



Market forces loosed on the rupee

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Overview

The Indian central bank's efforts to control inflation have been taking priority even over restraining rupee appreciation. This has led to one of the sharpest rallies in the currency in recent memory. Contrary to its undisguised disapproval of monetary tightening just one year ago, the government's reaction to the near perpendicular climb of the rupee has been almost inaudible. It boils down to a simple political calculation: rising prices erode the ruling party's vote bank, but there has been little correlation between rapid economic growth and electoral success.

This political climate has allowed the Reserve Bank of India to pursue a more flexible exchange-rate policy for the short-term purpose of checking inflation and credit growth. However, this will probably set the tone for a permanent widening of the tolerance band for rupee trading. With India hoping to pull in greater investment for its development needs and foreign investors chasing the Indian growth boom, large capital flows have become a fact of life for policymakers to manage.

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Core Case

The political cost of inflation is effecting a sea change in exchange rate policy, with the rupee floating more freely - and upwards

Assumptions and Evidence

A sequence of charts showing the factors that have combined to produce the rupee's sharp rally

Core Case

In a realization that the pursuit of opposing objectives leads to naught, the Reserve Bank of India (RBI) has finally loosened its grip on the rupee, letting the currency appreciate sharply to nine-year highs while turning its full focus to dousing inflation. Until just two months ago, the central bank was aggressively hiking interest rates to contain rising prices and slow down credit growth; but at the same time it was facing increasing criticism for undue aggression in monetary tightening to compensate for the effects of its heavy intervention in the foreign-exchange market (for details, click [here](#)).

The RBI has since scaled back its dollar purchases and, much to the chagrin of the exporting community, the rupee has suddenly become one of world's best performing currencies this year, recording gains of around 9 per cent in the past three months. What is glaring, though, is the absence of political opposition to the soaring rupee. Apart from a few noises made by Commerce Minister Kamal Nath about the pain inflicted on exporters by the stronger rupee, no voices can be heard.

The overarching worry is inflation. Rising prices are taking the gloss off the government's record of presiding over an unprecedented economic expansion. Ruling parties have lost elections owing to high prices but there is rarely a correlation between rapid economic growth and winning votes. Earlier this month in parliament, a lawmaker from the ruling coalition summed up the sentiment, saying that India's villagers, who form the bulk of the country's population, have little comprehension of 9 per cent economic growth, but they are conscious of rising prices.

The ruling Congress party is feeling the heat after losing two key state elections and municipal polls in the capital, Delhi, earlier in 2007. Many political commentators have blamed rising prices as a primary factor for those defeats. Last week, the government's key leftist allies as well as the opposition walked out of parliament as Finance Minister P. Chidambaram was responding to a debate on rising prices. From within the Congress party, too, the government is hearing voices of dissent, with one of its ministers saying that India's high growth rate is not benefiting the common man.

So there is no mystery to the contrast between Chidambaram's public calls last year for benign interest rates to spur investment even while the RBI was pursuing a hawkish policy, and his silence now despite the fact that credit growth is starting to slow. In the first half of May, inflation as measured by the wholesale price index finally eased closer to the RBI's current year target of 5 per cent (tightened from 5-5.5 per cent in the previous fiscal year). Inflation soared to a two-year high of 6.7 per cent year-on-year in January and remained stubbornly high for the first few months of 2007. In last week's parliament debate, Chidambaram said he is aiming for a rate of 4-4.5 per cent, a goal that matches the RBI's medium-term target range.

Signs of increasing flexibility

The political desire to curb inflation is giving ammunition to the not entirely autonomous RBI to conduct a more flexible exchange rate policy. To be sure, the central bank is still intervening in the foreign-exchange market; and as inflation eases, it will likely step up its dollar purchases. But it is worth considering RBI Deputy Governor Rakesh Mohan's remark in May 2007 that the level of intervention is small compared with the volumes traded in the market. This statement indicates the central bank's growing realization of its limitations in controlling the rupee's value, especially at a time when foreign investors are ploughing money into India's robust economy.

The RBI's increasingly flexible approach to currency management is also reflected in its unwillingness to impose capital controls, such as Thailand and, more recently, Colombia have done. Despite much speculation that the RBI would announce temporary controls at its last monetary policy meeting (at the end of April) and limit the level of foreign debt taken on by Indian companies, it did no such thing. External commercial borrowings, as they are known in India, are one channel of foreign inflows that are estimated to have overshoot an internal government cap of

\$22 billion for the fiscal year 2006-07 by a couple of billion dollars.

The government has tweaked the guidelines on foreign debt, recently imposing restrictions on real estate investors amid worries of a bubble forming in that sector. In a move to make it harder for small borrowers to tap the overseas debt market, it has also lowered the maximum permitted interest rate on foreign borrowings. However, these relatively minor measures are not damaging to investor sentiment.

The biggest risk to the stronger rupee policy is a bloating of India's already large trade deficit and the consequent widening of the gap in its current account. But India is likely to sustain a comfortable overall balance of payments surplus due to strong capital inflows, which are likely to stop only if US interest rates head higher. In that event, however, the RBI would not need to intervene in the foreign exchange market.

There may also be some positive side effects of cheaper imports. First, oil constitutes one-third of India's imports and a stronger rupee will partly negate the recent resurgence in global crude prices (in turn helping state-run oil companies maintain fuel prices at their current levels to aid the fight against inflation). Second, the import of capital goods will receive further impetus, helping sustain India's industrial boom, despite higher interest rates, and also helping India's knowledge- and technology-intensive products retain their competitiveness. Combined, engineering goods and petroleum products comprise nearly 40 per cent of India's total exports. Looser currency management will force the government to think of policies other than the crutch of an undervalued rupee to spur shipments (for details on India's transforming export sector, click [here](#)).

All this is not to say that the RBI will entirely give up its dirty float policy on the rupee; and if inflation moderates to below 5 per cent, it is likely to come back into the market to ensure a more competitive exchange rate. But the rupee's recent surge shows that the Indian central bank is willing to adopt a more hands-off approach to currency management. This trend to greater flexibility in exchange rate policy would be strengthened if neighbouring China goes further towards liberalizing its exchange rate regime.

Assumptions and Evidence

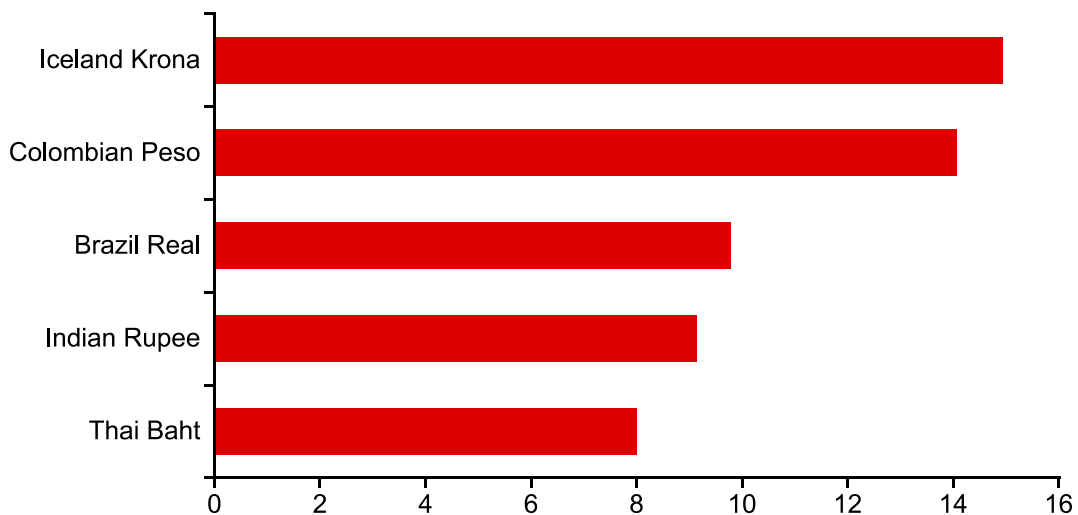
India's inflation rate has been running higher than current target set by the Reserve Bank of India (RBI).

Following the flak the RBI received after its surprisingly aggressive interest-rate hike in March, the rupee began to appreciate sharply against the US dollar, catching market watchers unawares.

Indian rupee vs US dollar

The rupee has now become the one of the world's best performing currencies.

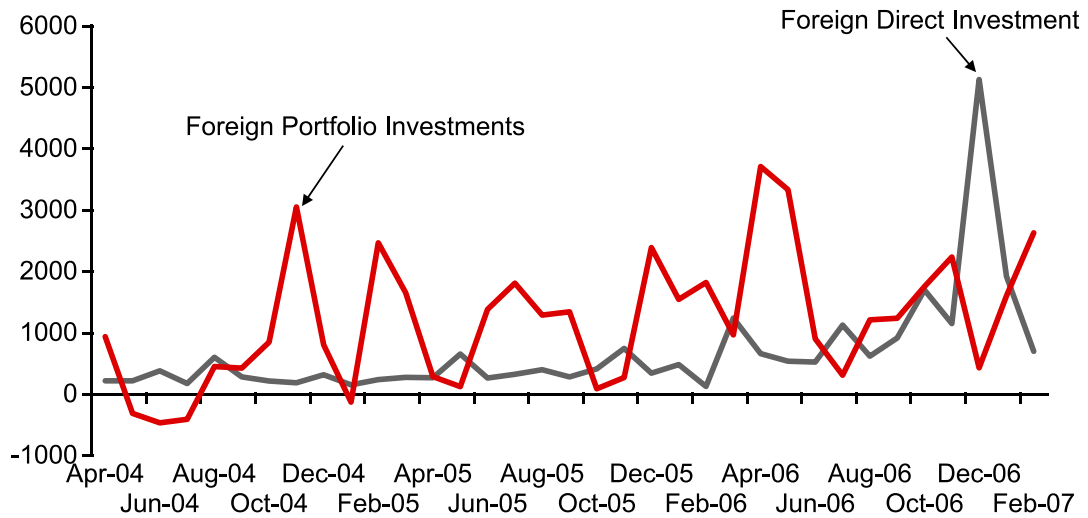
Best performing global currencies vs US dollar (% ytd)



Source: Bloomberg

One of the main reasons for the rupee's appreciation is the rising tide of foreign capital flows into the country.

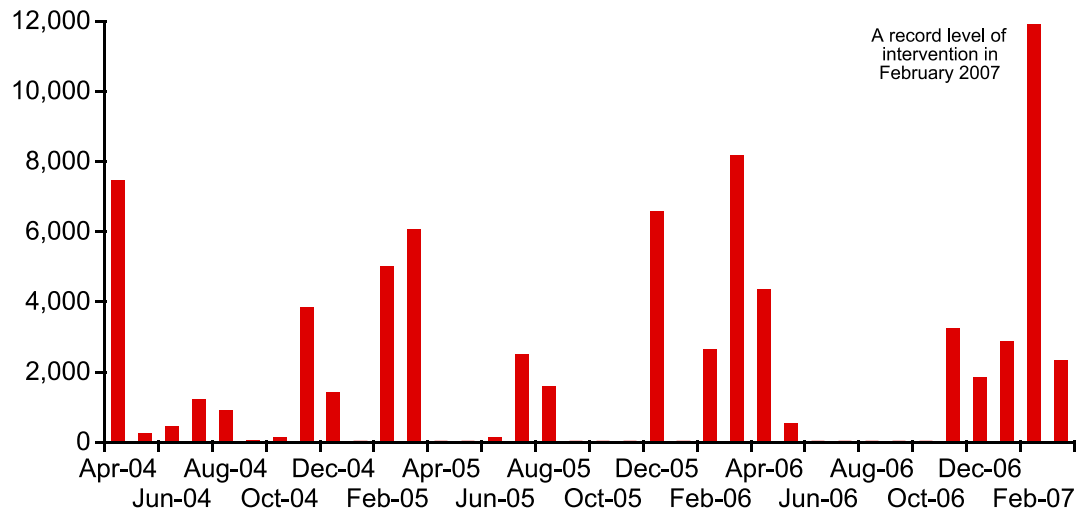
Monthly inflows of FDI and foreign portfolio investment to India (\$ mn)



Source: RBI

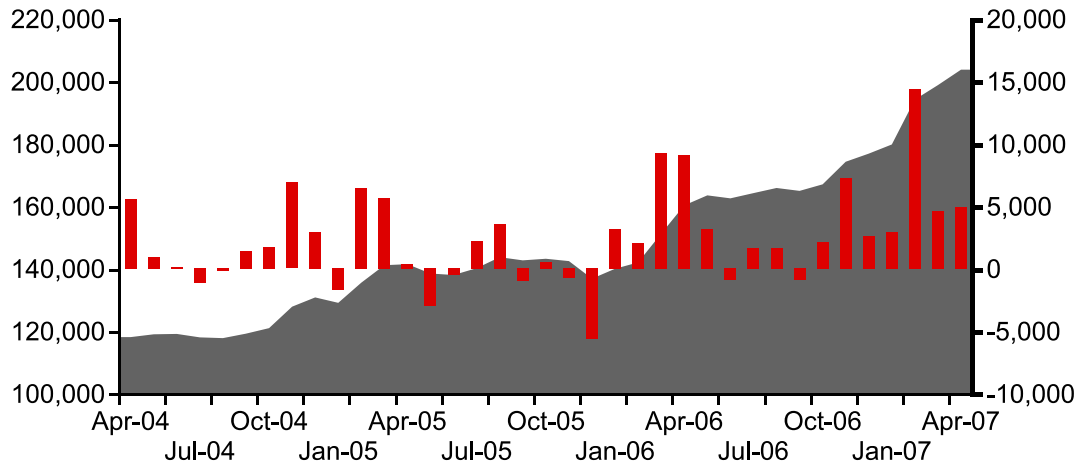
The RBI initially tried hard to intervene in the foreign exchange market but the strengthening rupee and the slower accumulation of foreign exchange reserves indicate the central bank has since slowed down its dollar purchases.

Net US dollar purchases by RBI (\$ mn)



Source: RBI

India's foreign exchange reserves (\$ mn)

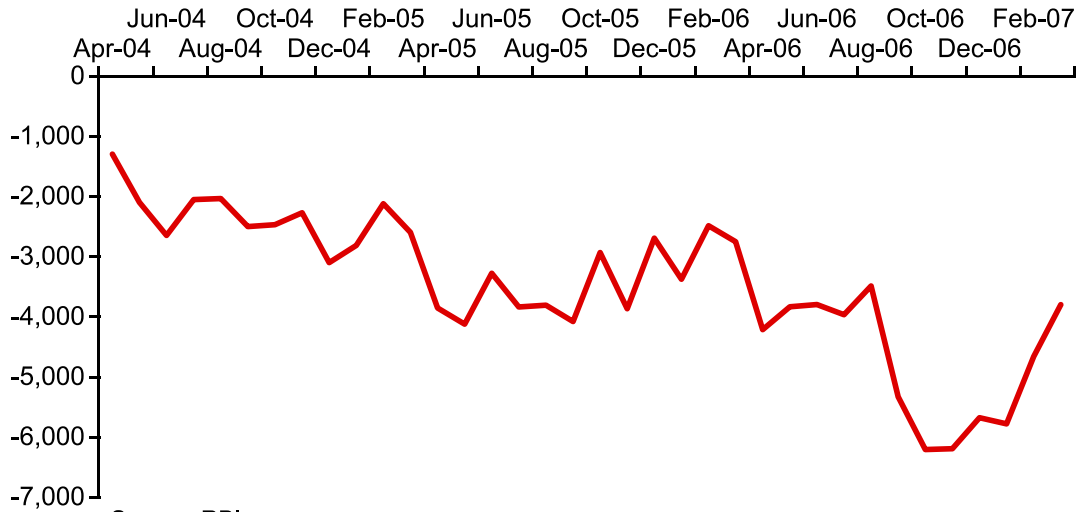


Source: RBI

■ Foreign exchange reserves (lhs) ■ Net addition (rhs)

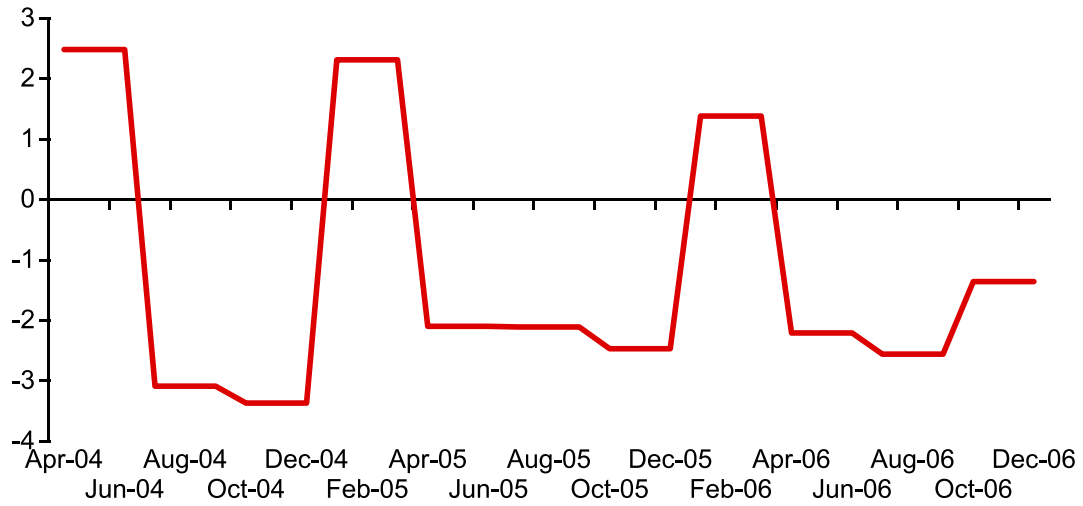
The main risk to the RBI's less interventionist approach is a further increase in India's already wide trade deficit and the consequent widening of the current account deficit.

India's monthly trade deficit (\$ mn)



Source: RBI

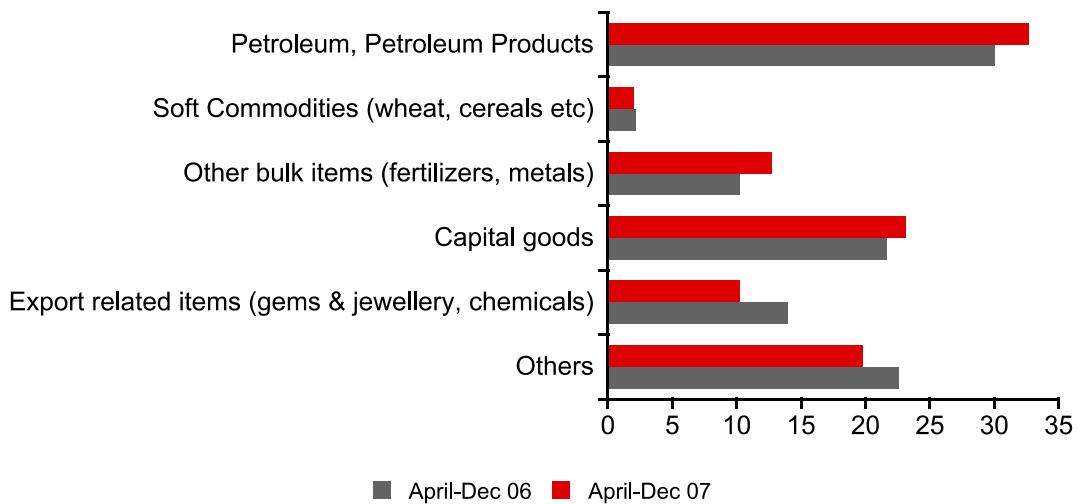
Quarterly current account deficit as % of quarterly GDP



Source: RBI, DGCI&S

However, one positive side effect could be a further jump in the import of capital goods.

India's import basket as a % of total imports



Source: DGCI&S

Contact us

If you would like to discuss any of the points made in this note, or ask further questions, please feel free to contact the authors:

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