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Just about two weeks ago, the rupee went down in value and touched ₹76 per US dollar. The factors responsible for depreciation of the Indian currency are the focus of this article. In fact, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) had already finished its three-day bi-monthly meeting much earlier, on December 8. It decided to continue its cheap money policy. The Repo rate at 4% which is the policy rate, serving as the lighthouse signal for all commercial banks and other institutions in the financial sector was fixed 20 months ago, for boosting aggregate demand. The objective was primarily to promote investment and raise consumption for meeting the adverse effects of Covid-19 pandemic induced recession.

The MPC was confident that all was well with the economy, as several sectors were seen returning to pre-pandemic levels of activity. The apparent signs of recovery were encouraging. However, it appeared that the RBI's decision to maintain the status quo of easy money policy was based on the assumption that consumer price index (CPI) and wholesale price index (WPI) inflation, which were due to high retail prices of petrol and diesel in recent months, would fall in November, following the cuts in central excise as well as in VAT by some states. Other assumptions were the newly announced supply incentives in November and seasonal corrections in prices of winter vegetables and fruits would help.

The hopes did not materialise. The bad news was received just a week later, on December 13 and 24. The usual mid-month inflation data based on CPI and WPI came as rude shocks. The November WPI based inflation was the highest at 14.23%; and the CPI based inflation was also up. It reached 4.91% rising from 4.52% in October and 4.40% in September. The CPI inflation, which is the target of RBI's monetary policy,

was above 4% - although it was within the permissible range, plus or minus 2%.

The MPC meeting of December 6-8 relied on a three-week old inflation data of November 13 and 14. That would raise a question sooner or later whether RBI would consider holding the bi-monthly MPC meeting in the second fortnight of the month.

An economic "pandemic"

The world is now realizing they are in for a 'new' pandemic. Though the new variant of Covid-19 virus, the Omicron is considered more virulent, experts have some comforting words that a more intensive and more rapid coverage of population with two doses of vaccine would reduce severity of any infection; and an additional booster shot for the elderly, and the usual masks, social distancing and other precautions should be adequate.

What is feared most is the impact of the likely faster normalization of monetary policy in the advanced countries, with rise in interest rates on the rest of the world. In the US, supply disruption and shortage issues and rise in rents and wages have pushed inflation from 5.4% in June to 6.8% in November. In Euro-zone, Germany registered the highest inflation, at 6% in November, which was the highest since 1997. Both countries as well as others in the Eurozone target 2% for conducting their monetary policy.

Economists Tobias Adrian and Gita Gopinath of IMF recently noted in their blog that in the context of supply-demand imbalances with uneven recovery, some sectors manufacturing automobiles and computers experienced shortages in the supply of semiconductors and chips resulting in supply

chain disruptions while demand for finished products was outstripping supplies. They noted that in such circumstances, the monetary policy stance aimed at supporting recovery could only fuel substantial and persistent inflationary pressures. Their advice is that in countries where economic recovery is under way with rising inflationary pressures, it would be necessary to accelerate the normalization of monetary policy.

The US Federal Reserve (the Fed) and other central banks seem to have finally moved away from their often-professed stand that inflationary pressures were transitory and soon they would vanish. They have now recognized the realities. The US Fed has begun charting a path to wean the economy away from cheap money by ending its bond-buying programme. In the early weeks of the coming New Year, we can see the lift off of interest rates from near zero held since March 2020. Just a week before Christmas on December 17, the Bank of England became the first central bank to raise its interest rate. It raised its bank rate to 0.25% from 0.10%. Governor Bailey observed that though Omicron was already hurting the economy, BoE was compelled to “stop the recent jump in prices from becoming a longer-term problem”. The choice is between growth and price stability.

Factors behind falling value of the rupee

The decline in rupee in mid-December to a historically low value is due to growing uncertainties in the minds of speculative investors. The uncertainties relate to RBI's stand in regard to the mandatory goal of price stability, especially in the light of the Fed's announcements that it would soon end quantitative easing and the divergence between the US Fed and central banks in advanced countries and India. Fearing a rise in interest rate differential between the returns, hot money flows to India were seen reversing. There are growing apprehensions that any delay by RBI to adjust to new external conditions would spell disaster in terms of outflow of capital in response to widening interest rate differential as well as the diminishing loss of credibility in RBI's approach to price stability as primary objective.

Now, we have another bad news: the trade gap in November, \$ 22.90 billion, the highest in two decades. Macro-economic factors do matter. Current account deficits which are given rise to by trade deficits negatively affect the external value of rupee, just as inflation reduces the domestic purchasing power reducing the domestic value of savings. That is amounting to loss of domestic value of the rupee. The risk loving foreign institutional and portfolio investment funds seek higher returns with predictable stability. They tend to move in and out at the click of the mouse. During the 2013 taper tantrum, foreign investors pulled out \$11 billion from the Indian markets.

Turning to trade deficits, we have only bad news to report: the trade gap in November, \$ 22.90 billion, is the highest in two decades. Depreciation of the currency is a double edged sword. While depreciation of the rupee would render exports

cheaper to overseas importers and thereby promoting exports, India's exports have a narrow range relative to China's and they are not certainly manufactured consumer exports. On the other hand, depreciation would make essential imports, including petroleum crude more expensive, which in turn contribute to the widening of trade deficits. On balance, India will be losing much more in the event of falling value of Indian rupee.

One may argue that foreign reserves would come to the rescue, as they can be used to finance trade deficits as well as sell dollars to reduce value of the dollar and stop depreciation of the rupee. Any central bank intervention to stop depreciation of the currency would reduce foreign reserves holdings and in turn would add to domestic money. The result would be additional inflationary pressures. In the meanwhile, the reserves themselves are decreasing. In the week before December 24, the reserves went down to \$635.7 billion from \$642.4 billion on September 3, 2021, an all time high. Overseas institutional investors/foreign portfolio investors turned net sellers of equities worth ₹1,092 crore in the week before December 15. This added to the rupee's vulnerability as the dollar strengthened on expectations that the US Fed might hike interest rates.

Restoring credibility

The hawkishness of the US Fed and the continuing dovishness of RBI would contribute to further weakening of the rupee. Increases in telecom rates, a hike in GST rate on clothing and footwear would push to push the CPI inflation to around 6% in December. The WPI and CPI data would be on hand only in mid January, 2022. The bi-monthly MPC meeting is scheduled on February 7-9, 2022.

Macro-economic factors need urgent attention. Outflows of capital and trade deficits negatively affect the external value of rupee, just as inflation reduces the purchasing power reducing the domestic value of savings. That is the domestic value of the rupee. Should the economy wait for the next meeting now scheduled in February? A symbolic rise in the policy rate, by 15 basis points, would restore credibility.

Sooner, the better. ■



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