UNCONVENTIONAL MONETARY POLICY & MACROECONOMIC INDICATORS OF INDIAN ECONOMY: IS INDIA STILL VULNERABLE?

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Abstract: During the global financial crises of 2008, most of the developed countries of the world applied unconventional monetary policy which essentially relates to the balance sheet policy of central banks. However, entry and exit from such policies have strong spillover effects on capital flows towards emerging market economies (EMEs) including India. Both Reserve Bank of India and govt. undoubtedly, handled the situation successfully. Under this backdrop this paper is an attempt to analyse various Macroeconomic Indicators of India. The results show that our external debt indicators are still vulnerable if we compare them with the benchmark 2004. Having clawed   back after a major threat to its sovereign ratings last year, India's policy makers now need to consolidate.

Keywords: Unconventional Monetary Policy, spillover effects, Macroeconomic Indicators, external debt indicators, emerging market economies, Bank for International Settlements (BIS), IMF, CAD, Fiscal Deficit, External debt, Foreign Exchange Reserves

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INTRODUCTION

A Conventional monetary policy is a policy which the central banks operate with an interest rate instrument. For a tight money policy, rate of interest is increased so as to discourage investment in the economy & for a easy monetary policy, rate of interest is lowered so as to initiate the investment in the economy. This policy has the main drawback that it proves almost ineffective during recession as the nominal interest rate cannot be lowered below zero and the very purpose of injecting money supply in the economy is defeated.

In that case the central banks have to use unconventional monetary policy measures to provide further monetary accommodation. Unconventional monetary policy relates to the balance sheet policy of central banks. In such a situation, central banks can resort to direct financial asset purchases and/or loosen collateral standards to expand their balance sheets. In the recent global financial crisis central banks of most of the advanced countries resorted to unconventional monetary policy. These policy measures included lending to financial institutions, targeting liquidity provisions for credit markets, outright purchases of public and private assets, purchase of government bonds etc. The aim of these measures was to lower longer-term bond rates and ease monetary conditions &maintaining interest rates at lower levels for a longer period.

Unconventional monetary policy measures not only supported domestic economies, but also boosted a broad range of asset prices globally, especially equity and bond markets in EMEs (Mohanty,2014). It is widely perceived that in absence of unconventional monetary policy measures, financial sector meltdown and recession, particularly in advanced economies, would have been more severe, which in turn could have significantly impacted the global economy (IMF (2013).

However the negative side of Unconventional monetary policy is that entry and exit from such policies have strong externalities and spillovers to emerging market economies (EMEs). When it is applied, Capital flows is pushed into EMEs due to ultra-accommodative monetary policy in source countries which leads to appreciating domestic currencies and escalation in asset prices. When it is withdrawn, the capital starts flowing back to the source country as now they are in a position to offer better returns. The exit from a prolonged use of unconventional monetary policy also poses the risk of asset prices overshooting on the downside which can cause significant collateral damage (Rajan, Raghuram G. (2014).

This is what exactly happened in case of global financial crisis of 2008. As a result of unconventional monetary policy applied by advanced countries, the capital started moving towards EMEs. EMEs received much larger net private financial flows of about US$ 3 trillion in the form of direct and portfolio investment during 2009-13 as compared with US$ 1.8 trillion during 2004-08 (IMF, 2014; World Economic Outlook Database, April). Besides domestic pull factors in EMEs, push factors - monetary policy in advanced economies and global risk appetite - were important determinants of capital flows to EMEs. (Fratzscher, M., LoDuca, M., & Straub, R. (2013); Lim, J., Mohapatra, S., & Stocker, M. (2014).

Keeping in view the complex interaction of global spillovers and domestic vulnerabilities, EMEs deployed a variety of policy measures. These policy responses were in the form of monetary, capital flow measures and other structural policy actions. For example, while Indonesia and Turkey made greater use of their forex reserves to curb downward pressures in their currencies, others like South Africa used exchange rate as the main shock absorber. Many EMEs had to raise policy rates to curb capital reversals and contain downward pressure on exchange rates (e.g., Turkey, Brazil, South Africa and India)

The multilateral institutions, such as the IMF and the Bank for International Settlements (BIS), have done significant research on the issue of spillover. Most studies found that EMEs with better domestic fundamentals and deeper financial markets were relatively more resilient to adverse shocks from the US Fed tapering (Mishra, Prachi; Kenji Moriyama ; Papa M'B. P. N'Diaye ; Lam Nguyen (2014); Nechio, Fernanda (2014).There was also a view that foreign investors did not differentiate EMEs based on macro fundamentals. Rather the EMEs with larger and deeper markets were under more pressure (Eichengreen, Barry and Gupta, Poonam (2014); Aizenman, Joshua; Mahir Binici and Michael M. Hutchison (2014).

IMPACT ON INDIA

Until the emergence of the global crisis in 2008, India was passing through a phase of high growth along with low and stable inflation. Growth was largely supported by domestic demand coming from growing domestic investment financed mostly by domestic savings and sustained consumption demand. Even in the initial phase of crisis, Indian Financial Markets were not affected much because of negligible exposure to illiquid securitized assets. But after the collapse of Lehman Brothers in September 2008, India could not remain

unhurt for long and was eventually caught in the grip of crisis through all the channels – financial, real and more importantly, the confidence channel.

Like the most other central banks, the Reserve Bank also took a number of conventional and unconventional policy measures to contain the adverse spillover of global developments. These included augmenting domestic and foreign exchange liquidity and a sharp reduction in the policy rate. The Government also supported the economy by fiscal stimulus packages, reversing the earlier efforts at fiscal consolidation.

With all these efforts, the domestic economy, no doubt recovered quickly but in the process, inflation also picked up, partly aggravated by skyrocketing global commodity prices, particularly oil. Consequently, the Reserve Bank again changed its policy stand. It exited from accommodative monetary policy and focused on tight monetary policy. Fiscal policy was also tightened. In spite of all these efforts of RBI, the growth could not be sustained because the economy was confronted with a number of supply constraints. In this process growth slowed, inflation still remained at levels not conducive to sustained high growth and current account deficit expanded which made the Indian rupee more vulnerable to external shocks.

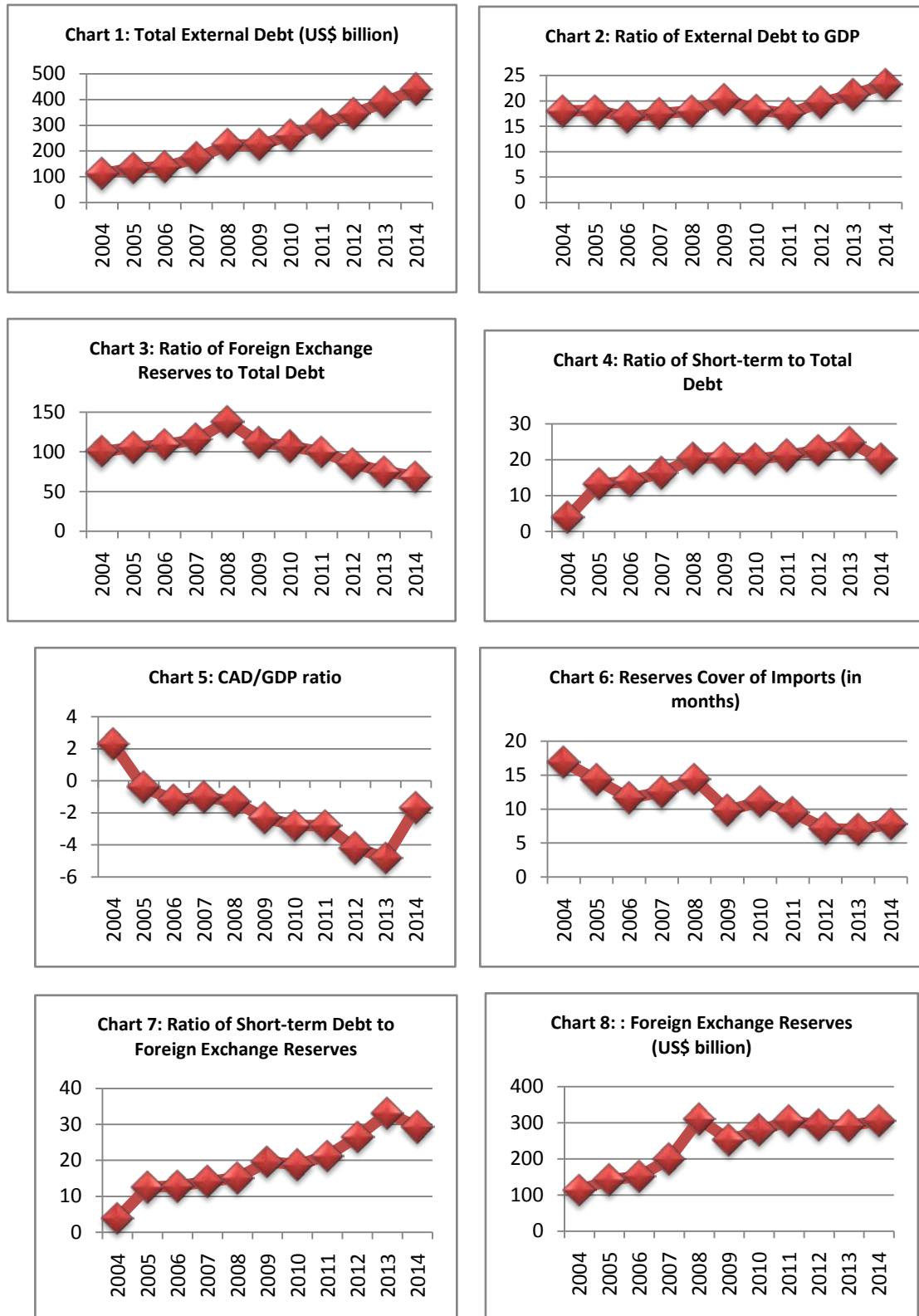| Table 1: Selected Macroeconomic Indicators in India								
	2003-04 to 2007-08 (average)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15*
Real GDP Growth (%)	8.7	6.7	8.6	8.9	6.7	4.5	4.7	5.5
WPI Inflation Rate (average) (%)	5.5	8.1	3.8	9.6	8.9	7.4	6.0	5.7
CPI Inflation Rate (average) (%)	4.9	9.2	10.6	9.5	9.5	10.2	9.5	8.1
Centre's Fiscal Deficit (% of GDP)	3.6	6.0	6.5	4.8	5.7	4.9	4.5	4.1
Overnight Call Rate (%)	5.6	7.1	3.2	5.8	8.2	8.1	8.3	8.0
Exchange Rate (`/$)	43.1	45.9	47.4	45.6	47.9	54.4	60.5	59.8
Current Account Deficit (% GDP)	0.3	2.3	2.8	2.8	4.2	4.7	1.7	2.1
*Targets Source: RBI & Government of India								

The data on selected Macroeconomic Indicators shows that almost all these indicators have been deteriorating since 2008 (Table 1), and showed their worst performance in 2012-13. In the financial year 2012-13, growth had slowed to its lowest level since 2003-04 at 4.5 per cent, current account deficit (CAD) had expanded to its highest level at 4.7 per cent of GDP, gross fiscal deficit of the central government was 4.9 per cent of GDP and consumer price inflation remained in double digits (10.2%), Hence, macroeconomic conditions were weak till 2013.

However, the analysis of the various macroeconomic variables also shows that Indian Economy performed better in 2013-14 as compared to the period 2008-13, credit goes to RBI governor Raghunath Rajan who took over in September 2013. A comparison of leading Macroeconomic Indicators in Sept 2013 & July 2014 shows that Consumer price inflation which was 9.8% in September 2013 improved to 7.96% in July 2014; wholesale price inflation was lower at 5.2% in July 2014 compared to 6.5% in September 2013; Forex reserves were also higher at $320 billion on July 2014 compared to $275.50 billion in August 2013, and the rupee was stronger at .`60.50 to the US dollar. Further, GDP growth in the first quarter of 2014-15 is 5.7% against 4.7% in the comparable period last fiscal year (The Economic Times, 29th August, 2014). The targets fixed by the government for the next financial year 2014-15 show that the economy will move on the right track.

On the other side, the data on External Sector Indicators shows that though moderated, these indicators are still vulnerable. India's external debt profile appears similar to that of other major emerging market economies. But its short-term external debt stock is now higher than countries such as Brazil and Russia (in terms of percentage of GDP), according to Taimur Baig and Kaushik Datta, economists at Deutsche Bank. India's share of short-term debt relative to the stock of total external debt is also higher than other emerging market economies, with the exception of Turkey (The Economic Times, 9th July 2014). Figure 1 shows that External debt is almost three times ($440.6 billion) in 2014, compared to $156 billion a decade ago (Chart 1). But the more worrisome is the Ratio of External Debt to GDP (chart 2) which is continuously increasing. It was 23.3% on march 2014, whereas it was 17.68% a decade ago.

Figure 1. Selected External Sector Indicators* still vulnerable

Chart 1: Total External Debt (US$ billion)

Chart 2: Ratio of External Debt to GDP

Chart 3: Ratio of Foreign Exchange Reserves to Total Debt

Chart 4: Ratio of Short-term to Total Debt

Chart 5: CAD/GDP ratio

Chart 6: Reserves Cover of Imports (in months)

Chart 7: Ratio of Short-term Debt to Foreign Exchange Reserves

Chart 8: : Foreign Exchange Reserves (US$ billion)

Source: RBI * self calculated

The Ratio of Foreign Exchange Reserves to Total Debt is yet another variable which is of concern for the country. The higher the ratio the better it is for the country. This ratio has continuously been declining since the global crises in 2008(Chart 3). In march 2014, this ratio was 69% which is almost half than what it was in 2008 which is a matter of concern. Another variable which was instrumental in the currency crisis of many economies in the past is the Ratio of Short-term to Total Debt. In order to be safe from the external shocks this ratio should be as small as possible. Unfortunately this ratio has continuously been increasing since 2008 and it was highest in March 2013 at 24.8% (Chart 4). Though it showed a declining trend during 2013-14 and approached 20.2% in March, 2014, the current share at 20% is significantly higher than what it used to be a decade ago. This share was only 4% in 2004. It started rising sharply since the global crisis of 2008. Though short-term debt was contained in FY14, it was largely due to a slowdown in imports and may again rise once there is a rebound in growth and imports pick up. Some economists point out that since GDP is expressed in dollar terms, a weak rupee translates into a lower GDP number and hence, a lower ratio could be misleading (The Economic Times, 9th July 2014).

Current Account Deficit as a percentage of GDP was another risky variable which led to the depreciation of currencies of many emerging economies including India, following the fed tapering announcement in may 2013. Unfortunately, India is losing on this front as well. Its CAD has been increasing sharply after 2008(Chart 5). It was highest at 4.8% in 2013. Then it decreased to 1.7% in 2014 mainly because of restrictions on gold import. If crude price risks persist, the current account deficit which was contained in 2013-14 could deteriorate further and also add to pressure on the rupee. Care Ratings has projected a CAD for the year at 2.5% of GDP assuming stable crude oil prices and a recovery in industrial production. Higher persistent crude prices would upset this calculation. Besides the import cover of reserves now is only adequate to fund eight months of import compared to fourteen months of imports in the period prior to the crisis in 2008(Chart 6), although the foreign exchange reserves of the government have almost doubled to $304 billion in March 2014 as compared to a decade ago (Chart 8).

SUMMARY:

The Reserve Bank's commitment to a monetary framework focused on inflation coupled with adoption of consumer price inflation as the nominal anchor and the Government's

commitment to fiscal consolidation may have helped in improving various external sector vulnerability indicators. Nevertheless, headwinds to growth from domestic constraints continue to pose downside risks. Vulnerabilities in India's external sector, though mitigated, have not totally disappeared. There is a need to use multiple instruments including drawdown of foreign exchange reserves, monetary tightening, augmentation of reserves and administrative measures to dampen speculative outflows and encourage inflows to stabilise market conditions.

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