Printed from
THE TIMES OF INDIA

Juggling The Rupee

Jul 29, 2010, 12.00 AM IST

It is a pity that just when the rupee has had a makeover with an exclusive new symbol of its own, its value on the home front is rapidly eroding. Today, the rupee will buy only about 80 per cent of what it would have bought two years ago; less if you are buying food. Are its prospects brighter on the external front? Will the value of the rupee appreciate or depreciate? The short answer is that nobody really knows.However, we do know the main determinants of the exchange rate, and these can point us towards the long-term trend. Start with the current account balance, the difference between the value of exports and imports plus the net inflow of income from services, remittances and investment incomes. India has typically had a current account deficit. Given its high growth relative to trade partners, India's imports will continue to grow faster than exports and the current account deficit may continue to widen over the next few years.

Prior to the post-1991 reforms, when foreign investment was negligible at 1 per cent of the current account deficit, the widening of the current account deficit would have been enough by itself to signal that the rupee would depreciate. Today, the story has changed. By 2007-08, the last normal year before the 2008 financial crisis, foreign investment had risen to over $43 billion, almost two and a half times the current account deficit. Hence, the quantity and quality of foreign investment is now a major determinant of the exchange rate.

The most stable form of foreign investment is foreign direct investment. The other component is portfolio investment. This footloose capital trawls the world in search of high returns and usually vanishes when economies come under stress. However, as the 2008 financial crisis gathered momentum in the US, the pattern was reversed. Wall Street firms pulled their money back into the US in their struggle for survival. Over $14 billion in portfolio money flowed out of India in 2008-09, causing the stock market to crash and pulling the rupee down at the same time. Unfortunately, this volatile form of investment accounts for the bulk of foreign investment in India.

The country is back on a strong growth path and the RBI has just raised policy rates to dampen inflationary pressures so portfolio investment will now increase, driving up both stock prices and the exchange rate. But any faltering of recovery in the US, including knock-on effects of the European sovereign debt crisis, could also reverse this trend. Over the long haul, portfolio investment will continue to drive exchange rate volatility. But this should be around a rising trend value of the rupee if market forces are allowed to reflect the strong growth fundamentals of the economy.

This trend would be reinforced by the balance of two other closely related factors, India's stock of foreign exchange reserves and external debt. Apart from foreign investment, varieties of debt flows add to the country's reserves. These flows are double-edged, adding to the stocks of both reserves and external debt. International investors closely monitor these aggregates. India's reserves were negligible at $6 billion when the country launched its economic reforms in 1991, but it grew to a peak of $315 billion by 2007-08. The accumulation of reserves has resumed after a temporary drop during the financial crisis of 2008. Though small compared to China's $2.5 trillion, India's reserves are still the fourth largest in the world. Moreover, the reserves are larger than India's total external debt, about seven times its short-term debt and enough to cover eight months of imports. Thus, the overall reserve position is very comfortable, leading to a progressive improvement in India's credit rating.

Clearly, market fundamentals would suggest that the long-term value of the rupee should appreciate. However, such appreciation could seriously hurt the competitiveness of Indian exports. It should be no surprise if the RBI, the custodian of India's exchange rate policy, leaned against the wind to prevent such appreciation as China has done for many years. The announced policy is a managed float: allowing the market to determine the exchange rate, with market interventions to prevent excessive exchange rate volatility or any sudden depletion of reserves. We should then expect an orderly and gradual appreciation of the rupee. The observed pattern however is quite different.

Temporary fluctuations apart, the nominal value of the rupee has consistently depreciated against the dollar, the main valuation currency, over the past 40 years. The cost of a dollar has risen from Rs 8 in 1980-81 to over Rs 46 today. However, adjusting for cross currency value movements and inflation, the trade weighted real effective exchange rate turns out to be remarkably stable around an average six-currency index of around 105. Thus, whatever the announced policy, RBI interventions have in effect maintained a stable real value of the rupee. This has been achieved by allowing the nominal value of the rupee to depreciate, offsetting India's higher inflation rate relative to its trade partners. This trend is likely to continue unless market forces grow so strong that they overwhelm the capacity of the RBI to lean against the wind.

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