Aditi Gupta
Economist

Currency Outlook

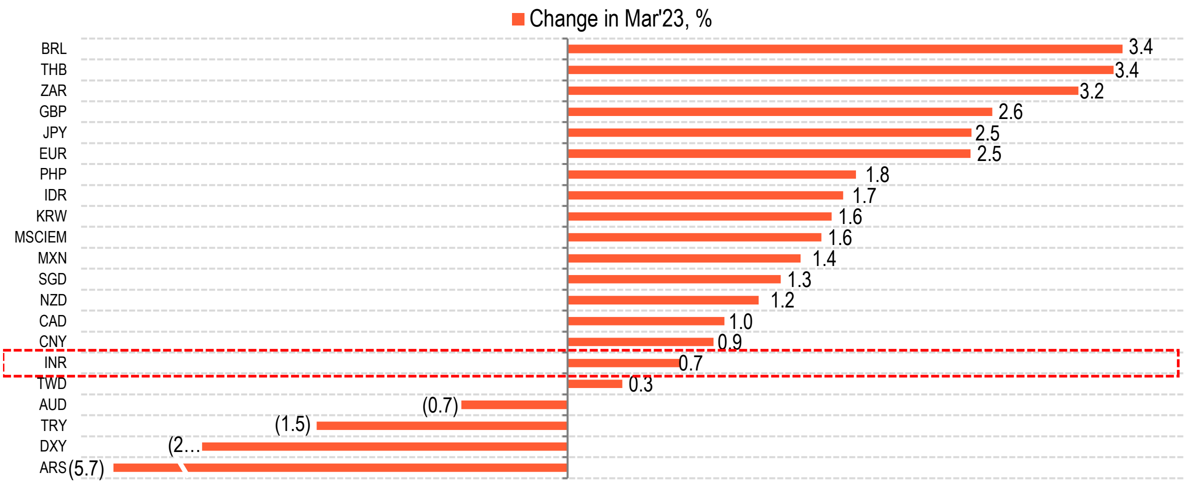
Further downside for INR likely

Driven by a weakness in DXY, global currencies appreciated. Volatility remained high amidst turmoil in global banking system and Fed policy meet. INR appreciated by 0.7% in Mar'23 amidst promising global as well as, domestic fundamentals. In FY23, INR depreciated by 7.7%, after depreciating by 3.5% in FY21. Increased expectations of a rate cut by Fed in the second half of CY23, will keep DXY under pressure. On the domestic side, a moderation in imports has kept trade deficit in check. Lower oil prices also bode well for the external sector outlook. Further, while merchandise exports have slipped, services exports have shown resilience suggesting that CAD is likely to remain in a comfortable range. While the stage looks set for a runaway appreciation in INR, we believe that the RBI is likely to maintain the exchange rate in the close range of 82-83/$, as has been the trend in recent past, as external demand remains weak.

Movement in global currencies

Global currencies mostly gained against the dollar in Mar'23. DXY was lower by 2.3%. Stress in the US banking sector due to the failure of a few regional banks and fears of further contagion dominated market sentiments. Market participants reprised expectations for future rate hikes, even as the regulators sprang into action to limit the fallout from the crisis. This weighed on the dollar. Global currencies too witnessed high volatility during this period. Against this backdrop, the Fed raised policy rates by another 25bps, however the pace of future rate hikes remained uncertain. As the damage from the banking crisis was largely contained due to timely intervention from the Fed, FDIC and US Treasury Department, the Fed was once again seen hiking rates. Macro data since then, specifically moderation in core PCE suggest that the after a last 25bps rate hike in May'23, the Fed may finally put its rate hike cycle on a pause mode. In fact, there are expectations of rate cuts in the latter part of the year which is weighing on the dollar.

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



Source: Bloomberg, Bank of Baroda Research, Data as of 31 Mar 2023 | Note: Figures in bracket denote depreciation against USD

Emerging Market (EM) currencies made smart gains against the weaker dollar. MSCI EM index rose by 1.6% in Mar'23, with currencies such as BRL, THB and ZAR gaining the most. On the other hand, weak macro data in China (industrial profits, manufacturing PMI), limited gains in CNY. Amongst Advanced Economy (AE) currencies, GBP and EUR appreciated the most by 2.6% and 2.5% respectively. Expectations that the Bank of England (BoE) and European Central Bank (ECB) will continue to hike rates at an aggressive pace amidst elevated inflation, supported gains in the respective currencies. JPY gained 2.5% on safe-haven demand.

<u>How did INR fare?</u>

In line with other EM currencies, INR too appreciated by 0.7% in Mar'23, reversing some of its losses. Apart from a weaker dollar, lower oil prices (oil prices were ~5% lower on an average in Mar'23), and year end FPI flows (US$ 712mn), supported the Rupee. Trade deficit too was lower in Feb'23 and CAD for Q3FY23 also showed significant moderation. Despite this, gains in INR were relatively muted when compared to other currencies. In fact, the median appreciation in the sample of 17 currencies was 1.7% in Mar'23, while INR appreciated by only 0.6%. It must be noted that since Feb'23, India's forex reserves have increased by US$ 17.8bn, suggesting that the RBI may be using this period of dollar weakness to strengthen its forex kitty which can explain INR's recent underperformance. Undeniably, a part of the increase in forex reserves can also be explained by valuation effects and higher gold prices.

Even so, INR has remained amongst the least volatile currency in Mar'23 with average annualized volatility at 4.2%. In fact, volatility in INR has declined from 5.1% in Jan'23 to 4.2% in Mar'23. On the other hand, AE currencies have seen sizeable increase in volatility in Mar'23, with currencies such as GBP, AUD, NZD and JPY witnessing volatility in double-digits.

<u>Table 1: Annualised daily volatility in major currencies</u>

Currency	**Jan'23**	**Feb'23**	**Mar'23**
PHP	6.6%	10.5%	4.0%
TRY	1.7%	1.5%	4.2%
INR	5.1%	4.6%	4.2%
TWD	4.4%	5.9%	4.3%
MSCI EM	4.0%	5.1%	4.5%
SGD	4.4%	5.5%	5.1%
IDR	8.3%	5.9%	5.8%
MYR	4.1%	7.4%	6.2%
CAD	8.5%	5.7%	6.3%
CNY	6.4%	5.0%	7.2%
EUR	8.0%	7.8%	9.9%
GBP	9.2%	10.2%	10.3%
THB	9.7%	10.2%	10.8%
BRL	17.1%	13.0%	11.1%
AUD	12.3%	12.6%	11.2%

NZD	10.4%	10.8%	11.3%
DXY	8.0%	11.5%	11.3%
JPY	12.5%	11.2%	11.6%
ZAR	11.4%	13.9%	13.7%
KRW	7.8%	11.5%	14.2%
MXN	7.1%	11.2%	16.8%

Source: Bloomberg, Bank of Baroda Research, Data as of 31 Mar 2023

Outlook for INR

The outlook for INR looks promising. This is due to a number of factors. First and foremost, we believe that room for further upside in DXY is limited. US Core PCE, Fed's preferred gauge for inflation, is signaling a slowdown in inflationary pressures which makes the case for more rate hikes difficult. In fact, expectations have increased that the Fed may have to cut rates in H2CY23. On the other hand, with the stress in the banking sector, Fed has infused dollar liquidity in the system which will also have a downward impact on the dollar in the near term.

On the domestic side, moderation in trade deficit and CAD is supportive of a further improvement in the exchange rate. Global oil prices are also in an amicable range. FPI flows though positive, remain scanty and unpredictable. With weak external demand and a dip in merchandise exports, RBI is likely to prevent a sharp appreciation in INR which will make India's export less competitive. RBI will also continue to use this period, to shore up the crucial forex reserves that it lost year in defending the rupee. Hence, despite favorable fundamentals, INR is likely to remain range-bound. Going by recent trends, a range of 82-83/$ looks likely.

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For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
chief.economist@bankofbaroda.com