
Exchange Rate Policy: The way forward

Raghuram Rajan & Eswar Prasad / New Delhi April 29, 2008
.....

Not all appreciation is bad. It makes foreign goods cheaper.

In our previous column on this page (April 25), we argued that monetary policy would be more effective if it was focused on a single objective — low and stable inflation. This would imply minimal management of the exchange rate by the RBI, except perhaps to smooth extreme volatility, including preventing significant departures from equilibrium. In this column, we explain the rationale behind this recommendation.

While the nominal exchange rate, especially relative to the US dollar, is the focus of much attention, what really matters for overall export competitiveness and import prices is the real (effective) exchange rate. This is a summary measure of the nominal exchange rate relative to each of India's trading partners, adjusted for inflation in India relative to inflation in those countries. The rupee's real exchange rate can appreciate if either the nominal rate appreciates or Indian inflation rises more than inflation in its trading partners.

A confluence of forces has in recent years put enormous pressure on India's real exchange rate to appreciate. Relative productivity growth of the traded goods sector (including manufacturing) has been higher than in most industrial countries that constitute final markets for India's exports, as well as relative to the domestic non-traded goods sector (services such as haircuts). Aggregate demand has been higher than supply, in part due to the large government budget deficit (centre and states together). And foreign investors have discovered India and are pouring money in. This last factor is important because people often consider only the real economy in determining the equilibrium real exchange rate. But the financial side cannot be ignored.

It is a seductive option to build a firewall that keeps out capital, but this is no longer viable in a world where there are multiple channels for those flows. Capital controls are notoriously leaky, even in a tightly-controlled economy like China, and rarely effective beyond short horizons. When incentives to move capital across borders are strong enough, investors will find a way. Moreover, even the direction of future flows is hardly a sure thing, so it is unwise to take actions today, when capital is plentiful, that will hurt us in the future, when it may be scarce. India's current account deficit, albeit small as a ratio to GDP (around 1.5 per cent), makes it vulnerable to a sudden stop or reversal of capital flows. In short, the volume and volatility of capital flows are practical realities that Indian policymakers will have to accept — better to use these flows in ways that make us more resilient, such as strengthening domestic markets.

So what should we do when foreign capital surges in, creating pressures for exchange rate appreciation, over and above other pressures stemming from productivity growth and excess domestic demand? The medium-term steps are naturally to work harder on reducing domestic demand (shrinking the fiscal deficit) and increasing supply (improving investment in infrastructure and reforming labour laws). In the short term, though, legitimate concerns arise about export growth and the loss of job growth that any loss of external competitiveness would entail. These political pressures have led the RBI to try and manage the nominal exchange rate by intervening in foreign exchange markets, essentially by selling rupees and buying dollars. But this causes inflationary pressures.

One obvious antidote is to "sterilise" the domestic liquidity generated by the capital inflows. This has been done by issuing market stabilisation bonds to

soak up the rupees injected into the economy during exchange market intervention. The problems are that sterilisation rarely soaks up all the liquidity, which means the RBI has to constantly flip between an exchange rate focus and an inflation focus. Moreover, it has to pay a rising rate of interest on these bonds to induce the market to absorb more of them. Thus, sterilisation becomes increasingly costly to the government as the interest rate on these bonds is well above the interest earned on foreign instruments that reserves are typically invested in, such as US treasury bills and bonds.

Sterilised intervention could in fact compound the problem it is meant to solve. It can act as a stimulus to further flows by widening the differential between foreign and local interest rates while creating expectations of additional returns once the postponed nominal appreciation finally occurs. Sterilisation also hampers financial reforms if the government relies on public sector banks to hold large stocks of the new bonds.

A more basic question is whether sterilised intervention is effective in limiting the nominal appreciation that could otherwise result from a surge in capital inflows. There is no evidence that India or other East Asian economies that have been experiencing large and persistent capital inflows have been able to significantly influence the level or changes in the exchange rate through sterilised intervention, especially beyond very short horizons. In fact, trying to manage the exchange rate in the face of large inflows simply results in a more abrupt adjustment when this objective comes into conflict with the objective of maintaining low inflation, as it invariably does.

There is some evidence, though, that sterilised intervention modestly reduces exchange rate volatility. This suggests that the role of intervention should be limited, if at all, to dampening sharp jumps in the exchange rate.

In sum then, while politicians typically want intervention, it is neither costless, nor particularly effective in preventing appreciation, even while distracting the RBI from controlling inflation. And not all appreciation is bad. It makes foreign goods cheaper and thereby raises the standard of living of the average citizen — it is part and parcel of growing rich. Moreover, it makes imports of energy, intermediate inputs and capital goods cheaper, and reduces the real value of the foreign currency debt of companies that have raised money in international markets.

Indeed, a steadily appreciating real exchange rate puts pressure on the export sector to improve productivity — this is precisely what is happening in the IT sector. While it is tempting for the government to offset the effects of appreciation by giving tax sops to exporters, it gives them less of an incentive to adjust. Instead of propping up the firms, the government should attempt to provide a safety net for workers in firms or sectors that have not been able to adjust.

Our intent is not to minimise the danger of a real exchange rate appreciating excessively, beyond what is warranted by fundamentals. However, neither is this scenario representative of India's situation today, nor is the best antidote intervention. Instead, steps to curb domestic demand or expand supply can help slow the rise of the rupee, as can steps to encourage domestic savings to be invested abroad. Even better in the medium term is to increase the flexibility of the economy to adapt to the appreciation. This is cold comfort for those who believe the government can always do something. It is anathema to those who believe India can still adhere to the old ways it followed when the economy was closed and India unattractive, but it may be the right answer today.

Raghuram Rajan (*professor, GSB Chicago*) and **Eswar Prasad** (*professor, Cornell University*) were part of the team that helped produce the report of the *Committee on Financial Sector Reforms*.