MCX-SX
India's New Stock Exchange

Research Digest
INR Macro-Scan

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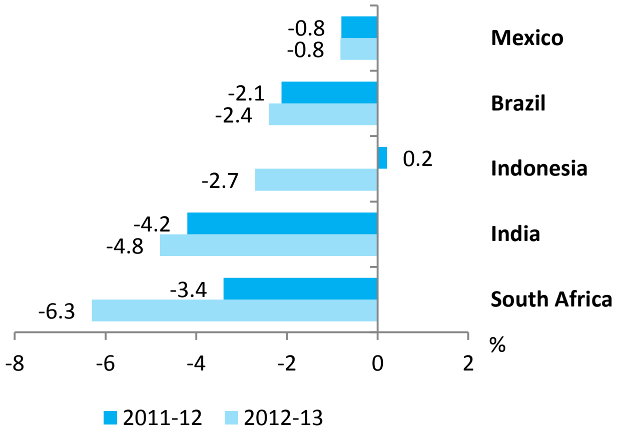
Cross Country Comparison of Currency Fundamentals – Would Swap Lines Help?

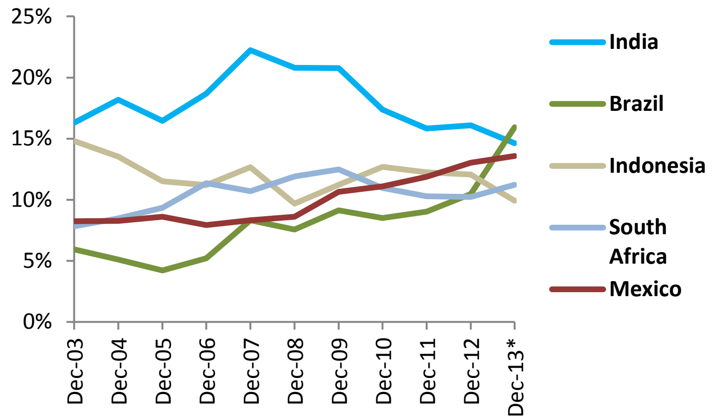
India's current account deficit being at a high next only to South Africa will continue to remain an eyesore for INR. Declining reserve indicates that though dollar demand side can be controlled to some extent, dollar supply side would have to be augmented. Nothing can be next best to augmenting export competitiveness and economic policy reforms in terms of augmenting supply side.

Cross Country CAD to GDP Ratio:



Source: Bloomberg and respective country's Central Banks

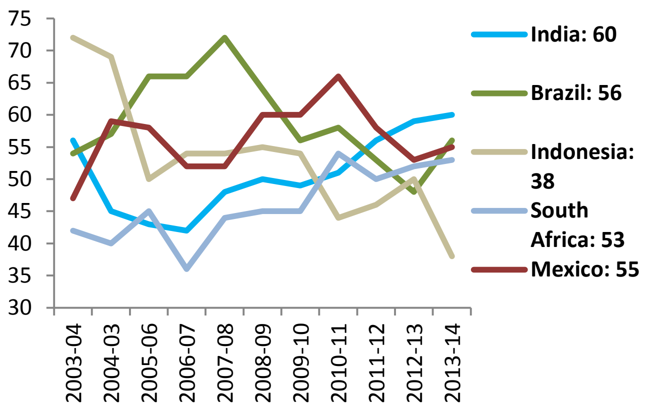
Cross Country Forex Reserves to GDP Ratio: Comparison:



Source: Bloomberg

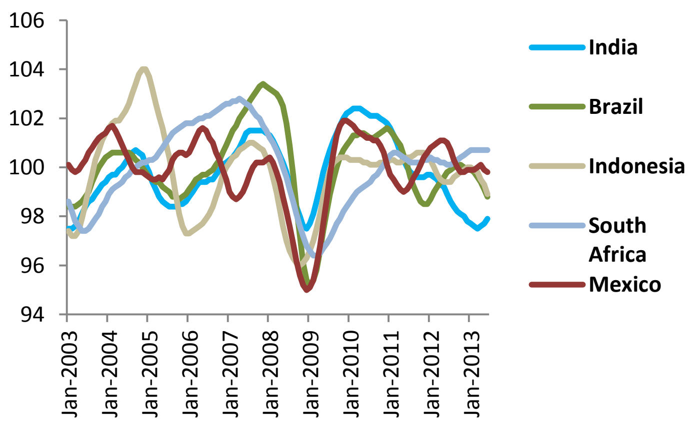
As per the Global Competitiveness Index rankings as released annually by the World Economic Forum, India's ranking has been declining steadily since the last 10 years while other economies in our comparison below have not gone down as much. However, as the OECD CLI indicates, India's economy has reached its trough and is expected to rebound. While the expected investments in reforms may strengthen our competitiveness, will this turn around aid in augmenting exports and capital flows?

Cross Country Global Competitiveness Index:



Source: World Economic Forum- The Global Competitiveness Report 2013-2014

Cross Country OECD CLI Comparison:

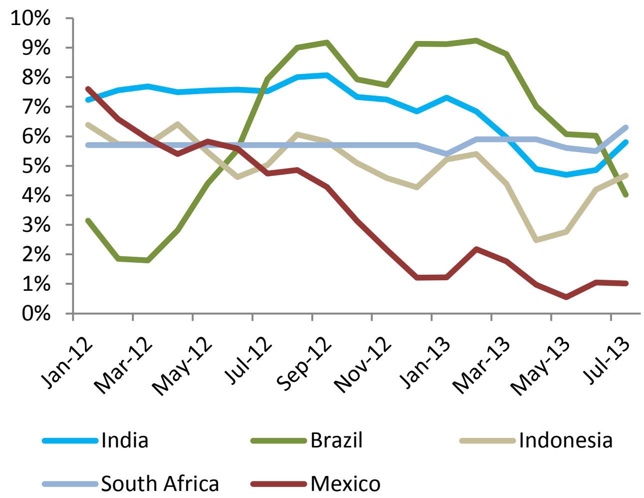


Source: OECD

Note: The OECD CLI uses the monthly index of industrial production (IIP) as a proxy measure for economic activity. The CLI system focuses on the business cycle, defined as the difference between the smoothed IIP data and its long-term trend. OECD CLIs aim to predict turning-points in this business cycle estimate.

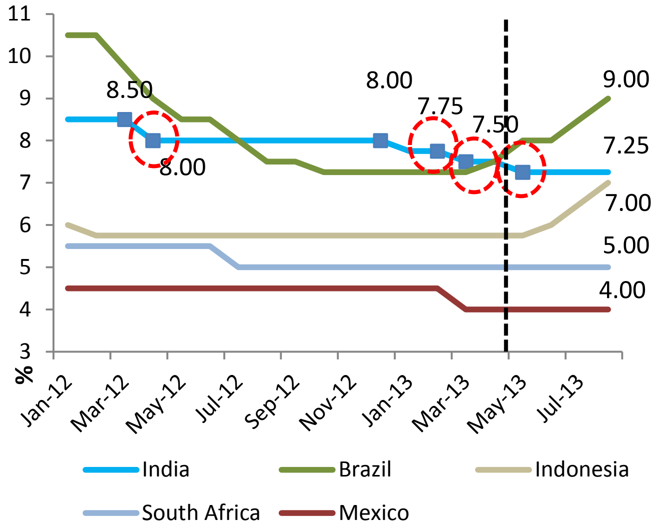
Despite the declining WPI, India's and Mexico's monetary policy had adopted status quo in 2013. Surprisingly, Brazil increased policy rates despite the declining WPI. Indonesia also increased policy rate recently in response to both inflationary conditions and currency scenario.

Cross Country Monthly WPI Comparison:



Source: tradingeconomics.com

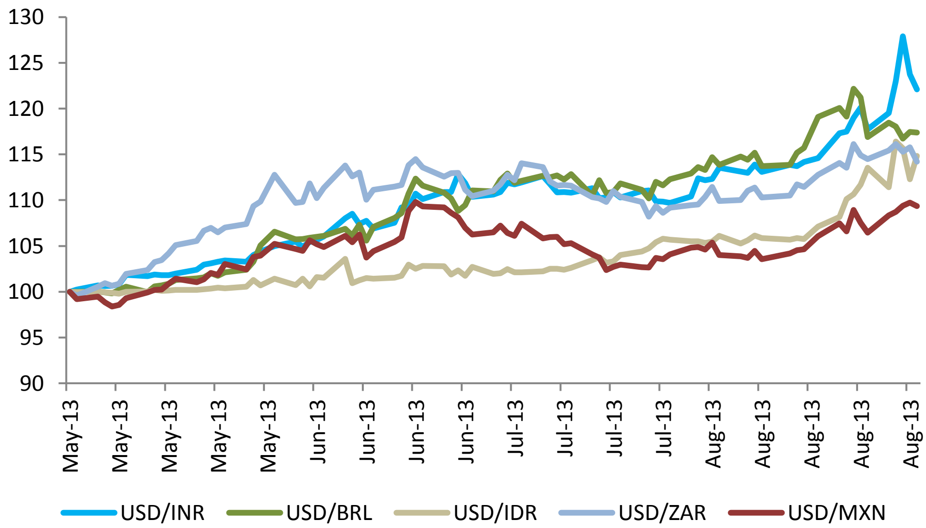
And, Policy Rate Responses:



Source: Bloomberg

Though other countries have also felt the heat of volatile capital flows, why is INR impacted the most? May be the answer lies in the way other markets for other asset classes (than currency) responded to the US tapering of the process of quantitative easing.

Trends in Currency Movement



Source: Bloomberg (Based at 100)

Thanks to the increased exposure to foreign investors, Indian stocks as an asset class has been much volatile than currency and bonds.

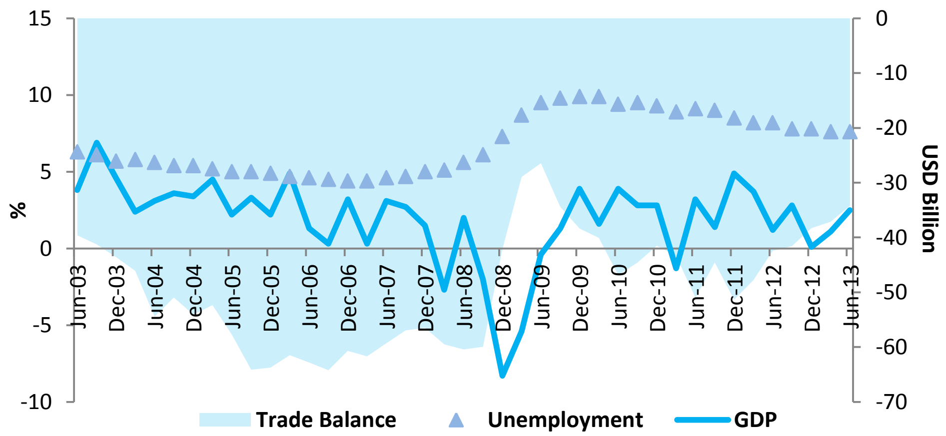
Asset Class Volatility Comparison (January-2012 to August 2013)

Country	Currency	Benchmark Stock Indices	10 Year G-Sec Yields
India (SX 40 Index)	0.5%	4.2%	2.0%
Brazil (IBOV Index)	0.6%	3.8%	7.6%
South Africa (TOP40 Index)	0.7%	3.6%	4.1%
Indonesia (JCI Index)	0.6%	2.7%	4.7%
Mexico (MEXBOL Index)	0.6%	2.4%	5.0%

Source: Bloomberg

After a prolonged rout, US fundamentals (GDP, Employment, Trade Balance, etc.) seem to be improving adding to the strength of USD and US Stock markets.

Improving US fundamentals:



Source: Bureau of Economic Analysis, U.S. Department of Commerce

The US stock markets have relatively outwitted the performance of the emerging country markets. While returns are a function of fundamentals, the strong currency-stock linkage would have to be weakened if Brazil's bond-currency linkage is any lesson in addition to the SE Asian currency crisis.

Country	Stock Returns		Correlation (Percent)	
	Post Tapering Indication (22nd May to 30th Aug-13)	Pre Tapering Indication (1st Jan to 21st May-13)	Currency-Bond	Currency-Indices
US (S&P 500 Index)	-0.7%	13.2%	32.0	25.0
India (SX 40 Index)	-6.4%	2.7%	82.0	-83.0
Brazil (IBOV Index)	-8.4%	-9.8%	91.0	-40.0
South Africa (TOP40 Index)	-18.7%	19.8%	77.0	-81.0
Indonesia (JCI Index)	6.1%	4.7%	72.0	20.0
Mexico (MEXBOL Index)	-2.4%	-9.4%	61.0	-45.0

Currency Swap Lines – The New Macro-Financial Species for Global Financial Health?

- While trade flows have historically been a critical element for the markets in pricing the currency, with increasing ease of capital flows across political borders, **capital flows are also gaining their say in the currency markets.**
- Thanks to the liquidity freeze post the Lehmann fall of 2007, being central to the world economy **US Fed had opened up 14 swap lines accounting for USD 755 billion in total so far**.
- **Evidence from the past suggests that emerging markets have experienced significantly larger nominal currency depreciation and drying up of short-term funding markets during times of high capital flow.** In such cases researchers argue that even the mere existence of swap line would help in stabilizing currency and trade, even if not used.
- **Swap lines are largely extended to fundamentally sound and well-managed emerging markets**, **and to important trade partners which makes the process selective.** By sound fundamentals it is also meant that the swap line receiver has healthy levels of foreign exchange reserves. By the very nature it had happened so far, it indicates that it is largely a negotiated process and is in the self-interests of the central banks to provide for the global public good of financial stability.
- With healthy forex reserves at this point in time and maintaining healthy trade balance with most of these developed nations, whose central banks have already opened such swap lines with other emerging markets, it is necessary that **swap lines shall be negotiated based on the short-term capital flows from these nations apart from the trade flows.** It will be a win-win for investors of the developed economies and the stakeholders of Indian economy.
- US Fed, Bank of England, Bank of Japan and Peoples Bank of China are the central banks that have so far opened up swap lines with major emerging markets. Apart from these, **Chiang Mai initiative** of Asean+ nations that allows its member contributors to have access to swap lines from a pre-determined reserve is worth having a look at joining or setting up one similar for South Asia+ nations including China. Of late, Bank of Korea's relatively frequent use of international currency swap lines to provide for trade financing and capital servicing is a clear proof of its currency and hence the national financial stability.

Moot Point: While there are reasons for the central banks of developed economies to promote swap lines, the mere existence or at the extreme situation its use would provide for the larger public good of financial stability. IF FUNDAMENTALS ARE OVERLOOKED BY MARKETS, THE FAITH OF ANOTHER CENTRAL BANK CAN MAKE FUNDAMENTALS LESS IGNORABLE TO THE PARTICIPANTS.

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