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THE CRASH-BANG
STORY OF THE RUPEE

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A currency in free fall

Rupee at new low of 53.74; likely to hit 55, predict analysts

A growing trade deficit and the low probability of a strong intervention from the RBI, is likely to keep the rupee under pressure.

Agencies , Dec 14, 2011

The rupee fell to a record low against the dollar for the third day on Wednesday as a slowing domestic economy and Europe's debt crisis hit risk appetite and triggered outflows.

On Tuesday industry chamber Assocham predicted that the rupee may depreciate against the US dollar further up to Rs 55 level by March next year if the weak run of the global economy continues.

It also said that a weak rupee will further put pressure on the overall inflation.

At 9:05 am, the partially convertible rupee was at an all-time low of 53.71/74, taking losses to 18.4 per cent from its year-high in July.

A growing trade deficit and the low probability of strong intervention from the Reserve Bank of India, given the limited firepower in its currency reserves, is likely to keep the rupee under pressure, traders said.

The rupee on Tuesday breached the 53-level for the first time against the dollar on sustained capital outflows amid compounding woes of the Indian economy.

A firmer stock market provided a bit of comfort, but traders said the rupee looks to be headed lower still as worries about the euro crisis add to anxiety about slowing foreign capital inflows into emerging market economies such as India.

Assocham said the rupee-dollar exchange rate could well reach the levels of 53.80 by January next year and 55.10 by March if the global economy continues to be bleak like in recent months.

Meanwhile, HSBC India, in an interview with CNBC TV 18, stated that the long-term target could be seen at around Rs 56 levels.

The domestic currency slid against the dollar from 44.40 in July to 45.50 in August, 47.60 in September, 49.30 in October and 52.70 this month, it said.

"Such wild fluctuations within a short span of time are unsettling and leaving imprint on rest of the economy," it said, adding it will add further pressure on the overall domestic inflation.

It will particularly hit industrial sector and put higher pressure on cost of items like oil, imported coal, metals and minerals and imported intermediate products.

Rupee hits new all-time low of 52.48. Next stop, 56 against the dollar?

What a miserable start to the week for the rupee. On Tuesday, the rupee raced past its all time low to hit 52.48 against the US dollar in the early morning trade. The currency's earlier all-time low was 52.19, which it hit against the dollar on 3 March 2009.

And it's seems there's no going back – at least for now.

According to an *AFP* story, the local currency has tumbled by more than 4 percent against the dollar in the past six days alone, hammered by fears that the eurozone sovereign debt crisis is gradually shifting from peripheral nations to the larger economies of the zone and the fact that no deal could be reached between US lawmakers on tackling the country's massive debt.
Rupee

> ***The local currency has tumbled by more than 4 percent against the dollar in the past six days alone, hammered by fears that the eurozone sovereign debt crisis is gradually shifting from peripheral nations to the larger economies.***
>
> *FP Editors, Nov 22, 2011*

Those fears are driving investors to dump relatively riskier emerging market assets in favour of safe haven currencies like the greenback.

There's also high demand from oil refining companies to settle month-end import bills. Oil refining companies are the biggest buyers in the dollar market in India. Oil accounts for one-third of the country's import bill and is also the largest component.

Moses Harding, executive vice-president and head of wholesale banking at IndusInd Bank, warned the rupee could fall as low as 54-56 against the dollar.

That prediction might have seemed unbelievable even five months ago, but now that the rupee is at 52, it doesn't seem that fantastically outrageous any more.

"There has been sudden reversal in rupee fundamentals driven by widening trade gap (the difference between exports and imports) and reduced capital flows," he wrote in a note to clients. "The Reserve Bank of India's ability to intervene is also hampered by squeeze in system liquidity and limited dollar reserves in its balance sheet."

While he also believed that the rupee's one-way slide from around 43 to 52 was excessive, he said it would take at least six months before the situation reversed.

More problems for the RBI

The falling rupee will complicate matters for policy-makers by pushing up the price of imports (especially oil, which feeds right through the economy) and fuelling inflation further when it is already at 9 percent. It also means RBI governor D Subbarao, despite all his intentions, will not really be able to take the pressure off raising interest rates.

Even thought the rupee is Asia's worst-performing currency, having fallen around 14 percent this year, most experts believe there is more pain to come.

"There's nothing preventing the rupee heading into uncharted waters," Abheek Barua, chief economist at HDFC Bank, told *AFP*.

On Tuesday, the rupee was already swimming towards them, especially after Economic Affairs Secretary R Gopalan said the central bank had "limited ability" to intervene in the foreign-exchange market to curb the rupee's sharp slide.

That means the best the markets can hope for now is that the rupee, will somehow, reverse course on its own.

Is that likely? Not really. "The chances of a self-correction in the currency are low and would depend on foreign direct investment and capital inflows," Shubhada Rao, chief economist at Yes Bank told *CNBC TV18*.

Already, foreign investment in equity markets have been subdued this year, at around $663 million compared with the $29 billion invested in 2010, according to the Securities and Exchange Board of India. There are rising fears that a further fall in the rupee could prompt foreign investors to pull out of stocks, further driving the currency lower in a vicious circle.

Even if the rupee recovers, it is unlikely to rise above 50-51 against the dollar, noted IndusInd's Harding.

That's making companies, even exporters, very, very nervous. On Monday, one of India's top software services exporter, Infosys, told Dow Jones newswires that it expects the rupee to strike a new all-time low and is, therefore, keeping its currency hedges light. Chief financial officer V Balakrishnan admitted the volatility in the rupee, however, is complicating Infosys' bets.

It won't be the only one feeling that way.

Watch video:Re to touch 54-56/$; chance of self-correction low: Experts

Why the rupee is down and only capital flows can rescue it

The rupee's recent drop will not be reversed till capital inflows resume substantially and the RBI tames inflationary expectations.

R Jagannathan, Sep 22, 2011

The joker in the pack this year has been the Indian rupee. At a time when the Indian and Chinese economies may be the last men standing, the rupee – unlike the Chinese yuan – is into steep decline and fall.

On Tuesday, the rupee hit a two-year low of 48.24 against the US dollar, suggesting that short-term demand and supply issues are determining its value when the macro-fundamentals should actually lead to a strengthening of the Indian currency.

The financial markets are clearly divorcing from reality – though in the long term they will surely correct.

There is, of course, one good economic reason for the rupee to fall. It's the growing trade deficit (imports minus exports), which hit $55 billion in the April-August period this year. Unless this deficit is bridged by capital flows, the rupee has to decline. Even the Reserve Bank cannot keep selling dollars – which it has shown no great inclination to do —to stem its fall.

The rupee's drop is complicating the fight against inflation. We are now importing inflation (whether it is through higher oil prices or something else), and this will push the Reserve Bank to keep raising rates till something gives.

As against this downer, two other macroeconomic indicators are a relative positive for us.

One of the key determinants of exchange rates is relative interest rates, adjusted for inflation. US policy rates are near zero, and will stay that way, while Indian rates are at 8.25 percent. The US inflation rate is 1-2 percent above the policy rate; ours is, too. This means there is no greater risk in the Indian currency than the US dollar. Sooner or later, capital flows should be headed our way, strengthening the rupee in the process.

Second, India scores on the growth potential front when compared to the US and Europe. No matter how much we slow down, we will still be growing 6-7 percent faster than both these big trading partners. This means capital should be flowing away from the dollar and eurozone, and towards India.

Then why is the rupee showing no spine?

One explanation, of course, is global risk-aversion, which is making capital seek safe havens. To be sure, there is no real safe haven in the world today, given the volatility of every currency, the threat of double-dip recession in the US, and the shakiness of most financial markets.

In fact, faced with the prospect of a eurozone collapse, money has been flowing into Swiss franc and the Japanese yen. This has forced the Swiss central bank to draw a line in the sand saying it will not allow the franc to rise above 1.2 against the euro. It will buy unlimited quantities of the euro to do this. The Bank of Japan also unleashed a tsunami of dollar purchases in August to prevent the yen from rising.

The joke is really on the concept of safe havens. Switzerland, whose banks handle assets that are six times its GDP, is really the most vulnerable of them all. A major bank collapse can bring down the Swiss economy, even as the world pressures the Swiss to wind down their support for global tax evaders. This is why the Swiss are planning to raise capital adequacy norms for banks to 19 percent.

Britain, which is home to huge global banks that are "too big to fail" and will need rescuing by the government in case there is a run on them, is planning to mandate at least 17 percent capital adequacy. The assets of British banks are 4.5 times its economy.

As for Japan, the less said the better. How can an economy with two decades of almost no growth and a domestic debt twice the size of its stagnant GDP, really be a safe haven? The only way Japan can keep the yen down is by unleashing another tsunami of yen debt – which will only worsen its macroeconomic stability. Japan is still an economy waiting for the ultimate implosion.

In that ultimate safe haven, the US, national debt more or less equals GDP, and the Obama administration is trying to cut down expenditure to make sure it stays solvent. But here's the sobering thought, according to David Rosenberg, who says the US economy is facing a double-dip recession, having accumulated $5

trillion of debt in just the last three years – to avoid a depression.

Europe is ticking time-bomb. The betting is that the euro will soon see some opt-outs like Greece and possibly Portugal. But even if Germany is blackmailed or cajoled into bankrolling the euro, the only consequence will be slower growth and economic uncertainty. Everyone knows that Greece is insolvent. The only way it can be rescued is by asking banks to take a "hair-cut" – that is write off some of their Greek debt. This, again, means German banks have to recapitalise themselves. They need capital.

In sum, the US isn't a safe haven, Europe isn't one, Switzerland does not want to be one, and Japan isn't anyone idea of a safe haven.

The only certainty is the prospect of slow growth, and a reduction is consumption and wealth, says Satyajit Das, a risk consultant and author of Extreme Money. In an article in DNA newspaper, he says:

"The proximate cause of recent volatility (in markets) is the down grading of the credit rating US (irrelevant) and the continuation of Europe's debt problems (relevant). The deeper cause is the realisation that future growth will be low and the lack of policy options."

So what will happen now?

"The most likely outcome is a protracted period of low, slow growth, analogous to Japan's Ushinawareta Junen — the lost decade or two. The best case is a slow decline in living standards and wealth as the excesses of the past are paid for. The risk of instability is very high; a more violent correction and a breakdown in markets like 2008 or worse are possible. Frequent bouts of panic and volatility as the global economy deleverages -reduces debt- are likely. Problems created gradually over more than the last three decades can only be corrected slowly and painfully," says Das.

Now, if Das is correct, capital flows should be moving away from US, Japan and Europe – which are heading for slow growth and even wealth erosion – and towards where they are more likely to show positive results: India, China and the emerging markets.

The conclusion, therefore, should be two-fold: in the short run, as western investors and banks worry about their problems back home, and seek to hoard capital against the prospect of huge losses from bad loans, there will be great risk aversion. This is why capital flows into India this year are down 80 percent from last year already.

However, the long-term prospects will depend on how soon investors in the rich nations redefine their mental idea of a "safe haven." When this happens, India will face a tsunami of capital flows, which will reverse the trend in the rupee.

Some research reports doubt whether this will happen too soon. A Deutsche Bank report dated 15 September says it has revised its long-standing view that "the exchange rate is poised to display a tendency toward medium term appreciation, as India's high growth potential would allow it to attract foreign capital and hence it would run an ample and steady balance-of-payments surplus. This view has run counter to the argument

that India's persistent current account deficit and reliance on commodity imports make the exchange rate unlikely to sustain trend appreciation."

So what is Deutsche Bank really saying?

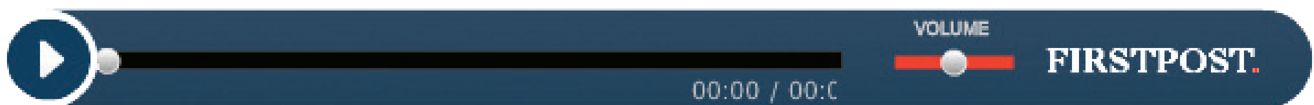
"We now see an additional force complicating the debate: inflation. The persistence of high inflation over a number of years is bound to impact the economy's competitiveness...Furthermore, latest estimates of India's purchasing power parity-based exchange rate also show that one needs substantially more local currency to purchase an internationally comparable set of goods."

"Going forward, one can envision one of two scenarios — either India brings down inflation sharply to stem the rise in the real exchange rate, or it succumbs to a bout of nominal exchange rate depreciation. This issue is independent of the ongoing bout of global risk aversion. We see the rupee's vulnerability rising unless inflation is brought back to the previous trend of 4-6 percent."

This explains the recent weakness of the rupee. It also suggests that the Reserve Bank cannot afford to pause on rate hikes till the back of inflation is broken. Once inflation is down, the rupee will start moving up towards it medium trajectory of appreciation.

Put another way, succour on capital flows are vitally dependent on the battle against inflation.

Listen to audio as our Editor-in-Chief, R Jagannathan talks to Moneycontrol.com Editor Santosh Nair on why the Rupee is headed for more turbulent times.



Can the RBI rescue the rupee?

Why RBI's gaze will shift from PRICES TO RUPEE AND LIQUIDITY

With inflation showing signs of easing, the RBI will have to focus on liquidity and guide the markets on the rupee's future direction.

Madan Sabnavis, Dec 15, 2011

The monetary policy so far this year has had a single target: inflation. It has, therefore, been easy to guess what the Reserve Bank of India will do as long as this number was high. Critics and analysts have tried to interpret their expectations from policy based on their own readings, but the RBI stuck to its task of combating inflation, resulting in few surprises.

In its last review, however, it did say that inflation would come down in December which could justify a pause in rate hikes. Now that inflation seems to be coming down and industrial growth is slipping, what will the RBI do?

The role of the RBI here is to provide direction by firstly admitting that there is an issue in rupee pricing. Reuters

Actually, the way things have turned out, inflation could now become a peripheral concern as new issues have surfaced. In fact, had inflation been 'stubborn', the RBI could have sat back and pulled the trigger once more. But with inflation easing marginally at harvest time, there is reason to believe that this trend will continue. A pause may be justified, which will probably be the RBI's stance this time. This will be good news for industry which has been cramped by stagnant demand and a drop in investment.

But the other markets, such as money and foreign exchange, have been playing truant – calling for RBI intervention. Liquidity seems to be an issue today even though there is little borrowing taking place. The difference between incremental cash reserve ratio-adjusted deposits and credit is Rs 1,70,000 crore as against a negative Rs 40,000 crore last year (for the period from April to 25 November), which should mean more liquidity in the system. Last year the 3G spectrum auction had added to the demand for credit. This year, retail loans are sluggish while corporate borrowing is low.

However, incremental investments in government securities by banks are as high as Rs 2,07,000 crore this year (last year: Rs 82,000 crore). This has led to pressure on liquidity, resulting in banks borrowing as much as Rs 80,000-Rs 1,00,000 crore every day through the liquidity adjustment facility (or the repo auctions). Borrowings were high last year too, but the reasons were different as growth in deposits was tardy while credit had increased briskly.

Last year, the RBI had voiced a concern that LAF was being used to fund lending, which increased the asset-liability mismatches for banks (who borrowed short to lend longer). The difference this time is that funds are moving to government bonds (G-secs), thus creating liquidity problems. The solution so far has been to use open market operations (OMO) for Rs 30,000 crore with an actual infusion of around Rs 25,000 crore. But this has not quite helped.

The RBI's informal take on repo borrowing is 1 percent of deposits or Rs 60,000 cr. Clearly there is a case for inducing more liquidity in the system through a reserve cut. Which one should it be— SLR or CRR? SLR will help at the margin for banks which are cash strapped. But with an investment deposit ratio of 30 percent, most banks may be unaffected. Therefore, a CRR cut makes sense as it will provide all banks with more money that can either be lent in the busy season or invested in the enhanced government borrowing programme.

Will this pose any contradiction for the RBI in terms of monetary policy, as a cash reserve cut means monetary easing? In a way, yes, as this will be an early signal that the central bank is willing to reflect on its monetary stance indirectly.

The foreign exchange (forex) market, on the other hand, continues to tease with high volatility in exchange rates caused by both global developments and imbalances in India's balance of payments. Liquidity is being drawn out today through this route as forex reserves have declined, albeit gradually.

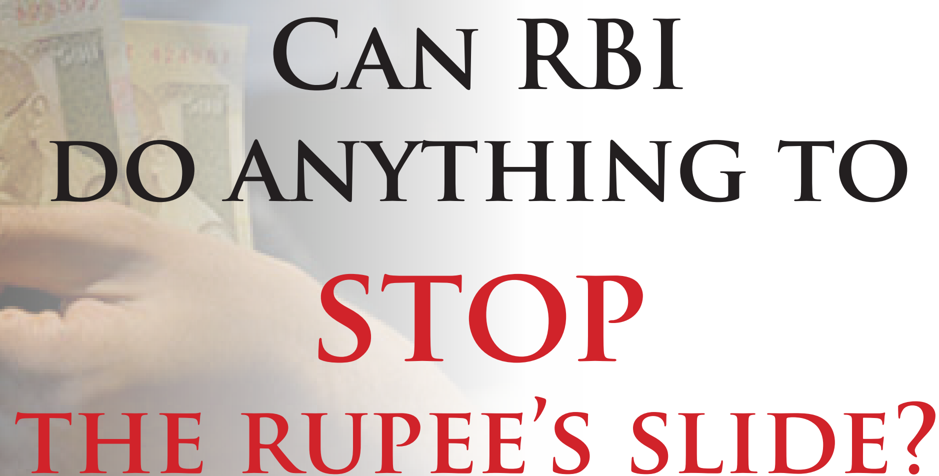
The role of the RBI here is to provide direction by firstly admitting that there is an issue in rupee pricing. Next, it could indicate whether there is a target number that it is looking at in the given circumstances. The RBI often uses the real effective exchange rate (REER) to provide guidance on the state of valuation of the rupee. Such views will help the market gauge whether or not there is room for further depreciation.

Lastly, provided the RBI is convinced that there is need for intervention, it could always indicate the same.

The recent mid-term review of the government blows hot and cold on the fiscal deficit while the Index of Industrial Production (IIP) numbers clearly give the thumbs down signal. While there are indications that the fiscal deficit target will be exceeded, the quantum is unknown. Disinvestment has not taken off, given the state of the markets. Lower growth projections also mean that revenue collections will be impacted as all targets were based on certain assumptions about growth (9 percent in February).

The RBI comes into the frame because this will also mean that there could be some additional borrowing in the market, which will drive the course of future interest rate movements.

Therefore, while policy rates may not be altered, market rates will be driven by the net impact of liquidity infusion by the RBI and borrowings by the government. This is why the money and forex markets matter more so today.



Can RBI do anything to STOP the rupee's slide?

The government could do its bit and launch some big-bang reforms to kick start the economy, but after the retail FDI fiasco, hope seems to have been abandoned on that front.

FP Editors, Dec 13, 2011

Down, down, down.

That's the direction the rupee seems to be heading at the moment. Today, the rupee hit fresh lows every few hours; currently, it is trading at 53.37 against the US dollar after hitting 53.51 a while ago.

So, why is the Indian currency unit being pounded so much?

Two reasons. The first is the growing eurozone crisis, which has prompted foreign investors to shun relatively riskier emerging market assets like Indian stocks and the currency, and seek refuge in safe havens like the US dollar. Global demand for dollars has surged, driving up the price of the greenback against other currencies.

The second reason is mounting concerns about the local economy: industrial output shrank by 5.1 percent in October, the first time it plunged into negative territory since June 2009. Slowing GDP growth, high borrowing costs, high inflation and falling demand have contributed to a relentless weakening of the rupee since July this year.

The rupee has lost 15 percent this year, the worst performer among Asian currencies.

"There is nothing positive for rupee at this stage," said Moses Harding, head of economic and market research and executive vice-president at IndusInd Bank, in a client note. "The fundamental concerns on trade gap; capital flows and growth pressures will stay valid into short/medium term. The higher fiscal deficit and low growth might bring India into rating watch. Overall, rupee bear run is expected to continue into short term."

Worse, no one seems to know where it will all end. Last month, HSBC warned the rupee could fall all the way to 58 against the dollar.

The RBI has been making token interventions in the market to prop up the rupee, mostly to

shave some of the "speculative froth" in the currency markets, but experts said those efforts are unlikely to have any sustainable effect on reversing the rupee's slide.

In the recent past, the central bank has also introduced measures to attract foreign capital portfolio flows and made it easier for companies to hedge their currency risks.

Now, tougher measures might be in store.

Possible steps the RBI can take

Shubhada Rao, chief economist at Yes Bank, told Firstpost state-run oil companies might be allowed to buy dollars directly from the Reserve Bank of India instead of through the foreign exchange market.

State-run oil companies are the biggest dollar buyers in the forex market; according to one estimate, they need to pay for crude oil imports of up to $6 billion every month. Buying from the RBI directly could ease some pressure in the forex market and help stabilise the rupee.

Another option, Rao said, would be to further enhance steps taken by the RBI last month, such as raising the rate on non-resident deposits (to encourage capital inflows) and directing Indian companies to immediately bring back funds raised through external commercial borrowings if they are meant to be used for expenditure in India (bringing back foreign funds into India requires converting into local currency, which increases demand for the rupee and raises its value).

Don't expect these measures to stop the rupee's slide though, even if they do possibly slow the slide.

In the end, sentiment on the rupee is dominated by external factors and the RBI has no control over that. The government could do its bit and launch some big-bang reforms to kick start the economy, but after the retail foreign direct investment fiasco, hope seems to have been all but abandoned on that front.

Tim Condon, Singapore-based head of Asian research at ING, summed up the situation perfectly when he told *Bloomberg* recently: "Anything that opens up the economy is positive for growth and risk assets like the rupee. But the origin of the problem is not India, so the rupee and any measures that India takes are hostage to the wider world."

Beating the rupee down: Why the RBI can't do MUCH ABOUT IT

When the rupee has fallen a precipitous 12-13 percent in less than two months, why is the RBI not acting? Is it saving its ammo for worse later?

R Jagannathan, Sep 24, 2011

After teetering on the brink of Rs 50 on Friday, the Indian rupee pulled back to close at Rs 49.43 against the US dollar. How much worse can it get?

In a global macro scenario of risk-aversion, the only way the rupee can be coaxed up or stay steady is through an intervention by the Reserve Bank of India (RBI). Why is RBI Governor D Subbarao sitting on his hands when his currency is beaten black and blue?

On Friday, when the rupee was dangling on the cusp of 50 to the dollar, RBI Deputy Governor Subir Gokarn said the RBI's job was to smoothen volatility, not manage the exchange rate. He said: "We, at this point, do not see any intervention from a rate targeting viewpoint. That is something that would reflect a change in policy stance, which we are not doing at this point."

In fact, Gokarn went further and said even the fact that the rupee's fall was worsening inflation was not enough to push the RBI to intervene actively. "One should not look at our exchange rate policy within the narrow boundaries of inflation management," Gokarn told CNBC TV-18. Rupee

Finance Minister Pranab Mukherjee said the RBI would intervene in the market "as and when the situation warrants", but "right now there is no such situation".

If a dramatic swing of the rupee by 12-13 percent in less than eight weeks (on 1 August the rupee was at 44.07) is not reason enough to act, what is?

Reading between the lines, one can interpret the RBI's masterly inactivity on the rupee in three ways: it either wants the rupee to go down; or it does not have the ammunition to fight the rupee's dramatic collapse; or it is conserving its resources for later, when things might get worse.

The first reason does not make sense since the RBI has been hawkish on inflation and is aggressively raising rates. The fight against inflation has been seriously compromised by the fall in the rupee. Even as commodity prices are falling worldwide, our domestic costs – especially of fuel – are rising, as evidenced by the recent Rs 3 hike in petrol prices. A stronger rupee will help the RBI fight imported inflation better.

The second reason – that it does not have the

ammunition – is also unlikely, for current foreign exchange reserves are around $316 billion, enough to defend the rupee.

This leaves us with the last reason. Is the RBI conserving its forex resources for a rainier day, assuming last week was not rainy enough for intervention?

A look at what happened in 2008-09, when the world market was turned upside down by the Lehman collapse, is instructive.

In the 12 months between June 2008 and May 2009, when the world was smelling a crisis and then duly tumbled into one, risk aversion peaked and the RBI had to step in and sell a gross $ 65 billion – yes, $65 billion – and a net $44 billion to ensure that there was no panic in the foreign exchange market.

If it is expecting to buy $44 billion this year — or more — it is right to hold its hand on defending the rupee.

The composition of India's foreign debt and hot money flows is also critical to an understanding of why the RBI is cautious about throwing good money to protect the rupee.
RBI

As on 31 March 2011, India's short-term foreign debt equalled $65 billion – around 22 percent of our total external debt. The position would not have changed much since then.

Moreover, we also have over $100 billion of foreign institutional investor (FII) money invested in the stock and debt markets. This money can easily flow out if the western capital crisis suddenly worsens.

Add the two components together and the potential worst-case scenario is an overhang of $165 billion (short-term debt, and FII money) that could leave all of a sudden.

Of course, it won't happen that way, for India is really the place to be for foreign investors. But short-term panics cannot be ruled out. In 2008-09, for example, the FIIs withdrew $14 billion from India. If the same were to happen this year – net FIIs investments in shares in 2011 is currently close to zero – the RBI would have to pay up.

In short, it is more than likely that the RBI is conserving its assets for a worst-case scenario as in 2008-09, when it had to sell $44 billion to smoothen the currency market. Also remember, this time it is worse. It is countries that are collapsing (Greece, Portugal), not just banks and Lehmans.

Against this backdrop, what is the RBI likely to do? Four conclusions emerge.

One, the RBI will intervene only occasionally when intra-day volatility gets too high.

Two, it will not bet against the market and current sentiment. It may have a target at which to intervene, but this target could be well into the 50s against the dollar.

Three, it will take the big dollar buyers – like oil companies – off the market by giving them a direct purchase window. This will ease pressure on the market.

Four, it will open the tap for more foreign exchange loans to be raised abroad. This is already happening.

The RBI is wary of using its ammo too soon in the war against global risk-aversion.

The RBI should forget forex rates and focus on inflation

Everything you wanted to know about the rupee market and how it is behaving now.

Ajay Shah, Dec 3, 2011

The rupee: Frequently asked questions

Q: How big is the market for the rupee?

The rupee is now a big market. Summing across both spot and derivatives, perhaps $30 billion a day of onshore trading and $40 billion of offshore trading takes place. Both these markets are tightly linked by arbitrage. In other words, for all practical purposes, it's like NSE and BSE which are a single market unified by arbitrage.

If you place a small order to buy 100 shares on either NSE or BSE, you get essentially the same price, and arbitrageurs are constantly at work equalising the price across both markets. It is a similar state of affairs between the onshore and the offshore rupee. Both markets are tightly integrated by arbitrage.

The offshore market for the rupee, and a large part of the onshore market, is OTC (over-the-counter) trading. Hence, the efficiencies of algorithmic trading and algorithmic arbitrage cannot be brought to bear on onshore/offshore arbitrage. So the arbitrage is done by manual labour. Still, it gets done. Both markets are tightly linked and show the same price. We should think of them as one market. It's one big market, it is one of the big currencies of the world, it's roughly $70 billion a day.

Q: How might the RBI manipulate this market?

If RBI wants to hit the market with orders big enough to make a difference, they have to be ready to do fairly big orders and to be able to do it on a sustained basis. As a rough thumb-rule, I might say that in order to make a material difference to a market with daily volumes of $70 billion, they have to be in the market with atleast $2 to $3 billion a day.

Q: What would go wrong if they tried this?

Three things would go wrong.
First, foreign exchange reserves are $275 billion. If RBI sells off $2.75 billion a day, the reserves would be quickly gone.

Second, when RBI sells dollars and buys rupees, this sucks liquidity out of the market. The side-effect of selling dollars would be a sharp rise in domestic interest rates. In other words, monetary policy would get hijacked by currency policy. This would not be wise. Monetary policy should be focused on delivering low and stable inflation: it should have no ulterior motives. We have to make a choice: Do we want to use up the power of monetary policy to achieve domestic goals, or do we want to use up the power of monetary policy to achieve currency policy goals?

Third, suppose you and I saw a fake market price of Rs 45 per dollar, which is created by RBI and not a market reality. We would know that in time, the truth will out, that the price will go back to Rs 52 a dollar. The rational trading strategy for each of us would be: To sell any and every domestic asset, and shift money out of the country. This would trigger off an asset price collapse in India. We would take the money out, and wait for the distortion of the currency market to end. At that point (perhaps Rs 52 a dollar, perhaps worse) we would bring the money back to India and buy back our assets. We might make two returns here: first, on the move of the INR/USD from 45 to 52 (or worse) and the second, on the gain from the drop in asset prices.

Q: Isn't it hard to take money out of India in this fashion?

It's easier than we think. Remember September 2008? The mythology in our heads was: we in India are crouching safely behind a wall of capital controls. In truth, the wall wasn't there.

Q: But until recently, the RBI used to give us a pegged INR/USD exchange rate! What changed?

In late 2003, the RBI ran out of bonds for sterilisation. Associated with that, there was a first structural break in the rupee exchange rate regime, with a doubling of volatility. A short while later, in March 2007, there was another structural break, with another doubling of volatility. From April 2009 onwards, the RBI's trading in the market has gone to roughly zero. The RBI stopped managing the exchange rate a while ago.

The exchange rate is the most important price of the economy. The decontrol of this exchange rate is the biggest achievement of the UPA in economic reforms. The credit for this goes to YV Reddy and Rakesh Mohan (who took the first two steps of doubling exchange rate flexibility twice) and to Dr Subbarao (who got out of trading on the currency market, which did remarkably little to INR/USD volatility).

Q: Why did nobody tell me that something changed in the exchange rate regime?

The RBI should be talking more transparently about what is going on. But they are not transparent about what they do. Even though hundreds of millions of people are affected by their trading on the currency market (or the lack thereof), the manual which governs their currency trading at any point in time (i.e., the documentation of the prevailing exchange rate regime) is not transparently disclosed to the people of India. We have to decipher what is going on by statistically analysing exchange rate data.

The dates of structural break of the exchange rate regime are extremely important dates in thinking about what was going on in macroeconomics and international finance. Any time one is using data about exchange rates, interest rates, etc., it is important to thinking within one segment of the prevailing exchange rate regime at a time. It is wrong to pool data across many years. All users of data need to be careful in this regard.

Q: So what might happen to the rupee next? Is there a `law of gravity' which will pull it back to erstwhile values of Rs 45 or Rs 50?

When you don't manipulate a financial market, the price time-series comes out to something close to a random walk. In the ideal random walk, all changes are permanent. The random walk never forgets; there is no law of gravity which takes it back to recent values. Your best estimator of what it will be tomorrow is: what you see today.

In order to get a sense of what will come next, go through the following steps. First, go to INR/USD options trading at NSE, and pluck out the implied volatility for the four at-the-money options. I just did that, and the values are: 10.43, 10.32, 10.33 and 10.08. Calculate the average of these four numbers. With the above four values, the average is: 10.3. (This is a quick and dirty method; here is one which is much better).

This tells a very important thing: The options market believes that in the future, the volatility of the INR/USD rate will be 10.3 percent per year.

In order to re-express this as uncertainty per month, we divide by sqrt(12). This gives the volatility for a month as : 3 percent.

Roughly speaking, the 95 percent confidence interval for what might happen over a month, then, runs from -6 percent to +6 percent (this is twice the standard deviation, which we just worked out was 3 percent per month).

The INR/USD is now Rs 51.62. By the above calculation, we can be 95 percent certain that one month from today, it will lie somewhere between 48.5 and 54.7.

These trivial calculations have been done by equity market participants for the longest time. It is a standard and trivial idea: To read the implied volatility off the Nifty options market, and to do such calculations to get a sense of what might come next with Nifty. But on the currency market, this is relatively novel. Only recently have we got a nice currency options market, and only recently have we got to a genuine market.

Now these skills can be brought to bear on the currency market. It's a brave new world, one

in which the operations of financial derivatives markets (Nifty options, INR/USD options) produces forward-looking and timely information about the economy (implied volatility).

Q: What changed in imports and exports which gave us the big recent move of the rupee?

The current account (goods, services, and then some) adds up to a mere buying and selling of $4 billion a day. The bulk of currency trading is about the capital account. The currency is a financial object; the exchange rate is defined by financial considerations and not by current account considerations.

Q: What happens to the Indian economy when the rupee depreciates?

This has been the source of a great deal of confusion and it's important to think straight about this. There are three important effects in play:

•Some people had borrowed in dollars, and left it unhedged since they were speculating that the INR would appreciate. They have got burned. That's okay – in a market economy, many people place bets about future fluctuations of financial prices, and half the time the speculator loses money. (If the rupee had not depreciated sharply, these speculators would have been truly joyous).

•When the rupee depreciates, imports become costlier and India's exports become more competitive. So exports (X) gradually start going up and imports (M) gradually start going down. The net gain in X-M is increased demand in the local economy. In this fashion, INR depreciation is good for aggregate demand (and conversely INR appreciation pulls back demand). However, we have to bear in mind that these effects are small and take place with long lags.

•Many things in India are tradeable. It is important to focus on the things that are tradeable and not just on the things that are imported. As an example, there are many transactions between a domestic producer of steel and a domestic buyer of steel. The buyer and seller are both in India. But the price at which they transact is the world price of steel (which is quoted in dollars) multiplied by the INR/USD exchange rate. This situation is called `import parity pricing'. Through this, the domestic prices of tradeables goes up when the rupee depreciates.

Q: What is the impact of costlier tradeables for RBI?

The RBI's job is to fight inflation. The RBI must work to deliver year-on-year CPI inflation (aka "headline inflation") of four to five per cent. When tradeables become costlier, domestic CPI inflation goes up. So the rupee depreciation has made the RBI's job harder. It will have to respond by hiking interest rates. (Note that one impact of higher interest rates will be that more capital will come into India, which will tend to yield a rupee appreciation; import parity pricing has created a new channelthrough which RBI rate hikes combat inflation).

Q: What is the impact of costlier tradeables for business cycle conditions in India?

As the example above about steel suggests, the price realisation of all tradeables companies goes up when the rupee depreciates. Costs change by less than revenues (since many costs are not tradeables), and profitability goes up.

Firm profitability has dropped sharply in 2011. My prediction is that firms producing tradeables will show better profitability in Oct-Nov-Dec 2011 when compared with the previous quarter, thanks to the rupee depreciation.

This is great news for business cycle conditions. Profitability goes up, which yields more cash for investment by financially constrained firms.

And, when profitability is higher, more investment projects look viable.

Q: In the bottom line, what is the link between the rupee and India's business cycle stabilisation?

If the RBI tried to peg the exchange rate, the lever of monetary policy would get used up to deliver the target exchange rate. By not trading on the currency market, the lever of monetary policy is now available. A pretty good use for this lever is to deliver low and stable CPI inflation. If this is done, then an RBI focused on inflation would help stabilise the economy by cutting rates when CPI inflation drops below 4 percent and hiking rates when CPI inflation goes above 5%.

But floating the exchange rate also yields stabilisation purely in and of itself. In bad times, capital leaves India, the rupee depreciates. This gives higher profitability in tradeables for firms and bolsters investment. Conversely, when times are good, more capital comes into India, the INR appreciates, which crimps the profitability of tradeables firms. This is the most remarkable feature of the floating exchange rate: it exerts a stabilising influence upon the economy. Purely by doing nothing on the currency market, the RBI has unleashed this new force of stabilisation which will help India.

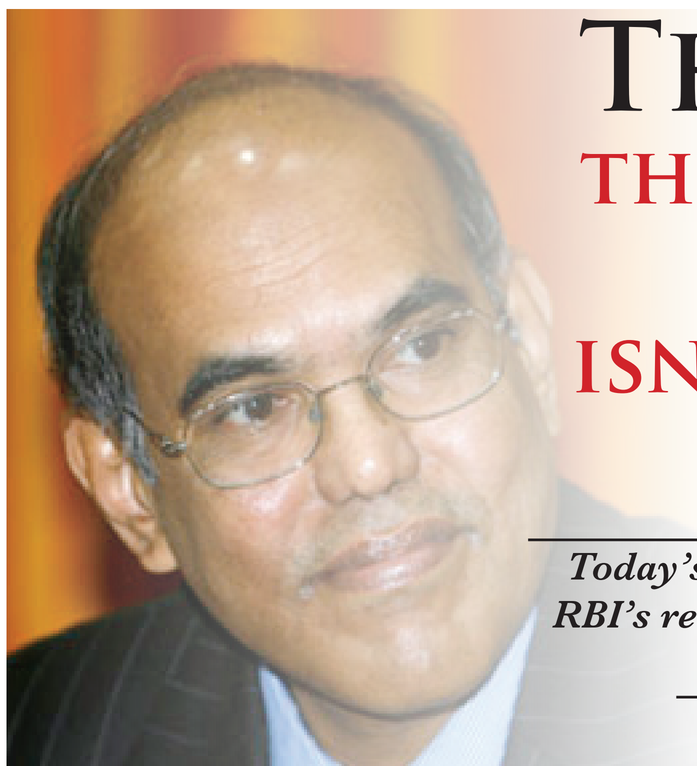
Q: What should RBI do next?

The RBI should do as they have done, i.e. avoided trading on the currency market. It should keep driving up the short-term interest rate until point-on-point seasonally adjusted CPI inflation shows a decline and goes into the target zone of 4-5 per cent. After this hangs in there for a year, "headline inflation"' (y-o-y growth of CPI) will be in the target zone.

Thank God the cool-headed RBI isn't propping up the rupee

Today's trend reversal in the rupee validates RBI's reasons for its reluctance to intervene in the currency market.

Venky Vembu, Nov 28, 2011



The rupee's sharp fall of recent weeks against the US dollar has been arrested – and even marginally reversed — this morning by an improvement in risk sentiment.

News of a likely loan lifeline from the IMF to Italy, and of a larger rescue mechanism, have buoyed up investor sentiment and the rupee, which had been battered by the avalanche of bad news out of Europe in recent days.

The turnaround in sentiment has come not a day too soon, since the chorus of voices demanding an intervention by the RBI to prop up the rupee was becoming a little too loud and a little too shrill. In UBS economist Jonathan Anderson's theatrical characterisation, the rupee is a "drama queen", given to hysterical excesses and dramatic flailing of limbs.

The RBI had indicated that while it would step in during periods of excessive currency volatility to smoothen things out, it wasn't about to prop up the rupee. That principled position, based on pragmatic considerations of the market situation, wasn't always appreciated.

The rupee's slide of recent days was, as Firstpost argued here, largely a function of the heightened risk aversion (and a flight to the relative safety the US dollar) although some elements of India's deteriorating macro economy were also to blame.

We had said then that once the hysteria over Europe abated, the rupee would turn around, even if it doesn't quite leap back to its earlier values. That view, and the RBI mandarins' cool head when all around them were losing theirs, has been borne out by today's trend reversal.

Rating agency Moody's too has commended the RBI's "restraint" – that is, its unwillingness to intervene in the currency market – as "credit-positive" for India. The agency's chief India sovereign rating analyst Atsi Sheth notes that that the RBI had, rather than aggressively selling dollars to reverse the rupee's depreciation, limited its intervention to periods of extreme volatility.

For sure, a falling rupee brings bad news. "The immediate effect of a falling rupee is clearly negative for unhedged importers and borrowers in foreign currency," points out Sheth. "Moreover, it raises the government's petroleum products related subsidy burden, widening an already high fiscal deficit."

And the currency depreciation was also further adding to inflation, which was already above 9 percent.

Yet, the RBI authorities' decision "not to spend large quantities of international reserves to support a higher rupee over the past three months is credit positive for two reasons," reckons Sheth.

First, an intervention would have used up foreign exchange reserves — without meaningfully reversing the depreciation, since global risk aversion and India's widening current account deficit would have forced the rupee to fall further against the dollar despite the intervention.

Second, notes Sheth, effective globalisation requires market participants to adjust their investment, consumption and borrowing plans according to the availability of foreign capital and import costs.

Over the past few years, external borrowing by Indian firms has risen significantly in response to the differential between higher domestic and lower foreign interest rates. Foreign borrowing has also funded rising imports.

The recent currency depreciation highlights that exchange rate risk, along with interest rate differentials, ought to be incorporated into private sector decisions about external leverage.

If the RBI had authorised the use of official foreign exchange reserves to maintain the exchange rate at a level higher than dictated by market forces, they would have assisted importers and foreign borrowers — at the expense of exporters and domestic producers competing with imports, reasons Sheth. This would have delayed or distorted private sector adjustment to global market signals.

In her estimation, currency depreciation would ultimately force an adjustment by making imports more expensive and exports cheaper – and thus help narrow the current account deficit over the next few quarters.

Of course, if inflation in India remains higher than in its trading partners, it would limit the extent to which a rupee depreciation would enhance Indian export competitiveness. In any case, the anaemic growth projections to the global economy paint a rather tepid outlook for export growth.

The RBI's other actions intended to arrest the steep decline in the rupee – such as the relaxation of capital controls, and the raising of caps on interest rates on non-resident Indian depots, on commercial borrowings and on foreign participation in domestic bond markets – would help support the rupee, or at any rate check its precipitous decline of recent days.

Yet, it's hard to see a sustained appreciation of the rupee so long as the current account deficit widens and global risk aversion remains high.

There's nothing to say that the rupee won't slide back if eurozone panic is accentuated again in the event the the rescue plans don't materialise in the manner that they've been announced. But today's trend reversal in the rupee's value, however minuscule, validates the RBI's stand on the underlying reasons for the rupee's slide, and the fact that panicky intervention — of the sorts that some commentators had sought -would have only compounded the problem.

Perhaps it's time for the back-seat drivers to mute their commentary — and allow RBI honchos to get on with what is decidedly a challenging task in a volatile environment...

Chart view: Why the RBI can't use forex reserves to rescue the rupee

External debt due in the next one year accounts for 43.5 percent of India's foreign exchange reserves.

FP Editors, Dec 14, 2011

As if we weren't depressed already, here's one more reason to feel some more economy blues: the rising level of short-term external debt.

According to a recent report by Morgan Stanley, external debt due in the next one year accounts for 43.5 percent of India's foreign exchange reserves.

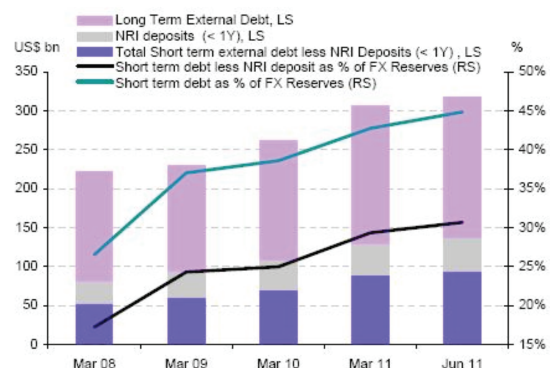
The fall in the rupee — it hit a new record of 53.74 against the dollar today — makes repaying those debts an even heavier burden. It also makes the Reserve Bank of India less inclined to spend the country's forex reserves to prop up the rupee.

Even excluding non-resident deposits (which are relatively more stable), short-term debt as a percentage of foreign exchange reserves has climbed to 30.7 percent at the end of June 2011 from 17.2 percent in March 2008, the brokerage said.

The report noted that while the ratio of total external debt to India's gross domestic product (GDP) remained stable at 17 percent, the share of short-term external debt had climbed.

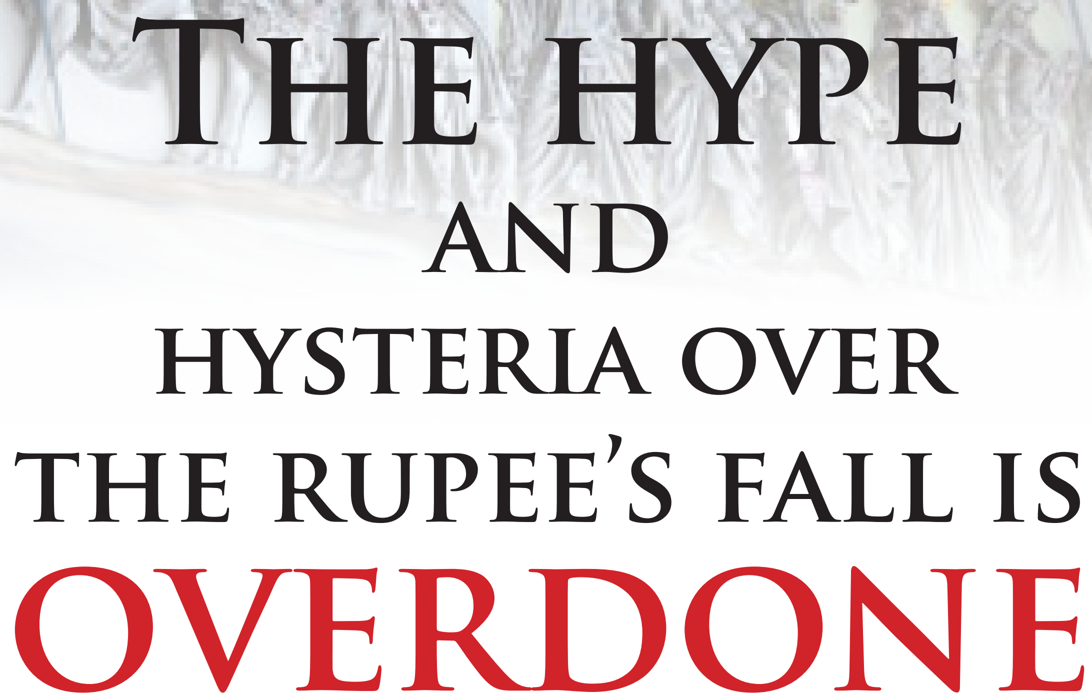
Short-term external debt as a proportion to total external debt increased to 21.6 percent at the end of June 2011 from 14 percent at the end of March 2006, it said.

No wonder the RBI can't stride into the forex market guns blazing to defend the floundering rupee.



Source: RBI, Morgan Stanley Research

A contrarian view



The hype and hysteria over the rupee's fall is OVERDONE

Investors have been spooked by the rupee's slide, but the anxiety is vastly overstated. Here's why...

Venky Vembu, Nov 23, 2011

The rupee's sharp slide in recent months - by as much as 16 percent against the US dollar since July – has given rise to a lot of anxiety about how long the depreciation will continue, and the effect it will have on inflation.

The equity market has been tanking on sustained fears of a worsening of imported inflation and a slowdown in economic growth. The seeming reluctance of the RBI and the government to directly intervene in the currency market has accentuated these concerns.

But this anxiety, while understandable, is also feeding an excess of mass hysteria and ill-informed commentary among analysts – and over-the-top panic in the markets. Even international investors appear to have been spooked by the rupee's fall: UBS economist Jonathan Anderson notes that his email inbox is choking with "panicky correspondence" from investors seeking to understand what the rupee's slide portends for the larger India growth story. Rupee

Media commentators are now arguing that if the rupee's depreciation continues, it will have an overhang effect on imported inflation, which would mean that the RBI may not be able to stick to its decision, taken last month, not to raise interest rates going forward.

In many cases, even the analyses about the underlying reasons for the underperformance of the rupee, which is far and away one of the worst performing Asian currencies in 2011, appear to be clouded over by an inadequate appreciation of fundamentals.

The 'red flags' aren't really red

For instance, three 'red flags' on India's macro condition are cited as explanations for the rupee's slide: rapidly falling economic growth, untamed (and seemingly untameable) inflation, and a stampeding by corporates to refinance US dollar borrowings.

"The trouble," says Anderson, "is that none of these explanations really make a lot of sense."

It's true, of course, that economic growth has slowed down throughout this year, but there's nothing to say that this should automatically be negative for the rupee. In fact, by reining in the external balance of trade – which is by far the biggest driver of a currency – a relative slow-down such as what India is experiencing should have the opposite effect on the rupee. And India's trade deficit is being kept under control.

Likewise with inflation. Consumer price inflation in India today is, on average, around 3 percentage points higher than the average across emerging markets. Yet, in 2010, when Indian inflation was as much as 10 percentage points higher, the rupee actually strengthened against the US dollar, and fared even better than its peers in the universe of emerging markets. At that time, analysts explained the rupee's rise by arguing that higher interest rates, intended to fight inflation, would be good for the rupee, and that in any case the RBI seemed keen to allow the rupee to rise as a way of tightening.

In other words, higher-than-average inflation need not always translate into a weaker rupee. And "it is very hard to point to any wrenching shift in the inflation or policy outlook that might have caused the recent rupee underperformance," adds Anderson.

Even the third pillar of the argument doesn't stand because among the universe of emerging markets, India actually has the lowest short-term external debt ratios (3 percent of GDP), and given the capital controls in place, it doesn't have excessive foreign positioning in local debt markets.

The one thing that has changed about India's currency macro is that its net reserve coverage buffer as a share of GDP (defined as foreign exchange reserves plus the annual current account balance less the short-term external debt outstanding) is today around 9.1 percent of GDP, a fall from 14 percent in 2008. With most other emerging economies, that buffer coverage actually increased since 2008. This puts the rupee squarely in the category of "risk currencies", which is why in the heightened risk aversion over the eurozone economies, the rupee has fallen sharply harder.

Which also means that so long as the fears of a eurozone crisis are top of the mind, the rupee

will suffer from heightened risk aversion. But equally, any return to the risk-on trade would almost certainly see a rupee rebound.

Interest rates need not go up

There's been some speculation that the imported inflation that would be set off by a weaker rupee would perhaps lead the RBI to go back on its pledge not to hike rates (and even cut rates if inflation falls below 7 percent). That argument too is flawed.

Indicatively, Indian WPI inflation is driven rather more by the percentage year-on-year change in rupee-denominated international commodity prices. Credit Suisse economists have calculated that even if the rupee-US dollar exchange rate remains at the recent low of 53.3 and the level of international oil, food and metal commodity prices remains unchanged, it won't have a significant impact on WPI inflation.

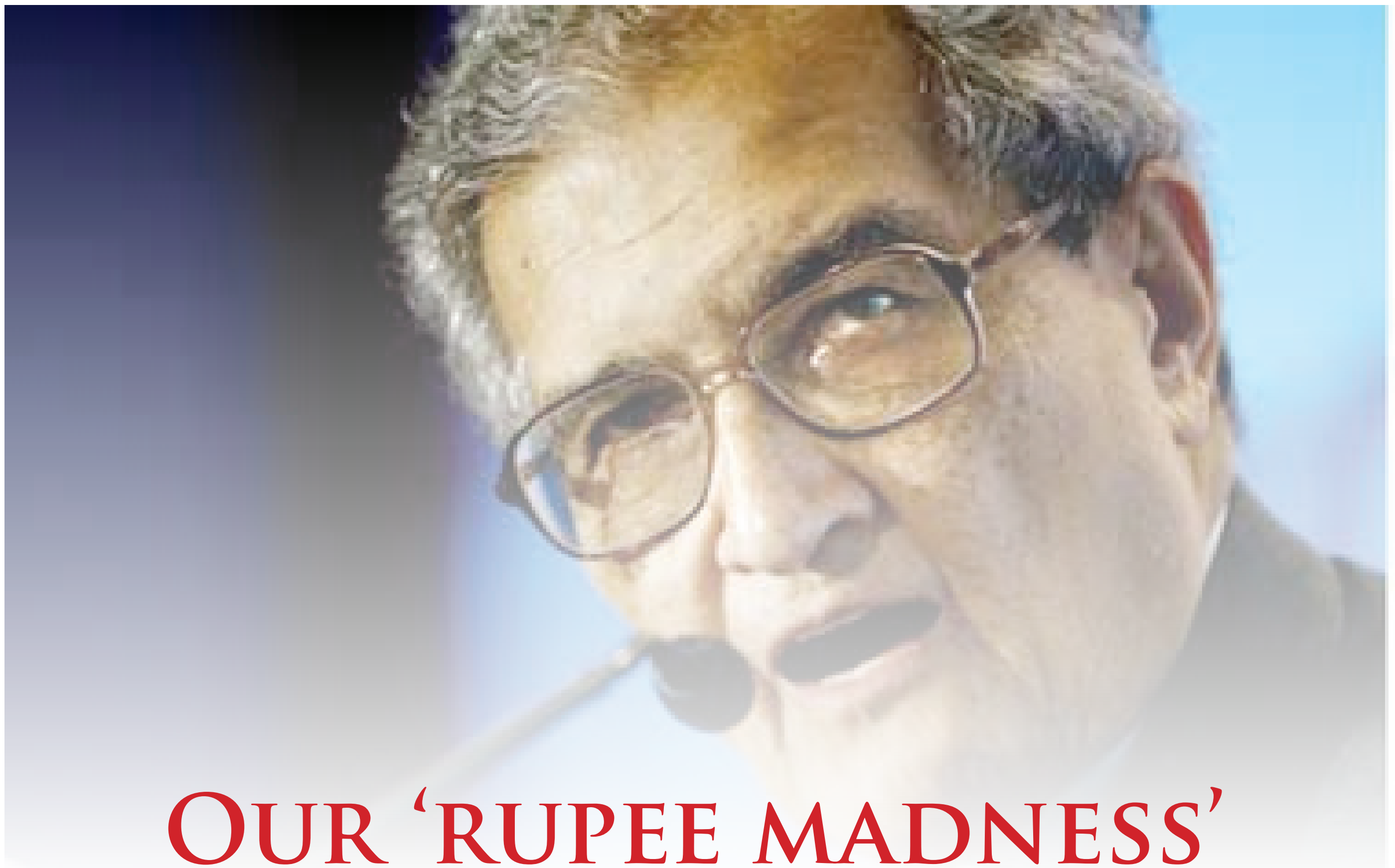
They in fact see WPI inflation dropping to 6.5 percent by March, even lower than the RBI's projection of 7 percent.

By their estimation, rupee-denominated commodity price inflation will rise again only if the rupee depreciates by another 20 percent against the US dollar – and reach 70 against the dollar — by March 2012. That's unlikely to happen.

Scope for rate cuts still exists

This is because of a high base effect of rupee-denominated commodity prices: they rose strongly between October 2010 and March 2011. That base effect may be enough to ensure that WPI inflation will come in lower than 7 percent by March – and for the RBI to in fact begin to cut interest rates.

So, there's absolutely no need to lose your head over today's exaggerated rupee slide or the headline inflation numbers. The numbers certainly look daunting, but there's the encouraging prospect of a retreat in WPI inflation and perhaps, if the risk-off trade sentiment turns around, for the rupee to regain a bit of lost ground.



Our 'rupee madness' swamps Amartya Sen's VOICE OF SANITY

For all the pain inflicted by a falling rupee, our hysterical response reveals a failure to understand the economic fundamentals that underlie it.

Venky Vembu, Dec 15, 2011

The rupee's sharp slide of recent weeks has induced a frenzy of hysteria and lamentation among ordinary folks, and occasionally among informed commentators too. And this morning, as the rupee breached the 54-to-the-dollar mark, it has again triggered another round of frenetic 'rupee rage'. We're running around like headless chicken, looking for someone, anyone, to blame.

As befits our times, when virtually everyone has an opinion on everything, including on arcane matters of monetary policy and exchange rate determination that befuddle and humble even the most keen economic minds, the battle-cry for the RBI to do something, anything, to check the rupee's slide has acquired a manic pitch.

It's not as if the RBI has been sitting idle. It's been tweaking rates to incentivise NRI inflows. And despite public comments by its policy mandarins reflecting the RBI's stated position that it does not intervene in currency markets to set exchange rates and will only intervene in periods of excessive volatility, the RBI has actually been selling US dollars to try and check the rupee's fall.
Rupee

Indicatively, in September, the RBI sold dollars

to a value of $845 million, and followed it up in October by selling an additional $943 million. Given that its war-chest of foreign exchange isn't exactly overflowing with dollars, the RBI has been intervening only on the margins. (Thank god for that!)

And it's been fighting a losing proposition. For despite that intervention, the rupee is now sharply lower than it was in September. This just goes to establish the point that RBI officials and economic thinkers have been making: that although there are some home-grown reasons – such as high inflation, a slowdown in the economy and a general puncturing of investor confidence in the India story in the short term – that account for the rupee's sharp fall of recent times, it owes rather more to external factors that are beyond the policymakers' control, such as widespread risk aversion among global investors triggered by concerns of a collapse of the euro.

Overnight, the euro slipped below the psychological threshold of 1.30 to the dollar. Virtually every asset class – from gold to crude oil to copper – was battered as investors stampeded to the safety of the US dollar.

As C Rangarajan, former RBI governor who now chairs the Prime Minister's Economic Advisory Council, said, "The behaviour of the rupee is also a reflection of the behaviour of the dollar... There is very little that can be done."

Going against the tide of investor sentiment – in the way that the RBI is being called upon to do by selling the dollar when everyone else is flocking to it – is a bit like running up an escalator that's going down. It takes a lot of running to stay in the same place. And, as happened with the rupee, if economic fundamentals are further dragging you down, you only end up sliding down for all your pretense of running up.

Indeed, the $2 billion that the RBI coughed up in September and October to defend the rupee against its own conviction, but evidently in order to be seen to be doing something, is now money down the drain. To intervene even more is a bit like swimming against the tsunami currents that today sweep the currency markets: it would only amount to throwing good money after bad. At the end of the day, it will leave us the worse off for it.

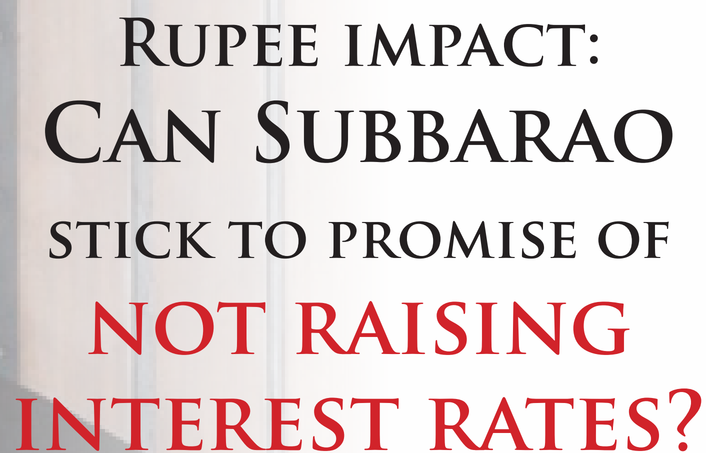
It isn't easy to keep your head when everyone around you is losing theirs, but Nobel Prize-winning economic philosopher Amartya Sen makes a forceful intervention and injects the voice of sanity to this squawk fest that passes for informed debate.

The rupee's fall, Sen noted in a media interaction, isn't quite the train wreck that it's made out to be. It's wrong to say that India is doomed on account of a falling currency, when in fact, countries like China, he noted, have gone to extraordinary lengths to artificially deflate their currency – and had profited from it in terms of higher exports.

Sen's point about the boost to exports from a currency depreciation conforms to classic economic theory. However, there are other factors that determine a country's ability to leverage an undervalued currency for higher exports, including, as is the case in China, labour productivity gains that far outstrip the wage price spiral we've seen in recent times. India has signally failed on that count, which is one reason why its gains in terms of higher exports may not be proportionate to the rupee's fall.

But Sen's philosophical point advances the merits of maintaining a cool head in times like this, not the 'sky-is-falling reflex' that we've exhibited thus far in response to the rupee's slide. Even if, as is widely prophesied, the rupee does slide to 59 to the dollar, there's a case for tuning into voices of sanity and allowing them to heal us of our 'rupee madness'.

Rupee impact: How it hurts the economy



Rupee impact: Can Subbarao stick to promise of not raising interest rates?

Predicament: The currency is in freefall. What will the Guv do?

FP Editors, Nov 23, 2011

What a predicament D Subbarao is in. In October, the Reserve Bank of India governor, after announcing the 13th hike in interest rates since March 2010, said the central bank might not need to raise rates at the next policy meeting in December because it expected inflation to start easing by then.

It's going to become increasingly difficult for the governor to stick to that promise, given the rupee's dramatic plunge. On Tuesday, the rupee hit an all-time low of 52.73 against the dollar, before bouncing back to end around 52.30 after deputy governor Subir Gokarn made some comments that suggested that the central bank might intervene if the currency went into freefall.

"We don't really have a target or a rate in mind (at which to intervene)," Gokarn said, according to Mint. "It's moving as per market dynamics. It's disruptive, there is no question. There (will be) impact on our import bill, particularly for energy. It's having an impact on companies and it is a problem."

It certainly is. A depreciating rupee will only aggravate what is already an increasingly unyielding problem for the Indian economy – inflation. Headline inflation, represented by the wholesale price index, has remained above 9 percent for most of this year.

Last month, Subbarao said that the central bank would consider cutting interest rates if inflation fell below 7 percent.

Fat chance of that happening now.

A falling rupee increases the value of imported goods and services in local currency terms. Oil is our biggest import, accounting for one-third of India's imports. That means it's not just the import bill that will rise, but also the fuel bill.

That, in turn, will raise input costs for companies and translate into — well, increased prices.

Of course, you can't blame only the rupee for

playing naughty. Firstpost had earlier argued that inflation is increasingly looking like a lost cause, even in 2012.

The burgeoning fiscal deficit (which increases government borrowings and puts pressure on interest rates), relatively high commodity prices (especially of oil), urban and rural income increases, as well as anticipated increases in coal and power tariffs make bringing down prices in the economy an almost impossible goal.

"Add the costs of the Food Security Bill and other irresponsible social security schemes that the UPA is planning to unleash, and inflation is increasingly looking like a lost cause for now," the article noted.

Indeed, consumers will have to brace themselves for higher prices for everything from vegetables and fruits to LCD televisions and computers in coming months if the rupee drifts around the 50 mark.

The RBI has raised rates by 375 basis points since March 2010, and so far, inflation has refused to relent.

On Tuesday, Subbarao said further monetary steps may be warranted to curb inflation expectations in face of sustained high food inflation, and flagged the need to revisit politically sensitive subsidy schemes in agriculture.

"The direct role of monetary policy in combating food price pressures is limited, but in the face of sustained high food inflation, monetary action may still be warranted to anchor inflation expectations," Subbarao said in a speech at a conference in Hyderabad, according to Reuters.

Some experts believe that taking into account the painful slowdown in the economy, the RBI should ease off hiking rates, irrespective of where inflation is at.

The question is how comfortable will Indian consumers be with unchecked inflation? The truth is, if it were not for the rate hikes so far, inflation would probably have been much higher. While it is valid to argue that inflation in the economy is also triggered by supply-side issues, the point to note is that a cash-strapped government can do pretty much do nothing to alleviate pressure from that front.

That puts the onus of managing supply and demand pressures in the economy back on the RBI governor.

For Subbarao, the promise of holding off on interest rates just got that much harder.

Rupee Power:
How the falling rupee affects Indian economy

The cost of oil, current account deficit, inflation, corporate margins, interest costs, foreign investments, exports - all the reasons why we must watch the falling rupee.

FP Editors, Sep 23, 2011

The rupee suffered its biggest single-session fall in nearly three years on Thursday after a grim outlook on the US economy sent investors diving into safer currencies and government bonds. The Reserve Bank of India (RBI) was suspected of selling dollars in the forex market at around 49.15 rupees, traders said, but the selling pressure on the rupee was too high for it to contain the drop.

The rupee ended at 49.57/58 against the dollar, its lowest since 15 May 2009.

The currency's fall is the largest single-day fall since 12 November 2008 when it dropped 2.6 % during the peak of the global financial crisis post the Lehman Brothers bankruptcy.

A depreciating rupee affects the local economy in several ways.

One, it keeps the cost of oil imports relatively high. India imports more than 70% of its crude oil requirements. Oil prices tumbled more than four percent to six-week lows on Thursday as the US Federal Reserve's gloomy economic outlook and disappointing China manufacturing data fuelled fears of a global recession and pummelled markets. While Brent crude slipped to around $105 per barrel, the WTI (Wholesale Texas Intermediate) benchmark fell to around $80 per barrel. Yet, if the currency continues to depreciate, there's a high chance that India will not benefit because it will still have to pay more in local currency per barrel of crude oil, keeping our oil import bill high.

Two, it can affect the current account deficit — the gap between foreign earnings against expenses (exports against imports plus net transfer payments). A falling rupee increases import costs while increasing export revenues in rupee terms. Since we have a deficit, our imports become more expensive (oil, by the way, is one of our largest imports) and, therefore, have the potential of increasing that deficit. Normally, foreign capital inflows help in bridging the gap and easing the overall balance of payments, which includes both the capital account and current account balances. But given the global risk aversion, those prospects could dim as investors are busy pulling out of relatively riskier emerging market assets. The fear is the deficit could move up by 0.5 % in the year ending March 2012.

Three, it has the potential to fuel inflation throughout the economy at a time when headline inflation is still above 9%. Higher oil import costs could translate into higher fuel costs, which will raise, or at least keep the pressure on the overall cost of economic activity. That will add to the headache of the RBI, which has been struggling to contain inflation, even at the cost of sacrificing short-term growth, by raising interest rates. A falling currency, if the trend continues, could compel the RBI to keep policy rates high for a longer time.

Four, a declining rupee adds to the pressure on corporate margins through higher imported input costs. Higher local prices also add to costs. According to a recent Morgan Stanley report, gross margins of companies are at decade lows, mainly driven by higher raw material costs and stiffer competition. Cooling global commodity prices might not afford much relief because the cost of imported raw materials will still be relatively high in rupee terms.

Five, with pressure to keep rates at higher levels, there may be little relief in interest costs for companies. According to a Morgan Stanley report, rising interest rates are negatively impacting corporate profits. "It is pertinent to note that capital costs-to-sales ratio remains above historical averages. In our view, this is one area of the income statement which could hurt further with slowing growth, and could be a dampener to the earnings," the report said. Companies with foreign currency loans on their books, either as working capital or acquisition-related debt, will also be affected.

Six, it affects foreign investments in stock markets. A plunge in the rupee – yesterday's fall was the second biggest in history – effectively accentuates foreign institutional investors' losses on their equity portfolios (because of foreign exchange value changes) and triggers stop-losses, which forces further sales, dragging markets even further down. That's what happened on Thursday. For a fund managing $1 billion in India stocks, the fall in rupee value has meant a blow of Rs 600-700 crore since August. Still, a depreciating currency could also be the trigger for renewed investments going

ahead, when the current murky global economic picture clears up. The Indian currency's vulnerability is particularly heightened by the fact that among its emerging market peers, India runs a high current account deficit.

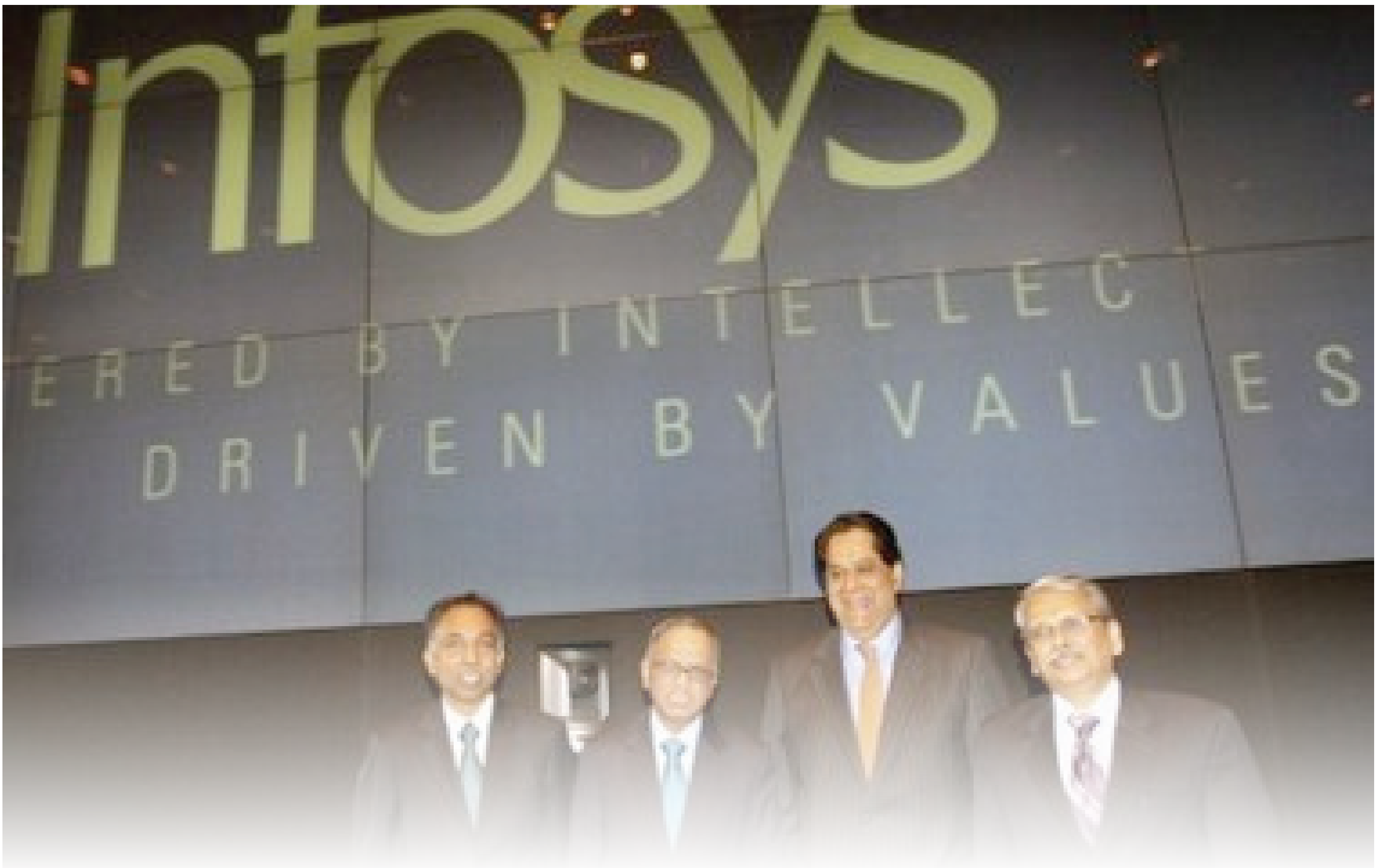
Seven, a falling rupee, in theory, should help exporters. In the current scenario, that might not be possible though. With the US and Europe looking increasingly likely to slip into a recession, export gains due to a depreciating currency may be limited. DK Joshi, chief economist, Crisil, told Business Standard that the benefits of the depreciating rupee would be neutralised by the hit to exports. Still, sectorwise, experts believe information technology exporters will be among the biggest beneficiaries. A 1% change in the rupee-dollar exchange rate has a 40-basis point impact on margins, and a 2-3.5% impact on net profits, on average.

Eight, the biggest losers will be importers and oil marketing companies, which import their main raw material, crude oil. For nationalised oil marketing companies, the under-recoveries (losses from subsidising prices) in diesel, kerosene (through the public distribution system) and domestic liquefied petroleum gas will climb further. With every fall in the rupee, the under-recovery goes up by Rs 9,500 crore per year on these price-controlled products.

Of course, all these effects kick in only if the rupee continues to fall or stay around these levels for a period of time. Sharp movements in either direction for a short period of time will not affect the economy dramatically.

Watch Video

Rupee fall:
Who gains, who loses?



Will a falling rupee really help IT stocks?

While the depreciation in the currency could throw up some short-term gains for IT stocks, the business environment outlook still remains muddied. If stability is not restored, these temporary gains could very well be reversed.

Rajanya Bose, Nov 23, 2011

No prizes for guessing the sector that is expected to gain the most from a steep fall in the rupee's value against the greenback.

Yes, it's information technology (IT).

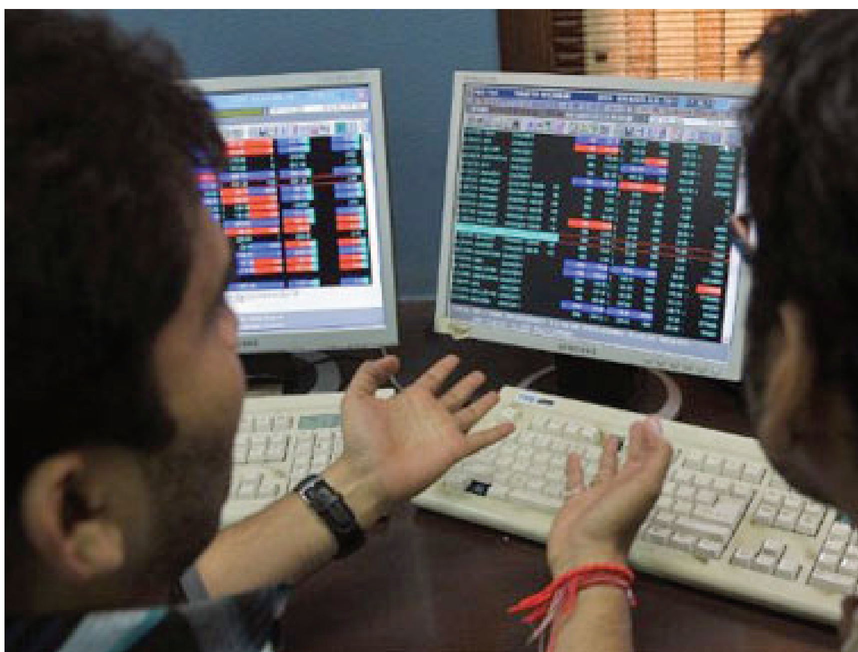
The rupee's gyrations have naturally led investors to bet on technology stocks, with the result that the IT index has only slipped 0.8 percent, while the Sensex has tumbled 5 percent over the past month.

A large proportion of the outperformance can be attributed to the currency's fall: the rupee is currently trading at 52.07 against the dollar after touching an all-time low of 52.73 yesterday. The currency has dived more than 16 percent from the level it was trading at in August (44 to the dollar).
Infosys

IT companies like TCS, Infosys, HCL Tech, Cognizant and Wipro export software services and earn their revenues in dollars. So, the gain in the value of the dollar is an advantage to them. Of course, they also spend significantly on salaries and other perks in dollars, so to some extent, the impact of changes in the rupee-dollar value is neutralised.

The remaining difference in dollar expenses and revenues is then hedged.

Hedging limits losses — and gains



Basically, hedging is an investment made to reduce the risk of adverse price movements in a security by taking an offsetting, or opposite, position in a related security. For example, if you invest in a fund that will gain due to an appreciating rupee, your 'offsetting' hedge is investing in a fund that gains because of an appreciating dollar.

Almost all IT companies engage in hedging. Infosys, for instance, has hedged over $700 million at 49 to the dollar. So, it won't be gaining hugely from the sudden depreciation in the rupee. An opinion piece in Mint said the sharp fall in the rupee will provide a margin buffer to IT companies. The increase in profitability can be used to offset wage hike pressures, and for marketing to boost demand, it claimed.

That seems logical, but if that were the case, why did Infosys, one of India's top software service exporters, warn that it might be unable to meet its revenue guidance? Infosys had earlier issued a guidance of 17-19 percent growth in dollar revenues for the year ending March 2012. For the third quarter, the guidance for revenue growth was issued at 3.2-5.4 percent, while the implied guidance for the fourth quarter was 3.3-5.6 percent.

Those estimates, however, sounded over-optimistic given the slowdown in the economy and execution issues with the company. Now the management has said they will meet only the lower end of their revenue outlook because the decision-making process among clients had slowed down.

Two points to be noted here: one is that hedging ensures that IT companies do not get the full benefit of a fall in the rupee and two, volatility in currencies affect a company's pricing capabilities.

IT is more than just currency gains

Indeed, currencies are also not the only determinant of profits for IT compa-

nies. As Pratibha Advani, CFO, NIIT Tech, told Economic Times, “We must also remember, that we are in the business of IT, and not treasury. Little forex gains are less important. A stable economy is necessary for businesses to flourish.”

Complicating the current situation is the fact that the dollar is gaining against other currencies.

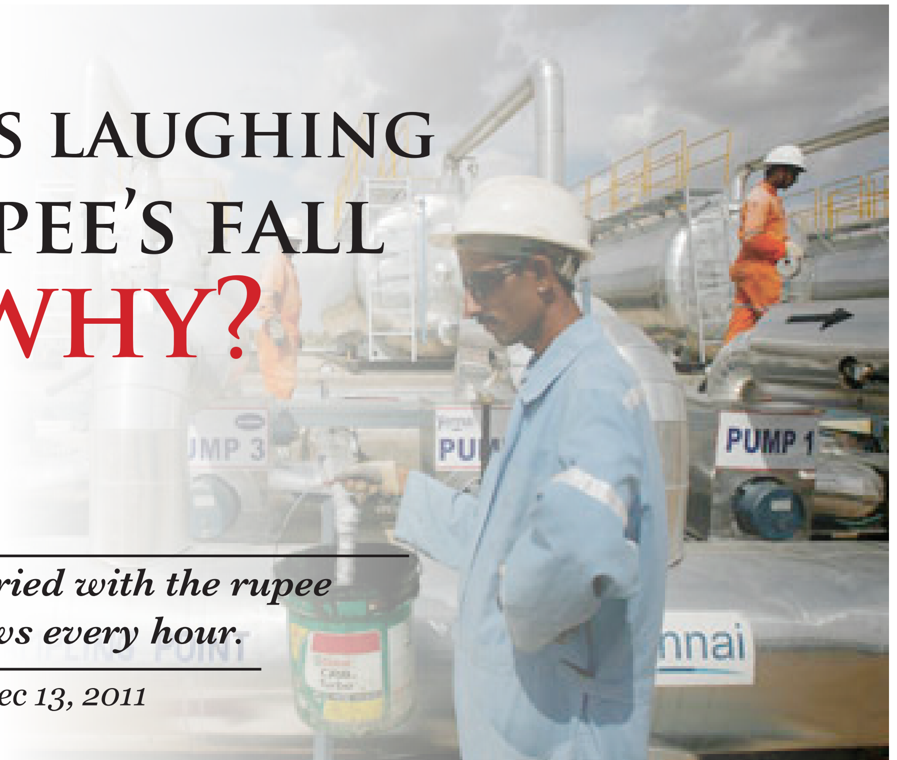
The volatility in currencies is actually a bigger headache than a one-sided currency move because it affects the ability of IT company officials to take good pricing decisions. For instance, a foreign client might demand a reduction in foreign currency prices arguing that the rupee’s fall would anyway hand them currency gains. An Indian company might agree to that but the deal is not without risks. After all, the situation could reverse soon enough: the rupee could start appreciating and then, the client might not agree so readily to a price hike.

In conclusion, while the depreciation in the currency could throw up some short-term gains for IT stocks, the more important point to remember is that the business environment outlook still remains muddied. If stability is not restored, these temporary gains could very well be reversed.

GUESS WHO IS LAUGHING AT THE RUPEE'S FALL AND WHY?

Not everybody is worried with the rupee touching new lows every hour.

FP Editors, Dec 13, 2011



Not everybody is worried with the rupee touching new lows every hour. Cairn India is laughing its way to the bank and with every rupee fall the laugh gets louder.

Though Cairn India sells its produce (Crude oil) in India, its revenue is booked in dollars. Every change in the rupee impacts the company's earning by 2.4 percent. Most of the analyst have pegged their earning estimates based on a rupee-dollar value between 45 and 46 not only for this year but for the next three years, that is till 2014.

Rupee has depreciated from an average of 45.66 in the second quarter to an all-time low of 53.51 today.

There is a difference of Rs 8.5 in the exchange rate based on analyst calculations. Even if we assume an average rate of 51, Cairn India is likely to post around 15 percent higher earnings than analyst estimates.

Importantly, the upgrades, as and when done by analysts, will have to be adjusted to the new rates over the next three years as they build in the new range for the currency.

Apart from the fact that the company books its sales in dollar, Cairn has also kept its cash war chest in dollars. As per a RBS report, the company has most of its net cash balance of Rs 7,130 crore in dollars. The report says that the company has Rs 5,460 crore in dollar deposits, which has been accounted for at a rate of 48.89 at the end of the previous quarter. A 10 percent depreciation in the value of rupee since then would result in a windfall gain of over Rs 350 crore.

Since the company plans to increase its output, rising price of crude oil will only act in its favour for prompting further upgrades.

Of course Kerala's smirking at the rupee's fall

The depreciation of the rupee has become a silver lining for the southern state as Keralites account for 50 percent of the expatriate population in the Gulf.

FP Staff, Nov 28, 2011

Wealth and Kerala. The two seem to have an increasingly intertwined relationship, judging by recent media reports. Only recently, it hit headlines after tonnes of gold was discovered in the cellars of the renowned Padmanabhaswamy temple.

Its next windfall seems to have come from the rupee's recent depreciation.

According to a report in Business Standard, the depreciation of the rupee is creating big gains for families of expatriates, especially those who live in the Middle East.

According to foreign exchange service providers and migration and economic experts quoted by the newspaper, the rate of remittances to India from the Middle East has jumped by around 25 percent. Most of them say that Kerala is the only state in India smiling at the rupee's fortunes even as several other states and industries suffer.

One forex exchange business official told the newspaper that transactions hit a peak the day the rupee hit 52.20 against the dollar.

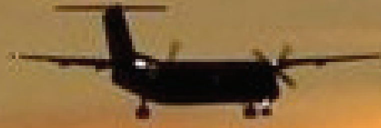
Indian migrants living abroad believe this is the best time for sending money back home, since a fall in the rupee's value allows them to remit more in Indian currency for a given amount of fixed currency.

Keralites accounts for 50 percent of the expatriate population in the Gulf.

The newspaper also quoted a study by the Centre for Development Studies (CDS), which said that the southern state gets almost Rs 50,000 crore as remittances from the Middle East.

For those at the receiving end of the currency gains, it might be time to book one of those famous house boats and float away in the back waters, dreaming of more windfalls to come.....

'Abroad' just got costlier. Here's how it will hit you



The rupee has been hogging all the headlines this week. On Tuesday, it broke past its previous all-time low of 52.19 against the dollar to hit 52.72, a new lifetime low.

The outlook remains gloomy for the currency, with most experts expecting the rupee to slide even further, perhaps to 56, against the greenback in the short term.

So what does this mean for you? The rupee's fall has different implications for different individuals.

The rupee's fall has different implications for different individuals.Here's a quick guide on what the currency's dive can mean for you.

FP Editors, Nov 22, 2011

Here's a quick guide on what the currency's dive can mean for you.

Non-resident Indians: This is a fantastic time to send some money back to India if you live and earn overseas. At least that's how your family back home will see it. The rupee's slide means that foreign currency remittances will fetch more in local currency. For instance, one dollar fetched Rs 44-45 before July; today, it fetches about Rs 52. India is the largest recipient of remittances in the world, of up to $50 billion.

And it's not just the dollar against which the rupee has tumbled: the rupee has also skidded against the euro, British pound, as well as the Australian dollar. One euro can be exchanged for Rs 69 (it was Rs around 66 a quarter ago); while one unit of UK currency can be exchanged for about Rs 81 (it was worth Rs 75 or so earlier).

Travellers: If you're travelling abroad, you'll find your rupees fetching lesser foreign currency, so be prepared to spend more. That applies whether you're going abroad for a holiday or even to study. Even if you're planning a trip in exotic South East Asia, you'll be disappointed. The rupee has slipped even against Asian currencies like the Thai baht and Singapore dollar.

One Thai baht could be bought with Rs 1.52 three months ago, now you need to spend Rs 1.66. Ditto for the Singapore dollar: it was worth about Rs 38 three months ago, now it's up to Rs 40.

Consumers: Bad news if you have a craving for imported goods – they're all going to get more expensive. Better buy them now before they get even more expensive later. From cars to mobiles and LCD televisions, consumers will be shelling out more for imported products. Your fuel bills could also go higher. While international crude prices have remained more or less steady at high levels, the fall in the rupee means that the country still pays more for its oil imports, which account for one-third of India's total imports.

That will eventually result in an increase in petrol and possibly diesel prices.

Workers: If you're an Indian working in India for a foreign company that pays you in dollars, rejoice! You get an unexpected windfall. What kind of jobs are we talking about? Well, offshore outsourcing is one example. For example, you could be writing articles for a foreign company. If you were paid $1,000 a month, for instance, you would have received about Rs 44,000 in July. Now, your income will jump to Rs 52,000, simply because of the currency fluctuation.

On the other hand, if you're a foreigner living in India earning in rupees, well, the situation's not so good if you decide to convert your earnings into foreign currency.

Investors: Typically, the rupee's slide is bad news for equity investors, because it worsens sentiment in the markets. A falling currency increases the cost of imported inputs for companies and that weighs on margins, dragging profitability lower. While, in general, a depreciating rupee helps exporters like software service providers, too much volatility in the currency's value can also cause problems.

If you were smart enough to invest in international mutual funds, you could stand to benefit from a falling rupee. The Business Standard recently had a story on how investors could have benefited by doing just that.

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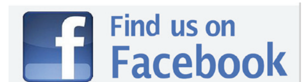

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