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Destructive Easing

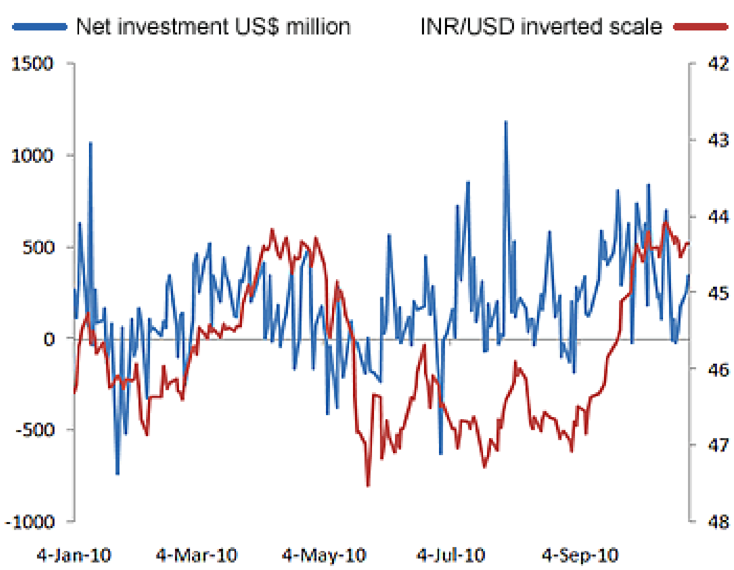
By Kunal Kumar Kundu

The world is awash with liquidity as fears of a double dip recession continue to engender the easy monetary stance maintained by the developed world. As the United States prepares to launch the sequel (popularly dubbed QE2) to quantitative easing, there will be a veritable liquidity tsunami staring at us.

Not only this.

With the pension funds in the developed world struggling with unfunded liabilities, many of them are increasingly looking toward investing in emerging market economies and so posing them a unique problem - excessive flow of liquidity. The problem is further exacerbated for those economies whose actual and expected growth rates are high, especially in comparison with the anaemic growth rates of the developed world.

Naturally, India is not immune to this. With inflows from foreign institutional investors (FII) touching US$25 billion this year, the rupee has strengthened sharply, especially since September, when the market witnessed a plethora of initial public offerings as well. Since September, the rupee has appreciated by nearly 5%.



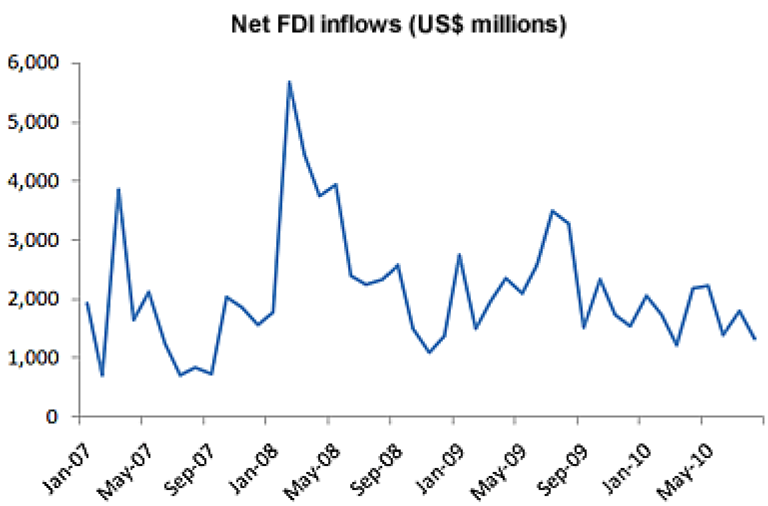
Source: SEBI, RBI

In fact, the average daily net inflow during the first eight months of the calendar year, was $131 million, the average daily inflow for September was nearly double that at $355 million, and in October (up to the 26th) was about $340 million.

In this regard, it is important to note that strong inflow is not the only cause of appreciation of the rupee vis-a-vis the US dollar. Weakening of the dollar itself adds to the pressure. Nevertheless, strong inflows do exacerbate the process.

Not only is the impact of inflow visible in the foreign exchange market, the Indian equity market is also experiencing an impressive bull run. So much so, that the market seems to have run beyond fundamentals, as liquidity pours in, in search of higher return, buoyed by the India growth story.

In contrast, however, the foreign direct investment (FDI) inflow presents an interesting picture. FDI in August dipped by about 60% to $1.33 billion from a year earlier - the lowest this financial year (which ends in March 2011). FDI inflow in August 2009 was $3.26 billion. During the first five months of 2010-11, the inflows declined 35% to $8.88 billion from $13.76 billion in the same period last year.



Source: SEBI

What explains this dichotomy?

Seemingly the global uncertainties are holding up the flow. Although India's growth story remains compelling, FDI investors are playing it safe and are postponing their investment decisions till a more stable environment emerges. In the longer run, however, I do feel that the FDI flow will perk up. On the other hand, from the FII point of view, momentum investment is ruling the roost as asset prices move north.

From India's perspective, it is a worrying signal. As FDI flows (which are longer term in nature) dwindle, FII flows (which are shorter term in nature) continue to flow in unabated. With the stock markets already reaching pre-crisis levels and with valuations running ahead of fundamentals, FIIs might turn their back soon and seek greener pastures. This can lead to a lot of volatility in both the stock and currency markets in the short to medium term.

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