1 December 2022

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Currency Outlook

INR strengthened in Nov'22

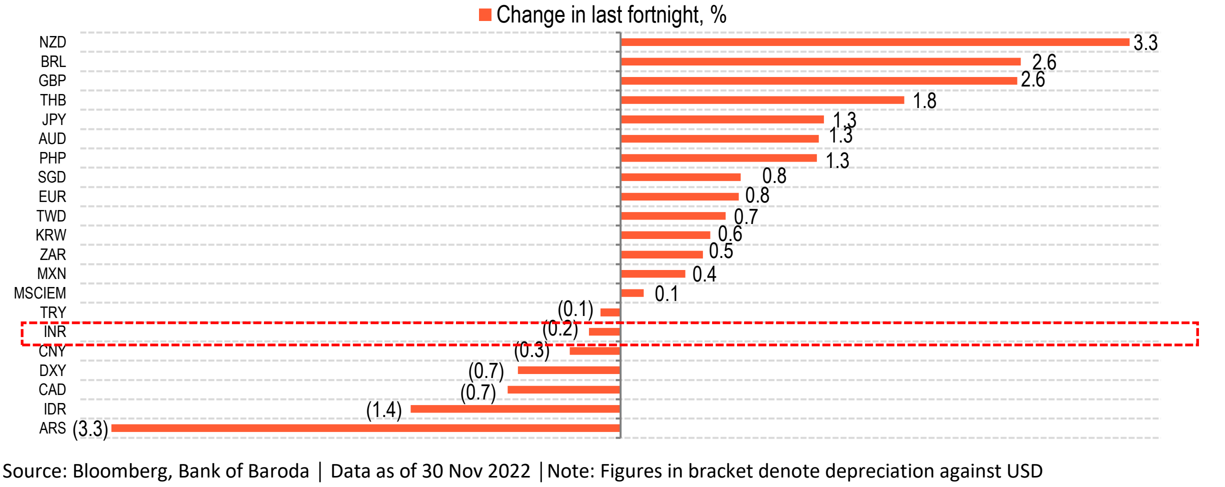
Dollar demand waned and other global currencies edged up as Fed Chair hinted at tapering the pace of rate hikes starting from Dec'22. Expectations that inflation has likely peaked and concerns over growth suggest that the Fed may be less aggressive. Markets have scaled back their expectations of peak Fed Fund rate. Hence, we may see some correction in DXY after its rather successful stint this year. INR remained range-bound in the last fortnight. Importantly, it recorded a 1.7% monthly gain against the dollar for the first time this year. We foresee INR in the range of 81-82/$ in the near-term supported by buoyant FPI inflows, lower oil prices and a weaker dollar.

Currency movement in the last fortnight

Most global currencies registered gains against the dollar in the last fortnight. DXY index fell by 0.7% in the fortnight, and about 5% in the month. With inflation in US expected to have peaked, investors expect the pace of Fed rate hikes to slow down. Weakness in economic indicators as well as some sluggishness in recent labour market indicators also point towards the same. Fed Chair too in his recent remarks suggested that the Fed may ease the pace of rate hikes "as soon as the December meeting". While the Fed Chair did not allude to a terminal rate, he did mention that it is likely to be higher than the official estimated given in Sep'22. Markets expect the Fed rate to hike policy rate by 50bps in Dec'22 and expect the Fed rate to now peak at below 5%.

Amongst the currencies registering the sharpest gains against the dollar in the last fortnight were: New Zealand dollar (NZD), Brazilian Real (BRL), and the British Pound (GBP). NZD was supported by a massive 75bps rate hike by the Reserve Bank of New Zealand (RBNZ). GBP gained 2.6% against the dollar, and EUR too rose by 0.7%. On the other hand, CNY depreciated by 0.3%, amidst continued Covid-19 woes in China. However, hopes that the government may ease its strict Covid-zero policy, helped offset some decline in the exchange rate.

Figure 2: Global currencies



Source: Bloomberg, Bank of Baroda | Data as of 30 Nov 2022 | Note: Figures in bracket denote depreciation against USD

What about INR?

INR depreciated marginally by 0.2% in the last fortnight. However, there was a significant reduction in the volatility in the exchange rate with INR trading in the narrow range of 81.1-81.85/$, in this period. In fact, while the annualized daily volatility in INR was 8.7% in the first fortnight of Nov'22, it declined to just 3.6% in the period thereafter. Notably, INR appreciated by 1.7% in Nov'22. This marks its first monthly gain since Dec'21.

Outlook for INR

While the INR outlook remained murky for most part of the year, it appears much more promising in the light of recent developments. One of the major factors for INR depreciation has been the dollar strength. There are signs that it may be abating. DXY is down 7.1% from its peak in CY22 and the future upside may be limited. With the Fed clearly signaling a slowdown in its rate hike cycle and with much of the rate hikes already priced in, the dollar rally is likely to stall. This is likely to lend further support to INR.

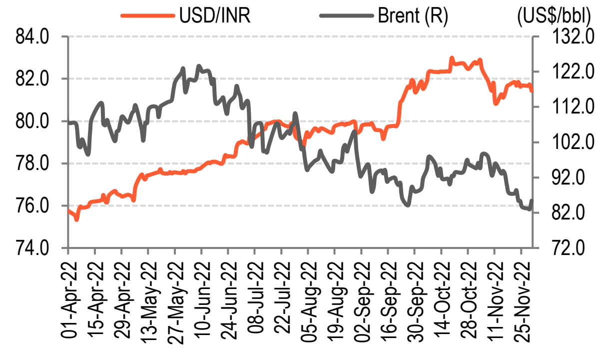
On the domestic side, FPIs have infused about US$ 4bn in the domestic market in Nov'22, driven by equity flows. The recent bull-run in the domestic equity market bears testimony to FPIs' confidence in India's macro fundamentals. With the threat of a recession looming large and a slowdown in Fed rate hikes, India is likely to remain the preferred choice for FPIs seeking better returns on investments. This will be positive for INR. Our analysis shows that FPI flows have a statistically significant positive relation with the exchange rate.

Concomitantly, concerns over India's foreign exchange reserves have also eased in recent weeks with FX reserves rising by US$ 16.2bn in Nov'22. The increase in FX reserves coincides with easing pressure on INR amidst a weakness in dollar and FPI inflows. FX reserves may see further accretion due to revaluation gains as the dollar rally wanes. This will be positive for India's external stability given the elevated trade deficit, which will also be positive for INR.

However concerns remain over India's elevated trade deficit. In the 7-months to Oct'22, trade deficit has been tracking at a run-rate of US$ 25.1bn per month, and may continue to increase at the same rate. This is because while export growth faces increased headwinds from a slowdown in global growth, imports may continue to grow as the domestic economy is expected to remain resilient. We expect trade deficit at US$ 300bn or ~9% of GDP. Even services exports may face some resistance due to a decline in economic momentum in key markets such as US and Europe. Overall, we expect CAD of 3.5% of GDP or ~US$ 110bn. This is likely to put some pressure on the INR. However, the recent decline in oil prices to below US$ 90/bbl should provide some comfort.

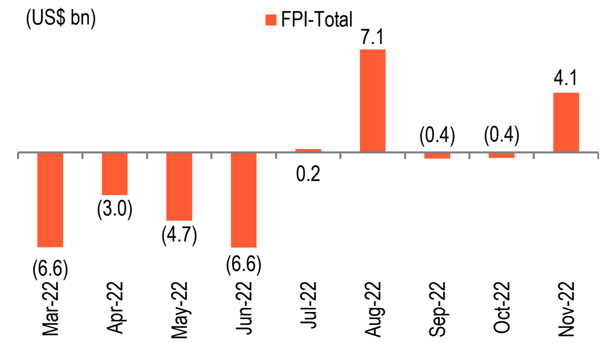
Overall, we continue to believe that INR will remain in the range of 81-82/$ in the near-term.

Figure 2: Oil prices have eased



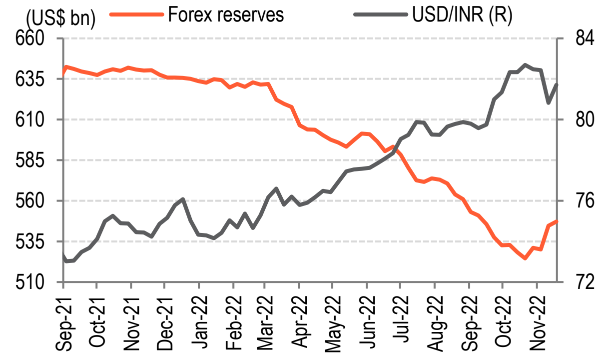
Source: Bloomberg, Bank of Baroda Research

Figure 4: FPI flows picked up pace



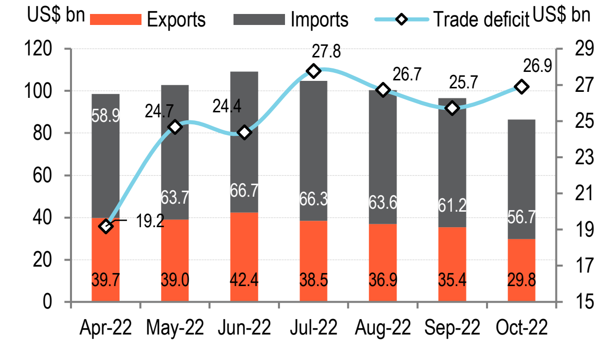
Source: Bloomberg, Bank of Baroda Research | Data as of 29 Nov 2022

Figure 5: Forex reserves increased



Source: Bloomberg, Bank of Baroda Research | Weekly data as of 18 Nov 2022

Figure 6: Trade deficit remains elevated



Source: Bloomberg, Bank of Baroda Research

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