The Rupee dilemma : What can be done?

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It is a relief that the Reserve Bank of Indiahas finally resumed buying FX. In my view, the rupee will continue to trade weak until the RBI reassures investor confidence by recouping at least the $65-billion (including forwards) of forex reserves sold since 2008.

After all, the import cover —months of imports forex reserves can fund — has halved to about 7 months, last witnessed in 1996!, in the past five years. We see the FX market stuck in what I call the 'Rupee Dilemma' — a la the Prisoner's dilemma — kind of "game".

Not surprisingly, the worst outcome of a weak rupee and inadequate FX reserves is playing out. The best outcome would be for the RBI to buy FX and the market to go long the Rupee. This would stabilise the FX market, defuse "imported" inflation and offer traders good returns in buying the Rupee.

So, why does the RBI hesitate to buy FX? Because it is concerned, in my view, that this could lead to a sell-off in the Rupee. And why do FX traders not buy the Rupee? Because they fear that bullish Rupee trades would get stopped out if the RBI began purchasing FX.

The only way out of this impasse for the RBI is to strategically buy FX — as it has rightly begun to do — to comfort the market, like it did in the late 1990s. This begs the question, how much can the RBI buy? $10 billion, according to our balance of payments estimates, assuming Dated Brent averages about $110/bbl.

We have pencilled in $10 billion from the recent cut in withholding tax (to 5% from 20%) on FIIs' investments in corporate and government bonds as well as Unilever's buyback offer of 22.5% stake in HUL.

Second, can the RBI really buy FX when the current account deficit has doubled to 5% of GDP in three years? Yes, in my view. The current account deficit is likely to peak off to 4-4.5% of GDP if oil stabilises at current levels.

Note $10/bbl swings $8 billion on the current account deficit. Furthermore, the very global liquidity that is widening the current account deficit by fuelling oil prices is also driving in capital flows.

We also hold the contrarian view that India would benefit from any withdrawal of quantitative easing by the Fed as it would stabilise commodity prices. As Fed tightening would signal a return to growth, it would encourage risk-taking into emerging markets and Indian equities.

Finally, FII interest in Indian bonds should sustain as the RBI would still have enough headroom to cut rates, as the differential with the US has hit a high of 750 bps.

Finally, we believe that a good bit of the jump in the current account deficit — about 1.5% of GDP — is really statistical. This reflects discrepancies in oil import data of about $13 billion between the commerce and petroleum ministries and the shift of about $10 billion of non-resident Indian savings to NRI deposits (in capital account) from remittances (in current account) after NRI deposit rate hikes. And finally, won't the RBI's FX intervention destabilise the market? Not unless there is a sudden spike in US dollar.

The recent rise in banks' nostro FX balances — which have expanded by $7 billion to $17 billion in March 2013 — should be able to cushion the RBI's purchases.

Banks have also contracted FX forward assets of $11billion with the RBI. In sum, we are happy that exchange rate policy appears to be shifting to fund the current account rather than trying to compress it.

After all, the high current account deficit will persist as long as we live in a world of low growth — that hurts our exports — and easy global liquidity, which pumps up the oil import bill.

If the INR is perceived as a depreciating currency, FII inflows will dry up and aggravate the problem of 'imported' inflation at a time when FX reserves have fallen below BRIC levels.

Looking ahead, we see three options to augment FX reserves beyond the withholding tax cut on FII debt investments. First, the government can raise FII debt limits with the provision that the FX leg has to be deposited with the RBI.

Second, the RBI can re-issue 5-year FX denominated NRI bonds like the Resurgent India Bonds of 1998 and the India Millennium Deposits of 2001. And finally, the government can issue sovereign debt.

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