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Currency Outlook

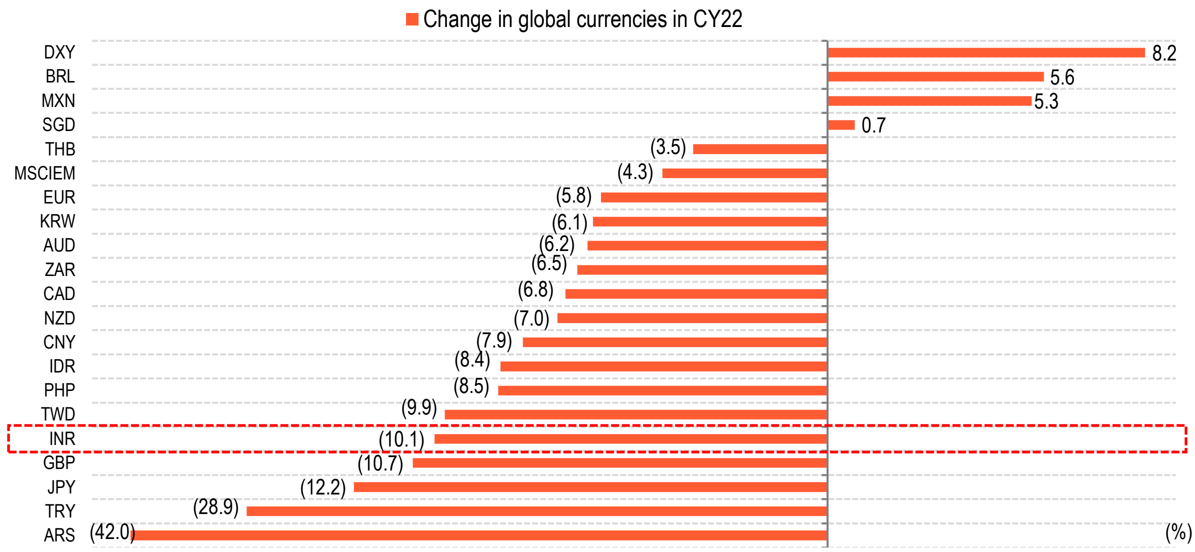
Where is INR headed in 2023?

In 2022, INR depreciated by 10.1% led by a rally in dollar. DXY index gained by 8.2%. This is turn was due to Fed's aggressive monetary policy tightening. In 2022, Fed raised policy rates by a cumulative 425bps. While other global central banks also raised rates, they lagged the Fed and hence saw their currencies lose value against the dollar. India too did not remain immune. Further complicating the narrative was India's weakening domestic fundamentals such as high inflation, surging trade and CAD deficits as well as softening foreign inflows. However, we remain optimistic that the worst may be over for the INR and it may appreciate to 80-83/$ in 2023. In saying so, risks do remain as a sharper than anticipated global slowdown may spur a fresh rally in the dollar.

Global currencies in 2022

Bettered by a resurgent dollar, global currencies ended 2022 sharply lower. Almost all major currencies were under pressure for most part of the year as dollar continued to surge higher. However, with the dollar losing some of its sheen in the fag-end of the year, global currencies did find some breathing space. Amongst advanced economies, JPY was the worst performer, losing about 12.2% of its value over the course of the year. Growing divergence between Bank of Japan (BoJ), and its counterparts in US and Europe, was the prime reason behind this trend. However, the BoJ's decision to widen its ceiling for benchmark 10Y yield, led to expectations that the bank may relent further from its dovish stance. As a result, JPY rose by ~5% in Dec'22.

Figure 1: Global currencies were mostly lower in 2022



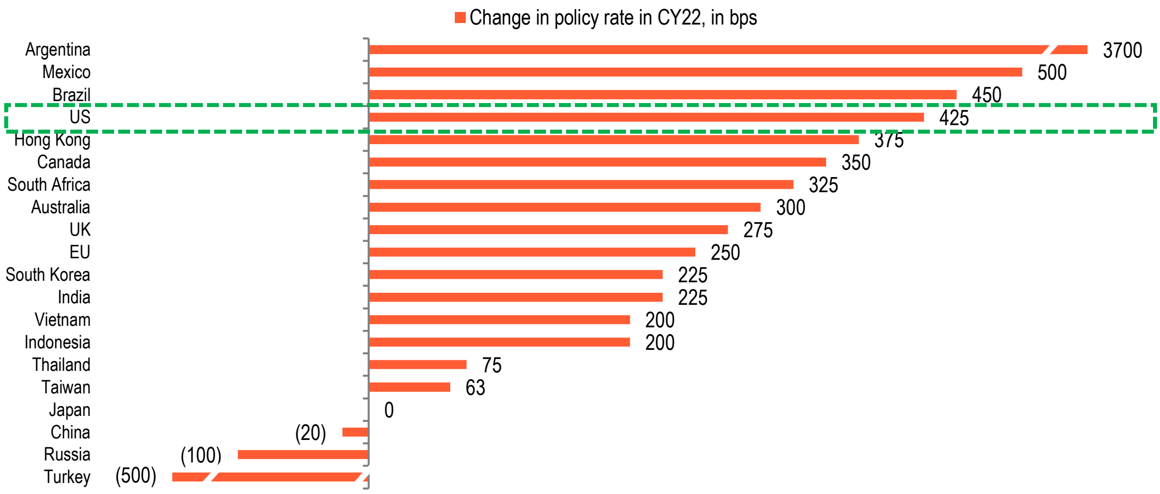
Source: Bloomberg, Bank of Baroda Research, Data as of 30 Dec 2022 |Note: Figures in bracket denote depreciation against USD

GBP too depreciated by more than 10% against the dollar, led by growth concerns amidst a worsening cost-of-living crisis which was in turn brought about by record-high inflation. CNY depreciated by 7.9% as the economic outlook remained marred by an ongoing property crisis as well as surging Covid-19 infections. This also put pressure on commodity currencies such as AUD and NZD. EUR ended the year on a relatively stronger footing, depreciating by only 5.8%. It must be noted that it slipped below the dollar-parity level during the year, due in part to the energy crisis from the fallout of the Russia-Ukraine conflict.

<u>What drove the dollar strength and what's next for DXY?</u>

While a number of factors drove the dollar higher in 2022, Fed action remained one of the most compelling reasons. With US inflation surging to more than 40-year high, the Fed aggressively hiked rates to tame price pressures. Cumulatively, Fed hiked policy rates by 425bps in 2022, to bring it close to a 14-year high. Other global central banks too have followed suit, but have not been able to match Fed's pace. As a result, yield differentials have widened in favour of the dollar. Other factors such as safe-haven demand, macro stability, high energy prices and an overall risk-off sentiment also contributed to the strength seen in dollar.

Figure 2: Fed was fairly aggressive with rate hikes



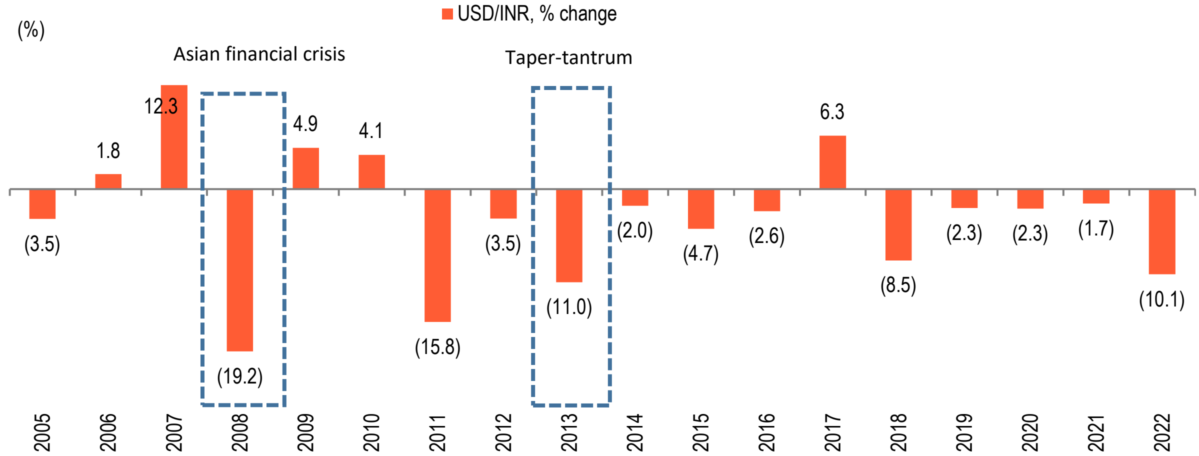
Source: CEIC, Bank of Baroda Research

Going forward, the Fed is likely to soften its stance in 2023. Earlier in Dec'22, Fed slowed down the pace of its rate hike to 50bps, after four consecutive rate hikes of 75bps each. Inflationary pressures have eased, with CPI inflation moderating to 7.1% in Nov'22 from its peak of 9.1% in Jun'22. Signs of stress in the economy have also emerged, with the housing sector being particularly badly hit. Even US yield curve which has remained inverted since the beginning of 2022, signals an imminent a recession. Lastly, even by Fed's own projections, growth is expected to remain subdued in 2023 while unemployment rate is expected to inch up, suggesting a slowdown in economic activity. With global inflation expected to have peaked, focus of the monetary policy is likely to shift from inflation to growth. With US growth looking increasingly fragile, the Fed may at some point have to cut rates. This suggests that we may see some correction in the dollar in 2023.

How did INR fare?

INR was also not immune to the sell-off in global currencies and shed about 10.1% of its value in 2022. This was the biggest annual drop in INR since 2013 taper-tantrum episode, when it fell by 11%. In fact, it was amongst the worst performing major Asian currency in 2022, after JPY.

Figure 3: INR has depreciated by 10.1% in 2022

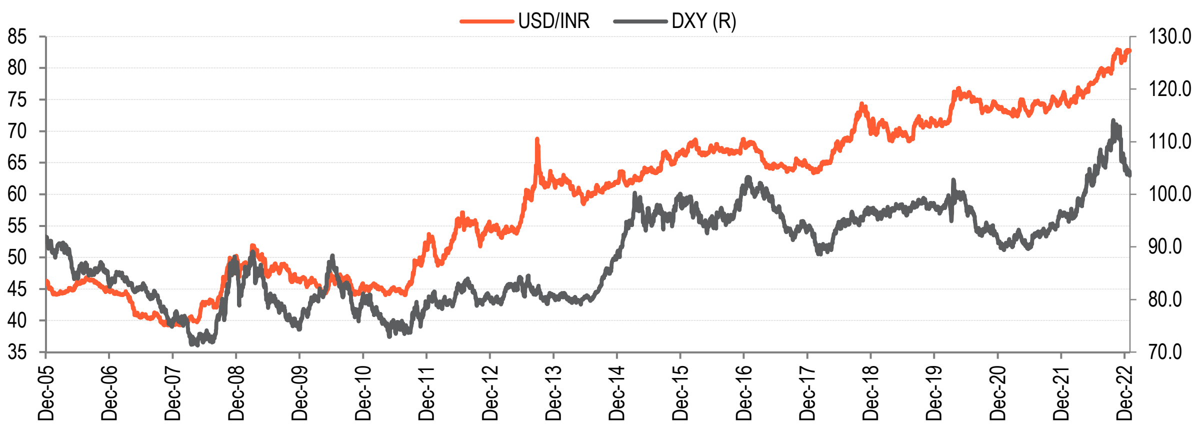


Source: Bloomberg, Bank of Baroda | Data as of 30 Dec 2022 | Note: Figures in bracket denote depreciation against USD

Main drivers of INR

1. **Movement in DXY:** Perhaps the single most important factor driving INR in 2022 was the movement in DXY. As noted earlier, dollar gained sharply (as measured by the DXY index) due to a number of factors which put significant pressure on all currencies, including INR. However, an interesting fact to note is that while a number of currencies gained against the dollar in Dec'22 amidst waning dollar strength, INR continued to remain under pressure. As a result, while EM currencies closed 2022 only about 4% lower, INR depreciated by much more. Even in 2023, the trajectory of INR will be contingent upon the movement in DXY.

Figure 4: DXY rose sharply in 2022

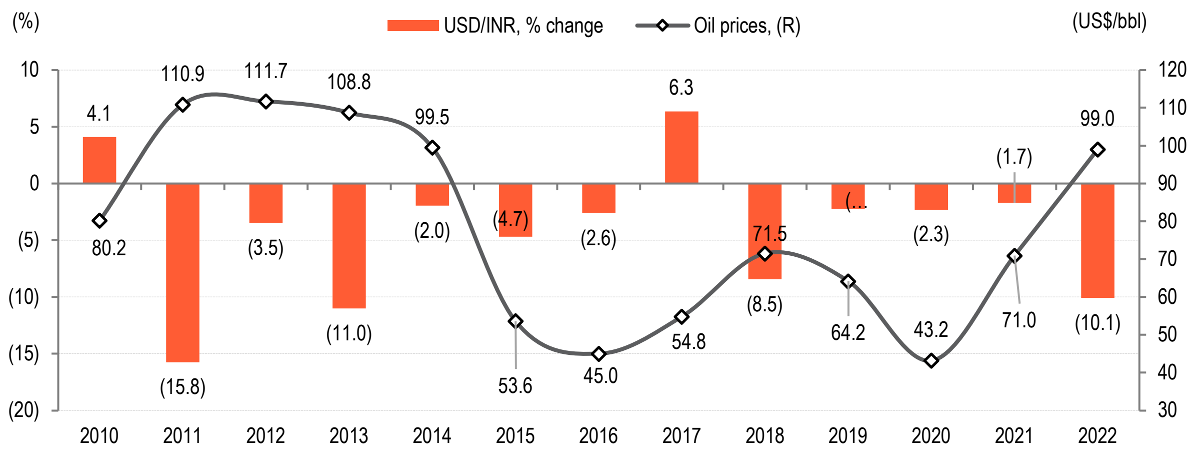


Source: Bloomberg, Bank of Baroda | Data as of 30 Dec 2022 | Note: Figures in bracket denote depreciation against USD

2. **Oil prices:** Oil prices remained quite volatile this year, due to the impact of the Russia-Ukraine war. In fact, in the immediate aftermath of the war, oil prices surged to above US$ 120/bbl, a

level last in 2012. Oil prices and INR are inversely related as India is a net importer of oil. Higher oil prices inflate the import bill and weaken the external position. While oil prices did soften in the latter part of the year, they did end the year with a ~40% gain. This also put pressure on the currency.

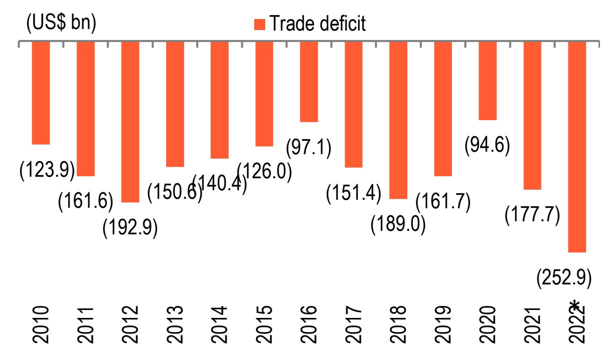
Figure 5: Higher oil prices also put pressure on INR



Source: Bloomberg, Bank of Baroda | Data as of 30 Dec 2022 | Note: Figures in bracket denote depreciation against USD

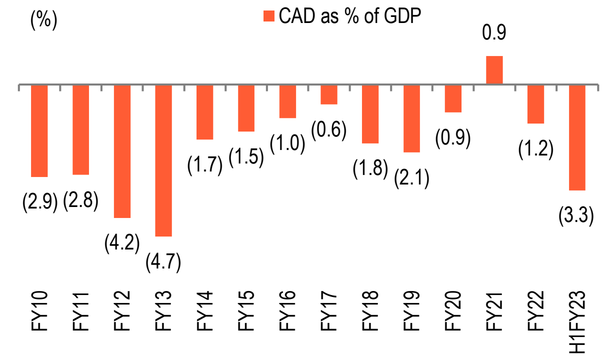
3. **<u>Trade and current account deficits:</u>** Apart from oil, other global commodity prices also saw a sharp upward momentum as economic momentum recovered. Economic activity worldwide merged strongly from the pandemic while supply chains still remained fragile. As a result, most global commodity prices picked up pace, particularly in the first half of the year. This pushed the value of imports higher. Concomitantly, pent-up domestic demand also ensured that imports remained buoyant. A combination of these two factors ensured that trade deficit surged sharply this year. While a part of this deficit was offset by resurgent services and remittances receipts, it was still not adequate. Consequently, the current account deficit still surged to a 9-year high in Q2FY23. At 3.3% in H1FY23, the CAD has swelled significantly from 1.2% in FY22.

Figure 6: Trade deficit has surged



Source: Bloomberg, Bank of Baroda Research | * Data as of Nov'22

Figure 7: CAD deficit has widened

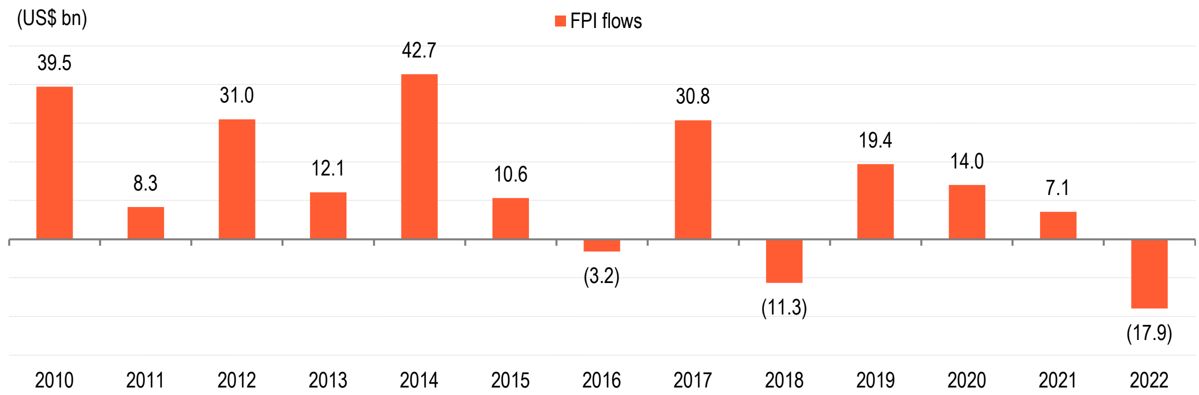


Source: CEIC, Bank of Baroda Research

4. **<u>FPI flows:</u>** Another important factor that drove the movement in INR was FPI flows. Our analysis has shown that there is a strong and statistically significant relation between FPI flows and INR. For most part of the year, FPI flows remained negative. Uncertainties due the geo-political conflict between Russia-Ukraine, monetary policy tightening and global risk-averse

sentiment kept FPI investors at bay. This coupled with a higher trade deficit raised concerns on BoP front which put further pressure on the currency.

Figure 8: FPI flows have been muted this year



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Apart from this, high inflation and narrowing yield differential with the US also contributed to the depreciation seen in USD/INR in 2022.

<u>**Outlook for INR**</u>

As was the case in 2022, the movement in INR will majorly be impacted by how the dollar moves. This in turn will be dependent on Fed action. While the Fed has maintained its hawkish stance and has projected the peak Fed rate of over 5%, recent indicators suggest that it may have to soften its stance in 2023. Many market participants have also alluded to the possibility of shallow rate cuts in H2CY23. This suggests that the DXY may not continue its bull-run. Further, as mentioned earlier, growth concerns will gain renewed importance in 2023 as the impact of monetary policy tightening is felt across the world. US growth is also likely to slow and it remains to be seen whether the Fed is successful in ensuring a "soft landing". Nevertheless, growth in US along with other major economies such as the Europe, UK and China may see a weakening momentum. On the other hand, India's growth momentum is unlikely to slowdown materially. This is positive for INR.

Commodity prices have eased and a global slowdown will keep further lid on commodity prices. Hence, we may see some normalization in imports. Admittedly, both merchandise and services exports will be impacted by a global slowdown. However, much of this will be offset by lower imports and hence we do not expect a significant jump in trade deficit. Further, CAD is likely to have peaked in Q2FY23 and may see moderation going forward. FPI flows have turned around in recent months and may see further acceleration driven by better growth prospects.

On balance, we believe that INR is likely to trade with an appreciating bias in the range of 81-83/$ till Mar'23. For 2023, we see INR in the range of 80-83/$. Adequate forex reserves and forward cover will ensure that INR will remain range bound.

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