The Rupee's Fall: Is this time different?*

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All is not quiet on India's external economic front. The rupee seems to be on a trajectory of accelerating decline, with its value relative to the dollar (as per the Reserve Bank of India's reference rate) falling from Rs. 76.4 at the beginning of April to Rs. 79.1 at the beginning of July.

Driving that trend are a range of developments. To start with, India's near-perennial trade deficit has widened in recent months as export growth remained sluggish and imports registered a sharp increase. In June, with exports estimated at $38 billion and imports at $63.6 billion, the trade deficit rose to a new high of $25.6 billion. Over the April to June quarter, while exports rose by 22 per cent in 2022 relative to the corresponding period of 2021, imports rose by 47 per cent. As a result, the trade deficit in the respective quarters rose from $31.4 billion in 2021 to $70.3 billion in 2022.

Compounding the effects of this "loss" of foreign exchange, foreign portfolio investors are pulling out of Indian equity and debt markets, with the net outflow during the first half of 2022 (January-June) estimated by the National Securities Depository Limited at $29.73 billion. Half of that outflow occurred in the April-June quarter. The exit of foreign investors has been in the making for almost a year now. The Financial Times (5 July) cites Goldman Sachs to report that foreign investors have dumped Indian shares valued at a record $33 billion since October last year. Given global uncertainty and expectations of significant increases in policy interest rates by the Federal Reserve and other developed country central banks, investors are booking profits that accrued over a two-year boom in Indian markets and exiting the country.

Finally, the volume of foreign exchange reserves with the Reserve Bank of India (RBI) fell by $14 billion between end-March and June 24, 2022. While a part of this decline is because of valuation changes that account for the depreciation relative to the dollar of other hard currencies held in reserve (such as the euro and the yen), significant contributing factors were the widening trade deficit and the outflow of portfolio capital.

Official spokespersons have held that the depreciation of the rupee relative to the dollar is not as troubling as it is made out to be. Rupee depreciation, they note, is a long-term phenomenon and reflects not just a weakening of the rupee, but also a strengthening of the dollar for 'external' reasons against all currencies. Moreover, it is argued, the recent depreciation has been steep because of short-term factors—such as the spike in oil prices following the Ukraine invasion, which has inflated the import bill, and restrictions on exports, for example of wheat, necessitated by global price trends—that have led to rising domestic prices and falling government stocks. These short-term influences are likely to fade. Meanwhile, since foreign reserves are still at comfortable levels, the central bank should in the interim not have much difficulty in deploying a part of those reserves to counter any excessive depreciation in the value of the domestic currency.

In fact, Duvvuri Subbarao, a former Governor of the Reserve Bank of India, in an interview to the Business Standard newspaper has pointed to the fact that “even as the rupee has depreciated vis-à-vis the dollar, it has actually strengthened against other hard currencies such as the euro and the yen” and that “the RBI should lean towards non-intervention rather than intervention, and allow the rupee to gradually depreciate.” Comparing the situation today with that during the Taper Tantrum of 2013, when the rupee slumped in value following foreign investor exit triggered by fears of interest rate hikes, he held that the macroeconomic situation today is much better, with “more credibility on the fiscal front” and the expected increase in the current account deficit to over 3 per cent this year like to “be a one-off.” In addition, he echoed the sentiment that “foreign exchange reserves at $600 billion” give cause for confidence that was lacking in 2013.

Such confidence, however, may not be warranted. To start with, the high import bill is not on account of higher oil prices alone, but also because of increased imports of commodities varying from gold to coal. Coal imports proved unavoidable because stocks with the thermal power plants had touched unsustainable lows, raising concerns that large scale outages can occur. When pushing for enhanced coal imports despite high prices, the government had suggested that this is a short-term problem created by factors such as unseasonal rains that have affected mining and transportation. But it now appears that India’s coal crisis is the result of the failure of policies aimed at restraining the public sector’s role in coal production and getting the private sector to step in. In practice, while the objective of curbing public sector growth worked, the drive to get the private sector to fill the gap, was a failure. As a result, the Indian power sector’s dependence on imported coal has increased. In fact, the government is forcing use of imported coal by all power plants despite high international prices. Factors such as these could necessitate expensive and large imports in the medium term, keeping the import bill and the trade deficit high, with attendant pressure on the rupee.

But more challenging is the evidence that these pressures emanating from the trade front are being intensified by the drying up of capital flows. In recent years, net capital inflows into India have been more than adequate to finance deficits in the current account of the balance of payments. In most years, the country was left with a ‘surplus’ that contributed to the rising and comfortable level of foreign reserves. But this implied that India’s reserves had been built with foreign exchange liabilities, involving inflows of a kind that were prone to exit at short notice. The principal driver of those excess inflows was the huge increase in cheap liquidity in the international financial system ensured by the easy money policies adopted by advanced country central banks in response to the global financial crisis and the Great Recession that followed. It was becoming clear in recent years that these “unconventional monetary policies” that were feeding global financial speculation with cheap credit had to be unwound. As and when they were, capital flow reversals could occur, and India’s reserves built with the capital inflows that those policies triggered could begin to shrink. That would exert pressure on the rupee.

In recent years there have been three episodes of sharp rupee depreciation—in August 2019, March 2020 and over May-June 2022. In all three instances a common and important driver of the depreciation was the outflow of capital. Fortunately for India, the net exit of capital caused by global uncertainty immediately after the onset of the COVID pandemic was soon reversed, as central banks chose to hold back on retreating from their cheap money policies for fear of aggravating the COVID-induced recession. But now, inflation in the advanced nations, that has defied expectations that it would be transient and has been aggravated by the Ukraine invasion, is forcing a policy reversal—interest rates are being pushed up and bond buying to infuse liquidity has been stopped. The impact on capital inflows to India has been immediate as the figures quoted earlier indicate.

This outflow of portfolio capital has two implications of relevance to the strength of the rupee. First, it ends the excess flow of dollars into the domestic market that had dampened the downward pressure that chronic trade and current account deficits exert on the value of the rupee. Second, it reduces the level of foreign exchange reserves held by the central bank and curbs its appetite to intervene in the market to stabilise the rupee by selling dollars. It does appear that the RBI has not been too keen on resorting to market intervention to stall the slide of the rupee. In fact, despite outflows of capital, foreign reserve assets with the central bank rose, rather than falling, in most months since late 2019. It was only in March 2022 that the RBI was a significant 'net seller' of dollars. This was possibly because it fears that a fall in reserves may send out a signal that the defence of the rupee cannot be sustained. That would encourage speculators to bet that the rupee would fall even further, accelerating the slide.

Seen from this angle the recent and rapid depreciation of the rupee vis-à-vis the dollar does give cause for concern. The drivers of the depreciation are not all short term. The trade deficit threatens to remain high for quite some time. And the excess inflow of capital that propped up the rupee even when deficits widened has all but dried up. In these circumstances, the depreciation may persist, attracting the attention of speculators who will resort to measures that accelerate the currency's decline. This time the story may be different.

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