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Falling Indian Rupee

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Most of the floating currencies of the world are depreciating against the US dollar. Changes in supply and demand determine a currency's worth in terms of the US dollar.

Chinese currency is under a fixed exchange rate regime. So, too are Fiji dollar, Samoan tala, Solomon and Tongan currencies, and Vanuatu's vatu. Only PNG's kina is a floating currency.

When values of currencies under fixed exchange rates are changed by authorities, it is known as devaluation. On the other hand, fall in currency due to result of free interplay of market forces without official intervention is called depreciation.

If a country's total external payments for imports of goods and services are more than receipts from exports of goods and services including inward remittances and tourism earnings, the deficit arises. Known as current account deficit (CAD), it results in more demand for foreign currency (say, the US dollar). Automatically, the value of domestic currency goes down against US dollar.

The CADs are not worrisome. They can be financed by capital inflows. A country with a good policy framework and investor friendly environment attracts capital inflows: foreign direct investment (FDI), or loans of long term nature. The CADs are then sustained without much pressure on exchange rate.

Countries without any track record of reforms, but with higher interest rates can still attract capital flows of short term maturity. These are known as hot money. They seek higher return and are quickly reversible.

Jitters in currency markets

Uncertainties were caused by a remark by US Federal Reserve Chairman Bernanke on May 22. He made a hawkish statement: "In the next few meetings, we could take a step down in our pace of purchases." That was the hint about the beginning of the end of the Fed's unconventional monetary stimulus of pumping money. Known as quantitative easing (QE), the Fed has been buying bonds for increasing money supply for keeping interest rate as low as zero percent for encouraging investment and growth.

The QE has been going on since 2009. Though no date has been set, it is clear it will end soon, as signs of recovery in US are visible. Global investors were seeking countries in Asia and elsewhere with higher interest rates. The countries benefitted by rise in capital inflows, included Brazil, Russia, India, Indonesia and South Africa.

Investors were happy to pour in money in several ways. Countries with friendlier and less bureaucratic hurdles, received long term FDI; and others, not so reform minded, but with still higher interest rates received hot money flows.

The remark of May 22 triggered a vicious global correction in stocks, in bonds and currencies of all economies. Global investors were looking forward to US recovery, as it has been a safe haven in normal times. The hot money guys were the first one to pull out funds from Asia and are now turning to US. The reversal of funds thus exposed the countries which are lagging behind in reforms.

The currencies of the countries which were hit hard are those with poor reform record and high CADs. They have been obviously living on borrowed moneys. Some of them relied more on hot money rather than long term durable FDI inflows which cannot be easily pulled out.

Free fall of Indian Rupee

The US dollar was worth 55.45 Indian rupees (INR) on May 23. There has been a fall all along and on August 22 it was INR 65.30. That was a record fall. The depreciation was 18 percent.

Indian Finance Minister readily blamed it on the US Fed's remark.

There were clear symptoms of a growing cancer. India's mounting CADs were well known ever since 2008. They were fed by annual budget deficits. As budget deficits spill over into external sector, resulting in CAD, they are called twin deficits.

India's budget deficit has been growing over a five year period. It is 5 percent of GDP in fiscal year ending March 2013. It is the highest amongst emerging economies: South Africa (4.8 percent) and Indonesia (2.2 percent). The CAD is 5 percent of GDP, also the highest.

India's budget deficit is financed by domestic and external debt, most of which is hot money inflows. The CAD was US$ 8 billion in 2008. It is now US$ 90 billion. India's reforms were delayed. As a result, FDI inflows have dried up. In 2008, FDI was US$ 48 billion; and today is US$ 27 billion.

It is obvious Indian economy is not doing well.

As India was growing at an average rate of 8 percent over the last ten years, no corrective actions were taken when twin deficits were mounting.

Professor Dornbusch, whose textbook is a staple for students, wrote long time ago "A crisis takes longer than anticipated to arrive, but moves faster than expected when it does".

Instead of the cosmetic palliative measures, serious steps are needed. One is to call off the US$ 23 billion food security subsidy program, which was introduced on August 19, when the falling rupee was creating a record.

That will send out a clear message to overseas investors that India means business of putting the house in order.