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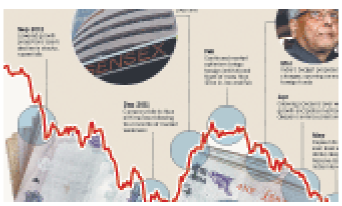
Battered rupee highlights India woes

By James Crabtree in Mumbai

As India's battered currency fell to new lows this week, local television news talked of "carnage" on Dalal Street, the home of the Bombay Stock Exchange.

But worried investors had a more pressing concern: just how much lower might the rupee fall?



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After a week of declines the currency dropped again on Thursday, hitting its lowest ever mark of Rs54.58 against the dollar, beating the previous low set the day before. This happened in spite of interventions from the Reserve Bank of India.

India is far from alone in seeing its currency fall as international investors pull back to safer assets. Other Asian currencies, including Indonesia's rupiah, have gone down too, while declines in Brazil's real have been greeted with undisguised enthusiasm in the country.

Not so in India, where the rupee's weakness is seen as a sign of more profound underlying economic problems.

Such things brings back unpleasant memories too: it was a humiliating balance of payments crisis that forced the country to open its economy in 1991.

"The dropping value of the Indian rupee essentially reflects the economic malaise in India as well as the sense about the economy's vulnerability to external shocks," says Eswar Prasad, senior fellow at the Brookings Institution and an adviser to India's finance ministry.

This vulnerability stems in part from the eurozone crisis, but more specifically from a distinctly Indian combination of slowing growth and high inflation, alongside growing current account and fiscal deficits that its government seems impotent to remedy.

“There are some emerging economies, like China, which have a reasonable amount of policy space ... but India is severely constrained on both fiscal and monetary policy, because of circumstance but also because of poor recent policymaking,” Mr Prasad says.

Some analysts are sanguine about the decline, noting that the depreciation of the currency – roughly 20 per cent over the past year – should gradually rebalance the current account, boosting exports in manufacturing and IT while curbing domestic consumption and cutting imports.

The RBI also claims to be comfortable with the fall, in spite of its moves this week.

“We don’t intervene to arrest the rupee’s fall, we intervene only to arrest the volatility, you must understand the difference,” said Kamalesh Chakrabarty, deputy governor.

Yet others are more concerned. Neelkanth Mishra, a respected equities strategist at Credit Suisse in Mumbai, said in a note on Wednesday that worries had even reached a point where many investors now feared an outright currency crisis.

The RBI has reserves of about $260bn – enough to cover at least six months of imports. Analysts suggest that it also has a range of options to bring in fresh funds if it feels the need – including selling dollars to oil importers; raising limits on bond purchases by foreign investors; or even introducing special bonds to attract capital from Indians abroad.

This provides some comfort, according to Arvind Subramanian, a fellow at the Peterson Institute for International Economics. “I don’t think there is going to be a serious collapse of the rupee. The central bank has enough ammunition to prevent anything major happening,” he says.

Yet if a full-blown balance of payments crisis is not on the cards, further downward pressure seems likely. India’s import bill is rising, notably in areas such as oil and energy, where in-elastic demand means less relief is likely from a currency depreciation.

Exports also fell unexpectedly in March, and are likely to continue to struggle as India’s dominant European markets slide back into recession.

Meanwhile, badly needed foreign capital is in short supply as disgruntled investors pull out money because of concerns about mooted tax changes.

The result, according to Ritika Mukherjee, an economist at Ambit Capital in Mumbai, is a current account gap projected to hit 4.4 per cent of gross domestic product this year, and a currency likely to head as low as Rs58 to the dollar.

Such moves would trouble foreign investors, worried about further currency hits on their portfolios. But they could have an even more profound effect on the wider economy.

Before the recent slide, consensus projections suggested the RBI would bolster growth through further rate cuts this year. But with depreciation-induced inflation pressures rising, fresh reductions look less likely.

Ultimately, economists agree that the rupee will remain weak pending more fundamental reforms to increase investment and attract foreign capital.

But while India's weak and drifting government has shown few signs of such actions, some still find limited room for optimism, even if only because they sense something approaching a crisis might finally stir the administration.

"I am actually very glad this is happening," says Mr Subramanian, "because unless this government gets a kick in the pants in terms of a withdrawal of money or a declining exchange rate, there will no spur to action towards real reforms."