ICICI Bank Global Markets

Indian Rupee: Charting strength amid risks

- **Strong foreign flows amid a global liquidity flush, an expansionary Budget, brighter domestic data and the start of the domestic vaccination drive have bolstered strength in the Indian Rupee**
- **The INR will mostly benefit from the risk trade fueled by a double-digit recovery in FY22, increased inoculations, and persistent flows. The Budget also set out a number of initiatives to ensure attractiveness of India as an investment destination for foreign flows**
- **However, the extent of gain for the Rupee would be moderated by the continued presence of the RBI, though the pace of intervention has eased sharply over January. Other risks include ascending oil prices, a slow vaccine rollout, virus mutations, and insufficient appetite for a considerable supply of Government paper, all of which can worsen risk appetite**
- **A USD/INR range of 72-74 is likely to persist in the near term with low volatility**

After remaining within the 73-74 band since December 2020, the USD/INR finally broke below the 73 handle toward the end of January 2021. As posited in our earlier report *(Indian Rupee: Multiple reasons to be strong, December 2020)*, the Indian Rupee strengthened with a gradual breach below the 73 handle, as a preponderance of factors urging the Rupee to appreciate played out gradually in the backdrop of persistent intervention by the Reserve Bank of India (RBI) to stem what the central bank deems as excessive strength. The factors included abundant global liquidity, stellar foreign flows into equity markets, greening of domestic data and the arrival of the COVID vaccine. The strength seen in the domestic currency continues to be moderated by the RBI, even though the pace of intervention slackened sharply over January 2021 from what was seen in November-December 2020.

The IMF recently upgraded its global growth forecast for 2021, reflecting the onset of vaccinations, additional policy support, and an expected increase in contact intensive activities as the pandemic wanes. *In tandem with this, India's growth forecast for FY2022 was also revised significantly higher to 11.5% YoY, which is 270 bps higher than the October forecast. The upward revision in India's forecast reflects carryover from a stronger-than-expected recovery in FY2021, according to the IMF.* While our expectation of real GDP growth in FY2022 is slightly lower than the IMF, it is still robust. Thus, the recovery horizon over FY2022 looks bright, giving reasons for a strong Rupee to be realized.

<u>Unabated flows into equities encouraging strength in the INR:</u> Abundant appreciation pressure for the Rupee has arisen from large Dollar inflows on account of overseas investments into Indian equities. The accommodative monetary policy by major central banks to revive growth has kept the global financial system flush with liquidity. Foreign investors have also made hefty investments into Indian companies in the last few months. FII inflows into equities totaled a stellar USD 16.8 bn over November-December 2020, following which, flows moderated to USD 2.0 bn during January 2021. A pickup has been seen post the Budget, with another USD 2.1 bn till February 4, 2021. *Thus, persistence of flows has been the largest factor pressurizing the Rupee into an appreciation bias, and without intervention, would have led to a much stronger domestic currency.*

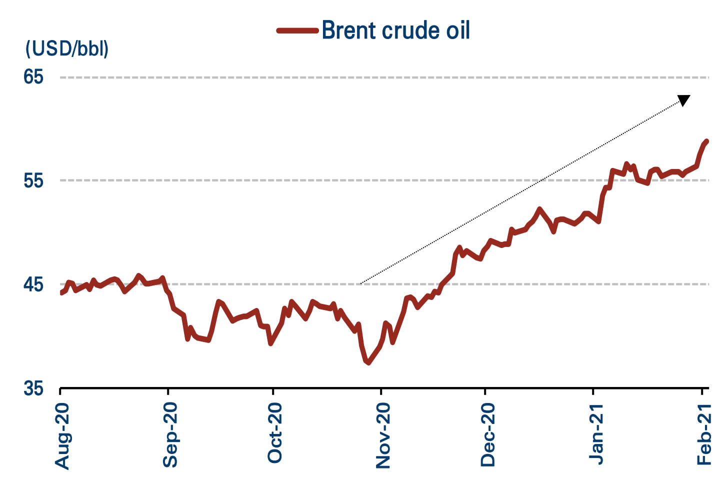
<u>Budget has focused on growth and amplifying flows:</u> A growth-stimulating Budget, as was the need of the hour, was delivered by the Finance Minister last week, assigning dispensations to stressed categories including MSMEs, health, infrastructure creation and agriculture. The favourable scenarios developed under the Budget for foreign investors (debt financing of REITs and InvITs to be enabled, hike in FDI limit in insurance to 74% from 49%, plan to launch a Development Finance Institution to manage long gestation infrastructure projects, among others) will all add to attractiveness of India as an investment destination, propelling flows, and adding strength to the Rupee. Additionally, growth recovery aided by the Budget (in addition to a favourable base) and a laudable bid for transparent accounting, are likely to add favour, despite an optically elevated fiscal deficit. *Thus, the expansionary Budget will guide the Rupee's strength in the near term till the next trigger comes along.*

<u>Oil prices need a watchful eye:</u> Despite growth (domestic and global) still not recovering fully, oil prices have recently made their presence felt, with Brent crude shooting up to ~USD 60/bbl from USD 51.8/bbl at end-December 2020. *Given India's dependence on oil imports, and the twin impact on fiscal and current account deficits (import bill and subsidy bill), this will act as a dampener for the strength in the Rupee, and needs to be watched for sudden surges*.

<u>Domestic data providing comfort:</u> Domestic data has improved significantly for most sectors, while some are still seeing a slow recovery. The propensity to consume has outlasted the festive season, and the anecdotal recovery of investment impetus in the form of private capex plans is encouraging. Pickup in export demand is also visible since December. The latest retail inflation print was also comforting, although bears watching to see sustenance. Given these trends, the second half of this fiscal will most likely witness positive GDP growth. On the external front, a robust current account surplus of USD 35 bn has been notched up in the first half of the fiscal, with a stellar balance of payments (BoP) surplus

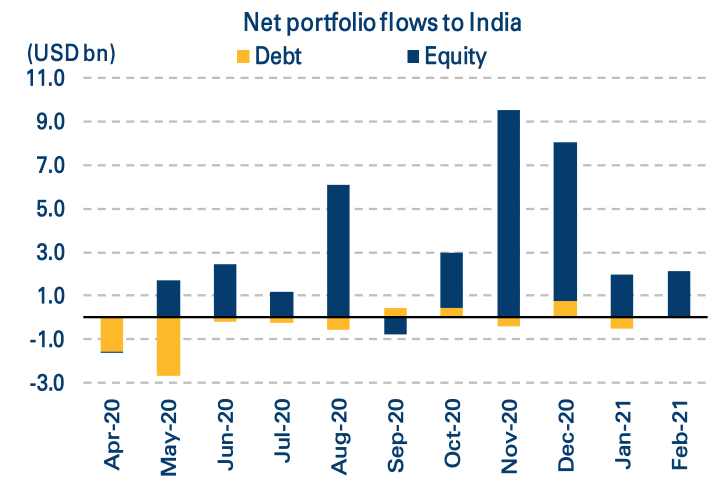
of USD 51.4 bn. The second half of FY2021 is likely to add significantly to this surplus, given the trends in flows and performance of invisibles. *All this spells out strength from the perspective of the domestic currency, and also indicates the pace of recovery, and hence attractiveness to flows.*

Oil prices gaining momentum swiftly



**Till 5th February, 2021*

Unabated FPI inflows favouring equity



**Till 4th February, 2021*

Source: NSDL, Bloomberg, ICICI Bank Research

A rising Dollar and a rising Rupee: While markets cheered the roll out of the COVID-19 vaccines in January and the prospects of swift economic recovery, fragility in global conditions surrounding the Coronavirus also re-emerged. A fresh surge in the number of Coronavirus cases across the world, with tighter restrictions on movement in some countries (European and the US especially), have posed concerns about the tenuous recovery that has come about so far. The FOMC, in its latest meeting, sounded worried about the pace of recovery moderating, especially for the sectors which have been most affected by the pandemic, and accordingly promised continued accommodation and easy policy. The latest payrolls print did not assuage concerns on this front. There are also fresh worries over efficacies of new variants and vaccinations, given that this is completely uncharted territory. In the European Union, political leaders have expressed their concerns over a delay in delivering vaccine doses. The next trigger on the global front is the much-awaited US fiscal stimulus package. In accordance with this risk-off sentiment, the Dollar index gained by 0.7% over January 2021, while some whipsawing has happened over February on news surrounding the US fiscal stimulus. *Over January, a strength in the Dollar index has gone hand in hand with a strength in the Rupee, as factors such as flows have been overarching in determining the direction of the USD/INR pair.*

In December, the US Treasury Department had included India in the list of countries monitored for currency practices, factoring in the RBI's foreign exchange interventions. Recently, the RBI Governor emphasized the need for Emerging Markets to build reserves as buffers against external shocks even at the risk of being added to the US currency watch-lists. **We feel the RBI may prefer to continue to intervene to limit a sharp appreciation in the Rupee, while a gradual strengthening may be the actual trend which manifests.** Global factors like accommodative measures by major central banks keeping liquidity abundant, and progress in vaccination across countries will support sentiment for the Rupee.

On the domestic front, FY2022 looks like a year of significant recovery on all fronts. While growth is likely to clock in double-digits, the stimulus provided from the Budget in terms of aiding different sectors and generating more flows is encouraging. Given the attractiveness of India in the EM basket, sturdy FII inflows are likely to continue, causing the domestic currency to gain. Credence to this superior performance was added by the IMF, in the form of the recent upgrade in the Indian growth forecast which far outstrips its peers. An inflated import bill as industrial recovery occurs will reduce the Balance of Payments (BoP) surplus for FY2022, although it will still remain quite high (~USD 35-40 bn). Vaccination is proceeding across the states at varying levels of progress, and this will decidedly hasten recovery, though high-contact sectors may still need to maintain vigilance. **We expect a range of 72-74 for the USD/INR in the near term, with the RBI intervening at suitable levels via adding to its arsenal of foreign exchange reserves (~USD 590 bn as on January 29).** Factors like swiftly rising oil prices, virus mutations, an optically high fiscal deficit, an inordinate supply of Government paper and its management, risk of premature withdrawal of accommodative policies will all act as potential dampeners for INR appreciation intermittently.

Sumedha Dasgupta
sumedha.dasgupta@icicibank.com

ICICI Bank: ICICI Bank Towers, Bandra Kurla Complex, Mumbai- 400 051. Phone: (+91-22) 2653-1414

Economics Research Group

Economics Research

Anushri Bansal	Senior Economist—Domestic Markets	(+91-22) 4008-1414 (ext 6220)	anushri.bansal@icicibank.com
Shivom Chakravarti	Senior Economist—Global Markets	(+91-22) 4008-1414 (ext 6273)	shivom.chakravarti@icicibank.com
Sumedha Dasgupta	Economist	(+91-22) 2653-1414 (ext. 7243)	sumedha.dasgupta@icicibank.com
Aniket Gaikwad	Research Analyst	(+91-22) 2653-1414 (ext. 8161)	aniket.gaikwad@icicibank.com
Kaushal Aryan	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	kaushalkumar.aryan@icicibank.com
Asha Sasikumar	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	asha.sasikumar@icicibank.com
Jyoti Sharma	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	sharma.jyoti@icicibank.com
Tanisha Ladha	Research Analyst	(+91-22) 2653-1414 (ext. 7309)	tanisha.ladha@icicibank.com
Nihal Kumar	Research Analyst	(+91-22) 2653-1414 (ext. 7309)	nihal.kumar@icicibank.com

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