

NO Proof Required

Rupee: Fundamentals vs. Mis-Management

By

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Blurb: Worsening fundamentals don't justify rupee's crash — RBI compounded policy paralysis by saying rupee free to float

The rupee has had its fastest two week slide in post 1992 history: a depreciation of 7.3 percent. Yes, history that includes the period of the East Asian crisis of 1997-98 (6.4 percent two week slide), and the period following the Lehman debacle of Sept. 2008 (5.6 percent two week decline). How did this happen, and more importantly, why did this happen? There is no reason that the rupee should be sliding at the fastest pace ever in October and November if the fundamentals have not changed drastically. But have they? If not, then can one conclude that management of the rupee was at fault?

A perspective on the rupee crash can be gleaned by observing what is happening in other emerging markets. Should our peers include China? Until yesterday, it was kosher to compare India with China – similar though not comparable growth rates, India to grow faster than China (I believed, and still believe, that that will be the story of this decade), etc. A conservative assumption is to exclude China (Figure 1). This emerging market currency basket has depreciated by less than 4 percent since Dec. 2010. The rupee has depreciated by 16 percent. Why the difference?

Several fundamental explanations – count them, six - have been offered for the rupee's slide. First, the rupee is reflecting “market fundamentals” and is finding its “free market” level; let it be. If it depreciates, that is normal. If it appreciates, it is natural. Now most reformers do believe in giving a lot more importance, and vision, to market forces than relying on the vicissitudes and idiosyncrasies of politicians and bureaucrats. Count me as a card carrying member of that near extinct tribe in Nehruvian-Gandhian socialist India. But prudence dictates that we do not get carried away by the myths of our own making. No country allows

the exchange rate to freely operate, not even the reserve currency, the US, and nor the most capitalist free market country called Switzerland. So, at a minimum, let's get real, and rational.

The second fundamental offering is that the FII's have been withdrawing money from Indian capital markets. (Recall that the rupee was at 45.8 on August 31, 2011, a good 15 percent away from its closing low of Rs. 52.50 a few days ago). According to SEBI data, there has been a **net** \$3.6 billion inflow in 2011 (until Nov. 24th). Equity inflows have been small, but the exchange rate is not determined by equity inflows alone. And in October 2011, the month of more than \$ 600 million inflows, (equity and debt \$ 330 and \$270 million, respectively) the rupee depreciated by more than 3 percent.

Third explanation: it is the Euro. Europe has been stuck in quagmire of its own making, and the news flow out of the Eurozone does not spark confidence in any soul, excluding the Germans. But even Germany cannot sell its bonds anymore. Given all these negative factors, the Euro is almost exactly the same level as it was on Dec. 31, 2010: 1.34 to the dollar. So the Euro doesn't explain.

Several other "fundamental" reasons abound. My favorite (besides the FII figures noted above) is that we had a \$ 20 billion trade deficit in September (fourth explanation). This is what caused the rupee's rout! But until yesterday, we were told about the great Indian success story of 2011. Exports exploding, and imports imploding. One month data does not determine the value of a currency the last time I looked. For the seven months April-October, trade deficit in 2010 was \$ 92 billion vs. a deficit of \$ 72 billion last year. So let us see, \$ 20 billion increase in the trade deficit causes a 17 percent depreciation of the rupee. And a \$ 600 million monthly inflow of dollars causes the rupee to depreciate by 3 percent. Simple conclusion – no matter what, the rupee depreciates. Why do we need economists, or policy makers, or traders, or markets?

Fifth explanation: the relentless hiking of the repo rate by the RBI. While interest rates in some developing countries have declined, and in many others a pause in hikes has been struck, the RBI increased the repo rate by 25 basis points in late October. For the year, this was the seventh increase, for a total of 225 basis points. Interest rate hikes are supposed to help, no? Actually not – they hurt; currency markets react much more to growth differentials

than interest rate differentials. Accompanying the interest rate increases – an uninterrupted decline in the value of the rupee. The more extreme and fundamentally unwarranted the repo hike, the worse the slide was in the rupee.

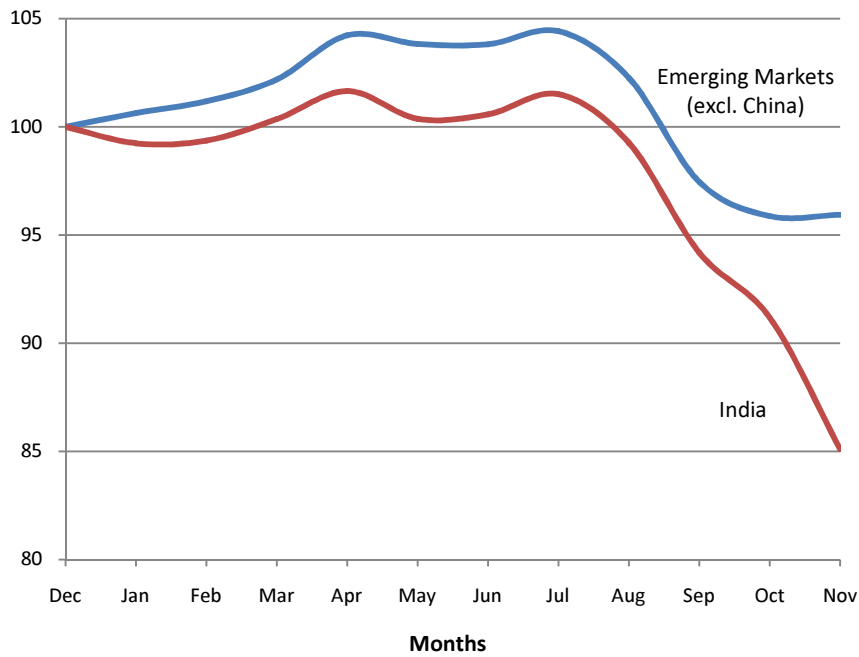
Sixth explanation: the real exchange rate had appreciated beyond a tolerance level. Of all the reasons offered above, this one is the real McCoy. But the second chart suggests otherwise. The RBI publishes a comprehensive 36 trade weighted country real exchange rate series. The data for October and November are approximations. For the entire near twenty year period 1993 to 2011, this is only the second time that the rupee has been so cheap. Excluding 2008/9, unambiguously the cheapest ever, even cheaper than the East Asian crisis years. And if the approximations are too conservative, then the rupee at 52.50 may have been at its lowest, ever!

Conclusion: there is precious little fundamental reason for the rupee to depreciate as it has done in 2011, and even less reason for it to depreciate at the speed of a Ferrari. If there are no fundamental reasons, what gives? Sentiment and expectations. The government at the centre has done everything possible to sour expectations and sentiment with regard to India. This has hurt. If this were not enough, the RBI messed up. By talking too much. By stating that the rupee was a free floating currency. The market tested that ridiculous assertion. The market won. The RBI had to backtrack. Central bankers should be more seen, less heard. The rupee slide was aided and abetted with mismanagement of interest rate *and* exchange rate policy. There is ample reason to believe that RBI is *not* independent, and that a considerable portion of mismanagement might actually be attributable to the centre. Whatever the real cause, India is the loser.

Maybe a loser in the past sense. Markets have a tendency to over-react, and even policy makers learn from past mistakes. Rupee at historical low levels is not sustainable. Nor are interest rates at such levels credible. Even before inflation falls (likely soon?), the fundamentals suggest a reduction in repo rates, and an appreciation of the rupee. The future is much less bleak than the past.

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RBI's Rupee: Slip Sliding Away in 2011



** Note - The exchange rate for Emerging Markets excludes China and is a weighted average of the currencies of 17 emerging market economies, which include - Brazil, Hong Kong, Korea, Taiwan, Turkey, etc.*

