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Sinking rupee highlights India’s growing vulnerability

By James Crabtree

There is no concept in economics akin to a baptism of fire but that is surely what awaits incoming Indian central bank governor Raghuram Rajan as he ponders what, if anything, can be done to protect his country’s ever-sinking currency.

The rupee has lost more than a tenth of its value since May when remarks by US Federal Reserve governor Ben Bernanke first prompted investors to pull back from emerging markets, especially those like India encumbered by dangerously high current account deficits.

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Indian rupee against the dollar

More worryingly, a series of interventions from the Reserve Bank of India last month failed to stop the currency hitting an all-time low of Rs61.80 against the dollar this week, even if it rallied slightly to close at Rs60.90 on Thursday.

The result leaves Mr Rajan facing a delicate, some might say impossible, balancing act: how to prop up the currency in the short term without spooking investors and undermining the country’s already precarious longer-term growth.

“It's a tough call, it’s very tough,” says Ajit Ranade, chief economist at the Aditya Birla Group, a large Indian industrial conglomerate.

“I think what we have seen was bordering on a panic reaction and now the path forward looks much more difficult.”

The rupee’s troubles stem from a current account gap that is likely to hit $15bn this year, according to JPMorgan.

If perturbed foreign investors don't make up the shortfall, India must raise funds elsewhere or prepare for further currency falls, which Bank of America Merrill Lynch says could see the rupee head below Rs65 next year.

When Mr Rajan takes up his post in September, therefore, he must first decide whether to keep the "temporary" tightening measures brought in by the RBI in mid-July.

These did little to stop the rupee's decline but removing them could now lead to a "vicious reaction" in foreign exchange markets, says JPMorgan's Sajjid Chinoy, meaning they are likely to remain for the foreseeable future.

Further tightening measures could also be introduced to tempt back some of the $2.6bn that foreign investors have removed from India since Mr Bernanke's comment in May, mostly from its debt markets.

Some analysts now think Mr Rajan may even be forced to follow recent moves by Indonesia and Brazil in raising base rates, although such a grave step would come with numerous complications, its negative effect on growth notwithstanding.

"The problem is that you might attract the debt guys back with higher rates but at the cost of pushing out the equity guys, who want lower rates and higher corporate growth," says Mr Ranade. "So it could be counterproductive."

Equity markets have so far held up relatively well in the face of last month's turbulence, falling just 5 per cent since the beginning of July.

Even so, previously bullish analysts at Morgan Stanley on Thursday sharply downgraded their year-end forecast for the benchmark BSE Sensex to around 17,900, just fractionally above its present level but far below their 23,000 prediction at the start of this year.

Much now depends on whether international investors, who currently hold a record 45 per cent of freely traded Indian stocks, hold their nerve.

"Until the last few days, the major foreign institutional investors haven't been all that worried about the cracks in the rupee," says Saurabh Mukherjee, head of equities at broker Ambit Capital.

"It has mostly been the hedge funds and so on that were yo-yoing around . . . but just this week I've felt the first hints that the more solid long-only funds are getting anxious, which is worrying."

Less orthodox measures are likely to be needed if equity funds do indeed pull out, potentially including a bond issue to attract capital from "non-resident" Indians abroad or measures forcing India's larger state-backed companies to take on more dollar loans.

Yet these too are fraught with risks, says Eswar Prasad, a senior fellow at the Brookings Institution, who fears they could undermine confidence without tackling the factors underlying the currency's decline.

"India needs to refocus on structural and other broader reforms," he says. "But my concern is that the sense of panic about the rupee could create the need to take short-term steps that will not serve the economy or the rupee very well in the short term."

Some such broader reforms are possible, including steps to liberalise foreign investment for industries like insurance or opening up the financial sector more generally, although these tend not to be under Mr Rajan's direct control at the central bank.

Instead, they will require governance action, which has been scarce of late, partly because New Delhi's politicians have half an eye on winning favour in next year's national elections.

More than anything, however, Mr Rajan is likely to be left hoping for less positive economic news from the US, the country from which he left an academic posting last year to return to India, and whose recent return to growth now threatens to attract more investment away from newly vulnerable developing nations like India.

"The near-term risk is now of a more severe pullback from emerging markets because of global factors," says Caesar Maasry, regional strategist for Goldman Sachs in Asia. "And here India is one of the main markets that could get caught out."

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