Currency market: After the panic

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2016 was fairly tumultuous for the currency markets with two major events exerting considerable influence over the movement in exchange rates – BREXIT and US Presidential Elections. The action of the Federal Reserve and status quo position of ECB were assumed to be known and were less likely to add to volatility in the market.

The victory of Donald Trump was particularly disruptive for the markets because of the presumed stance on different issues during the time of campaigning for Elections:

- Anti-immigration - especially from Mexico
- Protection of jobs of American citizens meaning thereby putting an embargo on immigration from other countries
- Higher government expenditure on infrastructure
- Lowering of corporate taxes in particular besides taxes on the rich
- Repeal of Dodd Frank regulation
- Revisiting the free trade agreements, especially NAFTA and TPP, thus gearing more towards protectionism

With the results of the Presidential Elections being announced there was substantial volatility in the currency markets and most of them fell relative to the dollar. The logic was that with the policies being implemented by the government and the US Federal Reserve increasing interest rates, the dollar would inherently become stronger which was reflected in the depreciation of almost all partner currencies. This was supported by the perspectives provided by multilateral agencies that USA would be the best performing developed country with the Euro region still taking time to recover even though the ECB has continued to be supportive. Japan continued to struggle to bring about growth as the government embarked on a multi-pronged approach. UK would remain in the speculative mode for some time given the final outcome of BREXIT.

The table below illustrated how currencies have moved vis-à-vis the dollar over two time periods. The first time period relates to averages of months and compares January 2017 with October 2016.(Donald Trump formally took over on 20th January 2017). The second column compares March over January (first few days of March – which in effect is February over January). This distinction is necessary because of two reasons: first, with the new President taking over there is likely to be more clarity on the actual policies to be followed and second, the initial panic that set in would tend to get corrected.

As can be seen, currencies which fell sharply in the first phase have recovered to a limited extent in the second. This is quite stark for Mexico where the peso which fell due to the single point attack made by the President on this country, which has gotten diluted over time. 16 currencies depreciated after October and the rupee was better performing being 13 in the hierarchy with the baht, Taiwanese dollar and real witnessing lower quantum of depreciation. The four currencies which appreciated were rand, pound, Hong Kong dollar and ruble.

Table 1: Currency movements vis-à-vis the dollar
(*Positive change is depreciation and negative sign is appreciation against the dollar).*

	Jan-Oct	Mar-Jan	Mar-Oct
Turkey lira	22.07	-1.56	20.16
Mexican peso	13.37	-7.58	4.78
Japan yen	10.54	-0.51	9.97
Malaysian ringgit	6.69	-0.13	6.55
Argentina peso	4.81	-2.99	1.67
Korean won	4.51	-2.63	1.76
Euro	3.56	0.86	4.45
Singapore dollar	3.10	-1.11	1.96
Philippines peso	2.90	1.19	4.12
Indonesia rupiah	2.65	0.20	2.86
China Yuan	2.39	-0.07	2.32
Australian dollar	1.97	-1.74	0.20
Indian rupee	1.94	-1.83	0.08
Thai baht	1.06	-1.14	-0.09
Brazil real	0.23	-2.18	-1.95
Taiwan dollar	0.15	-2.34	-2.20
Hong Kong dollar	-0.01	0.09	0.07
British pound	-0.17	0.56	0.39
South Africa rand	-2.66	-3.54	-6.11
Russian ruble	-4.54	-2.19	-6.63

Source: Pacific exchange rate services

During the second phase there was a correction in terms of an appreciation of currencies (denoted by negative sign in the table) in 13 of the 16 countries.

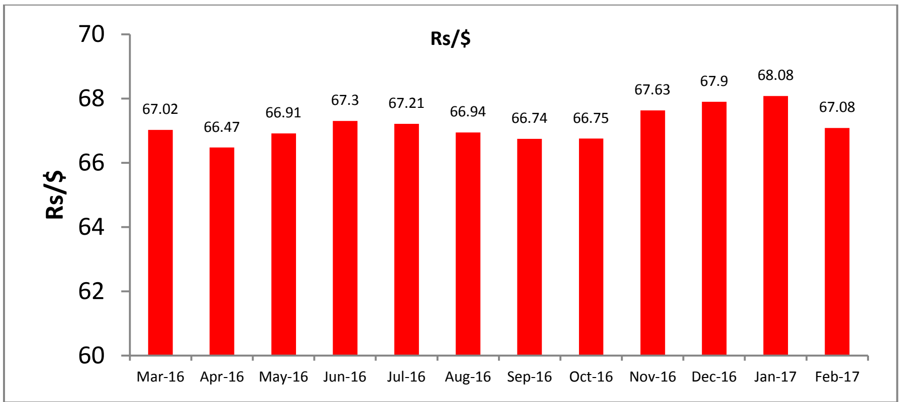
Going ahead, it may be expected that the Federal Reserve will be increasing interest rates at least twice this year by 25 bps each which will make the dollar stronger. Growth too in the US would be expected to be more buoyant especially with the fiscal stimulus to be provided by the government which will keep the Federal Reserve monitor these developments closely keeping in mind the inflationary potential of such growth as unemployment rates comes down progressively.

The only countervailing force would be a loss of export competitiveness for the USA as the dollar strengthens in a situation where other countries are satisfied with their currencies depreciating to boost their exports. This is one area of concern for the US during the course of the year as it also coincides with the government's protectionist policies. China in particular would be looking to prop up exports especially so if the US does slap punitive measures against imports from this region given that this has also been on the President's agenda.

Hence, the forex markets would be guided largely by how the American economy fares and the stated policies are pursued by the government in the areas of trade and protectionism.

The Indian rupee so far

The rupee has been a relatively better performing currency in this period, which is also the case when looked at from April onwards (Diagram).



As can be seen, on a point to point basis (average monthly rates) the value of the rupee has remained more or less unchanged with a peak being witnessed in January. A strong current account balance was the major cause of a stable rupee combined with measures taken by the RBI to counter volatility due to extraneous reasons. A major achievement was in maintaining this rate when there were outflows of the FCNR (B) deposits which were around $ 25-30 bn during the last quarter of 2016.

How will the rupee go?

Contrary to expectations that the rupee will move down during the year, the rupee has shown remarkable resilience, this can be traced to the fundamentals which have been strong.

Table 2
Forex fundamentals : FY16 and FY17

Variable (bn)	Period	FY16	FY17
Trade balance	10 months	-107	-86
Software	6 months	33.56	35.26
Remittances	6 months	32.68	28.20
FDI	9 months	33.5	33.6
FPI	11 months	-1.9	-3.3
NRI	9 months	11.6	-15.6
ECB (intention)	10 months	21.5	16.21
Forex reserves	***February end***	***346.8***	***362.7***

Source: RBI. CMIE

Table 2 provides details of the major heads of inflows of forex in the last 2 years for different months based on availability of data. It does show that the fundamentals driving the exchange rate so far this year has more or less evened out across the inflows. The major factor driving these developments has been the trade balance which was lower by around $ 20bn for the first 10 months of the year. Software receipts have maintained their levels, while remittances were lower mainly due to fewer opportunities overseas which also get linked to oil price besides growth prospects.

Factors that will drive the rupee

1. The most important factor will be the movement in trade balance. Contrary to expectations, crude oil price has been fairly stable in the range of $ 55-57/bbl which will provide a cushion for the imports bill. International prices of metals have been increasing which would be a factor that could drive the rupee down as imports climb. While exports too are expected to increase, with the non-USA markets not expected to show resurgence, the trade balance could still deteriorate relative to the picture seen in FY17.
2. There is some uncertainty in the software receipts given the perceptions of the US related to such imports. This factor could move down these flows.
3. While FDI would be strong, the level would be around what has been achieved this year.
4. FPI will be a critical factor that could turn the rupee in either direction; and any positive movement towards the double digit mark would be useful.
5. ECB flows would remain subdued as higher overseas rates may make such borrowing less attractive. Companies could toy with the idea of overseas rupee-bonds (masala bonds).

While the near term forecast would be around Rs 67/$, the rupee may on balance move towards the 69 mark towards the end of FY18 with there being an incentive to let the rupee find its level to support exports at a time when they would be increasing.

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