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India's currency crisis: Futility of Band-Aid Solutions

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The government finally decided to act much to the relief of all. With the Friday September 14 announcement of a set of five measures to arrest any further fall in the value of Indian rupee in terms of US dollar, the government made its intent loud and clear. It indicated to markets overseas: "Enough is enough."

The rupee fell to the lowest on Thursday. It was close to Rs 73 per dollar. On Friday came the Finance Minister's announcement of five steps.

With signs of escalating tension between the US and Iran, the fear is the oil price would hit the ceiling of $80 per barrel despite assurances that Saudi Arabia, Russia and America could together raise output fast enough to offset falling supplies. Mounting crude oil price has already pushed up value of oil imports in dollar terms and the trade deficit is widening. Given other earnings, the expanding current account deficit of 2.4% of GDP in the April-June quarter as compared to 1.9% in the previous quarter is a major factor behind the depreciation of the rupee.

Defending the rupee, although never aggressively done, was designed more for curbing volatility by supplying dollars for rupees, has already cost the economy over the last four months. The international reserves have come down to $399 billion from the record highest level of $426 billion registered in April.

Government measures

Worried about the seemingly unstoppable trend in the depreciation of rupee, the government announced its solutions on last Friday, September 15.

- Manufacturing units can avail external commercial borrowings of up to $50 million with a minimum maturity of one year instead of three years.

- Removal of exposure limit of 20% of foreign portfolio investment's corporate bond portfolio to a single corporate group.
- For all infrastructure loans, with regard to external commercial borrowings, mandatory hedging conditions will be reviewed.
- For 2018-19, with regard to masala bonds (rupee-denominated overseas bonds), there will be exemption from withholding tax for issuance done in this year up to March 31, 2019.
- Removal of restriction on Indian banks market making in masala bonds including underwriting of masala bonds.

The stress of the first measure was reducing the period of three years to one year and is seen as one of attracting capital inflows quickly rather than on a longer maturing period.

The second measure for waiving hedging is risky, as borrowers are exposed to exchange risks and no one is sure of stability in the immediate run.

The third one relates to debt investment and government wants more debt inflows.

The fourth and the fifth seek inflows of rupee capital and the exchange rate risk is absent. In the current uncertain period, overseas investors with rupees would not be inclined to take any risk in investing in rupee bond. It is unlikely any capital inflows would materialize.

The market reaction was mute and least inspiring. The initial recovery by a few paise was quickly reversed.

Continuing dependency on Private Investment Flows

It appears policy makers are continuing to depend on capital inflows to finance the deficit rather than secure a long term solution. The only solution is to step up exports and provide a long term remedy. India's trade deficit is increasing over last five years. Exports are not growing to match up with imports, which are rising to meet various developmental needs including capital and intermediate goods.

In 2016-17, exports were $275.8 billion; and imports were $384.4 billion giving rise to a deficit of $108.6 billion. In 2017-18, exports were $302.8 billion while imports were $459.7 billion, resulting in trade deficit of $156.9 billion. The 2018 IMF Annual Staff Consultation Mission Report has estimated the trade deficit for 2018-19 would be a close $200 billion, since imports of $ 546.6 billion would exceed exports worth $349.7 billion.

Positive measures

Exports have been rising slowly, 9.8 % in 2017-18, which is noted to be the highest in six years after stagnating for while. On the other hand, imports are growing faster at a close 20% in 2017-18. Curtailing imports through quotas and tariffs, which are often easier, amount to protectionism. They would undo all the good done to the nation by reforms undertaken since 1990-91. If bureaucrats have their way, they would return us to the days of License-Permit Raj!

Instead, there should be positive measures which include refund of pending input tax credits of a few thousand crore rupees to exporters and providing credit to whole range of labour intensive export industries including gems and jewellery, garments and others dominated by micro and small and medium enterprises. In this regard, there is a timely suggestion made earlier in July by Professor Arvind Panagaria, a former Vice-Chairman of Niti Aayog of India. The suggestion is to appoint a taskforce to devise strategies to expand exports.

Implementing this suggestion, rather than spending energy and resources on futile band-aid solutions, would be a better option.

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