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Rupee movement, Fed rate hike... What is one to make of it?

Contact:

Madan Sabnavis

Chief Economist

madan.sabnavis@careratings.com

91-022-67543489

Manisha Sachdeva

Associate Economist

Manisha.sachdeva@careratings.com

91-022-67543675

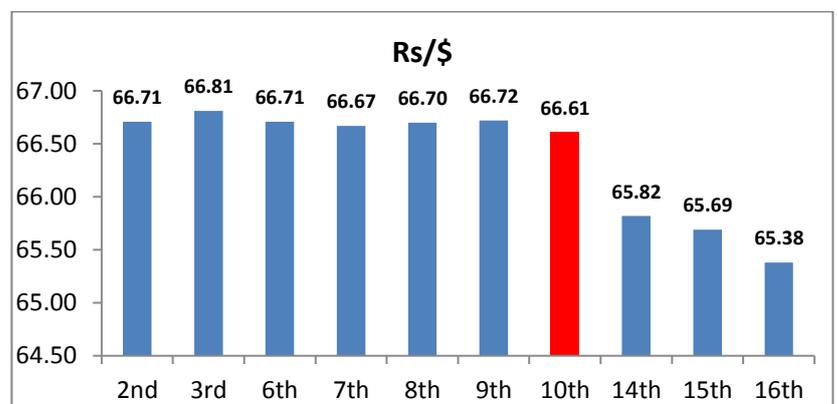
Mradul Mishra (Media Contact)

mradul.mishra@careratings.com

91-22-67543515

The rupee has started appreciating quite sharply following the announcement of the state elections results where the BJP and its alliances have secured an overwhelming support to form governments in 4 states. It is largely expected that the government will be in a position to accelerate the pace of reforms which will bring about higher growth in the economy. This has caused a rally in the forex market with the rupee strengthening sharply.

Exhibit 1: Exchange rate movements from 1st March'17- 16th March'17



Source: RBI

As can be seen in the graph above, the rupee traded in the region of Rs 66.70 since the beginning of the month and ended at 66.61 on Friday before the counting began for the state Elections. Subsequently the rupee has strengthened by 1.8% in three trading days (based on RBI Reference rate) to close at 65.38 on Thursday. In absolute terms it has appreciated by Rs 1.23/\$.

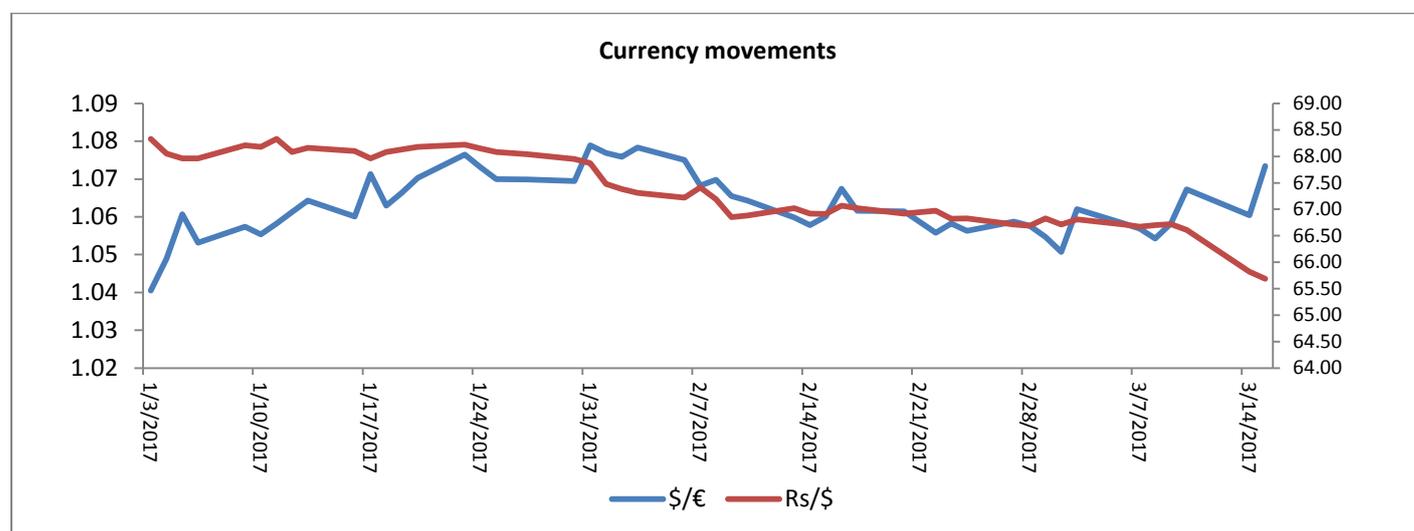
Why has the rupee strengthened?

1. The overriding factor has been positive sentiment and the expectation that foreign funds would come in larger numbers as policy implementation will be both aggressive and easier.
2. FPI funds have been stronger at \$ 2.289 bn this month with equity flows being very strong. However, this has been the case even prior to the Elections results being announced.
3. The recent trade data released for February showed exports increasing by 17.5% - an all-time high since Sept 2011. Though this is a one-off case, the markets today have perceived it positively.

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- Speculative forces which become reinforcing where exports sell more and importers demand fewer dollars thus strengthening the rupee further.

Exhibit 2: Movements in \$/€ and Rs/\$ rates



Source: RBI/CNN Money

The chart above traces the movements in both the \$/€ and Rs/\$ rates. As can be seen, the dollar has been moving in a narrow range of 1.04 to 1.07 while the rupee has tended to become stronger gradually with the final push coming in the last few days.

Implications of a stronger rupee

- Exports lose their shine as the competitive edge is lost. The rupee has already been one of the best performing currencies with the dollar holding on against the euro. In these conditions further appreciation will come in the way of growth in exports.
- Stronger rupee makes imports cheaper and they will tend to increase. In particular, gold imports could go up.
- Foreign investors will feel happier with a stronger rupee as it denotes stability.
- Remittances will deliver lower rupee value when converted to rupees.

Is this appreciation sustainable?

We do not think that this is sustainable unless the fundamentals alter sharply to justify this movement. The range of 66-66.50 looks more likely to prevail once the noise factor in the market diminishes. According to market sources, the RBI has started talking to banks to tone down the level of enthusiasm. Forex assets continue to remain stable at \$ 364 bn which does not warrant a sharp appreciation on a continuous basis.

How does the Federal Reserve rate hike fit in?

The Federal Reserve has raised interest rates as was expected and hinted at 'further' 'gradual' increases in the target rate during the year. The US economy is picking up momentum with the unemployment rate expected to remain in the 4.5%

range and inflation move up towards 2%. As monetary policy has to be forward looking the Fed may be expected to raise rates two more times this year by 25 bps each.

This coupled with the strong impetus to be provided by the government to growth through lower taxes and higher spending will accelerate the demand for goods thus making these rate hikes a natural corollary. This also means that two things will happen – one, the dollar will continue to be strong especially so as Japan is still to grow and the European area is under pressure of low growth and fragmentation. Second, investors may decide to gravitate back to the US shores which can mean a lower supply of funds to the emerging markets including India.

RBI's role...

In the current situation the RBI will view these developments more from the forex angle rather than interest rate consideration as monetary policy will be determined by CPI inflation and hence be data driven.

Concluding remarks

We do believe that the current trend of appreciation in the rupee will get corrected in the next few trading sessions. The fundamentals do not signal any sustained strengthening of the rupee and the RBI will have a role to play in correcting sentiments. The Fed rate hike should be viewed as a part of a campaign at increasing interest rates during the year which will keep the dollar firmer. From our point of view, flow of FPI, FDI and NRI deposits would tend to get affected besides ECBs where there may be less incentive to borrow from overseas markets.

CORPORATE OFFICE:

CREDIT ANALYSIS & RESEARCH LIMITED

Registered Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East), Mumbai - 400 022.

Tel: +91-22-6754 3456 | Fax: +91-22-6754 3457

E-mail: care@careratings.com | Website: www.careratings.com

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