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The story of the falling rupee: Why is the rupee so weak? And what can be done to pull it up?

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The question on everyone's mind is why this sudden fall in the value of the rupee and is there any end to this? In order to explain this story, we will have to connect a few dots—exchange rate, inflation rate, fiscal deficit, CAD, exports, imports and the US economy.

Under a floating exchange rate regime, the market determines the value of the exchange rate. In economics, there are two ways to determine the correct exchange rate. One, the goods market approach where the correct value of the exchange rate is based on the assumption of law of one price (LOOP) using the concept of purchasing power parity. Two, the asset market approach, where the value of the exchange rate is conditional upon the inflow and outflow of capital into and from the domestic economy.

LOOP states that in the absence of transport and other costs such as tariffs, similar goods will sell for the same price. Because of the combined activities of arbitrageurs, identical goods, primarily financial assets, cannot sell for different prices for long. The prices of homogeneous goods once converted to common currency should be same in different markets. In fact, The Economist publishes the Big Mac Index, which serves as an informal way of measuring PPP between two currencies. The index takes its name from the Big Mac of McDonald's.

If LOOP holds true then the real exchange rate (nominal exchange rate times the relative price between two nations) is one. Using this relation, it is easy to show that if domestic inflation is higher than the US inflation, the rupee is expected to depreciate against the dollar.

Now, why inflation in India? One school of thought is arguing inflation in India is because of factors such as increased payment through MGNREGA, higher minimum support price for farmers, and recently, the government committing to spend around R1.3 lakh crore per annum on account of the food Bill. Money spent without increase in storage capacity in the case of the food Bill, and many infrastructure projects not getting completed under MGNREGA, is bound to cause inflation.

Questions are also raised about the effective usage of government money on health and education. To take the case of the Sarva Shiksha Abhiyan, there has been a rise in literacy and gross enrolment ratios (at the primary level), which has been attributed to the programme. But these achievements say nothing about the quality of education. Critiques argue that although development indicators have improved, money is not being spent well as the quality of service has not improved. Add corruption to this, and one finds the perfect recipe for inflation.

Inflation and a rise in fiscal deficit is bad news for the exchange rate. In foreign exchange markets, expectation plays a crucial role. High fiscal deficits and higher inflationary expectations make domestic assets (government bonds) less attractive. Currency depreciates (following the asset market approach) as foreigners pull out money from the domestic capital market. The stock market tanking every other day is an indication of this.

Optimists will say this depreciation of the rupee is good for our exports. Here also, data suggest otherwise. A look at our major export items suggests there is a change in the composition of India's exports from price-sensitive items such as leather footwear, dairy products, beverages, textiles and apparel, to less price-sensitive items such as refined petroleum product, chemicals, mineral products, and machinery and transport equipment. It is to be noted that the share of petroleum products in India's export basket increased

dramatically from around 2% in 1993 to around 20% in 2012. The surge in exports in the case of petroleum items is because of India’s potential in oil-refining activities.
On the contrary, India’s CAD is likely to increase further as oil and precious metals still contribute to the bulk of our imports. Controlling CAD is an important factor from the perspective of sovereign rating—countries with higher fiscal deficits and CAD generally lose out in terms of investor attractiveness. For the last fiscal year, India’s fiscal deficit (Centre-states combined) was around 9%, the highest when compared with other BRIC economies—China’s 1%, Brazil’s 2.8%, and Russia’s negative 1% (or surplus). A lower sovereign rating is likely to reduce foreign capital inflow depreciating the rupee even further.
Adding to the effect of these factors is the US economy showing signs of revival. There is indication about quantitative tightening where the Federal Reserve is likely to reduce government bond purchase by $10 billion (from $85 billion per month to $75 billion). This has further strengthened the dollar against most Asian currencies. The likely attack by the US on Syria has already shot up the crude oil price to $113 per barrel. In fact, gold in the international market is now trading at $1,400 per ounce (around 28.3 gm). In India, gold is trading at R34,000 per 10 gm when it should have traded at R24,000, with R50 to $1 as the exchange rate. Much of the shooting price of gold can be explained through the weaker rupee.
Ways to arrest this fall? First, create an environment for long-term capital investment. Capital surplus countries such as Japan are keen on investing in our infrastructure. The value addition of a dollar invested in India’s infrastructure is higher than many places in Asia, including China. This is however conditional that we create necessary environment for investment. Second, improve trade relation with Iran. This will allow India to import oil in rupee, not spending from its dollar reserves. Third, implement government-funded programmes better. Reforms push such as direct cash transfer are a welcome move and are expected to plug leakages in the system. Another way to increase effectiveness is to make the programmes more flexible. In the case of MGNREGA, unskilled labourers were used to build rural infrastructure. Instead, MGNREGA labourers should also be allowed to be take up alternate activities such as working in agricultural farms, or in small and medium scale industries, depending on requirements. Likewise, the money sanctioned under any particular scheme, say, under the SSA to build schools, should be allowed to be used for the next best alternatives, say, building hospitals, if the village already has a school. This will ease inflation and may arrest the fall of the rupee.
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