Defending the falling rupee

■ *T. K. Jayaraman*

The Indian currency is falling in value in terms of the US dollar. Most of the commodity imports of India, which are denominated in US dollars, happen to be critically essential commodities such as petroleum crude. India imports 75% of its total crude oil requirements. They are also half of the country's total imports.

The concern of the authorities is understandable. A continuously depreciating rupee leads to a rising trend in the landed prices of essential inputs, which range from raw materials, intermediate inputs and capital goods to manufactured consumer goods, aside from fruits and nuts as well. They lead to a rise in the wholesale price index, which includes only goods, and no services. On the other hand, changes in the consumer price index (CPI), which denote the inflation rate targeted by Reserve Bank of India (RBI), comprises two types of goods. The first group consists of goods, whose prices are volatile in nature such as food items including food grains and vegetables, mainly determined by seasonal factors and weather, and all energy products including those falling under the description of fuel. The factors influencing their production and prices, given the demand for them, are beyond the country's control.

The second group excludes the aforesaid food and fuel categories. Known as core commodities, percentage changes in their prices denote core inflation. The core inflation has been steady and sometimes even falling. On the other hand, since late last year (September 2017), inflation of volatile fuel group comprising primarily crude oil price has been rising. The crude oil touched the near dangerous level at $79.41 per barrel in May this year. The RBI is aware that rising inflation in volatile items in the food and fuel category eventually seeps into non-volatile, core categories. Increasing costs of transport services and manufacturing costs following the rising energy prices affect the price level all around. The rise in CPI, the so-called headline, is no longer benign. It was 5.0%. The June 2018 inflation signalled the need for a rise in interest rate by RBI and RBI responded with an increase of 25 basis points. The whole sale price index (WPI), which excludes services, but includes all goods, besides consumer goods rose too, as all these items were affected by rise in energy prices. The WPI inflation was high at 5.77%.

Not by crude oil alone

The troubling factor is not the rising landed price of the crude price alone. The depreciation of the rupee was also another factor. The major factor was pulling out by foreigners of their funds in short term investment in India's equity and debt, known as portfolio funds. As the US Federal Reserve has already indicated two rate increases, the emerging markets were no longer attractive for the short term investors. They were looking to not only safer havens but also for higher returns for parking their funds on a temporary basis. During January-May 2018, the capital outflows from India were around $3 billion. The net capital flows on a quarterly basis are reported to have come down to $6 billion in the second quarter of 2018 from $26.3 billion in the first quarter of 2018. It is expected that total net portfolio funds for 2018-19 would further decline, if India is unable to improve the economic environment, aside from controlling inflation and making special efforts to put brakes on government expenditures in an election year.

The appreciation of the Indian rupee in yesteryear was due to heavy capital inflows of hot money seeking higher returns against the background of the expected higher interest premium and the government's apparent commitment to improve the economic climate with indicated reforms, which reduced sovereign risks. The depreciation of the rupee is due to reasons just the opposite. The flow of hot moneys is a double edged sword: "It would make or unmake." Higher the inflow, higher is the rise in the value of rupee in terms of dollar; and higher the outflow, the deeper is the fall in the value of the rupee.

The credibility question

Inflation was getting stubbornly higher, more due to fall in the exchange rate of the rupee and associated increase in the landed prices of petroleum crude, which was also rising in dollae terms. Worried by credibility image, RBI had to respond soonest. Without waiting for full report on inflation for July, RBI decided on another hike in the already scheduled bi-monthly meeting of Monetary Policy Committee meeting on August 1 by 25 basis points. The policy interest rate stands at 6.50%. Thus, there were two back-to-back interest hikes decided upon by two consecutive bi-monthly meetings of MPC, one in June and August.

The latest reports say inflation has come down in July to 4.51%. Yet the signs on the external front continue to remain grim. Petroleum oil price which cooled down a bit in late July rose again in early August after the US held out fresh threats to Iran. The deteriorating political climate introduced yet another cycle of rise in the price of crude oil. The volatility in oil price continues to persist. On the exchange rate, the downward slide in rupee has also not ended.

Aside from losing much of its value (nearly more than 7%,) and being called the worst performer among Asian currencies, the ongoing currency war between U.S.-China made the Indian rupee to trade at 69.122 against the dollar in late July.

Although the result of the poll of about 40 foreign exchange analysts conducted by Reuters soon after the RBI's monetary policy decision of August reveals, the rupee would trade in the next one year to 68.22 per dollar, Professor Kaushik Basu is of the view that the rupee is overvalued and the fair value of the local currency is 70-71 to a dollar. According to him, the depreciation is part of a correction process, since the earlier inflows were responsible for making the rupee appreciated.

These are all at best hunches

Under a flexible exchange rate regime, the volatility would continue. In the modern world, with electronic communications spreading news of all kinds: mostly bad and ugly, the exchange rate has to bear the first impact of shock. Overshooting of the exchange rate is now the new normal. A fresh equilibrium is always arrived at with passage of time, subject to no more new shocks.

In the long run, fundamentals alone determine the equilibrium. They include the twin balances: internal and external. If a country cannot control fiscal deficits, expenditure spills over into the external sector, giving rise to emergence of deficits in the current account in the balance of payments. The result is inflation.

RBI intervention

In the Indian context, RBI's efforts to arrest the fall in the rupee have cost implications: loss of foreign assets denominated in US dollars, which are part of international reserves. The RBI has been selling dollars for rupees to prop up the rupee. It sold $8 billion in US Treasuries in April and May. According to Bloomberg, India's holdings of US Treasuries declined to $148.9 billion as of end May from $157 billion.

A combination of pulling out of funds, a decrease in net inflows and intervention by RBI for stopping the fall in rupee value by sale of US Treasuries and dollars – all together imposed heavy costs: From the highest level ($426 billion) recorded in April 2018, the reserves have been reported to have fallen to $379 billion in early August 2018.

Foreign exchange reserves and the nominal exchange rupee rate

	Foreign Exchange Reserves US$ (billion)	Rupees per One US$
2015	360.2	66.53
2016	370.0	67.83
2017		
Jan	361.6	68.09
April	372.7	64.56
July	378.7	64.45
Oct	398.8	65.09
Dec	404.9	64.24
2018		
Jan	414.8	63.65
April	426.1	65.65
June	424.1	68.68
July	404.0	67.78
August	379.0	68.80

Source: Trading Economics

Opening up of an old debate

That opens up once again the debate: should India switch to targeting the exchange rate rather than inflation? There would be additional questions as well.

Has India adopted inflation targeting in haste? Is the monetary policy really effective? Does the interest change transmission mechanism work perfectly? Would an upward revision in policy interest rate change lead to reduction in the rising prices of onion or potatoes, as the food grains and vegetables form a major part (nearly 46% total weight) in the consumer basket of goods and services? Is not India dependent on oil and other critical imports from rest of the world? If so, should not India focus attention on the exchange rate?

Nominal versus real exchange rate

More importantly, it is the real exchange rate that matters most. Real exchange rate (RER) is the nominal exchange rate (NER), which is defined as units of foreign currency per unit of domestic currency, duly adjusted for domestic inflation relative to inflation overseas. The RER is calculated as the product of NER and the ratio of domestic price level index to the price level index of the rest of the world. RER is often expressed as index numbers for comparison over time. The stability in RER is more important than stability in NER.

A rise in RER reflects appreciation of the domestic currency; and decrease in RER denotes depreciation. Given the NER, it is the domestic price level relative to overseas inflation which determines the RER. If domestic inflation is higher than overseas inflation, RER rises and adversely affects export competitiveness and vice versa.

Easier said than done

For countries which depend on exports or want to promote a higher volume of exports for jobs and growth, the lesson is to keep the domestic inflation lower than the inflation in the rest of the world. Appropriate policy tools are those which enforce fiscal discipline at all levels: controlling states and central government expenditures; reducing debt; increasing revenues; and early completion of dragging infrastructural projects.

India is in election mode. Parliamentary elections are due in May 2018; and four state elections are scheduled in November-December this year. With handouts and freebies, fiscal discipline would be an elusive goal. ■

— Dr T.K. Jayaraman is an Adjunct Professor, Amrita School of Business, Bengaluru Campus

[The views expressed by the author in this article is his own.]