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Old older changeth

A NEW NORMAL FOR THE INDIAN CURRENCY IS IN THE MAKING WITH FOREX VOLATILITY BECOMING PAR FOR THE COURSE AND THE RBI RESTRICTING ITS INTERVENTION

The sudden depreciation in the rupee in the aftermath of the surprise devaluation of the Chinese yuan and subsequent outflows from the country have caught markets, investors, industry and policy-makers alike off-guard. The depreciation in the rupee and the ensuing volatility in the forex market have fast emerged as the primary concern and risk facing the economy. There is now a fear of a repetition of 2013, when there was a rout in the rupee, taking it down to 68 against the greenback.

Until recently, that is in the second week of August, the rupee was viewed as being one of the stronger emerging markets currencies, having maintained a fairly stable exchange rate (between 63 and 64 against the dollar) despite being under pressure owing to domestic as well as external pressures, chief among them being the likely hike in US interest rates. The rupee fell 4% during the month, taking the depreciation in the currency to 6% since the start of the fiscal. Despite the current weakness in the currency, India has fared better when compared with emerging economies, many of which have seen their currencies drop to multi-year or record lows.

Fundamentally, India is no doubt better placed and is being supported with improved forex reserves, tepid inflation, healthier fiscal and current account deficit numbers and a stronger balance of payment position. The country's trade balance has been rather stable, with both exports and imports on a decline. The country nevertheless has been affected by the recent turmoil in the currency and financial markets. There are a number of industries that have seen their forex vulnerability increase given their exposure to trade relations and/or foreign currency borrowings. It, thus, becomes pertinent to take a stock of the likely impact of the volatility in the forex

market, on the economy as a whole, as well as on sectors and industries that could benefit or bear the brunt of this volatility.

LIKELY IMPACT ON THE ECONOMY

The chief beneficiaries of the rupee depreciation would undoubtedly be exporters. The weakness in the domestic currency could lead to gains (rupee earnings) and provide for the much required edge (price advantage) to exporters who are being weighed down by the subdued global demand conditions.

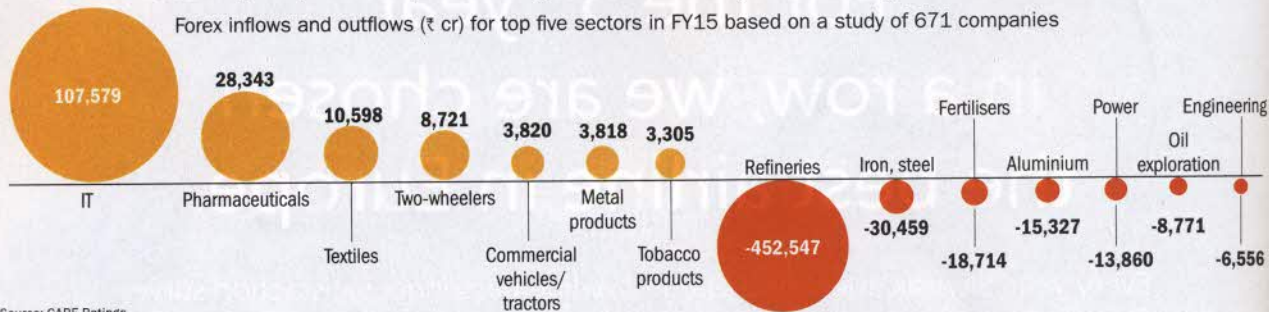
The country's exports have been subject to a declining trend over the past eight months, with growth in the same contracting 15% in the April-July '15 period (from that a year ago). Although exports stand to benefit, it needs be kept in mind that competing currencies, too, have been depreciating and the hopes for improvements in domestic exports may not materialise. Importers, on the other hand, would have to be prepared for a squeeze on their profits, with the rupee depreciation requiring



ILLUSTRATION BY KISHORE DAS

Currency blues

The sharp drop in the rupee has compounded the woes of some already stressed-out sectors



Source: CARE Ratings

them to pay more to buy dollars. The country's imports, too, have contracted by 12% in the first four months of the current fiscal. Given that several importing companies/sectors would have a natural hedge in the form of exports, the net impact of currency depreciation on such importers may not be severe. For those who do not enjoy any such advantage, their vulnerability increases. Also, the depreciation in the rupee is likely to offset the advantages arising from the fall in commodity prices.

LIKELY IMPACT ON CORPORATES

To gauge the negative impact of rupee depreciation on the economy as a whole, the trade deficit could serve as an appropriate indicator. For FY16 as a whole, based on the prevailing and foreseeable trends, a trade deficit of \$135 billion-\$140 billion can be expected (the trade deficit was \$137.7 billion in FY15). We have analysed net inflows and outflows of forex in FY15 for 671 companies in various industries (excluding the financial sector and miscellaneous groups of companies) based on the information provided in their annual reports to gauge the impact of forex volatility on various sectors. These net flows are more comprehensive than trade flows, as they also include other current flows and are, hence, analogous to the concept of current account balance at the company level. Although the sample cannot be termed exhaustive, as it does not include companies that have not provided this information because their reports are not yet out in the public domain, the sample can nevertheless be considered as being representative given that companies belonging to various sectors have been covered. With the exchange rate averaging 61.15 for FY15, exports for the 671 companies work out to \$120 billion and imports \$85 billion. We expect the observations to broadly hold for FY16 also and the same will be affected only in case of a sustained depreciation or the currency settling at a new low.

Based on the net forex outflow position in FY15, which was in the range of ₹1,000 crore-₹453,000 crore, it is observed that the five most vulnerable sectors that are net importers are refineries, iron, steel and products, fer-

tilisers, aluminium and power. The prudent approach for importers to tackle the risks associated with currency depreciation would be proactive hedging of their forex exposure. The prevailing volatility in the markets, however, makes it difficult for importers to take a call on hedging, given the uncertainty associated with the likely duration of this volatility. Import-intensive industries, thus, need to be closely watched, as their operations stand to be affected by the depreciation in currency. The premium on forward rates was found to be in the region of 7-7.10% for various tenures. Given the high premium rates, corporates may like to eschew hedging their forex exposure unless the expectation is that the rupee will fall by a greater level.

WHAT TO EXPECT?

India is not a country in isolation witnessing a weakness in its currency. At the same time, it is one of the countries that has fared better and is in a stronger position than most other markets. In the event of further depreciation in the yuan, the rupee could be pressured further. The timing of return to normality or whether the depreciation is of a long-term nature is anyone's guess. It is unlikely to revert to less than 64 levels. The rupee will be driven by external factors and, hence, it is safe to assume that a new normal for the rupee is being set — provided the current economic fundamentals persist — at around 65-66 against the greenback and the volatility in the forex markets is likely to prevail for some time. India nevertheless continues to retain its appeal to long-term foreign investors. This will spur the eventual recovery in the rupee. In the immediate future, given the export-import dynamics, a range of 66-67 may be expected. On the policy front, the RBI is unlikely to actively intervene and let the market chart out its own course. It may restrict interventions to only situations where it foresees the situation getting out of hand. Moreover, with improvement in the country's fundamentals, the central bank is not under undue pressure to intervene. In other words, India Inc would do well to watch the market movement and take a call on hedging its risks. ☺