Forex, Liquidity and Risk: Tracking the Indian Rupee

Following a long spell of Rupee stability, the Indian currency is set to weaken to the high 60s against the US dollar, led by domestic and global factors

An extended spell of calm – the Rupee has held strong in the 64-65/USD band for several months now – had dulled memories of volatile exchange rates. Through September, however, we have been reminded again of the reality of volatility. The Rupee dropped from 63.78/USD on September 8 to 65.71/USD on the 27th of the same month. It is clear that the only thing certain in forex markets is that turbulence will return, sooner rather than later. Consequently, any treasury department that is today not hedging its open foreign positions is engaging in speculation, whether actively or passively. (Choosing to 'do nothing' in expectation of a strong or rising Rupee is fundamentally not very different from a bank trader selling forward in the hope of squaring off the position at a profit.) Bearing this in mind, businesses that do choose to speculate should remember that even the very best traders have a long-term 'batting average' – the ratio of successful positions to the total number of trades – not much higher than 50 per cent. They should also know that the key tenet of speculation is to hope for the best, but be prepared for the worst. Brexit, Donald Trump's victory, and the BJP's spectacular win in UP earlier this year are but three recent examples of how 'long tail' events can quickly change existing market dynamics in big and unexpected ways. Going forward, corporates should be readying themselves for a fresh bout of volatility, and, more than likely, a fall of the Rupee.

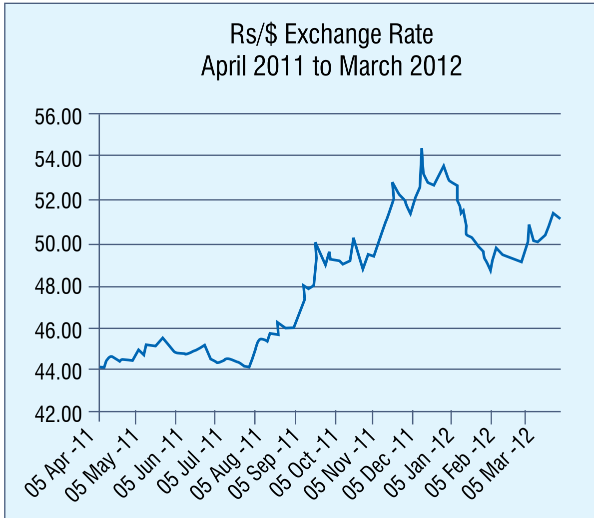
> **A strong currency, driven by FII inflows, has caused the CAD to surge this fiscal**

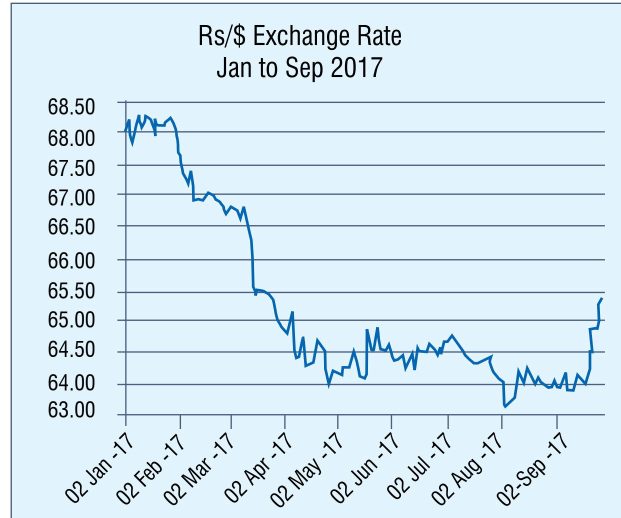
THE RUPEE IN 2017: UP OR DOWN?

The Rupee's direction has often been influenced by FII flows into India's markets. In turn, those flows are dependent on the political and policy environment domestically, and on the level principally, of stability in global markets. The US Federal Reserve's decisions are as always, a strong influencer, with interest rate differentials a key determinant in the funds flow to emerging markets. The Rupee's stark appreciation since early in this calendar year is yet another illustration. FII money started pouring in right after the BJP's big win in Uttar Pradesh: USD 8.6 billion in March 2017 alone. This trend continued over April-June, although investors became less bullish about the growth-and-reforms story, moving increasingly into debt (USD 10 billion of total inflows of USD 12 billion) that quarter. Since July, the mood has turned more cautious still, with equity seeing net outflows of USD 1.5 billion through mid-September, though debt, up USD 4.5 billion, remains attractive. The Rupee surged, but this triggered a stupendous rise in the trade and current account deficits (CAD). At USD 14.3 billion – 2.4 per cent of GDP – the CAD for April-June is the widest in 4 years, and already close to last year's total. Meanwhile, the trade deficit has been in the double-digits for 6 months straight, more than doubling year-on-year in April-June, from USD 19 billion to USD 40 billion. Plainly, this is difficult to sustain.

SIGNS OF THE FUTURE IN THE PAST?: PARALLELS WITH 2011

Interestingly, the parallels with 2011 are striking – and worrisome. Then, as now, the Rupee had been stable – at 44-45/USD levels – for many months. Then, too, the trade deficit had surged, and like today, this was driven largely by a sharp rise in imports, including, critically, of gold and silver. This year, gold imports rose 30 per cent in January-March, 75 per cent in April-June – half-year imports alone exceeded all of 2016 – and a whopping 95 per cent in July. Meanwhile, silver imports tripled in July. (In addition to official gold and silver imports, there is possibly a smuggling component that will eventually also feed into a worsening CAD in the form of lower remittances from abroad, which have already fallen for two consecutive years.) India's





trade deficit is worrisome from the perspective of India's Balance of Payments, also because it signals a slowdown in a key component of the India growth story. Exports grew just 4 per cent in July and that too mainly because the prices of petroleum products – which make up 17-18 per cent of India's total exports – have risen 8 per cent YoY. The only other significant item of export growth is iron ore, which saw year on year gains on account of a very low base effect (almost no growth last year). India's labour-intensive exports – are either flat or declining. Gems and jewellery export is down by 25 per cent, leather by 5 per cent, jute by about 3-4 per cent and textiles export is almost flat.

Going forward, vulnerabilities on the external account may start to create nervousness about the exchange rate, like they did in 2011. Back then; the CAD was being financed mainly by low-cost external commercial borrowings (ECBs), which were as high as USD 25 billion in the first half of 2011-12. In the belief of a stable interest rate regime, Indian corporates had ramped up dollar borrowings dramatically, given the 4 per cent interest rate differential. However, these flows came to an abrupt halt in October 2011, when an IMF official made a general statement about how developing countries cannot indefinitely finance their CADs with overseas borrowings. The statement may not have been targeted at India but within three months the Rupee dropped 18 per cent, to 54/USD from 46/USD as dollar borrowings came to a striking halt. This self-fulfilling prophecy was then stemmed by the RBI, which stepped in to pull the INR back up to 51-52/USD. The central bank has since clamped down on ECBs, but in their place, FII debt flows are financing India's current account deficit, again in the belief that the Rs/USD exchange rate will remain stable. As said, that now needs to be watched. Both then and now, a single trigger – external or internal – can send the Rupee plunging.

Any number of factors - from nervousness about the high CAD, to war in Korea - might trigger the Rupee's fall

FUNDS OUTFLOW: WATCH THE FED, AND FIIS

What might trigger a sudden fall in FII inflows, or even an outflow? A number of possibilities exist. Domestically, continued low economic growth – it was 5.7 per cent in Q1 – could panic the markets. Considering the recent PMI numbers, which show services (55 per cent of GDP) slipping into the red in July and August, Q2 figures are not likely to be much better. The Indian system's adaptation to the new GST regime will also create a drag in the immediate term.

Regrettably, the RBI may actually be exacerbating the situation by keeping real interest rates too high – and unusually; it has been over-estimating inflation, by 1-2 percentage points, for almost two years. Both a high interest rate and a strong Rupee are anti-inflationary, as is GST expected to be. (Anecdotal evidence suggests that the GST rate for over 90 per cent of all products is lower than or parallel to existing Excise Duty + VAT rates.) There is therefore clearly a crying need for a rate cut, but the central bank will, if at all, effect no more than a 25 basis-point cut in October – and if the Rupee falls quickly, it will hold back, fearing the inflationary impact of a weak Rupee.

Externally, should the North Korea situation worsen – such as if either side stumbles into war – the impact on markets would be disastrous. This however seems

unlikely. The more important trigger for now is Janet Yellen's intent to squeeze the Fed's balance sheet over the next few years, even as this is expected to be spaced out over time. As the Fed begins to wind QE down, it will start to squeeze as much as USD 50 billion of liquidity out of the market each month, impacting in particular the over-leveraged FIIs and hedge funds – some of which today have gearing ratios as high as 10:1. This could cause market rates, though not policy rates, to edge higher, and for foreign investments to slow or even reverse. The Fed is aware of this problem, and is likely to calibrate its response, but given the huge sums involved, some impact is inevitable. For their part, firms should guard against rising market rates by converting at least half their floating-rate loans into fixed rates. For now, Ms Yellen's statement on increasing US interest rates, if it is followed through in the next couple of months, could trigger funds outflow.

Worries from the Euro-zone have been allayed for now with Angela Merkel's historic fourth term but her ability to push through change may be hampered by two warring allies – the pro-environment Green Party and the pro-business FDP.

There may be a quick move down to 67-68/USD levels, but expect the RBI to stem the flow

(Companies with Euro payables would be advised to purchase call options – rather than forward contracts – to reduce the downside risk that might be emergent a year or two from now.) Meanwhile, in the US, Donald Trump may seek to shore up his support by sharply cutting corporate and HNI tax rates – a move that would be very popular with the Republican Party. However, this would cause billions of dollars stored overseas (mainly in Europe, Canada and Australia) by US companies to flow home, which would drive up the dollar.

EXPECT A DROP – BUT NOT BELOW 69/USD

Mildly over-valued, the Rupee should be trading in the 67-68/USD range – levels that would make domestic manufacturing, including steel, paint, and tyres, more competitive than they are today. Were it to correct, however, and left to its own devices, the currency would be expected to rapidly drop to 74-75/USD. That, though, is unlikely to happen. While the move down to 67-68 would occur fairly quickly, for three reasons, the Rupee is likely to hold below 69/USD, at least in the short-term (i.e., the next 5-6 months). First, inflation is well under control: compared to 7-8 per cent WPI and CPI inflation a few years ago, it is now in the 2-4 per cent range. This limits the scope for over-valuation, and reduces the chances of a sudden, dramatic fall. Second, the RBI's foreign reserves are in much better shape than in 2011. At just over USD 400 billion – an all-time high – this can comfortably finance a USD 10-20 billion intervention. Third, a weak (70+) exchange rate is not politically 'tolerable'. Unfortunately, Indian policymakers see a weak currency as a reflection of poor economic policies, and vice versa, so for that reason alone, the government, through the RBI, is unlikely to allow a sharp depreciation.

THE UPSHOT: HEDGE YOUR POSITIONS

All considered, a strong case could be made either for Rupee stability, or for depreciation in the short-term. Historically, when the Rupee moves down, it does so in short order, so a fall of 2-3 Rupees in a matter of weeks is par for the course. This makes it all the more important for companies with forex exposures to hedge their net (not gross) positions, with a 6-month horizon for payables, using options. Like insurance, such contracts serve the buyer best when a claim is not paid out. ■

The Outlook for Europe and Japan...

Although the ECB is unlikely to reverse course, it will start to taper its programme, especially given that inflation, while remaining below target, is no longer negative. That said, Germany's heavy influence makes the ECB focus more on inflation – real and potential – rather than growth. Nor is inflation likely to pick up elsewhere in the world, particularly with commodity prices staying subdued. In Japan, the government and central bank have been pump-priming aggressively, but to no avail, and today, the Bank of Japan has no room to do anything with interest rates. Nor is the Yen likely to strengthen against the dollar – and Yen weakness is more likely.

The Pound sterling is unlikely to go back up to 100 levels against the Rupee, especially while the Brexit overhang remains. That said, the Pound is strongly linked to the Euro – 60 per cent of its exports are Euro-denominated – and today, the two are close to parity, at about 1.1. Should the Euro unexpectedly strengthen to USD 1.35-1.4, despite expectations to the contrary, the pound would go up as well, and Rs 90-95 levels are not inconceivable. ■

This article is based on interactions of The India CFO Forum with Haresh Desai of AV Rajwade & Co, a leading currency and interest-rate specialist, in September 2017.