The Rupee Dilemma

Is the United States Responsible for India’s Economic Problems?

Neil K. Shenai

NEIL K. SHENAI is a professorial lecturer at American University’s School of International Service in Washington, D.C., and a Ph.D. candidate at Johns Hopkins University’s School of Advanced International Studies.

In September 2013, the economist Raghuram Rajan became the head of the Reserve Bank of India. Since then, India has had to cope with slow growth, a widening current account deficit, and a depreciating rupee -- a combination of challenges with no easy monetary fix. Making matters worse, these problems did not originate in India: they stem from the unintended consequences of U.S. monetary policy. Rajan now faces a policy dilemma with no easy answer.

After the housing bubble burst in 2008, the U.S. Federal Reserve slashed short-term interest rates [1] to zero percent in order to stimulate bank lending and spur economic activity. The Fed also began a bond buying program known as quantitative easing, purchasing billions of dollars’ worth of long-term U.S. government bonds and mortgage-backed securities [2]. From 2008 to 2014, the U.S. monetary base [3], which includes currency in circulation together with bank reserves, increased from $847 billion to roughly $4 trillion.

By boosting demand for U.S. bonds, quantitative easing lowered long-term interest rates in the United States. From October 2008 to the summer of 2012, the annual returns on ten-year U.S. Treasury bonds fell from four percent to 1.67 percent. Over the same period, 30-year U.S. Treasury bond yields fell from 4.35 percent to 2.56 percent. Adjusting for inflation, investors found themselves in the position of essentially paying the U.S. government to borrow their money. Low interest rates in the United States soon correlated with rising demand for assets in emerging markets. According to the Institute for International Finance [4], foreign holdings of government debt in Asian economies doubled from 2009 to 2013.
In a 2006 speech, Rajan, then the economic counselor and director of research at the International Monetary Fund, argued that lax monetary policy in rich countries could lead to dangerous macroeconomic distortions in developing countries. He claimed that investors purchase risky assets when advanced economies have falling interest rates, only to sell those assets when interest rates rise again. He termed this phenomenon “risk-shifting.”

To see why investors risk-shift, consider the case of a pension fund that promised a four percent annual return to its pensioners. The fund has to hold assets that match its promised obligations. When long-term interest rates fall from four percent to 2.5 percent, as they did under quantitative easing, the pension fund’s manager has to search elsewhere for higher yields, perhaps in a market like India, where assets still yield 4 percent. As more fund managers risk-shift, capital flows into risky markets, increasing asset prices, inflation, and trade deficits.

Now that the Federal Reserve is reducing, or “tapering,” its asset purchases by $10 billion per month, investors expect higher interest rates in the United States, causing risk-shifting to reverse: as interest rates normalize in the United States, fund managers will begin selling risky assets in emerging markets to buy safer assets at home. Investors will demand greater collateral, or higher interest rates, for their continued lending to emerging markets. As a result, firms and households in India may soon find it difficult to meet their maturing financial obligations. Vast sums of Indian wealth could be destroyed.

Before becoming head of the Reserve Bank of India, Rajan established himself as a skeptic of the Federal Reserve’s monetary policy. In a June 2013 speech to the Bank of International Settlements, Rajan argued that “monetary policy in large countries serves as a common accelerator pedal” for the global economy, and suggested that central bankers in the West should consider macroeconomic conditions in emerging markets when formulating monetary policy. Three months later, Rajan assumed the helm of the Reserve Bank of India, and became responsible for coping with the very problems that he foresaw.

Rajan now faces a difficult conundrum. He could try to entice foreign capital to stay in India by raising short-term interest rates, at the risk of curtailing economic activity by reducing consumption and investment, potentially causing a recession. Alternatively, Rajan could keep interest rates low to boost growth, though this policy risks inducing inflation, exacerbating capital flight (since investors will find better returns in countries where the interest rates are higher), and eroding investor confidence in India’s creditworthiness. Neither choice is appealing, and both present clear risks with unclear rewards. So far, Rajan has opted for a middle ground, raising interest rates on three separate occasions, before keeping interest rates steady at the central bank’s April 1 meeting.

Rajan surely recognizes the hazards of guiding a developing economy through these difficult circumstances, especially in an uncertain domestic political environment consumed by ongoing general elections. If India makes it through this period unscathed, it will be because of Rajan’s careful stewardship and despite U.S. monetary policy. But if India’s economy falters in the months ahead, Rajan will surely be blamed. Few will note that he faced a nearly impossible choice brought on by lax U.S. monetary policy -- or will acknowledge that, years ago, he urged developed economies to avoid imperiling emerging markets.