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Pressures on the Indian Rupee

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The Indian rupee fell to an all-time low of close to 64 to the US dollar on Tuesday 20 August 2013, and the Indian media as well as well as the analysts have been extremely critical of the policies announced by the Government of India. The Government, on its part, is pointing to the exit of funds across all emerging markets as US yields are set to rise, and is putting all the blame on external factors.

There is some truth in both the averments.

Financial markets across emerging markets did fall significantly, and Tuesday 20 August saw a significant fall in markets in Malaysia, Hong Kong, Singapore and Indonesia. Indian markets had fallen steeply on 14 and 19 August, and the fall on 20 August was comparatively less. Investors and funds expect an announcement from the US Federal Bank that the quantitative easing and the era of easy money are over. US growth figures have started to improve, and any such announcement would result in increasing interest rates in the United States, and financial flows would move towards such improved returns. There is some good news coming out of the European Union, especially from Germany, and signs of recovery are likely to brig funds back in. When compared to global financial flows, investment in the

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emerging markets is comparatively small. Indian financial markets are considered shallow and small by international markets, and the total investments have been only around 1.5% of all global fund allocations. Any pull-out of even a couple of billion dollars from Indian markets in a day is likely to result in a significant fall in the equities index. In addition, there is a growth in negative sentiments about the state of the Indian economy. As a consequence, the Indian markets have had a decline of close to 12% in Indian equity market indices just in the week of 14-21 August.

In addition, there has been the concern in India about the volatility in the exchange rates, the current account deficit, and the growing inflation. From 15 May to 16 August, the rupee lost 12.6% and Nifty lost 10.4%: one of the worst three-month periods in 20 years. The exit from the rupee is, in part, related to exit from financial markets. The current account deficit is very high, at over 4% of GDP. India is a major importer of energy, both oil and coal, and there is a huge demand for gold imports – these three commodities account for close to 40% of all imports.

Gold imports in terms of value stood at $56 billion for 2011-12, $40 billion in 2010-11 and $28 billion in 2009-10.[2] "The rise in imports of gold is one of the factors contributing to India's high trade deficit and CAD in 2011-12, forming 30 per cent of its trade deficit", India's Minister of State for Finance, Namo Narain Meena, has said in the *Lok Sabha*, the country's Lower House of Parliament.

On oil imports India's oil import bill in terms of value increased from Rs. 409,077 crore in 2009-10,[3] to Rs. 726,386 crore in 2011-12:

Import Bill from 2009-10 to 2011-12 (Prov.)						
	2009-10		2010-11		2011-12 (Prov.)	
	Quantity (MMT)	Value (Rs crore)	Quantity (MMT)	Value (Rs crore)	Quantity (MMT)	Value (Rs crore)
(A) Crude oil import	159.3	375277	163.6	455276	171.7	672220
(B) Product import	14.7	33800	16.8	52106	15.0	54166
Total Import(A+B)	174.0	409077	180.4	507382	186.7	726386
(C) Total product Export	51.0	144229	59.1	196862	60.8	284643
Net Import (A+B) – (C)	123.0	264848	121.3	310520	125.9	441743

2 *The Hindu* April 26, 2013
3 Press Information Bureau of India press release August 23, 2012

The figures for the current account deficit (CAD) are also quite revealing.[4] In the first quarter of 2013, the CAD was US$ 18.10 billion.

TRADE	LAST		PREVIOUS	HIGHEST	LOWEST	FORECAST		UNIT
CURRENT ACCOUNT	-18.10	2013-03-31	-32.63	7.36	-32.63	-14.69	2013-06-30	USD BILLION
CURRENT ACCOUNT TO GDP	-4.80	2012-12-31	-4.20	1.50	-4.80	-4.88	2013-12-31	PERCENT
EXTERNAL DEBT	345819.00	2012-12-31	305931.00	345819.00	75858.00	349301.29	2013-12-31	USD MILLION
FOREIGN DIRECT INVESTMENT	1954.00	2013-05-15	2802.00	5670.00	58.00	2488.33	2013-06-30	USD MILLION
REMITTANCES	7845.07	2013-02-15	8173.09	8549.25	5999.10	7401.50	2013-06-30	USD MILLION
TERMS OF TRADE	113.00	2011-06-30	91.00	113.00	77.00	114.74	2011-12-31	INDEX POINTS
BALANCE OF TRADE	-733.33	2013-07-15	-715.31	13.91	-1111.46	-740.74	2013-08-31	INR BILLION
EXPORTS	1544.27	2013-07-15	1389.02	1678.36	3.75	1439.41	2013-08-31	INR BILLION
IMPORTS	2277.60	2013-07-15	2104.33	2475.94	4.98	2263.72	2013-08-31	INR BILLION

The figures reveal imbalances in the last year in foreign investment, balance of trade as well as external debt. Foreign investments have been heavily into short-term flows to financial markets. Long-term investment (FDI) flows into the real economy of goods and services have not been significant. Outflows from the financial markets, coupled with serious trade imbalances, have put pressure on the rupee, which has slid against the dollar.

The responses to these events appear to have been *ad hoc*. Duty on imports of gold has been hiked to 10%, and all sales of gold bars and coins to retail customers have been banned, on the argument that these purchases have been for purposes of hoarding. Channels of finance have been cut drastically, with only exporters and jewellery makers having relatively easy access. This has helped, going by the government data on import of gold, though one is not really sure whether the harvest and festival season will cause a reversal.

On 13 August, there were announcements on curbs on outflow through remittances. Companies were earlier allowed investments overseas up to four times their net worth, which has now been curbed. Individual remittances overseas were reduced to US$ 75,000 per annum from the existing US$ 200,000 per annum. A ban on purchase of real estate overseas by individuals has been imposed. Add to these restrictions an outward FDI, and the measures have been fairly stiff. The next target could be non-essential imports, which cannot be ruled

4 http://www.tradingeconomics.com/india/current-account

out considering that a very determined Finance Minister P Chidambaram has averred with certainty that the CAD will be at 3.7% just as the fiscal deficit will be at 4.8%.

It is not clear whether these steps are likely to have the desired effects. Imports are lower at this time because these months are not the marriage season, but with the festive season ahead, imports and the consumption of gold are likely to go up. The curbs on gold are likely to drive the gold trade underground, and the *hawala* route for gold and currency exchange are likely to come back in full force, as prevalent prior to 2002.

The Reserve Bank of India has simultaneously squeezed liquidity by tightening the CRR norm, half-closed the LAF window, sold bonds through OMOs, introduced weekly CMB auctions to ensure that no speculative positions are taken in the forex market on account of arbitrage opportunities. This worked in a time frame of 1-2 days, after which it appeared to be a 'fall as usual'.[5] The NDF market has been held responsible at some point of time, but all legitimate participants have to inform the RBI of their actions, and while the volumes are substantial in this market, the impact would be low, as it is only the difference in price that has to be paid for, which will impact the spot market locally. The forex derivative market which is mainly on NSE and MCX-SX have witnessed volumes halve in the last month with curbs being placed on margins and position limits.

The RBI had sold US$1.8 billion up to June (the number would be higher in July) while foreign currency reserves have declined by US$8.4 billion. The decline in reserves is symptomatic of the decline in the value of the rupee, while the sale of dollars by the RBI indicates that this also has not really helped. Quite clearly, the sentiment factor has been working in pushing the rupee down.

Media and analysts' concern over the last few weeks has been the lack of coherence in Government policy. This has added to the negativity of sentiments about the economy. Once there is an additional curb on imports, the Government would have put in place all that is possible from the point of view of fundamentals. Speculative activity has been addressed, especially through the institutional route.

Stepping back, there are several points to be noted in this developing story.

Firstly, sentiments appear to be riding ahead of facts. There is little evidence that the Indian economic story is any different from what it was in May 2013, or that Government decision-making is any poorer than last year. However, market sentiments, as well as flight of FIIs, possibly due to US growth improvement, have added to the negativity of sentiments. A number of large corporates have been openly expressing reluctance to invest in India, and there have been no signs of improvements in FDI. These negative sentiments are not borne out by numbers, as the foreign exchange reserves still stand above US$ 290 billion, enough for over six months of imports (as against two-weeks' cover back in 1991).

[5] The RBI has reversed its position on 21 August, and returned to Open Market operations to buy back bonds and infuse liquidity in the markets—a clear sign that that the earlier decision was not well thought out.

Secondly, the actions of the Government have been perceived as retrograde. A striking feature of recent months was the willingness to reverse reforms. The gains of the last 22 years in the form of reduction of controls, removal of harassment by customs, currency trading at exchanges, outward capital flows for households and firms, have all been given up. “The reversal of reforms on trade, capital controls, financial development and the operating procedure of monetary policy are a body blow for optimism about India. We used to think that while India reforms slowly, changes are irreversible once they are made. Now, we see that the hard work of decades can be undone in moments and that decision makers are not embarrassed about central planning”.[6] This is indeed a serious concern that Government would look back to its economic policies of pre-1991 to correct the current situation.

Third, there is the pressure of domestic inflation as well. The Planning Commission in India has argued that wages in income in the rural areas have risen much faster than prices, and thus inflationary impact for the rural population has been negligible. However, India has been urbanising rapidly over the last decade; and the young, in employment, are increasingly in urban areas, and wages have not kept pace with inflation. The fixed-income-earning middle class appears to be bearing the brunt of rising prices. In particular, food inflation is affecting all those on fixed incomes. The Reserve Bank of India has been concerned about inflationary pressures, and its steps to tighten liquidity and to keep interest rates unchanged have signalled its concern over inflationary pressures. The Ministry of Finance, on the other hand, appears to be less concerned about this and more about growth and rupee volatility and there is clearly a lack of coordination between fiscal and monetary stances.

In balance, it does appear as though that there have been some errors of policy. It is clear that there is no significant dent in the Indian growth story, even though the growth numbers may be less than what they have been in the period 2003-2008.The fundamentals of the economy remain sound. Perhaps it would have been better not to try to defend the rupee and to allow it to find its own level, while at the same time taking measures to improve the output in the economy. The depreciation of the rupee is an opportunity to improve exports, and either through lower interest rates for exporters, or through lower input tariffs for value-adds, there is an opportunity to provide fiscal as well as monetary incentives to exporters. Automobiles and ancillaries, pharmaceuticals, light engineering, textiles and garments in the manufacturing sector and all value-added IT-based services would benefit from such targeted relief measures that would improve exports. At the same time, supply side measures to improve production and output in sectors where demand pressures are high would open up opportunities for greater output, growth and therefore greater balance between supply and demand. It is worrying that even in this crisis; there are no announcements of supply side measures, even though the Finance Minister has been repeatedly talking about supply constraints. Finally, capital allocation to infrastructure, and some decisions to keep infrastructure projects on track, would revive sentiments and confidence in the economy.

6 Ajay Shah, Economic Times 21 August 2013.

The India story is still intact, and requires only a few governance-based decisions to set the economy back on track. It is unclear whether the Government has the strength to follow through.

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