

NOTE

RUPEE DECLINES

Bharat Jhunjhunwala writes :

The unexpected decline of the rupee continues unabated. One reason is the world economy slipping into a recession. Collapse of Lehman Brothers indicates that things are likely to get worse. American citizens are unable to repay the loans taken by them. Reduced demand from Americans is telling on the balance sheet of American companies and the sub-prime crisis is spreading to good quality debt. The European economy has remained stagnant in the last quarter after constricting in the previous quarter. Japan is showing signs of recession. The China story appears intact at the moment but, given the all pervasive State control, it is difficult to fathom if the fundamentals are worsening. The demand for Indian goods in the world markets is declining as a result. Reduced exports means less foreign exchange is coming into Indian markets.

The worsening global economy is making Foreign Institutional Investors to sell in India. They have become risk averse. They are keen to bring back their capital home before unforeseen developments take over the Indian economy. The decline in the exchange rate of rupee from Rs 39 to Rs 45 a dollar has shaken the confidence of FIIs. They have incurred huge losses by not selling earlier. More generally, FIIs are withdrawing from all emerging markets, including that of India. FIIs seek the safety of their home turf in face of an imploding world economy.

On the other hand, the demand for dollars remains buoyant in the forex markets. FIIs are buying dollars for repatriation of their monies. There is also a huge demand from oil companies for imports of oil. This demand is stable despite a small decline in the growth rate from 11 percent to 8 percent. This high demand along with reduced supply of dollars is leading to increase in price of the dollar and a parallel decline in the exchange rate of the rupee.

The policies of Indian Government have not helped. Some impact of the global slowdown is to be expected. But why is Rupee declining speedily against all major currencies of the world? As Indian banks have not extended sub-prime loans of doubtful quality, India stands to lose less than the American economy. Relatively speaking, the decline of the rupee should be less than the dollar; or the rupee should rise against the dollar. After all, why should Indian rupee decline due to the mistakes made by American banks in extending sub-prime loans? One does not go bankrupt because one's neighbour has done so. *Instead, one finds that the rupee declining more than the dollar.*

The two causes of decline of the rupee, then, are slowdown in the world economy and oil subsidy provided by the Government to domestic consumers. Of the two, the slowdown in the world economy is likely to be of a longer duration. In any case, Government of India has no control over the same. However, the Government has the option of dismantling the oil subsidy. □□□