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Asia Economics Special

Limits to Rupee's Stress

Economics

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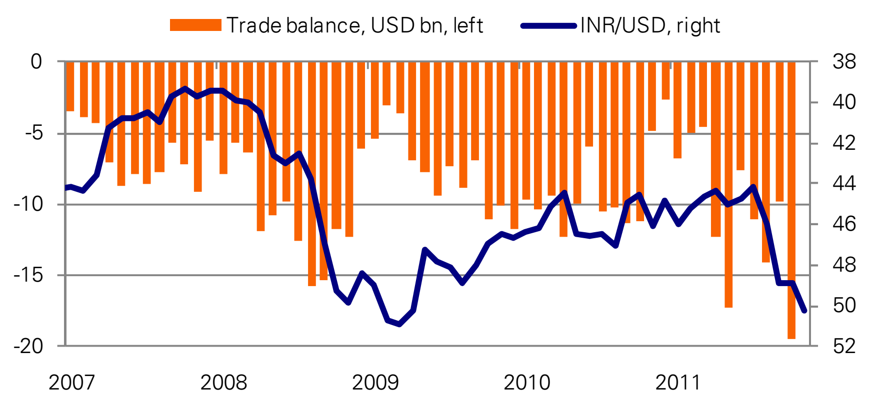
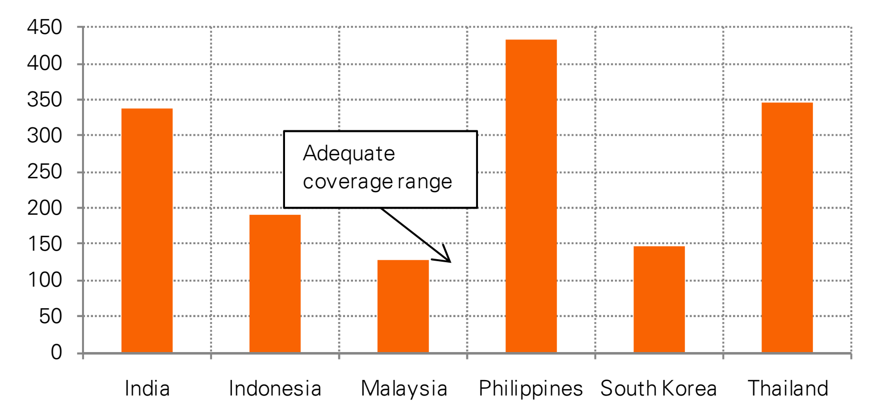
- Our previously published view that mounting external risks could exacerbate India's hitherto resilient balance of payments, and by extension, the rupee, has been reinforced by recent developments. A sharp deterioration in the trade balance has put renewed pressure on the currency, which has already been the worst performing one in the region.
- Rupee's outlook could however reverse quite quickly if growth slows (and hence import demand), capital account surplus rises due to a likely pick up in debt inflows, or global risk aversion eases. Cross country comparison shows India's reserve coverage is more than adequate, suggesting no systemic risk.

Worsening trade balance is associated with a weak rupee



Source: CEIC, Deutsche Bank

Reserves to risk-weighted liabilities show that the rupee is well insulated



Source: CEIC, Deutsche Bank. Risk weighted liabilities include short term external debt, current account balance, broad money, portfolio investment, and exports.

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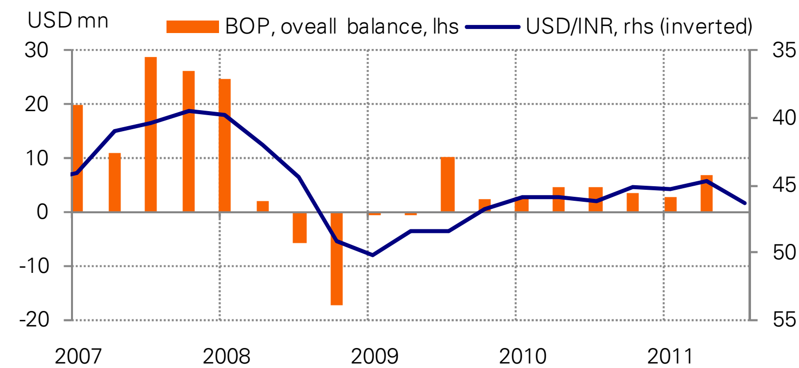
Weak BOP, weak INR

Asia's worst performing currency, pushed down by weak flows

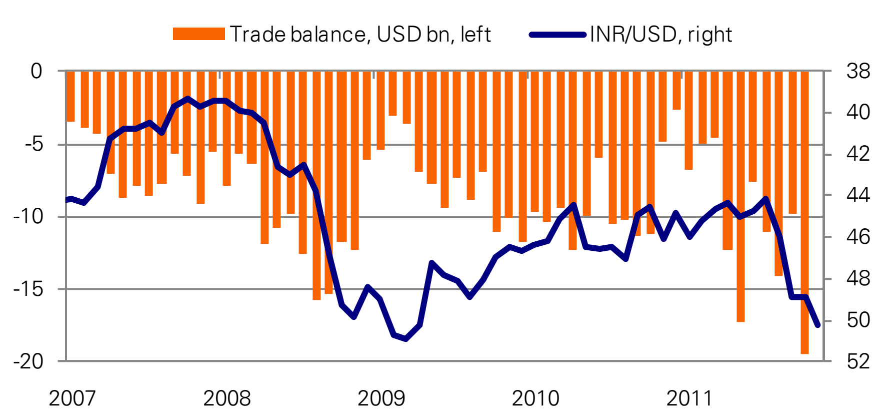
In our October 5 publication on India's balance of payments, we had written: "but there is a risk that this (BOP) resiliency could be challenged as external risks mount, which could exacerbate the outlook for the rupee." The exacerbation has already taken place in the form of a sharply weaker export and stubborn imports figures, translating into a sharp widening of the trade deficit for the month of October. It is thus not surprising to see the rupee come under renewed pressure.

BOP and rupee (quarterly data)



Source: CEIC, Deutsche Bank> BOP data is through June 2011 and exchange rate extended through September 2011.

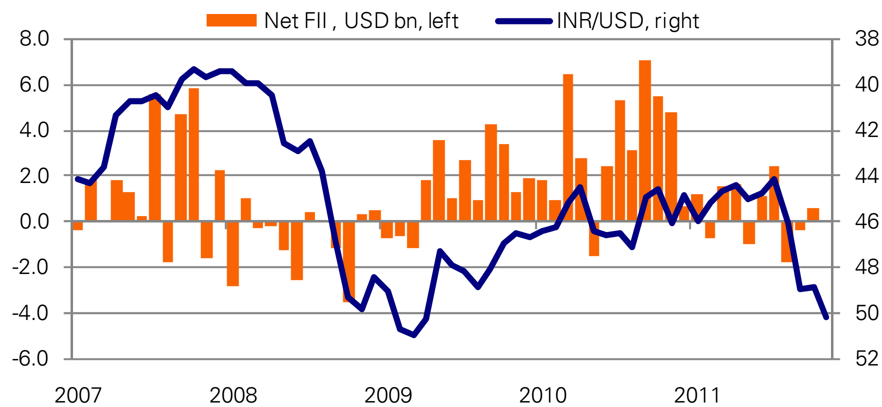
Trade balance and rupee (monthly data)



Source: CEIC, Deutsche Bank. Data is through October 2011

A sizeable increase in the trade deficit is the key driver of the exchange rate weakness. The chart in the next page shows that capital flows, when seen along with the trade deficit chart above, explain much of the exchange rate movement. In recent months however, the dynamic has been dominated by trade flows. The October trade figures were striking to say the least, with exports falling by USD5bn relative to the previous month and imports *rising* by USD5bn. A worsening of the trade balance by about USD10bn in one month is very large by India's historical trend.

Foreign Institutional flows to debt and equity markets and the rupee

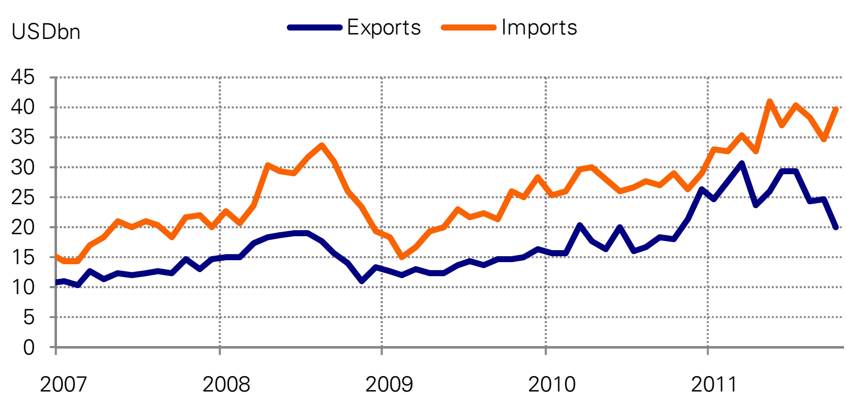


Source: CEIC, Deutsche Bank

Other than trade and portfolio flows, the rupee has also depreciated along with regional currencies in the face of ongoing global market volatility. Indeed, since the beginning of June a number of key Asian currencies have weakened against the USD by 4 to 5% (including ringgit, won, Singapore dollar, Taiwanese Dollar, and the Rupiah). We therefore reckon that the 10% weakness in the rupee seen so far can be divided in equal halves between India-specific weakness and regional pressure.[1]

But what is the risk that the rupee could be due for further correction? A stubbornly high import bill on account of pockets of strength in the economy could keep the trade deficit high, but we think that the sharp weakening in October was an anomaly as opposed to a marker for things to come. While there may be further downside to exports, it is hard to see imports remaining so strong given that growth is slowing. Historically, a sharp decline in exports has almost always been accompanied by a correction in imports. We see two scenarios—first, external outlook weakens, commodity price eases, domestic demand wanes, and both imports and exports weaken; second, external uncertainties ease, commodity prices remain high, but exports also revive. Under both scenarios we expect the trade deficit to stabilize at a smaller, more "normal" magnitude.

Latest trade data point appear anomalous



Source: CEIC, Deutsche Bank

[1] Another way of arriving at the broadly the same conclusion is that the same group of comparator currencies during the same period has appreciated against the euro by about 2% while the rupee has depreciated by 4%.

Reserve adequacy

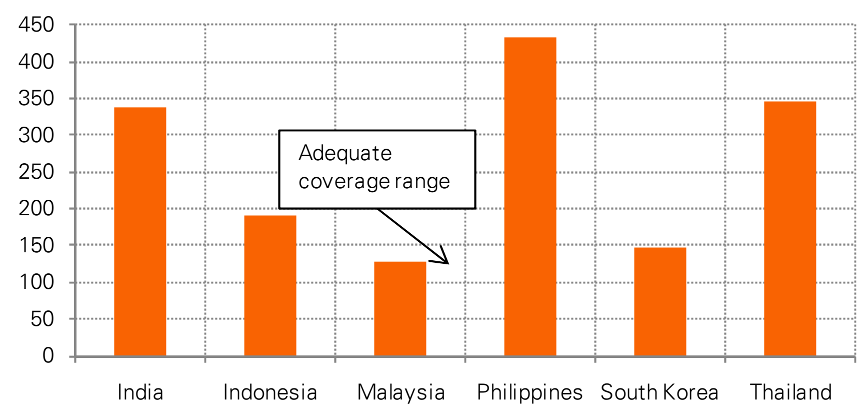
But what about that between financing need of the current account, weak capital flow outlook, and likely downside to exports, India's external position is likely to weaken and therefore the rupee is at risk? We examine this question by using a new approach to measuring external strength. Under this approach, a risk-weighted metric is used observe a country's reserve holdings. Based on a methodology recently published by the IMF, we infer the degree to which India's foreign exchange reserves cover is consistent with those of its peers.[2]

In this approach, variables that could constitute outflows are examined. These include short term external debt, current account balance, broad money, portfolio investment, and exports. The relative riskiness of each of these variables is estimated using historical volatility (based on observed distribution of outflows during episodes of exchange market pressure).

The chart below presents the estimates of this metric using latest available data. As per the IMF analysis, reserves to risk-weighted liabilities is considered to be "adequate" in 100-150 range. India, by virtue of having relatively low external debt and sizeable reserves, scores very high on this measure. In fact, India gets the second highest score of reserve adequacy in our analysis.

The analysis shows that the rupee is in little danger of facing a disorderly depreciation risk. If the exchange rate depreciates further, the Reserve Bank of India can readily intervene and comfortably backstop outflows and thus manage the exchange rate. We note the central bank has done little to prevent further depreciation and this is likely a reflection of the authorities' comfort level associated with the present valuation of the rupee, but there should be no doubt about the capability of the intervening authorities to protect the exchange rate.

Reserves to risk-weighted liabilities



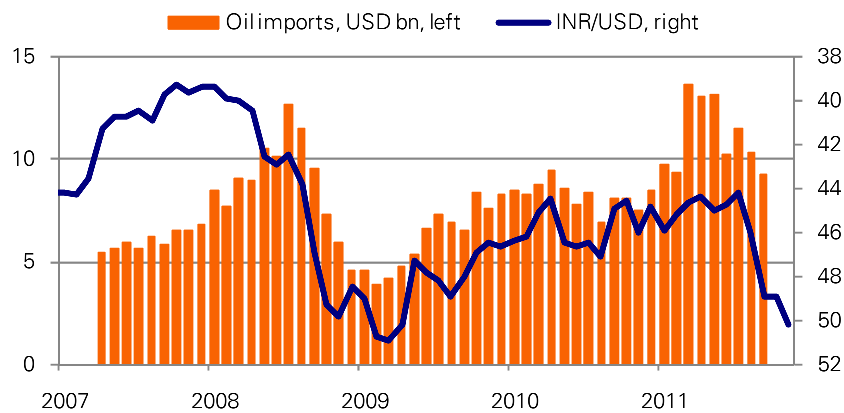
Source: CEIC, Deutsche Bank. Risk weighted liabilities include short term external debt, current account balance, broad money, portfolio investment, and exports.

Additionally, the rupee's outlook could reverse quite quickly if global risk aversion eases or the capital account balance improves due to a likely pick up in debt inflows. The latter is likely in the near term as the authorities are preparing easing foreign access to the local currency debt market by an additional USD10bn. The rupee may not enjoy a major bounce back soon, but the likelihood of a sharp, additional decline is small, in our view.

[2] See *Assessing Reserve Adequacy,* International Monetary Fund, February 2011.

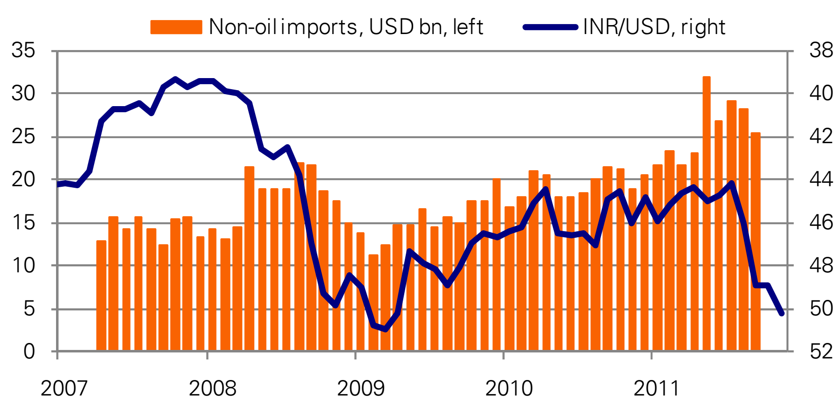
Relevant charts

Oil imports and the rupee



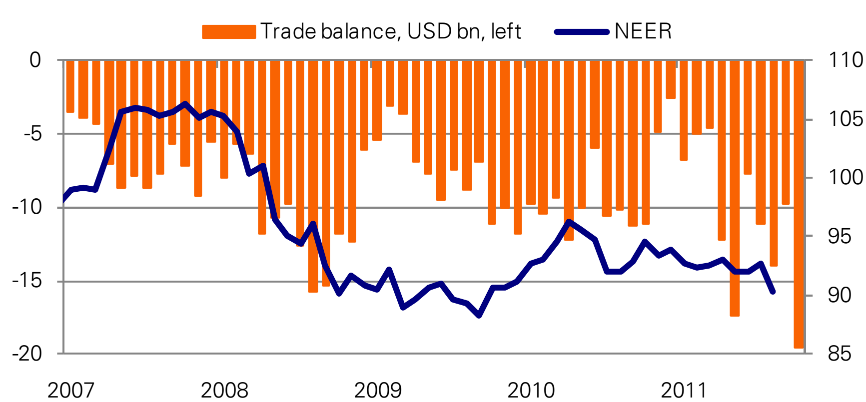
Source: CEIC, Deutsche Bank

Non-oil imports and the rupee



Source: CEIC, Deutsche Bank

Trade balance and the Nominal Effective Exchange Rate (NEER)



Source: CEIC, Deutsche Bank

Appendix 1

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