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Currency Outlook

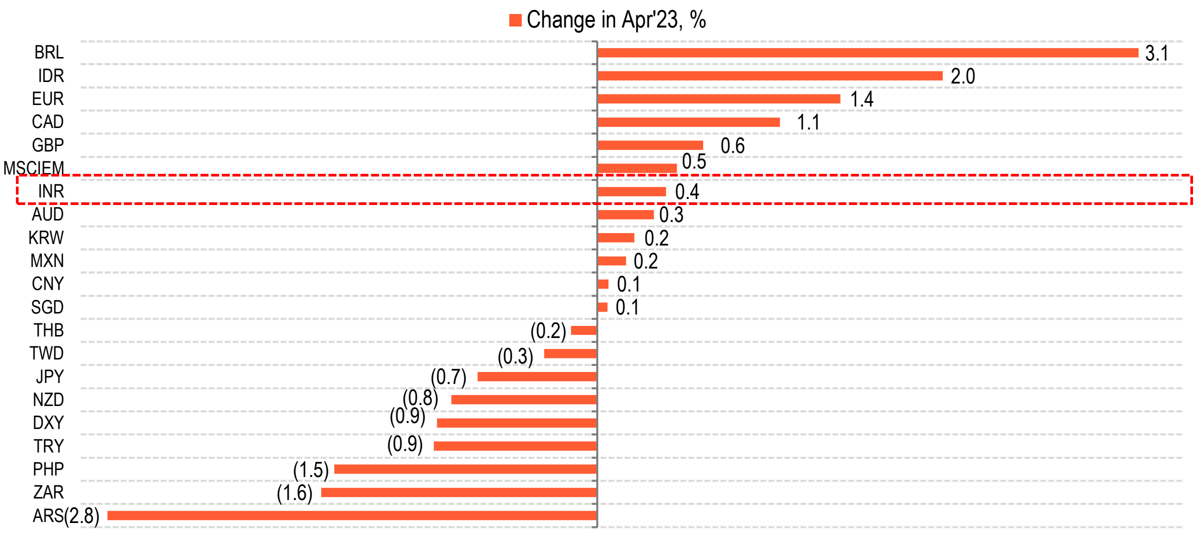
INR to strengthen

DXY fell by 0.9% in Apr'23 so far as expectations that the Fed is nearing an end to its rate hike cycle gained momentum. ECB and BoE on the other hand are expected to continue with their rate hike cycle amidst persistent stickiness in core inflation. INR appreciated by 0.4% in Apr'23, building on a gain of 0.6% it made last month. While oil prices increased, weaker dollar, FPI inflows and improvement in external outlook supported gains in INR. We believe that INR is likely to make further gains against the dollar in the next fortnight, with a range of 81.5/$-82.25/$ most likely.

Movement in global currencies

Global currencies ended mixed in the last fortnight. The dollar index (DXY) remained under pressure and fell by 0.9%. Macro data in the US remained mixed. Importantly, FOMC minutes reflected that members were wary of the stress in the banking sector. Even staff projections showed that the banking crisis could potentially tip the economy into a "mild recession". However, stickiness in inflation prompted the Fed to hike rates by another 25bps. Since then, macro data has reinforced the view that there may be some merit in the Fed raising policy rate by another 25bps in May'23 (CMEFedWatch probability at more than 85%), which will mark its last rate hike this cycle.

Figure 1: Global currencies were mostly higher in Mar'23



Source: Bloomberg, Bank of Baroda Research, Data as of 14 Apr 2023 | Note: Figures in bracket denote depreciation against USD

On the other hand, central banks in Europe are expected to continue raising rates as inflation, more specifically core inflation still continues to remain elevated. Both the European Central Bank (ECB) and Bank of England (BoE) are likely to raise rates even as the Fed takes a pause. As a result, both EUR and GBP made gains against the dollar, rising by 1.1% and 0.6% respectively in the first fortnight of Apr'23. JPY depreciated by 0.7% as the newly appointed Bank of Japan (BoJ) Governor defended the central bank's ultra-dovish stance. MSCI EM index rose by 0.5% in Apr'23, led by gains in BRL and IDR. Other

EM currencies were mostly lower as oil prices rose by ~8% following the OPEC+'s decision to cut oil production.

How did INR fare?

Defying the trend seen in other EM currencies, INR appreciated by 0.4% in Apr'23. Interestingly, INR had appreciated by 0.6% even in Mar'23. A weakness in dollar and improving external position supported the gains in INR. FPI inflows of US$ 1.1bn also supported the rupee. Further, volatility in INR remained low when compared with other currencies. The average annualized volatility in INR was 3.4% in Apr'23 compared median of 7.4% in the sample of 19 currencies. In fact, volatility in INR has declined from 4.2% in Mar'23 to 3.4% in Apr'23.

Table 1: Annualized daily volatility in major currencies

Currency	Jan'23	Feb'23	Mar'23	Apr'23
TRY	1.7%	1.5%	4.2%	0.9%
CNY	6.4%	5.0%	7.2%	1.9%
TWD	4.4%	5.9%	4.3%	2.4%
MYR	4.1%	7.4%	6.2%	2.6%
INR	5.1%	4.6%	4.2%	3.4%
IDR	8.3%	5.9%	5.8%	4.6%
SGD	4.4%	5.5%	5.1%	4.8%
CAD	8.5%	5.7%	6.3%	5.4%
EUR	8.0%	7.8%	9.9%	7.2%
PHP	6.6%	10.5%	4.0%	7.4%
MXN	7.1%	11.2%	16.8%	7.5%
GBP	9.2%	10.2%	10.3%	7.6%
JPY	12.5%	11.2%	11.6%	8.7%
THB	9.7%	10.2%	10.8%	9.7%
KRW	7.8%	11.5%	14.2%	10.1%
BRL	17.1%	13.0%	11.2%	11.3%
NZD	10.4%	10.8%	11.3%	12.6%
AUD	12.3%	12.6%	11.2%	13.2%
ZAR	11.4%	13.9%	13.7%	15.4%

Source: Bloomberg, Bank of Baroda Research, Data as of 14 Apr 2023

<u>Outlook for INR</u>

We believe that INR is likely to benefit from a weaker dollar. With US growth showing some signs of slowdown, Fed is likely to pause its rate hike cycle. There are also increased expectations of rate cuts in the later part of the year which will keep DXY under pressure. On the other hand, rate hikes by ECB and BoE will increase the rate differential and keep further check on DXY. This should help the INR. On the other hand, domestic external position has improved. While trade deficit in FY23 was much higher at US$ 266.8bn from US$ 191bn in FY22, the CAD remained comfortable due to buoyant service exports and remittances receipts. Even in FY24, CAD is expected to remain in a manageable range and may even fall below 2% of GDP. FPI flows too have resumed, and forex reserves have risen to a 9-month high. Together, this suggests that we can expect further strength in INR. *For the next fortnight, we expect INR to trade in the range of 81.50-82.25/$.*

<u>Review of India's external sector in FY23</u>

In FY23, India's merchandise exports rose by 6% to US$ 447.5bn from US$ 422bn in FY22. However, this was on the back of an increase in oil exports which rose by 40%. Non-oil exports contracted by 0.5%. Within this, exports of textiles dropped the most by 13.6% amidst a fall in global demand. Even engineering goods were lower by 4.8%. On the other hand, exports of electronic goods showed resilience and rose by 50.7%, helped by government's PLI scheme.

On the other hand, Imports rose by 16.5% to US$ 714.2bn due to elevated commodity prices. Oil prices rose by 29.5% in FY23, as oil prices increased by ~19% in the same period. Gold imports on the other hand fell by 24.1% as depreciation of rupee against the dollar made domestic gold more expensive, which weighed on demand. Non-oil-non-gold imports, an important barometer of domestic demand were up by 15.9% in FY23. However, this may partly be due to elevated commodity prices. Within this group, imports of coal rose the most by 56.9% as a scarcity of coal in the domestic market necessitated the need to import coal at much higher prices to meet domestic demand. Iron and steel imports also rose by 29.9% as construction activities picked up. Capital goods imports also increased by 14.5% as capacity utilization started improving post the pandemic.

As a result, India's merchandise trade deficit increased sharply to US$ 266.8bn in FY23 from US$ 191.1bn in FY22. Interestingly, while oil deficit increased by US$ 20.7bn, non-oil deficit jumped sharply by US$ 55bn. Cushioning the impact of higher merchandise deficit, India's services surplus rose to US$ 142.2bn in FY23 from US$ 107.5bn in FY22. While services exports rose by 25.6% in FY23, services imports rose by 20.7%.

We expect India's external position to improve in FY24. This is because we may see a further correction in global commodity prices due to a slowdown in demand in key markets. Domestic demand too may remain muted, thus keeping imports in check. Both goods and services exports may also see a slowdown as growth in major markets cools off. However, this will be offset by a dip in imports as well as buoyant remittances. Hence, we expect India's CAD in a comfortable range of 1.9%-2.2% in FY24. This on the margin is positive for INR.

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