SHANKAR IAS PARLIAMENT
Information is Empowering

Uncovered Interest Rate Parity vs Depreciation

What is the issue?

\n\n

\n
- RBI recently cut the policy repo rate by 25 bps (1 percentage point is 100 bps) to 6%, as headline inflation dropped to a historic low of 1.54%.
\n
- It is believed that as a result of this rupee will depreciate, as the interest rate differential between INR and USD narrows.
\n
- On contrast, despite the rate cut, the rupee appreciated further by 0.3% that day.
\n

\n\n

What is the reason?

\n\n

\n
- 'Uncovered Interest rate Parity (UIP) Theory' aims to predict the spot exchange rate of a small open economy with a fully-floating currency.
\n
- It states that the expected change in the exchange rate between the currencies of two countries should be equal to the difference between interest rates in those countries.
\n
- According to the UIP, an interest rate cut makes the home country's fixed income securities less attractive and capital flows out of the country and as a result home currency will depreciate.
\n
- Many market participants assume that the UIP theory will hold, which turned out to be wrong this time.
\n
- It is wrongly believed that RBI cutting interest rates will always lead to depreciation of the Indian rupee.
\n
- This is not necessarily the case as depreciation also depends on the rate of

inflation, equity flows, monetary policy spills over and politics, among other factors.
\n

\n\n

What are the flaws in the theory?

\n\n

\n
- **Inflation Parameter -**The UIP is a relationship between real exchange rate and real interest rate differential (which takes inflation into account), not nominal rates.
\n
- Since inflation in India has decreased significantly over the past few months, the real interest rate has actually risen and a 25-bps rate cut is not enough to offset its impact.
\n
- In fact, India has the highest real interest rate in Asia of 4.5%. China is in second place at 3%.
\n
- Since, many tend to ignore the implication of inflation in UIP, conclusions can go wrong.
\n
- **Equity Flows -** The UIP model assumes that the exchange rate is driven purely by fixed income flows and completely ignores equity flows.
\n
- However, equity inflows have become significant, accounting for 38% of total net purchases by Foreign Institutional Investors (FIIs) in India over the last year.
\n
- In such an environment, a model which only looks at fixed income flows may not give a correct answer.
\n
- **Dollar Dominance -** The UIP ignores the fact that the international monetary system is not egalitarian but hierarchical, with the dollar as the global reserve currency.
\n
- US monetary policy decisions spill over to India in the form of capital flows, a factor not in the scope of the UIP.
\n
- Presently, US monetary policy uncertainty is one of the reasons for a weak dollar (hence appreciating rupee).
\n
- **Political factors -**The UIP assumes that in countries with flexible exchange

rates and no capital controls, political developments do not affect the exchange rate.
\n

- This is not true.
\n
- The relationship between politics and exchange rate has grown stronger in an era of quantitative easing.
\n

\n\n

\n\n

Source: BusinessLine

\n