Depreciating Rupee and Forex Challenges

What is the issue?

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- The Centre’s response to the recent bout of weakness in the rupee has been surprisingly casual.
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- Widening trade deficit and sluggish export growth could put further pressure on the country’s forex reserves.
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What are the risks and responses thus far?

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- While the RBI has maintained a stoic silence, the Finance Minister merely tweeted that India’s foreign exchange reserves are comfortable.
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- Going by the global standards, for the country’s forex reserves are indeed better than many other emerging economies to meet volatilities.
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- But given the changing global liquidity conditions and their impact on FDI and FPI flows (foreign capital), the present currency situation is a risk.
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- The situation gets further complicated due to the structural issues - “widening trade deficit, sluggish export growth and growing imports”.
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- It would therefore be better to acknowledge the challenges and think about corrective action rather than be in denial.
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What is the situation with RBI’s forex reserves?

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- Taper Tantrum of 2013 and the subsequent widening of current account deficit eroded the forex reserves that the RBI had built till then.
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- Since then, RBI has been very cautious with currency reserves and had built strong buffers, which reached an all time high of $426 billion in April 2018.
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- **Investments -** Strong inflows from "Foreign Direct Investors" (FDIs) since 2013 had helped to a large extent in shoring up reserves.
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- But lately with less than 5% growth in 2018, FDI flows are already down from around 25% during 2015-16.
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- Foreign Institutional Investments (FII) is also likely to reduce with a net outflow of over 20,000 crores recorded this financial year.
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- The reduction in foreign inflows makes it difficult for the RBI to mop up reserves, and sustain the currency value.
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- Notably, in the three months from April to June 2018, the RBI has net sold $14 billion and the reserve levels have come down by about 10% thus far.
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- The import cover was 11.1 months in April 2018, but it is already down to 9.9 months currently and is likely to deteriorate further.
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How is the action of U.S. Federal Reserve affecting capital supplies?

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- Foreign capital inflow into a country is a function of global liquidity conditions, which isn't very conducive lately.
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- After pumping in trillions of dollars since the 2008 crisis, the Federal Reserve began shrinking its balance sheet since October 2017.
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- While this is reducing liquidity in global markets, the rate hikes from the Fed are making the cost of financing expensive.
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- Therefore global investors have less to spend and are reducing their investments in emerging markets including India.
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- “International Monetary Fund” (IMF) estimates that the Fed’s tightening can result in reducing flows into emerging markets by $35 billion a year.
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How is the debt situation affecting forex?

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- Due the excessive liquidity in global markets after 2008, the country’s external debt has doubled from $224 billion in 2008 to $529 billion now.
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- Indian companies made the most of easy liquidity conditions overseas, increasing non-governmental external debt to 80%.
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- Notably, External Commercial Borrowings (ECB) now account for over one-third of the country’s total debt.
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- Repayment of those loans that reach maturity in the coming months is likely to drain more forex and it will also be difficult to repay these due to less liquidity.
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Source: Business Line

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