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FX and the Demographic Divide: Indian Rupee vs U.S. Dollar

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Exchange rates, among other things, might reflect the relative fundamentals of the economies included in the currency pair, as well as the potential substitution effects from adjacent currencies. In the case of the Indian rupee (INR) and the U.S. dollar (USD), the long-term drivers related to divergent demographic patterns – the youth of India and the aging of the United States – could not be more striking or important. And while the demographic divide frames the primary challenges, the substitution effects of how India fares relative to other emerging market economies can also play a very large role in determining the INR/USD exchange rate – in the short-term and long-term.

In this report, we start with a concise discussion of the demographic divide between India and the U.S. which raises the possibility of long-term economic growth differentials colored by substantial political and economic risks. Then, we turn to substitution effects in foreign exchange. Just because an exchange rate is a currency pair, in no way does that mean what happens in adjacent markets cannot have a huge impact on exchange rates, including the potential for "contagion" effects when global risks are rising appreciably. **Indeed, in this era of very low or even negative policy rates from major central banks, at some point the global search for yield may find emerging market currencies, and the Indian rupee, more than worth the additional risks.**

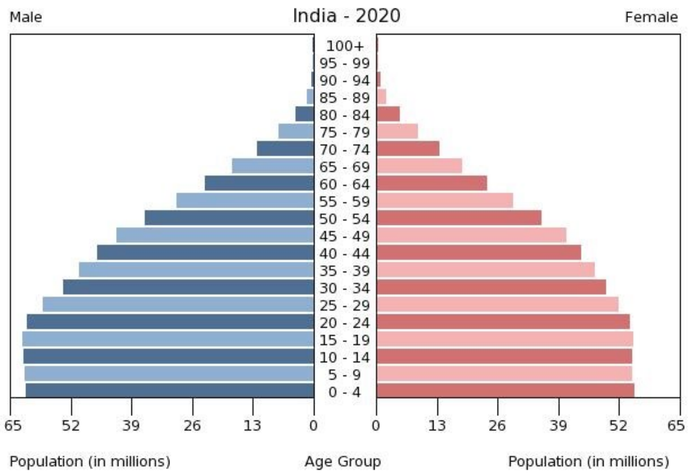
Policy Challenges of the Demographic Divide

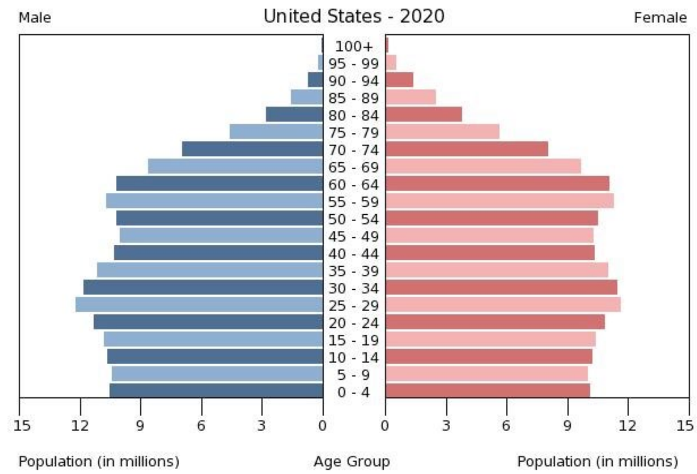
Demographically, India is young and very large. There are 680 million people under the age of 30, or over 50% of a population topping 1.2 billion – the second largest in the world after China. Less than 6% of the people are over 65, meaning very few people leave the labor force each year. And, over 20 million young people arrive at the age for entry level into the job market every year. Creating jobs is absolutely key for political stability. Failure to grow the economy can cause huge disappointments and raises the risk of political uncertainty.

By contrast, U.S. baby boomers, born roughly between the late 1940s and early 1960s, are now retiring. Just over 14% of the U.S. population is already older than 65 years of age, and that percentage will be rising steadily over the next decade. Retirees do not consume as much per capita as they once did in their peak-earnings years. The baby boomers, indeed, were known for their embrace of leverage and consumption, and many are now realizing their savings are insufficient for retirement. In their retirement years, boomers may become increasingly frugal. And, the economic drag from the aging baby boomers is not going to be offset by the millennial generation, at least not for next decade or two.

Moreover, while there are more young people arriving at the age of entry to the U.S. work force than people hitting retirement age, the net annual job creation required to keep the unemployment rate stable might be as low as 1,000,000 to 1,250,000. That does not mean that creating jobs is not important for the U.S. economy, but the job creation challenge in order of magnitude is less than that for India. India has no drag from retirees, while enjoying an extra push as the average age of workers rises toward their years of higher productivity and incomes.

Figures 1 & 2: Population Pyramids for India and the US for 2020





There are some basic exchange rate drivers that emerge from this economic divide. Economic growth differentials are expected to favor India by a large margin, albeit with considerable economic and political uncertainties about the government's ability to steer the economy. Our analysis suggests that the potential real GDP growth rate for the U.S. has dropped to about 2% annually, while potential real GDP growth in India is probably in the 5% to7% range annually. In our view, this wide and persistent growth differential swamps any risks associated with trade imbalances.

There is also an inflation divide, as economies with a compelling need to create jobs also tend to have a policy bias toward a modestly depreciating exchange rate and allowing for more inflation than mature industrial economies would prefer. From an exchange rate perspective, relatively high economic growth potential favors the Indian rupee, while low inflation favors the U.S. dollar, but this is before considering monetary and fiscal policy or factoring in global currency portfolio substitution effects.

Monetary and Fiscal Policy Considerations

Monetary and fiscal policy matters a lot. The U.S. Federal Reserve generally feels that 2% real GDP growth is substandard, and that an absence of inflation pressure is not desirable. Hence, the Federal Reserve (Fed) has only recently abandoned its zero-rate policy in favor of a small 0.25% rate increase in December 2015, and offered guidance that as many as four incremental rate rises might come in 2016. The market consensus differs from the Fed guidance, however, and expects future rate hikes to be long-delayed, possibly with only one small rate hike in 2016. This accommodative monetary policy stance largely removes the positive influence of low relative inflation for the U.S. dollar. And, fiscal policy, which might be used for tax reform or structural spending, both of which offer some potential to encourage U.S. economic growth, appear off the table in these times of highly-polarized U.S. politics and Presidential-Congressional gridlock.

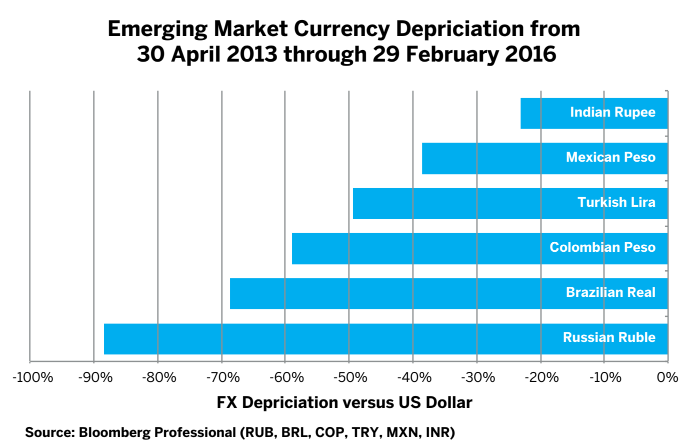
From a policy perspective, India stands in stark contrast to the US. Not long ago, Indian inflation was touching 10% and has now declined to just under 6%. The decline in inflation was due, in no small part, to India being a major beneficiary of lower energy and commodity prices globally. Although we must note, in India's case some of the benefits of low commodity prices accrue to the Government in the form of lower energy subsidy costs rather than to consumers. The Reserve Bank of India (RBI) has taken advantage of the reduced inflation rate to lower its policy interest rate to 5.75%. Of note, like the U.S., the RBI's policy rate does not offer any premium over the current inflation rate. This results in a relative neutral impact on the future exchange rate from a comparison of U.S. and Indian monetary policies.

Risks and Portfolios Substitution Effects

Interestingly though, while bilateral comparisons of economic fundamentals are important for exchange rate analysis, a better appreciation of possible risks and currency portfolio substitution effects may well be the determining factors for the INR-USD exchange rate over the coming year. For example, emerging market currencies as a group have tended to be under stress since May 2013 when then U.S. Fed Chairman Ben Bernanke initiated the debate about when quantitative easing should be withdrawn. From 30 April 2013 through 29 February 2016, emerging market currencies have declined across the board versus the U.S. dollar.

Emerging market currencies may be entering a very different phase in 2016. While the U.S. Fed may choose to hike rates all of 0.25% in 2016, it has become clear the lack of inflation in the U.S. and a lowered potential economic growth rate will keep the Fed far away from considering any form of aggressive removal of monetary stimulus. And, other major central banks from the European Central Bank to the Bank of Japan are expected to continue their quantitative easing programs, which along with negative or penalty interest rates for deposits held at these central banks, have led to negative yields along much of the Government bond maturity curve. In this low-rate financial environment in major countries, one can expect investors to increase their search for yield wherever they can find it – and that would include taking another look at emerging markets.

Figure 3:



This brings us to a discussion of relative risks among substitute currencies. Of course, one could buy a basket of emerging market currencies and diversify the risk (and the return) or one could examine the relative risks among different currencies and be more selective.

India is not without some obvious risks. Droughts have hurt farmers and some are protesting government policies. Fiscal subsidies for energy, electricity, and water have created large budget deficits and disrupted market price signals leading to poor resource allocation. And while the Government of Prime Minister Narendra Modi was elected in 2014 amidst enthusiasm for reform, real change has proved very slow in coming and political protests are on the rise. For all these risks, though, India still looks very good on a comparative basis. India is a clear beneficiary of low commodity prices, as noted above in the discussion of relative fundamentals, and lower commodity prices are helping to reduce the cost of Government subsidies. And while there is plenty of political uncertainty in India, it is hard to argue on a relative basis that India is in any way unique from other emerging market countries, from Brazil to Turkey to Thailand – not to mention the uncertainties related to the U.S. Presidential election in November.

On net, our perspective is that when one does the homework on the various factors that could impact the Indian rupee (vs the U.S. dollar), the striking fact is that there are very few countries able to grow consistently at 5% real GDP annually in this low-commodity price, slow-growing world. Among global financial markets searching for yield, India is likely to find growing enthusiasm despite some considerable risks. India has strong growth prospects, benefits from low commodity prices, and offers relative political stability. As such, the Indian rupee may stack up well against other emerging market currencies and this may help explain why the Indian rupee depreciated less than other emerging market currencies during the "contagion" phase.