

No Method in this Confusion

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Reserve Bank of India Governor Raghuram Rajan faces a challenge greater than that confronting his peers. Having taken office when the task of dealing with the global crisis had ostensibly been done with, he cannot appeal to circumstances to defend actions that go contradictory to his professed faith. Developed country finance ministers and central bankers did that through the crisis—borrowing to spend while swearing by fiscal consolidation or pumping liquidity into the system while claiming to be committed to a monetary policy framework that makes reining in inflation its prime target.

Rajan took office when many claimed the crisis was “over”, even if the recovery was weak. His job was not to address the direct impact of the crisis, but to correct what neoliberals consider the policy ills of an economy that otherwise fared the recession well. India had not only bounced back in terms of growth in the years immediately after the crisis-induced dip of 2008-09, but had also remained a favourite of international investors who stuck with the country once the liquidity crunch created by the crisis had been addressed in their home countries. The problem, analysts expressing the preferences of foreign finance argued, was that India’s effort at reducing its large fiscal deficit was inadequate and stalled by the crisis. And India’s monetary policy had proved ineffective in addressing what should be its principal objective—reining in inflation. What the country needed was a firm commitment to these principles both at the Finance Ministry and the Reserve Bank of India.

The reception his appointment received in the international and domestic media made clear that Rajan came with what many would consider impeccable ‘conservative’ credentials. But despite his antecedents—Chicago’s Booth School and the IMF, for example—the new governor had an aura of the uncertain around him. Was he the kind who goes against the grain and sees faultlines in a financial system that his peers lauded? Or is he the person who flies into India to chair a committee that recommends sweeping financial liberalisation just when a crisis precipitated by financial deregulation was breaking in the US? There is much in Rajan’s work that points to this pretence at being contrary even while being firmly in the conservative camp.

The question is, can Rajan use this ability, to appear on both sides while belonging to one, to deal with India’s predicament of high inflation, balance of payments vulnerability and slowing growth. Early in his tenure he made clear that he would try. In his first monetary policy review after assuming office, Rajan chose to run with the hares and hunt with the hounds. He hiked the repo rate, or the rate at which banks borrow from the RBI against government securities as collateral, arguing that the battle against inflation had not been won. He simultaneously sought to appease those arguing that easy and inexpensive liquidity was needed to boost demand and flagging growth, by lower the interest rate on the Reserve Bank of India’s marginal standing facility (MSF), under which banks can borrow funds at a rate linked to but set higher than the repo. Originally the MSF rate had been set at 1 percentage point higher than the repo rate. This differential was hiked by a further 2 percentage points to 10.25 per cent in July 2013. The September 2013 Mid-Quarter Review of Monetary Policy partially reversed that hike by reducing the differential between the MSF rate and repo rate by 75 basis points (bps) to 9.5 per cent. The consequent ability of the banks to obtain funds at a lower cost without collateral was seen as a measure aimed at boosting banking sector liquidity. This pointed to two contradictory planks in the RBI’s policy: that of keeping interest rates high on the grounds that this was required to fight

inflation, and of easing liquidity conditions so that banks can lend more and sustain demand. Industry was not too impressed.

The RBI governor seems to be continuing with this adoption of an ambiguous or even contradictory stance when dealing with the principal challenge currently facing not just India, but all emerging markets—the US Fed’s “taper” policy. Major emerging markets experienced a run on their currencies last summer, triggered by Ben Bernanke’s announcement that improved economic conditions warranted the gradual unwinding of the Federal Reserve’s policy of buying up government Treasuries and private asset backed securities to the tune of \$85 billion a month.

Till then, that policy had contributed to a strong bond market and low interest rates (given the inverse relation between bond prices and interest rates), which investors leveraged to earn high net returns by investing not just in the developed countries but in emerging markets as well. A corollary, therefore, was large capital inflows, strong equity and bond markets, and appreciating currencies in the developing countries.

When the taper was announced, fears that the unwinding of the bond-buying policy would raise interest rates in the US and other developed country financial markets triggered an exodus of investor capital and led to market and currency declines in June last year. But once the initial response to the Fed’s announcement had run its course, the market it was claimed had accounted for the impact of the ‘taper’ and there were no dangers confronting the emerging markets. This seems to have been [corroborated](#) when the first round of the taper in December 2013 reduced the Fed’s monthly purchases of Treasuries and bonds by \$ 10 billion to \$ 75 billion.

However, that has proved to be short-lived. As the date on which the second round of the taper, in the form of a reduction of Fed bond-buying from \$75 billion to \$65 a month approached in January, investor uncertainty and exit began to be felt in a number of countries from Argentina, through Turkey and to India and Indonesia. The extent to which countries were hit by the decision, when finally taken in end-January, was also influenced by their overall economic environment. Argentina, with problems varying from a high rate of inflation and an official exchange rate that ruled well above the black market was the first to feel the pressure, forcing the country’s central bank to [temporarily abandon its policy of supporting the peso through sale of foreign exchange from its reserves](#), resulting in a sudden fall in the value of the peso from 6.7 to the dollar to 8 to the dollar.

Turkey, which has been experiencing a sharp depreciation of its currency and saw the lira touch 2.4 to the dollar, and is dependent on short-term capital flows to finance more than 80 per cent of its current account deficit, had to call a late night emergency meeting to sharply hike interest rates in an attempt to prevent capital flight and a collapse of the currency. Brazil and South Africa too have been forced to hike interest rates. All these countries complain that the Fed’s taper is irresponsible. What they fail to mention is that maintaining open economic borders and allowing capital to flow in during the years of quantitative easing was also irresponsible. In fact, during those years countries like Brazil were complaining that the surge in capital inflow resulting from the Fed’s cheap money policy was resulting in an appreciation of its currency and a decline in competitiveness. [Brazil’s Finance Minister had in September 2012 declared the US policy as being akin to a currency war](#), but far too little was done to prevent the inflow which is likely to reverse with the taper and destabilise the country.

How has India’s central bank under Raghuram Rajan responded? The governor’s rhetoric once again seems contradictory. To start with, he declared in an interview to Bloomberg TV

India that: "International monetary cooperation has broken down," and that, "Industrial countries have to play a part in restoring that, and they cannot at this point wash their hands off and say we will do what we need to, and you do the adjustment you need to." Clearly industrial countries and the US in particular were unlikely to respond to that outburst and what was needed was an acknowledgement that the policy of keeping open financial borders, which the Rajan Committee had favoured, was misplaced and capital controls were in order. That, however, would require the governor to part company with the epistemic community he belongs to, which he will not.

So a few days later Raghuram Rajan changed his tune. After the recently held meeting of the Financial Stability and Development Council, he reportedly declared: ["We have done a lot to make the economy robust and we are better prepared](#) (to deal with impact of tapering). (But) I will never say we are fully prepared for any eventuality. We have to be vigilant." It was not clear as when "we" had done this. But in keeping with the change of tone, he also said: "the new US Federal Reserve chief Janet Yellen is a very experienced central banker... I have full faith that she will do whatever is appropriate and she will be a very reliable central banker." The earlier aggression had been conveniently shelved, because it could not be backed up with the necessary policies that were ideologically unacceptable.

Rajan's claim that India is better placed to address the taper may partly be based on the fact that he has from the beginning of his tenure emphasised the importance of high and rising interest rates as an antidote to inflation. Moreover, under his tenure the Reserve Bank has been taking on board the much higher inflation rates reflected by the Consumer Price Index as opposed to the Wholesale Price Index. As a result he has raised policy rates in three of the four monetary policy reviews undertaken since he took office. The governor is conscious of the fact that, being unwilling to regulate capital flows, this is the policy that he would have to adopt to stall capital flight triggered by the taper. To the extent that it reins in inflation and renders domestic financial assets more attractive, the high-interest regime he hopes will also sustain the attractiveness of the domestic market to foreign investors.

There are three problems with this policy response of raising interest rates adopted across a number of emerging markets. One is that it assumes that the high level of capital inflows to emerging markets that resulted from an easy and cheap money policy in the source, developed countries, particularly the US, can be sustained even after that policy is reversed. Second, it ignores the fact that the impact of the taper has been more severe also because of the slowing down of growth in most emerging markets and the worsening current account in some of them. Finally, it discounts the possibility that investors would see the rate hike as a signal of weakness in these economies, aggravating rather than stalling, capital exit.

While interest rate hikes may not work to stall capital flight, they would have an adverse impact on domestic investment and growth. This could imply that the deceleration in growth being experienced in most emerging markets may intensify making these countries the next geography after Europe into which the persisting recession spreads. That cannot be all too good for the world economy. Unless the so-called "breakdown of monetary cooperation", which never really existed, forces developing countries to consider controls on capital flows, especially inflows that are by nature volatile.

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