

# India's Inflation-Fighting Mistake

Higher Short-Term Interest Rates Did Not Solve One Problem, But Created Another

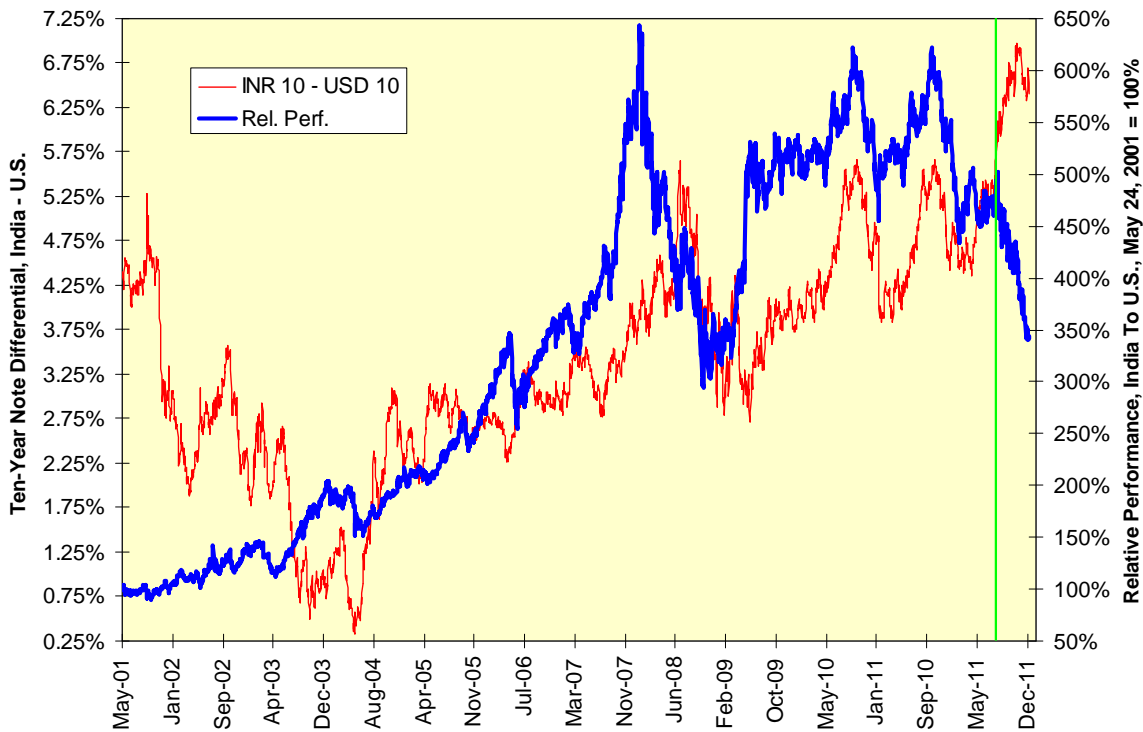
I concluded in February 2011's [Indian Rupee and Limits to the Carry Trade](#):

The Federal Reserve has insisted it has done something without precedent in human history; print a reserve currency without inflationary consequence. India would beg to differ, and all those who chased over to the BRIC markets in search of return will discover the carry trade has its limits. Mae West once proclaimed in another context, "Too much of a good thing can be wonderful." Not if it is money printed without regard to the consequences.

The results have been subpar on the sub-continent over the past year. The Reserve Bank of India took the bait to raise short-term interest rates; they now stand at 8.50% as opposed to 6.50% last February. Inflation has not come down very much; it was at 9.64% then for urban non-manual workers as opposed to 9.44% today. The rupee (INR) has taken it on chin; the excess carry return for borrowing the USD and lending the INR since last April's global equity peak has been -17.8%. Indian equities have lost almost 31.2% in USD terms.

Even Indian government bonds are reeling; 7-10 year Indian bonds have lost 14.6% in USD terms since last April while our Treasuries have gained almost 13.0%. This has not been pretty. As I noted [yesterday](#) in the context of Mexico, the August 2011 pledge by the Federal Reserve to keep short-term interest rates low, marked on the chart, scared investors into fearing a massive carry trade inflow into India.

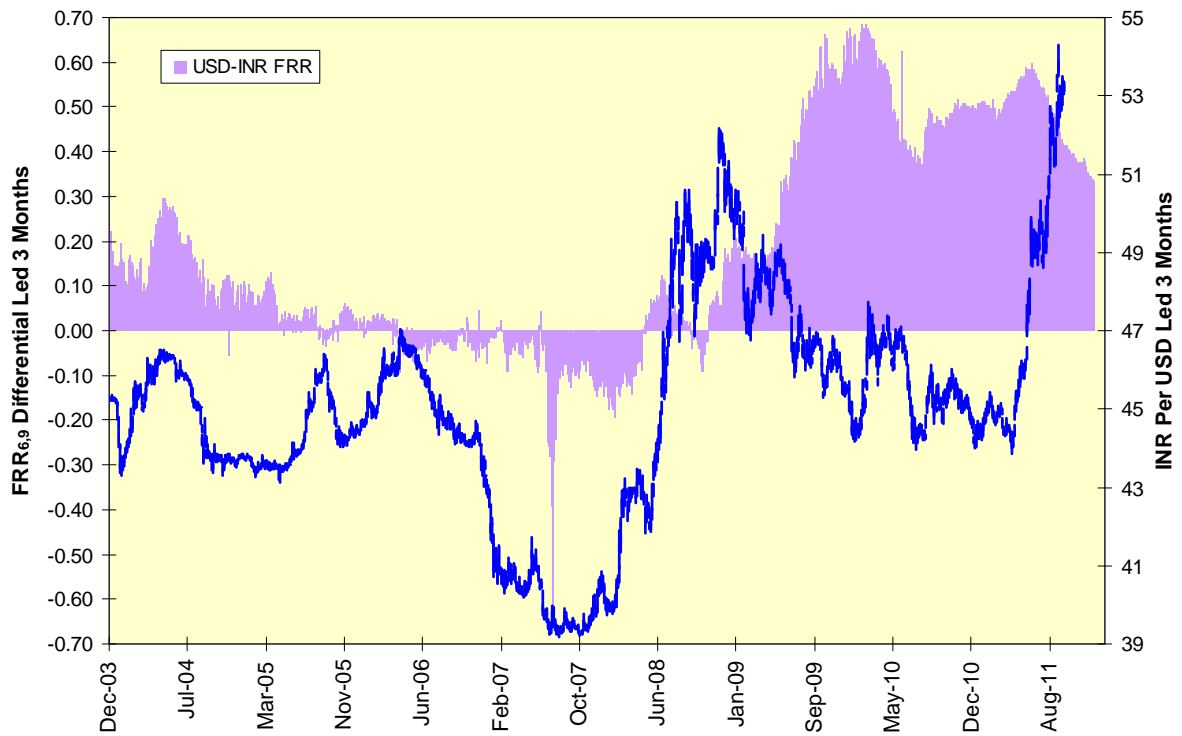
## Long-Term Interest Rates And Relative Stock Performance



### Short-Term Interest Rates

We can measure expected interest rate differentials via the forward rate ratios between six and nine months ( $FRR_{6,9}$ ) for the two currencies. These are the rates at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate. The USD  $FRR_{6,9}$  has flattened sharply relative to the INR  $FRR_{6,9}$  as markets expect lower short-term rates in the U.S. and higher ones in India. The narrowing differential has coincided with the INR's selloff as global investors have decided to look for someplace where short-term interest rates are not being jacked higher.

### Rupee Under Pressure



The Reserve Bank's rate hikes may have raised the price of money but as they reduced the demand for cash balances, they did not reduce the quantity of money in the Indian banking system. Thus higher short-term interest rates have led to a vicious cycle of inflation, higher long-term interest rates, lower asset valuations and a currency on the run. As I do not see the Reserve Bank reversing itself any time soon, I expect poor returns in Indian markets and would avoid them if you can.