

HOW WOULD INDIA'S EXTERNAL SECTOR LOOK POST COVID? CAREFUL REVIEW OF RUPEE AND CAPITAL FLOWS REQUIRED OVER MEDIUM TERM

Issue No. 19, FY21
Date: 08 June 2020

The world is witnessing a crisis with COVID which is all encompassing and the devastation in economic terms is huge. Although the 2008 Sub-Prime crisis and the ensuing European Sovereign Debt crisis exposed the fragility of the developed nations as well, the fact is that for emerging markets any crisis throws up humongous challenges as they have to fight the battle at the domestic, as well as external front, with limited resources. Rating agencies watch their metrics like a hawk and the investors are also not as forgiving about any lapses in the macro-economic parameters. Then there is the issue of contagion. An emerging economy could have sound metrics, however it can see its external metrics deteriorating substantially, if something goes wrong in other emerging market economies! Against this background, how would India's external sector look post COVID? **We cite here 2 asymmetric responses of Rupee following the Asian crisis and Global Financial crisis.**

First, in the 2008 crisis global financial crisis, rupee had lost more than 20% of its value, but that happened only with a lag. Specifically, in just the years following the crisis, non debt capital flows had jumped significantly, thus mitigating to a large extent the outflow in portfolio capital flows which happened in 2008. However, post 2011 when the US economy got downgraded and India started to face growth challenges, widening deficit on current account, the composition of capital flows turned adverse with more of short term volatile flows taking precedence. Things came to a pass in 2013 following the taper tantrum. However, as the current account deficit narrowed over the years on the back of lower crude prices, the rupee stabilised. **However, the important metric for such rupee disturbance was the adverse composition of capital flows and the growth metric!**

Second, when the 1997-98 Asian crisis unfolded Rupee did not see massive fluctuations as our Current Account Deficit was largely under control. Additionally, there were capital controls.

So how will Rupee behave post COVID? An answer to such will depend on our positioning of the External Sector. RBI has clearly stated that a diversified capital account, with a hierarchical preference for FDI over debt flows, and for long-term flows over short-term flows, should always be the focus of external sector policy. During the 1997-98 crisis, the average non debt component of net capital flows for the 4 year period beginning FY97 was 45% and did not witness any significant volatility. In contrast, the periods prior and post global financial crisis witnessed rapid volatility in debt creating flows as well as non debt capital flows. The primary reason for such was the significant growth overhang that the Indian economy had faced (growth had declined from a high of 8.5% in FY11 to 5.2% in FY12) . Although, the growth recovered thereafter to 6.4% in FY14, the impact on rupee came with a lag!

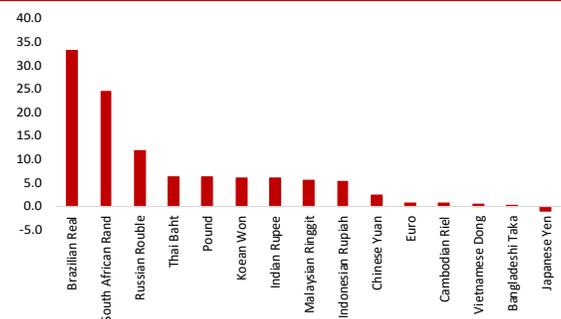
We are facing similar growth challenges now, with GDP growth declining from 8.3% in FY17 to 4.2% in FY20. The FY21 median growth contraction is currently at 5%, indicating a growth collapse of at least 9% from FY20 levels because of COVID. The only saving grace is that our external debt position is sustainable with the external debt to GDP ratio at 19.8% at end-June 2019. **We thus should be mindful of our external sector in FY21 as a prolonged period of growth slowdown could impact the external sector metrics, specifically the rupee. In FY21, we maintain that India is going to achieve a current account surplus owing to lower oil prices, although the magnitude might shrink if oil prices show undue volatility and stay at over \$40 /bbl for a sufficiently longer period of time.**

Meanwhile, for the first 7 days of June, India has tested on an average 1.32 lakh samples, with the number crossing 1.4 lakh on June 6 and June 7. This is perhaps the reason why the cases have started increasing at a much faster rate. The positivity rate has now moved up to 7% in the first 7 days of June from an average of 4.7% during March 27 till May 31. Based on the current 7-days moving average of new cases witnessed in India, we now believe that peak of new cases will get pushed back further and is likely to peak somewhere anytime in the second half of July. But this is based purely on current assessment, that can rapidly change.

CURRENT ECONOMIC SCENARIO

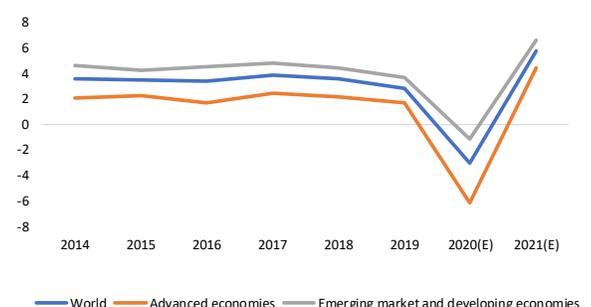
- ◆ The world is witnessing a crisis which is all encompassing. The devastation in economic terms is huge, with GDP projections getting farther and farther into the negative territory. IMF projects global growth in 2020 to fall to -3%. This makes the Great Lockdown the worst recession since the Great Depression, and far worse than the Global Financial Crisis.
- ◆ The loss of lives so far has been the greatest in the developed nations. However, with the amount of resources at their disposal, it is possible that their economic hardships faced by their citizens will be lesser. It is the emerging market economies which are highly vulnerable right now as they are already working with scarce resources and the restrictions due to COVID-19 will push down growth further. To top it all, they often rely on external borrowing and other capital inflows for financing their Current Account and thus are especially vulnerable to reversal in investor sentiment.
- ◆ Although, the 2008 Sub-Prime crisis and the ensuing European Sovereign Debt crisis have exposed the fragility of the developed nations as well, the fact is that for emerging markets any crisis throws up challenges which have to be fought with lesser resources. They have to fight the battle at the domestic, as well as, external front. The rating agencies watch their metrics like a hawk and the investors are also not as forgiving about any lapses in the macro-economic parameters.
- ◆ Then there is the issue of contagion. A country could have sound metrics, but because it is an emerging market economy, it can see its external metrics deteriorating substantially, if something goes wrong in other emerging market economies. Although the Eurozone debt crisis spread to many European nations, they have a common currency and a common central bank which could be one reason for the panic spreading across nations. With developing nations, this is not the case. Despite having different fundamentals and currencies they can become the victim of the investors' mindset. With the current situation toppling growth and raising uncertainties, developing nations have to keep an eye on the external metrics to see how they are positioned to handle this crisis and they have to keep inspiring confidence through their policy actions.

Currency Dynamics



Source: SBI Research, +Indicates Depreciation, between 01 Jan '20 and 01 Jun '20

GDP Growth (%)



Source: IMF

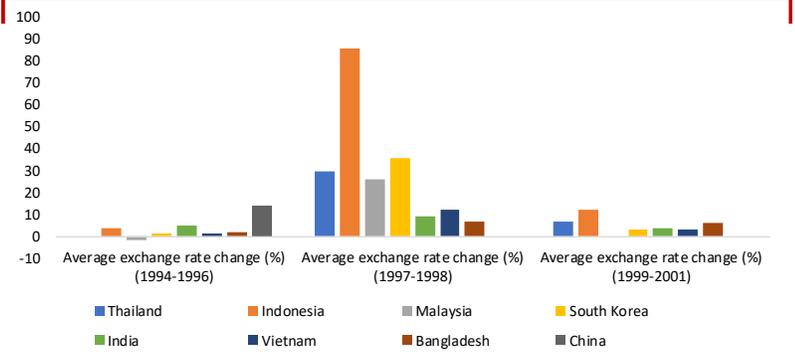
SYNOPSIS OF PAST CRISES AND MOVEMENT IN EMERGING ECONOMY CURRENCIES

- ◆ Nothing compares to what we are going through now. However, an assessment of how the currencies moved before and after the various crises the world went through can help us get at least some idea as to how currencies behave in crises and what could happen in the future.
- ◆ The major crises that we are considering for this study are the Asian financial crisis of 1997–98, the global financial crisis of 2007–09, the Euro Area sovereign debt crisis of 2010-2012. We tracked the movement of currencies vis-à-vis safe haven currency US Dollar, and checked how resilient these currencies have been in the face of crises. Comparing the movement of other macro-economic parameters, vis-à-vis currency prior to the crises and post crises, we have estimated how these metrics changed prior and post the crises.

THE ASIAN FINANCIAL CRISIS OF 1997–98

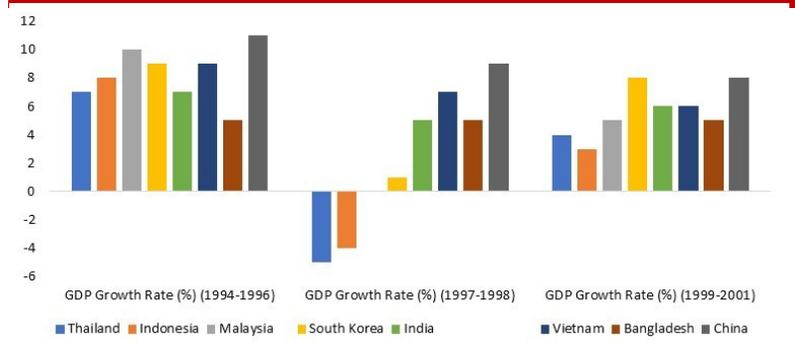
- ◆ The Asian financial crisis had originated in Thailand, which had seen building up of asset bubbles, as a result of rapid export oriented growth and FDI inflows. Thailand saw heavy investment in real estate and infrastructure sector prior to Asian crisis. When the U.S. Federal Reserve began to raise its interest rates around such time to counteract inflation, it led to less attractive exports (for those with currencies pegged to the dollar) and less foreign investment. The asset bubble in the country's property market burst as investments dried up and there was default of property developer Somprasong Land. As sentiments turned negative, currency traders began attacking the Thai baht's peg to the U.S. dollar. This proved successful and the currency was eventually floated and devalued. Following this devaluation, other Asian currencies including the Malaysian Ringgit, Indonesian Rupiah, all depreciated rapidly.
- ◆ If we look at the past data, these economies were growing handsomely before the Asian crisis struck. Thailand was growing at around 7% on an average for the three years prior to the crisis, Indonesia at 8%, Korea at 9% and Malaysia at 10%. However, when the crisis struck, growth plummeted for these countries, which were at the heart of the crisis, while for other Asian economies too there was slowdown in growth numbers.
- ◆ **However, growth and a fixed currency regime were the only factors which showed the same trend across the board.** Prior to the crisis, Thailand and Malaysia had high current account deficit of more than 5%, while that of Indonesia and Korea was at around 2%. Available data shows that Thailand's external debt as % of GDP was more than double that of Korea's external debt as % of GDP. But all these economies saw a loss in confidence with their currencies rapidly losing value in 1997.
- ◆ Among the inflows, it is hard to discern a clear pattern as to what happened during the crisis, with Malaysia seeing lesser FDI in 1998 vis-à-vis 1997, while Korea and Thailand seeing more. It was the FII which were clearly moving away from Asian economies between 1997 to 1998. Also the other capital component which has other debt creating inflows declined rapidly.
- ◆ However, as the fixed peg was abandoned by Thailand and others, it led to immediate improvement in their current account balances as the value of imports came down rapidly. The growth rate returned to positive and the depreciation was arrested. Except for Indonesia, which kept witnessing a decline in both FDI and FII inflows, in the later years also, these Asian economies saw robust FDI inflows later. It was the FIIs which were more skeptical, and not returning so easily to these economies, except for Korea which saw robust FII inflows in the years after the crisis. These economies moved towards non-debt creating FDI inflows which are considered better for funding external sector requirements. The decline in other debt creating assets also kept happening after the crisis.
- ◆ All in all the two years were painful for these Asian economies, but they recovered.

Currency Movement(% change)



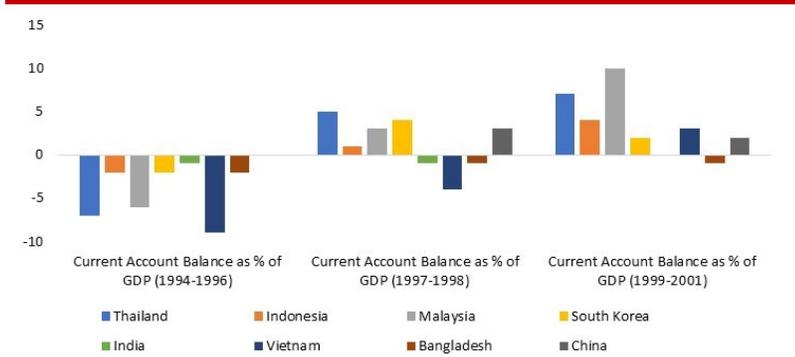
Source: SBI Research, + change indicates depreciation

Growth Metrics



Source: SBI Research

Current Account Balance as % of GDP



Source: SBI Research, + indicates surplus

| | | Capital Flow(\$ million) | | | | | | | |
|---------------------------|----------|--------------------------|-----------|----------|-------------|-------|-------|--------|--|
| | Year | Thailand | Indonesia | Malaysia | South Korea | India | China | Japan | |
| Average Net FDI Inflow | 1994-199 | 1923 | 4216 | 4533 | 2135 | 1848 | 36605 | -38 | |
| | 1997-199 | 5605 | 2218 | 3650 | 4645 | 3106 | 45542 | 2499 | |
| | 1999-200 | 4845 | -3131 | 2746 | 9586 | 3627 | 43387 | 10132 | |
| Average Net FII Inflows | 1994-199 | 3502 | 4327 | -784 | 14949 | 3680 | 2335 | 66785 | |
| | 1997-199 | 2451 | -2255 | 18 | 7041 | 977 | 3970 | 67628 | |
| | 1999-200 | -396 | -1316 | -1234 | 10944 | 2583 | 2622 | 78273 | |
| Other Net Capital Inflows | 1994-199 | 13678 | 375 | 503 | 19884 | 4953 | 1634 | 31083 | |
| | 1997-199 | -17933 | -4970 | 1092 | -1517 | 9097 | 1705 | -12649 | |
| | 1999-200 | -10788 | -2590 | -829 | -9341 | 4958 | 4083 | -97626 | |

Source: IMF, SBI Research

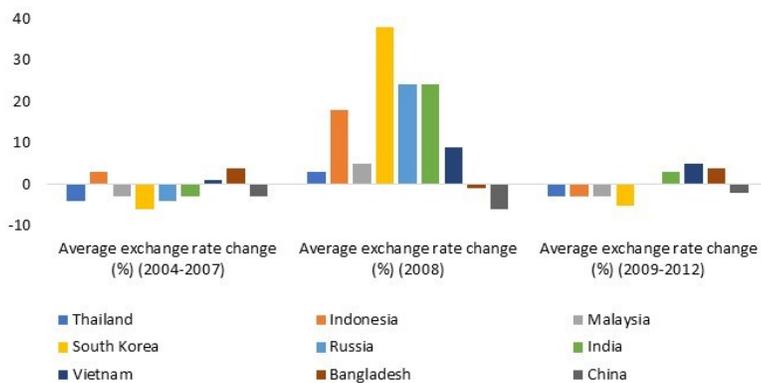
THE GLOBAL FINANCIAL CRISIS OF 2008 AND THE ENSUING EURO AREA SOVEREIGN DEBT CRISIS

- ◆ The bursting of the U.S. housing market bubble and a rise in foreclosures ballooned into a global financial and economic crisis, with investors pulling capital from emerging and developing countries, even those with small levels of perceived risk, and caused values of stocks and domestic currencies to plunge.
- ◆ However, for the Emerging Asian economies which we have taken into account the currencies stabilised very quickly in 2009 and 2010 and many of them saw y-o-y appreciation in these years. The value of depreciation was also not of the magnitude seen in the Asian Crisis.
- ◆ The Euro Area Sovereign Debt Crisis of 2010-12, which began in late 2009 when a new Greek government revealed that previous governments had been misreporting government budget data, eroded the investor confidence causing bond spreads to rise to unsustainable levels for the Euro Area economies. Fears quickly spread that the fiscal positions and debt levels of a number of Eurozone countries were unsustainable.
- ◆ Interestingly, between 2009-2012, when there were still the after-effects of the sub prime crisis and the Eurozone crisis was brewing, these economies saw on an average either appreciation or very modest depreciation. Although a little muted from the 2004-07 period, growth also returned to these Asian economies.
- ◆ In fact, the currencies of many Asian emerging economies plunged only when there were talks of Fed tightening liquidity conditions, the event known as taper tantrum of 2013. These Asian economies had seen a lot of capital inflows in 2009-2012 as the advanced world, awash with liquidity, sent its money all over the world in search of higher returns and when there was the fear that this will be withdrawn the currencies reacted badly.
- ◆ We are again witnessing a crisis of global scale. Due to the pandemic, the emerging currencies took a beating. Lockdown restrictions and overall loss in demand weighed heavily on currency sentiments. However, this week has seen emerging Asian currencies recovering as hopes of easing lockdown have buoyed sentiments.
- ◆ The current crisis has led Advanced nations to again go for stimulus measures and easing liquidity conditions. Once things stabilise the excess liquidity will again try to flow into the emerging markets for search of better returns.
- ◆ So the emerging markets have to carefully monitor the capital flows to check unnecessary build-up in debt creating assets, which can lead to questions about debt sustainability later.

THE CASE FOR INDIA'S EXTERNAL SECTOR POST COVID

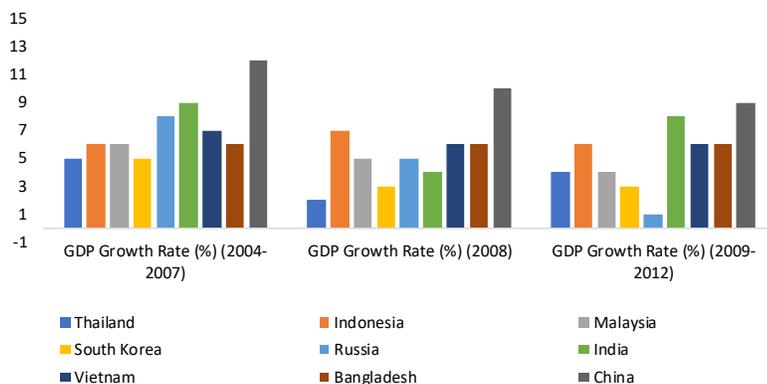
- ◆ The Indian Rupee has seen one massive devaluation in 1991 when the balance of payments crisis struck. After that there was steady depreciation over the years till the 2008 crisis when again, owing to the global scenario Rupee lost more than 20% of its value. However, in the interim period, when the 1997-98 Asian crisis unfolded Rupee did not see massive fluctuations as our Current Account Deficit was under control and we were not pegged to the dollar. Additionally, there were capital controls.
- ◆ We have now slowly become more integrated into the global financial system. That comes with the benefit of easy capital, but the cost involved is that of increased volatility and investor confidence can turn negative at the sight of one worsening metric. With rising oil prices in early 2010s India saw its current account deficit widening. Also, there was the issue of growth coming down. The news of Fed tightening its liquidity exacerbated the situation and Rupee saw depreciation in double digits in 2013, but it was less than that witnessed in 2008. However, as the current account deficit narrowed over the years on the back of lower crude prices, Rupee stabilised.

Currency Movement(% change)



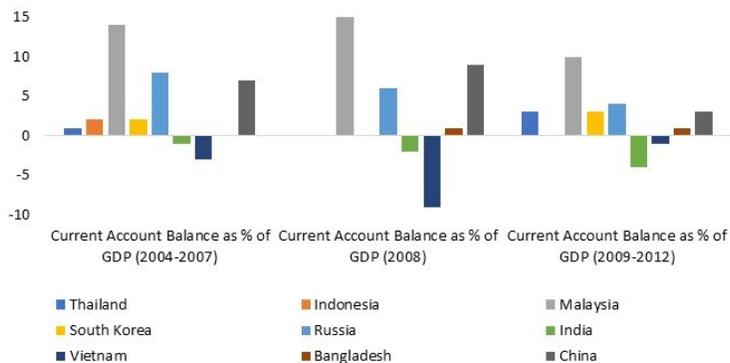
Source: SBI Research, + indicates depreciation

Growth Metrics



Source: SBI Research

Current Account Balance as % of GDP



Source: SBI Research, + indicates surplus

| Capital Flows(\$ million) | | | | | | | | | | |
|---------------------------|-----------|-----------|----------|-------------|--------|--------|---------|------------|-------|--------|
| Year | Thailand | Indonesia | Malaysia | South Korea | Russia | India | Vietnam | Bangladesh | China | |
| Average Net FDI Inflow | 2004-2007 | 7907 | 5519 | 6266 | 11232 | 31095 | 14489 | 3166 | 592 | 113139 |
| | 2008 | 8562 | 9318 | 7573 | 11188 | 74783 | 43406 | 9579 | 1328 | 171535 |
| | 2009-2012 | 9133 | 15484 | 8754 | 9447 | 46356 | 30868 | 7850 | 1246 | 224012 |
| Average Net FII Inflows | 2004-2007 | 5572 | 6354 | 5142 | 17439 | 7314 | 15894 | 2807 | -71 | 24619 |
| | 2008 | -8545 | 3059 | -21083 | -25902 | -27916 | -15030 | -578 | 92 | 9654 |
| | 2009-2012 | 8078 | 11641 | 17683 | 35881 | 6134 | 22185 | 1210 | 70 | 32214 |
| Other Net Capital Inflows | 2004-2007 | 1639 | -2611 | -226 | 23158 | 42768 | 21188 | 1368 | 737 | 55141 |
| | 2008 | -1701 | 3446 | -5352 | -11788 | 185110 | 24352 | 2963 | 1914 | -14992 |
| | 2009-2012 | 7419 | 5003 | 3471 | -2961 | 43814 | 39093 | 4903 | 1714 | 103621 |

Source: IMF, SBI Research

- ◆ Despite the current pandemic we still maintain that India is going to achieve a current account surplus owing to lower oil prices, although the magnitude is uncertain. With capital flows also turning positive as the economy slowly re-starts, it can mitigate some of the losses that we have seen. Analysis of past crises shows that currencies can swing wildly. However, they stabilise if the right measures are taken.
- ◆ So, what is important is that we focus on improving our macro-economic fundamentals and monitoring how the composition of our capital flows is changing, so that we are prepared to deal when the investor sentiment turns negative. RBI has stated that a diversified capital account, with a hierarchical preference for FDI over debt flows, and for long-term flows over short-term flows, should be the focus of external sector policy. And India has to a great extent succeeded in that and this has provided a cushion from the volatilities inherent in the various FPI components.
- ◆ Overall, at the time when Rupee was devalued in 1991 the debt component of net capital flows was 71% and this has gone down to 35% in 2018-19. Our external debt position is also sustainable with the external debt to GDP ratio at 19.8% at end-June 2019. If the Government takes the right steps and brings back growth, investors won't shy away from investing in India.

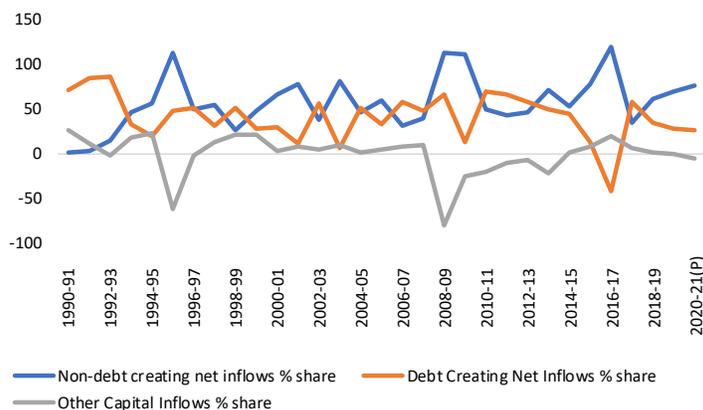
COVID UPDATE

- ◆ Meanwhile, India was testing less than 1 lakh samples per day till 18th May. This has consistently topped 1 lakh testings per day since then with minor exceptions. For the first 7 days of June, India has tested on an average 1.32 lakh samples, with the number crossing 1.4 lakhs on June 6 and June 7. This is perhaps the reason why the cases have started increasing at a much faster rate.
- ◆ Interestingly, Indian states and the Centre have formally decided to open up the economy beginning June 8. It may be noted that during the first 4 phases of Lockdown, the daily positivity rate (number of cases turning positive as a percentage of total tests during the day) has now moved up to 7% in the first 7 days of June from an average of 4.7% during March 27 till May 31. Clearly, the increased positivity rate is a reflection of more number of tests and if we look at the accompanying graph, the positivity rate clearly shows a decisive uptrend from May 2 onwards. At this rate, if India doubles the number of tests, the number of positive cases on a daily basis will remain in double digits from now on and this should not come as a surprise.
- ◆ Meanwhile, based on the current 7-days moving average of new cases witnessed in India, we now believe that peak of new cases will get pushed back further from earlier estimates towards the end of June and is likely to peak somewhere anytime in the period after July 7. Following that the new cases are expected to witness steep fall till the end of August after which it is expected to flatten only by mid-September. However, these are purely based on an assessment of current trends that can rapidly change.

Disclaimer:

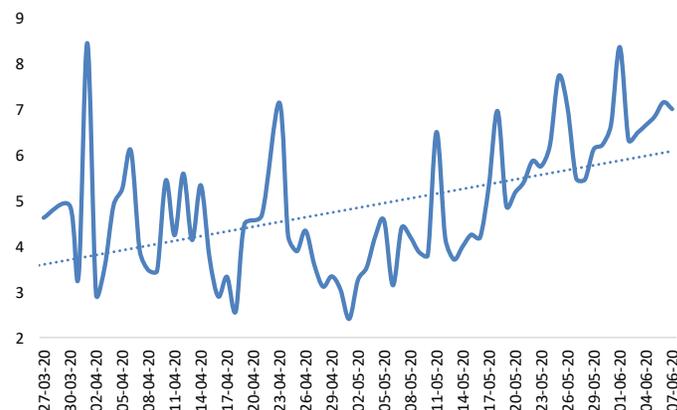
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Composition of Net Capital Flows to India



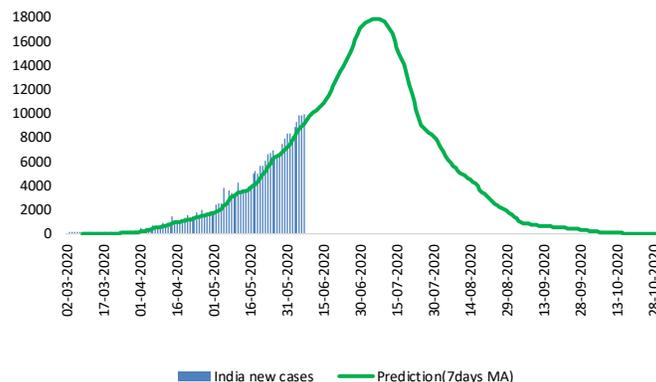
Source: SBI Research

India-Daily Test Positivity of COVID Cases (%)



Source: SBI Research, Covid 19.org, MOHFW, CEIC

Daily New Cases and Prediction in India



Source: SBI Research

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