26 May 2020

MOTILAL OSWAL

ECOSCOPE
The Economy Observer

Expect INR to stabilize at 74–75 against USD

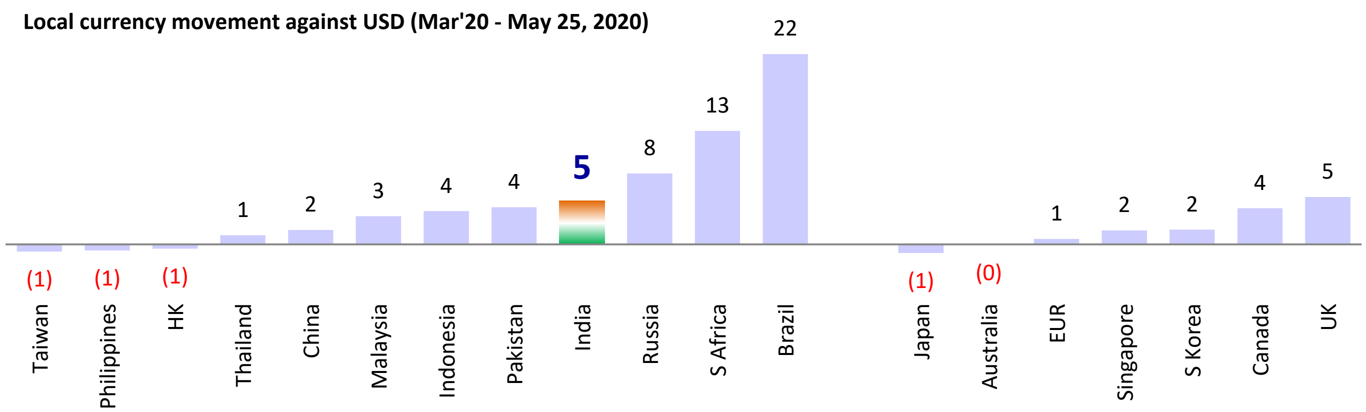
Current account surplus and record forex reserves to support INR

- **Since the beginning of Mar'20, the Indian rupee (INR) has weakened ~5% against the US dollar (USD). This is right in the middle of the EM currency pack – worse than the slight strengthening witnessed in the Philippine peso (PHP), but much better than the ~22% fall in the Brazilian real (BRL). The currencies of advanced nations have weakened only slightly in comparison.**
- **A sizable amount of foreign exchange reserves and the crash in crude oil prices may have supported INR. Although a large portion of lower import bill would be offset by lower remittance inflows and lower exports (on account of weak global growth), we believe that India's current account could post its first surplus of ~0.4% of GDP this year, against deficit of ~1% of GDP in FY20.**
- **It is also important to note foreign portfolio/institutional investment (FPI/FII) flows, driven by sentiment, are more important in determining INR movement than crude oil prices (or current account balance).**
- **Our calculations suggest India's balance of payments (BoP) could be in massive surplus this year (USD64b or ~2.4% of GDP), taking the foreign exchange reserves to USD540b by end-Mar'21. In the absence of any adverse global shocks (leading to global risk-off), we believe the INR could average 74–75 against the USD in FY21, weaker than 70.9 in FY20, but stronger than the all-time low of 76.8/USD seen in mid-Apr'20.**
- **Nevertheless, an uncertain economic environment and the lack of clarity over India's fiscal deficit keep the threat of a sovereign rating downgrade alive. Although we don't expect this to happen, any indications in this regard could weaken the INR and re-test all-time lows.**

Since Mar'20, the INR has depreciated ~5%; however, a comparison with other EM currencies confirms the INR falls in the middle of the pack.

INR has weakened ~5% against USD since Mar'20: The COVID-19 pandemic has caused massive disruption in the world economy and resulted in sharp movement in emerging economies' currencies, including the INR. Since the beginning of Mar'20, the INR has depreciated by ~5%; however, a comparison with other EM currencies (since this is a relative market) confirms the INR falls in the middle of the pack. The PHP and Thai baht (THB) have remained broadly unchanged, while the BRL has lost more than a fifth during the period *(Exhibit 1)*. Many developed economies' currencies have been largely stable, except the Great Britain pound (GBP) and Canadian dollar (CAD). In this note, we argue that while the Indian economy, owing to its twin deficit, always faces serious currency risks during any crisis, it may remain stable at 74–75/USD this year. A sovereign rating downgrade, however, remains an active threat.

Exhibit 1: INR has weakened ~5% against USD since Mar'20



Source: CEIC, MOFSL

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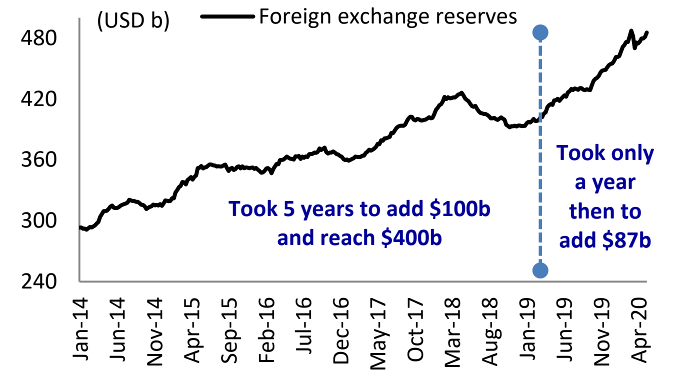
It took India almost five years (over 2014–19) to increase its forex reserves from USD300b to USD400b; however, it added the next USD87b in just a year and reached an all-time high of USD487b in early Mar'20.

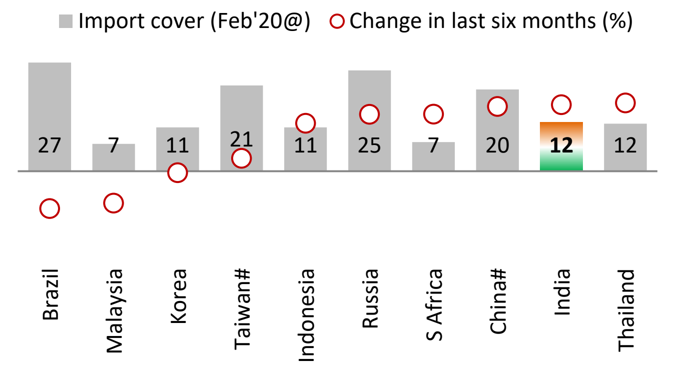
India could post its first current account surplus since FY04: One of the advantages on which India has added massively in the past one year is its large and growing foreign exchange reserves. It took India almost five years (over 2014–19) to increase its forex reserves from USD300b to USD400b; however, it added the next USD87b in just a year, reaching an all-time peak of USD487b in early Mar'20. Although forex reserves fell to USD470b in mid-Mar'20, they recovered quickly and had once again reached an all-time high of USD487b as of 15th May'20 *(Exhibit 2)*. If we look at pre-COVID-19 data, India's import cover (the ratio of foreign reserves and imports) increased to 12 months in Feb'20, from 10 months in early 2019, recording one of the fastest increases in import cover in a year *(Exhibit 3)*.

Exhibit 2: India's foreign exchange reserves have increased substantially in the past one year…



Source: Bloomberg, CEIC, MOFSL

Exhibit 3: …helping improve India's import cover at the fastest pace in the past one year



@ To avoid COVID-19 impact # Apr'20

While India could save almost USD150b (~5% of GDP) on the import bill, almost two-thirds of these savings would be lost due to lower exports.

Moreover, since India relies on imports for 80–85% of its crude oil consumption, the economy tends to benefit disproportionately from a crash in crude oil prices. *Exhibit 4* below gives our estimates of India's savings and losses in the current account in FY21 due to the disruption caused by COVID-19. India is likely to save USD59b on oil imports, less than one-third of which would be offset by lower exports of petroleum products. Similarly, while slower economic growth and the domestic lockdown would hurt non-oil imports, non-oil exports would be adversely affected by a weak global economy. Furthermore, lower remittance inflows this year would partly offset some portion of gains. Overall, our estimates suggest while India could save almost USD150b (~5% of GDP) on the import bill, almost two-thirds of these savings would be lost due to lower exports. Consequently, India's current account could improve by USD49b and post a surplus of ~0.4% of GDP this year, against deficit of ~1% of GDP in FY20 *(Exhibit 4)*. If so, this would be India's first current account surplus in 17 years since FY04.

Exhibit 4: India's current account could post surplus for first time in 17 years in FY21

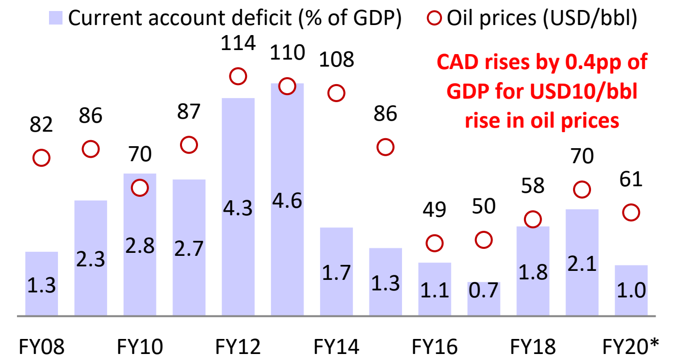
India's imports	Savings (USD b)	India's exports	Losses (USDb)	Net savings (+) /losses (-) on CAD
Lower crude oil prices to reduce import bill of oil & petroleum products	59.0	Lower crude oil prices to hurt export of petroleum products	17.2	41.8
Slower economic growth to lower non-oil import bill	62.6	Weak global growth and domestic lockdown to hurt Indian non-oil exports	50.0	12.6
Total fall in import of invisibles	26.7	Total fall in export of invisibles	32.2	(5.5)
Total positive impact on current account	148.3	Total adverse impact on current account	99.4	48.9

Source: CEIC, MOFSL

Contrary to popular belief, long-term data does not suggest any definite relationship between crude oil prices and the INR.

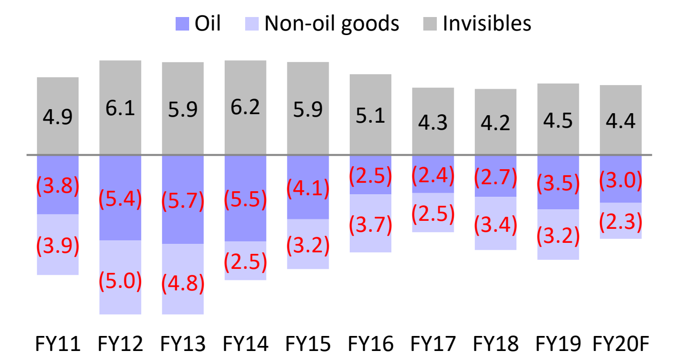
Crude oil prices affect current account balance, not INR…: Notably, a crash in crude oil prices or related improvement in the current account is not a determinant of the INR. A fall (or rise) of USD10/bbl in crude oil prices leads to an improvement (or deterioration) of about 0.4 percentage point (pp) of GDP in the current account balance, which is clearly visible in *Exhibit 5* below. However, contrary to popular belief, long-term data does not suggest any definite relationship between crude oil prices and the INR. As we had **discussed** earlier as well, change in crude oil prices is associated with a number of other factors that may be more relevant in determining INR movement. One of the key factors usually associated with a fall in crude oil prices is the slowdown in global economic recovery. If so, lower crude oil price is actually an indication of bad news for the INR; it would lead to depreciation in the INR against the USD (likely the case for other EM currencies too).

Exhibit 5: Crude oil prices affect India's current account balance…



* 1Q-3Q'FY20

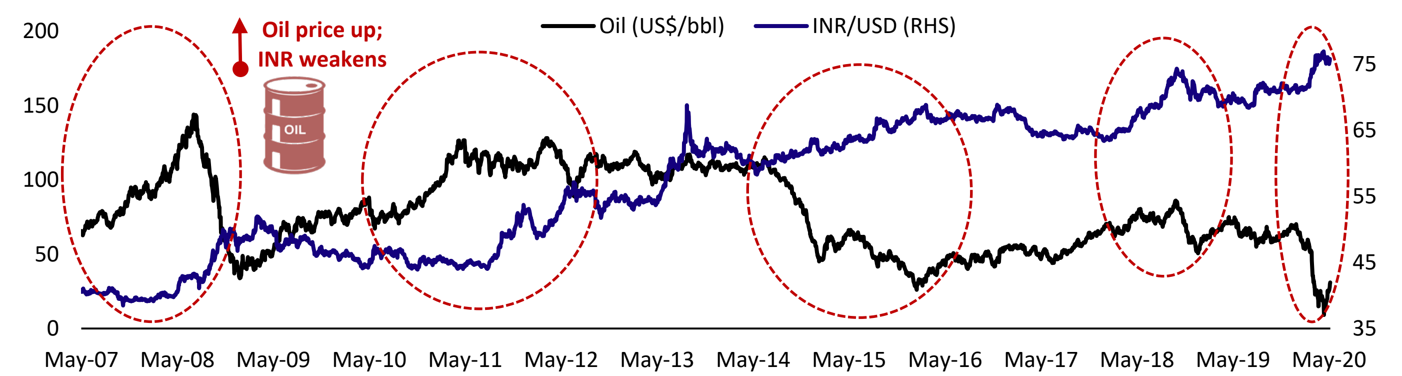
Exhibit 6: …since petroleum products account for a large part of India's current account deficit (% of GDP)



Source: RBI, CEIC, MOFSL

A simple correlation between crude oil prices and the INR confirms this. When crude oil prices rose to USD120/bbl in mid-2008 from USD80/bbl in mid-2007, the INR barely nudged; however, when oil collapsed to USD40/bbl by end-2008, the INR weakened >10% to 49/USD. Similarly, as oil climbed back to USD100/bbl by 2011, the INR strengthened to <45/USD. The Eurozone crisis in 2011 pushed the INR toward 55/USD in a few months, while oil prices remained largely stable. Again, when crude oil crashed 50% in 2015, the INR weakened ~5% during the period. Recently as well, while oil prices fell to an all-time low, the INR also weakened to an all-time low of ~77/USD in mid-Apr'20 *(Exhibit 7)*. These facts confirm factors other than oil and CAD are more important determinants of the INR.

Exhibit 7: Long-term relationship between crude oil prices and INR not certain



Up to May 22, 2020

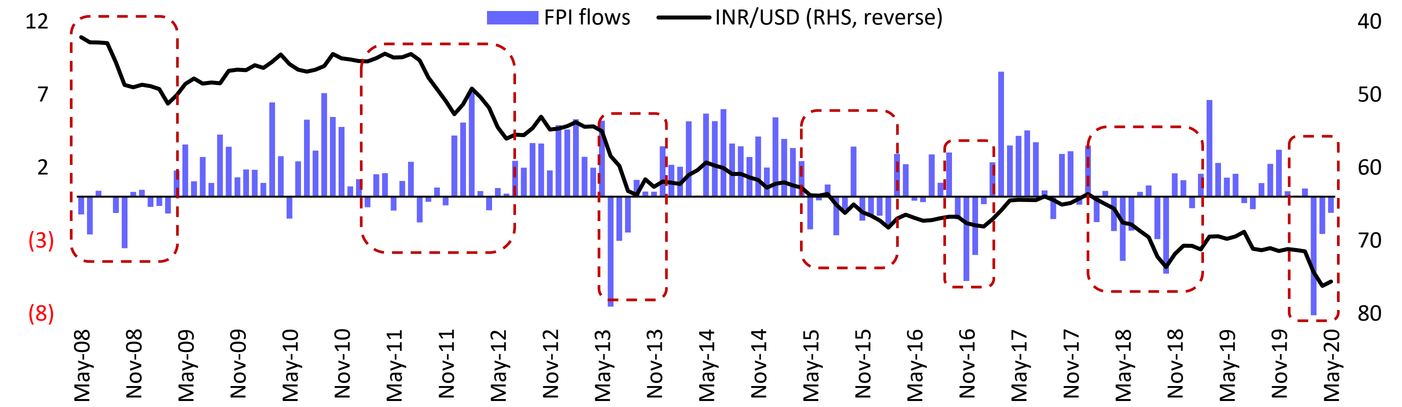
Source: Board of Governors of the Federal Reserve System (US), MOFSL

…which is highly correlated with foreign capital inflows: Since oil prices are not a major determinant of the INR, it is also difficult to establish direct links between movement in CAD and the INR. However, what matters more for the INR from a domestic perspective is India's BoP situation or the depletion/accretion in foreign exchange reserves. The current account is only one part of BoP; capital/financial account constitutes the other aspect. If the sum of current account balance and foreign capital inflows is positive, it is termed as a BoP surplus, which adds to foreign exchange reserves and vice-versa. Within capital/financial account, while foreign direct investments (FDIs) and NRI deposits are stable sources of inflow, foreign institutional/portfolio investments (FIIs/FPIs) are the most volatile component. Consequently, INR movement is highly correlated with FII/FPI flows. More buying/selling by FIIs reflects their positive/negative outlook on the economy, which leads to currency appreciation/depreciation.

INR movement is highly correlated with FII/FPI flows.

Almost all episodes of FII outflows, including the current one, during the past 12 years, has been associated with INR depreciation (highlighted in *Exhibit 8*); on the contrary, the INR has either remained stable or strengthened during the periods of FII inflows. In the first half of FY19, when FIIs withdrew USD16b (or ~INR1.1t), the INR had depreciated ~10% (from 66 to 73) against the USD during the period. In 2HFY19, when FIIs turned net buyers of USD10b (~INR700b) worth of assets, the INR had returned to 70/USD levels.

Exhibit 8: INR is highly correlated with foreign capital inflows over crude oil/CAD



Source: CEIC, MOFSL

We are, however, not implying that FII flows are the only determinant of the INR.

Since FIIs inflows are also affected by global monetary policy and foreign investors' perception of India's economic growth, INR movement tends to be highly correlated with FII inflows over crude oil prices and/or India's CAD. We are, however, not implying that FIIs flows are the only determinant of the INR. In FY20, the INR actually weakened from 69/USD to >71/USD between Apr'19 and Feb'20, although FIIs infused USD11.3b and crude oil price fell from USD70/bbl to USD50/bbl during the period. This suggests there are definitely other factors, ranging from India's fiscal/monetary policy to regulatory change, that have a direct bearing on the INR.

Massive BoP surplus in FY21 to support INR stabilization at 74–75; sovereign rating downgrade a threat

Overall, the recent sharp correction in crude oil prices did not create a stronger INR as it is usually driven by weak prospects of global economic recovery. This then results in FII outflows, leading to INR depreciation. However, INR depreciation is lower than that in some other EM currencies, probably owing to certain advantages, such as high forex reserves, a comfortable current account deficit, and, of course, the fact that the collapse in crude oil prices benefits India disproportionately.

The economy could add another USD64b (~2.4% of GDP) to its foreign exchange reserves this year, taking the total to USD540b by end-Mar'21.

As explained above, the sharp deterioration in the domestic and global economies would hurt India's exports and imports; however, India is likely to save USD49b (or 1.5% of GDP) on CAD this year. This implies India could post its first current account surplus of USD11b (or 0.4% of GDP) in 17 years in FY21. Along with stable FDI/NRI deposits and some FII inflows, the economy could add another USD64b (~2.4% of GDP) to its foreign exchange reserves this year, taking the total to USD540b by end-Mar'21 *(Exhibits 9, 10)*.

Exhibit 9: Decent capital inflows could complement current account surplus…

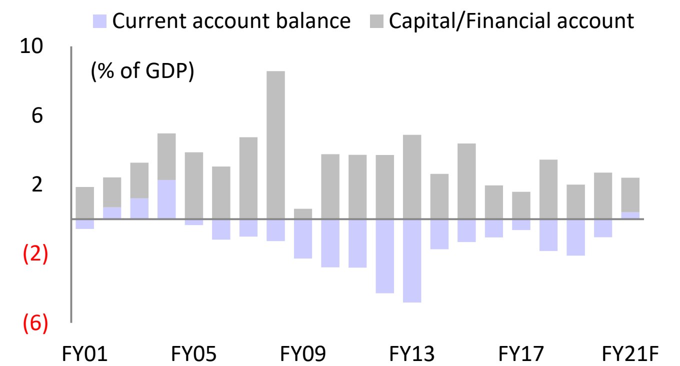
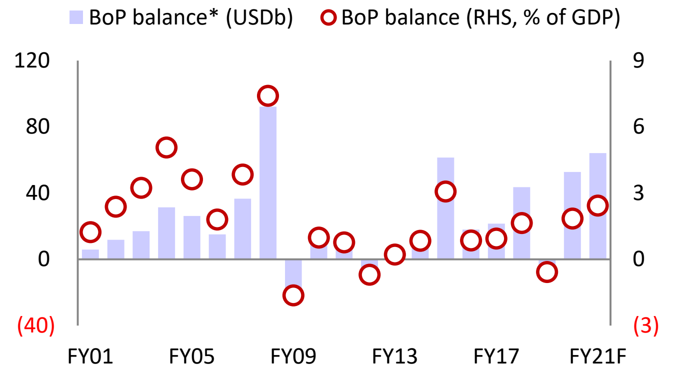


Exhibit 10: …leading to massive BoP surplus worth ~2.4% of GDP in FY21



Source: Bloomberg, CEIC, MOFSL

We believe the INR could average 74–75 against the USD in FY21, weaker than 70.9 in FY20, but stronger than the all-time low of 76.8/USD.

This, along with the fact that India's central government has **announced** a small fiscal stimulus this year (costing ~1.2% of GDP only), may provide some comfort to investors. In the absence of any adverse global shocks (leading to global risk-offs), we believe the INR could average 74–75 against the USD in FY21, weaker than 70.9 in FY20, but stronger than the all-time low of 76.8/USD seen in mid-Apr'20.

Nevertheless, an uncertain economic environment and the lack of clarity over India's fiscal deficit (due to a massive shortfall in receipts) keep the threat of a sovereign rating downgrade alive. Although we do not expect this to happen, any indications in this regard could weaken the INR and re-test all-time lows.

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Registration Nos.: Motilal Oswal Financial Services Limited (MOFSL)*: INZ000158836(BSE/NSE/MCX/NCDEX); CDSL and NSDL: IN-DP-16-2015; Research Analyst: INH000000412. AMFI: ARN - 146822; Investment Adviser: INA000007100; Insurance Corporate Agent: CA0579 ;PMS:INP000006712. Motilal Oswal Asset Management Company Ltd. (MOAMC): PMS (Registration No.: INP000000670); PMS and Mutual Funds are offered through MOAMC which is group company of MOFSL. Motilal Oswal Wealth Management Ltd. (MOWML): PMS (Registration No.: INP000004409) is offered through MOWML, which is a group company of MOFSL. Motilal Oswal Financial Services Limited is a distributor of Mutual Funds, PMS, Fixed Deposit, Bond, NCDs,Insurance Products and IPOs.Real Estate is offered through Motilal Oswal Real Estate Investment Advisors II Pvt. Ltd. which is a group company of MOFSL. Private Equity is offered through Motilal Oswal Private Equity Investment Advisors Pvt. Ltd which is a group company of MOFSL. Research & Advisory services is backed by proper research. Please read the Risk Disclosure Document prescribed by the Stock Exchanges carefully before investing. There is no assurance or guarantee of the returns. Investment in securities market is subject to market risk, read all the related documents carefully before investing. Details of Compliance Officer: Name: Neeraj Agarwal, Email ID: na@motilaloswal.com, Contact No.:022-71881085.

* MOFSL has been amalgamated with Motilal Oswal Financial Services Limited (MOFSL) w.e.f August 21, 2018 pursuant to order dated July 30, 2018 issued by Hon'ble National Company Law Tribunal, Mumbai Bench.