ISAS Brief

No. 175 – 16 November 2010

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QEII and India's Responses

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Abstract

The Quantitative Easing policy of the Federal Reserve has been criticised by several countries on account of the destabilising impact it can have on global trade and national currencies. This paper examines the likely implications of the policy for India.

Among major issues facing the G20 was the impact of the Quantitative Easing (QE) policy announced by the United States (US) Federal Reserve (Fed) last week. The Fed announced that this policy (QEII) is the second phase of injecting liquidity into the US economy in the last two years. The Fed will buy treasury bonds and securities from the market to the tune of US$600 billion at the rate of US$100 billion a month for the next few months. This will be funded by printing more dollars. There have been concerns in other economies about the impact of this additional liquidity, particularly on their currencies. The Fed has already created liquidity since August 2010 and the size of the Fed budget has expanded by over US$200 billion since then. Coupled with low interest rates in the US, continuing unemployment and lack of capital formation, there is apprehension that excess liquidity will wash over the shores of many emerging market economies, several of which are struggling to come out of the financial crisis. There has been considerable criticism of the policy on the ground from the European Union, Korea, Japan, Brazil and even China, that this would artificially strengthen their currencies and weaken trade.

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Asian financial markets have been on a roll since August 2010 buoyed by capital inflows from developed countries. There is significant liquidity in the markets and the equity prices are close to their 2007 levels with price-earnings (P/E) ratios appearing to be high. The impact of these developments on the Indian economy is expected to be fairly complex.

First, India is the only country grappling with a double-digit inflation. There are inflationary pressures in China, but of a lower order till now. There are three distinct elements to the inflationary pressures. The first is the rise in commodity prices. The quantitative easing announced will drive investors away from dollars into commodities and raise commodity prices even further. As a major importer of oil, coal and many other commodities, India will be affected by these price increases, which can only be partly offset by the strengthening of its currency in the wake of a weakening dollar. Inflationary pressure is also caused by food prices. During the last three years, there have been several increases in minimum support prices of cereals, oil seeds and cotton in India for making agricultural livelihoods more sustainable. There has also been significant increase in consumption due to growing prosperity in the country, especially in smaller towns and rural areas. Growth in food production has not kept pace with consumption. Policymakers have more or less given up the attempt to control the rise in food prices hoping that there would be improvements in production this year that would mitigate the price increases. The Reserve Bank of India (RBI)'s attempts to fight inflation is impacting only the real goods and services sector and the RBI has had to play a very cautious role. Monetary tightening might slow down the growth momentum and make capital formation more expensive; there are also signs of industrial output growth slowing. At the same time, consumers are affected by increasing prices. In this dilemma, both monetary and fiscal policy measures for addressing the impact of the QE are quite limited, unlike in other Asian and European countries.

Second, there will be an impact on financial markets that is not yet quantifiable. Since August 2010, equity markets in India have been on a bull run. Considerable investment inflows have taken place from Foreign Institutional Investors (FIIs), who are viewing emerging markets like India as sources of earnings. These inflows have strengthened the Indian rupee against the US dollar and have added to the arbitrage profits that these funds bring. Local funds and retail investors have booked their profits and exited from the market. The consequent domestic liquidity created by local investors booking profits has fuelled consumption leading to an upsurge in sale of luxury goods in the past eight weeks. Robust equity market prices driven by capital inflows are likely to remain and provide fresh opportunities for investors to raise capital. A spate of equity issues have either happened or are in the pipeline. The government has also accessed the equity market for selling shares in public sector companies like the Coal India Limited (CIL) with huge success. As a consequence, government finances are looking healthy, and fiscal deficit targets appear within reach. Government, corporates and individual investors

are keen on maintaining the buoyancy in equity markets without worrying about underlying risks associated with so much 'hot' money, which can fly away as quickly as it came in. Again, unlike other countries, including China, regulators are loathe to consider any curbs on capital inflows, arguing that such moves will slow down capital formation. Equities are a more risky class of investments and given the inflationary pressures, it is natural for savers to move from fixed deposits giving little real returns, to equities for obtaining higher returns.

Third, the capital inflows and expectation of more foreign investment are exerting upward pressure on the rupee, which has gained nearly 16.0 per cent in last five months. The RBI has begun resorting to currency stabilisation measures by purchasing foreign exchange and holding the rupee-dollar rate at around Rs 44.30. Any significant lowering of the exchange rate will adversely affect exporters' revenues. With the current account deficits reaching their highest levels as a proportion of gross domestic product, such measures for maintaining exchange rate levels appear necessary. There are, however, two likely consequences. First, expectations of exchange rate management will encourage more capital inflows with currency risks somewhat mitigated. Second, there will be even more liquidity in the economy through these securitisation measures and that aggravate inflation. Other risky class of investments such as real estate, where there are signs of a fresh bubble forming, might be influenced. The RBI has selectively tightened bank exposure to real estate lending though it may not be adequate. On the trade front, exports have started picking up, with 13.0 per cent growth in September 2010. In the automobile sector, India has become a global source of automobile parts with automobile manufacturing integrating over a global chain similar to textiles. But India's competitive advantage might erode if the rupee continues to strengthen.

In short, India appears vulnerable to the external shocks of the quantitative easing activity, with little leeway to act, without disturbing the growth momentum. The pressures could not have come at a worse time with India struggling with infrastructure deficiencies and governance problems. There is also the concern over what a lower US dollar implies for the Chinese Renminbi. A stronger Chinese currency is not in India's interest given its huge imports from China – not just consumer goods, but also equipment and machinery for power generation and telecommunications. Other Asian countries, Japan and Korea in particular, are also anxious over large inflows of dollars. Both rely heavily on exports. They are considering measures for controlling capital inflows including imposing taxes like Brazil. China is unlikely to be affected as its exports have already factored in a stronger currency and there is considerable diversification of production from China into Myanmar, Bangladesh, Laos, Cambodia and also poorer regions of China with low labour costs. China has been preparing for the currency war since 2008, unlike the US, which has been lurching from monetary expansion to government bailouts. There are already several multinational banks ready to trade Renminbi and the Chinese currency may well emerge as a safe haven along with gold and silver.

In South Asia, Bangladesh, driven by good internal demand, remittances, and growing textile exports, is likely to weather the volatility well, as is Sri Lanka, which is flush with capital inflows and several upcoming projects. Pakistan's fragility is not economic, but more due to security reasons. That leaves India to manage the forthcoming turbulence on her own – and as mentioned, without too much in the armory.

Policymakers in India are aware of the difficulties and several counter measures are likely. First, both the Securities and Exchange Board of India (SEBI) and RBI will closely monitor capital inflows for curbing excess liquidity or market distortions. In particular, real estate stocks and investments would be under close scrutiny. Government revenues are buoyant and the government would try to mop up more funds by selling shares in government companies. Apart from reducing liquidity, this will also mitigate effects of any sterilisation measures for foreign exchange inflows that the RBI may adopt. Second, capital inflows will sustain equity markets, and as corporate performance is reasonable, equity prices are likely to be buoyant. International bond yields may fall with the growing infusion of liquidity reducing the gap between long and short term yields. This may be an opportunity to tap global markets for raising finance for infrastructure. Third, the market activity is likely to keep the economy growing at a healthy pace, though capital formation and progress on infrastructure projects will be closely watched. One is likely to see considerable activity in these areas.

Finally, if QEII succeeds, then it would help the US regain its growth trajectory, a result that would be welcome to India, with opportunities for greater service exports. The Indian Prime Minister Manmohan Singh was among the few who supported the US measures at the G20 in light of their long term advantages rather than their short term volatilities.

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