Rupee depreciation could aggravate the current slowdown

Although the rupee has stabilised after a steep fall, it remains under pressure from multiple sources. Depreciation currently brings many costs in lieu of few benefits

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MACROSCAN

August was a particularly bad month for the rupee. From ₹68.9 to the dollar at the end of July, the currency depreciated to cross the ₹72-mark by the end of the month (Chart 1). While India's perennial current account deficit underlay the currency's weakness, in August, the average of daily prices of the crude oil basket that India imports fell to $59.35 a barrel from $63.63 in the previous month and $71 in April 2019. This reprieve, combined with the depressing effect that slackening domestic demand would have had on imports, should have strengthened the rupee, not weakened it.

Global uncertainty

The rupee value declined in August, despite these beneficial economic developments, because of the exit of foreign portfolio investors, which resulted in a fall in net investments followed by an outflow of capital. In June, net portfolio investment fell sharply, and then turned negative over the next two months. This decline and outflow contributed to the fall of the rupee (Chart 2). Subsequently, when net portfolio investment turned mildly positive in September, the rupee too, stabilised and registered mild appreciation. This central role of foreign investment flows in influencing the rupee's movements make the currency vulnerable for the near future.

Clearly, uncertainty with regard to global output and trade growth was the basic factor responsible for the deceleration and reversal in the volume of net portfolio investment inflows. Evidence that the Indian economy too has turned sluggish has not helped an already weakened investor sentiment. These determinants of the recent depreciation of the rupee suggest that the currency could lose further ground vis-à-vis the dollar.

With uncertainty and anxiety on the rise in the world economy, cross-border capital flows are likely to shrink further, as wealthholders flee to the safety of dollar-denominated assets. This tendency will be aggravated if projections of a plunge of the Indian economy into recession prove to be correct.

In normal circumstances, a rupee depreciation resulting from such factors would come with a silver lining. By lowering the dollar value of India's exports, a depreciating currency could enhance India's external competitiveness and contribute to a rise in exports. However, given the depressed demand conditions in the world economy, this outcome has not materialised.

India's exports over the April-September 2019 period fell by 2.4 per cent to $159.57 billion from $163.48 billion in the corresponding period of 2018.

Tipping the scales Foreign investment flows are one of the influencing factors on the rupee's movement

External borrowing

While exports are not responding, the depreciation is likely to have an adverse impact on the health of Indian business, which has become more reliant on external borrowing. As Chart 3 shows, much of the volatility, especially the overall decline in net inflows, was on account of shifts in equity investment. However, during the June-September period, when investment inflows into equity markets fell and turned negative, flows into the debt market were relatively stable.

This reflected a larger trend in which Indian business, attracted by the much lower interest rate in global markets and encouraged by the relaxation of restrictions on external commercial borrowing (ECB), have increased reliance on funds borrowed abroad. Overall, net ECB, that had fallen by ₹653 crore during April-mid-September 2018, rose by ₹54,073 crore in the corresponding period of 2019. The total stock of ECB rose 11 per cent from $193.4 billion to $214.1 billion over the year ended June 2019.

An important contributor to the rise was the easing of restrictions on ECB by the Reserve Bank of India. In the past, funds could be accessed through the ECB route only by manufacturing companies, special economic zone units, software companies, non-banking financial companies, and other similar entities. This policy was revised to allow all entities that are eligible to receive foreign direct investments and other specified entities like port trusts and start-ups, among others, to borrow from abroad. Service companies and trading entities could also access funds through the ECB route.

The sources from which funds could be borrowed were also widened to include any entity that is a member of the Financial Action Task Force and the International Organization of Securities Commissions. This brought in private equity firms and venture capital funds as investors in debt instruments.

Foreign currency risk

The increase in borrowing that resulted from these policy changes has also increased the exposure of Indian business to foreign currency risk. The depreciation of the rupee would raise the rupee costs of servicing debt in foreign currencies. This would either reduce profits or create losses, unless the borrower had hedged the foreign exposure. According to market reports, many borrowing entities, aiming to save on the costs of hedging and betting that the rupee would remain stable — or even appreciate — had not covered their foreign exchange exposure.

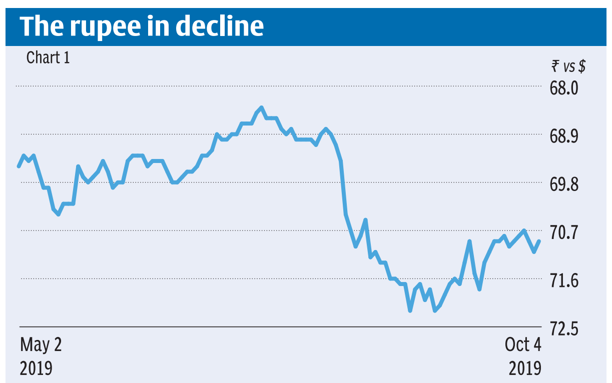
Here too, the RBI played a role. In a bid to ease access to foreign funds, in November 2018 the RBI reduced the mandatory hedge coverage to 70 per cent of the foreign exchange payment commitment, from 100 per cent.

It also reduced the loan tenure required for exemption from mandatory hedging to five years from 10 years. This would have contributed to an increase in unhedged exposures, raising the possibility that the rupee's depreciation has resulted in corporate losses.

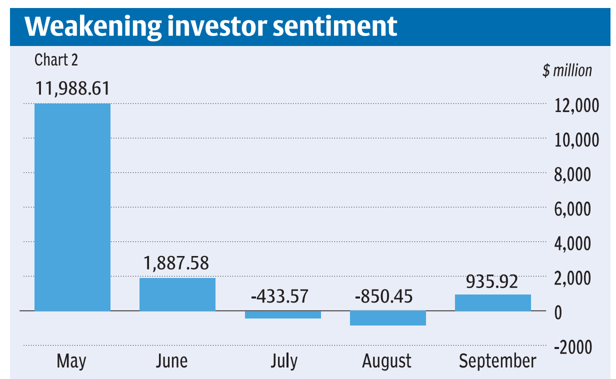
To the extent that this occurs, rather than positively affecting growth by enhancing export competitiveness, the rupee's depreciation could dampen investment and even worsen the ongoing growth slowdown. It has been argued that the exit of foreign institutional investors from the equity and debt markets can aggravate the credit slowdown by withdrawing liquidity from the system.

In addition, we now have further reasons for concern about a possible worsening of economic conditions on account of the impact that foreign investors' exit would have on the value of the rupee.

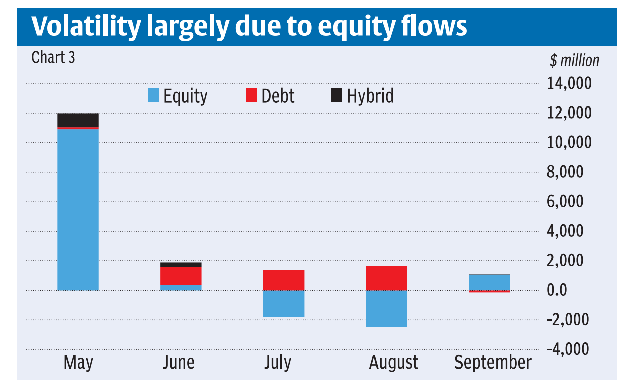
The rupee in decline



Weakening investor sentiment



Volatility largely due to equity flows



5 THINGS to WATCH OUT for TODAY

- **The 10-day** programme prepared by the 16-nation RCEP grouping to sort out 14 pending issues related to the mega trade deal will commence. Among the 14 points, six are specific to India. The points which fail to get resolved this time will be taken up on November 4 in Bangkok.

- **The all-India** bank strike is set to take place. The bank employees have called for a strike to oppose the government's decision to merge 10 state-run banks into four. The two unions that have called for the action are the All India Bank Employees Association and the Bank Employees Federation of India.

- **The GST** Network (GSTN) is set to release an improved version of GST return filing interface. The GSTN provides IT infrastructure and services to Central and State governments, taxpayers and other holders for implementation of the GST.

- **Air India's** board is likely to meet to clear the consolidated account statement for the fiscal ended March 2019. Last week, Civil Aviation Secretary Pradeep Singh Kharola took a review meeting of the airline. Earlier this month, Air India's management met with its trade unions on the proposed privatisation of the carrier.

- **Ninety foreign** envoys based in India will visit the Golden Temple in Amritsar. The visit is a part of the celebrations to mark the 550th birth anniversary of Guru Nanak. The event comes days ahead of the inauguration of the Kartarpur Corridor that will connect Indian pilgrims with the Gurudwara in Kartarpur, Pakistan.

All you wanted to know about...

ANAND KALYANARAMAN

SLATE

No, we aren't talking about the beleaguered boss of the Grand Old Party of India. Rather, this SONIA is one of the major alternatives to LIBOR (London Interbank Offered Rate), the predominant global interest rate benchmark that will say its last hurrah in 2021.

What is it?

SONIA is short for Sterling Overnight Interbank Average Rate. Since the 1990s, it is the weighted average overnight rate paid by banks for unsecured transactions in the British sterling market. In April 2017, the Bank of England selected SONIA as its preferred alternative to LIBOR.

But why is LIBOR — to which gazillions of dollars of loans and derivatives have been benchmarked for decades — on its way out? First, interbank borrowing, based on which LIBOR is calculated, has been on the decline since the 2008 global financial crisis. Second, LIBOR is based on estimates, not actual transactions, of surveyed global banks. Third, many of these participating banks took their jobs quite literally — in 2012, they were caught lying about the data, spawning cutting criticism about how LIBOR became 'LieBOR'.

Thus began the search for more viable and robust replacements, and SONIA has emerged as one. It is based on actual transactions and vetted by the Bank of England, giving it a greater credibility. Over the past year, British bank NatWest has effected the transition of some of its customers to SONIA. Many savvy financial investors have also started moving on to SONIA. It's early days still, but many more institutions and their clients are expected to follow suit over the next couple of years.

It's a mammoth task though. A large part of the market is still unaware of the impending end of LIBOR. The shift will call for a great deal of co-ordination among regulators, banks and their clients, especially given that many contracts will be maturing after 2021. Significant costs are expected to be incurred on training, legal expenses and on ensuring proper accounting and documentation. Besides, many customers seem reluctant to shift — not knowing their exact cost due to the lack (so far) of forward-looking SONIA term rates, unlike those in place for LIBOR. These concerns have to be addressed.

Unlike LIBOR though, SONIA is not the only show in town - there is competition from the SOFR (US), ESTR (European Union) and TONAR (Japan). On a lighter note, sometime in the future, there may be an Indian benchmark too, and we could name it MODI - Mumbai Overnight Derivatives and Interest rate.

Why is it important?

Finance is the lifeblood of business, and well-oiled global debt and derivative markets are a key part of the financial system. These, in turn, need trustworthy, widely-accepted benchmarks. SONIA, along with other benchmarks, will likely play a key role here.

The Indian government isn't a big borrower abroad (it shelved a plan to issue sovereign dollar bonds recently), but Indian businesses love dollar borrowings in the form of external commercial borrowings (ECBs). The interest costs on these borrowings are usually linked to LIBOR. In fact, RBI's regulations on ECBs also use LIBOR to calculate the cost of loans. All these borrowers will need to shift to other benchmarks sooner or later. Also, the MIFOR (Mumbai Interbank Forward Offer Rate) that is currently linked to LIBOR will see a change.

Why should I care?

It is said that a butterfly flapping its wings in one part of the world can cause a hurricane in the other part. Given the inter-connected world we live in, a major change in financial benchmarks — from LIBOR to SONIA or others — can certainly make its impact felt. For starters, if you have invested in companies that borrow or have derivative transactions abroad, you will do well to understand how this change will impact their debt servicing costs. If you plan to borrow abroad, know the interest rate peg you're committing to.

Bottomline

To replace LIBOR, SONIA will have to beat many other benchmarks. But the change is not so far off.

A weekly column that puts fun into learning

BusinessLine TWENTY YEARS AGO TODAY

October 22, 1999

Key sectors to be Y2K-ready by month-end

The high-level Y2K Action Force has assured that all the 11 critical sectors — banking, insurance, telecom, power, civil aviation, railways, petroleum and natural gas, ports, space, atomic energy and defence — would be Y2K-ready by the month-end. In its final report submitted to the Deputy Chairman of the Planning Commission, Mr. K.C. Pant, today, the Action Force has said, "India is in a much better position to make the transition into year 2000 than it was a few months ago."

Way cleared for derivatives law

The Cabinet today cleared the reintroduction of the Securities Contracts (Regulation) Amendment Bill, 1998, in Parliament. This will signal the introduction of trading in derivatives, regulation of collective investment schemes and delegation of regulatory powers to the RBI, after Parliamentary approval. By amending the Act, derivatives and units issued by collective investment schemes will now come under the ambit of the definition of securities, thus enabling trading in these instruments.

Cabinet clears 3 major Bills

Keeping in line with its promises, the BJP-led Government today cleared for introduction in Parliament three major economic Bills — the Foreign Exchange Management (FEMA) Bill, the Prevention of Money Laundering Bill (PMLB) and the SCRA Bill — incorporating most of the major changes recommended by the Standing Committee on Finance (SFC). The Cabinet also ratified the migration package for cellular operators as per the directives given by the Delhi High Court on August 3.

BL TWO-WAY CROSSWORD 1471

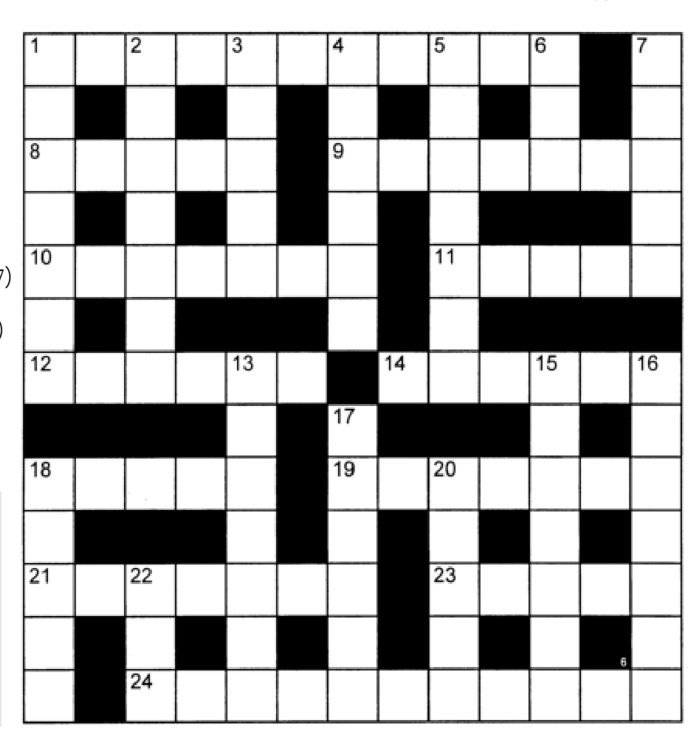
EASY

ACROSS
01. Pulled down, in ruins (11)
08. A fall, throw (5)
09. Renounce, apostasise from (7)
10. Gross feeder (7)
11. Support for board, canvas (5)
12. Put aside, postpone (6)
14. 4to (paper size) (6)
18. Stone craftsman (5)
19. Inherited (7)
21. Fugitive (7)
23. Of Lamb (essayist) (5)
24. Existing on the earth (11)

DOWN
01. Draws, forms a plan of (7)
02. Non-working time (7)
03. Aviator (5)
04. Through the time of (6)
05. Part of car opening at the back (7)
06. Use a spade (3)
07. Carapace (5)
13. Condiment, pickling medium (7)
15. 'Barber of Seville? Composer (7)
16. Number such as first, second (7)
17. Agree, assent to (6)
18. Merriness, noisy jollity (5)
20. Public, not concealed (5)
22. In suitable condition (3)

SOLUTION: BL Two-way Crossword 1470

ACROSS 07. Imperceptibly 08. Nervousness 12. Pistol 14. Soused 16. Pedalo 18. Crease 19. Up-and-coming 23. Adjudications
DOWN 01. Amen 02. Bear 03. Scroll 04. Spasms 05. Fine 06. Plus 09. Eased up 10. Sustain 11. Edge 12. Pipe 13. Owl 15. Our 17. Ordain 18. Choral 19. Undo 20. Arum 21. Iris 22. Gong



NOT SO EASY

ACROSS
01. Did a plaited form of it, seeing it in ruins (11)
08. Overflow used to carry a light (5)
09. Revoke at cards and urge bridge opponents to turn east (7)
10. He always takes too much, eliciting long tut (7)
11. To take lease out gets some support in studio (5)
12. He loves nothing less than to put it aside (6)
14. Nothing more than two pints of size for paper (6)
18. Craftsman is a man thus taken in (5)
19. Went over the line a third party may be on (7)
21. One fleeing seeks shelter with energy (7)
23. Like Charles, if not Mary, to lie about an ending (5)
24. Litter's rare, coming from the earth (11)

DOWN
01. Patterns GI sends out (7)
02. Freedom of occupation is rule misapplied by the English (7)
03. Trial programme involves one in the storyline (5)
04. In the course of run, dig around for it (6)
05. Where car opens at the back on a tune being played (7)
06. A taunt may make one work in the garden (3)
07. Intermediate class may be hard on the outside (5)
13. Condiment given a right shaking (7)
15. Composer is on, Sir, in the wrong order (7)
16. Second sort of number to land Rio in trouble (7)
17. Assent to entry in the Deccan when energy is out (6)
18. Jollity made him upset about radiotelephony (5)
20. Being finished, tabletop isn't hidden (5)
22. Well, it should conform to one's measurements (3)