Can the RBI's open Market Operations help the Rupee?*

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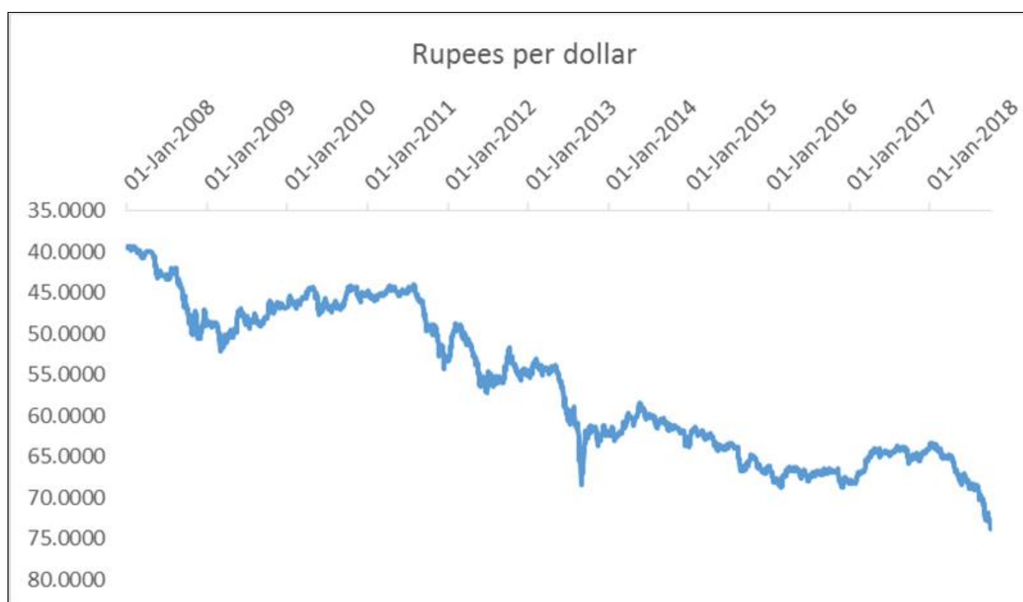
The recent depreciation of the rupee has created consternation among those who need to buy foreign exchange. It has also caused panic in the stock markets, whose decline partly reflects the exit of foreign investors, which contributes to the rupee's fall. It spells further trouble for companies that borrowed heavily in foreign currency, encouraged by lower interest rates abroad. It adds to domestic inflationary pressures that were already rising with higher global oil prices, which have been mostly passed on to domestic consumers.

While the recent slide in the rupee's value is particularly steep, it is part of a longer process of decline. As Chart 1 indicates, vis-à-vis the US dollar, the rupee is worth only around half of its value in January 2008: a remarkably rapid nominal depreciation in just over a decade. This occurred in fits and starts. The period of the Global Financial Crisis witnessed a depreciation of the rupee, like many other emerging market currencies, but in hindsight this was relatively small and the recovery of the rupee was also relatively rapid.

Chart 1: The rupee's decline over the past decade

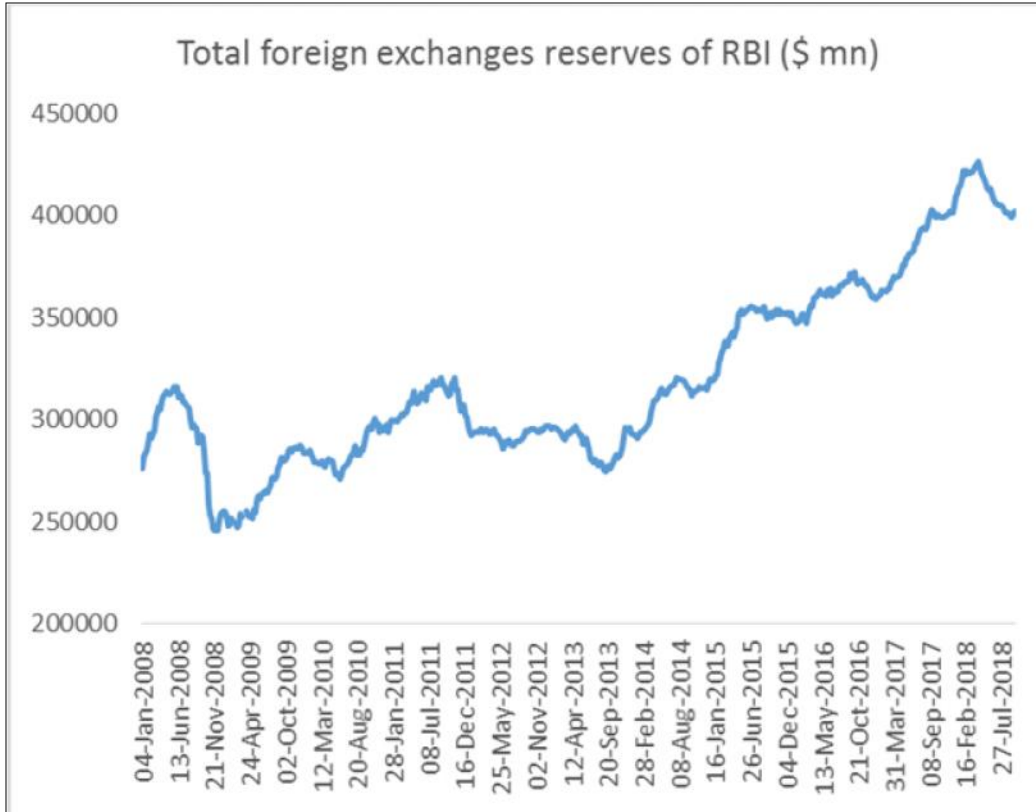


Source for all charts: Reserve Bank of India online database

Thereafter, the currency was relatively stable in nominal terms until late 2011, when it started declining relative to the US dollar once again, culminating in a particularly sharp decline in the middle of 2013. This is famously referred to as the "taper tantrum" that afflicted all emerging markets when Ben Bernanke, then Governor of the US Federal Reserve, noted that the Fed might soon start tapering off the extraordinary liquidity creation measures (Quantitative Easing) that had marked the recovery strategy after the global crisis. This should have been widely expected, but it still spooked the markets and led to significant capital flight back to the "safety" of the US economy.

Despite some slight recovery thereafter, that decline in the rupee's value became a major political talking point before the 2014 general elections, especially in Narendra Modi's campaign. Yet the performance of the currency during the tenure of the government he has led has been no better: even before the most recent sharp decline since January 2018, the rupee-dollar exchange rate had been deteriorating for the previous two years.

Chart 2: But forex reserves have increased



Yet in this period there were few external headwinds. The Indian economy was one of the major beneficiaries of low global oil prices, which provided a windfall gain to the government since it did not pass on these declines to domestic consumers but instead kept raising taxes and duties on imported oil. India was also a major recipient of portfolio capital inflows and more domestic companies also took on external commercial debt. Foreign exchange reserves also increased (Chart 2) but since the country continued to run a current account deficit, this was essentially based on short-term capital inflows.

Such a method of building up forex reserves is not sustainable or desirable, but one justification for it is that the holding of a significant level of reserves acts as a protection against capital flight and consequent rapid depreciation. It is argued that open market operations by the central bank can operate to stabilise exchange rates, not only to prevent excessive appreciation that could threaten export competitiveness, but more importantly to protect against sharp depreciation.

Chart 3: RBI's market intervention during the Global Financial Crisis

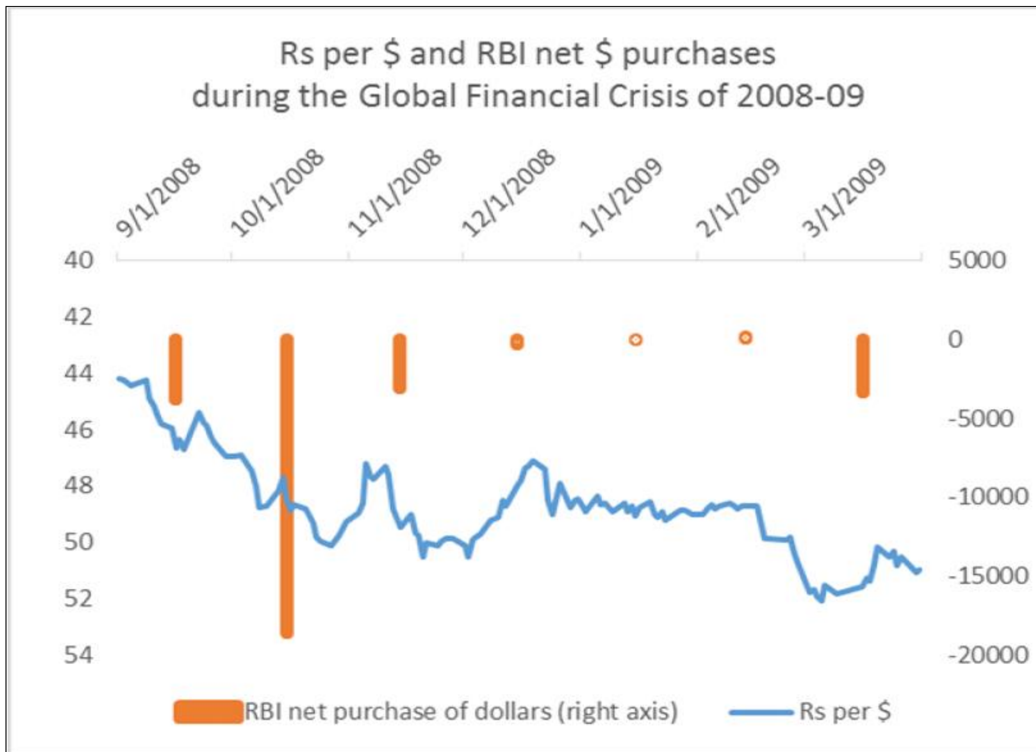
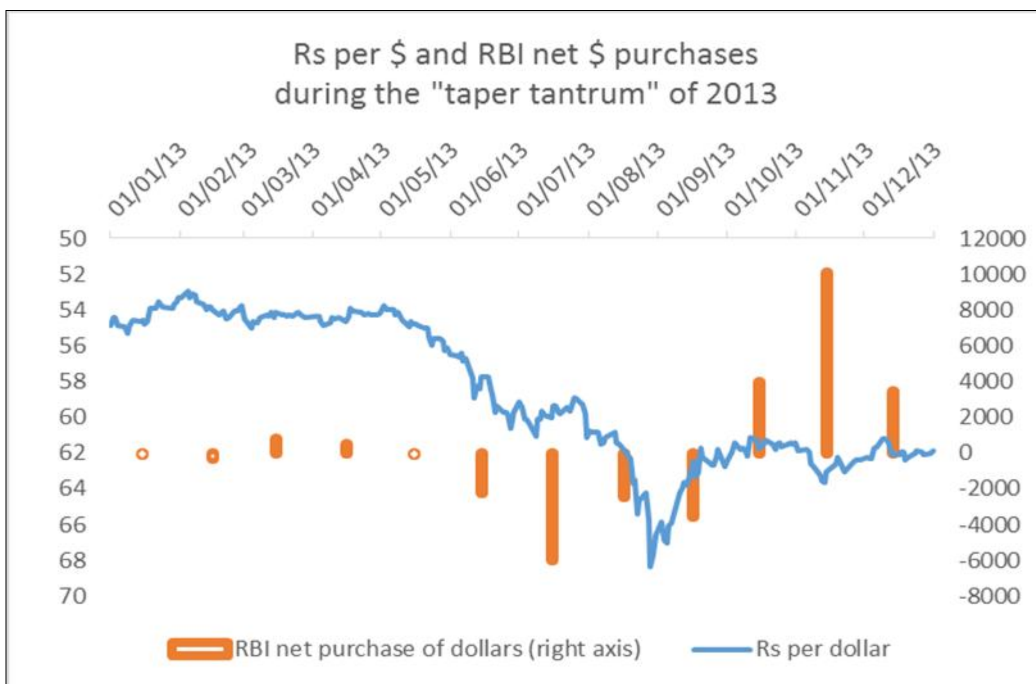


Chart 4: RBI's intervention during the "taper tantrum"



If so, then the fact that the Reserve Bank of India held around $400 billion worth of forex reserves in total over the past year should have been an insurance against currency market volatility. But – as has become all too evident in the past few weeks – that is far from the case.

In fact, previous episodes of currency volatility do not provide very clear signals on the direction and extent of impact of the RBI's open market operations. Two such episodes are described in Charts 3 and 4: the period immediately following the collapse of Lehman Brothers in the United States, which presaged the Global Financial Crisis, and the period around the "taper tantrum" in mid 2013. Neither suggests a significant role of such market-based intervention in stabilising the rupee.

Of course, such analysis is always problematic, open to dispute on counterfactual arguments such as that the situation would have been worse without such intervention. But the experience of balance of payments crises in many other developing countries suggests that, once market expectations have turned adverse, no amount of open market operations and no level of forex reserves is "enough". Indeed, the very running down of reserves in the process of such intervention by the central bank can send a signal to financial markets that further erodes trust in the currency and undermines its value.

It seems that open market operations are more successful in the "good times", when it is necessary to prevent excessive appreciation of the currency. But in a macroeconomic sense a build-up of forex reserves reflects an excess of ex ante savings over domestic investment, a high price for a developing country to pay. Truly, a cleft stick for policy markers once they have opted for liberalised capital accounts.

So a wider range of measures is required to tackle the crisis. It makes more sense for policies to address the current account deficit, for example with controls on gold imports beyond those required for jewellery exports, while capital account measures could seek to prevent outflows through transaction taxes.

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