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The exchange rate is the shock absorber

We should liberalise debt flows so that a larger change in capital flows is obtained by a small exchange rate change

SNAKES & LADDERS

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Foreign capital inflows finance the gap between investment and savings. The exchange rate is the price that adjusts to ensure that the capital inflow is exactly as large as is required. An important part of the capital flows into India is debt flows. When the perceived credit risk of borrowing entities worsens, overseas debt investors become uncomfortable, and there is a shortfall of inbound capital. Rupee depreciation makes Indian assets more attractive, and compensates for deterioration in domestic credit quality.

One of the great insights of macroeconomics is the idea that the current account deficit (which we normally think of in the international trade context) is exactly equal to the gap between investment and savings. This is not just a theory, this is an accounting identity. When crude oil prices go up, in the short run, the elasticity of demand is low, so households cut down on savings to pay more for fuel, and the gap between investment and savings goes up.

When domestic savings are inadequate to finance domestic investment, we import capital. These capital flows finance the gap between investment and savings. Every minute, in the currency market, supply equals demand because the capital inflow works out to be exactly equal to the shortfall.

It is important to see the time scales involved. Imports and exports adjust over multi-year horizons. Investment and savings adjust slowly. Minute to minute, what is adjusting is the capital flow.

When the current account deficit goes up, e.g. because the world price of crude oil went up, how do we instantly obtain a higher capital inflow? The key answer is: Through exchange rate depreciation.

From the viewpoint of a foreign investor, when the rupee depreciates, the risk-reward tradeoff in owning Indian assets changes. The risk of a future depreciation goes down, and there may even be some upside of a future rupee appreciation. Exchange rate depreciation makes Indian securities more attractive. This is present to a small extent with equity assets but it is strongly present with debt securities.

With debt securities, the arithmetic is simple. There is a cost of financing abroad, of about 4 per cent in hard currency. There is the return for 1 week on a debt security available in India, e.g. 8 per cent. This gap, of 4 percentage points, has to be compared with the risk of currency depreciation in one week. Once rupee depreciation takes place, the possibility of a further depreciation goes down, and there may even be a profit from an appreciation.

If government actions impede a rupee depreciation, Indian assets remain unattractive in the eyes of foreign investors. The problem, i.e. the funding gap, does not go away if the Indian authorities distort the exchange rate. If the exchange rate does not adjust downwards, the rupee price of Indian securities has to adjust downwards, to make Indian assets more attractive. This is generally a more painful adjustment.

This reasoning emphasises the importance of liberalising debt flows. In the short term, moment to moment, the place where equilibrium is obtained on the currency market is debt securities. Equity assets have a lower sensitivity to the exchange rate, as they have their own risk and return problem, over and beyond the outlook on the exchange rate. What adjusts in the currency market, from moment to moment, is debt flows.

When India gives low access for foreigners to Indian debt securities, a bigger change in the exchange rate is required to get the requisite modification of the capital flow. Greater debt capital flow liberalisation gives greater rupee stability.

In the range of debt securities that foreign investors can buy, there are government bonds and there are corporate bonds. Both these have shaped up as important elements of the Indian capital account. With corporate assets, from time to time, there are changes in credit quality.

As an example, recent events in India have created concerns about the credit risk associated with NBFCs. In the backdrop is a slowly worsening credit crisis in a large fraction of the corporate sector. Other things being equal, for a foreign investor, Indian corporate debt paper carries higher credit risk than it used to a few weeks ago. This adversely affects the flow of financing into India that was coming through foreign investment into corporate debt.

How do we fill the gap? Once again, the exchange rate holds the key. Indian corporate paper has become less attractive owing to higher credit risk. Exchange rate depreciation counters this problem. Exchange rate depreciation makes the same asset more attractive by taking away the risk of future depreciation and even offering an upside potential through future exchange rate appreciation.

The core intuition of economics is that prices move to ensure that supply is equal to demand. When the government interferes with price movement, this causes problems because the adjustments to supply and demand, which should be triggered by price changes, are then suppressed. This is true of all administered prices, such as steel, cement, fertilisers, wheat, or petrol. A key organising principle of the Indian economic reforms, from 1991 onwards, has been to get the government out of interfering with prices.

This intuition identically works on the currency market. There is a reason why exchange rates move. When events unfold, in the short run, imports or exports or investment or savings will not change. In the short run, the only thing that adjusts is the capital inflow. How can Indian assets be made more attractive to foreigners? Either the rupee depreciates or Indian asset prices (in rupees) decline.

The RBI is now yoked to the larger and more important objective, of delivering 4 per cent y-o-y CPI inflation. This is the right framework for a continental economy like India. We should now not ask the RBI to pursue an exchange rate objective in any form. We should liberalise debt flows so that a larger change in capital flows is obtained by a small exchange rate change, so that news turns into smaller exchange rate fluctuations.