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India – INR at 60: More pain than gain

- **Weaker INR could reverse some recent improvements in India's macroeconomic conditions**
- **Inflation, fiscal deficit may worsen; positive C/A impact is unlikely, and capital flows may slow**
- **Kick-starting the investment cycle is crucial, as other solutions can provide only short-term relief**

Summary

The Indian rupee (INR) has depreciated about 10% against the US dollar (USD) since 1 May, when fears of early 'tapering' of the Fed's QE3 programme gripped markets. This currency weakness was not triggered by India's domestic fundamentals. In fact, some macro parameters, including inflation and the fiscal deficit, have improved on the back of recent policy steps. We are now concerned that INR weakness may reverse some of these improvements. Our estimates (detailed below) show that a weaker INR can add to inflationary pressure, widen the fiscal deficit and slow capital inflows, without having a positive effect on the current account deficit. Rapid INR depreciation also affects business sentiment negatively as uncertainty rises and worries about a possible financial crisis set in. We see a need to stem currency depreciation, but scope for short-term fixes might be limited. While the Reserve Bank of India (RBI) has enough reserves to bridge a temporary balance-of-payments mismatch, the focus should be on medium- to long-term measures to improve the current account deficit and encourage stable foreign inflows.

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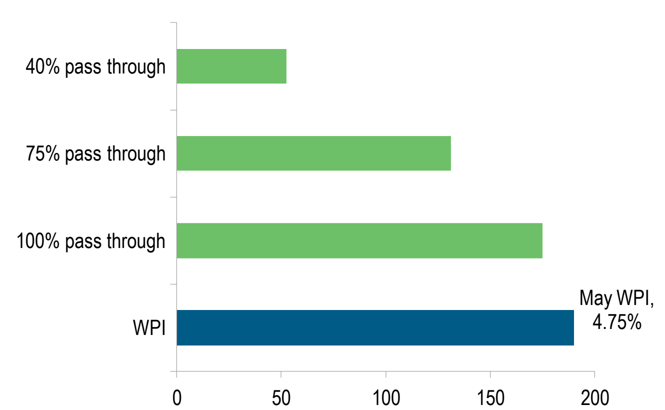
The adverse impact of a weaker INR

Inflation

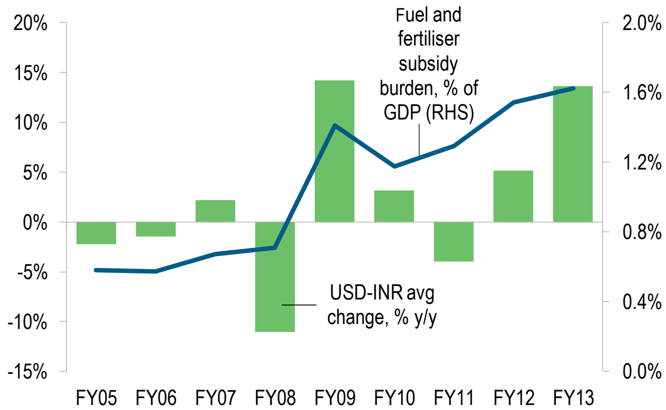
We assume that 30-40% of the increase in import costs resulting from a weaker INR will be passed on, resulting in a 70bps increase in WPI inflation. We have previously argued that a sustained 10% INR depreciation adds 150-200bps to headline WPI inflation as increased import costs are passed on to consumers. However, we think companies' ability to raise prices is restricted in the current sluggish demand environment. In fact, even the administered fuel price increases implemented since September 2012 have not been passed on.

Figure 1: Weaker INR can increase inflationary pressures
Additional impact on headline WPI inflation , bps



Sources: CEIC, Standard Chartered Research

Figure 2: Weaker INR increases the subsidy burden
%



Sources: CEIC, Standard Chartered Research

Fiscal deficit

Every 1 rupee depreciation increases oil companies' losses by INR 90bn

An additional oil subsidy burden of 0.15-0.2% of GDP is an inevitable result of a weaker INR, in our view. Every 1 rupee depreciation increases oil companies' losses by INR 90bn. Assuming that the government continues with monthly diesel price increases of 0.50 paise/litre (in effect since January 2013) and shares 60-65% of these losses, it will overshoot the budgeted oil subsidy bill. The fertiliser subsidy bill is also likely to exceed the budgeted amount if currency depreciation continues. The government will either have to reduce other expenditures or raise diesel prices more sharply to contain the fiscal deficit in a weak INR environment. These are difficult political decisions with elections nearing.

Exchange rate, C/A deficit and C/A deficit funding

Theoretically, exchange rate depreciation is expected to boost exports and reduce the current account (C/A) deficit. However, the strength of this effect is likely diluted in India by several factors.

High import intensity of exports, lack of a globally recognised brand, and similar depreciation in other currencies are likely to limit any positive impact on exports

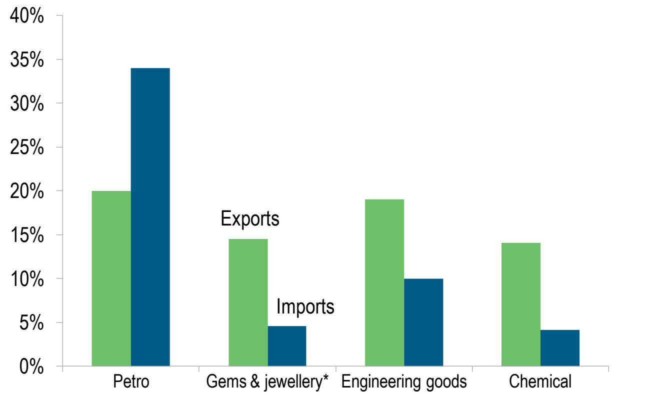
1. Some of India's exports are heavily reliant on imports; a weaker INR is therefore unlikely to provide a competitive edge. For instance, petro exports (20% of FY13 exports) and gem and jewellery exports (15%) have high import intensity.

2. Most Indian exporters deal with buyers who demand discounts whenever the INR weakens. Almost 45-50% of Indian exports are produced by SMEs, and the lack of a globally recognised 'Made in India' brand forces exporters to provide heavy discounts. This mitigates the positive impact of a weaker INR.

3. Exports are unlikely to benefit if exchange rate movements are driven by global factors rather than domestic factors. The current weakness is not specific to the INR, negating its benefits. South Africa and Indonesia compete with Indian textile, agricultural and engineering exports in the US and European markets. Since the beginning of 2013, the South African rand (ZAR) has weakened 15.3% against the USD, the INR by 8.6% and the Indonesian rupiah (IDR) by 4.13%; this limits the benefits to India's economy of a weaker INR. Even if the currency move is in India's favour, India's lack of cost competiveness in manufactured exports relative to countries such as China limits the gains, especially as cost pressures in the domestic economy remain high.

Figure 3: Some Indian exports rely heavily on imports

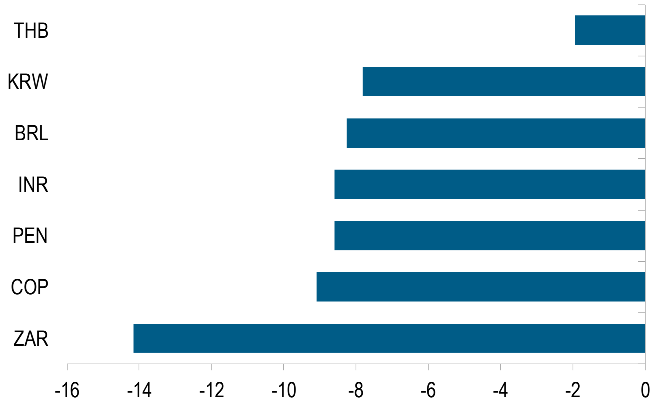
% of total exports, imports in FY13



* excludes gold Sources: CEIC, Standard Chartered Research

Figure 4: INR has weakened in line with other currencies

(% change since Jan 2013)



Sources: CEIC, Standard Chartered Research

4. Global demand plays a more important role than INR weakness/strength in driving exports. The slowdown in global GDP growth to 2.5% in 2012 from 3.1% in 2011 weighed on Indian exports. India's exports contracted 2.5% in 2012, following 35% growth in 2011, even as the INR weakened by 14% between 2011 and 2012. Given that 2013 GDP growth in most of India's major trading partners is likely to be below or similar to 2012 levels, a weaker INR is unlikely to provide a significant boost, at least in FY14. Overall, the trade and C/A deficits are unlikely to benefit significantly from a weaker INR on its own.

Increased currency volatility can slow capital flows

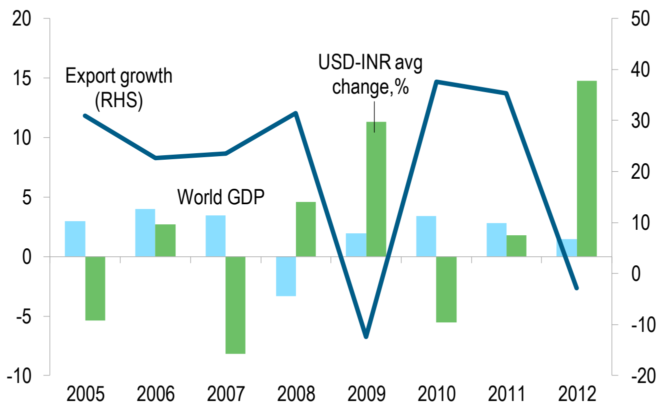
Increased exchange rate volatility can pose C/A deficit funding challenges. Foreign investors demand much higher returns if the currency of the country in which they are investing is depreciating. Portfolio inflows and loans (overseas borrowing and short-term trade credit) are impacted the most when the currency depreciates. USD returns on foreign portfolio investments in equities have suffered heavily, and the reduced interest rate differential between Indian bonds and US Treasuries might be discouraging bond investors. If INR depreciation weakens the macro environment, portfolio inflows could be affected further.

Currency volatility also increases hedging costs and discourages Indian companies from borrowing in foreign currency. Repeated sharp depreciation could affect the hedging activities of market participants. Portfolio investors and importers are likely to raise their hedge ratios substantially, while exporters might remain on the sidelines. These behaviours can accentuate currency depreciation, regardless of the actual BoP position. A weaker INR can also pose fresh challenges to Indian companies as external debt repayment requirements increase. For India Inc., a 10% INR depreciation will add USD 2bn in repayment liabilities to the USD 20bn of external commercial borrowings maturing in FY14, assuming such exposures are completely unhedged. Against this backdrop, our forecast of a USD 13bn BoP surplus in FY14 clearly faces downside risk. This risk arises primarily from lower FII investment – we currently expect USD 30bn of FII inflows in FY14.

Policy options

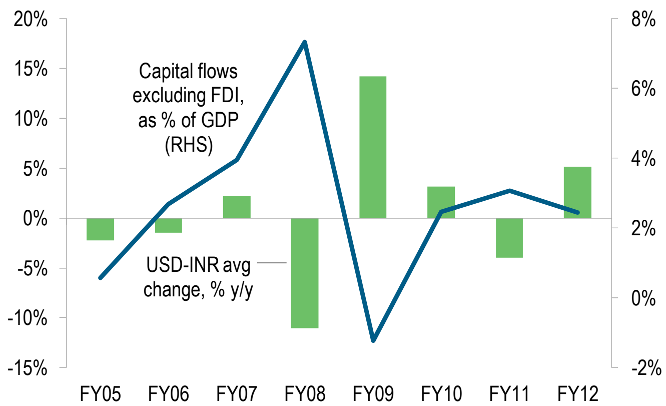
The negative effects of INR depreciation suggest that policy makers should avoid embracing the conventional wisdom that a weak currency leads to an improvement in the C/A deficit. Faced with similar INR depreciation pressure last year, the authorities responded with measures to encourage short-term inflows and check speculative

Figure 5: Global GDP growth is the key determinant of exports *(% y/y)*



Sources: CEIC, Standard Chartered Research

Figure 6: Volatile exchange rate slows capital inflows *%*



Sources: CEIC, Standard Chartered Research

activity in the FX market, as well as intervention from the RBI. Policy makers have not announced similar measures this time (except for restrictions on gold imports), although the RBI might have intervened, according to local media reports. We agree that measures to incentivise short-term capital inflows (particularly debt inflows) might not be successful at the moment and could even be counter-productive.

Commitment to supply-side reforms is necessary to improve the external situation

The RBI has been cautious about intervening aggressively because its FX reserves have been little changed in the past five years (at around USD 300bn) and the outlook for capital flows remains uncertain. In our view, though, the reserves are still large enough to meet a potential temporary BoP shortfall. Even in FY09, during the global financial crisis, the BoP deficit was only USD 20bn. We do not believe the current macro situation warrants a run on the currency.

We believe the policy focus needs to shift to supply-side reforms, which would improve productivity. In our view, only such measures can increase India's competitiveness and meaningfully reduce the C/A deficit. We see an urgent need to kick-start the investment cycle by fast-tracking investment approvals. A focus on infrastructure investment and the removal of procedural bottlenecks will not only increase export competitiveness but also attract foreign capital. Commitment to these reforms is the only way to bring about a sustainable medium-term improvement in India's vulnerable BoP situation, in our view.

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