Mecklai Financial
WHERE RISK MEETS ITS MATCH

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How low can it go...

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As USD/INR has been falling steadily, India's FX reserves have been rising. Indeed, since September last year, when our foreign currency assets hit a low of $ 246 billion, they have risen at an average of over $ 3 billion a month to reach nearly $ 270 billion (as on March 14), the highest they have been in 16 months. [Incidentally, foreign currency assets are the largest component of FX reserves, which include gold, SDR's and holdings with the IMF, and currently total $ 297 billion.]

The $ 23+ billion that have been added to the reserves is nearly three times the total net FII inflows into the country since September!

Clearly, RBI has been steadily buying up dollars, increasingly its pace over the past few weeks when global inflows drove the rupee higher, pushing it above 60. While containing volatility and protecting export competitiveness are the obvious tactical reasons, a more strategic objective may well be to build up reserves in case they are needed to protect the rupee if it hits another downward spiral, whether triggered by a global event, a domestic change of heart or both.

Dr. Rajan has often articulated his concern that US monetary policy is holding most other economies hostage. And while US credit markets remain very quiet – the yield curve continues with a very modest slope – history teaches us that while markets often stay quiet much longer than anyone expects, when they turn they do so viciously. Another empirical lesson is that, other than JPY/USD, US swap rates move faster than any other asset class. All of which goes to suggest that when – not if – the tide turns in the US and the Fed starts to raise rates, markets could take off like a scalded cat and the inflows that have been strengthening the rupee could turn on a dime.

A prudent man would be wise to ensure he has a large stash of reserves as a cushion for such an event.

There are other events which could also create some degree of havoc. A hung Parliament in the elections could certainly turn the tide against the rupee. Indeed, as I argued a couple of weeks ago, even a majority government could result in the rupee weakness reflecting an age-old market practice of "buy the rumor (which, in a thin market, you can create), sell the fact".

Again, RBI and the government need to, sooner rather than later, change the distorted structure in the gold market. There has been increasing evidence that gold smuggling is rebuilding its base – this has to be nipped in the bud now. Let's not forget that the first serious bomb blasts in India happened right after the gold market was liberalized (in 1991); this effectively closed down gold smuggling, which was a billion dollar industry at a time, when a billion dollars

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really meant something. The stakes are much higher today and we can ill afford to fight that battle all over again.

RBI may be looking for a period of calm when they could make this change but, as I'm sure Dr. Rajan knows, waiting for calm in the market is waiting for Godot. With the rupee apparently too strong for RBI's comfort, and cutting interest rates inappropriate – inflation is still India's number one problem and lower interest rates in the current mood might actually accelerate inflows – it may be an excellent time to lift the structural restraints on gold imports.

Of course, despite all of the above, the market may still want to push the rupee higher. It is threatening a long-term resistance at 59.80, and, if it breaks through, it may have a mind of its own.

The problem is that even at these levels, exporters are getting nervous. While the US economy – a key driver of global exports – is showing signs of growth, the Chinese yuan has been weakening recently and Indian exporters' hard-won competitiveness may be readily threatened. This is doubtless another reason why RBI has been intervening steadily over the past weeks.

A long-ago study I did to try and assess a reasonably correct value of the rupee – a REER analysis using April to August 2011 as a base (since both exports and imports were growing by over 30% at the time) – suggests the "correct" value for the rupee today is around 58.50, incidentally the same level one of my technical analysts had pegged as a long-term target.

Thus, while I have to accept this as the limbo limit of the rupee's range, my sense is that, on average, the rupee will be weaker than 60 over the next 12 months.