Rupee in a global world

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Highlights

- After languishing for two years, economic growth has begun a recovery of sorts in the last two quarters on the back of a straggling pickup in investment.
- However, with the government deficit (Centre and states combined) running at over 7 per cent of GDP and likely to widen, the rise in investment is largely being financed abroad.
- This has raised India's current account deficit (the part of investment that isn't funded by domestic savings) from 1.9 per cent of GDP in 2017-18 towards 3 per cent this year.
- When fiscal and current account deficits widen, the economy adjusts through higher interest rates and exchange rate depreciation.
- That is exactly what has happened to bond yields and the rupee.

Why?

- With tighter global financial conditions since April and a reassessment of emerging market risk since August, it should not even be surprising that the rise in bond yields and the rupee depreciation has had to be large.
- With no support from fiscal policy and only modest monetary tightening, all the adjustment has been borne by the exchange rate driving slide in the rupee.
- Therefore, the ongoing soul searching among analysts and policymakers whether the government and the RBI should or should not stop the slide in the rupee is largely misplaced.
- There is an entrenched and widespread belief among the same analysts and policymakers that India is a closed economy protected by its much vaunted regulatory and capital controls.

Issues

- The crux of the problem is that India's macroeconomic framework is based on an antiquated belief that the economy is closed when in reality it is far more open.
- For example, the RBI has rarely linked its policy decisions to changes in global interest rates even after shifting to an inflation-targeting framework. It is the same with fiscal policy.
- Every budget document begins with a perfunctory paragraph on "global developments" but neither taxes nor expenditure has been changed in response to what has happened outside of India except when forced by crises.
- The policy statements and the minutes of the Monetary Policy Committee (MPC) meetings suggest that the policy interest rate has been set based on the committee's view on the 6-12 month ahead inflation and its drivers including inflationary

expectations, the slack in the economy, government policies etc.
- This is the right framework only if the economy is closed.
- In an open economy, apart from the drivers of inflation, interest rate separately and explicitly responds to changes in global financial conditions too.

What should be done?

- Many inflation-targeting central banks with open economies, in both developed and emerging markets, routinely publish not only their assessment of how global financial conditions might evolve but also the extent to which their policy actions are determined by the changes in these conditions.
- Consequently, when faced with a global financial shock, neither fiscal nor monetary policy has, as matter of course, adjusted to safeguard the economy. Instead, we have scurried around for ad-hoc solutions, as is gaining currency now with suggestions for more NRI deposits or external bond issuance.
- The solution is to recognise that India has become more open, that capital controls do not provide adequate protection, and therefore both fiscal and monetary policies need to be adapted to the increased openness.
- It is not a question of whether one should respond to the rupee slide; it is a question of whether India can continue not to respond to changes in global conditions.

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