

Exchange rate policy in an inflation targeting regime

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October 11, 2017

The literature on inflation targeting

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- ▶ Elements of inflation targeting (Mishkin 2004):
 1. public announcement of medium-term numerical target for inflation
 2. an institutional commitment to price stability as the primary goal, to which other goals are subordinated
 3. an information inclusive strategy in which many variables, not just monetary aggregates or the exchange rate, decide the use of policy instruments.
 4. increased transparency of the monetary policy strategy through communication with the public and the markets about the plans, objectives, and decisions of the monetary authority.
 5. increased accountability of the central bank for attaining its inflation objectives.

The literature on inflation targeting

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- ▶ Subsequent work highlighted that most EMDEs follow a dual instrument policy – interest rate and exchange rate. Exchange stability is also an objective.

However, over time there is move towards greater exchange rate flexibility.

- ▶ Two aspects of exchange rate stability – linked to sudden changes in capital flows, and managing volatility and the exchange rate itself.

Active management of the exchange rate and volatility a controversial idea.

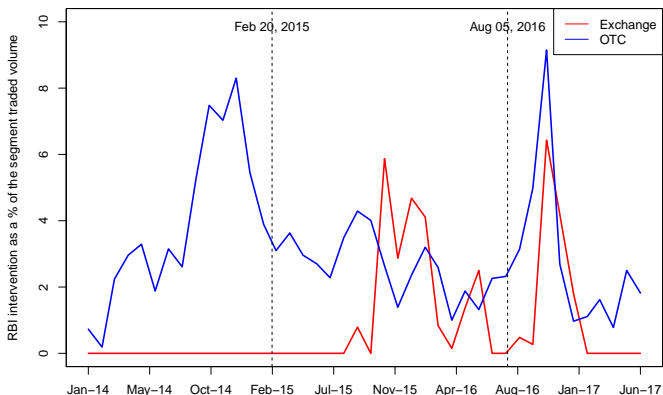
Inflation targeting in India

Two dates are relevant:

1. 20th February, 2015 – RBI signs the Monetary Policy Framework Agreement
2. 5th August, 2016 – Gazette Notification of the RBI (Amendment) Act, 2016 creating a statutory and institutional framework for an Inflation Targeting Monetary Policy

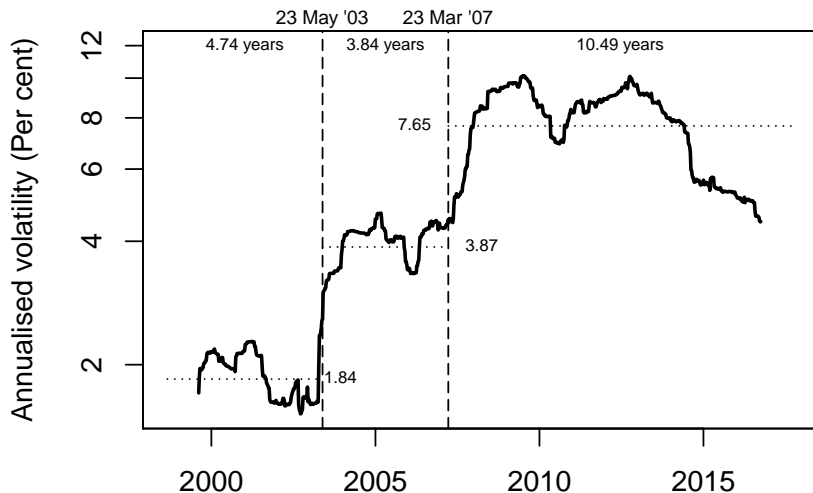
- ▶ Should India hold \$400 billion of forex reserves?
Livemint, 2nd October, 2017
- ▶ Why RBI intervened in futures market to stop rupee dip
Economic Times, 22nd Sept, 2017
- ▶ RBI faces a currency conundrum
Business Standard, 10th Sept, 2017
- ▶ Forex reserves: The problem of plenty
Livemint, 28th August, 2017
- ▶ RBI's forex operations risk India being tagged currency manipulator
Livemint, 23rd August, 2017
- ▶ New dawn for RBI rupee policy? Lack of intervention leaves traders surprised
Economic Times, 11th April, 2017
- ▶ Rupee hits 16-month high: RBI intervenes via banks to check wild swings in unit
Economic Times, 15th March, 2017

Active intervention by RBI in the currency market



Foreign currency assets have of increased at a CAGR of 11.1% between Sept-13 to Sept-17. Currently at USD 375.2 bn.

Tight control on exchange market volatility



Source: Patnaik, Shah, Did the Indian Capital Controls Work as a Tool of Macroeconomic Policy?, IMF Economic Review, 2012

As well as on the exchange rate



A growing offshore market for Rupee trading

	Q2-13	Q2-14	Q2-15	Q2-16	Q2-17
<u>Onshore</u>					
Spot	21.3	21.9	22.2	21.0	23.3
OTC derivatives	17.7	20.8	18.2	21.2	16.8
Exchange F&O	8.1	3.1	4.3	5.8	5.6
Total	47.3	45.1	44.7	47.8	45.7
<u>Offshore</u>					
OTC derivatives	3.6	8.5	8.8	7.0	9.9
Exchange F&O	1.4	1.2	1.4	1.9	2.0
Total	5.0	9.7	9.2	8.9	11.9
Grand total	52.3	54.8	53.9	56.7	57.6

Source: FRG-City of London Report on Features and trends in the NDF market for the Indian Rupee, 2016

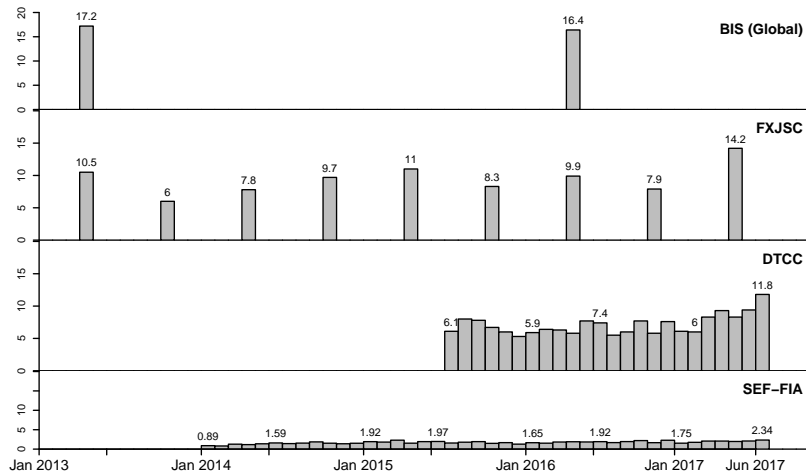
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35% of the global trading in rupee derivatives takes place in offshore markets. Most of this is in the OTC-NDF market.

Trading in the NDF market



Features of domestic market policy

1.	Capital controls	Constraints on access	High
2.	Position limits	Maximum size of transactions	Small
3.	Margin	Cost of eliminating counterparty risk	High
4.	Trading time	Time available to trade	Low
5.	Frictions	Procedure for market use	High
6.	Regulatory risk	Uncertainty about rules	High
7.	Vibrant Domestic Market	Domestic financial development	Low

Need for policy re-design?

- ▶ Complex permanent capital controls vs transitory controls
- ▶ Exchange market controls and impact on market microstructure
- ▶ Offshore trading and its impact on domestic market policy
- ▶ Transparency
- ▶ Accountability