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Currency Market Update

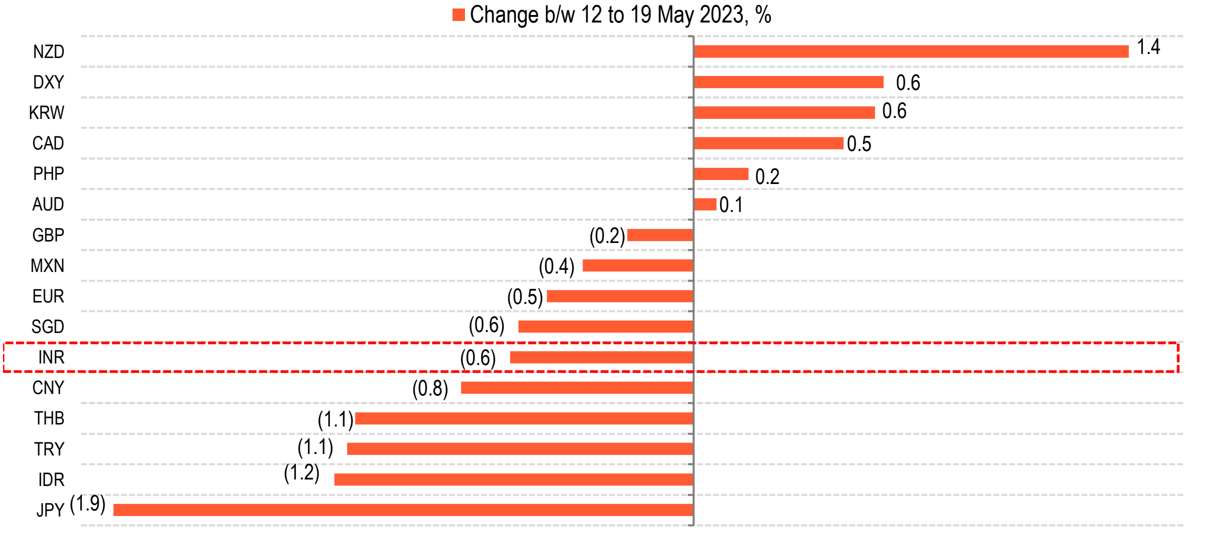
INR under pressure

After remaining stable for most part of the last few months, INR has come under pressure in the last few sessions. In May'23, INR has depreciated by 0.9%. However, bulk of the weakness in INR can be traced back to the last couple of sessions. In fact, since 12 May 2023 (when INR was last below the 82/$ mark), INR has depreciated by 0.6%. Prior to this, INR was fairly steady in a narrow range of 81.5-82/$. This was underpinned by robust macro fundamentals, improvement in external position, lower oil prices and buoyancy in FPI inflows.

So what are the reason behind INR's rather abrupt and sharp fall?

The most compelling reason for the rupee depreciation is a strength in dollar. In the last few sessions, dollar has once again strengthened amidst strong macro data from the US and hawkish Fed-speak. This has resulted in markets repricing the trajectory of Fed rate path. While markets widely anticipated that the Fed was done with its rate hike cycle after a final 25bps rate hike last week, macro data since then has dimmed those expectations. Strong labour market, rebound in housing sector, more than expected uptick in households' inflation expectations as well as positive developments surrounding US debt ceiling have all contributed to the belief that the Fed rate may still be behind its peak. Reinforcing this view, several Fed members have gone on record to say that inflation still remains a big challenge, warranting even higher rates. As a result, DXY has strengthened by 1.1% in the last 3 trading sessions alone. Most global currencies have seen depreciation.

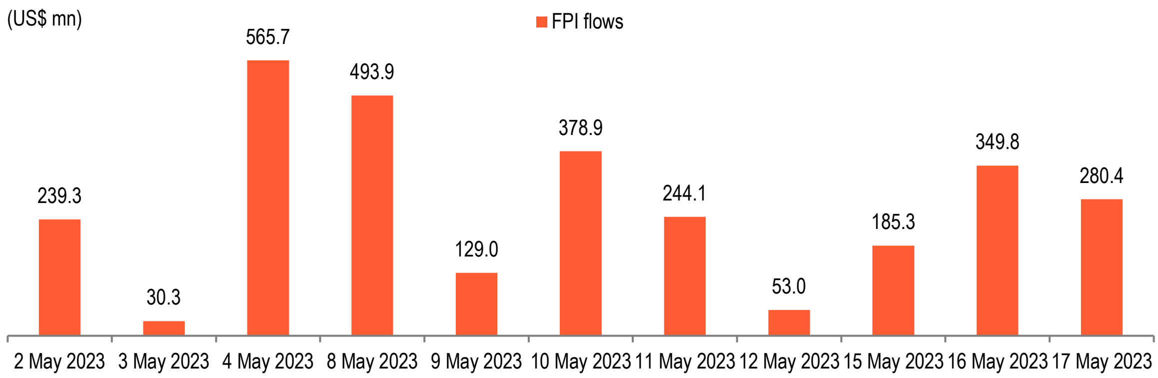
Figure 1: Pressure on global currencies



Source: Bloomberg, Bank of Baroda Research | Note: Data as of 19 May 2023 16:30PM IST | Figures in bracket denote depreciation against the dollar

Another reason, though not as significant, is a moderation in FPI inflows. FPI inflows which were showing some traction since the beginning of the month have lost momentum amidst a weakness in domestic equity markets and safe haven flows.

Figure 2: FPI inflows showing some moderation



Source: Bloomberg, Bank of Baroda Research

Will the trend continue?

With the changing narrative around US Fed rate path, some short-term pain for the INR cannot be ruled out. However, the extent of INR deprecation is likely to be mild, aided by effective intervention by the RBI. Fed Chair's testimony, due later today, will be key in determining the future trajectory of rates and dollar. While the dollar may strengthen in the short-term, as investors await more clarity on the Fed rate trajectory, it is likely to be temporary. Hence, we continue to remain bearish on the domestic currency over the long-term. This will be reinforced by improvement in external outlook, range-bound oil prices, foreign inflows and buoyancy in remittances and services receipts.

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