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Don't just do something, sit there

Defending the currency would require increasing interest rates, which might harm growth

US economic policy has shifted in favour of big deficits and higher interest rates. This sucks global capital into the US. That gives stress in asset prices and exchange rates in emerging markets. We should recognise these macro fundamentals and accept exchange rate depreciation. The RBI's mandate is 4 per cent CPI inflation, and not an exchange rate target. If a currency defence is attempted, it will make things worse, as happened in 2013.

In the last year, US economic policy has moved in two directions. Monetary policy normalisation has been taking place, with rates coming off the near-zero levels. Tax cuts without matching expenditure reductions have given enlarged deficit financing. Higher interest rates in the US have attracted global capital into the US.

When global investors retreat from emerging markets, there are two things at work. The bulk of the retrenchment tends to take place in countries and the securities where there is high liquidity. Liquid securities in Korea and India witness selling pressure. In addition, the countries with a loss of confidence in political and economic policy institutions take a beating.

In 2018 so far, some emerging markets (EMs) have seen large depreciations. Argentina (cut off engagement with the IMF for a decade, raised the interest rate to 60 per cent) has -52 per cent. Turkey (religious/nationalistic leadership that is putting intellectuals and journalists in jail) has -42 per cent. Brazil -20 per cent, and South Africa -16 per cent. India comes in fifth at -10 per cent.

We in India should be relaxed about exchange rate fluctuations. Price adjustment is the essence of the market economy and we should respect the outcome of the market. When the rupee depreciates, it makes Indian assets and exports more attractive, and deters imports and capital flight. Too often, in India, we have an old socialist instinct of trying to control a price. This always gives bad results.

SNAKES & LADDERS

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In 2013, there were global shocks, which impacted EMs. The Indian authorities decided to mount a muscular currency defence. Everything possible was thrown into play, including reversals of long-standing reforms and a 400 basis point interest rate hike. When the post-mortem is done (*https://goo.gl/KJq9na*), comparing how India fared vis-a-vis EMs that had more mature policy-making capabilities, we see that there was no bang for the buck.

So far, in 2018, the authorities have done reasonably well. The RBI has done some amount of selling reserves to defend the rupee. Outright distortions in terms of capital control and reversals of reform have not come. This calm approach needs to be followed through with a communications strategy that removes the gap between words and deeds.

A quantum leap has taken place in the Indian monetary policy arrangement, in the form of an objective for the RBI. At the time of the 2013 currency defence, the RBI had no stated objective; it wielded the powers of monetary policy without a purpose. This ambiguity of objective made it possible for the RBI to keep switching from one objective to another, and to often pursue dubious objectives.

In 2015, for the first time in its history, the RBI acquired an objective: To deliver 4 per cent CPI inflation. This has delivered remarkable results in terms of stabilising inflation at about 4 per cent. At the same time, we are in the early days. The RBI needs to stay the course for decades, for the populace to achieve confidence around the fact that inflation will remain at 4 per cent on long horizons, such as the 30-year horizon required for an infrastructure bond or the 70-year horizon required for a young person to plan for old age.

If the RBI switches gear to mount a currency defence, this will require sharply increasing interest rates. This will show that 4 per cent CPI inflation is actually not the RBI's objective, that there is a gap between word and deed. This will undermine the fledgling confidence in the inflation-targeting apparatus.

A long and difficult downturn in the economy began in 2011 (which is not visible in the flawed GDP data). We are only seeing the first signs of recovery in late 2017 and early 2018. It would be unfortunate if this fledgling recovery is harmed by a muscular currency defence, i.e. a sharp rise in interest rates.

Even if policymakers have an objective of staving off a sharp currency depreciation, the path to getting this is to look confident. The best way to attract the global interest of currency speculators is what India did in 2013: Panic, capital controls, reversals of economic reform, a new measure every day, large-scale borrowing by the government from NRIs, etc. The desperation and frequency of these measures sent out a signal to the world that it was worth short-selling the rupee. Other EMs, which had superior policymaking capabilities, stayed out of the radar by doing nothing.

There is one downside to the 10 per cent rupee depreciation that we have got in 2018, and the possibility of further rupee depreciation in the days to come. This is the fact that domestic and foreign participants were not prepared for it.

In May 2014, India went back from a floating exchange rate to a highly managed exchange rate. Currency volatility went down sharply. This creates a moral hazard: Private persons take on more currency risk when the government is giving out free currency risk management services. These persons have been hurt by the increased currency volatility, particularly because these changes of the exchange rate regime have taken place without announcement.

In the short run, there is nothing that can be done. The damage caused to private persons will just have to be endured. But there is a deeper message. The time to fix the roof is when the sun is shining. In good times, even if it is easy to manage the exchange rate, it is better to have a true market exchange rate. All private persons should know that the rupee will fluctuate. This induces private actions that reduce exchange rate exposure. This reduces the harm to the economy when large exchange rate fluctuations come, as they inevitably will.

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