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Indian Rupee: Tortuous Travails

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The recent numbers of the index of industrial production (IIP) and the consumer price index (CPI) in India have been the cause for some serious concern. The IIP and CPI numbers suggest that even as growth is decelerating, inflation is actually accelerating. Specifically for the IIP, the index declined by 1.6 per cent relative to May 2012, sharply below consensus estimates as there was an anticipation for small positive gains. This, if any, is an early indication that growth projections for the current year will be scaled downwards from their already modest levels. Concurrently, consumer inflation has accelerated at 9.9 per cent over June 2012, about half a percentage point higher than the previous month. Food prices largely contributed to this increase. While it was non–cereals in the earlier occasion that caused this inflationary pressure, this time, prices of cereals have increased almost by 18 per cent. 15 July 2013 figures of wholesale price index (WPI) indicated a worsening of inflationary pressures to 4.86%. Reuters reported a drop in industrial production figures (as evident in Exhibit 1), coupled with a volatile WPI inflation. High cost of funds coupled with pressure on net interest margins will constrain the efforts of the Reserve Bank of India (RBI) to reduce interest rates at the next monetary policy review on 30 July 2013.

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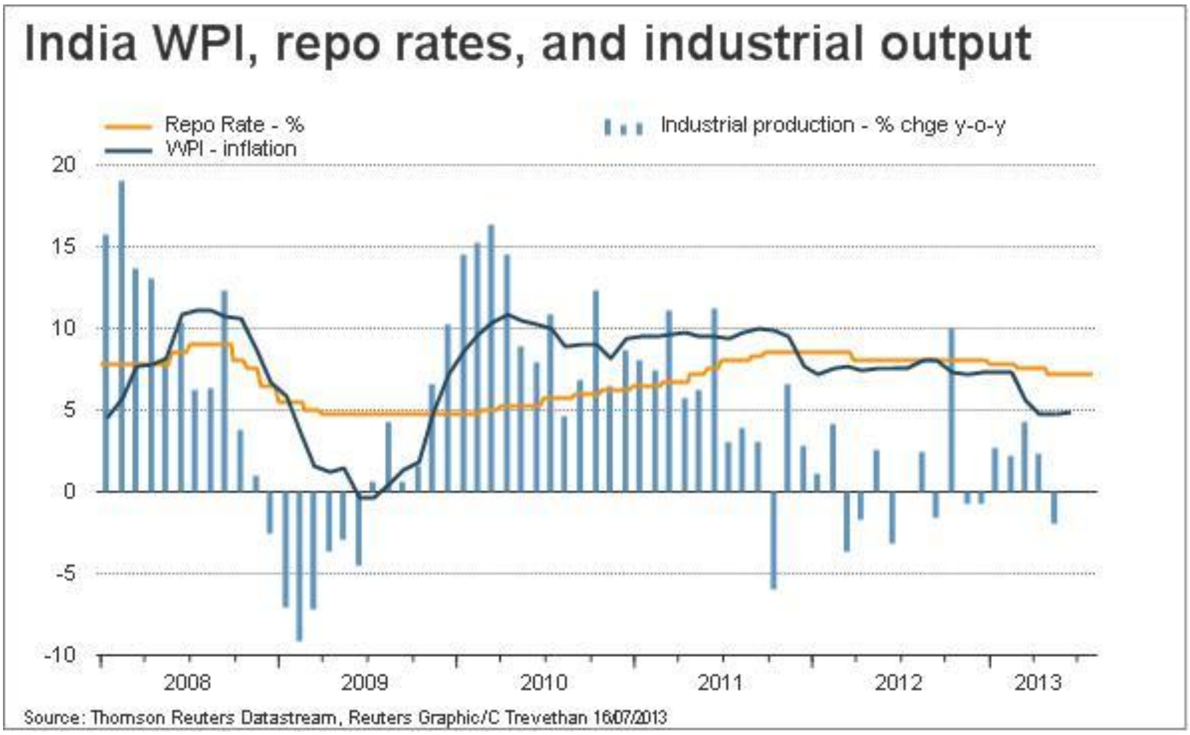

Policy uncertainty and global headwinds add to the predicament. The rupee has been under severe pressure due to high inflation, burgeoning current account deficit and high gold imports. Emerging market currencies across the world have depreciated as debt outflows have increased following the US Federal Reserve's suggestion that its asset purchases might be tapered down in September. The US Federal Reserve is adding $85 billion per month to the system under its Quantitative Easing (QE) programme. Any tapering of QE will reduce the amount of money flowing into emerging economies. The persistent underperformance of the EU zone has led to the exit of euro investors into dollars, thus raising the dollar demand.

The Indian debt market has seen an exodus of $ 3.3 billion dollars of debt capital since 21 May 2013, accelerating the rupee's fall. As foreign institutional investors (FIIs) have a relatively small share in the Indian bond market, the outflow has had a relatively low impact. In the last two weeks, FIIs have pulled out close to Rs. 8500 crores from the financial markets. In addition to this official flow, markets are also awash with rumours of huge informal flows through the grey market as rupee accumulations inevitably seek safe dollar denominated positions. The corporate sentiment that general elections is likely to happen earlier than later, has accelerated informal outflows of accumulated money to safe havens overseas.

On Monday 15 July, the Reserve Bank of India moved swiftly to contain short-term volatility of the rupee to curtail excess rupee liquidity. This has presumably caused the chase for dollars. In a statement issued late on Monday, the RBI noted “The exchange rate pressure also evidences that the demand for the foreign currency has increased vis-à-vis that of the rupee in part because of the improving domestic liquidity situation"[2]. The RBI said that countries with large current account deficit like India have been affected due to market perception of likely tapering of US quantitative easing despite their own relatively promising economic fundamentals. The measures announced include hiking the Marginal Standing Facility (MSF) and the Bank rate by 200bps to 10.25% with immediate effect[3].

From 17 July, the RBI has set a limit on overall overnight borrowing under liquidity adjustment facility (LAF) to Rs75,000 crore. This is 1% of net demand and time liabilities.[4] The average LAF in July stood at Rs45,000 but snorted to Rs92,000 crore on Monday. Perhaps the RBI suspects LAF money is being used to punt in the rupee. Also, in an unusual move, the RBI announced that it will sell government bonds worth Rs12000 crore via open market operations (OMOs) on July 18 to suck out liquidity.

Rupee has depreciated by 8% since the first statement made by the US Federal Reserve in May. The rupee recorded an all-time low of 61.21 per dollar last week. The combination of poor IIP figures, persistent inflationary pressures and current account deficit have weakened the rupee, at a time when the dollar has strengthened. Improvements in the expectations of growth in the US, the federal stance of reducing QE and perhaps tightening interest rates, as well as the continuing concerns of the EU, have contributed to the strengthening of the dollar in global markets. The currencies of all major emerging markets have been falling and in the case of India, the poor performance of the economy has exacerbated the situation.

It is interesting to note that while RBI has taken prompt measures to curb liquidity and volatility, there is little action from Government on fiscal controls and more absurdly the sheer absence of any articulation of even a short-term strategy to remedy the situation. The second quarter results for several Indian companies listed in the exchanges have been dismal. In all, this has led to declining investor sentiment for Indian financial instruments. Albeit, investors with greater risk appetite could take advantage of the interest rate arbitrage that is still available between US/Singapore rates and Indian rates. Even with the rupee depreciation fully accounted for, one cannot discount positive returns.

This trend would continue in the short-term into the medium term. The price point for the rupee in the long-term is likely to hover between 56 and 59 to the dollar. Self-correction, presumably with measures from RBI will set in, if it falls below this price line. Once the elections are over, monetary stability is likely to return. In the short run, the rupee is likely to

[2] RBI clamps down on liquidity to curb Rs swings. Parnika Sokhi. 16 July 2013. 16 July 2013. http://www.dnaindia.com/money/1861609/report-rbi-clamps-down-on-liquidity-to-curb-rs-swings

[3] The MSF is a window that banks resort to when they fall short of the mandatory Statutory Liquidity Ratio (SLR) of 23% to borrow funds from the repo window. But banks have been running SLRs 300-400 basis points more than the mandated 23% due to risk aversion among banks and a lack of corporate demand for loans. MSF can be availed of at a penal rate of 100bps above the repo rate. This margin has been increased to 300bps by RBI on Monday. The repo rate stands at 7.25% currently. But MSF has not been availed of since May this year.

[4] Sensex slumps as RBI announces measures to arrest rupee's fall. Capital Market-Live News. 16 July 2013. 16 July 2013. http://www.business-standard.com/article/news-cm/sensex-slumps-as-rbi-announces-measures-to-arrest-rupee-s-fall-113071600193_1.html

be weak. This could be further aggravated by increases in energy prices as India depends significantly on imports of oil and even coal. There has been a belated realisation that people were hoarding gold against inflation. Consequently, there were measures imposed on investment in gold and a ban on the sale of gold ingots and primary gold by dealers. Supply controls by themselves will not curb demand as investors are seeking refuge against inflation with the purchase of gold. A reduction in gold demand, stability in energy prices, coupled with some moderation in food inflation after the rabi harvest, is likely to reduce pressure on the rupee.

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