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India's Currency Practices – US Signals Caution

What is the issue?

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- US Treasury Department's recent semi-annual report has warranted India to be placed on the 'Monitoring List' for currency practices.
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- The move is largely unjustified as RBI interventions were on account of a surplus capital account and not for undervaluing the Rupee.
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Why has India intervened in foreign exchange markets?

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- India has been frequently intervening in foreign exchange markets through RBI – which means that it is purchasing more foreign exchange lately.
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- **The Concept -** RBI pumps in Indian Rupee and buys foreign currency from the international markets – which increases rupee supply internationally.
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- This reduces the demand for rupee and thereby reduces the rupee exchange rate, which helps in arresting any upswing in rupee value.
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- It is to be noted that a strong currency would make exports costlier and create losses for export dependent local businesses.
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- Contrarily, when there is a big depreciation of rupee, India's imports will become expensive and lead to domestic inflation.
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- In such a scenario, the RBI sells its foreign exchange reserves and drains out rupee liquidity internationally, which will push the exchange rates upwards.
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- Thus, the interventions are buffer mechanisms in RBI's arsenal to ensure that the currency neither gets overvalued nor gets undervalued.
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- **Current Stats -** Net annual purchases of foreign exchange reached $56 billion in 2017, which is equivalent to 2.2% of the GDP.
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- These interventions were to ease a strong Rupee Rally (appreciation) in the backdrop of a massive inflow of FDI and portfolio investments.
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- But despite these intervention, rupee appreciated by over 6% against the dollar and by more than 3% on a real effective basis in 2017.
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- Significantly, India's Forex reserves have been continuously rising (presently $424.86 billion) due to frequent intervention since 2013.
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- **Regulations -** Value of free-floating currency isn't supposed to be tampered with except in exceptional cases (rapid fluctuations), because appreciation and depreciation are balancing mechanisms in international trade.
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- IMF would've usually deemed the currency of counties that undertake such interventions as undervalued, but it has refrained currently as India has a 'Current Account Deficit' (CAD) that is as high 1.5% of its GDP.
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- Notably, RBI maintains that the value of the rupee is broadly market-determined and that interventions are only when there is undue volatility.
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What does the US report say?

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- India had a significant bilateral goods trade surplus with the US, which totals to $23 billion in 2017.
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- US has 3 criterions based on which it placing a country in the 'Monitoring List' for currency practices. They are -
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- Bilateral trade surplus of over $20 billion with the US
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- Frequent interventions in the Forex Market

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- IMF’s contention of that the currency is being undervalued

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- Hence, as India meets 2 of the 3 stated aspects, the US Treasury Department has warranted placing India on the aforementioned “Monitoring List”.

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- Notably, 5 other countries namely - China, Germany, Japan, Korea and Switzerland are already on the list.

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- The US has maintained that the list is to aid in monitoring and combating unfair currency practices and encourage policies to address trade imbalences.

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Is the US move justified?

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- India does indeed have a trade surplus with the US, but unlike China, it still has a large trade deficit overall – which implies that Rupee is still overvalued.

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- A recent assessment by the IMF has also held that the rupee is actually moderately overvalued and ‘closely aligned to its fair value over the long term’.

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- The accumulated foreign exchange reserves were largely due inflows into the capital markets and hence India doesn’t qualify as a currency manipulator.

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- Also, RBI is projected to merely purchase 0.6% of GDP as Forex, which is well below the IMF ceiling (2% of GDP) for being labelled a currency manipulator.

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How does the future look?

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- RBI’s forex reserves now covers only 11 months of imports, which is actually

below pre-2008 (global financial crisis) level of maintaining a 14 month buffer.
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- Also, the Current Account Deficit (CAD) is set to rise to 1.9% of the GDP.
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- More significantly, share of portfolio investments has jumped to 120% of forex reserves from pre-crisis level of 70% - which calls for jacking up reserves.
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- US listing has currently caused the rupee to fall sharply by 29 paise against the US dollar to close at 65.49 in one day.
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- However, forex dealers don’t expect a sharp fall as the RBI then props up the rupee by selling dollars from its reserves.
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- Hence, experts opine that RBI will continue with its interventionist approach at appropriate times, despite being placed on the US watch list.
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Source: Indian Express

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