Rupee on the ropes

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IT IS BECOMING clearer by the day that the RBI's valiant efforts at keeping rupee volatility contained is reaching the end of its rope. The accompanying chart shows how the RBI's dollar buying is having progressively less effect.

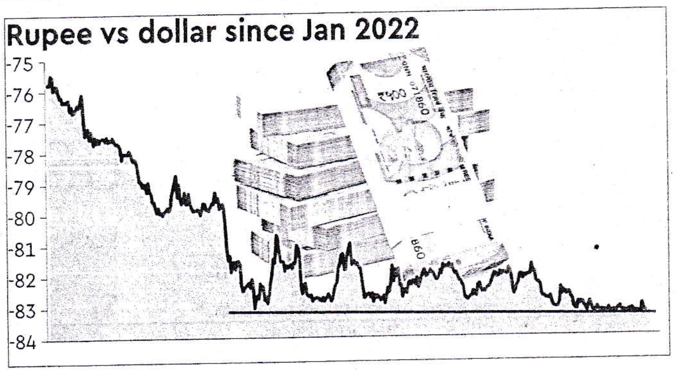
Digging deeper, we see that the rupee rebounded fiercely in October 2022, when RBI intervened after it fell below 83 for the first time—the rupee gained more than ₹2 to 80.69. The next episode was in December that year, when RBI intervened before the rupee fell to 83, and again it recovered to better than 81 (80.95) to the dollar. The next time the rupee threatened 83 (in February 23), RBI again sold dollars before the rupee hit 83, but this time the recovery was just to 81.70, after which it hovered between 81.70 and 82.70 for several months. Finally, in August 2023, it once again fell below 83 and this time, all the RBI's horses and all the RBI's men were not able to generate sufficient upward momentum; since September 15, the rupee has struggled just below 83.

What is, perhaps significant is that over the past two weeks, and more so over the past couple of days, the dollar weakened sharply overseas (from 106.75 to 104.20), falling more than 2.5%. Yet, the rupee (and RBI) was unable to take the benefit and it remained tightly wedded to the line that can be seen in the graph. It did skip up a bit above 83 when the last inflation report showed a sharp decline in US CPI, but the respite was short-lived, as is visible.

To me, all this suggests that the rupee has turned "fundamentally" weak, certainly weaker than over the last year or so when the RBI had little difficulty protecting the 83 level.

Let's first look at inflows to try and understand why there could be this change of heart. Since September 2023, FPIs have pulled nearly $5 billion out of our equity market in response to the strong risk-free returns available in the US debt markets; it is only domestic investors that have enabled our equity markets to hold their own. Interestingly, over the same period, foreign investment in debt securities has been strongly positive—more than $2 billion, the highest amount in any 2-1/2 month period since at least the end of 2019 (if we discount two boluses of inflows in September 2021, when Adani brought in some debt for one of its take-overs, and in June 2022, with the definitive announcement that Indian bonds will be included in global indices).

It seems clear that FPIs are preparing for bond index inclusion in June 2024, which should see a steady increase in debt inflows between now and then. This should make the rupee stronger, assuming there is no dramatic collapse in global equities, which looks increasingly unlikely now that US inflation appears to be moving in the right direction and markets are almost ready to applaud the Fed.



So, what then? It is clear that the rupee doesn't have even an ounce of the *dum* it had even a few months ago, and it's certainly not portfolio flows that are threatening it. The trade deficit is in the gutter, but it's been that way for a long time—why should it start affecting rupee sentiment now?

The only thing I can think of is the slate of upcoming state elections. With all political parties—notably the Congress and the BJP—vying with each other to distribute largesse to (hopefully) get elected, markets may well be getting increasingly concerned that the relative fiscal rectitude we have enjoyed is about to be thrown to the winds. This would threaten higher inflation and/or higher interest rates, either (or both) of which would sink growth likely below 6%.

And if, as seems possible, the BJP does badly in some (or all) of the state elections, the stakes would rise much higher as political instability would beckon. Even if the BJP performs better than expectations, the nervousness they are showing suggests that freebies for the people (including money for votes) will be all the rage before the national election next year. Thus, the pressure on the rupee is likely to remain and an "orderly" decline, whatever that means, is on the cards.

Prime minister Narendra Modi is certainly a political magician, but even if he can fool all of the people all of the time, he can't fool the market.