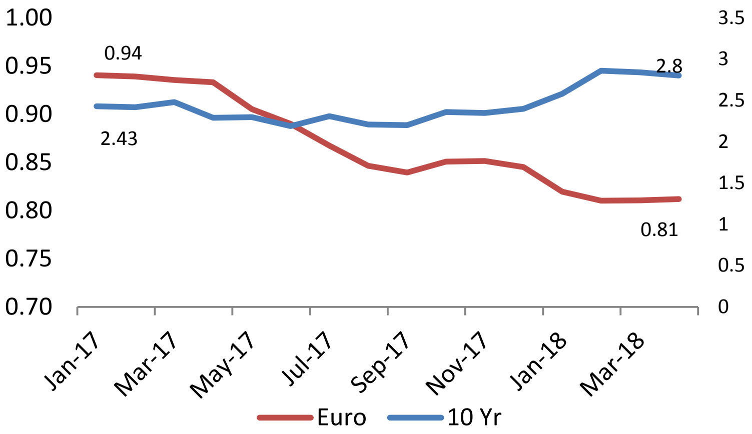
The rupee has started dropping vis-à-vis the dollar in the last couple of months which is different from what it was last year when it was appreciating. This can be put in the context of global developments where several currencies have appreciated against the dollar which weakened against the euro. Subsequently there had been change in direction for some currencies.

The dollar continues to weaken against the euro

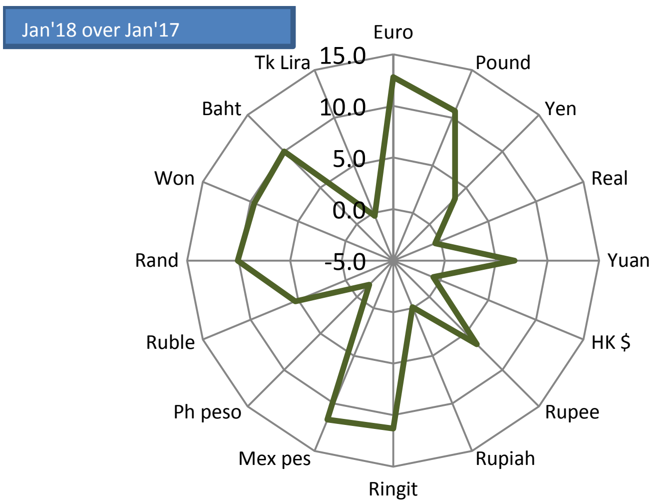


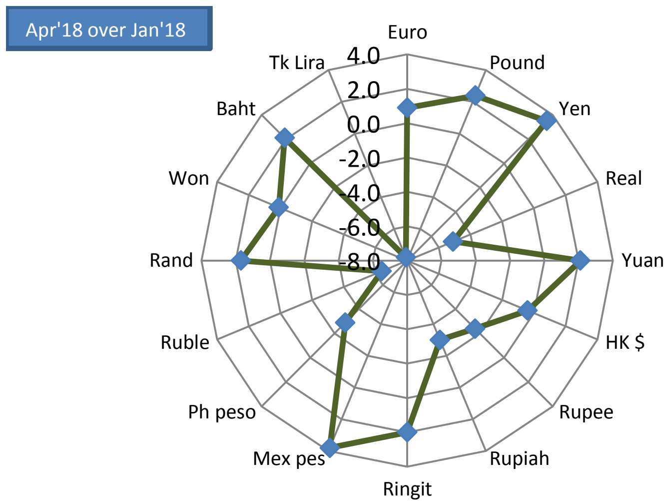
The chart alongside plots the movement of the dollar-euro rate for the period January 2017 onwards to April 2018. As can be seen the rate has come down from 0.94 to 0.81. The movement between Jan 2018 and Jan 2017 was 13%. It was widely expected that tax cuts and interest rate normalization would bring dollars back to the US and make the currency stronger. Similarly the tariff hikes being discussed should strengthen the domestic economy and the dollar, which has not worked out this way so far. The Fed being behind the curve on inflation can be one plausible reason for the dollar's weakness. The strong push on infra which was spoken of during Elections has not materialized which could be another reason keeping the dollar weak.

Further signs of sharp recovery in Europe's economy, particularly Germany and France, are causing some investors to flock to the euro instead of the dollar. The resurgence in Europe has more investors betting that the ECB will unwind its massive bond-buying program, similar to the Fed's after the 2008 financial crisis, sooner than expected. That would push up European bond yields and make the euro even more attractive compared with the dollar. Some even speculate that the ECB could start to raise interest rates later this year or early next year. Further, political dysfunction in the United States is also pushing the dollar down. The administration's plan to roll out tax reform could also slip as a result of the Republican-led healthcare overhaul bill.

How have currencies moved vis-à-vis the dollar?

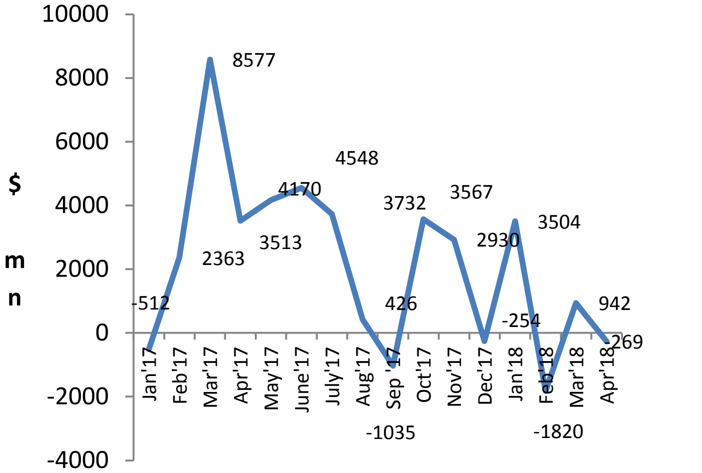
Currencies gained between Jan 2017 and Jan 2018 while some tended to lose subsequently till April





Of the 16 currencies considered here, 5 of them depreciated against the dollar in calendar 2017 which were real, Turkish lira, Hong Kong dollar, Rupiah and Philippines peso. The others had strengthened. However, in the subsequent period, there has been a reversal with there being 7 currencies depreciating including rupee and ruble. The won also was marginally stronger after rising significantly in 2017. A part of the reason could be fundamental distortions caused due to the oil price moving up which affected the flow of dollars as well as the Fed's stance on rates and the guidance of there being more rate hikes which caused a change in direction of investment flows. The tariff war with China has added to volatility.

FPI flows into India have been uneven in 2017 but been at lower levels post Jan'18



FPI flows will hold a significant clue to the future direction of the rupee in 2018

The RBI has already raised the limits for FPI in government and corporate debt while equity flows will be driven by the market. The important thing will be the yield differentials in Indian bonds and those of US and Europe. Presently the US treasuries are yielding 2.8-2.9% as against 7.5-7.6% for India. These rates have been affected by the ongoing tariff wars as well as elevated oil prices and signals provided by the RBI on future inflation and possible rate policy implications. With the forward rate being in the range of 4-4.2%, the differential between the two becomes critical for investors. Any decision taken by the RBI to lower interest rates would narrow down this gap making Indian markets less attractive for investors.

What to look out for in 2018?

Themes for the Dollar

- The US has already witnessed decline in the net international asset position and could run the largest twin deficits in recent history.
- Foreign investors are getting apprehensive about growing protectionism in Washington. As a corollary, any move towards actual negotiations between the US and China is likely to be a positive.
- Investors are not be as keen to finance mounting U.S. deficits which are historically correlated with weakening dollar
- World central banks seem to be losing confidence in the dollar and their allocation of FX reserves in dollar is at a four-year low
- Escalation of tension in Syria is another factor weighing on the market

But these could be glitches in the short run and the dollar may be expected to regain some of its strength. **The rate of 1 € = $ 1.23-27 could get reversed towards the end of the year as the Fed increases rates and the economy continues strengthening**.

The rupee determinants

- To be largely driven by fundamentals. We need to watch out for the CAD which involves the trade deficit, which widened of late and the invisible receipts. Software and remittance hold the key and should see an uptick in case world economy recovers.
- FPI and FDI would supplement the dollar inflows and will determine the final direction of the rupee based on fundamentals.
- Extraneous force can be the dollar still remaining weak which can firm the rupee.
- The rupee is nearing the 66 mark but this we believe is more due to the recent disturbances in the world geopolitics and may have less to do with fundamentals. **By March 2019, the rate should be between 66.5-67/$**

What the RBI does is also important as in FY18 (April-March), it bought $ 32.7 bn as against $ 12.4 bn in FY17 to steady the rupee from appreciating sharply. Forex reserves increased by $ 54.4 bn in FY18 as against $ 10.4 bn in FY17. Export boost is a consideration here.

Economics Department
022-67543489

Contact:
Mradul Mishra
Mradul.mishra@careratings.com
02267543515

CORPORATE OFFICE:
CARE Ratings Limited **(Formerly known as Credit Analysis & Research Ltd)**
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022; CIN: L67190MH1993PLC071691
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457
E-mail: care@careratings.com I Website: www.careratings.com