Indian Rupee: Multiple reasons to be strong

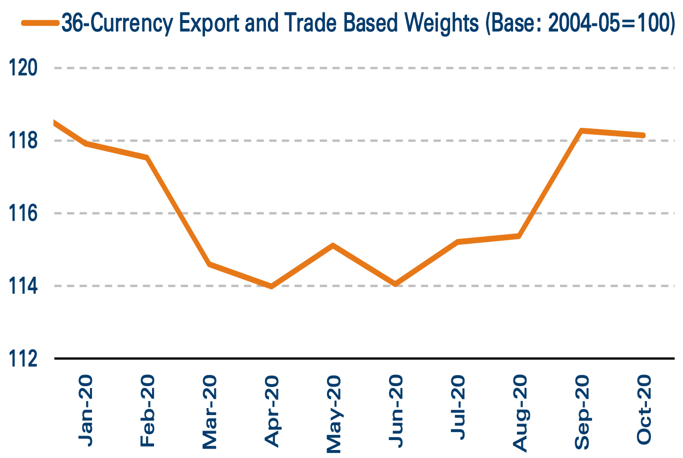
- **A global liquidity flush, hefty foreign flows, greening of domestic data and hopes of a vaccine arrival are factors which have spurred strength in the Indian Rupee**
- **However, the Rupee has been a limited participant in the weak Dollar trade rhetoric, given persistent intervention by the RBI to stem appreciation and curtail overvaluation, ensuring the currency accords with domestic fundamentals**
- **The INR will mostly benefit from the risk trade fueled by rising hopes of a rapid rollout of COVID-19 vaccine, and prospects of faster economic recovery across the globe. However, the extent of gain would probably slightly undershoot Emerging Market peers, given presence of the RBI**
- **A USD/INR range of 73-74 in likely to persist in the near term with low volatility. A moderation in pace of intervention could lead to a possible gradual breach below the 73 handle**

The Indian Rupee has strengthened considerably against the US Dollar from a level of ~74.47 seen in mid-November 2020 post the turmoil in the days following the US elections and uncertainty about the results. As posited in our earlier report *(Indian Rupee: Globally focused till US elections, October 2020)*, the Indian Rupee weakened in tune to the vagaries of the US elections, and subsequently resumed its footing once uncertainty on this front ebbed, and other news, including vaccine developments, and better domestic data took the forefront. Another major factor supporting the Rupee has been persistence of large foreign inflows, especially into domestic equities. **However, given a preponderance of factors urging the Rupee to appreciate, the strength seen in the domestic currency so far has been sharply moderated by the presence of the Reserve Bank of India (RBI), with the central bank stemming appreciation, while it juggles multiple open fronts of surplus liquidity, high inflation, overflowing Government paper, among others.**

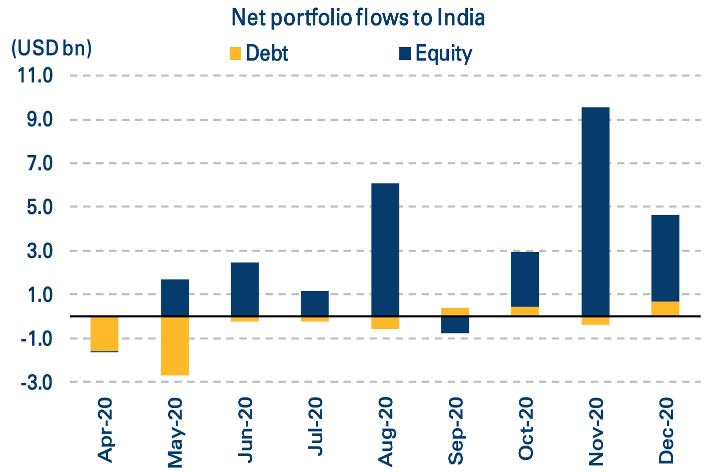
Unabated flows to India encouraging the INR to strengthen sharply: The Rupee has faced appreciation pressure due to large Dollar inflows on account of overseas investments into Indian equities. The accommodative monetary policy by major central banks to revive growth has made the global financial system flush with liquidity. Foreign investors have also made hefty investments into Indian companies in the last few months. FII inflows into equities totaled USD 9.6 bn in November, following which, ~USD 4.0 bn has already come in during December. Despite an expected portfolio rebalancing by balanced funds and pension funds, which could lead to some paring of equity holdings, *foreign investors are expected to remain net buyers of Indian equities in December, given the factors mentioned above. Thus, persistence of flows has been the largest factor pressurizing the Rupee into an appreciation bias.*

Valuation, intervention and the RBI's conundrum: Over the past few months, high inflation has made the Rupee prone to overvaluation. Compensating for the relatively high inflation in India, the RBI has been intervening to the extent of making the Rupee's nominal exchange rate lag among Asian peers, just so that the domestic currency does not get overvalued. The Rupee's real effective exchange rate (REER, based on a 36-currency basket) rose to 118.3 in October from 113.05 in June. During this period, the RBI added a considerable ~USD 55 bn to its foreign exchange reserves, while the Rupee strengthened by ~2% in nominal terms, making it one of the worst performing Asian currencies. *This preference of the RBI, which leads it to being rather bearish on the Rupee, stems from the urge to ensure the currency is trading in line with "underlying domestic fundamentals". This view, along with the view that volatility will be curbed, was emphasized by the RBI Governor's limited commentary on exchange rates at the last monetary policy review.*

Overvaluation in the Rupee



Unabated FPI inflows favouring equity



**Till 11th December, 2020*

Source: RBI, Bloomberg, ICICI Bank Research

Globally weakening Dollar, but move in the Rupee not concomitant: After the US elections, some risk sentiment has returned to global markets on several grounds such as optimism surrounding the vaccine, comfort on accommodative monetary policies staying in place, and firmer chances of a fiscal stimulus coming through in the US. The nomination of Janet Yellen as the next US Treasury Secretary under President-elect Joe Biden's administration has been hailed by markets, as Dr. Yellen is perceived as someone who would favour more government spending to counter the impact of the coronavirus pandemic, as suggested in one of her interviews in September. The FOMC, in its meeting last night, sounded more hopeful on economic prospects of the US going ahead, even as Federal Reserve Chair Jerome Powell warned that the coming months would be "particularly challenging," as the US battles a surge in Coronavirus cases. While cases around the world are still on the rise, and lockdowns and restrictions are in place in many nations, the US has started the inoculation process with the first vaccine, and markets are taking succor from that. The Fed also hopes that widespread distribution of vaccines would enable a strong rebound in the second half of 2021. Markets now await a breakthrough in terms of a coronavirus relief package in the US as a bipartisan group of lawmakers unveiled a USD 748 bn package that keeps the contentious package to provide state and local support on the back burner. *The Dollar index (a measure of the greenback's strength relative to a basket of six major currencies) slipped by 2.01 points in November, in response to events like the US Presidential election, vaccine development news, US fiscal stimulus news, etc. The index has fallen by a further ~1% so far over December. Despite the evident weakness in the Dollar, the USD/INR has seen limited bearishness, given the RBI's presence stemming the Rupee's strength, as discussed above. We gauge that despite the Dollar losing traction with better global economic data and news flow, the Rupee's gains may not be in consonance with the move in the greenback in the near term*.

Visible traction in domestic data providing comfort The ongoing quarter has seen the propensity to consume return in significant measure. The benchmark of this recovery being sustainable would be consumption impetus surviving beyond the festive season, and this will bear watching. The recovery of investment impetus, as seen in the latest GDP print, is encouraging, and in this regard, a lot of anecdotal evidence is available of some nascent private capex plans starting in sectors like cement, aluminium, realty, etc. Pickup in export demand is also likely to get back on track as the second wave of infections subsides globally. A host of high frequency indicators have displayed a turnaround to healthy growth rates/levels, including passenger vehicle & two wheeler registrations, manufacturing & services PMIs, railway freight traffic, output of consumer durables, etc., indicating an economic uptick. The latest retail inflation print was somewhat lower than expectations. It is probable that the second half of this fiscal will witness positive GDP growth. *While the USD/INR reacts limitedly to domestic data, lack of unfavourable data will desist from pressuring the Rupee to depreciate. The data on balance of payments for the July-September quarter is due at the end of this month. Given a comfortable surplus expected on the current account (at least USD 15 bn) and BoP fronts for Q2, the Rupee may show some knee-jerk strength in the trading session post the data.*

The US Treasury department has included India in the list of countries monitored for currency practices, according to a report on foreign exchange submitted to the US Congress, factoring in the RBI's foreign exchange interventions. We feel the fallout of this may be a slightly moderated pace of intervention, allowing some strength in the domestic currency to manifest. Global factors like accommodative measures by major central banks keeping liquidity abundant, the US Dollar on a weak footing, and progress in potential COVID-19 vaccines will support the Rupee, and on the domestic front, better growth data, a healthy current account and a robust Balance of Payments (BoP), positive commentary on vaccine approvals, sturdy FII inflows will also provide reasons for the domestic currency to gain. **We expect a range of 73-74 for the USD/INR in the near term, with factors encouraging a swift appreciation in the INR to be curbed by the RBI intervening at suitable levels. A moderation in pace of intervention could lead to a gradual breach below the 73 handle. The RBI's arsenal of foreign exchange reserves (USD 579 bn as on December 4) renders the question of volatility in the Rupee largely moot.**

We feel the Rupee will benefit from the risk trade fueled by rising hopes of a rapid rollout of COVID-19 vaccines, and prospects of faster economic recovery across the globe, which will weigh on the greenback. However, the extent of gain in the Rupee would probably slightly undershoot Emerging Market peers, given other economic conditions which the RBI is aiming to manage. Factors like elevated inflation, the Government's stretched fiscal purse and uncertainty about sustenance of demand improvement will remain in the backdrop, other than the RBI, to check unnecessary bullishness.

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