4 July 2022

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Currency Outlook

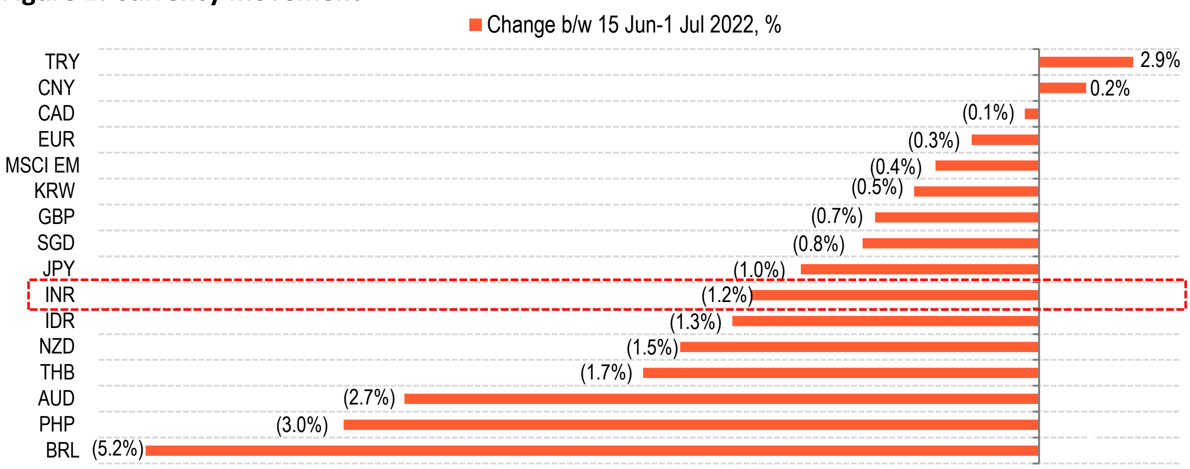
Rupee to remain under pressure

Increasing risks of global recession drove global currencies lower. On the other hand, DXY continues to trade near a two-decade high supported by safe-haven appeal as well as Fed's aggressive policy stance. Fed Chair reiterated the Central Bank's commitment to provide "unconditional" support to tame rising inflation. Similar views were echoed by ECB President. Soaring inflation across countries and synchronized monetary policy tightening has increased the risks of a global recession, denting investor sentiment. EM currencies have been particularly hit, including India. In the last few trading sessions, INR has touched a record-low several times breaching the 79/$ mark on 1 Jul 2022. Apart from global factors, headwinds on the domestic front have also increased. We expect, INR to remain under pressure in the near term and trade in the range of 78.5-79.5/$ in the next fortnight. In FY23, we expect INR in the range of 78-80/$.

How have currencies fared?

Global currencies closed lower in the last fortnight as risk-sentiment soured. Increasing risks of a global recession have dented investor sentiment. As a result, demand for safe-haven dollar has risen which continues to hover around a 20-year high. Apart from this, expectations of aggressive policy tightening by US Fed is also contributing to the dollar strength. An unexpected surge in US inflation to a 41-year high prompted US Fed to hike rate by 75bps (biggest rate hike since 1994). This is also contributing to the surge in US 10Y yield, pushing the yield differential higher. Further, global agencies such as World Bank and OECD have downgraded global growth forecasts and also warned of severe risks to the growth outlook. Manufacturing PMIs of major economies such as US, UK, Eurozone and Japan also moderated suggesting increased risks to global outlook, thus increasing the appeal for dollar.

Figure 1: Currency movement



Source: Bloomberg, Bank of Baroda | Data as of 1 Jul 2022 | Note: Figures in bracket denote depreciation against USD

Emerging market currencies continue to remain under pressure as investors turn risk-averse. MSCI EM index fell by 0.4% in the fortnight. However, BRL depreciated much sharply by 5.2%. Currencies of major advanced economies such as Eurozone and UK also depreciated amidst surging inflation and increased risks to global growth.

Currency volatility:

Apart from daily changes in currencies, volatility is also a major factor for the markets. Here, we compare volatility in two periods; 1-15 Jun 2022 and 16 Jun-1 Jul 2022. For a majority of the currencies, volatility has decreased in the latter period. Some important observations are:

- Median volatility observed in the basket of 20 currencies was 9% between 1- 15 June 2022. This declined to 7% between 16 Jun-1 Jul 2022.
- Significant reduction was seen in the volatility of Mexican Peso (MXN), South Africa rand (ZAR) and Pound sterling (GBP).
- However, volatility for New Zealand dollar (NZD), Australia dollar (AUD), Japanese yen (JPY), Turkish lira (TRY) and Brazilian real (BRL) remains elevated in double-digits.
- Volatility has increased for Turkish lira (TRY), Japanese yen (JPY), Indian rupee (INR), Thailand bhat (THB) and Philippine peso (PHP).
- Despite an increase, volatility in INR has remained below the median.

Table 1: Annualized average daily volatility (%)

Annualised daily volatility, %	Vol. 1-15Jun	Vol. 16 Jun-1Jul
HKD	0.2%	0.1%
MYR	2.3%	1.9%
CNY	5.0%	2.6%
TWD	4.0%	2.8%
IDR	6.5%	3.4%
SGD	5.4%	4.4%
INR	2.0%	4.8%
PHP	3.6%	4.9%
THB	4.3%	5.9%
CAD	8.6%	6.3%
KRW	10.8%	7.8%
EUR	9.3%	8.2%
MXN	16.1%	8.8%
GBP	14.6%	9.4%
NZD	12.6%	10.0%
AUD	16.8%	11.0%
ZAR	18.1%	11.4%
JPY	10.7%	13.7%
TRY	11.3%	15.6%
BRL	17.2%	17.2%

Source: Bloomberg, Bank of Baroda Research | Data as of 1 Jul 2022

INR performance:

INR remained volatile in the last fortnight and depreciated by 1.2%, amidst a stronger dollar and persistent FPI outflows. In fact, INR closed at a record-low of 79.04/$ in the last trading session. Apart from this, risks to India's external position have also exacerbated. Commodity prices including oil prices remain elevated at above US$ 110/bbl, pushing trade deficit higher. In May'22, trade deficit rose to a record-high and is expected to remain elevated in FY23, which will put pressure on BoP and INR. Second, FPIs continue to remain net sellers in the domestic market for the past 9-months. In Jun'22 as well, FPI outflows have totaled US$ 6.6bn which is putting further pressure on INR. Further, with interest rates in US likely to go up much faster than elsewhere, FPI inflows into EM markets such as India are likely to remain muted.

Outlook for INR:

INR has gained some ground today and is trading below the 79/$ mark today. Even so, worsening global outlook along with weakness in domestic macro fundamentals will continue to weigh on the INR going forward. However, RBI's intervention will prevent any sharp slide in the exchange rate. Overall, we expect INR to trade in the range of 78.5-79.5/$ in the next fortnight, with a depreciating bias. Surge in oil prices remains a key risk.

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