Understanding recent events on the rupee and analysing policy alternatives

NIPFP

National Institute of Public Finance and Policy
http://macrofinance.nipfp.org.in

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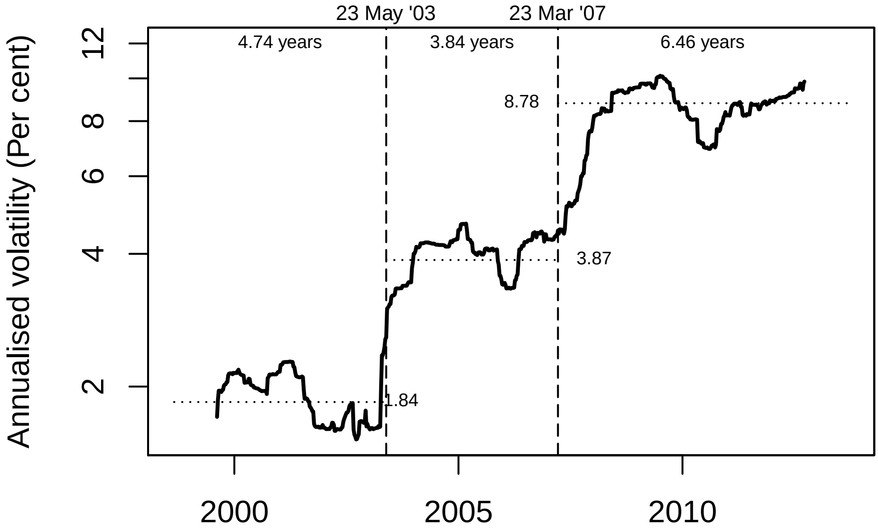
Part I

Background

Rupee moved to a float



The Indian strategy on macro/finance

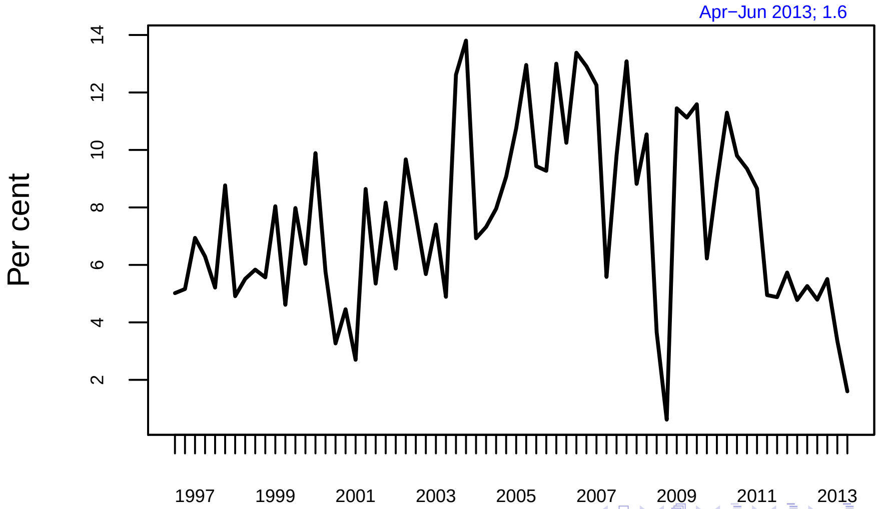
- Exchange rate policy: Move towards a float
- Capital account openness: Increasing *de facto* openness
- Monetary policy: Lack of commitment to inflation, lack of nominal anchor.

Part II

Present macroeconomic conditions

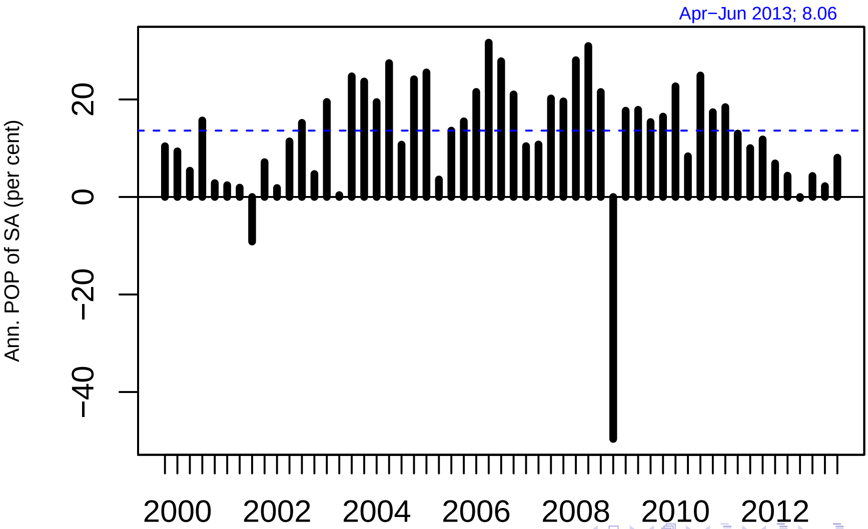
GDP growth

GDP non-agri non-government, real, pop sa



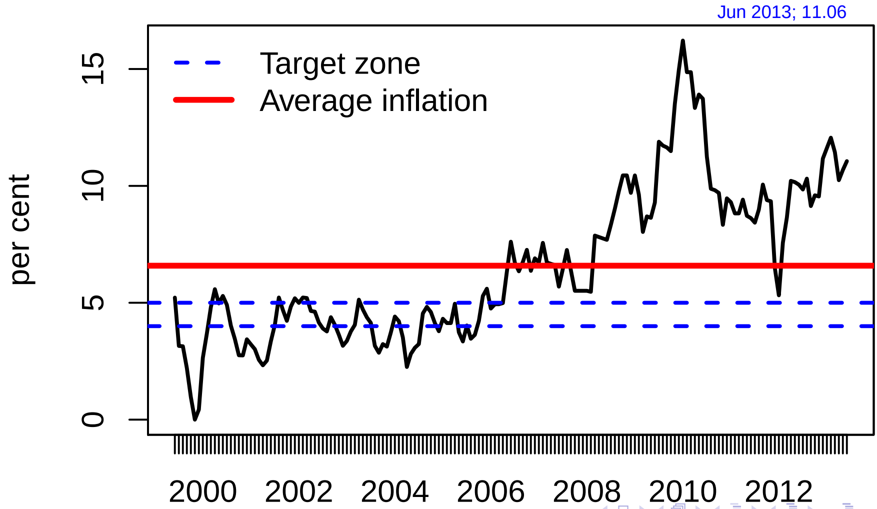
Revenue growth of large firms

Nominal, pop sa, of index of net sales of listed non-oil non-finance firms



CPI inflation

Headline inflation: Year-on-year

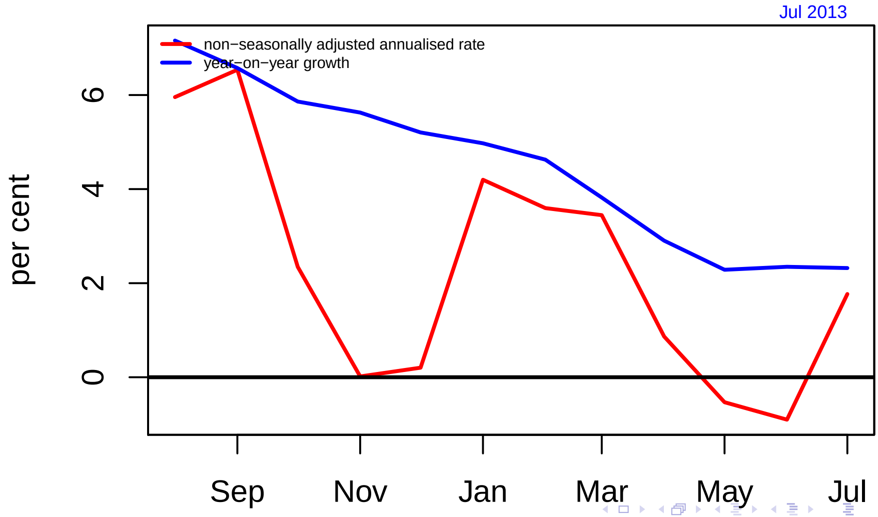


Current inflation data

Pop, SA, CPI inflation

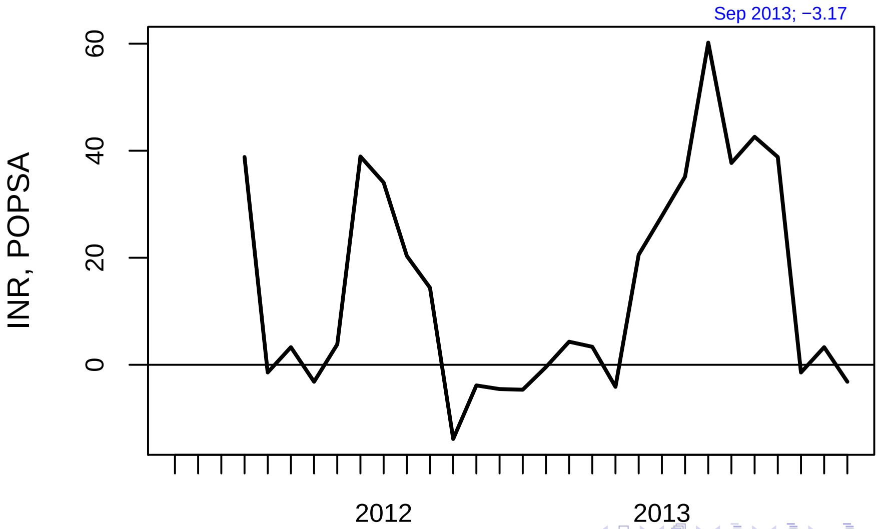
Tradeables inflation is low

WPI non-food non-fuel



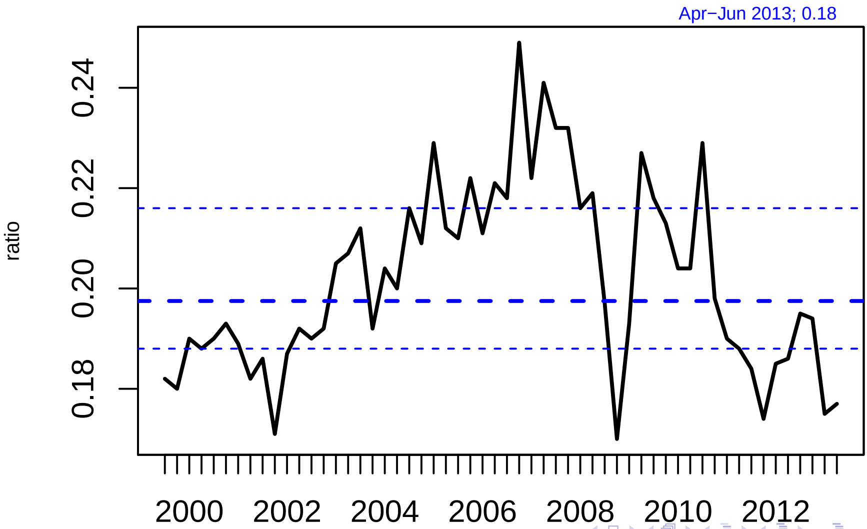
Outlook on tradeables inflation is good

US PPI, expressed in rupees, POP SA



Helps hold down operating profit margin of large firms

All listed non-oil non-finance firms

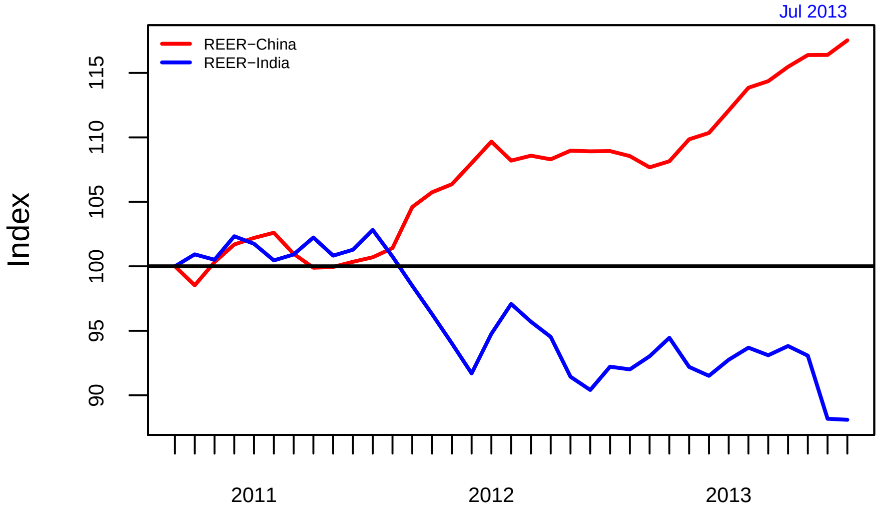


Part III

The recent rupee depreciation

The rupee has depreciated

The Chinese and the Indian REER in recent years



Why such a tizzy?

- Depreciations are expansionary
- A strong depreciation was a common ingredient of an old style IMF program
- As long as the corporate sector is intact, they can claw back into growth on the back of a big depreciation.

Did we have terrible corporate unhedged currency exposure?

- Sometimes, governments fight to prevent LCY depreciation in order to protect the corporate sector
- The backdrop is typically reckless unhedged foreign currency borrowing

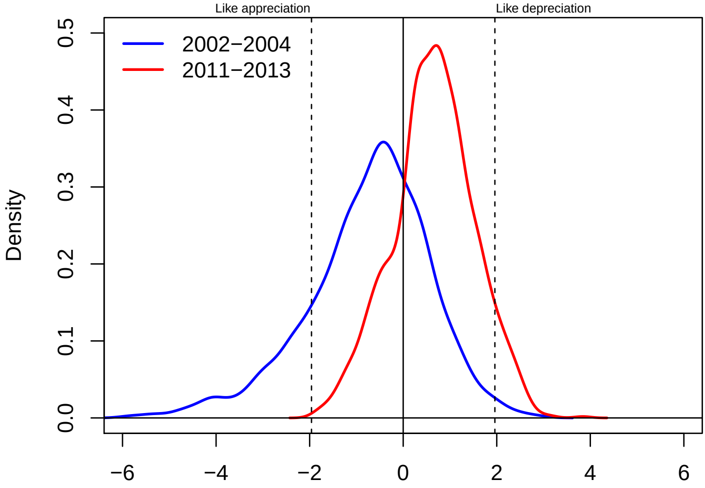
Did we have terrible corporate unhedged currency exposure?

- Sometimes, governments fight to prevent LCY depreciation in order to protect the corporate sector
- The backdrop is typically reckless unhedged foreign currency borrowing
- Why might corporations be reckless? Two possibilities:
  1. BCD Nexus is inadequately developed
  2. Moral hazard: Government has promised to take care of them.

Quantifying corporate exposure

1. For a 1% change in INR/USD, what's the impact on the stock price?
2. Measurement methodology from *Does the currency regime shape unhedged currency exposure?* by Ila Patnaik, Ajay Shah. *Journal of International Money and Finance*, page 760-769, 29(5), September 2010.
3. For each firm, we get a measure of this exposure, and we get a *t* statistic.
4. We implement this using the latest 2 years of weekly returns data.
5. For a comparison we also show the results obtained for 2002-2004.

Distribution of the *t* statistic of the currency exposure



The defence of the rupee

1. Damage the liquidity of the market for the rupee
2. Interest rate defence of the rupee (in a peculiar way).
3. Restrictions on gold
4. Other moves - e.g. trade barriers

If a strong rupee was desired, what might work?

1. Raise rates
2. Give access for foreigners to assets that were previously closed off
   - QFI
   - INR denominated bonds in Bombay
   - Currency derivatives to go with this.

   Key insights: The magnitude of impact upon INR of a 25 bps rate hike depends on how open we are on the bond market. Our bang for the buck depends on KAL.
3. Make India more attractive – e.g. reverse policy mistakes

The short term problem

- Most currency defences end in failure
- India is a *de facto* open capital account – defence is impossible.
- As long as GOI is defending the rupee, what's the rational speculator to do?
- Possibilities :
  1. Sell assets in India and take money out
  2. Sell assets in India and buy gold
  3. Short rupee on NSE
  4. Take money out and short rupee on DGCX or CME or ICE or NDF.

More controls are not a choice

1. Huge gross flows on the current account: Misinvoicing can be used to shift 5% to 10% of GDP when the government interferes with other mechanisms of capital mobility.
2. Foreigners who have invested in India require currency hedging. Capital controls or attacks on market development, that hinder their currency market operations, will induce reductions of ownership of Indian assets.

Acute uncertainty

- Long period average after March 2007: 8.78% volatility
- Implied vol off ATM options at NSE on last Friday : 20.27%
- 95% confidence interval on a one month horizon: $\pm$11.5%
- At Rs.67 to the dollar this runs from 59.3 to 74.7 over a one month horizon.

Bernanke FOMC dates: Big days for India

September 17-18
October 29-30
December 17-18

So far Bernanke has only described future events when he will reduce the magnitude of bond buying from $85 billion a month. On one of these four dates, there's a good chance that the actual decline will be announced. Further out, he will stop buying and further out he will start raising rates and possibly selling bonds.

Difficult outlook

- The defence of the rupee should not have been attempted
- The means adopted in this defence have been harmful
- The defence of the rupee has failed
- The harmful steps taken in this defence have not been reversed
- Market liquidity has declined; small shocks generate big movements.
- The market is illiquid, tense, volatile
- Implied vols are outrageously high
- Every investment in India – local or foreign – is a bet on the future of economic reforms in India. But the outlook for India is now darker with an illiberal and incompetent leadership.
- External conditions could worsen

Thank you.
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