CURRENCY OUTLOOK

02 March 2022

INR to trade at ~76/$ in Mar'22

Risks to the INR outlook have increased due to the Russia-Ukraine crisis and the resulting rise in oil prices. FPI outflows have also intensified as investors have turned risk-averse. We believe the dollar will remain strong, supported by safe-haven appeal and Fed stance. Further, with oil prices now at US$ 110/bbl, INR is likely to be under pressure. We expect INR to trade with a depreciating bias in Mar'22 and average ~76/$. RBI's ample forex reserves should limit any sharp downward moves in INR.

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Global macro backdrop: With military hostilities between Russia and Ukraine showing no signs of slowing down, risks to global growth outlook have risen. Commodity prices are surging higher, global yields have fallen and stocks are in deep red. Higher commodity prices, particularly for oil suggest that inflation is likely to remain high. Further, latest round of sanctions imposed on Russia, many of which relate to the financial system, pose considerable uncertainty to the outlook. It also threatens the nascent recovery in global supply chains, still reeling from the pandemic. Thus, the war, along with the sanctions imposed, impart considerable uncertainty and volatility to the global economic outlook.

Global central banks: While Central Banks in several advanced economies signalled a change in monetary policy stance in the beginning of the year, the Russia-Ukraine conflict is likely to question this rhetoric. As outlined above, risks to global growth have risen, and inflationary pressures have mounted further. It would be crucial to watch how Central Banks respond to this shock. Fed Chair's testimony to the Congress scheduled later, will be key.

Currency movement: DXY remained subdued for most of Feb'22 (1-23 Feb 2022), and was lower by 0.4%. However, since then it has strengthened by about 0.3% amidst safe-haven demand. Even JPY has appreciated by 0.5% due to its appeal as a safe-haven asset. On the other hand, EUR has fallen considerably to its weakest level since Jun'20, due to surging oil prices. GBP too has edged lower. On the other hand, AUD has strengthened by 1.2% buoyed by higher commodity prices. EM currencies have fallen in the aftermath of the crisis and are lower by 0.4% since 24 Feb 2022, mainly reflecting a sharp depreciation in RUB. In fact, RUB has depreciated by 12% since the war broke out, to a record-low, even as Russia's Central Bank rose its key interest rate to 20% from 9.5%.

Outlook: The uncertainty around the crisis has resulted in considerable volatility in the forex markets. Investors have sought comfort in safe-haven assets such as gold, dollar and government bonds. We expect dollar to strengthen in the near-term buoyed by safe-haven demand. Further, despite the uncertain outlook, the Fed is likely to hike rates this year, albeit at a softer pace than earlier anticipated. Nevertheless, Fed is likely to outpace other global Central Banks, particularly the ECB (as risks to Euro Area growth have risen sharply), in the rate hike cycle. This along with the backdrop of tightening global financial liquidity conditions suggest that dollar is likely to perform better than other currencies.

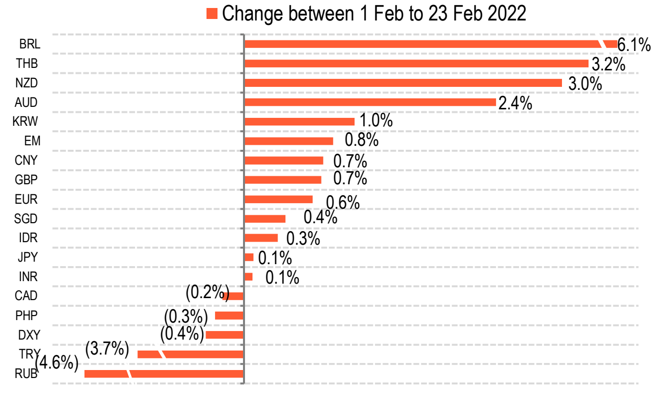
INR movement: After depreciating by 0.4% in Jan'22, INR remained range bound and rose marginally by 0.1% between 1 Feb to 23 Feb 2022. However, higher oil prices as a result of the Russia-Ukraine conflict have led to considerable volatility in the exchange rate. In fact INR depreciated sharply by 1.4% on 24 Feb 2022, as oil prices rose by 2.3% (to US$ 100/bbl) amidst Russia's invasion of Ukraine. Since then, INR has remained fairly stable at ~75.5/$.

However, increase in oil prices (currently at US$ 110/bbl) remain a key risk to INR. Higher oil prices pose a risk to India's external stability as it inflates the trade deficit. Our analysis shows that for every 10% increase in oil prices on a permanent basis, oil imports are likely to inch up by US$ 15bn or 0.4% of GDP. This will get reflected in higher current account deficit and hence put pressure on INR. Rise in oil prices is also inflationary.

CPI inflation in India already touched the 6% mark in Jan'22 and is likely to remain elevated going forward. Higher inflation generally leads to currency depreciation. Further, FPIs have remained net-seller even in Feb'22 (US$ 4.8bn), particularly in the equity segment. With considerable uncertainty in the global financial markets, FPI outflows are likely to continue. Apart from this, Central government's elevated borrowing program and RBI's dovish commentary also continues to weigh on the INR. Risks to domestic growth outlook have also risen as a result of the crisis. Overall, we expect INR to trade with a depreciating bias in Mar'22 at ~76/US$.

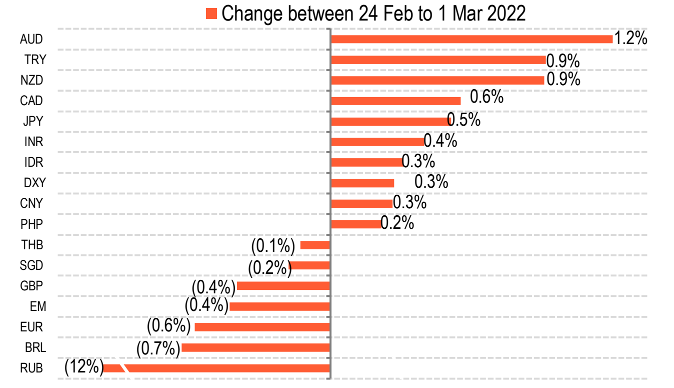
On the positive side, India's robust foreign exchange reserves are likely to lend some support to INR. Also the RBI has already announced a sell-buy swap of $ 5 bn which will help to stabilize the rupee. This can be used more often in case of temporary demand-supply mismatches. Apart from this, buoyant services receipts as well as steady ECB and FDI inflows are likely to limit the depreciation pressure on the rupee.

Fig 1 – Currency movement between 1 Feb to 23 Feb 2022



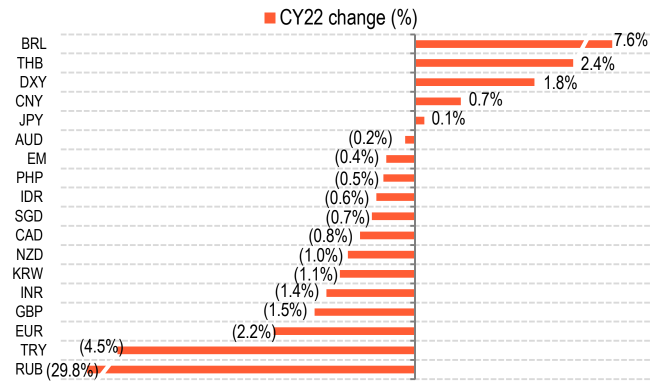
Source: CEIC, Bank of Baroda Research

Fig 2 – Currency movement between 24 Feb to 1 Mar 2022



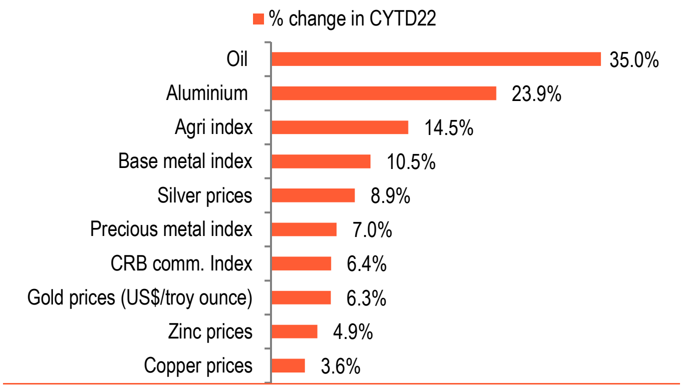
Source: CEIC, Bank of Baroda Research; Data as of 1 Mar 2022

Fig 3 – Global currencies in CYTD22



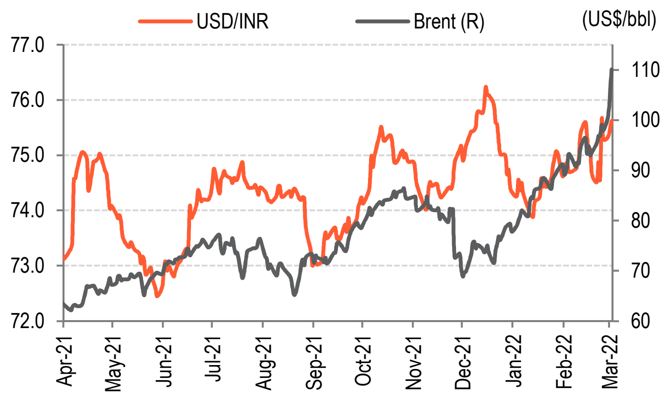
Source: CEIC, Bank of Baroda Research; Data as of 1 Mar 2022

Fig 4 – Global commodity prices have risen



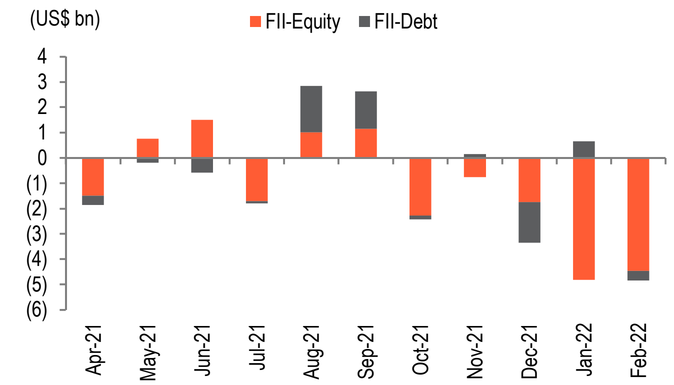
Source: CEIC, Bank of Baroda Research; Data as of 1 Mar 2022

Fig 5 – Higher oil prices weighing on INR



Source: CEIC, Bank of Baroda Research; Data as of 2 Mar 2022

Fig 6 – FPI outflows continue



Source: CEIC, Bank of Baroda Research; Data as of 25 Feb 2022

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