

Quickonomics

November 10, 2020

Thumbing nose at recession

The Indian rupee's stability amid the Covid-19 pandemic, which has roiled economies around the world, is both comforting and puzzling.

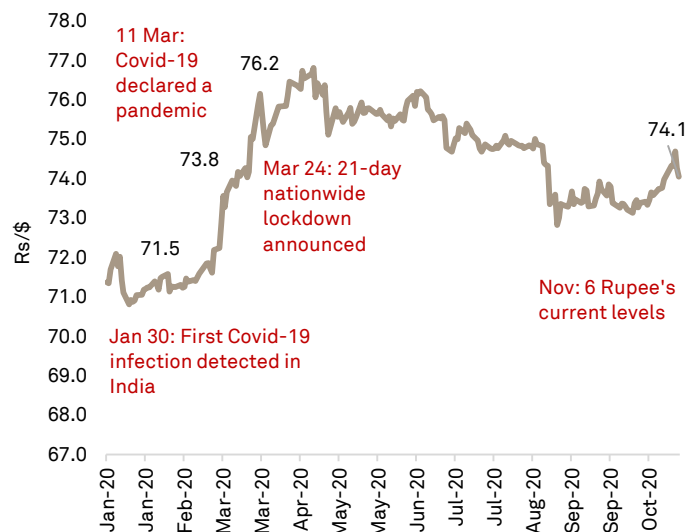
After depreciating sharply around when the pandemic was declared and the national lockdown announced in March, the rupee has appreciated against the United States (US) dollar since May 2020.

As of October-end, the rupee settled at 74/\$, much higher than the level of 76.8/\$ reached in March.

Rupee's movement in times of crisis

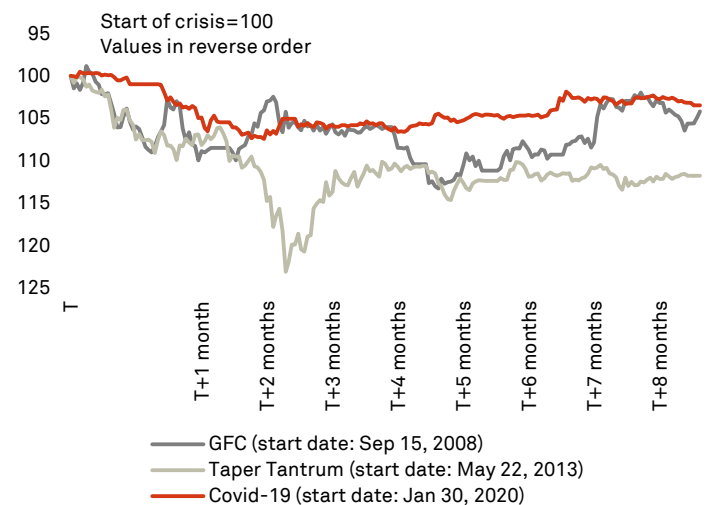
The rupee's current appreciation is at odds with its own behaviour during previous crises. In the past, it has usually depreciated sharply when the economy came under pressure: In the immediate aftermath of the Global Financial Crisis (GFC) of 2008, it depreciated and was below (~5%) pre-GFC levels even eight months after the crisis. During the Taper Tantrum of 2013, the depreciation was lagged, but much sharper, and similar to the GFC trend, the currency did not fully recover.

Comparing these three episodes, the rupee's initial depreciation has been least during the pandemic, and its recovery thereafter relatively swift. In fact, the rupee has been least volatile in this crisis: during the pandemic, the standard deviation (a measure of volatility) was 2.0 points, lower than that during the GFC (2.9) and Taper Tantrum (~4.0).



Source: FBIL, CEIC, CRISIL

No tantrums this time: Rupee has remained the most stable relative to other crisis episodes



Source: RBI, CEIC, CRISIL

Better than its BRICs peers, except China

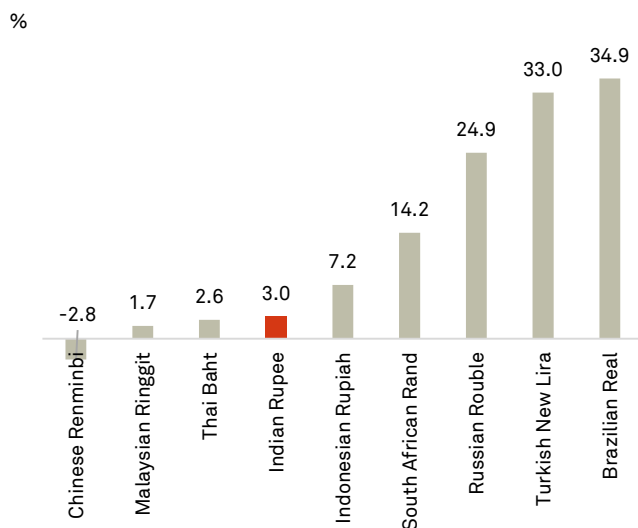
In the current crisis, the rupee's performance places India in the camp of emerging economies which have seen currency stability, i.e., China, Malaysia and Thailand.

From January till October, the rupee's average depreciation was relatively lower (~3%) as compared with its BRICS (Brazil, Russia, India, China, and South Africa) peers. This is with the exception of China, which has seen its currency appreciate overall. Some other key emerging economies such as Indonesia, Turkey, and Brazil witnessed sharper depreciation of their currencies. The Chinese renminbi's appreciation is understandable given the economy's fast recovery. The Malaysian currency's rise is supported by the recent increase in oil prices, while the Thai baht has benefited from the surge in gold prices and doubling of foreign direct investment (FDI) in the first half of 2020. In contrast, the currencies of India's BRICS peers, Brazil and South Africa, have been worst-hit: owing to South Africa's sovereign downgrade and the sharp sell-off by foreign investors in Brazil (largest among emerging markets in the first quarter of 2020), respectively.

Amid all this, Indian rupee's relative stability is an outlier of sorts.

In the league of stable currencies

Depreciation in currencies January-October 2020



Source: CEIC, CRISIL

What are the answers to this currency conundrum?

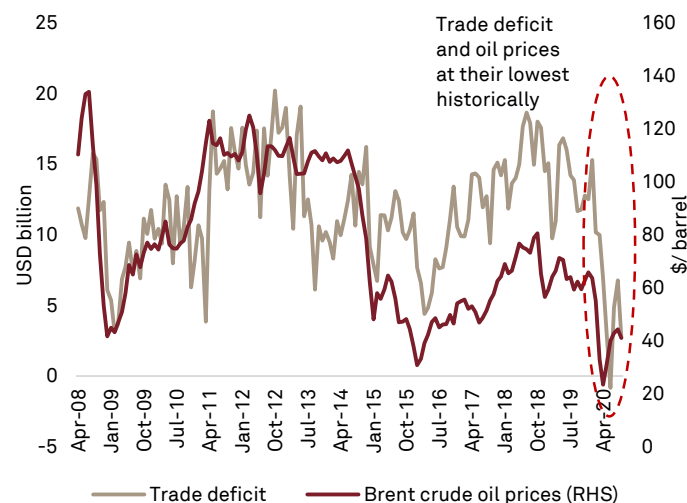
This time, it's different

Multiple domestic and global factors that impact the rupee have nudged it towards strengthening against the greenback:

- **Surplus current account balance** since the past two quarters, helped by low oil prices and weak import demand in general
- **Robust foreign investment**, which has bounced back amid abundant global liquidity
- **Record-high forex reserves** of \$544.7 billion (as of September-end), which now cover more than 16 months of imports
- **Low proportion of short-term debt** (18%, as of first quarter this fiscal) of total foreign debt
- **Weakening tendency of the US dollar**, with the dollar index falling over 5.5% between May and September

Let's take a detailed look at each of these.

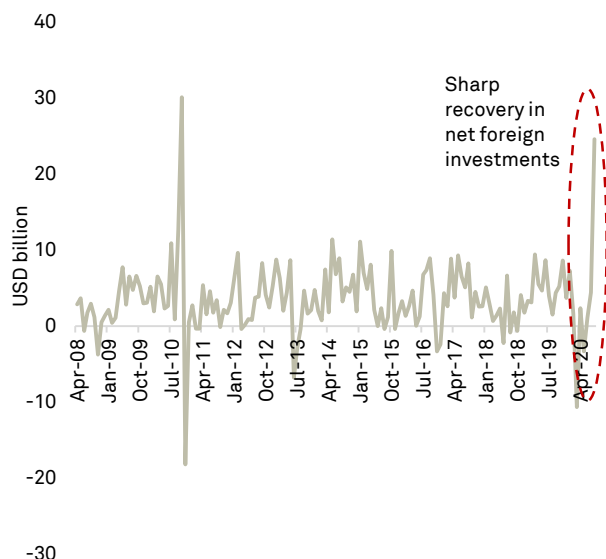
Current account recorded the highest-ever surplus of \$19.8 billion, or 3.9% of India's gross domestic product (GDP), in the first quarter of this fiscal. In the fourth quarter of fiscal 2020 too, it was in surplus. A sharper fall in imports relative to exports, reflecting weak domestic demand, narrowed the goods trade deficit and improved the current account. The goods trade deficit has, in fact, been the lowest since the GFC. Falling Brent crude prices have also led to lower imports. We expect the current account to be in surplus at 0.8% of GDP this fiscal. To put that in perspective, India's current account balance has been in surplus only 11 times since Independence, fiscal 2004 being the previous.



Source: Ministry of Commerce and Industry, CEIC, CRISIL

Foreign investment inflows (net, inclusive of direct and portfolio) declined sharply around the time the pandemic was declared, due to high risk aversion. However, they have bounced back since, amid abundant global liquidity. Particularly, growth in FDI into India, through cross-border mergers and acquisitions, has doubled in value in the first half of 2020 (from 2019), in sectors such as digital economy, infrastructure and energy (UNCTAD, October 2020). Foreign portfolio investments (FPI) have also rebounded: Regulatory changes may have played a role in their return. India raised the limit for FPIs in corporate bonds to 15% of outstanding stock for this fiscal to inject liquidity into the corporate bond market, and had increased the investment cap of the voluntary retention route for investment in Indian debt. In contrast to the sharp recovery in foreign investments in 2020, slow recovery post decline in

foreign investments characterised the GFC and Taper Tantrum episodes, hence prolonging the currency's depreciation.

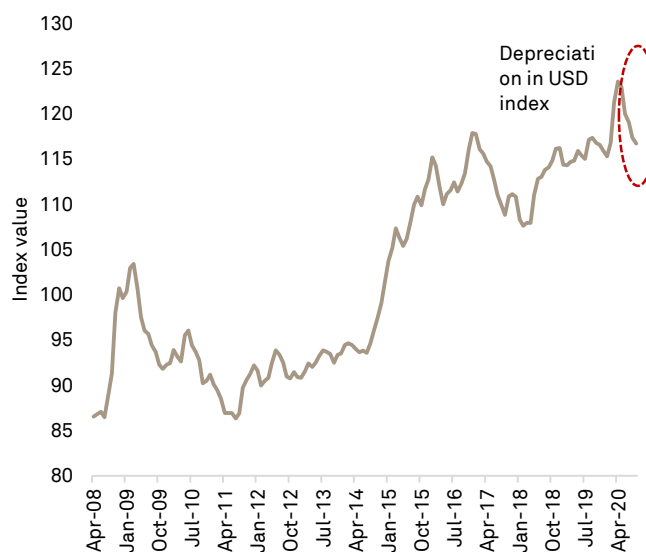


Source: NSDL, CEIC

Foreign exchange reserves reached an all-time high at \$544.7 billion in September 2020, with a comfortable import cover of more than 16 months year, thanks to the Reserve Bank of India's (RBI) dollar-buying spree and inflow of foreign funds

A declining dollar index for the past five months is another reason. The movement of the dollar index affects that in the rupee exchange rate. The dollar index measures the strength of the greenback against a basket of foreign currencies, and a fall in its value indicates depreciation.

After appreciating at the beginning of the year, as rising risk aversion prompted a demand for the safe-haven currency, the index has been falling since five months now. It fell by over 5.5% between May and September. This is a reflection of improved risk sentiment, and also concerns over the US economy's recovery given the large number of Covid-19 cases in the country, as pointed out by the International Monetary Fund in its latest World Economic Outlook. In contrast, during the GFC, the index had risen sharply, adding to the weakness in the rupee



Note: A fall in the \$ index indicates depreciation
 Source: Federal Reserve Bank of St Louis

What the rupee's appreciation implies

- 1. Terms of trade are stacked against India's exports:** The real effective exchange rate (REER)¹ has appreciated 2.7% from April to September 2020, reducing the currency competitiveness of exports. This is of concern, given the importance of exports in revival of the domestic economy. Given that exports have seen positive growth on-year only in September, supporting that momentum assumes significance.
- 2. Imported inflation is contained:** This is particularly helpful at a time when domestic inflation has consistently been outside the central bank's target range.
- 3. Comfort for Indian corporates with loans from abroad.** External commercial borrowings (ECB) in fiscal 2020 had increased ~24% on-year, buoyed by the central bank relaxing ECB rules, and relatively lower global interest rates. A rupee appreciation means servicing of the foreign-denominated debt of Indian corporates would remain under control when balance sheets are stressed on account of the hit to operations domestically.

¹REER measures the competitiveness of the currency with respect to a basket of currencies of major trading partners. It is adjusted for inflation effects

What's in store next

Going ahead, the rupee is expected to average 74/\$ by March 2021. Global interest rates are expected to be low through the year; thus, easy monetary policies may support the rupee, with foreign portfolio investors returning to emerging markets.

Further, the current account surplus will likely be at 0.8% of GDP this fiscal, with the hit to domestic demand and softer crude oil prices reducing imports.

That said, uncertainty regarding the pace of the economic recovery owing to the spread of the pandemic persists.

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