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Currency Outlook

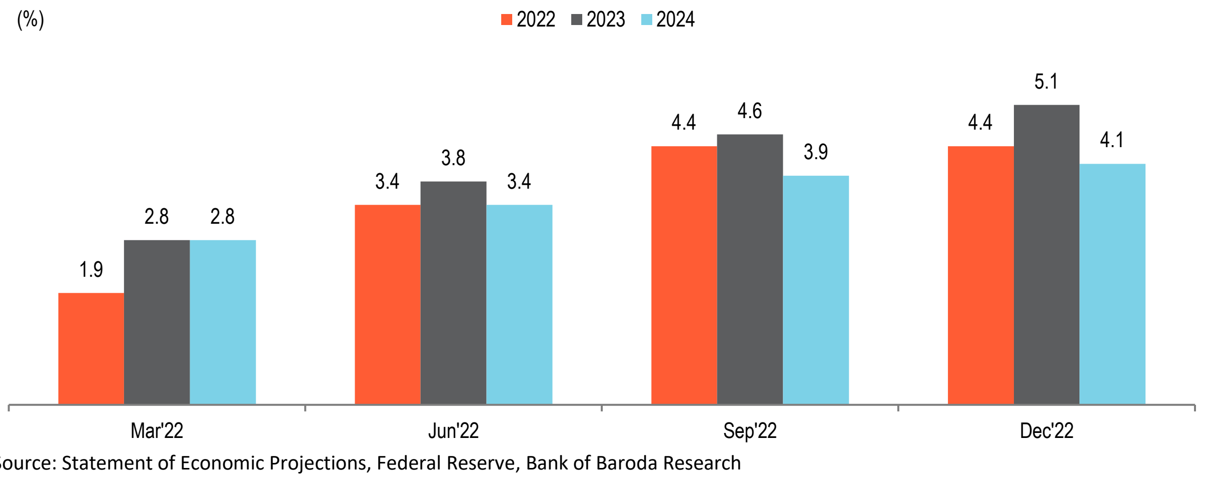
What's next for INR

Driven by a sharper than expected moderation is US CPI, dollar eased, leading to gains in most major currencies. However, some of these gains have since been reversed as the Fed signaled a higher terminal rate. Importantly, it also stated that rates are going to stay higher for longer, against market expectations of a rate cut next year. DXY has since strengthened, which has put pressure on other currencies. INR depreciated in the last fortnight, showing significant divergence from its other Asian peers. INR depreciated by 1.2%, erasing much of the gains it made last month. Volatility in INR also increased. We see limited upside risk for the INR while there are significant risks on the downside, mostly on the BoP front. We expect a range of 82-83/$ in the near-term.

Fed policy and DXY

The dollar eased to a 6-month low as a softer than expected CPI print in the US, which raised the possibility that the Fed will ease the pace of rate hikes going forward. US CPI eased to 7.1% in Nov'22 from 7.7% in Oct'22. Investors eagerly awaited the Fed policy to look for signs of a likely Fed pivot. These hopes were quickly quashed as the Fed, while tempering the pace of rate hike to an expected 50bps, gave no signs that the fight against inflation was nearing an end. In fact, as per the latest projections released, the terminal Fed Fund rate is expected to be higher at 5.1% in 2023 (4.8% earlier), implying another 75bps of rate hike in subsequent meetings. This also essentially quelled market expectations of rate cuts in the latter part of CY23, meaning that rates will remain higher for longer than expected. Hence, while DXY weakened in the last fortnight, it has regained some strength today.

Figure 1: Projections of Federal Fund rate higher



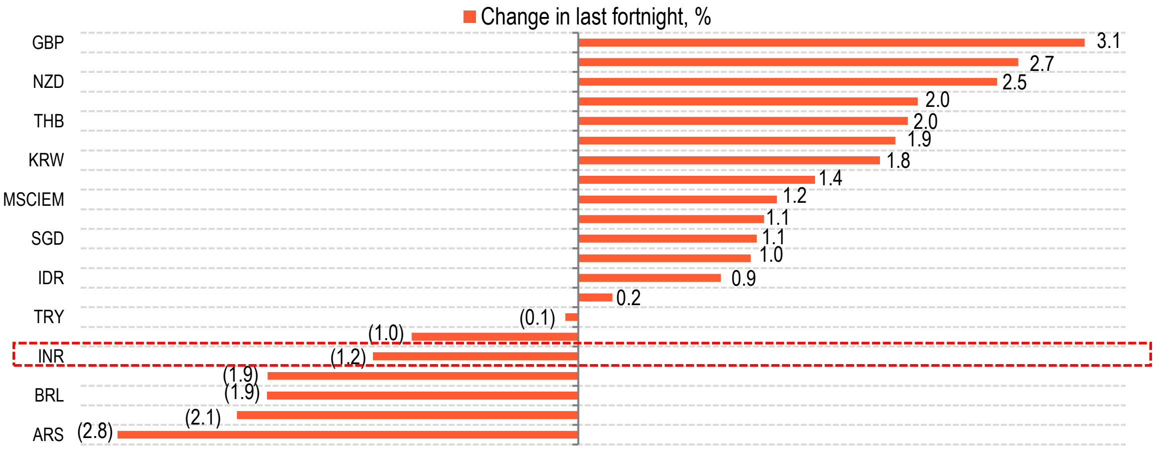
Source: Statement of Economic Projections, Federal Reserve, Bank of Baroda Research

Currency movement in the last fortnight

Most global currencies gained amidst a broad based improvement in risk sentiment. This was led by expectations that global inflation has peaked and reopening in China. EUR and GBP gained 3.1% and 2.7% against the dollar. DXY index fell by 2.1%. Apart from the weakness in dollar, positive macro data (improvement in investor sentiment index in Germany and rebound in UK's monthly GDP) also aided gains in the respective currencies. CNY also gained 2% as government announced easing Covid-19 curbs, even as concerns remain on the economic front. Recent macro data also points to a precipitous decline in economic momentum.

While the MSCI EM index rose by 1.2%, currencies of several EMs such as Argentina and Brazil came under pressure despite a weakening dollar.

Figure 2: Global currencies



Source: Bloomberg, Bank of Baroda | Data as of 14 Dec 2022 | Note: Figures in bracket denote depreciation against USD

What about INR?

Reversing the gains made last month, INR depreciated by 1.2% in Dec'22. The volatility in the exchange rate also increased. In fact, the annualized daily volatility in INR almost doubled to 6.5% in the first fortnight of Dec'22, compared with just 3.6% in the last fortnight.

The Rupee's underperformance in Dec'22 seems perplexing, particularly since the global environment is much more positive for INR. DXY index has eased, oil prices have been benign averaging a little over US$ 80/bbl), and FPI flows have remained positive (US$ 880mn in Dec'22 so far). It can perhaps be explained by strong seasonal demand from importers. Apart from this, yield differential with the US as well as concerns over financing of the widening trade deficit also weighed on the rupee.

Outlook for INR

The outlook for INR is contingent on a range of factors. On the global side, the movement in DXY will be one of the key defining factors for INR. With the Fed signaling that high rates are likely to stay even in CY23, and the possibility of a slowdown in the US being entrenched in its forecasts, the DXY may not see a significant downside move. Oil prices have seesawed, but have remained benign compared with the highs seen during the Russia-Ukraine war.

Concerns have however remained on the domestic side. Trade and current account deficits have been increasing, raising concerns over their financing. Goods exports are likely to slow down amidst a protracted slowdown in global growth. Even service receipts will be lower as growth in key markets slows down. The increasing pressure on the current account needs to be offset by strong capital inflows. However, concerns remain on that front as well. FPI flows although positive, may not be enough to compensate. Even FDI inflows have remained muted. With higher global interest rates, even ECB flows will be difficult to get. Over this backdrop, the recent increase in forex reserves is a welcome relief and they stand at $ 561 bn which is down since April by $ 46 bn and $ 74.7 bn over a year.

Overall, we expect INR in the range of 82-83/$ in the near-term.

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