

The Slide of the Rupee Is Bernanke Responsible?

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us Federal Reserve Chairman Ben Bernanke's statement appears to have caused a free fall in the value of the rupee, or so the Reserve Bank of India would have us believe. But the value of the rupee vis-à-vis the dollar has been declining since August 2011. The economy will have to settle for a protracted slow growth or high growth with high inflation. Else we will have to consider a radical reorientation of policy.

The Indian rupee has been falling in value quite consistently over the last two years. However, since early May 2013, there has been a significant 10% fall in its value leading to a historic low at Rs 60 per dollar by the end of June 2013. A slightly medium-term view tells us that between mid-June 2011, when its value was Rs 44 to a dollar and end of June 2013, it has fallen by a staggering 27%. The Reserve Bank of India (RBI) and the Ministry of Finance have been quite prompt in apportioning the blame of this drastic fall on a recent announcement made by the United States federal reserve chairman, Ben Bernanke, who said that there might be an end in sight for the quantitative easing in the us. This would mean that the us would gradually be tightening its monetary stance by increasing its federal funds rate. This, the RBI holds, has led to a flight of capital from India to the us. This commentary looks critically at this simplistic and erroneous argument of the RBI. We argue that this fall in the rupee is more a reflection of a structural problem in the current and the capital accounts of the Indian economy than of announcements made by Bernanke.

BoP and the Exchange Rate

To understand the forces at hand, we need to discuss the determinants of the exchange rate itself. In this respect, there are two relevant relationships to focus on: (a) foreign asset-market equilibrium; (b) account of the balance-of-payments.

In line with the Mundell-Flemming model, the workhorse of open economy macroeconomics, the asset-market equilibrium shows that the returns on domestic financial assets should be linked to its international counterpart. One could ask, why linked and not equal to? This is so because unlike its international

counterparts, in particular a federal security of the us, domestic financial assets in a third world country like ours carry with them a "country risk" for which the international rentiers need to be paid a premium.

But what does this risk premium depend on? It depends on the perception of international financiers on how safe investments in these countries are. Among other things, it could depend on: (a) the expected depreciation of the domestic currency; (b) backup in the economy to withstand capital flight (measured by the amount of foreign reserves the domestic economy holds); (c) how non-interventionist the government is (measured by whether the government is reining in its fiscal deficit); (d) how investor-friendly its capital account is (read a measure of swiftness with which capital invested can be withdrawn). Let us briefly look at them.

International financiers bring money in their own currency, let us say dollars, and convert it into rupees to invest in financial markets in India but what matters to them ultimately is the dollar return on the asset. So, it is not just the current exchange rate but their expectation about the future exchange rate that goes into the decision-making. Let us say they bring in \$100 and the current exchange rate is Rs 50/\$ and the nominal rate of return is 8%. At the current exchange rate, they expect to make \$8 (Rs 400 on an investment of Rs 5,000, a total of \$108). If they expect the exchange rate to depreciate to Rs 60 per \$, their total investment plus return in rupees would amount to only \$90, and they end up losing 10% of their capital. So, a mere expectation of depreciation for international financiers can lead to capital flight out of the domestic economy. Such an expectation gets aggravated especially if there is an actual depreciation taking place. In situations such as these, the central bank has to work overtime to allay the fears of international financiers. One of the ways in which the central bank does this is by keeping more than a buffer amount of foreign exchange reserves in its coffers (as is the case with the RBI today).

A higher fiscal deficit “scares” international capital away for two reasons. It represents a more interventionist government, which could potentially act on behalf of its people by reining in private capital. A higher fiscal deficit to them also means a curtailment of private investment through “crowding-out”, although the veracity of this concept is questionable. Similarly, a more investor-friendly capital account minimises their risk in taking their money out at short notice.

While a floating exchange rate is a flex-price equilibrium in the currency market, a fixed exchange rate is a fix-price equilibrium, and a managed-float is a combination of the two. The latter is the Indian case. So, the RBI intervenes in the foreign exchange market if the rate goes out of the exchange rate band it wants to maintain. The exchange rate within the band gets determined by the demand for and supply of foreign exchange. While imports of goods and services, outflow of capital and addition of foreign reserves in the coffers of the RBI represent the supply of the rupee (and demand for the international currency), exports and inflow of capital represent the demand for the rupee (and supply of the international currency).

If the ex ante supply of the rupee (demand for international currency), i.e., current account deficit, rises, technically speaking, the adjustment has to take place either through (a) an increase in the net capital inflows; (b) running down of reserves by the RBI; or (c) a nominal depreciation (fall in the price of the rupee). However, of these three possibilities, it is invariably the third that bears the burden of adjustment. This is typically so for a third world economy such as India, because the capital inflows are primarily exogenous given that they are determined more by international financiers than by the demand of the current account of an economy (Patnaik 2013). For example, in 2007-08, net capital inflows were over 9% of the gross domestic product (GDP), while the current account deficit stood at just 1.5%. As for the second factor, for reasons explained above, the RBI tries to avoid running down the reserves unless the situation

deteriorates drastically. So, the burden of adjustment falls on the exchange rate as is happening in the Indian economy today.

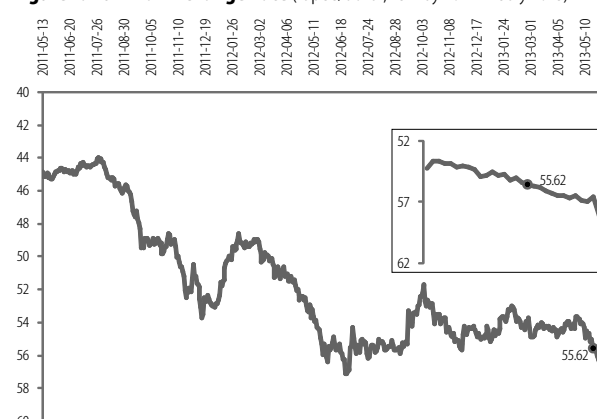
With this background, let us look at the official explanation versus an alternative one, which has also been pointed out by Chandrashekhar (2013), Ghosh (2013), and Patnaik (2013).

The Official Explanation

The official explanation, seen in the light of the above discussion, is essentially a capital account story. The RBI has argued that the announcement by Bernanke, which hinted at the end of quantitative easing, pushed expectations up regarding interest rates in the us. In the absence of a corresponding rise in rates of return in India, capital outflow happened, which led to a significant depreciation of the Indian rupee.

Credible as it may seem on the face of it, there are some problems with this argument. First, the rupee had started

Figure 1: Nominal Exchange Rate (rupee/dollar, 13 May 2011-11 July 2013)



Source: Table H 10 (Foreign Exchange Rates) US Federal Reserve.

depreciating much ahead of the announcement made by Bernanke on 22 May 2013 (see inset in Figure 1 where the marker indicates the date of the announcement). In fact, in a slightly medium-term view, it started depreciating even as the policy of quantitative easing was taking place in the us. To be precise, depreciation of the rupee started in August 2011 with some intermittent appreciation in January and September 2012 (Chandrashekhar 2013). Second, the rupee has depreciated (and continues to do so) not just vis-à-vis the dollar but all major currencies

like the pound sterling, yen and euro (Ghosh 2013, Chandrashekhar 2013). Third, at a more fundamental level, even if one were to accept the RBI's argument, it is the government and the RBI which have tied themselves to a regime of international finance where the highs and the lows of it determine the fate of the value of the rupee. So, they cannot put the blame on external factors, when the government has by choice made the country vulnerable to the caprices of international finance.

An Alternative Story

Instead, the current story of depreciation needs to be looked at keeping in mind both the current and the capital accounts. While the current account deficit is a structural problem facing the country, the mode of financing it is equally important, specifically whether the latter is non-debt creating and long term (Table 1).

In the case of the current account, three factors have played a role. First, with the slowdown in the us and the euro markets, the demand for exportable goods and services has taken a beating. Second, the imports have not followed suit because a significant part of it, oil, is a necessity and a part, gold, is a luxury good. While imports would fall eventually with the fall in the level of activity in the economy, there is a lag between

Table 1: Balance-of-Payments (in \$ billion)

	April-March 2011-12	April-March 2012-13
I Current Account Balance	-78.2	-88.2
II Capital Account (net)	65.4	92
(a) Foreign Investment (I+II)	39.2	46.7
(i) Foreign Direct Investment	22.1	19.8
(ii) Portfolio Investment	17.2	26.9
(b) External Commercial Borrowings	10.3	8.5
(c) Banking Capital	16.2	16.6
(d) Short-Term Trade Credit	6.7	21.7
III Change in Reserves [I+II]	-12.8	3.8
IV Valuation Change (Due to Depreciation/Appreciation)	2.4	-6.2
Total (III+IV)	-10.4	-2.4

Source: Press Release of the RBI, 27 June 2013.

the fall in the exports and imports. This is so because exports of a country are a function, apart from the real exchange rate, of the income of the importing country whereas its imports are determined by domestic income (ability to purchase imports). If there is a lag between the trajectories of incomes of the two categories, as seems to be the case today, because the global crisis has first hit the markets of the countries India exports to, then it is hardly surprising that the trade deficit is widening in the short to medium term. Third, the remittances from non-resident Indians have taken a hit too as a result of the crisis in these countries. Because of these three factors, the current account deficit has been rising in the case of India over a significant period of time (Table 1). This means a higher supply of rupees to buy dollars in the market, which would, independent of the capital outflow, lead to a depreciation of the currency in the absence of a central bank intervention.

The linkages between the current account deficit (CAD) and capital account can be seen as follows. First, a higher current account deficit has also had a negative impact on the expectations about the depreciation of the rupee, thereby, affecting net capital inflow adversely. Second, as the RBI governor, Duvvuri Subbarao, had said recently that, “we are financing our CAD through increasingly volatile flows” (see the increase in portfolio investment and short-term trade credit as opposed to the fall in foreign direct investment to finance the increased CAD between the two periods in Table 1). Third, an important component of the capital account that has scarcely been under discussion in this context is the external commercial borrowings. Bose (2013) has shown that when the capital inflows peaked in 2007-08, 52% of it comprised net debt inflows primarily on account of external commercial borrowings by Indian corporates and banks. A higher external debt is as repelling for international finance as domestic debt, which could affect short-term flows adversely. Bose (2013) says, “The widening current account deficit and its financing [through debt creation and short-term capital

inflows] pose a key challenge to India’s macroeconomic and financial stability.”

And finally, the role of the RBI, which is sitting on a pile of foreign reserves far in excess of the norm, should come under scrutiny. Traditionally, a central bank would have intervened and released the reserves in the market to prevent the exchange rate from falling. But in the current context, these reserves are nothing other than white elephants which the central bank maintains to keep the confidence of foreign investors high. So, there is quite a paradox here. While the reserves are maintained for the purposes of preventing such a free fall of a currency, they cannot be used for this purpose precisely because it would aggravate the problem!

Conclusions

So, is it a picture of continuing gloom for the Indian economy? We believe so. First, there are hardly any signs of the global crisis abating in the near future, which means the export prospects are not going to improve any time soon.

Second, on the import front, India is doomed both ways. If the growth rate in India declines further, which might mitigate the current account deficit problem because of a decline in imports, it would come at the cost of loss of employment and growing misery of the people. On the other hand, if the growth rate does pick up, it would, given the first point, aggravate the current account problem by increasing imports and further devalue the rupee.

Third, depreciation of a currency in countries where imports enter as necessary raw materials in the production of final goods leads to inflation because these enhanced costs just get passed on in final product prices. So, even though the oil prices in dollar terms might be stagnant, a depreciation of the rupee increases their rupee prices and, through forward linkages, the price of other commodities. This is especially so in the case of deregulated oil prices, which the government has so enthusiastically followed.

Fourth, even the prospect of an improvement of the current account through the exchange rate channel is limited because it requires (a) a real depreciation

of the currency, and (b) this substitution effect to dominate the income effect resulting from declining incomes abroad. For a real depreciation to happen, however, the domestic prices should not rise in tandem with nominal depreciation, the possibility of which is limited because imported raw materials enter as costs in final goods prices.

In other words, there is a possibility of either a protracted period of slow growth in the Indian economy or a growing economy with high inflation with a threat to its currency unless the international situation improves.

Could something else have been done? First, the current account problem could have been curtailed by reining in speculative gold hoarding by propertied classes in India, but the response was too little too late. Second, instead of a clamour for more reforms in the financial sector and the capital account, which would make both the inflow and outflow of hot money easier and aggravate the problem, there should be restraint on this count. Third, in the medium to long term, import intensity should be curtailed through structural changes in the growth process of the Indian economy, by moving away from the current job-displacing elite-based demand trajectory towards a more job-creating mass-goods demand trajectory (Patnaik 2013). But all of these, or other such steps, require not just sound economics but cutting the umbilical cord with international finance, a step which entails a political reorientation of the government.

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