



The Adaptability study of Quantitative Easing for Indian Economy

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Abstract: *The global economy is awash with successive waves of liquidity generated over the past few years by the four most advanced economies — the US, the European Union, Japan and the UK, known as the G4. This liquidity has taken the form of Quantitative easing (QE). When zero rates of interest have failed to stimulate their economies, these countries have resorted to large-scale asset purchases by their central banks, such as corporate bonds or mortgage-backed securities, to pump more money into the banking system. The aim is to extend credit to business and industry and encourage consumption. In the immediate aftermath of the 2008 crisis, when there was a danger of financial collapse, both advanced and emerging economies adopted stimulus packages, to revive demand, maintain trade flows and avoid large scale unemployment. During the crisis phase of 2008-09, QE played an important role in crisis management, helping advanced and emerging economies alike.*

Keywords: *Quantitative Easing, Zero Interest rates, Stimulus Package.*

I. INTRODUCTION

Quantitative Easing is a government policy designed to increase the money supply to promote lending. This is done by giving banks and other financial institutions extra capital.

It's an unconventional monetary tool used by central banks to stimulate the economy. It is used to refer to induced or stimulatory monetary policy. Quantitative easing is used to drive interest rates downwards by pumping more money into the economy. Tackling deflation becomes possible as more money in the system pushes prices upwards.

The “Quantitative” half of quantitative easing refers to a specific quantity of funds being created.

“Easing” refers to the reduced pressure on financial institutions that occurs after creating excess funds.

Quantitative Easing has mainly Two benefits till so far,

Firstly it injects more cash into banks, allowing them to lend more. And second, it lowers interest

Quantitative easing has ‘Two’ episodes till so far: QE1 and QE2

QE1 has started in Late 2008 November when financial crisis hits, the Federal Reserve started buying up mortgage-backed securities and Treasury bills in order to boost the economy. By June of 2010, the bank had bought about \$2.1 trillion worth of assets. In the first round, the Federal Reserve bought up \$600 billion worth of bad loans from the banks, and while it didn't seem to stimulate the economy, there's a real possibility that it kept the economy from getting as bad as it could have. QE1's main objective was to overcome those financial crises so that money flow in the country could be flourishing. The first round of quantitative easing appeared to be effective in preventing the economy from sinking into a giant depression. Economists say this was because everyone realized the Federal Reserve would do whatever it takes to avoid deflation. It was essentially a giant confidence boost. The economy stopped sliding and inflation slowly rose.

QE2 The second round of easing—“QE2”—was rolled out in November of 2010. It involved the Federal Reserve purchasing \$600 billion of Treasury Notes (Federal Reserve government debt securities that mature between two and ten years). By artificially increasing demand for government securities, interest rates were kept lower than they might have otherwise been.

QE3 The two principal components of QE3 are

- (1) A commitment to keep the Federal Reserve funds rate near zero through 2015, and
- (2) The monthly purchase by the Federal Reserve of \$40 billion in mortgage backed securities.



The net effect of those two actions are to make sure that interest rates continue to be low—with the idea that low rates stimulate economic growth—and that banks continue to stay liquid so they can lend.

Quantitative Easing firstly implemented by Bank of Japan on 19th March 2001. To fight with local deflation in domestic market. In March 2009, the Monetary Policy Committee (MPC) announced that it would reduce Bank Rate to 0.5%. The Committee also judged that Bank Rate could not practically be reduced below that level, and in order to give a further monetary stimulus to the economy, it decided to undertake a series of asset purchases. Between March and November 2009, the MPC authorized the purchase of £200 billion worth of assets, mostly UK Government debt or “gilts”. The MPC voted to begin further purchases of £75 billion in October 2011 and, subsequently, at its meeting in February 2012 the Committee decided to buy an additional £50 bn. In July the MPC announced the purchase of a further £50bn to bring total assets purchases to £375 bn.

The purpose of the purchases was and is to inject money directly into the economy in order to boost nominal demand. Despite this different means of implementing monetary policy, the objective remained unchanged - to meet the inflation target of 2 per cent on the Consumer Price Index (CPI) measure of consumer prices. Without that extra spending in the economy, the MPC thought that inflation would be more likely in the medium term to undershoot the target. This policy of asset purchases is often known as 'Quantitative Easing'. It does not involve printing more banknotes. Furthermore, the asset purchase programme is not about giving money to banks. Rather, the policy is designed to circumvent the banking system. The Bank of England electronically creates new money and uses it to purchase gilts from private investors such as pension funds and insurance companies. These investors typically do not want to hold on to this money, because it yields a low return. So they tend to use it to purchase other assets, such as corporate bonds and shares. That lowers longer-term borrowing costs and encourages the issuance of new equities and bonds.

II. EFFECT OF QUANTITATIVE EASING FOR DEVELOPED ECONOMIES

Due to the global financial and economic crisis of 2008, the leading economies of the western world went into a deep recession. This caused the unemployment rates to soar and industrial growth to languish. Many countries in the world adopted a slew of stimulus packages in a bid to revive their ailing economies. Among them is Quantitative Easing policy. So, the major western economies like USA, U.K, the Euro Zone, and Japan employed Quantitative Easing (QE) with the intention to reboot economic growth by increasing liquidity. But, this QE, apart from affecting their own economies, also started to have a ripple effect all over the globe. This affected many emerging economies in the Asian world. During the financial crisis, apart from the major western countries, many emerging economies too employed QE like policies to prop up the demand for goods and services in their fluctuating economies. While these emerging economies seem to have overcome the crisis with bright prospects of economic growth, the same is not the case with the major

III. EFFECT OF QUANTITATIVE EASING FOR EMERGING MARKETS

The policy of quantitative easing in the US will leave ripples across the globe. With economies across the world intertwined, the impact is bound to reverberate miles away. The possibility of the excess printed money floating into developing economies and creating asset bubbles is real.

Unabated influx of cheap dollars into emerging markets is not healthy for these economies. A chunk of quantitative easing will flow into emerging markets as part of hedge fund and foreign institutional investor (FII) investments. At the face of it, fund influx may appear a bright prospect, but the eluding reality is that it is still a bubble to reckon with.

The currency value appreciates, and expected appreciation further attracts more capital flows. Increased capital inflows could push up exchange rates and aggravate inflation. Bubbles burst. Inflated stock markets have to retreat some day.

The emerging economies were having moderate growth and bullish markets during that time. So, the western financial institutions invested huge capital in these markets to take advantage of the better returns and interest rates. Though this provided huge capital inflow to the emerging economies like Asian countries, it also inflated the debt in the balance sheets of their companies.

The Asian companies kept increasingly borrowing the foreign capital that flowed from the major western economies operating in their QE-phases. This has made these Asian companies that previously had healthy debt to equity ratios, more risk prone and vulnerable. This has placed them in a precarious position where they are now vulnerable to future changes in interest rates in the major western economies and other western countries. This foreign capital inflow also put an additional pressure on inflation rates of emerging economies like India that were already struggling to rein in their spiralling inflation.

As a consequence of these inherent risks, in the recent week the world saw unusual volatility in the currencies of India, Brazil, and other emerging economies. This was indeed triggered by the fears of an early wind-up of the QE policies in developed nations like U.S. As the interest rates started rising the bond markets in the U.S became more attractive. This caused western institutional investors to pull out of their investments in debt assets of emerging economies, on a sudden and massive scale. As a result, the



currency exchange rates of these emerging economies came under huge pressure and the world witnessed one of the most rapid intraday declines in the Asian currencies, especially in India, whose INR touched a life time low of 58.98 against the USD. This has led the emerging economies, especially the BRICS nations, to criticize the controversial QE policies in the major western economies. Apart from the effect on emerging nations the QE policy also had a considerable effect on the prices of bullion and other commodities like crude oil. Gold and crude oil prices fluctuated enormously due to the prospects of an early QE policy wind-up. History shows how the previous QE policies adopted by countries like Japan had adversely affected the Asian economies and had partly caused the Asian financial crisis in 1998.

The major western economies' currencies form the global basket of reserve currency and hence play a major role in the fluctuations of the currencies of emerging economies. Therefore, it would be in the best interest of the global economy, if these major western economies pursued their QE stimulus packages with adequate caution and responsibility towards the Asian and other emerging economies of the world. One has to wait and watch, whether the major western economies' next round of QE policy, whose previous effects have already jeopardized the currencies of Asian and emerging economies, will further cast them into a deep financial crisis.

IV. QUANTITATIVE EASING AND INDIA

There is an overhang lurking around the corner for India's battered economy and that is the possible winding down of the US' Quantitative Easing (QE) programme; meaning the U.S. stimulus program is set to taper off. This programme had boosted economies across the globe and its easing will not be easy for economies, including that of India. However, analysts believe that India is a mega-power in its own right; possible the third largest economy in the world, and has the potential to grow on her own steam although some discomfort will have to be borne through.

Firstly, the key unfavorable (domestic) development during QE3 (vs. edition 1 and 2) was that even as the fiscal picture has improved, the growth outlook has deteriorated markedly and current account shortfall ballooned. As a result of the latter, reliance on debt-creating foreign capital flows grew significantly. Therefore not surprisingly, since speculation on QE3 tapering surfaced in May, foreign capital outflows topped USD 4bn from the equity and debt markets and saw rupee tumble to record low. Secondly, two of the three US Fed QEs have been accompanied by domestic stimulus packages and reforms. This had served to magnify the gains in the local financial markets. In the early months since QE1 was announced (in depths of US financial crisis), the Indian government unveiled multiple stimulus packages, along with sharp cuts in the policy rate by the central bank. This led GDP growth higher from 6.0% in FY08/09 to 11.8% in 09/10, with the domestic federal elections also providing the much-needed stimuli. High commodity prices and inflation threats lowered scope for any policy support during the short QE2 haul. Then came QE3, which witnessed the then new Finance Minister Chidambaram lay out a reforms and fiscal responsibility roadmap. This led the dollar/rupee to fall back from record high above 57.00 to below 52.00 in the ensuing months, on strong debt and equity inflows. In sum, while the external developments have influenced the reaction function, the domestic situation has also played an important role. Hence the significant capital outflows and weak rupee at this juncture are a function of still lingering twin deficit problems – current account and fiscal (seen slight improvement last year, a repeat unlikely in FY13/14). These problems are compounded by decade low GDP growth, renewed risks of rating downgrade, a backlash from high external commercial borrowings and little scope for monetary easing.

V. QUANTITATIVE EASING AND THE RUPEE

It makes the rupee worth more dollars. QE increases the US monetary base. In other words, it creates dollars. Government cannot create value; only productivity can create value. Thus, QE makes each dollar worth slightly less. Thus, it makes each rupee worth slightly more in terms of dollars. So why is the rupee falling against the dollar? Because RBI is creating rupees faster than the Fed is creating dollars. Every rupee spent by the government of India in excess of tax revenues is a new rupee created. Where else would it come from? The government of India is spending 30% more than it receives. Indian people don't seem to understand that because their newspapers lie by omission. It leads to creation of hot money.

When Fed creates money, it does not immediately decrease dollar's value. That happens gradually when the new money has changed a few hands. Say there are 100 dollars in existence and you create 100 more. Now 200 dollars are chasing the same goods and services so each dollar is worth half its initial value - but not so soon. Till the time you make the transaction, its value hasn't changed, so you can still buy stuff at old prices. Okay, now that Fed has created money, you have financial institutions flush with cash looking for returns. So they (or someone they loaned the money to) go hunting for deals that would give them the most ROI. Some of this hot money that enters India goes into buying companies, distressed assets or anything else the investors feel they can profitably exit in a few years.

Now if this investment goes into building something that is a net FOREX earner it helps rupee in the long run even if the investors exit with a profit. This is a win-win situation. Example: An export oriented semiconductor fab.

If however, the money is invested in creating something that is a net FOREX spender (like Wal-Mart selling Chinese stuff in India) then such an investment hurts the rupee. Even if the company/asset is FOREX neutral itself, when the investors exit with profit, they take with them more dollars than the brought in.



Bottom line is, if the investment creates long term value then it is worth having. Else we are just providing the investors a market to grow their investment. Such investments are okay if you intend to use them to cover short term FOREX shortfalls but they hurt the rupee in the long run. These investments should not be seen as solution for widening current account deficit. In fact they exacerbate the problem.

“If US growth is tangible and broad based due to QE easing, the Indian rupee could become weaker by another 5 to 8%. However, if the Indian government, post elections maintains sound economic policy reforms, coupled with a good monsoon, the rupee could recover and stabilize at 55 levels,” says K. Jayraman of Bonanza Portfolio.

“The rupee will fall further due to increase in dollar demand,” says Kishor P Ostwal of CNI Research. However, India has sufficient dollar reserves, he notes. (3rd June 2013, Afternoon Dispatch and Couriers)

VI. QUANTITATIVE EASING AND EXCHANGE RATE APPRECIATION

Exchange rate appreciation is set to impact exporters and impede growth. This could lead to further unemployment in countries that have only recently rebound from economic slump and social instability. To stay afloat, slowdown in exports has to be replaced by increasing domestic demand.

Curbs to capital flows are likely to follow as remedial measures by governments intending to protect their interests. Otherwise it would be difficult to manage the scenario when dollar liquidity tightens in the future. Financial stability and growth would be adversely impacted in both regional and global domains if the asset bubbles persist due to excessive fund influx.

VII. CONCLUSION

An essential adjustment for the economy, elections to slow process Is the Fed’s decision to taper QE3 all gloom and doom for India? Not necessarily. The decision to withdraw excess liquidity might prove beneficial further out. The resultant market pressures could pressure authorities to address the current account imbalances and maintain the reform momentum. This might aggravate downside pressure on the rupee, but helps narrow the case for excessive monetary easing, in the light of the adverse macro imbalances and high retail inflation.

For the next twelve months, the reforms’ schedule is likely to remain reactive, rather than pro-active. Moreover the willingness to introduce reforms will also be hamstrung by political roadblocks, with much effort likely to be focused on populist and flagship schemes like the food security bill. As highlighted in our quarterly update (DBS 3Q13 Quarterly, India: Stuck in negative loop, dated 13 June) – risks from rating downgrade and reversal in the fiscal consolidation are the two main themes that will be watched closely here on. In the short-run, efforts will be on to contain stark and rapid rupee depreciation, to prevent risks to financial stability. The limited foreign reserves arsenal will make the central bank maintain minimal and intermittent presence, alongside frequent jawboning efforts. Other interim measures that can be considered include - enforcing of staggered dollar purchases by importers, conduct special market operations by way of providing dollar liquidity directly to oil companies and increasing FII limits in debt investments. On the FII debt limits, in particular, the potential to increase in the foreign participation in the local debt market is substantial, though that cuts both ways.

Leaving aside the need for a stable currency to maintain investors’ interests, an exposure to the extent of Indonesia and Malaysia (>30% of total debt) will be precarious for India, given the latter’s high fiscal deficit and need for stable debt markets. The flotation of an offshore NRI bond is also a suitable option, with ideal proceeds of USD 15-20bn sufficient to beef-up the reserves stock and also provide assurance of sufficient funding.

Globally, a basic presumption for the US Fed to claw back the asset purchases is based on the judgment that growth indicators are looking stable (veracity of which we question). Alongside, risks of a possible surge in inflation are also low. If this indeed is the case, then beyond the present volatility, an improved global growth and inflation outlook should prove beneficial to most asset classes and economic activity.

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