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Ramifications of the Fed taper

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How prepared is India this time around?

Highlights

- The shifting landscape of monetary policy in the United States (US) could test vulnerabilities of emerging markets (EMs) such as India in coming months
- With economic recovery under its belt, the US Federal Reserve (Fed) is likely to begin the process of 'normalisation' of monetary policy, first by tapering its asset purchases. This could have two major global fallouts. One, other central banks would follow suit. Two, it would spell the beginning of a gradual draw-down of ample global liquidity
- S&P Global expects the Fed to start tapering by 2021-end, with the Fed Chair indicating as much at the recent Jackson Hole symposium. However, normalisation is expected to be gradual, with a hike in policy rates expected only from 2023
- Compared with 2013, India's external position is much stronger on account of a lower current account deficit (CAD) and larger forex reserves to cover short-term liabilities
- Domestic macros, however, remain weak, though recovering. Gross domestic product (GDP) is moving towards pre-pandemic levels, but its pace lags EM peers such as China and Turkey. High inflation and public debt persist, ranking weaker than those of other EMs

The US Fed Chair Jerome Powell's virtual address at the Jackson Hole symposium last week holds some vital clues on what the Federal Open Market Committee (FOMC) might do when it convenes in September.

During the Covid-19 pandemic, the Fed brought short-term interest rates to near-zero and restarted large-scale bond purchases (of $120 billion each month), referred to as quantitative easing (QE).

QE has the effect of lowering yields, and significantly easing US financial conditions (see chart below).

Normalisation works in the reverse. It would begin with the Fed buying fewer bonds – hence 'tapering' – followed by raising of policy rates.

The last leg would be balance sheet reduction or sale of assets purchased. That could extend over years.

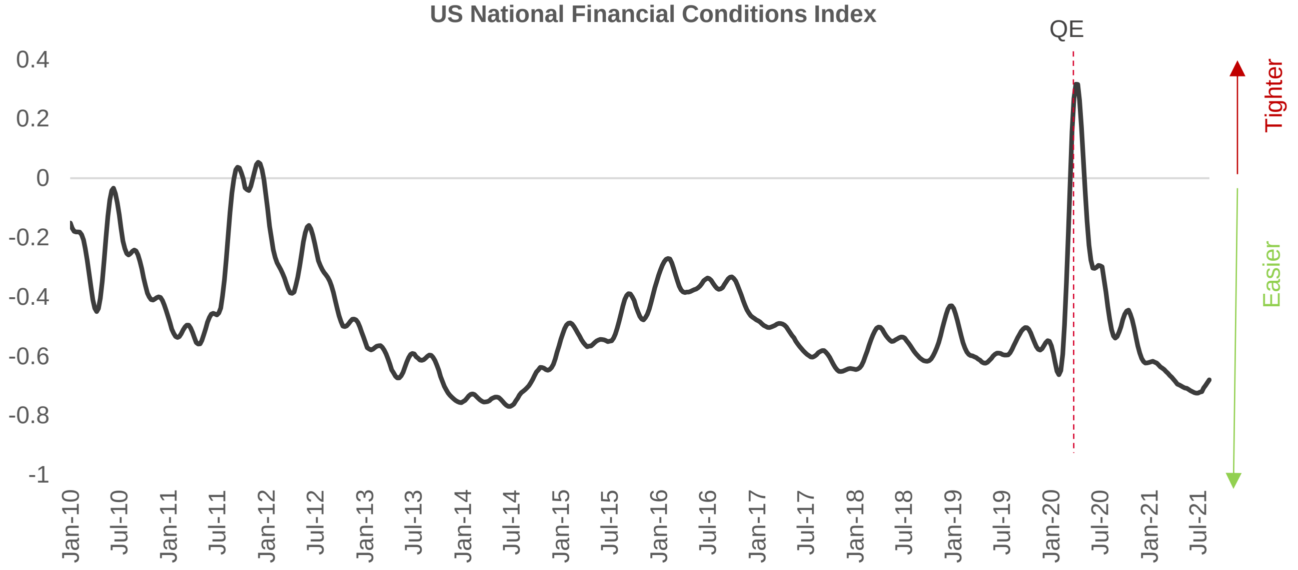
Compared with 2013, the Fed is being more cautious in normalisation this time, prioritising economic recovery even as inflation remains above their target. Powell also stated explicitly: though the Fed sees conditions ripe to begin tapering, the move is not intended to carry a signal on hiking policy rates, for which it has different and more stringent tests.

Thus, financial conditions have been unscathed so far.

But if we take a view longer than here and now, many unknowns lurk in the path to normalisation.

Historically, a shift in Fed's stance has shaken global risk sentiments of investors and caused capital outflows from EMs. In this Insight, we take a close look at what a potential tightening in global financial conditions as an outcome of Fed moves could mean for India.

US financial conditions eased significantly after Fed resumed QE



Source: Federal Reserve Bank of Chicago, CRISIL

All signs point to tapering by end-2021

Powell said from Jackson Hole that, against the Fed's earlier articulated guidance of continuing QE at the current pace until they make substantial further progress towards their targets on inflation and employment, his view was the "substantial further progress" test had been met for inflation. He also saw clear progress toward maximum employment.

Most participants at the July FOMC meet, including Powell, had echoed the view that "if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year."

S&P Global also expects the Fed to start tapering by 2021-end for over a year, post which the first rate hike is expected in early 2023.

For EMs such as India, normalisation talk evokes painful memories of the 2013 'taper tantrum', when currencies had nosedived 10-30% against the US dollar (*see annexure)*.

The worst-performing currency among EMs in 2013 was the Indonesian rupiah – depreciating 26.5%. India followed closely, with the rupee depreciating 14% on average, making it part of the 'fragile five'. At that time, the Reserve Bank of India (RBI) had to step in to support the currency in a big way.

Other than the risk of capital exit, tapering would come at a time when EMs are lagging advanced economies in post-pandemic recovery. Moreover, though the Fed appears confident about inflation for now, any surprises on the upside for an extended period of time could prompt a faster-than-expected normalisation.

Fed action and Indian reaction

Broadly, we believe the intensity of the normalisation shock this time could be less sharp than in the previous instances. In terms of India's vulnerability, though, a mixed picture emerges.

India is currently stronger externally and weaker domestically. Indeed, it will wear the shock depending on its health on both these fronts.

How will the ripples pan out?

- **Normalisation will be gradual.** The Fed is expected to begin with tapering asset purchases, i.e. continuing them, albeit at a lower magnitude. S&P Global estimates[1] an additional $1-1.5 trillion of QE is still possible before tapering is completed, probably by next year. Moreover, note that Powell said in his speech, “Even after our asset purchases end, our elevated holdings of longer-term securities will continue to support accommodative financial conditions.” Therefore, the beginning of tapering is not likely to result in significant reduction in liquidity in the near term. Even the previous time, the Fed had tapered over a period of 10 months. This time, it has also communicated its tapering plans well in advance to minimise potential market disruptions. Further, it has specified that the decision to taper will be independent of the timing of hike in policy rate. The latter will depend on a different and substantially more stringent test.
- **Right-sizing the balance sheet is also some time away**. The Fed’s balance sheet had ballooned to 36% of GDP as of July 2021, compared with 16% pre-pandemic (December 2019), and 6-6.5% in the pre-Global Financial Crisis period. This will have to be brought down over time. S&P Global believes that unwinding of QE-related asset purchases and bank reserves could stretch for over a decade. Even an aggressive asset sale, if pursued, would take about five years[2].

Where are India’s weak spots?

- **The external position is stronger than in 2013**. India’s current account deficit (CAD) is expected to be lower in fiscal 2022 than in fiscal 2014. Coupled with stable external debt, total external liabilities are expected to remain in the safe zone in the current year. The forex shield is tougher as the reserves adequately cover the country’s short-term debt liabilities and ~14 months of imports (**see Table 1**).
- **Domestic macroeconomic health has elements of weakness**. Even with the strong GDP growth of 9.5% this fiscal, we expect, GDP would be a mere 1.5% over the pre-pandemic (fiscal 2020) level. We expect CPI inflation at 5.8% this fiscal. While lower than in fiscal 2014, it could still worry investors as it comes over a high base of last year. Also, the government’s debt position is worse off.
- **Macro indicators are average compared with EM peers’**. India ranks fourth in terms of catch-up of expected GDP this fiscal to pre-pandemic level, third in terms of inflation rate, and first in ratio of government debt to GDP, compared with six other key EM peers (**see Table 2**).

How vulnerable is India this time?

Withdrawal of monetary stimulus leads to ‘risk-off’ behaviour, causing capital to leave weaker EMs for safe-haven, advanced markets.

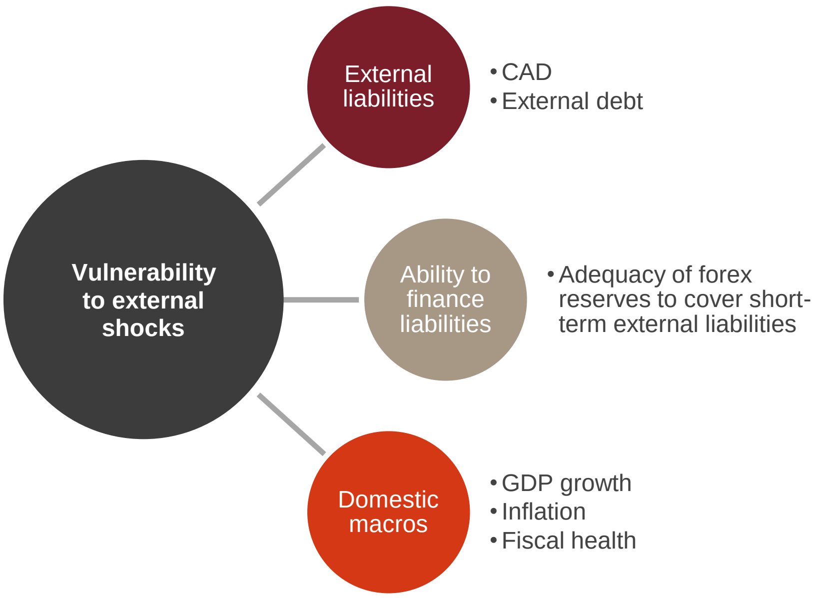
[1] S&P Global (August 2021), ‘*Complete Fed Balance Sheet Normalisation Is Still Years Away*’
[2] S&P Global (August 2021), ‘*Complete Fed Balance Sheet Normalisation Is Still Years Away*’

The impact of capital outflow on a country's currency depends on the size of external liabilities, and its central bank's ability to mitigate such risks using its forex reserves.

Investor sentiment towards an EM is further influenced by its domestic macroeconomic health, as gauged by GDP growth, inflation and fiscal deficit. Fiscal health has particularly become a key monitorable post pandemic, as EMs have been providing policy support to their economies amid limited fiscal space.

Thus, the nature and quantum of stimulus given will also have a bearing on their fiscal deficits and borrowing requirements. **Table 1** shows how India currently fares on these parameters.

Parameters to track



For better perspective, we also compare India's present vulnerabilities to two previous episodes of tighter global conditions impacting Indian markets in the past decade:

- 2013 (or fiscal 2014) – when Fed announced tapering post global financial crisis; and
- 2018 (fiscal 2019) – when Fed tightening peaked with four rate hikes that year

External liabilities in the safe zone

- India's current account is expected to move into deficit zone after briefly going into the surplus last year. However, we still expect CAD-to-GDP to be lower than that seen in fiscals 2014 and 2018. This is because domestic demand is still weak, having been hit by two pandemic waves. We expect CAD to average 1.2% of GDP in fiscal 2022, compared with 2.1% in fiscal 2019 and 1.7% in fiscal 2013.
- India's external debt did not increase materially even post pandemic. At end-fiscal 2021, overall external debt relative to GDP was slightly lower than in fiscal 2014, and similar to that in fiscal 2019. The proportion of short-term debt[3] within external debt (at 17.7%) was lower than in fiscals 2014 (at 20.5%) and 2019 (at 20%) as well.

[3] Based on original maturity

Forex reserves adequate to cover short-term debt liabilities and 14 months of imports

- Fiscal 2021 saw a record accumulation of forex reserves, by ~$105 billion on-year to $579 billion. This happened as foreign capital flows rose while the current account turned surplus. The rise has continued in the current fiscal as well, with reserves reaching $620 billion in July.
- The adequacy of forex reserves needs to be seen relative to the amount of short-term external liabilities the country owes to the rest of the world. One way to gauge this would be to measure the number of months of imports that reserves can finance. In fiscal 2022 (up to July), India had reserves that could cover ~14 months of imports. This is much higher than the import cover of 8 and 9 months available during fiscals 2014 and 2019, respectively. A broader measure would be to view reserves relative to total short-term external liabilities (i.e. CAD + short-term external debt). According to the Guidotti-Greenspan rule, reserves are considered adequate if this ratio is greater than one. At end-fiscal 2021, this ratio was at 7.5 for India.
- However, as the June 2021 RBI bulletin notes, forex reserves are also subject to valuation changes[4], which might affect their adequacy. India's current import cover is lower than that of countries like China, Russia, Japan and Switzerland.

Domestic macros weaker after pandemic

- While India remains comfortable on the external account front, domestic fundamentals are much weaker than in the past.
- The expected GDP growth of 9.5% on-year this fiscal is optically better than in fiscals 2014 and 2019. However, it would come on a low base of the previous fiscal, taking GDP to merely 1.5% above the pre-pandemic level of fiscal 2020. The extent of the third wave and pace of vaccinations would also affect the growth trajectory and investor sentiments.
- Inflation is expected to remain elevated at 5.8% this fiscal over an already high base of 6.2% previous fiscal. While that is expected to be lower than what prevailed during the taper tantrum in fiscal 2014, it would be higher than in fiscal 2019.
- Fiscal deficit of Centre and states is expected to remain higher than the pre-pandemic level, with total government debt at over 90% of GDP. That is also much higher than in fiscals 2014 and 2019.

[4] A valuation gain reflects depreciation of US dollar against major currencies and increase in gold prices, and vice versa

Table 1: India's vulnerability to Fed shocks in three spots

Taper tantrum (FY14) / Four Fed rate hikes (FY19)

	Indicator	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22 F
External liabilities	CAD (% of GDP)	2.7	4.3	4.8	1.7	1.3	1.1	0.6	1.8	2.1	0.9	-0.9	1.2
	External debt (% of GDP)	18.6	21.1	22.4	23.9	23.8	23.4	19.9	20.1	20.0	20.6	21.1	N/A
	- Short-term external debt (% of GDP)	3.9	4.3	5.3	4.9	4.2	4.0	3.8	3.9	4.0	3.7	3.8	N/A
Adequacy of forex reserves	Months of import cover	9.4	7.6	7.2	7.7	8.7	11.2	11.5	10.4	9.4	11.4	18.0	14.1 (YTD)
	Reserves/(short-term debt + CAD)	2.7	1.9	1.6	2.5	3.0	3.4	3.6	2.8	2.5	3.6	7.5	N/A
Domestic macro-economic health	GDP growth (% y-o-y)	8.5	5.2	5.5	6.4	7.4	8.0	8.3	6.8	6.5	4.0	-7.3	9.5
	CPI inflation (% y-o-y)	10.4	8.4	9.9	9.4	5.9	4.9	4.5	3.6	3.4	4.8	6.2	5.8
	General government deficit (% of GDP)	8.6	8.3	7.5	7.0	7.1	7.4	7.4	6.7	6.6	7.6	14.2*	11.7*
	General government gross debt (% of GDP)	66.0	68.3	67.7	67.4	66.8	68.8	68.7	69.5	70.2	73.9	90.2*	90.5*

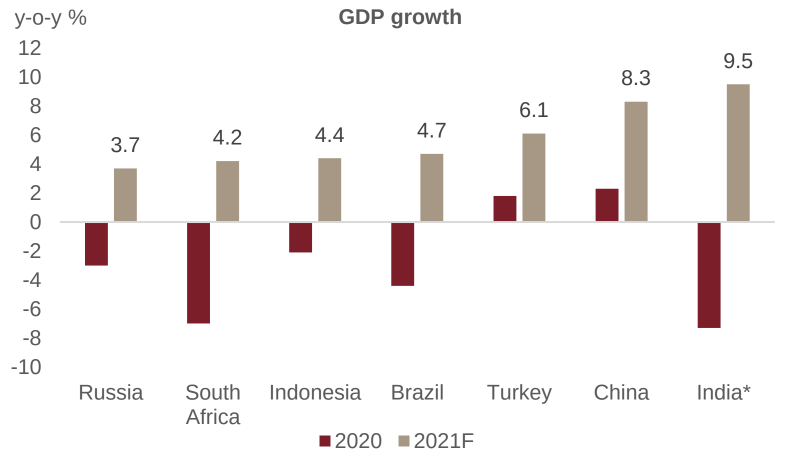
Vulnerability indicator: High vulnerability | Low vulnerability | Neutral vulnerability

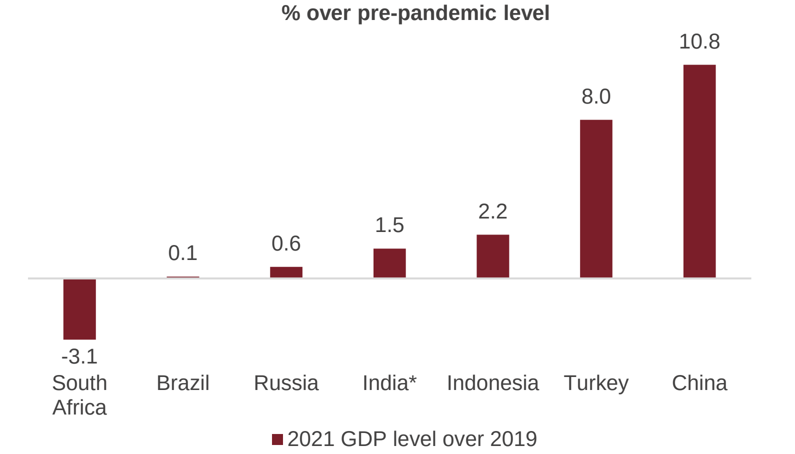
Note: Short-term debt data is for original maturity; *forecasts by S&P Ratings, rest are CRISIL's forecasts; YTD till July 2021

Source: RBI, National Statistics Office, CEIC, International Monetary Fund, S&P Global, CRISIL

Table 2: Macro indicators, India vs EM peers

- India is expected to record the strongest GDP growth rate among peers this fiscal, but that would come over an extremely low base of last fiscal
- India's GDP this fiscal is expected to be 1.5% higher than pre-pandemic level (fiscal 2020). That's a weaker rebound than that of China, Turkey and Indonesia, but stronger than South Africa, Brazil and Russia





Note: *For India, 2020 is taken as synonymous with fiscal 2021, and 2021 with fiscal 2022. 2021 calendar year forecasts are by S&P Global

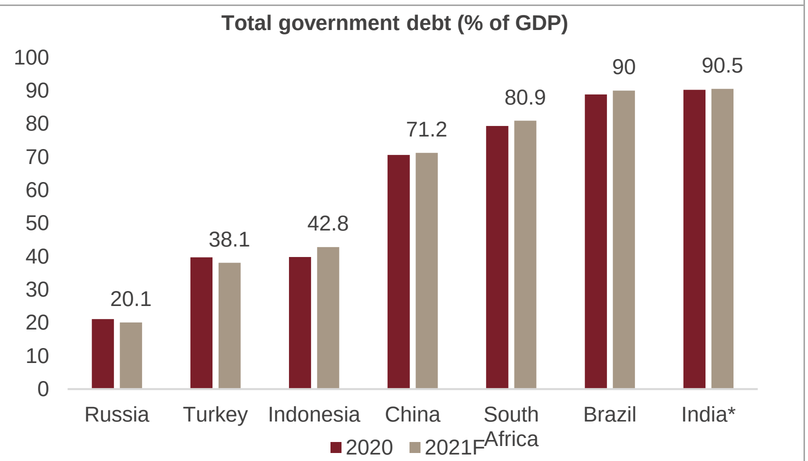
Source: S&P Global, IMF, CRISIL

- India's inflation is expected to be the third-highest among EM peers, lower than only Brazil's and Turkey's

Note: * For India, 2020 is taken as synonymous with fiscal 2021, and 2021 with fiscal 2022. 2021 calendar year forecasts are by S&P Global

Source: S&P Global, IMF, CRISIL

- India's government debt-to-GDP ratio is the highest among peers



Note: * For India, 2020 is taken as synonymous with fiscal 2021, and 2021 with fiscal 2022. 2021 calendar year forecasts are by S&P Global

Source: S&P Global, CRISIL

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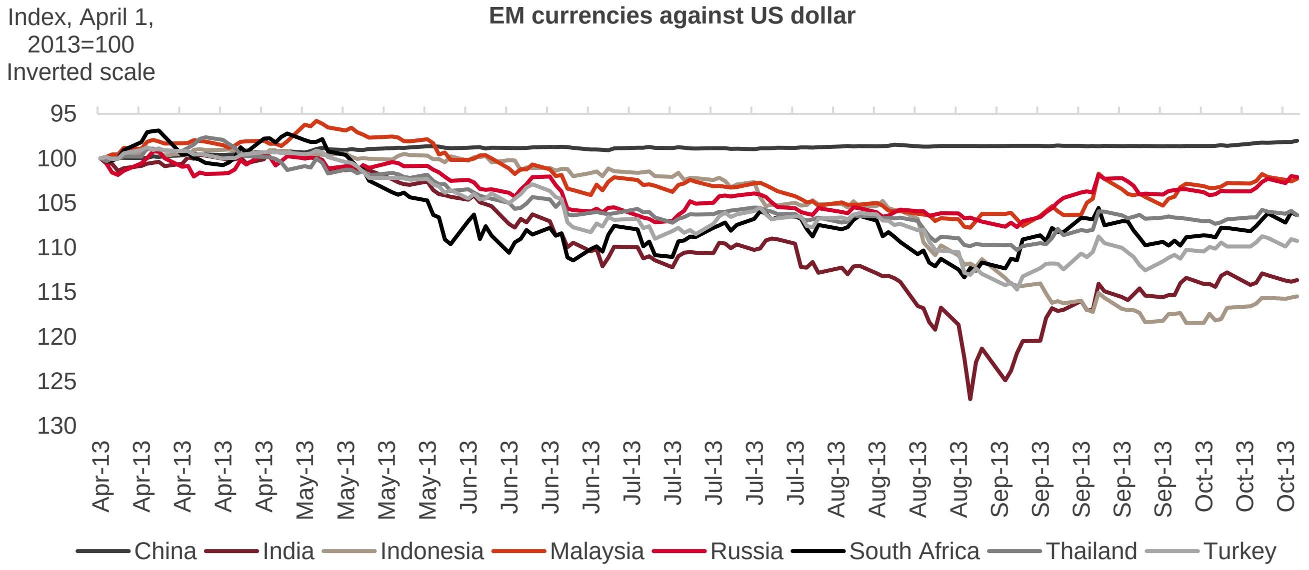
Annexure

Tumult after the 2013 taper



Source: University of British Columbia, CRISIL

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