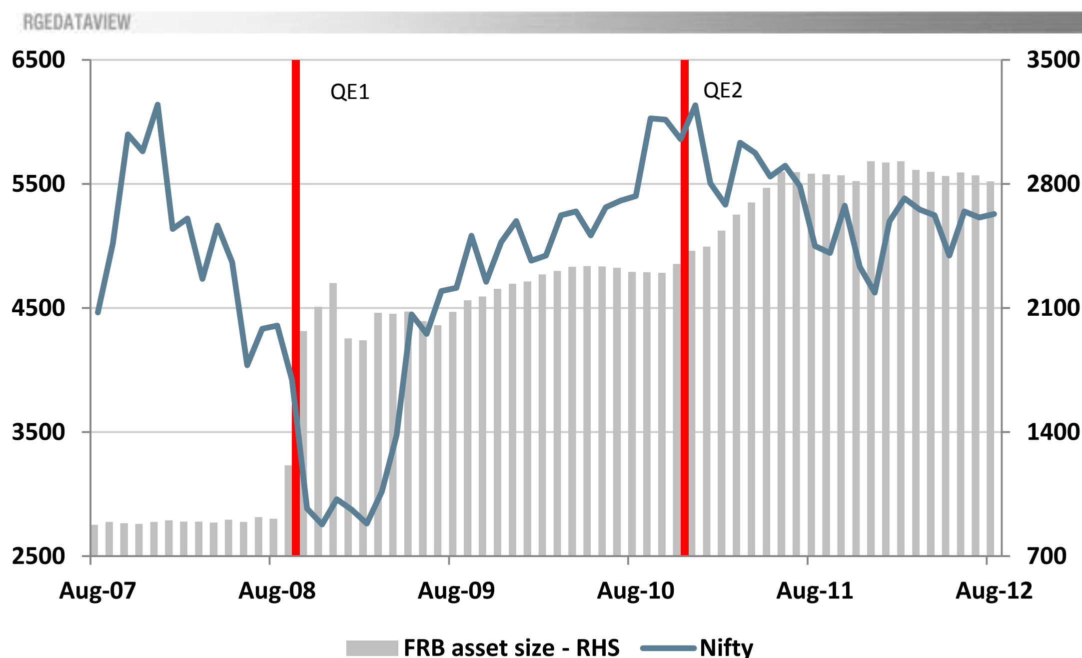
QE Does Not Drive Portfolio Flows Into India

By Kunal Kumar Kundu

Conventional wisdom has it that quantitative easing (QE) leads to deluge of capital flows into emerging market economies and are generally positive for risk-on assets. The focus of this piece is the impact of QE on Indian stock market.

While the impact of QE1 was clearly positive for the Indian stock market, it is important to realise, however, that mere perceived causality does not imply that necessarily one leads to the other.

Figure 1: Performance of NIFTY (Equity Index of National Stock Exchange or NSE)



Source: National Stock Exchange (NSE) of India and Federal Reserve Board (FRB)

As mentioned earlier, QE1 did lead to Indian stock markets virtually doubling from its low. However, QE2 failed to have the desired effect.

Similarly, while the portfolio investors became more active post QE1 (total net inflow during the two year period post QE1 was north of USD 75 billion), there was an overall net outflow till Aug'12 post QE2.

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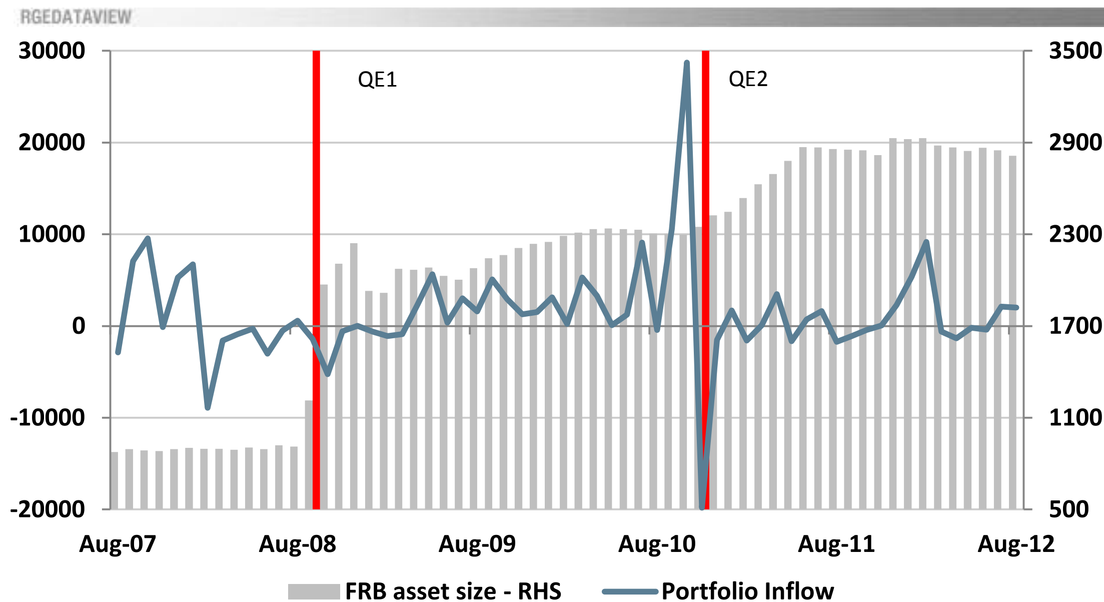
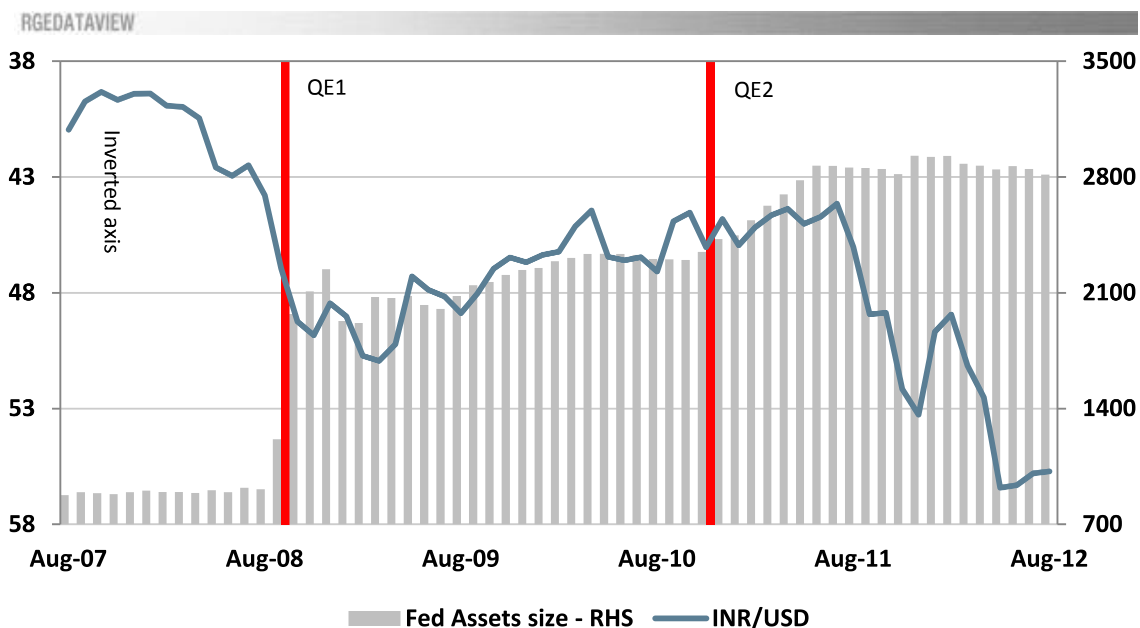
Figure 2: Net FII Inflow (USD billion)



Source: RBI, FRB

In the same vein, while the INR appreciated fairly strongly post QE1, it moved the other way post QE2.

Figure 3: Movement of INR/USD



Source: Haver Analytics, RGE

So, why is the reality different from perception? It has to do with differing macroeconomic fundamental of India over the period.

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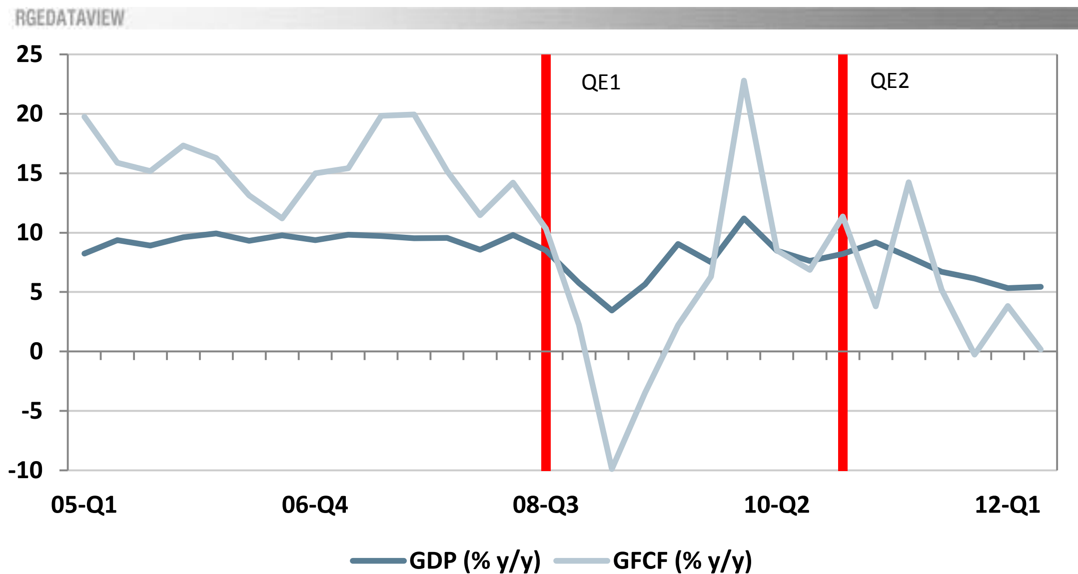
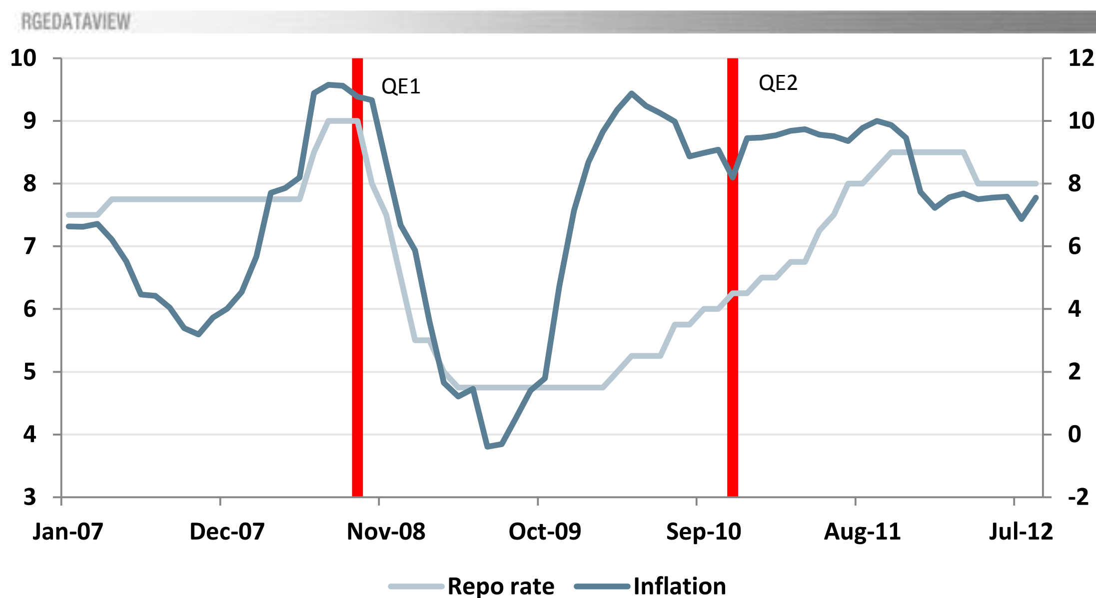
Figure 4: India's GDP And Capital Formation



Source: Haver Analytics, FRB

Figure 5: Inflation And Interest Rate



Source: Haver Analytics, FRB

Before the global financial crisis erupted, India enjoyed a period of high and sustained growth. Capital formation also remained quite strong. As the financial crisis resulted in a slowdown in global growth, Indian economy also felt the heat. However, the economy recovered fairly quickly and regained the strong growth momentum on the back of economic stimulus as domestic demand recovered fast, aided by falling inflation and a fast pace of easing by India's central bank (RBI). However, all these period of high growth had its toll as India hit a structural bottleneck

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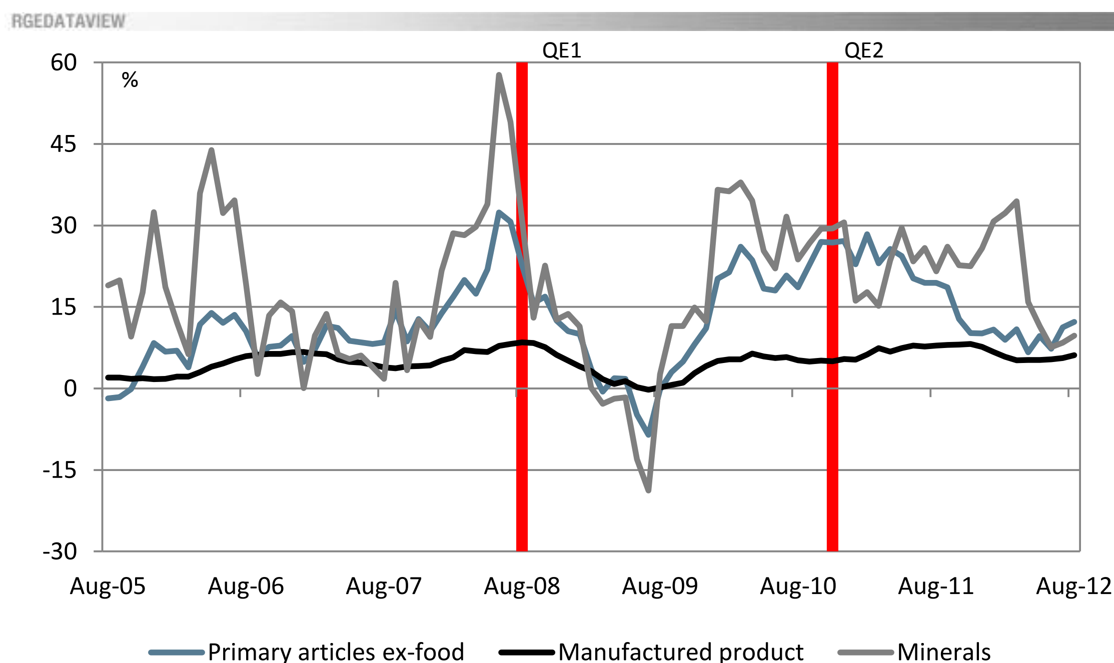
and inflation started to rise – led by rising global prices of commodities (including oil) and domestic food price. Rising inflation induced RBI to embark on a tightening mode. However, RBI was not only slow to react; even the pace of their tightening was much slow for comfort, which resulted in inflation and inflationary expectation galloping away. And then when RBI realised their folly, they moved way to fast but by that time the harm was already done and inflation continued to remain at elevated levels. High inflation and high interest rates had its toll on the economy as domestic demand started to suffer. Thus, by the time QE2 started, the economy was slowing down while inflation jumped to near double digit mark. Not surprisingly, the impact was muted. The problem was further exacerbated as Indian political environment worsened and policy paralysis gripped the country. Unending stream of populist expenditure and worsening global environment meant that high dual deficit (fiscal deficit at 5.8% of GDP and CAD at 4.2% of GDP during FY12) pulled down the economy even further.

Figure 6: Input And Output Inflation



Source: Office of Economic Adviser

Not just the macro factors, even corporate performance reflected the broader equity market performance. As input inflation started to fall, strong domestic demand ensured better pricing power and hence corporate bottomline remained healthy, resulting in improved stock market performance. However, by the time QE2 came into existence, input inflation was up again, while continued demand destruction meant much weaker pricing power for the corporate. This resulted in stable output inflation and hence worsening corporate bottomline.

Now that QE3 has been announced, there is no reason to believe that this will induce additional flow of fund into the stock market, simply because there will be more liquidity in the system. What will drive the flow of liquidity will be the overall macro as well as micro fundamental. Fortunately, the QE3 coincided with a stream of positive policy announcements by the government of India though the political environment hasn't improved sufficiently. Also, on the positive side, corporate bottomline is showing distinct signs of improvement – all of which explains recent inflow of portfolio investment and improved stock market performance.

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