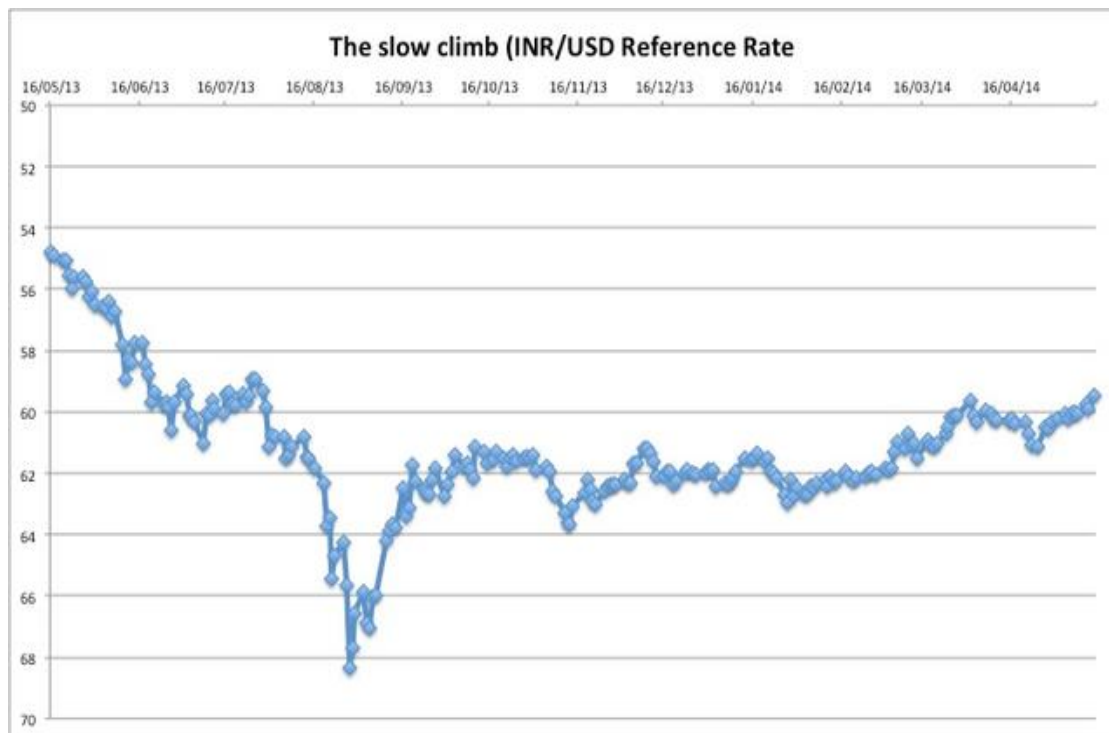


The Rupee's Climb

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Measured against the dollar, the rupee has been [gaining](#) ground, valued at 59.5 to the dollar (as per RBI's reference rate) on May 15, as compared with 60.2 at the beginning of the month and 62.7 at the end of the January. This appreciation, however, needs to be put in perspective. What we are witnessing is not a long term appreciation of the rupee but a rise in its value as a result of volatility. Thus, while when compared to a year back the rupee on May 15, 2014 had appreciated by about 8.6 per cent vis-à-vis the dollar, on 28 August last year its value (at 68.4 to the dollar) was 13 per cent below its May 16, 2013 value.



Second, even though the deficit on the current account of India's balance of payments has [come down](#) quite significantly (largely as a result of a fall in gold imports), India remains a deficit country, expending more foreign exchange on its current account transactions than the foreign exchange it "earns". So if currency movements are influenced by the net value of current transactions, the rupee should be depreciating rather than appreciation. This is the long-term tendency in the external sector.

So, third, this implies that the factors explaining the rupee's [fluctuations](#) are largely related to the capital account, with periods of capital outflow or expectations of net capital outflow, resulting in a depreciation of the rupee and periods of net capital inflow or expectations of the same creating pressures for the currency to appreciate. Thus the recent (relative) appreciation is the result of a capital surge, whereas the July-August 2013 depreciation was because of fears that the US Federal Reserve's decision to taper out its easy money policy would result in capital flight.

Fourth, the recent net inflow surge was largely the result of large speculative FII inflows into equity and debt markets. Speculation that a stable, assertive and business-friendly government would be elected to power, shoring up profits and profitability, encouraged large inflows. Further, given the role of asset management companies and instruments like participatory notes, it is not clear where the money flooding India's financial markets is originating. The fact that this surge in inflows was a pre-election phenomenon raises the possibility that a part of it may have even been related to election spending.

Net inflows over the year ending May 15, 2014 amounted to \$5.98 billion, whereas that during the four and a half months since the beginning of this calendar year amounted to \$11.73 billion and during the first 15 days of May as much as \$2.24 billion. This has not merely generated a bubble in the stock market, with the Sensex soaring to record highs, but triggered a short-run appreciation of the rupee, because of excess supply of foreign exchange.

Normally, under such circumstances, the Reserve Bank of India tends to intervene to buy up and generate demand for foreign exchange, to dampen the rupee's appreciation, which is damaging to exporters. However, when the surge is as sudden and strong as it has been, the RBI cannot match the increase in foreign exchange supply with its increased demand. Concerned with the monetary [policy implications](#) of acquiring foreign currency assets, the Reserve Bank of India has chosen not to mop up all the excess foreign exchange liquidity through purchases. If it resorts to huge purchases that raise the foreign currency assets it holds, the corollary is an increase in the central bank's liabilities or an increase in money supply. With its focus on reining in inflation the RBI is not keen on that.

The problem is that when the rupee is appreciating, the dollar returns that short-run foreign investors earn in the equity market tend to rise. Each dollar invested not only earns a return because of the equity market boom, but also because when investors book profits and exit, the rupees needed to recoup the dollar investment they made when they entered the market is lower than earlier. This only aggravates the speculative spiral.

To conclude, given this character of the forces driving rupee appreciation, it is unlikely that the surge would continue and the likely possibility is that it may even be reversed, encouraging capital exit. In those circumstances the rupee will either stabilise or will in all probability return to its long-term tendency to depreciate rather than appreciate.

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