“Meandering Through Currency Volatility in Uncertain Times”[1]

Good evening. I am delighted to be here today and am grateful to the Forex Association of India (FAI) and the organisers of this conference for inviting me to speak at this gathering. I am also happy to be in Thailand, a country known as the “Land of Smiles”, and a country that is widely popular for its impeccably scenic landscapes and ancient temples.

2. The FAI, an organization of treasury managers, foreign exchange dealers and brokers actively involved in foreign exchange trading and foreign exchange risk management, has played a pivotal role in promoting transparency, professionalism and ethical conduct in the forex market since 1979. While the FAI’s contribution in the forex market has been notable so far, I look forward to a scaled-up involvement of the FAI in inculcating among the dealing fraternity a discernible culture of fostering holistic development of the forex market going ahead.

3. A currency market without **volatility** is quite inconceivable to think of. Forex traders usually embrace high volatility as their friend! In fact, many of them get disoriented when confronted with a situation of prolonged low volatility! Volatility has reigned supreme in various financial markets in the recent months, and this has prompted me to choose the theme of my address today as “*meandering through currency volatility in uncertain times”*. However, the ramifications of high volatility in financial markets on the real economy and the associated social costs should

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always be kept in mind. Therefore, the Central Bank of the country is given the responsibility to maintain orderly conditions in the currency market and to contain undue volatility.

4. Let me emphasize here that the views expressed in this speech are my own and do not, I repeat do not, represent the views of the Reserve Bank of India. The opinions and commentaries mentioned at various places in this speech are aimed at stimulating an intellectual discussion. Concerned stakeholders intending to know the official stance of the RBI on the theme of today's discussion may please refer to various speeches, statements and related documents available on the RBI's website. I urge all of you present in this conference hall to take note of this throughout this event and seek your co-operation on the same.

5. Why are these ***"Uncertain times"***? Uncertainty started with the COVID-19 pandemic, when wave after wave of the pandemic swept across countries resulting in economic output getting scarred beyond estimation amidst unparalleled mobility restriction. The resultant supply-chain snarls led to countries world-wide reporting multi-decade high inflation that mutated from a 'transitory' narrative to "deeply entrenched". Meanwhile, the nascent economic recovery brought about by a global vaccination drive and historic monetary and fiscal policy stimulus in late 2021 was impacted by the Russia-Ukraine conflict in early 2022. The geopolitical upheaval resulted in a global commodity shock, which in turn led to soaring inflation. This has evoked aggressive rate hikes and monetary tightening by central banks in most countries. The frontloading of rate hikes by developed and emerging market central banks has gained pace in recent months. Let me dwell upon all of the above in some detail.

6. Coming on the heels of the pandemic, the Ukraine conflict has led to significant supply side disruptions. The global supply of commodities in which Russia and Ukraine are key producers and exporters has been badly affected. The **commodity price shocks** witnessed in the recent past are well known to the participants present here. However, I would like to highlight that the **elevated global food prices** can metamorphose into a hunger-led catastrophe. Larry Fink, CEO, Blackrock recently noted that "*Food inflation is a bigger worry than fuel costs*". The UN Food and Agriculture World Food Price Index touched an all-time high of 159.71 in March 2022, and has moderated slightly in the later months. Climate related changes have also played a role. Europe has suffered from an intense heat wave and **'heatflation'** has weighed on market sentiments recently. Ultimately, the above factors contributing to surging global inflation are not only margin compressors for the corporate sector and wealth destroyers for the household sector, but also causative factors for the rise in global hunger. As such, concerns about energy and food security continue to stoke inflationary fears and in turn cause elevated uncertainty in the financial markets.

7. This has led to Dani Rodrik, professor of International Political Economy at Harvard University's John F. Kennedy School of Government recently opine that the Covid pandemic and Ukraine conflict have brought to the fore food and energy security, public health, and national security as areas of national priorities where countries will no longer rely on global markets. Under the backdrop of the growing debate on "***whither globalisation***", Prof Rodrik believes that globalisation will be restricted to areas other than those crucial areas which countries view as too important to be left to the forces of globalisation.

8. Central banks across the world have embarked upon a **rate hike** spree to excoriate the inflationary headwinds. The quarter ended June 2022 witnessed record 62 hikes of 50 basis points each made by 55 central banks so much so that it is now said that *“50 is the new 25”*. Major developed and emerging market (EM) central banks continued the more than 50 basis points hike in July 2022 as well wrong-footing the financial market participants. G-10 central banks have hiked by a total 1,100 basis points this year (till August 02, 2022). EM central banks have raised interest rates by 5,265 basis points, nearly double of that for the whole of 2021 partly to curb inflation but also to protect their currencies from a rampaging US Dollar which aggravates imported inflation.

9. Incidentally, EMs today face a conundrum: *Can the domestic economy withstand the rate hikes needed to fight the **reverse currency war**?* This recent entrant, viz. reverse currency war, into the lexicon of financial markets has befuddled EM central banks as they have to (i) either go for aggressive rate hikes and risk the nascent economic recovery getting stymied, or (ii) use their foreign exchange reserves to stem the currency depreciation and contain imported inflation. Many have opted for the latter with Thailand and South Korea preferring to sell forex reserves along with hiking interest rates to protect the currency.

10. Uncertainty is compounded by a more potent and inscrutable tool known as **quantitative tightening** (QT). It is being implemented by the US Federal Reserve since June 2022. Financial Times has aptly captioned a recent article on this as *“the uneasy end of the easy money era”*. It is certainly not an easy task to assess the potential impact of the slew of QT programmes being undertaken by major central banks. A Fed study assessed the impact of the US$ 2.5 trillion drawdown in the balance sheet over the next few years as akin to just over a 50 basis points hike

in the benchmark policy rate. Other assessments range from a hike of as much as 300 basis points to even a, believe it or not, "*softening in Government security yields*"! As such, market volatility is likely to remain elevated until more clarity emerges on the contours and likely impact of QT.

11. The IMF in its July 2022 World Economic Outlook (WEO) update noted that *"the risks to the outlook for the global economy are overwhelmingly tilted to the downside"* and slashed its global growth forecast by 40 basis points to 3.2 per cent from its April estimate, while raising its global inflation projection by 100 basis points to 8.3 per cent for this year. Yield curve inversions, potential indicators of recessionary risk, have recently given mixed signals. While the spread between US 2-year and 10-year yields turned into the most negative since 2000, another gauge, i.e., near term forward spread (spread of three-month treasury yield after 18 months and three-month yield currently) is still in the positive territory. The probabilities of **recession or stagflation** continue to be debated. While the market is pricing in a US recession next year, and therefore rate cuts by the Federal Reserve starting 2023, recent speeches from Fed members point to the strength of consumer spending and tightness in labour markets as indications that recession is nowhere in sight. There are three questions that are hotly debated today:

(i) Whether there will be a US recession?

(ii) If yes, how bad? and,

(iii) Even if recession does occur, will it deter the Fed from hiking?

Concerns are expressed in some quarters that a recession is very much necessary and without that the excesses in the US economy caused by over a decade of loose policies and Fed puts cannot be exorcised to bring inflation back to target.

12. The aforementioned developments indicate a clear emergent pattern, which can be said to be contributing to a marked change from “***an era of Great Moderation to an era of Great Exasperation***”. The uncertainty surrounding the global economy in general, and global financial markets in particular, are leading to this exasperation. Jamie Dimon, CEO of J. P. Morgan, recently warned investors to brace themselves for an economic “hurricane” as the conflict in Ukraine and policy tightening by major central banks rock markets. Indicators of market volatility in various asset classes had touched multi-year highs during the Covid pandemic and are still at elevated levels. The volatility index for the US bond market, the Merrill Lynch Option Volatility Estimate (MOVE) index, recently veered close to the Covid peak. Currency and crude oil volatility have remained elevated this year. Other parameters of volatility assessment such as risk reversal, realized volatility, and economic policy uncertainty index are also at high levels.

13. The heightened uncertainty has kept the currency markets on razor’s edge and resulted in **depreciation** of emerging market currencies and even developed market currencies against the US Dollar. The Dollar Index, commonly known in the forex market parlance as DXY, has gained 10 per cent this year. The major G-10 currencies such as Euro, British pound and Japanese Yen have depreciated against the US Dollar in the range of around 9 to 13 per cent (till August 10, 2022). Major emerging market currencies and particularly Asian currencies have performed better. The ADXY (Asian Dollar Index) has recorded around 5.3 per cent fall this year, well below the decline witnessed in most of the earlier crisis episodes including the Asian Financial Crisis in 1997.

14. Many analysts have pointed out that the effects of the Dollar upsurge on corporate earnings in EMEs often lag behind the actual rise in DXY. As such **“*strong dollar*”** may be cited as a contributory factor for downbeat corporate earnings for several quarters going ahead even if dollar appreciation slows down. Further, narrowing interest rate differentials coupled with prospects of aggressive rate hikes by the FOMC has triggered record outflows from EMEs. As per the Institute of International Finance, the cross-border outflows by international investors in stocks and bonds of EMEs show no signs of abating and reached US$ 10.5 billion in July 2022, with total outflows of more than US$ 38 billion in the five months ended July 2022, which is the longest period of net outflows since records began in 2005. The outflows have, in fact, exacerbated mounting balance of payment crises in a few EMEs, with countries either defaulting on their sovereign debt or approaching multilateral agencies for assistance.

15. Adding to the prevailing uncertainty are events and likely developments in the near future which may exacerbate the exasperation of financial market participants. Let me briefly touch upon some of them.

16. With the onset of winter in Europe, it is possible that Russia will squeeze the supply of natural gas to Europe. This would lead to further rise in already elevated natural gas prices and may cause an energy crisis during winter. Besides, since the middle of the last decade, the trade wars and other developments have caused a setback to relations between USA and China. Any further escalation of tensions would cause volatility in financial markets. China's pursuit of 'zero Covid policy', coupled with the crackdown on speculation in real estate and actions to curb the power of tech giants have exacerbated the slowdown in its economy, complicating an already fragile global recovery. Recently, a string of mortgage boycotts

in China owing to unfinished projects by cash-strapped developers may dent the economic growth further as the real estate sector accounts for almost a quarter of China’s GDP. Further, the unprecedented co-ordinated sanctions imposed by the western countries on Russia in the aftermath of the Ukraine conflict has spurred other countries and/or economic blocs to explore bilateral trade and payment agreements. This is leading to **fragmentation** in the global order. The new imperatives of energy security amid the geopolitical shifts have made governments and companies scramble to balance their green ambitions with the persisting dependence on fossil fuels. As such, the planned **energy transition** is at crossroads and there is a relapse towards fossil fuels that will make the task of climate transition even more difficult.

17. To digress a bit, I will also take this opportunity to highlight one major issue which is very relevant to all of us who are participating in the FX markets on a daily basis. The **Global Forex Code**, developed by the BIS, is a compilation of best market practices formulated by Central Banks and market participants. It was initially launched on May 25, 2017 and was subsequently reviewed holistically. The updated Code was published on July 15, 2021. It comprises a common set of principles (55 in total with 6 leading principles such as ethics, governance, execution, information sharing, risk management and compliance, and confirmation and settlement) aimed at restoring trust and fostering greater confidence in the forex market. Although the adoption of the Code is voluntary, I urge all the non-bank participants present here to examine the Code and become a signatory to it. This will undoubtedly provide a positive signal to their clients, investors, counterparties and the wider FX market. The RBI has signed its renewed statement of commitment to the Code last month.

18. *Now some thoughts on **how to navigate** through the current volatility, especially in the Indian currency market.* We must remember that the implied volatility of the Rupee has been coming down since the GFC, barring sporadic surges during intermittent crisis episodes, despite a confluence of black swan events exerting continued unparalleled shocks. In fact, the trailing of realised volatility behind implied volatility attests to RBI's ability to anchor currency expectations. The Rupee has performed much better than most of its Asian peers as well as G-10 currencies this year.

19. No one knows how long the Ukraine conflict will last. It is also futile to make a guess regarding the US Fed funds terminal rate and whether rate hikes along with QT will take the US into recession, and if so, how deep the recession will be. However, it is pertinent to highlight that **India remains on a strong footing** and has revved up its armours to ensure that the over-arching goals of macro-economic and financial stability remain preserved. The signing of various trade agreements and announcement of PLI scheme to provide impetus to the *AatmaNirbhar Bharat* goals and many other steps taken in recent years will bolster growth prospects going ahead. Therefore, the Indian economy will remain an outperformer compared to most others. Our financial markets including forex market are likely to reflect the strong macro-economic fundamentals of the country. This will over a period of time lead to greater acceptability of Indian Rupee in cross border trade and investments, and the Rupee's acceptance within the league of internationally accepted reserve currencies will gradually grow. While most of our competitors and several advanced economies remain mired in a variety of structural and cyclical imbalances, India continues to enjoy the tag of an economy with "long-term growth prospects" notwithstanding temporary setbacks. This should

help us all in dealing with the volatility and uncertainty that prevail in financial markets today.

20. As I come to the end of my address, I am reminded of Michael Lewis, the celebrated author of books such as "*The Big Short: Inside the Doomsday Machine"*, and "*Liar's Poker". At a time* when it appeared imminent that the common currency bloc, *viz.* the Eurozone, would break up, with Greece being forced to abandon the Euro, he wrote the following last sentence in his book "*Boomerang: Travels in the New Third World",* and I quote,

"As idiotic as optimism can sometimes seem, it has a weird habit of paying off"

This quote does not need any further emphasis amidst the ongoing uncertain times and volatile markets. These trying circumstances too shall pass. Ultimately, we will be judged by history in terms of our response as well as reaction to these unprecedented events.

Thank you very much for the patient listening. Stay safe. Namaskar!