The Falling, Falling…Rupee

Jayati Ghosh

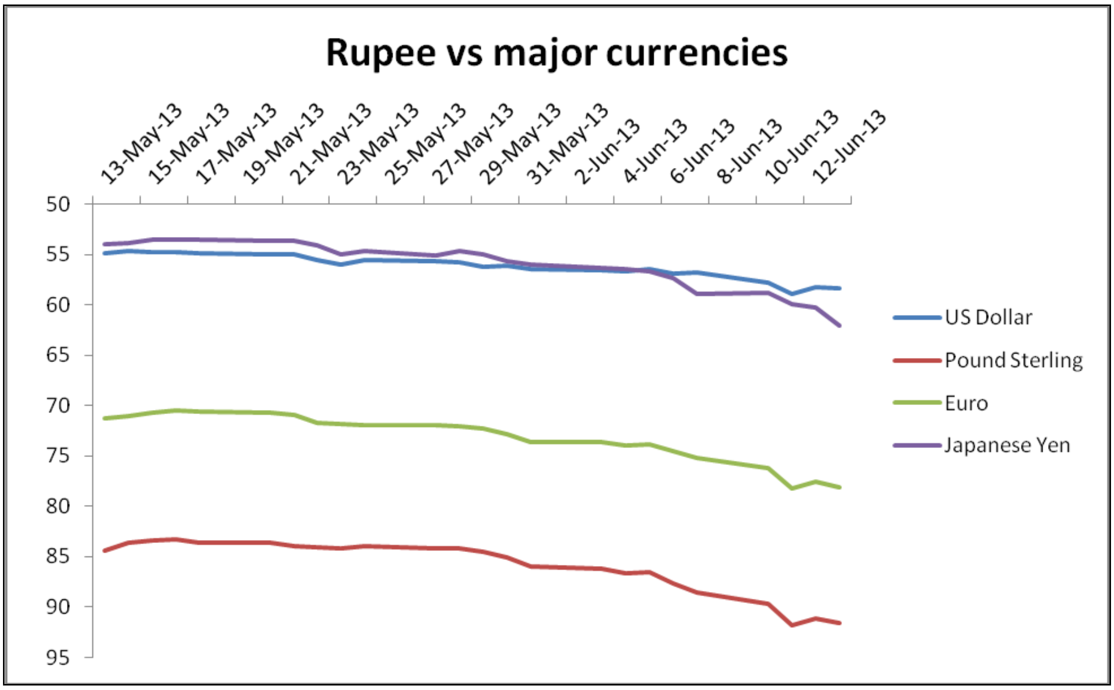
For the last couple of months, the sliding rupee has created consternation among many in the Indian economy. In the second week of June it came close to breaching the psychological barrier of Rs 60 to the dollar, and there is fear that even this may not be a real bottoming out for its value.

Of course those who are directly affected by the lower value of the rupee are concerned – such as importers, those wishing to travel abroad or spend on foreign education, and so on. But the rupee's decline affects everyone in the economy, because it feeds directly and indirectly into general inflation, which is a continuing problem even as output growth decelerates, and therefore hits common people hard.

The Finance Ministry has been arguing that this quite sharp decline in the rupee is "no reason to panic". Its representatives have suggested that this is happening because most currencies have been depreciated relative to the US dollar ever since Ben Bernanke, the head of the US Federal Reserve, indicated a possible decline in the monetary policy of "quantitative easing" that had encouraged capital to move away from the US in search of higher returns in other currency assets. In this argument, the rupee has supposedly been behaving like most other currencies, especially those of emerging markets, as investors bring their flows of hot money back to the US economy.

But this is simply not true. First of all, the rupee decline had occurred even while the US monetary policy was at is most lax, and when other countries like Brazil were complaining about the currency wars generated by US quantitative easing. More significantly, as the chart indicates, the rupee's recent decline has been against all the major currencies, not just the US dollar – and in fact the decline has been even sharper relative to the British pound and the Japanese yen. And in the recent past the Indian rupee has been depreciating faster than the currencies of most other emerging markets, and is the worst performer among major Asian currencies.

The past two months have accelerated a medium term decline in the rupee that has been in progress for around two years now. Between April 2011 and April 2013, the rupee lost nearly one-third of its value visavis the US dollar. In trade-weighted terms (relative to the currencies of India's important trading partners), the decline in value of the rupee has been less, but still significant at around 12 per cent. Since domestic inflation in India has continued to be higher than in many other countries, the real depreciation has been less, at around 7.5 per cent, but still notable.



What explains this decline in the external value of the rupee? Despite what the Finance Ministry claims, this is not the reuslt of global forces or US monetary policy, but of domestic economic mismanagement. Indeed, in a way it is surprising that it did not happen sooner. Most of India's balance of payments indicators are extremely fragile and the economy has looked quite vulnerable for some time now. The current account deficit is at the historically high level of around 5.5 per cent of GDP while the trade deficit is even larger at around 7 per cent of GDP.

Further, recent trends indicate a significant worsening of both trade and current accounts. Both exports and imports actually declined in 2012-13 compared to the previous year, but even so the trade deficit still increased by nearly 4 per cent, or more than $7 billion. In April 2013 exports were 2 per cent higher than in April 2012 – but imports were 11 per cent higher and non-oil imports were 15 per cent more. So the trade deficit increased by more than 26 per cent in April 2013 compared to the previous year. (Finance Ministry, Monthly Economic Report for April 2013)

A significant part of the growing imports is accounted for by gold imports, which have been ballooning in recent years. (Not for nothing did John Maynard Keynes refer to India as "that sink for precious metals" nearly a century ago…) It is surprising tha the government took so long to riase the import duty on gold, and that it has raised it so little, despite the hugely detrimental impact such imports are having on the economy. Menawhile, net invisibles have been declining, as there are larger outflows because of profit and interest repatriation and various service payments for travel and reduced inflows related to the global slowdown. So the surplus on invisibles is even less able to counterbalance the merchandise trade deficit.

And these large trade and current account deficits are increasingly financed by hot money flows, which are obviously likely to leave whenever problems loom. Departing flows of portfolio captial are said to be associated with the most recent decline in the rupee (and the associated fall in the stock market) but it could just as easily be – and may well be in future – the reduction in external commercial borrowing or the decline in FDI in the form of priavte equity.

But this generates a chicken-and-egg problem. Since imports are now such a significant part of India's economy, the fall in the nominal value of the rupee generates inflationary pressures that necessarily add to inflation. And so the nominal devaluation of the exchange rate need not generate any positive effects on the trade account, because of its impact on prices. And a continued deterioration of the current account can then have a further depressing effect on expectations, generating further movement of capital out of the country and further devalution.

One of the more obvious reasons why the current depreciation is not to be welcomed is the effect on domestic living standards. There are several ways in which the falling rupee immediately has an inflationary impact, one of the most important of which is the price of energy. Since the misguided decontrol of oil prices, it is not only the globally traded price of fuel but also the exchange rate that determines domestic oil prices. Not surprisingly, the second week of June therefore also witnessed an increase in domestic oil prices, the third such increase in just a few weeks. Since fuel is a universal intermediate, it enters into all other prices directly in production costs and also by affecting transport costs. So we can expect an additional round of accelerated inflation within a few months.

Other industries have also become increasingly import-intensive, which means that they too are immediately affected by rising cost pressures consequent on a devaluation. Both durable consumer goods like automobiles, white goods and electronic items as well as non-durable goods like soaps and toiletries are all likely to become more expensive. And of course food inflation – the most worrying aspect of recent price movements – is likely to go up as a result as well.

What is more, the increasing costs of imports can also affect exports, thereby wiping out any global cost advantage accruing from the devaluation. For example, important export sectors like gems and jewellery, automobiles, machinery and chemicals are all very import-dependent, and their rising costs could nullify the impact of the devaluation on their ability to sell more cheaply in export markets. This is made worse by the fact that in the current depressed global trade context, buyers are able to renegotiate contracts once the exchange rate has changed. Indeed, many global buyers even in sectors like garments and leather goods now insist on contracts and invoicing in rupee terms. This allows them to benefit completely from rupee depreciation, and force the local producers to bear the rising domestic costs. This means that the falling rupee need not generate any significant increase in exports as may be hoped.

So clearly the sliding rupee should be a major concern for everyone in the country. It is surprising that those who should be most concerned of all – the policy makers in charge of managing the economy – seem to be the ones who are the least bothered by this.

*** This article was published in the Frontline, Vol. 30-Issue 13, Print edition: July 12, 2013.**