The Slide of a Floating Rupee: What Should and Shouldn't Be Done?

The RBI should refrain from stepping in. The central bank should instead keep a careful watch on India's CAD levels and the government's fiscal consolidation efforts in the run-up to the 2019 elections.
The rupee’s value as against the American dollar briefly breached the 72-mark this week. Since the beginning of this year, the rupee has already depreciated by more than 10% and the trend is likely to continue over the coming months.

While it is far too early to use words like ‘currency crisis’ or ‘currency crash’ to describe the recent phenomena, any observable range of 18-20% currency depreciation (over a given year) is usually considered a red zone for developing economies in discussions around crisis economics.

Still, amidst all the news about the currency’s rapid fall, it is important to take a step back and see what underlying factors are causing the rupee to depreciate now; How corrective measures to check for currency depreciation may counter-productively hamper growth (at least in the short-run); and What can be done?

At first, it is important to acknowledge that the rupee, for at least two years, has appeared to be overvalued in comparison with other emerging market currencies aiming to push for greater exports. One of the reasons for the rupee’s lack of competetiveness (or overvaluation) has been due to the increasing confidence reflected in Indian financial markets by foreign investors who have invested heavily in India via means of foreign institutional investment (FII) or foreign direct investment (FDI).
An increase in foreign investment boosts demand for the rupee which subsequently increase its value over time. A higher relative value of the currency further causes prices of Indian products in foreign countries to rise over time. While this trend negatively impacted India’s exports, one probable (or accidental) reason for letting the rupee stay overvalued can be explained by the fact that as domestic private investment levels continued to dip over the past few years, the pressure for the government to keep aggregate investment levels optimal (for higher production capacity) seem to have remained skewed in favor of enticing foreign investors.

**Reasons for depreciation**

The current depreciating trend of the rupee certainly owes much to the dynamics of external (or exogenous) factors. US interest rates continue to rise in order to attract more inward foreign capital investment, affecting emerging market currencies (as US investors would prefer investing in US markets to get higher returns on their investment).

As global capital gets sucked in by US markets, asset prices and exchange rates across emerging markets become increasingly volatile and remain fragile. In such circumstances, for emerging markets, keeping a close watch on the volume of leverage (debt); their Current Account and Fiscal Deficits remains key.

However, in the Indian context, a rise in US interest rates is not the only factor that makes matters worse for the rupee. India’s current account deficit (CAD) has been sharply rising due to increased import costs and less export revenues. The CAD is expected to go up to 2.5%-3% of the GDP in the current financial year. Some may even argue that the earlier overvaluation of the rupee made exports much less competitive and therefore exacerbated the CAD. A higher CAD in an environment of tightening financial conditions (and increasing US interest rates) is always likely to make matters worse for India’s macroeconomic stability in the future.

**What must (mustn’t) be done?**

An important question to ask now is, what can the RBI do to correct or check for the rupee’s current depreciation? Or rather, should the RBI do anything at all?
The central bank’s standard policy towards managing exchange rates has been to ensure the rupee operates as a floating currency. Consequently, it would intervene only at times to reduce volatility and not target for any fixed range or any particular level. Technically, this does make sense as RBI (since Raghuram Rajan’s term) has emphasised clearly on a mandate to use monetary policy tools to ensure low inflation (via inflation targeting) and not intervene too much in managing exchange rates (except in times of emergencies).

At this point, even if the RBI intervenes by raising interest rates, this is likely to adversely affect growth and restrict credit growth and liquidity requirements for the domestic private sector, which is already a concern India faces.

In fact, the 2013 episode of the RBI-led exchange rate intervention while having high internal imbalances should act as a cautionary note at this point against any intervention. The central bank knows that it's better to use a wait-and-watch approach to let the currency slide and then allow it to float (say, at a parity of 75 rupee-dollar mark). In 2013, both inflation and CAD levels were significantly high as external factors allowed the rupee’s value to rapidly depreciate (with a high demand for the American dollar). The internal imbalances thus amplified the problem for the rupee then.

However, in the current context, our internal situation (as compared to 2013) is better. Inflation levels are much lower (thanks to a flexible inflation targeting system by RBI) and we have adequate dollar reserves to deal with any form of a currency crisis (i.e. if the rupee depreciates by 20% or so).

**Foreign currency reserves question**

While it is difficult to estimate actual foreign currency adequacy levels in dealing with a medium to long-term contingency, a simple way to answer this question is by knowing whether RBI has enough reserves to cover costs for three-four months of imports and short-term debt, which it appears to have.

What is more important to watch out for the RBI in the coming weeks are two things. One, India’s CAD levels shouldn’t widen or slide further. And two, the government should continue with its path towards fiscal consolidation, without increasing too much of its unproductive expenditure via subsidies or loan waivers.
Therefore, both things require the government to remain macro-prudent in an election year and push for greater exports. To ensure the first, the government must cash in on a depreciating currency which is likely to make the value of Indian goods/services go down in the international and regional markets. Export-intensive policies for small and medium scale products remain key here in ensuring a manageable current account deficit.

For the second, the current fiscal deficit target set by the Centre remains around 3.3% of GDP (was around 6% of GDP in 2011-12). Staying the course is critical for the government to ensure macroeconomic stability for the rupee to stay afloat.

In other words, at this point, the RBI is better off not intervening in the rupee’s depreciation but rather keep a close eye on its foreign currency reserves, the current account deficit levels while closely monitoring government’s efforts in moving towards fiscal consolidation.

For the government, ensuring an export-intensive push for goods and services (via time-sensitive policies) and managing a better fuel-subsidy cost management (i.e. to manage rising petrol prices as a result of currency depreciation) remains vital for ensuring macro-economic stability.

To keep the rupee competitive (even at 75 rupees/$), it would be unfair to load off any adverse spillover effects of a currency correction on consumption of essential goods, particularly for lower income groups.

Moreover, with a weak domestic private investment position and a heavily stressed public banking system, tackling these challenges will be a tight-rope walk for the government and the RBI needs to keep a close eye on government’s measures.

*Deepanshu Mohan is assistant professor of economics at Jindal School of International Affairs, O.P. Global Jindal University.*