Why the INR Will Strengthen By 10% against the USD in This Fiscal Year

The INR is trading at levels of Rs 53.90 to the USD, just over 5% from all-time lows of Rs 57 seen in June 2012. The currency can appreciate by 10% in fiscal 2013-14 to levels of Rs 48.5 to the USD. The reasons for the INR appreciation argument are a) Expected fall in CAD and Fiscal Deficit in 2013-14 b) Improving risk appetite in global markets c) Rising capital flows and D) Catching up factor

The INR has been the worst performing currency largely due to its widening current account deficit (CAD). India's CAD widened from 2.7% of GDP in 2010-11 to 5% of GDP in 2012-13. The widening current account deficit was accompanied by a rise in fiscal deficit that rose from levels of 4.9% of GDP in 2010-11 to 5.9% of GDP in 2011-12. India's GDP growth fell from levels of 8.4% to 5% over the 2010-11 to 2012-13 period. Inflation as measured by the WPI (Wholesale Price Index) trended at well over 9% levels in the 2010-2012 period. The widening CAD was financed by capital flows but the INR paid the price for an economy that showed sharply weakening macro trends.

The outlook for CAD in fiscal 2013-14 is largely positive and it is expected to come off to levels of 4.5% of GDP and below. The CAD is expected to come off largely on the back of falling oil and gold prices globally. Oil and gold prices are down by 12% over the last one year and given that these two commodities contribute to 34% and 11% of total imports, a fall in the prices will help lower trade deficit and hence the CAD. Trade deficit as a percentage of GDP widened from levels of 10.1% seen in fiscal 2010-11 to levels of 12.3% in the third quarter of 2012-13.

Fiscal deficit came off from 5.89% of GDP seen in 2011-12 to 5.2% of GDP in 2012-13 and is budgeted at 4.8% of GDP for 2013-14. The FM is confident of ending this fiscal with a lower than budgeted fiscal deficit. GDP growth rates are forecast to improve to 5.7% for this fiscal while inflation is expected to stay at levels of 5.5%. Macro indicators are looking positive even though the country has a long way to go to achieve trend growth rates and to bring down deficits to more manageable levels.

Global risk appetite is improving. Equity indices in the US are at record highs while indices of countries such as Japan and Germany have gained by 45% and 18% over the last one year. Bond yields of debt ridden countries of Spain and Italy are down over 200bps over the last eight months indicating that markets are comfortable in taking down bond yields of high debt countries. Gold prices falling by over 20% from highs seen in 2011 indicate that risk aversion trades are being unwound actively.

Capital flows into India were healthy in fiscal 2012-13 with FII investments in equities and debt at USD 31 billion. FIIs have lapped up the bond limit auction of USD 5.4 billion held in April 2013 and will fill up this limit in the coming months. The Unilever Open Offer for HUL is worth USD 5.4 billion and the offer is slated for June 2013. FII flows into equity and debt is looking healthy at present and FIIs are likely to put in money in Indian assets on expectations of rising equity markets, falling bond yields and strengthening Rupee.

The INR is the worst performing currency amongst its Asian peers . In the last two years the INR has lost over 20% against the USD while currencies such as the Thai Bhat and the Philippines Peso have gained. The Indonesian Rupiah is the next worst performer to the USD with a 13% loss. The Korean Won and Malaysian Ringgit have marginally declined against the USD over the last two years. The fact that the INR has weakened significantly against the USD will make speculators shift out of other Asian currencies into the Indian Rupee. The INR will be a "Catch Up" currency trade in the coming months leading to further strengthening of the INR.

Why 10% gains against the USD and not just 5% or even 15%? To be frank, there is no real scientific reason to this but the fact is that markets tend to overshoot and undershoot. It took the INR down to levels of Rs 57 when factors were looking negative for the currency and on a positive sentiment trade the markets can take the INR to levels of Rs 48.50. However the primary direction for the INR is up against the USD.

	25-Feb-12	25-Feb-14	% Change
USD/INR	49.1988	61.9575	25.93%
USD/THB	30.455	32.574	6.96%
USD/KRW	1125.8	1072.85	-4.70%
USD/IDR	9052	11665	28.87%
USD/MYR	3.0125	3.2802	8.89%
USD/PHP	42.755	44.63	4.39%

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