

Why 2023 Promises to Be a Rough Year For India's External Sector

Tightening monetary policy is going to increase the yield on US treasury security, making the dollar stronger.



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ECONOMY MACRO 42 MINUTES AGO

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The bulk of India's exports — refined petroleum products, pearls, precious stones and chemicals — are not picking up. Weak global demand means lower demand for these income-sensitive items. On the other hand, a strong Indian economy demands more energy and fossil fuels, most of which are imported.

Coordinated policy measures are required both from the government and the RBI. Otherwise, the excitement over India's current growth at 6.9% may be short-lived.

Fiscal measures

The government took a few micro-measures to reduce the widening current account deficit. India continues to buy cheap oil from Russia — the share of Russian mineral fuel imports in India's trade basket went up from 1% in February to 22% in November.

Additionally, on September 9, India banned the export of 100% broken rice, an input for producing the alternative fuel ethanol. With a target to reduce another important importable, customs tariffs on gold were increased from 7.5% to 12.5%.

The government also undertook measures such as Atmanirbhar Bharat Abhiyan and Production Linked Incentives (PLI) schemes to boost export competitiveness. This has benefited some sectors like high-value-added pharma — formulation and vaccines, electronics and engineering. PLI has drawn foreign smartphone manufacturers and enabled Indian electronic and engineering items manufacturers embedded in global value chains.

But it is too early for India to participate robustly in them, like China does.

Exports of telecommunication and turbine equipment have risen but the overall impact on exports is minimal. They continue to grow much slower than imports, widening the trade deficit and depreciating the rupee. Indian negotiators should find ways to deal with extra-trade provisions like labour, the environment and IPRs, which are increasingly hurting access to India's exports in the developed markets, especially the EU and US.

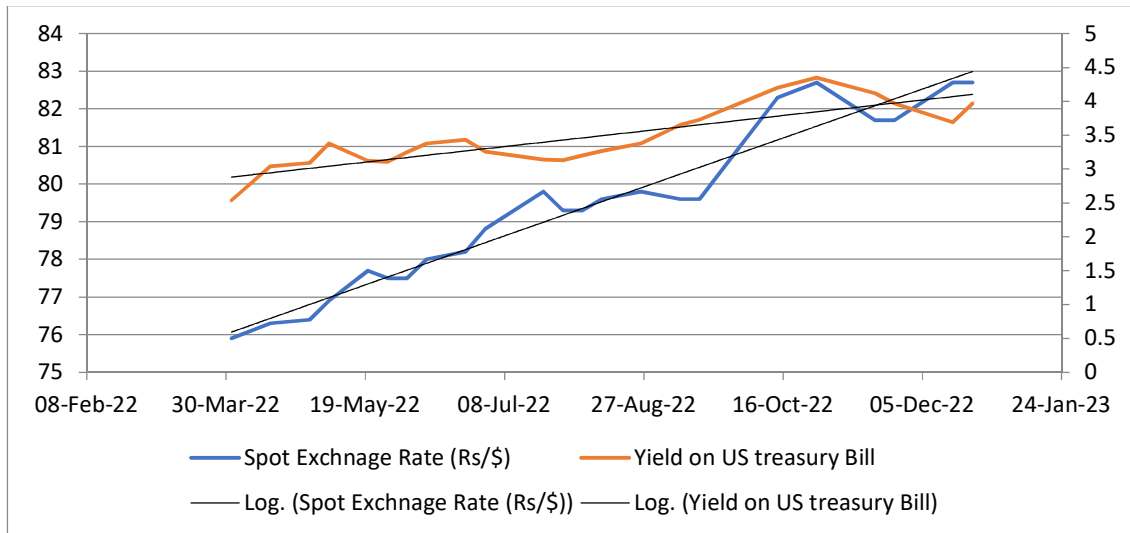
The UK has brought the Environment Act, banning the import of livestock and agricultural items like beef, cocoa, coffee, soy and maize, whose production is associated with large-scale forest loss. These fiscal measures involving structural reforms and negotiating trade deals will take time to yield results, but monetary policy can provide a quick fix for the macro numbers.

Monetary measures

The falling rupee has also to do with monetary tightening in the US. Since March 2022, the US Fed has raised interest rates by 350 basis points. Returns on US treasury security, which global investors

consider to be the safest assets, have risen. The yield on two-year US treasury security increased from 1.56% on August 1, 2020, to 4.50% on December 9, 2022. The resulting outflow of capital from the Indian economy is lowering the value of the rupee. The long-term yield is also increasing.

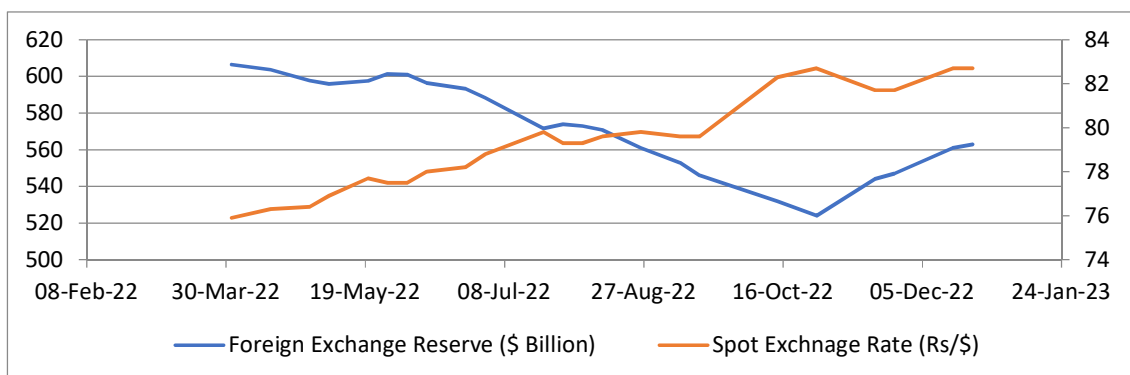
Yield on US Treasury Security (%) and India's Exchange Rate (Rs/\$)



Source: RBI Bulletin and Federal Reserve Bank of St. Louis

To arrest the fall of the rupee, the RBI started intervening in the foreign exchange market at the cost of India's foreign exchange reserves. Reserves were the lowest in October 2022, when the rupee also breached 83 versus the dollar.

India's Foreign Exchange Reserve and Exchange Rate



Source: RBI Bulletin and Federal Reserve Bank of St. Louis

India's current account deficit widened to \$3.6 billion, 4.4% of GDP. A depreciating rupee also leads to domestic inflation, as imported commodities and energy used for domestic manufacturing and services become costlier. To tame domestic inflation, the RBI has been increasing policy rates — by 225 basis points since March.

However, much depends upon how long the Fed continues with the rate hike. The US economy, in particular the labour market, remains strong. The consumer confidence index shot up from 51.50 in July to 59.70 in December.

The strong social security payment system and COVID-19 relief plan (Paycheck Protection Program) in the US meant that people were getting money during the pandemic. Saving accounts were flush with funds. As the economy opened up, businesses sprang into action, adding to the spike in demand. Demand for labourers, both in low-skilled gig-type jobs such as restaurant workers, delivery boys, etc., and high-skilled, for example in financial services, went up. Banks were making money, riding high on a higher housing mortgage rate.

According to the Federal Reserve Bank of St Louis the median sale price of a house in 2022 in the US is \$4,28,700, which is 14% higher than in 2021 and 30% higher than in 2020.

Housing prices are yet to cool off, and the real wage is falling slowly. Between November 2021 and November 2022, real wages fell by a meagre 1.2%, and that too at a time when the war in Europe led to higher commodity and crude prices. All this means that the Fed has to stick to the plan of continued rate hikes for most of 2023.

This is not good news, as tightening monetary policy is going to increase the yield on US treasury security, making the dollar stronger. 2023 could be a rough ride for India's external sector stabilisation. It remains the elephant in the room that could affect GDP growth and future employment prospects.

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