Never Mind the Dollar Strengthening, a Diving Rupee Is Wrecking Domestic Macroeconomic Stability

An attendant at a fuel station arranges Indian rupee notes in Kolkata, August 16, 2018. Photo: Reuters/Rupak De Chowdhuri/File Photo

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The Indian rupee is at 82.7 per dollar, rebounding from a record low of 83 on October 20, amid reports that the Reserve Bank of India resumed its dollar selling activity through state-run banks to support the domestic currency, adding to the over $100 billion sold from the central bank's foreign reserves this year.

Still, efforts to prop up the currency have failed to significantly keep it from hovering near the all-time low amid a dovish pivot by the RBI, soaring inflation, and trade imbalances.

RBI policymakers signalled that the central bank would pause its hiking path in its next meeting, as growth concerns should become the priority, despite stubbornly high inflation.

Source: Trading Economics

The latest data showed that retail prices rose by 7.4% annually, marking the ninth consecutive month where inflation surpassed the central bank's upper target of 6%.

While the RBI has raised its key repo rate by 190 basis points (bps) this year, continuing a path of monetary tightening, rate increases have been far slower than those of the US Federal Reserve. (A bps is one hundredth of 1 percentage point.)

Performance of the Indian rupee over the last 10 years. Source: Trading Economics

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Ramifications of a weaker rupee

1. Soaring inflation: An 'invisible tax' on India's vulnerable consumers

The annual inflation rate in India increased to a five-month high of 7.41% in September from 7% in August, above market forecasts of 7.3%. Prices increased faster for food (8.6% versus 7.62% in August), with vegetables (18.05%), spices (16.88%), cereals and products (11.53%) recording the biggest jump as erratic rainfall impacted the local crops and supply shock from the Russian invasion of Ukraine remained.

Prices of housing (4.57% versus 4.06%); education (5.68% vs 5.51%); transportation and communication (5.39% versus 5.2%); and health (5.52% versus 5.43%) also accelerated.

On the other hand, the cost of fuel and light grew at a slightly slower pace (10.39% versus 10.78%), but is still quite high. Compared to the previous month, consumer prices were up 0.57%.

A diving, or depreciating rupee, will only cause a further weakening of the consumer purchasing power in a festive period which usually witnesses a spending boom.

Prices of most consumer (and capital) goods and services are already high, and are likely to remain so for the next year or so. Wholesale price inflation has remained in double digits for over a year now.

The stubbornly high inflationary trend has been catalysed by external factors but is causally driven by vital internal factors, too. There are forces on the consumption demand side, led by the top 5%, and an asymmetric, disproportionate inequality-led business recovery that has made prices even more volatile.

This is once again a vindication of an earlier forecast from June 2021 when several experts had commented on the likely permanence of higher inflationary trends.

However, the callous indifference to putting inflation in check, exhibited by the RBI's poor monetary policy management, will act as a higher 'invisible tax' – and cost – on the poor and vulnerable sections in India's deeply stratified consumer base.

We are already observing the invisible 'tax' of inflation to be impacting two-thirds of India's rural consumers in the worst possible way.

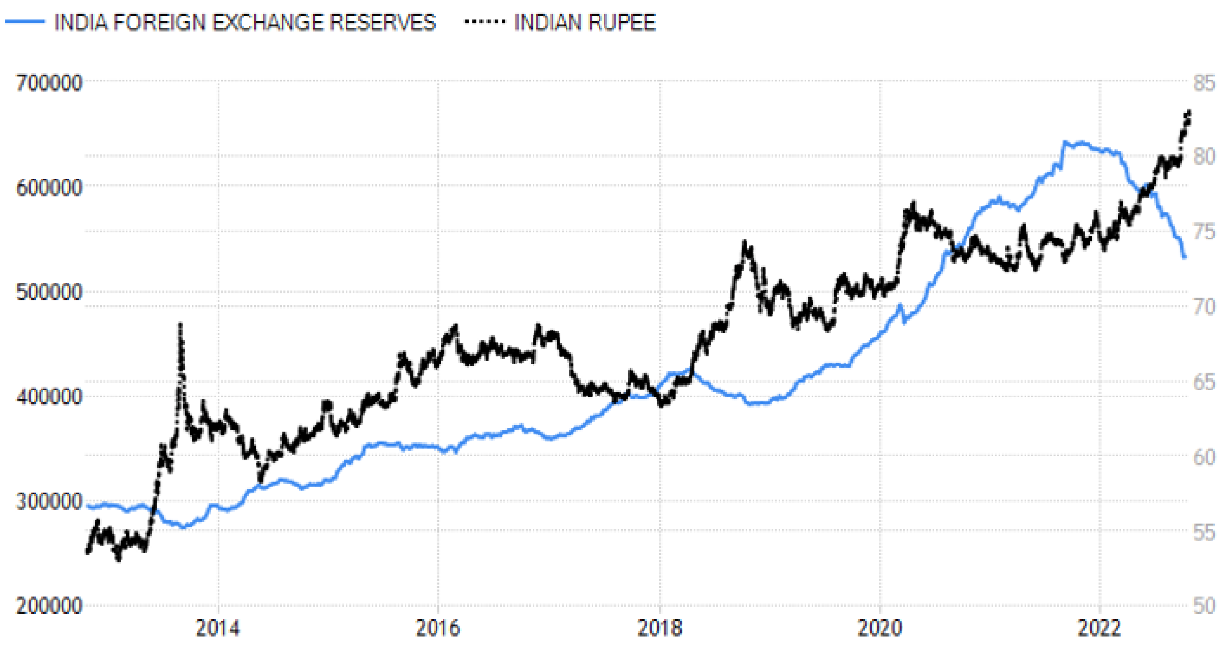
The low and lower-middle income households drive aggregate consumption in India, which means that 66% of all consumption comes from them. All income growth being concentrated in the top decile over the last many years has created a further drag for the most important component of GDP growth. And, inequality is not a social issue alone, but a huge economic problem.

The double whammy of lower employment and COVID-19 has now led to a significant reduction in consumption for low and lower-middle income households – who are contracting essential spending, delaying discretionary spends, and downtrading across categories. This has also led to a delayed recovery on many key sources of consumption – automotive, high value durables, out-of-home and discretionary spends like retail, restaurants and personal care.

2. Depleting forex reserves are making India more vulnerable to capital flight

In India, foreign exchange reserves are the foreign assets, in the form of gold or a currency, held or controlled by the country's central bank. The reserves can also include special drawing rights and marketable securities denominated in foreign currencies like treasury bills, government bonds, corporate bonds and equities and foreign currency loans.

India's forex reserves have remained sufficient for much of the period since 2000 due to a higher inflow of foreign capital. However, the rupee's collapse is now making India's strong forex position a little wobbly. The economy's forex reserves have fallen by $110 billion since September 2021, when it stood at a record high of $642.45 billion.



Source: Trading Economics

The RBI has been on a dollar spending spree to stabilise the exchange rate. Still, the results have been mixed. The rupee is expected to touch 85 to a dollar by the end of the year if the current trend continues.

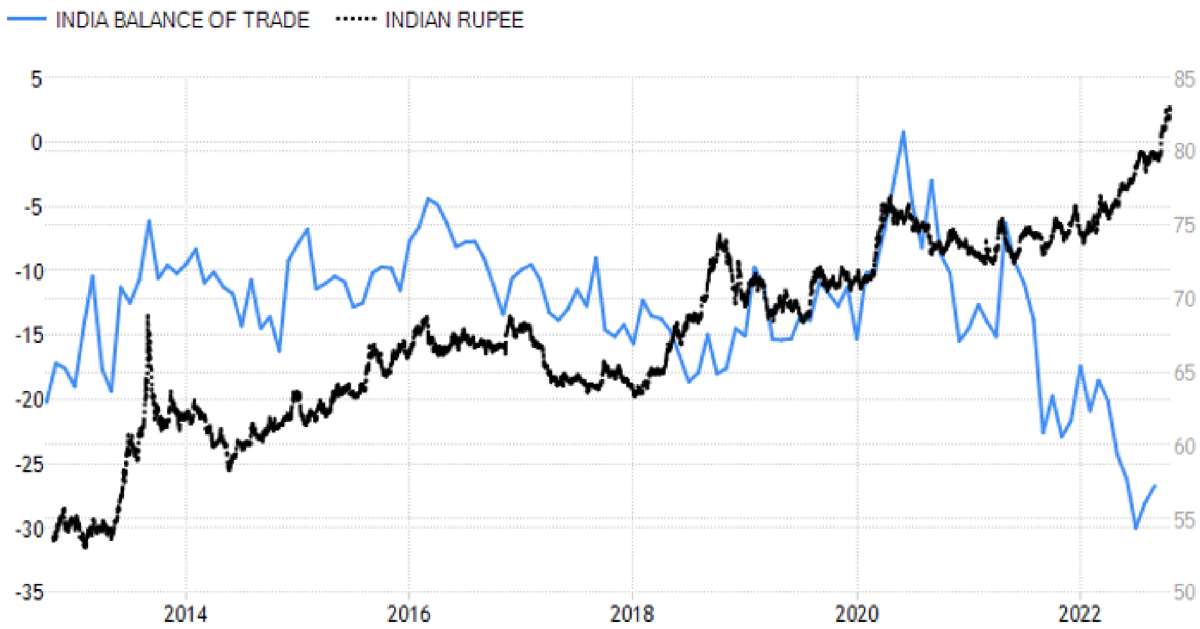
There are external factors worsening the trend. An aggressive policy of monetary tightening being pursued by the Federal Reserve will only result in an accentuation of capital outflow – further strengthening of the US dollar, which has triggered a withdrawal of portfolio investment by foreign investors.

Simply put, a higher interest rate by the US regime will incentivise investors to pull their money out from countries like India and invest it in the US for higher interest accrued return.

Having said that, our excessive dependence on foreign capital (via foreign portfolio investment and foreign direct investment) for meeting the domestic saving-investment gap in the economy, amid a low domestic private investment trend and an inadequate capacity utilisation, has structurally made the Indian economy more vulnerable to such exogenous (external) shocks.

Any radical change in the exchange rate will continue to affect the state of the economy more than it ever did.

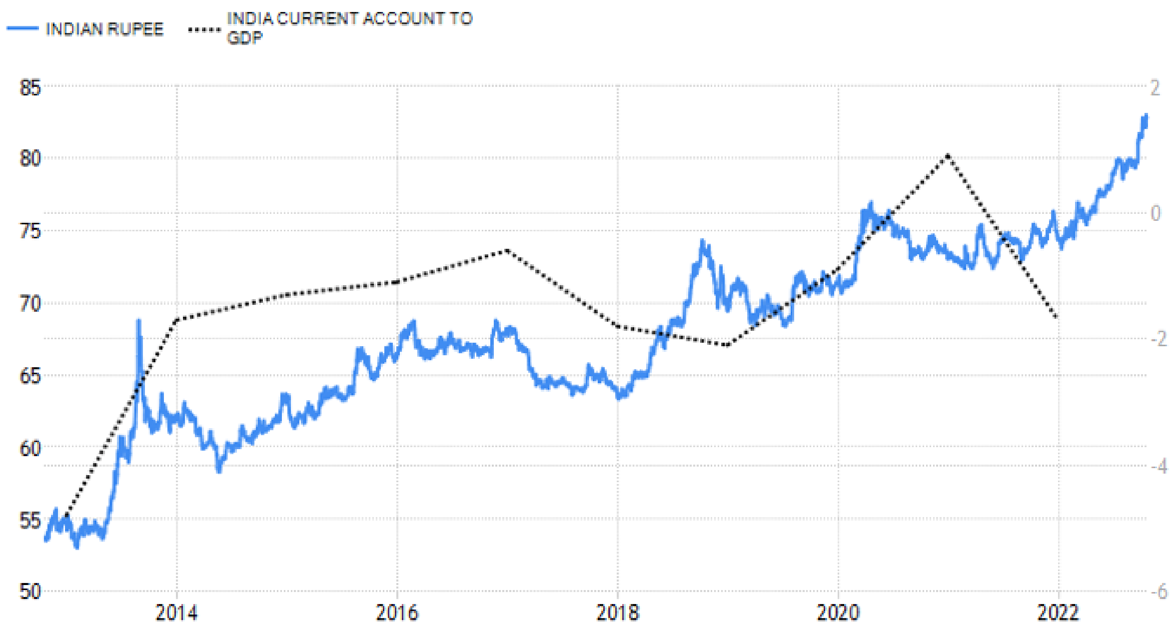
3. Rising current account deficit and trade imbalances



Source: Trading Economics

India's trade deficit was revised to $25.71 billion in September, compared to a preliminary estimate of $28.72 billion and $22.47 billion a year earlier. Imports surged 8.7% year-on-year to $61.16 billion amid higher commodity prices, while exports rose at a slower 4.9% to $35.45 billion.

The overall current account deficit started increasing after the sudden surge in the weakening of the rupee *(see chart above)*. On trade, Indian imports are still heavily dependent on China, even though, as per data, the US emerged to be India's most critical trading partner last year.



Source: Trading Economics

During 2021-22 alone, India-China trade aggregated at $115.42 billion, as compared to $86.4 billion in 2020-21. Most of this trade is in form of increased imports from the Chinese.

Therefore, it is critical to look at the effects of soaring inflation amid a weaker rupee in the context of other macro-micro realties.

Additionally, India's overall job creation rate has been poor (see CMIE data); domestic private investment has remained weak (see numbers on gross fixed capital formation); consumption demand has not risen across all income groups (see recent survey results on consumption expenditure surveys and consumer sentiment).

My most important concern here is on the domestic unemployment and private consumption trends. Personal consumption has long been the main component of India's GDP and a continued strong engine of GDP growth. Its contraction as a percentage of GDP by 300 bps over the last three years (down from 60.5% in 2019-20 to 57.5% in 2021-22) was already known, and it is this problem that needed urgent and purposeful remediation.

Alas, this was not addressed by any demand-side fiscal interventions. The impact of overall slowdown over the last three years is made even more urgent by the sharp slowdown in rural consumption over the last six to nine months.

All of these trends, when viewed in the collective ordering of their cumulative impact on the economy, reflect a 'wrecking' effect of the falling rupee on India's domestic macro stability. Immediate interventions for a medium to longer term timeline are required, but who's listening.

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