Aditi Gupta
Economist

Currency Outlook

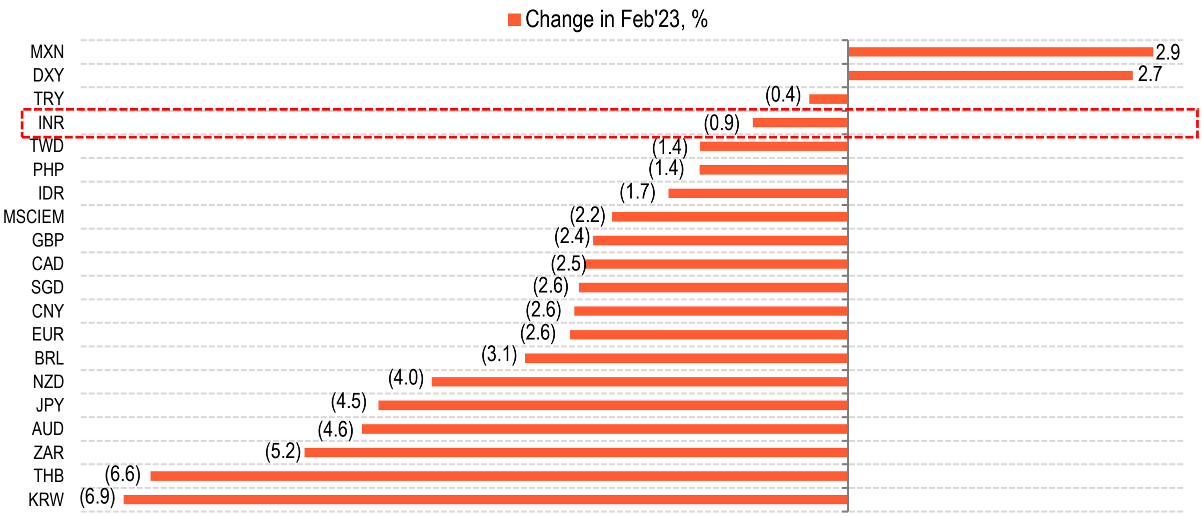
INR is likely to remain range-bound

Strong macro data from the US coupled with a strong labour market, has raised the likelihood of more rate hikes. Specifically, markets are now expecting at least two more rate hikes of 25bps each in the next two meetings. Another 25bps rate hike in Jun'23 is also on the table. This implies that the Fed terminal fund rate will be much higher than earlier expectations, which has once again fueled a rally in the dollar. DXY has strengthened, putting pressure on all currencies. INR has performed relatively better, supported by improvement in external outlook as well as RBI intervention. Oil prices are once again showing upward momentum buoyed by hopes of an economic recovery in China and FPI flows have been volatile. This suggests that INR is likely to remain under pressure. However, we do not expect INR to breach the 83/$ mark as RBI is seemingly looking to defend it. Hence, we expect INR to trade in the range of 82-83/$ in the next fortnight. Focus will be on US inflation and jobs report.

Movement in global currencies

Reversing the trend seen in Jan'23, global currencies once again came under pressure as the dollar regained strength. In Feb'23, DXY strengthened by 2.7% as markets' pricing of Fed future rate trajectory changed dramatically. This in turn was driven by a slew of macroeconomic data which reinforced the view that inflation continues to remain stubbornly high. Core PCE index, Fed's preferred measure of inflation showed a MoM increase in Jan'23. On the other hand, labour market conditions remained strong and the economy added a stellar 517,000 jobs in Jan'23. This suggests that risks to inflation remain tilted to the upside and this was also reiterated by several voting as well as non-voting members of the FOMC. Investors now expect the Fed terminal fund rate in the range of 5.25%-5.50%. This has once again led to a rally in the dollar, albeit the pace is a little more cautious this time around.

Figure 1: Global currencies were mostly lower in Feb'23



Source: Bloomberg, Bank of Baroda Research, Data as of 28 Feb 2023 | Note: Figures in bracket denote depreciation against USD

A stronger dollar weighed on almost all major currencies in the last month. Amongst major economies, the Korean Won (KRW) depreciated the most by 6.9%. GBP and EUR too slipped by 2.4% and 2.6% respectively even though there are expectations that the peak terminal rates in UK and Eurozone too will likely be higher. JPY was under pressure and depreciated by 4.5% as incoming BoJ Governor defended the central bank's ultra-loose monetary policy as appropriate. This came on the heels of the inflation report which saw Japan's inflation surging to a 41-year high.

How did INR fare?

INR too depreciated by 0.9% in Feb'23. This followed an increase of 1% in Jan'23. Compared to other currencies, INR performed relatively better. In fact, when compared with a median depreciation of 2.6% in the sample of 18 currencies, INR remained at the top of the pack.

Outlook for INR

With at least two more rate hikes by the Fed being priced in by the markets, and the possibility of another rate hike also looming large, we are likely to see some more upward traction in DXY. Furthermore, oil prices too may see an upward momentum supported by improvement in China's growth outlook (China's manufacturing and non-manufacturing PMI rebounded sharply in Feb'23). While FPI outflows did moderate in Feb'23, they continue to remain volatile and unreliable. This has put pressure on INR, and the situation is unlikely to change in the near-term. Active intervention by the RBI has helped ensure that the exchange rate remains range-bound. It must be noted that RBI's foreign exchange reserves have once again started to decline. RBI has shown a strong intent to ensure that the USD/INR does not breach the 83/$ level and hence we expect INR to remain range-bound in the near-term. Some volatility is expected in the run-up to the Fed meeting and the CPI report, but it is unlikely that the INR will breach the 83/$ mark. We expect a range of 82-83/$ in the next fortnight.

For further details about this publication, please contact:

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