CRISIL RESEARCH

August 2015

CRISIL Insight

The odds on Rupee

Two-third chance of the rupee touching 64/$ by March-end 2016; one-third chance of 67/$

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The odds on Rupee

Two-third chance of the rupee touching 64/$ by March-end, 2016; one-third chance of 67/$

- Rising frequency of external turbulence keeps rupee under pressure
- Commodity prices decline continues to benefit imports despite the depreciation of the rupee
- Rate hike by the US Federal Reserve to be next big temblor

Rupee has posted significant losses in the last few weeks bringing back memories of 2013, when it had depreciated 24% to 68/$ in a matter of four months. The rupee has dropped by as much as 3.7% in only a few days since the Yuan devaluation on August 11.

However, the current scenario is different than what we saw in 2013.

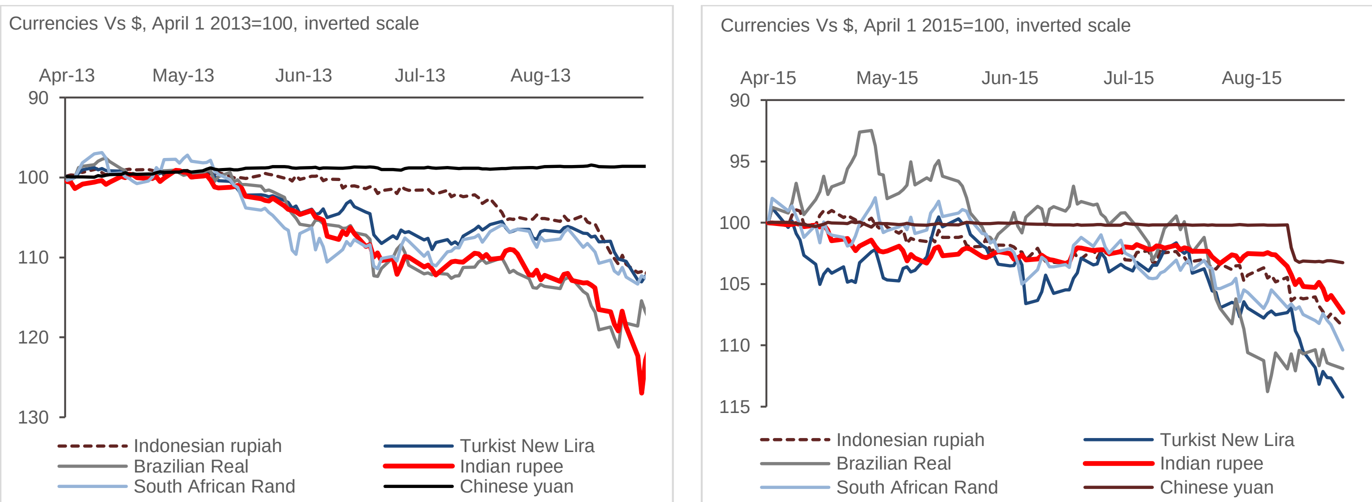
While our external vulnerability has declined, the frequency of global shocks has increased.

Moderating Vulnerabilities

First point to note is that this is not 2013. Back then, India's external vulnerability was high (high current account deficit, or CAD) and macroeconomic parameters weak (rising inflation, high fiscal deficit and low growth). India's macros have improved considerably since then – CAD is in safe zone, inflation is low, fiscal situation is better and growth is grinding up. Indeed, India's external vulnerability has not only declined over time, but also vis-à-vis peers (*Appendix, Table 1*).

Forecast at 1.5% of GDP for fiscal 2016, India's CAD, for one, is one of the lowest among major emerging countries, helped by lower commodity prices – especially oil. Commodity exporting countries such as Brazil and South Africa, on the other hand, continue to see high levels of CAD. In addition, short-term external debt as a percentage of total external debt remains benign in India (at 19% in 2014).

Chart 1: Currency volatility versus the U.S dollar : 2013 and 2015



Source: Respective Central banks, CRISIL Research

On other macroeconomic indicators, compared with 2012, the growth inflation mix in India has turned for the positive – with inflation climbing down and growth picking up. In contrast, in other emerging economies, such as Brazil, growth is expected to decline further in 2016 while inflation is estimated to pick up (*Appendix, Table 2*).

All this is reflected in relatively lower depreciation of India's currency, this year, compared to peers. The rupee has depreciated 9% year-on-year (as of August 25, 2015), while the Brazilian real has fallen 58%, Malaysian ringgit 32.6%, and the South African Rand 23% *(Chart 1, Table 1)*.

Table 1: INR has performed better than its Asian peers

Vs. USD	% depreciation*			
	Compared to last year	Compared to the beginning of 2015 (1 Jan'15 to 25 Aug'15)	Before Chinese devaluation (1 Apr'15 to 11 Aug'15)	Since Chinese devaluation (11 Aug'15 to 25 Aug'15)
Brazil	58.2	33.9	10.0	2.9
China	4.2	3.3	0.2	3.2
India	9.2	4.5	2.6	3.7
Indonesia	19.8	12.2	4.3	3.3
Malaysia	32.6	19.2	6.2	6.7
Mexico	31.0	16.2	6.9	5.3
Philippines	6.2	3.9	3.6	0.9
Russia	90.6	17.2	11.8	7.1
South Africa	23.2	12.7	6.0	4.0
Thailand	11.1	7.8	8.1	1.2
Turkey	34.4	25.0	7.2	5.3

Note: * till 25 Aug 2014

Source: Respective Central Banks, CRISIL Research

Then why has rupee depreciated?

The current situation is best captured in a simple equation:

Stress = f (shock, vulnerability)

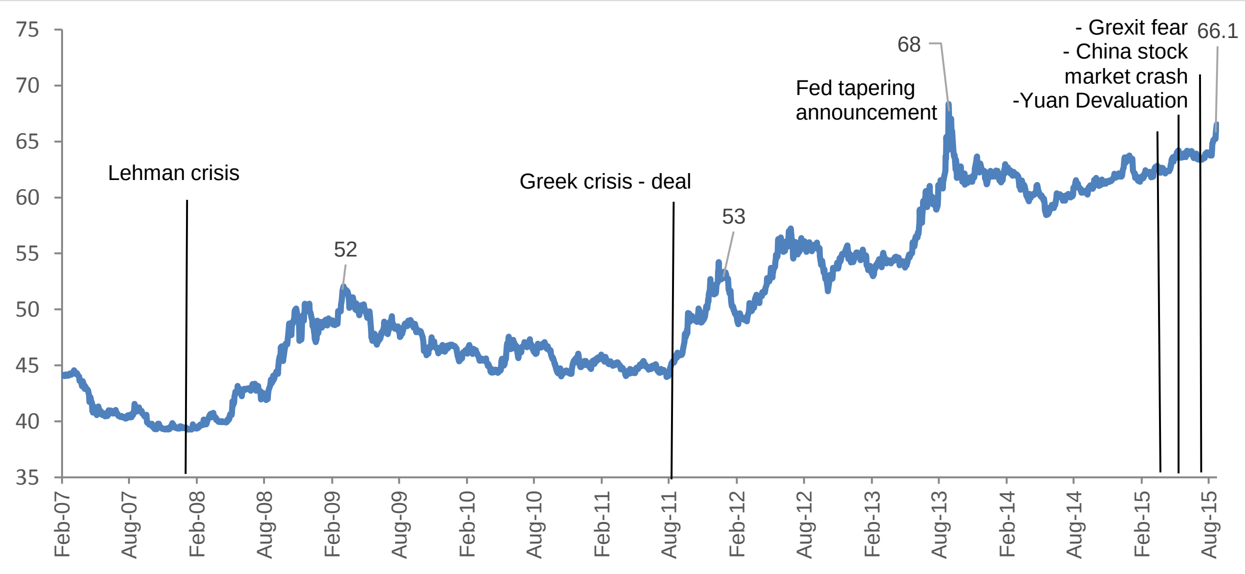
The 2013 depreciation was a case of high vulnerability but a single shock (the so-called taper tantrum led by U.S Federal Reserve announcement of QE withdrawal).

Since then, while India's macroeconomic fundamentals have improved and external vulnerability reduced, the shocks have become more frequent. The 2015 depreciation (current) episode is a case of reduced vulnerability but frequent shocks.

In June 2015, the uncertainty surrounding the Greek debt crisis loomed, which brought down the rupee to 64/$ from 62.6/$ at March-end 2015. In July, the Chinese stock market crashed, with the Shanghai Composite index falling 8.5% in a single day – the worst one day drop since February 2007. So, even as fears over a Greek exit abated, the volatility in the Chinese stock market kept the rupee under pressure in July.

More recently in August, China devalued its currency (by 4%), announcing a change to the daily fixing rate against the US dollar. The fragility of the Chinese economy, with weak demand and continued depreciation of the Yuan has depressed commodity prices and created jitters in currency and stock markets across the world. The ripple effects are being felt in India, too – with a decline in the rupee to 66.13/$ (as of 25th August 2015). The rupee has depreciated 3.7% since the announcement of the Chinese devaluation. The rate cut by the People's Bank of China on August 25 has lifted sentiment and provided some boost to the markets and emerging market currencies, albeit the relief is only marginal.

Chart 2: Rupee/USD - weathering global shocks



Source: CEIC, CRISIL Research

Overall, the frequency of shocks have increased in recent months and though India is better placed than other emerging economies, the rupee has also started losing ground. Net inflows from foreign institutional investors between April and July were a paltry $0.8 billion compared with $17 billion in the same period last year. Indeed, May and June had seen net outflows of $2.2 billion and $0.2 billion, respectively, and so far even August has seen a net outflow of $1.4 billion.

Is the depreciating rupee offsetting the gain from falling commodity prices: What is the net impact on imports?

Imports in India have contracted over the last eight months. Cumulatively this fiscal, the dollar value of imports between April and July was down 12% year -on-year. In rupee terms, however, the decline was

a more measured 6.7%, indicating the decline in global commodity prices has in part been offset by weakening of the rupee. The local currency has depreciated 6.1% on-year during April-July.

However, overall, the decline in commodity prices remains larger than the depreciation in the rupee. The currency has declined 10% since June 2014, much less than the sharp decline in commodity prices seen since June 2014 *(Table 2)*. ***The result: a lower import bill. The benefit is the most for oil imports.***

The decline in imports has been driven by falling commodity prices, especially crude oil imports, which fell 40% y-o-y in dollar terms between April and July'15. However, in rupee terms, the decline in oil imports has been lesser – at 36% for the same period. In volume terms, crude oil imports have actually risen 9.8% over the same period. We continue to benefit from lower oil prices, despite the rupee depreciation.

Crude oil and petroleum products account for 26% of India's imports. Crude oil prices started declining from June 2014 and have seen a 60% fall since then. A major part of this decline has come through since April 2015. After the Yuan devaluation, crude oil prices have fallen 11%. In addition, other commodities such as steel, aluminium and copper have also recorded a decline of 10%, 18% and 19%, respectively, since April 2015. This has helped lower the value of imports and hence benefitted the current account deficit.

Table 2: Commodity prices versus rupee depreciation

	% decline*			
	June - 2014 till date	Compared with last year (y-o-y)	Since fiscal year beginning (till Aug 25, 2015)	Since Chinese devaluation (August11 to 25, 2015)
Crude oil	-61.3	-57.6	-27.2	-11.1
Steel	-36.8	-36.5	-10.1	-7.1
Aluminium	-19.0	-26.8	-18.2	-4.0
Copper	-28.0	-30.2	-18.9	-4.9
Coal**	-21.0	-18.0	-1.7	-5.0
Gold	-11.1	-12.2	-5.1	2.6
	% depreciation *			
Rupee	10.0	9.2	6.3	3.7

Note: * till August 25, 2015, ** Thermal coal

Source: CEIC, CRISIL Research

Outlook: Rupee at 64 by March 2016

- **Two-third chance of rupee at 64/$**
- **One-third chance of rupee at 67/$**

CRISIL Research, in the base case scenario, expects the rupee to appreciate from the current levels (Rs 66.1 per dollar as of August 25), to settle at around 64 per dollar by March 31, 2016. We assign a two-in-three chance to this event. On the domestic front, the key underlying assumption is that the gradual improvement in India's macroeconomic indicators (a low CAD, falling inflation, lower fiscal deficit) will continue. And this would be accompanied by some more credible policy measures to improve ease of doing business, which can improve investor appetite.

The following factors should improve investor sentiment and stimulate return of capital inflows:

- Growth rate differential that India maintains with the West and other emerging markets
- Current account deficit, inflation and fiscal situation under control

In an alternative scenario, CRISIL Research expects the rupee to settle at around 67/$ and assigns a one-in-three chance to this event. This scenario assumes a status quo in domestic policy setting and ongoing global turbulence continuing. Although the pressure on current account will ease to some extent, due to lower global crude oil prices and declining gold imports, there could be an outflow of foreign capital if Fed surprises the market with a rate hike that will put pressure on the rupee.

We, however, regard the possibility of a situation akin to the taper tantrum of 2013, wherein there are significant capital outflows, as a tail event.

Facing the next shock: Fed interest rate hike

Given the ample foreign exchange reserves to combat the volatility in the rupee – the Reserve Bank of India had close to $354 billion in foreign exchange reserves as of 14 August 2015 – the rupee will be range bound.

While Standard & Poor's believes the first rate hike by U.S Federal Reserve could happen as early as September, the odds of it being postponed to December are now rising on fears that the US labour market could throw up weak data going ahead. The expectation that the rate hike will be postponed to December is also reflected in softer 10-year government bond yields in the US – down 2.06% as of August 25 compared with 2.45% at the beginning of July.

The normalisation of interest rates and the recent strength of the dollar will have an impact on capital flows and the exchange rate in emerging economies. As for India, improving growth-inflation mix and a low current account deficit puts it in a better position to deal with financial market volatility and outflows in the event of an interest rate hike by the Fed. In addition, an increase in foreign exchange reserves to nearly $354 billion (25 August 2015) compared with $270 billion during the 'taper tantrum' of July-August 2013 improves the ability to defend the currency. However, a stronger dollar might adversely impact businesses with foreign currency debt exposure.

Appendix

Table 1: External vulnerability indicators

	CAD (% of GDP)**		Short-term external debt/Total external debt (%)	Import cover (in months)
	2014	2015F	2014	2015*
Brazil	-4.5	-4.1	9.5	19
China	2.1	3.9	79.2	22
India	-1.3	-1.5	18.9	10
Indonesia	-2.9	-2.6	16.7	7
Malaysia	4.4	2.9	37.4	6
Mexico	-2.1	-2.8	20.5	6
Philippines	4.5	5.0	16.5	15
Russia	3.2	3.2	11.8	14
South Africa	-5.4	-4.6	22.1	6
Thailand	3.2	4.9	28.9	10
Turkey	-5.8	-4.7	33.2	6

Note: ** Forecasts from S&P, *value of 2014 imports/Foreign exchange reserves latest available

Source: World Bank, CRISIL Research

Table 2: Domestic macros - growth, inflation, fiscal deficit

	GDP % yr			Inflation % yr			Fiscal balance % GDP		
	2012	2014	2015F	2012	2014	2015F	2012	2014	2015F
Brazil	1.8	0.1	-1.5	5.4	6.3	8.4	-2.3	-6.1	-9.2
China	7.7	7.4	6.8	2.6	2.0	1.3	-0.2	-0.7	-1.6
India	5.1	7.3	7.4	10.2	6.0	5.8	-4.2	-4.1	-3.9
Indonesia	6.0	5.0	5.4	4.0	6.4	6.2	-1.8	-2.2	-2.3
Malaysia	5.5	6.0	4.6	1.7	3.1	1.7	-7.9	-5.9	-5.5
Mexico	3.8	2.1	2.5	4.1	4.0	3.3	-2.6	-3.2	-4.4
Philippines	6.7	6.1	6.0	3.2	4.2	2.1	-1.2	0.4	-0.8
Russia	3.4	0.6	-2.6	5.1	7.8	14.6	0.4	-1.2	-4.4
South Africa	2.2	1.5	2.1	5.6	6.1	4.9	-4.2	-3.5	-3.6
Thailand	7.3	0.9	3.4	3.0	1.9	-0.1	-0.3	-0.1	-0.6
Turkey	2.1	2.9	3.0	8.9	8.9	7.2	-2.1	-1.3	-1.5

Note: F is S&P and CRISIL Forecasts; values for India are in fiscal year and for other countries in calendar year

Source: S&P, CRISIL Research

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