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Pressure on rupee to continue

While fundamentally, the rupee at 58 (to a dollar) was overvalued, the rupee at 66 is indeed undervalued. Not that one can grudge the severe market reaction as India's inordinately high current account deficit (CAD) (engendered by India's poor macro fundamental that has been aided by even poor policy making) brought to question India's ability to finance the gap as expectations of tapering by the Fed heightened. Of course, it did not help that some of the decisions taken by the Reserve Bank of India (RBI) were questionable and the quality of its communication more so. The recent RBI move to impose restrictions on outflow of forex by domestic entities (individuals or corporate) without adequately explaining the move left it open to interpretation and the market reacted wildly since it thought that the move is a harbinger for the imposition of capital control when that wasn't the intention.

While weakening currency in response to weak economic fundamentals is a self-correcting mechanism, excessive weakening deals a body blow especially to aneconomy that has high dependence on imported energy and where structural weakness keeps inflation at inordinately high levels. And when pessimism gets the better of the market participants, the currency tends to weaken beyond levels suggested by the fundamental strengths.

However, some succour seems to be on the offing. The recently released minutes of the Federal Open Market Committee meeting showed lukewarm support for tapering as of initially perceived deadline of September. In fact, it is quite unlikely that tapering will take place during 2013 itself, given that the fundamentals do not support rapidly improving economy and job condition. The very fact that most of the job gains are temporary in nature underscores the soft underbelly of economic recovery and the hard truth behind the easing unemployment numbers. For an economy that depends on consumer spending, the recent increase in spending is good news. But spending rising relatively faster than income growth indicates that consumers have started to leverage. This when temporary employment is hardly budging while yields are moving up. Hardening interest will likely diminish any hope of sustained recovery when conditions are soft. In a recent interview with *The Wall Street Journal*, the head of the Boston Fed (Eric Rosengren) said any tapering of the Federal Reserve's $85 billion-per-month asset purchase programme should be limited. "If you're very uncertain about how strong the improvement in the economy is, and how self-sustaining, then you should move in fairly small increments. This is a good time to be patient and very watchful."

The fact is, the Fed is in uncharted territory. The vicious reaction to its initial announcement of potential tapering and recent hardening of yields show that the market perceptions of the impact of tapering is at variance with the intended consequence of Bernanke's quantitative easing and its exit strategy. The recent hardening in interest rates - the 10-year note, which many 30-year mortgages are priced off, has risen close to near 3 per cent recently - shows the market considers tapering as tightening, irrespective of what Bernanke believes.

I believe that even if the tapering takes place, it would be nominal enough not to roil the market too much. On the other hand no tapering action could lead to falling confidence on the US economy. While this will be positive for the rupee, the recent passage of the food security Bill has ominous portents for India's fiscal deficit. A slowing economy and additional tailwinds on government expenditure will perk up India's fiscal deficit, especially as a percentage of gross domestic product (GDP). This will also mean that CAD will continue to be a problem.

Finance Minister P Chidambaram believes that the steps taken so far will ensure that the CAD for FY2014 can be restricted to $70 billion and will result in a CAD to GDP ratio of 3.7 per cent against 4.8 per cent during the year ended March 31, 2013.

Even if for arguments sake one accepts that the deficit can be contained within $70 billion, the expectation of that being 3.7 per cent of GDP seems to be too optimistic. A simple calculation will explain this. For a CAD of $70 billion to account for 3.7 per cent of GDP, the nominal GDP for the year should be about $1.9 trillion. The rupee in the financial year that started in April has averaged 58.6 a dollar and is currently trading at 66. If we (optimistically) assume the rupee averages 61.5 a dollar over the rest of the year, this would mean that the average rate through to next April would be around 60.

This roughly translates into a GDP (at market price) of Rs 114 trillion, which would mean a near 12.25 per cent growth in nominal GDP this financial year.

For the first four months of the current financial year, India's official inflation, based on the Wholesale Price Index, averaged 5 per cent per annum. Even if we assume that inflation picks up over the next few months and that it averages 6 per cent for the full year, real growth in GDP would be 6.25 per cent. However, India can consider itself lucky if it can grow at 5.5 per cent during the current financial year. With slippage expected on both fronts (the CAD would be higher than targeted, while GDP would be lower), India's CAD for the current financial year will likely be around 4.5 per cent of GDP. The pressure on the rupee would, therefore, continue, especially under a scenario of deep pessimism that pervades the market.

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