Explaining the sharp rise in the rupee

What is the issue?

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Since the beginning of this year, the rupee has appreciated nearly 4% against the US dollar.

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What are the reasons behind this effect?

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- Part of it is due to the winding down of the “Trump-trade” and loss in the dollar globally.
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- As market participants have become sceptical about the implementation of Trump’s agenda, they have been cutting down long-dollar positions, and emerging market currencies in general have gained this year.
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- Meanwhile, there has been a host of factors on the domestic front leading to substantial gains in the rupee.
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- After the BJP’s landslide victory in the latest Assembly elections, foreign investors have turned more hopeful on the Indian equities.
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- Since the announcement of the election results, FIIs have poured in USD 3.4 billion into Indian markets, compared to an outflow of similar magnitude in the first ten months of FY17.
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- Another major change has been in the outlook of the policy rate.
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- The Reserve Bank of India has turned hawkish with a change in its stance from ‘accommodative’ to ‘neutral’.
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- Consequently, the rise in bond yields has led to an influx of foreign capital into the Indian debt market.
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- In addition, the GDP growth for the third quarter of FY17 has been much better than expected and has helped alleviate some of the earlier fears related to demonetisation.
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- On the domestic front, the current account deficit is likely to widen from 0.6 per cent of GDP in FY17 to around 1 per cent of GDP in FY18.
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- And inflation is expected to pick up from around 4.5 per cent in FY17 to 5.1 per cent in FY18.
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What are the causes of concerns?

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- On the international front, while two more rate hikes from the US Fed along with political uncertainties and policy risks, both in the Euro Zone and the US, could lead to a cause of concern.
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- With upcoming elections in France and Germany, there could be a wave of uncertainty that could lead to capital flights from the emerging world.
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- Against such a backdrop, the rupee is likely to depreciate in line with other emerging market currencies in the medium-term.
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- However, in the short-term, as long as capital inflows remain robust, the appreciation pressure could stay intact.
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- In such a scenario, the incremental room for rupee appreciation will largely be dependent on the intervention strategy of the central bank.
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What can be expected from RBI?

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- Unlike in the past, the RBI’s intervention in the currency market has not been aggressive enough this time around, due to multiple reasons.
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- One, the current episode of rupee appreciation is viewed as a short-term phenomenon.

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- With a gradual pick-up in inflation and deterioration in the current account dynamics, the rupee trajectory could reverse RBI policies any time.
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- Two, there is ample liquidity in the banking sector.
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- At the last count, systemic liquidity surplus was around Rs.4 trillion.
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- In such a situation, buying dollars and further infusion of rupee liquidity could put the RBI's foremost goal of inflation-targeting at risk.
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- Three, there is strong evidence that the fair value of the rupee has changed.
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- That is, the RBI is now likely to be more comfortable at a marginally higher level of the rupee than in the past.
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- This is the most important aspect to understand regarding the near-term rupee trajectory.
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- An over-valued exchange rate implies that the currency is too high for the state of the economy and it should depreciate for competitiveness to remain intact.
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- However, the contention that the rupee is over-valued based on the RBI's measure may be misleading since it gives more weightage to the EUR and AED instead of competing currencies such as China and other Asean countries.
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- Therefore, other measures of the REER by the ministry of finance (MoF) or by the IMF, which assigns higher weightage to Asian currencies, are probably better to gauge the rupee dynamics going ahead.
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- While globally other currencies have appreciated too, the decline in India's inflation has been more than that of its competitors thereby leading to a re-rating of India's exchange rate.
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- Thus, it would be safe to assume that the RBI will not become an aggressive buyer of the dollar until the exchange rate slips below some mark.
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- Of course, in the medium-term, as inflationary pressures pick up, this fair

value estimate would undergo a gradual change.
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Source: Business Line

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