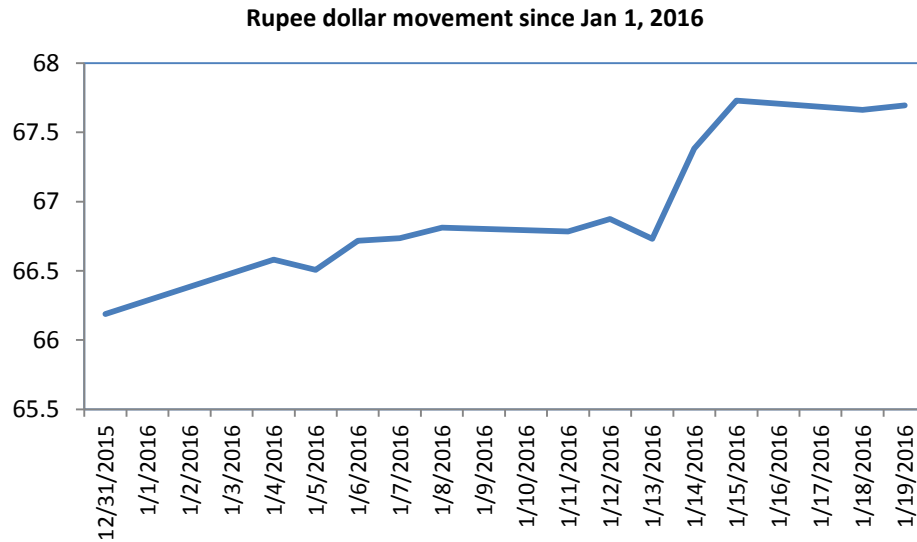


Rupee breaches 68 Mark: What lies ahead

The rupee has crossed the 68 level which was witnessed earlier in 2013 when the news of the tapering of QE programme of the Federal Reserve rocked all markets. This time it is the Chinese fear of a major slowdown, which has been reiterated by the IMF forecast, coupled with low crude oil prices which together portend to a major global economic slowdown.



Source: RBI

The rupee started at just above Rs 66/\$ on January 1, 2016 but since then has been moving sharply downwards with the currency crossing the 67 level on the 14th January 2016 and the 68 mark on the 20th January 2016. This movement was quite unexpected as the fundamentals had justified a level of 65-66.

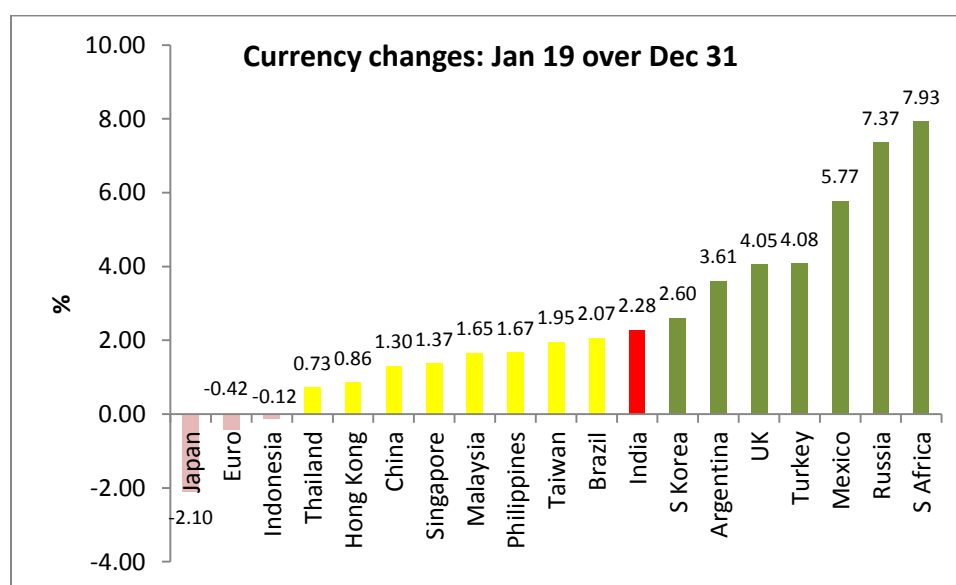
The factors pulling down the rupee are:

1. Global economic slowdown with China being the major factor. The IMF WEO update talks of further slowdown in 2016 and 2017.
2. Withdrawal of funds from emerging markets which has also affected stock markets. Prospects for further rate hikes by the Fed in 2016 can accelerate these flows.
3. Our own fundamentals have shown signs of weakening.
 - a. Trade deficit for December has increased.
 - b. Exports continue to fall
 - c. FII's have been in the selloff mode in equity segment for the last 3 months.
 - d. Forex reserves have also declined from the psychological level of \$ 350 to \$ 349 bn as of January 8th 2016 with an outflow of \$ 1.4 bn in the last week.

The market is now waiting for guidance from the RBI in the form of intervention or announcement on the rupee. In FY14, when the rupee fell, the RBI had intervened by restricting outflows on current account and later invoked the swap on FCNR deposits to bring in dollars. The situation this time is different as the psychological factors have been stronger than the fundamentals in weakening the rupee. However, prevalence of these trends in the market would also cause fundamentals to weaken further which will pressurize the rupee.

There is also a school of thought which believes that the weak rupee will help to prop up exports to the extent that it is possible. Hence by letting the rupee fall, there can be an exports competitive advantage to be obtained, provided other competing nations are doing better. In the last year or so the Indian rupee has been one of the best performing currencies compared with other nations. This in a way has come in the way of propping our exports in an otherwise dull market.

The chart below illustrates how other currencies have moved in descending order with a negative sign connoting appreciation.



Source : Pacific Exchange Rates

The fall in the rupee is almost mid-way across the spectrum of currencies that have been depreciating so far this year. At 2.28%, the rupee performed better than

- South Korea
- Argentina
- Turkey
- Mexico
- Russia and
- South Africa.

The currencies that did better are those of the South East Asian markets, barring S Korea, which have witnessed lower depreciation.

Options open now are:

1. As forex reserves have not fallen sharply, there does not appear to be any need to pull the panic trigger and look for ways to augment these funds.
2. The central bank has to be watchful on how speculative activity behaves as there is a tendency for such triggers to be unleashed with exporters holding back their earnings and importers rushing in. The problem this time is less acute compared with 2013 when the OMCs had rushed in to buy their dollars at a time when the crude oil price was high. This time the situation is different with crude oil prices trending low and should not engender such actions.
3. The FII action requires to be monitored as their continuous withdrawal is a sign of unease. Their inflow into the debt segment has been positive so far this month and the RBI may consider increasing their limits to enable higher and stable flows.
4. Selective intervention by the RBI could help. As of now according to market sources, state owned banks have been selling dollars to steady the rupee. This may have to be scaled up in case of more sustained depreciation of the currency.

Normally such movements should have a limit as the factors driving them are mostly exogenous and were known. Ensuring market discipline is important to ensure that panic does not set in until such time that the rupee returns to equilibrium.

Companies with large forex exposures which do not have a natural hedge through exports would be pressurized on imports as well as service of debt. This continues to be a challenge for the system with the forward premium being around 6.4-6.5% which has been a deterrent for hedging. But in these volatile times, the benefit from hedging would be significant. .

Our view

The rupee will remain volatile as long as these global sentiments prevail and crossing the next barrier of Rs. 69 cannot be ruled out in the very short term. However, a return to equilibrium is expected in case the speculative forces do not play out for a long time. As trade and current account deficit may be expected to remain well under control unlike 2013, and FDI continues to be strong, **a return to the Rs 66 mark could be expected. But the new range could be 66-67 given that every episode of disturbance pushes up the new equilibrium level.**

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