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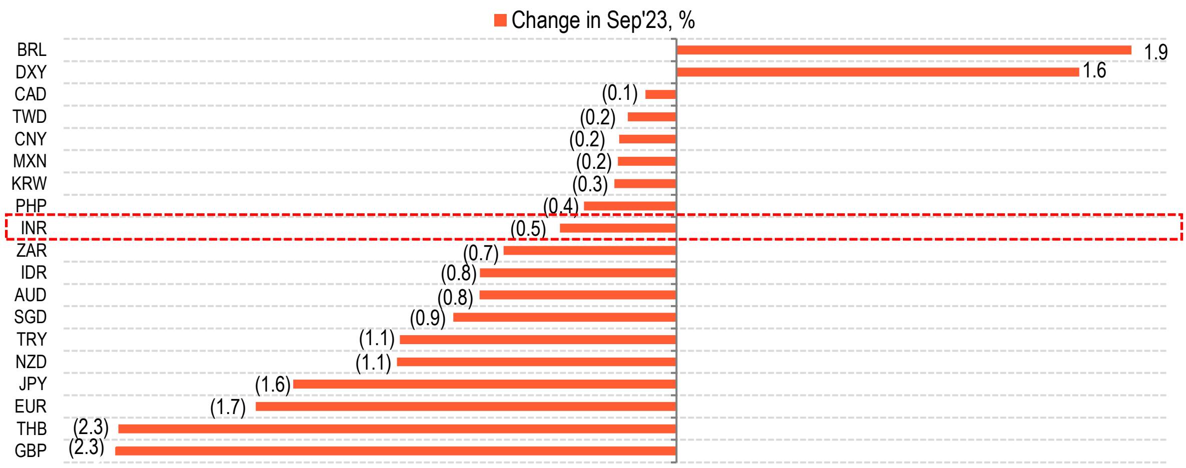
Fortnightly forex review

INR depreciated to a fresh record-low of 83.18/$ on 15 Sep 2023 led by a confluence of adverse shocks of rising dollar, higher oil prices and FPI outflows. In Sep'23, INR is lower by 0.5%. Pressure was also seen on other global currencies as DXY rose by 1.6%. Uncertainty remains over US monetary policy and hence investors will remain cautious ahead of the Fed's policy decision next week. A pause is widely expected, but more guidance will come from Fed's dot plot. With oil prices sustaining at current levels, India's external position also remains at risk. RBI is likely to intervene to prevent sharp moves in the exchange rate, as it has done in the past. On balance, we expect INR to trade in the range of 83-83.5/$ in the near-term. Risks remain from indications of 'higher-for-longer' Fed rates and a further escalation in oil prices.

Movement in global currencies

Global currencies depreciated against the dollar. Higher US yields amidst expectations of another rate hike by the Fed boosted demand for US dollar. Recent macro data from the US has reinforced views that the soft landing scenario is likely to materialize. US inflation accelerated to 3.7% in Aug'23, from 3.2% in Jul'23, led by higher energy costs. This has revived bets of a rate hike in Nov'23. While US 10Y yield has surged to over 5%, DXY has gained 1.6% this month. This has put pressure on other currencies. Amongst major currencies, GBP and EUR have depreciated the most. Economic conditions in both UK and Europe have worsened considerably as the services sector, which had so far remained resilient, is also showing signs of slowing down. While ECB raised its benchmark rates by 25bps, it hinted at an end to its rate hike spree. JPY continued to depreciate despite warnings from BoJ and the government. BoJ meets next week and all eyes will be on the Governor who has hinted at moving away from BoJ's ultra-dovish monetary policy by the end of the year.

Figure 1: Fortnightly currency movement in Aug'23



Source: Bloomberg, Bank of Baroda Research | Note: Data as of 15 Sep 2023

How did INR fare?

INR closed at a fresh record low of 83.18/$ in the last trading session. It is lower by 0.5% in Sep'23. Higher dollar, rising oil prices and a reversal in FPI inflows have contributed to the decline in exchange rate. Even so, the depreciation in INR is lower than the median deprecation in the sample of 17 currencies which stands at 0.8%. INR has also performed better compared with major advanced economy (AEs) such as GBP and EUR, and also some EM currencies such as SGD and IDR. However, it has since stabilized. Volatility in INR has also remained low at just 2.6% in Sep'23, compared with 2.5% in Aug'23.

Outlook for INR

INR has been caught in the perfect storm of rising oil prices and higher US dollar. Oil prices have sustained above US$ 90/bbl in Sep'23, compared with US$ 85/bbl on average in Aug'23. Oil supply is expected to remain tight led by output cuts from Saudi Arabia and Russia. On the other hand, demand is expected to be high due to seasonal factors as well as early signs of recovery in China. Market participants expect oil prices to inch up to ~US$ 100/bbl in the coming days, a level last seen in Aug'22. This will worsen India's external position.

Our analysis has shown that for every 10% increase in oil prices on a permanent basis, oil imports increase by ~0.4% of GDP. At a time when exports are also facing headwinds from weakening global demand, this could have serious implications for India's current account. In Aug'23, India's trade deficit rose to a 10-month high of US$ 24.2bn. In FYTD24 (upto Aug'23), trade deficit is tracking at a monthly run-rate of US$ 20bn versus US$ 22.6bn in the same period last year, led largely by a lower oil deficit. Higher oil prices threaten to reverse this trend and we may see further pressure on the currency.

There are other headwinds as well. DXY has strengthened by ~2% this year. The movement in dollar has been driven by expectations of the future course of Fed policy. In this regard, Fed's policy next week will be crucial. There is consensus amongst market participants of a pause next week, but there are differing views on policy action beyond that. In this regard, the dot plot will be crucial as it will shed more light on the direction of rates. More importantly, markets are awaiting for any signs of when a rate cut will materialize. This in turn will determine the trajectory of the dollar.

Apart from this, INR has also been impacted by a moderation in FPI inflows. After reaching a peak of US$ 6.9bn in Jun'23, FPI inflows have been moderating. In Sep'23, FPI's were net sellers in the domestic market, with outflows of US$ 356mn. Bulk of the outflows were concentrated in the equity segment, even as Sensex rose to an all-time high in the same period. Uncertainty about US rate policy as well as higher US yields can be attributed as primary reasons of keeping foreign investors wary of EM assets. The trend is likely to persist in the near-term, until clarity emerges on the future course of Fed policy. Domestic macros are also being challenged due to the double whammy of erratic monsoon and higher oil prices. This may also explain the reluctance of foreign investors to enter the Indian market.

Overall, we expect INR to remain under pressure in the near-term. RBI has been managing the currency well with the forex reserves it accumulated in the last few months. At US$ 593.3bn, India's foreign exchange reserves are comfortable and can cover ~10 months' worth of imports which is well above the adequacy norms. This should give RBI room to defend the rupee in case of any sharp depreciation. We expect INR to trade in the range of 83-83.5/$ in the next fortnight.

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