RBI – THE TRUE GUARDIAN OF INDIA'S FINANCIAL STABILITY

Published on January 3, 2012.

Some may say that India's relatively better economic moat globally is really the result of the "follower" approach (call it 'late mover advantage' if you will) of its fiscal and monetary policy makers to global liberalization. But some others opine that Duvvuri Subbarao and team are arguably amongst the smartest central bankers globally. An analysis of the central bank's apparent strategy of recent, to use a depreciated Rupee to our advantage may place most of us in the latter group.

The RBI follows a policy of stabilizing the Rupee around the real effective exchange rate (REER), which is the Rupee's value against a basket of six currencies of India's largest trading partners, adjusted for inflation. Until the latter part of 2008, dollar reserves were built up during periods of heavy capital inflows to prevent excessive appreciation and utilized to prevent excessive depreciation of the rupee. But the US sub-prime crisis changed the way central banks around the world looked at the US Dollar almost overnight, raising serious doubts about its status as the world's reserve currency in the longer term. In the more recent episode of exchange rate fluctuations, the RBI renounced its model of buying up forex (read USD) during periods of heavy capital inflows, instead diversifying its forex stockpile through addition of gold reserves.

Since 2009, India's share in global investment portfolios has increased, thanks to the reasonably strong economic fundamentals (For the three year period ending December 2011, the FIIs were net buyers of ₹600 billion in the Indian markets). The non-event of a FII sell-off even in the wake of extended policy paralysis at the centre, a slow-down in GDP growth, weaker IIP data and a plethora of corruption scandals, led conviction to the theory that FIIs this time round are here for a longer haul. In the absence of RBI buying US Dollars and the sustenance of FIIs unfailing love of the Indian markets, the rupee exchange rate hovered in the 44-46 range for the better part of 2010 and until September, 2011, while the REER appreciated by 19 per cent in the interim.

On the flip side, India's is the only economy amongst BRIC nations that is plagued by the phenomenon of rising Current Account Deficit (CAD) in recent years, with the imports exceeding the exports by almost 50%. China's policy of keeping the Yuan at artificially depreciated levels for elongated periods in the interim has adversely impacted the competitiveness of Indian exports. To make things worse, with the increase in overseas borrowings by Indian companies (in view of the interest rate differential available globally), India's External Commercial Borrowings nearly doubled at $18.2 billion in the first half of FY11-12 compared to $10.6 billion in the same period a year ago.

Thus in allowing the not so un-intended depreciation of the Rupee , the RBI seems to have made a calculated move based on a strategy of reducing CAD through bolstering exports, curbing imports and ECBs. While these developments may slow down growth in the short-term, the RBI apparently hopes to improve investor confidence through a strengthening of the Current Account. The resulting capital inflows (as already evident since the start of 2012), coupled with RBI's explicit measures would bring the rupee exchange rate in the 48-50 range keeping Indian exports fairly competitive globally.

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