CLSA ASIA-PACIFIC MARKETS
india unplugged

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Rupee woes

INR remains vulnerable

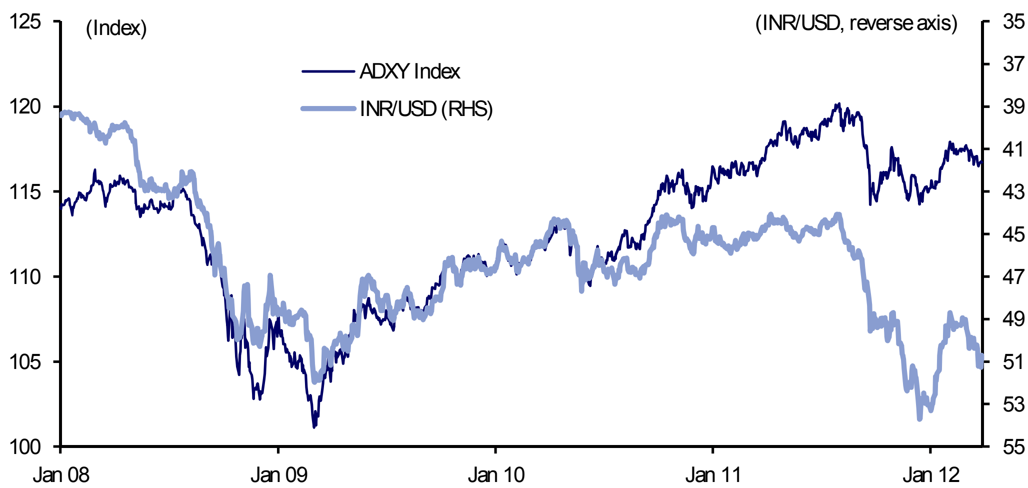
INR remains one of the riskiest currencies. India's large and widening current account (CA) deficit and its dependence on volatile capital inflows make it vulnerable to becoming a casualty of swings in global risk appetite and crude oil prices. INR's recovery in January was due partly to RBI's aggressive currency intervention, although global risk-on, RBI's anti-speculative measures and deregulation of NRI deposit rates also helped. However, INR has been weakening against USD since early February, despite a surge in portfolio inflows into India (1Q12: around USD13.5bn). Global risk-on will likely boost volatile capital inflows unless domestic factors, such politics and policy coordination, are turn-offs. But capital inflows may not be adequate to eliminate concerns about smooth financing of the CA deficit. On our forecast, the CA deficit of 3.9% of GDP in FY13 is beyond the RBI's comfort level. This, along with our expectations of a stronger dollar, sets the stage for INR to weaken. We maintain our end-2012 forecast of INR55:USD.

Exceptionally volatile ride for INR

INR has had an exceptionally volatile ride (Figure 1). It slumped to nearly INR54:USD in mid-December before recovering to INR49:USD by mid-February due to a combination of an unexpectedly strong jump in portfolio inflows triggered by global risk-on and RBI's desperate measures, including aggressive currency intervention in January. However, it weakened subsequently and has broken above the 51-mark despite USD weakness. The pace of capital inflows has slowed recently even as the CA deficit remains large. In the absence of meaningful RBI currency defence, INR had to weaken.

YTD INR has depreciated more than ADXY

Figure 1: ADXY Index and INR/USD

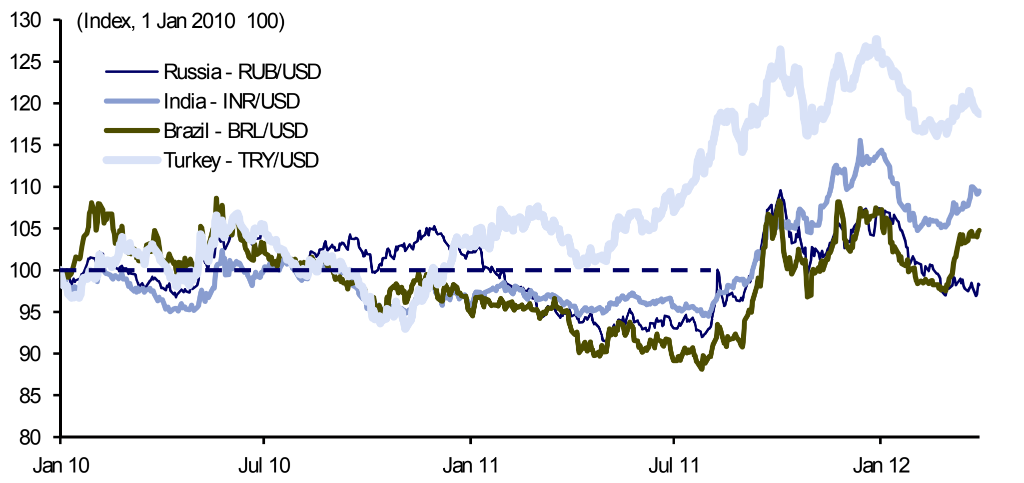


Note: Rise in ADXY indicates appreciation. Source: Bloomberg, CLSA Asia-Pacific Markets

INR's performance in recent months has been similar to that of some of the risky EM currencies (Figure 2). This suggests an understandable strong global risk on/off dimension that is complemented by domestic factors. For example, the turning point for INR in December is not substantially different from that of other EM currencies, despite the RBI's anti-speculative actions and deregulation of NRI deposit rates.

INR behaving similar to other risky EM currencies

Figure 2: Emerging markets exchange rate



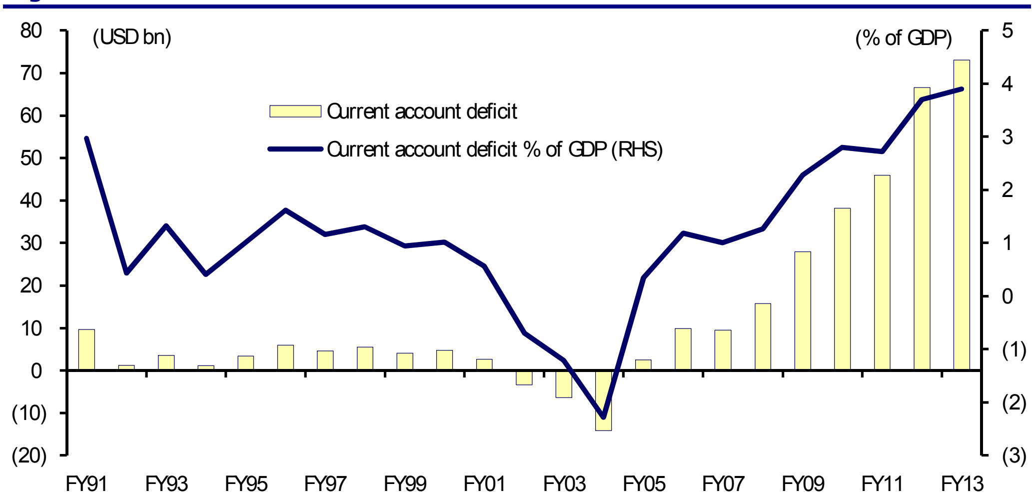
Source: Bloomberg, CLSA Asia-Pacific Markets

INR at the mercy of crude oil price and capital inflows

Looking ahead, three key factors will affect the outlook for INR. First, sustainability of global risk-on and its impact on international crude oil prices and capital inflows into India. Higher crude oil prices widen the CA deficit but higher capital inflows due to global risk-on temporarily ease the financing pressure. Every USD10/bbl increase in crude oil adds around USD10bn (0.5% of GDP) to the CA deficit. As highlighted in Figure 3, we expect the CA deficit to widen to USD73.1bn or 3.9% of GDP in FY13 from an estimated USD66.6bn (3.7% of GDP) in FY12.

CA deficit to widen to a record high

Figure 3: Current account deficit



Note: FY12 and FY13 are CLSA forecasts; Source: CEIC, CLSA Asia-Pacific Markets

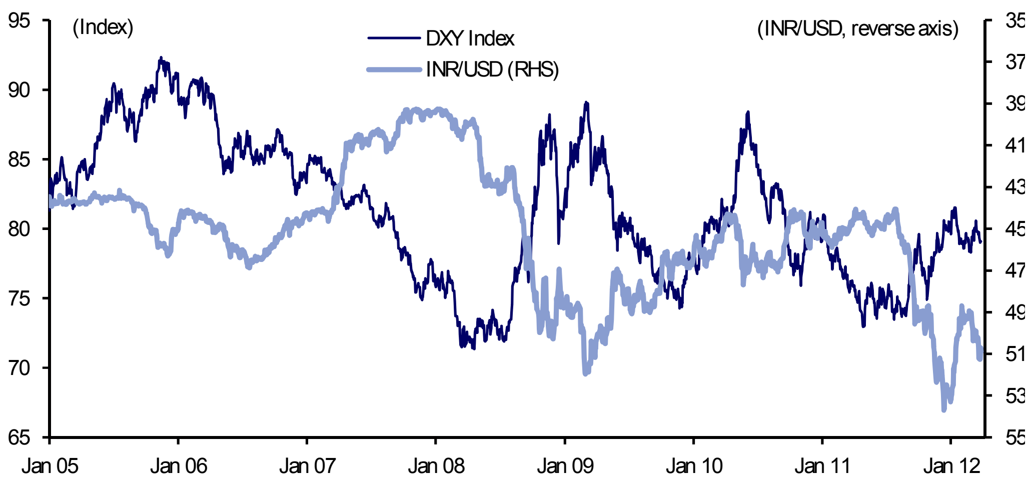
But no economy with a large CA deficit should rely mainly on portfolio inflows to finance the deficit as these inflows can be uncertain. Also, it is unlikely that capital inflows will comfortably and smoothly finance the wider CA deficit in FY13.

Stronger USD will be negative for INR

Second, outlook for USD. We expect USD to strengthen in 2H12, which in turn should be negative for INR. Note that INR has weakened in recent weeks despite USD weakness (Figure 4). Such an outcome does not boost confidence.

INR has depreciated recently despite USD weakness

Figure 4: INR/USD and DXY index

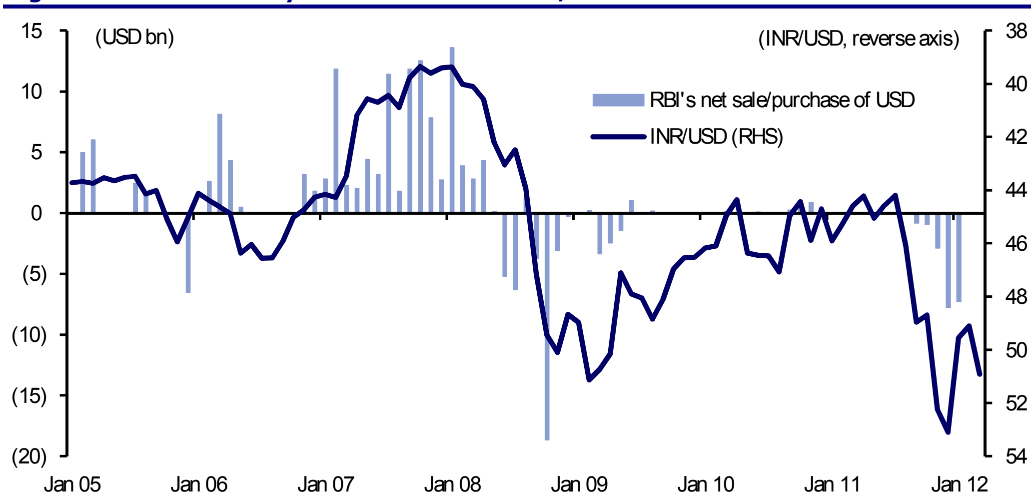


Source: Bloomberg, CLSA Asia-Pacific Markets

Third, RBI's intervention in the currency market to support INR, if capital inflows are inadequate to finance the CA deficit. Currency intervention to prevent depreciation of the exchange rate is a losing proposition that will leave the central bank with a combination of a decline in its foreign reserves and a still-weak currency, and could also be an invitation for a speculative attack.

RBI unlikely to intervene aggressively

Figure 5: RBI's currency intervention and INR/USD



Note: Positive number means net purchase of USD; Source: Bloomberg, CEIC, CLSA Asia-Pacific Markets

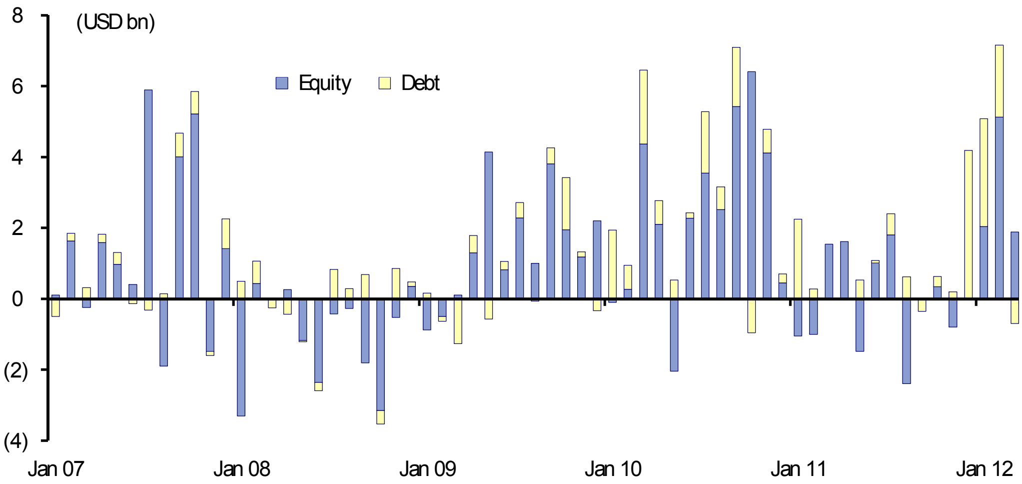
RBI has been aggressive in supporting INR with heavy USD selling at USD7.3bn in January, only slightly lower than the currency intervention of USD7.8bn in December (Figure 5). However, looking ahead, RBI is unlikely to prevent INR from adjusting because of inadequate capital inflows, although it is likely to manage INR better than it did late last year.

We maintain our forecast of INR55:USD

The combination of above three factors suggests to us that INR is poised to weaken. We reiterate our end-2012 forecast of INR55:USD but the ride will be volatile due to shifting global risk appetite.

FII inflows moderated in March

Figure 6: Net FII – Debt and Equity

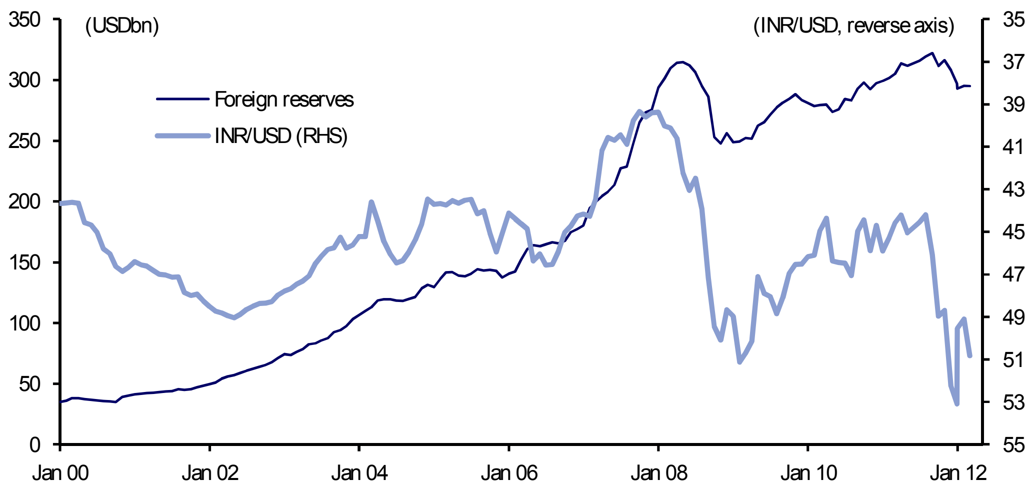


Note: March 2012 data up to 28 March; Source: CEIC, CLSA Asia-Pacific Markets

YTD total FII investment (net) is around USD13.5bn, with the equity portion at USD9.1bn and the debt portion at USD4.4bn (Figure 6). This is the second-highest quarterly level of total FII inflow after USD15.5bn in 3Q10. However, monthly inflows weakened significantly in March, and the outlook remains uncertain. This in turn will affect INR and the pace of accumulation of foreign reserves (Figure 7).

Foreign reserves affected by RBI's currency intervention

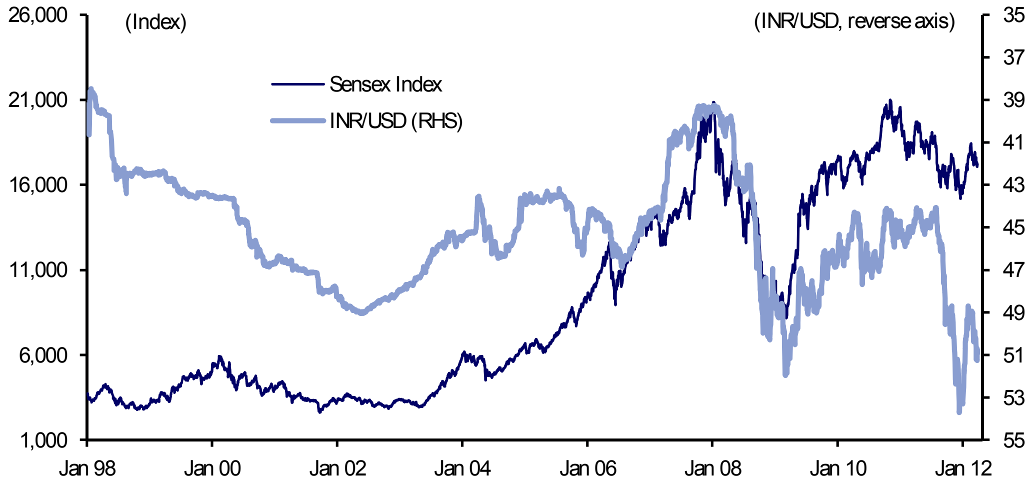
Figure 7: Foreign reserves and INR/USD



Source: Bloomberg, CEIC, RBI, CLSA Asia-Pacific Markets

EQUITY PERFORMANCE WILL IMPACT INR

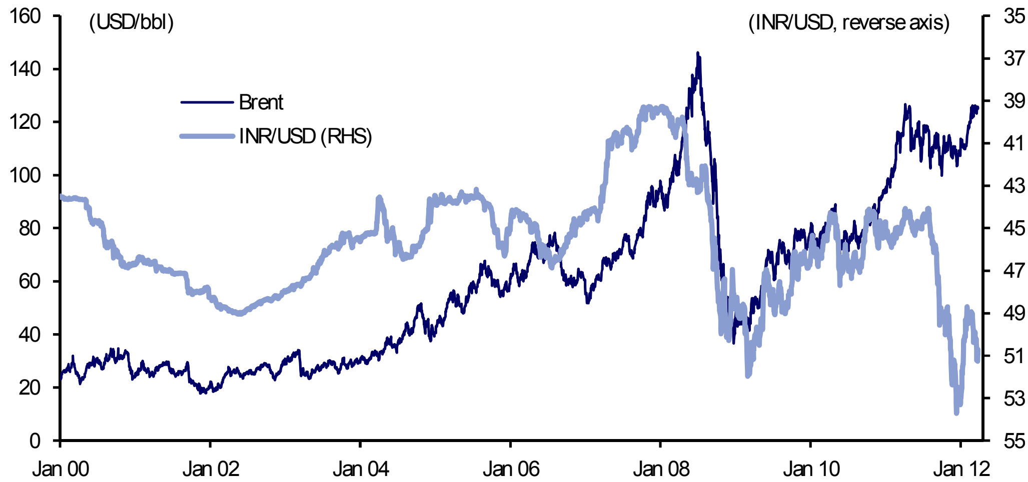
Figure 8: INR/USD and BSE Sensex



Source: Bloomberg, CLSA Asia-Pacific Markets

HIGHER CRUDE OIL PRICE + WEAKER INR TROUBLE

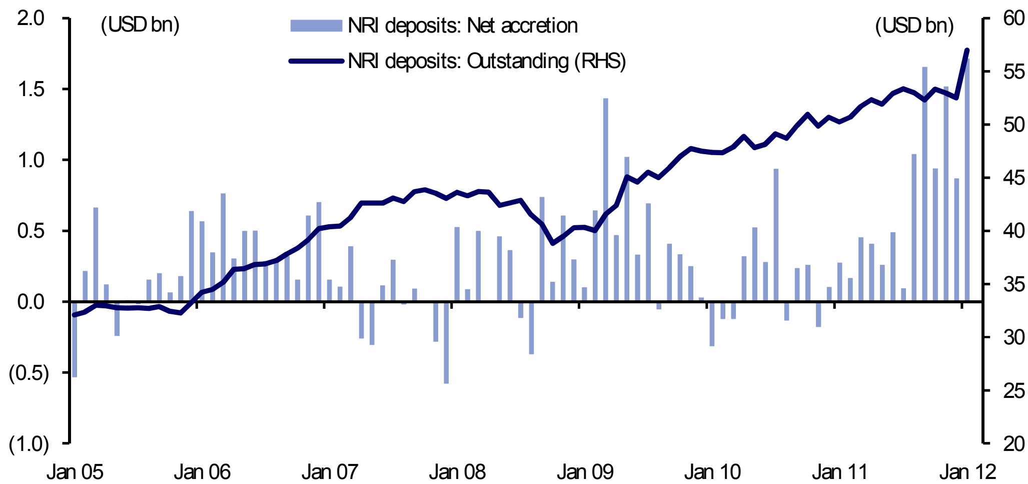
Figure 9: INR/USD and Brent



Source: Bloomberg, CLSA Asia-Pacific Markets

GAIN IN JANUARY NRI DEPOSITS DISAPPOINTING

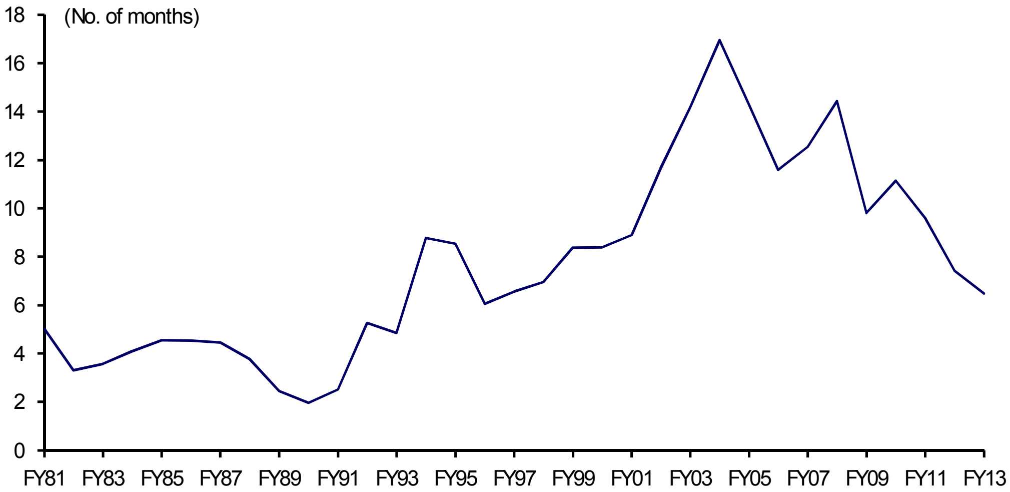
Figure 10: NRI deposits



Source: CEIC, CLSA Asia-Pacific Markets

IMPORT COVER IS POISED TO DECLINE FURTHER

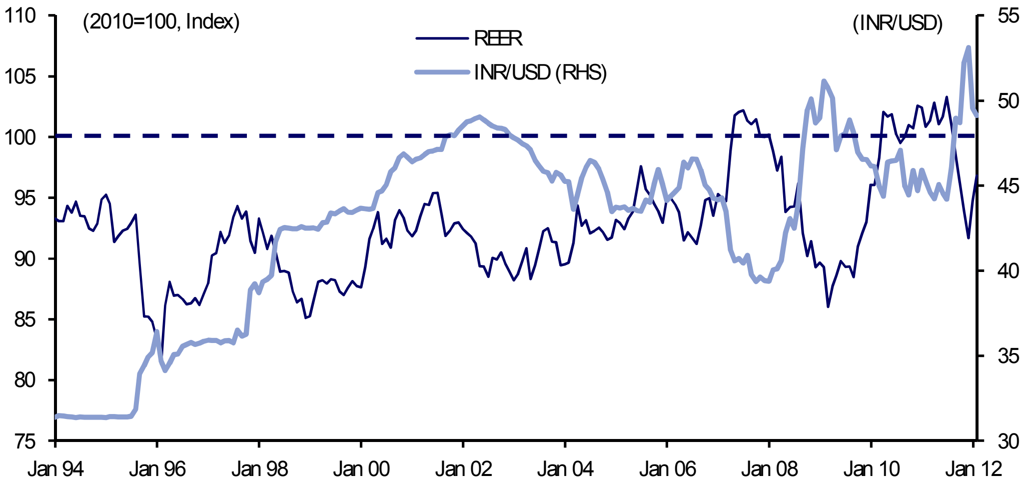
Figure 11: Merchandise import cover of foreign reserves



Note: FY12 and FY13 are CLSA forecasts; Source: CEIC, CLSA Asia-Pacific Markets

CAPITAL INFLOWS RATHER THAN REER APPEARS TO BE THE KEY DRIVER OF INR

Figure 12: Real effective exchange rate (REER) and INR/USD



Source: BIS, Bloomberg, CLSA Asia-Pacific Markets