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Currency Outlook

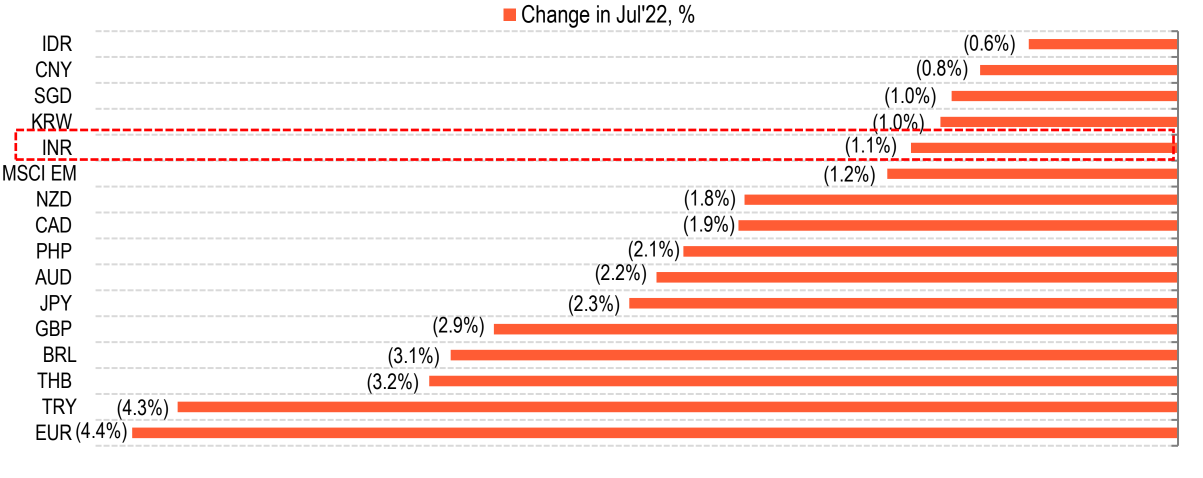
More depreciation inevitable

Global currencies depreciated against the dollar as a hotter than expected US inflation report drove the currency higher. Expectations that the Fed might hike its policy rate by 100bps next week after the inflation report along with increasing risks of a global recession are underpinning the dollar strength. EUR has been particularly impacted, falling below the crucial dollar-parity level for the first time in 20-years. INR too has been no exception. In the last trading session, INR fell to a record-low of US$ 79.88/$, just shy of the 80/$ mark. Adverse global environment along with rising concerns on the external front are likely to weigh on the rupee going forward. We expect, INR to remain under pressure in the near term and trade in the range of 79.75-80.15/$ in the next fortnight, with the Fed policy action providing further clues.

How have currencies fared?

A stronger dollar weighed on almost all major global currencies in Jul'22. DXY index gained by 3.7% in Jul'22 so far (13.5% in CYTD22), as higher than expected inflation print in the US have fueled expectations that the Fed may have to step up its efforts to curb inflation. US CPI rose to a 41-year high of 9.1% in Jun'22, much higher than expectations of an 8.8% increase. As a result, analysts now believe that the Fed might hike rates by a historic 100bps later in the month, following up on a 75bps hike in the last meeting. Fed officials, have hinted in the recent past that inflation remains a priority with the Chairman even pledging "unconditional" support to tame rising prices. Dollar has also found support from an increasingly pessimistic global outlook as higher rates are likely to impinge on growth. Apart from this, energy crisis in the Eurozone and a flare-up in Covid-19 cases in China, are also weighing heavily on the global growth narrative.

Figure 1: Currency movement



Source: Bloomberg, Bank of Baroda | Data as of 14 Jul 2022 | Note: Figures in bracket denote depreciation against USD

EUR has faced the brunt of the dollar's rally and has shed 4.4% this month, even slipping below the dollar parity level-a first in 20 years. It is presently trading just marginally above that level. The Eurozone has been impacted significantly from the Russia-Ukraine war and subsequent threat of Russia cutting of gas supplies to the region. Further, high inflation, dollar strength and ECB's relative hesitancy to raise rates have also contributed to the decline in EUR. In CYTD22, EUR has lost about 11.9% of its value. In UK, while the BoE started the rate hike cycle in Dec'21, inflation continues to remain elevated, which may prompt the Central Bank to hike policy rate by a record 50bps in Aug'22. Despite its safe-haven appeal, JPY has depreciated by 2.3% this month to a 24-year low, as the BoJ is widely expected to continue with its ultra-dovish stance, thus widening the interest rate differential with the US. Emerging market currencies have fared better than their developed counterparts and have declined by only 1.2%.

INR has depreciated by 1.1% outperforming the MSCI EM index. With respect to the other currencies as well, INR has fared well as the median depreciation in the above sample of currencies was 2%.

Currency volatility:

While most global currencies depreciated against the dollar in the last fortnight, volatility actually declined when compared with the fortnight ending 30 Jun 2022. Other important observations are:

- Median volatility observed in the basket of 20 currencies was 6.7% between 1- 14 July 2022, lower compared with 7.1% observed between 16-30 Jun 2022.
- Significant reduction was seen in the volatility of Turkish Lira (TRY) and Japanese Yen (JPY).
- On the other hand, volatility in Canadian dollar (CAD), Euro (EUR), Brazilian Real (BRL) increased in the latter period.
- Volatility in about half of the currencies in the sample remains above the median level. BRL, ZAR (South African Rand) and Australian dollar (AUD) have experienced high volatility in the latter period.
- On the other hand, volatility in some Asian currencies such as Hong Kong dollar (HKD), Malaysian Ringgit (MYR) and Indonesia Rupiah (IDR) remained low.
- Volatility in INR rose marginally to 3.1% from 3%. However, it remain below the median volatility seen in the sample.

Table 1: Annualized average daily volatility (%)

Annualised daily volatility, %	15-30 Jun	1 Jul-14 Jul
HKD	0.2%	0.1%
MYR	2.1%	1.6%
IDR	3.5%	1.7%
TWD	2.8%	1.9%
INR	3.0%	3.1%
CNY	3.0%	3.5%
THB	5.1%	5.3%
SGD	4.7%	5.3%
KRW	7.8%	5.7%
PHP	5.0%	5.9%
JPY	14.8%	7.6%

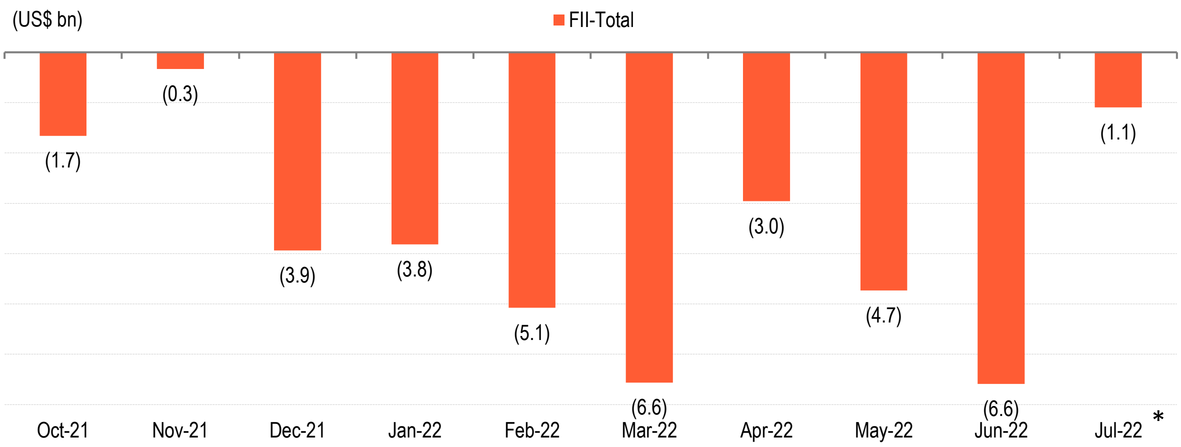
TRY	15.3%	7.7%
NZD	10.8%	8.7%
CAD	6.5%	9.3%
EUR	7.7%	9.6%
GBP	11.1%	10.1%
MXN	10.6%	10.8%
AUD	13.3%	13.2%
ZAR	14.0%	14.3%
BRL	18.1%	19.8%

Source: Bloomberg, Bank of Baroda Research | Data as of 14 Jul 2022

INR performance:

INR depreciated to a record-low of 79.88/$ in the last trading session. INR has touched a new record-low 19-times since Jan'22. The previous low was 76.84/$ in Apr'20, during the peak of the Covid-19 crisis. The rapid depreciation in INR seen presently is driven to a large extent by adverse global factors, particularly a strengthening USD and FPI outflows. Apart from this, India's external position which remained strong in the last 2 years, attributable to the Covid-19 pandemic, has deteriorated quite a bit. Trade deficit is at a record-high and this coupled with persistent FPI outflows has put pressure on the balance of payments which is also weighing on the rupee.

Figure 2: FPI outflows continue unabated



Source: NSDL, Bank of Baroda | Data as of 14 Jul 2022 | Note: Figures in bracket denote depreciation against USD

Outlook for INR:

INR has reversed some of its losses and is trading marginally stronger against the dollar today. However, rising global headwinds along with a worsening external outlook will continue to weigh on the rupee going forward. To counter the growing CAD, RBI announced a slew of measures to strengthen the capital account focusing on debt inflows and ECBs. However, these might not be enough to counter the burgeoning CAD. On the current account side, government announced a hike in gold import duty to curb non-discretionary imports. Global commodity prices too have moderated from their recent peaks which should help lower the deficit. On the other hand, export growth may not maintain its momentum amidst weakening global demand. Overall, we expect trade deficit to expand further in FY23. This coupled with a lower capital account surplus will weigh on INR.

RBI has reiterated its support for the exchange rate while allowing for an orderly depreciation of the rupee. RBI's foreign exchange reserves remain comfortable at US$ 580.2 bn. Overall, we expect INR to trade in the range of 79.75-80.15/$ in the next fortnight, with a depreciating bias.

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