South Asia

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Indian rupee catches Modi election fever

By Kunal Kumar Kundu

The Indian rupee, after a period of being very much out of favor and weakening from less than 50 to the US dollar in late 2011 to just shy of 70 last year, has suddenly become beloved by the currency markets. It has appreciated by nearly 3% over a one-month period, and at present is among the best performing currencies.

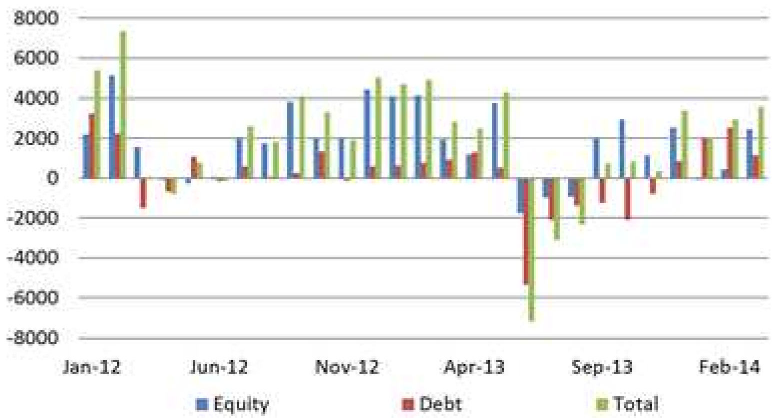
Source: RBI

This has resulted in some market analysts taking a view that not only will the appreciation pressure be sustained but that the currency will break back through the 60 rupees to the US dollar barrier and continue to trade closer to the high 50s levels.

Two important factors are cited to justify this bullish view - India's macro fundamentals are improving and that the outcome of the May general election will be hugely positive as far as reform in India goes.

As the chart above shows, the rupee has recorded impressive gains from the low it hit during late August following the announcement of potential tapering in May. For sure, the fall to near 70 levels was unwarranted and hence the recovery (backed by the prudent steps taken by the new Reserve Bank of India governor, Raghuram Rajan, with the government for a change acting in tandem) was not a surprise; essentially the fair value of the currency is somewhere between 61 and 63 to a dollar.

However, the recent uptick does not seem to be altogether driven by fundamentals. Rather it is the result of a surge in positive sentiment - especially related to the election outcome. In what is euphemistically called a "Modi trade", foreign institutional investors are banking on the National Democratic Alliance (NDA) with its prime ministerial candidate Narendra Modi coming to power during the forthcoming election with a working majority. Hence there has been a surge of foreign funds into India, especially after the state-level election results in December when the alliance leader, the Bharatiya Janata Party, made strong gains.



Source: Bloomberg

However, the sentiment seems to have moved further ahead than warranted and investors may be in for a disappointment.

For starters, while various opinion polls do suggest possibility of the NDA coming to power, their securing a decisive majority is far from certain. While the arrival of an NDA government will be a sentiment booster, especially for the business environment, major reforms are still likely to remain elusive especially in the short to medium term.

That said, the new government ought at least to be in a position to end the virtual policy inertia that has dogged the later part of the current United Progressive Alliance (UPA) government's tenure. Initial steps could help to push economic growth above 5% after two successive years in which it has been below that level. Much of the economy will, however, continue to muddle through, and a 7%-plus growth rate will remain elusive for a fairly long period.

And, in the event that a working majority eludes the NDA , the tide might turn and the highly volatile inflows of foreign cash may leave India's shores as fast as they entered.

Secondly, the much touted strengthening of economic fundamental seems to be a chimera. The recent easing of inflation is not sustainable and is driven mainly by a fall in vegetable prices, which remained highly elevated for nearly five consecutive years. Falling food prices (driven mainly by a decline of over 34% in vegetable prices during the period) have resulted in headline inflation as gauged by the Consumer Price Index (CPI) plunging by more than 3 percentage points over the past three months.

However, vegetable prices are now showing some signs of rebounding. More importantly, there is now an increased possibility of the return of the El Nino weather pattern, which can have a debilitating impact on the fate of India's agriculture sector.

Apart from food, the prices of the other components in the CPI basket remain stubbornly high, with the index reading inching up, albeit slowly, with every passing month. As a result, core CPI inflation remains in the vicinity of 8% - a clear indication of there being a wage-price spiral due to sustained high inflation rates.

India's current account deficit (CAD) for the year is likely to be near 2%, much lower than the 4.7% recorded a year back. However, that substantial improvement is likely to be temporary and can be attributed to a severe clampdown on gold imports as well as to the slowing economy.

India's gold and silver imports contracted during each of the past eight months, with an average contraction of nearly 70% per month in comparison with the year-earlier figures.

As a result, for the first 11-months of the financial year ending on March 30, India's cumulative gold and silver imports stood at $30.53 billion, down by nearly 42% from US$52.47 billion. India's trade deficit during the period narrowed by nearly 29% to $128.09 billion from $179.15 billion.

Any improvement in the trade balance due to increasing exports is a welcome sign. Unfortunately, for India, the recent improvement is due to a shrinkage in imports. Of course, the slowing down of the economy was a contributing factor, but that surely is an unhappy coincidence that India did not wish for. What is of critical importance here is that India's non-oil, non-gold and silver imports have been on a path of steady decline, a clear indication of a weak economy.

As the barriers to gold imports are slowly dismantled going forward and the economy starts to inch up, the current account deficit will widen, though it may not assume dangerous proportions as the external environment is likely to improve. In essence, the falling CAD is not a reflection of an improvement in economic conditions but a result of desperate (not desirable) measures taken by a desperate government.

Even India's ability to contain the fiscal deficit within 4.6% of gross domestic product can solely be attributed to creative accounting and a massive contraction in capital expenditure rather than any real effort at tackling the main problem - reducing unviable and badly targeted subsidies.

Every which way one looks at it, therefore, India's macro fundamentals remain weak, and with the rating agencies having put India on negative watch - its present sovereign rating is just a notch above junk - the recent rally in the rupee is clearly unwarranted.

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