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INR at record low: What's next?

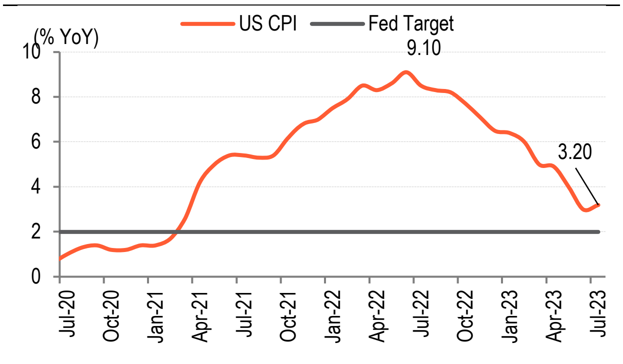
INR closed at a record low of 83.15/$ yesterday, just short of an intra-day low of 83.24/$ in Oct'22. Pressure on the domestic currency has come from exogenous factors, even as domestic macros continue to remain supportive. It appears that expectations of a peak in Fed rates have been pushed back. With growth on a strong footing, another rate hike is now a possibility. On the other hand, weak growth in China has weighed on CNY. We expect some short-term pressure on USD/INR but remain positive on the currency pair in the long-run. A range of 83-84/$ looks reasonable for the next fortnight. Further upside is also possible, given the volatility in global financial markets.

What is driving the rebound in dollar?

DXY, measuring the dollar's value against a basket of currencies, has risen to a more than 2-month high. Inherent strength of the US economy along with the uncertainty over Fed rate hikes has been driving the movement in DXY. Despite a cumulative 525bps increase in policy rate, US economy has remained resilient, indicating that a "soft landing" narrative remains intact. Recent indicators from the US, such as housing starts, retail sales, industrial production and jobless claims, suggest that growth has held ground. Labour market conditions remain tight with unemployment rate still below the pre-pandemic levels. Fed staff projections too do not foresee a recession this year.

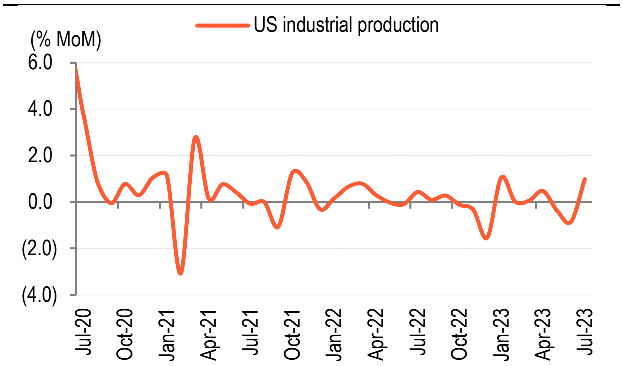
Inflation though moderating, remains above Fed's target. Minutes of Fed's last policy meeting show that given the uncertainty around the inflation outlook, rates may have to remain higher for longer. Post the release of Fed minutes, expectations of another 25bps rate hike have risen, which is fueling a rally in dollar. It must be noted that the Fed has been at the forefront of the synchronized global monetary policy tightening cycle being witnessed this year. With US policy rates already at a 22-year peak, and another rate hike expected, the dollar is likely to see further upside.

Figure 1: Inflation in US has moderated



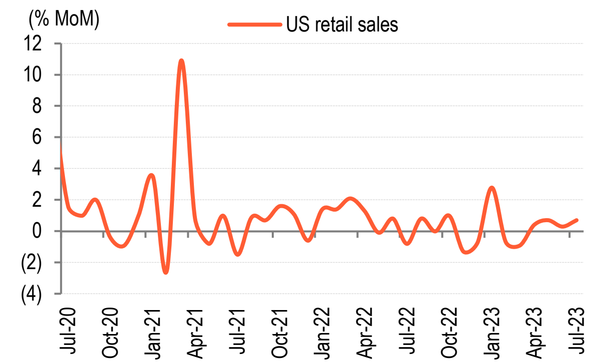
Source: Bloomberg, Bank of Baroda Research

Figure 2: Industrial production improves



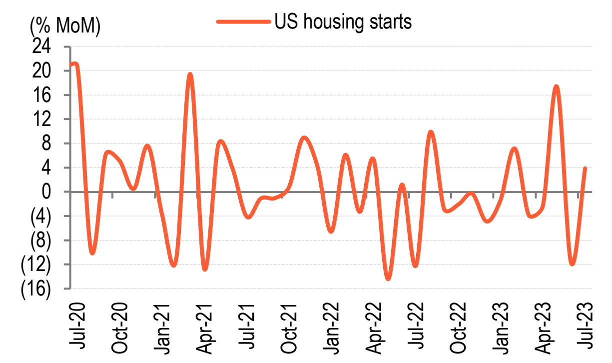
Source: CEIC, Bank of Baroda Research

Figure 3: Consumer spending robust



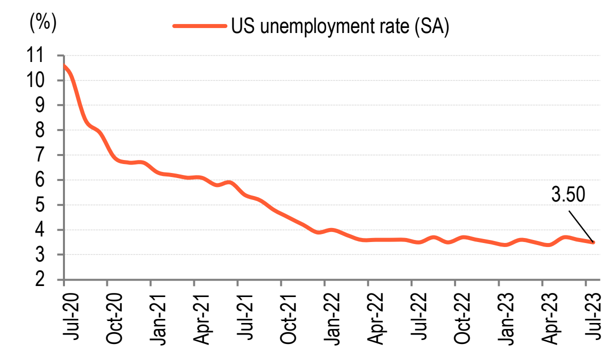
Source: Bloomberg, Bank of Baroda Research

Figure 4: Housing sector remains resilient



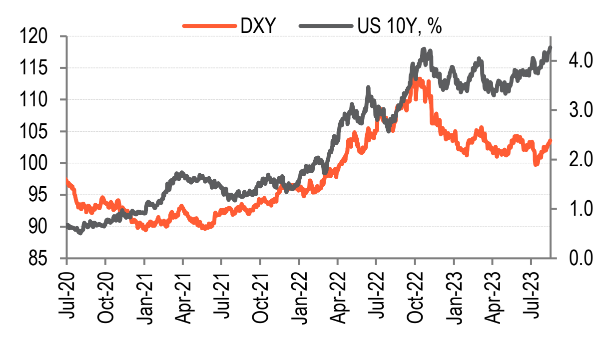
Source: Bloomberg, Bank of Baroda Research

Figure 5: Labour market strength remains intact



Source: Bloomberg, Bank of Baroda Research

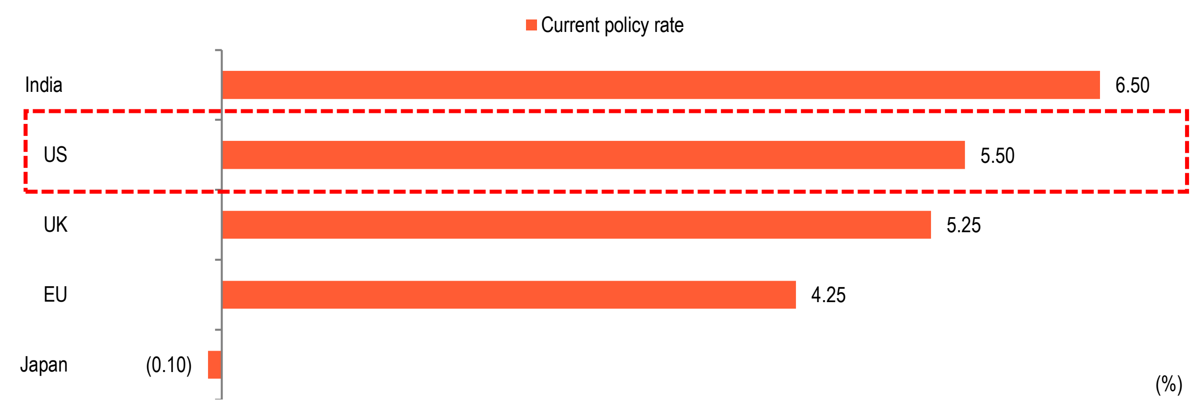
Figure 6: US 10Y yield inching up



Source: CEIC, Bank of Baroda Research | Data as of 17 Aug 2023

US treasury yields have also moved up, which is further contributing to the strength in dollar. US 10Y yield rose to its highest level since Dec'07 at 4.27% on 17 Aug 2023. Yields on other tenures have also moved up, drawing the attention of investors. Apart from this, DXY also gained as its appeal as a safe-haven asset has remained intact despite a rating downgrade.

Figure 7: US policy rate at a 22-year high

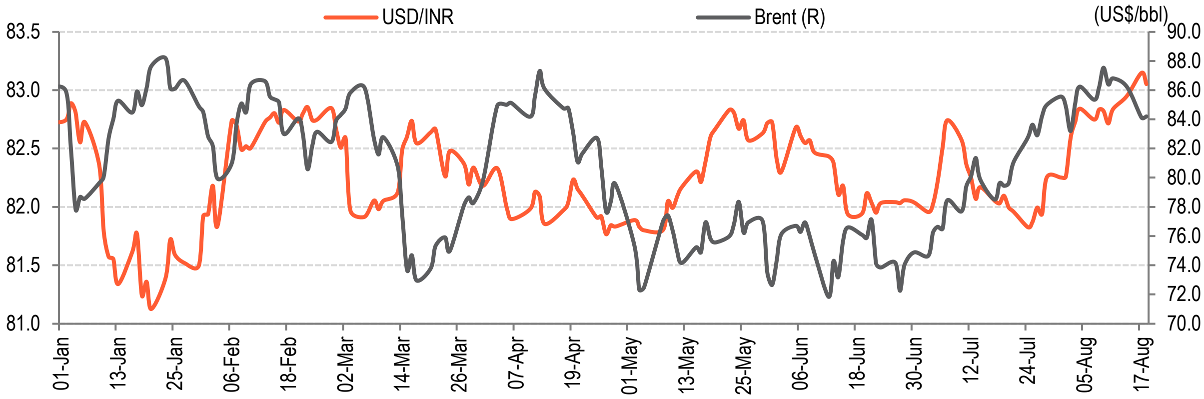


Source: Bloomberg, Bank of Baroda Research

Oil prices on an upward trajectory

Another factor which has been weighing on the domestic currency is a persistent increase in global oil prices. Oil prices and INR are negatively related as higher oil prices imply a higher import bill. This translates into a higher trade deficit. With export growth remaining weak due to global factors, higher oil prices pose a threat to India's external balance, which is also putting depreciating pressure on INR. From about US$ 75/bbl in Jun'23, crude oil prices have inched up to ~US$ 85/bbl currently. Production cuts by OPEC+ members, specifically Russia and Saudi Arabia have tightened supply and pushed global prices higher. However, gains have been capped due to demand concerns from China.

Figure 8: Oil prices have inched up

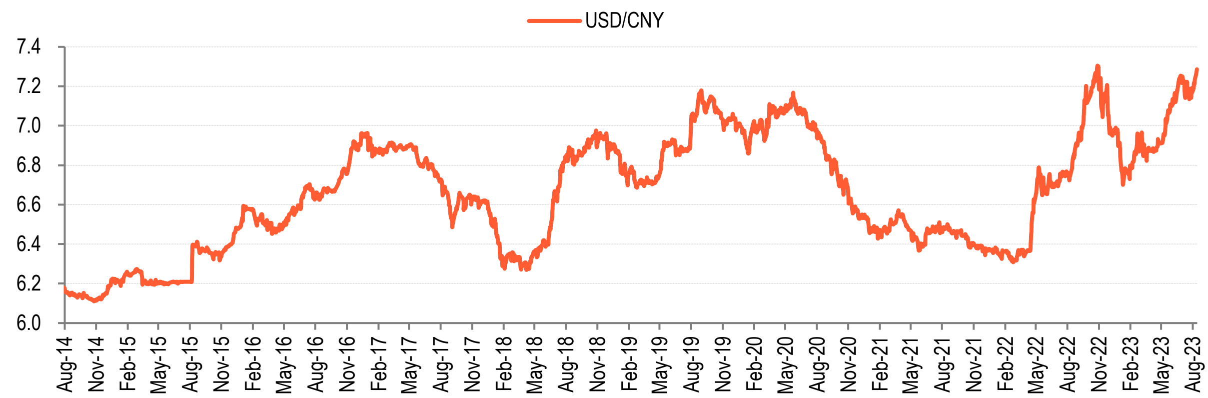


Source: Bloomberg, Bank of Baroda Research | Note: Data as of 17 Aug 2023

Yuan depreciation

Apart from this, a precipitous depreciation in CNY is also weighing on the rupee. CNY and INR are closely related and hence a weakness in CNY also puts pressure on INR. With lingering growth concerns, CNY has depreciated sharply in recent sessions. Both the government and the People's Bank of China (PBOC) have announced measures to stimulate growth in the economy. However, macro data points have continued to show a worsening outlook. The sharp fall in the currency has also led to active intervention by PBOC which has led to a marginal appreciation in the currency pair today.

Figure 9: CNY under pressure

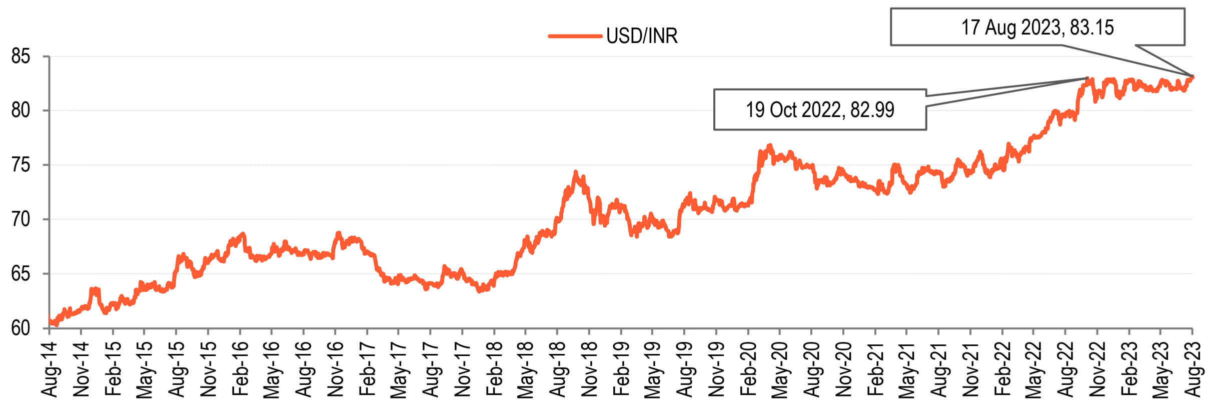


Source: Bloomberg, Bank of Baroda Research | Note: Data as of 17 Aug 2023

Where is INR headed?

The weakness in INR can be attributed to external factors, even as domestic factors remain favorable. INR depreciated to a fresh record-low of 83.15/$ yesterday. While there has been some correction in today's session, it continues to trade above the 83/$ mark. News reports suggest that RBI has been actively intervening in the forex market to prevent a sharp fall in INR. Even so, there is a belief that RBI may be more accepting of a weaker rupee, especially since export growth faces headwinds. A weaker rupee will improve India's export competitiveness. RBI has always maintained its stance that it its intervention in the currency market is limited to curb excess volatility in the forex market, and given its abundant forex reserves, it will continue to do so. In the past, RBI had shown a firm stance to defend the 83/$ mark, which has been breached. With the current global backdrop, more pressure on INR looks inevitable and hence we may see INR moving upwards. Higher than expected domestic inflation will also work against INR.

Figure 10: INR depreciates to a record-low



Source: Bloomberg, Bank of Baroda Research | Note: Data as of 17 Aug 2023

While the global backdrop suggest a weakening currency, squeeze in domestic liquidity post the implementation of incremental CRR requirements may limit RBI's ability to intervene in the currency market. In such a scenario we may see INR drifting closer to 84/$ level. Support for INR will come from steady FPI inflows and a correction in oil prices (lower demand due to weak growth in China).

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