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Trade-offs from the rupee's all-time low

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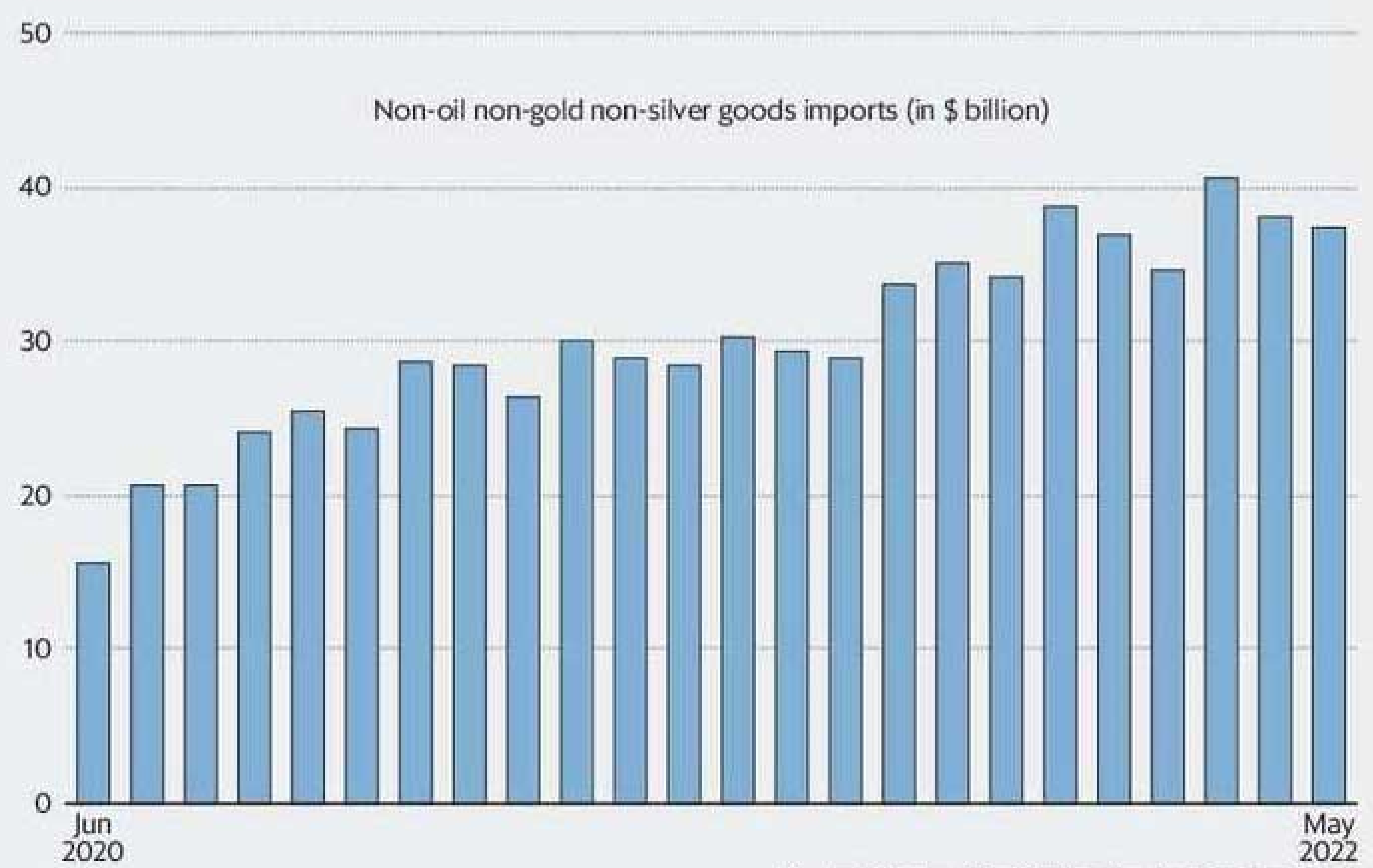
Becoming dearer

Between January and May, non-oil non-gold non-silver imports rose 32% from a year earlier. A weaker rupee makes these imports pricey and could limit them.



Source: Centre for Monitoring Indian Economy.

SATISH KUMAR/MINT

SOMETHING'S GOT TO GIVE

A high trade deficit can lead to macroeconomic instability and needs to be avoided

DEPRECIATING rupee can take care of it to an extent as it makes import costly and could curb them

HOWEVER, this is bound to have fallouts such as expensive crude oil imports to India

On 20 June, one US dollar was worth around ₹78. However, just nine days later, on 29 June, it was worth close to ₹79, the lowest it has ever been. This means that the value of the rupee has been depreciating against the dollar at a fast pace.

This is happening despite the Reserve Bank of India (RBI) intervening in the foreign exchange market by selling dollars from its foreign exchange kitty and buying rupees. The RBI sells dollars and buys rupees to ensure that enough dollars are circulating in the system and that the rupee doesn't lose value at a fast clip.

This comes at a cost. In fact, in the two weeks between 3 June and 17 June, the foreign currency assets of the RBI, of which the dollar is a major constituent, fell by nearly $10 billion to $526.9 billion.

In this scenario, the RBI will have to go slow in intervening in the foreign exchange market. This is simply because the RBI cannot create dollars out of thin air. Only the US Federal Reserve, the American central bank, can do that.

A falling rupee makes imports expensive, particularly energy imports, which feeds into inflation or the rate of price rise. The government has tried to control high fuel prices in two ways. One, it has cut excise duties on petrol and diesel. Two, the state-run oil marketing companies seem to have been instructed not to increase petrol and diesel prices and these have been stagnant since 22 May.

On the other hand, a weaker rupee might help control the burgeoning trade deficit. The trade deficit is the difference between imports and exports. If we look at non-oil non-gold non-silver imports, they have been growing rapidly. Between January and May, the non-oil non-gold non-silver goods imports stood at $188.4 billion, up almost 32% year-on-year. A weaker rupee will make these imports expensive and, in the process, hopefully, lower their demand and help control imports and the increasing trade deficit.

This is important because imports are paid for in dollars and other foreign currency. This money first needs to be earned, primarily through exports. However, exports are likely to come under pressure this year, with the rich Western world expected to grow slowly or even get into a recession.

This will impact remittances as well. Indians working abroad send money home to their families, bringing a lot of foreign currency into India. Further, foreign institutional investors who invest in stocks and bonds usually bring in foreign currency. However, in 2022, they have already taken out $28.3 billion from India. This selling is expected to continue.

Venture capitalists (VCs), when they invest in technology startups, also bring foreign currency into India through the foreign direct investment route. However, with interest rates rising in the rich world, the money coming in through the VC route is expected to come under pressure. To conserve cash, technology startups in India are firing people and indulging in less cash burn than in the past.

The point is that in an environment where dollars and other foreign currencies may not keep coming to India at the same pace as in the past, imports can't keep growing rapidly. As RBI's latest State of the Economy report pointed out: "The foreign exchange reserves... as on 3 June 2022 were equivalent to about 10 months of imports projected for 2022-23." The import cover was around 19 months at the same point last year.

A high trade deficit can lead to macroeconomic instability and needs to be avoided. A depreciating rupee can take care of that to some extent. However, it will have repercussions, including a higher price for energy imports.

That's the thing with economics. At the end of the day, it's all about trade offs.