

Factors Influencing the Indian Currency Market

India follows the Liberalised Exchange Rate Management System (LERMS), under which it is absolutely necessary for corporate executives to understand how the exchange rate moves, and why. Considering the large volume of transactions, a movement of even 2–3 paise in the exchange rate can hit the bottomline of any corporate. As such, there are several factors that influence the currency market. Some of the important ones, which have influenced the market recently, are discussed in this article.

Every major development in Indian or world economy affects the Indian currency market. Long gone are the days of the fixed exchange rate regime, when corporate executives used to be ill-informed about international news, movement of oil prices or other factors influencing the currency market. Today, India follows the Liberalised Exchange Rate Management System (LERMS), under which it is absolutely essential for corporate executives to understand how the exchange rate moves, and why. Considering the large volume of transactions, a movement of even 2-3 paise in the exchange rate can hit the bottomline of any corporate. There are a number of instances when a sudden movement in the exchange rate has made companies lose or gain heavily in foreign currency transactions.

There are several factors that influence the currency market. Some of the important ones among them, which have impacted the market recently, are discussed below:

Change of Interest Rate

The value of the currency of any country depends on the interest rate of that country. In case of upward movement of interest rate in the United States, the US Dollar (USD) appreciates against other currencies as well as against the Indian Rupee (INR). Any change of interest rate

by the Federal Reserve Bank of New York (FED) through the Federal Open Market Committee (FOMC) has a great impact on the currency market. In the recent past there have been instances of rate hikes by the FED, as a result of which the USD had appreciated against major international currencies as well as the Indian Rupee.

Even an expectation of change of interest rate has a great impact on currency market. Whenever there is any such expectation, the market reacts sharply. The possibility of changes in interest rate is a speculative move, and the market reacts only for a short period of time. The market generally discounts some portion of such expectations well in advance, before they actually happen.

Change of interest rate by the European Commercial Bank (ECB) is now equally important. The value of the Euro is influenced by a change of interest rate by ECB. Recently, there have been several occasions when the Euro strengthened against the USD following a hike in interest rate, or even the expectation of a hike in interest rate by the ECB.

Inflow of Foreign Funds

The exchange rate depends on demand and supply of currency. Strong economic fundamentals and good ratings by international rating agencies have boosted foreign investors' confidence in the Indian market. Huge foreign investments have already come to India, while big investments through Foreign Institutional Investors (FIIs) and Foreign Direct Investment (FDI) are expected in the near future. In the last couple of months, substantial foreign funds



—Debasish Mitra

(The author is Sr. Manager Finance, PSL Ltd., Mumbai. He can be reached at d_mitra240127@yahoo.co.in)

have been infused into the Indian market. Since most of these have been in the form of USD, the supply of USD against the Indian Rupee became high, and it depreciated against the Rupee. On the other hand, at the time when FII's wanted to withdraw funds from the market, the demand for USD in the Indian market became high, and it appreciated against the Rupee.

During the last one to one-and-a-half years, the Indian rupee has shown a tendency to appreciate due to a huge inflow of foreign funds in the Indian market by FII's or through FDIs in the form of External Commercial Borrowings (ECB) and Foreign Currency Convertible Bonds (FCCBs). A direct relationship may be drawn between the USD–INR exchange rate and the BSE index. Considering all other factors to be constant, whenever overseas FII's buy shares from the Indian market, there is an upward movement of the BSE index.

At the same time, due to inflow of foreign funds (foreign investors have USD to sell—they will buy INR to invest in Indian market against USD) in the Indian market, the supply of USD increases in the market and it depreciates against INR, or INR appreciates against USD. On the other hand, if there is any negative flow of funds by FII's, there would be a downward movement of the BSE index, and consequently USD would appreciate against INR.

Price of Oil

A large portion of India's import payment is mainly for payment of oil. Internationally, crude prices are named as BRENT, NYMEX, and Dubai Crude. Whenever there is any hike in the oil price per barrel, the Indian Rupee depreciates against the US Dollar. As such, the Indian Government buys more USD against INR to honour the import liability, resulting in heavy demand for USD. Consequently, the Indian rupee depreciates against USD.

The Indian currency market largely depends on the price of Dubai Crude. It is observed that USD appreciates at the end of the month when compared to other days of the month, primarily because of the month-end demand of USD in

the wake of payment for imported oil. However, today's market is mature enough, with players of foreign exchange covering themselves against this type of expected fluctuations in the market.

Whenever FII's book profits by selling their shares, the BSE index falls, and at the same time INR depreciates against the USD. On April 12, 2006, the BSE index fell by more than 300 points due to heavy selling by FII's, and on the same day the crude price also shot up to around USD70 per barrel. The Indian Rupee depreciated by 45–50 paise on the same day, owing to the impact of these two important factors.

Comments from Political Leaders

Comments from political leaders and top bureaucrats do influence the market, but this is very short-term. It is quite common in India, particularly when it comes to comments from political leaders or the Governor of the Reserve

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Bank of India (RBI). We know that the Japanese economy is export-oriented, and that Japanese exporters welcome any move that depreciates the Japanese Yen. It has been observed that whenever the Yen strengthens against the USD, Japanese politicians tend to pass comments on economy that allows the Yen to slip back to its original level.

Political unrests can also strongly influence the currency market, but again only for a short period of time. Extended periods of political uncertainty can, however, cause the rest of the world to lose confidence in that country, and

could finally result in a steep fall in the value of that country's currency.

Release of Economic Data

The economic data or surveys released by various national and international agencies, including FED, RBI, Moody's, etc. can influence market sentiments and lead to movement in exchange rates. Some data from the US, such as Non-Form Payroll, Jobless Claim, US trade deficit and GDP growth rate are known to influence the currency market. In the last week of May 2006, the Non-Form Payroll data (monthly data generally released on the first Friday of the month) was released by the US Department of Labor, and it was weaker than market expectations. As a result, the Euro became stronger against the USD, from 1.2739 to 1.2953 between 26 May and 5 June 2006.

Annual economic review, RBI credit policy, monetary policy, etc. also strongly influence the currency market. Understanding, interpretation and correlation of different data are important to gain a thorough understanding of the exchange rate movement by any corporate. Any mistake in the interpretation of data released could cause heavy loss to an organisation.

RBI Intervention

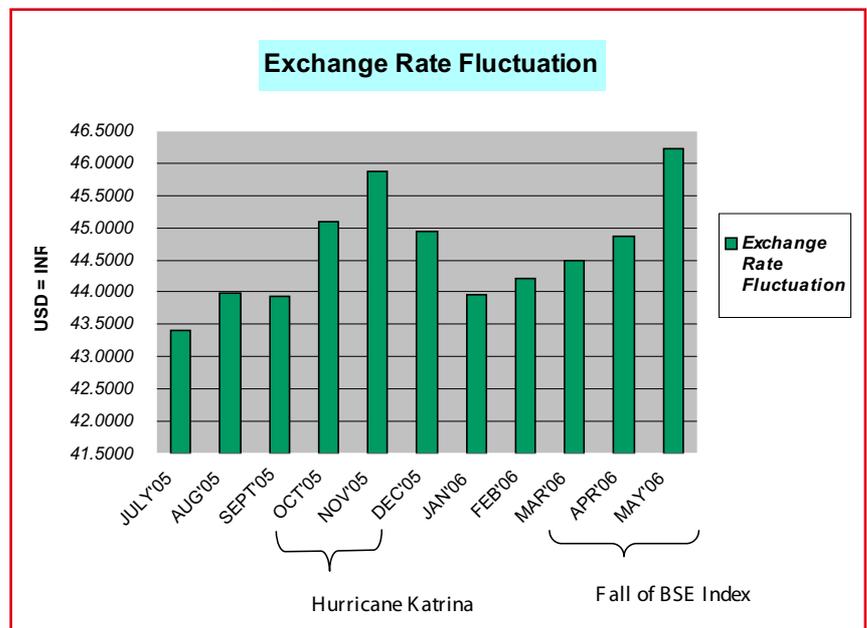
The RBI, which regulates the Indian currency market, does intervene whenever it feels it is required to stabilise the market, or to keep market volatility under control. It is the responsibility of the RBI to keep the exchange rate unaffected at a time of volatility in the foreign currency market. It has been observed that RBI intervenes in the currency market whenever there is any abnormal movement in the exchange rate, either upward or downward.

The RBI buys foreign currency (USD) to depreciate

the domestic currency, and sells foreign currency when the domestic currency depreciates abnormally. Sometimes the RBI does not intervene at all. In April and May 2006, the Indian Rupee depreciated heavily in the wake of the fall of the BSE Index, but the RBI did not intervene, much as previously the Indian Rupee had appreciated (in January and February 2006) to such a level that it needed to be depreciated solely by market forces.

Natural Calamities

Natural calamities may also affect the currency market for a short period of time. In August 2005, Hurricane Katrina affected the entire region around the Gulf of Mexico. This region contributes around one-third of US oil production and accounts for around half of the nation's refining capacity. Besides, a large part of US oil imports reaches ports in this area. The hurricane caused a huge loss in production of crude oil and natural gas. It affected the prices of crude oil and prices shot up to around USD70 per barrel in a very short time. Automatically, the oil price increased globally and at the same time affected the exchange rate. Since India had to buy more USD to honour its import liability, the Rupee became weaker by around 60-65 paise against the USD.



Source: Federal Reserve Bank of New York

Conclusion

We are living in a global economy. As such, the Indian economy is no longer immune to international news and events, and reacts accordingly. Some countries are now considering converting some portion of their reserve into Euro from USD, and recently a number of international transactions have started moving from USD to Euro. These changing circumstances may influence the Euro-USD exchange rate.

Also, many corporates are now entering into derivative contracts to protect future cash outflow. Further, some corporates also consider options such as double-no-touch barrier, particularly when entering into contract-like structure deposits on foreign currency denominated fund. While entering into such transactions, a corporate has to look into all factors that may influence the exchange rate of the currency pair (such as USD-INR, Euro-USD and USD-JPY, and also perhaps USD-CHF and GBP-USD).

Nowadays many corporates take Term Liability and enter into transactions by which they can reduce the Rupee interest burden by swiping the same liability into Japanese Yen (JPY), as interest rate on JPY is lower than that on the Indian Rupee. But in this type of transaction, the corporate is exposed to the currency risk of both USD-INR and USD-JPY. In India, direct quotation for USD-INR is available, but direct exchange rate between other foreign currencies (other than USD) and the Indian Rupee is not available.

So, if any corporate has to buy JPY to honour its financial liability on the maturity date, it has to undertake two transactions. First of all it will have to buy USD from Indian market against Indian Rupee. Then it will have to buy JPY from the international market against the said USD.

At the same time, the corporate has to bear the cost of two transactions in the form of margin, etc. So, in this type of transaction the corporate has to be well-informed about factors that may influence not only USD-INR but also USD-JPY.

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Some corporates may even undertake such transactions through the Swiss Franc (CHF), if they feel this is less volatile than JPY.

Since different currencies react for different reasons and economic fundamentals, it has been noticed many times that the Indian Rupee may depreciate against the USD, while at the same time other major currencies appreciate against the USD or remain unchanged. Corporates have to pay attention to all factors that may influence the currency market, and only then they can take a correct stance. It has been noticed that despite interest rate hike by FED, the USD depreciates gradually in comparison to other major currencies, primarily due to the release of negative data about current account deficit in the US.

It has also been observed that an increase in the Repo rate by RBI results in the Indian Rupee getting marginally stronger against the USD (as on 9 June 2006), but at the same time due to positive data released on the US trade deficit, the USD was still strong against other major currencies, including the Euro. □

