

Policy questions

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Part I

Policy choice 1: Market manipulation + sterilisation

How much currency trading will be required?

- From November 2006 till April 2007: \$24 billion were purchased in a six month period.
- As India's globalisation progresses, a bigger scale of currency manipulation will be required in order to achieve currency goals.
- A conservative scenario to plan for is: \$50 billion purchase in a year.

Sterilisation?

- Sterilisation is only a very short-term strategy.
- Constraints to sterilisation:
 - 1 Run out of bonds
 - 2 Implicit and explicit fiscal costs
 - 3 Selling bonds → bond prices go down → interest rates go up → sucks in more capital flows.

Consequences of \$50 billion purchase

- \$50 billion is Rs.2,00,000 crore
- Leave it unsterilised? It is a 28% hike in M_0 .
- CRR hikes just don't hit this scale of the problem.
- Incremental MSS issuance for doing sterilisation would involve an *incremental* on-budget interest cost of roughly Rs.20,000 crore per year.
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Fiscal costs MSS bonds involve explicit on-budget interest payments. India earns low returns on the reserves portfolio. (The number of \$50 billion is not standing still; the fiscal costs will go up sharply).

Proof of the pudding In Period IV, sterilisation broke down. This reflects the genuine difficulties faced in sterilised intervention.

Bottom line: The sterilised intervention strategy is no longer feasible. In addition, the US dollar has to decline so as to shrink the massive US current account deficit. India loses when the US dollar loses. Hence, holding reserves is particularly costly today.

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Part II

Policy choice 2: Capital controls

Capital controls?

There are proposals to (say) block ECB.

- Recall that 110% of GDP crossed the boundary in 2006-07.
- Blocking money from one channel will merely generate flows (perhaps disguised flows) through other channels.
- Small tinkering is useless.
- Seriously solving the problem requires a comprehensive assault on the four elements of *de facto* convertibility:
 - 1 Close down FDI
 - 2 Close down FII
 - 3 Close down ECB
 - 4 Setup an effective inspection regime to block misinvoicing.
- This will be destabilising - e.g. Thailand.
- Why is it fair on all the users of foreign capital?

Part III

Feasible choices under impossible trinity

The economic logic: There are 3 choices

1. **Close the capital account** This requires:
 - Close down FII, FDI (both ways)
 - Close down ECB
 - A draconian inspection regime to block misinvoicing.
2. **Let the exchange rate float** This inherently requires setting up sound currency derivatives markets.
3. **Give up monetary policy** Publicly say that you have no monetary policy, stop expecting monetary policy to address problems like inflation or stabilisation of the business cycle.

Any one of these three choices is technically feasible. Making any one of the three choices will yield a “consistent monetary policy regime”.

Who gains and loses from the three choices?

Choice	Who gains	Who loses
Close the capital account	Exporters gain because you can then choose your own exchange rate.	Indian firms consuming foreign debt / equity capital. Exporters and importers suffer a draconian inspection regime.
Float the exchange rate	India gains from low and predictable inflation; monetary policy which stabilises the business cycle. Lower fiscal costs.	Foreign speculators and Indian corporations lose free public sector currency risk management. Exporters suffer one-time shift to market exchange rate.
Give up monetary policy		India.

Political economy perspective

- A complex system of capital controls induces rent-seeking and corruption.
- RBI / MOF staff get more diwali gifts when firms have to interact with them owing to capital controls.
- Large corporations are more able to skirt the rules, obtain permissions / rule changes that favour themselves, do complex legal engineering. They benefit from a complex system of capital controls. Example: Indian multinationals have convertibility, most small firms do not.
- When RBI has multiple goals, it is accountable for none. Any agency enjoys having power without accountability.

Political economy constraints are not destiny – India has overcome many difficult situations before. Example: Removing tariffs.

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Part IV

Institutional arrangements for monetary policy

Inflation and monetary policy

- There is no tradeoff between growth and inflation. (If anything, high inflation hurts growth).
- What monetary policy can deliver is low and predictable inflation.
- Low and predictable inflation ends up stabilising the business cycle - the boom and bust of GDP is curtailed.
- Low and predictable inflation makes possible a long-term bond market, financial planning by households, etc.

How monetary policy works

- Central bank always fully pins down the rate for short-term borrowing - that is an integral task in the creation of fiat money
- Suppose central bank sees a rise in inflation coming up in the future
- The short rate is raised slightly
- Financial markets convert this into slightly higher rates – in real terms – for all maturities and for all financial instruments
- This induces slightly lower consumption & investment expenditures
- This pulls back aggregate demand and gets inflation back in control
- These responses take place with long and variable lags.

Relationship between monetary policy and finance

- There is absolutely no contradiction between running a world class monetary policy and uninhibited sophistication and liquidity of financial markets.
- Monetary policy effectiveness - the monetary policy transmission - *requires* uninhibitedly sophisticated and liquid financial markets.
- The central bank changes the short rate. The central bank tells the market it's operating manual.
- The *market* does the rest of the work, that of changing all rates.
- Without sophisticated and liquid financial markets, monetary policy is ineffective. So when politicians ask for lowering inflation, draconian things have to be done.

What is the right institutional framework for monetary policy?

- The creation of fiat money is fraught with danger
- In history, it has been associated with hyperinflations, the great depression, financial crises, BOP crises, etc.
- An inconsistent monetary policy is playing with fire.
- An intricate institutional dance is required to tame fiat money.
- Once this is done, monetary policy is the predominant tool for stabilising the business cycle.
- The role model for how this institutional dance should work is: the Bank of England.

The gold standard: The Bank of England reform

- George Soros and others profited from the efforts at BoE to peg the exchange rate.
- This led to soul searching.
- Late 1990s: Fundamental reforms.
- All functions other than setting the short rate were taken out of BoE.
- BoE has 1700 employees.
- There is a 'Monetary policy committee'
- BoE staff help the MPC to think.
- The MPC votes on raising or lowering rates to hit an inflation target.
- There are no capital controls; BoE never trades on the currency market.
- BoE never blocks financial market sophistication.

Comparing RBI against the Bank of England

Feature	Bank of England	RBI
Capital controls	None	Extensive
Currency trading	None	Extensive
Independence	Complete	Limited
Rules, Accountability	Inflation targeting	None
Org. structure	Small, high-skill	Sprawling
Executive MPC	Votes on rate changes	None
Transparency of MP	Near-complete	Near-zero
Other functions	None	Myriad
Staff strength	1,700	22,000

Part V

Harnessing globalisation

How an emerging market emerges

- Germany has no problems with 100% globalisation
- There are enormous benefits from globalisation
- What does a country need to do to harness globalisation?
- The main answer is: Institution building –
 - Fiscal
 - Financial
 - Monetary.
- Germany has sound fiscal, financial and monetary institutions, which eliminate the possibility of disaster in harnessing globalisation.

Fiscal

- stable debt/GDP
- fiscal rules
- sound debt mgmt.

Financial

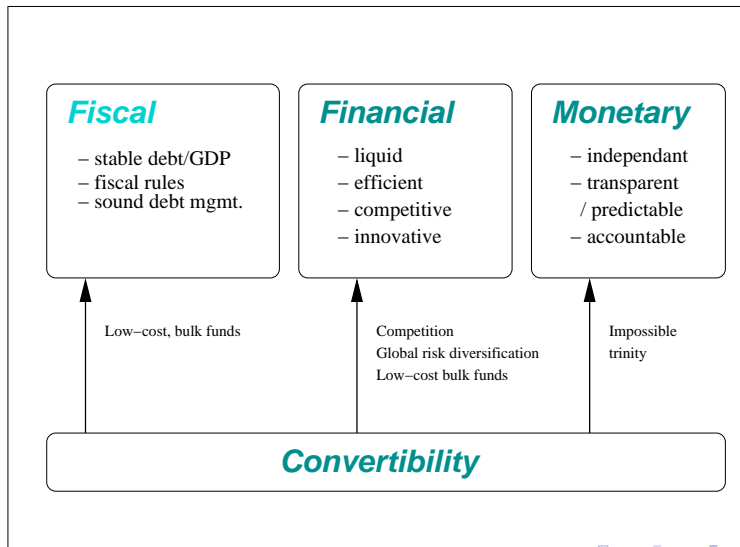
- liquid
- efficient
- competitive
- innovative

Monetary

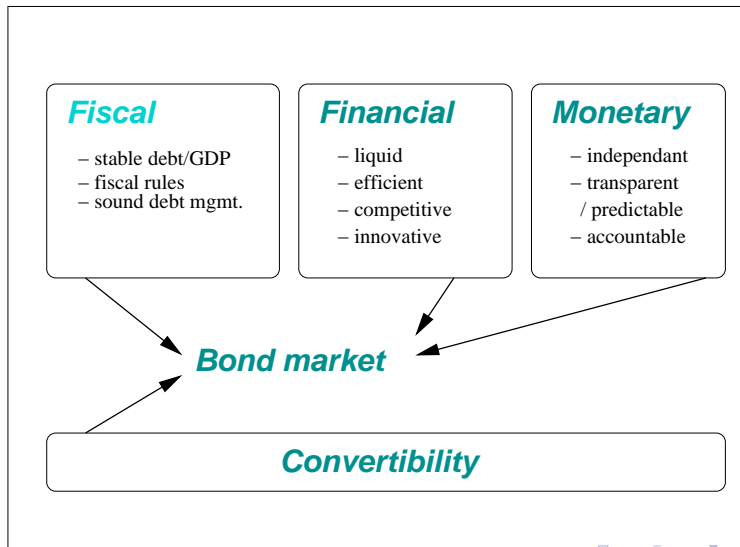
- independant
- transparent
/ predictable
- accountable

Convertibility

Convertibility shapes all three areas



All four areas make the bond market happen



What have we done so far?

Fiscal

- stable debt/GDP
- fiscal rules
- sound debt mgmt.

- FRBM
- NPS
- DMO

Financial

- liquid
- efficient
- competitive
- innovative

- equity market
- commodity futures exchanges

Monetary

- independent
- transparent / predictable
- accountable

- Ways & Means agreement
- DMO.

Convertibility

- De facto convertibility

Part VI

Summary

Key messages #1

- When faced with the impossible trinity, all mature market economies of the world have chosen: floating exchange rate + autonomous monetary policy + open capital account.
- What do you do with an autonomous monetary policy? Deliver an inflation target.
- Low and predictable inflation is politically precious directly. And, it reduces the boom-and-bust of GDP growth.
- Monetary policy works by pinning down the short rate and showing the market your manual. A sophisticated financial market converts changes in the short rate into changes in all other rates.
- Without a sophisticated financial market, monetary policy is ineffective.
- Harnessing globalisation requires financial, fiscal *and* monetary institution building. India has made progress with financial and fiscal but not with monetary.

Key messages #2: focus, independence, transparency, predictability, accountability

Focus	RBI has myriad, sprawling functions
Independent	RBI is likely to supply an incumbent government with loose monetary policy when elections approach.
Transparent	Dincer & Eichengreen, 2007: On a scale of 0 to 15, RBI stagnated at 2 from 1998 to 2005. Asian average rose from 3 to 5.1.
Predictable	The market does not know how RBI will react to future events.
Accountable	RBI is not accountable for anything.

- Bank of England website on their institutional framework.
- *A stable international monetary system emerges: Inflation targeting is Bretton Woods, reversed* by Andrew Rose, NBER WP, November 2006.

Thank you.