ISAS Brief

No. 241 – 22 May 2012

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Performance of the Indian Rupee: A Comment

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The Indian Rupee has depreciated by around 22 per cent since August 2011, and is hovering around the 55-56 mark with reference to the United States Dollar. It has declined sharply since March 2012, and there has been considerable anguished comment about the reasons as well as the foreseeable trends in the value of this currency.

At the top of the reasons cited is India's worsening current account deficit. Trade imbalances have increased, with negative trade balances with most of the major trading partners including China, the US and the Gulf Countries. Currently, the deficit is around four per cent of the Gross Domestic Product. Since a significant quantity of capital flows are short term, into the financial markets, any volatility can increase the risk of financing the deficit.

The Government has identified imports of gold as one of the sources of this imbalance, but this might not be the only culprit. The large energy imports envisaged, of oil, coal and gas, are likely to exacerbate the pressure on the current account. The budgeted figure for energy imports in Fiscal Year 2012-13 is around US $80 billion, an all-time high. Lower crude oil prices could be positive for the current account deficit — a $10-decrease in oil prices can decrease the current account deficit by 0.5 per cent of the GDP. However, the additional pressure this year is the very large coal imports that are being planned. The inability of the state-owned coal sector to ramp up coal production to meet the growing demands of the newly commissioned power generation plants is leading to increasing reliance on coal imports. In FY 12-13, coal imports for power generation are likely to exceed 120 million tonnes — an enormous expense and logistics management problem as well.

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There is yet another liability — that of over US$100 billion of liabilities of corporate overseas borrowings that need to be refinanced or repaid in the next 18 months. This would place considerable pressure on the reserves.

In addition, there has been a decline in foreign exchange reserves as well. In May 2011, the reserves were adequate to cover 11 months of imports — that is now down to six and a half. The current account deficit, coupled with volatility in the financial markets that has kept the equity and commodity markets volatile, has prevented the institutional investors from taking any but very short-term positions in the market, and the equity market, as a result is in a serious negative territory. The only support for the foreign exchange reserves appears to be coming from inward remittances, which continue to be healthy.

If we add to all this the concerns over poor governance, the large fiscal deficit, the reluctance to rein in subsidies, and the poor image that the Government has overseas, the inflationary pressures on the economy etc., it is not surprising that analysts are looking at it as a serious problem for the economy. It is also apparent that short-term measures like duties on gold imports and liberalizing investments by FIIs (Foreign Institutional Investors) in local currency debt are unlikely to provide any long term relief. The Finance Minister of India has admitted to the media that he is worried about the depreciation of the rupee.

Amidst this gloom, it is possible to take a different perspective about what is happening and to draw some conclusions about future expectations. First, the decline of currencies, especially those of the emerging markets, against the US Dollar, has been happening for some months now. There is a renewed confidence in the USD, given the dismal news from the euro-zone countries and the steady revival in manufacturing in the - US. Corporate results in the US have also been encouraging, and though consumer demand is still sluggish and job creation poor, the output of the US economy has been steadily expanding since August 2011. The uncertainties in China have also helped strengthen confidence in the US Dollar. The decline in the values of emerging market currencies mirrors the rise in confidence in the USD. The stepwise reduction in values in the Brazilian and Indian currencies is very similar, except that the Indian rupee has fallen much further.

In terms of managing the currency, the Reserve Bank of India (RBI) has been unique in that it has been following a flexible exchange rate policy in the last couple of years (except for the heavy intervention in the three months to January 2012). The current stance is significantly different from the rigid stance of the pre-1991 period. This flexible stance led to a significant REER (Real Effective Exchange Rate) appreciation since 2009, and in part, the current depreciation mirrors the expected correction. From this point of view, the flexible approach of the RBI is likely to help resolution of the problem, and not likely to be the problem itself. The INR/USD equation appears to be close to its long-term trend, and barring shocks from the euro-zone, the indications are that the Indian Rupee depreciation is close to its final adjustments.

There is also positive news from the trends of oil and gas prices. The emergence of the US as a major oil producer with surplus of associated gas has, on the one hand depressed spot market prices of gas. On the other, it is likely to reduce US dependence on imported oil and thus reduce volatility in oil prices. Given the large subsidies that the Indian Government is committed to in the oil and gas sectors, this would be a relief. Of course, concern over coal prices and power tariffs would remain, but in terms of value, oil and gas imports would put a greater burden on resources than coal.

There are also clear signs of fresh investments in the economy. In the automobile and auto ancillaries sector, there are several new players as well significant expansions of capacity that are taking place. The appreciation of the US Dollar has also led to increasing outsourcing of components to the Indian manufacturers, and the light engineering industry with all the associated electric, electronics industries. Japanese investments are increasing, with an increasing number of small and medium-size Japanese manufacturing firms setting up facilities in India. There is resurgence in the pharmaceuticals, textile and chemicals industries.

The Delhi Mumbai industrial corridor and the Chennai- Bengaluru link are likely to see substantial local and foreign investment in manufacturing, infrastructure construction as well as urban management. A number of power projects would get completed in the next 15 months, adding close to 45,000 MW of fresh generation capacity.

Campus hiring continues to be buoyant, with job offers from IT firms being matched by offers from infrastructure project firms. Real estate construction, especially retail housing, continues to grow rapidly. The growth of 7 per cent or above is not a myth, and is being driven by serious consumer demand that is leading to growth in the services sectors as well as in manufacturing. In short, there are no signs that the India story is over.

However, it is also clear that there are several issues that can be tackled only by the Government. These include incentives to improve exports, sorting out issues related to coal production, fast-tracking infrastructure projects, etc. Also needed is clarity on reduction of subsidies, increasing prices of petrol, diesel and gas and greater control over expenditure.

There is considerable resilience in the economy, which can bounce back on some positive news of lower interest rates, better fiscal prudence or some signs of improved governance. While the underlying story is still strong, sentiments would continue to remain depressed unless there are some clear positive signals from the Government.

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