THE OBSERVER
OF BUSINESS AND POLITICS

MONDAY FEBRUARY 26, 1996

Rupee under siege

The government added fuel to the fire by purchasing dollars from the market for debt servicing, says **Uttam Gupta**

THE rupee has fallen by over 20 per cent via-a-vis the dollar in six months time. Not long ago, the mandarins in the finance ministry argued that stability in the exchange rate in 1993-94 and 1994-95 vindicated the economic reforms programme.

Undoubtedly, the rupee was relatively stable during this period. But, the stability was clearly not the result of sound economic fundamentals. In fact, in both the years, fiscal deficit slipped the target by a substantial margin and inflation was running in double digits. Together with significant compression in investment (in real terms) and resultant slow industrial growth, this presented a situation of worst sorts.

Although, the deficit on trade account was low, this was largely fortuitous — being the result of depressed imports. However, what really helped in maintaining the rupee steady was the inflow of foreign funds through the FIIs and the GDR route on an unprecedented scale.

The irony is that we never bothered to improve the economic fundamentals. In fact, the government did not even take cognizance of the fact that the economy was weak. During the current year, the weaknesses have become even more glaring with fiscal profligacy and virtual funds squeeze at its peak. Moreover, a series of scandals in the capital market have almost shattered investors' confidence. The foreign investor could not have remained unaffected.

The BOP has come under serious stress. While on the one hand, the trade deficit is increasing mainly on account of faster growth in imports, on the other, there has been a steep decline in FII and almost complete drying up of inflows through the GDR route. Even the outflows on account of servicing of external debt this year is about $2.5 billion more than in 1994-95. Inevitably, there is pressure from all sides leading to a virtual siege on the rupee and, in turn, causing a precipitous fall in its value vis-a-vis the dollar.

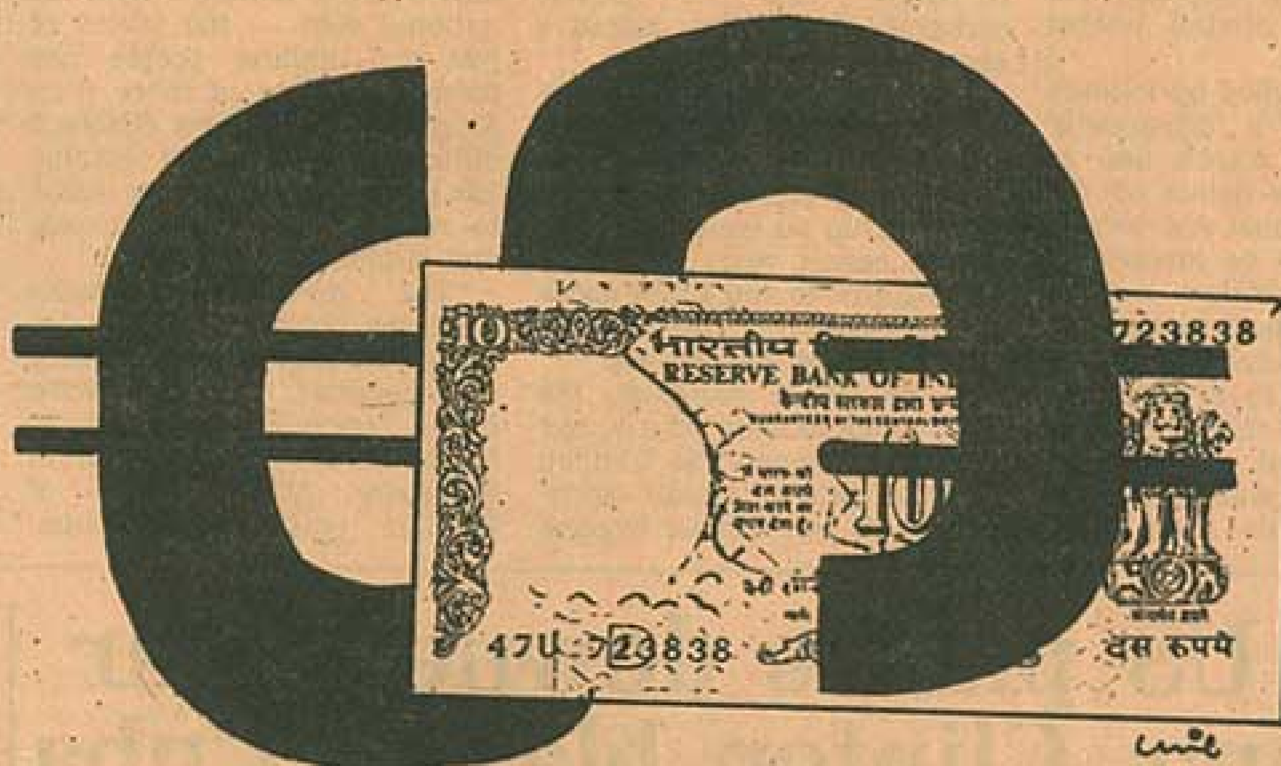
Commenting on the first bout of decline from Rs 31.5 to Rs 34 to a dollar in September 1995, the RBI Governor had described this as something "inherent" in a market guided system; the finance ministry went a step further to suggest that this was a necessary correction and had nothing to do with the fundamentals, which were strong. They even sought to pass on the buck to other forces like bunching of imports, exporters delaying bringing in their export proceeds, or speculators hammering the rupee. All these are secondary developments and are unavoidable in a situation where the rupee is perceived to be weak over a fairly long period.

Any importer, including corporates, who perceives the rupee to be weakening, is bound to minimise his impending loss by preponing imports. Even the government has done this in respect of imports of crude and POL. Likewise, an exporter will delay repatriation of export proceeds. For speculators, this is normal business and it would be wrong to believe that they will not indulge in it specially when the underlying circumstances are most favourable to them.

Instead of addressing the fundamental causes of the rupee's weakness, the government started penalising the importers and exporters alike by measures like surcharge on import finance, increase in the cost of export credit and stoppage of refinance facility to commercial banks for post shipment credit above 90 days, etc. Far from helping, these restrictions may even aggravate the trade deficit and thus prove counterproductive even from the viewpoint of stemming rupee's further slide.

The government has added fuel to the fire by authorising purchase of dollars from the market for servicing the external debt. It could have drawn on the reserves for the purpose as was the practice in the past. Better planning and management of crude and BOP imports, would have helped in easing the pressure.

The RBI could used a few billion dollars from the reserves to satisfy the hungry market? This will not only stem the rupee's decline, but may even roll back the dollar to Rs 34 or thereabouts. This will automatically force exporters to bring their dollars proceeds and importers to spread their import plans. Speculators will be on the run. That will further add to the supply of dollars.



Non-intervention carries its own price — not certainly a light one either. Each point slide in the value of the rupee raises the cost of current operations of all import dependent industries, cost of servicing external borrowings/equity and increases the investment cost of new projects — all these would lead to accelerated inflation and adversely affecting the BOP.

Exports, too, get affected as most of our exportables are import-intensive. Even exportables with low import content are hurt by the overall inflation triggered off by depreciation. Moreover, in the highly competitive world market, the likely benefit of rupee depreciation is taken away by the importer in the form of lower dollar denominated price.

Apart from being an enemy of the trade balance, the rupee depreciation may even lead to a major BOP crisis by causing unprecedented flight of capital. Let us not forget that this was a major element in the Mexican crisis wherein the withdrawal of the foreign funds on a large scale went hand-in-glove with the loss in the value of Peso. Such a possibility is not ruled out in India if the rupee is allowed to drift.

Our policy makers are fearful of the liquidity squeeze that the sale of the dollars from the reserves might entail. The liquidity crisis is, however, mainly due to distortion of the overall resource allocation mechanisms caused by virtual siege by the government on available resources and has to be tackled at that level only. RBI action alone will not be enough. This is only a temporary measure which is essential to prevent the situation from turning unmanageable. Simultaneously, the government has to make efforts to improve the economic fundamentals. This would involve control on fiscal deficit, inflation and measures to put the country's trade account on a sound footing.

While the export potential is infinite, huge opportunities are lost because of weak infrastructure. This includes power, railways, road transport and ports. The cascading effect of taxes and duties, especially at the state level, makes matter worse by rendering exports uncompetitive. These constraints have to be tackled on a war footing if exports are to grow at the desired pace to more than fully pay for imports and generate a positive balance. Efforts are also needed to increase the domestic production of bulk items like crude, fertilisers, edible oils, etc to reduce the import bill.

In recent years, the government has taken a number of policy decisions like allowing foreign companies to set up 100 per cent subsidiaries in the consumer goods sector, setting up of joint ventures for cars. Now it is proposing to allow them entry in areas reserved for the SSI sector. These need to be reviewed in view of the huge foreign exchange outgo by way of repatriation of profits and dividends involved.