Global Markets | Special FX

Heavy fog of war, views unchanged

FX Markets | Monthly Update | June 05, 2026

The USD gained in May with indications that the Iran conflict would actually be a prolonged one, with multiple attempts at closing an MOU failing, though the INR saw sharp appreciation with heavy intervention. We continue to see fiscal dominance ahead, with the Fed and BOJ most compromised, driving mild depreciation in the USD and JPY, while limited Eurozone and UK positives limit moves. We continue to see more nuanced CNY appreciation ahead, with recovery in CPI inflation muting pressures. On the INR, recent steps do not change the flow equilibrium, implying continued mild depreciation ahead.

Exhibit 1: Mild increases to INR projections

	INR	EUR	GBP	JPY	CNY
Dec'26	96.00-98.00	1.17-1.19	1.36-1.38	156-158	6.75-6.95
Mar'27	96.50-98.50	1.17-1.19	1.36-1.38	155-157	6.70-6.90
Jun'27	97.00-99.00	1.17-1.19	1.36-1.38	155-157	6.65-6.85
Sep'27	98.00-100.00	1.17-1.19	1.36-1.38	155-157	6.65-6.85
Dec'27	99.00-101.00	1.17-1.19	1.36-1.38	155-157	6.65-6.85
Mar'27	99.00-101.00	1.17-1.19	1.36-1.38	155-157	6.65-6.85
Jun'27	100.00-102.00	1.17-1.19	1.36-1.38	155-157	6.65-6.85
Sep'27	101.00-103.00	1.17-1.19	1.36-1.38	155-157	6.65-6.85

Source: Axis Bank Research

USD rises in May on longer West Asia conflict (Figs 2-7)

The broad USD was mixed in the first week, with chatter of a US/Iran one-pager, though the second week saw strong buying with no deal being signed and indications of fresh kinetic action. The third week saw markets settle, though aggressive RBI intervention at this point brought strong INR appreciation. The fourth week saw fresh USD supply on messaging of an Iran deal being done amid moves towards signing of an MOU to set a 60 day negotiating period around nuclear matter. The week also saw the GBP weaken on political concerns, but these faded with hopes of EU reunification, while the JPY was seen inching towards the 160 level. The CNY continued to see pushback against appreciation.

Continue to see mildly weaker USD, JPY and INR

We continue to expect the USD to weaken after the West Asia conflict fades (Fig 8). We see the Fed and the BOJ as compromised, driving weakness in the USD (Fig 9) and JPY (Fig 10), though slack in the Eurozone (Fig 11) and UK will limit hikes and flows, limiting the overall USD weakness. We also see the CNY appreciating slowly given higher inflation (Fig 12). Even with recent measures, we continue to see the underlying equilibrium for INR negative (Fig 13), keeping trends towards mild depreciation.

Putting it all together

We therefore persevere with our view of the EUR testing 1.20 again in the medium term, with fair value of around 1.18, while the GBP is expected to move on both sides of 1.35. The JPY is likely to test 165 in the medium term, though this move will be fought bitterly through intervention including hawkish comments from BOJ speakers. The CNY is likely to appreciate towards 6.70 in the year ahead. Lastly, despite heavy RBI intervention, the path to 100 on the INR remains alive unless strong actions are taken by the government. Anecdotes of things moving on the ground are heard, though a distinction will have to be made for measures merely boosting sentiment as against those changing the fundamentals through BEER – these would include increased asset supply, more fiscal spending, higher interest rates, or a larger supply of domestic assets.

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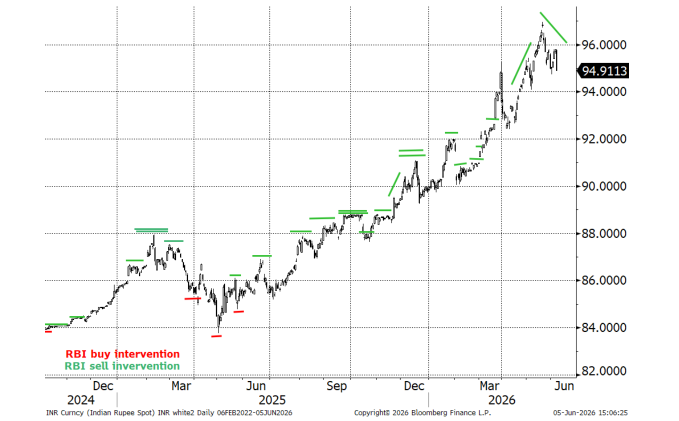
Exhibit 2: USD rises in May with no Iran deal

Source: Bloomberg, Axis Bank Research

Exhibit 3: Aggressive intervention pushes INR down



Source: Bloomberg, Axis Bank Research

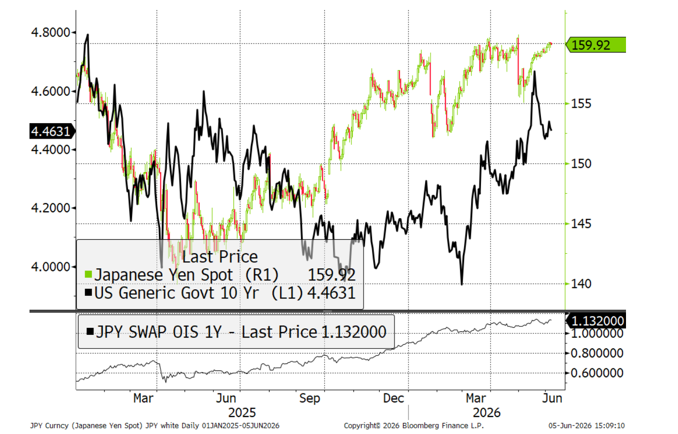
Exhibit 4: 1.20 remains next level for EUR

Source: Bloomberg, Axis Bank Research

Exhibit 5: With 140 for GBP

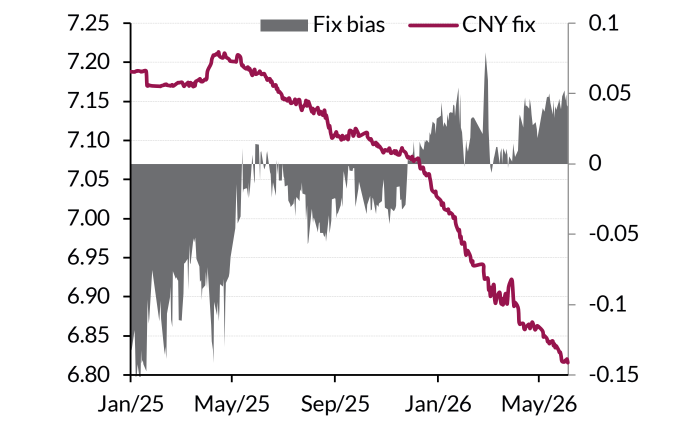
Source: Bloomberg, Axis Bank Research

Exhibit 6: JPY cautiously rising to 160



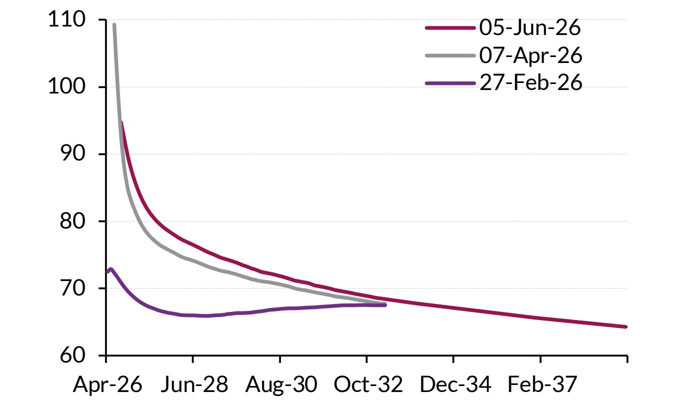
Source: Bloomberg, Axis Bank Research

Exhibit 7: China discouraging fast appreciation



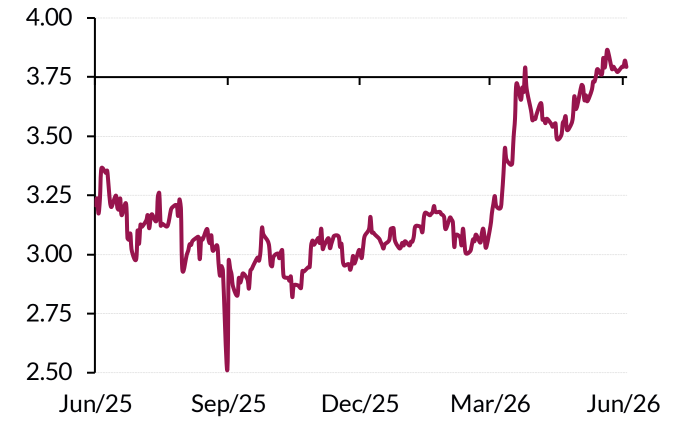
Source: Bloomberg, Axis Bank Research

Exhibit 8: Less backward oil curve on Iran hopes



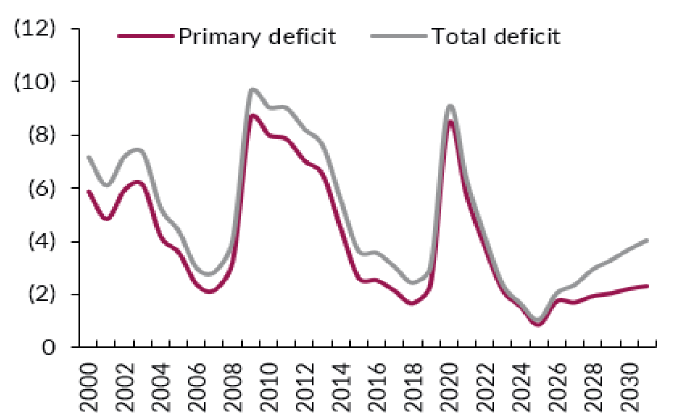
Source: Bloomberg, Axis Bank Research

Exhibit 9: Less than 25 bps Fed hikes priced, given chair Warsh and political pressures



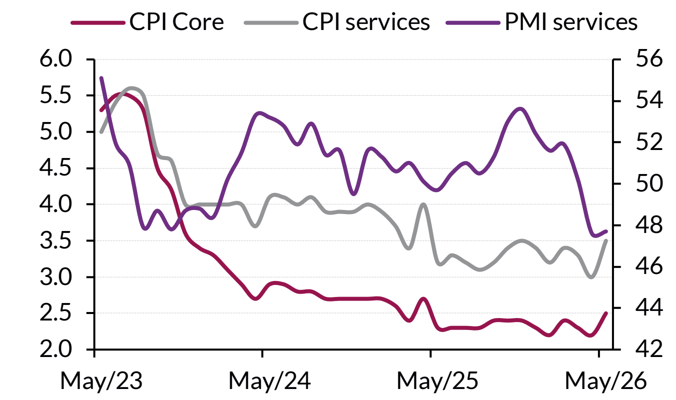
Source: Bloomberg, Axis Bank Research

Exhibit 10: Interest can worsen Japan dynamics, compromising Japan



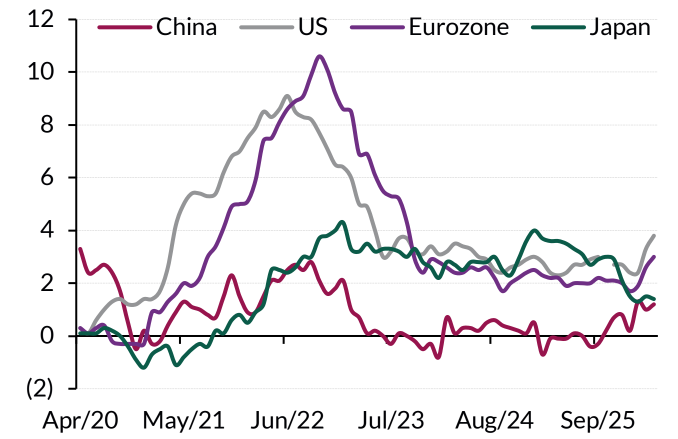
Source: IMF, Axis Bank Research

Exhibit 11: Considerable slack in Eurozone seen across indicators



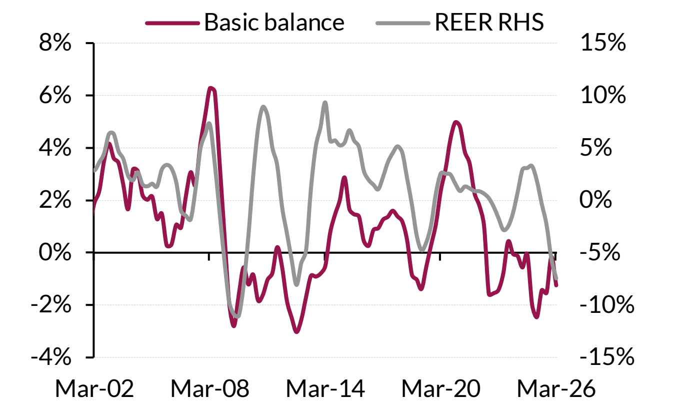
Source: Bloomberg, Axis Bank Research

Exhibit 12: Lower Chinese inflation limits REER weakening, compensatory NEER strengthening



Source: Bloomberg, Axis Bank Research

Exhibit 13: India basic balance negative even with measures



Source: RBI, Axis Bank Research

USD rises in May on longer West Asia conflict

The broad USD was mixed in the first week, with chatter of a US/Iran one-pager, though the second week saw strong buying with no deal being signed and indications of fresh kinetic action. The third week saw markets settle, though aggressive RBI intervention at this point brought strong INR appreciation. The fourth week saw fresh USD supply on messaging of an Iran deal being done amid moves towards signing of an MOU to set a 60 day negotiating period around nuclear matter. The week also saw the GBP weaken on political concerns, but these faded with hopes of EU reunification, while the JPY was seen inching towards the 160 level. The CNY continued to see pushback against appreciation.

USD rises in early May, but comes off with US/Iran one-pager news

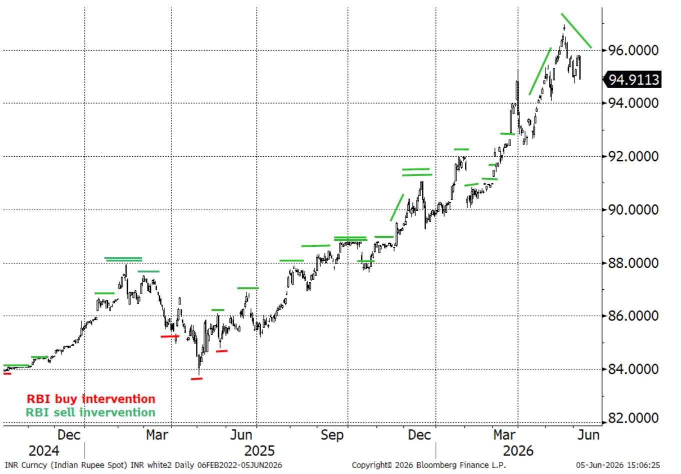
The broad USD opened May at 98.1280 with the EUR at 1.1730, the GBP at 1.3591, the JPY at 156.39, the CNY at 6.8229, the CNH at 6.8314 and the INR at 95.02. The USD was initially ranged to mildly lower as JPY strength (in thin liquidity due to the London holiday) and intervention fears weighed. It then rebounded as risk sentiment deteriorated amid escalating Strait of Hormuz headlines—Iran's new control zone, chatter of a US ship being hit (later denied), and reports of UAE air-defence activation on missile-threat concerns—alongside support from higher US Treasury issuance estimates. Later, with no US ships attempting a Hormuz crossing during the day, crude oil and Treasury yields eased, dragging the USD lower, while JPY outperformed as the earlier intervention shock faded.

Softer US data (weaker ISM services and higher JOLTs layoffs) extended the downside in yields and the USD, though renewed supply concerns and fresh UAE air-defence headlines helped stabilise the dollar. Overnight, as those headlines faded, the USD dipped again but saw mild Asian demand; suspected fresh JPY intervention drove additional USD supply. A brief USD bounce followed a downward revision to Eurozone services PMI, but the dollar sold off sharply on chatter of an early Iran deal and later reports of a finalising one-page US–Iran memo. As details emerged as market-supportive the USD stayed soft, before recovering on pushback—Trump saying it was too soon to prepare for a peace deal and Iran suggesting the reports were market-biased—while gains were capped by the retention of the "next several quarters" language in the US Treasury refunding guidance.

Exhibit 14: USD rises in May with no Iran deal

Source: Bloomberg, Axis Bank Research

Exhibit 15: Aggressive intervention pushes INR down



Source: Bloomberg, Axis Bank Research

The JPY then strengthened on signals of fresh MOF intervention and comments from Vice FM Mimura, and later on reports Iran was considering a US "one-pager" proposal for a ceasefire and negotiating period.

Even as yields and oil recovered, the USD remained capped amid strong German factory orders, before rising again on renewed geopolitical escalation—Iran's rules for ships transiting Hormuz, the US restarting Operation Freedom, and reports of US vessel–Iran clashes overnight. However, selling came in ahead of the weekend with UK election trends indicating survival of UK PM Starmer and conservative fiscal policy, as well as milder US payrolls internals. The USD was 97.8430, EUR at 1.1787, GBP at 1.3631, JPY at 156.68, CNY at 6.8006, CNH at 6.7971, and INR at 94.4850.

UK politics, negative West Asia news and Korean AI dividend lead USD up in second week
The broad USD was choppy but biased higher early in the second week on Iran escalation headlines (Trump rejecting Iran's counteroffer; later reports US weighing fresh action), with support from higher oil and UST yields (helped by stronger US CPI/PPI inflation and a weak 10y auction). The GBP underperformed on intensifying UK leadership-risk/resignation chatter and fiscal concerns, repeatedly lifting USD on GBP supply. Gains were seen in USD which were reversed with domestic markets assessing weakening in GBP. This move was driven by news of an Iraqi tanker having crossed the Strait of Hormuz. However, negative sentiments returned with US weighing fresh Iran action and markets ramping up probability of a UK PM change in addition to comments from South Korea policy makers on AI tax led USD higher. USD saw further demand with supply in the GBP with ministers resigning and 87 labour MPs asking Sir Starmer to resign with stronger US CPI inflation further supporting moves up in USD though survival of UK PM Starmer through the day helped USD tick lower. chatter of UK Health secretary Streeting resigning led the GBP to weaken sharply and the USD gain further supported by stronger PPI inflation.

However, reports of Chinese pressure on Iran to reopen the Strait of Hormuz amid the Trump-Xi meeting le to rapid reversal of much of the move higher however, it moved lower as JPY strengthened after BOJ board member Masu (a dove) surprisingly called for an early rate hike. However, heating up of the UK leadership contest – with former deputy PM Rayner indicating she was prepared to run, and with Health minister Streeting resigning to prepare for a run – led the USD to rebound sharply. Stronger US retail sales data and with reports of Mr Streeting above having enough nominations – with JPY intervention also absent further supported moves higher. Further demand was seen with US president Trump saying he did not need the Strait of Hormuz open. The USD was 97.8430, EUR at 1.1646, GBP at 1.3414, JPY at 159, CNY at 6.8001, CNH at 6.8015, and INR at 96.1488

Exhibit 16: 1.20 remains next level for EUR

Source: Bloomberg, Axis Bank Research

Exhibit 17: With 140 for GBP

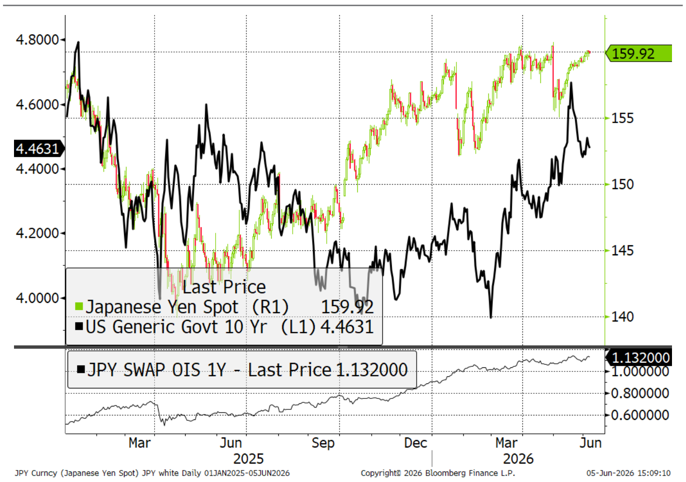
Source: Bloomberg, Axis Bank Research

Third week sees USD ranged, INR appreciates on heavy intervention
The USD was firmer early in the third week on escalation rhetoric from US president Trump (action if "nuclear dust" was not received) alongside strong US data. It then eased as US–Iran talks continued, with Iran explicitly saying dialogue was ongoing. USD softness was reinforced by GBP-led moves after PM-favourite Burnham rejected any loosening of fiscal rules, prompting position-squaring, while geopolitical back-and-forth kept price action two-way through the session. Overnight, USD stayed softer alongside GBP despite higher UST yields and crude but picked up as JPY dynamics (stronger Japan data but limited June hike pricing) guided the dollar higher. In subsequent sessions, USD edged up on no progress in negotiations and tech-stock weakness, before returning to a range. It later firmed as GBP weakened after softer UK CPI (alongside weak labour data) reduced hike expectations but then slipped as US president Trump described negotiations as in the "final stage," pulling treasury yields lower. Intraday USD spikes were repeatedly triggered by Iranian pushback—notably Supreme Leader Khamenei saying uranium would not be sent abroad—and by weaker EUR, GBP on PMI, though these gains faded on chatter of narrowing gaps in negotiations.

The USD then saw demand with the weaker UK fiscal data bringing risks around change in leadership. However, stronger German Ifo and GfK data brought some supply. Markets here on saw two-way volatility with chatter around Iran, with US comments suggesting a deal being close while Iranian comments pushed back– but the USD was overall weaker. Comments from FRB governor Waller effectively also pushed back on the easing bias leading demand return for a time, with Iran volatility taking over again. The USD was 97.8430, EUR at 1.1614, GBP at 1.3414, JPY at 159, CNY at 6.8001, CNH at 6.8032, and INR at 96.3237

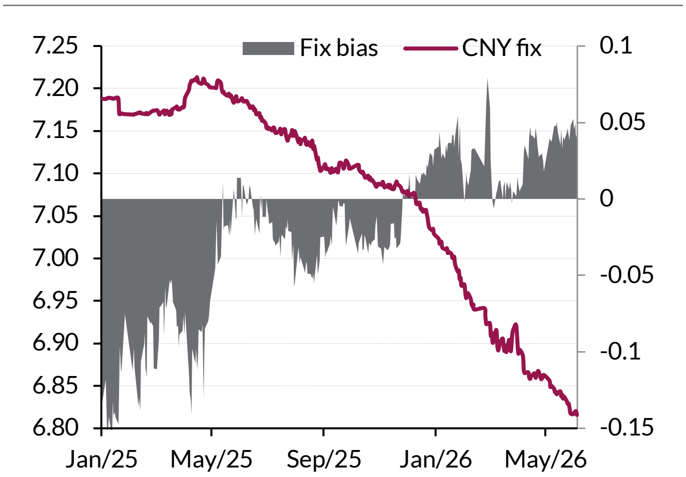
Fourth week sees USD dip on MOU messaging, INR intervention
After weekend messaging that a deal was close, USD opened lower but found support as JPY weakened; Selling continued on reports of 33 ships transiting Hormuz and of Iran's central bank governor travelling to Qatar to discuss frozen assets. The USD then reversed on reports that the US hit Iranian targets. Further, the broad USD was supported with stronger than expected Japanese prints, while softer than expected flash inflation prints from Eurozone countries also helped. Comments from BOE governor Bailey indicating softer activity would weigh on second order inflation impacts also pushed a hike back and supported the USD. However, hopes of the US and Iran signing an MOU, with US president Trump saying he would shortly meet to decide brought the USD down sharply despite stronger data- though failure of any MOU being signed led the USD back up later. The USD was 97.8430, EUR at 1.1646, GBP at 1.3459, JPY at 159.28, CNY at 6.7666, CNH at 6.7694, and INR at 95.98

Exhibit 18: JPY cautiously rising to 160



Source: Bloomberg, Axis Bank Research

Exhibit 19: China discouraging fast appreciation



Source: Bloomberg, Axis Bank Research

Continue to see mildly weaker USD, JPY and INR

We continue to expect the USD to weaken after the West Asia conflict fades from consciousness, with some indications that this is already happening. We see the Fed and the BOJ as more compromised central banks, driving weakness in the USD and JPY, though large slack in the Eurozone and UK will likely limit potential for hikes and flows, limiting the extent of overall USD moves. We also see the CNY appreciating more slowly given higher inflation-driven REER depreciation. Even with recent measures, we continue to see the underlying flow equilibrium for INR negative, keeping trends towards mild, not wild, depreciation.

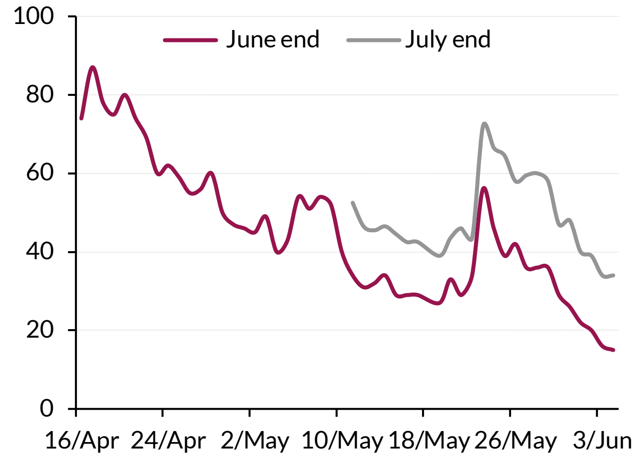
Strength of fiscal rules and central bank independence drive DMFX, INR may need to weaken more

We continue to expect the USD to weaken with a greater amount of fiscal dominance when compared to the EUR or GBP, as the West Asia theatre fades from consciousness – as might be taking place presently. The BOJ is seen as another compromised institution, resulting in pressures towards JPY 165 requiring heavy intervention. Incipient recovery in Chinese metrics that supported inflation and limited the need for NEER appreciation are now weaker, though authorities are pushing back. The INR might still need to weaken more on a FEER and BEER basis even before overshooting, with the size of RBI's forwards book preventing exporter panic. With these trends, the INR might need to weaken more barring a narrow set of structural GOI steps.

Expecting fiscal dominance to effect weaker USD after West Asia fade

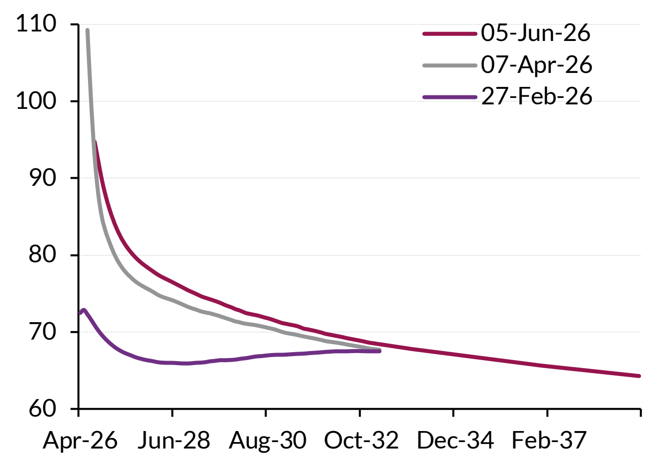
We continue to expect that the broad USD will weaken mildly after the West Asia conflict fades. Already, indications are of willingness to negotiate at both US and Iranian ends, with minor skirmishes not being responded to with escalations. At the same time, while not recorded in official data, Tasnim and Fars indicate an increase in the crossing of the Strait of Hormuz. Market pricing of Strait crossings coming over 60 have still not increased. The question of absence of any deal also indicates room for further negotiation, rather than military escalation for now – though this does remain a tail risk. Normalising of crude oil curves also indicates improving conditions, though this appears to indicate an unhealthy reliance on inventories. Even with resumption of normalcy, there might be room for near-end prices to increase on a convenience yield with moves towards restocking.

Exhibit 20: Pricing of SoH normalisation still low



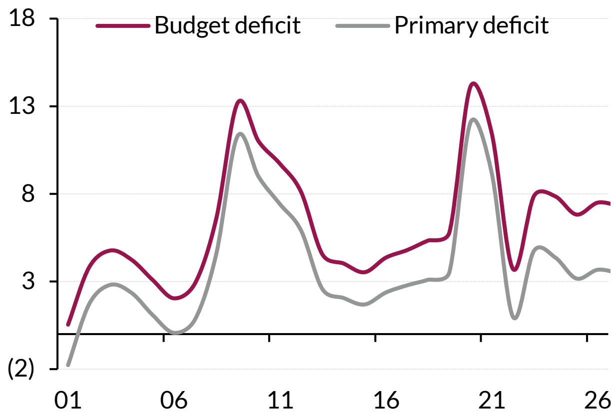
Source: Bloomberg, Axis Bank Research

Exhibit 21: Crude oil curve less backwardated



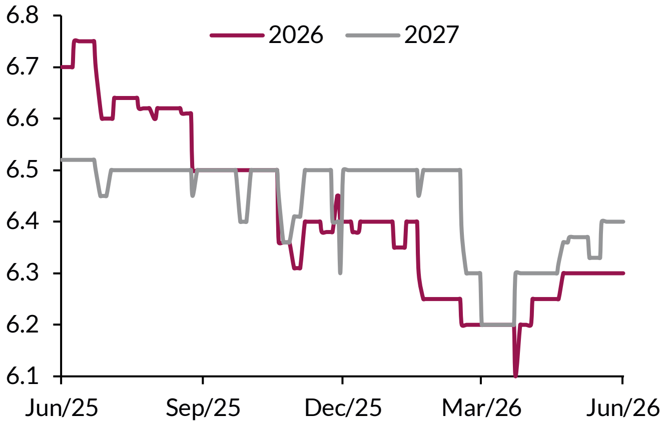
Source: Bloomberg, Axis Bank Research

Exhibit 22: **High US fiscal spending, but not a large interest cost wedge seen ahead**



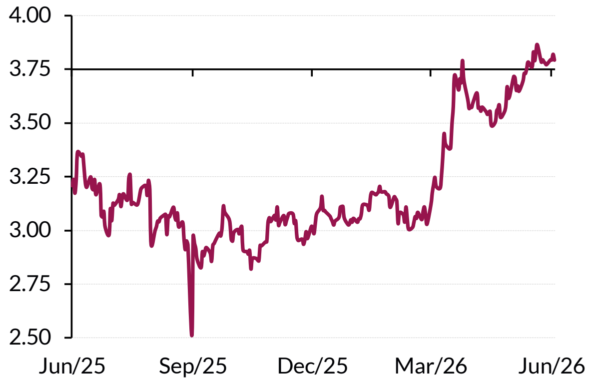
Source: Bloomberg, Axis Bank Research

Exhibit 23: **Projections of US fiscal spending have increased after the start of the West Asia conflict**



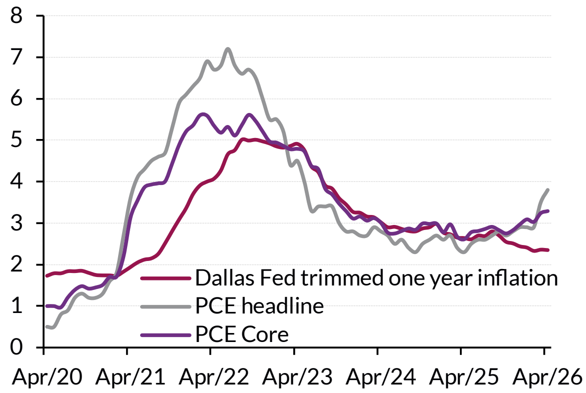
Source: Bloomberg, Axis Bank Research

Exhibit 24: **Market US FFR expectation by Dec'26 – a hike above current 3.75% is now seen**



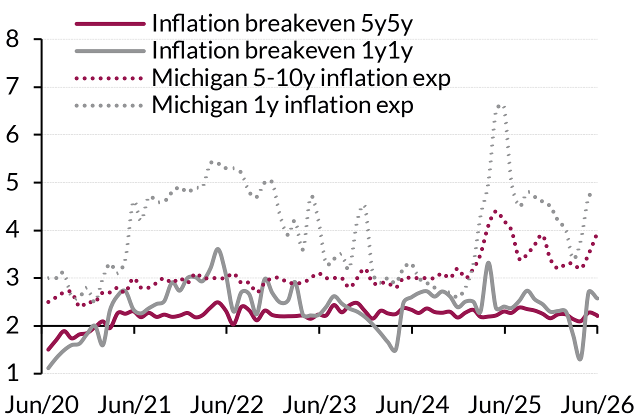
Source: Bloomberg, Axis Bank Research

Exhibit 25: **Fed chair Warsh's preferred inflation measure, Dallas Fed trimmed mean PCE, is lower**



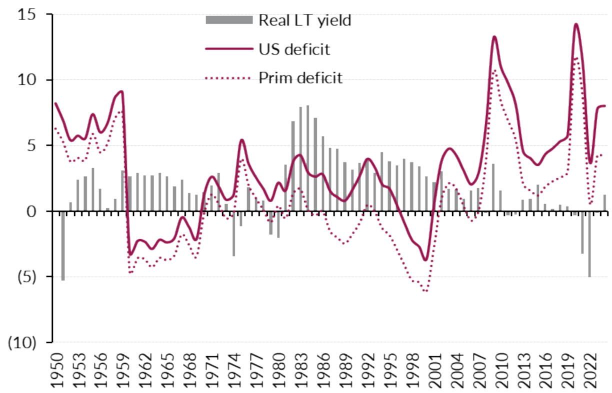
Source: Bloomberg, Axis Bank Research

Exhibit 26: **Inflation expectations are higher**



Source: Bloomberg, Axis Bank Research

Exhibit 27: **Fiscal dominance was used by the US in the 1970s, setting off competitive devaluation**

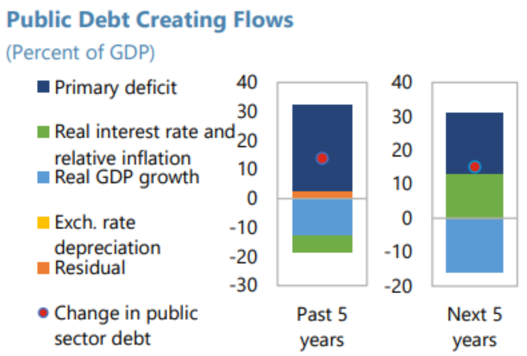


Source: Bloomberg, Axis Bank Research

The view for the weakening in the USD continues to rest on fiscal dominance. With defence driving a necessary expansion in fiscal and with broad political consensus away from debt sustainability for now, expectations are of continued heavy borrowing. High fiscal spending is also likely to come with rates being kept lower than they might need to be. While rate cuts are unlikely now, rate hikes also might be delayed and limited even if inflation were to rise, especially with focus on the Dallas Fed trimmed mean gauge of inflation favoured by incoming Fed chair Warsh So-called fiscal dominance was tried in the 1970s, leading to competitive devaluation across currencies

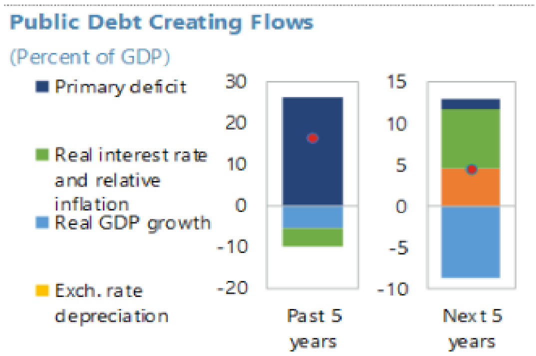
ECB and BOE less compromised than Fed and BOJ, leading EUR and GBP to find support
We also do not expect only the US to engage in fiscal dominance. Rather, with increasing defence-driven primary deficits (in the near-term, energy subsidies will also add to this) will necessitate lower real rates as seen in the IMF Debt Sustainability Analysis (DSA) plots below. However, the Fed and the BOJ are seen as more compromised than the ECB and BOE. At the same time, fiscal rules in the US and Japan have fewer constraints than those in the EU and UK. With the US and Japan therefore likely to carry out more fiscal dominance than the Eurozone and UK, the USD and JPY are likely to weaken in relative terms. This is also brought out by

Exhibit 28: DSA for the US



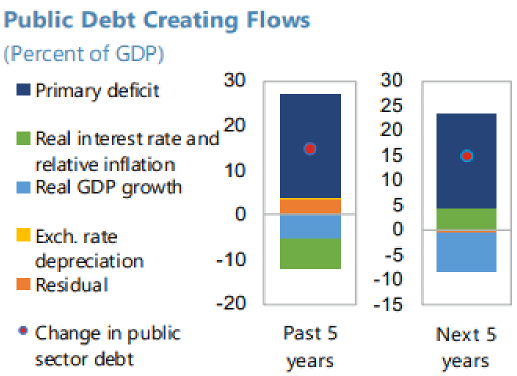
Source: Bloomberg, Axis Bank Research

Exhibit 29: DSA for the UK



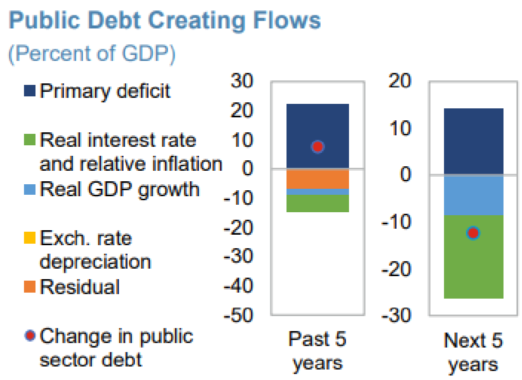
Source: Bloomberg, Axis Bank Research

Exhibit 30: DSA for France



Source: Bloomberg, Axis Bank Research

Exhibit 31: DSA for Japan

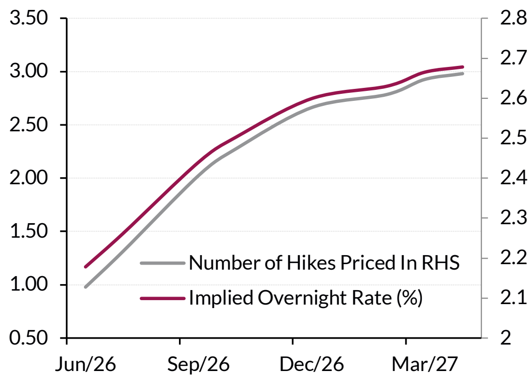


Source: Bloomberg, Axis Bank Research

ECB's guiding markets towards a near-term rate hike while the Fed under new chair Warsh is debating whether AI driven productivity can stay the need to hike rates and the BOJ is outright being influenced by political machinations.

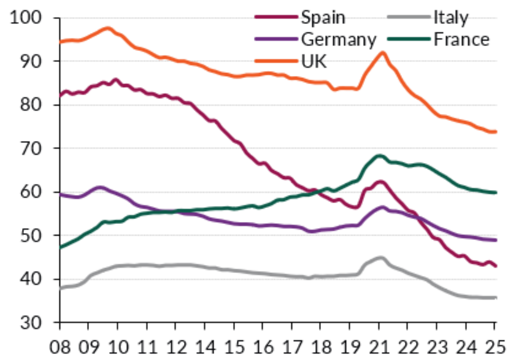
On the ECB itself, much will depend on the language in the upcoming ECB meet with there already being a number of hawkish governing council members. Appointment of a new president can also shift communication in a more hawkish direction. In the past, the ECB raised rates in 2011 and was forced to quickly reverse, given procyclical tightening in fiscal policy driven by the austerity cycle show how forced savings actually increased leverage. However, with fiscal spending likely to continue going ahead and the need to ramp up both defence and local value chains, this reversal is unlikely to be seen. Still, trends in core and services inflation are muted, and activity seen in PMI are low while consumer confidence and industrial confidence are mixed. With progress on structural shifts in the EU slow, the EUR is unlikely to gain significantly even with the start of a limited ECB rate hike cycle – especially if rates remain around neutral.

Exhibit 32: Markets now pricing in ECB hikes



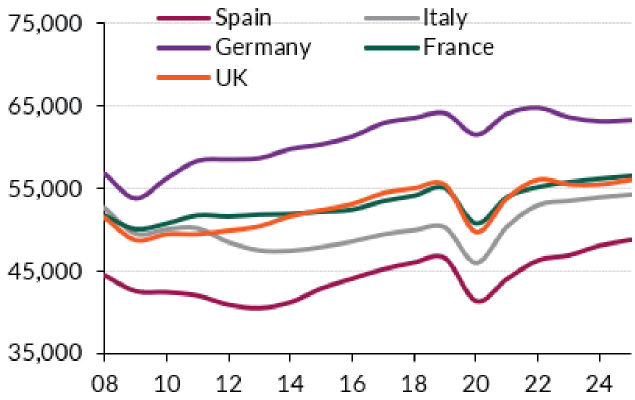
Source: Bloomberg, Axis Bank Research

Exhibit 33: Forced savings led household debt to increase (%GDP) in Spain, Italy, France



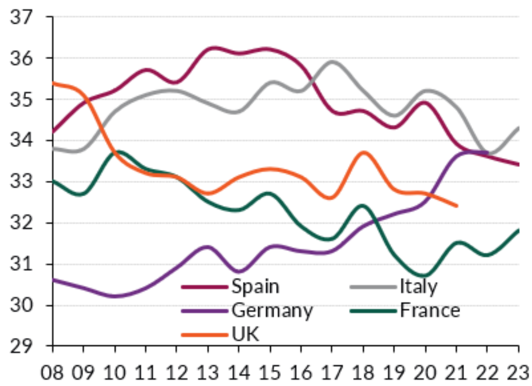
Source: Bloomberg, Axis Bank Research

Exhibit 34: With lower per capita GDP (USD PPP)



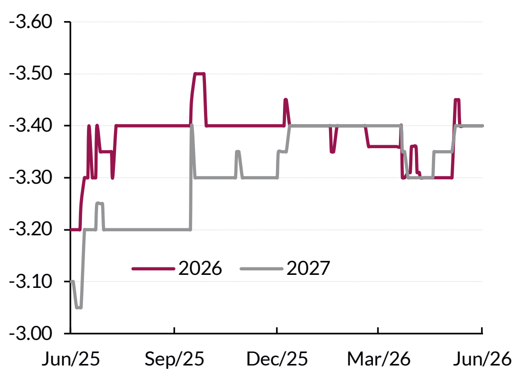
Source: Bloomberg, Axis Bank Research

Exhibit 35: With Gini indices showing higher inequality



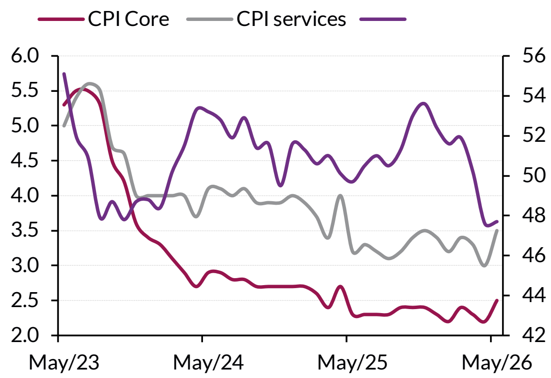
Source: Bloomberg, Axis Bank Research

Exhibit 36: Eurozone fiscal spending seeing expectations rise



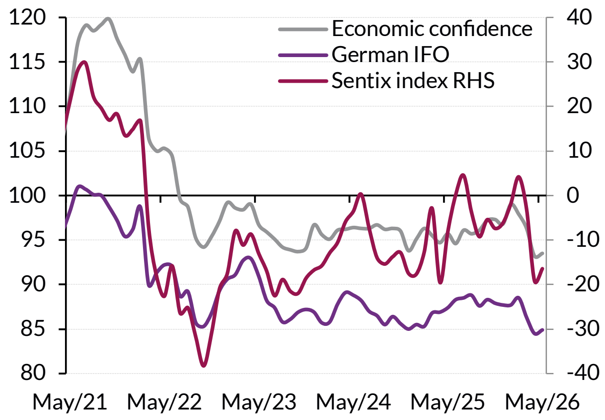
Source: Bloomberg, Axis Bank Research

Exhibit 37: Eurozone core and services inflation up only mildly, PMI shows limited pricing power



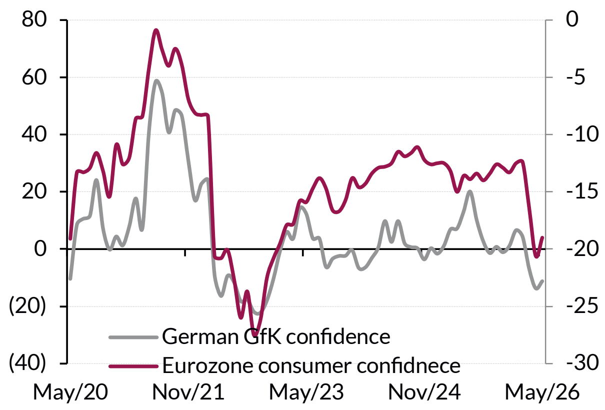
Source: Bloomberg, Axis Bank Research

Exhibit 38: Eurozone industrial confidence lower



Source: Bloomberg, Axis Bank Research

Exhibit 39: Consumer confidence also dips

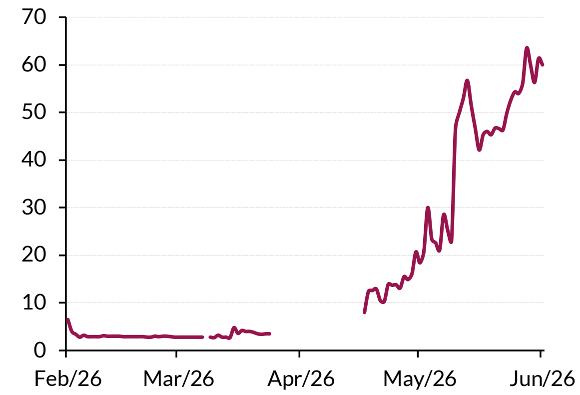


Source: Bloomberg, Axis Bank Research

A closer relationship with the EU is once again being discussed, also supporting GBP
In the UK, after initial fears around fiscal expansion with a change in the PM have blown over, focus has shifted to what a PM Burnham (market favourite), Streeting, or Rayner might mean. Mr. Burnham had been quoted expressing his displeasure around being in hock to the bond market, but recent statements appear to have toned down this rhetoric – with indications that existing fiscal rules would be kept in place. Additionally, a look at the Manchester development model shows limited fiscal expansion, though admittedly this was driven by large central grants. PMs Streeting and Rayner are also likely to tone down fiscal rhetoric if not required to compete with Mr. Burnham.

Apart from this, comments on a closer relationship with the EU have once again begun to the extent that even negotiations on rejoining have been mentioned as within the realm of possibility. Rather than being seen as an political deterrent for Labour given the strong showing of Reform in recent subnational elections, this is now seen energizing the Labour vote. Former PM Blair has written that it might still be too early to consider this and a

Exhibit 40: Prediction market probability of Andy Burnham as the next UK PM

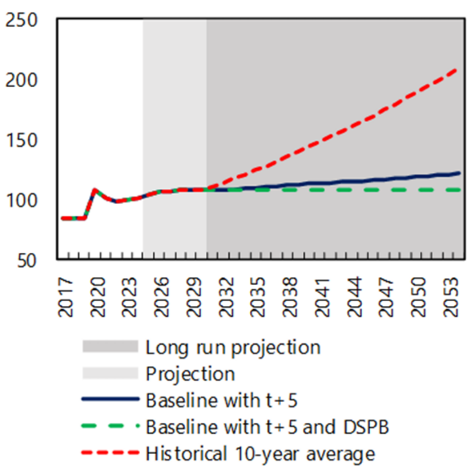


Source: Bloomberg, Axis Bank Research

Exhibit 41: Probability of PM Starmer out by

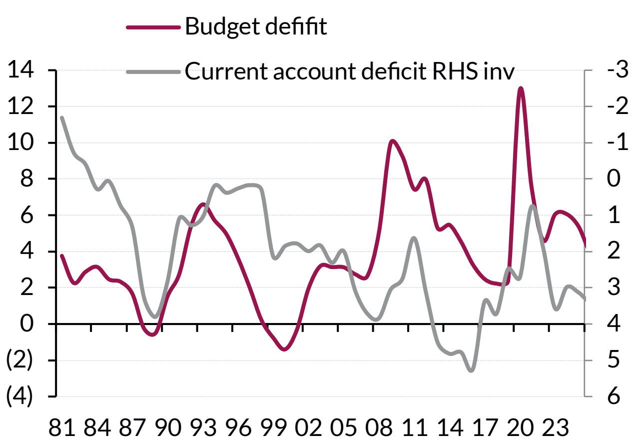
Source: Bloomberg, Axis Bank Research

Exhibit 42: With no change to fiscal, debt can spiral



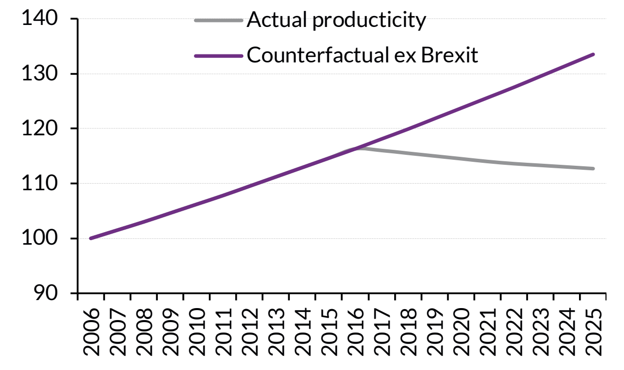
Source: IMF, Axis Bank Research

Exhibit 43: Current account deficit driven by fiscal



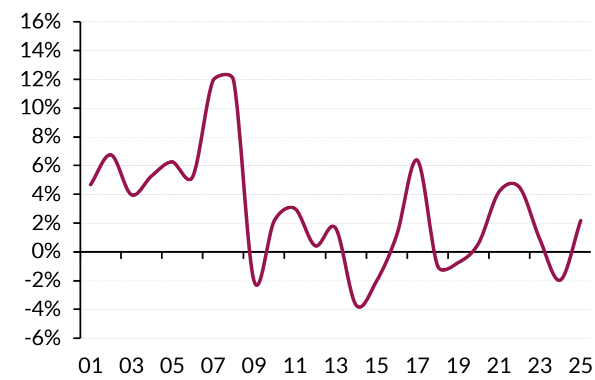
Source: Bloomberg, Axis Bank Research

Exhibit 44: Brexit saw a hit to UK productivity – a leftward shift was seen aligning closer to the EU



Source: NBER, Axis Bank Research

Exhibit 45: A return to the EU was also seen restoring UK net FDI, providing long-term inflows



Source: Bloomberg, Axis Bank Research

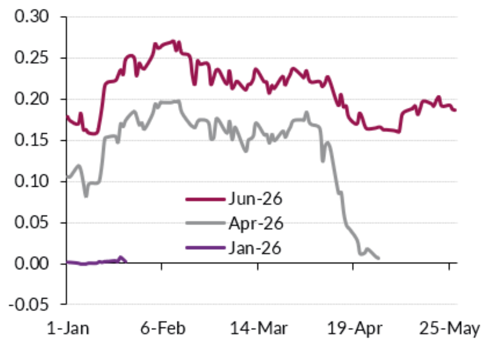
more limited relationship should be pursued rather than spending the next 10 years on debating how to rejoin, a closer relationship is likely to bring back some lost productivity and long term capital flows. As with the IMF debt sustainability chart above, a limited increase in the primary deficit, low real rates and increased productivity will likely limit fiscal, and the twin deficit transmission to the current account, even if the welfare state were to continue in its current form. While UK political developments remain inherently uncertain, the path lower in the GBP might not be as easy as anticipated, with potential upside risks also possible.

Reflationary mindset of Japanese policymakers indicates a 165 test on the cards
The Japanese political establishment continues to be enamoured by the reflation argument, seeking to expand fiscal while keeping rates low. This now comes at a time with slack being limited with inflation only limited by subsidies. With the BOJ seen succumbing to pressure to limit rate hikes, rates will likely remain below neutral, heaping pressure on the JPY. For now, intervention at 160-165 levels will likely continue, though it is possible that moves higher in the pair are seen. However, we continue to see momentum being limited here by a likely weaker USD as described above.

Chinese government support and inflation hold the key to CNY appreciation pressures
We wrote last month that input price shocks had supported Chinese inflation – the variable that so far had kept REER on a declining path given a long period of prints lower than DMs. We also wrote of stronger data on the activity front allowing some passthrough of shocks into generalized inflation, allowing REER to stop falling as fast. He tendency for REER to weaken through inflation was being compensated by NEER strengthening, meaning lower REER depreciation might mean weaker NEER increases, in line with recent PBOC and Politburo guidance. However, recent activity prints weakened, with the government footprint in both industrial production and fixed asset investment falling – this is likely to limit passthrough of shocks to inflation and strengthen forces calling for an NEER appreciation.

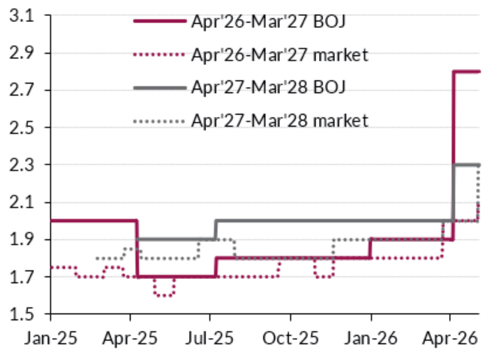
Amid these trends, the PBOC/SAFE have been managing the currency by discouraging appreciation. A look at the daily fix bias shows a moderate pushback against appreciation, though this is not as strong as the pushback against depreciation after ‘Liberation Day’ last year. At the same time, it looks as though a floor is being created under the CFETS RMB index (chart), the metric that the PBOC and SAFE use to measure the CNY.

Exhibit 46: Market implied rate increase by meeting date – note that Apr pricing fell a few days before meet



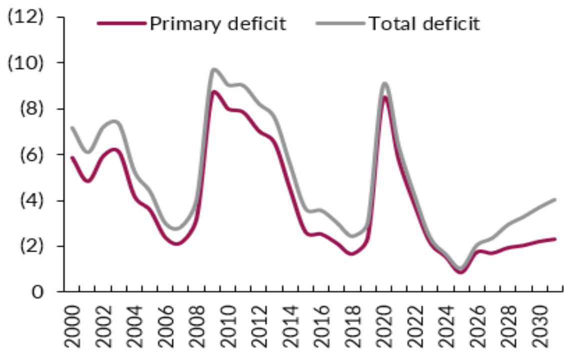
Source: Bloomberg, Axis Bank Research

Exhibit 47: Inflation projections (ex-fresh food) are showing higher prices, (prices passed on)



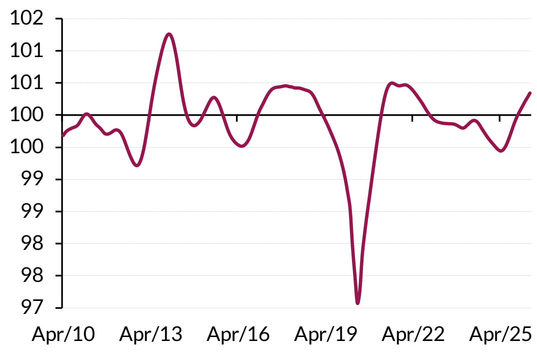
Source: Bloomberg, Axis Bank Research

Exhibit 48: IMF projects a modest fiscal increase – a sharper one on war subsidies will lead total deficit up



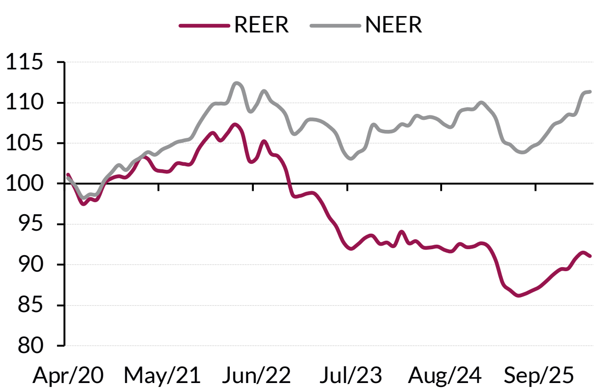
Source: IMF, Axis Bank Research

Exhibit 49: OECD's leading indicator shows Japanese growth currently above potential



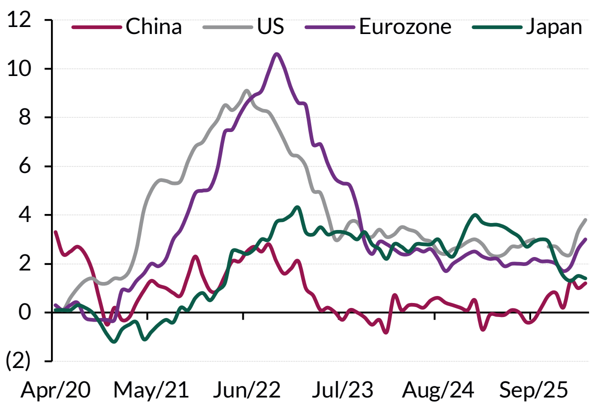
Source: Bloomberg, Axis Bank Research

Exhibit 50: Brexit saw a hit to UK productivity – a leftward shift was seen aligning closer to the EU



Source: Bloomberg, Axis Bank Research

Exhibit 51: Chinese inflation has been low until now



Source: Bloomberg, Axis Bank Research

We continue to see moderate further appreciation this year, and will be watching for a stronger pushback from the authorities.

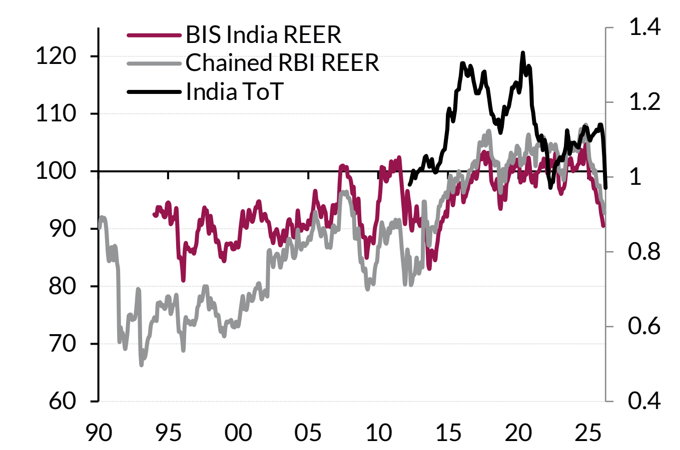
Barring a narrow path of government action, INR might need to weaken more structurally
The INR has seen weakening momentum since 2022, where the basic balance turned negative. This has historically been associated with REER weakening, but RBI actions at this point limited this move. We are now seeing catch-up depreciation, with the REER at the weakest level since 2014.

Does the weaker REER mean that the INR is undervalued? This is not necessarily true – a longer term metric called FEER (Fundamental equilibrium exchange rate) postulates that fair value is achieved with both external and internal balance. With external balance depending on financial inflows that have weakened with global savings having fallen (chart) amid rising G7+China defence spending, a weaker REER level might be the new fair. This is also best illustrated by the difficulties faced over the past few years to finance a CAD of less than 1% of GDP. While a 2.0-2.5% CAD was eminently financeable prior to the pandemic and this was chosen as the IMF EBA baseline, long-term financeable CAD might have now fallen below 1%.

We use RBI's past models to estimate the level of REER required at various levels of sustainable CAD to satisfy both the internal and external balance conditions of FEER. We see with this that the weakening in REER so far was largely required to bring the currency to fair value, reversing the appreciation of the 2010s driven by the global savings glut.

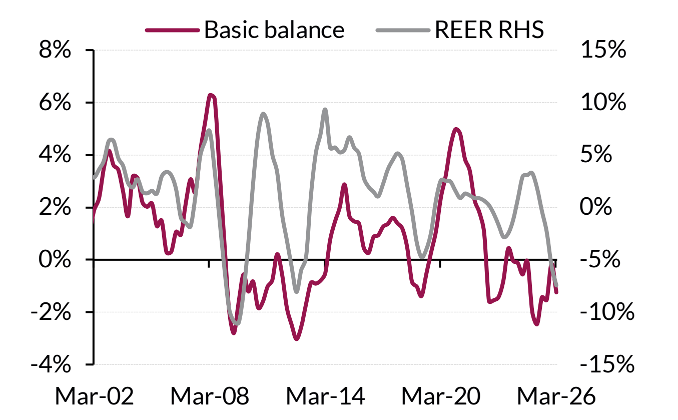
There are reasons to believe that the INR will currently weaken beyond fair value – this is given by a related metric called the Behavioural Equilibrium exchange rate (BEER). This is commensurate with the terms of trade shock from the West Asia theatre that has not yet been transmitted fully into domestic prices. Terms of trade shock are associated with departures from FEER, with current BEER implying some slight further weakening – even before considering the tendency for FX markets to overcorrect. As against this, the last few days have seen extremely heavy RBI intervention to force appreciation, but it is yet uncertain whether this is sustainable – anecdotes of importers waiting to buy on the sidelines are rife, with those of exporter panic still fairly distant. Adding onto this is RBI's record short position of around USD 100 bn onshore (chart) with further shorts offshore, requiring that reserves be rebuilt if inflows do indeed return.

Exhibit 52: Brexit saw a hit to UK productivity – a leftward shift was seen aligning closer to the EU



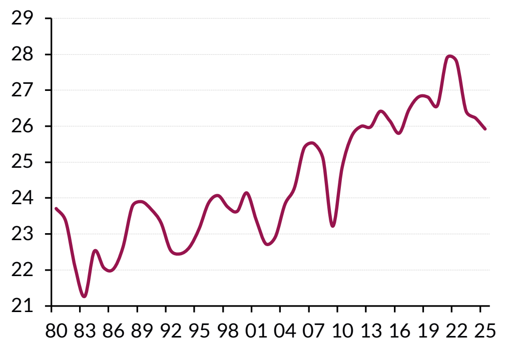
Source: Bloomberg, Axis Bank Research

Exhibit 53: Negative basic balance is factor dragging REER lower



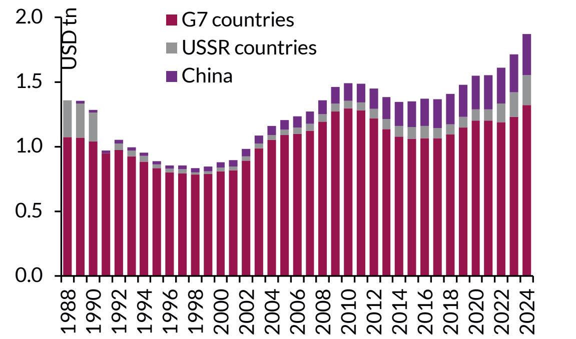
Source: Bloomberg, Axis Bank Research

Exhibit 54: Lower global savings is the proximate reason for weaker INR trends



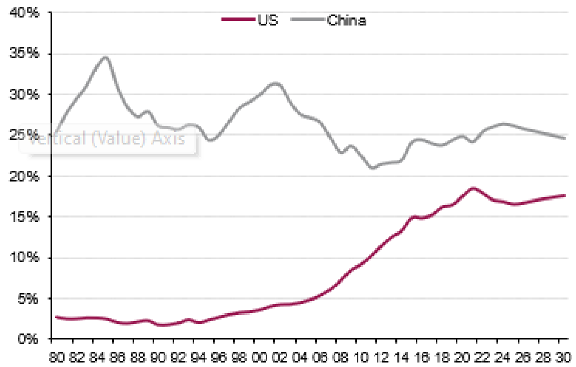
Source: IMF, Axis Bank Research

Exhibit 55: Driven by global defence spending (2023 USD) having risen



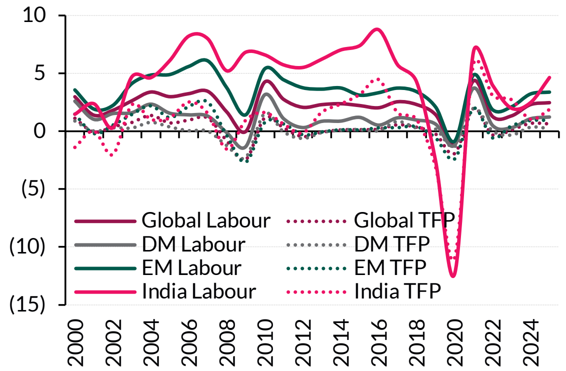
Source: SIPRO, Axis Bank Research

Exhibit 56: Falling China GDP share also creates fewer savings



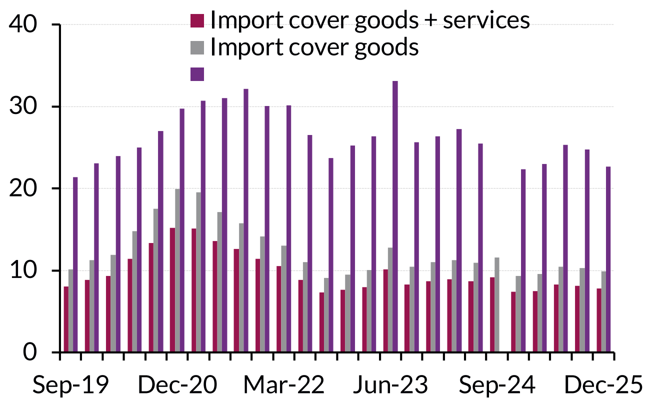
Source: IMF, Axis Bank Research

Exhibit 57: Productivity growth of India has been mixed of late



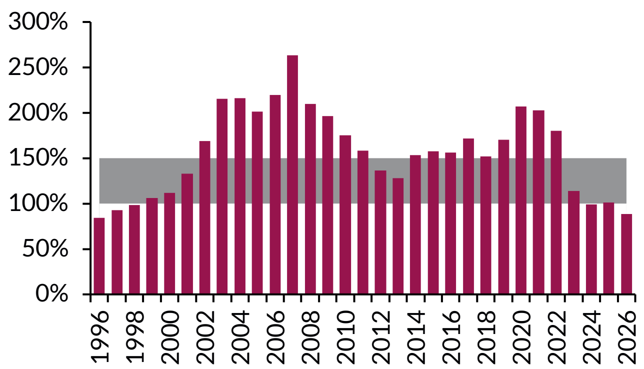
Source: Bloomberg, Axis Bank Research

Exhibit 58: On traditional reserve adequacy metrics (months), India is still well-placed



Source: RBi, Axis Bank Research

Exhibit 59: But the more nuanced IMF ARA (% of need) shows reserves are low on a long-term basis



Source: IMF, RBI, Axis Bank Research

Putting it all together

We therefore persevere with our view of the EUR testing 1.20 again in the medium term, with fair value of around 1.18, while the GBP is expected to move on both sides of 1.35. The JPY is likely to test 165 in the medium term, though this move will be fought bitterly through intervention including hawkish comments from BOJ speakers. The CNY is likely to appreciate towards 6.70 in the year ahead. Lastly, despite heavy RBI intervention, the path to 100 on the INR remains alive unless strong actions are taken by the government. Anecdotes of things moving on the ground are heard, though a distinction will have to be made for measures merely boosting sentiment as against those changing the fundamentals through BEER – these would include increased asset supply, more fiscal spending, higher interest rates, or a larger supply of domestic assets.

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