

*No Fundamental Reason for Rupee Volatility**

Raghuram G. Rajan

Good afternoon. There has been some turmoil in financial markets across the world as fears of a sooner-than-anticipated Fed tapering have grown. In India, we have had added volatility as the market has become concerned about policy rates and about oil marketing company demand for dollars.

There are issues we have to worry about and there are issues we should not be so concerned about. It is important that the RBI clarifies its interpretation of economic events and the likely direction of policies at times of uncertainty so that the market worries about the right things and does not get into a tizzy about the wrong ones. That is my goal today.

External Account

First, when the likely taper was announced in May, markets focussed on India partly because of the large size of its Current Account Deficit (CAD). The latest trade data suggest we have made significant progress in curbing the size of the likely deficit for this year.

I am especially happy about the 13.5 per cent increase in dollar exports since last October, the reduction in imports by 14.5 per cent and dramatic reduction in the trade deficit by 48 per cent. Our estimate is that the CAD for this year will be about US\$ 56 billion, less than 3 per cent of GDP and US\$ 32 billion less than last year.

Of course, some of that compression comes from our strong measures to curb gold imports. One worry is whether gold is being smuggled in sizeable amounts, and is being paid for through the *havala* channel. While we do see a sizeable increase in seizures, we believe gold smuggling has increased from a low base, and is still small.

A new worry that the market has latched on to is whether the much diminished CAD can be funded through capital inflows, given FII outflows. This is a little bit like a dog chasing its tail, because a reason for FII outflows is a worry about whether the CAD can be funded. The only way to address such worries is to do the math.

Last year FII inflows, both debt and equity, accounted for US\$ 26 billion. Let me assume that we get no inflows this year, and in fact outflows equal the inflows we got last year. In other words, there is a US\$ 52 billion turnaround in FII flows. Remember though that we have US\$ 32 billion less of CAD to finance this year, and till yesterday, we raised US\$ 18 billion of money through new channels. So if other financing remains the same as last year, which it seems on track for, even if foreign investors pull out significantly more money this year than they have so far, we still can break even on capital flows.

Remember also that the major outflows in summer were debt outflows. That money has not come back, indeed our FII debt exposure, both corporate and sovereign, has come down from US\$ 37 billion on May 21 to US\$ 19 billion today. I presume what is left is more patient money, but given its diminished size, I do not see its possible exit as a huge risk.

Note that all these calculations include meeting all the demand from the oil marketing companies (OMCs) for dollars! But still there are worries about what will happen to the exchange rate if they are fully back on the market. So let me turn to their demand. The simplest way to think about this is that the RBI sold dollars directly to oil marketing companies starting August 28, 2013, thus ensuring they would not enter the exchange market directly.

As the exchange market stabilised, we allowed oil marketing companies to return and purchase more and more dollars from the markets, starting on October 14. Today, a month later, I am glad to report that the majority of oil marketing company demand for dollars is back on market. The market absorbed the additional

* Statement by Governor, Raghuram G. Rajan on November 13, 2013.

demand quite smoothly – in fact, participants did not even know it was back until some talk from the Finance Ministry last week.

There has been some turmoil in currency markets in the last few days but I have no doubt that once markets calm down, the remaining demand will be absorbed easily. We have no intention of rushing this process.

The OMCs have entered a swap arrangement whereby they will have to repay dollars to the RBI on various dates from February 2014 till April 2014. One worry expressed by market participants is whether the OMCs will add to further downward pressure on the rupee when it comes time for them to repay dollars to the RBI.

This to my mind is a non-issue because we have three ways of managing the repayment. One is, of course, for the OMCs to buy dollars in the market. If exchange markets are calmer, this additional demand should be absorbed. But if they are not calmer, we could roll over some portion of the swaps so they mature at a calmer time. But perhaps the easiest option would be for us to settle the swap with the OMCs by making net payments in rupees, and avoid the need for them to go back to the market for dollars. When the time comes, we will choose the most appropriate combination.

Domestic market

Let me turn from the external account to the domestic market. Yesterday's data suggested still weak growth as the IIP numbers came below expectations. The earlier core industry growth numbers suggested an incipient recovery, and the IIP numbers have disappointed a little, partly because of the volatile capital goods sector. Nevertheless, I am still hopeful that the good monsoon and the associated pick up in consumption, the very healthy exports, and the strong growth in the power sector should lead to stronger growth numbers for the second half of the fiscal year.

Turning to inflation, the new CPI index came in at 10.1 per cent. Food inflation is still worryingly high, and the effects of the harvest are still awaited. But looking through the headline numbers, I am somewhat more heartened by the outcome of core CPI inflation, which declined to 8.1 percent from 8.5 percent in September. The momentum for core inflation is also on the decline.

Markets are worried about what these data mean for policy rates. As I have said before, the RBI is concerned about the weak economy as well as high inflation. We believe the weak economy, increases in food supply, and recent policy rate hikes will provide a disinflationary impetus over time, and recent data do not dispel this view.

We will watch the incoming data carefully, especially looking for the effects of the harvest on food prices as well as the second round effects of fuel price increases and exchange rate depreciation, before we make further decisions on interest rates.

RBI to undertake OMOs for ₹8,000 crore on November 18

Finally, the RBI is conscious of the need to keep the system adequately supplied with liquidity, as we indicated in a statement recently, so that productive sectors are well supplied with credit. While borrowing from the MSF facility has come down substantially after the RBI extended the term repo window, market interest rates suggest some liquidity tightness. To alleviate this tightness, we propose to conduct OMOs. On next Monday (November 18), we will undertake an OMO for ₹8,000 crore.

Let me conclude. There is no fundamental reason for volatility in the value of the rupee. We are left with fear about what others will fear and do to explain what is going on. At such times, it makes sense to take a deep breath and examine the fundamentals. I hope you all will do that.