Bank of Baroda

21 February 2023

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Currency Outlook

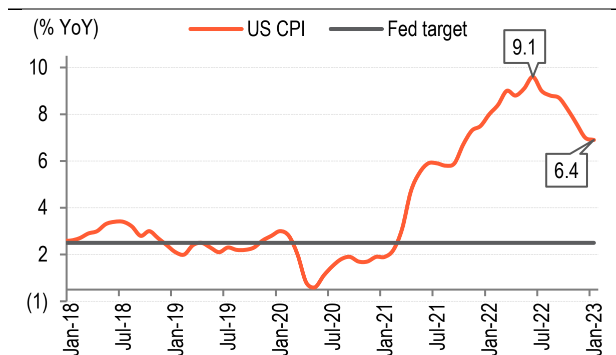
INR to trade in the range of 82-84/$ in FY24

The trajectory of USD/INR in the next year will be determined by both global as well as domestic macro fundamentals. Just like 2022, perhaps the most important driver of USD/INR rate this year will be the trajectory of the dollar. Amongst domestic factors, India's current account deficit will be the key factor impacting USD/INR. Apart from this, FPI flows and oil prices will also be important for the exchange rate going forward.

What will happen to the dollar?

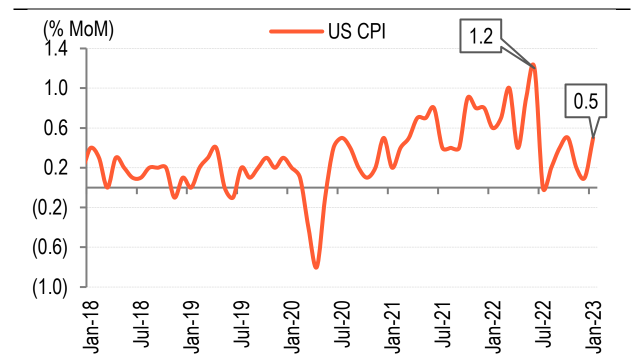
The trajectory of the dollar (DXY) will be quite significantly be contingent on the Fed action, which in turn will be determined by the inflation and growth dynamics. Recent data points from the US suggest that while inflation has shown signs of moderation, it still remains uncomfortably high. Furthermore, several sub-components, such as services, continue to show significant inflationary pressures. In Jan'23, both CPI and PPI inflation in the US inched up on a MoM basis. This reinforces comments from several Fed officials who have continued to maintain that the war against inflation is far from over.

Figure 1: CPI inflation continues to remain elevated



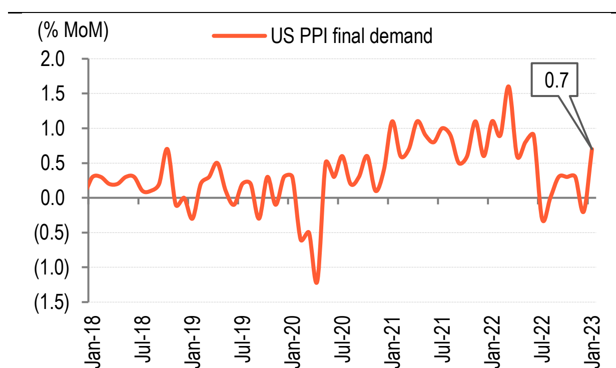
Source: Bloomberg, Bank of Baroda Research

Figure 2: Acceleration on a MoM basis



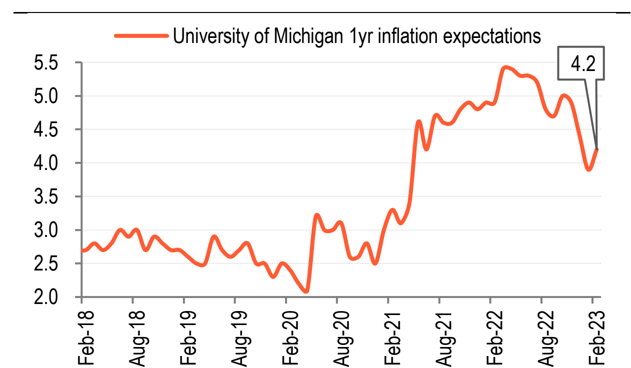
Source: Bloomberg, Bank of Baroda Research

Figure 3: PPI inflation also higher



Source: Bloomberg, Bank of Baroda Research

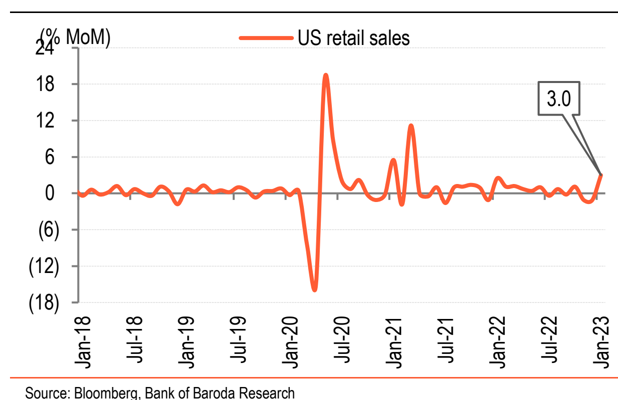
Figure 4: 1 year inflation expectations inched up



Source: Bloomberg, Bank of Baroda Research

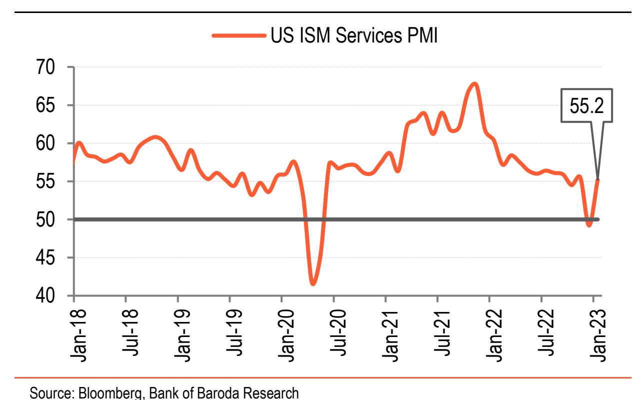
2023 started with a lot of pessimism surrounding US growth. This was based on the premise that high inflation and rates will impinge on consumer spending and investment. However, recent indicators suggest that consumption demand has been holding up well. In Jan'23, US retail sales posted a smart 3% increase. Similarly, services sector activity which accounts for 2/3rd of US economic activity, also rebounded sharply in Jan'23 as indicated by US ISM services PMI index. Underpinning this is a labour market which continues to remain strong. Unemployment rate continues to hover around a historical low and non-farm payroll additions have been robust.

Figure 5: US retail sales picked up in Jan'23



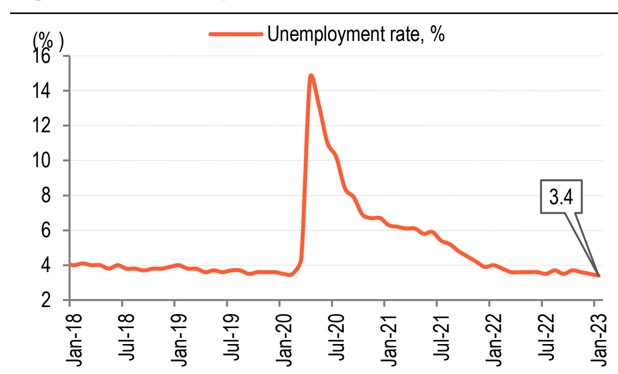
Source: Bloomberg, Bank of Baroda Research

Figure 6: Services sector activity remained robust



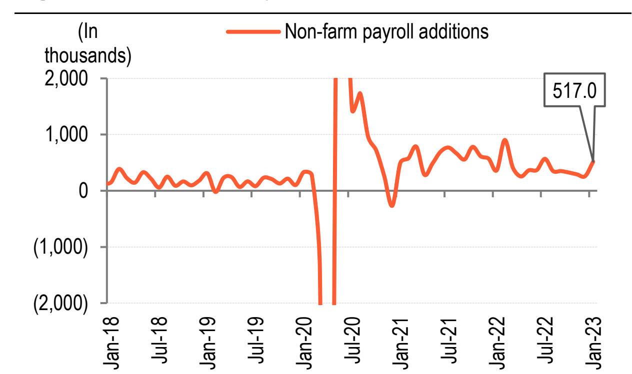
Source: Bloomberg, Bank of Baroda Research

Figure 7: Unemployment rate at historical lows



Source: Bloomberg, Bank of Baroda Research

Figure 8: Non-farm payrolls robust



Source: Bloomberg, Bank of Baroda Research

The above backdrop suggests that the Fed has room for further rate hikes. Notably, in Dec'22, Fed projected a terminal fund rate of 5.1%. However, developments since then suggest that the terminal rate could be much higher. Quite significantly several Fed officials including the Fed Chair have been openly advocating more rate hikes with some Fed members even estimating the terminal rate of closer to 5.5% or even higher. Markets have also adjusted their expectations, with the probability of at least two 25bps rate hikes in the next 2 meetings now above 80% (as per CME Fed Watch tool). This will push DXY higher.

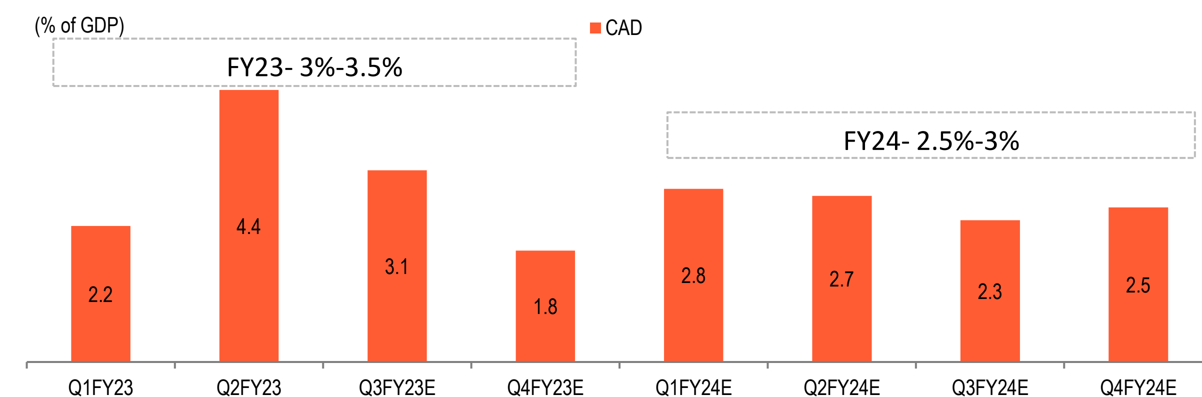
However, we do not foresee DXY rising to the peak it attained in 2022. The upward momentum in DXY will be more gradual this time around as rates elsewhere have also gone up, and the peak will also be lower. This will put mild depreciating bias on INR. Growth differentials will also be undermining the dollar strength seen in 2022, as Eurozone growth has been much more resilient than what was estimated at the start of the year. Furthermore, with China opening up, global economic prospects have brightened to an extent which will also dampen the dollar's safe-haven appeal.

Domestic macros to offer some support

1. CAD to moderate

India's current account deficit (CAD) surged to 4.4% of GDP in Q2FY23 led by higher trade deficit, as imports rose much faster than exports. With global commodity prices having eased from their peaks, we expect CAD to moderate going forward. Furthermore, while exports will be under pressure due to recessionary fears in the West, this will likely to be offset by buoyant services and remittances receipts. We expect CAD in the range of 3%-3.5% in FY23. This will likely narrow to 2.5%-3% of GDP in FY24. This should provide some comfort to INR at the margin.

Figure 9: CAD likely to moderate going forward

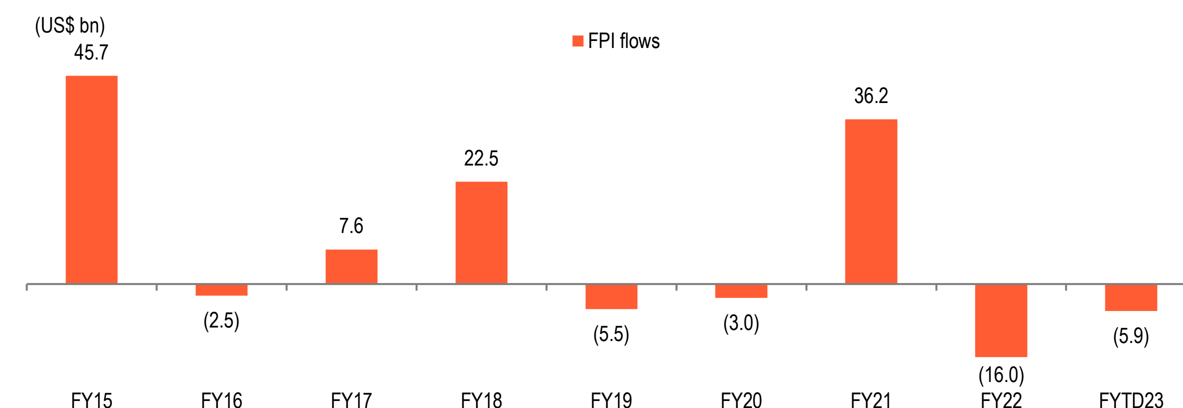


Source: Bloomberg, Bank of Baroda Research

2. FPI flows to be volatile

Our analysis has shown that FPI flows and USD/INR have a positive and statistically significant relation in the short-term. This was true for most part of 2022, with negative FPI flows exacerbating the depreciation in INR. So far in FYTD23, FPI outflows have totaled US$ 5.9bn and may not see a significant revival. Even in FY24, with the Fed rates likely to stay elevated and with China opening up, FPI flows may remain muted. This will have a negative impact on INR.

Figure 9: FPI flows



Source: Bloomberg, Bank of Baroda Research

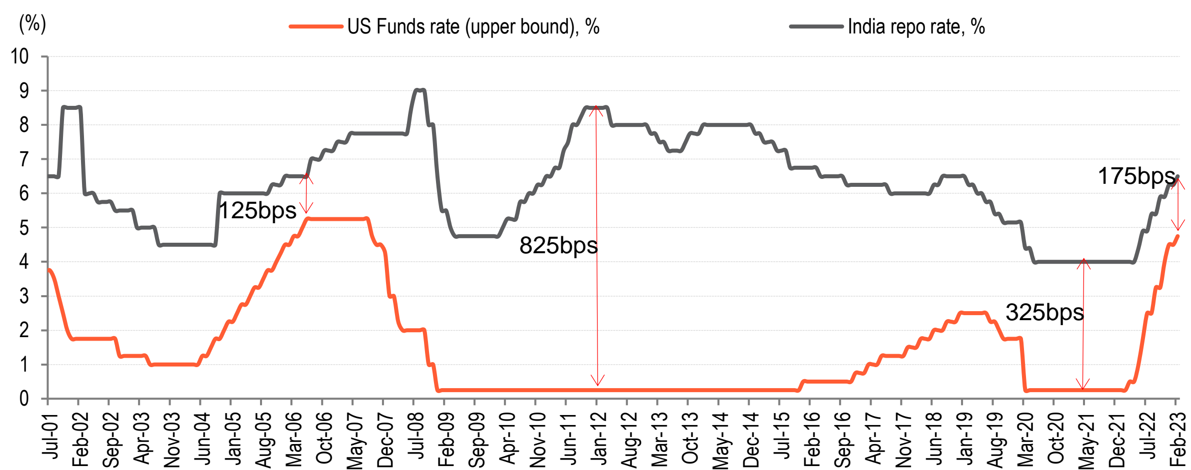
FPI flows would be affected by a variety of factors. The fact that we are talking of QT means that the quantum of investible funds would be low. Add to this the higher interest rates in the west, there would be a slowdown in flow of funds. On the positive side, India will be an exciting market with the highest growth rate being expected. Further, India Inc. can expect a revival in FY24 in terms of earnings as the shadow of high inflation would have passed by. This will justify higher valuations in the market. RBI would also probably not be lowering rates any time soon thus making debt investments comparable. The talk on inclusion of India in the bond indices may also take shape next year. Therefore on balance there is reason to be sanguine here and the net inflows will turn positive this year and gently rise to the US$ 10-20 bn range.

Apart from this, lower domestic inflation as well as stable oil prices (we estimate oil prices in the range of US$ 80-100/bbl in FY24), will also be positive for USD/INR.

Where do we see USD/INR in FY24?

Fed policy will be the most important driver of USD/INR in FY24. With the Fed widely accepted to hike rates by another 50bps in the next two meetings, the gap between US and India policy rate is likely to narrow to a record low of 125bps. This is based on the assumption that the RBI continues to remain on a long pause. Narrowing yield differential will put pressure on INR and also FPI flows. Hence we cannot rule out additional pressure on the currency, however the movement will be much more gradual. On a quarterly basis, we see USD/INR inching towards 82.5/$ in Q1, 83/$ in Q2 as the Fed rate hikes are materialized. We may also see the rupee inching closer to the 84/$ mark, toward the end of FY24. However, a smaller CAD and favorable growth differential will lend some support to INR.

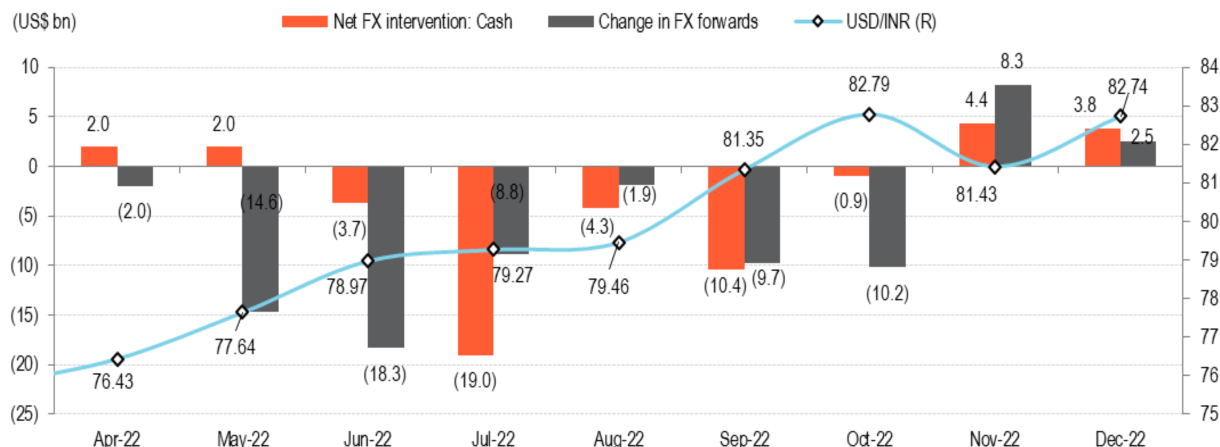
Figure 10: Difference between US and India policy rate nearing record low



Source: Bloomberg, Bank of Baroda Research

Apart from this, adequate forex reserves with the RBI will also ensure that the currency does not see any runaway depreciation. Figure 11 shows the intervention of the RBI during the course of the year through both the spot and forward windows.

Figure 11: RBI has been intervening in the forex market through both spot and forward positions



Source: Bloomberg, Bank of Baroda Research

Putting together all these factors, we believe that the rupee will trade in the range of Rs 82-84/$ in FY24.

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