A Long View of the Rupee

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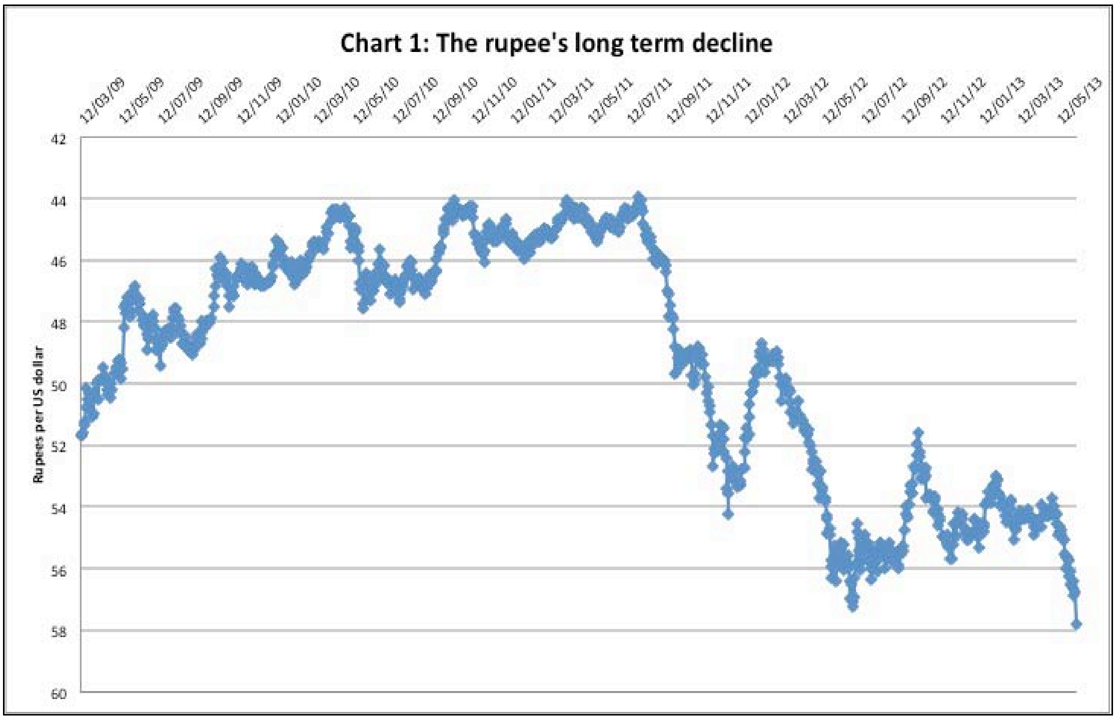
The rupee is at a historic low of 58.2-to-the dollar, having been subject to a sharp 7.5 per cent nominal depreciation since early May. Given the short-term perspectives of interested market observers, attention has been focused on some immediate triggers such as the signal of a possible retreat on monetary easing in the United States and India's adverse report card in terms of GDP growth, inflation and above all the current account deficit. Since the former could strengthen the dollar, it is seen as having encouraged a reverse flow of capital to the United States in search of dollar denominated assets. On the other hand, poor numbers in India are seen as provoking a pull out of capital from the country. It is the resulting exodus of capital, visible recently in the debt market, that is seen as underlying the rupee's decline.

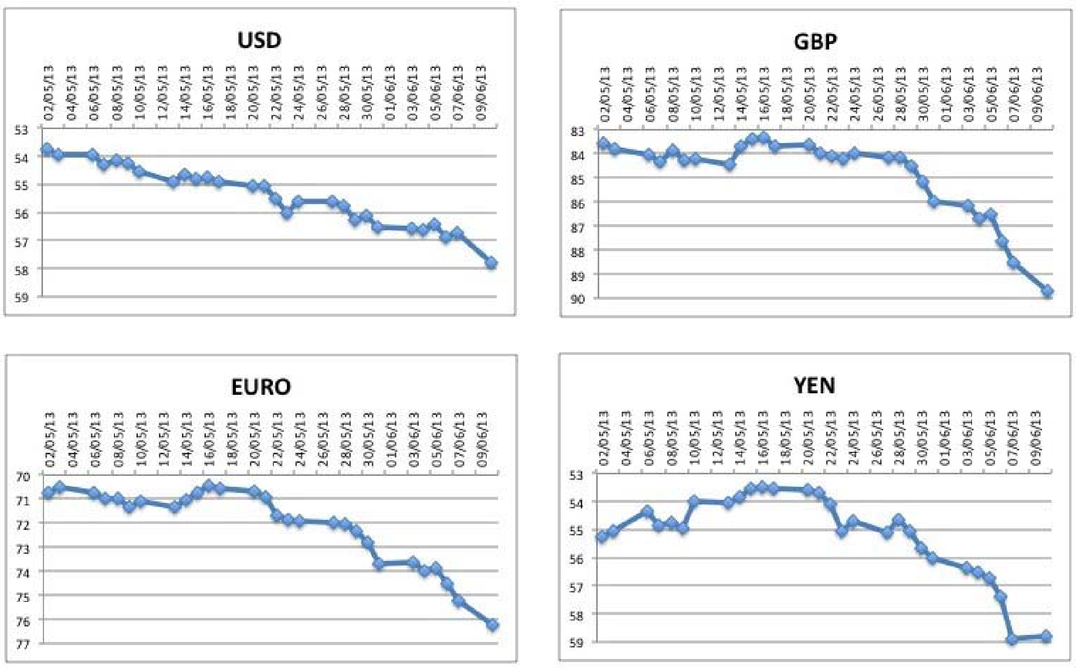


The role of these factors, among that of many others, as possible proximate explanations of the rupee's descent cannot be denied. But a more fundamental understanding requires taking a longer view of the rupee's movement. As Chart 1 shows, if we went back two years, to April-June 2011, the rupee was 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. Like many other developing country markets, 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.

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 as Chart 1 shows, from around August 2011, the rupee has once again been depreciating on average, despite brief periods of appreciation in January and September 2012.

This recent medium-term decline is 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.

Chart 2: The dollar can't be blamed



India, however, the evidence indicates, was already experiencing downward pressure on its currency. There were two forces underlying this tendency. One was a combination of a high oil import bill and rising gold imports that was working to widen the current account deficit on [India's balance of payments](). The lagged effect of the recession in Europe on India's exports only aggravated this adverse trend over time. Second, there appears to have been some reluctance on the part of the Reserve Bank of India (RBI) to retrench a part of its foreign exchange reserves to stall the rupee's depreciation. 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.

Thus, a fundamental weakness in India's balance of payments seems more important than inflows and outflows of foreign capital in influencing the course of the rupee. Thus, the month of May saw net foreign institutional investment inflows of more than $4 billion into the equity market and more than $1 billion into the debt market. Yet the rupee was in a state of continuous decline that month. All that can be said is that in time the BoP deficit would affect investor sentiment, and possibly partly explains FII withdrawals of as much as $1.5 billion from the debt market and reduced inflows of $133 million into the equity market during the first 10 days of June. This net outflow of capital then aggravates the decline of the rupee as has happened during the last few days.

It also needs to be noted that the rupee's decline cannot be 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. As Chart 2 shows, the rupee's depreciation has been visible with respect to other currencies as well. Over the last year while the rupee has depreciated by 29 per cent against the dollar, it has fallen by as much as 23 per cent vis-à-vis the pound and 18 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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