

Factors Supporting Rupee Comeback

23 January 2012

In the last three weeks the Indian rupee has staged quite a comeback, appreciating nearly 7% since reaching its all time low in mid December, and looks set to appreciate further in the coming weeks.

We believe that this appreciation can be attributed to a combination of four India specific factors:

1. On December 15, the RBI (Indian Central Bank) imposed a number of FX trading restrictions. These served to substantially reduce the ability of residents and foreign investors to roll over forward positions for hedging contracted current account, equity, and debt transactions and future import exposures. The central bank also cut banks' open FX position limits, which significantly reduced onshore speculation and, importantly, shrank liquidity in the onshore FX market, making RBI interventions much more effective. Since late December, the RBI has been reportedly intervening regularly in the FX market in modest doses. Along with reduced liquidity, these interventions have resulted in significant rupee appreciation.
2. The new year also brought surprisingly pleasant economic news: strong manufacturing and services PMI numbers, smart recoveries in IP and exports, and a 150 bps reduction in headline inflation to 7.5%. These have raised market hopes of the RBI finally starting to ease monetary policy. Reflecting the better-than-expected economic news and expectations of monetary easing, the equity market has risen nearly 7% since the start of the year, buoyed by around US \$1 billion of foreign portfolio investment.
3. In addition to the regulatory tightening, the RBI removed limits on banks' dollar deposits for non-resident Indians. In response, several banks raised their US dollar deposit rates, which reportedly have attracted significant inflows.
4. Lastly, as the rupee has appreciated and RBI has demonstrated its intent to support the national currency with regular interventions, exporters, who had all but disappeared from the market, have started to sell US dollars. Although the amounts are not big, given the reduced depth of the FX market, such sales have had a strong impact on the rupee. ■

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