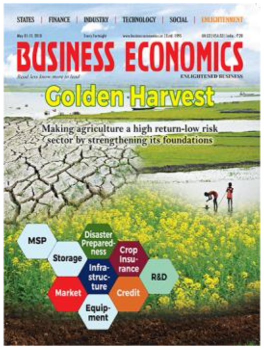

Falling rupee and widening current account deficit

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There are some new headaches for policy makers this past fortnight.

The rupee has been sliding faster. On the other hand, oil price is rising.

Indian currency fell to the lowest at Rs 67.13 on May 8, the lowest in the past 15 months. Last month, the decline to Rs 66.08 was the steepest in 12 months, since March 14, 2017. A Morgan Stanley Investment Management report states the US dollar rally would continue for a while. With growth in the euro zone flattening and China facing headwinds, the rupee's fall is not unexpected. The rupee has been the worst-performer in Asia, having weakened 4.2 percent during the last 12 months against the US dollar. The situation seems to be getting worse, as overseas investors are liquidating their holdings in the equity and debt markets.

In April alone, foreign investors took out more than $2 billion from the bond and equity markets, putting pressure on the Indian currency.

The latest decline has been causing concerns to Reserve Bank of India (RBI). It does not target any level of exchange rate, nominal or real. The RBI's target rate is inflation (4 percent with a margin of plus or minus 2 percent).

The crude oil (the international benchmark, Brent) price which started to climb up in recent months, shot up to US$77 per barrel on May 8, soon after the US withdrawal from the Iran nuclear deal followed by reinstatement of sanctions. The oil price rose by more than 2 percent. These prices are at highest level since November 2014. Historically, the highest price was US$145.31 in July 2008.

Another development of concern is the current account deficit (CAD), which was 2 percent of GDP in the third quarter of last FY 2017-18, is expected to treble soon.

Oil price and falling value of the rupee would make trade deficits to bulge, as India is a net importer of petroleum crude as imports meet 80 percent of its requirements. Indian exports have not been able to rise faster than the increase in imports. The depreciation of the rupee would not alone work.

Given the fact that Indian exports cannot increase in the immediate run, the estimates from the Petroleum Planning & Analysis Cell in the Ministry of Petroleum and Natural Gas have sounded the alarm: $10/ barrel oil price rise increases India's CAD by $15bn (0.6 percent of GDP) and the fiscal deficit by 0.1 percent of GDP. Of course, all short term impact predictions are subject to crucial assumptions that if all other things, including domestic fuel prices, are held constant.

Alarming concerns

The policy makers can take some comfort that internationally traded oil prices are beyond India's control. So too, international politics, including the decision on Iran Nuclear Deal and its impact on oil supply and demand situation cannot be influenced by India.

So, the worries centre on the rupee: why the exchange rate (expressed as the price of dollar in rupees) changes too often and why its day to day variations are so volatile?

First, in a liberal economy since the mid 1990s and under the growing globalisation conditions, changes in exchange rate are normal, as prices of commodities including price of foreign currencies in terms of domestic currency are determined by a free interplay of supply and demand forces. The price of foreign currency is determined by the same forces of supply of and demand for currency. A country's supply of foreign currency (which is the mirror image of the demand for the country's commodity exports, services such as inward tourism, and transfers and inflows of foreign currency of all kinds including non-debt creating, such as foreign direct investment and portfolio investment, and debt-creating flows such as long term or short term by government and private borrowings) are less than demand for foreign currency (which is demand for the country's commodity imports, services such as outward tourism and transfers and outflows of domestic currency of all kinds), the value of foreign currency goes up in terms of domestic currency.

Appreciation of foreign currency is automatically the depreciation of the domestic currency.

Flexible exchange rate

So, Indian rupee's depreciation is also of our own making. Again one can argue: everything is outside one's control. Not necessarily. India had controlled the exchange rate before 1994, as part of a repressed economy, with decades of experience of controls, permits and licenses. It had imposed high tariffs on imports; quotas for certain products; restrictions on inflows and outflows of foreign exchange; controls on outward remittances and travel money in dollars for each traveler. The famous movie of the period had a catchy title: *Around the world in eight dollars*.

India has moved away from those days. Since then, India's economic liberalisation in steps, of course, with gradual measures of relaxation over the last two decades in several areas, including foreign direct investment and both long term and short term capital glows, known as capital mobility, has made the economy more vibrant and an attractive place to invest.

That has also made the macroeconomic conditions often vulnerable to global economic uncertainties.

The instability in currency values are stemming from what is known as "the impossible trinity" also referred to as the trilemma faced by policy makers all over the world. A country cannot have all the three same time: a flexible exchange rate, perfect capital mobility and independent monetary policy. One has to sacrifice at least one for having the other two. If a country has to have free flows of capital and flexible exchange rate, it cannot have an independent monetary policy. Or if a country wants to pursue an independent monetary policy, it has to accept either a closed capital account or a fixed exchange rate, but not both.

Managed float

How do countries then manage their way out of the impossible trinity? They do it by moving away from the hard corners to middle solutions. The advanced countries have been doing it by what is known as currency market interventions by central bank, through their open market sales of foreign currency by purchase of domestic currency to arrest its fall. No doubt, such absorption of domestic currency would create liquidity problem. With a view to meeting the shortage in domestic money supply, central banks purchase bonds and pump in liquidity. Similar open market operations in opposite directions are resorted to prevent the domestic currency appreciating.

These interventions may not be approved by the puritans, as these interventions amount to "dirty floats". But, they have increasingly become more acceptable from the political economy point of view. All the flexible exchanged rate regimes fall under the description as managed floats.

India is no stranger to these interventions. It has been doing so when needed. It has done it again this time The RBI started intervening heavily soon after the slide started. It sold nearly US$ 2.5 billion and its foreign exchange reserves came down to $423.58 billion in the week of April 20.
During the Asian currency crisis in the 1990s, when the outflow of the US dollar and hard currencies wrecked the Thai economy and began to spread to the ASEAN economies, Malaysia's Dr Mahathir Mohamad imposed several measures of controls on capital movements, one of

which was known as “roach motel policy”. Under this, foreign currency can be checked in, but cannot be checked out! Capital controls were however withdrawn in about year, when macroeconomic stability returned. That was the promise by Dr Mahathir.

Though disapproved by IMF at that time, IMF softened its stand on capital controls over the period. The IMF Chief Horst Koehler (2000-04) observed that the Malaysian decision was the right decision.

As the saying goes, "all is fair in love in war!"

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