SBI RESEARCH

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CAN THE RUPEE TAKE ADVANTAGE OF "DOLLAR DISTANCING", EVEN AS INFLATION IN INDIA SET TO UNDERSHOOT MARKET PROJECTIONS

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The large rate hike from RBI in its last policy meet, taking the effective policy rates well above the pre pandemic level laid bare the growing unease on currency defence on the part of central banks globally, India included. Interestingly, the Indian rupee has actually weakened post policy to Rs 79.64 / $ on Thursday. Notably, during 2013 when rupee dollar exchange rate was extremely volatile , the RBI had announced a slew of measures including the increase of MSF by 300 bps above the repo rate in July. This also provided a temporary support to the exchange rate as rupee continued to slide down moving from the level of Rs 59 per dollar in mid-Jul'13 to around Rs 69 per dollar by Aug-end. The pull back happened only after the RBI announced the FCNR scheme that guaranteed the hedging risk resulting in avalanche of capital inflows.

Even though the RBI may have frontloaded the rate hikes in the latest policy, it remains to be seen how it influences the trajectory of rupee over the medium term. Research suggests that countries with low prior FX reserves are more likely to choose an interest rate defence than countries with high reserves. This is probably not the case for India (FX reserves: $573 billion). Further, defending the currency through interest rates could also indicate the market participants getting into a self-fulfilling prophecy of expecting more rate hikes to automatically protect the domestic currency whenever it is under pressure. However, in a situation when current account deficit is likely to cross 3.5%, raising the rates might be the best carry trade bet to finance the large CAD.

The good thing is that, there has been a rebound of portfolio capital inflows since July 29th with a capital inflow of around $3.3 bn. At this rate, portfolio capital flows in current fiscal could now turn positive from an outflow of $14.7bn till July 29th. We expect direct investment of around $45 billion, other investment of $30 billion and FII inflows of $10 billion, thereby leading to an overall Balance of payment deficit of $45-50 billion, that could be further scaled down with evolving situation.

Going forward, we now expect inflation trajectory for India to be benign. **CPI numbers for March 23 could be even lower than 5%, if July CPI numbers are closer to 6.5%-6.6%, a likely possibility.** While the crude has exhibited signs of softening thereby cooling off inflationary concerns further locally, we are in a paradoxical situation where inflation trajectory may not have a cascading effect on runaway exchange rate dynamics as sentiments in South China sea could steer the patchy global sentiments. Also, inflation numbers in US are likely to head lower, though core might remain elevated.

Meanwhile, an interesting development is taking place in the global currency market. There has been a significant jump in the demand for Yuan arising from short-circuiting the sanctions in place by corporates in select jurisdictions who have been utilizing multitude of non-dollar currencies to procure Crude and other commodities viz. coal through striking deals in Renminbi/HKD/AED pairs at discounted rates. On a related note, on 5th August, Turkish President Recep Tayyip Erdogan announced that one of the key takeaways from his meeting with Russian President Vladimir Putin in Sochi was bilateral agreement to use Rouble as a monetary unit in trade. The high level talks touched upon gas exports to Turkey with both Central Banks agreeing to partially pay for them in Roubles, and that Russia and Turkey were moving forward to a gradual transition to paying in national currencies only. Russian – Turkey bilateral trade is currently running at about US$ 23.5 billion with both sides committing to increasing this to US$100 billion by 2030. **With China vowing to anchor the bonhomie with Russia, there seems a certainty that 'Dollar Distancing' could be a reality in coming days.**

US Dollar has been a clear winner of the surging geo-political conflict. The surreptitious search for the Dollar alternative globally has interestingly seen many countries exploring non traditional payment and settlement mechanisms that points to **'Dollar Distancing' finally happening? Time for India to pitch Rupee as a credible, secular alternative in the changing world order?**

In fact, even with the clamour of positive real rates, This calendar year (2022) till now is exhibiting large deceleration in deposits for the period of Jan-Jul'22 as compared to last year corresponding period. However, even though the real rates might turn positive early next year, it is unlikely that deposits will stand to gain materially as households investment in stock markets has turned into a self-fulfilling prophecy.

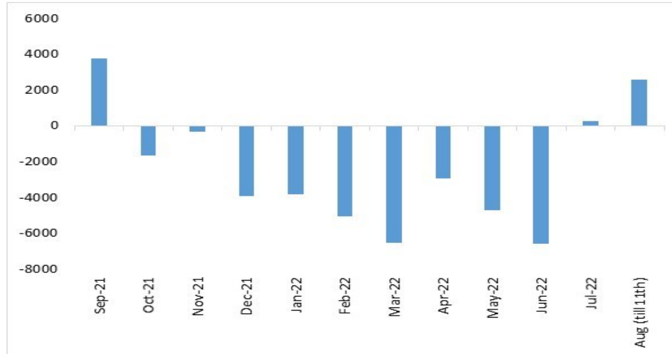
RUPEE CONTINUES TO WEAKEN

- The FII inflows have also turned positive since Jul-end pouring in $3.3 billion into the country. Notably, FII inflows remained in the negative territory for 9 months since Oct'21 and only reversed in Jul'22.
- Oil has also moved down below $100/bbl and moving around $96/bbl after the increase in US stockpiles indicated low demand.
- On the external data front, the recent trade deficit data shows an increase to record high in Jul'22, annualizing the current deficit numbers gives annual deficit of 8.5% of our GDP projections for FY23 which is much lower than the peak deficit of 10.7% of GDP achieved in FY13. Thus, the current situation is much better than that in 2012-13. Moreover, the market has already priced in higher CAD i.e. higher than 3% of GDP for FY23.
- Elsewhere if we look at the latest US payroll data, hiring in July was much better than expectations. Nonfarm payrolls rose 528,000 for the month and the unemployment rate was 3.5%, back to its pre-pandemic level. This in turn has led the market to believe that the Fed would continue to raise rates more aggressively to combat inflation as the fear of recession is reduced. However, the latest inflation data in Us has raised hopes of Fed raising rates in multiples of 50 bps now.
- Thus, it seems that the rupee depreciation is not linked to the economic fundamentals. Turnover data in Foreign Exchange Market shows further increase in merchant demand for dollars, in anticipation of strong dollar and hence may have been holding to long position in dollars. This was being balanced by excess dollar supply in interbank market.
- Also, it should be mentioned that RBI has also been intervening in the spot market. It has sold $18 billion worth of dollars in the spot market to protect the currency even as it depleted its forward dollar book by another $15 billion in Apr-May'22.

INTEREST RATE DEFENSE OF RUPEE

- Notably, during 2013 when rupee dollar exchange rate was extremely volatile RBI had announced a slew of measures including the increase of MSF by 300 bps above the repo rate in July. This provided the immediate support to the exchange rate. However, it was only temporary as rupee continues to slide down moving from the level of Rs 59 per dollar in mid-Jul'13 to around Rs 69 per dollar by Aug-end.

Net FII Inflows turned Positive ($ million)

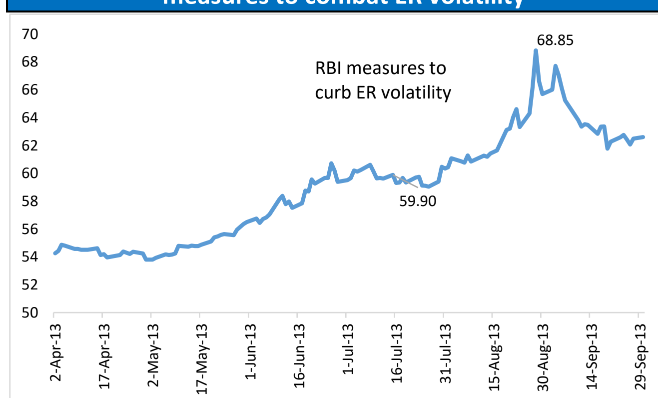


Source: SBI Research

Turnover in Foreign Exchange Market ($ mn)								
Month	Merchant			Interbank			Grand Total	IB SWAP
	Forward Excess Demand	Spot Excess Demand	Total Excess Demand	Forward Excess Demand	Spot Excess Demand	Total Excess Demand		
Jun-22	13,777	10,556	24,334	-9890	-16,050	-25,940	-1,606	-18,578
May-22	2,739	11,031	13,770	-7195	-7,941	-15,136	-1,365	-24,871
Apr-22	6,784	-1,201	5,583	7405	-781	6,624	12,207	-47,216
Mar-22	5,468	-5,497	-30	10259	-10,566	-307	-337	-41,838
Feb-22	2,321	1,270	3,591	3025	-5,181	-2,156	1,434	680
Jan-22	7,524	-1,108	6,416	-2135	-3807	-5,942	474	-737
Dec-21	8,406	-1,467	6,939	5055	-10793	-5,738	1,201	-29,091
Nov-21	9,380	3,918	13,298	-352	-6967	-7,319	5,979	-38,875
Oct-21	7,400	-8,054	-655	5016	-8367	-3,350	-4,005	-12,635
Sep-21	7,684	-5,575	2,109	2468	-3853	-1,385	724	-29,125
Aug-21	8,117	-4,598	3,519	-7174	1452	-5,723	-2,204	-18,220
Jul-21	2,900	-8,546	-5,647	-421	4812	4,391	-1,255	3,365
Jun-21	6,579	-5,396	1,183	3616	1529	5,145	6,327	19,120
May-21	7,903	-1,254	6,650	4008	-3536	472	7,121	6,483
Apr-21	717	-4,092	-3,375	10924	-3107	7,817	4,442	10,087
Mar-21	6,386	-5,415	971	9881	128	10,009	10,980	-4,810
Feb-21	-1,450	-2,830	-4,280	2922	9171	12,093	7,813	2,087
Jan-21	6,695	-8,014	-1,319	4990	1383	6,373	5,054	19,714
Dec-20	4,521	-12,779	-8,258	7610	-929	6,680	-1,578	9,029

Source: RBI, SBI Research

Rupee continued to depreciate in 2013 despite RBI measures to combat ER volatility



Source: SBI Research

- These measures instead pushed up the term structure of interest rates and reduced liquidity over the medium term.
- Thus, as we have already highlighted that defending the currency through interest rate could indicate market participants could get into self-fulfilling prophecy of expecting more rate hikes to automatically protect the currency whenever it is under pressure.

FIANANCING OF CAD CAN LOOK MUCH BETTER WITH $3.3 BN FII FLOWS COMING IN SINCE JULY 29

- Given current circumstance, CAD is expected to come at 3.7% of GDP or $131 billion in FY23.
- We expect direct investment of around $45 billion, other investment of $30 billion and FII inflows of $10 billion, thereby leading to an overall Balance of payment deficit of $45-50 billion.

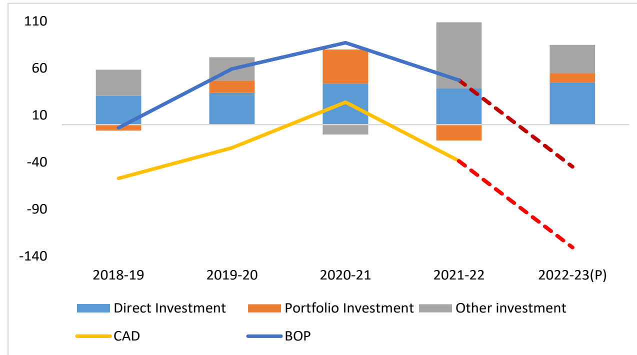
INFLATION TRAJECTORY & RATE CYCLE

- **We believe inflation in FY23 is likely to come around 6.4-6.5% (below RBI projection of 6.7%) with inflation moving below 6% only in Nov'22. For FY24 it should come at 4.8%.**
- However, there is another aspect that RBI would have to consider while increasing rates which is the impact of higher rates on growth.
- By Dec'21 around 39.2% of the loans are benchmarked to external benchmarks (EBR), so the increase in repo rate of 140 bps will eventually increase interest cost on consumers ~ Rs 42,500 crore on Retail & MSME consumers and demand is likely to be impacted. **This may have an impact on growth. Rural demand has also been impacted going by the results of FMCG companies.**
- Under the current situation interest rates will rise including in India. If the rate hike is aggressive in America and EU in subsequent cycles, then rate hike will reflect in India. Today's hike is already more than market expectation of some moderation. Under the evolving situation the repo rate will tend to be at 6% +/- 25 bps by end of FY23.
- The RBI could continue to intervene in the overseas non-deliverable forward (NDF) market, which will allow for round-the-clock trading of the rupee and continue to allow foreign subsidiaries of Indian banks to participate in the offshore rupee derivative market to help stabilise the volatility in the forex market.

WHERE BANK DEPOSITS ARE GOING?

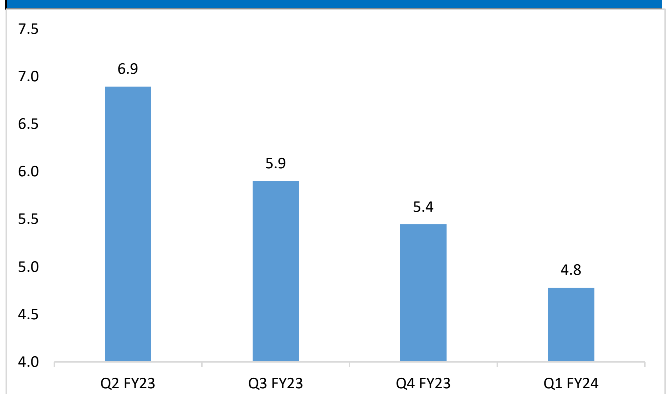
- This calendar year (2022) till now is exhibiting large deceleration in deposits for the period of Jan-Jul'22 as compared to last year corresponding period. During Jan-Jul this year, deposits growth decelerated by Rs 2.1 lakh crore on YTD basis as compared to same period during last year.

Financing of CAD (USD Bn)



Source: SBI Research

Inflation trajectory (%) - SBI Projections



Source: SBI Research

Period	Incremental Change in Deposits of ASCBs
Jan'21-16 Jul'21	Rs 7.9 lakh crore
Jan'22-15 Jul'22	Rs 5.7 lakh crore
Change	**-Rs 2.2 lakh crore**

Stock Market:
~Rs 1.2 lakh crore
(15 lakh new investors registered in Jan-Jul'22 as compared to Jan-Jul'21)

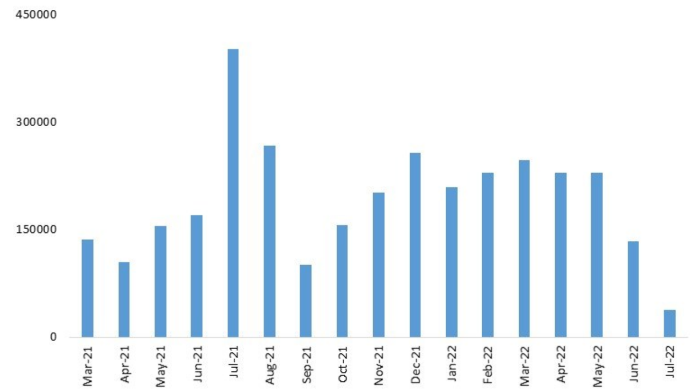
Mutual Funds:
~Rs 1.0 lakh crore
(~25 lakh new SIPs registered in Jan-Jul'22 as compared to Jan-Jul'21)

- Retail investors emerged as strong buyers of Indian equities since the pandemic, adding fuel to the ongoing rally. A sharp market crash in the quarter ending March 2020, due to the onset of COVID-19 outbreak and lockdown-induced economic uncertainty, lured retail investors into trading in equity markets, with an ensuing liquidity-led market rally further strengthening their sentiments.
- This is reflected in an increase in retail ownership in the NSE-listed universe during the last few quarters. This increased buying is also reflected in a sharp rise in new investor accounts added last year and increase in retail share in the cash market turnover. Moreover, the share of individual retail investors is stood at 37.2% in CY22.
- Braving the selloff by foreign investors, a meltdown in global equities, weakening rupee, soaring inflation and Nifty's 52-week low level, retail mutual fund schemes saw positive inflows for the 16th consecutive month since March 2021, data released by AMFI. Net inflows in such schemes stood at Rs 13,338 crore in June and Rs 3847 crore in July.

CURRENCY PAIRS ARE MOVING SIDEWAYS

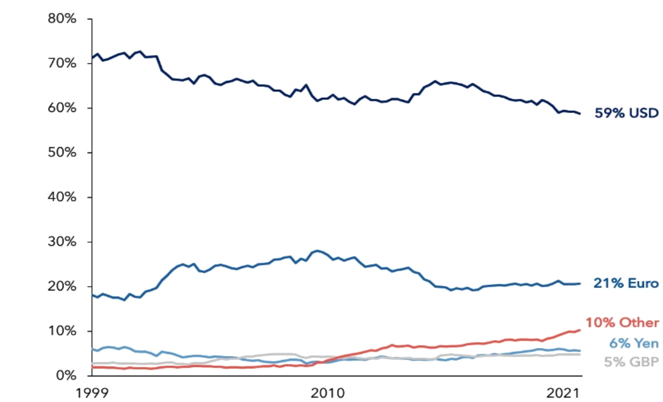
- US Dollar has been a clear winner of the surging geopolitical conflict, accentuated by the lingering war in Europe despite headwinds at home front from 40 years high inflation forcing the Fed to enhance rates at maximum throttle. The surreptitious search for the Dollar alternative globally has interestingly seen many countries exploring non traditional payment and settlement mechanisms that mirror the aspirations of countries to seek divergence from a currency order hugely tilted towards the Greenback. Is 'Dollar Distancing' finally happening?
- Trading volume in the Renminbi-Rouble pair had increased to the highest ever by end July touching a daily record of 7.82 billion yuan (nearly $1.16 billion) on a daily basis, Russian Exchange data showed. Incidentally, volumes for the Renminbi-Rouble currency pair inched higher than those for the Euro-Rouble pair as per exchange data. That also tamed the fiery rise of the rouble, taking some steam off the table as it had appreciated to sub-55 levels after falling to 139 in the early days of war. In July, the Rouble was month's worst performer against the dollar among 23 emerging-market currencies.

Net inflows in Retail Mutual Fund Schemes (Rs crore)

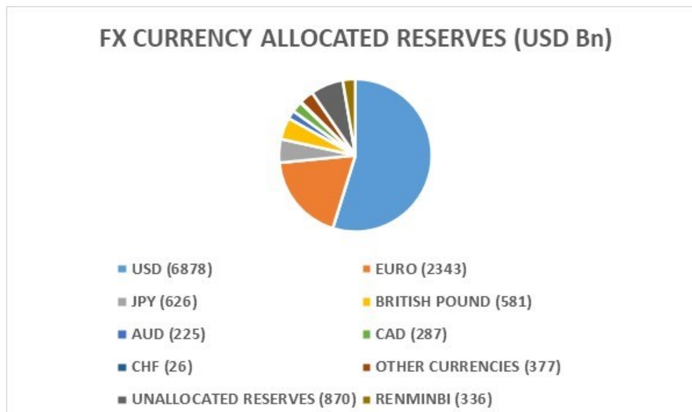


Source: SBI Research

Currency Composition Global FX reserves (in % terms)



(Source: IMF)



- The high demand for Yuan seems arising from short-circuiting the sanctions in place by select jurisdictions who have been utilizing multitude of non-dollar currencies to procure Crude and other commodities viz. coal through striking deals in Renminbi/HKD/AED pairs at discounted rates. This mirrors the relaxations inbuilt into the sanctions ab-initio to ensure energy and food security for Europe.
- On 5th August, Turkish President Recep Tayyip Erdogan announced that one of the key takeaways from his meeting with Russian President Vladimir Putin in Sochi was bilateral agreement to use Rouble as a monetary unit in trade. The high level talks touched upon gas exports to Turkey with both Central Banks agreeing to partially pay for them in Roubles, and that Russia and Turkey were moving forward to a gradual transition to paying in national currencies only.
- Russia is one of Turkey's main energy suppliers. In 2021, Moscow provided the nation with a quarter of its oil imports and about half of its gas purchases. Russian – Turkey bilateral trade is currently running at about US$ 23.5 billion with both sides committing to increasing this to US$100 billion by 2030. With China vowing to anchor the bonhomie with Russia, there seems a certainty that 'Dollar Distancing' could be a reality in coming days. Time for India to pitch Rupee as a credible, secular alternative in the changing world order.
- Share of USD in Global Foreign Exchange reserves has been shrinking since the start of the twenty first century, falling close to 59% as on end Dec'21 from above 70% two decades back. The share of non-traditional currencies, though still only 10% in the kitty could see a quantum jump given the geo political turmoil altering the fragile equilibrium between competing nations whose penchant for proliferation to non-dollar reserves can take new highs as Taiwan becomes the sweet spot of murky waters rising above the neck level.
- As per latest figures available, Russia held US$105 Bn of total US$ 336 Bn held in Yuan, followed by Brazil, Switzerland, Mexico, Israel, Chile and South Africa. The lure of PBOC's CBDC launch in near future should up the ante as more countries could finally gear up to challenge Dollar hegemony. The currency war of the future is surely having a nuanced beginning through such Dollar Distancing measures, waiting for the moment of reckoning soon.

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Contact Details:
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in,
gcea.erd@sbi.co.in
Phone:022-22742440
: kantisoumya