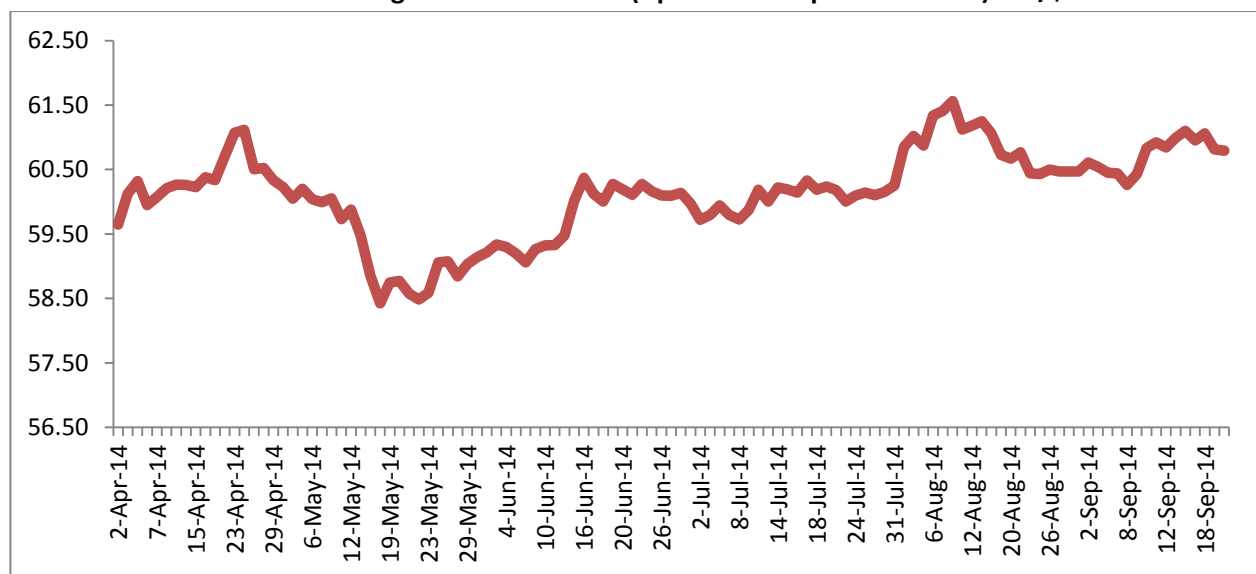


Exchange Rate Movement & Expectations

The steep decline in the Indian rupee came to be the foremost economic concern for a large part of FY14. Following a series of policy measures by the RBI and the government, the rupee strengthened from its record lows (Rs.68/\$) and has fairly stable in range of Rs.60-62/\$ since Q4 FY14. The stability of rupee was aided by the improvements in the country's economic fundamentals viz. the narrowing of the CAD and the increase of foreign inflows into the country.

Movements in the rupee

Chart 1: Exchange Rate Movement (April – 22nd September FY15) Rs/\$



Source: RBI

Chart 1 above shows the movement of the rupee dollar rate since the beginning of April 2014. The rupee has remained stable in this financial year so far. Since April 2014 the rupee has averaged Rs 60.1 per dollar, and remained in the range of Rs 58.4 – 61.6/ \$ up to 22nd September 2014.

Fundamentals driving the rupee

Besides sentiment, which is difficult to quantify, the exchange rate is driven by basic forces of demand and supply for foreign exchange or dollars. Data on foreign exchange rate is available on a daily basis but the factors that influence this rate come with different periodicity. The FII inflow which is a major factors that affect the movement, is available on a daily basis. However other fundamentals that affect the exchange rate such as forex reserves, trade balance are available on a weekly and monthly basis respectively.

Table 1 – Exchange Rate and Forex Reserve

Months	Rs/ \$ Average rate	Forex Reserves (\$ bn)	Change in Forex reserves (\$ bn)
April	60.35	311	7.0
May	59.25	312	1.0
June	59.78	316	4.0
July	60.06	320	4.0
August	60.90	318	-2.0
September	60.72*	317^	-1.0

Source: RBI (*data up to 22nd Sept'14, ^ data up to 12th Sept'14)

The fundamental driving the rupee movement is ultimately the change in foreign exchange reserves - decline in the forex reserves would result in depreciation of the currency. In FY15, Foreign currency assets increased in the first four months from \$ 311 bn in April to \$ 320 bn July; it declined marginally in the month of August to \$ 318 bn which also corresponds with the slight depreciation of the domestic currency. The factors that drive the fundamentals are mentioned below –

Trade Balance and Current Account Deficit

The trade deficit for April – August FY15 stood lower at \$ 56 billion as against \$ 70 billion in the corresponding period last fiscal. Exports were \$ 135 as against \$ 126 bn registering a growth of 7.3% while imports at \$ 191 bn, declining by 2.7%.

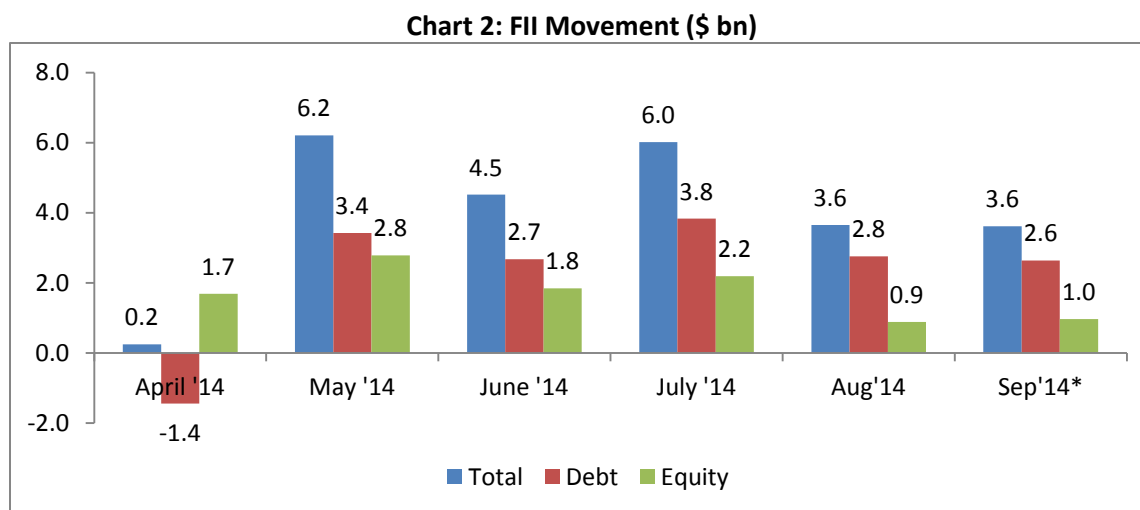
For the entire year, there is growing optimism that exports will improve, with expectations of improvement in global economic prospects and increase in consumption demand in advanced economies viz. the euro zone and the US. The country's imports too are expected to see an increase, especially the non-oil imports with the resurgence in the domestic economy. Oil imports are also expected to increase but the declining crude oil prices will provide a buffer. With the improving trade balances, the fundamentals appear to be stronger pointing towards a stable rupee.

Also, the CAD for the first quarter of the year has come in at 1.7% of the GDP with the absolute number being \$ 7.9 bn. The CAD has been under control in the last four quarters mainly due to compression of the trade deficit which was brought about by both controls on import of gold as well as lower non-gold-non-oil imports due to the slowdown in the economy. Any recovery in the economy will lead to the widening of the trade deficit relative to last year. CAD in the coming quarters is expected to be driven by the trade numbers. Based on current trends we expect the CAD to be 2-2.5% of GDP for the year.

FII movement

In FY14, the country witnessed a sudden and significant (net) outflow of funds, which led to a sharp drop in FII inflows and consequently for the year as a whole the country saw a 66% decline in net FII inflows from that in the

previous year. In FY15, with the improving sentiments a sizeable increase in FII inflow has been seen. Barring the month of April, more FII inflows have been in the form of debt instruments rather than equity.



Source: NSDL, *Data as of 22nd Sept'14

With the Federal Reserve cutting its bond-buying program down to \$15 billion a month and indicated quantitative easing to end in October, capital inflows in to the country is likely to moderate to a certain extent. However with China's own brand of QE through recap of banks would increase the reservoir of investable resources. Also, the ECB has hinted towards quantitative easing programme, opening doors to more FII inflows in the emerging markets. Also a pro-growth government in the centre is expected to further aid the inflow of these funds.

Based on the current trends, we expect FII inflows to be around \$35-40 bn for the entire year.

FDI

India remains one of the top destinations for FDI inflows. In terms of FDI, the country has received \$ 8,168 million in Q1 FY15 as against \$ 6,488 million in Q1 FY14. Based on DIPP data FDI investment for the first four month of the financial year stood at \$ 10,736 million (\$ 7,053 in the corresponding period last year). FDI inflows are expected to continue to increase in the coming months, *with \$35-40 billion of inflow for FY15.*

RBI Action

RBI plays a major role in regulating the exchange rate by buying or selling foreign currency. RBI has purchased dollars worth 15.7 billion till July 2014 as against a purchase of 8.9 bn in FY14 and -7.8 bn (between April – July 2013). It has been noticed that in the current financial year RBI has been purchasing dollars to maintain the exchange rate around the Rs 60 mark. Hence, any movement of the rupee below the 60 mark would result in RBI taking action with buying more dollars.

Going Forward

The exchange rate movement in largely depend on the sentiments, which is guided by the FII flows and the forex reserves. There have been net accruals to the forex reserves of \$ 17.6 bn (as of 12th September 2014) which is a positive for the economy as the rupee has been stable. ***We expect such stability to persist with a broad range of Rs 60-62/ \$ to prevail. Presently the rupee is in the region of Rs 61/\$ and can weaken towards December when FIIs could book their profits. We do believe that any sharp strengthening of the rupee below Rs 60/ \$ into the fifties will prompt purchase of dollars by the RBI to stabilize the rupee. Similarly, weakening beyond Rs 62 could have the RBI moving in to stabilize the rupee.***

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