Role of CAD in currency crisis

What is the issue?

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The recent currency crisis has been largely due to international events which call for proper policy measures to deal with the problem.

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Is the CAD of India worrisome?

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- The CAD is likely to end up at 2.7-2.8% this fiscal, which was 1.9% of GDP last year.
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- But the situation is near normal, since in a historical sense the CAD for fast growing developing economies with a lot of catching up to do is 2-3% of GDP.
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What is the problem then?

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- The problem lies in the financing of this deficit, despite a relatively normal CAD.
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- **Debt** - India received about $25 billion foreign portfolio inflows in the debt market last year.
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- The large inflow into India last year may in part be due to the RBI/MPC policy of keeping real policy rates extraordinarily high.
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- But the situation has reversed and about $9 billion have flowed out this year.
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- This is despite the emerging economies still receiving debt inflows, although not as large as last year.
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- A large part of the reduced inflow into India is due to the US Fed raising rates.
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- **Interest rate** - The real interest rate is the rate of interest an investor, saver or lender receives after allowing for inflation.
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- The real interest rate is approximately the nominal interest rate minus the inflation rate.
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- MPC had earlier stated that real policy rates should be around 1.25%, but in fiscal 2018, our real policy rates averaged 2.5% (double of the MPC guideline).
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- Though the inflation rate were so low last year, the real interest rates were not reduced, which affected the borrowers in the market.
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- **Bonds** - Raising the policy rates will also increase bond yields as well.
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- This is because bond issuers must pay a competitive interest rate to get people to buy their bonds.
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- New bonds paying higher interest rates mean existing bonds with lower rates are less valuable and prices of existing bonds will fall.
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- However, the lowering of inflation and the interest rates didn't result in lowering of bond yields in recent times.
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- This made the investors attracted towards higher yielding bonds and the bond price of previously issued bonds got affected which resulted in the exit of many domestic and foreign investors.
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- **Forecast-** The fundamental problem in our macro economy is that the central bank cannot seem to forecast inflation.
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- The (RBI) inflation expectations survey also needs to be looked into, which is not providing accurate estimates on the course of inflation.
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What should be done?

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- The fiscal deficit is well in control, though it was forecasted that it will

expand in fiscal 2018 because of loan waivers.
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- The GST revenues were not part of the fiscal deficit estimate for financial year 2018, hence including it would have brought in the fiscal deficit to below the initial target of 3.3%.
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- Hence the current currency crisis is made outside of India, where domestic factors play only a meagre role.
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- Rupee faces a major problem because of financing issues in the current account deficit.
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- India needs to diversify its international sources for oil imports and both the central and state governments should try to reduce the price burden by easing their respective tax rates.
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- Also, RBI should make sure that the inflation forecasts are better to have a timely change in the interest rates.
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Source: Business Line

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