Aditi Gupta
Economist

Currency Outlook

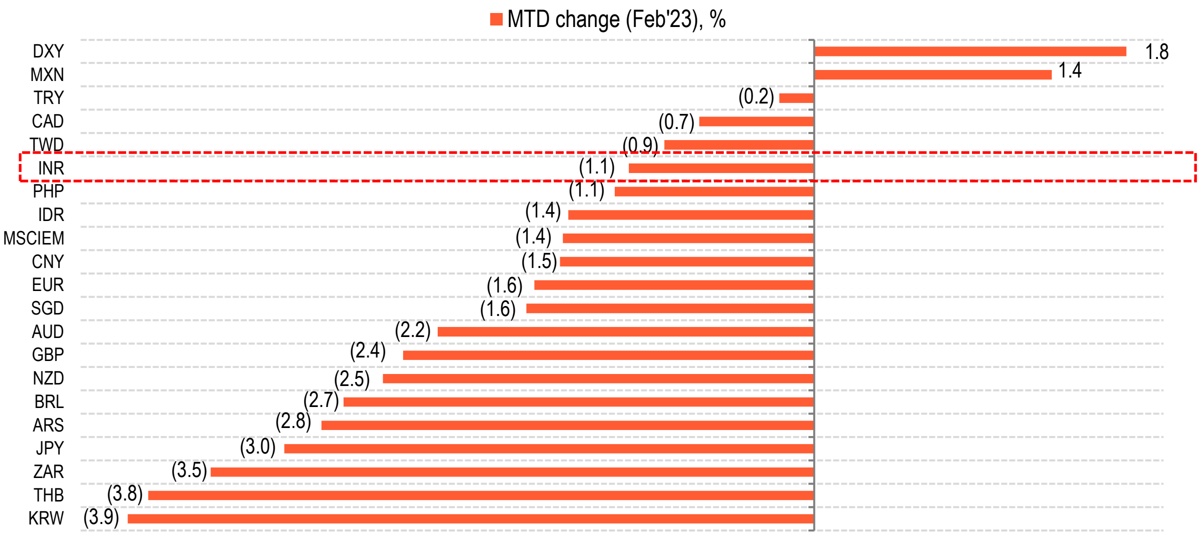
INR to remain steady

Dollar rally resumed once again as bets of more Fed rate hikes reemerged. Investors are now expecting two more rate hikes, implying a terminal Fed fund rate above 5.1% (Fed's projection Dec'22). This put pressure on all major global currencies. INR too depreciated by 1.1% in Feb'23, reversing the gains it made at the start of the year. Nevertheless, INR will find some support from improving balance of payments dynamics and stable oil prices. Interestingly, India's trade deficit fell to a 12-month in Jan'23 as imports declined more sharply than exports. On the other hand, services exports remained buoyant. FPI flows though negative, may also end FY23 on a positive note which will further support INR. We expect a range of 82-83/$ for USD/INR in the near-term.

Movement in global currencies

Global currencies once again depreciated as dollar dominance returned in Feb'23. The month started off with hawkish comments from several Fed officials, batting for higher rates cautioning that the battle against inflation has not been fully won. Reinforcing this view, US CPI data showed that prices increased on a MoM basis. This was followed by a stronger than expected retail sales report suggesting underlying momentum in demand. Thus, the case for more rate hikes by the Fed has strengthened and the possibility of the so-called Fed pivot has diminished even more. Market expectations of the Fed terminal rate have seen upward revisions to range of 5.25%-5.5%. Interestingly, this is above Fed's own projection of a terminal rate of 5.1% (as given in SEP Dec'22). Hence, dollar once again resumed its upward rally at the cost of other global currencies.

Figure 1: Global currencies fell in Feb'23



Source: Bloomberg, Bank of Baroda Research, Data as of 15 Feb 2023 | Note: Figures in bracket denote depreciation against USD

Most global currencies depreciated against the dollar in Feb'23 with losses ranging from 0.2% (Turkish Lira) to 3.9% (Korean Won). Amongst advanced economy (AE) currencies, while EUR depreciated by

1.6%, GBP fell by 2.4%. Cooling inflation and expectation of smaller rate hikes by BoE drove losses in GBP. JPY continued to remain under pressure and dropped by 3%, as the new BoJ Governor nominee deemed the central bank's ultra-loose monetary policy stance as appropriate, suggesting that the policy divergence between BoJ and Fed is likely to sustain.

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

Tracking global cues, INR depreciated by 1.1% in Feb'23 (up to 15 Feb 2023). This followed a 1% gain in Jan'23. Apart from a stronger dollar, weakness in domestic equity markets as well as FPI outflows can explain the weakness in INR in Feb'23. However, relative to other currencies INR has fared better. While the median depreciation in the sample of 19 currencies was 1.6%, INR depreciated by only 1.1%. Furthermore, it has also performed better when compared to other EM as well as many AE currencies.

<u>Outlook for INR</u>

While INR has come under pressure in the last few sessions, we believe that this may prove to be temporary. A number of factors support this view. First and foremost, unlike last year, the probability of any runaway appreciation in the dollar remain low. Second, despite the announcement of production cuts by Russia, oil prices remain benign, which will support INR. Third, while FPI flows have remained negative this year, there may be some revival especially in the debt segment. Lastly, India's external deficits are likely to find comfort from easing commodity prices and a slowdown in domestic demand.

Hence, we expect INR to remain stable in the short term and trade in the range of 82-83/$.

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For further details about this publication, please contact:

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