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Foreign Exchange Strategy

Cause & FX

The Rationale for the Rupee

Global

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- **Bottom Line**: We expect the INR to experience another wave of buying interest in the coming months. While the outlook on trade and capital flows is mixed, temporary policy support and a weak dollar will likely lead to accelerated demand for the INR. We anticipate exporters to sell USD in the forward market, with importers withholding USD purchases to take advantage of favourable levels in the coming months.

The Indian Rupee

The rupee strengthened to a four and half year high of USD-INR 43.40 on 1 April 2004. However, the two-year appreciation trend has since reversed. The normalisation of long INR positions, together with higher hedging interest amid a slowdown in inflows, led to this sharp reversal.

Since that volatile period, encouraging trends have emerged. Sentiment has improved and flows into India appear healthy. Expectations of a continued withdrawal of liquidity from Asia have been reduced as the USD gradually loses its interest rate support and as risk appetite gradually returns. The improving sentiment and regional currency strength against the USD will likely aid the INR.

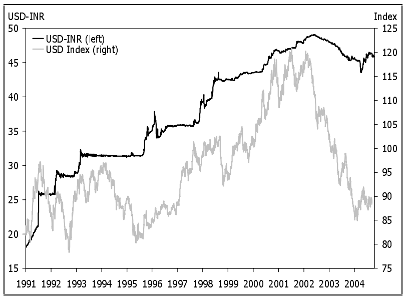
The INR will likely shrug off higher oil prices to trade higher against the USD. The internal drivers of strength will likely be FX inflows from foreign currency borrowings by corporations and private portfolio inflows.

The Reserve Bank of India (RBI) continues to intervene and has been a net seller of the USD in recent months. Nevertheless, there is little reason to believe that the intervention will be pared back as a weaker INR would add to inflationary pressures. This is important because most of the inflation pressures have been due to imported items.

The risks to our view are from factors that might delay the strength in the INR. These come in the form of a further rise in oil prices, leading to sentiment based demand for the USD and from the fact that the INR is relatively overvalued against the USD in real terms because of widening inflation differentials.

Refer to important disclosures on page 5.

Chart 1: The Rupee's Step Function



Source: Bloomberg.

A Little History of the INR

The INR has historically depreciated against the USD in a step function. Typical of other Asian currencies, the response to the USD has generally been asymmetrical – the INR weakened during periods of USD strength but was steady during periods of USD weakness (Chart 1). However, the last round of significant USD weakness, coupled with abnormally high inflows into India, triggered a breakout from historical trends. This trend came to an abrupt halt when reflation trades were unwound in May on concerns of tighter policy in the US and China. After a period of stabilisation and normalisation, the market appears ready for another round of INR strength, given support from the factors listed below.

The RBI's Role

Exchange Rate Management

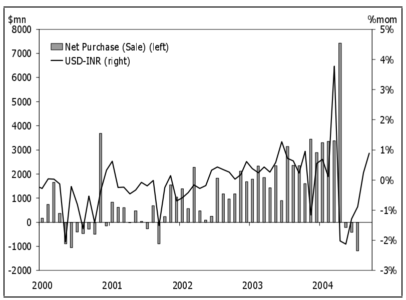
The RBI has defined the objective and purpose of its exchange rate management as follows:

The main objective is to ensure that economic fundamentals are reflected in the external value of the rupee. Subject to this predominant objective, the conduct of exchange rate policy is guided by three major purposes.

1. To reduce excess volatility in exchange rates, while ensuring that the market correction of an overvalued or undervalued exchange rate is orderly and calibrated.
2. To help maintain an adequate level of foreign exchange reserves.
3. To help eliminate market constraints with a view to the development of a healthy foreign exchange market.

(Speech on Exchange Rate Management by Dr Reddy, then Deputy Governor, RBI on 15 August 1997)

Chart 2: RBI Intervention

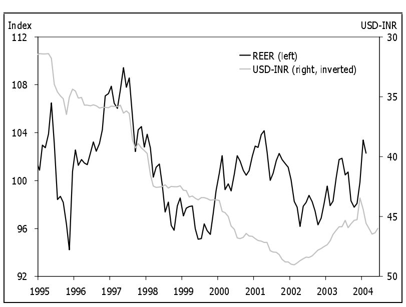


Source: RBI, Bloomberg.

RBI's response to volatile exchange rate movements has been a combination of monetary policy and administrative measures, together with intervention in the market to dampen excess volatility as necessary through discreet and smooth intervention (Chart 2). The RBI neither targets one specific exchange rate nor resists fundamentals. Thus, leads and lags are the major focus of exchange rate management. The objective is to ensure an efficient price mechanism that reflects underlying fundamentals.

Though the RBI does not target a specific value for the INR, the market tries to gauge underlying policy through movement in the Real Effective Exchange Rate (REER) index. The market believes that the RBI monitors the REER carefully (1993-94 base year, 5-country series) and tries to maintain the nominal INR in a +/-4% band (i.e. 96 to 104) over a longer period of time (Chart 3).

Chart 3: REER and USD-INR



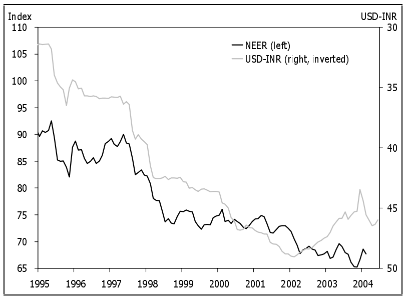
Source: RBI, Merrill Lynch.

The Reserve Bank has stated that, from a competitive point of view as well as a medium term perspective, it is the REER which should be monitored as it reflects changes in the external value of the currency in relation to its trading partners in real terms. In the short run, there is no option but to monitor the nominal rate, as these are most sensitive to capital flows. The RBI also acknowledges that they, along with others, have to pay the most attention to the USD.

Methodology Relating to REER and NEER Computations

The 5-country, trade-based Nominal Effective Exchange Rate (NEER) and REER are constructed with the following weights: US (38.71%), Germany (19.69%), Japan (18.72%), UK (16.56%) and France (6.32%).

Chart 4: NEER and USD-INR



Source: RBI, Merrill Lynch.

NEER: defined as a weighted geometric average of the bilateral nominal exchange rates of the home currency in terms of foreign currencies (Chart 4).

REER: defined as weighted average of NEER adjusted by ratio of the domestic inflation rate to the foreign rate of inflation.

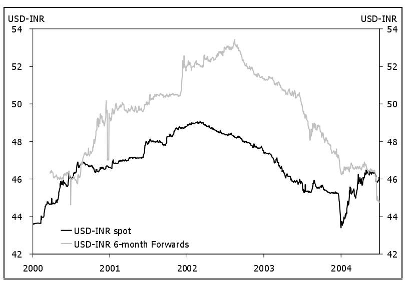
RBI's Monetary Management

Historically, volatility and a sharp weakening of the USD-INR exchange rate prompted the RBI to tighten monetary policy. This situation has reversed in recent years and the RBI has had to ease policy, to an extent, in the face of substantial inflows. Both the central bank and the government have been trying to neutralise the strong inflows using a mix of policies. They have eased exchange controls, prepaid external high-cost debt and introduced the market stabilisation scheme to sterilise inflows from FX intervention.

Excess liquidity and higher global commodity prices have been identified as key factors influencing the rising inflation rate (the WPI is up 7.2% year-on-year). The RBI has already stepped up measures to reduce liquidity and hiked the cash reserve ratio by 50bp to 5%, in two stages, effective from mid-September. Inflation control priorities also lead us to believe that the RBI would be comfortable with INR strength, despite the overvaluation of the INR according to the REER.

A Look at the Market Psyche

Chart 5: Spot vs. 6-month Forwards



Source: RBI, Merrill Lynch.

The RBI does not encourage speculation without an underlying transaction. The market has, over the years, realized that the spot INR has usually outperformed the forward value and leads and lags start to build (Chart 5). Exporters and owners of FX usually sell remittances in the forward market while importers postpone purchases. With the opening of the capital account, though gradually, the forward premia is becoming aligned with the interest rate differential. Policy makers have voiced concerns that market behaviour is not symmetrical in both directions, as there is a greater tendency to hold long positions in foreign currencies and hold back sales when news is bad and currencies are depreciating rather than vice-versa.

We believe that in the last six months risk appetite has risen, as the leads and lags would have corrected following the volatility in April. The market could again start to position itself in anticipation of a stronger INR.

Flows

Most of the components of India's Balance of Payments have been showing positive trends, both in the current account and capital account. This is a reflection of increasing competitiveness and strong international confidence. Recent worries, after the change in the government, have dissipated. The normalisation of the strong inflows from non-residents and perhaps portfolio flows could, to an extent, be compensated by higher flows from increased FDI and higher external borrowings as corporates take advantage of lower international borrowing rates. The higher import bill from higher oil prices should also be neutralised from higher software exports and strong trends in the invisible portion of trade. We expect flows to be supportive of the INR in the coming months.

Strategy Implications

We believe a reasonably bullish case is being built for the INR. Later this week, we will re-examine the components of our live Asian trade recommendation (30% IDR, 30% KRW, 30% TWD, 10% 12-mth RMB NDF's, now up 0.3%) with a view to including the INR as one of the components.

Ashish Agrawal

Traders Corner

DISCRETIONARY TRADES				
Trade	**Open Date**	**Open Price**	**Target**	**Stop**
Long 2.70 USD put BRL call and long 2.95 USD call BRL put with expiry Nov 10, 2004	Oct 13	0.42%	--	--
Short USD vs long basket of IDR (30%), KRW (30%), TWD (30%) and 1-year RMB NDFs with expiry Sep 27, 2005 (10%, spot 8.2766)	Sep 23	IDR 9135, KRW 1147, TWD 33.96, 1-yr RMB NDF 8.0516	3.0%	-1.0%
Long 107.0 USD put JPY call, expiry Nov 24, 2004	Sep 23	0.47% (vol 9.25%)	--	--
Long 31.4360 EUR put CZK call, expiry Sep 15, 2005	Sep 15	2.10% (vol 6.3%)	--	--
Long 33.78 USD call TWD put and long 33.78 USD put TWD call, expiry Feb 10, 2005	Aug 10	2.2% (vol 3.9%)	--	--
Long off-shore USD-BRL NDFs and short USD-BRL on-shore forwards with expiry May 5, 2005	Aug 3	55bp spread, USD-BRL NDFs 3.3950	190bp spread	--
Long EUR-GBP	Jun 23	0.6659	0.70	0.6660
Equal weighted basket of long CAD, NOK, SEK, vs short AUD, NZD, GBP	Jun 23	CAD 1.3607, NOK 6.9387, SEK 7.5854, AUD 0.6874, NZD 0.6239, GBP 1.8169	5%	-3%
Receive PLN yields and pay EUR yields at 5y5y forwards	Jun 23	175bp spread	100bp	230bp
Long EUR-USD	Apr 30	1.1985	1.2680	1.2200
Long 280 EUR call HUF put, accumulates on daily fix inside 245-265 1st year, expiry Nov 26, 2005	Nov 26	2.90%	--	--

ML FX AUTO PORTFOLIO OF TRADING RULES				
Trade	**Open Date**	**Open Price**	**Target**	**Stop**
Long EUR-NOK (STAT)	Oct 15	8.2026	--	--
Short USD-TRL (STAT)	Oct 15	1490.5	--	--
Short EUR-USD (SPEC)	Oct 8	1.2409	--	--
Long USD-MXN (SPEC)	Oct 8	11.2450	--	--
Long NZD & AUD versus short CHF & JPY (CARRY)	Sep 30	NZD 0.6779, AUD 0.7278 CHF 1.2455, JPY 109.99	--	--

Notes: Unless noted otherwise, the AUTO STAT trades are marked at 11.00ET and all others at 15.00ET. The AUTO STAT trading rule is open for the week ending Friday. We mark the open price at spot, though the trade is executed at the appropriate bid or offer of the one-week forward. We present the spot price to be consistent with other trades and reference the forward in the weekly summary. The AUTO SPEC trading rule is open until the 40/45-day moving average crossover turns negative (positive) for a long (short) position. The AUTO CARRY trading rule is open for a month when the filter supports a trade.

We assume a capital base of $100 in our discretionary trades. In the G10 currency regions, each spot and forward exchange rate trade is $100 while the notional value of an option trade is $300. Emerging market trades are one-half the size of the G10 currency regions. Trades that deviate from these benchmarks are specified accordingly. In our portfolio of trading rules, capital is allocated based on the expected frequency of the trades in the AUTO STAT, AUTO SPEC, and AUTO CARRY rules. The capital base for the portfolio of trading rules is $100. We allocate $100 per trade to the AUTO STAT, which trades most frequently, $300 to AUTO SPEC trades, which trades least frequently, and $200 to AUTO CARRY, which trades around 60% of the time. We compute the leverage ratios daily based on the total amount of capital allocated to trades divided by the capital base, which rises or falls with trading performance. The leverage ratio is the average of the daily observations. Performance is updated in our biweekly *Global FX Strategist*.

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