

### **Monetary Policy and the Exchange Rate**

The central bank's monetary steps in the last couple of weeks, and leaving the policy rates unchanged on 30<sup>th</sup> July, suggested that it had put a floor of Rs. 60 below the exchange rate, that the priority for monetary policy was to restore stability in the currency market. This has not worked at least so far -- at the time of writing, the rupee has already crossed 61!

The monetary steps could have been prompted by,

- The impact of the change in exchange rate on inflation and fiscal balance going beyond tolerable levels. (As it is the fiscal deficit would be strained by the expenditure on food security and other subsidies.);
- as the banking supervisor, the central bank's concerns about the impact of a further fall of the rupee on the quality of commercial bank assets, given that the corporate sector has huge unhedged short positions; and/or
- The rupee has depreciated enough to make the tradeables sector of the economy competitive enough to bring down the trade and current account deficit to more manageable levels.

Whatever the underlying rationale, the question is whether the monetary policy steps are enough to stabilize the exchange rate and help attract adequate foreign capital, in one form or another, to finance the deficit. Several pink papers have discussed an IMF loan, and comparisons are being made with 1991. The fact is that the policy choices for restoring stability to the country's external account are narrowing rapidly.

The other side is that, in terms of independent analyses of the sustainable exchange rate, the level could be significantly below Rs. 60. One wonders whether the RBI's faith in the REER index, as presently constructed, as a measure of the competitiveness of the tradeables sector, is as grievously wrong as the IMF's estimate of the fiscal multiplier. It may be recalled that the IMF realized last year that the multiplier (namely

the ratio of fiscal compression to nominal GDP change) is not 0.5 as it had assumed, but anywhere from 0.9 to 1.9! Use of mathematical models without clarity about their underlying assumptions and limitations can be highly misleading – and the cost is too often borne by people least able to bear it. Ask the Greeks, for example!

This apart, even if stability is achieved for a while (which seems unlikely), will it lead to capital inflows on the scale needed to finance the current account deficit? (Given the time lag between change in the exchange rate and its impact on trade, it is unlikely that the current year's deficits would be much lower than the last year's.) One is not very bullish – for several reasons. The higher interest rates would surely lead to slower growth; as it is, the Q1 corporate results suggest that profitability is under pressure thanks to the slowdown. Is this an attractive scenario for portfolio inflows in the equity market? As for inflows in the debt market, my impression is that moneys come only at the short end and if the arbitrage between the interest rates and forward margin is attractive, which today it is not. What about FDI? In the last two weeks alone, POSCO and Arcelor Mittal have withdrawn from two major steel projects; Bharati Walmart has given up leases on 17 properties acquired for its foray in retail business; and, faced with a demand of Rs. 800 crores for additional price of the land it acquired more than a decade back, the Managing Director of Maruti Suzuki has said, *"I have never heard of such kind of a thing in any country"* (Times of India, July 29).

Would higher domestic interest rates encourage external commercial borrowings because of the more attractive interest differential? The fact is that, in recent years, the "animal spirits" of the entrepreneurs have died and, with a slowing economy, few fresh projects are being launched in the country. Also, throwing open the ECB window for more and more businesses with no natural hedges to the currency risk, can only further strain the quality of bank assets. And, given the huge gap between the long and short currency positions of the corporate world, there is no way these can be hedged in the domestic market.

On a broader issue, when floating exchange rates came into being in the 1970s, Dani Rodrik attributed the volatility to differences in monetary policies in different countries. The logic was that a tight monetary policy decreases the supply of the currency and by the basic demand: supply logic the currency appreciates – and vice versa. Howsoever elegant the thesis seemed then, 25 years later, Kenneth Rogoff described it as an “empirical bust”.

Coming back to floating exchange rates, the theoretical justification is the efficient market hypothesis. Robert Schiller (author of *“Irrational Exuberance”*) criticized EMH as *“the most remarkable error in the history of economic theory”* a long time back. As John Kay wrote recently (Financial Times 17 July, 2013), *“In the past decade, the efficient market hypothesis has been mugged by reality”*. Obviously not in the minds of our policy-makers! To quote Reinhart and Rogoff (*“This Time is Different: Eight Centuries of Financial Follies”*), their belief perhaps is *“that financial crises are things that happen to other people in other countries at other times; crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes.”* Have we?

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