

The dollar drag

Effects of US monetary policy spill over into EMEs because of the overarching dominance of the dollar in the international monetary system

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The current global debate on monetary policy is centred on whether it should target financial stability in addition to the domestic business cycle. With relatively tight regulation of financial markets, where present concerns are more developmental than regulatory, the counterpart debate in EMEs centres on reconciling two widely held economic policy formulations, namely the Mundell-Fleming's Impossible Trinity and the Taylor Rule. The problem has become all the more compelling in a rapidly globalising world where large, volatile capital flows lead to misaligned and volatile exchange rates that threaten macroeconomic stability. The recent currency crisis which constrained Brazil, Turkey, Indonesia and India into tightening policy rates amidst collapsing growth, makes the case for reconciling the Impossible Trinity with the Taylor Rule of monetary policy all the more compelling.

Ceteris paribus, if a country runs a current account deficit (CAD), its currency should depreciate against those of its trading partners. There are, however, two major circumstances, one emanating from the current account (the 'Dutch disease syndrome'), and the other from the capital account ('southern cone syndrome') under which this reasoning does not hold. The latter is more germane here because large and volatile capital inflows into EMEs have become a far more frequent phenomenon as a result of loosening of financial regulation, innovation, globalisation and monetary policy spillovers. Cross-border flows of capital to EMEs have increased manifold since the 70s following the oil price hikes and export-led growth strategies adopted by several East Asian economies. The first manifestation of

this syndrome in developing economies was the wave of financial liberalisation which led to a debt-fuelled recycling of petrodollars by American banks in the 'southern cone' in Latin America.

While large capital inflows can sustain large CADs for some time, over the medium- to long-run, they tend to magnify external imbalances and lay the ground for external payments crises. There are also large capital flows into countries running account surpluses. Once the capital surge abates, and particularly in the event of a sudden stop, there is a likelihood of a sudden, rapid and accelerated correction in exchange rates, with the nominal exchange rate depreciating sharply, and the Real Effective Exchange Rate (REER) overshooting its neutral (long-term fundamental) rate. This can cause short-term macroeconomic instability, such as higher inflation, a loss in international confidence and credit downgrade that could compound the reversal in capital flows and even precipitate an external payments crisis.

What pushes capital into EMEs, and what triggers the sudden stops? While fundamentals and the prospects of higher returns are certainly contributory factors, it is now becoming increasingly clear that the major factor driving flows in and out of EMEs has little to do with the fundamentals of recipient countries but yields in the source countries—the US, in particular, which has the biggest and deepest financial market in the world. While the asymmetry in flows—particularly outflows—can to some extent be explained by differing fundamentals, the inflows and the outflows, seem to come in waves, across a wide swathe of countries.

Large global imbalances themselves should not result in destabilising flows. They are nothing new, and capital account flows have traditionally been simply the counterpart of current account balances. However, the cocktail of loosening of financial regulation, innovation, globalisation and the extant international monetary system have combined to open up a growing gap between gross capital flows and net flows that reflect current account balances. It is not entirely coincidental that the capital stop in the



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southern cone in the early-80s, in East Asia in the late-90s, and across a broad sweep of EMEs since May 2013, followed a tightening of monetary policy by the United States Federal Reserve. With the integration of financial markets and globalisation, the spillovers of US Fed monetary policies are only increasing because of the overarching dominance of the dollar in the international monetary system. Fed policies, therefore, hugely determine the direction and velocity of cross border capital flows. No other central bank comes even close to exercising this kind of influence, even within its own borders.

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As a result, US monetary policy has a determining influence on the direction and quantum of global capital flows. This, in effect, gives the issuer of the global reserve currency the flexibility to soak up capital when it needs it most, and to export it out when it suffers from excessive domestic liquidity. Through this mechanism, the US can fund literally unlimited amounts of external and internal deficits without being penalised by the markets as happens in the case of other countries. Open capital accounts, espoused by the IMF, only facilitates this funding and magnifies the 'exorbitant privilege' of the dollar.

It has long been argued, from the days of John Maynard Keynes, that the extant

international monetary system has a structural flaw in that it lacks a mechanism, market based or otherwise, to induce surplus countries to adjust. This can lead to the persistence of large external imbalances that are potentially destabilising. Recent history however indicates that this is not entirely correct, as there is also little pressure on countries with reserve currencies, and especially the global reserve currency, to adjust even when they run large CADs, on account of the large external demand for their currencies. The latter is also consistent with the Triffin Dilemma, by which the reserve currency issuer is expected to run larger and larger CADs to meet the growing needs of global liquidity. This is manifestly not true in the cases of currencies like the Japanese yen and the Swiss franc. Both countries have run current account surpluses over the last decade and a half. Similarly, even while its currency was becoming important in the composition of the global portfolio of reserve currencies, the euro was running a roughly balanced current account position with the rest of the world. This is because it is really the dollar that is accepted as the default global reserve currency by markets, even though the IMF may have classified other currencies also as reserves.

In effect, the US Federal Reserve acts as the global central bank. Policy easing by the US Federal Reserve, both prior to and following the global financial crisis, led to a surge in capital inflows into emerging markets, appreciating their currencies. There were intervening periods of sudden stops, as US monetary policy changed course, resulting in sharp currency depreciation, sudden stops and external payments crises. This happened in the 80s in Latin America, in the 90s in East Asia, and is now affecting EMEs globally. International financial markets in EMEs appear to respond more to US Fed actions than to domestic economic fundamentals.

According to Impossible Trinity, a country can have only two of the following three: Fixed exchange rate, monetary independence and free capital flows. A free monetary policy means that it is free to respond to the domestic business cycle. The Taylor Rule pre-

scribes a rule-bound—as opposed to discretionary—monetary policy by which the central bank adjusts its short-term policy rate based on a mathematical formula using differentials between a country's potential GDP and actual GDP, and inflation target and actual inflation. The Taylor Rule and its variants are now used by almost all advanced country central banks. The author of the rule, John B Taylor of Stanford University, is of the view that it is relevant for developing country central banks also. Many developing countries have indeed started using the Taylor Rule.

In advanced economies, the Taylor Rule responds to the domestic business cycle. Monetary policy in developing countries, on the other hand, is constrained to respond to the external financial cycle, which distorts the application of the Taylor Rule. Thus, if domestic growth concerns warrant low interest rates, a sudden stop in capital inflows may induce them to keep interest rates unduly high to attract foreign capital, thereby magnifying the downturn in the business cycle. In other words, they end up trying to negotiate the Impossible Trinity. Raising interest rates at such times rarely works because the stops are frequently not country-specific, and in any case, foreign investors are more concerned about capital losses than higher interest income.

Domestic debt in EMEs is backstopped by their central banks. External deficits denominated in international reserve currencies are not. The dependence on market support makes them susceptible to external payments crises in the event of market revolt if deficits are perceived to be excessive and unsustainable.

This threat of external payments crisis compels developing countries to frequently use monetary policy for managing external imbalances, in addition to managing the domestic business cycle. They need separate instruments, as part of a consistent policy framework, to target the external financial cycle so that their central banks to retain monetary independence.

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Easing up foreign investment

The new FPI Regulations ease up many processes for foreign investors. The challenge now is to offer greater clarity on the provisions

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In its bid to encourage and simplify foreign portfolio investments, the Securities and Exchange Board of India (Sebi) recently notified the Sebi (Foreign Portfolio Investors) Regulations, 2014 (FPI Regulations), which seek to repeal and replace the existing Sebi (Foreign Institutional Investor) Regulations, 1995 (FII Regulations), and the Qualified Foreign Investor (QFI) framework.

The FPI Regulations are a welcome move as this further simplifies portfolio investment in India. The Regulations merge all the existing Foreign Institutional Investors (FIIs), sub-accounts and the QFIs into a single class of investors known as Foreign Portfolio Investors (FPIs). While the eligibility criteria have been tightened, the process of applying for registration with Sebi has been done away with. FPI registration is now to be obtained from a Designated Depository Participant (DDP) who shall follow a risk-based model for completion of Know Your Client (KYC) requirements.

Depending on the risk-profile, the FPIs have further been divided into three categories, where Category-I includes government and government related foreign investors, Category-II includes appropriately regulated broad-based funds (BBF) and persons, university funds, pension funds and BBFs that are not appropriately regulated but whose investment managers are regulated and registered as an FPI, and Category-III is the residuary.

The investment avenues available under the FPI regime are mostly in line with the current FII and QFI regime. Total investment by each FPI or an investor group is restricted to 10% of the issued equity capital of the company. Furthermore, where two or more FPIs have the same common

beneficial owner (shareholding or voting rights or any other form of control in excess of 50% across the FPIs), the investment by all such FPIs will be clubbed together for the purpose of calculating the investment limit. Absence of clarity on the term 'control' is likely to create challenge for the DDPs. Nevertheless, the investment limit of 10% may certainly bring some cheer for a few investor groups like foreign corporate, foreign individuals and QFIs who were otherwise allowed to invest only up to 5% of

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the total issued capital of a company. The erstwhile prohibition on issue of Offshore Derivative Instruments (ODIs) by sub-accounts has been removed. Category-I and Category-II FPIs (except unregulated BBFs) are allowed to issue, subscribe or otherwise deal in ODIs directly or indirectly.

On the taxation front, FIIs were governed by a special tax regime which provides for special rates of taxes on income earned by FIIs. Post introduction of the FPI Regulations, there was a need to revamp the tax regime in line with the FPI framework. The Central Board of Direct Taxes has recently extended the benefits of section 115AD of the Income tax Act, 1961 to registered FPIs, something which was eagerly awaited.

While the FPI Regulations are a step in the right direction to boost investments in India, the new regime does throw up its share of interesting issues.

The FPI Regulations require the applicant to be a 'person resident outside India' under the income-tax law whereas the FII Regulations referred to exchange control regulations for determining whether the person is resident outside India. This could result in interesting situations. The relaxation in the FII Regulations with respect to requirement of 20 investors in the case one of the investors was an institutional investor does not feature in the FPI Regulations. Furthermore, underlying investors shall now be considered only in the case of entities which have been set up for the sole purpose of pooling funds and making investments. These changes may warrant the need to revisit several existing FII/sub-account structures.

On the registration front, each FPI is mandated to obtain a Permanent Account Number (PAN) from the tax department. This requirement seems onerous to the investment managers of unregulated BBF who would now have to obtain a PAN even though they do not intend to make investments in India. Further, in the case of multi-managed fund structures, the regulations are not clear on whether registration is to be sought at the scheme/manager level or at the fund level. Under the current FII Regulations, each of the scheme/manager of a multi-managed fund is registered with Sebi and income earned by all the managers is consolidated at the fund level at the time of filing annual tax return. Sebi is currently working with the custodians and it is expected that operational aspects of the FPI Regulations would be streamlined soon.

To conclude, the introduction of the FPI regime is a good move to increase and attract foreign investment in the country. However, speedy synchronisation with other laws and more clarity on the Regulations is imperative to make the foreign investors actually bite the bait.

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Withdrawal syndrome

RBI bets on pre-2005, high-value currency notes' withdrawal to combat counterfeiting and the black economy

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Days after RBI first announced that currency notes of 500 and 1,000 denominations issued prior to 2005 would be withdrawn by the end of this fiscal, it has emerged that the plan was in the works since May 2013 when the Finance Ministry wrote to the central bank asking it to withdraw "older series of banknotes in a time-bound manner"—this came after data revealed that as much as 70% of "discovered" counterfeit currency consists of higher denomination notes of 500 and 1,000.

The currency issued after 2005 is safe for the moment, but in the event of the enhanced security features also falling prey to counterfeiters, RBI and the government would step in once again. Officials involved in the process say "more action would be taken to phase out any note series based on reviews and data regarding counterfeiting".

The announcement was greeted with a bit of shock and some scepticism as to what it intended to achieve. After all, the central bank said that all banknotes issued prior to 2005 would be withdrawn from circulation after March 31 this year. From April 1 onwards, all banknotes would have to be taken to banks and exchanged for new notes issued after 2005. There was no data that was issued by RBI as to the total value of the banknotes that were to be impacted by the move. The announcement is reported to have led to a secondary market for discounted banknotes issued prior to 2005. Reports suggest people have started approaching jewellers and real estate brokers to exchange large sums of pre-2005 cash.

It was perhaps this nervousness that led RBI to clarify the matter two days later when it said that the rationale behind the move was to remove these banknotes from the market as they "have fewer security features compared to banknotes printed after 2005". The statement helpfully added that "the volume of the banknotes printed prior to 2005 today, still in circulation, is not significant enough to impact the general

public in a large way".

But given that the move had generated some adverse comment and disquiet in the political class, including the BJP, RBI diluted the measure to some extent by announcing that the process of exchanging notes at bank branches could be carried out "at convenience". It also said that the old series banknotes can be exchanged even after July 1, 2014 at the bank branches where people hold accounts. However, if a person seeks to exchange more than 10 pieces of 500-rupee and 1,000-rupee notes, at a branch where he or she does not have an account, providing proof of identity and residence would be manda-



tory. Regardless of all of this, RBI reiterated that the notes printed prior to 2005 will continue to be legal tender.

The timing of the move is interesting. It comes eight months after the Finance Ministry demand and just a couple of weeks after BJP leader Nitin Gadkari invited some journalists to a briefing by the Pune-based Artha Kranti organisation. Among some of their proposals is one to withdraw all high denomination currency. This is not to suggest any sort of link or similarity between RBI currency withdrawal and Artha Kranti's radical proposals, including demonetisation, but simply a pointer to the disquiet among all shades of political opinion over high denomination notes and their link with black money.

However, a return of the High Denomination Bank Notes (Demonetisation) Act, 1978—a law that phased out

notes of 1,000-, 5,000- and 10,000-rupee notes—is not under any consideration whatsoever. Higher denomination notes made a comeback in 1998, when the Finance Ministry argued that reintroducing 1,000-rupee notes was necessary to meet the demand of high-value transactions.

Over the last five years, the central bank, in consultation with the Finance Ministry, has phased out 100-, 500- and 1,000-rupee notes issued in two particular years—1996 and 2000. These banknotes are part of the "MG Series", whose security features had been successfully breached by counterfeiters and led to a rash of "nakli Gandhi" as the street tends to call fakes with a picture of the Father of the Nation.

The process for withdrawing 500-rupee notes from the MG Series was initiated in July 2008 and October 2009, while the withdrawal of 1,000-rupee notes happened in March 2011 and that of 100-rupee notes, in February 2012.

In July 2013, the Finance Ministry informed the Standing Committee of Parliament on Finance headed by BJP leader and former finance minister Yashwant Sinha that since 2006 the level of counterfeit currency in the banking system had been going up. For instance, an RBI inspection at the Domariaganj (Uttar Pradesh) branch of the State Bank of India detected 76,108 pieces of counterfeit notes valued at just over ₹4 crore. What was shocking though is that this translated into 16% of the total number of notes screened in the currency chest of this one branch under question. Such a high level of fakes set the alarm bells ringing across the establishment, especially as this was a case of "deliberate and large-scale replacement of currency held in a branch chest", and that too by the bank cashier.

Intelligence agencies have reported that fake Indian currency notes smuggled into India mostly originate from Pakistan, with the distribution network spread from Thailand in the east to the UAE in the west. Dubai, Dhaka, Kathmandu, Colombo and Bangkok are the principle transit hubs. Thailand has emerged as a safe haven for Pakistan based operatives and their associates in the fake currency racket.

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