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India Economics

INR – RBI's Tough Task of Fine Balancing – Part II

Rupee at a nine-year high: We believe that in early March this year, the Central Bank made a clear shift in exchange rate management approach allowing faster appreciation of the currency. The rupee has appreciated by about 8.4% since early March, compared with 3.4% appreciation in the preceding six months. Apart from reducing the pressure on liquidity management, the currency appreciation will only help in reducing the inflation pressure.

Capital inflows spiking up: India's foreign exchange reserves have increased by US$23 billion in the last 10 weeks – this implies an annualized run rate of US$120 billion and compares with US$40 billion accretion in the 12-month period prior to these 10 weeks. With the current account continuing to be in deficit, this increase in reserves is driven by strong capital inflows. This surge in inflows and rising cost of the sterilization appears to have triggered the shift on RBI policy to allow faster appreciation in the rupee.

Appreciation trend may remain intact but pace could slow: After the recent sharp appreciation, we estimate that on a real effective exchange rate basis the rupee has moved further away from its mean by about 10%. We believe that the medium-term implications of the over-valued currency for macro stability are that the RBI may have to start intervening soon to soften the pace of appreciation. However, this intervention would also necessitate further hike in the cash reserve ratio.

Capital controls next? While RBI may continue with the intervention for the next three months or so, if the pressure of capital inflows persists, it may have little choice but to initiate some capital controls on debt-oriented inflows. Some soft measures have already been announced recently – such as limiting returns on non-residents' deposits and restrictions on banks' borrowings from abroad.

For important disclosures, refer to the Disclosure Section.

INR – RBI's Tough Task of Fine Balancing – Part II

Rupee has Appreciated to a Nine-Year High

Our recent note (*INR – RBI's Tough Task of Fine Balancing*, dated April 9) highlighted the Reserve Bank of India's increasingly complex task of trying to pursue an independent monetary policy, a relatively open capital account and a managed exchange rate. We highlighted the possibility of the Central Bank having to let the rupee appreciate against the US dollar as it chooses to maintain an independent monetary policy (higher interest rates to control overheating) and an open capital account over a stable exchange rate regime. Since then (April 9), the Indian rupee has appreciated rapidly by 4.7% against the US$ – a perceptible shift in approach towards currency management (Exhibit 1). In this follow-up note, we further analyze the dynamics of this trend and the potential implications for the same on export growth and trade deficit.

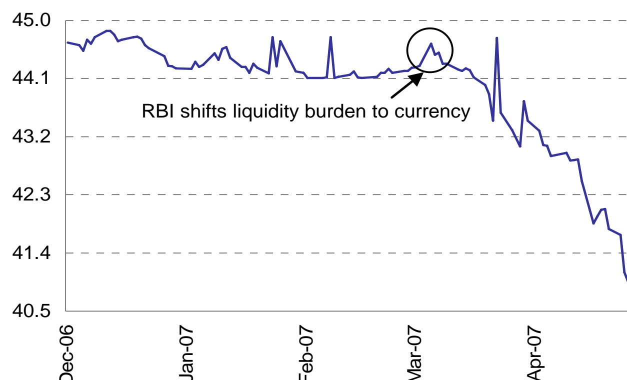
Spike in Capital Inflows in the Last Few Weeks

India's foreign exchange reserves have increased by US$23 billion in the last 10 weeks – this implies an annualized run rate of US$120 billion and compares with US$ 40 billion accretion in the 12-month period prior to these 10 weeks. This surge has resulted in cumulative appreciation of 7.3% of the rupee against the US dollar in this period. With the current account continuing to be in deficit, this increase in reserves is driven by strong capital inflows. A bulk of this rise is due to non-FDI (foreign direct investment) inflows – primarily debt, portfolio equity and private equity inflows. Although FDI flows have picked up recently, in our view non-FDI flows would have accounted for about 75% of the total capital inflows.

Rising Cost of Sterilization Makes it Difficult for RBI to Intervene in FX market

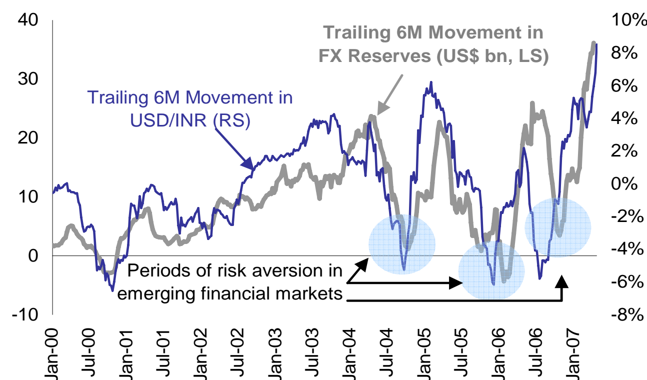
Even though the RBI may be concerned about the overvaluation of the currency and the widening trade deficit, we believe it is forced to let the currency move to the overvalued zone, as excessive intervention in the FX market is resulting in a large injection of liquidity in the banking system. Two years back, when domestic capacity utilization was low, the system could absorb this liquidity. With capacity utilization increasing to near peak levels, this liquidity has, over the last few months, posed a challenge to macro stability. To control this overheating, the Central Bank is forced to sterilize this excess liquidity via reverse repo (until recently), market stabilization scheme (MSS) bonds and cash reserve ratio hikes (see Exhibit 3 and Exhibit 8 for details).

Exhibit 1
Movement of USD/INR



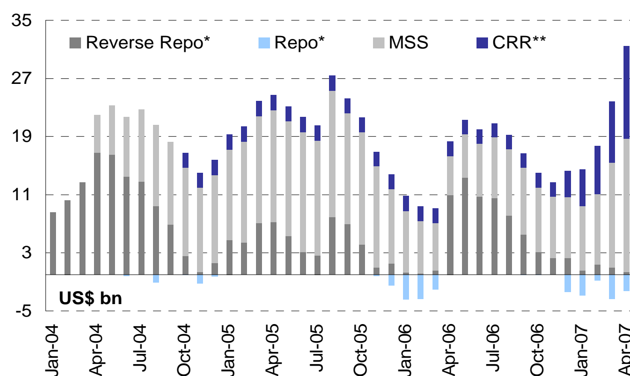
Source: Bloomberg, Morgan Stanley Research

Exhibit 2
USD/INR versus FX Reserves Accretion



Source: RBI, Morgan Stanley Research

Exhibit 3
Trend in Sterilized Liquidity Balance



Source: RBI, Morgan Stanley Research; * Repo and reverse repo balance represent average numbers for that month; ** CRR balances include the liquidity absorbed under this mechanism since October 2004 (raising the CRR from 4.5% to 6.5%)

Although many other Asian countries face a problem of excess liquidity, we think that the sterilization cost problem is more acute in India's case, as there is a negative carry involved (rates in India are significantly higher than in Asia and the US). Rising sterilized liquidity balances (Exhibit 3) and a sharp rise in short-term interest rates have led to an increase in sterilization costs to an estimated US$1.2-1.4 bn[1] (annualized in April 2007) from US$0.7 bn in January (annualized). Indeed, if the Central Bank had not resorted to cash reserve ratio hikes and instead had used the reverse repo/MSS mechanisms, the sterilization cost would have been even higher at US$1.8-2 bn[2] annualized in April 2007. This cost is currently being borne by the banking system as the money parked under the cash reserve ratio with the Central Bank earns no interest even as banks continue pay a weighted average deposit rate of 6.25-6.75% (including low-cost deposits) on them.

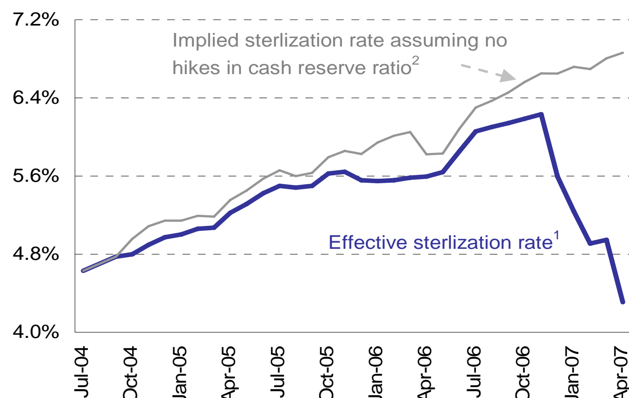
Burden Shifts to Exchange Rate

We believe that in early March this year, the Central Bank made a clear shift in exchange rate management approach allowing faster appreciation of the currency. The rupee has appreciated by about 8.4% since early March compared with 3.4% appreciation in the preceding six months. Apart from reducing the pressure on liquidity management, the currency appreciation will only help in reducing the inflation pressure. Over the last two months the commodity research bureau index has increased by 6.1%. The impact of the appreciating currency will help offset this rise of global commodities. Note that global commodity-linked products have a weighting of 37% in the wholesale price index.

Collateral Damage Will Be Felt on Export Growth

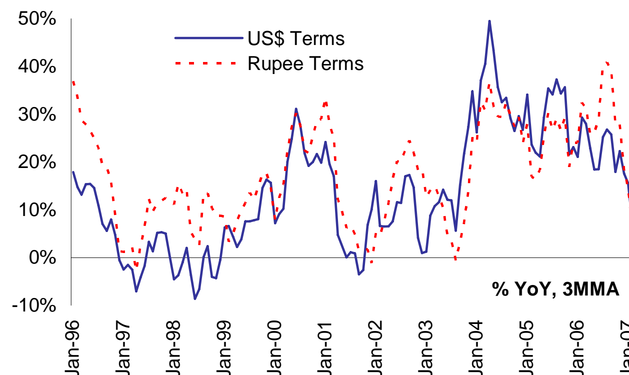
We believe the recent sharp appreciation against the US dollar could result in a further showdown in export growth. On a real effective exchange rate basis (REER, trade-weighted rupee adjusted for inflation differentials with trade partners), the

Exhibit 4
Trend in Approximate Average Interest Rate Cost on Sterilized Liquidity Balances



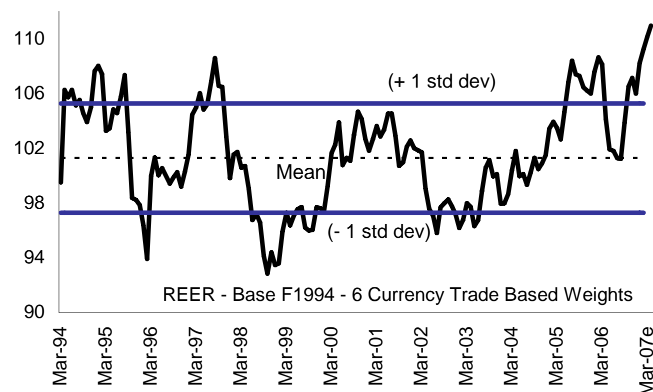
Source: RBI, Morgan Stanley Research; Note: See footnotes 1 and 2 for computation methodology

Exhibit 5
Export Growth Touching 3½ Year Low



Source: CEIC, Morgan Stanley Research

Exhibit 6
Indian Rupee: Real Effective Exchange Rate[3] (REER)



Source: RBI, Morgan Stanley Research 3. REER is based on a 6-currency index of India's top trading partners; e= Morgan Stanley Research Estimates

[1] This is an approximation based on available data. We have used the following components/assumptions – a) cost of reverse repo balance = average monthly reverse repo balance x reverse repo rate; b) gains from repo balance = average monthly repo balance x repo rate; c) cost of market stabilization scheme = outstanding MSS balance x trailing one-year average of 364-Day T-bill rate (assuming constant one-year maturity of issuances under MSS scheme); d) cost of cash reserve hikes = balance accumulated under CRR since October 2004 x prevailing rate of interest on CRR. The final number is computed as (a)-(b)+(c)+(d) divided by the total sterilized liquidity balance.

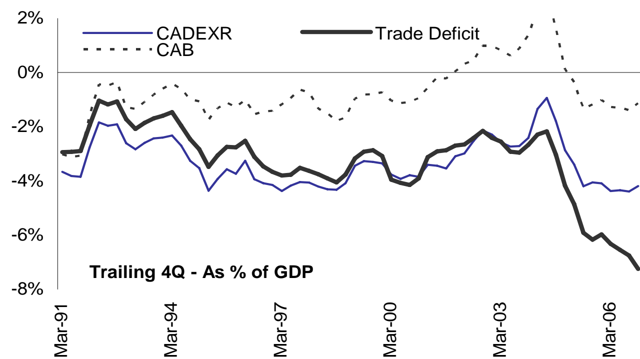
[2] For computing the implied cost if the Central Bank had not resorted to absorption via cash reserve hikes, we assume that the absorption would have alternatively been done by the reverse repo mechanism.

Indian currency has moved to its highest level in the last 14 years (maximum period for which we have data). On a REER basis, the rupee is now about 10% above its 10-year mean. Apart from the appreciation in currency, slower global demand growth is an added challenge for export growth trend. We believe that US dollar goods export growth, which recently slowed to just 7% (average during 3 months ended February), could potentially decelerate further to 0-3% in the next 3-4 months. Export growth in rupee terms has already slowed to 6% in this period. This trend would only cause further widening in the current account deficit excluding remittances, even as overall current account deficit may remain with manageable limits.

Although from a macro stability perspective one can look at the current account including a sustainable component of NRI remittances, we believe that, in the context of assessing the implication for the relative currency competitiveness and domestic output growth, CADEXR is a better measure. The current-account deficit, excluding non-resident Indians' (NRI) remittances (CADEXR) widened to the high level of 5.1% of GDP at quarter-end December 2006. We believe that this deficit would widen further to 6-6.5% of GDP over the next 2-3 quarters, if the rupee appreciation trend is maintained. We believe if export growth during 12 months ended March 2008 (F2008) reduces to 0-5% YoY in rupee terms compared with an estimated 23% in the 12 months ended March 2007 (F2007), it would reduce overall GDP growth by 0.8-1.2% points in F2008.

Exhibit 7

India: Trailing Four-Quarter Trade and Current-Account Balance (as % of GDP)



CADEXR = Current Account Deficit Excluding Remittances; Source: RBI, CEIC, Morgan Stanley Research

Capital Controls Next?

We believe that currently the RBI is focused more on slowing domestic demand growth and reducing inflationary pressure. Fighting the impossible trinity, RBI has so far chosen to let the currency appreciate and has tried to achieve greater effectiveness in management of monetary policy. However, after the recent sharp appreciation, we estimate that on a real effective exchange rate basis, the rupee has moved further away from its mean by about 10%. We believe that the medium-term implications of overvalued currency on the macro stability are that the RBI may have to start intervening soon to soften the pace of appreciation. However, this intervention would also necessitate a further hike in the cash reserve ratio. While the RBI may continue with the intervention for the next three months or so, if the pressure of capital inflows persists, it may have little choice but to initiate some capital controls on debt-oriented inflows. Some soft measures have already been announced recently – such as limiting returns on non-residents' deposits and restrictions on banks' borrowing from abroad.

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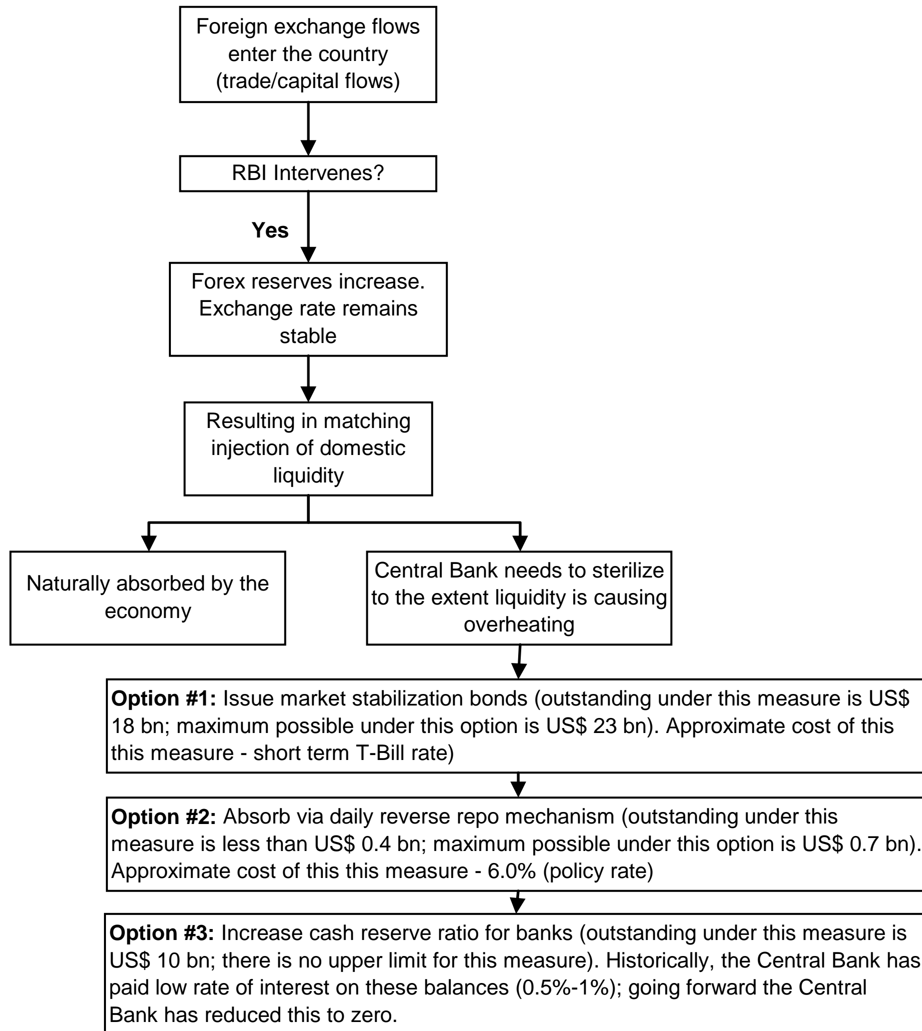
Exhibit 8

Central Bank's Methodology of Intervention and Sterilization



Source: Morgan Stanley Research

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