BOOK REVIEW

Published 24 November 2017

Managing the Macroeconomy — Monetary and Exchange Rate Issues in India

India has traversed a long and bumpy road towards integrating, both financially and for the purposes of trade, with the rest of the world. Focusing mainly on inward-looking policies for over four decades post-independence, India initially remained insulated from the global financial and trade systems. The balance of payments and currency crises of the 1990s forced India to introduce market-oriented reforms, deregulate its financial markets, restructure and re-orient its growth strategy towards a more export oriented growth regime. In the process of being more open to trade, moving towards complete global financial integration also became inevitable. And while India has sufficiently “progressed” on this front by gradually making the current account fully convertible over time, it continues to aspire to the implementation of full convertibility of the financial account.

Openness to trade and access to international financial markets has immense benefits, ranging from consumption smoothing to availability of cheap credit and portfolio diversification, among others. Nevertheless, a vast and expanding retrospective literature on the Indian growth experience continues to critically evaluate whether India has sufficiently benefited from these “reforms”. At the same time an emerging economy, like India, is also susceptible to many risks, such as “sudden stops” or “reversals” of capital flows, which also make its financial market and, possibly the entire economy, more volatile. Needless to say, this also has several important implications for domestic monetary and fiscal policy.

Therefore, a natural question to ask is how well has India “Managed its Macroeconomy” in recent times. It is well known that India managed to recover quite easily from the Global Financial Crisis (GFC) mainly because of being domestically self-reliant, and because the central bank — the Reserve Bank of India (RBI) — intervened using a combination of unconventional and conventional monetary policy so as to insulate the domestic financial markets from global financial risks. But soon after its recovery, India went into a phase of growth slow-down, accompanied by high inflation and a high current account deficit (CAD), and this experience has been linked to a variety of domestic “structural” and “political” problems which have piled up over time.
In such volatile conditions, the Central Bank has a big responsibility towards ensuring macroeconomic stability. This is because, with greater trade integration, the dynamics of the economy are strongly affected by exchange rate fluctuations and capital flows. Adding to this, India also faces a number of domestic challenges ranging from frequent monetization of government debt and priority sector lending to informal financial markets, and from inflationary spirals to “round-tripping” associated with foreign capital inflows. Therefore, the subject matter of this empirical volume, authored by Rajan and Yanamandra, spanning six chapters, and largely focusing on the period post-GFC, is very relevant and topical.

Chapter 1 provides a crisp overview of the Indian economy. The initial sections provide a lucid account of India’s tryst with liberalization and the post liberalization growth story, the structural features which gave rise to its current inflation problems, the dynamics of the balance of payments (BOP), and evolution of the functioning of the RBI. The chapter then elaborates on how the RBI gained more autonomy over time, and how many monetary policy tools got restructured and eventually emerged into becoming important stabilization tools, especially via controlling exchange rates and policy interest rates.

How successful has monetary policy been in serving as a stabilization tool in India? There are in fact four key channels that determine whether the transmission of monetary policy to the real economy is smooth: the interest rate channel, the exchange rate channel, the asset price channel, and the monetary aggregates channel. Chapter 2 focuses on the “interest rate pass through” (IRPT) channel of monetary transmission in India. Simply put, IRPT is the channel through which policy rates affect final bank lending rates. This is crucial, especially in the case of not so well developed financial markets, as in India, since the bank lending channel is the most dominant source of funds for borrowers (large or small) who do not have many other alternative sources of formal institutional borrowing. The novelty of this chapter is that, unlike in the previous literature, the authors empirically evaluate whether the IRPT is complete in a two-stage process. In other words, the authors evaluate how the policy rate affects the inter-bank rate (also called the call money rate), and how the inter-bank rate in turn affects the final bank lending rate. The broad conclusion from this chapter is that while the first stage of the pass-through from the policy rate to the inter-bank rate is complete, the second stage of IRPT, i.e., from the inter-bank rate to the bank lending rate is sluggish and incomplete. Most of the second stage of the pass-through is on account of the “direct effect” of policy rates (the repo rate in particular) on bank lending rates. In fact, the pass-through due to the direct effect accounted for about 35% pre-GFC, but far less post-GFC. Fiscal dominance is argued to be one of the most important hindrances for the second stage pass-through. Another important reason for poor second stage pass-through is the presence of many small saving schemes such as post office deposits which offer attractive returns and make it difficult for banks to cut lending rates even if the RBI does. Other reasons include high inflation, the high share of state owned banks, the large informal financial sector and poor financial inclusion.

Chapter 3 focuses on exchange rates and foreign exchange reserve management in India. As the economy inches on the path towards full capital account convertibility (read perfect capital mobility), at some juncture the central bank must choose between exchange
rate stability and full monetary autonomy, but can never have both simultaneously. In theory, this is called the “Impossible Trinity”. Once again, this is an important question to ask in the Indian context, except that India is still not so close to perfect capital mobility. Technically, the authors argue that India follows a “middle path”, i.e., it has a little bit of both-stability of the exchange rate by “managing it” and monetary autonomy. The broad conclusion of this chapter is that India has managed well to control exchange rate volatility and prevent asset price bubbles, and the ensuing hazardous outcomes for the economy, by following the middle path. In the process, the Rupee was pegged less to the US Dollar post-GFC and the RBI accumulated huge reserves (a precautionary motive) to prevent appreciation of the Rupee. But the RBI’s intervention has been argued to be asymmetric, i.e., when there is a fear of appreciation, reserve accumulation increases but the opposite is not true when there is a fear of depreciation. In addition, one can also not ignore India’s “Keeping up with the Joneses” behavior since it participates in comparative hoarding, i.e., comparing itself to other East Asian economies, and the authors do find sufficient evidence for this. Some more discussion on the asymmetries of the RBI’s reserve accumulation behavior, however, would have offered the reader some more insights into this area, as this is still very fertile.

Why do exchange rates matter at all? First, they affect the price of imports which in turn affects the domestic price level and, therefore, inflation. Exchange rates also affect the trade balance and competitiveness of domestic industries. Monetary policy therefore plays a crucial role in stabilizing the exchange rate, as discussed in Chapter 3. Building on this, Chapter 4 discusses the impact of exchange rate pass-through (ERPT) on inflation in India. ERPT refers to the transmission of the exchange rate to import prices in the domestic market. This eventually affects domestic inflation through consumer and wholesale prices, and more so if a significant portion of imports are essential inputs, such as petroleum. As acknowledged by the authors, the chapter focuses only on the asymmetries associated with the first stage of ERPT, from exchange rates to import prices, and leaves out the overall effects on domestic inflation, because a variety of “exogenous factors” also influence the latter. The broad conclusion, however is that there is an asymmetric response. That is, ERPT is higher when there is appreciation as compared to depreciation. Second, the first stage of ERPT is complete in the short run, but import prices rise by much more due to an exchange rate depreciation in the long run. This is because of a “hysteresis induced effect”, which the authors attribute to changes in the domestic market structure due to price changes over time. The authors could have however elaborated more on this. Does this imply that with persistent depreciation, India faces higher import prices, because importing industries have increasingly become “price takers” over time? In fact, a more than one-to-one ERPT in the long run could also be because of increasing competitiveness across countries. Second, an elaborate discussion on the second stage of ERPT would have had greater relevance, and this would have thrown some more light on the role of the RBI, especially in recent times.

Exchange rates also affect the trade balance. A well-documented phenomenon is the “J-Curve”, which suggests that upon devaluation of the domestic currency, the trade balance — measured in terms of the domestic currency — first worsens because imports
are instantaneously more expensive while exports remain constant. Exports, however, may pick up over time because they gradually become globally more competitive. Theoretically, the impact of currency devaluation on the trade-balance is governed by the “Marshall–Lerner” condition. Under this condition, if the sum of the demand elasticities of exports and imports is less than one, currency devaluation will cause a worsening of the trade balance. Hence the “J-Curve” occurs when the demand for imports and exports are inelastic. Chapter 5 discusses the impact of exchange rate depreciation on India’s overall trade balance as well as its trade balance with important trading partners and some important industries. The chapter also investigates whether India experienced a J-Curve as a result of the depreciation of the Rupee, and the authors conclude this was not the case. With exchange rate depreciation, not only did India’s overall trade balance improve in the short run, but continued to improve even in the long run. Keeping in mind all the results obtained in Chapter 4, exports in India should have grown faster than imports. The empirical study is conducted during the quarters of 2001 to 2013. At the sectoral level, trade manufacturing and mineral fuel exports (with US dollar invoicing) deteriorated. With the manufacturing sector not having really grown and with heavy reliance on fuel imports on the one hand, and India’s focus on the services sector post liberalization and being a large agricultural exporter on the other hand, these results are intuitive and expected, until 2008–2009. What is, however, puzzling and therefore unclear is this continued to hold true even post-GFC, a period of high inflation and high CAD.

Chapter 6, the last chapter of the book, discusses sources of external financing. The chapter focuses on the sources and types of Foreign Direct Investment (FDI) inflows into India. The authors argue that policy makers in India should be careful to attract only FDI that comes from “stable sources of external financing”, especially in the context of the recent “Make in India” drive. The chapter begins with a briefing on FDI and its different types. The authors then explain why FDI may not necessarily be “bolted down” which is contrary to popular belief. Nevertheless, FDI and remittances remain the two main sources of stable financing for India, whereas portfolio equity and commercial bank lending are extremely volatile. The authors then provide a breakdown analysis of the main sources and types of FDI flowing into India. They argue that “flow of funds” do not necessarily reveal “doing business in India”. Data shows that FDI mainly flows into India from Mauritius and Singapore (tax havens), with the latter’s share having increased over time. However, a closer look reveals that most of these funds originate in India but are routed through these countries, a feature commonly known as “round tripping”. Mergers and Acquisitions (M&A) on the contrary provide a clearer picture of who is actually “doing investments” in India. Most M&As are from US, UK and Japan. In fact, more than 1/3rd of M&As are in the pharmaceutical and telecom sectors in India, consistent with current global trends. The authors then briefly discuss the difference between Greenfield investments and M&A, and conclude that compared to China, India has a larger share of M&A to FDI inflows. On the whole, the authors conclude that FDI in the form of M&A may not lead to new production and that there may be a gap between the business objectives of foreign investors and broader developmental goals of emerging economies like India.
In terms of structure, each chapter is post-scripted with useful and insightful annexure. This provides additional technical material that is relevant to the main subject matter of each chapter. However, there is little discussion on the RBI’s recently revised “Monetary Policy Framework”, which now follows “Inflation Targeting” using the consumer price index (CPI) as the nominal anchor. It would have been nice if the authors had shed some light on this regime change too.

While some more analytical results — especially on the effectiveness of monetary policy through the IRPT and EPRT channels — could have complemented the empirical observations, the book on the whole succeeds in updating the empirical literature on the Indian macroeconomy. The volume provides a rich and detailed analysis of many issues related to monetary policy, exchange rates and capital flows in a very accessible manner to the reader. Many of these questions continue to baffle the academic world and so this work certainly contributes to the reader’s overall understanding of many topics discussed.

PAWAN GOPALAKRISHNAN
Strategic Research Unit
Reserve Bank of India, Mumbai, 400001
pawangopalakrishnan@rbi.org.in