Monetary policy to cap rupee rise

The new monetary policy framework adopted last year is a deep and long-term structural reform for the Indian economy. It makes the Reserve Bank of India (RBI) focus on a single policy mandate, i.e. controlling the inflation rate. The target rate is given to the monetary policy committee (MPC) by the government. It is actually a band, currently between 2% and 6%, and that's why the framework is more correctly called flexible interest rate targeting (FIT).

FIT as economic reform, in its significance, is right up there along with the discontinuation of automatic monetization of the fiscal deficit. In the bad old days, if the government had a fiscal deficit, what would it do? Just ask the RBI to print extra notes! Even a school kid understands the stupidity of this approach, but many developing countries followed this practice for several decades. That was discontinued as a big reformist step. This meant that the government would now have to borrow the extra funds, and not just print new notes.

The other related reform was that the borrowing would be at "market rates", i.e. it forced the government to sell fresh bonds in auctions. The more desperate the deficit situation, and the less the supply of savings in the economy, the higher the interest rate the government has to offer on its bonds. This major reform adopted in the early 1990s brought much needed discipline to government borrowing, after the disastrous splurge of the 1980s. This was practically the end of the era of financial repression in India, when interest rates were controlled both for lenders, i.e. depositors, and borrowers (with the biggest borrower being the government itself).

crackIAS.com

Of course, India remains the only country which still pre-empts national savings through the statutory liquidity ratio (SLR) requirement on banks. This means that roughly one-fifth of all deposits are compulsorily invested in government bonds even though their pricing is determined by auctions. The deficit is thus financed at "market prices", but a back-door clause of SLR makes sure that adequate finance is always available.

Which leads us to the other key "market price" that is currently the bane of the Indian economy. This is the exchange rate. The MPC sets the key policy rate (repo rate, or the overnight rate at which banks borrow from the RBI), and all other interest rates of all durations are presumably derived from this policy-determined rate.

Currently, this rate is very high compared to rates in the Western world. So, this is attracting foreign funds into the debt market. A dollar that would earn near-zero return in New York or London, is able to earn nearly 7% risk-free in rupee terms on shore in Mumbai. When that investment in Indian bonds is redeemed, it goes back by converting rupees to dollar, a rate which has gone up, not down. So, that makes total return on foreign flows into India's debt a handsome 10-12%.

This risk-free investment arbitrage encourages more inflows. This year, more money has come in than the previous two years combined. The dollar flow into debt has been close to $17 billion. Meanwhile, the rupee is stronger by more than 10%, which is the icing on the cake for the foreign investor redeeming his investment. This is encouraging more foreign funds to come in, which itself drives up the value of the rupee. It is a dangerous self-fulfilling prophecy, leading to a possible bubble. When that bubble bursts, it may result in a sharp and abrupt drop in the exchange rate.

Apart from the foreign investor in the debt market, the other constituency happy with a stronger rupee is (typically large) companies that had taken dollar loans when the rupee was weak, say, at 68. When the rupee gets stronger, it is music to these borrowers' ears. But elsewhere in the economy, there is much to lament. Exporters suffer, jobs are lost in sectors like gems and

jewellery, textiles and leather. Even domestic industry is suffering from the onslaught of imports which eat into their market share.

Meanwhile, dollars keep flowing in because we have an ever-increasing quota for foreign investors in the debt market, and unlimited access to the equity market. How then can this damaging strengthening of the rupee be prevented?

The purists will say that you cannot control both the interest rate (through the MPC) and the exchange rate, and also have free capital flows. But, in fact, we do not have a completely open capital account. Besides, we don't need to hunt for "corner" solutions of this extreme or that. We can gently guide the rupee back towards a more competitive rate (say, Rs68 to Rs70).

Defending an appreciating currency is a much easier task than defending the opposite. This is because the incoming dollars can simply be bought and dollar reserves can be accumulated.

China has ten times our reserves, though surely its economy is not ten times bigger. Most of all, we could do this through monetary policy, by cutting interest rates. This decreases the attraction of portfolio flows into the debt market. Lower interest rates will also have the much larger attendant benefit of spurring domestic investment. But that has been elaborately argued already by many others, who also point out that very high real rates are hurting the economy.

India badly needs a competitively priced exchange rate. Not an artificially undervalued exchange rate on which the tiger economies rode, but a strategically priced one which helps domestic jobs and industry.

Ajit Ranade is chief economist at Aditya Birla Group.

Comments are welcome at views@livemint.com

END

Downloaded from **crackIAS.com**

© **Zuccess App** by crackIAS.com

crackIAS.com