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The fragile rupee

The rupee's downward trajectory will accelerate unless underlying fundamentals are improved, says **Uttam Gupta**

THE recent precipitous fall in the value of the rupee vis-a-vis the dollar to almost Rs 34 is unambiguously the manifestation of a serious crisis; a crisis that existed at the time of launching of reforms in 1991 and continued throughout, notwithstanding claims to the contrary.

The crisis was the coexistence of high fiscal deficit, trade deficit and inflation each feeding on the other. In simple terms, fiscal deficit pumps in nominal demand far in excess of the capacity of the domestic economy to support. RBI helps this by monetising the budget deficit. This, in turn, has the potential of increasing imports. It is inflationary as well.

Fiscal deficit includes a heavy borrowing (including external) component by the government. Overall loanable funds being limited, this means reduced availability of credit for production which affects supplies and, in turn, contributes to inflation. The resultant high cost of credit to the industry further compounds the inflationary effect.

Domestic inflation undermines export competitiveness, thus jeopardising export prospects. Together with increase in import demand, this prepare the ground for higher trade deficit. High debt servicing inherent in high level of external debt aggravates the overall balance of payment problems.

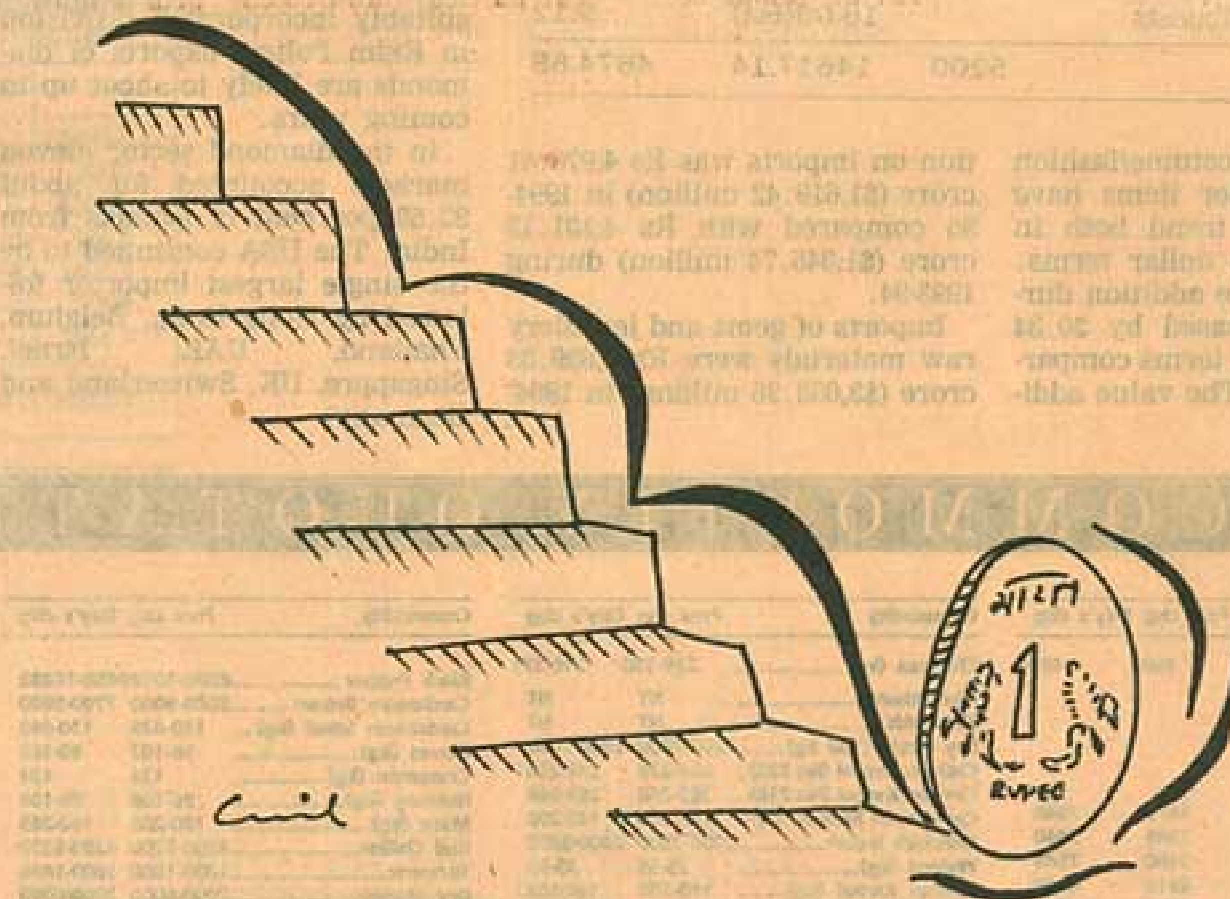
Of these three pernicious maladies, at the core was fiscal deficit which the Congress government made its prime target. It did succeed during the first two years i.e. 1991-92 and 1992-93, but at the cost of investment and growth. Industrial growth in India is led primarily by government investment. During 1992-93, there was unprecedented compression in the latter which made the former negative. That was also the year with lowest trade deficit.

During 1993-94 and 1994-95, government expenditure increased leading to an all-around surge in demand and, consequently, revival of industrial growth to about 5 and 8.4 per cent respectively. But fiscal deficit was on the upswing led predominantly by heavy borrowings even as the government tried to keep the monetised portion of the deficit low.

During 95-96, the government's spending spree reached its nadir. To support this, it is not only borrowing heavily from the market, but also asking the RBI to print currency notes on a monumental scale. Fiscal deficit this year is thus slated to reach an all-time high.

With government staff getting big bonanza, PSU salaries revised, huge funds earmarked for various social assistance schemes, there is resurgence of demand. No wonder, industrial growth is estimated at about 10 per cent with luxury segments like automobiles, electronics, etc taking the lead. But the flip side is widening trade deficit which the finance ministry estimates to be $5 billion.

The variations in exchange rate during the last 4 years or so have mirrored these continuing weaknesses although for certain periods, the effect was swamped by other developments. In July 1991, under the then fixed exchange regime, the rupee was devalued twice taking it from Rs 20 to 25 to a dollar within a week. Again in 1992-93, under the garb of partial convertibility, the rupee was further devalued to $ = Rs 29.



Following introduction of the market determined exchange system w.e.f. 1.3.1993, the rupee slid further to about Rs 31.3 to a dollar. In less than two years, the rupee had depreciated by about 56 per cent. This does not quite sustain claims about the stability of the rupee during the reform era. During the past two years, the rupee has been more or less steady. However, that has nothing to do with the economic fundamentals which continued to remain weak.

The value at which the exchange rate settles depends on the demand and supply of dollars in the market. For assessing this, investment related flows are as important as trade related ones. In the last two years, the former predominantly as portfolio investment by FII and GDR (raised by Indian corporates abroad) have helped in avoiding pressure on the rupee.

Export growth, too, contributed to increased inflows. But a good part may have been unaccounted money in the domestic economy coming back as dollars proceeds (through the havala route) of over-invoiced exports or exports that were never made. The unprecedented misuse of the VABAL and other concession schemes for exporters is a pointer.

The stability of the exchange rate during these two years was perceived as a healthy sign without analysing the basic causes. The government presumed that since foreign funds were coming in a big way, our economy must be sound. It was an illusion. Dollars came in because we promised to reform the economy, not because our fundamentals were sound.

During the current year, the ground reality stands clearly exposed. Foreign funds through the GDR and FIIs are coming in trickles (FDI was never in the reckoning from the word go). At the same time, there have been significant outflows as some FIIs divested their holding of Indian stock. While this support has weakened, there is enormous pressure by way of surge in import demand (38 per cent during April-July) with crude and POL in the lead. Besides, debt servicing has assumed menacing dimensions i.e. $13 billion, an increase of $2.3 billion over 1994-95.

Inevitably, there is pressure on the rupee. In the absence of RBI intervention, the slide was thus a foregone conclusion. The rupee's downward trajectory will continue to accelerate unless something drastic is done to improve the underlying fundamentals. Temporarily the RBI can contain the slide by selling dollars from its reserves. The reserves are no more than an artificial respirator and the patient must necessarily be on his own, sooner than later.

The need to correct the fiscal imbalances has been allowed to persist too long impairing our ability to act decisively. This is because of the mountain of debt that must be serviced. Inflow of foreign funds came to our rescue in 1994-95, but that would not always be the case. There is an urgent need not only to prevent more borrowing, but also to extinguish a significant part of existing debt.

For this, we must generate a substantial revenue surplus on the one hand and positive balance on current account on the other. Unfettered revenue spending (mostly on non-plan side), little effort to improve tax collections, would raise revenue deficit to alarming proportions, aggravating the problem on both fronts.

Downward slide of the rupee is not merely a sign of acute sickness. If not arrested, it will aggravate the sickness. Apart from increasing the external debt in rupee terms and, in turn, the cost of servicing it, will also raise the cost of key inputs and stoke the fires of inflation.

Those who talk of improved export competitiveness (due to change in nominal exchange rate), should consider the effect of all this even on exports. Inflation, in turn, will make matters worse in respect of fiscal and trade balance which will trigger a fresh round of inflation. It is an unending vicious circle which will ultimately paralyse the economy.