IMF's Advice and RBI's Rebuttal

Dr. T. K. Jayaraman

IMF Executive Director KV Subramanian

International Monetary Fund (IMF), under its Article IV of the Articles of Agreement, signed in 1944 by the original 29 member countries as well more by later, (now grown to 190) sends its staff, to its member countries for a three-week visit annually for major economies, which contribute a sizeable proportion of world's GDP, and once in every two years for small economies. The purpose of the Mission, known as Article IV Consultation Mission (the Mission) is to undertake a comprehensive review and assess the immediate past economic performance and offer advice on stabilizing their economies, preventing financial crises and improving living standards. The Mission would also seek to "identify areas of divergence away from and convergence towards orderly growth of the member countries for promoting freer trade with relatively less restrictions on trade and as needed as possible between nations and for fostering free market forces without restrictions on supply and demand as well for greater mobility of capital and labour between nations".

The Mission collected as usual economic and financial information, and discussed the country's economic progress and policies with the top officials in the Ministry of Finance and Reserve Bank of India (RBI). The staff prepared a draft report for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director IMF, as Chairman of the Board, summarizes the views of Executive Directors, which was transmitted to the country's authorities.

Findings of Mission

The Mission Report has good words on India's overall economy in several directions. First on economic growth, which has been described as robust. In regard to inflation, though it has been volatile, it is moderate. Employment has risen and surpassed the pre-pandemic level and the financial sector has been resilient. On the other hand, in the external sector, the current account deficit (CAD) in the balance of payments has widened, although there was considerable rise in the IT sector's export of services as well as diversification of oil imports to minimize the import costs. The post pandemic recovery of domestic demand and external shocks have been identified as causes for the widening of the CAD, which is manageable as the country has substantial foreign exchange reserves (Forex) to meet 9 months of imports. The negative

sides identified were the elevated total public debt (the central and state governments) despite the easing of the central government budget deficit. As for the rest of FY 2023/24, the Report projects the growth will be 6.3% and CPI inflation would fall and the current account deficit would decline as oil import costs are expected to be less.

The risks to growth are seen to be balanced. If global growth slows down, which would hurt India through trade and financial channels. Similarly, global supply disruptions would give rise to recurrent commodity price volatility; and domestic weather shocks create inflationary pressures. On the upside, consumer demand and private investment along with foreign investment could increase India's role in global value chains, boosting exports.

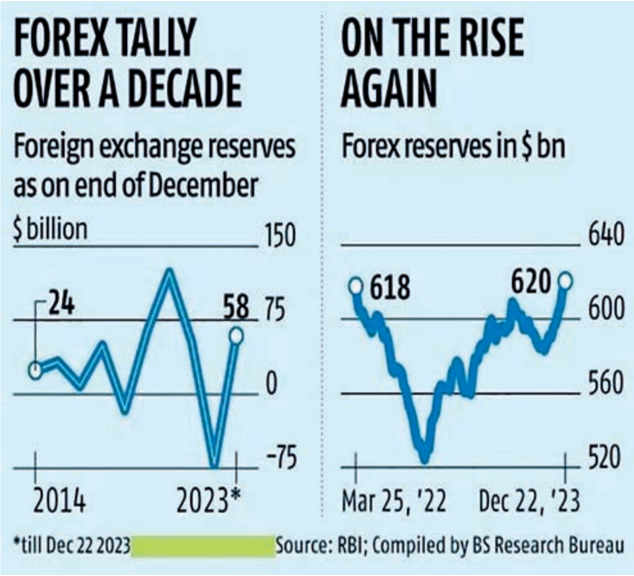
Volatility in India's exchange rate

Turning to exports, the Mission referred to the volatility in India's exchange rate movements during December 2022 to October 2023, at times, high to the extent of 15% from December in 2022 to first quarter of 2023. RBI's attempts to arrest volatility and loss of foreign exchange reserves (Forex). The Mission also stated that the interventions in foreign exchange market were "excessive". The IMF observed it is a divergence from the objective of fostering free market forces and interventions may be due to external shocks.

The Mission was fully aware of the nature of the shocks as well that the country of origin of the shocks was none other than the host country, the USA which houses the two Bretton Wood institutions. The US Federal Reserve Bank (the Fed) had ignored the signs of rising inflation right from the fourth quarter of 2021, after the waves of the pandemic (Covid-19) were receding. Even in January 2022, the Fed was dismissing the signs (shooting up of food and fuel retail prices) as transient and transitory.

Only after the Russia-Ukraine Conflict broke on March 22, 2022 and began to ravage the Eurozone and the UK, the Fed realized that the signs were real and not transitory. The Fed began a monetary tightening by raising its low, policy interest rate of 0.25% from March. However, by April 2022 the USA's retail inflation touched 9.1% in April, the highest in 20 years. Then for the next 13 months until August 2023, by the Fed steadily raised the interest by a total of 525 basis from 0.25%, 5.50% in August 2023. As inflation fell to 3.7% in August, the Fed indicated it might consider relaxing its policy of monetary tightening. The uncertainties soon developed. Speculative portfolio investors were rattled again, pulling out their funds out and reversed the outflows. The wild fluctuations were daily happenings when Varsha Meghani of Forbes India in her report of December 23, 2022, more than a year ago before the IMF Report of December 18, 2023, described the happenings on the exchange rate front thus: "the Indian Rupee was playing snakes and ladder against US dollar".

On September 28, 2022, the rupee breached the then much dreaded level of 82 per dollar before recovering slightly on September 29, 2022, to settle at around ₹ 81 per dollar. In the FY 2022, the rupee depreciated against the dollar by around 8%. Such a big fall in 5-6 months has certainly put pressure on RBI. That led RBI to intervene in the foreign exchange market to arrest the volatility in the rupee. The central bank sold $19 billion and increased the supply of dollars and cheapened the dollar and raised the value of the rupee. By then, India's Forex had decreased to cover the import of around seven months as compared to 12 months a year ago.



It may be recalled that in October 2021 India's Forex was the historically highest at $645 billion. The end of 2021 saw Forex was 634 billion. On the other hand, it was around only $562 billion in 2022 (**Table**). It is estimated that the slump was around $71 billion. Referring to the rupee depreciation, Finance Minister Nirmala Sitharaman said "It's not the rupee that is falling, but the dollar that is strengthening". Further, all advanced and developing countries were impacted by the dollar's rise, as their capital outflows became inflows to the US, which was considered then the safest haven by speculative, short term portfolio investors.

TABLE — Exchange Reserves and Exchange Rate

Calendar Year	FOREX (US$ billon)	Exchange Rate (Rs/US$)
2015	351	66.3
2016	360	68.0
2017	410	63.9
2018	396	69.8
2019	460	71.3
2020	586	73.1
2021	634	74.3
2022	562	82.8
2023	620	83.2

Source: Asian Development Bank Key Indicators 2023

Multi party network in global supply chain

> ... global supply disruptions would give rise to recurrent commodity price volatility; and domestic weather shocks create inflationary pressures. On the upside, consumer demand and private investment along with foreign investment could increase India's role in global value chains, boosting exports.

The US Fed was raising its interest rate to fight inflation with a steady rise of 25 basis points each month in its policy interest rate from October 2022 climbing up 5.50% until August 2023 and still continuing at the same rate on. Interest differential was the attraction. The Indian rupee slid by 10% against the US dollar compared to the British pound, the euro, the Japanese yen and the Chinese Yuan, all of which depreciated by 15-20%.

Theoretically, a depreciation of the rupee renders Indian exports cheaper to the importers outside. But, what is ignored is that demand for Indian exports abroad is relatively price inelastic and not attractive enough. Hence Indian exports do not have any chance of making big money. On the other hand, exchange rate depreciation makes imports of India such as edible oil and petroleum more expensive; and a sharp appreciation of the rupee would hurt exports.

Is India a manipulator?

The external shocks were indeed created by the Fed's hesitancy to initiate an early battle against rising inflation in time. The Fed delayed interest rate hikes in 2022 and the interest rate differential between US and India (as evidenced in a decline in US$ and Rs forward premia (forward premia declined from a range of 3.24-2.98 in August 2022 to a range of 2.96-2.74) exercised a negative impact on capital flows. Reversal of flows from India and other economies to US had forced the Fed to face a longer inflationary phase.

Possibly, the stability of and narrow range within which India's exchange rate fluctuated had led to the impression that India intervened excessively aiming at a particular exchange rate. India's de facto exchange regime rate was reclassified as 'stabilised arrangement' for the period between December 2022 and October 2023, while the *de jure* classification remained as 'floating'. The IMF advised instead of intervening, "a flexible exchange rate should act as the first line of defence in absorbing external shocks."

The RBI rebutted the IMF observation maintaining that it does not target any specific exchange rate, and that its intervention in the foreign exchange market is "both ways only to tackle undue volatility." It is not the first time that India is called a manipulator of interest to take unfair trade advantage of free date under the guise of a floating rate regime.

India was added to the list of manipulators by the US Treasury first in December 2018 but removed in 2019. Again it was include in the list in December 2020. The currency manipulator watch list includes the countries that are suspected of intervening in their foreign exchange (Forex) markets to gain an unfair trade advantage.

The IMF did not put the stamp of manipulator on India's credentials. But it was the US Federal Government, which looked upon India as a manipulator.

In October last year, at the Annual Meeting of IMF and World Bank, the RBI Governor told IMF officials that one has "to get out of the one-sided approach to call someone a manipulator or a currency stabilizer and put on the watch list. Market intervention should not be viewed in "black and white", and "the term is more nuanced, as emerging market economies and developing countries have to deal with consequences of policy actions of the countries in developed world." ■

— Dr TK Jayaraman is an Honorary Adjunct Professor at Amrita School of Business, Bengaluru and Visiting Research Professor under International Research Collaborative Research Pogramme, University of Tunku Abdul Rahman, Kampar Campus, Perak State, Malaysia. Earlier he was a Senior Economist, Asian Development Bank, Manila. His website: www.tkjayaraman.com.