

₹ gains sharply vs \$ as Fed softens view on rate hike

Forward premiums jump to five-month high as US rate view changes

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The rupee strengthened sharply versus the US dollar on Thursday as the Federal Reserve's latest monetary policy statement sparked hopes of the central bank nearing the end of its tightening cycle, dealers said.

The domestic currency settled at 82.26 per US dollar as against 82.67 per US dollar at previous close. Thursday's move marks the sharpest single-day gain for the rupee versus the dollar since March 3 and the strongest closing level since March 13.

After depreciating by around 10 per cent against the dollar in 2022, the rupee has enjoyed a stronger spell in the current calendar year, appreciating 0.6 per cent so far.

Late Wednesday, the US Federal Open Market Committee raised interest rates by 25 basis points, with the federal funds rate now at 4.75-5 per cent. The latest rate hike takes the total tally of increases since March 2022 to 475 bps. Even as it hiked interest rates, the Fed's language regarding future tightening was perceived to be softer than before, especially in the light of the recent crisis in the US banking sector.

"Though price stability continues to be the major focus area for the Fed, there has been a change in the forward guidance language. Fed Chair stated that the Fed anticipates that some additional policy tightening is required vs "ongoing increases in the target range will be appropriate" indicated on February 1," economists at YES Bank wrote.

Most analysts now expect only one more 25-bp rate hike by the Fed in coming months with some expecting no more tightening.

With some segments of markets even pricing in rate cuts by the Fed later in 2023, given the volatility in the US banking system brought about by tighter financial conditions, the US dollar index weakened sharply on Thursday. The index was at 102.37 at 3:30 pm IST versus 103.28 at the same time on Tuesday.

"It is more to do with the Fed view — I think 81-83/\$ is the range I would go ahead with for the rupee. There is improvement in the balance of payments because of lower oil prices, but unless there are capital account inflows again, you may not see too much change in the rupee's dynamics till the time US interest rates remain higher," HDFC Bank's executive vice-president of overseas treasury, Bhaskar Panda said.

Shinhan Bank Vice-President Kunal Sodhani predicted a range of 81.80-82.80 per dollar for the rupee till the end of the month.

Trajectory of forward premiums

With markets now increasingly convinced of the Fed reaching the end of its rate hike cycle, dollar-rupee forward premiums have risen sharply over the last couple of weeks. The forward premium reflects the interest rate differential between India and the US.

In 2022, the forward premiums had plunged to an 11-year low as the rate differential narrowed sharply.

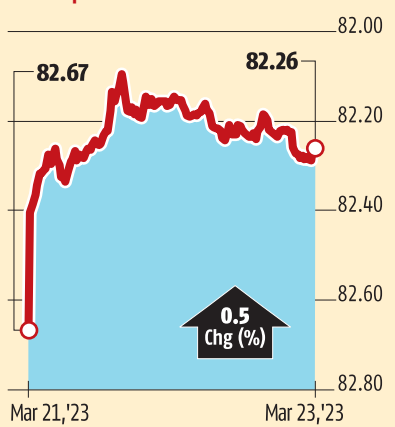
This was owing to the faster pace of the Fed's rate hikes vis-à-vis those of the RBI. The



FED EFFECT

₹ vs \$

(in reverse scale)



12-month forward yield (in %)



Compiled by BS Research Bureau Source: Bloomberg

RBI has raised interest rates by 250 bps since May 2022. A narrower rate differential reduces the appeal of Indian assets for overseas investors. The one-year forward premium rate has jumped as much as 34 bps since March 8, around the time the Silicon Valley Bank collapsed.

On Tuesday, the rate was at 2.48 per cent, the highest since October 20, 2022, Bloomberg data showed.

"The one-year forward premium is impacted by the interest rate differential. As far as the interest rate differential is concerned, a structural story is playing out. US short-term rates have fallen significantly in the last one month or so because of the banking crisis. Because of this, the interest rate differential has improved quite a bit," Anindya Banerjee, VP at Kotak Securities said.