INDIAN RUPEE – LIFE AFTER 70

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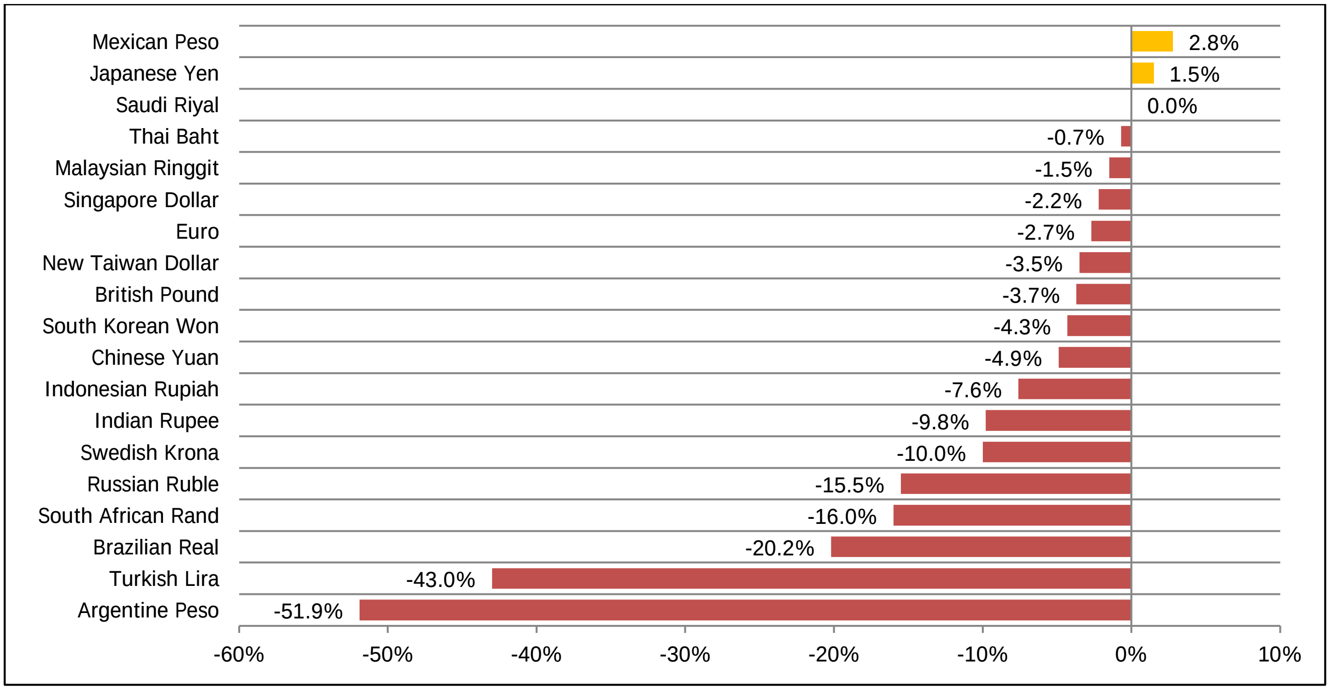
Much has been talked about the Indian Rupee hitting the 70 level against the US Dollar lately. After a slump of 10% this calendar year, it surely is a new low that the INR has seen against the US Dollar. The immediate trigger being, rise in crude oil prices, which adversely impacts the current account deficit and inflation expectations, thereby raising concerns on the currency front. However, there is a need to put things in an economic and historical context to gain some perspective on understanding the currency movements.

The **Purchasing Power Parity** in economics implies that, for the 'Law of One Price' to prevail, the inflation differential between two countries should be reflected in their exchange rate. Hence, the currency of the country with a higher inflation ought to depreciate by the inflation differential. Otherwise, one can just buy a basket of goods in a cheaper market and sell it at a higher price in the other, thereby making risk free arbitrage. There are other factors that can impact exchange rates as well like capital flows, productivity differentials etc.

Since 2001, average inflation differential between the US and India has been about 3.90% per annum. Over these 17 years, the Rupee should have depreciated by an average 3.90% annually. However, it fell by about just 1.90% each year. During this period, we had capital inflows to the tune of about INR 12 lac crores which may have arrested the fall. Thus, the current correction in the Rupee could be viewed as a move towards its fundamental fair value.

In 2018 so far, most currencies have depreciated against the US Dollar, with emerging markets experiencing greater cuts. While increase in commodity prices and monetary tightening by the US Fed have been the primary factors, geo-political risks have intensified the impact. The Indian Rupee has fallen about 10% this calendar year, but the Argentine Peso and the Turkish Lira are down between 43% - 51%. The Russian Ruble, the Brazilian Real and the South African Rand are down between 16% - 20%. Indonesia, the country to which we are usually compared to, has seen an 8% decline in the Rupiah. In case the Rupee was not to correct along with other currencies, India would lose its export competitiveness and the current account deficit could shoot up, thereby probably fuelling domestic inflation which in turn would imply rate hikes, resulting in slowdown of economic growth.

Major currencies against the US dollar, year-to-date change (Source: Thomson Reuters Datastream):



In the past, the Rupee has had its share of periodic plummets; one in 2013 owing to the infamous Taper Tantrum, and another in 2008 at the time of the Global Financial Crisis. The intensity of the fall in 2008 and 2013 was much stronger as the global economy was far more fragile then. Today, the global growth appears more resilient and our domestic fundamentals are more favorable as well. Inflation is much lower; the twin deficits are better controlled and foreign exchange reserves much higher as compared to the past. However, continued rise in crude oil prices is threatening to upset the internal balance.

Gradual depreciation in a country's currency improves competitiveness & provides impetus to exports. On the other hand, large and sudden moves can have adverse economic effects, as players do not have adequate time to adjust their expectations. While it is prudent for a regulator to step in and stem such movements, it is also important that keep such actions controlled so that they are not perceived as acts of currency manipulation. Over the next five years, as per IMF estimates, average annual inflation in India is expected to be just below 5% while the US number is pegged at just above 2%. Thus, going forward, the Rupee should theoretically depreciate by around 2-3% annually against the US Dollar. In the coming years, we may well see levels higher than what we're seeing today but that would very much be in line with what the underlying economic fundamentals warrant. **A depreciating currency may not imply economic weakness. Wisdom lies in letting the market determine fair value of a currency rather than focusing on absolute figures.**

70 after all is just another number.