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The Sliding Rupee: Crisis or Opportunity?

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The Indian Rupee's (INR) sudden slide has created panic in the business and policy circles. The major concerns are over whether the almost free-fall will adversely affect the Current Account Deficit (CAD) and inflation. There are also concerns over whether a depreciating rupee will increase the fiscal deficit by increasing expenditure on subsidies and jeopardise the repayment schedule for external commercial borrowings (ECBs).

The Indian government has been putting up a brave face assuaging the market, investors and industry about the volatility being short-lived. The Finance Ministry and the Reserve Bank of India (RBI) appear largely unruffled by the episode. Till now, the RBI has not made any major interventions to shore up the rupee by selling US dollars in the open market, except a minor exercise on 11 June 2013. The Finance Ministry, on the other hand, appears confident about the rupee stabilising over the next two-three months.

How drastic has been the fall? On 11 June 2013, the rupee dropped to 58.92 against the US dollar (USD) before pulling back a bit. Exactly a year ago, on 11 June 2012, the rupee was at 55.24 against the USD. The year-on-year decline marked an annual depreciation of 6.7 per cent. The fall, however, has not been gradual. Rupee had fallen to a low of 57.21 against the USD on 27 June 2012. It had steadily recovered thereafter to climb to 51.61 against the USD on 5 October 2012. After remaining range-bound at 52.0-54.0 against the USD for more than

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six months, it weakened to 55.03 on 20 May 2013. Since then, the drop has been rather sharp over the last three weeks.

While much of the hue and cry has been over the rupee's fall against the USD, it has depreciated by an almost equal amount (6.8 per cent) against the Euro and to a greater extent against the UK pound (12.0 per cent) during the last one year. Surprisingly, however, it has appreciated by 13.6 per cent against the Japanese Yen during the same period. Indeed, looked at against a basket of major currencies as revealed by the RBI's nominal effective exchange rate (NEER) indices (both 36-country and 6-country), the depreciations during May 2012-May 2013 are almost minimal.[2] This might explain why the Government and the RBI are not unduly agitated over the development.

Nonetheless, a sharply sliding rupee does have its downsides particularly if the fall continues unabated. Most of the concerns expressed in this regard are valid. India's already high CAD (at 6.7 per cent of GDP in the third quarter of 2012-13) can widen further due to a weakening rupee. This can happen with imports becoming more expensive, particularly crude oil imports, which will accentuate the trade deficit. Inflation can be another casualty apart from the CAD. If the Government refuses to 'pass through' higher import prices to domestic consumers by increasing subsidies (fuel and fertiliser), the rather delicate fiscal deficit will come under more pressure. A weakening rupee will also increase debt service obligations and make repayment of ECBs more expensive for corporates.

A closer look at the factors pulling down the rupee points to changes in the US dollar as a proximate trigger. The 7.0 per cent depreciation in the value of the INR against the USD since 20 May 2013 has been provoked by an appreciating dollar. With macroeconomic data from the US showing signs of recovery, US bonds have suddenly recovered their attractiveness. This has prompted the FIIs to pull out funds from emerging market economies for investing in US bonds. In markets like India, this has led to a sudden shortage in supply of dollars making them dearer with respect to the local currency. Future signals from the Fed suggesting a gradual withdrawal from an expansive monetary policy might strengthen the dollar even more.

While the dollar has acted as the trigger, the large volatility in rupee also reflects the macroeconomic imbalance building up in the external sectors of the Indian and other emerging market economies through the high CADs. The Rand (South Africa), Real (Brazil) and the Rupiah (Indonesia) have depreciated almost as much as the rupee in the last few weeks, along with the Mexican and Chilean pesos. Most of these economies have CADs

[2] Indices of Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) for the Indian Rupee; *Monthly Bulletin*, Reserve Bank of India, Mumbai, India, June 2013; rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/36T_BUL100613F.pdf (Accessed on 11 June 2013)

higher than 5.0 per cent of their GDPs.[3] These high-CAD emerging markets are more susceptible to currency volatility since financing the CADs requires large doses of dollar-denominated capital inflows. Once these inflows reduce, excess demand for dollars for bridging the CAD makes dollars scarcer and sharply increases their value against local currencies. India is a typical example.

Import compression can help in the above situation by reducing the demand for dollars. Unfortunately the two strongest imports pumping India's trade and current account deficits – oil and gold – appear unstoppable. Crude oil is a necessity and cannot be compressed. Higher customs duties discouraging crude oil imports will be a retrograde measure given the high domestic demand. The Government has increased customs duties on gold with the hope that it will reduce gold imports. But given the insatiable appetite for gold in India, the measure might end up in only increasing retail gold prices and encouraging smuggling.

Should the Government therefore wait and watch the rupee dip further? In a sense, the room for manoeuvre is limited given that direct intervention by the RBI through sale of dollars is only a stop-gap arrangement. Foreign exchange reserves of around US$ 290 billion are not a huge pile for supporting continuous market intervention. The cure probably lies in measures for addressing the burgeoning CAD.

One of the suggestions doing the rounds is issue of tax-free NRI (Non-Resident Indian) bonds. These bonds, similar to the India Millennium Deposits (IMD) issued by the State Bank of India (SBI) in 2000,[4] can attract non-reversible capital flows from the diaspora for financing the CAD, increase the supply of dollars in the economy and arrest the slide in the rupee. But while these bonds are attractive options for NRIs given their high coupon rates and arbitrage opportunities, the RBI and other Indian banks might not be too keen on them, as the foreign exchange outgo at the time of their redemption might be rather substantial.

What policy makers would be hoping is for the FIIs to retain faith in the Indian economy and remain net buyers of Indian equities to ensure regular inflow of dollars. That, however, cannot happen in vacuum and would require some policy action. If NRI bonds take time to be finalised, the Government can always contemplate more concessions in FDI by raising ceilings on long-term foreign investment in specific sectors such as telecom and insurance. The RBI also can affirm its faith in the country's long term-growth outlook by cutting interest rates for reviving investment, instead of refraining from doing on the ground of a falling rupee increasing inflation. The depreciating rupee is also an opportunity for several exporters to increase their overseas business and policy measures for encouraging exports is another feasible option.

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[3] 'Bernanke Sneezes, Rupee gets the flu', Sajjid Chinoy, The Financial Express, 12 June 2013; http://epaper.financialexpress.com/124612/Indian-Express/12-June-2013#page/8/2 (Accessed on 12 June 2013)

[4] The five-year foreign currency deposits issued for NRIs in dollar, pound sterling and euro had fixed rates of interests. They were preceded by the Resurgent India Bonds and India Development Bonds issued in 1998 and 1991 respectively.

The sliding rupee does not require hitting the panic button. But the right buttons have to be hit for re-attracting capital at a time when it is deserting emerging markets like India. By choosing the right buttons, the Indian policy makers can convert the falling rupee into an opportunity for cutting CAD and restoring the somewhat precarious health of India's external sector.

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