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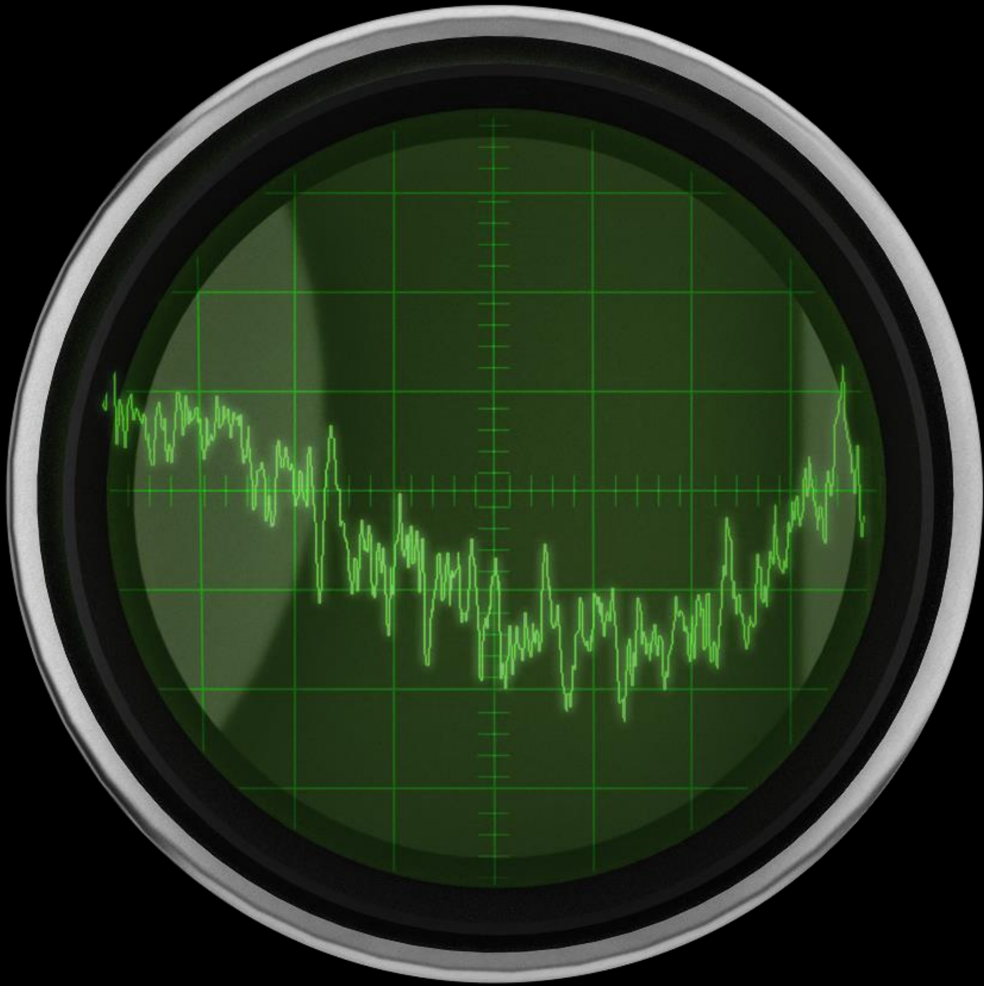


Keeping an eagle eye on two 'I's will be imperative–Inflation and INR

December 2022

A year has passed since the US Federal Reserve first hinted at a taper tipoff (in November 2021). Since February, the Fed has hiked policy rates by 3.75 percent. The Russia–Ukraine crisis, higher commodity prices, and the impending global slowdown weighed on the economic fundamentals and outlook of all nations. India has not been spared as well and these events have led to a slower-than-anticipated recovery in India. The country's GDP grew by 6.3 percent year-over-year in the July–September quarter of FY23 (after the high growth of 13.5 percent in the April–June quarter buoyed by the low base effect). As a result, we have seen a strong possibility of our growth projections being revised down by at least 0.3 ppts from our October forecast.

However, the RBI governor expressed confidence in India's resilience during the monetary policy committee statement in October. **Comparative analysis suggests that India has done well in several economic parameters relative to Advanced Economies (AEs) and a few Emerging Economies (EEs).** However, its economic performance must improve relative to the peer EEs with whom the country is competing for investment.

A key differentiator would be the course India takes in charting inflation and the INR currency (the two I's) trajectories over the next year. **We believe that inflation is expected to be a menace for longer**, due to relatively higher oil prices, a stronger US dollar (USD), and supply chain interruptions in certain industries. Further, a stronger economic recovery may add to the overall pressure.

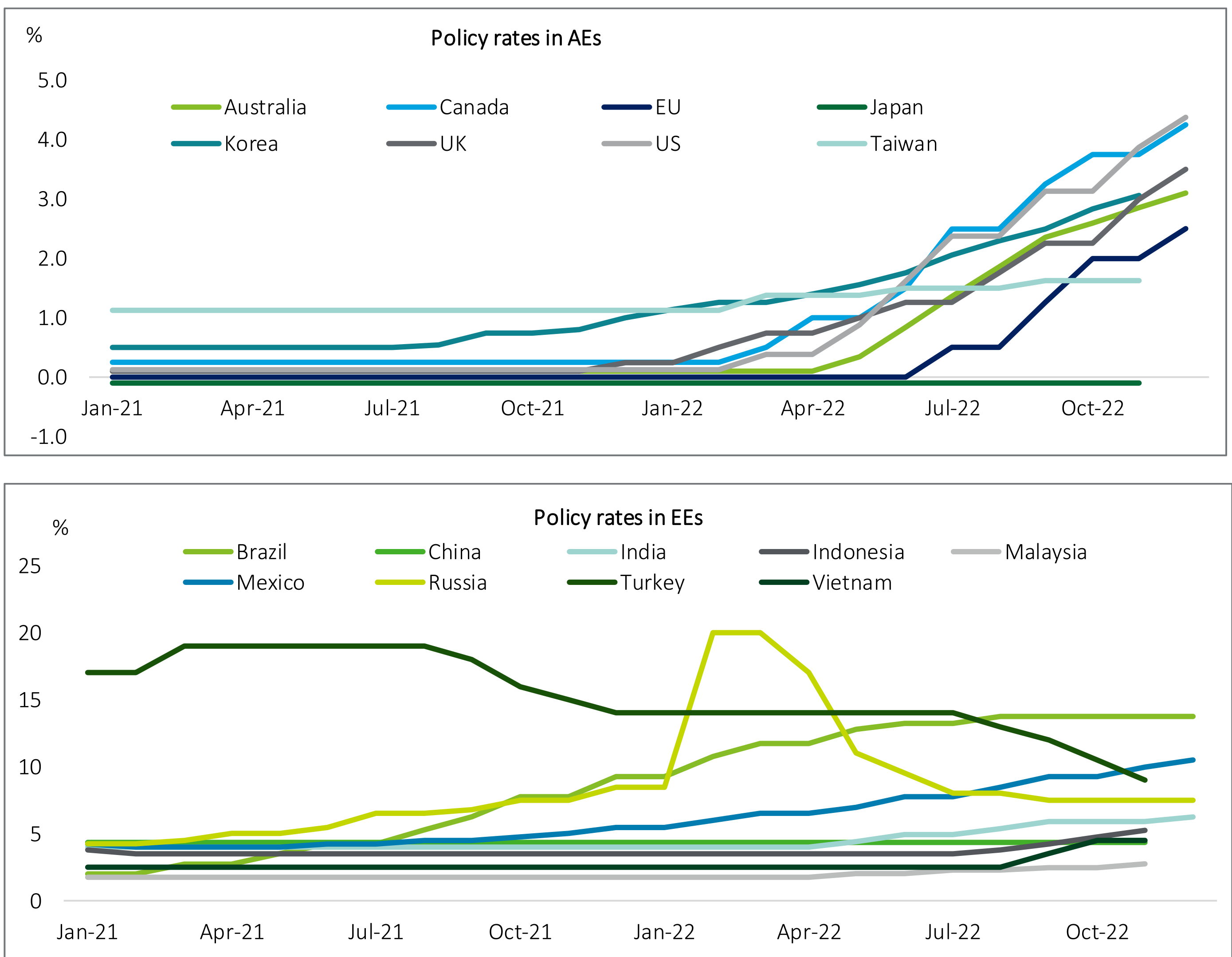
As we examine the curious case of INR currency, **we expect the domestic currency trajectory to reverse** with an improved domestic demand outlook and stronger capital flows. The USD index may also retreat, as seen in the past. However, gains may get offset by a weaker current account balance.

In the face of a global slowdown (implying slow export growth), could the possible solutions be reducing India's import dependence on non-essentials, looking for alternative import destinations, or increasing trade in its own currency?

India fared better on several economic parameters

Across the world, policymakers have pivoted towards tighter monetary policies in a synchronised manner (except in a few countries[1]). The tightening of the policy rates has been aggressive in several countries, particularly in AEs, in terms of both magnitude and frequency. The fact that AEs were far behind the normalisation curve due to the extraordinarily low policy rates for too long, it was possible to raise rates by larger magnitudes. That was not the case with EEs (Figure 1).

Figure 1. A synchronised increase in policy rates across the world



Note: We have clubbed Taiwan and South Korea under AEs per the definition of WB and the IMF.

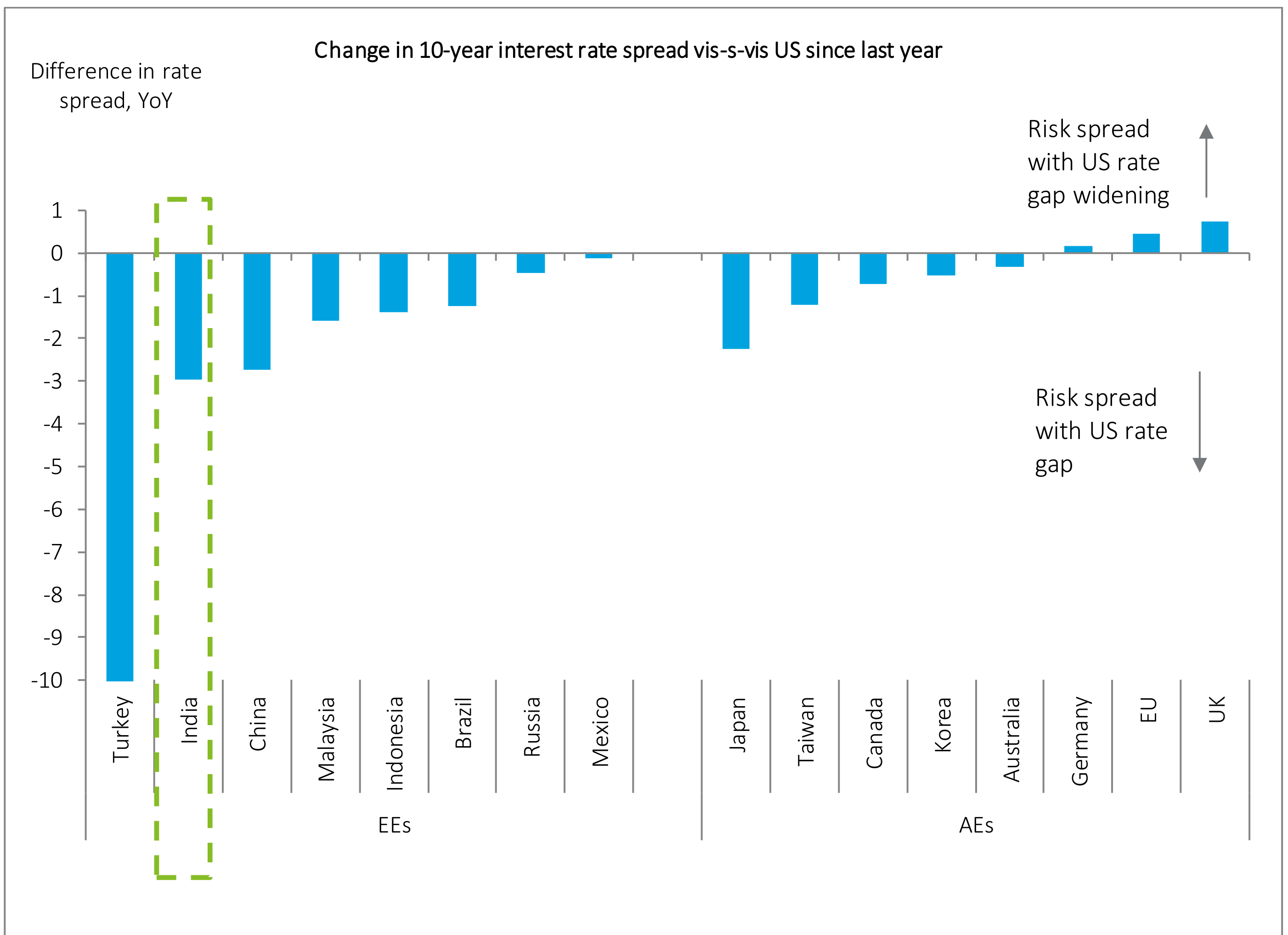
Source: Haver Analytics

[1] China, Russia, Turkey, and Japan are the few nations that have either cut policy rates or have kept them untouched.

As the US aggressively raised its policy rates, **the interest rate differentials (the risk spread) between long-term US bonds and those of other nations started narrowing.** This led to the re-pricing of risks associated with bonds held outside the US, while investment in US bonds became more attractive and safer. Consequently, the US became more attractive in terms of investment (Figure 2).

- The interest rate differential (the risk spread) between the US and India has narrowed despite the RBI raising policy rates to control domestic inflation. This has been one of the causes of capital outflows, as seen in the past.

Figure 2. Interest rate differentials with the US are narrowing for most nations

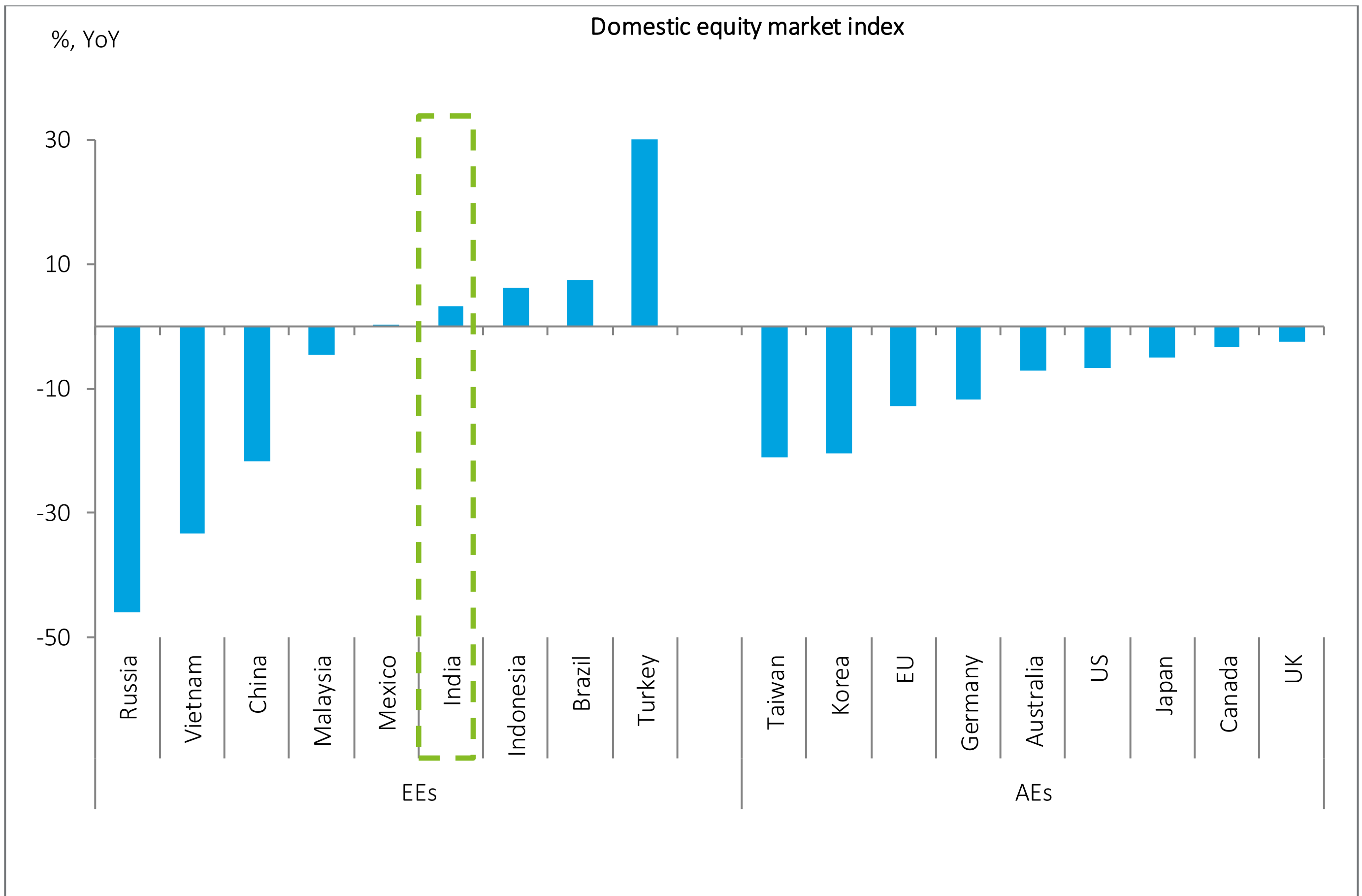


Source: Haver Analytics

The potential impact of liquidity shortages and the prolonged geopolitical crisis reduced the risk appetite of institutional investors worldwide. These investors started pulling money back to the US by selling risky assets (mostly those of the EEs initially) in favour of US securities and cash. Soon AEs started feeling the heat too as their asset prices declined. None of the AEs captured in Figure 3 has seen a rebound yet. A few commodity-backed EEs have started showing some rebound lately.

- **India has been amongst the better-performing nations in the equity markets since October 2022.** Foreign Portfolio Investors (FPIs) pumped in more than INR 36,239 crore in equities during November. Even FDI has seen an improvement since September.

Figure 3. A few nations have seen their equity markets bounce back to levels a year back

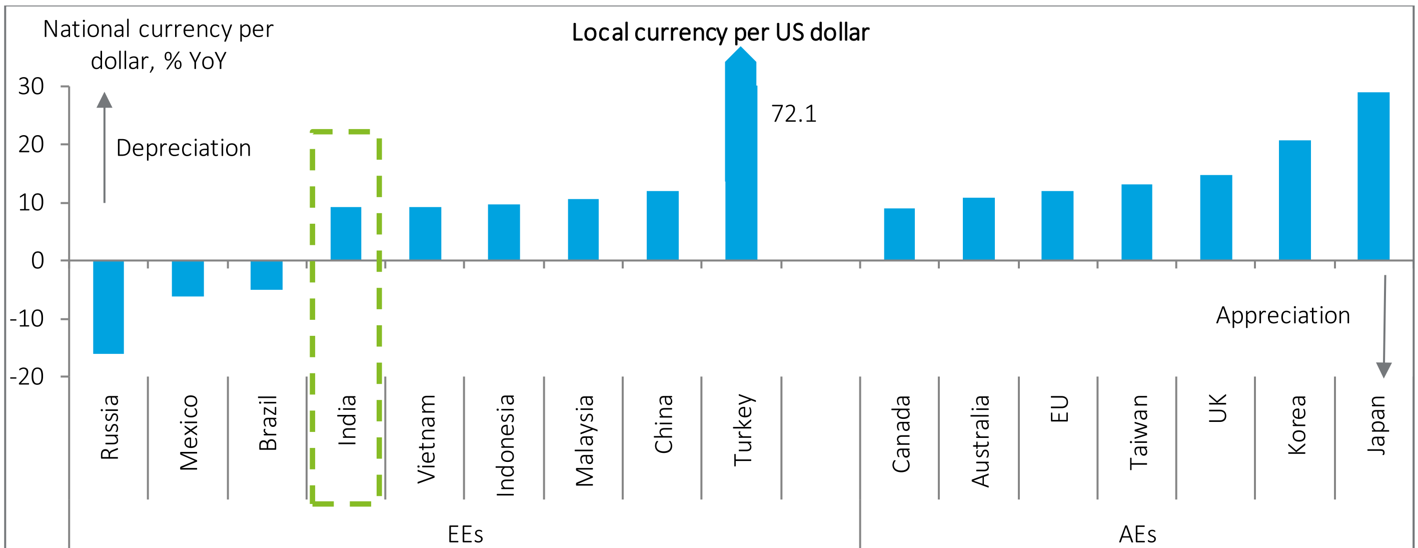


Source: Haver Analytics

Investors have been selling assets and moving to the US, leading to significant capital outflows from the rest of the world. This has led to an unrelenting rise in the USD index while currencies across the world have suffered against the USD (Figure 4). A strengthening dollar not only reflects the higher demand for US fixed-income assets (because US financial markets become more attractive and rising interest rates increase relative return on USD), but also the possibility of global slowdown risks. The tightening monetary policy around the world is expected to reduce demand. China's policy on mobility and the slowdown in the property market has affected its economy.

- Even AEs are hit by USD's appreciation to multi-decade highs in ways that were once more familiar to their EEs. Currencies in AEs have depreciated faster than those in most EEs.
- Commodity-backed currencies, such as Brazil's Reais, Mexico's Peso, and Russia's Rubles, performed strongly. As Russia is trading oil in its own currency (due to international sanctions), its currency Ruble has become stronger.
- Worldwide, the depreciation of currencies against the USD is yet to bottom out (barring the commodity-backed currencies) as the flight of capital to safety continues.
- **INR has performed better; while the USD index increased by 11.9 percent, INR has depreciated by only 9.9 percent against USD.**

Figure 4. The strengthening of USD has led to extreme volatility in currencies across the world

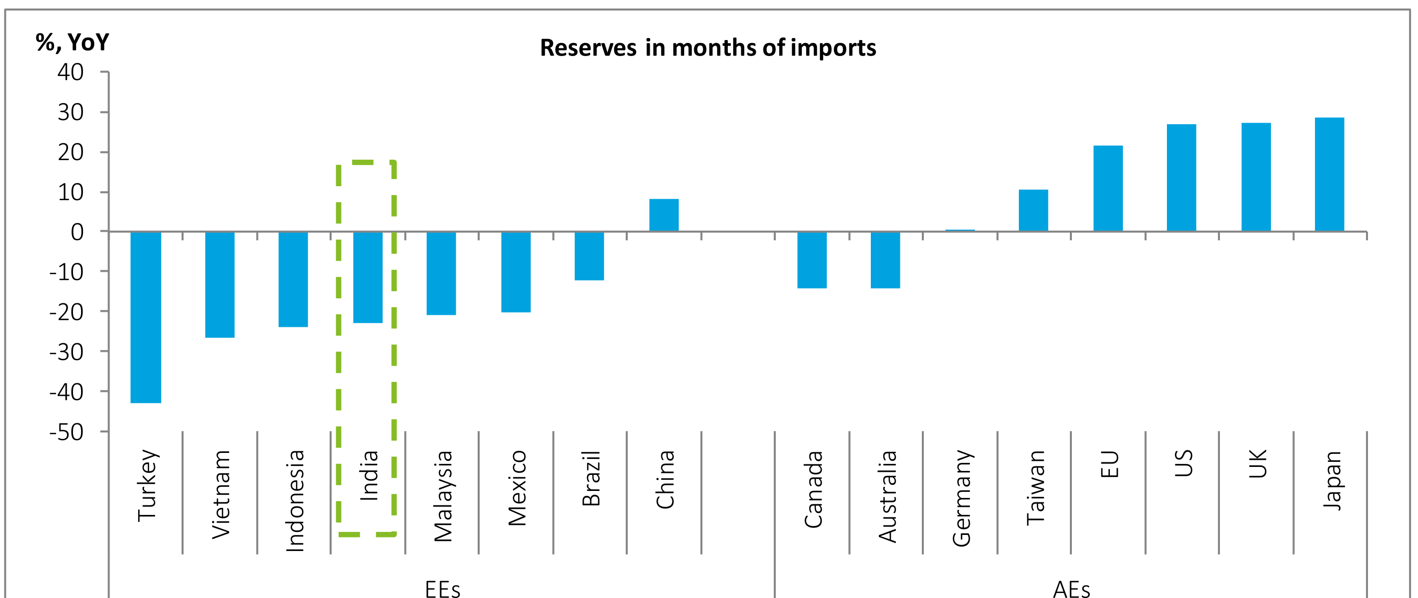


Source: Haver Analytics

Extreme volatility in currencies compelled policymakers of EEs to urgently intervene and correct the course of depreciation. Central banks for almost all EEs dipped into their foreign reserves and sold-off US currencies to halt the local currency depreciation (Figure 5).

- Due to foreign institutional investment outflows and the RBI's intervention to support INR, India's forex reserves declined from 13 months of import cover at the beginning of 2021 to 8 months. However, India is not in a worrisome situation as the country has accumulated sizeable forex reserves over the years (despite having a current account deficit) by importing capital.
- After declining for months, Foreign Direct Investments (FDI) are showing signs of an uptick. **Most importantly, there is a healthy rise in FDI equity flows from Japan, Singapore, the UK, and UAE in H1 FY2022–23. This points to rising confidence amongst global investors to invest in India and India's inflows becoming more diversified.**[2]

Figure 5. Central banks are trying to contain the currency volatility by dipping into their forex reserves



Source: Haver Analytics

[2] https://dpiit.gov.in/sites/default/files/FDI_Factsheet_September_2022_0.pdf

India's pain point - Inflation

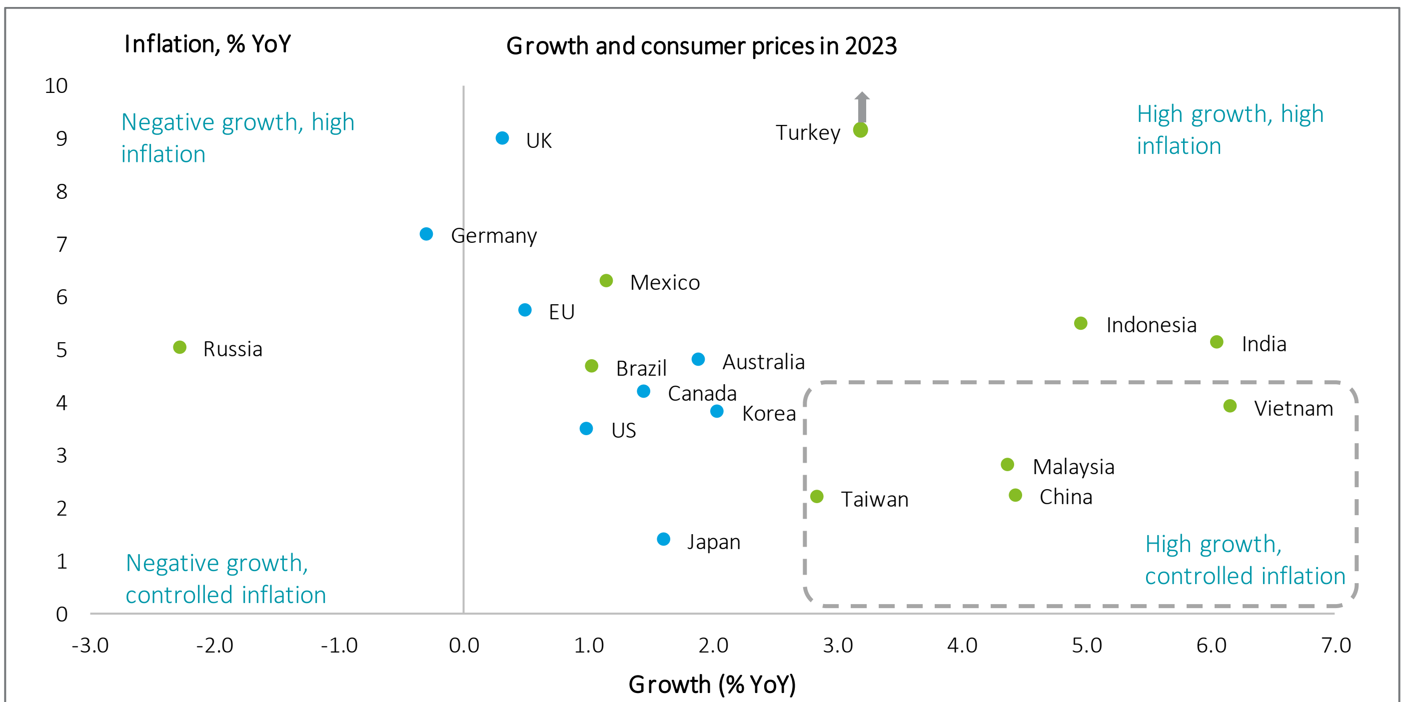
Currently, significant uncertainties and low visibility on the outlook are impairing investment decisions. With time, investors will eventually focus on economic fundamentals and cautiously move out of countries whose economic outlook does not look promising in the long run. The most important criteria for risk assessment of an economy as an investment destination will be the growth outlook and its stability.

Economies with high growth and controlled inflation (within the nation's central bank's target range) are considered low-risk and high-return investment destinations. Strong growth increases the probability of higher returns on investment and low inflation prevents erosion of the value of their investment returns in the long run. In Figure 5, economies are positioned relative to each other based on their real economic growth and consumer price inflation outlook for 2023. Amongst EEs, China, Malaysia, Vietnam, and Taiwan show relatively higher growth and lower inflation. Brazil, Russia, and Mexico are at the other extremes of growth and inflation.

India scores high on growth. Even though the outlook is uncertain, the good news is that high GST and direct tax collections give the government an ammunition to spend and cushion the impact of the impending global slowdown and keep the economy buoyant.

The bad news is that inflation is expected to persist. Higher import costs due to global inflation and elevated oil prices, rising service prices, and improved pricing power amongst producers are expected to translate into higher consumer prices. Higher food prices will persist due to irregular Kharif pulses sowing and paddy production, and inconsistent monsoon in various regions that affect vegetable prices. Core prices have been on the rise and inflation expectations barely show signs of moderation. That said, the high-base effect will come into play next fiscal year (FY 23-24) and easing supply disruptions and softening commodity prices may partly offset. **The growth-inflation dynamics will continue to evolve and containing inflation for India will be imperative.**

Figure 6. Growth and inflation projections for 2023 suggest India must make efforts to contain inflation



Source: Haver Analytics, Forecasts are from IMFWEO

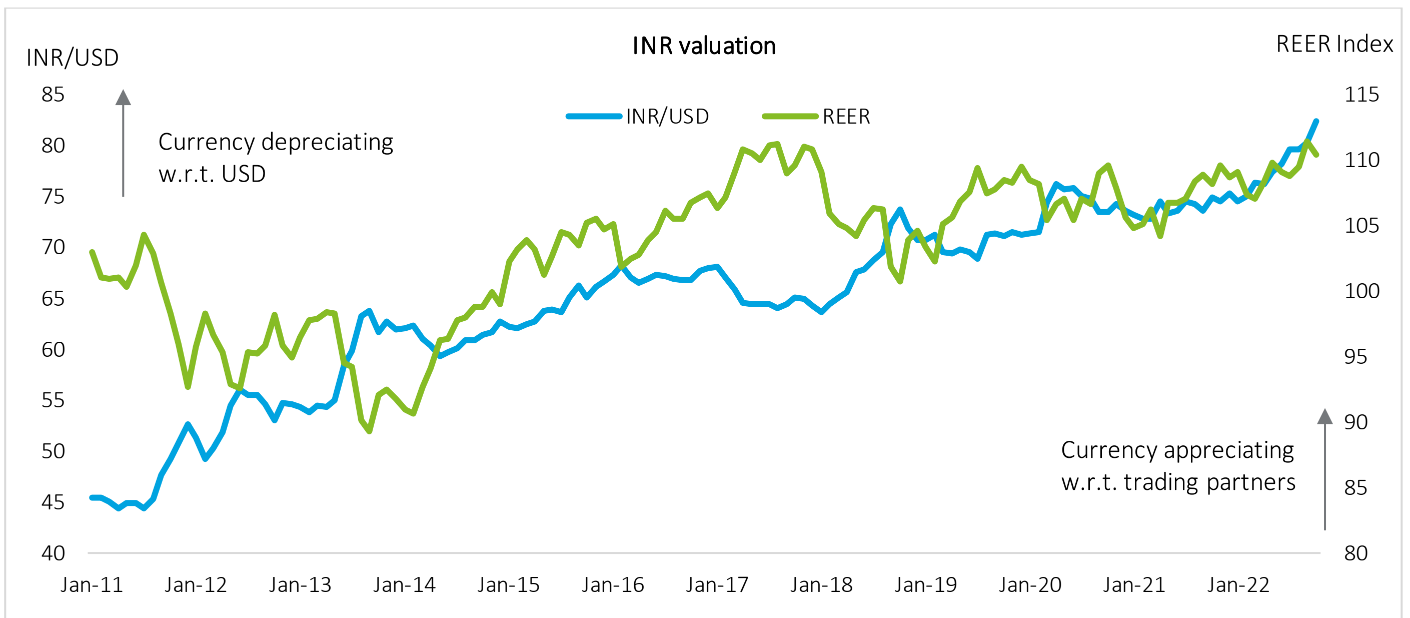
The curious case of currency volatility

The INR depreciation against USD will be another big concern as 86 percent of India's trade is invoiced in dollars[3]. INR has been fluctuating at 81–83 INR/USD, and according to analysts, it may not have bottomed out yet.

That said, INR has appreciated against other major currencies (EUR, Yen, and Pound) and against a few Southeast Asian peers, including Malaysia and Taiwan (Figure 4). More importantly, Real Effective Exchange Rate (REER) has been steady, and Nominal Effective Exchange Rate (NEER) is declining. This suggests that higher domestic inflation has been weighing on India's competitiveness against its trading partners.[4]

We believe that INR will gain some of its lost ground because the magnitude of depreciation has been lower than the appreciation of the USD index (mentioned earlier). Besides, this is the first time in 20 years where INR has appreciated against major currencies, while the REER has remained steady despite its depreciation against USD. In the event of a reversal in USD, and the possible reversal of capital flows into the country (which we are already seeing signs of), INR will appreciate.

Figure 7. INR remains appreciated in real terms



Source: Haver Analytics

[3] https://www.eximbankindia.in/blog/blogcontent.aspx?BlogID=9&BlogTitle=Dollar%20Dominance%20in%20Trade:%20Facts%20and%20Implications

[4] The real effective exchange rate is a nominal effective exchange rate (such as the trade-weighted index) multiplied by the ratio of Indian prices to the prices of our trading partners. Since trade competitiveness is ultimately determined by changes in the price of Indian goods and services relative to foreign goods and services, the REER can be a better measure of trade competitiveness than the NEER. It is often used in analytical work, whereas the other types of exchange rates are more visible in our daily lives.

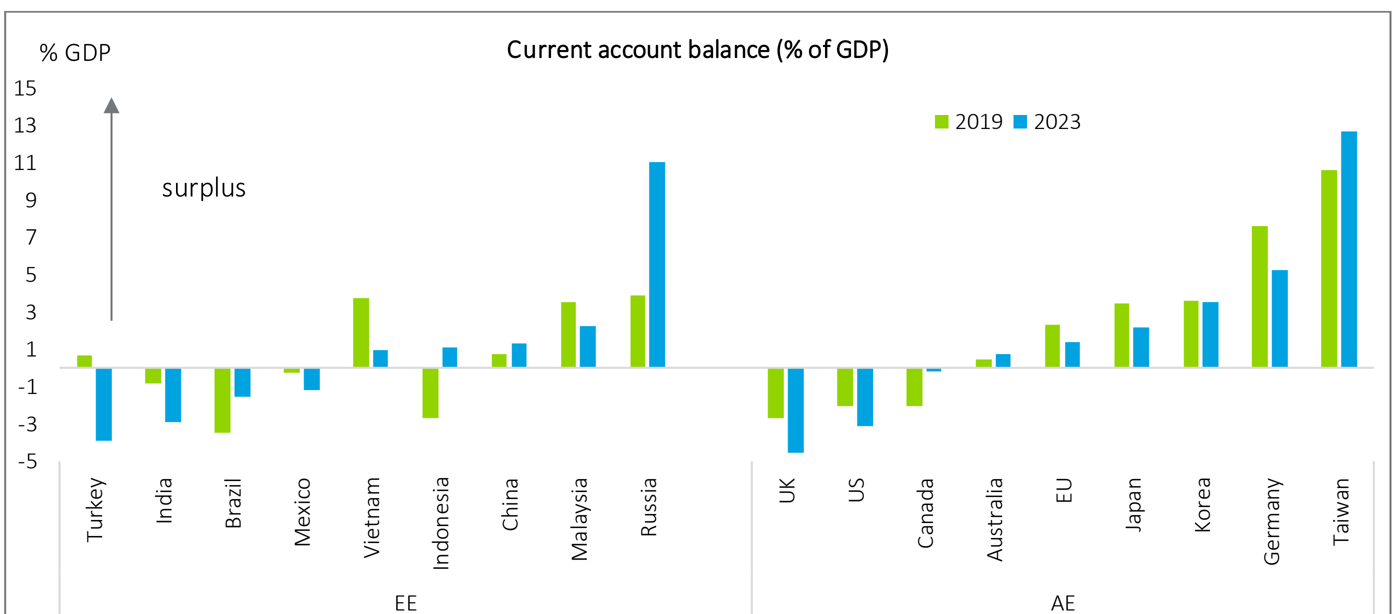
Possible implications

Not always a depreciated currency is bad for an economy. We can expect an increase in exports as we become more competitive. One of the major beneficiaries would be the services sector. For instance, with rapid digitisation, India is expected to see a rise in the export of technical services. A depreciated USD will make our IT services more competitive, and the same holds true for other exporting sectors as well. With the rising emphasis on manufacturing, a competitive INR will only embolden India's bid to attract investors that are willing to diversify supply chains. Multiplier effects of policy initiatives and building infrastructure will kick in to enhance export competitiveness.

The only challenge in this narrative is how demand for exports will shape up over the next year as the world economy slows down. We expect a rebound in domestic demand despite a global slowdown next year and demand for imports to remain high. Expensive imports would feed into higher inflation and lower purchasing power of consumers. Not to mention, a lower value of INR also exerts pressure on imports and 86 percent of India's imports are invoiced in USD.

India is expected to witness a very high Current Account Deficit (CAD). It is the only nation expected to see a sizeable rise in CAD due to higher imports and slower exports. A widening CAD could put further pressure on INR valuation against USD (and **one can see a vicious cycle of depreciated INR and higher CAD at play)**. Consequently, foreign exchange reserves may fall further.

Figure 8. India's current account is expected to worsen relative to other nations



Source: Haver Analytics, Forecasts are from IMFWEO

The pressure on INR is worrisome and India could deal with the situation by restricting imports of non-essentials or looking for alternative cheaper import destinations. In July, the RBI announced the scheme permitting international trade settlement in INR. Can this increase the demand for INR (raising its value) and help reduce India's dependence on USD? Not anytime soon.

On the other hand, inflation will compel the RBI to keep the monetary policy tight. Higher inflation and borrowing rates will likely hurt consumption and investment over the next year, thereby moderating the economic demand.

However, India's resilience will help it sail through these uncertain times and recover at a steady pace. What will be critical is to stay prepared for the time when the global economy recovers. India must do what it takes to keep the economic fundamentals strong; it will not only help India stay ahead of its peers in the investment race but will also aid in a quick economic rebound when uncertainties subside.

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