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Currency Outlook

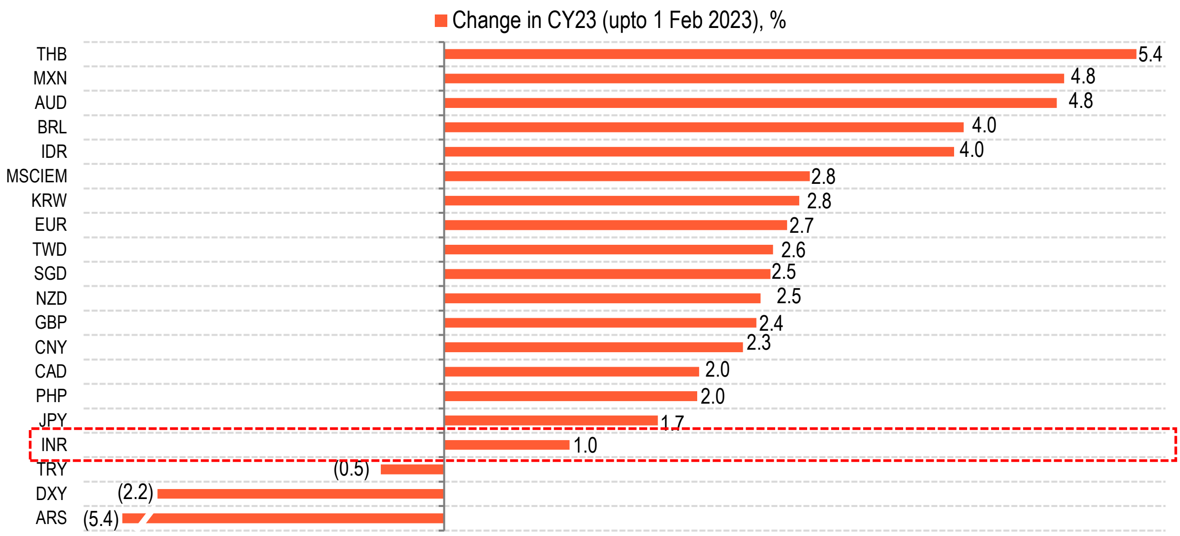
INR to remain steady

A changing Fed narrative as well as a global risk-on sentiment explain the rally in global currencies in 2023. Dollar has weakened as markets continue to expect Fed terminal rate to peak lower than the Central Bank expectations. There is also a renewed optimism over global economy with reopening in China and growth resilience in Europe. Consequently, global currencies including INR, have regained some of the losses incurred last year. The gains have differed, and INR has remained an underperformer. FPI outflows as well as concerns over elevated external deficits have limited the gains in INR. The outlook remain uncertain with several conflicting factors at play. Weaker dollar and benign oil prices are likely to support INR, even as FPI flows may still remain elusive. On balance, we expect INR to trade in the range of 81.5-82.5/$ in the short-term, while ruling out any sharp swings on either side.

Movement in global currencies

After a seemingly capricious year, global currencies started 2023 on a positive note. While a strong dollar accentuated losses in almost major currencies in 2022, a weakness in the greenback have supported other currencies. After a stellar year, DXY has started 2023 on a somber note having fallen 0.9% since the start of the year. The stark difference in the dollar's plight can be attributed to the changing narrative around Fed rate hikes. Bets that the Fed will be overly aggressive have abated this year with a slew of economic data pointing towards a precipitous decline in economic momentum as well as inflation. In fact, Fed Chair only yesterday, noted that "the disinflationary process has started". However, the Fed statement mentioned about the need of "ongoing increases" in policy rate, with the Fed Chair too advocating for a "couple" of more rate hikes.

Figure 1: Global currencies were mostly lower in 2022



Source: Bloomberg, Bank of Baroda Research, Data as of 1 Feb 2023 | Note: Figures in bracket denote depreciation against USD

Apart from a weaker dollar, improved risk sentiment has also aided gains in other currencies. Reopening in China, one of the world's major economies, has helped bolster investor sentiments. IMF in its latest outlook has upgraded the global growth forecast for 2023, led by higher growth outcomes in US, Europe and China. Emerging market currencies have particularly profited from this, with the Thailand Bhat (THB) and Mexican Peso (MXN) appreciating by 5.4% and 4.8% respectively. Other major advanced economies' currencies, such as the Euro (EUR), Japanese Yen (JPY) and Pound (GBP) noting gains ranging between 1.7% to 2.8%.

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

In line with other currencies, INR also appreciated by 1% in 2023 (upto 1 Feb 2023). A tepid dollar, and benign oil prices underpinned the strength seen in USD/INR even as FPI outflows resumed in Jan'23. It is worth mentioning that, INR's appreciation this year is small when compared with other EM currencies such as IDR and BRL which have gained more than 4%. Furthermore, when compared with a median appreciation of 2.6% in the sample of 17 currencies, INR remained at the bottom of the pack.

<u>Road ahead for INR</u>

While the global backdrop has been favoring a breakthrough USD/INR appreciation, the currency has not been able to maintain any significant appreciating bias. Global factors such as a weaker dollar and lower oil prices have lent support to the INR. On the domestic side, Union Budget was widely supportive of the exchange rate as the government emphasized on fiscal prudence and capex spending. However, there are antagonizing factors also at play. FPI flows turned negative after a gap of two months, led by a weakness in domestic equity markets. Concerns also remain on the external front with an elevated trade and current account deficit. Furthermore, the equity market rout is also weighing on the rupee with the USD/INR breaching the 82/$, a first since 9 Jan 2023.

Despite these conflicting factors, we do believe that INR is likely to remain range-bound in the near-term and any sharp movement on either side, will be capped. Gains from a favorable global environment will be offset by volatility in domestic equities. RBI has also been using this period to shore up its foreign exchange reserves (accretion of ~ US$ 11bn in 2023), which will prevent any sharp gains in the INR. On balance, we believe that INR is likely to trade in the range of 81.5-82.5/$ in the near-term.

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