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The Fall of the Indian Rupee and the Unholy Trinity

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Let us begin with an anecdote first – last year, Lehman Brothers predicted that the Indian rupee (INR) would appreciate to Rs36 per United States dollar (USD) by the end of 2008. Ironically, the former investment bank did not anticipate that it would not be around to witness the reversal of its predictions. This signifies the limitations of currency forecasting.

Following the volatilities in oil and other commodity markets, currencies around the world have had a roller coaster ride in recent months. The USD surged to a 15-month high vis-à-vis a basket of major currencies. The Japanese yen (JPY) has been the strongest currency in the currency markets while commodity currencies such as the Australian dollar (AUD) and the Canadian dollar have witnessed a free fall. The INR, the South Korean won and the Indonesian rupiah have been the worst performing currencies in Asia in recent times.

This brief looks at the reasons behind the fall of the INR followed by an assessment of the economic implications of the currency depreciation on South Asia's largest economy. It also revisits the behaviour of the Indian currency (for the period of 2006-2008) and contends that it is very likely that the INR fluctuations are here to stay, largely owing to the iron triangle of international finance.

The Fall of the Indian Rupee: Causes

The INR recently breached the psychological mark of Rs50 per US$. The currency has lost its values substantially, both in nominal and real terms, notably against the USD and the JPY. Only about one year back, the INR-greenback exchange rate was Rs39.26 per US$. What has caused the marked downward spiral of the INR?

In recent months, fluctuations in low interest rate currencies such as the JPY[1] and high interest rate currencies such as the AUD have been heavily subjected to carry trade.[2] In the case of the INR, the evidence is less sanguine.

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[1] Indeed, the impact of carry trade on the JPY has been so strong that it has broken down the long-standing strong positive correlation between USD/JPY and the Japanese trade balance.

[2] This is a popular trading strategy used in the foreign exchange market. It consists of selling low interest-rate currencies (funding currencies) and investing in high interest-rate currencies (investment currencies).

The unexpected strength in the USD relative to a basket of six major currencies, known as the USD index, outflow of foreign institutional investments (FIIs) from the Indian market, the country's widening trade deficit, and the significantly lower flow in external commercial borrowings (ECBs) by Indian corporate houses, *inter alia*, have caused the depreciation of the INR.

The USD index has strengthened 17 percent over the past quarter.[3] As the financial crisis spreads to the emerging markets, the money is moving to the United States in search of a safe haven, despite mounting credit and other economic malaise in the world's largest economy.[4]

Moreover, there is an inverse relation between oil prices and the USD. As the developed world is in a recession and most emerging markets prioritise inflation check over growth, there is a big fall in oil and other commodity prices.

The Indian equity market has witnessed a rapid withdrawal of portfolio investments in the last few months that instigated, among others, the free fall of the Indian stock markets.[5] The Reserve Bank of India (RBI) reports that, during the first quarter of 2008-09, there were portfolio investment outflows by FIIs in the order of US$5.2 billion, compared to a net inflow of US$7.1 billion during April-June 2007.[6] According to data from the Securities and Exchange Board of India, international investors sold a record US$13.5 billion in Indian equities this year as at 24 November 2008.[7] The net ECB was only US$1.6 billion during April-June 2008, as against US$6.9 billion a year ago.[8]

However, foreign direct investment (FDI) statistics show a different trend. India received US$19.3 billion in FDI as at September 2008. Inflows under the American depository receipts, global depository receipts and non-resident Indians deposits were higher during April-June 2008 than the corresponding period last year.[9]

Although exports of both primary and manufacturing products recorded a higher growth in the current year than in the previous year, the trade data for the first quarter of 2008-09 showed a widening merchandise trade deficit, as the growth of imports (33.3 percent) outpaced that of exports (22.2 percent). Higher commodity prices, notably oil, have widened the export-import gap. Merchandise trade deficit widened to US$31.6 billion during the first quarter of 2008-09. However, the gross invisible receipts recorded US$37.7 billion, a year-on-year increase of 29.7 percent. Nevertheless, the current account deficit amounted to US$10.7 billion in the first quarter of 2008-09, according to the RBI.[10]

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3 The Hindu Business Line, 19 October 2008.

4 According to the Emerging Portfolio Fund Research, the United States equity funds witnessed an inflow of US$42 billion in the third quarter of 2008, the United States Money Market Funds attracted roughly US$40 billion, and the US Bond Funds drew US$8.9 billion in the same period. (The Hindu Business Line, 19 October 2008).

5 The BSE Sensex declined from the peak of 20,873 on 8 January 2008 to 10,170 in October 2008.

6 Statement by Dr D. Subbarao, Governor, Reserve Bank of India, on the Mid-Term Review of Annual Policy for the Year 2008-09.

7 http://www.bloomberg.com/apps/news?pid=20601091&refer=india&sid=aHK4FwcVc2jM

8 Statement by Dr D. Subbarao, Governor, Reserve Bank of India, on the Mid-Term Review of Annual Policy for the Year 2008-09.

9 Ibid.

10 Ibid.

The dynamics in the current and capital accounts resulted in a decline in India's foreign exchange reserve – it stood at US$245.8 billion as at 21 November 2008.[11] The reserve reached more than US$313 billion at the end of April 2008. Moreover, the RBI had to intervene in the foreign exchange market by selling the USD and buying the INR to curb the rapid fall in the INR.

All these factors placed huge pressures on the INR, and the currency depreciated by 18.9 percent vis-à-vis the USD, 19.1 percent against the JPY, and 0.4 percent against the Euro in nominal terms during the current fiscal year (as at 22 October 2008).[12]

The Fall of Indian Rupee: Implications

The northbound or southbound of a currency is a common phenomenon in an economy such as India which is quite integrated with the global trade and finance.[13] Moreover, the RBI pursues managed float exchange rate policy.[14] However, what worries the stakeholders in the economy is the pace of appreciation or depreciation of the INR. Extreme volatilities in the currency market hurt exporters and importers who do not find adequate time to hedge against currency risk. For instance, a study shows that, in the period of 2004-2008, 96 out of 124 industry indices exibited signs of a bet on the INR appreciation.[15]

Theoretically, the fall of the INR could benefit India's exports sector and discourage imports. Individuals (for instance, study loan) or corporate houses who have taken the foreign currency loans expect to be adversely affected.

There had been a hue and cry among Indian exporters last year when the INR appreciated markedly as they were worried that the country's currency appreciation could erode its export competitiveness. As the financial crisis spreads all over the world, Indian exporters are expected to experience negative price and revenue shocks. The INR deprecation is a welcome relief for them. However, the benefits of currency depreciation depend on how much it depreciates in real terms. For instance, the real effective exchange rate (REER) which is calculated by adjusting the nominal effective exchange rate (NEER) for inflation differentials with the countries whose currencies are included in the basket vis-à-vis the domestic currency is the actual measure of the rise and fall in a country's currency.

The RBI and the Bank for International Settlements data show that, from October 2007 to September 2008, the INR has depreciated 14 percent and 16 percent respectively in nominal terms or NEER, whereas in real terms or REER, the depreciation has been only 7 percent and 8.5 percent respectively. These numbers are hardly surprising as India has been experiencing a higher inflation level vis-à-vis its major trading partners. The real benefits of the INR depreciations on the Indian exports are, thus, not that high as they sound.

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11 Ibid.

12 Ibid.

13 Trade, one of the important indicators of global integration, has risen markedly as a proportion of GDP; net FDI has been growing at a good pace; and capital inflows, as a percentage of GDP, though volatile, have markedly increased during this decade.

14 The rupee exchange rate is neither completely free-float nor fixed, but is "managed" by the Reserve Bank of India which is governed by broad principles of careful monitoring and management of exchange rates with flexibility without targeting a pre-announced rate on a bank, coupled with the ability to intervene if and when necessary.

15 Patnaik, Ila and Shah, Ajay (2008), 'One Way Bets on Pegged Exchange Rates', available at <http://www.nipfp.org.in/nipfp-dea-program/PDF/SP2008_onewaybets.pdf>, accessed on 3 December 2008.

Nevertheless, the INR depreciation is expected to have a positive impact on India's manufacturing and info-technology services sectors, among others. As India imports 70 percent of its crude oil needs and follows an administered pricing, the INR depreciation has significant implications for the sector. The drop in oil prices have benefited, except for inventory losses,[16] the country's oil refining and marketing companies such as Hindustan Petroleum, Bharat Petroleum Corporation Limited and Indian Oil Corporation. However, the INR depreciation has affected them adversely. It is reported that although crude oil price corrected by roughly 57 percent in dollar terms, it contracted by 52.5 percent in real terms owing to the nine percent fall in the INR in the last four months.[17] As a result, the breakeven point for the oil marketing companies has pushed back further. With Rs41-42 per US$, the crude oil's cut-off was US$67-68 per barrel which has been revised to US$59 as INR depreciated to Rs49-50 per US$. It is estimated that for every Rs1 decrease in the value of the Indian currency against the USD, the annual under-realisations of these oil marketing companies' increases by around Rs3,000 crore.[18]

It is expected, at least theoretically, the fall in the INR will discourage the country's imports to some extent. However, the flip side of this fact is that it is not good news for the companies whose exports contain high-import contents. Moreover, the fall in capital machinery imports followed by currency depreciation indeed adversely affects a country's productivity. Further, the currency depreciation can countervail the RBI's fight against inflation, though the drop in oil price is a big solace for the country.

The INR Fluctuations and the Unholy Trinity

As India's financial markets have undergone significant liberalisation and the economy relies on international markets for capitals, gone are the days of a stable INR. The reason is that it is not possible for a country to have free international capital mobility, a fixed exchange rate and an independent monetary policy. Economists call the phenomenon 'unholy trinity' or 'impossible trinity' which essentially means that one of three things has to change, that is, either one reduces capital mobility, or adopts flexible exchange rate policy; or abandons monetary control.

In the face of huge capital inflows in 2006-08, the RBI had to intervene in the foreign exchange market by sterilising the inflows through the market stabilisation scheme (MSS), increasing cash reserve ratio, etc. Now with the reversal of the capital inflows and widening trade gaps, the RBI faces the same unholy trinity. The country's central bank's dilemma is either to allow the currency to depreciate and maintain the current level of interest rate; or to intervene in the foreign exchange market (buy the INR and sell the USD) but to accept the tightening liquidity conditions in the market.

To ease the tight liquidity conditions, the RBI has responded several times in the last few weeks by reducing key interest rates, unwinding the MSS-liquidity stocks and relaxing the ECB norms. As the global liquidity condition is extremely tight and the outlook for India's current account remains bleak, it is expected that the liquidity conditions in India will remain

[16] As the crude oil prices in the international markets plunged, the worry emerged in the form of inventory losses. The reason is the companies' oil stocks were brought at higher prices that severely affected their financial health. It is estimated that the oil importing companies' combined losses stood at Rs13,000 crore in the second quarter of FY2009.

[17] The Business Standard, 17 November 2008.

[18] Ibid.

stiff despite the RBI’s several liquidity support measures. As the country’s monetary authority has little choice but to intervene in the foreign exchange market, the liquidity support measures may not completely offset the tight liquid market which is a result of foreign exchange intervention, among others.

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