Rupee depreciation in the context of monetary policy, trade deficit, inflation and general elections

Recently, Rupee depreciated to a record low of INR 70 to a US dollar in nominal terms and that has sent some shockwaves across the Indian Media and created trembles among some group of investors in the economy. But, is this situation really that troublesome to get shocked and cause a neurotic attack to the investors and policymakers alike? Let's explore. Firstly, the recent depreciation in the currency, the substantial depreciation over the last few weeks has been largely driven by the decline in the Turkish Currency Lira due to Turkish-US disputes and that has led to adverse effects on most emerging market currencies including India. Yes, the significant depreciation in the currency over the last few weeks is indeed a cause of concern in terms of the magnitude of the change in such a short span of time, however, if the currency had depreciated gradually then it wouldn't have been a major cause of concern, in fact that could have been somewhat favourable. This is because - if we look at dollar rupee in trade weighted terms then between 2014 and 2018 the currency has appreciated by around 20% of which though in this year it has lost only 6% and in addition to that since Indian exports have been sluggish over the past 2 years, the currency depreciation gives an ammunition to boost the exports which will improve competitiveness of the domestic produces/exporters in the global market.

Now, if we look at the current account deficit (CAD) and the impact on it, we see that the CAD is currently 1.9% and is slated to be 2.5% in FY19. But, if we look at the composition of this, then the oil import bill (80% of total imports) and gold import bill constitute the entire deficit and rest is just surplus. So, yes if the oil prices were to rise significantly in a short term then it would balloon the CAD and this would be unfavourable. Moreover, if we look at the recently released trade deficit data for the month of June, it was 16.6 Billion USD, this indicates a twin-problem and this has to be effectively handled by boosting exports as well so in that sense a gradual and tapered currency depreciation would do well to keep the trade deficit under control unless oil prices were to rise significantly in the short run.

The RBI's attempt to handle the currency and inflation pressures in the economy can be commended somewhat as it has been able to insure the economy against these risks by hiking interest rates twice by 25 basis points in its last 2 monetary policy meetings otherwise the currency would have depreciated further because of the global macroeconomic developments due to Lira depreciation. Furthermore, India is also insured against significant fluctuation in terms of the depreciation of INR since it holds 403 Billion USD in foreign exchange reserve, which constitutes over 150% of the reserve adequacy metric mandated by the IMF to several countries so that they are adequately positioned to prevent themselves from any sudden external shocks. This positions the Indian economy well compared to other emerging economies like China, South Africa and Malaysia which are below the 100% reserve adequacy metric. In that aspect also, the RBI has done well to curb the significant depreciation by selling 23 billion USD since April.

In context of the upcoming elections in 2019, the tables have turned for the Narendra Modi led BJP Government since it took stage in 2014 as during that time the oil prices started dropping from its highest levels and the currency in relative trade weighted terms was rather muted or appreciating that led to decline in the current account deficit and also kept inflation under check and the government could pocket more revenue by hiking taxes on oil but now with oil prices rising over the last few quarters and widening CAD the government is facing the ire of the opposition and public alike as it had also linked the nation's petroleum prices to the global oil price fluctuations. Now, to turnaround the situation, reforms are highly unlikely in the election year. Furthermore, the government also faces an uphill task of maintaining fiscal prudence by sticking to its target of fiscal deficit to 3.3% in the election year combined with the twin balance sheet problem that the banking sector faces that has constrained the credit growth and thereby the GDP growth that could have materialized had the NPA levels remained under control.

To effectively keep the situation under control, the RBI and the government have to be on the same page and work in tandem so as to keep the macro environment favourable. The inflation control is likely to be the common ground in the election year for both the government and the RBI and the recent consumer inflation number of 4.17% in July will soothe the nerves of both. Though the Indian macroeconomic environment is favourable in the sense that it has been more dependent on domestic growth rather than having global dependence but if the trade war between US and China and its likely manifestation to other trading partners was to escalate then this wouldn't immune the Indian economy from the ripples of the global shocks and the disgruntled investor sentiment. So, to mitigate this impact the government should stick to its objective of fiscal prudence even if it is not able to stick to its 3.3% target of the fiscal deficit. However, it should not surpass the target by large gap as that would make the economy more vulnerable amid hazy global macro environment and uncertainties. Furthermore, the collaboration between RBI and the government should extend ensuring a healthy balance between sustainable GDP growth and inflation and not just focus on garnering large share of vote bank at the cost of both because this macroeconomic balance can likely yield complementary benefits of gaining larger vote share during the 2019 elections.