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Futile Efforts to Fight Depreciation

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Impact of inflation on the value of a currency has two sides. One side is reduction in the domestic purchasing power of the rupee. The other side is fall in the external value of the rupee, which is known as depreciation. It raises the cost of essential imports, aggravating the inflationary pressures further.

Following the hopeful signs in May 2021 of global economic recovery from the aftermath of the Covid-19 pandemic, restrictive measures including lock downs came to be relaxed. The revival in the aggregate demand was promptly reflected in petroleum crude oil price.The world price of the crude rose from $69/barrel in May 2021 to $79 in September 2021. After some volatility, the price rise was unstoppable from January 2022. From $92, it shot up to $108 in April. It touched $114/barrel in May.

Retail inflation measured on the basis of consumer price index (CPI) has been rising since mid June 2021. India imports 85% of its petroleum crude requirements, which amount to 25% its total imports. Transport costs stemming from rise in retail prices of diesel and petrol, are a major component in the pricing of goods: from farms to factories and from raw materials to finished goods. The retail inflation hit the ceiling in January 2022 at 6%, which is the aimed at by Reserve Bank of India (RBI): 4% with a 2% margin. The monthly inflation data for example, of March are known only in the second half of the following month, April. Hence, the bi-monthly meetings of the interest rate setting Monetary Policy Committee (MPC) of RBI are held in the first week of the month (April, June , August , October, December, February), the policy indicator rate is decided based on old data.

The MPC in its meeting on April 6-8, 2022 decided on the basis of February inflation, namely 6.10%, since March CPI data was unavailable till April 12. As RBI then concluded the breach in the targeted comfort zone of inflation was slight, it preferred no change in the interest rate at 4%.

MPC's emergency meeting

Authorities were shocked, when March inflation data was released on April 12. It was much higher, 7%. Had the MPC met a week later, the decision would have been different. The lesson is obvious: MPC should consider scheduling MPC bimonthly meeting in in the third week of the month.

An emergency meeting of MPC held on May 4 did what was expected for controlling aggregate demand to curb inflation. It raised the the repurchase rate (RPO) at which the central bank lends against bonds from the commercial banks to inject further liquidity into the system, making it costlier for banks to borrow as well as lending to investors and consumers. The RPO was raised by 40 basis points (bps) to 4.40%. The cash reserve ratio (CRR) , the mandatory cash that was to be parked with RBI was was also raised by 50bps. The factors causing steady rise in retail inflation for past seven months were no longer considered "transitory" and but to be longer lasting. They were attributed to " global commodity prices touching historic highs, pick-up in core (fuel and food) inflation, revision in electricity tariffs and the continuing war in Europe." It looks certain the MPC meeting on June 6-8 would raise RPO interest rate by 60bps to 5.0%

The other front

In the context of rupee depreciation following domestic inflation and increases in interest rates by advanced economies, RBI has to open another front for arresting fall in exchange rate. A great deal of hesitancy and a pleasing approach of "extraordinary accommodation" have dented RBI's image of autonomy. Short term foreign portfolio investors have been pulling out funds as in their perceptions that India was not "a safe haven". As macroeconomic indicators deteriorated, the hot money has been flowing out, as investors are rattled by rising exchange rate risks. Further, imports have become expensive causing trade deficits, reflected in the monthly declines in foreign exchange reserves (forex) .

From a record $642 billion in September 2021, the forex level is shrinking. The RBI's latest upward revision of RPO to 4.40% failed to stop capital outflows. The forex level is now $593 billion. The exchange rate as of May 24 is Rs 77.52 per dollar. Towards arresting a further fall in rupee, RBI has been intervening in the market by selling dollars for rupee for making dollar cheaper relative to rupee.

Though there are upsides, long-term in nature though, to depreciation of the currency, such as : (i) exports would pick up, (ii) tourists would rush to India and (iii) make India attractive for foreigners to invest in initial IPOs, the downsides in the short-run weigh more. The costs of imports would be up faster. The response of export sector would not be quick enough. One immediate negative effect is the rupee depreciation will add to inflation.

Limits to intervention

The current forex level is equivalent to 10 months of imports. There are limits to what RBI can do by intervening on the rupee depreciation. Instead, immediate fiscal measures are needed. They include measures such as the recent reduction in central cess on petrol and diesel. There would be loss of revenue. But they would result in early gains. Retail inflation will likely fall, though the impact will be known only in mid July when June CPI data released. In the meantime, the government should curb its own consumption.

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