‘RBI intervention won’t help rupee in long run’

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CNBC-TV18

Upasna Bhardwaj, senior economist, Kotak Mahindra Bank; Pinaki Chakraborty, professor, National Institute of Public Finance and Policy; M. Govinda Rao, former member of the Economic Advisory Council to the Prime Minister; Soumya Kanti Ghosh, group chief economic adviser, State Bank of India; on the state of the economy. Edited excerpts:

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(From left) Upasna Bhardwaj, senior economist, Kotak Mahindra Bank; Pinaki Chakraborty, professor, National Institute of Public Finance and Policy; M. Govinda Rao, former member, PMEAC; and Soumya Kanti Ghosh, group chief economic adviser, SBI.

Rupee depreciation to 70.64, is that worrisome? Does that change things, or is it good that the economy gets a fillip almost like a rate cut?

Bhardwaj: If we continue to see a slow and steady depreciation in the currency, it is really not a worrying thing right now. But, having said that, we will have to be very cautious, because India being a net importing country, oil prices are also not providing too much of comfort at this point in time. Besides, non-oil and non-gold imports are also structurally showing a significant upward pressure. All-in-all, the current account deficit seems to be really coming under a lot of pressure. So, clearly we do have a significant risk of a sharp move, and that could become a little bit of a problem.

Having said that, yes, if we do continue to depreciate at a reasonable pace, then at some point, we will reach where some of our exports start getting competitive and that could start boosting exports, which is much needed at this point in time. But in the near term, for sure, it does point towards a worrisome move.

As an economist how are you looking at this depreciation of the currency? I don’t know whether to call it gentle really. A large part of the deprecation has come in the last 10 days, from 69 we are now to almost 71; 70.59 when we went to bed and 70.64 when it got traded. Can the Reserve Bank of India (RBI) really ensure a gentle depreciation, or once it starts depreciating it usually gets out of hand?

Ghosh: That is a very interesting question. In the context of this RBI annual report, let me just put some very interesting facets of what the RBI has actually documented in the annual report. It is also in the monthly bulletin report, which came out in August.

I think one of the concerns which the RBI has clearly made in the annual report, is that the continued intervention in the foreign exchange market is not going to be efficient on the part of any central bank, because what happens is that whenever you intervene in the foreign exchange market, there is an attended liquidity implication, and for that liquidity implication, there also has to be liquidity management.

And that could come in several ways, but the most common is the open market operation.

We need to quickly implement the SDF facility because ...that comes at a fixed rate of interest and without any collateral, says Ghosh

Now, whenever you do an open market operation, basically, you can take out the liquidity which is injected into this system. This is called sterilization.

The higher the sterilization, it means the central bank has been successful in sterilizing their liquidity inflows, which has arisen because of the purchase on sale of dollars. However, the important point is that, over a point of time, as this impacts the interstates, it also leads to capital inflows in the second round.

Therefore, when the first round impact of sterilization impact is actually offset with an increased capital inflow, and ultimately the intervention may not have the desired consequence on the exchange rate. That is what the RBI is trying to do. So, we actually end up spending more reserves, but at the same time, we are unable to defend the currency from external disturbances.

This has been very vividly put out by the central bank in the report and the suggestion, which it gives out is very interesting. It has already been discussed in the public domain separately, that we need to quickly implement the SDF facility, because that is unremunerated and that comes at a fixed rate of interest and comes without any collateral. So, if we can do these two things, that could be actually the base landing from the current crisis. As of now, I am not bemused by the continued weakness in the currency because I think there is a limit to what the RBI can intervene in the forex market.

This is a fairly significant depreciation—from 69 per dollar just about two weeks back, to 70.64 per dollar, and counting. Does this actually protect growth?

Rao: It is important to adjust your exchange rate depending on the real effective exchange rate (REER). I think, in that sense of the term, some depreciation was warranted. As Soumya said, RBIs intervention is not going to help much, it is not going to give you the benefit. It may be some short-term palliative, but it is not going to help in the long run.

One other thing that I wanted to put across is that in addition to the current account deficit, this is also going to put some pressure on the prices. So, all the imported prices will be much higher in terms of domestic currency. This will particularly affect the transport sector and that is something we need to take into account. However, I think one is not going to get sleepless nights because there has been an adjustment in the exchange rate. RBI’s intervention can only smoothen the process, but it has to eventually adjust to the real effective exchange rate (REER). I do not think it is a severe problem.

The rupee is going towards 71, and you have crude prices at the \$75-80 range. RBI repeatedly points out in its assessment and prospects chapter of the annual report, that there are upside risks to inflation. Do you think that is going to be a bit of a problem? Does RBI have to resort to one or two rate hikes simply to deliver on the monetary policy committee (MPCs) target of 4%?

Chakraborty: I think it has the potential to do that. I think this sharp depreciation definitely would increase the price of our oil imports and, in turn, it would have an impact because inflation is structural in nature in India. So definitely, it would have an impact on prices. That is one aspect. The second, in the short-run, in the next 3-5 months, if we have to look at the budget 2019-20, I think what it would do actually is reduce the fiscal policy space for increasing taxes on oil to a great extent, because oil prices are hardening, and also going up because of the dollar depreciation.

So, I think, the fiscal as we had seen in 2016-17, which the RBI report also mentions, the government was able to generate more revenues by increasing taxes on oil. Now, that possibility reduces very significantly because of the sharp depreciation of the rupee. So it would have a huge fiscal risk and if we have a larger deficit compared to 3.5%, and 3% is the next years target, in that case we definitely have a fiscal pressure on inflation, as well as the inflation, which may come due to the hardening of the oil prices and depreciation of the rupee.

So, there are two risks. As I said, the first is direct risk, as you have mentioned about the deprecation of the rupee, and the consequent increase in oil prices. And, oil not being a part of GST, different states have different rates, can have really a significant impact on food prices. However, of course, the RBI report also talks about good monsoon and things like that. We do not know what would happen, but definitely it is a concern.

Out of the 15.4 trillion demonetised notes, 15.30 trillion have come back. Govinda Rao, how would you look at this now? We knew, last year itself, that 15.28 trillion had come back. Now we know it is 15.30 trillion, or 99.30%, have come back. Can we pass a verdict on demonetization’s pluses and minuses?

Rao: This was known. There is nothing surprising about the number. It is just that now it has been confirmed.

The RBI putting all these numbers has confirmed the fact that there hasn’t been any gain in terms of not getting the cancelled currencies back. If you have seen the government, the narratives went on changing from one objective to another.

As far as the government is concerned, it has always been on denial and it will continue to be on denial. They will say that digitization of economy will happen, terror funding has stopped and variety of things.

However, when I had earlier come on the channel, I had very categorically stated that this was an ill-conceived move, and this was not going to help the economy, but is going to disrupt the economy enormously.

Now there is large consensus that the economy has been disrupted enormously. And there is a clarification that the entire money has come back. I don’t know what we were trying to do, maybe there were some political gains.

Even if we assume that the entire money has come back, probably that would not have solved our black money problem, says Chakraborty

I have no idea about that, but as far as the economic gains are concerned, I think it was a very ill-conceived move and it was most unfortunate that when there were already other problems, you added to the problem particularly in the small and medium sectors.

Was there a tax gain? I can quote some numbers: Personal income tax was growing at about 11% in FY15 and FY16, in FY17 it grew by 27%, in FY18 by 21%. Let me ignore FY18, because there must have been GST repercussions. Also the government claimed that the number of tax assessees increased by several lakhs, maybe 11 lakhs. The CEA pointed out that most of them showed ₹2.7 lakh as income, so they were not really in the taxable net, but separately the government said it could apply analytics to a lot of the new accounts, and the old accounts, and there are some 1.8 million cases of high income. What it was saying is that we can now go after these guys and get more taxes. Are you buying that there was a fiscal gain to the economic loss that demonetisation caused?

Chakraborty: I would post a certain hypothesis. First with regards to money coming back to the system. When we say entire notes have come back to the system and, then your last point about some of them are suspicious, and has to be verified, and all that.

We do not know how much of it was black and how much of it was white. If we say that predominantly it is white, then definitely the gain has not been very significant.

However, the question here is the size of the black economy. If we talk about the size of the black economy, available estimates varies from 20%, which was the World Bank estimate, to 40%-plus.

If we take ₹15.86 lakh crore, which was the demonetized currency, it works out to be something like roughly 10% of our GDP. So, even if we assume that the entire money has come back, probably that would not have solved our black money problem.

When everything has come back, probably it shows that money is held not in the form of cash, but in something else. So, we need to have different strategy in terms of controlling black economy.

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