

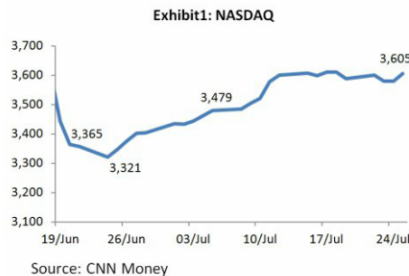
Impact of tapering of the QE

- D.R Dogra, MD & CEO, CARE Ratings



Since the advent of the global financial crisis from 2007 onwards, the Federal Reserve has for the last five years or so provided an artificial stimulus (through its quantitative easing or QE programme) with an aim to propel growth in the US economy. The modus operandi has been bi-nodal – first, pursuing a highly accommodative monetary policy stance by keeping interest rates at near-zero levels and second infusing liquidity into the system through buyback of financial assets. The first round of bond buying, famously referred to as QE1, began in November 2008, with the Fed purchasing \$ 600 billion of mortgage-backed securities (MBS). While, the US economy did respond well to this stimulus, the boost to economic growth fell short of targeted levels which prompted the need for another round of easing (QE2) in November 2012, for an equal amount of asset buyback. In September 2012, The Fed launched the QE3, a differentiating factor of which was it being an open-ended bond purchase scheme (\$40 billion per month until such time as deemed necessary). Expanding this further, three months hence in December 2012 the FOMC (Federal Open Market Committee) moved towards unlimited purchase of \$85 billion (MBS and long-term treasury combined) per month.

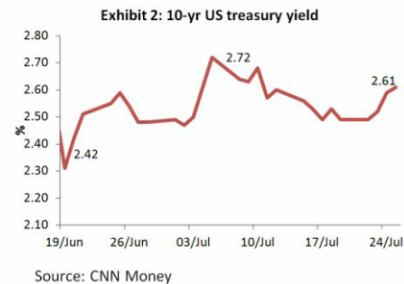
The QE programme cumulatively appears to have yielded the desired outcome for the US economy. Jobless



claims have declined, regional manufacturing data has picked and housing starts have also improved. Inflation and inflationary expectations appear well anchored close to the comfort level of 2%, on the back of fewer cost pressures for manufacturers. With consumer sentiment turning upbeat private demand has received the much needed bolster supported by the historically low interest rates. Although the unemployment rate remains high at above 7% and labour productivity has slackened, the long-term target of 6.5% appears relatively more attainable now. Despite such improvement, the US economy is yet to re-establish itself in its strongest and most robust form, with headwinds from the Euro-zone crisis continuing to prevail.

The ample liquidity provided by the Fed had very much become a vital ingredient to US economic growth, when on June 19, 2013 US Fed's Chairman Ben Bernanke rather unexpectedly announced a likely tapering of the quantitative easing (QE) programme. The timelines hinted for such tapering starts September 2013, when the Fed could likely lower the quantum of asset purchases, with a possibility of wrap-up by mid-2014. The minutes of the meeting released eventually were found to be more pragmatically stated, highlighting that labour market conditions, inflation trends and financial developments would be balanced consistent with long-term economic objectives to determine the size, pace and composition of asset purchases by the central bank.

Instantaneous reactions to this news, one of fear of uncertainty on economic growth and financial soundness and sustainability, sent the markets into a tizzy causing prices across asset classes to dip precipitously. Stock markets traded



low for three consecutive trading sessions following the announcement of QE tapering. With greater clarity coming in after the release of the minutes of meeting the NASDAQ slowly began to move upwards (exhibit 1). Government yields however, have not reversed direction and have continued to jump up as treasury prices fell (exhibit 2).

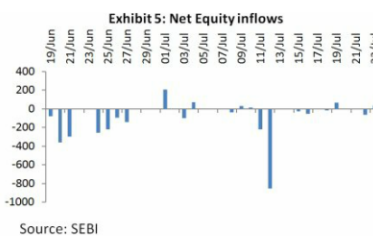
Domestic markets have been no different. The Sensex and Indian 10-year Government Security yields have charted similar movements as the US markets, after the announcement of QE tapering. In the month that followed the Fed's announcement, US central bank officials have tried to ease markets and investor concerns to some extent by providing various statements. However, the impending threat of the absence of such easy money now lingers and markets have not entirely bounced back.



The Sensex being impacted by foreign capital inflows has registered some volatility. Foreign institutional investors (FIIs) have had considerably large positions in emerging market economies, particularly debt. Consequently the

threat of QE being tapered has had a discernible impact on financial and currency markets of most emerging markets. India has for long been a favoured investment destination for FIIs and concerns on tapering have caused them to withdraw substantially. In the months of June and July, FIIs have mostly maintained negative investment positions on the net (exhibit 5 and 6). Net FII debt inflows have been severely impacted as investors have pulled out of these local funds. The interest rate differential does not seem to provide enough incentive for foreign funds to remain invested in Indian debt, in the face of increased economic uncertainty.

Also, the demand for dollars, as safe haven, has in such a scenario increased considerably, causing the greenback to strengthen against all major currencies. Coupled with this appreciation of the dollar, the weakening of domestic economic fundamentals and withdrawal of foreign capital inflows from local avenues have adversely impacted the rupee; which has so far depreciated more than 8% since the start of FY14. Indeed, during the months of June and July, the rupee also drifted higher the Rs 61 to a dollar mark, compelling the central bank (RBI), capital markets regulator (SEBI) and the Government to introduce a slew of measures to cap rupee volatility. While such measures have restricted rupee depreciation to 0.3% since the date of announcement of QE tapering (until July 26, 2013), pressure on the Indian currency continues to persist. The implications of a tapering of QE, for India are many and rather severe

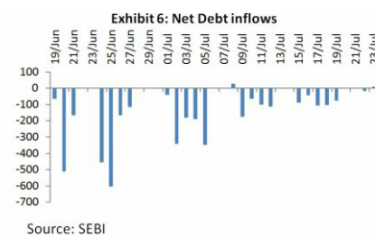


too. With no precise indication of the timing of reduction this stimulus support from the Fed, investors have moved to the sidelines, rather withdrawn. It would be a huge challenge for India to bring back those funds into the country once again in such an environment. This implies increased pressure on the rupee, which has direct negative consequences on the country's trade and current account deficit, external debt position and hence domestic fiscal balances.

For one, existing forex reserves of the country are sufficient to support only 7 to 6.5 months of imports, which limits the ability to draw down reserves in a bid to cushion the falling rupee. With imports turning expensive due to a depreciated rupee and exports growth remaining subdued in a low global demand phase, the trade and current account deficit (CAD) are bound to widen (as has been happening in the last few quarters).

Secondly, capital inflows that generally finance the CAD of the country have also started to moderate. Worsening of the CAD without adequate cushion from the capital account is a further pressure on the currency.

Thirdly, in a high-interest rate scenario with a depreciating rupee,



comes more vulnerable. The share of external borrowings (ECBs/FCCBs) in the CAD has increased substantially, escalating debt-service pressures for the country.

Moreover, the concern of imported inflation rising on account of a weaker rupee would bring back the dilemma of inflation-growth trade-off before the monetary authority. The interest-rate trajectory as decided by the RBI would have important implications in terms of liquidity, credit off-take, investments growth, production activity and consumer demand.

The coming months would hence, be critical determinants of growth prospects of the global economy. Monetary policy stance as embarked on by the Fed would not just impact future course of the US economy, but also countries across the globe. Liquidity as pumped in by the Fed, or the absence of it, would influence monetary policies of all economies; particularly, those of emerging market giants such as India. For India, specifically, walking the tight rope of prudence in the immediate/short-run and making informed choices that would impact long-term growth objectives, would bring with it challenges abound.

CDC PSRS completes 5 years



- CDC Report

SAFE has organized a Multi-Stakeholder Advocacy Moot for discussing progress of the RFI project funded by USAID for harmonizing regulatory frameworks of the capital

markets of South Asia.

CMDA, Maldives Stock Exchange (MSE), Maldives Securities Depository (MSD) & the broker/dealers attended meetings with the consultants who visited Maldives for collecting information for the project. As part of the continuing support to the project, CMDA will be attending SAFE's Multi-Stakeholder Advocacy Moot in Mumbai, India on 5th July 2013. Discussions will focus on ways to address the challenges in the proposed framework and identify additional recommendations to incorporate into the Rule Book &

anticipated support of regulators, exchanges, ministries and governments to adapt the proposed framework.

CMDA is currently reviewing the draft RFI report in order to identify the suitability of the proposed framework to the Maldives Capital Markets.