The rupee through three lenses

Resilience higher, risks clear, ride-down checked

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Global economic conditions have changed rapidly in the past month, with intensifying geopolitical shocks from the Russia-Ukraine conflict leading to a pervasive risk-off sentiment and a surge in crude oil prices.

These, together with liquidity tapering and start of rate hikes by the US Federal Reserve, are testing the resilience of the Indian rupee, which has depreciated against the US dollar over the past few weeks, crossing 76/$ as on March 16 from 74.5/$ before the Russia-Ukraine conflict started on February 24. The local currency, though, has been battered less this time, compared with the taper tantrum of 2013 (the last time elevated oil prices and prospects of liquidity tapering by the Fed had rocked the currency).

We look at three key issues in this edition of **Insight**:

1. Resilience is higher relative to past

Unlike the taper-tantrum episode of 2013, the rupee has held up quite well this time compared to its own past. But then, other emerging market (EM) currencies have also witnessed orderly currency movements by and large, depending on their crude-oil dependence and the extent of repricing of the US Fed's actions. As a consequence, the rupee has depreciated more than its peers in the past one month.

2. Risks are real and present

We see the risks clearly tilted to the downside, with an escalation or even delayed de-escalation of the geopolitical conflict pushing up energy prices further and expanding the current account deficit. Assuming crude oil to average $85-90/barrel in fiscal 2023, we do not expect Indian macros to test the levels of 2013, when India was dubbed a part of the 'fragile five' — a group of EMs vulnerable to capital outflows due to their weak macroeconomic fundamentals.

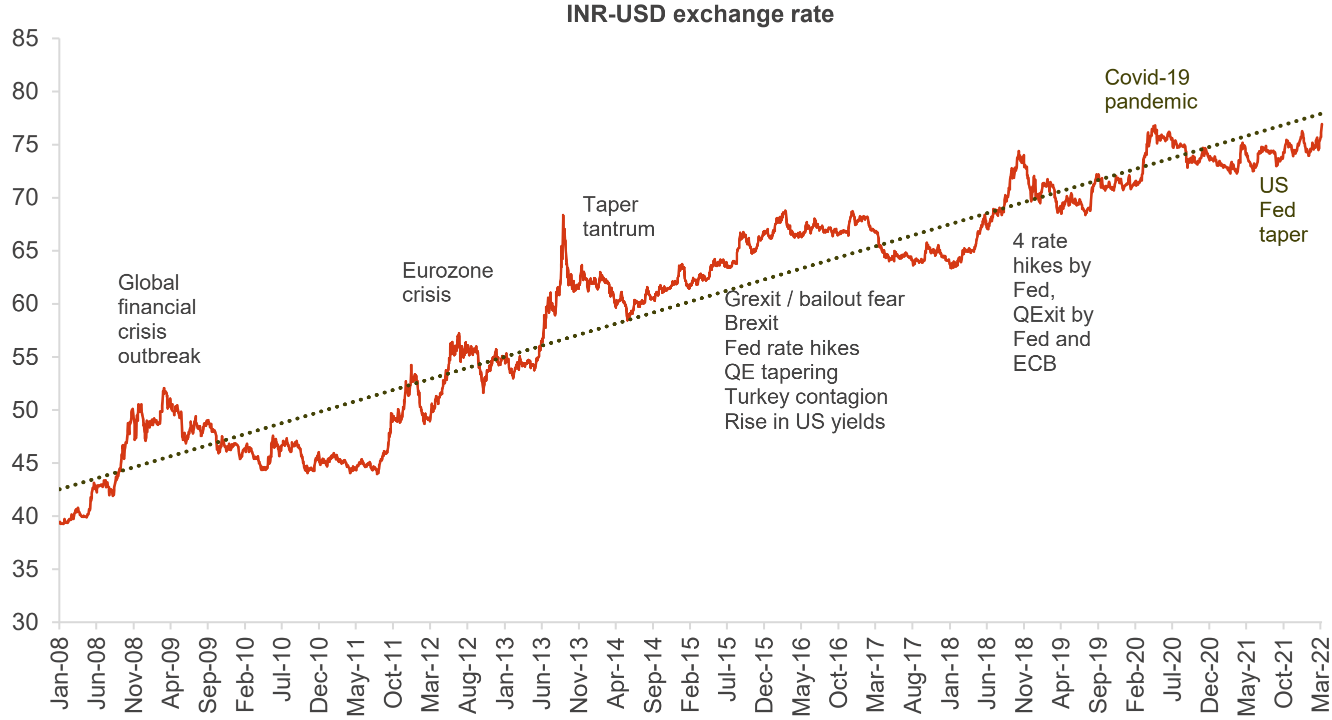
3. Ride down is unlikely to be sharp

The rupee is already reacting to the external tensions and, we believe, will depreciate further and settle around 77.5/$ by March 2023. Two factors will play a pivotal role in driving the weakness: higher energy prices widening the current account deficit, and rate hikes by the US Fed resulting in some capital outflow. But with Reserve Bank of India (RBI) expected to continue intervening in the forex markets (thanks to larger forex reserves) to manage volatility, a sharp depreciation in the rupee may be avoided though it could face volatility near term so long as geopolitical tensions persist.

Rupee relatively stable so far in the current period relative to previous crises

The current episode of rupee weakening versus the greenback is not entirely unexpected. The long-term trajectory of the rupee-dollar exchange rate since the Global Financial Crisis (GFC) of 2008 indicates the currency tends to depreciate during crises as uncertainty yields higher capital outflows *(see graph below)*.

Interestingly, compared with the past, the rupee has been hit less severely this time around. But it still remains below the long-term trend, indicating further depreciation due to mean reversion, which a surge in geopolitical risks and rate hikes by the US Fed amid rising inflation has hastened.

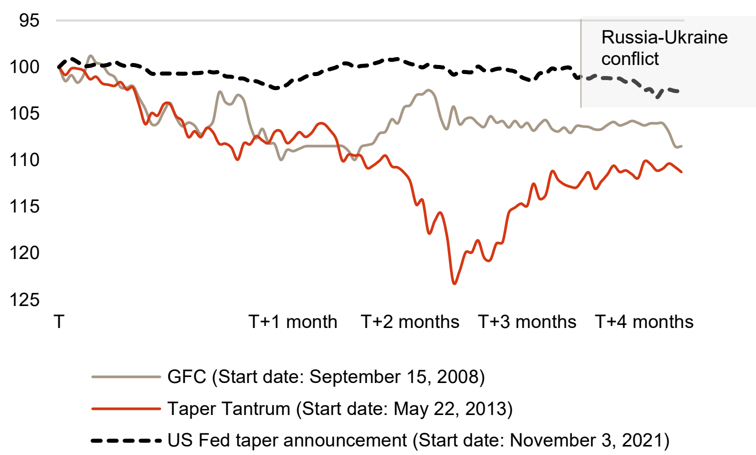


Note: Dotted line indicates long term trend of the rupee-dollar exchange rate

Source: RBI, CRISIL

In previous episodes of external shock, the rupee displayed a lot more weakness. Since the start of the Fed tapering early last November, the rupee has depreciated 2.6% (as of March 14), less than that seen during GFC 2008 (8.5%) and the taper tantrum of 2013 (11.3%)[1]. In fact, between November and late February, the currency hardly moved, on average. Depreciation has been marked only after February 24, when the Russia-Ukraine conflict escalated. Further, the volatility in exchange rate (as measured by standard deviation) is far lower (at 0.9 Rs/$) this time, than that during the GFC and taper tantrum episodes (2.4 and 5.2, respectively).

Rupee steadier during the current crisis



Period	Depreciation (%)	Volatility *
GFC (2008)	8.5	2.4
Taper tantrum (2013)	11.3	5.2
US Fed tapering (2021)	2.6	0.9

[1] Depreciation measured for the period of four months from the start of the crisis

What explains the rupee's stability? A combination of adequate forex reserves, the RBI's interventions (*more on this ahead*), and lower external account vulnerability (compared with previous crises).

India is better placed than in fiscals 2013 and 2014 to withstand external shocks

Indicator		FY13	FY14	FY22E	FY23F
External liabilities	CAD (% of GDP)	4.8	1.7	1.6	2.4
	- Short-term external debt (% of GDP)	5.3	4.9	3.2*	N/A
Adequacy of forex reserves	Months of import cover	7.2	7.7	12.8**	N/A
	Reserves/(short-term debt + CAD)	1.6	2.5	4.2	N/A
Domestic macroeconomic health	GDP growth (% y-o-y)	5.5	6.4	8.9@	7.8
	CPI inflation (% y-o-y)	9.9	9.4	5.5	5.4

Vulnerability indicator: High | Low | Neutral

*Note: F refers to CRISIL's forecasts. *As of September 2021, **FY22 import cover is average until January 2022. @NSO second advance estimate.*
Source: Source: RBI, National Statistics Office, Ministry of Finance, CEIC, International Monetary Fund, S&P Global, CRISIL

Thus, compared with 2013, we are relatively better placed to weather the external shocks, though not completely insulated.

Going ahead, a few of these fundamental factors (especially the current account deficit) could worsen further, if crude oil prices remain elevated. Still, we do not expect the current account deficit to test the levels of 2013.

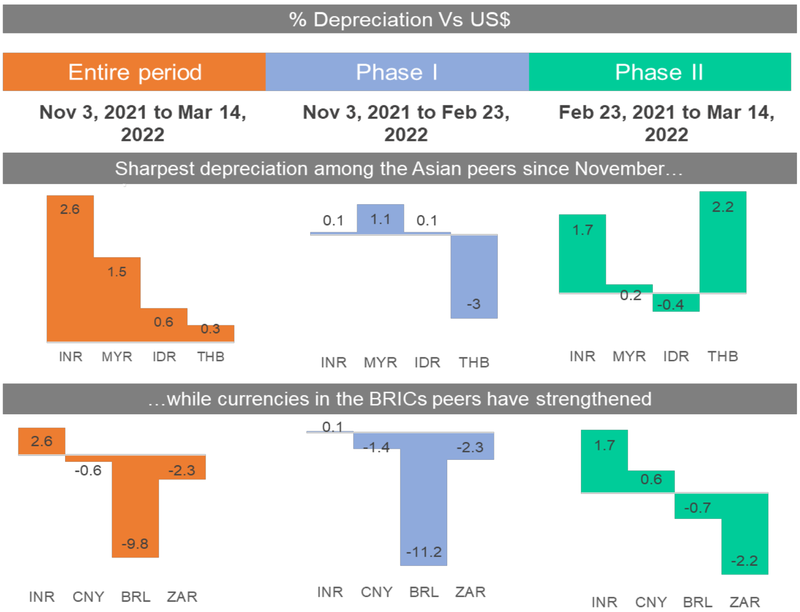
But the rupee has not fared well compared with its peers

Despite a better performance (in terms of both extent of depreciation and volatility) this time around compared to its own past, the rupee has not fared as well as its EM peers. As of March 14, 2022, the rupee's depreciation in the November 2021-March 2022 period was the sharpest relative to Asian and BRICS economy peers[2]. Much of the weakness, though, was seen in the past month as foreign portfolio investors (FPIs) withdrew funds amounting to $5.1 billion owing to risk-off sentiment arising from the Russia-Ukraine conflict and tapering of global liquidity.

The response to two separate events, the US Fed tapering announcement (November 2021) and Russia-Ukraine conflict (March 2022) help explain the dichotomy in currency movements.

[2] Barring of course, the Russian ruble, which has tanked since the start of the war

Rupee's performance with respect to peers is weaker in Phase II



Phase I

- Robust exports and foreign fund inflows (because of the inclusion of its debt assets in the global bond index last year) in Chinese renminbi supported appreciation
- Brazilian real strengthened as the central bank raised policy rates drastically
- Thai baht saw foreign funds inflow and higher tourism revenues on prospects of the sector's revival following the country's quarantine-free visa provision.
- South African rand, initially depreciated in December as Omicron variant was first discovered there, but later trimmed its losses

Phase II

- Malaysian and Indonesian currencies stand to gain from elevated energy exports as prices surge.
- High dependence on energy imports and a wide current account deficit put pressure on the Thai baht
- Among other EMs, Brazil, being a net commodity exporter, also stands to gain from high international commodity prices and high interest rates pulling in capital flows

Note: Positive value indicates depreciation , INR: Indian rupee, MYR: Malaysian ringitt, IDR: Indonesian rupiah, THB: Thai Baht, CNY: Chinese renminbi, BRL: Brazilian real, ZAR: South African rand
Source: CEIC, CRISIL

How will the rupee-dollar exchange rate move in future?

A very sharp depreciation of the rupee in the year ahead is unlikely in our base case, though the currency could face volatility near term, if geopolitical tensions persist and crude oil prices rise further. The following factors will be key in influencing the rupee's trajectory in fiscal 2023:

- **Brent crude oil:** Crude oil crossed $130/barrel in early March 2022 on concerns over supply disruption due to energy sanctions on Russia, but has since dropped to ~$100/barrel. India, being heavily reliant on imports of crude oil for its energy needs, faces a widening of current account deficit next fiscal. CRISIL expects the current account deficit to widen to 2.4% of GDP in fiscal 2023, compared with an estimated 1.6% in fiscal 2022 (with an assumption of crude oil at $85-90 per barrel for fiscal 2023). With the rising demand for dollars to pay for expensive oil imports, the depreciation pressure on the rupee will intensify. Already, in past episodes of crude oil price spikes, India has witnessed concomitant widening of current account deficit and, consequently, sharp depreciation of the currency.

Episodes of spikes in Brent crude oil are associated with rise in the current account deficit and, consequently, depreciation of the exchange rate

Period	Crude oil price range	Current account deficit	Average exchange rate depreciation Vs US$ during the period
Oct 2007-Sept 2008	$82-132/b	Widened to 2.3% of GDP in FY09 from 1.3% in FY08	15.3%
Oct 2010-Oct 2014	$82-125/b	Touched decadal high of 4.8% in FY13	9.5%

Source: Ministry of Commerce & Industry, RBI, CEIC, CRISIL

- **US Fed raising interest rates:** Elevated inflation has been a flashpoint for US monetary policy since last year. US CPI inflation reached a multi-decade high of 7.9% on-year in February 2022. The banning of US imports of Russian energy products in March only intensifies the price pressures, which the US Fed will be keen to temper. The US Fed has already raised rates by 25 basis points (bps) on March 16, and six more are projected for this year. This is the fastest pace of rate hikes in a decade. A rise in US policy rates hardens US long-term yields (e.g., on Treasury bills), reducing the interest rate differential between US assets and those in EMs. This increases the relative attractiveness of US assets, leading to capital flows out of riskier assets of EMs. As a consequence, demand for domestic currencies reduces, putting depreciating pressure.

US Fed rate hikes are accompanied by depreciation of exchange rate, but not always…

Period	US Fed rate hike	Average exchange rate (Rs./$)	Depreciation (y-o-y) (%)
FY16	25bps	65.5	7.1%
FY17	Twice by 25bps each	67.1	2.5%
FY18	Thrice by 25bps each	64.4	-3.9%
FY19	Thrice by 25 bps each	69.9	8.4%

Depreciation of currency   Appreciation of currency

Note: FY18 saw rupee appreciate on average even in the face of rate hikes by the US Fed. The currency in that year was supported by high foreign inflow of funds and RBI raising repo rate too.
Source: RBI, CEIC, CRISIL

This time too, as global liquidity reduces owing to US Fed tapering and Fed rate hikes, foreign investors have been pulling out funds since October 2021. This fiscal, as of February, they have withdrawn $13.1 billion, the highest in the past decade. This is indicative of the additional downside pressure on the rupee owing to capital outflows.

- **RBI interventions to manage rupee volatility:** That the rupee will continue to face depreciation pressure seems a likely outcome at this juncture. But the central bank will continue to intervene to manage volatility:
    - In December 2021, the RBI sold dollars amounting to ~$2.9 billion in the spot market, as the US Fed tapering and emergence of Omicron variant weighed on the rupee. The central bank has been active in not just the spot market, but also the forwards market, and bought dollars to the tune of ~$49 billion in December. This is in line with its trend of buying dollars mostly in the forwards market in fiscals 2021 and 2022, and accumulating its forex reserves.
    - In February-March 2022, as the current energy price shock escalated, leading to the rupee crossing 76/$, the RBI has been active in selling dollars in the spot market, as per media reports[3] (official RBI data on interventions comes with a lag of two months). Apart from direct interventions, banks too have been selling dollars on the RBI's behalf[4]. The central bank also conducted a dollar sell-buy swap of $5 billion on March 8, 2022, as part of its liquidity management measures, but this will also have an incidental impact on arresting the rupee's slide.

[3] https://economictimes.indiatimes.com/rupee-falls-to-record-low-vs-dollar/articleshow/90065401.cms ;
[4] https://economictimes.indiatimes.com/markets/forex/rbi-is-estimated-to-have-bought-up-to-2-bn-to-curb-rupee-swings/articleshow/89954064.cms

Outlook

With elevated crude oil and commodity prices, and its consequent impact on the current account balance, the pressure on the rupee is expected to persist.

The global uncertainty caused by the Russia-Ukraine conflict is adding to the risk-off sentiment. Fed rate hikes causing capital outflows only exacerbates the impact.

The depreciation in the rupee, however, is likely to be relatively less compared with say the 2013 taper tantrum episode, as India’s external account situation is more comfortable (in terms of short term external debt and import cover).

Adequacy of foreign exchange reserves (~$630 billion) is also acting as a shield.

Lastly, the expected inflow of funds during the mega initial public offer of the Life Insurance Corporation of India and the inclusion of India’s debt in the global bond index towards the later part of fiscal 2023 are expected to provide some support to the currency.

Net-net, we expect the rupee to depreciate to 77.5/$ in March 2023, compared with an estimated 76.5/$ in March 2022.

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