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INR OUTLOOK

INR to trade in a range of 73.7-75.5/US$, until policy normalisation by the US Fed becomes imminent

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HIGHLIGHTS

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The RBI may continue to accumulate foreign exchange reserves during periods of INR appreciation.

This would help to contain the extent of the depreciation in the Rupee, once the Fed commences its monetary policy normalization.

INR to trade in a range of 73.7-75.5/US$ in the near term, until policy normalisation by the US Fed becomes imminent

In its July 2021 policy meeting, the Federal Open Market Committee (FOMC) of the US Federal Reserve Bank maintained status quo on the Federal Funds Rate (at 0.0-0.25%) and the monthly Quantitative Easing (QE) purchase program of USD 120 billion. The Central Bank continued to term the inflationary pressures as 'transitory', suggesting no immediate move to hike rates. It remained constructive on the growth outlook despite the rising incidence of the delta variant of Covid-19 in the US. While tapering was discussed in the meeting, the Fed Chairman indicated that more progress on the job market front is needed, before a final decision can be taken on the timing of tapering of bond purchases.

With no imminent move towards tapering bond purchases by the US Fed, the INR has strengthened marginally today. However, going forward, we expect the US Dollar to gain ground, reflecting its 'safe-haven' appeal as the US Fed starts tapering discussion. **Overall, we expect the dollar index to maintain a range of 90.5-93.5 in the near term, which is likely to impart a depreciation bias to the INR.**

In addition, while the unlocking and vaccine ramp up have brightened the prospects for the pace of the economic revival, uncertainty persists given the emergence of the Delta Plus variant of Covid-19 amid a slower-than-expected administration of vaccines. Such factors are likely to impact the sentiment and result in a modest depreciation bias for the Rupee.

We expect the Monetary Policy Committee (MPC) to commence policy normalisation in Q4 FY2022, after the domestic growth revival solidifies, with a change in the stance to neutral from accommodative. However, this may be preponed to the Dec 2021 policy review, if inflation springs a negative surprise. **The eventual onset of the rate hike cycle may cause more outflows from the FPI debt segment, as the foreign investors would look to avoid capital losses**. This would in turn weigh on the Rupee.

We expect the Indian current account to revert to a modest deficit of US$20-25 billion (-0.8% of GDP) in FY2022 from the surplus of US$ 24 billion (+0.9% of GDP) in FY2021. Additionally, we expect the FII and FDI inflows to ease significantly in FY2022, relative to FY2021. **However, the inclusion of Indian bonds in global bond index could lead to the sentiment related flows into the debt segment, propping up the INR.**

Going forward, the Reserve Bank of India (RBI) may continue to accumulate foreign exchange reserves during periods of INR appreciation. This would help to contain the extent of the depreciation in the Rupee, once the Fed commences its monetary policy normalization. At present, we expect the INR to trade in a range of 73.7-75.5/US$, until policy normalisation by the US Fed becomes imminent.

INR HAS STEADIED IN JULY 2021 AFTER DEPRECIATION IN JUNE 2021: The Rupee turned from an outperformer in May 2021 to one of the worst performing Asian currencies in June 2021, led by rising global crude oil prices as well as a stronger dollar on the back of a seemingly hawkish Fed (refer Exhibits 1 and 2). Relative to the US$, the INR depreciated by 2.4% over the course of June 2021, its worst performance since March 2020. In this month, it performed better than only three of the EM currencies (South African Rand; -4.0%, Turkish Lira; -2.5%, and Thai Baht; -2.7%).

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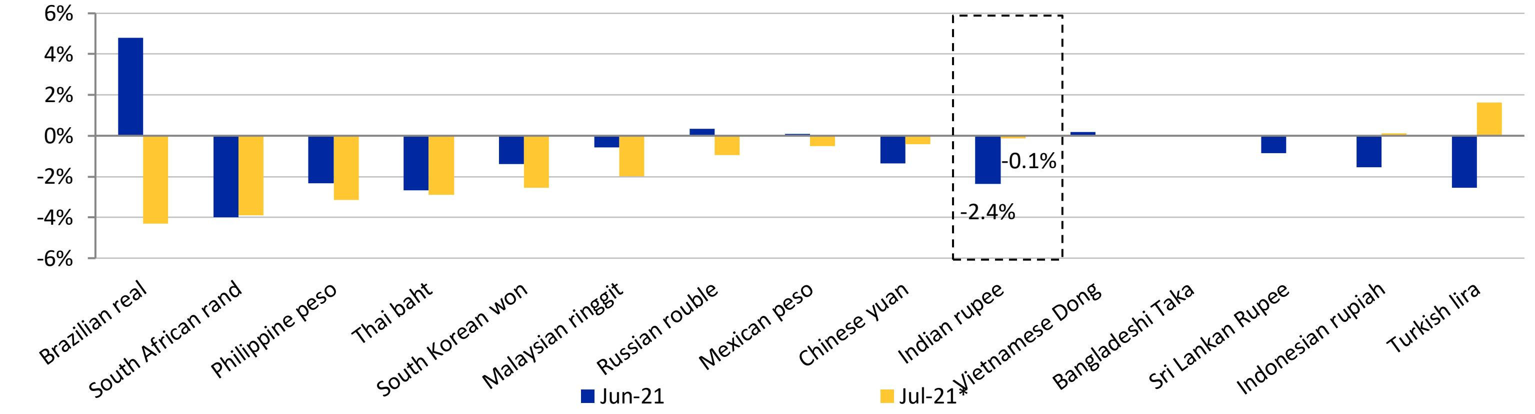
EXHIBIT 1: Exchange Rate Movements of Various Currencies Relative to the US$ in June 2021 and July 2021



*Note: Exchange rate movements are relative to the previous month; *till July 26, 2021; **Source**: Bloomberg; RBI; ICRA research*

Subsequently, in July 2021 (till July 26, 2021), the INR has depreciated by a mild 0.1% against the US$. Notably, the dollar index increased to 92.6 in July 2021 (till July 26, 2021) from an average of 91.0 in June 2021, as the global risk aversion intensified, driven by increased concerns about the spread over the Delta variant of Covid-19. Notwithstanding the broad-based dollar strength, robust IPO inflows along with modest pressures from the current account have limited the USD/INR pair under the 75 mark. The performance of the INR, relative to the US$, in this period was stronger than that of EM currencies such as the Brazilian Real, Philippine Peso, Russian Rouble, Thai Baht, South Korean Won, South African Rand, Mexican Peso, Chinese Yuan, and Malaysian Ringgit (till July 26, 2021).

In its July 2021 policy meeting, the FOMC of the US Federal Reserve Bank maintained status quo on the Federal Funds Rate (at 0.0-0.25%) and the monthly QE purchase program of USD 120 billion. The U.S CPI YoY inflation had jumped to a 13-year high 5.4% in June 2021 from 5.0% in May 2021, well above the Fed's 2% target, reflecting increases in both core and non-core components. The Central Bank continued to term the inflationary pressures as 'transitory', suggesting no immediate move to hike rates. It remained constructive on the growth outlook despite the rising incidence of the delta variant of Covid-19 in the US. While tapering was discussed in the meeting, the Fed Chairman indicated that more progress on the job market front is needed, before a final decision can be taken on the timing of tapering of bond purchases.

With no imminent move towards tapering bond purchases by the US Fed, the INR has strengthened marginally today. However, going forward, we expect the US Dollar to gain ground, reflecting its 'safe-haven' appeal as the US Fed starts tapering discussion. Overall, we expect the dollar index to maintain a range of 90.5-93.5 in the near term, which is likely to impart a depreciation bias to the INR.

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EXHIBIT 2: Movement in USD-INR reference rate

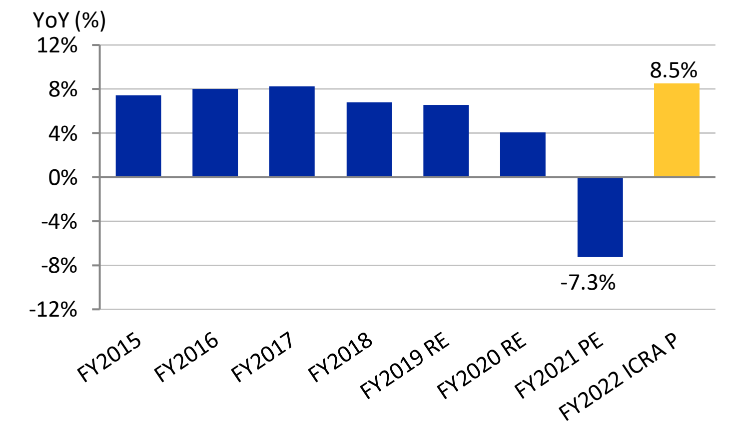
till July 20, 2021; **Source: Bloomberg; RBI; ICRA research*

We forecast GDP expansion at 8.5% in FY2022, with accelerated vaccination to offer an upside of 9.5% growth in this fiscal year. However, uncertainty persists given the emergence of the Delta Plus variant of Covid-19 amid a slower-than-expected administration of vaccines

DELTA VARIANT AND SLOWER-THAN-EXPECTED VACCINE ADMINISTRATION KEEP DOMESTIC GROWTH PROSPECTS UNCERTAIN: The second wave of Covid-19 led to the imposition of state-level restrictions, and most indicators recorded a MoM decline in volumes in April 2021 and May 2021. Following a dip in the new Covid-19 cases, many states commenced a phased unlocking over the month of June 2021. While a revival has undoubtedly set in, volumes for most non-financial indicators in June 2021 were weaker than the levels in both April 2021 and June 2019, suggesting that the recovery is incomplete. We expect that the real GDP in Q1 FY2022 will trail the Q1 FY2020 level, while recording a double-digit YoY expansion.

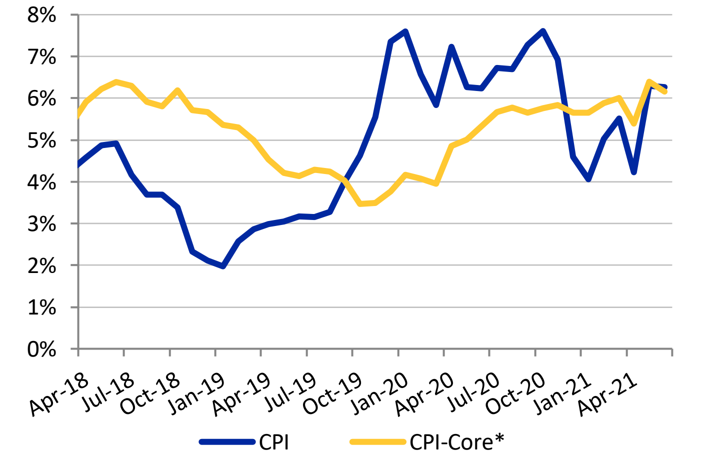
In July 2021, the available high frequency indicators have continued to record a sequential improvement with the further unlocking and easing of restrictions. **While some indicators such as vehicle registrations and generation of GST e-way bills appear set to surpass the April 2021 levels in July 2021, they remain weaker than the robust performance seen in February-March 2021. We continue to forecast GDP expansion at 8.5% in FY2022 (refer Exhibit 3), with accelerated vaccination to offer an upside of 9.5% growth in this fiscal year. However, uncertainty persists given the emergence of the Delta Plus variant of Covid-19 amid a slower-than-expected administration of vaccines. Such factors are likely to impact the sentiment and result in a modest depreciation bias for the Rupee.**

EXHIBIT 3: YoY Growth in GDP (at constant 2011-12 Prices) and ICRA's forecasts for FY2022



*RE: Revised Estimates; PE: Provisional Estimates; P: Projected; **Source:** NSO, CEIC, ICRA research*

EXHIBIT 4: Headline and Core CPI Inflation (YoY)



Since the detailed data for March-May 2020 is not available, we have not excluded prices for petrol and diesel of vehicles in the calculation of the core-CPI index for the YoY inflation rates; **Source: NSO; ICRA research*

The eventual onset of the rate hike cycle may cause more outflows from the FPI debt segment, as the foreign investors would look to avoid capital losses. This would in turn weigh on the Rupee.

POLICY NORMALISATION EXPECTED TO COMMENCE IN Q4 FY2022: The Indian CPI inflation for June 2021 eased marginally to 6.26% from 6.3% in the previous month (refer Exhibit 4), despite a pickup in food inflation and rising retail fuel prices. However, it did remain above the upper threshold of the MPC's 2-6% medium term target for the second month in a row, and exceeded our projection of 6.1%. In MoM terms, the CPI had hardened by a sharp 1.6% in May 2021, which we believe reflects the impact of supply-side issues related to the widening state-level restrictions during the second wave of Covid-19. The MoM uptick eased to 0.6% in June 2021, as the unlocking started.

Given the uncertain growth outlook, we expect the MPC to maintain a status quo in the rates and stance in the next two policy reviews, with a reiteration of the intention to support economic activity. However, an upward revision in the CPI inflation forecast is likely to inject a tone of uneasiness, especially in the individual MPC members' minutes. In our view, the tussle between supporting the nascent, incomplete revival in growth and preserving the anchoring of inflationary expectations will continue. We expect policy normalisation to commence in Q4 FY2022, after the growth revival solidifies, with a change in the stance to neutral from accommodative. However, this may be preponed to the Dec 2021 policy review, if inflation springs a negative surprise.

The eventual onset of the rate hike cycle can cause more outflows in the FPI debt segment in the near-term, as the foreign investors would look to avoid capital losses. This would in turn weigh on the Rupee. In our view, the policy rates would have to go up by a considerable magnitude, before the Indian debt segment starts attracting fresh inflows.

A favourable base effect is likely to pull down the headline CPI inflation print for July 2021 below 6.0%. In our view, the CY2021 CPI inflation peak is likely to be behind us. Nevertheless, we expect the CPI inflation to average a high 5.5-5.7% in FY2022. Accordingly, we expect the MPC to revise its inflation forecast upwards in the next scheduled review in August 2021, from the June 2021 expectation of 5.1% in FY2022, with risks broadly balanced.

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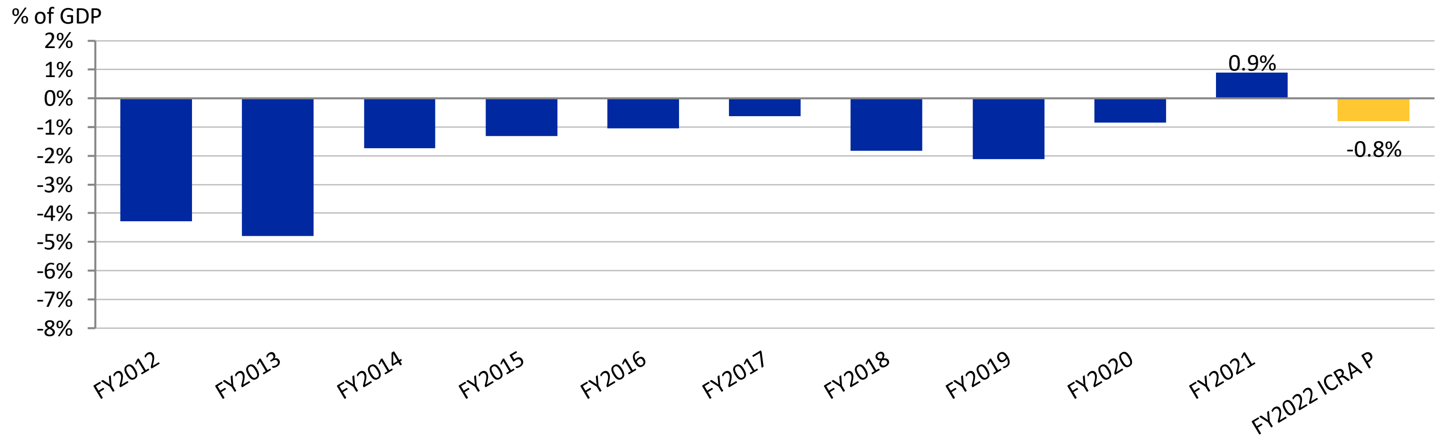
As the states unlock further and the recovery gathers pace, we expect the current account to report moderate deficits of US$5-10 billion each in Q2-Q4 FY2022

HIGHER CURRENT ACCOUNT DEFICIT TO WEIGH ON THE RUPEE: India's current account deficit widened considerably to a seven-quarter high US$8.1 billion (-1.0% of GDP) in Q4 FY2021 from US$2.2 billion (-0.3% of GDP) in Q3 FY2021, on account of the normalisation in import demand as well as a surge in gold imports. Going forward, we expect the current account to revert to a small surplus in Q1 FY2022, with surging exports and relatively subdued gold imports in May-June 2021 dampening the aggregate trade deficit to a three-quarter low US$31 billion in that quarter. **However, as the states unlock further and the recovery gathers pace, we expect the current account to report moderate deficits of US$5-10 billion each in the remaining quarters of FY2022, factoring in crude oil prices in the range of US$70-75/barrel. Overall, we expect the current account to revert to a modest deficit of US$20-25 billion (-0.8% of GDP; refer Exhibit 5) in FY2022 from the surplus of US$ 24 billion (+0.9% of GDP) in FY2021.**

EXHIBIT 5: Current Account Deficit as a percentage of GDP and ICRA's projections for FY2022



*P: Projected; Surplus (+)/Deficit (-); **Source**: RBI, CEIC; ICRA research*

FII INFLOWS TO IMPROVE SEQUENTIALLY, BUT TRAIL FY2021 LEVELS: FIIs had turned into net sellers in the equity segment during April-May FY2022 (net outflows of ~US$1.7 billion), with concerns about the near-term growth prospects, amid escalating Covid-19 cases and announcements of localised restrictions. Subsequently, with the unlocking of the economy, the FII inflows into the equity segment witnessed a turn-around, with modest the net inflows of ~US$1.2 billion during June-July 2021 (till July 28, 2021). Going forward, with ample global liquidity, and the prospects of a pick-up in domestic demand in H2 FY2022 if the vaccinations gather pace, FIIs inflows are likely to improve in remaining quarters of FY2022, unless the fears of a third wave of Covid-19 cases manifest. **Nevertheless, we expect FII inflows into Indian equities to ease significantly to ~US$15-20 billion in FY2022 from US$37.0 billion in FY2021.**

Meanwhile, the debt segment witnessed mild net outflows of US$0.5 billion during Q1 FY2022 and mild net inflows of US$0.5 billion during Q2 FY2022 so far (till July 28, 2021). **Given the likelihood that monetary policy normalisation may begin in Q4 FY2022, we expect continued FII outflows of US$2-4 billion in FY2022 from the debt segment, as compared to the US$2.2 billion witnessed in FY2021. In contrast, the inclusion of Indian bonds in global bond index could lead to the sentiment related flows into the debt segment, propping up the INR.**

The inclusion of Indian bonds in global bond index could lead to the sentiment related flows into the debt segment, propping up the INR

With a surge in May 2021, gross FDI inflows rose significantly by 188.8%, to US$15.1 billion in April-May 2021 from US$5.2 billion in April-May 2020. Going forward, plans by Google to invest up to US$10.0 billion in India over the next five years (including US$4.5 billion investment in Reliance Jio), proposed divestment of BPCL by the GoI, as well as the raising of FDI limits in the insurance sector could potentially support FDI inflows in the medium to long term. However, the ongoing uncertainty may delay some planned disinvestment. Even if big ticket deals fructify, FDI inflows are expected to moderate to US$45-50 billion in FY2022 from the record-high US$61.4 billion in FY2021. **However, we anticipate ECB approvals to rise to US$35-40 billion in FY2022 from US$35.1 billion in FY2021. Further, we expect NRI deposit inflows to increase to US$10-12 billion in FY2022 from US$7.4 billion in FY2021 (refer Exhibit 6).**

EXHIBIT 6: Magnitude of FII, Gross FDI, ECB Inflows and NRI Deposits in FY2020, FY2021 and ICRA's expectations for FY2022

US$ billion	FY2020	FY2021	ICRA's Expectations for FY2022
FII Equity	1.3	37.0	*15 to 20.0*
FII Debt*	-5.4	-2.2	*-2 to -4*
Gross FDI	51.7	61.4	*45 to 50*
ECB	52.0	35.1	*35 to 40*
NRI Deposits	8.6	7.4	*10 to 12*

Including debt flows through VRR segment; **Source: RBI Bulletin, NSDL; CEIC; ICRA research*

HEALTHY FOREIGN EXCHANGE RESERVES COULD PREVENT A SHARP DEPRECIATION IN THE RUPEE AFTER THE FED COMMENCES TAPERING:

Foreign exchange reserves rose sharply to US$609.0 billion at end-June 2021 from S$579.3 billion at end-March 2021. Subsequently, the reserves have risen to an all-time high US$612.7 billion on July 16, 2021 (refer Exhibit 7). The bulk of the YTD increase of US$33.4 billion in forex reserves as on July 16, 2021, was in foreign currency assets (+US$30.8 billion), followed by a moderate uptick in gold (+US$2.4 billion). **Going forward, the RBI may continue to accumulate foreign exchange reserves during periods of appreciation. This would help to contain the extent of the depreciation in the Rupee, once the Fed commences its monetary policy normalization.**

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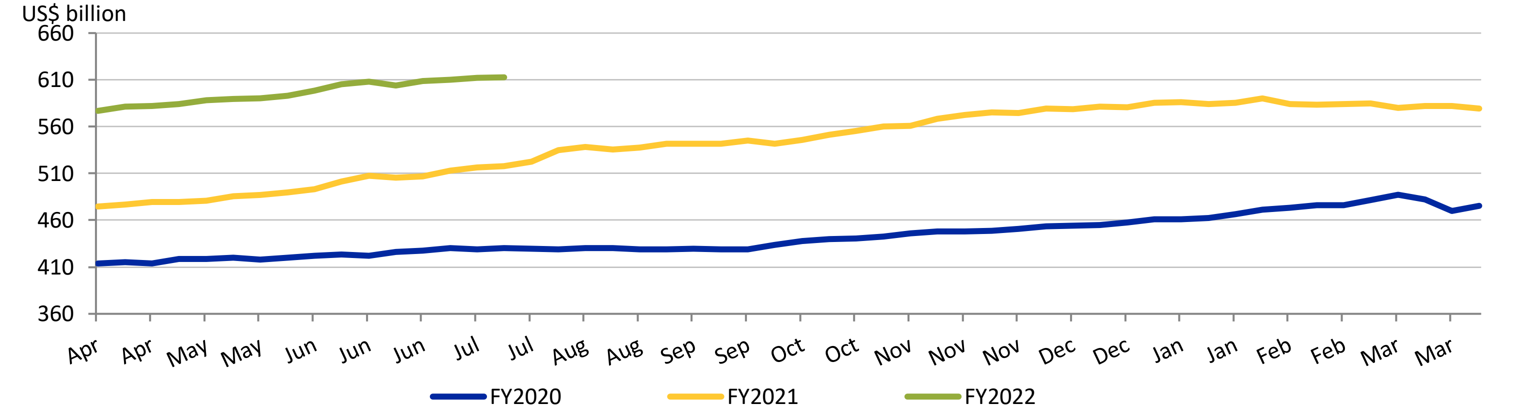
EXHIBIT 7: India's Foreign Exchange Reserves (US$ billion)



***Source**: RBI; CEIC; ICRA research*

As markets refine the expectations around the Fed's tapering plans and rate hike trajectory, the US Dollar may demonstrate broad-based strength going forward. An increase in US bond yields (as tapering becomes imminent) might cause capital flight across the EM economies and result in volatility across the emerging economies currencies, including the INR. However, we don't expect another episode of taper tantrum in India, as was the case in 2013, chiefly on account of an improved current account position (expected deficit of 0.8% of GDP in FY2022 vs. deficit of 4.8% of GDP in FY2012), and all-time high foreign exchange reserves.

Overall, we expect the INR to have a depreciation bias and trade in a range of 73.7-75.5/US$, until policy normalisation by the US Fed becomes imminent.

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