The fall in the rupee's value has to be moderated without interfering with fundamental trends

How to Stand By Its Slide

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The scenario relating to the rupee is undergoing a fast change. Even as late as January, there have been complaints about the appreciation of the rupee and its adverse impact on exports. In January, the Real Effective Exchange Rate (REER) of the rupee stood at 121.57, a clear appreciation.

Things have since changed with a steady decline. The US dollar, worth ₹63.64 in January, rose to ₹65.64 in April and, as of now, it has touched ₹68.02. The REER declined to 115.89 by April. Numbers for May will be available only later. By April, REER declined by 4.7% from January. Is this depreciation a cause for concern? Or, is it a process of natural adjustment?

Globally, two significant factors are influencing world trade. First, President Donald Trump's initiative to safeguard US interests by raising tariffs. This has been partially retaliated by China even as things have not yet developed into a full-fledged trade war. Fear, however, exists and it has an impact.

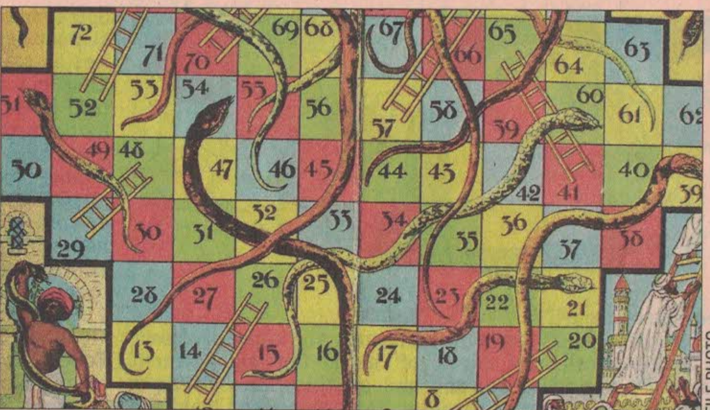
The second is the rise in crude oil prices. This again has roots in US foreign policy. Crude oil prices have touched $79.38 a barrel against $69.08 in January. The impact of this is very much seen on India's balance of payments. The trade deficit stood at $13.7 billion in April. There is apprehension that if this trend in crude prices continues, India's current account deficit (CAD) will touch 2.5% of GDP in 2018-19.

Fall In Rupee Value Justified

In the days when capital flows were 'accommodative', to use an expression coined by Nobel-winning economist James Meade, the exchange rate was determined by the CAD. It was then that the 'purchasing power parity' theory held good. This is no longer the case. Capital flows are much more 'autonomous' than they are 'accommodative'. Thus the nominal exchange rate may remain the same, or even appreciate, even when the current account is in deficit. In short, the exchange rate that equilibrates the currency market is not necessarily the rate that will equilibrate the current account.

There have been many instances in recent years when the rupee has tended to appreciate despite a substantial CAD. In 2010-11, for instance, India's CAD was 2.8% of GDP. In that year, the Nominal Effective Exchange Rate (NEER) went up to 93.54 from 90.94 in the previous year. REER rose to 112.7 from 103.9 in the previous year. In fact, in 2011-12, when CAD was as high as 4.2% of GDP, REER went down only to 110.3.

If we have to bring about a greater balance in our trade account, it is important to neutralise the impact of capital flows and bring down the rupee's appreciation in real terms.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The ups and downs and ups... of life

What we are witnessing in relation to the exchange rate of the rupee now is the impact of capital outflows as well as the rise in trade deficit.

The rupee is in a correction process. Thus the decline in its value is justified. The decline, however, has to be moderated and made smoother without interfering with the fundamental trends. That is where the availability of reserves matters. We have today close to $420 billion in reserves. The participants in the market also need to cover themselves. However, a depreciating currency will have an adverse impact on capital inflows. Foreign investors will need a still higher return.

BoP Under Control

India's balance of payments has been under control in most of the years since liberalisation. In the last few years, it has been facilitated by the fall in crude oil prices. The capital flows were also adequate, except in the first half of 2013. In fact, it is ... flows than CAD.

As the trade deficit begins to rise because of sharper rise in crude oil prices, the exchange rate will depreciate unless compensated by larger capital flows. The latter is unlikely to happen. Therefore, one must accept the fact that the rupee's exchange rate will fall as crude oil prices remain high.

A CAD of the order of 2.5% of GDP is high, particularly if it is sustained. It is, therefore, imperative to bring it down. Which is why the task of raising our exports gains urgency. In this effort, exchange rate adjustment will help.

But the true answer to reducing India's trade deficit lies in improving the overall competitiveness of our exports, both of goods and services. Improved infrastructure, both in terms of transport and power, is critically important. Indeed, in constraining the appreciation of the rupee in real terms, an important consideration ...