

Is rupee depreciation the new normal?



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Unless we control inflation and reduce the supply-side constraints, the rupee is expected to depreciate further against the dollar.

India has been relying on capital inflows to fill the current account deficit and this strategy had worked successfully in the last decade. Over the last three-four years, India has slowly and cautiously opened its doors to debt capital by raising caps on ECB/FII/FDI debt investment.

Coupled with the increasing interest rate differentials between India and the developed world, there was a sizable increase in debt capital inflows into the country in the last couple of years. Though these inflows seem to have compensated for the almost dried up inflows towards equity this year, there could be challenges, going ahead. How? Read on.

India's overall external debt outstanding as of June-2011 was \$317 billion, an increase of 38 per cent in last two years. The short-term external debt increased at a much faster pace of 62 per cent (in absolute terms) during the same period and it now constitutes about 21.6 per cent of total external debt.

However, a much worrying fact is that the total external debt maturing within the next one year, short-term and long-term debt (with residual ma-

EXTERNAL DEBT DUE WITHIN ONE YEAR			
As of	Amount in \$ billion	As % of Total External Debt	As % of India's Foreign Currency reserve
Mar-04	10.60	9.4%	9.4%
Mar-05	32.10	24.0%	22.7%
Mar-06	25.50	18.3%	16.8%
Mar-07	36.50	21.2%	18.3%
Mar-08	54.80	24.4%	17.7%
Mar-09	56.60	25.2%	22.5%
Mar-10	64.90	24.9%	23.3%
Mar-11	84.10	27.4%	27.6%
Jun-11	137.2	43.3%	43.5%

turing of less than one year), is about \$137 billion, as of June 2011, constituting about 43.3 per cent of the aggregate external debt — one of the highest witnessed in last decade; and 43.5 per cent of India's total foreign currency reserve (see table).

Additionally, a sizable portion of India's external debt is believed to be financed by European banks, which were the most active lenders to emerging Asia, much higher than the US or Japanese banks put together.

Thus, with the ongoing re-capitalisation needs of European banks, it is likely that these banks will be less forthcoming in refinancing Indian corporate debt. What makes matters even worse is that between March 2010 and June 2011, when the short-term forex repayment obligations have more than doubled, India's foreign currency reserves have grown by just 13.14 per cent over the same time frame.

DOLLAR LIABILITY

The rupee has remained fairly stable (except during Lehmann Brothers crisis) and confined to the 44-48 range against the dollar. This was supposed to be a new normal and with India's GDP growth recovering to 9 per cent in a short span after the crisis, the rupee was expected to appreciate *vis-a-vis*

the dollar by market participants and economists alike. Though inflows and outflows on the currency front were more or less matched during this period, what changed was that short-term credit funding by Indian corporates was taken in dollars instead of rupees.

Further, some corporates converted their rupee liability to dollar liability. With interest rate differential between the RBI repo rate and Fed rate reaching the highest level in recent history, corporates were led to believe that either the rupee would appreciate or the interest differential on their liabilities conversion would more than offset rupee depreciation, if any.

However, contrary to general belief, the rupee depreciated 10-12 per cent against the dollar. In fact, the rupee was so weak that it depreciated 8-10 per cent against currencies such as the euro and the yen.

IMPORT ISSUES

India remains a net importer of goods in foreign trade, with about a third comprising inelastic oil imports. A sharp depreciation in the rupee in recent times would pose a challenge for the import Bill. With a foreign currency reserve of \$311 billion, as of September 2011, and import value of about \$35 billion for the month, India now

has the lowest import cover of 8-9 months; this is the lowest in the last decade.

The elevated inflation, rising wages and increased capital costs during the last three years has diminished India's competitiveness. Further, with slow-down in the global economy, a slow-down in exports growth is inevitable.

The currency depreciation will put pressure on inflation. Sticky inflation and lack of infrastructure will slow down the productivity gains. An interesting point to ponder at this juncture would be — having attracted reasonable amount of foreign money with 8-9 per cent GDP growth, now, if the new normal GDP growth gets closer to 6-7 per cent, will that impact funds flow into the country?

STRAINED LIQUIDITY

The central banker's ability to intervene in the currency market remains strictly limited as we are running close to the lowest foreign currency reserves in terms of import cover in the last decade.

We believe that a sizable portion of external debt maturing in the next one year would require to be rolled over domestically, as global risk aversion would make the dollar availability limited and will, in turn, put pressure on the rupee liquidity. Any move by the RBI to support the rupee would put further pressure on the already strained liquidity. Along with all these factors mentioned above, a heightening risk on the current account deficit front, the best for the rupee seems to be over and we are in a new normal where unless we bring inflation under control and reduce the supply-side constraint, the rupee is expected to depreciate further against the dollar.

(The author is Head of Investments, Canara Robeco Asset Management. The views are personal.)