India Fighting Worst Crisis Since ’91 Seeks to Buoy Rupee

By Jeanette Rodrigues and Ye Xie for Bloomberg

India increased efforts to stem the rupee’s plunge and stop capital outflows that are pushing the economy toward its biggest crisis in more than two decades.

The Reserve Bank of India, whose Governor Duvvuri Subbarao steps down next month, cut the amount local companies can invest overseas without seeking approval to 100 percent of their net worth, from 400 percent, according to a statement late yesterday. Residents can remit $75,000 a year versus the previous $200,000 limit. Rupee forwards rose for the first time this week.

Policy makers’ moves since July to tighten cash supply, restrict currency derivatives and curb gold imports have failed to arrest the rupee’s slump to record lows as they struggle to attract capital to fund a record current account deficit. The rupee has weakened 28 percent in the past two years, the biggest tumble since the government pledged gold reserves in exchange for loans from the IMF in 1991.

The minute you restrict outflows, people will start legitimately speaking in terms of capital controls, although these are only on locals and not on foreign investors.

Cash Reserves

Central bankers also exempted lenders from cash reserve rules for certain foreign-currency deposits yesterday. Banks accepting non-rupee deposits after Aug. 24 from Indians living abroad need no longer keep 4 percent in cash and invest 23 percent in government-approved securities, the RBI said.

Nomura Holdings Inc. estimated that private remittances and outward direct investment abroad totaled $15.9 billion in the year ended March 31, citing central bank data.

Indian companies' outward foreign direct investment has been growing in recent years for various reasons such as pursuing growth markets, technology, natural resources, and these could be adversely hit. While the authorities aim to reduce foreign-exchange volatility, they may end up sending a panic signal.

One-month offshore non-deliverable rupee forwards, which investors use to hedge or speculate on the currency, rose 0.2 percent 61.83 per dollar today. NDFs touched a record low of 62.53 on Aug. 6. The contracts, settled in dollars, are agreements to buy or sell assets at a set price and date.

Rupee Falls

The rupee fell 0.4 percent to 61.4437 per dollar before the announcement. It has lost 11 percent this year, the second most among 12 Asian currencies. The rupee touched an all-time low of 61.8050 on Aug. 6. Financial markets in India are closed today for the Independence Day holiday.

Indian stocks traded overseas rose 0.2 percent yesterday to 1011.77, paring its decline this year to 3.3 percent. India's benchmark Sensex index is down 0.3 percent this year.

The rupee's plunge accelerated since May as foreign investors pulled money from Indian bonds and stocks on concern the U.S. will pare stimulus. International investors cut their holdings of Indian bonds by $10 billion since a peak in May to $28 billion, the lowest since January 2012, according to central bank data.

Steadying the rupee is the top priority for policy, the monetary authority said on July 29.

Capital Controls

The imposition of capital controls is one facet of the "impossible trinity trilemma" that Subbarao says the central bank is facing. The economic theory argues that it isn't possible to have free movement of capital, a fixed exchange rate and an independent monetary policy simultaneously.

To contain the currency decline, the RBI raised two interest rates July 15 and restricted bank's access to cash through its daily repurchase auctions.

India also boosted import duties on gold and silver on Aug. 13 and banned the import of gold in the form of coins and medallions to reduce the trade deficit. Imported gold must be stored in government-mandated warehouses.

So far, the efforts have fallen short as capital outflows make it more difficult for India to bridge the gap in the current account, the broadest measure of trade.

The deficit widened to an unprecedented 4.8 percent of gross domestic product in the year ended March 31. The government aims to narrow the gap to 3.7 percent of GDP, or $70 billion, this year, Indian Finance Minister Palaniappan Chidambaram told parliament in New Delhi yesterday.

New Banker Raghuram Rajan, the University of Chicago economist credited with predcting the 2008 financial crisis, will take charge of the Reserve Bank next month after Subbarao's term ends Sept. 4. There's no "magic wand" to fix India's problems, he said on the day of his appointment Aug. 6., while adding the RBI and the government will deal with the challenges.

The measures "are unlikely to have a meaningful impact on the currency," Aneesh Srivastava, chief investment officer at IDBI Federal Life Insurance, said in a phone interview. "For a long-term impact we need to increase the attractiveness of India as an investment destination."

1990s Crisis

The rupee's decline is a reminder of the crisis in the 1990s when the widening deficits in the budget and current account pushed the currency down 37 percent between 1991 and 1992. The government secured an emergency loan of $2.2 billion the IMF by pledging 67 tons of India's gold reserves as collateral. Growth slowed to 2.1 percent in 1991, from 5.6 percent the previous year.

Assistance from the IMF led then finance minister and now prime minister to open India's economy to foreign investment. Since then, economic growth has accelerated, with GDP expanding more than 9 percent in each of the three years through March 2008 compared with 3.7 percent between 1950 to 1973.

The country is in a better position to counter a crisis, with $277 billion foreign reserves, enough to cover more than six months of imports, according to data compiled by Bloomberg. That compares with less than two months of import coverage in 1991, according to a RBI report in August 2012.

Growth Slowdown

At the same time, the economy is posting its slowest growth since 2003, expanding 5 percent in the year ended March 2013. Last month, the RBI cut its growth forecast for the year through March 2014 to 5.5 percent form 5.7 percent.

The slowdown won't last long as the government removes hurdles for stalled projects, eases foreign ownership rules and starts work on new ports and rail lines, the prime minister said in a speech in New Delhi today. Singh is seeking to repair the image of his government and the ruling Congress party before elections due by May.

India's currency defense will raise borrowing costs for the government and companies, slowing economic growth further.

“It is historically very difficult to defend a currency when you have large current account deficit,” Shaoul, who helps manage $13 billion in assets, said. “These measures are not really helpful as they are going to do damages to the local economy. The real danger is that foreigners start to withdraw more capital and you start a vicious cycle.”