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Currency Outlook

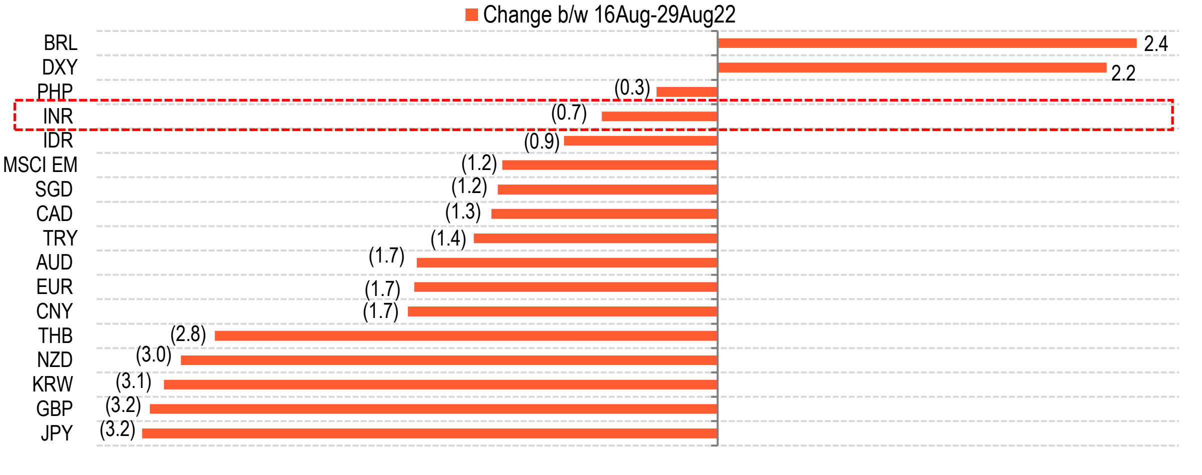
What's in store for INR

Volatility returned to the global markets this week driven largely by a more hawkish than expected commentary from the Fed Chair. In a much anticipated speech at the Annual Jackson Hole symposium, Fed Chair stated that he expects rate to remain high "for some time" while cautioning against "prematurely loosening policy". He also acknowledged that higher rates are likely to impinge on growth and labour market which will bring some "pain to households and businesses". The comments spurred a decline in global currencies against the dollar. INR too has depreciated against the dollar, briefly breaching the 80/$ mark.

How have global currencies fared?

Global currencies have declined post the Fed Chair's speech. DXY index, which measures the dollar strength against a basket of currencies has risen by 2.2% in the last fortnight. Unsurprisingly, the Japanese yen (JPY) has seen the maximum decline as the widening policy divergence between the BoJ and other global central banks continues to weigh on the currency. The pound (GBP) has witmnessed a sharp decline of 3.2% amidst a worsening cost-of-living crisis which is expected to push the economy into a recession. The euro (EUR) too has been weakening against the dollar. In fact, it is trading below the dollar-parity mark for 7-straight sessions now. A domestic energy crisis due to the Russia-Ukraine war, can be attributed to the weakness in EUR.

Figure 1: Currency movement



Source: Bloomberg, Bank of Baroda | Data as of 29 Aug 2022 | Note: Figures in bracket denote depreciation against USD

CNY too continues to remain under pressure amidst a deteriorating economic outlook, led by the ongoing property crisis. While INR remained largely stable in the last fortnight, it has come under renewed pressure after the Fed Chair's speech on Friday. It continues to flirt around the psychological level of 80/$, with active intervention from RBI preventing a fall below the level.

Apart from the dollar strength, other factors have also exacerbated the fall in INR in the last couple of days. First, oil prices which traded below the US$ 100/bbl for most part of Aug'22, have started inching up again. In fact, in the last fortnight alone, oil prices have increased by 13.8%. Second, moderation in FPI inflows. From US$ 4.7bn in the first fortnight of Aug'22, FPI inflows have slowed down to US$ 1.9bn in the latter part of the month. Third, the trade balance continues to widen with exports growth slowing down while imports remain buoyant due to higher demand. The decline in global commodity prices has helped to limit the upside in imports growth in value terms.

Outlook:

With the Fed Chair clearly signaling higher rates are likely to stay, the dollar index may see a further uptick. This will keep global currencies, including INR under pressure. While FPI flows have remained positive in Aug'22, higher rates in the US along with a slowing global growth may spur a fresh bout of FPI withdrawals from the Indian market. On the positive side, oil prices may see some correction as higher rates tip the global economy into a slowdown if not recession.

Overall, we may expect the rupee to trade in the Rs 79.75-80.0/$ range in the near-term. However, the RBI has shown a strong intent to defend the 80/$ mark, in which case a move above that level may not materialize.

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