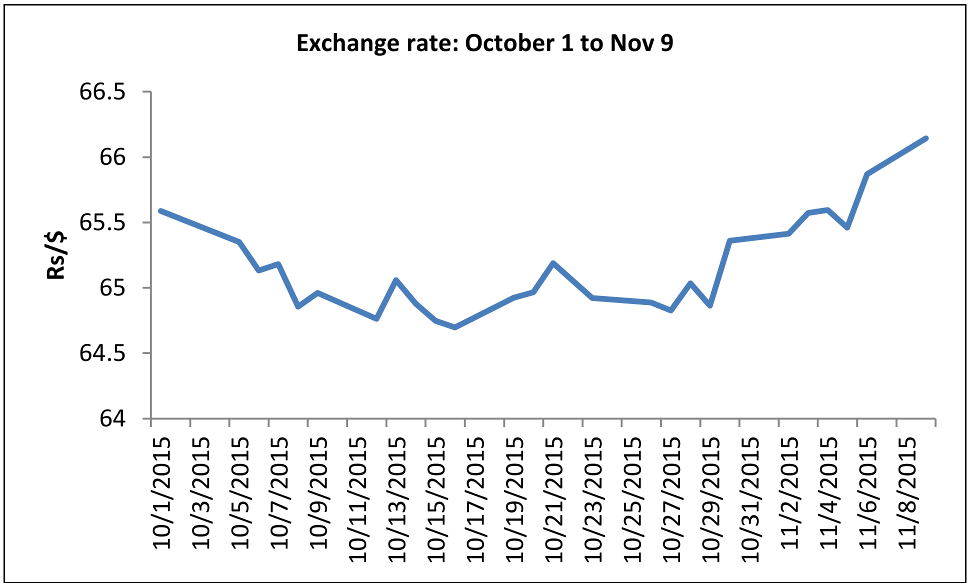
Economics

November 10, 2015

Declining rupee, strong externals

The rupee has once again come under pressure with the Rs 66/$ mark being breached. A further trigger has been the Bihar Elections which has had a negative impact on the forex market thus exacerbating the situation. The question is whether or not the rupee is intrinsically strong or weak and whether there are other extraneous forces affecting the rupee.



Source: RBI

The rupee started at just above Rs 65/$ on October 1st 2015 and strengthened through the period to Rs 64.70 on October 16th. Subsequently it has gradually weakened but remained within Rs 65.5 till the end of the month. Subsequently the rupee has started declining sharply to cross Rs 66/$ mark on 9th of November.

Fundamentals driving the rupee include trade developments, invisible flows and capital movements. The trade deficit for the first six months of the year was lower at $ 68 bn as against $ 72.7 bn last year. Capital flows have varied. Information on FDI is available for the first quarter only and was higher at $ 9.5 bn as against $ 7.2 bn last year. FPI flows have been volatile and turned positive to $ 3.4 bn in October, but have declined by nearly half billion dollar in November so far. This could be one factor that has accelerated the decline of the rupee this month.

The net impact of all fundamentals put together is however reflected in the change in the forex reserves. Here there was net accretion in October by $ 2.8 bn to $ 353.6 bn. It may be surmised that these may have declined in the first 9 days of November to cause the rupee to weaken.

However, an important development in the forex market has been the strengthening of the dollar over time. This has been hastened with the expectation of the Fed increasing the interest rate causing the dollar to strengthen as funds keep flowing back to the US. The table below gives a comparative picture of the depreciation in various currencies with respect to the dollar. Two aspects are covered:

1. Average daily depreciation between the period October 1 and Nov 15.
2. Coefficient of correlation with the euro/dollar rate.

Table 1: Depreciation across Currencies (Relative to USD)

Currency	Depreciation	Correlation
Euro	4.02	1.00
Pound	0.26	0.43
Yen	2.85	0.92
Argentina peso	1.70	0.66
Real	-5.30	-0.27
HK Dollar	0.02	0.66
Rupee	**1.25**	**0.75**
Rupiah	-6.98	-0.18
Ringgit	-0.81	0.42
Mexico peso	-0.20	0.24
Philippines Peso	1.07	0.88
Ruble	-1.55	0.40
Rand	3.13	0.88
Won	-1.68	0.03
Baht	-1.51	0.08
Turk lira	-3.63	-0.29

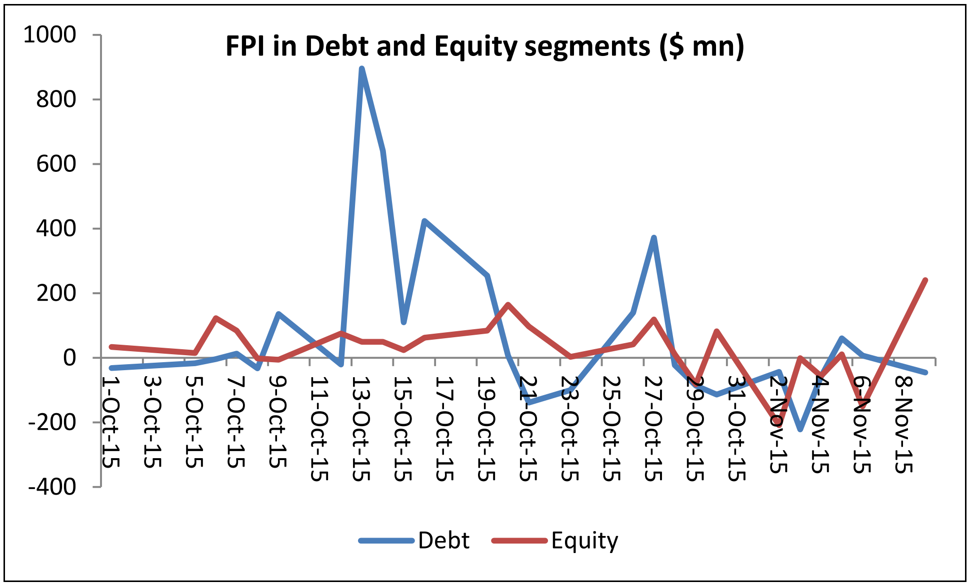
Source: Pacific Exchange Rate Services

The table shows that:

1. 7 of the 15 currencies witnessed depreciation during this period. Of these 5 had declined by more than 1%, with the yen and rand witnessing the highest decline followed by the Argentina peso. The rupee performance was better at 1.25%. Philippines Peso declined by 1.07% and the UK pound by 0.26%
2. Further, 4 of these currencies, yen, rupee, Philippines peso and rand had a high coefficient of correlation with the dollar of above 0.75 while Argentina peso followed with 0.66. Hong Kong dollar had a coefficient of 0.66 but still showed very low depreciation.
3. The currencies with appreciation during the period had low to negative coefficient of correlation with the dollar.
    a. This indicates that for this period not all currencies have moved in tandem with the dollar. Their own fundamentals or lower relations with the US currency could be reasons for the same.

The FPI picture

The flow of FPI in both the equity and debt segments would hold the key to driving the fundamentals of the rupee. The flow of these funds since October 1 is depicted in the graph below.



The chart above shows that FPI flows were predominantly in the debt segment, with a boost being provided by the enhanced limit of investment in government paper and the inclusion of SDLs as an avenue. However, with saturation being reached, this has also tended to move downwards from the end of October onwards. Equity flows have tended to be generally positive but low during the first 3 weeks of October, but slowed down subsequently.

What will drive the rupee now?

- To answer the question posed in the beginning: The rupee is definitely quite stable based on fundamentals, but cannot escape the impact of the global influences such as strength of the dollar.
- The rupee will be driven by a combination of the dollar impact and the fundamentals. With a strong coefficient of correlation with the dollar, any strengthening of the same will necessarily mean a weaker rupee in the absence of RBI intervention.
- Daily FPI flows will provide direction to the rupee. Debt flow in particular would be influenced by two factors:
    - The space provided by the limits that are available for FPI to operate in the GSec/SDL market.
    - The immediacy of the Fed rate hike. Presently, it does appear that the Fed would go in for a rate hike in December, which will cause funds to flow out of emerging markets to an extent.

- Other fundamentals such as trade deficit and invisible flows would tend to remain stable. A revival in the USA leading to Fed rate hike could augur well for the IT sector that could see enhanced incomes which will have positive impact on the balance of payments.
- The idea of masala bonds floated by the RBI and being considered by some companies would mean at the margin lesser dependence on ECBs and hence slowdown the flow of dollars into the country.

A fair range for the rupee would still be between Rs 65-66/$, and while there could be movements across this band in both directions, it should mean revert to this mark.

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