The Tumbling Rupee*

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The central government's recent decision to raise import tariffs on a range of non-essential items like telecom equipment, precious stones and jewellery, ACs, refrigerators, washing machines etc. has come in the backdrop of the current account deficit rising to 2.4% of GDP in Q1: 2018-19, further up from 1.9% in 2017-18. Through these steps the government expects to compress the external deficit and stall the rupee's ongoing downslide. Will it work in the longer-term?

A Longer View

During the high growth phase of the Indian economy in the last decade, with real GDP growth averaging 8.7% from 2003-04 to 2010-11, merchandise import growth far outstripped export growth and led to a persistent trade and current account deficit. When growth started slowing down and yet the current account deficit continued to widen, peaking at 4.8% of GDP in 2012-13, there was a sharp currency depreciation episode during the "taper tantrum" of mid-2013.

That a rising current account deficit will once again bring the balance of payment under strain, especially with the end of accommodative monetary policies in the United States, was known to the policymakers. Yet the period since the "taper tantrum" was not utilised to seriously address the persistent current account imbalance. With imports falling significantly following the sharp fall in crude oil prices during 2014-2016, attention got diverted from the fact that India's export growth practically collapsed during this period.

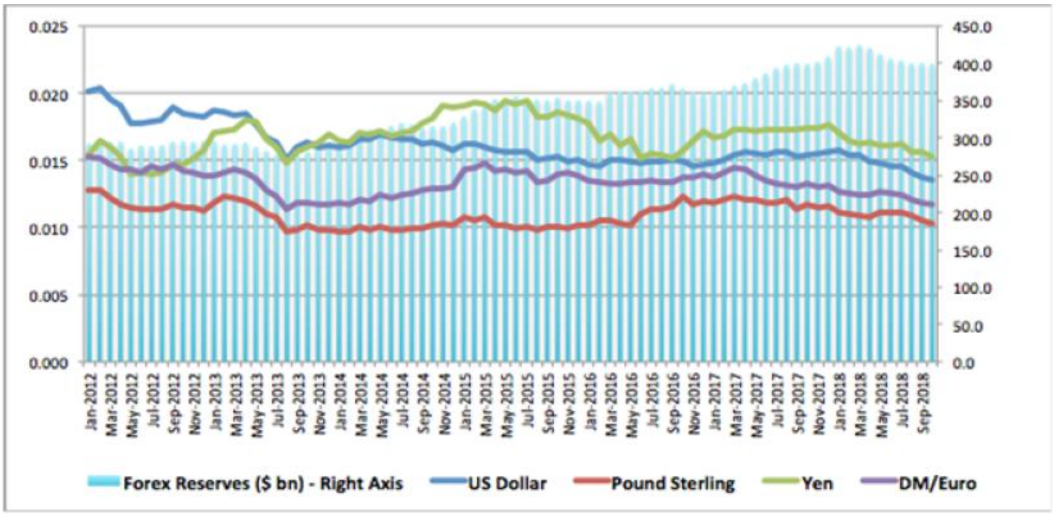
Export performance during 2016-2018 has also been modest, following which the current account deficit started widening in 2017-18, with rising crude oil prices and enhanced non-oil imports like electronics goods, precious stones, coal etc. Moreover, foreign exchange earning sectors like software services exports and remittances have witnessed growth stagnation since 2013-14. The government's "Make in India" thrust has clearly failed in reviving exports so far; rather the digitisation drive appears to have increased import dependence on electronic goods.

A longer view of the rupee-dollar exchange rate shows that while the rupee value remained within the band of Rs. 40 to Rs. 50 per dollar in the period from late-1990s to 2011, it breached the Rs. 60 per dollar threshold during the "taper tantrum" of 2013 and has now crossed the Rs. 70 mark in 2018; there has been an accelerated depreciation of the rupee over the past six years.

Chart 1 reveals two notable features of this phase of accelerated nominal depreciation of the rupee: (i) While the movement of other major international currencies like Euro, British Pound or Japanese yen were not always in tandem with the dollar, they have all moved together during the episodes of sharp depreciations in 2013 and 2018 (ii) Despite India's foreign exchange reserves increasing from a monthly average of around $292 billion in 2012 to $411 billion in 2018, such an increase has neither been able to stall the gradual decline in the rupee's value nor prevent the sharp fall vis-a-vis all major currencies in the current year.

This brings out the inadequacy of foreign exchange reserves, built on the basis of volatile capital inflows, in stabilising the domestic currency in the face of sharp changes in the direction of such flows. The central government should stop bragging about India's foreign exchange reserves touching a "historic high" and realize that in the era of globalised speculative finance, even such historic high reserves cannot prevent currencies from touching historic lows.

Chart 1: Exchange Rates of Rupee with US Dollar, Pound-Sterling, Japanese Yen & DM/Euro (end-Month): 2012 to 2018



Source: Database on Indian Economy, Reserve Bank of India

Chart 2: Indices of Real Effective Exchange Rate (REER) & Nominal Effective Exchange Rate (NEER) of the Indian Rupee (Monthly Average)

Source: Database on Indian Economy, Reserve Bank of India

Note: 36-Currency Bilateral Export-Based Weights; Base: 2004-05 = 100

While the inflationary impact of the rupee's fall, especially in terms rising domestic fuel prices are obvious, what needs an explanation is why India's export performance has continued to remain lacklustre despite long-term nominal depreciation. Chart 2 shows the long-term nominal decline of the rupee vis-a-vis the basket of 36 currencies belonging to India's trading partners, through the nominal effective exchange rate (NEER). It is noteworthy that the real effective exchange rate (REER) index shows divergence with the NEER from 2008 onwards, with the rupee actually witnessing an appreciation in real terms in relation to its export partners. The divergence between the NEER and REER indices indicate that the price level in India has remained much higher than its export partners since 2008, which is one of the reasons why there has not been any J-curve effect on India's export growth and the current account balance. Nominal depreciation is therefore imposing costs while the benefits have remained elusive.

Policy Options

Unless policy measures address the structural problems underlying India's current account imbalance, piecemeal steps like tariff hikes would fail to stall the tumbling rupee. There is an urgent need to bring down the import intensity of the growth process itself in India, besides gradually moving away from high fossil fuel dependence over the longer term. Without such a strategic shift in policies, India's external vulnerability will persist.

India ranks 4th among the top ten NIIP deficit emerging/developing economies, with a negative net international investment position of $425 billion in Q1: 2018 (Table 1). High NIIP deficits add to the external vulnerability of the emerging/developing economies, particularly for those with high net debt liabilities. Chile and Turkey have debt-equity ratios of net liabilities at high levels of 3.5 and 2.4 respectively, while the debt-equity ratios of Mexico, Brazil and India also exceed 1.

Table 1: Debt & Equity Decomposition of NIIP Deficit Countries, Top Ten Emerging/Developing Economies in 2018Q1 (US $ Billion)

	Net Position of Debt	Net Position of Equity	Net Position of Reserve Asset	Net Position of NIIP
Brazil	-559.6	-545.4	375.1	-729.9
Mexico	-433.4	-342.3	177.6	-598.2
Turkey	-391.6	-165.7	110.3	-447.0
India	-431.9	-418.9	424.9	-425.9
Indonesia	-200.2	-253.6	126.0	-327.9
Colombia	-81.7	-118.4	46.4	-153.7
Egypt	-85.3	-107.6	41.9	-151.0
Pakistan	-82.6	-46.0	16.0	-112.6
Morocco	-47.2	-58.4	25.6	-80.0
Chile	-83.1	-23.1	38.1	-68.1

Net Position of Debt   Net Position of EquityNet Position of Reserve AssetNet Position of NIIP

Source: BoP & IIP Statistics, IMF

What adds to India's vulnerability is the bubble in the equity market, which now figures among the most overvalued markets across the world in terms of metrics like P-E ratios. The rupee's downslide in 2018 was a consequence of net foreign portfolio and debt flows turning negative in Q1: 2018-19. The domestic mutual funds have so far provided the counterweight to net selling of equities by the FIIs, through higher net purchases, which has kept the equity boom going. However, the 10% correction in the BSE Sensex in September-October 2018 after a 17% climb between March-August, reflects the instability of the bubble. It is high time to impose some curbs on volatile capital flows, which aids and abets such bubble-building only to inflict currency meltdowns in future.

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