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A bet with no upside

A strong rupee policy will deepen the very vulnerabilities it is trying to ward off

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In early May, when one US dollar bought 54 rupees, we claimed that the rupee was overvalued by 20-25 per cent. This latest overvaluation episode began in 2009 when India's inflation started galloping at 8-10 per cent a year while inflation in advanced economies remained around two per cent. Inflation in India during the past four years was higher than that in all G20 countries, other than possibly Argentina. But despite the inflation differentials, the rupee-dollar rate stayed roughly unchanged after spring 2009.

By early this year, India's competitiveness gap *vis-à-vis* its international competitors reached a new threshold. The trade deficit expanded sharply: the growth of exports slowed to a crawl, but there was no pause in the growth of imports. For nearly a decade, India's exports had grown more rapidly than world exports; but just when world trade decelerated sharply in 2011-2012, India's export growth fell faster to below the pace of world exports. Since mid-2012, foreign direct investment has also declined.

No one can time the movement of exchange rates, but Ben Bernanke, chairman of the US Federal Reserve, stirred world markets on May 22 with his speculation on the withdrawal of US monetary stimulus. Three countries with growing current account deficits felt the impact: Brazil, India and Turkey. Their pre-existing vulnerabilities caused markets to back off, leading to sharp currency depreciations. By late June, a dollar bought ₹60, a level around which it has since remained. Mexico was not similarly vulnerable: the peso experienced a brief depreciation, but quickly regained lost ground.

The fall in the rupee's value has prompted a strong rupee policy. Traditional rivals – the government and the Reserve Bank of India (RBI) – have, in a display of rare unanimity, promised to prevent a further fall in the rupee. The RBI has tightened domestic liquidity, presumably to limit the purchase of foreign currency. The government is exploring additional duties on imports, including on so-called luxury goods. Both the government and the RBI are working to attract more foreign cash to fund the current account deficit.

A strong rupee policy is wrong-headed in so many ways. Its (unstated) premise must be that competitiveness weaknesses will disappear while the authorities hold the rupee steady. But that is a dangerous illusion. India's high inflation and falling inflation in the rest of the world ensure that the rupee's overvaluation will relentlessly increase and competitiveness will be further eroded. The pressure on the rupee will intensify, rather than diminish. The gust will be stronger when Mr Bernanke, or his successor, offers new proclamations.

What's more worrisome is that, in holding the rupee steady, the financial vulnerabilities are deepening. Foreign exchange reserves continue to fall; and the financing of the current account deficit is increasingly reliant on the most fickle forms of international capital. Together, these are classic warning signals of a sudden stop in capital flows and a balance of payments crisis. The warning could not be clearer. The lesson also from nearly three decades of international experience is that it almost never pays to prop up the currency in such a situation. A pre-emptive orderly depreciation saves much grief later.

A strong rupee appears to symbolise a sense of economic strength. The opposite is true. The rupee's sharp depreciation in 1991 was an adrenaline shot to exports and growth while economic reforms worked at their inevitably slower pace. China has masterfully practised the policy of a weak currency to maintain high growth. A weaker rupee helps growth and the current account. Tighter liquidity to support the rupee damages growth while doing nothing to achieve a sustainable current account.

To be sure, a weaker rupee will hurt some interests. In particular, in response to the overvaluation, Indian companies have increased their foreign currency debt. Deprecation of the rupee increases their repayment burden. But postponing the depreciation will only increase the country's exposure to foreign currency debt. By encouraging further exposure, the current policy is, in effect, doubling the bets.

A weaker rupee will also increase inflation as imports become more expensive. Again, postponing the depreciation will not help. Containing inflation requires a long-term strategy that works on demand and supply. Little progress has been made in containing fiscal demand pressures. The International Monetary Fund projects the consolidated fiscal deficit for 2014 at nearly 8.5 per cent of GDP, and expects the deficit to remain above eight per cent through 2018. Whatever the deficit reduction measures, their impact is small and long-drawn.

It has become fashionable to decry populist giveaways. And, indeed, such measures must be subject to rigorous economic analysis. But the problems lie deeper. Under the façade of populism, the giveaways to the well-connected are fraught with waste. A culture of government-business relationships is eroding public finances while diverting entrepreneurial energies from productive ventures.

The challenges on the supply side are daunting. It is stunning that the entire reaction to the large trade deficit and the falling rupee has been on ways to reduce imports and finance the deficit. The absence of a policy discussion to revive exports presumably reflects a sense of helplessness. Not only have manufactured exports gone into a swoon, but software exports' growth has also fallen dramatically. Once again, this is not just a reflection of slower world growth. While the world is moving on, India is lagging.

On another occasion, Montek Singh Ahluwalia, deputy chairman of the Planning Commission, said that India has a strong consensus for weak reforms. Some lauded that balance as a distinctively Indian growth strategy. However, the rationalisation was cynically expedient even in the good days when world prosperity was lifting all boats. The task then was to press vigorously ahead with institutions and infrastructure for today and the next generation. The moment passed. Today, the urgency is acute.

The present pressures on the rupee reflect past failures. But holding the rupee up would only make matters worse. A strong rupee policy will deepen the very vulnerabilities it is trying to ward off — it is a bet with no upside. An orderly depreciation would take the sting out of the short-term vulnerabilities. But, if not accompanied by bold changes, the short term could morph into a dreary long term.

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