Case Study

IIMK/CS/128/ECO/2021/01

March 2021

India's New Impossible Trinity

Ashok Thomas[1]

[1]Assistant Professor, Economics Area, Indian Institute of Management, Kozhikode, IIMK Campus PO, Kunnamangalam, Kozhikode, Kerala 673 570, India;
Email - ashok.thomas@iimk.ac.in, Phone Number - 0495-2809128

INTRODUCTION

Aftermath the Covid-19 pandemic like most of the economies, Indian economy also witnessed sudden contraction, in GDP, supply constrained effected inflation and huge outflow of financial portfolios investments creating depreciation in currency amounting to a record fall of 76.4 INR per USD. The rupee is likely to fall nearly 6% in next two months as forex market faces economic uncertainties due to the rising number of cases of coronavirus pandemic across the world. Recent selling by foreign institutional investors (FIIs) has also contributed to the downfall of Indian currency. The currency which hit an all-time low of 76.91 today is likely to depreciate 5.7% further to 80.6 by end-June and by 7.2% to 82.4 by end-September, according to a report by Bloomberg Economics. A key factor for Indian currency falling to all-time low is FIIs having withdrawn over Rs 12,000 crore from the Indian capital markets in April. The report further said Reserve Bank of India (RBI) is not seen intervening in the forex market to stem the fall in rupee. However, this trend didn't last long. Among financial flows, foreign portfolio investments (FPIs) remained in deficit in the first two months of 2020-21. Net foreign direct investment (FDI) inflows, at USD 4.4 billion, were also 39 per cent lower than a year ago. While the official data is available from the RBI only till May, data of FPI investments released by Central Depository Services shows that FPI interest in Indian market returned in June and they pumped in USD 3.7 billion during June-July 2020. Also, India has bagged big-ticket FDI deals in the last few months, with Reliance's Jio alone attracting investment commitments of nearly USD 18 billion. in the last two months, foreigners have bought around $11 billion of Indian equities and in periods of excess foreign capital inflows the currency appreciates from 76.4 INR /USD reaching 73.45 in Oct 2013 (exhibit 1)

On the other hand, the real growth in the economy have plummeted by -23.4% in Q1 2020 (exhibit 1) and lesser fall of -7.9% was recorded in the Q2 2020. All the major components of GDP have registered negative growth with an exception to net exports largely due to the fall in imports than the fall in exports. (exhibit 4 and exhibit 5) Surprisingly, even with the fall in the demand in the Indian economy, the inflation figures were higher than 6% (exhibit 6 and exhibit 7) largely due to the supply disruptions during the Q1 and Q2. The less expected impossible trinity is on the door step.

Deepak Chopra, a research analyst at the country's central bank, the Reserve Bank of India (RBI), was asked to prepare a white paper that analyzed the challenges facing the Indian economy and made appropriate recommendations regarding the central bank's monetary policy. He would also have to give a 10-minute presentation on his findings and recommendations to the bank's governor and senior economists.

The Monetary policy committee headed by Dr Shatikanth Das has exemplary credentials. The policy makers from the Indian economy have high expectations that MPC committee will steer this country out of the difficult situation of falling growth, inflation and appreciating currency. Though India faced various episodes of Impossible trinity, the current situation is quite complex. The basic questions are: Has India reached maturity to overcome the crisis? What kind of monetary policy it should follow? What should be given more significance exchange rate management or capital controls? How do we deal the new impossible trinity?

BACKGROUND

India was a relatively closed economy until 1990/91, when the nation was faced with a severe BoP crisis. This crisis prompted the country to embark on a reform program to liberalize the economy both internally and externally. India had a high fiscal deficit (8.4 per cent)[9] and high inflation (customer price index (CPI) inflation was 13.6 per cent),[10] while the exchange rate was pegged to a basket of currencies. Rising inflation combined with a rigid exchange rate resulted in an appreciation of the real exchange rate, and therefore a loss of export competitiveness. In 1990, the Gulf War further exacerbated the problem as petroleum prices shot up, leading to a sharp rise in the import bill and current account deficit.[11] Further, India plunged into political uncertainty as the ruling Congress party lost its majority in 1989,[12] followed by two changes of prime ministers in quick succession. During the campaign for fresh elections in 1991, Rajiv Gandhi, the Congress party's prime ministerial candidate, was assassinated.

All of these factors resulted in a loss of confidence in the Indian economy and dried-up external commercial sources of borrowing. Even non-resident Indians withdrew their bank deposits. India turned to IMF borrowing (US$1.8 billion)[14] to tide over its BoP deficit in 1990/91.By this point, the country's reserves had dropped to a precarious US$1.1 billion and default on its external debt was imminent. In October 1991, India negotiated a US$2.3 billion standby loan arrangement with the IMF, followed by a structural adjustment loan of US$500 million with the World Bank. The IMF loan came with standard conditions of contractionary policies and structural reforms.

After the Balance of Payments crisis in 1991, a comprehensive series of liberalization, privatization and deregulation reforms were implemented in the banking sector, trade sector as well as financial markets in India, the net result being, over the next couple of decades the Indian economy witnessed several structural changes India's program of economic reform began with the devaluation of the rupee in July 1991, to correct the BoP current account deficit. India pledged to cut the fiscal deficit from 8.4 per cent (FY1990/91) to 6.5 per cent in FY1991/92, and introduce a restrictive monetary policy.[15] These policies had the aim of: (a) reducing domestic demand to bring down inflation, and (b) shifting demand from imports to domestic goods to cut the BoP current account deficit.

A number of challenges have emanated from India's greater integration with the global financial markets during the last two decades, one of which includes managing the policy tradeoffs presented by the Trilemma. The importance of the Trilemma in present day macroeconomic context in India cannot be overstated. The issue of the Trilemma is highly pertinent for India—a major emerging economy in a world where emerging or transitioning countries are increasingly playing a crucial role in restoring global economic growth in the post-crisis era. This is perhaps because for the longest of time India has followed a pegged exchange rate regime, and a relatively closed capital account compared to other emerging economies. However, with the passage of time and increasing integration with the global economy, a shift away from pegged exchange rate regime and steady albeit cautious liberalization of the capital account has made the macroeconomic management of the Trilemma policy objectives increasingly complex.

Halfway into the current decade, India is experiencing several interesting phenomena in its macroeconomic environment. Its GDP growth rate is increasing once again after few years of slowdown in the aftermath of the Global Financial Crisis; its equity and debt markets continue to attract foreign capital inflows buoyed by the economy's revitalized growth prospects and improving macroeconomic scenario; it is on the verge of embarking on a 'glide-path' of inflation targeting following the release of the Urjit Patel Committee Report by the RBI in 2014, and finally, it continues to face growing currency volatility owing to a rapidly changing post-crisis global environment. In view of these, the question of where India stands with regard to the Trilemma becomes all the more pertinent now.

TRILEMMA IN INDIA A BRIEF ACCOUNT:

We provide a brief account of the Indian economy with respect to the two main tenets of the Trilemma-capital account openness and exchange rate stability.

Capital Account Management India's capital account liberalization that began in early 1990s has since then been a steady albeit slow and gradual process As regards opening up the financial markets to foreign investment, Indian authorities have always proceeded with a lot of caution and apparent skepticism about the benefits of foreign capital balanced against the potential instability that such capital inflows might trigger. While on one hand foreign capital offers diversification opportunities to investors and provides avenues to bridge the gap between domestic saving and investment, on the other hand unbridled flows can fuel inflationary pressures, fan asset price bubbles, and sudden reversals in capital inflows can lead to instabilities and even crises in financial and currency markets. The decade of the 1990s was replete with several such incidents of financial crises all over the emerging world as seen in Mexico (1994), East Asia (1997), Russia (1998), Brazil (1999) and eventually Argentina (2000). All these episodes of crises were triggered by rampant volatile debt inflows into the domestic economies. It is not surprising therefore that when its turn came after the crisis of 1991 India adopted a calibrated and hierarchical approach towards capital account liberalization, prioritizing

some flows over others. With the memories of the emerging economy crises fresh in mind, India gradually opened up non-debt flows (FDI, and portfolio) more than debt flows. From early 2000s onwards India has been receiving significant amount of foreign investment. India experienced as many as three separate capital inflow surge episodes between 2000 and 2008 including periods of capital surges and stops. This was the period when interest 5 rates in the advanced world were relatively lower, emerging economies had started registering impressively high growth rates and their domestic macroeconomic fundamentals looked robust post recovery from the slew of financial crises of the 1990s, emerging economy central banks were also flush with foreign currency reserves and hence looked capable of defending any speculative attack on their respective currencies, and foreign investors in search of yields began investing massively in the equity and debt markets of the emerging world.

India with an average growth rate of 9% and interest rates much higher than that of the advanced world was needless to say an attractive destination for these investors seeking higher yields. Net capital flows increased from $17.3 billion in 2003-04 to over $107.9 billion in 2007-08. The pre-GFC surge episodes were primarily driven by bank and non-bank flows such as commercial borrowings by the Indian corporate sector, short-term trade credits and deposits by non-resident Indians as well as by portfolio equity flows. These inflows were encouraged by the widening interest rate differential between India and the advanced economies, greater liberalization of borrowing norms, improved domestic economy fundamentals and availability of abundant global liquidity. Even today, more than two decades after India started opening up its capital account, there exists an extensive array of restrictive controls imposed by authorities on different categories of foreign investment in order to actively manage the capital account.

Exchange rate management India officially moved to a market based exchange rate system in 1993Q3. Empirical analysis of the data shows that the nominal exchange rate has gone through several structural breaks While the Rupee was closely pegged to the dollar till 1997, during the Asian financial crisis of 1997-98, there was a short period of flexibility when the Rupee depreciated significantly. Thereafter from 1998 to 2004 the Rupee was once again tightly pegged to the Dollar. 2004 onwards the peg to the Dollar was replaced by a basket peg to several Here Dollar is used to imply the US dollar. 6 other international reserve currencies such as Euro, Yen etc, implying that the exchange rate exhibited greater flexibility than before. The basket peg sort of ended around 2007 and gave way to a more flexible exchange rate regime that continued till 2013 July. In the summer of 2013 when the US Federal Reserve chairman Ben Bernanke announced a possible tapering of its Quantitative Easing (QE) program, large amounts of foreign capital fled India to safety driven by risk aversion thereby resulting in a sharp depreciation of the Rupee. The RBI intervened in the foreign exchange market in order to stabilize the Rupee and reduce the currency volatility. Excessive foreign exchange intervention unless sterilized can fuel inflationary pressures by increasing the reserve money base. So in order to insulate the domestic economy from rising inflation central banks intervening in foreign exchange market

to prevent a currency appreciation, conduct contractionary open market operations by selling bonds so as to absorb the excess liquidity from the system. The Rupee appreciated significantly in response to the surge in capital inflows from 2000 onwards thereby adversely affecting the competitiveness of Indian exports. During this time the RBI intervened actively in the foreign exchange market to prevent the Rupee from appreciating, given that India has had a long history of current account deficit and a nominal appreciation would have further aggregated the deficit. Till 2004 RBI sterilized this intervention by selling government bonds, raising the reserve requirements of the commercial banks by the concomitant amount and thereby reducing liquidity in the system. RBI continued the sterilization till 2003 when it ran out of government bonds to sell. The Market Stabilization Scheme (MSS)- a new instrument for sterilization, was started around this time and RBI began issuing MSS bonds to sterilize its intervention but the rising fiscal costs of interest payment on bonds meant that sterilization could only be partial. This timing also happened to coincide with increased flexibility in the Indian rupee vis-à-vis the US dollar. We also find that RBI's intervention in the foreign exchange market has been sort of asymmetric, intervening when the exchange rate has been appreciating and adopting a hands off approach during times of depreciation, either for fear of losing reserves or to let a depreciating currency ameliorate a growing current account deficit. The above discussion throws some light on where India stands with regard to capital account as well as exchange rate management. It seems India's capital account is only partially open and the exchange rate is in a managed floating regime. India has also been accumulating massive amounts of foreign currency reserves since the early 2000s. Foreign exchange reserves 7 climbed from around $150 billion in mid-2005 to over $300 billion in mid-2010, a doubling in just five years and making India one of the largest reserve-holding countries in the world

The rise in the volatility of global capital flows has made macroeconomic management increasingly complex especially for emerging economies that are striving to achieve a balance between the diverse objectives of robust growth rate, sustainable current account deficit, competitive exchange rate, access to adequate external capital for financing investment, moderate inflation, and sufficient international reserves. This has also reignited the debate on suitable macroeconomic management measures. One of the main challenges that emerging economies face today as they integrate with global capital markets is managing the trade-offs presented by the well known Impossible Trinity or open economy Trilemma and in this, India is no exception. India seems to have actively managed its exchange rate, building up a high level of international reserves by intervening heavily in the foreign exchange market and has also managed to retain some control over domestic monetary policy. In fact, active intervention in foreign exchange market coupled with maintaining a reasonable degree of control over international capital flows seem to have emerged as a potent combination of policy instruments in India as it strives to manage the macroeconomic Trilemma. These issues are likely to be highly relevant in the current context in India as policy makers actively engage in inflation targeting to control domestic inflationary pressures, the Rupee exhibits renewed volatility in the face of foreign investment inflows and India strives to revive its erstwhile high growth rate.

THE POST CORONA: THE NEW IMPOSSIBLE TRINITY

GDP growth:

Indian Economy which was climbing post the post-2014 was jolted with two landmark decisions: Demonetization and implementation of GST which cut the throttle of the economy post 2016. The Indian economy slowed down in 2016-17, with the gross domestic product declining drastically from 8 per cent in 2015-16 to 7.1 per cent the next year, following by absymial growth of 5% in 2019-20. Prior of the pandemic, the country lost the rhythm and fell to a low consumption, low investment cycle leading to growth fall below 5% since 2013-14. The onset of pandemic and the lockdown further complicated the issue. As per the official statistics . India's real GDP declined y-o-y by 23.9 per cent in the quarter ended June 2020, reversing the economy back to its 2014 quarterly level of less than Rs.27 trillion. Investment demand took the biggest beating from Covid-19 and the nation-wide lockdown announced to arrest its spread. Gross fixed capital formation (GFCF) slumped by 47.5 per cent year-on-year in the June 2020 quarter. Construction activity remained virtually absent in April due to government restrictions. And even today, after removal of most restrictions, it remains far from its pre-Covid-19 level due to labour shortages, slump in demand for both, residential and commercial real estate, and re-assessment of capex plans by corporates in light of weakened aggregate demand.

Key inputs in construction cement production and finished steel consumption reported a 38.3 per cent and 52.8 per cent fall, respectively, in the June 2020 quarter. Their double-digit contraction got extended into July. Findings of CMIE's CapEx service reveal that industrial & infrastructural project completions shrank to Rs.192 billion in the June 2020 quarter from an average of Rs.1.5 trillion per quarter in the last two years, which itself was a period of slowdown. Corporates and government announced new projects worth only Rs.706 billion in the June 2020 quarter, as compared to an average quarterly announcement of Rs.3.5 trillion in 2018-19 and 2019-20. The extreme sluggishness in capex activity continued in July and August, with project completions remaining subdued at Rs.262 billion and fresh announcements sedate at Rs.516 billion. This, along with statements from large corporates such Tata group of companies, Baja Auto, Maruti Suzuki, Apollo Tyres, Hero MotoCorp, Honda Motorcycle and Scooter India, Mahindra CIE, Adani Ports, Grasim Industries, Godrej Consumer Products and Britannia about deferral of their capex plans suggest that the economy has a long way to go before it gains its investment appetite back. Job losses and salary cuts, along with rising prices of essentials took a toll on the purchasing power of Indian househods. Over 85 million people lost their jobs between March 2020 and June 2020, according to CMIE's Consumer Pyramids Household Survey. Reduced requirement for goods and services during the lockdown, along with weakening of consumer sentiments due to uncertainty

and financial risks arising out of the pandemic made households go slow on consumption. They preferred to save more than spend. This is evident from the fact that outstanding term deposits with scheduled commercial banks increased by Rs.3.5 trillion during the June 2020 quarter, whereas their personal loans portfolio shrank by Rs.633 billion.

The Indian economy reported a steep contraction in external trade in the June 2020 quarter. Exports fell by 19.8 per cent and imports declined by 40.4 per cent. The steeper fall in imports than exports suggests that the domestic demand in Indian took a harder beating than overseas. This probably explains why India has witnessed the steepest GDP contraction among G-20 countries in the June 2020 quarter. Government, both central and states, stepped up their aggregate spending by 16.4 per cent during April-June 2020. But, this fiscal push was too small to make up for the fall in private consumption and investment demand.

The unlock process that began in June 2020 helped the Indian economy regain three of its lost years. India's real gross domestic product (GDP) measured Rs.33.1 trillion during July-September 2020 quarter. This was equivalent to the GDP recorded in the December 2017 quarter. GDP in the September 2020 quarter was 7.5 per cent lower than a year-ago. This marks the second consecutive quarter of year-on-year contraction in GDP, after the 23.9 per cent slump suffered in the June 2020 quarter, which means that India has technically slipped into a recession. This recession was inevitable given the intensity of the jolt the economy received in terms of the lockdown. Also, many restrictions on functioning of the economy were lifted only gradually during the unlock process, while some remained in place even by the end of September 2020. The improvement in GDP in the September 2020 quarter over the June 2020 quarter was almost equally contributed by private consumption and investment demand. Private consumption expenditure increased by Rs.3.3 trillion to Rs.18 trillion from a near six-year low of Rs.14.6 trillion it had dropped to in the June 2020 quarter. Investment demand, depicted by gross fixed capital formation (GFCF), increased by Rs.3.6 trillion to Rs.9.6 trillion in the September 2020 quarter, after slumping to a 43-quarter low of Rs.6 trillion during April-June 2020. Despite this, the September 2020 quarter GFCF was only at par with the GFCF recorded in the June 2017 quarter i.e. three-and-a-half years back. The cash-strapped Central Government axed its capital expenditure y-o-y by 37.7 per cent in nominal terms in the September 2020 quarter. State governments also cut their development spending. Most corporates decided to put their future expansion plans on the backburner after the announcement of the lockdown. Consequently, fresh industrial & infrastructural project announcements captured by CMIE's CapEx database dropped to a 16-year low of Rs.759 billion in the September 2020 quarter. Net fixed assets of 3,035 listed non-finance companies increased y-o-y by six per cent as of end-September 2020. This suggests that post

lockdown, corporates probably resumed work only on the projects that were in the last leg of completion. The government did not make any direct contribution to the September 2020 quarter GDP improvement. Government final consumption expenditure (GFCE), in fact, dropped to Rs.3.6 trillion, its lowest in the last six quarters.

India's exports were quick to recover from the pandemic in comparison to the domestic demand. During July-September 2020, they not only rose by Rs.1.2 trillion to Rs.6.9 trillion in real terms over the June 2020 quarter, but also nearly recovered to their pre-Covid level of Rs.7.03 trillion. Exports improved as the unlock process began in most countries around the world by June 2020. While the Indian economy has bounced back strongly in the September 2020 quarter from its June 2020 quarter slump, the road ahead is challenging. Both, consumption and investment demand still remain significantly lower than their year-ago levels. And, future recovery remains vulnerable to resurgence in Covid-19 cases and sustainability of the pick-up in consumption demand which contains an element of pent-up release and festive celebrations.

Inflation

One of the interesting fact was that despite the fall in Aggregate demand, the inflation in the economy rose to uncomfortable heights. Retail price inflation, measured by the Consumer Price Index (CPI) rose to 6.9 per cent in July 2020 from 6.3 per cent in May 2020 and 6.2 per cent in June 2020. The increase was across-the-board with an exception of housing which saw inflation fall to 3.3 per cent from 3.6 per cent due to a higher base, notwithstanding the sequential rise in prices. Inflation in the food & beverages group rose to 8.7 per cent in July 2020 from 7.9 per cent in June 2020. Food inflation rose in both, urban and rural India, with the rise being more prominent in the latter. The rise in food inflation was led by vegetable prices. The CPI of vegetables shot up to 178.4 in July 2020 from 156.5 in June 2020. Inflation in fuel & light too rose to 2.8 per cent in July 2020 from 0.5 per cent in June 2020. Supply disruptions caused by local lockdowns were exercising upward pressure on food prices.

This trend continued for the Q2 2020-21, with Consumer price inflation rose to 7.3 per cent in September 2020, its highest level in the last eight months. Headline inflation has remained elevated since December 2019, hovering in the range of 5.8 per cent to 7.6 per cent. The trend in headline inflation was dominated by prices of food & beverages, which account for a huge 46 per cent of the consumption basket of an average Indian. Inflation in food & beverages stood high at 10.5 per cent in April. It softened to 8.1 per cent during May-June, before inching up again to 8.4 per cent during

July-August and shooting up further to 9.7 per cent in September. Food inflation, in turn, mirrored the trend in vegetable prices, which started rising rapidly from July 2020 on account of short-supplies. From four per cent in June, inflation in vegetable prices shot up to 11.1 per cent in July, inched up further to 11.5 per cent in August, before zooming up to 20.7 per cent in September. The RBI, in its bi-monthly monetary policy review, announced on August 6, also said that inflation would remain high in the first half of 2020-21. Inflation expectations of households too remain high. 5,411 urban households polled by the RBI, which perceive the current inflation level to be 9.9 per cent, expect it to increase further to 10.5 per cent in the next three months. On one hand the faltering growth and on the other side the increasing inflation has put RBI into a fix. The RBI has pledged that it will remain accommodative into the next financial year. This means they will not increase the interest rates and will continue to keep the system liquidity in surplus.

Capital flows and exchange rate

The pandemic in Q1 forced huge outflow from emerging markets like India. As a result, The rupee is likely to fell nearly 6% in first two months as forex market faces economic uncertainties due to the rising number of cases of coronavirus pandemic across the world. Dollar inflows on financial account remained weak during the June 2020 quarter. Foreign direct investments (FDI) reported net outflows to the tune of USD 392 million. This was the first quarter since March 2006 when the country witnessed outflows of FDI on a net basis. Foreign portfolio investments (FPI) did return after witnessing record outflows of USD 13.7 billion in the March 2020 quarter. But, at USD 641.7 million, these were a tenth of the average quarterly inflows of USD 6.1 billion seen during the four quarters preceding January-March 2020. NRI deposit inflows at USD 3 billion, reported an improvement over the preceding four quarters, while external commercial borrowings (ECBs) saw net outflows of USD 1 billion. The selling by foreign institutional investors (FIIs) has also contributed to the downfall of Indian currency. A key factor for Indian currency falling to all-time low is FIIs having withdrawn over Rs 12,000 crore from the Indian capital markets in April. Among financial flows, foreign portfolio investments (FPIs) remained in deficit in the first two months of 2020-21. Net foreign direct investment (FDI) inflows, at USD 4.4 billion, were also 39 per cent lower than a year ago These trends suggested that Reserve Bank of India (RBI) is not seen intervening in the forex market to stem the fall in rupee. The currency which hit an all-time low of 76.91 In March and was showing signs of further depreciation by 5.7% further to 80.6 by end-June and by 7.2% to 82.4 by end-September, according to a report by Bloomberg Economics.

The unlocking process across the world stimulated economies around the world to unlock fiscal packages resulting in huge surplus liquidity. In this background, Indian economy was swamped with foreign capital flows from Q2, 2020 Initially, it was Reliance Industries' breath-taking fundraise. Now, in the last two months, foreigners have bought around $11 billion of Indian equities. This trend backed by the higher liquidity spillovers saw an overwhelming flow of equites to Indian soil. India's foreign exchange reserves kitty increased by USD 18.7 billion in October 2020 and by another USD 15.1 billion in November 2020. By December 4, 2020, it swelled by another USD 4.5 billion to touch a new high of USD 579.3 billion. It is impressive to find out that forex reserves surged despite the country's merchandise trade balance, which had turned positive in June 2020, gradually deteriorating into a deficit of USD 8.7 billion in October 2020 and USD 10 billion in November 2020. What boosted forex reserve accumulation is the capital inflows, particularly of foreign portfolio investors (FPIs). FPI investments in Indian capital market amounted to USD 3 billion in October 2020. They surged to a record high of USD 8.5 billion in November 2020 and advanced further by USD 1.7 billion in the first four days of December 2020. A bulk of the foreign portfolio investments in November were attracted by the financial services sector. FPIs invested Rs.3.8 billion in financial services equity and debt instruments in November. FPIs have been gushing over Indian equity markets to park excess liquidity floating around in the developed economies owing to stimulus packages pushed out by various governments to battle economic woes arising out of the Covid-19 pandemic.

THE NEW CRISIS IN THE MAKING

The new impossible trinity comes to the fore in periods of excess foreign capital inflowsThis issue comes to the fore in periods of excess foreign capital inflows. As capital inflows increase, the currency appreciates – capital mobility. If the central bank deems these inflows as excessive, it buys up the supply of dollars from banks and resists the appreciation – exchange rate management. The buying of dollars increases its foreign exchange reserves. The resultant printing and sale of Rupees increase the liquidity in the banking system and drives down interest rates – monetary policy. Banks then use this new liquidity to buy bonds and give loans. If it deems the capital inflows to be short-term hot money, it will priorities exchange rate management and capital controls over inflation and domestic liquidity, as happened in 2007. If it wants to control inflation, it has to stop printing excess money and suck out the excess liquidity. This means it cannot buy the excess dollar inflows and has to allow the currency to appreciate. The RBI under Governor Das has resisted rupee appreciation. It has been buying up dollars and bulking up the foreign

exchange reserves. The resultant money printing along with other measures during the pandemic has taken banking system liquidity to an unprecedented surplus. The banking system's 'core' liquidity now stands at around Rs 9 lakh crore. Short-term money market rates (treasury bills, CP,CDs) are below the Reverse Repo Rate of 3.35%. The policy Repo Rate is at 4%. CPI inflation is at 7.6% and is forecasted to average above 5% until September 2021. RBI targets CPI at 4% with a threshold band of 2-6%. The RBI has pledged that it will remain accommodative into the next financial year. This means they will not increase the interest rate.

Learning To Live With The Impossible Trinity

1.The RBI cannot use capital controls to control the flows.

2.It does not want the rupee to appreciate much as it impacts the Atma Nirbharta policy.

3. It does not want to suck out the liquidity from the markets as it wants to keep rates low to revive growth.

Amidst all these challenges facing the economy, we look forward to Chopra's white paper would be one of the key inputs that the governor would use in making a decision. Chopra had been working at RBI's Department of Economic and Policy Research for the past six years, but this was one of his toughest assignments to date. Not only did he have to explain the headwinds facing the Indian economy, but he had to recommend policy priorities and a course of action for RBI as well. Should RBI letting go of independence of monetary policy? Decrease inflation? Support faltering growth? Make conscious capital controls As Chopra sat down to work on his report, he knew he faced a daunting task.

Exhibit 1: Gross Value Added at Constant Basic Prices: By Economic Activity: Base Year 2011-12 (Quarter wise data)

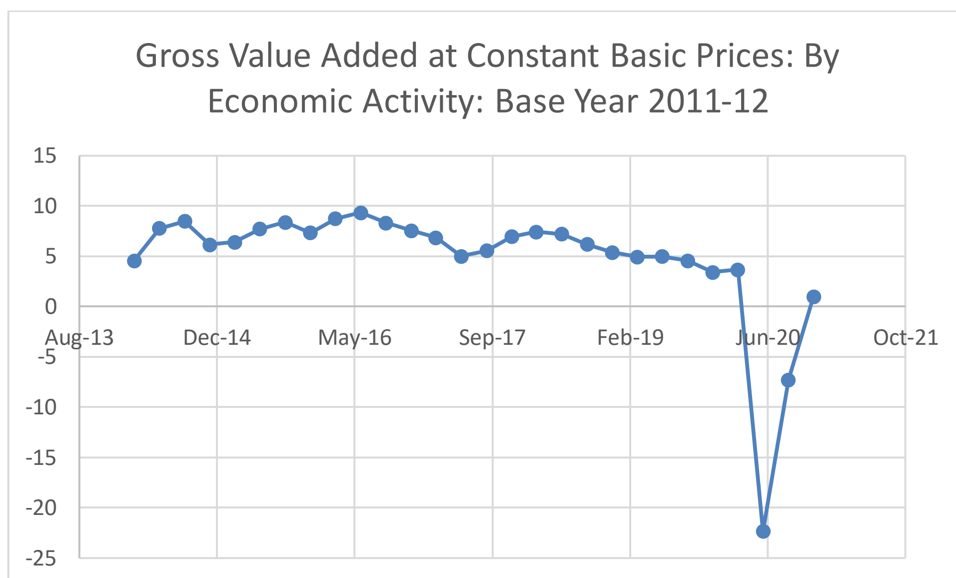


Exhibit 2: Gross Domestic Product at Constant Prices: By Expenditure/Demand: Base Year 2011-12

Quarter ended	Total	PFCE	GFCE	GCF Total	Exports of goods and services	Imports of goods and services	Discrepancies
Jun-14	8.02	7.25	2.35	8.44	13.11	0.89	
Sep-14	8.7	8.74	10.06	9.45	-2.87	-0.42	
Dec-14	5.92	2.13	28.96	5.42	3.5	7.61	
Mar-15	7.11	7.83	-7.2	7.49	-4.74	-4.18	
Jun-15	7.59	7.11	4.77	1.28	-6.43	-5.78	
Sep-15	8.03	7.1	9.01	2.41	-4.74	-3.63	
Dec-15	7.2	8.57	8.27	8.86	-8.87	-9.74	
Mar-16	9.09	8.8	7.79	6.39	-2.51	-4.16	136.82
Jun-16	8.68	6.96	2.43	8.6	3.55	0.41	111.96
Sep-16	9.67	9.6	2.34	3.06	2.46	-0.11	255.75
Dec-16	8.58	11.21	6.22	2.14	6.88	10.62	
Mar-17	6.29	4.93	15.84	1.25	7.03	6.98	139
Jun-17	6.11	8.6	21.53	6.05	3.95	21.73	59.07
Sep-17	5.32	4.85	7.34	9.55	4.65	10.57	2.99
Dec-17	6.67	4.16	10.43	11.57	4.51	14.09	144.52
Mar-18	8.93	7.49	8.7	15.92	5.1	23.57	85.13
Jun-18	7.56	6.75	6.18	10.92	9.53	5.04	-56.73
Sep-18	6.49	9.06	7.62	11.58	12.47	17.77	-53.38
Dec-18	6.33	7.93	3.11	11.77	15.68	11.97	
Mar-19	5.84	6.56	8.1	5.28	11.67	0.58	-48
Jun-19	5.39	7.55	1.77	9.82	2.96	9.37	-89.2

Sep-19	4.61	6.5	9.62	0.81	-1.28	-1.7	-42.1
Dec-19	3.28	6.42	8.87	-0.41	-5.39	-7.49	
Mar-20	3.01	1.98	12.14	-0.74	-8.77	-2.65	94.37
Jun-20	-24.38	-26.34	12.76	-46.85	-21.99	-41.1	706.7
Sep-20	-7.35	-11.31	-24	-7.84	-2.07	-18.15	104.54
Dec-20	0.41	-2.37	-1.13	2.14	-4.58	-4.55	
Cumulative	Apr-Dec	Apr-Dec	Apr-Dec	Apr-Dec	Apr-Dec	Apr-Dec	Apr-Sep
2016-17	8.97	9.31	3.55	4.56	4.27	3.54	190.86
2017-18	6.04	5.8	12.85	9.03	4.37	15.36	21.43
2018-19	6.79	7.91	5.75	11.43	12.59	11.49	-54.82
2019-20	4.42	6.81	6.67	3.36	-1.36	-0.17	-61.53
2020-21	-10.4	-13.08	-4.91	-18.19	-9.53	-21.81	174.29

Note: Data prior to June 2011 is spliced by CMIE by using old GDP series with base year 2004-05 and 1999-00.

Exhibit 3: Table Inflation trends in India (quarter wise)

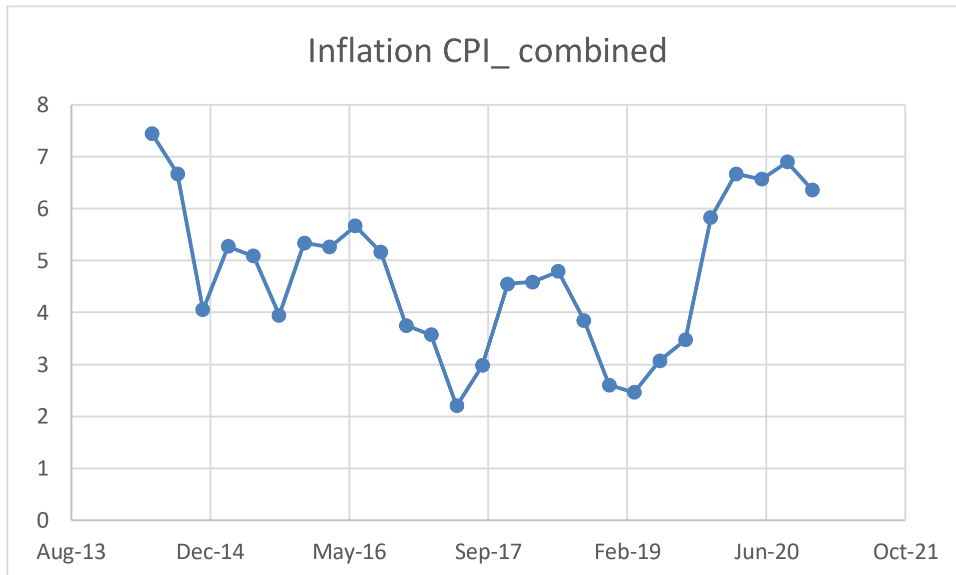


Exhibit 4 Balance of payment Indian in INR

Quarter ended	Current account Total	Current account Goods and services	Capital account	Financial accounts Total	Financial accounts Direct investments	Financial accounts Portfolio investments
Jun-16	-25,590.00	-5,41,180.00	10,650.00	2,320.00	2,59,630.00	1,40,700.00
Sep-16	-2,30,990.00	-6,23,930.00	-930	2,89,290.00	11,38,320.00	4,05,130.00
Dec-16	-5,36,970.00	-10,44,620.00	-1,280.00	4,93,720.00	6,56,300.00	-7,64,650.00
Mar-17	-1,71,150.00	-7,50,280.00	1,580.00	2,01,220.00	3,34,880.00	7,23,630.00
Jun-17	-9,64,660.00	-15,22,990.00	750	10,00,160.00	4,60,480.00	8,02,610.00
Sep-17	-4,46,440.00	-9,05,030.00	-2,010.00	4,76,460.00	7,97,910.00	1,32,810.00
Dec-17	-8,87,020.00	-15,08,820.00	2,160.00	8,44,700.00	2,79,840.00	3,44,450.00
Mar-18	-8,39,520.00	-13,80,750.00	-2,760.00	7,59,960.00	4,12,290.00	1,46,440.00
Jun-18	-10,57,214.20	-18,13,705.70	1,167.50	10,77,648.20	6,41,258.30	-5,45,652.90
Sep-18	-13,35,180.00	-20,89,220.00	-1,490.00	12,95,850.00	5,19,850.00	-1,13,500.00
Dec-18	-12,78,390.00	-19,89,420.00	-5,500.00	13,06,530.00	5,26,800.00	-1,52,120.00
Mar-19	-3,26,200.00	-9,78,430.00	-5,870.00	3,62,450.00	4,52,460.00	6,65,020.00
Jun-19	-10,41,565.90	-18,56,791.30	-57,190.20	10,73,380.50	9,73,130.20	3,36,792.10
Sep-19	-5,31,975.20	-13,17,663.50	-7,050.10	6,01,121.40	5,15,151.90	1,74,413.80
Dec-19	-1,85,521.40	-10,08,672.90	-10,676.70	1,53,118.60	6,93,978.40	5,57,651.20
Mar-20	42,300.20	-9,42,082.80	-1,401.50	-1,05,046.30	8,65,943.90	-9,94,910.20
Jun-20	14,59,398.90	7,38,787.80	-59,207.70	-13,68,825.70	-60,741.60	48,685.90
Sep-20	11,55,222.40	4,74,899.70	-6,491.90	-11,96,135.40	18,28,551.90	5,20,502.00
Cumulative	Apr-Sep	Apr-Sep	Apr-Sep	Apr-Sep	Apr-Sep	Apr-Sep
2016-17	-2,56,580.00	-11,65,110.00	9,720.00	2,91,610.00	13,97,950.00	5,45,830.00
2017-18	-14,11,100.00	-24,28,020.00	-1,260.00	14,76,620.00	12,58,390.00	9,35,420.00
2018-19	-23,92,394.20	-39,02,925.70	-322.5	23,73,498.20	11,61,108.30	-6,59,152.90
2019-20	-15,73,541.10	-31,74,454.80	-64,240.30	16,74,501.90	14,88,282.10	5,11,205.90
2020-21	26,14,621.30	12,13,687.50	-65,699.60	-25,64,961.10	17,67,810.30	5,69,187.90

Exhibit 5: CPI based Inflation: Composition

Quarter ended	General Index	Food and beverages	Pan, tobacco and intoxicants	Clothing & footwear	Housing	Fuel & light	Miscellaneous
Jun-15	5.09	5.44	9.53	6.12	4.59	5.77	3.75
Sep-15	3.95	3.34	9.49	5.88	4.62	5.52	3.29
Dec-15	5.34	5.91	9.39	5.7	4.97	5.35	3.75
Mar-16	5.26	5.79	8.69	5.6	5.28	4.45	4.11
Jun-16	5.67	6.99	7.68	5.31	5.39	2.96	4.02
Sep-16	5.16	5.95	6.83	5.21	5.3	2.77	4.23
Dec-16	3.75	2.75	6.57	5.06	5.06	3.16	4.74
Mar-17	3.57	2.1	6.31	4.54	4.96	4.24	4.88
Jun-17	2.2	-0.05	5.95	4.39	4.8	5.35	3.78
Sep-17	2.98	1.38	6.73	4.48	5.53	5.15	3.65
Dec-17	4.55	3.83	7.52	4.87	7.43	7.5	3.66
Mar-18	4.59	3.71	7.52	4.93	8.31	6.77	3.93
Jun-18	4.79	3.13	7.99	5.39	8.45	6.06	5.35
Sep-18	3.85	1.17	5.75	4.93	7.65	8.38	5.68
Dec-18	2.6	-1.16	5.97	3.46	5.95	6.73	6.42
Mar-19	2.46	-0.24	5.19	2.71	5.07	1.9	5.91
Jun-19	3.07	1.93	4.12	1.77	4.81	2.43	4.75
Sep-19	3.47	3.33	4.83	1.19	4.82	-1.4	4.63
Dec-19	5.83	9.26	3.52	1.48	4.46	-1.09	3.76
Mar-20	6.67	9.66	4.16	2.02	4.04	5.53	4.56
Jun-20	6.57	8.91	7.82	3.19	3.72	1.66	5.76
Sep-20	6.9	8.87	10.81	2.84	3.06	2.88	6.9
Dec-20	6.36	7.58	10.57	3.32	3.22	2.23	6.83

Exhibit 6:Export, Import growth rate in India Quarter wise

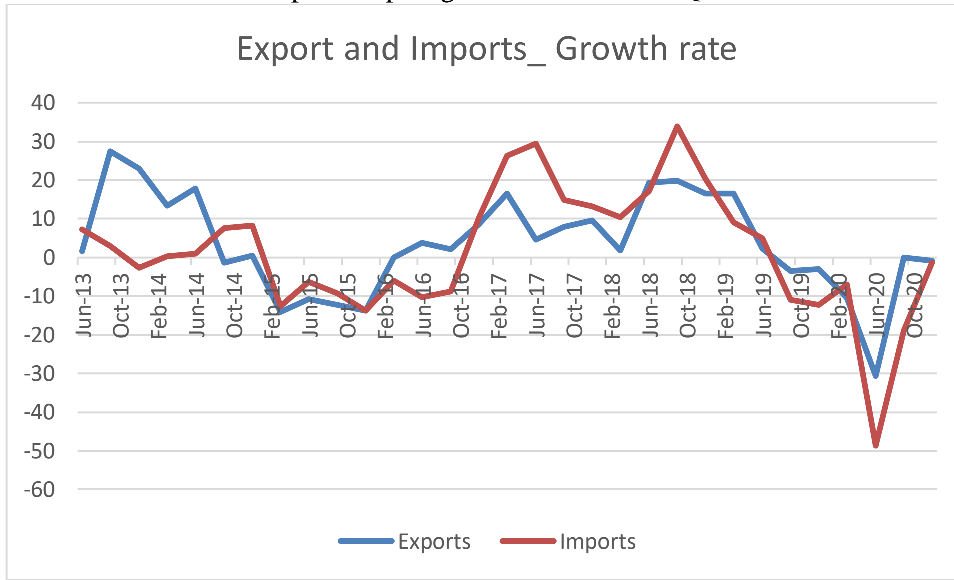
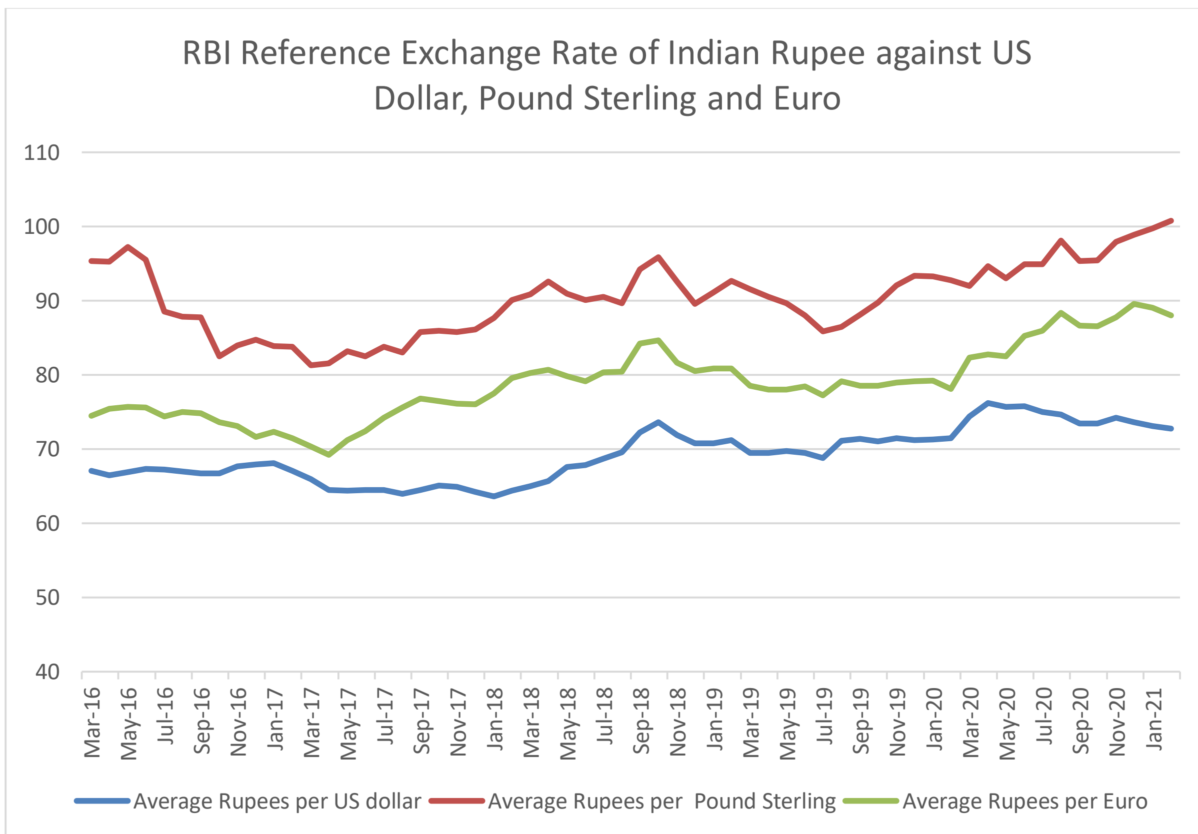


Exhibit 7: RBI Reference Exchange Rate of Indian Rupee against US Dollar, Pound Sterling and Euro



Research Office
Indian Institute of Management Kozhikode
IIMK Campus P. O.,
Kozhikode, Kerala, India,
PIN - 673 570
Phone: +91-495-2809238
Email: research@iimk.ac.in
Web: https://iimk.ac.in/faculty/publicationmenu.php