NIPFP Neemrana Opening Address

Monetary and Exchange Rate Policy in a Mostly Open Capital Account: Issues and Challenges by Ajay Chhibber

This is a very timely Conference. We could be headed towards a crisis - the first wave has just hit us but there is more to come. It is a squall before a bigger storm as the tapering has only been announced and is likely to begin soon, an election is only a few months away. But at least we have been given an early warning, which we can use to assess our vulnerabilities and see how best to go forward from here.

Everyone, including the new RBI Governor seems to think that the fundamentals of the economy are strong - and that India is passing through a temporary loss of confidence which can be restored. While it's fine to put up a brave face externally, if our politicians are not convinced that we have fundamental problems there is a risk they will continue to carry on as usual and expect technocrats to manage the country's finances and financial markets.

But does India face a temporary loss of confidence or are the problems much deeper. India faces twin deficits - fiscal and external, persistent inflation and declining growth. We have had the sharpest decline in growth (without a full blown crisis) and the largest depreciation in our currency and it is not clear whether the carnage is over.

At the G20 meeting the PM led the charge from the EMs to prevail upon the US and advanced countries to have a more orderly (whatever that means) exit from their stimulus programs. The US is likely to face its own challenges in designing its tapering program and is unlikely also want to consider its timing based on its impact on EM's. In the mid 1990s, John Connally a Texan Treasury Secretary said at the G7 - "our dollar, your problem". Ben Bernanke who taught me macro in Grad School is far too polite to say that but that is what we should expect (remark on if Larry becomes FED chair).

While I fall into the camp that believes there are fundamental problems in the economy which only deep second generation structural reforms can deal with - such reforms are not likely before the election. So what can we do to avoid a crisis, so that we can tide over until after the election - when we can do more serious reforms? At one simple level to avoid a crisis we must lower the CAD, reverse the declining growth and lower inflation. This is the immediate objective before the election and in order to avoid a downgrade, which could create the conditions for a disorderly exit.

Time is of the essence and the policy makers must also contend with the fact that the Indian markets at the moment are in a state of disequilibrium - with sentiment driving some of the behaviour. We must also ensure that short term actions do not hurt India's future ability to restore growth and competitiveness in the future.

For this conference, I was asked to focus on the policy framework for monetary and exchange rate policy in a mostly open capital account. There are so many questions on what should or should not be done, should interest rates be raised or lowered, should the rupee be defended or not, should India use part of its existing reserves to defend the rupee as it looks for more external financing (as Brazil appears to do) or should it keep its powder dry for more trouble ahead.

But first to understand better our options we must have a clearer analysis of how we got here.

The period 2000-1 to 2007-8 can be described as a "golden" period of growth in India. Growth accelerated on the back of high investment and very rapid growth in Total Factor Productivity. There was a sharp improvement in India's saving rate, household and corporate savings improved sharply, and public sector dissavings fell thanks to a fiscal consolidation plan and rising revenues. The revenue deficit fell from around 4.4% of GDP in 2000-1 to around 1%of GDP by 2007-8. Gross domestic savings as a share of GDP went up from 23.8 % of GDP in 2000-1 to almost 37% of GDP in 2008-9, but fell thereafter. As a result the CAD stayed below 2% of GDP.

Then came the global crisis. As is by now well known we handled the global crisis reasonably well - it was an accidental stimulus package designed to win the 2008 election, with loan waivers, huge step increases in public wages - but what saved us was the global crisis, which made an election related folly into a virtue. Monetary policy was also loosened very quickly and the economic came out with a V shaped recovery by 2009 Q4 when growth again crossed 8 percent - the level last seen in 2008 Q2. My own assessment is that it was fiscal policy not monetary policy that carried much of the bang for our recovery - but it's an interesting research question.

So far so good - but both loose fiscal and loose monetary policy continued, well after a recovery was underway - and inflation accelerated, and has stayed very high - more on this later. For a while stimulus based growth continued unabated and India (as well as others) felt we had decoupled from the global economy. But by 2011 Q3 growth began to decelerate, inflation stayed persistently high and the fiscal deficit, which continued became a twin deficit as the CAD widened.

At some simple level we can explain what is happening by looking at the issue not just from an Indian perspective but by looking at it more globally. A simple Mundell- Fleming framework could explain the problem that all EMs face by acknowledging that we are in the midst of an international trilemma or an international impossible trinity. The monetary stimulus in the developed countries especially QE3 has created a huge global trilemma. As return to capital fell to almost zero in the US capital flowed to EMs. The EMs had three options - capital controls as in China, allow your currency to appreciate as in Brazil or keep the nominal currency fixed and allow more inflation, as India appears to have done. So a simple macro explanation for India for the last five years is that India came into an international trilemma created by the US and advanced country monetary stimuli and once India had decontrolled its capital markets - even partially it was faced with a choice of nominal currency appreciation or higher inflation.

India happily accepted these inflows and may even have encouraged them - especially for the last 12 months when the first signs of concern over the persistence of the CAD were beginning.

Having opened the capital account could India have used the temporary surge in capital inflows to build up bigger reserves and not allowed the CAD to increase? What would have been the macro economic measures that would have allowed that to happen? Was this option available or even considered by our policy makers?

In addition, the macro position was worse than in other EMs because during this period India also ran large fiscal deficits in this period reducing competitiveness even further- hence we see that India experienced high growth for a period after the global crisis but since 2011 has seen the fastest decline in growth (without a real crisis) and now the largest fall in the value of the currency even among EMs.

The former governor - with the benefit of 20/20 hindsight - feels he should have tightened monetary policy much earlier. But with a more open capital account, a desire to maintain the exchange rate nominally at a managed band of around Rs 44-46 to the $ (albeit with huge RER appreciation), the CAD widened, financed by growing foreign inflows and its not clear there was much option to control inflation with monetary policy. Financing also flowed into the debt and equity markets. It's therefore not clear whether with an open capital account and a desire to fix the exchange rate (primarily to manage inflation) whether the governor could have exercised an independent monetary policy - the impossible trinity would have made that impossible, as higher interest rates would have led to even larger capital inflows in both the debt and equity markets.

Later in order to revive growth he tried to lower rates, while trying to maintain a managed exchange rate, but as capital started to flow out and the CAD widened, the exchange rate started to depreciate putting further pressure as well on inflation.

So one issue India must ask is whether its capital account opening (even partial) was premature. Whether India should perhaps not have opened its capital account - its more open than China's capital account. But now having done so we cannot go back to capital controls and as we have seen recently trying to start tampering with the capital account regime can itself generate a huge loss of investor confidence. In fact the first move by the new governor has been to signal no reversal of capital account liberalisation. But those very decisions circumcise our options on monetary and exchange rate policy.

India has not had a classical crisis yet-one may still come later. Instead, it was a perfect storm that crept up on us, but you cannot say no one warned what was coming. Growth had started declining from around of 2011 Q3. India began getting off the "golden turnpike of growth". It's interesting that India has seen the fastest decline in growth - without being in a real crisis. What were the reasons for this rapid decline in growth- loss of competitiveness due to lack of reforms, REER appreciation, wage increases without productivity growth. India has not only seen a decline in investment but also a decline in TFP growth. At least 1% of our slowdown in growth is due to TFP slowdown. But as external financing was easily available, India could avoid reforms until the FED signalled that it was considering taking away the "punch - bowl" and puncture the emerging market bubble. I am very interested in the last session of this conference which tries to unpack the slowdown in investment.

So India made two huge mistakes first, it opened (even partially) the capital account prematurely and once having opened it did not treat the surge of capital after 2010 as a temporary inflow which would eventually be reversed. We got carried away with the growth story which in hindsight was not built on growth in productivity but was built on a surge of temporary financing. The second mistake was the continuing fiscal deficit after India had recovered from the global crisis.

While the Indian rupee has not yet stabilised, India must also be conscious that once the tapering begins it faces some tough decisions to avoid further weakening of the currency and equity markets, as more capital outflows can be expected and a rating downgrade has at least a significant probability. So far much of the exodus has been from the debt market and much less from the equity market - but this could change if there is further loss of confidence.

India has limited fiscal policy options to revive the economy but must take strong fiscal measures to ensure that the fiscal deficit stays under 4.8 % of GDP to avoid a downgrade; among these the priority has to be strong actions to contain subsidies, cut expenditure to maintain the target fiscal deficit as revenues come below budget and disinvestment targets unlikely to be met. But all fiscal options that India has - cutting expenditure, raising controlled prices etc. will be anti-growth in the short run.

Strong structural measures are not likely before the elections but some administrative measures to revive coal production, remove project bottlenecks etc. could help a bit. A good agricultural crop will help to some extent by helping hold up rural demand.

So in addition to the key task of containing the fiscal deficit to 4.8 % of GDP a Lakshman Rekha of the FM, the main instruments left for government to manage inflation, reduce the CAD and reverse the decline in growth and revive confidence in the economy are exchange rate and monetary policy and to some extent trade policy – boost exports and manage imports and their financing.

On monetary policy the new governor has established a new committee under deputy governor Urjit Patel. There is a huge debate within the country on the correct monetary policy to take. What do we do now and what if any is the role of monetary policy? Should we have higher or lower interest rates? A year ago the RBI finally began to lower interest rates but this helped increase the CAD which was financed by even larger capital inflows. More recently, the RBI increased short term interest rates in a classic textbook defence of the rupee to deter short term speculation against the rupee -a move which has many critics on the ground that its impossible to defend the rupee, that the speculation against the rupee is largely taking place in off shore markets, and that higher interest rates would lower growth even further. In response Operation Interest Rate Twist was introduced to flatten the yield curve and ensure that long term interest rates would not be allowed to rise. We must analyse whether it can be made to work at all - especially in a country in which the yield curve is quite flat to begin with. I would be quite interested in views on this at the conference.

Are there examples of other countries that were able to successfully manage an Operation Interest Twist? The US administration tried this during the Kennedy administration and it took them more than a year to flatten the yield curve by spending almost 2% of GDP in government paper. Not clear if the RBI has that kind of money.

In trying to get a fix on the right monetary policy – the new committee will have to get a better handle on the dynamics of inflation. One of the big puzzles of India's macro economic story over the last 5 years has been persistent inflation and the big debate over its causes and the role of monetary vs structural factors causing inflation. CPI inflation has remained above 8 percent since the 2008 Q3 and above 9 percent every quarter except for two quarters. One explanation for the persistence of inflation is that with an open capital account, and a desire to maintain a managed exchange rate in a fixed band, inflation was a natural outcome.

In Understanding inflation, we must also contend with the divergence between: WPI inflation vs CPI inflation vs GDP deflator. Huge divergence in CPI and WPI inflation (and GDP deflator) from 2008 Q3 onwards. What is this due to? Is it the bottlenecks in retail delivery and huge retail margins driven by transport and storage bottlenecks that are driving this divergence and how can these be contained?

Then there is the peculiarly vexatious Indian issue of food inflation. One question which macro-economists must answer is how food inflation can drive overall inflation without a macro accommodation. The answer is they cannot do so. A food shortage can trigger a food price rise but for it to manifest into persistent food inflation some underlying macroeconomic phenomenon must exist that creates excess aggregate demand for food. One such trigger could be fiscal policy - especially the social spending which has led to higher purchasing power for the poor whose mpc for food is very high. Some have blamed government procurement pricing with very high purchase price increases from 2006 onwards. But we need to keep in mind that world grain prices showed a huge real increase in this period, and between 2006-08 our domestic prices only adjusted 30% (pass through coefficient) to that world price increase. So the increase in domestic grain prices from 2009-2011 was a catch up to the earlier increase in world grain prices. But we must also keep in mind that the faster increase in food prices was not in cereals but in non-cereal prices – pulses, oilseeds and milk which form a bigger part of middle income diets. Anyway without going deeper into this – there are some puzzles here that need more research and untangling.

The Exchange rate was allowed to appreciate after 2009 - REER appreciated very heavily. In fact the Nominal exchange rate appreciates between 2009: Q1 to 2011:Q4, so REER appreciates hugely as well. Along with this the capital account was gradually opened up - so that the counterpart of the exchange rate appreciation was a rising CAD financed by foreign inflows. While India's capital account is only partially open India has a more open capital account as compared to China. An interesting issue is whether the capital account opening was the real problem. We have seen that many countries with open capital accounts have been affected by news of the tapering - even those with CAS like Malaysia not large CADs.

This was also true in the 1997-98 financial crisis when only countries with open capital accounts were badly affected - Thailand, Korea and Indonesia were the worst whereas China, Vietnam, Taiwan which had not allowed as much financial opening were affected much less. Malaysia in fact moved from open capital account to temporary but complete control and recovered quite rapidly. The papers at this conference also point to the pro-cyclicality of capital flows which further exacerbates volatility in the real markets.

But having opened the capital account, rightly or wrongly, an important question is whether the RBI should have accumulated larger reserves during the period 2010-2013 and treated the inflows as a temporary inflow which would eventually reverse. In order to do this the Rupee would have to have been much more depreciated and not allowed to go back to a band of Rs 44-46 after 2009 but stayed closer to Rs 48-50. Could the RBI have done this easily - it would have been forced to sterilize the purchase of foreign reserves and tightened monetary policy much more? So far the RBI has been quite passive with managing inflows and outflows resulting in a capital flows being pro-cyclical and exaggerating the boom and now the decline. I would be interested in views at this conference if this would have been possible.

So we face many dilemmas and there are many questions for this conference and all the expertise that is gathered here?

How do we first establish some degree of equilibrium in currency and financial markets without some further back up financing? Even with a very aggressive fiscal retrenchment - which is very necessary to raise public savings and help reduce the CAD it's not clear that will be enough to calm the markets.

The exchange rate is now depreciating rapidly and may have overshot its equilibrium level - but is necessary to help contain the CAD and good because it helps expenditure switching and reduces the need for more expenditure reduction. But it's impact on capital flows particularly on equity markets remains unclear. So far the exit from equity markets is contained but if the rupee continues to weaken will it remain so? There is a strong negative correlation between rupee depreciation and stock market performance but no established causality. The impact of the exchange rate on inflation and balance sheets must also be carefully examined, because we know from other crisis in which such sharp depreciation took place balance sheet effects must be very large and Bank NPLs have been rising in any case as growth has slowed down.

While we do not want to go back to the regime of import controls - the trade reforms were gained with so much effort - is there a role for some temporary management of imports. Our largest trade deficit is with China - which is all non-oil, non- gold. Can we organize a yuan trade like we did with Russia many decades ago? Gold imports - should they be seen as a current account or a capital account item? FTA'S not including services have hurt us? Some have suggested a temporary import surcharge for a defined period to reduce both the fisc and the CAD, but this runs the risk of affecting our agreed WTO commitments and sends signal that we are going back on our hard fought trade reforms.

Given that the capital account is now partially open - and trying to fiddle with it will cause further loss of confidence do we have any scope for independent monetary policy? Should the interest twist be maintained or reversed? Is it working or can ever be made to work. What is the diagnosis on inflation? Is it supply side vs demand side? If demand side can monetary policy has any role in containing it or is it primarily in the hands of fiscal policy.

Should we be targeting an exchange rate? Should we allow the exchange rate to fluctuate and deal with its consequences - on inflation, the fisc and on bank and corporate balance sheets. In any case we cannot target an exchange rate and have an independent monetary policy - if we want to target the exchange rate we have to accept much lower growth to reduce the CAD, with no way to revive it via monetary policy.

What is the role of macro and micro (structural) factors in explaining the slowdown in growth? To revive growth and exports and contain imports would it make sense to target an undervalued REER?

Without deep structural reforms, in subsidies, in factor markets, and in the doing business indicators can we really run an effective macro economic policy? To fix the macro we must fix a micro? We need a package of measures that will simultaneously reduce the CAD and the Fisc. - diesel prices, fertilizer subsidy, temporary import surcharges.

In summary, we must ask first, what is the set of necessary actions to avoid a complete exit and a full blown crisis and second, how should India having contained an exit prepare to get back to the India Growth story - that may perhaps have to wait for a new government.