The Fall of the Rupee*

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The rupee's current tendency to fall is hardly surprising. India's growth experience, unlike China's, was built on the quicksand of a more or less persistent trade and current account deficit on the balance of payments. But there was always enough financial inflow not just to cover the current account deficit but even to add to our foreign exchange reserves. Initially this inflow was stimulated by the sheer fact of the economy's being opened up to such flows: wealth-holders abroad got a chance to diversify their portfolios by buying into hitherto- unavailable Indian assets. Later, the higher interest rates in India were an attraction, especially when the Federal Reserve in the U.S. pushed interest rates there down to near-zero levels for reviving the U.S. economy after 2008.

But two things have changed: first, the U.S. has started raising its interest rates; and, second, Trump's protectionism, which reins in U.S. firms locating plants abroad to import to the U.S. (and offsets their loss through such protectionism by substantial corporate tax cuts), while allowing free global financial flows, has put a question mark over the future of neo-liberalism, causing much uncertainty. For both these reasons finance is flowing back into the U.S., which it considers a safe "home base", raising the dollar vis-à-vis other currencies, notably the rupee.

What is surprising is not the rupee's tendency to fall, but the absence of any government intervention to support it, even though the inflationary consequences of the rupee's slide, via higher prices of imported crude, which have a direct bearing on the lives of the working people, are palpable. Some measures no doubt have recently been announced, but they are much too feeble, as is obvious from the subsequent slide of the rupee.

The argument of many which perhaps also influences the government is that the falling rupee will eventually reach an equilibrium level; but this is wrong. The falling rupee, in the absence of any government commitment to support it at a particular value, creates expectations of a further fall, which makes finance move out, and causes an actual further fall. This process can go on and on without ever reaching any equilibrium.

There has been no historical stability in the external value of the rupee (even when there has been no actual foreign exchange crisis), to which expectations can be tethered. At the beginning of the 1990s the value of the rupee was 20 to a U.S. dollar; now it is 72. And this nominal depreciation far exceeds the relative rise in prices in India compared to the U.S., which means that the real effective exchange rate of the rupee vis-à-vis the dollar has also secularly depreciated. With nothing to tether expectations, a downward spiral in the exchange rate would not stop.

Two factors will strengthen this tendency. One is the very fact of inflation caused by the falling rupee. Since any inflation generates expectations of a depreciation in the nominal exchange rate, such depreciation has a self-propelling effect. The other is the fact that several Indian companies have borrowed abroad to take advantage of the lower interest rates that were prevailing there; a depreciation of the exchange rate raises the value of their liabilities relative to assets; and the financial stress they face will create a tendency for speculative capital to leave Indian shores, and hence cause a further actual depreciation, which would further compound the problem. This is an echo of what underlay the East Asian financial crisis of the late 1990s.

But, it may be thought, the depreciating rupee would have the effect of closing the trade deficit by making our goods more competitive vis-à-vis foreign goods; and as this happens, the speculators would stop expecting any further depreciation and would therefore no longer take out any more funds, so that the process of depreciation will automatically come to a stop, unlike what I have suggested. The effect of an exchange rate depreciation on the trade deficit however, even if in the right direction, takes long to work; and speculative capital outflows meanwhile can cause havoc to the economy before any equilibrium can possibly arrive.

Awaiting an equilibrium that never comes would not only keep squeezing the working people but would eventually make the government run to the IMF and other financial institutions in panic; and the "conditionalities" they would impose by way of "austerity" measures would be disastrous for the people, reminiscent of the bind that countries like Greece have got into.

The government must therefore intervene to stabilize the rupee. Such intervention acts in two ways. First, it directly stems the rupee's slide; and second, the government's resolve makes speculators believe that the rupee would not fall below the limit set by it, which also acts to stem outflows and stabilize the rupee.

But how should the government intervene? Raising interest rates, the obvious tool, lowers activity, aggravates unemployment, and hurts small producers in particular. Fiscal compression likewise hurts the people. Using foreign exchange reserves results in their depletion; and as they get depleted, speculators' belief in the government's ability to hold the rupee to a particular value starts getting eroded, causing outflows that again generate a downward spiral. Merely using foreign exchange reserves therefore is not enough. There have to be direct restrictions of inessential imports, combined, as and when it becomes necessary, with some controls on capital outflows. The government has recently mentioned controlling inessential imports, but nothing concrete has emerged.

Such control is not as drastic as it sounds. In 2013, during the previous episode of rupee's slide, the government had imposed controls over gold imports for stemming this slide, as it felt that the rupee's fall was pushing wealth-holders from rupees to gold. Supplementing the use of foreign exchange reserves with measures of direct control so that the rupee is held at a particular value is essential; it would also curb speculative outflows. The government must give up chasing the will-o'-the-wisp of an equilibrium to stabilize the rupee and control inflation.

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