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Professional Risk Opinion

Currency review

April 1, 2021 I Economics

FY21 was clearly the year of the dollar when it comes to analyzing currency trends. With the dollar being the main anchor currency, the fortunes of the US economy were the drivers of all such movements. There have been phases of the dollar falling as the virus infection cases relentlessly went up and the government stood back without taking any major steps in terms of trying to prevent the same. Then there were the US Elections where the run-up was felt in the currency market all the time. And last the growth forecasts of the US economy continued to improve over time and now it does appear that the economy will only move in the upward direction. This scenario has been supported by the Fed with the assurances of buyback of bonds as well as maintaining a low interest rate regime. However, notwithstanding these positive impulses, the bond yields have been rising of late with the 10-year yield now at 1.74%. last year it was around 70 bps. Inflation concerns have come in expectations. Hence there has been an increase of around 100 bps during this period.

This becomes important for the rest of the world as global investment flows are driven by these factors. When the US economy is doing well and bond yields go up, there is a tendency for investors to invest in domestic markets. Also with growth prospects improving investment in physical assets open up thus making the US market attractive. This leads to a reallocation of funds across geographies which can be seen in the foreign investment trends especially in the stock market which gets reflected in balance of payments and hence currency value.

A way to gauge how things have changed in the currency market is to look at averages for the months starting March 2020 till March 2021 and measuring the changes that have taken place over the year along with the volatility. The former says whether the currency is stronger or weaker against the dollar, while the latter speaks more on the noise elements during the year. Both of them provide fairly revealing pictures.

Currency movements

The dollar over the year had declined, but interestingly has been strengthening since February mainly due to the concerns that were there earlier being addressed and the economy emitting the right signals.

- Among the developed markets the pound and euro gained by 10.9% and 7.1% against the dollar.
- The other currencies which went up on a point-to-point basis were Australian dollar (19.4%), rand (10.2%), renminbi (7.3%), Mexican peso and won (7.2%), Taiwan dollar (6.2%), rupiah (5.6%), Singapore dollar (5.3%), Philippine peso (5.2%), baht (4.2%), ringgit (4.5%) and Indian rupee (2.3%). Quite clearly the rupee was managed well to ensure there was no sharp appreciation which could have exacerbated problems with declining exports.
- The currencies which depreciated against the dollar were yen (1%), real (15.4%), Turkish lira (21%).
- Hong Kong dollar and ruble remained virtually unchanged.

Volatility

Annualized monthly volatility during the year is a useful indicator to capture the noise during the year and here the rupee fared well with 3.3%. The other currencies that had volatility of less than 5% were pound, yen, renminbi, Hong Kong dollar, Singapore dollar, ringgit, Philippine peso, won and Taiwan dollar.

Those with volatility between 5-10% were rupiah, Australian dollar, ruble and baht. Currencies with volatility of above 10% were real, rand, Turkish lira and Mexican peso.

What has the RBI done so far?

Cumulative purchases of dollars in the market were $ 75.2 bn which was required to ensure that the rupee did not appreciate sharply. Besides there were also forward transactions undertaken in the market and as of January the outstanding purchases were $ 47.3 bn which has the same impact on the market without adding to liquidity and hence increasing money supply.

How will the rupee look like?

The rupee will tend to depreciate based on the 'stronger dollar' factor and the fundamentals will have a role to play. Trade deficit will widen for sure and a positive current account balance will turn to a deficit. Foreign investment flows will hold the clue on the capital account and the high amounts witnessed n FY21 could get tempered to an extent especially on the FPI side. Therefore, a movement towards the Rs 74-75 mark during the course of the year looks likely.

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