SBI RESEARCH

ECOWRAP

GONE(ING) WITH THE WIND!

Issue No. 42, FY22

Date: 28 Oct 2021

Oil prices have been on an upward trajectory supported by a global supply shortage and strong demand as the world recovers from COVID-19. It is reminiscent of the early 2010s when oil was way above the $100 mark. The downward slide of oil from late 2014 started providing support to the external sector of India, which is heavily dependent on crude oil imports to meet the demand. Current Account Deficit which touched a high of –4.82% of GDP in FY13 started declining and has not gone above -2.1% since then. However, the rising crude prices and overall supply side bottlenecks due to COVID-19 are raising concerns again. The eerie similarity does not end here. The news of bond purchase taper in the recently published FOMC Minutes for September 21–22 is akin to that suggested in May 2013 by the then Fed Chairman Ben Bernanke, that the Fed would begin reducing its program of asset purchases. In the four months after Bernanke had first mentioned tapering, emerging-market exchange rates fell by 6% against the dollar. Between May'13 and Sep'13 Rupee lost as much as Rs 14.

If we look at the current rupee trajectory, Rupee saw a tumultuous 2020, when the news of COVID-19 pushing the exchange rate down rapidly. However, Rupee started gaining strength as India saw a current account surplus and foreign investors maintained faith in the economy by pouring in capital. RBI had continuously made forex purchases. In FY21, RBI purchased Rs 5.1 trillion worth of forex and its forex reserves swelled by $103.72 billion. Despite the second wave of COVID-19, Rupee gained strength and even went below 73 per dollar.

However, recently, Rupee went from 73.09 per dollar as on September 1 to a low of 75.52 per dollar on October 12. It has again started appreciating and is presently at around 75. If we look at the turnover in the forex market, there has been excess supply of dollars at $2.2 billion in Aug'21. This clearly shows that the appreciating bias on Rupee remains.

The September 2021 merchandise trade deficit at $22.59 billion is quite high and has the closest counterpart in October 2012 when India recorded a merchandise trade deficit of $20.21 billion. But it needs to be remembered that trade data shows seasonality and it is fairly common to see jump in imports, as well as exports every quarter end month. So far India's exports have been doing quite well. India's merchandise exports in April-September 2021 were USD 197.9 billion, a robust increase of 24.3% over USD 159.2 billion in April-September 2019. In composition terms engineering goods are the most valued. India has also seen considerable increase in products like cereal preparations, cotton, electronics. drugs and pharma and chemicals are also performing well. Thus, achieving the target of $400 billion is not a pipe dream and this will provide a strong cushion to the current account balance, even if the oil import bills rise rapidly. Taking everything into account our CAD projections stand at (-)1.4%. India is also witnessing robust FDI inflows even if the FPI flows are showing some volatility.

With CAD at a comfortable situation and an extremely unlikely devastating third COVID, Indian Rupee is going to handle any taper news with relative calm. **Considering higher domestic inflation, as supply disruptions mount, it will not do any harm for RBI to lean with the wind and let rupee appreciate as it can lead to reduced imported inflation when metal and oil prices are rising, and clearing the liquidity overhang to some extent**. Meanwhile, RBI has been globally applauded for its effective management of exchange rate fluctuations. IMF in its recently released article IV consultation welcomed the authorities' commitment to maintain exchange rate flexibility.

WPI inflation has averaged 11.6% in H1 FY22, remaining markedly above CPI inflation (5.34%). Since the onset of the pandemic in 2020, consumer price and wholesale price inflation rates have been exhibiting considerable divergence. Recent RBI studies have shown that over time and through the course of the pandemic the sensitivity of CPI inflation to WPI inflation has come down. Such a development might miss the concerns of manufacturers who are grappling with extremely high imported inflation and a depreciating Rupee just might add to their woes. **India's backward linkages in the global value chains is higher than forward linkage and a weak Rupee might not help in pushing the exports as much as is touted by traditional economic theory.**

FOMC MINUTES

- In the recently published FOMC Minutes for September 21–22, participants expressed their views on how slowing in the pace of purchases might proceed. In particular, participants commented on an illustrative path, developed by the staff and reflecting participants' discussions at the Committee's July meeting, that gave the speed and composition associated with a tapering of asset purchases.
- The illustrative tapering path was designed to be simple to communicate and entailed a gradual reduction in the pace of net asset purchases that, if begun later this year, would lead the Federal Reserve to end purchases around the middle of next year. The path featured monthly reductions in the pace of asset purchases, by $10 billion in the case of Treasury securities and $5 billion in the case of agency MBS. Participants generally commented that the illustrative path provided a straightforward and appropriate template that policymakers might follow, and a couple of participants observed that giving advance notice to the general public of a plan along these lines may reduce the risk of an adverse market reaction to a moderation in asset purchases. Participants noted that, in keeping with the outcome-based standard for initiating a tapering of asset purchases, the Committee could adjust the pace of the moderation of its purchases if economic developments were to differ substantially from what they expected. Several participants indicated that they preferred to proceed with a more rapid moderation of purchases than described in the illustrative examples.
- No decision to proceed with a moderation of asset purchases was made at the meeting, but participants generally assessed that, provided that the economic recovery remained broadly on track, a gradual tapering process that concluded around the middle of next year would likely be appropriate. Participants noted that if a decision to begin tapering purchases occurred at the next meeting, the process of tapering could commence with the monthly purchase calendars beginning in either mid-November or mid-December.

INDIA'S MERCHANDISE TRADE POSITION AND IMPACT ON EXTERNAL METRICS

- If we look at Rupee's recent performance, it went from 73.09 per dollar as on September 1 to a low of 75.52 on October 12. It again started appreciating and is presently at around 75.
- The combination of taper news and rising crude prices has sparked fears that Rupee might lose a lot of value. Comparisons are being drawn with the 'Taper Tantrum episode of 2013'. In May 2013, then-Fed Chairman Ben Bernanke first suggested that the Fed would begin reducing its program of asset purchases—Treasuries and mortgage-backed securities—commonly referred to as quantitative easing, or QE3, as a means of supporting the U.S. economy. In the four months after Bernanke first mentioned tapering, emerging-market exchange rates fell by 6 percent against the dollar. Between May'13 to Sep'13 Rupee lost as much as Rs 14. However, it settled and by the end of the financial year settled at Rs 59.89, displaying a full year depreciation of Rs 5. Exacerbating the situation were crude oil prices which were at $108 per bbl in FY13, thus impacting the Current Account adversely. India, however, slowly managed to bring its current account deficit to manageable levels as oil prices started declining and India's exports, especially services, and remittances did well.
- However, again worries have surfaced with the September 21 merchandise trade deficit at $22.59 billion. The closest value to it came in October 2012, when India recorded a merchandise trade deficit of $20.21 billion. But it needs to be remembered that trade data shows seasonality and it is fairly common to see jump in imports, as well as exports every quarter end month. So far India's exports have been doing quite well. India's merchandise exports in April-September 2021 were USD 197.9 billion, a robust increase of 57.5% over USD 125.6 billion in April-September 2020 and an increase of 24.3% over USD 159.2 billion in April-September 2019. In composition terms engineering goods are the most valued. India has also seen considerable increase in products like cereal preparations, cotton, electronics. Drugs and pharma and chemicals are also performing well. Thus, achieving the target of $400 billion is not a pipe dream and this will provide a strong cushion to the current account balance, even if the oil import bills rise rapidly. Taking everything into account our CAD projections stand at (-)1.4%. India is also witnessing robust FDI inflows even if the FPI flows are showing some volatility.

Category-wise exports					
Broad categories	Apr'19-Sep'19	Apr'20-Sep'20	Apr21-Aug21	**Growth over 2019**	**Growth over 2020**
Agri and allied	14.7	14.8	17.6	19.5%	19.0%
Ores and minerals	3.4	3.8	4.7	38.2%	23.6%
Leather & leather products	2.4	1.4	2.0	-15.6%	43.9%
Ceramic products & glassware	1.4	1.3	1.7	19.4%	36.3%
Gems & Jewellery	19.2	8.7	19.3	0.6%	122.1%
Chemicals and pharmaceuticals	21.4	22.1	25.9	20.7%	16.9%
Engineering Goods	39.9	33.7	54.5	36.4%	61.5%
Electronic Goods	5.5	4.1	6.5	18.4%	60.7%
Textiles, handicrafts and garments	17.0	11.6	19.4	14.4%	67.2%
Petroleum Products	21.9	12.1	28.7	31.2%	136.7%
Plastic & Linoleum	4.0	3.8	4.9	24.0%	29.3%
Sub-Total	150.9	117.5	185.3	22.8%	57.8%
GRAND TOTAL	159.4	125.6	197.9	24.1%	57.5%

Source: SBI Research

WHERE IS RUPEE GOING ?

- With CAD at a comfortable situation and an extremely unlikely devastating third COVID, Indian Rupee is going to handle any taper news with relative calm.
- Also, India has managed to accumulate sufficient foreign exchange reserves. Meanwhile, RBI has been globally applauded for its effective management of exchange rate fluctuations. IMF in its recently released article IV consultation welcomed the authorities' commitment to maintain exchange rate flexibility, which can serve as the main shock absorber, with foreign exchange interventions limited to addressing disorderly market conditions.
- Regarding the impact of exchange rate on our exports, we have found that exchange rate depreciation has negative impact on our export growth. This can be explained by higher import content in our exports. Furthermore, the global growth has a significant positive impact on export growth. Thus it can be inferred that there is no harm in allowing rupee to appreciate and ease on the forex purchases.
- Also, considering higher domestic inflation, as supply disruptions mount, it will not do any harm for RBI to lean with the wind and let rupee appreciate as it can lead to reduced imported inflation when metal and oil prices are rising, and clearing the liquidity overhang to some extent.
- In the forex market, in the merchant market there has been excess demand of dollars amounting to $2.3 billion during Apr-Aug'21. Also, in the interbank market there has been excess demand of dollars in both the spot and forward segment, totalling $12.1 billion. Thus, for the entire market, the demand for dollars has been higher in the Apr-Aug'21 period. However, in the recent month there has been tepid forward demand for dollars in the interbank market which shows that the appreciating bias on rupee remains.

Turnover in the foreign exchange market ($ mn)

Month	Merchant			Interbank			Grand Total
	Forward Excess Demand	Spot Excess Demand	Total Excess Demand	Forward Excess Demand	Spot Excess Demand	Total Excess Demand	
Aug-21	8,117	-4,598	3,519	-7174	1452	-5,723	-2,204
Jul-21	2,900	-8,546	-5,647	-421	4812	4,391	-1,255
Jun-21	6,579	-5,396	1,183	3616	1529	5,145	6,327
May-21	7,903	-1,254	6,650	4008	-3536	472	7,121
Apr-21	717	-4,092	-3,375	10924	-3107	7,817	4,442
Mar-21	6,386	-5,415	971	9881	128	10,009	10,980
Feb-21	-1,450	-2,830	-4,280	2922	9171	12,093	7,813
Jan-21	6,695	-8,014	-1,319	4990	1383	6,373	5,054
Dec-20	4,521	-12,779	-8,258	7610	-929	6,680	-1,578
Nov-20	-3,260	-10,441	-13,701	6317	2259	8,575	-5,126
Oct-20	-1,876	-12,300	-14,176	-1120	8785	7,664	-6,512
Sep-20	1,257	-7,174	-5,917	4303	2973	7,276	1,359
Aug-20	1,650	-13,461	-11,811	4595	3181	7,776	-4,035
Jul-20	2,239	-8,466	-6,227	341	7,248	7,589	1,362
Jun-20	1,726	-12,647	-10,921	943	6,354	7,297	-3,624
May-20	1,495	-7,603	-6,108	1,661	-202	1,459	-4,649
Apr-20	1,691	-5,476	-3,785	2,663	-3,326	-663	-4,448
Mar-20	9,343	-4,694	4,649	4,937	-9,601	-4,664	-15
Feb-20	3,053	-8,884	-5,831	1,875	3,693	5,568	-263
Jan-20	4,471	-8,532	-4,061	-628	4,109	3,481	-580
Dec-19	5,897	-11,599	-5,702	2,838	3,520	6,358	656

Contact Details:
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in, gcea.erd@sbi.co.in
Phone:022-22742440
: kantisoumya