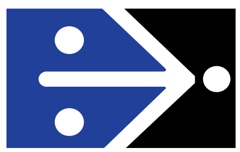


S A R T H I
Bridging the Gap

INFO BYTE

RBI Stance & Rupee Slide

Preface

The Indian Rupee's value against the US dollar is taking a beating on account of various factors. The Rupee's depreciation marks a new risk for the Indian economy. INR has depreciated by more than 10% in the last one month and crossing the psychological level of 60 per dollar in June-end it touched 61-level in the previous week.

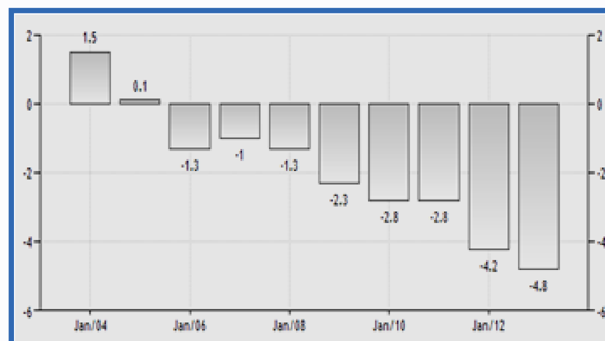
INR against US Dollar

The US Fed stance that indicated tapering of quantitative easing going forward triggered outflows of portfolio investment and resulted in a sharp increase in volatility of Rupee & other emerging market currencies. Following this, Indian Rupee has depreciated against the USD by 10.4% in FY14 till date and record selling of FII debt holdings has in large part contributed to more than 7% depreciation of the rupee. The demand for USD has also increased vis-à-vis INR because of the improving domestic liquidity situation. The impact has been severe because of widening Current Account Deficit (CAD).

Key Factors that pushed INR into the well

- **Current Account Deficit:**

  The primary reason behind India's flagging currency is a structural problem of Current Account Deficit (CAD) which is mainly because of increasing demand for oil & gold. The fall of oil price has helped India to fight the depreciating rupee up to some extent but at the same time Euro zone crisis has significantly impacted Indian exports because of reduced demand. Thus India continues to see CAD of around 4.8%, depleting the forex reserve and thus depreciating INR. Although the trend has been narrowing, it is still sizeable and provides an enduring demand for dollar onshore.



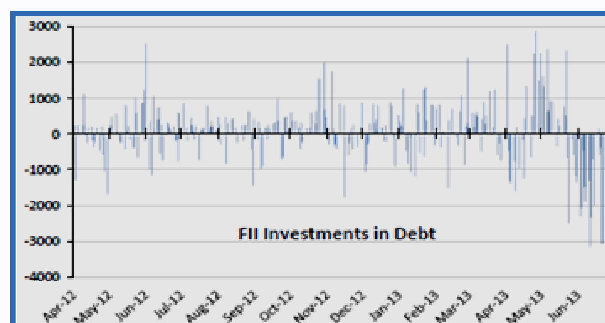
CAD as % of GDP

- **Capital Account flows:**

  India needs dollars to finance its current account deficit. Global uncertainty combined with domestic worries, record CAD and high uncertainty over the central bank's monetary policy stance, have prompted foreign investors to sell $11.5 billion of Indian debt and equities since late May. This Continued net outflow of FIIs has caused INR depreciated from 39 levels to 61 against dollar since 2008.

- **Persistent inflation:**

  India has experienced high inflation, above 7%, for almost two years. If inflation becomes a prolonged one, it leads to overall worsening of economic prospects and capital outflows which eventually leads to depreciation of the currency.



FII net Investments in Debt

- **Interest Rate Difference:**

  Higher real interest rates generally attract foreign investment but due to slowdown in growth there is increasing pressure on RBI to decrease the policy rates. Under such conditions foreign investors tend to stay away from investing. This further affects the capital account flows of India and puts a depreciating pressure on the currency.

- **Lack of reforms and Regulatory uncertainties:**

  Policy inaction on the reforms front and regulatory uncertainties have also largely contributed to the downfall of Rupee. A retrospective tax law (GAAR) and other taxation related cases have already earned a lot of flak from the investors. These regulatory complexities have been discouraging for the investors' community. Attempts are being made to control the subsidy bills but fiscal deficit continues to hover around 4.5-5% of GDP. Though the government has recently announced key reforms in opening up the FDI in various sectors, investors sentiment is still negative over the Indian economy.

- **Continued Global uncertainty:**

  Owing to uncertainty prevailing in Europe and slump in international market, investors are preferring to stay away from risky investments (flight to security) which puts a downward pressure on exchange rate. This Global uncertainty has adversely impacted the domestic factors (current and capital account etc.) and caused the depreciation of rupee.

RBI Steps into Action – July 15, 2013

In a move to stem the Rupee crisis, RBI announced the following measures to tighten domestic liquidity and control rupee depreciation. The new steps were announced after RBI's earlier steps to sell dollars in forex markets through state-run banks failed to halt the slide in the currency

✓ **Higher Lending Rates:**

RBI raised Bank rate and Marginal Standing Facility by 2% to 10.25% making the loans costlier. It primarily intended at regulating liquidity in the short term and to control volatility in the foreign exchange market.

Note: MSF is the rate at which banks borrow from the RBI during periods of acute liquidity shortage (using their statutory liquidity ratio securities as collateral).

✓ **Capped Liquidity Adjustment Facility borrowings:**

The central bank restricted banks' borrowing through Liquidity Adjustment Facility (or a window to borrow funds from RBI called LAF) to the tune of 1 percent of Net Demand and Time Liabilities (NDTL) or Rs 75,000 crore.

✓ **RBI Open Market Sale:**

Perhaps realizing the impact on the bond market, RBI announced open market bonds sale of Rs.12 Bn to suck out the domestic liquidity and to ensure more flows of government papers in the market especially when bond prices are likely to fall due to rise in yields, in a move to make rupee dearer.

Additional Measures – July 23, 2013

✓ RBI has further reduced the LAF for each bank from 1% to 0.5% of the total NDTL, thus further limiting the banks' access to borrowed funds. This bring down the total quantum of funds available to all banks to Rs 37,000 crore. This measure will come into effect immediately, i.e., from 24 July, 2013.

✓ RBI has increased minimum required average daily CRR (cash reserve ratio) balance to 99% of as against earlier 70% reducing banks' flexibility to average the CRR balances over the fortnight. This measure will come into effect immediately, i.e., from 27 July, 2013.

RBI Policy Review at Glance – July 30, 2013

RBI in its recent monetary policy review maintained Status Quo on policy rates In line with market expectations as it supports a battered rupee. The Repo Rate is unchanged at 7.25% while Reverse Repo Rate remains at 6.25%. The MSF rate also remains unchanged at 10.25% with the newly increased 300 bps mark-up above the repo rate. CRR has been retained at 4% of NDTL while SLR stays at 23% of NDTL.

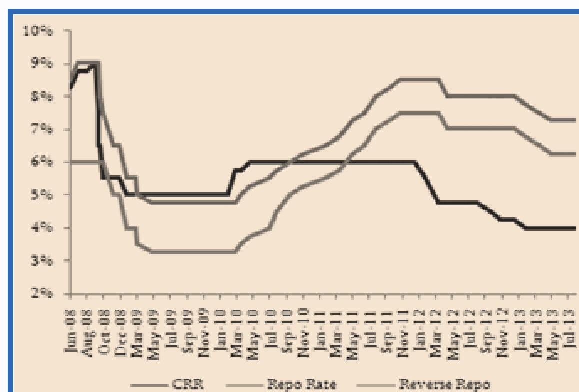
The key points that highlights rational behind RBI's current stance in its policy review for Q1 FY14 are as follows

✓ **Global Economic Activity** remains subdued with still elevated downside risks suggesting slower recovery in developed economies. Further the turmoil in global financial markets on the perception of an earlier than expected tapering of QE by the US Fed posed biggest risk to the macroeconomic outlook

✓ **Domestic Economic Activity** weakened in Q1 of FY14. Key macro indicators suggested that the industrial production & service sector remained muted during April-May suggesting broad-based sluggishness in economic activity.

✓ **CAD** is well above the sustainable level which has brought the external payments situation under increased stress, reflecting rising external indebtedness

✓ **Weak Investment Climate** in the country leading to cost & time overruns, high leverage, deteriorating cash flows, erosion of asset quality and muted credit confidence



Policy Rates Movement

✓ Though **WPI** remained at RBI's comfort level, Retail Inflation surged to double digits in June, driven primarily by a sharp increase in food prices. High CPI has lead to slowdown in private consumption. However timely arrival of the monsoon and average rainfall provides some comfort to RBI in food inflation going forward

This time RBI's monetary policy stance was guided particularly more by the concerns on external risk in addition to the growth-inflation dynamics. RBI took a dovish tone cutting India's growth forecast to 5.5% from 5.7% earlier. While it indicated that the current situation – moderating inflation, robust monsoon and decelerating growth would have provided a reasonable case for further easing but it had to move with the recent tightening measures to address external sector concerns & contain the volatility in forex market. It further added that it will roll back these measures when stability returns to the currency market, enabling it to resume supporting growth.

Impact of RBI measures on the Market

❖ Following the liquidity tightening measures by RBI on July 15, the yields on benchmark G-Sec and other bonds spiked up by 100-200 bps amid negative investors sentiments.

❖ The yield spike caused havoc in mutual funds with several long duration funds and even liquid funds losing value.

❖ Following additional measures by RBI on July 23, the G-Sec yields touched 8.40% while Yields on, CP, CD, T-Bills & bonds further shifted upwards raising borrowing costs across the board and reversing the interest rate cuts of the past few quarters.

India 10 Yr G-Sec Bond Yields

- Anticipating that the liquidity tightening measures would have redemption pressures on mutual funds, RBI opened a special repo window at an interest rate of 10.25% for a total of Rs.25,000 crore. It, however, did not receive any bids.
- RBI in its policy review on July 30 seems to have sent mixed signals and confused the markets. It is quite clear that currently the currency management would supersede growth orientation for RBI. It has indicated that these measure are only temporary and would be rolled back once Rupee assumes stability, though the timing is uncertain.
- Consequently, the rupee and financial markets reacted negatively. RBI's stance that they are not against gradual fall in the rupee but are concerned about volatility created some panic in the forex market, because of uncertainty over how far the rupee could weaken. The market expectation had been that the rupee would be protected from falling below 60 per dollar.

Concluding Remark

Grim global economic outlook along with high inflation, widening CAD and FII outflows have contributed to the fall of Indian Rupee. RBI has responded with timely interventions by selling dollars intermittently. But in times of global uncertainty, investors prefer USD as a safe haven. Further, higher interest rates amidst an ongoing slowdown in growth will also put incremental pressure on asset quality of banks and the growth outlook.

RBI's latest move is likely to provide only short-term relief to the currency. The Rupee is expected to remain under pressure in the medium-term as external market volatility, high CAD and the ability to attract long-term foreign capital inflows are still weighing on the currency. Further rising yields are bound to erode the efforts of the RBI to drain liquidity from the system.

Government has signaled that the move should not be seen as an increase in the long-term interest rate. We expect RBI to address the related concern in its next policy review. RBI has refrained from increasing CRR to absorb liquidity. Considering the fact that, CRR is projected as a policy tool, there stands a justifiable evidence to believe that the current measures can't be a permanent measures and RBI will roll-back these steps once volatility in the currency market stabilizes. This will compress yield spreads in the market. Thus current phase offers attractive opportunities on the bond front over a few months of horizon.

With key macroeconomic indicators like Inflation, IIP, Monsoon situation turning favorable, there could have been some case for rate cut in upcoming policy review but the expectations for rate cut seems to be extinguished as RBI's current stance doesn't provide much room for lowering the policy rates. It would be interesting to see what stance RBI takes in its next policy review to save rupee and restore growth. However what is needed is a sustainable solution to country's structural issues of trade imbalance, fiscal consolidation and investment slowdown which will pave way for a strong Indian Currency in the future.

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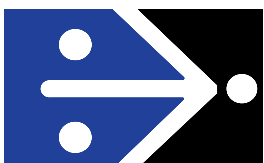

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