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Policy challenges to the unfolding crisis in India's external sector

It seems inevitable that India will witness a slowing down in its real GDP growth rate as a response to the pressures in its external sector prompted by the actions of the US Fed

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Representative image.

Just as the US economy recovered from the COVID-19 pandemic by crossing pre-pandemic (July 2019) real GDP levels in July 2021 and continued to grow robustly, a heady concoction of a strong recovery in aggregate demand, tight labour markets, global supply-chain bottlenecks and corporate profit-seeking triggered off an acceleration in the inflation rate.

The inflation hawks at the US Federal Reserve (Fed) finally saw an opportunity to use the weapon that they have been empowered with--setting the benchmark Feds Fund rate. Since March 2022, the Fed raised interest rates steeply, actually inducing a recession in the US that they hope will cool aggregate demand, tame inflation and the labour market too. By announcing a commitment to the +2% inflation target, Chairman of the Fed Jeremy Powell hopes to lower inflation expectations. Nonetheless, with (annualized) core inflation still around 5%, there is a still a long way to go. The sharp hike of 75 basis points earlier this month, has indeed made Powell's threat that, 'it may take some time. Hope for the best, plan for the worst', a credible one.

Unfortunately, the recession that the Fed seeks is not restricted to the US. Every rise in US interest rates sucks dollar liquidity out from the rest of the world, causing it to appreciate and other currencies to depreciate. To overcome this trend, central banks in other countries across the world are forced to raise domestic interest rates that dampens domestic spending and, consequently, growth.

Resistance to raising interest rates will either result in a depreciating exchange rate that induces imported inflation, eventually forcing central banks to raise interest rates, or to deplete their dollar reserves to maintain the exchange rate of their currencies. Propping up the domestic currency could, however, mean a loss of export competitiveness and consequently an increasing current account deficit. Speculative forces anticipate that an eventual depreciation of the domestic currency is inevitable as the country depletes its dollar reserves, resulting in a situation that rekindles memories of the 1997 Asian financial crisis.

There seems to be no easy way of escaping unscathed from the web that the US Fed has drawn the world into.

India too is caught in this crisis unleashed by forces outside its control, just when the economy showed signs of a strong recovery from the pandemic. Since the beginning of this financial year, the Reserve Bank of India (RBI) resisted the depreciation of the rupee through strong interventions in the foreign exchange market, selling off some $80 billion of its reserves. This has, however, impacted India's trade balance: with competitors in the export sector benefiting from their own currency depreciations, India's exports have seen a sequential decline in the past few months. This decline in exports has been further accentuated by the adverse economic situation in Europe, primarily on account of the slow post-pandemic recovery and worsened by the ongoing Ukraine-Russia war. Meanwhile, with a relatively strong rupee, total imports have seen a steady increase, with India's consumption picking up in spite of high global commodity prices including oil.

If the RBI were to pull back from its interventions in the foreign exchange market and let the rupee depreciate, the current account will have to find a balance through readjustments in exports and imports. This can, however, be a painful process given the inelasticity of demand for both exports and imports to changes in exchange rates. The plausibility of imported inflation remains high with global oil prices still strong. Competitive depreciation of exchange rates and global recessionary trends also make exports inelastic to exchange rates. Ultimately, the RBI will have to raise interest rates to slow growth to control import demand. The logic is straightforward here: if prices (exchange rates) cannot equilibrate the balance of payments, then quantities (real GDP) must. It, therefore, seems inevitable that India will witness a slowing down in its real GDP growth rate as a response to the pressures in its external sector prompted by the actions of the US Fed.

What makes this scenario more challenging is that the depreciation of the rupee, rising interest rates and slowing growth all happen simultaneously. This poses policy challenges that countries usually encounter during stagflation. Expansionary fiscal policy that may be needed to enhance growth will put more pressure on the balance of payments. Austerity measures, on the other hand, would mean slower growth, lower taxes and more spending on welfare schemes that ultimately widen the fiscal deficit.

If this is true for India, it must also hold true for many other countries. What this implies is that the US Fed's policy of inducing a recession to tame inflation domestically will also become imperative for the world. With exchange rates alone unable to bring about an equilibrium in the balance of payments, countries will be forced into a recession that will lower aggregate demand and consequently import demand, which means that countries which have surpluses in their current accounts also face a slowdown.

As long as the US Fed continues to hike interest rates to quell inflation, the world, including the US, is likely to witness growing recessionary forces. At the same time, there will be mounting pressure – economic and political – on the Indian government to tackle the tradeoff between high imported inflation induced by a depreciating rupee and slowing growth and rising unemployment induced by high interest rates.

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