14, out of the $25 billion fall in total merchandise imports, nothing came from oil imports, which registered marginal rise; $14.6 billion was due to declining gold imports; and $11.1 billion from a fall in non-oil, non-gold imports. Clearly, recessionary trends that squeezed non-oil, non-gold imports contributed to the 'improved' trade balance. On the other hand, during the first half of 2014-15, when merchandise imports rose by $12 billion, about $2.5 billion was due to gold imports as import restrictions were loosened, whereas close to $15 billion was on account of non-oil, non-gold imports. The increase in the import bill relative to the corresponding period of the previous year was reined in by the benefit of an oil price decline that reduced the value of the oil import bill by $5.7 billion.

It is in this light that we need to assess the support for the rupee that can come from India's merchandise trade account. Given the government's commitment to liberalise gold imports and reduce import tariffs on the commodity, an increase in gold imports is likely. While there is considerable uncertainty in oil markets, prices as of now are on the rise and that could add to the import bill. In sum, unless there is a significant contraction in output, any improvement in the merchandise trade balance which would help shore up the rupee is uncertain.

Since there is little that the government can do about the decision of foreign financial investors to stay in or exit the country, the government's attention should turn to efforts at reducing substantially the merchandise trade deficit. But, there too, simply inviting foreigners to come and make in India would not be enough.

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