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GOVERNMENT OF INDIA
भारत सरकार

Asian Age, Delhi
Sunday, 30th September 2018; Page: 7
Width: 37.17 cms; Height: 26.89 cms; a3r; ID: 19.2018-09-30.68

'High oil prices will put pressure on current account deficit, rupee'

Dr Sunil Kumar Sinha, principal economist and director public finance, talks to Pawan Bali about recent moves taken by the government to hike custom duty on non-essential items and its impact on rupee.

Oil is hovering at a four-year high. How badly can it impact India, as 80 per cent of our oil is imported?

The straight impact is visible on the current account deficit (CAD) and indirect impact has also started becoming visible in terms of oil and petrol price going up. It will impact the economy adversely through both the trade channel and inflation.

Is there a fear that the current account deficit may spiral out of control?

It is unlikely. It certainly will be much higher than what it was in the last fiscal. Our estimate is that the CAD this fiscal will be 2.6 per cent of the GDP against close to 1.9 per cent in the last fiscal.

What is the outlook on rupee as it has already hit its lowest levels? Do you see further weakening of the rupee?

So far as rupee is concerned, it has already depreciated this year, significantly till September 11-12. It has depreciated by 13 per cent in this calendar year. Depreciation is driven by two factors: first one relates to the fact that our CAD was widening, oil prices were rising. As a result, our import bill was rising too, but at the same time the export growth was not keeping pace with the import growth. So the CAD widening meant that the rupee would depreciate.

The unfortunate part is that this is not something new to the Indian economy that the current account has been in deficit. However, the cushion used to come from the capital account, where most of the capital inflows are accounted for, whether it is FDIs or FIIs. FIIs have been a big support for the Indian economy because they were bringing in a lot of dollars. As a result, the capital account was always in surplus.

In fact, capital account surplus was not only good enough for covering the CAD but to leave some scope for addition in the foreign currency reserve. But April onwards, when capital inflows started reversing, till July the total net outflow of capital from the Indian economy was to the tune of $9 billion. So if you see that along with CAD, then that's what put pressure on rupee to depreciate.

> Due to increase in oil prices, the inflationary pressure on the Indian economy is high. To guard against that, the RBI may go for another interest rate hike in 2018-19. But when that will happen is debatable.

And other factors?

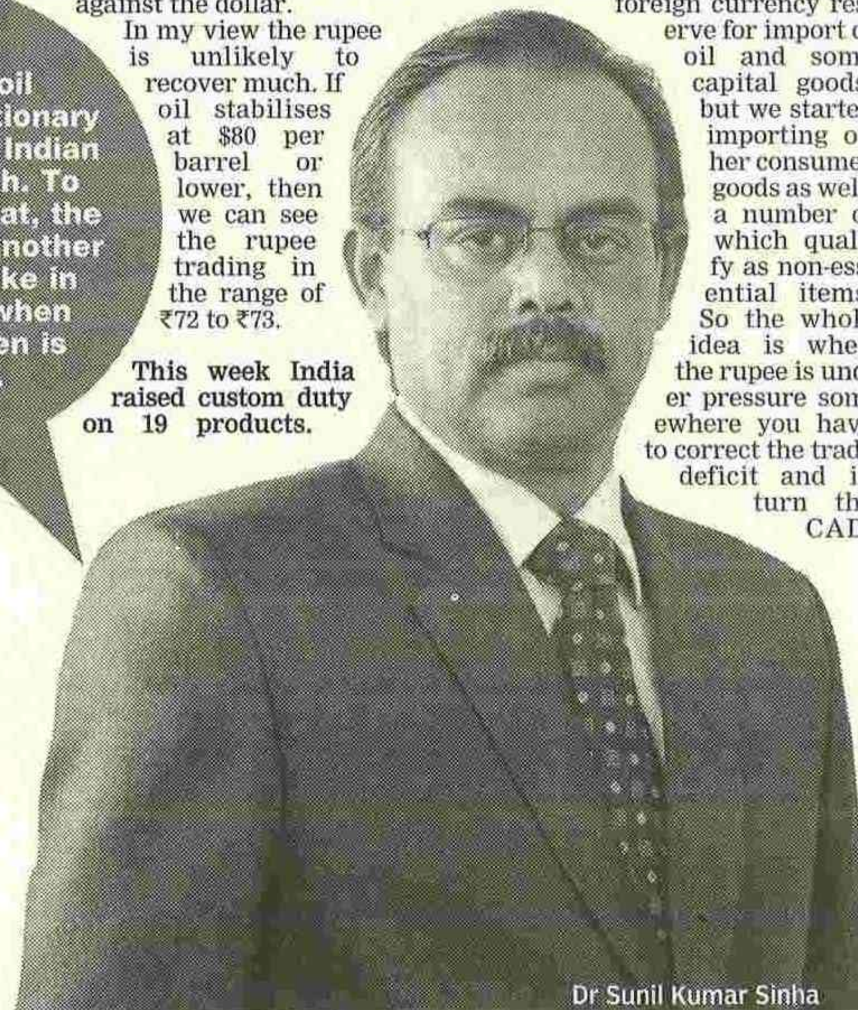
Simultaneously, the other factor that played out was that in the last three-four years we have seen that the rupee was fairly stable against the US dollar, which should not have been the case given that inflation rate difference between the US and Indian economy is always there. On an average, the inflation rate in our economy will be five per cent if you take last two-three years. But at the same time the average inflation rate in the US economy will be close to one per cent or little higher.

While the dollar is depreciating every year by one per cent, the rupee is depreciating by five per cent every year. So that should have got equated on yearly basis. But that didn't happen. This time, when the rupee came under pressure, these factors played out simultaneously. On the one hand the ability of the capital account to cover up the CAD went down and at the same time this inflation rate differential started correcting itself. These two things together resulted in the rupee depreciating from ₹67 to close at ₹73 against the dollar.

In my view the rupee is unlikely to recover much. If oil stabilises at $80 per barrel or lower, then we can see the rupee trading in the range of ₹72 to ₹73.

This week India raised custom duty on 19 products. What impact do you think it will have on CAD along with measures announced on external commercial borrowing and masala bonds?

All measures taken are to ease the pressure on rupee. The import duties, which have been raised, its main purpose has been to make import of non-essential items costlier. Over the years we have seen that we are not only using foreign currency reserve for import of oil and some capital goods, but we started importing other consumer goods as well, a number of which qualify as non-essential items. So the whole idea is when the rupee is under pressure somewhere you have to correct the trade deficit and in turn the CAD.


Dr Sunil Kumar Sinha

But one will have to wait and watch its real impact and how much it can reduce import. The measures on external commercial borrowing and masala bonds are targeted at enhancing capital inflow in the economy.

Many economists believe that the RBI may hike interest rates to strengthen the rupee.

The RBI has already done two back-to-back interest rate hikes. The way the rupee has depreciated, it is quite obvious the interest rate arbitrage (between the US and Indian markets) was coming down. This week also US Federal Reserve has raised interest rates. A lot of money used to come into Indian market because the difference between interest rates of India and US market were high.

Let's hypothetically say it was four per cent. Now if the US Fed has raised the interest rate by 25 basis points then this interest rate arbitrage will fall to 3.75 per cent. This factor could result in the Indian market becoming less attractive for a lot of capital, which flows into our debt market. So there is a view that to restore that arbitrage and make Indian debt market attractive for FII we should raise the rate of interest and that's how we should attract more capital.

But my own sense is that this is not a correct strategy to shore up the rupee or protect against further depreciation. The RBI is unlikely to raise interest rate to protect or shore up currency. I don't see another policy rate hike taking place in October. Due to increase in oil prices, the inflationary pressure on the Indian economy is high. To guard against that, the RBI may go for another interest rate hike in 2018-19. But when that will happen is debatable.