How vulnerable is our External Sector to US Fed Moves

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The Indian forex market has again come under a significant bout of volatility ever since the Russia Ukraine war started in February 2022. The Indian Rupee has depreciated by more than 7 percent in the current calendar year. RBI has been apparently intervening in the forex market pumping in substantial amount of dollars from its FX reserves to quell the downward spiral of the Rupee and cushion its fall to some extent. From a level of foreign exchange reserves of USD 633 billion in the beginning of 2022, the reserves have declined to a level of USD 571 billion by July 2022 thereby showing a depletion of USD 62 billion. Can this depletion be entirely attributed to RBI selling dollars in the market? Not necessarily. The FX reserves is made up of both US Dollar as well as non USD currencies like Euro, Pound, Australian Dollar, Canadian dollar, etc. Many of these currencies have suffered much more depreciation against the USD than the Indian Rupee. In fact, the Dollar Index (which is made up of major convertible currencies) has appreciated by about 11 percent since the beginning of 2022, thereby clearly indicating that the USD's appreciation has been much more against these currencies than against the Indian Rupee. This gets reflected in the FX reserves of RBI in the form of valuation losses. So, a part of the reserve depletion of USD 62 billion could be attributed to such cross currency movements.

Any stress points in the external sector balance sheet of the country have a tendency to show up in the form of rupee volatility /movements in the Rupee USD forex market. The purpose of this piece is to examine the gravity of the US Fed moves on the external sector balance sheet of India. After an extended period of easy money policy, the US Fed has got into the tightening act, driven by the huge surge in inflation. That the US inflation has hit a 40 year high of 9.1 percent seems to have surprised the US Fed even though anybody with a common understanding of basic economics would have certainly anticipated this surge. It is now becoming increasingly clear that the US Fed has fallen behind the curve and wants to make up for the lost time by way of accelerated hikes in interest rates.

In the process, the US Fed has resorted to successive hikes of 75 basis points each bringing the interest rates to 2.25 to 2.50 percent. The Fed Chairman Powell has indicated that the Fed is likely to effect further rate increases in future although no guidance on quantum of hikes has been provided by him. The market is expecting the US Fed rates to reach 3,25 to 3,5 percent by this calendar year end. How is this likely to impact our external sector?

The normal interest rate differential between India and US has been around 5 percent. Any significant departure from this differential has been seen to heavily influence capital flows in either direction. At present, this differential is at about 2.4 percent, which is much less than the normal level of 5 percent. This has given a huge impetus to the foreign portfolio investors (FPIs) to sell their equity and debt assets in India and move the capital outside the country. The FPIs have so far pulled out approximately USD 30 billion from the start of 2022 both from equity and debt, which is unprecedented in terms of magnitude. This has naturally impacted the Rupee by pulling it down by more than 7 percent against the USD. So, apart from being driven by its own monetary policy considerations, RBI is forced to raise the repo rates in order to widen the interest rate differential between the Rupee and USD, in order to attract FPI flows. But, does this mean that RBI can tune its monetary calibrations in step with the Fed Reserve ? This is virtually not possible for RBI as it tantamounts to placing the domestic considerations on a lower pedestal compared to the interest rates differential factor. Indian policy makers will continue to be driven more by economic growth considerations for a variety of reasons. One, RBI considers the surge in inflation to 7 percent as transitory and it is expected to trend down shortly. Second, as evidences of inflation trending down becomes clearer, RBI will have to think of switching over to a neutral policy stance quickly in order not to derail the growth prospects. For an emerging economy like India, keeping the growth engines on is a must from the angles of containing fiscal deficit, keeping the current account deficit minimal as also to provide better employment potential. Given these important considerations, India will have to chalk out its own monetary policy path without being swerved entirely by externalities.

That the RBI has already started looking at other avenues (than just the policy interest rates) to attract FPI flows is quite clear from the measures that it has rolled out recently. These measures involve relaxations in respect of NRI deposits, External commercial borrowings, FPI investments in Rupee bonds and Foreign currency lending by banks. RBI is quite conscious of the fact that repo rate is too blunt an instrument to be used to attract FPI flows beyond a point as it can cut both ways. Given this well known stance of RBI, RBI may not prefer to go lockstep with US Fed in terms of interest rates.

Yet another measure rolled out by RBI pertains to permitting invoicing, payment and settlement in Indian rupees of external trade transactions. This can bring about immediate significant savings in foreign exchange at least in respect of transactions with countries like Russia, Srilanka , Iran etc; more particularly, it should ease up oil purchase transactions from Russia since Russia also cannot transact in US dollars. But the long term benefits of the measure are still debatable, as INR is not a convertible currency. Russia will be permitted to accumulate rupees in Vostro accounts and invest in Indian government securities. But, as long as Russia has a huge trade surplus with India, there is no way of using up this rupee accumulation. At some point, Russia may like to repatriate. But the moot question is, repatriate in which currency ?

India's current account deficit is expected to touch 3 to 3.2 percent in the current FY. Funding a deficit of this magnitude is going to be a colossal issue if the foreign inflows continue to be lacklustre. While the measures rolled out by RBI as discussed above may, to some extent, mitigate the gravity of the issue, it is still most likely that the CAD will be about USD 120 billion in absolute terms. Unless there is a significant reversal in the trend of capital flows, FX reserves will be forced to bear the brunt of CAD. It is worthwhile to note that the FX reserves of the country have already come down by about USD 70 billion from the peak touched in September 2021 of USD 642 billion. It provides an import cover of just about 8 months and any further decline in reserves may itself spook the market sentiments. So, the most important question that the RBI will be confronted with is : Should FX intervention be scaled down in the face of US Fed rate hikes and should Rupee be allowed to fall albeit in a smooth curve ? This is really a million / billion dollar question as rupee fall has ramifications in terms of inflation as well as country's fiscal deficit. There is felt need to control the fiscal deficit and the Debt to GDP ratio in order not to attract the adverse attention of the Rating agencies. It will, therefore, be interesting to watch RBI as to how it will deal with this issue in the months ahead. Equally interesting will be US Fed moves. US Fed has indicated that it will bring down inflation "whatever it takes to". What does this mean? Will the US Fed push the interest rates higher and higher? This will only result in crash landing of the US economy and the country getting gripped in inexorable recession. Are the US policy makers prepared for such a trade off ?