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Currency Outlook

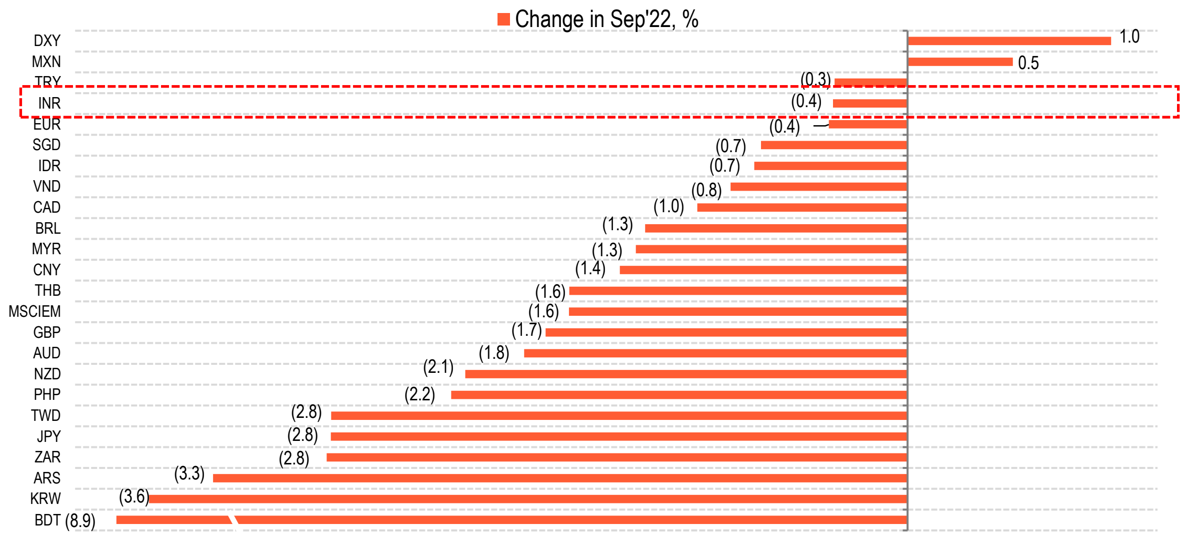
All eyes on Fed

Dollar continued its upward momentum with the DXY index hovering close to a 20-year high. Investors are now focused on the Fed meeting this week, with a growing consensus of a 75 bps rate hike. More importantly, investors now expect a much higher Fed terminal rate which is contributing to the dollar strength. Global currencies have seen sharp decline against the dollar, languishing at multi-year lows. This has prompted global central banks to intervene in the forex market to support their respective currencies. In comparison, INR has fared better and has depreciated by only 0.4% in Sep'22. Lower oil prices and stable FPI inflows have limited the losses in INR. We expect INR to trade in the range of 79.65-79.90/$ in the near-term. A lot will depend on Fed's commentary.

Currency movement in Sep'22

There has been a sharp decline in global currencies in Sep'22 (Figure 1), as the widely anticipated US inflation report was higher than expected. CPI inflation in US edged up by 0.1% in Aug'22, on a MoM basis compared with expectations of a decline of (-) 0.1%, despite a moderation in global commodity prices and easing supply pressures. As a result, expectations of a third consecutive 75 bps rate hike by the Fed have increased (82% probability as per CME Fed watch tool). There are also expectations that the Fed may deliver a surprise 100 bps rate hike (20% probability). Projections of the terminal rate have also seen a sharp upward revision in recent days from about 3.7% to ~4.45% this week. This has also been reflected in rising US 2Y yields which are currently trading at a 15-year high of 3.87%. DXY index, measuring dollar's strength against a basket of other currencies has surged by 1% this month. As a result, almost all major currencies have depreciated against the dollar.

Figure 1: Global currencies depreciated in Sep'22



Source: Bloomberg, Bank of Baroda | Data as of 17 Sep 2022 | Note: Figures in bracket denote depreciation against USD

While other central banks are also raising rates to combat inflation (Table 1), US continues to lead the pack amongst its advanced economy (AE) peers. US Fed has raised cumulatively by 225 bps this year, much higher than BoE (150 bps), ECB (125 bps) and RBI (140 bps). Much of the currency movements can be attributed to this. For example, Japan's currency has depreciated by sharp 19.5% in CYTD22, amidst widening policy divergence with the dollar. Despite rising inflation, BoJ has maintained its ultra-dovish policy stance, which has pushed JPY to a near 24-year low. The government as well as BoJ have in recent days raised concerns over the rapid decline in the exchange rate, which has prevented an even sharper decline in the currency (down by 2.8% in Sep'22). Even in the Eurozone, policy rates have risen to a lesser extent than US despite a surprise 75 bps rate hike in Sep'22. Hence, the EUR continues to trade close to the dollar-parity mark. Looming risks of recessions due to the ongoing energy crisis have only exacerbated the Euro's fall. Similarly, in UK, a worsening economic outlook has pushed the GBP to a 37-year low (down 1.6% in Sep'22). On the other hand, China has been following an expansionary monetary policy amidst increasing risks to growth. China's strict Covid-zero policy coupled with the ongoing property crisis and droughts pose considerable threats to the economic growth in the country. As a result, CNY has depreciated by 1.4%, staying just marginally below the crucial 7/$-a level last seen in Apr'20 during the peak of Covid-19 pandemic.

Table 1: Rising inflation prompting central banks to raise policy rates

Country	CPI inflation (latest), % YoY	Change in policy rates in CYTD23, in bps
Argentina	78.5	3700
Brazil	8.7	450
Mexico	8.7	300
Canada	7.6	225
US	8.3	225
Australia	6.1	175
South Africa	7.9	175
South Korea	5.7	150
UK	9.9	150
India	7.0	140
Eurozone	9.1	125
Bangladesh	7.5	75
Malaysia	4.4	50
Taiwan	2.7	38
Indonesia	4.7	25
Thailand	7.9	25
Japan	2.6	0
Vietnam	2.9	0
China	2.5	(20)
Russia	14.3	(50)
Turkey	80.2	(100)

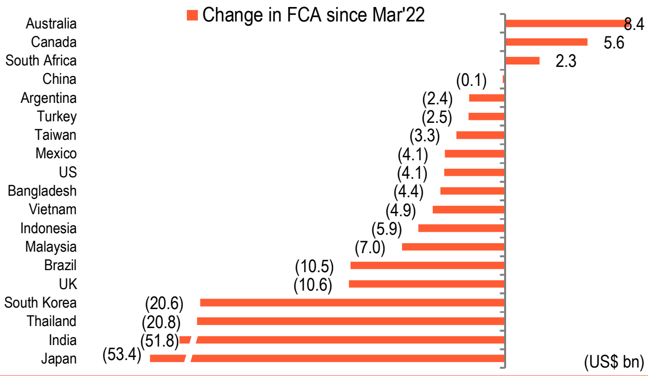
Source: CEIC, Bank of Baroda Research

Foreign exchange reserves and currency movement:

The recent bout in the forex market has also prompted several central banks rushing to cushion sharp volatility in the currency markets. As a result, foreign currency assets (FCA) for several countries have fallen in recent months suggesting active foreign intervention by the respective central bank. It must however be noted that a part of the decline in FCA can also be explained by a stronger dollar.

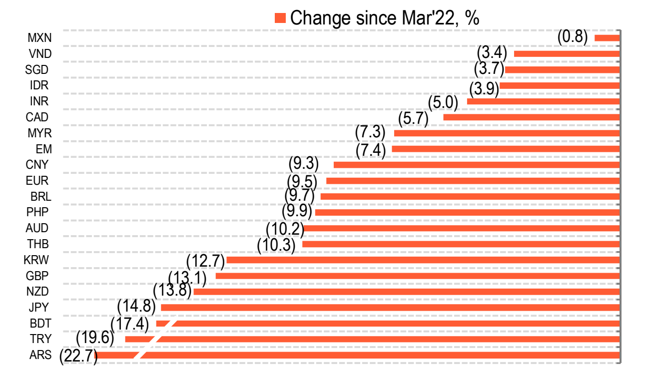
It is not surprising to see that EM countries have seen the largest depletion in their FCAs as these have been impacted the most due to the dollar's strength. Policy tightening by the Fed has prompted huge outflows from EMs, pushing these currencies to multi-year low. Countries like Japan, India, Thailand and South Korea with their huge forex reserves, have seen a sharp decline in FCA since Mar'22, with a fall of US$ 20bn or more. An interesting thing is that in case of Japan, Korea and Thailand, their currencies depreciated by over 10% while for India it was just 5%. On the other hand, countries with a much smaller pool of forex reserves have seen a more modest depletion.

Figure 2: Foreign currency assets (FCA) have declined



Source: CEIC, Bank of Baroda Research Baroda

Figure 3: Global currencies have depreciated sharply since Mar'22

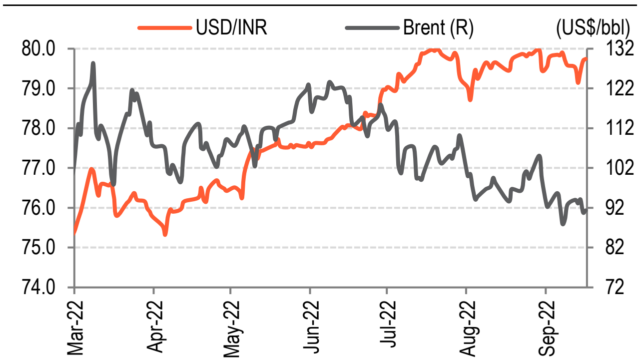


Source: Bloomberg, Bank of Baroda Research

INR performance:

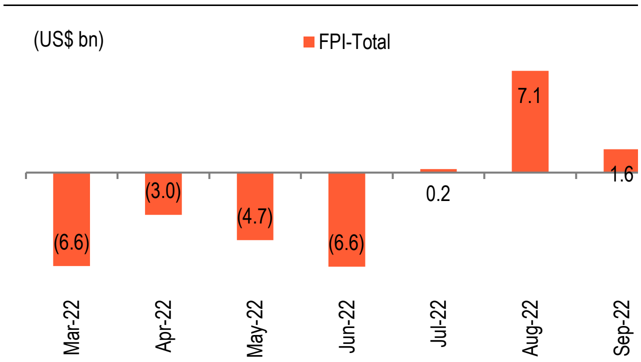
INR has performed relatively well when compared to other EM currencies. While the MSCI EM currency index has fallen by 1.6% in Sep'22, INR has fallen by only 0.4%. Apart from active intervention by RBI, the rupee was also supported by lower oil prices (down 8% from end-Aug'22) and positive FPI flows (US$ 1.6bn in Sep'22).

Figure 4: Lower oil prices have supported INR



Source: Bloomberg, Bank of Baroda Research | Data as of 15 Sep 2022

Figure 5: FPI flows remain in positive territory



Source: Bloomberg, Bank of Baroda Research | Data as of 17 Sep 2022

Outlook for INR:

Aggressive Fed along with higher risks to global growth imply that the dollar index is unlikely to move downwards. INR trajectory will depend on the outcome of the Fed policy due this week. While a 75 bps rate hike by the Fed has been fully priced in by the markets and may not cause wild swings in the currency market, a higher than expected rate hike will push global currencies further lower. In such a scenario, INR may breach the 80/$ mark.

INR trajectory will also be influenced by RBI's policy decision next week. Overall, we expect the rupee to trade in the range of Rs 79.65-79.90/$ in the near-term.

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