A Speculative Attack on the Rupee?

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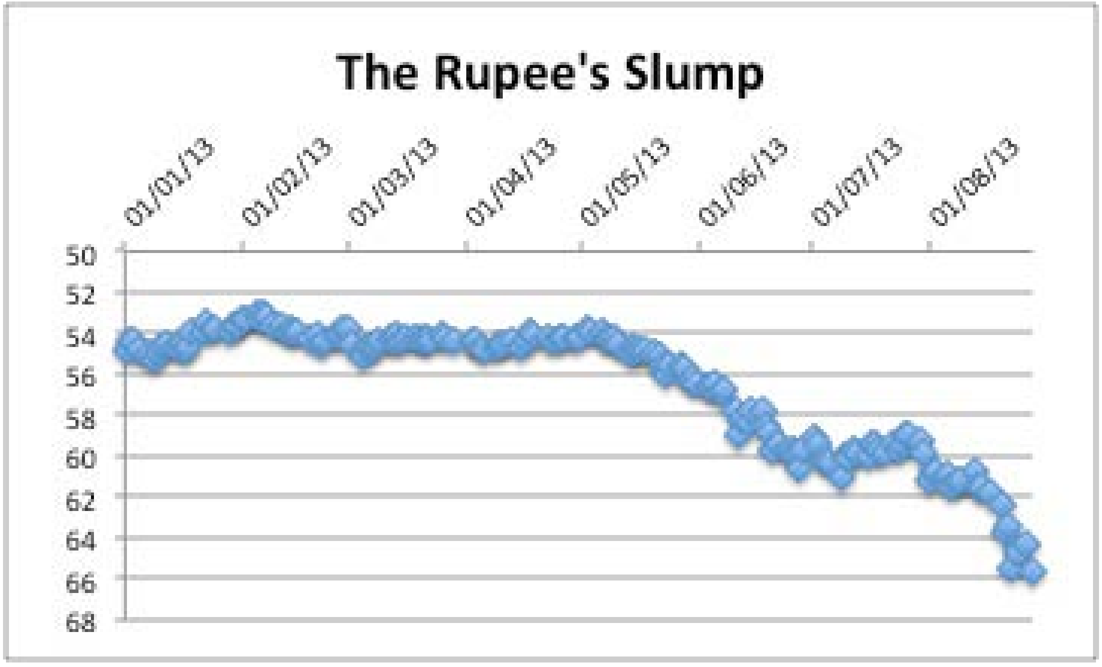

The rupee that touched another record low at below 66-to-the-dollar is on a downward slide the end of which none can see. What is clear is that this round of depreciation has been sharp and rapid. Even over 2013, it is clear that the currency was more or less stable for much of the first half and has depreciated by 16 per cent or more vis-à-vis the dollar over the last two months (see Chart).

This does signal that there are more factors than the so-called fundamentals responsible for the currency's recent collapse. It is indeed true that the current account deficit on India's balance of payments rules high, indicating that the country's demand for foreign exchange exceeds its ability to earn it. But it has been high for sometime and expectations are that the deficit as a ratio of GDP could fall marginally in the coming months. So this alone cannot explain the dramatic decline in the rupee's relative value. It is also true that foreign investors and lenders, who were more than willing to send hard currency across the country's borders in search of profit, are now less willing to do so. Moreover, with fears that the policy of quantitative easing, under which the US Federal Reserve was pumping dollar liquidity into the world system, is to be 'tapered off', investors are reportedly returning to the US and dollar denominated assets. But though the flow of capital has shrunk as a result, India still seems to receive enough foreign capital inflows to finance its deficit and even add marginally to its reserves. So that too cannot be an immediate explanation for the rupee's plight.

We may be reaching a point where the artificial situation in which a country with a large current account deficit has a relatively stable and even occasionally appreciating currency because of large capital inflows cannot hold anymore. But the timing of the rupee's collapse is not easily explained only by the conventional fundamentals.

Enter, therefore, the 'speculator', who has decided to bet against the rupee, as a potential explanation for the rupee's condition. The government and central bank are clearly looking in this direction. Besides working to increase foreign capital inflows into the country, a number of measures have been taken to reduce dollar asset accumulation by residents and prevent hoarding of the dollar by institutions involved in trade in the currency. Moreover, the Reserve Bank of India, which has been pointing fingers at the currency derivatives market as a speculative hub where the dollar rules higher, now argues that prices in those markets, or those driven by speculation, are beginning to influence spot dollar prices in terms of the rupee.

It recent Annual Report is quite direct. Noting that the volume of trading in exchange-traded currency derivatives increased from Rs. 2.6 billion in September 2008, when such trading was first permitted, to Rs. 234.4 billion in June 2013, the RBI hints at a link between this and exchange rate volatility. According to it, econometric tests suggest "there is causality running from speculation to exchange rate volatility". Given this conviction it is not surprising that: "The Reserve Bank recently banned proprietary trading by banks in the currency futures/exchange-traded currency options markets. Such trading is allowed only on behalf of clients. SEBI also tightened exposure norms for currency derivatives to check excessive speculation by increasing margin requirements and curtailing open positions on currency derivatives."

But the efficacy of such measures is under question, and there are other markets where the RBI or SEBI can do little. There exists a market termed the "non-deliverable forward" (NDF) market for the rupee. This the rupee version of markets for non-convertible or partially non-convertible currencies of countries with capital controls that ostensibly emerged to hedge exposure in such currencies, but then developed as sites for speculation. A typical NDF contract would involve an agreement in which one party agrees to buy at some date in the future a notional quantity of dollars at a contracted forward rate, implying a sum of rupees (say X). On the settlement date, the investor would be able to sell the quantity of dollars purchased and deliverable at the prevailing spot price, to obtain, say Y, rupees. The difference between the two would reflect the profit or loss in the trade. Such trades are however settled in dollars in these over-the-counter markets, since the counterpart currency such as the rupee is "non-deliverable". The forward contract rupee-to-dollar rates reflect the direction in which speculators expect the rate to move.

If capital controls are strong, developments in these NDF markets should not affect prices in onshore spot markets. But financial liberalisation dilutes those controls. There is now evidence from many emerging markets that prices in the 'offshore' NDF markets affect 'onshore' dollar prices. The RBI refers to a study which "suggests that there is a long-term relationship between the spot and NDF markets for the INR" and that during periods of depreciation "shocks originating in the NDF market may carry more information, which gets reflected in on-shore segments of the market". The transmission mechanism is not clear, but it could be the involvement of domestic banks in these markets because, though "onshore financial institutions are not allowed to transact in the NDF markets", "since domestic banking entities are allowed specific open position and gap limits for their foreign exchange exposures, there is scope for domestic entities to participate in the NDF markets to take advantage of any arbitrage." Besides that, foreign banks and corporate entities with an international presence can participate in the NDF market. Liberalisation has only increased the intensity of such linkages between onshore and offshore markets.

In sum, a series of changes that have occurred since financial liberalisation began have increased India's exposure to the adverse effects of currency speculation. Given the nature of these changes there is little that the RBI and the government can do about such speculation, despite the claim that: "While introducing currency futures, the Reserve Bank and the Securities and Exchange Board of India (SEBI) had put in place various safeguard mechanisms to monitor positions, prices and volumes in real time so as to control excessive speculation." In any case, there is nothing whatsoever the RBI and the SEBI can do to curb speculation in the NDF market that is outside its jurisdiction.

It is, therefore, possible that the sudden and sharp depreciation of the rupee is result of the spillover onto domestic spot markets for the currency of speculation-driven price trends in derivative markets. In which case the slide is difficult to control and can continue with no clear prediction possible where the decline will take the currency in the days ahead.

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