Indian Exceptionalism*

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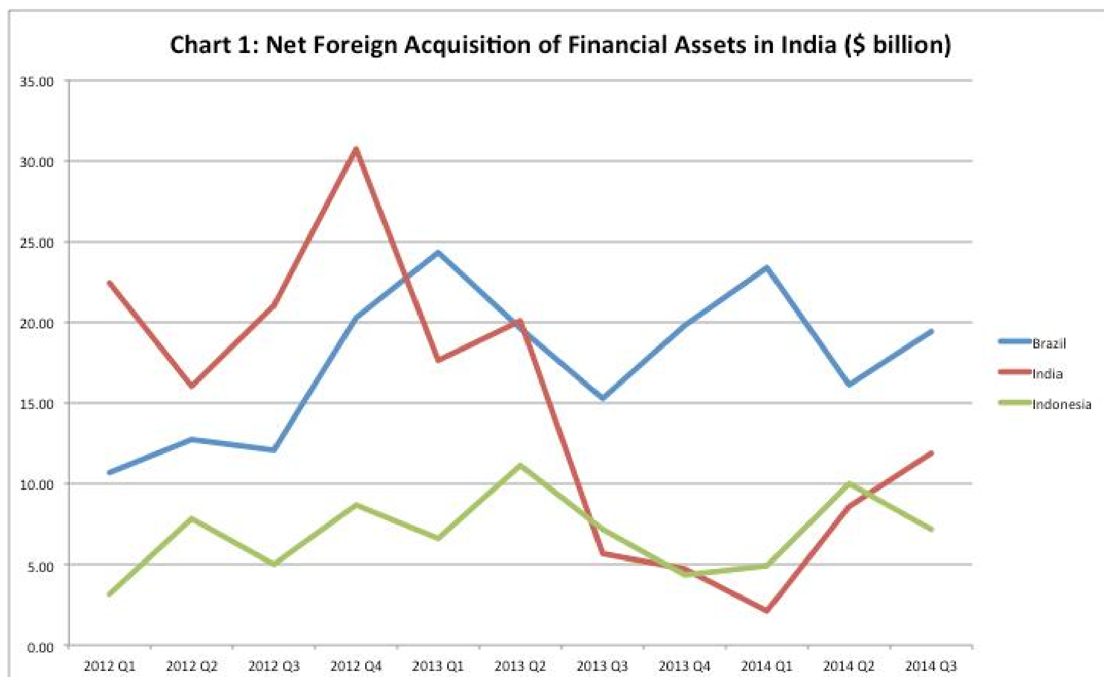
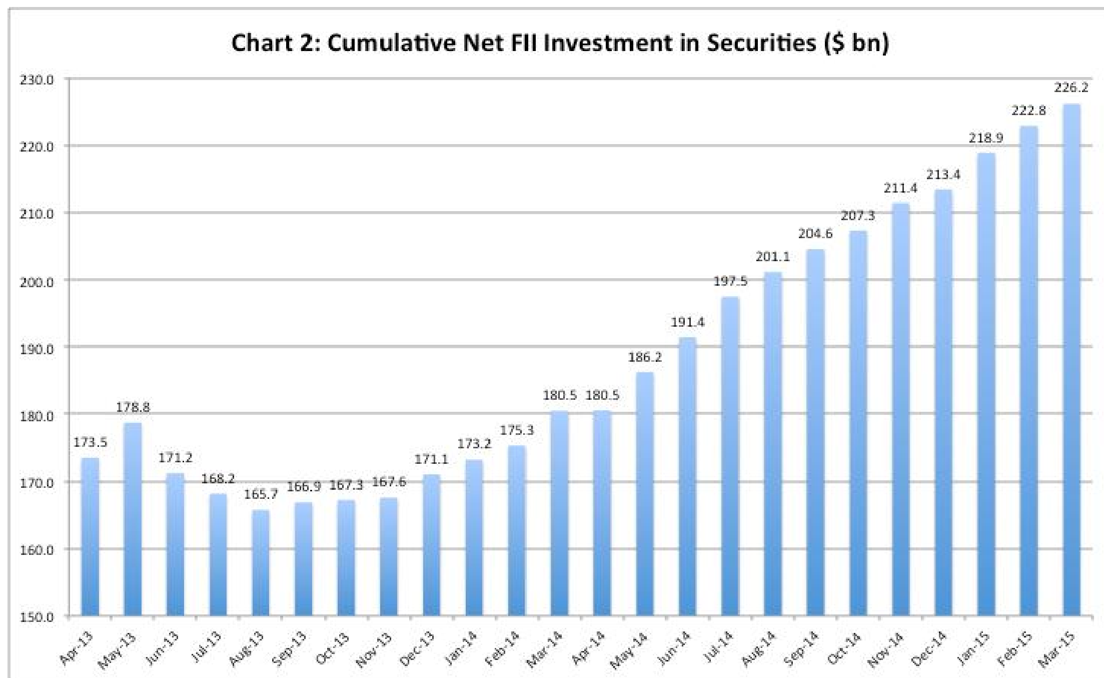
While Indian industry still claims that at ground level the experience is that the economy is sagging, revised GDP growth figures point to a robust recovery and financial markets are buoyant. The balance of payments too appears strong with falling oil prices and large capital inflows resulting in an increase in official foreign reserve assets from $291 billion in January 2014 to almost $342 billion by March 2015.This has persuaded even Moody's, which like most credit rating agencies responds with a lag (besides often getting it wrong), to raise the sovereign rating outlook for India from 'stable' to 'positive'. One of the factors the agency has quoted to explain its ratings upgrade is that India has grown faster than similarly rated peers in recent years. But the evidence on growth is, of course, controversial. Even those who believe that the new national income estimates are correct in indicating a recovery are not persuaded by the high absolute growth numbers they yield.



The real surprise is the resurgence in foreign investor interest in India, after the brief period of the "taper tantrum" starting May 2013, when investors responded to the fear that the Fed would sharply unwind its quantitative easing or bond buying programme and send interest rates soaring, by pulling out of 'emerging markets'. As can be seen from Chart 1, the net foreign acquisition of all kinds of financial assets (equity, debt and other assets), or in IMF-terminology India's "net borrowing" from the rest of the world fell sharply between the second quarter of 2013 and the first quarter of 2014. Judging by trends in Brazil and Indonesia, for example, India seems to have been one of the more badly affected countries in terms of financial capital exit as a result of the tantrum. But such flows recovered smartly in the next two quarters. In fact, that recovery has turned into a veritable surge in the last two quarters since then, as suggested by the evidence on foreign institutional investments in India's debt and equity markets. The cumulative net inflows of FII investment into securities (Chart 2) rose from about $174 billion in April 2013 to as much as $226 billion by the end of

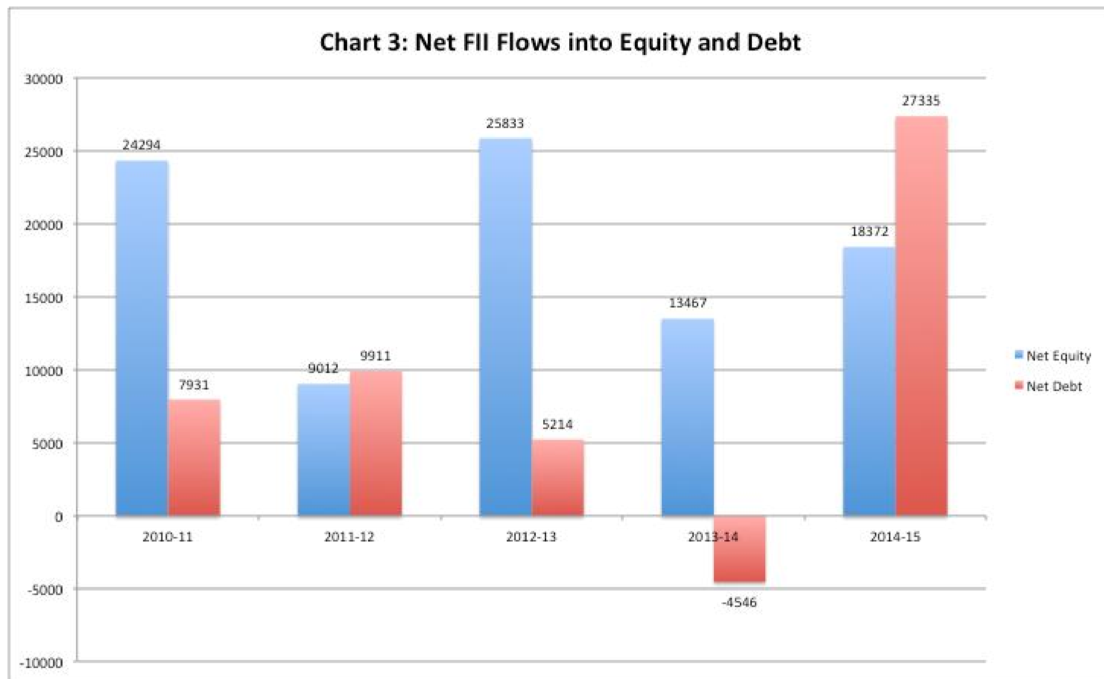
March 2015—an average increase of $26 billion in those two years as compared to an average annual increase of $10 billion over the previous 17 years starting 1996.



This upsurge in investment inflows, even though the Federal Reserve continued with its taper by reducing in stages its bond buying programme from the peak of $85 billion a month, has been taken as a signal that fears that the taper would lead to capital exit were wrong. Investors, it was argued, had already factored in the effects of the taper. And, in any case the taper came to an end in October 2014 with a final $15 billion purchase.

What is disconcerting, however, is that there appears to be a change in the structure of FII inflows in recent years. The share of debt in net FII inflows into India, which had fluctuated between zero and 20 per cent during the first decade of this century, has not just risen sharply since, but has turned extremely volatile. As Chart 3 shows, the period of monetary easing was also one when foreign institutional investor preference shifted in favour of debt instruments rather than equity. This shift has intensified after the taper tantrum, with FII investment in debt securities amounting to 60 per cent of net flows in 2014-15. At $27.3 billion in that year, these flows were not only larger than net equity investments but higher than the previous peak of $25.8 billion that net investments in equity touched in 2012-13.

Associated with this shift in favour of debt is also a much higher degree of volatility in investments in debt. When the capital exit triggered by the taper tantrum occurred, the contraction seems to have been much sharper in the case of debt than investments in equity. Net flows of investment into debt securities contracted from $5.2 billion during 2012-13 to a negative $4.5 billion in 2013-14. On the other hand, net flows into equity fell from $25.8 billion to $13.5 billion. In the following year, 2014-15, net investments in debt instruments jumped back to $27.3 billion, while investments in equity rose only to $18.4 billion.



Clearly, what has been happening in Indian financial markets is that investors in search of yields have opted for investments in debt securities that promise quick gains through arbitrage by borrowing at near zero interest rates and investing them in higher-return instruments. This has been encouraged by the high interest rates in India and the fact that capital inflows have kept the rupee strong relative to the dollar, when compared with many other emerging market currencies.

One factor often ignored in assessments of influences on financial flows to emerging markets in recent years is the fact that despite the taper, then Federal Reserve Chair Ben Bernanke had kept to his promise that the Fed would not allow U.S. monetary conditions to tighten and would keep short-term interest rates near zero till such time as there were clear signs of recovery in the US. His successor Janet Yellen has adopted the same position.

The difficulty is that with signs of some improvement in US growth, the possibility that the US would have to move out of a zero interest rate regime has increased. The question is not whether the Fed should raise rates, but when. For emerging markets the issue is whether an interest rate hike in the US would result in the capital exit, even though the taper did not. In February, the Institute of International Finance argued that that total private sector investment flows to emerging markets, which fell by $250 billion last year to $1.1 trillion (from a 2013 record high of $1.35 trillion), are likely to fall further to $1.06 trillion in 2015 given the prospect of higher U.S. interest rates.

That fallout is more likely in India because investments in debt securities, especially when driven by expected gains from arbitrage, are bound to respond to differentials in interest rates. The shift in favour of debt flows is a source of vulnerability. By March 2015 the cumulative investment net investment in debt securities since April 1997 was $58 billion or about a fifth of India’s foreign currency assets.

It is in this context that the uncertainty created by excessive stock market buoyancy, bordering on euphoria, has to be seen. After slipping at the time of the taper tantrum

in the summer of 2013, the Bombay Stock Exchange Sensex, for example, has registered a dramatic rise from just short of 18000 in late August 2013 to close to 30000 by early late January 2015. In mid-2013, an exit of foreign institutional capital invested in equity accompanied the short-term slump in the markets. But the subsequent recovery and boom have been accompanied by large net purchases by FIIs. That adds another source of vulnerability, which can aggravate the panic generated by a rise in US interest rates.

It is to be hoped that these trends were factored in by Moody's when it changed its outlook on India. But, then as we noted, rating agencies are now notorious for being behind the curve.

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