Shifting Tides in Currency Markets: Dollar Weakness, Asian FX Gains & Implications for the Rupee

May 29, 2025 | Economics

The US dollar index (DXY) has weakened significantly this year, declining 8.6% calendar year-to-date (CYTD) and falling below the 100 level for the first time since 2023. If it closes the year at current levels, this would mark the steepest annual decline since 2017. The dollar's softness is largely driven by concerns about slower US growth and rising fiscal risks, and the weakness is expected to continue. Meanwhile, many Asian currencies have strengthened. Even the Chinese yuan has gained against the dollar, though its appreciation has been modest as authorities are focused on maintaining currency stability.

For India, this external backdrop - combined with strong domestic fundamentals - has eased the weakening pressure on the rupee. After a weakening trend seen in most of H2 FY25, the rupee has been strengthening in recent months, appreciating by around 2.8% against the dollar from its all-time low in February. In light of these factors, we have revised our USD/INR forecast to 85-87 by end-FY26 (from our previous forecast of 88-89). That said, FPI flows into India are likely to remain volatile, and developments around US trade policy and the fiscal trajectory will have a strong bearing on the US dollar and will be important factors to watch for in the months ahead.

Dollar Strength Fading

For much of the past decade, the dollar appreciated steadily. But investor confidence in US assets now appears to be fading. This year, we have seen a rare combination - US equities are down, Treasury yields are rising, and the dollar has weakened. While the S&P 500 has begun to recover, it remains about 6% below its all-time high in February 2025. At the same time, the 10-year US Treasury yield has risen by 50bps since early April, and the DXY index has declined 8.6% CYTD. As the dollar loses momentum, more investors are reportedly hedging their currency exposure on US assets.

One major driver of the dollar's recent decline is the narrowing US growth premium. For years, the US economy outpaced its peers like Germany, Japan and the UK, drawing capital on the back of strong relative growth. That advantage, however, is now coming under pressure.

In 2024, US real GDP grew by 2.8%, well above Germany (-0.2%), Japan (0.1%), and the UK (1.1%). But by 2029, the IMF projects this gap to narrow considerably - US growth is expected to slow to 2.1%, while Germany rebounds to 1.0%, Japan improves to 0.5%, and the UK reaches 1.4%. As a result, the US growth differential, which averaged 2.3 percentage points (pp) over Germany, 2.2pp over Japan, and 1.5pp over the UK between 2020 and 2024, is projected to fall to 1.0, 1.4, and 0.6pp, respectively, over the 2025–2029 period.

Trade policy is also clouding the US outlook. While trade tensions have eased - for instance, the US and China agreed on a 90-day tariff truce, and the UK and US recently reached a trade deal - US tariffs are likely to remain elevated, at their highest levels since the early 1900s. These tariffs are expected to feed into inflation and weigh on domestic demand. While the US Court of International Trade has recently blocked President Trump's tariffs, the Trump administration has appealed the decision. The resulting legal process is likely to prolong uncertainty around the future direction of US trade policy and could weigh on growth.

Meanwhile, capital appears to be rotating into other regions. European equities are benefiting from improving growth prospects, supported by fiscal stimulus and increased defence spending in Germany. In Asia, Chinese equities have seen a rebound, led by an AI-driven boost and supportive fiscal and monetary policies.

Concerns over the US fiscal profile are also back in focus. A tax cut and spending bill currently under consideration in the Congress is expected to increase the US federal deficit. According to the Congressional Budget Office, the proposed tax changes could add around USD 3.8 trillion to the federal deficit over the next decade. Although the bill also includes some reductions in federal spending, it is still projected to widen the deficit. This would come on top of an already high federal deficit of USD 1.8 trillion in 2024, equivalent to about 6.4% of GDP. Investor worries over the fiscal outlook are reflected in weak demand at Treasury auctions and rising term premia - the 30-year UST yield has surged by 60bps since early April, touching 5% for the first time since 2023. While the US Treasury Secretary plans to bring down the deficit to 3% of GDP by 2028, progress remains uncertain. Without a clear path toward fiscal consolidation, the dollar will likely remain under pressure. Adding to all this, there is also speculation that the current US administration may be leaning towards a weaker dollar to reduce the US trade deficit and promote domestic manufacturing.

On a broader, structural level, central banks have been gradually diversifying away from US assets, contributing to further dollar weakness. The freezing of Russia's dollar reserves following the invasion of Ukraine marked a turning point in perceptions of dollar safety. In response, several central banks have increased their gold purchases. Between 2014 and 2021, net central bank gold purchases averaged 123 tonnes per quarter. Since 2022, this figure has more than doubled to about 266 tonnes per quarter (Refer to Exhibit 2).

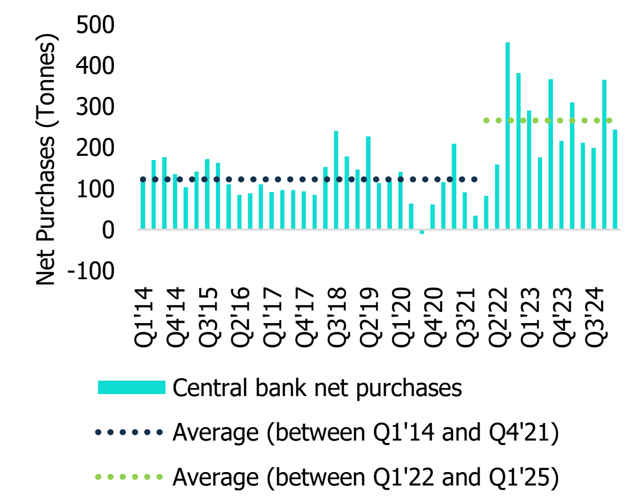
Looking ahead, any positive surprises on the fiscal front - such as a scaled back version of the proposed tax cut and spending bill - could result in some near-term strengthening of the dollar. However, from a valuation perspective, the dollar remains overvalued relative to historical levels based on the real broad dollar index - suggesting some further weakness during the year is likely (Refer to Exhibit 3). Expected Fed rate cuts in H2 2025 should also keep the dollar soft. However, any sharp decline seems unlikely, as a weaker dollar could raise imported inflation and add to fiscal risk concerns.

That said, the dollar's global dominance is not going away soon. The dollar continues to dominate global foreign exchange reserves and international trade finance. Moving to an alternate currency would take years, so the dollar's safe-haven status remains intact for now, even as investors begin to reassess its long-term trajectory.

Exhibit 1: Movement in Dollar Index

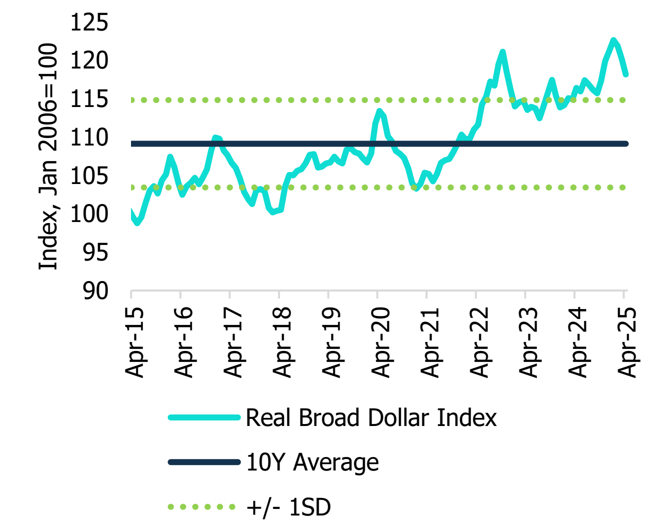
Source: Refinitiv. Data as of May 26.

Exhibit 2: Central Bank Gold Purchases



Source: World Gold Council

Exhibit 3: Real Broad Dollar Index



Source: Board of Governors of Federal Reserve System

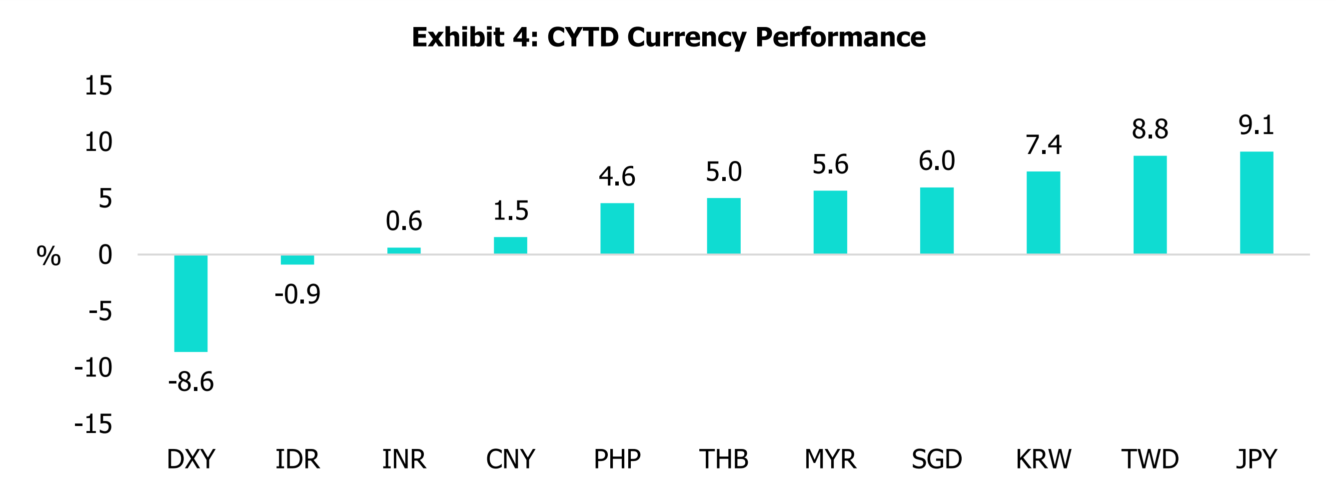
Asian Currencies Strengthen Amidst Shifting Dollar Dynamics

Asian currencies have generally appreciated against the US dollar so far this year, with several posting notable gains. The Japanese yen (JPY) is up 9.1%, the Taiwanese dollar (TWD) 8.8%, the Korean won (KRW) 7.4%, the Singapore dollar (SGD) 6.0%, the Malaysian ringgit (MYR) 5.6%, the Thai baht (THB) 5.0%, and the Philippine peso (PHP) 4.6% (Refer to Exhibit 4).

Asia is the second-largest foreign holder of US financial securities, accounting for 29% of total foreign holdings (Refer to Exhibit 5). Several Asian economies are major exporters that channel their trade surpluses into US securities (Refer to Exhibit 6). However, in the current weaker dollar environment, many Asian economies are believed to be reducing their dollar exposures and rebalancing their currency positions, which is resulting in an appreciation of their domestic currencies. There is also speculation that authorities in countries like Taiwan and South Korea may be allowing their currencies to strengthen as part of the trade negotiations with the US.

The Chinese yuan (CNY) has appreciated modestly, up 1.5% CYTD, in part supported by deeper-than-expected US-China tariff cuts. Still, significant appreciation seems unlikely, as authorities prioritise currency stability. Sluggish domestic economic momentum may also cap CNY gains. Persistent weakness in the real estate sector continues to weigh on domestic consumption. Real estate fixed asset investment contracted by 10.6% YoY over the January-April period. Meanwhile, consumer prices fell by 0.1% YoY in April 2025, marking the third consecutive month of deflation and underscoring subdued domestic demand.

Overall, we expect the yuan to remain tightly managed - in contrast to the sharp 10-12% depreciation during the first trade war, which had put pressure on other regional currencies, including the Indian rupee (INR).

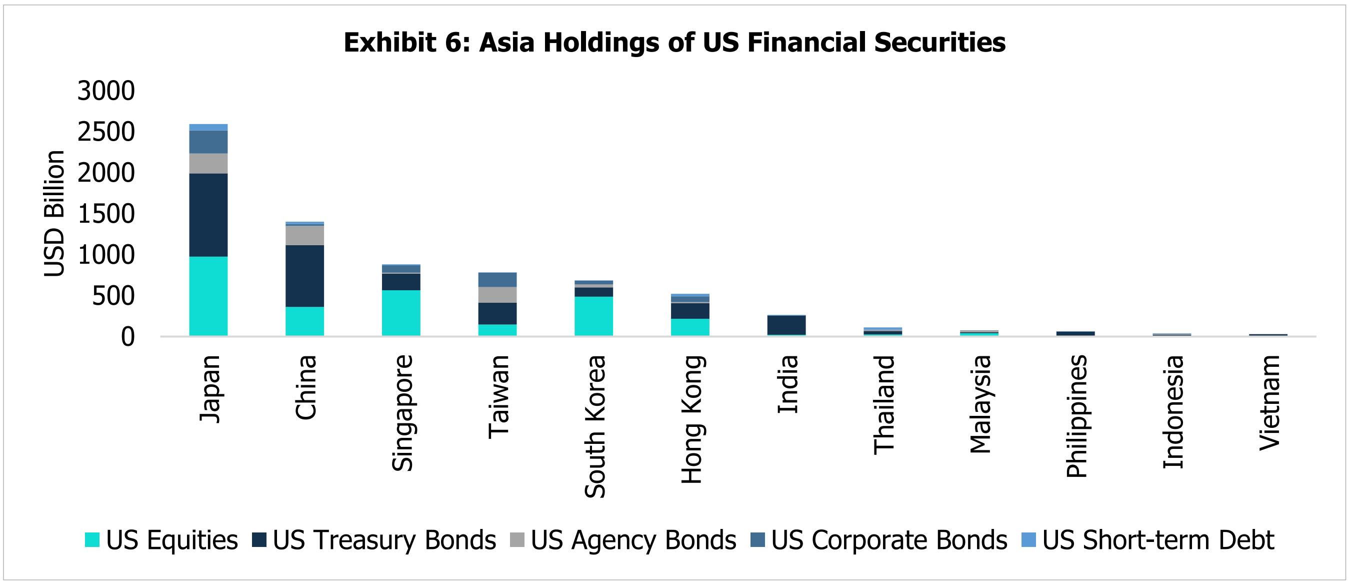


Source: Refinitiv. Data as of May 26. Note: Negative values imply the currency has weakened. DXY measures the dollar's performance against a basket of currencies, while other currencies' performance is measured against the USD.

Exhibit 5: Region-wise Breakdown of Foreign Holdings of US Financial Securities (% Share)

	Total	Equities	Treasury Bonds	Agency Bonds	Corporate Bonds	Short-term Debt
Europe	45%	48%	36%	17%	56%	48%
Asia	29%	23%	46%	59%	18%	21%
Caribbean	12%	13%	4%	8%	17%	19%
Canada	8%	10%	5%	11%	5%	3%
Latin America	3%	2%	6%	1%	1%	4%
Australia/Oceania	3%	4%	1%	1%	1%	1%
Others	1%	0%	2%	1%	2%	3%

Source: US Department of the Treasury. Others include Africa, country unknown and int. and reg. org.



Source: US Department of the Treasury. Holdings as of June 30, 2024

Rupee Outlook: Supported by Strong Fundamentals though FPI Uncertainties Persist

The rupee has strengthened by around 2.8% against the dollar from its February lows (Refer to Exhibit 7). The currency remains supported by India's position as the fastest-growing major economy, low inflation and a comfortable current account deficit (CAD). External factors, such as a weaker dollar and a stronger yuan, have also eased the pressure on the rupee.

We expect India's CAD to remain manageable at around 0.9% of GDP in FY26 (revised down from our earlier projection of 1.1% of GDP), supported by resilient services exports and lower crude oil prices. With OPEC+ increasing output, oil prices are likely to stay in the USD 60–70 per barrel range through FY26, with a bias towards the lower end - aiding India's trade balance.

On the capital account side, uncertainty around global trade policy may weigh on investor sentiment and keep FDI inflows muted in FY26. Net FDI inflows fell to just USD 0.4 billion in FY25, down 97% YoY and marking the fourth consecutive year of contraction. While gross inflows rose 13.7% YoY to USD 81 billion, this was largely offset by a repatriation/disinvestment of USD 51.5 billion (up 15.8% YoY) and FDI outflows of USD 29.2 billion from India (up 75% YoY).

FPI flows are expected to be volatile. So far in CY25, net FPI outflows (equity+debt) stand at around USD 10 billion (up to May 27). The debt segment has seen net inflows of around USD 1 billion, though the last two months have seen outflows, as India 10Y GSec yield declined to near 4-year lows, supported by RBI's OMO purchases and a dovish MPC (Refer to Exhibit 8). In equities, there have been net FPI outflows of USD 11 billion in CY25. However, since April, equity net flows have turned positive, amounting to USD 2.4 billion (Refer to Exhibit 9), likely helped by some rotation out of US assets and India's relatively domestic-oriented and services-driven economy – a structural advantage in a world facing high global trade uncertainty and rising tariffs on goods.

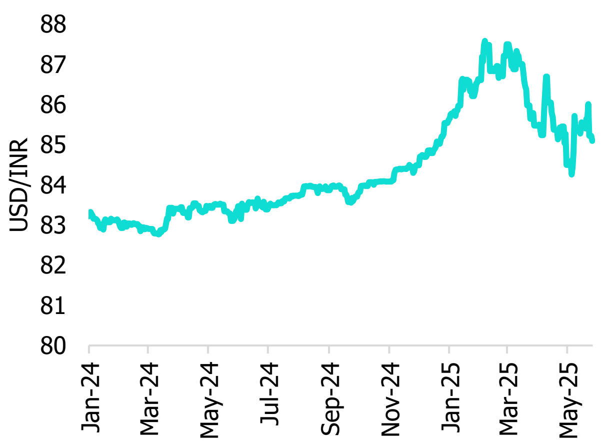
Still, the upside for equity flows may be limited given expectations of slower domestic growth and lingering valuation concerns. The US-China trade truce could also redirect some FPI flows towards China. Additionally, the recent gains in Japanese government bond yields may influence foreign portfolio allocation trends. Overall, we expect FPI flows into India to stay volatile this year. A key factor to monitor will be the outcome of US trade talks with India and other Asian countries, which could reshape investment sentiment and capital flows into India.

On a real effective exchange rate (REER) basis, the rupee remains undervalued - trading below its 5-year average and one standard deviation threshold - indicating that it still maintains export competitiveness (Refer to Exhibit 10). Going forward, India's inflation differential relative to its trading partners like the US is expected to narrow, which should further support REER strength.

India's foreign exchange reserves have risen by around USD 45 billion so far this calendar year, reaching USD 686 billion as of May 16 (Refer to Exhibit 11). However, reserves remain slightly below their September 2024 peak of USD 705 billion. We believe the RBI is likely to continue building its reserves given the ongoing market volatility, especially considering its sizable net short forward position of USD 64 billion as of March 2025 (Refer to Exhibit 12). This reserve accumulation could limit rupee appreciation.

We now expect the USD/INR to trade in the 85-87 range by end-FY26, a revision from our earlier forecast of 88-89. This reflects our view of continued dollar softness and the expectation that any sharp USD/CNY depreciation is unlikely at this stage. We feel that India would be relatively less impacted by the global trade policy uncertainty and the CAD will remain comfortable at 0.9% of GDP. Global uncertainties and the evolving US trade and fiscal landscape could keep FPI flows volatile. These factors, along with developments around a US-India trade deal, will be key to watch, given their potential impact on market sentiment and capital flows.

Exhibit 7: Indian Rupee



Source: Refinitiv. Data as of May 26

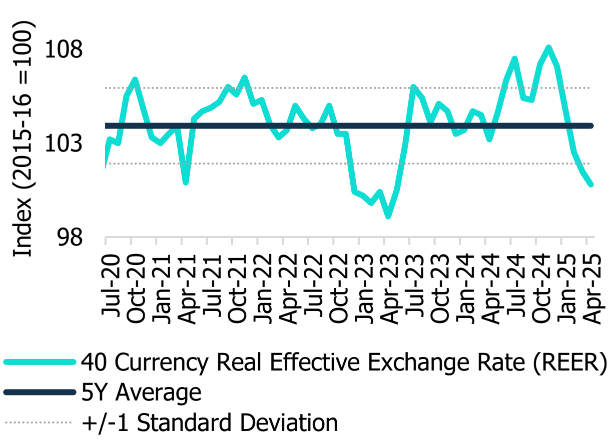
Exhibit 8: Net FPI in Debt

Source: NSDL. *Data as of May 27

Exhibit 9: Net FPI in Equity

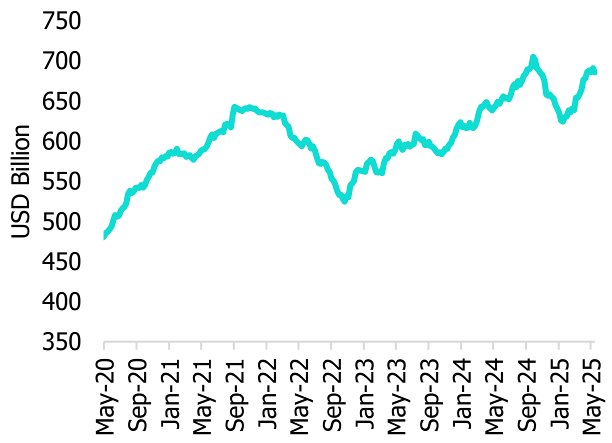
Source: NSDL. *Data as of May 27

Exhibit 10: 40 Currency REER



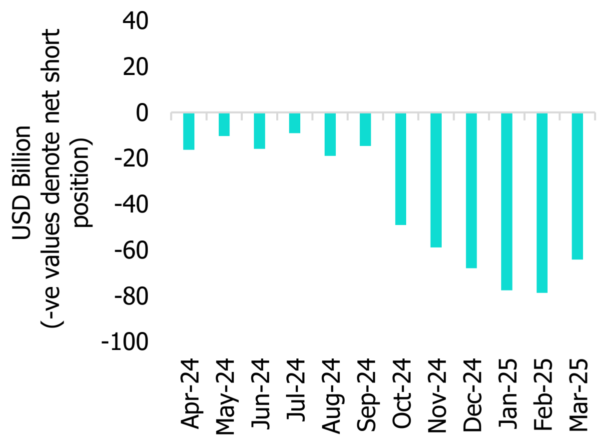
Source: CMIE

Exhibit 11: Forex Reserves



Source: CEIC. Data as of May 16

Exhibit 12: RBI Net Forward Position



Source: CMIE

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