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Most financial market models have been discarded in recent years; no reason why REER should be treated differently

By: [Jamal Mecklai](#) | Updated: March 29, 2016 7:34 AM

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RBI should set up a revolving panel of CFOs who it meets, say, once a quarter to get a direct picture of on-the-ground competitiveness. (Reuters)

Judging from his continuing comments and as well, indeed, as his actions, it appears that RBI Governor [Raghuram Rajan](#) remains extremely concerned about the denouement of the ongoing crisis in global markets. Some may feel that the word “crisis” is inappropriate since things are currently quite calm, with occasional blips of risk-on asset buying quickly reversed by the phantom of some macro numbers or other. However, more than at (almost) any time I can recall, markets seem to have no idea of where to go—there aren’t even any loud (and generally wrong) forecasts from the usual suspects: Goldman saying gold is going to \$2,000, someone else saying oil is going to \$5. In this environment, it is virtually certain that markets will break out dramatically sooner rather than later, which, to my mind, justifies RBI’s conservatism both on interest rates and on keeping the rupee volatility contained without, as they say (with a pinch of salt, as we shall see later) focusing on any specific value.

To my mind, RBI should stop spouting this policy line and increase its data-set by actually meeting its constituents—the tens of thousands of companies that have to buy or sell foreign exchange—to get a firsthand idea of what their real needs are. Using REER (6-country or 32-country or whatever) to figure out competitiveness is nuts—we have a REER model that today shows the rupee overvalued by about R8; other models will have different numbers. Models are lovely and all very well for the ramp, but change the make-up and the clothes and the way they look changes. Most financial market models have been discarded in recent years and there is no reason why REER should be treated differently.

Instead, RBI should set up a revolving panel of CFOs who it meets, say, once a quarter to get a direct picture of on-the-ground competitiveness. The process would take some trial and error to separate the men (people who give you an honest picture) from the boys (100% parochial), but it would be a direct way for RBI to understand the real impact of its exchange rate policy and determine whether it needs to shift gears.

As a case in point, Thai exports rose in February, for the first time in 14 months; India’s exports, as we all know, have been down 15 months in a row. Is the long-awaited improvement in Thailand’s performance a sign of improving global markets or is it simply a twitch specific to Thailand’s trade? Is it a signal that a weaker rupee would now give our exports some support? Or not? I don’t know, but I believe talking to a cross-

section of exporters (and importers) would certainly provide a better picture of what would work. 

In any event, the market today remains dangerous, and, while the odds are stacked towards lower asset prices and a weaker rupee, companies (on either side of the fence) who need to manage risk need to stay in (or move into) a risk-off mode.

Of course, this doesn't mean simply hedging blindly. Forward costs (or earnings) need to be factored in, as does the iron hand of RBI, which has been keeping the rupee contained in a descending band with a range of about R2. Movements in the reserves provide definitive evidence of RBI buying dollars when the rupee reaches the top of its band (as it did recently), and, of course, the reverse when the rupee threatens the lower edge.

And, given that the two iron-cast rules in markets are (a) the trend is your friend, and (b) don't take on the central bank in a relatively closed market, we believe it makes sense to ride these rails intelligently till such time as the pattern breaks.

Clearly, near-term imports should be hedged now; medium-term (3 months plus) imports should have a process to weigh the forward cost against the probability of the rupee falling sharply to the bottom of its band. While it is impossible to assess this probability, it is possible to create a program that, over time, is able to take advantage of this pattern and save 15 to 50% of the forward cost, depending on how volatile the market turns out to be.

For exporters, it is exactly the reverse situation. Remember a bird in the hand is worth possibly several times those in the bush, irrespective of how lovely the flowers on the bush are. Thus, a significant front end hedge is the way to go. Again, a structured process can deliver excellent results.

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